Brief China Economic Update

National Australia Bank

The most recent batch of partial economic indicators provide further evidence that China's economy may be stabilising, supported by improved foreign demand and a shift in policy stance. There may have also been a delayed impact from rapid credit growth earlier in the year, although tighter monetary conditions since June will be offsetting.

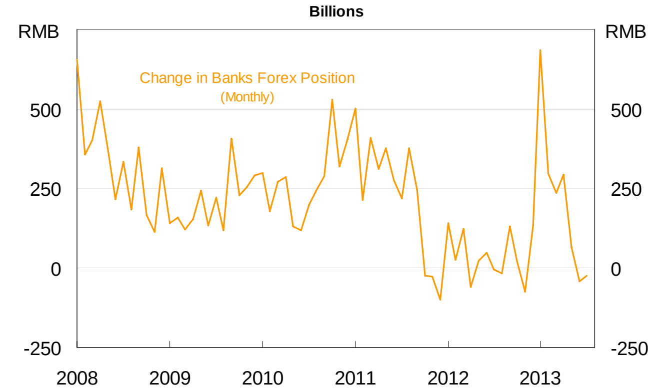
Domestic demand is tracking better. Industrial production, business investment and retail sales were all above expectations for the month, in line with our forecast for China's growth to stabilise in the second half of 2013. Better than expected exports growth has been a welcome sign for the economy, although other big export oriented countries in the region have not been faring quite so well. Concerns over the coming US Fed tapering have also exposed vulnerabilities within emerging Asia, although the biggest problems have largely been restricted to the big deficit countries such as India. Nevertheless, indicators suggest that net foreign inflows have halted, contributing to tighter liquidity conditions within China that may weigh on domestic activity.

The recent pick up in activity is not expected to continue much beyond the end of this year as efforts to rebalance and restructure the economy gain more traction. We have maintained our forecast of 7.5% growth for 2013, decelerating to 7¼% next year. Regarding the monetary policy outlook, we expect the central bank to continue ensuring adequate liquidity for domestic banks while maintaining tighter overall monetary conditions to discourage speculative investment and rapid credit growth. The main policy instruments – reserve requirements and benchmark lending rates – are expected to remain unchanged for some time despite relatively benign inflation. However, a cut to reserve requirements can not be completely ruled out and may depend on how US Fed QE tapering unfolds. Also, we would expect to see more aggressive monetary easing should growth be at risk of dipping below the implied 7% floor. In contrast, we expect fiscal policy to remain accommodative, albeit more targeted than in the past.

Turning to the partial indicators in more detail, industrial production growth accelerated to 10.4% y-o-y in August (from 9.7%), consistent with rising merchandise exports, business investment and retail sales. Both major manufacturing PMI's also rose in the month. The official NBS index increased to 51 (from 50.3) indicating further expansion for large and state owned enterprises. The Markit index, more representative of small and medium sized firms, was 50.1 in August (up from 47.7) indicating a more modest expansion. By type, production of construction related material remains robust. Steel output rose 15.6% over the year to August, while cement production eased slightly to 8.2%. As for other products, vehicle and textile production eased to 14.8% and 8.1% respectively, while power generation accelerated to 13.4%.

On the services side, the PMI eased in August, but is still pointing to robust expansion (53.9, down from 54.1). The employment component picked up in the month and continues to show expansion in labour demand. Favourable government policies and a structural shift in the Chinese economy should see this sector continue to expand.

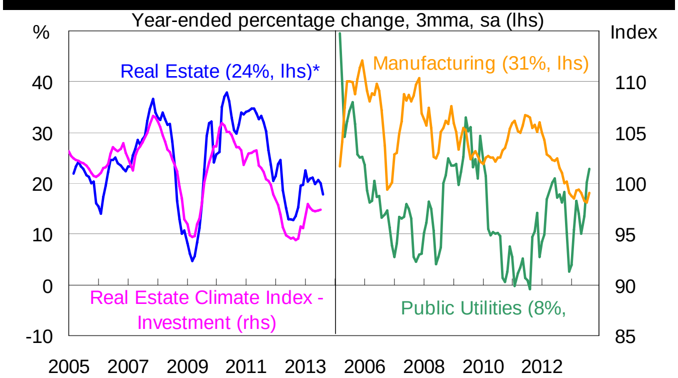
Net capital inflows have stopped, but no sign of dramatic outflow



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

Our estimates of fixed asset investment growth show that momentum picked up again in August with growth rising to 21.6% y-o-y, up from 20.2% y-o-y in July. By sector, manufacturing investment showed signs of improvement having faced headwinds from overcapacity in some industries and weak profits growth, rising 22% y-o-y in August (up from 17% in July) Utilities investment eased back from the relatively rapid growth in recent months, which could reflect an easing in public infrastructure investment, although the series tends to be volatile; growth is still elevated in trend terms. In August, central government investment growth eased sharply to 3% (down from 24%), partly reflecting base effects following a 13% m-o-m jump last August. Growth in real estate investment has been volatile over the past year, but remains above 2012 lows. However, growth eased noticeably in August to around 13% y-o-y. Forward indicators of investment were mixed this month, but annual growth in newly started investment projects picked up. Growth in total floor space started in the month softened, but real estate developer finance rose.

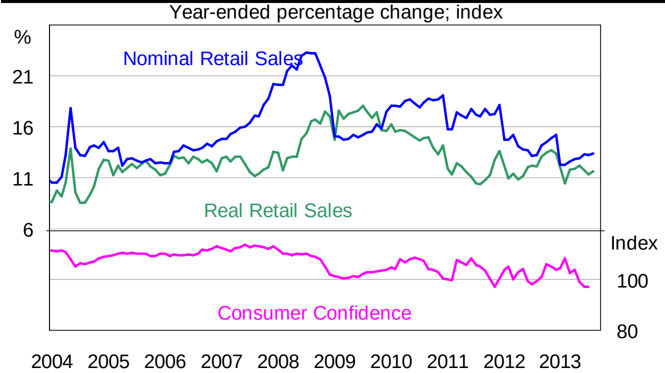
Nominal retail sales growth was slightly better than market expectations in August, rising to 13.4% y-o-y (up from 13.2% the previous month). However, this is still below the governments target rate of 14½% for 2013. Accounting for retail prices in the month real growth in retail sales was 11.6% y-o-y (up from 11.3% the previous month). Retail sales have held up reasonably well in light of a noticeable deterioration in consumer confidence, which remained around all time lows in July, and slower income growth in the first half of the year. However, with consumer price inflation remaining muted and the economy apparently stabilising, confidence may start to improve over coming months. The employment component of the PMI picked up to its second highest level in more than a year, but points to below trend labour demand. By product, softer sales growth in automobiles, jewellery and communication devices was offset by stronger growth in other categories, particularly for food items, textiles, household electronics, furniture and construction materials. Plans to levy consumption taxes on more luxury goods could weigh on consumption growth, but may also see a bringing forward of demand.

Trade data for August are looking a little more positive and should continue to pick up as the global economy improves going into 2014. Growth in merchandise export values was 7.2% y-o-y to August (following 5.1% in July and a very weak -3.3% the previous month). This was above market expectations, but still soft relative to history. After adjusting for seasonality, exports rose by 2.2% m-o-m in August. By product, high tech exports rose 6% in August to be up 10.3% y-o-y, while mechanical and electrical exports were up 2.5% to be 7.2% higher over the year. Exports of lower-end goods were softer. This outcome was consistent with an improvement in manufacturing export orders during July and a number of policy measures introduced in recent months to assist the exports sector – these included tax waivers, simpler export procedures, financial support, and a pledge to maintain a more stable exchange rate.

While global growth is expected to improve further, there appears to be a shift taking place in the composition of global growth away from emerging markets and towards the large advanced economies. Growth in the advanced economies remains low, but the trends are improving. Stronger growth in the US is expected to see US Fed "tapering" to begin in coming months, while stimulus measures are having a positive impact on Japan. Even Europe is gradually shifting out of recession. In contrast, headwinds facing a number of emerging economies have had an impact on business sentiment, trade and industry data.

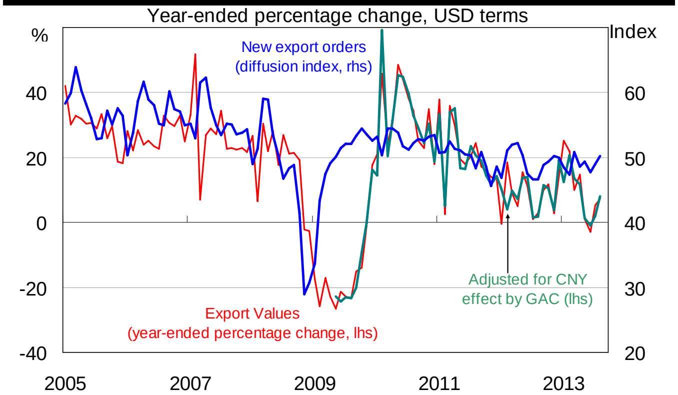
Nevertheless, growth in exports to other east Asian economies (excluding Japan) have picked up from the lows that followed a

Retail Sales

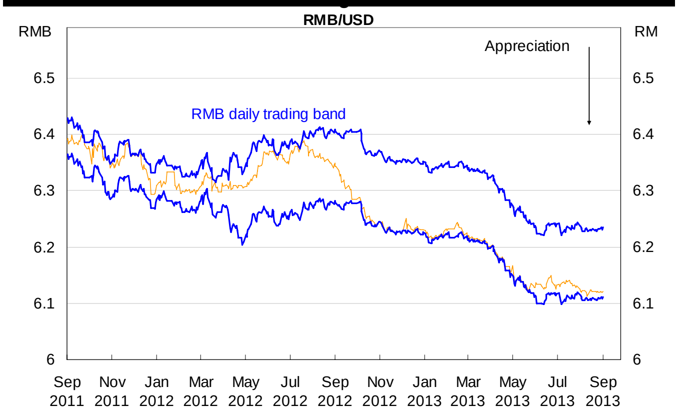


* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.

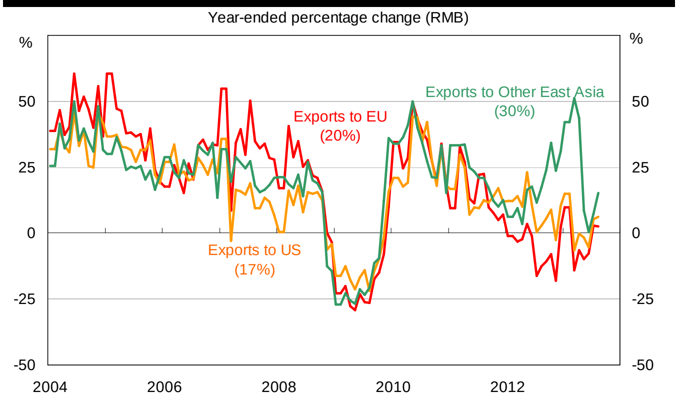
Merchandise exports and new export orders



CNY appreciation has slowed



Merchandise exports to major trading partners



Sources: CEIC; NAB

government crack down on hot money flows and misreporting of trade data. Exports to the United Kingdom, European Union and United States rose by 12.3%, 7.1% and 5.3% y-o-y respectively. Exports to Hong Kong, which were heavily affected by controls on hot money flows, rose in August to be up 6.4% y-o-y, while exports to emerging Asian economies were up sharply.

In contrast to exports, imports growth did not build upon the improvement recorded last month. Growth over the year was recorded at 7%, which was below market expectations but much better than the rate of growth posted during the second half of last year. Official estimates suggest that imports fell by 0.4% m-o-m (sa). Nevertheless, the composition of imports tentatively points to more stable domestic demand with imports of goods not for processing and re-export remaining solid in the month. However, imports of raw commodities fell from July's high levels. Imports of crude oil fell by 18% in the month, but remained 16½% higher on last year, while copper imports fell by 5.6% to be 9% higher y-o-y. Iron ore imports fell 5.6% in August to be 10% higher y-o-y (well down on the 25% y-o-y growth recorded last month). Nevertheless, iron ore demand has remained relatively robust given the tough conditions facing Chinese steel producers, although steel prices have lifted from their June lows, bolstered by government efforts to boost infrastructure spending. With imports growth dipping below expectations, the trade surplus widened in August to US$28.5 billion (up from US$17.8 billion in July), the largest since January.

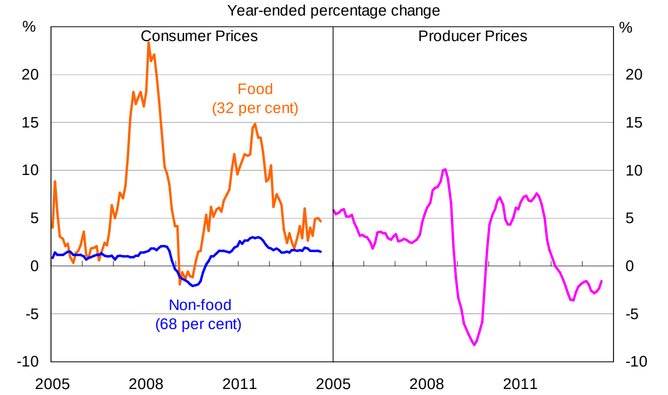
The inflation story has not changed in China since last month. CPI inflation has remained well within the official target of 3.5% for 17 consecutive months; year-ended CPI inflation eased slightly to 2.6% y-o-y in August. Food prices growth softened to 4.7% y-o-y (down from 5.1% in July). Non-food inflation also eased slightly in the month to be 1.5% higher over the year (down from 1.6%). 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. However, producer prices provided some hope that deflation in the industrial sector may be coming to an end. The PPI rose slightly in the month but remains 1.6% below August of last year (from -2.3% y-o-y in July).

Policy expectation:

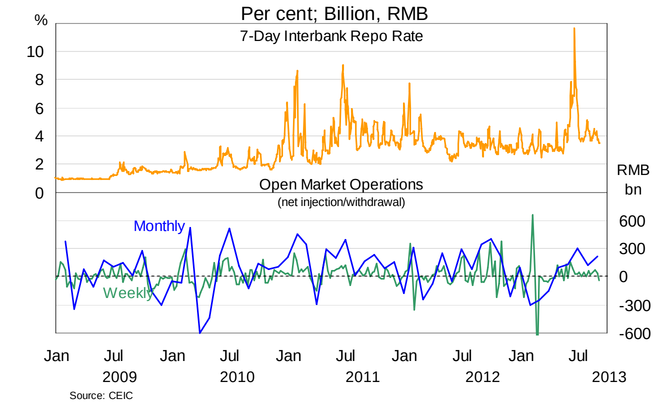
Subdued inflation pressures have stoked confidence that the central bank will have scope to stimulate the economy if necessary. However, the PBoC may still be hampered by efforts to rein in rapid credit growth and shadow banking. Consequently, GDP growth will probably need to be at risk of falling below the implied floor of acceptable growth (suggested to be around 7%) before the central bank will abandon these efforts and more aggressively stimulate growth. Rather, we expect to see a continuation of the current policy mix which has involved greater management of short-term money market rates to ensure sufficient liquidity for banks, but a tightening of monetary conditions at longer maturities to discourage speculative investment and credit growth. Interest rates across the yield curve have already risen by around 150bp in recent months. Our modelling of a temporary rise in rates of this magnitude suggests a deviation in GDP growth of up to 0.5 ppts from baseline (chart). Nevertheless, total social financing rose more than expected in August to RMB 1,570 billion, while new yuan loans rose less than expected (RMN 711.3 billion). The increase was driven largely by a jump in non-bank lending.

The central bank injected liquidity via money market operations in late August, but injections have generally been too small to significantly ease liquidity. The 7-day interbank repo rate picked up ahead of the end-of-month liquidity squeeze (driven by regulatory requirement) but has subsequently eased back below 3½%. We expect the PBoC to continue to use open market

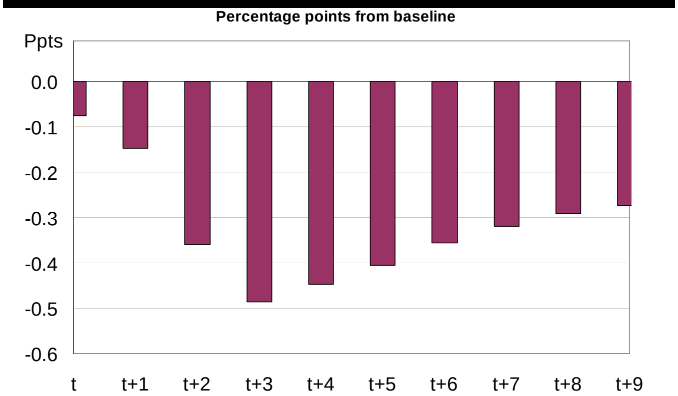
Consumer Prices



Liquidity conditions



Impact of temporary interest rate shock on GDP growth



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 as US Fed tapering begins).

Fiscal and administrative policies will continue to be targeted at supporting near term growth in desirable areas of the economy (eg. infrastructure, environment, SME's, social spending etc.), and data on fiscal spending suggest there is scope for stimulus spending of a similar magnitude to H2 2012. However, local government (LG) debts are still an area of concern – despite efforts to encourage more private funding of public investment products. A review of LG debts is currently underway that may shed more light on the issue (results expected around October).

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