

China's 2006 GDP Growth Exceeds Expectations

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Preliminary data released this morning by China's National Bureau of Statistics showed China's economic growth remained on a firm path despite a series of policy tightening and administrative measures since Apr 2006.

China's GDP growth in 2006 came in at 10.7%, ahead of expectation of 10.5% and the revised 10.4% in 2005. This marks the fastest expansion since the 10.9% pace in 1995. GDP growth for 4Q06 also exceeded expectation, coming at 10.4%/y/y, compared to our forecast of 10% and consensus view of 10.1%.

The key drivers in 2006 were the manufacturing sector, which saw output expanding 16.6% compared to 15.9% in 2005, as well as the firm pace of investment growth, despite tightening measures. This in turn saw exports growth rising 27.2% in 2006 to US\$961.9bn and imports at a slower pace of 20% to US\$791.6bn. Trade surplus was at US\$177.5bn, compared to US\$102bn in 2005. China's forex reserves officially came in at US\$1066.3bn as at end-2006.

Domestically, flush liquidity and robust consumer demand saw inflation rate ratcheting up significantly in Dec 06 to 2.8%/y/y vs. 1.9% in Nov, although full year inflation rate is still tolerable at 1.5% and below PBoC's threshold level of 3%.

The latest batch of data suggest that China's growth remains robust despite a series of tightening measures. Of great concern is that the 2005 GDP growth figure has already been revised up to 10.4% from 10.2% just a day earlier, added to that, 2006 GDP growth figure in fact exceeds expectation. In addition, fixed asset investment growth in 2006 has far exceeded official target of 18%.

China's growth momentum is likely to persist in 2007 with some moderation as the impact of previous measures continue to linger. For now, we are keeping China's GDP forecast unchanged at 9.5% for 2007.

Implications:

With the stronger than expected growth and inflation data for 2006, this has given rise to expectations that the RMB could accelerate its rise against the USD. However, we believe that impact on the currency front is likely to be minimal as official comments have been quite consistent in terms of maintaining a gradual appreciation pace for the RMB. Most recently, the two-day high level Central Financial Work Conference chaired by Premier Wen Jiabao (12-13 Jan) further reaffirmed this line of

China's Macro Data						
%y/y change	2006	2005	4Q06	3Q06	2Q06	1Q06
GDP growth	10.7	10.4	10.4	10.6	11.5	10.4
	2006	2005	Dec-06	Nov-06	Oct-06	Sep-06
Industrial Output	16.6	15.9	14.7	14.9	14.7	16.1
CPI	1.5	1.8	2.8	1.9	1.4	1.5
PPI	3.0	4.9	3.1	2.8	2.9	3.5
Urban Fixed Asset Investment	24.5	27.2	13.8	26.6	26.8	28.2
National Fixed Asset Investment	24.0	25.7	-	-	-	27.3
Retail Sales	13.7	12.9	14.6	14.1	14.3	13.9

Source: CEIC, National Bureau of Statistics

thinking, when the mention of the RMB was limited to the usual mantra of increased flexibility and a market-driven exchange rate.

As such we continue to maintain the view that the RMB would rise within the 3-5% range in 2007, with our end-2007 forecast unchanged at 7.47/USD. This implies a 4.5% rise vs. 3.4% in 2006. This morning, the RMB central parity fixing hit a new post-revaluation high of 7.7735/USD from Wed's record high fixing of 7.7755.

In contrast, the implications on the monetary policy front is far more significant as the PBoC is likely to keep to a tightening posture to contain credit and liquidity growth in China. The strong performance of the A-share market, which is up about 23% YTD for Shenzhen A market after the 96% gain in 2006, could be another sign of excess domestic liquidity.

As a recap, PBoC has during the current cycle raised the key 1Y working capital interest rate twice since April 2006 (to 6.12%) and increased reserve requirement ratio four times (to 9.5%) since July 2006.

While there is limited room for the central bank to raise interest rate due to the differential with US\$ interest rate, we continue to expect a 60% probability of an interest rate hike of 27bps, to 6.39% by 2Q07, as well as at least one more reserve requirement ratio increase before the end of 1Q07.

In addition to interest rate/reserve ratio tools, the Chinese government is likely to step up controls on investments (the latest of which was the enforcement of Land Appreciation Tax effective 1 Feb 07 and harmonization of corporate tax rates in the months ahead) to divert investments into more productive/desirable areas.

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