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China: Economic Focus: June 2013

British Embassy Beijing

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The latest data for industrial production, investment and retail sales suggest that annual growth has stabilised in the region of 7.5-8.0 percent: very fast, but below the super fast levels seen in recent years. Trade data were poor last month but methodological changes make interpretation difficult. Lending has fallen back, which is reassuring.

Alongside the data, the State Council (China's Cabinet) issued a statement stressing the need to push ahead with structural reform, thereby 'fixing the roof while the sun is still shining'. Priorities for reform included: increasing the power of markets; encouraging more private investment; and addressing over-capacity.

The official response to the slower growth has therefore been consistent with the need to focus on the quality rather than the pace of growth. The authorities seem to interpret signs of risks to the economy shown in the data as further evidence of the need to push on with reform, rather than as an excuse to resort to more short-term stimulus.

The challenge the authorities face is how to preserve stable inflation and low unemployment while the economy restructures. It is easier for the authorities to lower the rate of investment than raise the rate of consumption. It is therefore inevitable that China's future growth trajectory will be more bumpy than its past.

We think there are three significant risks to the outlook: the external environment; the housing market; and the financial system. Of these, the financial system remains the most rapidly evolving and poorly understood. It is a relief that credit expansion moderated in May but the shadow financial system in particular remains a source for concern.

That said, China's overall level of debt remains quite low (50 percent GDP, according to the IMF's latest 'augmented debt' metric), there is very little foreign debt and the capital account remains largely closed. So while China may experience significant financial problems in the coming years, she is unlikely to experience a system-wide financial crisis along the lines seen in the UK or US in 2008.

And momentum is now clearly building towards a major set of policy announcements later this year, to coincide with Communist Party's October 3rd Plenum. This has traditionally been the point in the political cycle where the new leadership has stamped its mark on the future reform programme.

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.

Detail

More growth forecasts revised down

Over the past month, OECD downgraded the forecast from 8.5 percent to 7.8 percent. And IMF changed it from 8 percent to 7.75 percent. All forecasts remain above the official target of 7.5 percent. **See Figure 1.**

Figure 1: External growth forecasts for 2013

Institute	Forecasts
World Bank	8.3 percent (revised on 15 Apr, down from 8.4 percent)
IMF	7.75 percent (revised on 29 May, down from 8 percent)
OECD	7.8 percent (revised on 29 May, down from 8.5 percent)
HSBC	8.2 percent (revised on 15 Apr, down from 8.6 percent)

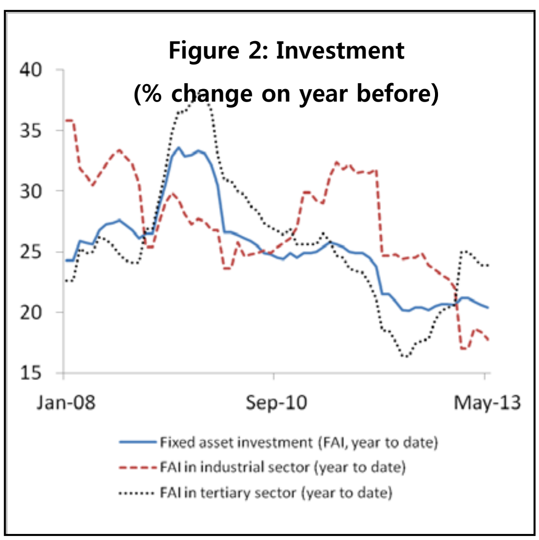
The Chinese senior leaders have

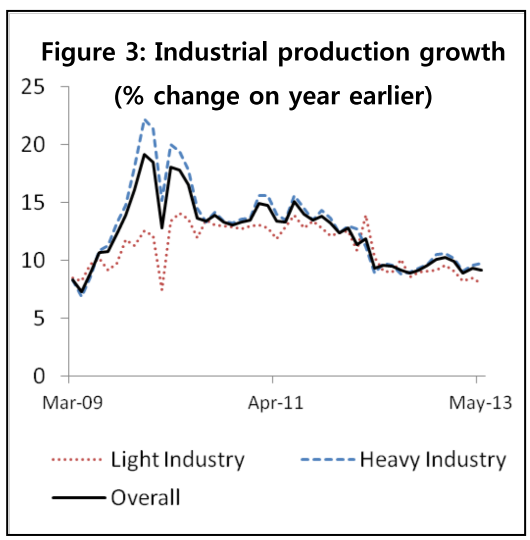
repeatedly shown they are relaxed about the slower rate of growth. In Premier Li Keqiang's recent speech, he reiterated the pressure of economic downturn, but he directly rejected stimulus as a solution (see here). On 8 June, the State Council (China's Cabinet) issued a further statement stressing the need to push ahead with structural reform.

May's key economic indicators broadly stable

Headline fixed asset investment (FAI) growth decelerated marginally to 20.4 percent in the first 5 months (on a year earlier), compared with 20.6 percent in the first 4 months. Growth of investment in industrial sector decelerated slightly (to 15.7 percent in the first 5 months from 16.3 percent in the first 4 months), and that of tertiary sector remained the same (at 23.9 percent). **See Figure 2.**

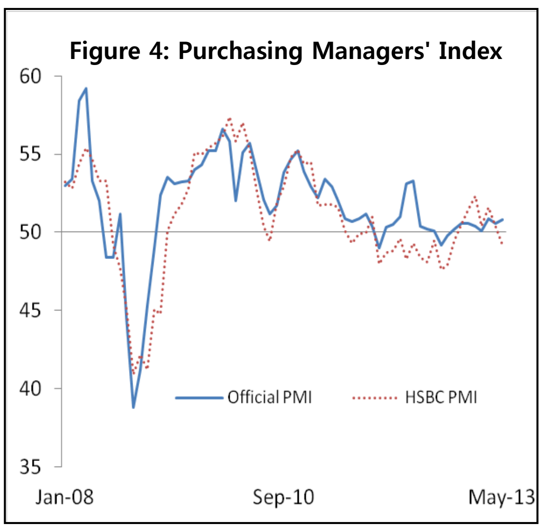
Property investment increased by 20.6 percent in the first 5 months (on a year earlier), slower than 21.1 percent in the first 4 months but higher than 20.2 percent in the first 3 months. Growth of residential property, which accounts for 68.5 percent of property investment, continued a moderate acceleration, picking up by 0.3 percentage points to 21.6 percent in the first 5 months from the first 4 months.

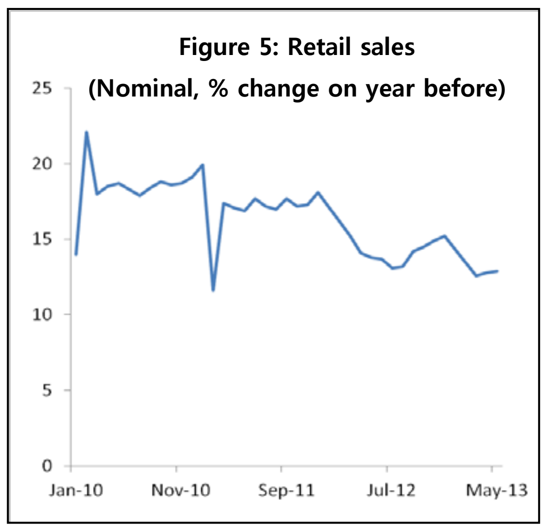




Growth of industrial production (IP) slowed marginally to 9.2 percent in May (on a year earlier), down 0.1 percentage points from April. Deceleration of light industrial growth was the main drag – light industry increased by 8 percent in May, compared with 8.5 percent in April. Heavy industry growth edged up by 0.2 percentage points to 9.8 in May from April. Growth of steel production accelerated; whereas that of electricity, cement, crude oil processing and automobile production slowed. **See Figure 3.**

The official purchasing manager's indices (PMI) picked up to 50.8 in May, compared with 50.6 in April. This was the 8th consecutive month in the expansion zone (above 50). PMI for big corporates (51.1) and medium-sized ones (51.4) saw a slight improvement, whereas PMI for small firms (47.3) deteriorate marginally over the past month. Consistent with this, the separate HSBC PMI, which is seen as a better measure of business conditions for small enterprises, fell to 49.2, which is an 8-month low. **See Figure 4.**

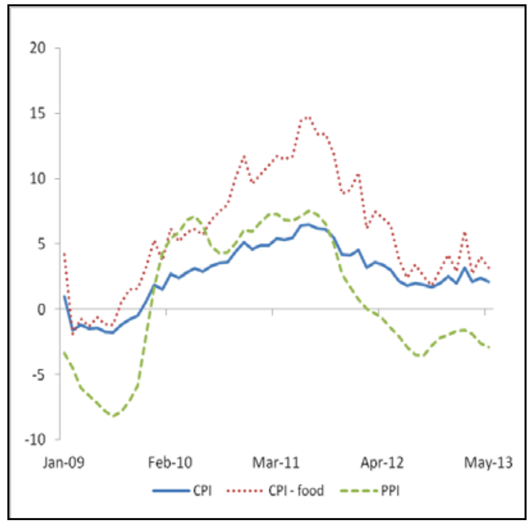




Retail sales grew by 12.9 percent in May (on a year earlier), 0.1 percentage points higher than in April. Sales from the catering sector, which it is said had been influenced by the central government's austerity campaign, increased by 9.2 percent in May, compared with 7.9 percent in April (and compared with 13.6 percent growth in 2012). **See Figure 5.**

Inflation falls due to vegetable prices

Consumer prices index (CPI) eased to 2.1 percent in May (on a year earlier), below April's 2.4 percent and market expectations of 2.5 percent. This was mainly driven by decreasing vegetable prices. Pork prices also continued to drop. Growth of non-food prices stayed flat from April to May at 1.6 percent.



Growth of producer prices index (PPI), a measure of upstream inflation pressures, dropped further to -2.9 percent in May (on a year earlier), compared with -2.6 percent in April. This was the 15th consecutive month of decrease and an 8-month low. **See Figure 6.**

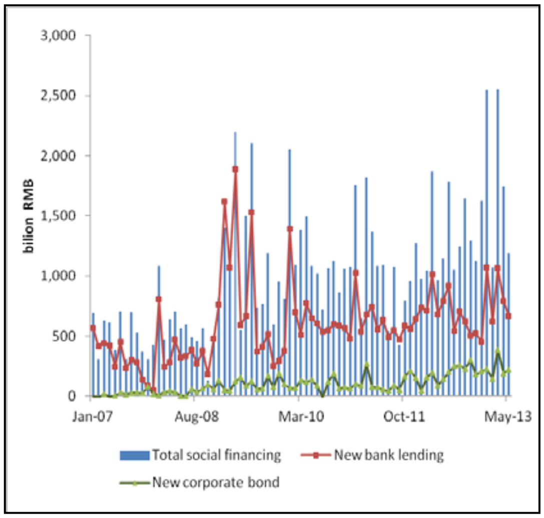
Although the fall in inflation in theory gives the authorities room for monetary stimulus, most analysts are forecasting that rates will remain steady for the foreseeable future.

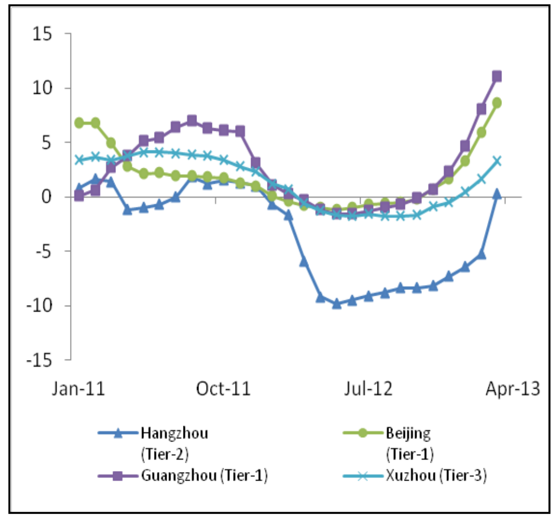
Credit growth slows, in response to more stringent regulations

Money supply (M2) grew by 15.8 percent in May (on a year earlier), below 16.1 percent in April but above the official annual target of 13 percent.

New bank lending totalled RMB 667 billion (£70.2 billion) in May, compared with RMB 792.9 billion (£83.5 billion) in April and below market expectations of RMB 815 billion (£85.8 billion). The slowdown was mainly led by reduction of loans to the corporate sector, which totalled RMB 285 billion (£30 billion) in May, down from April's RMB 420 billion (£44.2 billion).

Total social financing (TSF), a measure of all forms of new credit, decreased to RMB 1.19 trillion (£125.3 billion) in May, compared with RMB 1.75 trillion (£184.2 billion) in April. The slowdown reflected that the CBRC (the banking regulator)'s recent announcement to manage Wealth Management Products





(WMP) and to tighten bank acceptance bills. With more stringent regulations, TSF growth is expected to continue curbing in the coming months. **See Figure 7.**

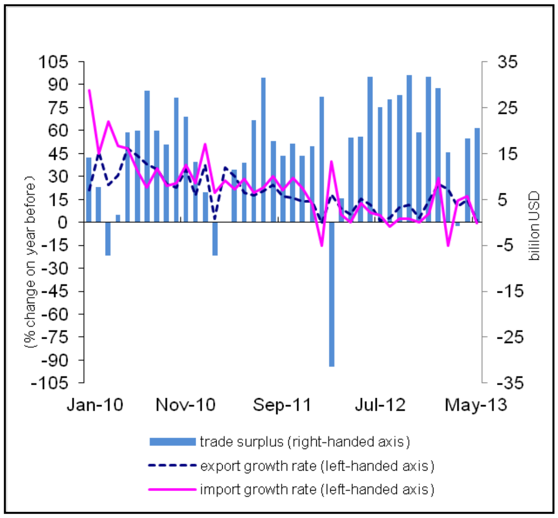
Property sector remains quite buoyant

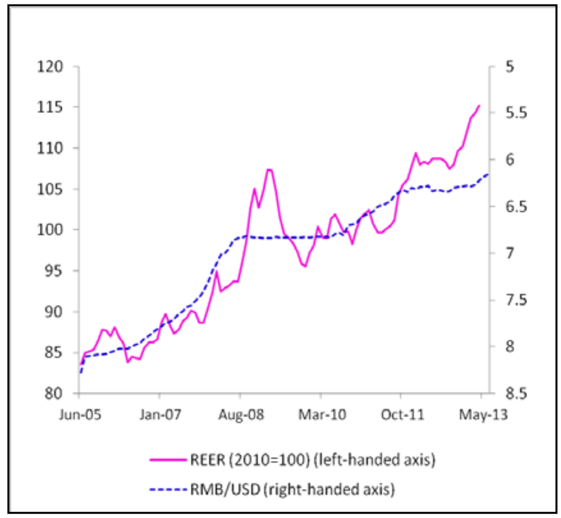
The latest data show that 67 out of 70 cities surveyed saw higher property prices in April, compared with 68 in March and 66 in February. Prices in China's Tier 1 cities continue to rise faster than in Tier 2 or 3 cities. **See Figure 8.**

Export data methodology changed making interpretation difficult

The monthly trade figures for May surprised markets, with exports contracting by 1 percent and imports contracting by 0.3 percent. Both figures were significantly below expectations. It is difficult to interpret what this means, given significant changes, designed to eliminate false invoicing, have been introduced to the way trade data is collected. This has been to eliminate the effects of false invoicing, which is seen to have elevated previous month's trade data.

The Customs attributed weak trade data to two major reasons: firstly, the





government had managed to curb trade arbitrage; and secondly, the domestic and international trade environment was deteriorating, including domestic economic slowdown, sluggish external demand, high costs for enterprises' operation, and appreciation of RMB's real effect exchange rate. The balance of exports and imports registered a slightly higher surplus of $20 billion in May, compared with $18.2 billion in April. **See Figure 9.**

RMB continues to appreciate against both the dollar and in REER terms

The RMB has continued to appreciate reasonably quickly. In April and May alone, the currency appreciated (against the US dollar) by 0.77 and 0.67 percent respectively, exceeding the annual appreciation of 0.24 percent in 2012. Since de-pegged in June 2010, the RMB has appreciated by 10.8 percent (as of 11 June 2013). The latest figures from the Bank of International Settlement show that the RMB's real effective exchange rate has appreciated by 13.1 percent since June 2010. **See Figure 10.**

A report from the Chinese Academy for Social Sciences (CASS – a government-owned think tank) explained 3 reasons for recent acceleration in RMB appreciation:

- higher interest rates in China and increasing appreciation expectations have attracted increasing capital inflows;
- worries about China's economic hard-landing have subsided after the leadership transition in last November; and
- the quantitative easing schemes that several developed countries have introduced have increased global liquidity, increasing capital inflows.

CASS economists expected the RMB appreciation would slowdown after the US-China Summit, which concluded on 9 June.

RMB deposits in Hong Kong, an offshore market for the Chinese currency, totalled RMB 677.2 billion (£71.3 billion) in April (latest data), compared with RMB 668.1 billion (£70.3 billion) in March. RMB cross-border trade settlement totalled RMB 275.4 billion (£29 billion) in April, dropping by 19.2 percent from a month earlier.

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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