China Economic Update

National Australia Bank

Our expectations that China will achieve its growth target this year remain unchanged. Domestic demand has strengthened recently, with consumer confidence improving, while exports increased strongly during November – contributing to the widest trade surplus for four years. These trends were tempered by a slight easing in industrial production and slowing investment.

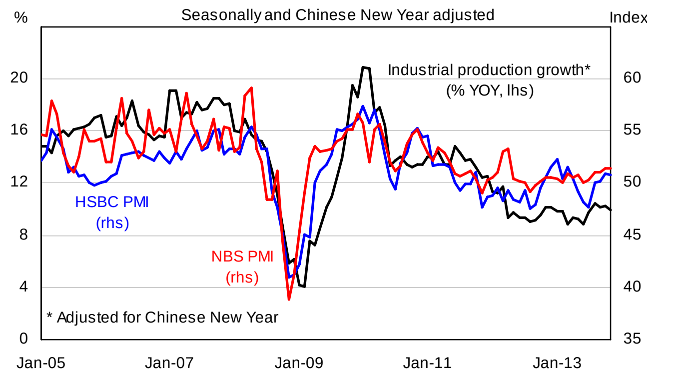
China's economy is expected to expand by 7.6% in 2013, but there are mixed signals for 2014. There is growing speculation that next year's growth target will be cut to 7.0%, as the government seeks to commence reforms that will attempt to rebalance the economy. In contrast, our contacts in China report stronger levels of business confidence post the Third Plenum, which could support stronger than previously expected private investment and boost growth. Our forecast for 2014 is unchanged at 7¼%.

The first major reform following the Third Plenum was introduced this week, with the People's Bank of China beginning the process of interest rate liberalisation. Financial institutions will soon be able to sell negotiable certificates of deposit, using the Shanghai Interbank Offered Rate as the reference rate. This move will likely increase the cost of funds for financial institutions but also provide more stability in their funding. It also signals a shift away from benchmark interest rates to market based mechanisms.

Looking closer at partial indicators, industrial production growth eased back to 10.0% yoy in November (from 10.3% previously). There had been a considerable rebound in output over the past four months, driven largely by the mid-year 'mini stimulus' program, but these effects have likely come to an end, particularly given an increase in finished goods inventory in November. Production trends in construction related heavy industry were mixed – with rolled steel growth rates slowing to 10.0% yoy (compared with 12.3% in October) while cement production was up by 10.0% yoy (compared with 8.9% previously). Monthly trends for both products have softened from recent peaks in September (steel) and October (cement). Electricity generation (a key indicator of industrial activity) increased by 6.4% yoy in November, down from 8.4% in October.

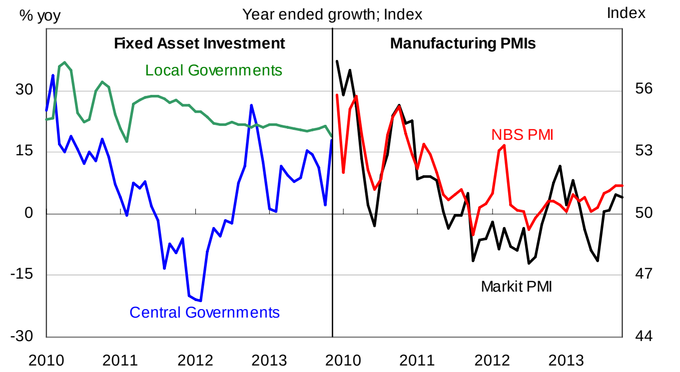
The slight easing in industrial production was in line with the manufacturing PMIs, which ran out of momentum in November. The official NBS PMI – which is more representative of large and state owned enterprises, was unchanged in November at 51.4 points. The Markit PMI, which includes more of the small to medium sector, was marginally softer at 50.8 points (from 50.9 points previously).

Industrial Production



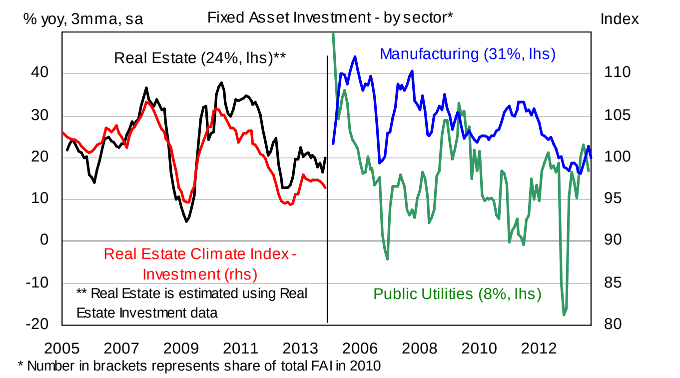
Source: CEIC, NAB Economics

Mini stimulus contributed to recent growth trends



Source: CEIC, NAB Economics

Fixed Asset Investment by Sector



* Number in brackets represents share of total FAI in 2010

Source: CEIC, NAB

Fixed asset investment slowed in November. According to our estimates, seasonally adjusted growth was 18.4% yoy (down from 19.3% in October). By industry, manufacturing investment pulled back to 19.9% - stronger than most of 2013, but well below the typical rates prior to 2012. Measures to address excess capacity in the manufacturing space are likely to limit the upside to investment in the short to medium term.

Similarly, investment in the real estate sector remains comparatively weak – despite a slight uptick in November – reflecting the ongoing uncertainty around government policy. In mid-November, a policy statement announced that property tax legislation would be implemented ‘at the appropriate time’. Taxes have been trialled in Shanghai and Chonqing since 2011. Combined with proposals to reduce constraints on Chinese investors investing overseas, these measures could reduce longer term real estate investment.

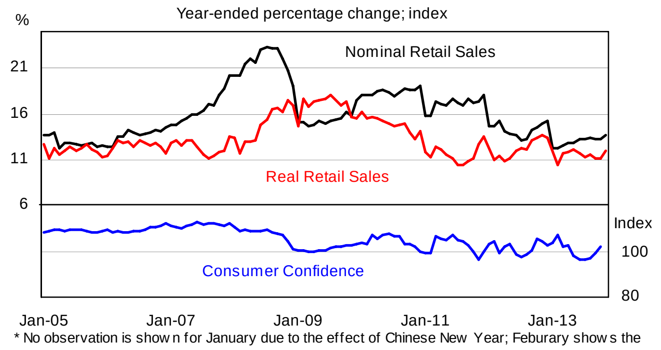
Retail sales growth was stronger than market expectations in November, at 13.7% yoy in nominal terms (up from 13.3% in October). In real terms, retail sales growth increased by 12% yoy (up from 11.2% previously), with the upturn in line with stronger consumer confidence in October, which recovered from weak conditions across the middle of the year to the strongest level since April 2013. By product category, growth in food & drink retail was relatively stable (at 14.1%), while there was acceleration in growth rates for household electronics, furniture, communications equipment and household commodities. In contrast, there was a slowing in growth for motor vehicles – with sales up by 11.6% yoy (down from 14.2% yoy in October).

November’s trade data was stronger than the market expectations – with a large increase in exports. Despite a softer than expected result for imports, total trade totalled US$3.7 trillion for the first 11 months of 2013, an increase of 8.3% on the same period last year (broadly in line with the official target of 8% for 2013). The monthly trade surplus of US$33.8 billion in November was the highest in four years.

Growth in US dollar denominated merchandise exports accelerated to 12.7% yoy (compared with 5.6% in October) – the strongest rate of growth since April 2013. However, this should be viewed with some caution, as there was a sharp pull back in exports in November 2012. More broadly, export growth remains somewhat constrained by the muted economic recoveries in key international markets – particularly Europe and the United States – and the comparative strength of the RMB.

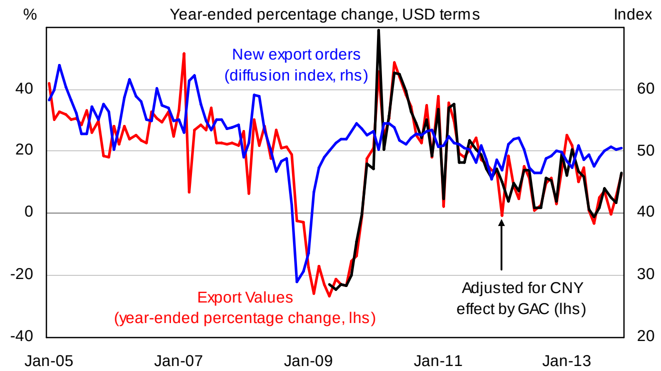
That said, there has been a notable acceleration in the growth in exports to both the European Union and the United States across the past two months. In November, exports to the EU increased by 18.4% yoy (compared with 13% in October), while exports to the US were up 17.7% yoy (from 8% previously). Export growth comparatively modest in for key markets in Asia – growing by 8.7% yoy in November. Trends in Asia were somewhat mixed, with Hong Kong, South Korea and Malaysia the key contributors to growth, while growth rates slowed for Japan, and exports to Taiwan declined marginally.

Retail Sales



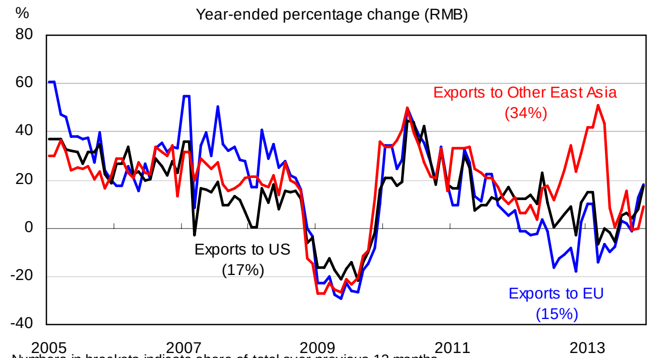
* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.
Source: CEIC, NAB Economics

Merchandise exports and new export orders



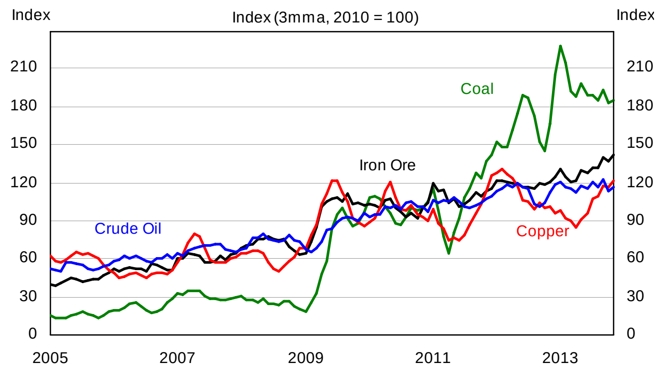
Source: CEIC, NAB Economics

Merchandise exports to major trading partners



Numbers in brackets indicate share of total over previous 12 months
Sources: CEIC, NAB Economics

Commodity import volumes supported by investment



Sources: CEIC, NAB Economics

By category, there was an acceleration in growth rates for High Tech (up 6.2% from 0.2% previously) and Mechanical & Electrical exports (up 10.2% from 4.1%) in November. In contrast, there was a marked slowdown in exports for lower-end goods during the month.

Import growth was weaker than market expectation in November, increasing by 5.3% yoy in November. An overall slowing trend in imports reflects declining commodity prices over the past two years. Imports of crude oil were around 0.8% higher year-on-year in November, while iron ore imports were 9.7% higher yoy. The rate of growth for both of these commodities slowed when compared with October.

Headline CPI was marginally softer in November, at 3.0% yoy (from 3.2% in October) – a level that was broadly in line with market expectations and below the official target of 3.5% for 2013. The pullback was related to food prices – with food inflation at 5.9% yoy (compared with 6.5% in October). In part, this reflects a softening in vegetable prices – which were elevated in the third quarter due to poor weather related supply disruptions. In contrast, non-food inflation has remained stable – at 1.6% yoy.

Producer prices remained negative in November, though marginally less so at -1.4% yoy (compared with -1.5% in October). There have now been twenty one consecutive months of falling producer prices – the longest period of declines since 1999 – however this largely reflects falling commodity prices over this period.

Policy expectations:

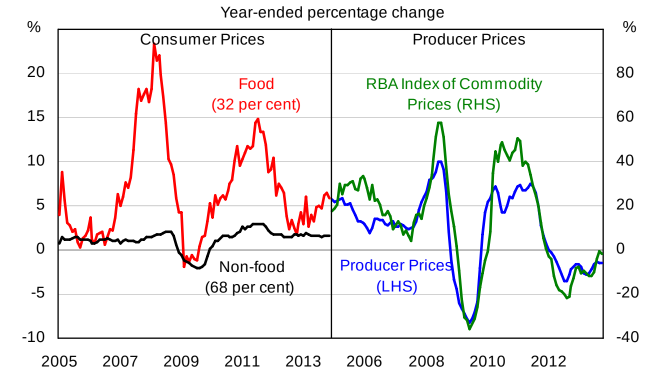
The People's Bank of China (PBoC) continues to face a challenging policy environment. While headline inflation is not particularly concerning – particularly when compared with the target rate – food price inflation poses some risks. High prices contribute to social tension, and persistently high prices can eventually flow through into non-food via wage increases. Previous periods of high food price inflation have triggered tighter monetary policy – however these periods also coincided with a far more robust domestic economic environment.

So far, the PBoC has shown no intention to tighten liquidity by traditional means – with official policies such as the benchmark lending rate remaining unchanged since July 2012 (at 6%) and the reserve requirement ratio stable since May 2012 (at 19.5%). Instead, since late September, the PBoC has resisted injecting any liquidity into the market via open market operations – allowing for passive tightening as market rates rose.

Chinese monetary policy remains opaque, with the benchmark lending rate remaining stubbornly unchanged despite a broad upward trend in government bond yields and the 7-day Shanghai Interbank Offered Rate (Repo) across 2013. The proportion of loans above the benchmark rate has increased significantly since late 2010, and has trended higher across 2013.

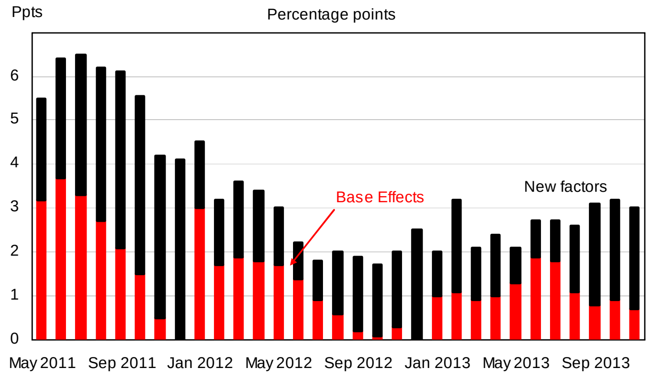
Yields on 3 year government bonds climbed to almost 4.5% in mid-November (from around 4% at the start of the month), and after a brief pullback later in the month, have been edging higher in December. There has been a clear upward trend since early 2012. The Repo rate was highly volatile across November – rising from just over 3.5% to almost 5.5% mid month.

Consumer and Producer Prices



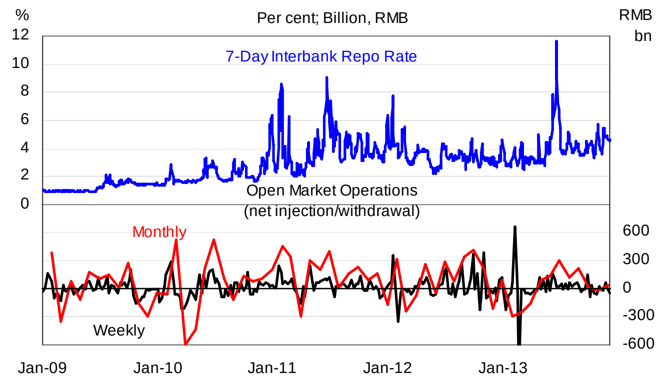
Sources: CEIC, RBA, NAB Economics

CPI inflation – lower impact from base effects recently



Sources: CEIC, NAB Economics

Liquidity conditions



Source: CEIC, NAB Economics

Longer maturity interest rates

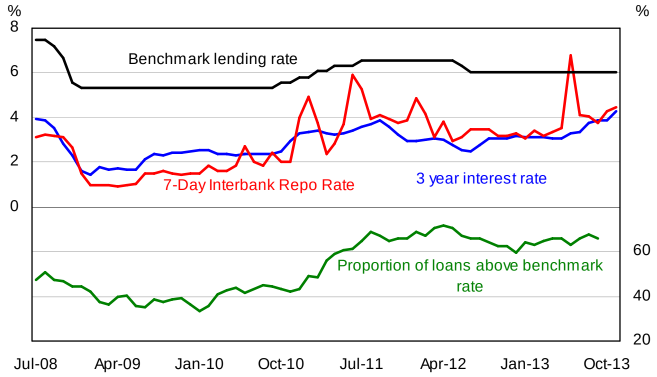
Sources: CEIC

The Repo rate is likely to become increasingly important in coming months, as the PBoC begins a process of interest rate liberalisation, the first major reform following the Third Plenum.

In early December, the bank announced that financial institutions will be allowed to sell negotiable certificates of deposit (NCDs), using the Shanghai Interbank Offered Rate as the reference rate. This change will likely increase the cost of funds for Chinese financial institutions and borrowers, but provide more stability as well. The current cap on deposit rates is below the inflation target, providing little incentive for saving (although savings rates previously remained high due to a lack of alternative financial products) and limiting the capacity of smaller scale banks to attract deposits. Total bank deposits fell by 0.4% month-on-month in October, however higher returns for savers could reverse this trend.

This reform could represent the first step in an increasingly market oriented financial sector, in line with the reform agenda outlined following the Third Plenum.

Liberalisation of interest rates – shift away from benchmarks



Sources: CEIC, NAB Economics

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