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ASIAN WEEKLY ECONOMIC INSIGHTS

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China Update

Economic data released for July continues to show reviving inflation, slower credit and output growth, strong local consumption and robust export expansion. However, fixed-asset investment shows a marked rebound, which will give Beijing the warning of not relaxing its overall tightening policy pre-maturely.

CPI inflation rose to 5.3% yoy in July (from 5% in June). Core (non-food) CPI remained relatively subdued, up 0.8% yoy in July (from 0.7% in June). PPI increased 6.4% yoy in July, same as the increase in June. Rising oil and coal prices remained the prime causes for PPI inflation (**see Display 1 and 2**)

M2 growth slowed further to 15.3% yoy in July, from 16.2% in June. Loan growth eased to 15.5% yoy in July from 16.7% in June. This is the first time growth has stayed below the 17% growth target set by the PBOC earlier this year (**see Display 3**).

Meanwhile, industrial production growth moderated to 15.5% yoy in July from 16.2% in June (**see Display 4**). But the output deceleration was mainly concentrated on heavy industries and has not affected manufacturing output. As such, export growth remained firm at 34% yoy in July, although it came down from 47% in June. Exports to the US and Asian markets held up well and to EU showed renewed signs of strength. As an indication for local consumption, retail sales remained solid at 13.2% yoy in July, against 13.9% yoy in June.

The key concern is the rebound of fixed-asset investment growth to 31.5% yoy in July, from 23% in June and 18% in May (**see Display 5**). It was reported that the sectors, which showed an investment rebound in July, were quite broad-based, ranging from transport equipment, electrical machinery, chemicals, to utilities and gas.

The investment series is erratic, and the lumpiness of investment projects makes it difficult to explain the investment revival in a single month. But the key point is that, whether the rebound was due to a slight easing of credits or investment regulations during the month as some suggested, the central bank's tight grip on credits will remain key to bring down investment growth. We believe Beijing's target for a 'soft landing' of investment growth is at around 10% yoy.

In our recent research trip to China, we found that the local views on the current economic condition were extremely mixed after the economy 'soft-landed' in 2Q/04. Some government officials and company executives argued that the underlying strength of the economy remains too robust, while some concerned that a credit crunch is in the making as the government chokes off the credit lines for working capitals of many SOEs. However, there are no strong evident in addition to the official data to support either of the above argument.

Where the risk of credit crunch is concerned, recall that our analysis of the breakdown of bank lending (*see Asian Weekly, China's Monetary Condition Improving, July 30, 2004*) suggested that the recent decline in short-term loans has been mostly affecting the real estate and construction sectors (-21% yoy in June). Lending to the industrial sector remained healthy (+7.6% yoy) and to the agricultural sector showed no sign of a slowdown (20% yoy). These trends are in sink with the current objective of credit restructuring (**see Display 6**).

Our discussion with senior officials at the PBOC left us the feeling that the central bank wanted to raise rates as inflation revives (i.e. normalization of interest rate structure), but has been confronted with fierce resistances from other policymaking bodies and SOEs. On balance, we maintain our view that the anticipated rate hikes on bank lending and deposits will be modest in magnitude and in pace.

Quietly behind the scene, the policy focuses are definitely shifting towards market-based/structural measures to address some of the key imbalances in the economy as well as promoting selective sectors of the economy. For instance, the State Council is revising the company laws so that the new legislations will be much more market-oriented to encourage private businesses. The MOF is considering measures that will help rectify the budget imbalances between the central and local governments.

In conclusion, we expect that the overall tightening policy (especially controls on land supply and investment credits) will stay course for the rest of this year. The investment rebound in July is a wake-up call to policymakers that it is yet to claim victory over economic overheating. However, we expect that no new measures are likely to be implemented until after the Communist Party plenum session in mid-September. Market-based measures – such as interest rate hikes and the allowance of greater exchange-rate flexibility – will remain the best policy option to fine-tune the economy following the success of administrative tightening.

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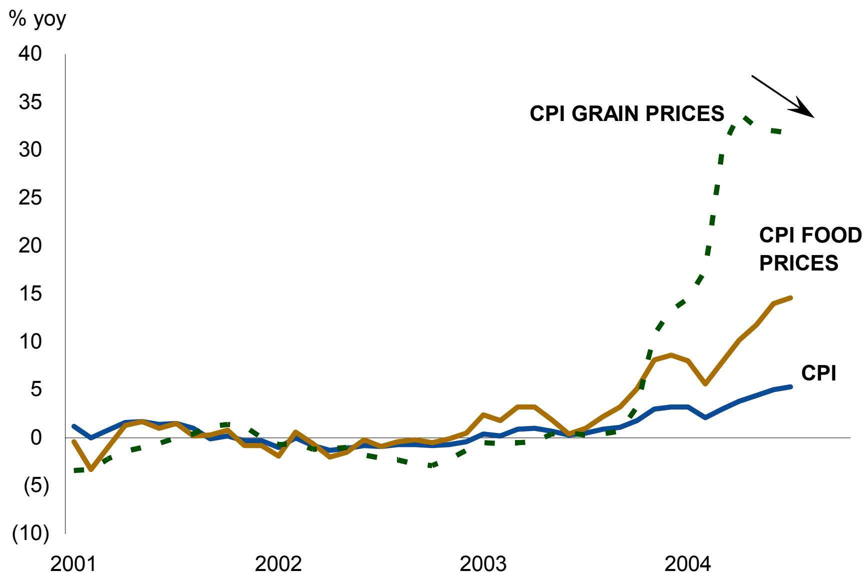
Display 1: CPI Inflation is Mainly Driven By Food Prices

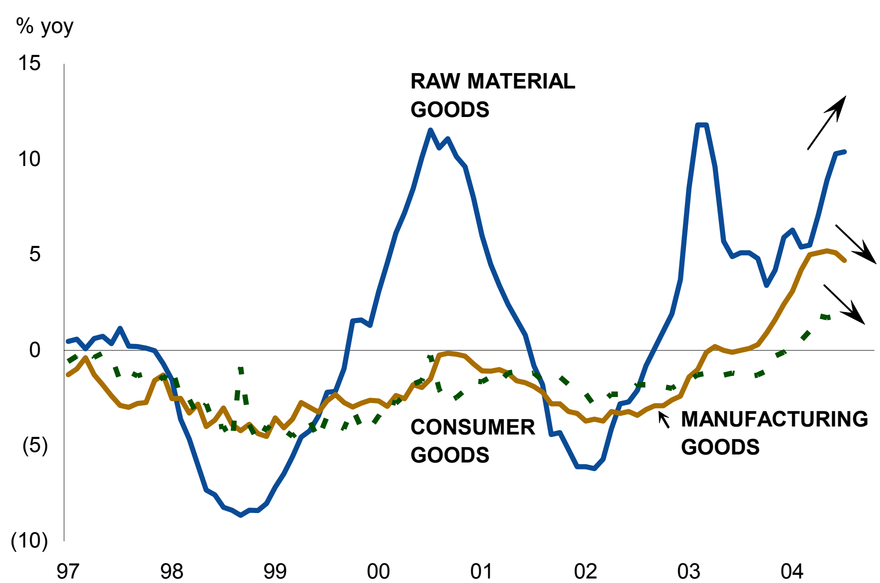
China CPI



Source: CEIC and Alliance Fixed Income estimates, August 20, 2004

Display 2: Upstream vs. Downstream Inflation – Slow Passthrough Effect

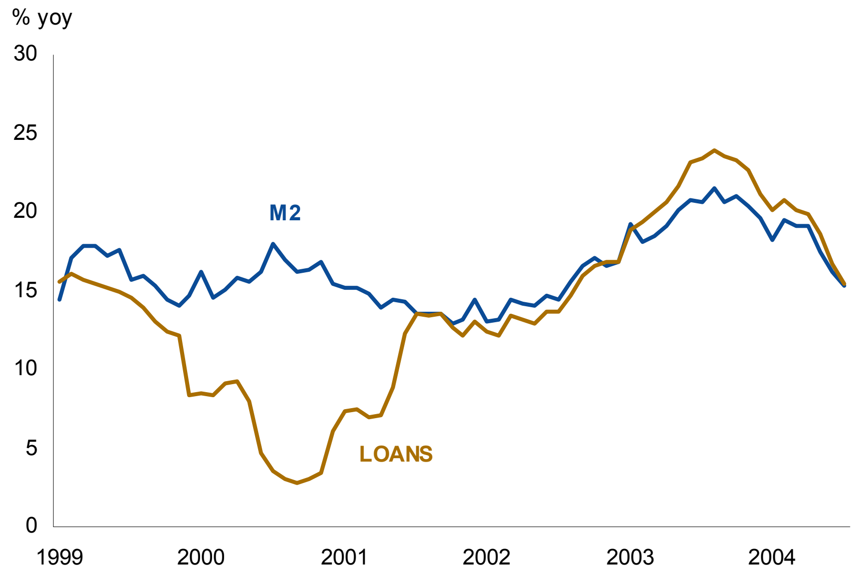
China PPI



Source: CEIC and Alliance Fixed Income estimates, August 20, 2004

Display 3: Liquidity Growth Decelerating Steadily – No Credit Crunch

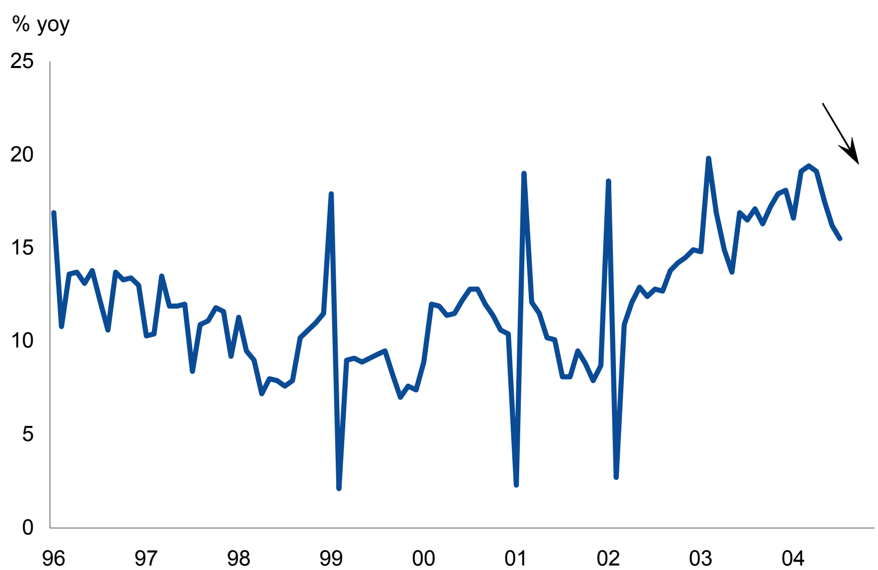
China M2 and Credit Growth



Source: CEIC and Alliance Fixed Income estimates, August 20, 2004

Display 4: Output Growth is Rolling Over

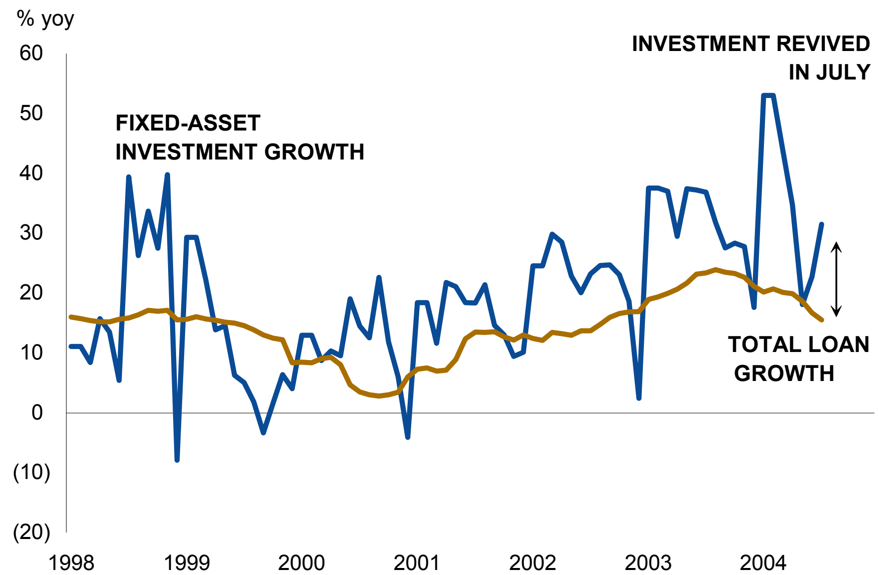
China Industrial Production



Source: CEIC and Alliance Fixed Income estimates, August 20, 2004

Display 5: Credit Slowdown Remains Key to Bring Down Investment Growth

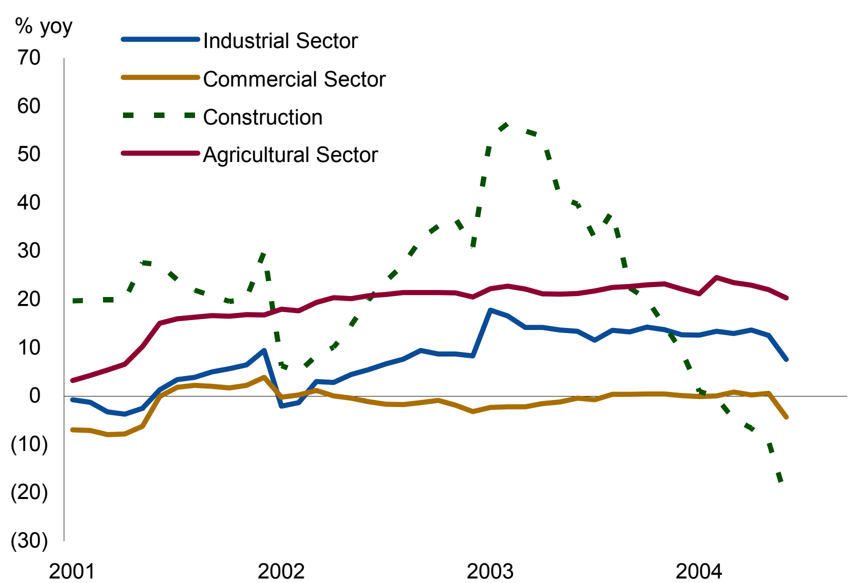
China Fixed Asset Investment and Loan Growth



Source: CEIC and Alliance Fixed Income estimates, August 20, 2004

Display 6: Tight Credit Policy Affects Construction Activities Most Severely

China Sector Breakdown of Short-Term Loans



Source: CEIC and Alliance Fixed Income estimates, August 20, 2004