

# China Trade Quarterly

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## Domestic Trade

Retail sales of consumer goods grow by 9.4% yoy in 1H18.

Both rural and urban households see high single-digit growth in income in 1H18.

Growth in nominal fixed asset investment falls to 6.0% yoy in 1H18.

China to amend Individual Income Tax Law.

Entrepreneur Confidence Index for secondary industry drops in 2Q18.

Growth of manufacturing sector moderates.

July NMI indicates deceleration in growth of non-manufacturing sector.

## Foreign Trade

Both exports and imports record double-digit growth in July.

Exports to US manage to grow at a faster pace in 1H18.

Exports from Guangdong, Shanghai and Shandong show relatively slow growth in 1H18.

FDI increases slightly by 1.1% yoy in 1H18.

Foreign exchange reserves post first quarter-on-quarter drop in five quarters.

China-US trade war breaks out.

Chinese yuan depreciates against US dollar and Euro.

China lowers import tariff rates on a wide range of consumer products.

# In This Issue:

## Part 1: Domestic Trade

<b>A</b>	<b>Recent developments</b>	4
<b>B</b>	<b>Highlights</b>	14
<b>C</b>	<b>Outlook</b>	18

## Part 2: Foreign Trade

<b>A</b>	<b>Recent developments</b>	22
<b>B</b>	<b>Highlights</b>	30
<b>C</b>	<b>Outlook</b>	32

2

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# Executive Summary

## Domestic Trade

Retail sales of consumer goods reached 18,001.8 billion yuan in 1H18, up by 9.4% yoy. Online retail sales of goods, which accounted for 17.4% of total retail sales, increased markedly by 29.8% yoy over the period.

Both rural and urban households saw high single-digit growth in income in 1H18. The per capita disposable income of rural households grew nominally by 8.8% yoy to reach 7,142 yuan; while the per capita disposable income of urban households rose by 7.9% yoy in nominal terms to reach 19,770 yuan in 1H18.

Growth in nominal fixed asset investment fell to 6.0% yoy in 1H18 from 7.2% yoy in 2017, attributable to the FAI growth deceleration in infrastructure (excluding power, heat, gas and water infrastructure).

On 29 June, the Standing Committee of the National People's Congress released the 'Draft Amendments to the Individual Income Tax Law' to seek public opinions until 28 July. The draft proposes to set the minimum threshold for individual income tax at 60,000 yuan per year (or 5,000 yuan per month), up from the current minimum threshold for individual income tax of 3,500 yuan per month. Besides, the tax brackets of the three lowest grades — 3%, 10% and 20% — would be widened. The tax-deductible items would also cover expenses on children's education, continuing education, medical treatment for serious illnesses, housing mortgage interest and housing rent.

Entrepreneur Confidence Index for the secondary industry dropped to 130.3 in 2Q18 from 132.9 in 1Q18, indicating that Chinese entrepreneurs have become less optimistic recently.

Growth of the manufacturing sector has moderated recently. PMI dropped from its recent peak of 51.9 in May to 51.5 in June, and further to 51.2 in July.

July NMI indicates that the non-manufacturing sector has expanded at a slower pace. NMI dropped to 54.0 in July, after rising slightly from 54.9 in May to a five-month high of 55.0 in June.

## Foreign Trade

Both exports and imports recorded double-digit growth in July. Exports grew by 12.2% yoy, while imports soared by 27.3% yoy in the month.

Exports to the US managed to grow at a faster pace in 1H18. Growth of exports to the US was 13.6% yoy in 1H18, compared to 11.5% yoy in 2017.

Exports from Guangdong, Shanghai and Shandong showed relatively slow growth in 1H18. Exports from Guangdong, Shanghai and Shandong expanded by 5.6% yoy, 7.7% yoy and 11.3% yoy, respectively, lower than the country's total export growth (12.8% yoy) during the period.

FDI increased slightly by 1.1% yoy to 446.3 billion yuan in 1H18. FDI in the Hi-Tech industries grew by 1.6% yoy to 93.3 billion yuan, accounting for 20.9% of the total FDI in the quarter.

Foreign exchange reserves decreased by US\$ 30.7 billion in 2Q18. This is the first time in five quarters that the foreign exchange reserves posted a quarter-on-quarter drop.

The China-US trade war finally broke out on 6 July as the US started to levy 25% additional tariffs on US\$34 billion worth of Chinese imports, and China followed suit immediately and imposed 25% additional tariffs on the same amount of US imports. These tariffs were part of the tariffs proposed on US\$50 billion of products from each of the countries. The US tariffs on the remaining US\$16 billion will take effect on 23 August. China will also begin to levy tariffs on US\$16 billion of US imports on the same date.

Chinese yuan has depreciated against US dollar and Euro in recent months. The daily fixing rate of the Chinese yuan against the US dollar depreciated to 6.8513 on 6 August, the weakest level since 1 June last year. The daily fixing rate of the Chinese yuan against the Euro depreciated from its recent peak of 7.4379 on 15 June to 7.9864 on 1 August, before appreciating slightly to 7.9257 on 6 August.

On 31 May, the Chinese government announced to reduce the tariff rates for imports of 1,449 tariff items effective from 1 July. These 1,449 tariff items include a wide range of consumer products such as food, beverages, medicines, chemical products for daily use, clothing, shoes, hats, home textiles, kitchen products, home appliances and watches, etc.

## A Recent developments

### 1. China's real GDP growth moderates in 2Q18

China's real GDP growth decelerated to 6.7% year-on-year (yoy) in 2Q18 from 6.8% yoy in 1Q18, indicating a moderation in the growth of the Chinese economy (see exhibit 1). Overall, in 1H18, China's nominal GDP amounted to 41.9 trillion yuan, up by 6.8% yoy in real terms.

Compared to 2017, the growth of the tertiary industry decelerated while that of the secondary industry stayed stable in 1H18. The real growth rate for the value-added of the tertiary industry came in at 7.6% yoy in 1H18, lower than 8.0% yoy in 2017. In the meantime, the real growth rate for the value-added of the secondary industry was 6.1% yoy in 1H18, the same as in 2017.

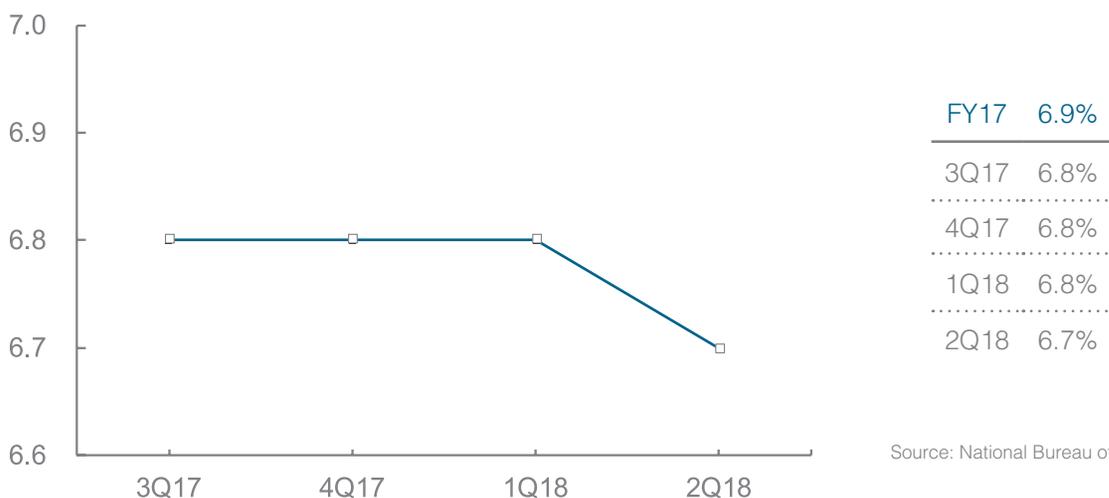
In 1H18, final consumption expenditure contributed 5.3 ppts to the real GDP growth, while gross capital formation contributed 2.1 ppts. These figures show that China has been shifting towards a consumption-led economy.

Looking ahead, the Chinese policy makers will strive to maintain stable growth of the Chinese economy in near future. We predict that the central bank will adopt a more accommodative monetary policy and will maintain abundant liquidity in the banking system. On 5 July, the central bank made a targeted cut in the reserve requirement ratios (RRRs) of some banks in China by 50 bps, pumping funds of about 700 billion yuan into the banking system. The central government will also continue with its active fiscal policy; in particular, the government will focus on reducing taxes and fees in a bid to alleviate cost burden on enterprises. For example, on 1 May this year, the value-added tax rate on the manufacturing sector was reduced from 17% to 16%, while the value-added tax rate on the transportation, construction, telecommunication services sectors and agricultural products was decreased from 11% to 10%. Given these policy directions, we predict that the real GDP growth will be around 6.7% in 3Q18. Downside risks to the economic growth, in our view, come mainly from the China-US trade war, the negative impact of the ongoing property tightening measures and the strengthened regulation of the financial sector.

4

**Exhibit 1** China's real GDP growth, 3Q17 to 2Q18

yoy growth (%)



Source: National Bureau of Statistics, PRC

## 2. Growth in retail sales stays low in June

According to the National Bureau of Statistics, the growth in China's total retail sales of consumer goods decelerated from 10.1% yoy in March to 9.4% yoy in April, and further to 8.5% yoy in May, the slowest in 15 years, before staying low at 9.0% yoy in June. The month-on-month (mom) growth in seasonally-adjusted retail sales fluctuated within the range of 0.31% to 0.73% throughout April to June.

Overall, in 1H18, the total retail sales of consumer goods reached 18,001.8 billion yuan. The growth rate

was 9.4% yoy in 1H18, lower than the 10.2% yoy growth recorded in 2017 (see exhibits 2 and 3).

China's online retail sales of goods increased by 29.8% yoy to reach 3,127.7 billion yuan in 1H18. Consequently, the share of online retail sales in the total retail sales of consumer goods went up to 17.4% in 1H18 from 15.0% in 2017, indicating that the popularity of online shopping has been growing rapidly.

**Exhibit 2** Exhibit 2: China's total retail sales, year-on-year nominal growth, July 2016 to June 2018



Source: National Bureau of Statistics, PRC

**Exhibit 3** China's total retail sales, month-on-month nominal growth, January to June 2018

	mom growth (%), seasonally adjusted					
	Jan 18	Feb	Mar	Apr	May	Jun
Total retail sales	0.64	0.53	0.76	0.65	0.31	0.73

Source: National Bureau of Statistics, PRC

# Part 1 : Domestic Trade

Both rural and urban retail sales have increased at a slower pace: the growth in rural retail sales moderated to 10.5% yoy in 1H18 from 11.8% yoy in 2017. In the meantime, the growth in urban retail sales decelerated to 9.2% yoy in 1H18 from 10.0% yoy in 2017.

The growth in catering services sales came in at 9.9% yoy in 1H18, down from 10.7% yoy in 2017. Meanwhile, the growth in sales of goods decelerated to 9.3% yoy in 1H18 from 10.2% yoy in 2017.

The growth rate for the retail sales of goods by enterprises above a designated size<sup>1</sup>, which amounted to 6,553.8 billion yuan in 1H18, decelerated to 7.6% yoy in 1H18 from 8.2% yoy in 2017. Among products, 'cosmetics' saw the strongest growth in sales (14.2% yoy) in 1H18, followed by 'products for daily use' (12.6% yoy). Meanwhile, 'automobiles' witnessed the weakest growth in sales (2.7% yoy). Exhibit 5 demonstrates the growth in China's retail sales by product among enterprises above a designated size.

**Exhibit 4** China's total retail sales, 2017 to 1H18

Nominal growth, yoy (%)	FY17	1Q18	1H18
<b>Total retail sales</b>	<b>10.2</b>	<b>9.8</b>	<b>9.4</b>
- Goods	10.2	9.8	9.3
Sales by enterprises above a designated size	8.2	8.6	7.6
Online sales	28.0	34.4	29.8
- Catering services	10.7	10.3	9.9

Source: National Bureau of Statistics, PRC

### 3. Chinese consumers remain optimistic

The consumer confidence index<sup>2</sup> rose from 122.3 in March to 122.9 in April and May, the second highest level in 2018. These figures indicate that Chinese consumers have remained optimistic recently (see exhibit 6).

### 4. Both rural and urban households see high single-digit growth in income in 1H18

Both rural and urban households continued to see high single-digit nominal growth in income in 1H18. The per capita disposable income of rural households grew nominally by 8.8% yoy (or 6.8% yoy real) to reach 7,142 yuan; while the per capita disposable income of urban households rose by 7.9% yoy in nominal terms (or 5.8% yoy real) to reach 19,770 yuan in 1H18.

With higher income, both rural and urban households had more room to increase their consumption expenditures in 1H18. In particular, the per capita consumption expenditure of rural households, which reached 5,806 yuan, posted double-digit growth of 12.2% yoy in nominal terms (or 10.1% yoy real). Meanwhile, the per capita consumption expenditure of urban households grew by 6.8% yoy in nominal terms (or 4.7% yoy real) to reach 12,745 yuan in 1H18.

<sup>1</sup> 'Enterprises above a designated size' refers to enterprises with annual sales of 5 million yuan or more and with an employee strength of 60 or more.  
<sup>2</sup> A reading above 100 indicates that consumers tend to be optimistic; a reading below 100 indicates that consumers tend to be pessimistic.

**Exhibit 5** China's retail sales by enterprises above a designated size, by product, 2017 to 1H18

Nominal growth, yoy (%)	FY17	1Q18	1H18
Grain, oil and food	10.2	10.1	9.8
Beverages	10.3	9.1	9.6
Tobacco and liquor	7.9	9.2	8.9
Clothing, shoes, hats and textiles	7.8	9.8	9.2
Cosmetics	13.5	16.1	14.2
Gold, silver and jewellery	5.6	7.9	7.4
Products for daily use	8.0	12.3	12.6
Sports and entertainment products	15.6	1.3	-
Home appliances and video equipment	9.3	11.4	10.6
Chinese and Western medicines	12.4	10.4	9.3
Stationery and office accessories	9.8	4.0	6.6
Furniture	12.8	9.3	10.1
Telecommunications equipment	11.7	7.7	10.6
Petroleum and related products	9.2	9.1	11.9
Automobiles	5.6	7.4	2.7
Building and decoration materials	10.3	8.0	8.1

Source: National Bureau of Statistics, PRC

**Exhibit 6** China's consumer confidence index, June 2016 to May 2018



Jun 17	113.3
Jul	114.6
Aug	114.7
Sep	118.6
Oct	123.9
Nov	121.3
Dec	122.6
Jan 18	122.3
Feb	124.0
Mar	122.3
Apr	122.9
May	122.9

Source: National Bureau of Statistics, PRC

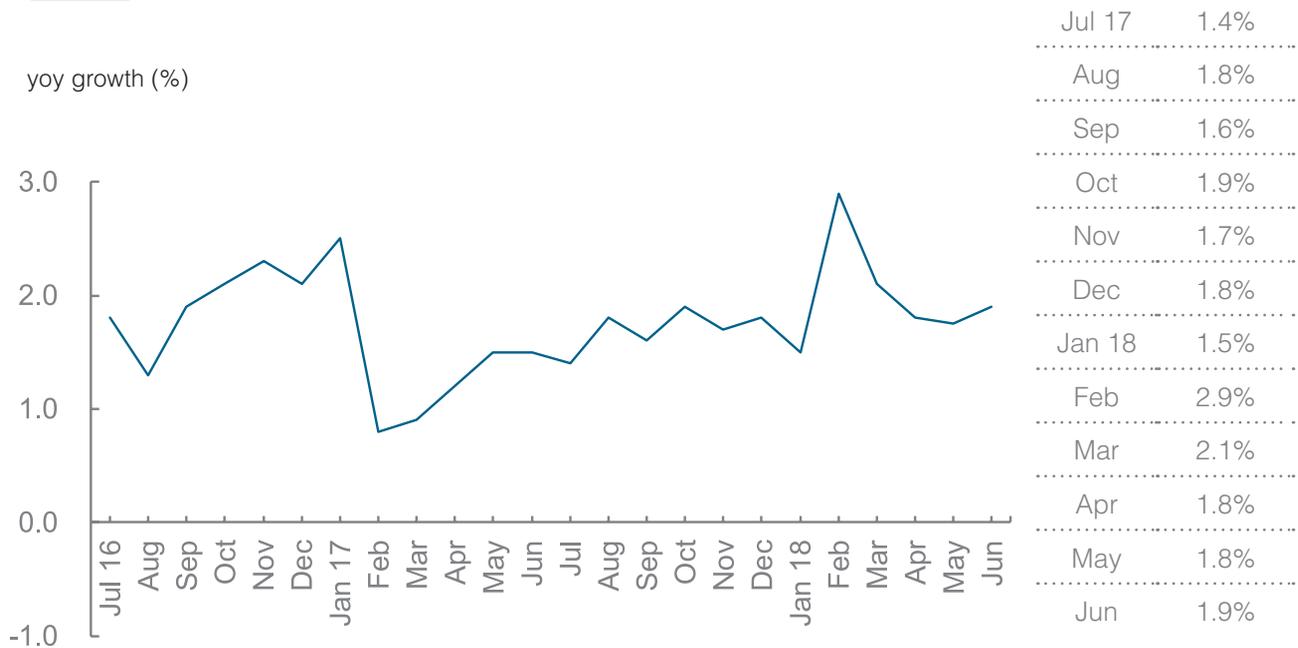
## 5. CPI growth registers 1.9% in June

The year-on-year growth rate of China's consumer price index (CPI)<sup>3</sup> went up from 1.8% in April and in May to 1.9% yoy in June, still below the government's target for 2018 (i.e. 3%) (see exhibits 7 and 8). The mild acceleration in the CPI growth in June was attributable to a slightly faster rise in food prices in the month. The year-on-year growth in the food component in the CPI went up from 0.1% in May to 0.3% in June, due largely to a smaller decline in pork prices. Meanwhile, the year-on-year growth in the non-food component stayed flat at 2.2% in June compared with the previous month.

On 6 July, the 25% retaliatory tariffs on US\$50 billion worth of US imports came into effect. Since the targeted products are mostly agricultural products (including soybeans, which are mostly used as a livestock feed) and aquatic products, food prices, in particular pork prices, in China are likely to rise as a result. Thus, we expect that China's CPI growth will trend slightly upward in the coming months.

8

**Exhibit 7** China's CPI growth, July 2016 to June 2018



Source: National Bureau of Statistics, PRC

<sup>3</sup> The CPI, compiled by the National Bureau of Statistics (NBS) of China, measures the price of a basket of goods and services purchased by a typical household. It is noteworthy that the NBS has changed the weights assigned to the various components in the CPI basket, effective from January 2016. The weight of the food component, for example, has been reduced by 3.2 ppt; the weight of the housing component has been increased by 2.2 ppt; and the weights of other components have been adjusted by around or less than 1 ppt. The impact of the re-weighting on the CPI growth was limited, according to the NBS.

**Exhibit 8** China's CPI growth by commodity, January to June 2018<sup>4</sup>

yoy growth (%)	Jan 18	Feb	Mar	Apr	May	Jun
Food, tobacco and liquor	0.2	3.6	2.0	1.1	0.7	0.8
Clothing	1.4	1.1	1.1	1.1	1.1	1.1
Housing	2.7	2.2	2.2	2.2	2.2	2.3
Household goods and services	1.5	1.8	1.6	1.5	1.5	1.5
Transportation and communication	0.2	1.5	0.3	1.1	1.8	2.4
Education, culture and recreational activities	0.9	3.7	2.2	2.0	1.9	1.8
Medical and healthcare	6.2	6.0	5.7	5.2	5.1	5.0
Other goods and services	1.2	1.7	1.2	0.9	1.0	0.9

Source: National Bureau of Statistics, PRC

Since April this year, the year-on-year growth in China's producer price index of industrial products (PPI) has trended upward, rising to 4.7% in June, the highest level in six months (*see exhibits 9 & 10*).

On a month-on-month basis, the PPI moved higher by 0.3% in June, posting month-on-month rise for two consecutive months. The increase in the PPI in June was caused mainly by a jump in the ex-factory prices in the 'extraction of petroleum and natural gas' and 'processing of petroleum, coking, processing of nucleus fuel' industries.

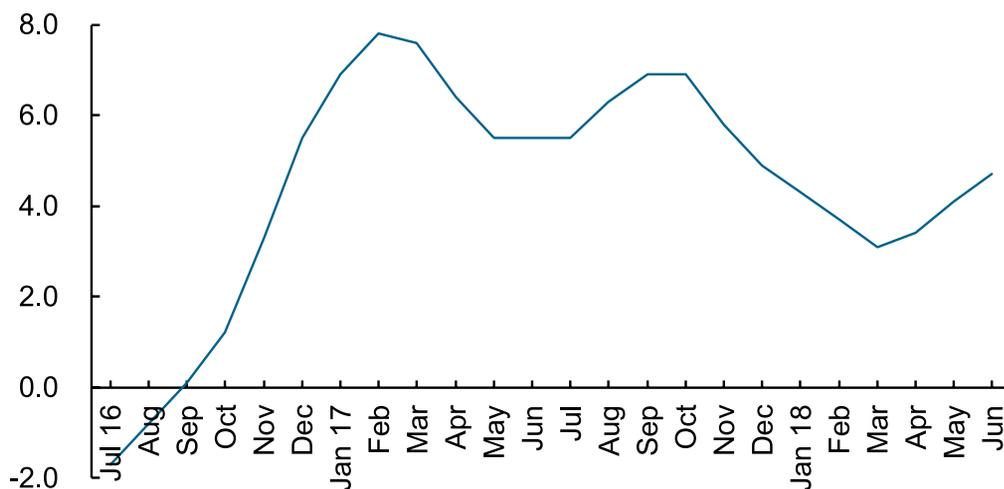
Going forward, the year-on-year growth in the PPI is expected to stay high in July as the latest reading of the input prices sub-index of China's manufacturing PMI shows a recent hike in the domestic prices of production inputs. However, the growth in the PPI is likely to fall in the following months till year-end, due partly to a higher base for comparison in the same period last year.

<sup>4</sup> The NBS has re-categorized the categories in the CPI basket, effective from January 2016. For example, the old category of 'household goods and maintenance services' has been re-categorized into a new category called 'household goods and services' and the category of 'other goods and services'. The old category of 'recreational, educational products and services' has been re-categorized into a new category called 'education, culture and recreational activities' and the category of 'other goods and services'.

# Part 1 : Domestic Trade

**Exhibit 9** China's PPI growth, July 2016 to June 2018

yoy growth (%)



Jul 17	5.5%
Aug	6.3%
Sep	6.9%
Oct	6.9%
Nov	5.8%
Dec	4.9%
Jan 18	4.3%
Feb	3.7%
Mar	3.1%
Apr	3.4%
May	4.1%
Jun	4.7%

Source: National Bureau of Statistics, PRC

**Exhibit 10** China's PPI growth by selected industry, January to June 2018

yoy growth (%)

	Jan 18	Feb	Mar	Apr	May	Jun
Textile	2.1	1.7	1.7	1.7	1.9	2.1
Textile wearing apparel and ornament	0.8	0.7	0.4	0.5	0.6	0.6
Processing of timbers, manufacture of wood, bamboo, rattan, palm, and straw products	1.2	1.2	1.2	1.6	1.7	1.9

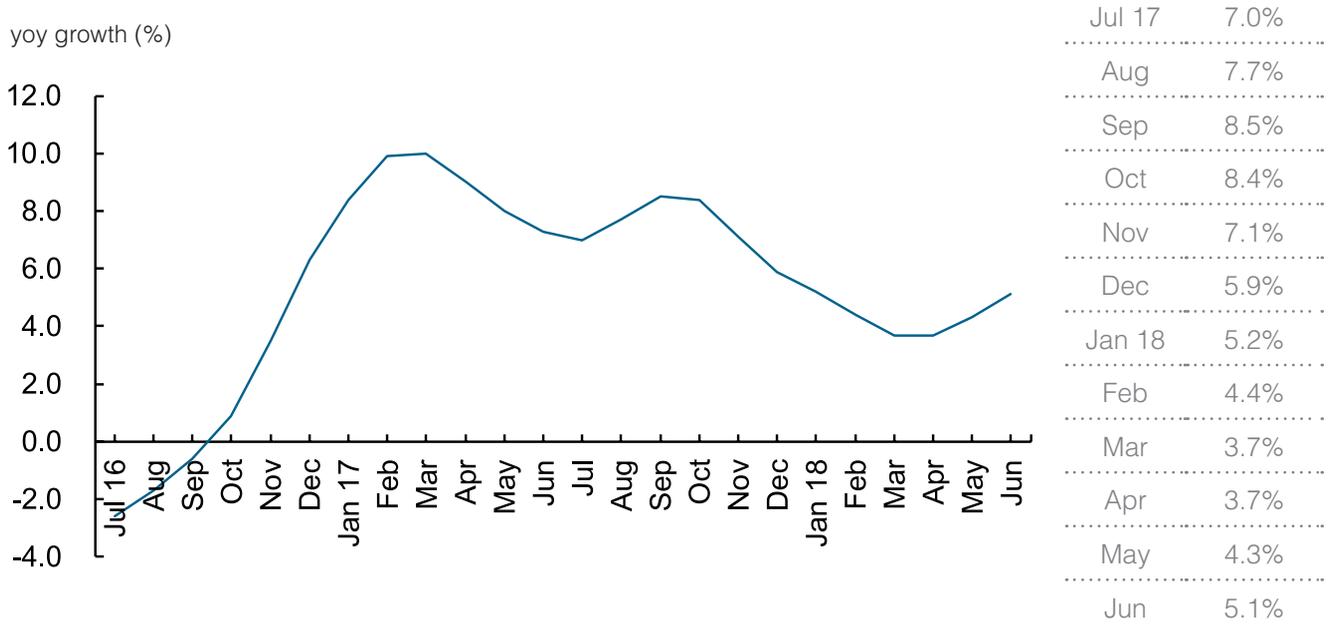
Source: National Bureau of Statistics, PRC

The year-on-year growth rate of the purchaser price index of industrial products rose from 3.7% yoy in April to 4.3% in May, and further to 5.1% in June (*see exhibits 11 & 12*). On a month-on-month basis, the purchaser price index climbed by 0.4% in June, posting month-on-month increase for two consecutive months. The uptrend indicates a rise in prices of production in recent months.

The input prices sub-index of China's manufacturing PMI, a leading indicator of upstream prices, registered 57.7 in June. The index reading is higher than that of

last month (56.7) and is well above the neutral level of 50, indicating that domestic prices of production inputs have been rising strongly. Thus, we expect that the year-on-year growth rate of the purchaser price index will go up further in July. However, the growth in the purchaser price index is likely to drop in the following months till year-end, due partly to a higher comparison base in the same period last year.

**Exhibit 11** Growth in China's purchaser price index of industrial products, July 2016 to June 2018



Source: National Bureau of Statistics, PRC

**Exhibit 12** China's purchaser price index of industrial products by selected commodity, January to June 2018

yoy growth (%)	Jan 18	Feb	Mar	Apr	May	Jun
Fuel and power	6.2	6.0	4.9	4.6	5.5	8.1
Non-ferrous metal materials and wires	10.5	8.3	6.8	6.4	7.6	7.9
Chemical raw materials	5.9	4.3	3.4	4.2	5.3	5.8
Wood and pulp	7.0	6.4	6.5	7.0	7.8	7.4
Textile raw materials	2.3	1.7	1.7	1.7	1.7	2.1

Source: National Bureau of Statistics, PRC

## 6. Growth in industrial production decelerates

The growth rate for China's industrial production (IP), measured by the value-added of industrial output (VAIO), decelerated from 7.0% yoy in April to 6.8% yoy in May, and further to 6.0% yoy in June (see exhibit 13).<sup>5</sup> Overall, in 1H18, China's IP expanded by 6.7% yoy, slightly higher than the 6.6% yoy growth recorded in 2017.

Looking ahead, we expect that the industrial production (VAIO) growth will stay low in coming months as both domestic demand and export demand have shown signs of moderation recently. In addition, challenges facing Chinese manufacturers include the China-US trade war, stronger government's efforts to enforce environmental regulations, a marked increase in prices of materials, intense competition in the international market, and the weak demand for luxury products.

## 7. Industrial profits gain 16.5% yoy in 1H18

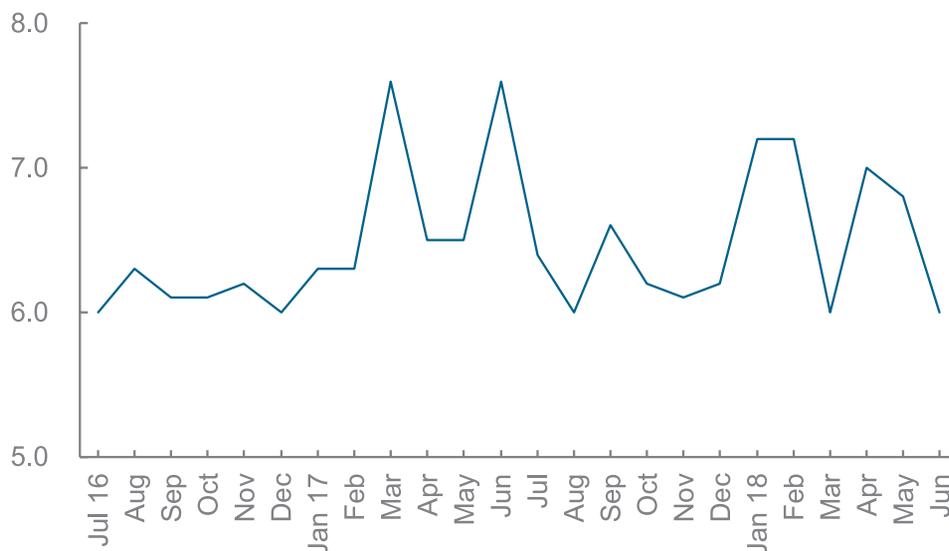
The growth rate for the total profits earned by large and medium industrial enterprises above a designated size<sup>6</sup> accelerated from 3.1% yoy in March to 21.9% yoy in April, and then stayed high at 21.1% yoy in May. One of the major reasons behind the stronger profit growth in April and May was a faster rise in prices of ex-factory products. In the first five months of 2018, China's industrial profits totalled 2,729.8 billion yuan, up by 16.5% yoy, compared to the growth rate of 21.0% yoy in 2017 (see exhibit 14).

Among sectors, profits of the manufacturing sector rose by 13.8% yoy to 2,315.0 billion yuan; profits of the mining sector increased by 41.6% yoy to 233.4 billion yuan in 1H18; profits of the 'electricity, heat, gas and water' sector grew by 26.1% yoy to 181.5 billion yuan in 1H18.

12

**Exhibit 13** China's industrial production growth, July 2016 to June 2018

yoy growth (%)



Jul 17	6.4%
Aug	6.0%
Sep	6.6%
Oct	6.2%
Nov	6.1%
Dec	6.2%
Jan-Feb 18	7.2%
Mar	6.0%
Apr	7.0%
May	6.8%
Jun	6.0%

Source: National Bureau of Statistics, PRC

<sup>5</sup> The National Bureau of Statistics has changed the method of compiling the value added for industry (industrial production, IP), effective January 2011. The statistical threshold for industrial enterprises has been raised to cover those with annual revenues of 20 million yuan or above, up from the previous threshold of 5 million yuan or above.

<sup>6</sup> 'Industrial enterprises above a designated size' refers to industrial enterprises with annual sales of 20 million yuan or more.

**Exhibit 14** China's industrial profits growth, November 2017 to May 2018

<i>yoy growth (%)</i>	Nov 17	Dec	Jan-Feb 18	Mar	Apr	May
Total profits made by industrial enterprises above a designated size	14.9	10.8	16.1	3.1	21.9	21.1

Source: National Bureau of Statistics, PRC

## 8. Fixed asset investment growth falls in 1H18

The growth in China's nominal fixed asset investment (FAI) (excluding rural households) fell to 6.0% yoy in 1H18 from 7.2% yoy in 2017.<sup>7</sup> Overall, in 1H18, China's nominal FAI (excluding rural households) amounted to 29.7 trillion yuan (see exhibit 15).

The drop in the overall FAI growth was largely attributable to the deceleration of FAI growth for infrastructure (excluding power, heat, gas and water infrastructure), which fell markedly to 7.3% yoy in 1H18 from 19.0% yoy in 2017.

In contrast, the growth in FAI (excluding rural households) for the manufacturing sector accelerated to 6.8% yoy in 1H18 from 4.8% yoy in

2017; the growth in FAI (excluding rural households) in real estate development went up to 9.7% yoy in 1H18 from 7.0% yoy in 2017.

Going forward, we expect that China's overall FAI will continue to show weak growth in the near term, as the tighter rules on financing activities of local governments are set to weaken the growth in infrastructure investment and the ongoing property tightening measures is likely to drag down the growth in real estate investment.

**Exhibit 15** China's FAI (excluding rural households) growth, January to June 2018

	Jan 18	Feb	Mar	Apr	May	Jun
FAI (excluding rural households) <i>(year-to-date, yoy growth %)</i>	-	7.9	7.5	7.0	6.1	6.0
FAI (excluding rural households) <i>(mom growth %, seasonally adjusted)</i>	0.48	0.49	0.48	0.47	0.46	0.48

Source: National Bureau of Statistics, PRC

<sup>7</sup> The National Bureau of Statistics has expanded coverage of the monthly statistics for FAI from the urban areas to rural enterprises and institutions, effective from 2011. Thus: 'FAI (excluding rural households)', the new indicator, has been released by the bureau as from March 2011 to replace 'urban FAI', the previous indicator. Also, a new statistical criterion has been adopted. The statistical threshold for the size of investment projects has been adjusted upwards from 500,000 yuan to 5 million yuan.

## B Highlights

### 1. China to amend Individual Income Tax Law

On 29 June, the Standing Committee of the National People's Congress released the 'Draft Amendments to the Individual Income Tax Law' to seek public opinions until 28 July.<sup>8</sup>

The draft proposes to set the minimum threshold for individual income tax at 60,000 yuan per year (or 5,000 yuan per month), up from the current minimum threshold for individual income tax of 3,500 yuan per month. Besides, the tax brackets of the three lowest grades — 3%, 10% and 20% — would be widened (*see exhibit 16*). Moreover, the tax-deductible items would be increased to cover expenses on children's education, continuing education, medical treatment for serious illnesses, housing mortgage interest and housing rent.

The deadline for collecting public opinions has already passed on 28 July. It is likely that a revised version of the draft, which is very similar to the original version, will be reviewed and then passed by the Standing Committee of China's National People's Congress soon. The amendments to the tax law are widely expected to be effective early next year. We believe such a change would reduce tax burden on low- and middle-income earners and thus improve their disposable income, boding well for consumption in China.

### 2. Both broad money supply and total outstanding RMB loans continue to show weak growth

Both the broad money supply (M2) and the total outstanding RMB loans have continued to show weak growth recently. The M2 growth decelerated from 8.3% yoy as at the end of May to 8.0% yoy as at the end of June (*see exhibit 17*).

Meanwhile, the growth rate of the total outstanding RMB loans stayed low at 12.7% yoy as at the end of June, down slightly from 12.8% yoy as at the end of March. Overall, in 1H18, the rise in the total outstanding RMB loans amounted to 9.03 trillion yuan, higher than the increase seen in the same period of the previous year (i.e. 7.97 trillion yuan). The main reason behind the larger bank loans in 1H18 was that the tightening in financial regulations had driven banks to shift off-balance sheet credit onto their balance sheets.

On 5 July, the central bank made a targeted cut in the reserve requirement ratios (RRRs) of some banks in China by 50 bps, pumping funds of about 700 billion yuan into the banking system. According to the announcement made by the central bank, the main purpose of the move was to support the debt-to-equity swap programme and to encourage more funds to flow towards small and micro businesses.<sup>9</sup>

China's monetary policy has shown signs of easing recently. On 31 July, Xi Jinping, the General Secretary of the Chinese Communist Party, chaired a meeting of the Politburo, a top decision-making body of the ruling party. According to the report on the meeting published by the state-run Xinhua news agency, China would 'adopt a prudent monetary policy'. It is noteworthy that the wordings were slightly different from those used in the past few months: according to media report on the Politburo meeting held on 23 April, China would 'maintain a prudent and neutral monetary policy'. In our view, the change in wordings implies that the monetary policy is likely to become more accommodative in near future.

<sup>8</sup> [http://www.npc.gov.cn/COBRS\\_LFYJNEW/searchervlet?action=103&sCASM=CA&lawid=9106683](http://www.npc.gov.cn/COBRS_LFYJNEW/searchervlet?action=103&sCASM=CA&lawid=9106683)

<sup>9</sup> <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3564334/index.html>

**Exhibit 16** Individual income tax brackets and tax rates: before and after the amendments

Current progressive tax rate scheme			Proposed progressive tax rate scheme		
Grade	Monthly taxable income (yuan)	Tax rate	Grade	Monthly taxable income (yuan)	Tax rate
1	not in excess of 1,500	3%	1	not in excess of 3,000	3%
2	>1,500 to 4,500 (the next 3,000)	10%	2	>3,000 to 12,000 (the next 9,000)	10%
3	>4,500 to 9,000 (the next 4,500)	20%	3	>12,000 to 25,000 (the next 13,000)	20%
4	>9,000 to 35,000 (the next 26,000)	25%	4	>25,000 to 35,000 (the next 10,000)	25%
5	>35,000 to 55,000 (the next 20,000)	30%	5	>35,000 to 55,000 (the next 20,000)	30%
6	>55,000 to 80,000 (the next 25,000)	35%	6	>55,000 to 80,000 (the next 25,000)	35%
7	>80,000 (remainder)	45%	7	>80,000 (remainder)	45%

Source: National People's Congress

**Exhibit 17** Broad money supply (M2) and RMB loans, July 2017 to June 2018

As of	Broad money supply (M2)		Total outstanding RMB loans		Increase in RMB loans (trillion yuan)	
	Amount (trillion yuan)	yoy growth	Amount (trillion yuan)	yoy growth	FY17	1H18
End-Jul 17	162.9	9.2%	115.4	13.2%	Jul 17	0.83
End-Aug	164.5	8.9%	116.5	13.2%	Aug	1.09
End-Sep	165.6	9.2%	117.8	13.1%	Sep	1.27
End-Oct	165.3	8.8%	118.4	13.0%	Oct	0.66
End-Nov	167.0	9.1%	119.6	13.3%	Nov	1.12
End-Dec	167.7	8.2%	120.1	12.7%	Dec	0.58
End-Jan 18	172.1	8.6%	123.0	13.2%	Jan 18	2.90
End-Feb	172.9	8.8%	123.9	12.8%	Feb	0.84
End-Mar	174.0	8.2%	125.0	12.8%	Mar	1.12
End-Apr	173.8	8.3%	126.2	12.7%	Apr	1.18
End-May	174.3	8.3%	127.3	12.6%	May	1.15
End-Jun	177.0	8.0%	129.2	12.7%	Jun	1.84

Source: People's Bank of China

16

### 3. 'Total social financing' increases at a slower pace

The increase in 'total social financing' (covering sources of financing such as RMB loans to the real sector, foreign currency loans to the real sector, trust loans, entrusted loans, bank acceptance bills, corporate bonds, equity issuance and other instruments) amounted to 9.1 trillion yuan in 1H18, smaller than the increase seen in the same period of the previous year (i.e. 11.2 trillion yuan) (see exhibit 18).

The smaller increase in 'total social financing' could be associated with the slowdown in shadow banking activities due largely to the strengthened regulations of the financial sector. Entrusted loans decreased by 800.8 billion yuan in 1H18, compared to an increase of 599.0 billion yuan in the same period of the previous year. Meanwhile, trust loans decreased by 186.3 billion yuan in 1H18, compared to the increase seen in the same period of the previous year (i.e. 1,310.0 billion yuan).

**Exhibit 18**

Increase in total social financing, 2017 to 1H18

	2017		1H18	
	Amount (billion yuan)	Share (%)	Amount (billion yuan)	Share (%)
Total social financing	19,440.0	100.0	9,100.0	100.0
RMB loans to the real sector	13,840.0	71.2	8,760.0	96.3
Foreign currency loans to the real sector	1.8	0.0	-12.5	-0.1
Trust loans	2,260.0	11.6	-186.3	-2.0
Entrusted loans	777.0	4.0	-800.8	-8.8
Bank acceptance bills	536.4	2.8	-271.7	-3.0
Corporate bonds	449.5	2.3	1,020.0	11.2
Equity issuance	873.4	4.5	251.1	2.8

Source: People's Bank of China

## C Outlook

### 1. Chinese entrepreneurs become less optimistic

China's Entrepreneur Confidence Index (ECI) for the secondary industry dropped from 132.9 in 1Q18 to 130.3 in 2Q18, indicating that Chinese entrepreneurs have become less optimistic recently (*see exhibit 19*).<sup>10</sup>

By sector, the ECIs for the 'electricity, gas and water' and the 'manufacturing' sectors recorded a quarter-on-quarter fall, down by 1.6 pts and 2.6 pts respectively in 2Q18. Meanwhile, the ECI for the 'mining' sector rose slightly by 0.1 pts in the same quarter (*see exhibit 20*).

### 2. Growth of manufacturing sector moderates

18

China's manufacturing PMI dropped from its recent peak of 51.9 in May to 51.5 in June, and further to 51.2 in July, the lowest level since March this year. The downtrend indicates that the growth of the manufacturing sector has moderated recently (*see exhibit 21*).

The new orders index went down all the way from 53.8 in May to 52.3 in July.<sup>11</sup> Meanwhile, the new export orders index fell from 51.2 in May to 49.8 in June and in July, dipping into the contractionary zone. These readings suggest that both domestic demand and export demand have shown signs of moderation recently amid the escalating China-US trade tensions.

Against the backdrop of moderating demand, the output index dropped from 54.1 in May to 53.6 in June, and down further to 53.0 in July, showing a deceleration in the output growth.

The purchases of inputs index also trended downward, falling to 51.5 in July, the lowest level in five months. The latest reading indicates that manufacturers have slowed their purchasing activities recently.

The stocks of finished goods index rose all the way from 46.1 in May to 47.1 in July, showing that the stocks of finished goods held by manufacturers have dropped at a slower pace recently. Meanwhile, the stocks of major inputs index dropped from 49.6 in May to a five-month low of 48.8 in June, and then stayed low at 48.9 in July. The index readings in the past two months indicate that the stocks of major inputs decreased at a relatively fast pace during the period.

After rising from 56.7 in May to 57.7 in June, the input prices index fell to 54.3 in July, indicating that upstream cost pressure on manufacturers has eased recently. Meanwhile, the ex-factory prices went up slightly from 53.2 in May to 53.3 in June, but then fell to 50.5 in July. The latest reading shows that ex-factory prices of finished goods have risen at a slower pace lately.

The business expectations index went down from 58.7 in May to 57.9 in June, and further to 56.6 in July, the lowest level since February this year. The downtrend shows that purchasing managers are becoming less optimistic about the near term outlook for their respective industries.

<sup>10</sup> China's Entrepreneur Confidence Index (ECI) ranges from 0 to 200. A reading above 100 indicates that entrepreneurs tend to be optimistic; a reading below 100 indicates that they tend to be pessimistic.

<sup>11</sup> The 'new orders index' covers both domestic and export orders. That is to say, the manufacturers are not asked to differentiate between domestic and export orders when filling in questionnaires.

**Exhibit 19** China's Entrepreneur Confidence Index (Secondary Industry), 3Q16 to 2Q18

	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18
Entrepreneur Confidence Index (Secondary Industry)	113.4	115.4	129.2	127.3	127.3	126.0	132.9	130.3

Source: National Bureau of Statistics, PRC

**Exhibit 20** Entrepreneur Confidence Index by sector, 2Q18

	2Q18	Compared with the previous quarter
Secondary industry	130.3	Lower
Mining	117.0	Higher
Manufacturing	130.6	Lower
Electricity, gas & water	138.3	Lower

Source: National Bureau of Statistics, PRC

Part 1 :  
**Domestic  
 Trade**

**Exhibit 21** China's manufacturing PMI at a glance, July 2018

Index	Seasonally Adjusted Index	Index Compared with the Previous Month	Direction
PMI	51.2	Lower	Expanding
Output	53.0	Lower	Expanding
New Orders	52.3	Lower	Expanding
New Export Orders	49.8	Unchanged	Contracting
Backlogs of Orders	45.7	Higher	Contracting
Stocks of Finished Goods	47.1	Higher	Contracting
Purchases of Inputs	51.5	Lower	Expanding
Imports	49.6	Lower	Contracting
Input Prices	54.3	Lower	Rising
Stocks of Major Inputs	50.5	Lower	Rising
Ex-factory Prices	48.9	Higher	Contracting
Employment	49.2	Higher	Contracting
Suppliers' Delivery Time	50.0	Lower	Stable
Business Expectations	56.6	Lower	Optimistic

Source: China Federation of Logistics & Purchasing; National Bureau of Statistics, PRC

### 3. Non-manufacturing sector expands at a slower pace in July

China's Business Activity Index, which is quoted as the Non-manufacturing Purchasing Managers' Index (NMI), rose slightly from 54.9 in May to a five-month high of 55.0 in June, but then dropped to 54.0 in July. The latest figure indicates that the non-manufacturing sector expanded at a slower pace in July (see exhibit 22). This was due partly to the hot and rainy weather conditions in various places in China in the month.

After dropping from 51.0 in May to 50.6 in June, the new orders index rebounded to 51.0 in July, showing a reacceleration in the growth of new orders. Against this backdrop, the sales prices index rose all the way

from 50.6 in May to 52.0 in July, the highest level since February this year, showing that enterprises have been able to raise their service charges lately. Meanwhile, the input prices index climbed from 52.7 in April to 54.2 in May, and then stayed relatively high at 53.5 in June and 53.9 in July, indicating that the input prices have increased at a relatively fast pace in recent months.

The business expectation index was 60.2 in July, well above the critical 50-mark, suggesting that purchasing managers in the non-manufacturing sector have stayed optimistic about the near term outlook for their respective industries.

**Exhibit 22** China's non-manufacturing purchasing managers' index (NMI) at a glance, July 2018

Index	Seasonally Adjusted Index	Index Compared with the Previous Month	Direction
Business activity	54.0	Lower	Expanding
New orders	51.0	Higher	Expanding
Input prices	53.9	Higher	Rising
Sales prices	52.0	Higher	Rising
Business expectations	60.2	Lower	Optimistic

Source: China Federation of Logistics & Purchasing; National Bureau of Statistics, PRC

## A Recent developments

### 1. Both exports and imports record double-digit growth in July

China's exports growth decelerated from 14.1% yoy in 1Q18 to 11.8% yoy in 2Q18 amid the escalating trade tensions between China and the US in 2Q18 (see exhibits 23, 24 and 25). Overall, in 1H18, China's exports amounted to US\$ 1,172.8 billion, up by 12.8% yoy.

Compared to 2017, China's exports to the US managed to grow at a faster pace in 1H18. China's export growth to the US was 13.6% yoy in 1H18, up from 11.5% yoy in 2017. Meanwhile, China's exports to its other major trading partners such as the EU, Japan and the ASEAN also showed improvement in 1H18. China's export growth to the EU, Japan and the ASEAN accelerated to 11.7% yoy, 8.0% yoy and 18.3% yoy respectively in 1H18 from 9.7% yoy, 6.1% yoy and 9.0% yoy respectively in 2017. Also noteworthy is that China's exports to Brazil, one of the major commodity-exporting countries in the world, continued to post impressive growth of 34.0% yoy in 1H18.

The growth rate for China's imports improved from 19.0% yoy in 1Q18 to 20.2% yoy in 2Q18, indicating that the domestic demand for imported goods has remained strong lately. Overall, in 1H18, China's imports totalled US\$ 1,033.1 billion, up by 19.9% yoy.

Compared to 1Q18, China's exports increased markedly by US\$ 84.7 billion in 2Q18, as many factories resumed their operations after Chinese New Year holidays. Meanwhile, China's imports rose at a relatively slower pace, by US\$ 37.4 billion, over the same quarter. Consequently, China's trade surplus went up to US\$ 95.3 billion in 2Q18 from US\$ 48.0 billion in 1Q18.

In July, China's exports maintained double-digit growth of 12.2% yoy, while China's imports soared by 27.3% yoy. The strong import growth in July was due largely to the reduction in import tariff rates for a wide range of consumer products since 1 July. (More details about the reduction in import tariff rates of consumer products can be found in the *Highlights* section.)

**Exhibit 23** China's quarterly foreign trade data, 3Q17 to 2Q18

*USD billion (yoy growth)*

	Exports		Imports		Trade Balance
FY17	2,263.5	(7.9%)	1,841.0	(15.9%)	422.5
3Q17	589.2	(6.6%)	474.3	(14.5%)	114.9
4Q17	636.7	(9.9%)	504.8	(12.5%)	131.9
1Q18	545.3	(14.1%)	497.3	(19.0%)	48.0
2Q18	630.0	(11.8%)	534.7	(20.2%)	95.3

Source: China Customs

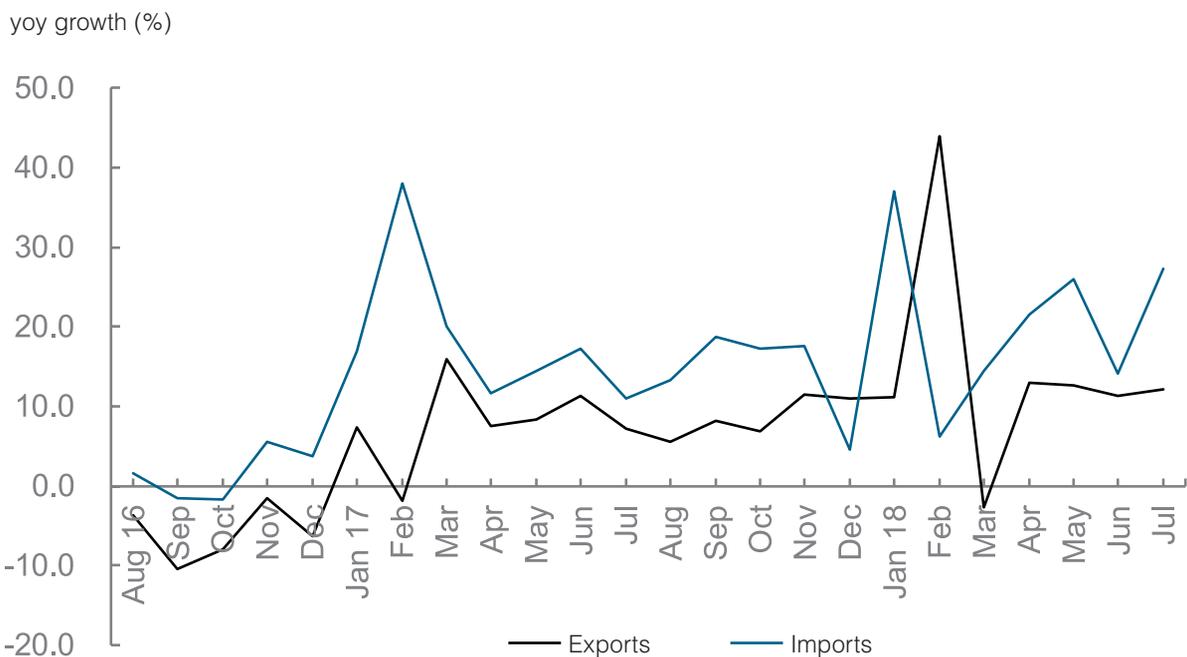
**Exhibit 24** China's monthly foreign trade data, August 2017 to July 2018

*USD billion (yoy growth)*

	Exports		Imports		Trade Balance
August 2017	198.6	(5.1%)	157.5	(13.5%)	41.0
September	198.3	(8.1%)	169.8	(18.7%)	28.5
October	189.0	(6.9%)	150.8	(17.2%)	38.2
November	215.9	(11.5%)	176.9	(17.6%)	39.0
December	231.8	(10.9%)	177.1	(4.5%)	54.7
January 2018	200.1	(11.0%)	180.4	(37.1%)	19.7
February	171.1	(44.0%)	137.8	(6.2%)	33.3
March	174.1	(-2.7%)	179.1	(14.4%)	-5.0
April	200.4	(12.9%)	171.7	(21.5%)	28.8
May	212.9	(12.6%)	187.9	(26.0%)	24.9
June	216.7	(11.3%)	175.1	(14.1%)	41.6
July	215.6	(12.2%)	187.5	(27.3%)	28.1

Source: China Customs

**Exhibit 25** Growth rates of exports and imports, August 2016 to July 2018



Source: China Customs

**Exhibit 26** Exports by category, 2017 and 1H18

<i>yoy growth (%) of export value, calculated in USD</i>	2017	1H18
Textile materials and products	4.5	10.3
Garments and clothing accessories	-0.4	-2.0
Footwear	2.0	-4.9
Toys	30.4	1.6
Coal	58.1	-46.3
Crude oil	93.2	-29.7
Refined oil	30.9	55.2
Steel	0.0	10.0
Mechanical and electrical products	9.3	15.0

Source: China Customs

**Exhibit 27** Imports by category, 2017 and 1H18

<i>yoy growth (%) of import value, calculated in USD</i>	2017	1H18
Cereal and cereal flour	13.7	17.1
Soybean	16.7	2.1
Iron ore	31.4	-7.9
Crude oil	39.1	36.0
Refined oil	29.8	33.5
Steel	15.3	14.7
Textile yarns, fabric and textile products	3.6	6.2
Vehicles and vehicle chassis	13.4	-2.3

Source: China Customs

## 2. Growth rate for general trade exports decelerates in 2Q18

The year-on-year growth rate for general trade<sup>12</sup> exports decelerated in 2Q18. The growth in general trade exports fell to 16.4% yoy in 2Q18 from 20.3% yoy in 1Q18. Meanwhile, the growth in processing trade<sup>13</sup> exports came in at 6.2% yoy in 2Q18, almost the same as in 1Q18 (6.3% yoy) (see exhibit 28).

On the import side, the growth in general trade imports accelerated to 23.7% yoy in 2Q18 from 20.3% yoy in 1Q18. In contrast, the growth rate for processing trade imports dropped to 7.7% yoy in 2Q18 from 10.7% yoy in 1Q18.

The share of processing trade in China's total trade fell to 25.8 % in 2Q18 from 27.0% in 1Q18. That being said, with a large surplus of US\$ 81.1 billion in 2Q18, processing trade still plays an important role in China's foreign trade.

<sup>12</sup> 'General trade' refers to China's import or export of goods by enterprises holding import-export rights. According to China's National Bureau of Statistics, the scope of general trade covers: Imports and exports using loans or aids; the import of materials by foreign invested enterprises (FIEs) for processing of goods for sale in the domestic market; the export of goods purchased by FIEs or manufactured by processing domestically-produced materials; the import of food and beverages by restaurants and hotels; the supply of domestically-produced fuels, materials, parts and components to foreign vessels or aircraft; the import of goods as payment in kind, in lieu of wages in labour service cooperation projects with foreign countries; and the export of equipment and materials by enterprises in China for their investment abroad.

<sup>13</sup> 'Processing trade' refers to the business of importing all or part of the raw and auxiliary materials, parts and components, accessories and packaging materials from abroad, and re-exporting the finished products after processing or assembly by enterprises within the Chinese Mainland.

**Exhibit 28**

China foreign trade (general and processing trades), 2017 to 2Q18

Item	yoy growth (%)			Share (%)		
	FY17	1Q18	2Q18	FY17	1Q18	2Q18
<b>Exports</b>	<b>7.9</b>	<b>14.1</b>	<b>11.8</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Of which:						
General Trade	8.7	20.3	16.4	54.6	56.0	58.0
Processing Trade	5.9	6.3	6.2	33.4	32.4	30.3
<b>Imports</b>	<b>15.9</b>	<b>18.9</b>	<b>20.2</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Of which:						
General Trade	20.2	20.3	23.7	58.7	60.8	61.4
Processing Trade	8.7	10.7	7.7	23.5	21.1	20.6
<b>Total of Imports and Exports</b>	<b>11.4</b>	<b>16.3</b>	<b>15.2</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Of which:						
General Trade	13.8	20.3	19.7	56.4	58.3	59.5
Processing Trade	6.9	7.9	6.8	29.0	27.0	25.8

Source: China Customs

### 3. China's exports to US post faster growth in 1H18

The EU was still China's largest trading partner, accounting for 14.6% of China's total foreign trade in 1H18. Sino-EU trade amounted to US\$ 322.6 billion, up by 13.0% yoy in 1H18. Specifically, China's exports to the EU expanded by 11.7% yoy in 1H18, compared to the growth of 9.7% yoy in 2017; and China's imports from the EU increased by 15.0% yoy in 1H18, compared to the growth of 17.6% yoy in 2017 (see exhibits 29 and 30).

Accounting for 13.7% of China's total foreign trade, the US continued to be China's second largest trading partner in 1H18. Against the backdrop of the escalating China-US trade tensions, Sino-US trade expanded by 13.1% yoy to US\$ 301.8 billion in 1H18. China's export growth to the US accelerated in 1H18: after expanding by 11.5% yoy in 2017, China's exports to the US grew by 13.6% yoy in 1H18. In contrast, China's imports from the US recorded weaker growth of 11.8% yoy in 1H18, compared to 14.5% yoy in 2017.

The Association of South East Asian Nations (ASEAN) accounted for 12.7% of China's total foreign trade in 1H18. Sino-ASEAN trade grew by 19.3% yoy to US\$ 280.6 billion in 1H18. Of which, China's exports to ASEAN rose by 18.3% yoy, while China's imports from ASEAN gained 20.6% yoy, in 1H18.

Sino-Japanese trade increased by 10.7% yoy to US\$ 157.5 billion in 1H18. China's exports to Japan gained 8.0% yoy, while China's imports from Japan expanded by 12.9% yoy in 1H18.

#### 4. Growth rates for China's exports to Russia and Brazil accelerate in 1H18

China's export growth to Russia accelerated to 17.7% yoy in 1H18 from 14.8% yoy in 2017. Meanwhile, China's import growth from Russia improved to 31.6% yoy in 1H18 from 27.7% yoy in 2017 (see exhibits 29 and 30). Consequently, the growth in China's trade with Russia rose to 24.8% yoy in 1H18 from 20.8% yoy in 2017.

China's export growth to India dropped slightly to 15.0% yoy in 1H18 from 16.5% yoy in 2017, while China's import growth from India fell to 15.5% yoy in 1H18 from 38.9% yoy in 2017. Overall, the growth of Sino-Indian trade decelerated to 15.1% yoy in 1H18 from 20.3% yoy in 2017.

The growth in China's exports to Brazil stayed high at 34.0% yoy in 1H18, after registering 31.8% yoy in 2017. In contrast, the growth in China's imports from Brazil decelerated to 20.0% yoy in 1H18 from 27.8% yoy in 2017. Consequently, the growth in Sino-Brazilian trade moderated to 24.3% yoy in 1H18 from 29.1% yoy in 2017.

Together, these three BRIC members accounted for 6.6% of China's total exports and 6.9% of China's total imports in 1H18, up from 6.2% and 6.3%, respectively, in 2017.

26

**Exhibit 29** China's trading partners, 1H18

Country/ Region	Trade value (USD billion)	Share of total trade (%)	Export value (USD billion)	Import value (USD billion)	yoy growth (%)		
					Total trade	Exports	Imports
EU	322.6	14.6	191.8	130.8	13.0	11.7	15.0
US	301.8	13.7	217.8	84.0	13.1	13.6	11.8
ASEAN	280.6	12.7	152.9	127.7	19.3	18.3	20.6
Japan	157.5	7.1	70.4	87.1	10.7	8.0	12.9
Brazil	51.9	2.4	17.2	34.7	24.3	34.0	20.0
Russia	49.1	2.2	22.5	26.6	24.8	17.7	31.6
India	46.9	2.1	37.4	9.5	15.1	15.0	15.5

Source: China Customs

**Exhibit 30** China's trading partners, comparing growth rates for 2017 and 1H18

Country/Region	Total Trade		Exports		Imports	
	2017	1H18	2017	1H18	2017	1H18
EU	12.7	13.0	9.7	11.7	17.6	15.0
US	12.3	13.1	11.5	13.6	14.5	11.8
ASEAN	13.8	19.3	9.0	18.3	20.1	20.6
Japan	10.1	10.7	6.1	8.0	13.7	12.9
Brazil	29.1	24.3	31.8	34.0	27.8	20.0
Russia	20.8	24.8	14.8	17.7	27.7	31.6
India	20.3	15.1	16.5	15.0	38.9	15.5

Source: China Customs

## 5. Exports from Guangdong, Shanghai and Shandong show relatively slow growth in 1H18

China's top six provinces and municipalities in terms of value of exports – Guangdong, Jiangsu, Shanghai, Zhejiang, Shandong and Fujian – jointly accounted for 77.1% of China's total exports in 1H18, down from 78.1% in 2017 (*see exhibit 31*). The drop in the share of exports of these six provinces was due to the relatively slow growth of exports from Guangdong, Shanghai and Shandong in 1H18. Exports from Guangdong, Shanghai and Shandong expanded by 5.6% yoy, 7.7% yoy and 11.3% yoy, respectively, in 1H18, lower than the country's total export growth (12.8% yoy) during the period.

Several western provinces in China witnessed robust year-on-year growth in exports in 1H18. Exports from Gansu and Shaanxi soared by 63.9% yoy and 60.0% yoy respectively over the period.

**Exhibit 31** Top six provinces and municipalities in terms of value of exports, 1H18

Provinces/ Municipalities	Value of exports (USD billion)	yoy growth (%)	Share of total exports (%)
Guangdong	325.9	5.6	27.8
Jiangsu	198.7	15.3	17.0
Zhejiang	157.3	14.3	13.4
Shanghai	88.0	7.7	7.5
Shandong	82.7	11.3	7.1
Fujian	50.3	17.2	4.3

Source: China Customs

## 6. China's FDI grows slightly by 1.1% yoy in 1H18

After falling by 1.1% yoy in April, China's foreign direct investment (FDI) in Renminbi terms recorded positive growth of 7.6% yoy and 0.3% yoy in May and June, respectively. Overall, in 1H18, China's FDI amounted to 446.3 billion yuan, up slightly by 1.1% yoy (*see exhibit 32*).

In 1H18, FDI in the Hi-Tech industries grew by 1.6% yoy to 93.3 billion yuan, accounting for 20.9% of the total FDI in the quarter. Among Hi-Tech industries in the manufacturing sector, FDI in the 'electronics and communications equipment industry', the 'computers

and office equipment industry' and the 'medical instruments, meters and equipment industry' grew rapidly by 36.0% yoy, 31.7% yoy and 179.6% yoy respectively during the period. Among Hi-Tech industries in the service sector, FDI in the 'transformation of scientific and technological achievements industry' recorded year-on-year growth of 22.2% yoy in 1H18.

**Exhibit 32** China's FDI, July 2017 to June 2018

	Amount (billion yuan)	yoy growth
FY17	877.6	7.9%
1H18	446.3	1.1%
July 17	43.9	-11.8%
August	62.5	9.1%
September	70.6	17.3%
October	60.1	5.0%
November	124.9	90.7%
December	73.9	-9.2%
January 18	80.4	0.3%
February	59.0	0.8%
March	88.1	0.4%
April	59.2	-1.1%
May	58.8	7.6%
June	100.7	0.3%

Source: Ministry of Commerce, PRC

## 7. China's foreign exchange reserves decrease in 2Q18

As at the end of 2Q18, China's foreign exchange reserves amounted to US\$ 3,112.1 billion, down by US\$ 30.7 billion in 2Q18 (*see exhibit 33*). This is the first time in five quarters that the foreign exchange reserves posted a quarter-on-quarter drop.

The fall in the foreign exchange reserves in 2Q18 was due largely to the depreciation of the non-US dollar currencies.<sup>14</sup> In our view, the value of China's foreign exchange reserves in the near term will depend largely on the strength of the US dollar, which affects the US-dollar value of non-US-dollar denominated assets in the reserves. If the US dollar continues to appreciate, the value of China's foreign exchange reserves (in terms of the US dollar) is likely to drop further.

**Exhibit 33** Foreign exchange reserves by quarter, 3Q17 to 2Q18

USD billion	Accumulation	End of the quarter
FY17	129.4	
3Q17	51.7	3,108.5
4Q17	31.4	3,139.9
1Q18	2.9	3,142.8
2Q18	-30.7	3,112.1

Source: State Administration of Foreign Exchange, PRC

<sup>14</sup> According to the Bloomberg, the US dollar index was 94.47 on 29 June, compared to 89.97 on 30 March.

## B Highlights

### 1. China-US trade war breaks out

After a few months of back-and-forth tariff threats between the US and China, a China-US trade war finally broke out on 6 July as the US started to levy 25% additional tariffs on US\$34 billion worth of Chinese imports, and China followed suit immediately and imposed 25% additional tariffs on the same amount of US imports.

These tariffs were part of the tariffs proposed on US\$50 billion of products from each of the countries. The US tariffs on the remaining US\$16 billion will take effect on 23 August. China will also begin to levy tariffs on US\$16 billion of US imports on the same date.

30

The US tariffs mainly target China's industrial goods, in particular products from the ten industrial sectors highlighted in the *Made in China 2025* policy. The tariffs do not affect general consumer goods such as apparel, footwear, or mobile phones. Meanwhile, China's tariffs are imposed on US agricultural products, aquatic products, autos, energy products, chemical products, and medical supplies.

On 10 July, the US administration announced a list of US\$200 billion worth of Chinese goods for 10% additional tariffs in retaliation for China's revenge. On 1 August, the US proposed to raise the tariff rate to 25%. This round of tariffs is undergoing a public review process until 5 September, after which the United States Trade Representative (USTR) will issue a final determination. US President Donald Trump also warned to levy extra tariffs on all Chinese imports if China retaliates.

The US\$200 billion-worth product list covers 6,031 tariff items, including consumer goods such as apparel, footwear, furniture, handbags and suitcases, gloves, beauty products, and refrigerators. It also includes hundreds of food products as well as textiles, tobacco, chemicals, coal, steel and aluminum and technology products.

In retaliation, the Chinese government announced on 3 August that it is poised to impose additional tariffs of 5%, 10%, 20% or 25% on US\$60 billion worth of US imports, if the US goes ahead with its latest tariff threat. The implementation date of the tariffs will be announced later and subject to the actions of the US.

A Chinese delegation led by Vice Minister of Commerce Wang Shouwen will visit Washington on 22-23 August to meet US representatives led by Treasury Under Secretary for International Affairs David Malpass. In our view, it is still possible that the China-US trade disputes can be resolved through negotiations before further escalating to a full-fledged trade war. We will continue to keep a close eye on the latest developments of the China-US trade war in the coming months.

### 2. Chinese yuan depreciates against US dollar and Euro

The Chinese yuan has weakened against the US dollar since mid-April. The daily fixing rate (also known as the central parity rate) of the Chinese yuan against the US dollar depreciated to 6.8513 on 6 August, the weakest level since 1 June last year (*see exhibit 34*).<sup>15</sup>

In line with the movement of the daily fixing rate, the USD-CNY spot exchange rate has shown depreciation trend since mid-April.<sup>16</sup> So far this year, the USD-CNY spot exchange rate has depreciated by 4.82% (as of 6 August).

The daily fixing rate of the Chinese yuan against the Euro depreciated from its recent peak of 7.4379 on 15 June to 7.9864 on 1 August, before appreciating slightly to 7.9257 on 6 August (*see exhibit 35*). So far this year, the daily fixing rate of the Chinese yuan against the Euro has depreciated by 1.56%.

<sup>15</sup> According to the PBOC, the daily fixing rate (also known as the central parity rate) of the Chinese yuan against the US dollar is directly formed by market makers based on the closing rate of the previous day, the supply-demand conditions in the market and the movements of major international currencies.

<sup>16</sup> The daily trading band of the Chinese yuan against the US dollar is  $\pm 2.0\%$  around the daily fixing rate.

According to the Bank for International Settlements, the real effective exchange rate (REER) of the yuan rose from 126.32 in April to 127.24 in May, the second highest level since April 2016, and then dropped a bit to 126.43 in June.<sup>17</sup> Overall, in 1H18, the Chinese yuan appreciated in real terms against its trading partners by 4.0% (see exhibit 36).

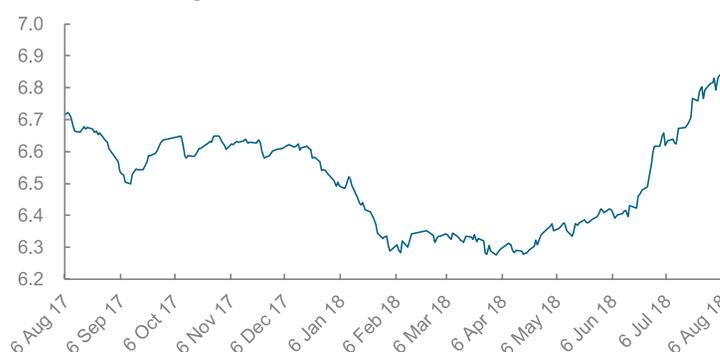
Looking ahead, we predict that the exchange rate of the Chinese yuan against the US dollar will remain weak as the US dollar is set to stay strong against major currencies in the global market and China's monetary policy has shown signs of easing recently. On 5 July, China's central bank made a targeted cut in the RRRs of some banks in China by 50 bps, pumping funds of about 700 billion yuan into the banking system. Besides, at the Politburo meeting held on 31 July, Chinese leaders vowed to 'adopt a prudent monetary policy', dropping the term 'neutral' used just a few months ago.

### 3. China lowers import tariff rates on a wide range of consumer products

On 31 May, the Chinese government announced to reduce the tariff rates for imports of 1,449 tariff items effective from 1 July.<sup>18</sup> These 1,449 tariff items include a wide range of consumer products such as food, beverages, medicines, chemical products for daily use, clothing, shoes, hats, home textiles, kitchen products, home appliances and watches, etc. According to the notice published by the Chinese government, this move would reduce the average tariff rate for imports of those 1,449 tariff items from 15.7% to 6.9%.<sup>19</sup>

It is expected that the retail prices of related imported products will fall, as the lower import tariffs will give the retailers more room to reduce prices.

**Exhibit 34** USD-CNY daily fixing rate, August 2017 to August 2018



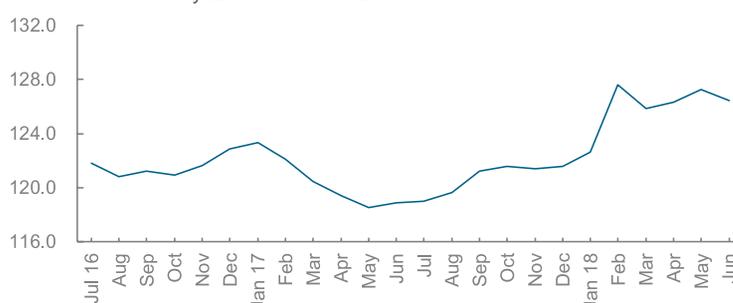
Source: State Administration of Foreign Exchange

**Exhibit 35** EUR-CNY daily fixing rate, August 2017 to August 2018



Source: State Administration of Foreign Exchange

**Exhibit 36** Real effective exchange rate of the Chinese yuan, July 2016 to June 2018



Source: Bank for International Settlements

<sup>17</sup> The Bank for International Settlements (BIS) calculates effective exchange rate (EER) indices for a total of 61 economies (including individual Eurozone countries and, separately, the Eurozone as an entity). Nominal EERs are calculated as geometric weighted averages of bilateral exchange rates. Real EERs are the same weighted averages of bilateral exchange rates adjusted by relative consumer prices. The weighting pattern is time-varying, and the most recent weights are based on trade in 2011-13.

<sup>18</sup> [http://www.gov.cn/xinwen/2018-06/01/content\\_5295388.htm](http://www.gov.cn/xinwen/2018-06/01/content_5295388.htm)

<sup>19</sup> [http://www.mof.gov.cn/zhengwuxinxi/caizhengxinwen/201806/t20180601\\_2915138.htm](http://www.mof.gov.cn/zhengwuxinxi/caizhengxinwen/201806/t20180601_2915138.htm)

## C Outlook

### 1. US economic growth accelerates in 2Q18

Due partly to the faster growth in personal consumption expenditures and exports, the US economic growth accelerated in 2Q18. The US real GDP expanded by an annual rate of 4.1% in 2Q18, the highest level since 4Q14, compared to the annual growth of 2.2% in 1Q18 (*see exhibit 37*).

On the production side, industrial production grew by 0.6% mom in June, recording positive month-on-month growth in four of the past five months (*see exhibit 38*). Besides, the new orders for manufactured durable goods gained 0.8% mom in June. However, the manufacturing PMI dropped from its recent peak of 60.2 in June to 58.1 in July, indicating a moderation in the growth of the manufacturing sector.

The non-manufacturing sector has expanded at a relatively slow pace lately: the non-manufacturing index (NMI) went down from 59.1 in June to 55.7 in July, the second lowest level in 12 months.

The retail sector in the US has fared well in recent months. The US retail sales gained 0.5% mom in June, posting month-on-month growth for five consecutive months. Nevertheless, the Reuters/ University of Michigan index of consumer sentiment came in at 97.9 in July, the lowest level since February this year, indicating that US consumers have become less optimistic lately (*see exhibit 39*).

The labour market in the US has remained solid in recent months, boding well for the consumption in the country. The US unemployment rate stayed low at 3.9% in July (*see exhibit 40*). Meanwhile, the non-farm payroll employment increased at a relatively slow pace, by 157,000, in the same month.

Looking ahead, the US economic growth is likely to further accelerate in near term, especially as the tax reform beginning this year would boost both consumption and investment in the country. According to the latest projection by the IMF, the real GDP growth rate for the US is forecast to be 2.9% in 2018, up from 2.3% in 2017.<sup>20</sup>

**Exhibit 37** US national accounts, 2016 to 2Q18

Annual growth (%)	2016	2017	3Q17	4Q17	1Q18	2Q18
Real GDP	1.6	2.2	2.8	2.3	2.2	4.1

Source: US Department of Commerce

**Exhibit 38** US industrial sector, January to June 2018

mom growth (%), seasonally adjusted	Jan 18	Feb	Mar	Apr	May	Jun
Industrial production	-0.3	0.4	0.5	1.1	-0.5	0.6
New orders for manufactured durable goods	-4.2	4.5	2.7	-1.0	-0.3	0.8

Source: US Federal Reserve, US Department of Commerce

**Exhibit 39** US consumer market, February to July 2018

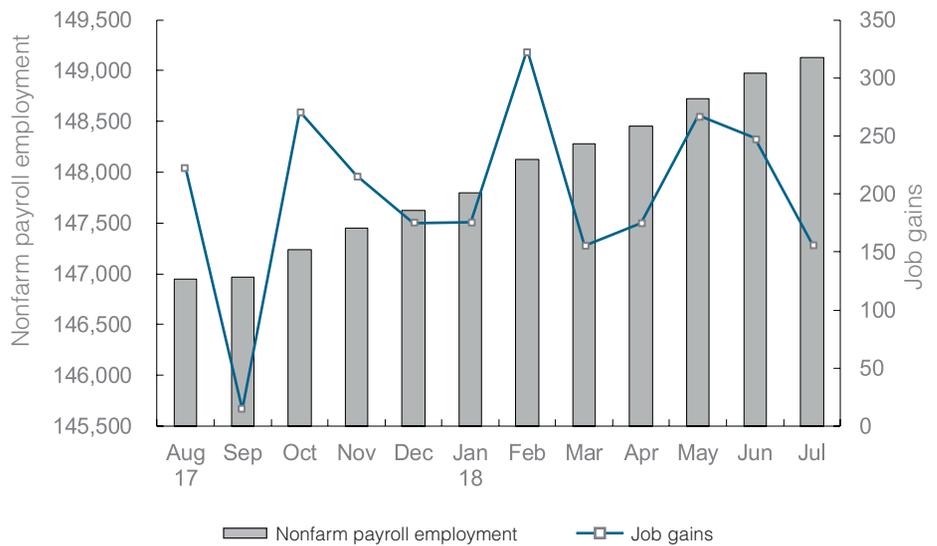
	Feb 18	Mar	Apr	May	Jun	Jul
Retail and food services sales (mom growth %, seasonally adjusted)	0.1	0.7	0.3	1.3	0.5	-
Reuters/University of Michigan index of consumer sentiment	99.7	101.4	98.8	98.0	98.2	97.9
CPI (yoy growth %)	2.2	2.4	2.5	2.8	2.9	2.9

Source: US Department of Commerce, Reuters/University of Michigan Surveys of Consumers, US Department of Labor

**Exhibit 39** US employment

	Unemployment rate (%)
2016	4.9
2017	4.4
Aug 17	4.4
Sep	4.2
Oct	4.1
Nov	4.1
Dec	4.1
Jan 18	4.1
Feb	4.1
Mar	4.1
Apr	3.9
May	3.8
Jun	4.0
Jul	3.9

Nonfarm payroll employment, August 2017 to July 2018  
In thousands, seasonally adjusted



Yearly figures: Annual average  
Monthly figures: Seasonally adjusted

Source: US Department of Labor

## 2. Eurozone economy shows signs of further moderation

The Eurozone economy has shown signs of further moderation recently.<sup>21</sup> The real GDP growth in the Eurozone came in at 0.3% qoq in 2Q18, falling for two consecutive quarters (see exhibit 41).

According to the global survey firm Markit Economics, the Eurozone manufacturing PMI fell all the way from 60.6 in December to an 18-month low of 54.9 in June, before showing a slight rebound to 55.1 in July. The latest figure indicates that the manufacturing sector in the Eurozone has expanded at a relatively slow pace recently.

<sup>21</sup> The member countries of the Eurozone include Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

## Part 2 : Foreign Trade

The Eurozone services PMI rose from 53.8 in May to 55.2 in June, and then dropped to 54.2 in July, indicating a fluctuation in the growth of the service sector in the region.

The retail trade volume in the Eurozone rose by 0.3% mom on a seasonally adjusted basis in June, recording positive month-on-month growth in four of the past five months (*see exhibit 42*).

The labour market conditions in the region have further improved recently. The seasonally-adjusted unemployment rate fell from 8.4% in April to 8.3% in May and in June (*see exhibit 43*). Nevertheless, confidence

among consumers and managers in various sectors has continued to decrease: since January this year, the Eurozone's economic sentiment indicator (ESI) has been on a downward trend, falling to an eleven-month low of 112.1 in July (*see exhibit 44*).

Going forward, the growth of the Eurozone economy is expected to decelerate in near future. In its latest *World Economic Outlook Update* published in July, the IMF forecasts that the real GDP growth rate for the Eurozone will fall gradually from 2.4% in 2017 to 2.2% in 2018, and further to 1.9% in 2019.<sup>22</sup>

**Exhibit 41** Eurozone's real GDP growth, 2016 to 2Q18

	2016	2017	3Q17	4Q17	1Q18	2Q18
Real GDP ( <i>qoq growth %</i> )			0.7	0.7	0.4	0.3
Real GDP ( <i>yoy growth %</i> )	1.8	2.4	2.8	2.8	2.5	2.1

Source: Eurostat, World Bank

**Exhibit 42** Eurozone consumer market, January to June 2018

	Jan 18	Feb	Mar	Apr	May	Jun
Volume of retail trade ( <i>mom growth %, seasonally adjusted</i> )	-0.4	0.3	0.6	-0.2	0.3	0.3
Annual inflation (%)	1.3	1.1	1.3	1.3	1.9	2.0

Source: Eurostat

**Exhibit 43** Eurozone labour market, January to June 2018

<i>seasonally adjusted</i>	Jan 18	Feb	Mar	Apr	May	Jun
Unemployment rate (%)	8.7	8.6	8.5	8.4	8.3	8.3

Source: Eurostat

**Exhibit 44** Eurozone economic sentiment indicator, February to July 2018

<i>seasonally adjusted</i>	Feb 18	Mar	Apr	May	Jun	Jul
Economic sentiment indicator	114.3	112.8	112.7	112.5	112.3	112.1

Source: Eurostat

### 3. China's exports are expected to show single digit growth in 3Q18

According to the *World Economic Outlook Update* released in mid-July, the IMF forecasts that the world economic growth will accelerate modestly from 3.7% in 2017 to 3.9% in 2018 and 2019. The growth in the advanced economies is projected to maintain relatively fast growth of 2.4% in 2018, before moderating to 2.2% in 2019. Meanwhile, the growth in the emerging market and developing economies is projected to accelerate from 4.7% in 2017 to 4.9% in 2018 and 5.1% in 2019 (see exhibit 45). Nevertheless, the downside risks to the world economic growth have become more salient lately, coming mainly from escalating trade tensions, geopolitical instability, tighter financial conditions and the resulting reductions in capital inflows to emerging markets.

Looking ahead, we forecast that China's exports will only show a single-digit year-on-year growth in 3Q18, compared to the growth of 11.8% yoy in 2Q18. Challenges facing Chinese manufacturers include the China-US trade war, stronger government's efforts to enforce environmental regulations, a marked increase in prices of raw materials, intense competition in the international market, and the weak demand for luxury products.

**Exhibit 45** Latest GDP growth forecasts by the IMF

<i>yoy growth (%)</i>	2017 (Estimates)	2018 (Forecasts)	2019 (Forecasts)
<b>World economy</b>	<b>3.7</b>	<b>3.9</b>	<b>3.9</b>
<b>Advanced economies</b>	<b>2.4</b>	<b>2.4</b>	<b>2.2</b>
US	2.3	2.9	2.7
Eurozone	2.4	2.2	1.9
Japan	1.7	1.0	0.9
<b>Emerging market and developing economies</b>	<b>4.7</b>	<b>4.9</b>	<b>5.1</b>
China	6.9	6.6	6.4
India *	6.7	7.3	7.5
Brazil	1.0	1.8	2.5
Russia	1.5	1.7	1.5

\* Data and forecasts are presented on a fiscal year basis.

Source: IMF, US Department of Commerce, Eurostat, National Bureau of Statistics, PRC

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