China Economic Update

by NAB Group Economics

21 July 2014

National Australia Bank

A falling working population increases the urgency of China's economic reform

The growth in China's economy over the past thirty years has been extremely impressive, overtaking Japan in 2009 to become the world's second largest economy. However when measured on a per capita basis, China's economy still remains comparatively small – within the 'middle income' band.

China's growth momentum has slowed over the past few years, with the model of development – centred around investment and exports running out of steam. Experience from other developing economies shows that China risks getting caught in the 'middle income trap', where countries are unable to compete against lower cost rivals or reach the levels of wealthier economies.

In part, the reform agenda at last year's Third Plenum was intended to address the middle-income trap concerns – which are heightened in China due to the demographic changes currently underway, a legacy of the long running One Child Policy. Restrictions to the country's birth rate have skewed the population profile – both in terms of age and in gender, potentially limiting future economic growth.

The One Child Policy legacy

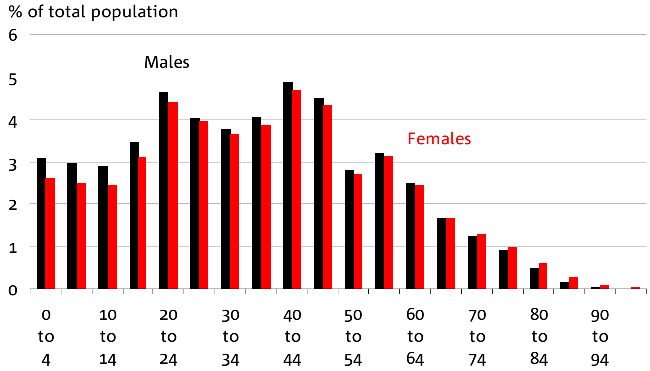
China's One Child Policy was introduced in 1979, initially as an emergency measure. It could be argued that the policy was only part of broader plans intended to boost living standards and economic growth – particularly increasing GDP per capita – following on from the turmoil of the Cultural Revolution.

The One Child Policy has not been as strict as many outsiders may believe. For example, while it has been strongly enforced in most urban areas, in rural areas families are usually permitted to have a second child if their first child was female or suffered a disability. Ethnic minorities are usually exempt from the restrictions. As a result, in 2007, only around 36% of China's population were subject to a strict one child limit (The Australian).

There are some disputes as to the impact of the One Child Policy. Official estimates suggest the policy prevented around 400 million births (using a basic extrapolation of crude birth rates between 1950 and 1970), however demographer Wang Feng argues that this estimate overstates the effect, since much of the change in fertility rates occurred before the introduction of the policy.

However, there is little doubt that the policy contributed to the significant distortion in the population towards males – it is estimated that there are around 32 million more males under the age of 20 than females.

One Child Policy has favoured male births



Source: CEIC, ABS, NAB Economics

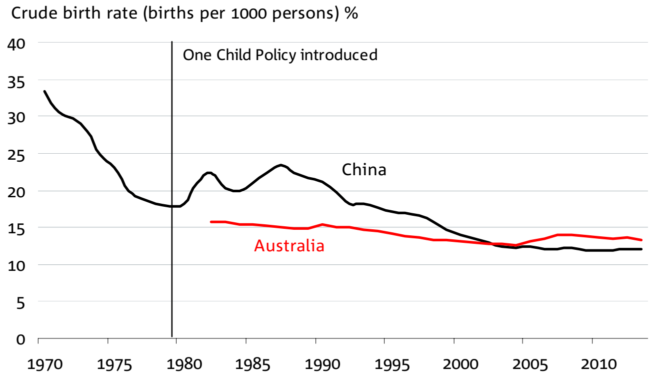
In late 2013, China's government announced reforms to the One Child Policy. It was altered to allow couples to have more than one child if one of the parents is an only child (previously both parents had to be only children).

So far, the response to the policy change has been minimal – well below official expectations of a spike in applications for eligible second children. Various surveys in recent years have highlighted that most Chinese households favour smaller family sizes – such as official surveys in Shanghai that indicated 81% of respondents only wanted one child. Costs associated with raising children are highlighted as major factors in constraining family sizes.

The demographic dividend contributed to growth, but is starting to turn

As economies start to develop, they typically experience what is referred to as the demographic dividend. Improving access and quality of healthcare lowers infant and child mortality rates, which leads to declining fertility rates. In China, the crude birth rate (the number of births per 1000 people) fell sharply between 1970 and 1980 – down from 33 per 1000 people to 18, even before any impact from the One Child Policy (introduced in 1979) was evident.

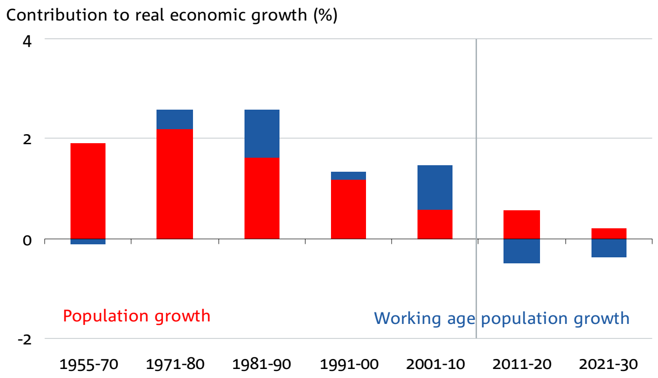
China's birth rate has fallen sharply since the early 1970s



Source: CEIC, ABS, NAB Economics

The demographic dividend occurs as the working age population expands (increasing the productive capacity of the economy). This larger workforce has fewer children to support (allowing for higher savings and consumption rates) and can invest greater resources into the health and education of these fewer children – improving their outcomes.

Demographic dividend set to reverse over the next two decades, with working population detracting from growth

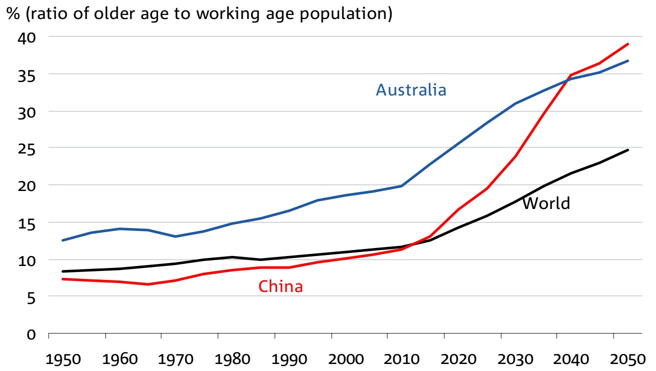


Source: CEIC, UN population database, NAB Economics

However, the demographic dividend is a temporary effect and the benefit eventually becomes a burden. As the fertility rate falls, the population ages, resulting in a larger number of older people relying on a smaller working age population to support them – particularly as the improved healthcare system that lowers infant mortality also increases life expectancy.

This is typically referred to as the older age dependency ratio. At present, China's older age population is around 13% of the size of the working age population – a similar level to the global average. However, the reversing demographic dividend is starting to reduce the working age population – meaning that the older age dependency ratio is set to increase substantially over the next few decades – exceeding the level for Australia from 2040 onwards (according to UN population forecasts).

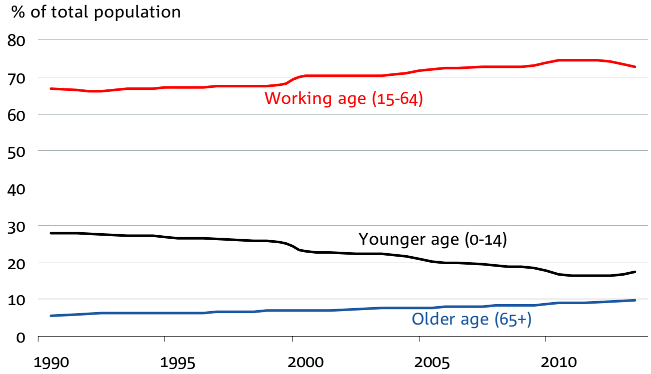
Ageing population set to impact on China's economy



Source: UN population database, NAB Economics

In 2013, China's population grew by almost 0.5%, but the working age population fell by 1.4% to 990 million (defined here as ages 15 to 64 for the purposes of international comparison).

China's working age population has started to fall

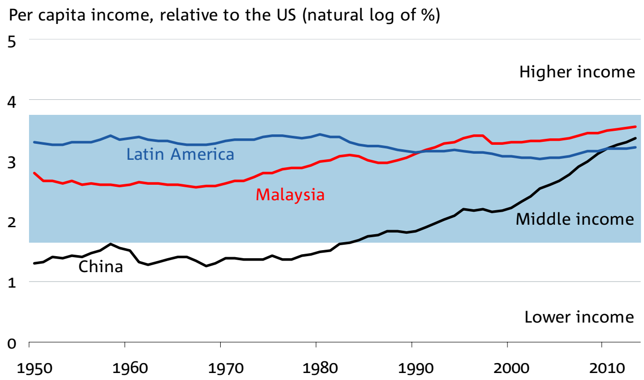


Source: CEIC, NAB Economics

The risks of the middle income trap

A key concern related to the unwinding of the demographic dividend is the risk that China could be stuck in the middle income trap. This occurs when developing economies lose their low cost advantages (as demonstrated in China with rising labour costs and falling surplus rural labour) and are unable to eliminate constraints that restrict growth in per capita income from reaching advanced economy levels.

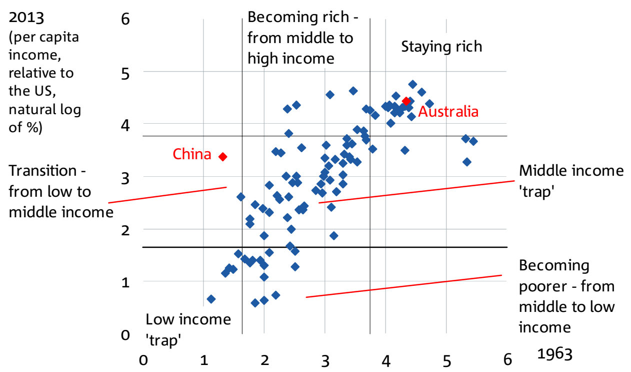
China is approaching higher income levels, but not guaranteed to reach them



Source: The Conference Board Total Economy Database, World Bank, NAB Economics

Breaking out of the middle income gap is extremely challenging. For example, Latin American economies have remained consistently within these bounds (as defined by the World Bank) since the 1950s. In Asia, Malaysia has also struggled to breakout over the same period.

Few economies escape the middle income trap

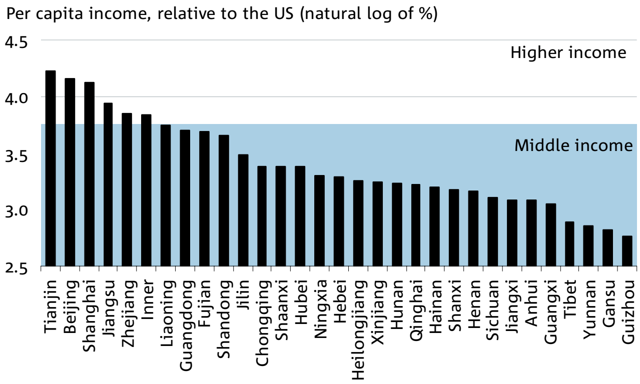


Source: The Conference Board Total Economy Database, World Bank, NAB Economics

In fact in the fifty years between 1963 and 2013, only ten economies were able to shift from middle to high income levels (with some like Portugal and Greece retreating back to middle income levels due to economic decline following the GFC). These include Asian neighbours such as Japan, South Korea, Taiwan, Hong Kong and Singapore.

There remains considerable disparity in per capita GDP across China – reflecting the more rapid development of east coast provinces. In 2013, there were six provinces that had already achieved higher income levels – the three main cities of Tianjin, Beijing and Shanghai (where fertility rates are also at their lowest), along with Jiangsu and Zhejiang (just north and south of Shanghai respectively) and resource rich Inner Mongolia.

Parts of China have reached higher income levels



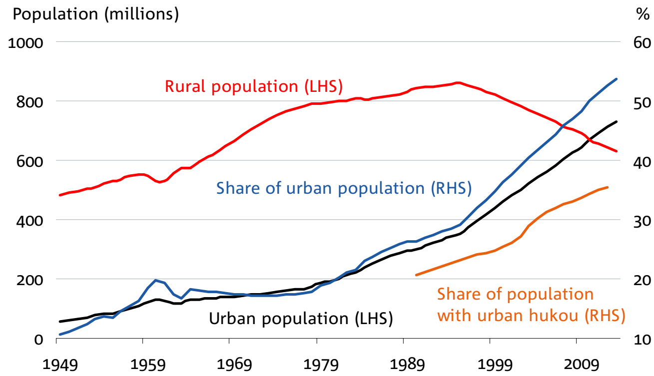
The key challenge is to expand per capita GDP in the middle income provinces, to allow China to catch up to advanced economies. However, this will become more difficult as the older age population expands, relative to the working age population.

Further reform is needed to avoid the trap

The rising trend of older age dependency and the risk of the middle income trap highlights the urgent need for broad based economic reforms – some of which were outlined at last year's Third Plenum.

According to the Asian Development Bank, China can escape the middle income trap if it focuses on private sector development and innovation (in particular shifting to higher value production to offset higher labour costs), rebalancing the economy towards consumption and reducing inequality – which has increased sharply in recent years. The bank also notes the importance of reform to State Owned Enterprises and the finance sector, to improve the allocation of financial resources within the economy.

Further urbanisation and hukou reform could present an opportunity



Source: CEIC, NAB Economics

One area of reform that received only modest consideration at the Third Plenum was hukou (household registration) reform. While almost 54% of the population live in urban areas, only 35% of the population held an urban hukou in 2012.

Migrant workers (those lacking a hukou) receive lower incomes than registered residents and lack access to social services provided by local governments. Reforms to the hukou system could provide greater labour mobility, reduce inequality and provide additional time for China to reach a higher income level.

GDP and partial economic indicators

Government financial reforms could ease local government debt fears

In late June, China's politburo agreed to fiscal and taxation reforms that were outlined at last year's Third Plenum, setting a deadline for implementation at the end of 2016. These reforms should provide greater transparency and predictability of local government revenues.

This move follows the introduction of the local government bond pilot scheme, which commenced in June. Guangdong province issued bonds totalling RMB 14.8 billion, with maturities ranging between 5 and 10 years.

Together these measures could reduce the concerns around local government debt and the high dependency on land sales to service debt obligations (a major concern given softening trends in the real estate sector).

Gross Domestic Product

China's National Accounts data shows that the economy grew by 2.0% qoq in the June quarter and 7.5% in year-on-year terms (levels marginally stronger than market expectations of 7.4%). This result was consistent with partial economic indicators, which showed the economy stabilising in the June quarter, following on from the declines recorded in Q1.

On an expenditure basis, consumption was the major contributor to GDP in the first half of the year (accounting almost 54% of growth), however this was weaker than Q1 (around 64% according to our estimates). Investment had a stronger contribution in the second quarter – despite the weakening trend in fixed asset investment. This likely reflects the disconnect between this measure and the national account measure – with the latter excluding land sales. Net exports continued to detract from GDP in the first half – albeit relatively modestly (-20 basis points in the first half).

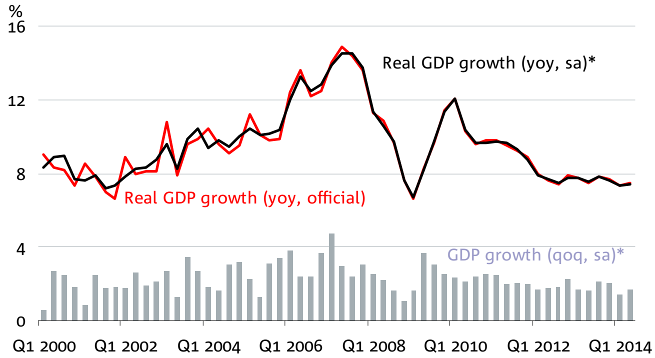
Policy measures have been introduced to stabilise the economy, however they remain well short of previous stimulus measures. Investment in social housing, for example, is unlikely to compensate for the slowing trends in residential construction. Our forecasts remain unchanged, with economic growth at 7.3% in 2014, and slowing further to 7.0% in 2015.

Industrial Production and Investment

Growth in industrial production picked up in June – with output increasing by 9.2% yoy in June (up from 8.8% in May). This level was ahead of market expectations (9.0%), and points to stabilisation in the secondary sector, following the slowdown since late 2013.

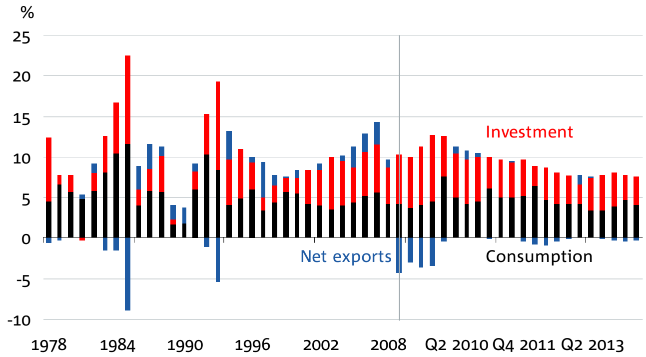
China's PMI surveys have been showing improving trends since April. The official PMI, produced by the National Bureau of Statistics and more representative of the larger

Real GDP growth edged up to 7.5% yoy in June quarter



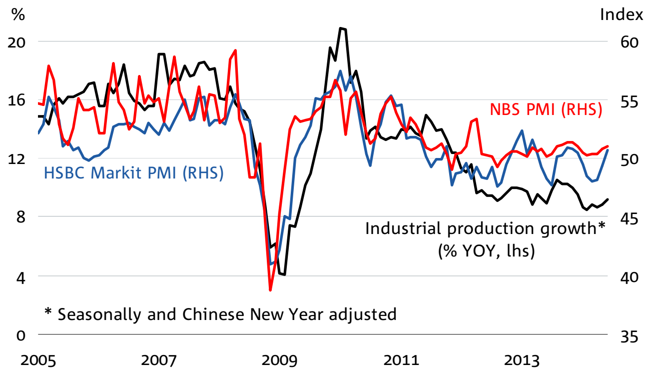
* Seasonally adjusted growth series are estimated by NAB.
Source: CEIC, NAB Economics

Consumption's share of GDP growth pulled back compared with Q1



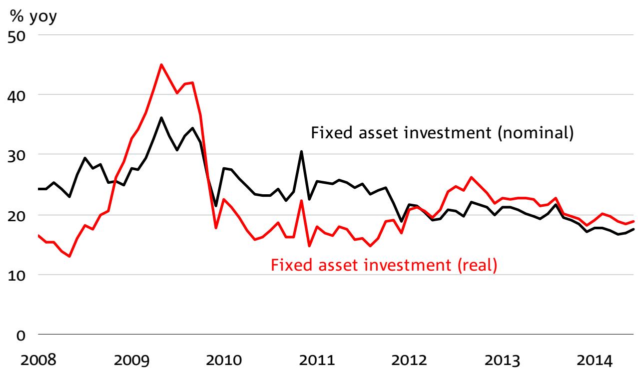
* Annual data until 2008, Quarterly from Q1 2009
Source: CEIC, NAB Economics

Industrial production picked up in June, recovering from the slowing trend



Source: CEIC, NAB Economics

Fixed asset investment slightly stronger in June, but below levels of recent years



Source: CEIC, NAB Economics

state-owned sector, edged up to 51.0 points in June (from 50.8 points previously). The HSBC Markit PMI (which includes more SME firms) pushed up to 50.7 points (from 49.4 points) – the highest since November 2013.

Output levels at the sub-sector level were mixed in June. There were stronger levels for crude steel production – increasing by 4.5% yoy (from 2.6% in May) and steel products (7.1% yoy in June from 6.1% previously). In contrast, cement – a sector closely tied to construction – decelerated, growing by 0.8% in June from 3.2% previously, while electricity and motor vehicles were also slower.

Trends in fixed asset investment also pointed towards stability, having fallen sharply in late 2013, with growth at 17.6% yoy in June, up from 17.0% in May. This was the strongest growth rate since February this year.

By sector, the slowing trend in real estate remains evident. Real estate investment rose by 12.9% yoy (from 13.7% previously), the slowest rate of growth since July 2012, and in line with weakening survey trends. Similarly, investment in manufacturing remained weak – at 14.5% (from 14% in May).

Conditions in the broader residential property market were less negative in June – with property sales falling by -3.5% yoy (significantly lower than falls in April and May) – while prices fell by -1.9% yoy (again less negative than early 2014). Anecdotal reports suggests that a range of cities have reduced restrictions on property purchases in an effort to support markets.

International trade

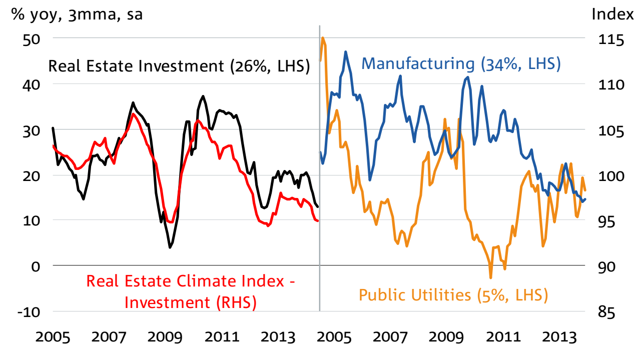
China's trade surplus remained strong in June, at US$31.6 billion (narrower than May at US$35.9 billion). The level of both exports and imports was lower in June (compared with May), although the monthly decline was larger for exports.

In year-on-year terms, US dollar denominated exports rose by 7.2% – weaker than market expectations. In the first half of the year, exports were around 0.9% higher than the same period last year, however data has been distorted by the crackdown on false invoicing, designed to avoid China's capital controls. The second half of this year should provide a clearer indication of physical trade.

There has been a major improvement in exports to East Asia – increasing by 7.1% yoy in June. For the first time this year, exports to Hong Kong increased on a year-on-year basis – rising by 6.5% – with Hong Kong having been the main destination for invoicing schemes. Exports to the United States and European Union remained at slightly softer levels than recent trends – up by 7.5% and 13% respectively.

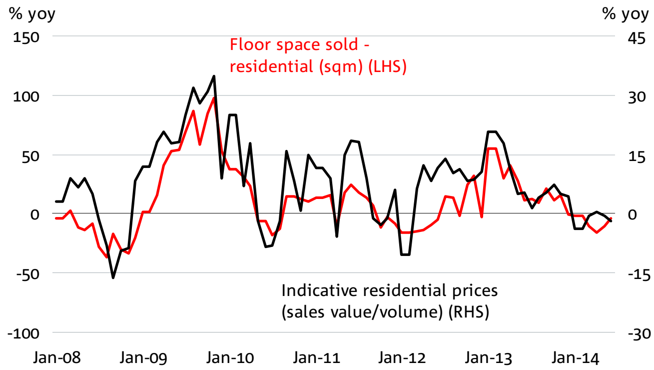
The stronger trends for exports have been supported by growth in both Mechanical & Electrical goods and High Tech products – both of which have switched from falling export levels between February and April to year-on-year growth in May and June.

Real estate investment trends continue to weaken



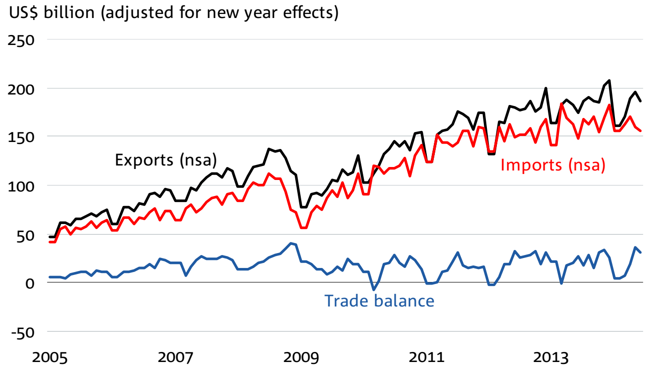
Number in brackets represents share of total FAI in 2013
Source: CEIC, NAB Economics

Residential prices falling, but relatively modestly



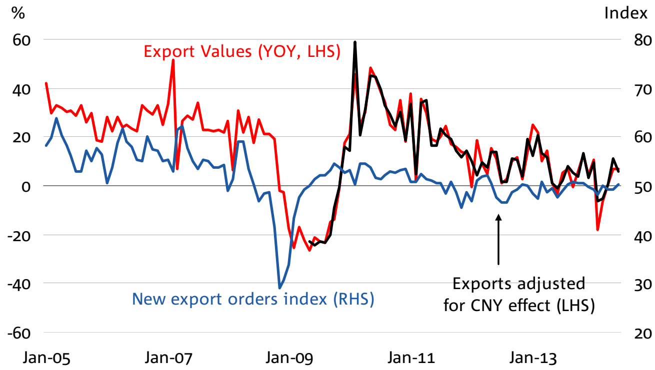
Sources: CEIC, Datastream, NAB Economics

Trade surplus remained strong in June



Sources: CEIC, NAB Economics

Exports marginally higher in the first half of 2014



Source: CEIC, NAB Economics

China's imports increased by 5.5% yoy in June (following on from a -1.7% fall in May). By commodity, trends were quite divergent, with growth rates likely influenced by weakness in June 2013, due to the credit crunch at this time (coal imports for example slumped in June 2013). In June, coal imports rose by 12% yoy (compared with -13% in May), iron ore imports increased by 20% yoy, while copper fell by -7.9% yoy –in part reflecting an investigation into commodity financing at Chinese ports.

Retail Sales and Inflation

In nominal terms, growth in retail sales was stable in June at 12.4% yoy. In real terms, sales trends were also stable, rising by 10.6% yoy (compared with 10.7% in May). Consumer confidence recovered a little in June, having eased from a recent peak in March, and generally remains in positive territory.

By category, food and drink sales grew in line with broader retail trends – up by 12.4% yoy (from 13.7% last month), while there was an acceleration in household goods sales – up by 10.7% yoy (from 6.6% in May). Jewellery sales remain weak – down -0.2% yoy – with these sales possibly impacted by the official anti-corruption drive.

There was a slight pullback in inflation in June, with the headline consumer price index rising by 2.3% yoy (compared with 2.5% in May). Changes in food prices typically have the main influence on the headline result – with non-food price inflation stable at 1.7% in June.

In contrast, there was a slight deceleration in food price growth, with prices rising by 3.7% yoy in June (compared with 4.1% in May). Meat and poultry price growth slowed – rising by just 1.9% yoy last month (from 3.2% in May), while prices for fresh vegetables fell -1.8% yoy, the third straight month of falls.

Producer prices fell once again – down by -1.1% yoy. Producer prices have fallen for twenty-eight months in a row – approaching the thirty-one month record between June 1997 and December 1999. Heavy industrial producers continue to record the largest declines in producer prices.

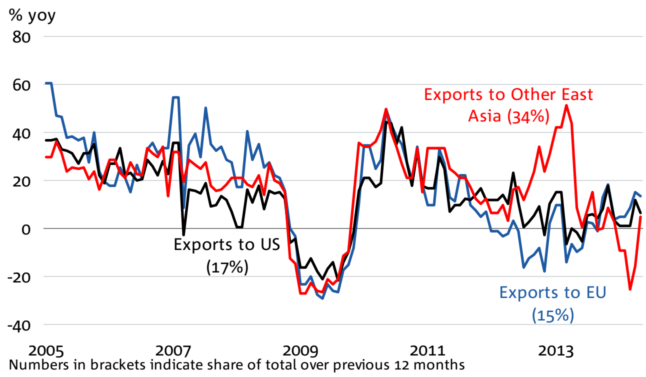
Policy expectations

In year-on-year terms, there was a noticeable expansion in Chinese credit in June. During the five months to May, new credit was smaller than the same period in 2013 (down -5.9%), however this trend reversed in June, with new credit (total social finance) increasing by 3.9% in the first half of the year.

That said, this increase likely reflects the impacts of the credit crunch in June 2013, rather than a broader loosening in credit policy. Despite calls for broad based cuts to reserve requirement ratios for banks, cuts have so far been limited.

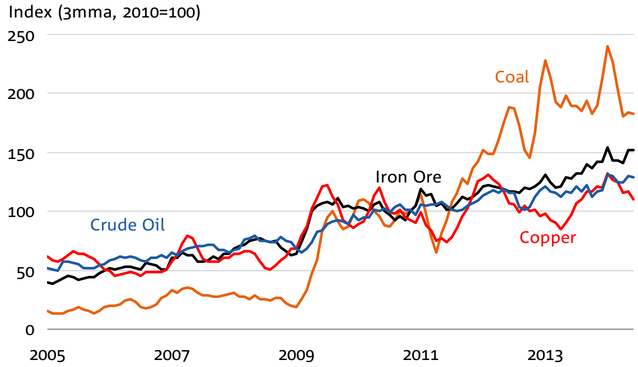
By sector, growth remains particularly evident in the traditional banking sector – which increased by 9.6% yoy in the first half – while shadow banking components such as

Exports to East Asia have rebounded recently



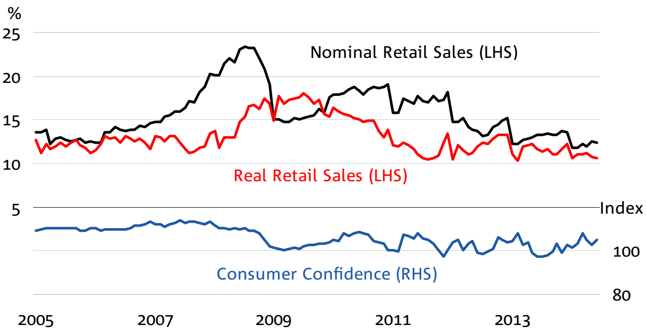
Numbers in brackets indicate share of total over previous 12 months
Sources: CEIC, NAB Economics

Copper imports pulled back in June



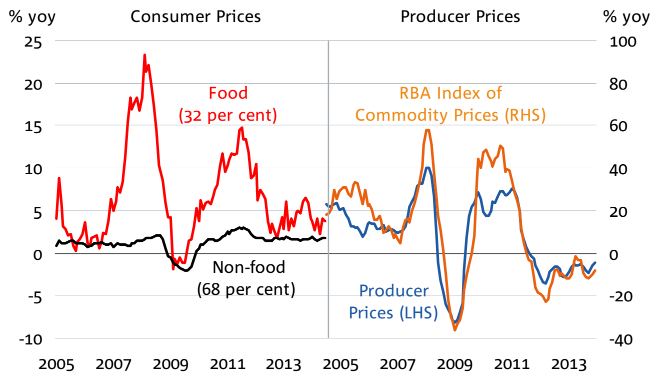
Sources: CEIC, NAB Economics

Retail sales trends remaining stable, confidence slightly improved



* 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.
Source: CEIC, NAB Economics

Consumer and producer price inflation subdued



Sources: CEIC, RBA, NAB Economics

trust and entrusted loans fell by -23% yoy (in part reflecting efforts to rein in the sector)

For most of June, there was little movement in the 7 day Shanghai Interbank Offered Rate – trading between 3% and 3.5%, levels broadly unchanged from May. This stable period has been in stark contrast to the volatility across most of early 2014. The SHIBOR began to trend higher in late June, as end-of-quarter demand (such as meeting financial regulatory requirements) increased cash demand, driving the SHIBOR briefly above 4%, before drifting back below this level in early July.

Monetary policy remained accommodating over this period, with the People's Bank of China (PBoC) injecting liquidity into money markets from mid May onwards.

In contrast, longer term rates dropped in early June – following relatively stable levels across early 2014 – with 3 year rates falling around 25 basis points. Rates recovered in late June, in line with upturn in the SHIBOR.

Commentary from the PBoC Governor in early July indicated that the bank is continuing to develop necessary policy tools to manage short and medium term interest rates – in line with international practices. This should allow for lower volatility in the SHIBOR in the longer term, as the bank continues down the path of liberalisation.

More generally, short term interest rates remain relatively low (when compared with the levels of late 2013). Efforts to slow credit growth appear a lower immediate priority than stabilising economic trends and property markets.

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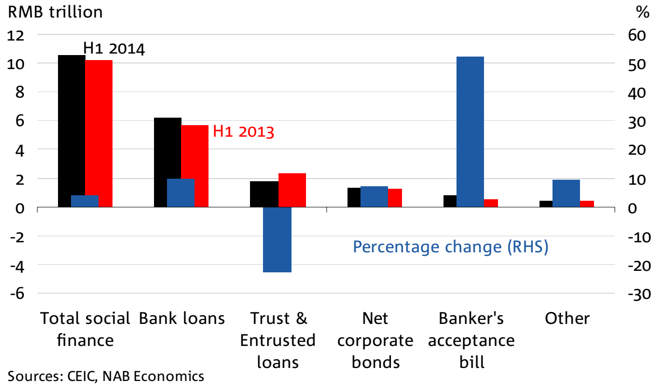
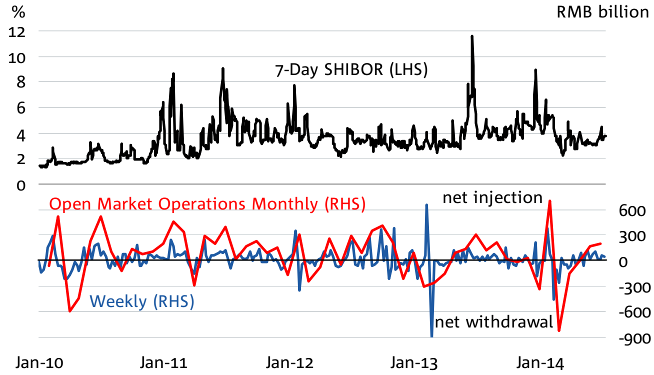
Banking sector the main contributor to growth in credit



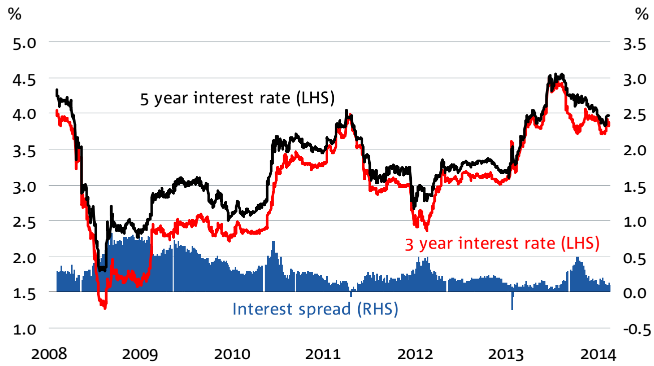
Sources: CEIC, NAB Economics

SHIBOR comparatively stable across most of June



Source: CEIC, NAB Economics

Longer rates were more volatile in June



Sources: CEIC, NAB Economics

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