

China – exceptional growth pace continues

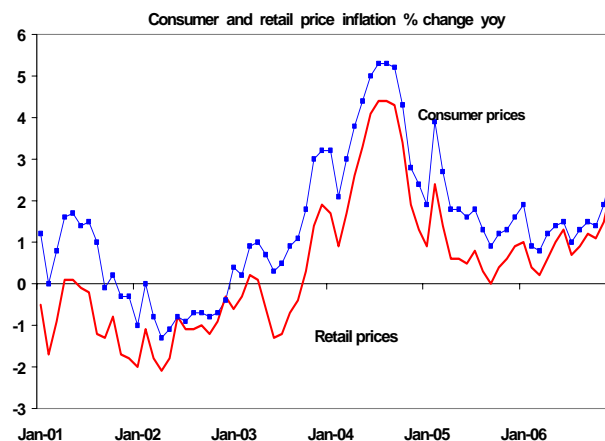
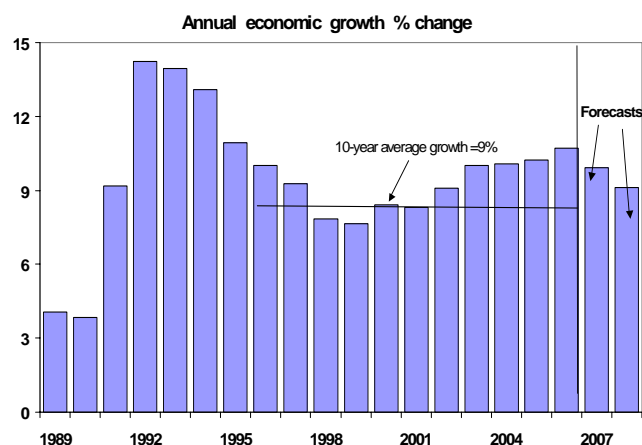
Key trends

- Despite the efforts of the authorities to slow the economy, growth accelerated in 2006 to 10.4%.** In view of the repeated failure of official steps to curb growth and the likelihood of continued but half-hearted efforts to dampen activity, we have upgraded our forecasts of Chinese economic growth to 10% in 2007 and 9% in 2008.

- There has been a modest drop in the growth of fixed investment spending but it is still running at almost 25%.** The composition of Chinese economic growth remains unchanged with a heavy reliance on fixed investment spending and net exports and little sign of the acceleration in (still very strong) consumer spending that the authorities want to see.

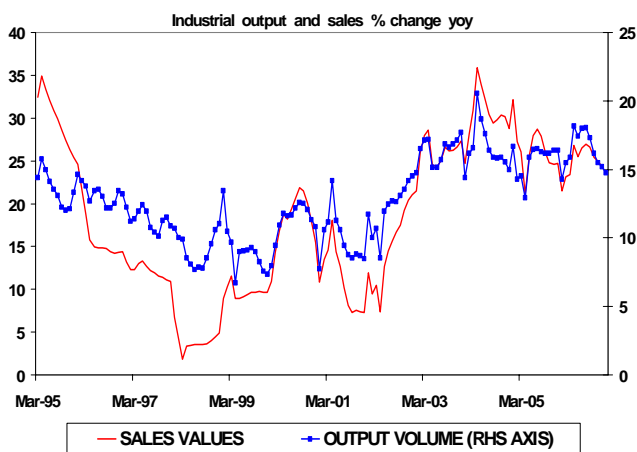
- Inflation is still quite low but it has accelerated through the latter months of 2006.** Although much of the acceleration in prices reflects increased food costs, high rates of capacity utilisation, persistent strong demand allowing firms to pass on higher raw material costs and increased wages have the potential to boost inflation.

- While the national accounts show no sign of growth slowing, the monthly partial indicators (on industrial output, sales, investment spending and export deliveries) so show an easing in growth.** This could reflect problems in the national accounts or a lack of coverage of the fast-growing service sector in these monthly series.

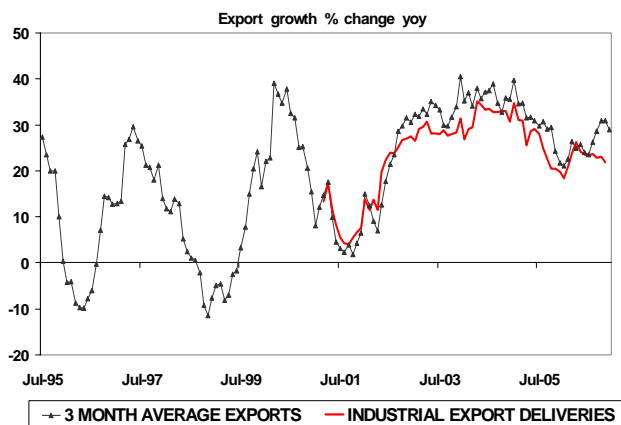


Some signs of slowing

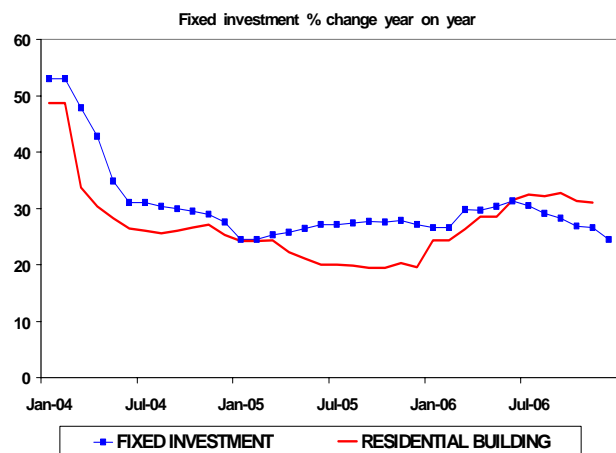
The monthly data on industrial output and sales as well as trends in export orders and fixed investment spending all suggest that the pace of growth - while still strong - has eased slightly. Growth in the 3-month average volume of industrial output peaked at around 18% yoy in mid-2006 and it was down to 14¾% yoy by the end of the year. Over the same period, the 3-month trend growth rate in the value of sales has dropped from around 27% yoy to 24%.



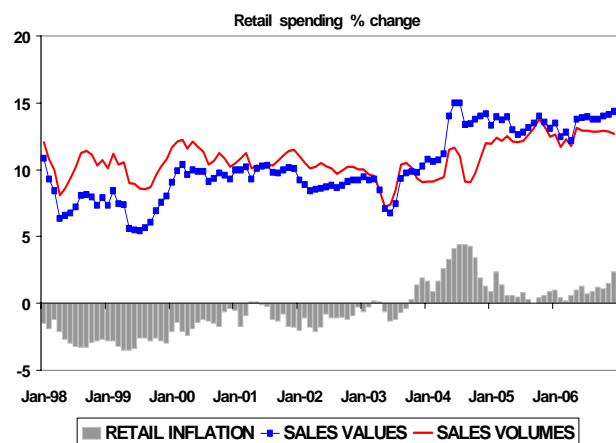
Part of this slowdown reflects less rapid expansion in exports. While US\$ export growth remains very strong, this partly reflects currency movements. In renminbi terms, the growth rate of industrial export deliveries has been slowing.



Fixed investment has been the biggest single driving force in Chinese economic growth and here again there has been a modest slowdown in growth - which, again, remains exceptionally rapid. Cumulative growth in investment spending was running at around 30% yoy in the first half of 2006 but by December it had dropped to around 25%. While investment growth in state-owned operations has slowed steadily since May (as might be expected as that sector is most open to official arm-twisting to cutback), housing investment picked up in the latter half of 2006.

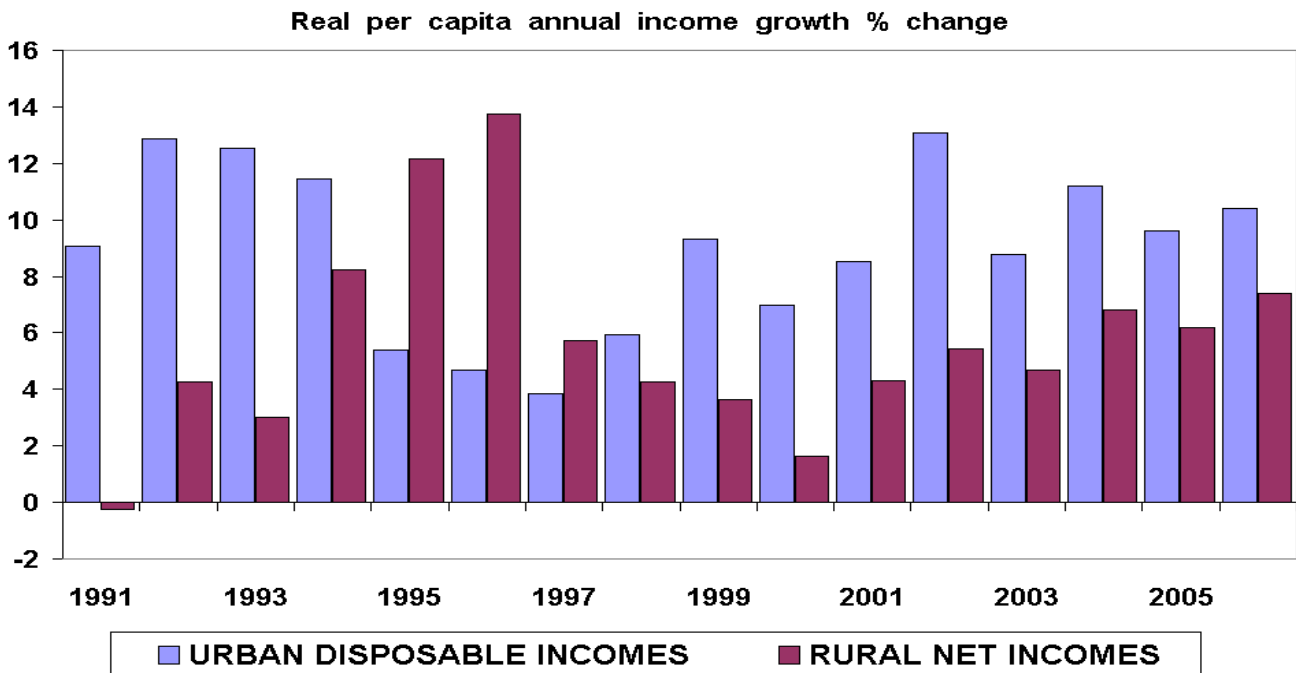
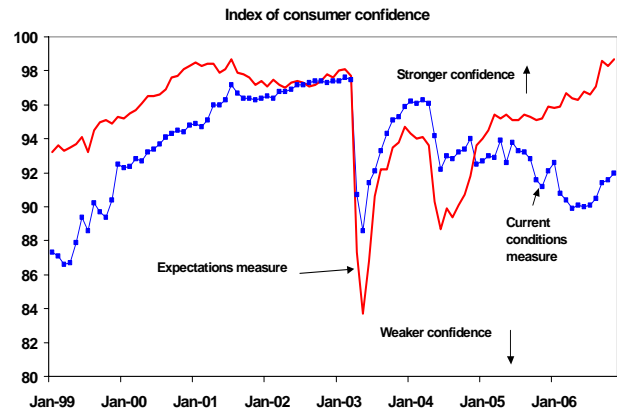
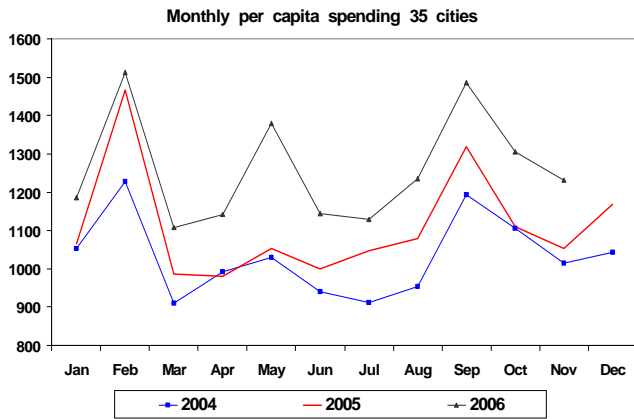


While retail spending increases remain solid, volume growth has not accelerated (12 to 13% for most of 2006) and higher inflation explains the pick-up in the closing months.



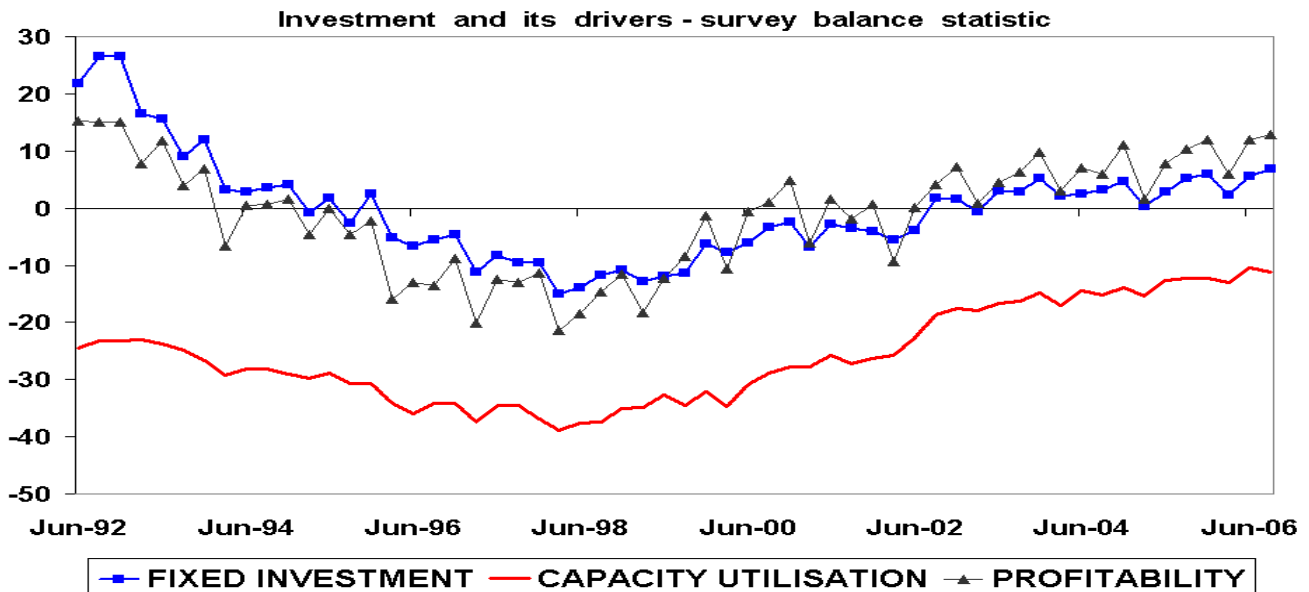
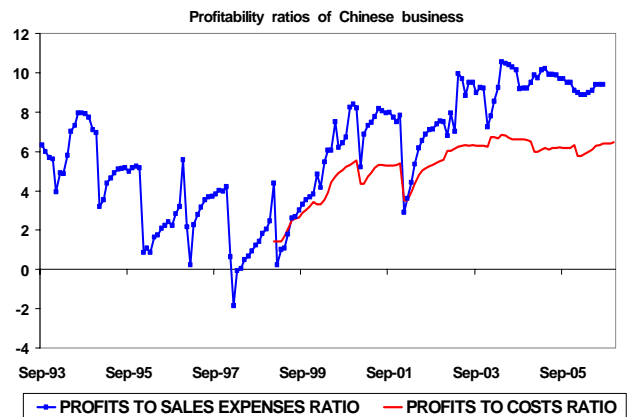
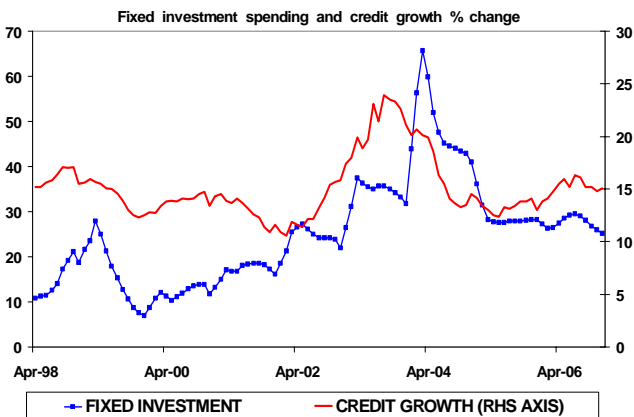
The other source of data on consumer spending (the monthly survey of urban households) also shows solid growth in nominal expenditure - averaging around 14½% in 2006 as opposed to 14% shown in the retail trade figures. This spending growth reflects solid gains in real incomes with real urban household income rising by 10.4% in 2006 while rural incomes grew by 7.4%.

Judging by the outcomes of the consumer confidence survey, Chinese households expect solid income growth to continue. The expectations component of the household survey has reached its highest level for years. This optimism is backed up by the results of the latest Peoples Bank quarterly survey of household savings which showed less interest in precautionary saving and higher incomes now and expected in the future.



The slowdown shown in fixed investment is reflected in the bank lending data where credit growth has stabilised at around a 15% growth rate - well down on the peak growth rate of over 20% seen in 2003. However, Chinese firms fund much of their investment spending from retained earnings and so the course of investment spending will be heavily influenced by profit trends.

There are a number of indicators of business earnings and they generally look positive. The quarterly business survey shows both capacity utilisation and business profitability trending higher through the last few years. The surveyed ratios of profitability have also consolidated at high levels and there have been big increases in the absolute level of earnings. In view of all this, we expect fixed investment to stay strong through the next two years.



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