

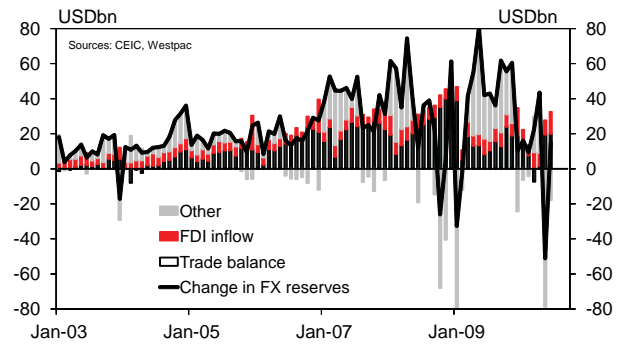
31 August 2010

- The market is presently fixated with the rumour that the Governor of the People's Bank, Zhou Xiaochuan, has defected to the US. The topic gets 155k hits on Google. The apparent reason for the defection? A loss of \$431 billion on US Treasuries. **Phat Dragon's** take, based on various inconvenient facts for the rumour mongers, is that this is a most unlikely trigger and response. Fact #1: SAFE manages the bulk of the FX reserves, with a portion allocated to the CIC, so the PBoC is only obliquely responsible for the returns achieved. #2: a "buy and hold" strategy on USTs is seriously in the money right now. 3# When the CIC suffered major losses on various equity investments during the Crisis, the PBoC was never mentioned as culpable. 4#: he isn't Cuban. Unless Mr Zhou has secretly developed an unhittable fastball/curve combination and has a dream to pitch in the big leagues, he just doesn't seem like a great candidate to "defect". Given that **Phat Dragon's** advance scouts have him topping out at 82mph with a gale behind him, we can safely count this one out. #5: the Cold War has been over for two decades, so the security hawks should go take a frigid shower. #6: Zhou is historically aligned with the "Shanghai Gang" that has been out of power since the Hu/Wen pairing took office and he is thus something of an outsider in the current administration. In sum, this apocryphal news story is most likely be remembered as the first major blow struck in the jostling for position ahead of the next round of political succession in 2012.
- The NBS PMI is out tomorrow with the market anticipating a gain from 51.2 to 51.6. The July headline translated to a seasonally adjusted outcome of 52.7. The market forecast implies a seasonally adjusted headline of 52.5: a mild deceleration indeed. **Phat Dragon** sees the risks to the downside on this occasion, with a seasonally adjusted outcome close to 50 more consistent with other indicators.
- Worried about current and projected excess capacity in global shipping? The fact that China's shipbuilders increased output 87% in the year to July versus the same period last year, with orders up 420% on the same basis, will not do much to alleviate these anxieties. Prices have apparently dropped back to 2005 levels, indicating to **Phat Dragon** that an undignified scramble for shares of a receding market is underway - margins be damned.
- Surrender requirements for foreign exchange accrued through trade have been relaxed, the latest step in the veritable snowstorm of currency internationalisation initiatives announced in recent months. The combined initiatives have had a major impact on FX trading, driving a major divergence between offshore (i.e. HK) and onshore pricing with the former far more aggressive in terms of appreciation. These developments tell **Phat Dragon** two things. One, China's capital controls still bind. Two, the apparent appreciation pressure in the offshore market is signalling a temporary excess demand for RMB as portfolios are rebalanced to take account of the regulatory changes. This distortion is not evident in onshore markets, where expectations of an accommodative policy shift is driving pricing. This disconnect is more likely to be resolved in the Mainland's favour in the short term, something that the NDF curve is starting to factor in.
- **Stats of the week: China had 2.3 hospital beds per capita at the end of 2009, up from 1.2 in 1980.**

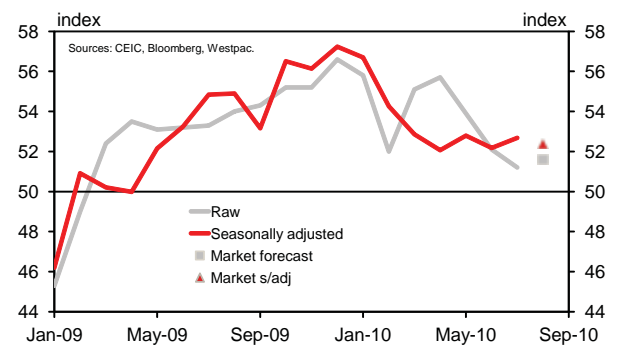
Phat dragon

a weekly chronicle of the Chinese economy

FX reserves growth by type of flow



The NBS manufacturing PMI: headline



USD/CNY NDF curves

