Economics

China: prices, currency going with the flow

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One of the objectives set out at the 17th National Congress of the CCP was to "create conditions that would enable citizens to have property income so as to increase the income of urban and rural residents."

China to encourage property income...

Simply put, besides wages and salaries – the main source of income for the rural population – the government hopes to raise incomes through capital gains from assets such as securities and real estate. Currently, property income accounts for virtually nothing in terms of total income.

Per capita cash income of rural households (2Q07)	
per capita cash income	% of total
- wages/salaries	57
- household operations	35
- transfer income	5
- property income	3

Sources: NBS, DBS

...and seemingly favors the current method of wealth creation- via asset market appreciation

China seems to favor the recent method of wealth creation- that is via asset price appreciation. By and large, property prices in China have enjoyed an uptrend this year, where prices in 70 large and medium-sized cities have risen 8.2% YoY in the third quarter (***Chart 1***). The number of newly built homes jumped 9% YoY. As for the equity market, after successfully resuscitating the A-share market in 2006, the lower capital required for investing in equities opened another channel for residents to participate in the asset market. The number of stock investment accounts at the Shanghai and Shenzhen stock exchange surged to a record high totalling 127mn by end-Sep07, up 60% year-to-date. Shanghai and Shenzhen A-share indexes rose 107% and 183% respectively year-to-date (as of Sep07).

But can China keep consumer inflation in check?

If the government does indeed expedite the advancement of the capital markets, (by maintaining macro-conditions necessary for asset markets to thrive), can China keep consumer inflation in check? For the last quarter, the government has shown heightened concern over the surge in CPI inflation. In September, it rose to 6.2% YoY. For the remainder of the year, it is likely to hover above the 6% level before softening a tad due to the high-base effect. Since 2006, consumer inflation has risen in tandem with robust consumption arising from wage growth and wealth effect from asset price appreciation (***Chart 2***). If household consumption strengthens

Chart 1: Asset market appreciation

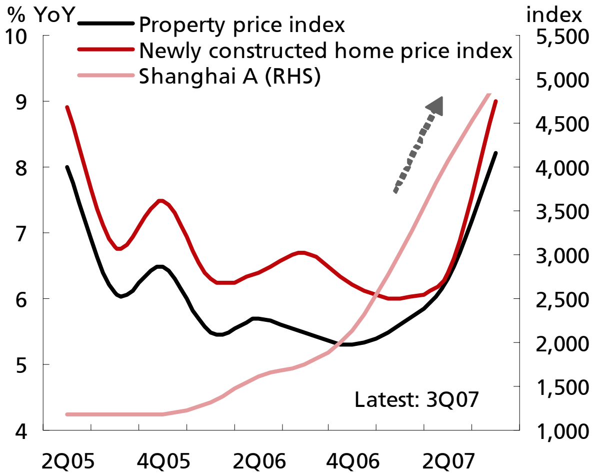
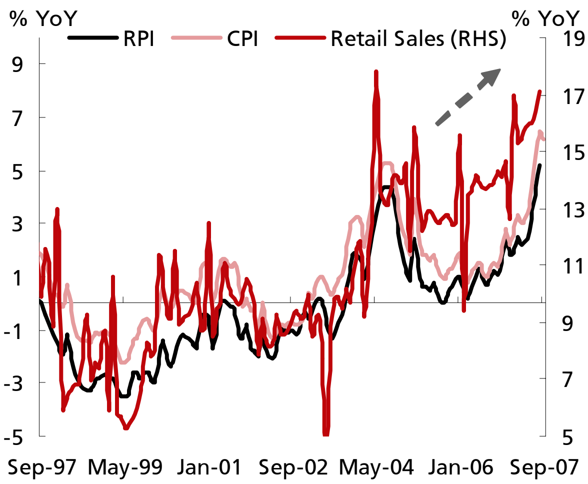


Chart 2: Retail sales growth vs inflation



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further, demand-side inflationary pressure may well increase.

So far, inflation seems to be affecting only food prices (***Chart 3***). Non-food inflation has remained low at 0.9% YoY, hardly inflationary even when compared to the rest of the world. However, the central bank cannot afford to lower its guard. For a developing country, higher household consumption naturally manifests itself in terms of higher food prices (which account for a third of the CPI basket) before progressing to other components of the basket.

Fuel prices have been kept artificially low

Moreover, the inflation in non-food components could be much greater than the 0.9% rate suggests. Non-food CPI inflation has been distorted by the government's efforts in keeping domestic utilities prices/fuel prices lower than market determined/ international market levels. By 2006, the country's oil imports amounted to over 40% of its total oil consumption. Yet, the government's price caps on domestic fuels prevented rising international oil prices from fully filtering into major sectors such as manufacturing and transport. For the past year, retail gasoline and diesel prices remained unchanged. The impact is evident in the both the falling producer price index and corporate goods purchasing index of oil and fuel in spite of record high international oil prices (***Chart 4***).

Chart 3: CPI

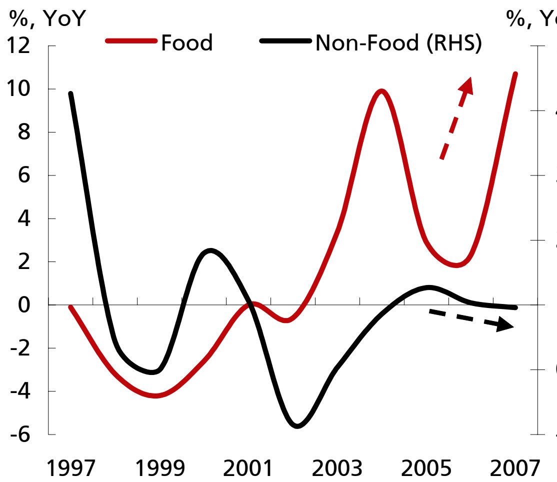
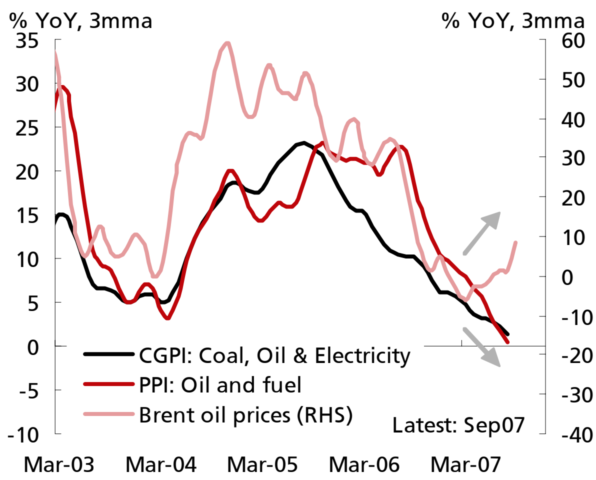


Chart 4: PPI/CGPI of fuel vs Brent

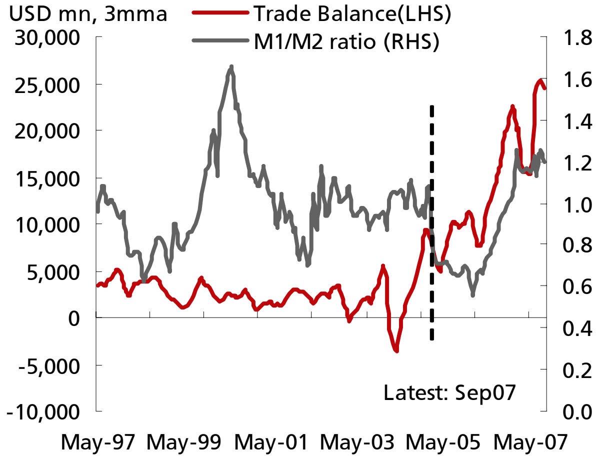


Despite intensifying calls for hikes in fuel price from oil refiners, China demonstrated its commitment to keep non-food inflation low by freezing state-controlled prices for the rest of the year (special requests for price hikes are subject to approval by the National Development and Reform Commission). While non-food inflation is artificially suppressed, the build-up in underlying pressure should be not overlooked.

Inflows remains a challenge

Into 2008, liquidity growth remains a challenge. The large and growing external surplus has become the major determinant of money supply growth (***Chart 5)***. As of September, the trade surplus had surged 56% YoY to USD24bn. Year-to-date, it stands at USD186bn and is on track to reach US$260bn for 2007 overall, about 8% of GDP. The gradual CNY appreciation against the US dollar over the

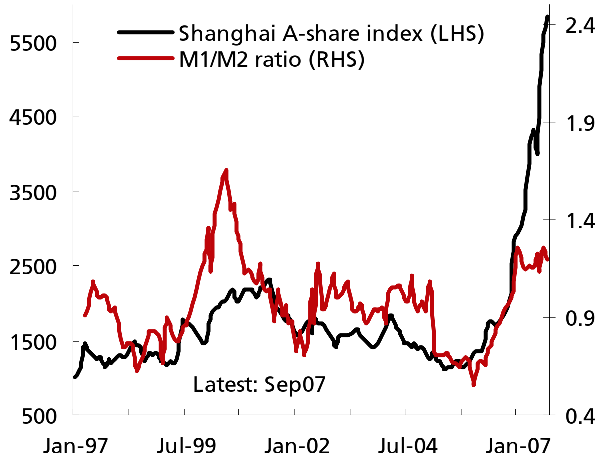
Chart 5: Trade surplus vs M1/M2 ratio



past 27 months has had little if any effect on surplus. This comes as no surprise, given that the currency is up by only about 2% in trade-weighted terms on the same time horizon.

We expect the currency to continue to appreciate gradually in 2008 despite intensifying calls for a one-off revaluation. We think the latter is unlikely because of the risks it would pose, especially given the approaching Olympics. We look for 5% appreciation against the US dollar in 2008. Assuming the CNY meets our 7.35 target by end-2007, this would put the currency 7.00 at end-2008. At this pace of appreciation, the trade surplus is likely to widen further. We expect a surplus of USD322bn in 2008. Amidst sustained high money supply growth, asset price inflation is bound to rise. Not surprisingly, the A-share market has become more in sync with the trend of the M1/M2 ratio (***Chart 6***).

Chart 6: M1/M2 ratio vs Shanghai A share index



Taking these conditions into account, we have raised our CPI inflation forecast for 2007 to 4.5% YoY, from 4.0%. Inflation could rise to 5.0% on average in 1H08. And as noted above, inflation would be considerably higher were it not for distortions in state-controlled utilities/fuel prices. In the event, China's fiscal health may allow the government to continue subsidizing domestic fuel prices for much longer than most expect.

Monetary and exchange rate policies to remain stimulative

At least for the inflation-adjusted deposit rate to edge closer to the positive territory, the one-year deposit rate and one-year lending rate would have to rise by 36bps and 27bps to end 2007 at 4.23% and 7.56% respectively. They should continue to increase by the same magnitude in Q1 and Q2 of 2008 to 4.59%/7.83% and 4.95%/8.10% respectively. Even if these set of forecasts materialize, the monetary and exchange rate policies remain stimulative.

Sources for charts are CEIC and DBS Research

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