

# China Economic Update



As is usually the case for this time of year, the seasonal impacts from the Lunar New Year (LNY) holiday are reaping havoc with China's economic data. In addition to the obvious seasonal impacts, statistical authorities also refrain from releasing some of the more closely watched statistics on economic activity for January. The data that have been released paint a fairly mixed picture of the economy, but are worth mentioning nonetheless. Trade data for January saw a spike in both imports and exports, with exports growth accelerating to 25% y-o-y (up from 14% for December). While this was above market expectations, official estimates stripping out the LNY effect actually show growth decelerating to 12.4% y-o-y (down from 19.2% in December). Despite this easing in the growth rate it is still up on the sluggish pace seen for most of last year, continuing on from the surprising improvement in external demand recorded in December.

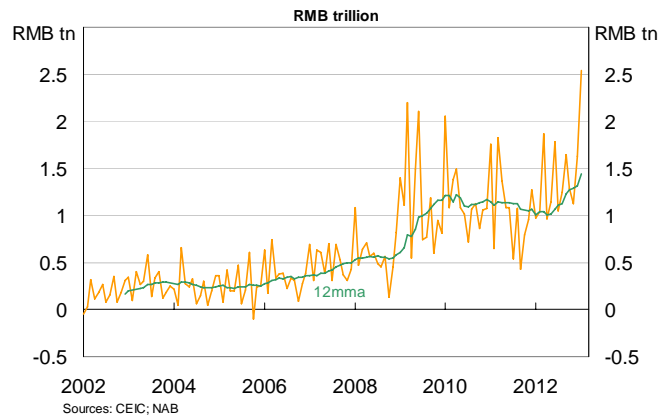
China's monetary aggregates were also released for January, showing a sharp up-tick in credit for the month. While this is a positive sign for credit demand in the economy, it could also partly represent a bringing forward of demand ahead of LNY. Similarly, reports of a clamp down on credit issuance late last year (as some banks approached their credit limits) may have resulted in some pent-up demand as well. While the magnitude of these effects is difficult to gauge, they could suggest that the strength in January may not be sustained over coming months. It is worth noting that much of the increase in credit demand has been serviced via strong growth in non-bank financing. This is likely to concern authorities, particularly in the face of potential hot money inflows from quantitative easing in developed economies.

Finally, CPI data shows that inflation pressures remain under control, at least for the time being, although the shift of LNY to February will likely see a one-off spike in CPI next month. With the economy showing signs of improvement, we may start to see attention shifts from supporting the economy to containing prices – a sentiment hinted at with the latest quarterly monetary report from the PBoC.

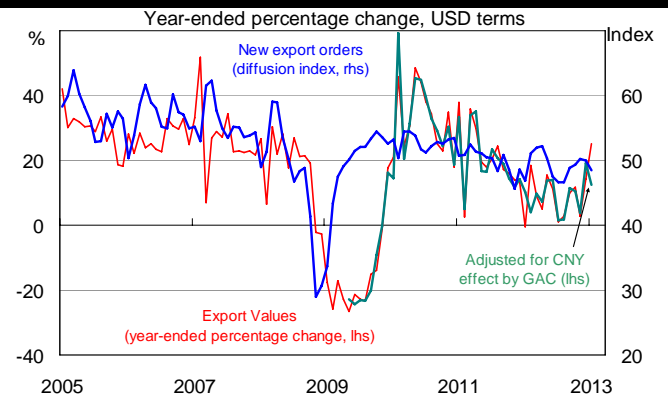
Given the limited release of economic data this month, we have taken the opportunity to look at an issue that has garnered a fair bit of attention lately – China's shifting demographics. Although this is a topic that has long held the interest of 'China watchers', broader interest has been renewed following the release of annual population data showing that China's working age population actually declined in 2012 (aged 15 to 59), falling by 3.5 million workers in the year. This observation coincides with the release of a new report from the IMF that investigates the depleting supply of excess labour in China; a demographic dividend that has been crucial to the industrialisation of the economy – a major driver of China's impressive economic growth.

Following the introduction of the one child policy in 1978, China has experienced a pronounced shift in its demographic composition. According to UN statistics, China's child dependency ratio peaked at over 70% in the mid-1960s following the Great Chinese Famine of 1958-1961, which resulted in the deaths of tens of millions of people (although estimates vary significantly). In the three decades following the introduction of the 'family

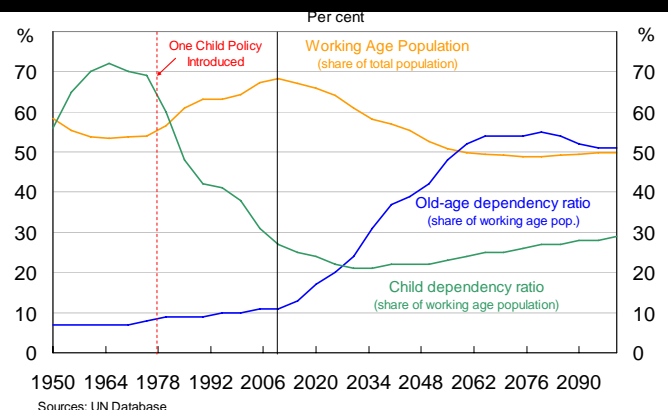
China's total social financing



China's export growth improving, but partly driven by LNY



China's demographic dividend has deteriorated



planning policy' the ratios has fallen significantly (to around 25%) as the working age population soared – an important driver of China's labour cost competitiveness.

However, breaking down the population into age cohorts demonstrates that the situation is approaching a turning point. The cohorts of the population that are about to drop out of the working age population have started to become so large that UN projections have the working age population peaking in the near-term, consistent with the decline recently observed for 2012. Although demographic shifts are slow moving, they are also impossible to prevent (at least in the medium-term). What does this mean for the Chinese economy?

Without delving too much into the economic theory, China's shifting/deteriorating demographic composition suggests to many observers that the economy is fast approaching its 'Lewis Turning Point' (LTP) – where the supply of surplus labour runs dry, driving up wages and eroding the competitiveness in international trade. Under Lewis' theory, more productive (industrial) sectors of the economy are able to grow rapidly in the early stages of economic development by drawing on abundant surplus labour within the unproductive/ inefficient (usually agricultural) sectors. This allows for much faster growth in the industrial sector without putting upward pressure on wages. The result is higher profits for firms that can be reinvested to accumulate capital.

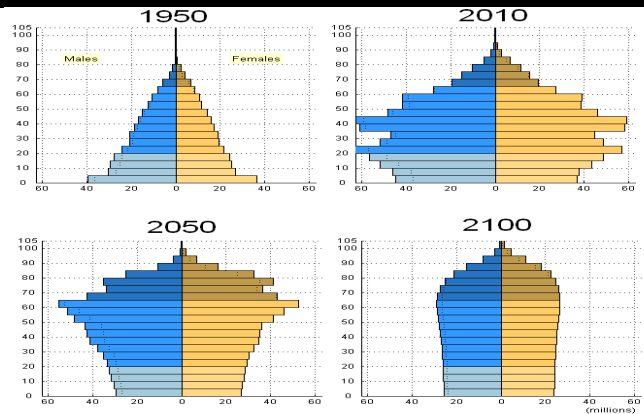
Observed trends in China are consistent with this first phase of development. Employment data shows a clear shift in the concentration of Chinese workers away from the inefficient agricultural sector towards industry and services. Similar observations can be found in the production data, with the share of primary industries in the economy falling to around 10% from 30% three decades ago. Similarly, firms and SOEs have reaped the benefits of productivity growth that has outpaced wages, evidenced by rapid growth in industrial profits and capital accumulation.

While most would agree that China is fast approaching the Lewis Turning Point, evidence of when it will occur (if it has not already) remains mixed. The falling working age population, rising wage pressures (although partly attributable to increases in minimum wages) and softer profit growth all suggest the turning point has arrived. Urban registration records suggest that labour markets in Chinese cities have become more balanced in recent years, and may now be considered relatively tight. An increase in labour activism observed over recent years further supports the idea that tighter labour markets are shifting (marginally) more power in favour of workers.

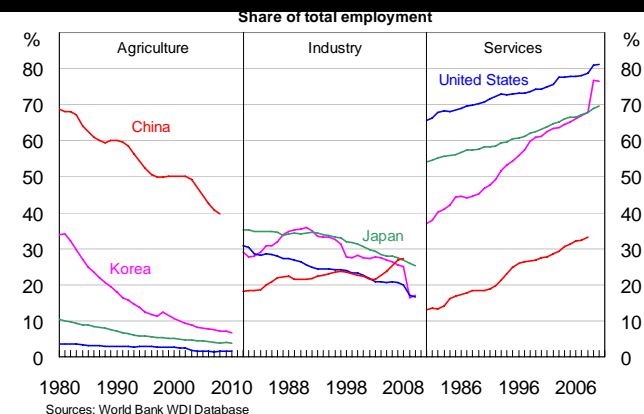
In contrast, the large share of agricultural workers in the economy, and the wide (albeit shrinking) income divide, suggest there continues to be an excess of labour in the agricultural sector. Note that China's gini coefficient (0.474 in 2012) remains above the levels typically associated with civil unrest. However, restrictions on the mobility of labour (Hukou system) are contributing to the excess labour, suggesting that (in the absence of policy reform) crossing the LTP in China may be a more drawn out process than would otherwise be expected. IMF estimates of China's excess labour suggest that, if the status quo is maintained (fertility and labour participation rates), excess labour should be exhausted between 2020 and 2025. Policy reforms to boost participation, such as more training for rural workers, accelerating hukou reforms and improving productivity in the agricultural sector could help to free-up additional labour. The IMF estimates that such policies could postpone the LTP until after 2025.

China's unit labour costs have risen significantly in the past 6 years (abstracting from declines during the GFC) – implying that wage growth has started to outpace overall productivity in the economy. In the past five years, real

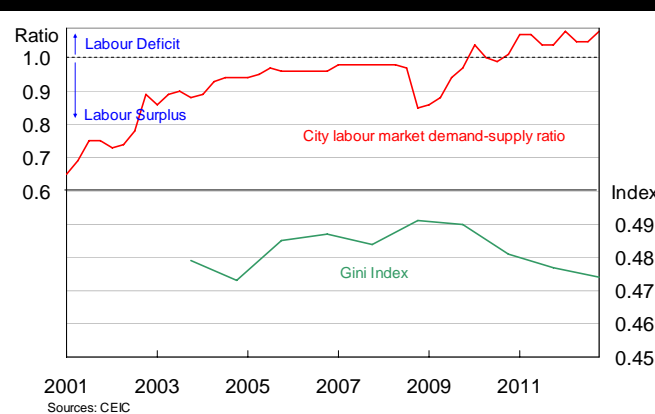
Evolution of China's population distribution (UN)



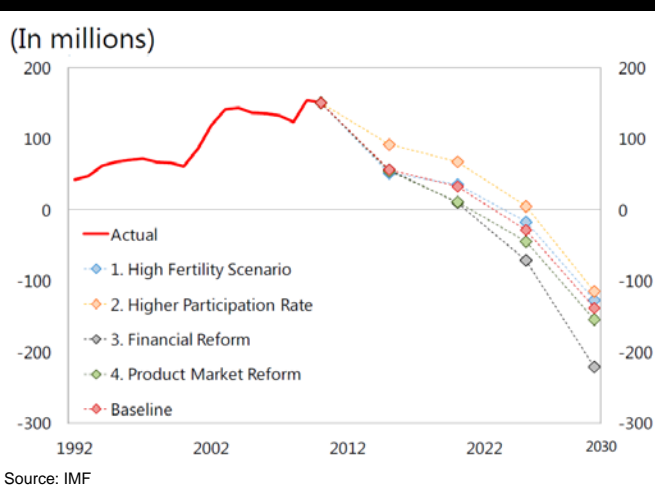
Composition of labour



China's labour market conditions



China's Surplus Labour (IMF Estimation – Various scenario)



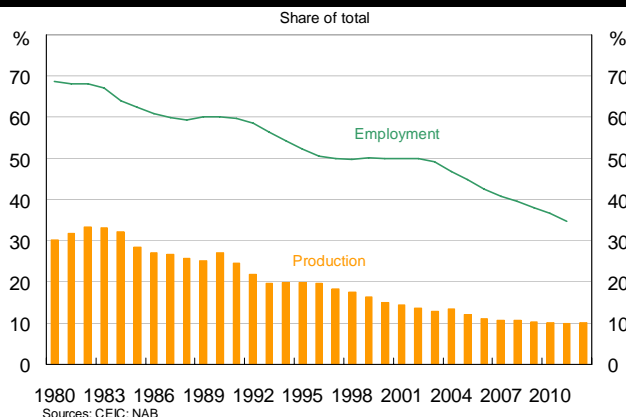
incomes of urban households have increased around 9% annually, keeping pace with labour productivity while total factor productivity (TFP) has risen around 4½% annually; incomes rose faster than EIU's estimates of labour productivity in 2012. Rising exchange rates and unit labour costs have been eroding China's competitiveness in international trade. Since 2007, China's unit labour costs have risen by around 40% relative to their trading partners.

Consequently, China has lost some of its allure as a base for manufacturing operations of large multinationals. There are many examples where operations have shifted offshore, particularly in low-tech/labour intensive industries, and a "China plus one" strategy has increased in popularity among firms to test the waters of other markets as a base of manufacturing operations. Foreign direct investment in China declined in 2012 for the first time since the GFC, including a 6.2% decline in manufacturing FDI, although rising labour costs haven't been the only driver of this trend. Nevertheless, China has remained relatively competitive in manufacturing, not just because of low cost labour. Established infrastructure in coastal areas, reliable supply chains and proximity to China's growing domestic market keeps China an attractive destination for foreign investors compared to countries with lower labour cost such as Vietnam, Sri Lanka and Bangladesh. Firms also have the option of moving their operations inland to where labour is cheaper, although this often presents its own difficulties (eg. local regulations, a lack of infrastructure and so on). While Central and Western provincial still only account for a small share of national production, stronger investment growth (including FDI) in these regions suggest that firms consider this to be a viable option.

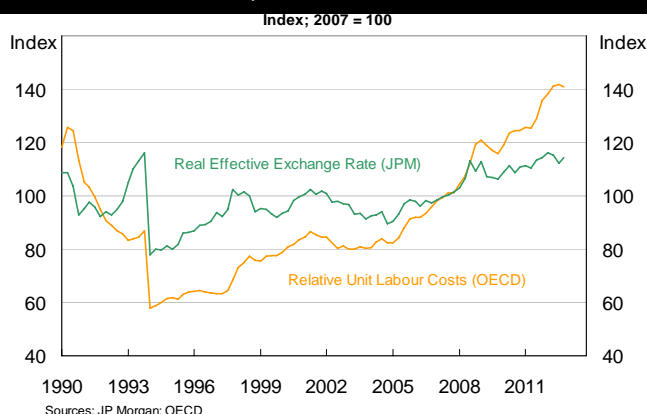
China's workforce has also become more productive and better skilled. Productivity improvements will be crucial to maintaining a rapid pace of growth in China post-LTP period – productivity will need to offset slower capital accumulation. This can be achieved via further progress in opening up China's economy to foreign investment, strengthen regulatory systems, and improving the quality of human capital (through greater education and training). These systems can help China to maintain competitiveness by moving up the 'value chain' and producing more technologically advanced and specialised exports. Companies such as Huawei are leading the way in this regard, attracting highly skilled workers and encouraging innovation, while strong growth in China's services sector is also a positive sign.

The peak in working age population is certainly a warning to Chinese authorities that even if the Lewis Turning Point has not quite been reached, they need to act quickly to get their house in order for the next phase of development. Exchange rate flexibility, financial liberalisation and institutional reforms will be necessary to increase productivity, promote innovation and assist the shift to more high-tech production and greater household consumption as wage growth accelerates.

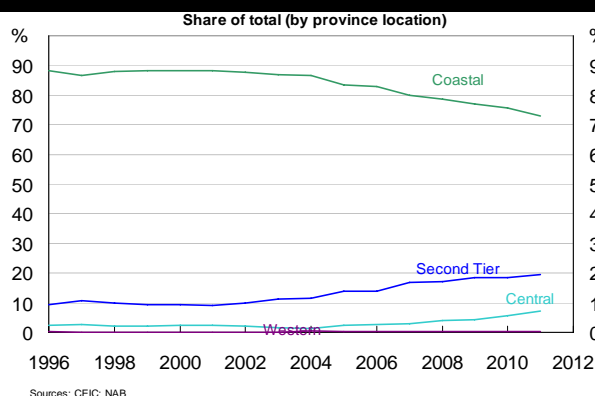
**Productivity of China's agricultural sector remains low**



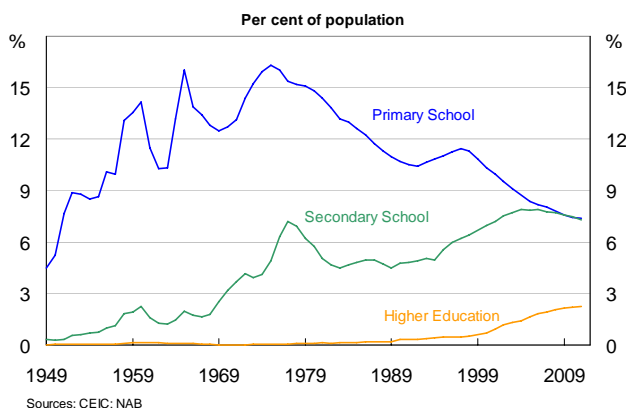
**China's international competitiveness**



**Foreign investment picking up in inland regions**



**Demographics could limit productivity from human capital**



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