Brief China Economic Update

National Australia Bank

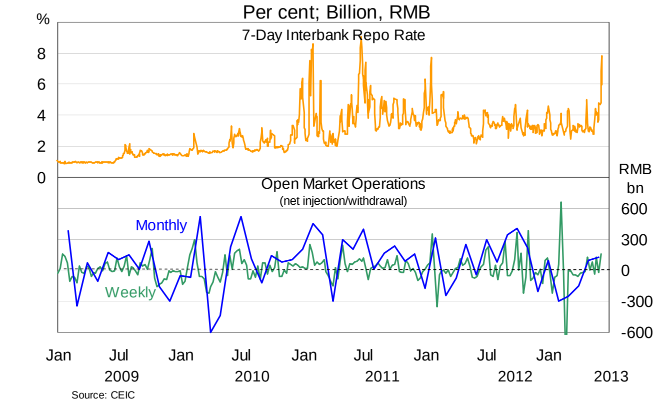
Economic activity in China appears to have slowed further during the month of May, although the moderation in growth continues to occur at a gradual pace – keeping concerns of a hard-landing at bay. Nevertheless, hopes of a meaningful acceleration in growth this year have faded, and expectations are now for growth to stabilise at sub-8% levels. As a result of the slower than expected growth, we reduced our growth forecast for 2013 last month to 7¾% (from 8% previously) – although even softer growth remains a possibility. Authorities appear content with slower rates of growth suggesting that monetary policy will remain unchanged until at least next year. However, there has been a noticeable tightening of liquidity conditions leading up to the national holiday, and following a clamp down on capital inflows.

Indicators of real economic activity show that growth in China has stagnated, but has maintained a reasonably rapid pace. Outcomes for May came in close to market expectations, which have become far less optimistic then they were at the start of the year. Industrial production growth ebbed slightly lower in May to 9.2%, which is well below the long run average. Taken together with softer growth in the services sector – as indicated by the non-manufacturing PMI index – that implies that GDP growth for the June quarter may not improve from the disappointing rate (7.7%) recorded in the March quarter. Manufacturing PMI's show that small and medium sized manufacturers came under renewed pressures with the HSBC PMI – which is more representative of these firms – dipping below 50 to 49.2 (from 50.4). In contrast, the official PMI index – which is more representative of larger and state owned firms – improved marginally to 50.8 (from 50.6).

Industrial activity has come under pressure from soft global demand as well as a government crack down on property markets and shadow banking – having a large impact on heavy industries where are also battling with excess capacity. Overcapacity and elevated inventories in construction related industries like steel and cement have contributed to deflationary pressures (see below), whilst weighing on industrial profits. Nevertheless, steel output rose 11.3% over the year to May, while cement production increased 8.5%. Other products, auto production and power generation eased to 15.7% and 4.1% respectively. In value added terms, general equipment and textile production also slowed to 9.4% and 8.9% respectively.

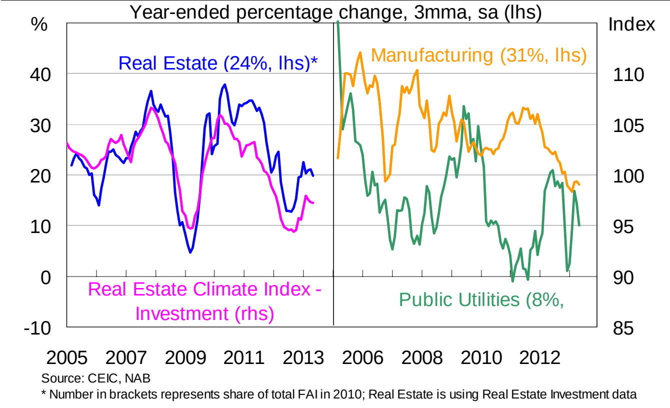
Our estimates of fixed asset investment growth show that momentum has eased further with growth dipping below 20% for the first time since August last year (increasing 19.8% y-o-y). By sector, investment in manufacturing has softened significantly since late 2011 as industry comes to grips with over-capacity in some sectors (particularly steel, cement, aluminium, plate glass and coking coal). Growth in real estate investment has remained volatile, but has not returned to the lows of last year (increasing 18¾% y-o-y). The sector is likely to continue seeing headwinds in response to the uncertainty from renewed attempts by the government to deflate the sector. Consistent with this, there has been a slowdown in housing starts, land purchases and property transactions recently, while slower growth in new project approvals are all pointing to a weaker trend for investment growth. Signs of government led investment stimulus have been fading in

Liquidity conditions



Industrial Production

Fixed Asset Investment by Sector



recent months. Investment in public utilities has eased, as has central government investment (around 8% yoy in May, down from almost 20% yoy late last year).

Turning to consumption, nominal retail sales growth once again came in consistent with market expectations for May, picking up slightly to 12.9% over the year (but below the government 14½% target for 2013). Retail price inflation eased in May, implying real growth in retail sales of 12.1% (up from 11.8% the previous month). The improvement came despite a noticeable deterioration in consumer confidence in recent months, although this may be taking a larger toll on purchases of big ticket items. Sales growth of automobiles fell to 9% in May (from 13% the previous month). By other commodity, catering picked up in May after coming under pressure from anti-extravagance measures in previous months (rising 18% y-o-y), while sales growth for food and clothing goods also improved. In contrast, sales of items tied-in with real estate development (furniture, construction materials etc) slowed, although household appliances picked up solidly.

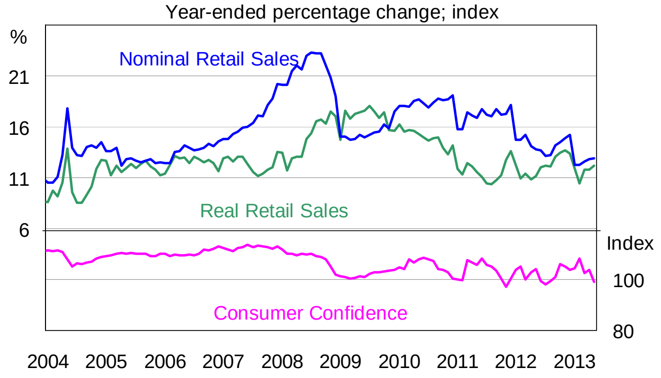
Export growth slowed significantly in May, although this was partly expected following the governments recent crackdown on the misreporting of exports to disguise unapproved capital inflows. Merchandise exports declined 8.2% (seasonally adjusted) in May, to be just 1% higher over the year. With headwinds from weak external demand and an appreciating exchange rate, this outcome probably more accurately represents conditions facing Chinese exporters. The decline in the month was largely driven by sharp falls in exports to trading partners such as Hong Kong and Taiwan, where exports were thought to be the most 'inflated' to cover-up hot money inflows. Exports to other parts of Asia were relatively mixed with our own seasonally adjusted estimates pointing to large m-o-m declines to Indonesia, Japan and Singapore, while exports to India picked up. Exports of both machinery and high-tech goods declined in the month.

Reflecting the weakness in domestic demand, imports declined 8.6% in May to be 0.1% lower over the year. Nevertheless, demand for seaborne raw commodities recorded some improvement in the month. Imports of crude oil, iron ore and copper all rose in the month (3.8%, 2.1% and 21% respectively). Iron ore imports have remained relatively resilient, rising 7.4% over the year, although this has been a reflection of China's (arguably) excessive steel production and low port inventories rather that robust end-user demand. Given the decline in imports from the previous month, the trade balance jumped in May to US$20.4bn. Trade conditions are expected to improve this year, although the mixed economic indicators out of many major economies suggest that headwinds remain. Export orders improved marginally in May, but remain at levels that suggest a contraction in exports in coming months. Recent strong appreciation is also expected to have a negative impact on exports over coming months.

Concerns over a return of inflation pressures were further alleviated by prices data for May. Year-ended CPI growth eased to 2.1% in May (from 2.4% in April). Muted inflation pressures have reduced the need for policy tightening in the near-to-medium term. Lower inflation was driven mostly by a decline in food costs, while non-food inflation actually rose slightly. While base effects and an improving global economy (likely to lead to pressure on commodity prices) are expected to boost headline CPI numbers over the rest of the year, upstream prices are still suggesting relatively benign inflation pressures; producer prices fell 2.9% over the year. Falling producer prices have been driven by lower costs for commodities as well as emerging over capacity in some heavy industries.

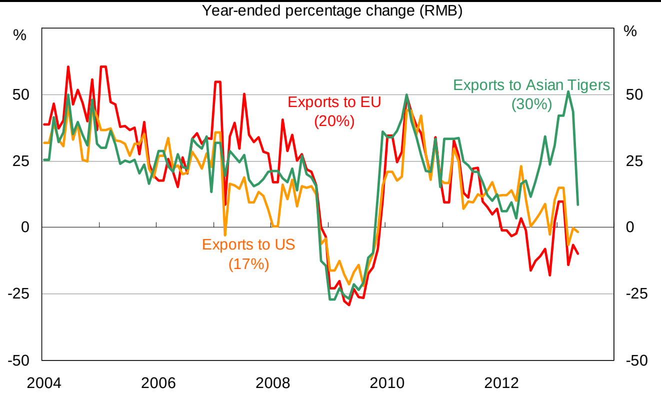
Chinese banks issued fewer loans in May, while other sources of finance also came in lower, reducing the value of total social financing. Although softer credit growth may be pointing to

Retail Sales



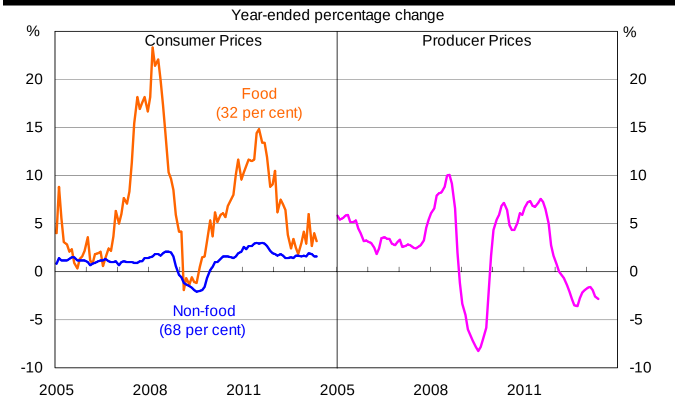
* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.

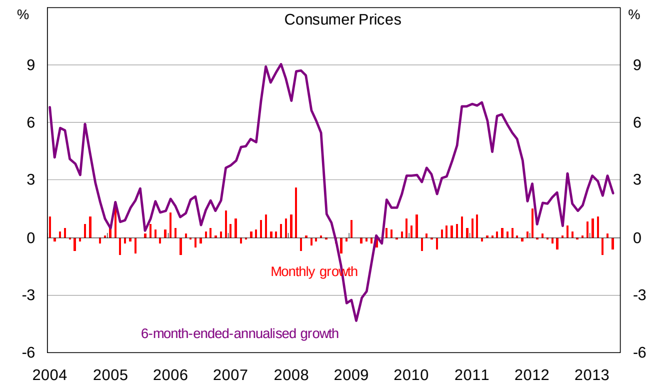
Merchandise exports to major trading partners



Sources: CEIC; NAB

Consumer Prices





Source: CEIC Database, NAB

further weakness in the economy, it also provides a small amount of relief given mounting concerns over the rapid pace of debt accumulation that has been taking place. Banks issued RMB 667.4 billion in new loans during May, down from RMB 792.9 billion the previous month, to see bank credit 14½% higher over the year. Total social financing fell to RMB 1.19 trillion in May, from RMB 1.75 trillion in April. After including outstanding government bonds, total social financing figures suggest that outstanding debt in China is currently exceeding 220% of GDP, with this ratio increasing significantly since 2008 – although this fails to account for double counting due to interest rate arbitrage between banks and trust companies.

Policy expectation:

Despite a disappointing economic recovery and tightening monetary conditions, we maintain our view that monetary policy (benchmark interest rates and reserve requirements) will remained unchanged until at least next year. While muted inflation has provided the PBoC with room to ease, they are likely to wait and see how rapid growth in total social financing at the start of the year feeds into economic activity, and inflation, over coming quarters. Also, authorities have emphasised their tolerance to slower growth, placing more importance on the 'quality' of China's growth model. Because of this, short-term money market operations will be relied on to manage market liquidity, while structural reforms (along with fiscal policy) will be used to address the structural imbalances that have developed.

Statistical releases available here:
[National Bureau of Statistics]

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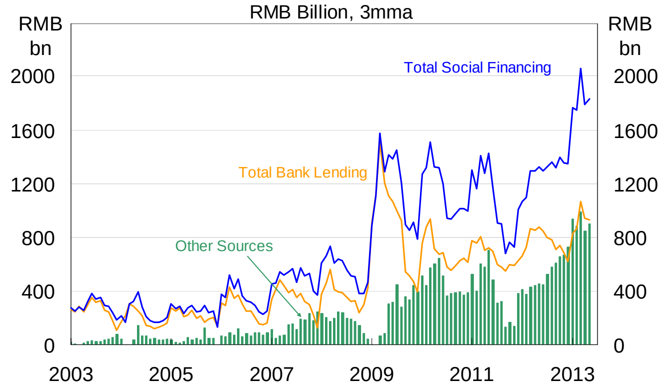
Total social financing



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