2008 Credit Risk Conference

An Overview for Hong Kong Exporters

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China: Economic Outlook

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Summary

- China’s key challenges: inflation, exports, earthquake
- Export slowdown is more worrying than headline numbers suggest
- Margin pressure on manufacturing
- Second round impact of export slowdown
- Inflation-related policy risk is abating
- Investment growth to remain robust in near-term
- Quantifying the impact of earthquake

Macroeconomic forecasts

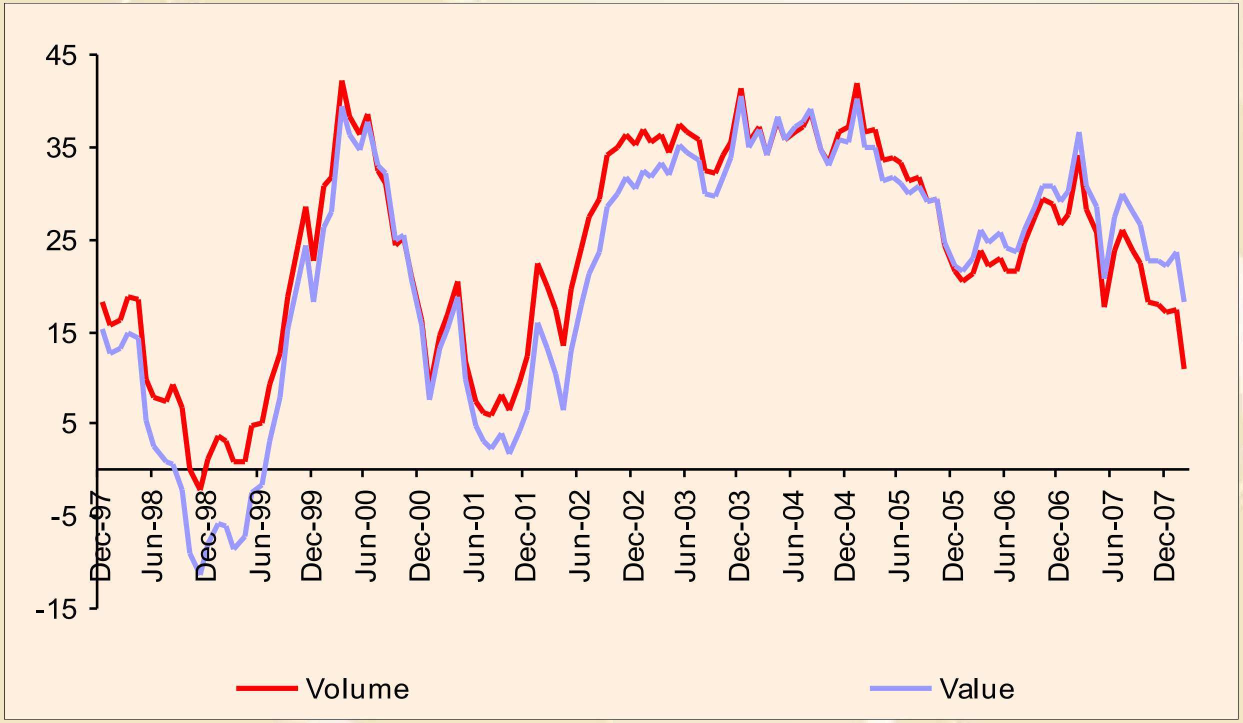
DB's China Macroeconomic Forecasts				
(% yoy)	2006	2007F	2008F	2009F
Real GDP	11.0	11.9	10.0	9.3
CPI	1.5	4.8	7.2	4.3
Bank loan (nominal)	15.1	16.1	14.5	14.5
Merchandise exports (nominal)	27.1	26.0	21.0	20.0
Merchandise exports (volume)	24.0	24.0	13.0	14.0
Fixed asset investment (nominal)	24.0	25.0	25.0	20.0
Retail sales (nominal)	13.7	16.5	19.0	15.0
Industrial production (real)	16.6	18.0	15.5	15.0
FX reserves (USD bn)	1066	1520	1820	2020
FX rate (eop) CNY/USD	7.81	7.35	6.70	6.40
1-year deposit rate	2.52	4.14	4.68	4.68

Sources: CEIC and Deutsche Bank

Export volume growth has slowed more quickly than official data suggests

- Overall export volume growth has slowed more sharply than official export growth (value terms).

Growth rates of China exports: Value vs Volume (yoy %, 3MMA)

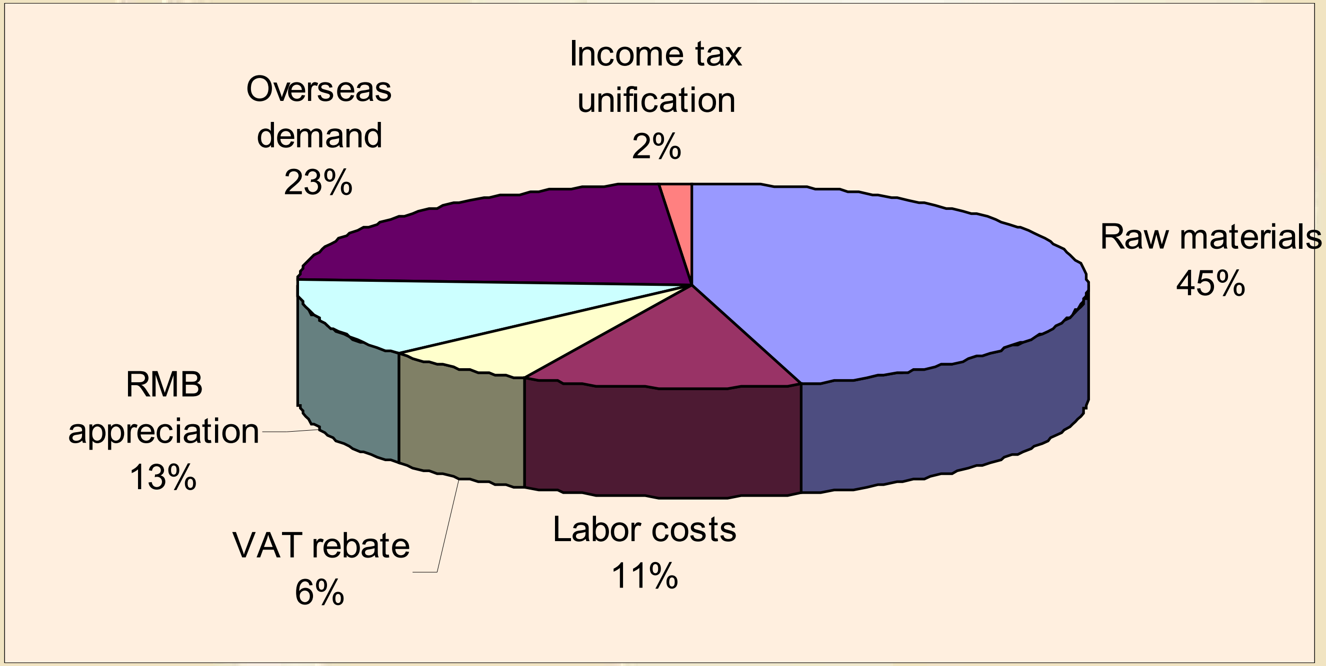


Source: CEIC, Deutsche Bank

Quantifying the sources of margin pressure

- Biggest sources of margin pressures are raw material costs, US slowdown, RMB, and labor costs 。

Key margin squeezers for Chinese exporters

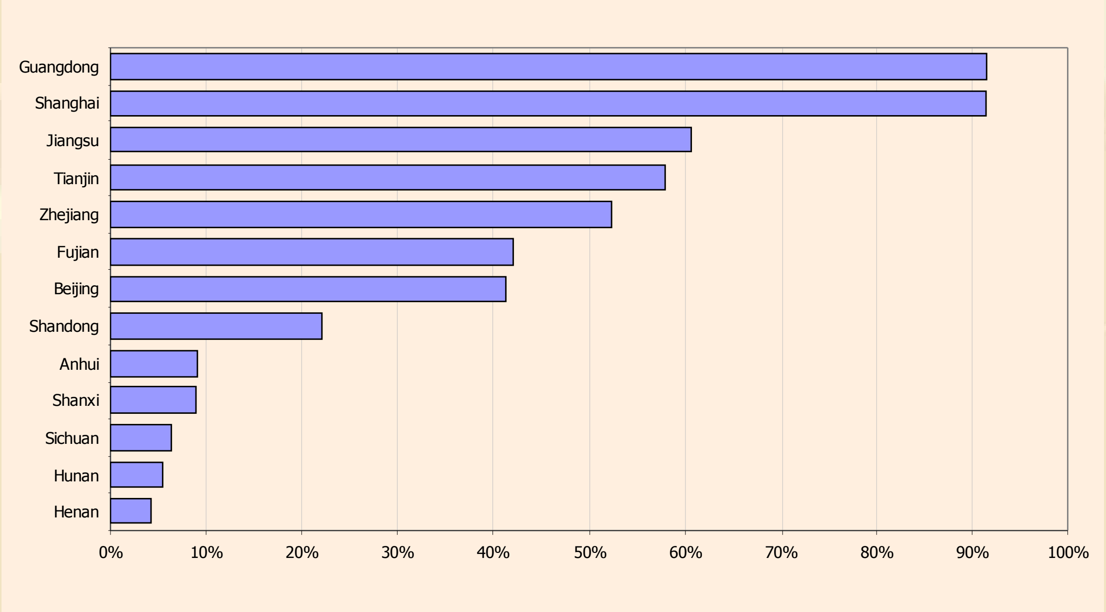


Source: Deutsche Bank

Negative second round impact of export slowdown

- Direct impact on banks with exposure to exporters; on ports and expressways in coastal provinces.
- Indirect ("second-round") impact through weaker investment and consumption in these provinces.

Export/GDP ratio by province, 2007

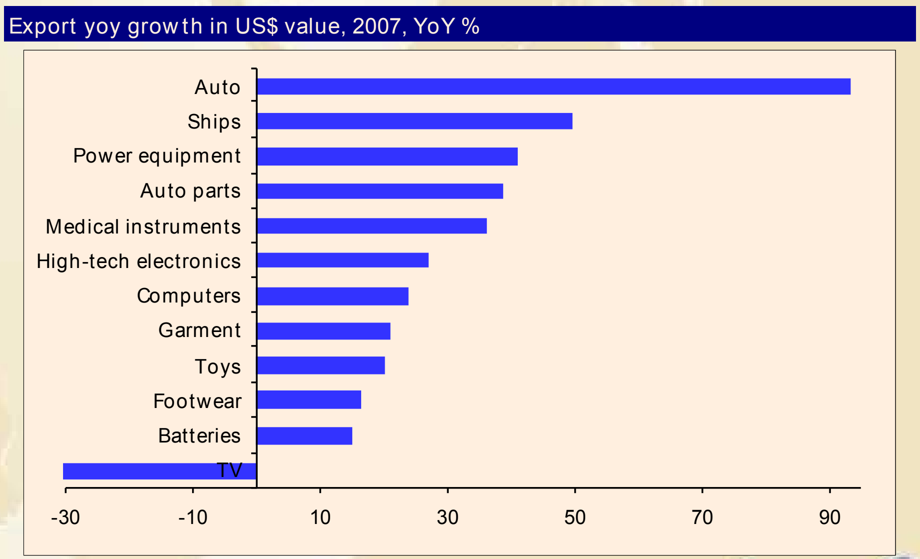


Source: CEIC.

Survival strategies

- Switching to domestic sales
- Investing in/acquiring brands & technologies
- Vertical integration
- Exporting to emerging markets
- Exporting high-end products
- Relocating to low cost regions

Source: CEIC.

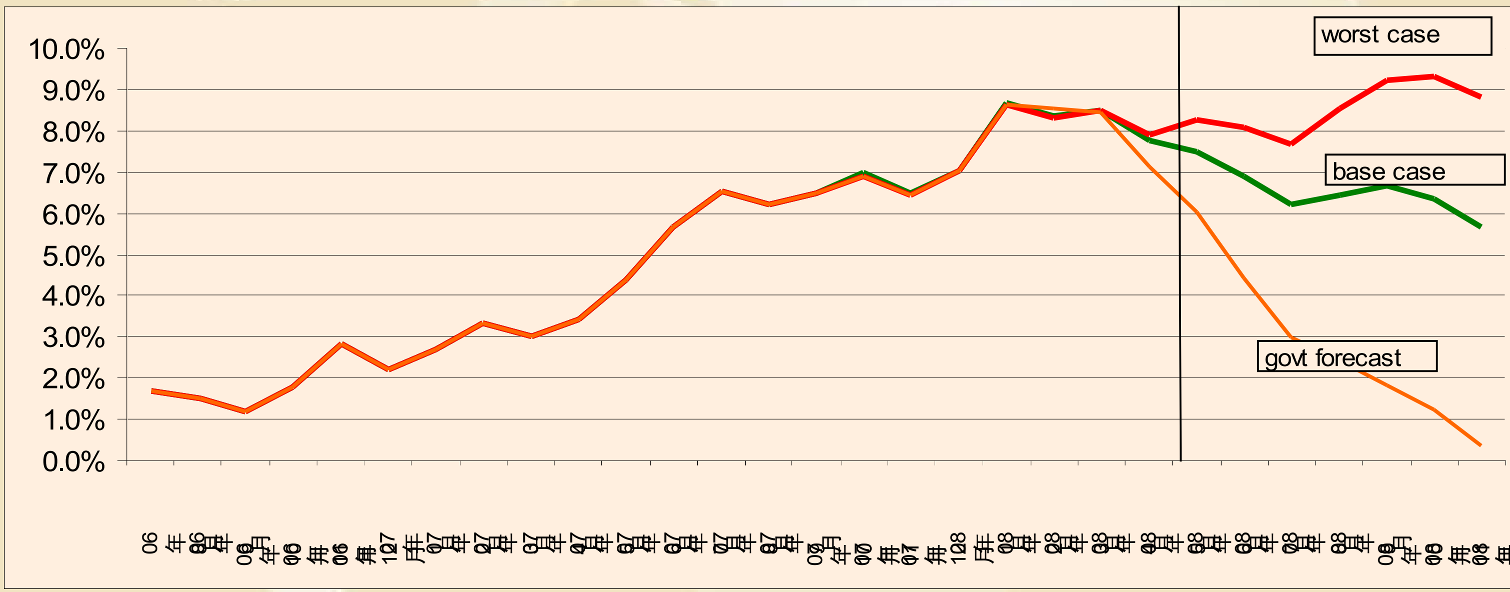


Source: CEIC.

Inflation outlook

- Our central scenario is that CPI inflation will fall to 7.5-7.8% in May and decelerate more gradually in the remainder of this year towards 6% in Q4

China’s CPI inflation, yoy%

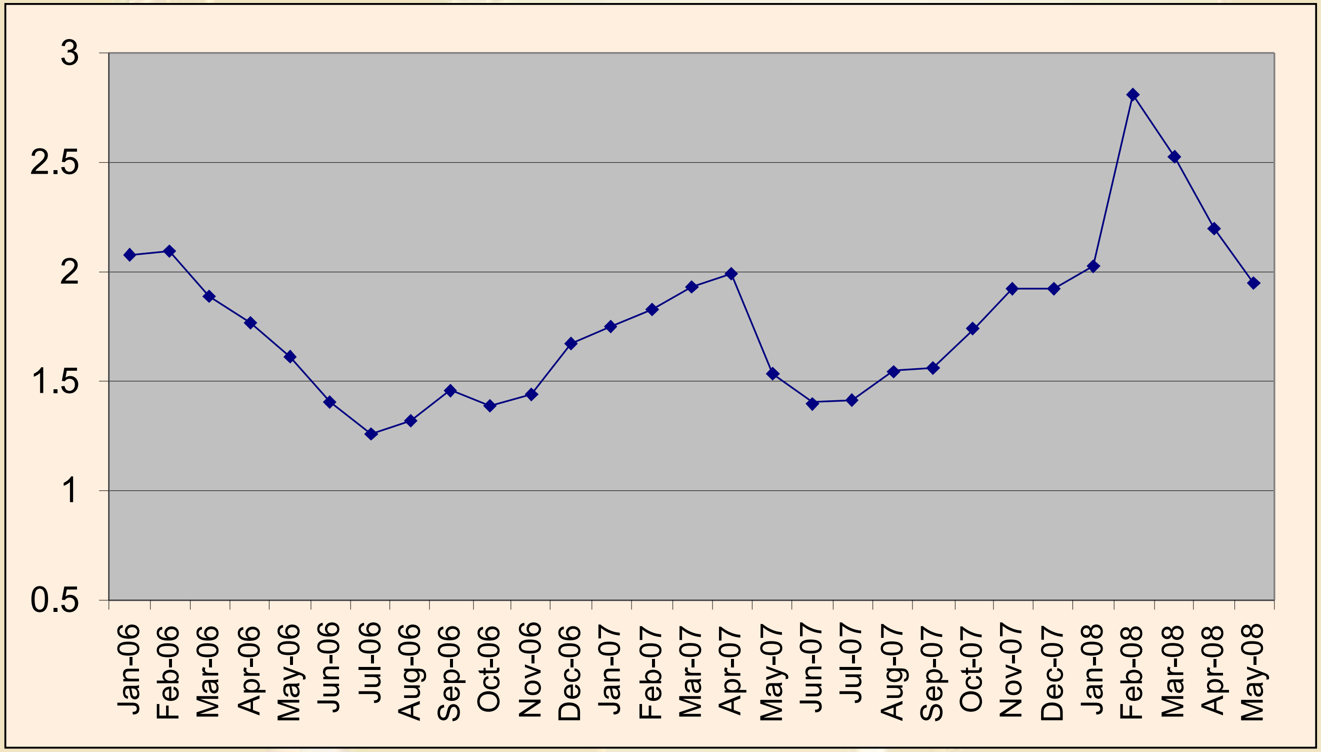


Source: CEIC and Deutsche Bank.

Near-term deceleration is driven by vegetable prices

- In recent weeks, the most important contributor to disinflation is the 30% decline in vegetable prices

Decline in vegetable price index is main contributor to near-term disinflation

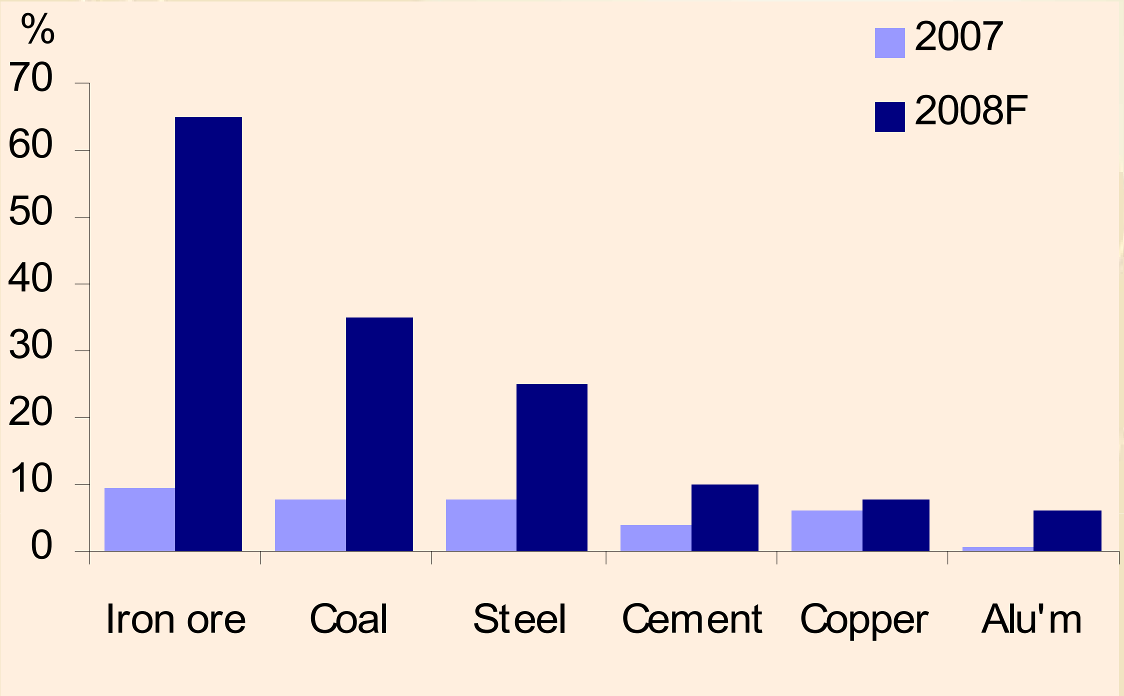


Source: Deutsche Bank. The numbers plotted in this chart are vegetable price index calculated by DB using Ministry of Commerce data

Potential upside to inflation: raw material prices

- We expect stronger raw material price increases this year than last year

Raw material price increases to accelerate

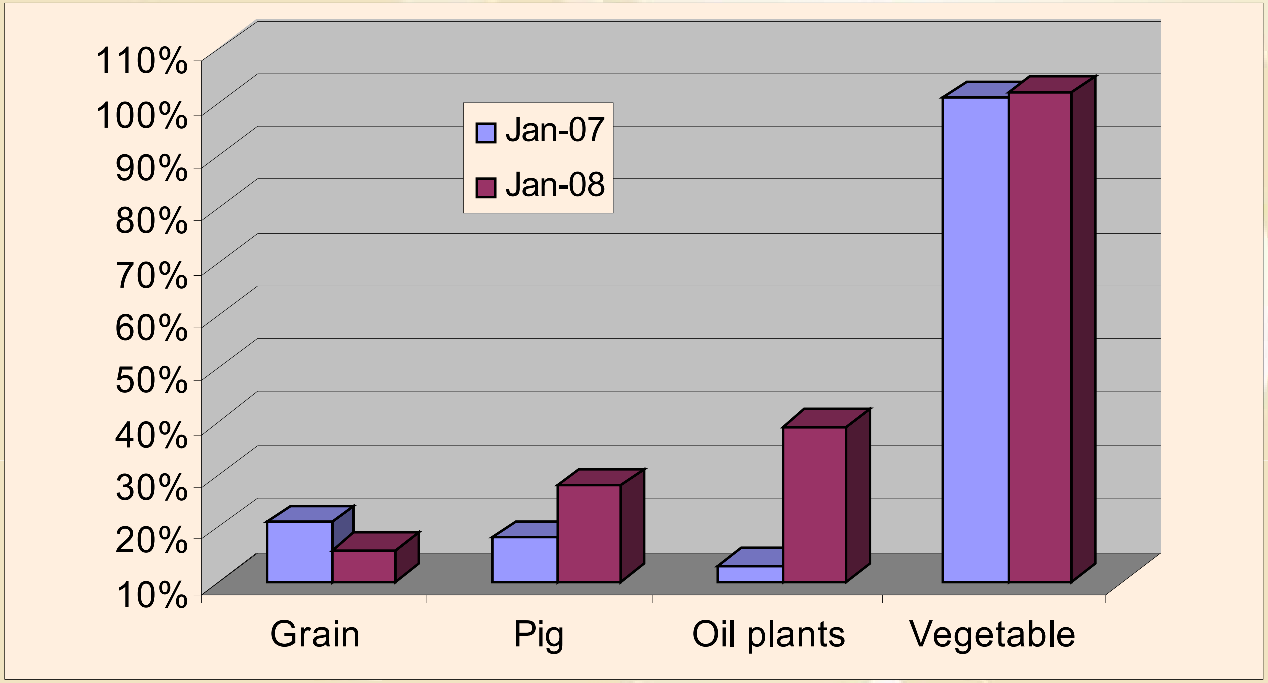


Source: Deutsche Bank

Potential upside to inflation: grain prices

- Although vegetable and pork production is recovering, falling profit margins on grain production could lead to another "surprise" to inflation in H2 this year. So far grain prices are up only 7% yoy vs 20% increase in fertilizer prices.

Return on producing agricultural products

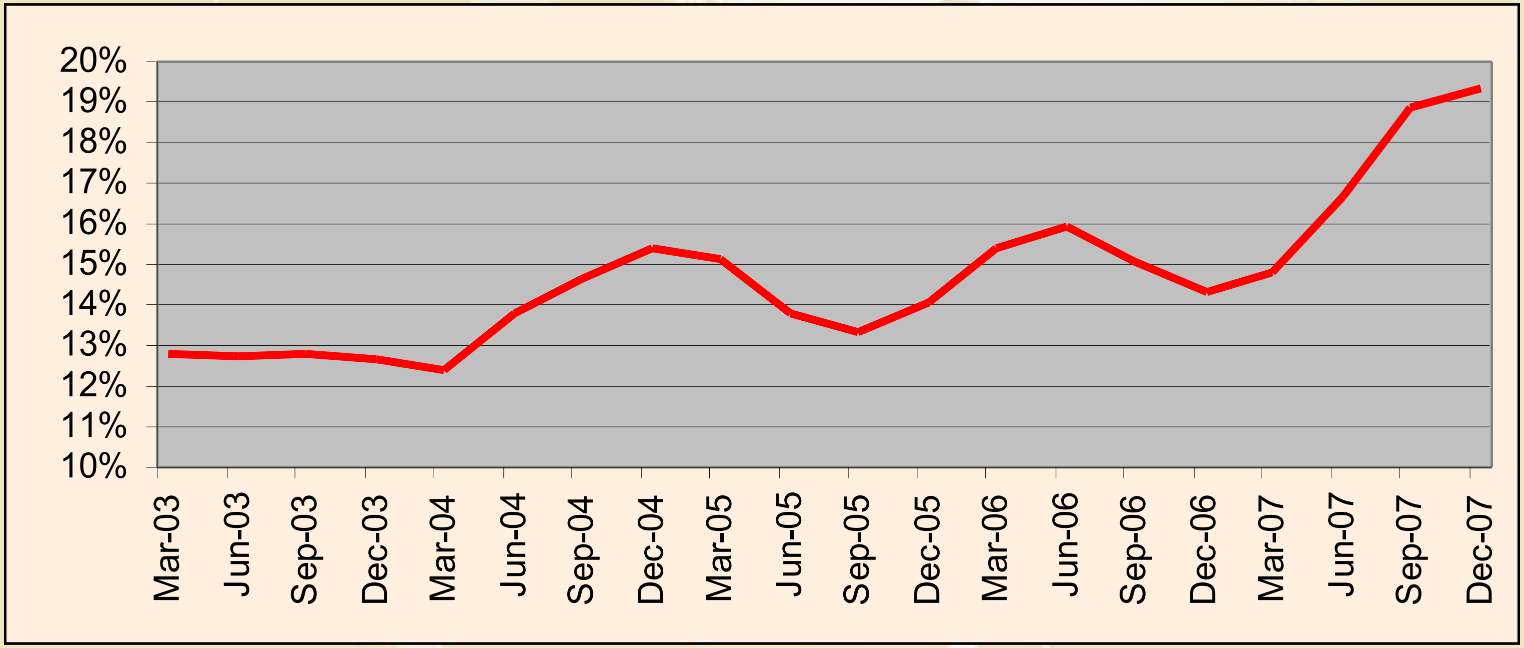


Source: Deutsche Bank

Potential upside to inflation: labour costs

- **Exacerbated by inflation, min wage hikes and new Labour Law, wage growth is accelerating. This helps to sustain real consumption but could simply trigger more inflation.**

China Average Wage Index, yoy% change, 3MMA



Source: Deutsche Bank, CEIC

Policy responses to inflation

- In the coming months, we expect
  - **Further monetary and credit tightening**
  - **Restrictions on agriculture/fertilizer/coal exports**
  - **Raising agriculture protection prices; increasing grain production subsidies**
  - **Increased imports of agriculture products**
  - **Maintenance of price controls**
- The following will be options in case inflation runs out of control:
  - **Cuts in fiscal spending; tougher project approvals by NDRC**
  - **Broadening of price controls to sectors like coal, fertilizer**
  - **Wage controls**
  - **Deposit rate indexing to CPI**

Measures to maintain supply under price controls

- We do not expect increases in retail oil prices and power tariffs on households before the end of the year, as inflation is unlikely to fall to 6% by then
- For refining sector, VAT tax relief was given to diesel and gasoline products, and will be granted to crude oil imports, to mitigate the potential negative impact of price control on supply
- For IPPs, six options are being considered by govt to maintain production:
  - **Government subsidies or tax relieves**
  - **Raising tariffs on grids**
  - **Raising tariffs on industrial users**
  - **Controlling coal prices**
  - **Reducing exports of coals**
  - **Resuming production of more small coal mines**

Near-term FAI momentum to remain strong

- There was a recent pick up in # of newly started FAI projects, although the time series has not been stable
- Post-election syndrome at local level: after local gov't reshufflings, most are seeking to attract investments to demonstrate their "political performance"
- Reconstruction after earthquake will continue to support strong FAI growth in coming months.
- Positive for steel, cement, and coal in near term.

FAI growth may slow by end-year, due to margin compression

- Margin compression has become visible since beginning of this year.
- If this trend continues for another 6 months, FAI may slow by end of this year due to weaker profitability.
- Many non-export manufacturing sectors, including non-ferrous auto parts, machine tools, and paper, are facing similar margin pressures due to stronger raw material and wage inflation.

Before-tax profit margin

	Jan-Nov 2007	Jan-Feb 2008	Margin Change(ppt)
Oil refining	1.4%	-6.3%	-7.8
Water supply	3.5%	-3.3%	-6.8
Power supply	7.3%	1.9%	-5.4
Chemical fiber	3.8%	2.0%	-1.8
Non-ferrous smelting	6.0%	4.6%	-1.4
Raw chemical materials	6.3%	5.1%	-1.2
Steel smelting	5.5%	4.3%	-1.1
Textile	3.8%	3.0%	-0.8
Machinery	6.4%	5.6%	-0.8
Auto	6.2%	5.5%	-0.7
Paper	5.7%	5.1%	-0.7
Electronics	3.3%	3.1%	-0.3
Garment	4.3%	4.3%	0.0
Coal mining	10.4%	11.0%	0.6
Food manufacturing	6.0%	6.7%	0.6
Ferrous mining	14.8%	20.7%	6.0
Oil & natural gas	43.7%	51.1%	7.5

Source: CEIC, Deutsche Bank

Impact of earthquake: post-quake construction will stimulate FAI

- People
  - **34,073 dead, 245 thousand injured, 4.6mn evacuated as of May 19**
- Economy
  - **Total direct loss: about RMB 500bn**
- Infrastructure
  - **4.7mn houses destroyed or damaged**
  - **6,043 km of road damaged**
- Preliminary estimates on reconstruction spending
  - **Total: RMB 600-800bn over next 3 years (6-8% of 07 FAI)**
  - **Houses: RMB200-300bn over next 3 years (8-11% of 07 real estate investment)**

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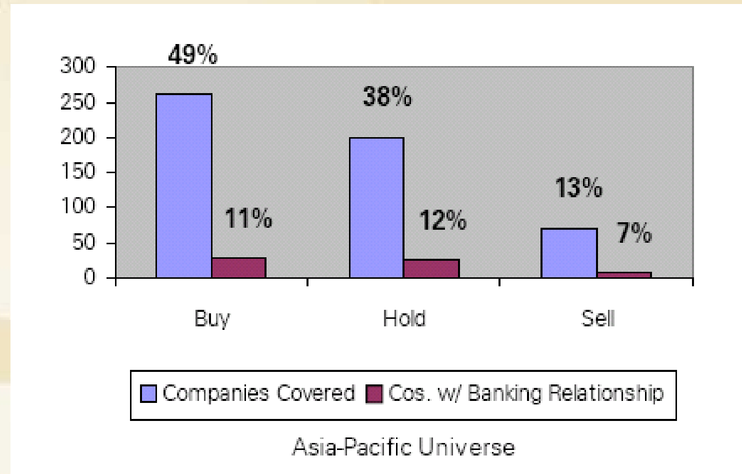

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