ChinaIntelligence
Investment and business advice on China

中國智慧

themonthlydragon #4

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Don't underestimate Beijing

Amid a structural downward trend, China's economy is holding up quite well. However, tight credit hinders the cyclical recovery. Beijing keeps a sharp eye on the labor market.

The West should get used to the fact that the Chinese economy is slowing down. This has nothing to do with a hard landing but with structural reforms, rebalancing of the economy and base effects. As mentioned in previous reports, we expect no hard landing but gradually declining growth rates. To maintain this gradual slowing and avoid an uncontrolled slip, Beijing must reverse to well-known policies like boosting infrastructure investments. This does not ease the debt problem – debts which eventually will be transferred to the public – and further slows economic growth in the long run. The main issues at the moment are insufficient credit growth and signs of weakness in the labor market. We want to point out that some major risks to the Chinese economy also lie outside of China: the possibility of strongly rising US interest rates, coupled with a hefty appreciation of the USD.

HIGHLIGHTS

- *GDP: on target, but growth rates declining*
- *PMI: stable and in slightly expansionary territory*
- *PBoC benchmark interest rate and targeted RRR cuts*
- *Credit growth: still dangerously low*
- *Real estate: strong home sales and higher prices*
- *Trade data: weak imports, sluggish exports*
- *Equity markets: volatility redefined*

In June, the industrial sector remained weak. However, policy support started to show traction and the rate of contraction eased. The purchasing managers' indices (PMIs), the earliest available indicators for industrial output in China, came in slightly lower than expected – but stable – and showed **a further stabilization of economic activity in June.** The official PMI for manufacturing in June showed a value of 50.2, unchanged from May and in slightly expansionary territory. This official value is heavily biased in favor of large enterprises and somewhat overstates actual conditions. **The situation for smaller firms has deteriorated, and they have not profited from increased infrastructure investments.** Therefore, the HSBC PMI, which encompasses more small and medium size enterprises, came in at 49.4.

The overall stable PMI was driven by a steady growth in production. Downward pressure came from the new orders and employment sub-indices. The stable PMI does not capture the fact that many industrial enterprises – especially in the heavy industry sector – face default risks due to lower margins and declining profitability. The non-manufacturing PMI increased from 53.2 in May to 53.8 in June and continues to show a satisfactory pace of expansion. Electricity data underline this trend: While electricity consumption in the light industry, tertiary and residential sectors increased significantly, it continued to go down in the power-hungry heavy industry.

Trade challenges

Exports are sluggish. **Demand for Chinese exports was weak in all major export markets.** New export orders continue to decrease. Combined with even faster declining imports, this led to a trade surplus of almost USD 60 billion for May (see chart #1, next page). The export outlook remains pessimistic, export conditions have deteriorated, and the relevant indices turned negative. **Since the People's Bank of China (PBoC) seems to have put a soft RMB-USD peg in place, the RMB's trade-weighted appreciation or depreciation against its Asian trading partners largely depends on the USD's development.** Despite all this,

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one should not forget that trade data can be highly distorted by seasonal and statistical effects and should be treated with care.

The low import figures stem mainly from the price collapse of imports of key commodities during the last year. But they also highlight the problems of the heavy industry in China. **These figures, however, should improve in the coming months as the comparison base (yoy) will soon be much lower due to the sharp fall of commodities prices in H2 2014.** In addition to that, manufacturing input prices rose, suggesting a stabilization of commodity prices.

In May, **consumer price inflation** was 1.2% (yoy), down from 1.5% in the previous month. A fall in food price inflation, which came in at 1.6% (2.7%), was responsible for this decline, while non-food prices increased by 1% (0.9%). Producer prices declined by 4.6% yoy; they still are on an absolute steep decline, caused by low commodity prices and lingering overcapacities. But as is the case for import figures, the yoy-comparison base will adjust for lower commodity prices soon, which should push up CPI and PPI.

Credit problems

Overall, growth is stable due to policy-driven stronger domestic demand. **Construction activity is the key demand factor for industrial goods.** Beijing takes some pressure off local government debt by loosening restrictions on the financing of local government financing vehicles, which helps infrastructure investment growth **(for more details see themonthlydragon #3).**

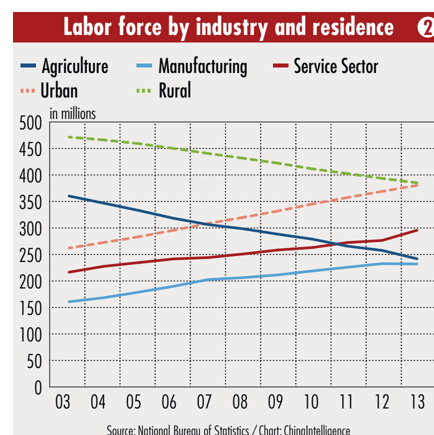
In recent weeks, home price growth accelerated at the fastest pace since December 2013. Home sales growth continued to rise in June, albeit somewhat slower than in the previous three months. The underlying demand is strong. While financing conditions for real estate developers improved, **the financing for home buyers remains relatively expensive despite targeted policy measures.**

The main problem for a sustainable recovery of the Chinese economy is tight credit. Net new medium- and long-term loans fell sharply in the last weeks. Credit growth also shows continued weakness due to tighter regulations of shadow banking. Beijing's local government debt swap should definitely help credit growth and infrastructure investment, but the transmission to the real economy is lagging.

Equity market turbulences

Last month, we wrote that we expect another 25 bps cut in benchmark lending rates later this year and a large reduction in the reserve requirement ratio (RRR). In the meantime, the PBoC reduced benchmark deposit and lending rates by another 25 bps and introduced targeted 50 bps RRR cuts. **These steps were also taken due to sharp drops in the equity market and happened one day after the Shanghai Composite Index fell 7.4%,** although Beijing did not announce them like that. The PBoC actions highlight the strategic importance of domestic equity prices and that the bull market is also policy-led to attract overseas money back to mainland China. Strong equity prices also support the reform and privatization of state owned enterprises (SOEs). **Beijing is very unlikely to let the equity markets crash much further, at least until president Xi Jinping is well into his second term.**

The Chinese equity markets experienced a highly turbulent month, and the fast and extreme rally halted abruptly in mid-June when the Shanghai Composite suffered losses of 22% (Shenzhen Composite –25%) within two weeks. **However, as foreigners own less than 2% of the affected stocks, investors outside China do not suffer, and there is no contagion.** Year-to-date, A-share performance still was phenomenal, with 32% for the Shanghai Composite and 74% for the Shenzhen Composite through the end of June. For a detailed analysis of the Chinese equity rally please see «thequarterlydragon #2».



Labor issues

Beijing is not only keeping a keen eye on equity prices but also on the labor market. The main reasons for this are to keep consumption up and – maybe more importantly – to avoid labor issue-induced social unrest. **And as with the equity market, Beijing's willingness and ability to steer economic parameters in the desired direction should not be underestimated – although the means and their consequences can be criticized.**

In recent years, we have observed three major trends in the labor market: **a shift of labor from the state sector to the private sector, from manufacturing to service related jobs and from rural areas to urban areas** (see chart #2). The service sector has added more value to GDP than the industrial sector for the past two years. 80% of new jobs in urban areas are created in the service sector, by private companies, but the majority of all employees are still working for SOEs. Interestingly, in Shanghai, one-third of university graduates still want to work for public institutions, one-third for foreign companies and a hefty 23% for SOEs. Only 10% want to work for private Chinese enterprises (source: www.stats-sh.gov.cn). All sectors and regions have experienced high single- to double-digit average wage growth year after year. Only last year that figure slipped below 10% but still significantly outpaced GDP growth.

Since the beginning of the year, China's labor market has sent conflicting signals consisting of layoffs in the manufacturing sector due to cost programs, a decreasing employment index and at the same time a tight labor market in some areas (services, highly skilled manufacturing). **Responsible for this contradictory development is the large scale structural change in the Chinese economy** and the fact that overall the cost of labor is more and more determined by the service sector.

In June, an increase in labor demand was offset by a decline in manufacturing and construction. The urban registered unemployment rate has been hovering at somewhat above 4% for years. But even Beijing admits this figure is not that relevant as the work status of hundreds of millions of migrant workers is not sufficiently registered.

One of the key questions Beijing has to address is at what speed wage growth can continue among overall declining growth rates – and what to do with laid-off

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unskilled workers. We will publish a detailed structural analysis of China's labor market in our next «thequarterlydragon».

What does this mean:

- Overall, economic growth is stable due to policy-driven stronger demand in domestic activity.
- Industrial activity is stable. Heavy industry enterprises suffer from overcapacities and declining profitability. Smaller firms suffer from difficult financing conditions, and they cannot profit from the pickup in infrastructure investments.
- The service sector is robust and expanding.
- Import and export growth is at sub-par levels due to weaker demand and the comparison base.
- The property market is resilient; there still is a shortage in low-level housing in the cities.
- Tight credit and overall high financing costs hinder a sustainable recovery and stabilization of the economy.
- Government action in the form of easing (interest rate and RRR cuts, elimination of the loan-to-deposit ratio cap for banks, banking reform, etc.) will continue.
- Beijing will keep a very sharp eye on the labor market and pursue all necessary means to contain unemployment – to keep consumption high and to avoid social unrest.
- Risks remain, maybe more so outside of China than inside China. The main risk to our core scenario (see below) are strongly rising US interest rates, coupled with a strong appreciation of the USD.

Important Indicators

	June 2015	May 2015	April 2015	Mar 2015	Dec 2014	Sep 2014
Quarterly GDP, growth yoy (%)	–	–	–	7.0	7.3	7.3
Retail sales of consumer goods, growth yoy, real (%)	–	10.2	9.9	10.2	11.5	10.8
Official Consumer Confidence Index	–	109.9	107.6	107.1	105.8	105.4
FTCR Labor Demand yoy Index	–	67.5	85.4	76.0	72.6	68.1
Real estate floor space newly started, growth yoy (%)	–	–16.0	–17.3	–18.4	–10.7	–9.3
FTCR mom Home Price Index	–	58.4	60.6	55.0	51.5	50.0
CPI, growth yoy (%)	–	1.2	1.5	1.4	1.5	1.6
PPI, growth yoy (%)	–	–4.6	–4.6	–4.6	–3.3	–1.8
PMI manufacturing	**50.2**	50.2	50.1	50.1	50.1	51.1
HSBC/Markit PMI	**49.4**	49.2	48.9	49.6	49.6	50.2
Fixed-asset investments, growth yoy (%)	–	11.4	12.0	13.5	15.7	16.1
Required ReserveRatio (large banks) (%)	**17.5**	18.0	18.0	19.0	19.5	19.5
Benchmark rate for 1-year loans (%)	**4.85**	5.10	5.35	5.35	5.60	6.00
Benchmark rate for 1-year deposits (%)	**2.00**	2.25	2.50	2.50	2.75	3.00
New total social financing, growth yoy (%)	–	–12.9	–31.0	–44.0	35.0	–26.0
New bank loans, growth yoy (%)	–	–2.3	3.9	–5.1	44.0	9.0
Exports, growth yoy (%)	–	–2.5	–6.4	–15.0	9.7	15.3
Imports, growth yoy (%)	–	–17.6	–16.2	–12.7	–2.4	7.0
Trade balance (USD billion)	–	60.0	34.1	30.8	49.6	30.9
Electricity consumption, growth yoy (%)	–	1.1	0.9	0.8	3.8	3.9
Freight Traffic, growth yoy (%)	–	–	4.1	4.5	7.1	7.7
Iron ore imprts (million tons)	–	70.9	80.2	80.5	86.9	84.7
Coal imports (millions tons)	–	14.3	20.0	17.0	27.2	21.2
Crude oil imports (million tons)	–	23.2	30.3	26.8	30.4	27.6
Bloomberg Commodities Index (BBIX)	**102.69**	100.95	103.75	98.12	104.33	118.69
CSI 300 (China Equity Index)	**4 473**	4 841	4 749	4 051	3 534	2 451
RMB trade-weighted, indexed (2010=100)	–	124.9	125.9	126.1	121.5	116.0
RMB / USD spot	**6.20**	6.20	6.20	6.21	6.20	6.15

Source: ChinaIntelligence

Key developments we expect for the coming 12–24 months

We expect political, economic and financial stability despite all the looming challenges. Regarding some key topics our expectations are:

- *GDP growth: 2015 around 6.5%, 2016: 5.5% to 6%.*
- *Labor market: stable, with continued wage growth of between 4-7% p.a., at the lower end for high-wage earners, at the higher end for low-wage earners*
- *Interest rates: 1-2 additional cuts in the benchmark rates in 2015, each by approx. 25 bps.*
- *No big stimulus program, but a multitude of smaller and targeted measures and reforms to support the economy.*
- *Real estate prices: a stabilization of prices and demand towards the end of 2015 and 2016.*
- *Property developers: some will face liquidity difficulties and may have to restructure their outstanding bonds.*
- *RMB: slightly weaker (2-3%) from the current rate of 6.20 RMB per USD.*
- *Retail sales growth: approx. 10% p.a.*

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