

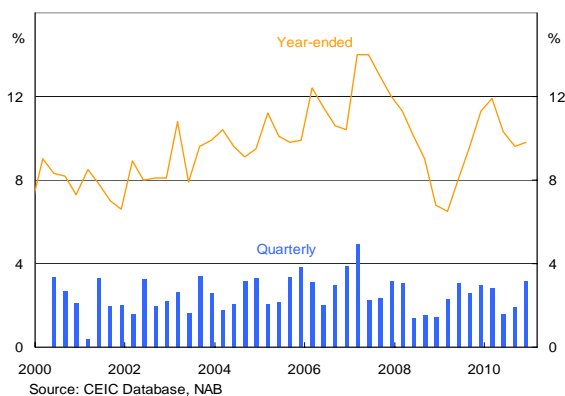
Chinese Monthly Update

January 2010

All indications are that Chinese economic growth remained strong through the final months of 2010. Powered by a rebound in production activity, GDP growth was also aided by household consumption growth holding up. With consumer prices continuing to show signs of upward momentum, the major risk to the Chinese economy is that higher prices become embedded in inflation expectations and authorities have to act drastically in response. Notwithstanding such a development, we expect the Chinese economy to grow by around 9 per cent over the 2011 calendar year. As the year evolves, we expect authorities to continue gradually tightening monetary settings.

We estimate that Chinese GDP grew by 3 per cent in the December quarter, rising by 9.8 per cent over the year. After easing through the middle of 2010 with some cyclical de-stocking and less expansionary policy settings, Chinese production activity appears to have strengthened through the final quarter of 2010.

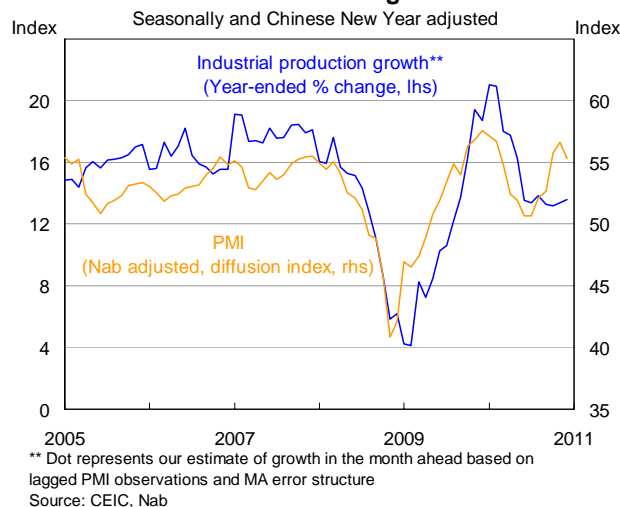
China - Real GDP
Percentage change



Industrial production rose by 13.6 per cent through the year to December, or by 1.6 per cent in the month (seasonally adjusted; see Graph). Production growth was around 1½ per cent for each of the last

three months of the year – around ½ per cent higher than average monthly growth in the past decade. While both of the Chinese PMI measures fell in December, current readings continue to signify a strong expansion in manufacturing activity.

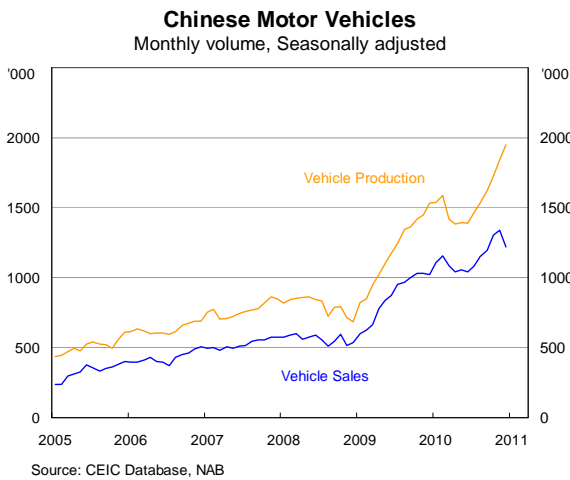
China - Manufacturing Sector*



Of the components of Chinese industrial production, crude steel output has been a strong contributor to recent growth. China accounts for just under half of world steel production and experienced weakness in output between April and October 2010. With steel re-stocking ahead of the Chinese New Year, however, production appears to have recently rebounded.

Automobile production also strengthened through the second half of 2010 and rose by around 6 per cent in the month of December. Incentives introduced by the Chinese government over the past few years such as subsidies for rural car buyers, a consumption tax rebate for fuel efficient cars and a form of 'cash-for-clunkers' scheme have supported domestic car sales along with production (see Graph). However, with the announcement of a 10 per cent sales tax on cars with a 1.6 litre engine or smaller (effective at January 1,

2010), steps are being taken to unwind some of the stimulus that has supported China's auto sector.



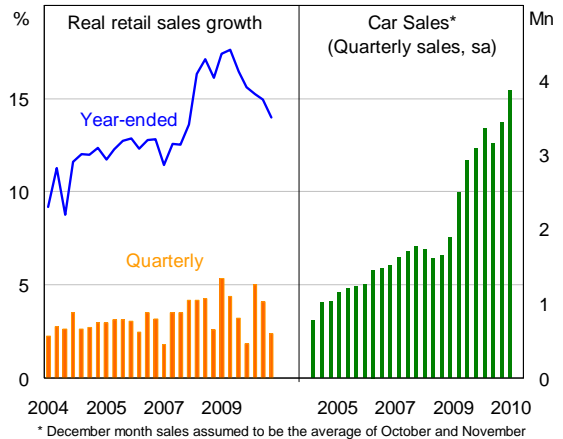
Chinese trade flows have picked up over recent months. Following some weakness in the September quarter, exports rose in each month of the December quarter. However, a dramatic rise in imports in November and December resulted in the external sector making a subtraction from overall GDP growth.

Consumption

The most recent data suggests that Chinese consumer spending activity continues to hold up. While we estimate that real retail sales growth was flat in October and November (weighing on the quarterly growth rate), the data depicts a pick up in spending in the month of December. On a year-ended basis, we estimate that real retail sales rose by around 14 per cent to December, a moderation from the lofty growth rates through 2009 (partly attributable to base effects) but high by historical standards (see Graph).

While car sales have been an important contributor to overall retail sales growth, some unwinding of government incentives for car purchases is likely to soon translate to car sales more in line with those observed in the period prior to 2009.

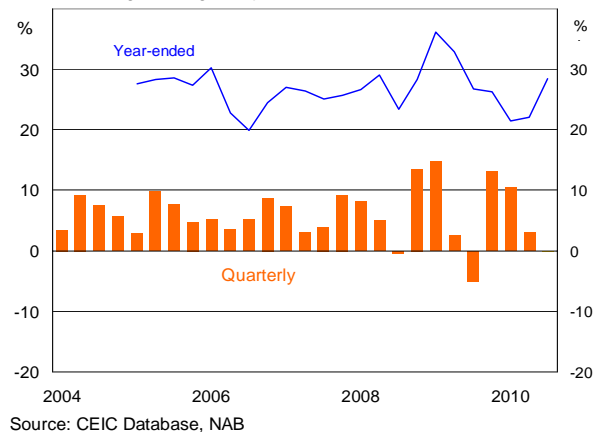
China - Consumption



Investment

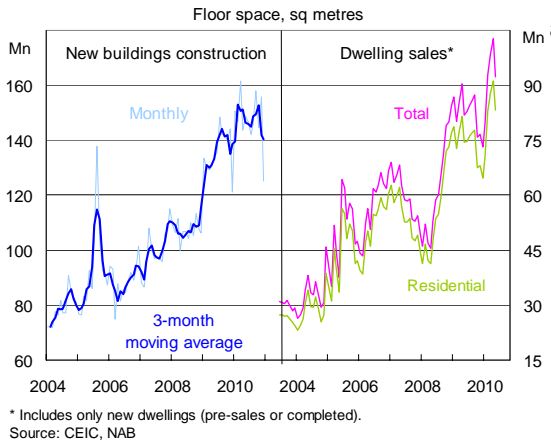
Fixed asset investment (FAI) has slowed sharply over the past six months, with data exhibiting no growth in the December quarter. While widely reported, we would argue that this series is becoming an increasingly unreliable read on investment. Despite our best attempts to seasonally adjust the quarterly series, residual seasonality exists (which appears to have become amplified in recent years).

China - Nominal Fixed Asset Investment *



Even so, alternative data from the construction sector tell a similar story to the FAI numbers (see Graph). Both the pace of construction activity and dwelling sales fell in December, a sign that tighter government policy settings may be starting to have an impact on the real economy.

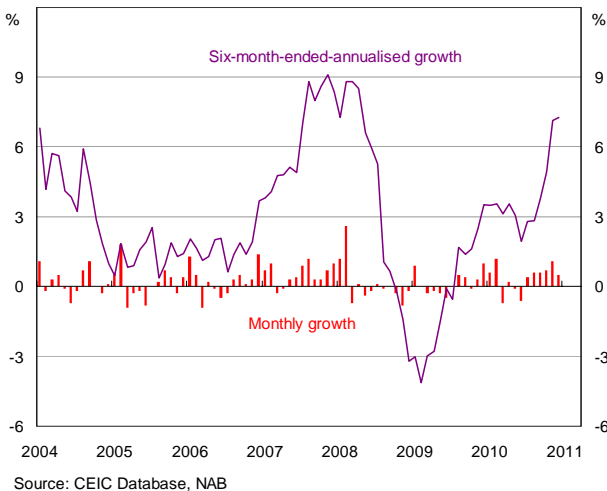
China - Construction Sector



Prices

An evolving concern for the Chinese administration is the upward momentum in consumer prices that began in mid-2010. Although the year-ended pace of price growth is low compared with the early 2008 period, this has largely been a result of the price weakness through the middle of 2010. Indeed, a six-month-ended annualised growth rate shows China's current rate of inflation is now approaching pre-crisis levels (see Graph).

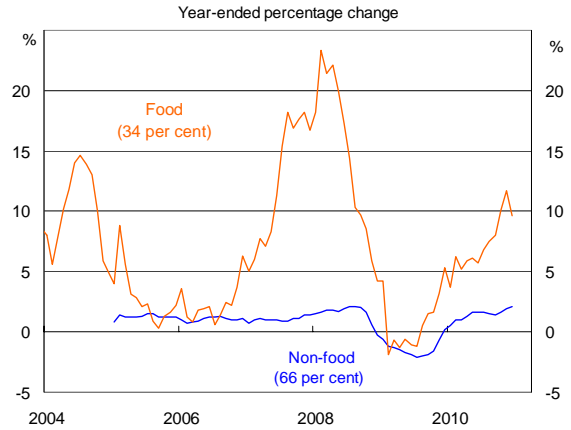
China - Consumer Prices



At the component level, while food prices continue to explain a significant degree of inflationary pressure, non-food inflation has begun to pick up (see Graph). With higher food prices partly reflecting seasonal constraints to domestic supply, some of these price

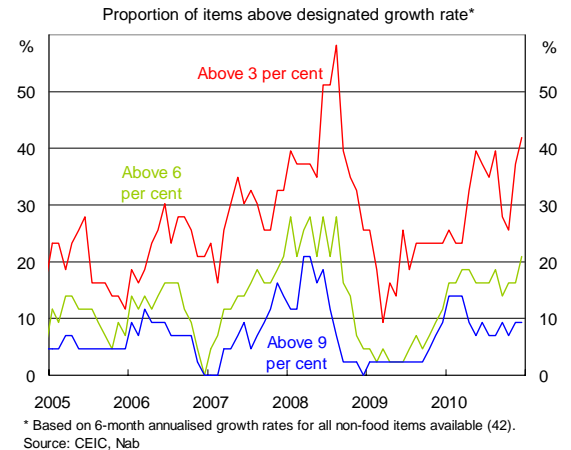
pressures are expected to abate. However, the rise in non-food prices is concerning and portends a risk that inflation becomes embedded in consumer price expectations.

China - CPI



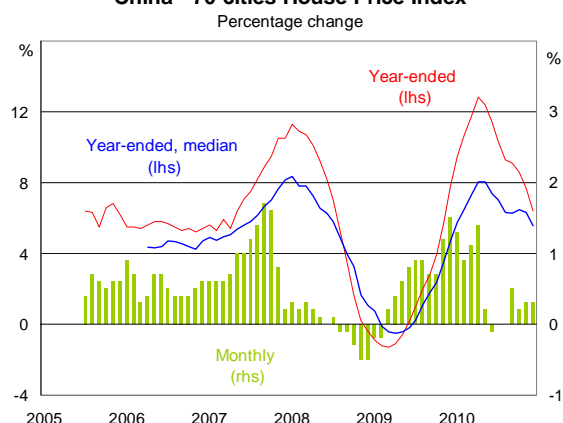
Decomposing non-food consumer prices into the component series, price pressures appear to be quite broadly based: the proportion of items growing above 3 per cent is now at the highest level since September 2008 (see Graph).

China - Non-food inflation

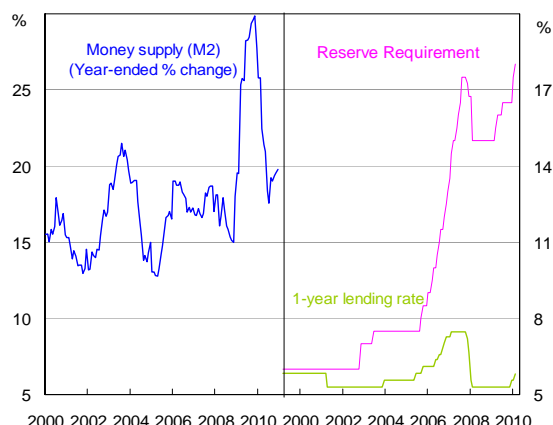


In the housing market, while prices grew by around ¾ per cent in the December quarter, the rise in values appears to be modest compared with the year to April 2010. Furthermore, some rise in house prices is expected, given continued strong household income growth and the trend decline in China's house price-to-income ratio over the past decade.

China - 70-cities House Price Index



China - Monetary Policy



Policy settings

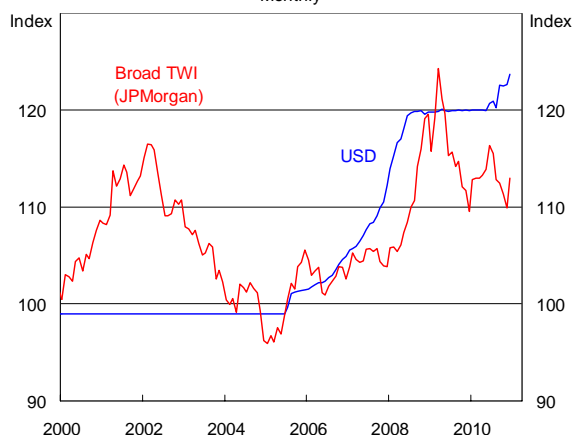
The Chinese administration continue to tighten policy in response to inflationary pressures and the risk that the economy will overheat. While the People’s Bank of China increased lending and deposit interest rates in December, benchmark rates remain some 166 basis points below where they stood prior to the financial crisis (see Graph). On this metric, monetary policy settings remain expansionary.

While authorities continue to raise financial institutions’ reserve requirements, it is uncertain whether current reserve requirements are binding (due to institutions holding excess reserves). Indeed, Chinese money supply growth still remains high and credit growth is yet to show any substantive sign of slowing.

Since Chinese authorities announced a policy of greater currency flexibility in mid-2010, the RMB has appreciated by around 3 per cent against the US dollar. While further international political pressure for a continued appreciation in the RMB is likely, we see such a process as being in China’s best interests: A prominent objective of the country’s 12th five year plan (due for release in March) is likely to be a further reorientation of the Chinese economy to production growth that is domestically focused. A gradual appreciation of the RMB would be a powerful policy lever in achieving this.

China - Exchange rate

Monthly



Overall, while the effects of fiscal stimulus continue to gradually dissipate, further monetary tightening in China is in prospect. Robust production activity and signs that price pressures are taking hold dictates that contractionary policy settings are appropriate. However, while policy initiatives over 2010 recalibrated policy settings in the right direction, we judge monetary conditions to remain accommodative at present. Although the risk of a policy mistake dictate a cautious approach, we expect further normalisation of interest rates, money supply and the exchange rate over 2011.

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