Mizuho Securities Asia Ltd

China macro monitor

November 2012

A new era under China's new leadership

Chief Economist

Dr. Jianguang Shen

jianguang.shen@hk.mizuho-sc.com
+852 2685 2022

Please refer to pages 95 – 96 of this report for important disclosure and analyst certification information.

A new era under China's new leadership

The 18th CCP Congress has concluded and China's new leaders, led by Xi Jinping and Li Keqiang, have been announced. Notably, only these two leaders will be able to serve two terms, whereas the other five members of the most powerful politburo standing committee will have to retire in five years due to the age limit. This will cement Xi and Li's power in the new government. Additionally, Xi has replaced Hu Jintao as the chairman of the military committee, which will further enhance Xi's role. This setting allows the new leadership to be in a much more powerful position to push for comprehensive reforms that are required to transform China into a medium- to high-income country in the next decade. A new era under new leadership has begun (see "China's new era under Xi Jinping" 15 November).

The new leadership will immediately face a challenging year ahead in 2013, as investment will suffer from over-capacity problems in the production sector, weak property demand in Tier 2 and 3 cities, and increasing friction in infrastructure investment (see "No smooth sailing for the year ahead – Takeaways from the Mizuho macro day" 20 November).

Indeed, compared to the previous downturn sparked by the global financial shock in 2008-2009, the magnitude of the current downturn is smaller; however, it could last much longer, due to four reasons: 1) Less decisive policy actions due to the leadership transition; 2) The banking system is still experiencing an overhang from the previous credit boom; 3) Local governments' fiscal conditions have deteriorated; and 4) China's advantage as a low-cost producer is diminishing (see "A tale of two downturns in 2008 and 2012" 10 October).

Despite these challenges, economic activity has stabilized in the last two months (see "Worrying trend despite positive macro data" 9 November). At least from headline figures, the condition of China's economy has improved from the notable hard-landing risk in July and August. It is mainly supported by government-driven investment such as railway and highway investment (see "Positive October trade and macro data shadowed by uncertain outlook" 12 November). The rebound can also be partly attributed to the political cycle, as positive media coverage and expectations of stimulus after the National Congress boosted consumption and production (see "18th Party Congress and economic cycle" 13 November).

At the same time, monetary easing was put on hold since the second interest rate cut in July (see "A second rate cut to kick start aggressive policy easing in 2H" 6 July 2012). Despite the frequent use of open market operations in 2H, the market's liquidity remains neutral at best (see "Positive October trade and macro data shadowed by uncertain outlook" 12 November). Overall, the government's response has been more moderate than expected (see "Window to avoid hard-landing is closing fast" 31 August).

Hence, we expect China's economic growth to stay close to its potential in the quarters ahead. Also, other aspects of the economy show that lingering uncertainty remains:

- Rising account receivables and overdue loans. Recent news revealed that businesses in China are hit by sharp rises in account receivables and "triangular debt", liabilities owed by companies to each other that could potentially set up a chain reaction in defaults;
- Decelerating business and property investment. Despite the surge in investment in railway and highway construction, investment in other sectors remains lukewarm; and
- Grim export outlook. Despite the recent strength in exports, weak results at the fall session of the Canton Fair reveal a more sobering picture. In the future, the fiscal cliff in the US and deteriorating outlook in the Euro area suggests that exports will continue to be a main source of uncertainty.

We maintain that the new leaders will strive for a steady and conservative policy environment, and large-scale stimulus is unlikely. As the recovery is not yet on solid footing, and risks from external demand and property market continue, downside risks remain for 2013. Therefore, we maintain our full-year 2013 forecast unchanged at 7.8%YoY, up slightly from 7.7%YoY in 2012.

Jianguang Shen
jianguang.shen@hk.mizuho-sc.com
+852 2685 2022

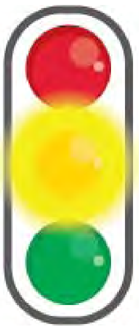
Michael Luk
michael.luk@hk.mizuho-sc.com
+852 2685 2155

SALES	Hong Kong	**Alan Chen**	alan.chen@hk.mizuho-sc.com	+852 2685 2268
		Paul Kim	paul.kim@hk.mizuho-sc.com	+852 2685 2058
		Ivy Kim	ivy.kim@hk.mizuho-sc.com	+852 2685 2062
		Hirou Kaneshige	hirou.kaneshige@hk.mizuho-sc.com	+852 2685 2171
	London	**Philip Baillieu**	philip.baillieu@uk.mizuho-sc.com	+44 207 090 6567
	New York	**John Bai**	john.bai@us.mizuho-sc.com	+1 212 209 9354
		Dan Shin	dan.shin@us.mizuho-sc.com	+1 212 205 7619
	San Francisco	**Tamae Koketsu**	tamae.koketsu@us.mizuho-sc.com	+1 415 268 5513
SALES TRADING	Hong Kong	**David Harris**	david.harris@hk.mizuho-sc.com	+852 2685 2237
		Kevin Pereira	kevin.pereira@hk.mizuho-sc.com	+852 2685 2288
		KK Wong	kk.wong@hk.mizuho-sc.com	+852 2685 2055
		Ruvann Kavanagh	ruvann.kavanagh@hk.mizuho-sc.com	+852 2685 2176
	New York	**Angelo Iannone**	angelo.iannone@us.mizuho-sc.com	+1 212 209 9367

Table of contents

20 November 2012

No smooth sailing for the year ahead – Takeaways from the Mizuho macro day



Mizuho held a macro policy seminar in Beijing on 19 November where participants shared their insights on China's economic outlook after the Party Congress. In the discussion, participants generally held the view that 2013 will be a challenging year for China, as both external and domestic demand will face substantial head winds. Investment is particularly worrisome due to over-capacity in the production sector, weak property demand in Tier 2 and 3 cities, and increasing friction in infrastructure investment. GDP growth would be considered very good if it reached 8% in 2013.

Key observations after the 18th Party Congress

The 18th Party Congress has one key task: Leadership change

- Out of the seven members of the Politburo Standing Committee (all except Xi Jinping and Li Keqiang) will have to retire in five years, due to the age limit. The new balance of power will make the role of Xi Jinping even more important (see "China's new era under Xi Jinping" 14 November).

- It gives Xi Jinping the political manoeuvring room that is conducive to carrying out structural reforms. However, as the leadership transition is still in progress, the government will ensure a smooth handover and little policy change is expected in the short term.

- In the upcoming Central Economic Work Meeting in December, Li Keqiang will make his debut as the leader in economic policies, and lay out the government's direction in economic affairs for the coming year.

- Overall, we do not expect any significant departure from the current policy, as the leaders emphasize stability and a steady transition. No large scale stimulus is expected (see "18th Party Congress and economic cycle" 13 November). We expect the government to keep a proactive fiscal policy and prudent monetary policy as its formal position for the third consecutive year.

- And then in March 2013, the National People's Congress will announce the change of other key appointments. Li Keqiang's first government work report will set the tone for his economic policy. In April-May 2013, the second Plenary Meeting of the Central Committee will lay out the direction of the Communist Party under Xi's leadership. At the third Plenary meeting and central economic work meeting in November and December 2013, a further timeline for implementation will be unveiled.

- Going forward, the implementation of fundamental reform depends on the new leadership's determination. All eyes are on how the important reforms, including: growth engine rebalancing, income inequality reduction, productivity and human capital development, and SOE monopoly correction, will be carried out. It will be a key indicator on how radical the new leadership is on pushing China's development forward.

- In the 18th Party Congress, the government set a new target for China's economic growth: to double its 2010 income per capita for both urban and rural residents in 2020. It translates into around 7%YoY growth. It is believed that the target is achievable; however the challenge will be on equally delivering the growth to different parts of the country. It has been raised that the economy has to go through a transition from "quantity" growth to "quality" growth. This is an important challenge for the new leadership if it is to turn China into a high income country.

Jianguang Shen
jianguang.shen@hk.mizuho-sc.com
+852 2685 2022

Michael Luk
michael.luk@hk.mizuho-sc.com
+852 2685 2155

Negative bias | Caution | Positive news

New leaders to pursue corruption

- The new leadership will begin an anti-corruption campaign after the 18th Party Congress. On 17 November, Xi Jinping reportedly told members of the Politburo that the rule of the Communist Party faces demise if corruption is not addressed. In his speech, Xi expressed resolve in punishing everyone in violation of party discipline, reflecting his determination. According to the participants the property market monitoring system, which keeps record on property ownership, will be used to investigate corruption charges. It will weigh on the housing market and luxury consumption in the short-term as potential buyers avoid suspicion.

Investment to slowdown amid rising constraints

The 12th FYP investment target

- It is believed that investment growth in 2013 will, at best, be the same as 2012, at around 20.7%YoY. It will again be supported mainly by government-driven infrastructure investment, such as railway and subway.

- Compared to historical average, however, the whole sector remains bearish: Property investment was down by half, while infrastructure investment was down by more than half, and the support from this sector in 2012 comes mainly from projects that are already in progress. Investment on the manufacturing sector, meanwhile, has been plagued with over-capacity built up in the previous stimulus package.

Infrastructure investment faces more constraints

- Infrastructure investment will rebound in 2013, with support coming from the railway. As railway spending comes from the central government's budget, funding should not be a problem. This year railway investment may be a bit above CNY500bn, and next year will be close to CNY600bn.

- Other than railway, many infrastructure projects have been put on hold due to longer delays in bank loan approval and more aggressive resistance from the local residents, as exemplified in the recent protests in Zhejiang.

- The NDRC is concerned that it may not meet the CNY21tn investment target next year when the half-period progress is reviewed. This is because the nuclear power plants will not go ahead after the nuclear disaster in Japan last year.

- Participants at the Macro day also mentioned that China's infrastructure construction has to stay ahead of China's aging problem, so it will continue to speed up in the 12th and 13th five-year plan.

Over-capacity

- The manufacturing sector is still plagued with excess capacity due to the investment splurge from the previous stimulus package, such that the demand for capacity upgrades is weak. Steel production may reach 930mn tonnes this year.

- One survey shows that there is a huge over-capacity problem in China's industrial sector, as 32% of firms reported idle capacity.

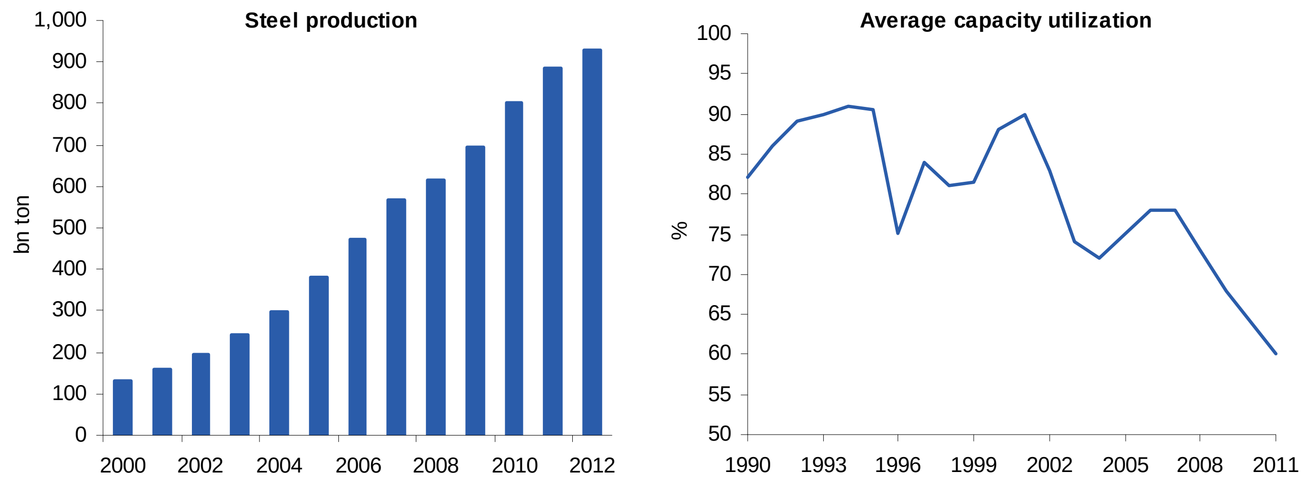
- According to recent estimates from an IMF report, China's capacity utilization rate was around 80% before the outbreak of the global financial crisis, and it was already low by international comparisons. However, it dropped further to around 60% in 2011 (see "A tale of two downturns in 2008 and 2012" 10 October). It will be a drag on investment growth in the foreseeable future.

Property investment

- Participants at the macro day believe the restriction on property development loans will not loosen. Although the curbs are considered temporary, the government still needs to identify policy replacements as soon as possible. The property tax, which was on trial in Chongqing and Shanghai, is no longer considered for expansion.

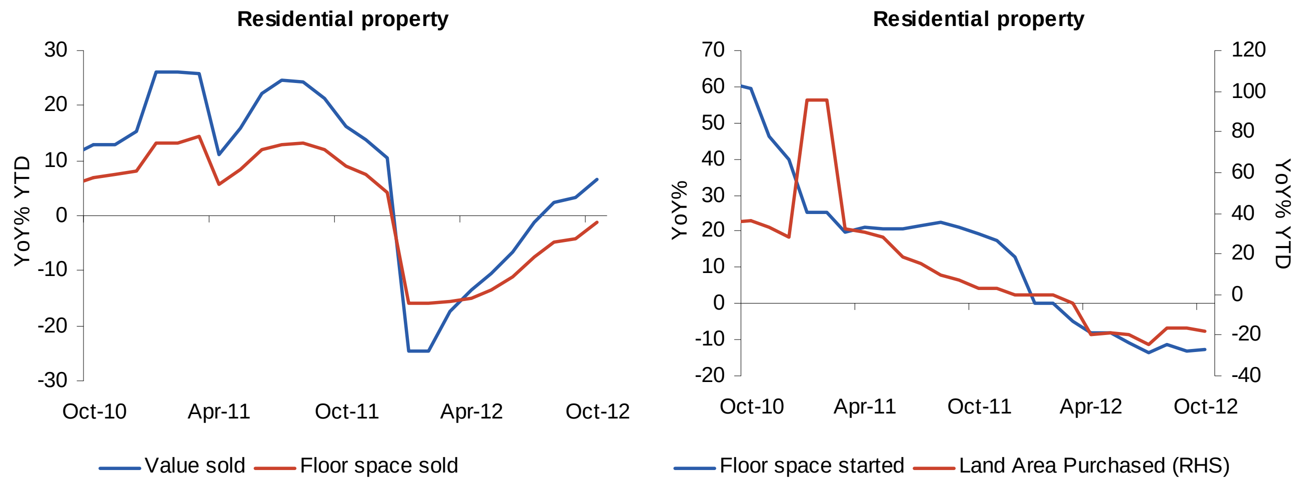
- It is believed that a rebound in the housing market can be expected in Tier 1 cities, as demand remains strong. Inventory pile up in Tier 2 and 3 cities, however, have become a problem.
- Our concerns with the upcoming bottleneck in housing supply (see “Worrying trend despite positive macro data – October macro data review” 9 November), monitored by the government, are part of the government's consideration on household registration system reform and population migration. The government will seek to provide housing options for the diverse demand created by urbanization: The urban citizens require improvements, while the new migrants need their first homes.
- Social housing will continue to be actively promoted as a main option to solve the housing problem. As social housing that began construction in 2010 is starting to become available this year, supply in the next two years will increase.
- It has been argued however that social housing could come in the form of in-kind construction or monetary subsidy. Meanwhile, solving the housing problem in the middle-income group can be more difficult.

Fig 1 Over-capacity will be a drag on investment growth



Source: CEIC, Mizuho research

Fig 2 There can be a bottleneck in property supply



Source: CEIC, Mizuho research

Days of strong export growth are over

- Participants believe that the days of strong Chinese exports are likely over, and more moderate growth will dominate in the future. The share of exports from private businesses will increase, and the share of regular trade will increase while processing trade will become less important.

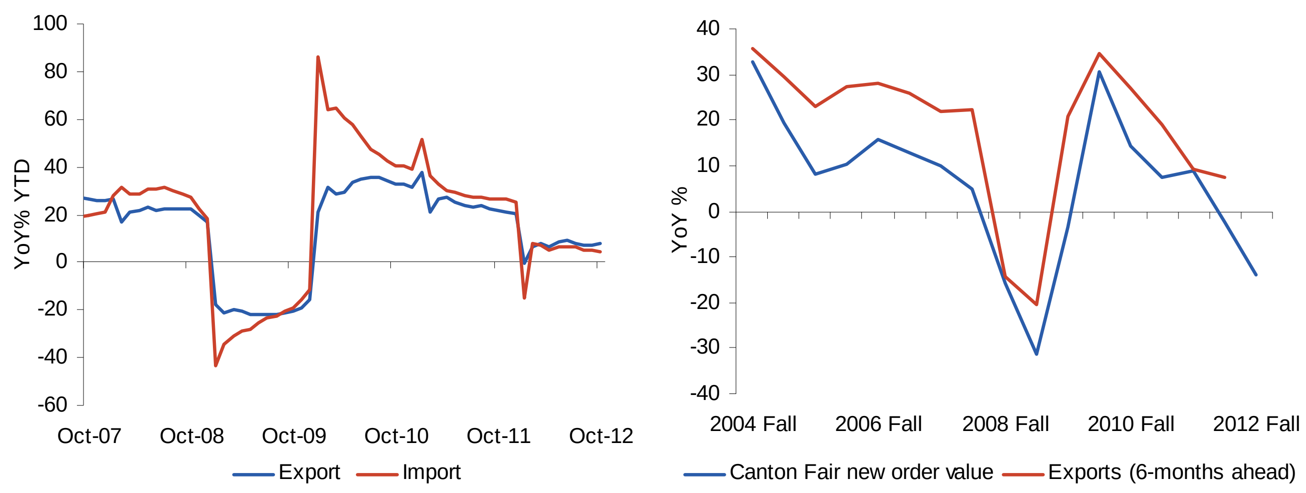
- The strength in Chinese exports in September and October was likely temporary. In our view, it was partly due to local government subsidies to stimulate exports from local factories before the 18th Party Congress. It is in-line with the "window dressing" we suspected in "Positive October trade and macro data shadowed by uncertain outlook" (13 November). Also, exports to Hong Kong were strong because mainlanders sold jewellery, gold and other valuables across the border in exchange for cash.

- The external outlook is grim for 2013. Weak new orders and buyer turnout at the fall session of the Canton Fair reveals a sobering picture. In the months ahead, the fiscal cliff in the US and deteriorating outlook in the Eurozone suggests that exports will be on a downtrend (see "Positive October trade and macro data shadowed by uncertain outlook" 13 November).

- As we argued in "China's exports at a crossroad" (10 May), Chinese exports are negatively affected by rising labour costs, deteriorating terms of trade, a much more expensive RMB, and the endless trade disputes as well as rising awareness for environmental protection, which all indicate that China will not retain its position as the dominant low-cost production centre that it was a decade ago, in our view.

- As such, we expect a more moderate export growth for 2013, at 8.0%YoY.

Fig 3 Export outlook is grim



Source: CEIC, Mizuho research

Consumption remains the bright spot in economic outlook

Poor external and domestic demand

- Government survey revealed that Chinese manufacturers face not only poor external demand, but poor domestic demand as well. It is in line with the disappointing 3Q data from the listed companies.

- Compared to investment and external demand, consumption remains the bright spot, with little further stimulus necessary, according to participants. So far, it is especially true for luxury consumption.

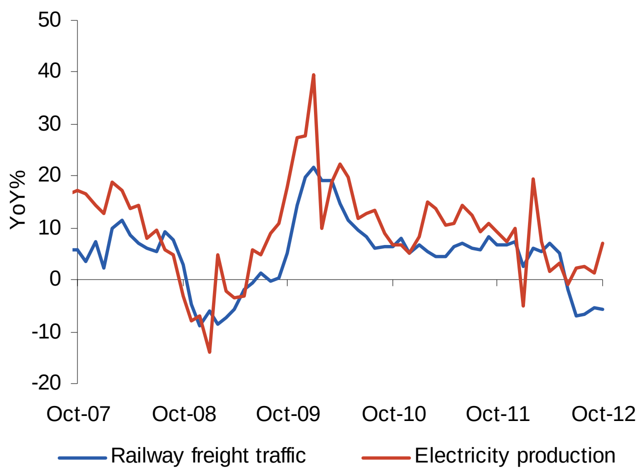
- For industrial production, many indicators, including electricity consumption and cargo throughput, have improved. However, industrial profit remains highly uncertain despite the rebound in October. Account receivables also remain a concern.

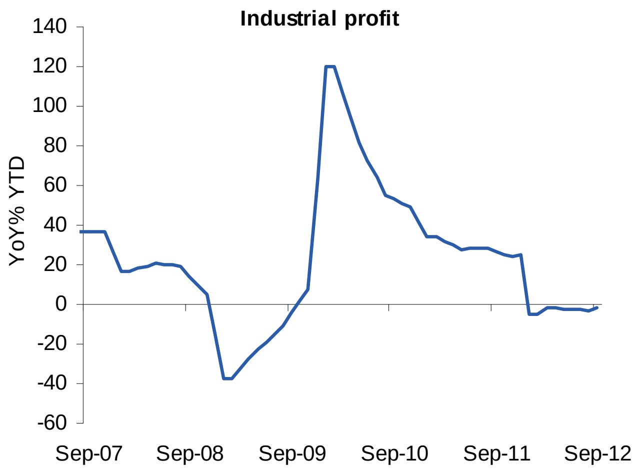
- By region, resilient employment conditions were supported by the central/western region in 2012. However, it is expected that while economic growth in the eastern area may improve modestly in 2013, the central/western region may begin to slow down. It could dampen the momentum for a recovery in the quarters ahead.

"L" shape recovery is likely

- The current government will likely finish up the fiscal surplus before the end of 2012. It will likely create some stimulus for 1Q 2013. But overall, the growth in 2013 will be weak, with a cap at 8%YoY. In the medium term, China will probably go through a "L" shape recovery rather than a "U" shape recovery.

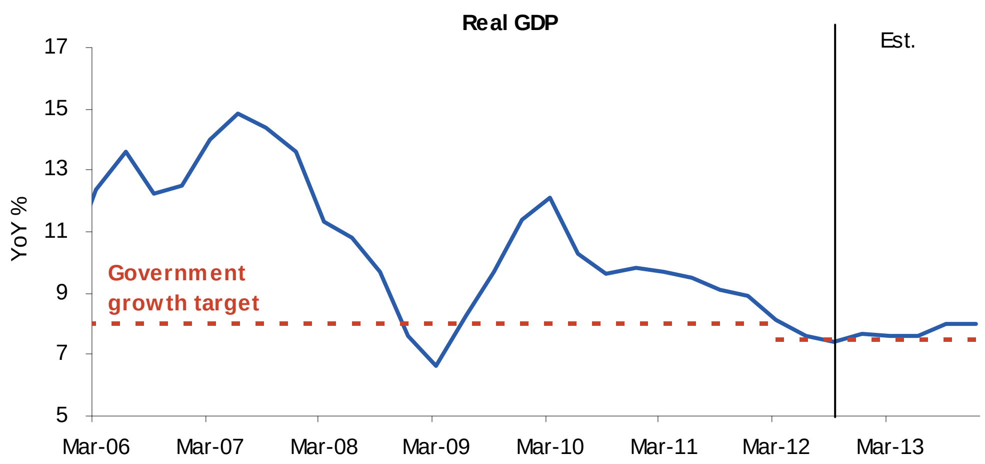
Fig 4 Outlook for production remains uncertain





Source: CEIC, Mizuho research

Fig 5 Economic recovery will be modest in 2013



Source: CEIC, Mizuho research

Loan quality may become a concern

- For full-year 2012, it is expected that money supply (M2) growth will reach the government's 14%YoY target, while new loan growth may amount to CNY8.2tn.

- After the PBOC relaxed the restriction on the lending rate floor along with the interest rate cuts in 2012, it was reported that the new flexibility was not implemented at the bank level. After review, the deposit rate likely will not gain any more flexibility in the near future. So far, the banking sector has not been significantly affected by the relaxed restrictions, according to participants.

Rising bad debt under the watch of CBRC

- The participants at the macro day mentioned that there is currently around CNY3tn of private loans in the Chinese credit market, reflecting the increase in alternative financial channels after monetary easing was put on hold in 2H.

- Meanwhile, the definition of non-performing loans is antiquated, and it is unable to reflect the true situation of the market. The government had wished to see some reasonable increase in NPLs to reflect the market's situation, but at the current level it is too good to be true, and the CBRC is already aware of that.

- The recent development of property trust, according to the participants, does possess risks as the market has argued. However, it is not a systemic risk and the situation is currently under control. Additionally, bad debts in the market have risen to around CNY400bn. However it is still sufficiently covered by the CNY2.4tn in reserves.

- Local government financing vehicles (LGFVs), which can be used to finance the over CNY20tn stimulus announced in 2012 by the local governments (see "A tale of two downturns in 2008 and 2012), is reported to have sold CNY579.3bn of bonds year-to-date, above CNY150bn for the full-year of 2011. In response to the accelerated involvement of LGFVs in alternative financing channels, the new government will not relax its control. Instead, it is expected that the local governments should come up with more transparent disclosure of their financial situations.

Fig 6 Interest rate flexibility will be put on hold

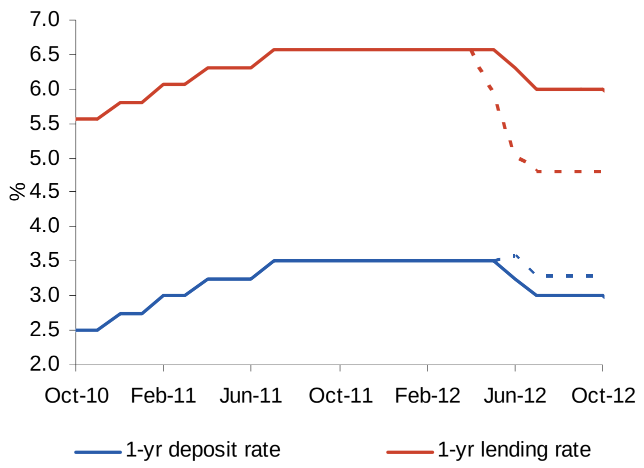
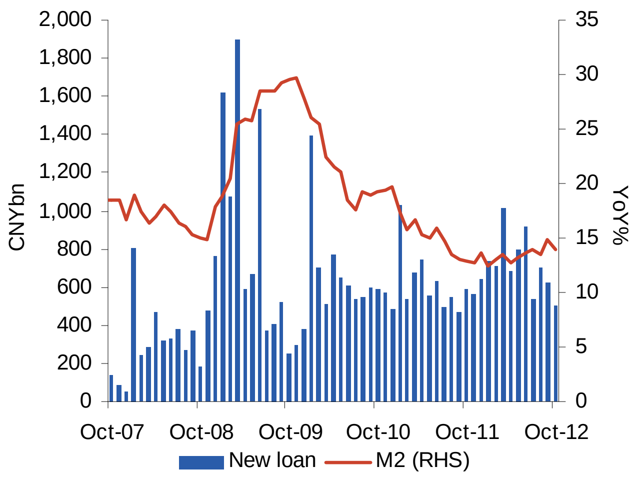


Fig 7 M2 will meet 14% target in 2012

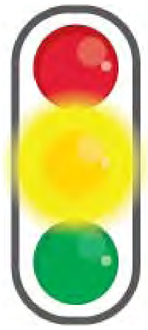


Source: CEIC, Mizuho research

.

14 November 2012

China's new era under Xi Jinping



The new Politburo Standing Committee has been announced today, with Mr. Xi Jinping and Mr. Li Keqiang being the top two leaders, as expected. Mr. Xi has also become the Chairman of the Military Committee. This setting accentuates the role of Mr. Xi Jinping as the leader in the next decade, and allows the new leadership to be in a much more powerful position to push for its agenda.

In the short-term outlook, we do not expect any significant departure from the current policy, as the leaders emphasize stability and a steady transition. The government change will happen during the NPC next March, but the new leadership's priorities will be revealed next Oct-Nov, in the 3rd plenary session. We expect a proactive fiscal policy and prudent monetary policy will continue as the official position in the upcoming Central Economic Work Meeting.

- Following the end of the 18th National Congress of the Chinese Communist Party, the new Politburo Standing Committee has been formally announced today. As anticipated, the list includes Xi Jinping, Li Keqiang, Zhang Dejiang, Yu Zhengshan, Liu Yunshan, Wang Qishan, and Zhang Gaoli.

- There were no surprises in the final list. Xi Jinping and Li Keqiang are expected to be selected as the Chinese government's president and premier respectively, in the National People's Congress (NPC) in March 2013. Wang Qishan has been appointed as the head of central disciplinary committee, reconfirming that Li Keqiang will be the person in charge of economic affairs.

- Notably, out of the seven member politburo standing committee to be announced, all except Xi Jinping and Li Keqiang will have to retire in five years, due to the age limit. It will cement the power of the Xi and Li in the new government. Also, among the seven committee members only Li comes from Tuanpai. The new balance of power will make the role of Xi Jinping even more important.

- Also, it has been announced that Hu Jintao will not continue to serve as the chairman of military committee. Instead the position has been replaced by Xi Jinping. With him now holding all the key positions, the change will further enhance the role of Xi in the coming years. This setting allows the new leadership to be in a much more powerful position to push for its agenda.

- In addition, Zhou Xiaochuan is no longer a member of the party's central committee, suggesting that he may also step down as chairman of the PBOC in March 2013.

- In the upcoming Central Economic Work Meeting in December, Li Keqiang will make his debut as the leader in economic policies, and lay out the government's direction in economic affairs for the coming year. Overall, we do not expect any significant departure from the current policy, as the leaders emphasize stability and a steady transition. No large scale stimulus is expected (see "18th Party Congress and economic cycle" 13 November). We expect the government to keep a proactive fiscal policy and prudent monetary policy as its formal position for the third consecutive year.

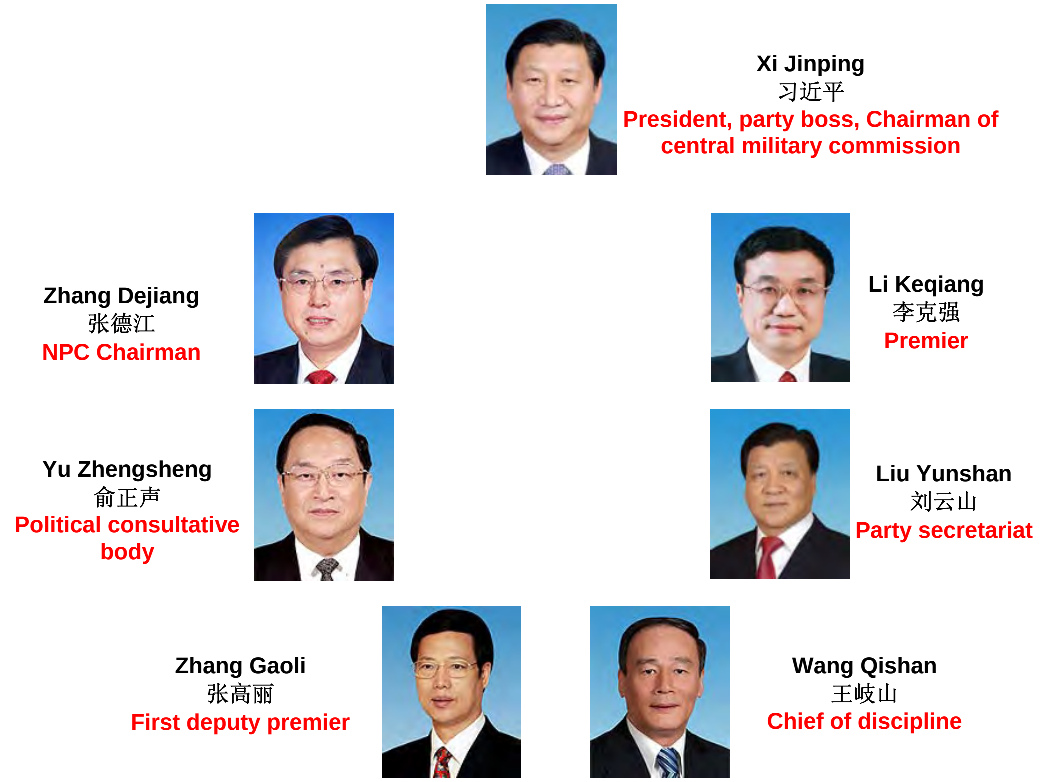
- And then in March 2013, the National People's Congress will announce the change of other key appointments. Li Keqiang's first government work report will set the tone for his economic policy. In April – May 2013, the 2nd Plenary Meeting of the Central Committee will lay out the direction of the Communist Party under Xi's leadership. At the 3rd Plenary meeting and central economic work meeting in November and December 2013, the further timeline for implementation will be unveiled.

Jianguang Shen
jianguang.shen@hk.mizuho-sc.com
+852 2685 2022

Michael Luk
michael.luk@hk.mizuho-sc.com
+852 2685 2155

Negative bias | Caution | Positive news

Fig 8 China’s new leadership: line-up after 18th Party Congress

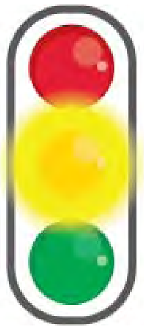


Source: Mizuho research

.

13 November 2012

18th Party Congress and economic cycle



The connection between political and economic cycles has been obvious in China. We believe that the ongoing party congress has positively affected China's September-October macro data in three ways: 1) the need to maintain a positive environment, via massive fiscal spending in infrastructural projects (railways, in particular); 2) positive media guidance to boost consumer confidence; and 3) induce firms to expect impending stimulus.

As the "party congress" effect is key to stabilising economic growth in 4Q, we believe that a broad-based recovery in 2013 is still not assured, for three reasons: 1) weak business and property investment; 2) rising account receivables; and 3) a grim export outlook.

The economic indicators in October have again exceeded expectations. Building upon the momentum in September, industrial production, consumption and investment rebounded, especially government-driven investment such as railway and highway investment. However, as the world economy continues to deteriorate amid the impending fiscal cliff in the US and further downward revisions in the EU, we continue to have reservations on China's outlook.

Meanwhile, the 18th National Congress of the Communist Party is now in session. This is the most important meeting in the decade and the Congress will not only review China's development, it will also outline China's development in the future. Most importantly, the new Politburo central committees will be announced at the end of the Congress. The new committee will have a pivotal impact on China's economic development in the next five to ten years.

The connection between politics and economics has been widely observed, with remarkable research from Alberto Alesina from the Economics department of Harvard University. It includes the interconnection between the US election cycle and the net increase in transfer payments between 1961-1985 (Alesina 1988), the existence of a political economic cycle in Germany, despite its independent central bank and conservative fiscal policy (Alesina and Roubini, 1992); and the existence of political cycles in 18 OECD countries (Alesina, Roubini and Cohen, 1997), among others. All in all, it has been clearly established that political cycles and economic cycles are closely connected.

In China, the connection has been even more obvious because the government has more control on the economy. We believe that the government is boosting the economy through three channels:

First, through fiscal stimulus. The government has delivered a favourable economic environment consistently in the years with Party Congresses. For example, in the month before the 16th PC in 2002, retail sales and industrial production was up by 9.4% and 14.2%, above the average 8.8% and 12.7% in the same year. In the month before the 17th Party Congress, retail sales, industrial production and fixed asset investment rose by 17.0%, 18.9% and 26.4%, all above the average of 16.7%, 17.5% and 26.0% for the whole year. Now, as the month before the 18th Congress, the economic activities showed were also clearly in recovery. It reflects the impact from the fiscal stimulus this year, including the 240%YoY increase in railway investment in October.

Jianguang Shen
jianguang.shen@hk.mizuho-sc.com
+852 2685 2022

Michael Luk
michael.luk@hk.mizuho-sc.com
+852 2685 2155

Second, through positive media coverage to boost consumer confidence. The policymakers and media are often surrounded by optimism at the Congress. In sharp contrast to just a few months ago, both Zhou Xiaochuan, governor of the PBOC and Zhang Ping, chairman of the NDRC, are now expressing very optimistic views regarding the Chinese outlook. The dominant coverage of very rosy economic outlook tends to boost

Negative bias   Caution   Positive news consumer confidence and thus consumption.

Third, through expectations of stimulus to boost production. As the media have also unified to express optimism for economic outlook, entrepreneurs are now expecting stimulus to resolve weak demand after the party congress, and thus increasing production, even though their receivables have surged.

As such, it is difficult to ignore the potential impact on recent economic data from the political forces. Strictly from the breakdown of the data, we have also identified some areas for concern:

- **Rising account receivables.** Recent media reports revealed that businesses in China are hit by sharp rises in account receivables and "triangular debt", liabilities owed by companies to each other that could potentially set up a chain reaction in defaults. In September, the account receivables increased to CNY8.2tn, indicating a 16.5% increase from a year ago. At the end of the 3Q, the account receivables reported by the 2268 A-share listed companies have increased by 19.78%YoY to CNY1.99tn, far exceeding the growth in operations, at 6.17%YoY.

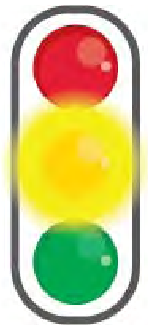
- **Decelerating business and property investment.** Despite the surging investment in railway and highway construction, investment in other sectors remains lukewarm. The investment in manufacturing and the utility industry were, for example, 0.4ppts and 0.5ppts lower than September, respectively. Within manufacturing, computer; communication, and other electronic manufacturing and automobiles were down by 1.5% and 33.7% respectively, suggesting the basis for investment rebound is not yet solid. Meanwhile, growth in real estate investment growth remained flat, and the new floor space started for commodity building has declined. It remains questionable if infrastructure spending is sufficient to support the economy, while the business and property investment remains weak.

- **Export outlook is grim.** The strength in exports is unsustainable. The encouraging exports growth in October was actually significantly caused by shipments for the new iPhone, for which China is the only producer. The weak new orders and buyer turnout at the fall session of Canton Fair, on the other hand, reveals a more sobering picture. In the future, the fiscal cliff in the US and deteriorating outlook in the Euro area suggests that exports will continue to be a main source of uncertainty.

In our view, the political cycle has a major role in the recent economic rebound. After the Party Congress, we maintain that the new leaders will strive to maintain a steady and conservative policy environment, and the market's expectations for more policy support will be disappointed. As the recovery is not yet on a solid footing, and the risks from external demand and property market continues to develop, downside risk remains in 2013. Therefore, we maintain our cautious view on China's economic outlook, and that more has to be done to put the Chinese economy back on track.

10 October 2012

A tale of two downturns in 2008 and 2012



- **China's disappointing macro data in July and August suggest that China is again in an economic downturn. Compared to the previous downturn sparked by the global financial shock in 2008–2009, we find many similarities, such as the negative impact of external shocks, a sharp slowdown in investment, and the market's concern of excess production capacity.**

- **Despite that, we believe the magnitude of the current downturn is smaller; however, it could last much longer than previously. In fact, in terms of underlying macroeconomic conditions, China has become very different since 2008: 1) Policy making has been put on hold due to the political leadership transition in progress; 2) The banking system is still experiencing an overhang from the previous credit boom; 3) Local governments' fiscal conditions have deteriorated; and 4) China's advantage as a low-cost producer is diminishing.**

- **In addition, with the property market still under control, and limited credit support for new investment projects, the effectiveness of China's stimulus may be limited. Increased production costs, trade protectionism and concern for capital outflow will also affect China's ability to recover soon.**

- **The delay of the 18th Party Congress to November 8 reflects the difficult leadership transition process, and increases political uncertainty. The new government after March 2013 will focus primarily on resolving the obstacles to long-term development, through fundamental structural and governance changes. As such, to deflate the asset bubble and eliminate excess capacity would be considered necessary.**

- **However, the short-term challenge is to avoid both a hard landing and worsen the excess capacity problem. Thus in order to strike a balance between stabilizing growth in the short term and pushing the reforms forward to achieve sustainable growth in the longer term, policymakers may launch some scaled down stimulus measures, along with RRR cuts before the Party Congress on November 8. However, any significant stimulus measures are unlikely.**

Jianguang Shen
jianguang.shen@hk.mizuho-sc.com
+852 2685 2022

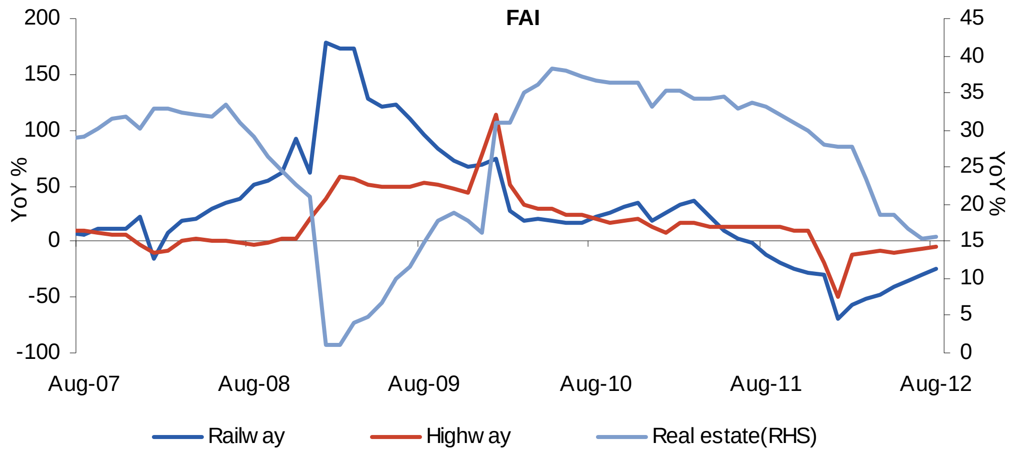
Michael Luk
michael.luk@hk.mizuho-sc.com
+852 2685 2155

Negative bias | Caution | Positive news

Similarities with the 2008-09 downturn

As the August economic indicators revealed, China's growth momentum continued to slow due to ineffective government stimulus (see "Matching investment and credit support to stabilize growth – August macro data review" 10 September). Without further support from the government, the economy is unlikely to stabilize in 4Q, and we believe the economy is heading towards a hard landing.

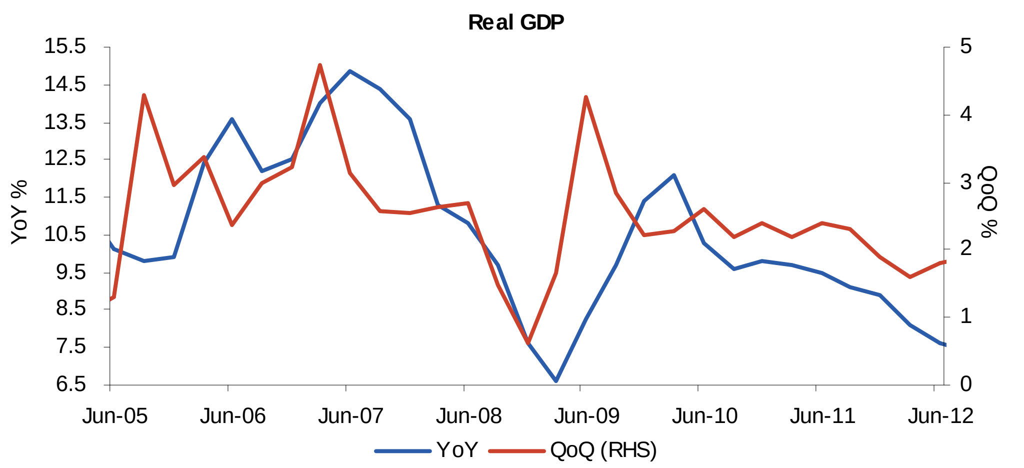
Fig 1 FAI growth in recent months suggests an investment led downturn



Source: CEIC, Mizuho research

Increasingly, the situation is reminiscent of China's previous downturn in 2008–2009. In the previous downturn, which was triggered by the outbreak of the global financial crisis in the US, many major economic indicators, such as inflation, industrial output, exports and employment, plunged sharply to the lowest in a decade. Meanwhile, GDP growth troughed at 6.6%YoY in 1Q 2009.

Fig 2 The economic slowdown in 2012 is reminiscent of the situation in 2008-2009



Source: CEIC, Mizuho research

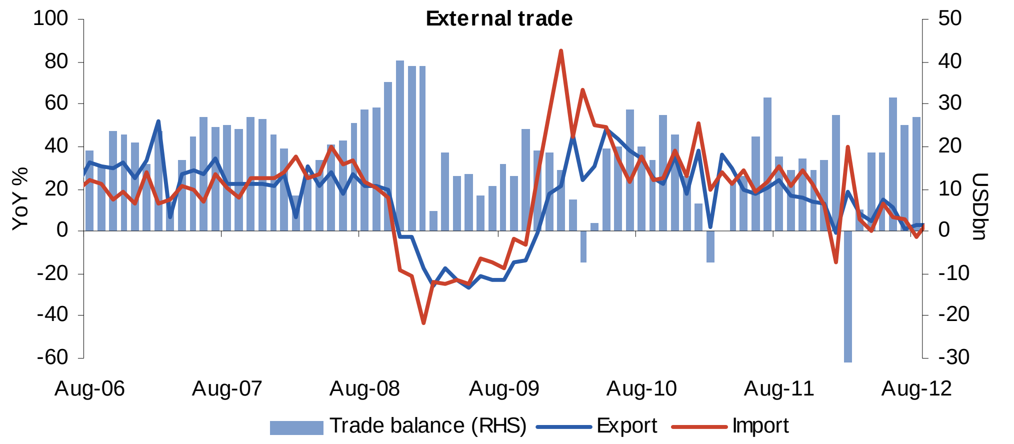
External headwinds to drag down China's growth momentum

On 15 September 2008, the bankruptcy filing of Lehman Brothers could be considered as one of the key milestones of the global financial crisis. It triggered a collapse in global demand, which led to China's economic downturn in 2008-2009. In May 2009, export growth declined by 26.3%YoY, the lowest in more than a decade.

In 2012, the Chinese economy is again under the threat of another global recession. Although the slowdown in export growth was milder than 2008–2009, the underlying crisis in the Euro area has been described as a "train wreck in slow motion".

While the downside risk of the crisis is difficult to measure now, it is unlikely that external demand will provide any support to the Chinese economy anytime soon, as the waning external demand significantly depressed China's export outlook.

Fig 3 External demand could be under the threat of another global recession again



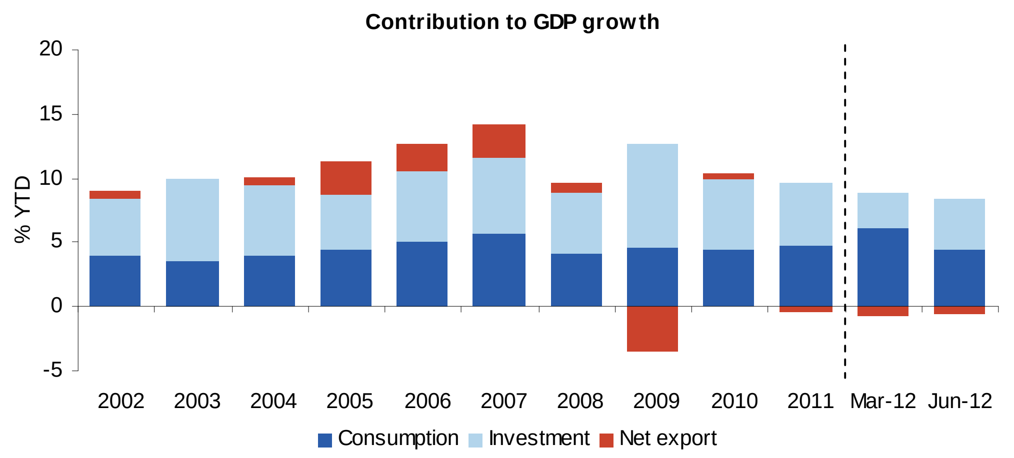
Source: CEIC, Mizuho research

Consumption unlikely to become a growth driver

China has long been a country with a high savings rate and a low consumption rate. In fact, China's consumption has shown a downward trend because of the poor income distribution and social security system since 2000 (see "A Tale of Two Bubbles: Will China repeat Japan's 'bubble burst' experience?" 28 May 2010). Despite the government's attempts since the 11th five-year plan to promote economic restructuring, consumption remains a soft spot in the Chinese economy.

Although consumption has started to pick up in recent years, in 2012, as in 2009, it is unlikely that consumption can become the key driver for China's economic growth.

Fig 4 Consumption is insufficient to become a growth driver



Source: CEIC, Mizuho research

Investment has to fill the gap

Given that neither external demand nor consumption is sufficient to take over as a sustainable driver of growth, in both cases the government needs to rely on investment. On 9 November 2008, the government announced the CNY4tn stimulus package in an attempt to minimize the impact of the global financial crisis on China. The focus of the stimulus was on infrastructure and social welfare, in a wide range of areas such as housing, rural infrastructure, transportation network, healthcare, education, and environment.

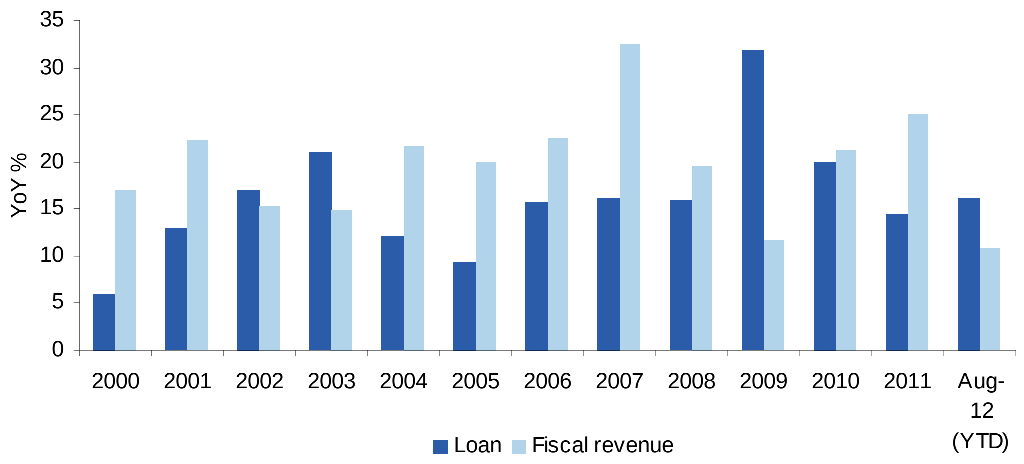
In 2012, in order to counter the downward momentum in the economy, the government is about to rely on investment again to support the economy. It is because neither external demand nor consumption are in a position to support China's economic expansion. On 5 September, the NDRC approved 49 projects, of which 25 are for subway and light railway construction. Then again on 6 September, the NDRC approved another 20 projects, of which 13 are for highway construction. The total size of the projects exceeded CNY1tn. On the local government level, policymakers have also announced local stimulus packages that totalled close to CNY20tn, although the implementation results are questionable due to the limited access to liquidity (see "Window to avoid hard-landing is closing fast" 31 August).

Fig 5 CNY20tn stimulus measures are at the local government level

Government	Date	Amount	Key measures
Sichuan	24 Sep	CNY3.67tn	2242 major projects including infrastructure, social welfare, and environmental protection
Zhejiang	28 Aug	CNY1.2tn	Pilot projects to develop marine industries
Guangdong	20 Aug	Over CNY1tn	177 projects to utilize marine resources in the next five years
Guangdong	16 Jul	CNY235.3bn	44 projects to raise funds from the private sector, involving 11 transportation projects
Guangdong	2 Jul	n.a	19 projects to expedite the construction for petrochemicals, ferrous metals and other manufacturing facilities
Tianjin	21 Aug	CNY1.5tn	10 production chains in petrochemical and green energy industries in the next four years
Shanxi	20 Aug	CNY2tn	Plan to raise private sector capital from investment expo to invest in various projects
Chongqing	20 Aug	CNY6tn	Build 37 manufacturing clusters in the next ten years
Fujian	17 Aug	CNY1.4tn	Invest on technology reform in the 12th five-year plan. CNY200bn will be spent in 2012 and CNY260bn in 2013
Hubei	15 Aug	CNY313.1bn	82 projects to improve the mass transportation network in Wuhan
Heilongjiang	14 Aug	n.a	17 measures to promote production and ease liquidity pressure for local manufacturers
Changchun	14 Aug	CNY2bn	25 measures to promote steady economic growth, and inject CNY20bn in 2012 to revitalize the local economy
Guangzhou	7 Aug	CNY200bn	Invest in key infrastructure projects such as subways, airports, etc.
Changsha	25 Jul	CNY829.2bn	195 construction projects to cover social welfare, transportation network, public facilities, and new industries involving CNY829.2bn in 2012
Guizhou	23 Jul	CNY3tn	Develop eco-tourism in the provinces involving transportation network, public facilities and hospitals in the next decade
Nanjing	23 Jul	n.a	30 measures to support domestic demand in property market, automobile purchase etc.
Ningbo	16 Jul	n.a	26 measures to reduce corporate tax, expedite key industrial projects and develop new strategic industries

Source: Mizuho research

Fig 6 Loan growth has been moderate compared to the years of monetary easing in the past

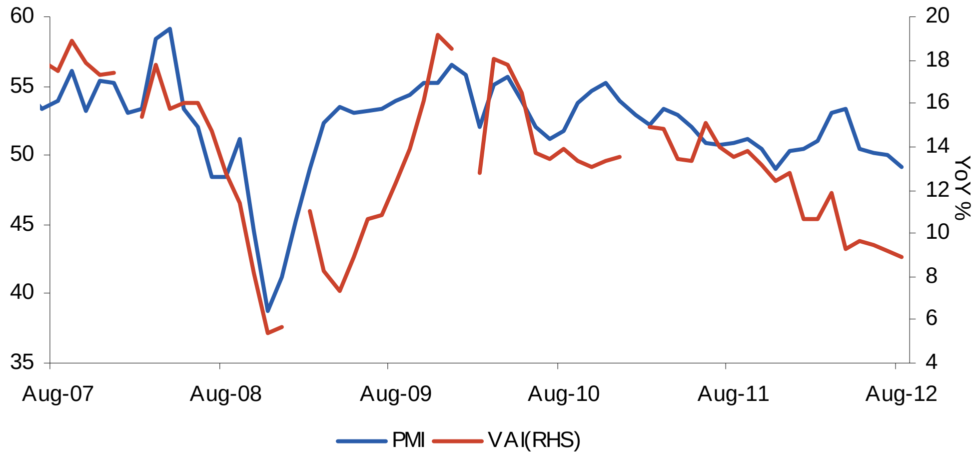


Source: CEIC, Mizuho research

Industrial production weakened

As such, although the growth in industrial production in August, at 9.0%YoY, remains above the previous trough reached in November 2008, at 5.4%YoY, it is the weakest growth in more than three years. Since 2Q, similarly, China's railway cargo volume has dropped sharply, from 350mn tonnes to around 300mn tonnes in July. The scale of the decline is comparable to what we saw during the outbreak of the global financial crisis at the end of 2008.

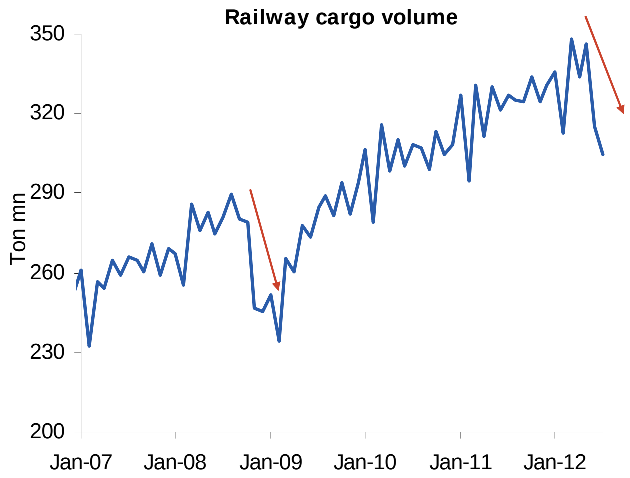
Fig 7 Industrial production in August, at 9.0%YoY, is the weakest since May 2009

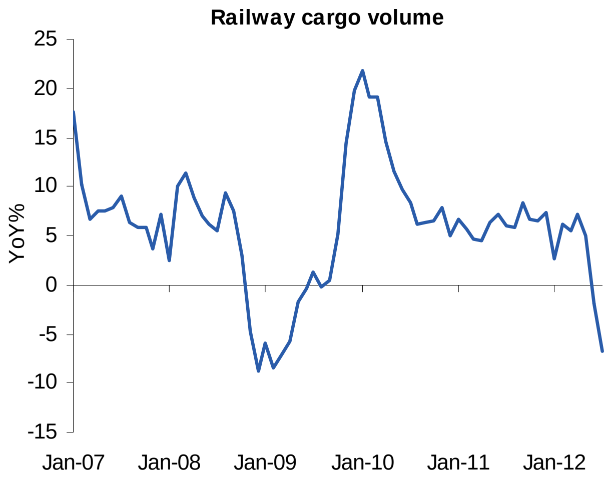


Source: CEIC, Mizuho research

By the 2010 breakdown, over 70% of the total railway cargo volume was for raw materials, including coal (51%), metal ores (12.4%), and steel, iron and non-ferrous metal (7.3%). It is in line with the decline of raw material inventory sub-index of manufacturing PMI in August. This suggests that manufacturers have become more conservative in their production outlook due to a finished goods stockpile and lack of working capital. As the Euro crisis is still highly uncertain and stimulus package may be insufficient, the possibility for a further decline in the coming months cannot be ruled out.

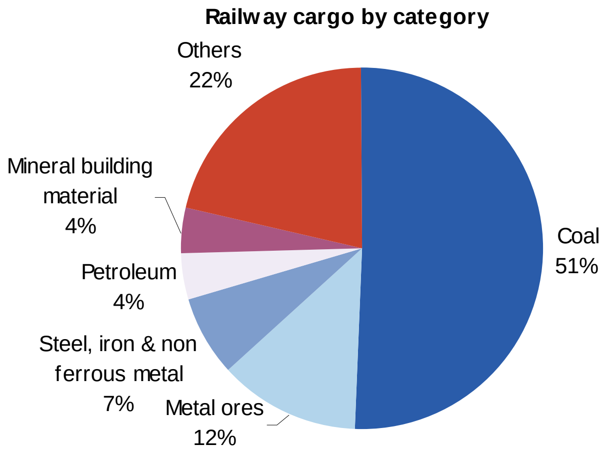
Fig 8 Railway cargo volume decline is comparable to 2008-2009





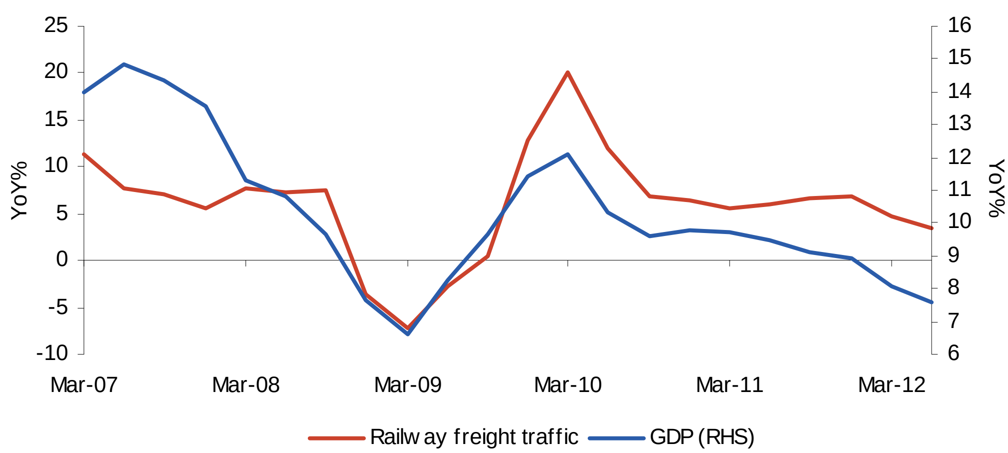
Source: CEIC, Mizuho research

Fig 9 Over 70% of the total railway cargo volume is for raw materials



Source: CEIC, Mizuho research

Fig 10 Remarkable correlation between railway traffic and GDP growth



Source: CEIC, Mizuho research

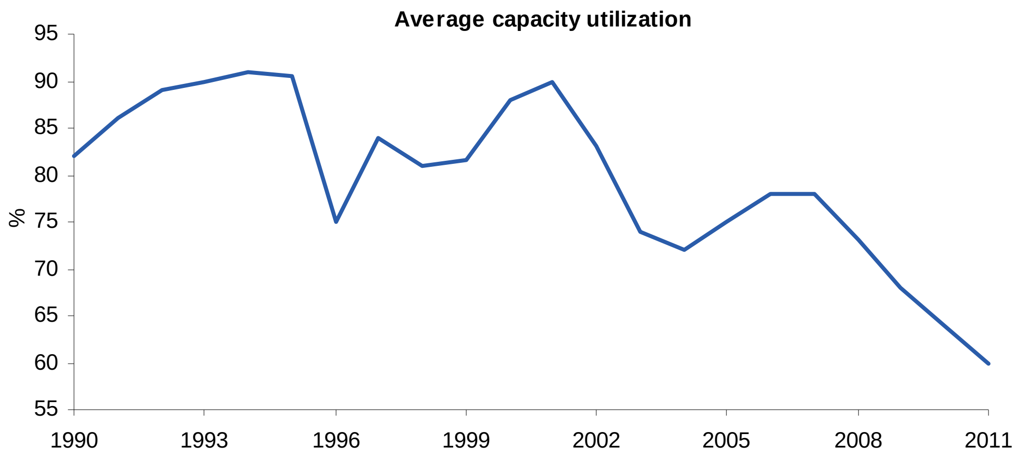
Excess capacity remains a problem

According to the Ministry of Industry and Information Technology (MIIT), as of March 2009 about 30% of the nation's aluminium production capacity was idle, as was 20% of cement and plate-glass capacity and 70% of semiconductor production. After the first downturn, the CNY4tn stimulus package depressed the utilization rate even further.

According to recent estimates from an IMF report, China's capacity utilization rate was around 80% before the outbreak of the global financial crisis, and it was already low by international comparison. However, it dropped further to around 60% in 2011. Core inflation thus remained low in 2008, as well as currently, despite the volatile food prices in China.

Due to the increasing idle capacity, private demand for new investment has been weak, as reflected in the disappointing share of medium- to long-term loans for businesses, which is mainly for investment. In comparison, the loan growth for the household sector has been more resilient, implying property demand is much stronger than industrial investment which contrasts against the intention of policymakers.

Fig 11 China is plagued by excess capacity



Source: IMF, Mizuho research

Key differences from 2008–2009

The stimulus package from 2008–2009 successfully pulled China out from a more severe downturn, but it also created an asset bubble in the housing market, a strong inflationary cycle, oversized local government financing vehicles (LGFV), and an increase in excess capacity. China's advantage in manufacturing and exports has also changed due to rising production costs. China's competitiveness ranking, according to the World Economic Forum, dropped for the first time since 2005 from 26th in 2011 to 29th in 2012. It shows that the 2012 crisis is in many ways different from 2008 in terms of the underlying macroeconomic conditions:

Leadership change not conducive to large-scale stimulus measures

China is entering a new round of political reshuffling, as the 5th generation leaders are making last-minute preparations before the National People's Congress (NPC) in March 2013, when Xi Jinping and Li Keqiang are expected to take over the Presidency and Premiership, respectively.

The delay of the 18th National Party Congress from mid-October to 8 November, in our view, reflects the difficult process to balance completing demand from key different camps within the Communist Party. Contrary to the swift response from the policymakers in 2008, policy making will be delayed in the short term. So far, there hasn't been sufficient government stimulus, and monetary easing has stopped after the second interest rate cut on 5 July, reflecting the political stalemate right now.

Also, following the recent rebound of the housing market, room for more easing has been curtailed. The average housing price in 70 cities rose in August for the third consecutive month. This indicates that the government is missing out on a powerful tool to boost construction and investment, as the market demand for new housing remains strong. Going forward, the government will have to rely mostly on infrastructure investment, which may not be enough to jump start the economy.

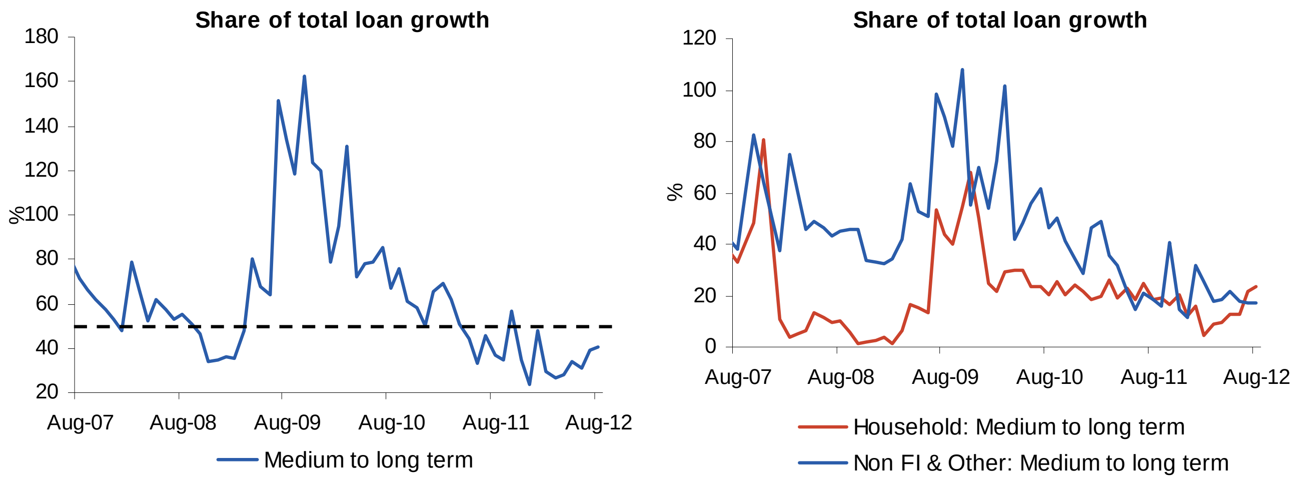
Banks still experiencing an overhang from the last credit boom

For the 2008–2009 stimulus package, investments were readily financed by the government, and a flood of private sector funding primarily through: 1) issuance of treasury bonds earmarked for local government; 2) a special program of extra long-term, concessionary interest rate bank loans; and 3) the issuance of local government financing vehicles (LGFV) endorsed by local governments. As such, sufficient funding ensured that the projects could begin as soon as they were announced.

In 2012, the funding of new projects is not guaranteed by the government. Instead, due to the limited monetary easing so far, and the strained fiscal revenue at the local government level, some of these recently approved projects could face difficulties in finding financing for the near-term after the approvals (see "Matching investment and credit support to stabilize growth – August macro data review" 10 September).

The share of medium- to long-term loans remains at around 30%–40%, below the historical level at around 50%. The share from the corporate sector, in particular, reached 17.1% in August, significantly below the trough at 2008-2009 crisis, at 32.3%. It could limit the effectiveness of the investment boost.

Fig 12 The share of medium- to long-term loans stays below historical levels



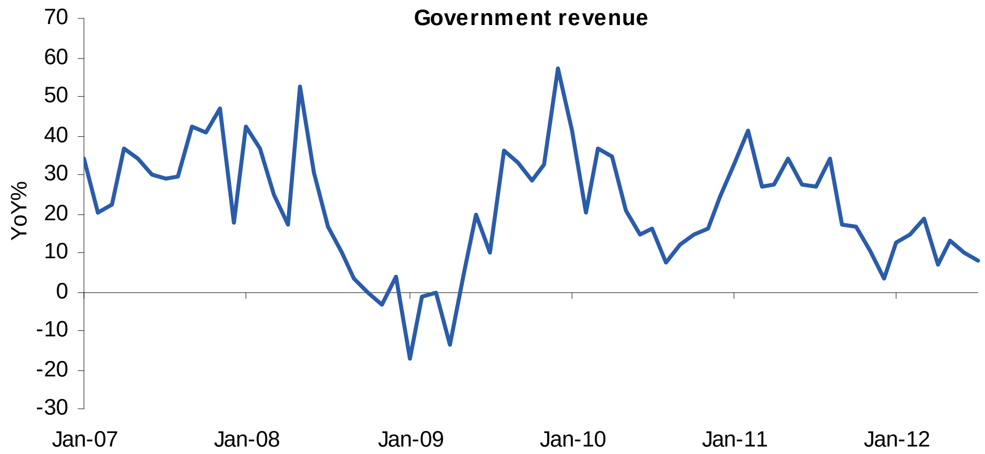
Source: CEIC, Mizuho research

Waning fiscal revenue at local governments

Also the local government is beginning to experience fiscal difficulties. Recently, the local government of Wenzhou put up 52 pieces of land for sale in one road show, with a total area of 3,220 mu. Hangzhou, meanwhile, put up 7 land lots for sale on 27 August, Beijing is also putting up 11 land plots for sale on 17 September, and Shijiazhuang is putting up 8 plots.

Despite the recent slowdown in land price growth, many of the land plots are premium land. It reflects a return of aggressive land sales by the local governments, amid hope that this will help their finances when close to 40% of the local governments have been unable to reach their half-year budget target in 1H. Overall, total government revenues increased by 8.2%YoY in July, significantly lower than 26.7%YoY in 2011. The tight budget also implies that the local government stimulus packages, which totalled up to CNY10tn, will be difficult to finance.

Fig 13 Total government revenues increased by 8.2%YoY in July, significantly lower than 2011



Source: CEIC, Mizuho research

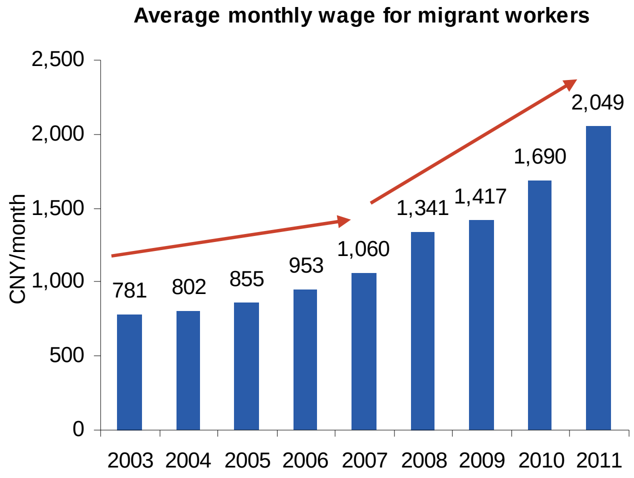
Investment projects all planned out in 2012

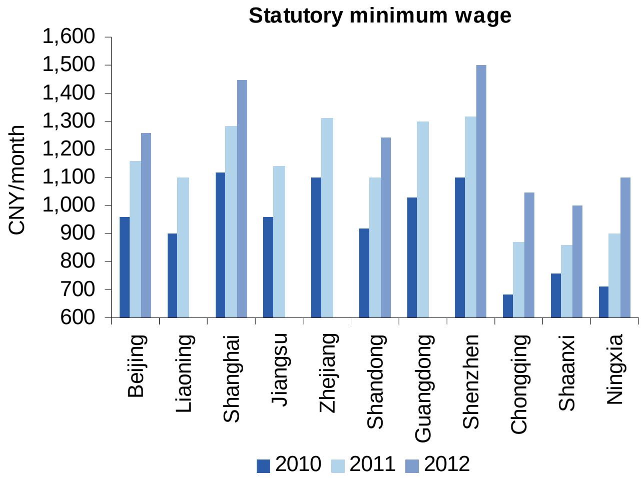
On the upside, when the 2008-2009 stimulus plan was announced, it was hastily put together due to the urgency of the situation. In comparison, the current stimulus could take advantage of the investment plans in the 12th five-year plan, and focus on energy conservation and social welfare projects that were already planned in advance. In 2012, we are now at the second year of the 12th five-year plan and projects that have been studied can be expedited to provide an investment opportunity. For example, the NDRC approved 22 subway projects among other transportation projects with a total investment of about CNY1tn. These are expedited projects that were originally part of the 12th five-year plan for transport sector investment.

Rising production costs to hurt China's low-cost advantage

Compared to 2008-2009, the production costs in China have visibly increased. We argued in "How will wage increases shape China's economic landscape?" (25 June 2010) that the surplus of labour in China is ending at the emergence of Lewis Turning Point (LTP), and it will be replaced by a shortage of labour and pressure for higher wages. It is evident in the broad-based increase in minimum wages since the publication of the report about two years ago: Cumulatively, the minimum wages in Shenzhen, Beijing, and Shanghai has been raised by 36%, 31% and 29%, respectively. It erodes China's export advantage as a low-cost producer.

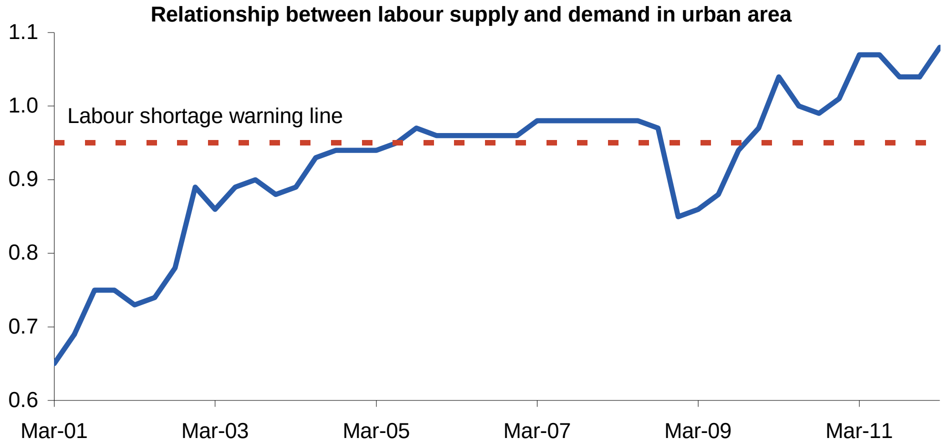
Fig 14 Wage levels have surged in recent years





Source: CEIC, Mizuho research

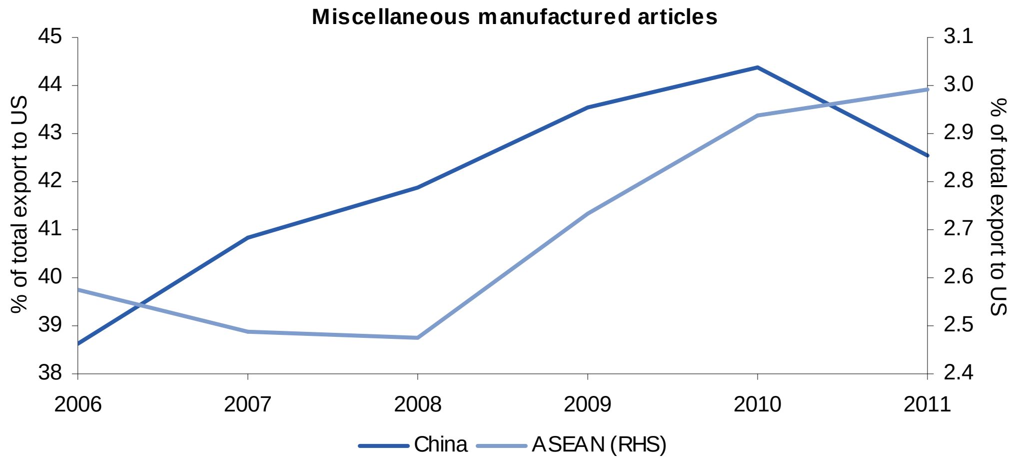
Fig 15 The shortage in labour supply has worsened since 2009



Source: CEIC, Mizuho research

The production costs in China are already notably higher than those in South Asia and Southeast Asia, such that China can no longer rely on low-wages to maintain its competitiveness. The transition is especially pressing in the light industries where the production of toys, footwear, apparel and travel goods tends to be more labour intensive. As such, other Asian economies are taking a growing share of world trade. Although China exported close to 40% of the world's footwear in 2010, ASEAN's share increased from 8.6% in 2009 to 9.1% in 2010. Likewise, China maintained a 32% share in world textile exports, but South Asia's share increased from 7.6% to 8.5%.

Fig 16 China's market share of labour intensive products declined in the US

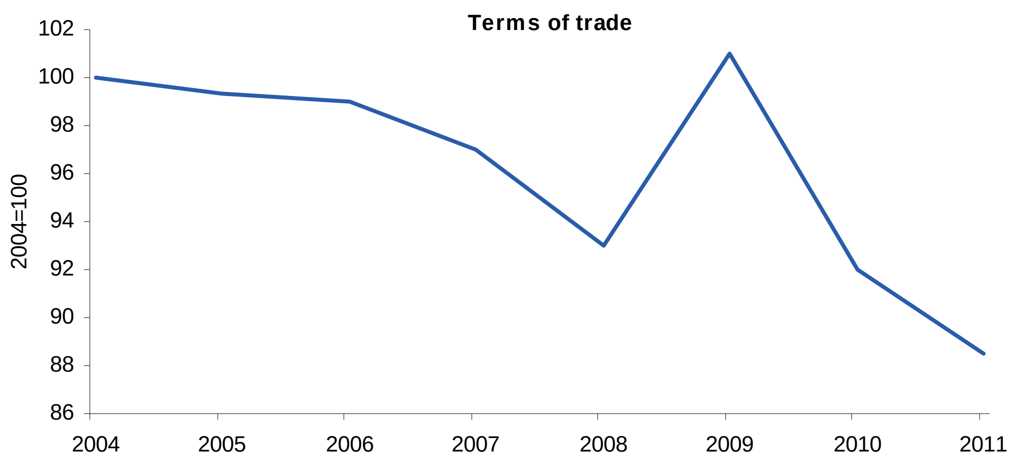


Source: US Census Bureau, Mizuho research

Deteriorating terms of trade and more expensive RMB

Following the quantitative easing in the advanced economies since 2008-09, the imported inflationary pressure has been translated into higher production costs for Chinese manufacturers. On the other hand, manufactured products from China have been under intense competition from production centres with lower costs, as well as other Chinese manufacturers. In effect, it erodes the terms of trade for Chinese products, and weighs on China's trade balance further.

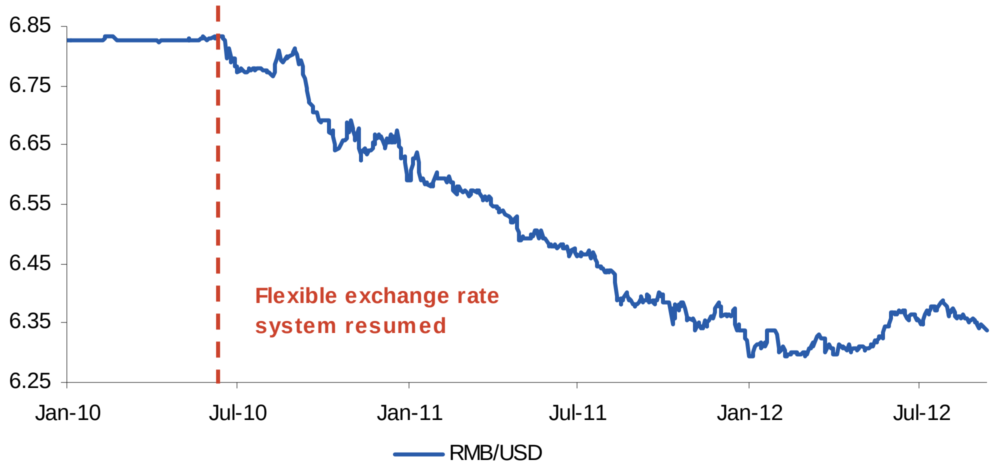
Fig 17 China's terms of trade are deteriorating due to rising import prices



Source: CEIC, Mizuho research

In addition, despite the unrelenting pressure from the US to further appreciate the RMB, the RMB has already moved up by 7.2% since appreciation resumed in June 2010. It intensifies the existing cost-driven challenges to export-based enterprises in China, especially the smaller producers whose price setting power is limited by fierce competition.

Fig 18 RMB has substantially appreciated



Source: CEIC, Mizuho research

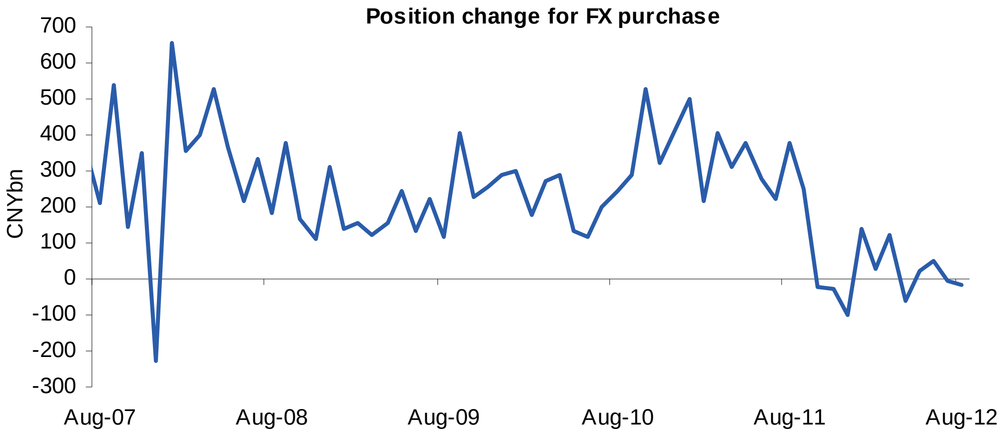
Trade protectionism to weigh on China's export outlook

Trade protectionism may be rising as the global economic downturn intensifies. The European Commission said on 5 September that it has launched an investigation against Chinese solar panel producers. This case would be one of the largest trade actions in European history and could lead to punishing tariffs on China's USD20bn annual exports of solar panels to Europe, after the Commerce Department of the US imposed similar anti-dumping tariffs in May. As we argued in "China's exports at a crossroad" (10 May), protectionism is already forcing companies to reassess the merit of keeping their production in China.

Concern for capital outflow

As Premier Wen Jiabao declared in the National People's Congress this year, the RMB is now close to equilibrium. The days of one-way RMB appreciation are gone, and two-way fluctuation will become more common going forward. It has changed the market's expectations for the RMB. Along with China's trade surplus, and dampened foreign investment, the potential for China's capital outflow has become a concern. It has slowed the growth of foreign exchange purchases, which affected China's monetary base and cancels out part of the government's monetary easing.

Fig 19 No increase in the banking system's foreign exchange position despite a rising trade surplus



Source: US Census Bureau, Mizuho research

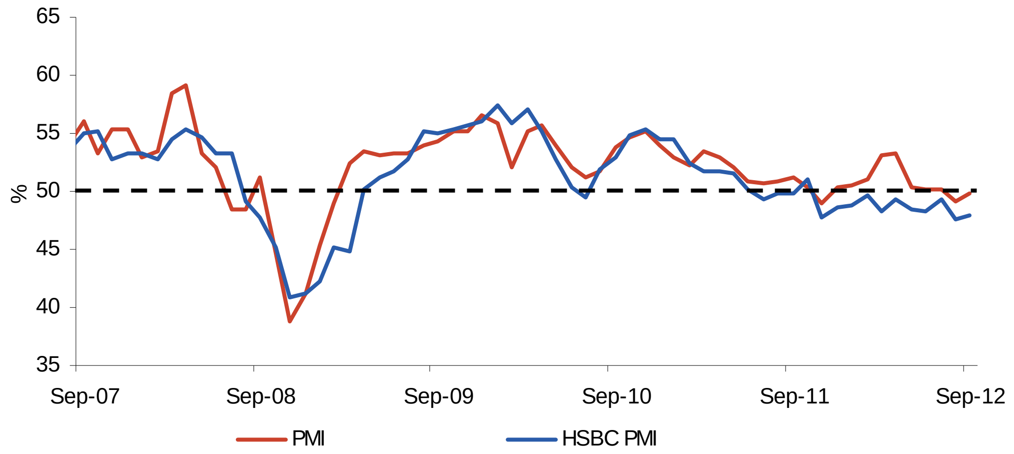
Cyclical trough is not yet in sight

The leading economic indicators recently released have shown that the cyclical trough for the current downturn is not yet in sight:

PMI reflects weak demand across the board

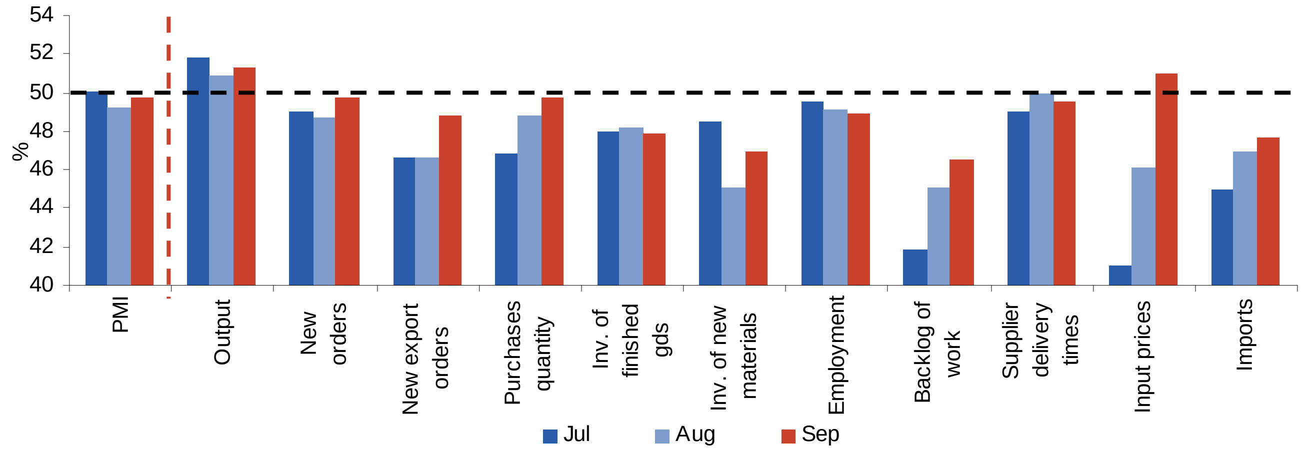
In September, the official manufacturing PMI improved to 49.8 from 49.2 in August. It was, however, mainly due to the seasonal effect, possibly related to the increased export orders for the Christmas sales season. Overall, although the PMI survey is claimed to be seasonally adjusted, the September reading in the past seven years was on average 2.0 higher than August's. With an improvement of just 0.6 this year, the PMI in September shows that the economy actually continued to decelerate. That will be reflected in lackluster economic activities in September.

Fig 20 PMI improved in September, but it is likely due to residual seasonality



Source: CEIC, HSBC, CFLP, Mizuho research

Fig 21 PMI sub-indices breakdown

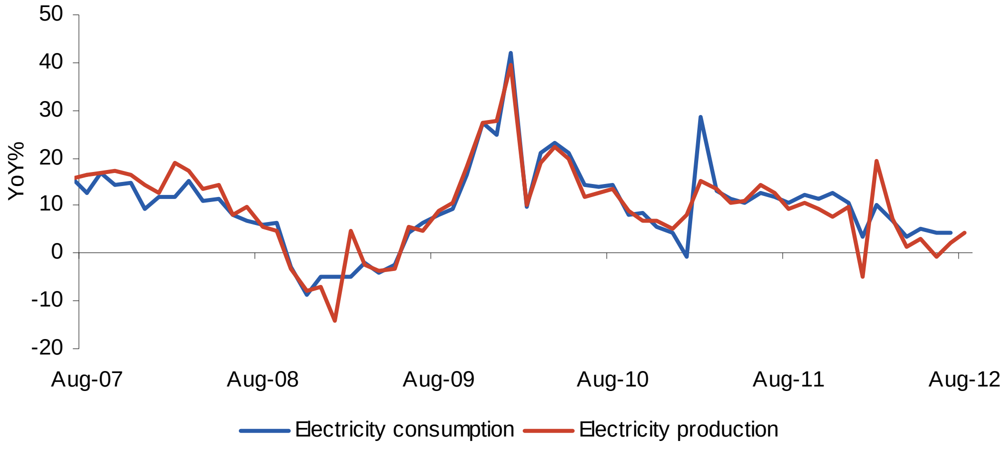


Source: CFLP, CEIC, Mizuho research

Weaker industrial activities to be expected

Also in-line with China's cooling factory activities and industrial output is the weak electricity production in August, which was up by only 4.3%YoY, below 2011's average at 11.0%YoY. Alternatively, electricity consumption increased by 4.5%YoY in July, and its breakdown for industrial and manufacturing sector was even lower, 3.6%YoY. It implies that industrial production in the coming months will remain lacklustre.

Fig 22 Electricity data shows industrial production will remain lacklustre

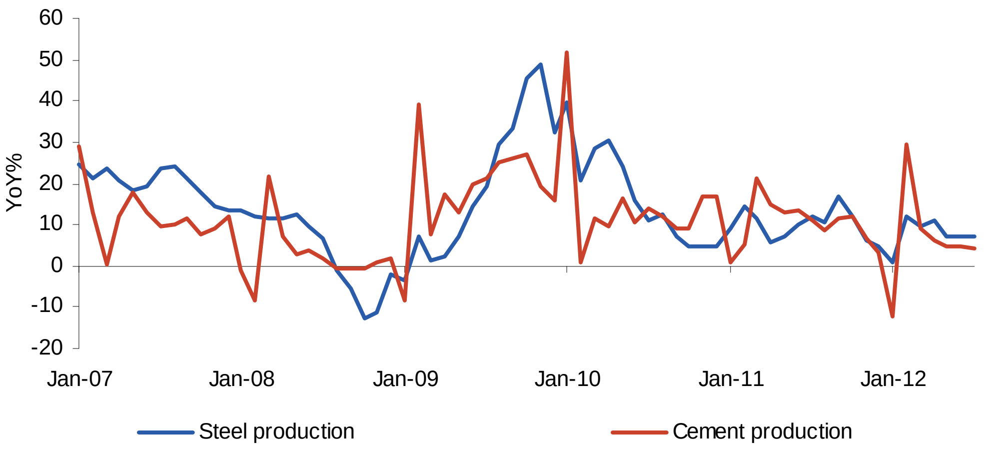


Source: CEIC, Mizuho research

Easing production for raw material

In addition, the production of raw materials such as steel and cement has visibly slowed. In January-July 2012, the production of steel and cement increased by 7.9%YoY and 5.6%YoY respectively, below 10.0%YoY and 10.4%YoY in 2011. It underlies the lack of new investment in the property sector, as well as the limited success from the government's stimulus so far. As construction is closely tied to an extended supply chain in the economy, its weakness is a clear indication that economic growth will remain weak in the next two quarters.

Fig 23 Production of construction materials continues to moderate



Source: CEIC, Mizuho research

All in all, the absence of a dramatic fall in the current downturn could be deceiving. As China is now facing more structural adversities than in 2008-2009, the slowdown could drag on for some time.

A dilemma: short-term stimulus vs. long-term stability

The government to focus on long-term development

The key to boosting China's economic growth is to launch counter-cyclical measures to stabilize the economy, and this is exactly what the government promised. In the central economic meeting, the government set the objective of China's economic policy in 2012 as "stabilizing economic growth", with proactive fiscal policy and prudent monetary policy, which in effect is widely understood as easing (see "Is prudent policy enough to prevent a hard landing? China's 2012 Macro outlook" 15 December 2011).

However, we believe the government is facing a more complicated situation now than in 2008-2009 in policy easing, as the Chinese economy is in transition: The government has emphasized the importance of economic restructuring to promote consumption since the 11th five-year plan. As the economy continues to expand, the need for reforms has become more pressing.

In the reforms, the economy should move away from the traditional investment-driven growth, as it will eventually backfire on China's long-term economic prospects. Rather, it should focus more on productivity growth, consumption driven growth, more developed service sector, and a more efficient market mechanism, in order to avoid China from falling into the medium income trap.

Also, China is now in the midst of a political power transfer to a new government, that will lead the country for the next ten years. The new government leaders may want to focus on the long-term development of the economy, including structural reforms and elimination of the asset bubble and excess production capacity that have built up after the CNY4tn stimulus in 2008-2009. Counter-cyclical measures to stimulate growth will be relegated to lower priority. Therefore, the government is cautious to launch a new stimulus package.

Large scale stimulus measures are unlikely

In our view, the government's goal is to strike a balance between stabilizing growth and promoting the reforms, which is not going to be an easy task. It has focused on launching various small-scale stimulus measures that attempt to bolster economic growth in the right direction.

In terms of investment, it includes: 1) The CNY1tn subway and transportation network projects already approved by NDRC. In the coming months more projects that are conducive to structural reforms may be announced, on social housing, infrastructure, water management, and renewable energy. 2) Encouraging private sector participation in industries that are traditionally monopolized by the state, in areas such as the railways, public utilities, energy, telecommunications, financial, health and education industries. 3) Speeding up the investment from the Ministry of Railway. In August, the Ministry's spending on infrastructure construction was up by nearly 20%YoY.

As for consumption, the government has 1) offered CNY14bn subsidy for energy-saving home appliances such as desktop computers and air-conditioners. It is an extension of the subsidy program that has boosted sales of energy efficient products by over CNY600bn since 2009; and 2) commenced the pilot conversion from value-added tax to business tax to improve the tax system and reduce tax burden starting from 1 September.

In addition, the government is planning to boost exports by raising the VAT rebate from the current range of 13-15% to 17%. It will cover labour intensive products including furniture, shoes and toys. Also there will be little pressure for the RMB to appreciate further in 2012, and it will stay broadly stable at CNY6.35/USD1 (see "Weak domestic demand to drag down imports" 10 September).

In addition, we expect the government will continue to inject liquidity into the market through the sales of reversed repo in the financial markets. We also expect at least two more RRR cuts in 2012 to accommodate the increased credit demand from the new infrastructure investment projects (see “Corporate medium- to long-term loan still weak” 11 September).

Overall, we believe massive stimulus measures of a similar scale to 2008-2009 are unlikely if the economy continues to slow down moderately. Instead, the new policymakers will consider a healthier economy with slower yet steady growth to be superior to an effervescent economy that is volatile. We believe more substantial stimulus measures will be reserved for a more severe meltdown of the economy that would harm the effective governance of the country’s leaders, such as:

- Further deterioration of the global economic situation. The external environment remains highly uncertain, and the possibility of a large scale collapse of the Eurozone economies, while small, cannot be completely ruled out; and

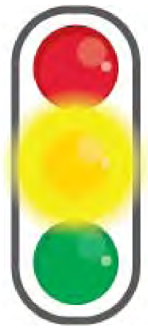
- Sharp deterioration of the domestic labour market. In 2008-2009, the Ministry of Agriculture showed that more than 20mn migrant workers lost their jobs during the downturn. The CNY4tn stimulus package was announced partly out of the concern that mass unemployment could challenge China’s social stability.

So far, the labour market has been a bright spot in China’s economy. Labour supply and consumer demand in urban areas were reported to be resilient. However, labour conditions tend to be a lagging indicator. It suggests that businesses may begin to lay off workers months after production slowed. If there is labour market related unrest that threatens stability, it is likely that the government will again launch a massive stimulus in the hope that it will retain the people’s support for the government.

As a consequence, we expect the economy to moderate further in the coming quarters. We maintain that China’s GDP will ease further to 7.4%YoY in 3Q, and 7.2% in 4Q, leading to 7.6%YoY in 2012. China’s GDP growth in 2013 may see a slight rebound, to 7.8%, but will be substantially below the GDP growth recorded in 2008-2009, which was 9.8%YoY and 9.0%YoY, respectively.

12 November 2012

Positive October trade and macro data shadowed by uncertain outlook



- **China's exports were again stronger than expected in October, despite the worsening external outlook. We believe that the better export data was mainly due to shipments for the new iphone, delays in seasonal orders, and a weak base from last year. We maintain that the strength in exports is unsustainable, as evident from deteriorating external conditions and the results from the Canton Fair.**
- **The new loan growth in October, which also came in below expectations, shows that the path to recovery is still rife with uncertainty. The frequent open market operations have been unable to substantially ease the economy's liquidity pressure, and we maintain that one more RRR cut is necessary before year-end.**
- **The October data showed that stabilization in the economy has continued amid government support. However, the improvement is limited to specific sectors that benefit from the boost in fiscal investment spending. The investment in the manufacturing and property sectors, meanwhile, remains weak. We are also wary about the "window dressing" type of stimulus during the party congress. As a result, we upgrade our forecast for 4Q and full year 2012 GDP slightly, to 7.7%YoY, but maintain our forecast for 2013 at 7.8%YoY amid continuing uncertainty.**

Fig 1 Key economic indicators

(YoY%)	Sep	Oct (Est.)	Oct (Actual)
CPI	1.9	1.8	1.7
PPI	-3.6	-2.4	-2.8
VAI	9.2	9.2	9.6
FAI (YTD)	20.5	20.6	20.7
Retail sales	14.2	14.1	14.5
Exports growth	9.9	6.0	11.6
Imports growth	2.4	3.0	2.4
Trade balance (USDbn)	27.7	22.3	32.0
New loans (CNYbn)	623.2	600.0	505.2
M2	14.8	14.4	14.1

Source: CEIC, Mizuho research

Strength in export growth unlikely to be sustainable

Export outlook remains grim

The strong export growth in October, at 11.6%YoY, comes mainly from the delay of seasonal orders to September and October this year, shipments for new i-phone models, as well as a weak base from last year. By product, strong growth was reported in telephone handsets, garments, and footwear. The export of handsets, in particular, was up by 86%YoY, contributing 5.4ppts to export growth. By region, export growth to the United States was up again, along with the ASEAN countries. Meanwhile, demand from the European Union continued to fall, with more severe declines from Italy and France.

The strong export growth is unlikely to sustain amid the external headwinds. The US fiscal cliff, in addition, poses the main source of economic uncertainty in the US and beyond. The Euro crisis is still lingering on. The IFO economic sentiment for the Euro area plunged to 81.7 in 4Q, from 88.9 in 3Q, the lowest since 3Q 2009. It reflects that the firm expectations for the next six months have deteriorated, amid the weak demand and unemployment. The global economic outlook remains grim for the quarters to come.

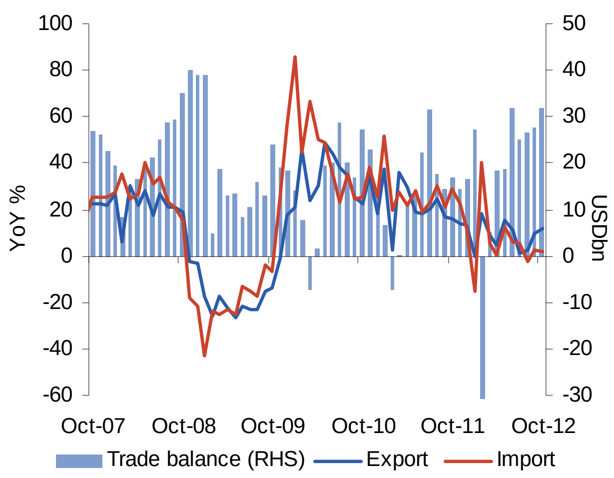
Jianguang Shen
jianguang.shen@hk.mizuho-sc.com
+852 2685 2022

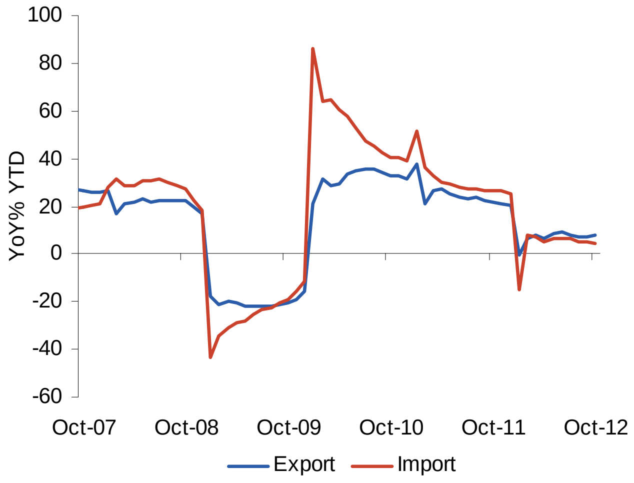
Michael Luk
michael.luk@hk.mizuho-sc.com
+852 2685 2155

The downbeat global demand for Chinese goods was also witnessed at the Fall session of the Canton Trade Fair. The final figures released on 4 November showed that the number of overseas participants dropped by 10.26%, and turnover dropped by 9.3% compared to the Spring session. Historically there is a strong correlation between order value from the trade fair and actual exports. As such, China's export growth in the next two quarters will be lower than 2Q-3Q 2012.

In particular, orders from the developed economies dropped considerably. China-Japan agreements fell 36.6%, due mainly to the lingering territorial dispute. Orders with the US and EU also declined by 9.4% and 10.5%, respectively, due to weak economic situations. Orders from emerging markets also showed minor declines, confirming that demand from emerging economies is unlikely to stand on its own.

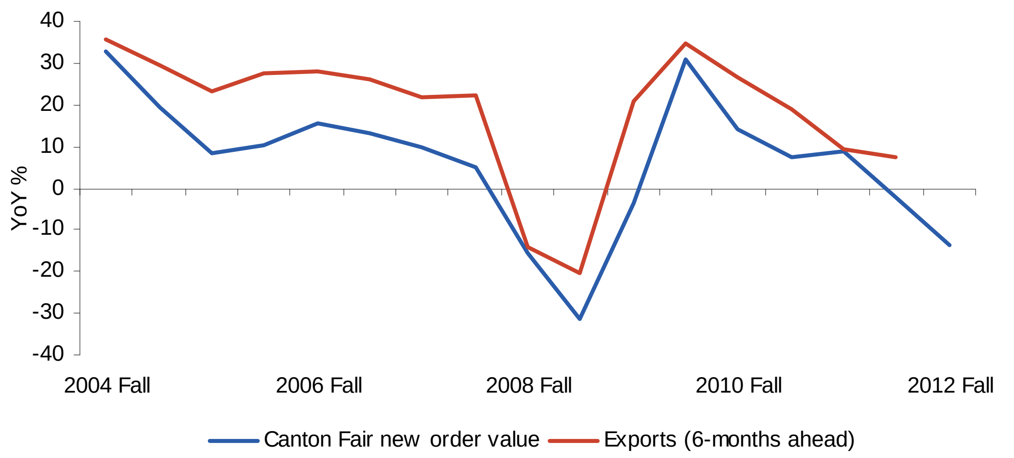
Fig 2 Exports were up strongly in October, but it is unsustainable





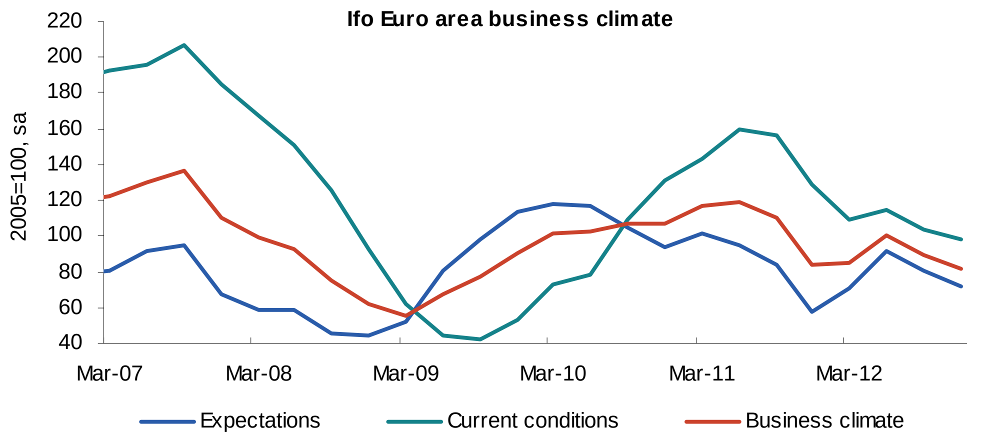
Source: CEIC, Mizuho research

Fig 3 Disappointing Canton Fair result points to weaker exports in the near future



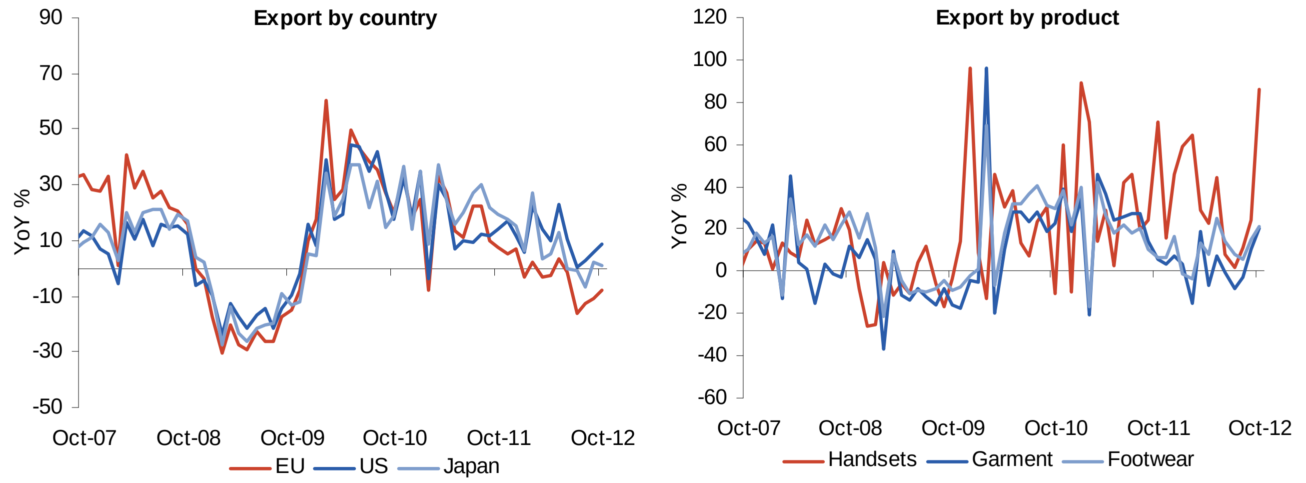
Source: CEIC, Mizuho research

Fig 4 The economic sentiment in EU is at the lowest since 3Q09



Source: DataStream, Mizuho research

Fig 5 Exports to EU continues to fall

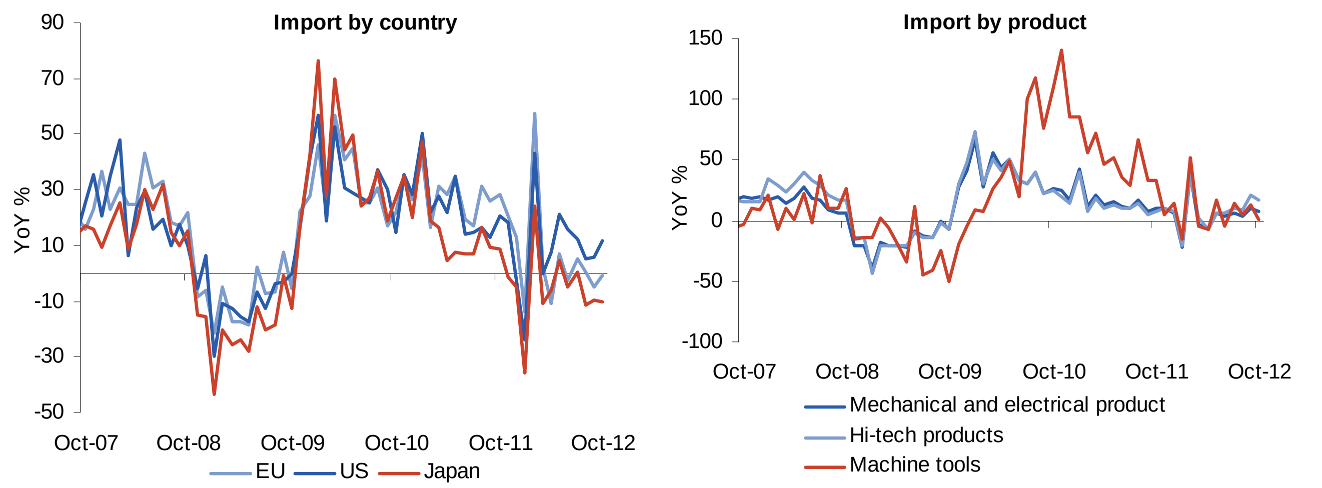


Source: CEIC, Mizuho research

Imports of commodities goods rebounded
Import growth stayed flat in October with a 2.4%YoY increase, leading to a trade surplus of USD32.0bn. By product, crude oil and iron ore imports increased by 13.8%YoY and 13.0%YoY, respectively, in volume, reflecting the pickup in infrastructural investment and restocking process, but on the other side, the import of machine tools, mechanical and electrical products, and hi-tech products moderated.

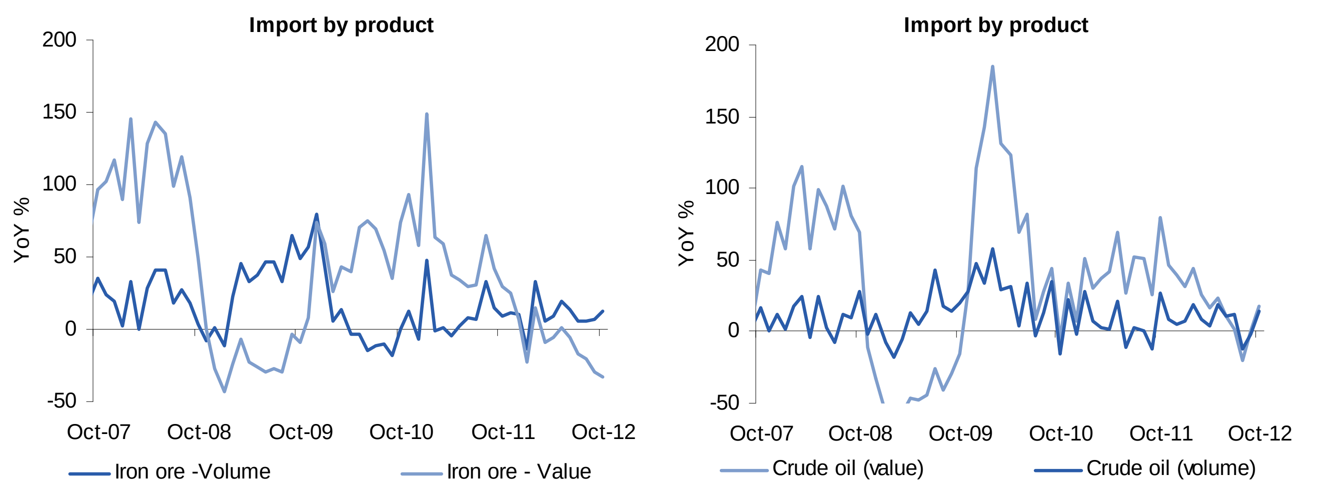
On the sidelines of the ongoing 18th National Party Congress, the Minister of Commerce Chan Deming said China will need to expand the domestic consumption of imported goods, especially luxury goods. It adds to recent discussion that the tariffs for imported luxury goods could be lowered in the near future, which could constitute a boost to import growth.

Fig 6 Imports from Japan weakened due to political dispute



Source: CEIC, Mizuho research

Fig 7 Raw material imports was triggered by infrastructure investments



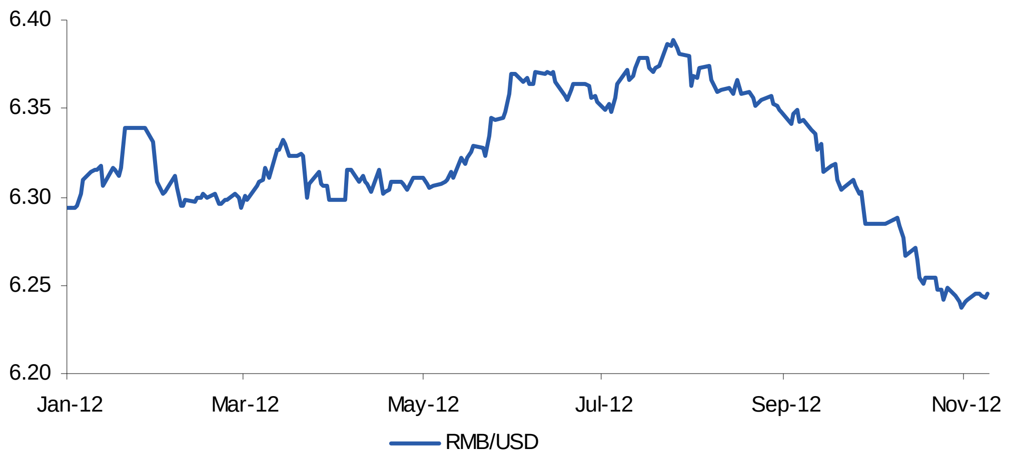
Source: CEIC, Mizuho research

RMB appreciation will not last

In January–October, China's total trade expanded by just 6.3%YoY. It is significantly below the government's 2012 growth target of 10%YoY. In the NPC, the Minister also said that trade situation will be grim until next year, amid the downbeat global outlook. As we argue in the "Flood of money: QE3's impact on China and Hong Kong" (24 October), this puts pressure on policymakers to support China's exports.

Behind this backdrop, we argued that the government cannot tolerate further one-sided appreciation of the RMB. The recent pace of RMB appreciation is especially hard to ignore. Between the high of 25 July and 31 October, the RMB appreciated by 2.37%. Since November the trend of appreciation has stalled. We maintain that the RMB/USD rate will stay broadly stable around CNY6.25-6.3/USD1 for the coming quarters.

Fig 8 The pace of RMB appreciation has slowed since November



Source: CEIC, Mizuho research

Credit data reflects market uncertainty

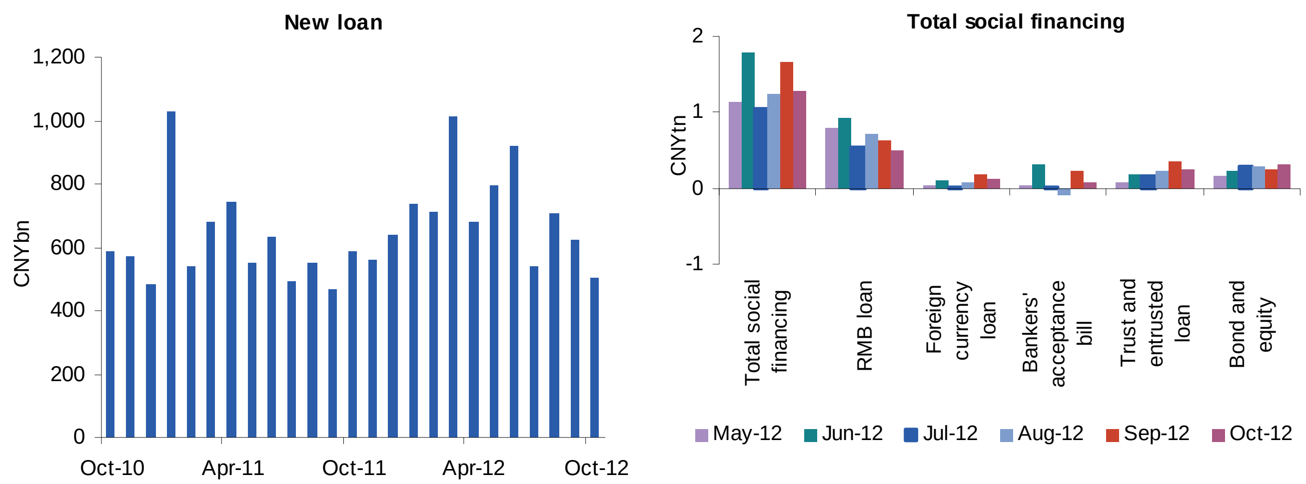
Lower new loans than expected
In October, CNY505.2bn in new RMB loans was extended below expectations, as well as below last month's growth at CNY623.2bn. The share of medium- to long-term corporate loans, nevertheless, increased to 33.4% from 20.5% in September, reflecting improved use of funding. Money supply (M2) increased by 14.1%YoY, down from 14.8%YoY in September.

Liquidity shortage increases unpaid bills
Total social financing was also down to CNY1.29tn in October from CNY1.65tn in September. By breakdown, all sources of funding except bond issuance declined in October. Overall, the credit data reflects another uncertainty in the economy:

In the absence of monetary easing since the interest rate cut in July, liquidity conditions are putting a damper on the economy. Also, the weighted average interbank lending rate remained relatively high at 2.87%, reflecting that tight liquidity conditions continue, despite frequent open market injections through reversed repo in October.

It is also in-line with soaring account receivables in the corporate sector, especially those linked to the construction and infrastructure sectors. We maintain that there should be one more RRR cut before year-end.

Fig 9 Credit data disappointed in October, reflecting another source of uncertainty



Source: CEIC, Mizuho research

Fig 10 The share of medium- to long-term corporate loan improved

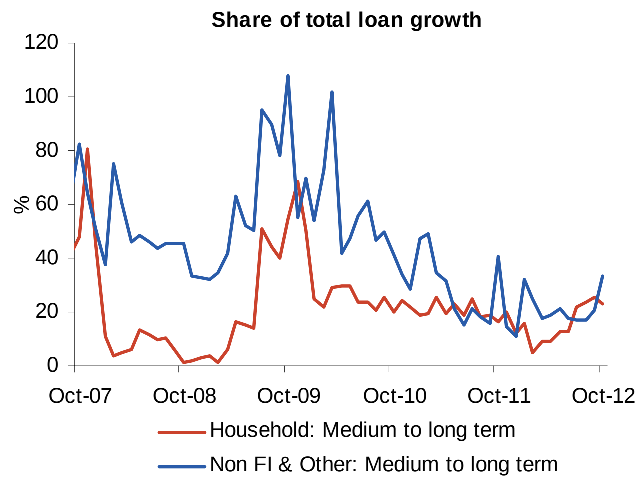
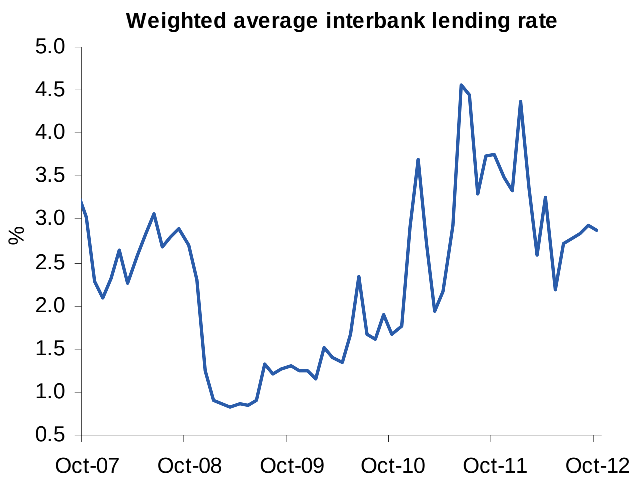


Fig 11 Interbank rate reflects tight market liquidity



Source: CEIC, Mizuho research

Better macro data with uncertain outlook

Fiscal spending behind improvements in macro data in October
Overall, the October data showed that stabilization in the economy has continued amid government support. The fixed asset investment, up by 20.7%YoY YTD, was triggered by the accelerated implementation of the government's investment projects, mainly through railway and highway spending. As a result, the production of electricity, steel and cement were also up by 7.1%YoY, 11.7%YoY and 11.5%YoY, respectively; reflecting that the government-driven demand is also supportive up the supply chain.

China's retail sales were also up strongly in October, on the back of the favourable policy change and the strong demand during the extended mid-autumn/national day holiday. It was up 14.5%YoY, 0.3ppt above September. More notably, the sales of daily use goods was up by 19.0%YoY, reflecting the resilient consumer sentiment as the employment market stands firm (see "Worrying trend despite positive macro data – October macro data review" 9 November).

Fig 12 FAI in October depends mainly on fiscal boost

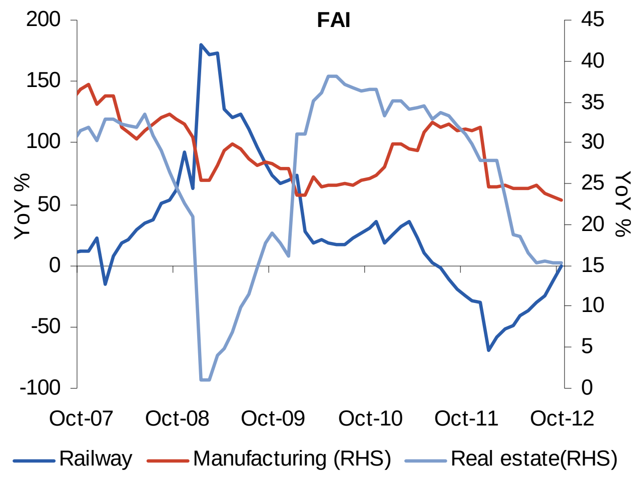
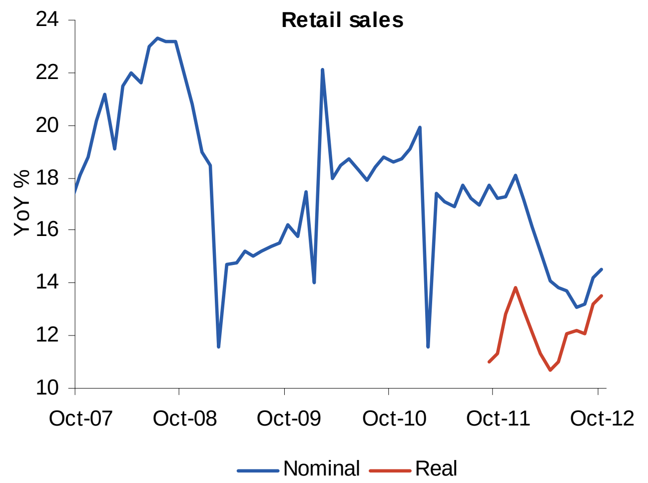
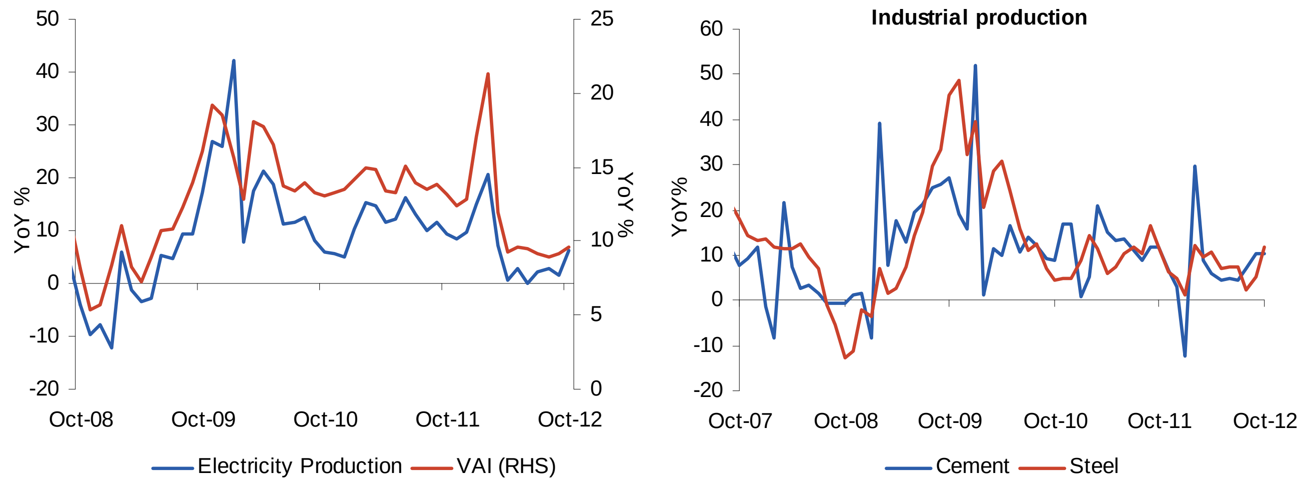


Fig 13 Retail sales remained a bright spot



Source: CEIC, Mizuho research

Fig 14 Improving industrial production reflects stronger demand from government infrastructure



Source: CEIC, Mizuho research

Slight revision on 2012 GDP projection amid risks

In our view, although headline economic data in October has strengthened the market's view that the economy is improving, its breakdown reveals that the recovery is not yet on a solid footing. It is due to:

1) **Decelerating business investment.** Despite the surging investment in railway and highway construction, investment in other sectors remains in downturn. The investment in manufacturing and the utility industry were, for example, 0.4ppts and 0.5ppts lower than September, respectively;

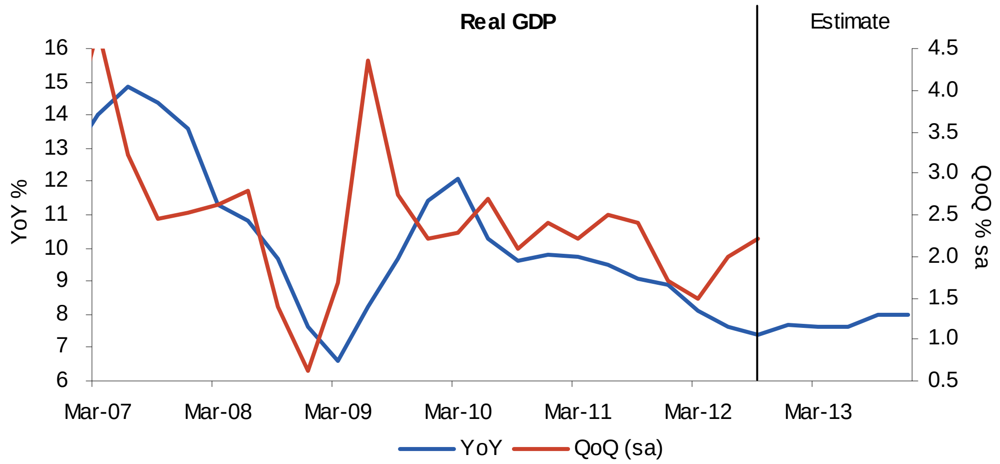
2) **Weak housing investment.** The property market investment is going to be full of uncertainties in the period ahead. On the one hand, the sales of property related goods, including home appliances, furniture and renovation materials have decelerated by 4.5ppt, 1.6ppt and 2.2ppt respectively. On the other hand, real estate investment remained flat at 15.4%YoY YTD in October, and new floor space started for commodity building dropped by 8.5%YoY. It remains questionable if infrastructure spending is sufficient to support the economy, while the property market remains weak;

3) **Rising account receivables.** Recent media reports revealed that businesses in China are hit by sharp rises in account receivables. At the end of the 3Q, 234 of the 2,200 listed companies reported above 100%YoY increase of account receivables. Many companies,

especially those in the iron and steel sectors and equipment manufacturing, were hit by the “triangular debt” problems. “Triangular debt” is essentially liabilities owed by companies to each other that could potentially set up a chain reaction in defaults;

All in all, the government will seek to keep policy steady to ensure a smooth transition in political power, and it is unlikely that large-scale stimulus will be launched again, considering the political transition, impact on the asset market and inflation after the 2008 stimulus, and the demand to keep policy stable. Thus, we maintain our cautious stance on China’s economic outlook. Although we have upgraded our forecast for 4Q and full year 2012 GDP slightly, to 7.7%YoY, we keep our full year 2013 forecast unchanged at 7.8%YoY amid impending uncertainty.

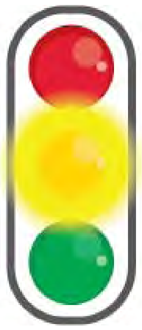
Fig 15 We have revised our 4Q GDP forecast to 7.7%YoY



Source: CEIC, Mizuho research

24 October 2012

Flood of money: QE3's impact on China and Hong Kong



- **The new round of quantitative easing in the US (QE3) is expected to attract significant capital inflows to China and Hong Kong once again. Given the different economic cycles and monetary policy frameworks, China may initially experience a slight positive impact from the US's QE3, as the recent capital flight was reversed. As a consequence, the RMB has recently appreciated to an all-time high. In contrast, the Hong Kong Monetary Authority (HKMA) was forced to intervene in the currency market at the strong side of the peg. It leads to increased liquidity and risks further increases in local asset prices.**
- **However, given the gloomy global economic outlook, we believe the CNY appreciation will be short-lived, and the currency will be range-bound at the current level. This is because both merchandise exports and FDI lack support and will see further weakening. We also reiterate our view that the HKD peg is unlikely to change until the RMB becomes convertible, thus risking further asset price bubbles.**

Quantitative easing triggers a new round of capital flows

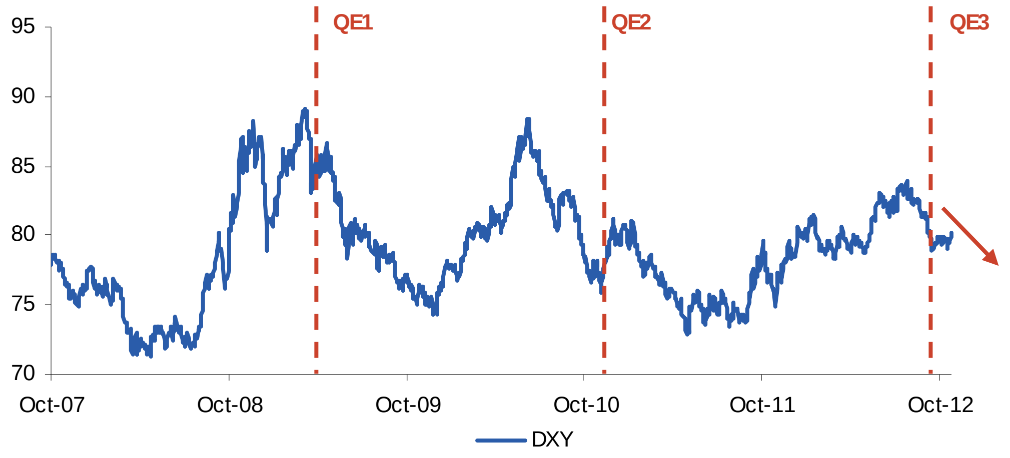
QE3 causes capital leakage to emerging market
The Fed announced a new round of quantitative easing (QE3) on 13 September. According to the announcement by the Fed, it would purchase USD40bn of mortgage-backed bonds each month to stimulate the housing market and keep long-term interest rates low. In both QE1 and QE2, the extra liquidity in the US created a capital influx into the emerging markets as investors seek better returns. In the process, it also created what the IMF acknowledged as large and volatile capital flows to emerging economies that could be destabilizing, in addition to inflation, asset price pressure and the risk of a currency war through competitive depreciation.

A recent report from the International Institute of Finance (IIF) has revised up its estimate for net private capital flows to emerging markets by USD114bn to reach USD1026bn. It was due to a boost from additional monetary easing by the Fed and a decline in risk aversion after the ECB's Outright Monetary Transactions (OMT) have mitigated market fear for the collapse of the Euro. Emerging Asia will account for much of the capital flows. It could reflect rising asset prices in these markets in the coming months.

Jianguang Shen
jianguang.shen@hk.mizuho-sc.com
+852 2685 2022

Michael Luk
michael.luk@hk.mizuho-sc.com
+852 2685 2155

Fig 1 US Dollar depreciates amid capital leakage after QE

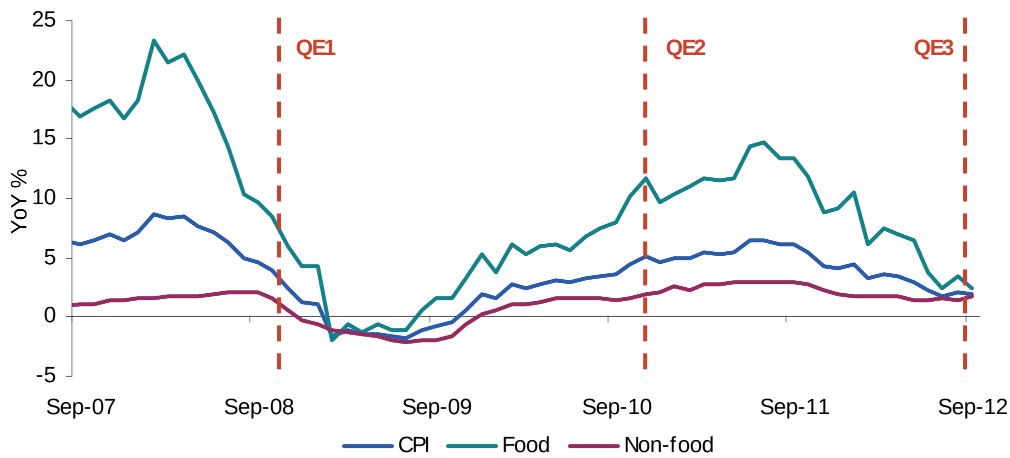


Source: CEIC, Mizuho research

For the case of China, the spillover effect from quantitative easing has contributed to the inflationary cycle in 2011, as 1) Global commodity price hikes drive up non-food prices (see "China's new paradigm of higher inflation" 14 December 2012); 2) In order to preserve China's export competitiveness amid a currency war, the RMB's exchange rate was fixed at around CNY6.83/USD1 from 2Q 2009 to 2Q 2010 (see "The RMB Myths" 14 May); 3) Increased hot money inflows contributed to China's asset price bubbles; and 4) The depreciation of the USD has also created concerns over the value of China's FX reserves, denominated mainly in USD.

When the QE2 was announced on 3 November 2010, it was met with a strong reaction from China. Chairman Zhou Xiaochuan of the PBOC said the stimulus was a good option for the US economy but it may not be the right choice for the global economy. According to Zhou, the QE2 would only lead to dollar depreciation and a flood of speculative capital into global markets. Hence, in comparison, China's reaction to the QE3 was much more restrained. It is likely because during QE2, China's policy focus was the asset bubble and mounting inflation, while it is facing a deflated share price and capital outflows. Also, the government has expressed a view that most of the increased liquidity would likely remain in the US.

Fig 2 Different inflation cycles

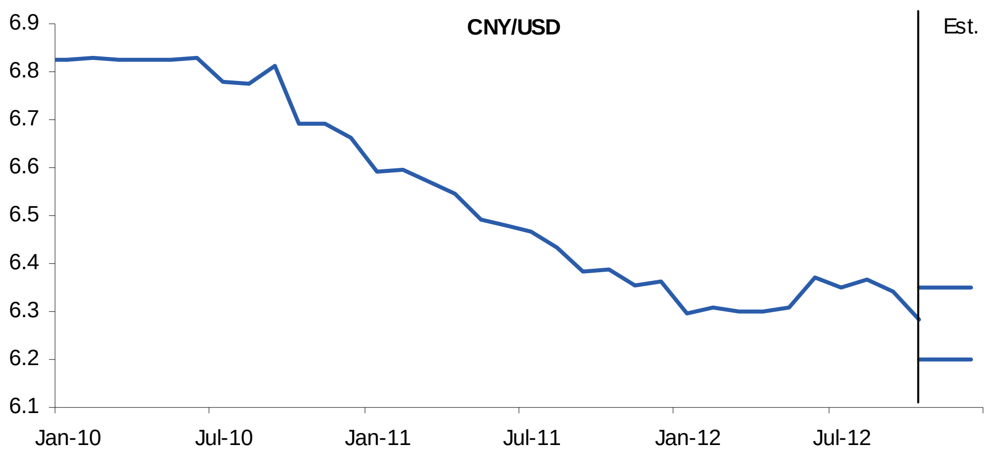


Source: CEIC, Mizuho research

Mixed implications for China

CNY appreciated to an all-time high
From CNY6.33/USD1 when the QE3 was announced, the RMB reached a record high at CNY6.25/1USD on 18 November. Since January 2012, the RMB has stopped appreciating against the USD. Instead, it has traded range bound at around CNY6.30 /USD1 for an extended period, before depreciating to CNY6.38 at the end of July. It reflects that the RMB has basically reached a more balanced level, a view that was further confirmed when the PBOC expanded the currency's daily trading range from 0.5% to 1.0% on 14 April (see "Is the RMB appreciation trend over?" 18 April).

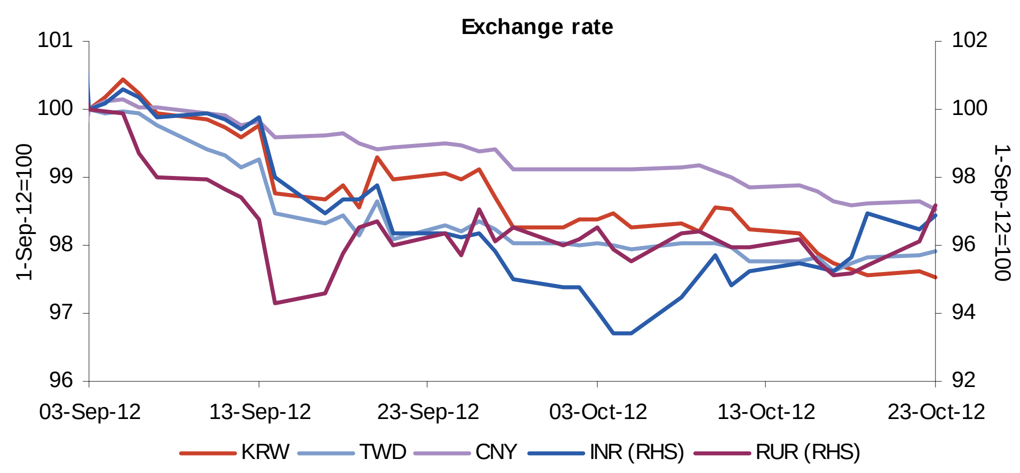
Fig 3 RMB appreciation has resumed in recent weeks



Source: CEIC, Mizuho research

Compared to the other emerging Asia currencies, RMB's appreciation, at around 1.4% since the beginning of September, was small compared to 4.8% for the Russian Rouble, and 4.3% for the Indian Rupee. The North-East Asian economies, including Taiwan and Korea, also appreciated significantly. It is due to the partial restrictions in China's currency market, such as the restriction on hedge fund's access to the domestic market, which shielded the RMB from excessive volatility.

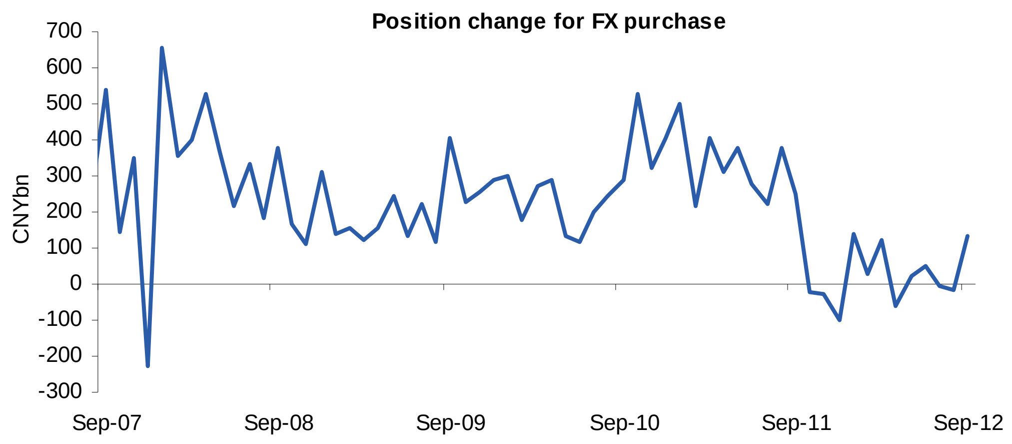
Fig 4 CNY appreciates less than other emerging market currencies



Source: CEIC, Mizuho research

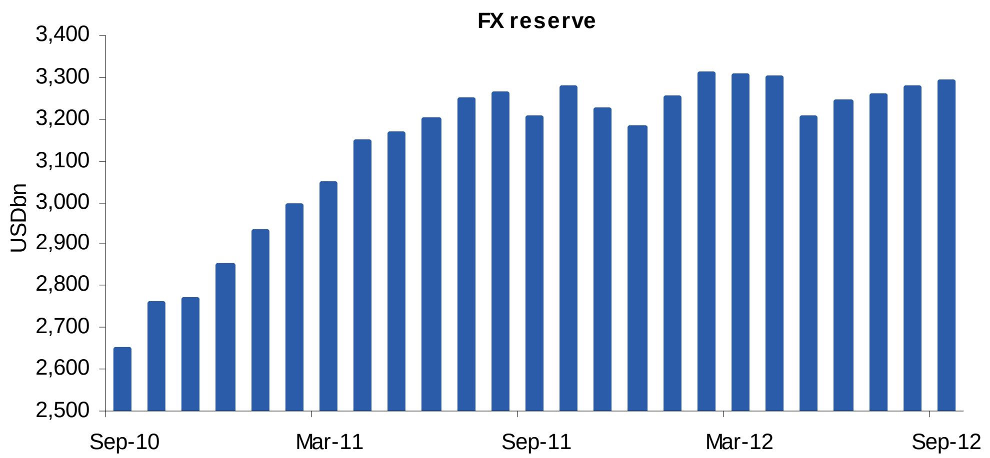
The return of capital inflows into China
The position of China's FX purchases, a measure of capital flow, rebounded in September, at CNY130.68bn compared to a net outflow of CNY17.43bn in August. China's foreign reserves also increased to USD3.29bn in September from USD3.24bn in June. It suggests that China is again becoming a destination for global capital, when the economic indicators in September started to show an early, albeit mixed, signs of improvement.

Fig 5 Capital inflows resumed in September



Source: CEIC, Mizuho research

Fig 6 FX reserves also increased again



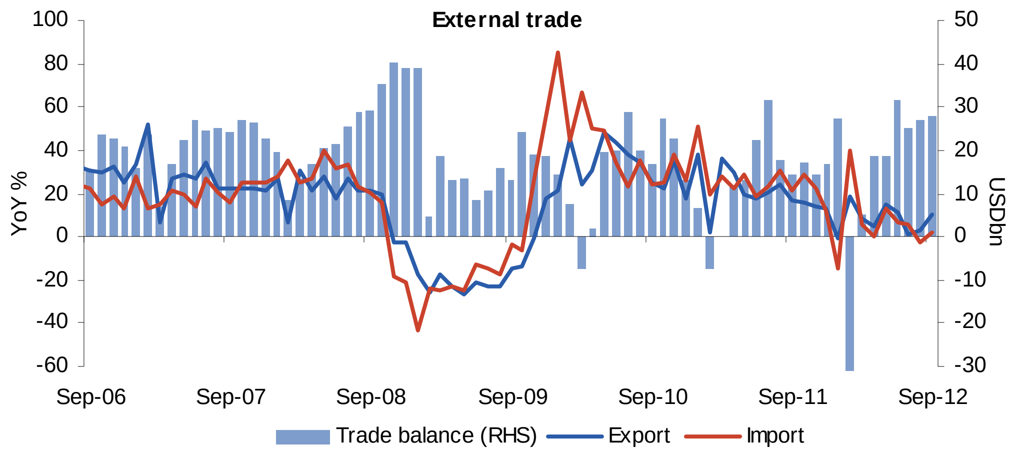
Source: CEIC, Mizuho research

Sustained appreciation is unlikely

Export outlook remains grim
In addition, the economic situation in China has reported some improvement, albeit still at a precarious stage. China reported a stronger-than-expected export growth in September, at 9.9%YoY. It led to stronger current account surplus, at USD27.7bn.

However, we believe the upside surprise in September is due to 1) iPhone shipments; 2) Delayed shipments from August due to typhoons striking its main ports; 3) Expedited shipments before the extended Mid-Autumn/National day holiday (see "3Q growth moderated as expected, with mixed signals ahead" 18 October).

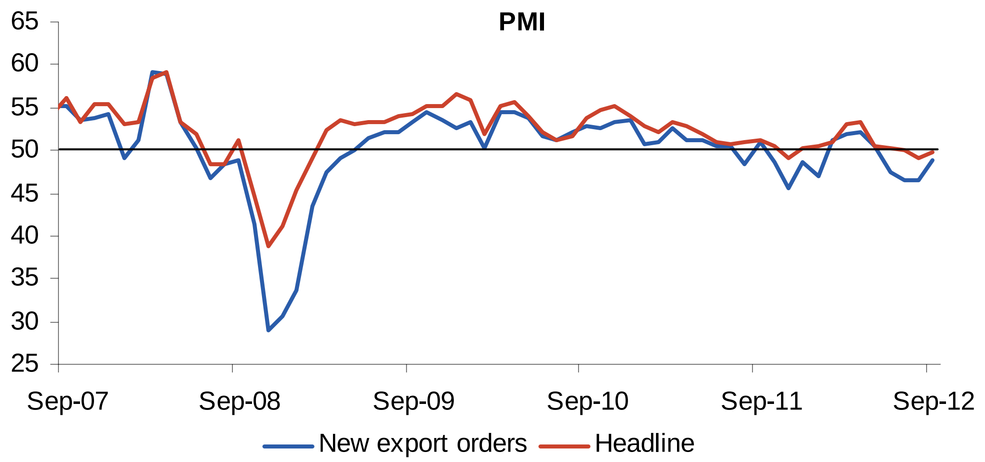
Fig 7 Export growth picked up in September, but it is likely temporary



Source: CEIC, Mizuho research

We maintain a downbeat outlook for China's external environment as the global economic outlook remains highly uncertain (see "World economy under a cloud of uncertainty" 16 October). In the September manufacturing PMI, the new export orders reported a notable improvement due to seasonal sales season. However, it is still below the contraction threshold, reflecting the anemic external demand as the global economy remains highly uncertain. The improvement, at 2.2, is also below 2.6 in 2011.

Fig 8 New export orders rebounded in September, but still in a contraction threshold



Source: CEIC, Mizuho research

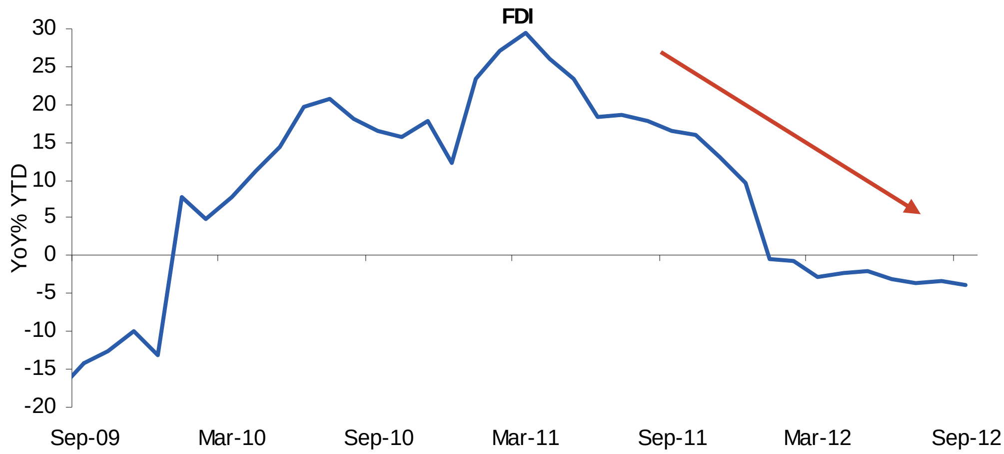
Statistics from the first week of the Canton trade fair shows that the number of overseas buyers declined considerably. The fair registered a total of 93,529 overseas buyers as of 18 October, 11.4% below the same period in the spring session. The number of buyers from Europe and US reportedly dropped by more than half during the fair. Transaction volumes are expected to weaken further. Given the challenges, the government has already announced increases in export rebates and improved support for exporters such as insurance and export credit. It is unlikely that RMB will be allowed to appreciate much further without intervention from the government.

FDI fell amid global headwind

While China's inflow of short-term capital is increasing, the inflow of long-term capital continues to decelerate. FDI fell 3.8%YoY in the first nine months of 2012 as economic headwinds from global financial crisis dent corporate spending plans. September's inflow alone down 6.8%YoY. In January-September, investment from the US dropped 0.63%YoY to

USD2.37bn, while investment from the EU dropped 6.3%YoY to USD4.83bn. Over the same period, China approved the establishment of 18,025 new foreign-funded companies, down 11.7%YoY.

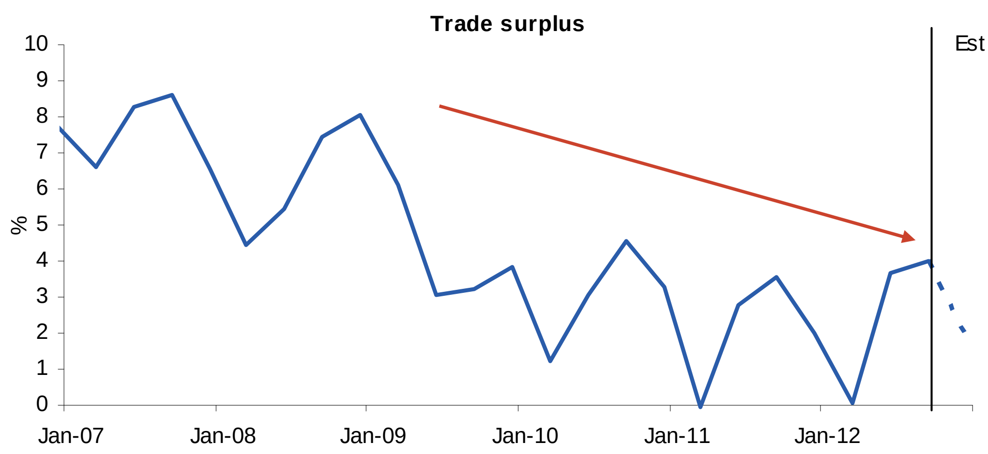
Fig 9 FDI remains weak as corporate spending is put on hold



Source: CEIC, Mizuho research

RMB to steady at current level
In the previous downturn in 2008–2009, the PBOC put appreciation temporarily on hold at CNY6.83 as a measure to maintain China's competitiveness. While it is unlikely that the RMB will be allowed to depreciate now amid the international political pressure, especially the president election going on in the US, we believe the Chinese government will only allow the RMB to trade range bound at the current level, around CNY6.2-6.4/USD1.

Fig 10 Trade surplus has been declining in recent years amid RMB appreciation

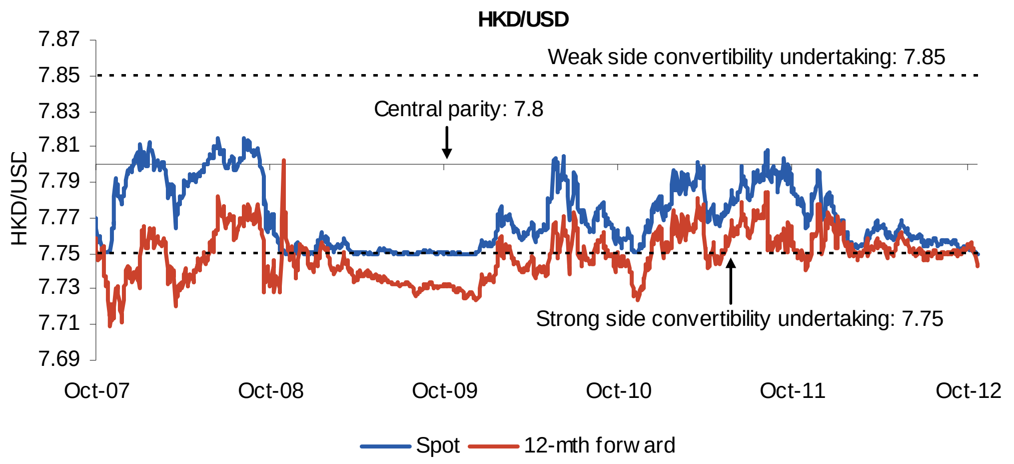


Source: CEIC, Mizuho research

More negative impact on Hong Kong

Capital inflows to Hong Kong surged as the floodgate opens
Hong Kong, as a first point of entry for capital coming into Asia due to its currency peg with the USD, saw significantly capital inflows in recent weeks. The Hong Kong Monetary Authority (HKMA) announced that in the week of 22 October, it defended the strong end of the peg at HKD7.75 through buying a total of HKD14.4bn. It was the first time since 2009 that the HKMA has stepped in the market.

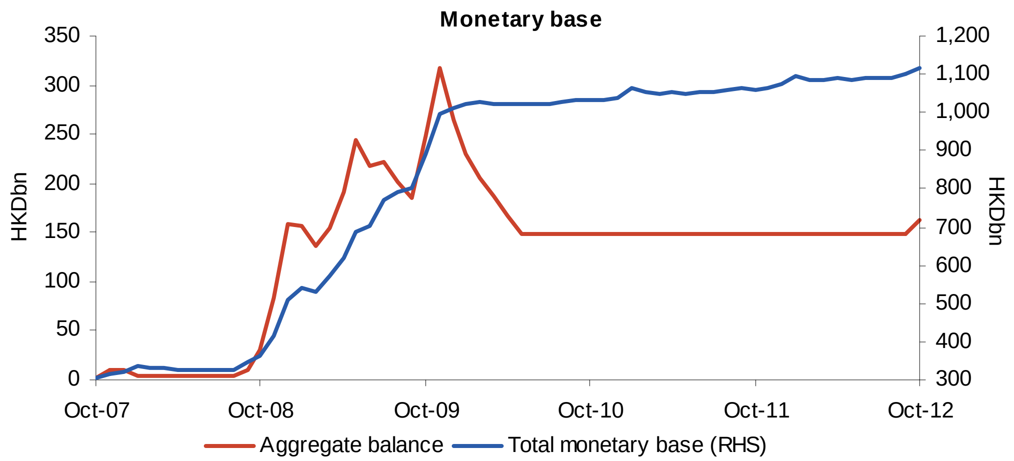
Fig 11 The HKMA intervened as the HKD reached the strong side threshold



Source: CEIC, Mizuho research

Subsequently, the inflow of capital is also reflected in the aggregate balance in Hong Kong's monetary system. On 24 October, the sum of balances on clearing accounts maintained by banks with the authority was lifted to HKD163bn, the first time with a notable increase since the height of financial crisis in 2009. As in the HKMA, it reflects a flux of capital into the currency and equity markets in the region, amid the weakness in the USD and declining US interest rates.

Fig 12 Aggregate balance picked up strongly again since 2009

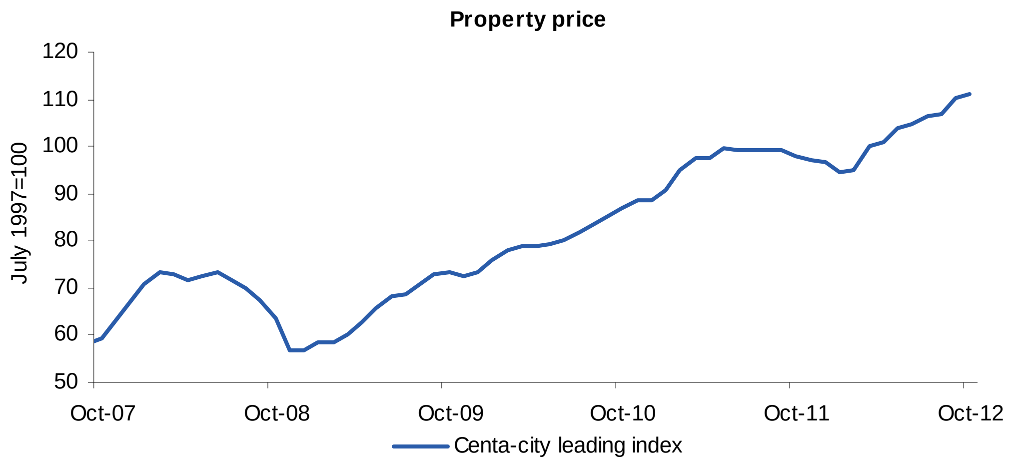


Source: CEIC, Mizuho research

Implications on the asset market

In reaction, the Hong Kong government has tightened the terms for mortgage lending to help moderate the rising property prices on 14 September. It includes limiting the maximum term on all new mortgages to 30 years, and mortgage payments for investment properties can't be more than 40% of buyers' monthly incomes, up from the previous 50%. Despite the efforts, the Centa-city leading index, an indicator for Hong Kong's property prices, was up by 2.79%MoM since the measures were launched, reflecting the pressure in the asset market. We believe there is more upward pressure on the property prices and stock prices.

Fig 13 Hong Kong's property market keeps rising

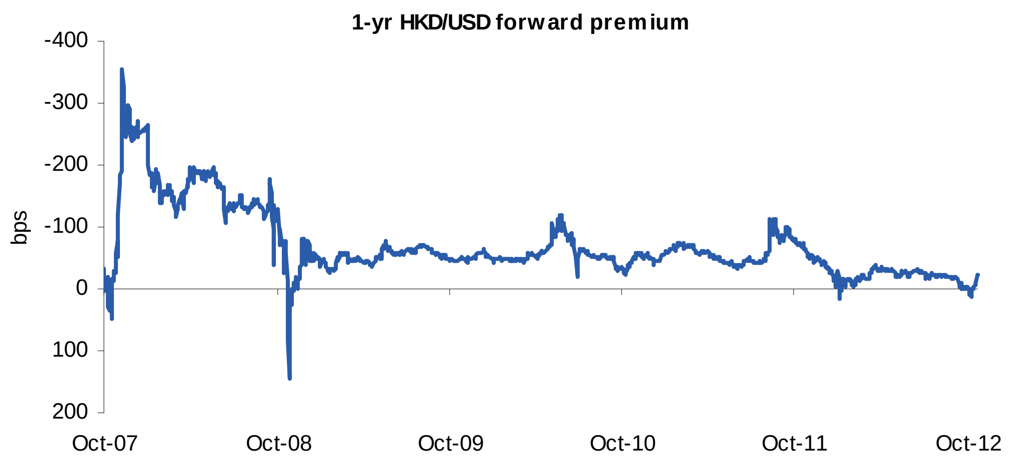


Source: CEIC, Mizuho research

Not really a challenge to the peg
Overall, the capital inflows represent a manageable risk to the HKMA, as the previous episodes similarly were unable to challenge the system. The 1-year forwards of the HKD strengthened by 0.1% to HKD7.743/USD1, the biggest gain since 24 January, however its premium is still below its average level in the past few years.

We reiterate our view in "How will the new Chief Executive shape Hong Kong's future?" (3 April), the currency peg is unlikely to change at this point due to the lack of a superior and readily available alternative. The change of the peg, instead, may have to wait till the CNY becomes more freely convertible.

Fig 14 The HKMA intervention unlikely to trigger a regime change



Source: CEIC, Mizuho research

CNY Internationalization continues

Meanwhile, the progress for CNY internationalization continues. Trading volume in the offshore RMB (CNH) derivatives market has fallen by 40% to an average of USD1.5bn a day after peaking at around USD2.5bn in September 2011. However, in terms of the number of products for hedging against FX risk exposure, the market has expanded, especially after the PBOC announced the expansion of the CNY trading band to 1% in April (see "On 17 September, the Hong Kong Exchanges and Clearing Limited (HKEx) launched the first deliverable RMB futures. It will be followed by the Chicago Mercantile Exchange (CME) in 4Q.

Meanwhile, the global use of RMB has steadily increased. In August, the RMB is ranked as the 14th payment currency with a global market share of 0.53%. It compares to January 2012 when the RMB was the 20th payment currency with a share of 0.26%. This means that the RMB's use in international trade has significantly improved in the first eight months of 2012.

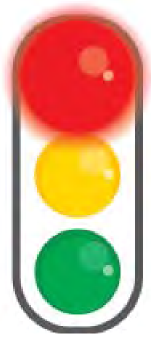
In the IMF/World Bank Group annual meeting in Tokyo, Yi Gang, deputy governor of PBOC said that the central bank's job as just to remove the barriers for using the RMB, given the previous restrictions on China's financial market and foreign exchange system. Instead of promoting the use RMB, the central bank provides the market infrastructure, and the pace of expansion will be left to the market to decide.

Although we expect the recent appreciation of the RMB to be temporary, it shows that market mechanism is becoming more integrated into the RMB, and it is another small step towards achieving RMB internationalization.

As we argued in “RMB's roadmap towards full convertibility” (7 April 2011), CNY's internationalization is key to China's new stage of development. It requires 1) Capital account liberalization; 2) Development of offshore RMB market; 3) Exchange rate liberalization; and 4) Interest rate liberalization to go hand-in-hand. With notable progresses made already, we continue to expect basic RMB convertibility to be achieved by end-2015. This is also consistent with the 12th five-year plan for the financial industry, which also mentioned currency convertibility by 2015.

31 August 2012

Window to avoid hard-landing is closing fast



- **China's economy is on a deteriorating trend. The risk of a hard-landing has become very high due to the absence of aggressive policy stimulus. Five reasons may be behind the hesitation: 1) to avoid making similar mistakes that emerged from the CNY4tn stimulus package in 2009; 2) incoming leaders may wish to implement easing after the next government is formed in March 2013; 3) a housing price rebound; 4) food price inflation is rising; and 5) the labour market remains stable.**

- **We believe the delay in much-needed policy easing is closing the window to avert a hard-landing. We now expect China's 3Q and 4Q GDP growth to decelerate to 7.4%YoY and 7.2%YoY, respectively, leading to 7.6%YoY growth for full-year 2012. Rather than avoiding action due to the competing objectives, the government should learn from its previous experiences, and could address key areas of reform through a tax reduction and the issuance of special-purpose government bonds, in order to achieve economic reforms, whilst stabilizing growth.**

Jianguang Shen
jianguang.shen@hk.mizuho-sc.com
+852 2685 2022

Michael Luk
michael.luk@hk.mizuho-sc.com
+852 2685 2155

Negative bias | Caution | Positive news

Economy is heading towards a hard-landing

Rebound in growth is not yet in sight
So far in 3Q, the key economic indicators show that China's domestic demand continues on a downward trend.

Declining by 2.7%YoY, the January–July industrial profit confirmed that the mild decelerating trend in China's industrial sector has extended into 3Q, likely due to an over-capacity and weak demand in key industries, such as chemical material and products, and both ferrous and non-ferrous metals. Even profit growth in machinery and equipment production were on a declining streak, close to zero.

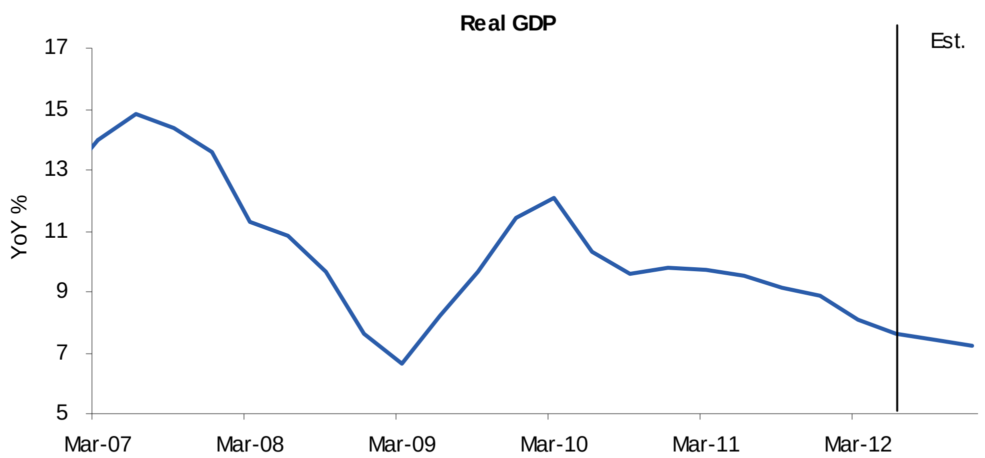
This is in-line with China's disappointing economic activity recorded recently, which slowed down across-the-board. Headline FAI growth stayed flat in July, but construction investment eased further, along with real estate investment. This indicates that the recent rebound in the property market has not triggered new investment in the sector. It is also in-line with the easing production growth for electricity, steel and cement at 2.3%YoY, 6.5%YoY and 6.1%YoY, respectively, and the decline in cargo throughput volume.

Likewise, industrial production weakened to 9.2%YoY in July from 9.5%YoY in June. It was due to the slowdown in heavy industry. In particular, railways, shipbuilding, aerospace and other transportation equipment were down by 4.5ppt to 1.4%YoY in July, while automobile production and electric machinery and equipment were both down visibly (see "Delayed rebound requires further policy stimulus – July macro data review" 9 August).

Going forward, leading data suggests that a rebound is not yet in sight. The HSBC flash PMI, at 47.8 in August, fell to a 9-month low. This has sent a warning signal that the 3Q economic stabilisation and 4Q rebound that we anticipated may be delayed even further, and that the economy is heading towards a hard-landing.

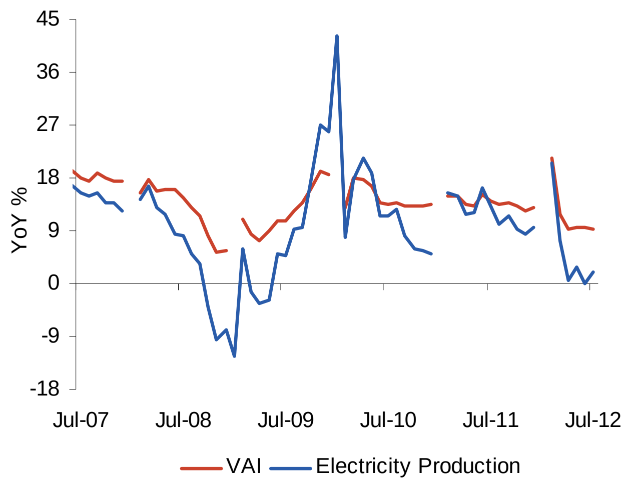
As such, we have revised our China GDP forecast to 7.4%YoY and 7.2%YoY for 3Q and 4Q, respectively, leading to 7.6%YoY growth for full-year 2012. If so, this will be the weakest annual GDP growth in China since 1999.

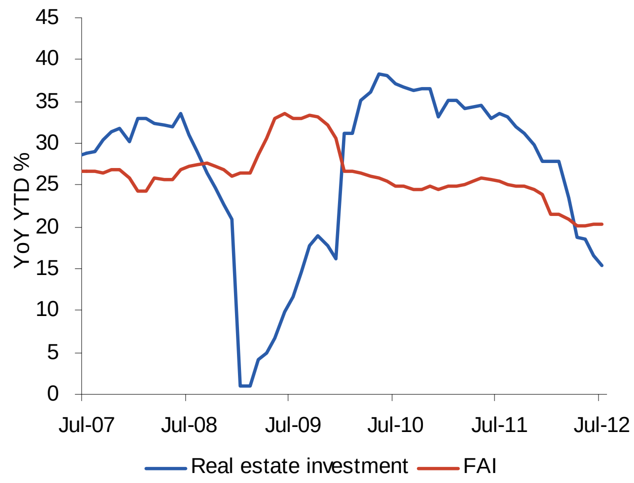
Fig 1 We now expect 7.4%YoY in 3Q, before the economy dips still further to 7.2%YoY in 4Q



Source: CEIC, Mizuho research

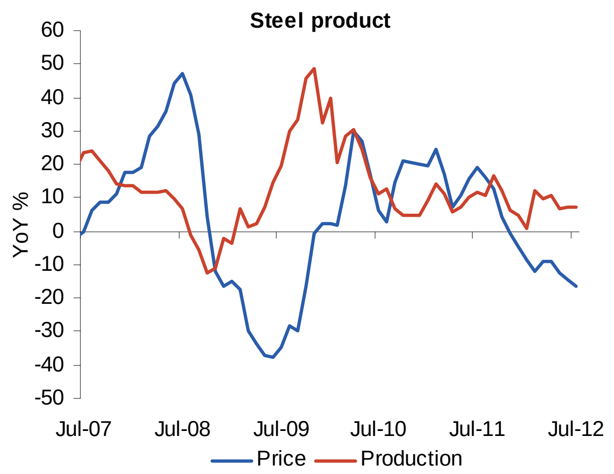
Fig 2 Domestic demand lacks the policy stimulus for a rebound

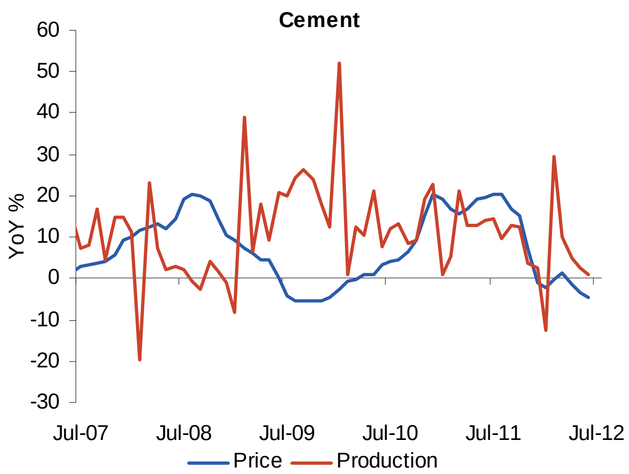




Source: CEIC, Mizuho research

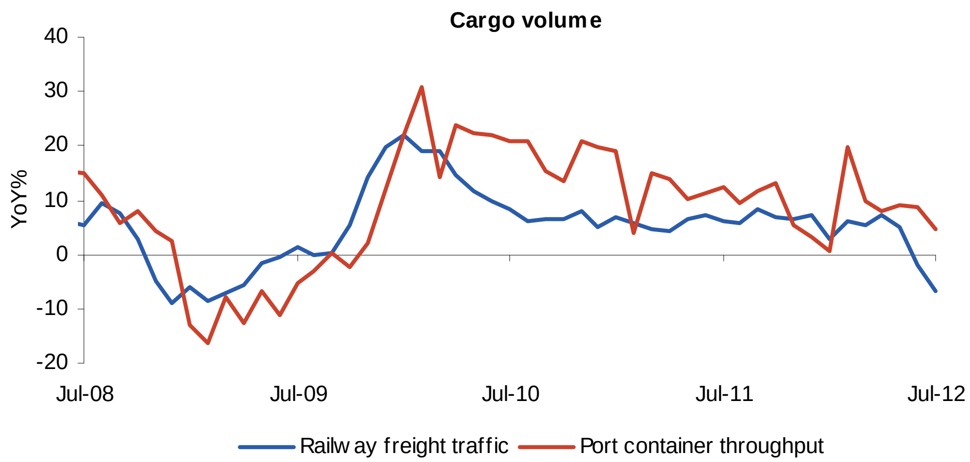
Fig 3 Market conditions for construction material is weak





Source: CEIC, Mizuho research

Fig 4 Decline in cargo volume indicates weak production growth



Source: CEIC, Mizuho research

Fig 5 Industrial profit continues to be weak in January–July

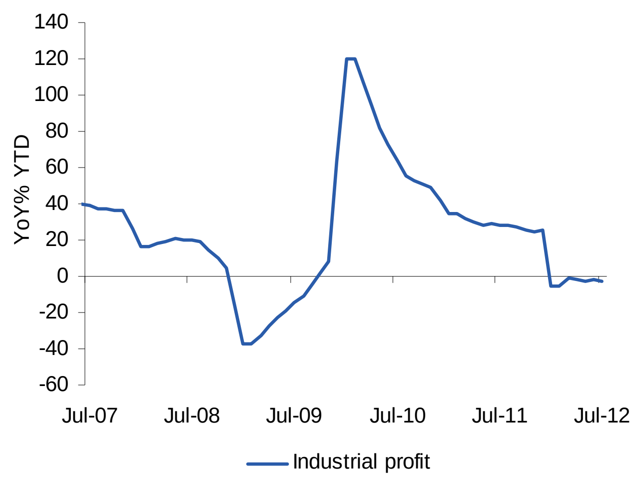
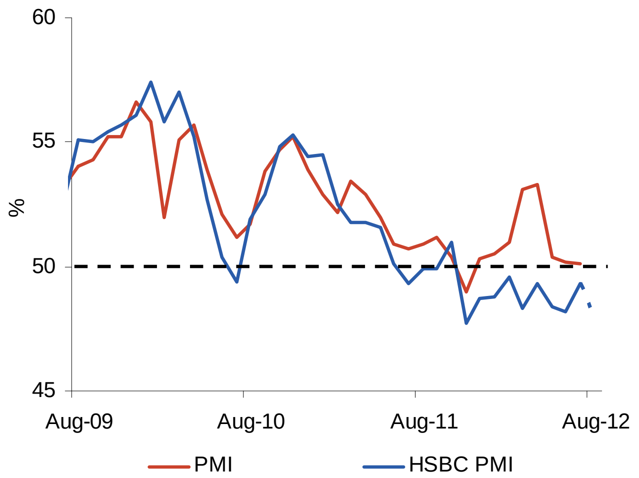


Fig 6 HSBC flash PMI suggests rebound is not yet in sight



Source: CEIC, Mizuho research

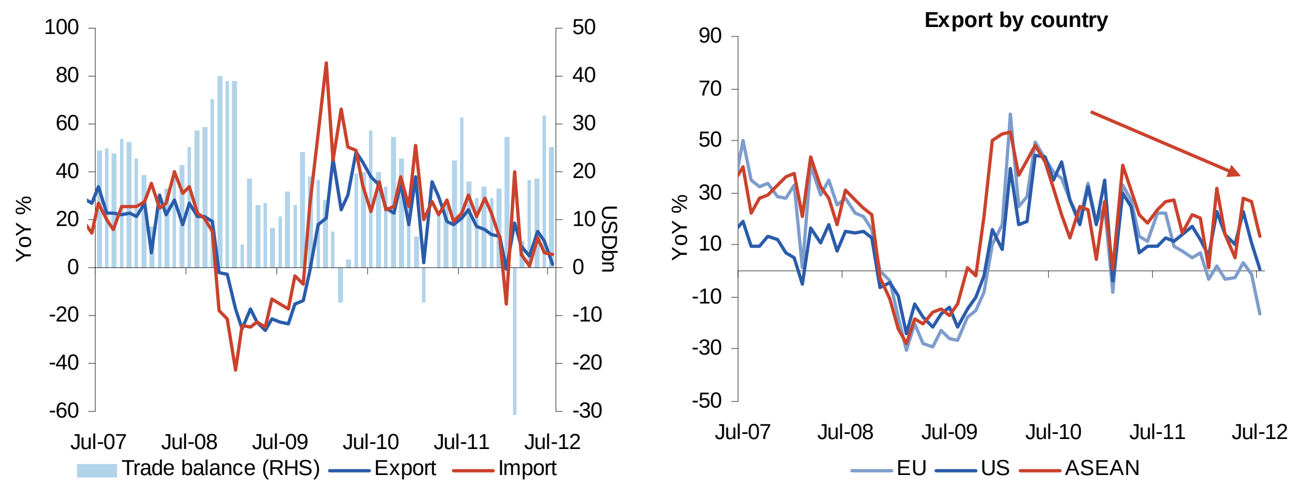
External demand likely to worsen further

Meanwhile, external demand has been shown to be much worse than anticipated.

In July, China's exports expanded by 1%YoY, disappointing the market by a wide margin amid slowing demand from the key markets. Coupled with 5.7%YoY growth in imports, the trade surplus narrowed to USD25.2bn. Exports to the EU were particularly dismal, as they contracted 16.2%YoY in July, the weakest since the start of the Eurozone debt crisis.

It shows that as external headwinds drag on, exports will offer no support to China's economic growth in the months ahead (see "External demand offers no support for 2H outlook" 10 August).

Fig 7 Exports likely to worsen further



Source: CEIC, Mizuho research

Why is there no aggressive stimulus so far?

The key to boosting China's economic growth is to launch counter-cyclical measures to stabilize the economy, and this is exactly what the government promised. In the central economic meeting, the government set the objective of China's economic policy in 2012 as "stabilizing economic growth", with proactive fiscal policy and prudent monetary policy, which in effect is widely understood as easing (see "Is prudent policy enough to prevent a hard landing? China's 2012 Macro outlook" 15 December 2011).

Except for two rate cuts and three RRR cuts, as well as accelerated approval of infrastructure projects, the stimulus measures so far are insufficient to avert the downturn in China's domestic demand.

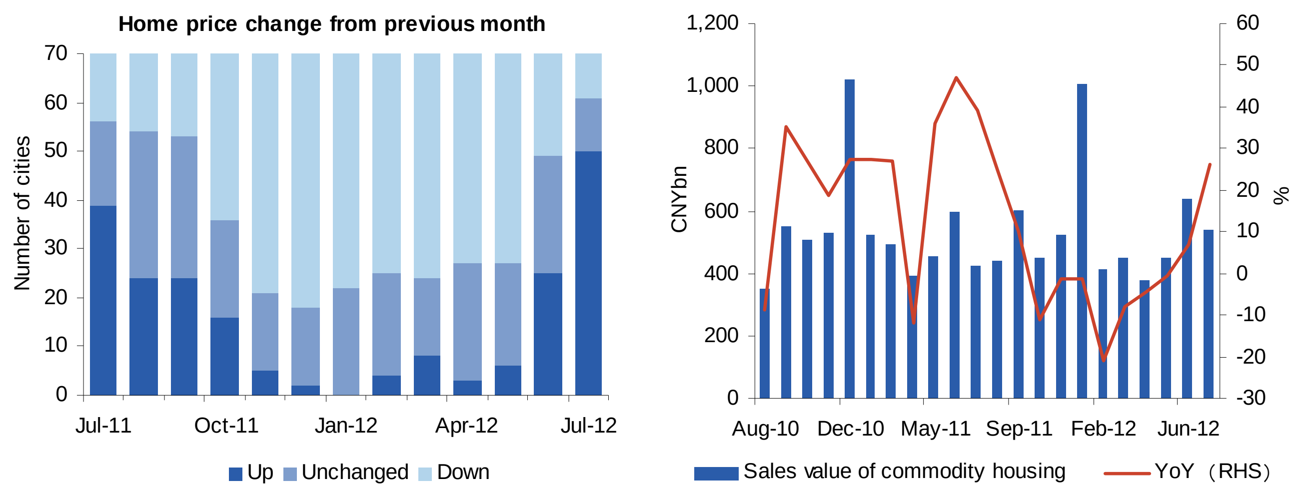
We think the resistance to a large-scale stimulus package is strong among policy makers, for the following five reasons:

- First, policy makers believe that the CNY4tn stimulus package from 2009 was the trigger for the asset bubble, high inflation and the risks from local government financing vehicles (LGFVs) loans that the economy is now facing. Therefore, they are of the mind that they should not repeat past mistakes.

- Second, as the 18th National Congress, which is scheduled to take place in October, approaches, policy makers are in the midst of last minute preparations for the transfer of power. In addition, the incoming leaders may wish to avoid over stimulus in 2012. Rather, stimulus measures could be postponed until after March 2013, when the new government comes into office.

- Third, following the recent rebound of the housing market, room for more easing has been curtailed. The average housing price in 70 cities rose in July for the second consecutive month. This indicates that the government is missing out on a powerful tool to boost construction and investment, as the market demand for new housing remains strong. Going forward, the government will have to rely mostly on infrastructure investment, which may not be enough to jump start the economy.

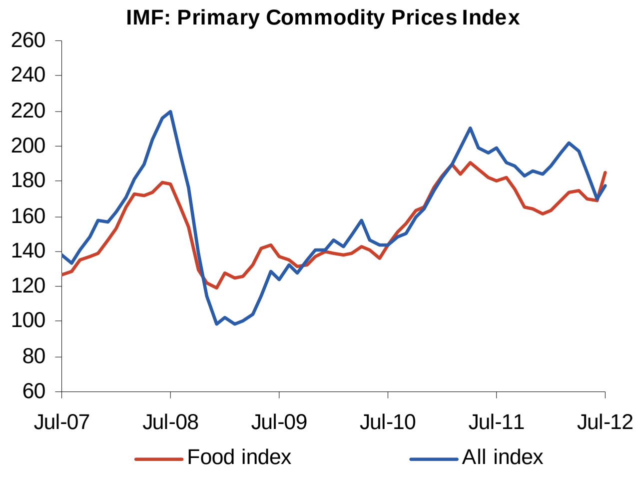
Fig 8 The property market has rebounded amid strong demand, creating a challenge for policy easing

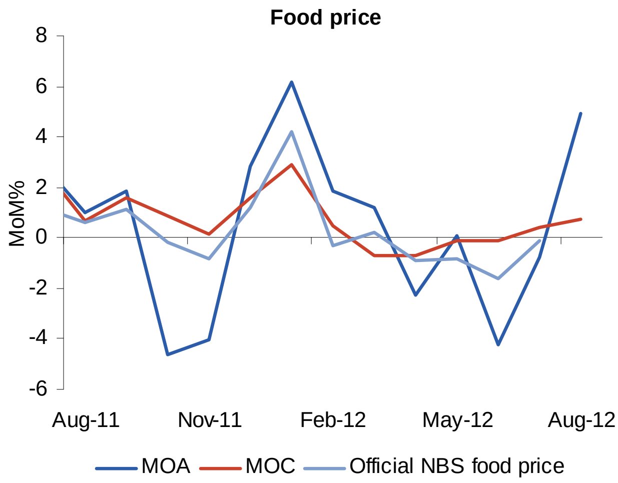


Source: CEIC, Mizuho research

- Fourth, the MoM decline in food prices narrowed in July, possibly marking the return of another inflationary cycle. In July, international food prices increased by 9%MoM, according to the IMF. In addition, the domestic food price update provided by the Ministry of Commerce and Ministry of Agriculture both suggest that food prices in August will be up more strongly than in July which has led the PBOC to become more hawkish on inflation.

Fig 9 Returning inflationary cycle keeps the PBOC hawkish in further policy easing

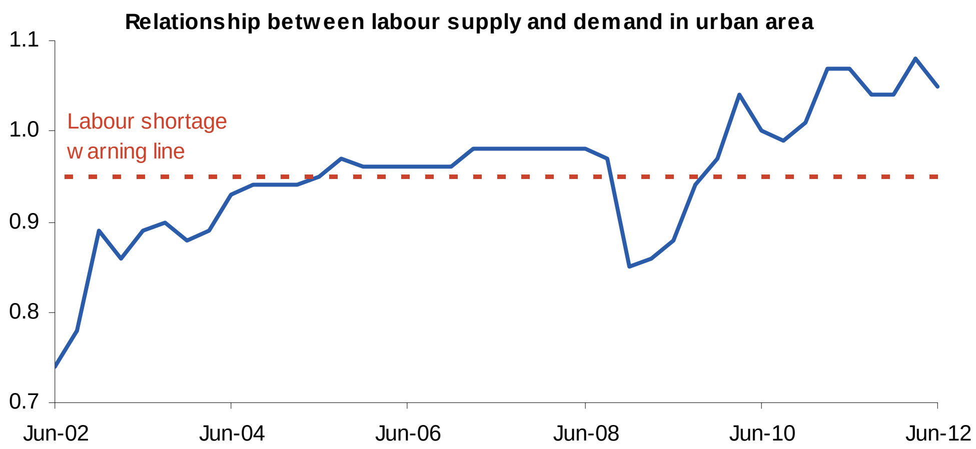




Source: CEIC, Mizuho research

- Fifth, the labour market has so far been a bright spot in China's economy. The relationship between labour supply and demand in urban areas was reported to be resilient up to 2Q.

Fig 10 The labour market has remained largely resilient, but it may not hold up much longer



Source: CEIC, Mizuho research

To reconcile policy objectives and actions

Conflicts in policy objectives and actions

The actual implementation of China's economic policy has frequently departed from its stated objectives in the past few years. The official objective in 2012, ie. prudent monetary policy and proactive fiscal policy, is identical to the rhetoric in 2011. In practice, however, the policy in both years cannot be described as such. In 2011, the actual policy was clearly biased towards tightening, while easing has begun in 2Q12. In our view, the frequent changes are caused by conflicting underlying priorities in policymaking.

It is a challenge for the policymakers to integrate the different priorities in a coherent set of economic policies. In addition, the Chinese government's dependence on administrative actions for immediate response results in policies that often lack continuity. As a result, actual policy measures implemented could lead to sub-optimal results.

Contradicting priorities are often found in the following:

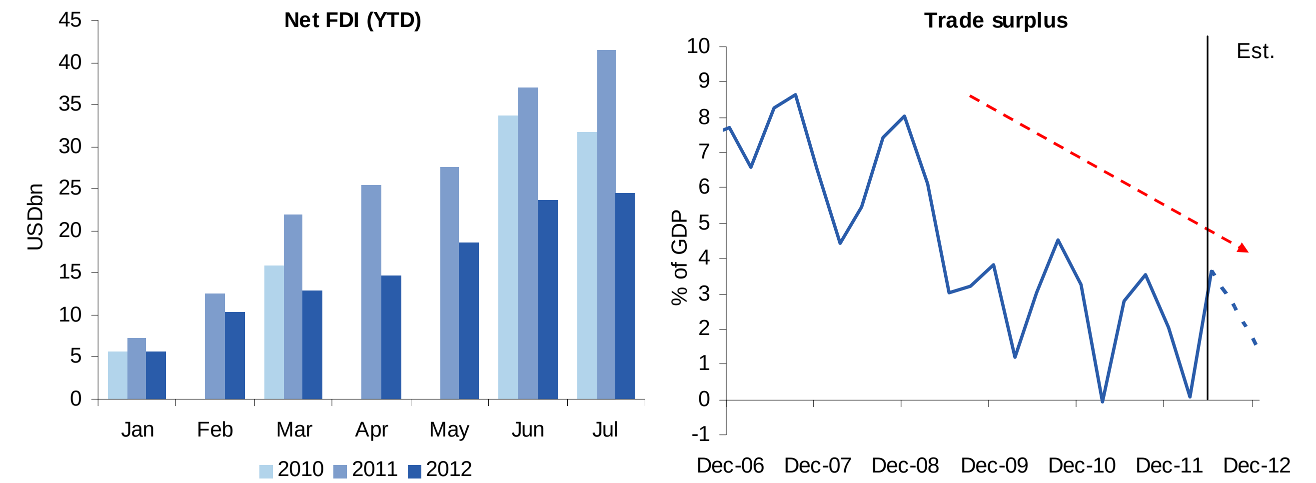
- First, stabilizing growth and structural reforms are the two main priorities in China's economic policy, but implementing both simultaneously can appear contradictory. Policy makers aim to reduce the economy's dependence on investment as a growth driver in the 12th five-year plan. However, consumption is still unable to replace investment at this stage. The reform process thus may require some slowdown in China's growth momentum, which contradicts the government's stated goal to maintain steady economic growth. Therefore, the government has returned to bolstering investment in order to stabilize growth in 2012, a break from the prevailing measures.
- Second, curbing the housing market has been a top priority for policymakers. However, the restrictions have caused a decline in property sales and related consumption such as home electrical appliances, furniture, and construction and renovation materials. While the rebound in the property market has led to improvements in related consumption, it has become a dilemma for policymakers.
- Third, eased restrictions on the lending rate floor and deposit rate ceiling have led to an asymmetric rate cut in effect, with reduced net interest margins (NIM) for banks in China. Considering that the banks constitute ten of the top twenty stocks in the Shanghai stock exchange, the reduced margins weigh down on the equity market. Hence, it was against Premier Wen's pledge to support public confidence in China's stock market in June.
- Fourth, the global financial crisis and the emergence of Lewis Turning Point (LTP) have made RMB internationalization a top priority in policymakers' agenda. However, the economic slowdown has raised concerns of capital outflow from the Chinese market. While the RMB trading band was expanded in April, the adverse sentiment worldwide has strengthened the USD. Coupled with China's reduced trade surplus so far in 2012, the RMB appreciation has stopped in recent months. The pressure to depreciate and the general pessimism towards China's economic prospects have increased speculation for China's capital outflows.

Fig 11 The stock market is under pressure from reduced bank NIM

Fig 12 The end of appreciation raised concerns for capital outflow

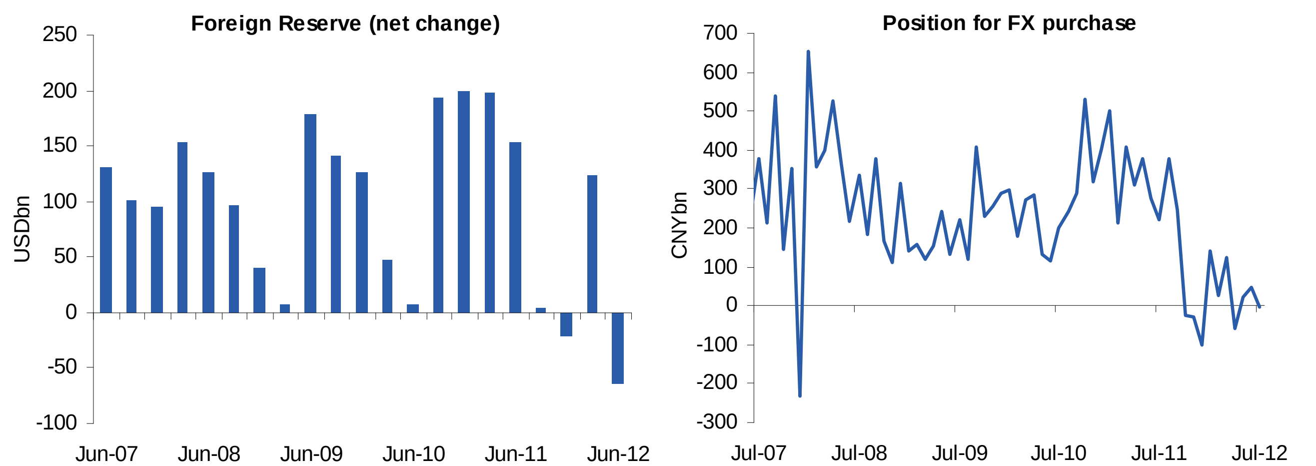
Source: CEIC, Mizuho research

Fig 13 The weakened FDI and trade balance supports signs of a slowdown



Source: CEIC, Mizuho research

Fig 14 Capital outflow has become a concern



Source: CEIC, Mizuho research

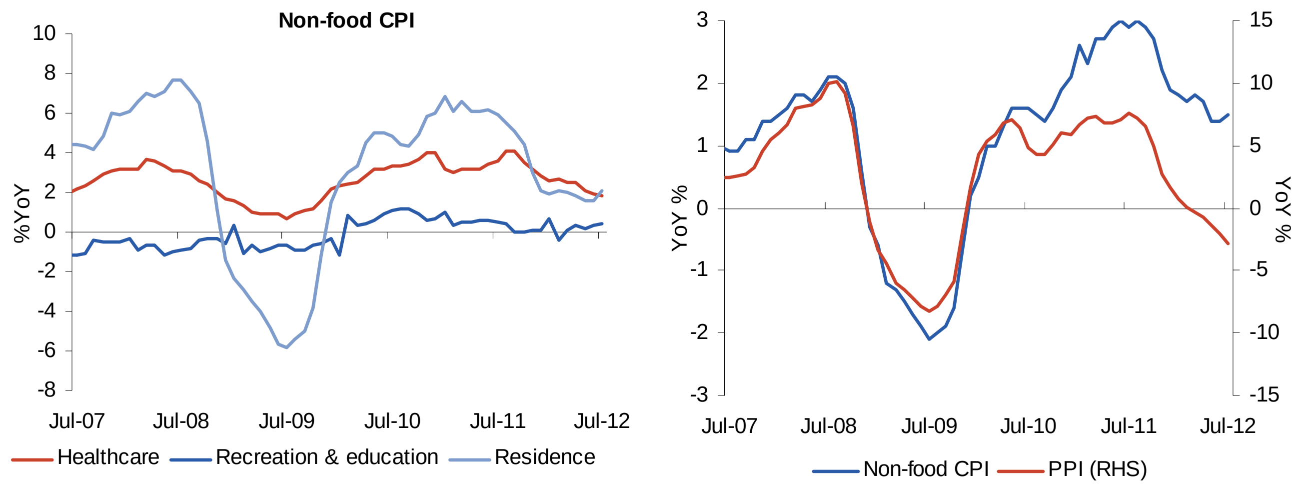
Current macro policy needs a significant overhaul

Inflation should not be a primary concern

Although inflation will rise, the pressure will be mild for the rest of 2012 (see “China Inflation Monitor” 30 August). On grain prices, the drought in the US has reduced the world output of grains in 2012, and it has significantly raised the international prices of corn, soybean and wheat. However, the direct impact for China’s food price will be contained, as China has imported a massive amount of grains in 1H, and self sufficiency is high in most products.

The return of inflationary pressure is also not a pressing threat for non-food inflation. Producer price index is in deflation for the fifth consecutive month. As such, the concern for inflationary pressure may have been overstated. All in all, we expect the CPI to rebound moderately to 2.0%YoY in August, and maintain our full-year 2012 CPI forecast at 2.6%YoY.

Fig 15 Inflation is not a pressing threat

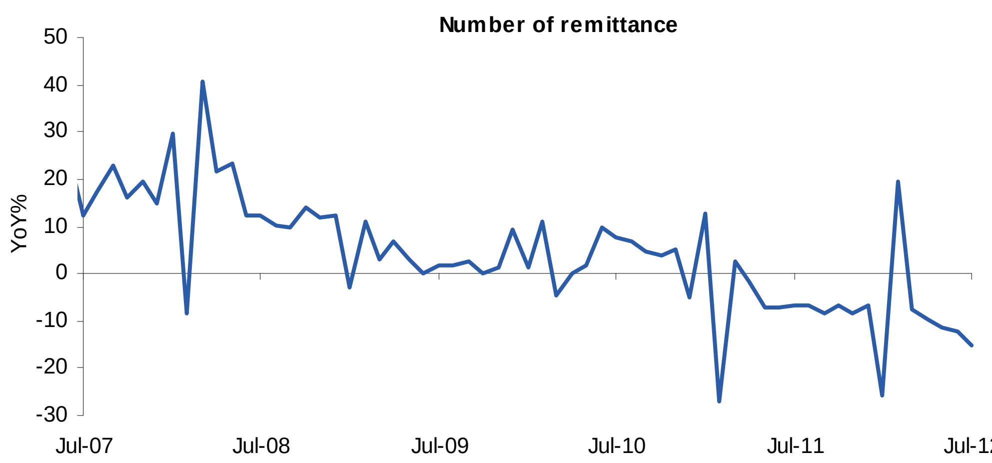


Source: CEIC, Mizuho research

Labour markets set to worsen

In July, the employment sub-index of the official PMI eased below the contraction threshold at 50, suggesting the businesses may have begun to lay off workers as production slowed. Likewise, the slowdown in industrial production has reduced the amount of overtime work for migrant workers, leading to reduced remittances in recent months. It shows that the labour market cannot hold up independently as the businesses begin to slash production.

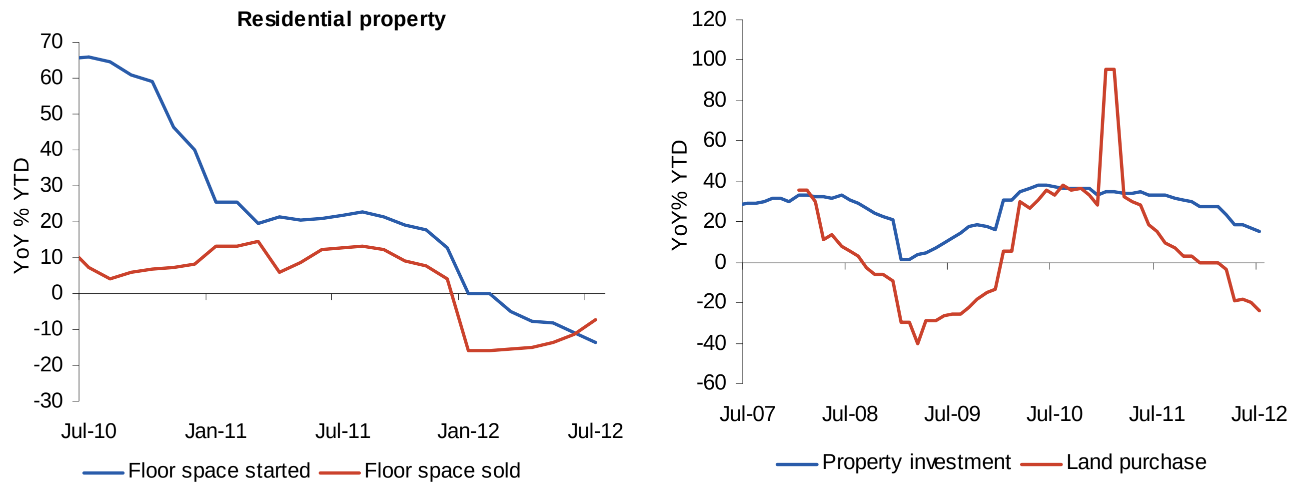
Fig 16 The labour market is weakening



Source: CEIC, Mizuho research

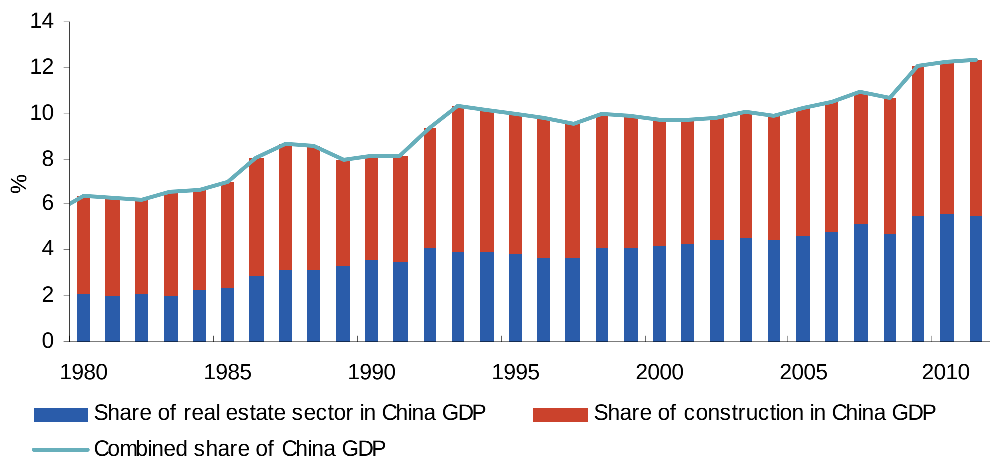
Easing on housing market restriction is inevitable
As the government's capital injection may become too much for existing infrastructure projects, easing of the housing market restrictions are inevitable. Also, discouraged investment in the sector will create a bottleneck for future supply, and price spikes in housing. Total property investment in July was up by 15.4%YoY YTD, the lowest since August 2009. Contrary to the recent improvement in residential floor space sold, floor space started continues to deteriorate, declining by 13.4%YoY YTD in July. Meanwhile, land purchased decreased by 24.3%YoY YTD in July.

Fig 17 Housing market restriction creates a supply bottleneck



Source: CEIC, Mizuho research

Fig 18 The property sector constitutes around 12% of GDP



Source: CEIC, Mizuho research

Local stimulus needs monetary easing

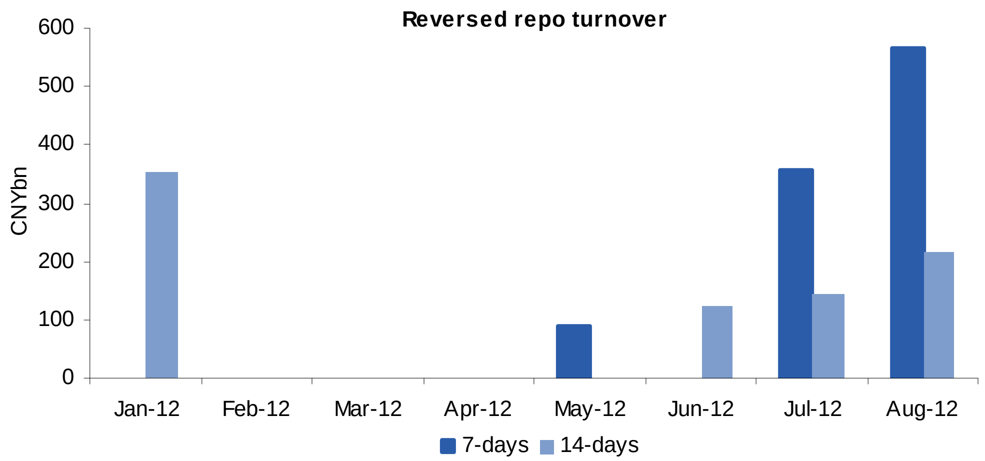
So far, the easing is done mostly by boosting infrastructure spending at the local government level. This includes Changsha, Chongqing, Tianjin, among other provinces and cities, with expenditure totalling more than CNY10tn. In our view, the actual stimulus implemented may be a fraction of the original target, and it will be carried out over a number of years (see “Local governments to lead fiscal stimulus” 26 July). The actual result from the stimulus may be questionable.

Also, the actual effectiveness of the local government measures depends mainly on the availability of the credit facility from banks, which in turn is decided by the monetary easing by the central government. For some local governments, their liquidity conditions have turned from bad to desperate: The local government of Wenzhou put up 52 pieces of land for sales in one road show, with a total area of 3,220 mu. However, according to the media, of all the sites being offered, only ten of them were reportedly sold on that day.

As an alternative to bank financing and land sales, while the first batch of asset-backed notes has been filed on 7 August, the size of it is still too small compared to the total LGFV market, such that it is limited as a source of funding for the local government stimulus package (see “How to finance China’s new stimulus package?” 8 August).

The PBOC has so far relied on the reversed repo agreement for temporary liquidity injections, while keeping the key monetary tools on hold since the second interest rate cut on 5 July, despite the urgency for further easing (see “Further monetary easing before inflationary pressure returns” 2 August). The disappointing new loan growth in July supports our view that the monetary conditions are far from enough to finance the local government packages.

Fig 19 The PBOC relied on reversed repo for short-term liquidity injections



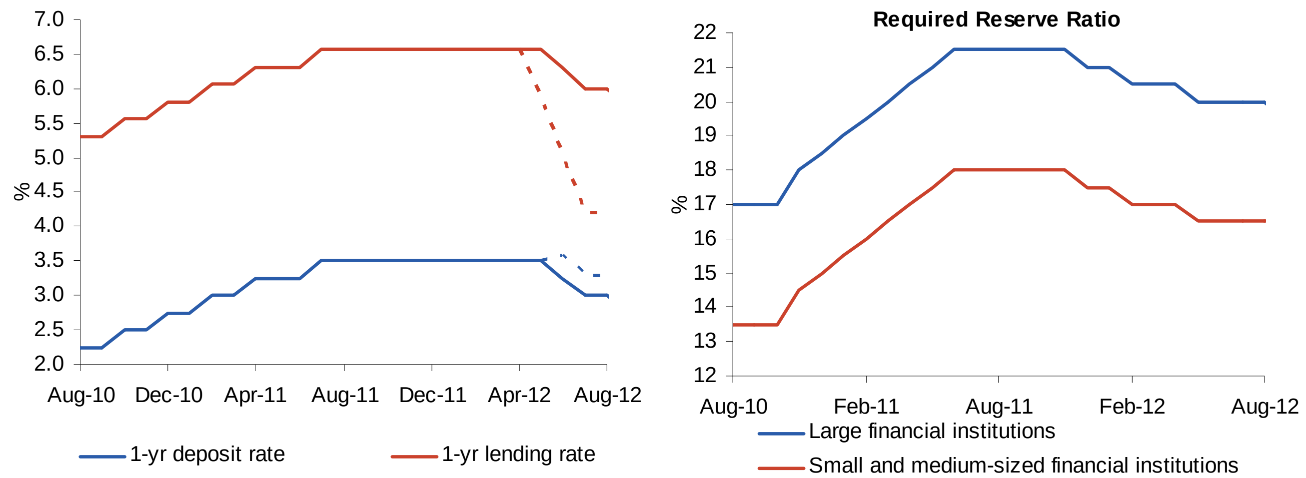
Source: CEIC, Mizuho research

Fig 20 New stimulus measures at the local government level as of 28 August

Government	Date	Amount	Key measures
Guangdong	20 Aug	Over CNY1tn	177 projects to utilize marine resources in the next five years
Guangdong	16 Jul	CNY235.3bn	44 projects to raise funds from the private sector, involving 11 transportation projects
Guangdong	2 Jul	n/a	19 projects to expedite the construction for petrochemical, ferrous metal and other manufacturing facilities
Tianjin	21 Aug	CNY1.5tn	10 production chains in petrochemical and green energy industries in the next four years
Shanxi	20 Aug	CNY2tn	Plan to raise private sector capital from investment expo to invest in various projects
Chongqing	20 Aug	CNY1.5tn	Build 37 manufacturing clusters in the next five years
Fujian	17 Aug	CNY1.4tn	Invest on technology reform in the 12th Five Year Plan. CNY200bn will be spent in 2012 and CNY260bn in 2013
Hubei	15 Aug	CNY313.1bn	82 projects to improve the mass transportation network in Wuhan
Heilongjiang	14 Aug	n/a	17 measures to promote production and ease liquidity pressure for local manufacturers
Changchun	14 Aug	CNY2bn	25 measures to promote steady economic growth, and inject CNY20bn in 2012 to revitalize the local economy
Guangzhou	7 Aug	CNY200bn	Invest in key infrastructure projects such as subways, airports, etc.
Changsha	25 Jul	CNY829.2bn	195 construction projects to cover social welfare, transportation network, public facilities, and new industries involving CNY829.2bn in 2012
Guizhou	23 Jul	CNY3tn	Develop eco-tourism in the provinces involving transportation network, public facilities and hospitals in the next decade
Nanjing	23 Jul	n/a	30 measures to support domestic demand in property market, automobile purchase etc.
Ningbo	16 Jul	n/a	26 measures to reduce corporate tax, expedite key industrial projects and develop new strategic industries

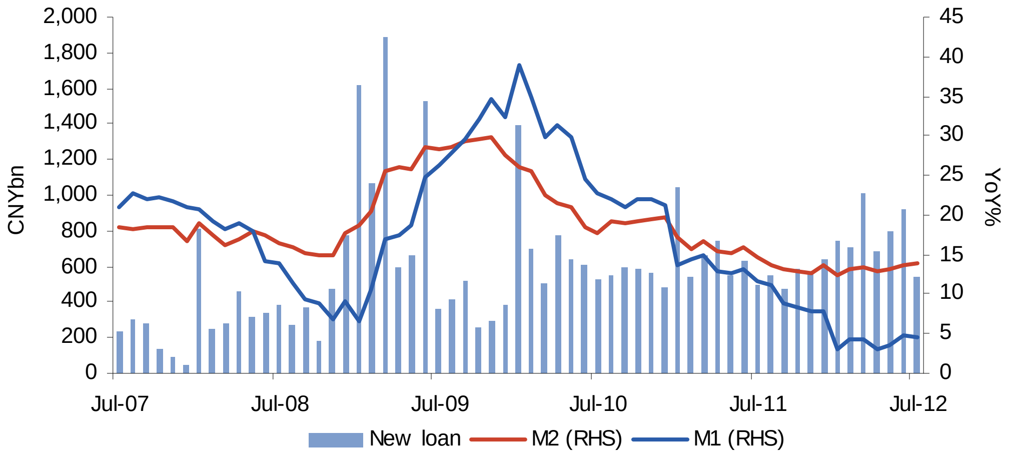
Source: Mizuho research

Fig 21 The central bank has not announced any monetary easing since the interest rate cut on 5 July



Source: CEIC, Mizuho research

Fig 22 The monetary loosening is far from enough to finance the local government packages



Source: CEIC, Mizuho research

In terms of fiscal easing at the national level, the measures are more limited. The government has encouraged private sector participation in previously monopolized industries, and the investment on railway infrastructure may double in 2H. There are also new subsidies to boost consumption of energy-saving home appliance and automobiles, along with tax reforms that aim to reduce the burden for businesses.

However, none of these can be considered “real action” that is powerful enough to jump start the slowing growth momentum, as the overall spending on stimulus at the national level is considerably smaller than the 2009 stimulus (see “A tale of two stimulus macro policies in China” 16 July). Overall, the scale of the stimulus so far has fallen below our expectations both in terms of size and timeliness. It is leading directly to the increased risk of a hard-landing in China.

Balancing pro-growth policy and reforms

Obviously, balancing reforms and supporting growth simultaneously is no easy task. For China, it requires policymakers to reflect on the lessons from the CNY4tn stimulus in 2009. In the previous episode, many investment projects were hastily launched in order to stabilize market confidence. In comparison, the current stimulus could take advantage from the investment plans in the 12th five-year plan, and focus on energy conservation and social welfare projects that were already planned in advance.

On the other hand, a critical problem from the previous stimulus package was the intertwined relationship between the government and the banking sector. Although CNY4tn stimulus was announced by the government, the final size of the stimulus was well above CNY10tn due to the expansion of bank loans in overdrive to the local government.

Thus, we believe the new stimulus should not rely on financing from the banking sector. Rather, it should rely on fiscal policy, including tax reductions and the issuance of special purpose government bonds of CNY1trillion to support the economy counter-cyclically. This fiscal seed money can be leveraged at least three times, and should be earmarked for social housing, infrastructure, water management, and renewable energy, in order to stimulate the economy effectively.

In our view, there is no reason to deny the significance of government stimulus, based on the sub-optimal results from the previous package alone. Rather, the new stimulus could rely on economic restructuring to lift the economy out of the current downturn. It will be a challenge for the government, as it requires the policymakers to reflect on the shortcomings in the previous package. However, as the debt burden for the central government is still at a manageable level, it could also be the most effective way to push for China's long-term development.

Fig 23 There are sufficient resources to increase fiscal spending

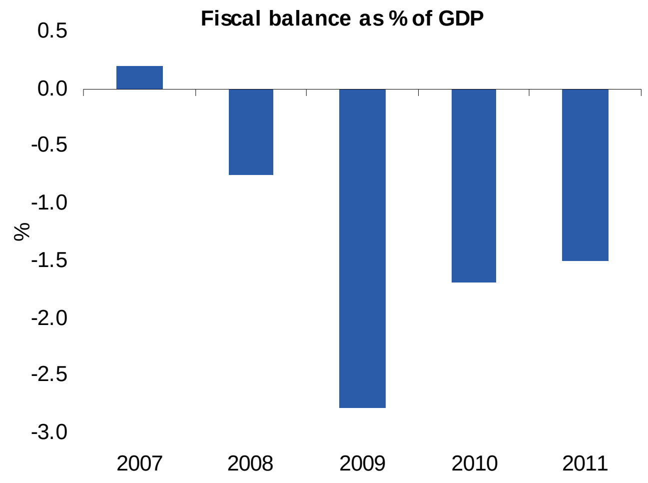
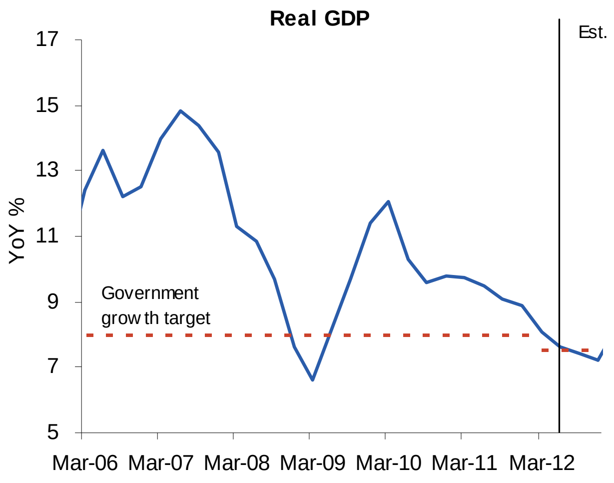


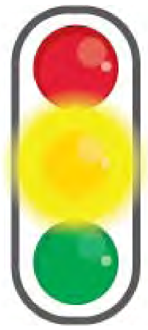
Fig 24 We have revised down our GDP forecast to 7.6%YoY



Source: CEIC, Mizuho research

9 November 2012

Worrying trend despite positive macro data – October macro data review



The economic activities data released today shows that the economy has broadly rebounded in October. Even though growth in fixed asset investment rose, business and housing investment actually decelerated, reflecting that the pickup is entirely due to infrastructural investment (mainly railways). Thus, the current recovery mostly depends on the government's fiscal expansionary policy. Overall, we maintain that the 4Q rebound in the economy is mostly due to fiscal stimulus, rather than solid foundations.

Fig 1 Key economic indicators

(YoY%)	Sep	Oct (Est.)	Oct (Actual)
VAI	9.2	9.2	9.6
FAI (YTD)	20.5	20.6	20.7
Retail sales	14.2	14.1	14.5

Source: CEIC, Mizuho research

Fixed asset investment supported by fiscal boost
Fixed asset investment (FAI) was up strongly by 20.7%YoY in January – October, above market and our expectations. It was triggered by the accelerated implementation of the government's investment project, including a 240%YoY increase in railway investment, to CNY69.7bn in October. The Ministry of Railway (MOR) predicted railway-related FAI to increase in 2013, suggesting the fiscal stance will continue to be expansionary next year.

Meanwhile, business investment is still down. The investment in the manufacturing industry increased by 23.1%YoY in January – October, 0.4ppt lower than January – September and significantly below 31.8%YoY in January – December 2011. Real estate investment remained flat at 15.4%YoY in January – October. All in all, it reflects that the foundation for recovery is not yet solid without government support.

Similar to September, the non-bank financing channels have become more important for new investment projects, as monetary conditions remain tight. Self-raised funds increased by 22.1%YoY. In comparison, funding from foreign investment dropped further to 10.1%YoY, in line with the recent weakness in FDI, amid the external headwinds.

Bottleneck in the real estate market continues
The sales value in the property market continues to expand by 5.6%YoY in January – October, against 2.7%YoY in January – September. Meanwhile, new starts in the property market are still weak, as it declined by 8.5%YoY in January – October, 0.1ppt below January – September. Meanwhile, investment remained flat at 15.4%YoY in January – October. Given the trend, the bottleneck in property supply will become a challenge for the new leadership.

In order to avoid surging property prices in the future, we believe the government may have to relax some of the restrictions in the property market after March next year. It may again become a key factor for the 2013 Chinese economy.

Government stimulus moves up the supply chain
Industrial production increased by 9.6%YoY in October, significantly above 9.2%YoY in September. It is in line with electricity production growth in October, and industrial profit in September, both of which rebounded strongly in the latest month.

Also, the production of steel increased by 11.7%YoY and 11.5%YoY, while cement maintained strong growth at 11.5%YoY, reflecting that demand supported by government infrastructure spending is creating support up the supply chain.

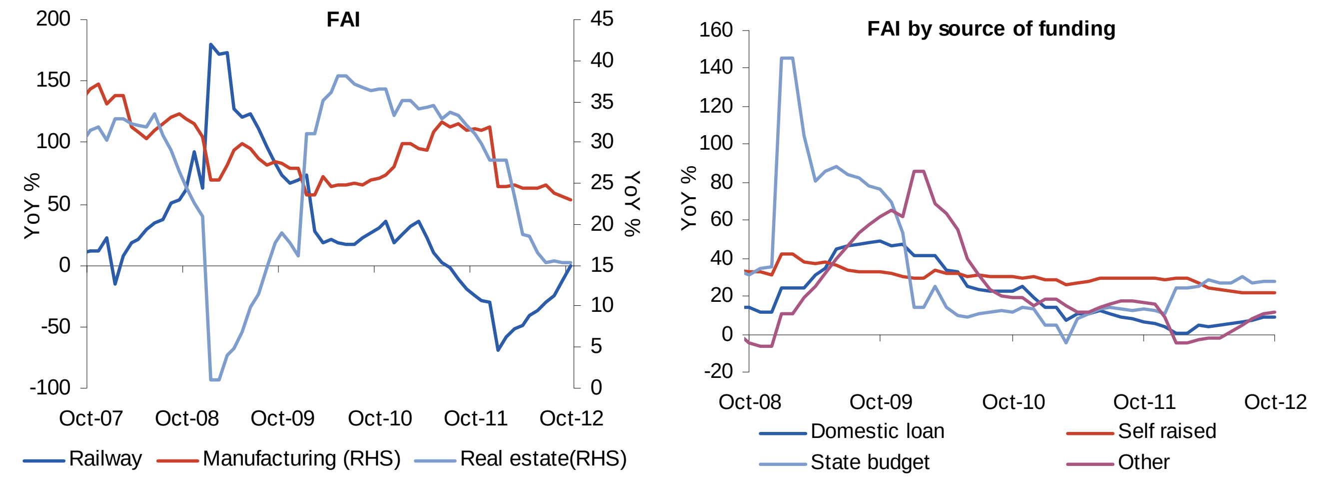
Consumer spending remains a bright spot
Consumer spending is a bright spot during the extended Mid-Autumn/National Day holiday. Retail sales increased by 14.5%YoY in October, above 14.2%YoY in September. In real terms, it increased by 13.5%YoY, up from 13.2%YoY in September.

By industry, the increase was backed by increased food and beverage sales (up 21.8%YoY from 18.5%YoY in September), and cosmetics (up 18.1%YoY from 15.7%YoY) likely due to the extended holiday period.

The sales of daily use goods were also up strongly, to 19.0%YoY from 15.8%YoY, reflecting the resilient consumer sentiment as employment market stands firm.

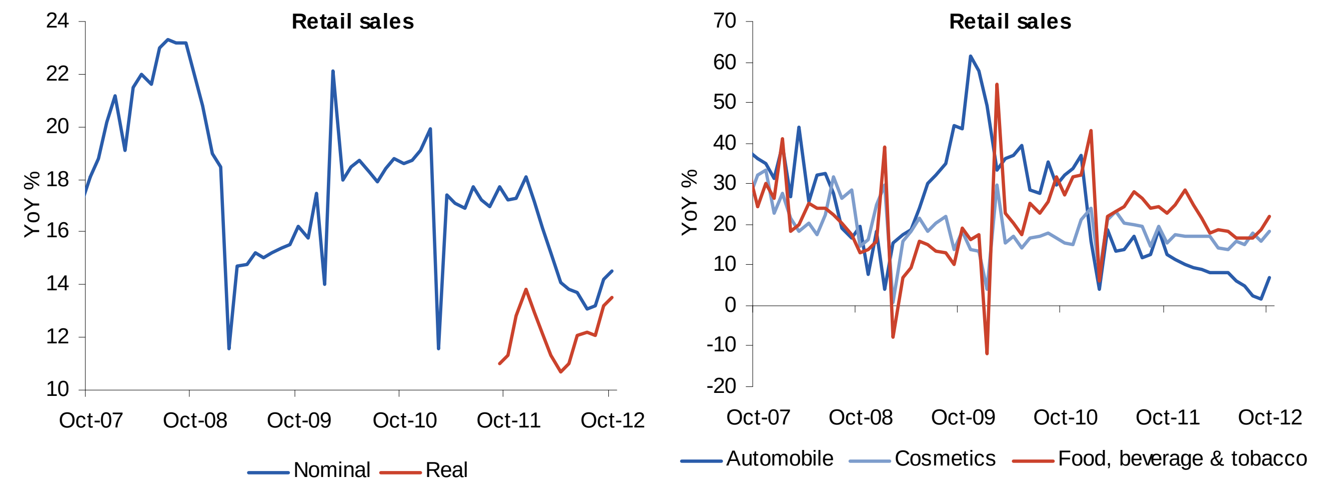
Property related consumption, such as home appliances and renovation materials, on the other hand, consolidated in October after strong growth in the previous months.

Fig 2 FAI in October depends mainly on fiscal boost



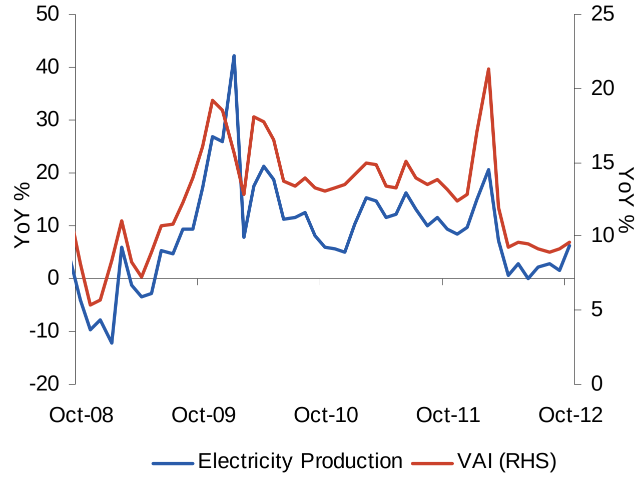
Source: CEIC, Mizuho research

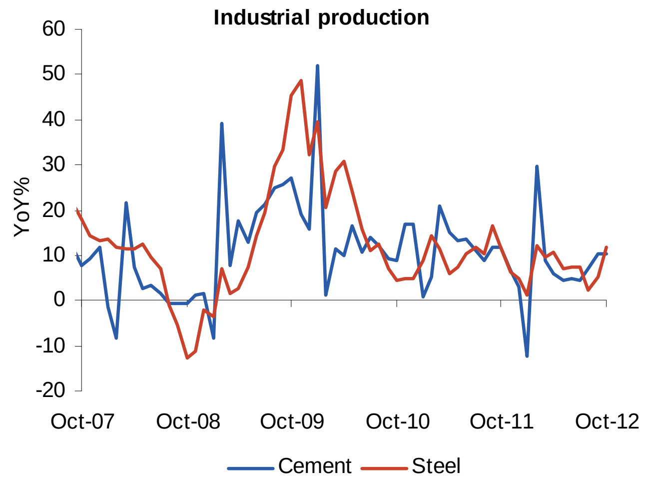
Fig 3 Retail sales remained a bright spot



Source: CEIC, Mizuho research

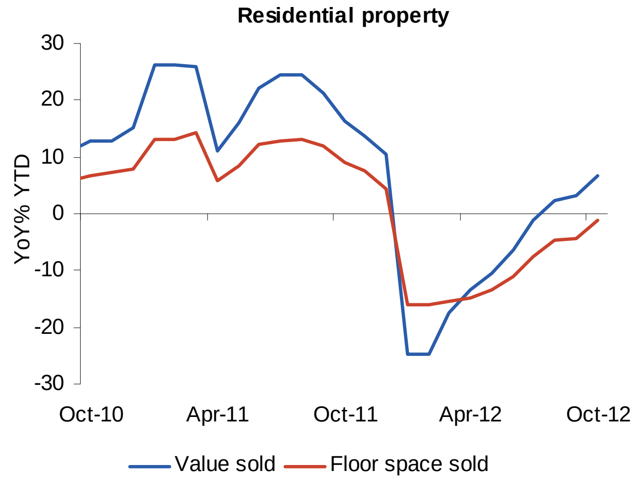
Fig 4 Improving industrial production reflects stronger demand from government infrastructure

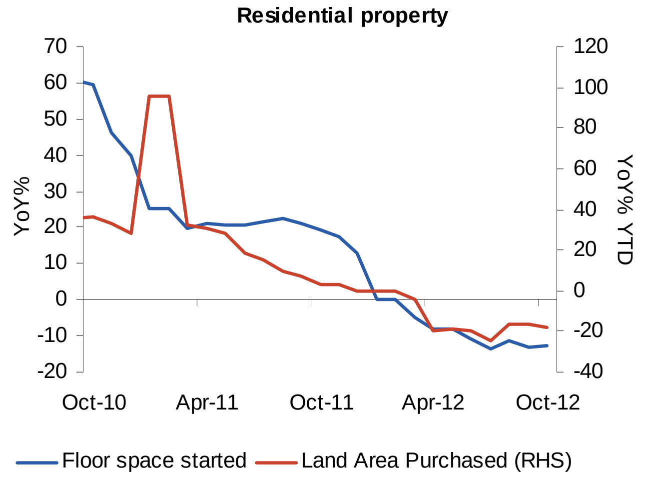




Source: CEIC, Mizuho research

Fig 5 Bottleneck in property market requires existing curbs to lift

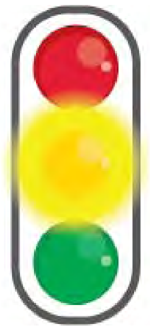




Source: CEIC, Mizuho research

18 October 2012

3Q growth moderated as expected, with mixed signals ahead



China's GDP eased further to a three-year low in 3Q, in line with our expectations. Meanwhile, economic activities in September were generally better, as the headline figure for industrial production, fixed asset investment and retail sales were above our expectations. A closer look at their breakdown, however, shows that the improvements are mixed. We believe the economy is still in a precarious position, which will take time and further support from the government to stabilize. We expect China's economic growth to be flat in 4Q, and we maintain our GDP forecast of 7.6%YoY for full year 2012.

Fig 1 Key economic indicators

(YoY%)	Aug	Sep (est.)	Sep (Actual)
GDP	7.6 (2Q12)	7.4 (3Q12)	7.4(3Q12)
CPI	2.0	1.9	1.9
PPI	-3.5	-3.4	-3.6
VAI	8.9	8.8	9.2
FAI (YTD)	20.2	20.2	20.5
Retail sales	13.2	13.1	14.2
Exports growth	2.7	4.0	9.9
Imports growth	-2.6	-3.0	2.4
Trade balance (USDbn)	26.7	26.0	27.7
New loans (CNYbn)	703.9	650	623.2
M2	13.5	13.6	14.8

Source: CEIC, Mizuho research

Economic growth decelerated further in 3Q

China's GDP eased further to a three-year low of 7.4%YoY in 3Q, below the government's target at 7.5%YoY, and in line with our view. On a quarter-on-quarter basis, 3Q GDP increased by 2.2% QoQ after the seasonal adjustment. It is rather surprising given the PMI in 3Q was below 50, suggesting that the manufacturing activities have moderated.

The breakdown shows that the contribution from investment remains flat, at 3.9ppts, reflecting the lack of substantial policy support in much of 3Q. Meanwhile, the contribution from consumption eased to 4.2ppts from 4.5ppts. Contribution from net exports improved further in 3Q, to -0.4ppt from -0.6ppt. It is due to the weakness in imports, which led to an improvement in the trade surplus.

Economic activities in September generally improved, as the headline figure for industrial production, fixed asset investment and retail sales were above our expectations. A closer look at their breakdown, however, shows that the improvements are mixed. In particular, the pick up in investment was mainly due to increased railway spending. We believe the economy is still in a precarious position, which takes time and further support from the government to stabilize.

Premier Wen Jiabao remarked in the day before the 3Q GDP release that positive changes have been witnessed in 3Q. He also said that the government is confident of achieving the full-year growth target at 7.5%YoY. In our view, his comments suggest that the government is satisfied at the current growth level, such that no major stimulus measure is deemed necessary. As we argued in "A tale of two downturns in 2008 and 2012" (10 October), there are many similarities between the downturn in 2009–2009, such as the negative impact of external shocks, a sharp slowdown in investment, and the market's concern of excess production capacity. Although the current downturn is milder than 2008-2009, it could take longer to recover as: 1) the government is no longer going to launch an enormous stimulus as in 2008; and 2) the economy continues to be plagued by excess capacity, which will take more time to consolidate. We expect the economic growth to be flat in 4Q, and maintain our 7.6%YoY GDP forecast for 2012.

Investment boosts growth through alternative financing
The economic activities generally improved in September. Fixed asset investment rose to 20.5%YoY in January–September, compared to 20.2%YoY in January–August. By industry, investment on the railway industry increased to CNY308.5bn in September, up by CNY70.9bn from August. It thus narrowed the year-on-year decline in the sector to 12.4%YoY from 23.9%YoY. On the other hand, real estate investment moderated to 15.4%YoY, from 15.6%YoY in August, reflecting that property sales are still unable to trigger the incentive for property development to invest. Construction as a whole, therefore, also eased to 14.1%YoY from 15.0%YoY.

By source of investment, self-raised financing increased by 21.9%YoY in January – September, slightly below the 22.0%YoY in the previous month but it was still the dominating source of credit. Other financing sources, including corporate bonds, pick up to 10.3%YoY YTD in September, up by 2.5ppt from August. Overall, it confirms that the increase in financing from the alternative channels is reflected in September FAI. As such, trust loans and corporate bonds may take a more important role in financing, and investment will be supported going forward.

Meanwhile, rest estate investment continued to ease in January–September, to 15.4%YoY, below 15.6%YoY in January–August. Investment related measures, including new projects started, and land purchases also slowed. It is in contrast with the property sales, which remained resilient along with the steady property prices. It reflects that the housing market is still in a dilemma that is a major consideration in economic policies.

Sign for industrial production is mixed at best
Although industrial production expanded by 9.2%YoY in September, above 8.9%YoY in August, electricity production was up by just 1.5%YoY compared to 2.7%YoY. Also, as reflected in the PPI deflation in the previous months, and the declining streak in industrial profit since 2012, the incentive for production remains low among manufacturers.

Production for exports picked up in September, as evident from the improved delivery value for exports, at 6.4%YoY compared to 3.6%YoY in August. It confirms that export-facing manufacturers have picked up production, in-line with the surging export growth in September. However, as we argued in ("Are positive trade and financial data sustainable?" 15 October) the export rebound is likely to be unsustainable amid lacklustre global demand. In our view, the signs for a recovery in industrial production are mixed at best.

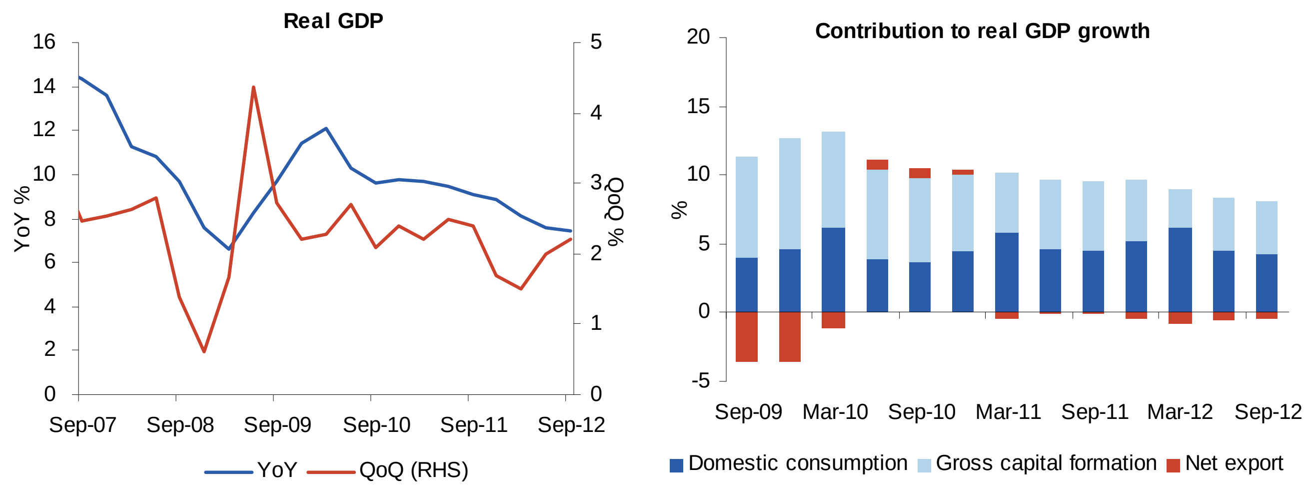
Retail sales remain the bright spot
Overall, the bright spot is still in retail sales, which increased by 14.2%YoY in September, 1.0ppt above August. In real terms, it also increased by 13.2%YoY, up from 12.1%YoY in August. It is supported well by policies such as tax reforms and subsidies on energy-conserving home appliances, as evident from the 13.7%YoY increase in the sales of household electric and video appliances, up by 1.6ppt from August. The sales of discretionary products, such as cosmetics, jewellery and automobiles, were still weak, reflecting that consumers have become more cautious amid the economic downturn.

In the medium term, we expect retail sales to be a growth driver: Following the wage increase in the past five years, the actual disposable income among workers has significantly increased. The accumulated increase in wealth from the asset market appreciation also leads to more spending. In the 12th Five Year Plan, the government will also aim to increase the share of consumption in the economy, leading to a transformation of the economy to a new, sustainable phase. It will increase household income through: 1) Reducing the tax burden; 2) Raising SOEs dividend payments; 3) Raising interest rates on deposits; and 4) Providing better public goods (see "It's time to share the wealth: Outlook for the 12th five-year plan" 10 October 2010).

The economy to hit bottom in 4Q, but signals are mixed
Overall, the September economic indicators suggest that China's improvement in 4Q is less than guaranteed, despite the signs of growth stabilization in 3Q. It is because the economy is still lacking in underlying strength. The upside surprise in exports, which increased by 9.9%YoY, was likely temporary due to: 1) Increased export orders for the Christmas high season in the US; 2) Delayed shipments from August due to typhoons striking its main ports; 3) Expedited shipments before the extended Mid-Autumn/National day holiday; 4) Favourable base effect as Mid-Autumn Festival fell in mid-September in 2011 rather than 30 September in 2012. As we argued in "Are positive trade and financial data sustainable? (15 October), however, the outlook for China's exports is still grim for the coming months as the global economic outlook remains highly uncertain (see "World economy under a cloud of uncertainty" 16 October).

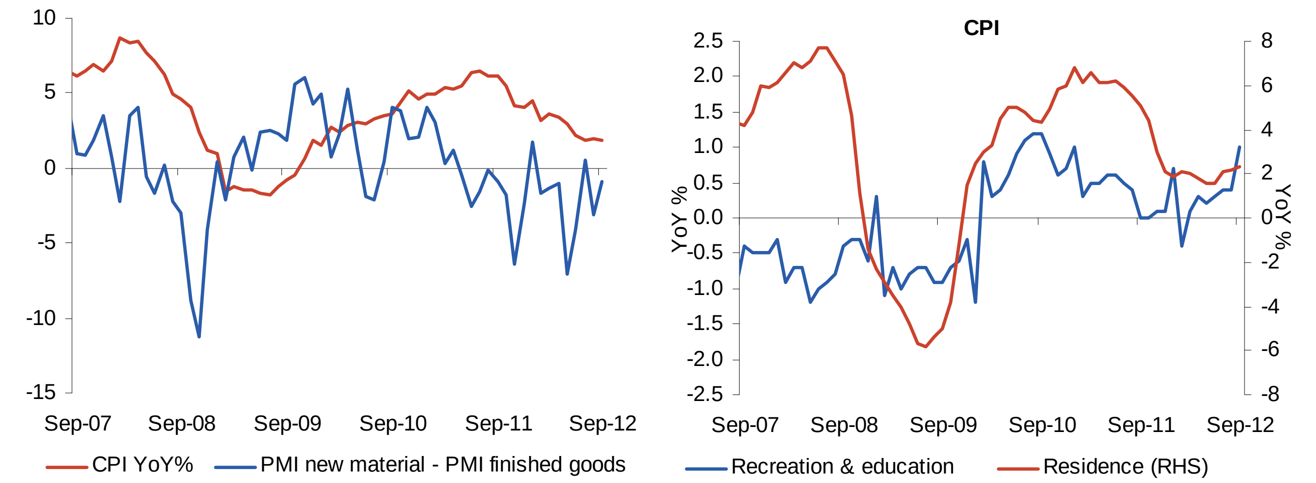
Looking ahead, the 18th National Party Congress, will convene on 8 November, and its highlight will be the transfer of power in the top leadership. As we argued in "Lacklustre growth in the absence of policy stimulus – September macro data preview" (3 October), policymaking has been put on hold in preparation for political reshuffling. We maintain that the small scale positive policy measures, including RRR cuts before the congress is likely, but nothing significant is in store.

Fig 2 GDP eased to 7.4%YoY in 3Q, as expected



Source: CEIC, Mizuho research

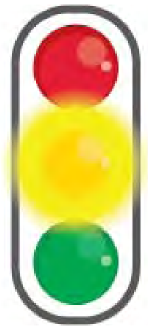
Fig 11 Non-food prices increased due to fuel price hikes



Source: CEIC, Mizuho research

16 October 2012

World economy under a cloud of uncertainty



In my view, the IIF and IMF/World Bank annual meeting was characterized by the rising positive sentiment towards the global economic outlook, a view that I do not share. Instead, I would focus more on the rising risk from global easing, the rising political tension in the Euro area and its implication on the region's reforms, and the rising competition from other emerging economies with China. In my view, world leaders need to focus more on the risks in order to bring the world economy back on track as soon as possible.

In the annual general meetings of the Institute of International Finance (IIF) and International Monetary Fund (IMF)/World Bank Group in Tokyo, world experts gathered to share their views on the global economic outlook. While many have expressed their concerns for the rising risks ahead, the meeting reached a more upbeat conclusion: many experts believe that following the new round of quantitative easing, global GDP growth next year will be better than in 2012. Remarkably, the US Treasury Secretary Tim Geithner noted that neither the US economy nor the fiscal cliff is reason for concern, to my surprise. Contrary to the widespread optimism in the meeting, I am more concerned about the risks ahead, and its implications on global economic growth.

Is Geithner too early for optimism?

In Geithner's speech on the first day of the IIF annual meeting, I did not get the sense that he had any concerns about the risk in the US. To him, the sub-par economic growth in the US was caused by the Euro crisis, the Japan earthquake, two oil crises, and the drought in the US. In his view, without the impact from these exogenous events, US economic growth would have remained at 3%-4%. He said that the economic fundamentals in the US were diverse and dynamic, with strong energy and agricultural sector and competitive technology and hi-tech manufacturing, etc. On the fiscal cliff, Geithner remarked, in a confident tone, that the automatic spending cuts will put the US in a unique position, which brings domestic differences into consensus eventually.

Contrary to the optimism seen from the US government, I am much more concerned about the US economic situation. Since the outbreak of the subprime crisis, the US government has launched three rounds of quantitative easing in order to limit the response in the real economy. For example, compared to the USD2tn expansion on the balance sheet so far, there was only a 2 million increase in job positions. This means that each position created costs the government nearly USD1mn. The money-printing ended up increasing the wealth of just a handful of individuals. In a breakdown on job creation, most of the positions created are in the public sector and financial industry, while the number of jobs created in the manufacturing industry pales in comparison. As a result, I cannot help but wonder if the US government's optimism reflects an attempt to overlook the risks. How should the market prepare for the negative impact from quantitative easing? This is an issue that deserves closer attention.

Political risk in the Euro area still looms

The situation in the Euro area has significantly improved from six months ago. This is because the ECB agreed to step in, which has eased the market's concerns of the sustainability of the Euro. It bought much-needed time for reforms in the region. However, as the crisis enters a new phrase, the political tension in Europe is rising. As major elections in core countries in the region approach, the position of Germany will be a critical factor for the Euro.

Surprisingly, the differences between the German Finance Minister, Wolfgang Schaeuble, and the IMF's Managing Director, Christine Lagarde, surfaced during the IMF/World Bank annual meeting. The IMF believes that the government leaders in the European countries should relax the austerity requirements for debt-ridden countries and focus on growth. In response, Schaeuble said that Christine Lagarde appears to contradict the IMF's own stance in advocating austerity easing and said that, “when someone starts climbing down the mountain before reaching the top, the mountain will get even higher.” The position from Germany may prove to be a major obstacle to progress in the Euro area.

In addition, as the Euro crisis enters the third phrase, political risks are not to be under-estimated. The market’s focus has again turned to Spain, the fourth largest economy in the Euro area. Troubled by the deep recession and high unemployment, a large number of protestors have taken to the streets to denounce the proposed austerity measures.
The three upcoming regional elections will put voter support for austerity to the test. The election in Catalonia on 25 November, in particular, has again put its secessionist movement on the spot. Amid rising political risk, the Spanish government will unlikely request for full financial support. Also, as next year’s elections in Germany and Italy draw closer, voter support for austerity and the Euro will be a key variable in the Euro crisis’ resolution.

Emerging economies, hard to come out from the shadow
The emerging economies have received a lot of attention at the 2012 annual meeting. As the second largest economy, China’s economic slowdown has received widespread attention. The PBOC Governor Zhou Xiaochuan and Financial Minister Xe Xuren cancelled their trip to the Tokyo meeting amid the geopolitical tension between China and Japan. This reflects the increasing political uncertainty for the already-dampened world economy.

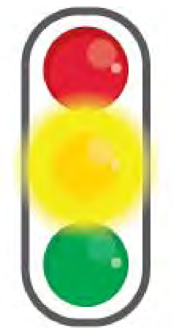
Deputy Governor Yi Gang, who replaced Governor Zhou to give the closing speech at the meeting, predicted that the Chinese economy will expand by 7.8%YoY in 2012. This is a view that I find too optimistic. In order to achieve 7.8%YoY, 4Q GDP will have to rebound significantly from the current downtrend. Given the government’s policies implemented so far, I believe this will be a challenge.

Apart from China, economic growth in ASEAN was also recognized at the meeting. Speeches from top officials show that the countries in Southeast Asia maintained upbeat growth amid their ongoing reforms and the global crisis. These countries are following the Chinese path for development, which is characterized by foreign investment, infrastructure, cheap labour and export expansion. It suggests that the challenges for China’s economic outlook will come not only from the structural adjustment in developed economies, but from the fierce competition from ASEAN countries as well.

All in all, the annual meeting concluded with a message of rising confidence. Although the experts are concerned about different risks that may dampen the global economic outlook, they are still optimistic on the whole. In comparison, I am relatively more reserved in my view on the world economic outlook. As the impact from the quantitative easing in developed economies is still largely unknown, and amid the rising political tension in the Euro area, there is little reassurance, in my view. I believe that world leaders need to focus more attention on the risks in order to bring the world economy back on track as soon as possible.

15 October 2012

Are positive trade and financial data sustainable?



- **Exports in September were up strongly mainly due to the increased new export orders for the Christmas high season and the increase in shipments before the extended Mid-autumn/National day holiday in early October, in our view. Amid the lacklustre global economic outlook, the upside surprise in October is a temporary blip and external demand will continue to be downbeat.**

- **New loan growth in September was inconsistent with the money supply growth, as alternative financing channels have expanded (as reflected in the 35%YoY increase in total social financing), while the banking system remains under tight control. While the situation represents some improvement in market liquidity, we are unsure how much of a role the need to make debt repayments will play due to tight credit conditions. Thus we will need to see if rising financing will translate into higher investment growth.**

Fig 1 Key economic indicators

(YoY%)	August	September (Estimate)	September (Actual)
Exports growth	2.7	4.0	9.9
Imports growth	-2.6	-3.0	2.4
Trade balance (USDbn)	26.7	26.0	27.7
New loans (CNYbn)	703.9	650	623.2
M2	13.5	13.6	14.8

Source: CEIC, Mizuho research

Seasonal spike in exports may not last

- China's exports rose 9.9%YoY in September, sharply up from 2.7%YoY in August. As we argued in "Lacklustre growth in the absence of policy stimulus – September macro data preview" (3 October), the spike in export growth was mainly due to the increase in new export orders for the Christmas high season in developed economies. In addition, shipments are likely to be overdrive before the extended Mid-autumn/National day holiday in early October.

- By destination, exports to the US picked up again to 5.5%YoY in September from 3.0%YoY, while exports to Japan rebounded to 2.2%YoY from the 6.7%YoY contraction in August. The decline in exports to the EU also narrowed in September, albeit only marginally to 10.7%YoY from 12.7%YoY in August. By product, improvements were mostly seen in finished products and consumer goods, such as garments (up 10.3%YoY), toys (up 8.4%YoY) and plastic articles (up 51.1%YoY).

- Meanwhile, imports rebounded by 2.4%YoY, ending three months of a consecutive decline. Thanks to strong export growth, the trade surplus increased to USD27.7bn in September from USD26.7bn. The rebound of imports would have been stronger if not for the easing prices of key raw materials such as iron ore (down 29.3%YoY in value, up 7.3%YoY in volume) and copper (down 8.6%YoY in value, up 3.8%YoY in volume). It is also reflected in the import growth from resource-rich countries such as Australia (down 18.0%YoY) and Brazil (down 14.2%YoY). Also, imports from Japan declined by 9.6%YoY, reflecting the initial reaction from Chinese consumers after the territorial disputes between the two countries.

- We believe the upside surprise in October is a temporary blip, and we maintain our downbeat view on China's external demand. As the global economy remains highly uncertain, and austerity measures and structural reforms in developed economies are going to drag on global demand, exports will remain weak in the months ahead. (see "A tale of two downturns in 2008 and 2012" 10 October).

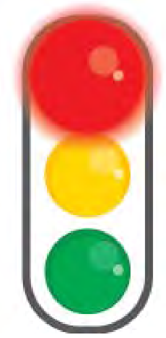
Mixed signals from credit data shows RRR cuts still necessary

- China's new loan growth came in at CNY623bn in September, around 10% below the August level. Also, the weighted average interbank lending rate increased further to 2.93%, compared to 2.84% and 2.78% in August and July, respectively, thus reflecting that tight liquidity conditions in the market will continue in September.

- A further breakdown, nevertheless, shows that there is some improvement. New medium- and long-term loans extended to enterprises stood at CNY127.7bn, accounting for 20.5% of total new loans in September, up from 17.1% in August. However, it is still significantly lower than its historical average at around 44%; the monthly total social financing reached CNY1.65tn (35% higher from a year ago) as the alternative sources of funding has flourished. Year-to-date net bond issuance jumped from CNY842bn in 2011 to CNY1560bn in 2012, a growth of 85%. In addition, YTD new trust loans increased from CNY84bn to CNY702bn; M2 also accelerated by 14.8%YoY, above the government's target at 14%YoY.

- We find that the credit data in September show some improvement in market liquidity. It is mainly due to the increased funding from alternative sources outside of the banking system. Meanwhile, liquidity within the system remains tight, especially as deposit growth has fallen short of loan growth in the previous months. It is hard to gauge how the need to make debt repayment plays a role due to tight credit conditions, in our view. Thus it remains to be seen if rising financing will translate into higher investment growth.

3 September 2012



Alert for rising hard-landing risk – August PMI review and macro data preview

China's August official PMI fell below the contraction threshold for the first time in nine months. In our view, this indicates that the manufacturing sector is facing weak demand from both domestic and external buyers. China's August economic indicators to be released on 9-10 September will likely be disappointing again. We now expect China's 3Q and 4Q GDP growth to decelerate to 7.4%YoY and 7.2%YoY, respectively, leading to 7.6%YoY growth for 2012. The delay in much-needed policy easing is closing the window to avoiding a hard-landing.

Fig 1 Projections for key economic indicators

(YoY%)	**Jun**	**Jul**	**Aug (est.)**
CPI	2.2	1.8	2.0
PPI	-2.1	-2.9	-3.3
VAI	9.5	9.2	8.9
FAI (YTD)	20.4	20.4	20.1
Retail sales	13.7	13.1	13.2
Exports growth	11.3	1.0	0.0
Imports growth	6.3	5.7	2.0
Trade balance (USDbn)	31.7	25.2	14.7
New loans (CNYbn)	919.8	540.1	580
M2	13.6	13.9	14.0

Source: CEIC, Mizuho research

China's official manufacturing PMI fell to 49.2 in August, below the contraction threshold for the first time in nine months. By components, all except production sub-index were under the threshold. In particular, the decline in new order and export order sub-indices were remarkable. The August data indicates that China's manufacturing sector is facing weak demand from both domestic and external buyers, and it is caught in over-capacity problems. The HSBC flash PMI, which dropped to 47.8 in August, also shows that the small and medium enterprises are facing even bigger challenge. The labour market, which is a lagging indicator, could begin to deteriorate very soon.

The decline is broadly in-line with our expectations. As we argued in "Window to avoid hard-landing is closing fast" (31 August), we expect China's 3Q GDP growth to decelerate to 7.4%YoY. Our view is supported by recent data releases including July industrial profit, the official as well as HSBC PMI, as well as the latest economic developments in the Eurozone. If policymakers in China continue to delay policy stimulus, the economy may slow even further to 7.2%YoY in 4Q.

Decline in orders reveal weak outlook

New order sub-index dropped to 48.7 in August, 0.3 below July. Eleven industries, including special equipment manufacturing, ferrous metal smelting and processing, and textile, were below the threshold. The production sub-index, at 50.9, also fell by 0.9 in August. It indicates that weakening domestic demand has put manufacturers under pressure, a situation that will deteriorate in the coming months.

Another remarkable feature of the current slowdown is the accumulation of inventory. The PMI finished inventory sub-index increased by 0.2 in August, while the raw material sub-index dropped by 3.4. It suggests that manufacturers have become more conservative in their production outlook as finished goods stockpiles and lack of working capital.

Projecting from the PMI reading, the August economic indicators to be released on 9-10 September will again paint a gloomy picture. Industrial profit declined by 2.7%YoY in

January-July, 0.5ppt below January-June. It implies that industrial production in August will remains lackluster. Also, the economic downturn will dampen consumption sentiment, such that at best retail sales may stay unchanged in the short term.

As policy stimulus was more moderate than expected, its support to investment is likely limited. Coupled with the property market, which continues to be controlled tightly, fixed asset investment in August may ease further.

Anemic export demand amid rising global headwind
The new export order sub-index stayed flat at 46.6 in August. In particular, thirteen industries including food processing, metal product, textile, ferrous metal smelting and processing were below the threshold. Meanwhile, the import sub-index increased by 2.0 to 47.0 in August, with fourteen industries including metal product, pharmaceuticals, wood processing and furniture manufacturing below 50.0. Although the external demand related PMI has not deteriorated further in August, both are still significantly below the contraction threshold, suggesting that external demand is unlikely to provide any buffer.

Rising external headwinds will dampen China's export outlook in the months to come. Uncertainty continues to loom in the Eurozone, in events such as: 1) the assessment of Greece's budget cut plans; 2) the worsening situation in Spain with Catalonia, the second most populous region, asking for bailout funds from the central government in late August; 3) the verdict from the German constitution court on the European Stability Mechanism (ESM). Recent economic indicators show that the crisis is beginning to drag down the German economy. It shows that demand from the European markets will continue to wane.

Signs of an economic recovery are clearer in the US, but the fiscal cliff remains a source for uncertainty. As a result, we remain pessimistic about China's external trade in August, as exports may stay flat from a year ago, and import growth will continue to slow.

Inflation may return, but it is not a primary threat
The input price sub-index in August rebounded to 46.1, 5.1 above July. Eight components including petroleum processing and coking, food processing, chemical fiber manufacturing, rubber and plastic manufacturing, tobacco manufacturing and pharmaceutical manufacturing were above 50.0. The strong rebound in the sub-index may imply that the current downtrend in China's CPI has ended.

Combined with the food price update from the Ministry of Commerce, the Ministry of Agriculture and the National Bureau of Statistics, China's food prices rebounded on beef, egg and vegetables in August (see "China inflation monitor" 30 August).

All in all, we expect the CPI to rebound moderately to 2.0%YoY in August. However, as the economy continues to expand below trend, and the deflationary PPI environment suppressing non-food price increases, we maintain that inflationary pressure will be mild for the rest of 2012, leading to 2.6%YoY inflation for the whole year.

Stimulus delay to increase hard-landing risk
As we argued in "Window to avoid hard-landing is closing fast" (31 August), the risk of a hard-landing has become very high due to the absence of aggressive policy stimulus. In our view, there are five reasons behind the hesitation: 1) to avoid making similar mistakes that emerged from the CNY4tn stimulus package in 2009; 2) incoming leaders may wish to implement easing after the next government is formed in March 2013; 3) a housing price rebound; 4) food price inflation is rising; and 5) the labour market remains stable.

But we feel that the delay in much-needed policy easing is closing the window to avert a hard-landing. As economic restructuring cannot be done when the economy is losing momentum, the government will have to launch counter-cyclical measures to stabilize the economy. Obviously, balancing reforms and supporting growth simultaneously is no easy task. The new stimulus should rely on economic restructuring to lift the economy out of the current downturn.

In particular, it should rely on fiscal policy, including tax reductions and the issuance of special purpose government bonds of CNY1tn to support the economy counter-cyclically.

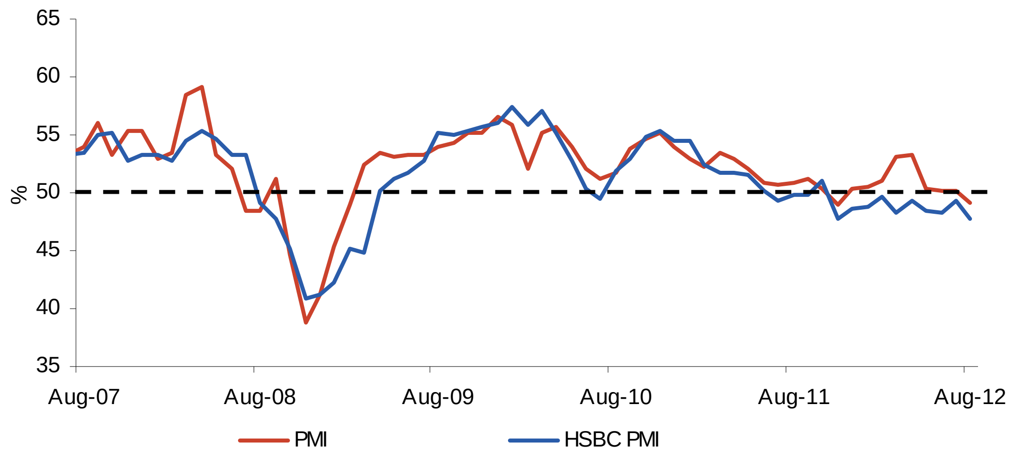
This fiscal seed money can be leveraged at least three times, and should be earmarked for social housing, infrastructure, water management, and renewable energy, in order to stimulate the economy effectively.

Fig 2 CPI breakdown

	Jun	Jul	Aug (est.)
CPI (YoY %)	2.2	1.8	2.0
CPI (MoM %)	-0.6	0.1	0.6
Food (YoY %)	3.8	2.4	3.3
Food (MoM %)	-1.6	-0.1	1.4
Non-food (YoY %)	1.4	1.5	1.5
Non-food (MoM %)	0.0	0.2	0.2

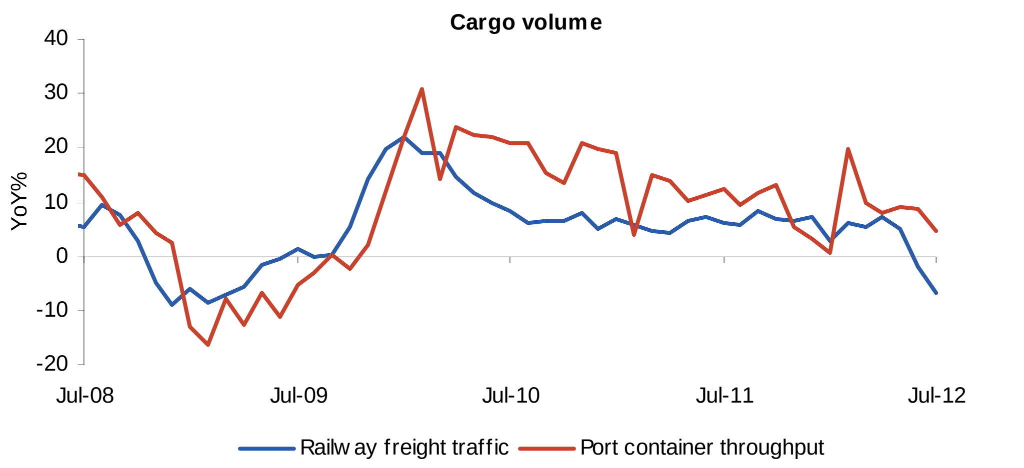
Source: CEIC, Mizuho research

Fig 3 PMI dropped to 49.2, confirming our view for further slowdown in 3Q



Source: CEIC, HSBC, CFLP, Mizuho research

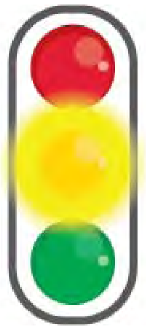
Fig 4 Decline in cargo volume supports weak production growth



Source: CEIC, Mizuho research

8 August 2012

How to finance China's new stimulus package?



- **In order to support economic growth, a number of investment projects have been announced by local governments since June, to the magnitude of nearly CNY4tn. The market has become concerned if the governments' ability to finance the projects without repeating the problem with local government financing in 2009.**

- **In response, the government has recently: 1) issued asset backed notes to allow LGFVs to tap funds from the financial markets. Although the size of the initial issue is small, it marks the beginning of an important financing tool for the future; 2) requested LGFVs that borrow to demonstrate good returns; 3) encouraged private sector participation in industries that are traditionally monopolized by the government; 4) encouraged the issuance of high-yield corporate bonds to improve private sector's access to credit; 5) increased the Ministry of Railway's spending on infrastructure through the sale of ministry assets; and 6) increased liquidity supply through monetary easing and expedited project approval from the NDRC.**

- **Overall, we believe that as local governments are expected to lead the stimulus this time, their financing channels are critical to the success of the policy. As such, the contribution of the LGFV deserves to be reassessed. Overall, the easing measures indicate that the government has become more cautious of the potential risks from policy stimulus than 2009, and is committed to increasing policy transparency and market participation in the stimulus.**

In order to support economic growth, a number of investment projects have been announced by local governments since June, to the magnitude of nearly CNY4tn, according to the Chinese media. It includes the CNY830bn investment plan laid out by Changsha city government on 25 July (see "Local governments to lead fiscal stimulus" 26 July). In our view, it is a new wave of fiscal stimulus that in essence is similar to the package in 2009, except that local governments are going to lead the effort this time.

One of the main criticisms for the 2009 stimulus package was the expansion of Local Government Financing Vehicles (LGFV). Data from the National Audit Office shows that loans made by banks to LGFV surged by more than 50% between mid-2009 and end-2010, when the total size of it ballooned to CNY10.7tn. Many of these financing vehicles bypassed the existing government restrictions on government borrowing, and were difficult to monitor (see "Fiscal reform key to alleviating LGFV risk" 28 June 2011). Thus, the new stimulus package in 2012 has drawn widespread concern if the governments will be able to finance the projects without repeating the same problem.

In response, the government has recently announced a number of policy initiatives hoping to finance the investment projects with increased market participation:

- The first batch of three ABN (Asset-Backed Notes), with a combined CNY2.6bn value, has been filed on 7 August. It came after China issued rules on 3 August allowing domestic companies outside the financial sector to securitize assets through ABN offerings. Although the size of the initial issue is small compared to the total LGFV market, it opens the gate as another source of funding for investment. We expect that there will be more ABN in the near future as a key financing tool for infrastructure projects. Under the rules, the notes must be backed by assets or property rights that can produce a cash flow. Trading of the ABN will be limited to selected institutional investors. The ABN will help LGFVs with steady income flow to obtain liquidity in a more transparent and efficient way.

- The government is going to encourage private sector participation in industries that are traditionally monopolized by the state. On 30 July, the government announced that it will introduce some projects as soon as possible to allow private investments in areas such as the railways, public utilities, energy, telecommunications, financial, health and education industries. The announcement came after the NDRC issued the "New 36 Clause" to attract private investment and remove barriers (See “Aggressive policy easing to rescue the economy” 29 June).

- Also, for the first time the government has encouraged the issuance of high-yield corporate bonds on the Shanghai Stock Exchange. It will improve the small and medium sized enterprises’ access to credit, and allow for more effective interest rate setting mechanism to increase efficiency of the market.

- On 31 July, the China Securities Journal reported that the regional arms of key commercial banks have been requested by their headquarters to enhance credit support to provincial LGFVs, as well as projects on the local government financing vehicle platform. It has been reported that bank credit support will focus on infrastructure projects that can demonstrate good returns, in areas of highway, railway, natural gas, and clean energy (see “Policy easing to accelerate amid slow recovery – July macro data preview” 1 August)

- After announcing that it will increase the spending on railroads and bridges construction by 14% in July, the Ministry of Railway is expected to spend CNY470bn in 2012. The additional investment will be financed by land development, sales of the ministry’s asset, and expansion of the railway development fund collection criteria.

- In addition, the PBOC has already cut interest cuts two times and RRR three times. It also relaxed its restrictions on the lending rate floor to 70% of the benchmark. Effectively, it has resulted in a maximum cut of interest rate by 236bps, rather than the 56bps cut based on the headline. It could trigger a significant increase in market liquidity. Going forward, we expect policymakers to cut interest rate cut again in 3Q to support economic growth (see “Further monetary easing before inflationary pressure returns” 2 August). According to the Shanghai Securities News, the “big four” state banks lent out CNY220bn in July, above the CN190bn lent out in June. It suggests that loan growth in July will likely be encouraging. In June, total new loan expanded by CNY919.8bn.

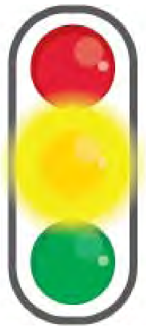
- In response to the increased liquidity supply, the central government has expedited the approval process for infrastructure investments, in order to release market demand, and provide a channel for increased market liquidity to stabilize the economy (see “Housing market is the main obstacle to policy easing” 19 July). The NDRC has approved more than 200 projects per month since the government began emphasizing the importance to stabilize growth in May. On 1 August, 27 projects were approved by the NDRC. Most of the projects were on infrastructure spending.

In our view, as local governments are expected to lead the stimulus this time, their financing channels are critical to the success of the policy. As such, the contribution of the LGFV deserves to be reassessed. As we discussed in “Fiscal reform key to alleviating LGFV risk” (28 June 2011), the problem of LGFVs can be alleviated only through comprehensive fiscal reforms to provide stable financial resources for the local government, involving a redistribution of expenditure and revenue between the central and local governments.

Overall, the easing measures indicate that the government has become more cautious of the potential risks from policy stimulus than 2009, and is committed to increasing policy transparency and market participation in the expansionary measures. We maintain that these measures will lead to a rebound in China’s economy in 2H. While it will be mild in 3Q, we expect the pick up to become more visible in 4Q, leading to 8.1%YoY growth in 2012.

9 August 2012

Delayed rebound requires further policy stimulus – July macro data review



- **Economic activities continue to disappoint in July. As FAI, and VAI are below our expectation, the government stimulus so far is still not sufficient to counter the economic downturn. Real estate investment, meanwhile, remains lukewarm despite the warming signs in the property market. Going forward, we believe more aggressive policy actions will be necessary to put the economy back on track.**
- **Inflation declined further in July, to the lowest in 30 months. It was due to economic slowdown, lower food price, and favorable base effect. Overall, we expect even lower CPI in the next few months, as PPI fell deeper into negative territory amid lower commodity price. It will hence increase the room for further policy easing, including one more interest rate cut and at least two RRR cuts for the rest of the year, with the next RRR cut likely in August.**

Fig 1 Key economic indicators

(YoY%)	June	July (Est.)	July (Actual)
CPI	2.2	1.6	1.8
PPI	-2.1	-2.0	-2.9
VAI	9.5	9.6	9.2
FAI (YTD)	20.4	20.6	20.4
Retail	13.7	13.5	13.1

Source: CEIC, Mizuho research

Economic activities continue to disappoint in July
July economic activities show that the Chinese economy continues to disappoint. Last month when 2Q GDP were above our expectation, we argued that it was no reason for celebration (see "What's wrong with China's 2Q GDP data?" 17 July). Instead, we expected July to mark the beginning of a mild recovery, but the data released today indicates that the government stimulus is still not sufficient to counter the economic downturn. Real estate investment, meanwhile, remains lukewarm despite the warming signs in the property market. Going forward, we believe more aggressive policy actions, as we outlined in "How to finance China's new stimulus package?" (8 August) will be necessary to put the economy back on track.

The slowdown in July was across the board, as FAI and VAI were below our expectation. Headline FAI stayed flat at 20.4%YoY YTD in July due to the bright spot in railway and highway construction, among other infrastructure investments. These industries improved due to the increased involvement from the government to support growth in recent months. Meanwhile, fixed investment on construction eased to 19.6%YoY in January – July, from 20.6%YoY in January – June. Real estate investment also rose by just 15.4%YoY in January – July, 1.2ppt before January – June. It suggests the property market is still a lingering concern, and policymakers will have to rely on infrastructure as the only pillar for economic growth for now.

Likewise, industrial production weakened to 9.2%YoY in July from 9.5%YoY in June. It was due to the slowdown in heavy industry. In particular, railways, shipbuilding, aerospace and other transportation equipment were down by 4.5ppt to 1.4%YoY in July, while automobile production and electric machinery and equipment were both down visibly. In line with the declining investment in the property sector, the production of steel and cement were also down to 6.5%YoY and 6.1%YoY respectively.

The slowdown in nominal retail sales growth, at 13.1%YoY in July compared to 13.7%YoY in June, is caused by further easing of inflationary pressure. In real terms, retail sales growth improved slightly to 12.2%YoY in July from 12.1%YoY in June, reflecting that consumer sentiment remains largely resilient. Nevertheless, nominal retail sales of items related to the property market, such as home electrical appliance, furniture and construction and renovation material, were down visibly by 0.6ppt, 2.3ppt and 3.8ppt to 8.9%YoY, 26.4%YoY and 25.5%YoY respectively.

Inflationary pressure to ease further in coming months
Inflation dropped further to 1.8%YoY in July, from 2.2%YoY in June. Despite being slightly higher than our expectation, it fell below 2.0%YoY for the first time since October 2010. It is also much lower than the government's target at 4.0%. Food prices eased to 2.4%YoY in July from 3.8%YoY in June, due to falling prices for meat (down by 6.1%YoY vs. 1.7%YoY decline in June) and egg (down by 6.5%YoY vs. 3.6%YoY decline in June). The increase in vegetable price has also moderated to 8.0%YoY from 12.1%YoY in June. On a month-on-month basis, however, the recent decline in food price has narrowed to a 0.1%MoM decline. It may also mark the beginning of the upward cycle in food price, which we expect to return mildly in 4Q (see "Further monetary easing before inflationary pressure returns" 2 August).

Non-food price edged up to 1.5%YoY in July, above 1.4%YoY in June, mostly due to the increase in residence cost (2.1%YoY vs. 1.6%YoY). It is attributable to both the rebound in property market, as rental increased by 3.1%YoY from 2.9%YoY in June, and the implementation of tiered electricity tariff system in June, as the price for electricity, fuel and water increased by 2.5%YoY from 1.0%YoY. Barring for the increase from residence, non-food price would have moderated due to lower global commodity price. We continue to expect lower CPI in the next two months, as PPI fell deeper into negative territory, at 2.9%YoY in July. It will hence open the room for further policy easing, including one more interest rate cut and at least two RRR cuts for the rest of the year, with the next RRR cut likely in August.

Policy stimulus to redouble to put economy back on track
The economic activities in July indicate that policy easing so far is insufficient, and more aggressive actions are required to put the economy back on track. The easing inflationary pressure in the coming months allows for more accommodative monetary policy, as negative real interest rate is not yet a concern. As such, we expect one more interest rate cuts with two more RRR cuts.

In terms of fiscal easing, investment spending will continue to be the key driver for China's growth in 2012, with the more aggressive actions outlined in "How to finance China's new stimulus package?" (8 August): 1) issued asset backed notes to allow LGFVs to tap funds from the financial markets. Although the size of the initial issue is small, it marks the beginning of an important financing tool for the future; 2) requested LGFVs that borrow to demonstrate good returns; 3) encouraged private sector participation in industries that are traditionally monopolized by the government; 4) encouraged the issuance of high-yield corporate bonds to improve private sector's access to credit; 5) increased the Ministry of Railway's spending on infrastructure through the sale of ministry assets; and 6) increased liquidity supply through monetary easing and expedited project approval from the NDRC.

With increased policy intervention, we maintain that China's economy will pick up mildly in 3Q, followed by stronger rebound in 4Q, leading to annual economic growth at 8.1%YoY.

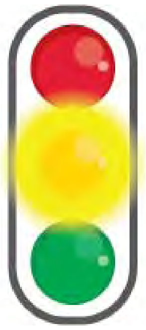
Fig 2 CPI breakdown

	June	July (est.)	July (Actual)
CPI (YoY %)	2.2	1.6	1.8
CPI (MoM %)	-0.6	0.0	0.1
Food (YoY %)	3.8	2.7	2.4
Food (MoM %)	-1.6	0.1	-0.1
Non-food (YoY %)	1.4	1.3	1.5
Non-food (MoM %)	0.0	0.0	0.2

Source: NBS, Mizuho research

26 July 2012

Local governments to lead fiscal stimulus



The Changsha city government announced that it will invest CNY829bn in infrastructure projects. In our view, this is the beginning of a new wave of fiscal stimulus led by China’s local governments, in response to the recent green light given by Premier Wen to promote investment and expand employment, in order to stimulate the economy. The new stimulus packages are consistent with our expectation that fiscal stimulus will be the focus of policy easing in 2H12, and we believe more local governments will soon follow suit with similar announcements.

- The government of Changsha, the capital city of Hunan in south-central China, announced on 25 July that it will promote 195 “big projects”, which will involve CNY829.2bn in investment. Out of them, 40 projects will require investment of CNY374.8bn including the construction of ten new development areas, ten key infrastructure, and ten industry projects. The projects will cover a wide range of policy areas including social welfare, transportation, urban planning, and new industry development.

- Changsha’s construction plan was announced after a CNY3tn stimulus package was unveiled by the government of Guizhou province, which focuses on eco-tourism infrastructure. This plan will include ten national level projects, and 250 provincial level projects, which will begin construction in the years ahead.

- The announcements highlight that local governments are leading the way for new fiscal stimulus measures. With the central government’s tight controls on local government lending previously, there has been widespread panic among local governments in regard to the recent downturn. Moreover, following the recent leadership change at the local government level, new officials are eager to implement stimulus measures into the economy in order to boost their track records. On 25 July, the State Council approved a strategic plan to promote the central region’s economy. It provides guidelines that are in-line with Premier Wen’s recent pledge to promote investment and expand employment as the government’s top priority. Subsequently, it opens the door for local governments to double their efforts to stimulate the economy.

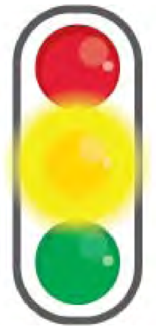
- The projects will be financed by increased bank loans to local governments via local government financing vehicles (LGFVs). As we argued in “Is policy easing enough to reverse the downturn? Review of 2Q 2012 GDP data” (29 June), a new directive from the CBRC in late June has urged banks to increase lending to infrastructure projects if the project demonstrates good returns. The new projects in Changsha, for example, will focus on infrastructure that will promote the city’s long-term development, such as the expansion of the Huanghua airport, and the construction of new peripheral areas in the city.

- In our view, the headline investment target announced will be spread over the next few years, and eventually the actual amount of investment recorded could be discounted to a third of its original target. The situation will be similar to 2009, when local governments announced a total investment of CNY20tn, and then later approving only CNY9tn in investment.

- The new packages are consistent with our expectation that fiscal stimulus will be the focus of policy easing in 2H (see “Aggressive policy easing to rescue the economy” 29 June). In particular, the central government will expedite the approval for infrastructure investments, in order to release market demand, and provide a channel for increased market liquidity to stabilize the economy (see “Housing market is the main obstacle to policy easing” 19 July). We expect Changsha, Nanjing and Ningbo to be the start of a wave of nationwide stimulus packages, with more announcements from other local governments to come.

19 July 2012

Housing market is the main obstacle to policy easing



- **We believe the government's housing market restrictions have now come to a critical point. Amid the rebounding property prices, policymakers will continue to curb the housing market, and therefore it risks becoming an obstacle to policy easing.**

- **Going forward, the government will rely on infrastructure investment to support China's economic growth. It includes increased spending on railway, highway, social housing, along with other infrastructure projects. We believe, however, that infrastructure investment alone may not be sufficient to support the economy, and the government's capital injection may become too much for the sector to digest. Thus, easing on housing market restrictions will be inevitable eventually. Overall, the theme of the Chinese economy will be on proactive government stimulus in 2H, which will be the key to ensuring China an economic soft-landing in 2012.**

After 2Q GDP was released last week, Premier Wen reiterated that the recovery momentum in growth wasn't yet in place and that "difficulties" may persist for a while. As we argued in "A tale of two stimulus macro policies in China" (16 July), the government has become more concerned about the economic downturn. It is going to step up policy fine-tuning in 2H, mainly through increased investment spending.

During the 2009 downturn, the economic stimulus package was mainly focused on infrastructure and property investment. In 2012, however, the slowdown has coincided with a rebound in property market. The rebound is against the government's stated objective to bring housing prices back to an affordable level, and policymakers will not tolerate a return to an overheated housing market. Thus, the property market has developed into an obstacle for policy easing, and the government's reaction will be critical for China's economic outlook.

Housing market has become an obstacle to policy easing
The housing market has rebounded in June on resilient demand and an interest rate cut. 25 cities reported property price increases on a MoM basis, up from just 6 in May. The home sales transaction volume rose 41%MoM in June. It also brought a return in sales of household products, such as home electrical appliance and audio equipment, furniture, and construction and renovation materials. In June, real retail sales climbed to 12.1%YoY, from 11.0%YoY in May.

On the supply side, tightening in the housing market continues. Total property investment in June was up by 16.6%YoY YTD, slowing from 18.5%YoY YTD in May (see "Is policy easing enough to reverse the downturn? Review of 2Q 2012 GDP data" 13 July). It was the lowest level since the beginning of the global financial crisis. New residential housing has begun to decline by 10.7%YoY YTD in June, from 8.2%YoY YTD in May. Funding for developers remains tight, as its share from domestic loans decreased further to 8.1%YoY YTD in June from 8.5%YoY YTD in May. It reflects more conservative land purchases, as the area of land sold decreased by 19.9%YoY YTD in June, compared to the 18.7%YoY YTD decrease in May. The contracting construction, funding, and land purchase suggests that housing supply will continue to be tight in the near future.

While increasing housing market transactions is good news to policymakers, the decline in property investment can lead to a bottleneck in housing supply. It could become a cause for uncertainty as to when property prices will return to an affordable level in the future. As such, China's government housing market curb has come to a critical point.

How will housing market controls continue?
In our view, the government's restrictions on the housing market will not change in the near future, due to the recent pick up in housing prices. For example, although the PBOC has announced that banks are allowed to lend at 30% of the lending rate floor starting from 6 July, the adjustment does not apply to personal mortgages, which remains at 20% below the benchmark (see "A second rate cut to kick start aggressive policy easing in 2H" 6 July). It proves that the government's determination to contain speculative activities has not changed.

To promote the healthy development of the housing market, the government should:

- While housing market bubbles exist in medium and lower income households, it is not as much a problem as it is in the luxury home market. As such, it is not suitable for the government to apply "one-size fit all" policies, and expect housing prices to decline across the board. The government should also focus on promoting income redistribution, and increase transfer payments for medium to lower income households. The government should also expedite the reform of the financing market, and improve the governance of the capital market, to expand the available investment options for Chinese households (see "Crossroads for China's property market control" 21 November 2011).
- The government could improve the quality of housing market indicators. In order to regulate the housing market, the government needs to have indicators that give unbiased insight into the current market situation. The property price indicators are too confusing for policymakers to make reliable decisions.
- The government needs to pay attention to maintaining policy measures. Frequent changes and sudden reversals of government policy could be harmful to the market environment, and even the economy.

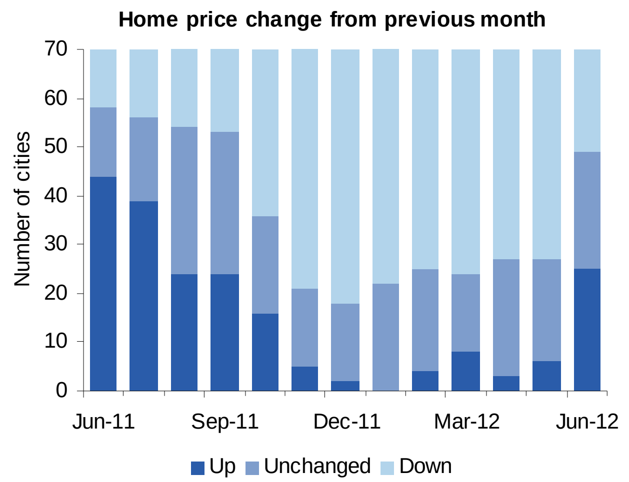
Other policies to stabilize the economy
Given the constraints on the housing market, policymakers need to launch policies to bolster investment in other areas, in order to stabilize the economy. It includes:

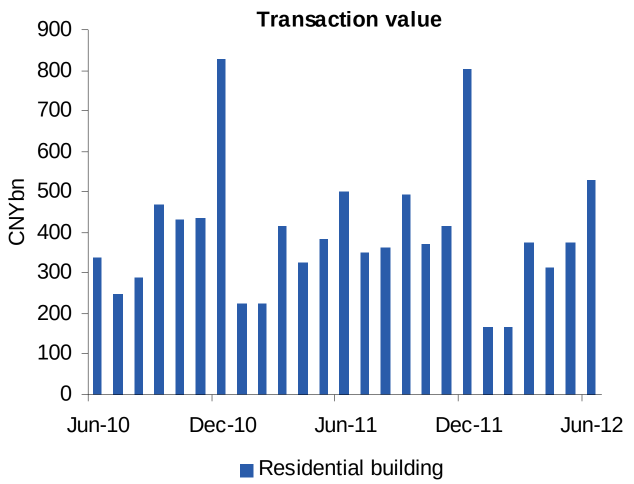
- Speeding up the approval process for investment projects. The slowdown in infrastructure spending has been a main cause for the current slowdown. Following the credit tightening, interest rate hikes, RRR hikes, and consolidation of local government financing vehicles (LGFVs) in 2011, infrastructure investment declined from 52%YoY growth in 2009 to -6.5%YoY in May 2012. The concern has been raised that policy easing is in effect another CNY4tn stimulus package as seen in 2009, which created inefficient spending. Nevertheless, as we are now in the second year of the 12th five-year plan (FYP), the proposed investment projects in FYP amounts to more than CNY4tn each year. Many of these investment projects were just put on hold last year due to the tightening policy. The government can now simply resume the proposed investment projects, to ensure reasonable return from the investment. A new directive from the CBRC in late June urged banks to lend to infrastructure projects if there is sufficient cash flow to repay the loans, and LGFVs that demonstrates good returns will receive support in gaining financing access.
- Promoting the participation of the private sector in key industries. The government is going to encourage private sector participation in industries that are traditionally monopolized by the state. As pledged by Premier Wen Jiabao, the "New 36 Clause" has been released, covering a wide range of industries such as railway, energy, communication, healthcare, and education. (See "Aggressive policy easing to rescue the economy" 29 June).
- It has been shown that recent slowdown is partly caused by insufficient demand. Thus, proactive fiscal spending can more effectively support the economy. China's fiscal deficit was respectively 2.8%, 1.7% and 1.5% of GDP in 2009-2011. It is relatively low by international standards. Coupled with steadily increasing fiscal revenues, it shows that the government is equipped with sufficient resources to increase fiscal spending.

Considering the experience from 2009, however, we believe that infrastructure investment alone may not be sufficient to support the economy. Also, despite that projects are readily available, surging capital injections that aims to boost 2H GDP may become too much to digest. As such, easing on the housing market restrictions may become inevitable eventually.

All in all, we believe the government's housing market control has reached a critical point. Policy makers' determination to curb the speculative activities in the housing market will not change, especially when housing price is in a rebound. Meanwhile, the government will rely on infrastructure investment to support China's economic growth. It includes increased spending on railway, highway, social housing, along with other infrastructure projects. Eventually, however, easing on housing market restrictions may become inevitable as infrastructure alone may be insufficient to support the economy. Overall, the theme for the Chinese economy will be proactive government stimulus in 2H, which will be the key to ensuring China an economic soft-landing in 2012.

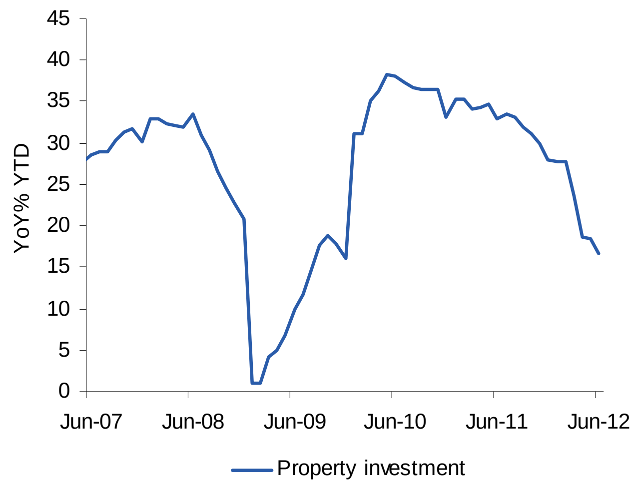
Fig 1 Housing market has rebounded in June

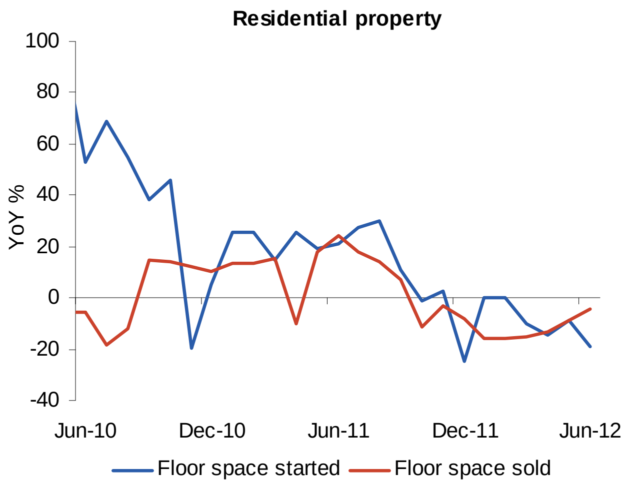




Source: CEIC, Mizuho research

Fig 2 Investment in the property sector remains weak, suggesting bottleneck in supply going forward





Source: CEIC, Mizuho research

Fig 3 Developers have reduced construction

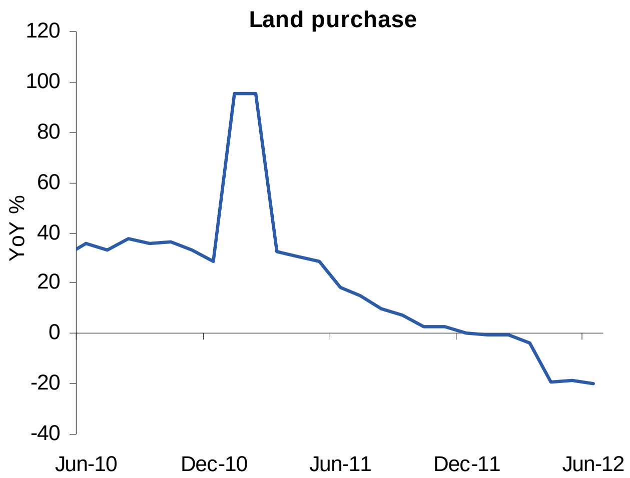
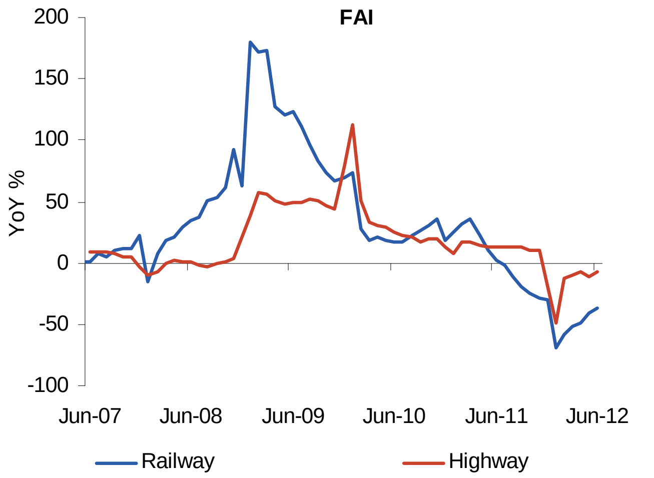


Fig 4 Infrastructure investment is a main cause for current slowdown



Source: CEIC, Mizuho research

Fig 5 There is sufficient resources to increase fiscal spending

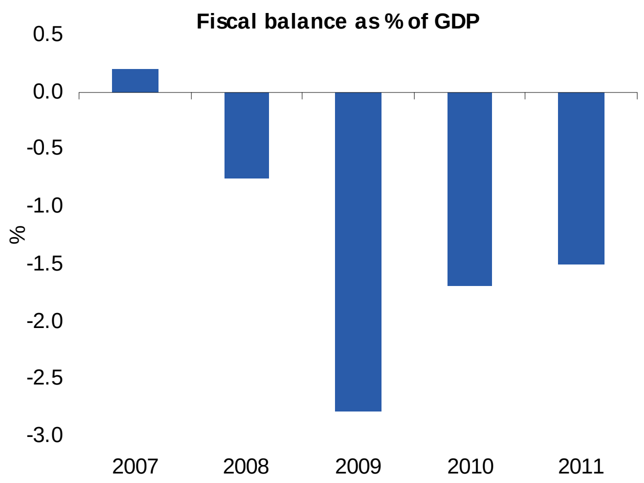
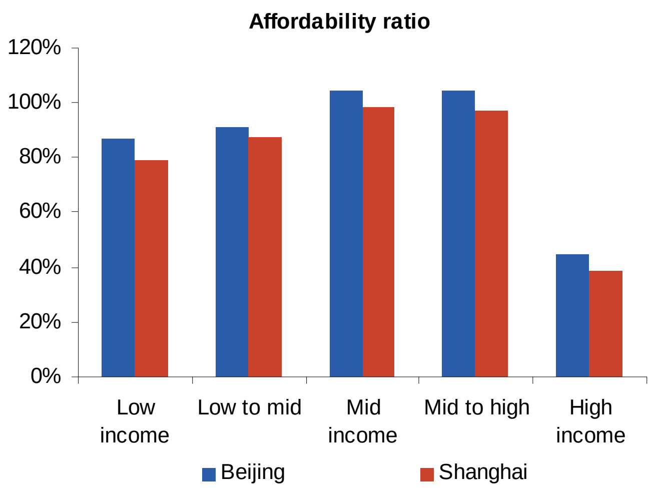
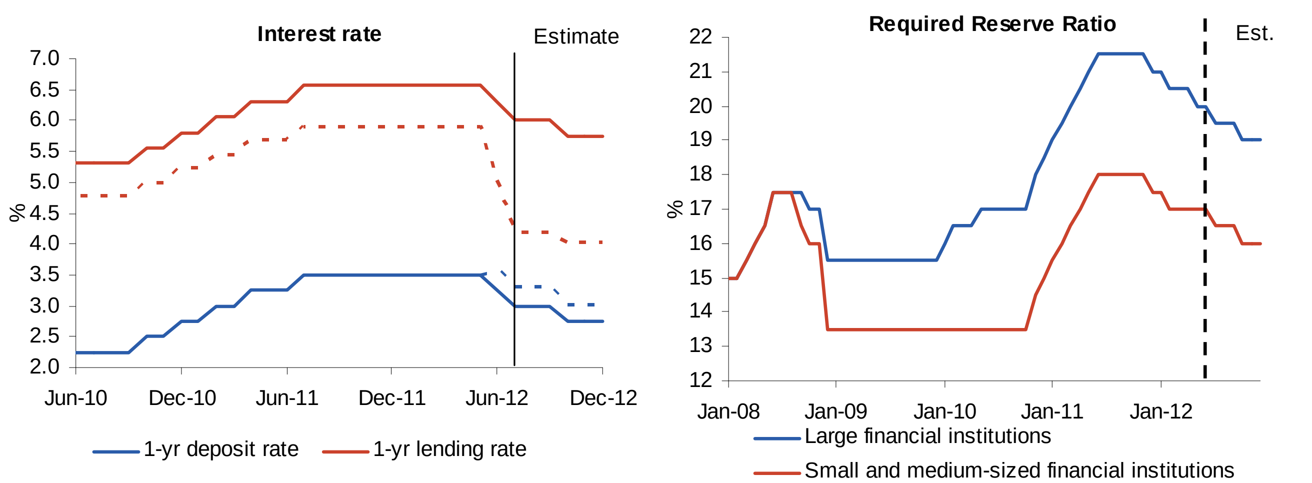


Fig 6 Housing bubble is not a high income group problem



Source: Centaline, CEIC, Mizuho research

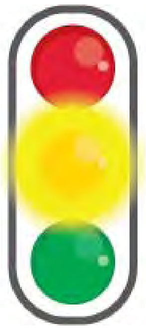
Fig 7 We expect one more interest rate cut and two RRR cuts



Source: CEIC, Mizuho research

17 July 2012

What's wrong with China's 2Q GDP data?



- **China's 2Q GDP data released by the NBS is controversial. At 7.6%YoY, the GDP growth rate remains above the government's target of 7.5%. However, it is inconsistent with deteriorating monthly economic indicators, the difficulties that many enterprises are experiencing, and the government's recent urgent actions to stimulate growth. Moreover, the breakdown in contributions for consumption and investment to GDP is more problematic, as the strong pickup in the contribution from investment to GDP growth as shown by official releases is contradictory to the marked slowdown in 2Q investment.**

- **During an economic slowdown, it is important to maintain market confidence, but this confidence needs to be built on reliable data. Facing the problem head-on is the key first step in dealing with the problem, and will help China's efforts to boost the economy along with the rest of the world.**

On 13 July, the NBC released China's 2Q GDP, which slowed to 7.6%YoY, the lowest in three years (see "Is policy easing enough to reverse the downturn? Review of 2Q 2012 GDP data" 13 July). It remains above the government's target at 7.5%YoY, and is believed to be the bottom of the current down cycle (Fig 1). However, if this is true, then why do we still see reports of declining industrial profit amid a negative business environment? Why would Premier Wen Jiabao repeatedly emphasize the importance of stabilizing growth since May? Why should the NDRC expedite project approval urgently? Why should the PBOC cut interest cuts twice in a month (Fig 2)? From the recent policy easing, it is easy to develop the feeling that China is approaching an economic hard-landing. The contradictions between the official growth data and the policy changes calls for closer inspection.

Conflicting GDP and economic activities data
GDP is the most important economic indicator that the market follows, especially during an economic downturn. However, as GDP is released on a quarterly basis, the market also follows PMI, industrial production, electricity production, inventory, and other micro data as a proxy for GDP and more general economic developments. Historically, these indicators have shown to be closely correlated with GDP.

China's 2Q GDP, at 7.6%YoY, no longer adheres to the established relationship between these indicators, however, and it doesn't correlate with to the general market perceptions either. For example, China's manufacturing PMI was 51.3 in 2Q on average, 0.2 below 1Q. The official 2Q GDP, on the other hand, increased to 1.8%QoQ from 1.6%QoQ in 1Q. In detail, the PMI output, new order and new export order sub-indices in 2Q are declining fast (Fig 3), while the finished goods inventory sub-index was up notably. It shows that China's growth momentum has slowed visibly, with significant surplus in production capacity.

The contradictions are also remarkable when looking at decelerating industrial production:

- Industrial profit was bleak. In January-May, larger industrial enterprises realized profits of CNY1.84tn, down 2.4%YoY. It deteriorated by 0.8ppt from January-April (Fig 4). For state-owned enterprises, profit declined by 11.6%YoY in January – June.

- The growth of industrial sector and secondary industry has been relatively steady in the past. VAI was consistently around 4% higher than GDP, and around 3ppt below secondary industry GDP. In 1H12, however, the gap between VAI and GDP narrowed to 2.7ppt, while that of secondary industry GDP narrowed to 2.2ppt (Fig 5).

- Electricity production has moderated. In June, electricity production growth was flat from a year ago (Fig 4). Officially, it was due to more effective energy conservation measures and industrial restructuring. However, we find it hard to accept as the slowdown happened in mere months, amid an economic downturn.

- Inventory levels have significantly increased. Since 2012, the inventory for steel and cement have pushed their market price back to 2007 levels (Fig 6).

From the industrial forums that we have recently attended, we found that manufacturers have become very pessimistic on the current situation. Thus, we believe the 2Q GDP, at 7.6%YoY, may not be able to give a fair representation of the real economic situation in China right now.

Contribution from investment and consumption are hard to account for
The NBS also released the contribution from the "troika" of economic growth: Consumption, investment and net exports on 13 July. It showed that the contribution from consumption was down, while investment was up notably. Negative contribution from net exports narrowed.

We believe the contribution from net export was reasonable, as trade surplus was up in 2Q due to weak import demand. However, we believe the other two components are questionable: For consumption, retail sales(after adjusting for price effect) was up steadily in recent months, to 12.1%YoY in June from 10.7%YoY in April (Fig 7). It is not in-line with the weakening consumption contribution to GDP.

In addition, the contribution from investment in 1H was 3.9ppt, up from 2.7ppt in 1Q. It shows that investment is accelerating. However, the NDRC did not accelerate its project approval process until late May, and the first interest rate cut was announced on 8 June. Considering that the usual lag between policy implementation and the actual impact on the economy, the impact from these stimulus measures should only become significant in 2H. Also, the June credit data released by the PBOC shows that credit growth in June was mainly short-term bills, while medium- to long-term lending was still hovering at around 30% of total loan growth, below the historical average at 50% (Fig 8). It shows that credit demand for investment is still relatively weak.

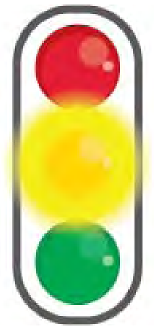
Stabilizing efforts are stepped-up
Since the end of May, Premier Wen Jiabao has gone on tour to raise support for the economy. After the 2Q GDP was released, Premier Wen reiterated during his Sichuan visit that the momentum for a recovery in growth isn't yet in place and that "difficulties" may persist for a while. Since May, the effort on policy fine-tuning has stepped up, as evidenced by: 1) increase in new loan growth; 2) expedited investment project approval; 3) increased subsidy for consumption; 4) expansion of tax reform; 5) promotion for private capital to enter previously state-monopolized sectors; 6) trial scheme for bond issuance by SME, and 7) resuming band lending for local government financing vehicles. It indicates that policymakers are deeply concerned about China's economic outlook.

Remarkably, the PBOC has joined the ranks of the central banks worldwide on monetary easing. Starting from the European Central Bank's 25bps rate cut to 0.75%, the Bank of England injected GBP50bn in its third round of quantitative easing. The Bank of Korea also cut interest rates for the first time in three years to 4%. The central bank of Brazil, similarly, cut interest rates for the eighth time in 2012. As a partner in the world economy, the PBOC also cut interest rates for the second time in a month on 5 July. The PBOC also relaxed its control on the lending rate floor to 30% below the benchmark, in a bid to push forward interest rate liberalization. Combining the effect from two interest rate cuts and the 30% floating limit, the interest rate for 1-year loans could drop to 4.2% from 6.56% before the June rate cut. The effective cut could be over 200bps.

To sum up, we believe that China's efforts to boost the global economy along with the rest of the world should be recognized. The orchestrated easing was done amid deteriorating global economic outlook. On 16 July, IMF downgraded its forecast for global economic growth to 3.5%YoY in 2012, and China's growth to 8.0%YoY. However, if economic data cannot support market pessimism, why should the PBOC goes to such great lengths to boost the economy? During an economic slowdown, it is important to maintain market confidence, but this confidence needs to be built on reliable data. Facing the problem head-on is the key first step in dealing with the crisis and solving the economic problems ahead.

16 July 2012

A tale of two stimulus macro policies in China



In essence, the stimulus measures introduced in 2012 are no different from the stimulus package introduced in 2009, as policymakers are again behind the curve in decision making. Similar to 2009, the stimulus measures rely primarily on infrastructure and property investment. The difference this time is mostly down to the scale, as the downturn in 2012 is not as bad as in 2009. The government has become more cautious after the 2009 stimulus package received criticism for leading to an asset price bubble and inflationary pressure.

According to a report from Xinhua agency on Sunday, Premier Wen reiterated, during his latest Sichuan province visit, that the momentum for a recovery in growth isn't yet in place and that "difficulties" may persist for a while. The government will step up policy fine-tuning in the second half, he said, to make policy easing more forward looking and effective. He also said that the growth momentum is still within the growth target set at the beginning of 2012, and results from the government's growth stabilizing effort is starting to show.

The more Chinese policymakers talked about the need to stimulate the economy leads us to think that the current policy is increasingly similar to 2009, for two reasons:

- Chinese macro policy was often behind the curve of the changing macro environment, and would then react frenetically to catch up. This has happened every year since 2008. For example, we issued a report after the 1Q GDP release saying that aggressive policy easing, especially investment policy, was needed to avoid a hard landing. However, government officials at that time were universally complacent, as they were mostly concerned about inflation, but not so much about growth, until disappointing economic data was released in recent weeks. Once they realized that the economy was out of control, then they would try to catch up, and often overdo it.

- The most effective stimulus policies in China are always, and still, infrastructure and property investment. In the final six months of his term in the government, Premier Wen will do all that it takes to keep growth above his target, so it seems natural that he is resorting to investment. It is evident that the new directive from the PBOC, urging banks to resume lending to infrastructure projects. In our view, this is a confirmation that lending has been eased for LGFVs (see "Is policy easing enough to reverse the downturn? Review of 2Q 2012 GDP data" 13 July).

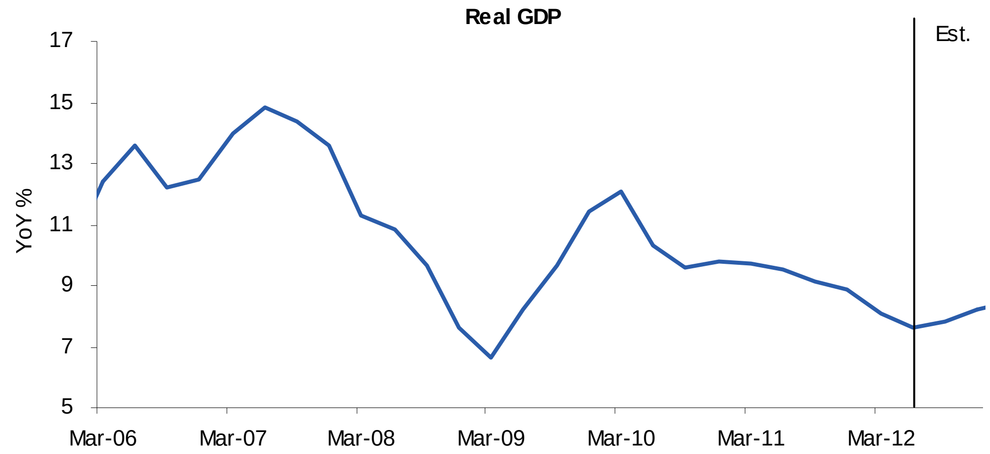
There are also two differences between now and 2009:

- The 2009 shock was much larger than the situation now. For example, exports declined 26.3%YoY in May 2009. Currently, exports are still relatively resilient at 11.3%YoY in June despite the slowdown in the recent months. Industrial production, likewise, dropped to 5.4%YoY in November 2008 and is currently hovering at slightly below 10%YoY in 2Q 2012. In terms of employment, there were widespread layoffs in 2008, causing a significant return of migrant workers back to the rural area in 2009. At that time, around 15% of the 130mn migrant workers in urban areas returned home jobless after the Chinese New Year. In comparison, the current labour market remains relatively firm now, with news of layoffs still relatively rare.

- People realized and were critical of the negative consequences from the 2009 stimulus, so the government has become more cautious when implementing stimulus measures into the economy. However, the government is accelerating projects before even announcing them, such as: expedited investment projects approved by the NDRC; a CNY36bn subsidy for energy-saving appliances; and CNY66bn subsidy for the construction of public rental homes that all show that stimulus measures are clearly in progress (see "Aggressive policy easing to rescue the economy" 29 June).

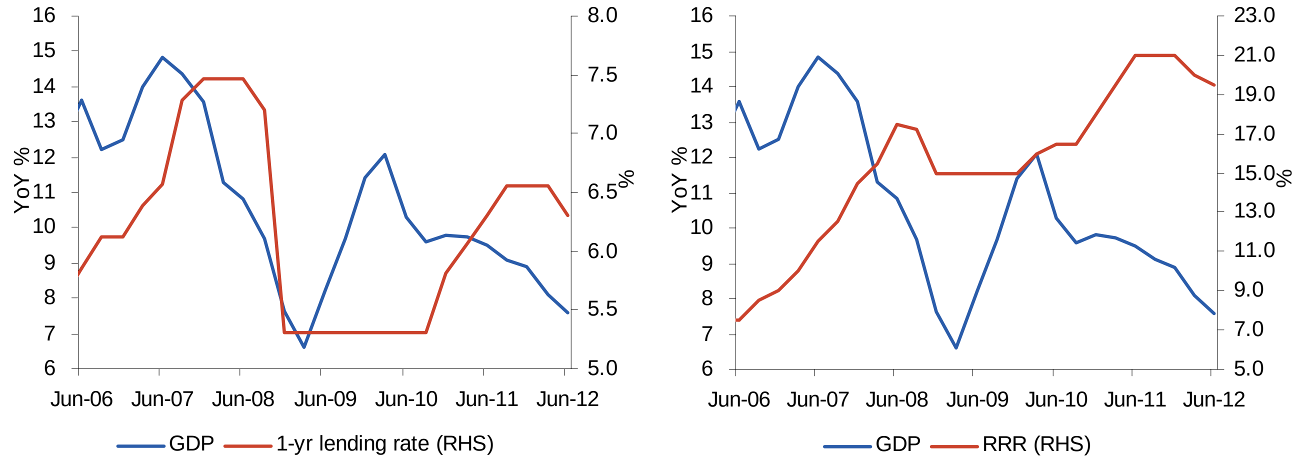
In summary, we believe that the central government's stimulus package for 2012 is in essence no different from the stimulus package of 2009. It is just that the scale of the stimulus is currently smaller as the downturn is not as bad as last time. Also, the government has become more cautious than last time, after they received criticism for the CNY4tn stimulus in 2009 as it was believe to have led to an asset price bubble and inflationary pressure.

Fig 1 Premier Wen said that the momentum for a recovery in growth isn't yet in place



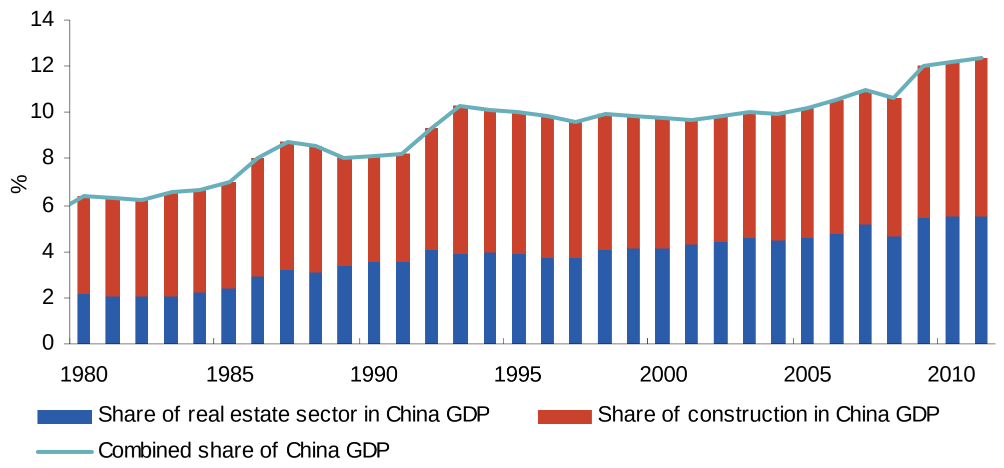
Source: CEIC, Mizuho research

Fig 2 Chinese macro policy was often behind the curve



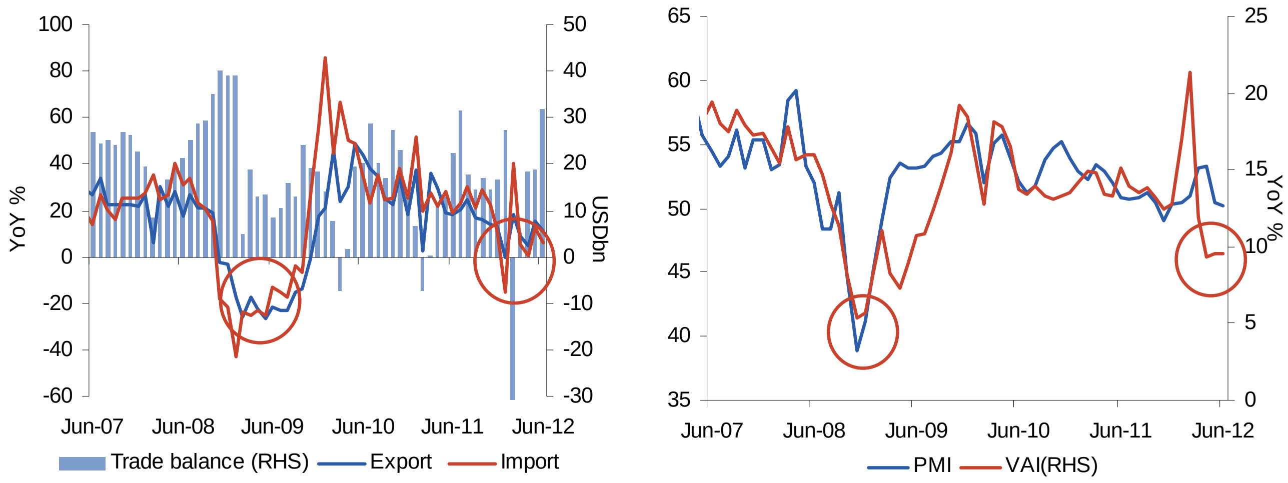
Source: CEIC, Mizuho research

Fig 3 Infrastructure and property investment are two pillars of China's economy



Source: CEIC, Mizuho research

Fig 4 Despite recent slowdown, the economy is still stronger than 2009



Source: CEIC, Mizuho research

Fig 5 Labour demand remains relatively firm compared to

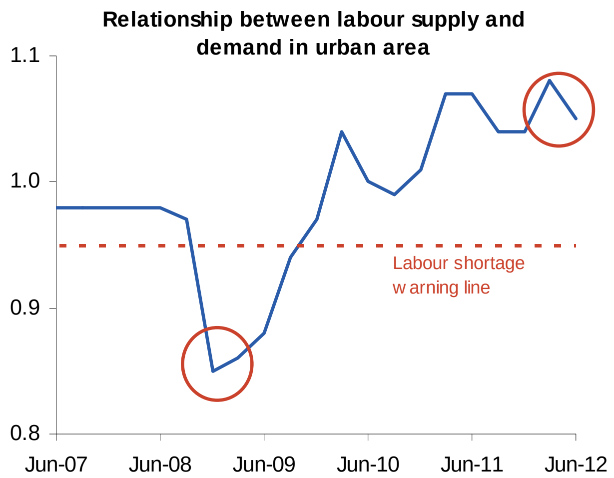
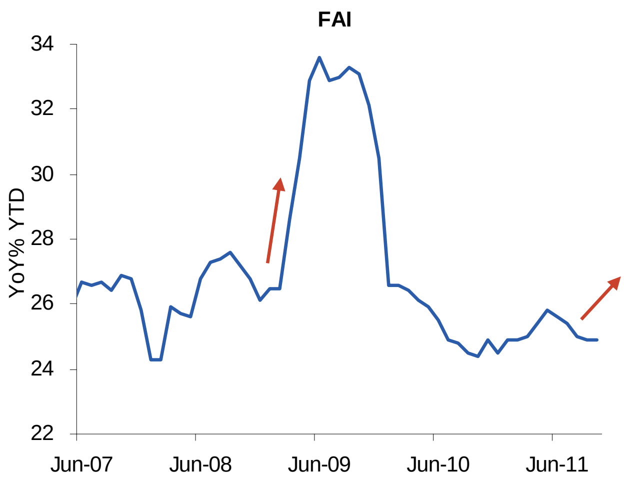


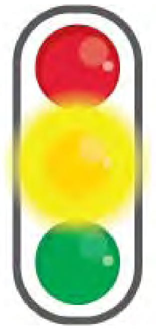
Fig 6 The government will again rely on investment to boost GDP



Source: CEIC, Mizuho research

13 July 2012

Is policy easing enough to reverse the downturn? Review of 2Q 2012 GDP data



- **China's economic growth moderated further in 2Q, to 7.6%. It is higher than our forecast, however, the headline GDP figure is inconsistent with the visible deceleration in imports, close to zero electricity output, negative industrial profits, and sluggish transportation volumes. Therefore, the 2Q GDP growth rate should not be seen as an indicator that the economy has avoided a hard landing.**
- **In response, the government has implemented aggressive policy easing, including two rate cuts in one month where the one-year borrowing cost could decline by a maximum of 170 bps. We believe further policy easing in infrastructure investment will likely boost the economy starting from 3Q.**
- **The constraints facing policymakers, such as excess capacity and the rebounding housing market, may limit the stimulus package as seen during 2009-10. However, it would be a positive to see China's GDP growth return to above 8% in 4Q.**

Fig 1 Key economic indicators

(YoY%)	May	June (Est.)	June (Actual)
GDP	8.1 (1Q)	7.2 (2Q)	7.6 (2Q)
CPI	3.0	2.3	2.2
PPI	-1.4	-1.5	-2.1
VAI	9.6	9.8	9.5
FAI (YTD)	20.1	20.0	20.4
Retail sales	13.8	14.0	13.7
Exports growth	15.3	9.0	11.3
Imports growth	12.7	12.0	6.3
Trade balance (USDbn)	18.7	20.1	31.7
New loans (CNYbn)	793	1000	919.8
M2	13.2	13.8	13.6

Source: CEIC, Mizuho research

Economic growth above expectations, inconsistent with fundamentals
China's GDP growth slowed to 7.6%YoY in 2Q from 8.1%YoY in 1Q, above our expectations. However, it is inconsistent with the visible deceleration in electricity consumption and industrial profit, as well as sluggish transportation volume. It could be partly explained by the slowdown in imports, which has helped to partly offset some of the negative impact from the slowdown in exports. Therefore, the better-than expected 2Q GDP growth reported should not be seen as an indicator that the economy is better than expected.

As we argued in our 2H China macro outlook "Aggressive policy easing to rescue the economy" (26 June), 2Q will likely be the bottom of the current downturn due to policy easing starting from May, and the economy will pick up in 2H. However, the constraints for the policymakers, such as excess capacity and the rebounding housing market, will prevent them from launching aggressive easing to bring a about a strong rebound. As such, we maintain our GDP forecast for 2012 at 8.1%YoY.

As expected, industry production decelerated
The value-added of industry (industrial production) also slowed slightly to 9.5%YoY in June. In particular, the production of textile, general equipment manufacturing, automobile manufacturing, and communication, computer and other electronic equipment decelerated in June.

Notably, electricity generation was flat from a year ago, the slowest pace since May 2009 for a non-lunar New Year month. It is in-line with the industries' declining profit: In May, realized profit for industry declined by 2.4%YoY YTD. Together, they point to a further slowdown in production in the months ahead.

Strangely, June investment went up
Meanwhile, fixed asset investment (FAI) edged up to 20.4%YoY in 1H. It was slightly higher than the 20.1%YoY growth in January-May. In real terms, investment rose 18.0% in 1H compared to 17.1%YoY in January-May.

By industries, investment on electricity, gas and water production and supply accelerated by 1.1ppt to 20.5%YoY, indicating that investment on government endorsed infrastructure projects is picking up momentum. By source of funding, investment that was funded by domestic loans increased by 5.8%YoY YTD, up from 4.8%YoY YTD in May. All in all, it shows that the first interest rate cut on 7 June was effective, as investors are more willing to seek financing from banks.

Again unexpectedly, June retail sales surged in real terms
Retail sales moderated to slightly to 13.7%YoY. Adjusting for price, real retail sales were up strongly, by 12.1%YoY in June, from 11.0%YoY in May. In particular, sales of household products, such as home electrical appliance and audio equipment, furniture, and construction and renovation materials, have increased notably, in-line with the rebound in property sales in June.

Fundamentally, China's consumption carries good potential and a dramatic decline is unlikely, due to: 1) robust income growth in recent years; 2) increasing propensity for consumers at the coastal area from a low historical level; and 3) it is further aided by favorable government policies, including subsidy on the consumption of energy-efficient household electronic appliances, automobiles, and power generators as well as further tax cuts.

Rebounding home sales coexist with declining property new starts
From the supply side, tightening in the housing market continues. Total property investment in June was up by 16.6%YoY YTD, slowing from 18.5%YoY YTD in May. New residential housing started declining by 10.7%YoY, while completion slowed to 20.7%YoY from 26.3%YoY.

New loans for property developers slowed to 8.1%YoY from 8.5%YoY, while funding for mortgage rebounded to 0.8%YoY from the 2.9%YoY decline in the previous month. As such, the land purchased by developers declined further by 19.9%YoY.

On the other hand, strong fundamental demand in the housing market triggered swift response after recent rate cuts, despite all the restrictions on property purchases. China's home sales transaction value rose 41%MoM in June, despite having an overall 6.5%YoY YTD decline in 1H.

Compared to the excess capacity and lacklustre demand in most other industries in China, the housing market came up with the fastest response to the recent rate cuts, against the intentions of policymakers (see "Aggressive policy easing to rescue the economy" 29 June). Now, the rebound in the housing market will limit the policy options available to government leaders, who also have to keep housing prices under control.

Broad-based decline of inflationary pressure
China's inflation moderated to 2.2%YoY in June, the lowest level in the past two years. This was mainly due to the notable decline in food prices, but overall the decline was broad-based. The cost for transportation and communications decreased by 0.4%YoY, after the NDRC cut the retail prices of gasoline and diesel on 8 June. The cost of residences (which at around 20% of total weighting makes it the second most important item in the CPI basket) also stayed at a two year low at 1.6%YoY in June. The inflation in healthcare, tobacco and liquor also moderated.

The reduction in domestic fuel prices also reflects a more broad-based commodity price easing due to the deteriorating global economic outlook. It is the backdrop against which China's PPI dropped a further 2.1%YoY in June, the fourth consecutive month of deflation. Given that it is unlikely that the global economy will significantly improve in the months ahead, we expect imported inflationary pressure to be weak for the rest of 2012 (see "Cooling inflation in 2H opens the door for more monetary policy easing" 9 July).

Slowing import growth reveals hard-landing risk
China's exports moderated to 11.3%YoY in June from 15.3%YoY in May, while imports further weakened to 6.3%YoY from 12.7%, leading to the largest trade surplus in three years, at USD31.7bn. As the decline in exports was offset by weaker import growth, the January-June trade balance was USD68.9bn, 56.4% higher than a year ago (see "Cooling inflation in 2H opens the door for more monetary policy easing" 9 July).

Strong credit data in June signals that policy easing may start to work
Meanwhile, China's new loans expanded by CNY919.8bn in June, while M2 money supply increased by 13.6%YoY. Total social financing in June also expanded by almost CNY8tn, which reflects that policy easing is starting to have an impact on the credit market, and is stimulating the economy through increased market liquidity.

Overall, it suggests that the credit demand for investment projects is returning, after the expedited project approval process in May. Also, FX reserves for June, at USD3.24tn, is slightly below the USD3.31tn recorded in March. It highlights that capital outflow is still an issue in 2Q and provides proof that further RRR cuts are necessary.

The lack of policy flexibility may dampen the rebound
Easing inflationary pressure has created more room for further monetary easing, but now policymakers have to be wary of the housing market rebound. We now expect, at maximum, one more interest rate cut but at least two RRR cuts in 2H.

In addition, the government's effort to stabilize the economy will continue to create investment-driven growth in 2H. On 8 July, Premier Wen Jiabao called for more aggressive efforts to preset and fine-tune economic policies to avert the downward pressure in the economy. In particular, he mentioned that reasonable growth in investment is now the key to stabilizing China's economic expansion. The government, in our view, will:

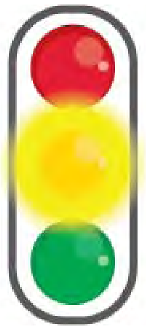
- **Speed up the approval process for investment projects.** It is already a work in progress. Subsequently, the medium- to long-term loan growth in May and June, which rebound to around 30% of total loan growth, also reflect that credit demand for infrastructure projects is on the rise;

- **Promote the participation of private sector in key industries.** The government is going to encourage private sector participation in sectors that are traditionally monopolized by the state. As pledged by Premier Wen Jiabao, details of the "New 36 Clause" have been released, covering wide range of industries such as railway, energy, communication, healthcare, and education.

- **Encourage bank lending to local government financing vehicles (LGFVs).** A new directive from the CBRC in late June urged banks to lend to infrastructure projects if there is sufficient cash flow to repay the loans. In our view, this is a confirmation that lending has been eased for LGFVs, a key engine for infrastructure spending.

6 July 2012

A second rate cut to kick start aggressive policy easing in 2H



- **The PBOC announced on 5 July a second interest rate cut in a month. It marks the government's efforts to ease monetary policy decisively in 2H 2012, in order to reinvigorate China's growth momentum. The announcement came in the week before the June economic indicators are released, which indicates to us that the June data will likely disappoint.**
- **PBOC also relaxed its restrictions on the lending rate floor to 70% of the benchmark from 80%, reflecting that interest rate liberalization is high on policymakers' agenda. The housing market, however, remains tightly controlled on the back of recent news that it is turning a corner. The government will thus have to focus on approving more infrastructure projects in the months ahead.**

The PBOC announced on 5 July a second interest rate cut in a month. Effective 6 July, the benchmark 1-year lending rate will be cut by 31bps to 6.0%, while the 1-year deposit rate will be cut by 25bps to 3.0%. The PBOC also announced that banks will be allowed to lend at 30% below the lending rate floor. The adjustment does not include interest rate for personal mortgages, which remains at 20% below the benchmark.

We expect one more interest rate cut in 2H. As we argued in our 2H China macro outlook "Aggressive policy easing to rescue the economy" (29 June), the government has entered a "catch-up" phase in 2H, with decisive policy easing to reinvigorate China's growth momentum. We expected two interest rate cuts in 2H. As such the announcement today is in-line with our expectations. Going forward, we expect there will be at least one more interest rate cut accompanied by two more RRR cuts in 2H.

Disappointing June data next week. The announcement came in less than a month after the last rate cut, before the June economic indicators are released next week. It indicates to us that the June data will likely disappoint, and suggests the rising risk of a hard-landing in China. As such, we reiterate our downbeat forecast for China's 2Q GDP at 7.2%YoY. Also, the rate cut indicates that inflationary pressure has likely eased to below our expectations at 2.3%YoY, thus confirming there is no more risk of negative real interest rates.

There is also further progress in interest rate liberalization. PBOC also relaxed its restrictions on the lending rate floor to 70% of the benchmark from 80%. The pace at which the PBOC relaxes the lending rate floor is beyond our expectations. Nevertheless, as we argued in the previous rate cut, the change will promote more efficient loan pricing and encourage more lending. It will also tests the adaptability of the current banking system to open competition, and pushes for greater interest rate liberalization (see" First rate cut since 2008 signals monetary easing and interest rate liberalisation" 8 June).

Restriction on housing market to remain tightly controlled. However, the lending rate floor for personal mortgages will not be affected, as the PBOC urges financial institutions to follow the existing restrictive policies on the housing market, and curb speculative demand. It is in line with our view that the biggest risk to policy easing in 2H is the housing market: There are emerging signs that the housing market is turning a corner, and the government thus has to extend the current restrictions. As the government aims to boost economic growth in 2H through increasing investment spending, it will have to focus on approving more infrastructure projects in the months ahead.

It could be part of a global effort. In addition, the interest rate cut could also be part of an orchestrated effort by central banks around the world to stabilize the slowing global economic growth. Yesterday, the Bank of England launched a third round of monetary stimulus by injecting GBP50bn through asset purchases. The European Central Bank (ECB) also announced that it has cut its main interest rate to a historic low of 0.75%.

This page is intentionally blank.

This page is intentionally blank.

This page is intentionally blank.

Recommendation History

Company name (ticker)	Date of recommendation	Recommendation	Relevant disclosure [1]

Note: NR = Not Rated. Source: MHSC Group

Important Disclosure Information

Note 1: Where "disclosure date" appears below, this means the day prior to the report date for securities listed on the Hong Kong Stock Exchange. For all other securities, it means the end of the month preceding the date of this report, unless that month end is within 10 calendar days of the report date in which case the disclosure date is the end of the preceding month. All share prices quoted are the closing price for the business day prior to the date of the report, unless otherwise stated.

As at the disclosure date, the following applies :-

Company Disclosures

Mizuho Securities Co., Ltd. and its affiliates (collectively, the "MHSC Group") have verified that there are no relevant disclosures for the securities mentioned in this report.

Distribution of rating of companies covered by Mizuho Securities Asia Ltd.

Rating matrix	Distribution of ratings*(%)	Investment banking relationship**(%)
BUY	36.0	4.0
NEUTRAL	23.0	0.0
UNDERPERFORM	41.0	0.0

Note *: Distribution of rating on all companies covered by Mizuho Securities Asia Ltd.
Note **: Percentage of companies within each rating category receiving investment banking services from Mizuho Securities Asia Ltd in the past 12 months.

Mizuho Securities Asia Limited Ratings for Fundamental Research

Mizuho Securities Asia Limited ratings are based on the following definitions.

Ratings and price objectives are based on returns expected over the next 6-12 months.

BUY	Stocks for which our price objective, as of the date it is set, exceeds the share price by 10% or more as of the date of the rating.
NEUTRAL	Stocks for which our price objective, as of the date it is set, is within 10% of the share price as of the date of the rating.
UNDERPERFORM	Stocks for which our price objective, as of the date it is set, is below the share price by 10% or more as of the date of the rating, and/or which are expected to be among the stocks that provide lower investment returns than stocks within their respective coverage groups that have "BUY" or "NEUTRAL" ratings.
RS	RATING SUSPENDED – rating and price objective temporarily suspended.
NR	No Rating – not covered, and therefore not assigned a rating.

Guidelines for ratings

Mizuho Securities Asia Limited is using an absolute performance rating system, based on capital returns of share prices compared to price objectives with an investment horizon of six-to-twelve months. Stocks are classified into coverage groups, with the proviso that "Underperform" ratings must apply to at least 10% of any coverage group equal to or greater than 10 companies. However this ratings dispersion may be varied from time to time if we believe that different ratings better reflect the prospective investment returns from a given coverage group.

Prior to 4 October 2011, Mizuho Securities Asia Limited had a Buy/Hold/Sell rating system with definitions that correspond with the Buy/Neutral/Underperform recommendations outlined above.

Investors should be aware that share prices are prone to volatility. An investor's decision should depend on individual circumstances and other considerations. Recommendations should not be the only factor in making an investment decision. Should you require additional information on the valuation methodologies used to derive the price objective(s), please contact the author(s) of this report.

THIS RESEARCH HAS BEEN PRODUCED BY MIZUHO SECURITIES ASIA LIMITED IN HONG KONG. IT HAS NOT BEEN PRODUCED IN THE UNITED STATES
For the purposes of disclosure under FINRA rules, our ratings correspond to "Buy", "Hold/Neutral", and "Sell", respectively.

Analyst Certification
Each research analyst listed on the cover page of this report certifies that the views expressed in this research report accurately reflect the analyst's personal views about the subject security(ies) and issuer(s) and that no part of his/her compensation was, is, or will be, directly or indirectly, related to any specific recommendation or view expressed in this research report.

As of the date of this report, the research analyst listed on the cover page of this report, or his/her associate(s), does not have any interest (including any direct or indirect ownership of securities, arrangement for financial accommodation or serving as an officer) in any company mentioned in this report, knows or has reason to know of any conflict of interest at the time of publication of this research report that could influence the research analyst's views in the report.

Disclaimer

This report has been prepared by Mizuho Securities Asia Limited ("MHSA"), a subsidiary of Mizuho Securities Co., Ltd. ("MHSC"), solely for the purpose of supplying information to the clients of MHSA and/or its affiliates to whom it is distributed. This report is not, and should not be construed as, a solicitation or offer to buy or sell any securities or related financial products.

This report has been prepared by MHSA solely from publicly available information. The information contained herein is believed to be reliable but has not been independently verified. MHSA makes no guarantee, representation or warranty, and MHSA, MHSC and/or their affiliates, directors, employees or agents accepts no responsibility or liability whatsoever, as to the accuracy, completeness or appropriateness of such information or for any loss or damage arising from the use or further communication of this report or any part. Information contained herein may not be current due to, among other things, changes in the financial markets or economic environment. Opinions reflected in this report are subject to change without notice.

This report does not constitute, and should not be used as a substitute for, tax, legal or investment advice. The report has been prepared without regard to the individual financial circumstances, needs or objectives of persons who receive it. The securities and investments related to the securities discussed in this report may not be suitable for all investors. Readers should independently evaluate particular investments and strategies, and seek the advice of a financial adviser before making any investment or entering into any transaction in relation to the securities mentioned in this report.

MHSA has no legal responsibility to any investor who directly or indirectly receives this material. Investment decisions are to be made by and remain as the sole role responsibility of the investor. Investment involves risks. The price of securities may go down as well as up, and under certain circumstances investors may sustain total loss of investment. Past performance should not be taken as an indication or guarantee of future performance. Unless otherwise attributed, forecasts of future performance represent analysts' estimates based on factors they consider relevant. Actual performance may vary. Consequently, no express or implied warranty can be made regarding future performance.

Any references in this report to Mizuho Financial Group ('MHFG'), MHSC and/or its affiliates are based only on publicly available information. The authors of this report are prohibited from using or even obtaining any insider information. As a subsidiary of MHFG and MHSC, MHSA does not, as a matter of corporate policy, cover MHFG or MHSC for investment recommendation purposes.

MHSA or other companies affiliated with MHFG or MHSC, together with their respective directors and officers, may have or take positions in the securities mentioned in this report, or derivatives of such securities or other securities issued by companies mentioned in this report, for their own account or the accounts of others, or enter into transactions contrary to any recommendations contained herein, and may also perform or seek to perform broking and other investment or securities related services for the companies whose securities are mentioned in this report as well as other parties generally. This report has been prepared in accordance with MHSA's internal conflict of interest management policies. Details of MHSA's organizational and administrative controls for the prevention and avoidance of conflicts of interest are available upon request.

Restrictions on Distribution

This report is not directed to, or intended for distribution to or use by, any person who is a citizen or resident of, or entity located in, any locality, territory, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to or restricted by law or regulation. Persons or entities into whose possession this report comes should inform themselves about and observe such restrictions.

United Kingdom/European Economic Area: This report is distributed or has been approved for issue and distribution in the UK by Mizuho International plc (MHI), Bracken House, One Friday Street, London EC4M 9JA, a member of the MHSC Group. MHI is authorized and regulated by the Financial Services Authority and is a member of the London Stock Exchange. For the avoidance of doubt this report is not intended for retail clients. This report may be distributed in other member states of the European Union.

United States: Mizuho Securities USA Inc., a member of the MHSC Group, 320 Park Avenue, New York, NY 10022, USA, contact number +1-212-209-9300, distributes or approves the distribution of this report in the United States and takes responsibility for it. Any transaction by a US investor resulting from the information contained in this report may be effected only through Mizuho Securities USA Inc. Interested US investors should contact their Mizuho Securities USA Inc. sales representative.

Japan: This report is distributed in Japan by Mizuho Securities Co., Ltd., Otemachi First Square Otemachi 1-chome, Chiyoda-ku, Tokyo 100-0004, Japan. Registered Financial Instruments Firm, No. 94 (Kinsho), issued by the Director, Kanto Local Finance Bureau. Member of Japan Securities Dealers Association, the Japan Securities Investment Advisers Association, Financial Futures Association of Japan, and the Type II Financial Instruments Firms Association.

Singapore: This report is distributed or has been approved for distribution in Singapore by Mizuho Securities (Singapore) Pte. Ltd. ("MHSS"), a member of the MHSC Group which is regulated by the Monetary Authority of Singapore. Any research report produced by a foreign Mizuho entity, analyst or affiliate is distributed in Singapore only to "Institutional Investors", "Expert Investors" or "Accredited Investors" as defined in the Securities and Futures Act, Chap. 289 of Singapore. Any matters arising from, or in connection with this material, should be brought to the attention of MHSS.

Hong Kong: This report is being distributed in Hong Kong by Mizuho Securities Asia Limited, a member of the MHSC Group, which is licensed and regulated by the Hong Kong Securities and Futures Commission.

Australia: This report is being distributed in Australia by MHSA, which is exempted from the requirement to hold an Australian financial services licence under the Corporation Act 2001 ("CA") in respect of the financial services provided to the recipients. MHSA is regulated by the Securities and Futures Commission under the laws of Hong Kong, which differ from Australian laws. Distribution of this report is intended only for recipients who are "wholesale clients" within the meaning of the CA.

If you do not wish to receive our reports in the future, please contact research@hk.mizuho-sc.com and kindly remark as "Unsubscribe" in the subject line.

www.mizuho-sc.com/hk
research@hk.mizuho-sc.com

FEATURED ANALYST

Jianguang Shen
Chief Economist
jianguang.shen@hk.mizuho-sc.com
+852 2685 2022

Thomas J. Monaco
Financial (non-banks) Research
thomas.monaco@hk.mizuho-sc.com
+852 2685 2181

James Antos
Banking Research
james.antos@hk.mizuho-sc.com
+852 2685 2287

Charles Park
Technology Research
charles.park@hk.mizuho-sc.com
+852 2685 2028

Peter Tang
Consumer Research
peter.tang@hk.mizuho-sc.com
+852 2685 2275

Zeno Tse
Gaming & Mid Cap Research
zeno.tse@hk.mizuho-sc.com
+852 2685 2220

Alan Jin, PhD, CFA
Property Research
alan.jin@hk.mizuho-sc.com
+852 2685 2018

Andrew Chan
Oil & Gas Research
andrew.chan@hk.mizuho-sc.com
+852 2685 2082

Marvin Lo
Telecoms Research
marvin.lo@hk.mizuho-sc.com
+852 2685 2029

Ole Hui
Autos & Industrials Research
ole.hui@hk.mizuho-sc.com
+852 2685 2036

Jeremy Yeo
Autos & Industrials Research
jeremy.yeo@hk.mizuho-sc.com
+852 2685 2083

Kelvin Ng
Metals & Mining Research
kelvin.ng@hk.mizuho-sc.com
+852 2685 2035

HONG KONG	**Mizuho Securities Asia Ltd.**	12th Floor, Chater House, 8 Connaught Road, Central, Hong Kong Tel: (852) 2685-2000 Fax: (852) 2685-2400
TOKYO	**Mizuho Securities Co., Ltd.**	Otemachi First Square, 1-5-1, Otemachi, Chiyoda-ku, Tokyo 100-0004, Japan Tel: (81 3) 5208-3210 Fax: (81 3) 3516-7228
LONDON	**Mizuho International Plc.**	Bracken House, One Friday Street, London, EC4M 9JA, United Kingdom Tel: (44 20) 7236-1090 Fax: (44 20) 7329-6136
NEW YORK	**Mizuho Securities USA Inc.**	320 Park Avenue, New York, NY 10022, USA Tel: 1 (212) 209-9300 Fax: 1 (212) 209-9470
SINGAPORE	**Mizuho Securities (Singapore) Pte. Ltd.**	One Raffles Quay, North Tower Unit 32-02, Singapore 048583 Tel: (65) 6603-5688 Fax: (65) 6225-6431