ASIA PERSPECTIVE

Asia Perspective Economic Update Report

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Consistent but Moderate Growth

China's economy is still on track with the government's economic target of 6.5-6.7% growth in 2016 and an annual growth rate of 6.5% for the subsequent four years. The growth rate reached 6.7% during the second quarter of 2016, according to the National Statistics Bureau (NBS). The rate is thus also equivalent to the one obtained during the first quarter, and slightly ahead of the 6.6 % that economists expected according to a poll done by Reuters.

The industrial sector, which is suffering from overcapacity, grew by 6.2% year on year, accelerating by 0.3% from Q1. The service sector was, however, still the main growth driver with an expansion of 7.5% year on year, despite a this being a deceleration by 0.1% from Q1. A quarterly survey done by one of the leading data analytics firms focusing on the Chinese economy, China Beige Book International (CBB), also showed better hiring figures and a strong rebound in the service sector.

These reports are in line with the long-term goal of rebalancing the economy. The service sector now account for 56, 9% of the GDP while the secondary sector has declined to only 37.5%. A large share of the service sector output, however, came from just two sectors: financial services and logistics and transportation, casting doubts whether the service sector is actually as flourishing as one could assume at a first glance.

Optimistic numbers are also reported in nominal retail sales. These grew by 10.6% year on year, increasing from 10.1% in April and 10.0% in May. The inflation also remained stable, although somewhat below market expectations in the second quarter, at around 2.4% in April, and 2.0% in May. Despite the Chinese yuan weakening by 3% in the second quarter, a new second-worst 3 month run to this date, Investors have reacted with moderation.

Brexit in the Middle Kingdom

UK's decision to leave the European Union will not leave the Chinese economy unaffected, even though the direct effects are expected to be small. The bilateral trade flows between the UK and China only account for around 2% of China's total external trade, but Brexit is likely to have a negative impact on the demand in the EU, which is Chinas largest export market. This means that China's struggling export sector might not be receiving a demand boost any time soon.

Chinese companies have in recent years invested greatly in the UK and the stock of Chinese direct investments in the UK have been around US 13 billion, according to latest data by the Ministry of Commerce in China. The future of certain planned projects between China and the UK that are currently under discussion, such as the Hinkley Point nuclear power, high-speed railways and certain financial services might be affected. Chinese banks will also certainly have a more careful approach towards investments in the UK as the direct access to the European market through the country is at risk.

The most direct financial consequences of Brexit on China will, however, most likely be seen on the currency markets. Economists are expecting investors to place their money in "safe" currencies such as the US dollar, thus depreciating emerging-market currencies such as the Chinese Yuan.

The Chinese stock market, on the other hand, might not be affected by Brexit in the same way that other global markets are. The stock market in China is still relatively heavy regulated and not fully open for global investors, thus making capital flight a less likely outcome if and when the yuan depreciates as a consequence of Brexit. As stock markets around the world plummeted in the aftermath of the Brexit referendum, Shanghai Composite Index dropped by only a moderate 1.3 percent following the vote. The market was also fast to recover.

According to Xiang Songzuo, deputy director of the International Monetary Institute at Renmin University of China, Brexit will only result in short term psychological effects and not have any long-term consequences for China. In line with this reasoning, many economists argue that China is not as heavily dependent on its exports as before, and will therefore not be significantly hurt by neither the indirect or direct effects of the Brexit. China's GDP growth has in fact continued despite various turmoil in the world, and domestic consumption is now the main source of demand, delivering over 4% of the total GDP. However, other economists are not as positive, and are concerned that Brexit could impose long-term negative effects on China's exports, increasing its spare production capacity, causing capital flight and hampering foreign direct investment. Time will tell who was right.

Shifting Gears - From Black to Green

The Chinese government is pushing green development, paving the way for energy-saving technologies and trying to reduce the number of carbon- emitting vehicles as well as the use of inefficient energies. This development is revolutionizing the Chinese electric vehicles industry, and it is considered to be one of the key industries that China will be fostering for the next five years. Under the 13th 5-year plan, the Chinese government has plans to increase both the production and sales of new-energy vehicles, setting a target of 5 million sold vehicles by 2021.

In 2015, China produced and sold over 300 000 new-energy vehicles (NEV), amounting to a 300 % annual increase compared to the previous year. Within the same industry, electric battery vehicles saw an astonishing increase in sales by 400% compared to the previous year, along with plug-in hybrid electric vehicles, that saw an increase by 200%. With the surge in NEV sales in 2015, China has now become the largest electric vehicle market in the world. The sales of NEV has continued at the same pace during 2016 as well, and over 26 000 units were sold in China in May alone.

To encourage consumers to buy new-energy vehicles the government has adopted a number of subsidies for consumers.

This green-car development goes hand in hand with the target of reducing carbon emissions by 18 % in the next five years as well as to increase the supply of wind, solar, and biomass energy production. However, it is not only within the automobile industry that the Chinese government is pushing green products. In January 2016, China became the first country in the world to issue official rules on issuing "green bonds", i.e. bonds that are dedicated to finance sustainable solutions. Furthermore, China can also boast with the highest number of fast-growing clean technology companies in the Asia-Pacific region. Hopefully, this development will bring China a successful economic sector as well as cleaner air.

Government Backed Growth

Despite China's attempts to avoid excessive reliance on investments to drive economic growth, policymakers have in recent months turned back to state-led investments in order to stimulate the economy. Several local governments have declared aggressive spending targets on infrastructural projects to boost investment, and earlier this month the People's Bank of China granted $25 billion in subsidized loans to China Development Bank, the state-owned policy lender. The money is earmarked to finance redevelopment projects in underdeveloped areas. The governments attempt to stimulate economic activity has been aimed at stopping the deceleration of investment, as property developers pull back on construction due to unsold flats and as factories slow expansion in the face of falling sales.

Data from June shows that the Chinese government's stimulus efforts are having an impact on investments. Fixed-asset investment growth, including both infrastructure and manufacturing investments, stabilized at 11.4% year on year, unchanged from May. This marks as an important shift as growth have been slowing for nine out of the last ten months.

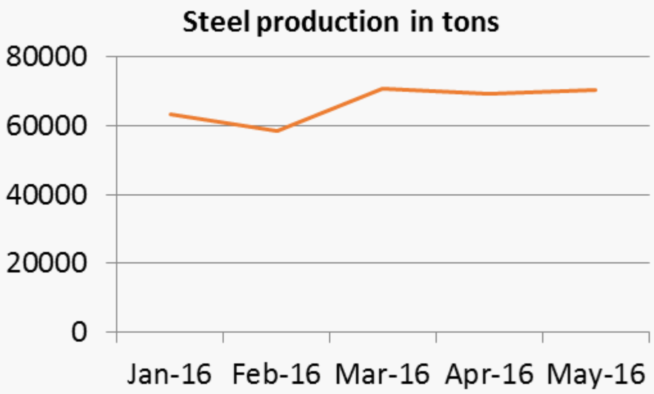
Despite continuous decline in real estate investment during the second quarter, property sales rose by 16% in terms of floor-area in June. This marks the fastest monthly growth since the end of 2013, and it is the strongest evidence yet that the property market is recovering after falling for 13 months straight.

According to Du Jinsong, property analyst at UBS, property investments are, however, likely to remain low as the market still has to adjust to the amount of unsold apartments.

Although the economic growth is set to meet its annual target, economists are expecting further stimulus this year to sustain the development. The 11.4% rate of fixed-asset investment in the first half of 2016 is still far below the government's full-year target of 15%. Its however important to remember that the Chinese government is likely to remain cautious with its stimulus attempts as to avoid the financial risks of increasing debt.

Recovering Industrial Sector

Despite the somewhat unsteady second quarter, with both expansions and contractions in the secondary sector, the Purchasing Managers' Index (PMI) has stayed just above the 50-threshold that separates contraction from expansion. The Purchasing Managers' Index (PMI) decreased from March's nine-month high of 50.2 to 50.1 in both April and May according to the National Bureau of Statistics.



Industrial production expanded around 6.0% year-on-year in April and May, albeit declining from the high number in March. In addition to this, the industrial sector saw a 3.7 % growth in profits during the first quarter of the year, which continued in the second quarter. The increase in profits has been seen as an indication of the government's focus on supply-side reforms by removing excess capacity in the inefficient coal and steel sectors. The central government has granted 27.64 billion Yuan to help local governments pay for capacity closures in 2016, amidst plans to cut steel capacity by 45 million tons and coal by 280 million tons.

China's steel exports rose 6.4 percent to 46.28 million tons in the first five months of the year, according to Chinese data. The Chinese steel exports may however soon take a heavy blow from regulators worldwide. In mid-July The U.S. International Trade Commission (ITC) ruled that imports of both Chinese cold-rolled and corrosion-resistant steel products were hurting local producers, thus paving the way for hefty anti-dumping duties. The EU is also stepping up their efforts to stop the Chinese from causing a global glut on steel, and European policymakers are threatening to impose import duties on Chinese steel products.

ASIA PERSPECTIVE

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Asia Perspective is an Independent Management Consultancy with global presence and local knowledge. We assist our clients with business advisory regarding Analysis, Strategy and Implementation. Our mission is to turn our clients' Asia business vision into reality and add significant value to your business.

We offer specialist services covering Supply Chain Management, Purchasing, Market Entry, and Financial Advisory. This includes market entry research and strategy sourcing and pricing strategy, M&A advisory, risk management, operational improvements etc.

What differentiates us from our competitors is the knowledge and expertise we have gained after several years in the Asian market. We have experience from a variety of industries and clients including leading international companies from Europe, the US and Asia.

With a highly collaborative team of problem solvers and a passion for excellence we will add value to your business. We work closely with our clients to create and deliver insight, advantage and real impact.

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