British Embassy
Beijing

China Economic Focus – August 2012

Summary

- China's economy continues to slow, however the authorities believe that the economy has shown signs of stabilising. While it may be difficult to achieve a full year growth of 8 percent, the latest figures are consistent with the Government's 2012 growth target.

- July's economic data were worse than expected. The trade figures were very weak, with exports impacted by a contraction of exports to the EU. If this continues, the authorities are likely to miss the annual target of 10 percent export growth.

- Growth of fixed asset investment, the key driver of China's economic growth, continued to slow down. The deceleration of infrastructure investment was a surprise. Figures for business performance were particularly weak.

- However domestic demand has held up, and retail sales growth in July continued to strengthen. This is being driven by a steady increase in household incomes, indicative of a continued gradual rebalancing of the Chinese economy.

- Most analysts expect more cuts to interest rates and the required reserve ratio before the end of the year. Inflation is no longer a policy constraint, as consumer prices index fell below 2 percent and producer prices index contraction expanded.

- The authorities are unlikely to introduce massive stimulus measures soon, as employment is holding up, and wage growth is continuing to increase. UK press reports of an 8 trillion RMB stimulus are much exaggerated.

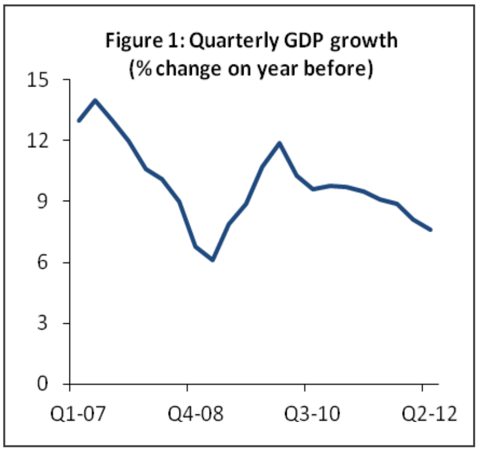
- Property prices are no longer decline in most cities, and the authorities have reiterated their commitment to tightening policy stance.

- The RMB was allowed to depreciate marginally against the dollar in July. RMB deposits in Hong Kong increased marginally from June to July.

- The PBoC and Taiwan's monetary authority signed an agreement to allow each side to set up a clearing bank and directly process currency transactions.

Growth is slowing, but stabilising

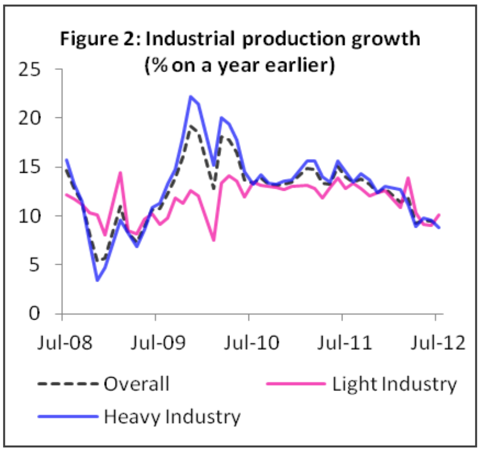
1. China's economy continued to experience a 'soft landing'. The economy grew by 7.6 percent in 2012 Q2 (on a year earlier), down from 8.1 percent in 2012 Q1 and 9.2 percent in 2011 as a whole (see Figure 1). This was the lowest level since 2009 Q1.



2. July's growth figures were worse than expected. Analysts were expecting activity to have picked up faster than it has by now. But most indicators were still slowing down, making it more difficult to achieve a full year growth of 8 percent. However, the growth is still likely to exceed the official annual target of 7.5 percent growth. The authorities seem remain relatively confident overall. Premier Wen Jiabao recently stressed that the direction of China's economic growth remained unchanged, and there were positive factors to stabilise growth.

3. Fixed asset investment (FAI) – the key driver of China's economic growth – grew by 20.4 percent in the first 7 months of 2012 (on a year earlier), the same as in the first 6 months. This was slightly below market expectations (20.6 percent). Seasonally-adjusted figure suggested that growth of FAI was slowing on monthly basis. Deceleration of infrastructure investment, the most likely driver to China's economic recovery, was a surprise.

4. Growth of industrial production (IP) slowed to 9.2 percent in July from 9.5 percent in June (both on a year earlier), and registered its lowest level since May 2009. This was mainly dragged down by heavy industry – growth of July's heavy industry IP slowed to its lowest reading since May 2009 (see Figure 2). However, production of steel and cement remained stable; and electricity production recovered modestly, likely due to increasing civil use of electricity in summer.



5. Corporate profitability contracted by 5.3 percent in July (on a year earlier), compared June's -1.7 percent and a double-digit growth in the same time last year. This was the fourth consecutive month of contraction. According to official data, among the 41 sectors of industry covered in the report, 25 saw an increase in profitability in July, compared with 27 in June. Profitability in chemical production and metal processing saw the biggest drop.

6. July's official purchasing managers' index (PMI), a forward-looking gauge of large business activities, fell below 50 (49.2) for the first time in the past 9 months (below 50 indicates contraction). The separate HSBC PMI, which provides an assessment of conditions facing firms of all sizes, slowed to 47.6. This was the 10th consecutive months below 50, and the lowest level since March 2009.

7. Retail sales, the closest monthly metric China has for consumption, remained stable. Although growth of retail sales slowed to 13.1 percent in July from 13.7 percent in June (both on a year earlier), it has increased steadily in the past 4 months once adjusted for inflation. Sales of food and beverage, furniture, telecommunication equipment, and medicine remained robust. With disposable income per capita (both urban and rural) continuing to outpace economic growth, residents' consumption capacity is expected to remain strong.

Authorities stay firm with property tightening policies

8. Property prices are no longer declining. Official figures show that 50 of 70 cities surveyed saw property prices increase (month-on-month) in July (compared with 25 in June), 11 saw flat prices and 9 saw a decline. Cheaper credit after two cuts to the interest rate this year has impacted on the property market.

9. The authorities remain firm with its tightening policy stance, though further measures are unlikely to be introduced in short term. The results from the State Council's (Cabinet) property prices investigation team suggested that price increases were limited. The investigation team believed that prices would be under control if local authorities strictly implemented existing tightening policies. During his trip to Jiangsu Province, Premier Wen Jiabao reiterated the implementation of existing policies.

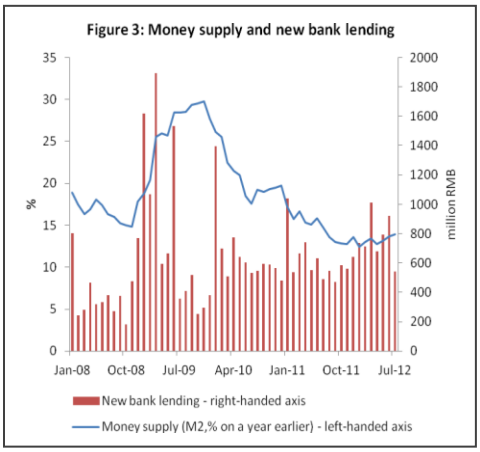
10. Official figures suggested that the property sector would be unlikely to pick up substantially in the near future. Growth of property investment slowed to 15.4 percent for the first 7 months of the year (on a year earlier) – less than half of the growth for the same period last year. And volume of land sales contracted by 24.3 percent for the first 7 months, compared with a 15.4 percent increase during the same period last year. Given property investment directly accounts for around 8 percent GDP and has wide-ranging secondary impacts, this will present a drag on headline GDP growth.

Low inflation gives more scope for policy easing

11. The consumer prices index (CPI) eased to 1.8 percent in July, compared with 2.2 percent in June – this registered the lowest CPI reading since January 2010. Most analysts predict that CPI will remain at a low level at 2-3 percent. Producer prices index (PPI) contracted for the 6th consecutive month to -2.9 percent in July, reaching the lowest level since October 2009.

12. With CPI now below 2 percent and PPI continuing to decline, the authorities have plenty of scope for further easing. Most analysts expect 3-4 0.5 percentage points cuts to required reserve ratio (RRR) before the end of the year. The PBoC has been using open market operation to supplement RRR cuts.

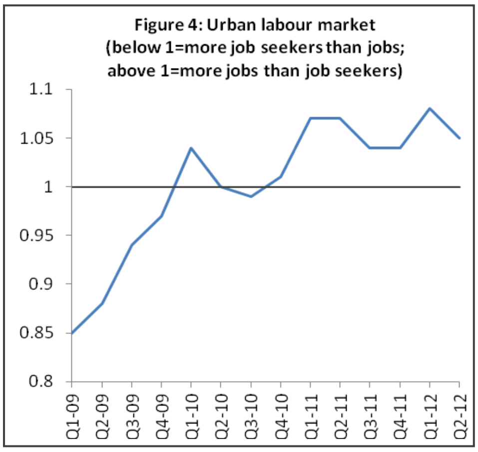
13. Money supply (M2) grew by 13.9 percent in July, up from 13.6 percent in June (both on a year earlier). This was the 4th consecutive month of money supply growth expanding. And now M2 is very close to the official annual target of 14 percent.



14. New bank lending dropped to RMB 540 billion (£54 billion) in July, far less than June's RMB 920 billion (£92 billion) and market expectations of RMB 700 billion (£70 billion). This was partly due to seasonal factors – new lending in the second half of the year is usually less than the first half of the year. In addition, new lending is constrained by the loan to deposit ratio, and deposits are usually smaller at the beginning of each quarter. Lower than expected new lending was consistent with weak FAI and IP performance.

Relative robust labour market means a massive stimulus is unlikely

15. Monetary policy and acceleration of approval for key investment projects have been the major tools that the authorities are using to stimulate the economy. There is no sign that the central government will introduce a significant stimulus. Some media report the stimulus measures announced by local authorities are above RMB 8 trillion (£800 billion). But this is misleading because the figure has been a mix of unfunded promises and investment plans over the next 5-10 years.



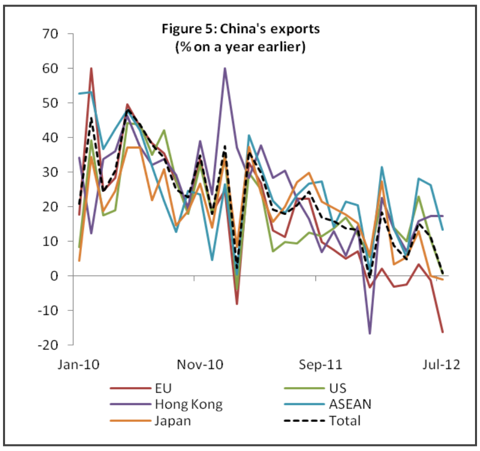
16. A relatively robust labour market is likely the reason why the central government have not introduced massive stimulus measures. Official figures show that the current labour market stayed stronger than 3 years ago when the economy was hit by global financial crisis. There were more jobs than job seekers in 102 cities surveyed in Q1 and Q2 (although job/job seeker ratio slipped from Q1 to Q2).

17. Increasing wages have reflected increasing labour demand as well. In the first half year of 2012, average urban wages grew by 13 percent and rural wages increased by 17 percent (both on a year earlier), outpacing headline GDP growth. Foxconn, Apple's Chinese factory, raised wages by nearly 150 percent in the past two years (a series of employees' suicides forced the company to limit overtime and boost wages) – with a 16 percent increase in the last week of August alone.

18. However, the labour market might deteriorate. The employment PMI moderated to 49.1 in July, compared with 49.6 in June (a reading below 50 means contraction). But employment situation in different sectors varies – employment in railway, shipping and aviation transport equipment manufacturing, food and beverage manufacturing, oil processing, and telecommunication equipment were expanding, while employment in labour-intensive industries (e.g., textile and furniture manufacturing) were contracting.

Exports - a key concern for the authorities

19. Growth of exports and imports was particularly weak. July's exports growth dropped to 1 percent (on a year earlier) from June's 11.3 percent and far below market expectations. The decline of exports to the EU was the major culprit – exports to the EU contracted by 16.2 percent in July, compared with a contraction of 1.1 percent in June. Exports to the US grew by 0.6 in July, much slower than 10.6 percent in June (see Figure 5).



20. Growth of imports increased by 4.7 percent in July, compared with 6.3 percent in June and 12.7 percent in May (both on a year earlier). The weak import growth reflected weak domestic demand and cooling external orders. The balance of exports and imports showed a trade surplus of $25.2 billion in July. This was smaller than June's $31.7 billion and far below market expectations of $35.1 billion.

21. Foreign direct investment (FDI) to China declined by 8.7 percent (year-on-year) to $7.6 billion in July. This was the smallest inflow since July 2010. The Ministry of Commerce reckons that global economic slowdown, and domestic land supply tightening and labour costs increasing have impaired China's attraction as a FDI destination. However, the Ministry believed that this was temporary.

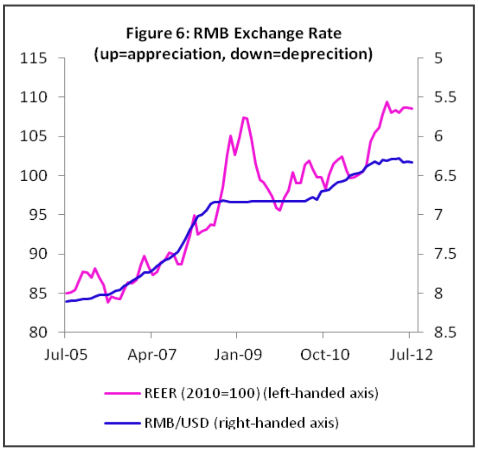
22. The authorities have been very concerned about the weak trade performance. If the trend continues, the government is likely to miss the yearly trade target of 10 percent growth. In late August, Premier Wen Jiabao said in his trip to Guangdong Province (exports from Guangdong accounted for nearly 30 percent of China's total) that there were many "uncertainties" and "difficulties" in exports, according to the number of new external orders.

23. The authorities are taking a series of measures to boost trade. 5 policies have been re-emphasised:
    - continuously to implement and improve policy to stabilise exports, including speeding up the process of tax rebate, expanding the use of export credit insurance, and introducing exchange rate risk-hedging products;
    - to speed up trade growth model transition;
    - proactively to expand imports, especially advanced equipment, key parts and daily necessities;
    - to reduce risks and influences from trade conflicts; and
    - to increase the quality in using FDI.

24. Chinese top leaders have shown firm support to the Eurozone crisis. President Hu Jintao described Europe's early financial recovery as being conducive to the stability of the world economy and to China's economic growth. When meeting German Chancellor Angela Merkel, Premier Wen expressed China's willingness to buy more Europe government bonds, if Eurozone risks can be contained.

PBoC agrees to set up a clearing bank in Taiwan

25. In July, the RMB depreciated marginally against the dollar. The currency has depreciated by 0.7 percent since the beginning of the year. This reflected lower expectations about future RMB appreciation. But overall the currency is expected to remain roughly in equilibrium.



26. According to the Bank of International Settlement (BIS), the RMB's real effective exchange rate (REER – trade-weighted and inflation-adjusted) also depreciated slightly in July. It had depreciated by 0.81 percent since the beginning of the year.

27. RMB deposits in Hong Kong, an offshore market for the Chinese currency, increased to 56.32 billion (£56.3 billion) in July, up 1 percent from June. RMB cross-border trade settlement totalled RMB 22.3 billion (£2.23 billion) in July, down 7.5 percent from June to July.

28. On 31 August, the PBoC and Taiwan's monetary authority signed an agreement to support Cross-Straits currency clearing cooperation. Effective in 60 days, the agreement allows each side to set up a clearing bank and directly process currency transactions. Under the agreement, the RMB, which will be designated as "CNT" in Taiwan, will have its own spot and interbank markets.

We encourage readers to get in contact for further information on any points covered in this note, or to suggest ways of improving the note for next month. Our details are:

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