There were few surprises in the latest Chinese data release, with the weakening trends evident since the latter part of last year continuing into the first quarter of 2014, with slower economic growth, comparatively soft industrial production and investment data continuing to point downwards.

There remains some speculation regarding Government stimulus in response to the weaker performance. Last year’s ‘mini-stimulus’ was critical to the Chinese economy exceeding its growth target, and an April announcement from the State Council regarding investment in rail infrastructure was seen by some observers as the 2014 equivalent. Instead, it appears to be an attempt to encourage private sector investment (via favourable tax treatment to investors) and may not have the same impact.

**Gross Domestic Product and Business Climate**

For the first quarter of 2014, China’s National Accounts data showed the economy grew by 1.4% quarter-on-quarter, and 7.4% year-on-year (slightly ahead of market expectations of 7.3%), continuing to highlight a slowing trend (down from 7.7% yoy growth in the December quarter).

This softening was broadly in line with our expectations for China’s economy and was also consistent with weaker partial indicators – such as industrial production, fixed asset investment and exports.

Data on the contribution to GDP on an expenditure basis has not yet been released, however China’s National Bureau of Statistics has indicated that consumption made up almost 65% of GDP and it is likely that net exports subtracted from growth.

By industry, the tertiary sector – largely services – has continued to record stronger than average growth. As a result, the share of services in the broader economy has increased – at around 46% on a rolling four quarter basis (to account for considerable volatility in the raw data).

We expect economic conditions in China to remain comparatively weak across 2014 – with the Government more focussed on its reform agenda than headline growth. As a result, the share of services in the broader economy has increased – at around 46% on a rolling four quarter basis (to account for considerable volatility in the raw data).

**Industrial Production and Investment**

China’s industrial production increased by 8.8% yoy in March – slightly stronger than levels in February (8.6%) but also marginally weaker than market expectations (9.0%). Growth in industrial production remains near its lowest level since May 2009 – when China was in the midst of its post-GFC recovery.
Trends in manufacturing PMI surveys were mixed in March. The official NBS PMI – which has a larger representation of state owned enterprises – edged marginally higher to 50.3 points (from 50.2 points in February), while the HSBC Markit PMI – which is more representative of small to medium manufacturers – fell to 48.0 points (from 48.5 points previously).

Trends in the major industrial sectors were mixed. Growth in rolled steel output was largely unchanged, increasing by 5.0% yoy (from 4.9% in February), while cement production picked up – to 5.9% yoy (from 2.4% previously). Electricity production was also slightly stronger – recording an increase of 6.2% yoy (compared with 5.5% in February), while motor vehicle production slowed to 7.3% yoy (compared with 12.5% in February and 23% at the end of 2013).

Fixed asset investment also softened in March, with the seasonally adjusted rate easing to 17.4% yoy (down from 17.9% in February). This rate of growth has been steadily trending downwards over the past few years, as authorities have attempted to rebalance the economy towards consumption. Government influenced investment has slowed significantly in early 2014 – with last year’s stimulus program no longer influencing investment trends.

Investment was marginally weaker in the real estate sector in March – with growth slowing to just under 18% yoy (seasonally adjusted), compared with 20% in February. The collapse of an unlisted, private property developer in mid-March highlighted some broad concerns in the sector, with a controlled slowdown likely to be positive for the broader sector.

In contrast, investment trends for manufacturing and utilities were marginally improved, with manufacturing fixed asset investment increasing by a seasonally adjusted 18% yoy (compared with 16% in February), while public utilities (electricity, water and gas) increased by 11% (compared with 10% in February) – albeit a level well below those recorded in late 2013.

International trade

March was the first month of the year to provide a clear signal around Chinese trade activity – with considerable volatility in January and February due to the timing of Chinese New Year (CNY). Both exports and imports declined in year-on-year terms, with a sharper fall in imports contributing to a widening in the trade surplus to US$7.7 billion (compared with a smoothed value of US$4.4 billion for each of January and February).

Merchandise exports fell by -6.6% yoy in March (in US dollar terms). When seasonally adjusted and smoothed across the CNY period, exports have consistently fallen by around -5.5% a month since the start of the year. This reflects distortions in export data for the first half of 2013, due to false invoices used by firms to avoid capital controls. Export trends across the first half of 2014 are likely to remain weak as a result of this trend.

This decline was only evident in exports to East Asian markets – which fell by over -25% yoy. Hong Kong (the largest single export market in March) has been the major location for invoice schemes, and US dollar exports plunged in March – down -44% yoy. Excluding Hong Kong, exports to East Asia rose by 4.1%, while exports to the European Union increased by 8.8% yoy and to the United States by 1.2% yoy.

Exports falling but false invoice scheme distorts data

Exports to key Asian trading partners plunged in March
There was a noticeable fall in exports of High Tech products – which may again be related to the invoicing issues – down by -20% yoy. Declines were also significant for Mechanical & Electrical goods, which fell by -11% yoy, while Agricultural products increased by 7.1% yoy.

US dollar denominated imports fell sharply in March – down by -11% (compared with a smoothed 10.6% increase across January and February). This fall appears to be largely price related – with commodity prices for iron ore and coal (in particular) falling in recent times.

Import volumes were somewhat mixed, with strong growth in copper and iron ore (increasing by 31% and 15% yoy respectively) while crude oil imports rose by 2% yoy and coal imports fell by -3.3% yoy.

### Retail Sales and Inflation

Retail sales growth was relatively stable in March – with nominal growth up by 12.2% yoy (compared with 11.8% in February) – a level that was in line with market expectations. In real terms, sales growth was 10.9% yoy, unchanged from the previous month. Consumer confidence has also been fairly stable in recent months – in positive territory and stronger than the weak levels recorded in mid 2013.

Sales growth for food & drink was largely unchanged, increasing by 9.9% yoy (compared with 10.1% in February), while household goods accelerated to 13% yoy (from 7.3% previously) along with motor vehicles – up by 14% yoy (from 11.5%). Jewellery sales contracted in March – falling by -6.1% yoy (compared with growth of 9.1% in February).

Headline CPI has moved marginally higher in March (having trended lower between November 2013 and February 2014) – increasing by 2.4% yoy (compared with 2.0% in February). The increase largely reflected base effects – with new factors contributing less to the increase (1.1%) in March than in February (1.6%). Food prices increased strongly – increasing by 4.1% yoy (the strongest level since December, but well below the levels across most of the second half of 2013), while non-food prices eased back to 1.5% yoy (from 1.6% previously). Prices for fresh fruit and vegetables rose sharply in March (up 17% yoy and 13% yoy respectively), while meat and poultry was cheaper (prices falling by -1.8% yoy).

Producer prices continued to fall in March, down by -2.3% yoy (compared with -2.0% in February) – a trend that has been evident for over two years. Heavy industry continued to record the largest falls – with the trend closely following trends in US dollar denominated commodity prices.

### Policy expectations

Efforts to address concerns around shadow banking appear to have driven some changes in the broader financial sector. Growth in the People’s Bank of China’s (PBoC) Total Social Financing measure has slowed significantly since the second half of 2013 – generally declining in year on year terms.

Growth in bank loans was generally slower than total social financing over recent years – reflecting the growth in shadow banking (Total Social Financing includes some, but not all components of Shadow Banking) – however growth rates have been stronger since the second half of 2013. Tightening regulation has forced banks to bring a range of off-balance sheet items back to traditional loan products.
Trends in Chinese money markets have been highly volatile across the past three months – with recent downward movements in short term interest rates counter to the passive tightening trend across 2012 and 2013. The scale of recent injections and withdrawals by the PBoC has far exceeded the typical levels across the past few years – contributing to this volatility.

From mid-February to mid-March, the Shanghai Interbank Offered Rate (Repo) fell sharply – down from around 5% to 2.5%. Liquidity withdrawals brought the rate back to around 4% by the end of March, but the rate has continued to fluctuate in April.

In contrast, movements have been far more modest in longer term rates – with a modest easing in 5 year rates from January peaks and a slight fall, followed by a reversal in 3 year rates.

Competing policy goals have been contributing to these market trends – with lower short term rates likely an attempt to address recent corporate failures in the solar and property development sectors and avoid a credit crunch.

Lower rates may also have been required to aid the adjustment away from shadow banking – with reports suggesting regulations related to trust products have been tightened in April (although so far there has not been any official confirmation).

However, these lower rates are at odds with broader goals around slowing credit growth, meaning that we continue to anticipate a higher rate for the Repo in coming months, once short term concerns have been cooled.

On the deposit side, The Vice-Governor of the PBoC announced in April that a deposit insurance scheme is planned and will ‘probably’ be introduced before the end of this year – a key step towards full liberalisation of deposit rates, which would likely improve the efficiency of funding allocation.

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