Foreign & Commonwealth Office

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FCO COUNTRY UPDATES FOR BUSINESS

China Economic Focus – August 2013

British Embassy Beijing

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Overview

- Data published this month was slightly better than markets had been expecting. Growth in industrial production and trade (both exports and imports) accelerated. Fixed asset investment and retail sales were both essentially unchanged from the previous month. Inflation is low and stable. Forward-looking data like the Purchasing Managers' Indices present a mixed picture and credit expansion fell to its lowest level since November 2011.

- The bigger picture is that China's growth rate has been slowing over the past couple of years. The latest GDP data, published in July, showed annual economic growth of 7.5 percent. This is still very quick but it is significantly lower than the average annual growth rate of 10 percent between 1978-2011 (see here).

- In the face of the slowing economy, the authorities have introduced a number of small, targeted stimulus measures, for example this month's tax reliefs for small businesses (see here). This is in contrast to the policy response to slow-downs in 2008 and (to a lesser extent) 2012, when the authorities quickly expanded credit to sustain economic activity.

- Two factors explain the current restraint:

    - the increasingly urgent need to rebalance the economy towards consumption and services, and reduce the economy's reliance on cheap credit. The failure of last year's mini investment stimulus to give the economy momentum has highlighted the increasing ineffectiveness of China's investment driven growth model; and

    - resilience in the labour market. China doesn't have decent labour market data but all indications suggest that the current economic slowdown has not yet caused unemployment to rise. If unemployment does rise, we'd expect the policy response to become more forcible.

- China's latest IMF Article IV report, published in July, stressed that continued rapid credit expansion represented the greatest risk to the economy. In the past four months, credit growth has slowed, in contrast to the rapid expansion of credit seen in the first few months of this year.

- A big question is whether credit restraint will be continued, and what impact that would have on overall economic growth. There is clearly scope to increase the efficiency of capital allocation in China, e.g. through further interest rate liberalisation (see para 21 below). But such financial sector reforms carry inherent risk (not to mention opposition from vested interests) and the authorities are therefore likely to proceed slowly.

- Further information about many of these topics can be found at: http://www.ukti.gov.uk/export/countries/asiapacific/fareast/china/fcoupdates.html. Please get in touch if you have any questions or comments.

China's economy is slowing gradually, not reaching a crisis yet

1. China's economy is slowing gradually. The growth reached 7.5 percent in 2013 Q2 (on a year earlier), the lowest since 2012 Q3. Many analysts are now forecasting growth of around 7.4-7.5 percent in 2013, compared with the official target of 7.5 percent. **See Figure 1 and 2**.

Figure 1: GDP growth
(% change on year earlier)

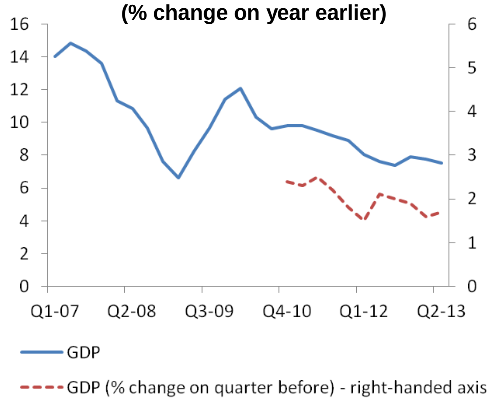


Figure 2: External growth forecasts for 2013

Institute	Forecasts
World Bank	7.7 percent (revised on 13 June, down from 8.3 percent)
IMF	7.75 percent (revised on 29 May, down from 8 percent)
HSBC	7.4 percent (revised on 19 June, down from 8.2 percent)
Standard Chartered	7.5 percent (revised on 15 July, down from 7.7 percent)
Goldman Sachs	7.4 percent (revised on 22June, down from 7.8 percent)
CICC	7.4 percent (revised on 22 June, down from 7.7 percent)
'Official Target'	7.5 percent

2. However, the authorities remained relatively optimistic. In the Party's Politburo meeting on 30 July, President Xi Jinping re-iterated the government's view that the growth remained in a "reasonable range" in the first half year as targeted.

3. A series of small and targeted measures have been announced to sustain growth, including temporary removal of value-added tax and business tax for small firms, simplification of export procedures, to attract private investment in railway sector and urban infrastructure construction, and acceleration of fiscal spending. These measures are in line with the authorities' determination to balance growth and economic reforms.

Industrial production accelerates, other main data series are largely stable

4. Headline fixed asset investment (FAI) increased by 20.1 percent in the first 7 months (on a year earlier), the same as in June. Growth of investment in industrial sector accelerated slightly by 0.4 percentage point to 16 percent from the first 6 months to the first 7 months. Growth of investment in tertiary sector edged down marginally to 23.1 percent in the first 7 months, compared with 23.5 percent in the first 6 months. **See Figure 3.**

Figure 3: Investment
(% change on year before)

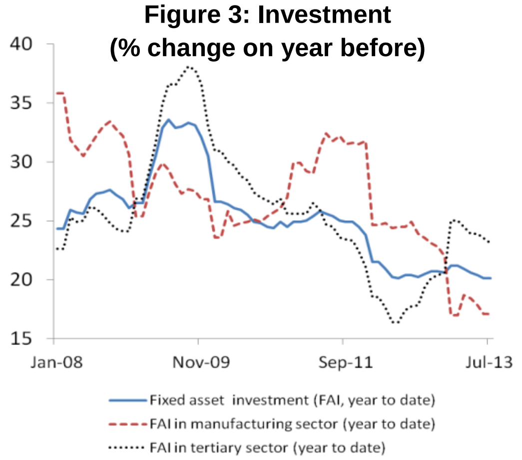
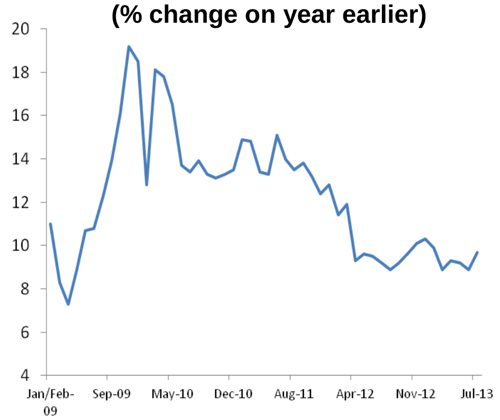


Figure 4: Industrial production growth
(% change on year earlier)



5. Industrial production (IP) increased by 9.7 percent, up from June's 8.9 percent and above market expectations of 9 percent. Growth of production of electricity, steel, cement, ferrous metal and automobile quickened; whereas growth of crude oil production moderated. **See Figure 4.**

6. The official purchasing manager's index (PMI) edged up by 0.2 percentage points to 50.3 from June to July. This was the 10th consecutive month in the expansion zone (above 50). PMI for big firms remained at a more advantageous status (50.8), whereas PMI for medium and small firms (49.6 and 49.4 respectively) remained in the contraction zone. The separate HSBC PMI, which is seen as a better measure of business conditions for small enterprises, slowed to 47.7 in July, compared with 48.2 in June. This was a 10-month low. **See Figure 5.**

Figure 5: Purchasing Mangers' Index

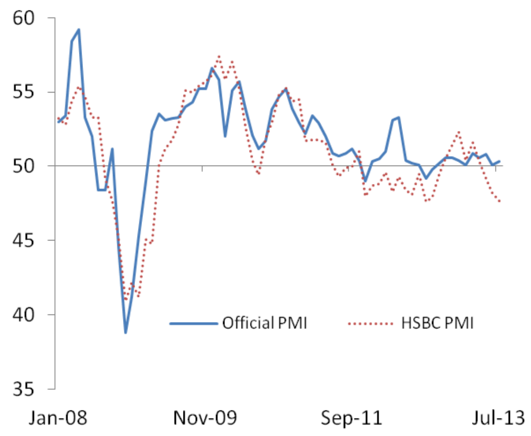
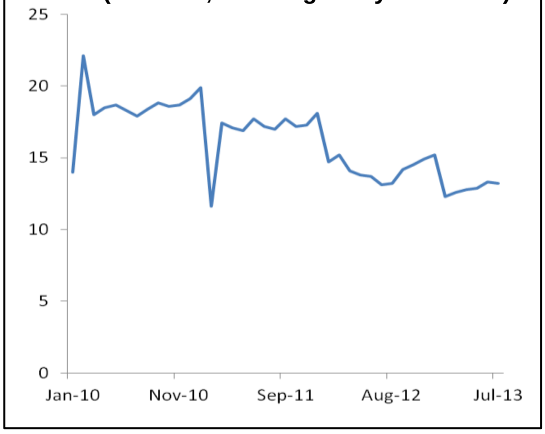


Figure 6: Retail sales (Nominal, % change on year before)



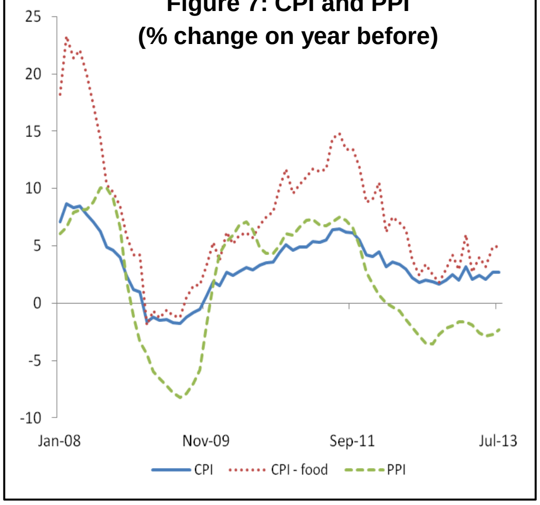
7. Retail sales increased by 13.2 percent in July (on a year earlier), edging down marginally from June's 13.3 percent, but higher than the 13.1 percent growth in July 2012. Retail sales has holding up well since the beginning of 2013. **See Figure 6**. Growth of rural consumption continued to outpace that in urban areas. Sales of gold and jewellery retained a strong growth, due to reducing gold prices. Sales of food and beverage, daily necessities and construction and decoration materials accelerated.

Inflationary pressure remains low

8. July's consumer prices index (CPI) was 2.7 percent (on a year earlier), unchanged from June and generally in line with market expectations. It remained below the official ceiling of 3.5 percent. Food prices continue to be the main contributor, especially vegetable and meat prices due to higher-than-usual weather and more-than-usual rainfalls. Pork prices started to pick up again.

9. Producer prices index (PPI), a measure of upstream inflation pressure, contracted by 2.3 percent in July (on a year earlier), up from -2.7

Figure 7: CPI and PPI (% change on year before)



percent in June. Prices of ferrous metal, non-ferrous metal and chemical products picked up during the month. China's National Statistic Bureau was confident that the recent growth supportive measures supported the price increases. **See Figure 7.**

Growth in total social financing slows

10. Total social financing (TSF), a measure of all forms of new credit, totalled RMB 809 billion (£85 billion) in July, down from RMB 1.04 trillion (£112 billion) in June. This was the lowest amount since November 2011. The decline of foreign currency loans and bank acceptance bills' issuance was the major drag. New corporate bond issuance remained at a low level - RMB 46 billion (£4.8 billion) in July, compared with RMB 248.6 billion (£24.8 billion) in July 2012. Analysts believe this is mainly seasonal and expect bond issuance will recover. **See Figure 8.**

11. Money supply (M2) growth rebounded to 14.5 percent in July (on a year earlier), compared with 14 percent in June.

12. New bank lending totalled RMB 700 billion (£73.7 billion) in July, below RMB 860 billion (£92.5 billion) in June, but higher than market expectations of RMB 638 billion (£67 billion). This is partly because of loan issuance delay due to credit crunch in June; and partly because of the government's supportive measures to invest in railway, urban infrastructure, slum renovation and green growth. Mid-to-long term corporate loans' increase reflected the FAI demand likely picked up.

13. During the Party's Politburo meeting on 30 July, President Xi Jinping reconfirmed to continue 'prudent monetary policies' in the second half year. Most analysts continue to expect monetary policy will remain unchanged for the time being.

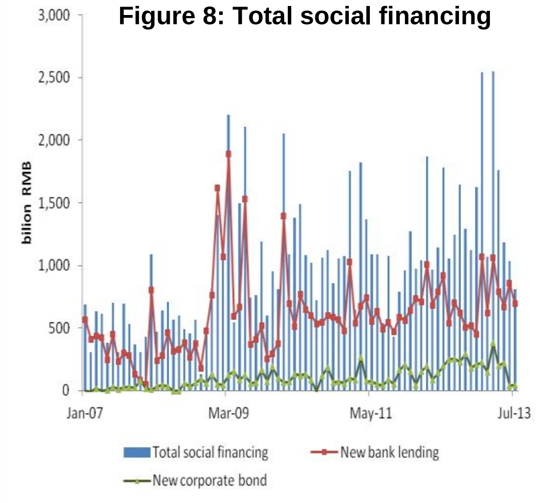


Figure 8: Total social financing

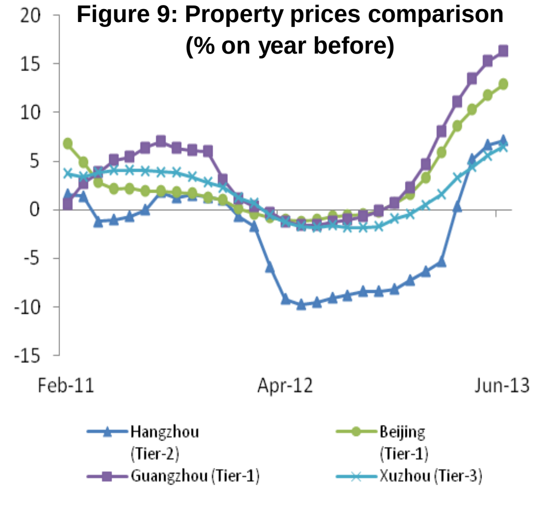


Figure 9: Property prices comparison (% on year before)

Property prices in Tier 1 cities increase quickly

14. The latest data show that 63 out of 70 cities surveyed saw higher property prices in June, compared with 65 in May. All of the Tier 1 cities (Beijing, Shanghai, Guangzhou and Shenzhen) are seeing a double digit property price increase, and the prices growth accelerated from May to June. Growth of prices in Tier 2 and 3 cities are slower, but catching up, especially the satellite cities to Tier 1 cities. **See Figure 9.**

15. Property investment growth picked up to 20.5 percent in the first 7 months (on a year earlier), slightly higher than 20.3 percent in the first 6 months. Residential property, which accounts for 68.4 percent of property investment, grew by 20.2 percent in the first 7 months, compared with 20.8 percent in the first 6 months.

16. The authorities officially retain their position not to loosen the property market. On 19 July, the PBoC (Central Bank) liberalised the lending rates, but their policy on mortgage loans was kept unchanged. The PBoC announced to continue strictly implementing differential property credit policies. On 5 August, Xu Shaoshi, Chairman of NDRC (the key economic planning body), reemphasised to retain property controlling policies, and to speed up social housing construction.

The Government takes measures to support trade

17. Both exports and imports rebounded in July, beating market expectations. China's export increased by 5.1 percent in July (on a year earlier), compared with a 3.1 percent contraction in June. This was mainly due to stronger demand from the US and the EU. Exports to the US increased by 5.3 percent in July, up from -5.4 percent in June. Exports to the EU expanded by 2.8 percent, improving from a contraction of 8.3 percent in June. Contraction of shipment to Japan narrowed to -2 percent in July from -5.1 percent in June.

18. Imports also rebounded, after two-month's contraction. July's imports increased by 10.9 percent (on a year earlier), up from -0.7 percent in June. There was a broad increase of energy and resource commodities' imports in volume terms, including iron ore, coal, crude oil and soy bean.

19. During the State Council (Cabinet) Executive Meeting on 24 July, Premier Li Keqiang announced 6 measures to support foreign trade against weak performance, including simplifying Customs clearance procedures and reducing administrative fees. Separately, SAFE (foreign exchange regulator) also announced to simply foreign exchange transaction procedures to support services trade.

20. The balance of exports and imports registered a smaller trade surplus of USD 17.82 billion in July, compared with USD 27.1 percent in June. **See Figure 10**.

Figure 10: Import and export growth vs trade surplus

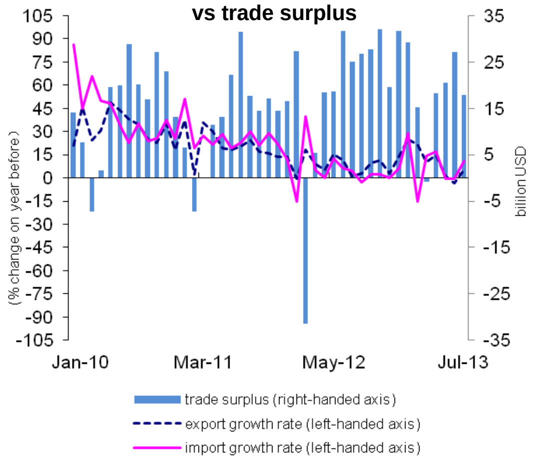
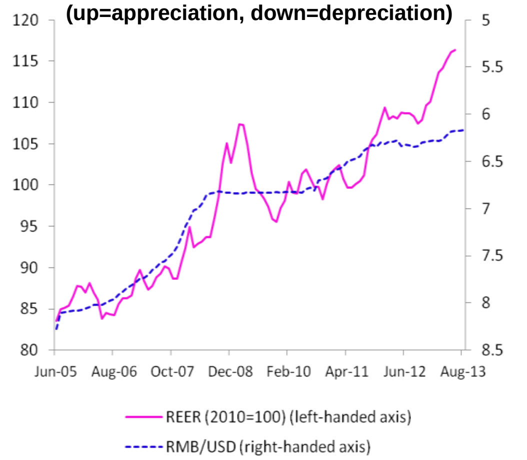


Figure 11: RMB Exchange Rate (up=appreciation, down=depreciation)



A further step of interest rate liberalisation

21. The authorities are taking a further step to liberalise the financial sector. On 19 July the PBoC announced the full liberalisation of lending rates (previously banks weren't able to lend at rates below 0.7 times the benchmark rate). The impact of this move is profound in longer term, in terms of supporting individual and companies' financing, but it is unlikely to have a significant short-term impact because the lending rate floor is currently not a binding constraint.

22. The announcement did not include a commitment to liberalise deposit rates (i.e. to remove the ceiling on interest rates for deposits). Liberalising deposit rates would be more significant than lending rates because higher interest rates would increase household incomes and therefore consumption, but it would also be more risky, as it would erode banks' profit margins. The authorities are expected to continue their cautious attitude towards interest rate reforms.

23. The RMB exchange rate (as of 12 August) stayed nearly the same as a month ago - the currency depreciated marginally (by 0.35 percent) in the second half of July, and appreciated again (by 0.24 percent) in the first half of August. The RMB has appreciated by 1.92 percent since the beginning of 2013, compared with a 0.24 percent appreciation in 2012. According to the Bank of International Settlement, the RMB's real effective exchange rate appreciated by 5.7 percent in the first 6 months (latest figure), compared with 2.1 percent in 2012. **See Figure 11.** The RMB exchange rate is expected to remain stable in the coming months, as the authorities have announced to keep it at a "reasonable and equilibrium level" as part of the measures to support export competitiveness.

24. RMB deposits in Hong Kong, an offshore market for the Chinese currency, totalled RMB 698 billion (£73.5 billion) in June (latest figure), down 0.1 percent from May. RMB cross-border trade settlement totalled RMB 270.8 billion (£28.5 billion) in June, decreasing from RMB 318.1 billion (£33.5 billion) in May.

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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