ACM FUNDS

GLOBAL ECONOMIC RESEARCH

ASIAN WEEKLY ECONOMIC INSIGHTS

November 11, 2005

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With Investment Under Control, China Looks to Boost Consumption

After a massive buildup of production capacity and worsening resource conservation during the investment boom in 2001 to 2004, Beijing is apparently turning its attention to the task of shifting the engine of growth from investment to consumption over the next five years—according to its just-announced economic program for 2006 to 2010. But recent signs of a rebound in fixed asset investment (FAI) growth and the continued surge in broad money supply (M2) growth have exacerbated fears of a renewed construction boom, thereby forcing the government to clamp down on investment again in the coming year. Moreover, given Chinese consumers' high propensity to save, we don't see how adequate consumption growth can be achieved, even with increased tax breaks and other incentives, until needed social welfare reforms are well underway.

More Balanced Investment

In truth, risk of a renewal of the property-led construction boom is low. Growth of land purchases has stayed benign since the economic tightening cycle began in the second quarter of 2004 (**Display 1**). Though investment in real estate from January to September advanced a healthy 23% year-over-year, it was lower than total fixed asset investment (FAI) growth of 28% during the same period (**Display 2**). Real estate construction in inland and second-tier cities is still robust, and underlying demand in these places is naturally stronger because of the low degree of urbanization. Nationwide, total floor space under construction remains well-behaved and the growth rate is much lower than that witnessed during the construction boom in 2003 and 2004. Total floor space completed has rebounded noticeably over the past few months (**Display 3**), but this could well be because developers rushed to complete ongoing projects in response to the central government's high-profile measures to correct the property bubble in Shanghai early this year.

Clearly, FAI has become more balanced. But as there is a need to prop-up investment in the sectors of the economy still experiencing bottlenecks, we expect underlying investment strength to stay robust in 2006. FAI growth rebounded in the third quarter in both real and nominal terms (**Display 4**), in line with the recent revival of growth of commodity and raw materials imports (**Display 5**). Indeed, investment is strong on the whole but a breakdown by sector shows an improved structure, in tune with the government's intended policy of boosting investment in bottlenecked sectors. During the first three quarters of 2005, investment growth rates in the officially indentified overheated sectors such as ferrous and non-ferrous metals and real estate have been far lower than that in bottlenecked sectors such as coal mining, railways, energy and agriculture (**Display 6**). On a year-over-year basis, growth of investment in coal mining is up by a spectacular 77%, and in electricity and utilities, is up 37%. The explosive advancement in coal and electricity investment may even lead to a temporary glut in those markets one or two years down the road, according to senior government officials with whom we talked recently.

Liquidity Rebounds But Lending Under Control

Growing 18% year-over-year in September, M2 growth has exceeded the central bank's annual target of 16% for three months in a row (**Display 7**) and has also outperformed the growth of bank loans (up 13.8% year-over-year in September) and M1 growth (up 11.6% year-over-year). The sharp revival in M2 growth was caused by the surge in quasi-money (M2 equals M1 plus quasi-money)—the result of the influx of funds into bank deposits by investors expecting further renminbi (RMB) appreciation (**Display 8**).

We think the central bank may have deliberately allowed a temporary increase in liquidity by underachieving in its sterilization effort (which attempted to maintain a low domestic interest-rate structure in a bid to reduce the attractiveness of the currency). In restrospect, despite an influx of speculative funds since early 2004, policymakers were able to slow the growth of reserve money from 18.0% to 19.0% year-over-year in the second quarter of 2004 to a mere 10.4% in April 2005, thanks to effective domestic sterilization via bond issues and the withdrawal of government deposits. Yet reserve money growth rebounded to 15.4% year-over-year in July. This could be an intended policy rather than a loss of sterilization control (**Display 9**).

Although the strong expansion of broad liquidity could boost investment and rekindle inflation in the long run, at the end of the day the central bank has the ability to fully sterilize the excess liquidity if it so desires.

Equally important, as long as the risk appetite of Chinese banks remains tame, we do not expect a big surge in loan growth in the next few quarters. To be sure, the rebound in investment has yet to be reflected in loan growth (**Display 10).** Banks are awash in liquidity, yet they have become increasingly risk-averse and are less willing to expand their loan books because of higher capital adequacy constraints. In discussions with Chinese banks we learned that new loans are being made primarily to first-tier customers and the risk appetite of lending is generally low, even among branch loan officers.

Although total loans outstanding picked up in August and September following a sharp contraction in the prior three months, the most noticeable revival was in short-term loans which no doubt were used to ease the squeeze on working capital funds at domestic enterprises (**Display 11**).

To Replace Investment, Consumption Has a Ways to Go

In the end, though the administration has certainly been successful in bringing the overheating pace of investment under control, we believe the plan to shift the engine of growth from investment to consumption by 2010 may be too optimistic. In our view, the country's low per capita income and inherently high saving rate caused primarily by the grossly underdeveloped social welfare program suggest that consumption will not replace investment for a long while.

Beijing plans to double China's per capita GDP by 2010 from the 2000 level of US$853. This implies real GDP growth of 7.2% p.a. in 2006 to 2010 (versus an actual growth rate of 8.8% p.a. over the past five years).

We don't see how they can do it in that timeframe. China's high national saving rate (47% of GDP in 2004) is largely motivated by the inadequacy of government programs for social welfare, health care and housing. Thus, the propensity to save, especially among urban dwellers, is high. In order to create a structural improvement in consumption growth, we believe the government will have to successfully embark upon social welfare reforms which could take three to five years just to develop. In our view, the saving mentality of Chinese consumers is unlikely to change until this reform is well underway. Moreover, the government will have to address the need to expand production capacity to absorb an extra 65 million in the working population during the next 10 years.

Beijing will no doubt focus on stimulating rural consumption, but we think the effect on GDP growth will not be significant. The split of rural/urban consumption is 40/60 in the national income account, and urban per capita GDP is around US$780—double that of rural areas.

Thus, the way we see it, given the current stage in China's growth cycle, the investment-led growth model should last for at least another decade.

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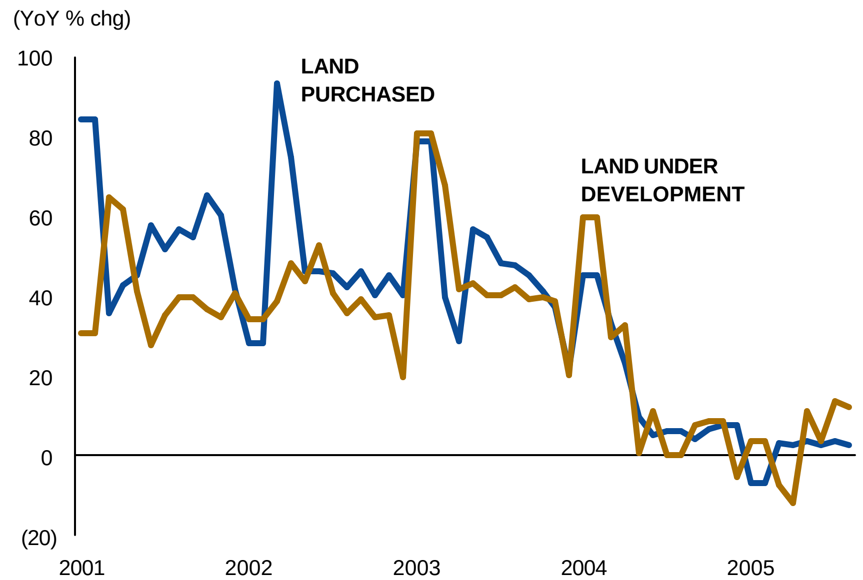
Display 1: Land Purchase Data Do Not Suggest a Construction Boom

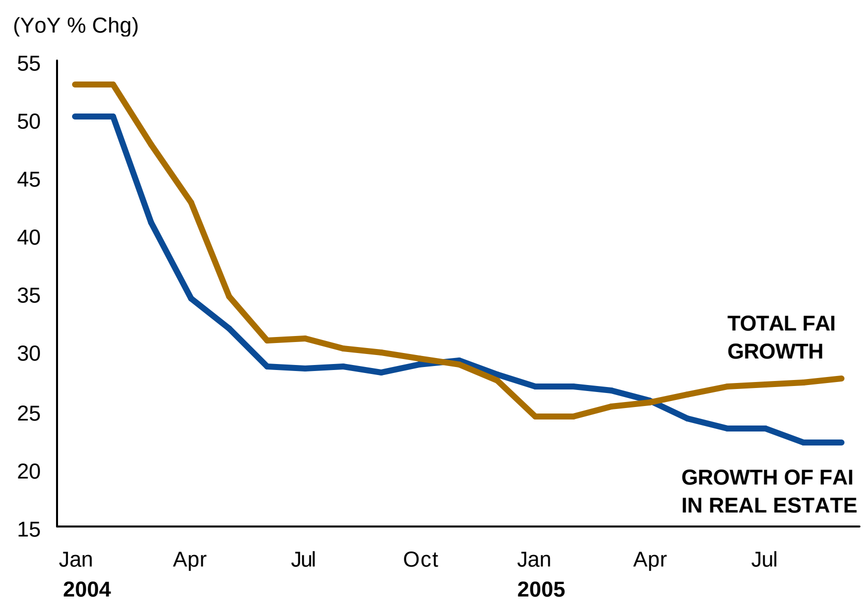
Trends in Land Purchases



Source: CEIC Data and Alliance Capital Fixed Income estimates: 11/11/05

Display 2: Investment in Real Estate Remains Stable

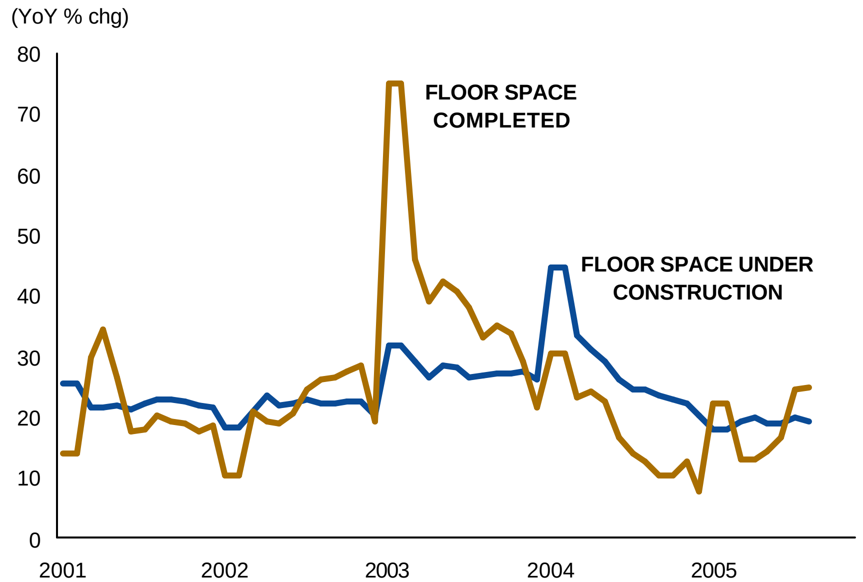
Growth of Real Estate Investment vs. Total Fixed Asset Investment



Source: CEIC Data and Alliance Capital Fixed Income estimates: 11/11/05

Display 3: Anticipating Government Controls, Developers Rushed to Complete Third-Quarter Projects

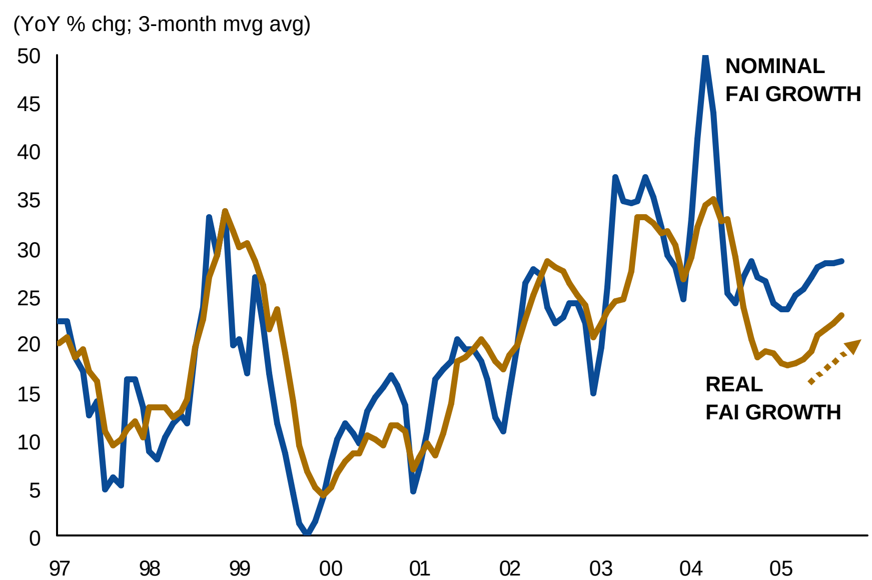
Floor Space Construction (Year-to-Date)



Source: CEIC Data and Alliance Capital Fixed Income estimates: 11/11/05

Display 4: Is Investment Making a Comeback?

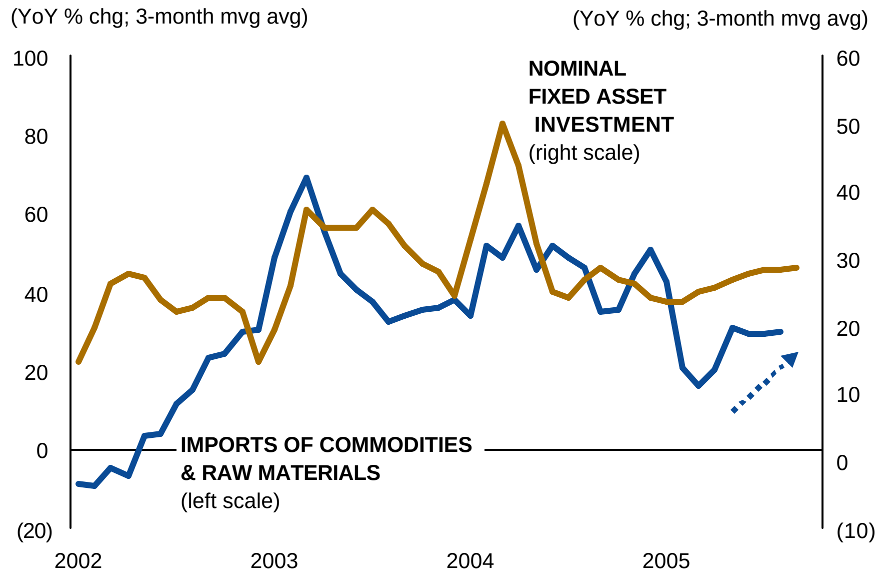
Fixed Asset Investment Growth



Source: CEIC Data and Alliance Capital Fixed Income estimates: 11/11/05

Display 5: Import Revival in Line With Investment Rebound

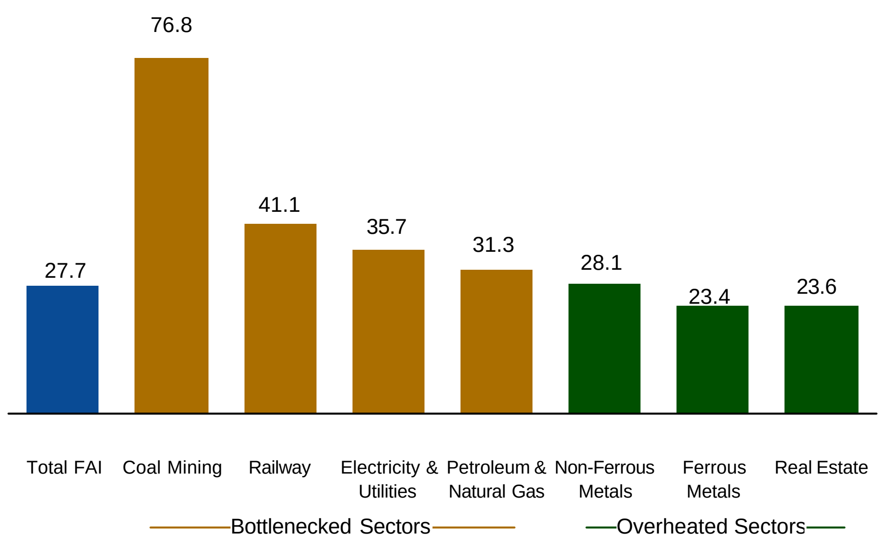
Investment and Imports



Source: CEIC Data and Alliance Capital Fixed Income estimates: 11/11/05

Display 6: Increased Investment Flows to Bottlenecked Sectors

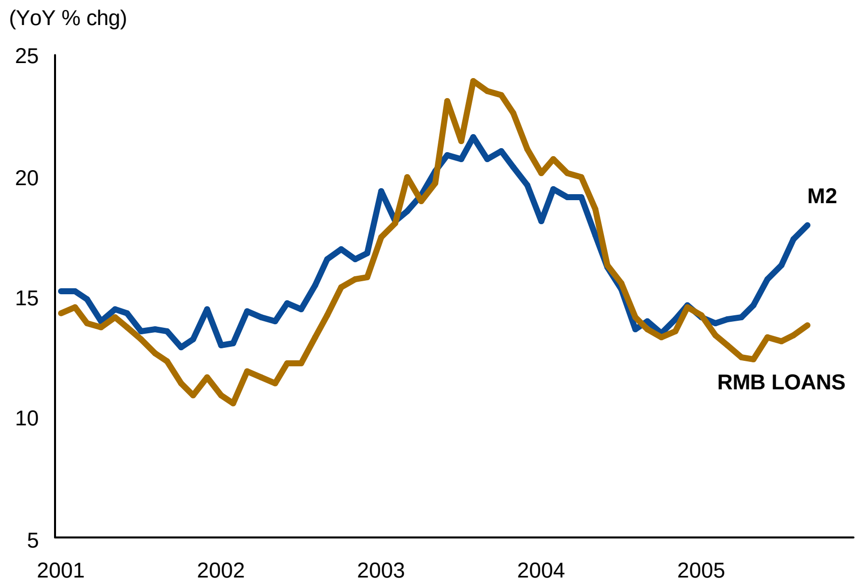
Fixed Asset Investment Growth By Sector (January–September 2005)



Source: CEIC Data and Alliance Capital Fixed Income estimates: 11/11/05

Display 7: Loan Growth Has Lagged M2 Expansion

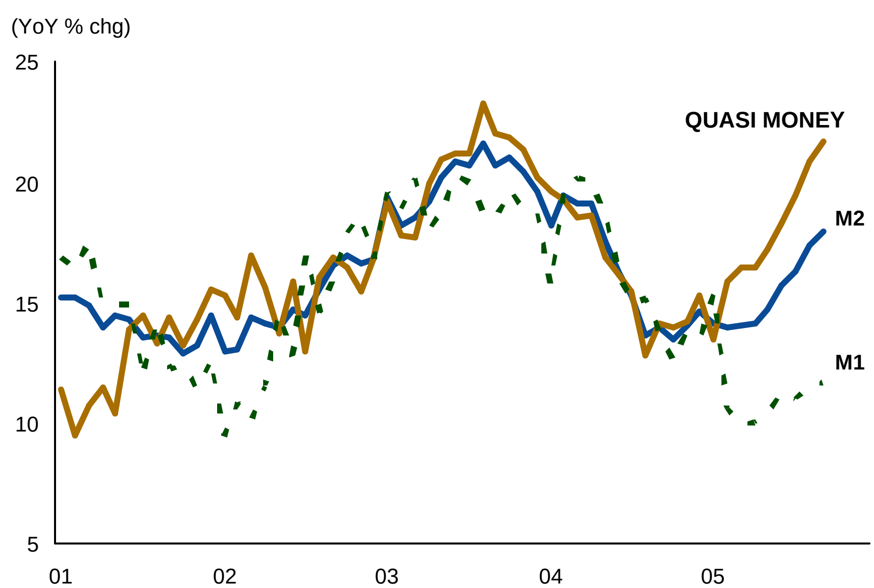
Money Supply and Loan Growth



Source: CEIC Data and Alliance Capital Fixed Income estimates: 11/11/05

Display 8: Pickup in M2 Growth Not a Sign of Monetary Easing

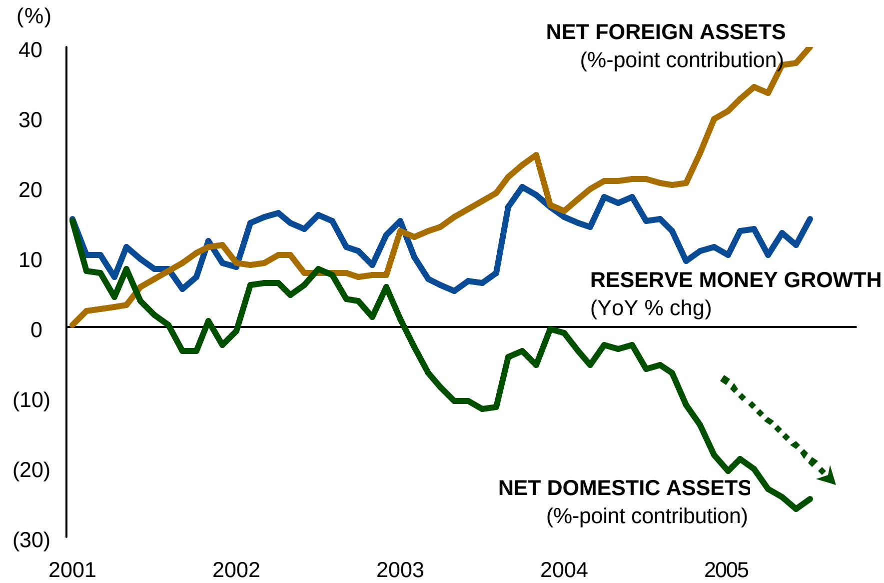
Money Supply Growth



Source: CEIC Data and Alliance Capital Fixed Income estimates: 11/11/05

Display 9: PBOC Maintains Active Foreign Exchange Steralization

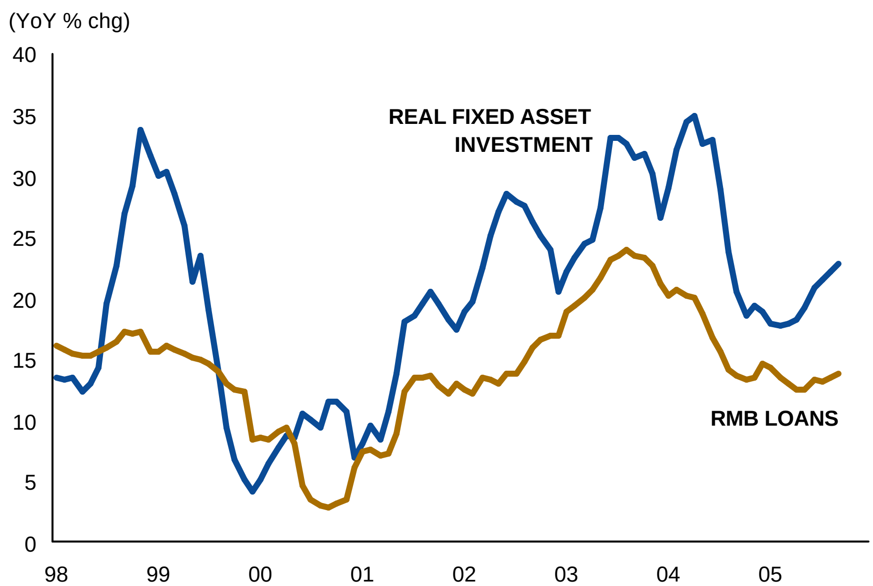
Central Bank Balance Sheet



Source: CEIC Data and Alliance Capital Fixed Income estimates: 11/11/05

Display 10: Stable Loan Growth Not Supportive to Investment Upturn

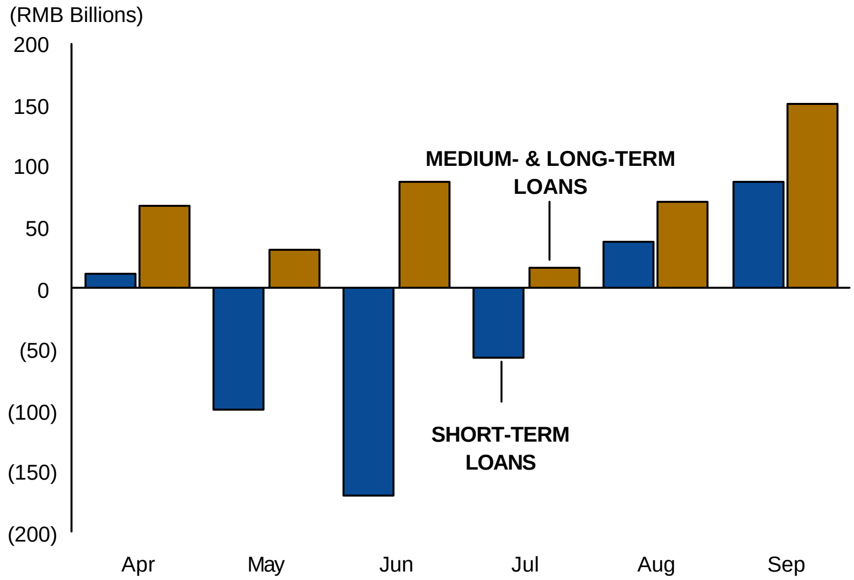
Growth of Investment vs. Bank Loans



Source: CEIC Data and Alliance Capital Fixed Income estimates: 11/11/05

Display 11: Pickup in Short-Term Working Capital Loans

Monthly Changes of RMB Loans By Duration



Source: CEIC Data and Alliance Capital Fixed Income estimates: 11/11/05