

Macro Research Presentation



7 January, 2009

China

From overheating to economic slowdown

Overview

- China, the global growth locomotive
- Not long ago overheating was the main concern
- Turnaround came quickly
- ...following global financial credit crisis and global recession
- Resolute support to the economy
 - Major rescue packages
 - Monetary policy also joining in
- Implications for the global economy
 - Soft landing will not save global growth
 - ...but domestic focus will provide vital support for global growth
 - ...and make growth in China more sustainable
 - China will once again contribute to lower global inflation
- The long run growth story intact
 - ...growth will slowly trend downwards as catching up progresses

Catching up since 1978, but still absolutely poor

- Strong growth since rise from communism and major reforms initiated in 1978.
 - From plan economy to market economy
 - Reorganisation
 - Mobilisation of resources
 - Technology
 - Infrastructure
 - Strong investments
 => Strong productivity gains

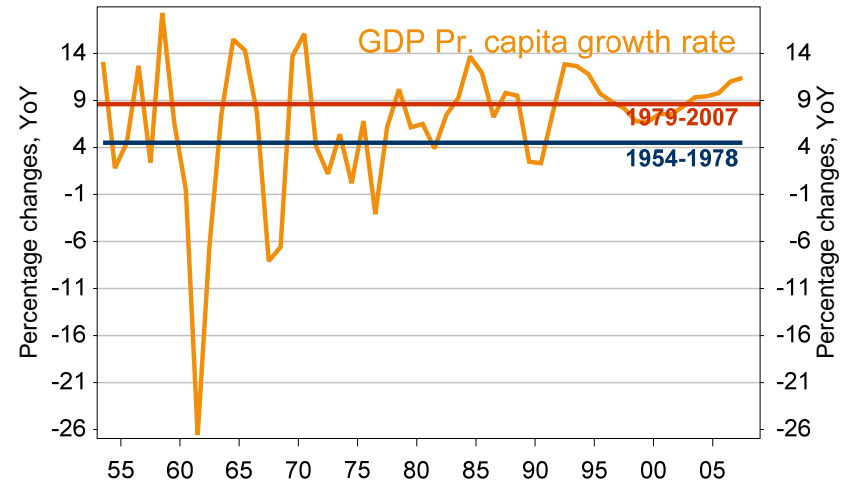
- Average growth almost 9% since 1979
 - Significant external impetus

- Remarkable expansion of role in the world trading system

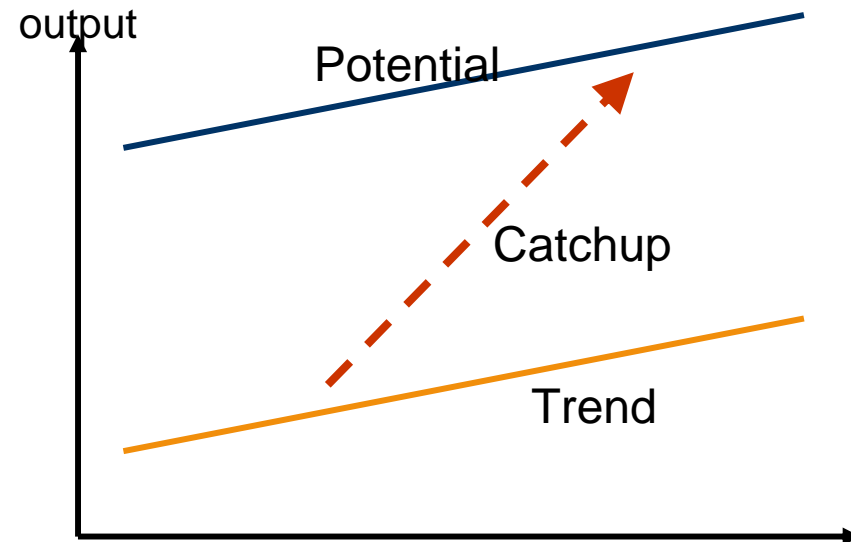
- Has also become a global financial power

- ...but much remains...productivity in best ¼ of international best practice so further catching up possible

- ...and financial markets are still underdeveloped

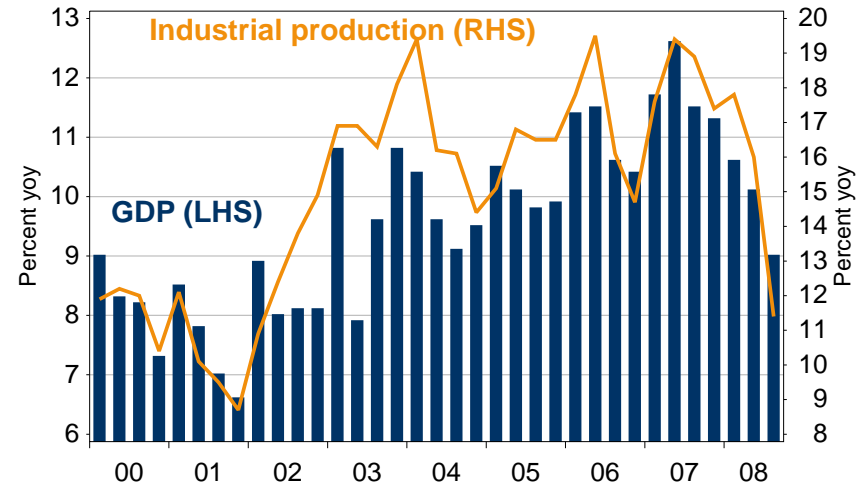


Source: Reuters EcoWin

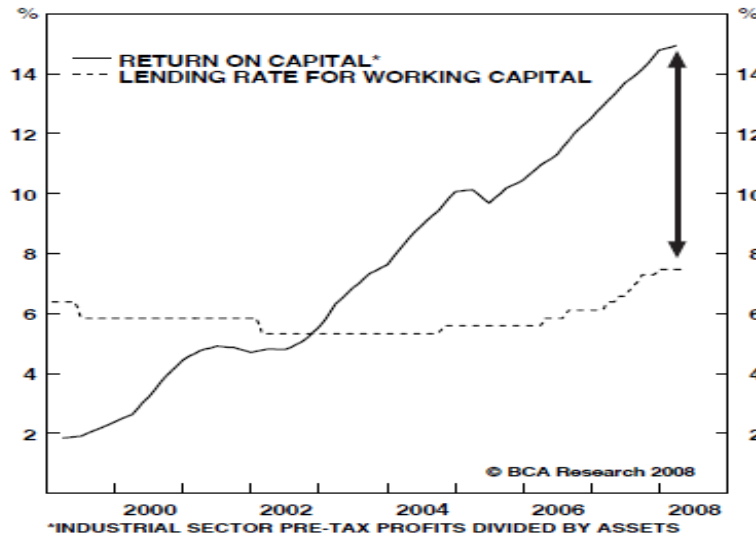


China impresses the world...but risk of overheating

- High growth rate no indication of overheating *per se*
- Overinvestment? No new structure remained idle for long...
- Low rate of return on investment? No..not relative to lending rate for working capital
- Housing market boom key driver behind investment boom



Source: Reuters EcoWin



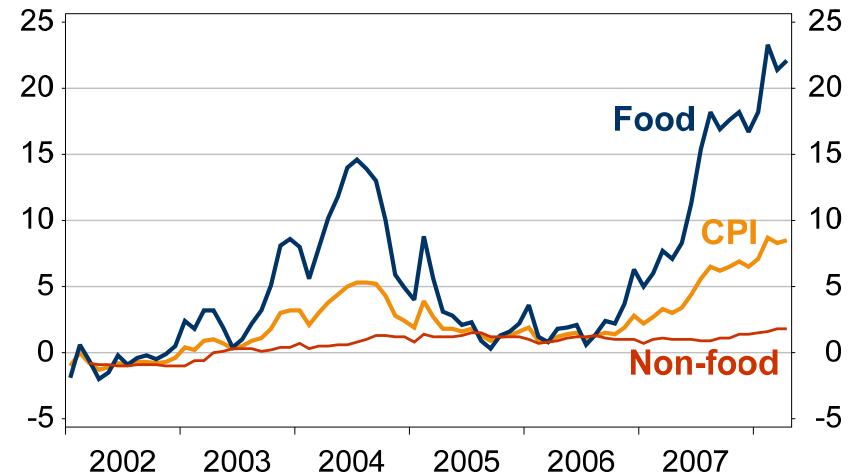
*INDUSTRIAL SECTOR PRE-TAX PROFITS DIVIDED BY ASSETS

Urban Fixed Asset Investments

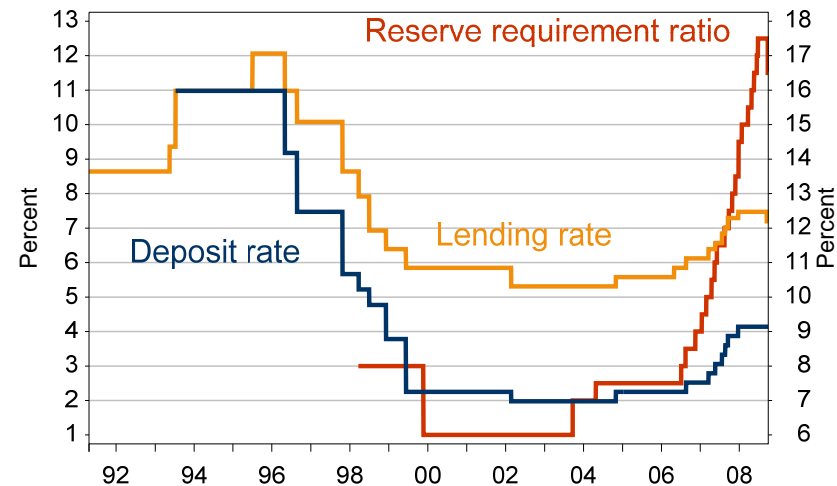


The economy was overheating => tighter economic policy

- Ultimate criterion: Inflation
 - Accelerated rapidly
- Became a political problem
 - Food hard to afford for many
 - Negative real return on deposits
 - Fear of unrest—as important as plant closings
 - No desire to repeat 1989!
- Monetary policy tightening
 - Not really that effective
- Direct controls
 - Credit control
 - Much stricter than before...
 - ...and had clear effects
 - Investment controls
- Currency appreciation
 - intensified by monetary tightening



Source: EcoWin

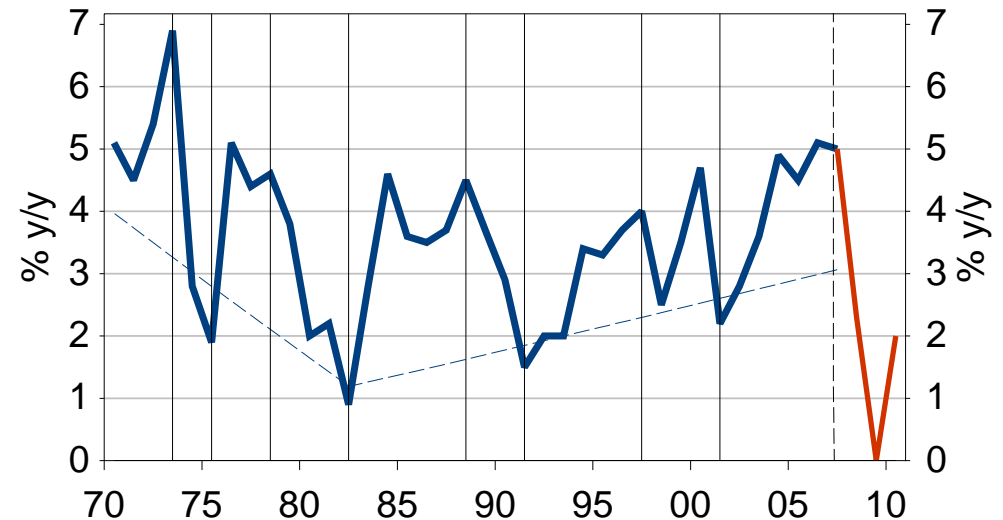


Source: Reuters EcoWin

Global financial and economic crisis

- Started as a US sub-prime crisis and evolved into a full-fledged global crisis
- Led to capital flight to safe-haven assets such as US government bonds and out of emerging markets
- At first China and other emerging markets looked rather unharmed...
- ...but as the US crisis spread globally and became a global economic crisis the outlook deteriorated...
- Economic growth slowing everywhere...US in technical recession since 2007, euro area following suit and so is Japan
- Implications:
 - Weaker global demand
 - Less risk-willing capital

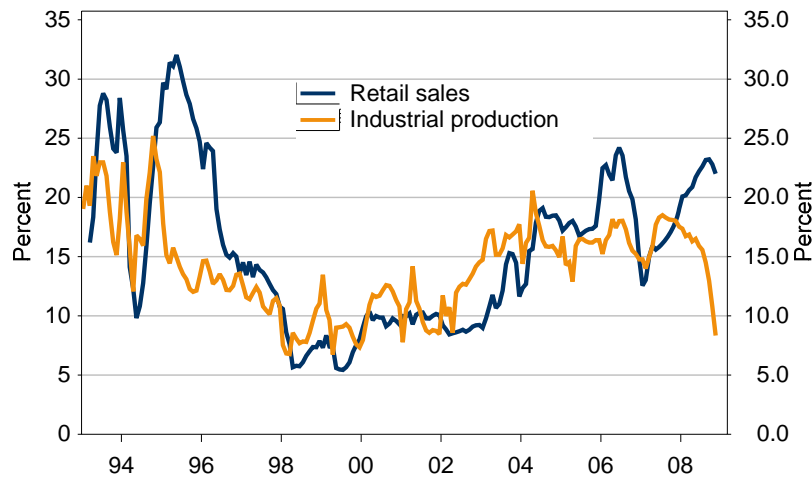
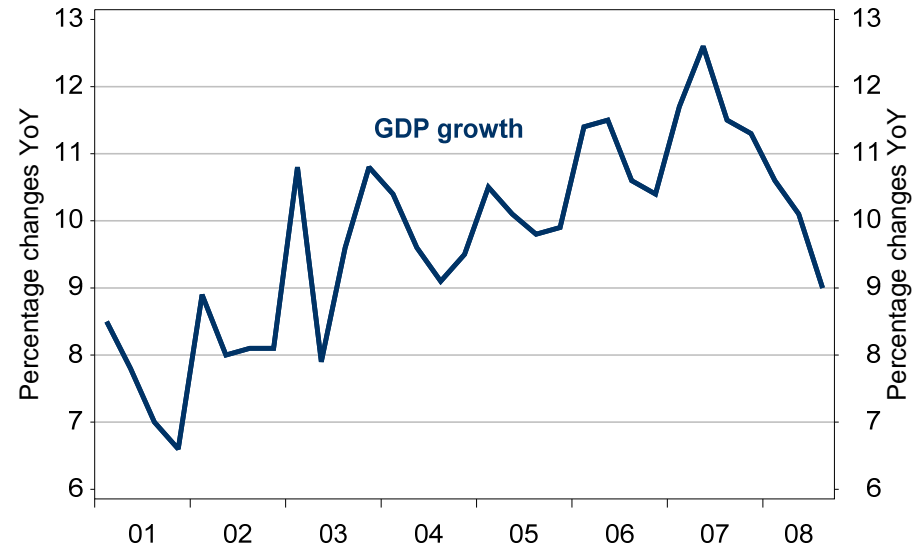
World GDP growth cycle



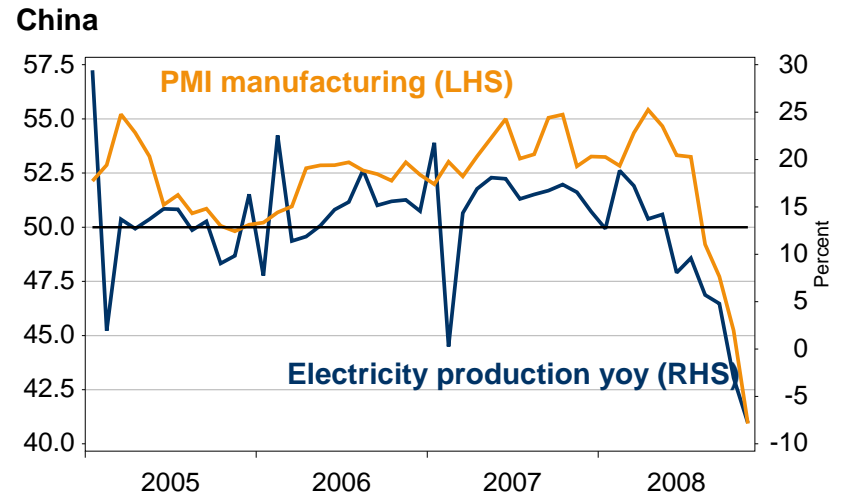
Chinese economy turning around on a dime

Economic story rewritten in less than nine months

- Shock from Q3 GDP data
 - Surprisingly sharp slowdown to 9%
 - Note sharp decline in yoy growth rates
- Industrial production growth collapsing
 - PMI collapsing.....though sub-50 need not mean outright activity decline in China
 - Electricity production falling for the first time since 2002
 - Profits are declining and will hurt industrial investment activity



Source: Reuters EcoWin



Source: Reuters EcoWin

Economic slowdown

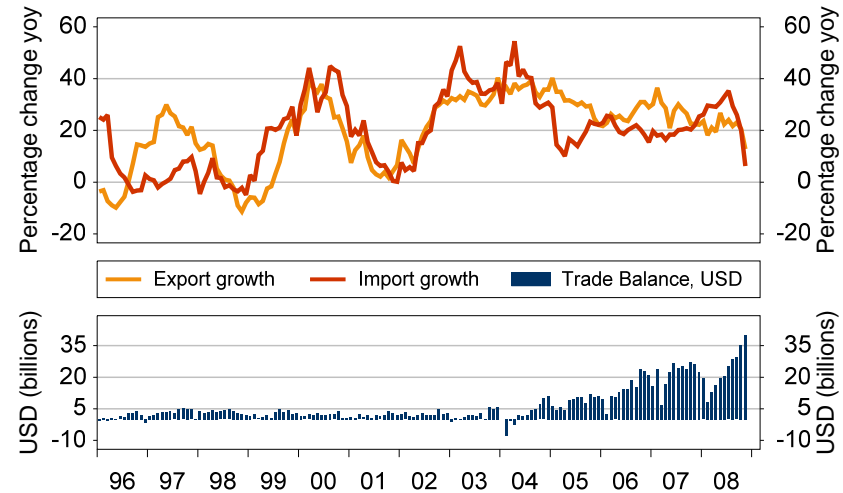
Trouble in exports

- Declining growth rate
 - Textiles declining
 - Bankruptcies in toys
 - Export hubs have been badly hit

- Causes
 - Global markets slowing down
 - Currency following USD (stronger)
 - Rising costs
 - Losing competitiveness to lower-cost nations

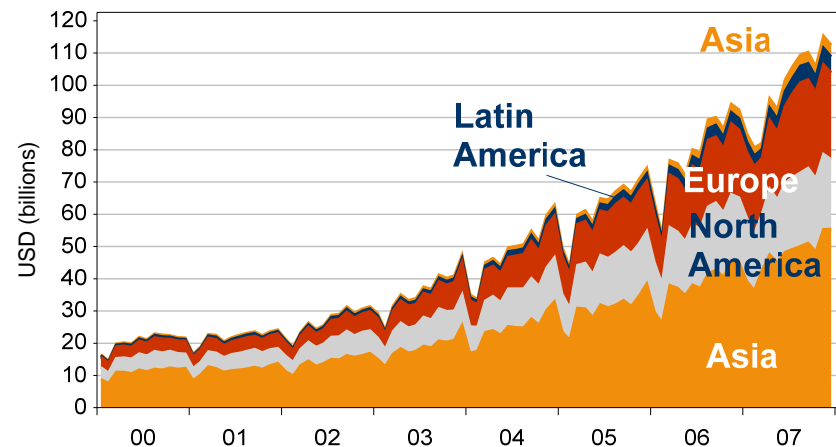
- Bright spot:
 - Moving upward in value chain
 - "Made in China" no longer stamp of low quality
 -but cost advantage should still make China a relative winner during a global downturn

- Could this give rise to protectionism?



Source: Reuters EcoWin

China, Exports, USD

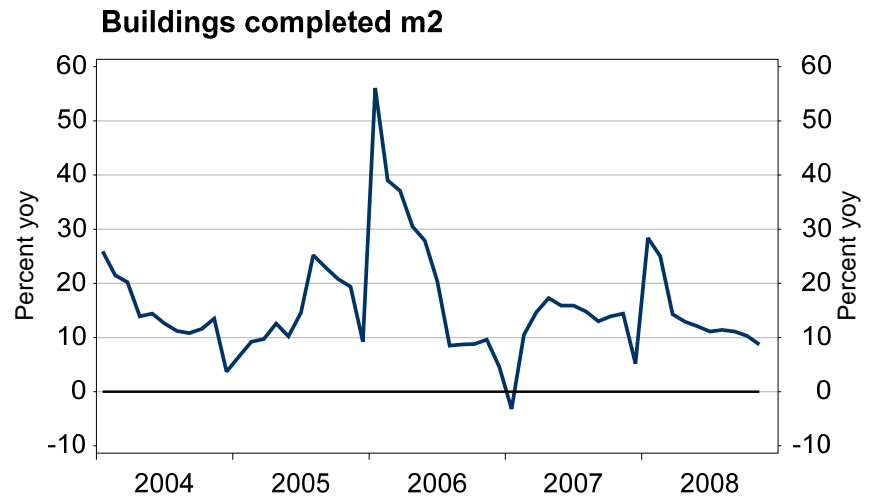
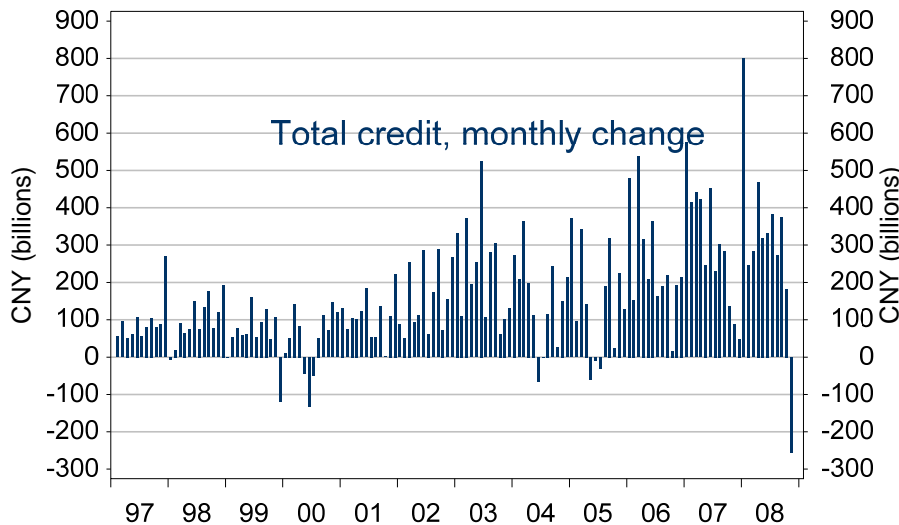
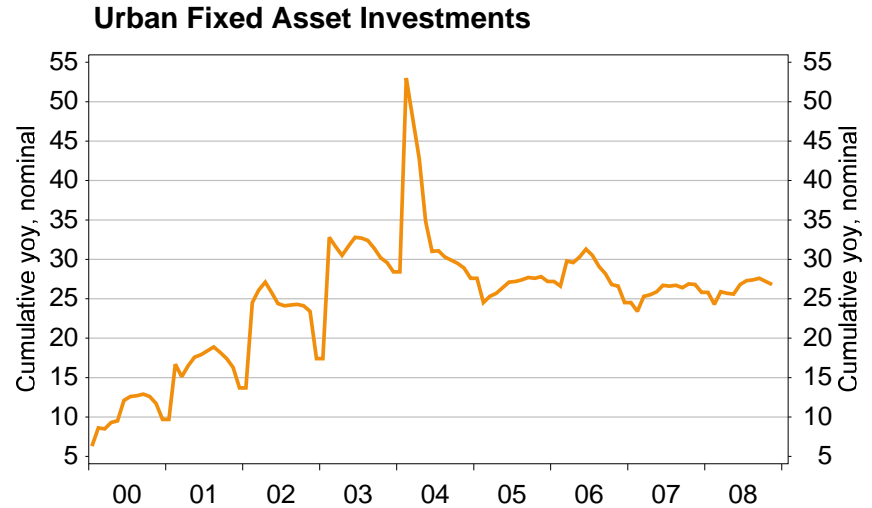


Source: Reuters EcoWin

Economic slowdown

Fixed investment not as strong as it looks

- Urban Fixed Asset Investment data strong, but somewhat misleading
 - Data include land purchases
 - Nominal data
- Floor space data more informative
 - Growth rates now in single-digit area
- Credit is declining
 - From November to October credit annually fell by CNY 260 billion.

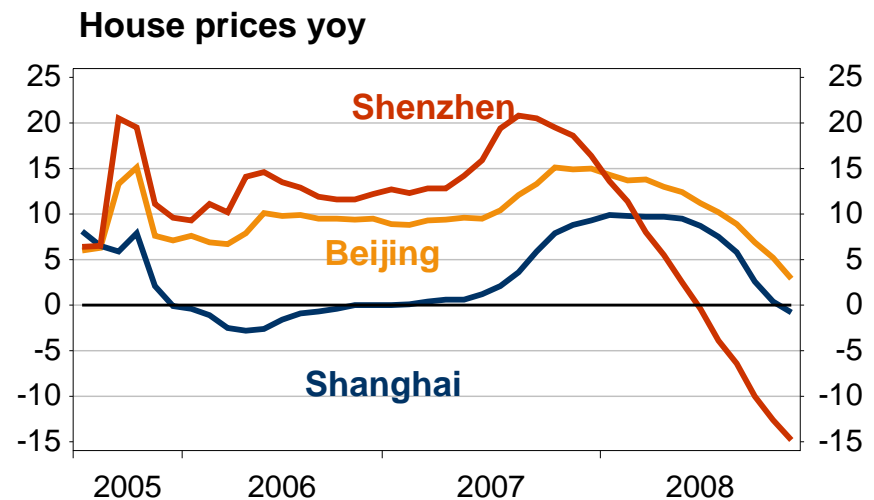


Source: Reuters EcoWin

Source: Reuters EcoWin

Economic slowdown Fixed investment (cont'd)

- Housing sales volumes collapsed in Q1 of 2008 after which prices followed suit
- Residential housing
 - Prices levelling out or falling in big cities
 - Vacancy rates slowly rising
 - Fewer expats entering
 - Still high demand for “affordable”, i.e. < 90 m²
- Foreign acquisitions low
 - Global credit crisis
 - Prices too high
- Construction collapse is especially hurting heavy industries that catered to domestic construction industry
- Excess capacity in the economy needs to be scaled back



Source: Reuters EcoWin

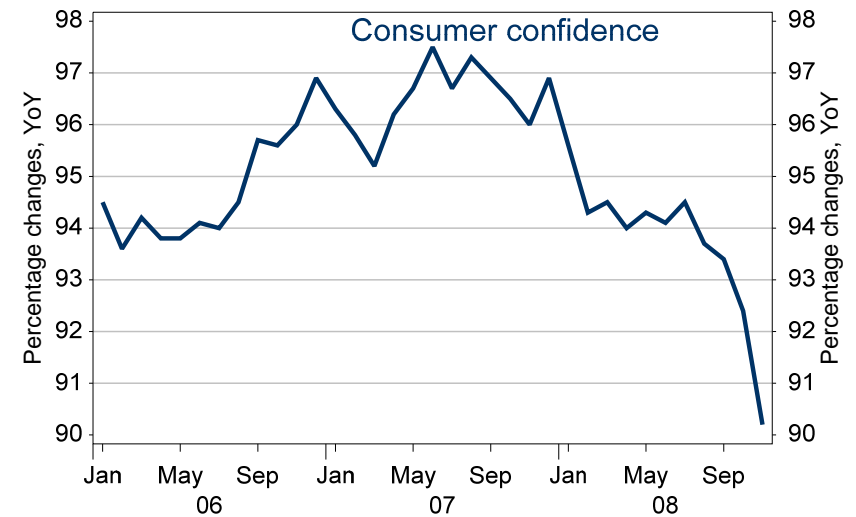
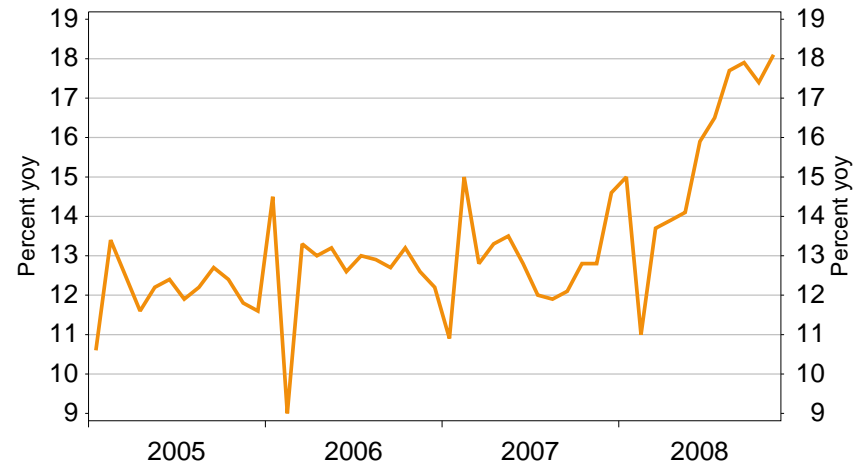
Economic slowdown

Private consumption: Robust, but vulnerable

Best available data:

- Retail sales...not slowing yet
- But major shortcomings:
 - Includes government and business purchases
 - No services
 - Anecdotal evidence of slowdown
- Apparent acceleration may be for real
 - Most households now own housing—reduced saving motive
- But real estate and stock market collapse expected to drag down retail sales
- Problem: Vulnerability
 - Bankruptcies, unemployment
 - Real slowdown a new experience
 - Consumer confidence has plummeted and consumers are increasing bank deposits

Retail sales deflated by RPI



Source: Reuters EcoWin

Resolute support to the economy - Supporting growth is now the name of the game

- In July 2008 the State Council was still confident enough of the economy's ability to generate at least 9% growth that it declined a fiscal stimulus proposal program of USD 54 bn.
- By October industrial production had collapsed and consumer confidence started to slow, making economist scramble to adjust growth expectations downwards
- Beijing made a quick U-turn on its policy priorities and now inflations is out and growth is the name of the game
- Goal is to keep growth at 8% in 2009-10
- Fiscal and monetary policy supporting growth:
 - **Focus is on spurring domestic demand: Capital formation and private consumption**
 - Two-year USD 586 billion stimulus package (15% of GDP) – largest in the country's history
 - Additional spending plans from provincial governments
 - Other measures include VAT-changes that will reduce taxes by CNY120 bn annually
 - Monetary policy easing has already been substantial and more is to come
 - Promote bank lending by removing lending-ceiling
 - Strengthen housing demand
- The determination of the authorities seem clear but much uncertainty about how much of the stimulus package is actually new

Resolute support to the economy - Stimulus package

- Initial market reaction was very positive worldwide and in emerging markets in particular.
- Main components to address both short-term cyclical downturn and growth in the longer run:
 - **Cyclical downturn:** Boost investment through direct investments in mainly infrastructure, affordable housing and public housing and VAT rebates on capital goods
 - **External shock:** Export VAT rebate to support exporters.
 - Initiatives to spur domestic consumption: Investments in health and education and most likely plans will come that involves initiatives to boost household disposable income (boosting wages, low-income subsidies)
- Notice that **not** all spending measures are new
 - Includes spending on reconstruction in areas hit by the earthquake in early May (1 trillion yuan)
 - Many measures have already been announced (railway investments and rural infrastructure investments)
 - Most likely the "new" stimulus component is less than 1 trillion yuan (aprx. 4% of GDP)
- Immediate winners are obviously miners and commodity-related companies
- Difficult to see visible positive effects on developed economy exporters in the short term

Financing

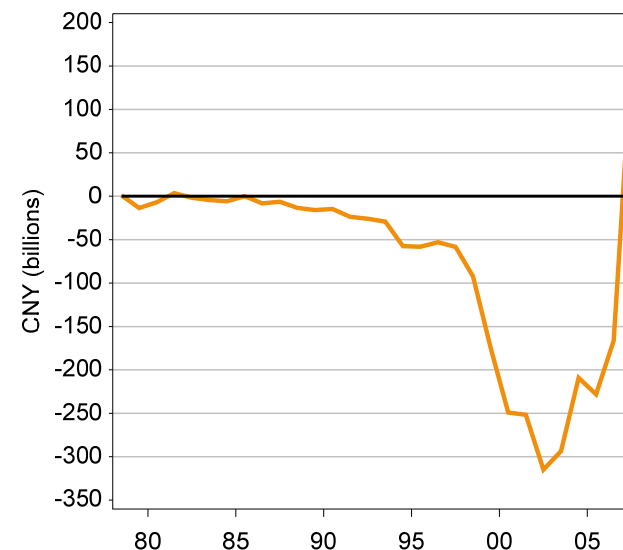
- Any consequences for USD

- Fiscal policy removed 1.5 %pts from growth in 08...
 - ...can easily add 1-2 % pts in 09
- Solid finances, can afford it
 - Not FX reserves (can't be exchanged into RMB)
 - But strong domestic finances, too
 - Can issue bonds, auction land
 -but economic slowdown and shrinking corporate profits and tax cuts are slowing revenues
- Financing only partly from Beijing
- Financing could have negative spillover effect on US borrowing costs

Rmb 4 trn spending in 2009-10

| | Rmb bn |
|---|--------|
| Infrastructure (mainly within the transport sector) | 1800 |
| Post earthquake reconstruction | 1000 |
| Rural development | 372 |
| Environmental projects | 348 |
| Public housing | 280 |
| Promoting high-tech enterprises | 160 |
| Social services (health and education) | 40 |

General government surplus

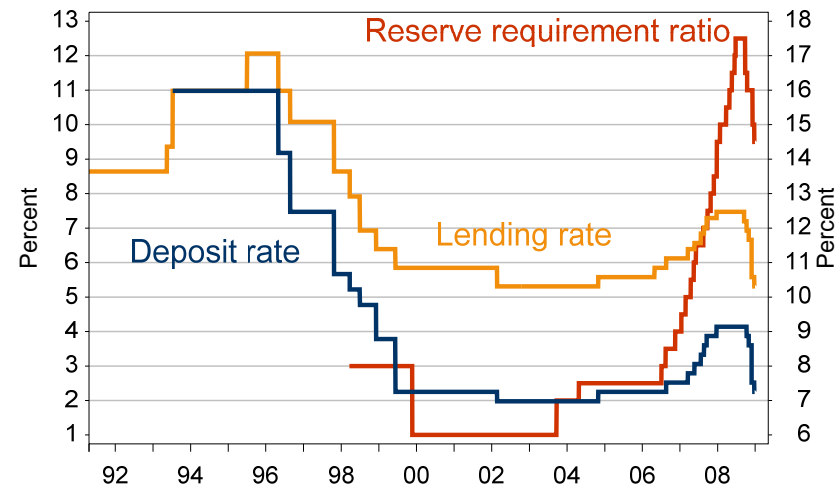
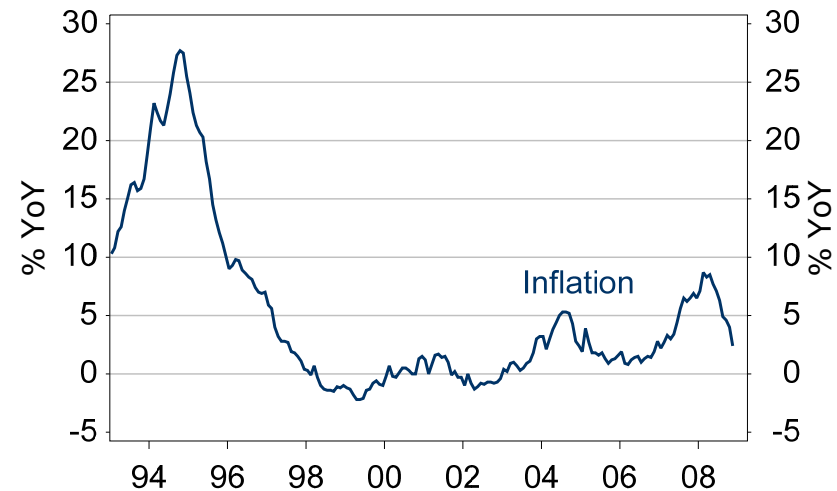


Source: Reuters EcoWin

Resolute support to the economy

- Policy to save the day: Monetary policy

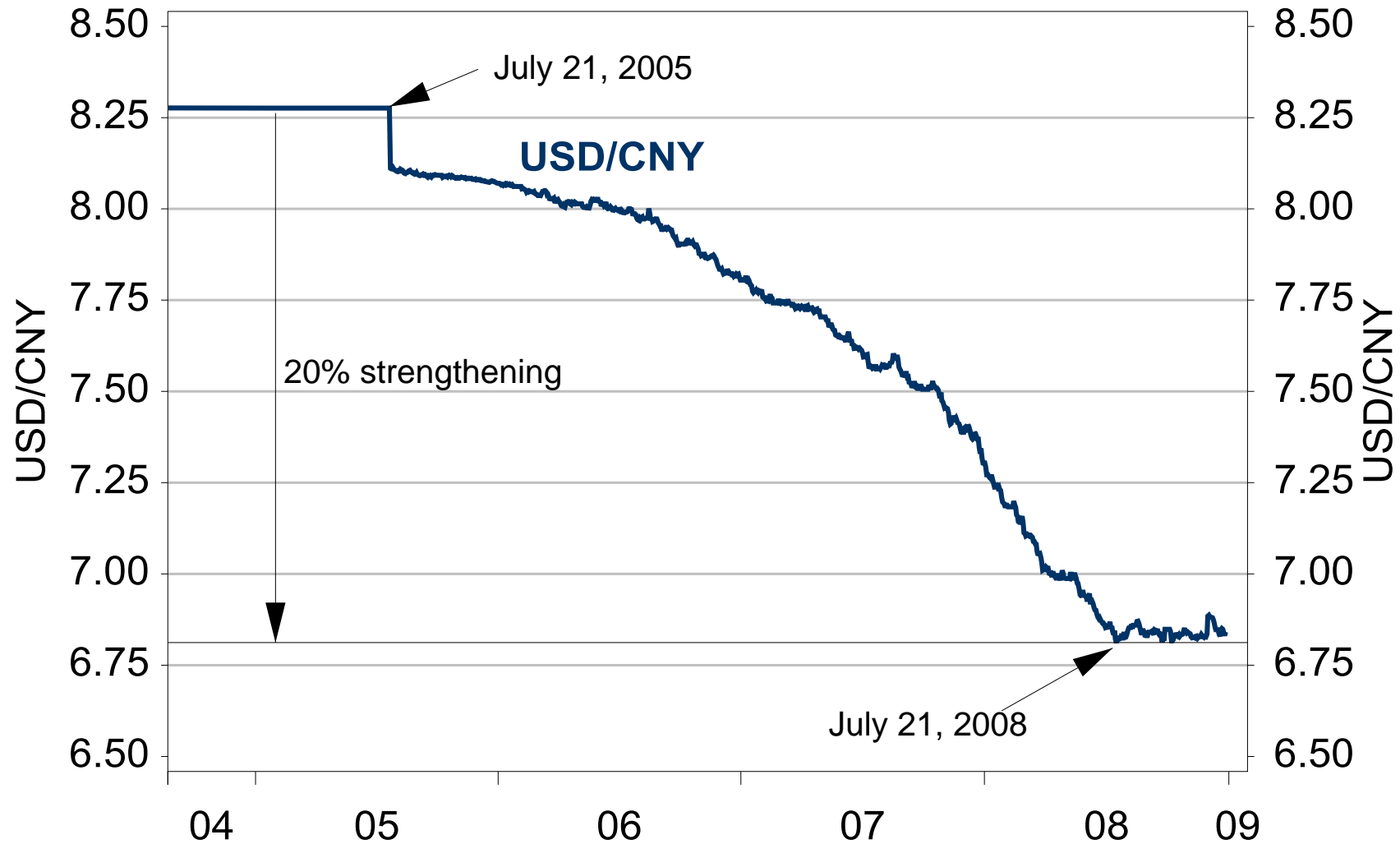
- Inflation no longer an issue...reached 22-mth low in November and is rapidly declining
- Leeway to cut rates
 - Benchmark lending and deposit rates
 - Actual lending rates
 - Unimportant for spending...
 - ...but quite important for SME CAPEX
- Easing reserve requirements
- Raising lending quotas
 - Preferably directed to SME and agriculture
 - Mostly symbolic
 - Banks didn't fill them
- Special encouragement to buyers of "affordable housing" (< 90 m²)
 - Lower mortgage rates
 - Lower equity requirements
 - Cut in transactions tax



Source: Reuters EcoWin

Resolute support to the economy

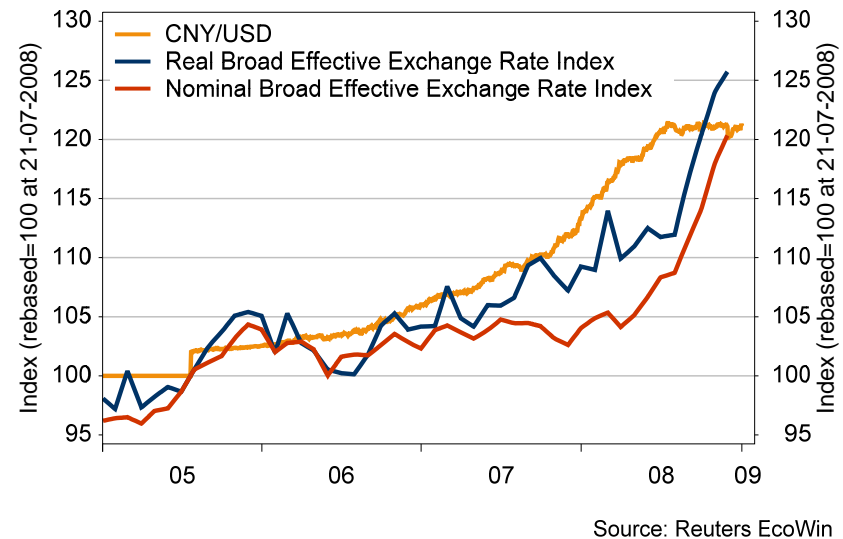
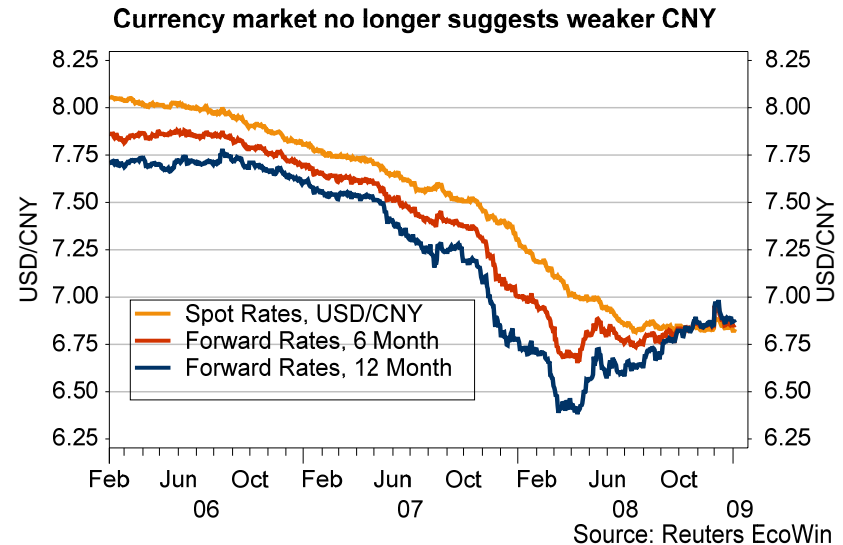
- What about the renminbi – return to a hard peg?



Resolute support to the economy

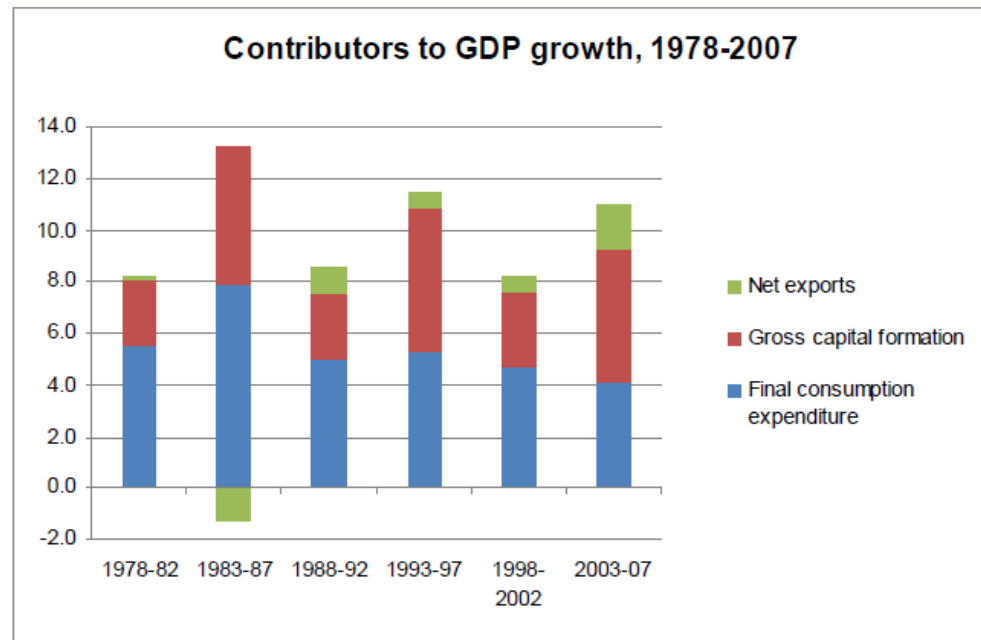
- And the exchange rate is also helping – shift in exchange rate policy?

- Risk to outlook from weaker than expected exports
- VAT refunds for exports
 - Protectionism?
- Depreciation of the CNY? Would be bad for the rest of the world...deflation!
- No....We expect a flat CNY/USD during 2009
- Continued real strengthening despite nominal weakening
- We expect policymakers to remain focused on shifting the growth engine towards domestic demand



Hard or soft landing? - Historical evidence...

- Runs 5-year business cycles of upswings and slowdowns with investment activity being the primary swing factor
- China has had two hard landings in the past 30 years:
 - Tiananmen Square protests (1987-1991)
 - Asian Financial Crisis (1996-2000)
- Both those recessions resulted from a combination of cyclical, structural and exogenous shocks
- During previous slowdowns net exports actually contributed positively to growth

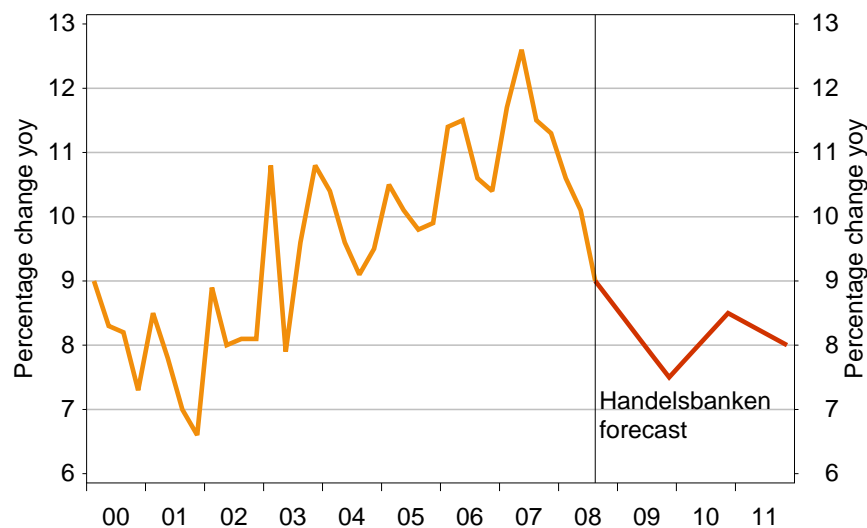


| | Up cycle average | Down cycle average | 2007 | 2009-10 forecast |
|--------------|------------------|--------------------|-------------|------------------|
| Net exports | 0.4 | 0.6 | 2.3 | -0.5 |
| Investment | 5.3 | 2.7 | 4.9 | 3.3 |
| Consumption | 5.7 | 5.1 | 4.7 | 5.2 |
| Total | 11.5 | 8.3 | 11.9 | 8.0 |

Hard or soft landing?

- Things are much different today!

- More severe exogenous shock this time
- plus cyclical downturn
- and no help from net exports
- sets the stage for a tough 6 months
- ...but structural rigidities has been greatly improved and...
- ...the government and bank's have plenty of funds to support the economy and cover their losses
- And the government is willing to do what it takes to keep growth at 8% or above
- Soft landing most likely but risks remain:
 - Global growth will slow further
 - Domestic consumption weaker than expected



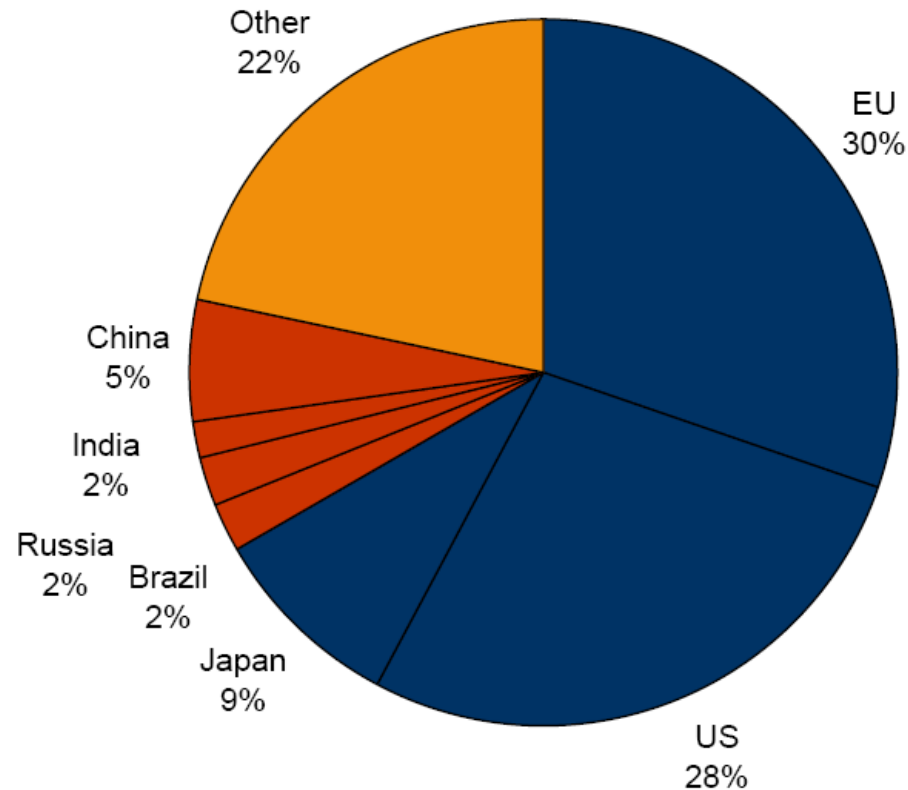
China and the rest of the world

- Global implications

- Strong enough to manage...but too weak to lead
- China's biggest contribution to help world stability is to keep it's own economy stable
- Investment slowdown is resource intensive which will slow demand for many commodities and undermine prices on global markets
- Big switch from exports to domestic demand
 - important for sustainability and
 - good for the world
- Many sectors negatively affected
 - Result in weaker commodity demand and
 - increased reliance on domestic demand will hurt shipping
- Adjustment to overcapacity will likely produce a new wave of downward pressure on global inflation
- China less of a source of funds
 - Trade surplus levelling out—closing?
 - Who will buy the new government bonds of developed nations?

In a global economy context, China is still relatively small...

World GDP at current prices in 2006 (IMF)



While the share of the BRIC countries in global GDP is smaller in current dollars than at PPP exchange rates, the absolute change in the combined nominal GDP of the BRIC countries is already now bigger than the change in nominal GDP in the US.

Handelsbanken's growth projections

Global GDP forecasts

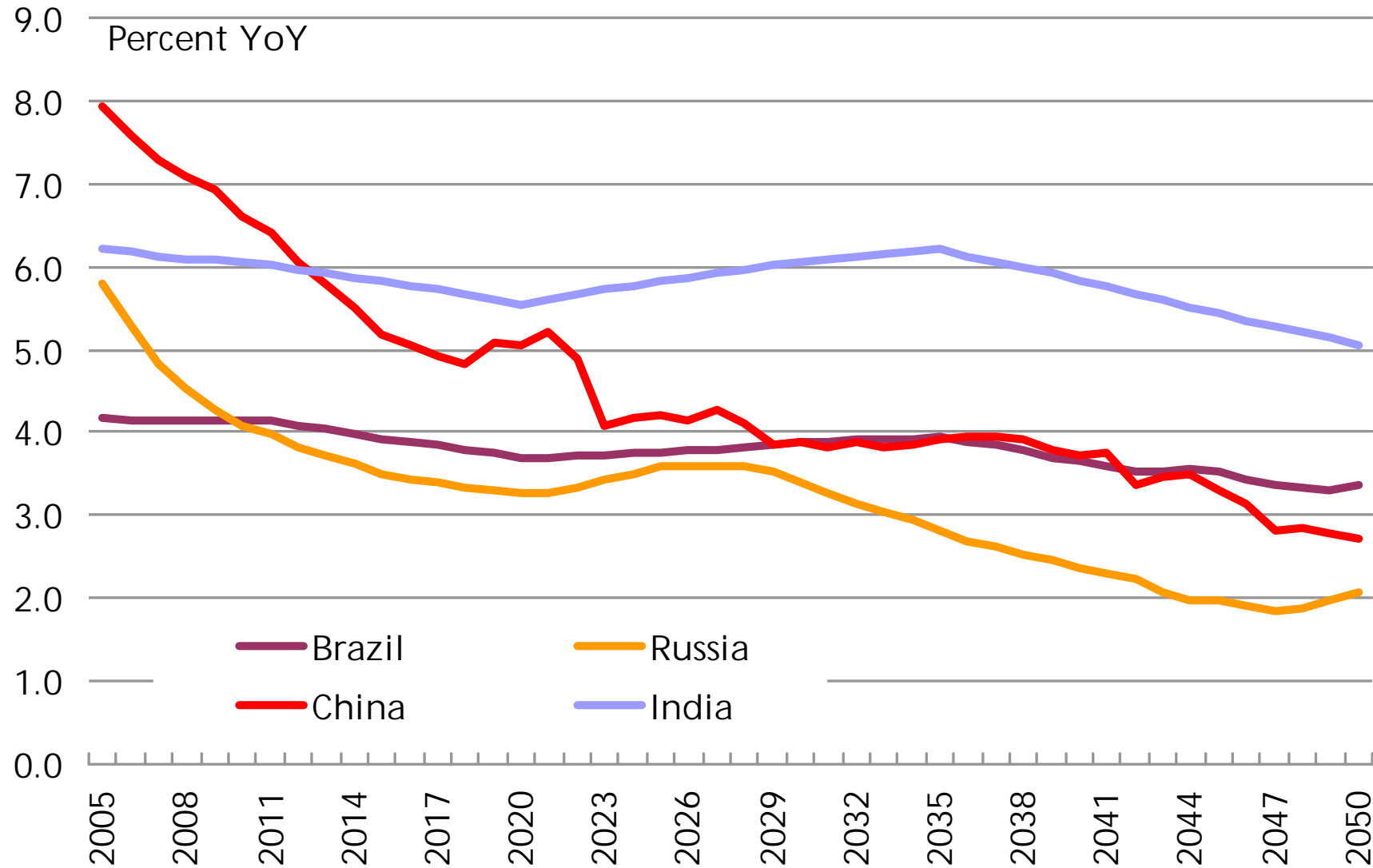
Percentage changes

| | | 2007 | 2008 | 2009 | 2010 |
|------------------------|--------------|------|------|------|------|
| USA | GDP | 2.0 | 1.3 | -1.9 | 1.1 |
| Eurozone | GDP | 2.6 | 1 | -1.2 | 0.6 |
| Germany | GDP | 2.5 | 1.6 | -1.4 | 0.7 |
| France | GDP | 2.1 | 1.2 | -1.2 | 0.6 |
| Italy | GDP | 1.4 | -0.2 | -1.4 | 0.5 |
| Japan | GDP | 2.0 | 0.2 | -1.0 | -0.2 |
| United Kingdom | GDP | 3.0 | 0.8 | -1.6 | 0.7 |
| Sweden | GDP | 2.7 | 0.4 | -1.8 | 1.1 |
| Denmark | GDP | 1.7 | -0.7 | -1.5 | 0.0 |
| Finland | GDP | 4.5 | 1.7 | -0.5 | 0.5 |
| Norway | GDP | 3.1 | 1.4 | -1.0 | 1.3 |
| Norway | Mainland GDP | 6.1 | 2.1 | -0.5 | 2.0 |
| Czech Republic | GDP | 6.6 | 4.3 | 2.5 | 4.4 |
| Hungary | GDP | 1.3 | 1.6 | -0.3 | 3.8 |
| Poland | GDP | 6.6 | 5.2 | 3.2 | 4.6 |
| Slovak Republic | GDP | 10.4 | 7.0 | 4.7 | 5.5 |
| Russia | GDP | 8.1 | 6.8 | 2.6 | 4.4 |
| Turkey | GDP | 4.6 | 2.5 | 1.8 | 4.5 |
| South Africa | GDP | 5.1 | 3.3 | 2.5 | 3.6 |
| China | GDP | 11.9 | 9.0 | 7.5 | 8.5 |
| India | GDP | 9.0 | 6.5 | 5.0 | 4.0 |
| Argentina | GDP | 8.5 | 5.0 | 2.5 | 4.0 |
| Brazil | GDP | 5.7 | 5.0 | 3.0 | 4.5 |
| Mexico | GDP | 3.2 | 2.0 | 1.6 | 2.4 |

Longer-term outlook

- Private investment growth was too high to be sustainable...
- Sustaining growth above 8% difficult in the long term...
- ...though 7-8% should be possible
 - Further reforms
 - Moving up the value chain and
 - Promoting private consumption and less saving among Chinese households
- Productivity is at best ¼ of developed economy best practice
- China's high structural growth rate depends heavily on the existence of a liberal system of global trade and capital flows
- The export channel contributes to vital technology transfer
- Hence, avoidance of protectionism is vital for long-run growth

Long run growth story intact - Productivity and currency appreciation to drive GDP



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