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Methodology p. 2

Overheating risks mount further

But global slowdown may temper extent of tightening

The China Overheating Indicator (COI) has steadily notched up since April 2007 and has almost reached the amber threshold, a first warning sign of overheating. Comparing the COI's components, the upward trend was mainly driven by strong increases in sales (both retail & industrial) as well as imports. Seasonally adjusted, industrial sales showed the strongest growth in November, reaching 2% mom. Interestingly, the FI loans component exhibited the weakest monthly increase, which suggests that administrative measures are finally making themselves felt.

CPI has continued to rise faster than the COI, with food price increases being the major source of higher CPI inflation. CPI reached 6.5% yoy in December 2007, leading to an average 4.8% CPI increase in 2007 compared with only 1.5% in 2006.

Food prices remain the wildcard in China's CPI inflation in 2008, which we expect to moderate somewhat from last year's pace but overall to stay at elevated levels. The authorities are expected to continue to be vigilant on controlling money supply and bank credit. Growing concerns over the global economic outlook, however, will likely temper the pace and the extent of tightening measures this year. Interest rate hikes and increases in reserve requirements remain possible, but will likely be lesser in degree and frequency. Administrative measures to ease supply constraints, especially in food and agricultural products will be the preferred measures.

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* For a description of the thresholds and other methodological aspects please see page 2

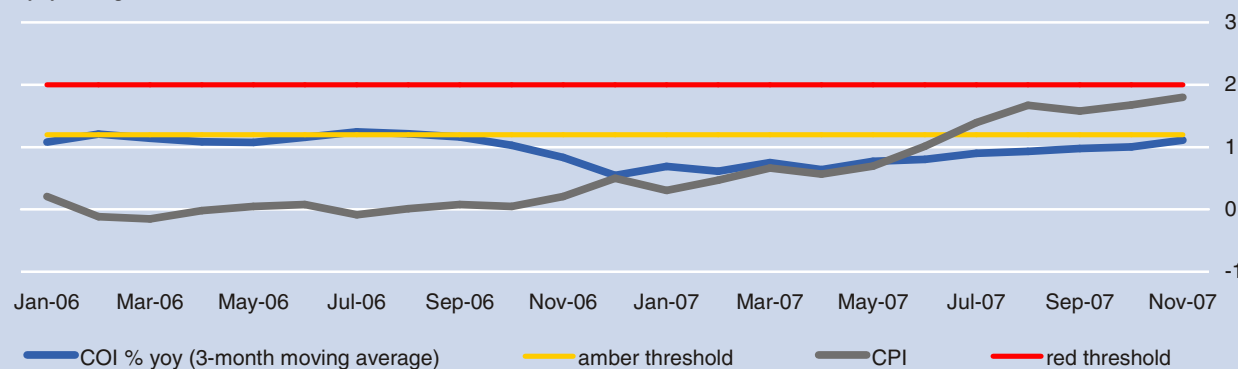
China Overheating Indicator

% yoy change in standard deviations
(3M mov. avg.)

Nov-06	0.83
Dec-06	0.55
Jan-07	0.69
Feb-07	0.61
Mar-07	0.75
Apr-07	0.64
May-07	0.77
Jun-07	0.80
Jul-07	0.90
Aug-07	0.93
Sep-07	0.98
Oct-07	1.00
Nov-07	1.11

China Overheating Indicator

% yoy changes in standard deviations



Source: DB Research

China Overheating Indicator

A tool to monitor overheating pressures in China

- *There has been increasing concern over overheating pressures building up in China, which could lead to a boom-bust cycle with global repercussions.*
- *We have therefore constructed a China Overheating Indicator (COI) in order to assess overheating pressures, gauge the risk of a hard-landing and derive conclusions for the future policy response by the Chinese government, including exchange-rate policy.*

China Overheating Indicator: Description

Our China Overheating Indicator (COI) tracks demand factors that exert upward pressure on prices and can be used as leading indicator for inflation with a lead of roughly 3-12 months. To gauge the extent of overheating pressures, we have established 2 thresholds, amber and red, which indicate increasingly high degrees of overheating risk. The amber and red thresholds represent 1.3 and 2 standard deviations¹ from the historical average of the series, starting in the period after the last big overheating / high inflation episode in China in the early to mid 1990s. The 2 thresholds are intended to serve as warning: If the COI crosses the “amber threshold” from below, it signifies that the COI is nearly entering overheating territory. Moving above the “red threshold” indicates the presence of overheating. Conversely, if our indicator falls below the “amber threshold” it would indicate that overheating pressures are subsiding.

Variables included in the COI

The COI tries to capture **demand-push factors** that would eventually lead to a rise in inflation. This must be distinguished from exogenous cost-push factors, such as higher oil prices or higher food prices due to adverse weather or other external shocks.

We include **five variables** available in monthly series at least since January 1993 (the year of the latest overheating episode).

The variables are:

- **Merchandise imports** as a gauge of overall domestic investment and consumption demand;
- **Retail sales** as a gauge for private consumption;
- **Industrial sales**, a proxy for industrial production, as a gauge for investment activity;
- **Money supply (M2)** as a gauge for inflationary pressures arising from monetary policy;
- **Financial Institution loans**, to gauge the risk of a boom-bust credit cycle.

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¹ The thresholds have been adjusted upward slightly as the adjusted model (without the monthly income per capita variable) tends to show slightly lower COI value. The directions of the adjusted COI model are consistent with the original model.

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