China Economic Insight

2014

Contents

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Executive Summary

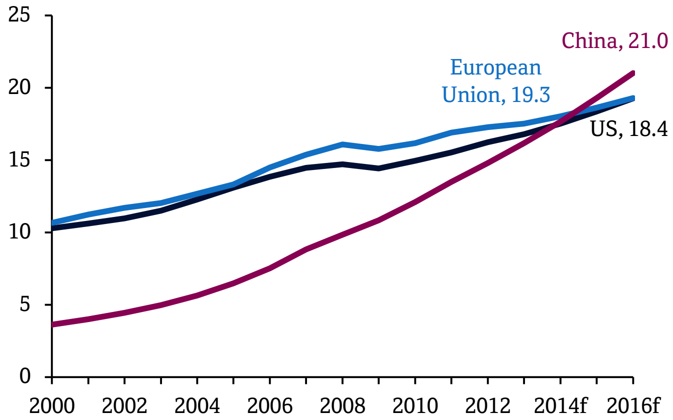
- **Strong investment and exports have driven rapid GDP growth** over the last 30 years, but this model is no longer sustainable due to overcapacity and weak global demand
- **The authorities aim to guide growth onto a more sustainable path** by encouraging domestic consumption and services in order to raise China from a middle to high income economy; this will inevitably mean lower GDP growth over the medium term
- **Reforms have been accelerated after the new leadership came to power in early 2013** (see the *Sustainable Growth* chapter) and primarily aims to: open markets and increase private sector involvement; liberalize exchange rates, interest rates and the capital account (see the *Financial Liberalization* chapter); increase urbanization; and tackle the buildup of leverage in government finances and shadow banks
- **The investment slowdown is dragging down overall GDP growth**, but government stimulus measures are expected to keep growth above 7% in 2014-16
- **The current account surplus should continue to narrow** as higher consumption strengthens domestic demand
- **The budget deficit has narrowed owing to higher tax revenue, but is expected to widen slightly in 2014-16** as the authorities add fiscal stimulus to meet the growth target
- **Inflation is expected to remain below target in 2014-16** leaving room for monetary stimulus
- **Exchange rate controls have been eased** and a gradual strengthening of the currency is expected as the capital account is liberalized, leading to larger portfolio inflows
- **Growth in the banking sector is likely to remain robust** as Chinese consumers are expected to take out more loans to finance the purchase of homes, durable goods and higher consumption
- **The shadow banking sector is mushrooming** as a means to circumvent the restrictions in traditional banking, leading to rising liquidity and default risks
- **The main systemic risks relate to a slowdown in the real estate sector**, which is connected to excessive leverage in shadow banking and high local government debt
- **Reforms will also need to address other medium term challenges and risks,** such as high debt, rising pollution and corruption

Background

China is set to become the world's largest economy by 2014

China has transformed over the last 30 years from a predominantly agrarian economy to the world's factory, lifting 500m people out of poverty in the process. It is now the most populous nation (1.36bn people), the largest contributor to global growth, the largest exporting nation, and is expected to become the world's largest economy in 2014. Nonetheless, China remains a middle income country, with the challenge of raising itself to a high–income economy—GDP per capita was just under USD12k in China in 2013, compared with USD53k in the US. To achieve this, China plans to enact a new transformation from an investment–led to a consumer-based economy. China currently has the world's highest private savings at around USD5tn. Encouraging people to spend more of these savings to drive the economy forward is the main challenge for the future.

GDP of the World's Largest Economies
(tn USD adjusted for purchasing power parity, 2016 value shown)

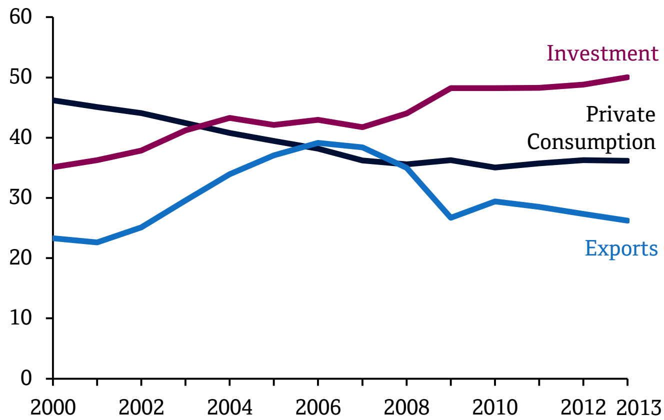


Sources: International Monetary Fund (IMF)

Strong investment drove growth over the last 30 years, but this model is no longer sustainable

Investment in infrastructure and manufacturing and a focus on exports have driven rapid GDP growth. In the 2000s, privatization, low labor costs and opening up to foreign investment drove economic expansion. In 2008, a USD600bn stimulus (mainly infrastructure projects) further boosted investment growth as exports slowed due to the global recession. This growth model is now unsustainable: over-investment, combined with weak global demand, have led to excess capacity in manufacturing and infrastructure and high credit levels (196% of GDP) from traditional and shadow banks. As a result, the authorities aim to guide the economy onto a more sustainable growth path by encouraging domestic consumption and a service-oriented economy (see *Sustainable Growth* chapter).

Consumption, Investment and Exports
(Share of GDP)

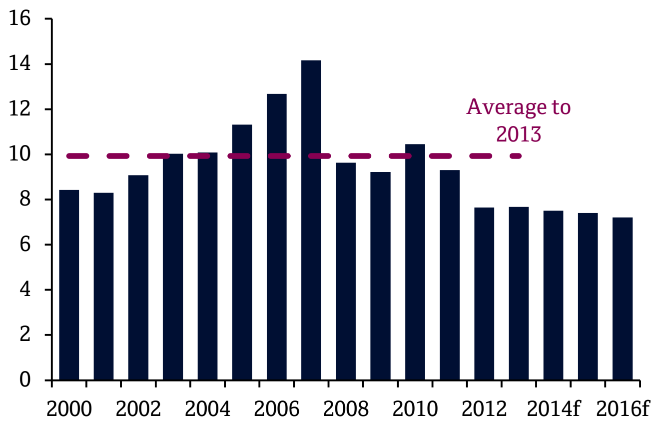


Sources: National Bureau of Statistics (NBS)

Lower growth is just one of China's medium term challenges

Chinese growth fell below its historical average in 2011-13 and is expected to slow further. China grew by an average annual rate of 9.9% since 2000. However, growth has slowed progressively in recent years, from 10.4% in 2010 to 7.7% in 2013, and is expected to continue slowing to around 7.2% by 2016. China's new leadership (in power since March 2013) has taken action to enhance growth (financial liberalization; tax breaks for small companies; and more financing for social housing). Further reforms are expected to increase openness and encourage the development of the private sector (see *Sustainable Growth* chapter). However, reforms will also need to address other medium term challenges and risks, such as high debt, rising pollution, a mushrooming and unregulated shadow banking system (see *Banks and their Shadows* chapter) and corruption.

Real GDP Growth
(%)



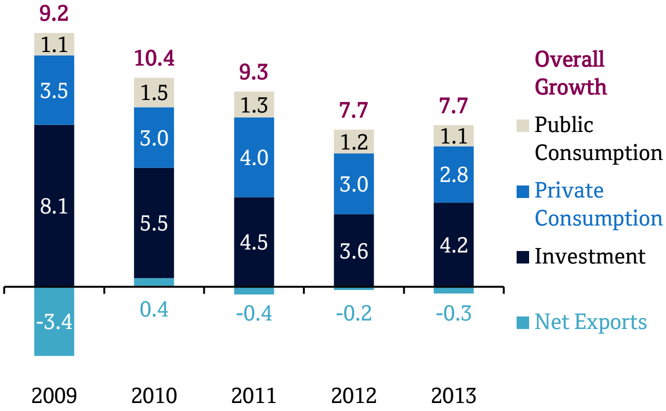
Sources: NBS

Recent Developments (2013-14)

The investment contribution to GDP rose in 2013, after falling for the previous four years

A hefty government stimulus program boosted the contribution of investment to real GDP growth in 2013, partly offsetting lower contributions from consumption and net exports. The contribution of investment picked up as the government increased railway investment and loosened monetary policy in order to achieve its targeted growth rate. This helped stabilize overall growth at 7.7%. The contribution of private and public consumption slowed, partly reflecting a tightening of fiscal policy and a cooling of the property market. The weak global recovery weakened demand for Chinese goods, pushing down the contribution of net exports.

Contributions to Real GDP Growth
(% of GDP)

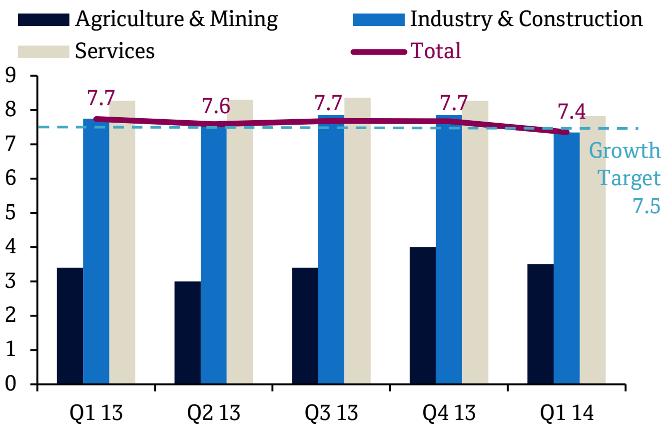


Sources: NBS

Growth slowed below target in Q1 2014, but a further government stimulus will sustain the growth momentum

Real GDP growth in Q1 2014 slowed to 7.4%, falling below the official target of 7.5%, but the government has already announced stimulus measures to boost growth. Growth slowed across the major sectors, although some of the slowdown may have been related to the Lunar New Year holiday, when many firms close down for two weeks. In Q2, the government announced fiscal and monetary stimulus measures, such as tax breaks, increased spending and cuts to bank reserve requirements (see below), which should be supportive of growth. Services was the fastest growing major sector in 2013-14, supporting the transition to a more consumer-oriented economy (see *Sustainable Growth* chapter).

Real GDP Growth
(%, year on year)

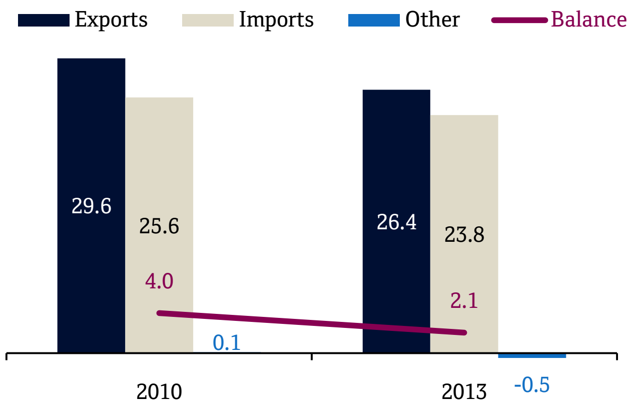


Sources: NBS

The current account surplus has narrowed, indicating that external economic rebalancing is underway

The current account surplus has narrowed gradually as export growth has slowed due to weak global demand. A high percentage of Chinese imports are inputs for export manufacturing. Therefore, import growth slowed in line with export growth. Nonetheless, import growth has been somewhat higher than export growth as a growing share of imports are for domestic consumption and rapid growth in Chinese tourism has boosted imports of services for transportation and travel. Historical current account surpluses and high inflows of foreign investment have led to the rapid accumulation of international reserves. Controls on the capital account limit foreign portfolio inflows.

Current Account
(% of GDP)

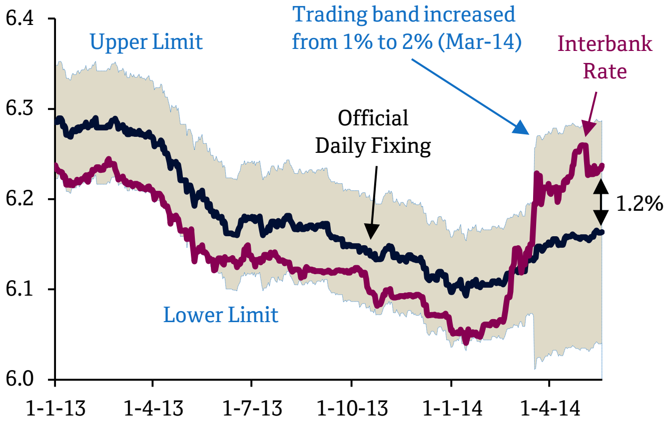


Sources: NBS and IMF

Exchange rate controls have been eased as China moves towards full capital account liberalization

The exchange rate is allowed to float within a 2% band above or below a level set daily by the PBC, up from 1% since March 2014. The authorities have stated the objective to gradually move toward a fully floating exchange rate as part of reforms to liberalize the capital account (see *Financial Liberalization* chapter). Having allowed the exchange rate to appreciate during 2013, the PBC has reversed course since early 2014 and the currency has weakened. This may be to increase export competitiveness as growth slows or to ward off speculators betting on further appreciation before increasing the exchange rate band. The sale of Chinese Yuan to weaken the currency has led to an accumulation of foreign exchange reserves, which have risen from around 18.1 months of import cover at end-2012 to around 20 months at end-March 2014, or USD3.9tn.

Exchange Rate
(USD:CNY)

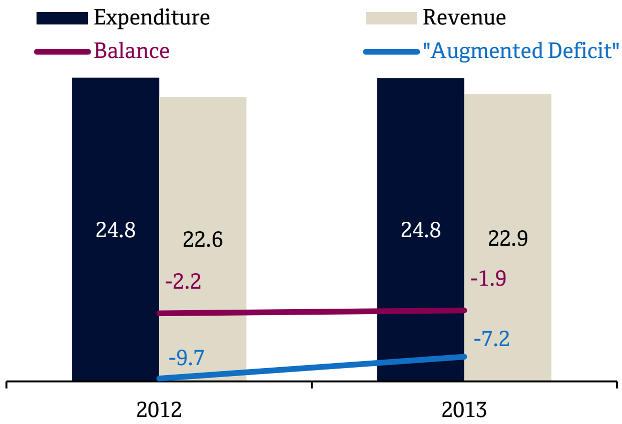


Sources: Bloomberg

The budget deficit narrowed, leaving room for fiscal stimulus even when off-budget activities are factored in

Rising tax revenue helped narrow the fiscal deficit. However, the official fiscal deficit excludes a number of off-budget activities. In recent years, local governments have increasingly financed infrastructure projects through the shadow banking system (see *Banks and their Shadows* chapter) or through land sales. If this is considered as extra financing, it would add to the fiscal deficit. The IMF estimates that this "augmented fiscal deficit" was around 7.2% of GDP in 2013. There are additional government liabilities related to financial sector, state owned enterprise (SOE) debt and shortfalls in the pensions system. However, offsetting all of this, the government holds significant assets in sovereign wealth funds, pension funds and equity stakes in SOEs. Therefore, the government has sufficient resources to provide additional fiscal stimulus, if needed, to help meet its growth target.

General Government Budget
(% of GDP)

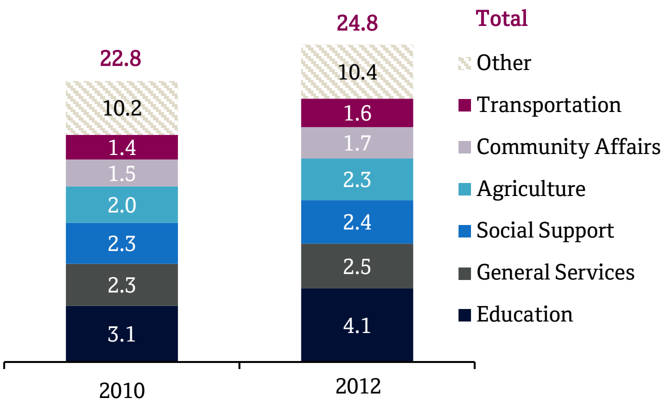


Sources: IMF

Fiscal policy has been used to stimulate growth and support key sectors, such as education

The government has implemented a series of fiscal stimulus packages and boosted spending on education. There was a significant increase in education expenditure in 2010-12 as part of efforts to rebalance the economy towards services. This should help boost human capital over the longer term, supporting the development of a service-oriented economy. Fiscal stimulus measures in 2013-14 have mainly included tax breaks for small companies to support the private sector; increased financing for social housing; and spending on new high-speed railways. This has led to higher community affairs, general services, social support and transportation.

Expenditure Breakdown
(% of GDP)



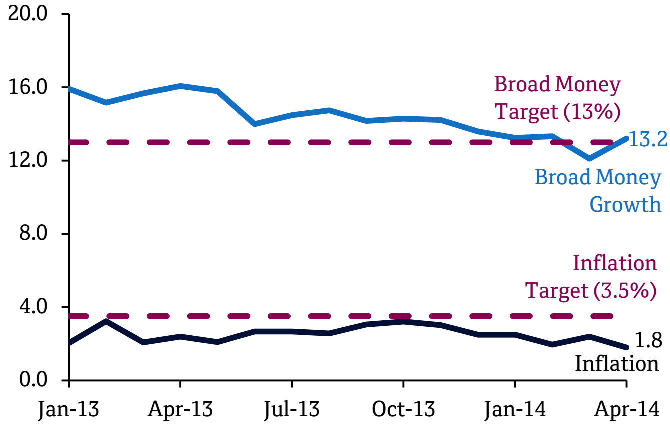
Sources: NBS

Inflation is below target, leaving room for monetary stimulus

Inflation was 1.8% in the year to April and has been consistently below the target of 3.5%, which gives the PBC room for further monetary stimulus. Meanwhile, broad money growth was just above the 13% target, but this target is of secondary importance to the authorities. Producer prices fell 1.4% in the year to May and have fallen each of the last 27 months. This should leave the authorities with room to ease monetary policy further without deviating too far from their targets. The central bank cut the reserve requirement ratio (RRR) from 21.5% in 2011 to 20% in 2012. It cut the RRR at rural banks by between 0.5% and 2.0% in April 2014, just after Q1 GDP growth came in below target. Another 0.5% cut to the RRR was made in June for banks that lend to the agricultural sector and SMEs in order to add liquidity and further stimulate private consumption.

Inflation and Broad Money Growth

(%)



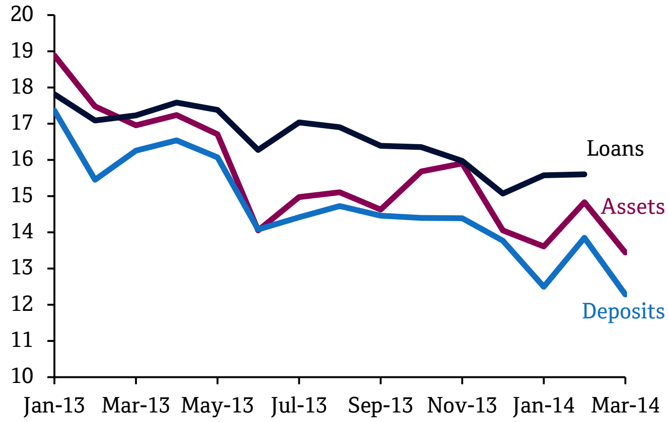
Sources: People's Bank of China (PBC) and NBS

Growth of the banking sector is slowing

Growth in the banking sector has been slowing in 2013-14, reflecting the authorities' intent to control excessive credit growth. The PBC is concerned about high lending to certain sectors (property and mining) and the growing shadow banking sector. Almost half of all new credit in China last year was issued through the shadow banking system, which is mainly banks creating off-balance sheet vehicles to boost lending and attract investment (see *Banks and their Shadows* chapter). The average return on equity is falling (19.2% at end-2013) owing to slowing growth and higher provisioning. Recognized NPLs were only 1.0% at end–2013, but unrecognized NPLs are thought to be significant, but estimates are unavailable. However, capital buffers are adequate at most banks, with the capital adequacy ratio at 12.2% at end-2013.

Banking Sector Growth

(% change, year on year)



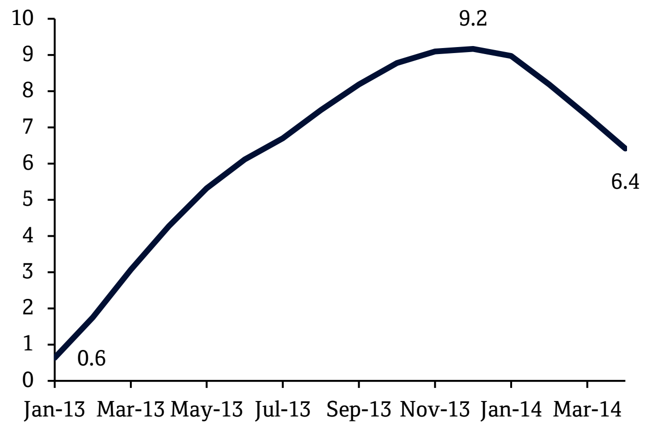
Sources: PBC

Links between real estate, shadow banking and local government debt are the main systemic risk

The authorities are concerned about a slowdown in the real estate sector. The number of new projects and investment in real estate has slowed, leading to slower price increases. Annual growth in an official index of house prices in 70 major cities slowed from 9.2% in December 2013 to 6.4% in April 2014. A private index covering 100 cities showed a decrease in prices of 0.3% in April 2014. There is a risk that a downturn in real estate could impact the real economy by eroding household wealth and negatively impacting production in connected sectors, such as steel, cement and household appliances, which are already suffering from excess capacity. Lending to local governments, property developers and mining companies through the shadow banking system (see *Banks and their Shadows* chapter) may have led to the buildup of excessive debt. A correction in property prices could put pressure on leveraged borrowers, potentially leading to defaults and liquidity issues in the shadow banking system.

Real Estate Prices (in 70 major cities)

(% change, year on year)



Sources: NBS

Macroeconomic Outlook (2014-16)

A continued investment slowdown is expected to lead to lower real GDP growth over the medium term

Real GDP growth is expected to slow gradually from 7.7% in 2013 to 7.2% by 2016 owing to the slowdown in investment. Private consumption should pick up, encouraged by government policies to open markets and boost spending. We expect the contribution of private consumption to real GDP growth to rise to 3.3 percentage points (pps) by 2016, compared with 3.1pps from investment, as the economy becomes more consumer driven (see *Sustainable Growth* chapter). The contribution of public consumption should remain flat at 1.0pps as the government expands its education and health services. A recovery in external demand should support export growth in 2014 and 2015, making the contribution of net exports positive.

The current account surplus is projected to narrow slightly as import growth outpaces exports

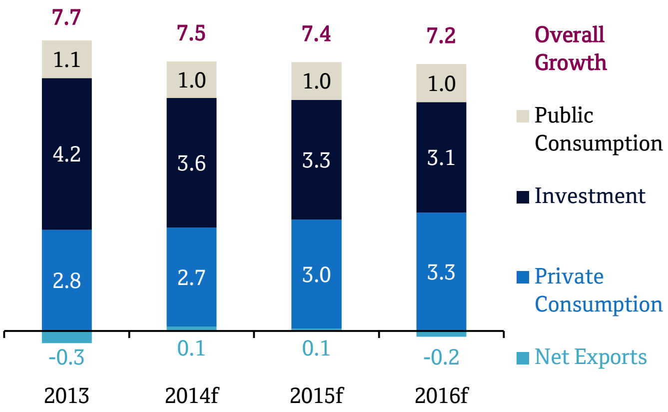
Imports are expected to rise on higher private consumption as the economy becomes more consumer based and services oriented. Accelerating private consumption growth and the stronger exchange rate should increase demand for imports, tourism and travel. Meanwhile, the environment for Chinese exports is expected to remain challenging. Rising wages and a stronger exchange rate (see below) will undermine the competitiveness of Chinese exports while competition from other Asian emerging markets increases. Conversely, the global recovery should support demand for Chinese exports. As a result, exports are expected to remain broadly constant as a share of GDP. Overall, we expect the current account surplus to narrow slightly as imports grow faster than exports.

A managed appreciation of the exchange rate is expected and international reserves may start falling

We expect the exchange rate to appreciate steadily in 2014-16 as capital inflows are gradually liberalized, leading to higher portfolio inflows (see *Financial Liberalization* chapter). The authorities are likely to continue their policy of allowing the currency to strengthen gradually in order to encourage domestic consumption (by making foreign goods cheaper) and to reduce external imbalances by helping to lower the current account surplus. As a result of the narrowing current account surplus and growing imports, international reserves are likely to fall to around 19.1 months of import cover by 2016. However, in absolute terms they should continue to accumulate to around or USD5.4tn.

Contributions to Real GDP Growth

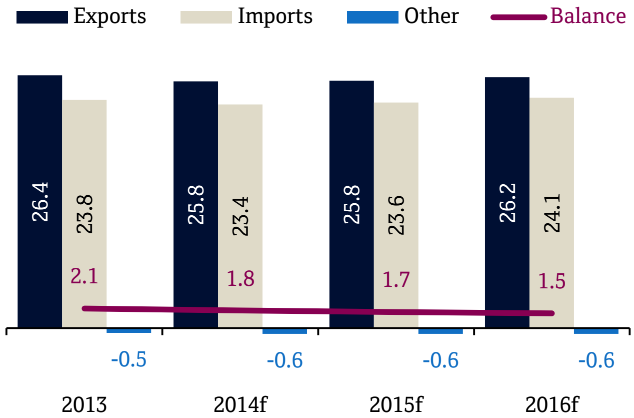
(pps)



Sources: NBS and QNB Group forecasts

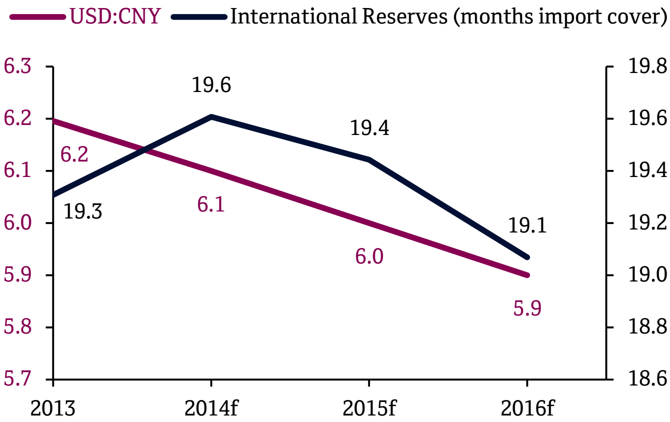
Current Account

(% of GDP)



Sources: NBS, IMF and QNB Group forecasts

Exchange Rate

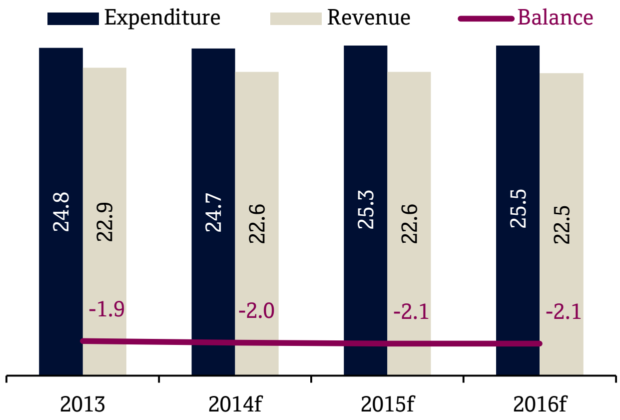


Sources: Global Insight and QNB Group forecasts

The government budget deficit is expected to widen slightly on continued stimulus to meet the growth target

The fiscal deficit should continue to expand as the government adds further stimulus to help rebalance the economy and meet growth targets. Further government stimulus packages are likely, as per the increased railway spending and tax breaks for small companies announced recently. The tax breaks are likely to lower revenue in 2014, while rising expenditure on education and health is likely to gradually push up expenditure. Therefore, the fiscal deficit is likely to widen marginally in 2014-16. Meanwhile, the augmented fiscal deficit is expected to narrow to 5.8% of GDP by 2016 as local governments reduce their recourse to land sales and financing through the shadow banking system.

Government Budget
(% of GDP)

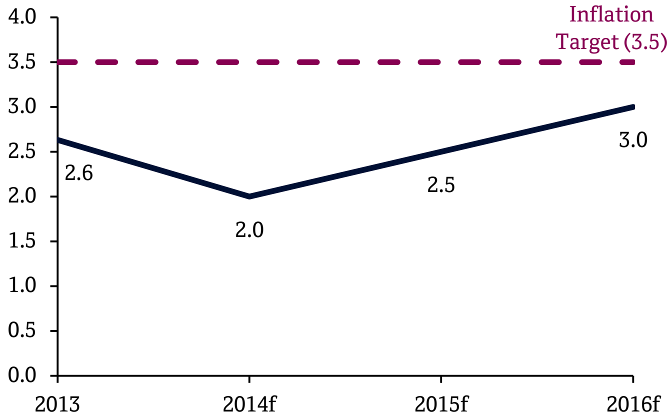


Sources: IMF and QNB Group forecasts

CPI inflation is expected to pick up gradually on rising domestic demand and government stimulus

Rising wages and the push to move the economy towards higher private consumption should increase inflationary pressures on the demand side. Therefore, we expect inflation to rise towards the 3.5% target in 2014-16. Inflationary pressures will be partly offset by the expected appreciation of the exchange rate (see below), which will reduce imported inflation, and overcapacity, which could ease some cost-push inflation. Moreover, rising interest rates (after the expected lifting of a cap on deposit rates) and the curbing of growth in shadow banking should put further downward pressure on inflation.

CPI Inflation
(annual average % change)

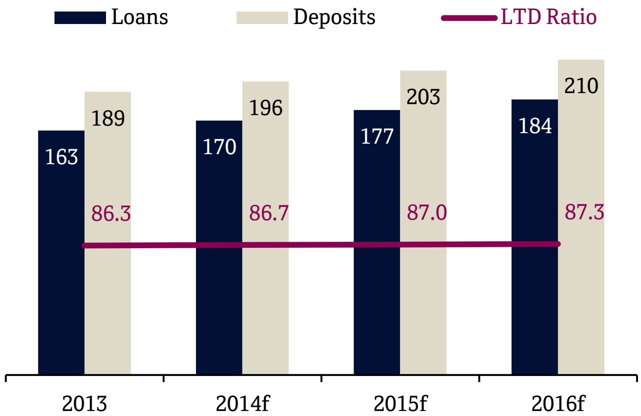


Sources: PBC, NBS and QNB Group forecasts

Banking sector growth is expected to remain robust on strong demand for consumer loans and mortgages

We expect deposit growth to slow to an average 12.8% in 2014-16, compared with 15.6% in the previous three years as households are encouraged to save less and spend more. Loan growth is projected to remain robust on strong demand for consumer loans and mortgages. This should lead to a steady but small rise in the loan to deposit ratio (LDR). Profitability is likely to fall owing to a number of factors: slower GDP growth; narrower net interest margins (NIMs) owing to the liberalization of deposit rates and the opening of the banking sector to competition; and higher provisioning, defaults or write-offs. Furthermore, as the authorities aim to gain tighter control of the shadow banking system (see *Banks and their Shadows* chapter), it is likely that banks will need to bring some low-quality shadow banking assets onto their balance sheets, which could add to provisioning and further depress profitability.

Banking Sector
(% of GDP)



Sources: PBC and QNB Group forecasts

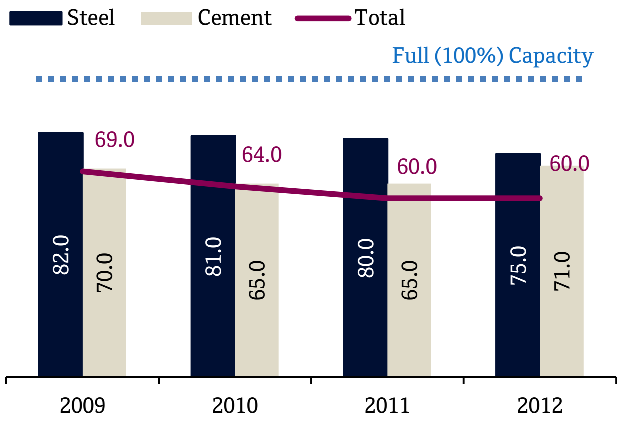
Sustainable Growth

Excess capacity requires a continued slowdown in investment growth to rebalance the economy

Growth has mainly been driven by investment since 2000, leading to excess capacity. This was accentuated by the government investment stimulus after the 2008 financial crisis and subsequent weak global demand. For example, steel capacity was 970m tons per year (t/y) at the end of 2012, but production was only 710m t/y (75% capacity utilization). Similarly, cement capacity was 3.1bn t/y, but only 2.2bn tons were produced. China's capacity utilization is dependent on the world economy (China accounted for 46% of global steel production and 57% of global cement production in 2012). Furthermore, export competitiveness declined as wages and other production costs rose and as competition from other emerging markets stiffened. Therefore, a gradual slowdown in investment and new sustainable sources of growth are needed to help rebalance the economy.

Capacity Utilization in the Economy

(Production as % of total capacity)

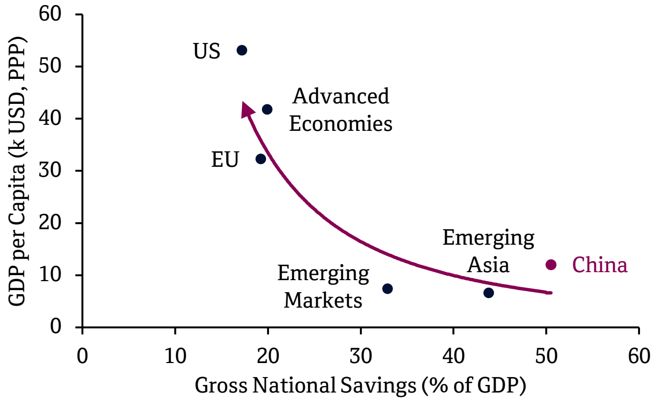


Sources: IMF and NBS

Various reforms are underway to facilitate the transition to a more sustainable advanced economy growth model

China is implementing a package of reforms to boost consumption, reduce the savings rate and thereby raise GDP per capita towards advanced economy levels. Future growth could be generated from higher consumer spending through a lower savings rate. With about USD5tn in savings, China has the highest savings in the world. Unleashing these savings should generate growth in consumption, helping to raise GDP per capita towards advanced economy levels, with estimates that China will catch up with the US per capita income by 2050. China's past growth model depended on absorbing surplus labor from the countryside into factories. With excess manufacturing capacity, new jobs will need to be found for future migrants in services sectors. The new leadership is already implementing reforms to guide the economy towards consumption and services.

Savings Rates and GDP per Capita (2013)



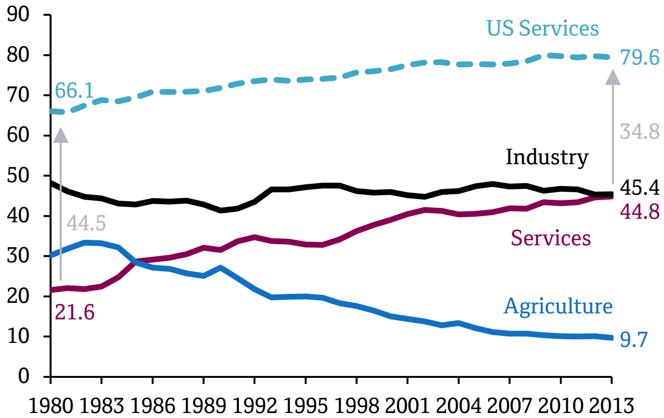
Sources: IMF and QNB Group Analysis

Reforms aim to open up markets...

China's new leadership outlined a blueprint for reform at its Third Plenum in November last year. The leadership aims to raise the share of services in GDP to levels in advanced economies, such as the US. The gap has already narrowed by almost 10% of GDP since 1980. To further close this gap, the government is implementing reforms, including a greater role for the market through: financial reform (permitting small private banks and further liberalization (see *Financial Liberalization* chapter); market–based pricing of resources and utilities; and reforms to allow greater private ownership in SOEs. In May 2014, private companies were invited to participate in 80 major national projects in infrastructure, energy and communication sectors. A greater role for the private sector and stronger financial services should encourage innovation and growth of services.

Services and other Sectors

(% of GDP)



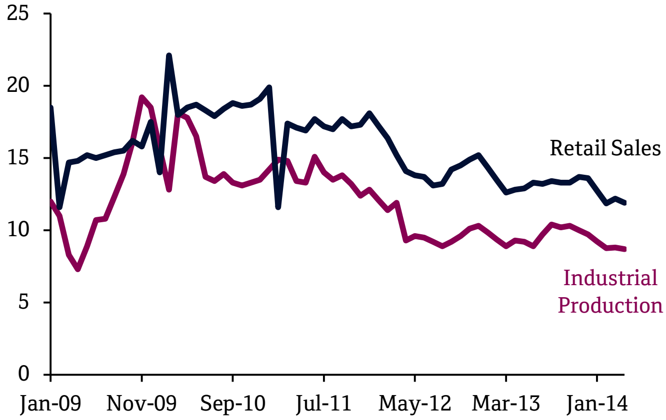
Sources: NBS

...and free up resources for consumption

Reforms aim to increase urbanization and unlock resources for consumption. The government plans to encourage urbanization by reforming resident permits, relaxing controls on rural residents moving to urban areas. Urbanization typically boosts growth of services and consumption. Land reforms will give farmers greater rights and allow the transfer, mortgage or rent of land leases. This should unlock resources, boosting retail sales, which are stronger than stated as online sales are omitted from official statistics but are up about 50% in the last year. An increase in SOE dividends is being directed towards social spending, also supporting consumption. In the longer term, relaxation of the one-child policy (couples can now have two children if one parent is an only child, instead of both parents previously) should alleviate the drag on growth from an aging population.

Retail Sales and Industrial Production

(% change yoy)

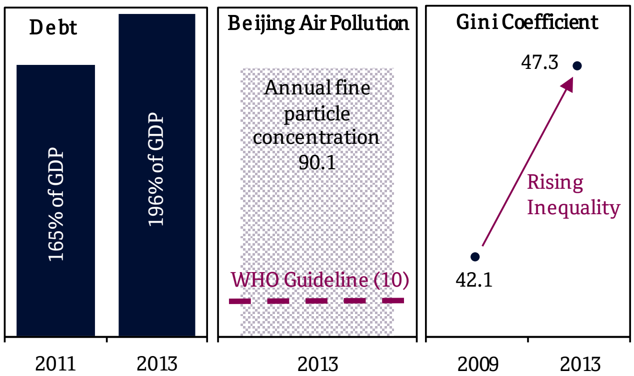


Sources: Bloomberg

Reforms will also tackle unsustainable costs of growth, such as rising debt levels, pollution and inequality

Mounting debt, higher pollution and rising inequality all undermine the sustainability of China's current growth model. The investment boom was partly debt-financed. Total debt rose by 31pps over the last two years to 196% of GDP at end-2013. Overcapacity means some investments yield insufficient returns to service debt, so reform of government finances and broader financial oversight are planned. The speed of economic growth has created acute environmental issues, such as poor air quality and desertification. It has also led to resource shortages, notably water, which is a significant constraint on growth as it is non-tradable. The authorities plan to address environmental issues through regulation and investment in cleaner technology. Finally, rapid growth has sharpened inequalities, which is being addressed by reform of rural-urban resident permits, an anti-corruption drive and social welfare reforms.

Costs of Growth:
Debt, Pollution and Inequality



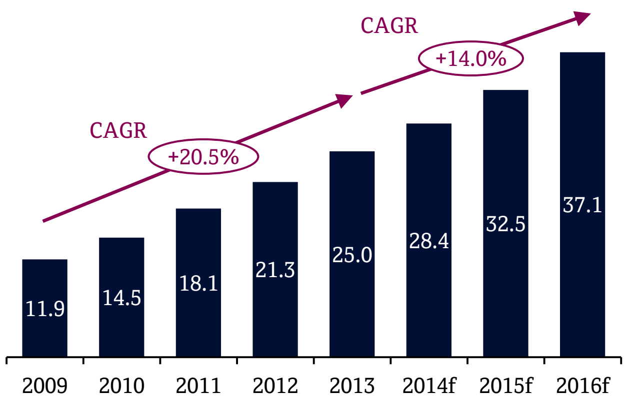
Sources: PBC, Financial Stability Board, Beijing Environmental Protection Monitoring Center, World Health Organization (WHO), World Bank and CIA

Banks and their Shadows

Asset growth has slowed in line with the slowing economy

Asset growth has been rapid up to 2013 owing to the strong economy, but expansion is slowing in line with lower GDP growth and high asset penetration. In 2009-13, asset growth was 20.5%, but it is expected to slow to around 14.0% in 2013-16 owing to slower economic growth. This is still a relatively high rate of growth as government policies to boost consumption as well as monetary stimulus, such as RRR cuts, should be supportive of credit growth.

Bank Assets
(tn USD)

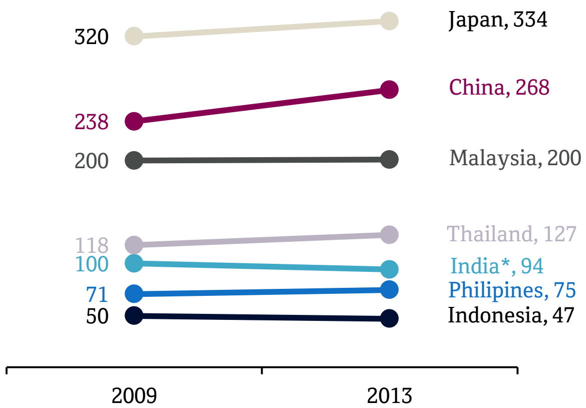


Sources: PBC

Asset penetration is high by Asian standards

China's asset penetration is high compared to Asian peers. Asset growth is slowing, but remains higher than nominal GDP growth, so penetration is expected to continue rising. Steady deposit growth provides a stable source of funding and a low loan to deposit ratio (86.3%) leaves room for further growth in assets (see *Macroeconomic Outlook* above). However, even though asset penetration is already high, there is room for continued steady growth through financial deepening as China moves towards becoming an advanced economy, such as Japan.

Asset Penetration
(Assets as a % of GDP)

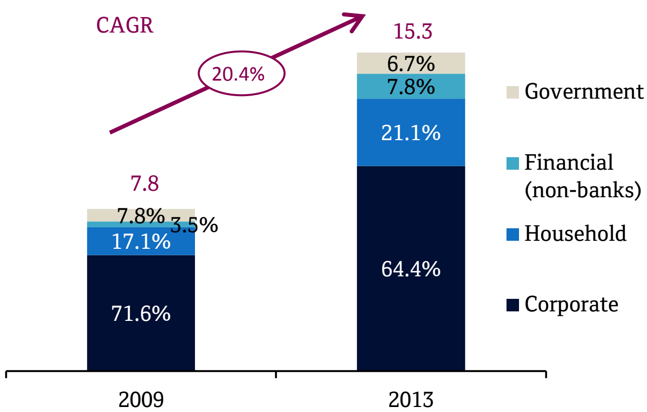


Sources: PBC; * March 2013 data (latest available)

Households are accounting for an increasing share of bank lending, which should help boost consumption

In 2009-13, loan growth was rapid (20.4%) on the back of strong economic growth.[1] The bulk of outstanding loans are in the corporate sector. However, households are taking an increasing share of lending in line with government policies to stimulate consumption. In particular, there has been strong growth in mortgages in recent years as a more affluent middle-class has started buying properties in urban areas. The household segment of bank lending is likely to grow faster than corporate over the medium term as the economy becomes more consumer-oriented.

Bank Lending
(tn USD and % share of total loans)



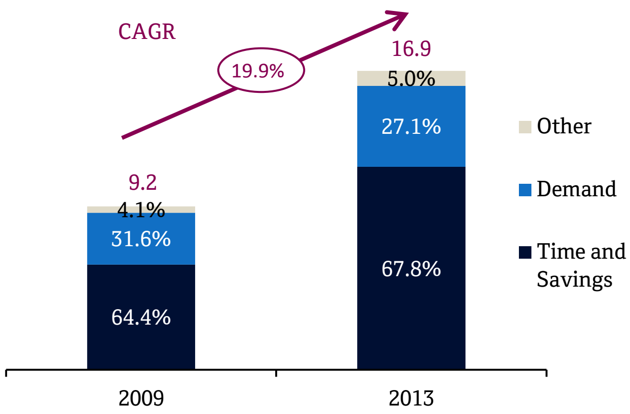
Sources: PBC

[1] This is the compounded annual growth rate (CAGR), which is a geometric mean. In general, unless otherwise specified, all multi-year growth rates mentioned in this report will be CAGRs rather than arithmetic averages.

Strong growth in time and savings deposits provides a strong funding base for banks

Deposits grew at a CAGR of 19.9% in USD terms in 2009-13. China's high savings rate means time and savings account for the largest share of deposits, which grew 24.1% from 2009-13. This ensures that banks have a large and stable deposit base that is growing rapidly, providing a strong source of funding. The large size of time and savings deposits is partly explained by the lack of alternative investment and pension schemes to save for retirement.

Bank Deposits
(tn USD and % share of total deposits)

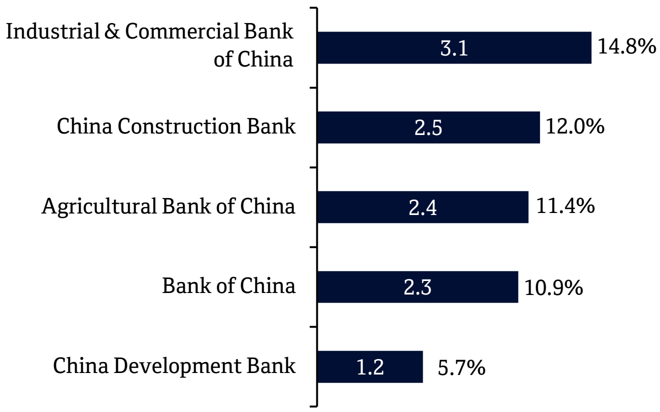


Sources: PBC

State banks dominate and a rapidly expanding shadow banking system is emerging to circumvent restrictions

China's official banking system is tightly controlled, highly protected and dominated by a handful of very large state-owned banks. There are around 170 operational banks with a high level of government ownership and low levels of foreign participation. The top five banks are all state owned and account for 54.9% of total assets. Industrial and Commercial Bank of China (ICBC) is the largest bank in the world by assets. High government ownership affords some banks with preferential access to state business, particularly the top public banks. Growth and profitability are slowing as the economy cools. In addition to traditional banking, a rapidly expanding shadow banking system has emerged, circumventing lending restrictions and caps on saving rates.

Top Five Banks' Market Share by Assets
(tn USD and % share of total assets)

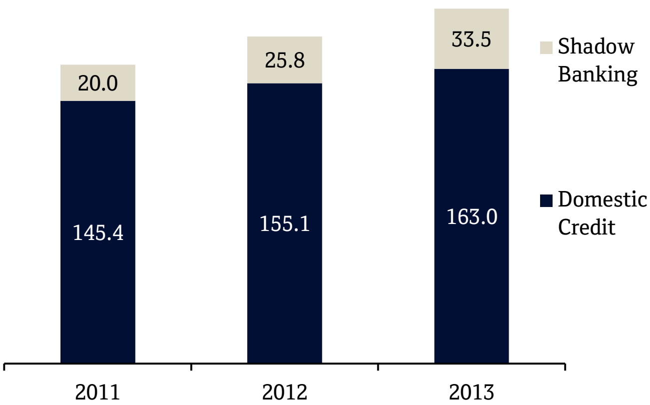


Sources: Bankscope

Shadow banking is mushrooming as a means to circumvent restrictions in traditional banking

Regulations have pushed banks off balance sheet to generate growth, leading to rapid expansion of shadow banking to about 33.5% of GDP, according to the Financial Stability Board. Other estimates are considerably higher (47.9% of GDP from CASS, or 81.7% from JP Morgan). The stimulus during the global recession encouraged local governments and banks to establish special trusts to avoid lending restrictions and finance investment. These loans have been converted to Wealth Management Products (WMPs) and sold on to investors seeking higher yields than available in traditional banking where deposit rates are capped (WMPs yield on average about 6% compared with a bank deposit rate cap of 3.3%). Local governments met 51% of their financing needs through bank loans as at June 2013, compared with 75% at the end of 2010. Shadow banking lacks regulatory oversight and investors have come to assume many government related products are backed by an implicit guarantee.

Shadow and Traditional Banking
(% of GDP)

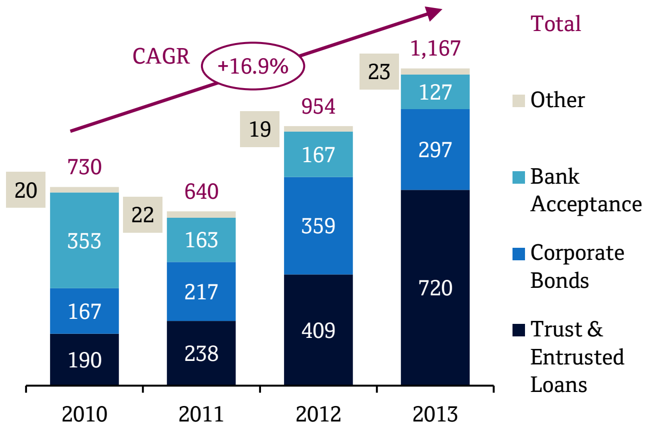


Sources: Financial Stability Board and PBC

Shadow banking accounted for almost 45% of all new credit issuance in 2013, mainly through trust vehicles

In 2013, shadow banking grew by about 42% and accounted for circa 45% of new credit issuance. The issuance of new credit through the shadow banking system has almost doubled since 2011. The bulk of new shadow banking credit is through trust companies or entrusted loans. However, shadow banking credit issuance fell in H2 2013 after the authorities implemented measures to slow growth. The PBC allowed interest rates to rise. The CBRC limited WMPs to 4% of bank assets and asked banks not to increase exposure to LGFVs, including trusts and entrusted loans. The CBRC also prohibited banks from providing guarantees to WMPs or LGFVs. Regulations were further tightened in early 2014 to reduce credit through trusts and WMPs and increase transparency in off-balance sheet activities. Most of the corporate bonds in the shadow banking system are issued by LGFVs to finance infrastructure projects but issuance is slowing.

New Issuance of Shadow Banking Products
(bn USD)

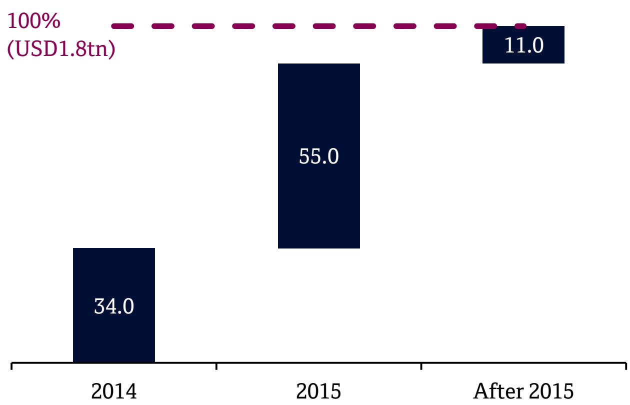


Sources: Bloomberg

Liquidity and default risks are high in shadow banks...

The short-term structure of shadow banking debt adds to liquidity risks and defaults could be contagious. Local governments have used short term financing to fund long term infrastructure projects, creating a maturity mismatch and liquidity risks. Approximately 25% of shadow banking debt falls due within one year and USD557bn of corporate bonds mature in 2014. The situation is worst in the Trust sector where 89% of trusts mature within two years. There is an increasing risk of defaults as the economy slows and the government needs to strike a delicate balance in dealing with them without reinforcing perceptions of a strong implicit guarantee. Two examples illustrate this point. First, a USD495m trust product distributed by ICBC (China's largest bank) received a *de facto* bailout in January 2014 from a consortium consisting of the trust company, ICBC and local government. The bailout avoided a damaging default, but reinforced perceptions of an implicit guarantee.

Trusts Maturity Profile
(% share of total trust products)

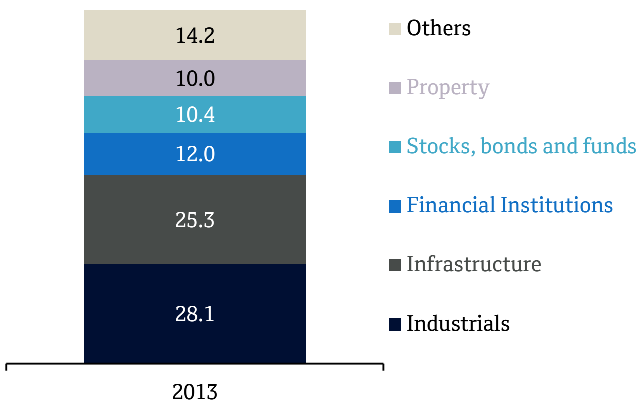


Sources: Use Trust and HSBC

...but risks are mitigated by strong government backing as the bulk of trusts are used for public projects

The majority of the trusts (estimated at 84% by HSBC) are backed by strong shareholders (government or state-owned financial institutions) making possible defaults manageable. Local governments have significant assets at their disposal (land and stakes in SOEs), while central government also has more than ample resources (USD4tn in international reserves) to insulate the economy and bail out the banks that have financed local governments. The authorities recognize the risks in the shadow banking system and have regulated to reduce these risks. Reforms are being implemented to address the maturity mismatch, such as permitting more local governments to issue bonds directly rather than through the shadow banking system.

Trust Assets by Sector
(% share of total)



Sources: China Trustee Association

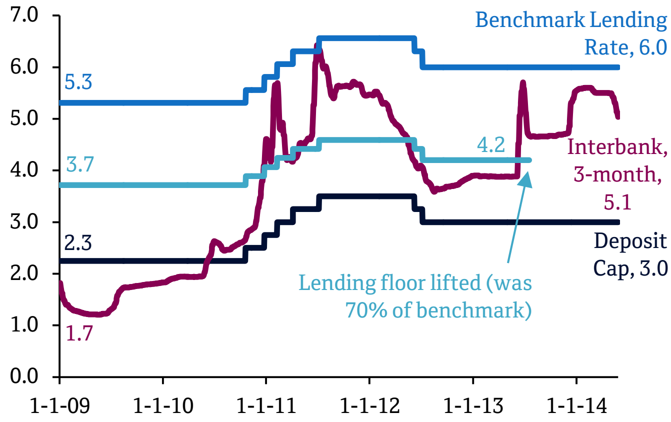
Financial Liberalization

The authorities have started a long and steady process of financial liberalization

Partial liberalization of banking, exchange rates, interest rates and the capital account have begun, but will be finalized in small steps owing to the risks involved. The authorities plan to open up banking to the private sector, permitting small private banks. Lending rates have been liberalized and, while caps on deposits remain, the central bank governor expects them to be lifted in 1-2 years. As a precursor, interest rates on foreign currency deposits in the Shanghai Free Trade Zone (SFTZ) were liberalized from March 2014. More competition and rising interest rates are likely to narrow NIMs in the banking sector. Exchange rate restrictions have been eased (see *Recent Developments* above) with full currency convertibility expected in 2-3 years. Finally, gradual steps are expected to liberalize financial account flows.

Interest Rate Liberalization

(%)



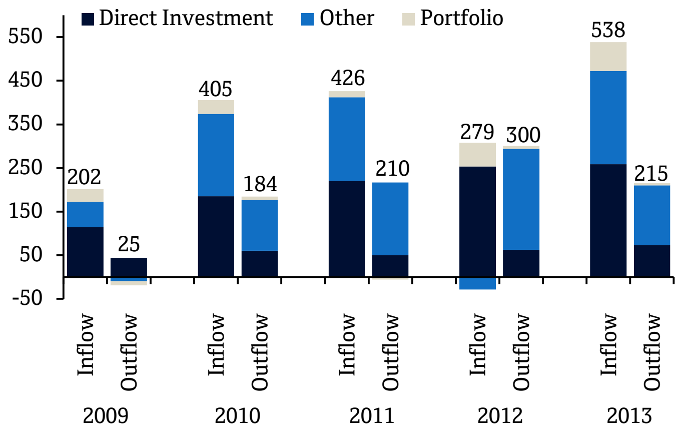
Sources: Bloomberg

The gradual liberalization of the financial account could take up to ten years

Financial account liberalization has begun, but will take time to complete. Portfolio inflows are permitted under a qualified foreign institutional investor (QFII) program, which was piloted in 2002 and allows foreign investment in Chinese securities using foreign currencies within a quota. The current quota is USD80bn with plans to raise it to USD150bn. Transfers between the Shanghai and Hong Kong stock markets were permitted in April, which may encourage portfolio flows. SFTZ was recently launched and will be used to test reforms. Further liberalization is planned in a series of steps. In 2014-16, controls on FDI by enterprises will be relaxed. In 2016-18 controls on trade–related credit will be eased and internationalization of the Renminbi promoted. From 2018, full liberalization of capital flows is expected, including personal transactions and financial instruments.

Financial Account Flows

(USD bn)



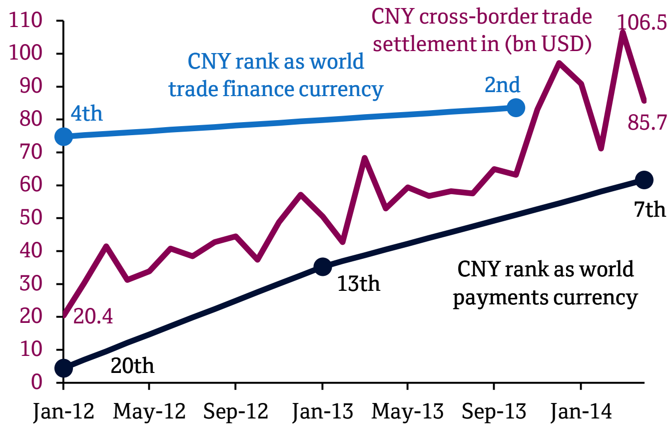
Sources: NBS

Renminbi internationalization could create a new global reserve currency

Reforms to ease the international use of the Renminbi are already in motion. The trading band has been widened (see *Recent Developments* above) and financial account restrictions are being eased. The authorities are taking additional steps to push CNY internationalization. First, the authorities have successfully promoted CNY settlement of cross border trade, which reached 18% of global settlements in 2013 (up from 12% in 2012), thus overtaking the Euro. Second, they have established offshore settlement centers, such as those in Frankfurt Hong Kong, London, Singapore and Taiwan. Finally, they have been encouraging the use of CNY in cross border investment. As a result, an increasing number of central banks are diversifying reserves into CNY and ensuring greater CNY liquidity. Offshore bond issuance in Renminbi (Dim Sum Bonds) started in 2007 and has risen to USD54.2bn in 2013; almost all issuance is corporate.

Rise of the Renminbi

(bn USD and world rank)



Sources: Bloomberg and Swift

Macroeconomic Indicators

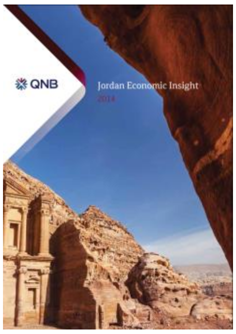
	2009	2010	2011	2012	2013	2014f	2015f	2016f
Real sector								
Real GDP growth (%)	9.2	10.4	9.3	7.7	7.7	7.5	7.4	7.2
Government consumption	8.5	11.2	9.8	8.9	7.8	7.5	7.8	7.7
Private consumption	9.7	8.5	11.3	8.5	7.8	7.6	8.4	9.0
Fixed investment	19.2	12.0	9.6	7.7	9.0	7.6	7.0	6.5
Exports	-4.9	18.3	7.8	5.1	8.6	6.8	7.2	7.2
Imports	4.2	20.1	10.1	6.2	10.6	7.1	7.7	8.3
Nominal GDP (tn USD)	5.0	5.9	7.3	8.2	9.2	10.2	11.3	12.4
Growth (%)	10.4	18.8	23.5	12.4	11.6	10.7	10.7	10.5
GDP/capita (USD, PPP)	8,141	9,053	10,041	10,960	11,919	10,842	11,951	13,190
Fiscal (% GDP, general government)								
Budget balance	-3.1	-1.5	-1.3	-2.2	-1.9	-2.0	-2.1	-2.1
Revenue	20.2	21.3	22.6	22.6	22.9	22.7	23.2	23.4
Expenditure	23.2	22.8	23.9	24.8	24.8	24.7	25.3	25.5
Public debt	17.7	33.5	28.7	26.1	22.4	20.5	19.2	18.2
External (% of GDP)								
Current account balance	4.9	4.0	1.9	2.3	2.1	1.8	1.7	1.5
Trade balance (goods and services)	4.4	3.9	2.6	2.8	2.6	2.4	2.3	2.1
Exports	26.7	29.6	28.5	27.3	26.4	25.8	25.8	26.2
Imports	22.3	25.6	25.9	24.5	23.8	23.4	23.6	24.1
Income, transfers and omissions	0.5	0.1	-0.7	-0.5	-0.5	-0.6	-0.6	-0.6
Capital and financial account balance	3.6	3.8	3.0	-0.2	3.6	3.2	2.9	2.6
International reserves (import cover)	18.9	18.0	18.9	18.1	19.3	19.6	19.4	19.1
External debt	8.9	9.4	9.5	9.0	9.5	10.6	11.7	12.7
Exchange rate USD:CNY (av)	6.8	6.8	6.5	6.3	6.2	6.1	6.0	5.9
Monetary								
M2 growth	26.3	21.2	16.5	13.9	13.7	11.7	11.6	11.3
Consumer price inflation (%)	-0.7	3.3	5.4	2.7	2.6	2.0	2.5	3.0
Interbank interest (%, 3 months, eop)	1.8	4.6	5.5	3.9	5.6	5.6	6.3	7.3
Banking (%)								
Return on equity	16.2	19.2	20.4	19.8	19.2	-	-	-
NPL ratio	1.6	1.1	1.0	1.0	1.0	1.0	1.0	1.0
Capital adequacy ratio	11.4	12.2	12.7	13.3	12.2	-	-	-
Asset growth	26.2	18.7	18.3	17.5	14.1	13.1	12.9	12.5
Deposit growth	28.5	19.5	17.7	15.4	13.8	13.1	12.9	12.5
Domestic credit growth	30.4	18.8	17.1	17.1	15.1	13.5	13.3	13.0
Domestic credit (% GDP)	145.1	146.3	145.4	155.1	163.0	169.7	176.6	183.6
Loan to deposit ratio	85.1	84.5	84.1	85.3	86.3	86.7	87.0	87.3
Memorandum items								
Population (bn)	1.33	1.34	1.35	1.35	1.36	1.37	1.37	1.38
Growth (%)	0.49	0.48	0.48	0.50	0.50	0.50	0.50	0.50
Unemployment (%)	4.3	4.1	4.1	4.1	4.1	4.1	4.1	4.1

Source: NBS, PBC, Bloomberg, IMF and QNB estimates and forecasts

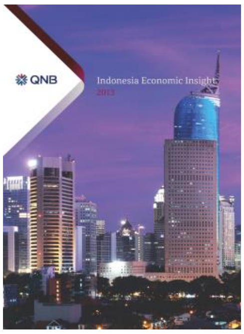
QNB Group Publications

Recent Economic Insight Reports

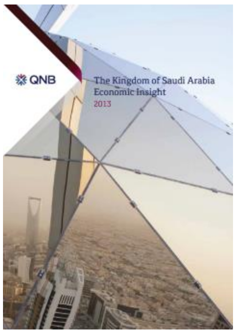
Qatar 2014 (April)



Jordan 2014



Indonesia 2013

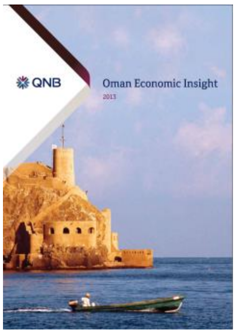


KSA 2013

Kuwait 2013

Qatar 2013 (April)

Qatar 2013 (Sept)



Oman 2013

Qatar reports

Qatar Monthly Monitor

Recent Economic Commentaries

ECB Monetary Stimulus May Avoid Eurozone Deflation
Could the Emerging Market Slowdown Jeopardize the Global Recovery?
Oman Is on Its Way to a New Growth Model
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GCC Countries Continue To Be the Main Engine of Growth in MENA
India's Economy Is On The Mend
The US Economy Is On a Tight Rope Between Recovery and Policy Tightening
The Rise of the Chinese Consumer
Calm in Emerging Markets but Underlying Vulnerabilities Remain
Qatar's Economic Growth To Accelerate on Strong Investment Spending and Higher Population
IMF Programs Restore Investor Confidence in Several MENA Countries
The World Economy On a Bumpy Road to Recovery
Qatar's Real GDP Growth Accelerated to 6.5% in 2013 on Strong Investment and Higher Population
The Eurozone Takes A Final Step Toward a Banking Union
Foreign Ownership of Debt is an Important Indicator of Vulnerability to the Emerging Market Crisis
Natural Gas To Outpace All Other Energy Sources Until 2035
Construction Projects, Lower Energy Costs and a Recovery in Tourism Should Boost Jordan's Economic Growth
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Age Matters for Economic Performance
Qatari Banks Lead Asset and Loan Growth in the GCC
Kingdom of Saudi Arabia's Non-Oil Sector to Drive Growth

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