

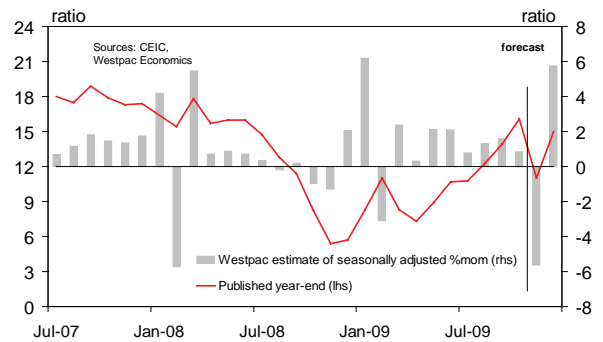
30 November 2009

- The early arrival of harsh winter weather has been having a material impact on activity in a variety of locations, including in a number of export manufacturing provinces. Snowstorms and freezing conditions have hit both logistics and production. With global confidence levels fragile, as clearly illustrated by the Dubai situation, the last thing the risk trade needs going into year end is some choppy November data out of China over the next fortnight. It was not so long ago that the economy was hit by a nasty cold snap - Jan/Feb 2008 - that was worth 2ppts on the year-ended rate of industrial value-added. As far as seasonally adjusted estimates go, in February 2008 IVA fell 5.7%, and bounced by a similar amount in March as the thaw commenced. If that sort of pattern was repeated in November/December this year, then the published growth rate of IVA would read something like 16.1%yr in October (actual), 11% in November and 15% in December, with the different base effects providing a larger shift in the yoy rate than in early 2008. Watch for signs of this coming through in the PMI data, due tomorrow. From **Phat Dragon's** point of view, even if the actual degree of dispersion is less than outlined above, that still looks like a decent opportunity for the savvy macro investor.
- **Phat Dragon** is again being regaled with questions on the future course of the FX regime. From the corporate arena, a common enquiry revolves around issues of denomination. Increasingly, firms are finding that their Chinese counterparts are requesting RMB denomination, on both the export and import side. However, outside of the small number of Mainland cities and external jurisdictions in the current pilot scheme, there is no supply of RMB offshore for importers from China to acquire for payment - and exporters to China without any costs in RMB would be disadvantaged if they accepted a non-convertible currency for their products. Basically, it is a nice idea from a Chinese perspective, staring at nominal CNY appreciation out to the horizon, but for the moment, it is just not practical.
- Comments from Yu Yongding, a professor of economics at the Chinese Academy of Social Sciences and a noted policy insider, got a lot of coverage last week. The basic points in his argument were long term and structural in nature and were rather conventional. They did not appear to be directed specifically at the immediate policy stance. Like **Phat Dragon**, he is concerned with the dynamics of the transition from today to a future where the virtuous circles of catch-up begin to fatigue, it becomes more difficult to simply grow out of poor resource allocation decisions, and China gets too big to expand exports at a rate in excess of global demand.
- The main point of immediate relevance is Yu's observation that the weakening efficiency of investment is not being helped by the fiscal and monetary expansion. China's ICOR (incremental capital-output ratio, here defined as marginal GDP/marginal investment) has been trending lower over the course of this decade, to a current reading of just 2.11, not far above previous 'bust' levels of 1.95 in 1993; 1.87 in 1998; and 1.79 in 02/03. Between 1994 and 1997, the ICOR averaged 3.6. Getting back to that sort of efficiency level, which is representative of a successful latecomer, is the aspirational goal.
- **Stats of the week:** As of the Friday close the Shanghai market had a market cap of just over \$US2½ trillion, or 53% of 2009 GDP.

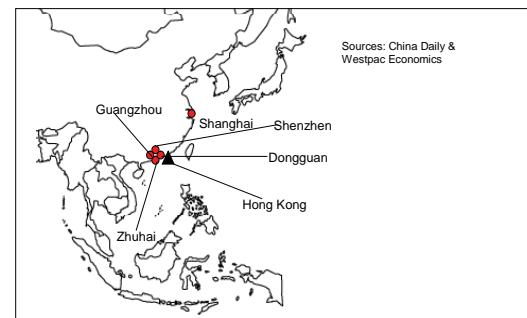
Phat dragon

a weekly chronicle of the Chinese economy

Wild weather and swings in production



Designated sites for CNY trade settlement



The efficiency of Chinese investment

