China Economic Update

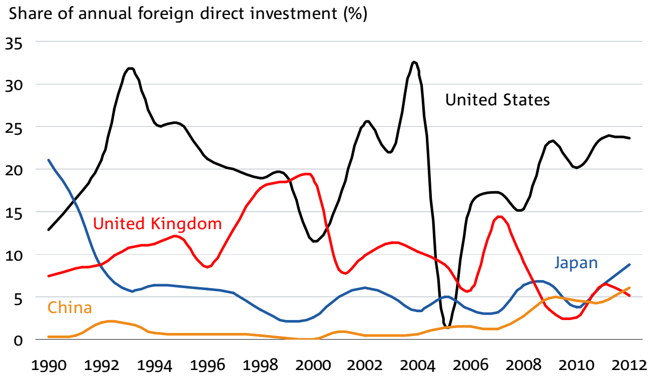
National Australia Bank

China's role in global investment is growing, but the scale remains small

As China's economy has grown over the past decade, so too has China's overseas investment. This has become a highly controversial issue in a number of countries, in part due to the difficulties faced by firms and individuals when attempting to invest in China as well as the considerable influence of state-owned enterprises in China's major industries. While China's foreign direct investment has grown significantly in recent years, it still pales in comparison to major global investors such as the United States and Japan.

Data from the United Nations shows that China's foreign direct investment (which excludes investment in financial assets) has increased strongly over the past decade – rising from around US$2.5 billion in 2002 (around 0.5% of the global total) to US$84 billion in 2012 (a share of 6.1%) (the most up to date data available), making China the third largest investor globally. In contrast, the United States accounted for almost 24% of global investment in 2012, followed by Japan at 8.8%.

China's share of annual investment is increasing



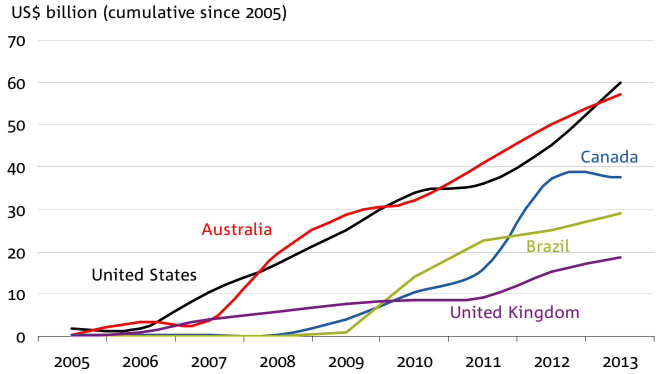
Source: UNCTAD, NAB Economics

In part, the fact that China, the world's second largest economy, lags slightly behind in terms of foreign investment reflects domestic regulatory constraints – including constraints on capital flows – as well as restrictions imposed by potential host countries for Chinese investment.

Despite the challenges in investing in China, the country is also a major recipient of foreign direct investment. In 2012, China received around US$121 billion in foreign direct investment – or around 9% of the global total – second only to the United States, which received over 12%.

The Heritage Foundation, a US based think-tank, maintains a database of Chinese foreign investment between 2005 and 2013, which breaks down investment by country and industry category. Over this nine year period, China's foreign direct investment totalled US$479 billion (a figure comparable to the UN dataset), compared with investment of almost US$2.8 trillion by private firms and individuals from the United States.

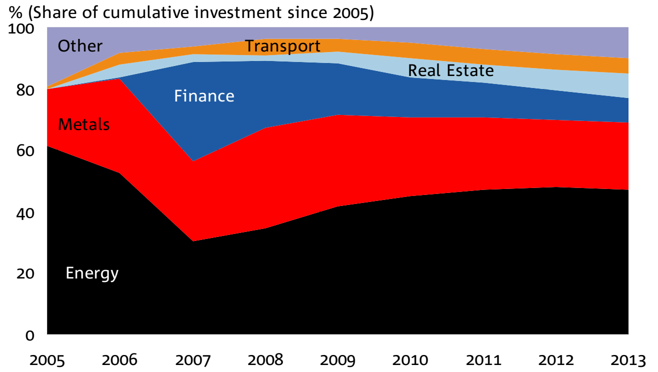
US and Australia the key markets for China's investment



Source: Heritage Foundation, NAB Economics

The Heritage Foundation's data shows that the United States and Australia were the two largest recipients of Chinese foreign investment between 2005 and 2013 – totalling US$60 billion and US$57 billion respectively. In percentage terms, the United States received around 13% of the total investment over the period, while Australia received 12%.

Energy & Metals have dominated China's investment

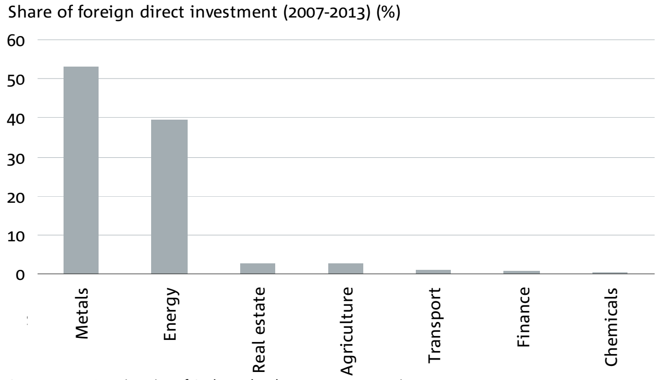


Source: Heritage Foundation, NAB Economics

Over the nine year period, investment by industry was been dominated by the energy sector (47% of total Chinese foreign investment) and metals (22%). This largely reflects efforts by Chinese firms to secure access to the raw materials required for the country's rapid industrialisation. In contrast, the finance and real estate sectors each accounted for around 8% of total investment – although smaller scale investments may have been overlooked.

Given that Australia is a major exporter of resource and energy commodities, it is unsurprising that China's investment in Australia is focussed in these sectors. The Heritage Foundation's data shows that Australia's metals sector accounted for around 53% of Chinese investment over the nine year period, followed by energy with 40% of the total.

China has invested heavily in Australia's mining industry



Source: KPMG-University of Sydney database, NAB Economics

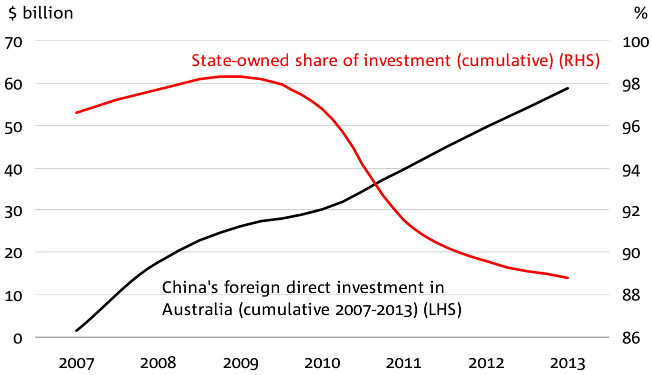
In contrast, investment in the United States has been far more broad based. The largest share of investment was in the finance sector – due to large scale investments in 2007 and 2008 – accounting for around 34% of the total. This is followed by the energy sector, at around 21% of investment, and real estate and agriculture, at 14% and 12% respectively. The comparatively large share of agriculture was driven by the US$7 billion acquisition of Smithfield Foods – the country's largest producer and processor of pork products – in 2013.

Global agriculture is likely to receive further investment from China in coming years, in an effort to acquire intellectual property as well as secure access to high quality produce – particularly in the wake of food scandals that have impacted domestic producers.

One of the issues that cause controversy regarding Chinese foreign investment is the dominant role of state-owned enterprises in a range of the country's industries. The Heritage Foundation estimates that around 90% of the total investment between 2005 and 2013 was made by state-owned firms, however the share has gradually fallen over the course of the nine year period – reflecting private sector investments such as multi-billion dollar acquisitions in the United States and United Kingdom by the Dalian Wanda Group.

This trend is echoed in Australian data produced by KPMG and the University of Sydney. State-owned firms accounted for around 98% of China's investment in Australia between 2007 and 2009. By 2013, the cumulative share fell to 89%, driven by private sector investment in the renewables sector.

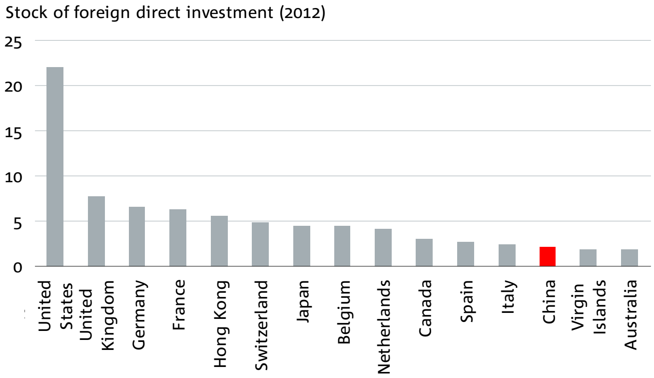
Chinese private sector investment slowly rising



Source: KPMG-University of Sydney database, NAB Economics

Although there has been considerable growth in China's foreign investment over the past decade, China's stock of foreign owned assets is not nearly as significant as other major investors. United Nations data for 2012 showed that the United States controlled the largest share, at 22%, followed by the United Kingdom (8%) and Germany (7%). China was the thirteenth largest investor overall, accounting for just over 2% of the total stock.

China still small in global investment stock



Source: UNCTAD, NAB Economics

It is highly likely that China's foreign investment will continue to grow in coming years, as regulatory reform eases constraints on Chinese investors and continued economic growth expands the size of the country's financial capital. The Heritage Foundation expects that China's foreign investment could total US$1.2 trillion across the next decade.

However, the longer term investment prospects for Australia are less certain. The slowing trends in investment within the mining industry may reduce the potential investment pool for Chinese firms, particularly if they increasingly seek higher value assets in other markets.

Recent economic trends

Partial economic indicators suggest that China's economy has stabilised in recent months. These trends remain in line with our expectations, meaning that our forecasts for economic growth remain unchanged at 7.3% in 2014 and 7% in 2015.

Beijing has encouraged local governments to speed up budget spending, announced investment plans in the railways and social housing sectors and introduced targeted cuts to the reserve requirements for some banks – however the People's Bank of China (in particular) remain resistant to broader stimulus measures.

Moves to allow local governments to issue bonds (initially a pilot scheme limited to 10 better managed authorities) could begin to reduce concerns around capacity of governments to service debt as well as reduce their dependence on shadow banking. That said, careful supervision will be necessary, as mismanagement and scandals in the 1990s resulted in the current regulatory constraints.

Industrial Production and Investment

Industrial production growth was largely unchanged in May – rising by 8.8% yoy (compared with 8.7% in April). This level was in line with expectations, and may point to stabilisation in the secondary sector, following the slowdown since late 2013.

Trends in the PMI surveys were somewhat improved in May. The official NBS PMI – which is more representative of larger, state-owned firms – edged up to 50.8 points (compared with 50.4 points last month). The HSBC Markit PMI (which has stronger coverage of small-to-medium sized firms) moved up to 49.4 points (from 48.1 points previously) – the strongest level since January 2014.

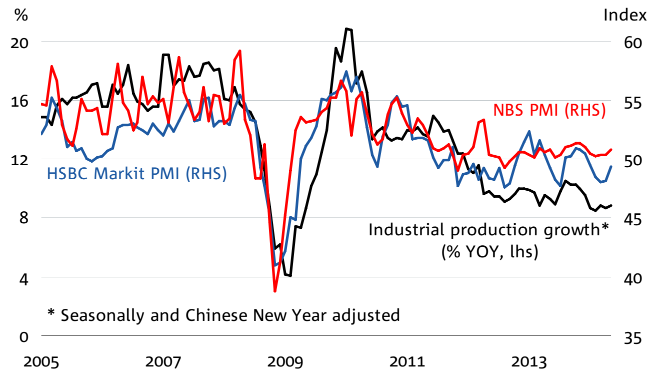
Trends in the major industrial products remained mixed in May. There was a strong acceleration in motor vehicle production – up by 12.2% yoy (compared with 7.9% last month) – and modest pick ups in rolled steel (6.1% yoy versus 5.4% previously) and electricity (5.9% yoy compared with 4.4% in April). In contrast, cement manufacturing increased by 3.2% yoy (down from 3.9% last month).

Fixed asset investment was marginally stronger in May, with the growth rate edging up to 17.0% (on a seasonally adjusted basis), up from 16.8% last month.

Investment trends were mixed at the sector level. The softening trend in manufacturing investment continued, with the growth rate down to 14% yoy (seasonally adjusted) from 15.1% previously, along with investment in real estate down to 13.7% yoy (from 16.1% in April). In contrast, there was a pick up in public utilities, increasing by 19.4% yoy in May (from 13.1% last month).

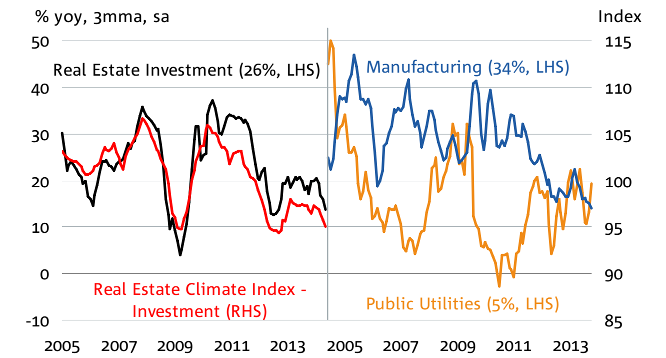
Trends in the residential property market appear to remain weak, with property sales continuing to fall in year-on-year terms (down -10.8% yoy in May). Government initiatives related to social housing are unlikely to have a major impact on the sector (given the relatively modest scale of these developments). However measures to allow some

Industrial production trends stabilising after slowdown



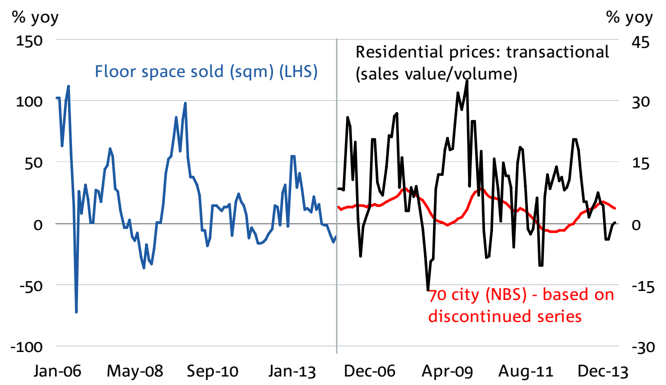
Source: CEIC, NAB Economics

Further slowing in real estate and manufacturing investment



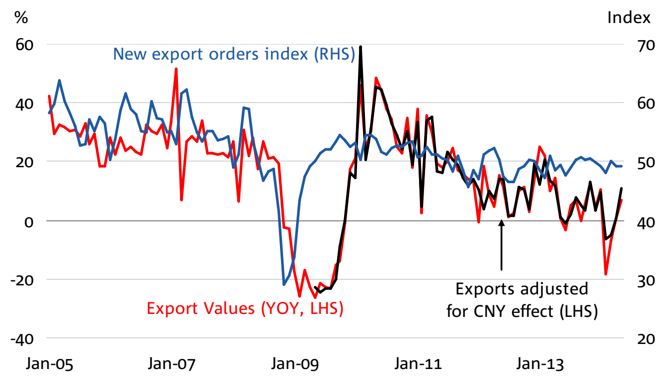
Number in brackets represents share of total FAI in 2013
Source: CEIC, NAB Economics

Residential property sales slowing and prices softening



Sources: CEIC, Datastream, NAB Economics

Export trends to remain weak in the first half of 2014



Source: CEIC, NAB Economics

local governments to issue bonds could reduce our broader concerns related to a property slowdown (weaker land sales reducing the capacity to service short term government debt).

International trade

China's trade surplus widened in May – reflecting a recovery in exports and a year-on-year decline in imports – rising to US$35.9 billion (from US$18.5 billion in April), a level considerably higher than market expectations.

US dollar denominated merchandise exports increased by 7.0% yoy. Over the first five months of the year, exports remain marginally weaker – down by around -0.3% from the same period last year. Data has been distorted by the crackdown on false invoicing, and is unlikely to show clear trends until the second half of the year.

By destination, the key driver in the stronger export trend was the increase in exports to East Asia – increasing by 5.0% yoy (compared with a fall of -16% yoy in April). Exports to Hong Kong (the main destination for the false invoice schemes) were still lower – at -0.8% yoy in May – but less negative than previously (-31% last month). Export growth to the United States and Europe were slightly softer in May, at 6% yoy and 13% yoy respectively.

By product, the largest improvement was recorded for High Tech products – with exports rising by 4.9% yoy in seasonally adjusted terms (compared with a fall of -11% last month) – followed by Mechanical & Electrical goods (up by 5.7% yoy, from -2.8% in April), while growth in Agricultural products were relatively stable at 7.1%.

China's imports fell in May – down by -1.7% yoy (compared with market expectations for an increase of around 6%), following a marginal increase in April. The rates of growth slowed across commodity categories – with a sharp fall in the volume of coal imports (down -13% yoy), while copper (increasing by 5.9% yoy, from 52% yoy in April), crude oil (up by 8.9% yoy from 21% last month) and iron ore (13% yoy from 24% previous) eased.

Retail Sales and Inflation

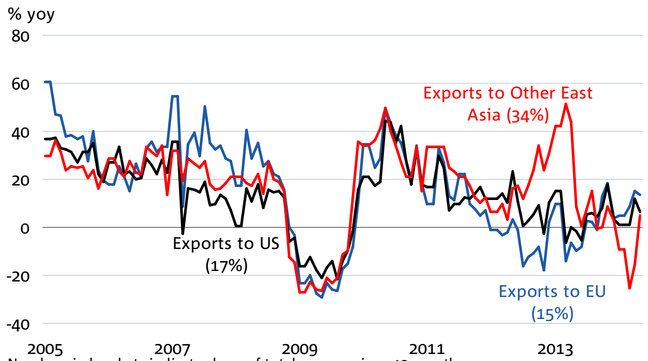
Nominal retail sales growth was a little stronger in May, accelerating to 12.5% yoy, compared with 11.9% in April. This result was stronger than market expectations.

However in retail terms there was a marginal slowing in the growth rate – down to 10.7% yoy from 11.0% last month, reflecting a modest pick up in retail price inflation. Consumer confidence was a little weaker in April, but has remained at strong levels (compared with recent history).

By category, there were gains in food and drink sales – increasing by 13.7% yoy in May (compared with 11.9% last month) – and household goods (up by 6.6% yoy from 2.9% previously). In contrast, growth slowed for motor vehicles, down to 7.6% yoy from 12% in April, while jewellery sales remained negative, down by -12% yoy.

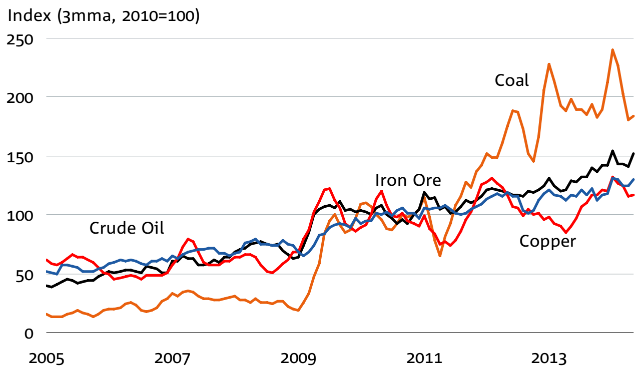
Consumer price growth accelerated in May, with the headline consumer price index rising by 2.5% yoy (compared with 1.8% in April). Food prices remain the main

East Asia the key driver of growth in May



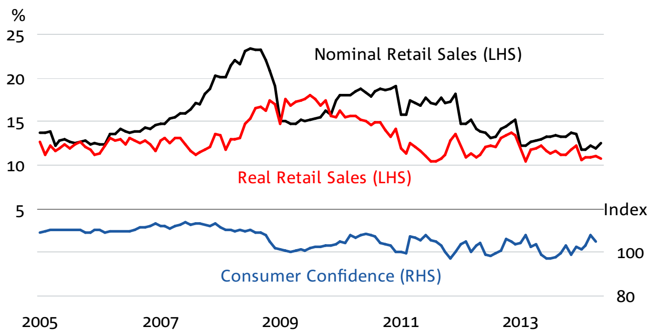
Numbers in brackets indicate share of total over previous 12 months
Sources: CEIC, NAB Economics

Slowing trend across commodities – led by coal



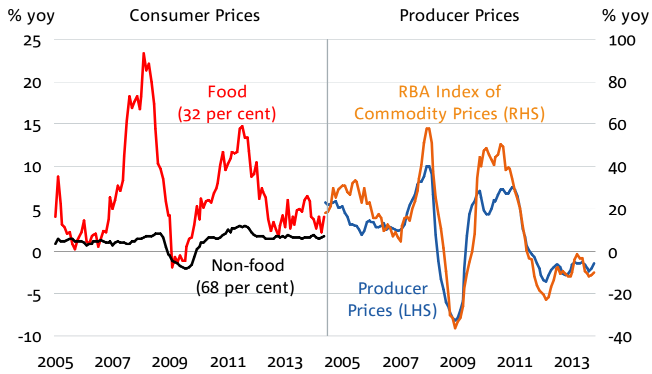
Sources: CEIC, NAB Economics

Stable trend in real sales, confidence still relatively strong



* 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.
Source: CEIC, NAB Economics

Consumer and Producer Prices controlled



Sources: CEIC, RBA, NAB Economics

influence on the headline result – with non-food prices increasing by 1.7% yoy (compared with 1.6% previously).

Food prices rose 4.1% yoy in May (up from 2.3% last month), with fresh fruit (up 20% yoy) and eggs (18% yoy) recording the largest increases.

Producer prices have continued to fall in year-on-year terms, down by -1.4% yoy in May (following on from -2% in April). Producer prices have fallen for twenty-seven months in a row, with heavy industrial producers recording the largest declines – in line with falling US dollar denominated commodity prices.

Policy expectations

The policy response to the slowing trend in China's economy has so far been modest – at least when compared with previous stimulus programs. Limited cuts to reserve requirements (50 basis points) for agricultural and small business-focussed banks fall well below the expectations of some commentators calling for wholesale cuts.

According to Bloomberg, the reserve requirement cut applies to two-thirds of city commercial banks, 80% of non-country level rural commercial banks and 90% of non-country level rural cooperative banks, along with finance firms and financial-leasing and automobile-financing companies. This move could boost liquidity in some markets.

Efforts to address concerns around shadow banking appear to be impacting on the financial sector. For the first five months of the year, new social financing has slowed in year-on-year terms – down -5.9%. New bank loans have increased by 7.0% yoy, while non-bank (which includes some, but not all, components of shadow banking) fell by -20% yoy. The falls are particularly evident in new trust and entrusted loans over this period.

The 7-day Shanghai Interbank Offered Rate was comparatively stable across May and early June, tracking between 3% and 3.5% across this period, a range considerably below the trends evident across most of 2013. This was in stark contrast to April, where the SHIBOR fluctuated a 150 basis point range.

Monetary policy was more accommodating across this period, with the PBoC injecting liquidity into money markets over the past five weeks.

Longer term rates trended downwards across the month, with 5 year rates falling below 4% for the first time since October 2013. Spreads between the 5 year and 3 year rates remained around the typical levels observed across most of 2012 and 2013.

Lower interest rates (compared with late 2013) continue to highlight the challenges facing policy makers, attempting to arrest weakening economic trends and cool concerns in the property market while also attempting to slow rampant credit growth.

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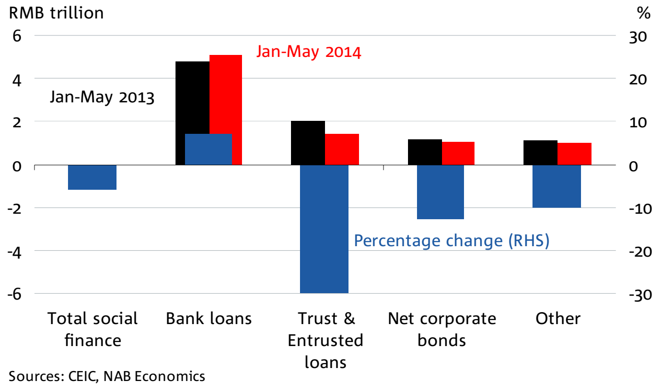
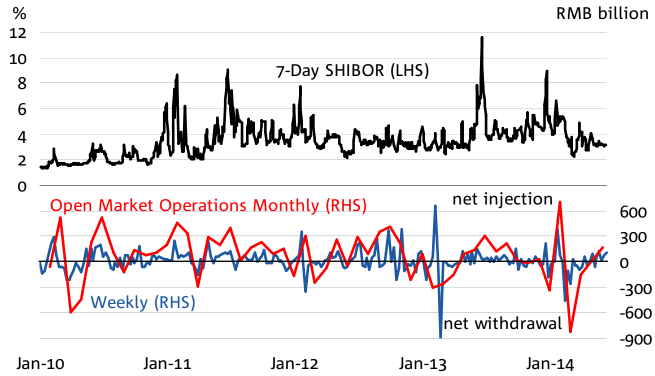
Banking sector the only growing component of social finance



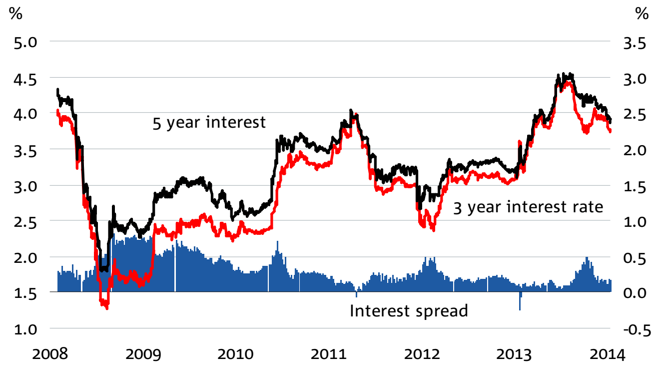
Sources: CEIC, NAB Economics

SHIBOR comparatively stable in recent weeks



Source: CEIC, NAB Economics

Longer term rates pulled back in May



Sources: CEIC, NAB Economics

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