ChinaIntelligence
Investment and business advice on China

themonthlydragon #2

May 1, 2015

HIGHLIGHTS

- *GDP: Q1 2015 at 7% and in line with expectations*
- *PMI: stays in slightly expansionary territory*
- *PBoC: RRR cut of 1% down to 18%*
- *Credit growth: slower*
- *Real estate: home sales up in April*
- *Bond markets: first SOE default*
- *Equity markets: the rally continues*

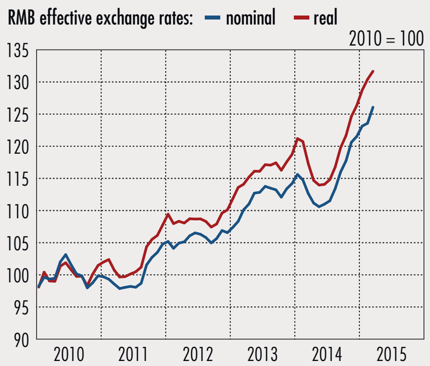
China: weak industrial sector, strong consumption and misunderstood QE

The weak start of the Chinese economy into the New Year and overall disappointing macro data were substantiated by the Q1 2015 GDP reading. From January to March 2015 China's economy grew at a rate of 7%. This is down from 7.3% in Q4 2014 and the lowest reading since 2009. The property downturn, factory overcapacity, sluggish exports and high levels of local government debt are slowing the economy down.

Some of the Q1 2015 weakness was due to temporary factors. But the fact that industrial production slowed down to 6.4%, a 6-year low, is a clear sign of **pronounced and prolonged lower growth rates.** Solid infrastructure investment and a robust service sector helped, but could not outweigh the downward pressures. Monetary conditions tightened, deflationary pressures lingered, there were significant capital outflows, and credit growth slowed significantly.

In March, total social financing (the aggregate of all lending activities) fell sharply, new bank loans dropped 5% yoy. Policy support followed immediately: the People's Bank of China (PBoC) cut the reserve requirement ratio for commercial banks (RRR) by 1 percentage point and Beijing is planning measures to increase policy bank lending (e.g. to the China Development Bank) with more pledged supplementary lending.

Continued RMB strength ❶



Source: Bank for International Settlements / Grafic: ChinaIntelligence

In mid-April, **export data for March shocked quite a few observers.** China's exports dropped by 15% yoy in March, while imports declined by 12.7% yoy, leading to a substantially reduced trade surplus for the month. The decline in imports reflects the weakening economic growth, low prices for imported commodities and the gradual reorientation of the Chinese economy towards a more internally-sourced, consumer-led economy. Falling exports are no surprise in light of the substantial strengthening of the trade-weighted RMB in recent years. Please see chart # 1, showing an **appreciation in the trade-weighted RMB of 26% over the last 5 years** (nominal), and an appreciation of 31% (adjusted for purchasing power).

Inflation in consumer and producer prices is low (see monthlydragon #1, dated April 1, 2015). Producer prices are still on an absolute steep decline, mostly induced by low commodity prices and lingering overcapacities.

Slow-down, despite ok PMI readings

The purchasing managers' indexes (PMIs), the earliest available and most prominent indicators for economic activity and industrial output in China, showed a **stabilization in April.** The readings in January and February were below the growth line with values of 49.8 and 49.9 respectively. The official PMI for manufacturing in March came in at 50.1, April data showed the same value. While 50.1 is slightly better than expected it is barely in the expansion zone. The newest PMI was supported by a pick-up in industrial output, new orders were flat, new export orders declined slightly, and the sub-index for employment was weaker.

The stable PMI is some good news after the previous series of poor data, but not too much emphasis should be put on it. It is biased towards large, mainly state-owned companies. In April, large enterprises still fared better than small- and medium-sized ones. However, the PMI of large-sized enterprises was 50.6, which is a decrease of 0.9 percentage points from March. The readings for medium and small enterprises were 49.8 and 48.4 respectively, an increase of 1.5 percentage points month-on-month. While this still is below the threshold of 50 it shows a significant improvement – the performance divergence between small and large companies is narrowing. **Since the private sector of the economy, which consists of smaller enterprises than the state controlled sector, is responsible for more than 80% of urban job creation, this is good news.**

The service sector and retail sales held up quite well, despite the RMB's strength. The official non-manufacturing PMI cooled slightly to 53.4 (53.7), a 15-month low. This indicates the relative strength of the service sector compared to the industrial sector. But both manufacturing and service PMIs showed that companies continued to reduce staff in April. This is somewhat confusing, as other data show a continuously robust labor market and ever rising wages.

The property market continues to be one of China's heaviest burdens on growth, due to its prominent role for the economy and its broad interdependencies with other sectors. **Newest property bureau data suggest that home sales rose sharply in April.** Transactions may have increased almost 20% from last month and about 30% year-on-year. This is unusual considering that home sales usually are weak in April. Housing inventories fell as a result, although residential floor space available for sale still is much higher than during the same period last year. But there seems to be a stabilization; the newly introduced, loosened restrictions for property ownership at local levels are beginning to show results. However, **mortgage lending slowed in March,** after a very strong January and February, which is worrying. Also in the coming months, the property sector needs very close attention due to its huge impact on the economy.

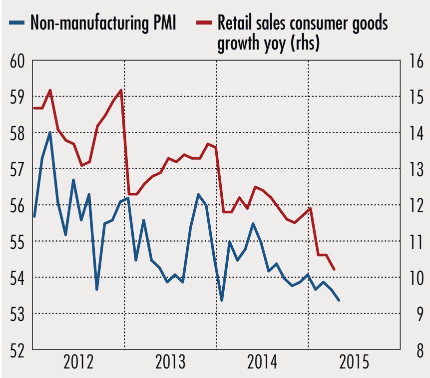
Beijing's growth target for 2015 is set at 7% «or slightly lower». We maintain our GDP forecast for 2015 at 6.5% and for 2016 at 5.5% to 6%. However, we would like to point out that the Chinese policymakers have a history of reaching their goals «at all costs». Therefore the ongoing necessary adjustments and the rebalancing of the economy from an investment-driven towards a more consumption-oriented model could be slowed down somewhat in order to achieve the officially stated growth target. Should the labor market – Beijing's main focus – remain robust and wage growth continue at between 5% and 8%, the government could allow a growth rate of less than 7%.

What does this mean?

- The industrial sector is weak. In Q1 2015 industrial output rose only by 6.4% (+8.7% in Q1 2014). This puts a heavy burden on the economy but is in line with the structural reforms Beijing wants and must implement.
- Sectors related to construction and commodities are soft.
- Outstanding credit growth and new bank lending fell significantly.
- In March, exports fell 15% yoy. In February they increased by almost 50%. These figures are distorted by seasonal factors (Chinese New Year, this year the middle of February).
- Consumption and service sector activity held up well.
- Real income continued to grow at healthy rates; the increase in Q1 2015 was 8.1% overall, for migrant workers and in rural areas it was in the double digits.
- The robust wage growth was supported by positive consumer sentiment leading to strong retail sales (10.8% growth rate in Q1 2015).
- The real estate sector shows signs of stabilization due to the reduction of down payment requirements and other locally targeted support measures. New home sales rose sharply, but mortgage lending slowed down.

The Chinese economy is slowing down, a process which will continue in the coming years. This does not imply a pending collapse, but an adjustment to a more consumption-oriented and therefore lower-growth model. This adjustment will not be painless. And more pain in the form of debt restructuring and defaults – which until now has been postponed – will follow.

A gradual slowdown 2



Source: National Bureau of Statistics / Grafic: ChinaIntelligence

▸▸▸

April take-aways:

April 15th: GDP Q1 2015 at 7%

China's economy grew at a rate of 7% in the first quarter of this year amid overall weak macroeconomic data. This Q1 2015 reading is the lowest since 2009. The property downturn, factory overcapacity and high levels of local debt are slowing the economy down. Some of the weakness was due to seasonal and temporary factors, but domestic demand is still deteriorating and export demand is weak. Industrial production slowed to 6.4%, a 6-year low. Many banks and economic research institutions lowered their growth target for the whole year to below 7%. We maintain our GDP forecast for 2015 at 6.5% and for 2016 at 5.5% to 6% (see above).

April 20th: RRR cut by 1 percentage point

China's central bank cut its reserve requirement ratio (RRR) for commercial banks by 1 percentage point. The current RRR is 18%, which is still very high when compared to other countries (USA: 10%, Russia: 4.25%, Euro-area: 1%, Switzerland: 2.5%). This was the second cut this year, after the 0.5 percentage point cut on February 5, and the largest since December 2008. Rural credit cooperatives, village banks and rural cooperative banks are eligible for an additional reduction of 1 percentage point, subject to regulatory checks. The announcement was made after weak macroeconomic data for March. **The RRR cut can be read as an attempt to stabilize the economy and boost credit growth.**

April 22nd: First SOE default

Kaisa Group, a privately-owned property developer, missed USD 52 million in interest payments on an offshore bond, and Cloud Live, a technology group, did not make USD 13.8 million and USD 39 million in interest payments on domestic bonds, respectively. In previous cases where bond issuers had gotten into trouble, government agencies invariably ensured on-time payment of interest and principal. The fact that authorities let these defaults happen must be seen in the context of overall financial market and interest rate liberalization. As many different elements (e.g. deposit rates, access to the Hong Kong stock market for mainland investors) are opened to market participants' decisions and licenses for several privately-owned banks have been issued for the first time, **nothing disciplines the market more than some defaults.**

Baoding Tianwei, a solar panel and power transformer manufacturer, failed to make an interest payment of RMB 85.5 million on a RMB 1.5 billion bond on time. **It was the first state-owned borrower to miss an interest payment in the domestic bond market.** There have been temporary defaults by private companies in the problem driven solar sector before, but they have always been bailed out by banks and/or government bodies. Also this time, the bond's underwriter China Construction Bank has been «encouraged» – probably by the central bank – to offer the company a loan.

Important Indicators

	April 2015	March 2015	Feb 2015	Jan 2015	Dec 2014	Sept 2014
Quarterly GDP, growth yoy (%)	–	7.0	–	–	7.3	7.3
Retail sales of consumer goods, growth yoy, real (%)	–	10.2	11.0	11.0	11.5	10.8
Official Consumer Confidence Index	–	107.1	109.8	105.7	105.8	105.4
China Confidential Labor Demand yoy Index	–	76.0	66.0	68.4	72.6	68.1
Real estate floor space newly started, growth yoy (%)	–	–18.4	–17.7	–17.7	–10.7	–9.3
ChinaConfidential mom Home Price Index	–	55.0	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 (%)	–	13.5	13.9	13.9	15.7	16.1
Required Reserve Ratio (large banks) (%)	**18.0**	19.0	19.0	19.5	19.5	19.5
Benchmark rate for 1-year loans (%)	**5.35**	5.35	5.35	5.60	5.60	6.00
Benchmark rate for 1-year deposits (%)	**2.50**	2.50	2.50	2.75	2.75	3.00
New total social financing, growth yoy (%)	–	–44.0	44.0	–21.0	35.0	–26.0
New bank loans, growth yoy (%)	–	–5.1	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)	–	30.8	60.6	60.0	49.6	30.9
Electricity consumption, growth yoy (%)	–	0.8	2.5	2.5	3.8	3.9
Freight Traffic, growth yoy (%)	–	4.5	9.2	7.9	7.1	7.7
Iron ore imprts (million tons)	–	80.5	67.9	78.8	86.9	84.7
Coal imports (millions tons)	–	17.0	15.3	16.8	27.2	21.2
Crude oil imports (million tons)	–	26.8	25.6	28.0	30.4	27.6
Bloomberg Commodities Index	**102.91**	98.12	103.44	100.84	104.33	118.69
CSI 300 (China Equity Index)	**4749.0**	4051.0	3572.8	3434.4	3533.7	2451.0
RMB trade-weighted, indexed (2010 = 100)	–	126.1	123.6	123.1	121.5	116.0
RMB/USD spot	**6.11**	6.13	6.14	6.13	6.13	6.15

Source: ChinaIntelligence

焦点

Bonds, bonds, bonds and a misunderstood QE

In an effort to support the commercial property market, the regulators have recently announced that banks will be allowed to sell bonds secured by commercial mortgages before the end of the year. As mentioned in our quarterlydragon #1, dated April 1, 2015 (Focus Topic: «Residential real estate: pricey overall but not bubbly, and not crashing any time soon») the market for asset-backed securities in China is tiny and mortgage-backed securities do not exist after their issuance was banned in 2009. **The re-introduction of commercial mortgage-backed securities, if structured properly, adds a useful new instrument to China's bond market. And it lets banks transfer their mortgage loans to the buyers of the mortgage-backed bonds, thus freeing up capacity for additional loans in the property sector.**

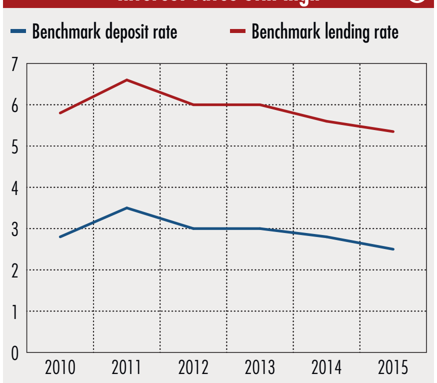
Separately, China's central bank is considering additional measures to boost the credit flow to heavily indebted local governments in order to recapitalize the provinces. **The People's Bank of China (PBoC) apparently will be willing to accept bonds issued by local governments as collateral for loans to banks, which in turn are meant to purchase the bonds issued by the local governments.** The goal is to lower debt-servicing costs and extend maturities by converting short-term, high-interest bank loans taken out by the local governments to lower-interest, long-term municipal bonds issued by the local governments.

China's local debt has surged since the 2008 financial crisis as regional governments borrowed to finance infrastructure projects in an effort to stimulate the economy. Approx. RMB 1.9 trillion (USD 300 billion) in debt by local governments is due to mature this year alone. We see such steps by the PBoC as more technical in nature since the government is majority owner of all the major commercial banks anyway. But it certainly can make sense to broaden the domestic bond market, in effect establishing a large municipal bond market.

Another discussion about the Chinese bond market was launched by the fact that several provinces were forced to postpone bond auctions due to lacking demand from commercial banks. **The local government debt swap, under which local governments should issue bonds to pay off bank loans, is held up by weak investor demand.** Speculations popped up that the People's Bank of China (PBoC) would directly purchase such local government bonds and expand its balance sheet to ensure enough liquidity.

This led to worldwide headlines, speculating whether the PBoC would introduce large scale quantitative easing (QE). Many arguments in the media followed the Western line of thinking: China has a credit and a housing bubble and is heavily indebted on a provincial level – and the PBoC is now «lender of last resort» for the local governments. Soon, Beijing will drown the country in liquidity and, as a result, export even more deflationary pressures to the rest of the world. Therefore, this is QE! The Chinese policymakers did not help the speculations by loudly thinking about «other unconventional policies», and then delivering a denial right afterwards.

Interest rates still high 3



Source: World Bank / Grafic: ChinaIntelligence

Quantitative norm

However, the PBoC being «lender of last resort» has nothing or only very little to do with monetary policy. Even if the central bank acquires assets directly from commercial banks – or if it lends directly to banks, taking local government bonds as collateral –, it follows a purpose which is different from the one pursued by similar actions in the USA, Europe and Japan. First, these countries wanted to drive down borrowing costs even further, although the short-term interest rates were at zero already. China's interest rate level is a long way from zero, the overnight repo rate is currently 1.9%, and the one-year lending benchmark rate is still above 5%. The PBoC can use a va-


Container port Shanghai

PHOTO: E. TESTER RUDOLF

riety of conventional monetary tools, should it want to. Second, the use of so-called unconventional quantitative tools is the norm in China's monetary policy.

Why is that so? In China, the government sets the target for the money supply (this year a 12% increase for M2). Banks' lending quotas have always been a tool to influence the behavior of commercial banks. **In China, no interest rate declines are necessary to stimulate the lending volumes, because determining the amount of money to lend was not really the individual banks' decisions in the first place – it is the government who decides how much money the banks should lend (and to whom, in some cases), by periodically allocating lending quotas to the banks.** Then, it is the banks' job to make sure the lending process is orderly and the loan documentation satisfies the regulations.

If the PBoC were to buy local government debt it would not address monetary policy issues, but rather the fact that high yields on the new municipal bonds hinder the debt swap's goal to lower interest costs for the municipalities. So the motivation for such action would be concerns about local government debt.

The comparison to QE in the West also implies a huge monetary stimulus. But the recent measures primarily attempt to replace recent capital outflows and not to add extra new money. **The PBoC does not want to pour money all over the economy, but rather uses specific tools to allocate credit to areas which the government wants to support.** One could argue that the unconventional element of China's monetary policy is the pledged supplementary lending to the China Development Bank (CDB): The PBoC gives money to the CDB who in turn lends it out for infrastructure investment and environmental projects. But also this is not really new.

However, in the long run quantitative tools tend to work only in closed economies and closed financial markets. The more China opens its capital flows and liberalizes interest rates and other parts of the financial system, the more it should consider to allocate credit not by predetermined volumes but through interest rates. As the «Economist» notes: «Easing has always been quantitative in China. The point is to get away from that.»

ChinaIntelligence AG 中国智慧咨询公司 Forchstrasse 2/Kreuzplatz CH-8008 Zürich/Switzerland
+41 79 678 5568 info@chinaintelligence.com www.chinaintelligence.com