Brief China Economic Update

National Australia Bank

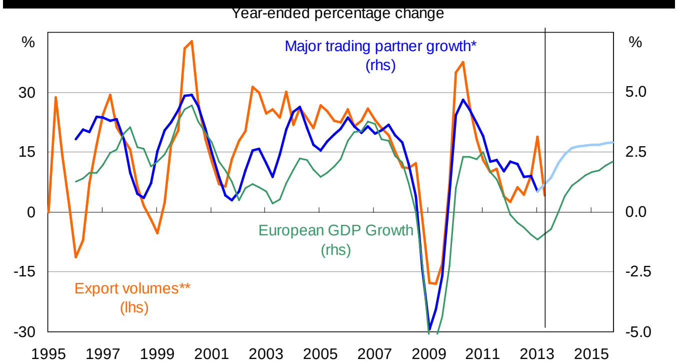
Partial economic indicators, although still subdued, provided some signs that the economy may now be stabilising. Trade data came in somewhat above expectations, including much stronger import growth pointing to a pick up in domestic demand. This was consistent with slight improvements in other partial indicators such as industrial production and business investment, although retail sales growth eased – potentially discouraging to rebalancing efforts. These outcomes are in line with our expectation for China's growth to stabilise in the second half of 2013 at relatively subdued levels as authorities press on with structural rebalancing efforts – partially offset by an improvement in export demand from major developed economies and a variety of policy fine tuning measures. Nevertheless, signs of improvement in the global economy (not just China's) remain tentative and a further deceleration of growth can not be ruled out.

While last month we highlighted the apparent grey area surrounding China's growth target the leadership have subsequently provided some clarity by confirming the target of 7½% this year, while implying a floor of 7% -- the rate necessary to achieve prosperity goals by 2020 and maintain stable employment. We have maintained our forecast of 7.5% growth for 2013, decelerating to 7¼% next year. Regarding the monetary policy outlook, the 'wait and see' approach taken by policy makers to date is likely to continue despite relatively benign inflation providing scope for further loosening – a reflection of concerns over speculative financial activity and asset bubbles.

Turning to the partial indicators in more detail, industrial production growth accelerated in July, consistent with the improved trade data and other partial indicators. Growth accelerated to 9.7% y-o-y in July, although this is still well below its long run average. Manufacturing PMI's were mixed during the month with the official NBS index showing improvement, rising to 50.3 (from 50.1) indicating further expansion. In contrast, the Markit index, more representative of small and medium sized firms, deteriorated further in the month to 47.7 (from 48.2). The divergence might be explained by the 'liquidity squeeze' that took place in late June, which had a disproportionate impact on SME's. By product, steel output rose 10.9% over the year to July, while cement production increased 9.1%. Looking at other products, vehicle and textile production picked up to 15.4% and 8.2% respectively, while power generation also rose to 8.1%. Regarding the services sector, the PMI rose to 54.1 in July from 53.9 at the end of 2012 with the employment component pointing to continued expansion in labour demand. Policies designed to support the services sector (such as VAT reforms, tax cuts for SME's and targeted credit support) and a real estate recovery should help to support the sector.

Our estimates of fixed asset investment growth show that momentum picked up a little in July with growth rising to 20% y-o-y, up from 19.2% y-o-y in June which was the slowest pace since April 2012. By sector, overcapacity in some industries and weak profits growth has kept investment in manufacturing relatively subdued, rising 17% y-o-y in July (up from 15% in June). Growth in real estate investment has been volatile over the past year, but remains above 2012 lows despite ongoing uncertainty in the sector; real estate investment increased around 20% y-o-y in July

Exports and major trading partner growth

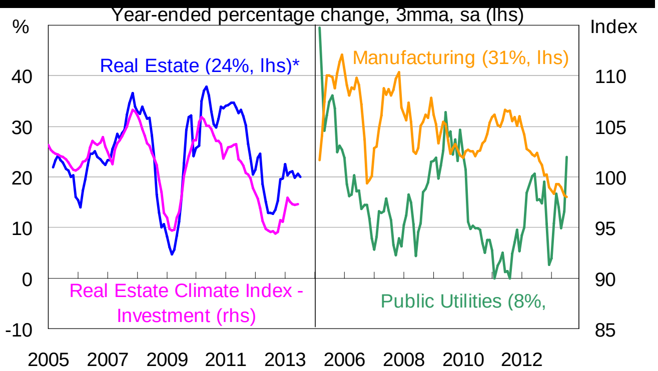


* Adjusted for Hong Kong re-exports; covers roughly three-quarters of Chinese exports
** Deflated by Hong Kong re-exports prices up to 2000, Japanese / Euro prices of Chinese imports between 2000 and 2005, and the Chinese export price index thereafter.

Industrial Production

* Adjusted for Chinese New Year
Source: CEIC, Nab

Fixed Asset Investment by Sector



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

Forward indicators of investment were mixed in July, but annual growth in newly started investment projects eased in July. Government led investment stimulus appears to have ramped up in July with central government investment growth picking up to 24% y-o-y in July (up from 17½%). Investment in public utilities also accelerated.

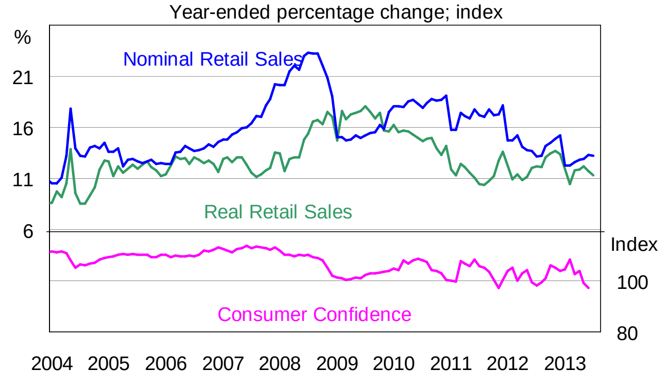
Turning to consumption, nominal retail sales growth was somewhat disappointing in July easing slightly to 13.2% y-o-y (down from 13.3% the previous month), below the market expectation of 13.5% and the governments target rate of 14½% for 2013. The deceleration is worse once we account for higher retail prices in the month. Higher retail price inflation implies real growth in retail sales of 11.3% (down from 11.7% the previous month). The slowdown is relatively consistent with deterioration in consumer confidence, which tends to be highly sensitive to price movements. Softer wage growth – the result of weakening corporate profits – and easing labour demand may be contributing to the deterioration in confidence, although labour market conditions remained relatively tight in the June quarter. The employment component of the PMI however points to a further contraction in labour demand. Nevertheless, the short-term growth momentum of retail sales has improved since Q1 following the one off impact from a government crack down on extravagant public spending. By product, softer sales growth in automobiles, textiles and household electronics appear to have contributed to the deceleration, while sales growth for food items, construction materials and jewellery picked up notably.

A rebound in trade growth during July provides a positive sign that improving demand in the global economy – particularly in the advanced economies – could help to offset softer private investment and stabilise the Chinese economy during the second half of the year. Nevertheless, growth in merchandise export values remains soft, rising just 5.1% over the year to July (following a very weak -3.3% the previous month). In seasonally adjusted terms exports actually fell 1.2% in July. This outcome was consistent with an improvement in manufacturing export orders during July, while the improvement in exports was also reasonably broad based across the major trading partners.

Much of the deterioration in exports growth in previous months has been driven by a government crack down on hot money inflows, but underlying export demand has been subdued for some time now, particularly in developed western economies. However, with signs that conditions in these economies are beginning to improve, a pick up in Chinese exports to these countries is a welcome sign. Exports to the United Kingdom, European Union and United States rose by 8.9%, 2.8% and 5.3% y-o-y respectively. Exports to Hong Kong, which were most affected by controls on hot money flows, rose in July to be up 2.3% y-o-y. Base effects helped the growth numbers this month, but a series of announced policy measures should also assist the sector over coming months. These include a pledge to maintain a more stable exchange rate, tax waivers, simpler export procedures and more financial support.

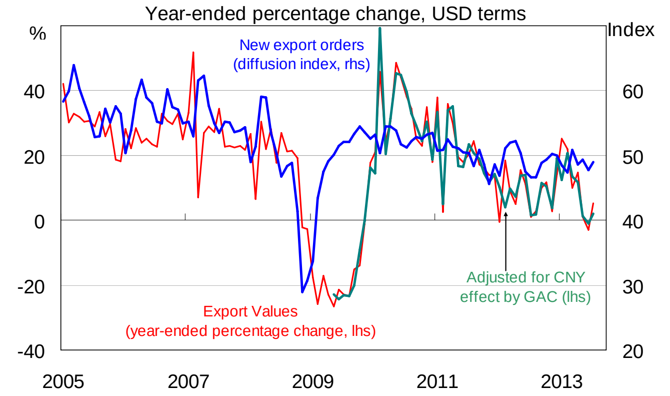
Acceleration in imports growth during July comes as a welcome sign for domestic demand, although these data tend to be volatile. Merchandise import values rose sharply in July to be 10.9% higher y-o-y. However, official seasonally adjusted figures again show that imports fell in the month (-3%). Nevertheless, base effects played a much smaller role in the improvement of year-ended imports growth, and the composition of imports

Retail Sales

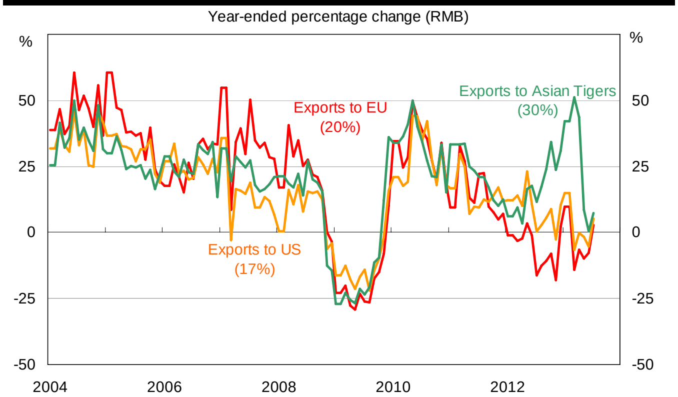


* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.

Merchandise exports and new export orders

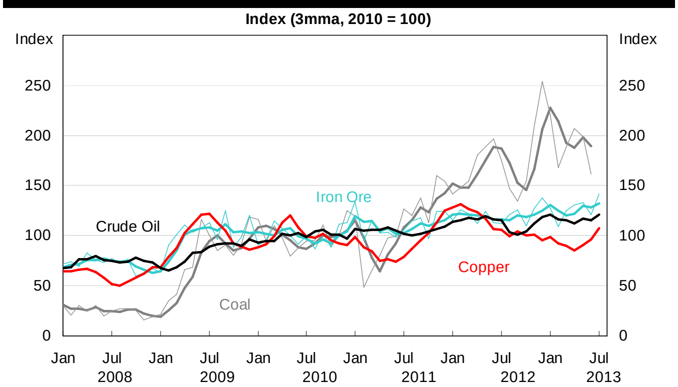


Merchandise exports to major trading partners



Sources: CEIC; NAB

Chinese commodity imports picking up



Sources: CEIC; NAB

tentatively points to more stable domestic demand. Imports of goods not for processing and re-export picked up in the month, while imports of raw commodities were generally better as well. Imports of crude oil rose 17% in the month to be up by almost a fifth over the year, while copper imports picked up 8% to be 12% higher y-o-y – although some of this demand could stem from financing deals. Iron ore imports rose 8½% in July to be more than a quarter higher than last year and hit a record high. The resilience of Chinese steel production has surprised us, pushing iron ore prices higher again despite increasing global supplies. Announced stimulus policies and infrastructure spending has probably helped support the market.

With imports accelerating more quickly than exports during the month, the trade surplus dropped in July to US$17.8 billion (down from US$27.1 billion in June), suggesting that net exports may provide some drag on September quarter GDP. Nevertheless, trade conditions are expected to improve this year driven largely by a gradual recovery in the major developed economies. In contrast, the growth in emerging economies that has driven global growth over recent years looks set to remain sluggish. Combined with recent strong appreciation of the RMB, there are still significant risks and headwinds to the trade outlook over coming months.

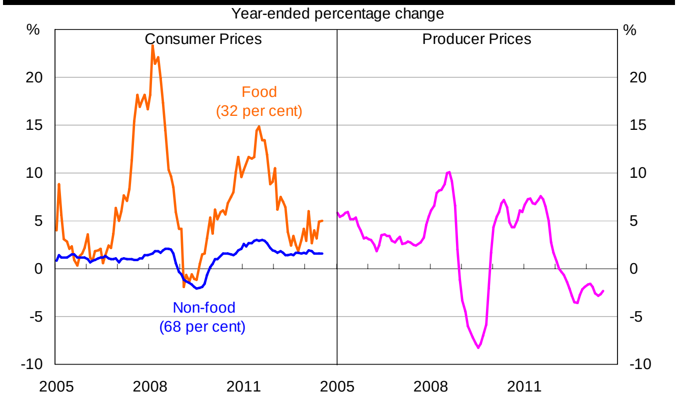
The inflation story has not changed in China since last month. CPI inflation has remained well within the official target of 3.5% for 16 consecutive months; year-ended CPI inflation remained at 2.7% y-o-y in July. Food prices growth ticked up slightly to 5% y-o-y (up from 4.9% in June). Non-food inflation was unchanged in the month to be 1.6% higher over the year (similar to the previous month). Base effects and an improving global economy could see a boost in the headline CPI over the rest of the year, although idle capacity in some industries has been keeping upstream prices at bay; producer prices fell 2.3% over the year. The IMF's recent assessment of the inflation situation in China suggests that a food supply shock may be the only way that China will see a return of high inflation pressures in the near term. Consequently, muted inflation pressures to date have provided policy makers with additional scope to keep an accommodative policy setting.

Policy expectation:

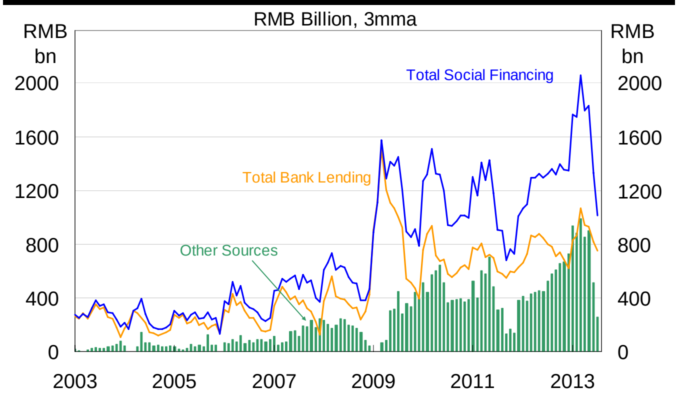
Tighter liquidity conditions in late June and steps to clamp down on shadow banking contributed to an easing in total social financing in July to RMB 809 billion, a 21-month low. New bank loans issued were above expectations at RMB 699.9 billion in July, but were also down noticeably from the prior month, while M2 growth unexpectedly accelerated to 14 ½ %. The outcome for system credit is consistent with the objectives of policy makers who are looking to control the rapid credit growth seen earlier in the year as well as improve the allocation of credit.

Given recent trends, we expect monetary policy to remain on hold, although it is worth noting additional steps taken towards interest rate liberalisation during the month with the removal of lending rate controls. While this is unlikely to have significant immediate impact on the economy – nearly 90% of loans are already priced above the benchmark rate – further steps towards full liberalisation can be expected. However, with the economy clearly slowing this year authorities have become more vocal on economic policies and introduced a variety of micro reform measures. This policy fine tuning has included renewed focus on infrastructure spending (particularly in rail and transport), cutting down 'red tape', tax waivers and reform (VAT) as well as measures to support exports. Consistent with these and the governments overarching goals of economic rebalancing, we are also likely to see additional spending on social infrastructure and services, although at this stage it looks to be a compositional shift rather than a fiscal expansion.

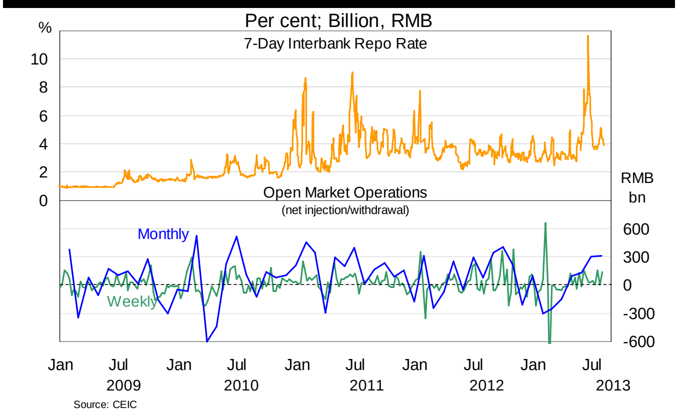
Consumer Prices



Loan demand deteriorated last quarter (survey)



Liquidity conditions



The central bank injected liquidity via money market operations in late July in response to rising interbank rates. The 7-day interbank repo rate has subsequently eased back below 4% after breaking through 5% in late July. We expect the PBoC to continue to use open market operations to keep liquidity in the interbank market at acceptable levels although a cut to reserve requirements can not be ruled out if liquidity deteriorates (possibly through a reversal of foreign capital inflows).

Statistical releases available here:
[National Bureau of Statistics]

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Important Notices