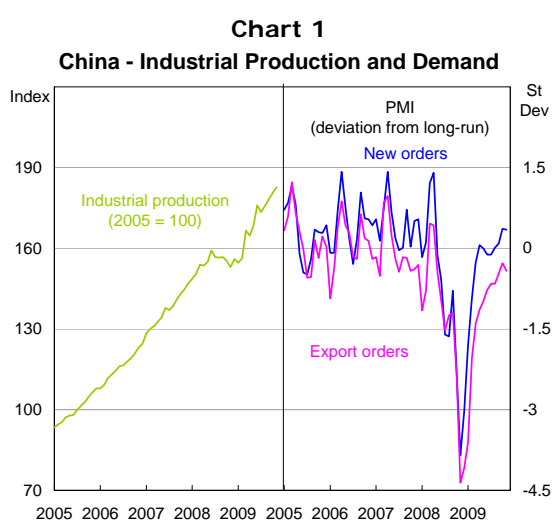


China – November in Review

The Chinese economy continued to expand in November, although the main economic indicators were more mixed than in previous months. Industrial production rose strongly in November, while retail sales growth slowed and fixed asset investment fell for the second consecutive month. Inflationary pressures continued to emerge in the month, and the pickup in dwelling and equity prices accelerated. While the most recent developments have not led us to change our annual forecasts – we anticipate annual growth of 8¼ per cent in 2009 and 9 per cent in 2010 – the potential for a slowdown in investment sooner than expected has risen.

Activity

Manufacturing output continued to expand quickly. Industrial production increased by 1¼ per cent in November – its fourth consecutive monthly increase – to be 19.2 per cent higher over the year (Chart 1). Production growth in the December quarter to date is similar to the September quarter, but roughly half that in the June quarter.

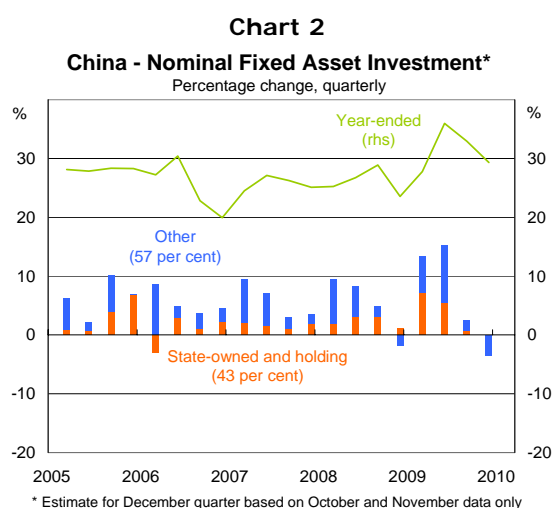


Production has responded to higher domestic and external demand. According to the PMI, domestic and

John O'Connor
Economist - International
+61 3 8634 8076
John.F.O'connor@nab.com.au

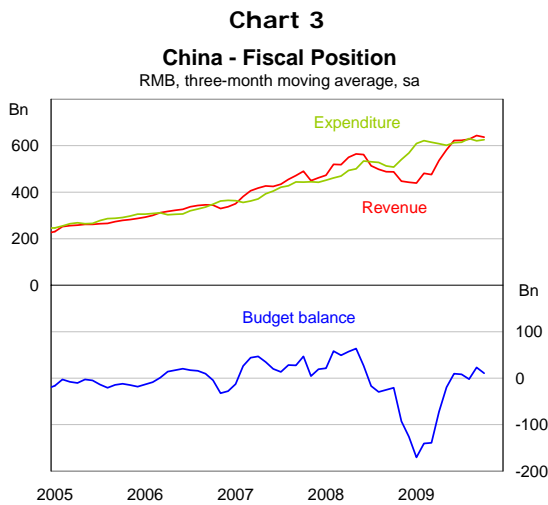
external new orders have improved gradually over the past six months (export volumes have risen by around 20 per cent in same period). Further, a literal read of the PMI finished goods stock index continues to suggest the pace of inventory rundown is similar to earlier in the year. This seems to suggest an unintended rundown in inventories and could point to further increases in production in coming months.

Investment appears to have slowed so far in the December quarter (Graph 2). Nominal fixed asset investment is estimated to have fallen for the second consecutive month. This follows very rapid growth in the first half of 2009, and only moderate growth in the September quarter. The historical relationship between fixed asset investment and national accounts investment is poor. Nonetheless, fixed asset investment data is the only monthly indicator of investment and given a) the large magnitude of the fall; and, b) the economy's high investment share, it constitutes a downside risk to growth in the December quarter.



One possible explanation for the apparent slowdown in investment is that the *implementation* of stimulus

projects was front loaded. This is illustrated by the level of investment undertaken by state-owned and holding companies being virtually unchanged for six months, following a rapid expansion in the first half of the year. A similar trend has occurred in central government expenditure, with the level barely increasing since the middle of the year (the central government was to directly fund one-third of the fiscal stimulus package, Graph 3).



Emerging overcapacity is another possible explanation of weaker investment. This would be expected to be most pronounced in private-related investment, which we estimate has fallen in the December quarter so far. The Ministry of Industry and Information Technology found overcapacity was most acute for the steel, cement and glass sectors. These sectors account for a relatively trivial contribution to overall investment, but they may be symptomatic of emerging trends in other sectors.

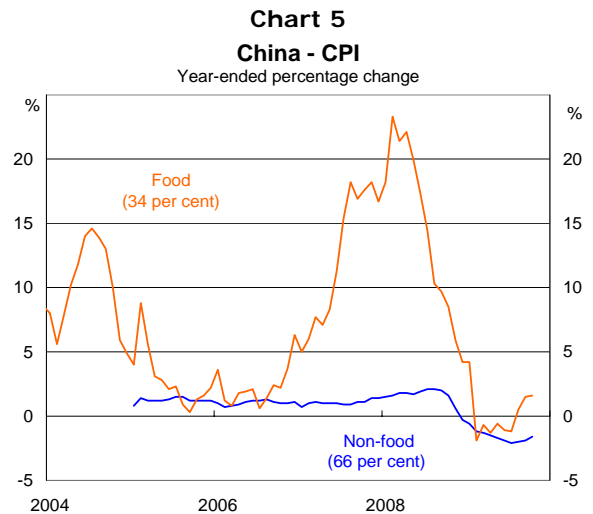
The pace of consumer spending has slowed slightly though policy measures will continue to be supportive. *Real* retail sales is estimated to have barely risen in November, but is still 2½ per cent higher in the December quarter so far (Graph 4). In order to spur 'sustainable and fast consumer spending' the State Council – the chief administrative authority in China – announced the continuation of the subsidy program for household appliances and

agricultural machinery. Further, sales tax for purchases of small cars will be 7.5 per cent next year which, though higher than the current rate (5 per cent), is lower than in 2008 (10 per cent).



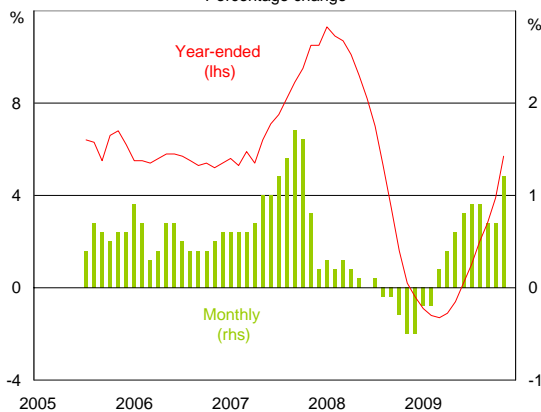
Prices and Policy

Inflation continues to emerge, and though benign by historical standards is an increasing concern of authorities. The CPI rose by 0.6 per cent over the year; food prices increased by 3.2 per cent while non-food prices fell by 0.7 per cent (Graph 5). Food prices have risen persistently for much of the year, with the most rapid increases in fresh fruit & vegetables and grains. Since food accounts for one-third of the CPI basket, it has significant effects on aggregate inflation but also welfare implications.



Growth in asset prices accelerated in November. The 70-cities House Price Index rose by 1.2 per cent in November – its fastest monthly increase since late 2007 – and by 5.7 per cent over the year (Graph 6). House prices have risen sharply in some cities; Shenzhen prices are 17 per cent higher than at the beginning of the year and 5 other cities have experienced appreciations of more than 9 per cent. However, a widespread housing bubble has not yet developed, with the median price increase in the 70 individual cities at only 4 per cent. This view is similar to Vanke – China’s largest real estate company – whose chairman said that house price bubbles were evident only in some cities at this stage. Meanwhile, equity markets rose sharply in both October and November.

Chart 6
China - 70-cities Property Price Index
 Percentage change



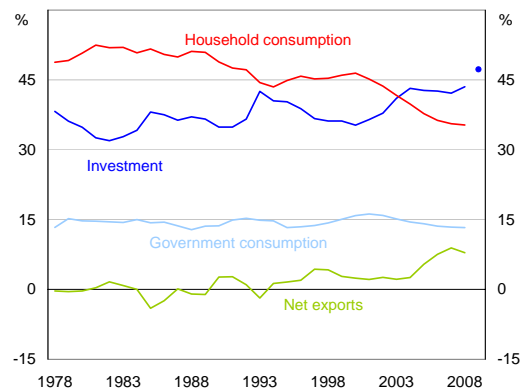
Authorities appear to have become more concerned by the prospect of asset-price bubbles. In recent months authorities have provided greater guidance on lending, requesting that it be ‘stable and sustainable’ for the remainder of the year, to more closely scrutinise borrowers use of funds and to restrict credit for speculative purposes. Further, the State Council last week sought to dampen housing market speculation by tightening sale tax exception rules. In particular, a dwelling must be owned for a minimum of five years for it to be sales tax exempt, compared with two years previously.

The emerging inflation and escalating asset prices raise the probability of policy tightening next year. However, it is likely to be gradual as the underlying strength of the economy – excluding state-influenced activity – remains less than certain. Separately, the *China Daily* reported the China Banking Regulatory Commission would aim to limit credit growth to RMB8 trillion yuan in 2010. If true this would be around RMB1 trillion less than in 2009, though still high by historical averages.

Central Economic Work Conference

The Central Economic Work Conference is one of the most important forums in formulating economic policies for the coming year. This year’s meeting emphasised the need to manage inflationary pressures, to ensure stable and relatively fast economic growth, and to accelerate the reorientation of the economy away from investment and exports and toward household consumption. As a share of GDP, investment is estimated to have reached 47 per cent of GDP in 2009, which is high by any international standard (Graph 7). To assist this reorientation, the conference recommended greater provision of education, health and social security services, focus on improving the distribution of income, and the continuation of policies to encourage spending.

Graph 7
China - GDP
 Per cent of nominal GDP



Macroeconomic, Industry & Markets Research

Australia

Alan Oster	Group Chief Economist	+ (61 3) 8634 2927
Jacqui Brand	Personal Assistant	+ (61 3) 8634 2181

Vacant	Head of Australian Economics & Commodities	+ (61 3) 8634 2832
John Sharma	Economist - Australia	+ (61 3) 8634 4514
Ben Westmore	Economist - Australia & Commodities	+ (61 3) 8634 8602

Dean Pearson	Head of Industry Analysis	+ (61 3) 8634 2331
Gerard Burg	Economist - Industry Analysis	+ (61 3) 8634 2778
Daniel Farley	Economist - Property	+ (61 3) 8634 2168
Brien McDonald	Economist - Industry Analysis	+ (61 3) 8634 3837
Frank Drum	Economist - Agribusiness	+ (61 3) 8634 2041

Michael Lee	Senior Economist - Modelling & Econometrics	+ (61 3) 8634 8562
-------------	---	--------------------

Tom Taylor	Head of International Economics	+ (61 3) 8634 1883
Robert De Iure	Economist - Country Risk	+ (61 3) 8634 4611
John O'Connor	Economist - Asia	+ (61 3) 8634 8076
Mark Rodrigues	Economist - International	+ (61 3) 8634 1823

Markets

Peter Jolly	Head of Markets Research	+ (61 2) 9237 1855
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 Markets Economics - BNZ	+ (64 4) 474 6905
Craig Ebert	Markets Economist - BNZ	+ (64 4) 474 6799
Mark Walton	Markets Economist - BNZ	+ (64 4) 474 6923

London

Tom Vosa	Head of Markets Economics - UK	+ (44 20) 7710 1573
David Tinsley	Markets Economist - Europe	+ (44 20) 7710 2434

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