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Asian Economic Perspectives

China's Structural Adjustment Takes Shape

China's much-needed economic adjustment appears to be in the works. Fixed-asset investment (FAI) and imports appear to be shifting from overheated to bottlenecked sectors, while early signs have emerged that industrial production and inventory accumulation will moderate during the year.

Meanwhile, both domestic consumption and exports remain the main pillars of growth. If these trends continue, conditions will be perfect for Beijing to reduce its reliance on administrative controls and shift toward more market-based measures as a means to fine-tune the economy. Indeed, a firm economy combined with a more balanced growth structure will provide the perfect conditions for China to embark on its next phase of market reforms.

Improved Investment Structure

At first glance, it was a worry that FAI growth in January and February had not decelerated further. Nominal FAI growth averaged 24.5% year-over-year in January and February, against 24.2% in the fourth quarter. (We estimate that real FAI growth was about 19% year-over-year in January and February versus 16% in the fourth quarter.) But to our relief, we discovered that behind the headline FAI numbers reflect a reallocation of investment, away from overheated sectors toward bottlenecked sectors, thanks to the government's improved restructuring efforts.

To be sure, the majority of investment growth in January and February was seen in bottlenecked sectors such as petroleum and natural gas, where it was up 54% year-over-year; coal mining, up 149%; electricity and utilities, up 63%; and the agricultural sector, up 74%. In contrast, investment in overheated sectors such as ferrous metals and non-metal mining was down 8% and 9% year-over-year, respectively, while investment in non-ferrous metals increased by a mere 9%.

Slower Imports in Overheated Sectors

Imports recorded weaker-than-expected 8.3% year-over-year growth in January and February, a marked decline from 30% year-over-year in the fourth quarter.

Detailed information of the import breakdown is not yet available, but inspection of import volume data up to January shows that, while imports for exportrelated purposes and local consumption remained firm, construction-related import items have slowed down noticeably. For example, the volume of steel imports increased at mere single-digit rates yearover-year by the end of last year, following a contraction in the third quarter. And, year-over-year growth in aluminum imports contracted by about 8% in the fourth quarter, in comparison to a growth rate of over 50% in the first quarter of 2004. At the same time, double-digit expansion has been maintained in imports of machinery and electrical items, as well as textile varn and fabrics. And, imports of fertilizers have picked up significantly on the back of the government's renewed effort to boost domestic food production (Displays 1 and 2)

Inventory Accumulation Appears Set To Moderate

According to our analysis, stockpiling of industrial inventories continued unabated up to December 2004. Real inventory growth surged to 24.5% year-over-year in December, from about 16% in the first quarter. The ratio of real inventories to GDP jumped to 8.0% from the trough of 6.8% in October 2002, although the ratio of real inventories to real industrial sales remained relatively low and steady at around 60% to 65%. Chemical/metal products and mining have been the main drivers of the stock buildup, while the contribution from machinery and equipment has declined (**Display 3**).

Inspection of the breakdown of real industrial sales shows that, while sales to local light industry (a proxy for domestic consumption) and export sales have remained steady, growth in heavy industrial sales has decelerated noticeably over the past few months.

If these trends continue, we expect that the ratio of real inventories to real industrial sales will revive further this year. This, in turn, will lead to a further slowdown in industrial production, primarily led by the deceleration in heavy industry, setting the conditions for inventory accumulation to moderate (**Displays 4–6**).

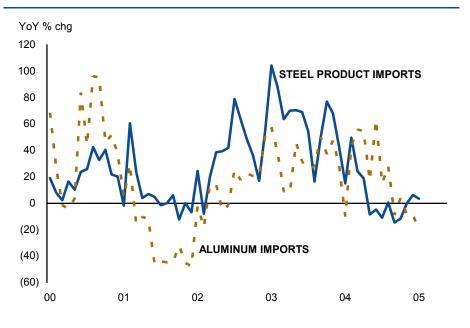
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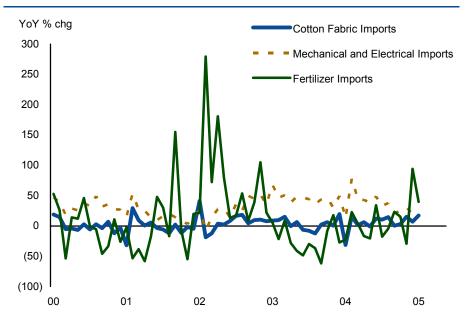
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Display 1: Construction-Related Imports Have Slowed Import Volume



Source: CEIC and Alliance Capital Fixed Income estimates. March 18, 2005

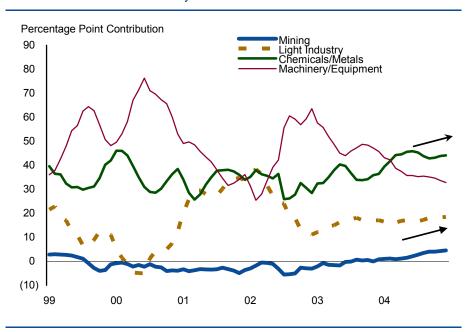
Display 2: Export- and Consumption-Related Imports Stay Firm Import Volume



Source: CEIC and Alliance Capital Fixed Income estimates. March 18, 2005

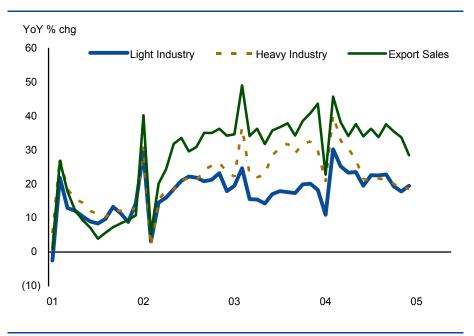
Display 3: Chemical/Metal Sectors and Mining Remain Key Drivers of Inventory Buildup

Contribution To Real Inventory Growth



Source: CEIC and Alliance Capital Fixed Income estimates. March 18, 2005

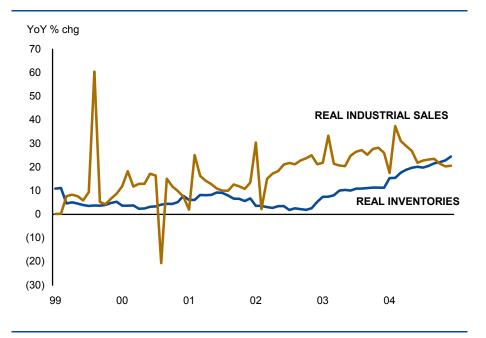
Display 4: Sales To Heavy Industrial Have ModeratedBreakdown of Real Industrial Sales



Source: CEIC and Alliance Capital Fixed Income estimates. March 18, 2005

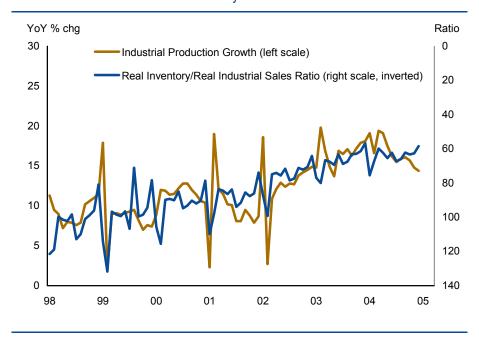
Display 5: Inventory Gorwth Has Outpaced Sales

Growth of Real Inventories and Industrial Sales



Source: CEIC and Alliance Capital Fixed Income estimates. March 18, 2005

Display 6: Output Will Moderate As Inventory/Sales Ratio Revives Industrial Production & Real Inventory/Sales Ratio



Source: CEIC and Alliance Capital Fixed Income estimates. March 18, 2005