



# Economic Observatory

3 November 2008

Li-Gang Liu

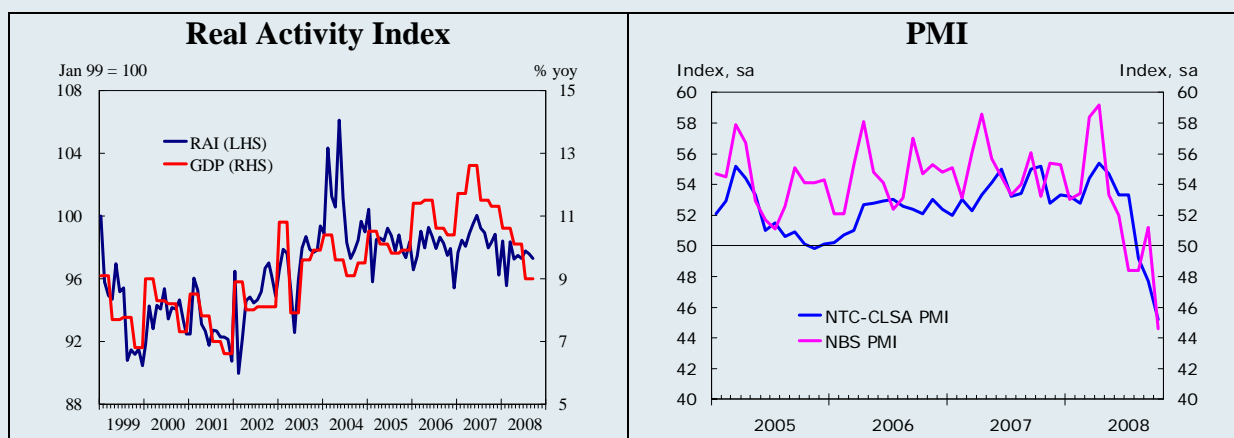
[lliu@bbva.com.hk](mailto:lliu@bbva.com.hk)

Andrew Tsang

[andrew.tsang@bbva.com.hk](mailto:andrew.tsang@bbva.com.hk)

## Highlights of the month: Economic Activities Slowed Further

China's GDP growth slowed to 9.0% in Q3, which is a fall of 1.1 percentage points from that in Q2. This marks the first time that China's quarterly GDP growth has fallen below 10 percent since the end of 2005, fuelling expectations of a faster economic deceleration in Q4 and 2009. Indeed, our real activity index shows that economic momentum has been quite volatile so far and is likely to continue its downward trend in Q4. Meanwhile, China's manufacturing PMIs in October also showed signs of much weaker economic activities. The PMIs, produced by the National Statistical Bureau (NBS) and the CLSA, both fell below 50, indicating a contraction in the manufacturing sector. It appears that financial conditions of firms have started to deteriorate as well. The recent data show that the profits of all state-owned enterprises (SOE) fell by 2.9% yoy in the first nine months in 2008 from 1.3% in the first eight months, indicating the profitability of SOEs, particularly those large ones, has worsened.

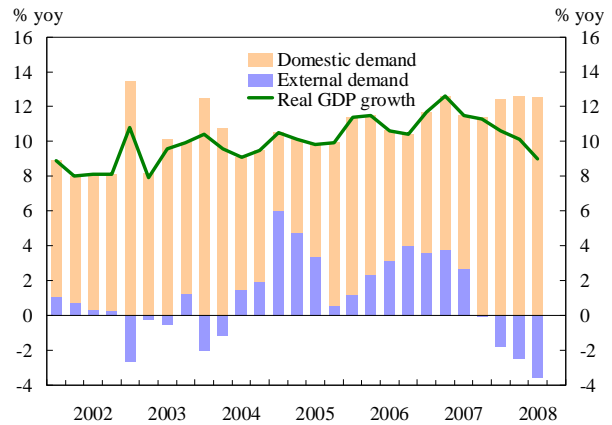


Sources: CEIC and BBVA staff estimates.

**I. Real Economic Activities**

**(a) GDP by component**

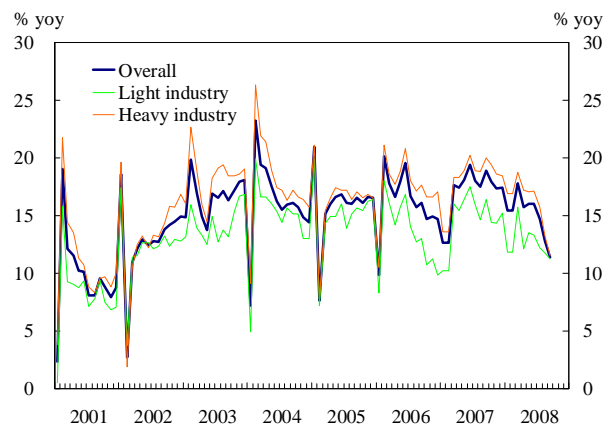
The deceleration in growth was mainly led by contracting net exports, while domestic demand was relatively robust.



Sources: CEIC and BBVA estimates.

**(b) Industrial production**

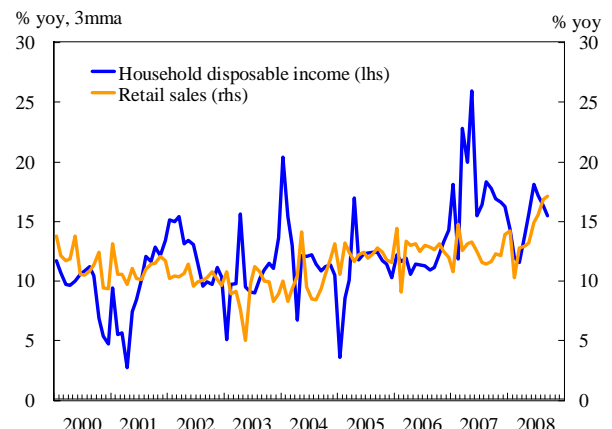
Growth in industrial production slowed further to 11.4% in September from 12.8% in August, largely reflecting a slowdown in export growth and possibly the Beijing Olympic Games in August and September.



Sources: CEIC and BBVA estimates.

**(c) Household income and real retail sales**

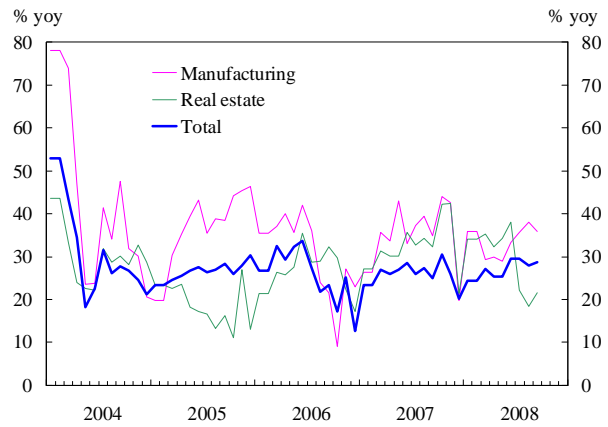
Household disposable income in nominal terms grew slower, after the rebound in growth in Q2. Nevertheless, growth in real urban income stood at around 9.5% in Q3, which is same as that in Q2. Growth in real retail sales continued to register a further pick-up of 17.0% in September from 16.8% in August.



Sources: CEIC and BBVA estimates.

**(d) Fixed Asset Investments**

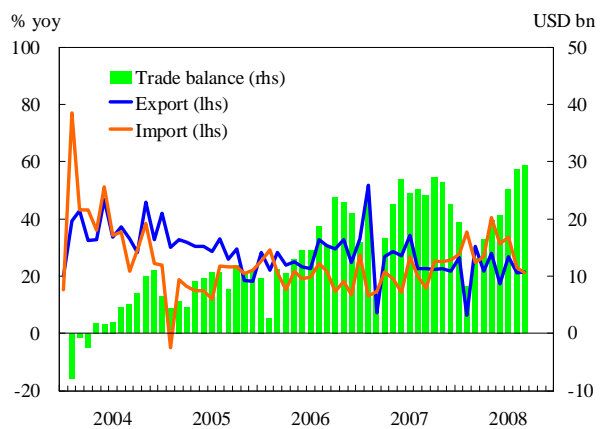
Growth in nominal fixed asset investment (FAI) grew further to 28.7% yoy in September from 28.0% in August, while real growth in FAI picked up to 18.3% from 16.4% in August. Growth in manufacturing investment remained robust but growth in real estate investment fell to 21.6% yoy, from the peak 37.9% in June 2008. It rebounded compared to a growth of 18.3% in August.



Sources: CEIC and BBVA estimates.

**(e) External Trade**

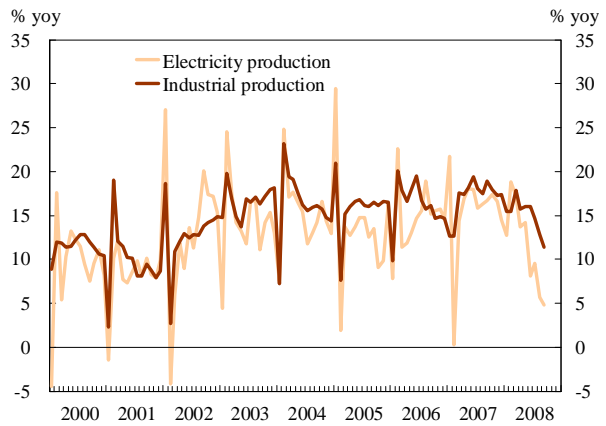
Export growth picked up slightly to 21.5% yoy in September from 21.1% in August, while import growth moderated further to 21.3% yoy. Trade surplus remained large, increasing by US\$ 29.4 billion. Trade surplus remained substantial at US\$ 181 billion in the first three quarters of 2008, about US\$ 4.7 billion below that in the same period in 2007.



Sources: CEIC and BBVA estimates.

**(f) Industrial production and electricity**

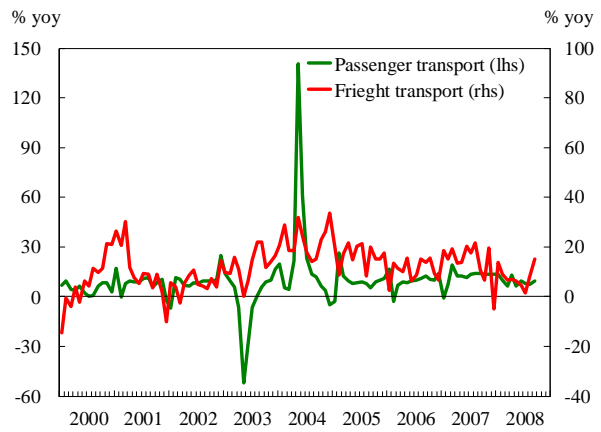
Growth in electricity production continued to contract sharply in September. The sharp decline in electricity production growth in this year is mostly reflected by a slowing growth in industrial activities.



Source: CEIC and BBVA estimates.

**(g) Transportation**

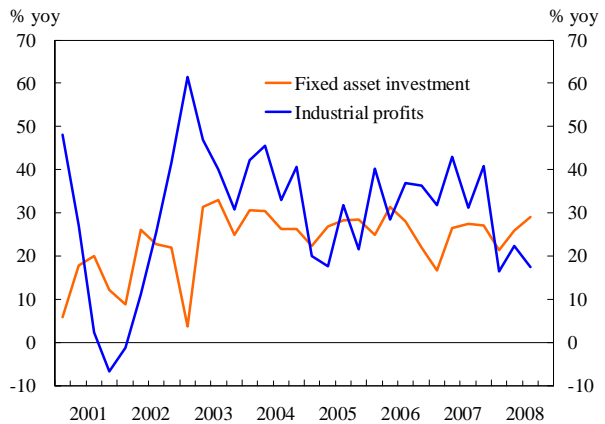
Growth in passenger transport picked up slightly after the Olympic Games in August and first half of September. In addition, growth in freight transport increased sharply in August and September after falling to close to zero percent in July.



Source: CEIC.

**(h) General industry profitability**

Growth in industrial profits fell again in 2008 Q3, after rebounding in Q2. The decline in profit growth is expected to continue as global slowdown intensifies.

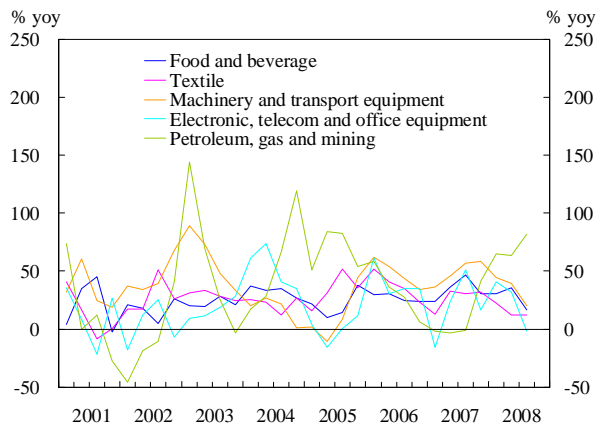


Source: CEIC.

Note: 2008Q3 figures of industrial profits are up to August 2008.

**(i) Profitability by industry**

Energy sector continued to experience the fastest growth in profits, while profit growth slowed sharply for electronic, telecom, and the office equipment industry.



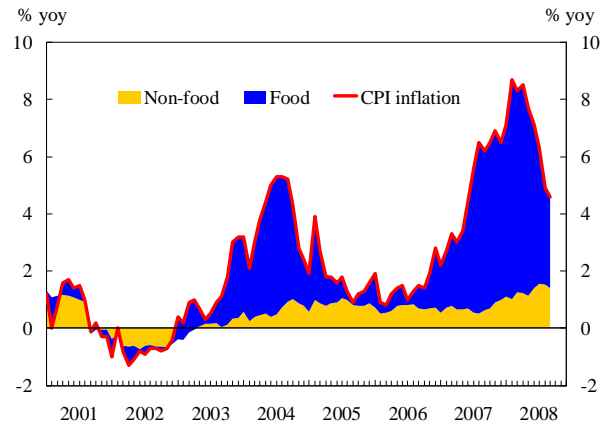
Source: CEIC.

Note: 2008Q3 figures of industrial profits are up to August 2008.

**II. Price Developments**

**(a) Consumer price inflation**

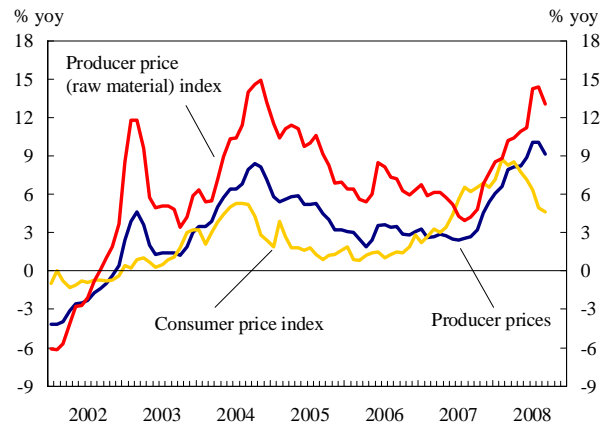
China's CPI inflation fell further to 4.6% yoy in September from 4.9% in August, the slowest increase in the recent 15 months. The fall in CPI was mainly driven by falling food prices while imported inflation from international energy and commodity prices has started to ease.



Sources: CEIC and BBVA estimates.

**(b) Producer prices**

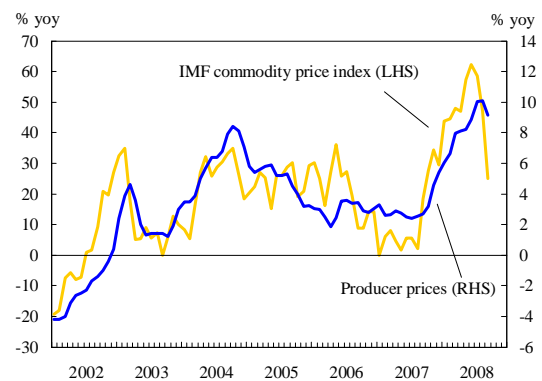
PPI inflation remained elevated, but started to ease to 9.1% yoy in September from the 12-year high of 10.1% in August. The inflationary pressure from this segment is expected to ease because of slowing pass-through from PPI inflation to prices in non-food component of the CPI basket.



Sources: CEIC and BBVA estimates.

**(c) Commodity prices and PPI**

China's PPI inflation is highly correlated to price changes in international commodity prices. While the global commodity prices have fallen sharply in recent months, China's PPI inflation will follow, but with a lag.

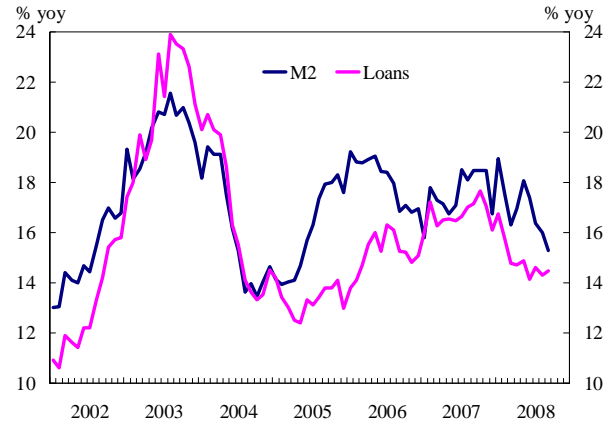


Sources: IMF, CEIC and BBVA estimates.

**III. Monetary Conditions**

**(a) Money supply and credit**

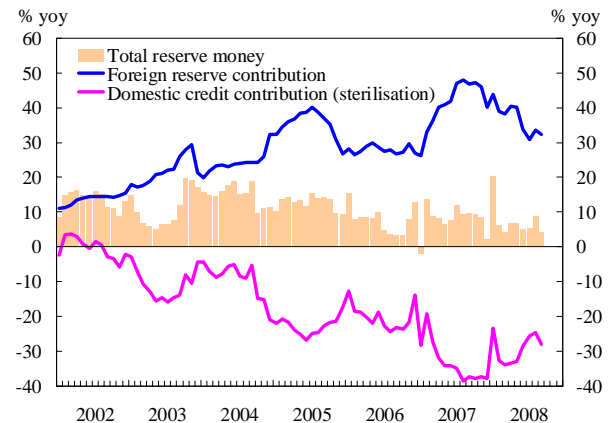
Growth in broad money (M2) fell considerably to 15.3% yoy in September from 16% in August. Meanwhile, growth in domestic credit picked up slightly to 14.5% from 14.3% in August.



Sources: CEIC and BBVA estimates.

**(c) Reserve money**

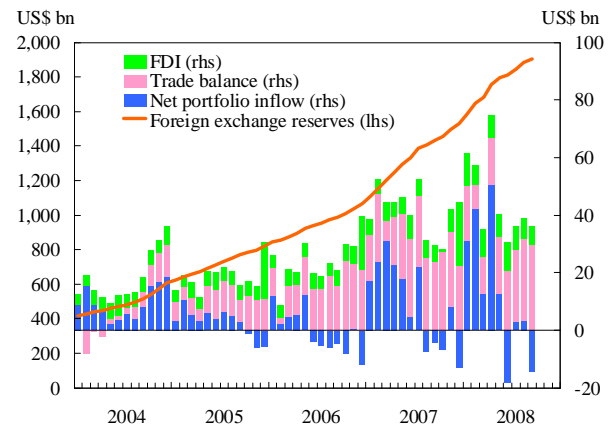
Reserve money growth has fallen sharply after February due to increased sterilization measures by the monetary authorities. However, the cut in interest rates and reserve requirement ratio signaled that monetary policy has started to ease.



Sources: CEIC and BBVA estimates.

**(d) External capital inflows**

China's FX reserves continued to increase, rising by US\$97 billion in Q3 alone on large trade surplus and FDI inflows. Though still large, the pace of reserve accumulation has slowed, relative to an increase of US\$ 154 and 127 billion in Q1 and Q2, respectively. Portfolio investment experienced another large outflow in September. By the end of September 2008, China's FX reserves stood at US\$1.906 trillion.

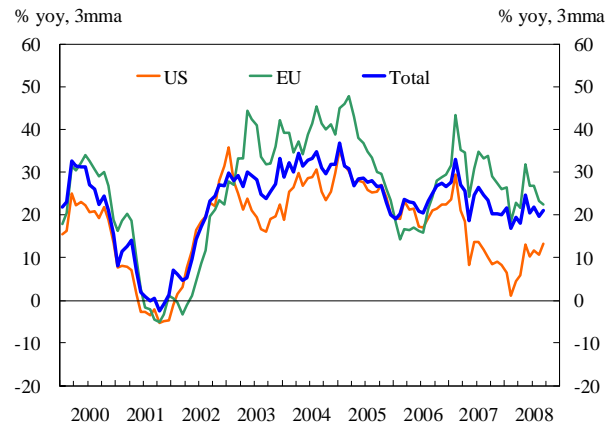


Sources: CEIC and BBVA estimates.

**IV. External Trade**

**(a) Exports by region**

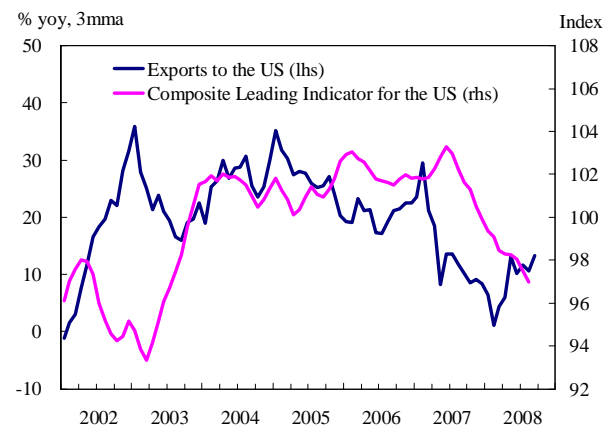
Export growth picked up moderately in September, on 3-month moving average basis. Growth in exports to the EU continued to fall in September, while that to the US increased slightly.



Source: CEIC.

**(b) Exports to US**

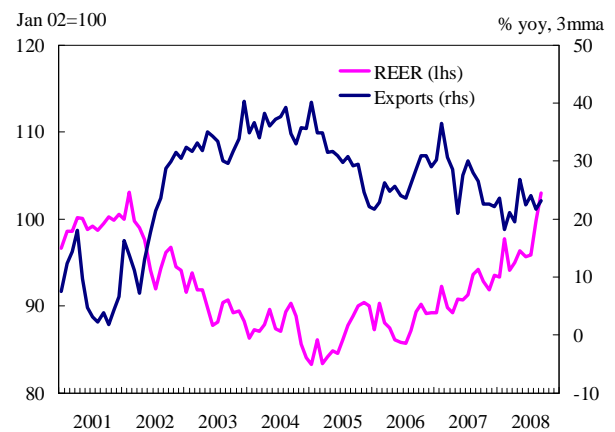
In line with the economic outlook of the US--shown by the leading indicator for the US, the export growth to US was on the declining trend since 2007.



Source: OECD, CEIC and BBVA estimates.

**(c) Real exchange rate and exports**

REER appreciation continued to exert a negative impact on China's export growth since the end of 2007. Combined with slowing external demand, China's export growth should continue to decline in the rest of 2008.

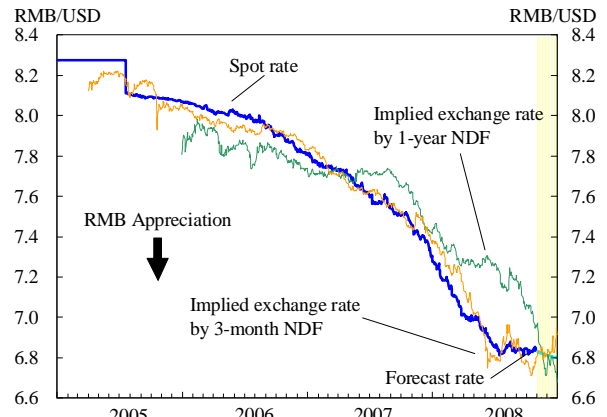


Sources: CEIC and BBVA estimates.

**V. Exchange Rate**

**(a) Spot and expected appreciation of renminbi**

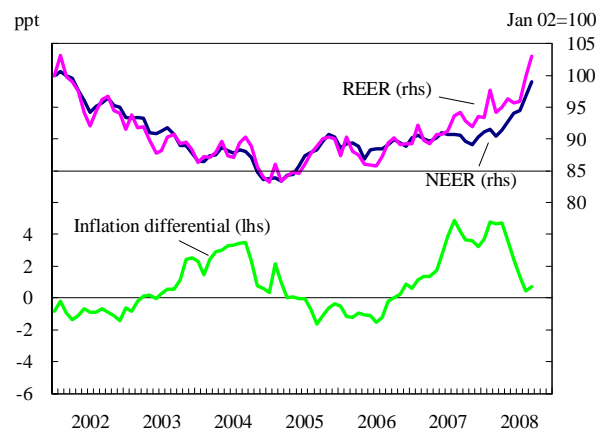
Renminbi stabilized at around the RMB/USD 6.8 level. A sharp rebound of US dollar recently may explain the stabilization of the RMB started in July. Our forecasts suggest that the renminbi exchange rate will appreciate to around 6.8 per one US dollar by the end of 2008.



Sources: CEIC and BBVA estimates.

**(b) REER, NEER, and inflation differential with trading partners**

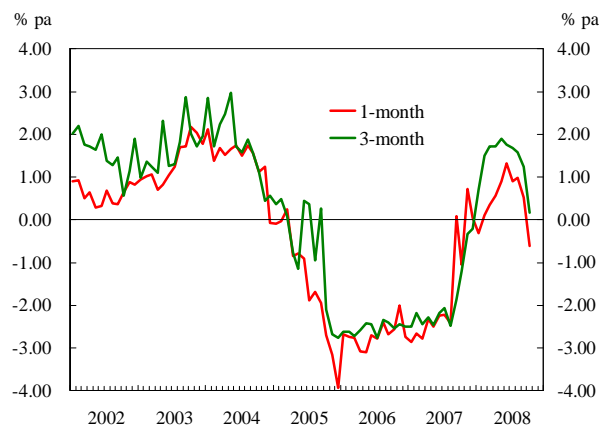
China's REER and NEER of the renminbi continued to appreciate reflecting large depreciation in some key trading partners' currencies and China's relatively low inflation rate to its key trading partners.



Sources: BIS, CEIC, Datastream and BBVA estimates.

**(c) Interest rate differentials (spreads of Chibor over Libor)**

The interest rate differentials between 3-month Chibor and Libor contracted sharply to zero from around 150 bps in August, reflecting the surges in LIBOR due to the global financial turbulence.



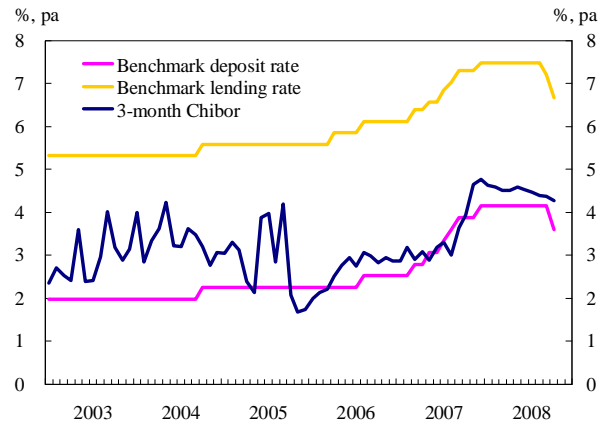
Sources: CEIC and BBVA estimates.



**VI. Financial Markets**

**(a) Benchmark interest rates and Chibor**

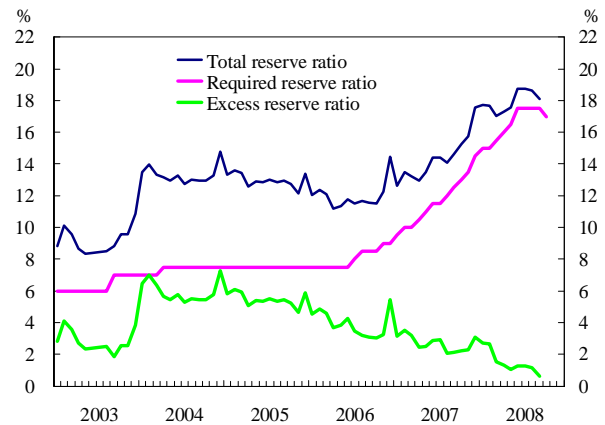
To ease external slowdown, PBoC lowered the benchmark (one-year) lending rate twice by 54 bps to 6.66% in October, while the deposit rate was also cut by 54 bps to 3.60%. Meanwhile, the 3-month Chibor, continued to fall, but still higher than the benchmark deposit rate.



Sources: People Bank of China and CEIC.

**(b) RRR & Excess reserves**

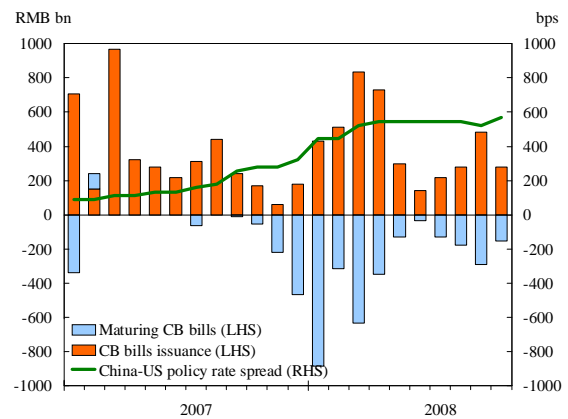
To inject liquidity to the banking system, PBoC also cut the reserve requirement ratio (RRR) for all banks by 0.5 percentage point effective on October 15. The required reserve ratio (RRR) for small- and medium-sized financial institutions is 16.0%, and 17.0% for the six largest banks (the Big Four (ABC, BOC, CCB, and ICBC), Bank of Communications, and Postal Savings Bank of China).



Sources: CEIC and BBVA estimates.

**(c) Open market operations**

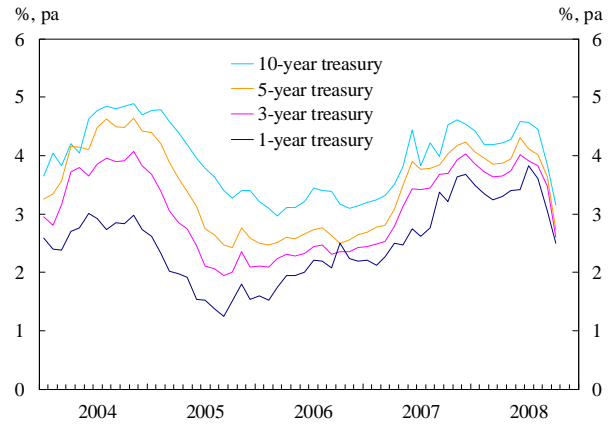
PBoC's open market operations reduced sharply since Q2 as net capital inflows eased. The costs of sterilization, measured as the spread of Chinese policy rate over US fed fund target rate, remained high after 2007 H2.



Source: CEIC.

**(d) Treasury yields**

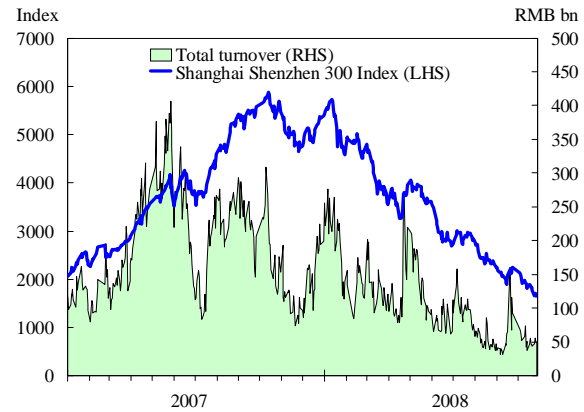
Treasury yields across different maturities decreased slightly in recent months, reflecting the falling inflation rate in recent months.



Source: CEIC.

**(e) Stock Market Performance**

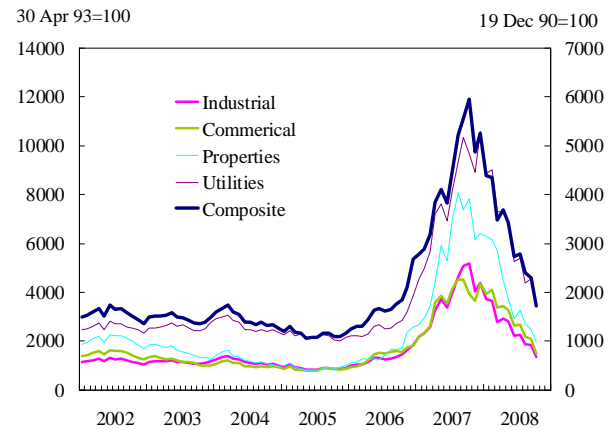
China's stock prices fell by close to 70% year to date from the peak in last October. The decline in stock prices was particularly large since September, led by global market falls. Meanwhile, trading value also fell to about one-eighth of the turnover at the peak level.



Source: CEIC.

**(f) Shanghai Stock Exchange Index**

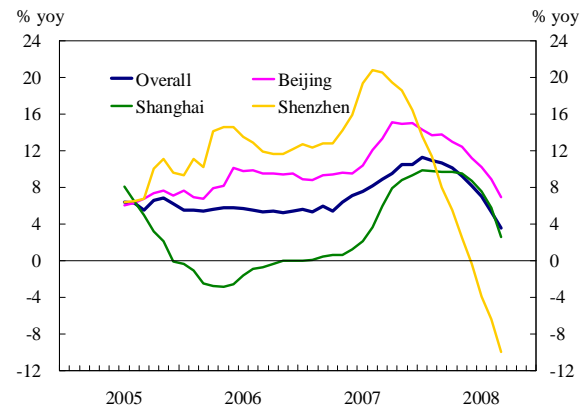
Stock prices fell across board. Compared with the peak in October 2007, various indices in Shanghai Stock Exchange Index have fallen by over 70%.



Source: CEIC.

**(g) Property market**

Growth in real estate prices has experienced a fall nationwide since 2007 Q3. It turned negative sharply in Shenzhen since June. Tight monetary policy since the end of 2007 has contributed to the slowdown in price rises in the real estate market nationwide.



Source: CEIC.