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FCO COUNTRY UPDATES FOR BUSINESS

China Economic Focus: September 2013

British Embassy Beijing

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Overview

- Latest Chinese data shows economic momentum is stronger in the 3rd Quarter of 2013 than it was in the 2nd Quarter. Industrial production, fixed asset investment and retail sales all showed improvement from the previous month. Inflation (2.6 percent) remains low and stable. Recent export growth has been solid. Total social financing (a broad measure of credit) nearly doubled between July and August, reflecting a significant increase in non-bank lending, following months of relatively subdued credit growth.

- The better data has led to an upward revision of some external forecasts. This illustrates the highly volatile nature of much economic reporting about China, as only a few weeks ago many were forecasting an imminent hard landing for China. We judge the swing has been exaggerated in both directions. The most likely outcome this year will be growth of around 7.5 percent, consistent with the authorities' target.

- Developments this year illustrate the authorities' determination to carefully manage downwards China's economic growth. This will lead to bumpy monthly data outturns, as activity either under- or over-shoots targeted levels. It will also lead to inefficient investments, given China still lacks strong market mechanisms.

- The broader trend however should be a longer-term transition from investment-led to consumption-led growth. Assuming the authorities are serious about accelerating economic reform (which we judge they are), we should expect investment growth to taper down in the coming years, leading to a gradual reduction in overall growth rates.

- This combination of more volatile data and a gradual reduction in growth rates means fears of an imminent "hard landing" are unlikely to go away. We continue to believe this is unlikely. We share concerns raised recently by Fitch Ratings and the Financial Times about levels of Chinese corporate debt and the increasing credit-to-GDP ratio. But we do not think these will have a serious impact on China's short-term economic prospects.

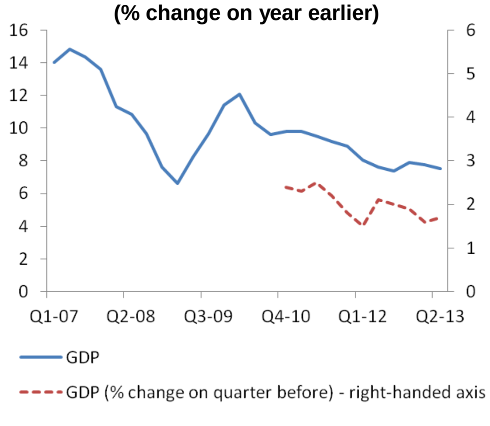
- China's most plausible 'bad-scenario' instead entails gradual slow-down as banks divert more resources to servicing bad debts, rather than financing new lending. Observers – internal and external – are looking to the 3rd Plenum in November for evidence that the new Chinese leadership is ready for such action.

- 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.

China's economy has been slowing

1. China's economy has been slowing gradually since 2010 Q1, falling to a 7.5 percent year-on-year growth in 2013 Q2 (year-on-year growth in 2007 Q2 was over 14 percent). Following a recent pick-up in activity, most analysts are forecasting full year growth this year of around 7.5 percent, which would be consistent with the authorities' growth target. **See Figure 1**.

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



2. The authorities remain relatively optimistic. Speaking in the World Economic Forum on 10 September, Premier Li Keqiang admitted economic downward pressure in the first half year, but there had been positive trends of key economic indicators in August. Li recently wrote in the Financial Times that "this year there has been steady economic progress…if our economy is kept within the reasonable range, markets and society will have stable expectations".

3. The authorities stay firm with their reform ambition. Also in the World Economic Forum, Premier Li reiterated the policy stance to coordinate economic growth, economic restructuring and reforms. He ruled out the option to loosen monetary policy, as this may increase risks for the economy in longer term. He was confident that China had long-term internal growth potentials via reforms.

Latest data points to a pick-up in activity

4. Headline fixed asset investment (FAI) picked up slightly to 20.3 percent in the first 8 months (on a year earlier), compared with 20.1 percent in the first 7 months. Growth of industrial FAI continued to accelerate – it grew by 16.6 percent in the first 8 months, compared with 16 in the first 7 months. Manufacturing FAI grew by 17.9 percent in the first 8 months, 0.8 percentage points higher than in the first 7 months. Acceleration of government-led project contributed to headline FAI growth. Railway FAI growth picked up to 11.4 percent in August, up from 5.8 percent in July. **See Figure 2.**

5. Industrial production (IP) increased by 10.4 percent in August (on a year earlier), compared with 9.7 percent in July. This is the highest reading since March 2012. Growth of production of electricity and steel quickened; whereas growth of cement, crude oil and automobile production softened. **See Figure 3.**

Figure 2: Investment (% change on year before)

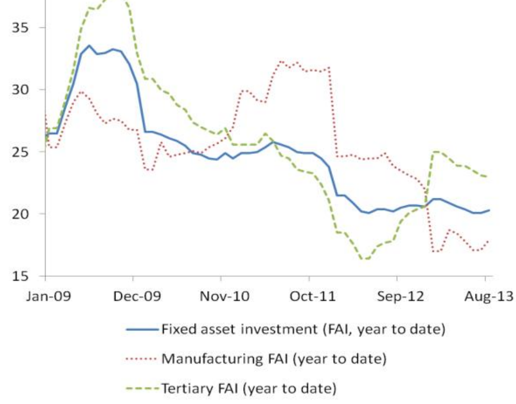
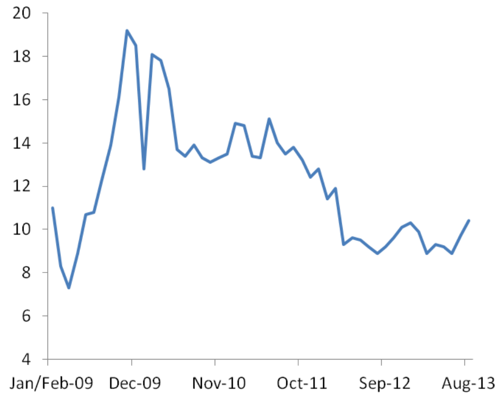


Figure 3: Industrial production (% change on a year before)



6. The purchasing manager's indices (PMI), a forward-looking measure of business conditions, have also recently picked up. The official Manufacturing PMI reached a 16-month high of 51 in August, up from 50.3 in July. The official non-manufacturing PMI measured 53.9, consistent with previous months. The separate HSBC manufacturing PMI, seen as a better measure of business conditions for small enterprises, recovered to 50.1 – the first reading in the expansion zone in the past 4 months. HSBC services PMI accelerated to a five-month high of 52.8. **See Figure 4 & 5.**

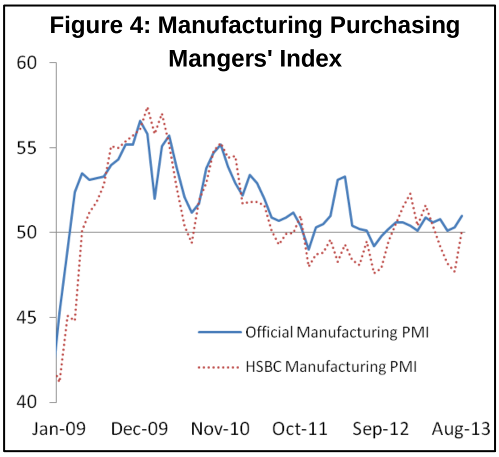


Figure 4: Manufacturing Purchasing Mangers' Index

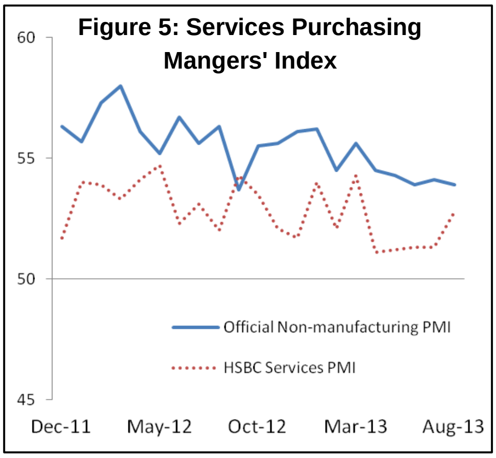


Figure 5: Services Purchasing Mangers' Index

7. Retail sales increased by 13.4 percent in August (on a year earlier), slightly higher than July's 13.2 percent. Retail sales have been growing steadily and holding up well since the beginning of the year. **See Figure 6.** Growth of rural consumption continued to outpace that of urban consumption. Sales of food and beverage, textile products, cosmetics, daily necessities and furniture showed the largest increases.

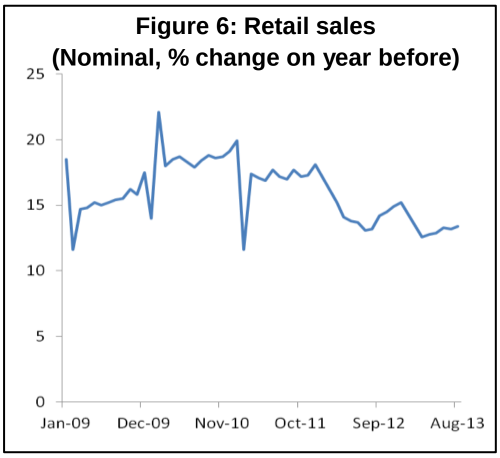


Figure 6: Retail sales (Nominal, % change on year before)

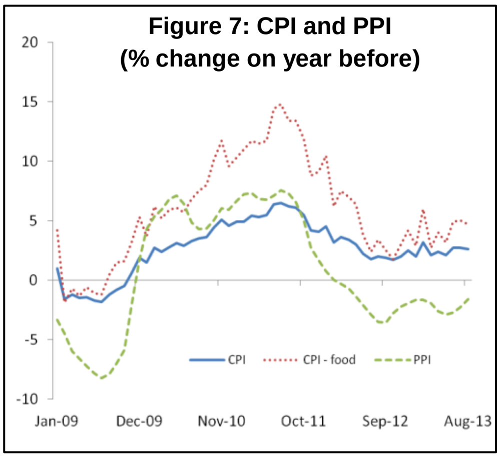


Figure 7: CPI and PPI (% change on year before)

Inflation remains low and stable

8. The consumer prices index (CPI) moderated marginally to 2.6 percent in August (on a year earlier), compared with 2.7 percent in July. It was in line with market expectations. Food prices contributed 1.54 percentage points to headline CPI, remaining the main contributor. Prices of vegetable, pork and egg increased the most, probably attributable to unusually hot weather this summer. **See Figure 7.**

9. The contraction of producer prices index (PPI), a measure of upstream inflation pressure, narrowed to -1.6 percent in August (on a year earlier), up from -2.3 percent in July. On month-on-month basis, PPI increased for the first time in 4 months, rising by 0.1 per cent.

Total social financing picks up again

10. Total social financing (TSF), a measure of all forms of new credit, totalled RMB 1.57 trillion (£165.3 billion) in August, nearly double the amount in July and representing more than 20 percent growth on the previous year. The main sources of growth came from corporate bonds, entrusted loans and bank acceptance bills (all of which form part of 'shadow banking'), rather than traditional bank lending – **see Figure 8**.

11. The August pick-up in TSF is likely attributable to the mini-stimulus announced by the authorities at the end of July. It follows four months of declining credit growth, and a significant contraction in non-bank lending in particular. If the August credit growth figures were sustained for the rest of the year, it would lead to a further worrying rise in China's credit-to-GDP ratio.

12. Money supply (M2) growth accelerated slightly to 14.7 percent in August (on a year earlier), compared with 14.5 percent in July. Since the beginning of the year, M2 has remained above the annual target of 13 percent.

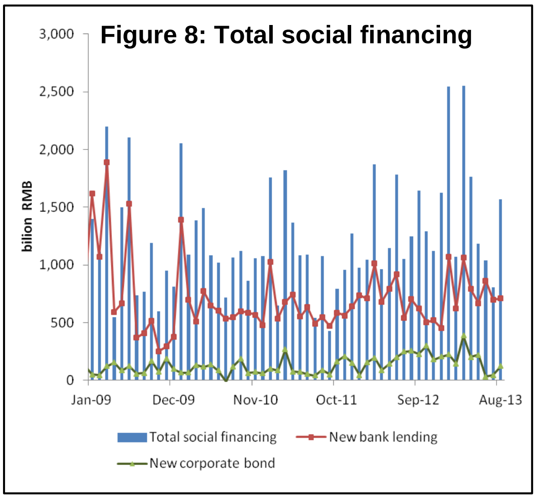


Figure 8: Total social financing

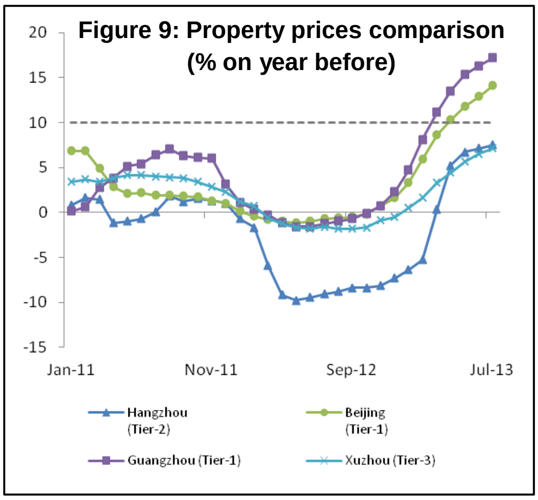


Figure 9: Property prices comparison (% on year before)

Property prices continue to rise

13. The latest data show that 62 out of 70 cities surveyed saw higher property price in July (on a month earlier), compared with 63 in June and 65 in May. All the Tier 1 cities (Beijing, Shanghai, Guangzhou and Shenzhen) are currently seeing prices rise by more than 10 percent per year. Price increases in Tier 2 and 3 cities are also picking up, especially the satellite cities to Tier 1 cities and the provincial capital cities. **See Figure 9.**

14. Property investment growth slowed to 19.3 percent in the first 8 months (on a year earlier), compared with 20.5 percent in the first 7 months. Residential property, which accounts for 68.6 percent of property investment, grew by 19.2 percent in the first 8 month, 1 percentage point lower than that in the first 7 months.

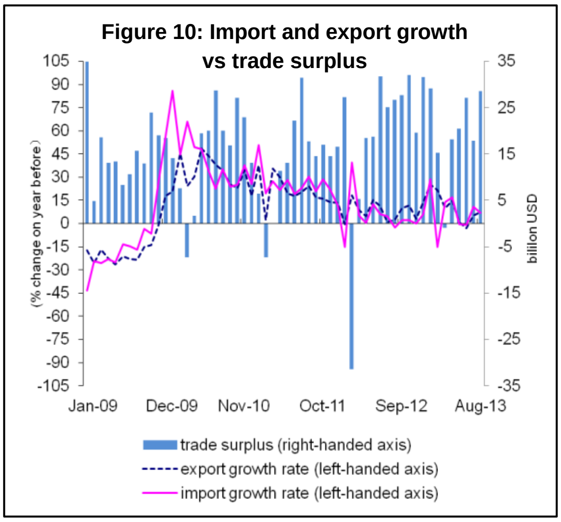
Trade data is improving, led by stronger external demand.

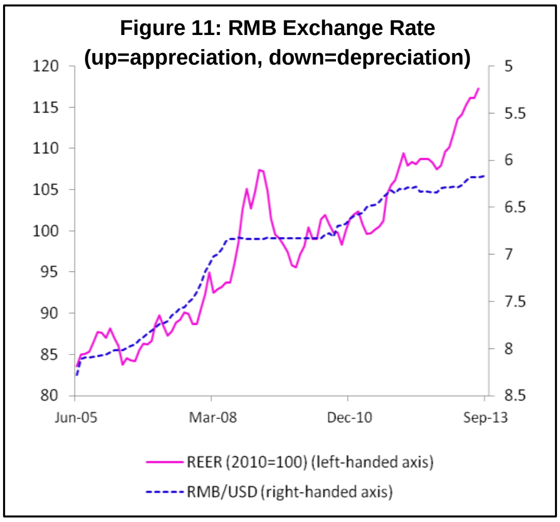
15. China's exports holding up well in August. Exports grew by 7.2 percent in August (on a year earlier), up from 5.1 percent in July, beating market expectations of 5.5 percent. China's exports to the US edged up to 6.1 percent in August (5.3 in July); and exports to the ASEAN countries surged by 30.8 percent (21.3 percent in July). Exports to the EU grew by 2.5 percent in August,

down from 2.8 percent growth in July. According to China's Customs, exports of machinery and electronics and labour intensive goods increased steadily.

16. China's imports increased by 7 percent in August (on a year earlier). Although it was below July's 10.9 percent and market expectations of 11 percent, it was higher than May's -0.3 percent and June's -0.7 percent. In volume terms, imports of iron ore, crude oil and oil products slowed; imports of soybean increased significantly in past month.

17. The balance of exports and imports registered a trade surplus of USD 28.52 billion in August, higher than July's USD 17.8 billion. **See Figure 10**.





RMB:US$ exchange rate has been flat

18. The RMB:US$ exchange rate (as of 11 September) has been flat for the past month, and has appreciated by 2.1 percent since the beginning of 2013, compared with 0.24 percent appreciation over 2012. According to the Bank of International Settlement, the RMB's real effective exchange rate appreciated by 6.5 percent in the first 7 months (latest figure), compared with 2.1 percent in 2012. **See Figure 11.**

19. RMB deposit in Hong Kong, an offshore market for the Chinese currency, totalled RMB 695 billion (£73.2 billion) in July (latest figure), down slightly from June's RMB 698 billion (£73.5 billion). RMB cross-border trade settlement totalled RMB 258.4 billion (£27.2 billion) in July, increasing by 5.4 percent from June.

20. On 9 September, the PBoC (Central Bank) signed a bilateral local currency swap agreement with Hungary's Central Bank. The size of the swap facility is RMB 10 billion (£1.05 billion). This is the first Eastern European country that signed currency swap with China. So far, China has signed agreements with 21 countries, totalling RMB 2.2 trillion (£231.6 billion).

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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