Phat dragon # 185

a weekly chronicle of the Chinese economy

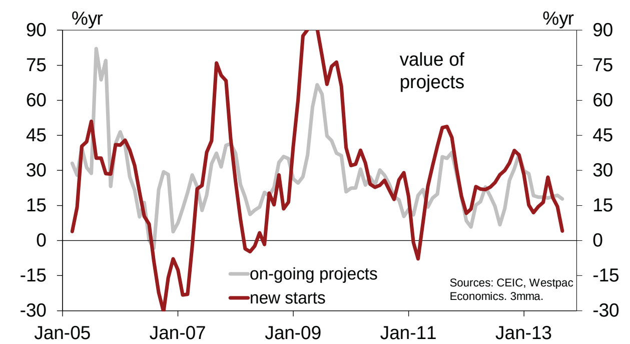
22 October 2013

- Writing in his Q3 GDP and month-of -September data review last Friday, ***Phat Dragon*** argued that "... The major story here it that some fatigue is beginning to creep into the infrastructure spend, particularly in the railway segment. ***Phat Dragon's*** abstract conception of the 2013 growth 'hump' has always included an allowance for this, and it is manifesting on cue." Such a statement demands deeper enquiry, which was unfortunately not possible on Friday. Consider the raw numbers. Fixed investment in railways ended 2012 at 2.4%ytd and ended the first half of 2013 at 22.2%ytd. As of September, railways capex is tracking at 10.2%ytd. The corresponding year-ended rates are very volatile and the cycle amplitude large, but the month of September figure of –12.8% is certainly striking, given the end-2012 equivalent of +21.3% and the April peak at +61.9%. The predictable cresting and then decline in the growth rate of railway investment is now conclusively underway, and will be a drag on the (progressively broadening) categories of transport, infrastructure and tertiary industry capex through the end of this year and in the first half of 2014.

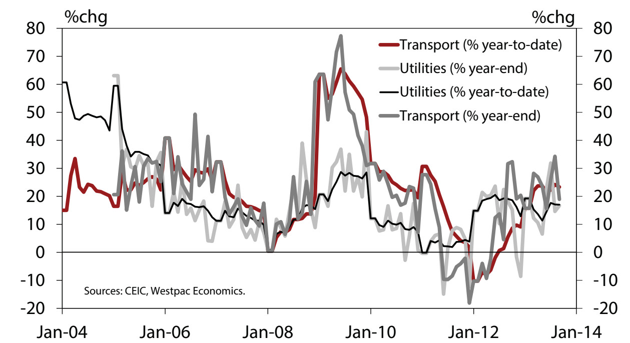
- The factors holding up those important categories in the face of the rail slowdown have been accelerating outlays on highways and continued high growth in the strategically important (and massive) utility and environmental management complex. Yet even here there are signs that a peak in growth rates has been reached. ***Phat Dragon*** observes that the growth in the value of new projects across the urban economy has slowed quite abruptly, to be well below that of ongoing work, implying that the pipeline is being replenished at a rate that is insufficient to maintain current growth rates. A rolling over in the growth of centrally-approved and SOE capex is consistent with that inference, as is the observation that the investment upturn has been relatively narrow (i.e. very large project size, but fewer of them), which made it fundamentally vulnerable once the swing sectors saw their momentum crest.

- China's financial plumbing has been a fascinating study over the last year and a half. The major story has been the rising sophistication of the PBoC's liquidity management. Since the last cut to required reserves in May 2012, the PBoC has increasingly come to rely on repo and reverse repo transactions as its primary tools, while taking advantage of the maturity schedules of prior activity to keep its actions as parsimonious as possible. ***Phat Dragon*** has previously noted the subtle volume-price adjustments of very recent times, and the complex interplay between domestic liquidity imperatives and increasingly dynamic cross border flows. The month of September is instructive. FX reserves increased by an extremely large $US109.6bn in the month, the most substantial marginal accretion since the same month in 2010, despite a narrower trade surplus. By way of context, FX reserve growth has only exceeded $US100bn in a month on three other occasions, and the $US85.6bn residual (non-trade and FDI) is the largest on record. This liquidity injection (plus the modest revival observed in interbank lending and bond issuance volumes) enabled the PBoC to run a relatively austere operation through the month, without any deleterious impact on system funding. And as an aside, ***Phat Dragon*** wonders exactly where SAFE will choose to deploy that presumably unexpected jump in its holdings, with US debt suffering a further reputational loss over the latest Congressional fiasco. Come to think of it, the Korean won and the Australian dollar have looked awfully strong of late ...

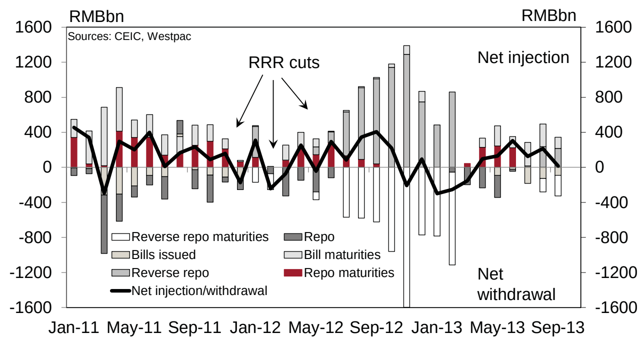
New and ongoing projects



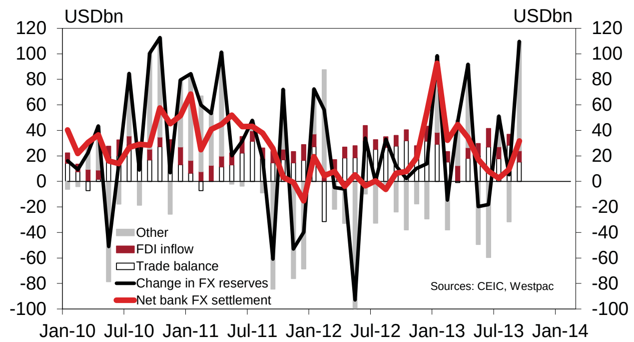
Infrastructure investment



People's Bank open market operations



FX reserves, capital flows & bank FX positions



- **Stats of the week: China is the world's 5th largest oil producer, despite having only the 16th largest reserve.**

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