

May 2010

China Chartbook

Morgan Stanley Asia Limited

Qing Wang

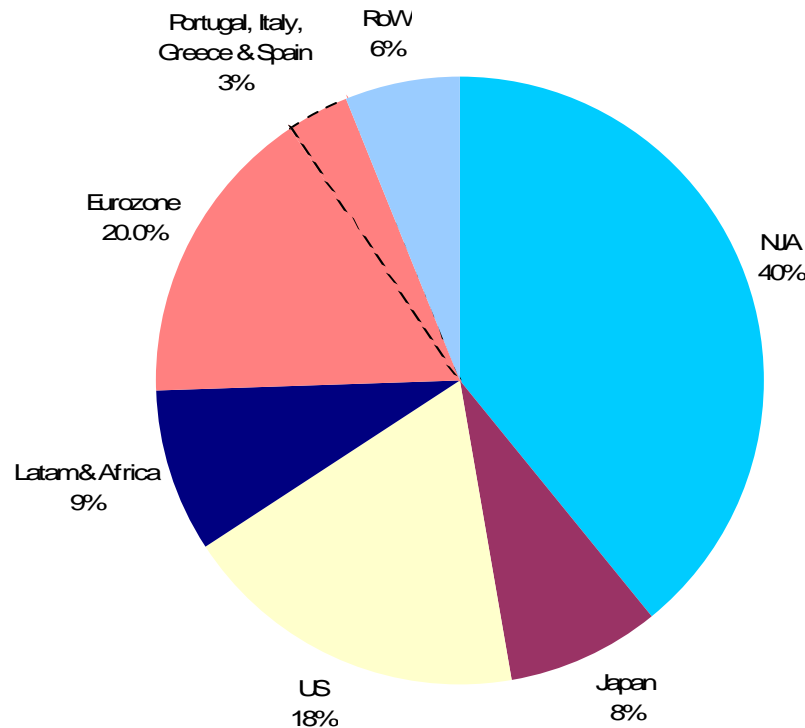
qing.wang@morganstanley.com
+852 2848 5220

Steven Zhang

steven.zhang@morganstanley.com
+86 21 2326 0029

Perception Gap

Chart of the Month:
China's Exports in 2009: Breakdown by Market of Destination



Source: CEIC, Morgan Stanley Research

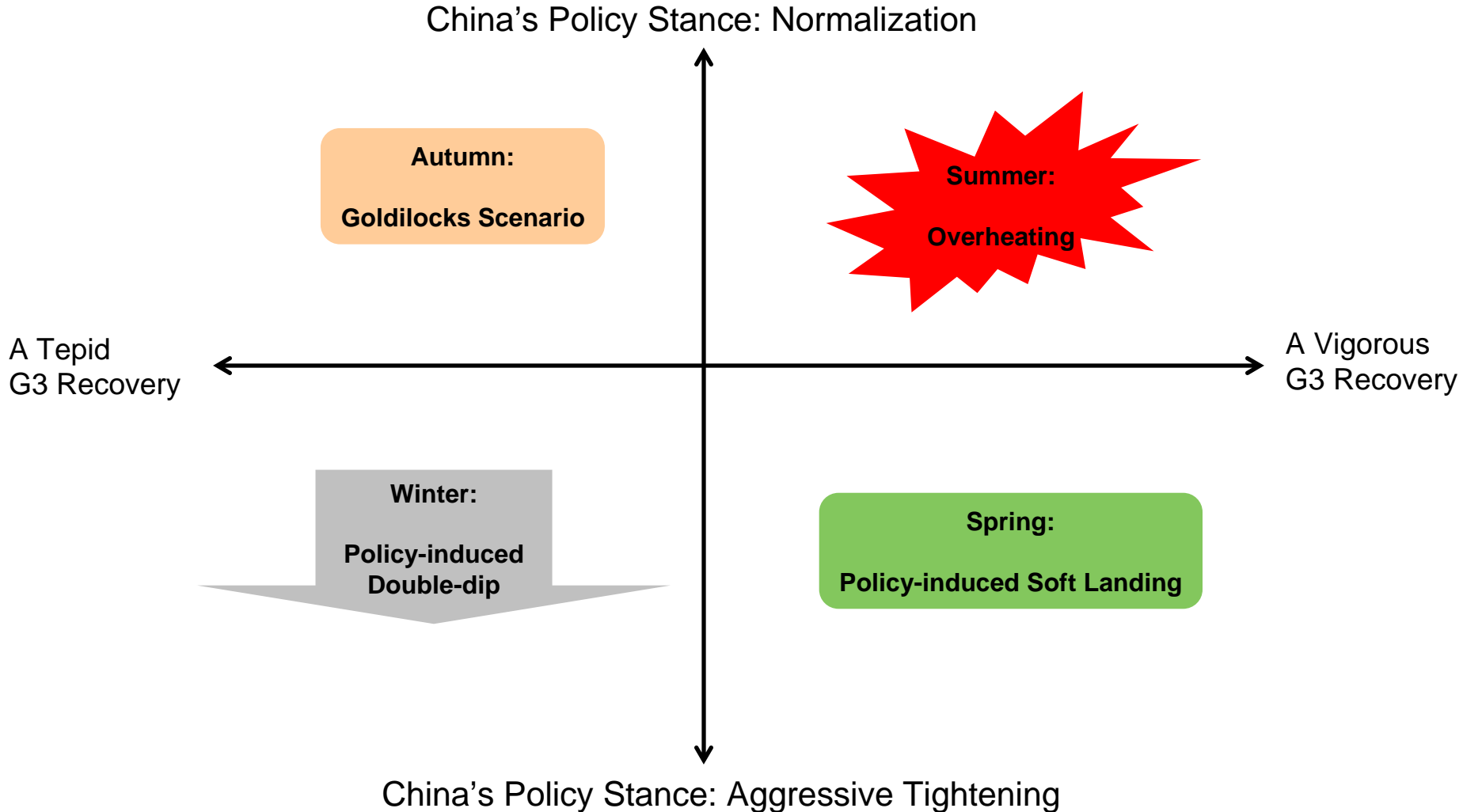
China Economics

For important disclosures, refer to the Disclosures Section, located at the end of this report.

While China produces tons of statistics every month, its quality of macroeconomic analysis is generally poor, as is the case for many developing countries. There is no single set of indicators that are most reliably useful. One should instead examine a wide range of indicators covering every important aspect of the economy in order to get a ‘feel’ for the current situation of the economy. Morgan Stanley’s China Economics Chartbook is a systematic effort to this end.

— Morgan Stanley China Economics Team

**Perception Gap – Equity Markets:
Discounting the ‘Winter Scenario’**



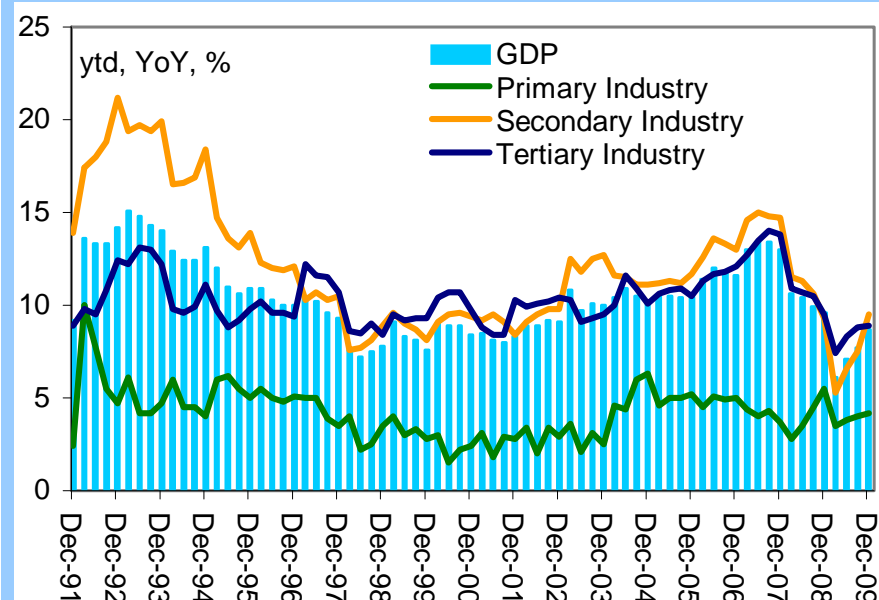
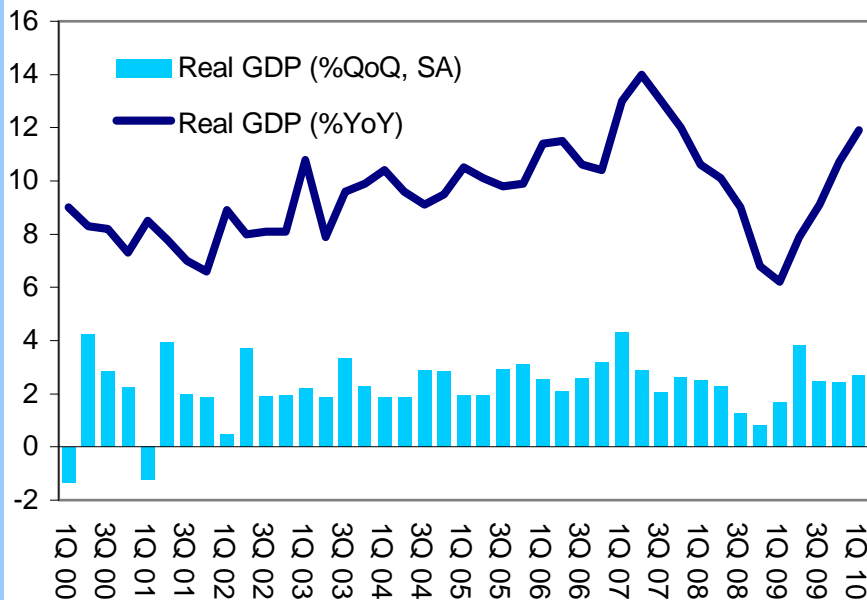
Perception Gap – Reality: Moderation in Activity; Reflation; and Policy Normalization

- **Moderation in activity and reflation:** The overall trend of April economic data can be characterized as “moderating activity with CPI inflation creeping up in the context of policy normalization”.
 - Moderation in fixed-asset investment (pp. 20-22) reflects not only the high base effect but also the gradual policy exit, as Chinese authorities have tightened controls over newly started FAI projects since the beginning of this year (p. 21).
 - Export growth came in stronger-than-expected, which brought back trade surplus after US\$7.2bn of deficit was recorded in March (pp. 33-39).
 - Buoyed by the strong external demand, industrial production remained elevated (pp. 23-25), although the tightening measures have dampened domestic demand to some extent.
 - Retail sales continued to show resilience (pp. 29-30), as consumer confidence returned to pre-crisis level (p. 8).
 - As the output gap narrows, reflation is under way with CPI and PPI inflation creeping up (pages 12 - 13).
- **Economic and policy outlook:** CPI inflation will likely edge up in the coming months, but we still believe the overall inflation outlook will be rather benign for the year, with CPI inflation likely peaking around mid-year. In light of the recent Greek sovereign debt crisis, major central banks are expected to postpone their policy tightening. Dick Berner, Morgan Stanley’s Chief US economist, now expects the US Fed to be on hold until early 2011. Elga Bartsch, Morgan Stanley’s Chief Europe economist, does not expect the ECB to hike rates before mid-2011. We have changed our call for ‘one rate hike in 1H10’ to ‘no more than one rate hike in 2H10’.
- **Potential impact of Greek Debt Crisis and Contagion:** In general, ‘bad economic news in G3 should be good news for GS. First, a substantial deterioration in external environment will significantly reduce the probability of over-tightening in policy stance. Second, the decline in international commodity prices should help ease (imported) inflationary pressures in China. Third, potential delays in rate hikes by major central banks (e.g., ECB, Fed) should also lower the risk of early and aggressive rate hikes or RRR hikes in China. Renminbi revaluation remains a policy option despite recent Euro weakness; however, we do not expect an imminent Renminbi move in the run-up to the US-China Strategic Dialogue that is to take place later this week. We still consider June/July as the most likely window of opportunity for such a move.

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Real Economic Activity: Strong GDP Growth in 1Q10

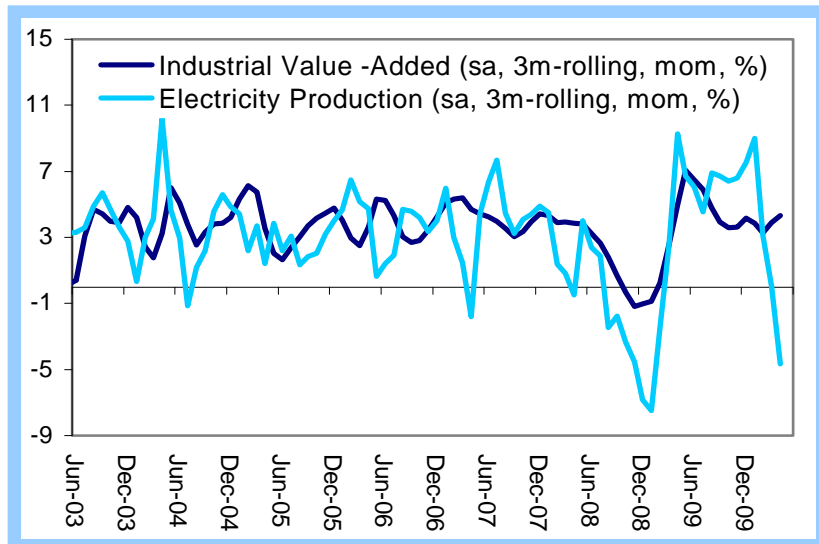
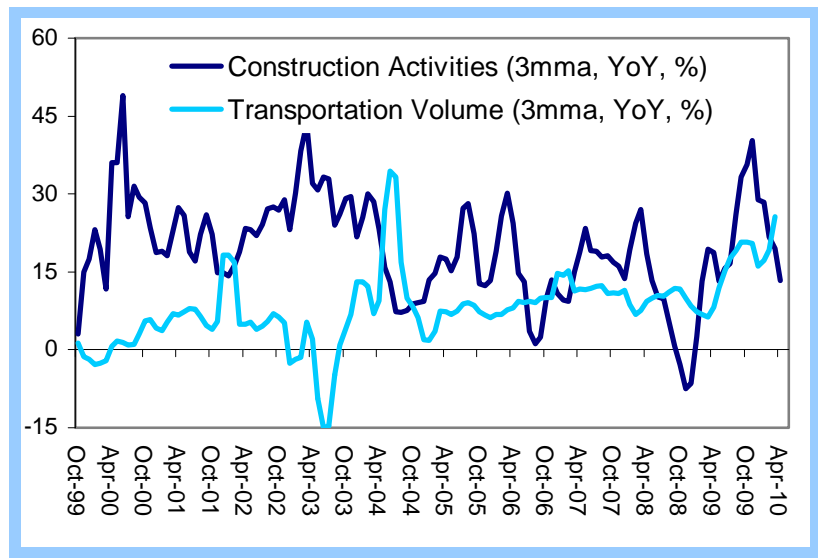
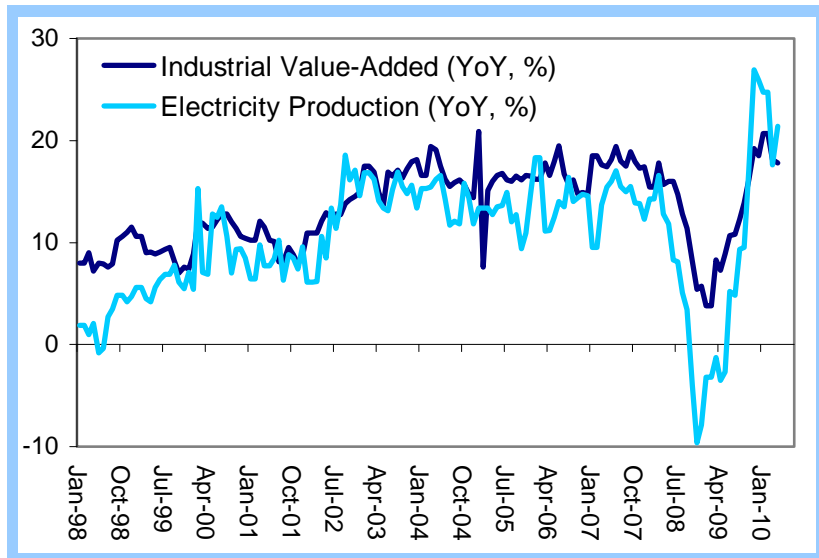


Despite a bumpy economic recovery in the rest of the world, the Chinese economy strode forward to +11.9% YoY in real terms in 1Q10 from +10.7% YoY in 4Q09, in line with our forecast of +12% YoY but beating market consensus of +11.7% YoY. This strongest reading since 4Q 07 should be partly explained by the low base in 1Q 09 when the Chinese economy tumbled to +6.2%YoY at the nadir of the financial crisis. On a seasonally-adjusted basis, the QoQ sequential growth accelerated to +2.7% (+11.2% annualized) from +2.4% (+10.2% annualized) in 4Q 10.

Regarding the industry breakdown, there was broad-based acceleration, led by secondary industry (mining, manufacturing and construction), reflecting aggressive policy stimulus that boosted fixed asset investment growth. Secondary and tertiary (service) industry outperformed headline growth by growing +14.5% and +10.2% (vs. +9.5% and +8.9% YoY for 2009, and +3.5% and +5.4% in 1Q 09). Primary industry recorded 0.3 ppts of improvement from +3.5% in 1Q 09 but remained weaker than +4.2% YoY for the whole year of 2009.

Source: CEIC, Morgan Stanley Research

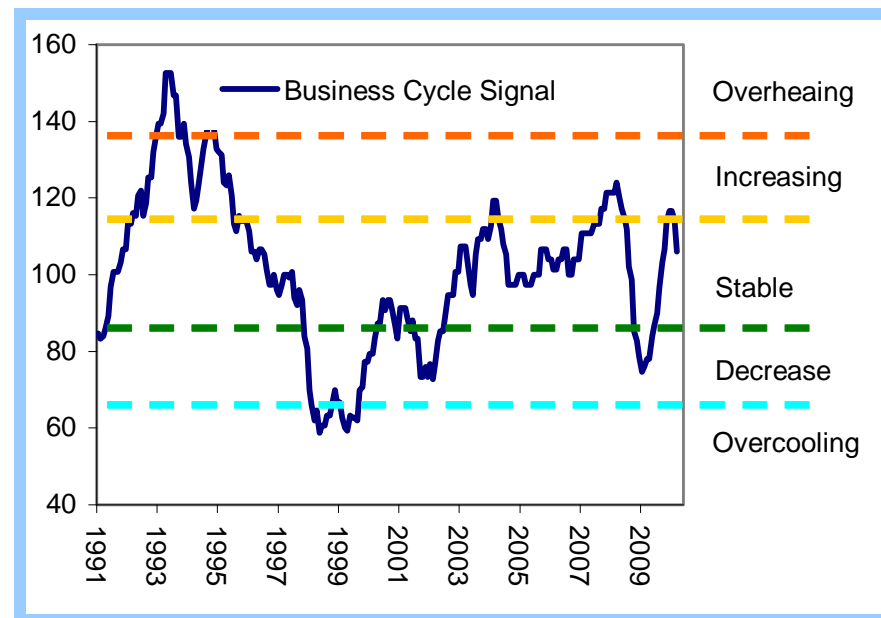
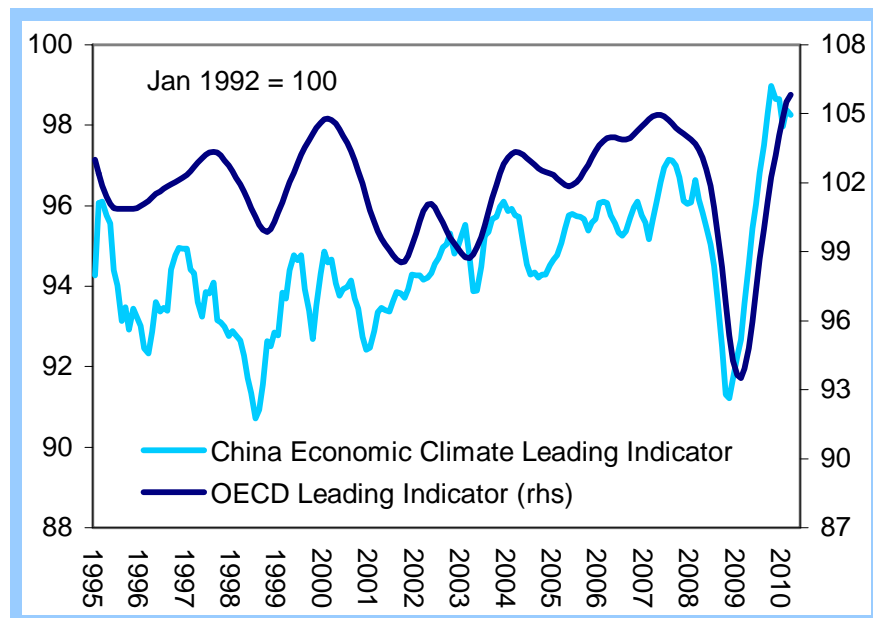
Real Economic Activity:
Industrial Production Decelerated in April



- Weaker than our forecast and market consensus of +18.5%, growth in industrial value-added softened to +17.8% YoY (-2.3% MoM sa) in April from +18.1% YoY (+4.2% MoM sa) in March. Power generation defied the deceleration of IP by strengthening to +21.4% (vs. +17.6% in March). However, due to weakness in February, the 3-month-rolling sequential growth of power generation softened significantly.
- The downward trend of construction activities was mainly explained by gradual exit of infrastructure-focused policy stimulus, while transportation continued to strengthen via strong economic growth (data available through March).

Source: CEIC, Morgan Stanley Research

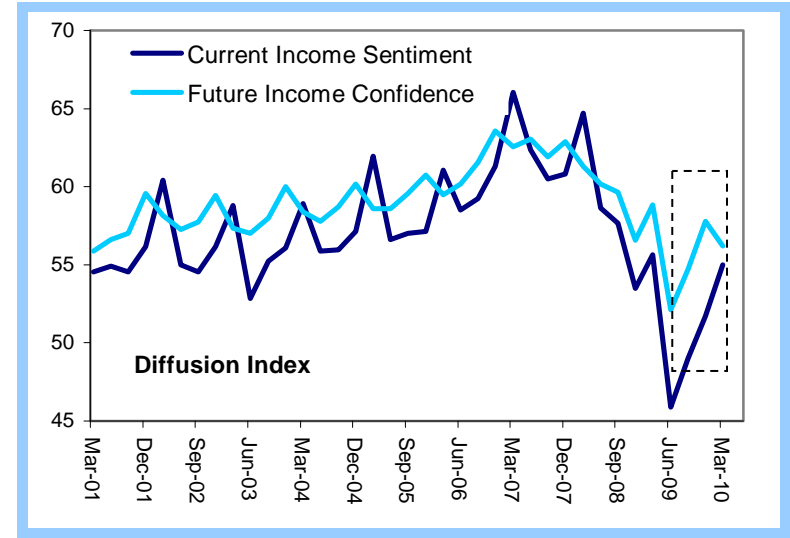
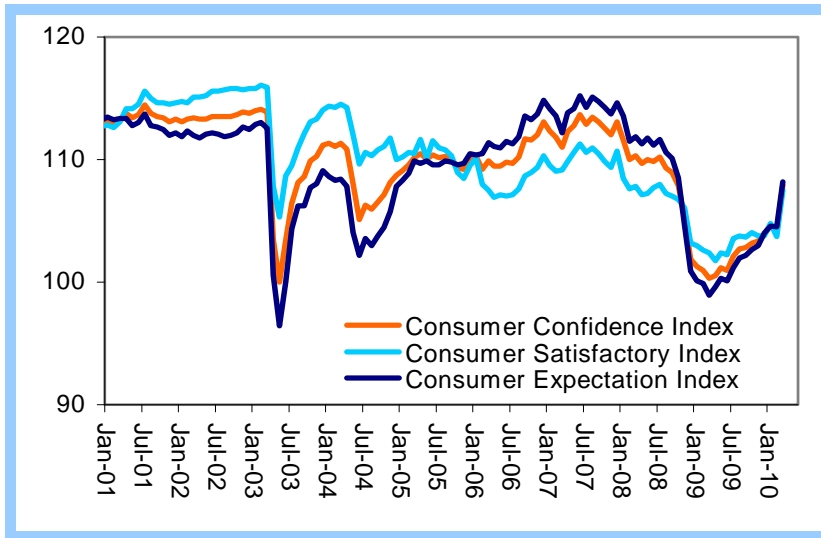
Sentiment and Leading Indicators: Leading Indicators Peaking



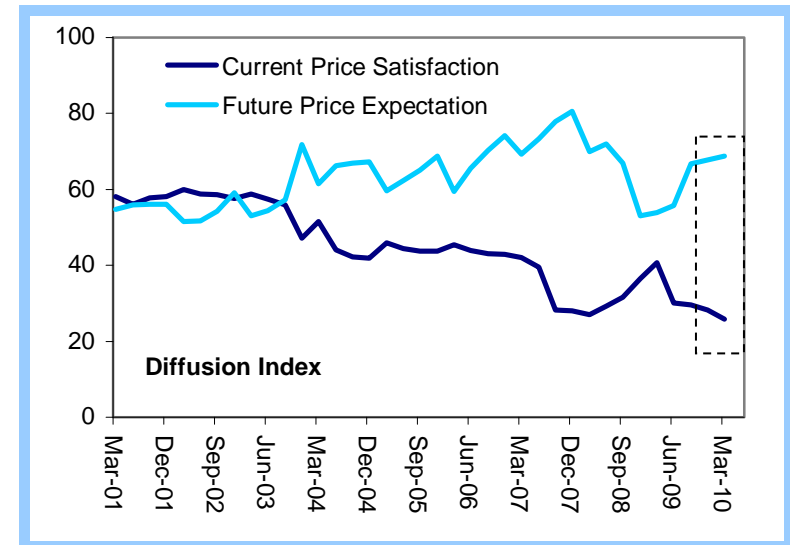
- China has spearheaded the global recovery since early 2009 thanks to strong policy response, mirrored in the strengthening China Economic Climate Leading Indicator (CECLI). However, CECLI appears to have peaked since last October, implying gradual normalization of the policy stimulus, given the solid recovery on track. OECD Leading Indicator rallied from the trough of Feb 09 and the trending-up momentum remained distinctly strong.
- Business Cycle Signal strengthened into “Increase” territory last December as the result of aggressive policy stimulus, but fell back into the “Stable” zone in January and continued to soften afterwards with the launch of policy exit in both fiscal and monetary fronts.

Source: CEIC, Morgan Stanley Research

Sentiment and Leading Indicators: Consumer Confidence Returned to the Pre-Crisis Level

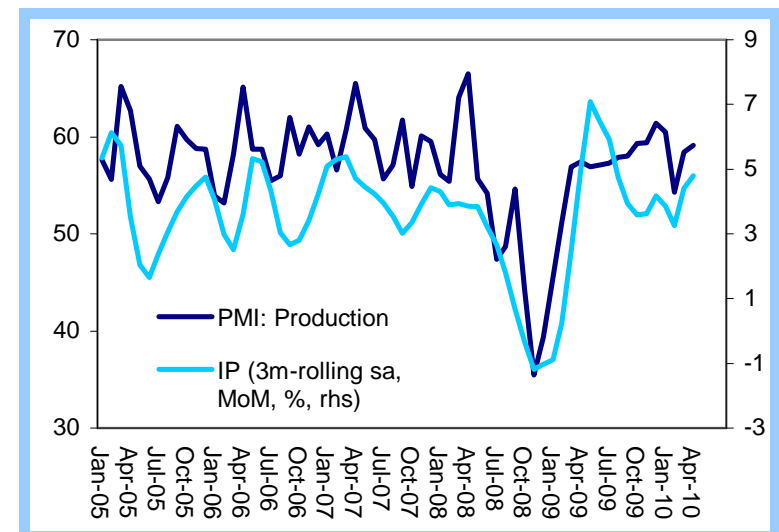
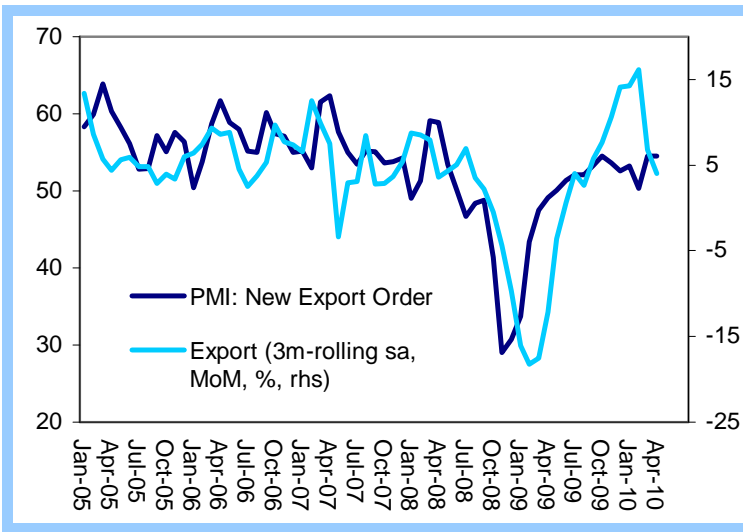
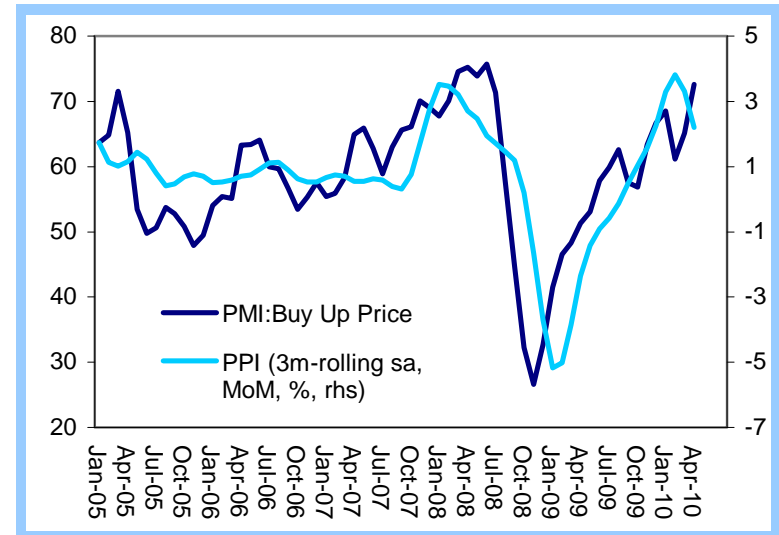
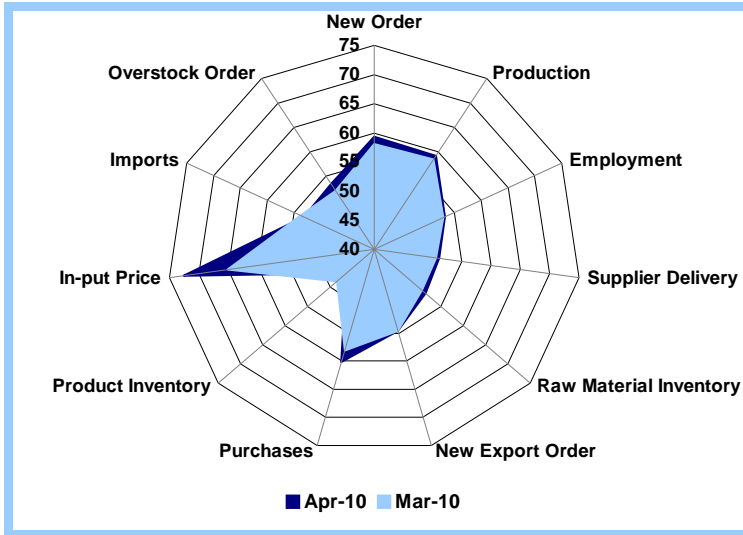


- Buoyed by the strong economic recovery, the consumer index picked up noticeably in March, after which the index has managed to return to the pre-crisis level. Besides the headline index, two sub-indices, Satisfactory and Expectation Index, improved significantly as well.
- Owing to the stable labor market, households' current income sentiment has kept improving since 3Q 09, but future income sentiment softened a bit in 1Q 10.
- Both urban residents' inflation expectations (up) and satisfaction (down) deteriorated in 1Q 10 as concerns about inflation were mounting, a reflection of rising asset prices.



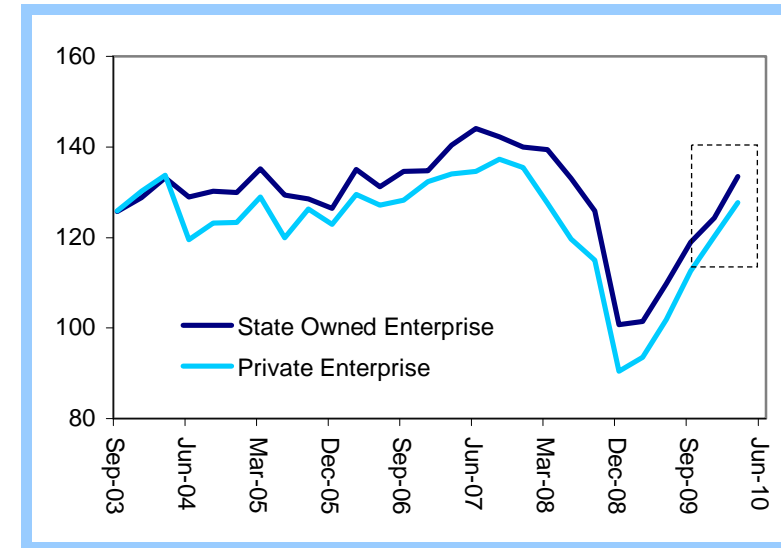
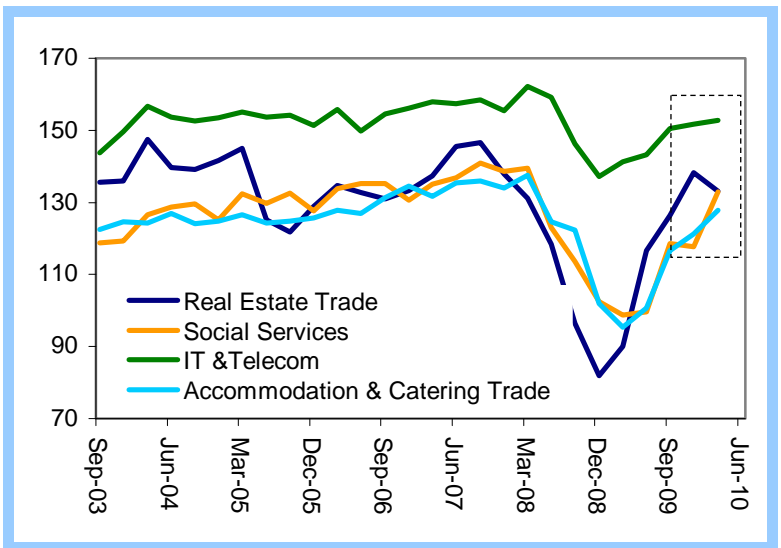
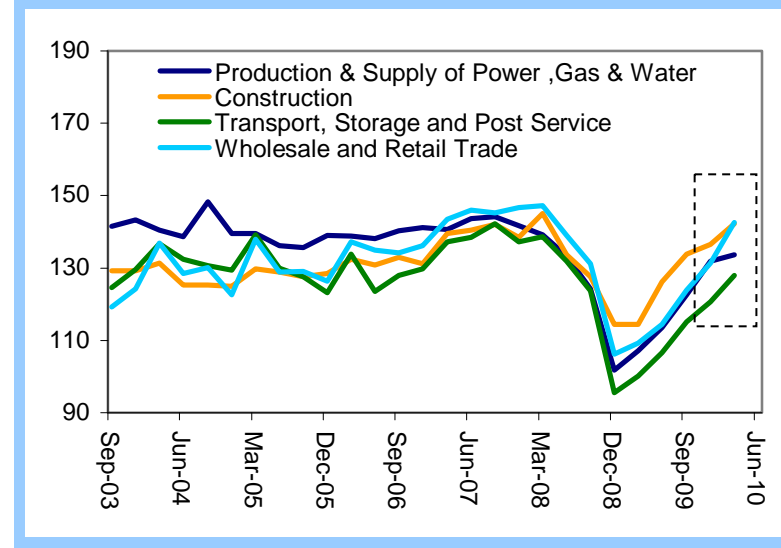
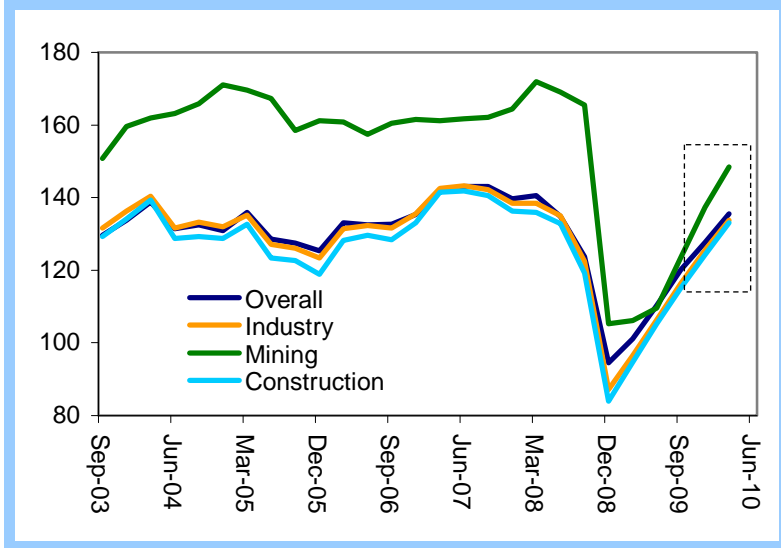
Source: CEIC, Morgan Stanley Research

Sentiment and Leading Indicators: Continued Improvement of Mfg PMI in April



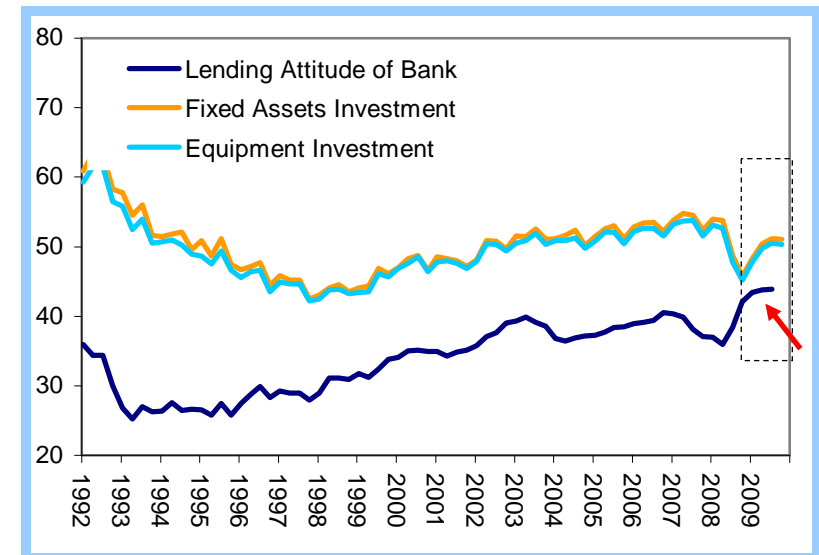
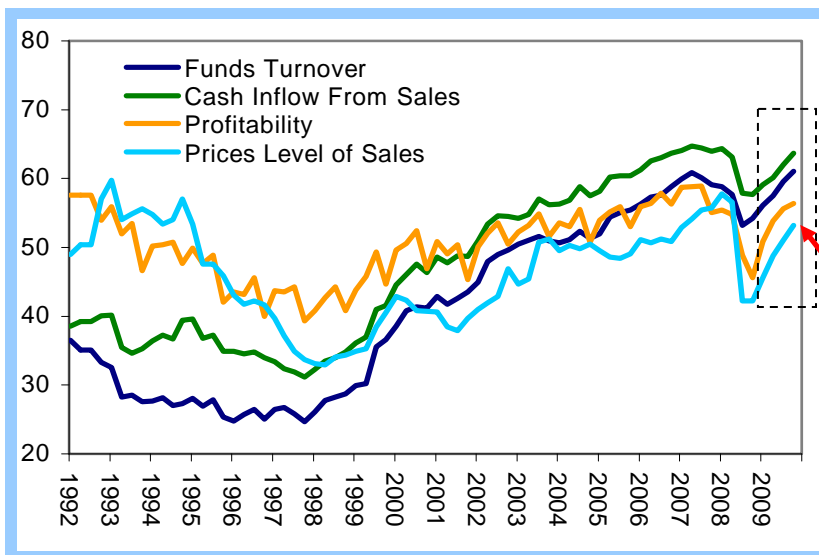
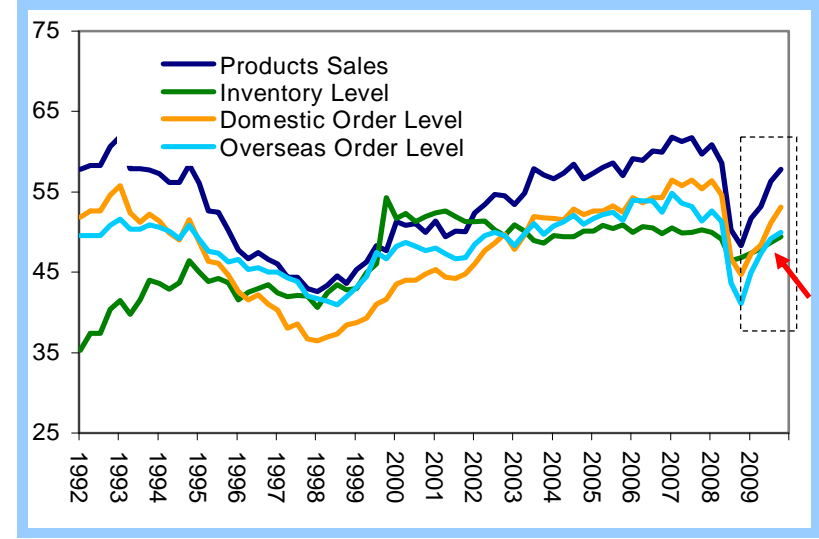
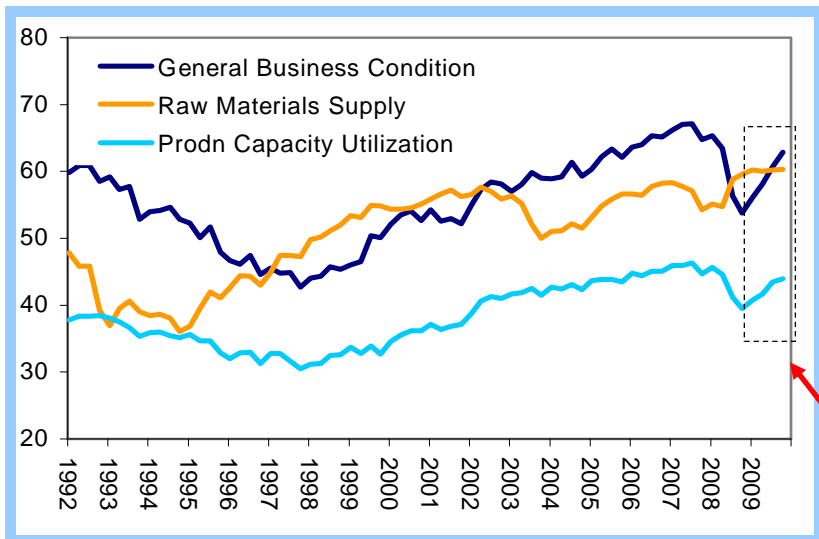
Source: CEIC, Morgan Stanley Research

Sentiment and Leading Indicators: Entrepreneurs' Confidence Has Almost Fully Recovered



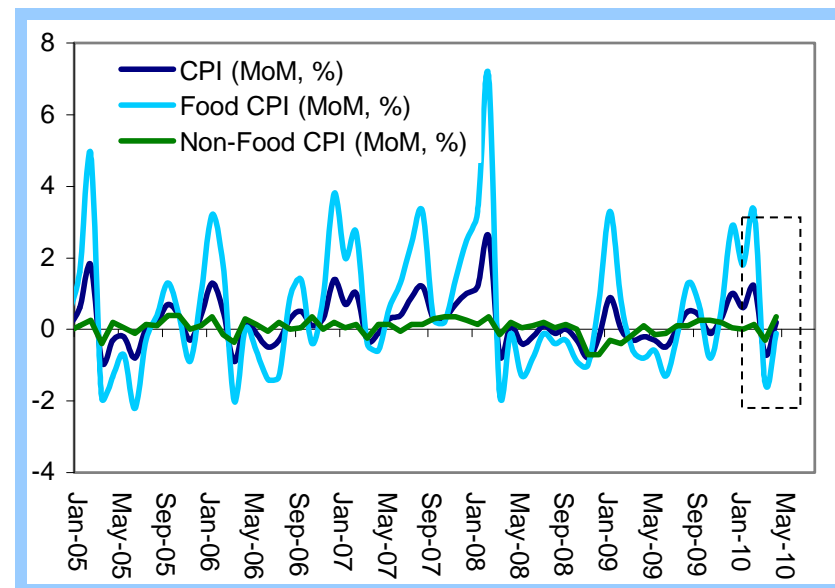
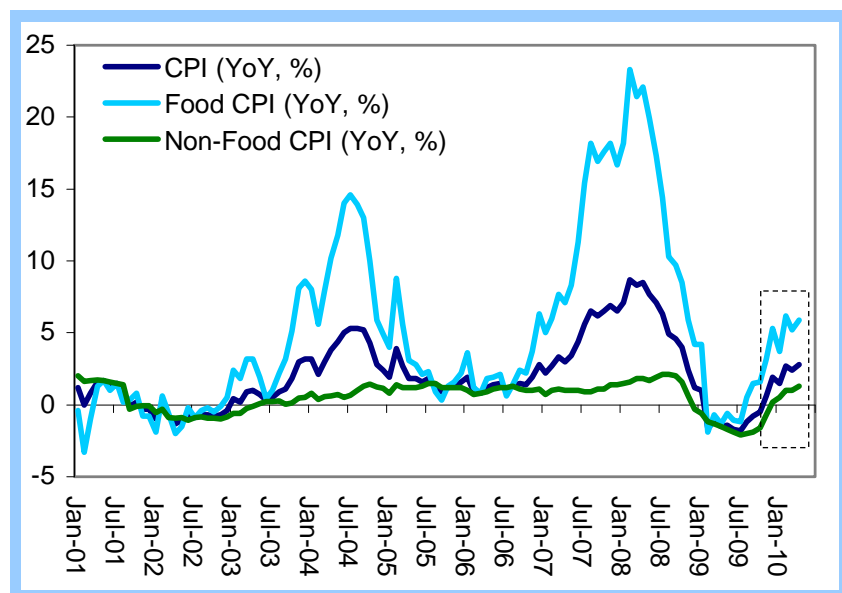
Source: CEIC, Morgan Stanley Research

Sentiment and Leading Indicators: Industrial Diffusion Index Approaching Previous Peaks



Source: CEIC, Morgan Stanley Research

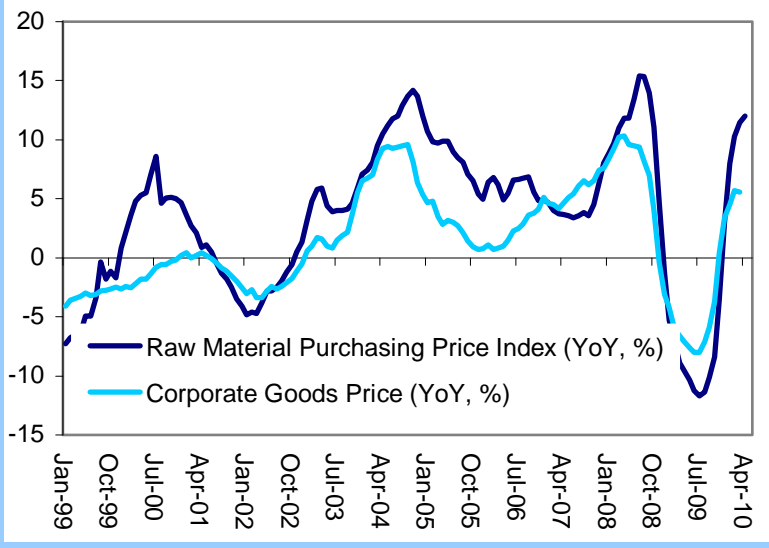
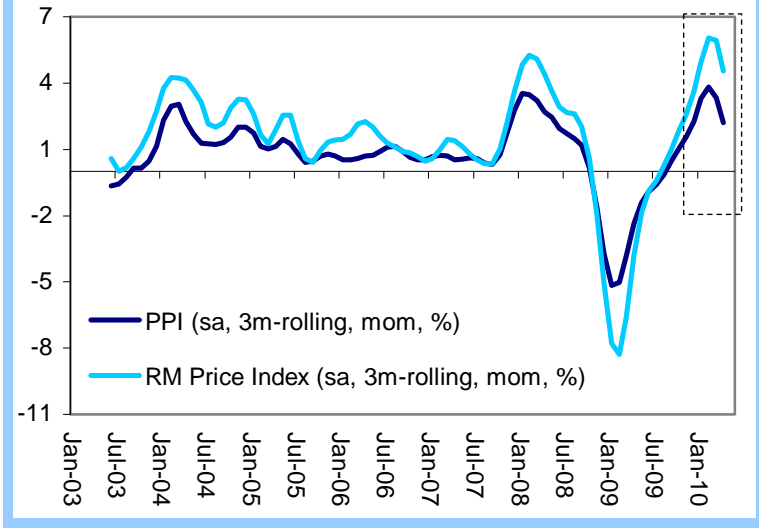
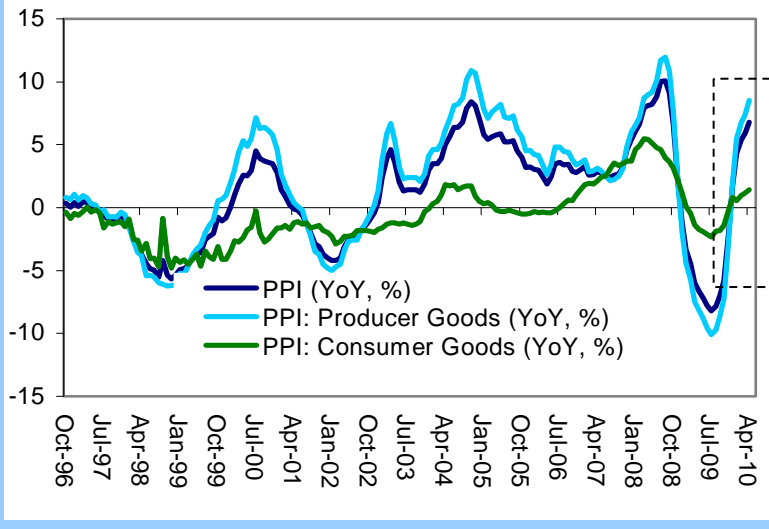
Price Developments: CPI Inflation Edged Up in April



- CPI inflation rebounded to +2.8% YoY in April from +2.4% YoY in March, exactly equal to our forecast but stronger than market consensus of +2.7% YoY. On a MoM sequential basis, CPI rose +0.2% but even more by +0.5% after being seasonally adjusted.
- Buoyed by bottoming-out of pork prices, food inflation bounced back to +5.9% YoY in April (vs. +5.1% YoY in March). Non-food inflation climbed to +1.3% YoY in April (vs. +1.0% YoY in March). The carryover effect explained 1.3ppts of CPI in April (vs. 1.1ppts in March).
- We expect that headline CPI inflation will continue to edge up as food inflation will reaccelerate, reflecting bottoming-out pork prices and the gradual pass-through of upstream inflation to non-food inflation .

Source: CEIC, Morgan Stanley Research

Price Developments:
Heightened Upstream Inflation

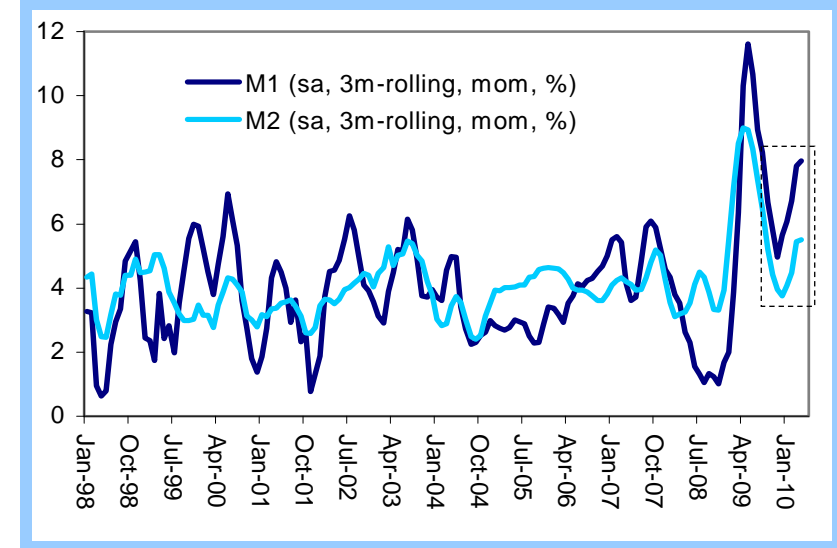
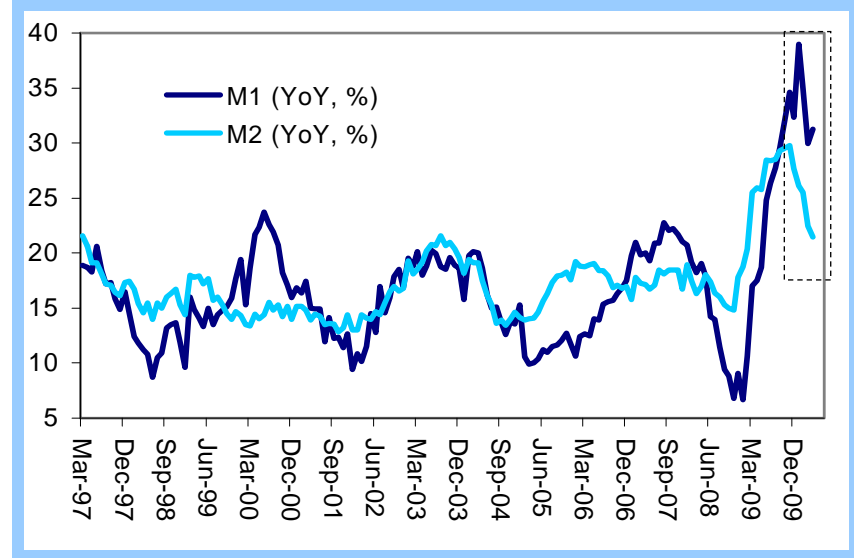
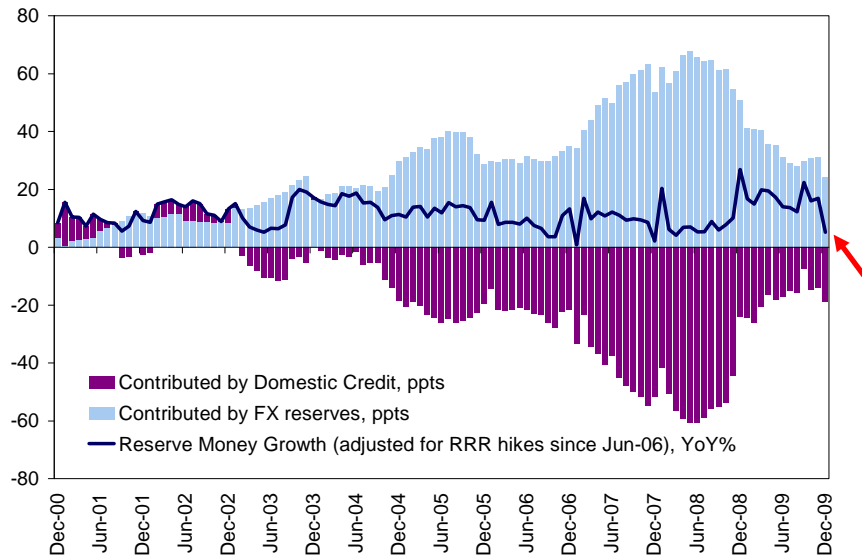


- The PPI inflation accelerated to +6.8% YoY in April from +5.9% in March, beating our forecast and market consensus of +6.5%. Sequential gains of PPI inflation lifted to +1.0% MoM and +0.6% MoM after being seasonally adjusted in April.
- Raw materials remained the key driver of upstream inflation as RMPPI intensified to +12% YoY in April (vs. +11.5% in March), spearheaded by ferrous metals (+29% YoY) and fuels & power (+24% YoY).

Source: CEIC, Morgan Stanley Research

Monetary Indicators:

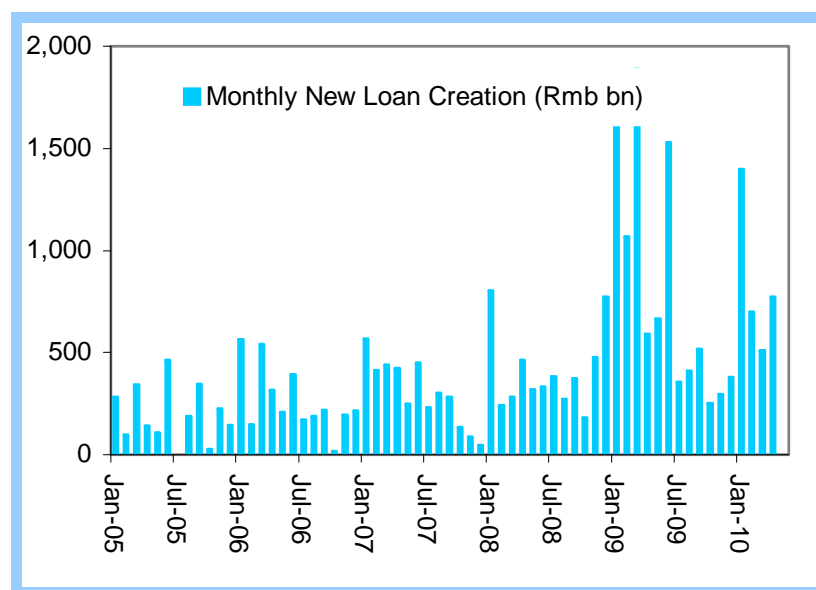
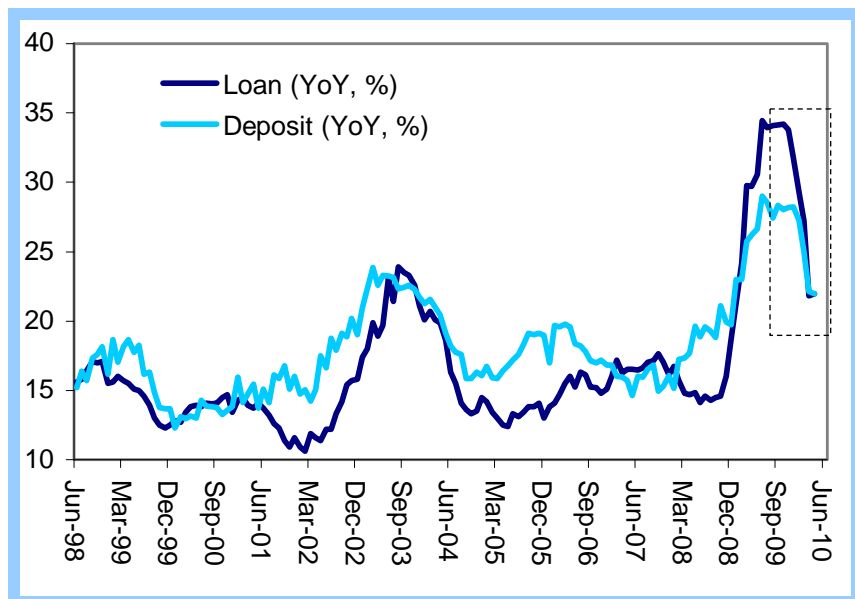
Monetary Aggregates Moderated Year-over-Year but Strengthened on a Sequential Basis



- The pace of reserve money moderated noticeably at the end of 2009, due to a high base caused by the multiple RRR decreases in Dec 2008
- M2 growth slid to +21.5% in April (vs. +22.5% YoY in March), while M1 growth rebounded modestly to +31.3% YoY in April (vs. +29.9% YoY in March), implying less appetite for time deposits in view of rising inflation.
- On a sequential basis, both M1 and M2 growth rates continued to drift up, implying that the softening YoY growth should in part be in part explained by the high base of last year.

Source: CEIC, Morgan Stanley Research

Monetary Indicators: New Loan Creation On Track To Reach Year-end Target

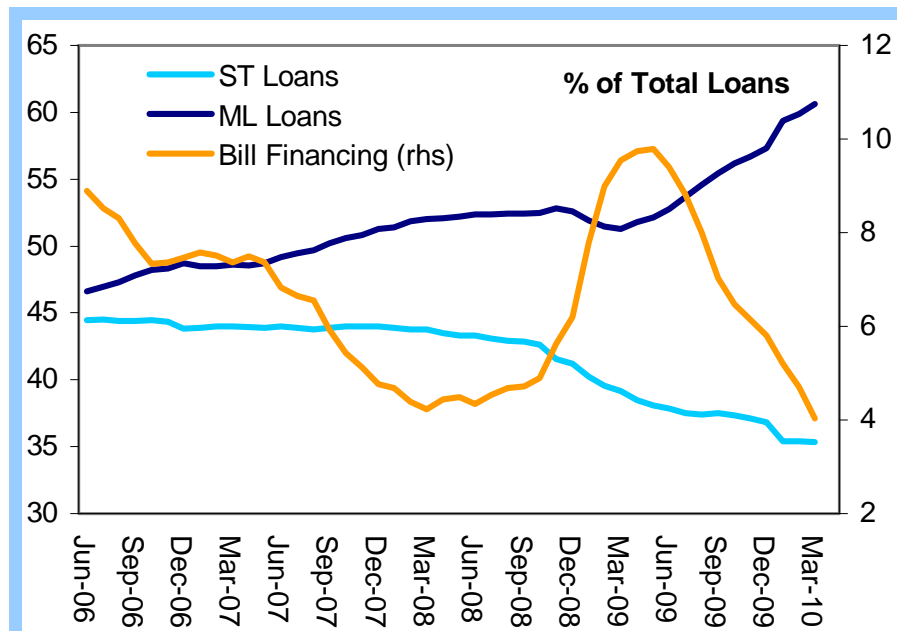
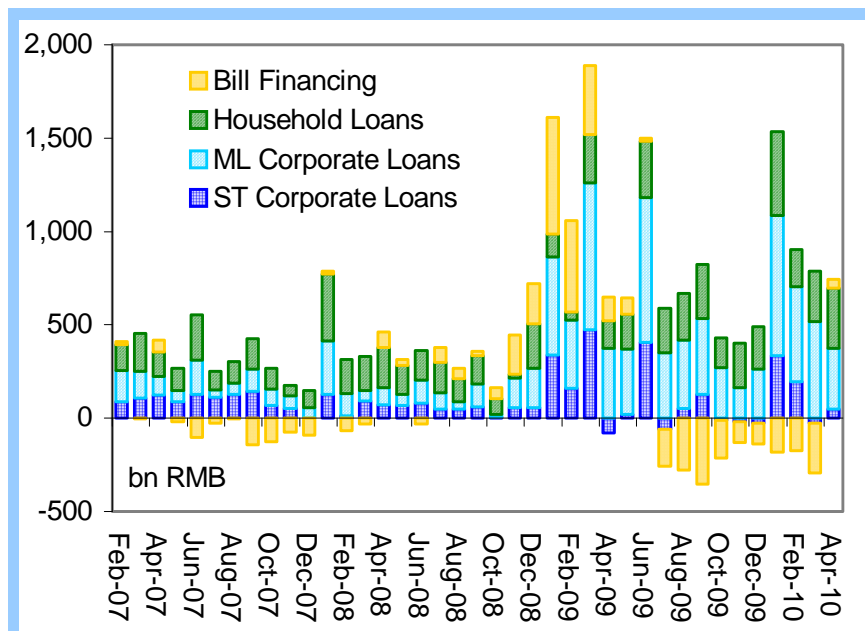


- New Rmb loans rebounded to Rmb774 bn (vs. Rmb510 bn in March) in April. The strong loan creation in April suggests that the loan quota might be still implemented on a quarterly basis, under which the commercial banks still have strong incentive to front-load lending in the beginning of each quarter. As a result, YoY loan growth edged up marginally to +22% from +21.8% in March.
- We believe that overall new loan creation is still well on track to reach the year-end target of Rmb 7.5 tn by following the traditional distribution of 3:3:2:2 for each quarter. The total new loan creation in 1Q 10 and April 10 accounted for 34.7% and 10% of annual target, respectively.

Source: CEIC, Morgan Stanley Research

Monetary Indicators:

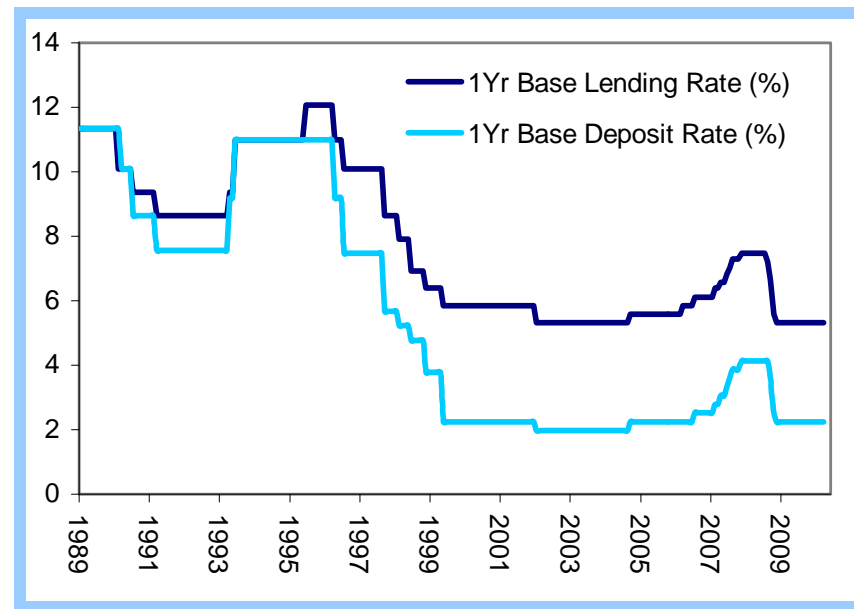
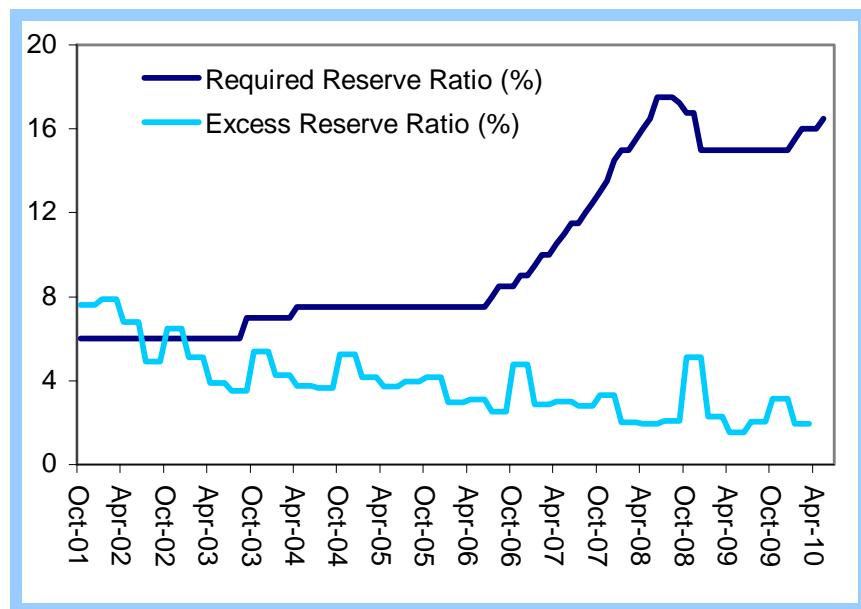
Short-term Loan Contraction Makes Room for Medium-Term Loan Expansion



- Medium- to long-term loans remained the main driver of ongoing credit expansion, increasing by Rmb556bn (Rmb230bn household loans and Rmb326bn of non-financial-institution loans).
- After nine consecutive falls, bill financing increased Rmb 47bn in April. By March, the share of medium- to long-term loans in total loans rose to 60.6% while the share of short term loans and bill finance declined to 35.4% and 4%, respectively

Source: CEIC, Morgan Stanley Research

Monetary Indicators: Three RRR Hikes and Counting...

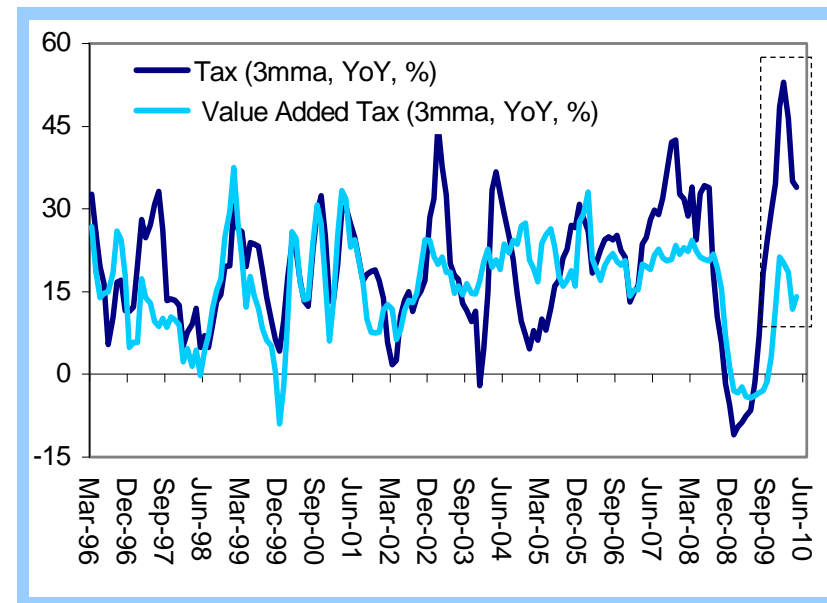
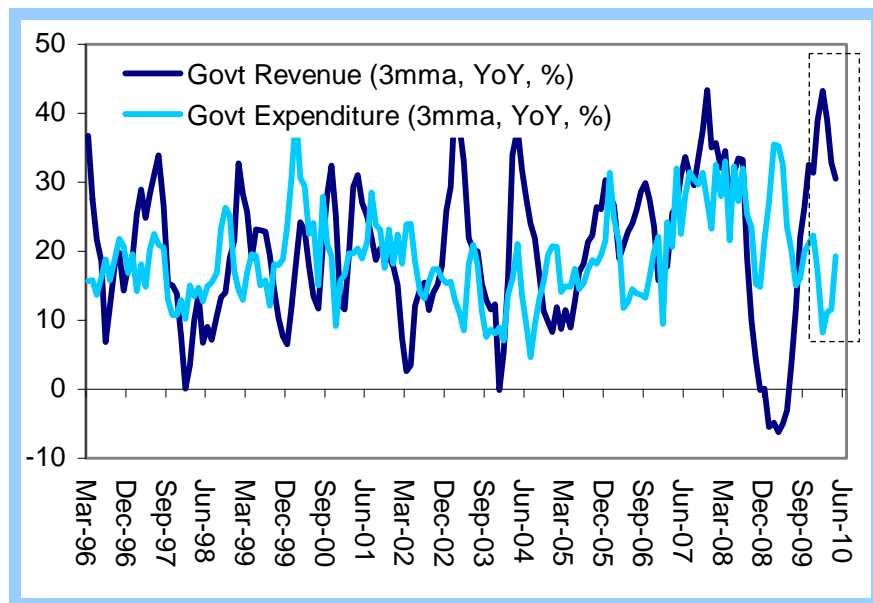


- The PBoC announced a 50bp hike in the Requirement Reserve Ratio (RRR), effective May 10. Rural cooperatives and rural (village and town) banks are exempt from this hike. This is the third rise after two increases earlier this year (January 12 and February 12), after which large depository institutions will see their RRR rise from 16.5% to 17%, just one step away from the historical peak of 17.5% in Jun-Aug 2008
- After ten consecutive weeks' net liquidity withdrawal, PBoC drained more than Rmb 1 tn of liquidity from the system, which was mirrored in a lower excess reserve ratio (ERR) of 1.96% in March (vs. 3.13% in December)

In light of the recent Greek sovereign debt crisis, major central banks are expected to postpone their policy tightening. Dick Berner, Morgan Stanley's Chief US economist, now expects the US Fed to be on hold until early 2011 (see *US Economics: Sovereign Credit Risk Means a Lower Path for US Rates*, May 10). Elga Bartsch, Morgan Stanley's Chief Europe economist, does not expect the ECB to hike rates before mid-2011 (see *Euroland Economics: ECB Watch*, May 6). We have now changed our call for one rate hike in 1H10 to no more than one rate hike in 2H10.

Source: CEIC, Morgan Stanley Research

Fiscal Policy Indicators Robust Fiscal Revenue Growth



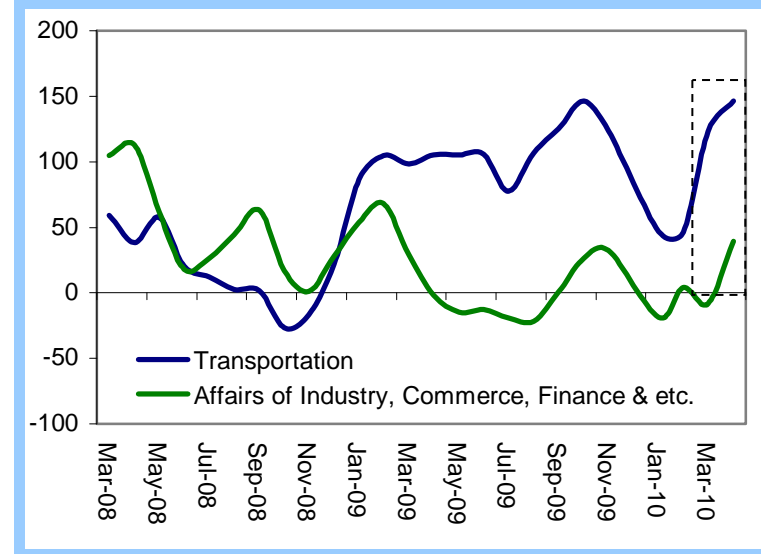
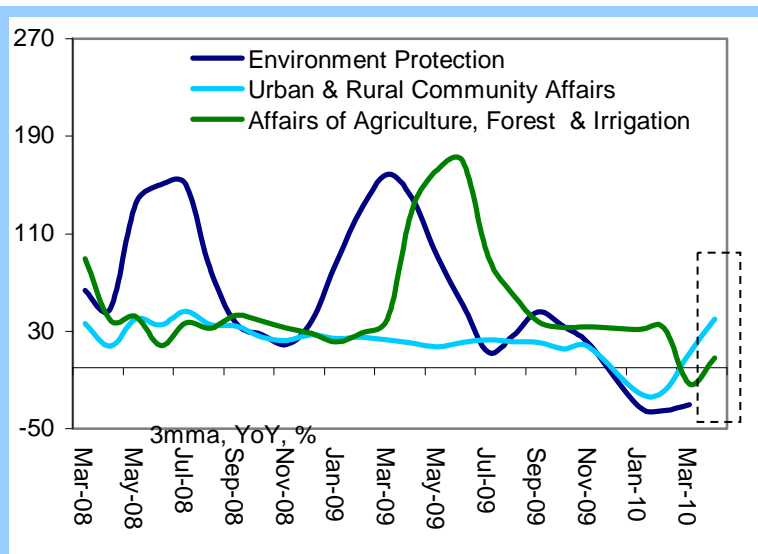
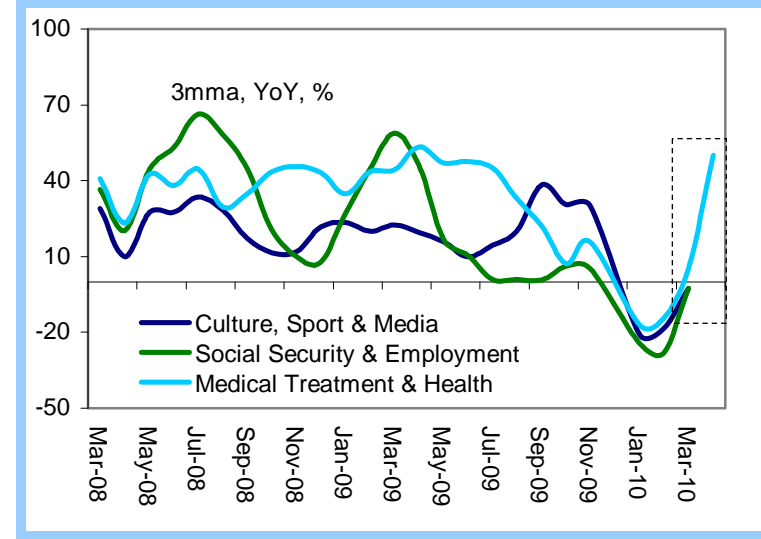
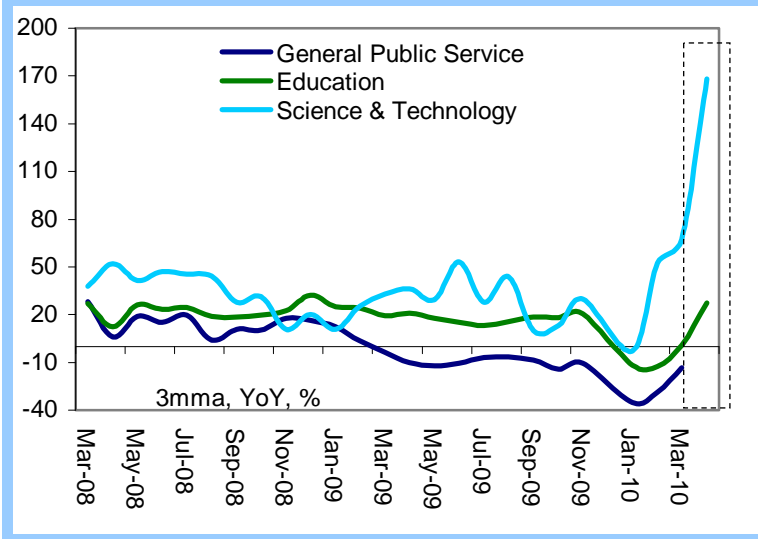
The growth of fiscal revenue slid to +34.4% YoY in April (vs. +36.8% YoY in March). Besides the low base last year, the robust fiscal revenue is also explained by the increase of tax revenue stemming from the strong recovery of economic activities. At the same time, fiscal expenditure softened to +9.8 YoY in April (vs. +18.3 YoY in March).

Tax revenue, which accounted for around 90% of fiscal revenue, with VAT as the primary tax type, remained strong due to the strong growth in industrial output, investments and trade. Strong sales of property and autos also made noticeable contributions.

Source: CEIC, Morgan Stanley Research

Fiscal Policy Indicators

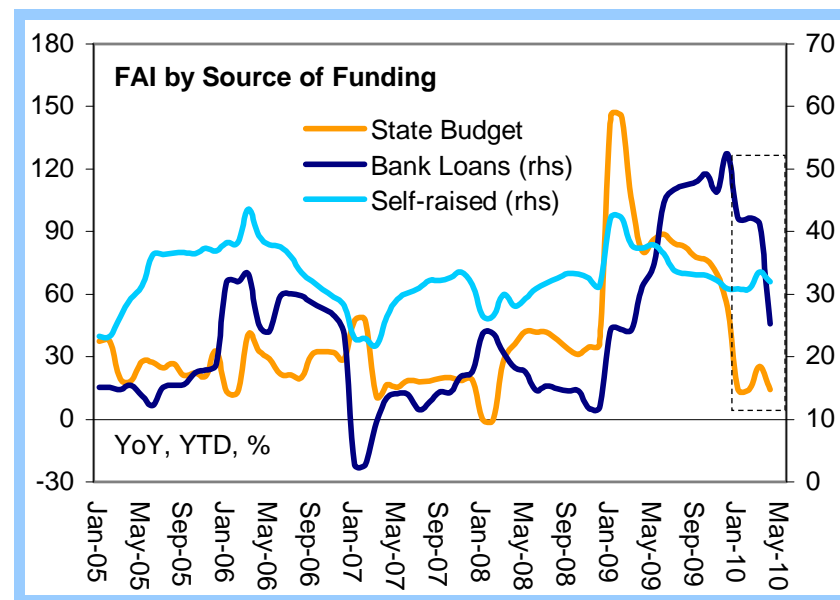
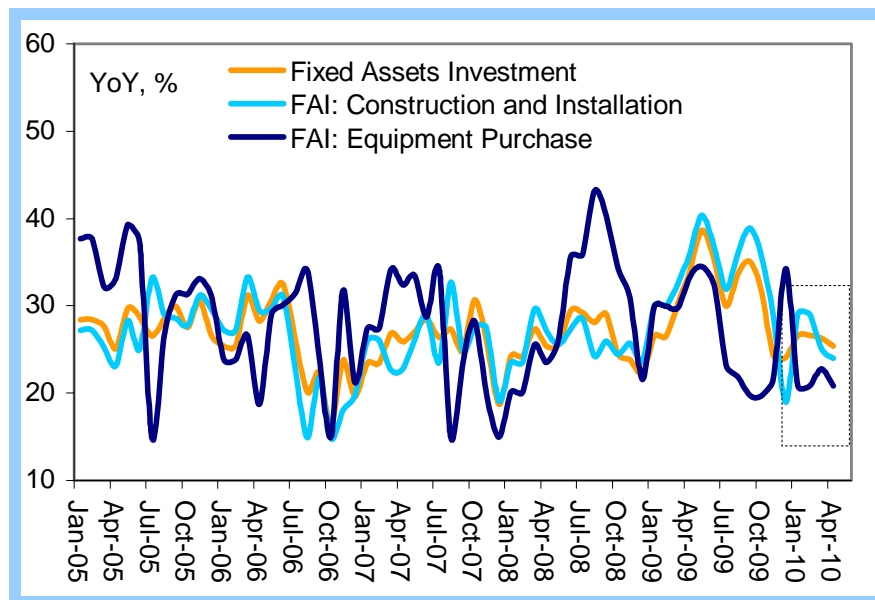
Fiscal Spending Demonstrates Policy Priorities



Source: CEIC, Morgan Stanley Research

Investment:

Moderation of FAI Growth as the Result of Policy Normalization and High Base

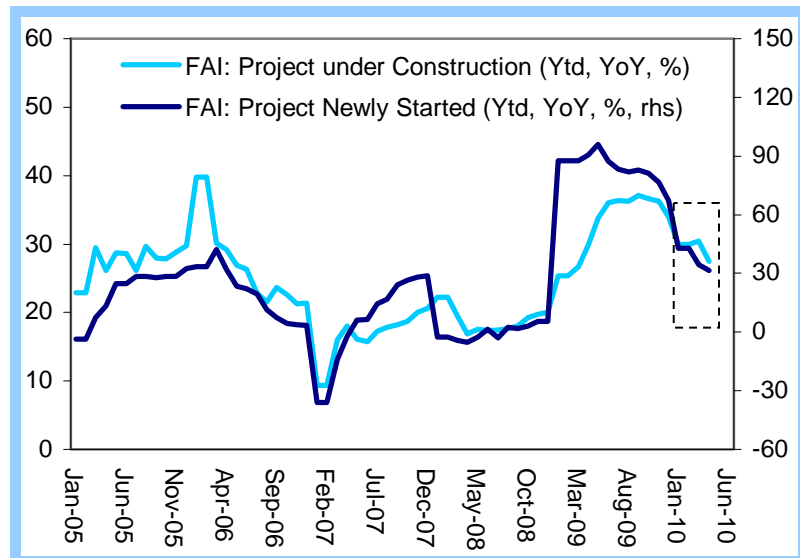
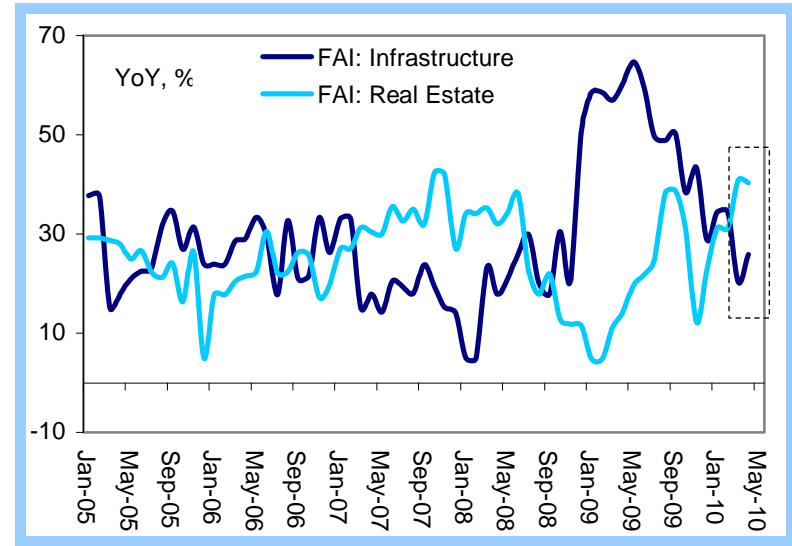
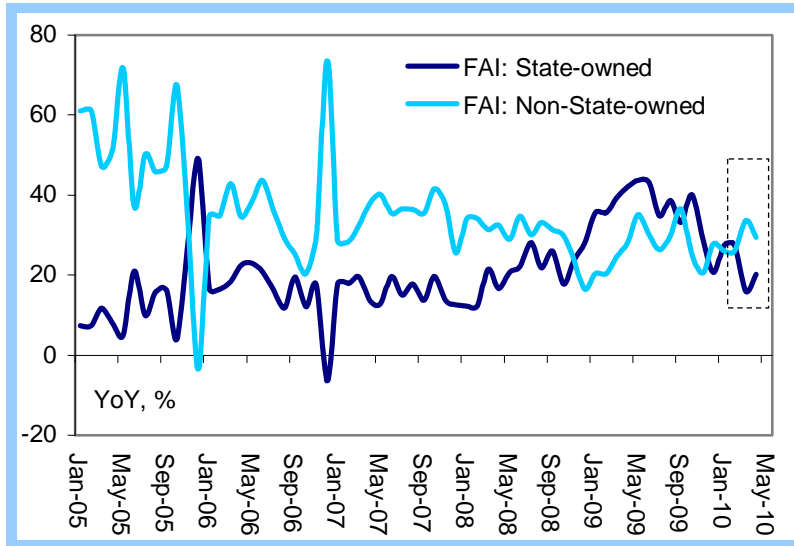


- Urban FAI softened to +26.1% Ytd YoY in April (vs. +26.4% Ytd YoY in March), stronger than our forecast of +25.3% Ytd YoY and market consensus of +26% Ytd YoY. It also translates into a further slowdown to +25.4% in April alone from +26.3% in March. “Construction and installation” growth outpaced “equipment purchase”, indicating the capex cycle is still at an early stage.
- The gradual policy exit on fiscal and monetary fronts has been reflected in the noticeable slowdown of FAI financed by state budget and bank loans (+14.2% and +33.8% Ytd YoY in April vs. +25.3% and +41.2% Ytd YoY in March).

Source: CEIC, Morgan Stanley Research

Investment:

Infrastructure FAI Decelerated, as Real Estate Investment Remains Buoyant

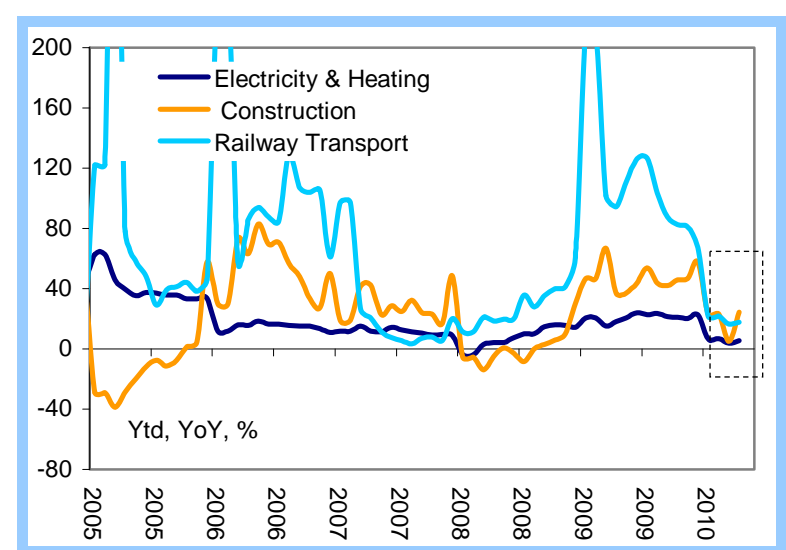
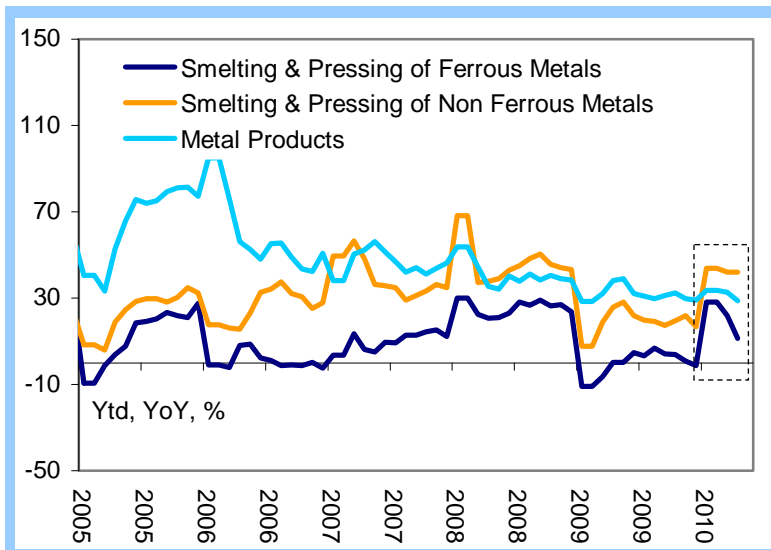
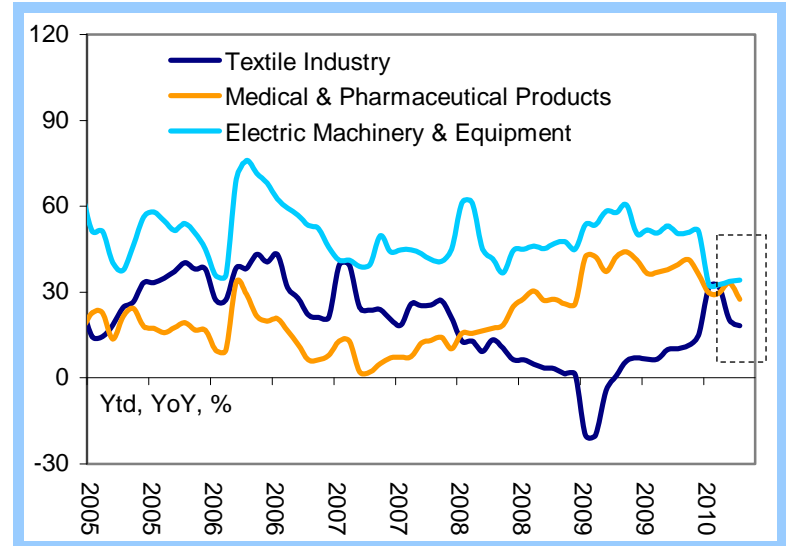
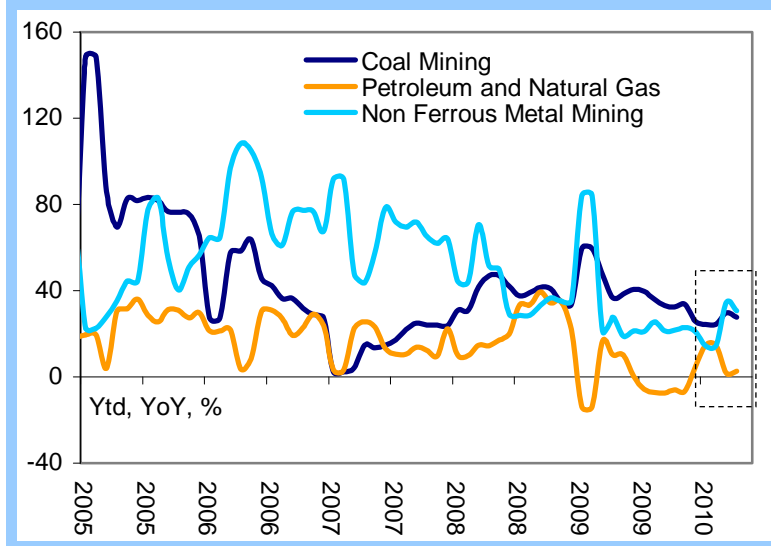


- Infrastructure investments and public investments, which assumed the responsibility for cushioning the hard landing of the Chinese economy during the crisis, have gradually passed the baton to private investments, spearheaded by real estate development.
- The growth of projects-newly-started dropped noticeably as the Chinese government has started to tighten the approval of newly started projects. However, it remained elevated, standing above +30% YoY.

Source: CEIC, Morgan Stanley Research

Investment:

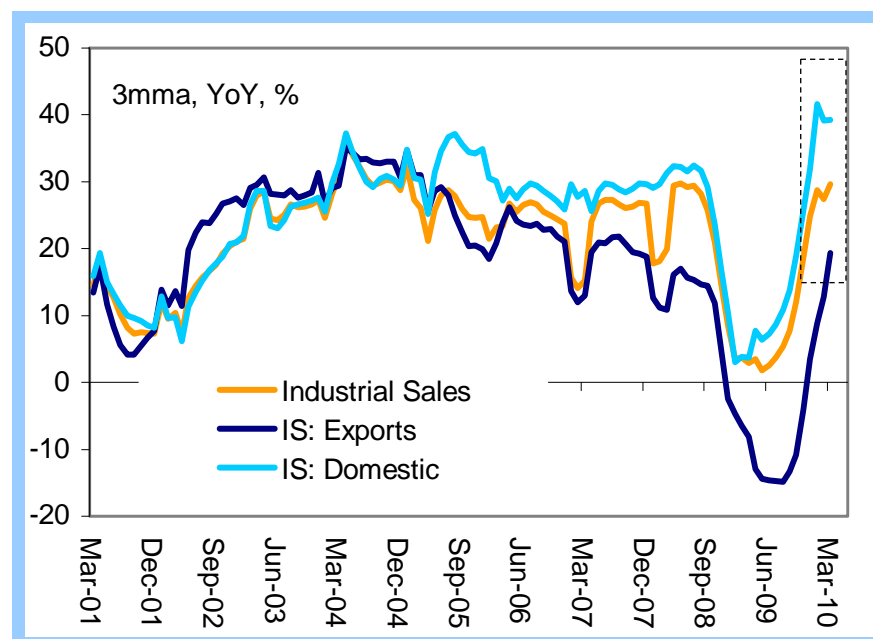
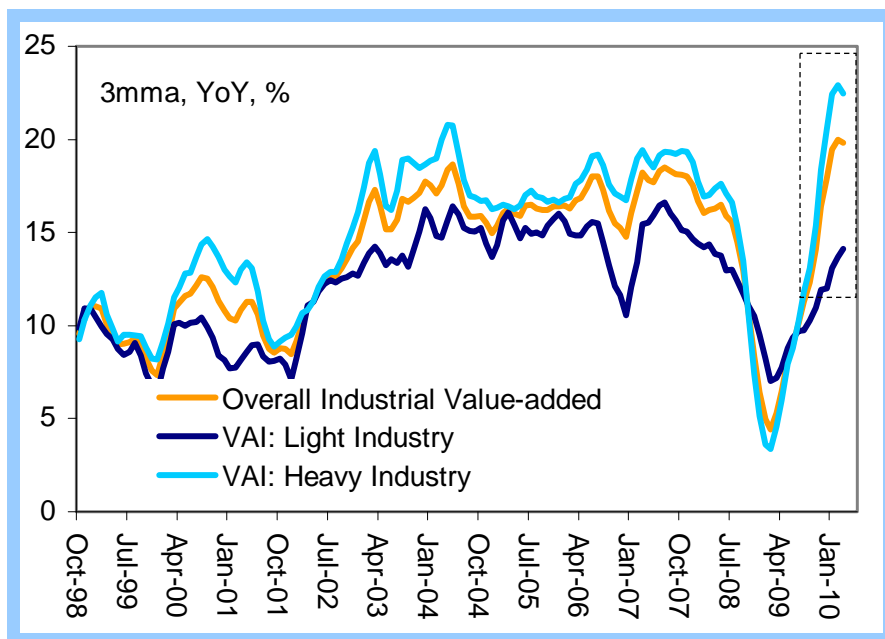
Key Categories – Slowdown in Infrastructure Investments Partly Cushioned by Other Investments



Source: CEIC, Morgan Stanley Research

Industrial Production and Sales:

Robust Industrial Production Underpinned by Strong Export Growth

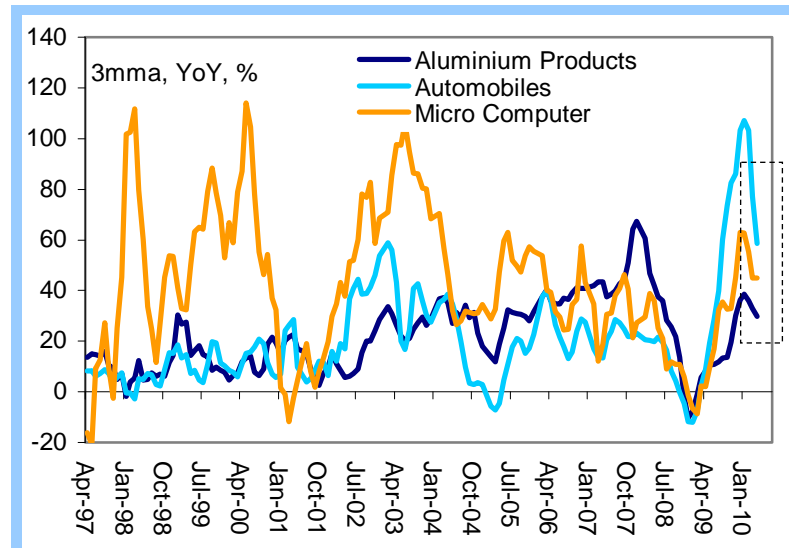
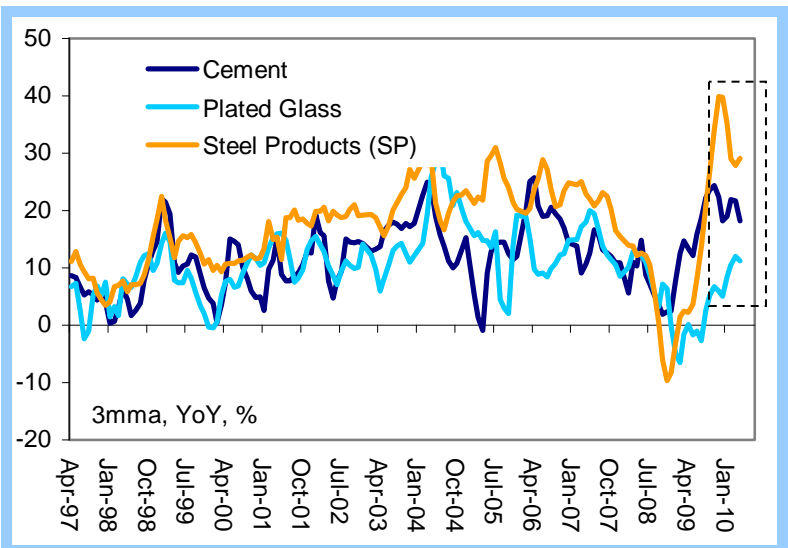
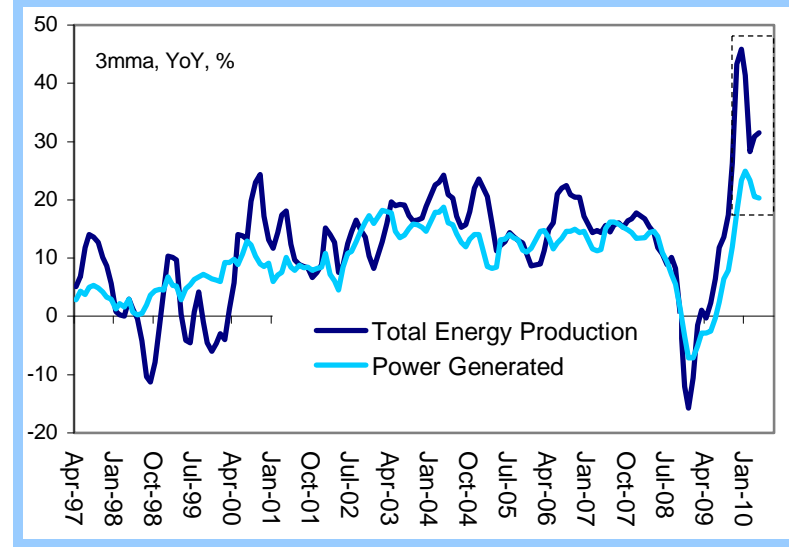
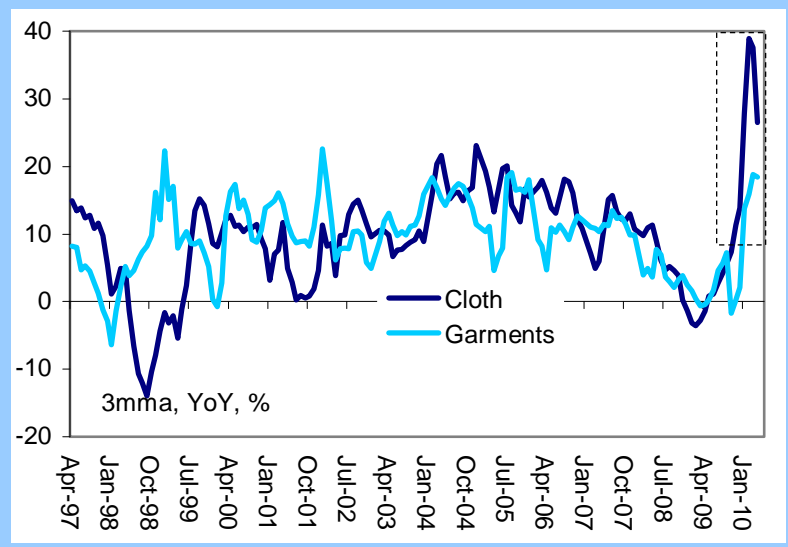


- Weaker than our forecast and market consensus of +18.5%, growth in industrial value-added softened to +17.8% YoY (-2.3% MoM sa) in April from +18.1% YoY (+4.2% MoM sa) in March.
- In view of weakening FAI and placid retail sales growth, industrial activity was mainly underpinned by the strong export recovery, endorsed by the rise of growth of output value for export delivery to +27.5% in April from +25.7% in March.

Source: CEIC, Morgan Stanley Research

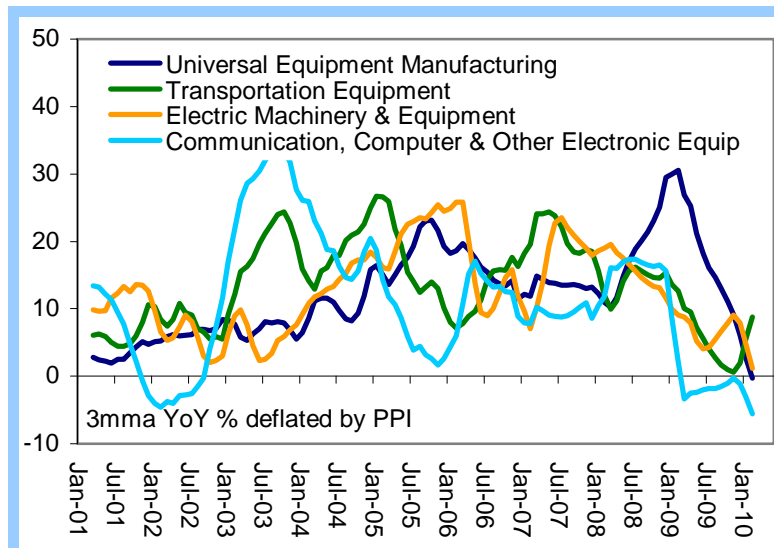
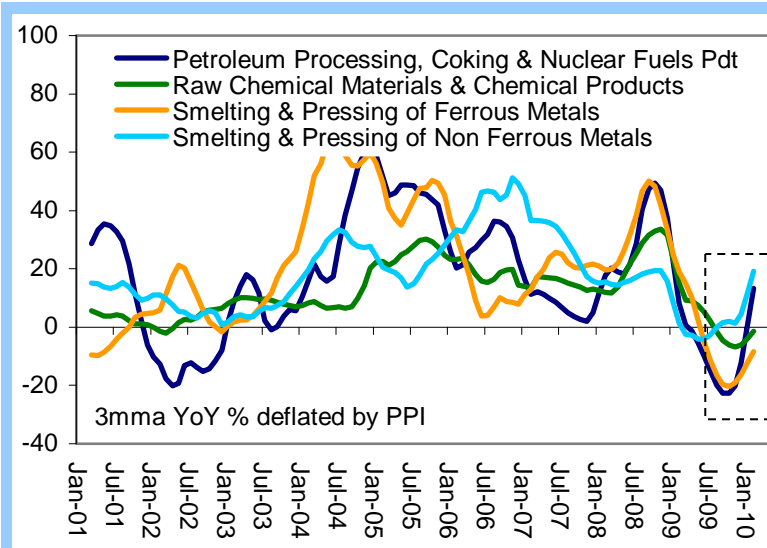
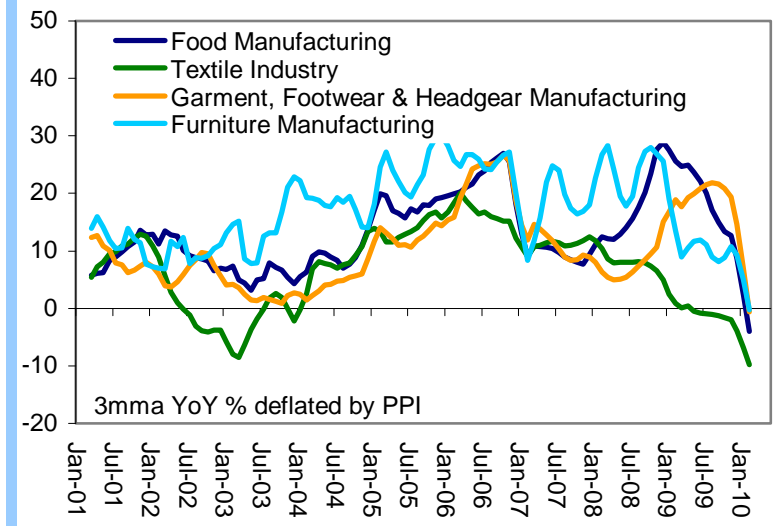
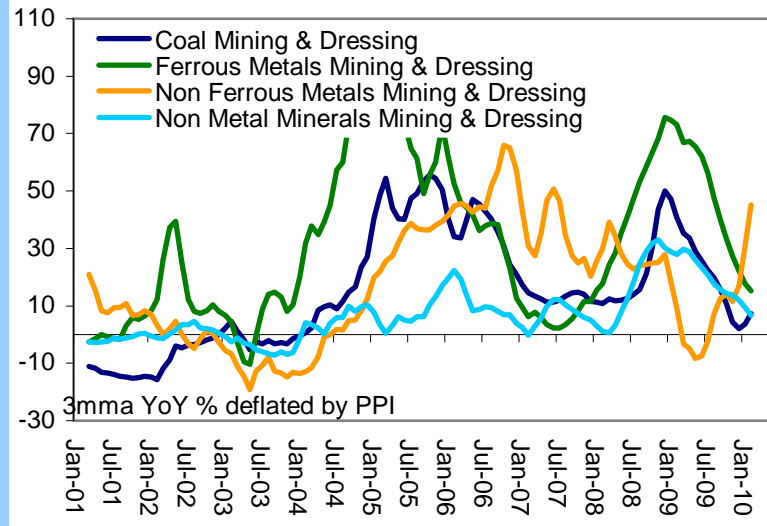
Industrial Production:

Key Categories – Broad-based Slowdown Due to Kick-in of High Base



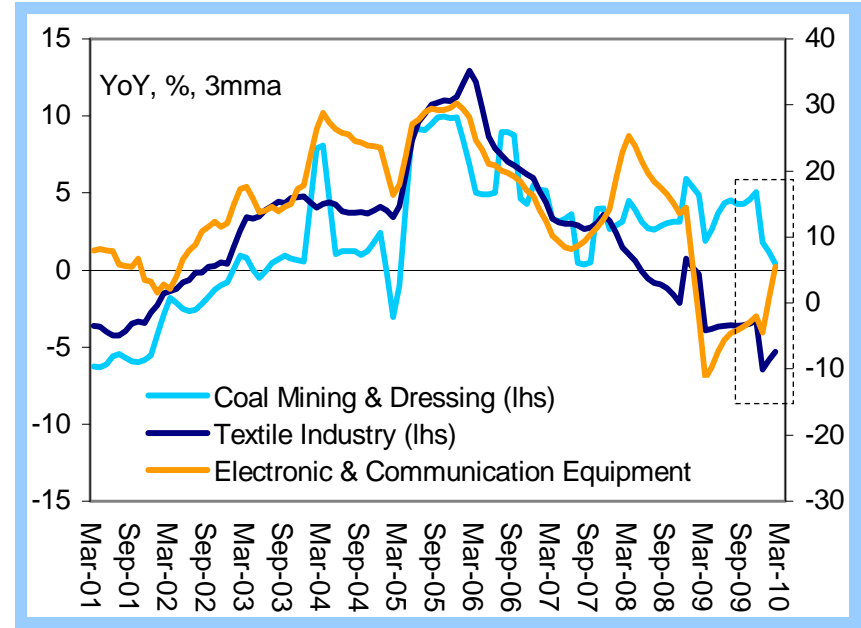
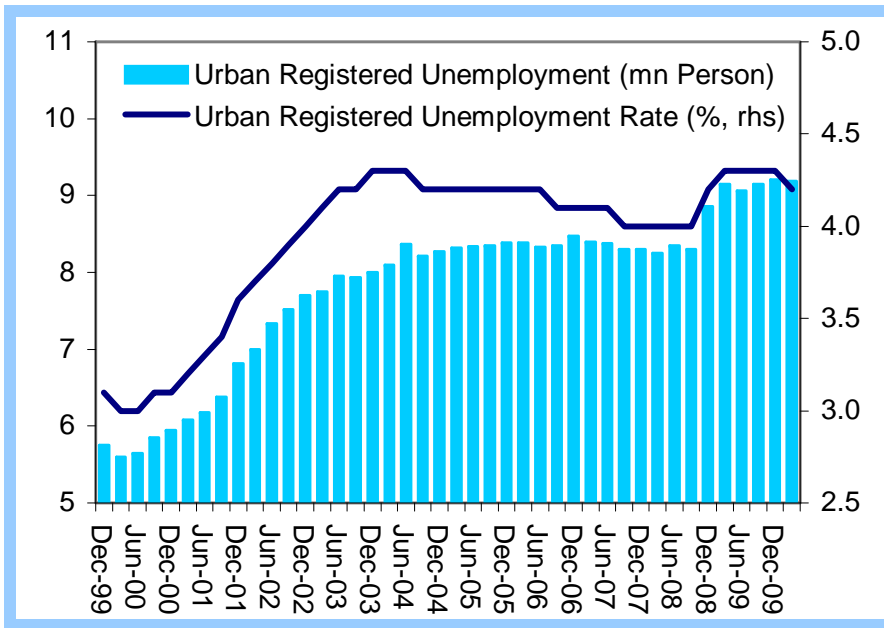
Source: CEIC, Morgan Stanley Research

Industrial Inventory:
Upstream Sectors Restocking; Downstream Sectors Destocking



Note: Change of inventory in value term is deflated by PPI
Source: CEIC, Morgan Stanley Research

Employment: Job Market Improved

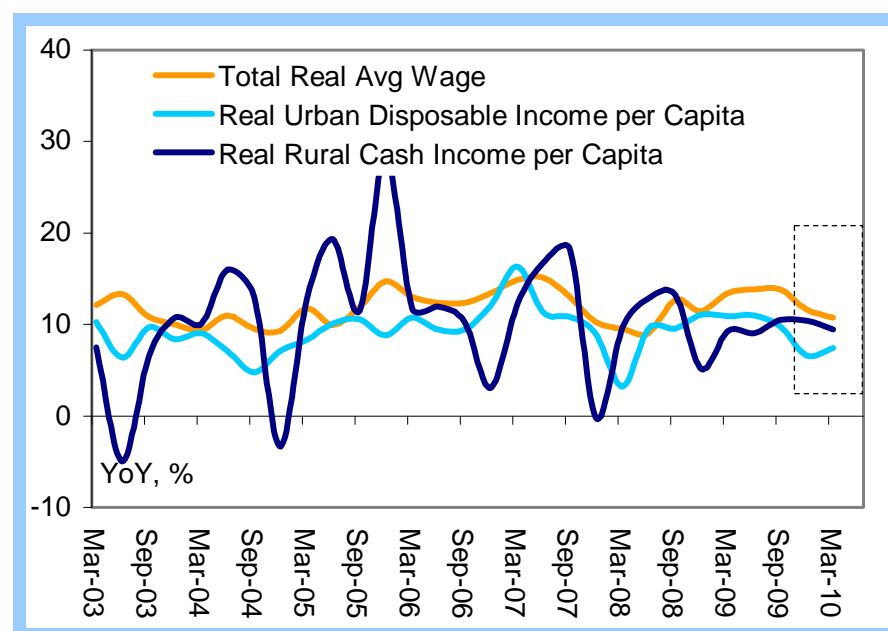
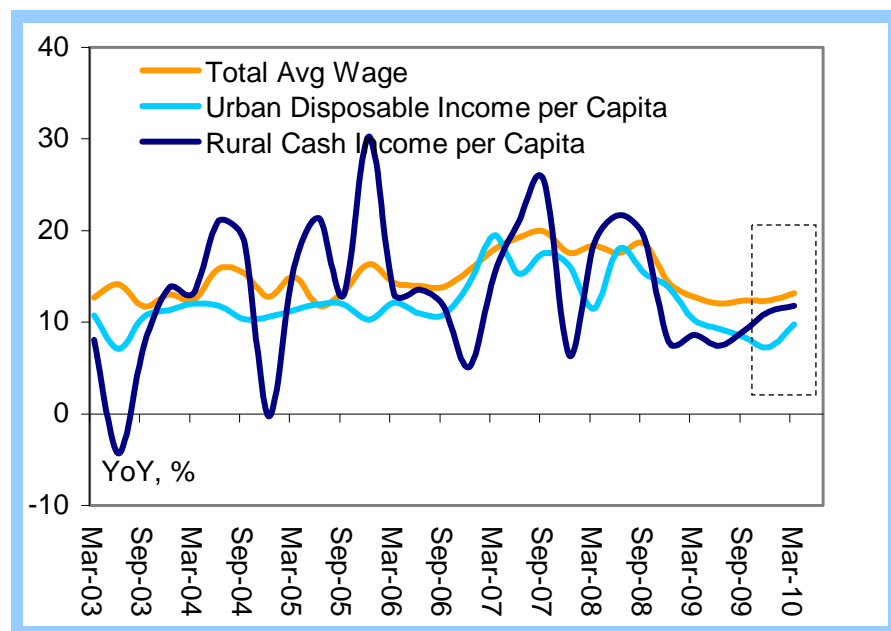


After stabilizing at 4.3% for three consecutive quarters, the registered urban unemployment rate edged down to 4.2% in 1Q 10, providing further evidence of a steady economic recovery. This echoed the improved consumer confidence which has returned to the pre-crisis level.

Job creation in export-oriented industries, such as textiles and electronic & communication equipment, faced stronger headwinds than domestic-oriented industries, such as coal mining. However, the recent improvement in those industries was in accord with the strong recovery in exports.

Source: CEIC, Morgan Stanley Research

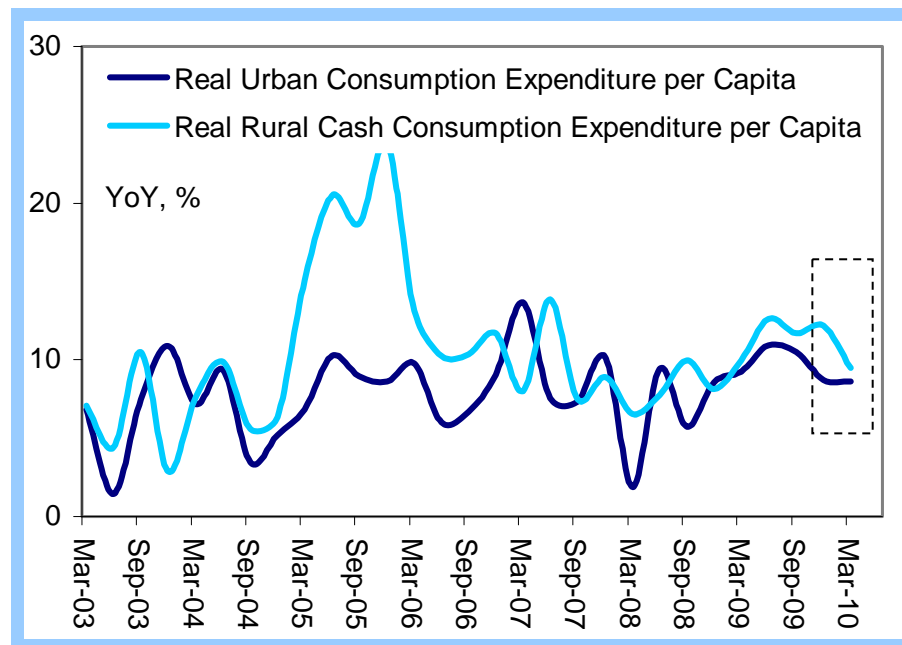
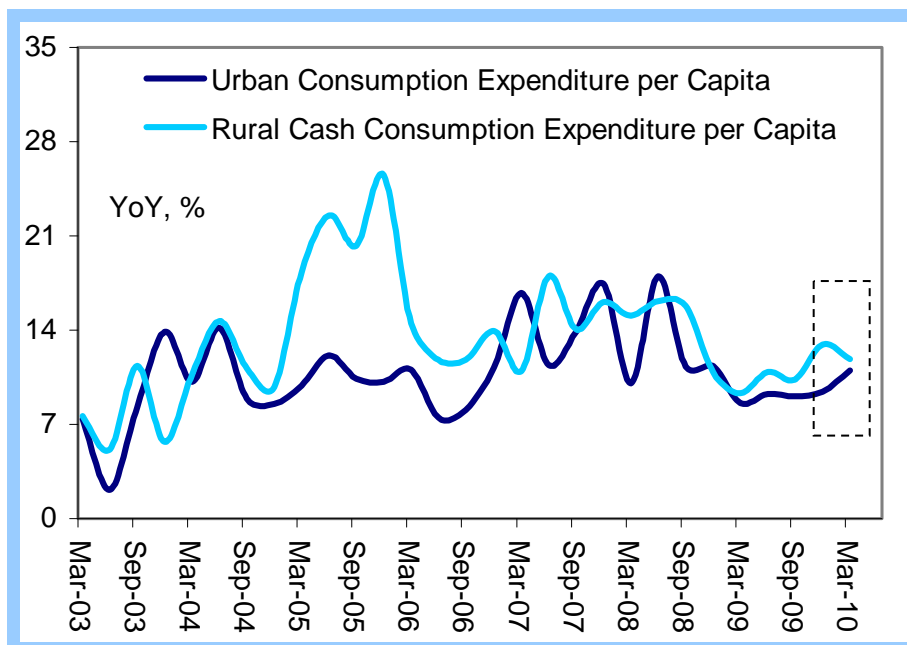
Household Income: Rising Inflation Brought Down Real Income Growth



- The rise of both urban and rural income in 1Q 10 can be attributed to the improvement of employment, buoyed by the strong economic recovery. The growth of rural income continued to outperform urban income, suggesting that farmers are less vulnerable to financial crisis, thanks to the government's introduction of favorable policy support in recent years (such as direct subsidies, tax reduction and protective minimum purchasing prices).
- After adjustment for inflation, real urban income rose to +7.4% YoY in 1Q from +6.7% YoY in 4Q 09 while real rural income fell noticeably to +9.4% YoY in 1Q 10 (vs. +10.4% YoY in 4Q 09).

Source: CEIC, Morgan Stanley Research

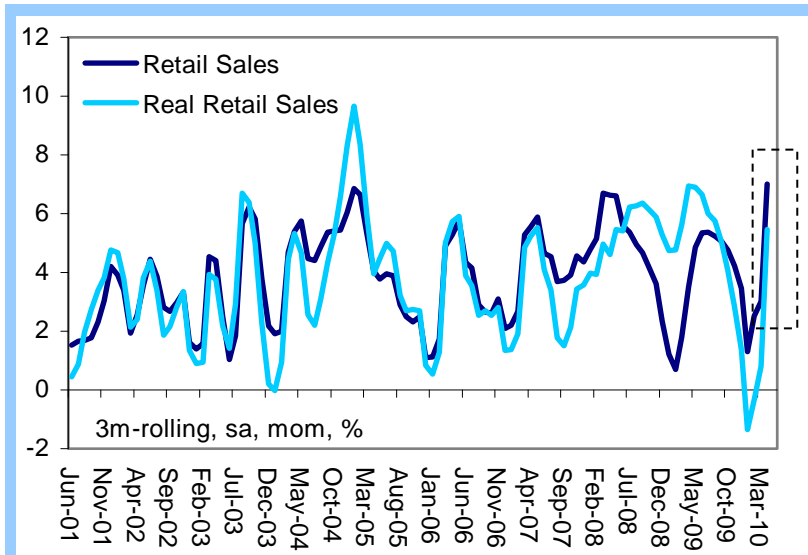
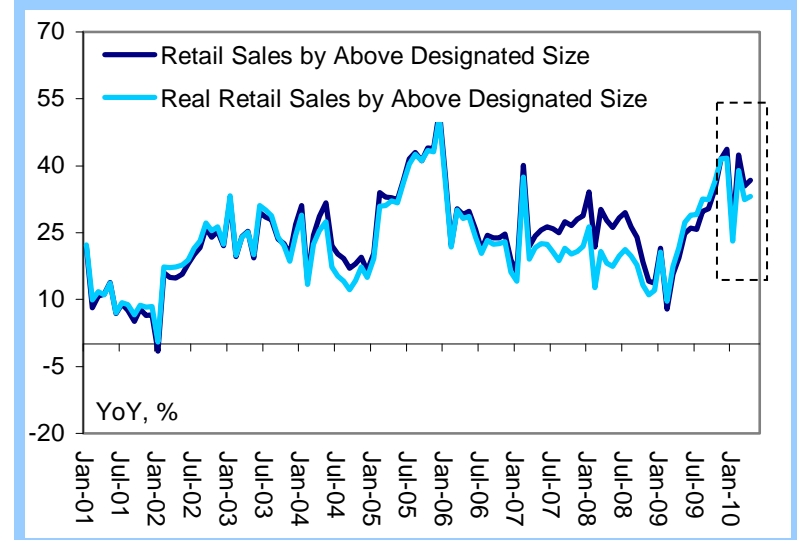
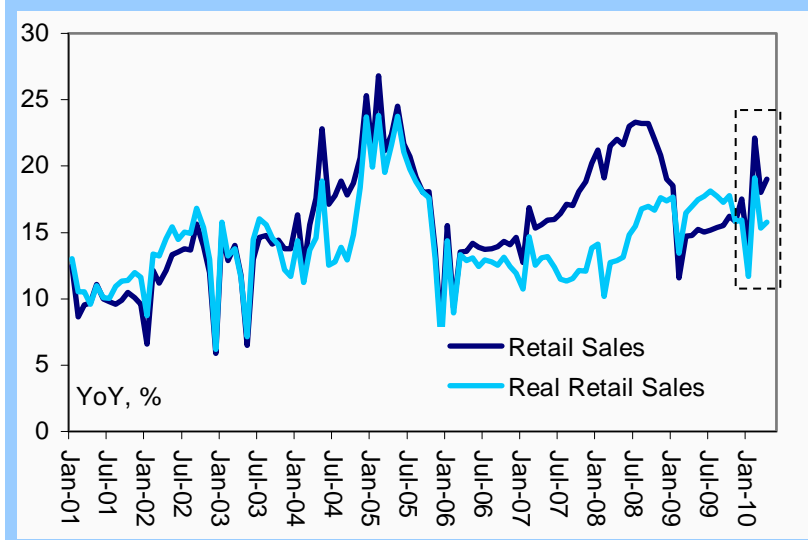
Household Consumption: Consumption Demonstrated Resilience



- Both urban and rural consumption bottomed out in 2Q09, reflecting pro-consumption stimulus measures such as subsidies to home appliance replacement and purchase of low-emission cars. Urban consumption continued to improve in 1Q 10 (+11% YoY in 1Q 10 vs. +9.4% YoY 4Q 09) while rural consumption softened to +11.9% YoY in 1Q 10 from +12.9% YoY in 4Q 09.
- After adjustment for inflation, real urban consumption slipped marginally to +8.6% YoY in 1Q from +8.7% YoY in 4Q 09 while real rural consumption fell noticeably to +9.5% YoY in 1Q 10 (vs. +12.2% YoY in 4Q 09).

Source: CEIC, Morgan Stanley Research

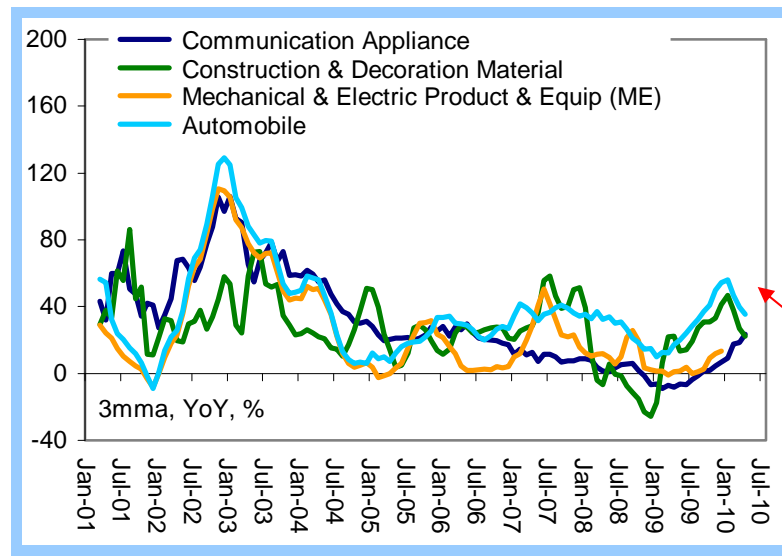
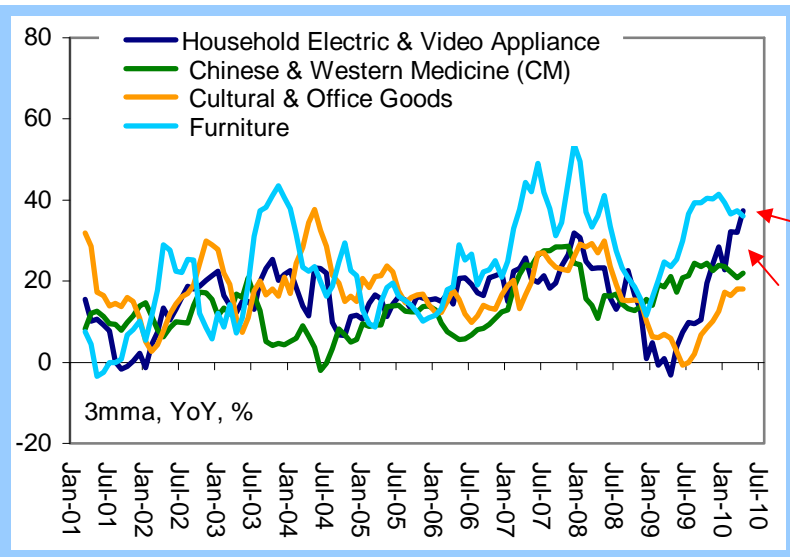
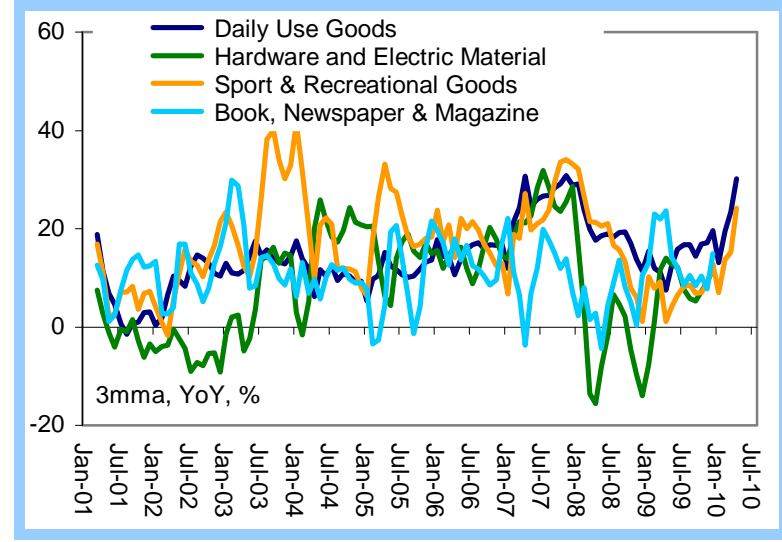
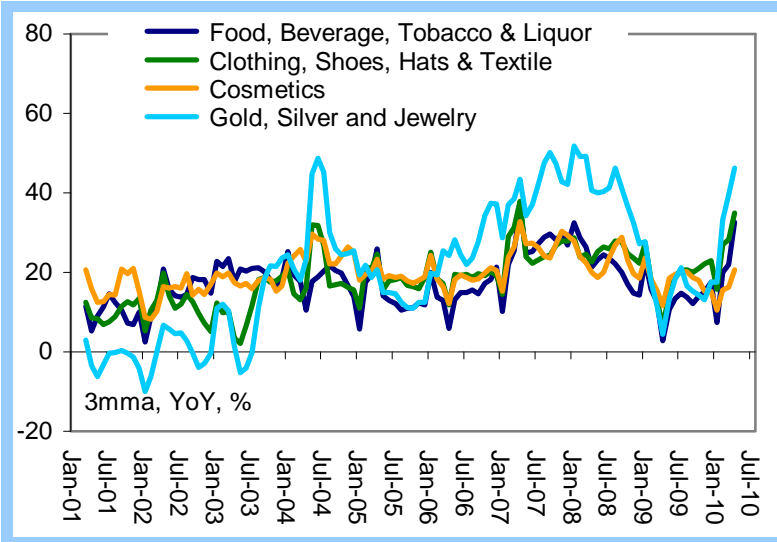
Household Consumption: Retail Sales in Good Shape



- Partly thanks to strong consumption before the Labor Holiday, the growth of retail sales rose to +18.5% YoY in April (vs. +18% YoY in March), better than our and market forecast of +18.2% YoY.
- On a seasonally adjusted MoM basis, retail sales rebounded to +2.1% MoM, compared to -1.9% MoM in March. Real growth of retail sales edged up to +15.3% YoY (vs. +15.2% YoY in March) by factoring in the pickup of headline CPI inflation.
- Since the consumer confidence index has returned to pre-crisis levels, we expect the upward momentum of retail sales to be sustained for the rest of the year.

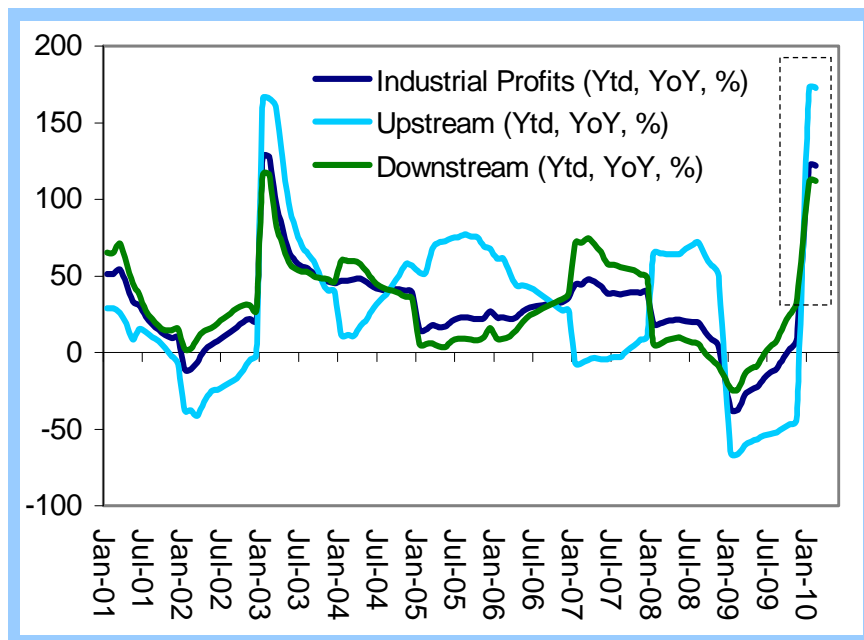
Source: CEIC, Morgan Stanley Research

Household Income and Consumption: Strong Large Store Sales Broadening Across Sectors

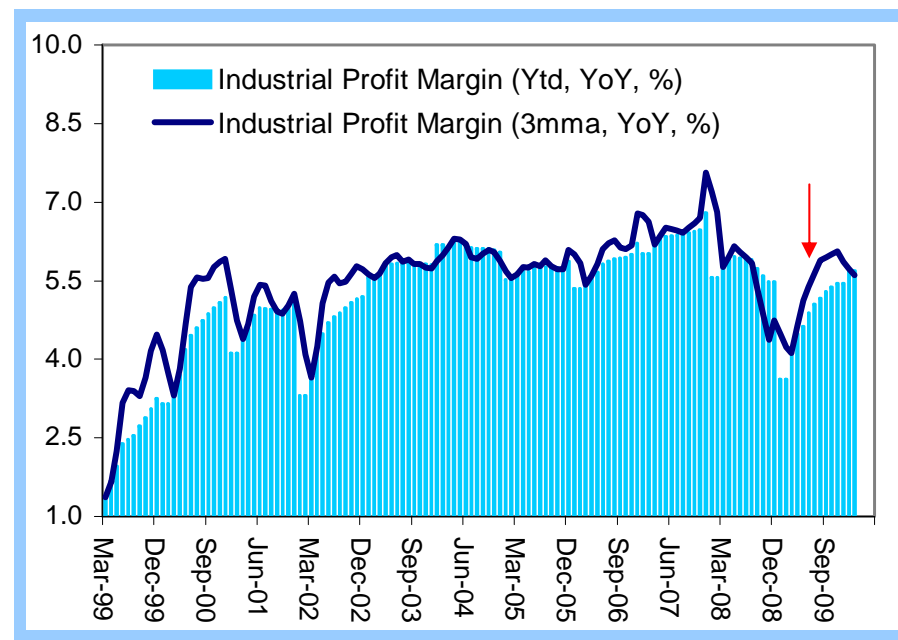


Source: CEIC, Morgan Stanley Research

Industrial Profitability: Upstream Outperformed Downstream Sectors So Far



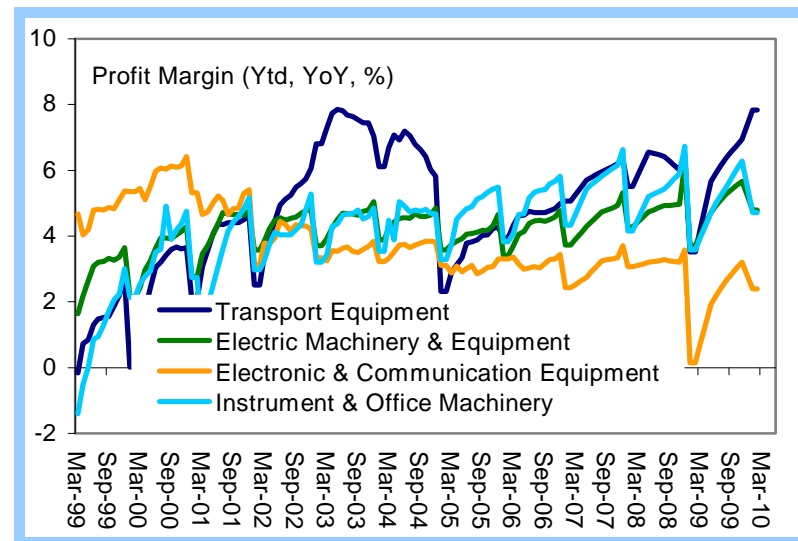
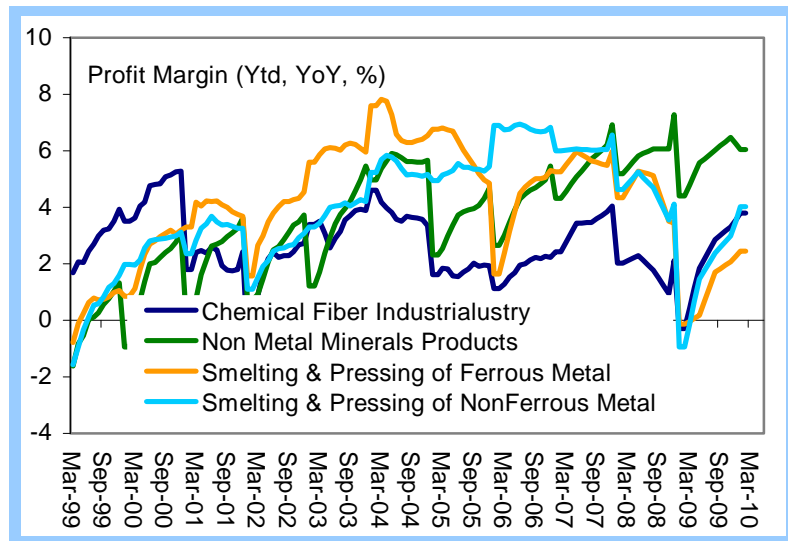
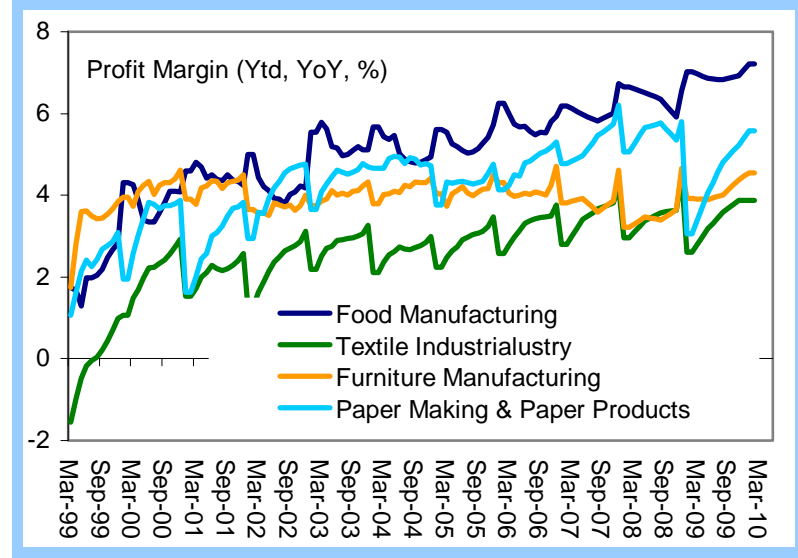
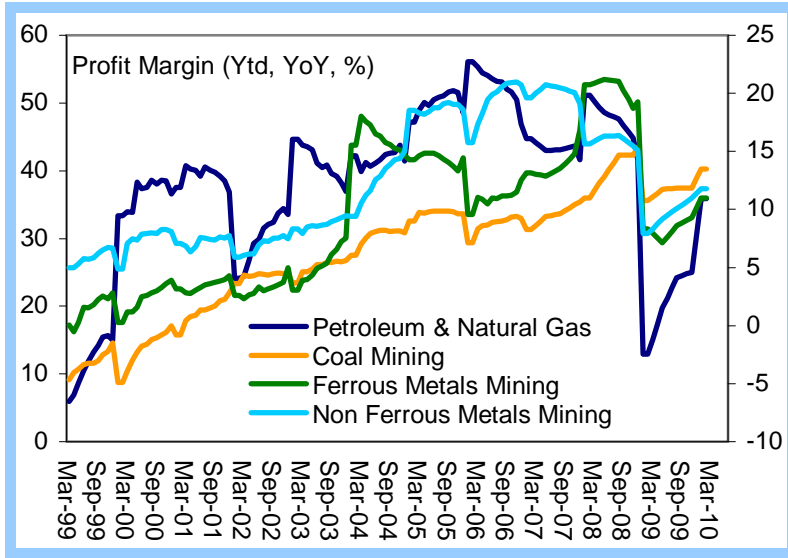
Industrial profit growth turned positive at +7.6% YoY in the first 11 months of 2009, and surged to +122% YoY in Jan-Feb from the low base in the same period of last year (vs. -37% YoY in Jan-Feb 09). Downstream sectors outperformed upstream sectors, owing to aggressive policy stimulus centering on infrastructure construction and relatively lower base.



Profit margins improved to +5.7 in Jan-Feb from +5.2% by Nov 09, as pricing power has returned partly, due to the upbeat domestic demand spurred by fiscal and monetary stimulus as well as improvement in production capacity utilization.

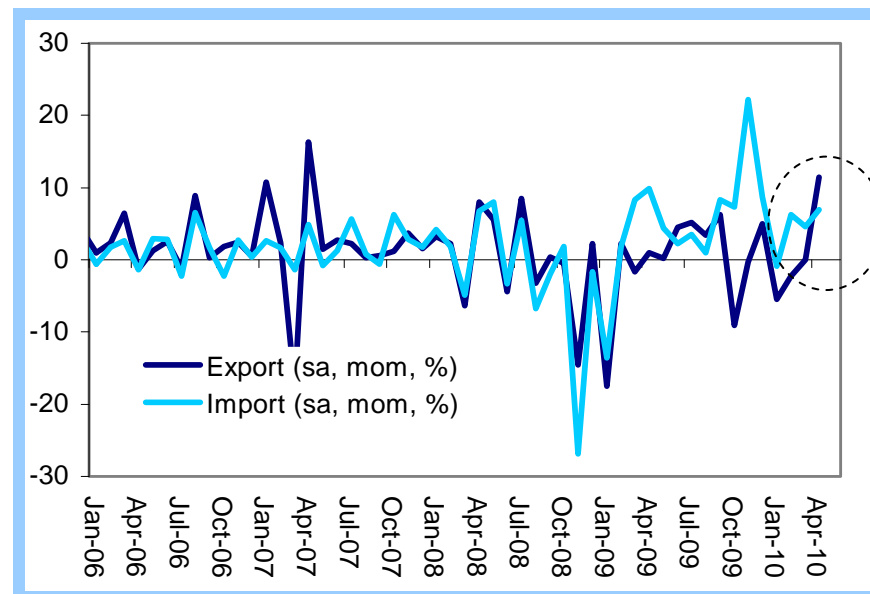
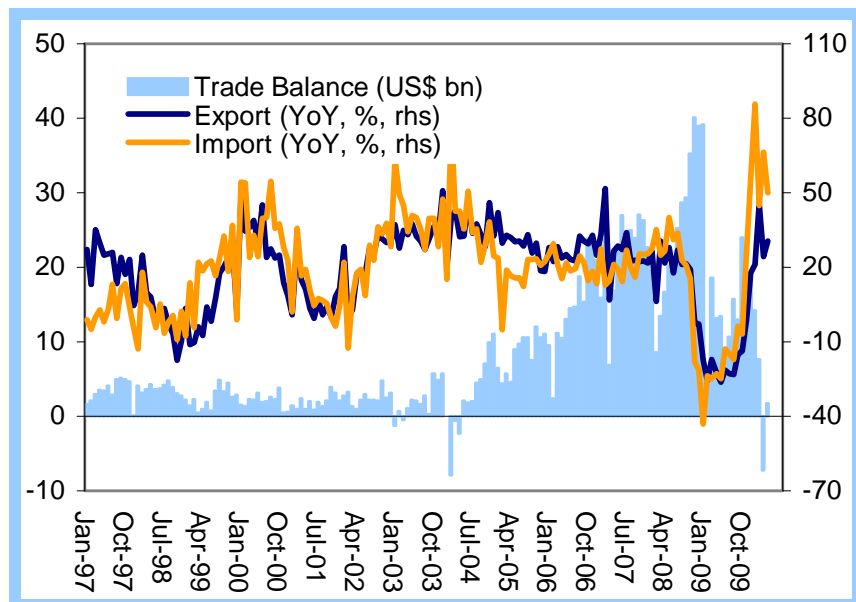
Source: CEIC, Morgan Stanley Research

Industrial Profitability: Broad-based Improvement in Profit Margins



Source: CEIC, Morgan Stanley Research

External Trade: Trade Surplus Resurfaced in April

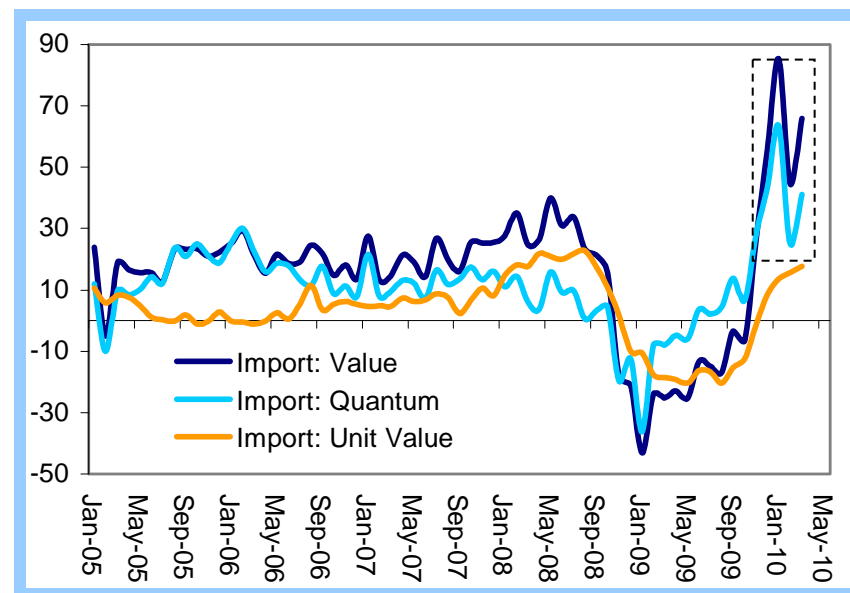
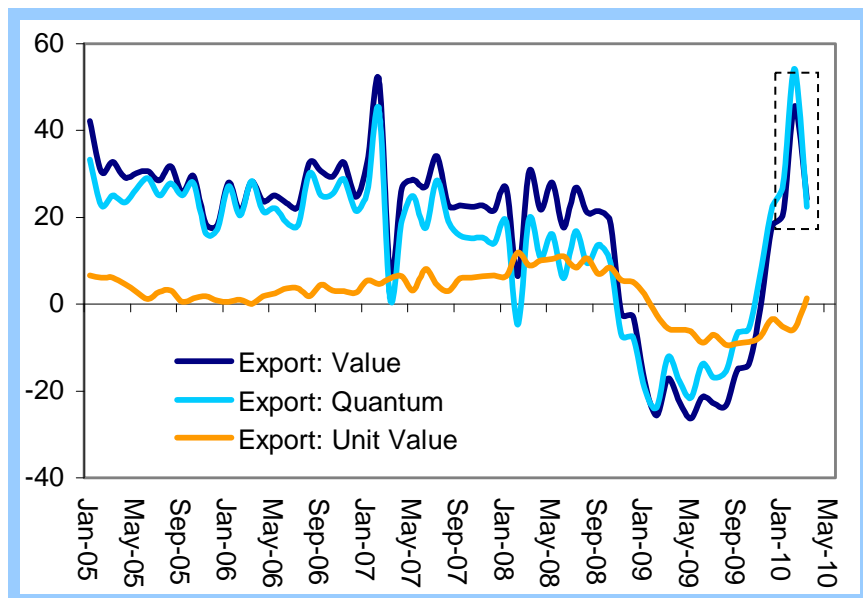


- Export growth strengthened to +30.5% YoY from +24.2% in March, beating our forecast of +21.1% YoY and market consensus of +28.9% YoY. Imports peaked and decelerated to +49.7% (vs. +66% in March), stronger than our forecast of +45.3% but lower than market consensus of +51.5%. On a seasonally adjusted MoM basis, April exports leapt +11.4%, while imports grew +6.9%. The April trade data suggested that the recovery of external demand has been well on track, and the domestic tightening measures have helped to moderate domestic demand and thus imports accordingly.

- After recording the first deficit (US\$7.2bn) in six years in March, China managed to return to trade surplus (US\$ 1.68 bn) in April. The quick turnaround endorsed our argument that the March deficit was a temporary phenomenon, as the fundamental structural factors contributing to trade surplus have remained intact.

Source: CEIC, Morgan Stanley Research

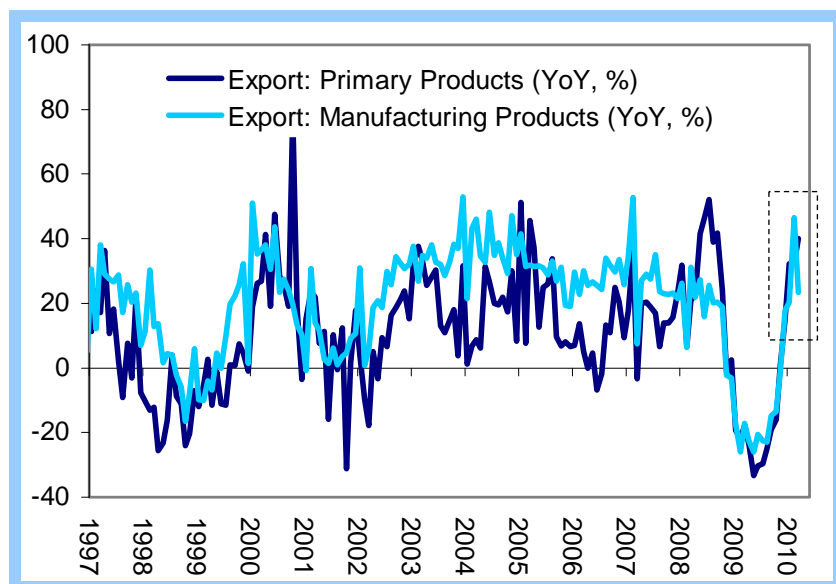
External Trade: Deterioration in Terms of Trade



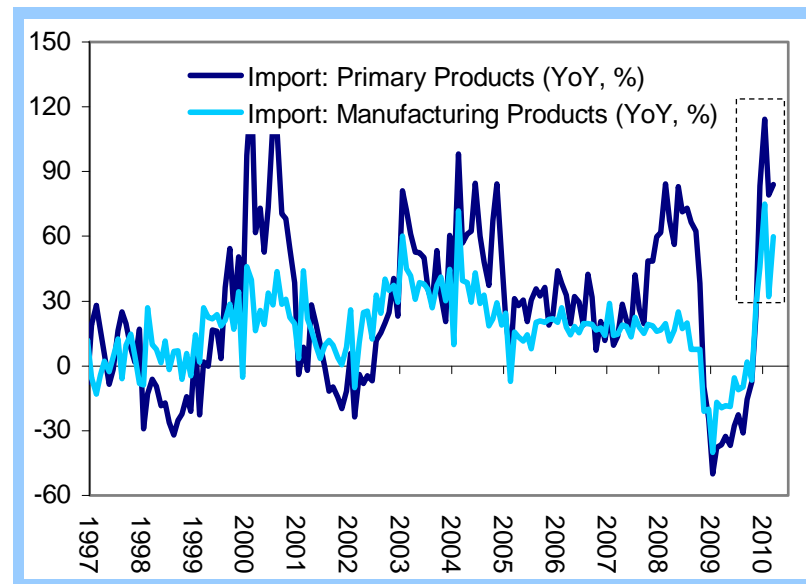
- Exports fell back in March in terms of both value and volume. However, the unit value of exports managed to climb back to positive territory in March after being depressed for a long time in the aftermath of financial crisis.
- Imports rebounded strongly in March in both value and volume terms. Since raw materials made up a big portion of total imports, unit value of imports keeps drifting up due to surging international commodity prices.

Source: CEIC, Morgan Stanley Research

External Trade: Manufacturing Trade Caught Up with Primary Goods Trade



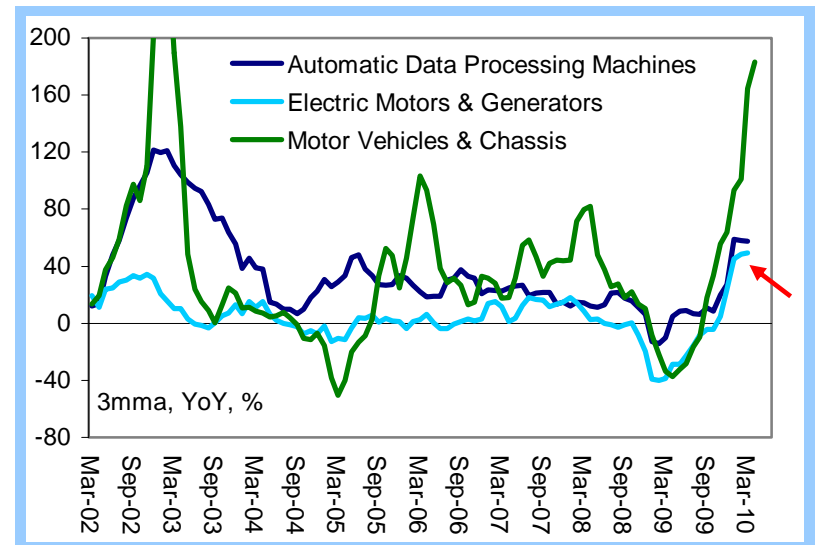
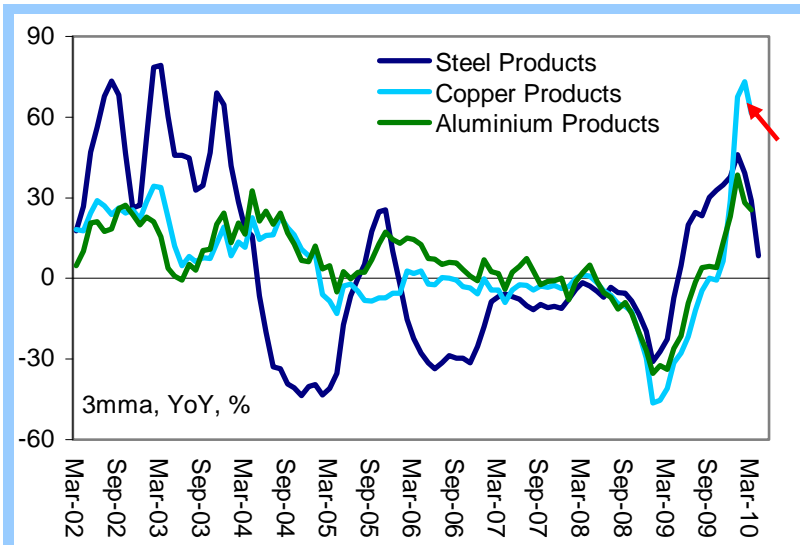
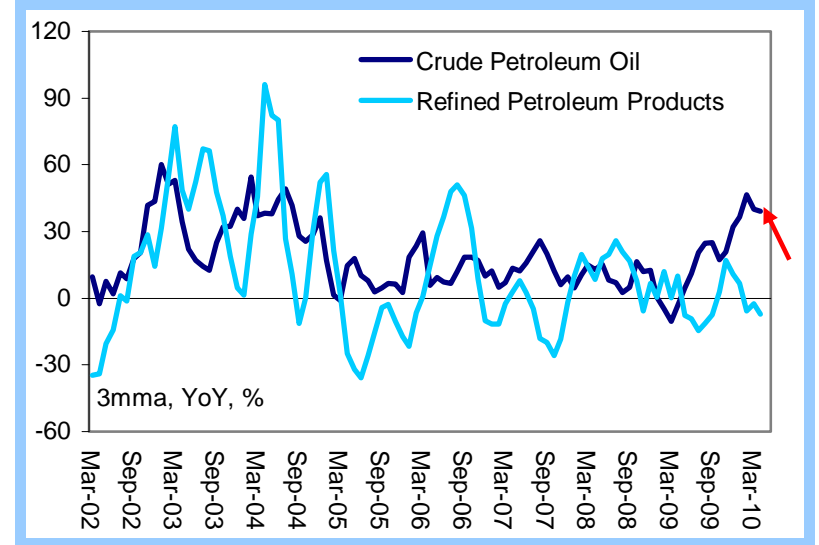
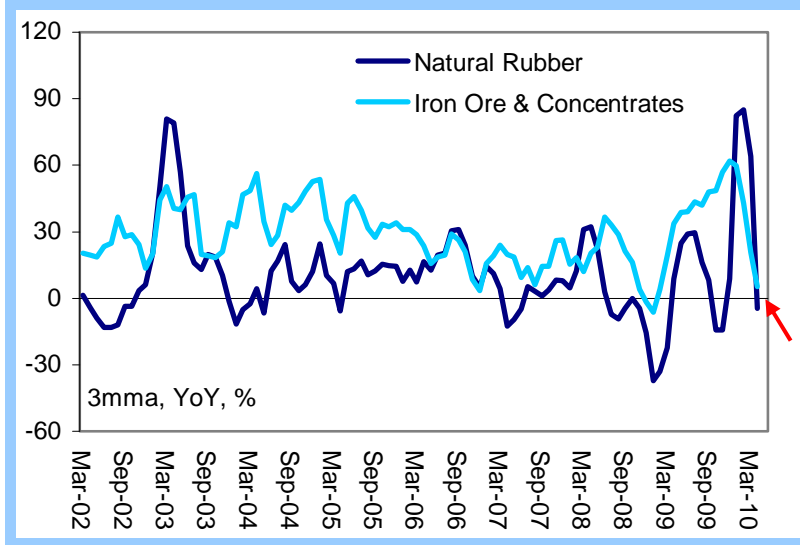
Against the backdrop of global recovery, China's exports, especially manufacturing goods, have been recovering quickly in recent months.



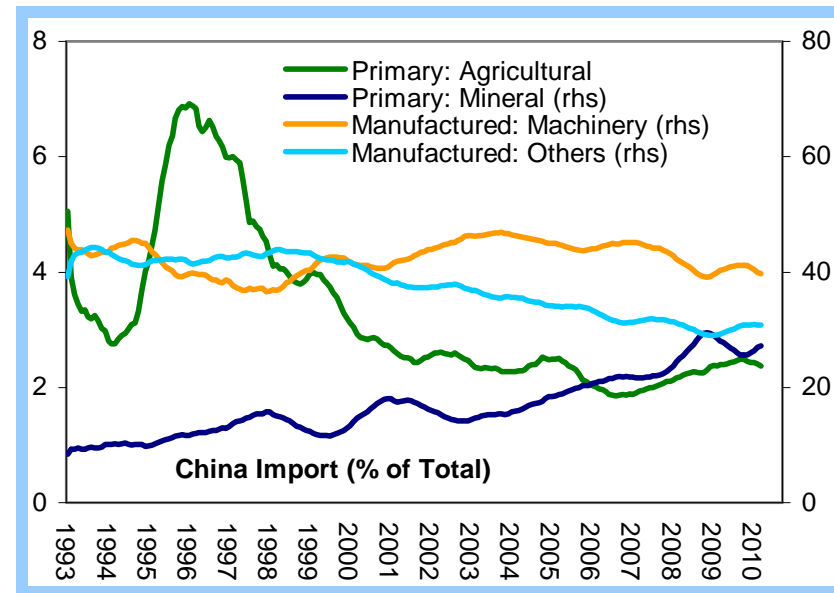
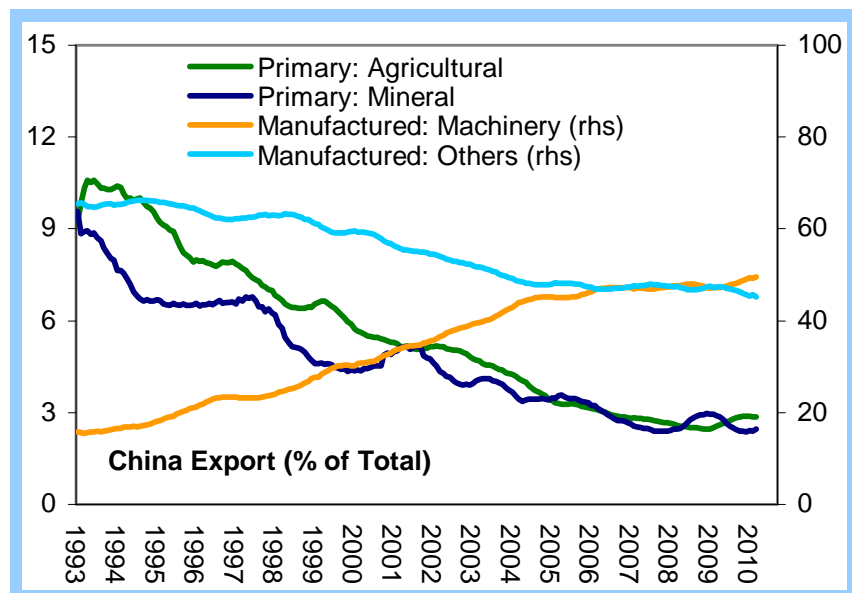
Thanks to domestic demand spurred by the policy stimulus, China's imports, especially primary goods (such as iron ores, coal, crude oil), surged.

Source: CEIC, Morgan Stanley Research

External Trade: Imports of Key Commodities: Softening Demand for Commodities



External Trade: Climbing Up the Value-Added Ladder



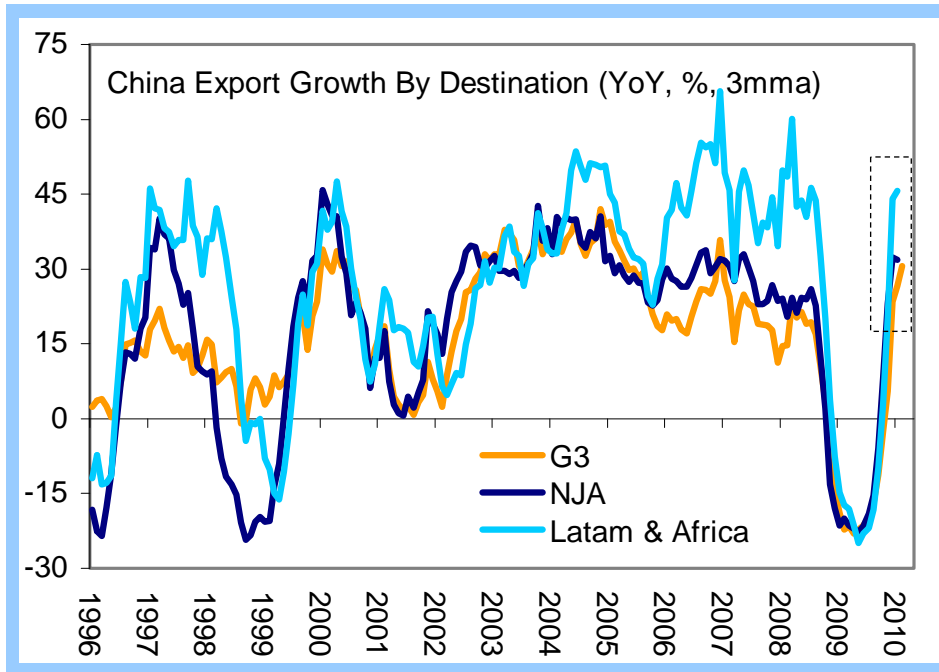
In the early stages of China's development, primary products (agricultural & mineral) and labor-intensive, low-valued-added manufactured goods as apparel, furniture, and toys accounted for the majority of exports. However, the spike in export volume since the late 1990s stemmed from exports of machinery and equipment (e.g., electronics, general industrial equipment), which require highly skilled labor and technology content. Machinery and equipment accounted for 50% of China's total exports in 2007.

The share of manufactured goods in China's total imports has declined steadily since the late 1990s as China has emerged to become a global powerhouse for production of manufactured goods. On the other hand, China's imports of crude materials and fuels have been rising steadily.

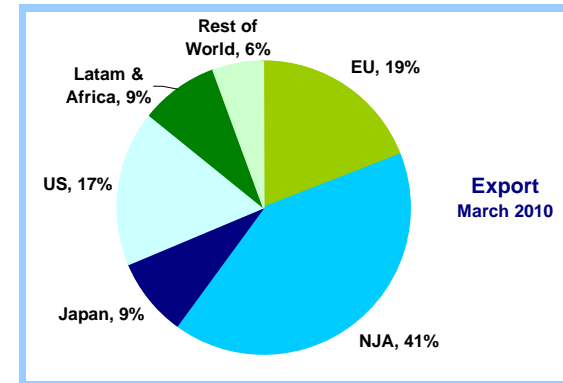
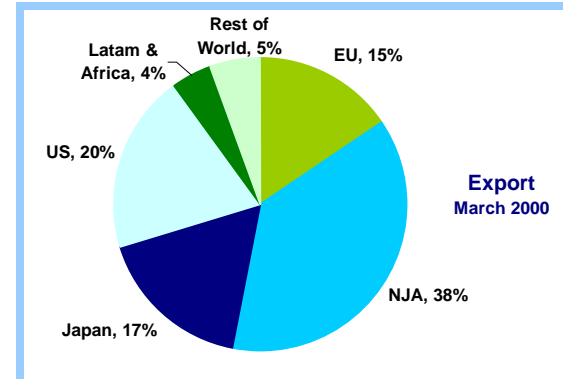
Source: CEIC, Morgan Stanley Research

External Trade:

Broad-based Improvement of Exports in Terms of Export Destination



% of Share of Total Exports by Destination

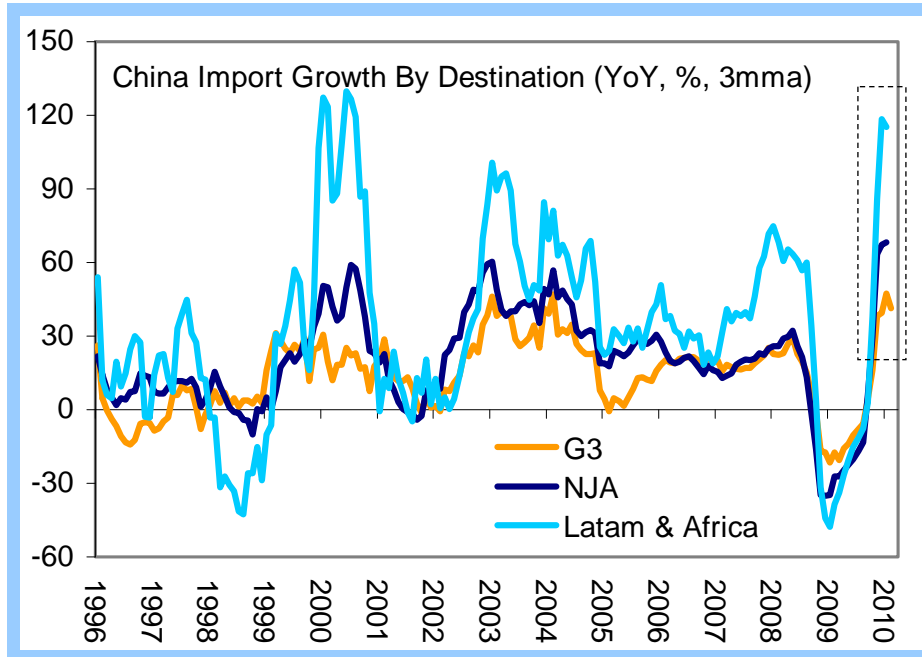


China has strived to diversify its export destinations against the backdrop of the sluggish demand from G3 nations, which were hit by the Great Recession. However, exports showed a broad-based improvement in recent months in both G3 and emerging markets.

The share of exports to the EU exceeds that of exports to the US by a widening margin, solidifying the EU's position as the no. 1 export destination for China. On the other hand, Japan's importance as an export market for China has been on the decline since 2001.

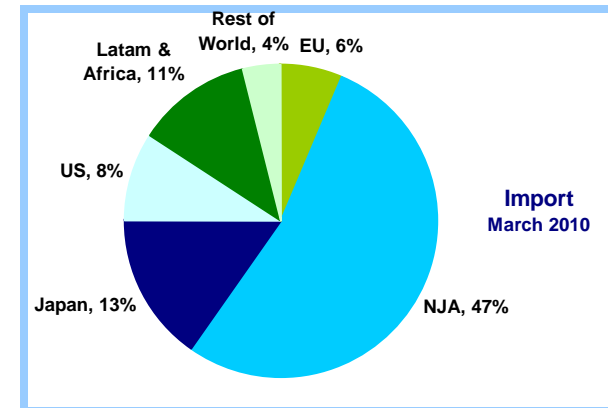
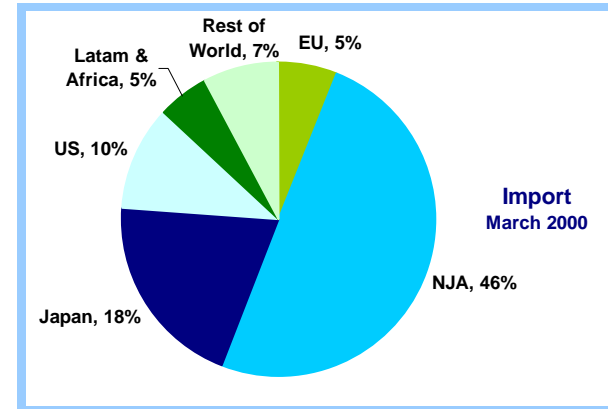
Source: CEIC, Morgan Stanley Research

External Trade: Imports: Benefiting Latam & Africa Most



The upbeat import growth in recent months mirrored the recovery in domestic demand spurred by the fiscal and monetary stimulus, and revival of processing trade associate with rallying exports. The strong imports from Latam & Africa show China's big appetite for raw materials such as iron ore and crude oil.

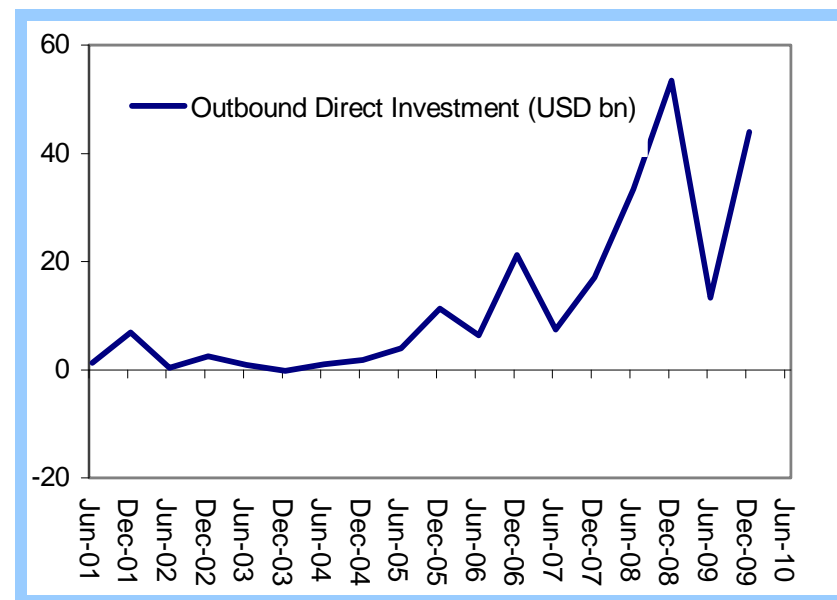
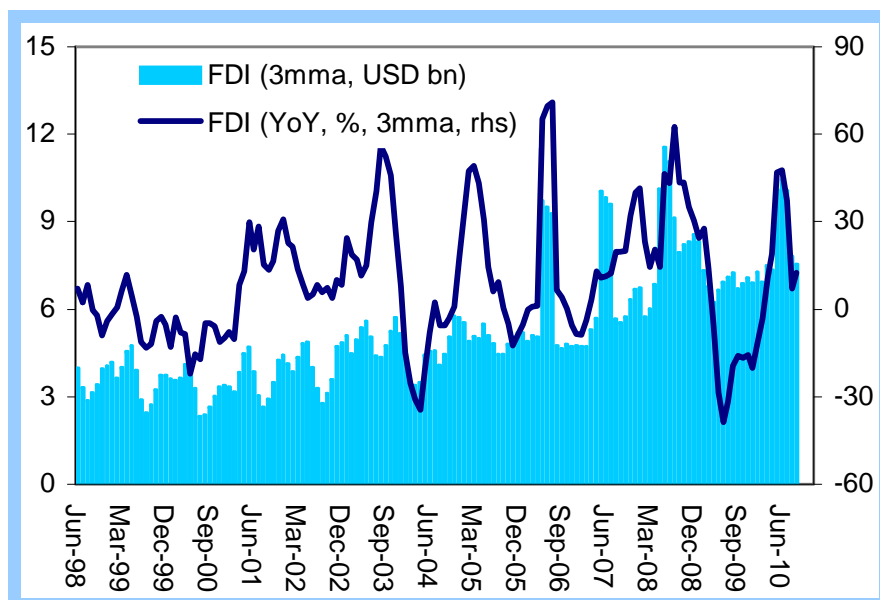
% Share of Total Imports by Origin



Imports from NJA and other countries are taking share from traditional developed countries, which might be explained by surging demand for raw materials but less appetite for manufactured goods.

Source: CEIC, Morgan Stanley Research

Foreign Direct Investment: Continued Rebound of FDI

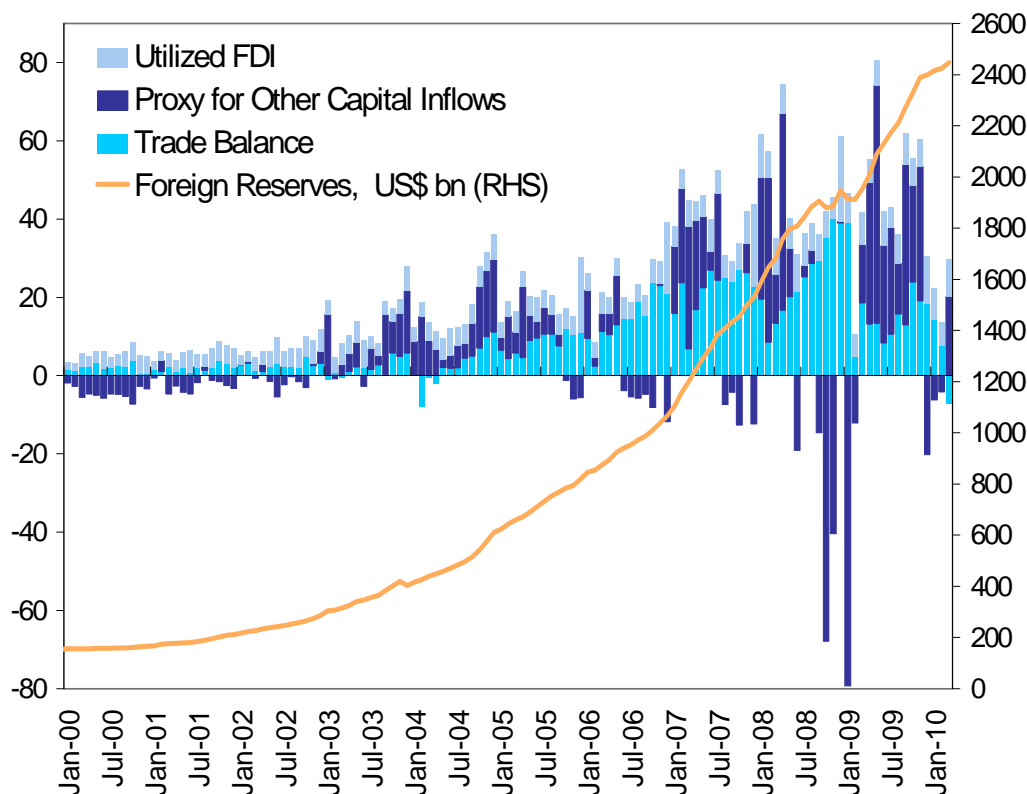


- FDI recorded USD 7.3 bn in April (vs. USD 9.4 bn in March), accelerating to +24.7% YoY in April from +12.1% YoY in March.
- China's state council and various ministries have rolled out new measures on foreign investments in recent weeks. The goal is to expand the fields opened to foreign investments and encourage investments in high-tech, clean-energy industries. This indicates that China is differentiating FDI to favor its industrial upgrading.

Outbound direct investment flows from China have increased sharply since 2005, albeit from a very low base. Total outflows investments rebounded to USD 44 bn in 2H 09 from USD 13 bn in 1H 09 as strong demand triggered by the aggressive stimulus motivated Chinese enterprises to hunt cheap assets around world

Source: CEIC, Morgan Stanley Research

Foreign Reserve: “Hot Money” Inflows Persist



FX reserve accumulation remained robust in 1Q10: China's foreign exchange reserves reached US\$2.45tn in March, or US\$47.9bn new accumulation from end 2009 level.

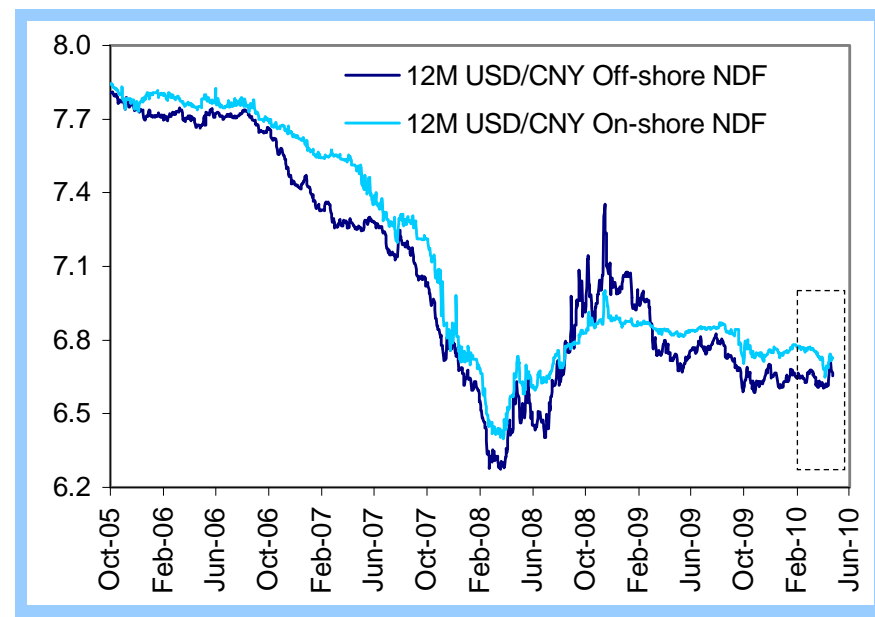
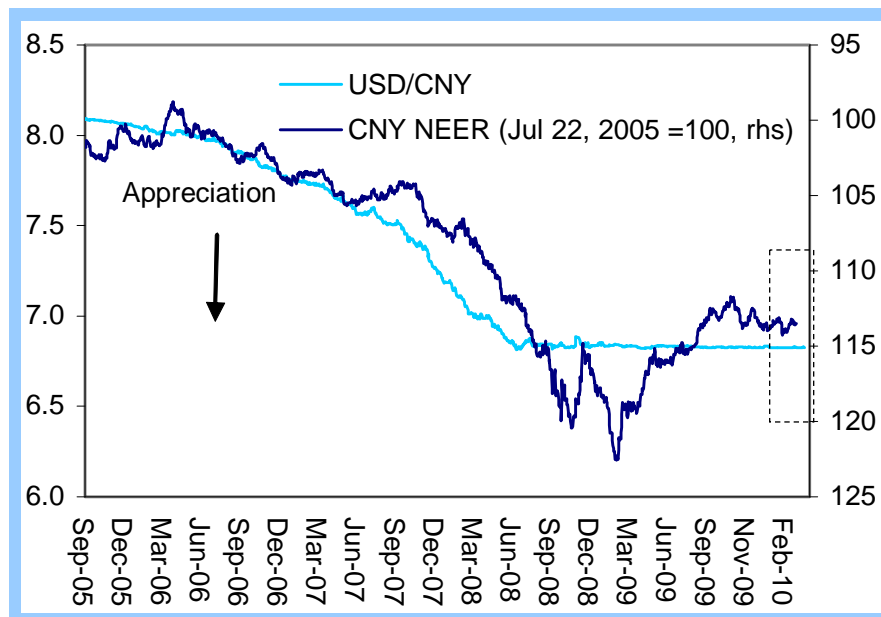
In particular, despite a trade deficit of US\$7.2bn in March, China still managed to increase its FX reserves by US\$22.5bn in the month, suggesting that other FX inflows through the capital accounts may have been quite strong.

We suspect that Chinese financial institutions may have repatriated a sizable amount of offshore financial assets. The capital inflows as a result of this type of operation are typically (and mistakenly) treated as 'hot money' inflows into China. Chinese domestic banks carried out this operation to meet strong demand for FX funding by onshore enterprises.

Our proxy for "hot money" inflows – the incremental change in reserves, net of the trade surplus and FDI and adjusted for exchange rate movements and interest income – showed sustained positive inflows above US\$30 bn in 1Q10. Given the strong expectation of RMB appreciation, we expect the inflow of hot money will intensify accordingly.

Source: CEIC, Morgan Stanley Research

Exchange Rate: Hard Peg to USD; But for How Long?

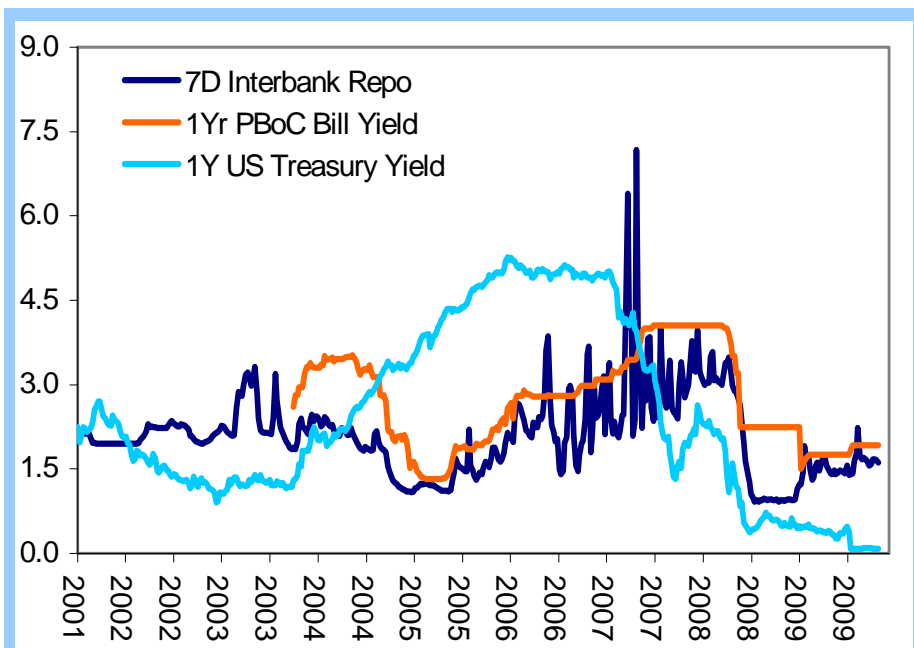


In contrast to the *de facto* hard peg with USD, the RMB nominal effective exchange rate (NEER, its exchange rate against the underlying currency basket) remained weak in recent months, reflecting a weak US\$ vis-à-vis other major currencies, although the euro was hit heavily by the Greek crisis.

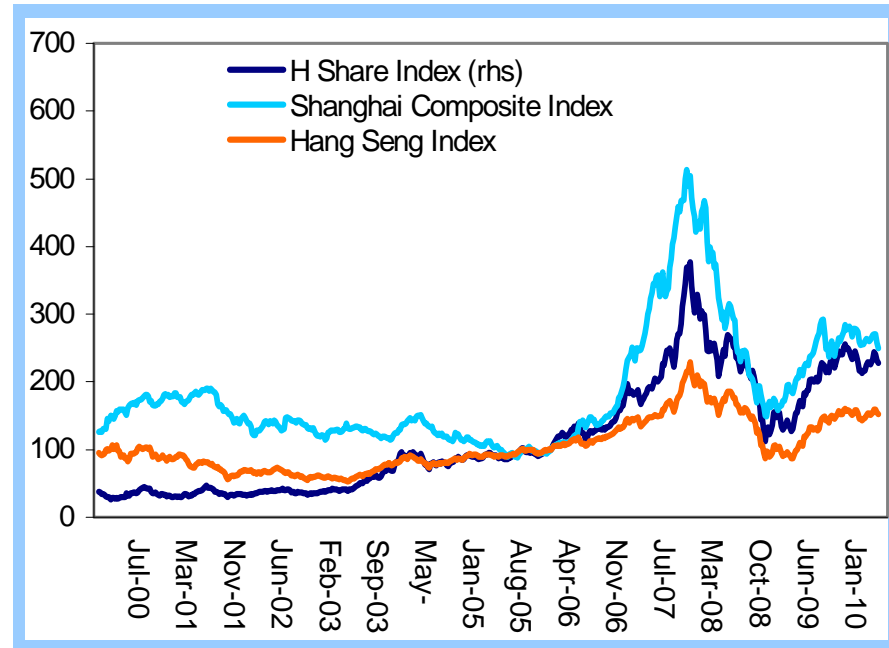
- The deadline is approaching (though delayed to July) for the US to issue its semi-annual Treasury report to consider labeling China a currency manipulator. In light of this, both o-shore and offshore NDF has priced in the re-ignited expectation of RMB appreciation by speculating that China will de-peg with USD by adopting a more flexible FX regime before that.
- We expect USD/CNY rate to reach 6.54 by end 2010 and 6.17 by end 2011. The “asymmetry of long- and short-side players” suggests that the current offshore USD/CNY NDF pricings are ‘wrong’. (see *China Economics: Renminbi Exit from USD Peg: Whether, Why, When, How*, April 5, 2010)

Source: CEIC, Morgan Stanley Research

Financial Markets: Underperformance of A and H Share Markets



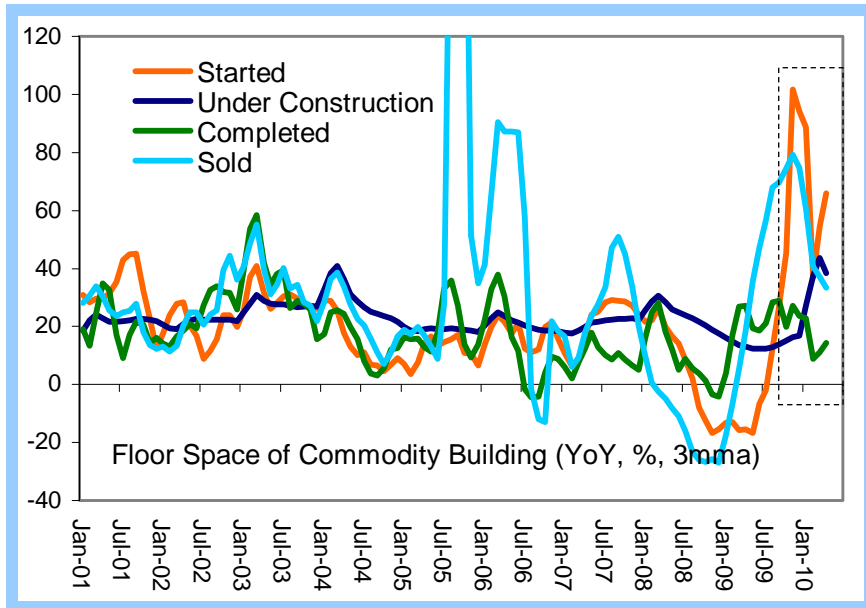
The reference rate of 1-Yr central bank bills climbed to 1.93 in January and has since stabilized, indicating the market's easing expectations of inflation. The 7-day Repo jumped in Early February due to RRR hike but fell back quickly.



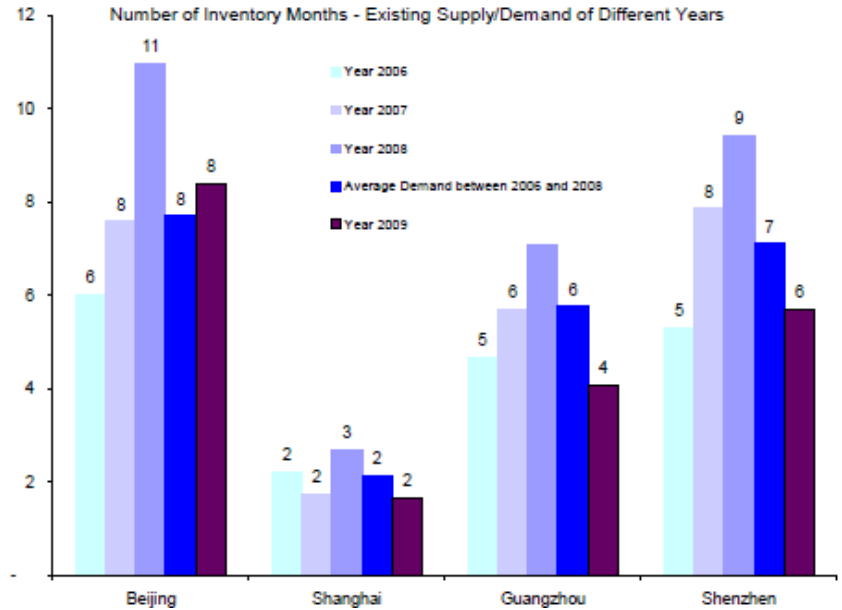
Chinese equity markets have reacted quite negatively, ever since the Chinese authorities announced a set of austere policy measures to rein in rapid property price increases. The negative reaction of the market has in part reflected uncertainty over the effectiveness of property sector policy and its potential impact on the underlying real economic activity in general.

Source: CEIC, Morgan Stanley Research

Property Markets:
Property Prices On Fire



Inventory Months Based on Existing Supply

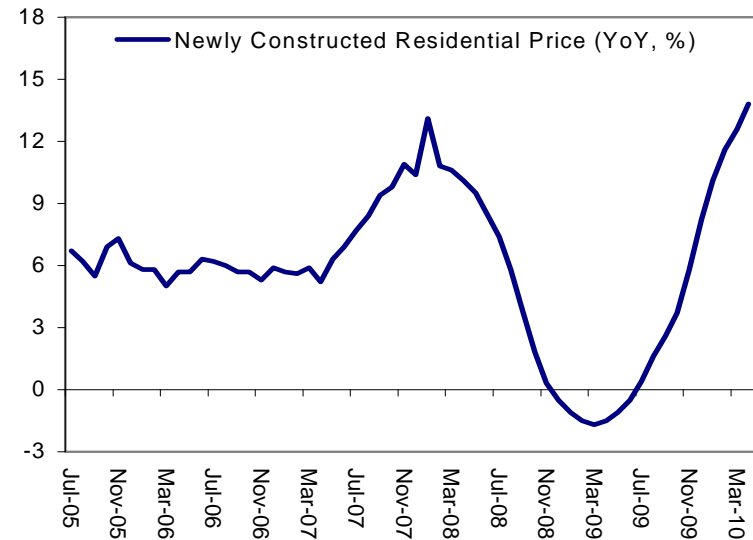
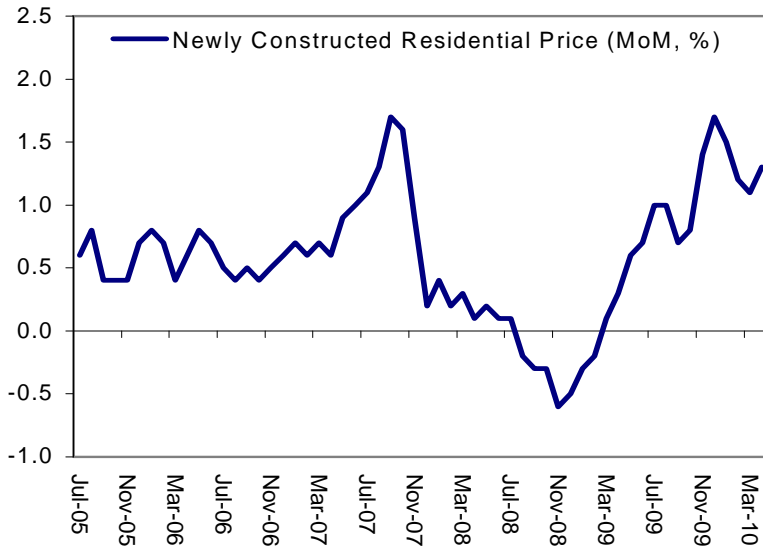
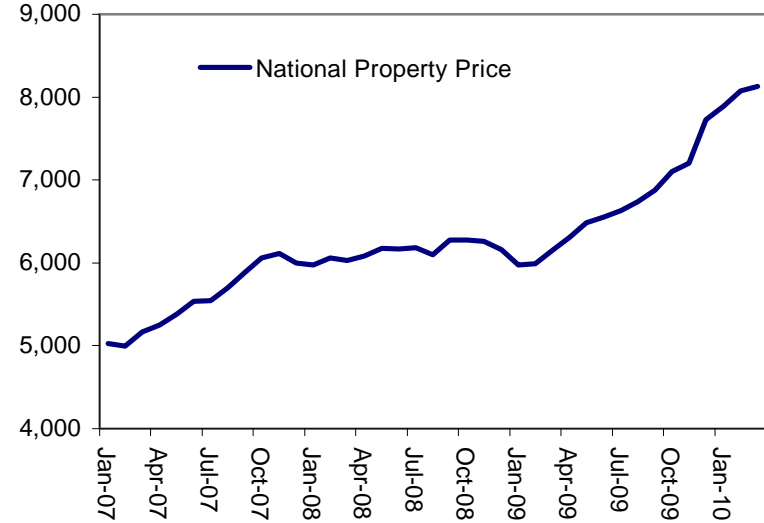
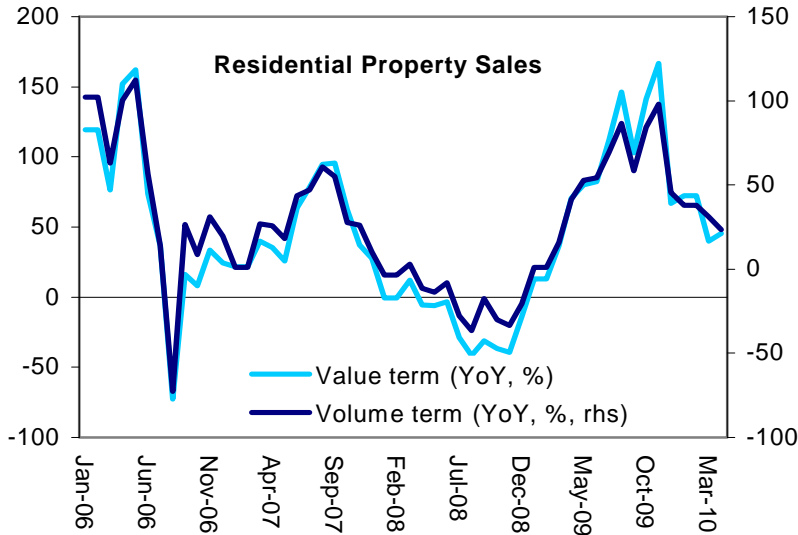


Owing to austerity measures, property sales cooled off quickly. Floor space completed rebounded in April, implying the changing attitude of developers. The sharp increase in the floor space newly started and under-construction suggests that supply will catch up in the latter part of the year, likely helping to dampen rapid property price increase.

As a result, inventory level is in the comfort zone in most cities – i.e., between 6-12 months. Shanghai, as usual, reported the lowest inventory months, only 2. Measuring the inventory months of four major cities under different demand-level assumptions versus the spot demand (monthly transactions) in the market avoids the seasonal fluctuations/volatility involved in tracking the historical “spot demand” against “spot supply”.

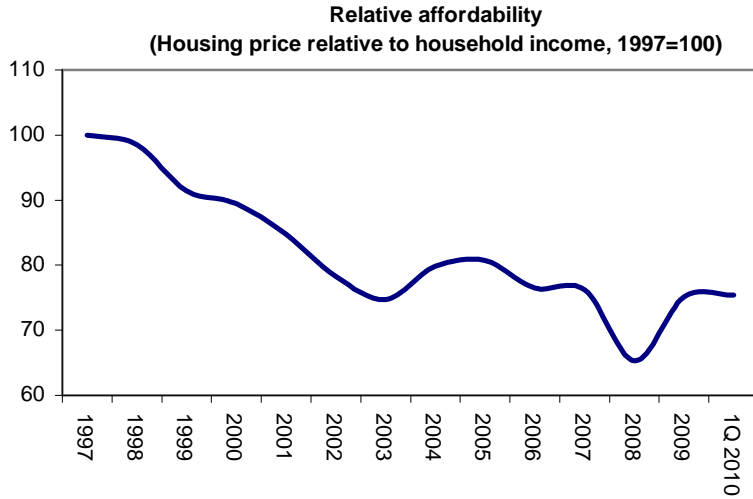
Source: CEIC, Morgan Stanley Research; Morgan Stanley Research Report *China Property: China Property Transaction Tracker, May 11, 2010*

Property Markets: Property Prices On Fire

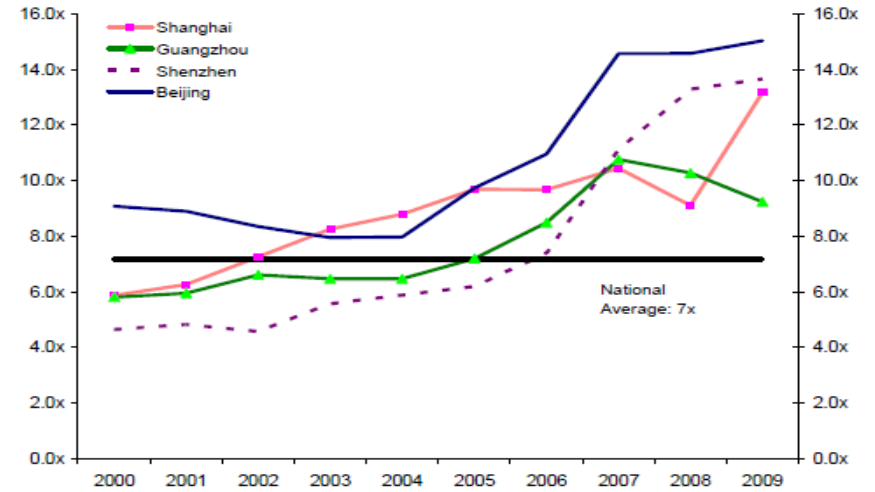


Source: Morgan Stanley Research Report *China Property: China Property Transaction Tracker*, May 11, 2010

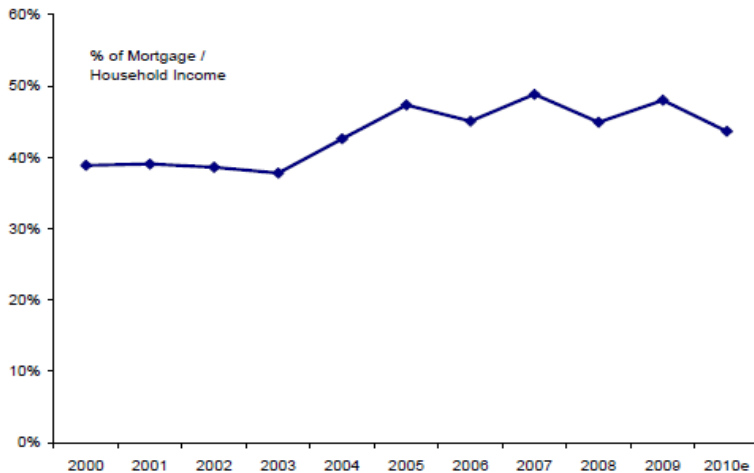
Property Markets: Affordability Deteriorated In Tier-1 Cities



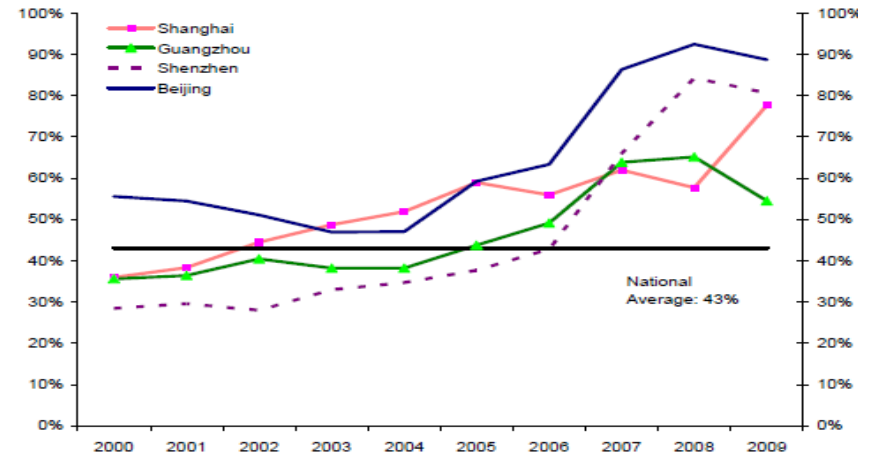
Property Price/Annual Income: Four Major Cities



Mortgage Payment/Annual Income: National



Mortgage Payment/Annual Income: Four Major Cities



Source: Morgan Stanley Research Report China Property: China Property Transaction Tracker, April 20, 2010

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The Americas

1585 Broadway
New York, NY 10036-8293

United States

Tel: +1 (1)212 761 4000

Europe

20 Bank Street, Canary Wharf
London E14 4AD

United Kingdom

Tel: +44 (0)20 7425 8000

Japan

4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008

Japan

Tel: +81 (0)3 5424 5000

Asia/Pacific

1 Austin Road West
Kowloon

Hong Kong

Tel: +852 2848 5200