

A Gathering Storm?

China's Growth Prospects and the Need
for Scenario Planning

APCO
worldwide®



INTRODUCTION TO APCO

APCO Worldwide is a global consulting firm and a leading provider of corporate advisory, government affairs and strategic communication services in China. We have been serving clients in China since 1989. Today, our China team includes more than 100 employees from a diverse range of backgrounds, including business, government, journalism, academia and civil society. We maintain well-established offices in Beijing, Shanghai, Guangzhou and Hong Kong.

TABLE OF CONTENTS

EXECUTIVE SUMMARY.....	2
MACROECONOMIC ENVIRONMENT AND RECENT POLICY DEVELOPMENTS	3
CHINA'S GDP GROWTH - DIVERGING FORECASTS	5
Optimistic Scenario	5
Pessimistic Scenario	6
IMPLICATIONS FOR FOREIGN INVESTORS AND THE NEED FOR SCENARIO PLANNING	7
APCO'S SENIOR STRATEGISTS.....	7
CONTACT INFORMATION	8

EXECUTIVE SUMMARY

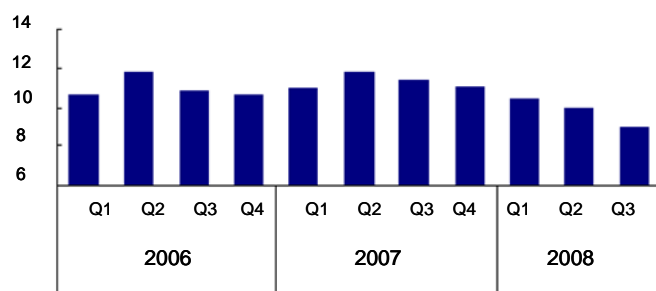
- In the midst of the storm of commentary and analysis accompanying the global financial crisis, most forecasters have remained relatively optimistic over growth prospects for China.
- Although many experts predict GDP will decline from uncomfortably high double-digit levels there is a consensus view that growth will remain healthy with declining exports offset by increased domestic consumption and investment.
- In this view, China's low external debt, high reserves, and improved fiscal position afford sufficient flexibility and resources for an appropriate policy response to the ongoing external shock.
- However, with recently released Q3 2008 data revealing China's GDP growth at its slowest rate in five years, the views of more pessimistic commentators who question the ability of policy makers to spend their way out of a downturn have begun to gain traction.
- How then should corporate managers who are now planning their 2009 budgets understand the debate, and the range of possible outcomes for the Chinese economy?
- In this note APCO identifies and comments on some factors that could adversely affect the baseline consensus view on China's prospects over the next one to two years.
- We suggest that now is the time for companies to conduct strategic scenario planning so that they will have an agile and flexible response under whatever conditions may prevail.

MACROECONOMIC ENVIRONMENT AND RECENT POLICY DEVELOPMENTS

Key Indicators Trending Downwards

China's economic environment has changed radically in 2008. In the first half of the year concern focused on what was seen to be an overheating economy, where inflation reached an 11-year high of 8.7 percent in February. In response the government maintained and strengthened tightening measures, continuing a policy of macroeconomic adjustment designed to slow the economy and gradually deflate asset bubbles. However, in recent weeks, the economy has shown signs of cooling more rapidly than desired. The Q3 2008 GDP growth rate of 9 percent, down from the previous quarter's 10.1 percent, was below the consensus forecast of 9.7 percent. This is the lowest growth rate since 2003.

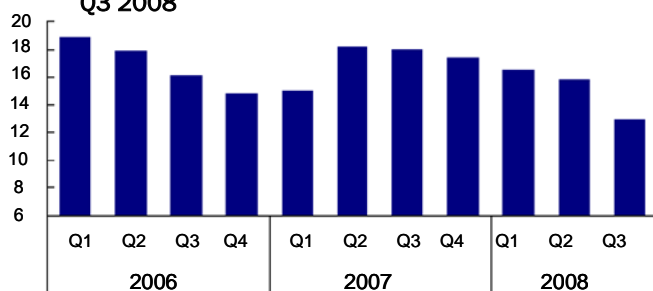
Chart 1: China GDP Growth 2006 – Q3 2008



Source: National Bureau of Statistics

The slowdown has come about as exports, industrial activity, housing investment, auto sales and other key indicators have all begun trending downwards. From January to September net export growth declined 4.8 percent from the same period last year and industrial production growth hit a six-year low, expanding by 11.4 percent in September as compared to 12.8 percent in August and 18.5 percent for the year in 2007.

Chart 2: China Industrial Production Growth 2006 – Q3 2008



Source: National Bureau of Statistics

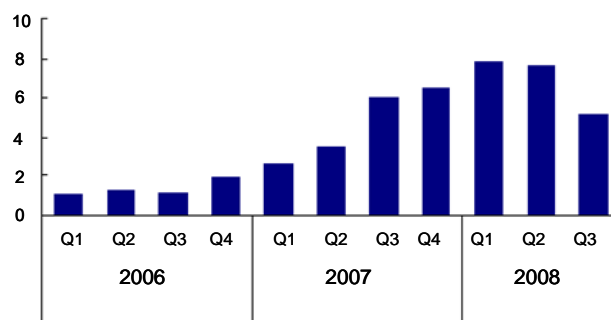
Given the combined impact of increased labor cost, renminbi appreciation, product safety issues, and slackening demand, it is no surprise that low margin, export-oriented factories in the Pearl River delta are suffering. However, it is more surprising to hear that higher-end, domestic-focused industrial segments are also being hit hard. For instance, a major manufacturing company of equipment for the domestic market forecasts fourth quarter sales approximately half of second quarter sales.

Data up to August shows that investment in the property sector has decelerated sharply in recent months, rising at 18.9 percent in August compared to 33.5 percent in H1 2008. Sales of housing in key cities such as Beijing and Shanghai were down by 80 percent in September compared to the same month in 2007. Property prices are declining in both cities. Auto-sales have also slowed significantly with many leading players reporting major drop offs. Ford's sales in China dropped 28 percent in August from the same month last year, Volkswagen was down 20 percent and General Motors was off 16 percent. The Shanghai stock market has also lost more than two thirds of its value since the 2007 peak, deflating that bubble despite official attempts to moderate the decline. These recent changes are occurring more rapidly than desired.

Reasons to Remain Positive

However, China's macroeconomic situation is far from entirely negative and despite recent downward trends, GDP and other key indicators remain relatively high. CPI further moderated in September rising at 4.6 percent year-on-year, bringing inflation back down within the government's target range. PPI is also moderating due to reductions in international oil and commodity prices.

Chart 3: China CPI 2006 – Q3 2008



Source: National Bureau of Statistics

Surpluses of both trade and fiscal accounts remain strong and at the end of September China's foreign exchange (forex) reserves stood at USD 1.9 trillion, a record high. China's recently recapitalized financial institutions have avoided the worst of the shocks that convulsed firms in other markets. The Olympics also caused a downward effect on industrial production as the government sought to ensure blue skies for the Games; a revival of industrial activity is now expected in and around Beijing.

Increasingly Proactive Policy

In recent weeks and months the Chinese government's reaction to slowing growth has become increasingly proactive, encompassing a number of monetary and fiscal measures. The substantial pressure the Chinese government is under to maintain rapid economic growth – necessary to create tens of millions of new jobs, increase living standards, and maintain social and political stability – means further and more extensive measures are highly likely, particularly if Q4 2008 data shows further downward trends in key indicators.

In July the Politburo officially switched macroeconomic policy from “double prevention” or “*shuang-fang*” – preventing inflation from becoming entrenched and preventing overheating – to “one supporting, one restraining” or “*yi-bao, yi-kong*” – maintaining stable and relatively fast growth and ensuring ongoing low CPI. To achieve this, the Chinese government has stepped up efforts to increase demand from within China in the hope of mitigating any impact of the wider global slowdown.

In the last six weeks China's central bank, the People's Bank of China (PBOC), has cut its benchmark one-year lending rate by 27 basis points on three occasions and cut the reserve requirement ratio for banks by 150 basis points. The government has also announced several fiscal steps including tax rebates for export-oriented industries such as textiles, garments, furniture and some high value-added electrical machinery products (over 3000 product items in total). To support China's equity markets authorities have cut the stamp duty tax for stock transactions by 50 percent, and announced that China's sovereign wealth fund would buy equity in China's biggest banks in the A-share market. Central government-controlled companies are also being encouraged to buy back their own shares.

The Chinese government has also recently announced potentially significant rural reforms that have the long term aim of positioning China's 800m rural residents as a future engine of domestic consumption and demand. The 3rd Plenary Ses-

sion of the 17th Communist Party Congress (CPC), in October 2008, proposed policies that would allow rural residents to engage in the trade or sale of land-use rights. In theory the reforms would allow farmers to use the land rights as collateral for loans, and encourage the establishment of large-scale farms. However, the principle of collective land ownership at the township level was not changed and agricultural land must continue to be used for agriculture, with the government setting aside 120 million hectares to ensure security of food supply. The reform also does not yet encompass extending land use rights contracts from 30 to 70 years to match that in cities.

However the proposals do indicate the direction of policy and if property rights are further strengthened and a freer market allowed, this could be one of the most significant reforms in the 30 years since China's opening up. In any case, the land reform is part of a range of measures including increased spending on pensions, education and healthcare designed to create a social safety net across society to boost consumer confidence and promote consumption rather than saving, especially in rural and urbanizing areas. However, it should be noted such measures will only feed through to the economy in the medium term.

To address more immediate concerns in response to rapidly falling property prices in major cities, the government announced it will temporarily suspend stamp duty for individuals buying or selling homes; waive the land value-added tax for individual sellers; set up new first-home lending rules; cut the deed tax levied on first-home transactions under 90 square meters to 1 percent; introduce a lower loan rate floor for first-home borrowers, and cut the first-home down payment to 20 percent. With investment in the housing sector accounting for one quarter of FAI and 10 percent of GDP the government has become particularly concerned that the coordinated steep declines in property markets could severely undermine consumer confidence and prospects to promote domestic consumption.

The government has also recently taken measures to speed up investment in key infrastructure projects such as the South-North Water Transfer Project and the redevelopment of Sichuan to promote demand during this time of cooler growth.

The State Council has promised further targeted tax, credit and trade-related measures to maintain growth of the economy. There is the strong likelihood of further cuts to interest rates and the RRR in the coming weeks. A further extensive policy package could be released after the Central Economic Work Conference later in the year.

CHINA'S GDP GROWTH - DIVERGING FORECASTS

In forecasting China's growth prospects in the near term the majority of commentators have remained relatively optimistic and a baseline view of 8 percent growth or above in 2009 has prevailed. However, with the recent sharper than expected slowdown in Q3 GDP data the views of more pessimistic analysts have begun to gain greater attention. The following section will firstly set out the key tenets of the optimistic growth scenario before analyzing some of the factors that could cause divergence from this forecast.

OPTIMISTIC SCENARIO

GDP Growth - China will experience a soft economic landing where growth will moderate over the next year but remain above 8 percent, a figure considered necessary for ongoing employment growth and therefore social and political stability. Such moderation indicates a gradual normalization towards a medium-term sustainable growth trend, rather than a crash in overall economic activities.

Exports - Declining exports will not cause too significant a fall off in GDP growth due to three main reasons. Firstly, there has been a misconception about China's growth model which rather than being export led is instead primarily driven by domestic shifts in investment and consumption. The evidence of this is in China's economic cycles which over the last 30 years have gone against those of key export markets such as the USA, and corresponded directly with upswings in domestic spending. Secondly China, as a low cost producer of most of the goods that it exports, is actually well positioned to pick up global export market share in a slowdown. Thirdly, any decline in exports can be offset through public expenditure and the promotion of domestic demand.

Budgetary Surpluses and Public Expenditure - Public spending will be financed by strong trade and fiscal surpluses, built up over the last decade of very rapid growth, which will enable the Chinese government to invest hundreds of billions of RMB to pump prime the economy and stimulate demand. A number of further large-scale infrastructure projects, such as municipal subway schemes and airport developments could be initiated to ensure ongoing high levels of demand adding at least one percentage point to GDP. Such schemes would follow already initiated road and rail projects that have committed several trillion RMB to develop China's transport network in the 11th fifth year plan (2006-2010). Large-scale investment can also be made into China's social security in-

frastructure including education, pensions and healthcare providing the basis for increased consumer consumption over the long term. The process of industrialization and urbanization which will see a further 250 million people move from rural areas to cities by 2020, will provide an ongoing powerful driver of GDP expansion and allow the Chinese government to continue to make significant investment to support the economy even as key export markets slow, and in some cases contract, over the coming months and years.

Financial Service Sector - China's financial service sector has largely avoided the worst of the turmoil due to its relative insulation from other markets and will therefore emerge as one of the world's most highly capitalized and strongest financial sectors. If the Chinese government chooses to do so there will be excellent opportunities to buy highly discounted assets and radically increase China's global financial presence.

Consumer Confidence - Consumer confidence will remain resilient despite the equity and property market shocks. Looser monetary policy and fiscal incentives, such as raising the income tax threshold, can be implemented to ensure ongoing consumer spending as growth moderates. Chinese consumers are also comparatively under-leveraged with household debt amounting to only 13 percent of GDP as opposed to 100 percent in the US.

Structural Maturity - As a result of the reform that has followed previous economic slowdowns major structural weaknesses in the Chinese economy, such as an undercapitalized banking system, have been addressed. Therefore ticking time-bombs that previously included non-performing loans (NPLs) and massive over employment in a highly inefficient state sector have undergone significant reform giving the economy enough resilience to weather the current global economic environment.

Opportunity to Rebalance - A relatively slower rate of growth in the coming months and years will give the Chinese government further opportunity to address some of the imbalances in the economy, moving away from the model that has powered growth in recent years towards a more value added, sustainable and environmentally friendly approach to generating growth. Highly fragmented industries will be restructured and consolidated to become more productive, as smaller more inefficient producers are forced out of business. Due to already tight labor conditions this can be done without pushing unemployment to socially risky levels.

Diverging from Optimism

Although the optimistic view of China's GDP prospects is still widely held the recent sharper than expected slowdown in growth and the continuing severity of the global financial crisis mean it is prudent to examine some factors that could cause a harder than expected landing. Such factors have become more widely discussed in recent weeks and should feature in scenario planning by all investors who wish to ensure an effective response is available under whatever conditions prevail.

PESSIMISTIC SCENARIO

GDP Growth – As a result of the broadening and intensifying of the negative impact caused by the global financial crisis, in conjunction with ineffective policy tools to spur investment and demand, China could experience a harder than expected landing where growth declines below the threshold figure of 8 percent in 2009.

Capital Flight - Until recently, concern had centered on managing the impact of surging inflows on domestic money supply. However, recent data shows hot money inflows have almost certainly stopped with headline reserve growth moderating from USD 153.9 billion in Q1 2008, to USD 96.8 in Q3 with the massive unexplained inflows from previous quarters abating. This has occurred as inflation has eased and along with it the appreciation of the renminbi. Reserve accumulation in Q3 was less than the trade surplus added to utilized foreign direct investment signaling an unexplained outflow – presumably hot money. In a negative scenario further sustained capital flight could put pressure on asset prices throughout the economy, tighten liquidity, and weaken the asset quality of China's banks. A renewed banking crisis would be both financially challenging and deeply demoralizing after such enormous efforts to recapitalize the banking system and improve risk management.

Ineffective Monetary Policy – Looser interest rates may not result in greater borrowing and investment. Under current circumstances, companies may believe there are insufficient profit opportunities to justify increased debt. This problem could be compounded by the fact that recent record levels of FAI mean industrial capacity and production are already very high. With lower demand starting to take effect, overcapacity and rising inventories would further disincentivize borrowing. Therefore a key policy tool would be rendered ineffective.

Weaker-than-Expected Fiscal Position – A key tenet of the optimistic scenario is that the Chinese government will be able to mitigate any negative

effects of a slowdown on GDP growth by pump priming the economy to stimulate demand. A key assumption here, however, is the strength of the government's fiscal position. Some analysts question this strength, arguing that total direct and indirect debt is actually much higher than official statistics suggest. Contingent liabilities such as unfunded government pension plans, state owned enterprise debt, and local government obligations are the basis for estimates that government debt stands at around 50 percent of GDP, even without considering higher-than-reported NPLs. Under these circumstances the Chinese government may have far less capability to run large fiscal deficits to support increases in spending. As growth slows tax revenues would also fall putting pressure on the fiscal balance making it harder to fund further fiscal stimulus and contingencies.

Financial Service Sector –There is a risk that China's financial service sector is actually in a far more vulnerable position than many analysts believe. This is not because of large undeclared exposure to toxic US sub-prime mortgage assets but rather because the same expansionary monetary environment that existed elsewhere, and lies at the root of the current crisis, has also been present in China. This will be the first test of the Chinese banking system since massive expansion began four years ago and the first time consumer credit has been a significant part of Chinese bank's portfolios. A sharper than expected slowdown could expose structural problems within the sector and could also test the robustness of Chinese banks' real estate, mortgage and credit card portfolios. When Chinese banks last faced massive NPLs 10 years ago, consumer credit was a negligible part of their portfolios, whereas it now presents a significant unknown for the future.

Consumer Confidence –Chinese consumer confidence could also be found to be very weak. China has traditionally displayed one of the world's highest saving rates and a sharper than expected slowdown, combined with precipitous declines in property and equity markets could be enough to shock consumers back to long established saving patterns.

Opportunity to Rebalance –A consequence of the slowdown may be that the Chinese government reverts back to the 'old' model of growth. Recent export tax rebates granted to clothes and textiles producers may be evidence of such a policy choice. This could potentially delay the desired shift to a more sustainable growth model that underscores higher-value, innovation, energy efficiency, and pollution control.

IMPLICATIONS FOR FOREIGN INVESTORS AND THE NEED FOR SCENARIO PLANNING

Implications for Foreign Investors

Under whatever conditions prevail implications for foreign investors could be far-reaching. Ongoing resilient GDP growth would certainly enable foreign enterprises to maintain steady levels of revenue growth and profitability. Yet continued healthy levels of growth, set against recessions in other key global markets, could also reinforce the belief among some Chinese policy makers that following an increasingly nationalistic model of economic development is the right path to take. In other words, under the optimistic scenario, foreign firms' balance sheets may be better protected, but the environment to expand and grow their businesses may become more restrictive.

A sharper than expected slowdown in the Chinese economy would indeed pose difficult operating conditions for any company. However, it could also provide investors an excellent opportunity to strengthen their Chinese operations. In an effort to shore up growth, many recent policies and regulations which are potentially restrictive on overseas investors (e.g. Anti - Monopoly Law, indigenous in-

novation), may be reassessed or enforced flexibly as the Chinese government seeks to maintain high levels of inward FDI. Indeed both the tenor of new legislation and the attitude of a number of Chinese officials could change from one which seeks to limit and control foreign participation to one of more openness and fairer competition.

Overall, APCO and most observers remain positive about Chinese GDP growth. Put simply, over the medium term China's ongoing emergence as one of the world's largest and most vibrant economies is not in doubt. However, risk in the short term is certainly on the rise and companies that wish to maintain and enhance the success of their China operations must be ready for the possibility of a sharp break in the positive trends in 2009. Detailed scenario planning that allows for a flexible and decisive response whatever conditions may prevail is therefore recommended at this complex and challenging time.

APCO'S SENIOR STRATEGISTS

APCO's team of senior strategists, with their unique blend of experience at the top levels of business and politics in China, the USA and Europe, are ideally placed to help companies understand how developments within the global and Chinese macro-economic environment could impact their business and how to develop a robust scenario planning process to account for such eventualities.

Christian Murck, CEO of APCO Worldwide's Asia Region

Christian Murck brings to clients expertise in financial services, corporate advisory and intellectual property rights. After joining APCO in 2001, Mr. Murck was elected to two terms as chairman of the American Chamber of Commerce in China in 2002-03, and subsequently served two years as a director of the Bank of Shanghai, having been nominated to the Board by the International Finance Corporation. Mr. Murck joined APCO after five years in Beijing as managing director and senior country officer of the Chase Manhattan Bank.

Alastair Campbell, Vice Chairman of APCO Worldwide's Greater China Region

Alastair Campbell, former executive director and head of corporate finance at Bank of China International, is vice chairman of APCO Worldwide's Greater China region. Before joining APCO, Mr. Campbell served as China president of Thomson S.A., the world's leading provider of solutions for the capture, management and delivery of digital video content for the media and entertainment industries. From 2000 to 2004, he was executive director and head of corporate finance at Bank of China International. In this role he was responsible for the origination and execution of cross-border merger and acquisition transactions, corporate restructuring and general corporate advisory assignments on a global basis.

Kenneth Jarrett, Vice Chairman of APCO Worldwide's Greater China Region

Kenneth Jarrett has more than 20 years of experience in U.S.-Chinese affairs. Mr. Jarrett previously served as the US consul general in Shanghai; a position to which he was appointed in 2005. In 1997, Mr. Jarrett was assigned to Beijing as deputy chief of the political section of the US embassy with responsibilities for US-China bilateral political issues, leadership dynamics, human rights and social issues. Due to his extensive experience in

China and Asia, he was rotated to the US National Security Council as director of Asian affairs and was one of four officials in the Asian affairs office with direct responsibility for all issues related to mainland China, Taiwan, Hong Kong and Mongolia.

Gao Weijie, APCO Senior Counselor

Gao Weijie is former chairman of China Ocean Shipping Company (COSCO) America and serves as chairman of the China operation of Lloyd's Register Asia. Mr. Gao has more than 42 years of experience in the shipping, transportation and logistics industry. With broad experience in China, Europe and the United States, Mr. Gao provides expert council to clients navigating complex trade and regulatory issues in diverse markets. Mr. Gao started his career at COSCO in 1965, eventually serving as executive vice president. His duties involved overseeing various aspects of the firm, including ship husbanding; planning; chartering; operations; pricing; and the commercial aspects of shipping, such as insurance, protection and indemnity issues and claim settlements.

Sharon Ruwart, Managing Director of APCO Worldwide's Beijing Office

Sharon Ruwart is an expert in Chinese media, publishing, corporate positioning, science and technology and before joining APCO was the managing director for Elsevier Science & Technology, China. Prior to her position at Elsevier, Ms. Ruwart was

the director of special projects at *Caijing Magazine*. Before moving to China, Ms. Ruwart was the vice president of marketing for E-LOAN, Inc., a Silicon Valley company she took through the NASDAQ listing process. Ms. Ruwart was selected as one of the "Top 10 Financial Marketers of 2000" by *Financial Marketers Magazine*, a designation shared with the marketing vice presidents from American Express, Merrill Lynch and Charles Schwab.

Murray King, Managing Director of APCO Worldwide's Shanghai Office

Mr. King joined APCO after working as a trade commissioner for the Canadian Department of Foreign Affairs and International Trade (DFAIT) from 1996-2004, during which time he held assignments in Beijing and Shanghai. After entering the Canadian Diplomatic Service in 1996, Mr. King served as second secretary (commercial) and vice consul at the Canadian Embassy in Beijing from 1999 to 2001, specializing in the transportation and defense sectors. He was posted to the Canadian Consulate General in Shanghai from 2001 to 2004 as consul (commercial) responsible for advanced manufacturing technologies, advanced materials, information and communication technology, automotive, nuclear power, aerospace and defense, as well as Canada-Zhejiang bilateral relations.

CONTACT INFORMATION

For further information on how APCO can help your organization with detailed scenario planning please contact:

BEIJING

Sharon Ruwart, Managing Director
16th Floor, NCI Tower
12 A Jianguomenwai Avenue
Chaoyang District, Beijing, China 100022
Phone: +86.10. 6505.5127
Fax: +86.10.6505.5257
sruwart@apcoworldwide.com

GUANGZHOU

Ouyang Jun, Chief Representative
Room A1309, Center Plaza Tower A
161 Linhe Xi Road, Tianhe District
Guangzhou, China 510620
Phone: +86.20.3825.1955
Fax +86.20.3825.1016
jouyang@apcoworldwide.com

SHANGHAI

Murray King, Managing Director
2102 CITIC Square
1168 Nanjing Road West, Shanghai, China
2000041
Phone: +86.21.5298.4668
Fax: +86.21.5298.4669
mking@apcoworldwide.com

HONG KONG

Vivian Fung, Managing Director
9/F, Cambridge House, Taikoo Place
979 King's Road, Hong Kong
Phone: +852.2866.2313
Fax: +852.2866.1917
vfung@apcoworldwide.com