Macro
China Economics

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China Inside Out

Selective easing

- **Cooling inflation allows Beijing to strike a balance between inflation and growth**
- **However, it is still too early for a policy U-turn ...**
- **... We expect selective easing of fiscal and monetary policy to support SMEs, public housing and ongoing projects**

The latest statements from the State Council and central bank indicate China will fine-tune its macro policy stance, moving away from tightening towards selective easing. Indeed, with inflation now on a slowing trend, Beijing can look at risks to both inflation and growth, although notions of a policy reversal seem premature in the near term given inflation is still above the official target of 4%. More importantly, the latest hard data shows that China's growth is still holding up at 8.5-9%, so there is little need for a cross border easing in the form of rate or reserve ratio cuts.

That said, Beijing would still want to minimize the risk of a sharp slowdown by easing its policy stance selectively in the coming months. The last 12 months of intensive quantitative tightening have had a disproportionally heavy impact on small- and medium-sized enterprises (SMEs) – China's key employment growth driver. We expect selective easing to come mainly in the form of credit support to SMEs, public housing and key ongoing infrastructure projects.

We expect fiscal policy to play a role as important, if not more important, as credit policy. As we argued earlier (see *CIO: Slower, smaller and just enough*, 28 September), there is no need for a replay of 2008-09's massive stimulus package. But the government's fiscal revenue has been growing at a much faster-than-expected pace of nearly 30% so far this year, and the central government's accumulative cash deposits have reached over RMB3.8trn. We think this places Beijing in a strong position to mitigate downside risks to growth through fiscal measures. We expect Beijing to reduce tax for SMEs and companies in services and exporting sectors. Beijing can and will also increase its spending on public housing. Also, jumping start a pilot programme for municipal bond issuance should enable local governments to raise funds for any needed infrastructure projects.

1 November 2011

Qu Hongbin
Chief Economist, Greater China
The Hongkong and Shanghai Banking Corporation Limited
+852 2822 2025 hongbinqu@hsbc.com.hk

Sun Junwei
Economist

Contents

Selective easing

- Cooling inflation means Beijing can now try to strike a balance between inflation and growth
- However, an outright reversal in monetary policy seems unlikely
- We expect the authorities to start easing both fiscal and monetary policy selectively to support SMEs, public housing and ongoing infrastructure projects

Green light for selective easing

Messages from the top

China's top policy makers have started talking more about stabilising exports and shoring up economic growth. The policy shift started recently with a series of on-the-ground health checks on provincial economies. In Zhejiang Province, for instance, Premier Wen Jiabao and key ministers responsible for economic policy inspected Wenzhou, a private sector business hub that has seen a rash of defaults, during the National Day holiday. Premier Wen also visited Guangdong Province in mid-October, paying special interest to export-oriented companies. And in his visit to Tianjin last week, the premier spoke for the first time of a "timely and appropriate fine-tuning" and "pre-emptive adjustments" – signalling strongly to the markets that there may be some selective policy easing ahead.

While talk from the top about economic policy has been subtly shifting away from a single-minded fight against inflation towards supporting growth, officials have also indicated that they expect inflation to ease. Recently, an official from the National Development and Reform Commission (NDRC) officially announced for the first time that inflation had peaked and headline CPI should moderate to below 5% in the last two months of this year (from 6.1% y-o-y in September).

We expect this easing of inflation pressures, against the backdrop of slowing external demand, will provide Beijing with the room it needs to strike a better balance between inflation and growth priorities. This would signal an end to the intensive quantitative tightening that the government has carried out to cool down credit growth and contain inflation risk.

State Council has made it official

Launching VAT trial reform

Almost immediately after Premier Wen's remarks about fine-tuning economic policy in Tianjin, China's cabinet, the State Council, gave the green light for selective policy easing (see *China: Official green-light for selective easing: State Council kicks off VAT reform*, 27 October). It announced the launch of a trial value-added tax (VAT) reform programme starting 1 January 2012, following its weekly meeting on 26 October. The programme is intended to replace the current business tax system with a VAT system for a selection of industries and regions on a trial basis, affectively addressing the current problem of duplicated taxation within the country. By improving the tax system, it aims to support the development of modern services industries.

More specifically:

- The trial programme will kick off with Shanghai's transportation and modern service sectors, after which a nationwide roll-out is planned once conditions are right.
- Two new lower VAT categories of 11% and 6% will be added to the exiting 17% standard VAT rate and 13% lower VAT rate.
- During the trial period, income from the new VAT system (formerly the business tax income) will go to the authorities of the trial regions. Industries participating in the trial programme can still enjoy preferable business tax policies, which may be adjusted according to features within the proposed VAT framework.

The trial VAT reform programme should lower the tax burden for the services sectors, which currently pay their taxes under a business tax framework (3% for transportation sector and 5% for most services sectors). This transition from a business tax to a VAT tax system should help eligible businesses to lower their input costs and give services sectors (which support 55% of nonfarm employment and accounts for 43% of GDP) a much needed fiscal boost.

Prioritise policies

Just three days later, the State Council met again on 29 October to assess China's macro condition and prioritise economic tasks for the coming months. These include the following:

- Appropriately fine-tuning economic policy in a pre-emptive manner – i.e. maintaining reasonable credit and money supply growth, optimising financing structure, improving fiscal policy, pushing forward structural tax reduction, credit policy aligned with industrial policy.
- Continuingly stabilising prices
- Securing autumn harvest and winter agriculture production
- Implementing firm property market macro-control
- Proactively supporting the development of small and micro-sized companies
- Promoting stable development of foreign trade
- Making continuous efforts in energy conservation and pollution reduction

Selective, pre-emptive easing

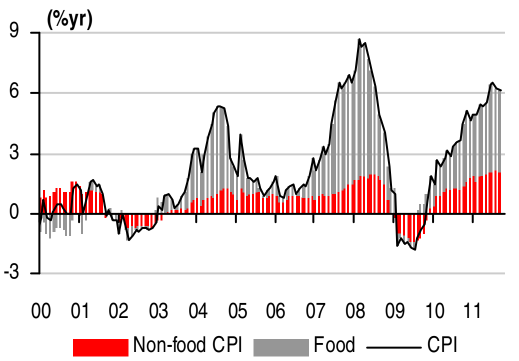
The selective easing in China comes at a time when inflation has started to slow and growth is likely to moderate, with risks tilted to the downside given the downbeat outlook for developed markets and the lagged impact of the earlier quantitative tightening measures. In addition, we believe Beijing has learned a lesson from the economic downswing of 2008, which was partly due to external shocks and partly self-inflicted through aggressive tightening measures (reserve requirement rate was raised five times in 2008 to the pre-crisis high and interest rate spiked to a decade high for three quarters).

The current mix of easing inflation and moderating growth would allow Beijing to make tweaks in a pre-emptive way to support growth and secure jobs.

Easing inflation

After peaking out at 6.5% y-o-y in July, headline CPI has been moderating in the months of August and September. On top of normalising credit growth, which has removed the monetary conditions for inflation, slowing domestic and global economic growth is also helpful to further easing of inflation pressures. Meanwhile production-side policy measures have started to filter through. The price of pork, for instance, which was the single largest driver of CPI over the recent months, has begun to fall. Higher frequency data suggests food prices are likely to see a sequential decline in October, likely bringing headline inflation reading below 6% in October before moderating further towards to around 4% at year-end.

Chart1. Headline CPI has peaked and will trend down



Source: CEIC, HSBC

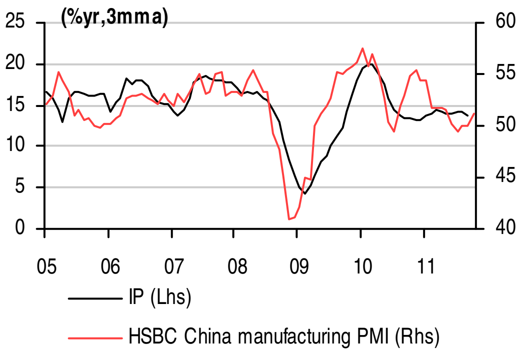
Growth to moderate, no melt-down

Quantitative tightening cooled economic growth to 9.1% y-o-y in 3Q from 9.5% in 2Q and 9.7% in 1Q (see *China: Steady steps: 3Q GDP slows but September data strong*, 18 October). This is a desired result and was essential to containing inflationary pressures.

That said, the pace of the slowdown is still modest and concerns about a hard landing in the near term have been over-played, in our view. This is evidenced by the upside surprise in the latest HSBC China flash manufacturing PMI reading – which jumped to a five-month high at 51.1 in October thanks to gains in new business from both domestic and external markets (see *HSBC China Flash Manufacturing PMI (Oct): What hard landing?*, 24 October). The PMI has now shown sequential improvement for the past three months.

If history serves a guide, this points to better sequential growth in industrial production, with around 13% y-o-y growth in the coming months.

Chart2. PMI and IP



Note this includes the HSBC Flash PMI reading for October
Source: CEIC, Markit, HSBC

Exports to feel the pinch

We expect exports growth to slow further. Exports growth hit a seven-month low in September at 17.1% y-o-y versus 24.5% y-o-y in August, thanks to faster deceleration in growth of exports to developed markets. (See *China Exports (Sep): Feeling the chill from West, but still steady*, published 10 October 2011).

Will China's exports soon see a total collapse like three year ago? Not likely. The jump in October's export orders sub-index within the HSBC flash manufacturing PMI should help reduce fears of a near-term collapse in exports growth (which is not our base-case assumption) dragging China into a new recession. The upbeat flash manufacturing PMI number is likely to have been driven by slight positive surprises in recent US data points and still-resilient emerging market demand.

That said, the ongoing downturn in the global trade cycle and uncertainties lingering over the Eurozone debt crisis (the "grand plan" agreed in the October EU summit is still lacking details) will likely continue to weigh on China's exports for a while longer, as suggested by the continued slowdown in Taiwan's September exports orders.

It's not a rerun of 2008

That said, it is not necessary to engineer an outright easing or a repeat of stimulus on the scale seen in the last battle against recession. Current economic conditions are different from those seen just prior to the launch of the RMB4trn stimulus package three years ago (see Table 1): inflation remains at an elevated level – well above the official 4% annual target and growth; above 13% y-o-y industrial production growth is still consistent with above 9% GDP growth; exports growth has slowed but is still steady considering the weak global recovery; PMI has shown a noticeable rebound; interest rates are almost 1ppt below the previous high.

Table1.Comparison of key economic indicators

	Sep-11	Oct-08
CPI (y-o-y)	6.1	4
IP (y-o-y)	13.8	8.2
Exports (y-o-y)	17.1	19
HSBC Manufacturing PMI (Flash)	51.1	45.2
1 year lending rate (%)	6.56	7.47
RRR(%)	21	16.75

Source: CEIC, HSBC

What's next?

Reversal in monetary policy not likely

Monetary policy is shifting from a strong tightening bias over the past 12 months (via nine consecutive reserve ratio hikes and five consecutive rate hikes) to a neutral stance for the coming months, as we expected. Since the credit growth has normalised to around 15-16% y-o-y, in line with the historical average, the central bank is likely to keep growth ticking at the current rate to strike a balance between inflation and growth. In fact, both September M1 and M2 growth saw a notable deceleration, hitting their lowest levels in almost three years. This invited some worries about over-tightening. While we believe the sequential growth of M2 is still steady and a swing in a single month doesn't warrant tightening, the central bank doesn't want to see a further sharp slowdown either.

That said, we don't expect a reversal in monetary policy either. Cuts in the reserve ratio or rates are unlikely in the near term, in our view. This is because:

- Inflation is still at a high level, as headline CPI slows gradually. At the current juncture, loosening monetary policy will lead to a rebound in inflation, which is the last thing Beijing wants to see after painful tightening.
- The still robust growth, evidenced by the pick-up in PMI readings, should reduce near-term concerns of a sharp slowdown. We believe the strength in domestic demand can still support around 8.5-9% GDP growth in the coming quarters.
- Selective credit easing is already in progress. We expect the targeted credit easing to mainly focus on supporting small enterprises and export-oriented companies, public housing and ongoing infrastructure projects.
  - First, the State Council already introduced policies of extending credit and financial support to small companies (see *China: State Council extends support for small companies*, 10 October). More concrete measures have been finalised by the China Banking Regulatory Committee (CBRC).
  - Increasing credit support to public housing projects. According to the PBoC, banks loans to public housing reached RMB115bn in the first three quarters, accounting for 52% of total new loans for property developers during the same period (compared with 43% in 1H). In addition, special bonds designated for funding public housing projects have been issued since June.

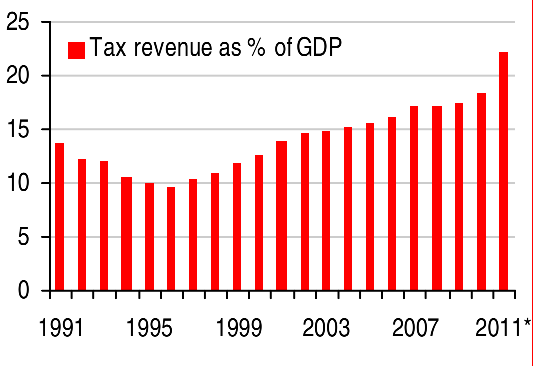
- Massive ongoing infrastructure projects have received additional credit support, such as the new issuance of Ministry of Railway bonds, with full state backing, and the trial municipal bonds for four cities/provinces. These should ease near-term funding constraints.

Plenty of fiscal muscle

We believe fiscal policy can and should play a larger role in selective easing, given Beijing's deep pockets:

- China's total fiscal revenue surged 29.4% y-o-y for the first three quarters this year. China's tax revenue, representing nearly 90% of total fiscal revenue, expanded by 27.4% for the first three quarters this year (representing 22% of GDP for the same period), well above the initial 8% annual tax revenue growth target set for the full year.

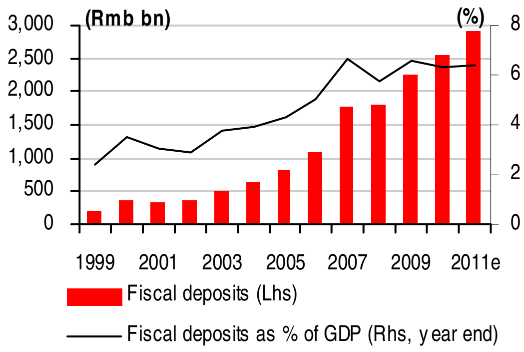
Chart3. Beijing's deep pocket



*The first three quarters of 2011
Source: CEIC, HSBC

- Fiscal deposits have been on the rise, reaching a high level of RMB3.8trn at end-September, or likely representing 6.4% of 2011e GDP even considering additional fiscal spending by year-end.

Chart4. Fiscal deposits stood at RMB3.8trn



Source: CEIC, HSBC estimates

All these suggest that the central government has deep enough pockets to allow it to launch a series tax reduction and targeted subsidies to support small- and medium-sized enterprises, companies in export-oriented sectors and services sectors – all important drivers for employment growth. Likely measures may include favourable tax policies that allow faster appreciation and more investment deduction, general and targeted fiscal subsidies, a higher share for SMEs in the annual government public procurement, and easier market access and simplified approval process.

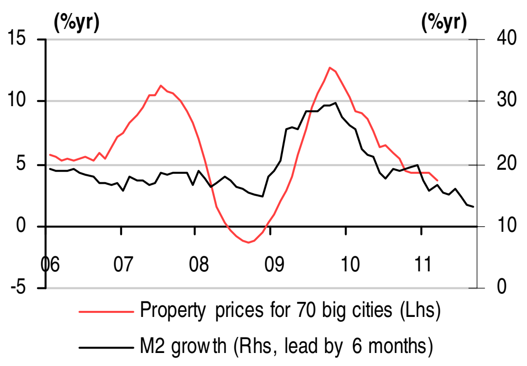
We believe Beijing also can and will increase its spending on public housing construction. As we argued in the September issue of China Inside Out, China can and should front-load the rest of its 25 million units of public housing construction planned for the rest of the 12th Five-Year Plan (2011-15), if there is a need. Jump-starting a pilot programme for municipal bond issuance should also enable local governments to raise funds for their needed infrastructure projects.

Apart from the credit support for SMEs and public housing, we believe targeted fiscal adjustment will not only provide short-term relief for relevant sectors, but also pave the way for long-term structural improvement.

No reversal of property tightening

Property market has felt the chill, as well. But we don't expect the government to reverse property tightening policy. There are increasing reports of sluggish property sales and falling property prices. Property developers will have been disappointed by the so-called "Golden September and Silver October", traditionally the peak sales seasons, and many developers have tried to stimulate sales by slashing prices in promotional activity. In some cases, prices have been cut by 20-30%, which has led to complaints and protests by recent homebuyers.

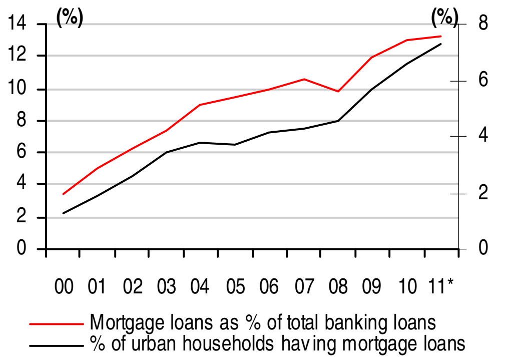
Chart 5: Property prices to slow further



Source: CEIC, HSBC

Historical correlation between property prices and M2 growth suggests a further slowdown in property prices seems inevitable. Will this ongoing correction in the property market have a big impact on growth? Simply put, no. Given the still low leverage of the Chinese property market (mortgage loans are less than 15% of total loans, and less than 10% of urban households have mortgage loans), the mild correction should not have any material impact on households' balance sheets (see *China Inside Out: Three big myths on credit*, 31 May). And the accelerated public housing construction should offset the slowdown of private property investment.

Chart 6: Property market is still under leveraged



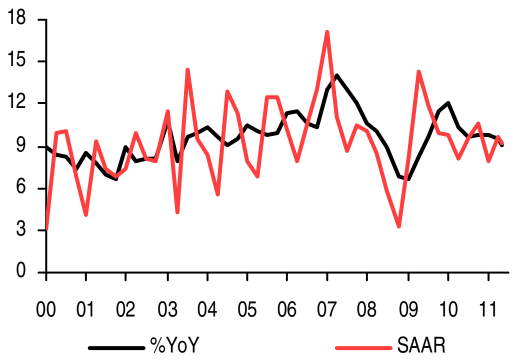
*As of end-September 2011
Source: CEIC, HSBC

Charts

GDP

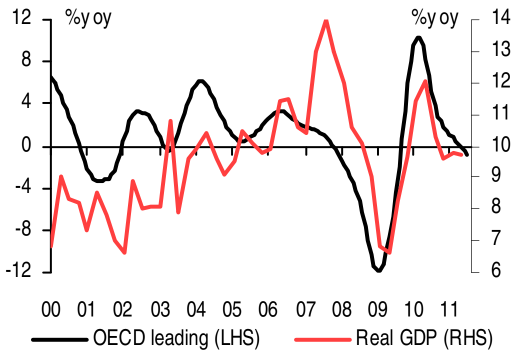
- Chinese economy growth slowed to 9.1% y-o-y in 3Q from 9.5% y-o-y in 2Q and 9.7% y-o-y in 1Q. Seasonally adjusted q-o-q growth eased to 2.3% in 3Q from 2.4% in 2Q
- China's GDP growth is likely to slow to 8.5-9% in the coming quarter thanks to the lagged impact of credit tightening and slowing external demand
- But concerns about a hard-landing are over-played given the strength of domestic demand, which is likely to be consolidated by the fiscal tweaks and targeted support for SMEs

1. Long-term real GDP trend



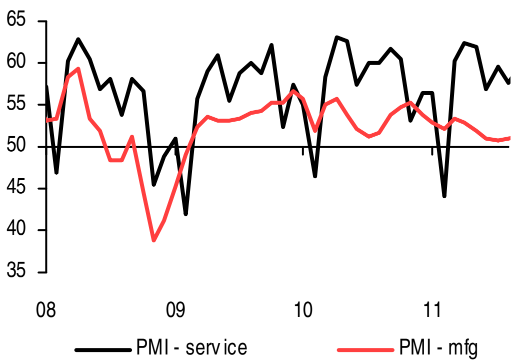
Source: CEIC, HSBC

2. OECD leading index versus China real GDP



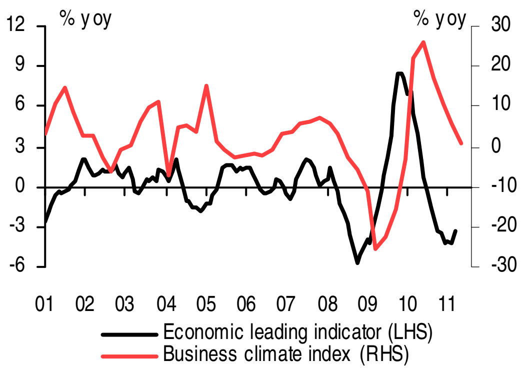
Source: CEIC, HSBC

3. Service and manufacturing PMI



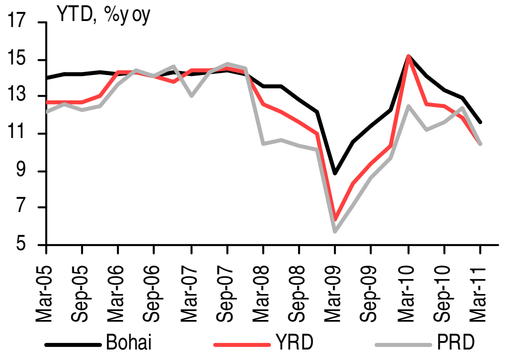
Source: CEIC, HSBC

4. Economic leading indicator versus business climate change



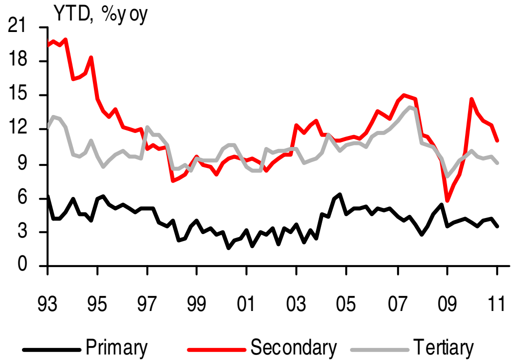
Source: CEIC, HSBC

5. GDP, by region (nominal GDP, weighted)



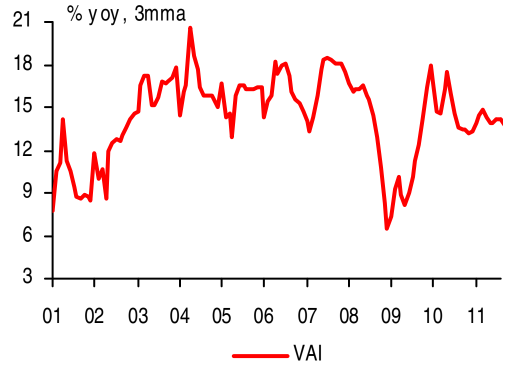
Source: CEIC, HSBC

6. GDP, by industry



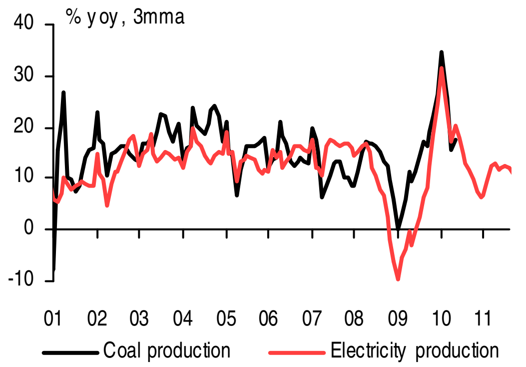
Source: CEIC, HSBC

7. Industrial production



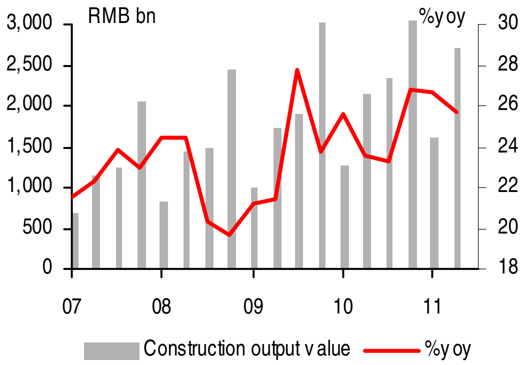
Source: CEIC, HSBC

8. Commodity production



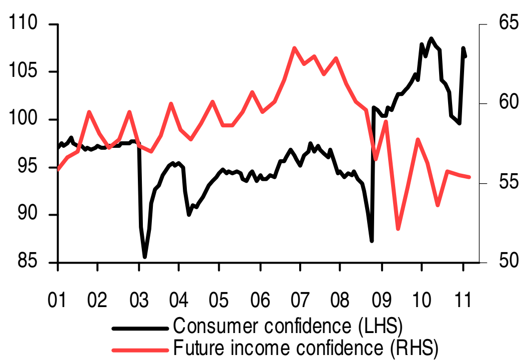
Source: CEIC, HSBC

9. Construction sector



Source: CEIC, HSBC

10. Confidence indices

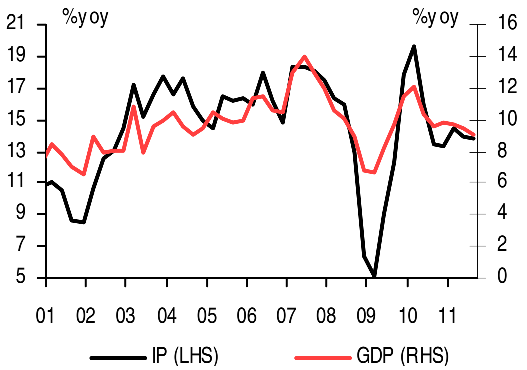


Source: CEIC, HSBC

Industrial production

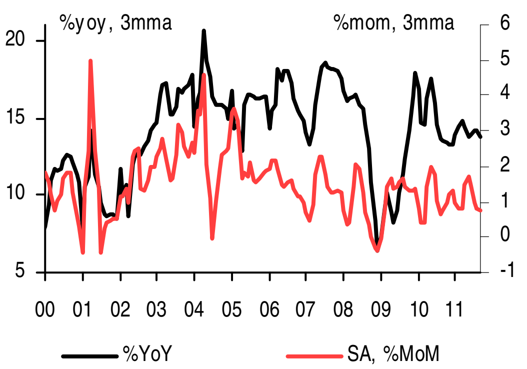
- IP growth picked up to 13.8% y-o-y in September from 13.5% y-o-y in August; seasonally adjusted, IP growth quickened to 1.2% m-o-m from 1.02% in August
- Growth of heavy industries accelerated to 14.3% y-o-y in September from 13.5% in August, contributing to 0.6ppt to IP growth; growth of light industries dipped to 12.8% y-o-y in September from 13.4% in August
- The notable rebound in HSBC flash manufacturing PMI heralds a sequential improvement in IP growth in the months ahead

1. Industrial production vs GDP



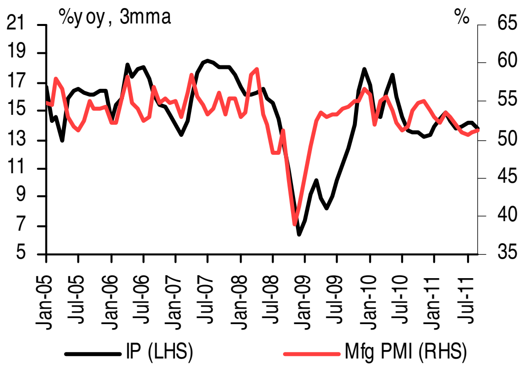
Source: CEIC, HSBC

2. Industrial production growth trend



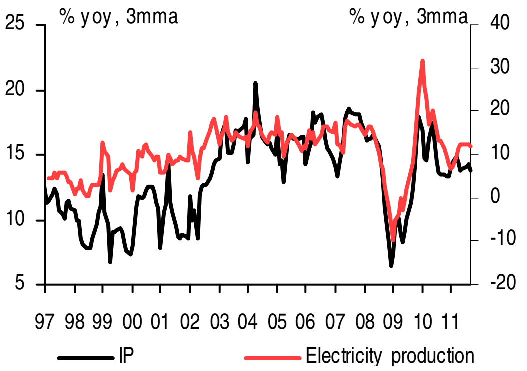
Source: CEIC, HSBC

3. Industrial production vs manufacturing PMI



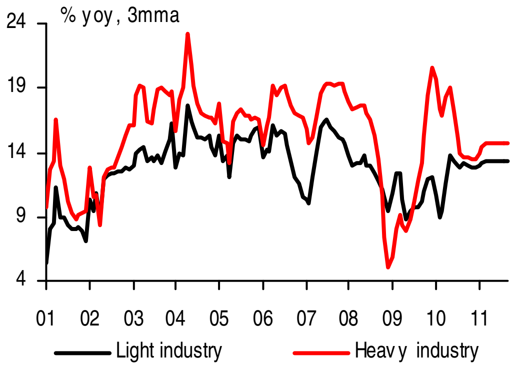
Source: CEIC, HSBC

4. Electricity production changes together with IP



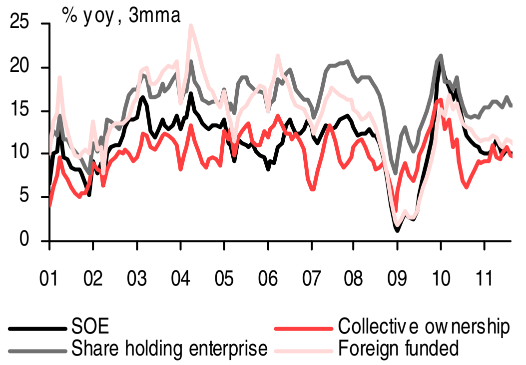
Source: CEIC, HSBC

5. GDP, by region (nominal GDP, weighted)



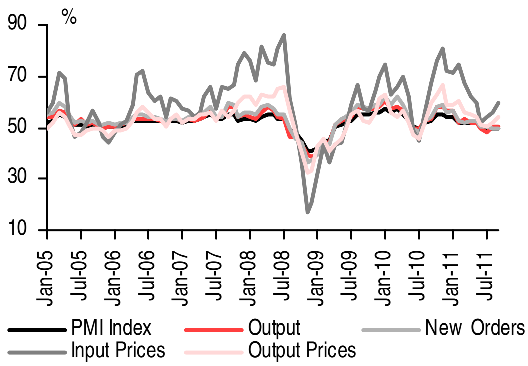
Source: CEIC, HSBC

6. GDP, by industry



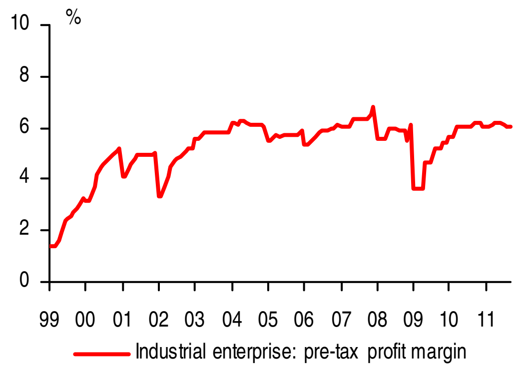
Source: CEIC, HSBC

7. Manufacturing PMI breakdown



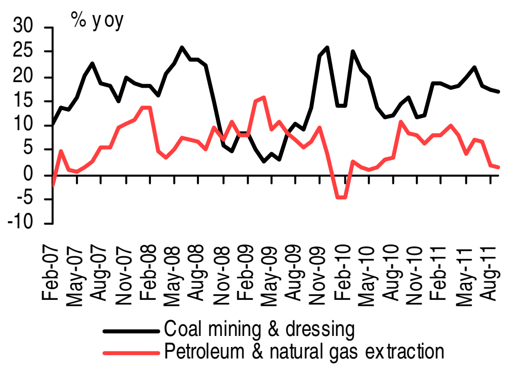
Source: CEIC, HSBC

8. Industrial profit margin



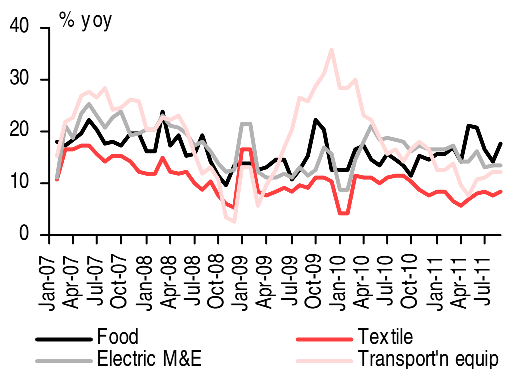
Source: CEIC, HSBC

9. Mining, petroleum and natural gas extraction



Source: CEIC, HSBC

10. Manufacturing production

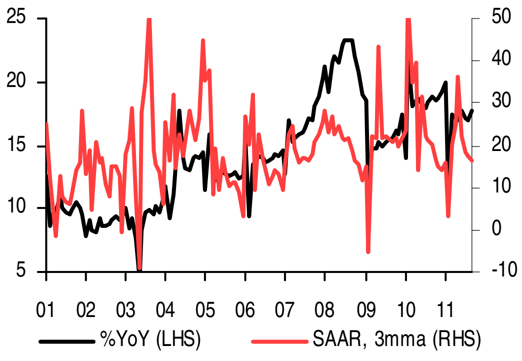


Source: CEIC, HSBC

Private consumption

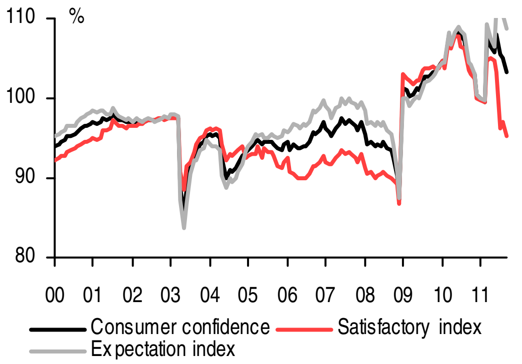
- Retail sales growth expanded by 17.7% y-o-y in September, beating the 17% for August; seasonally adjusted m-o-m growth rate picked up to 1.35% in September from 1.30% in August.
- In real terms, retail sales growth remained steady at 11.8% y-o-y; notably, car sales expanded by 18.7% in September compared with 12.4% y-o-y in August
- Consumer consumption is likely to remain resilient, thanks to rapid income growth and the anticipated petering-out of inflation to boost consumer confidence

1. Retail sales trend



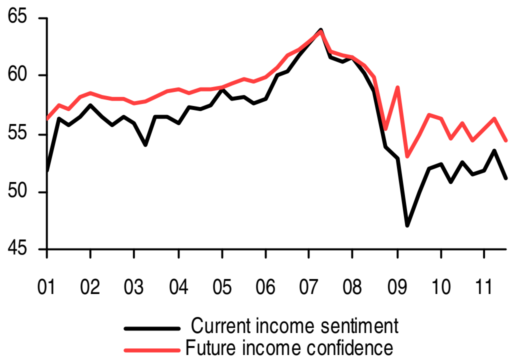
Source: CEIC, HSBC

2. Consumer confidence



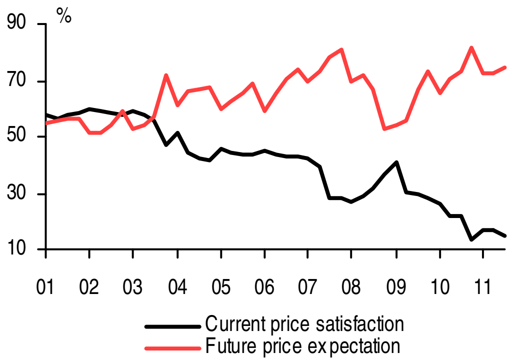
Source: CEIC, HSBC

3. Confidence in income



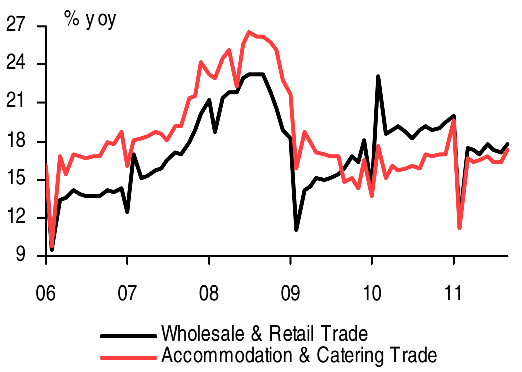
Source: CEIC, HSBC

4. Confidence in prices



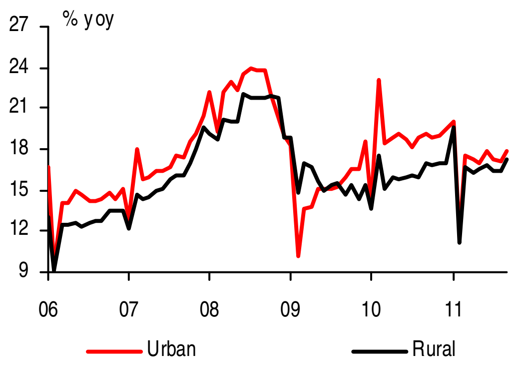
Source: CEIC, HSBC

5. Retail sales, by sector



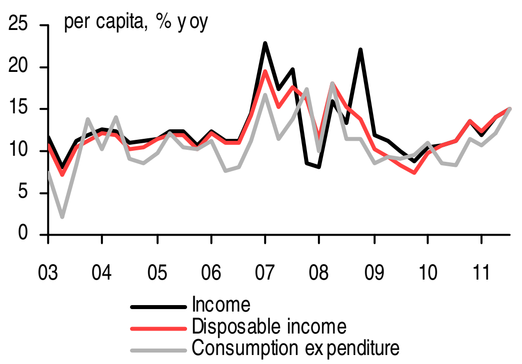
Source: CEIC, HSBC

6. Retail sales in urban vs rural areas



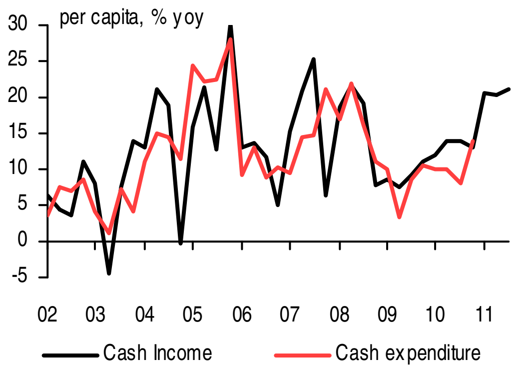
Source: CEIC, HSBC

7. Per-capita income vs expenditure – Urban households



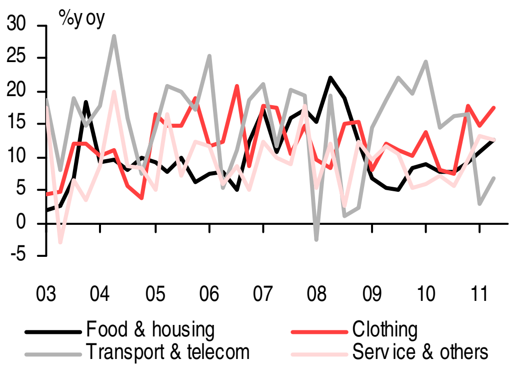
Source: CEIC, HSBC

8. Per-capita income vs expenditure – Rural households



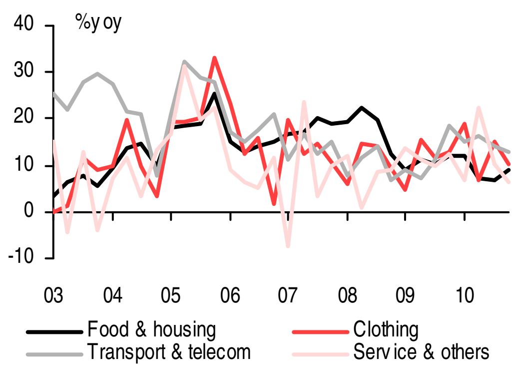
Source: CEIC, HSBC

9. Expenditure, by product – Urban households



Source: CEIC, HSBC

10. Expenditure, by product – Rural households

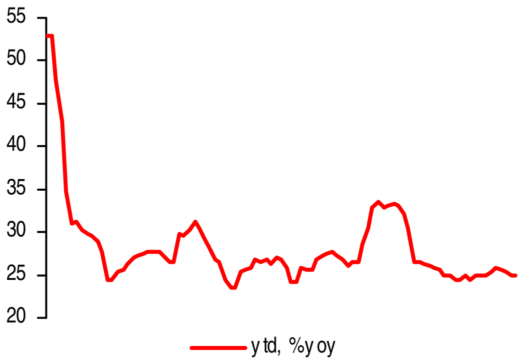


Source: CEIC, HSBC

Fixed investment

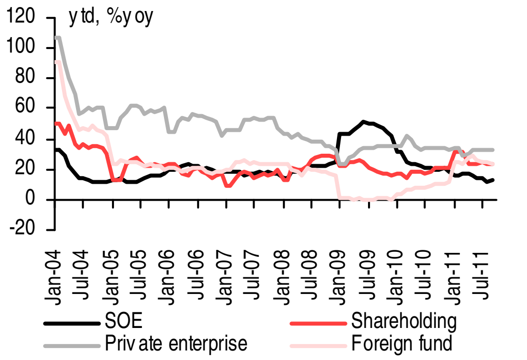
- FAI growth slowed marginally to 24.9% y-o-y Jan-Sept from 25.0% in Jan-Aug. The real growth rate for fixed investment held steady at 16.9% y-o-y for the first three quarters.
- The implied single month growth rate accelerated 24.3% y-o-y in September from 22.7% in August; this translated into a marginal m-o-m decline of 0.16% in September from 1.45% in August.
- We expect the lagged impact of credit tightening to cool down investment growth further but it will be just moderation not meltdown

1. FAI growth



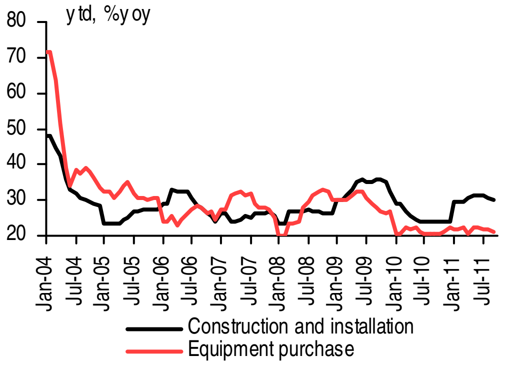
Source: CEIC, HSBC

2. FAI, by enterprise ownership



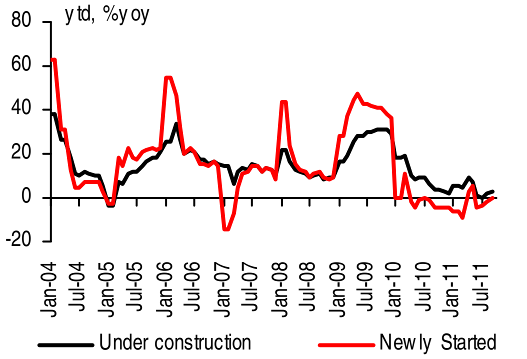
Source: CEIC, HSBC

3. Construction vs equipment purchase



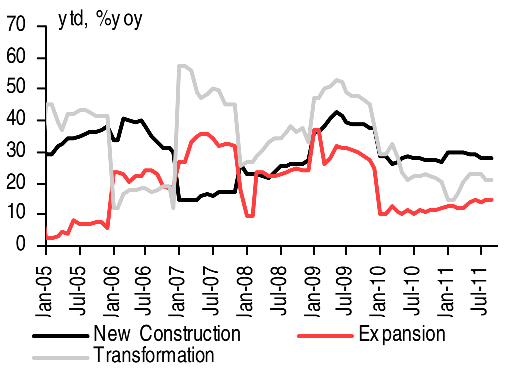
Source: CEIC, HSBC

4. Number of projects started and under construction



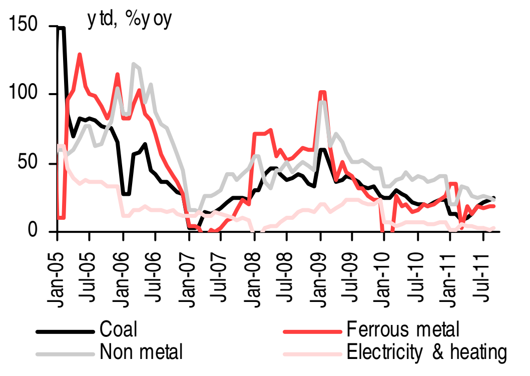
Source: CEIC, HSBC

5. FAI, by work type



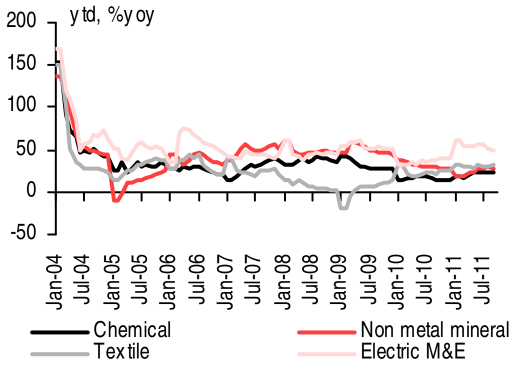
Source: CEIC, HSBC

6. FAI in mining sector



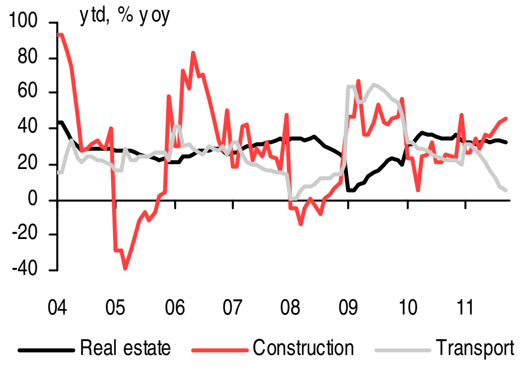
Source: CEIC, HSBC

7. FAI in manufacturing sectors



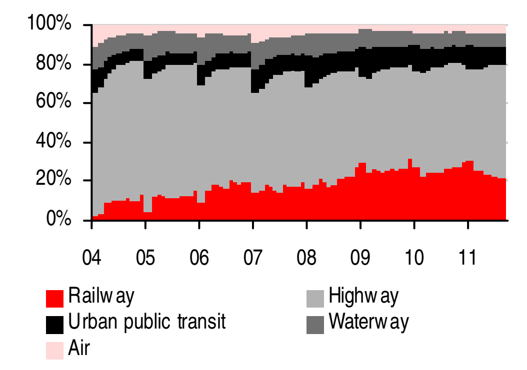
Source: CEIC, HSBC

8. FAI in construction, real estate and transport



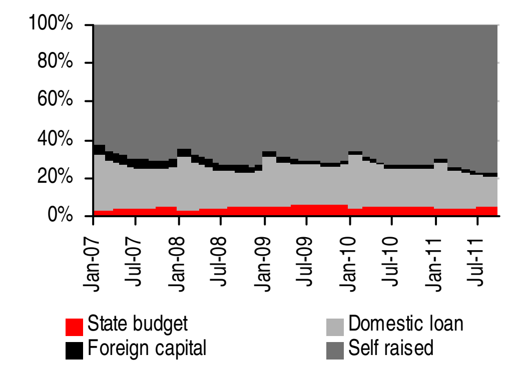
Source: CEIC, HSBC

9. FAI, by infrastructure project



Source: CEIC, HSBC

10. FAI, by source of financing

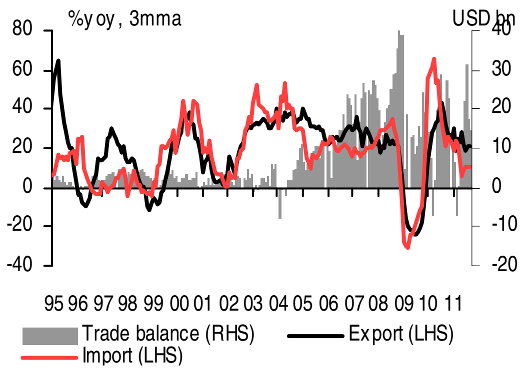


Source: CEIC, HSBC

Trade

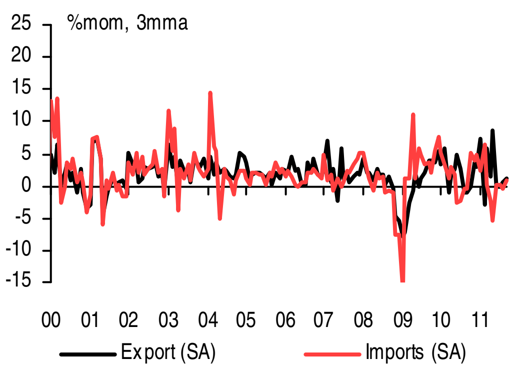
- Exports growth recorded a seven-month low at 17.1%y-o-y in September (vs. 24.5% in August); yet, seasonally adjusted m-o-m growth rose 1.6%, reversing the 3.3% contraction in August
- Import growth slowed to a three-month low at 20.9% y-o-y in September, down from the robust 30.4% y-o-y in August; seasonally adjusted m-o-m growth jumped to 8% in Sep
- Trade surplus fell to USD14.5bn in Sep from USD17.7bn in August; for the first three quarters, the trade surplus was USD109.1bn, or 9.6% less than the same period last year

1. Overall external trade trend



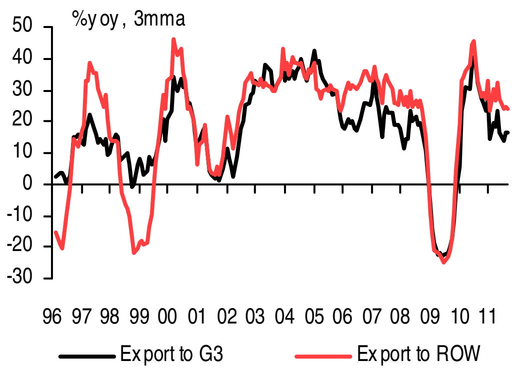
Source: CEIC, HSBC

2. Sequential growth in exports and imports



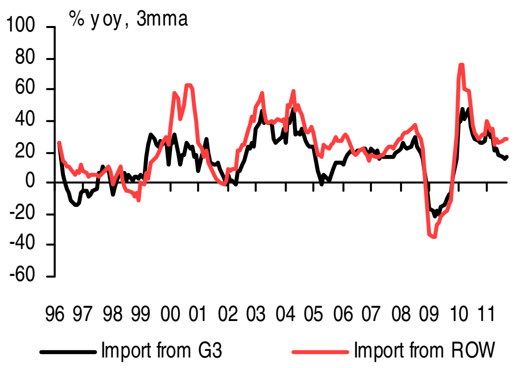
Source: CEIC, HSBC

3. Exports to G3 and ROW



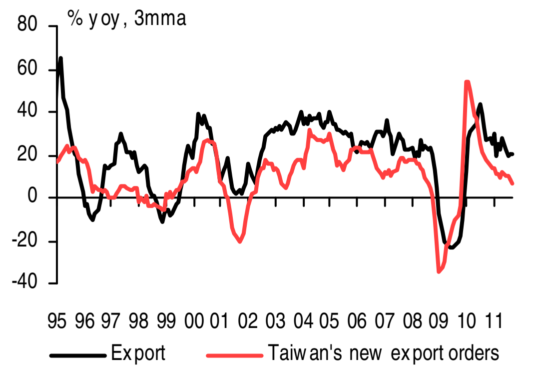
Source: CEIC, HSBC

4. Imports from G3 and ROW



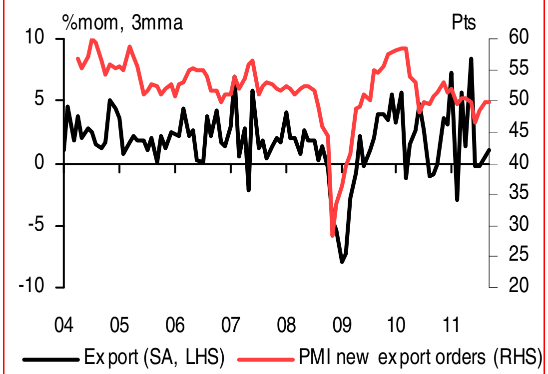
Source: CEIC, HSBC

5. Taiwan's new export orders as a leading indicator



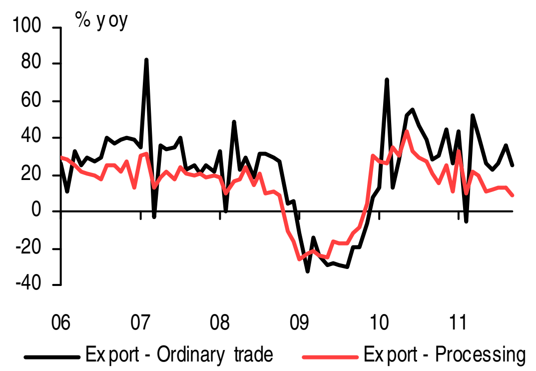
Source: CEIC, HSBC

6. PMI new export orders vs exports



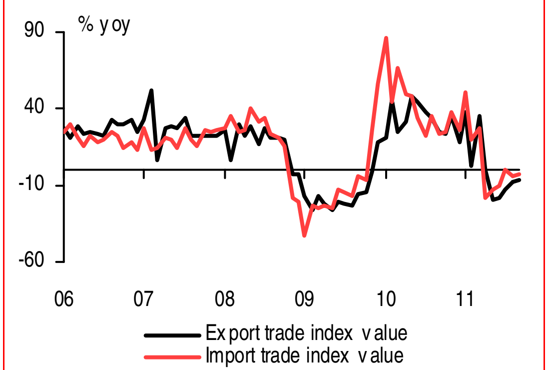
Source: CEIC, HSBC

7. Exports – ordinary vs processing trade



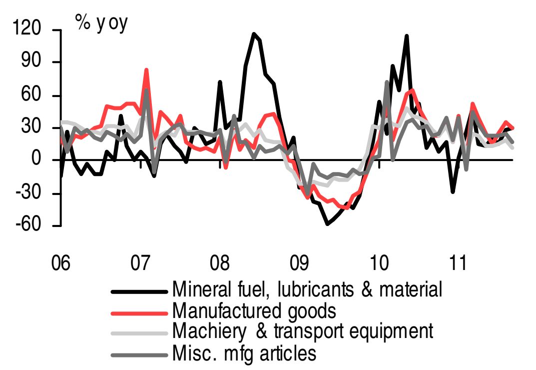
Source: CEIC, HSBC

8. Trade price index



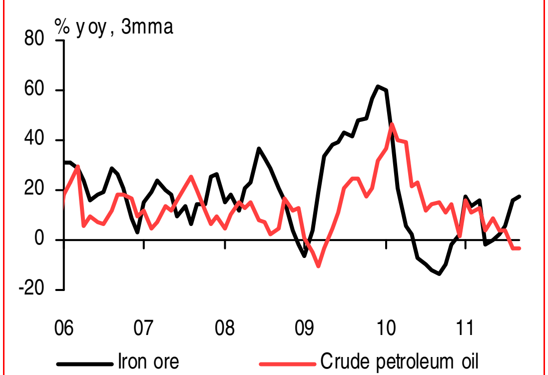
Source: CEIC, HSBC

9. Exports, by major commodity



Source: CEIC, HSBC

10. Imports, by major commodity

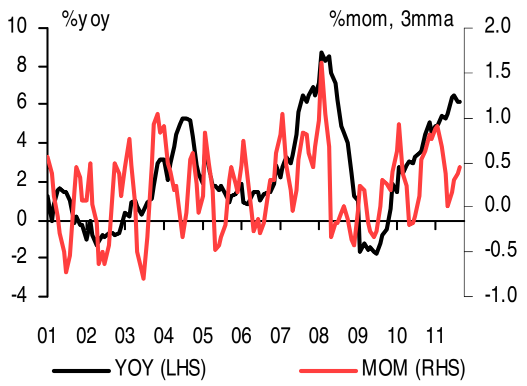


Source: CEIC, HSBC

Prices

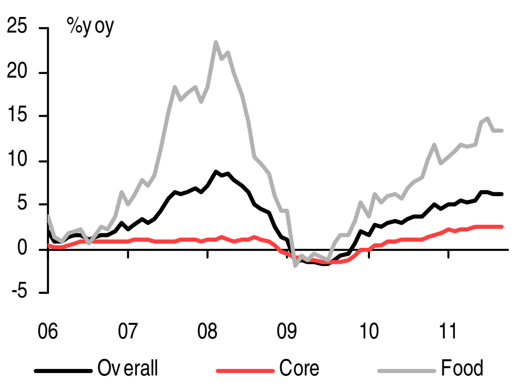
- Headline CPI moderated slightly to a four-month low of 6.1% y-o-y in September from 6.2% in August; seasonally adjusted m-o-m growth rate was almost unchanged at around 0.3% in Sep
- Food inflation remained high and contributed 4.05ppts to headline inflation while non-food inflation eased a little
- We believe CPI has peaked, but the subsequent slowdown is likely to be gradual not least because of still high food prices

1. Consumer price trend



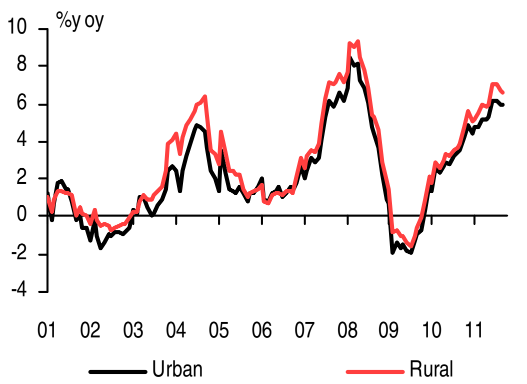
Source: CEIC, HSBC

2. CPI, by major segment



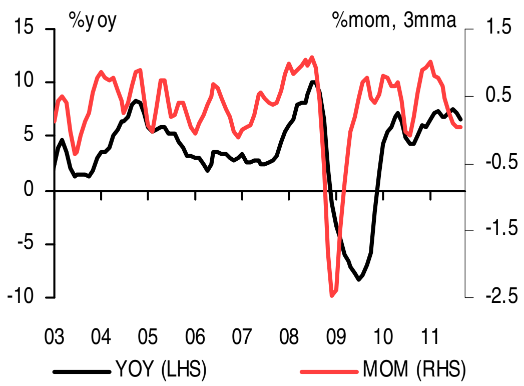
Source: CEIC, HSBC

3. Urban vs rural inflation



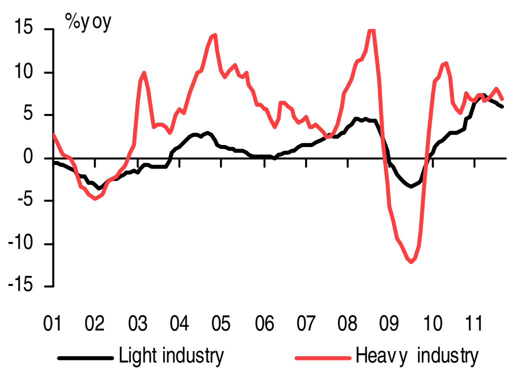
Source: CEIC, HSBC

4. Producer price index



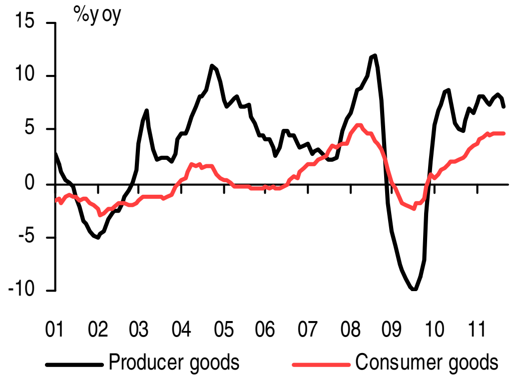
Source: CEIC, HSBC

5. PPI, by industry (1)



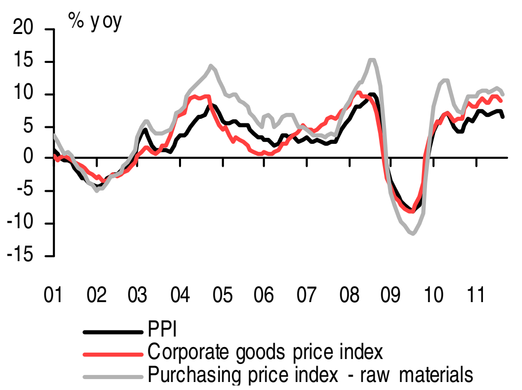
Source: CEIC, HSBC

6. PPI, by industry (2)



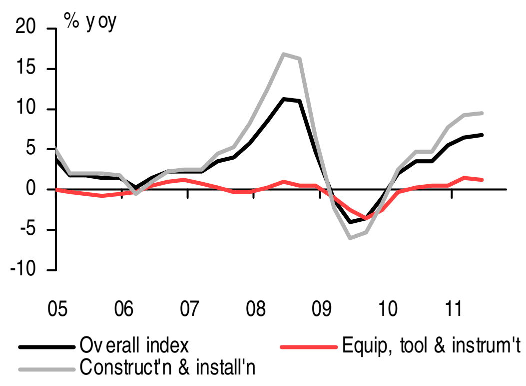
Source: CEIC, HSBC

7. Purchase and output prices



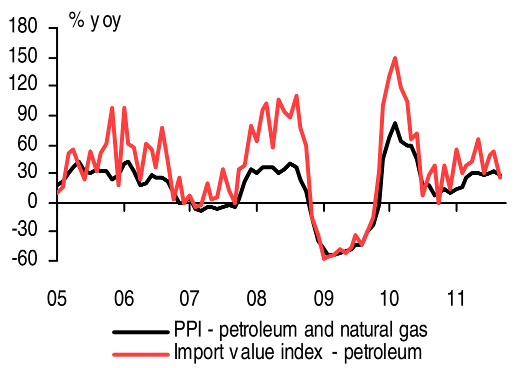
Source: CEIC, HSBC

8. Fixed asset investment price index



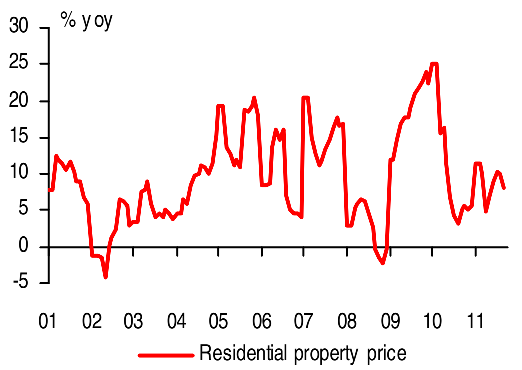
Source: CEIC, HSBC

9. Petroleum prices



Source: CEIC, HSBC

10. Property prices

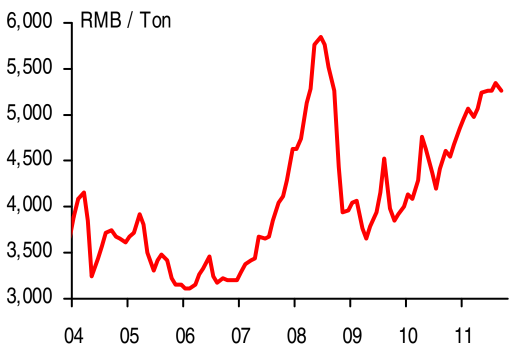


Source: CEIC, HSBC

Commodity prices

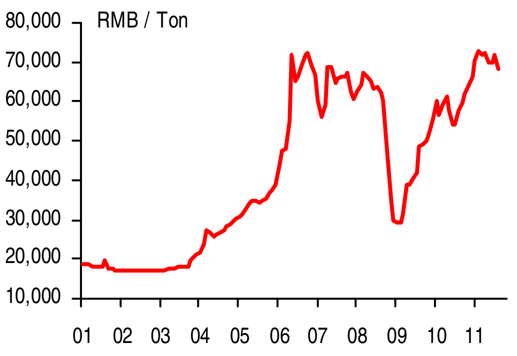
- Producer price inflation decelerated to 6.5% y-o-y in September from 7.3% y-o-y in August, the lowest reading this year
- This is mainly driven by a sharper slowdown of PPI for producer goods, which slowed to a nine-month low at 7.1% y-o-y in September from 8% in August, while PPI for consumer goods edged down to 4.6% y-o-y in September from 4.8% in August
- Softening global commodities prices against the backdrop of global slowdown are helpful in containing domestic commodities inflation

1. Wholesale price: Whorl steel



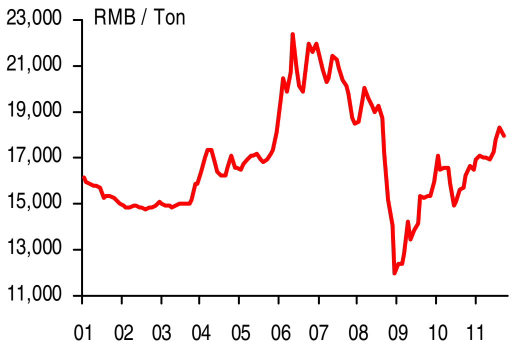
Source: CEIC, HSBC

2. Wholesale price: Electrolysed copper



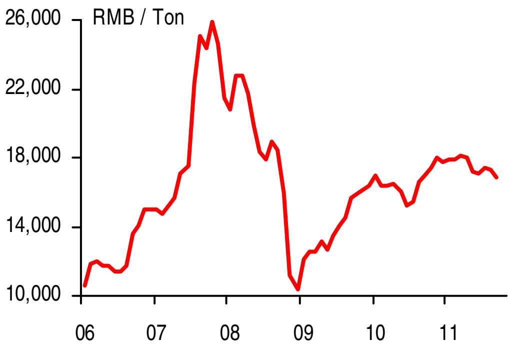
Source: CEIC, HSBC

3. Wholesale price: Aluminium



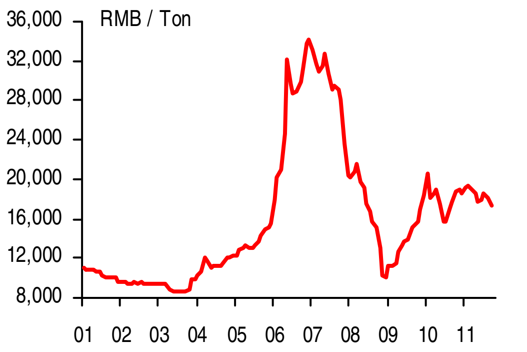
Source: CEIC, HSBC

4. Wholesale price: Lead



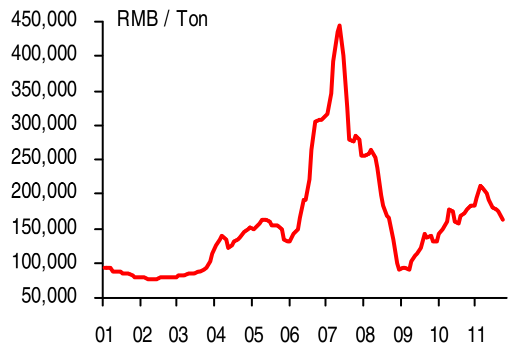
Source: CEIC, HSBC

5. Wholesale price: Zinc



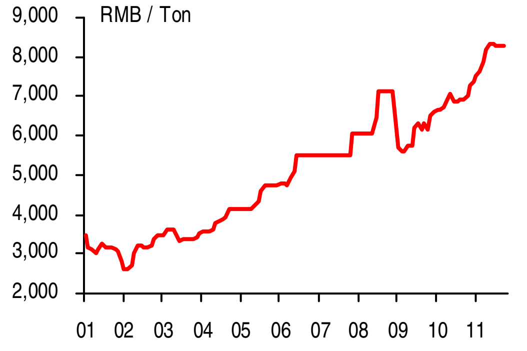
Source: CEIC, HSBC

6. Wholesale price: Nickel



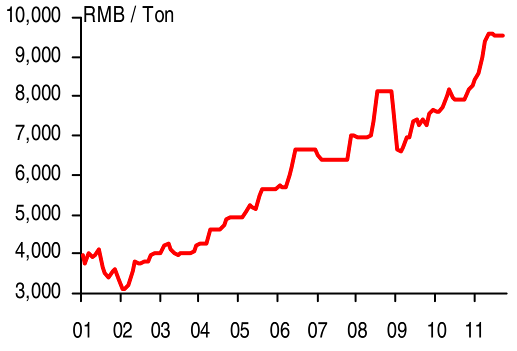
Source: CEIC, HSBC

7. Wholesale price: Diesel oil



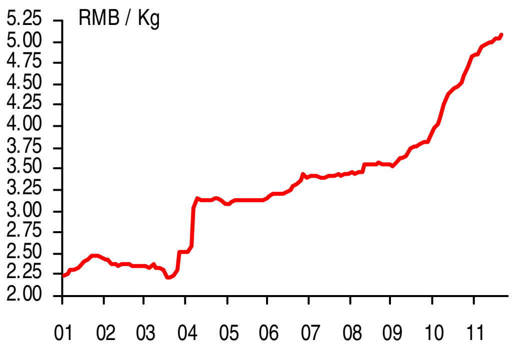
Source: CEIC, HSBC

8. Wholesale price: Gasoline



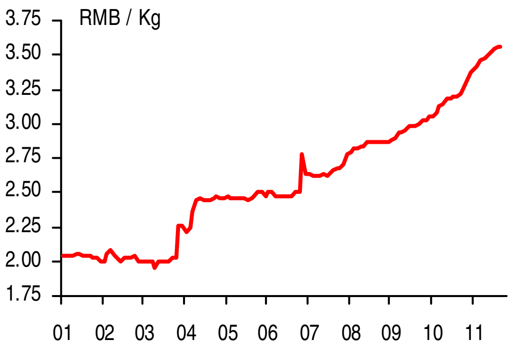
Source: CEIC, HSBC

9. Retail price: Rice



Source: CEIC, HSBC

10. Retail price: Flour

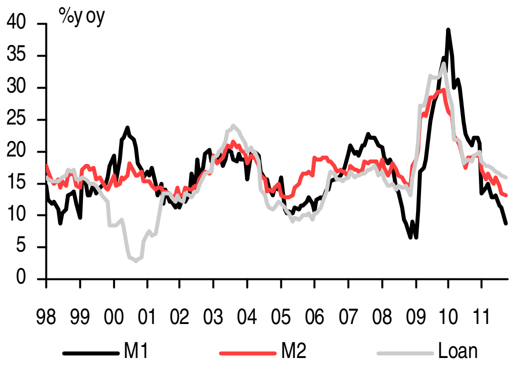


Source: CEIC, HSBC

Money and credit growth

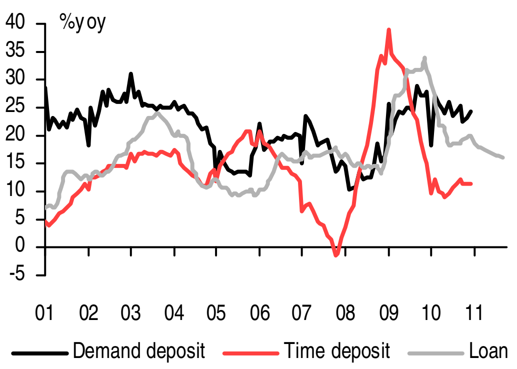
- Both new loan and money supply growth continued to slow last month due to quantitative tightening measures earlier in the year; outstanding loan growth edged down to a post-crisis low of 16.1% y-o-y in September from 16.4% in August, and M2 growth fell to 13.0% y-o-y in September from 13.5% in August
- However, both M2 growth and credit growth were steady sequentially
- On top of the selective credit easing, we expect the PBoC's to shift to neutral from tight-bias in the coming months

1. Loans vs money supply



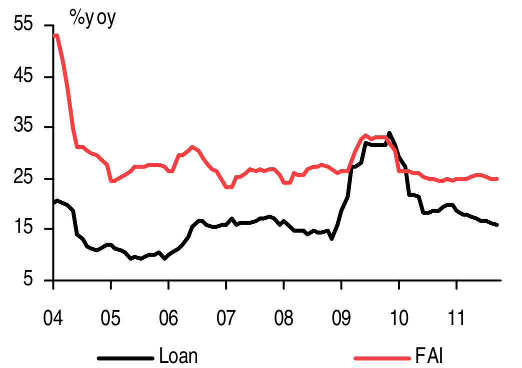
Source: CEIC, HSBC

2. Deposits vs loan growth



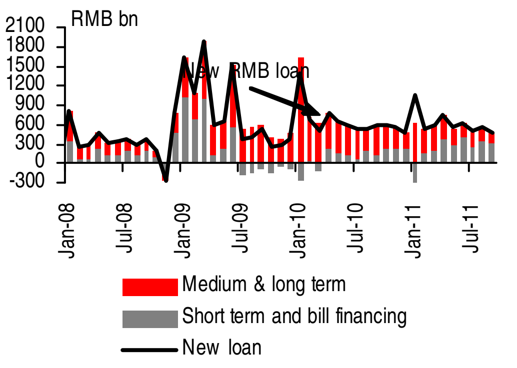
Source: CEIC, HSBC

3. FAI vs loan growth



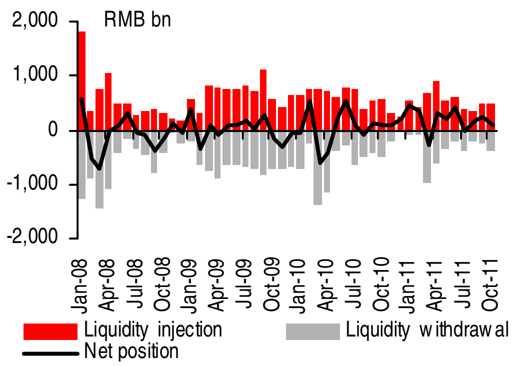
Source: CEIC, HSBC

4. New renminbi loans



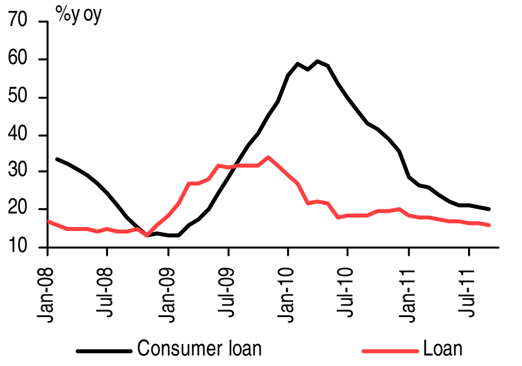
Source: CEIC, HSBC

5. PBoC open market operations



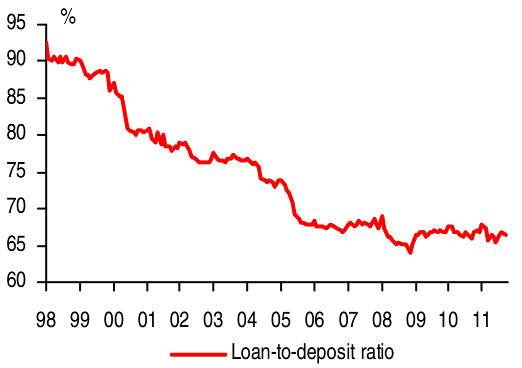
Source: Wind, HSBC (data up to 31 Oct 2011)

6. Consumer credit



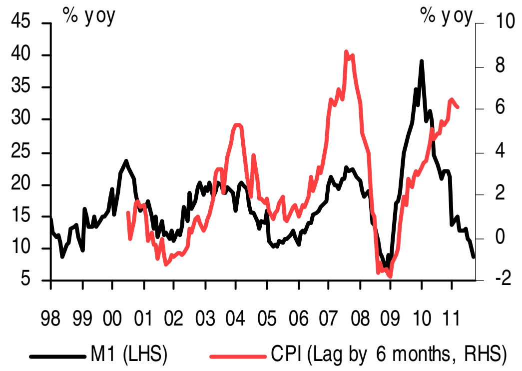
Source: CEIC, HSBC

7. Loan-to-deposit ratio



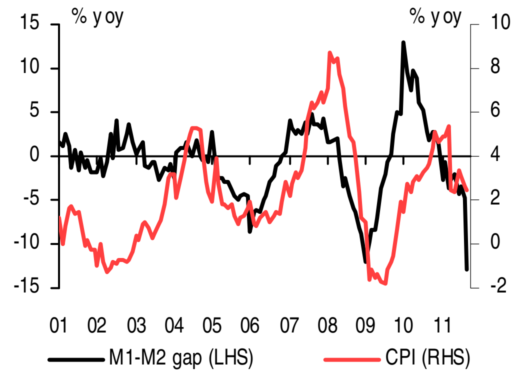
Source: CEIC, HSBC

8. Money supply vs price level



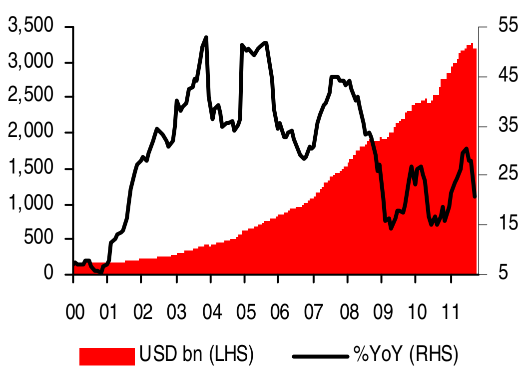
Source: CEIC, HSBC

9. M1-M2 gap vs CPI



Source: CEIC, HSBC

10. Foreign reserves

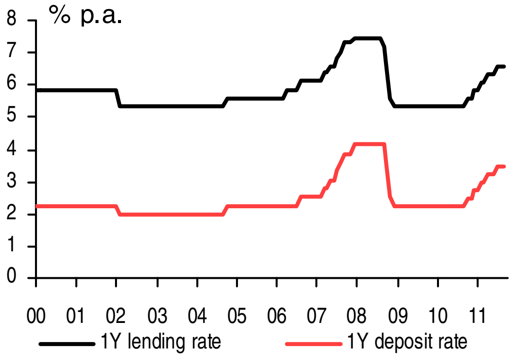


Source: CEIC, HSBC

Interest and exchange rates

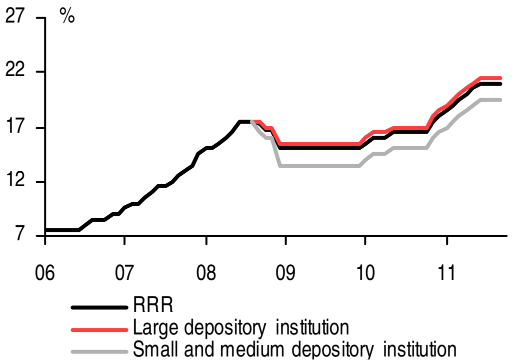
- The PBoC has raised interest rates three times since January, pushing the one-year deposit rate to 3.50% and the one-year lending rate to 6.56%
- We believe the tightening cycle is approaching an end; the peak of inflation in July and the slowdown of growth support our call of zero rate hikes for the rest of this year
- The RMB has appreciated against the USD by 4% since January, but appreciation is not likely to be the main tool to fight inflation, given China's huge impact on international commodity demand

1. Lending vs savings rates



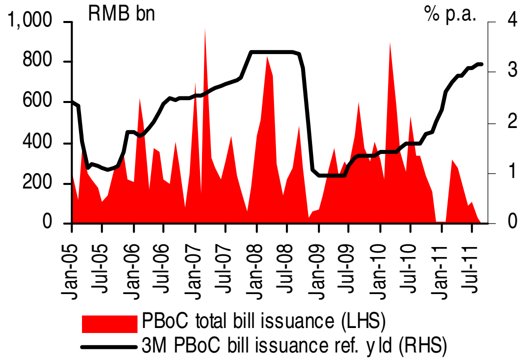
Source: CEIC, HSBC

2. Required reserve ratio



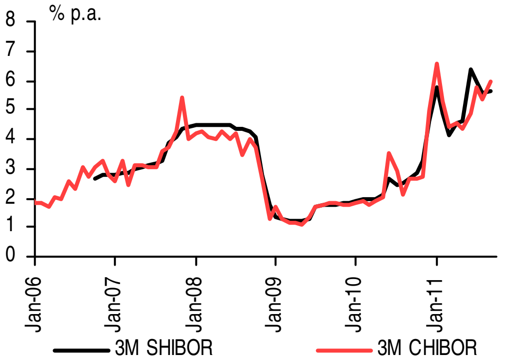
Source: CEIC, HSBC

3. PBoC bill issuance and reference yield



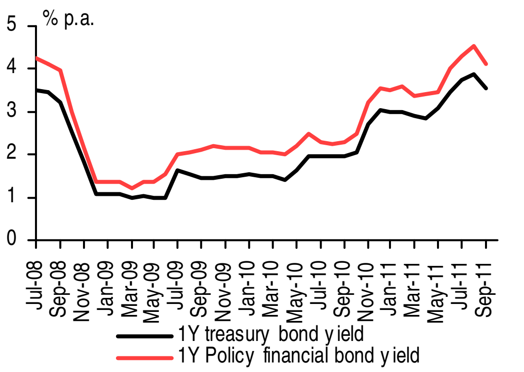
Source: CEIC, HSBC

4. Interbank rate



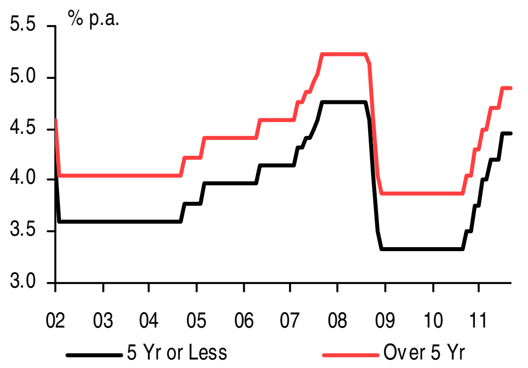
Source: CEIC, HSBC

5. Bond yields



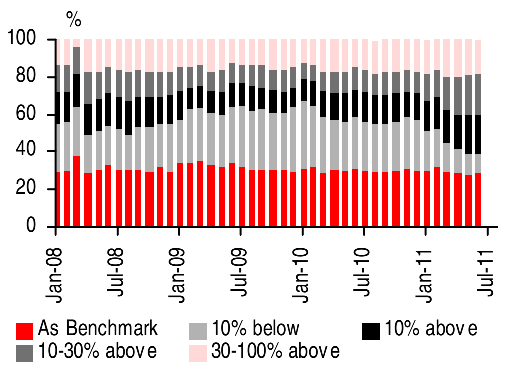
Source: CEIC, HSBC

6. Mortgage rate



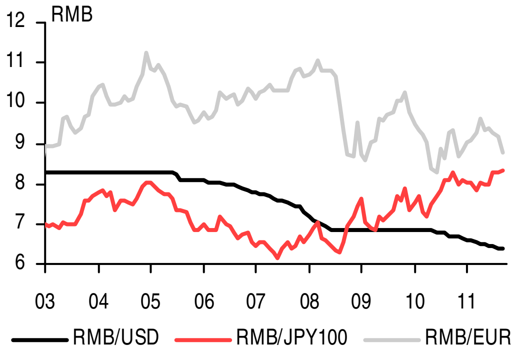
Source: CEIC, HSBC

7. Distribution of actual lending rate



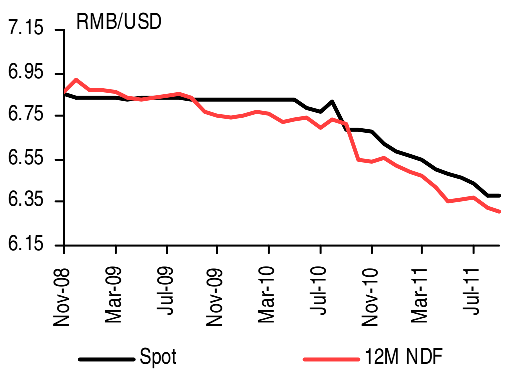
Source: CEIC, HSBC

8. Foreign exchange rate



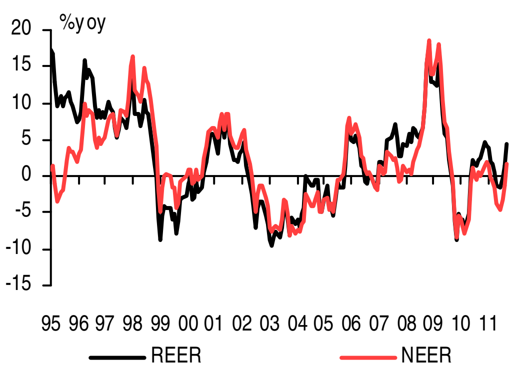
Source: CEIC, HSBC

9. RMB spot vs forward rate



Source: CEIC, HSBC

10. Effective exchange rate

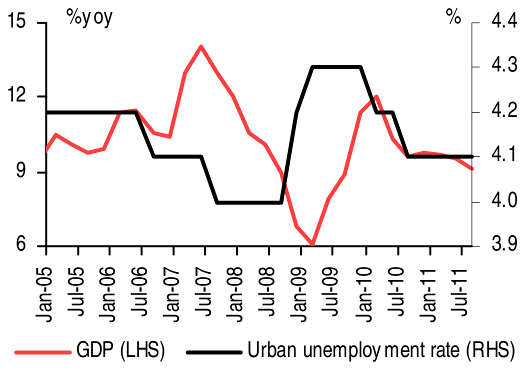


Source: CEIC, HSBC

Employment and income

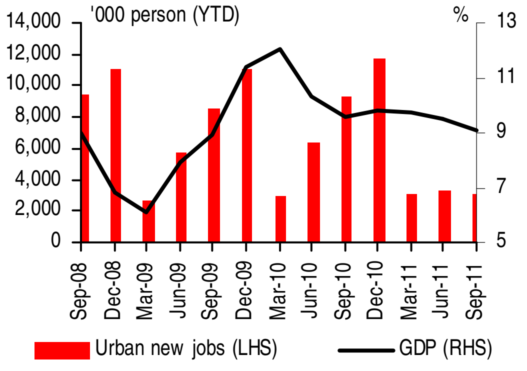
- China created 9.44m new jobs in Jan-Sep 2011 (overshooting the annual target of 9m), and the official urban registered unemployment ratio remained at 4.1% at end-Sep
- Robust growth has been continuously lifting labour demand and wages, reflected in the expanded employment components of HSBC China PMI readings and rapid wage growth
- Household income saw rapid growth in the first three quarters, particularly that of rural households, which grew 13.6% y-o-y in real terms, almost double the rate of 7.8% for urban households

1. Economic growth vs unemployment



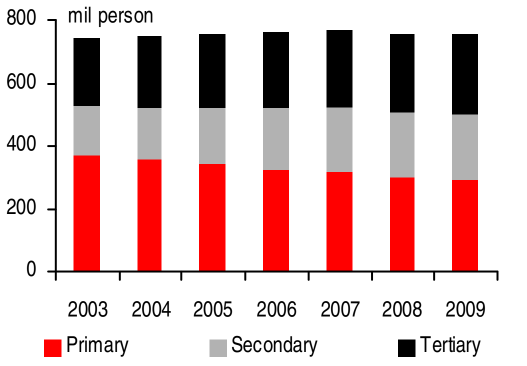
Source: CEIC, HSBC

2. Creation of jobs



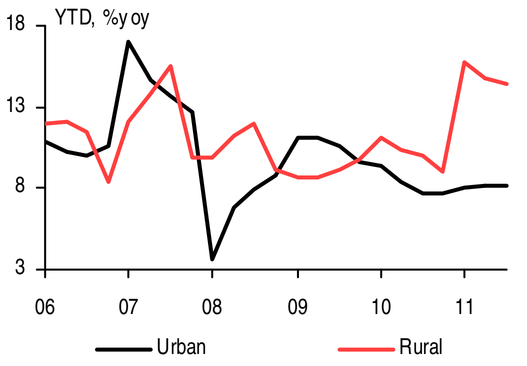
Source: CEIC, HSBC

3. Employment, by major industry



Source: CEIC, HSBC

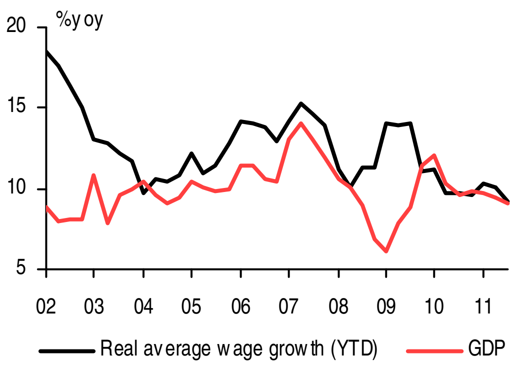
4. Real household income per capita



Source: CEIC, HSBC

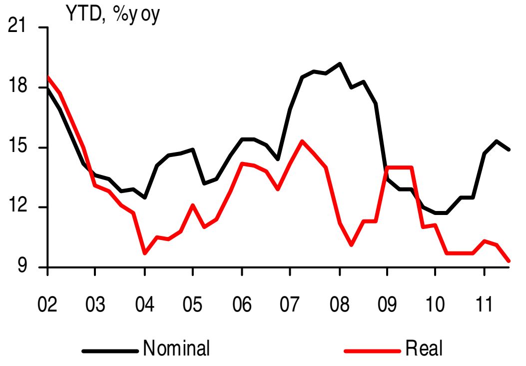
HSBC

5. Economic growth vs real wage growth



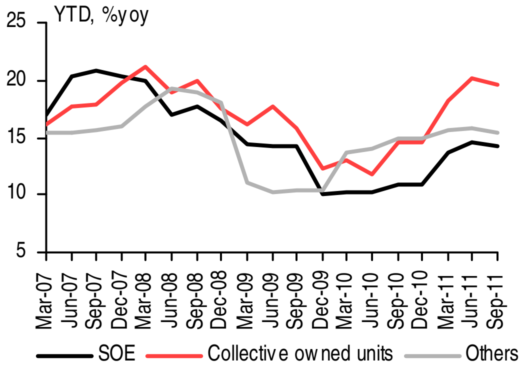
Source: CEIC, HSBC

6. Average wage growth



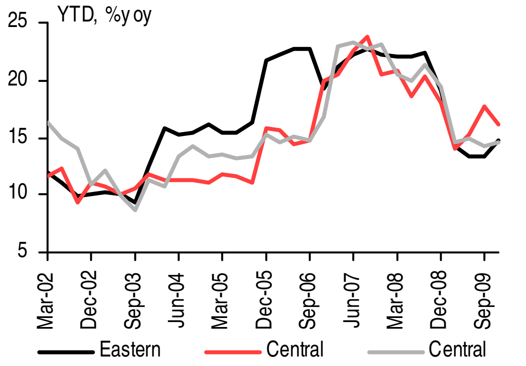
Source: CEIC, HSBC

7. Wage growth, by enterprise



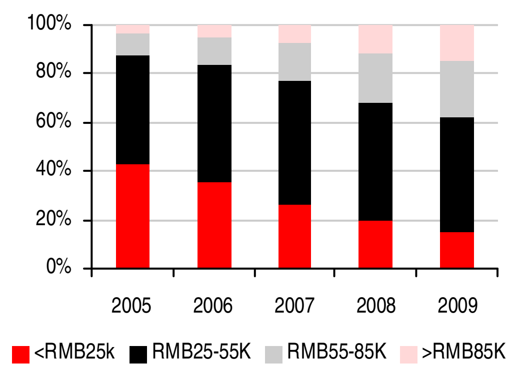
Source: CEIC, HSBC

8. Wage growth, by region



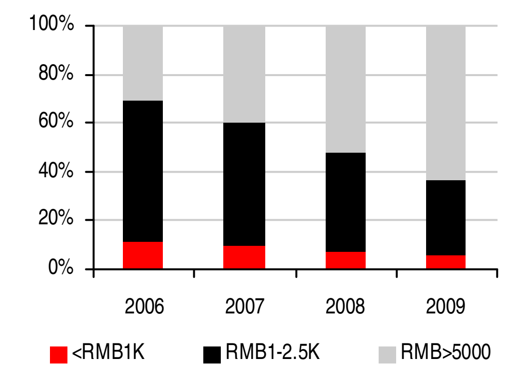
Source: CEIC, HSBC

9. Household income distribution – Urban



Source: CEIC, HSBC

10. Household income distribution – Rural

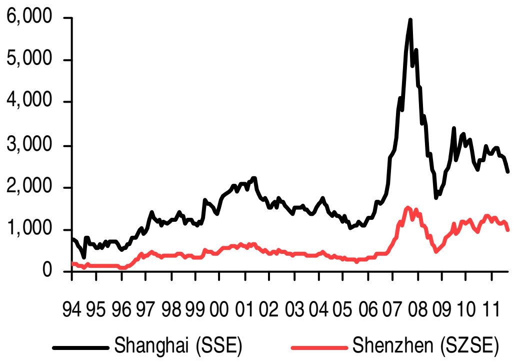


Source: CEIC, HSBC

Asset markets

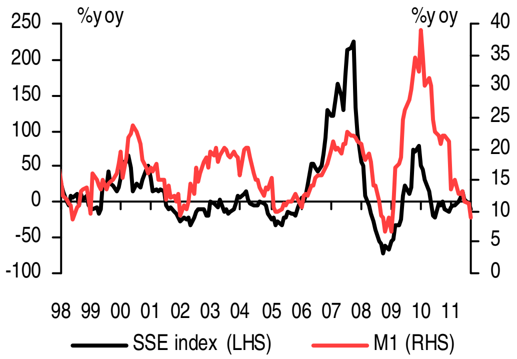
- Property market showed initial signs of correction with transaction volume sluggish and property prices slowing down; that said, we expect property market tightening to continue
- SCHCOMP fell by around 12% from the beginning of the year against the backdrop of sustained credit tightening and growth slowdown
- HSBC equity strategist viewed the current distressed valuation level on SHCOMP reflects an overly pessimistic long-term EPS growth outlook; targeting 2,700 for SHCOMP for 2012

1. Stock indices



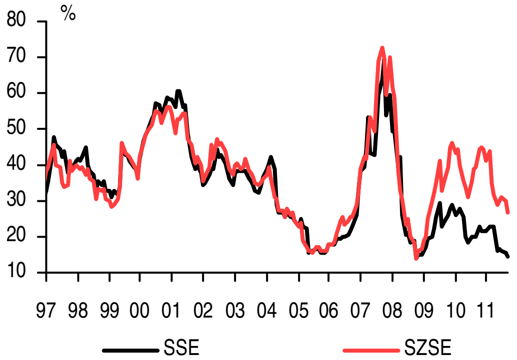
Source: CEIC, HSBC

2. Stock index vs money supply



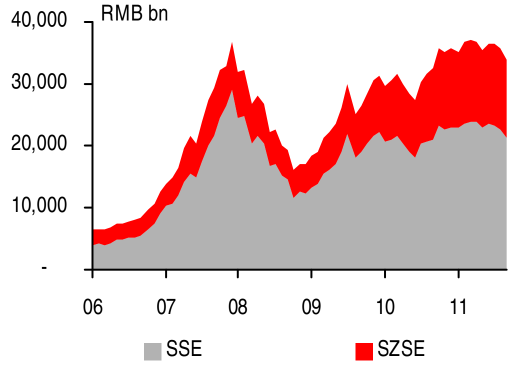
Source: CEIC, HSBC

3. Price-to-earnings ratio



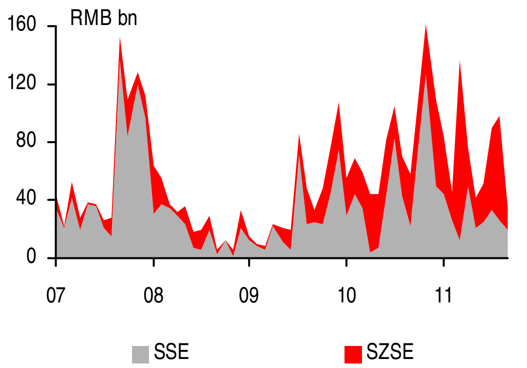
Source: CEIC, HSBC

4. Market capitalisation, by stock exchange



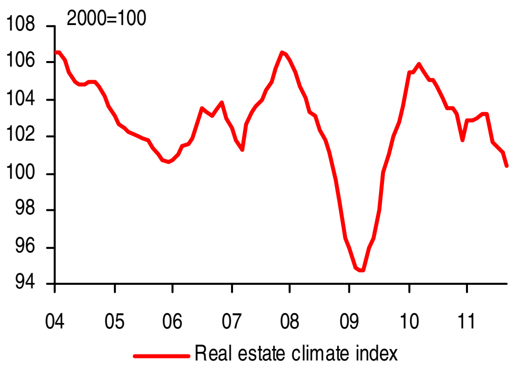
Source: CEIC, HSBC

5. Capital raised, by stock exchange



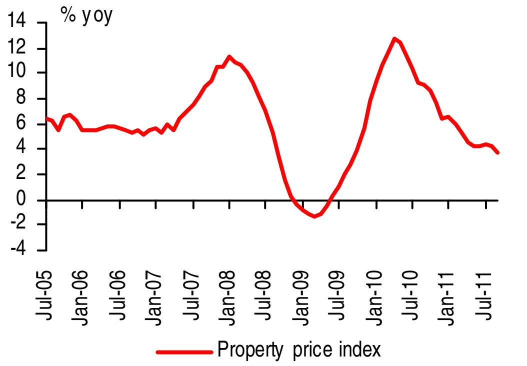
Source: CEIC, HSBC

6. Real estate index



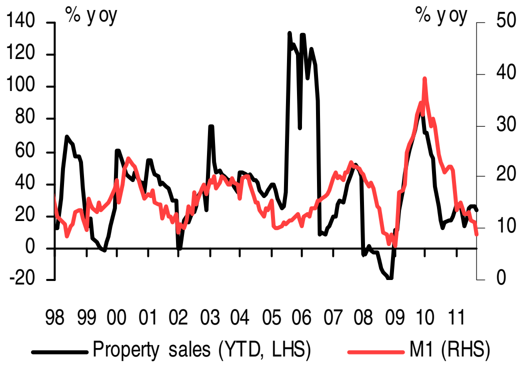
Source: CEIC, HSBC

7. Property prices



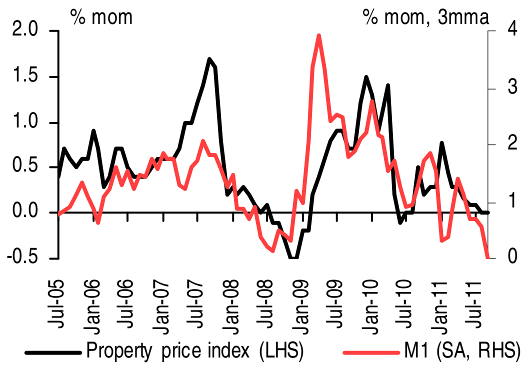
Source: CEIC, HSBC

8. Property sales vs money supply



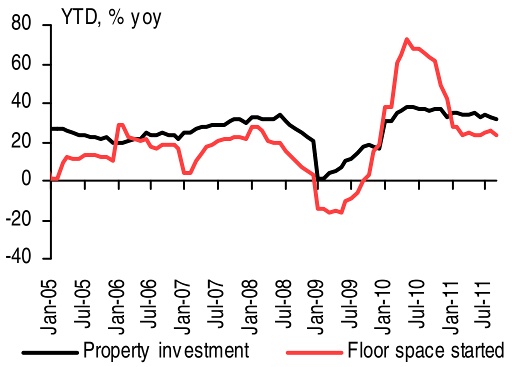
Source: CEIC, HSBC

9. Property prices vs money supply



Source: CEIC, HSBC

10. Property investment vs property started



Source: CEIC, HSBC

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Data and forecasts

China

Macro framework

	2006	2007	2008	2009	2010	2011F	2012F
Production, demand and employment							
GDP growth (% y-o-y)	11.6	14.2	9.6	9.2	10.3	8.9	8.6
Nominal GDP (USDbn)	2716	3498	4524	4994	5886	7004	8121
GDP per capita (USD)	2077	2661	3424	3760	4389	5197	5996
Nominal retail sales (% y-o-y)	13.7	16.8	21.6	15.5	18.5	19.0	17.0
Fixed asset investment (nominal, % y-o-y)	24.5	25.8	26.1	30.5	24.5	21.5	19
IP (excl. small enterprises % y-o-y)	16.2	17.1	12.9	12.9	15.7	13.2	12.5
Gross domestic saving (% GDP)	50.1	51.0	51.4	50.0	50.5	50.0	50.0
Unemployment rate, average (%)	4.1	4.0	4.2	4.3	4.1	4.3	4.3
Prices & wages							
CPI, average (% y-o-y)	1.5	4.8	5.9	-0.7	3.3	4,8	2.9
CPI, end-year (% y-o-y)	2.8	6.5	1.2	1.9	4.6	3.5	3.0
PPI, end-year (% y-o-y)	3.1	5.4	-1.1	1.7	5.9	5.8	4.3
Manufacturing wages, nominal (% y-o-y)	14.0	16.2	17.0	9.0	13.0	13	12
Money, FX & interest rates							
Central bank money M0, average (%)	13.2	13.6	12.4	12.1	14.9	11.0	11.0
Broad money supply M2, average (%)	18.1	17.5	16.7	26.5	23.7	17.9	15.5
Policy rate, end-year (%)	6.12	7.47	5.31	5.31	5.81	6.56	6.56
5yr yield, end-year (%)	6.48	7.74	5.76	5.76	6.16	7.00	7.00
RMB /USD, end-year	7.81	7.30	6.82	6.83	6.61	6.35	6.15
RMB /USD, average	7.96	7.60	6.94	6.83	6.72	6.48	6.25
RMB /EUR, end-year	10.3	10.66	9.48	9.77	8.82	8.89	8.61
RMB /EUR, average	10.01	10.56	10.11	9.54	9.18	8.86	8.75
External sector							
Merchandise exports (USDbn)	969	1,219	1,429	1,202	1578	1863	2086
Merchandise imports (USDbn)	792	956	1,133	1,006	1394	1673	1940
Trade balance (USDbn)	178	263	296	196	184.5	189.9	145.8
Current account balance (USDbn)	253	372	426	284	250	260	210
Current account balance (% GDP)	9.5	11.0	9.4	5.8	4.2	3.8	2.6
Net FDI (USDbn)	73	84	108	90	106	122	134
Net FDI (% GDP)	2.7	2.5	2.4	1.8	1.8	1.8	1.7
Current account balance plus FDI (% GDP)	12.2	13.4	11.8	7.6	6.0	5.6	5.3
Exports (% y-o-y)	27.2	25.8	17.2	-15.9	31.4	18.0	12.0
Imports (% y-o-y)	19.9	20.8	18.5	-11.3	38.6	20.0	16.0
International FX reserves (USDbn)	1,066	1,528	1,946	2,399	2,850	3150	3300
Import cover (months)	15.0	17.7	18.9	27.9	24.8	23.8	22.7
Public and external solvency indicators							
Commercial banks' FX assets (USDbn)	200	188	181	212	245	292	292
Gross external debt (USDbn)	323	374	375	350	330	360	360
Short term external debt (% of int'l reserves)	17.2	14.4	10.8	6.3	4.2	4.1	4.8
Consolidated government balance (% GDP)	-1.0	0.6	-0.4	-2.2	-2.5	-2.0	-1.7

Source: HSBC

Notes

Notes

Notes

Disclosure appendix

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Issuer of report

The Hongkong and Shanghai Banking Corporation Limited

Level 19, 1 Queen's Road Central
Hong Kong SAR
Telephone: +852 2843 9111
Telex: 75100 CAPEL HX
Fax: +852 2801 4138
Website: www.research.hsbc.com

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Global Economics Research Team

Global

Stephen King
Global Head of Economics
+44 20 7991 6700 stephen.king@hsbcib.com

Karen Ward
Senior Global Economist
+44 20 7991 3692 karen.ward@hsbcib.com

Madhur Jha
+44 20 7991 6755 madhur.jha@hsbcib.com

Europe & United Kingdom

Janet Henry
Chief European Economist
+44 20 7991 6711 janet.henry@hsbcib.com

Astrid Schilo
+44 20 7991 6708 astrid.schilo@hsbcib.com

Germany

Lothar Hessler
+49 21 1910 2906 lothar.hessler@hsbc.de

France

Mathilde Lemoine
+33 1 4070 3266 mathilde.lemoine@hsbc.fr

North America

Kevin Logan
Chief US Economist
+1 212 525 3195 kevin.r.logan@us.hsbc.com

Ryan Wang
+1 212 525 3181 ryan.wang@us.hsbc.com

Stewart Hall
+1 416 868 7523 stewart_hall@hsbc.ca

Asia Pacific

Qu Hongbin
Managing Director, Co-head Asian Economics Research and Chief Economist Greater China
+852 2822 2025 hongbinqu@hsbc.com.hk

Frederic Neumann
Managing Director, Co-head Asian Economics Research
+852 2822 4556 fredericneumann@hsbc.com.hk

Leif Eskesen
Chief Economist, India & ASEAN
+65 6239 0840 leifeskesen@hsbc.com.sg

Paul Bloxham
Chief Economist, Australia and New Zealand
+61 2925 52635 paulbloxham@hsbc.com.au

Donna Kwok
+852 2996 6621 donnahjkwok@hsbc.com.hk

Trinh Nguyen
+852 2822 6975 trinhdnguyen@hsbc.com.hk

Ronald Man
+852 2996 6743 ronaldman@hsbc.com.hk

Sun Junwei
Associate

Sophia Ma
Associate

Global Emerging Markets

Pablo Goldberg
Head of Global EM Research
+1 212 525 8729 pablo.a.goldberg@hsbc.com

Bertrand Delgado
EM Strategist
+1 212 525 0745 bertrand.j.delgado@us.hsbc.com

Emerging Europe, Middle East and Africa

Murat Ulgen
Chief Economist
+44 20 7991 6782 muratulgen@hsbc.com

Alexander Morozov
+7 495 783 8855 alexander.morozov@hsbc.com

Simon Williams
+971 4 507 7614 simon.williams@hsbc.com

Melis Metiner
+90 212 376 4618 melismetiner@hsbc.com.tr

Latin America

Andre Loes
Chief Economist, Latin America
+55 11 3371 8184 andre.a.loes@hsbc.com.br

Argentina

Javier Finkman
Chief Economist, South America ex-Brazil
+54 11 4344 8144 javier.finkman@hsbc.com.ar

Ramiro D Blazquez
Senior Economist
+54 11 4348 5759 ramiro.blazquez@hsbc.com.ar

Jorge Morgenstern
Senior Economist
+54 11 4130 9229 jorge.morgenstern@hsbc.com.ar

Brazil

Constantin Jancso
Senior Economist
+55 11 3371 8183 constantin.c.jancso@hsbc.com.br

Marcos Fernandes
+55 11 6847 9787 marcos.r.fernandes@hsbc.com.br

Mexico

Sergio Martin
Chief Economist
+52 55 5721 2164 sergio.martinm@hsbc.com.mx

Claudia Navarrete
Economist
+52 55 5721 3284 claudia.navarrete@hsbc.com.mx

Central America

Lorena Dominguez
Economist
+52 55 5721 2172 lorena.dominguez@hsbc.com.mx