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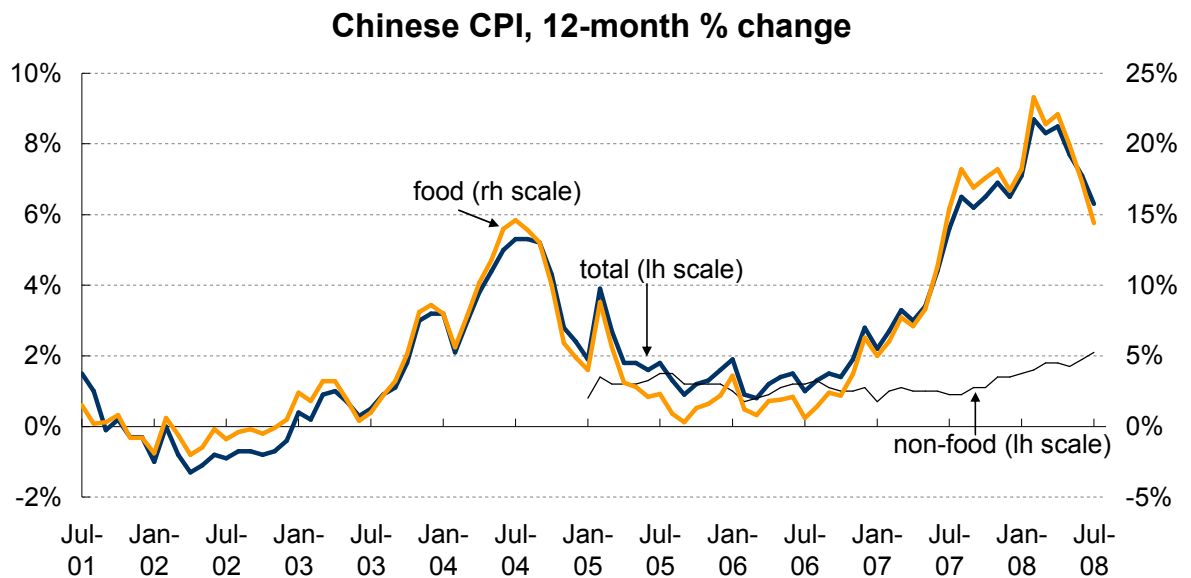
Daily Note: 12 August 2008

China in July: a bit slower, still overheating

WE SUGGEST: Global inflation problem still worsening, ex oil bubble bursting

SUMMARY: China's food prices continue to decelerate as the effects of last year's pig disease come out of the figures. But when that is finished inflation could still end up having doubled to over 5% in just over a year, despite controls, with food inflation still at 10%. The general overheating continued in July, to judge by the import data, still strong, and exports, likewise. China has not solved its policy conundrum.

Yesterday's July trade figures from China, and today's CPI numbers, suggest the economy is still growing at above its (roughly) 10% trend rate, and that the inflation problem is far from solved.

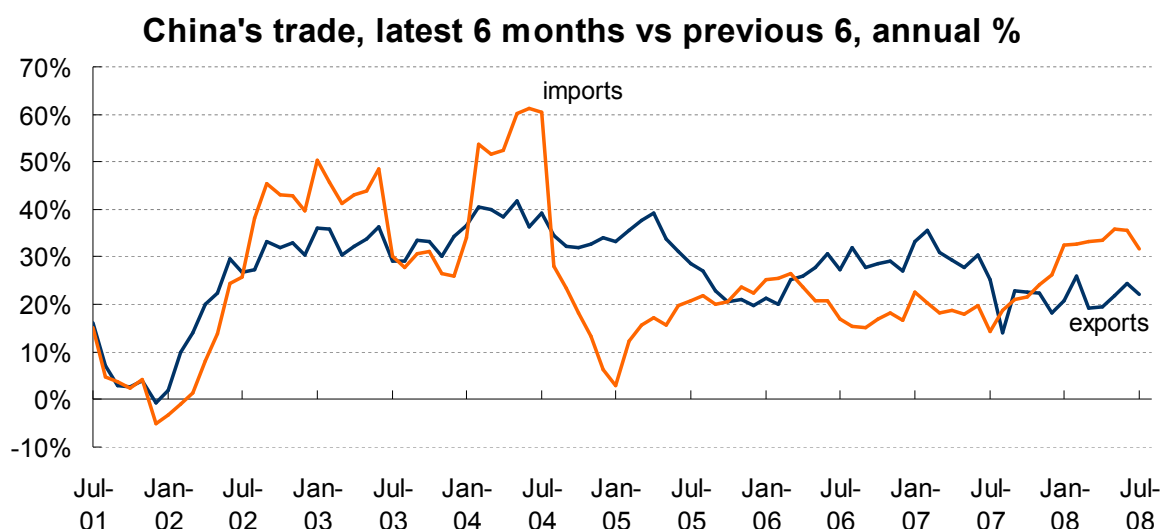


The above chart illustrates how food price fluctuations, with a 34% weight in the CPI, have dominated the total. But the non-food section has steadily accelerated from 0.9% a year ago to 2.1%, and only a small part of that reflects oil prices, which are controlled at the consumer level. The interpretation of the food price data is extremely imprecise for three reasons:

- Only 12-month changes are given, not levels of the indices; so last year's sharp acceleration within the year, and this year's deceleration, can not be traced

- Pig disease last year underlay the particularly quick upswing of food prices, and its waning as a factor accounts for much of this year's improvement, but this effect can not be traced without the index levels
- Nonetheless, food price inflation remains 14-15%, versus 5-6% at the start of 2007, reflecting the importance of food prices in the overheating of the economy, with much of the growth impetus coming from higher industrial wages in a poor population that naturally uses extra income to eat better than it has historically

No doubt food price inflation will come down further. But if, for example, it settled at 10%, with non-food reaching 2½%, then total inflation would be over 5%, double its 2-3% of early 2007. This acceleration could only be attributed to overheating, doubly so when one considers the over-10% appreciation of the yuan in that period, and heavy restraint of the inflation upswing by price controls and other non-market interventions.



Nor is the overheating being reduced. Yesterday's import data showed their growth pulse remains well over 30% in dollar terms. Even allowing for higher oil prices and the dollar's decline, the implied real increase in real yuan terms is well over 10%. Quite possibly GDP growth has eased a bit from Q2's torrid pace, but our analysis shows that real growth then was more like 14% than the officially published 10.1%. Beijing's problem is that any growth over 10% increases the degree to which GDP is above trend, and therefore makes the overheating, and potential acceleration of inflation, that much greater. And the minor easing of double-figure growth that the import figures may suggest is offset by quite strong exports. With dollar growth well over 20%, real export growth is still into double figures despite the yuan's upswing. This hardly justifies the premature halt to yuan appreciation, ostensibly to protect export growth, in an economy that badly needs to cool off.

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