

# Emerging Markets Economics Research

Emerging Markets • Economics • Asia

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## China: Five unexpected trends in 2007

We highlight five contrarian calls on China for 2007:

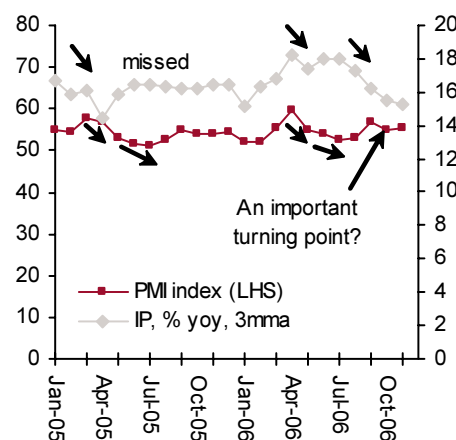
- Growth and economic activities will rebound soon — as suggested by the PMI data.
- Interest rates will likely rise — the booming stock market is starting to draw deposits away from banks.
- Tax breaks will erode — FDI, exporters and large SOEs likely to be affected.
- RMB to appreciate faster — Paulson needs this to placate Capitol Hill and Beijing will reciprocate.
- Food and coal prices are set to rise — Beijing may push up food prices to boost rural incomes and coal-oil conversion projects may lift coal prices.

## The economy will rebound

The austerity program was surprisingly effective in cooling economic activities. Monthly data for October suggested a faster than expected moderation in economic activities. Industrial production growth slowed to 14.7% year on year vs 16.3% yoy in Q3 and 17.7% yoy in H1 2006; fixed asset investment growth eased to 16.8% yoy, vs 24.2% yoy for Q3 and 31.3% yoy for H1. A further deceleration is expected, as we project 9.8% yoy in GDP growth, 14.5% yoy in industrial production and 16% yoy in fixed asset investment in Q4 2006 — all falling back to the policy target ranges. China is on track for a soft landing. The faster than expected moderation is likely to lift Beijing's foot off the brake a little (though it is unlikely to declare the end of the austerity program). The recapitalized banking sector is eager to lend, as long as the government shows some tolerance.

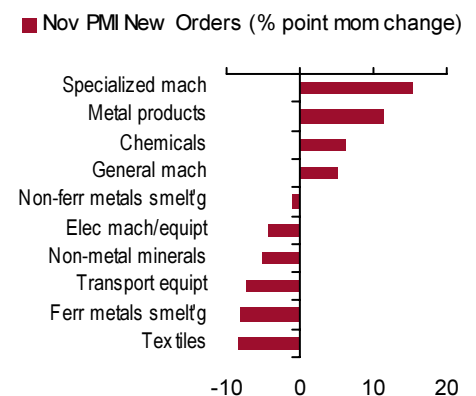
The forward looking Purchasing Managers' Index is indicating a possible pick-up in economic activities in early 2007, in line with our prediction, but against market consensus. The November PMI saw a 0.6 point increase to 55.3, indicating that confidence seems to be back to pre-austerity levels. The rise of new orders was concentrated in special machinery and metals. We think that infrastructure investment, especially in transportation, is reaccelerating after a pause in summer. We hold the view that the Chinese economy will begin to rebound in early 2007, led by infrastructure investment and a property boom revival. It is our view that credit policies are likely to be subtly eased after a successful soft landing in the economy. The excess liquidity situation has not changed and banks are still eager to lend, so once the magnitude of the austerity measures are eased, lending is likely to pick up. A strong H1/slower H2-followed by a rebound early next year has been the pattern since 2000, and we expect the same in 2007, though the strength of rebound is likely to be smaller than the ones seen in H1 2004 and H1 2006. For further details, please refer to our 5 December 2006 report: *China Manufacturing November 2006: More evidence of an investment rebound?* and *China: The economy starts to rebound soon?*, published on 3 October 2006.

**Exhibit 1: Purchasing Managers' confidence saw a significant pick-up in the past three months**



Source: China Logistics Information Centre, Credit Suisse

**Exhibit 2: News orders are mainly related to machineries, driven by infrastructure projects**



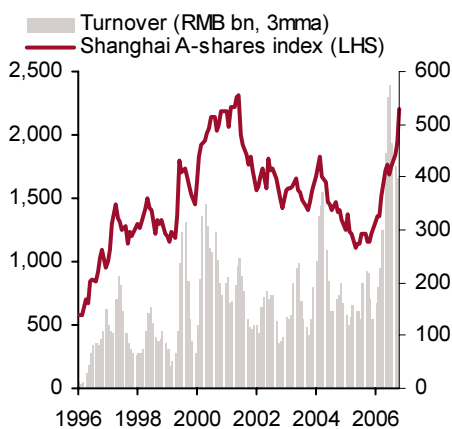
Source: CLIC, Credit Suisse

## Interest rates will move higher

Despite the softening monthly statistics, we think China's interest rates are heading higher. The central bank has been talking about shifting from administrative tightening to conventional monetary policy tightening as the principal tool of liquidity management. This was stated in the Monetary Policy Quarterly Report and in the statement following the National Economic Working Conference last week. So far, the central bank has focused on the reserve requirement ratios, without touching interest rates.

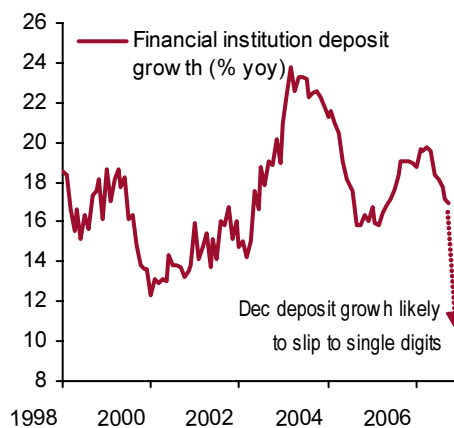
The catalyst that might trigger a rate hike would be a significant outflow of banking deposits into the robust stock market. There is no official data point available yet, but we estimate that mutual funds have raised more than RMB 100 bn, mostly from the banking system, over the past four weeks. China's deposit rate, at 2.5% (or near 0% stripping out inflation and tax) is not attractive to depositors. The rallies in the domestic stock markets have provided a new outlet for dormant capital. The most significant data in the October monthly statistics was not investment growth or new loan issuance, but very soft deposit growth. We believe that there is a strong possibility that deposit growth may slip to single digits in December. This has never happened in the past three decades and would undermine the biggest strength of domestic banks i.e., their vast network to raise deposits. This comes at an inconvenient time, too, as banks face WTO-induced market openings from foreign competition.

**Exhibit 3: Domestic stock market surged ...**



Source: CEIC, Credit Suisse

**Exhibit 4: ... draining away bank deposits**



Source: CEIC, Credit Suisse

If this takes place, it would not necessarily mean further tightening, as Beijing switches away from administrative austerity to conventional tools like the reserve requirement ratio and interest rates, as the latter may be offset by a little easier credit control stance. We see limited impact on the RMB exchange rate – China has capital controls, so it is rare that any hot money inflows are targeting China for interest rate differentials. We look for one or two rate hikes in the next six months.

## Tax breaks may be out

Reunification of tax codes has been discussed for many years, but was delayed due to fears of losing FDI. Timing has finally matured, as it has become national consensus that China has too much foreign capital and foreign investment should be placed on an equal

footing to domestic companies. FDI is currently subject to a 15% corporate tax rate, in addition to other tax breaks during the first five years of investment, while Chinese companies are subject to a 33% corporate tax. We think that this tax issue will be discussed during the National People's Congress this coming March, and could possibly be implemented in 2008.

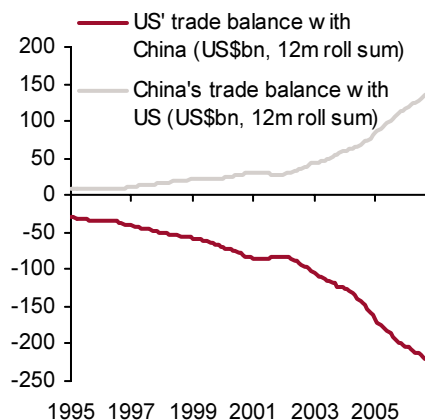
VAT rebates to exports could come under review, as Beijing is committed to narrowing the trade imbalance (China's trade and current account surplus are expected to reach 6.7% and 9.1% of GDP in 2006). The government has already adjusted the VAT rebate rate towards a few industries, as part of industrial policy, but a more general review may take place soon, though timing is not exactly clear, especially in the event that US demand weakens sharply.

Several speeches from senior officials from the State-owned Assets Management Commission suggest that the Commission plans to force SOEs under its control to pay dividends in 2007. The SOEs, which formerly surrendered all their revenues to the government, are now permitted to retain post-tax earnings following a tax reform in 1994. But over the past two years, the Commission has argued that it is entitled to dividends from SOEs under its control given that it is a shareholder. We think this policy will be launched as early as March 2007, without a pre-set dividend pay-out ratio. This has implications for investment growth, corporate earnings, social pension funds and fiscal balance. The Ministry of Finance projects that the earnings of government-controlled state companies will reach around RMB1 tn post-tax this year.

## RMB appreciation accelerates

The first year after exchange rate reform was surprisingly smooth, as Beijing succeeded in its aim to "bore speculators to death" with the very gradual appreciation strategy, and a negative carry between RMB and USD interest rates. Hot money recorded net outflows since July 2006. However, senior leaders in Beijing are starting to realize the harm of excess liquidity caused by massive FX intervention to keep the RMB exchange rate steady. Further, China faces a more hostile US Capitol Hill, with looming anti-China sentiment.

**Exhibit 5: The trade imbalance is a major contention to US Capitol Hill...**



Source: CEIC, Credit Suisse

**Exhibit 6: ...and China needs to help its friend, Henry Paulson**



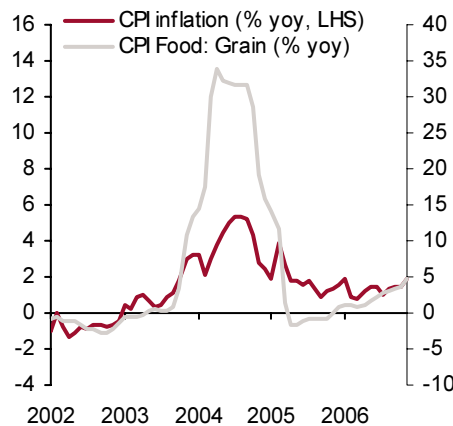
Source: Bloomberg, Credit Suisse

Meanwhile, US Treasury Secretary Henry Paulson, who has a better knowledge of China than any other world leader, is trying to build a close bilateral relationship through strategic dialogue between the world's two largest growth engines. Beijing has responded to Paulson's initiatives enthusiastically. It realizes that Secretary Paulson is probably its best ally to deal with a hostile US Congress and to build a constructive and cooperative bilateral relationship. It also realizes that the more Paulson and his team are able to achieve breakthroughs and tangible progress in areas, such as the RMB, easing of financial service market entry barriers and intellectual property rights protection, the greater his ability will be to push back protectionist sentiment in Congress. We believe that Beijing has greater flexibility in the exchange rate front now compared to a year ago given the progress in banking reform and shoring off hot money inflows. We look for 5-8% RMB appreciation against USD in 2007 vs 3.1% appreciation in the year-to-date period. For further details, please refer to, *China: The new Sino-US relationship — Paulson vs. Capitol Hill*, published on 8 December 2006.

### Food and coal prices go higher

CPI inflation spiked to 1.9% yoy in November, compared to 1.4% in October and 1.3% yoy in the year-to-date. The rise was almost single-handedly fanned by the surge in foods prices (grain up 27% yoy and meat up 17%). Both the central bank and the national planning agency downplayed the spike as an one-off event, but Premier Wen Jiabao paid a visit to supermarkets and low income families to investigate the impact of food price hikes. Our reading on the situation is that: 1) Beijing intends to raise agricultural prices as a means of improving income growth in the rural sector, just as it quietly pushed up the migrant workers' wage rates; 2) Beijing will try to avoid social stress among low income families caused by rising food prices, and; 3) Beijing is prepared to intervene in case inflationary pressures get out of control. In view of Beijing's new focus on rural incomes, low grain inventories and diminishing farming land, we think a gradual increase in food prices has just started, though the government is prepared to smooth out excess price volatility. With the rise in food and wage costs, CPI inflation could reach 2.6% by the end of 2007, doubling the estimated 1.3% average for 2006, though this is still benign by China's standards.

**Exhibit 7: Food price increases are likely to drive up CPI inflation**



Source: NBS, CEIC, Credit Suisse

**Exhibit 8: Coal prices moved up amid the closure of small mines, but maybe more movements ahead**



Source: China Coal Market Network

A slower than expected increase in capacity and higher than expected demand have already pushed up domestic thermal coal prices. Beijing is taking tougher action to shut down small coal mines, after a series of accidents due to lax safety requirements. Meanwhile, many coal-to-oil projects are under construction. According to Credit Suisse's metal and resource analyst Trina Chen, there are 27 coal-to-oil projects under construction or planning to start soon, with capacity of producing 31.5 mn tons of oil. This would suck in 110 mn tons of coal from nowhere — about 5% of China's national coal consumption and 3.8% of sea-borne coal trade. While the first drop of oil may not arrive until late 2007, and it would take an additional three-four years to reach full capacity, market prices may react on day one once it realizes the magnitude of the projects. Like China's steel investment rush, coal-to-oil investment is heavily front-end loaded. Once started, the buying of coal will continue even when coal prices surge due to interest payment burden.

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