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GLOBAL ECONOMIC RESEARCH

ASIAN WEEKLY ECONOMIC INSIGHTS

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Asian Economic Perspectives

As China's Investment Bubble Deflates, So Does Inflation Threat

For the past five years, China's main economic problem has been overcapacity. Too much supply has created economic bottlenecks which have led to sectoral inflation, primarily in upstream sectors.

But as the investment cycle unwinds, this trend is set to turn.

Inflation in final goods and services is tame. In addition, last year's bumper harvest restrained food price increases, which still have a vital influence on inflationary expectations for the Chinese economy.

Furthermore, the latest tightening measures introduced by the central government to curb property speculation in major cities have turned out to be much tougher than anticipated. This has raised our confidence in Beijing's ability to engineer a correction in the real estate market, principally in Shanghai, in the second half of the year. Moreover, as a result of these measures, growth in fixed asset investment could surprise on the downside in 2005.

Consequently, we do not anticipate alarming inflation risk on the six- to 12-month horizon. In fact, inflation today is less worrying to us than the possibility of renewed deflation over the next few years.

Inflation Risk Is Overstated

In our view, the market has overpriced inflation risk for the coming year. To be sure, though a stronger pass-through of upstream inflation to downstream prices has long been anticipated, nothing has actually happened over the past six to nine months. There is simply too little pricing power among firms in the finished goods sector, both locally and globally (**Display**).

We believe that upstream inflation is unlikely to hold for long because the margin squeeze—which already has occurred in most of the down- and mid-stream industrial firms—will move up the production chain. We expect that producer price inflation, which rose to 5.8% year-over-year in April from 5.6% in March—still much lower than the 8.4% peak of last October—will hover at around 4% to 5% year-over-year in the second half. Core consumer prices (CPI excluding food) are expected to average about 2% in 2005, against 1% in 2004.

Less Real Estate Speculation Means Slower Investment Growth

Now that investment in steel, cement, and motor vehicles has slowed, the government's prime tightening target has shifted to property. Additional tightening measures unveiled by the government last week included a sales tax to be applied to residential flats sold within two years of purchase, tax penalties for developers holding idle land, and the prohibition of the resale of unfinished flats. Moreover, local authorities are now politically accountable for containment of property prices.

The initial results of the new tightening measures are quite encouraging. According to figures released this week, property loans in Shanghai stood at RMB 384 billion at the end of April, up 34% year-over-year compared to 40% at the end of March. Secondary market trading has slowed markedly over the past month. And, anecdotal evidence suggests that residential property prices in Shanghai have declined by 15% to 20% over the past few weeks in response to the tightening measures. We have also learned that many developers with large land bands have been holding off on real estate projects.

Given our confidence in the government's ability to engineer a correction in the property market—most importantly, in Shanghai—we forecast that fixed asset investment growth will surprise on the downside as the year progresses, notwithstanding increased domestic investment flows to bottlenecked manufacturing sectors. Indeed, given the probable adjustment in property speculation, we see investment growth slowing more quickly than currently envisaged in the second half, say, from the

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current 25% year-over-year to around 10% to 12% by year-end.

The key question now is whether the current correction is sustainable. At the very least, we expect to see temporary relief in demand for steel and raw construction materials, as the property market consolidates.

Interest-Rate Hikes Will Be Modest

In the absence of a serious inflation threat, there will be limited upside risk on interest rates. We expect the one-year benchmark lending rate will increase by at most 50 basis points to 6.08% in 2005. In addition, we have learned that the central bank is inclined to maintain a low deposit rate in order to buttress consumer spending—a key contributory factor to GDP growth in 2005 as investment eases. Thus, though they are mostly in negative territory, real interest rates on bank deposits are likely to remain low.

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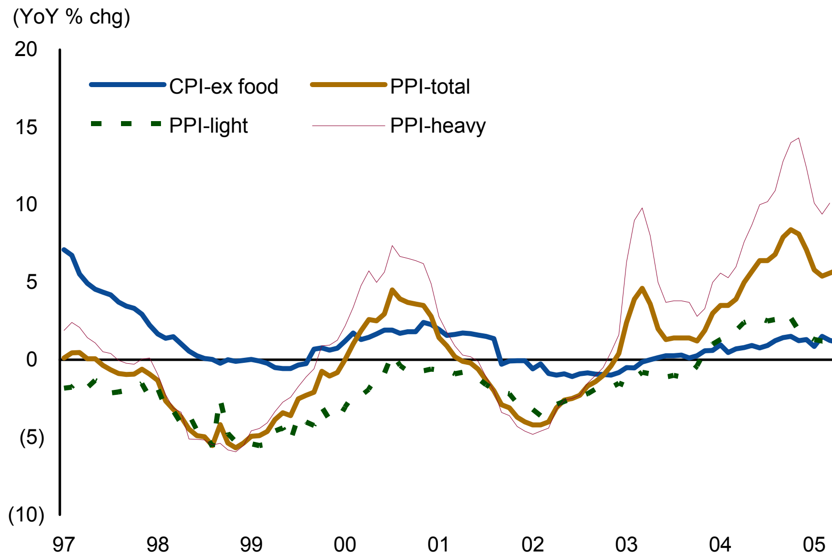
Display: Contrary to Expectations, Little Pass-through of Upstream Inflation to Downstream Prices Has Occurred over the Past Year

Producer and Consumer Price Inflation



Source: CEIC Data Inc. and Alliance Capital Fixed Income estimates

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