

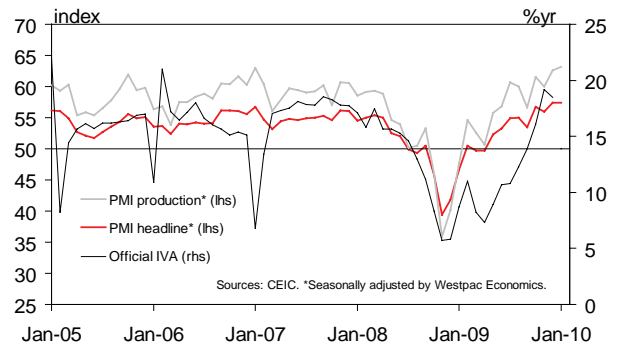
4 February 2010

- The manufacturing PMIs, out on Monday, implied that industrial activity began 2010 in rousing form. The official PMI came in at 55.8 in January versus 56.6 in December. The HSBC PMI rose from 56.1 to 57.4, disappointing markets that were primed for a dramatic print. Going back to the official series, our estimates put the seasonally adjusted headline at 57.4 in both December and January, the highest readings in the short history of the series. The seasonally adjusted detail shows a sharp acceleration in new export orders (54.8 to 59.0); further incremental improvement in employment, imports and production; and a modest deceleration in new orders (62.1 to 61.3).
- There is no crack in the fortress based upon this data. However, it is becoming clear that the point of maximum impetus for growth is right now, with the signs of a second half slowdown there for all to see. Most fundamentally, the leading index has rolled over in 6mth annualised terms, while the coincident index has sprinted to its fastest growth pace since 1994. Crossover points in these indicators are excellent pointers to future shifts in growth momentum.
- Offering further support for the case, it is abundantly clear that credit will be less freely available in the coming year. As **Phat Dragon** reported last week, broad money supply leads GDP by 3 to 4 quarters, implying that the lending deceleration will impact upon activity from Q3. Further, the 2009H1 bulge in new project starts is swelling the work done figures, but the pipeline of starts coming behind is not sufficient to maintain that spectacular momentum. (Note that the authorities indicated late last year that they are now focused on completing current projects, with new ventures not being actively sought). That is also starkly evident in the provincial and sectoral cuts of the investment numbers, with decelerating growth rates in the transport infrastructure segments and in the western provinces.
- What does this mean for policy? The first point is that the expected deceleration must be balanced against the first half inflation outlook and the development of asset prices. Real deposit rates are likely to go negative in March or April - a situation that has triggered rate activity in the past. The property market is hot enough in some areas that the authorities have moved to prevent third mortgages, a tactic reminiscent of the Shanghai experiment of 2004/05. The various recent initiatives in the lending sphere are well worn expedients. With modest inflation will come modest currency appreciation (assuming the US makes the right noises about an exit from emergency policy on a reasonable timeframe). So monetary/credit policy is shifting unambiguously to a less accommodative position. *But do not forget fiscal policy.* The fiscal stance for the coming half decade has been confirmed as expansionary. Revenues are also recovering as profits have returned, providing more flexibility. It may be that instead of pulling in the same direction, as in the 2004-08H1 tightening phase and the 2008H2-present easing phase, the two main arms of policy begin to point in opposite directions by the end of this year. If the second half deceleration is in any way abrupt, expect the fiscal lever to be primed once again, particularly if growth has not been able to rebalance at least some way in the direction of external demand.
- **Stats of the week:** The average number of persons per household in China top 35 cities is currently 2.88, against 4.01 in rural areas.

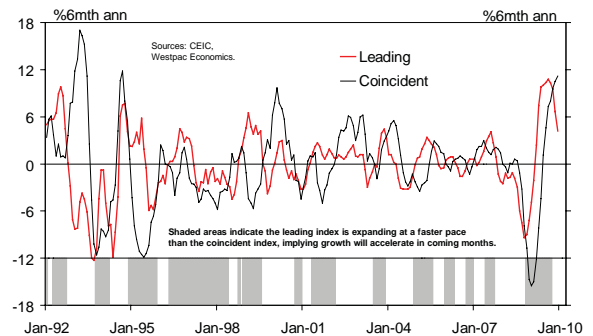
Phat dragon

a weekly chronicle of the Chinese economy

The official PMI & industrial value added



China: leading and coincident indicators



Central government finances & profits

