

21 July 2010

- This week's chronicle is devoted to the outlook. **Phat Dragon** has always eschewed precipitate speculation in the wake of the quarterly data round, preferring a considered approach that allocates time for both absorption and contemplation. The result of these cogitations has been a downgrade of the second half outlook that has negative implications for the calendar year outcomes for both 2010 and 2011. This is turn flows through to lower inflation projections and a more accommodative policy environment than previously anticipated. In terms of the profile, growth will be at its lowest six month ebb in 2010Q4 and 2011Q1, while inflation peaks in 2010Q3, a quarter earlier than previously envisaged. *Detailed forecasts are on page 2.*
- This shift in momentum should be seen as a mid cycle slowdown. It is a transition phase where the drivers of the recent growth surge dissipate and the economy pauses to gather itself for a further spring. This is healthy enough in isolation: but it is hard not to think that the timing could be better given the state of the developed world.
- The major moving parts contributing to the slowdown are well known to readers of this chronicle. The first is the winding down of the pipeline of fiscal stimulus related projects. This fact is evident in decelerating aggregate investment volumes and in the corresponding regional, sectoral and state-owned enterprise activity details. The SOE element has not been emphasized by **Phat Dragon** of late, so here is the lowdown. The SOE share in total investment growth has fallen from its Jan/Feb 2009 peak of 51% to around its decade average of 37% in June 2010. The direct contribution of SOEs to investment growth peaked in June 2009 at 17.7ppts and it is now 8.9ppt, which explains all of the observed slowdown in total nominal investment.
- The second is the reduction in the monetary support for growth. Credit expansion has descended from the Himalayan heights of 2009. In the first half of 2010, new lending was a decent 28.5% of GDP: above the decade average but just a little over half of the 2009 pace. M2 leads GDP by 3 to 4 quarters, indicating a moderation in due. The slowdown in lending is one driver of the weakness in the composite leading indicators that **Phat Dragon** has been tracking from day one.
- The third is the slowdown in private sector real estate construction in response to policy measures designed to limit speculation at the top end of the market, principally in the tier 1 cities. While partial offsets do exist, notably the government's new found interest in sponsoring public rental housing, but with transaction volumes falling sharply in May and June, a deceleration in real estate investment is assured, with predictable consequences for heavy industry and resource demand.
- The fourth is of course the state of the global economy. **Phat Dragon** has always had one elegantly taloned paw in the OECD (shallow) double dip camp, while the other three are placed firmly in the adjoining marquee that is accurately (if clumsily) labelled "sub-trend post-stimulus but not a return to contraction". In either scenario, China will not be able to look outward for much impetus.
- The fiscal cavalry may yet arrive but policy is unlikely to change tack *über-aggressively* at this early stage. Yes, the central government's fiscal position has recovered dramatically, with the operating balance

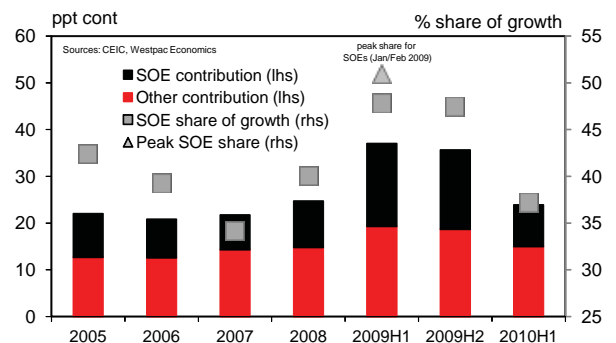
# Phat dragon

a weekly chronicle of the Chinese economy

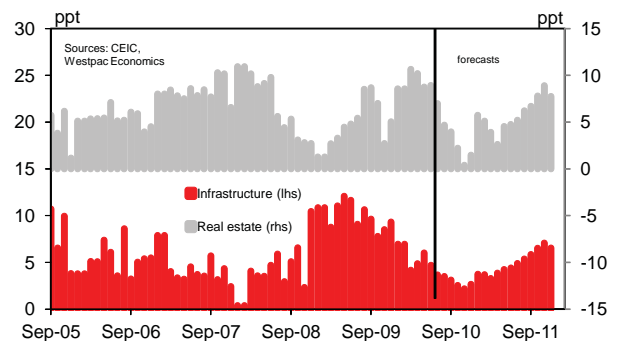
narrowing by 1.6% of GDP since 2009Q2. Revenues are now 28.8% higher than a year ago, driven principally by the stimulus induced rebound in corporate profits, while outlays are tracking at just 19.2%yr. The ammunition for a further fiscal impulse is certainly there. The extension of various rebate schemes and the announcement of a new(ish) western development package were both illustrations of this. The rebound in activity that **Phat Dragon** has pencilled in for mid-2011 will almost certainly be associated with a fiscal tailwind. However, the economy will be fending for itself in the mean time and it may not be an altogether pleasant experience.

- In sum, the negative cyclical factors look set to win the arm wrestle with the strong structural fundamentals for the short term, pulling growth temporarily below trend. A reversal of the impending policy drag will fuel the subsequent rebound.
- **Stats of the weeks: China's energy use is now 19.5% of the world total: and just a rounding error below the US.**

## State owned enterprises & fixed investment



## Contributions to investment growth



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# Phat dragon

## Economic & financial forecasts

### Financial forecasts

	Latest	Sep 10	Dec 10	Mar 11	Jun 11	Sep 11
1 year CNY deposit rate %pa	2.25	2.25	2.25	2.25	2.25	2.25
1 year CNY lending rate %pa	5.31	5.31	5.31	5.31	5.31	5.31
Required reserve ratio % <sup>^</sup>	16.50	16.50	17.00	17.50	17.50	18.00
CNY per USD	6.78	6.75	6.73	6.71	6.68	6.65
Implied NDF rate*	na	6.76	6.74	6.71	6.66	na

### Economic forecasts

	2006	2007	2008	2009	2010f	2011f	2012f
Real GDP	12.7	14.2	9.6	9.1	10.3	9.1	9.9
Consumer prices	1.5	4.8	5.9	-0.7	3.0	2.8	3.0
Producer prices	3.0	3.1	6.9	-5.4	5.5	2.8	4.5
Industrial production (IVA)	16.2	13.5	8.8	10.7	12.9	12.1	13.9
Retail sales	13.7	16.8	21.8	15.4	17.0	15.8	13.9
Money supply M2	18.1	17.5	16.7	26.5	20.0	15.3	15.0
Fixed asset investment	25.5	25.8	26.7	31.9	24.0	22.3	24.0
Exports	27.0	26.7	17.9	-15.9	28.9	8.1	7.9
Imports	20.3	20.7	19.6	-10.0	35.9	7.3	7.7
Trade balance USDbn	177	262	298	196	201	176	192
Bank lending	15.2	16.7	15.3	31.0	20.4	14.3	14.0
Property prices	5.5	7.6	6.5	1.5	9.5	-0.5	3.3

Sources: CEIC, IMF, Westpac Economics. Year average growth rates unless specified. \* Actual market implied NDF rates at t+3, t+6, t+9 et cetera. Therefore, the rate reported will not necessarily correspond exactly to the forecast dates. The difference between the forecast and the forward rates should be interpreted with caution. <sup>^</sup> Large banks only.

### Economic variables – recent history

	2009						2010					
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
<b>Monthly data %yr</b>												
Consumer prices – headline	-1.8	-1.2	-0.8	-0.5	0.6	1.9	1.5	2.7	2.4	2.8	3.1	2.9
Consumer prices – non-food	-2.1	-2.0	-1.9	-1.6	-0.7	0.2	0.5	1.0	1.0	1.3	1.6	1.6
Producer prices	-8.2	-7.9	-7.0	-5.8	-2.1	1.7	4.3	5.4	5.9	6.8	7.1	6.4
Money supply M2	28.4	28.5	29.3	29.5	29.7	27.7	26.1	25.5	22.5	21.5	21.0	18.5
Bank lending	34.0	34.1	34.2	34.2	33.8	31.7	29.3	27.2	21.8	22.0	21.5	18.2
Fixed asset investment %ytd#	32.9	33.0	33.3	33.1	32.1	30.5	26.6	26.6	26.4	26.1	25.9	25.5
Industrial production (IVA)	10.8	12.3	13.9	16.1	19.2	18.5	12.8	12.8	18.1	17.8	16.5	13.7
%3m saar*	21.3	18.3	15.5	18.6	16.9	18.4	19.0	6.7	17.1	12.5	24.9	4.3
Retail sales	15.2	15.4	15.5	16.2	15.8	17.5	14.0	22.1	18.0	18.5	18.7	18.3
%3m saar*	26.4	24.8	21.8	20.5	14.6	16.7	18.5	52.3	22.4	27.7	9.2	36.0
Exports	-22.9	-23.1	-15.0	-13.7	-1.2	17.6	21.0	45.7	24.2	30.4	48.5	43.9
%3m saar*	39.7	17.4	68.4	37.9	54.5	90.7	47.6	91.6	-24.6	1.7	39.9	76.9
Imports	-14.9	-17.1	-3.8	-6.8	26.3	55.6	85.6	44.7	66.4	50.1	48.9	34.6
%3m saar*	125.0	32.1	30.8	3.7	51.8	107.9	85.7	80.2	25.2	17.0	38.5	-5.0
Trade balance USDbn	10.6	15.7	12.9	24.0	19.1	18.4	14.2	7.6	-7.2	1.7	19.5	20.0
Foreign direct investment USDbn	5.4	7.5	7.9	7.1	7.0	16.2	8.1	14.0	9.4	7.3	8.1	12.5
Foreign reserves chg USDbn	43.0	36.2	61.8	55.7	60.5	10.4	16.1	9.4	22.5	43.4	-51.0	14.8
PMI manufacturing (NBS)*	54.8	54.9	53.2	56.5	56.1	57.2	56.7	54.3	52.9	52.1	52.8	52.2
<b>Quarterly data</b>	<b>Sep 07</b>	<b>Dec 07</b>	<b>Mar 08</b>	<b>Jun 08</b>	<b>Sep 08</b>	<b>Dec 08</b>	<b>Mar 09</b>	<b>Jun 09</b>	<b>Sep 09</b>	<b>Dec 09</b>	<b>Mar 10</b>	<b>Jun 10</b>
Real GDP %yr	13.0	12.0	11.3	10.1	9.0	6.8	6.5	8.1	9.1	10.7	11.9	10.3
Real GDP % saar*	8.7	11.8	10.6	8.3	5.4	4.0	7.1	14.8	10.6	10.9	11.1	8.5
Real fixed asset investment %yr#	22.1	18.2	17.3	16.0	17.8	18.5	29.8	39.8	36.5	27.3	24.5	21.9
Real household consumption %yr*# <sup>^</sup>	7.8	10.8	2.0	10.2	6.0	8.8	9.2	10.7	10.4	8.7	8.8	5.8
Property prices – national %yr	8.2	10.2	11.0	9.2	5.3	0.5	-1.1	-0.5	1.9	5.8	10.6	12.2

Sources: Government agencies, Bloomberg, CEIC, Westpac Economics. January data omitted from certain series due to Lunar New Year distortions. In these instances the February number is the average for the first two months of the calendar year. \*Seasonally adjusted by Westpac Economics. # urban, <sup>^</sup> per capita.

Past performance is not a reliable indicator of future performance. The forecasts given above are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The results ultimately achieved may differ substantially from these forecasts.