China Economic Update

National Australia Bank

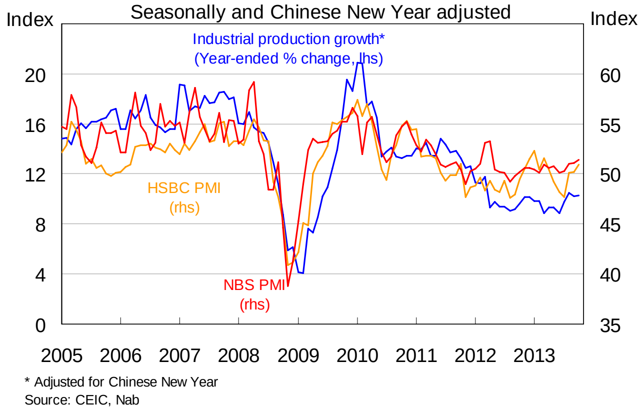
China remains on track to achieve its growth target for the year with domestic demand holding up in October, while exports picked up from the disappointing outcome in September. Industrial production was slightly better than expectations for the month, while retail sales and investment were slightly below. Regulatory distortions to trade data are making it difficult to gauge the health of export manufacturers, but solid industrial activity and a pick up in demand from major advanced economies is a positive indication. Demand from these economies is expected to gradually improve.

The acceleration in activity since mid-year is expected to lose some steam going into next year as efforts to rebalance and restructure the economy gain more traction – we should get more guidance on how these reforms will unfold following the 3rd Plenary Session of the 18th CPC Central Committee, which is currently underway. We have maintained our forecast for 2013 at 7.6%, with growth decelerating to 7¼% next year. Despite higher headline inflation, temporary price pressures suggest little incentive for the central bank to materially change its stance on monetary policy. 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. Bouts of tight liquidity could prompt a cut to reserve requirements, but the central bank has been reluctant to do this so far, and indications that foreign capital is returning will likely add to their reluctance. Therefore, reserve requirements and benchmark interest rates are expected to remain stable.

Turning to the partial indicators in more detail, industrial production growth accelerated marginally to 10.3% y-o-y in October (from 10.2%), consistent with a pick up in merchandise exports and steady business investment and retail sales. By type, production of construction related materials was mixed. Rolled steel output rose 12.3% over the year to October (down from 15.5%), while cement production picked up to 8.9%. As for other products, vehicle and electrical equipment and machinery production rose to 25.5% and 11.8% respectively, while textile production eased to 7.8%. Power generation – often used as a bellwether of industrial activity –rose to 8.4%.

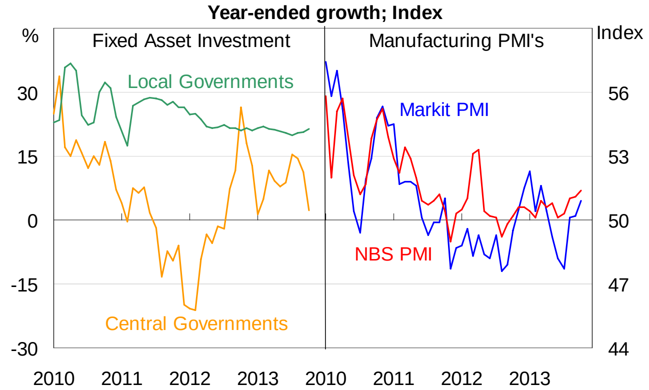
Manufacturing PMI's had pointed to additional expansion in manufacturing activity, while client demand has also improved both at home and abroad according to measures of new orders. The official NBS PMI index, which is taken to be representative of large and state owned enterprises, increased to 51.4 (from 51.1). The Markit index, which is more representative of small and medium sized firms, rose to 50.9 in October (up from 50.2). This could suggest that the private sector is now taking up some of the slack in the economy, reducing the need for public stimulus – growth in central government investment stimulus is starting to ease, albeit with some large base effects from last years stimulus. The non-

Industrial Production

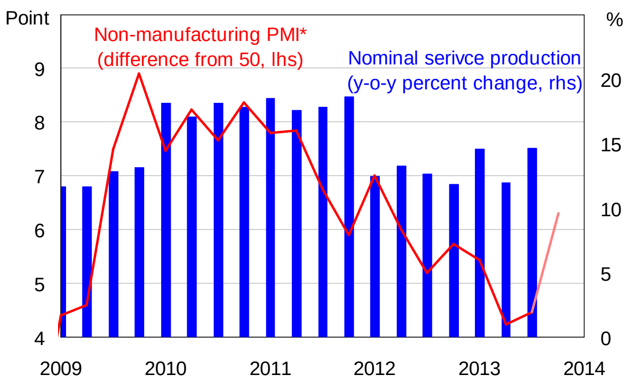


* Adjusted for Chinese New Year
Source: CEIC, Nab

Private sector may now be taking up some of the slack?



Non-manufacturing sectors gaining momentum



* A positive reading supposably indicates the sector expanded; dot represents July and August observations

manufacturing sectors of the economy have also been gaining some momentum. Following solid growth in tertiary GDP in the September quarter, the non-manufacturing PMI jumped to 56.3 in October, the highest level since mid-2012.

Fixed asset investment growth remained stable in October according to our estimates, increasing 19.3% over the year (19.4% y-o-y in September). By sector, manufacturing investment picked up slightly, but the ongoing need to tackle excess capacity in many sectors – which has led to sluggish profits growth in recent years – is likely to limit any recovery in this space. Utilities investment is still relatively solid, but could start to ease if public infrastructure investment starts to wind down as private sector activity picks up. Growth in real estate investment is still relatively soft despite strong increases in property prices.

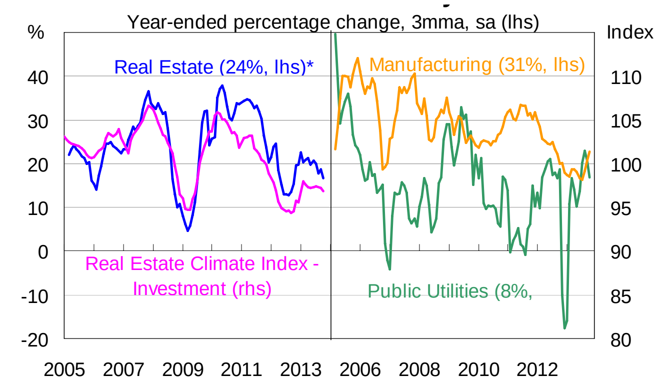
The outlook for real estate investment remains clouded by policy uncertainty as government concerns over affordability gather pace. The central bank sees property price inflation as a big problem and we expect to see further measures employed by authorities to address it – some of which will be detrimental to developers. For example, Beijing is considering a halt to approvals for the sale of more expensive homes and it also wants to place a 10% cap on price increases for previously approved projects. It has also been reported that Shenzhen would raise minimum down payments for second home purchases. All tier 1 cities including Guangzhou and Shanghai are under the spotlight and will fell pressure to respond to price gains in recent months. However, government measures will also include supply management, which will benefit building construction.

Nominal retail sales growth was slightly below market expectations in October, but remained steady at 13.3% y-o-y; the government's target for consumption growth is 14½% for 2013. Accounting for retail prices in the month, real growth in retail sales was 11.2%y-o-y (similar to the previous month). However, households appear to be taking some comfort from the improvement in economic activity last quarter and the extended period of relatively contained consumer prices, with consumer confidence returning to long-run averages in September (despite softer urban income growth). By product, sales growth in food & drink was steady, while furniture, communication appliances, autos and petrol all had the most notable acceleration. Most of the remaining product categories eased or were broadly steady.

Trade data for October came in above market expectations, following a disappointing result for exports last month. Growth in merchandise export values was 5.6% y-o-y to October (following -0.3% y-o-y decline for September). This turn around in annual growth suggests that China is still within reach of achieving its growth target for total trade of 8% for 2013; total trade in the first 10 months has reached US$3.4 trillion, which is up 7.6% on the same period last year. Better exports growth is consistent with growing export orders in recent months (according to the PMI survey) and a slight pick up in industrial activity. However, disappointingly drawn-out recoveries in the major advanced economies has kept export demand relatively soft (growth in merchandise exports is still well down on average rates seen in previous year's), which along with recent rapid appreciation of the RMB (setting record highs) has weighed on China's industrial sector.

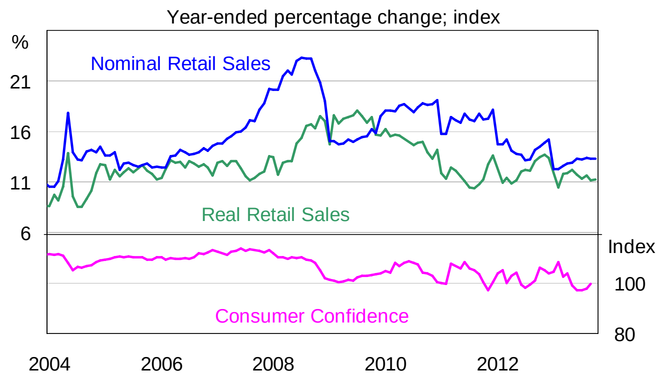
By destination, exports to the EU jumped in October to be up

Fixed Asset Investment by Sector



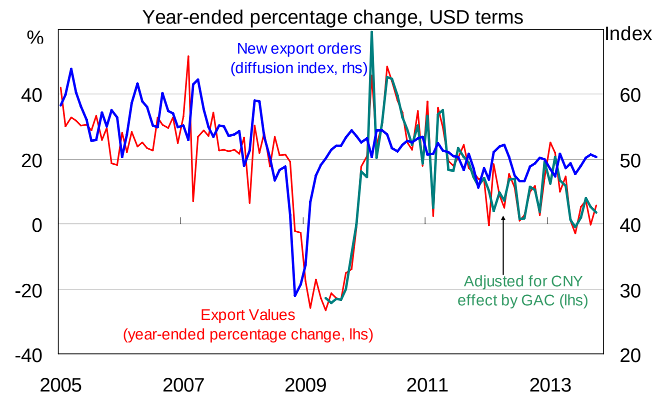
Source: CEIC, NAB
* Number in brackets represents share of total FAI in 2010; Real Estate is using Real Estate Investment data

Retail Sales

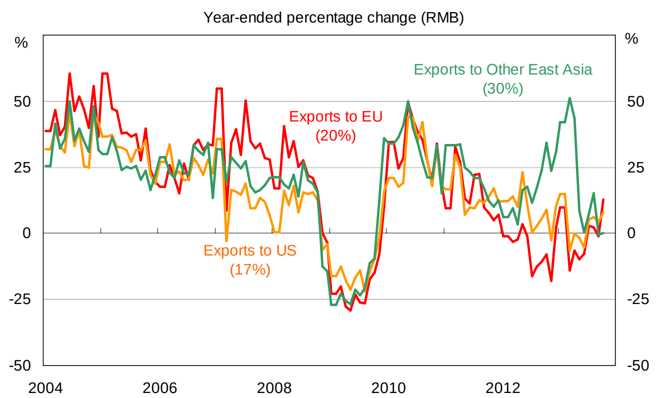


* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.

Merchandise exports and new export orders



Merchandise exports to major trading partners



Sources: CEIC; NAB

nearly 13% over the year (compared to -1% y-o-y in September). Exports to the US also improved, while shipments to Asia were mixed. Exports to Japan were down in the month, but growth over the year improved. Exports to Hong Kong and Taiwan remain very soft, although this could reflect the ongoing impact of the government's clamp down on the practice of misreporting exports to disguise capital inflows. By product, high tech exports rose around 2% m-o-m sa in October to be broadly flat over the year. Mechanical and electrical exports were up 3% m-o-m sa to be 3.8% higher over the year. Exports of lower-end goods picked up sharply in the month.

Robust imports growth has been a positive signal for domestic demand in China. Merchandise import values increased 7.6% over the year to October, which was slightly above market expectations. However, official estimates suggest that imports declined by 1.8% m-o-m (sa), following a sharp increase the previous month on the back of strong commodity demand underpinned by stimulus investments. Imports of crude oil fell by 6½% in the month to be down 13.8% on last year. Demand for industrial metals on the other hand has remained solid despite a decline in unadjusted volumes during the month. Copper imports fell by 11% in October, but are 26% higher y-o-y. Similarly, iron ore imports fell 9% from September's record high; but remain 20% higher y-o-y. With exports picking up last month, the trade surplus widened to US$31.1 billion in October (up from US$15.2 billion in September).

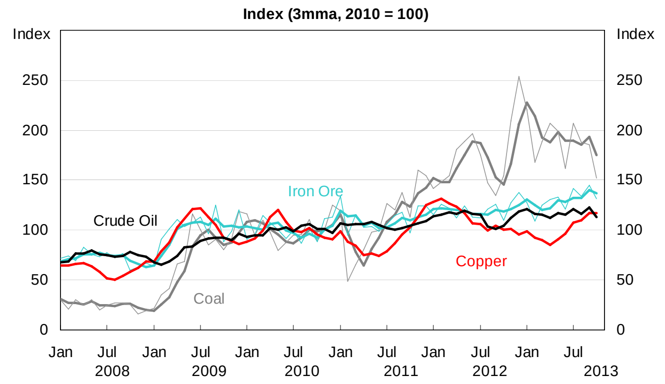
The headline CPI rose to 3.2% y-o-y in October, up from 3.1% in September. While this was slightly below expectations, it is the closest the CPI has come to the official target of 3.5% this year. This raises the risk that a tightening in monetary policy could come sooner than currently expected, but further deflation in factory gate prices means that the central bank is likely to sit back and wait for signs that price pressures are becoming more broadly based – they have remained confined to food prices. Food prices increased 6.5% y-o-y (up from 6.1% in September), while non-food inflation has held steady at 1.6% over the year. Deflation in factory prices picked up again in September, accelerating to -1.5% y-o-y, but this is still better than deflation of around -3½% in late 2012. This was the twentieth consecutive annual decline in producer prices.

Policy expectation:

Tighter liquidity is having a significant impact on the cost of capital in China. There has been some suggestion that authorities have allowed liquidity conditions to tighten to head off inflation pressures, but given the market volatility that was generated following the liquidity squeeze earlier this year, the PBoC is likely to remain cautious. Technical factors such as month-end bank capital requirements have also been contributing to tighter liquidity. The central bank has refrained from using open market operations to inject liquidity into the market, which allowed the 7-day interbank rate to spike to 5.59% in late October, up from around 3½% mid month – the rate has subsequently eased back to 3.9%. Yields on government bonds however have continued to climb, reaching their highest levels in around 6 years.

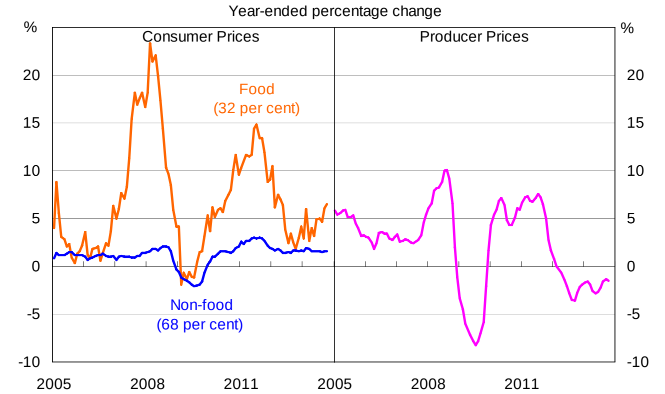
Data due out in coming days will indicate whether high yields are having a material impact on the demand for credit. Credit growth in recent months has remained surprisingly robust, which could prompt action from the central bank, particularly in light of their recent comments on the need for the economy

Commodity import volumes supported by investment

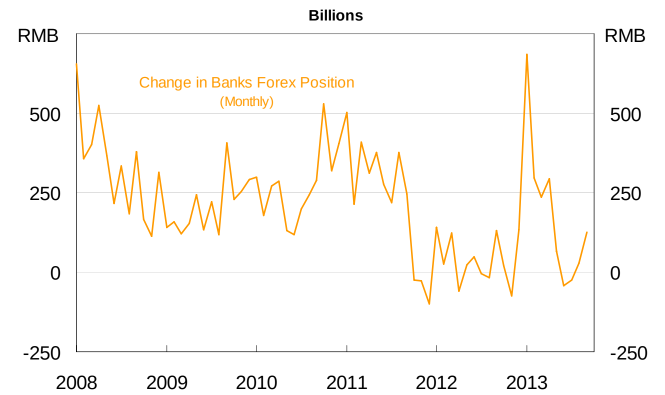


Sources: CEIC; NAB

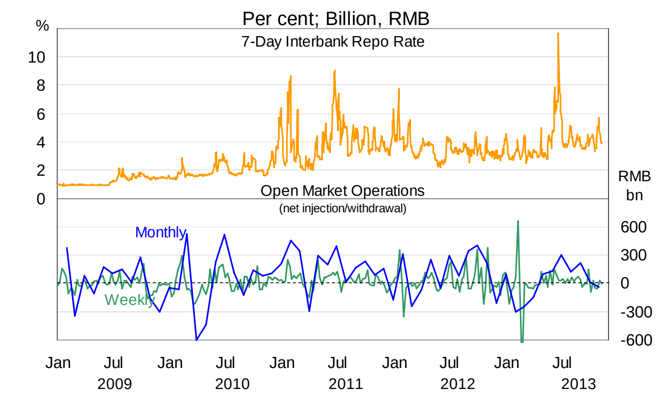
Consumer Prices



Capital inflows picking up again – risk to inflation



Liquidity conditions



Source: CEIC

to undergo a long de-leveraging process – something that is not usually suggested by government authorities.

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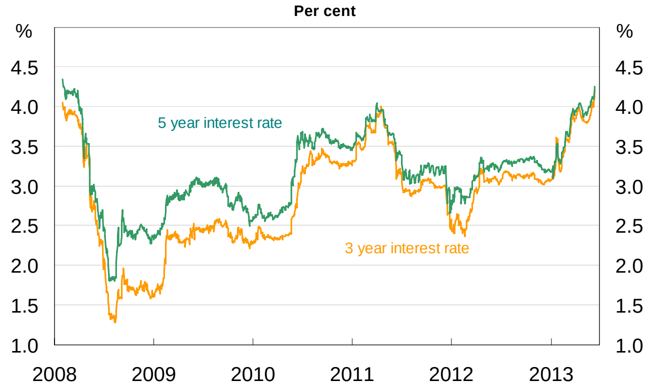
Longer maturity interest rates



Sources: CEIC Database

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