more give, less take

# China's economy at a glance

by NAB Group Economics

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National Australia Bank

## China's 'old economy' – manufacturing & real estate – continue to slow, but still signs of services growth

- China's service sector has been the main contributor to economic growth in recent times – particularly as trends in the industrial sector continue to weaken. In Q3, the secondary industries – manufacturing and construction – provided the lowest contribution to GDP since the GFC – while services (led by finance) maintained fairly stable growth.
- The weakness in the 'old economy' remains evident – industrial production slowed further in October, while investment continued to trend lower (albeit recording marginally stronger growth than in September) – led by contractions in the real estate sector (where new construction activity remains weak).
- Industrial weakness is also evident in trade data, with import values falling in October – driving the trade surplus to record levels. Falling commodity prices remain a key driver of this trend.
- In stark contrast to the weakening in the industrial sector, China's real retail sales edged higher to 11% yoy – a signal to the stronger performance in services. Consumer confidence also improved in the most recent reading in September. Despite the slowing economy and the impact of the mid-year equity market crash, confidence has remained in positive territory since the end of 2013.
- As expected, the People's Bank of China cut interest rates in late October, bringing the benchmark one year lending rate down to 4.35%. Given the comparatively high rate – when compared with policy rates in advanced economies – the PBoC has considerable scope for further monetary policy easing. We expect two further cuts in H1 2016 – to bring rates to 3.85% by mid year. Further cuts to the Required Reserve Ratio will also be likely to ensure adequate liquidity remains in financial markets.

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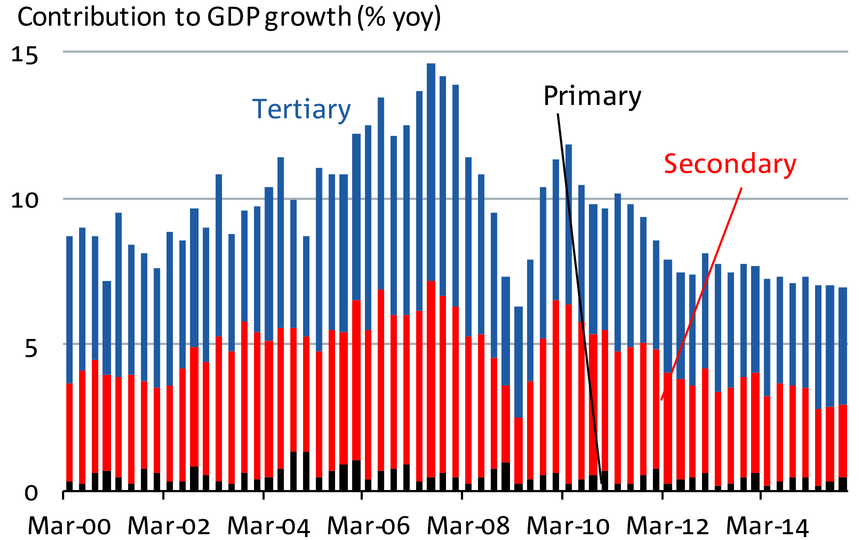
# Gross Domestic Product – components

- As noted last month, China's service sector has been the main contributor to economic growth in recent times – particularly as trends in the industrial sector continue to weaken. The contribution of the secondary industries – manufacturing and construction – to GDP in the third quarter fell to 2.5 percentage points – the lowest level since the GFC.
- In contrast, the services sector contributed around 4 percentage points – in line with the trend evident since the start of 2011. That said, the composition of service sector growth has changed considerably over this time.

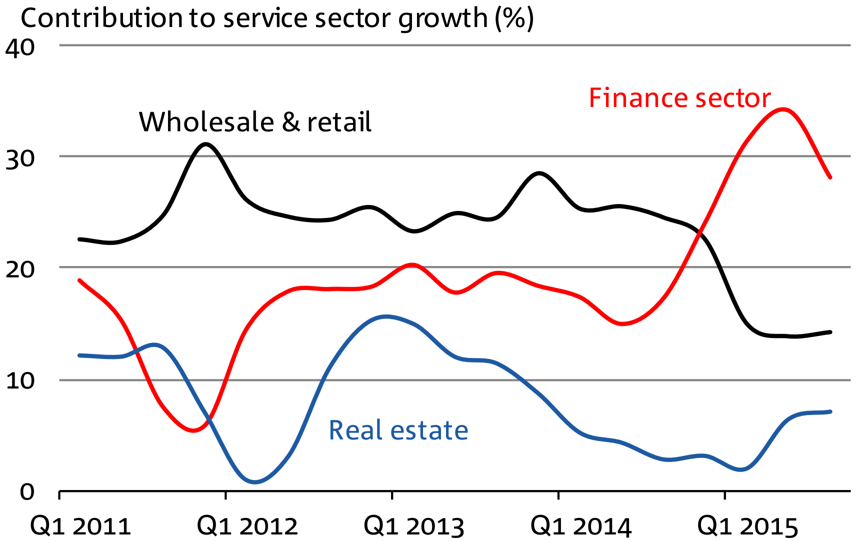
- We first noted the uptick in the contribution from finance following the release of Q1 GDP data. A major contributor to the growth in finance activity was the boom in share markets across the first half.
- Despite the correction that commenced in June, the finance sector continued to contribute a sizeable share of service sector growth in Q3 – accounting for 28% of total services growth. Given that the equities boom commenced in Q4 2014, it is unlikely that finance will continue to provide significant growth momentum in this quarter.
- As noted last month, we forecast economic growth to slow from 6.9% in 2015 to 6.7% in 2016.

### China's industrial slowdown means a weaker contribution to growth from the secondary sectors




Source: CEIC, NAB Economics

### Finance has been the main contributor to services growth in 2015 – but this may not be sustainable




Source: CEIC, NAB Economics

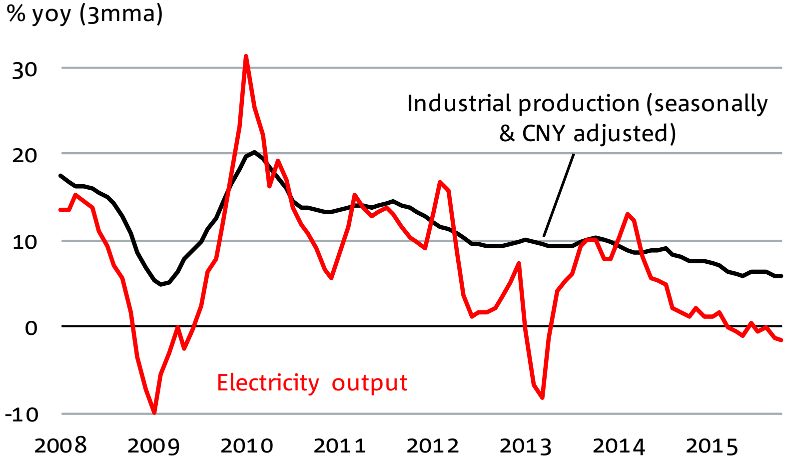
# Industrial production

- Growth in China's industrial production eased a little further in October – down to 5.6% yoy (from 5.7% in September). This level was marginally below the level of market expectations (5.8% in the Bloomberg survey).

- Conditions in China's heavy industrial sector remain weak – with production of cement falling by -3.5% yoy and crude steel by -3.1% yoy in October. Similarly electricity production fell as well – down by -3.2% yoy.

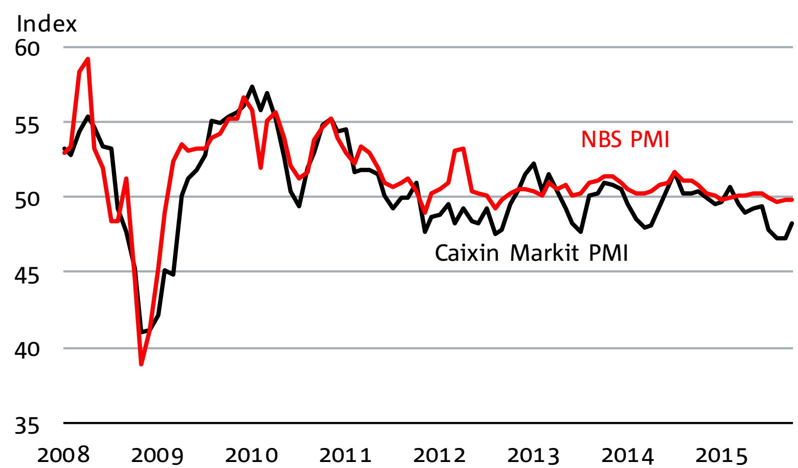
- In contrast to weaker production data, China's industry surveys pointed to less negative conditions in October. The official NBS PMI was unchanged – at a relatively neutral 49.8 points – while the Caixin Markit PMI remained well in negative territory – albeit less negative at 48.3 points (compared with 47.2 points in September – the weakest reading since March 2009).

**China's industrial production has continued to trend down, while electricity production has contracted**




Source: CEIC, NAB Economics

**Purchasing manager surveys pointed to less negative conditions for manufacturing in October**




Source: CEIC, NAB Economics

# Investment

- The growth rate for China's fixed asset investment picked up in October – up to 9.5% yoy (from 6.8% in September, which was a twelve year low) – largely in line with market expectations. That said, there was a noticeable spike in investment in September 2014 – meaning that the sharp slowdown last month may have exaggerated the continuing slowing trend, and this month's reading may not signal an improvement.

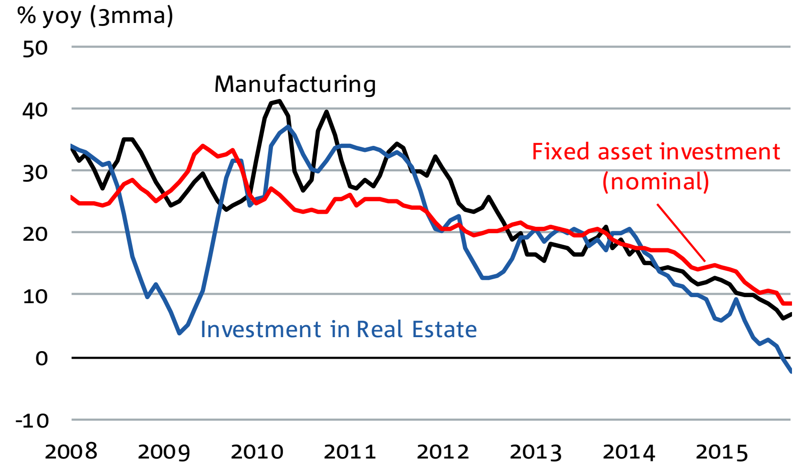
- We are continuing to see a slowing trend in real estate investment – with investment contracting by -2.2% yoy (on a three month moving average basis), compared with -0.4% in September. In contrast, there was a slight pickup in manufacturing investment – at 6.8% yoy (3mma) (up from 6.3% previously).

- In contrast, there remains significant investment growth in both public utilities (14% yoy) and water conservation and environmental management (16%), with these sectors accounting for around 15% of the total investment across the first three quarters of 2015.

- The weakness in real estate investment is evident in residential construction activity. Over the first ten months of the year, housing construction starts fell by almost -15% yoy. There was a noticeable exception in September, with starts increasing by almost 17% yoy, however this was not sustained into October, with a year-on-year decrease of -24%.

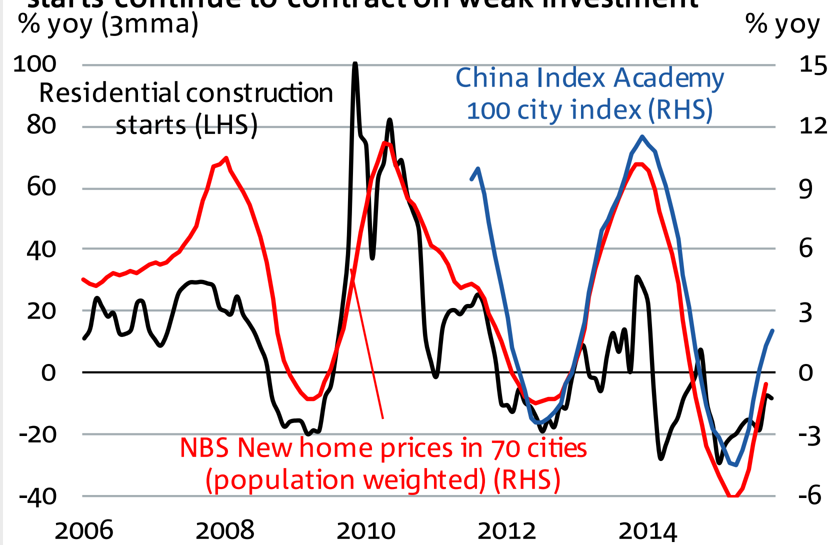
- While price trends in the residential property market have improved – China Index Academy data showed a 2.1% yoy increase at a national level – most of the gains have been in China's premier cities. Prices in tier 1 cities were almost 12% higher than a year earlier, whereas tier 2 city prices were around -1.7% yoy lower and tier 3 and below around -2.3% yoy lower – limiting the potential for an improvement in construction activity.

**Investment in real estate is contracting in year-on-year terms, driving overall investment growth lower**




Source: CEIC, NAB Economics

**While house price trends are improving, construction starts continue to contract on weak investment**

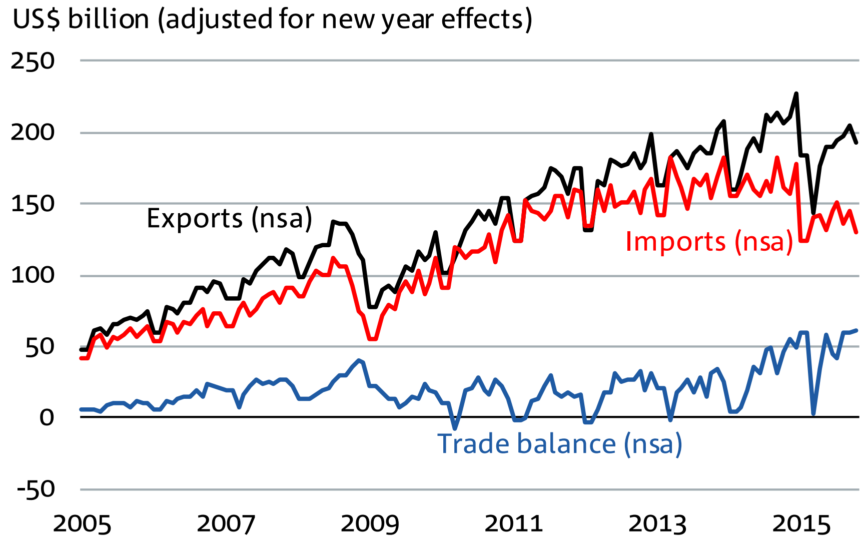



Source: CEIC, Datastream, NAB Economics

# International trade – trade balance and imports

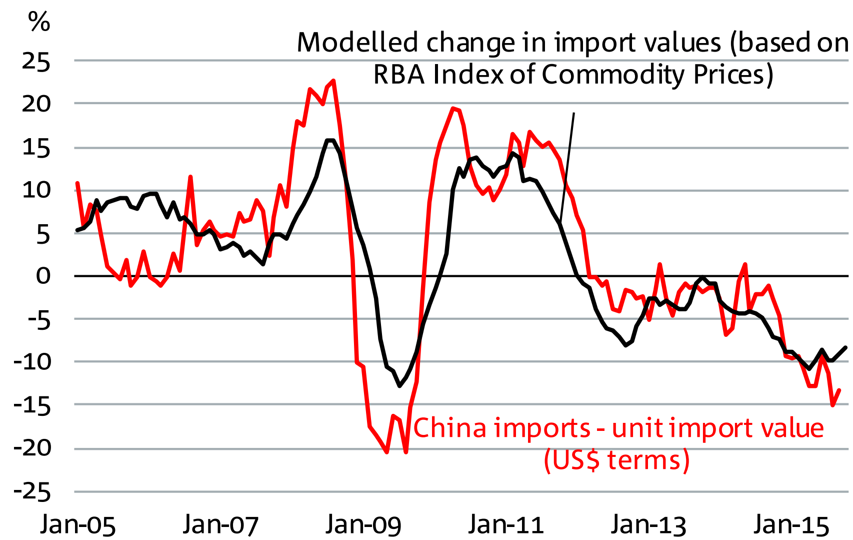
- Another pullback in imports (along with a more modest fall in exports) saw China's trade surplus widen to a new record in October – at US$61.6 billion (from US$60.3 billion in September) – around US$1 billion larger than the previous record of February 2015.
- China's imports contracted to US$130.8 billion in October, down from US$145.2 billion previously. In year-on-year terms, this represented a fall of -19%. Weaker imports across 2015 have raised concerns around the health of China's economy.
- As noted previously, the key driver of China's economic growth is the services sector – which is far less import intensive when compared with the slower growing industrial sector.
- In addition, price effects have distorted the scale of the fall – over the first nine months of the year, import volumes fell by around -15% yoy, while volumes only fell by -4.1% yoy.
- Import trends by commodity remain highly divergent – with crude oil imports rose by 8.9% yoy over the first ten months of the year, while coal imports fell by -30% yoy. Imports of iron ore were marginally lower over this period.

**China's trade surplus widened to a record level in October, with imports pulling back more sharply than exports**




Sources: CEIC, NAB Economics

**The average price of China's imports continues to fall – driven in a large part by weaker commodity prices**




Source: CEIC, Datastream, NAB Economics

# International trade – exports

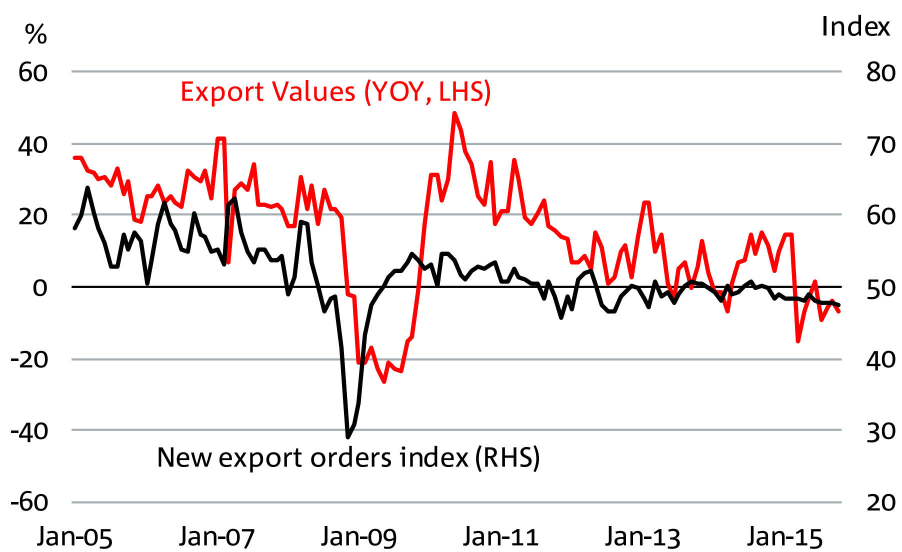
- Exports pulled back in October, down to US$192.4 billion (compared with US$205.6 billion in September) – a year-on-year decline of -6.9%. China's firms remain relatively negative regarding export trends – with new export orders continuing to trend lower in the NBS PMI survey (at 47.4 points in October, from 47.7 points previously).

- The key contributor to the overall year-on-year decline was a drop off in exports to other East Asian economies – with exports falling by -11% yoy in October (similar to the decline recorded last month). In contrast, exports to the United States fell by -0.9% yoy (compared with an increase of 6.7% previously) and exports to Europe fell by -2.9% yoy (from -0.2% in September).

- There continues to be divergent trends within Asia – with another steep decline in exports to Hong Kong – down by -17% yoy in October (from -23% in September). In contrast, exports to non-Hong Kong Asia fell less significantly – down by -5.2% yoy (compared with a 2.9% increase previously).

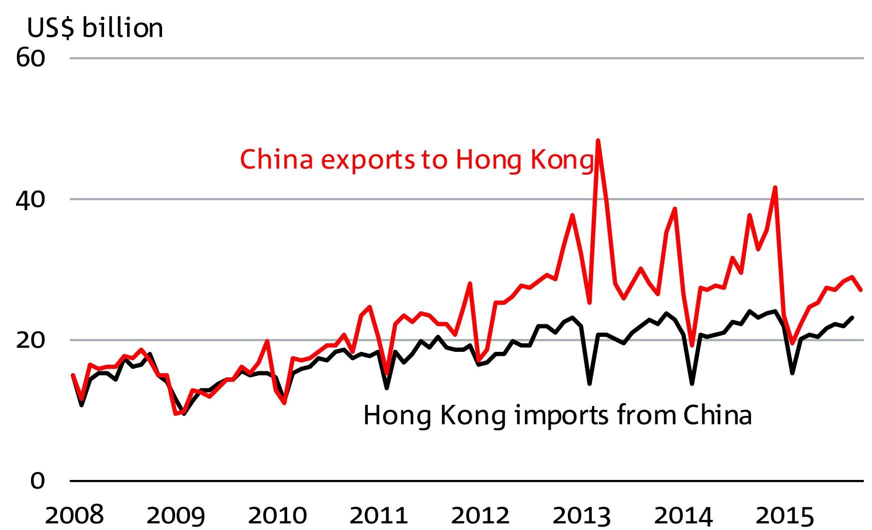
- The scale of the fall in exports to Hong Kong could reflect discrepancies in trade data – due to measures to avoid China's capital controls. For example, in October 2014, China Customs reported exports to Hong Kong totalled US$32.7 billion, while Hong Kong Customs reported imports of just US$23.1 billion – meaning that the scale of the decline in exports could be significantly overstated.

**Sentiment among China's exporters remains negative, with values continuing to fall year-on-year**




Source: CEIC, NAB Economics

**Disparity between Hong Kong and China Customs data risks overstating any fall in export activity**




Sources: CEIC, NAB Economics

# Retail sales and inflation

- In stark contrast to the weakening in the industrial sector, China's retail sales growth was marginally stronger in October – at 11% yoy (from 10.9% previously). With retail prices flat in year-on-year terms, real retail sales were also 11% yoy (up from 10.8% in September).

- Consumer confidence also improved in the most recent reading in September – edging back up to 105.6 points (from 104.0 points in August). Despite the slowing economy and the impact of the mid-year equity market crash, confidence has remained in positive territory since the end of 2013.

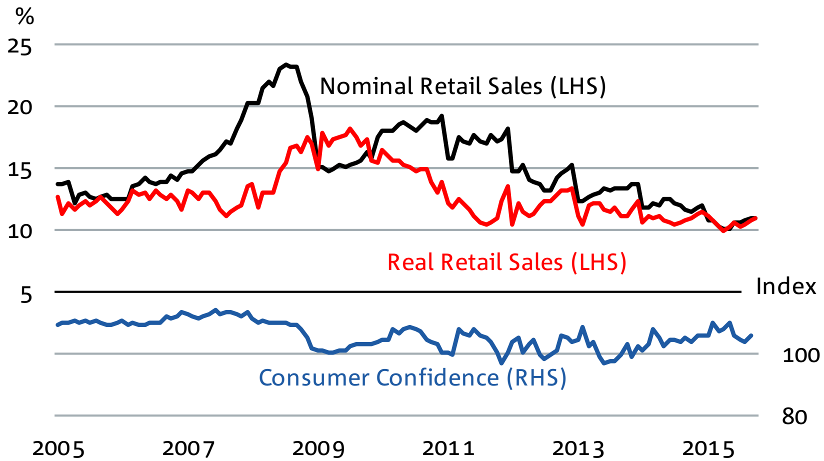
- Inflation continued to soften in October, with headline CPI slowing to 1.3% yoy (from 1.6% in September), as the growth rate for food prices eased.

- Food price inflation was 1.9% yoy in October (down from 2.7% previously) – easing away from a recent peak in August. Pork prices continue to influence headline inflation trends – with pork rising by 15.8% yoy in October (less significantly than recent months) – although this has been offset by slower growth in fresh vegetable prices and falling fresh fruit prices.

- Non-food price trends were slightly softer in October, with prices rising by 0.9% yoy (down from 1.0% previously). Fuel price trends remain negative – but less so than recent months – down 15.5% yoy (compared with 19.2% in September).

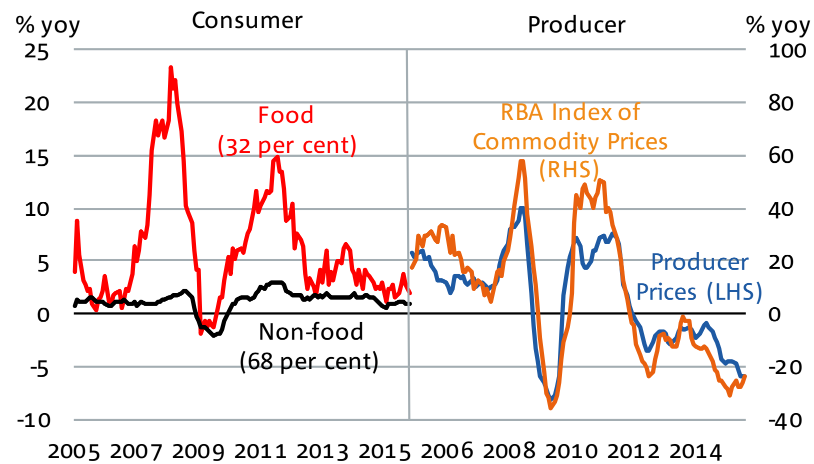
- For the forty-fourth month in a row, producer prices fell – down by -5.9% yoy (the same rate for the third straight month). While this trend may be influenced by excess production capacity in many industrial sectors, we continue to argue that falling commodity prices are the main driver – with the RBA Index of Commodity Prices falling by 24% yoy in October.

**Real retail sales have continued to strengthen – highlighting the better performance of the service sector**




Source: CEIC, NAB Economics

**Lower food price growth led to a softer headline CPI, while producer prices fell yet again**

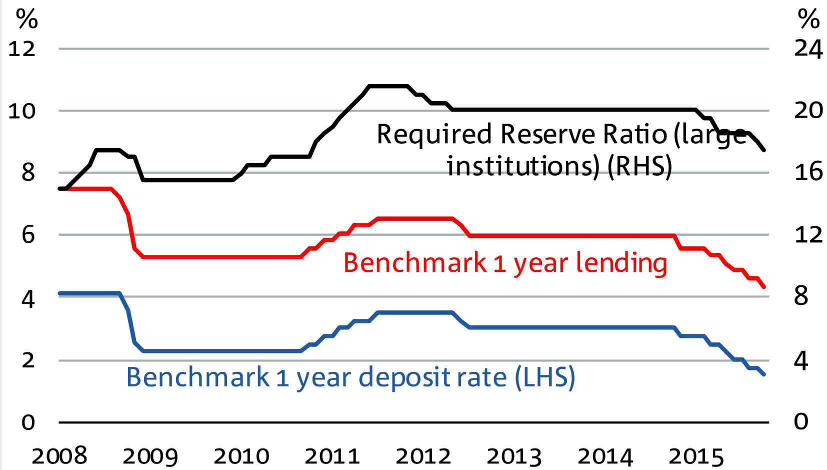



Sources: CEIC, RBA, NAB Economics

# Credit conditions

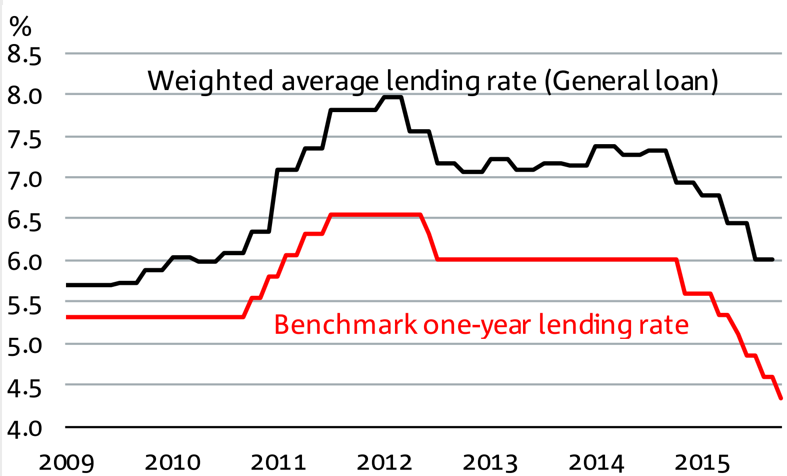
- As expected, the People's Bank of China (PBoC) cut interest rates in late October, bringing the benchmark one year lending rate down to 4.35% (a 25 basis point cut). Similarly benchmark deposit rates were also cut – to 1.5% – but this cut was accompanied by a complete deregulation of deposit rates, meaning banks are free to set a rate independent of the benchmark.
- Despite the recent cuts to benchmark rates, the average lending rate remains comparatively high – at around 6%. There is a considerable lag between policy rate cuts and actual lending rates – with many bank loans having only a single rate adjustment each year.
- The interest rate cut was also accompanied by a 50 basis point cut in the Required Reserve Ratio (RRR) – down to 17.5% for large institutions – a move that could add around RMB 690 billion in liquidity to the finance sector. As we have previously noted, cuts to the RRR in 2015 have largely offset capital outflows – maintaining rather than expanding liquidity.
- Given the comparatively high lending rate – when compared with policy rates in advanced economies – the PBoC has considerable scope for further monetary policy easing. We expect two further cuts in the first half of 2016 – to bring rates to 3.85% by mid year. Further cuts to the RRR will also be likely to ensure adequate liquidity remains in financial markets.
- At the time of writing, new credit data was not available – however the Bloomberg survey expected a slight slowdown (compared with the relative strength recorded in September) – to around RMB 1.05 trillion – below the average of the first nine months of the year.

**China's monetary policy has continued to ease across 2015, as the PBoC attempts to support a soft landing**




Source: CEIC, NAB Economics

**Lending rates have been come down, but have been slower to fall than the PBoC's benchmark rates**




Source: CEIC, NAB Economics

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