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It's the commodities, stupid – and nothing new from the «conflict-of-interest-zone» which deals with the risk that deleveraging might hurt growth

HIGHLIGHTS

- *GDP: growth target 2015 set at «around 7%»*
- *Industrial output fell sharply*
- *CPI: bottomed out*
- *PPI: down and down*
- *PMI: in slightly expansionary territory again*
- *Credit growth: stabilization*
- *Real estate: continued weakness or silver lining?*

The Chinese economy started the year with a distinct albeit not unexpected weakness of growth. Some of the problem spots deepened and broadened, but there are also signs of stabilization.

One of the closely watched economic indicators is inflation. The changes of the price level are closely monitored by central banks worldwide and have a strong impact on monetary policy. In China, the price indices were at a five-year low in January. Consumer prices (CPI) moved up from 0.8% to 1.4% (yoy) in February and March, but producer prices (PPI) are still on a steep downward slope (–4.8% and –4.6% in February and March). These deflationary trends point to a deep weakness of demand and overcapacities in certain industries, but it is premature to talk about outright deflation in China. Consumers do not postpone purchases in expectation of lower prices and the growth rate of retail sales still is in double-digit territory.

Down and up in PMIs

The PMIs, the most prominent indicators for economic activity and industrial output in China, have been on a downward trend since last August. They continuously point towards a lower level of growth, culminating in readings for January and February of 49.8 and 49.9 respectively. With readings below 50 they indicate an industrial contraction. The last time the PMIs were below the growth line of 50 was in September 2012. However, it is always difficult to judge January and February data due to Chinese New Year related distortions. The preliminary Flash PMI from HSBC/Markit for March (49.2) also pointed towards a contraction of economic activity. The definite HSBC value was 49.6 and the official PMI for manufacturing came in at 50.1, slightly better than expected but barely in the expansion zone.

In March, large enterprises fared better than small and medium sized ones. The PMI of large-sized enterprises was 51.5, an increase of 1.1 percentage points from February. The readings for medium and small enterprises were 48.3 and 46.9 respectively, a decline of 1.1 and 1.2 percentage points month-on-month and well below the threshold of 50. As the private sector, which consists of smaller enterprises than the state-controlled sector, is responsible for more than 80% of urban job creation, the government certainly should quickly implement the reform measures aimed at the liberalization and strengthening of the private sector.

The services sectors and retail sales held up quite well and export growth is positive despite the rise of the RMB exchange rate. The official non-manufacturing PMI cooled only slightly to 53.7, a one-year low. This indicates the relative strength of the service sector in comparison to the industrial sector. But both manufacturing and service PMIs showed that companies continued to reduce staff in March. The labor market remained surprisingly robust despite weakening growth in 2014. Any significant sign of deterioration could force Beijing to introduce more aggressive easing measures.

We would like to mention that, although PMIs are good economic indicators, we should not put too much emphasis on them. As the Chinese economy is fully engaged in the process of rebalancing from an investment-driven towards a more consumption-oriented model, growth rates must decline – towards a «more normal» rate that is realistic for an economy which rapidly moves up the value chain. The West should get used to the idea of significantly lower growth in China – which has nothing to do with a hard landing or a collapse.

Severe slowdown in commodity – related sectors

Some economists say that the overall slowdown of the Chinese economy is caused by the property market. Fact is that the economic weakness is most pronounced in sectors related to construction activity and in commodity related sectors.

The slowdown in provinces with heavy industries, induced by overcapacities and the slump in commodity prices, is in line with the PMI and PPI readings. The North-Eastern provinces (Heilongjiang, Jilin, Liaoning), where the mining, extraction and processing heavy industries are predominant, suffered most. In 2014 the GDP growth of the North-Eastern provinces was 5.9%, nationwide it was 7.4%. Fixed asset investment growth was 3% compared to 16% overall.

Quite a few of the key developments in March are related to commodity prices. Over the period of the last twelve months the Bloomberg Commodity Index (previously DJ UBS Commodity Index), which consists of a higher industrial metals and a lower energy complex weight than other commodity indices, declined by 25%, since the beginning of the year it lost 5% and in March 4%.

The decline of commodity prices has a broad impact on the Chinese economy. Lower commodity prices usually bring some upside to commodity importing countries – cheaper oil tends to boost the disposable income of households, lower prices in input goods-related commodities are positive for the production sector. But in the case of China, everything is a bit complicated. Although energy prices, also gasoline prices, are state controlled, market forces play an increasingly important – but as of today – still minor role. **China is a net commodity importer and the world's largest exporter of consumer goods. The country's trade surplus increases due to the lower commodity prices.** This fact might be welcome to other countries, but for China it is a mixed blessing, not least for its dealings with the USA, and highlights latent structural problems.

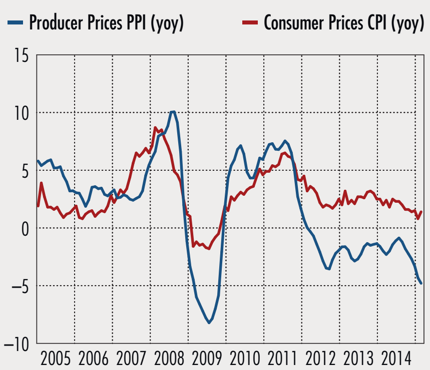
Profitability of industrial firms is deteriorating

The main problem, however, is the fact that due to the prolonged and significant weakness in commodity prices the profitability of industrial enterprises declines and the deflationary tendencies increase. Lower commodity prices in China are not good for the production sector, quite the opposite. Because China also is a huge commodity producer and processor, the already inefficient and state-subsidized heavy industry is suffering badly. **Regarding the deflationary tendencies, the government faces a difficult conflict of interest: more monetary easing could fight deflation but would increase the danger of another credit bubble.**

Some direct consequences of lower commodity prices are: Railway traffic has gone down significantly, freight volume indices are deeply in contraction, electricity output and consumption fell, iron ore, crude oil and coal imports declined. All these factors are considered to be good proxies for the economic activity in heavy industries. Coal consumption fell by more than 20% (yoy) in March, steel production went down, and steel prices are at multi-year lows.

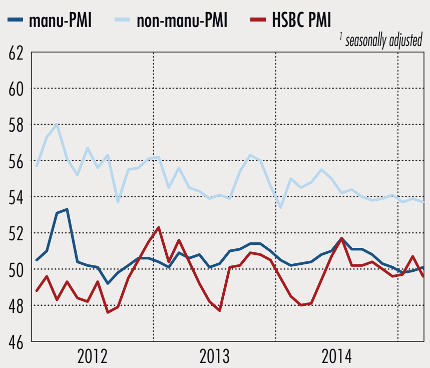
The profitability of industrial firms is deteriorating. The profit growth of industrial enterprises sank to 8% in December, Q4 2014 was the worst since early 2009. Their profitability (RoA) is also deteriorating which increases the risk of defaults in the industrial sector and therefore is a danger to the financial system. The weak industrial output since the beginning of the year will continue to put pressure on margins in the next few months. Growth in industrial output and fixed-asset investment is the lowest since 2008. Industrial output slipped to a six-year low of 6.8% yoy after 8.3% in 2014.

Producer prices down and down



Source: CEIC / Chart: ChinaIntelligence

China manufacturing PMI sub-index[1]



Source: National Bureau of Statistics, HSBC / Chart: ChinaIntelligence

But the economic weakness is not only prompted by overcapacities in heavy industries and weak commodity prices – it is also driven by the deterioration in domestic demand due to the weakness in the property sector. Despite recent interest rate cuts and a loosening of property purchase restrictions, house sales have continued to go down. One of the consequences of this trend is that house owners feel less wealthy and are more careful with their consumption. Also, fewer home sales have an impact on the purchase of many related goods such as appliances, electronics and other fittings. The weaker domestic demand has already led to more easing and credit growth. Beijing is well aware that achieving the growth target of 7% will need more stimulus and policy support.

Where is the bottom?

However, there are some signs that the bottom may have been reached:

- In the industrial sector, inventory levels before the Chinese New Year were at record lows – restocking could boost production.
- Areas most responsible for the slowdown are showing signs of stabilization: real estate and credit growth.
- While floor space sold remained flat, mortgage lending has gone up. Loosening restrictions for property ownership at local levels – like cutting down-payment requirements for «upgraders» – might soon be installed on a national level.
- Bank lending also has gone up in March. From January to December 2014 credit growth slowed from 18% to 14.5%. This trend seems to have stopped, credit growth has been flat since the beginning of the year.
- **These data must be put in the context that some of this bank lending is a substitution for shadow banking activities, where restrictions still continue, but overall credit growth should still have stabilized.**
- It might take some time until all this transforms into a strengthening of the economy, but the outlook for Q2 2015 is somewhat better than Q1 2015, which might fall short of the growth target of 7%.

March take-aways:

March 3rd to 15th

At the Annual Twin Meeting of the National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC) the official growth target for 2015 was set at «around 7%», due to risks in the property market and local government debt, which to a large extent is not automatically covered by Beijing anymore. Some banks and research houses lowered their estimates for 2015 to 6.5%. The government might tolerate a slightly lower growth rate, but that would probably still be close to 7%. Premier Li Keqiang said it would not be easy to reach this target.

Managing debt is the key priority for China. The overall debt level has reached 217% of GDP. Further interest rate cuts are likely, but lower interest rates increase the risk of a renewed surge in borrowing. Beijing also follows other policy lines regarding debt: **The ministry of Finance (MoF) has announced that 1 trillion of Yuan off-budget local government debt will be refinanced as municipal bonds.** Interest rates on these bonds will be around 4%, a good 3% less than before. The size of the local government bond market thus increases dramatically. Other priority topics are the deposit insurance scheme, pension and health care insurance, free trade zones, the capital market opening and the reform framework for state owned enterprises (SOE).

March 31st

The responsible government body announced that the **deposit-insurance scheme** will be introduced as of This is a step towards further interest rate liberalization. For the first time in China, a bankruptcy law and settlement procedure for insolvent banks is being installed. Deposits up to 500'000 Yuan (approx. USD 80,000) are covered by the deposit insurance, which applies to accounts of private individuals and companies. According to the People's Bank of China (PBoC) 99.3% of all bank accounts are protected – but less than half of all deposits. The potentially unprotected accounts are mainly company accounts, including many SOEs.

Under the new deposit-insurance scheme, deposit rates will likely increase closer towards market rates. According to Capital Economics, if deposit rates go up 1%, household income would increase by approximately 0.8% of GDP, supporting consumption. Bank net interest margins will deteriorate but because they are so high, most banks will be able to cope. Although interest rate liberalization alone will not remove inefficient capital allocation and the quasi state guarantee for most large SOEs, it is a long-awaited step in the right direction.

Important Indicators

	Mar 2015	Feb 2015	Jan 2015	Dec 2014	Sep 2014
Quarterly GDP, growth yoy (%)	**–**	–	–	7.3	7.3
Retail sales of consumer goods, growth yoy, real (%)	**–**	11.0	11.0	11.5	10.8
Official Consumer Confidence Index	**–**	109.8	105.7	105.8	105.4
China Confidential Labor Demand yoy Index	**–**	66.0	68.4	72.6	68.1
Real estate floor space newly started, growth yoy (%)	**–**	–17.7	–17.7	–10.7	–9.3
ChinaConfidential mom Home Price Index	**–**	50.2	51.7	51.5	50.0
CPI, growth yoy (%)	**1.4**	1.4	0.8	1.5	1.6
PPI, growth yoy (%)	**–4.6**	–4.8	–4.3	–3.3	–1.8
CFLP PMI	**50.1**	49.9	49.8	50.1	51.1
HSBC/Markit PMI	**49.6**	50.7	49.7	49.6	50.2
Fixed-asset investments, growth yoy (%)	**–**	13.9	13.9	15.7	16.1
Required ReserveRatio (large banks) (%)	**19.0**	19.0	19.5	19.5	19.5
Benchmark rate for 1-year loans (%)	**5.35**	5.35	5.60	5.60	6.00
Benchmark rate for 1-year deposits (%)	**2.50**	2.50	2.75	2.75	3.00
New total social financing, growth yoy (%)	**–**	44.0	–21.0	35.0	–26.0
New bank loans, growth yoy (%)	**–**	77.0	11.0	44.0	9.0
Exports, growth yoy (%)	**–15.0**	48.3	–3.3	9.7	15.3
Imports, growth yoy (%)	**–12.7**	–20.5	–19.9	–2.4	7.0
Trade balance (USD billion)	**3.1**	60.6	60.0	49.6	30.9
Electricity consumption, growth yoy (%)	**–**	2.5	2.5	3.8	3.9
Freight Traffic, growth yoy (%)	**–**	9.2	7.9	7.1	7.7
Iron ore imprts (million tons)	**–**	67.9	78.8	86.9	84.7
Coal imports (millions tons)	**–**	15.3	16.8	27.2	21.2
Crude oil imports (million tons)	**–**	25.6	28.0	30.4	27.6
Bloomberg Commodities Index	**98.12**	103.44	100.84	104.33	118.69
CSI 300 (China Equity Index)	**4 051.0**	3 572.8	3 434.4	3 533.7	2 451.0
RMB trade-weighted, indexed (2010=100)	**–**	123.6	123.1	121.5	116.0
RMB / USD spot	**6.13**	6.14	6.13	6.13	6.15

Source: ChinaIntelligence

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