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ASIAN WEEKLY ECONOMIC INSIGHTS

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China's Soft Landing Is On Track

China has released the key economic data for August. On balance, the latest trends point to a renewed moderation in investment growth, still firm industrial production but mainly because of robust export demand and local consumption. There are early signs of a possible peaking of CPI in the coming quarter, despite rising producer costs. Meanwhile, credit growth decelerated markedly but this may be exacerbated by the bad-debt disposals of state banks as happened in the prior two months.

Overall, the August data has reinforced our call that the Chinese economy is on course for a soft landing. Market talks of the risk of renewed economic strength, or the concern of a pending credit crunch are unwarranted. Beijing should be pleased with the August economic outcome and the policy implications will be as follows:

- Overall economic tightening will stay course but the risk of additional administrative tightening measures will remain low.
- Market-based measures will place high on the policy agenda, and these will include higher real interest rates, renewed domestic sterilization measures by the PBOC, and, ultimately, a stronger and more flexible currency.
- Structural policies will be focused on the reforms of land supply, the revisions of the company laws and investment regulations that will aim at promoting private-sector investment and business activities.

Production stays firm due to exports and consumption

The rebound of August industrial production growth to 15.9% yoy (from 15.5% in July) was mainly underpinned by strong manufacturing production and domestic retail sales (**see Display 1**). Exports surged 37.5% yoy in August, up from the already strong 34% yoy in July. August retail sales grew 8-9% yoy in real terms, even though car sales have further weakened. But falling car sales is mainly a supply-side factor rather than a demand problem as consumers anticipate the pending 7.6% cut in cars' import tariff next year. We see a strong possibility of a marked rebound of car sales in 2H/05.

What inflation risk?

Headline CPI was stable at 5.3% yoy in August, while PPI increased further to 6.8% yoy (from 6.3% in July). Stable headline CPI was, as we anticipated, due to the easing of food/grain prices. Again, the increase in core CPI (ex. food and energy) was not serious, up from 0.8% yoy in July to 1.1% yoy in August (**see Display 2 and 3**).

The inflation data is basically painting the same picture as last month - cost-push inflation remains serious but CPI inflation is unlikely to surprise too much on the upside thanks to stable food prices and the squeeze in firms' profit margin. We expect headline CPI will peak in the coming quarter or so, and maintain our forecast for a lower CPI inflation of 3.5% in 2005, from 5% in 2004.

Gap between investment and credit growth still too large

Fixed asset investment (FAI) growth eased to 26.3% yoy in August, from 31.1% yoy in July. Earlier report by *Bloomberg* of a continued surge of FAI growth to 32% yoy in August was, therefore, incorrect. Meanwhile, financial institutions' total loan growth and M2 growth slowed noticeably further to 14.5% yoy and 13.6% yoy respectively in August, from 16-17% yoy in July (**see Display 4**).

Looking at these two sets of data we have the following conclusions: a) We suspect that the credit slowdown was exaggerated by NPL disposals of several state banks again. In July, the exclusion of bad-debt resolution roughly boosted loan growth by about 1.5 percentage points. b) Nevertheless, the gap between loan growth and investment growth remains large, and this reflects that companies must have opted for alternative funding sources to complete their unfinished investment projects which were temporarily put on hold during April and May. A draw down of corporate deposits has been quite noticeable over the past few months (**see Display 5**).

Modest rate hikes in 4Q/04

Although inflation is set to peak, the urgency to maintain positive lending rate and deposit rates will demand higher nominal interest rates in the coming quarter. On balance, we expect the PBOC will be able to push through its initial proposal of a 25bp hike on lending rate and 50bp hike on deposit rates after the fourth plenum session of the Communist Party's Central Committee meeting on September 16-19. Thereafter, chances of further rate hikes look less unlikely if inflation starts rolling over and credit growth eases further in the next few months. Moreover, too high of a rate hike on bank deposit may run the risk of choking off the growth of consumer spending.

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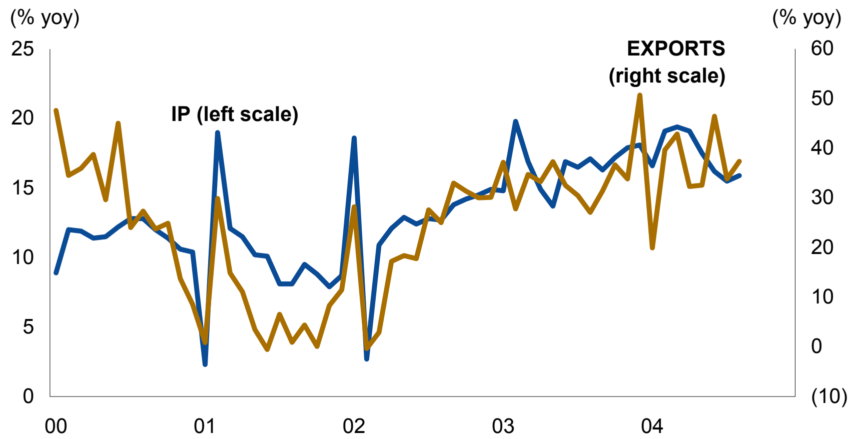
Display 1: Production Underpinned By Exports

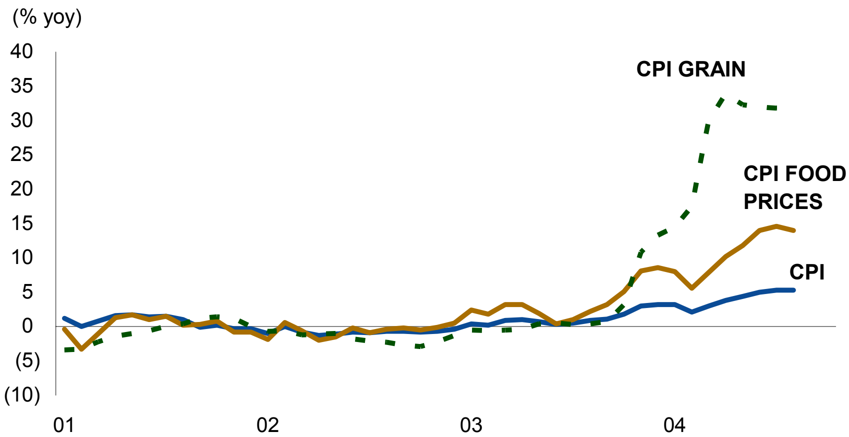
China Industrial Production and Exports



Source: CEIC and Alliance Fixed Income estimates, September 13, 2004

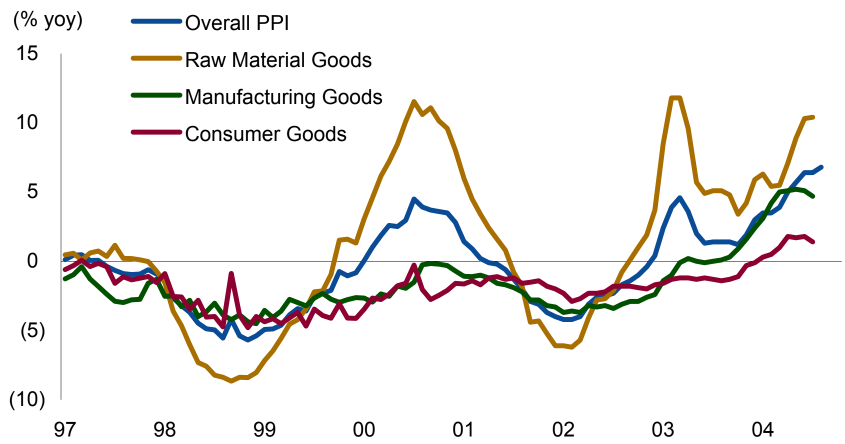
Display 2: CPI Inflation is Set to Peak

China CPI



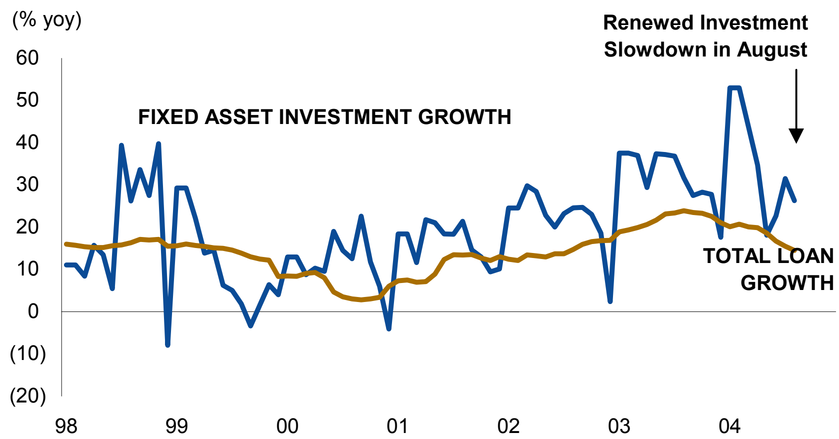
Source: CEIC and Alliance Fixed Income estimates, September 13, 2004

Display 3: Firms Are Taking a Margin Squeeze Despite Rising 'Upstream' Producer Prices
China PPI and Breakdown



Source: CEIC and Alliance Fixed Income estimates, September 13, 2004

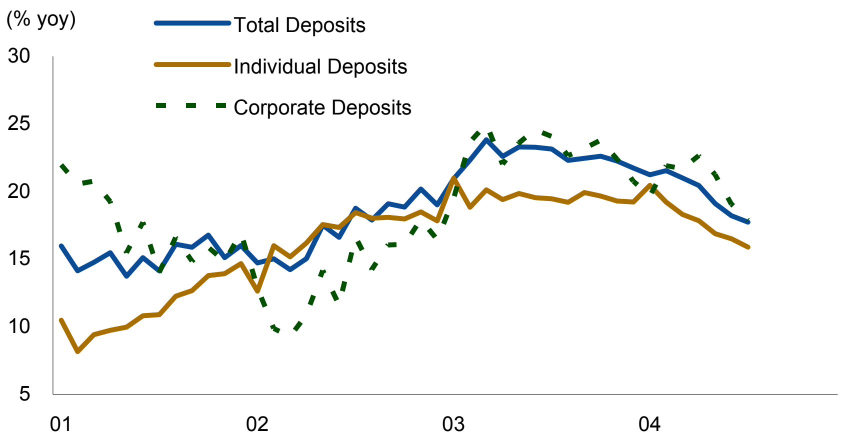
Display 4: Gap Between Investment Growth And Credit Growth Still Too Large
China Fixed Asset Investment and Financial Institutions' Total Loans



Source: CEIC and Alliance Fixed Income estimates, September 13, 2004

Display 5: Falling Bank Deposits

China Bank Deposits



Source: CEIC and Alliance Fixed Income estimates