China Economic Update

National Australia Bank

China's latest National Accounts data shows that the economy grew by 1.8% quarter on quarter in December, and 7.7% year on year – representing a marginal slowdown from the September quarter (when yoy growth was 7.8%). For the full year, China's economy expanded by 7.7%, marginally below the rate of growth in 2012, and therefore the slowest rate of growth since 1999.

The easing in economic activity in the December quarter was broadly in line with our expectations and was consistent with partial indicators during the quarter that pointed to a modest slowing in industrial production. A slowing in government stimulus flowed through into softer industrial activity, while a crackdown on measures to circumvent capital controls contributed to slower export growth in the second half of 2013.

Despite intentions to rebalance the economy, the main contributor to China's economic growth in 2013 was investment (which contributed 4.2 ppts to growth), followed by consumption (with 3.9 ppts). Investment was boosted in the middle of the year by the mini-stimulus program, which was largely focussed on infrastructure spending. In contrast, net exports were modestly negative for economic growth, at -0.3 ppts (the weakest export contribution since Q3 2012).

The slowing trend for China's economy is expected to continue into 2014, as the government becomes increasingly focussed on its reform agenda. A clear signal as to this focus should come at the National People's Congress in March, when the official growth target is announced. There is speculation that the target could be cut to 7%, which would likely signal weaker growth prospects for the year. Our expectations remain unchanged at 7¼%.

A major concern for Chinese policy makers is the credit intensity of the country's growth in 2013. Driven in part by the mid year 'mini-stimulus', the ratio of credit growth to nominal GDP growth accelerated in early 2013, peaking at 2.3 times GDP growth in the second quarter of the year – the highest level since 2003 (excluding the period of emergency stimulus during the Global Financial Crisis). In Q3, this ratio pulled back to 1.6 – a level still quite high when compared with the past decade.

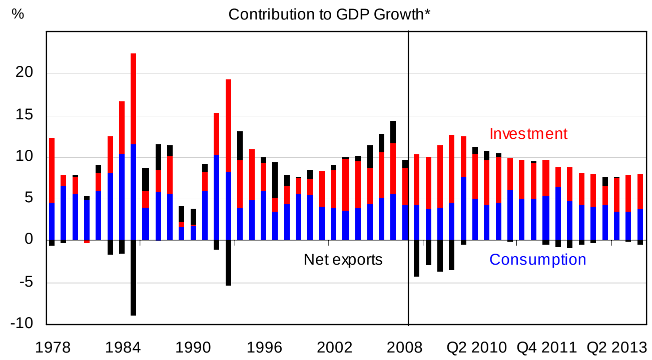
The People's Bank of China is attempting to manage credit growth via passive tightening in liquidity – allowing market rates to rise without any direct intervention. Market interest rates trended higher across 2013, and the central bank is gradually liberalising the money market – which should eventually lower speculative investment and shadow financing.

Business surveys point to softening conditions – with the Business Climate Index down to 119.5 points in the December quarter, the lowest reading since mid 2009. The index has been broadly trending downwards since late 2010. Conditions

Real GDP growth eased to 7.7% in 2013

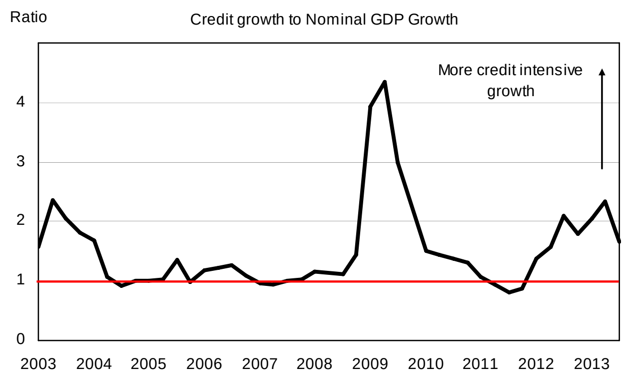
* Data prior to DQ2010 are estimated by NAB.
Source: CEIC, NAB Economics

Contribution to GDP growth



* Annual data until 2008, Quarterly from Q1 2009
Source: CEIC, NAB Economics

Credit intensity increased in the first half of 2013



Source: ADB, CEIC, NAB Economics

were softer in the fourth quarter in all of the major industry categories, although the climate for Real Estate is near its strongest levels since Q3 2011. In contrast, conditions in Retail & Wholesaling remain comparatively weak – near the levels recorded during the worst of the GFC.

Looking closer at partial indicators, the slowing trend in economic activity was evident in industrial production growth – which eased back to 9.7% in December (from 10.0% in November). The rebound in industrial production – also boosted by the mid year 'mini-stimulus' program – peaked in August (at 10.5%), but growth has eased back since this time. Production trends in major construction related sectors were marginally stronger in December – with cement production growing by 10.8% yoy (compared with 10.0% in November) and rolled steel production rising by 10.3% yoy (from 10.0% previously). In contrast, there was a moderating trend in motor vehicle production – which grew by 22.8% yoy in December, down from 25.6% in November. Electricity generation increased by 8.3% yoy in December, compared with just 6.8% in November.

The slight softening trend in the industrial sector was in line with the results of the manufacturing PMIs, which have eased back from recent highs in October. The official NBS PMI – which is weighed more towards the large, state owned enterprises – pulled back to 51.0 points (from 51.4 points previously). The HSBC Markit PMI (which has a greater representation of small to medium sized manufacturers) was at 50.5 points in December (down from 50.8 points in November).

Fixed asset investment slowed in December, with our seasonally adjusted estimates for growth declining to 17.2% yoy (compared with 18.4% in November). Across the majority of 2013, growth government influenced fixed investment was stronger than private investment – boosted by a strong pickup in Central Government funded infrastructure projects.

By industry, investment growth in the manufacturing sector slowed in December, down to 18.1% yoy (seasonally adjusted) – broadly in line with typical levels in 2013, but well below the rates prior to 2012.

Investment in the real estate sector was marginally softer in December – with seasonally adjusted growth of 19.7% yoy (compared with 20.0% in November). Policy uncertainty – particularly related to proposed property tax legislation – is an issue for the sector. In mid-January, the Ministry of Land and Resources announced plans to establish a national system for tracking real estate ownership and sales – a likely prerequisite for establishing taxation for the sector.

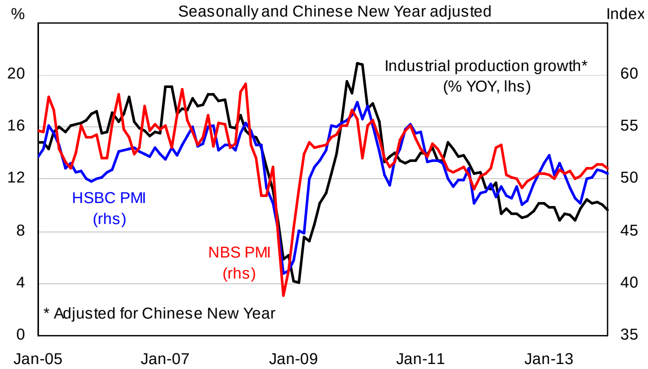
In contrast to declines elsewhere, investment in public utilities (electricity, gas and water) recorded stronger trends across 2013, increasing by a seasonally adjusted 21.9% yoy in December.

Retail sales growth was largely in line with market expectations, at 13.6% yoy in nominal terms (edging down from 13.7% in November). Real retail sales were slightly stronger in December – moving up to 12.2% (compared with 11.8% in November), the strongest rate of growth in 2013. These sales trends came despite a pullback in consumer confidence, which fell to 98.9 points in late November (compared with 102.9 points previously). By product category,

China's business climate – retail near GFC lows

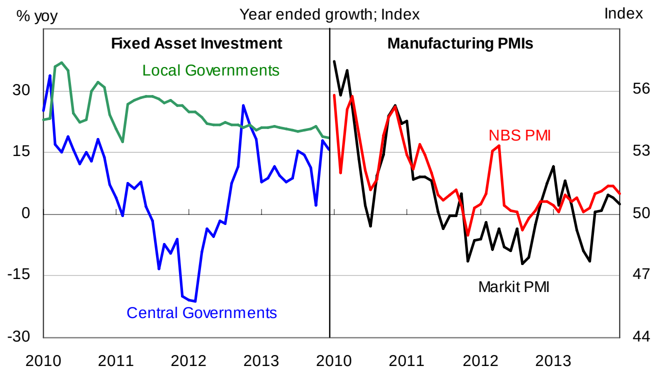
Source: CEIC, NAB Economics

Industrial Production



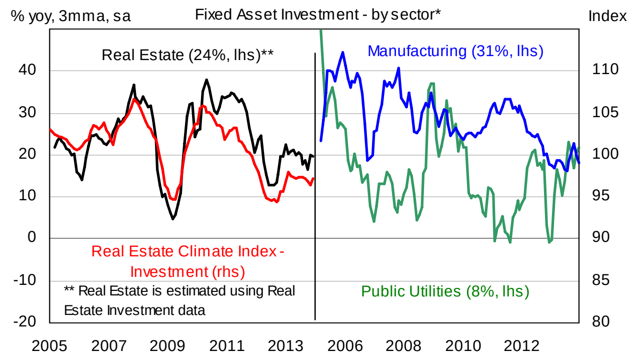
Source: CEIC, NAB Economics

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 Economics

growth in food and beverage sales edged higher (to 14.8% yoy from 14.1% in November), along with a pickup in motor vehicle sales (13.4% in December, compared with 11.6% previously). In contrast, there was a slowing trend in household electronics – with growth at 10.9% (down from 19.6% in November).

After a strong result in November, December's trade data was softer than market expectations, driven by a large increase in imports. For the full year, total trade was US$4.2 trillion, an increase of 7.6% over 2012 (compared with the official target of 8%). China's trade surplus pulled back in December to US$25.6 billion (from US$33.8 billion in November, which was a four year high).

In US dollar terms, growth in merchandise exports pulled back significantly in December – to 4.3% yoy (compared with 12.7% in November). That said, this result reflects base effects from these periods in 2012 – where November was particularly weak, and December particularly strong.

By category, there was a slowdown in growth rates for both High Tech goods (contracting by -1.5% yoy in December, from 6.2% previously) and Mechanical and Electrical goods (increasing by 2.3%, down from 10.4% in November). Combined, these sectors accounted for around 86% of total exports in the month.

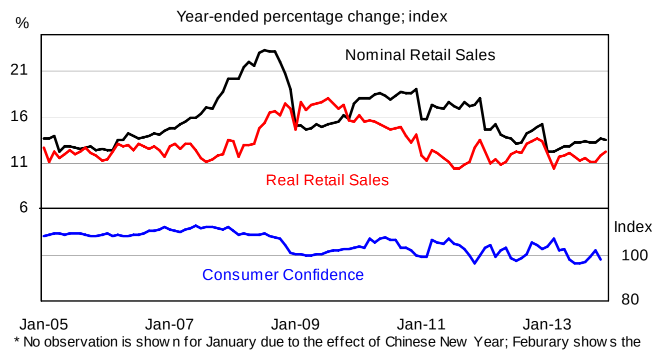
In line with the overall pullback in export growth, there was a slowdown in the growth rates to each of the major export regions in December. Exports to the European Union grew by 3.9% yoy (slowing from 18% in November) while shipments to the United States increased by 3.0% yoy (down from 18%). Exports to non-Japan East Asia also slowed – down to 2.8% yoy – largely due to slower export growth to Hong Kong (in part reflecting efforts by China Customs since the second half of 2013 to crack down on fake export invoices that disguise financial flows that circumvent the country's capital controls). In the short term, export prospects are somewhat mixed – with stronger economic conditions expected in both the United States and Europe in 2014, but comparatively subdued conditions in Emerging Asia.

Growth in imports was stronger than market expectations in December, increasing by 8.3% yoy. Softer trends in import data in 2013 largely reflected declining commodity prices over the year – with increasing volumes of most raw materials (particularly coal and iron ore). Import trends for major commodities in December were mixed – with strong increases copper (29% yoy) and crude oil (13% yoy), while coal increased by almost 9% yoy. In contrast, iron ore imports increased more slowly, at just 3.4% yoy.

Inflationary pressures were considerably softer in December, with the headline CPI pulling back to 2.5% (from 3.0% in November) – a level marginally softer than market expectations. This slowdown was largely in food prices – down to 4.1% in December from 5.9% previously, with lower price increases for vegetables was the main driver (2.6% compared with 22% in November). Non-food inflation was marginally stronger in December – at 1.7% yoy (from 1.6% previously).

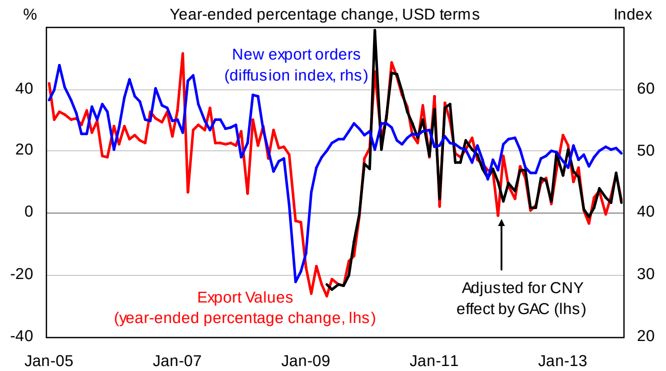
The negative trend in producer prices remained in December – with the level unchanged at -1.4% yoy, the twenty second consecutive month of falling prices. As noted last month, there is a close relationship between declining producer prices and

Retail Sales



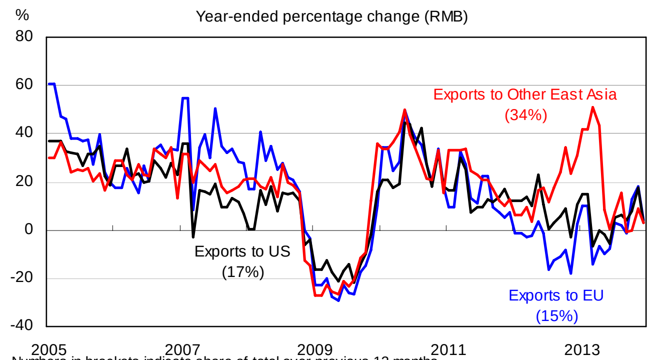
* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.
Source: CEIC, NAB Economics

Merchandise exports and new export orders



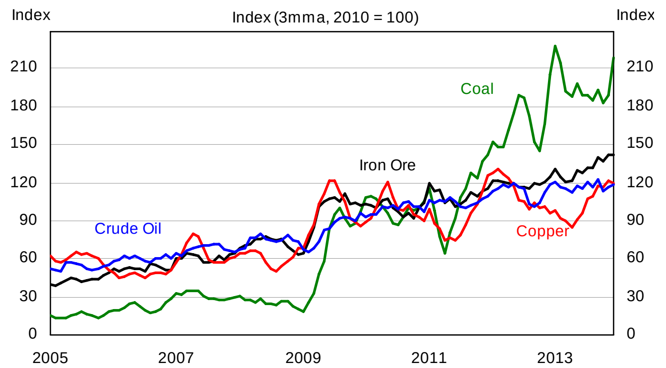
Source: CEIC, NAB Economics

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

falling commodity prices over this period – with the bulk of declines in producer prices reported in heavy industry.

Policy expectations:

Slowing headline inflation (and particularly food price inflation) means that there is little requirement for the People's Bank of China (PBoC) to tighten liquidity via its traditional policy measures – the benchmark lending rate (unchanged at 6% since July 2012) and the reserve requirement ratio (unchanged at 19.5% since May 2012). Over the past quarter, the PBoC has allowed passive tightening, as market rates have trended higher in the absence of liquidity injections via open market operations. This tightening is largely seen as an attempt to curb the debt levels.

While Chinese monetary policy is gradually being liberalised, the volatility of the 7-day Shanghai Interbank Offered Rate (Repo) poses some significant challenges for policy makers. The Repo rate spiked in late December – rising from 4.4% on 16 December to 8.9% on 23 December – as demand for cash surged before the end of the quarter.

In part this peak reflects regulatory requirements for the finance sector – such as loan-to-deposit and reserve ratios – increasing short term demand for cash. In addition, the maturing financial products require additional cash reserves for payments. The sharp pullback in rates following this peak – back to 4.3% in mid-January – was supported by corporate tax refunds from the Ministry of Finance.

The increasing importance of the Repo rate highlights the gradual process of liberalisation of China's money markets – such as the decision in December to allow banks (initially only ten) to issue negotiable certificates of deposit (NCDs), priced using the Interbank rate as its reference.

On 12 December, both the China Construction Bank and Bank of China issued three month NCDs – at a rate of 5.2% (compared with the 3 month SHIBOR at 5.33% at this time). However, activity in the NCDs market has so far been relatively limited.

The path to full liberalisation of deposit markets is likely to be slow, with the Central Government signalling its intention to introduce a deposit insurance scheme prior to further reforms – such as scrapping the regulated deposit rate ceiling. Rising deposit rates would lead to higher lending costs (which rose across 2013). That said, pushing up rates for State Owned Enterprises could reduce the risk of private sector firms being crowded out of traditional lending – which would reduce the uncertainty surrounding shadow financing

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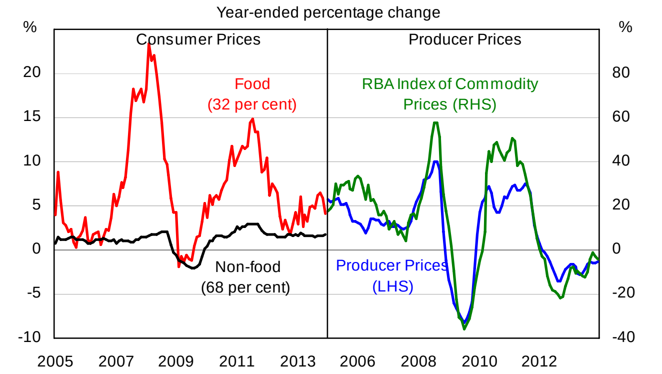
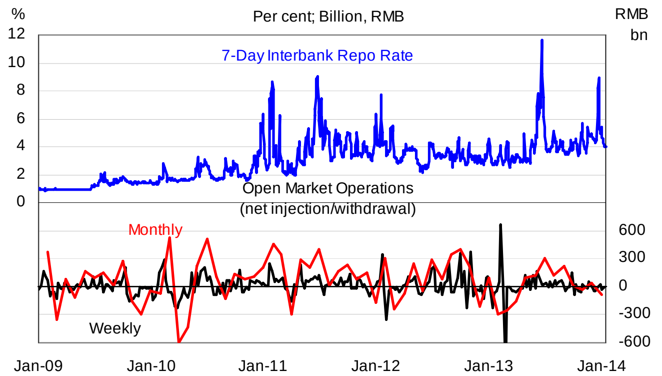
Consumer and Producer Prices



Sources: CEIC, RBA, NAB Economics

Liquidity conditions

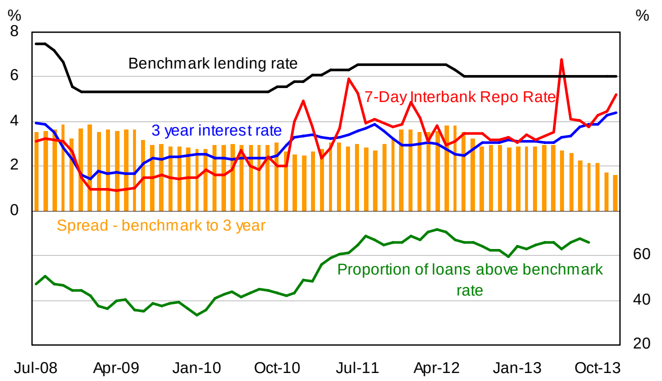


Source: CEIC, NAB Economics

Longer maturity interest rates

Sources: CEIC

Liberalisation of lending rates will push them higher



Sources: CEIC, NAB Economics

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