Chinese Monthly Update

National Australia Bank

- **China's economy showed further signs of steadying in October with most of the partial indicators recording an improvement in the month. Year-ended growth in production, retail sales, fixed investment and exports all accelerated in the month. In contrast, bank credit came in below expectations.**
- **The new members of the Politburo Standing Committee were revealed following the National Congress meeting. As expected, Xi Jinping looks set to replace Hu Jintao as President next March, while Li Keqiang will likely replace Wen Jiabao as Premier. The new group are considered to be relatively conservative, suggesting Chinese economic reforms may be more gradual than previously thought.**
- **We have kept our forecast for China's GDP growth at 7½% in 2012 as the final quarter recovery will likely be modest. Growth should start to pick up in 2013 as recent policy stimulus gains more traction. We no longer expect any more cuts to interest rates this year, but a 50bp cut to reserve requirements is still possible.**

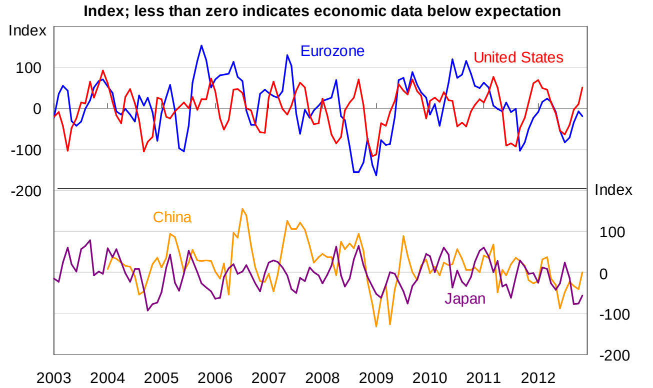
Overview

Potentially the biggest news in China over the past month was the appointment of China's new leadership following the 18th Communist Party Congress. Seven new members of the Politburo Standing Committee were revealed last Thursday – a group that is both older and more conservative than many had hoped; five of the seven members are aligned with former President Jiang Zemin's "elitist" faction. While this may potentially slow the progress of future political and economic reforms, it may also inject some stability into the political environment. Following the Bo Xilai scandal in the lead up to the CPC, the fight against corruption was a major theme for discussion, as was the growing concern over inequality and the environment. In his opening address, outgoing President Hu Jintao set a medium-term objective of more balanced, coordinated and sustainable development, and stated that China should double its 2010 GDP and per capita income by 2020. However, the main purpose of the national congress was to appoint the new leadership, and we will need to wait for the Central Economic Work Conference in December to shed more light on the Party's macroeconomic policies for the coming year. As expected, Xi Jinping looks set to replace Hu Jintao as President next March, while Li Keqiang will likely replace Wen Jiabao as Premier.

China's economy has continued the trend seen in September with most of the partial indicators recording an improvement in the month. Efforts by the Chinese authorities to stabilise the economy appear to be working, although we have also seen signs that improvement in external demand is helping bring about a recovery in manufacturing activity. While there continue to be a number of risks facing the economy, the recent trends in the data go a long way towards allaying concerns over an economic hard landing, at least in the near term.

In November, Citigroup's economic surprise index for China posted its first positive result since March, with the anticipated economic recovery for Q4 coming along broadly in line with expectations. Signs that the economy is stabilising comes at a good time for Chinese authorities who are hoping the leadership transition goes smoothly. The more positive data are also welcome as the uncertainty of the US fiscal cliff approaches and Europe continues to struggle to sort out their debt issues and reinvigorate growth. Improving confidence in the near-term outlook for the Chinese economy, combined with quantitative easing by major central banks, appear to have put a stop to capital flowing out of China, helping to ease liquidity strains, but also putting pressure on the currency to appreciate.

Economic Surprise Index



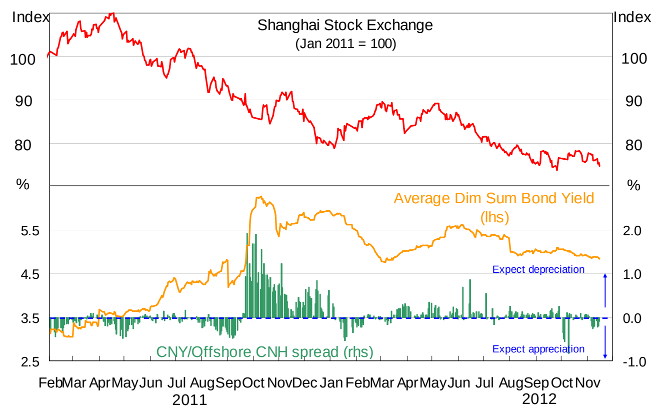
Sources: Citigroup; Thomson Reuters

On the production side, October industrial production growth accelerated to be 9.6% over the year, up from 9.2% in September. Exports for the month rose 11.6% compared to last year (up from 9.9% in September), with demand from the US and parts of Asia improving. However, solid retail sales and fixed asset investment growth indicate that domestic demand has also contributed to the improvement in manufacturing, although a significant amount of the strength probably stems from government stimulus measures. Real estate investment growth looks to have bottomed out and timely indicators have been improving, but this has triggered concerns that authorities will ramp up their efforts to rein in the market to further improve affordability.

Inflation pressure were more subdued than generally expected in October, and despite signs of a slowing labour market, the upbeat partial economic indicators suggest to us that the potential for additional monetary easing by the PBoC has diminished substantially. Nevertheless, although the economic recovery will remain tenuous, inflation is expected to pick up towards the end of the year as favourable base effects disappear and the economy's growth momentum improves gradually. Consequently, we no longer expect to see any more cuts to interest rates this year since officials have voiced their expectations for a stronger economy in the fourth quarter. They are also wary of reigniting the property bubble that has been so difficult to contain. We continue to have one more 50bp cut to reserve requirements pencilled in by the end of the year as a liquidity squeeze remains a risk. However, potential for more foreign capital to flow back into the country, along with the PBoC's preference of late to rely on open market operations to manage liquidity, could discourage a bold policy move.

We have left our GDP forecasts unchanged for now, but the better than expected outcomes recently indicate more upside to the outlook. Overall, we expect growth to remain relatively subdued in the final quarter, with overall growth for 2012 coming in slightly above 7½%. We are forecasting growth to pick up to around 8% next year as the impact of stimulus measures shows up in the real economy, and the global economic environment starts to stabilise. The risks to growth in the global economy are weighing on the near term outlook, while domestic imbalances are adding to the potential for much slower growth further along the forecast horizon.

Financial indicators



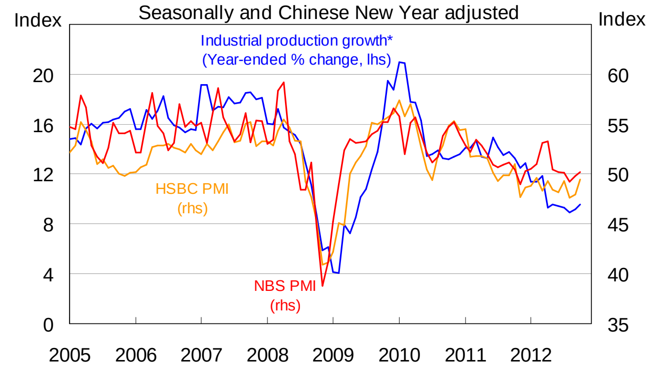
Sources: Bloomberg; CEIC; NAB

Any positive reaction experienced by China's equity market in response to recent economic data has been relatively short lived, although the steady decline seen since mid year seems to have ceased. Equities have underperformed this year on the back of slower economic growth and increased uncertainty which had triggered some capital to exit the economy. Poor profit results – net income of industrial firms has declined for the year to date – has dampened investor appetite for equities. Similarly, many firms may be experiencing cash flow difficulties as rising accounts receivable point to difficulties with unpaid bills. Nevertheless, better than expected export growth, in conjunction with the recent monetary easing announcements by foreign central banks – increasing the potential for capital inflows – may have reinvigorated market expectations of RMB appreciation. The spread on CNY/CNH turned negative earlier in the month.

Industry

Consistent with an improvement in the NBS manufacturing PMI (rising to 50.2 from 59.8 in September), industrial production growth accelerated to 9.6% in October, from 9.2% in the previous month. The manufacturing PMI compiled by HSBC, thought to be more representative of small and medium sized firms, also rose to 49.5 in October from 47.9 the previous month, but has remained below 50 for 12 consecutive months. Seasonally adjusted data show that month on month growth remained at 0.8%.

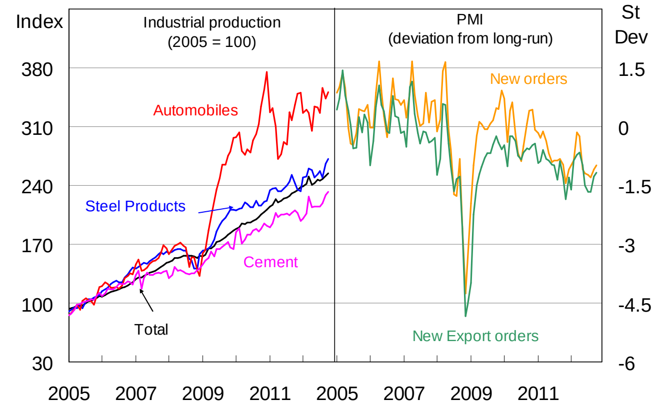
Manufacturing sector growing at a more sustainable pace



* Adjusted for Chinese New Year
Source: CEIC, Nab

Increased production volumes of steel products and cement could suggest that de-stocking pressures that have weighed on production are now coming to an end – steel inventories have been run down and domestic steel prices have risen recently. It may also reflect the pick-up in government infrastructure spending as officials work to ensure that growth targets are achieved for the year. However, steel mills will often restock ahead of the winter months, meaning an increase in production could partly reflect seasonal factors rather than an improvement in end-user demand. Consistent with this, iron ore import volumes fell 13% in October, which could point to a slowdown in steel production in coming months; copper imports also fell 18½% in the month.

Production and PMI Components



Aside from construction materials, production of automobiles rose by 2.3% in the month, after adjusting for seasonality (sa), to be 4.5% higher over the year. Production of automobiles has remained at elevated levels despite potential for disruptions to the industry stemming from political tensions with Japan; Japanese automakers announced in late September that they were slashing car production in China. Raw data produced by the China Association of Automobile Manufacturers show autos production declining 4½% from September, attributing the decline to a sharp drop in the output of Japanese-branded vehicles; sales of Japanese cars are reported to have declined almost 40% in the month of October, to be down almost two-thirds compared to last year. Looking at indicators for the next few months, new domestic orders have risen above 50 for the first time since April, and while overseas orders remain below the 50 mark, they rose to 49.3 in October (from 48.8). China's Leading Economic Index increased 0.7% in September, but remains significantly below previous highs.

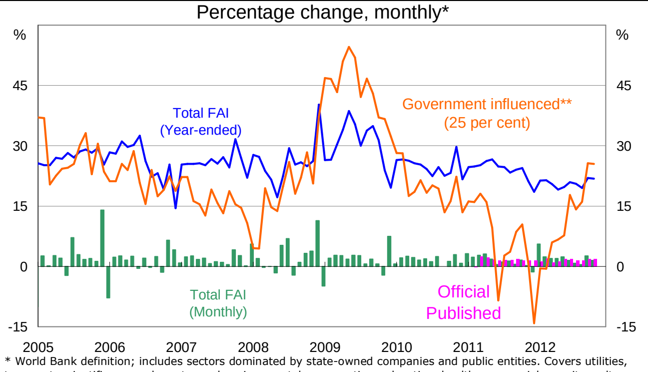
Conditions may now be turning more favourable for industrial firms. Net income for September reportedly increased 7.8% over the year, up from a 6.2% decline over the year to August.

However, part of the improvement is due to base effects; industrial profits in the year-to-date are down 1.8% compared to the same period last year.

Investment

Fixed asset investment

Percentage change, monthly*

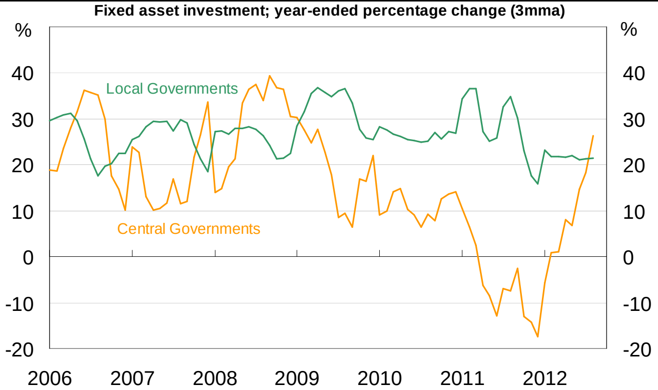


* World Bank definition; includes sectors dominated by state-owned companies and public entities. Covers utilities, transport, scientific research, water and environmental conservation, education, health care, social security, culture, sport, and public administration.
Sources: CEIC; NAB

Fixed asset investment has remained robust. We estimate that investment increased 21.8% over the year (similar to last month), largely thanks to strong investment in government influenced sectors, particularly infrastructure, while investment in manufacturing has continued to moderate. Forward indicators have been solid, but still don't suggest an imminent influx/surge of investment projects; the value of investment projects newly started increased around 33% from last year – compared to more than a doubling in new projects at the peak of the 2009 stimulus. So far, the acceleration in public fixed asset investment has been completely driven by a ramp-up in projects by the central government. In contrast, growth in local government's investment has remained unchanged (but at a high level) despite showing exuberance in their announcements of ambitious investment plans in recent months.

Government stimulus investment

Fixed asset investment; year-ended percentage change (3mma)

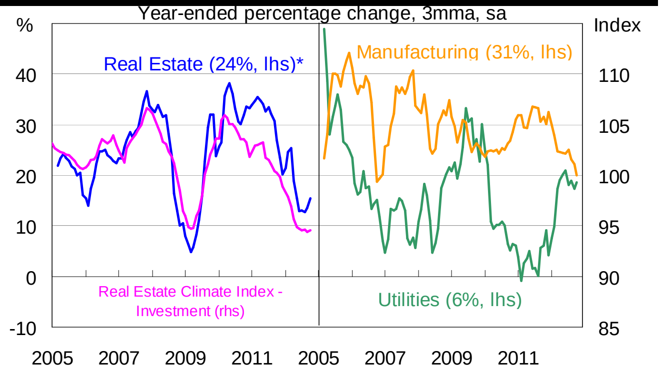


Sources: CEIC

It's possible that local governments are finding it difficult to raise the necessary funds to finance their investment plans – the significant rise in debt obligations following the credit fuelled investment stimulus of 2009 has made banks reluctant to lend to local government. Similarly, curbs on property sector have dried up an important revenue source for local governments which are heavily reliant on land sales; revenue from land transfers is down almost 40% in the year to October compared to what was received for all of 2011. Timely data on local governments total debt obligations is difficult to come by; reported to be RMB 10.7 trillion at the end of 2010. Estimates of current obligations vary widely, with some suggesting the situation has deteriorated to the point where local governments will soon have difficulty servicing interest obligations. However, during a session of the 18th CPC, the chairman of China Banking Regulatory Commission said that local government debts have been reduced over the past two years to RMB 9.25 trillion at the end of September.

The policy induced slowdown in real estate investment has been a major drag on the economy. Conditions have started to stabilise recently, but there is little chance of seeing a sharp recovery in the sector as authorities remain steadfast on addressing concerns over affordability and overinvestment. Shares in real estate developers dipped lower recently after the Xinhua News Agency, citing the head of the Ministry of Housing and Urban-Rural Development, reported that the government would not modify its curbs on home purchases in the near future and was doing research on how to expand the country's pilot property tax program.

Nominal fixed asset investment by industry

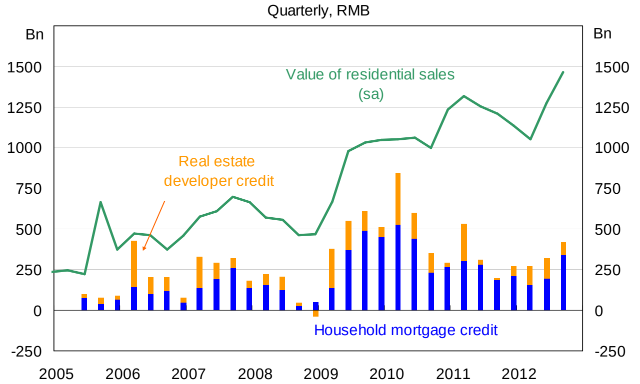


Source: CEIC, NAB
* Number in brackets represents share of total FAI in 2010; Real Estate is using Real Estate Investment data

Investment in real estate (sa) ticked up in October, helping to bolster expectations that the sector may have bottomed; RE investment increased 15½% over the year. New construction of residential floor space (sa) rose steadily in October, but remains well below levels seen in mid-2011 and actually eased in the month in unadjusted terms. The real estate climate index has now flattened out at around 94½, suggesting conditions aren't getting worse, but the series has remained below the level seen during the depths of the GFC slowdown. This could reflect the fact that smaller developers are still finding it difficult to offload assets at a sufficient price to pay down debts.

Partial indicators for Real estate market turning softer again

Quarterly, RMB



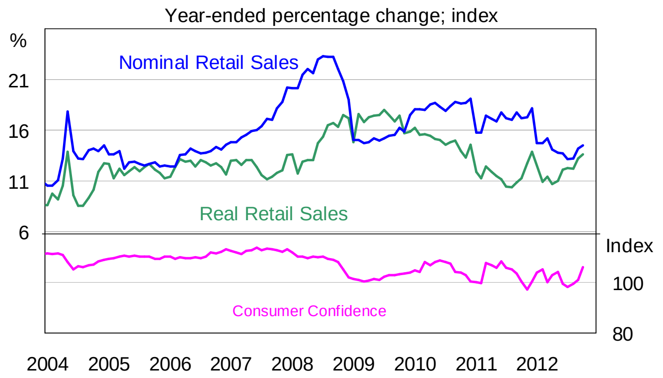
Source: CEIC, NAB

Nevertheless, the amount of floor space sold in October remains almost 80% above the average levels recorded in the first half of the year. The value of sales (sa) increased nearly 15% in the September quarter, support by a rise in mortgage credit. While officials may be nervous over signs of increased demand in real estate, more subdued loans issued to developers may suggest that speculative investment is still under control. However, they would probably like to see prices ease a little further before they consider taking their foot off the brake. Property prices remained broadly flat in September, above the troughs of earlier in the year, although prices in first-tier cities are approaching previous peaks. In October, prices of new homes declined from last month in 17 of 70 cities (less than in September) and only 2 cities reported an annual price increase greater than 1%.

Consumption

Although there have been some concerns over emerging softness in China's labour market, retail sales continue to point to robust consumption growth, increasing 14½% over the year to October, up from 14.2% the previous month; month on month growth was 1.3%. Retail prices have remained subdued, meaning real retail sales also accelerated to 13½% over the year. Auto sales remain solid in the month despite political tensions with major auto producer Japan.

Retail sales



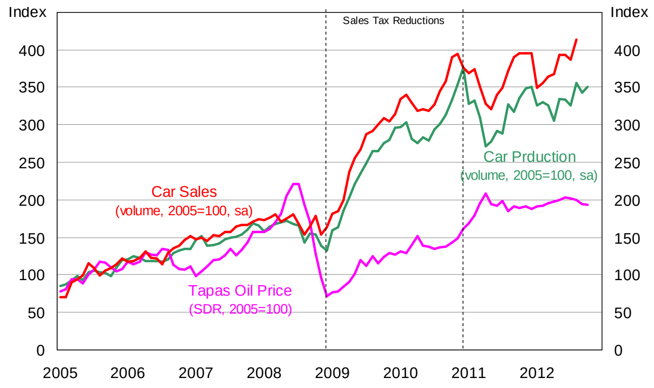
* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.

Consumer confidence improved significantly in October, backing up increases in the two preceding months, as lower price inflation, holiday consumption and a stabilising economy all help to improve the outlook for households. Growth in the value of furniture retail sales since last October eased from last month, but is still solid at 29.8%. Stronger furniture sales are consistent with the gradual stabilisation of the real estate market seen in recent months. Growth in sales of household appliances has also eased after showing signs of improvement in recent months. In mid-May officials announcement stimulus plans to encourage the purchase of energy-saving home appliances.

Solid retail activity has contributed to a rebound in the services sector for October; China's services PMI rebounded to 55.5 in October from 53.7 the previous month. In addition to retail, stronger activity in construction also underpinned the rebound.

Chinese sales (volume, sa) of passenger vehicles picked up solidly in October, increasing 8% in the month to be 6.4% higher over the year. Sales of Japanese cars are reported to have declined almost 40% in the month of October, to be down almost two-thirds compared to last year, following anti-Japanese sentiments in the wake of the sovereignty dispute over islands in the East China Sea. Chinese merchandise import values from Japan dropped 14% in the month of October, although exports from other major economies also eased in the month.

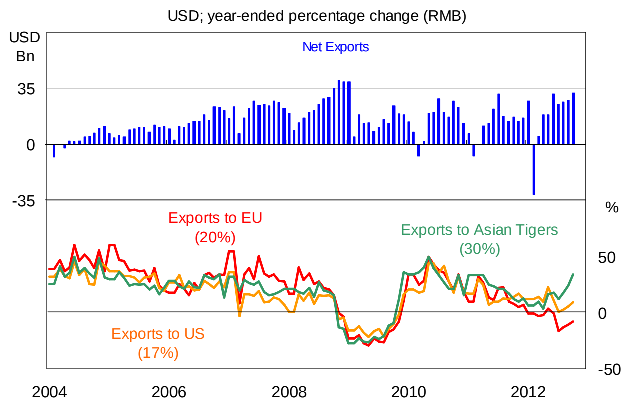
Auto sales (sa) picked up in October



Rebalancing China's economy by encouraging household consumption will remain a major policy objective of China's new party leadership. At the Communist Party congress last week, outgoing President Hu Jintao emphasised the need for China to double its efforts to transform the economy: "In response to changes in both domestic and international economic developments, we should speed up the creation of a new growth model and ensure that development is based on improved quality and performance." To achieve the government's rebalancing targets, consumption growth will need to continue growing at a faster rate than the rest of the economy. Back in September, the State Council pledged to increase fiscal and monetary support to boost domestic consumption in its Five year Development Plan for Domestic Trade. The plan also set a target for retail sales of RMB 32 trillion by 2015 – a fairly ambitious target, albeit with a lower implied annual growth rate than seen in recent years.

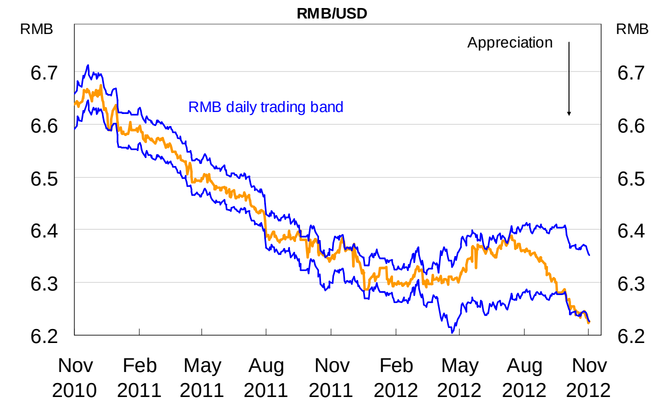
External Sector

Chinese Trade



External demand appears to have improved. Exports of manufactured goods increased 11.6% over the year to October, up from 9.9% last month, with exports to the US and ASEAN countries picking-up; exports to the EU and Japan remained soft. However, there is reason to be cautious about the implications for the economy looking forward. Export growth is still well below the average rates recorded in recent years, and part of the acceleration can be explained away by favourable base effects – the USD value of exports actually declined 5.8% in the month. Also, the potential for significant disruption from Europe's economic woes, the US fiscal cliff, and political tensions with Japan, means that Chinese officials need to ensure that domestic sources of economic growth remain robust.

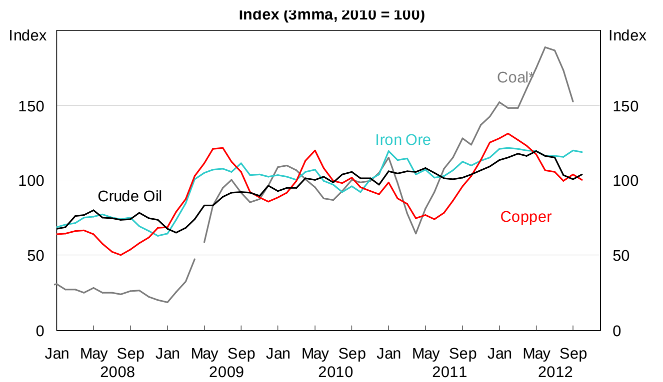
Exchange Rate



Imports have been a bit of a different story, which is curious considering the improvements in the real estate sector and solid consumption and investment growth. Imports only rose 2½% over the year – the same as last months. Imports growth has slowed markedly over the past 12 month thanks to a softening of domestic demand and significant declines in commodity prices. As a result of soft imports and a pick up in exports, the trade surplus rose further to US$32 billion in October, which has fanned the frustrations of some of China's major trading partners, particularly the United States. With signs of improvement in China's economy, along with a return of capital inflows, the RMB has been under pressure to appreciate more quickly. Despite appreciating more than 2% against the USD since early August – and hitting fresh highs – RMB/USD has been trading close to the lower daily trading band since September.

China recently surpassed the US to become the largest recipient country of foreign direct investment, according to a report by the United Nations Conference on Trade and Development. However, China recorded a slight decline in FDI inflows from a year earlier in September; the slowing economy and global uncertainty have contributed to a 3.8% decline in FDI this year.

Commodity import volumes

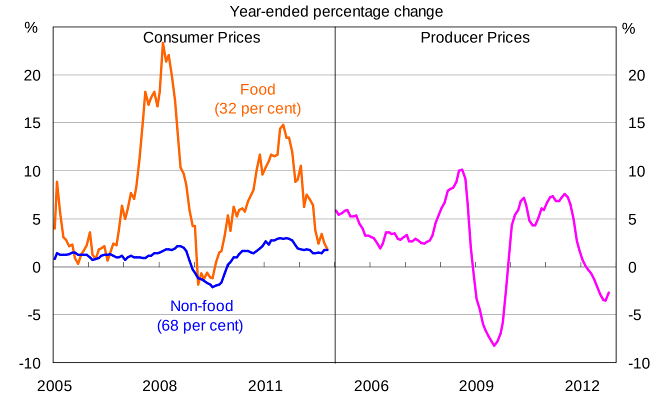


* Data only available up to June 2012.
Sources: CEIC; NAB

Imports of iron ore and copper – both commodities heavily used in construction – declined in October; iron ore and copper import volumes fell 13.2% and 18.5% respectively in the month. Lower demand may partly be in response to higher prices. Copper prices temporarily spiked higher in mid September/early October in response to quantitative easing announcements. Iron ore prices also recovered strongly in October from their recent lows and have managed to hold on to the gains as steel mills restock ahead of the winter period. However, Octobers decline in iron ore imports could suggest that the restocking process may soon come to an end, and it's not clear whether end-user demand will improve enough to offset the negative headwinds facing commodity exporters. In contrast to construction related materials, China's imports of crude oil spiked higher in October.

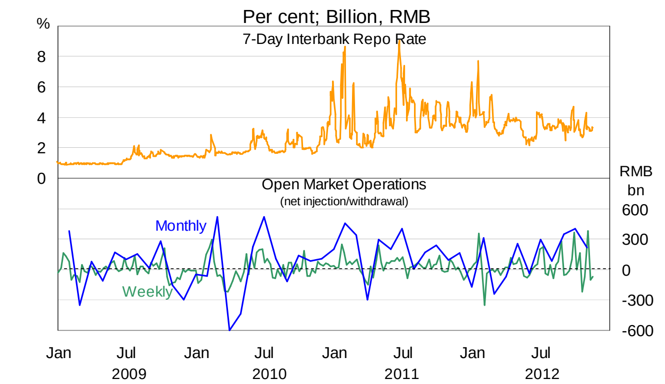
Prices and Monetary Policy

Inflation Indicators



Inflation pressures have eased providing the central bank a little breathing room if needed, although they are likely to be wary of food and energy cost pressures and the risk of rekindling the property boom. Year-ended CPI growth eased to 1.7% in October (from 1.9% over the year to September), with non-food inflation unchanged (1.7%); month-on-month CPI inflation declined for the first time since June (-0.1%). Upstream prices are still suggesting some deflationary risks – largely thanks to lower commodity prices – with the PPI falling 2.8% over the year. Part of the reason for the subdued price rises over the year has been the favourable base effects, although these are expected to diminish towards the end of the year, which could see the inflation rate drift higher, but will probably remain below the policy target of 4% as upstream price pressures have remained soft.

Liquidity conditions

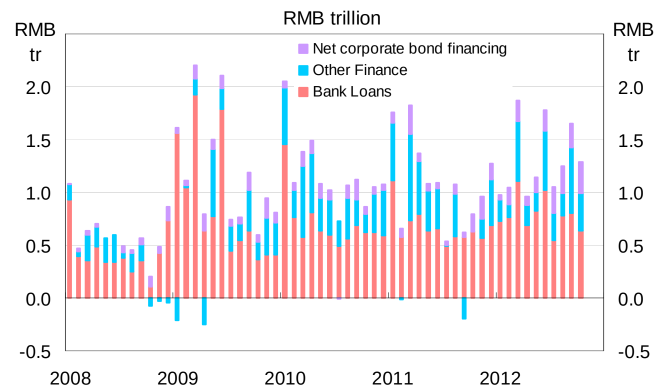


Source: CEIC

While chances of another interest rate cut have fallen significantly due to improvements in activity, the PBoC continues to actively manage liquidity in the banking system. Early this month the central bank stepped up efforts by injecting a record amount of cash (RMB379 billion) into banks through its open market operations, an amount almost equivalent to a 50bp cut to reserve requirements. However, with the potential for capital inflows to the country to pick up (following QE measures by other central banks, and signs of improvement in the Chinese economy), we may continue to see the PBoC manage short-term liquidity via open market operations rather than a more aggressive RRR cut. Nevertheless, for now we have maintained our forecast of one more 50bp cut by year end.

The value of new loans issued by banks disappointed again in October, coming in at RMB 505.2 billion, down from the already soft RMB 623 billion issued in September; total loans for the year have reach 85-90% of the annual target of RMB 8-8.5 trillion. Other sources of finance have remained popular in recent months, although they too have eased from last month; non-bank debt fell RMB 196 billion to RMB 656 billion. Demand for bank credit has softened during the year, consistent with the increased popularity of alternative sources of finance. However, smaller banks have also been quite reluctant to make loans due to deposit constraints; RMB deposits declined by 280 billion in October. Bank deposits have had to compete with the rise of wealth management products as investors look to receive a higher yield on their savings – raising both the stability and the cost of funds – encouraging off-balance-sheet (shadow banking) activities to thrive. However, as the risky nature of these products starts to emerge, they may start to lose favour with investors. WMP's rose steadily in the September quarter, but the number of WMP's issued in October dropped more than 10% from the previous month. Average rates of return on WMP's have also fallen 1.2 ppts since the start of the year to 3.8%; the PBoC's ceiling rate on bank deposits is 3% for one year.

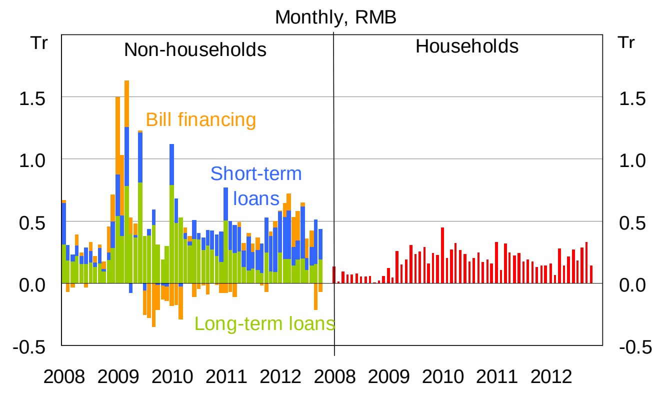
Total debt financing has improved



Sources: CEIC; NAB

In contrast, the big banks have performed reasonably well, each recording double digit growth for profits in the third quarter compared to the same quarter last year. Credit growth at the major banks is probably being supported by an increase in loans for public infrastructure investment; suggested by a steady rise in longer-term loans. However, in a sign that they may be becoming more concerned over poor industrial profits and the increased indebtedness of local governments and SOE's, major banks are raising their provision for bad loans (despite official statistics indicating very low NPL ratios). Agricultural Bank of China, China Construction Bank and ICBC each raised their provisions 48.1, 21.48 and 21.44 percentage points respectively from the end of last year.

New bank loans

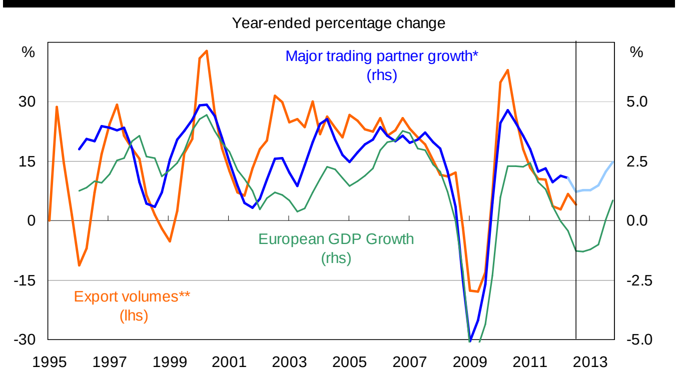


Source: CEIC, Nab

Outlook

We have kept our forecasts for the economy largely unchanged this month despite the more positive tone apparent in the data. However, we now feel like the chances of more substantial monetary policy easing before the end of the year has significantly diminished. As a result we have removed our expectation of a 25bp interest cut in the final quarter of the year. However, we have maintained our expectation for a 50bp cut in bank's reserve requirement to address tight liquidity, although any dramatic pick-up in capital inflows would preclude any cut. With the leadership transition well underway, we expect the government to maintain some level of investment stimulus to ensure growth targets are achieved, but with expenditure targets for the year nearly met, and revenue sources diminishing, scope for more substantial stimulus is limited.

China's exports and major trading partner growth



* Adjusted for Hong Kong re-exports; covers roughly three-quarters of Chinese exports
** Deflated by Hong Kong re-exports prices up to 2000, Japanese / Euro prices of Chinese imports between 2000 and 2005, and the Chinese export price index thereafter.

Overall, we forecast growth to come in slightly above 7½% this year, consistent with a soft landing, before improving slightly next year to around 8% as policy easing gains more traction and the global economy improves. That said, we expect China's potential growth rate to continue to ease in subsequent years as the numerous imbalances that have become apparent in the economy start to be unwound. In the near-term, uncertainty over Europe and the US fiscal cliff has the potential to disrupt China's recovery, but our central expectation is for demand from major trading partners to improve.

For more information, please contact

James Glenn 0392088129

Economic Forecasts

	Year Average Chng %			Year-ended Chng %							
				2012				2013			
	2011	2012	2013	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP	9.3	***7 1/2***	***8.0***	8.1	7.6	7.4	***7.5***	***7.6***	***7.9***	***8.0***	***8.3***
Exchange Rate (USD/CNY)	6.3	***6.3***	***6.3***	6.3	6.3	6.3	***6.3***	***6.3***	***6.3***	***6.3***	***6.3***
Monetary Policy (end of period)											
Benchmark Lending Rate	6.56	***6.00***	***6.5***	6.56	6.31	6.00	***6.00***	***6.00***	***6.00***	***6.25***	***6.5***
Reserve Ratio Requirement*	21.0	**19.5**	***19.5***	20.5	20.0	20.0	***19.5***	***19.5***	***19.5***	***19.5***	***19.5***

Sources: CEIC; NAB Group Economics

*** For large depository institutions**

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics

Rob Henderson
Chief Economist, Markets
+61 2 9237 1836

Spiros Papadopoulos
Senior Economist
+61 3 8641 0978

David de Garis
Senior Economist
+61 3 8641 3045

FX Strategy

Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Emma Lawson
Senior Currency Strategist
+61 2 9237 8154

Interest Rate Strategy

Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

Credit Research

Michael Bush
Head of Credit Research
+61 3 8641 0575

Ken Hanton
Senior Credit Analyst
+61 2 9237 1405

Equities

Peter Cashmore
Senior Real Estate Equity Analyst
+61 2 9237 8156

Jenny Khamphet
Senior Real Estate Equity Analyst
+61 2 9237 9538

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Markets Economist
+64 4 474 6923

Mike Jones
Currency Strategist
+64 4 924 7652

Kymberly Martin
Strategist
+64 4 924 7654

UK/Europe

Nick Parsons
Head of Research, UK/Europe,
and Global Co-Head of FX Strategy
+ 44 207 710 2993

Gavin Friend
Markets Strategist
+44 207 710 2155

Tom Vosa
Head of Market Economics
+44 207 710 1573

Simon Ballard
Senior Credit Strategist
+44 207 710 2917

Derek Allassani
Research Production Manager
+44 207 710 1532

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Tom Taylor
Head of Economics, International
+61 3 8634 1883

Rob Brooker
Head of Australian Economics
+61 3 8634 1663

Alexandra Knight
Economist – Australia
+(61 3) 9208 8035

Michael Creed
Economist – Agribusiness
+(61 3) 8634 3470

Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Property
+(61 3) 8634 4611

Brien McDonald
Economist – Industry Analysis
+(61 3) 8634 3837

Gerard Burg
Economist – Industry Analysis
+(61 3) 8634 2778

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

James Glenn
Economist – Asia
+(61 3) 9208 8129

Tony Kelly
Economist – International
+(61 3) 9208 5049

Important Notices