



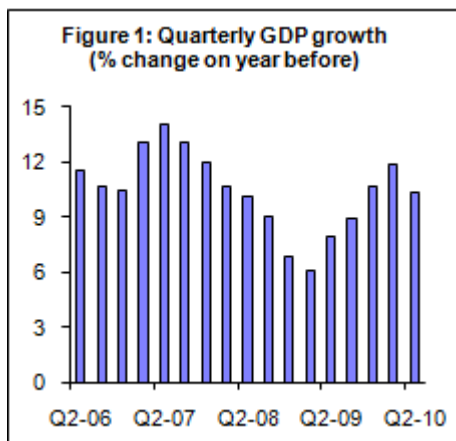
British Embassy
Beijing

China Economic Focus – July 2010

Summary

- China's economy grew at a rate of 10.3% in the second quarter of 2010, down from 11.9% in the first quarter. Fixed asset investment (which accounts for 40% of GDP) continues to moderate, but remains relatively robust – growing at a rate of 25% in the first half of the year, compared with a rate of over 33% early last year. Industrial production growth slowed to 13.7% in June. The official Purchasing Managers' Index (PMI) tells a similar story.
- The slowdown is the result of deliberate steps taken by the authorities earlier this year to cool the property market, reduce excess capacity in certain industries (e.g. steel), crackdown on the use of local government investment vehicles, and reduce central government spending on infrastructure. Consumer demand remains relatively robust – retail sales (albeit an imperfect indicator) rose at a rate of 18.3% in June.
- China is still on track to beat its 8% growth target this year and overtake Japan to become the world's second largest economy. The IMF recently raised their growth forecast for 2010 to 10.5%. That would make China the fastest growing major economy. The OECD predicts 11% growth this year (and believe China will account for a third of global growth), and the World Bank forecast 10%. But should growth slow more sharply than expected the authorities have deep pockets, the ability to ramp up state bank lending again, and could unwind recent policy 'fine tuning' in order to support employment - their primary objective. But they will be reluctant to do so, as it would run contrary to their aim of restructuring the economy.
- Goods exports continue to surge, rising at a rate of 43.9% (though down from May's 48.5% rise). June's record \$137.4 billion of exports was just above the pre-crisis peak of July 2008 (and compares with a crisis low of \$65 billion in February 2009). Imports rose at a rate of 34.1% in June, down from May's 48.3% rise. The monthly trade surplus rose slightly, to \$20 billion, in June. But given uncertainties over the global economic outlook the authorities will only allow the bare minimum appreciation of the renminbi against the dollar necessary to keep US Congressional pressure at bay.
- Consumer price inflation was 2.9% in June, down from 3.1% in May. Slower credit and economic growth has weakened inflationary pressure. Vice-governor Du Jinfu said at the recent China-UK SME Finance Forum that the central bank (PBoC) was confident of hitting their inflation target of 3% for 2010. Property prices fell 0.1% in June on the month before - the first month-on-month fall in official property prices since February 2009. The volume of property sales continued to slow in June.
- Agricultural Bank of China (ABC) was finally listed in Shanghai on 15 July and Hong Kong on 16 July. Shares only rose 0.8% in Shanghai and 2% in Hong Kong on their debut. China now has four of the ten largest banks in the world, by market capitalisation.

Domestic economy has lost some its steam.....



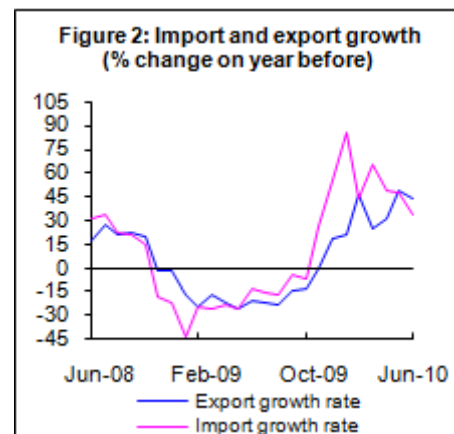
1. China’s economy grew 10.3% in the year to the second quarter of 2010, down from 11.9% in the year to the first quarter (see Figure 1). Fixed asset investment (which accounts for 40% of GDP) continues to moderate but remains relatively robust – growing at a rate of 25% in the first half of the year, compared with a rate of over 33% early last year. A reduction in new infrastructure projects and tighter restrictions on the use of arms-length investment vehicles by local governments (which had become an increasing concern) has slowed investment growth. These measures have also fed through to a cooling in industrial activity - industrial production growth slowed to 13.7% in June. The official Purchasing Managers’ Index (PMI) tells a similar story.

..... but no need to panic

- Confirmation that China’s economy is slowing is more a cause for cheer than concern. Earlier this year China’s economy was overheating - with local property bubbles and rising inflationary pressure serious concerns. The authorities had deliberately sought to take some of the heat out of the economy. But they have done this through targeted measures (or policy “fine tuning”), such as tightening lending to the property market and sectors suffering from overcapacity, refraining from launching new infrastructure projects, cracking down on the use of local government investment vehicles, and increasing bank’s reserve requirements - rather than shifting from their ‘moderately loose monetary policy and proactive fiscal policy’.
- Investment and industrial activity may be growing at a slower pace but consumer demand remains relatively robust – retail sales (albeit an imperfect indicator) rose at a rate of 18.3% in June (although car sales growth slowed to a 14-month low of 19.4% in June, possibly due to recent labour strikes at a number of car factories). Exports have returned to their pre-crisis peak (see next section). China is still on track to beat its 8% growth target (the level the authorities believe is necessary to create enough jobs to maintain social and political stability) this year and overtake Japan to become the world’s second largest economy. The IMF recently raised their growth forecast for 2010 to 10.5%. That would make China the fastest growing major economy. The OECD predict 11% growth this year (accounting for a third of global growth), and the World Bank forecast 10%. But should growth slow faster than expected the authorities have deep pockets and the ability to ramp up state bank lending again to support employment - their primary objective. But they will be reluctant to do so, as it would run contrary to their aim of restructuring the economy.

Exports still surging.....

4. Goods exports rose at a rate of 43.9% in June (down from May’s 48.5% growth). June’s record \$137.4 billion of exports was just above the pre-crisis peak of July 2008 (and compares with a crisis low of \$65 billion in February 2009). Imports rose 34.1% in June on a year earlier, to \$117.4 billion, down from May’s 48.3% rise (see Figure 2). The monthly trade surplus rose to \$20 billion in June, up from May’s \$19.5 billion and 140% higher than June 2009. The EU remained China’s largest trading partner in the first half of the year with a bilateral trade

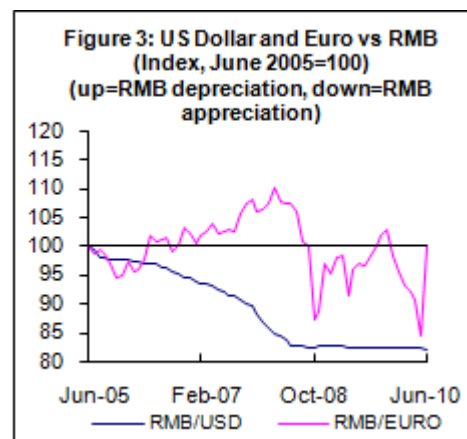


volume of \$219.4 billion (up 37.2% on a year earlier) followed by the United States (\$172 billion), Japan (\$136.6 billion) and ASEAN (\$136.5 billion, up 54.7% on a year earlier). China-Brazil trade surged 60.3% to \$26.4 billion in the first six months of this year.

- China's foreign reserves reached \$2.45 trillion at the end of June. But foreign reserves only increased \$7.2 billion in the second quarter, sharply lower than the \$47.9 billion increase in the first quarter. According to the central bank, PBoC, the smaller increase in foreign reserves was largely explained by the depreciating euro. But the slower rate of accumulation in the second quarter (despite a higher trade surplus) also implies significant capital outflows and greater overseas investments by Chinese companies in recent months. The outlook for China's property and equity markets has weakened in recent months (the stock market has fallen 25% to date this year). The recent de-pegging of the renminbi from the US dollar may also have been a factor.

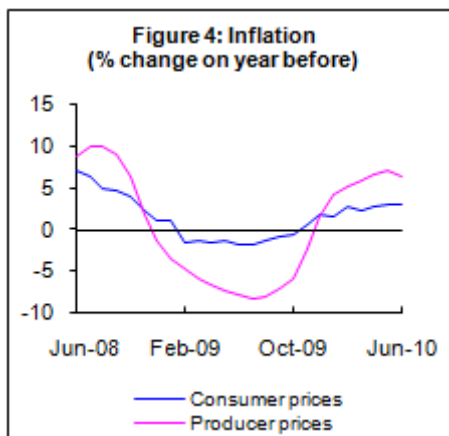
.....but renminbi appreciation likely to be limited this year

- On 19 June the authorities reverted to their pre-crisis policy of allowing +/-0.5% intra-day fluctuation in the value of the renminbi against the dollar. It has since appreciated by 0.6% - equivalent to an annual rate of around 6.2%. But that pace is unlikely to be maintained and only limited appreciation of the renminbi is likely in the next 12 months. Despite the recovery in exports the authorities remain concerned about the global economic outlook and there are signs that export orders have weakened slightly.



- In July the US Treasury once again refrained from labelling China a currency manipulator, in its delayed report to Congress. But Congress is not satisfied with the limited move in China's currency – given the recovery in China's exports and higher monthly trade surplus in June. The authorities will need to allow the renminbi to appreciate further if they are to avoid a serious escalation in US-China trade tensions – but they will only allow the bare minimum appreciation against the dollar necessary to keep US (Congressional) pressure from boiling over. In its defence China points to the fact that its trade surplus fell 42.5% in the first half of this year (on the same period last year). China's current account surplus was \$53.6 billion in the first three months of this (4.5% GDP). According to the authorities, China's current account surplus is expected to decline in 2010, for the second year in a row, as domestic demand is making a greater contribution to growth.

Inflationary pressure has abated.....



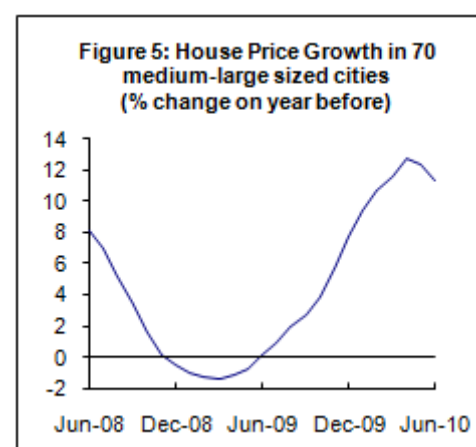
- Consumer prices rose 2.9% in June on a year earlier, lower than May's 3.1% increase and below the authorities' inflation target of 3% (but this is for the year as a whole and is more of an aspiration than a binding target, unlike the Bank of England's). Central bank officials have told us the authorities can easily tolerate consumer price inflation up to 5%, above which level they would start to become concerned about social and political stability. Food price inflation was 5.7% in June, lower than in May. Producer price inflation was also lower in June, at 6.4%.

- In addition to slower economic growth, weaker credit growth has reduced inflationary pressure. Banks extended fewer new loans in June than in May. Total new lending in the first half of this year was

RMB 4.6 trillion (£450 billion), down 37% on the same period last year. The authorities lending target for 2010 is RMB 7.5 trillion (£728 billion) – but this is an aspiration rather than a binding cumulative quota. Money supply growth slowed to a rate of 18.5% in June, down from 21% in May. The official benchmark lending rate and deposit rates have been maintained at 5.31% and 2.25% (now negative in real terms), respectively, since December 2008. But while the scope for the authorities to raise interest rates has increased (less of a concern over exacerbating hot money inflows), the need to do so has diminished. Vice-governor Du Jinfu of the central bank (PBoC) said at the China-UK SME Finance Forum on 19 July that the authorities are confident of hitting their inflation target of 3%. But he said although inflationary pressure had eased, uncertainties remained – including the potential impact of recent floods in southern China. At a Politburo meeting on 22 July President Hu and Premier Wen reiterated that the authorities were sticking to their ‘proactive fiscal policy and moderately loose monetary policy’.

... and property market continues to cool

10. Property prices rose 11.4% in June on a year earlier, lower than May's 12.4% rise. But the average price for homes in 70 major cities fell 0.1% in June on the month before - the first month-on-month fall in official property prices since February 2009. The volume of property sales continued to slow in June. But the central government is resolute in its goal to deflate local property bubbles in a handful of major cities. On 13 June the authorities repeated their tough stance on the property market, saying that policies to tame rapidly rising prices would be maintained. On the same day the banking regulator, CBRC, also dismissed recent rumours that restrictions on second-home mortgages would be loosened.



11. Measures have largely been focused on reducing speculation, not cooling the underlying demand for housing (which remains high given urbanisation). And the announced significant expansion in affordable housing should help offset the anticipated reduction in private housing construction in a handful of major cities. But some economists, including Liu Yuhui of the Chinese Academy of Social Sciences (CASS), argue the authorities should relax the restrictions put in place earlier this year - as they risked causing the economy to slow more sharply than expected. Recent reports suggest the authorities will introduce a property holding tax in the next few years, aimed at reducing speculation and providing local governments with an additional source of revenue.

Agricultural Bank of China listed

12. The long awaited initial public offering (IPO) of Agricultural Bank of China (ABC) took place in Shanghai on 15 July and Hong Kong on 16 July. Predictably the offering was oversubscribed (11 times in Shanghai and 5 times in Hong Kong), but investor sentiment towards ABC has been mixed. Shares only rose 0.8% in Shanghai (though the market as a whole was down) and 2% in Hong Kong on their debut. After listing, ABC became the world's seventh largest bank by market capitalisation (China now has four of the top ten).

13. On 11 June the bank announced its net profits rose 26% in 2009, and ABC predicts 30% profit growth this year. But despite a generous interest rate margin, maintained by the government's policy of setting different benchmark lending and deposit rates, ABC's net interest income fell 9.2% last year. The relatively high proportion of lending to rural areas and the size of the bank's branch network are a drag on its operating profits. But like

other major Chinese banks, non-interest income (e.g. advisory fees and sales of investment products) is becoming an increasingly important source of revenue for ABC, rising 50% in 2009 (but from a low base). ABC's capital adequacy ratio, at 10.1%, is good by international standards but is below the banking regulator's requirement of 11.5%. ABC's loan loss provisioning rate, at 105%, is also below the regulator's target, 150%. Like other state banks, ABC saw a jump in its lending last year (to help finance the stimulus package). Some of these loans are likely to turn sour. But investment in ABC is largely seen as a bet on China's long-term growth potential - hence institutional investors, who normally only account for 10% of transactions in Shanghai, bought half the shares issued.

14. Standard Chartered made a US \$500 million 'cornerstone' investment in ABC in the Hong Kong IPO. It hopes to expand its renminbi business by partnering with ABC to provide international financial services to ABC's corporate clients and to expand its renminbi settlement business in Hong Kong. ABC is also seeking to expand its international presence. It has had a representative office in London for 18 years but is currently in the process of upgrading this into a full subsidiary.
15. Chinese companies have raised RMB 251 billion (£24.4 billion) from IPOs in the first half of this year, compared with RMB 187.9 billion (£18.2 billion) in the whole of 2009. Most of the IPOs in the first half were by small and medium-sized enterprises (SMEs) listing on the special ChiNext board in Shenzhen (launched last October). As of 30 June, 90 SMEs had listed on ChiNext.

China and UK discuss ways to improve SME's access to finance

16. On July 1 the PBoC and the three financial regulators issued a joint statement announcing new measures to ease the financing problems faced by SMEs. China's SMEs account for 60% of GDP, 80% of employment, and 65% of exports. But banks are reluctant to lend to SMEs because of the higher risks involved. During the National People's Congress (NPC) in March, Premier Wen said RMB 10.6 billion (£1 billion) would be allocated this year to support the development of SMEs. He also said SMEs would enjoy more preferential tax policies and easier access to finance this year. At the China-UK SME Finance Forum in Beijing on 19 July around 150 government officials and practitioners discussed ways of improving SME's access to finance – focusing on credit collection and assessment, loan guarantees, and definitions of collateral.

China's outward FDI rising rapidly

17. China's total outward financial direct investment (FDI) rose 24% in the first half of this year (on the same period last year), to \$55 billion. FDI in non-financial sectors rose 43.9%, to \$17.8 billion. There were a record 74 new Chinese FDI projects into the UK last financial year. But despite the rapid growth in Chinese outward investment, the Ministry of Commerce recently accused other countries, in particular India and the US, of protectionist policies against Chinese FDI.
18. From 1 September Chinese banks will no longer need to secure special approval from the State Administration of Foreign Exchange (SAFE) to make investments overseas. The relaxation of the regulations will apply to the funding of overseas branches and subsidiaries, and equity investments in foreign companies. But Chinese banks seeking to expand overseas will still have to obtain approval from the banking regulator, CBRC.

QFII license holders will be able to invest in stock index futures

19. State media reports suggest the securities regulator, CSRC, will allow Qualified Foreign Institutional Investors (QFII) to invest up to 10% of their permitted investment quotas in stock index futures. But no timeframe has been given for the implementation of this policy. As of the end of June, 89 foreign financial firms held QFII licences and a combined quota of around RMB 120 billion (£11.7 billion).

CIRC relaxes investment restrictions on insurance firms

20. The insurance regulator, CIRC, recently announced that insurance companies would officially be able to invest in a broader set of assets in the second half of this year, including property and unlisted companies, and would be able to use interest rate swaps if the company had proven risk management capabilities. But according to the announcement, insurance companies could only use interest rate swaps for hedging, not for speculative purposes, and investments in interest rate swaps should not exceed 10% of their fixed-income assets. The announcement marks the culmination of a pilot programme, started in 2006, to allow selected insurers to trade interest rate swaps to hedge against interest rate risks. As of the end of June, 30.5% of the insurance sector's RMB 4.2 trillion (£407 billion) in assets was invested in savings deposits, 51.8% in bonds, and only 15.1% in stocks and other equity-linked assets. The authorities also recently suggested weather insurance could be introduced later this year (to be piloted first in Fujian province).

Dagong becomes first non-Western rating agency to assess sovereign risks

21. Dagong Global Credit Rating Company recently became the first non-Western rating agency to assess international sovereign credit risks. Dagong, perhaps unsurprisingly, gave China a very positive rating - on the basis of China's relatively low debt, large foreign exchange reserves, strong growth prospects, and political stability. Other emerging economies were also rated more positively by Dagong than they have been by the three leading Western agencies - Moody's, Standard & Poor's, and Fitch. The US, UK, France and some other developed countries were given less positive ratings by Dagong, given their slower economic growth and larger debt burdens. Dagong's ratings have been portrayed in the state media as an attempt to break up the Western oligopoly that China believes deserves a fair share of the blame for the financial crisis.

New measures announced to increase renminbi use in Hong Kong

22. On 19 July the Hong Kong Monetary Authority (HKMA) and the PBoC signed an agreement to allow Hong Kong banks to establish renminbi accounts for financial institutions and allow them to provide related services. Individuals and corporations will also be able to conduct renminbi payments and transfers through the banks. This will enable local financial institutions to launch more renminbi denominated financial products. The PBoC and the Bank of China (the renminbi clearing bank in Hong Kong) also signed a revised Settlement Agreement, which will allow interbank transfers of renminbi deposits in Hong Kong. Both agreements are aimed at increasing the level of renminbi in circulation in Hong Kong and are another step in the gradual process of 'regionalisation' of the renminbi. Analysts estimate the level of renminbi deposits will increase from the current level of about RMB100 million (£9.7million), to RMB 1 trillion (£97 billion) in the next five to ten years.

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