Brief China Economic Update

Partial economic indicators were largely in line with expectations during April. However, we are yet to see signs that real activity is picking up significantly, although monetary expansion has been much more rapid. Nevertheless, we have left our growth expectations for 2013 unchanged at 8%, although we continue to view the risks as skewed to the downside – sub-8% growth this year is looking increasingly likely. But even with the growth outlook turning more moderate, expectations for the Chinese economy – and the currency – have encouraged capital inflow since late last year (spurred on by quantitative easing by major central banks). These factors are creating a quandary for policy makers who have become increasingly concerned over building inflationary pressures and (arguably unsustainable) expansion in system credit. Consequently, this has added to the uncertainty surrounding the likely path of macro economic policy in China.

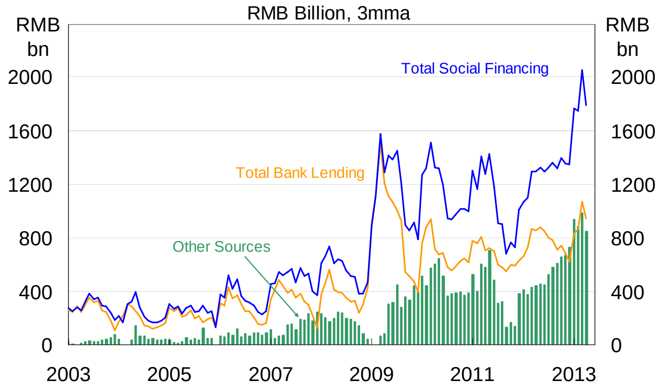
Credit growth has stepped up noticeably in the first four months of the year. Although total social finance issued in April eased back from the previous months record, it remained high at RMB1.7 tn for the month (RMB7.9 tn in the year to date). Bank credit increased 16.1% over the year, with RMB878 bn in bank loans issued in April (27% higher than last year). At face value, strong credit growth may be considered a positive sign for the economy – if the funds are put to productive use. However, this trend is becoming a concern in light of rapid credit and investment growth over recent years that has contributed to an excess of (unproductive) capacity – total credit to GDP has risen from around 120% of GDP in 2008 to around 190% this year.

Capital inflows – including hot money looking for higher yield – are contributing to excess liquidity in the system. In the first quarter of the year, foreign reserves increased around USD131 bn, with only a small amount of this attributed to direct foreign investment – raising the risk of disruption from (volatile) 'hot money' flows. In an attempt to stem these flows, authorities responded recently by ramping up macroprudential measures, taking aim at large speculative currency positions held by banks and deliberate misreporting of exports. 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.

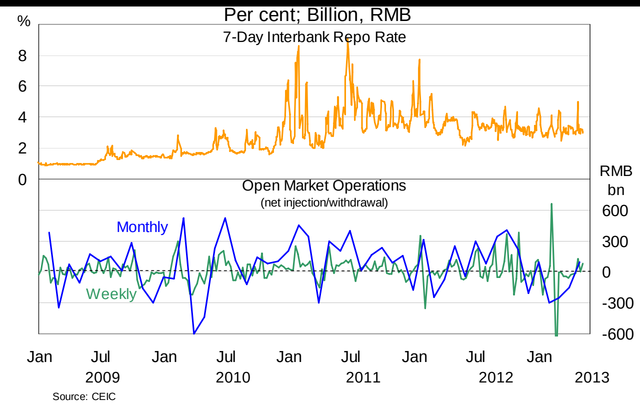
Rather, we are likely to see continued use of macroprudential measures (and its management of the currency) to discourage inflows, and money market operations to sterilise currency interventions. In May, the PBoC issued RMB10 bn in bank bills (3 month maturity) – the first bills issued in nearly 17 months – to help soak up the added liquidity and stabilise interest rates; however, these only partly offset maturing bills and repos.

Turning to real activity, there is still a lack of any strong indication that the economy has accelerated as expected. Partial indicators have generally surprised on the downside since the start of the

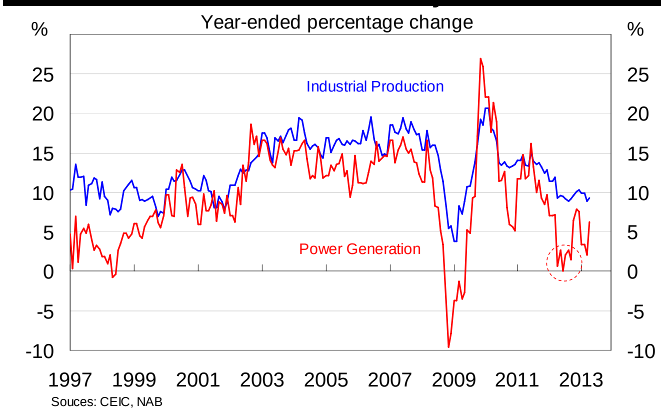
Total social financing



Liquidity conditions



Industrial Production



year, highlighting the slack that remains in private demand despite government efforts to jump start the economy last year. April's outcomes were more in line with expectations, but market expectations have been revised significantly lower in recent months. Nevertheless, electricity production growth – often cited as a good indicator of the underlying strength of the economy – accelerated in April, although it remains at a subdued pace. However, other trends in the industrial sector are still a concern. Soft demand and a rapid build up of excess capacity has contributed to struggles experienced by the sector. Data for capacity utilisation, available to December 2012, shows a steady deterioration over the course of last year – a trend that has likely continued going into this year. This is contributing – along with lower commodity prices – to deflation of producer prices; PPI inflation dipped to -2.6% in April. Falling prices is weighing on profitability in some industries and making it more difficult to pay off debts. Producers of materials such as steel, coal, glass, aluminium and cement are particularly affected by excess capacity.

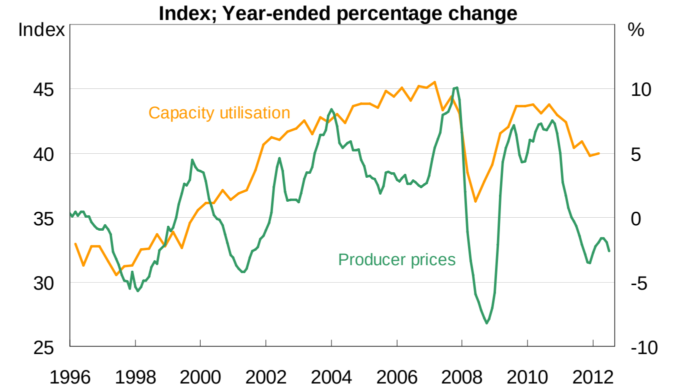
Industrial production growth ticked slightly higher in April to 9.3%, although this is still well below the long run average. The improvement was in contrast to timelier manufacturing PMI's which recorded marginal deterioration in the month. The official PMI published by the NBS eased slightly to 50.6 in April (down from 50.9), driven by a decline in new orders (particularly for exports) – pointing to a continuation of more moderate industrial activity in coming months. The PMI also reverted back to showing de-stocking in April. 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%).

Our estimates of fixed asset investment growth show that momentum has eased slightly, but investment growth has maintained a healthy pace (increasing 20.2% y-o-y). By sector, investment in manufacturing has softened significantly since late 2011 as industry comes to grips with over-capacity in some sectors (particularly steel, cement, aluminium, plate glass and coking coal). Growth in real estate investment continues to show signs of stabilisation (increasing 23½% y-o-y), but is likely to see headwinds in response to additional uncertainty in the wake of the governments renewed focus on deflating the sector. 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).

Turning to consumption, nominal retail sales growth came in dead 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 downturn in consumer confidence in March, which is more consistent with the softer rates of consumption and income growth we have seen recently. By commodity, there was an acceleration in sales growth 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.

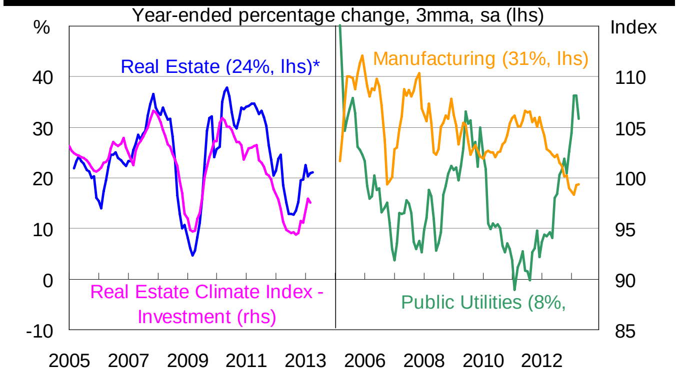
Export growth was once again above expectations in April, although questions are still being asked over the accuracy of the data – exports may be getting misreported in order to disguise hot money inflows (see below). Merchandise exports rose 7.7% (seasonally adjusted) in April, to be 14.7% higher over 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; exports to other parts of Asia picked up in the month. The relatively broad based rise in

Industrial sector is deflating?



Source: CEIC

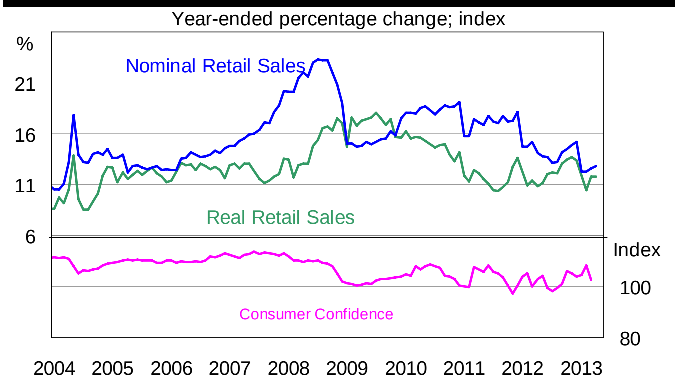
Fixed Asset Investment by Sector



Source: CEIC, NAB

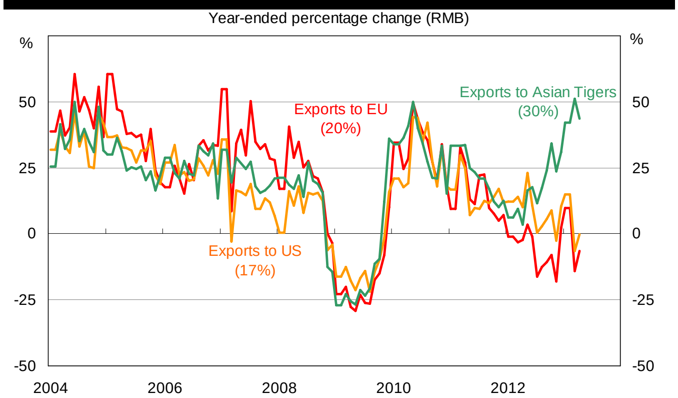
* Number in brackets represents share of total FAI in 2010; Real Estate is using Real Estate Investment data

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.

Merchandise exports to major trading partners



Sources: CEIC; NAB

exports for the month could be an indication of improving global demand, which is a good sign for the slowing Chinese manufacturing sector, although exports of capital and high-tech goods appears to have declined in the month. Given the decline in imports from the previous month, the trade balance jumped in April to US$18.2bn. Merchandise imports fell 6.6% m-o-m (sa) in April. Data published by the NBS adjusted for seasonality show annualised growth easing to 7.9% over the year from 23.7% in March. By commodity, iron ore and coal volumes were higher in the month, while copper imports fell; crude oil was broadly flat.

Trade conditions are expected to improve this year, although the mixed economic indicators out of many major economies suggest that headwinds remain. Export orders showed only a temporary improvement in March and shifted well back into contraction levels in April. Appreciation of the RMB is likely to constrain any potential recovery in Chinese exports, although the JPY depreciation since late last year is likely to weigh most heavily on competing exporters like Taiwan and Korea.

As mentioned above, in response to concerns over misreporting of exports the State Administration of Foreign Exchange (SAFE) signalled the need for more stringent trade records (to match up invoices with a physical transaction of goods) in addition to tighter regulations on forex positions. The magnitude of the problem can be seen when comparing exports data to customs data from Hong Kong and Taiwan – two hubs often used for hidden capital flows. However, with the economy softening and the government crack down on speculative sectors (such as real estate), these practices were likely to abate of their own accord.

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 (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.

Policy expectation:

On monetary policy, while the return to central bank bill issuance last week could signal a shift to a tightening monetary bias by the PBoC, we think that they are likely to refrain from more heavy handed moves, such as raising the reserve requirement, while growth foundations are not looking solid. However the central bank is also wary about potential inflation pressures. Consequently, we expect the PBoC to remain on the sidelines this year, but it will continue to employ market operations to control liquidity and manage the impact from capital inflows.

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

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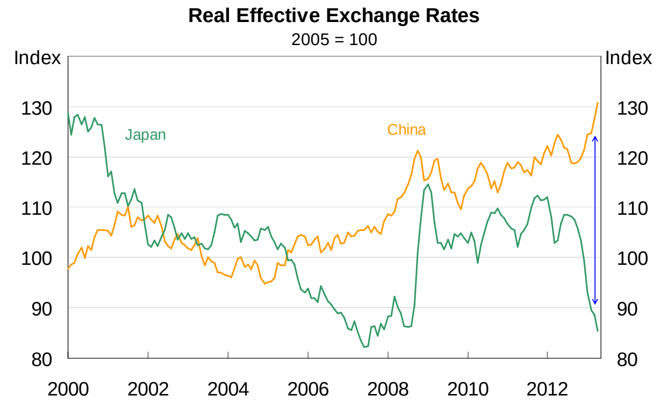
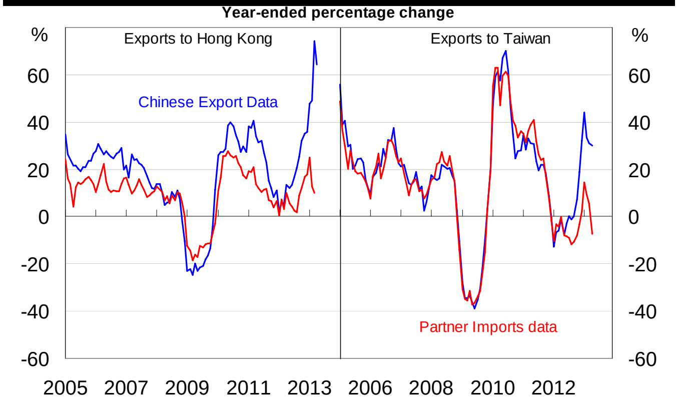
Appreciation to weigh on competitiveness



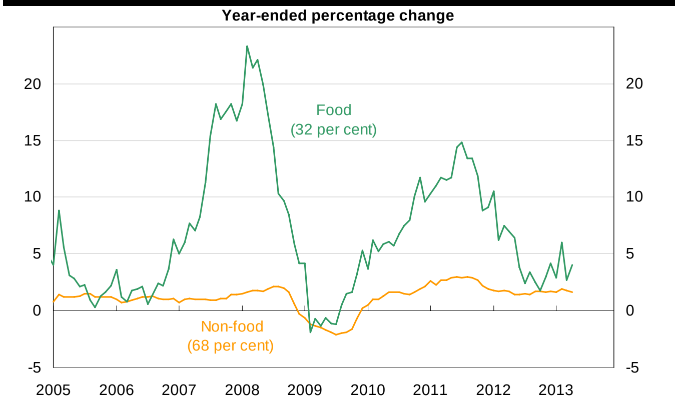
Sources: CEIC; NAB

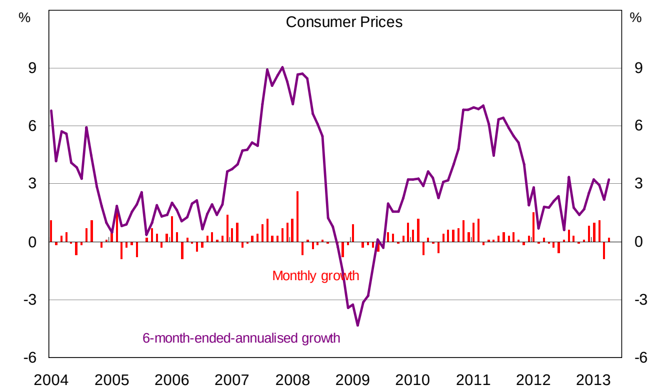
China's inflated export data



Sources: CEIC; NAB

Consumer Prices





Source: CEIC Database, NAB

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