

China Economic Update



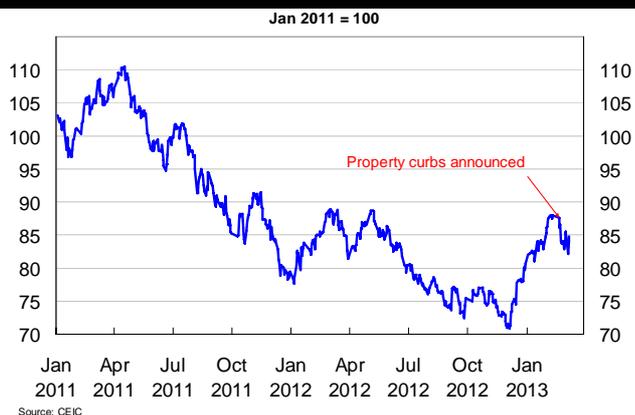
It has been an eventful month with the annual National People's Congress (NPC) getting underway early last week, while a number of policies to curb property prices were also announced in the lead up to the gathering – triggering a sharp correction in equity markets. The NPC is an important assembly of the Chinese leadership where the annual budget and economic targets are announced – the GDP growth target for 2013 was kept at 7.5%. Chinese statistical authorities have also recently released some of the major economic data for February. We had been eagerly anticipating the February data for further confirmation that the turnaround in the economy seen late last year continued into 2013. February data is more informative as it tends to be more complete than January, and allows us to (attempt to) look through seasonal distortions from Lunar New Year (although residual seasonality often remains).

Many of the partial indicators – particularly those relating to private domestic demand – came in below expectations this month. Even after taking January and February together (a simple way of adjusting for some of the LNY impacts) the outcomes still cast some doubt on the expectation for a rapid recovery in the economy during the first half of the year. This softness in the partials suggest that the need for policy tightening may arise later than currently forecast (September quarter), despite an acceleration in CPI for February that was largely seasonal. Nevertheless, we maintain our expectation for a modest recovery in the economy this year to around 8¼% (above the government's 7.5% target), with the majority of the acceleration to occur in H1. However, with a substantial pick-up in private domestic demand remaining elusive, the balance of risks to the outlook has shifted to the downside.

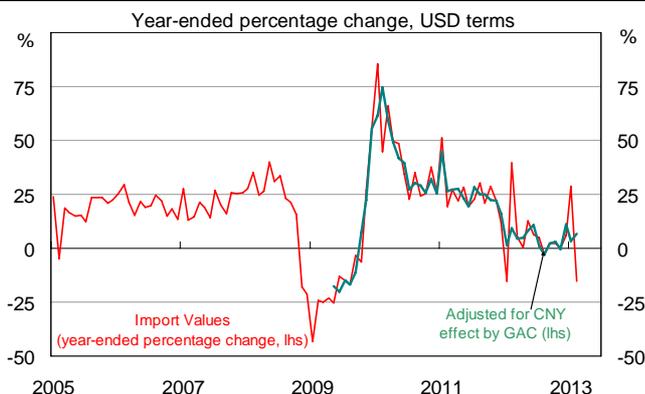
A sharp decline in Chinese imports has raised some alarm bells over the strength of China's domestic demand. Merchandise imports declined 15.2% y-o-y in February, although the slowdown is exacerbated by fewer working days this February compared to last year. However, seasonally adjusted imports data published by the NBS indicate a more positive trend in imports with growth actually accelerating to 6½% over the year from 3.4% in January. By commodity, iron ore, oil and copper were all lower over the year to date – copper recording significant declines (27.8%). Iron ore imports were 1.9% lower following a sharp increase in prices, despite a pick-up in daily steel production in February, while crude oil imports were down 2.4% over the year-to-date.

Industrial production eased in the first two months of the year, broadly in line with a softening of both manufacturing PMI's. The official PMI published by the NBS shows little sign of a significant rebound in manufacturing activity over coming months with new domestic orders remaining neutral, while export orders have deteriorated – in contrast with the solid exports data for February (see below). The PMI is continuing to show some destocking pressures in the manufacturing sector with the finished goods inventory component hitting its lowest level since early 2011. Electricity production – often sighted as a good indicator of the underlying strength of the economy – softened significantly, rising just 3.4% in the year-to-date. In contrast, the auto industry has continued to gain momentum with growth picking up to 12.4% ytd

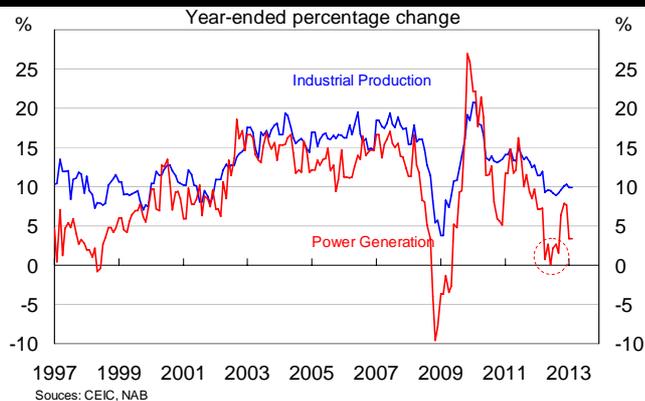
Markets losing confidence in the recovery (Shanghai Composite)



Merchandise Imports Growth



Industrial Production



(from 5.3% y-o-y in January), while average daily steel production was up more than 4½% in February (according to China Iron and Steel Association (CISA)).

Government investment stimulus appears to have been scaled back a little in recent months with central government spending growth clearly slowing. Nevertheless, our estimates of fixed asset investment growth show that investment momentum has remained steady (increasing 21% y-o-y). The NPC confirmed that the government will maintain its proactive fiscal policy stance and the budget deficit for 2013 was recently announced to be RMB1.2 trillion in 2013 (2% of GDP), up from last year's budgeted deficit of RMB800 billion. In a positive sign of commitment by the leadership to rebalancing, the budget has a heavy focus on social spending with RMB1½ to be spent on education, health care, social security and affordable housing (up 13% from last year's budget).

By sector, investment in manufacturing has softened significantly since late 2011, although this may come as good news to authorities following recent warnings from the National Development & Reform Commission (NDRC) that some sectors within China's manufacturing industry face significant overcapacity (particularly steel, cement, aluminium, plate glass and coking coal). Growth in real estate investment has accelerated from the lows of last year (increasing 22.8% y-o-y), spurred on by the anticipation of additional government investment and rising prices. However, the outlook for the sector has turned less favourable with the government announcing a number of additional curbs on the sector in late February (see table below). While these curbs are expected to weigh on building activity, the impact could be gradual, with ongoing investment in affordable housing helping to keep construction ticking over. Authorities expect to commence 6.3 million affordable housing units, while 4.7 million will be completed in 2013 (down from 7 million starts and 5 million completions planned last year). However, we expect to see additional curbs on real estate if the sector continues to pick up during the year.

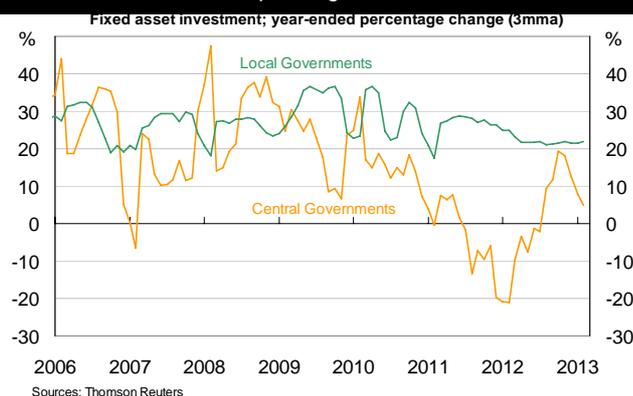
Recent Curbs on Real Estate

Price Targets	Local governments to set annual price easing targets
Purchase Restrictions	transaction taxes, increased down payments and interest rates for 2nd homes, restrictions on purchases by non-locals
Land Supply	Increase land supplies and availability of information on land supply
Affordable housing	Accelerate construction on subsidised housing and include migrant workers in the housing program
Market Supervision	Improve availability of market information and persecute the spreading of false information

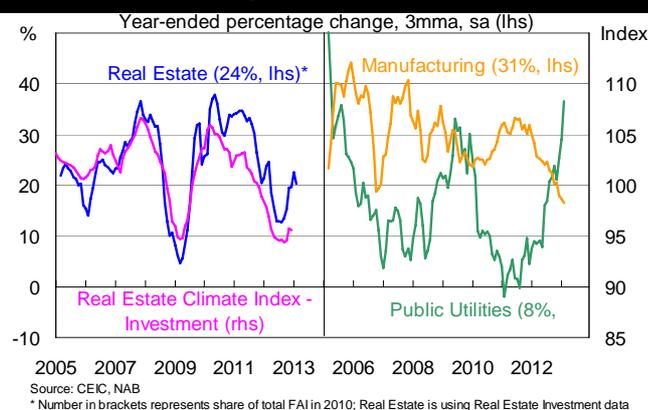
Turning to consumption, nominal retail sales growth was relatively disappointing, decelerating to 12.3% over the year to date on softer than usual activity during LNY. The slowdown in consumption is in stark contrast to the recent improvement seen in consumer confidence – which was surprising in itself given the expectation that weak corporate profits will weigh on income growth. The government's recent clamp down on corruption and public expenses may have also weighed on consumption of luxury goods (spending on catering slowed to 8.4% y-o-y from 15.1% in December). By commodity, the deceleration in sales was relatively broad-based, although office supplies and household electronics were noticeable exceptions.

External demand has been a surprising bright spot in recent months. The trade surplus came in above expectations in the

Government Investment Spending



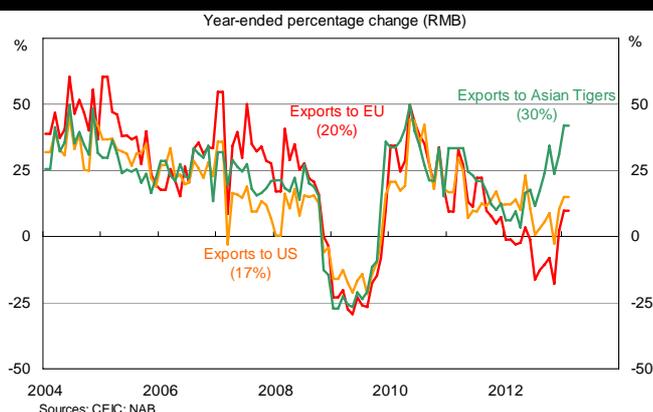
Fixed Asset Investment by Sector



Retail Sales



Merchandise exports to major trading partners



month at US\$15.3bn. Growth in merchandise exports came in at 21.8% over the year, well above market expectations of 8.1%. This outcome reflected a broad based improvement in exports to most major trading partners (including Europe). However, export orders have become more subdued recently and could point to softer export growth in coming months.

Year-ended CPI growth rose to 3.2% in February (from 2% in January), driven by an acceleration in food costs – largely attributable to higher food prices during LNY. While base effects are expected to boost headline CPI numbers over coming months, upstream prices are still suggesting relatively benign inflation pressures; producer prices fell 1.6% over the year.

While we have not ruled out another cut in reserve requirements, the PBoC's recent net liquidity withdrawals and the lower inflation target for 2013 (3.5%, down from 4%), suggests the PBOC see no need to boost liquidity by cutting further. Forex purchasing positions also hit a record high in January, which could be the result of larger capital inflows (as well as a greater willingness to hold RMB) that have increased market liquidity (base money).

Statistical releases available here:

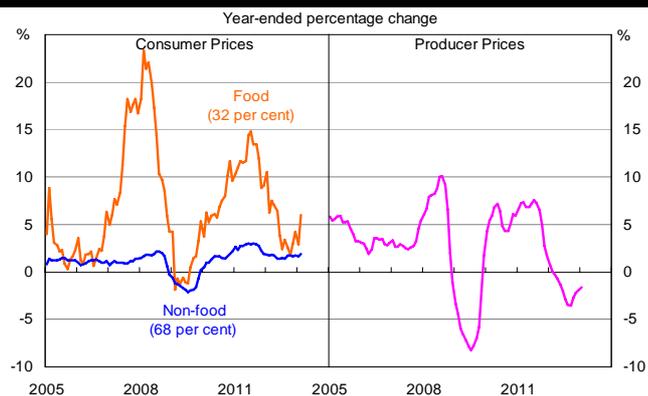
[National Bureau of Statistics](#)

A more comprehensive note will be released in the coming week.

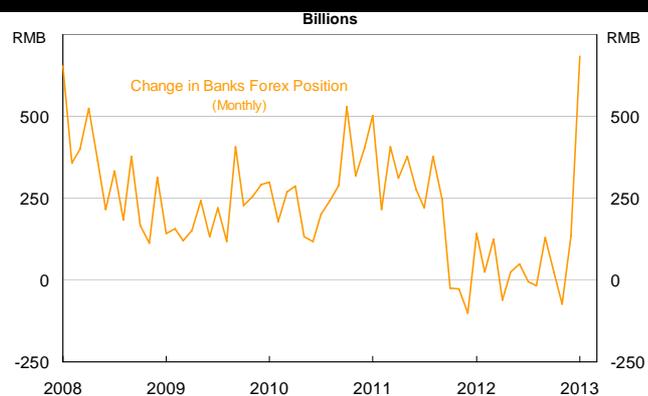
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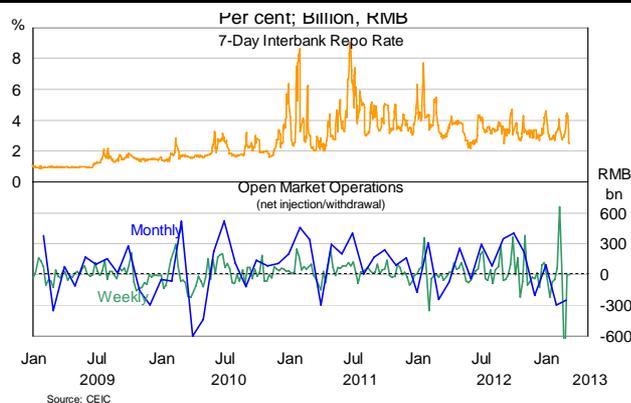
Inflation



Capital inflows picking up pace again



Liquidity conditions



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