China Economic Briefing

by NAB Group Economics

20 January 2015

National Australia Bank

Slowing trend set to continue in 2015, but the decline is a manageable one

Across 2014, we observed a slowing trend in China's economic growth, as weaker levels of investment and credit growth impacted and Chinese authorities resisted calls for widespread stimulus, noting that lower rates of growth were a 'new normal'.

We expect this trend to continue in the short term, as the Government's reform agenda continues – prioritising a more sustainable consumption led model of growth. China's growth is expected to slow to 7.0% in 2015 and 6.8% in 2016, which would be the slowest rate of growth since 1990.

Ongoing weakness in the residential property sector will act as a drag on the construction sector (long a key contributor to China's growth) – providing some downside risk. In part to counter this risk, the Government accelerated 300 infrastructure projects in January, valued at around RMB 7 trillion.

Gross Domestic Product

China's national accounts data showed that the economy expanded by 7.4% in 2014 (compared with our forecast of 7.3%), the slowest annual rate of growth since 1990 and below the official target of 7.5%.

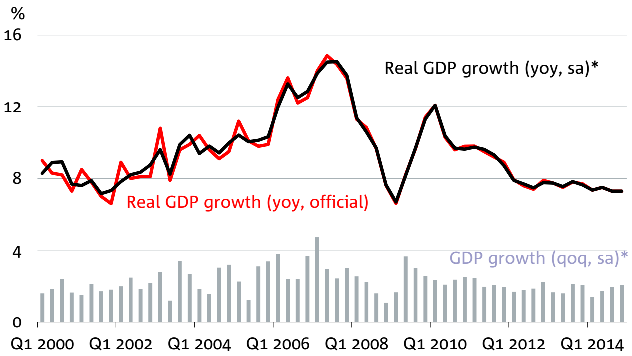
In the December quarter, China's economy grew by 7.3% yoy, unchanged from Q3 and remaining at the weakest quarterly growth result since March 2009 (the low point of the global financial crisis).That said, this result was just ahead of market expectations (at 7.2% yoy).

China's economy continues on its gradual transition, away from a manufacturing hub towards a modern, consumption based economy. One signal of this trend is the increasing share of China's services sector (tertiary industries), averaging 48% of GDP in 2014 (up from 47% in 2013). In contrast the share of secondary industries (such as manufacturing and construction) fell below 43%.

Industrial Production and Investment

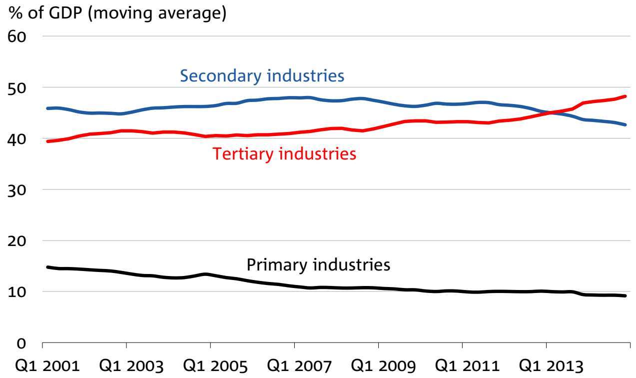
Conditions in China's industrial sector picked up a little in December, with growth at 7.9% yoy (compared with 7.2% in November). The November results were distorted by the shutdowns implemented ahead of the APEC conference, and the relative strength in December may reflect the recovery in utilisation rates. That said, this rate of growth was weaker than the levels recorded in the first seven months of 2014.

Real GDP stable in Q4, the 'new normal' remaining at its weakest level since March 2009



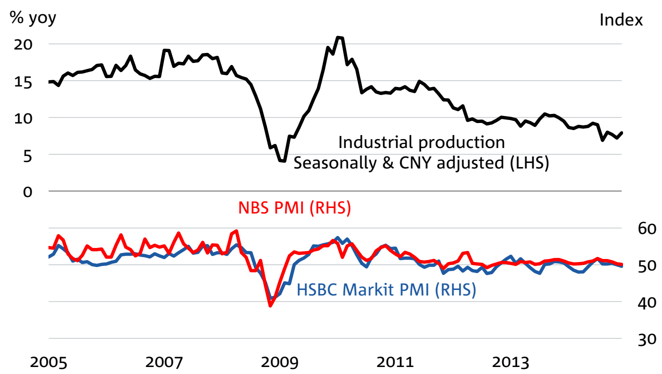
* Seasonally adjusted growth series are estimated by NAB.
Source: CEIC, NAB Economics

Growing importance of services highlights the transformation of China



Sources: Datastream, NAB Economics

Industrial production a little stronger in December, but growth remained weaker than first half trend



Source: CEIC, NAB Economics

The relatively soft conditions in the industrial sector were in line with weak performances in the PMI surveys. The official NBS PMI eased to 50.1 points (from 50.3 points previously), while the HSBC Markit PMI fell to 49.6 points (down from 50.0 points in November).

Trends at the sub-sector level were mixed once again. The weakness in construction flowed through to cement manufacturing (down -1.4% yoy, the fourth straight month of declines), while crude steel output rebounded – up 1.5%, recovering from APEC shutdowns in November. Similarly, electricity output rose by 1.3% (from 0.6% previously).

China's fixed asset investment has also remained comparatively weak (albeit it has recorded stronger growth over the last quarter than the lows of August and September). Investment rose by 14.8% yoy in December (edging down from 14.9% previously).

That said, prices for key inputs – particularly steel and copper – have fallen in recent months, meaning that in real terms, investment growth has strengthened since recent lows in August, rising by 19.1% yoy in December (up from 18.4% last month).

Investment trends remain divergent by industry. Reflecting the weak conditions in the property sector, investment in real estate continued to slow – down to 6.2% yoy on a three month moving basis (from 9.3% in November). In contrast, manufacturing investment strengthened a little – up by 12.7% yoy (from 12.2% previously).

There remain legitimate concerns around the residential property sector – average prices for new homes fell by 4.5% yoy in December (based on NBS data) – however monthly changes are starting to look less negative. China Index Academy data shows tier 1 city house prices stopped falling in December (on a three month moving basis), while the rate of decline for tier 2 slowed. That said, trends for lower tier cities remain negative, and pose some risk.

International trade

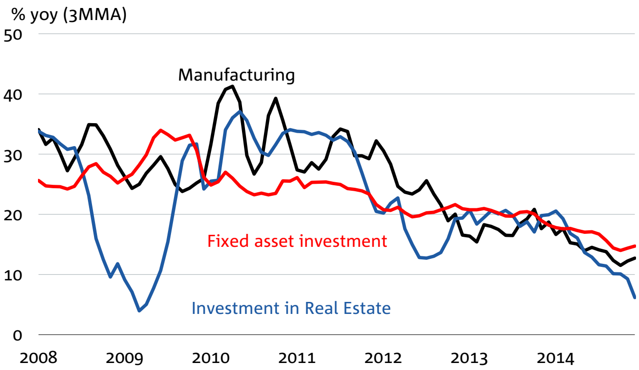
China's trade surplus narrowed marginally in December 2014 – pulling back from a record level. The surplus was US$49.6 billion in December, compared with US$54.5 billion in previously, driven by a recovery in imports.

Export growth was also strong in December – rising by 9.7% yoy in US dollar terms (well above market expectations), compared with 4.7% in November.

The key drivers of this increase were accelerating exports to Asia and the United States. The former increased by 15% yoy (compared with 7.2% in November) while the latter grew by 9.9% yoy (from 2.6% previously). In contrast, growth in exports to the European Union was relatively stable at 4.9% yoy.

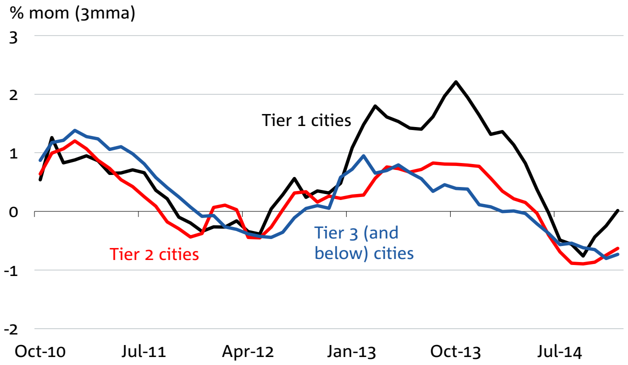
That said, there remains a significant discrepancy between official trade data between Hong Kong and China. In November (the most recently available data), Hong Kong Customs reported imports of US$23.8 billion, compared with US$35.5 billion of exports reported by China Customs. Hong Kong has been the main export market used for the false invoicing schemes used to bypass capital controls.

While fixed asset investment has stabilised, growth in real estate investment has fallen sharply



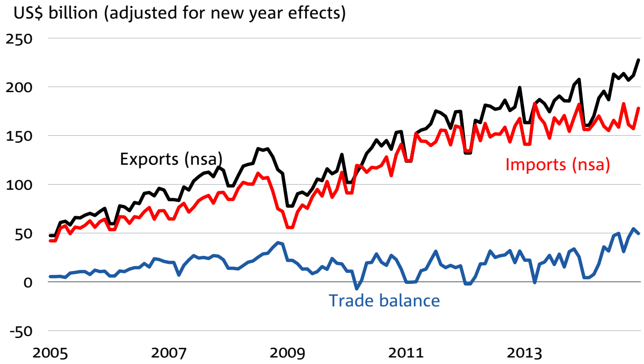
Source: CEIC, NAB Economics

Property markets still mixed – tier 1 trends improved, but concerns persist for smaller markets



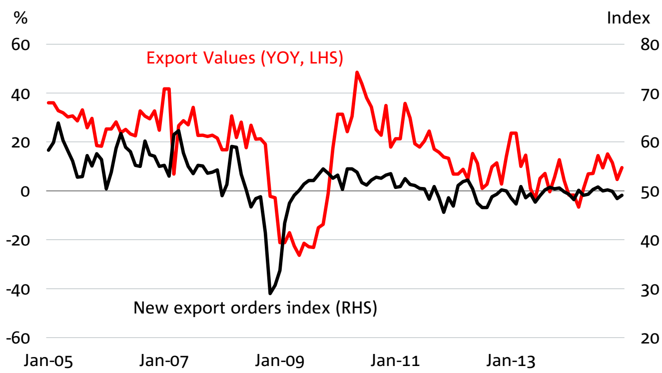
Source: China Index Academy, Datastream, NAB Economics

Trade balance wider on weak import growth in 2014



Sources: CEIC, NAB Economics

Growth in exports picked up in December, but was below recent (likely false invoice distorted) highs



Source: CEIC, NAB Economics

China's imports remained weaker than a year earlier – down -2.3% yoy in US dollar terms, but the growth rate was considerably stronger than November (when imports fell by -6.7%). Imports in December were also stronger than expectations.

For the full year, imports rose by just 0.6%, however falling commodity prices contributed to this result. In 2014, average commodity prices – as measured by the RBA Index of Commodity Prices – fell by 15%. This included weaker prices for crude oil and iron ore (which respectively accounted for 12% and 4.8% of China's US dollar denominated imports in 2014).

That said, with commodity prices falling further in December, Chinese consumers took advantage of the opportunity to restock. The volumes of crude oil and iron ore hit record levels, while coal imports reached the highest level since January 2014.

Retail Sales and Inflation

Retail sales trends have slowly improved across recent months, increasing by 11.9% yoy in December, up from 11.7% previously. In terms of recent history, this rate of growth has been relatively weak, however slowing retail price inflation – remaining at just 0.4% yoy (unchanged from November) – has boosted real sales. Real retail sales grew by 11.5% – the strongest rate in 2014.

Sales of food & beverages remained strong – growing by 13% yoy (the same rate as November) – while household goods sales strengthened, up by 12.6% yoy (from 11.3% previously). Growth in car sales improved, but was weaker than average at 6.1% yoy (from 2.0% in November).

Inflation remained soft in December, with the headline CPI up 1.5% yoy (compared with a five year low of 1.4% in November).

Non-food price growth has continued to ease – down to 0.8% yoy (from 1.0% in November). A key driver of this trend was the transportation & communications category, reflecting the impact of lower global oil prices.

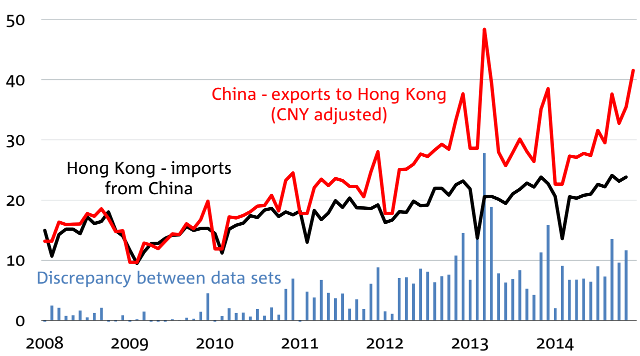
In contrast, food price growth was stronger in December, up by 2.9% yoy – the strongest level since August, but below the trend levels from the first half of the year. Prices for fresh vegetables rose by 7.2% yoy – counter to eight months of year-on-year falls in prices.

There was an acceleration in producer price deflation, with prices down -3.3% yoy in December (compared with -2.7% in November). These prices have fallen for thirty-four months in a row, however this has been closely correlated with falling commodity prices. Consistent with this relationship, deflation is more evident for heavy industry (-4.3% yoy in December) than light (-0.7%).

Credit conditions

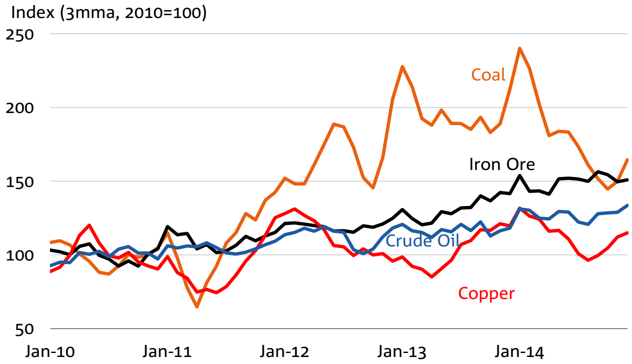
For the full year, China's credit growth weakened, as efforts to rein in the shadow banking sector impacted on new lending. New Total Social Finance was RMB 16.4 trillion in 2014, down -5.4% from the level of 2013.

The false invoicing issues highlighted by discrepancy between HK and China trade data



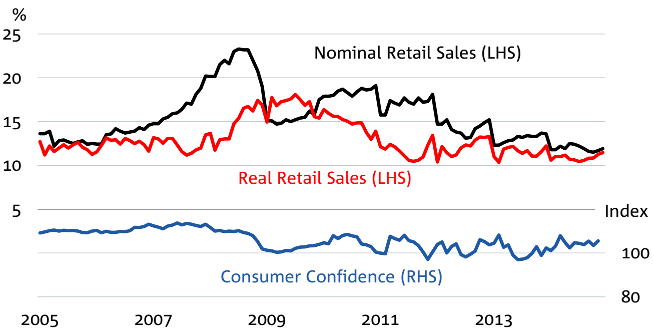
Source: CEIC, NAB Economics

Lower commodity prices helped push iron ore and crude oil imports to record levels in December



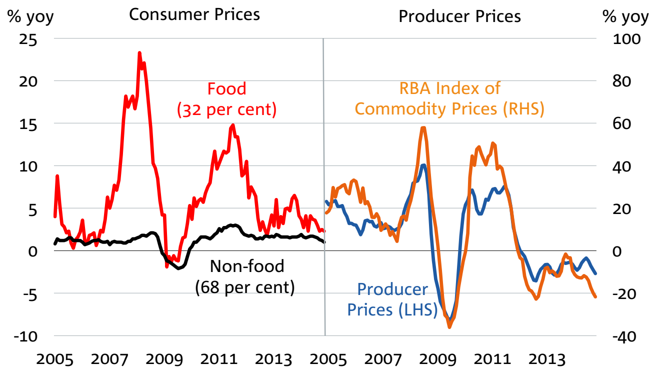
Sources: CEIC, NAB Economics

Slowing inflation has driven real retail sales higher



* 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

Inflation still softening, non-food price growth slowing to 0.8% in December



Sources: CEIC, RBA, NAB Economics

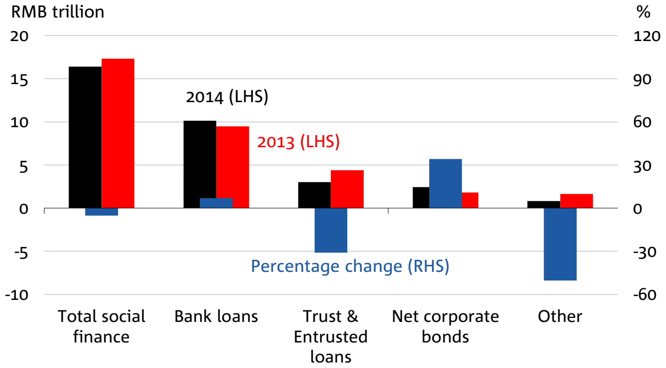
China's crackdown on shadow banking forced many off-balance sheet bank products to become traditional bank loans – resulting in a 7.0% increase in new bank loans, totalling RMB 10.1 trillion (in both domestic and foreign currency). Bank loans accounted for almost 62% of Total Social Finance in 2014, up from 55% in 2013.

In contrast, key components of shadow banking declined. Trust and entrusted loans fell by 31% in 2014 – despite a comparative surge in entrusted loans in the month of December. The broader sector has faced tighter regulation and oversight across the year, with the likelihood of further changes in 2015 – including draft rules from the China Banking Regulatory Commission for increased supervision over entrusted loans (announced mid-January).

Despite the slowdown in new credit, the total stock of credit (as a percentage of GDP), rose in 2014 – from around 196% of GDP in the March quarter, to 200% of GDP in the December quarter (although revisions to GDP due in coming months will alter this estimation).

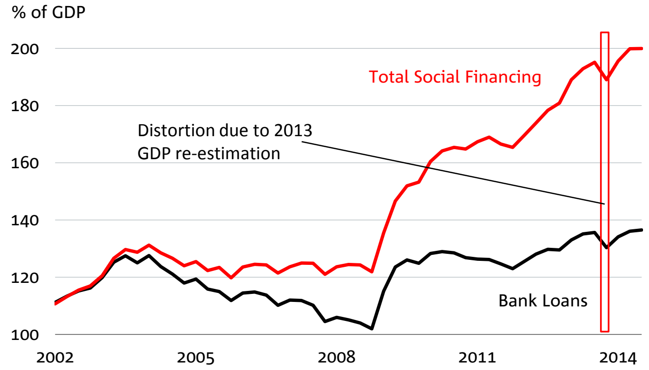
Counter to the expectations of some observers, the late November cut to benchmark interest rates has not yet (at the time of writing) been accompanied by cuts to the Reserve Requirement Ratio. There were rumours that a cut was imminent in December, and there are suggestions that one could occur following today's GDP announcement – however the People's Bank of China remain keen to control the growth of debt, which would only rise further should a cut to the RRR occur.

Volume of new credit contracted in 2014, driven by shadow banking crackdowns



Sources: CEIC, NAB Economics

Debt as a share of GDP continued to rise in 2014



Sources: CEIC, NAB Economics

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