Chinese Monthly Update

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National Australia Bank

- Partial economic indicators, although still subdued, provided some signs that the economy may be stabilising. Trade data were somewhat above expectations, including much stronger import growth pointing to improved domestic demand. This was consistent with slight improvements in other partial indicators, although retail sales growth eased contrary to rebalancing efforts.
- We have maintained our expectation for China's growth to stabilise in the second half of 2013 at relatively subdued levels as authorities press on with structural rebalancing efforts – partially offset by an improvement in export demand from major developed economies and policy fine tuning.
- CPI inflation remains well within acceptable levels, but policy makers are more likely to rely on money market operations, structural reforms, and policy 'fine tuning' to improve credit allocation and encourage growth, rather than monetary easing.
- This month we included a closer look at China's financial liberalisation.

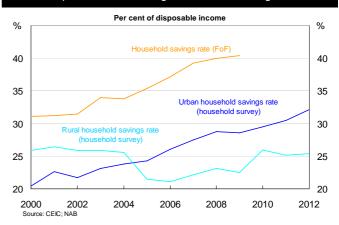
China takes another step toward financial liberalisation

In the face of a deteriorating (or at least more subdued) growth outlook, much of the good news out of China recently has related to positive steps taken on financial reforms – key to achieving the goal of structural rebalancing in the economy and helping to mitigate the risks from expansion in less regulated parts of the financial system. Perhaps one of the most notable announcements of late was the removal of long held controls on lending rates that can be offered by banks. From July 20, the maximum discount on the benchmark interest rate (determined by policy makers) that banks could offer to borrowers was removed, meaning that bank lending rates are now fully liberalised.

This was consistent with calls for more financial reforms by the IMF which, in addition to interest rate liberalisation, has also listed priorities such as strengthening regulation and supervisory oversight of financial institutions, establishing an explicit deposit insurance scheme (expected soon), addressing moral hazard, and employing interest rates as the primary tool for monetary policy. We expect to see many more reforms from China on this front, although the potential timing of these reforms is something that is still up for debate.

While removing controls on lending rates is a significant (or at least symbolic) step towards financial liberalisation, the shopping list of reform priorities, along with the financial risks that have accumulated over recent years, suggests that much more still needs to be done. The liberalisation seen to date in the Chinese financial system has not altered its basic character – which mops up low cost savings and largely channels them into big state-run banks that lend to other government agencies as well as to large businesses that are still effectively state controlled. Deposit rate

Financial repression contributing to household savings rate

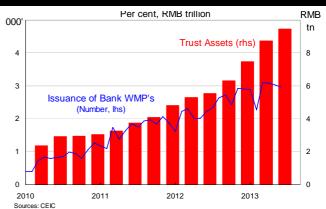


Savers seeking out higher returns

Bank deposits losing competitiveness (interest rates)



Money flowing rapidly into less regulated products



ceilings keep funding rates down, while the lack of alternative investment vehicles (besides the big banks) along with the need to finance their own education, health care and old age encourages significant amounts of household savings. This system of "financial repression" has underpinned the mobilisation of the enormous amounts of funding needed to drive China's investment-led growth model. The loser in all this is the household sector which faces unduly low returns on its savings, eroding household incomes.

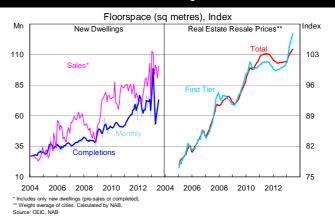
In an attempt to receive higher yields, investment vehicles such as wealth management products (WMP's) have grown rapidly in popularity with savers - one of the loosely regulated segments of the financial system referred to earlier. The value of WMP's has more than tripled since 2009 (valued at around RMB 7 trillion), while assets under management of trusts more than tripled between 2010 and mid-2013 (valued at around RMB 91/2 trillion). Authorities have introduced a number of policy measures to try and rein in growth of these products, but have so far pulled up short of liberalising deposit rates (to make traditional bank deposits more competitive). These policies included stricter limitations on how the proceeds from WMP's can be invested, tougher standards of disclosure, and rules on the management of assets. In particular, banks have until the end of the year to meet new requirements limiting illiquid assets to 35% of wealth products, or 4% of total assets - this implies that a greater proportion will need to be held in lower yielding products. These policies appear to be gaining some traction with reports showing that bank issuance of these products has fallen in recent months.

While this is helping to address some of the risky aspects of these practices, the drawback of course is that stricter measures may also limiting financial intermediation by the shadow banking sector. Non-bank finance can be an important source of funding for some firms, particularly SME's that can have difficulty raising traditional bank loans due to banks preference to lend to government and SOE's. It also once again limits the options for savers. The answer therefore is likely to lie (in large part) with deposit rate liberalisation whereby banks can capture a larger share of deposits by offering a more attractive yield. The concern however is that competition for deposits among banks could also be destabilising to the banking sector as bank profits margins are

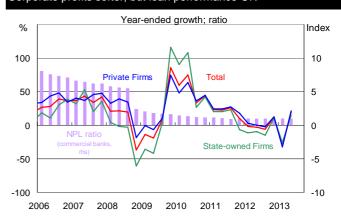
Consequently, reforms are likely to be gradual and deposit rate liberalisation is unlikely to go ahead until after a deposit insurance scheme is implemented. The slowing economy may also prove to be a barrier as banks could be vulnerable to a sudden deterioration in corporate sector financial performance. Nevertheless, reported data suggests that bank balance sheets remain healthy overall, with only a modest deterioration in asset quality emerging in the loan book during the current slowdown. In line with the gradualist approach to deposit rate liberalisation, it has been reported that the PBOC will introduce Certificate of Deposits (CDs) trading in the interbank market late this year or early next year. Introduction of CDs allows Chinese banks to smoothly phase their huge balance of WMP's into banking

In the long run, shifting to more market based lending (ie more costly capital) would dampen the overall amount of investment spending. It will also help to shift income away from the corporate and state owned sectors that have saved and re-invested their profits, towards households, which should support greater consumption. Winding back the amount of state direction of business and credit allocation would reduce the amount of borrowed money wasted in uneconomic projects. However, there are also a number of structural hurdles outside of the financial sector that need to be overcome for rebalancing to become successful. For example, the low share of household income in

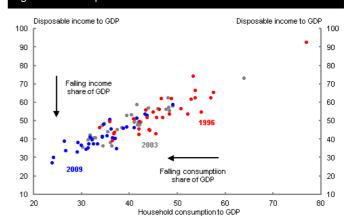
As well as real assets such as housing



Corporate profits softer, but loan performance OK



Higher cost of capital will assist shift of income to households



Source: Australian Federal Treasury

the economy is likely to keep savings rates high and consumption constrained. A large driver of this has been the low returns on labour (wages) stemming from structural factors eg. surplus labour and a relatively small services sector (which tends to be more labour intensive).

Although financial reform is clearly beneficial to the economy, it may not be all smooth sailing - justifying the gradual approach taken to date as adverse consequences from mistakes in reforming the financial regulatory system are potentially serious for bank earnings, the budget and the growth and stability of the

economy. There may also be some internal pressure to maintain the status quo. The Chinese financial system produces inefficiencies but it also works - it has helped drive rapid economic growth and offers levers that the authorities can use to achieve their policy goals. This was most evident in 2008/9 when they warded off a severe economic downturn by ramping up policy lending and public investment. The risk from the Government's point of view is that tinkering with the system robs them of powers they might later want and can also produce unforeseen consequences that would need to be fixed up.

Despite these reasons for caution, there should still be reforms. The consensus view among senior officials accepts that boosting living standards will be best served by re-balancing the economy toward higher consumption but that does not have to entail a rapid de-regulation of the financial sector. Instead, this can be achieved by supporting continued rapid growth in real household incomes through setting higher minimum wages and the Government can also strengthen the welfare state to provide pensions, income support and health care. That would directly improve households' welfare and reduce their need to save as much.

Finally, it is important to address whether we believe that the recent liberalisation of lending rates will at least provide some near-term support to the economy? In recent years, real GDP growth has been steadily moderating and growth for the calendar year could now be at risk of falling below the government's growth target for the first time - prompting many to call for addition monetary stimulus to prop up growth. In this respect, we expect that lending rate liberalisation is likely to have a fairly marginal impact on the economies near term growth momentum. Firstly, the central bank appears to be deliberately maintaining tighter liquidity conditions, which included a fairly severe cash squeeze in June that was engineered in large part as a warning to banks and trusts to scale back on risky lending practices. These conditions are likely to limit the scope for interest rate cuts by banks.

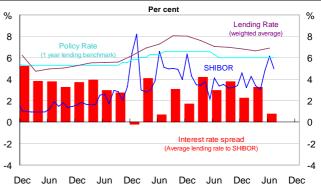
Secondly, the previous lending floor did not appear to be a very binding constraint on banks lending. Available data shows that almost 90% of loans are priced at or above the current benchmark rate (around a quarter of loans are priced at the benchmark). Interest rates in Wenzhou provide an example of the types of lending conditions facing borrowers. In July, the private lending composite rate in Wenzhou (1 year) was 16.1%, while the national weighted lending rate was already 91bp above the benchmark in Q2. With that said, firms that are receiving a competitive interest rate on borrowing (normally large SOE's) may see a benefit from greater interest rate flexibility. This will provide these firms with some relief from debt repayments but possibly at the risk of triggering another debt binge?

Macroeconomic update (dated 9 August 2013)

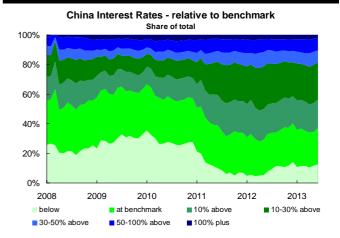
Partial economic indicators, although still subdued, provided some signs that the economy may now be stabilising. Trade data came in somewhat above expectations, including much stronger import growth pointing to a pick up in domestic demand. This was consistent with slight improvements in other partial indicators such as industrial production and business investment, although retail sales growth eased - potentially discouraging to rebalancing efforts. These outcomes are in line with our expectation for China's growth to stabilise in the second half of 2013 at relatively subdued levels as authorities press on with structural rebalancing efforts – partially offset by an improvement in export demand from major developed economies and a variety of policy fine tuning measures. Nevertheless, signs of improvement in the global economy (not just China's) remain tentative and a further deceleration of growth can not be ruled out.

While last month we highlighted the apparent grey area surrounding China's growth target the leadership have

Tighter liquidity may limit interest rate cuts for borrowers



Also, most interest rates already set above previous 'floor'





**Deflated by Hong Kong re-exports prices up to 2000, Japanese / Euro prices of Chinese imports bet and 2005, and the Chinese export price index thereafter.

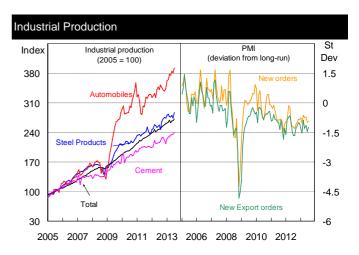
subsequently provided some clarity by confirming the target of 71/2% this year, while implying a floor of 7% -- the rate necessary to achieve prosperity goals by 2020 and maintain stable employment. We have maintained our forecast of 7.5% growth for 2013, decelerating to 71/4% next year. Regarding the monetary policy outlook, the 'wait and see' approach taken by policy makers to date is likely to continue despite relatively benign inflation providing scope for further loosening - a reflection of concerns over speculative financial activity and asset bubbles.

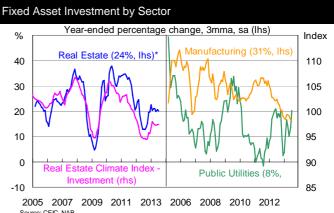
Turning to the partial indicators in more detail, industrial production growth accelerated in July, consistent with the improved trade data and other partial indicators. Growth accelerated to 9.7% y-o-y in July, although this is still well below its long run average. Manufacturing PMI's were mixed during the month with the official NBS index showing improvement, rising to 50.3 (from 50.1) indicating further expansion. In contrast, the Markit index, more representative of small and medium sized firms, deteriorated further in the month to 47.7 (from 48.2). The divergence might be explained by the 'liquidity squeeze' that took place in late June, which had a disproportionate impact on SME's. By product, steel output rose 10.9% over the year to July, while cement production increased 9.1%. Looking at other products, vehicle and textile production picked up to 15.4% and 8.2% respectively, while power generation also rose to 8.1%. Regarding the services sector, the PMI rose to 54.1 in July from 53.9 at the end of 2012 with the employment component pointing to continued expansion in labour demand. Policies designed to support the services sector (such as VAT reforms, tax cuts for SME's and targeted credit support) and a real estate recovery should help to support the sector.

Our estimates of fixed asset investment growth show that momentum picked up a little in July with growth rising to 20% y-oy, up from 19.2% y-o-y in June which was the slowest pace since April 2012. By sector, overcapacity in some industries and weak profits growth has kept investment in manufacturing relatively subdued, rising 17% y-o-y in July (up from 15% in June). Growth in real estate investment has been volatile over the past year, but remains above 2012 lows despite ongoing uncertainty in the sector; real estate investment increased around 20% y-o-y in July Forward indicators of investment were mixed in July, but annual growth in newly started investment projects eased in July. Government led investment stimulus appears to have ramped up in July with central government investment growth picking up to 24% y-o-y in July (up from 171/2%). Investment in public utilities also accelerated.

Turning to consumption, nominal retail sales growth was somewhat disappointing in July easing slightly to 13.2% y-o-y (down from 13.3% the previous month), below the market expectation of 13.5% and the governments target rate of 141/2% for 2013. The deceleration is worse once we account for higher retail prices in the month. Higher retail price inflation implies real growth in retail sales of 11.3% (down from 11.7% the previous month). The slowdown is relatively consistent with deterioration in consumer confidence, which tends to be highly sensitive to price movements. Softer wage growth - the result of weakening corporate profits - and easing labour demand may be contributing to the deterioration in confidence, although labour market conditions remained relatively tight in the June quarter. The employment component of the PMI however points to a further contraction in labour demand. Nevertheless, the short-term growth momentum of retail sales has improved since Q1 following the one off impact from a government crack down on extravagant public spending. By product, softer sales growth in automobiles, textiles and household electronics appear to have contributed to the deceleration, while sales growth for food items, construction materials and jewellery picked up notably.

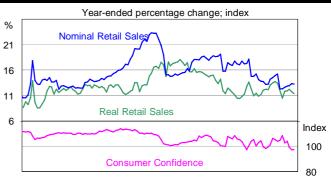
A rebound in trade growth during July provides a positive sign that improving demand in the global economy - particularly in the advanced economies - could help to offset softer private investment and stabilise the Chinese economy during the second half of the year. Nevertheless, growth in merchandise export values remains soft, rising just 5.1% over the year to July (following a very weak -3.3% the previous month). In seasonally adjusted terms exports actually fell 1.2% in July. This outcome was consistent with an improvement in manufacturing export orders during July, while the improvement in exports was also





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

Retail Sales



2004 2005 2006 2007 2008 2009 2010 2011 2012 2013

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 and new export orders



reasonably broad based across the major trading partners.

Much of the deterioration in exports growth in previous months has been driven by a government crack down on hot money inflows, but underlying export demand has been subdued for some time now, particularly in developed western economies. However, with signs that conditions in these economies are beginning to improve, a pick up in Chinese exports to these countries is a welcome sign. Exports to the United Kingdom, European Union and United States rose by 8.9%, 2.8% and 5.3%y-o-y respectively. Exports to Hong Kong, which were most affected by controls on hot money flows, rose in July to be up 2.3% y-o-y. Base effects helped the growth numbers this month, but a series of announced policy measures should also assist the sector over coming months. These include a pledge to maintain a more stable exchange rate, tax waivers, simpler export procedures and more financial support.

Acceleration in imports growth during July comes as a welcome sign for domestic demand, although these data tend to be volatile. Merchandise import values rose sharply in July to be 10.9% higher y-o-y. However, official seasonally adjusted figures again show that imports fell in the month (-3%). Nevertheless, base effects played a much smaller role in the improvement of yearended imports growth, and the composition of imports tentatively points to more stable domestic demand. Imports of goods not for processing and re-export picked up in the month, while imports of raw commodities were generally better as well. Imports of crude oil rose 17% in the month to be up by almost a fifth over the year, while copper imports picked up 8% to be 12% higher v-o-v although some of this demand could stem from financing deals. Iron ore imports rose 81/2% in July to be more than a quarter higher than last year and hit a record high. The resilience of Chinese steel production has surprised us, pushing iron ore prices higher again despite increasing global supplies. Announced stimulus policies and infrastructure spending has probably helped support the market.

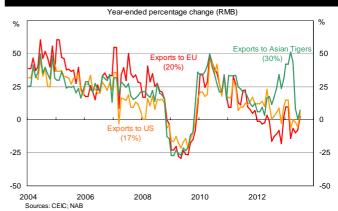
With imports accelerating more quickly than exports during the month, the trade surplus dropped in July to US\$17.8 billion (down from US\$27.1 billion in June), suggesting that net exports may provide some drag on September quarter GDP. Nevertheless, trade conditions are expected to improve this year driven largely by a gradual recovery in the major developed economies. In contrast, the growth in emerging economies that has driven global growth over recent years looks set to remain sluggish. Combined with recent strong appreciation of the RMB, there are still significant risks and headwinds to the trade outlook over coming months.

The inflation story has not changed in China since last month. CPI inflation has remained well within the official target of 3.5% for 16 consecutive months; year-ended CPI inflation remained at 2.7% y-o-y in July. Food prices growth ticked up slightly to 5% y-o-y (up from 4.9% in June). 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 could see a boost in the headline CPI over the rest of the year, although idle capacity in some industries has been keeping upstream prices at bay; producer prices fell 2.3% over the year. The IMF's recent assessment of the inflation situation in China suggests that a food supply shock may be the only way that China will see a return of high inflation pressures in the near term. Consequently, muted inflation pressures to date have provided policy makers with additional scope to keep an accommodative policy setting.

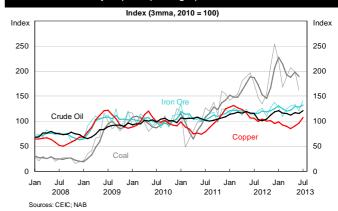
Policy expectation:

Tighter liquidity conditions in late June and steps to clamp down on shadow banking contributed to an easing in total social financing in July to RMB 809 billion, a 21-month low. New bank

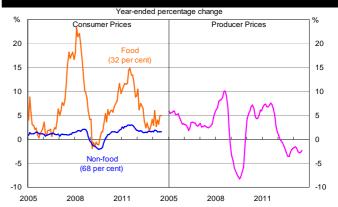
Merchandise exports to major trading partners



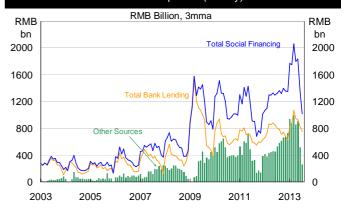
Chinese commodity imports picking up



Consumer Prices



Loan demand deteriorated last quarter (survey)



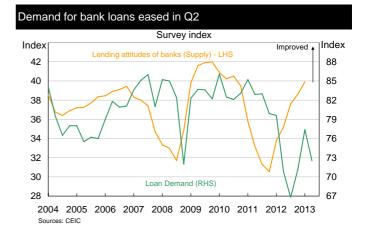
loans issued were above expectations at RMB 699.9 billion in July, but were also down noticeably from the prior month, while M2 growth unexpectedly accelerated to 14 ½ %. The outcome for system credit is consistent with the objectives of policy makers who are looking to control the rapid credit growth seen earlier in the year as well as improve the allocation of credit.

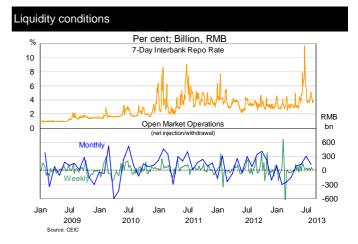
Given recent trends, we expect monetary policy to remain on hold, although it is worth noting additional steps taken towards interest rate liberalisation during the month with the removal of lending rate controls. While this is unlikely to have significant immediate impact on the economy - nearly 90% of loans are already priced at or above the benchmark rate - further steps towards full liberalisation can be expected. However, with the economy clearly slowing this year authorities have become more vocal on economic policies and introduced a variety of micro reform measures. This policy fine tuning has included renewed focus on infrastructure spending (particularly in rail and transport), cutting down 'red tape', tax waivers and reform (VAT) as well as measures to support exports. Consistent with these and the governments overarching goals of economic rebalancing, we are also likely to see additional spending on social infrastructure and services, although at this stage it looks to be a compositional shift rather than a fiscal expansion.

The central bank injected liquidity via money market operations in late July in response to rising interbank rates. The 7-day interbank repo rate has subsequently eased back below 4% after breaking through 5% in late July. We expect the PBoC to continue to use open market operations to keep liquidity in the interbank market at acceptable levels although a cut to reserve requirements can not be ruled out if liquidity deteriorates (possibly through a reversal of foreign capital inflows).

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Economic Forecasts											
	Year Average Chng %			Year-ende	d Chng %						
				2013			2014				
	2012	2013	2014	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP	7.8	7.5	7.3	7.7	7.5	7.4	7.5	7.6	7.4	7.1	7.1
Exchange Rate (USD/CNY)	6.3	6.1	6.1	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	6.3	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.25
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

Sources: CEIC; NAB Group Economics

^{*} For large depository institutions

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