GLOBAL ECONOMIC RESEARCH

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China's Inventory Adjustment Taking Shape

At long last, the anticipated inventory correction is underway in China's industrial sector. So far, the pace of the stock adjustment has been modest. But over the next six to nine months, further deceleration of inventory growth is expected as the investment bubble deflates.

Importantly, the ongoing adjustment probably will have only a marginal impact on global demand, as this is a typical business cycle inventory adjustment and risk of sharp inventory depletion remains low as long as China's real economic expansion stays well above 6% to 7% per annum.

We estimate that stockpiling of industrial inventories reached a peak at the end of 2004. Indeed, real inventory growth eased to 19.8% year-over-year in June 2005 compared to 24.5% last December. Over the past six months, the slowdown was witnessed across the board, with the machinery and equipment sector being the key contributor to the growth downturn, while the contribution from light industry was stable (**Displays 1–2**).

During the second quarter, however, metal and chemical sector inventories showed regained momentum, contributing almost half of the total inventory expansion in June. The contribution from the mining sector rose as well, but its share of total inventory growth remained below 6% .

Thus, our biggest concern is the continued stock building of base metals and chemical products. Even still, as long as local consumption and exports—the two pillars of economic growth—are able to absorb the industrial stocks generated by existing and new capacity in the coming year, any buildup of inventory would be unlikely to cause a major disruption to China's macroeconomic adjustment, in our view. And, at around 60% to 65%, the ratio of real inventories to real industrial sales has remained relatively low and steady. After experiencing a temporary dip at the end of last year, real industrial sales growth outpaced the expansion of inventories during the first six months of 2005. Moreover, a breakdown of industrial sales by sector shows light-industry sales—a proxy for domestic consumption—were steady over the past year, and sales to export markets stayed high. At the same time, a noticeable deceleration in heavy-industry sales occurred over the past year. A further slowdown should bring along a continued moderation in inventory building of metal products (**Displays 3–5**).

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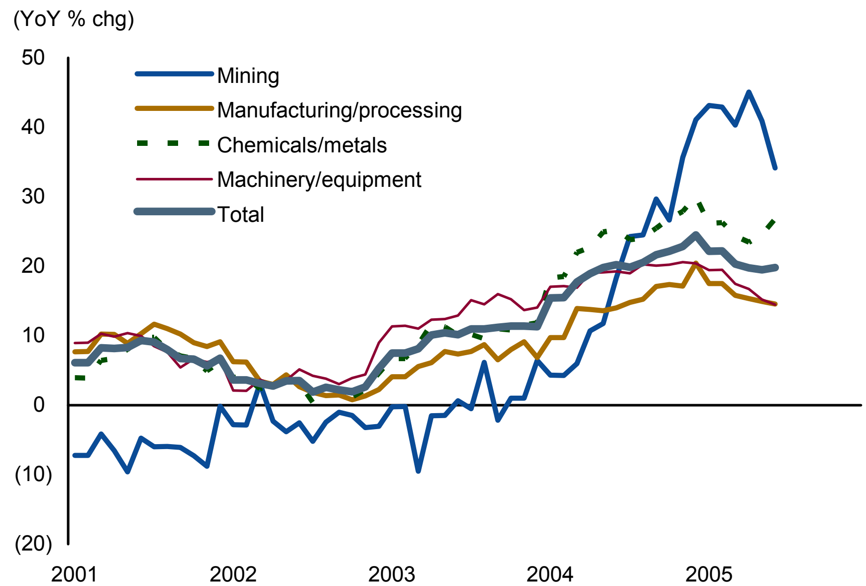
Display 1: Inventory Correction Is Taking Shape

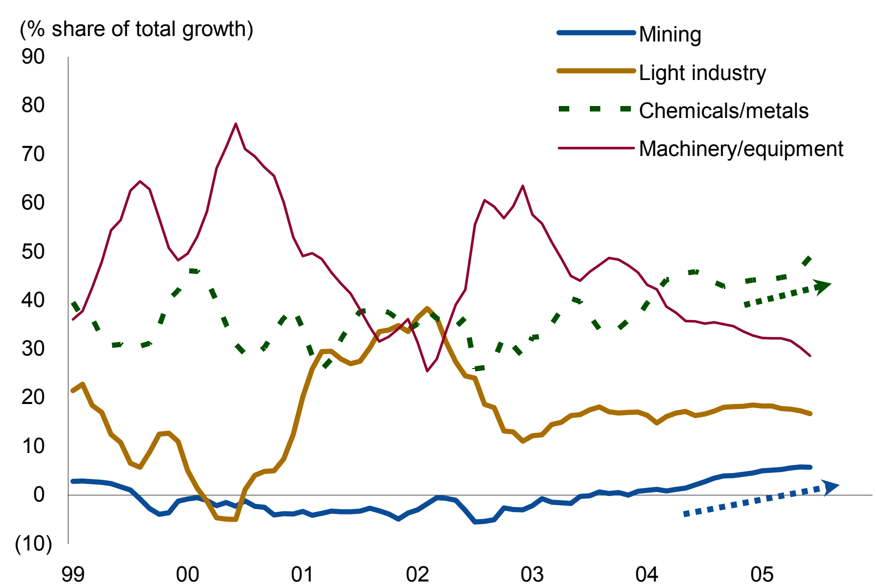
China Real Growth of Inventory and Sector Breakdown



Source: CEIC Data and Alliance Capital Fixed Income estimates. August 5, 2005

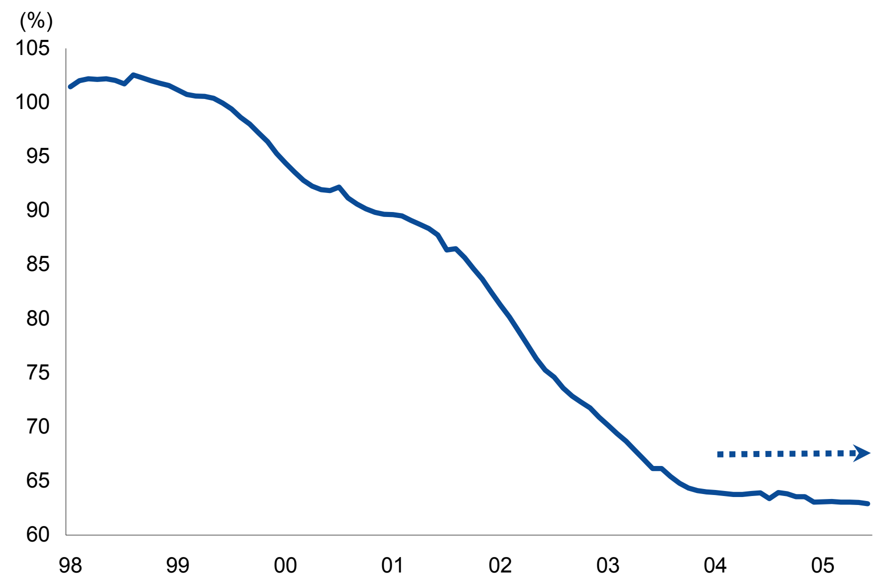
Display 2: Metal/Chemical and Mining Sectors Remain Key Drivers of Inventory Buildup

China Sector Contribution to Real Inventory Growth



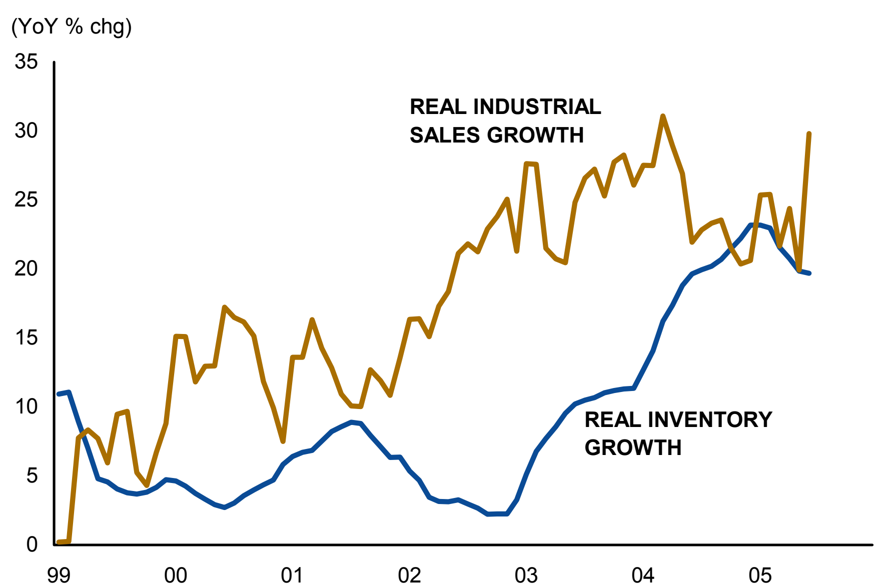
Source: CEIC Data and Alliance Capital Fixed Income estimates. August 5, 2005

Display 3: Relative to Sales, Inventories Remain Low and Stable
Ratio of Real Inventories to Real Industrial Sales



Source: CEIC Data and Alliance Capital Fixed Income estimates. August5, 2005

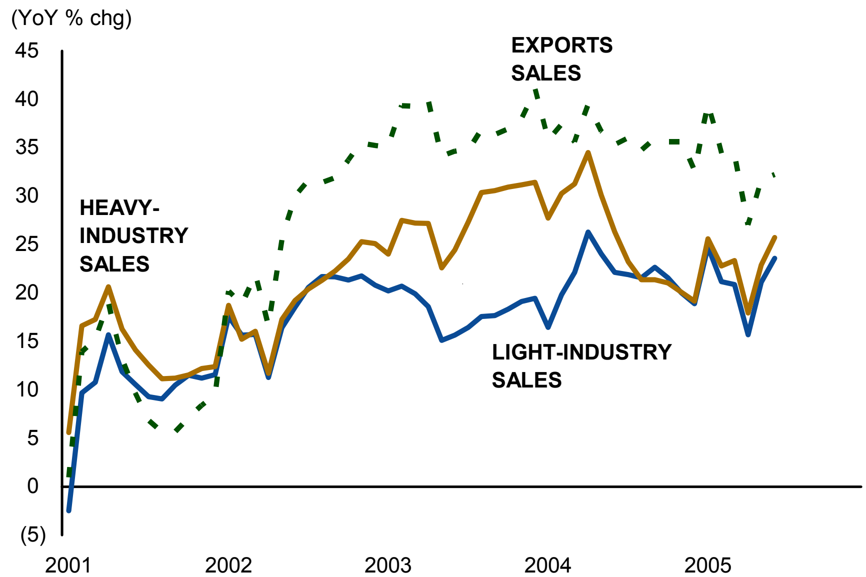
Display 4: Sales Growth Continues to Outpace Inventory Growth
Growth of Real Inventories and Industrial Sales



Source: CEIC Data and Alliance Capital Fixed Income estimates. August 5, 2005

Display 5: Sales to Heavy-Industry Sectors Have Moderated

China Sector Breakdown of Real Industrial Sales



Source: CEIC Data and Alliance Capital Fixed Income estimates. August 5, 2005