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GAO HUA ECONOMIC WEBSITE
Economic Research from the Gao Hua Portal
at **https://portal.ghsl.cn**

Hong Liang
hong.liang@gs.com
+852 2978 0036

Eva Yi
eva.yi@gs.com
+852 2978 1870

China: Why should we care about M3 growth?

- In this article, we address a few questions raised by investors following our latest article on M3 growth and fast monetary expansion.
- We argue that investors should care about M3 growth because it offers us a better explanation for why growth and inflation have surprised so much on the upside since 2H2006.
- But more importantly, we believe it gives us a better tool to assess potential upside risks for growth and inflation in the future.

Many clients have followed our latest article on China's monetary expansion with great interest and more questions (see *China: M2 growth may have understated the speed of monetary expansion*, Asia Economics Flash, July 6, 2007). In this article, we try to address a few common issues raised by investors, in particular those on why it is important to watch M3 growth in China.

Question 1: The question being asked the most: Why should we care about M3 growth?

Because we believe M3 growth offers us a better explanation for why growth and inflation have surprised so much on the upside since 2H2006. But more importantly, we believe it allows us to better assess the upside risks for growth and inflation in the future.

M3 is a more comprehensive indicator for monetary expansion, and a better leading indicator for activity growth and inflation for most mature economies. In the case of China, capital-market-related assets were so small that M2 growth (which includes mostly liabilities in the banking system) was a good enough indicator for monetary expansion. However, China's financial markets are changing so fast that we believe investors need to watch closely for what may have been left out significantly by M2 statistics.

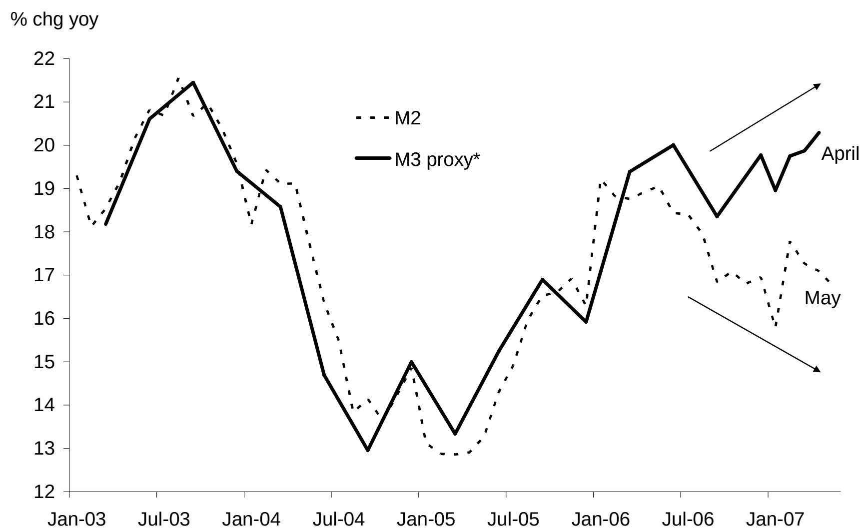
The differences between M1, M2, and M3 are mostly related to the differences in liquidity of the underlying financial assets involved, with M1 including only cash and demand deposits, M2 having term deposits, and M3 also containing bonds and equity-related assets. With fast development in the capital markets, many financial assets that are only included in M3 have now arguably been as important and as liquid as deposits in the banking system. For example, open-ended mutual funds can be bought and sold easily by investors but are not included in the M2 statistics. Moreover, Chinese households have been reallocating their financial assets out of bank deposits (M2) into equities (some of which are only included in M3) in the past 18 months.

Therefore, we believe monitoring a money supply indicator broader than M2 growth has become important.

Question 2: What does M3 tell us about the cycle?

While M2 growth has moderated since 2H2006 except for an up-tick in January-February 2007, M3 growth has been hovering around 18%-19% for a year, and now approaching its peak level as in mid-2003 (see Exhibit 1). Not surprisingly, demand growth and inflation have surprised on the upside.

Exhibit 1: Growth of M2 and M3 supply in the banking system started to diverge in 2Q2006



* M3 proxy includes net foreign assets and domestic credits, "other assets" are not included in this graph as the level is only attainable since 2006, however, it should not have much impact on the growth rate of overall financial assets due to its small share and stable performance.

Source: CEIC, Goldman Sachs Economics Research.

In our view, the economy is already running above its potential, but more importantly, is still gaining more momentum. Such above-trend growth in aggregate demand will translate into heightened supply constraints (such as in the power and transportation sectors) and inflation pressures.

Question 3: What is the near-term growth outlook?

Broad money expansion leads to higher activities growth with about a 3-6 months' lag. Therefore we are likely to see stronger activities growth (GDP, industrial production, investment, corporate profits etc.) in the coming quarter. Given the low-base of 3Q2006, we are likely to see 12% GDP growth, 20% industrial production growth, and 30%+ fixed asset investment growth in 3Q2007.

Question 4: The most important implication of fast M3 growth—inflation

- How long does it take for M3 growth to translate into CPI inflation?
- What is the M3-implied CPI quarterly path?
- When and at what level would CPI inflation peak?

Broad money supply tends to translate into inflationary impulse with about a 12 months' lag. Hence, the pickup in inflation we see in 2Q2007 likely reflected the over-expansion of M3 supply in 2Q-3Q in 2006. Using M3 growth as a leading indicator, we see sequential CPI inflation to stay high in the remainder of the year. The year-on-year reading of the CPI may peak in 3Q2007 (with an average of over 4%), due to its low base in 3Q2006 and high base in 4Q2006. **However, we see upside risks to this forecast**.

Given our assumption of more decisive tightening in 3Q-4Q in 2007, the sequential CPI inflation rate may start softening in 1Q2008. However, that said, the potential evolution of CPI inflation is very much dependent on the timing of decisive monetary tightening. Delays in policy actions could result in higher inflation that also sticks around for longer.

Question 5: Does the central bank care about M3 growth?

It is our understanding that the People's Bank of China has been paying attention to M3 growth for a while, although it still only sets an annual operating target for M2 growth. However, as the market starts to pay more attention to M3 growth, and growth and inflation continue to be stronger than what would have implied by the M2 growth rate, we believe the central bank would also begin to watch for changes in M3.

Question 6: What are the likely policy responses in the near term? Will the recent correction in the A-share market alleviate policy concerns on overheating?

In our view, inflation, including food-price-related price pressures, is a much more pressing concern for policymakers than the performance of the equity market. Therefore, as more signs point to broad-based overheating pressures in the economy, we believe the government will take decisive actions to slow down and "dis-inflate" the economy.

Since we believe CPI inflation is likely to breach the 4% level very soon, we expect policymakers to start taking actions soon. We maintain our forecast of two more 27-basis-point hikes in the remainder of the year and 9% CNY appreciation in 12 months' time. Other possible measures include the abolition of the Interest Income Tax, more trade tax adjustments, more window guidance on lending, and more intensified sterilization operations.

If policy adjustments are put off for too long, we believe inflation could run higher, and the risks for a more blunt and full-fledged administrative tightening would increase.

Question 7: What are the important data points to watch?

First and foremost is CPI inflation, especially the food price component, because it not only takes up one-third of the basket weight but is also a very politically sensitive component. Apart from downstream inflation, we would also watch for any signs of supply constraints and upstream inflation, such as power shortage or any signs of bottlenecks re-emergence. In addition, we would continue to closely monitor bank lending and fixed asset investment growth.

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