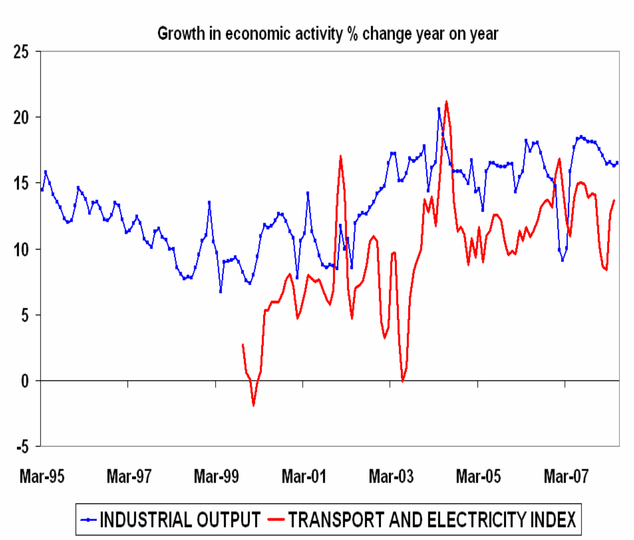
June 2008

# China – growth still solid

## Key trends

- **Chinese economic growth continues at a rapid pace with surprisingly little evidence of any slowdown in the industrial sector.** Industrial growth was still running at 16% yoy in May, fixed investment spending showed no signs of slowing, exports were remarkably strong and retail spending growth was much the same as before. Our measure of monthly activity based on utility and transport volumes showed solid growth too.




- **We still expect the rate of growth to slow as softer global trading conditions eventually hit exports while the run of tightenings in monetary policy also eventually slow domestic demand growth.** However,we are still expecting solid growth of 9¾% yoy in 2008, slowing 8¼% in the following year.

- **Inflation is an increasing problem for the Government.** Alhough higher food prices are still driving most of the surge in Chinese inflation, there are other areas of concern. Non-food CPI inflation has accelerated, further down the pipeline there are pressures in the industrial sector and energy subsidies are to be reduced.

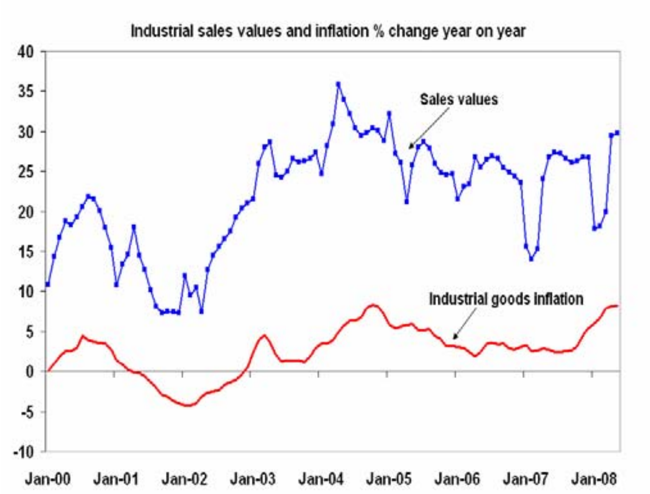

- **The replacement of deflation with inflation in China has significant consequences for the global economy.** In combination with the lower US$, we can see the ramping up in the cost of Chinese goods in measures of Hong Kong and US import prices.


Tom Taylor
Head of Economics - International
(613) 8641 3475
Tom_Taylor@national.com.au

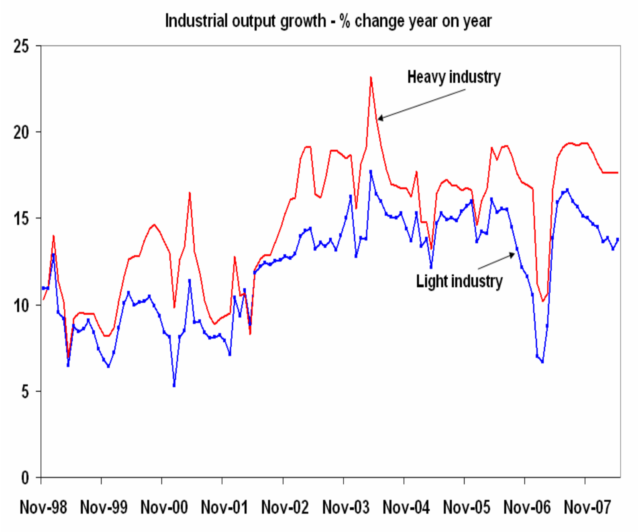
Robert De Iure
Economist – Country Risk
(613) 8641 3445
Robert_De_Iure@national.com.au

## Growth still surprisingly strong

Industrial growth was surprisingly strong in May – with year on year expansion in volumes still running at 16% and 3-month growth at 16½% yoy. Admittedly, this is below the 18% plus growth rates seen through most of the latter half of 2007 but it is still an exceptional pace of growth by global standards. The growth in industrial sales values has accelerated in recent months to nearly 30% yoy, up from around 26% yoy in mid-2007. However higher inflation accounts for that pick-up and so sales value growth has stayed around 20% yoy.




Looking at the split between industry sectors, we can see a moderate slowdown in both the light and heavy industry categories. Heavy industry has been particularly targeted by a range of government measures trying to slow its rate of growth of capacity. So far, these have only had a modest effect when it comes to output expansion. Output growth peaked with over 20% yoy expansion in the first half of 2004 but it was still running at a solid 19% yoy through the latter half of last year. Since then growth has slipped further to around 17% yoy in the 3-months ended May. Light industry is more export market oriented and there has been a slowing there but again growth has only slowed slightly (to a still strong 13¾% yoy in May.



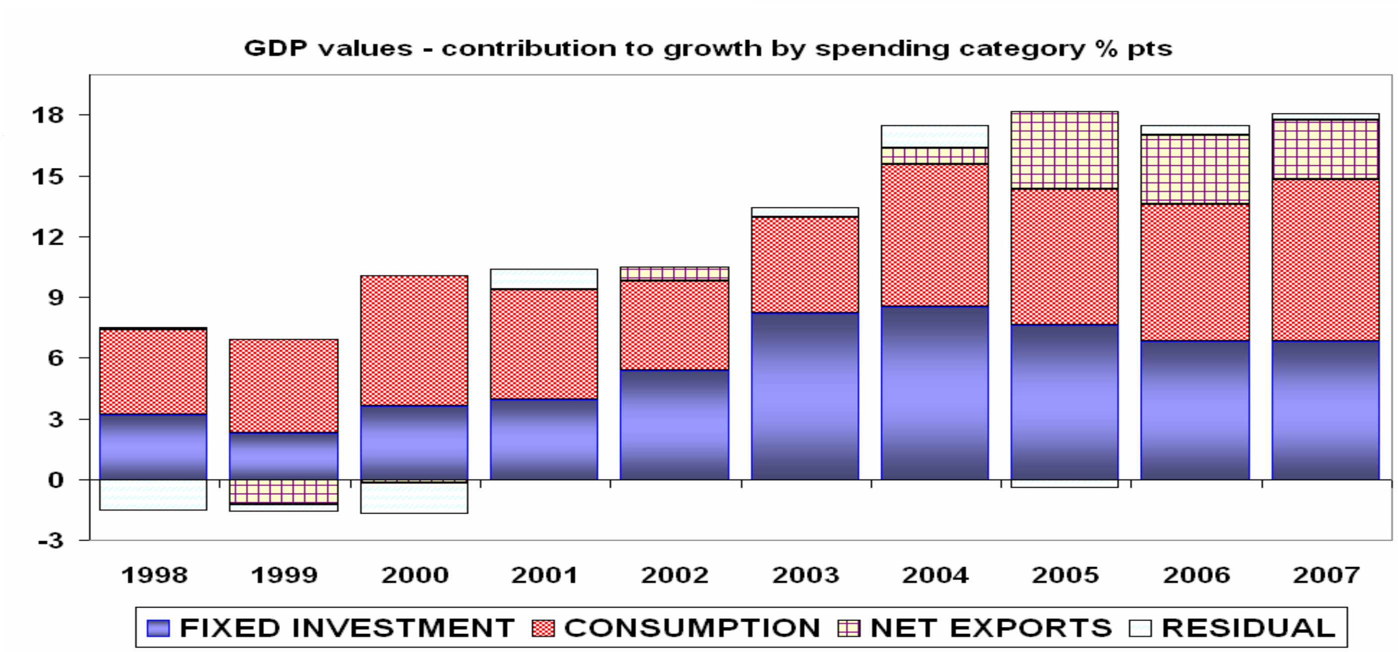

Until recently, export growth had seemed to be experiencing a downward trend and that would not be surprising as yuan appreciation was eroding profitability (and incentives to supply) and lifting prices to US customers while slower demand growth in key markets would also be expected to dampen Chinese export growth. Against that background, the April and May export outcomes were remarkably good. Export revenue growth in US$ was almost 30% yoy in the month of May and the 3-month growth rate, which had been slipping, rose again. Yuan export orders also picked up in May after trending down before.

## Domestic spending still rising fast

The Government have been adopting a range of policies for several years to try to slow the pace of demand expansion. Excessive growth in fixed investment has been a particular target (the fear being overheating as huge amounts of capacity were rapidly built up could be followed by excess supply later). These official measures have not had much success in slowing the growth of urban fixed investment. This has continued growing at around 25% yoy and as inflation in this area was only around 4% in 2007 (up from 1½% in the previous two years), volume growth is solid.

While the authorities have wanted to curb investment spending, they have been keen to lift consumer demand. Again they have not had as much success as they would have liked. The growth rate of retail spending has accelerated from around 15% yoy in late 2006 to around 22% yoy now but that essentially reflects higher retail price inflation. Retail volume growth has remained around 14% yoy through this period. The bar chart below shows the extent to which Chinese GDP growth has been reliant on fixed investment and net exports. There has been an increasing contribution from household consumption too but these current values are boosted by recent retail inflation





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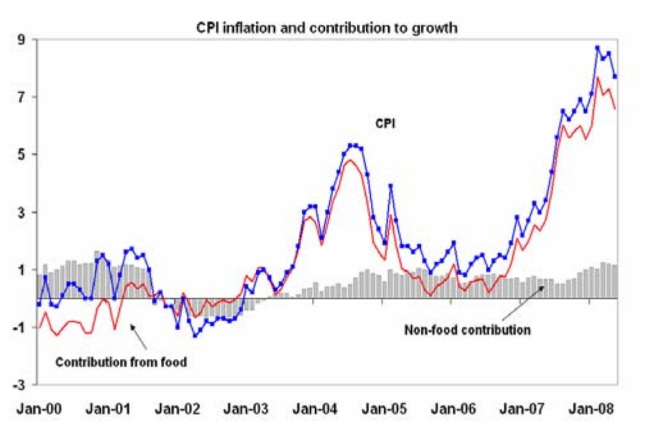
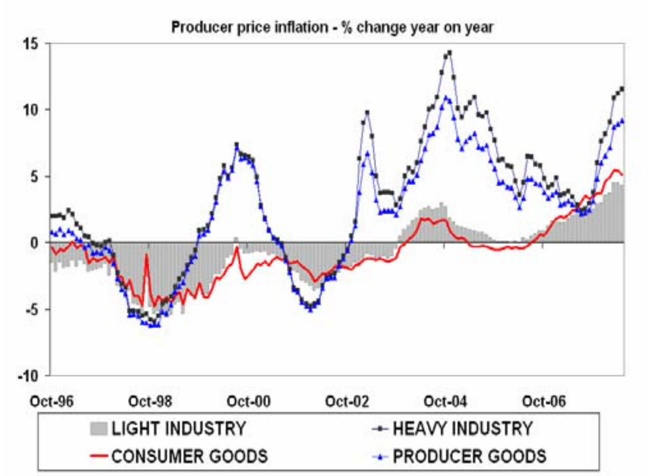
## Inflation problen worsening

The inflationary problem in China is worsening with CPI inflation reaching 7.7% yoy in May, part of the worst surge in inflation outcomes since the inflationary surge of the early 1990's. While it is true that supply disruptions in the food industry account for the bulk of the lift in prices, there are growing signs of inflationary pressures across the economy.

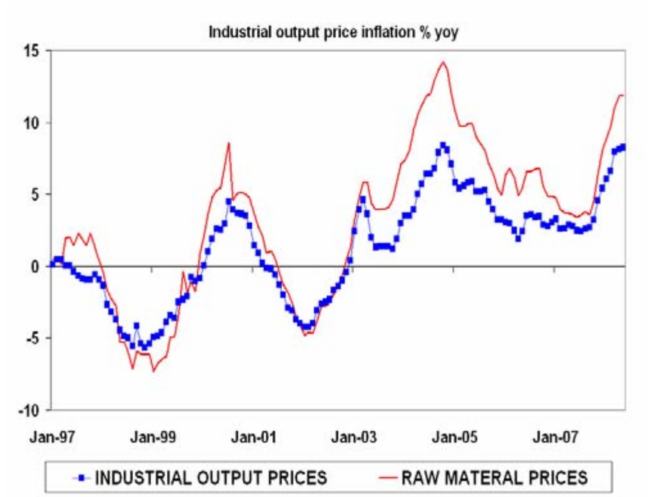



Looking back down the chain of production, we can now start to see signs of a pick-up in producer price inflation. Producer output prices had been climbing by around 2% yoy through much of the last few years but the pace of growth has quickened recently – to 8¼ yoy in May The central bank's price measure for corporate goods shows inflation for processed goods picking up from around 3% yoy in mid-2007 to 8% yoy by May.

The business surveys suggest that inflationary pressures are not about to suddenly wane in the industrial sector. Although the Peoples Bank survey shows a reduction in the share of responding firms considering that the economy is overheated it still shows an economy facing serious cost pressures. The same survey reported a continuing rapid increase in costs – largely based on higher raw material prices and increased funding costs (the interest rate for 1-year working capital has risen from around 5.3% to 7.5% over the last few years).




The official measures of industrial raw material prices shows that their inflation rate is again exceeding that of industrial output, squeezing margins. The Peoples Bank survey shows a significant drop in respondent profitability in March quarter but it ascribes it to the snow storms. Other surveys also point to an erosion in profits and a slight drop in the profit to costs ratio – although it is still high by historical standards.



# Macroeconomic, Industry & Markets Research

**Australia**

| | | |
|---|---|---|
| Alan Oster | Group Chief Economist | +(61 3) 8641 3464 |
| Jacqui Brand | Personal Assistant | +(61 3) 8641 4179 |
| Jeff Oughton | Head of Economics – Australia & Industry | +(61 3) 8641 3469 |
| James McKinlay | Economist – Australia | +(61 3) 8641 4304 |
| Dean Pearson | Senior Economist – Industry & Commodities | +(61 3) 8641 3474 |
| Gerard Burg | Economist – Minerals & Energy | +(61 3) 8641 3984 |
| John Sharma | Economist – Property, Business Services, TMTs | +(61 3) 8641 3473 |
| Ian Gordon | Economist – Transport, Healthcare, Retailing | +(61 3) 8641 3472 |
| Anthony Tooman | Economist – Manufacturing | +(61 3) 8641 3672 |
| Skye Dixon | Economist – Agribusiness | +(61 3) 8641 3442 |
| Tom Taylor | Head of Economist – International | +(61 3) 8641 3475 |
| Robert De Iure | Economist – Country Risk | +(61 3) 8641 3445 |
| Carolyn Fraser | Economist – International | +(61 3) 8641 3694 |
| Simon Calder | Economist – International | +(61 3) 8641 3848 |
| Robert Henderson | Chief Economist Markets – Australia | +(61 2) 9237 1836 |
| David de Garis | Senior Economist – Markets | +(61 2) 9237 1180 |
| Spiros Papadopoulos | Senior Economist – Markets | +(61 3) 8641 0978 |

**New Zealand**

| | | |
|---|---|---|
| Tony Alexander | Chief Economist – BNZ | +(64 4) 474 6744 |
| Stephen Toplis | Head of BNZ Market Economist | +(64 4) 474 6905 |
| Craig Ebert | Senior Economist, Markets | +(64 4) 474 6799 |
| Mark Walton | Market Economist | +(64 4) 474 6923 |

**London**

| | | |
|---|---|---|
| Tom Vosa | Head of Market Economics – UK | +(44 20) 7710 1573 |

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