

ASIAN WEEKLY ECONOMIC INSIGHTS



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Asian Economic Perspectives

Time for a Period of Economic Consolidation in China

The past few years of overheated expansion in China may finally be behind us. Certainly, the fact that nominal GDP growth has decelerated from a peak of 17.4% year-over-year in the third quarter of 2004 to 13.6% in the second quarter of 2005 would suggest that overall, Beijing's tightening policy has been effective in slowing the economy.

As such, we expect a period of consolidation to occur in 2005–2006, with nominal GDP growth slowing to 11.5% in 2006 from 13.0% in 2005 while real GDP growth eases to 8.0% next year from 9.0% in 2005. In addition, the engine of growth will further shift from investment to consumption while the export sector stays firm, provided the absence of more trade sanctions.

A Shift from Investment to Consumption

The central bank's credit tightening has worked well to cause a deceleration in real investment growth from its frenetic pace of expansion in 2003 and 2004—of over 30% year-over-year—and we expect the deflation of investment bubbles and the consolidation of property investment to lead to a further slowdown of investment in the coming year. While investment growth remained strong overall at around 20% year-over-year over the last few months, the structure has actually improved and become much healthier. Indeed, we have seen increased investment resources shifting toward bottlenecked sectors such as coal, railways, and energy and away from overheated sectors such as base metal products.

Meanwhile, real retail sales growth picked up markedly during the past two years and is currently running at a robust 10% to 12% year-over-year. We expect this double-digit rate of expansion to stay on course in 2006 as consumption remains the main pillar of growth, underpinned by rising income in both urban and rural areas.

Inflation Under Control

Notwithstanding surging energy prices, inflation appears set to remain under control in China. Thanks to the investment slowdown, falling domestic metal and raw material prices are counteracting the rise in oil prices. In fact, rising input costs have yet to result in a serious inflation pass-through onto prices of finished goods. Chinese industrial enterprises are operating with thin profit margins at around 3% to 5% among downstream finished goods producers and midstream raw-material processing firms, and many finished goods producers simply lack pricing power in domestic and overseas markets. As such, Chinese industrial enterprises have been taking a margin squeeze in the face of rising input costs instead of lifting finished good prices. Consequently, growth of industrial profits has slowed to 20% year-over-year in first seven months of 2005—almost half the 38% rate of expansion that occurred over the full year in 2004. Growth of total sales revenue remained robust at 28% year-over-year in the period from January to July, however, only marginally lower than the 31% growth that occurred during the whole of last year.

More Room For Credit Easing

Given the current slowdown in economic growth and the absence of serious near-term inflation risk, we expect the central bank to shift to a more relaxed credit policy in the next six to 12 months. If consumer price inflation remains benign, say below 2% year-over-year, and the investment cycle adjustment brings a downside surprise, we would expect the central bank to consider easing interest rates again in the first six months of 2006. On the currency front, we anticipate renminbi appreciation by another 5% against the US dollar over the next 12 months. The central bank may be more willing to use a firmer currency to control imported inflation (mainly oil), but the move is unlikely to be drastic.

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Alliance China Economic Forecast

September 2005

Levels (2000 RMB, Billions)	Quarterly								Annual			
	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06	3Q06	4Q06	2003	2004	2005	2006
GDP	2,774	3,204	3,361	4,276	3,001	3,444	3,630	4,627	11,406	12,489	13,615	14,701
Primary Industry	191	359	501	727	200	376	524	759	1,586	1,686	1,778	1,859
Secondary Industry	1,629	1,878	1,836	2,052	1,776	2,037	2,010	2,257	6,028	6,697	7,395	8,081
Tertiary Industry	954	964	1,024	1,498	1,025	1,031	1,096	1,610	3,799	4,114	4,439	4,762
GDP*									12,066	13,266	14,480	15,634
Household Consumption									5,212	5,621	6,015	6,496
Government Consumption									1,465	1,559	1,591	1,670
Fixed Investment									5,014	5,695	6,264	6,828
Change in Inventory									25	45	(40)	20
Net Exports									350	346	650	620
Domestic Demand									11,716	12,920	13,830	15,014
Percent Changes												
	(% Y/Y)								(%)			
GDP	9.4	9.6	8.9	8.4	8.2	7.5	8.0	8.2	9.5	9.5	9.0	8.0
Primary Industry	4.6	5.2	6.0	5.5	4.5	4.5	4.5	4.5	2.5	6.3	5.5	4.5
Secondary Industry	11.1	11.3	10.0	9.5	9.0	8.5	9.5	10.0	12.7	11.1	10.4	9.3
Tertiary Industry	7.7	7.9	8.0	8.0	7.5	7.0	7.0	7.5	7.8	8.3	7.9	7.3
GDP*									10.7	9.9	9.1	8.0
Household Consumption									6.5	7.9	7.0	8.0
Government Consumption									5.1	6.5	2.0	5.0
Fixed Investment									19.2	13.6	10.0	9.0
Change in Inventory (contrn.)									-0.1	0.2	-0.6	0.4
Net Exports (contrn.)									-0.2	0.0	2.3	-0.2
Domestic Demand (contrn.)									10.9	10.0	6.9	8.2
Key Macro Indicators												
Nominal GDP (Levels)	3,132	3,610	3,864	4,840	3,513	4,026	4,310	5,396	11,739	13,688	15,446	17,245
%Y/Y	14.9	13.6	12.2	11.6	12.2	11.5	11.5	11.5	11.6	16.6	12.9	11.6
Industrial Production (% Y/Y)	14.5	16.5	16.0	14.5	12.5	11.0	10.0	11.5	16.7	16.2	15.4	11.3
Fixed Asset Investment (% Y/Y)	24.0	26.8	26.5	23.0	18.0	16.0	15.0	18.0	26.7	27.6	25.1	16.8
Retail Sales (% Y/Y)	13.7	12.6	12.8	12.5	12.2	12.0	11.5	11.5	9.1	13.3	12.9	11.8
Exports (% Y/Y)	34.7	30.9	28.0	25.0	20.0	18.0	15.0	15.0	34.7	35.4	29.7	17.0
Inflation %Y/Y												
GDP Deflator	5.0	3.7	3.0	2.9	3.7	3.7	3.3	3.0	1.9	6.3	3.6	3.4
Consumer Price Index	2.8	1.7	1.6	1.2	1.2	1.5	1.8	2.0	1.2	3.9	1.8	1.5
Producer Price Index	5.6	5.6	5.5	5.3	5.5	5.0	4.5	4.0	2.3	6.1	5.5	4.8
Key Rates (End Of Period)												
1Y benchmark lending rate (%)	5.58	5.58	5.58	5.58	5.33	5.33	5.33	5.33	5.58	5.58	5.58	5.33
10Y benchmark lending rate (%)	6.12	6.12	6.12	6.12	5.87	5.87	5.87	5.87	5.76	5.76	6.12	5.87
RMB/US\$	8.28	8.28	8.11	7.90	7.85	7.80	7.70	7.70	8.28	8.28	7.90	7.70

*Real growth rates and constant prices of expenditure-based GDP are estimated by Alliance Capital based on published official nominal data.

Source: Alliance Capital Fixed Income; September 9, 2005