

China

Slowdown led by state-owned manufacturers

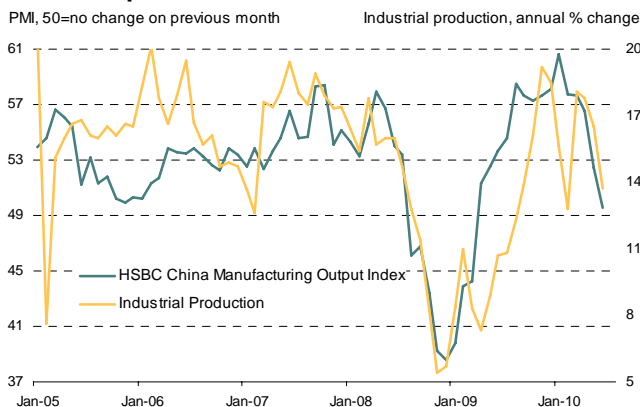
- Overall drop in manufacturing output centres on state-owned enterprises.
- State-owned firms see steeper rate of price discounting, and also job losses.

PMI dips below 50.0

The HSBC China Manufacturing PMI™, produced using the same methodology used by Markit for PMIs in 20 countries, fell below the neutral 50.0 mark that separates expansion from contraction in July, pointing to the first month-on-month deterioration in Chinese manufacturing sector operating conditions since March 2009. Behind the latest PMI reading, July's survey pointed to further declines in output and new business, while staff numbers rose only marginally.

Fall in manufacturing output led by state-owned enterprises

Industrial production



Sources: Markit, National Bureau of Statistics.

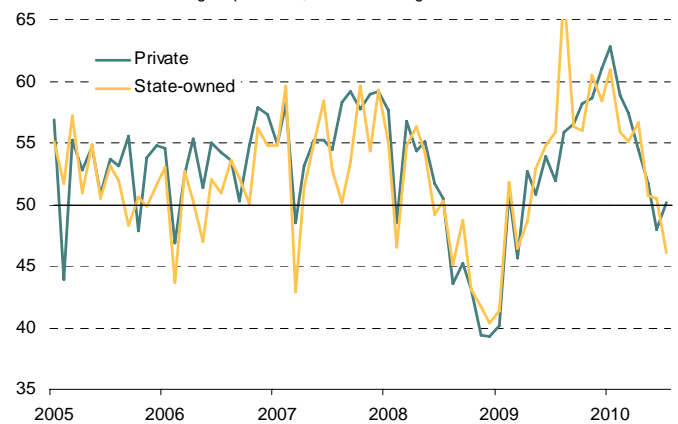
The slowdown signalled by the PMI is being borne out by official data. The National Bureau of Statistics (NBS) stated that industrial production grew at an annual rate of 13.7% in June, compared with a 16.5% increase in May and almost 20% at the end of last year.

Many analysts believe the slowdown is at least in part attributable to deliberate policies designed to prevent overheating by the authorities, a belief which gains

weight with the publication of the July PMI data, which showed state-owned enterprises leading the downturn.

Manufacturing output

HSBC PMI Manufacturing Output Index, 50 = no change



Source: Markit.

Throughout the first half of 2010, the slowdown in manufacturing output growth – a key component of the headline PMI – was broad-based across both private and public sector enterprises. However, July PMI data paints a more divergent picture. Output at state-owned enterprises fell solidly, dropping for the first time since April of last year (with the rate of contraction the steepest since January of last year). On the other hand, production at private sector enterprises was little changed since June, although the rate of growth has slowed sharply since earlier in the year.

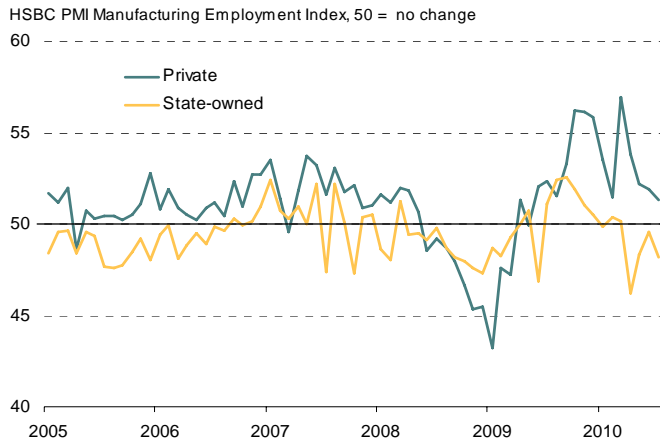
Falling staff numbers at state-owned enterprises

More significant than the output growth differential, however, has been the difference between employment and price setting trends at state-owned and private companies.

At the headline level, Chinese manufacturing employment growth was signalled for the fourteenth month running in July, supported by a modest rise in staffing levels at private sector enterprises. In contrast, employee numbers at state-owned companies fell for the fourth month in a row. The average reading of the

state-owned enterprises Employment Index has been 48.7 in the latest three-month period compared to an average of 51.8 for private enterprises.

Manufacturing employment



Source: Markit.

The employment situation in China has become more complex since the economic recovery began. Reports suggest that manufacturers are currently facing a shortage of once abundant labour, with anecdotal evidence from the PMI survey signalling that output was restricted by a reduced supply of labour at a number of manufacturers in July. This appeared to be most evident in the clothing & textiles sector.

Labour shortages have also boosted wages across the manufacturing sector. Anecdotal survey evidence indicated that staffing levels fell at some companies as employees left their jobs to seek higher wages elsewhere.

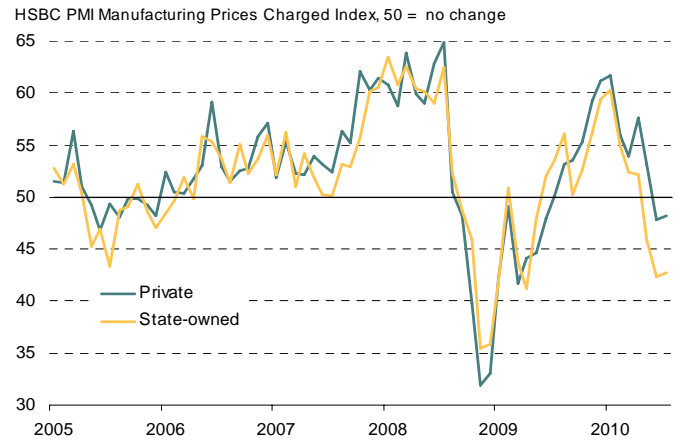
State-owned companies persist with steep price discounting

PMI data for Q2 as a whole signalled that state-owned enterprises led the fight against inflation, with the seasonally adjusted Output Prices Index for SOEs averaging 46.8 compared to 52.8 for private enterprises. This trend continued in July, with the rate of price discounting at state-owned manufacturers similar to that seen in June, which was the highest for 14 months and substantially greater than seen in the private sector.

Given that state-owned enterprises have seen slightly higher rates of (raw material) input price inflation than privately-owned companies in recent months, the greater rate of output price discounting seen at state-owned companies is usual and suggests that state

enterprises are more actively engaged in the fight against inflation.

Manufacturing output prices



Source: Markit.

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