Brief China Economic Update

National Australia Bank

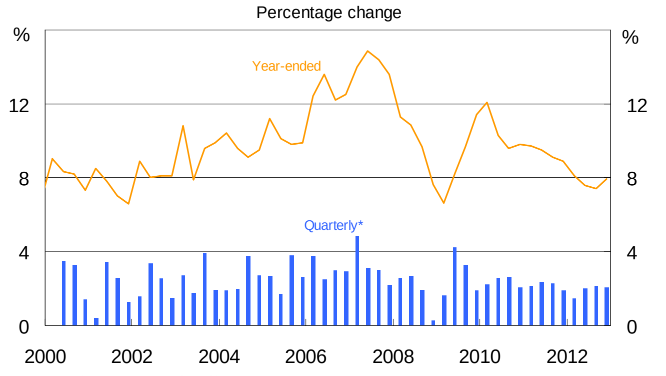
Today's economic data releases for China came in broadly in line with expectations, providing evidence that the economic slowdown may have bottomed in the September quarter. The national accounts show that the economy expanded by 7.9% over the year to the December quarter, up from 7.6% in the June quarter, which is the first time growth has accelerated in two years. However, revised q-o-q growth rates suggest the economy's growth momentum stabilised around the June quarter and has remained relatively steady; q-o-q growth was 2% in the quarter (from a 2.1% revised rate in Q3). The outcome was slightly stronger than our forecast for 7.6% y-o-y growth made late last year, largely reflecting the much stronger than expected foreign trade result. Average growth for 2012 came in at 7.8%, slightly stronger than our previous forecast of 7.7%. Note that all figures in this brief may change slightly once all revisions to the data are available.

China's partial economic indicators recorded some improving trends over recent months, although some of the outcomes for December were a little mixed. Overall however, the trend appear to support our expectation for a continued recovery in GDP growth in H1 2013, assisted by ongoing government spending – although public investment appears to have slowed in December – and improving confidence in the real estate and external trade sectors. Consumption should also remain supportive.

Looking at the particulars, industrial production was broadly in line with market expectations, increasing 10.3% over the year to December, up slightly from 10.1% the previous month. Electricity production, considered a bellwether of economic activity, decelerated slightly to 7.6%. Growth in cement production also slowed, possibly reflecting the easing in construction, but the auto sector showed signs of recovery with production growth accelerating to 5.3 per cent over the year. Seasonally adjusted data show that month on month growth in total IP remained at 0.9%. The solid IP result was consistent with the closely watched manufacturing PMI measures, with both the HSBC and official measures pointing to modest growth for the month. While the acceleration of IP by heavy industries had been indicative of the government's investment stimulus program, light industry picked up in December, possibly reflecting improved demand for tradable goods.

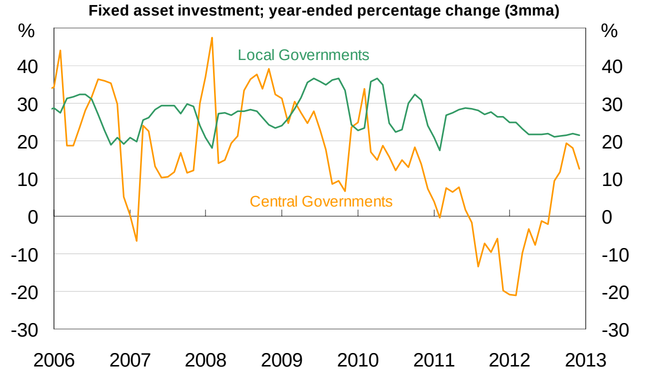
Turning to consumption, nominal retail sales growth accelerated again to 15.2% over the year to December (up from 14.9%), although this was partly driven by an increase in the price of consumer goods. Real retail sales growth remained around 13¾%. By commodity, sales growth of furniture and construction materials picked up, as did the sale of autos and petrol. Retail sales growth has been supported by solid increases in per capita disposable income, which has increased 11½ per cent over the year (faster than nominal GDP). Consumer confidence eased slightly in December, by remains buoyed by rapid income growth, subdued inflation, and renewed optimism following the recent leadership transition.

China's Real GDP Growth



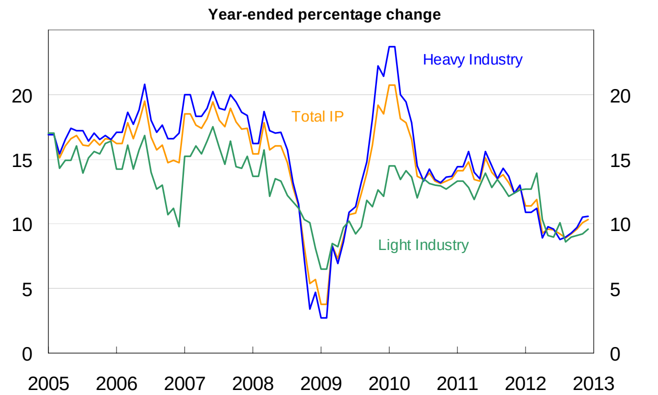
* Data prior to DQ2010 are estimated by NAB.
Source: CEIC Database, NAB

Government Investment Spending



Sources: Thomson Reuters

Industrial Production



Sources: CEIC; NAB

Fixed asset investment continued to grow at a robust pace in December, although our estimates suggest that the pace of growth has eased slightly; FAI increased 20.2% y-o-y (down from 20.9%). The improvement we saw in real estate investment last month appears to have been partly unwound, although construction may have been affected by cold weather. Government investment also slowed in the month (see chart on p.1). The business climate index and entrepreneur confidence both improved in the fourth quarter, signalling that improving sentiment toward the economy and real estate sector could soon filter through to business activity.

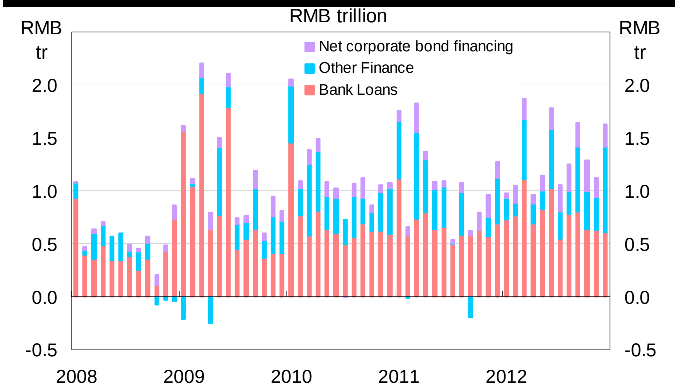
External trade data for December (released earlier this month) surprised on the upside, suggesting that external demand has picked up, while better than expected imports also bodes well for domestic demand. The trade surplus rose sharply in the month to US$31.2bn. Growth in merchandise exports came in at 14.1% over the year, well above market expectations of 5%. This outcome reflected a broad based improvement in exports, and is consistent with an improvement in export orders in recent months. Exports to most major trading partners accelerated, which included a surprising pick up in exports to Europe. Nevertheless, the outlook for export demand remains uncertain in the current climate.

Year-ended CPI growth rose to 2.5% in December (from 2% over the year to November), driven by an acceleration in food costs – partly attributable to supply disruptions from cold weather. While base effects are expected to boost headline CPI numbers over coming months, upstream prices are still suggesting relatively benign inflation pressures; the PPI fell 1.9% over the year.

Chances of another interest rate cut by the PBoC have all but evaporated due to improvements in activity, and while we have not ruled out another cut in reserve requirements, the PBoC has scaled back net liquidity injections in recent months. We continue to expect a 50bp reduction in reserve requirements early this year to alleviate tightness in money markets. New bank loans came in below expectation in December (RMB 454 bn), but an acceleration in non-bank lending suggests that the demand for credit remains robust. This year we expect growth to recover to around 8¼%, with the PBoC possibly commencing monetary tightening later in the year if inflation pressures start to return.

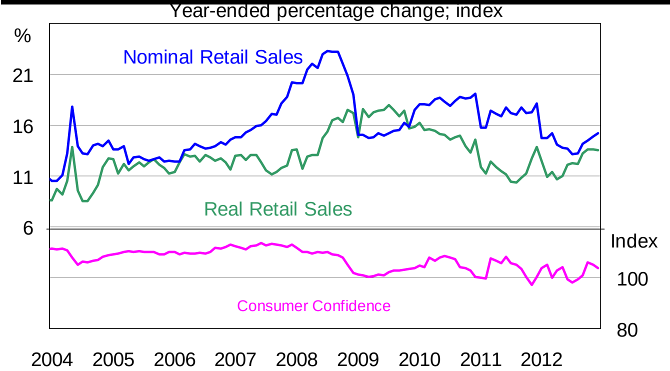
Statistical releases available here:
National Bureau of Statistics
A more comprehensive note will be released in the coming week.

New Total Social Financing (non-bank lending)



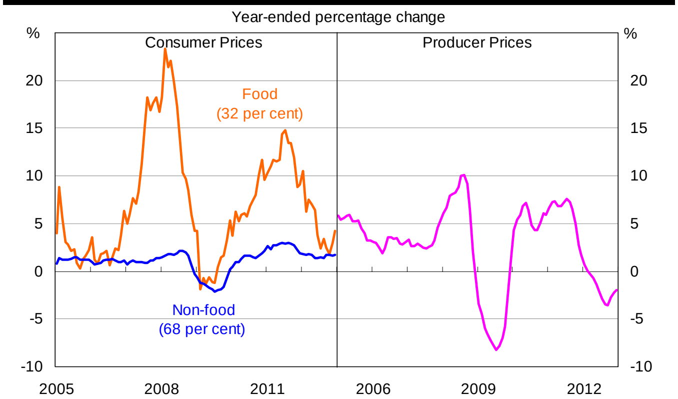
Sources: CEIC; NAB

Retail Sales

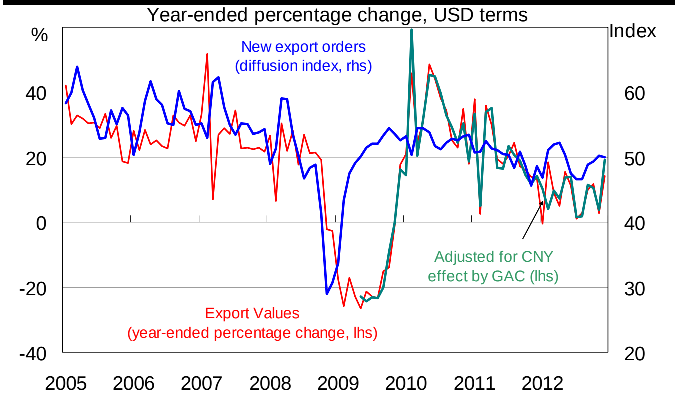


* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.

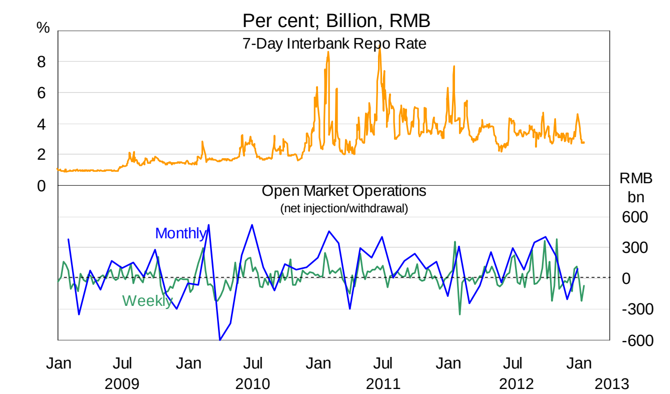
Inflation



Merchandise exports growth



Liquidity conditions

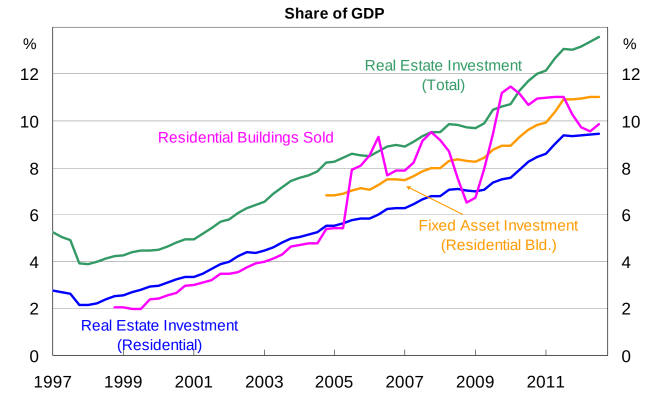


Source: CEIC

Signs of a real estate turn around in China?

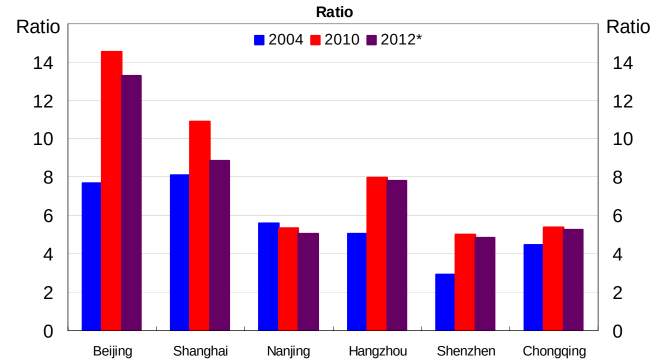
- Of all the potential uncertainties facing the Chinese economy – sluggish global demand, European sovereign debt risks, local government debts – the risk of a domestic real estate market collapse (or conversely, a renewed bubble) is considered to be one of the biggest risks to watch for many analysts. The real estate sector has been a major driver of Chinese growth, thus a sharp correction would have a significant impact on other sectors of the economy. The sector directly contributes over 10 per cent of GDP via real estate investment (see graph), however, the total contribution to the economy is much larger once wealth and income effects are included, not to mention the benefits reaped by related industries.
- Chinese authorities have introduced a number of policy measures in recent years to address concerns over a real estate bubble and growing unrest over the lack of affordable housing. Such measures included stricter requirements on down payments, restrictions on multiple home purchases, a very large affordable housing construction scheme and the introduction of property taxes in Shanghai and Chongqing. There was also a noticeable tightening in monetary policy through 2010/11, with numerous interest rate and reserve requirement ratio hikes, although these were targeted at inflationary pressures more generally.
- These policies appeared to have had some success in deflating the sector over the past 12-months, although more benign economic conditions (at home and abroad) would have also played a part. Residential real estate investment has now slowed relative to the rest of the economy (which has also eased), while house prices have declined from their peaks. Official statistics show prices for new houses are currently around 0.9 per cent below previous peaks, while existing dwellings are 1.9 per cent lower. This is a fairly significant reversal in an economy when incomes are growing rapidly. Consequently, home affordability appears to have improved last year, particularly in cities where property curbs were strictest, although price-to-income ratios remain elevated by most standards.
- However, with the economy slowing more rapidly than many anticipated last year, authorities (particularly some local governments that are heavily reliant on income from property transactions) hinted that they may begin to temper some of the curbs on real estate – a sentiment that was swiftly quashed by central government. Officials have continued to emphasise the need for property curbs, although the emphasis appears to have shifted towards cracking down on speculative investment rather than lowering prices as well.
- Nevertheless, monetary conditions have been loosened via 150bp in cuts to RRR and 50bps in cuts to interest rates in late 2011 and 2012 (along with an increase in interest rate setting flexibility for banks). Credit has also been made more available for first home buyers. Following this, real estate bank loans picked up after H1 2012, driven by a rise in mortgage credit (developer credit has remained relatively steady). Both the volume and value of residential transactions have picked up in H2 2012, and real estate investment has also started to improve in recent months.
- Given these trends, it is possible that authorities would move to stifle the apparent recovery in the sector if necessary to prevent another bubble from forming. With real estate credit, prices and construction activity all picking up, authorities will be sure to keep a close watch on the sector, particularly as the rising stock of unsold floor space continues to put pressure on developers. Authorities are already widely

Direct contribution of real estate sector has been large



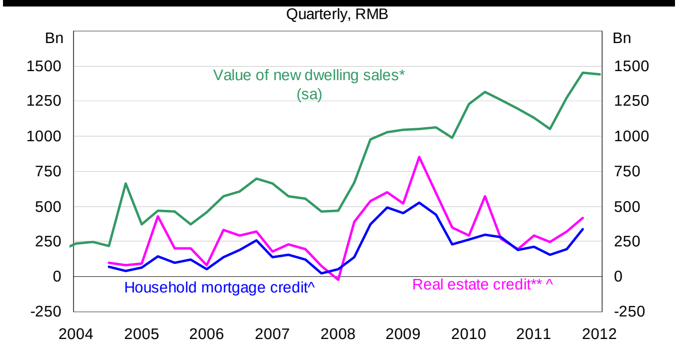
Sources: CEIC, NAB

House Price to Income Ratios



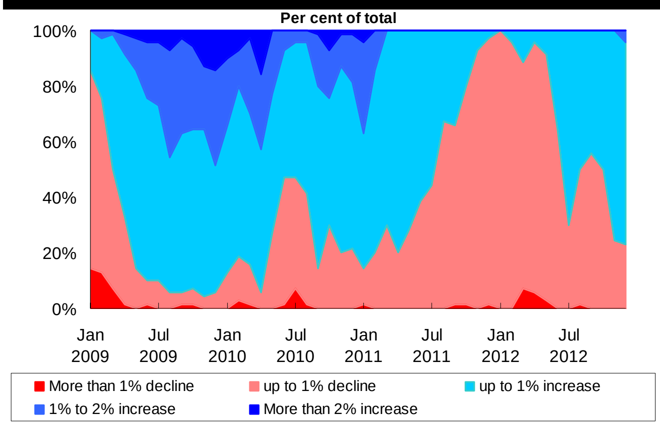
* Price of a 70sqm home as a multiple of household disposable income
** Year to date; Shenzhen is using 2011 data
Sources: CEIC; NAB estimates

Mortgage Credit and New Dwelling Sales



* Estimated by NAB. Includes only new dwellings (pre-sales or completed).
** Includes finance to real estate developers
^ Non-break adjusted

Monthly Residential Prices Growth



expected to expand the current property tax trial to more cities this year, although this may be used to phase out the existing administrative curbs.

- Significant amounts of investment in property over the past decade and the rise of shadow banking activity have heightened the risks stemming from the sector. Measures taken to date have managed to strike a reasonable balance between maintaining economic growth while helping to align the real estate market to fundamentals. Maintaining greater balance in the sector will be a major challenges facing China's new leadership.

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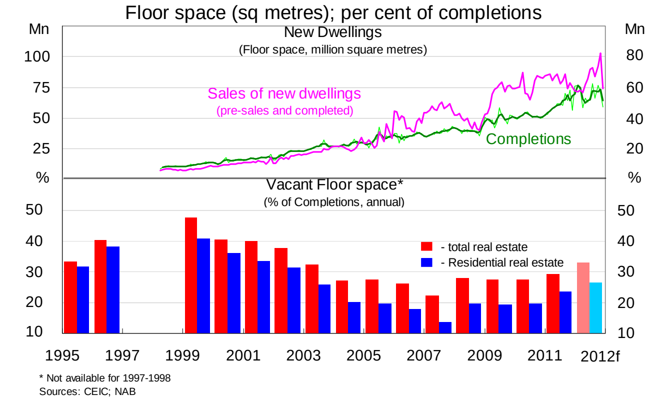
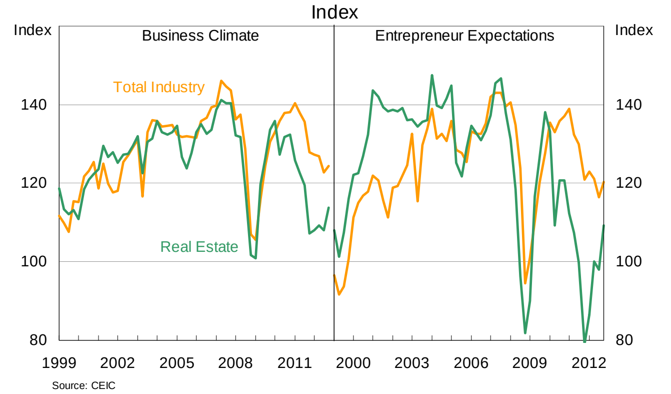
Real Estate Supply/Demand Fundamentals



Real Estate Sentiment



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Important Notices