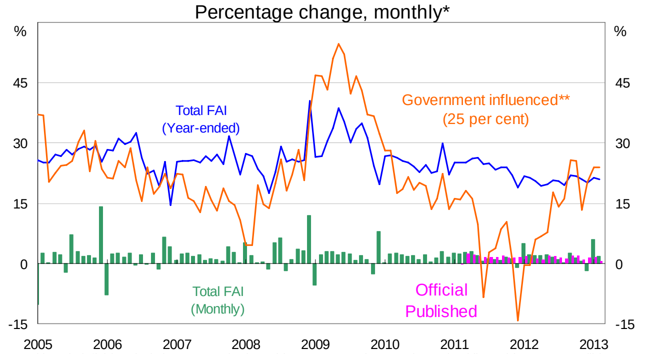
Chinese Monthly Update

National Australia Bank

In this months economic update we revisit our outlook for the Chinese economy and what we can expect to see from the People's Bank of China over the forecast horizon. The PBoC is in for another big year as it continues to face not only a challenging global environment, but an anticipated recovery in the domestic economy that we bring with it the renewed threat of inflation and overheating pressures. Markets will also be watching the central bank closely to see if it can maintain (or even ramp up) the progress of gradual financial development seen in recent years.

For some time now our expectation has been that the government's recent program of investment stimulus would help to jump start the economy in H1 2013, before tapering off in the later stages of the year as public spending was scaled back and was only partly offset by improving external and private domestic demand. While we still see this as the most likely scenario for the growth trajectory, recent partial indicators suggest that the anticipated acceleration in growth may not be as robust as previously thought (see note). However, it is also important to keep in mind that the first quarter of the year is often heavily affected by Lunar New Year – particularly true this year due to the change in timing from 2012 – while the current leadership transition may still be having some lingering impacts on the economy. Consequently, we are reluctant to change our growth forecast significantly – our anticipated recovery was always more subdued than most other forecasters – but we have made some marginal changes to our expectations for monetary policy over the next 12 months.

China's fixed asset investment

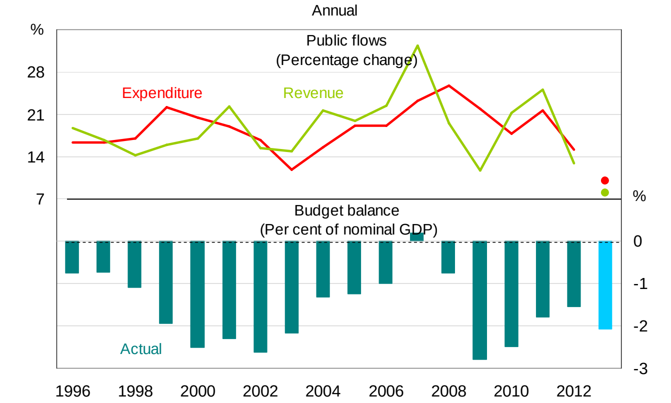


* World Bank definition; includes sectors dominated by state-owned companies and public entities. Covers utilities, transport, water and environmental conservation, education, health care, social security, culture, sport, and public administration.
Sources: CEIC; NAB

Despite all the rhetoric around China's need to restructure and improve the quality of its economic growth model, investment is still expected to play a vital role as a driver of the economy in 2013. Investment tends to surge in the year following a leadership transition, and while lingering risks of overinvestment may pose a constraint, authorities have continued to emphasise the importance of investment for supporting sustainable growth. The question is whether or not authorities can achieve the 'quality' investment that they seek. The NDRC has recently announced its annual target for fixed asset investment (FAI) growth at 18%. This target is higher than the one set for 2012 (16%), but is actually below the realised investment growth rate of 20.6% for the year. Although we have seen some slowdown in the pace of central government spending growth in recent months, we expect public spending to remain supportive.

In the recent budget statement for 2013, the Ministry of Finance raised the budget deficit to RMB1.2 trillion from RMB 800 billion the previous year (continuing the 'pro-active' stance on fiscal policy). The budget included increased spending on defence, as well as a greater 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). The government will also continue working on tax reforms such as expanding the pilot program of replacing business tax with VAT. Finally, while the ministry raised the quota for bonds issued by local governments, they simultaneously pledged to curb irregular financing activities and strengthen the regulation of local government debt. The governments management of non-performing local government debt has long been one of the most significant risks we have flagged for the medium-term growth outlook.

Fiscal Policy to remain pro-active (modestly expansionary)

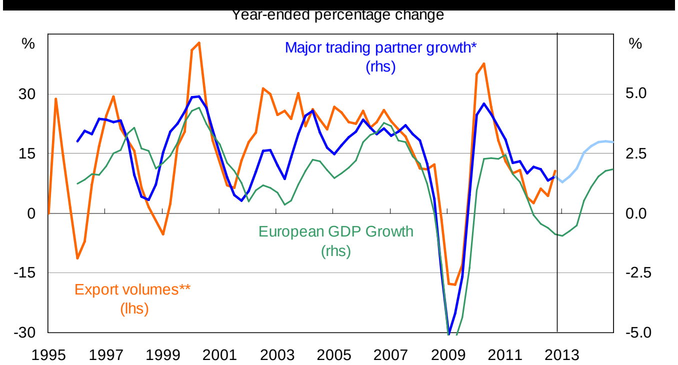


However, one area of particular uncertainty continues to be in the housing sector. We had expected a recovery in real estate to underpin some of the acceleration in economic growth this year, but authorities have been quick to discourage some of the recent improvements seen in the market by reiterating its commitment to housing affordability and reintroducing measures to curb speculative investment. Some of these measures have included the reintroduction (enforcement) of capital gains tax, further restrictions on 2nd home purchases, increased land supply and so on. In a positive for the construction industry, the government will also continue to press on with its affordable housing scheme with a plan 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).

On the consumption side, 2013 did not get off to the best start with real retail sales growth slowing to around its softest pace in years (10.4% y-o-y), partly reflecting softer than expected spending during the LNY. 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. It is not clear whether this trend is likely to continue over the remainder of the year. On the one hand, the governments commitment to rebalancing – such as raising minimum wages, spending on social welfare and affordable housing etc – should help to reduce the income gap and support consumption (see below for a closer look at income inequality in China). However, further clamp downs on corruption and extravagant spending are likely to weigh on sales of luxury goods, while a renewed effort to rein in real estate could reduce demand for furniture and household appliances.

However, one relative bright spot in recent months has been the acceleration in exports, with demand apparently improving in most of China's major export markets. Exports came in above expectations for February, surging more than 20% over the year (seasonally adjusted). While some softness in export orders suggests slightly more subdued exports growth over coming months, our outlook for the global economy implies a significant improvement in growth over 2013/14 that will drive stronger demand for Chinese exports. Nevertheless, there is still a great deal of uncertainty over the trade outlook with headwinds from the US sequester, and political uncertainty in Europe (just to name a few) potentially weighing on consumer demand over the forecast horizon.

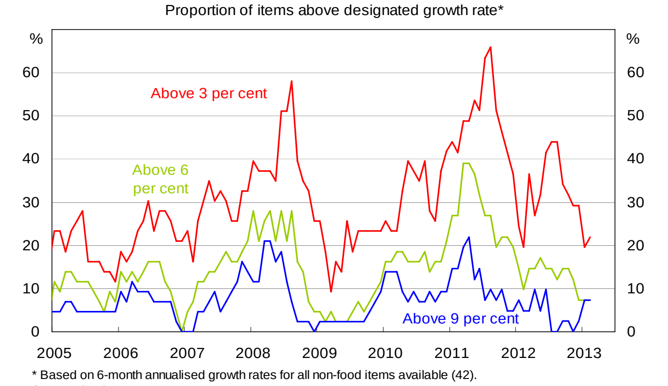
Exports and major trading partner growth



* 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.

Chinese authorities have stuck to their stance of a 'prudent' monetary policy for 2013. To us this suggests that they intend to keep monetary policy relatively neutral, although our expectation for a pick up in inflationary pressures (combined with the recent lowering of the inflation target to 3.5%) suggests that an interest rate hike may become necessary late in the year. 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. Non-food price inflation has been relatively more subdued (picking up 0.3ppts to 1.9%) and appears to have been partly driven by a sharp acceleration in prices for a small subset of goods (see chart). 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.

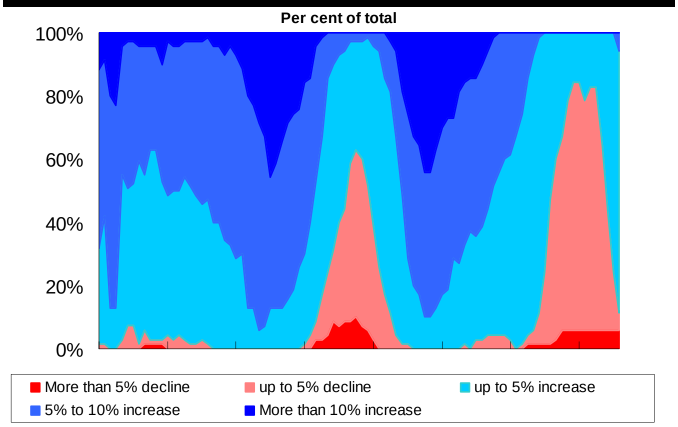
Non-food inflation pressures have relatively narrow base



* Based on 6-month annualised growth rates for all non-food items available (42).
Source: CEIC, NAB

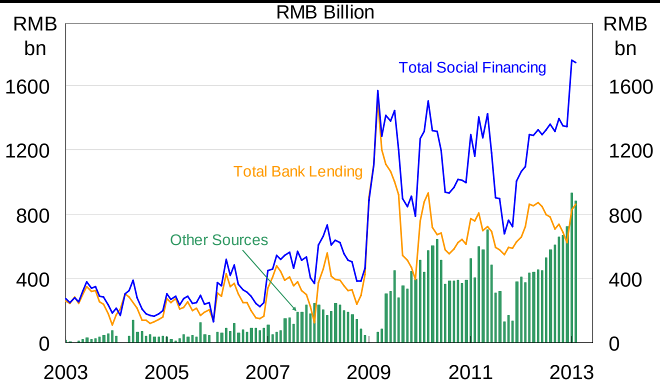
As indicated by the recent measures to dampen real estate demand, authorities are becoming increasingly concerned over asset price inflation. According to official statistics, prices of new and existing real estate rose again in February. Prices in first-tier cities have been recovering quite well and have now surpassed the peaks reached last year before government curbs on the sector started to gain traction. Prices of new homes declined in just 1 of 70 cities in February, while the number of cities reporting an annual price increase greater than 1% improved to 50. While the central bank is expected to reinforce efforts to curb house prices this year, recent comments from officials suggest that consumer and producer price inflation will be the primary focus.

Annual house price growth (proportion of cities)



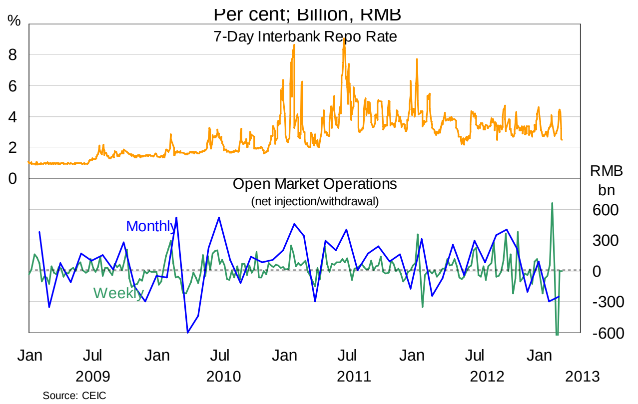
Tight liquidity will likely be less of a constraint on monetary policy in 2013 – in contrast to what we saw last year – with the M2 growth target reduced to 13% (from a target of 14% in 2012). Quantitative easing from central banks around the world and solid trade surplus's have lifted liquidity in money markets to levels where the PBoC has become more concerned about inflationary pressures. Indeed, data on bank lending in the start of the year could be pointing to overly accommodative monetary conditions. Although bank loans were soft in February, when taken together with January the data show than new loans surged by around a third compared to the same period last year; reversing the trend seen over the past 6 months. However, the real strength in funding has come from non-bank loans, which have risen at a steady pace over the past year.

System credit solid (looking through LNY impacts)



Since the start of this year there has been a net withdrawal of liquidity by the PBoC via open market operations as they ramp up efforts to offset money inflows and constrain credit growth. Because of these trends, we no longer expect to see the PBoC cutting reserve requirements under our central forecast scenario, although the possibility can't be ruled out completely. Rather, the central bank will continue to focus on short-term liquidity management via open market operations.

Liquidity conditions

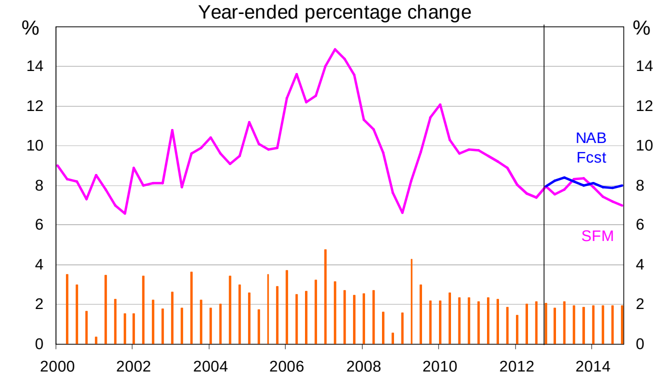


Source: CEIC

The use of more market based tools to implement monetary policy is expected to be an ongoing trend over coming years as further steps are taken to develop China's financial system. Authorities have reiterated their intentions to gradually liberalise interest rates and further develop exchange rate mechanisms in line with their long-term goals of internationalising the RMB. Our view is that China's financial development will continue to evolve at a slow pace. While some progress has been made to liberalise interest rates and allow foreign investment in RMB assets, the reluctance to fully relinquish control over the currency and capital flows is likely to hamper progress.

Feeding in our expectations for policy and external demand over the next two years, our simple China model supports our forecast for an improvement in growth momentum to a little over 8% for 2013. However, as policy conditions tighten in response to rising price pressures in late 2013/early 2014, the model suggests that there may be some downside risk to our forecast of 8% for the out year.

GDP Outlook



Source: CEIC, NAB

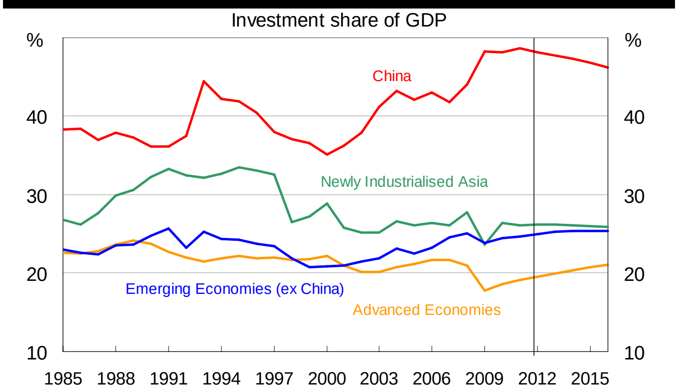
China's Income Inequality

The rising importance of China to the global economy is clearly apparent to most people. China's highly cost competitive manufacturing sector has been one of the defining factors driving the country's economic success. Chinese industries ability to draw upon an abundance of excess labour has helping to keep costs low and profits high – conditions that proved to be ideal for the type of rapid investment spending (industrialisation and urbanisation) witnessed in China over the past decade or more. But with incomes rising rapidly, the end of China's competitive cost advantage in low-tech manufactures is gradually coming into sight. Therefore, China now needs to look at new sources of growth – outside of capital accumulation and low-tech manufacturing – if it wishes to continue its impressive economic performance in the decades to come.

While we have often talked about China's need to continue moving up the 'value-add' chain to remain competitive in manufacturing (something that certainly is happening in China at the moment), another key theme that dominates discussions over China's longer term outlook is the requirement for consumption to play a greater role in the economy. A very high saving rate has facilitated the very capital intensive growth strategy for China, but with investment in China now accounting for almost half of the economy – much higher than any other major developing economy – the sustainability of this growth model is under question.

To reduce the investment share of the economy, consumption will of course need to grow faster than FAI – a tough task to accomplish without a concurrent slowdown in investment growth that is likely to see aggregate growth in the economy slow. Nevertheless, policies that accelerate consumer spending can help to offset some of the drag from investment.

Economic rebalancing in China is critical

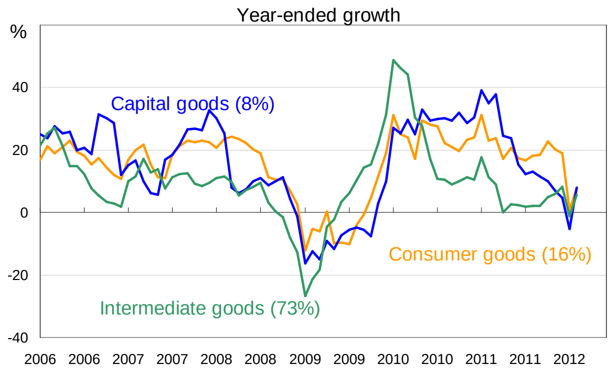


Sources: IMF WEO Database; NAB

But the Chinese consumer is not only critical to the outlook for the domestic economy, as the global economy is increasingly looking to China to drive global growth. With many parts of the developed world (particularly Europe) remaining in disarray, Chinese demand has become more important than ever to fill the void in demand left by these economies. China has overtaken Japan to become the world's second largest economy, and with a population of over 1.3 billion people, many expect China to become one of the world's largest global consumer markets within the next decade. If this eventuates, it will also go a long way towards alleviating some of the external imbalances that have emerged from persistent large trade surpluses.

Trends in international trade give some evidence of a shift in China's role in the global economy. Chinese imports of consumer goods has grown strongly following the stimulus measures introduced to boost consumption in 2009/10, outpacing growth in imports for intermediate goods (a proxy of China's integration into regional low-tech production lines). Consumer imports growth has also outpaced imports of capital goods since mid 2011. However, demand for intermediate and capital goods imports still accounts for more than 80% of imports, while growth in demand for consumer good imports slowed significantly mid last year.

Signs that China is becoming a global consumer are mixed

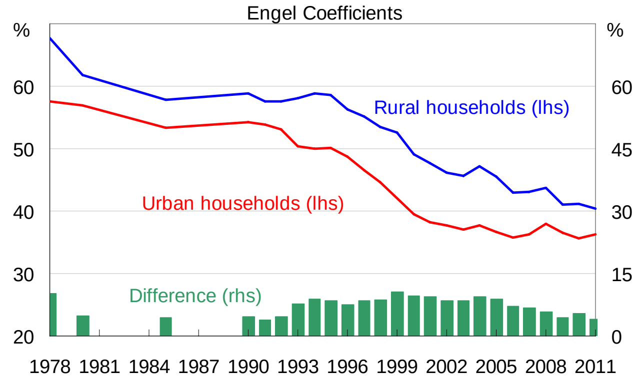


* Numbers in brackets represent share of imports in 2010
Sources: NBS; NAB; UN Comtrade Database

Nevertheless, to mitigate the potential drag on China's economy from 'rebalancing', and further the countries emergence as a global consumer, it is important to ensure that the macro environment is accommodative for household consumption. However, consumer behaviour in China is heavily distorted by a number of institutional factors that are inclined to induce higher savings. Financial repression, an underdeveloped financial system and limited social safety nets are all examples of some of the difficulties weighing on Chinese consumers.

However, income inequality is a socioeconomic issue that has garnered particular attention and has been the focus of political discussion during the recent leadership transition. For our purposes, income inequality is very significant as this could impede the emergence of (in China's case a very substantial) middle class that has a higher propensity to consume non-essential goods. Engle coefficients (the proportion of income spent on food) help to demonstrate this since food costs are a major component of the consumer basket in developing economies. In China, Engel coefficients have steadily declined for both urban household (36, down from 50 in 1995) and rural households (40, from 59 in 1995), adding to the potential for discretionary consumption. However, if the distribution of income is biased (unequal), the country then runs the risk of falling into the 'middle income trap' (where economic development stalls), following the footsteps of countries like Brazil during the 1980s.

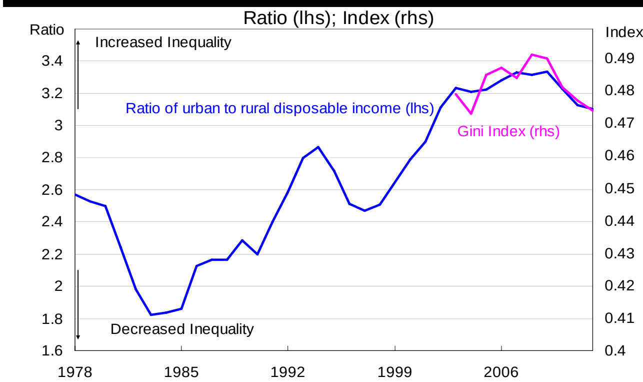
Urban/Rural income gap a major driver of inequality



Sources: CEIC; NAB

How significant is the inequality issue in China? Gini coefficients are a common measures of income inequality. This metric simply shows how skewed the income distribution is, where a value of 0 reflect perfect equality, and 1 shows perfect inequality. In 2012, China's official Gini index eased to 0.474, which in part is reflecting a slight narrowing of the gap between urban and rural incomes (although some researchers claim the index is underestimated). Nevertheless, the Gini remains above the warning level of 0.4 used by the UN, and the gap in incomes between urban and rural residents remains very large at more than 3 times.

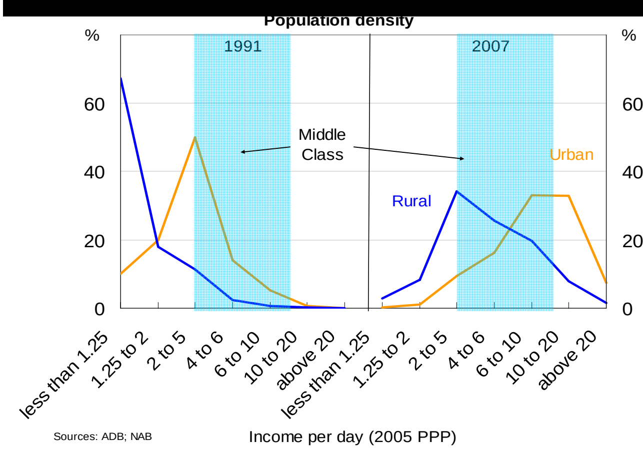
Urban/Rural income gap a major driver of inequality



Sources: CEIC; NAB

Although disparities in nominal incomes between urban and rural households are still large, these metrics can sometimes overstate the degree of the problem since households in rural and urban regions tend to experience different costs of living. Since prices in rural regions are generally lower, trends in real incomes tend to make for better comparison.

Real income distribution and the middle class

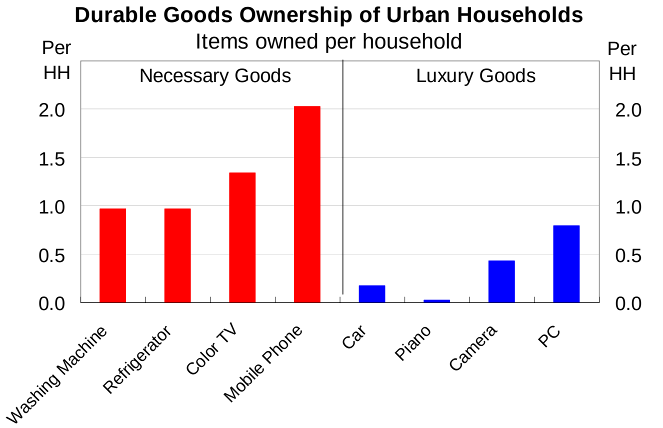


Sources: ADB; NAB

The Asia Development Bank compiles data on income distributions using incomes adjusted for purchasing power parity at 2005 prices. Examination of these data suggests that China has actually made some good progress in at least reducing poverty in rural areas, while simultaneously shifting more urban households to upper-middle and high income classifications. However, incomes of rural households are still heavily skewed to the lower end (high risk households) suggesting more needs to be done to boost incomes for people in these regions.

Despite the progress made in reducing extreme poverty in China, the skewness of household income – in addition to precautionary saving – is probably contributing to cautious consumer behaviour. Data on spending habits of China's urban households demonstrates this point. Ownership rates of luxury goods are far lower than ordinary goods, with almost universal ownership of washing machines and refrigerators, while the average urban household owns two mobiles phones. In contrast, only around 1 in 5 households own a car (although this may also relate to congestion and restrictions on vehicle registrations), a very low rate relative to China's economic development.

Durable Goods Ownership of Urban Households



To address the rising concerns (and potential for civil unrest) over income inequality, China's leadership have recently announced a number of initiatives aimed at bridging the gap over coming years. President Xi Jinping has committed to addressing income equality (as well as corruption), and in early February authorities released a 35 point plan to tackle the issue. Some of the key policies included:

- Plans to boost minimum wages by at least 40% by 2015 (having doubled between 2006-2011) and doubling per capital income between 2010 and 2020.
- Liberalising interest rates (reducing financial repression)
- Increased spending on education and affordable housing (expand the proportion of expenditure on social security).
- Restrictions on extravagant government spending and stricter reporting of income and assets held by government officials and the family members
- Some minor reforms of SOE's, including an increase in required returns on equity to the treasury, and calls for caps on incomes for SOE employees.
- Expansion of property taxes and high end consumer taxes to redistribute wealth
- Foreign individuals will no longer be exempt from personal income taxes on stock dividends and bonuses they obtain from foreign-funded enterprises in China.
- There were also a number of measures aimed specifically at rural households.

While these are all positive policy steps, without further wide-ranging reforms, real progress in addressing income inequality seems unlikely. However, the political appetite for such reforms may not be present since they tend to involve limiting the influence of the communist party. Nevertheless, the governments commitment to assist migrant rural workers to register as urban residents is a noticeable first step in alleviating the restrictions on labour mobility (created by the Hukou system) that has contributed to the income divide, although further opening up of labour markets is needed. The tax system also needs improving to provide a progressive (fairer) system with a broader tax base that will help direct funds towards social welfare programs. To complement this, tax collection mechanisms and administration need to be strengthened to reduce tax avoidance. But most importantly, initiatives to improve governance and efficiency (eg SOE reforms) need to be built upon. Promotion of fair competition, enforceable rights, corruption prevention, reduced discrimination and strengthening of the legal system are all important objectives in this regard.

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Economic Forecasts

	Year Average Chng %			Year-ended Chng %								
				2012	2013				2014			
	2012	2013	2014	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP	7.8	*8.2*	*8.0*	7.9	*8.2*	*8.4*	*8.2*	*8.0*	*8.1*	*7.9*	*7.9*	*8.0*
Exchange Rate (USD/CNY)	6.3	*6.2*		6.4	*6.2*	*6.2*	*6.1*	*6.1*	*6.1*	*6.1*	*6.0*	*6.0*
Monetary Policy (end of period)												
Benchmark Lending Rate	6.00	*6.3*	*6.5*	6.00	*6.00*	*6.00*	*6.00*	*6.25*	*6.50*	*6.50*	*6.50*	*6.5*
Reserve Ratio Requirement*	20.0	*20.0*	*20.0*	20.0	*20.0*	*20.0*	*20.0*	*20.0*	*20.0*	*20.0*	*20.0*	*20.0*

Sources: CEIC; NAB Group Economics

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