GLOBAL ECONOMIC RESEARCH

ASIAN WEEKLY ECONOMIC INSIGHTS

June 21, 2005

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Asian Economic Perspectives

Chinese Data Imply Receding Investment and Inflation Risk

We have long argued against market fears of renewed growth and inflation risk in the Chinese economy. In our view, those concerns ignore ongoing trends in trade, investment and demand that suggest the economy is healthier and actually making a turn for the better (see this publication of April 21 and May 19, 2005).

According to our analysis, the investment cycle is unwinding more successfully than generally thought. The margin squeeze among industrial firms is restricting the inflation pass-through from upstream to downstream firms and limiting investment potential. And, now that the Shanghai property market has started to consolidate, we believe overall inflationary pressure will continue to ease.

We have learned that the consensus forecast for Chinese consumer price inflation has been revised down (from 4%-plus) closer to our projection of 2.5% for full-year 2005. Moreover, we sense that more analysts now agree that producer price inflation is under better control. And, those who predicted a renewed investment boom in 2005 followed by another economic crackdown have moderated their outlook, moving closer to our forecast for a soft economic landing in the next 12 months.

Lowered Inflation Expectations

In May, growth in the Consumer Price Index (CPI) reached a 19-month low of 1.8% year-over-year. At the same time, growth in the non-food CPI showed little change over the past two quarters at a benign 1.3% year-over-year. Accordingly, the central bank lowered its official CPI forecast for 2005 last week to 3.0% to 3.5% (from 4.0%). The move triggered the downgrade of market inflation forecasts, which are now closer to our projection of 2.5%.

The policy implication of lower inflation expectations is that the central bank will be in no rush to raise local interest rates, nor to renew credit tightening.

Importantly, there is a chance that we'll lower our forecast further in the coming six months. Good weather conditions so far this year imply a bumper harvest, and if food prices fall more than anticipated, we won't be surprised to see consumer price inflation decline to near zero again in the next six to 12 months.

Admittedly, growth of the Producer Price Index in May was relatively sticky at 5.9% year-over-year against 5.8% in April, but this was fueled mainly by high energy prices, particularly those of oil and coal. Prices of base metals and other construction materials have eased in line with the deflating investment bubble.

Improved Investment Structure

At first glance, investment may not seem to be slowing. After all, headline fixed-asset investment growth rebounded to 26.4% year-over-year in the period from January to May, versus 25.4% from January to April. But the higher growth rate was largely due to the extremely low base in May of last year (18% year-over-year versus 35% in April 2004) which occurred at the start of Beijing's economic tightening.

A closer look at the data shows that the structure of investment has in fact improved, with investment flows shifting from overheated sectors (real estate slowed to 24% in the five months from January to May from 26% in January to April) to bottlenecked sectors (coal and railways are up 83% and 58%, respectively). Moreover, consolidation of the property market could lead to an investment deceleration in the second half. Already, the average real estate price in Shanghai has reportedly come down by about 20% over the past two months while sales transactions have been cut in half. Meanwhile, the continued profit margin squeeze in the industrial sector means there will be less money for capital spending. And equally important, the continued slowdown in commodity imports also implies slower investment growth as the year progresses (**Display**).

Thus, we stick to our call that fixed-asset investment growth will take a noticable dip in the fourth quarter. At this writing, we see year-over-year growth decelerating to around 10% to 12%.

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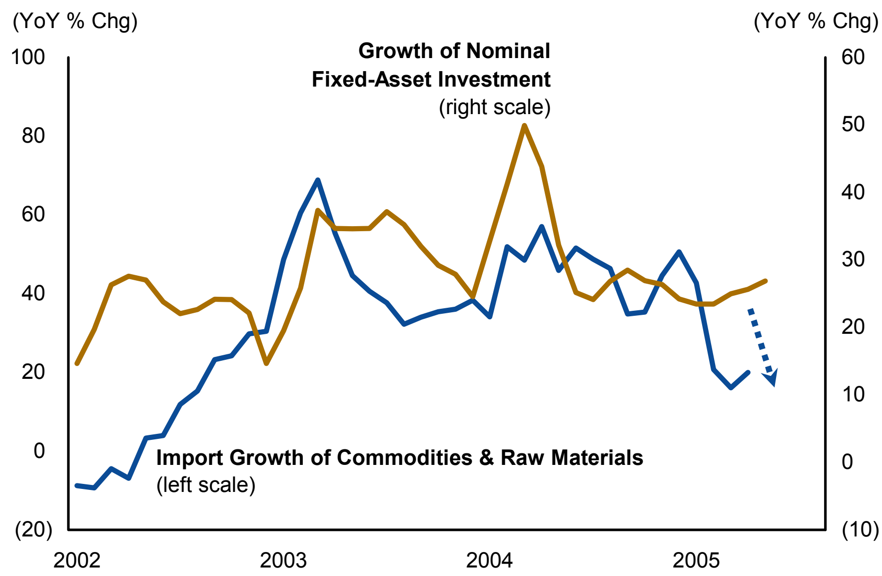
Display: Slower Import Growth Points to Decelerating Investment Growth



Source: CEIC Data and Alliance Capital Fixed Income estimates:June 21, 2005