British Embassy
Beijing

China Economic Focus – July 2014

Overview

- Latest official monthly data suggest a slight improvement in economic outlook. External analysts have maintained or upgraded their 2014 growth forecasts. The labour market is buoyant and the inflation risk remains low. However, the property market has weakened further and will continue to present downward pressure on growth.

- The pick-up in economic activity comes after the government introduced a number of targeted stimulus measures, including relaxation of lending restrictions. These measures have generated an acceleration in credit growth. Standard Chartered this month released an estimate that at the end of June China's debt-to-gross domestic product ratio had reached 251%, a sharp rise from just 147% at the end of 2008, and much higher than other emerging economies.

- Growth remains very unequally distributed across China, with inland, commodity and heavy industry dependent provinces doing particularly badly. However, regional stimulus measures implemented over the past quarter appear to have had some effect, and growth in Q2 picked up in almost every Province.

- Stimulus measures have been accompanied by redoubled efforts to implement long term reform. Further reforms have been announced, including a substantive plan to overhaul the tax system and centre-local fiscal dynamics, one of the thorniest but most fundamental elements of structural reform. In our view this demonstrates the seriousness of the government's commitment to the reform agenda.

- The ratcheting up of Xi Jinping's anti-corruption campaign represents a concerted effort to root out vested interests and strengthen the centre's power, paving the way for faster implementation in future. Real obstacles remain: a recent People's Daily survey suggests that many officials still think that they are best off keeping their heads down and doing as little as possible.

- But it currently looks like the authorities can maintain growth through targeted stimulus measures at the same time as pushing forward the programme of reforms necessary to guarantee the Chinese economy's long term health. While stimulus measures have generated fast credit growth, China is effectively insured against serious financial instability through its $4trn reserves, capital controls and vast state assets.

- Further examples of our recent reporting can be found at: https://www.gov.uk/government/collections/fco-political-and-economic-updates#china. Please get in touch if you have any questions or comments.

GDP growth slightly above market expectations

1. China's economy grew by 7.5 percent y.o.y in Q2 2014, slightly above 7.4 percent of Q1 2014 and the market consensus of 7.4 percent. GDP growth in the first half of 2014 was 7.4 percent. On a quarterly basis (seasonally adjusted), growth picked up from 1.4 percent in Q1 to 2.0 percent in Q2. **See Figure 1.** Given the improvement in Q2 and the government's recent stimulus, some analysts have upgraded their forecast. **See Figure 2**.

Figure 1: China's GDP growth (% change on year before)

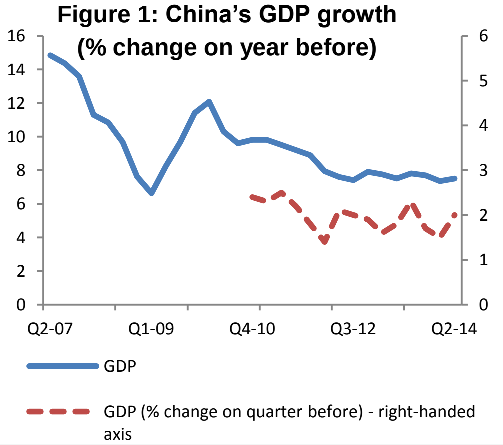


Figure 2: External growth forecasts for 2014

Institute	2014
World Bank	7.6%
IMF	7.5%
HSBC	7.5%(up from 7.4%)
Standard Chartered	7.4%
UBS	7.3%
Goldman Sachs	7.3%
JP Morgan	7.3%(up from 7.2%)
Bank of America - Merrill Lynch	7.4%(up from 7.2%)
CASS	7.4%
'Official Target'	7.5%

2. Growth of primary, secondary and tertiary sectors all improved. But growth of tertiary sector (8.0 percent) continued to outpace that of secondary sector (7.4 percent).

Growth unevenly distributed between China's inland and coastal Provinces

3. Growth in Q2 in most provinces slightly improved as compared to Q1, but growth remains very unevenly distributed across China's Provinces. **See Figure 3.** Many provinces introduced moderate stimulus measures, especially those with the lowest rates in Q1, such as Hebei and Heilongjiang.

Figure 3: Local GDP growth in Q1 and Q2

Provinces/ Municipalities	Q1 2014	Q1 2013	Q2 2014	Q2 2013
Beijing	7.1%	7.9%	7.2%	7.7%
Hebei	4.2%	9.1%	5.8%	8.7%
Shanxi	5.5%	9.5%	6.1%	9.0%
Heilongjiang	2.9%	9%	(to be announced)	8.7%
Shanghai	7.0%	7.8%	7.1%	7.7%
Zhejiang	7%	8.3%	7.2%	8.3%
Guangdong	7.2%	8.5%	7.5%	8.5%
Jilin	7.0%	10.2%	6.8%	9.0%
Inner-Mongolia	7.3%	9.9%	7.6%	9.0%

Stimulus measures limited, emphasis on implementation

4. The Chinese authorities have stepped up their efforts to ensure that the programme of reform and stimulus is implemented. On 6 June in a Party meeting, Chinese President Xi Jinping insisted on the importance of implementing reforms and stimulus policies. Earlier that week in a State Council meeting Premier Li Keqiang castigated local officials for dragging their feet on reform and growth.

5. The high profile anti-corruption campaign has been stepped up over the past month. In June, Xu

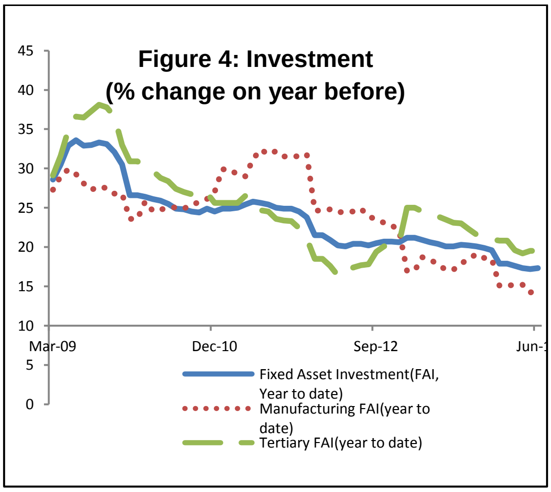
Caihou, former vice president of China's Military Commission, was expelled for corruption charges, the highest ranking official expelled so far. 4 vice-minister level officials were also charged for corruption in June. This is seen by many as a concerted effort to root out vested interests and opponents of reform and strengthen the centre's power paving the way for faster implementation of reform in future.

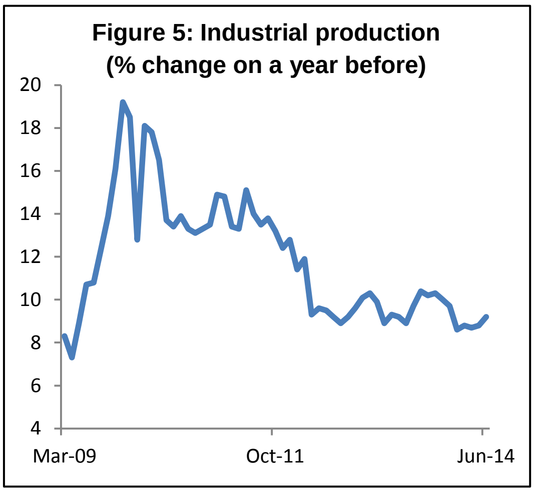
6. On June 30th China's Politburo endorsed a substantial plan to reform the nation's fiscal and tax system. The plan focuses on three areas: improving budget management, rationalising the tax system, better balancing distribution of revenue and obligations between central and local government. This plan addresses one of the thorniest and most fundamental elements of the programme of economic reform set out at the Third Plenum.

7. The PBOC (Central Bank) said that from June 27 it would remove the ceiling on foreign-currency deposit rates across Shanghai for small accounts, a step toward easing interest-rate controls across the nation. In June the PBoC announced a second round of targeted required reserve ratio (RRR) cuts. China's banking regulator the CBRC announced on 30 June that it would ease restrictions on bank lending enforced by Loan to Deposit Ratio(LDR).

Slight improvement in key economic indicators

8. Headline fixed asset investment (FAI) came in at 17.3 percent for the first half of the year (on a year earlier), slightly higher than 17.2 percent in the first five months and the market expectations of 17.2 percent. **See Figure 4.** On monthly basis (seasonally adjusted), FAI growth rose 1.45 percent in June. Infrastructure investment remained strong. FAI from the private sector increased by 20.1 percent in the first half of 2014.





9. Industrial production (IP) grew by 9.2 percent in June (on a year earlier), compared with 8.8 percent in May and beating market expectations of 9 percent. On a monthly basis (seasonally adjusted), IP growth rose to 0.77 percent in June from 0.72 percent in May. Growth of production of steel and crude oil improved; while that of cement, electricity and automobiles slowed. **See Figure 5.**

10. The official manufacturing purchasing managers' index (PMI), a forward-looking measure of business conditions, continued to improve for the fourth month to 51 in June, compared with 50.8 in May. The separate HSBC manufacturing PMI, as a better measure of business conditions

for small enterprises, came in at 50.7, up from 49.4 in May. Official services PMI weakened slightly to 55 from 55.5 in May. The HSBC services PMI rose to 53.1 in June, the highest since March 2013. **See Figure 6 and 7.**

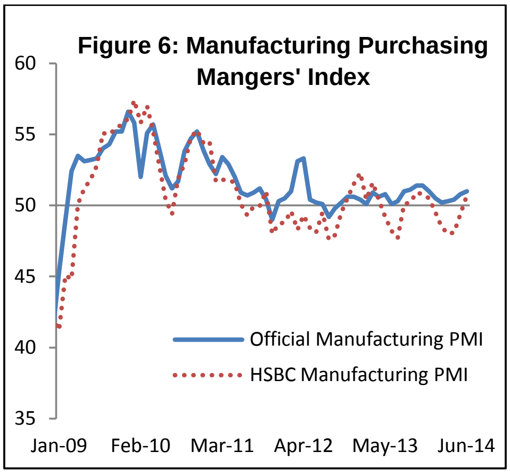


Figure 6: Manufacturing Purchasing Mangers' Index

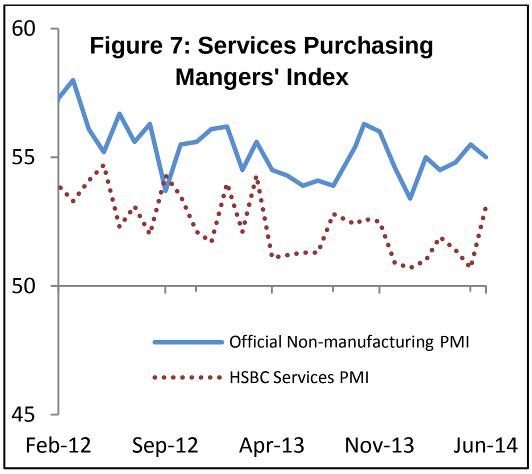


Figure 7: Services Purchasing Mangers' Index

11. Growth of retail sales increased by 12.4 percent in June (on a year earlier), compared with 12.5 percent in May. On monthly basis (seasonally adjusted), retail sales grew by 0.96 percent in June. The dampening effect from jewellery sales improved, while the sales of items related to government austerity and anticorruption campaign remained weak. **See Figure 8.**

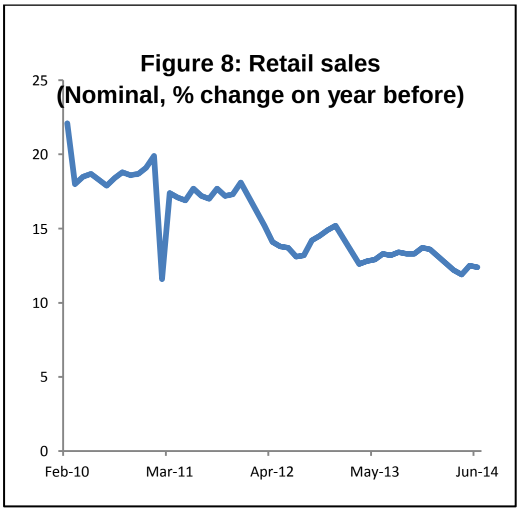


Figure 8: Retail sales (Nominal, % change on year before)

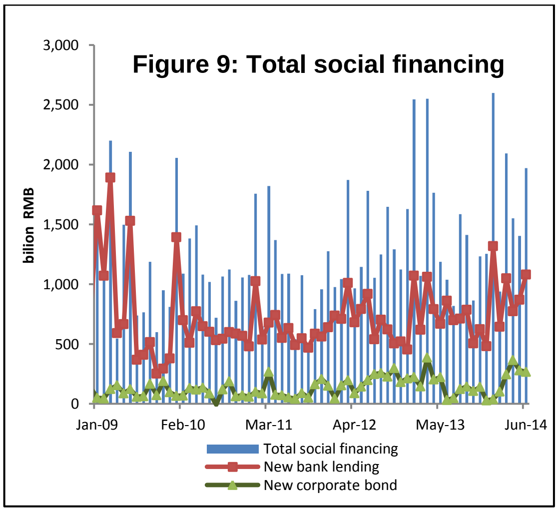


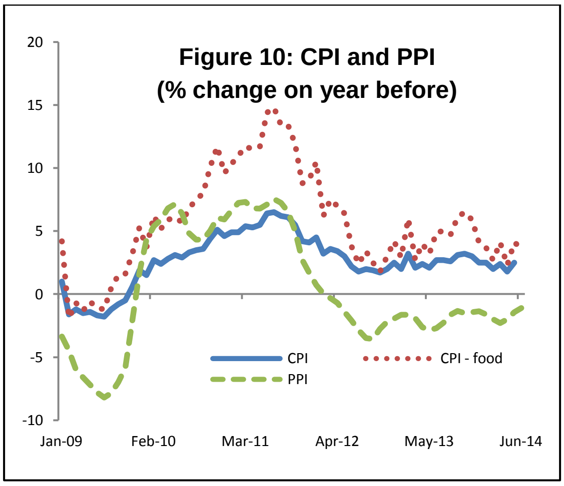
Figure 9: Total social financing

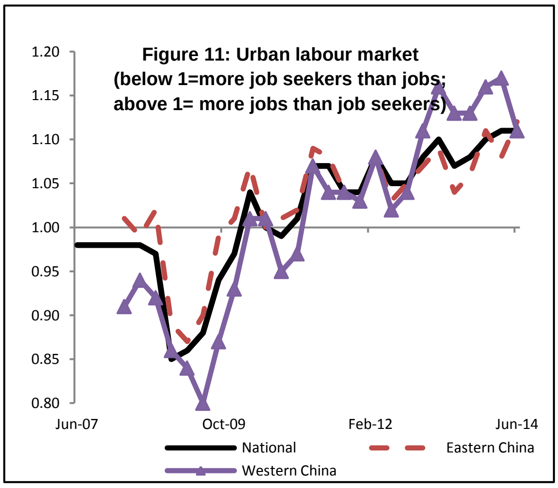
Total social financing and bank lending rebound

12. Total social financing (TSF), a measure of all forms of new credit, increased RMB 1.97 trillion (£197 billion) in June, higher than RMB 1.4 trillion (£140 billion) in May and above market expectations. For the first half of 2014, TSF reached RMB 10.57 trillion (£1.057 trillion), the highest in record. Loans were the largest contributor to June's growth and short-term loans are still the main driver. Apart from bank-lending, non-bank lending activities also picked up. **See Figure 9.**

13. New bank lending in June increased to RMB 1.08 trillion (£108 billion), up from RMB 871 billion (£87.1 billion) in May, an increase of 24 percent. The rise was due to increasing financing demands brought by the recent economic recovery, adequate inter-bank market capital, and increased bank loan capacities.

14. Money supply (M2) grew by 14.7 percent in June (on a year earlier), higher than 13.4 percent in May and was the highest in ten months.





Low inflation risk

15. The consumer prices index (CPI) rose by 2.3 percent in June (on a year earlier), down from 2.5 percent in May and slightly below market expectations of 2.4 percent. On monthly basis, CPI contracted by 0.1 percent. Soft food prices contributed to the slight decline but food inflation is still the main driver of CPI.

16. The Producer Prices Index (PPI), an indicator for upstream inflation pressure, declined by 1.1 percent in June (on a year earlier), compared with the decline of 1.4 percent in May. The improvement was mainly driven by favourable base effect. **See Figure 10.**

Labour market remains stable

17. Income growth remained strong. Growth of rural income continued to outpace headline GDP growth. It grew by 9.8 percent in Q2, lower than 10.1 percent in Q1. Growth of urban income slowed to 7.1 percent in Q2, compared with 7.2 percent in Q1.

18. The labour market remained buoyant. The quarterly job/job seeker ratio was 1.11 in Q2, the same as in Q1. **See Figure 11.** China National Statistics Bureau spokesman said that over 7 million new urban jobs had been created in the first half of 2014.

International Trade recovers, but still below expectations

19. China's exports rose by 7.2 percent in June (on a year earlier), improving slightly from 7 percent in May but below market expectations of 10.4 percent. Weak export growth suggests external demand is still recovering.

20. Imports rose by 5.5 percent (on a year earlier), compared with a 1.6 percent decrease in May. The rebound shows recent targeted stimulus measures have begun to help improve import demands.

21. China registered a trade surplus of USD 31.56 billion in June, lower than May's surplus of USD

35.9 billion. **See Figure 12.**

22. China's foreign exchange reserves totalled USD 3.99 trillion as of the end of June.

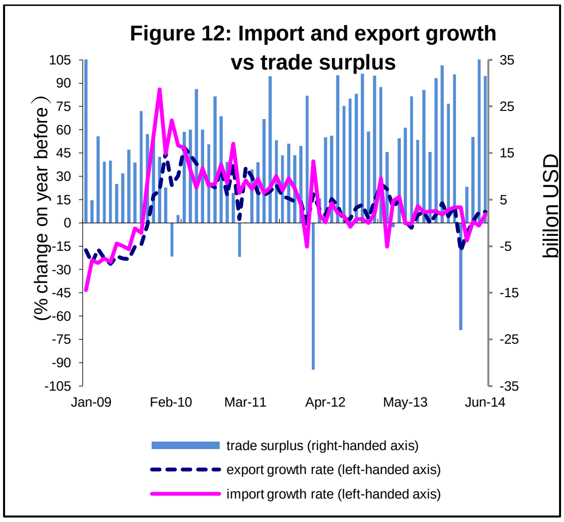


Figure 12: Import and export growth vs trade surplus

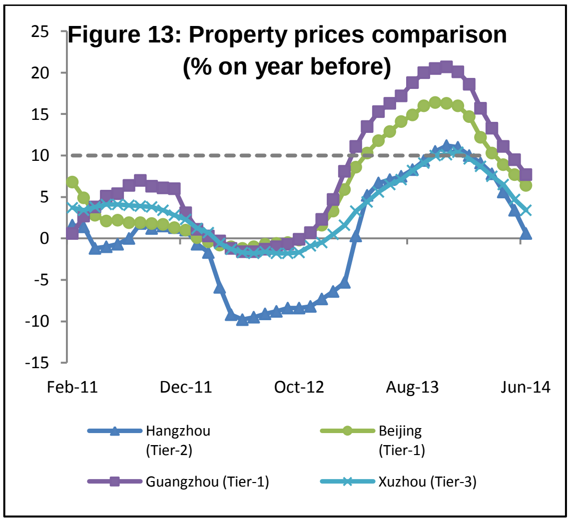


Figure 13: Property prices comparison (% on year before)

The property sector weakens further

23. Official data show that only 8 out of 70 cities surveyed saw higher property prices in June(on a month earlier), compared with 15 in May. Of all Tier 1 cities (Beijing, Shanghai, Guangzhou and Shenzhen), only Beijing's property prices rose (on a month earlier). At the end of June, Hohhot became the first city to officially ease home purchase restrictions. More cities are expected to follow. **See Figure 13.**

24. Property investment grew by 14.1 percent in the first half of 2014, further declining from 14.7 percent in the first five months.

The pace of RMB depreciation slows

25. As of 21 July, the RMB:US$ exchange rate has depreciated by 0.87 percent since the beginning of the year, though it has appreciated by 0.25 percent over the past month. **See Figure 14.** According to the Bank of International Settlements, the RMB's real effective exchange rate (REER) appreciated by 0.06 percent from May to 114.03 in June. In the first six months of 2014, the RMB's REER had depreciated by 3.97 percent.

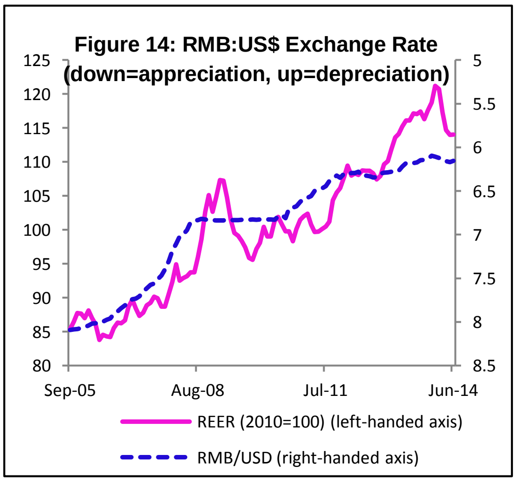


Figure 14: RMB:US$ Exchange Rate (down=appreciation, up=depreciation)

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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