China Economic Update
by NAB Group Economics

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National Australia Bank

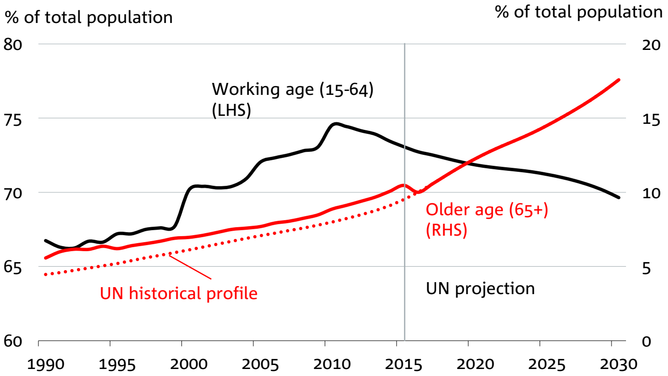
Short term volatility risks derailing China's critical reforms – risking weakness longer term

China's longer term growth prospects are dependent on a range of economic reforms – critical to supporting the broad based productivity growth necessary to offset the negative demographic effects from the country's declining working aged population. China's progress on the reform agenda unveiled at 2013's Third Plenum has been at best mixed – with some measures implemented, some partially introduced or delayed and others reversed in the face of economic volatility.

The urgent need for reform – China's growing demographic pressure

As we have previously noted, China's key long term challenge is its demographic profile – with a working age population that has declined as a share of the population since 2010. The lagged impacts of declining birth rates from the 1970s onwards – reflecting both improving health standards and the One Child Policy – have meant that there are fewer new entrants to the workforce each year than those leaving it. The pool of older aged residents is steadily climbing (at around 10.5% of the population in 2015) and is expected to reach 17.5% by 2030.

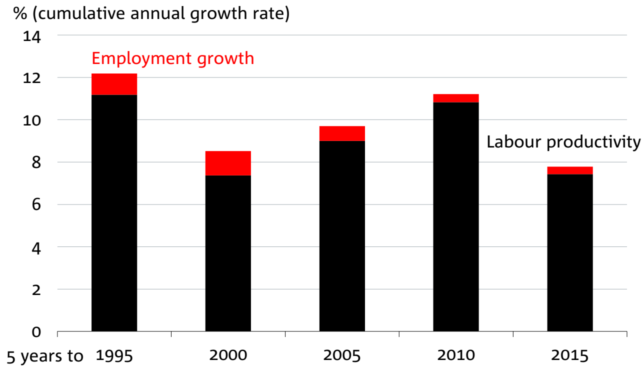
China's working age population declining, meaning productivity becomes critical longer term



Source: CEIC, United Nations, NAB Economics

A shrinking workforce and rising older age dependency ratio increases the necessity to boost labour productivity – a significant challenge in a period of generally low productivity growth globally. Simply maintaining existing productivity would see China's economic growth slow considerably in coming years, as the declining working age population contracts from growth. As it is, labour productivity has slowed in recent years, down from an average close to 11% a year in the five years to 2010 to 7.4% a year in the five years to 2015.

China's labour productivity has slowed across the past five years



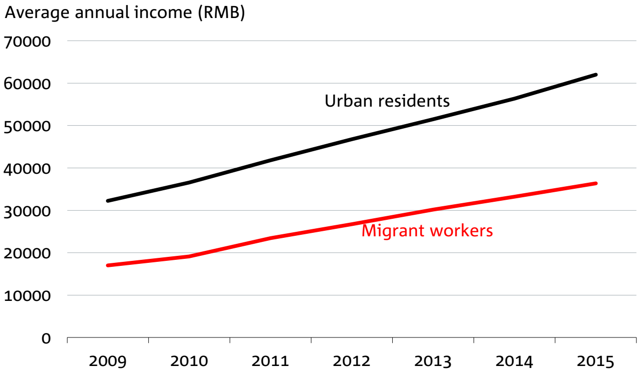
Source: CEIC, NAB Economics

Increasing labour productivity is a complex problem, as it is impacted by a wide range of factors. These include investment in physical capital, technological change and investment in labour (building skills and competencies). The scope for productivity gains from the first two factors is arguably limited. First, the transition of China's economic growth model away from heavy industry towards services means that economic growth is likely to be less capital intensive than has been the case in recent decades – due to the more labour intensive nature of service provision. Second, opportunities for major productivity gains from adoption of technology appear limited, as it is generally accepted that the technology gap between Chinese and advanced economy firms has rapidly closed in recent years.

Instead, the focus should be on building the quality and mobility of China's workforce. We have previously highlighted the importance of enhancing the country's education system – particularly increasing the share of the population with tertiary qualifications (which may be required in the services sector) – with less than 4% of the population having a university qualification in 2012, compared with 33% in advanced economies (OECD). That said, China also has to effectively address the brain drain – where highly qualified residents (either domestically or overseas educated) choose to emigrate – to ensure skilled labour remains available.

Improving labour mobility also presents the potential for significant gains – although this remains constrained by the country's household registration system (hukou). In 2015, there were around 277 million migrant workers in China – primarily moving from rural areas to major cities – accounting for just over 20% of the population. Migrant workers who lack an urban hukou are locked out of local social services and typically earn less than urban residents. Educational outcomes for the children of migrant workers are usually worse than for urban residents as well – with many children remaining behind in their parent's home provinces – where generally sub-standard educational standards perpetuate the cycle of disadvantage.

Incomes for China's migrant workers continue to lag their urban peers



Source: CEIC, NAB Economics

Hukou reform announced in 2014 represented a partial solution to the problem – removing the distinction between urban and rural citizens, and allowing permanent residence in the country's smallest cities. However, the greatest economic opportunities remain in China's largest cities – where permanent residence remains strictly controlled. The policy is also relatively slow acting – over five years – and narrow, covering only around 100 million migrants. Further reform – potentially the complete removal of the hukou system – could represent a positive productivity measure.

The appetite for reform – seriously under question

The partial reform of the hukou system highlights in part the competing political pressures that can constrain reform. Many local governments fought reform, as they would face the added burden of social services provision. Similar pressures exist in attempting to address over-capacity in state-owned enterprises – which could result in rising unemployment in some regions.

More recent reform attempts have also struggled to gain traction. In August 2015, the People's Bank of China altered its foreign exchange policy to adopt a more market based approach – in line with broader financial and current account reforms. However central bank minutes recently released to the Wall Street Journal revealed that the PBoC reversed this reform in early January – as the bank attempted to maintain FX stability and stem capital outflows. So far this change has not been officially acknowledged, but this highlights that long term reforms can be derailed by short term concerns.

In November 2015, China's government announced that it would implement 'supply side reforms' – however little detail on the exact nature of these changes has subsequently been released, except to stress that this policy would not replicate the Western-style policy agenda of the 1980s. In the absence of detail, China observers have debated whether this uncertain policy change signals further market reforms or closer control by the state.

Moody's argue that China's government is attempting to simultaneously achieve three competing goals – achieve strong economic growth, implement reform and maintain stability. It argues that at best two of the three can occur together, and that current policy is favouring growth and stability ahead of reform. This will likely support short term economic activity, but not provide the support for productivity gains necessary to underpin stronger long term prospects.

Conclusions

In 2013 we expressed cautious optimism towards China's broad reform agenda. The slow pace of reform is a major concern, given the increasing demographic pressure and the urgent need to increase labour productivity. Failure to boost productivity will result in medium term economic growth slowing considerably and China's economy remaining constrained at middle income levels.

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