more give, less take

China Economic Briefing

by NAB Group Economics

July 2014

National Australia Bank

Government financial reforms could ease local government debt fears

In late June, China's politburo agreed to fiscal and taxation reforms that were outlined at last year's Third Plenum, setting a deadline for implementation at the end of 2016. These reforms should provide greater transparency and predictability of local government revenues.

This move follows the introduction of the local government bond pilot scheme, which commenced in June. Guangdong province issued bonds totalling RMB 14.8 billion, with maturities ranging between 5 and 10 years.

Together these measures could reduce the concerns around local government debt and the high dependency on land sales to service debt obligations (a major concern given softening trends in the real estate sector).

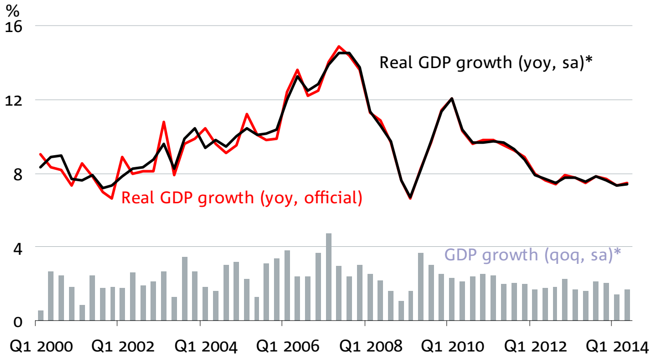
Gross Domestic Product

China's National Accounts data shows that the economy grew by 2.0% qoq in the June quarter and 7.5% in year-on-year terms (levels marginally stronger than market expectations of 7.4%). This result was consistent with partial economic indicators, which showed the economy stabilising in the June quarter, following on from the declines recorded in Q1.

On an expenditure basis, consumption was the major contributor to GDP in the first half of the year (accounting almost 54% of growth), however this was weaker than Q1 (around 64% according to our estimates). Investment had a stronger contribution in the second quarter – despite the weakening trend in fixed asset investment. This likely reflects the disconnect between this measure and the national account measure – with the latter excluding land sales. Net exports continued to detract from GDP in the first half – albeit relatively modestly (-20 basis points in the first half).

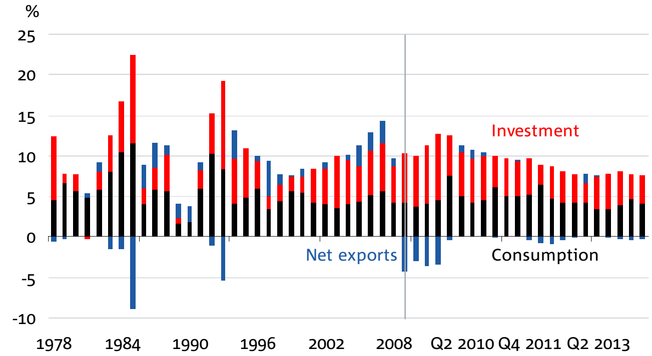
Policy measures have been introduced to stabilise the economy, however they remain well short of previous stimulus measures. Investment in social housing, for example, is unlikely to compensate for the slowing trends in residential construction. Our forecasts remain unchanged, with economic growth at 7.3% in 2014, and slowing further to 7.0% in 2015.

Real GDP growth edged up to 7.5% yoy in June quarter



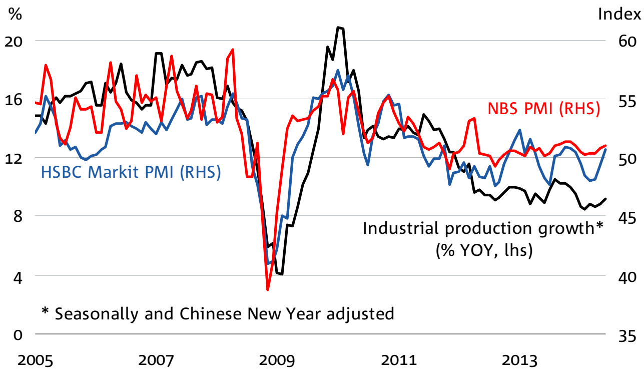
* Seasonally adjusted growth series are estimated by NAB.
Source: CEIC, NAB Economics

Consumption's share of GDP growth pulled back compared with Q1



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

Industrial production picked up in June, recovering from the slowing trend



Source: CEIC, NAB Economics

Industrial Production and Investment

Growth in industrial production picked up in June – with output increasing by 9.2% yoy in June (up from 8.8% in May). This level was ahead of market expectations (9.0%), and points to stabilisation in the secondary sector, following the slowdown since late 2013.

China's PMI surveys have been showing improving trends since April. The official PMI, produced by the National Bureau of Statistics and more representative of the larger state-owned sector, edged up to 51.0 points in June (from 50.8 points previously). The HSBC Markit PMI (which includes more SME firms) pushed up to 50.7 points (from 49.4 points) – the highest since November 2013.

Output levels at the sub-sector level were mixed in June. There were stronger levels for crude steel production – increasing by 4.5% yoy (from 2.6% in May) and steel products (7.1% yoy in June from 6.1% previously). In contrast, cement – a sector closely tied to construction – decelerated, growing by 0.8% in June from 3.2% previously, while electricity and motor vehicles were also slower.

Trends in fixed asset investment also pointed towards stability, having fallen sharply in late 2013, with growth at 17.6% yoy in June, up from 17.0% in May. This was the strongest growth rate since February this year.

By sector, the slowing trend in real estate remains evident. Real estate investment rose by 12.9% yoy (from 13.7% previously), the slowest rate of growth since July 2012, and in line with weakening survey trends. Similarly, investment in manufacturing remained weak – at 14.5% (from 14% in May).

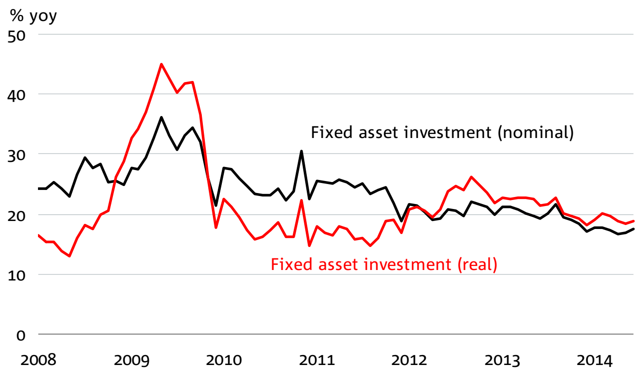
Conditions in the broader residential property market were less negative in June – with property sales falling by -3.5% yoy (significantly lower than falls in April and May) – while prices fell by -1.9% yoy (again less negative than early 2014). Anecdotal reports suggests that a range of cities have reduced restrictions on property purchases in an effort to support markets.

International trade

China's trade surplus remained strong in June, at US$31.6 billion (narrower than May at US$35.9 billion). The level of both exports and imports was lower in June (compared with May), although the monthly decline was larger for exports.

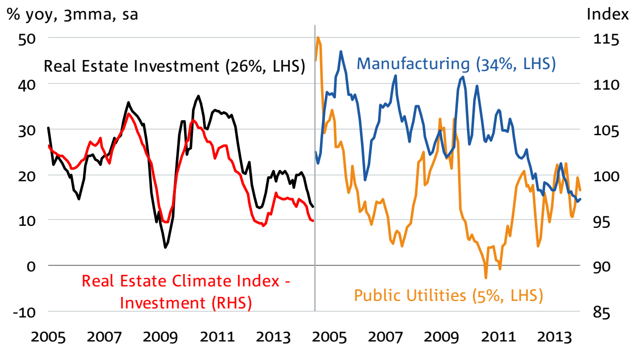
In year-on-year terms, US dollar denominated exports rose by 7.2% – weaker than market expectations. In the first half of the year, exports were around 0.9% higher than the same period last year, however data has been distorted by the crackdown on false invoicing, designed to avoid China's capital controls. The second half of this year should provide a clearer indication of physical trade.

Fixed asset investment slightly stronger in June, but below levels of recent years



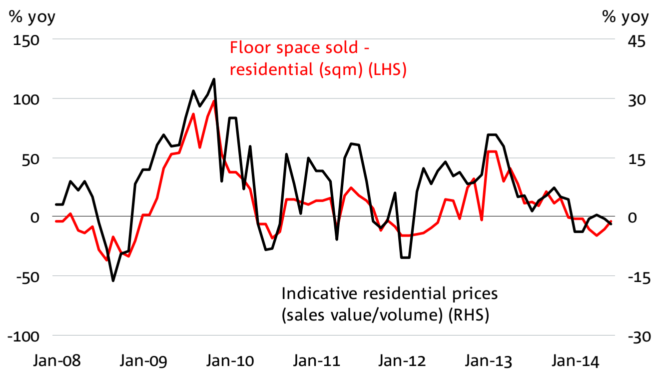
Source: CEIC, NAB Economics

Real estate investment trends continue to weaken



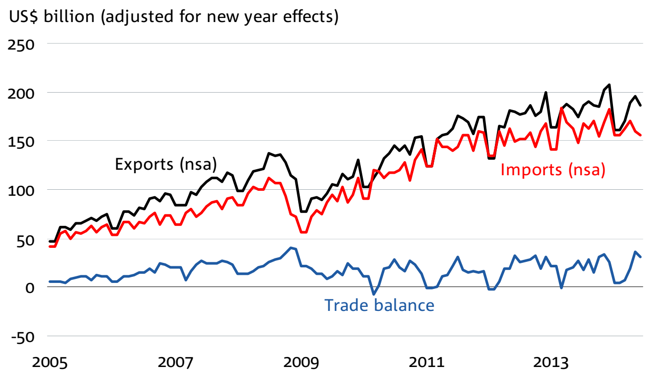
Number in brackets represents share of total FAI in 2013
Source: CEIC, NAB Economics

Residential prices falling, but relatively modestly



Sources: CEIC, Datastream, NAB Economics

Trade surplus remained strong in June



Sources: CEIC, NAB Economics

There has been a major improvement in exports to East Asia – increasing by 7.1% yoy in June. For the first time this year, exports to Hong Kong increased on a year-on-year basis – rising by 6.5% – with Hong Kong having been the main destination for invoicing schemes. Exports to the United States and European Union remained at slightly softer levels than recent trends – up by 7.5% and 13% respectively.

The stronger trends for exports have been supported by growth in both Mechanical & Electrical goods and High Tech products – both of which have switched from falling export levels between February and April to year-on-year growth in May and June.

China's imports increased by 5.5% yoy in June (following on from a -1.7% fall in May). By commodity, trends were quite divergent, with growth rates likely influenced by weakness in June 2013, due to the credit crunch at this time (coal imports for example slumped in June 2013). In June, coal imports rose by 12% yoy (compared with -13% in May), iron ore imports increased by 20% yoy, while copper fell by -7.9% yoy –in part reflecting an investigation into commodity financing at Chinese ports.

Retail Sales and Inflation

In nominal terms, growth in retail sales was stable in June at 12.4% yoy. In real terms, sales trends were also stable, rising by 10.6% yoy (compared with 10.7% in May). Consumer confidence recovered a little in June, having eased from a recent peak in March, and generally remains in positive territory.

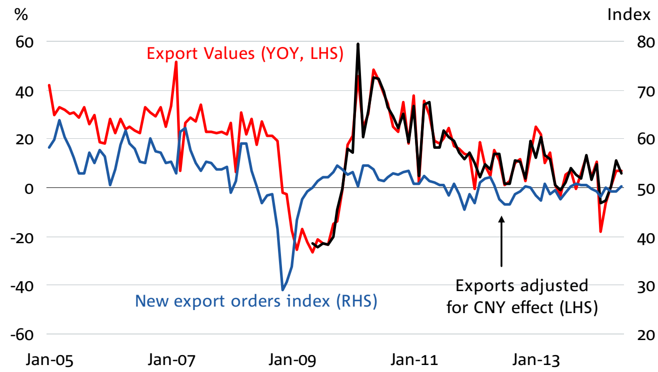
By category, food and drink sales grew in line with broader retail trends – up by 12.4% yoy (from 13.7% last month), while there was an acceleration in household goods sales – up by 10.7% yoy (from 6.6% in May). Jewellery sales remain weak – down -0.2% yoy – with these sales possibly impacted by the official anti-corruption drive.

There was a slight pullback in inflation in June, with the headline consumer price index rising by 2.3% yoy (compared with 2.5% in May). Changes in food prices typically have the main influence on the headline result – with non-food price inflation stable at 1.7% in June.

In contrast, there was a slight deceleration in food price growth, with prices rising by 3.7% yoy in June (compared with 4.1% in May). Meat and poultry price growth slowed – rising by just 1.9% yoy last month (from 3.2% in May), while prices for fresh vegetables fell -1.8% yoy, the third straight month of falls.

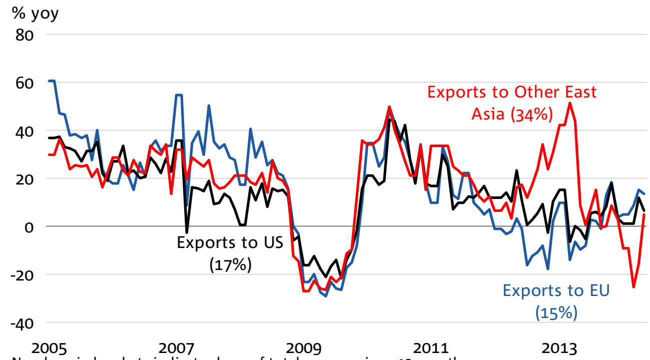
Producer prices fell once again – down by -1.1% yoy. Producer prices have fallen for twenty-eight months in a row – approaching the thirty-one month record between June 1997 and December 1999. Heavy industrial producers continue to record the largest declines in producer prices.

Exports marginally higher in the first half of 2014



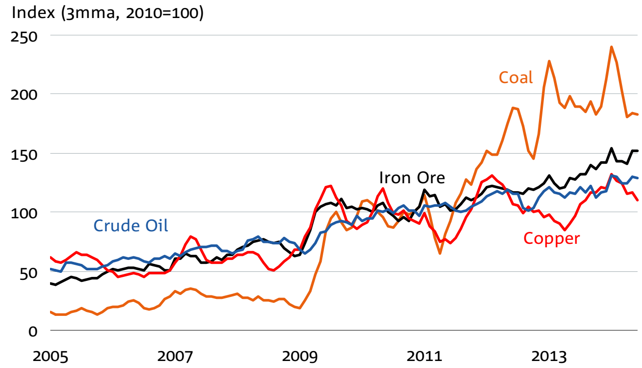
Source: CEIC, NAB Economics

Exports to East Asia have rebounded recently



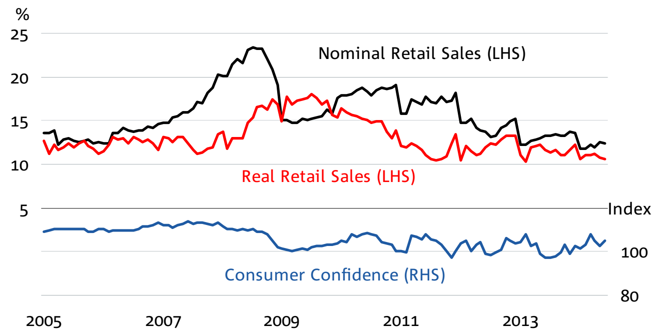
Numbers in brackets indicate share of total over previous 12 months
Sources: CEIC, NAB Economics

Copper imports pulled back in June



Sources: CEIC, NAB Economics

Retail sales trends remaining stable, confidence slightly improved



* 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

Policy expectations

In year-on-year terms, there was a noticeable expansion in Chinese credit in June. During the five months to May, new credit was smaller than the same period in 2013 (down -5.9%), however this trend reversed in June, with new credit (total social finance) increasing by 3.9% in the first half of the year.

That said, this increase likely reflects the impacts of the credit crunch in June 2013, rather than a broader loosening in credit policy. Despite calls for broad based cuts to reserve requirement ratios for banks, cuts have so far been limited.

By sector, growth remains particularly evident in the traditional banking sector – which increased by 9.6% yoy in the first half – while shadow banking components such as trust and entrusted loans fell by -23% yoy (in part reflecting efforts to rein in the sector)

For most of June, there was little movement in the 7 day Shanghai Interbank Offered Rate – trading between 3% and 3.5%, levels broadly unchanged from May. This stable period has been in stark contrast to the volatility across most of early 2014. The SHIBOR began to trend higher in late June, as end-of-quarter demand (such as meeting financial regulatory requirements) increased cash demand, driving the SHIBOR briefly above 4%, before drifting back below this level in early July.

Monetary policy remained accommodating over this period, with the People's Bank of China (PBoC) injecting liquidity into money markets from mid May onwards.

In contrast, longer term rates dropped in early June – following relatively stable levels across early 2014 – with 3 year rates falling around 25 basis points. Rates recovered in late June, in line with upturn in the SHIBOR.

Commentary from the PBoC Governor in early July indicated that the bank is continuing to develop necessary policy tools to manage short and medium term interest rates – in line with international practices. This should allow for lower volatility in the SHIBOR in the longer term, as the bank continues down the path of liberalisation.

More generally, short term interest rates remain relatively low (when compared with the levels of late 2013). Efforts to slow credit growth appear a lower immediate priority than stabilising economic trends and property markets.

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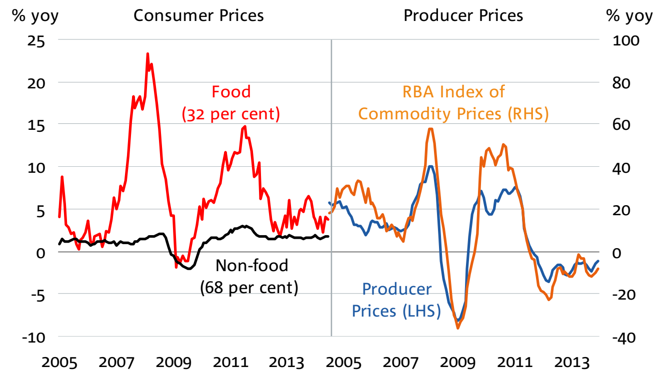
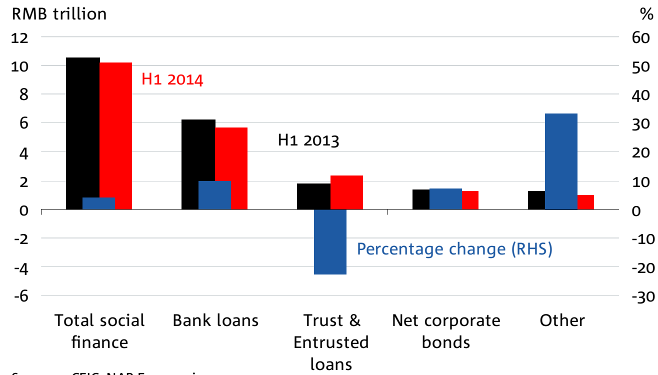
Consumer and producer price inflation subdued



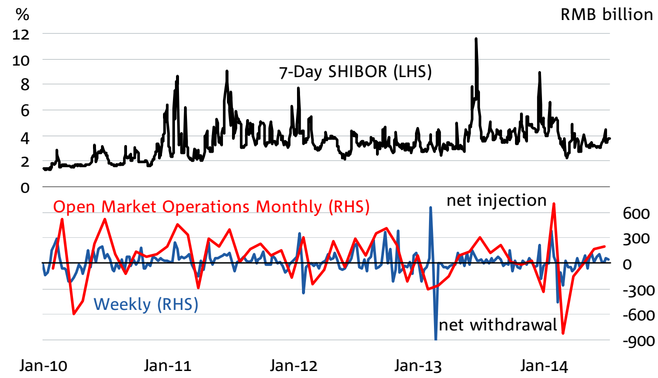
Sources: CEIC, RBA, NAB Economics

Banking sector the main contributor to growth in credit



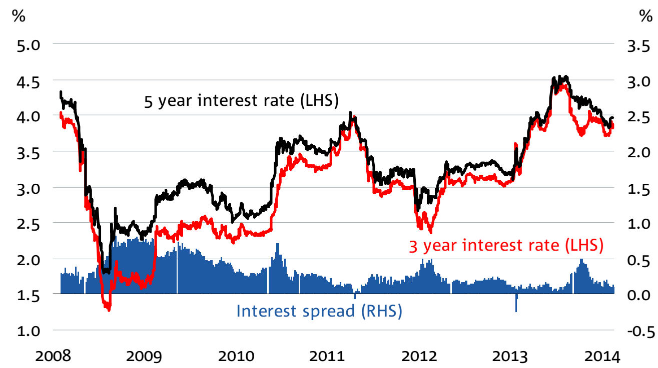
Sources: CEIC, NAB Economics

SHIBOR comparatively stable across most of June



Source: CEIC, NAB Economics

Longer rates were more volatile in June



Sources: CEIC, NAB Economics

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