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ASIAN WEEKLY ECONOMIC INSIGHTS

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Asian Economic Perspectives

China: As Good as it Gets

Almost a year after the central government's implementation of tightening measures to cool China's overheating economy, trends continue to suggest that the economy is on track for a soft landing. And, although the past 12 months have not been smooth sailing for policymakers, when compared to prior economic adjustments the disruption caused by their austerity program has probably been the least severe.

In a nutshell, a peak in the industrial production cycle early this year was followed by a gradual normalization in the rate of expansion to a more sustainable pace. Yet this hasn't dampened the performance of exports, which have remained resilient and outshined their regional counterparts. Nor has it dampened local consumption, which remains a buffer to growth.

Investment in fixed assets has slowed noticeably, although further adjustments are needed to halt excess in some overheated sectors.

Credit growth is under control far earlier in the tightening cycle than in prior episodes of overheating. There is even room for the monetary authority to loosen credit somewhat, as higher interest rates kick in.

And finally, inflation has greatly surprised on the downside, an indication of the severity of excess capacity in the economy. Falling inflation, and the resultant increase in real interest rates, will allow the central bank to raise interest rates in a more steady and measured manner over the coming year.

Overall, we believe that the current pace of the slowdown and the economy's subsequent adjustments are within the comfort zone of Chinese policymakers. Continued strength will increase Beijing's confidence to accelerate reforms in state-owned enterprises and the banking sector, and to proceed in adjusting the exchange rate in 2005.

Sustainable Output and Soaring Exports

Output growth on a year-over-year basis is normalizing to the more sustainable 12% to 15% range. To be sure, industrial production growth stayed firm in November, down slightly at 14.8% from 15.7% in October (**Display 1**). Production in heavy industries has continued to ease, with the output of raw steel slowing to 21.2% year-over-year (from 24.4% in October), coal declining to 12.1% (from 16.3%), and power production moderating to 14.4% (from 15.8%).

Despite easing in industrial production, exports continued to expand by a hefty 46% year-over-year in November from 28% in October, to a record high of USD 60.9 billion. Equally important, import growth rebounded further to 38% year-over-year from the recent trough of 22% in September, reaching a historical high of USD 51 billion (**Display 2**). It is important to note that September's marked slowdown in import growth was influenced by many technical factors which created a high base effect, so we look to investment and consumption data as a better guage of domestic demand growth for the period.

Also in November, the trade surplus expanded further to a record monthly high of USD 9.9 billion. We don't think the dramatic turnaround of the trade balance, from a deficit in the first four months of the year to a growing surplus in the following six months, is a sign of weakness in domestic demand (**Display 3**). Rather, we suspect Chinese export companies have over-invoiced their export earnings and/or under-invoiced imports as a means to gain on a possible RMB revaluation.

Inflation Has Surprised on the Downside

Year-over-year growth in the consumer price index (CPI) fell to 2.8% in November (against our expectation of 3.5% to 4.0%), from 4.3% in October. The sharp decline was due in part to a high base effect and in part to a marked deceleration of food prices, which have a 33% weighting in the index. Year-over-year growth in grain prices fell to 19.2%

in November (from 29% in October), resulting in the total food component declining to 5.9% (from 10% in October). We estimate that core CPI (CPI excluding food) has eased to 1.2% year-over-year in November (from 1.5% in October), the first decline after four consecutive months of increase (**Display 4**).

Year-over-year growth in the producer price index (PPI) also eased marginally in November, to 8.1% from 8.4% in the prior month.

As argued in previous writings, the pass-through effect from PPI (downstream inflation) to CPI (upstream inflation) will be a gradual process because of the continued margin squeeze on upstream firms as well as the rigidity of China's overall pricing system. As a result, our 3.5% CPI inflation forecast for 2005 now appears a bit aggressive on the upside.

More importantly, the massive 150 basis-point decline in CPI inflation has provided a significant boost to 'real' interest rates for both bank lending and deposits (**Display 5**). The real lending rate for one-year capital is now running at 278 basis points and the real interest rate on one-year time deposits has narrowed to –55 basis points. As such, the central bank is under considerably less pressure to raise interest rates further.

Despite the fact that fears of bank liquidity leaking to the 'curb' market have faded, further hikes on deposit interest rates may be delayed as speculative funds into RMB deposits continue in anticipation of a currency revaluation. The net monthly increase in total deposits reached RMB 331 billion in November, a significant jump from only RMB 145 billion in October and RMB 256 billion in September. The most dramatic turnaround was seen in corporate deposits, where the net monthly change showed an increase of RMB 126 billion in November against a depletion of RMB 31 billion in October.

Liquidity Up Mildly

Year-over-year growth in M2 revived slightly to 14.2% in November, from 13.7% in October. Total loan growth also picked up somewhat to 13.5% in November from 13.3% in October (**Display 6**). The data confirms a loosening of credit controls in the current quarter, although the extent has been much milder than expected. It could be too soon to tell, however. As year-over-year loan growth still remains far below the central bank's year-end target of 18%, banks have room for credit expansion in December.

Consumption Remains Strong

Year-over-year growth in real retail sales improved further to 11.1% in November from 9.9% in October, although nominal sales growth eased to 13.9% from October's 14.2%, on the back of slower inflation (**Display 7**). In the month, consumption remained firm across the board: the year-over-year change in nominal spending was up on home furnishings by 51%, jewelry by 27%, restaurant receipts by 19%, while auto sales recovered to 11.8% (from 2.1% in October).

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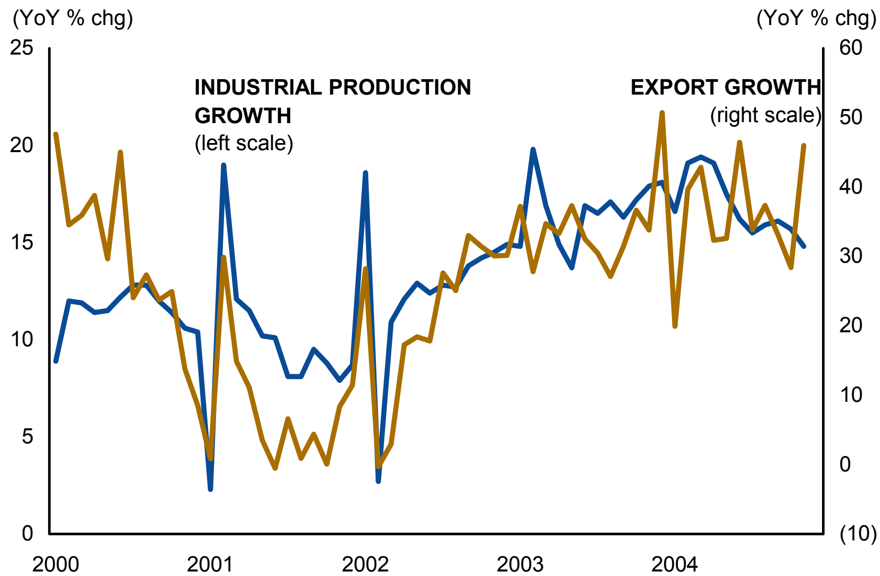
Display 1: Output Growth Appears to be Normalizing

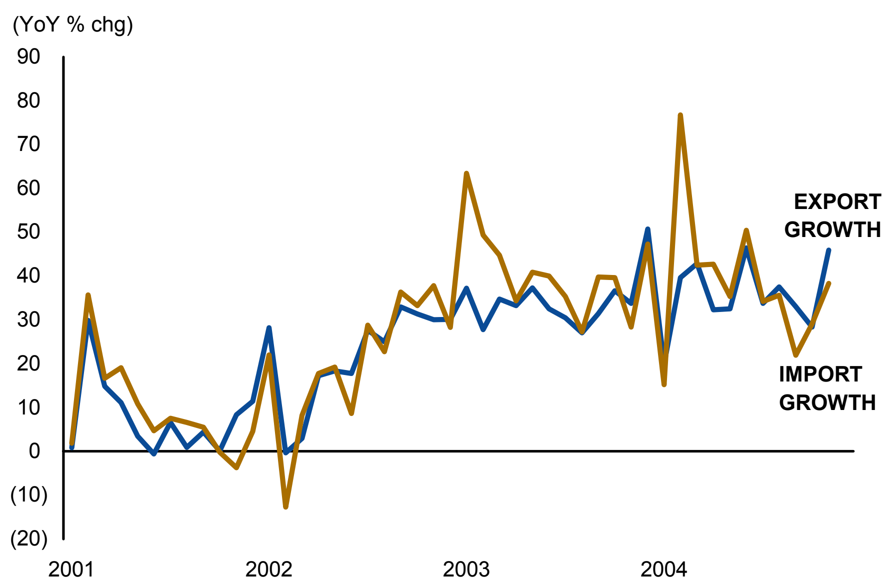
Growth in Industrial Production and Exports



Source: CEIC Data and Alliance Fixed Income, December 16, 2004

Display 2: Import Growth Has Revived Along With Exports

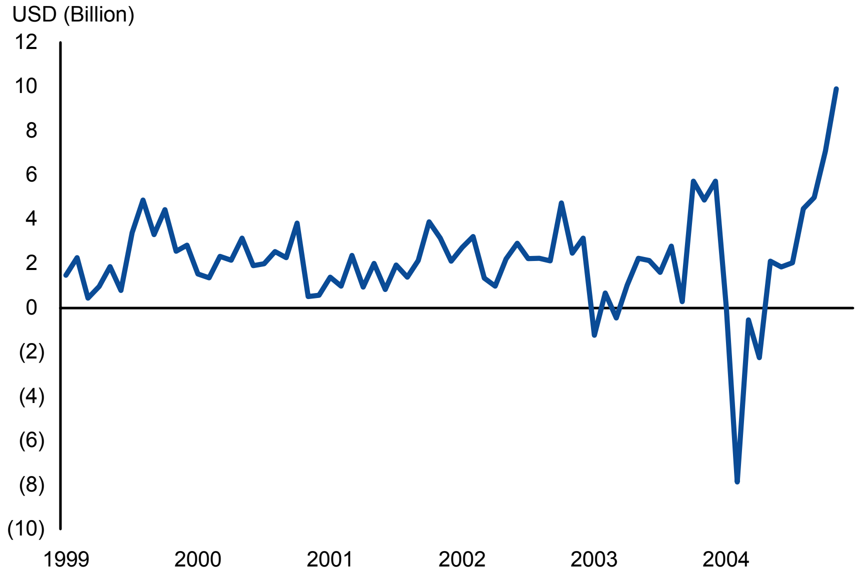
Export and Import Growth



Source: CEIC Data and Alliance Fixed Income, December 16, 2004

Display 3: A Dramatic Turnaround in the Trade Balance

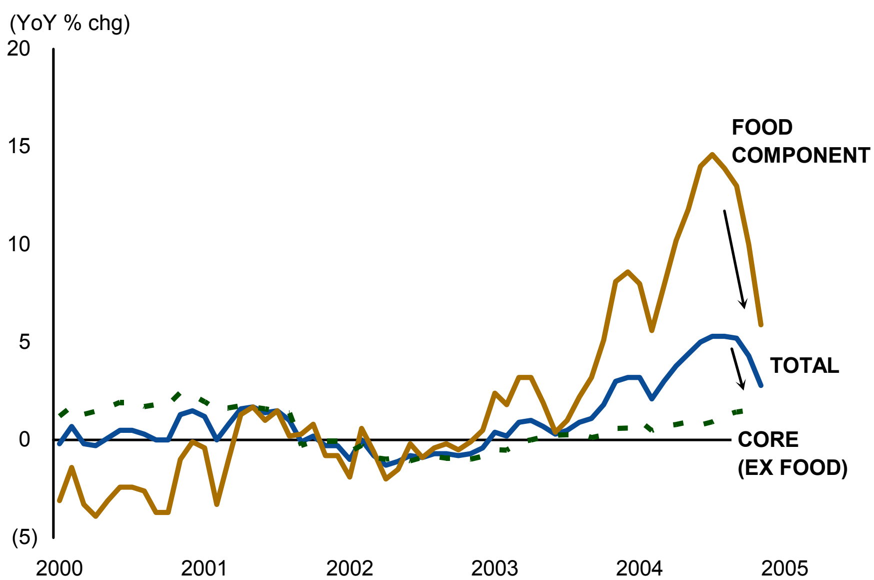
China's Trade Balance



Source: CEIC Data and Alliance Fixed Income, December 16, 2004

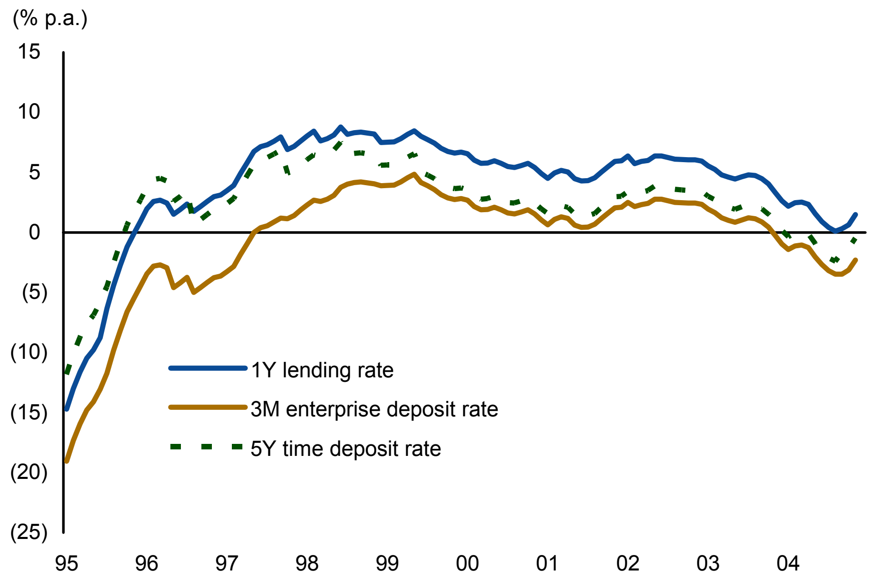
Display 4: Inflation Has Greatly Surprised on the Downside

Consumer Price Index (CPI)



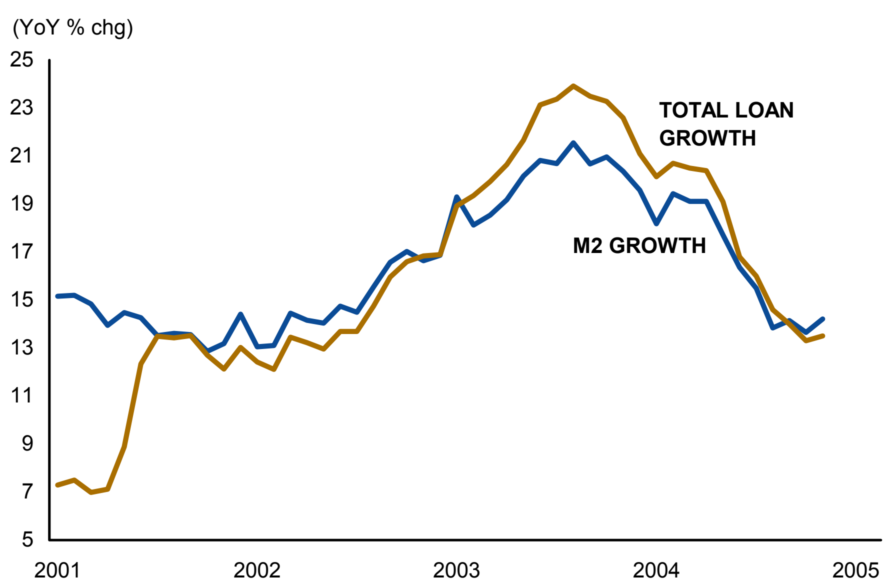
Source: CEIC Data and Alliance Fixed Income, December 16, 2004

Display 5: Falling Inflation Has Caused Real Interest Rates to Rise
Real Lending and Deposit Rates (Based on Three-Month Moving Average of CPI)



Source: CEIC Data and Alliance Fixed Income, December 16, 2004

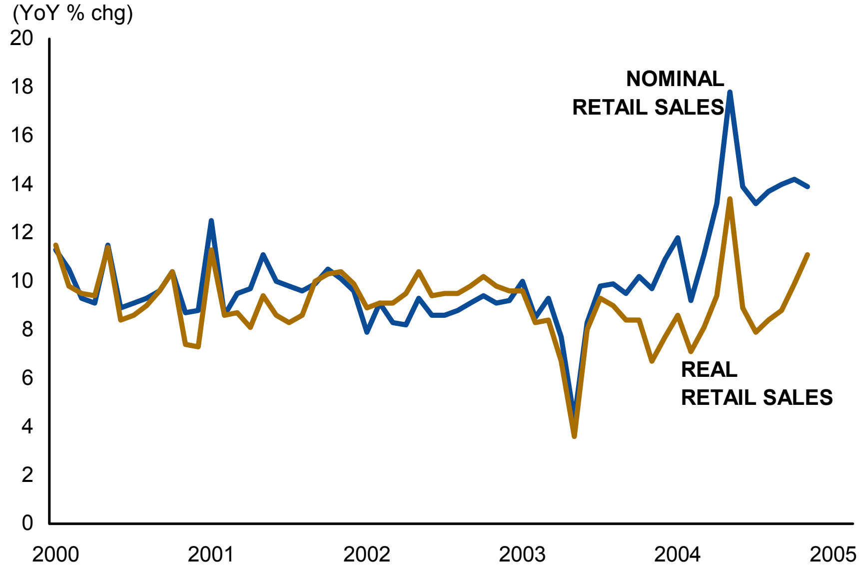
Display 6: Credit Growth Appears to be Bottoming Out
M2 And Total Loan Growth



Source: CEIC Data and Alliance Fixed Income, December 16, 2004

Display 7: Consumption Still a Main Pillar of Growth

Growth in Real And Nominal Retail Sales



Source: CEIC Data and Alliance Fixed Income, December 16, 2004