China Briefing

National Australia Bank

At the start of this month's National People's Congress, Premier Li Keqiang confirmed China's growth target at 'about 7.5%' in 2014, but noted that reform was the Government's top priority. While the target is notionally unchanged from last year, comments by other government officials suggest that there could be some flexibility this year.

Finance Minister Lou Jiwei told a media briefing that job creation was a higher priority than economic growth, and that growth at around 7.2-7.3% would be in line with the target. Missing the growth target is not unprecedented, although Reuters note that the last time this occurred was 1989.

The unchanged growth target seems somewhat at odds with official targets for other measures. Economic growth targets for most provinces have been cut this year, the National Development and Reform Commission is aiming for growth in fixed asset investment of 17.5% (down from a target of 18% and actual outcome of 19.6% last year), while the Ministry of Industry and Information Technology cut the industrial production target to 9.5% (from 10% last year).

Our forecast for China's economic growth is unchanged – reflecting our expectations for softer investment and export trends in 2014, with domestic consumption unable to fill the gap. We expect growth of 7.3% in 2014 (along with 7.0% for 2015) – however the stronger growth target may indicate modest upside to this view.

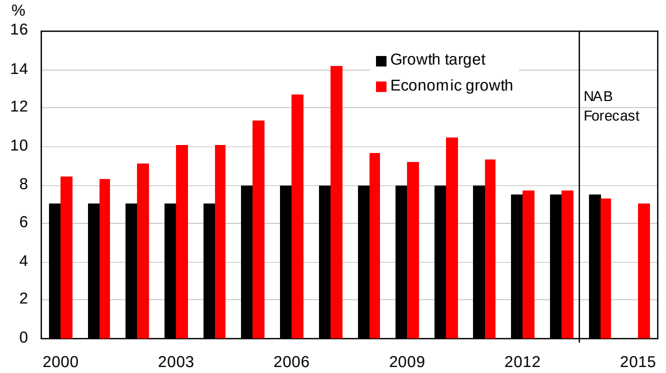
Industrial Production and Investment

Growth in industrial production slowed significantly in February – down to 8.6% yoy (well below market expectations of 9.5%) from 9.6% yoy in December 2013. This level is the lowest recorded since May 2009 (when China was recovering from the global financial crisis). Although this result is quite soft, it may have been impacted by Chinese New Year effects (and a clearer picture of industrial conditions will emerge next month).

The downward trend in industrial production was unsurprising, given the falls in manufacturing PMIs across recent months. The official NBS PMI – which is more representative of larger state owned enterprises – eased to 50.2 points in February (from 50.5 points in January). The HSBC Markit PMI (which has a greater representation of small to medium sized manufacturers) was at 48.5 points in February (from 49.5 points previously).

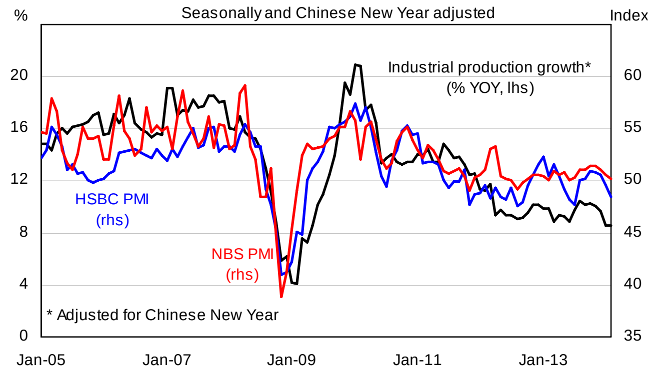
Industrial production growth slowed in most major categories. Rolled steel output rose by 4.9% yoy (down from 10.3% in December), while cement production slowed to 2.4% yoy (down from 10.8%) – with both of these sectors closely tied to the construction sector. Growth in electricity production also dipped – down to 5.5% yoy (from 8.3%), while motor vehicle production increased by 12.5% yoy (down from 23% previously).

China's economic growth vs. annual growth target



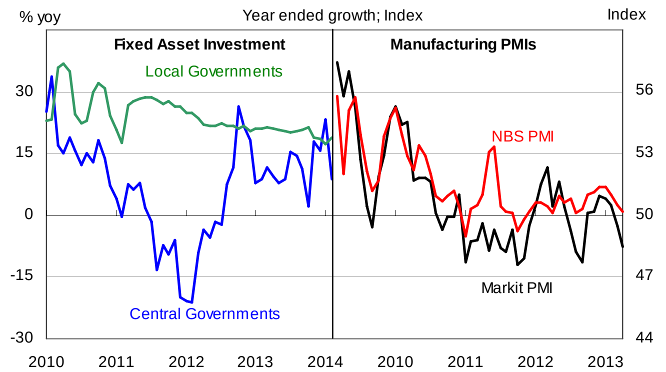
Sources: CEIC, NAB Economics

Industrial Production slows to post-GFC low



Source: CEIC, NAB Economics

Mid-2013 mini stimulus effects now washed out of system



Source: CEIC, NAB Economics

Fixed asset investment was marginally stronger across January and February, with the seasonally adjusted rate at 17.9% yoy (up from 17.2% in December). That said, the rate of growth was still below the typical levels recorded across the past decade. Government influenced investment has slowed significantly across recent months – indicating that the effects of mid-2013's mini-stimulus program have now washed out of the system.

Weaker investment levels are particularly evident in the manufacturing sector. In response to last year's stimulus, fixed asset investment in manufacturing peaked at around 23% yoy in October, but growth has declined since – down to 16% in February (on a seasonally adjusted basis). Similarly investment in public utilities (electricity, water and gas) has pulled back significantly since late 2013.

In contrast, investment in real estate has remained relatively stable – increasing by 20% yoy in February (seasonally adjusted), broadly in line with the trend levels observed across 2013. Reports from the National People's Congress suggest that Chinese authorities are currently drafting national property tax legislation, however it is unclear when it will be implemented, and what it means for pilot programs in Shanghai and Chonqing.

International trade

Trade data in February was particularly weak – which appeared to spook global markets – but this followed unexpected strong levels in January. This volatility reflects the timing of Chinese New Year (CNY).

In nominal terms, both exports and imports plunged (compared with January) – with the fall in exports particularly noticeable, resulting in a trade deficit of US$23.0 billion (compared with a surplus of US$31.9 billion in January). Smoothed across the CNY period, there was a modest surplus – equivalent to around $4 billion in both months.

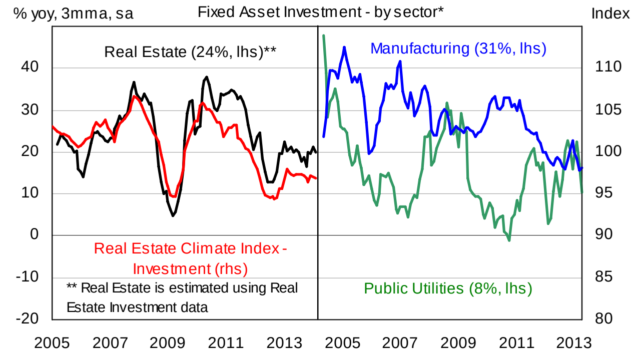
US dollar denominated merchandise exports fell by 18.1% yoy (following on from a 10.5% increase in January). When smoothed for the CNY, exports were marginally weaker over the period – down by 1.7%. This is more in line with our expectations for weak export growth in the first half of 2014 – due to crackdowns on false invoices used to avoid capital controls (a trend which artificially inflated export growth in the first half of last year).

This trend is evident in the export data by region – with a sharp slowdown in exports to East Asian markets (which fell by an average of 9.2% across January and February). This decline was driven by lower exports to Hong Kong – the main location for invoice schemes. In contrast, exports to the European Union and United States were marginally stronger – up by 4.7% and 1.3% year on year over the period.

Exports fell across all of the major categories, but most noticeably among High Tech producers. High tech exports fell by an average of 9.7% year on year across January and February (compared with -1.8% in December). Declines were more modest for Mechanical & Electrical goods (down 5.2% yoy) and Agricultural products (down 2.7% yoy).

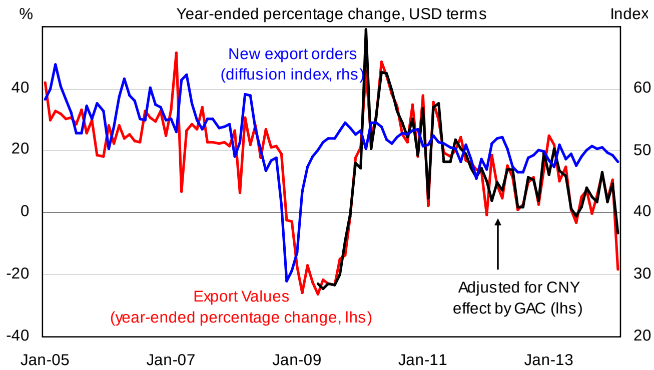
Import data also showed a sharp pullback in February (compared with unexpectedly strong results in January) – although historically February is typically a weak month for imports. When smoothed across the CNY period, average

Fixed Asset Investment by Sector



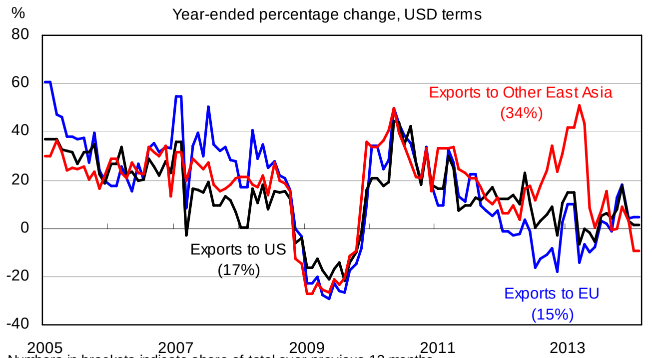
* Number in brackets represents share of total FAI in 2010
Source: CEIC, NAB Economics

Merchandise exports and new export orders



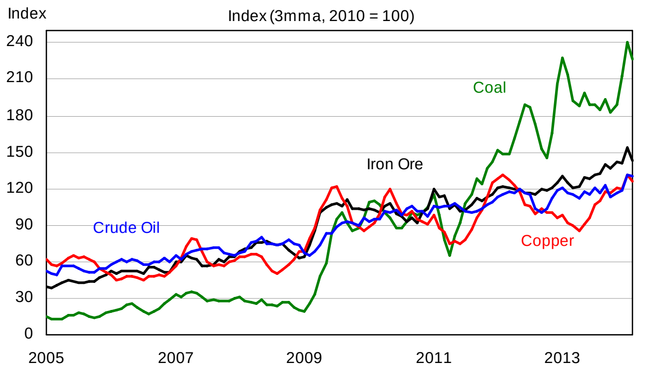
Source: CEIC, NAB Economics

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

growth was relatively strong – at around 10.6% year on year (up from 8.6% yoy in December). Commodity markets were hit sharp slowdowns in February, however this once again may reflect volatility due to the new year. Over the two month period, copper imports increased by 41% yoy, iron ore increased by 21% yoy, crude oil by 11.5% yoy and coal by 9.1% yoy, with only crude oil recording slower growth than in December.

Retail Sales and Inflation

Growth in retail sales was softer than market expectations in February, at 11.8% yoy in nominal terms (down from 13.6% in December). In real terms, real sales growth was 10.9% yoy – also weaker than the levels of late 2013. Recent trends in consumer confidence have been relatively muted, and remain well below the levels recorded a year ago.

Growth rates slowed across most product categories – with food & drink retail increasing by 10.1% yoy (down from 14.8% in December), household appliances by 7.3% yoy (compared with 10.9% previously), consumer goods up by 11.8% yoy (from 13.6%) and motor vehicles sales at 11.5% yoy (down from 13.4% in December).

Headline CPI has continued to slow from the recent peak in October 2013. In February, consumer prices increased by 2.0% yoy (down from 2.5% in January). The decline was evident in both food and non-food prices – with food prices increasing by 2.7% yoy in the month (compared with 3.7% previously), while non-food edged down to 1.6% (compared with 1.9% in January). Falling prices for meat and poultry contributed to the softer food price trends.

Producer prices fell by -2.0% yoy in February (compared with -1.6% in January). The negative trend in producer prices has been evident for two years, the longest period of declines since 1999. The trend has been particularly evident in heavy industry, and closely follows US dollar denominated commodity price movements over this period.

Policy expectations

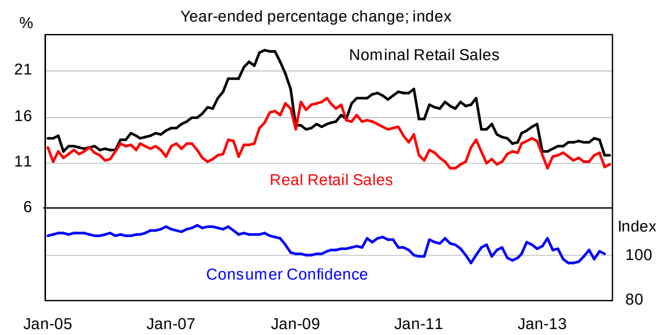
Competing policy goals may be influencing money markets at the present time. From mid-February onwards, there has been a notable downward trend in the Shanghai Interbank Offered Rate (Repo) – down from around 5.0% on 13 February to around 2.2% in mid-March – in stark contrast to a gradual increasing trend since early 2012.

The People's Bank of China (PBoC) appear to have reduced the level of weekly liquidity withdrawals in recent times – in part a likely response to the corporate bond default in early March (which immediately pushed yields on corporate and enterprise bonds higher).

The fall is far more evident in near term rates – with more modest declines seen in three year and particularly five year rates.

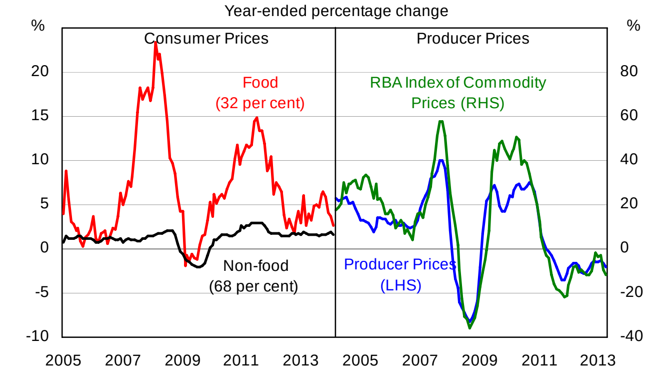
Given broader concerns around unsustainable debt growth, we expect to see the Repo rate resume its upward trend, once short term concerns are cooled.

Retail sales growth slowed in February



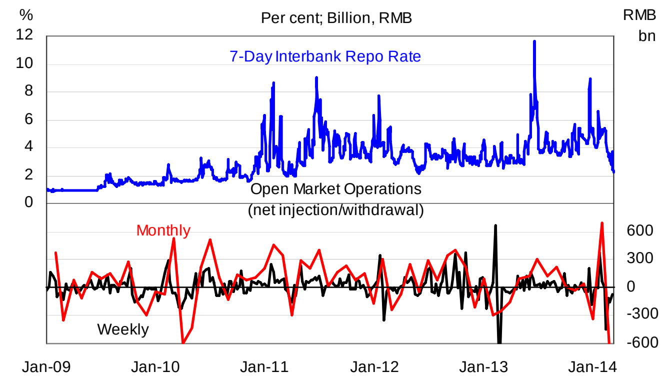
* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.
Source: CEIC, NAB Economics

Consumer and Producer Prices



Sources: CEIC, RBA, NAB Economics

Liquidity conditions



Source: CEIC, NAB Economics

Longer maturity interest rates

Sources: CEIC

Increased liquidity may also be in response to regulatory changes connected to shadow banking. A spike in bank loans across January and February – leading to an increasing share of bank loans within the PBoC's Total Social Financing measure – likely reflects banks being forced to bring off-balance sheet items back to their books.

Rumours suggest that the PBoC is also considering cutting the Required Reserve Ratio – which has remained unchanged at 20% for larger banks since May 2012 – according to reports in Chinese newspaper Economic Information Daily. That said, several Chinese banks have dismissed the suggestion, demonstrating some of the uncertainty in current policy arrangements.

On the deposit side, the Governor of the PBoC announced during the National People's Congress that deposit rates are likely to be fully liberalised in one or two years. As previously noted, the Chinese Government has signalled its intention to introduce a deposit insurance scheme prior to further reforms – reaffirming this intention at the Congress. Higher deposit rates will impact margins for major banks, but could improve funding allocation longer term.

Growth in internet based finance has played a key role in driving this reform. Rates offered by firms such as Alibaba, Baidu and Tencent are almost twice those available to traditional savers – increasing competivie pressures in the banking sector. Deposits with Alibaba's Yuebao product have reportedly increased from a few billion yuan to half a trillion yuan in the space of eight months.

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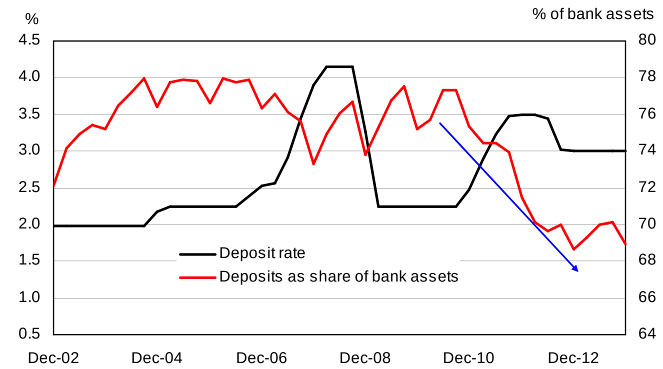
Deposits declining as share of bank assets



Sources: CEIC, NAB Economics

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