British Embassy
Beijing

China Economic Focus – March 2014

Overview

- It has been a busy month for the Chinese economy, with the annual meetings of the National People's Congress (NPC), a stream of weaker-than-expected economic data, and a widening of the RMB trading band.

- The authorities used the NPC meetings to convey two messages:
  - a commitment to economic reform. Changing the role of government and allowing markets to play a decisive role in the allocation were the two main themes of Premier Li's work report, which was more specific and technocratic than those of his predecessor, Wen Jiabao.
  - a commitment to stability. The growth target was maintained at 'around 7.5 percent'. Both Premier Li and Finance Minister Lou have made clear that this target is flexible and that employment and inflation are the more important indicators. However, the authorities still believe the growth rate plays a crucial role in setting expectations and are unlikely to let annual growth for 2014 slip below 7.2 percent.

- The leadership is clear that investment remains 'the key to maintaining stable economic growth'. It places less urgency on deleveraging than many observers advocate. But assuming no major shocks to the economy, credit growth should continue to slow gradually. Li's confidence that levels of debt are manageable is probably justified: the total value of China's assets and its insulated financial system make widespread financial instability unlikely.

- Data at the start of the year have disappointed, with industrial production, retail sales, fixed asset investment and exports all coming in below expectations. This sense of malaise has been compounded with greater than usual financial market volatility, with the RMB depreciating over the month, a corporate bond default and more visible stress among property developers and the steel industry.

- But it's worth keeping things in perspective. The latest data hasn't been too bad and it has been subject to seasonal distortions caused by Chinese New Year (and, in the case of the trade data, a strange base effect caused by rampant over-invoicing at the start of last year). Similarly, recent defaults and financial market volatility are in many ways welcome, if they lead to a decline in moral hazard and the more realistic pricing of financial risk.

- Finally, widening the RMB trading band to 2 percent is the most significant policy move in 2014 so far, and consistent with the reform plans set-out in both November's Third Plenum and the recent NPC meetings. Although the RMB is still far from being a free floating currency, widening the band will make it more volatile and ought to lead to a resumption of the RMB's gradual appreciation, following the last month's policy-induced period of depreciation.

- Further examples of our recent reporting 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.

National People's Congress sets up growth targets

1. The Chinese authorities announced their targets for the economy in 2014 during the annual National People's Congress (NPC) meeting in early March. Headline growth is set at 'around 7.5 percent', the same as in 2013. **See Figure 1** for more economic targets. The World Bank expects China's economy will grow by 7.7 percent in 2014; and the IMF predicts 7.5 percent.

Figure 1: Key economic targets

	2013		2014
	Target	Actual	Target
GDP	7.5%	7.7%	7.5%
CPI	3.5%	2.6%	3.5%
M2	13%	13.6%	13%
Fixed asset investment	18%	19.6%	17.5%
Trade (imports plus exports)	8%	7.6%	7.5%
Retail sales	14.5%	13.1%	14.5%
Fiscal deficit (% of GDP)	2%	1.9%	2.1%
Urban registered unemployment rate	4.6%	4.1%	4.6%
Job creation	>9 million	13.1 million	>10 million

2. Reform was the top among nine work priorities for the government in 2014. Premier Li Keqiang announced to further devolve administrative approval rights, change the role of the government and allow markets to play a decisive role in resource allocation. Fiscal reform (including budget transparency, VAT reform expansion and local/central fiscal relationship) and financial sector reform (including interest rate and exchange rate further liberalisation and deposit insurance) are the key reform items.

Data at the start of the year fall short of expectations

3. Headline fixed asset investment (FAI) growth decelerated to 17.9 percent in January and February combined (on a year earlier), compared with 19.6 percent in 2013. This was below market expectations of 19.5 percent. On monthly basis (seasonally adjusted), FAI has slowed to 1.33 percent in February, down from 1.35 percent in January and 1.42 in December 2013. Manufacturing FAI growth slowed and infrastructure FAI growth accelerated over the past month. **See Figure 2.**

Figure 2: Investment (% change on year before)

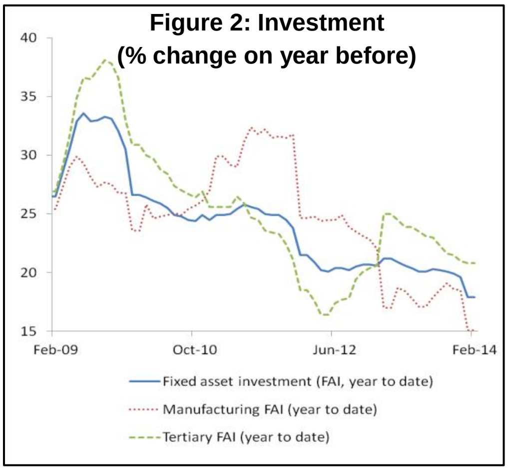
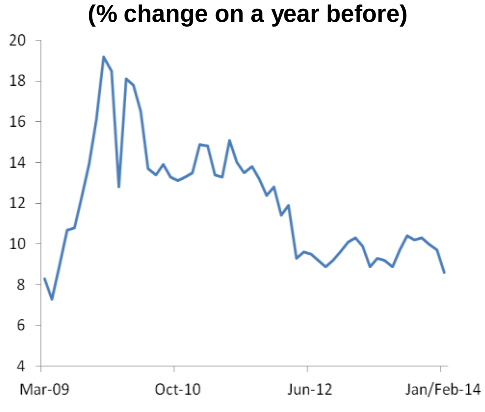


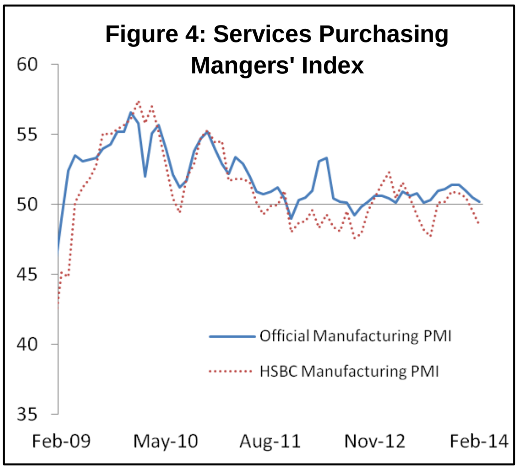
Figure 3: Industrial production (% change on a year before)

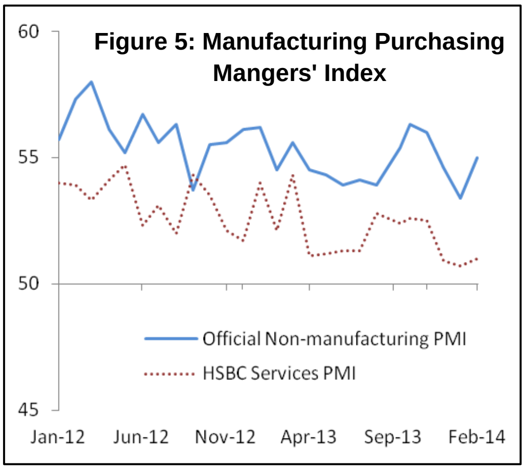


4. Industrial production (IP) growth dropped to 8.6 percent in January and February combined (on a year earlier), down from 9.7 percent in December 2013 and 9.7 percent for 2013 as a whole. On monthly basis (seasonally adjusted), IP growth decelerated from 0.64 percent in December 2013 to 0.59 percent in January and then picked up marginally to 0.61 percent in February. Growth of production of steel, cement, automobile and electricity all dropped quickly.

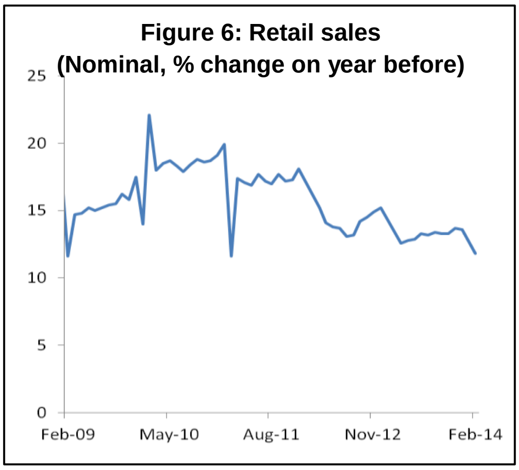
Production of crude oil contracted. **See Figure 3.**

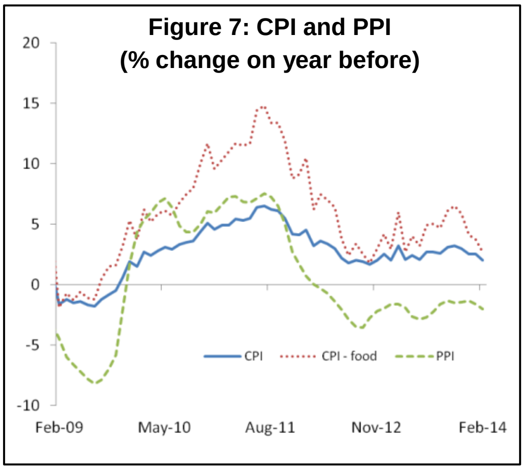
5. The official purchasing managers’ index (PMI), a forward-looking measure of business conditions, declined to 50.2 in February. This was the lowest reading since March 2013 but it remains in the expansion zone (above 50). The separate HSBC manufacturing PMI, as a better measure of business conditions for small enterprises, contracted further to 48.5 in February, down from 49.5 in January. Services PMI turned stronger. The official and the HSBC services PMI figures accelerated to 55 and 51 respectively. **See Figure 4 and 5.**





6. Growth of retail sales moderated to 8.6 percent in January and February combined (on a year earlier), down quickly from 13.6 percent in December 2013 and 13.1 percent in 2013 as a whole. Growth of catering sector, affected by the government’s austerity campaign, continued to subside. On monthly basis (seasonally adjusted), retail sales grew by 0.78 percent and 0.71 percent in January and February respectively, compared with 0.93 percent in December 2013. **See Figure 6**.





Inflationary pressure remains low

7. The consumer prices index (CPI) eased to 2 percent in February (on a year earlier), down from 2.5 percent in January. The average CPI of January and February (excluding Chinese New Year’s distortion) was 2.2 percent. Headline CPI slowdown was mainly attributed to food prices moderation – food prices grew by 2.7 percent in February, compared with 3.7 percent in January.

8. Zhou Xiaochuan, PBoC (Central Bank) Governor, said in G20 meetings in late February that China's inflation situation compared favourably with that of other emerging markets. With CPI well below the official inflation target (ceiling) of 3.5 percent, the authorities should have more room to ease the liquidity situation and introduce reforms like deregulation of resources and utilities prices.

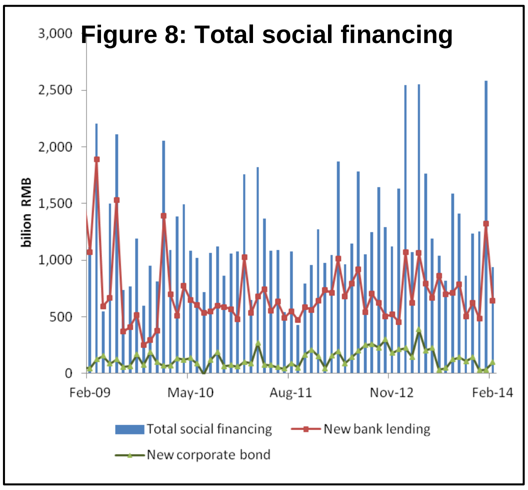
9. The Producer Prices Index (PPI), an indicator for upstream inflation pressure, contracted for the 24th consecutive month. PPI declined by 2 percent in February (on a year earlier), compared with 1.6 percent in January. **See Figure 7.**

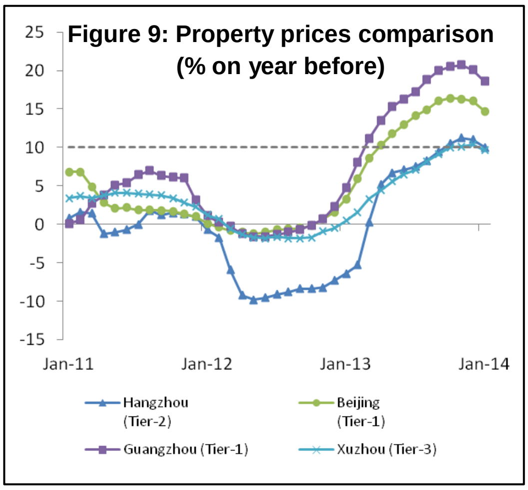
Total social financing falls steeply in February and credit growth continues to slow gradually

10. Total Social Financing (TSF), a measure of all forms of new credit, totalled RMB 938 billion (£93.8 billion) in February, significantly below the RMB 2.58 trillion (£258 billion) in January. This was mainly seasonal due to the Chinese New Year. By combining January and February's data, TSF totalled RMB 3.52 trillion (£352 billion), a little lower than the equivalent data for January and February 2013. **See Figure 8.**

11. February's new bank loans totalled RMB 644.5 billion (£64 billion), compared with RMB 1320 billion (£132 billion) in January. But this was still above RMB 620 billion (£62 billion) in February 2013. Taking January and February's data together, the growth of new bank loans was still quite stable – 17.2 percent for January and February's average (on a year earlier), compared with 17.7 percent in December 2013.

12. Money supply (M2) grew by 13.3 percent in February (on a year earlier). It was slightly above the government's target of 13 percent.





Pace of property prices increase slows

13. According to the latest official figure, 62 out of 70 cities surveyed saw higher property prices in December (on a month earlier), compared with 65 in November. Property price growth in all Tier 1 cities (Beijing, Shanghai, Guangzhou and Shenzhen) eased slightly. **See Figure 9.** The National Statistics Bureau reiterated that the policies to adjust property market and to support social housing had taken effect.

14. In Premier Li Keqiang's Work Report during the NPC, 'to control property prices' was not mentioned for the first time since 2005. It signalled the authorities sifted policies from focusing on imminent prices curbs to a longer term market mechanism and differentiated policies for different cities.

15. Property investment growth was broadly stable. Property investment grew by 19.3 percent in January and February combined (on a year earlier), slightly lower than 19.8 percent in 2013 as a whole but higher than 16.2 percent in 2012. Social housing will continue to support property investment growth. During the NPC, Premier Li Keqiang announced 7 million new social houses to be launched in 2014, compared with 6.3 million in 2013.

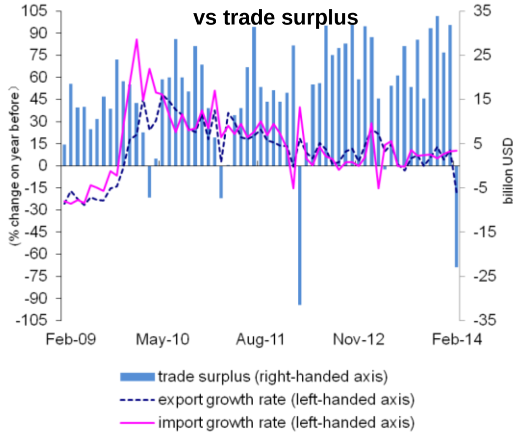
Exports weaker than expected, imports figure remains stable

16. February's export growth was much weaker than expected. China's exports contracted by 18.1 percent in February (on a year earlier), compared with a 10.6 percent growth in January and market expectations at 7.5 percent. This was the lowest reading since August 2008. But the data was heavily distorted by both Chinese New Year and a weird base-effect caused by widespread over-invoicing last year.

17. China's imports growth remained stable. Imports increased by 10.1 percent in February (on a year earlier), compared with 10 percent in January. Combined January and February imports figures showed an increase of 10 percent, higher than 8.3 percent in December 2013. In volume terms, imports of key commodities including iron ore, crude oil, copper and steel saw robust increases in the first two months.

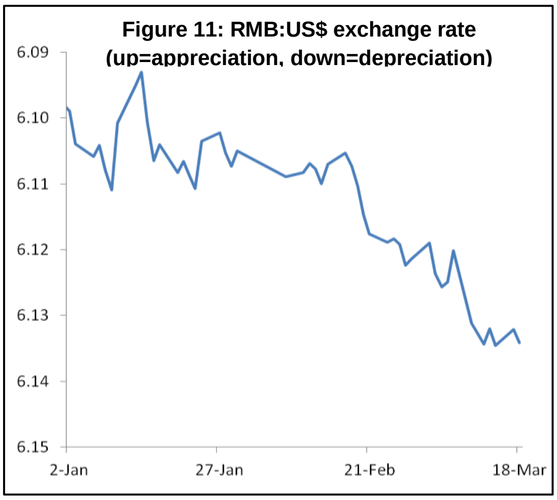
18. The weak exports and robust imports figures registered a trade deficit of USD 23 billion in February, compared with a surplus of USD 31.9 billion in January. **See Figure 10.**

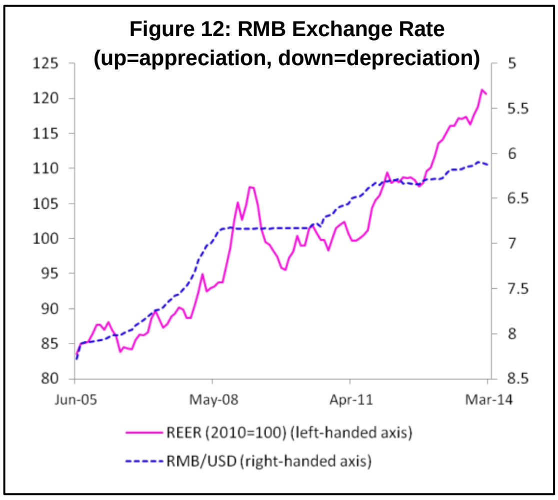
Figure 10: Import and export growth vs trade surplus



Further step to liberalise exchange rates

19. The RMB:US$ exchange rate depreciated quickly in the past few weeks. As of 18 March, the currency depreciated by 0.47 percent in the past month. The exchange rate stood at a level as in 3 months ago. **See Figure 11.** However, perspective is important, and the longer term trend is clearly towards appreciation, as shown in **Figure 12**. Overall, the RMB has appreciated by 11.3 percent against the dollar since it was de-pegged in June 2010. According to the Bank of International Settlement, while the RMB's real effective exchange rate (REER) depreciated by 0.5 percent from January to February, it has appreciated by 18.4 percent since it was de-pegged.





20. Most importantly, the recent depreciation was clearly policy induced (the PBOC had been setting the daily 'reference rate' consistently lower during the period of depreciation), and many analysts thought depreciation was laying the groundwork for further exchange rate liberalisation.

21. This was confirmed on 15 March, when the PBoC announced to widen the RMB trading band to 2 percent, effective on 17 March. This is the most significant policy move since the start of the year.

22. RMB deposits in Hong Kong, an offshore market for the Chinese currency, totalled RMB 893.4 billion (£89.3 billion) in January (latest figure), compared with RMB 860.5 billion (£86 billion) in December 2013. RMB cross-border trade settlement totalled RMB 492.3 billion (£49.2 billion) in January, increasing by 4.8 percent on 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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