Chinese Monthly Update

National Australia Bank

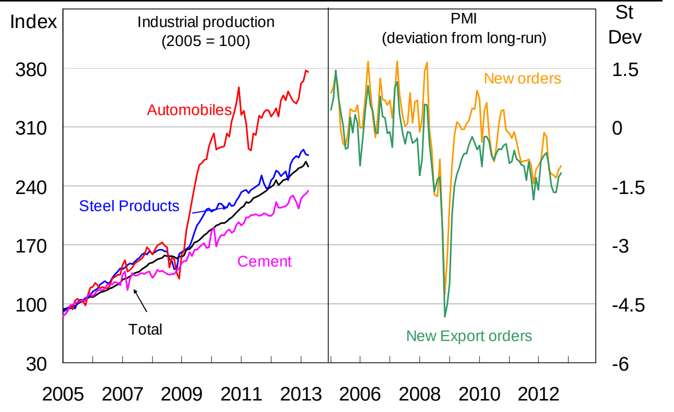
- **Partial economic indicators lack any strong indication that conditions are improving in China. While indicators for April came in broadly consistent with expectations, the market has revised expectations lower in response to a run of disappointing outcomes since the start of the year. Year-ended growth in production ticked higher, but remains subdued. Investment eased moderately, while real retail sales growth was unchanged at relatively subdued levels. Exports have improved, but there is still some question over the accuracy of the data.**
- **CPI inflation remains well within acceptable levels, but strong credit growth – while a positive sign for future GDP growth – may be of concern to policy makers. Nevertheless, we expect interest rates to remain on hold this year.**
- **We revised our forecast for China's GDP growth down further to 7¾% in 2013 and 7½% in 2014 (both were 8% previously). This outlook requires an improvement in activity over coming months.**
- **This month we included a closer look at 'hot money' inflows, which have picked up again after a short reprieve in 2012. Authorities have responded, but an uncertain global environment could be the determining factor.**

The Chinese economy continued to exhibit signs of below expected rates of economic growth going into the June quarter. While we are not seeing any clear indications of a significant downturn in the economy, there is also no sign of the acceleration that appeared likely at the start of the year. In response, we have lowered our growth forecasts to 7.8% in 2013 (from 8%) and 7.6% in 2014 (from 8%). However, we have not altered our outlook for monetary or fiscal policy, with PBoC expected to remain on the sidelines until next year – managing liquidity conditions via short term market operations.

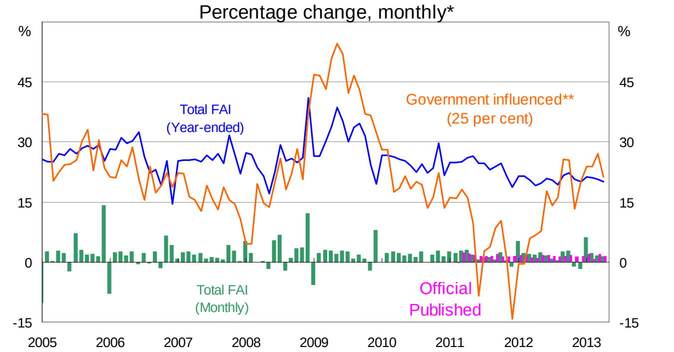
Turning to April's outcomes, many of the partial indicators came out broadly in line with market expectations. However, expectations have been revised down significantly following a string of surprises to the downside since the start of the year. Industrial production growth ticked slightly higher in April to 9.3% yoy, although this is still well below the long run average. The improvement was in contrast to manufacturing PMI indicators – an early gauge of industrial activity – which recorded marginal deterioration in the month, largely driven by a decline in new orders (particularly for exports). By product line, stronger production growth was assisted by a rise in cement (8.7%) and motor vehicle (18.3%) production, as well a power generation (6.2%). However, overcapacity in some industries is having an impact, and is likely to weigh on growth and commodity demand.

Our estimates of fixed asset investment growth show that momentum has eased slightly, but investment growth has

China's industrial production – selected products

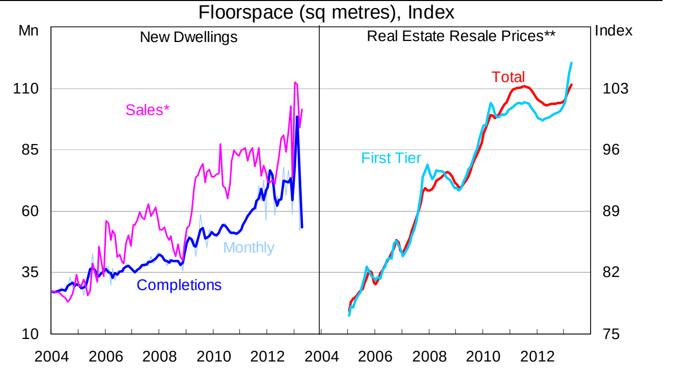


China's fixed asset investment



* World Bank definition; includes sectors dominated by state-owned companies and public entities. Covers utilities, transport, water and environmental conservation, education, health care, social security, culture, sport, and public administration.
Sources: CEIC; NAB

Annual house price growth (proportion of cities)



* Includes only new dwellings (pre-sales or completed).
** Weight average of cities. Calculated by NAB.
Source: CEIC, NAB

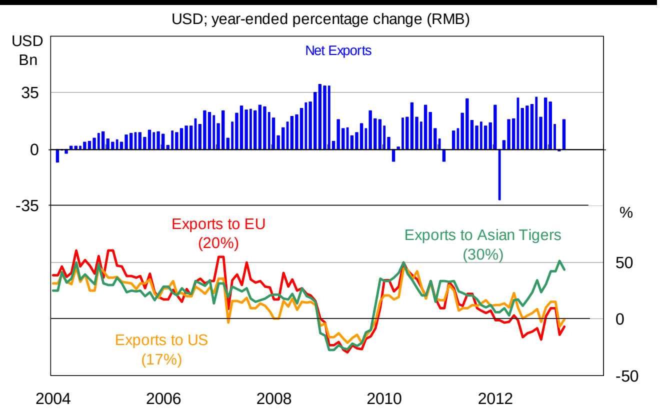
maintained a healthy pace (increasing 20.2% y-o-y). By sector, investment in manufacturing has softened significantly since late 2011, responding to over-capacity in some industries (particularly steel, cement, aluminium, plate glass and coking coal). Signs of acceleration in government led investment stimulus have become less apparent in recent months. Investment in public utilities has eased slightly, so too has central government investment (around 10% yoy in April, down from almost 20% yoy late last year).

Growth in real estate investment showed more signs of stabilisation (increasing 23½% y-o-y), but this is partly due to base effects, with construction activity (seasonally adjusted) easing from peaks earlier in the year.. Sales growth has also slowed as the sector comes under pressure from the government's renewed focus on deflating the sector. Prices in first-tier cities have recovered quite strongly and are now well beyond previous peaks. The turnaround in property prices has been broad based – which will be concerning to policy makers – as prices of new homes declined in just 2 of 70 cities in April, while the number of cities reporting an annual price increase greater than 1% improved to 65. Activity in commercial property appears to have bottomed, although excess capacity has emerged in some second and third tier cities.

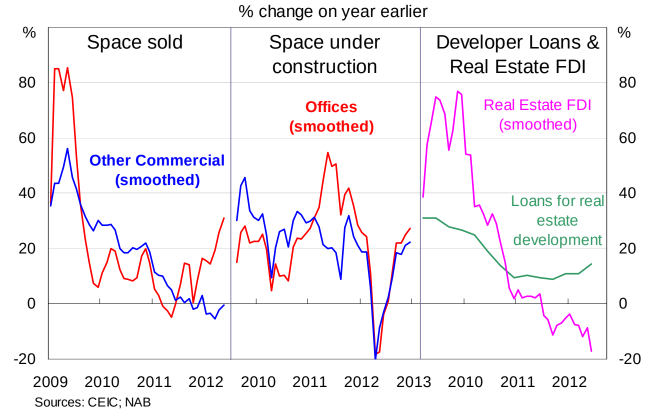
Turning to consumption, nominal retail sales growth was in line with market expectations for April, picking up slightly to 12.8% over the year. Retail price inflation rose in April, implying real growth in retail sales of 11.8% (broadly unchanged from the previous month). There was also a noticeable easing in consumer confidence over recent months, which is more consistent with the softer rates of consumption and income growth we have seen recently. Nevertheless, indicators of employment conditions – while they have eased – continue to look solid and should remain supportive of household consumption growth. Sentiment towards employment has improved markedly, and employment demand within the services sector (as measured by the PMI) has been solid. By commodity, sales growth accelerated for automobiles and jewelry, while sales of food, clothing and daily use products eased. Sales of items tied-in with real estate development (furniture, construction materials etc) also slowed.

Export growth was once again above expectations in April, although questions are still being asked over the accuracy of the data (see below). Merchandise exports rose 7.7% (seasonally adjusted) in April, to be 14.7% higher over the year. Export data (seasonally adjusted by NAB) shows a solid rise in exports to most major trading partners in the month of April, although Hong Kong was a notable exception following the questionable surge in trade in March. Given the decline in imports from the previous month, the trade balance jumped in April to US$18.2bn. Commodity imports showed some improvement; iron ore and coal volumes were higher in the month, while copper imports fell and crude oil was broadly flat. Trade conditions are expected to

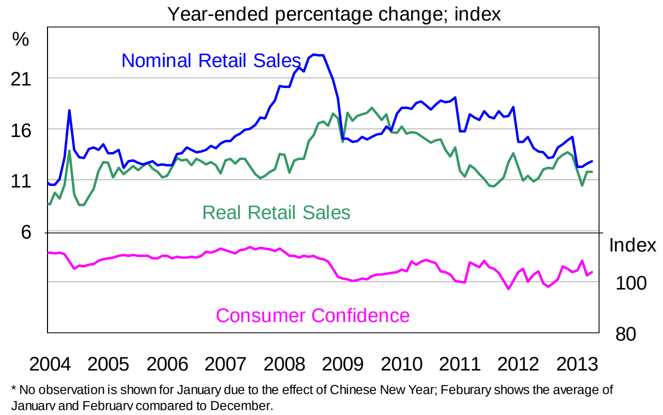
Employment indicators



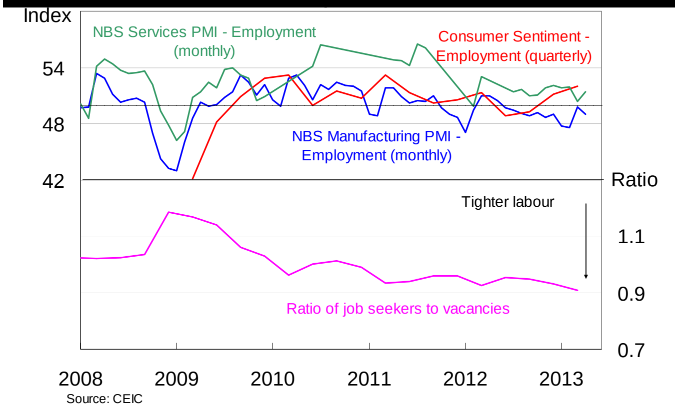
Commercial property indicators



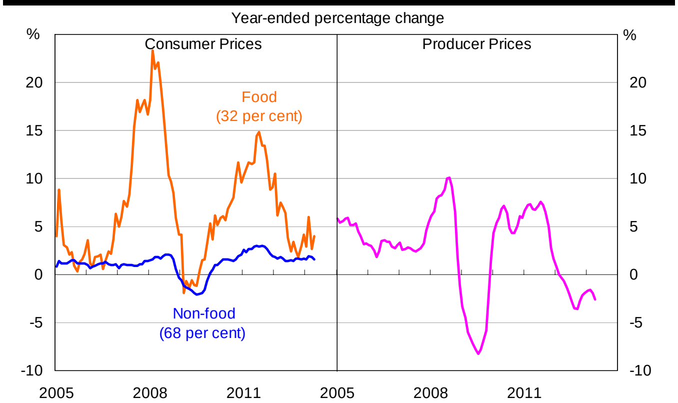
Consumption indicators



Employment indicators



Price inflation



improve this year, although the mixed economic indicators out of many major economies suggest that headwinds remain. Export orders shifted well back into contraction levels in April, and strong appreciation of the RMB is likely to constrain any potential recovery in Chinese exports.

Finally on inflation, year-ended CPI growth moved higher to 2.4% in April (from 2.1% in March). This suggests that inflation pressures remain muted (for now), reducing the need for policy tightening in the near-to-medium term. Higher inflation was driven mostly by a rise in food costs, while non-food inflation actually eased slightly. While base effects and an improving global economy later this year (likely to lead to pressure on commodity prices) are expected to boost headline CPI numbers over the rest of the year, upstream prices are still suggesting relatively benign inflation pressures; producer prices fell 2.6% over the year.

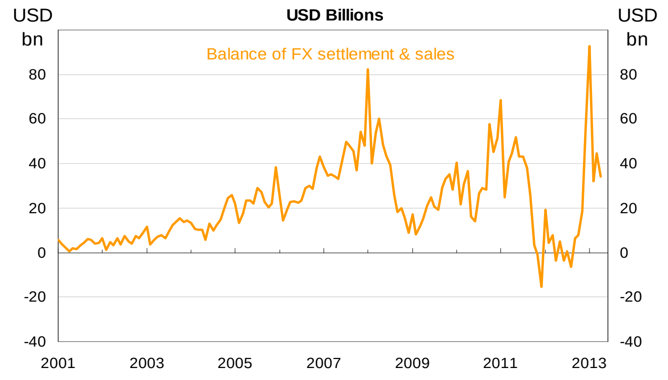
Hot money flows adding to uncertainty

In recent years, quantitative easing policies undertaken by central banks have contributed to global liquidity, generating waves of capital that have made a bee line for emerging markets. China has been particularly vulnerable to these 'hot money' inflows as a result of its relative economic strength during times of global economic uncertainty – underpinned by positive long term growth fundamentals – and the prevailing view that the RMB remains undervalued. These factors make China an attractive destination for money seeking out higher yields. Since 2007, interest rates in China and the United States have generally moved in opposite directions, creating an incentive for investors to shift their deposits from the US to China for a higher rate of return. In addition to this, the RMB has appreciated almost 10% since the temporary USD peg was removed in mid-2010, and plans to internationalise the currency led many to expect further appreciation going forward – further bolstering returns in USD terms.

While foreign capital injections can be positive for an economy – generating much needed investment and importing expertise – there are a number of reasons why authorities generally try to discourage 'hot money' flows. Currency appreciation and inflationary pressures (which erode export competitiveness) and capital volatility are all symptoms of 'hot money' flows that can work to destabilise an economy. In China's case, many of these risks have generally been kept to a minimum in the past due to rigid controls over capital markets (although these are gradually being loosened). Nevertheless, investors have often managed to skirt China's capital controls by such means as misreporting of direct investment or trade data for example – a strategy that appears to have been employed heavily in recent months. 'Hot' inflows have picked up again since the start of 2013. Reflecting the magnitude of the flows, bank's balances on FX settlements and sales soared to an average USD 51 bn in the first four months of this, up from USD 9 bn last year, while FX reserves rose by a large USD 131 billion in the first quarter .

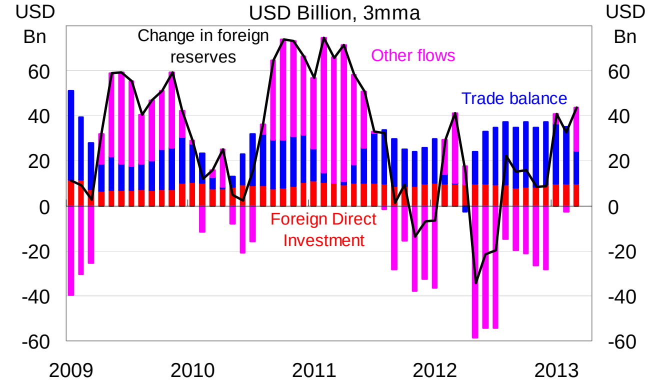
Previous bouts of 'hot money' flows to China have contributed to a sharp rise in their money supply – despite sterilised currency intervention – generating inflationary pressures and exacerbating price bubbles in equity and housing markets. To address these issues, China has had to employ targeted administrative measures, including lending quotas on banks to try and deflate the property market, and price controls on food and energy. These measures appeared to have some success in deterring capital inflows between late 2011 and late 2012, helping bring consumer and real estate prices back towards more manageable levels – although deterioration in China's economic outlook last year also contributed. While 'cold flows' such as direct investment and (to a lesser extent) net trade remained relatively stable/positive last year, 'other flows' reversed heavily over 2012, alleviating pressure on the currency and domestic prices (including real estate).

China's capital inflows picking up again



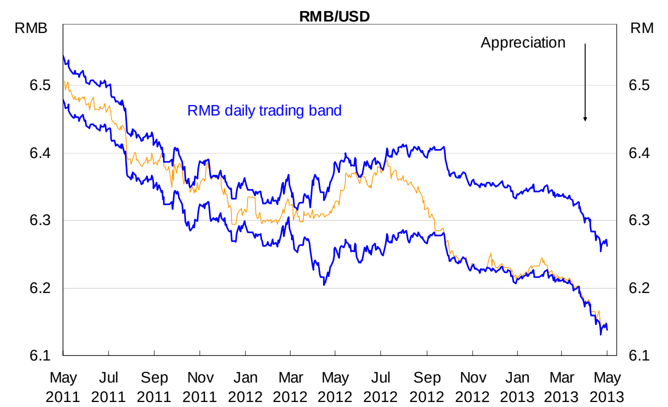
Source: CEIC

'Cold' flows relatively steady, while 'other' turns positive

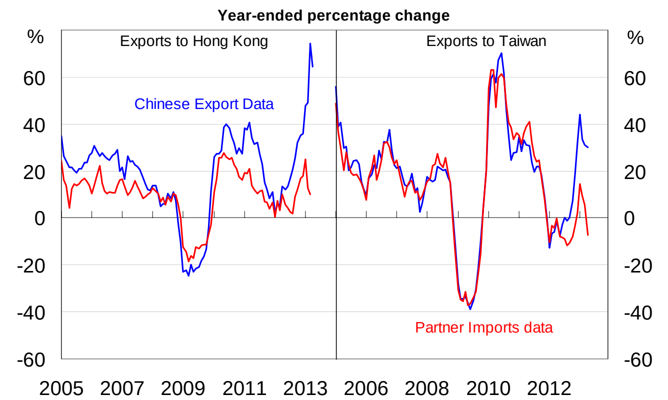


Sources: CEIC; NAB

Inflows putting pressure on currency to appreciate)



China's inflated export numbers becoming more apparent



Sources: CEIC; NAB

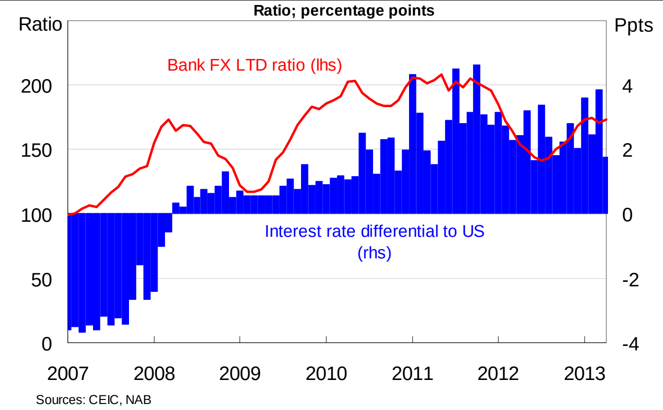
Flows of ‘hot money’ are difficult to quantify, but a handful of indicators – such as net FX sales & settlements and changes in foreign reserves – demonstrate a tentative link between China’s ‘hot’ inflows and monetary stimulus in developed economies (particularly the Fed’s QE programs of late 2008 and 2010); generally surging in the 12 months following the commencement of each QE program. As major central banks around the world press on with their large cash injections to bolster their respective economies, the negative consequences in a place like China are beginning to become more apparent.

Despite slowing GDP growth, and indications that this is set to continue along a more moderate track, monetary aggregates have picked up from last year’s lows, outpacing the nominal growth rate of the economy. China’s money supply (M2) to annual GDP jumped 5 percentage points in the first quarter of 2013. While such a trend could be the result of a number of factors, the concern is that it is signalling the imminent onset of more rapid inflation – property prices have started to pick up noticeably, possibly a symptom of more abundant liquidity. Nevertheless, speculative demand for RMB assets has continued, possibly reflecting expectations for a shift in policy stance that will see interest rates – and the RMB – move higher, well before any comparable move in developed economies. Indeed, our own forecast is for the PBoC to commence interest rate hikes some time during 2014 in response to building inflation pressures.

In an attempt to stem inflows, authorities have recently responded by ramping up macroprudential measures, taking aim at large speculative currency positions held by banks and deliberate misreporting of exports. The former (which comes into operation July 1st) is perhaps the most significant, limiting net open positions by a formula relating to loan to deposit ratios (LTD) of FX on banks balance sheets. The system wide FX LTD ratio of banks is currently around 170% (lower once policy banks are excluded), which is well above levels allowed under the formula. As banks unwind their positions over the coming month to comply with the requirement, the ensuing USD demand is likely to outstrip FDI and trade demand for RMB, placing downward pressure on the RMB – potentially providing an opportunity to further liberalise the RMB by widening the daily trading band.

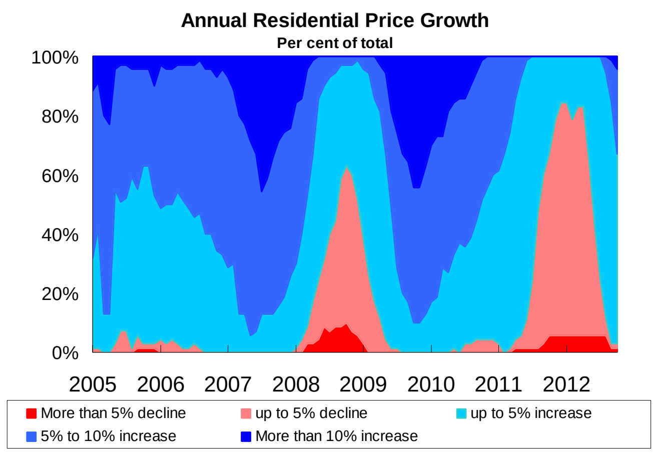
While these policies should help to stem inflows and alleviate some pressure on USD/RMB spot rates, there have been increasing calls for a reduction in interest rates to remove the allure of interest rate differentials – simultaneously lending support to the softening real economy. Although an interest rate cut is a possibility, we do not think it is a likely response from Chinese policy makers who continue to voice concerns about excessive credit accumulation, overinvestment in some sectors, and looming inflation pressures. Rather, we are likely to see continued use of macroprudential measures (and its management of the currency) to discourage inflows, and money market operations to sterilise currency interventions. In May, the PBoC commenced issuing bills (3 month maturity) for the first time in 17 months (RMB10 bn in early May and RMB 44 bn the following week) to help soak up the added liquidity and stabilise interest rates; however, these only partly offset maturing bills and repos.

Authorities to clamp down on carry trade positions

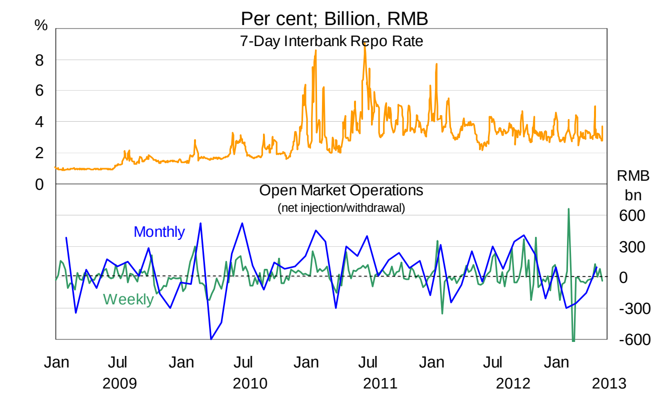


Sources: CEIC, NAB

Asset price pressures are re-emerging



PBoC managing liquidity via open market operations



Source: CEIC

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Economic Forecasts

	Year Average Chng %			Year-ended Chng %								
				2012	2013				2014			
	2012	**2013**	**2014**	Q4	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Real GDP	7.8	***7.8***	***7.6***	7.9	*7.7*	***7.8***	***7.9***	***7.9***	***7.9***	***7.8***	***7.4***	***7.3***
Exchange Rate (USD/CNY)	6.3	***6.1***	***6.1***	6.4	*6.2*	***6.1***	***6.1***	***6.1***	***6.1***	***6.1***	***6.1***	***6.1***
Monetary Policy (end of period)												
Benchmark Lending Rate	6.00	***6.0***	***7.0***	6.00	*6.00*	***6.00***	***6.00***	***6.00***	***6.25***	***6.50***	***6.75***	***7.00***
Reserve Ratio Requirement*	20.0	***21.0***	***21.0***	20.0	*20.0*	***20.0***	***20.0***	***20.0***	***20.0***	***20.0***	***20.0***	***20.0***

Sources: CEIC; NAB Group Economics

*** For large depository institutions**

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