Brief China Economic Update

National Australia Bank

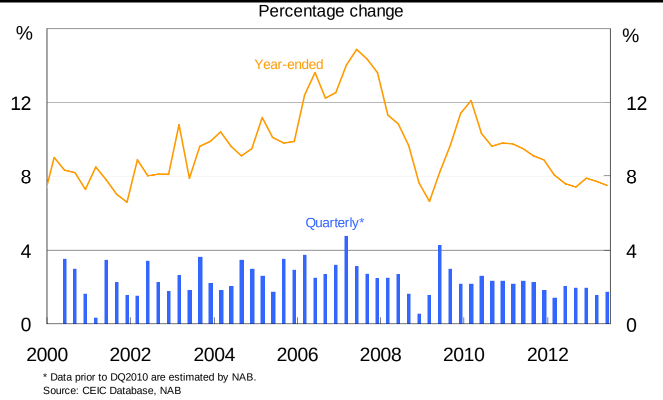
According to National Accounts data released today, the Chinese economy grew 1.7% in the June quarter to be 7.5% larger than the same period last year. This result is in line with our forecast for the quarter, but is a solid outcome relative to the recent spate of soft partial indicators nonetheless. In contrast to rebalancing objectives, official data show that growth over the year in H1 2013 was driven by investment (contributing 4.1ppts to growth), followed by consumption (3.4 ppts). Net exports made a negligible contribution. Revised q-o-q growth rates suggest the economy's growth momentum has stabilised at a slower pace than we saw towards the end of 2012. While some of the slowing has been an intentional attempt by authorities to achieve more sustainable (and balanced) growth, maintaining this pace of growth (6.8% saar) for H2 2013 would see annual growth dip below the government's target of 7.5%.

While this could suggest some downside risk to our outlook, we are maintaining our forecast (for now) of 7.5% growth for 2013. Regarding the policy outlook, the relatively hardline stance taken by policymakers in the past month suggests that they may keep monetary conditions tighter for a little while longer – indicating that there will be no cuts to interest rates. The liquidity squeeze that created market jitters during June has largely subsided, although conditions remain tighter than they were earlier in the year. Nevertheless, with inflation pressures remaining under control we can not rule out the possibility of policy stimulus measures to help achieve the growth target for the year. This could potentially include cuts to bank's reserve requirements, although this is not provided for in our forecast.

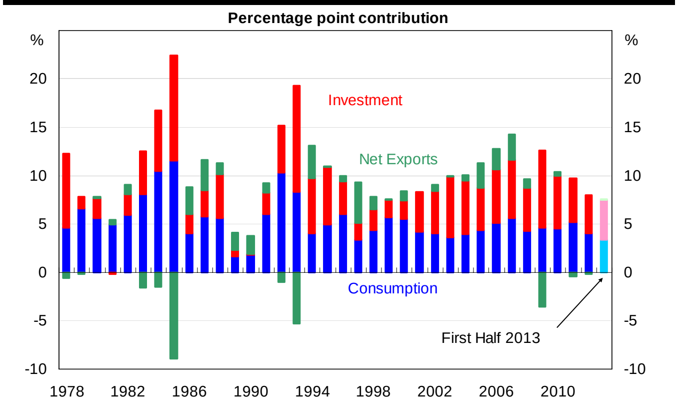
Partial economic indicators show that weak overseas demand has weighed on China's manufacturing sector, although domestic demand has also been softer, due in part to the government's rebalancing efforts – including a tighter stance on credit policies. Although the deceleration appears to be occurring at a gradual pace – once we account for the impact of policy changes – hope of a meaningful acceleration in activity during H2 2013 is looking increasingly unlikely. Business surveys show that conditions facing Chinese firms remain challenging, while signs of improvement in the important real estate sector appear to be losing traction as credit conditions tighten and authorities work to rein in the sector. However, it is the conditions facing retail and wholesale business that is particularly concerning since much of the rebalancing needed in the economy – a major focus of the Chinese leadership – will rely on much stronger household consumption. Further to this, growth in real urban household's disposable income has undershot GDP in H1 2013 (6.5%), although income growth for rural households was somewhat better (9.2%).

Many of the partial indicators came out relatively consistent with expectations for June, although some sectors were a little stronger while others were a little weaker. Overall however, they generally point to a much softer economy than we would like to see. Industrial production growth decelerated again in June to 8.9%, which is well below the long run average. Manufacturing PMI's show that small and medium sized manufacturers have come under the most pressures in recent months with the HSBC

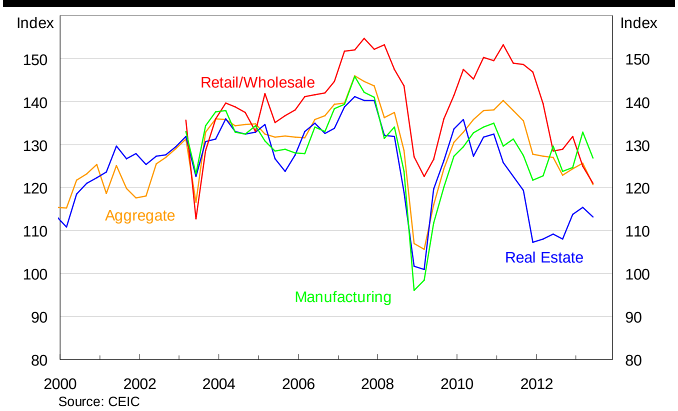
Real GDP Growth



Contribution to GDP growth



China's business climate – concerning trend for retail



PMI – which is more representative of these firms – dipping further below 50 to 48.2 (from 49.2). In contrast, the official PMI index – which is more representative of larger and state owned firms – remains above neutral levels, although it eased to 50.1 in June (from 50.8). Nevertheless, both heavy and light industries have slowed according to official data; growth in heavy industry production eased to 9.3% y-o-y (from 9.8%) while light industry eased to 7.9% y-o-y (from 8%). By product, steel output rose 7.2% over the year to June, while cement production increased 8.8%. Looking at other products, vehicle and textile production eased to 13.5% and 8% respectively, while power generation rose to 6% and general equipment production picked up to 9.9%.

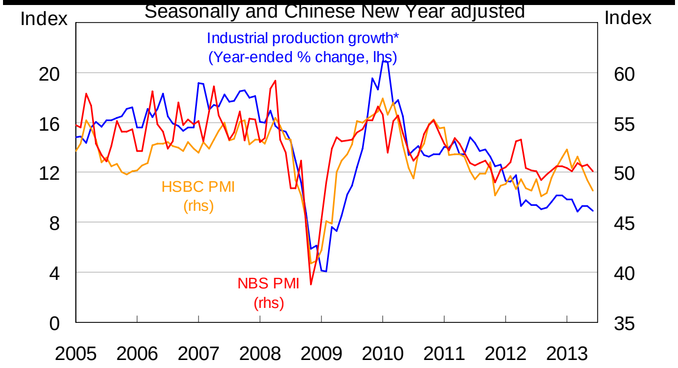
The national accounts show that the services sector has remained relatively resilient with tertiary GDP rising by 8.3% over the year in H1 2013, the same as the first quarter. This is despite other indicators for the services sector softening; the services PMI eased to 53.9 in June from 56.1 at the end of 2012. Policies designed to support the services sector (such as VAT reforms, tax cuts for SME's and targeted credit support) probably contributed to the solid result.

Our estimates of fixed asset investment growth show that momentum has eased further with growth dipping to 19.2% y-o-y, the slowest pace since April 2012. 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 has remained volatile, but has not returned to the lows of last year despite rising headwinds (increasing 20½% y-o-y). Forward indicators are pointing to ongoing weakness in investment, with annual growth in newly started projects easing to 15.1% in the year to date (down from 15.6%). However, growth in residential floorspace started actually picked up in the month. Government led investment stimulus appears to have stabilised in recent months, although investment in public utilities has eased, as has central government investment (around 9% yoy in June, down from almost 20% yoy late last year).

Turning to consumption, nominal retail sales growth came in above market expectations for June, picking up to 13.3% over the year, but much of the acceleration was driven by higher retail prices in the month, while nominal growth remains below the government's 14½% target for 2013. Retail price inflation picked up in June, implying real growth in retail sales of 11.7% (down from 12.2% the previous month). The slowdown is relatively consistent with deterioration in consumer confidence, which tends to be highly sensitive to price movements. Sales growth in automobiles and textiles contributed to the improvement, while sales growth for food items, household electronics and daily use items slowed. Spending on catering services improved again in June after coming under pressure from anti-extravagance measures earlier in the year, while sales of items tied-in with real estate development (furniture, construction materials etc) slowed.

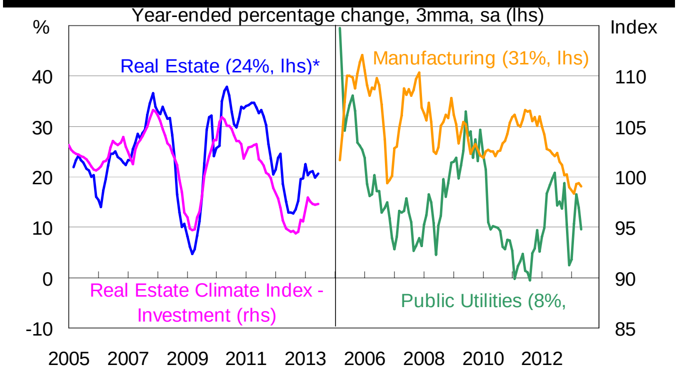
A clamp down on misreporting of exports contributed to yet another disappointing outcome for exports growth in June. Growth in merchandise exports deteriorated to -3.3% over the year to June (-1% y-o-y seasonally adjusted), down from 0.9% in May. Most of the deterioration was again focused in trading partners such as Hong Kong and Taiwan, where inflating of export data – to disguise the movement of capital is thought to be most common. Exports to Hong Kong and Taiwan declined by 7% and 2.2% over the year respectively, down from 7.7% and 26.7% in May. However, exports to other regions have eased as well. With headwinds from weak external demand and a higher exchange rate, this outcome probably more accurately represents conditions facing Chinese exporters.

Industrial Production



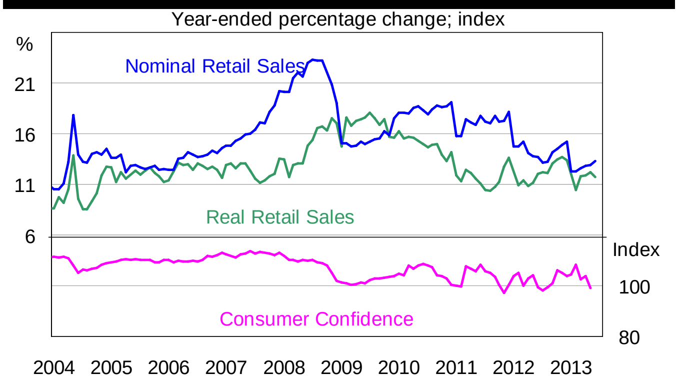
* Adjusted for Chinese New Year
Source: CEIC, Nab

Fixed Asset Investment by Sector



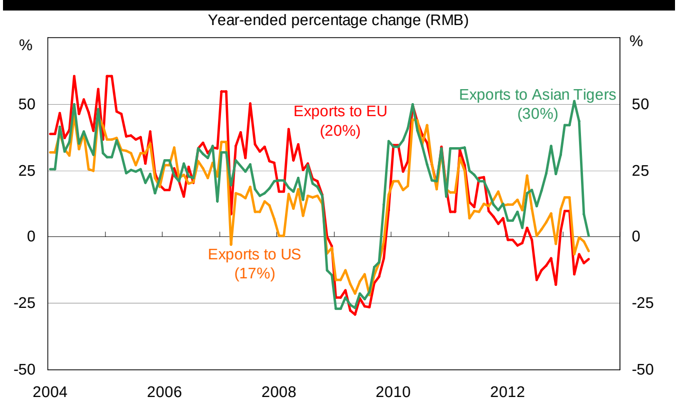
Source: CEIC, NAB
* Number in brackets represents share of total FAI in 2010; Real Estate is using Real Estate Investment data

Retail Sales



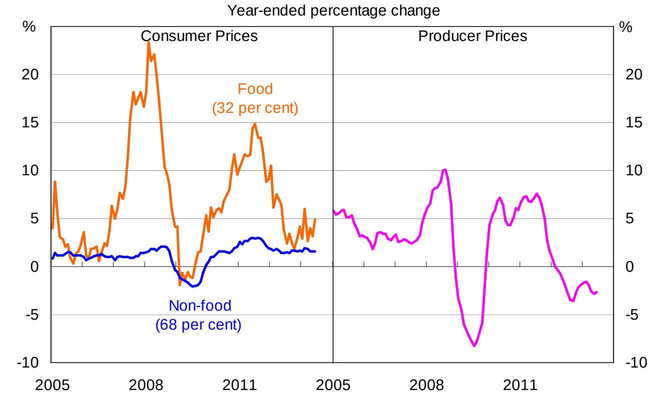
* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.

Merchandise exports to major trading partners

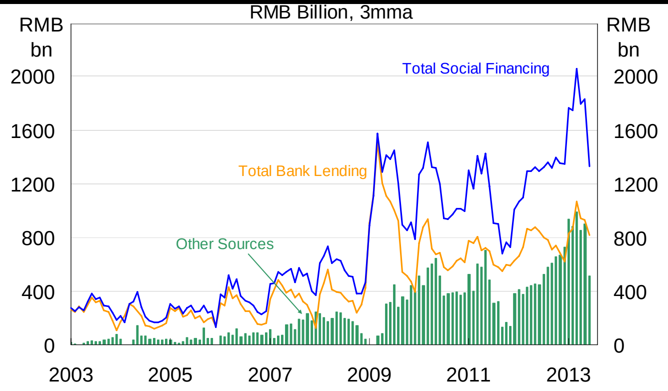


Sources: CEIC; NAB

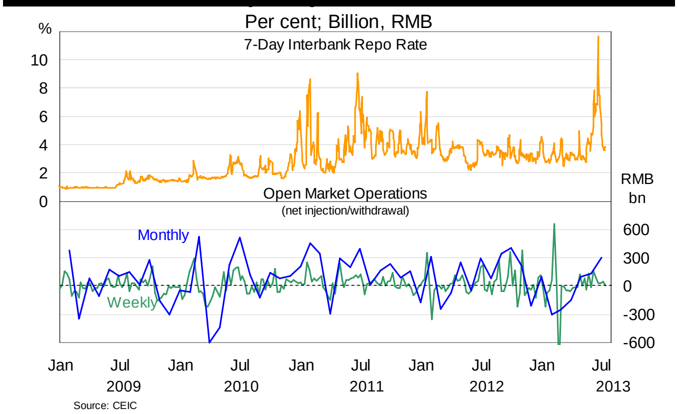
Consumer Prices



Total social financing



Liquidity conditions



Softness in domestic demand and manufactured exports has weighed on imports this year, declining 0.9% over the year to June, although imports actually rose 3.2% in the month (seasonally adjusted), following an 8.6% decline in the previous month. Imports of raw commodities were relatively mixed in the month. Imports of crude oil, iron ore and coal all declined in the month (-7.4%, -9.1% and -19% respectively). Nevertheless, resilient production by Chinese steel mills has seen Iron ore imports continue to rise in annual terms, rising 6.8% over the year. With imports falling more heavily than exports during the month, the trade surplus jumped in June to US$27.1 billion. Trade conditions are expected to improve this year, although the mixed economic indicators out of many major economies – including emerging Asian economies – highlights the difficulties that will continue to face China's manufacturing sector in particular. Export orders deteriorated again in June and dipped further into levels that suggest a contraction in exports over coming months –the higher currency has likely contributed.

A source of comfort has been the benign inflation environment in China. CPI inflation has remained well within the official target of 3.5% for 15 consecutive months. Nevertheless, year-ended CPI inflation accelerated slightly to 2.7% in June, 2.1% in May. The acceleration was driven solely by an increase in food prices which were 4.9%higher over the year (up from 3.2% in May), although prices were actually flat in the month. Non-food inflation was unchanged in the month to be 1.6% higher over the year (similar to the previous month). Base effects and an improving global economy (likely to limit further declines in commodity prices) are expected to boost headline CPI over the rest of the year. Nevertheless, muted inflation pressures to date have reduced the need for policy tightening in the near-to-medium term. Upstream prices are also suggesting limited risk to the upside on prices. Producer prices fell 2.7% over the year, but while this is helping to contain inflation pressures, it also points to ongoing strains on the manufacturing sector which is facing problems with excess capacity.

Despite the dramatic tightening of monetary conditions that took place in China during June, banks actually issued more loans in June than during the previous month. There was RMB 860.5 billion in new loans issued during June, compared to RMB 667 billion in May. The increase in loans issued was driven by a pick up in corporate loans, while household loans declined in the month. Overall, growth in the stock of bank credit eased to 14.2% over the year to June, down from 14.9% the previous month. Although new bank loans rose in the month, the tightening of interbank liquidity during June – along with stricter rules on wealth management products and interbank assets – appears to have helped slow system credit. This will be a welcome trend to authorities who had become concerned over too rapid credit growth earlier in the year. Total social financing eased to RMB 1.04 trillion in June, from RMB 1.19 trillion in May.

Policy expectation:

The June quarter National Accounts confirm that the Chinese economy has continued to slow. Nevertheless, authorities will welcome signs that the rapid credit growth seen earlier in the year has started to ease. We maintain our view that monetary policy (benchmark interest rates and reserve requirements) will remained unchanged until at least next year. While muted inflation has provided the PBoC with room to ease, we believe that authorities will elect to focus on improving the flow through of credit to the real activity, rather than simply encouraging additional credit growth to support the economy. Authorities have emphasised their tolerance to slower growth, placing more importance on the 'quality' of China's growth model. Nevertheless, policymakers may still rely on money market operations to manage market liquidity, while structural reforms (along with fiscal policy) could be used to address the structural imbalances that have developed and could also be employed if growth slows more than they expect – the recent confusion over the Finance Minister's comments regarding the growth target suggest that 'acceptable rates of growth' may be a grey area among the leadership.

Statistical releases available here:
[National Bureau of Statistics]

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