China Economic Update

National Australia Bank

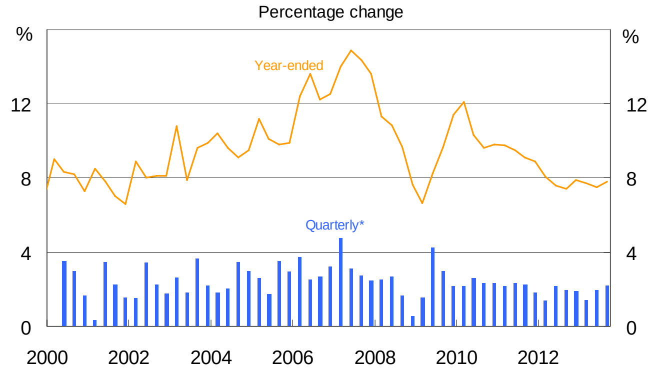
According to National Accounts data released today, the Chinese economy grew 2.2% in the September quarter to be 7.8% larger than the same period last year. The improvement in growth from last quarter was slightly above our expectation, but is consistent with partial indicators during the quarter. The Chinese economy has been gaining support from improvements in external demand – although export data for the month of September softened significantly – as well as stimulus measures intended to ensure that annual growth targets are achieved. Rapid credit growth earlier in the year may also be working to economic activity, but borrowing costs have now lifted noticeably.

In contrast to rebalancing objectives, official data show that growth over the year-to-date in Q3 2013 was driven by investment (contributing 4.3ppts to growth), followed by consumption (3.5 ppts). This reflects the leaderships renewed emphasis on infrastructure spending to stimulate growth for this year. Net exports made a minor contraction, reflecting the smaller trade surplus. Revised q-o-q growth rates suggest the economy's growth momentum has picked up over the past two quarters, suggesting stimulus measures have been successful in helping achieve the growth target for this year (7.5%). Annualised growth for Q3 was 9.1%, well above the 7.5% rate of growth in H1 y-o-y.

The recent pick up in activity is not expected to continue much beyond the end of this year as efforts to rebalance and restructure the economy gain more traction. We have revised our forecast for 2013 slightly higher to 7.6% (from 7.5%), but we still see growth decelerating to 7¼% next year. Regarding the monetary policy outlook, we expect the central bank to continue ensuring adequate liquidity for domestic banks while maintaining tighter overall monetary conditions to discourage speculative investment and rapid credit growth. Reserve requirements and benchmark interest rates are expected to remain stable. A cut to reserve requirements can not be completely ruled out, particularly in the event of an external shock to liquidity, but this is not our expectation. We can also expect to see ongoing policy 'fine tuning' as policymakers balance inflation (and debt market) concerns against annual growth targets (ensuring growth above the implied 7% floor). In terms of the longer term policy objectives, the upcoming 3rd Plenary Session of the 18th CPC Central Committee (in November), should provide insight into the new leaderships policy objectives and their approach to achieving reform targets.

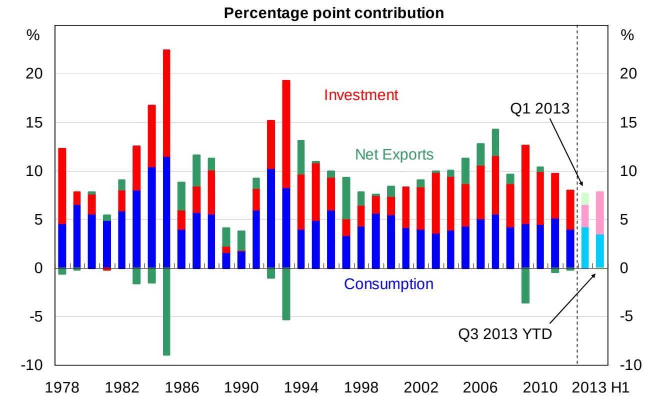
Business surveys show that conditions facing Chinese firms remain challenging, but are starting to recover. Conditions in the real estate sector continue to pick up on the back of stronger demand and expanding developer credit, but rising funding costs and concerns over affordability may soon dampen the sector. Conditions facing retail and wholesale business ticked higher, but remain at low levels, reflecting

Real GDP growth

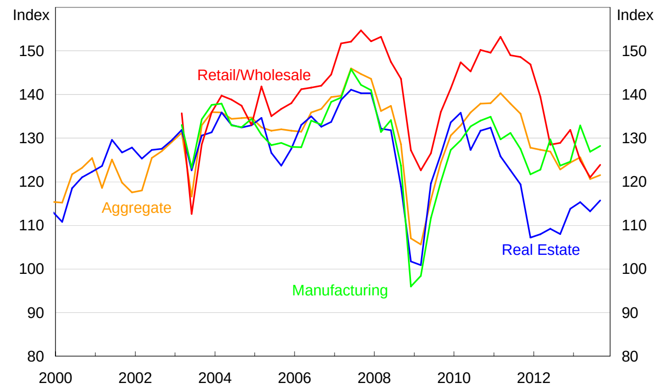


* Data prior to DQ2010 are estimated by NAB.
Source: CEIC Database, NAB

Contribution to GDP growth



China's business climate – concerning trend for retail



Source: CEIC

the muted growth in nominal retail sales relative to history. Consistent with this (and demonstrating the difficulties in rebalancing the economy), growth in real urban household disposable income has undershot GDP this year (6.5% ytd), although income growth for rural households was somewhat better (9.6%).

Domestic demand is tracking better. Industrial production was in line with expectations for the month, while retail sales and investment were slightly below. Softer than expected exports growth may put a dampener on expectations for a recovery in manufacturing, but seasonal impacts and a reduction in 'hot money' inflows may help to explain some of the weakness.

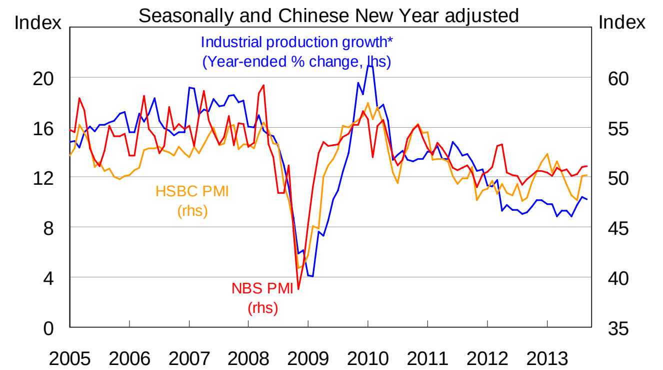
Turning to the partial indicators in more detail, industrial production growth decelerated marginally to 10.2% y-o-y in September (from 10.4%), consistent with softer merchandise exports, business investment and steady retail sales. Both major manufacturing PMI's also rose in the month. The official NBS index increased slightly to 51.1 (from 51) indicating further expansion for large and state owned enterprises. The Markit index, more representative of small and medium sized firms, was 50.2 in September (up from 50.1) indicating a more modest expansion. By type, production of construction related materials were mixed. Steel output rose 15.5% over the year to September, while cement production eased to 6.4%. As for other products, vehicle and textile production rose to 17.5% and 8.9% respectively, while power generation decelerated to 8.2%.

On the non-manufacturing side, the PMI jumped to 55.4 in September (up from 53.9), the highest level since March, consistent with solid GDP growth for the tertiary sector in Q3. The employment component of the index eased slightly, but still indicates robust labour demand. However, business expectations dipped to their lowest level since the global financial crisis, which may suggest flagging support from the services sector despite favourable government policies and a structural shift in the Chinese economy. This sentiment has also been echoed in private surveys and may reflect tighter monetary conditions and uncertainty over the policy and economic growth outlook.

Our estimates of fixed asset investment growth show that momentum slowed in September with growth easing to 19.4% y-o-y, down from 21.5% y-o-y in August. By sector, manufacturing investment was steady, having faced headwinds from overcapacity in some industries and weak profits growth, rising 22% y-o-y in September. Utilities investment remained soft compared to mid-year's relatively rapid growth, which could reflect an easing in public infrastructure investment, although the series tends to be volatile and growth is still elevated in trend terms. Growth in real estate investment has been volatile over the past year, but remains above 2012 lows. Growth jumped in September to around 22% y-o-y. Looking forward, annual growth in newly started investment projects picked up in September, while the real estate climate has remained steady.

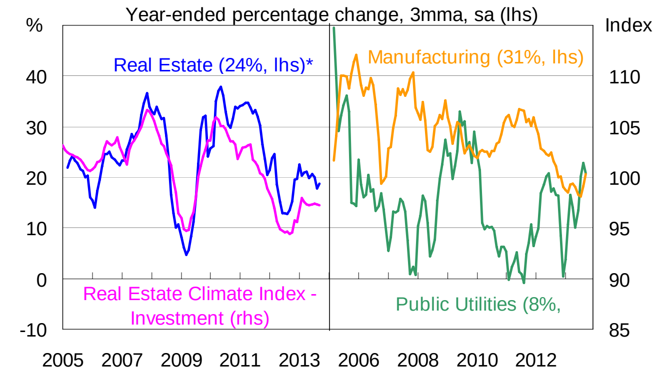
Nominal retail sales growth was slightly below market expectations in September, easing to 13.3% y-o-y (down from 13.4% the previous month). This outcome is below the government's target rate of 14½% for 2013, suggesting more needs to be done to promote household incomes and spending. Accounting for retail prices in the month, real growth in retail sales was 11.2%y-o-y (down from 11.6

Industrial Production



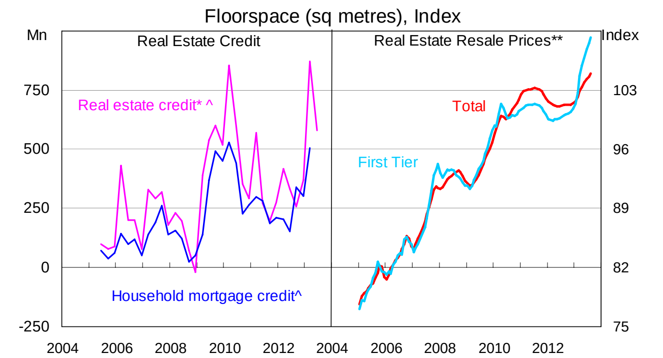
* Adjusted for Chinese New Year
Source: CEIC, Nab

Fixed Asset Investment by Sector



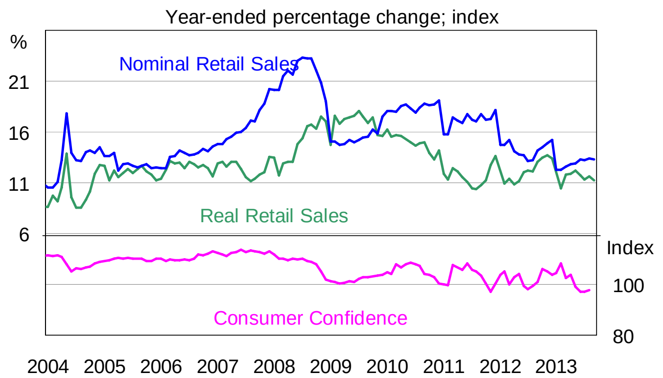
Source: CEIC, NAB
* Number in brackets represents share of total FAI in 2010; Real Estate is using Real Estate Investment data

Easier finance earlier in the year driving property prices



* Includes finance to real estate developers
** Weight average of cities. Calculated by NAB.
^ Non-break adjusted
Source: CEIC, NAB

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.

% the previous month). Consumer confidence remained around all time lows in August, consistent with slower income growth in the first three quarters of the year and may signal concern over labour market conditions. Indicators of the labour market are a little mixed. The employment component of the PMI eased in September and has remained below 50 since May 2012. In contrast, the city labour market demand-supply ratio suggests very little slack in the urban labour market – although this can be impacted by labour migration. By product, softer sales growth in food & drink, catering services and petroleum has offset stronger growth in other categories, particularly for automobiles, textiles, and household electronics.

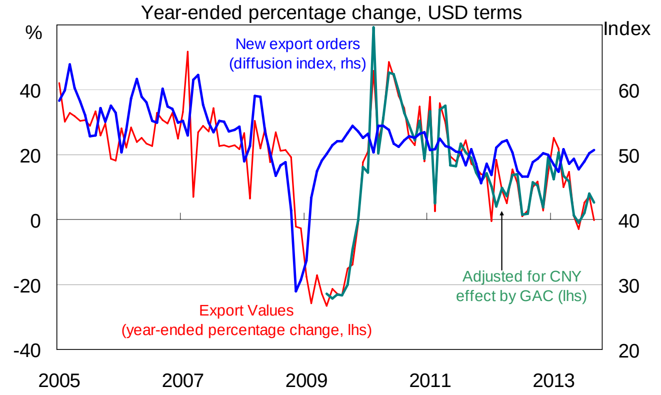
Trade data for September were mixed, although special factors may be having an impact on the headline numbers. Growth in merchandise export values was -0.3% y-o-y to September (following 7.2% y-o-y increase for August). This was well below market expectations, and might dampen hopes for further support to industrial activity from the exports sector – particularly given headwinds from political problems in the US. However, after adjusting for seasonality, exports rose by 8.3% m-o-m in September, which appears to be more consistent with recent improvements in export orders according to the PMI survey. Part of the inconsistency could stem from distortions created by the timing of the mid-Autumn holidays. Hot money inflows could also be partly to blame as these began to gather pace around this time last year.

Consistent with the timing of holidays and trends in hot money flows, exports non-Japan Asia were particularly soft in the month, driven by weaker exports to ASEAN, Korea, Taiwan and Hong Kong. Exports to the EU also softened marginally, shipments to the US were relatively steady, while exports to Japan accelerated. By product, high tech exports fell almost 2% m-o-m sa in September to be up 2.7% y-o-y, while mechanical and electrical exports were down 2.7% m-o-m sa to be 0.4% higher over the year. Exports of lower-end goods were also softer, falling 4% m-o-m sa.

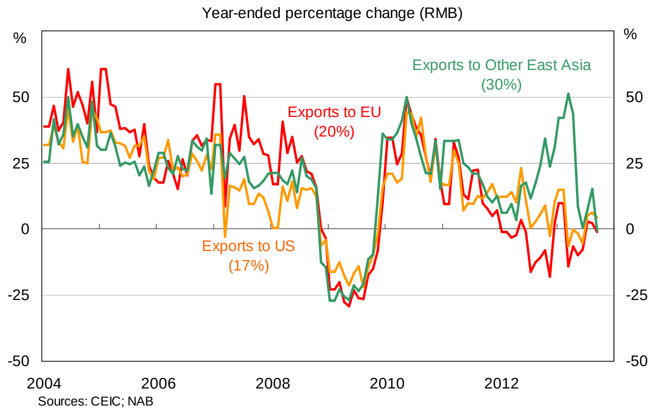
Imports in September provide a more positive signal for domestic demand in China. Growth over the year was recorded at 7.4%, which was slightly above market expectations. Official estimates suggest that imports rose by 11% m-o-m (sa), although some of this comes on the back of strong commodity demand under pinned by stimulus investments. In contrast, imports of manufactured goods and machinery and transport equipment have slowed (0.7% and 2.6% y-o-y respectively), which suggests a trend that is counter to domestic rebalancing efforts. Imports of crude oil rose by 20% in the month to be 28% higher on last year, while copper imports rose by 18% to be 16% higher y-o-y. Iron ore imports rose 8.1% in September to hit a record high; 14.7% higher y-o-y. With exports growth dipping below expectations, the trade surplus narrowed in September to US$15.2 billion (down from US$28.5 billion in August).

The headline CPI rose to 3.1% y-o-y in September, up from 2.6% in August. Looking through seasonal distortions, this is the closest the CPI has come to the official target of 3.5% this year. Food prices were the primary driver of the acceleration, increasing 6.1% y-o-y (up from 4.7% in August). Non-food inflation rose only slightly in the month to be 1.6% higher over the year (up from 1.5%). Deflation in factory prices moderated further in September, easing to -1.3% y-o-y (down from -3.6% in late 2012). However this was the nineteenth consecutive

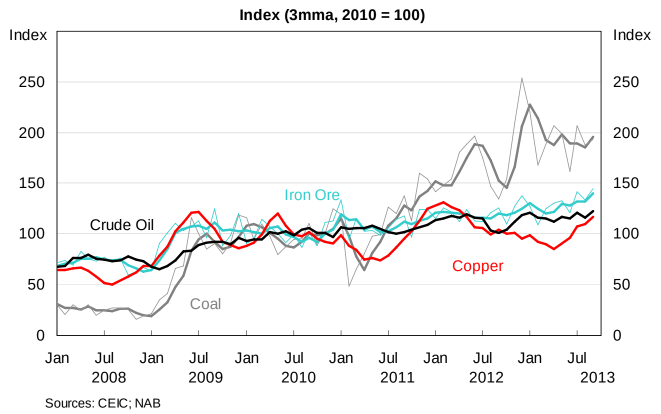
Merchandise exports and new export orders



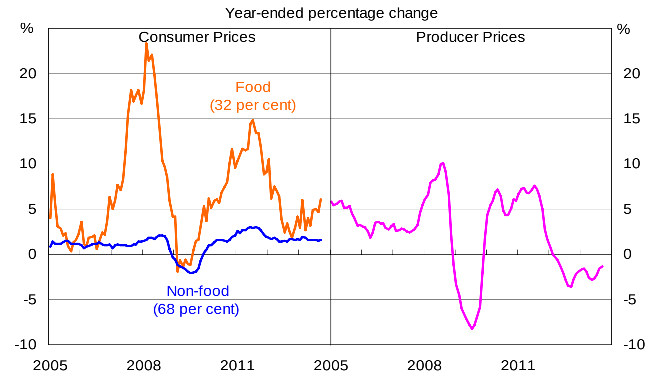
Merchandise exports to major trading partners



Commodity import volumes supported by investment



Consumer Prices



annual decline in producer prices.We have been flagging a potential rise in consumer inflation pressures, but September's acceleration was a little more than expected. It came on the back of poor weather conditions driving up food costs, particularly for vegetables and dairy which increased more than 17% and 6% on last year respectively. The NBS also sighted seasonal demand as a factor behind the increase. Given that most of the spike is stemming from temporary supply disruptions, policy makers are unlikely to respond in a hurry, but will be on the look out for any pass-through to other prices. We expect that solid credit growth and a global economic recovery could push CPI inflation above the government's target rate during 2014, which will present a possible constraint on further policy stimulus should it be necessary.

Policy expectation:

China's policy makers have recently affirmed their position on policy, indicating that they will be keeping monetary policy 'prudent' and largely stable, with some fine-tuning while maintaining appropriate levels of bank liquidity. But while inflation pressures appear to be broadly under control for now, credit expansion has been robust, which could warrant a tightening response, particularly if capital inflows resume – foreign reserves rose by more than US$163 billion in the September quarter, one of the largest ever increases. Given these conditions, chances of a cut to major policy instruments (benchmark interest rates and/or reserve requirements) are slimming, and it will likely require a significant shock to growth and the labour market to alter this position.

Consistent with this, monetary conditions in longer dated debt markets have remained very tight in an apparent attempt to rein in speculative investments. Bond rates (3 and 5 year) have held up around the highs seen at the peak of the 2010/11 policy tightening cycle. Despite this, total social financing was stronger than expected in September at RMB 1,420 billion (down from RMB 1,568 billion), as were new yuan loans (RMB 787 billion). The smaller increase in non-bank lending is a good sign for those concerned about the burgeoning shadow banking sector, although non-bank finance has been volatile recently and has been trending up from this years low in recent months (non-bank finance accounted for around 40% of total finance).

Liquidity conditions have remained significantly better than mid-years 'credit crunch', although interest rates remain elevated from earlier in the year. While the central banks liquidity injections were smaller in September and October to date, trade surpluses and concerns over the US government shutdown have kept liquidity at adequate levels. 7-day interbank rates dipped to 3.34% recently, the lowest level since May.

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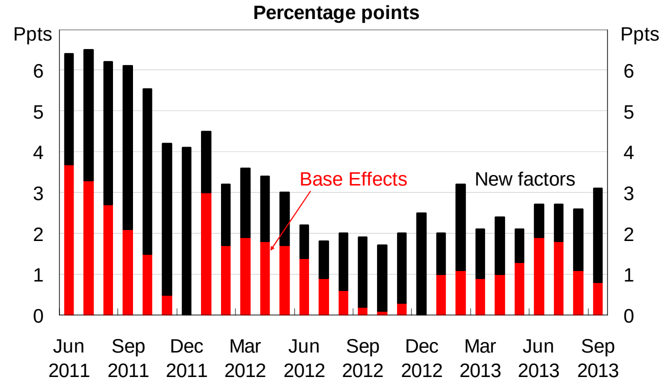
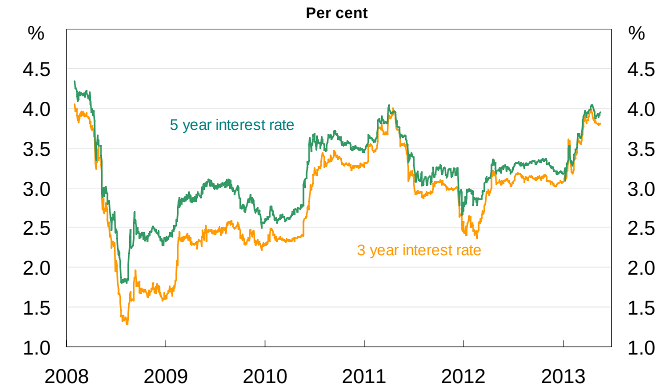
CPI Inflation – impact from base effects



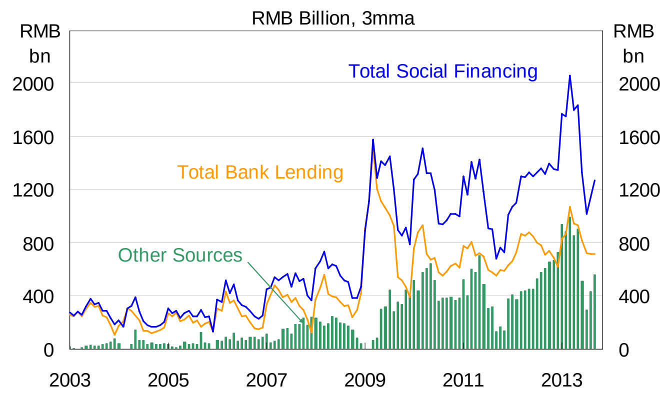
Sources: CEIC: NAB

Longer maturity interest rates

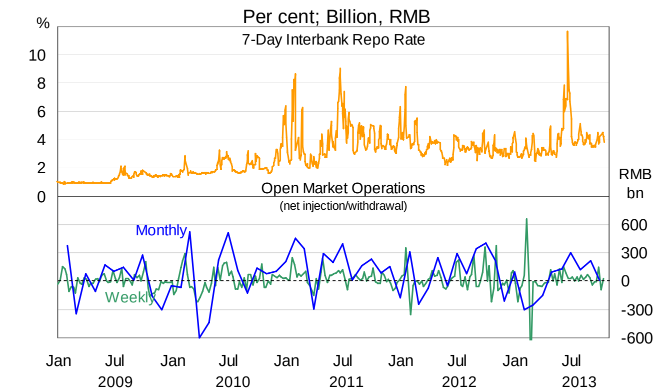


Sources: CEIC Database

Total social financing rising again



Liquidity conditions



Source: CEIC

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