China Economic Comment

National Australia Bank

China's murky labour data improving

China has one of the most important labour markets in the world. This is true for a number of reasons. The most apparent is that it has the largest labour market in the world, and rapid income growth is generating a middle class in China that is expected to define the global economy for decades to come. Nevertheless, some negative demographic trends have emerged in China over the years, and the cyclicality of labour markets has come to the fore as a major policy concern. Maintaining a healthy and stable labour market is an important factor for China's policy makers when determining their stance on fiscal and monetary policy. As the leadership look to rebalance and restructure the economy, they are likely to be very mindful of the implications for the labour market and potential flow on effects to social unrest.

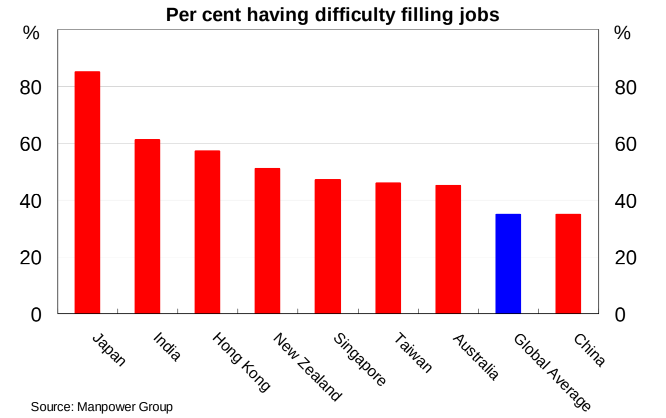
Yet despite its importance, China's labour market is quite poorly understood, due in large part to the lack of reliable official statistics, including rudimentary metrics such as a national unemployment rate. Nevertheless, Premier Li Keqiang has recently commented that China needs to maintain a growth rate of around 7.2% per annum to maintain stable employment growth (around 10 million jobs a year) and an urban unemployment rate of around 4%. Our own growth forecasts have the Chinese economy comfortably meeting that growth rate this year, before easing to around this (officially calculated) benchmark in 2014.

But does this suggest there will be nothing but smooth sailing for China's labour market? Policy makers face the difficult challenge of targeting an indicator that is often misunderstood and poorly measured. Recent policy discussions in the US highlight the problems involved in using the unemployment rate as a benchmark for policy. There the issue has been the impact of falling participation rates on the unemployment rate, as falling participation by workers who have given up on finding work, gives an artificially positive read on the economy and the state of the labour market.

These types of problems are often compounded in emerging economies, and particularly China, where a raft of other issues are at play. For example, slack in the labour market of emerging economies tends to be captured by a surplus of labour in the rural sector – contributing to deterioration in the sector's productivity and human capital – rather than a rise in unemployment. However, in China's case it is worth noting that there is not only an oversupply of unskilled labour in the rural sector. According to the 2013 Talent Shortage Survey undertaken by Manpower Group, Chinese firms have the least trouble finding workers for specialised positions of all the countries surveyed within the Asia-Pacific region (35% of Chinese firms are experiencing difficulty).

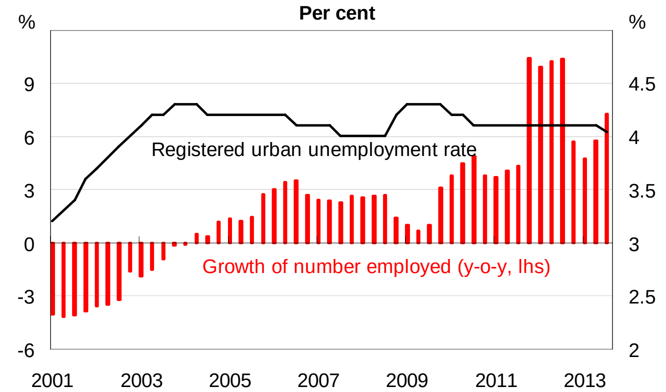
Many academics and commentators have examined China's labour market statistics and formed their own – usually

Chinese firms finding it relatively easiest to fill positions



Source: Manpower Group

Official labour market statistics – UE rate unbelievably smooth



Source: CEIC

unfavourable – opinion on their quality and usefulness. One of the most common criticisms relates to the restrictiveness of the data. This is because most of the labour market statistics in China only cover urban areas; the unemployment rate is restricted to 'urban registered unemployed'. That is, the measure of unemployment only covers a select group of surveyed employers (many of which are state owned entities), looking exclusively at urban workers in the jurisdiction where they are officially registered.

The problem with this is that employment in the private sector can be much more cyclical as state influences create an incentive to retain unneeded SOE workers during a downturn. If private firms are being underrepresented in the survey, this might create misleading stability in the unemployment rate. Recent experience could support this as during the global financial crisis China's urban unemployment rate barely lifted from 4% in September 2008, to a peak of 4.3% in early 2009. This was despite the fact that GDP growth slowed from over 14% in 2007 to below 8% in late 2008 – working age population continued to grow over the period too (0.8-0.9% p.a. during 2007-09).

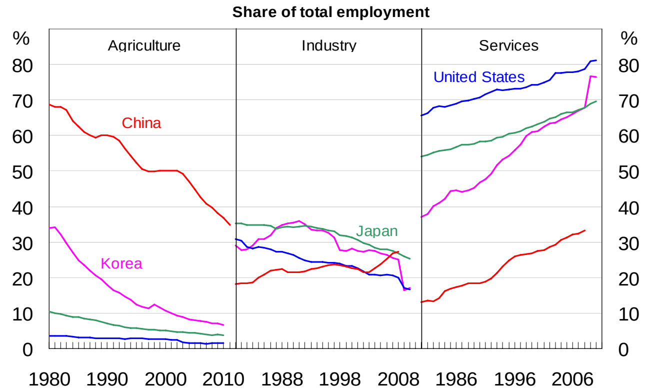
There have been a number of attempts to produce a more robust gauge of Chinese unemployment, but this has proved to be a difficult task and estimates tend to vary significantly. However, a Chinese Government White Paper on human resources (2010) provides some useful insight. In the paper the total labour force is reported at 1.07 billion persons, 780 million of which were currently employed (consisting of 311 million urban employees). This implies a national unemployment rate of around 29% which, compared to the official urban rate of 4.2% for the year suggests that a significant number of China's unemployed are registered in rural areas. These people are under-represented in the official statistics, which is a problem that is growing in significance given the rapid rise of migrant workers in China, numbering 262.6 million in 2012.

To alleviate the problems, China watchers have turned to an array of additional partial indicators of the labour market. Indicators that give some guidance on the degree of surplus labour in the economy and the tide of migrant workers are particularly helpful. In terms of the underlying structural position, data on the composition of labour suggest that the surplus of labour (demonstrated by an abundance of unproductive labour in the agricultural sector) has been in steady decline over the past couple of decades – thanks to a surge in services employment. Nevertheless, the magnitude of the surplus remains large and previous work by the IMF examining the Lewis Turning Point (where surplus labour runs dry and incomes rise) indicated that it will not be exhausted until 2025 assuming the status quo (fertility and participation rates) remain unchanged (see note). Data on migrant workers can be a timely way of examining the pace at which the labour surplus is still being drawn down. Growth in the number of migrant workers eased between 2011 and early this year, but has picked up again in the September quarter, which along with solid growth in the number of persons employed in the official statistics, suggests that labour market conditions have remained reasonably robust and are now improving.

There are a number of other indicators, some of which are quite timely that paint a similar picture. One of the most often cited is the employment component of the PMI survey of manufacturing and non-manufacturing firms. This is a diffusion index where a value of 50 denotes the point where firms are neutral in regard to their hiring intentions – a value above 50 suggests expanding employment and vice versa when below 50. The index for both manufacturing and non-manufacturing has eased since late 2011/early 2012, but the non-manufacturing survey remains well within expansionary territory (51.5). The manufacturing index has suggested contraction in employment (49.2), but the level has improved since mid year. A similar index produced by Markit Economics, that is more representative of SME's and private firms, suggest employment conditions have been quite weak but are also starting to improve. Manufacturing firms indicated renewed employment expansion in October, while services firms recorded their second consecutive monthly increase. Overall, employment conditions in October showed only their first month of expansion in around six months.

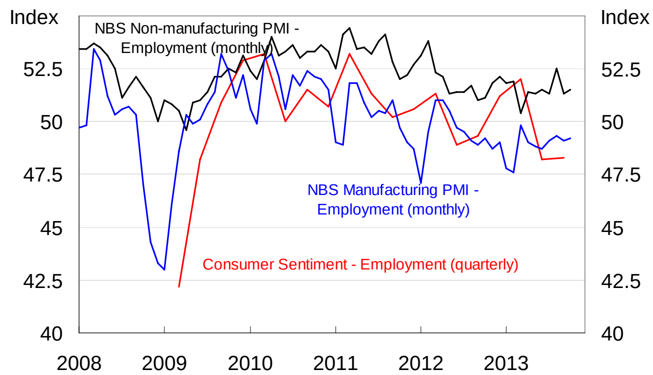
But while these measures suggest that labour demand may be stabilising following a recent soft patch, they do not quantify the degree of slack that may have emerged in the market. For this, data on the ratio between labour demand and supply (vacancies available to job seekers at employment centres in main cities) is often used, including by policy

Labour surplus in rural sector can impact labour statistics



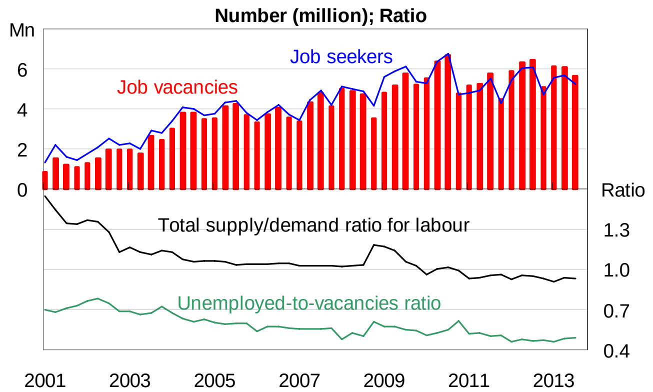
Sources: World Bank WDI Database

PMI Manufacturing employment stable, households cautious



Source: CEIC

Alternative indicators show tight market, but new jobs growth soft



China's hiring intentions stabilising

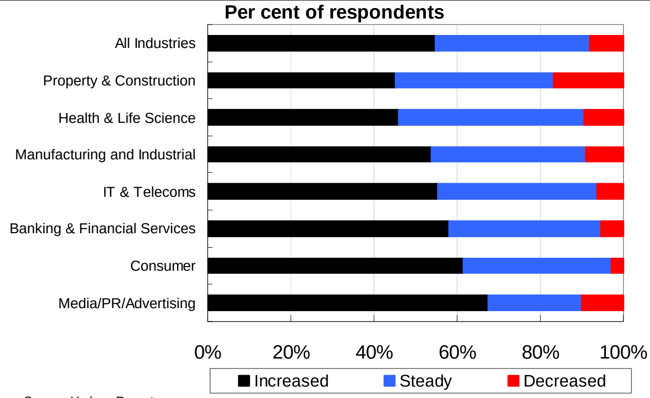
Source: Hudson Report

makers. This measure still has the drawback of neglecting rural areas, but has the benefit of timeliness. It has increased in popularity in part because it demonstrated a noticeable deterioration during 2008/09 when tens of millions of workers in export factories reportedly lost their jobs (the ratio of seekers to vacancies rose from 1.03 to 1.18 during the period). However, these data suggest a suspicious trend over much of the past three years with the number of job vacancies consistently outpacing the number of job seekers. Also, if you restrict the supply of labour to just those that are unemployed, the ratio shows very little change over time. This is hard to reconcile with broader economic trends.

Nevertheless, other private surveys are also pointing to a relatively positive employment outlook. The Hudson Report on hiring expectations for Q4 showed a rebound following the recent economic stabilisation. In Q4, 54.9% of employers are looking to increase their headcount, up 3.4ppts from Q3, although this is still well down on the peaks of 2011. According to Hudson, '*… cautious sentiment among employers remains. Large organizations are being more stringent, setting higher selection criteria for candidates and demonstrating increased patience in order to secure the ideal employee. Comparatively, second and third tier players are more actively hiring in their effort to grab market share.*' By sector, intentions have been softest in construction – despite recent public infrastructure spending – which could reflect uncertainty over the policy outlook as authorities look to stem concerns over housing affordability as prices rise rapidly. In contrast, media, consumer and banking services are showing the strongest hiring intentions due to growing interest in things like e-commerce and R&D as business models develop.

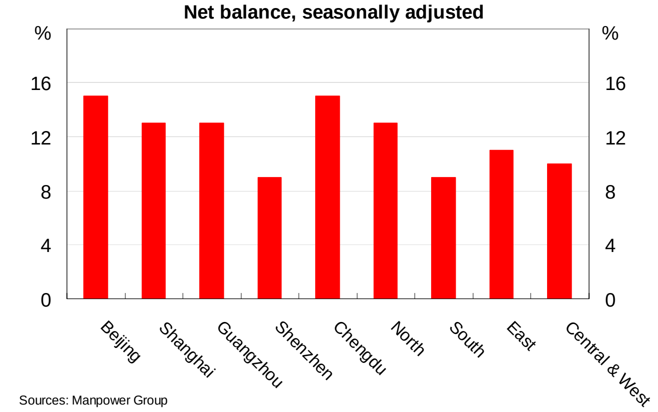
What does this all mean? Somewhat robust conditions and stabilisation in economic activity suggests that the labour market is becoming less of a constraint on policy (for now). This is good because it frees up policy makers to focus on containing inflation, credit and speculative investment as well as long term rebalancing objectives, which are likely to be more easily managed when the economy is doing well. However, the long term health of the labour market will also be contingent on successful reforms. We agree with recent statements from the PBoC that targeting economic growth alone will not be enough to ensure long term stability in the labour market. More needs to be done to further develop advanced manufacturing and particularly services, with the latter being the main sector putting China's surplus labour to more productive use.

Hiring intentions vary across sectors…



Source: Hudson Report

… and by region (Q4) – but conditions generally still soft



Sources: Manpower Group

Recent economic data

China remains on track to achieve its growth target for the year with domestic demand holding up in October, while exports picked up from the disappointing outcome in September. Industrial production was slightly better than expectations for the month, while retail sales and investment were slightly below. Regulatory distortions to trade data are making it difficult to gauge the health of export manufacturers, but solid industrial activity and a pick up in demand from major advanced economies is a positive indication. Demand from these economies is expected to gradually improve.

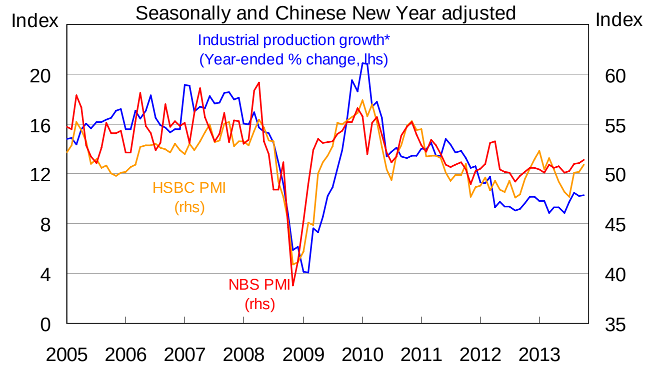
The acceleration in activity since mid-year is expected to lose some steam going into next year as efforts to rebalance and restructure the economy gain more traction – we should get more guidance on how these reforms will unfold following the 3rd Plenary Session of the 18th CPC Central Committee, which is currently underway. We have maintained our forecast for 2013 at 7.6%, with growth decelerating to 7¼% next year. Despite higher headline inflation, temporary price pressures suggest little incentive for the central bank to materially change its stance on monetary policy. We expect the central bank to continue ensuring adequate liquidity for domestic banks while maintaining tighter overall monetary conditions to discourage speculative investment and rapid credit growth. Bouts of tight liquidity could prompt a cut to reserve requirements, but the central bank has been reluctant to do this so far, and indications that foreign capital is returning will likely add to their reluctance. Therefore, reserve requirements and benchmark interest rates are expected to remain stable.

Turning to the partial indicators in more detail, industrial production growth accelerated marginally to 10.3% y-o-y in October (from 10.2%), consistent with a pick up in merchandise exports and steady business investment and retail sales. By type, production of construction related materials was mixed. Rolled steel output rose 12.3% over the year to October (down from 15.5%), while cement production picked up to 8.9%. As for other products, vehicle and electrical equipment and machinery production rose to 25.5% and 11.8% respectively, while textile production eased to 7.8%. Power generation – often used as a bellwether of industrial activity –rose to 8.4%.

Manufacturing PMI's had pointed to additional expansion in manufacturing activity, while client demand has also improved both at home and abroad according to measures of new orders. The official NBS PMI index, which is taken to be representative of large and state owned enterprises, increased to 51.4 (from 51.1). The Markit index, which is more representative of small and medium sized firms, rose to 50.9 in October (up from 50.2). This could suggest that the private sector is now taking up some of the slack in the economy, reducing the need for public stimulus – growth in central government investment stimulus is starting to ease, albeit with some large base effects from last years stimulus. The non-manufacturing sectors of the economy have also been gaining some momentum. Following solid growth in tertiary GDP in the September quarter, the non-manufacturing PMI jumped to 56.3 in October, the highest level since mid-2012.

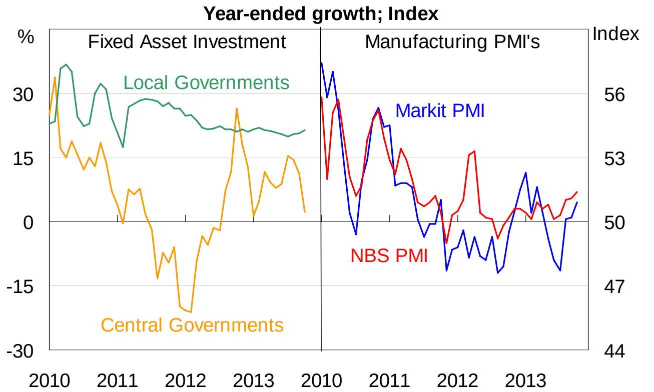
Fixed asset investment growth remained stable in October according to our estimates, increasing 19.3% over the year (19.4% y-o-y in September). By sector, manufacturing investment picked up slightly, but the ongoing need to tackle

Industrial Production

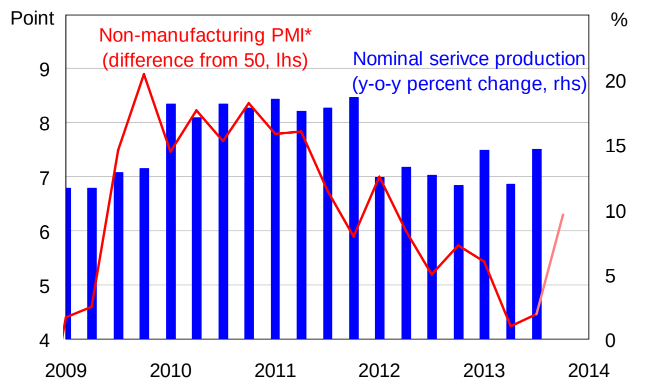


* Adjusted for Chinese New Year
Source: CEIC, Nab

Private sector may now be taking up some of the slack?

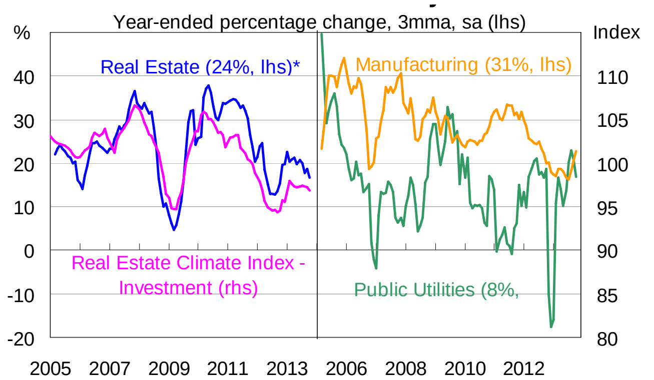


Non-manufacturing sectors gaining momentum



* A positive reading supposably indicates the sector expanded; dot represents July and August observations

Fixed Asset Investment by Sector



Source: CEIC, NAB
* Number in brackets represents share of total FAI in 2010; Real Estate is using Real Estate Investment data

excess capacity in many sectors – which has led to sluggish profits growth in recent years – is likely to limit any recovery in this space. Utilities investment is still relatively solid, but could start to ease if public infrastructure investment starts to wind down as private sector activity picks up. Growth in real estate investment is still relatively soft despite strong increases in property prices.

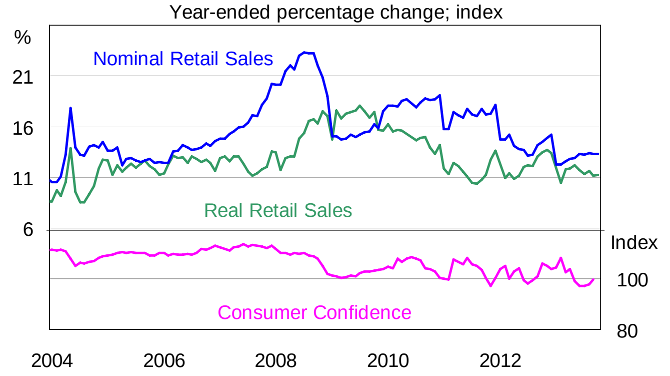
The outlook for real estate investment remains clouded by policy uncertainty as government concerns over affordability gather pace. The central bank sees property price inflation as a big problem and we expect to see further measures employed by authorities to address it – some of which will be detrimental to developers. For example, Beijing is considering a halt to approvals for the sale of more expensive homes and it also wants to place a 10% cap on price increases for previously approved projects. It has also been reported that Shenzhen would raise minimum down payments for second home purchases. All tier 1 cities including Guangzhou and Shanghai are under the spotlight and will fell pressure to respond to price gains in recent months. However, government measures will also include supply management, which will benefit building construction.

Nominal retail sales growth was slightly below market expectations in October, but remained steady at 13.3% y-o-y; the government's target for consumption growth is 14½% for 2013. Accounting for retail prices in the month, real growth in retail sales was 11.2%y-o-y (similar to the previous month). However, households appear to be taking some comfort from the improvement in economic activity last quarter and the extended period of relatively contained consumer prices, with consumer confidence returning to long-run averages in September (despite softer urban income growth). By product, sales growth in food & drink was steady, while furniture, communication appliances, autos and petrol all had the most notable acceleration. Most of the remaining product categories eased or were broadly steady.

Trade data for October came in above market expectations, following a disappointing result for exports last month. Growth in merchandise export values was 5.6% y-o-y to October (following -0.3% y-o-y decline for September). This turn around in annual growth suggests that China is still within reach of achieving its growth target for total trade of 8% for 2013; total trade in the first 10 months has reached US$3.4 trillion, which is up 7.6% on the same period last year. Better exports growth is consistent with growing export orders in recent months (according to the PMI survey) and a slight pick up in industrial activity. However, disappointingly drawn-out recoveries in the major advanced economies has kept export demand relatively soft (growth in merchandise exports is still well down on average rates seen in previous year's), which along with recent rapid appreciation of the RMB (setting record highs) has weighed on China's industrial sector.

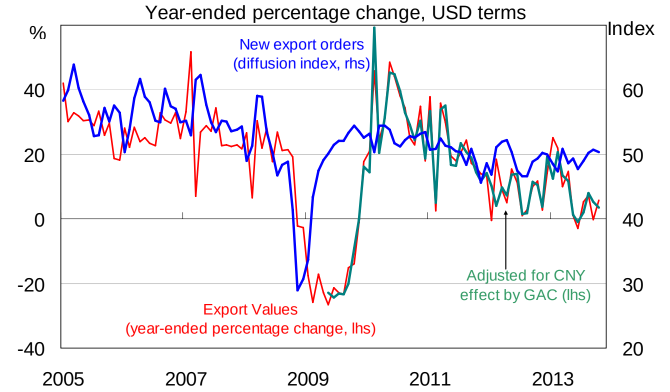
By destination, exports to the EU jumped in October to be up nearly 13% over the year (compared to -1% y-o-y in September). Exports to the US also improved, while shipments to Asia were mixed. Exports to Japan were down in the month, but growth over the year improved. Exports to Hong Kong and Taiwan remain very soft, although this could reflect the ongoing impact of the government's clamp down on the practice of misreporting exports to disguise capital inflows. By product, high tech exports rose around 2% m-o-m sa in October to be broadly flat over the year. Mechanical and

Retail Sales

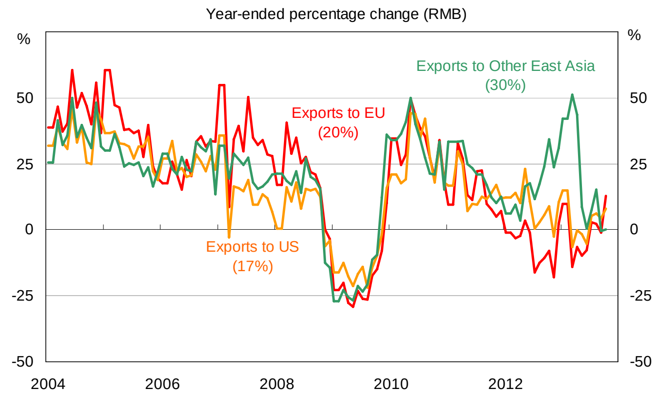


* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.

Merchandise exports and new export orders

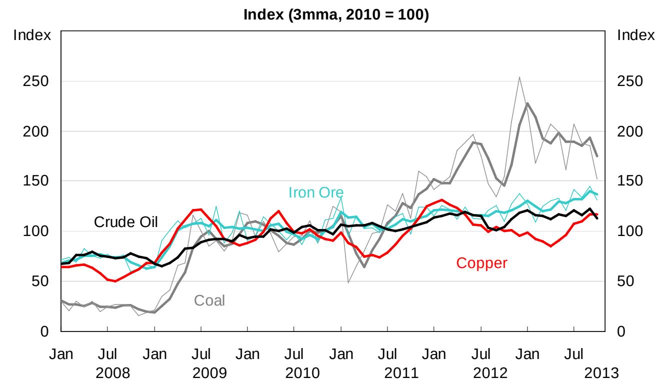


Merchandise exports to major trading partners



Sources: CEIC; NAB

Commodity import volumes supported by investment



Sources: CEIC; NAB

electrical exports were up 3% m-o-m sa to be 3.8% higher over the year. Exports of lower-end goods picked up sharply in the month.

Robust imports growth has been a positive signal for domestic demand in China. Merchandise import values increased 7.6% over the year to October, which was slightly above market expectations. However, official estimates suggest that imports declined by 1.8% m-o-m (sa), following a sharp increase the previous month on the back of strong commodity demand underpinned by stimulus investments. Imports of crude oil fell by 6½% in the month to be down 13.8% on last year. Demand for industrial metals on the other hand has remained solid despite a decline in unadjusted volumes during the month. Copper imports fell by 11% in October, but are 26% higher y-o-y. Similarly, iron ore imports fell 9% from September's record high; but remain 20% higher y-o-y. With exports picking up last month, the trade surplus widened to US$31.1 billion in October (up from US$15.2 billion in September).

The headline CPI rose to 3.2% y-o-y in October, up from 3.1% in September. While this was slightly below expectations, it is the closest the CPI has come to the official target of 3.5% this year. This raises the risk that a tightening in monetary policy could come sooner than currently expected, but further deflation in factory gate prices means that the central bank is likely to sit back and wait for signs that price pressures are becoming more broadly based – they have remained confined to food prices. Food prices increased 6.5% y-o-y (up from 6.1% in September), while non-food inflation has held steady at 1.6% over the year. Deflation in factory prices picked up again in September, accelerating to -1.5% y-o-y, but this is still better than deflation of around -3½% in late 2012. This was the twentieth consecutive annual decline in producer prices.

Policy expectation:

Tighter liquidity is having a significant impact on the cost of capital in China. There has been some suggestion that authorities have allowed liquidity conditions to tighten to head off inflation pressures, but given the market volatility that was generated following the liquidity squeeze earlier this year, the PBoC is likely to remain cautious. Technical factors such as month-end bank capital requirements have also been contributing to tighter liquidity. The central bank has refrained from using open market operations to inject liquidity into the market, which allowed the 7-day interbank rate to spike to 5.59% in late October, up from around 3½% mid month – the rate has subsequently eased back to 3.9%. Yields on government bonds however have continued to climb, reaching their highest levels in around 6 years.

Reflecting this tightening in conditions, total social financing eased in October to RMB 856 billion (down from RMB 1,405 billion), with new yuan loans hitting a 10-month low (RMB 506 billion). Non-bank finance accounted for around 70% of total finance in the month. The slowdown may be a welcome sign to policy makers, particularly in light of their recent comments on the need for the economy to undergo a long de-leveraging process – something that is not usually suggested by government authorities.

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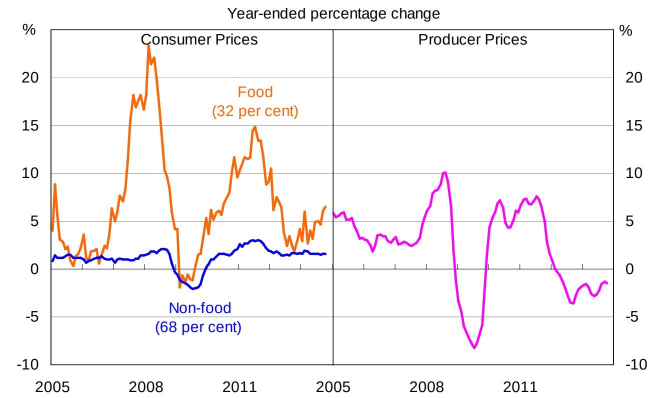
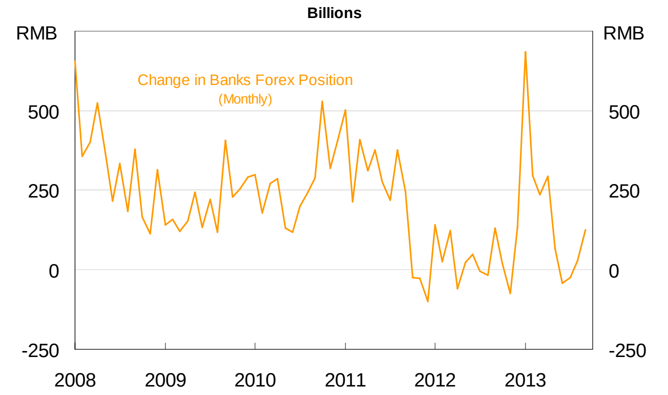
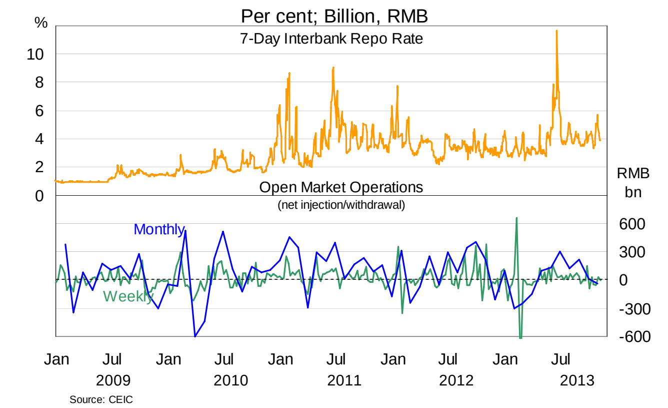
Consumer Prices



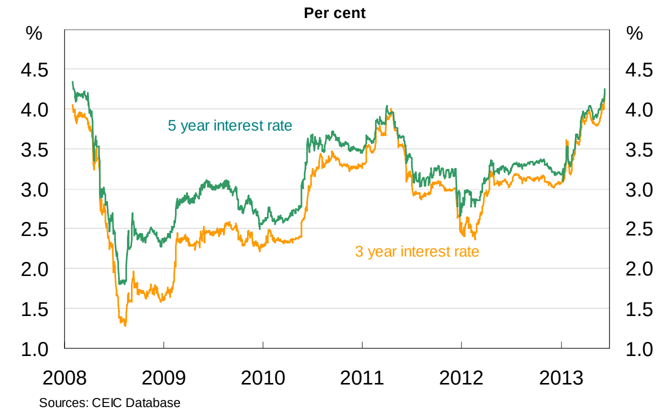
Capital inflows picking up again – risk to inflation



Liquidity conditions



Longer maturity interest rates



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