Macro
China Economics

China: Faster reform, slower growth

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- **Beijing's new leaders prefer to use reforms rather than stimulus to sustain growth**
- **While reforms can boost long-term growth prospects, they will have a limited impact in the short term**
- **We cut our GDP forecasts to 7.4% (from 8.2%) for this year and 2014 (from 8.4%). Growth should rebound in 2015**

Three months into the job Beijing's new leaders are clearly determined to use the reform process rather than stimulus to sustain growth. Premier Li Keqiang recently stated that reforms would be deepened in order to unleash the potential of consumption and private investment, whereas room to further stimulate the economy via government investment would be limited. And so it seems – with weaker numbers released recently, Beijing has shown little enthusiasm for launching new stimulus, indicating a greater tolerance for slower growth.

The reform agenda includes financial, fiscal, deregulation, and urbanisation reforms. Once implemented, these measures should invigorate the private sector and improve efficiency, lifting growth prospects in the medium to long term. And few would disagree that financial and fiscal reforms are the only solution to local government debt, shadow banking and other structural problems.

That said, it will take time for these measures to filter through to the economy and have an impact on growth. In the short term some reform initiatives will actually be negative for demand, implying that growth will slow before regaining momentum in 2015. This factor, on top of the weaker-than-expected data flows, leads us to cut our GDP growth forecasts to 7.4% for 2013 (vs. 8.2% previously and consensus of 7.8%) and 2014 (from 8.4%).

Sub-8% GDP growth will likely add to disinflationary pressures, therefore we lower our CPI forecast to 2.5% y-o-y for this year (from 3.1%). Further, taking into account energy pricing reforms, we revise our 2014 CPI forecast to 2.6% (from 2.7%). This leaves room for a 25bp interest rate cut and further widening of interest rate floating range this year, and another 25bp cut in 2014 (previously we expected no changes).

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Faster reform, slower growth

- Signs are emerging that Beijing's new leaders are prioritising reforms over stimulus in order to sustain growth
- Reforms will reduce tail risks and lift medium to long-term growth prospects
- But unlike stimulus, reforms cannot lend much support to demand expansion in the near term. We cut our GDP forecasts to 7.4% (from 8.2%) for this year and 2014 (from 8.4%)

New leaders' policy thinking: It's all about reforms

Three months after the leadership transition, there is now enough evidence to show that Beijing's new policymakers are putting reforms ahead of stimulus as the policy tool of choice to sustain growth.

In a speech broadcast to officials around the country on 13 May, Premier Li Keqiang said: "To achieve this year's economic targets the room to rely on stimulus policies or government direct investment is not big – we must rely on market mechanisms… We must revitalise private investment and spending through deregulation and other reforms." (Source: Bloomberg).

Cutting government red tape for business approvals and removing entry barriers in the service sector will certainly help unleash private business and create more jobs. At the same time, reforms are also seen as the best solution to local government debt problems and other tail risks the economy is facing. Policymakers are also emphasising the quality of growth over quantity and reforms are expected to address this issue by concentrating on structural problems.

China's GDP growth slowed unexpectedly to 7.7% in 1Q and the latest indicators suggest that growth is still weakening (see: *HSBC China Manufacturing PMI (Final, May): Slowing or stabilising?* 3 June and *China: Mid-year slowdown*, 9 June). What's different this time is that top officials seem to be less enthusiastic about launching new stimulus, with their latest policy statements dominated by comments about the need to speed up reforms.

In early June President Xi Jinping told a press conference during his visit to the US that "China's economy grew by 7.7% in 1Q, such a growth rate is actually helpful for structural adjustment." (*Dow Jones Business News*, 9 June). Meanwhile, Premier Li stated that "China's economy delivered steady growth in 1Q, and is still within a reasonable range". (*Wall Street Journal*, 8 June).

He also vowed to keep adjusting and upgrading the Chinese economy as well as expanding its openness to the world.

We believe Beijing's focus on speeding up reforms will, once implemented, improve efficiency as well as revitalise private business. This will put China on a sustained and steady growth path in the medium to long term.

However, it will take time for the impact of the reforms to filter through, so growth is likely to stay lower in the near term, especially given weak global demand.

This, combined with weaker-than-expected data flows in recent weeks, leads us to cut our GDP forecasts to 7.4% (from 8.2%) for this year and 7.4% (from 8.4%) for 2014. However, we believe growth should rebound in 2015 when the impact of reform measures filters through.

Streamlining government

The new leadership has proved to be not only reform-minded but also quick to take action. Even before the National People's Congress (NPC) earlier this year, President Xi banned official extravagance, a sign of changes to come.

During the NPC, the State Council, China's cabinet, unveiled plans to streamline government efficiency and reduce direct government intervention (see *China NPC: Beijing's streamlining drive*, 11 March). The Ministry of Railways and three other departments have been scrapped, while the food safety regulators have been consolidated to more effectively tackle health and environmental problems.

All these moves signal that new leaders want to reduce the government's role in business while enhancing its capability to provide health, environment and other public services.

Top reform agenda for 2013 and beyond

A long list of government announcements suggests a determination to deliver concrete reforms despite concerns about tepid economic growth. For example, on 6 May a State Council meeting chaired by Premier Li outlined nine key measures to be introduced in 2013 (see *China: Concerns about risks won't slow reforms*, 7 May). Details of these policies will be unveiled this year but the broad guidelines are:

- **Streamlining government:** Simplify the investment approval process by cancelling another 61 items that need approval or delegating them to lower levels (71 items have already been cancelled). Reform the financing system for railways through deregulation to attract private investments.

- **Financial reforms:** Promote interest rate liberalisation and develop an operational programme for renminbi convertibility under the capital account. A pilot programme allowing individuals to invest in overseas markets will be rolled out. Measures to protect small and medium-sized investors and better regulate investment products such as bonds, stocks and trusts will also be introduced.

- **Fiscal reforms:** Establish an open, transparent, standardized and comprehensive budget system, control local debt risks, expand pilot reforms of VAT and develop plans for a resources tax and to tax mineral resources.

- **Pricing reforms:** Establish a progressive pricing system for the supply of major urban utilities, including electricity, water and natural gas.

- **Urbanisation reforms:** Emphasise the quality of urbanisation in mid to long-term plans. A new city residential permit system to gradually replace the half century-old *hukou* (household registration) system will be rolled out. Related public services and social security system will also be improved. Beijing will make efforts to develop modern agriculture through better legal protection of farmers' land rights.
- Other reform measures concerning social welfare will also be accelerated. These include medical, public housing, food safety and environmental protection.

On 24 May the State Council issued detailed guidance on deepening economic reforms for 2013. This was a follow-up document to the 6 May meeting, explaining that this year the focus will be on seven reforms covering the administrative system, fiscal, financial, investment, resources pricing, social security, and urbanisation. Each reform task has been delegated to the relevant government ministries and departments (see Table 1).

Table 1: Details of top reform agenda

Areas of reform	Reform agenda	Details	Ministries taking responsibility
Reforms of administrative system	Streamline government	Formulate and revise provisions for newly formed departments, and promote streamlining local government	State Commission Office for Public Sector Reform (SCOPSR)
	Decentralization	Simplify investment approval process	SCOPSR, NDRC, MOHRSS, SCLAO
	Innovate public service supply	Introduce government purchase of services from social entities, decouple the industrial associations from administrative departments, deepen official vehicles reform	MoF, NDRC, SCOPSR, MCA, MOHRSS, SAIC, SASAC, GOA
Fiscal reforms	Improve fiscal budget system	Promote to establish an open, transparent, standardized and comprehensive budget system	MoF
	Expand pilot reforms of VAT tax	Expand VAT tax reforms, adjust consumption tax and expand pilot reform of property tax	MoF, SAT, MoHURD
	Develop plans for resources tax	Develop plans for resources tax and taxation on mineral resources	MoF, NDRC, SAT, MLR
	Improve system of SOEs	Establish budget and sharing system covering all the SOEs	MoF, SASAC, MoST, MIIT, SAT
Financial reforms	Promote interest/ exchange rate liberalization	Steadily promote interest rate liberalization and develop an operational program for renminbi convertibility under capital account. Allow individuals to invest in overseas markets	PBoC, NDRC, MoF, CBRC, CSRC, SAFE
	Improve OTC equity market business rules	Protect small and medium-sized investors and better regulate investment products such as bonds, stocks and trust. Promote commodity and bond futures market	CBRC, NDRC, MoF, PBoC, NEA
	Promote deposit insurance system	Establish a risk compensation and sharing mechanism for financial institutions' business failures. Speed up and standardize the development of private/ small and medium-sized financial institutions.	PBoC, CBRC, MoF
Investment and financing reforms	Investment and financing reforms	Deregulate to attract private investments, and reform the financing system for railways	SCLAO, NDRC, MIIT, MoT, PBoC, SASAC, CBRC, NEA, Railway Bureau
Pricing reforms	Reform prices of water and electricity	Establish a phased pricing system for the supply of major urban utilities, including electricity, water and natural gas	NDRC
Social security reforms	Reforms concerning social welfare will be accelerated	Progressively improve the basic medical insurance system nationwide and assistance for the poor (e.g. minimum living standards, employment assistance, serious illness assistance). Establish a stringent supervision system for food and drug safety, and the environment	MOHRSS, SCOPSR, MoF, MoHURD, MCA, NDRC, SDA, MEP, State Forestry Administrative, National Health and Family Planning Commission
Urbanization reforms	Reforms of household registration and land	Study and formulate development plans for urbanization. A new city residential permit system to gradually replace the household registration system will be rolled out. Related public services and social security system will also be improved. Beijing will make efforts to develop modern agriculture by providing better legal protection of farmers' land use rights	NDRC, SCOPSR, MoHURD, MCA, MoA, MPS, MoF, MOHRSS, National Health and Family Planning Commission, MoE, SCLAO, MLR, PBoC, CBRC, CDRC, CIRC, MWR, State Forestry Administrative

Note: SCOPSR, State Commission Office for Public Sector Reform, 中央机构编制委员会; NDRC, National Development and Reform Commission, 国家发展改革委员; MOHRSS, Ministry of Human Resources and Social Security, 人力资源社会保障部; SCLAO, Legislative Affairs Office of the State Council, 国务院法制办公室; MoF, Ministry of Finance,财政部, MCA, Ministry of Civil Affairs,民政部; SASAC, State-owned Assets Supervision and Administration Commission of the State Council,国务院国有资产监督管理委员会; SAIC, State Administration for Industry and Commerce, 国家工商行政管理总局; GOA, Government Offices Administration of the State Council, 国务院机关事务管理局; SAT, State Administration of Taxation, 国家税务总局; MoHURD, Ministry of Housing and Urban-Rural Development;住房和城乡建设部; MoLR, Ministry of Land and Resources, 国土资源部; MoST, Ministry of Science and Technology, 科学技术部; MIIT, Ministry of Industry and Information Technology, 工业和信息化部; PBoC, People's Bank of China, 中国人民银行; CBRC, China Banking Regulatory Commission,中国银行业监督管理委员会; CSRC, China Securities Regulatory Commission, 中国证券督管理委员会; SAFE, State Administration of Foreign Exchange,国家外汇管理局; NEA, National Energy Administration, 国家能源局; MoT, Ministry of Transport, 交通运输部; Railway Bureau, 铁路局; SFDA, State Food and Drug Administration ,国家食品药品监督管理局; MEP, Ministry of Environment Protection, 环境保护部; SFA, State Forestry Administration, 国家林业局; NHFPC, National Health and Family Planning Commission, 国家卫生和计划生育委员会; MoA, Ministry of Agriculture, 农业部; MPS, Ministry of Public Security, 公安部; MOE, Ministry of Education,教育部; CIRC, China Insurance Regulatory Commission, 中国保险监督管理委员会; MWR, Ministry of Water Resources, 水利部.

Source: State Council, HSBC

More to come

2013 is likely to mark the start of an era of new reforms led by the Xi-Li government. A longer-term reform blueprint will probably be announced as early as the third plenary meeting of the CPC's 18th Central Committee, probably in October. We do not expect any sudden changes as a gradual and smooth reform process will suit China's interests.

Reforms to boost sustainable mid and long-term growth

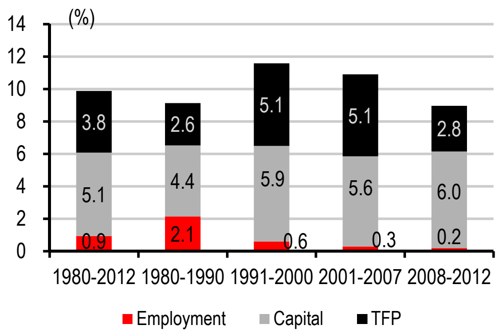
The reform agenda will play a vital part in boosting supply-side efficiency and removing bottlenecks to growth in the medium and long term. We believe it's the only solution to the daunting challenges China is facing, which include a rapidly aging population, an elevated investment/GDP ratio, high environmental costs, and a rising income gap.

History suggests that it was reform that created the gains in labour productivity which is one of the root causes of China's high economic growth. While aging population is an inevitable and irreversible trend in the medium term, maintaining rapid labour productivity gains holds the key to sustaining strong growth.

Of these gains in productivity, the largest share has come from investment and total factor productivity (TFP) (see Chart 1). We have written a lot about the potential of investment but this now requires sustainable long-term financing instruments which can only be delivered by financial market reforms (see *China Inside Out: Return on investment, perception vs. reality*, 3 April and *China's growing pains*, 16 May).

China's growth is increasingly driven by investment, while the contribution from TFP has dropped by nearly 45% in the post-crisis era to 2.8ppt from 5.1ppt since the 1990s. This reflects the shift of growth driver from exports to infrastructure. As infrastructure is more capital intensive and takes longer to bear economic fruit, this is likely to reduce productivity in the short term. Reforms are needed to lift TFP and sustain China's long-term growth.

Chart 1. Accounting for China's growth



Source: CEIC, HSBC

The key to reform lies in redefining the relationship between the government and the market. More market-driven reforms will raise the efficiency of supply by encouraging private investment, establishing long-term sustainable funding mechanisms, and releasing the potential of human capital. It's these reforms that can resolve the country's structural problems. We now look at the agenda in more detail.

Financial reforms

These reforms are progressing faster than expected and could be the catalyst for sustaining rapid growth. Investment has been and will remain a key driver of productivity gains. This requires an effective allocation of capital to sustain investment growth. At the same time TFP gains require innovation to boost technology advances, which also need easier funding.

However, the current financial system – with a smaller but still dominant banking sector and underdeveloped capital markets, especially the bond market – is unbalanced. Quantitative controls and caps on interest rates are still in place.

Large companies and state-owned enterprises (SOEs) have much easier access to funding than small and medium-sized enterprises (SMEs). SMEs contribute 60% of GDP, 50% of tax revenues and 80% of urban employment opportunities. Despite this 90% of them have no lending relationship with any financial institutions, according to a survey by the All-China Federation of Industry & Commerce (ACFIC).

Financial reforms led by interest rate liberalisation and bond market development will expand the financing channels for large infrastructure projects and big companies. This will force banks to shift their focus to SMEs. Meanwhile, liberalised interest rates will allow financial institutions to price risks better. This is a vital step for the development of the bond market as it will provide long-term financing tools and improve overall funding efficiency.

In addition, structural problems such as the high levels of local government debt can be resolved through the issuance of municipal bonds. So again, developing the bond market holds the key to progress.

Together with fiscal reforms to strengthen the balance sheets of local governments and split fiscal revenue between central and local governments, the trial programme of allowing some municipal governments to issue bonds can be expanded nationwide. This should help price the risks of different local governments and also create a long-term financing channel to sustain the urbanisation-driven investment boom.

Fiscal reforms

This is the key to changing the role of the government – from a big government which crowds out private businesses to a smaller one that is still capable of providing adequate public services.

First, Beijing is making efforts to establish a more standardized and transparent fiscal budget. This will not only maximize the efficiency of fiscal spending but will also pave the way for building balance sheets for both central and local governments, which would allow them to raise funding through municipal bond issuance. A more comprehensive reform to split fiscal revenue between central and local governments more equitably is necessary.

Table 2. How reforms will affect the economy

Reform measures	Short-term (3 months-1 year) impact	Medium/long-term (>2 years) impact
Financial	▸ Slower expansion in shadow lending affects the finding of local projects ▸ Interest rate liberalisation increases the cost of funding while giving better returns for household savings ▸ Bond market development expand the financing channel for investment projects	▸ Boost investment efficiency; more effectively price risks, ▸ Ease the financing constraints to SMEs
Fiscal	▸ Reduce government administrative spending ▸ Pricing reforms are likely to dampen demand for resources and add inflationary pressures for related consumption; ▸ VAT reform reduce tax burden for services sectors ▸ Fiscal support for micro and small companies of high growth potential, high technology and high openness ▸ Improve social provisions to ensure labour market stability	▸ Boost the fiscal sustainability and transparency ▸ Provide adequate public services to spur consumer spending ▸ Cut red tape to lift efficiency
Deregulation	▸ Improve business environment, especially for SMEs ▸ Boost private investment in railway through invest financing reforms ▸ Breakthrough of private investment in areas like telecom, energy	▸ Break the monopoly of SOEs and encourage private investment ▸ Promote innovation and technology advancement
Urbanisation	▸ Boost private investment in infrastructure construction and public services ▸ Gradual reform on *hukou* and land reform helpful to boost consumer spending ▸ Urbanisation-related construction helpful to lift investment	▸ Expand the labour supply by speeding up the transfer of rural migrant workers and lengthening the their stay in cities ▸ Provide better city infrastructures and its spill over effects erases the supply-side constraints ▸ Encourage consumer spending through faster income growth and equal access to social benefits ▸ Efficient land usage

Source: HSBC

Second, as the government redirects resources to social welfare, this will boost household demand by reducing the levels of discretionary savings. According to a PBoC survey these savings are motivated by three main factors – education, retirement and medicare. China's public spending on education was around 17% of fiscal spending in 2012, compared with over 20% in Singapore.

Third, reforms are vital for reducing tax on businesses. Replacing business tax with VAT in the service sectors is expected to significantly lower their tax burden. According to the Ministry of Finance, under the new VAT scheme 95% of service enterprises will get lower tax rates and the total tax reduction could top RMB200-300bn per year, or around 2-3% of fiscal revenue.

Last but not least, the extension of property tax should help prevent the property market from overheating. In addition, this should provide an additional source of fiscal revenue for local government to provide better public services.

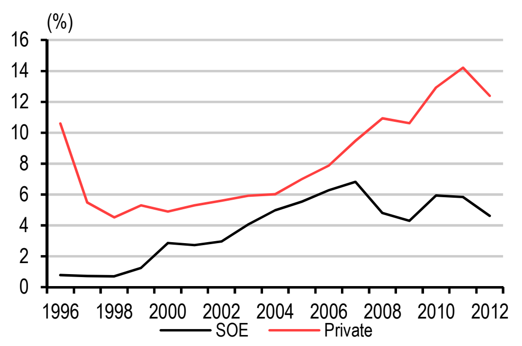
Deregulation

This is all about lifting the level of efficiency by introducing more competition and expanding the number of sectors that are open to private enterprise. There is no doubt that previous reforms improved efficiency by downsizing SOEs in terms of industrial production and employment. Measured by profitability, private companies have much higher returns, both on assets and equity. However, even after 30 years of market-oriented reforms, SOEs still have a big advantage through their access to cheap funding, natural resources and manpower.

Breaking the monopoly of SOEs – one of the biggest challenges for the reform process – and lowering entry barriers for private investment should improve investment efficiency and speed up the technology advancement.

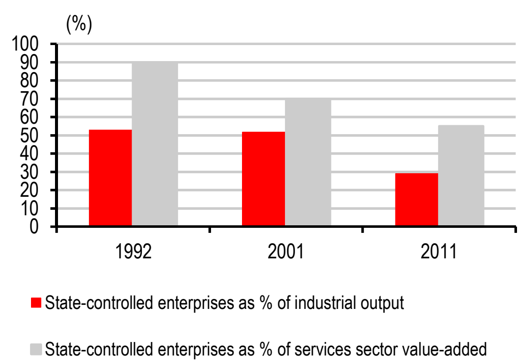
Private investment is likely to be increased in the following areas: 1) railways: following the split of Ministry of Railways and the subsequent investment system reform; 2) infrastructure construction: with fiscal constraints and high debt burdens, local governments should invite private investment in urban infrastructure; and 3) service sectors such as education, finance and telecoms where there is huge potential consumer demand and the opportunity to create large numbers of jobs.

Chart 2. Private enterprise is more efficient (return on assets)



Source: CEIC, HSBC

Chart 3. But SOEs still dominate in many sectors



Source: HSBC, CEIC

Urbanisation

Urbanisation will mobilise the labour force and mitigate the impact of the aging population. It will also sustain the transfer of labour from low productivity agriculture to higher productivity manufacturing and service sectors.

The State Council is set to hold a working conference on urbanisation as early as this summer, according to *21st Century Business Herald* (21 May). But this is not just about building roads and houses; it is increasingly about people – employment opportunities, equal access to public services such as education, pensions, medicare and the best use of land.

Rural land rights and *hukou* reform are the two key issues. Land is used by local governments to attract and stimulate investment. Yet the interests of farmers are often overlooked, especially when property prices are rising.

Pilot land reform programmes (e.g., Chongqing and Chengdu) offer much better methods of land transfer as well as the more intensive use of land. The schemes allow migrant workers to sell the rights to use the land, previously left idle. The restructuring of land usage should increase efficiency and also accelerate the release of rural surplus workers. We estimate the number is likely to top 154m over the next 10-15 years (see *China Inside Out: Slowdown more cyclical than structural*, 28 August 2012).

Hukou reform will accelerate and smooth the process of turning migrant workers into urban citizens. This requires local governments to provide public services to new residents, essential for migrant workers who want to settle in cities and compete with urban citizens on an equal basis. Better social security should also change the consumption pattern of migrant workers, who earn money in cities and remit funds back home.

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Table 3. New HSBC forecasts vs. Consensus

	2013f			2014f		
	New	Old	Consensus	New	Old	Consensus
GDP y-o-y	7.4	8.2	7.8	7.4	8.4	7.8
CPI y-o-y	2.5	3.1	3.0	2.6	2.7	3.5
PPI y-o-y	-1.5	1.0	n/a	0.7	4.0	n/a
1yr lending rate	5.75	6.00	n/a	5.50	6.00	n/a
FAI	20	21.5	n/a	19	20	n/a
Retail sales	12.5	13	n/a	12	14	n/a

Source: Bloomberg Consensus, HSBC estimates

Yet reforms offer limited support to short-term growth

Unlike stimulus, reforms won't lend much support to growth in the near term. For one thing, the new measures will take time to have an impact as administrators and businesses get used to the new environment. For example, private enterprise has limited experience of investing in railway projects. After the splitting up of the Ministry of Railways and the establishment of China Railway Corp, private investment in railway projects is likely to become easier at the operational level.

For another, some reform initiatives are likely to have negative implications for demand and supply. On the demand side: 1) public spending has fallen thanks to the anti-extravagance campaign and the impact is unlikely to taper anytime soon. Retail sales growth could be about 2ppt lower than previously expected; 2) deregulation and the simplification of the investment approval process are likely to lead to a temporary slowdown of investment approvals; 3) the extension of the property tax pilot scheme is likely to limit property purchases for the purpose of investment and speculation; and 4) the redirection of fiscal spending from investment to welfare is likely to reduce infrastructure demand.

On the supply side: 1) resources pricing reform is likely to raise costs for industrial enterprises; 2) to narrow the income gap, the increase in minimum wage and the expansion of social insurance is likely to be an extra burden for employers; 3) many sectors which have already suffered excess capacity are likely to go through a painful process of capacity elimination; and 4) tighter regulation on shadow banking is likely to slow funding for local projects. This is likely to weigh on growth and investment in the short term as long as no new stimulus is rolled out.

With persisting external headwinds, growth momentum was weaker than expected in 1Q and it has not showed any meaningful improvement in 2Q. Manufacturing growth is likely to stabilise at a relatively low level, judging from the two manufacturing PMIs. The underlying environment is fragile and conditions for SMEs – the key provider of new jobs – are especially tough.

Change of forecasts: GDP and CPI

We revise our whole-year GDP growth forecasts to 7.4% y-o-y (from 8.2% previously) for this year and 7.4% y-o-y (from 8.4%) for 2014.

The downward revision for this year's growth reflects the following factors:

- Weaker-than-expected data flows. Growth momentum continues to weaken following the 1Q disappointment as weaker exports curb business investment.

- Beijing's policymakers are less enthusiastic about launching new stimulus. Instead, they are focused on speeding up reform to sustain growth and it will take time for the impact of the reforms to filter through.

The revision to 2014 GDP reflects the following factors:

- Infrastructure-led investment is likely to take a breather as the y-o-y growth momentum for infrastructure projects started in 2H 2012 will taper. This may not be fully offset by likely robust property investment growth.
- As growth slows, wage growth is likely to follow suit, even if there is no widespread stress in the labour market. This is likely to weigh on consumer spending.
- Reform measures to revive private investment and consumption will take time to filter through.

That said, we believe the risk of a sharp slowdown in the coming years is remote, not least because urbanisation will continue to create new demand for infrastructure and housing. Moreover, despite a greater tolerance for slower growth, Beijing still has some fiscal and monetary ammunition it can use to support growth if necessary (we discuss this later).

Given the slower and below-trend growth, we see less demand-pull inflation pressures and limited upstream inflation. As such, we lower our 2013 CPI forecast to 2.5% y-o-y from 3.1% y-o-y. Taking into account softer growth and pricing reforms, we revise our 2014 CPI forecast to 2.6% y-o-y from 2.7%. PPI is likely to turn positive (around 0.7%) in 2014, up from our forecast negative 1.5% in 2013.

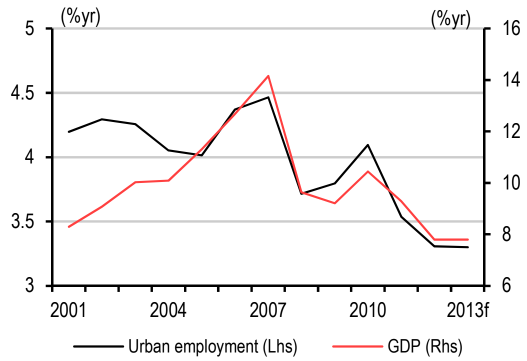
What's the minimum growth rate Beijing can tolerate?

Although policymakers will tolerate slower growth, it is wrong to believe that Beijing no longer needs a floor to growth. Keeping the labour market stable to avert social unrest should remain the most important economic and political goal.

So where is the floor? We think it is around 7% GDP growth. Let's take a look at the country's labour supply and demand dynamics in the coming years:

GDP: GDP growth is still a key driver for employment growth. GDP growth and the employment growth rate have had a tight correlation of over 0.9 over the past five years as shown in Chart 4.

Chart 4. Tight link between GDP and employment growth



Source: CEIC, HSBC estimates

This means when GDP growth slows, urban employment will slow by almost the same magnitude. We estimate that a 1ppt drop in GDP growth would translate into a 1.5m cut in new jobs. The official unemployment rate stands at 4.1%, but this understates the real situation as it

Table 4. New HSBC quarterly forecasts for GDP and CPI (%)

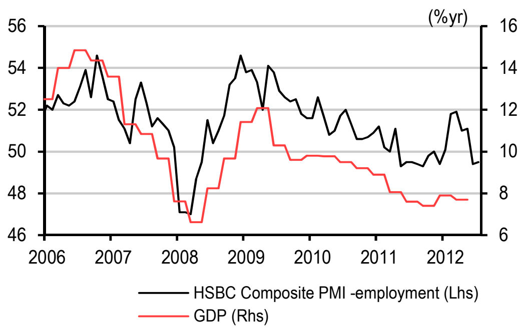
	1Q13	2Q13f	3Q13f	4Q13f	1Q14f	2Q14f	3Q14f	4Q14f
GDP y-o-y	7.7	7.4	7.4	7.3	7.2	7.3	7.4	7.5
GDP q-o-q sa	1.6	1.5	1.8	1.9	1.8	1.7	1.8	2.0
CPI y-o-y	2.4	2.3	2.4	2.9	2.9	2.8	2.44	2.3

Source: HSBC estimates

only covers those with urban resident status. Our best guess is that the real jobless rate is at least 2ppt higher than the official rate.

PMI: A more timely labour market indicator is the employment index within PMI. The HSBC composite PMI provides the employment index starting from November 2005. Again, this is highly correlated with GDP growth. We find a 1ppt change in GDP growth impacts the employment index by about 1point. When China's GDP growth decelerated sharply from 9.7% y-o-y in 3Q 2008 to 6.6% y-o-y in 1Q 2009, the employment index dropped from 51.3 (in line with the historical average) to a trough of 47 in January 2009. This led to massive numbers of migrant workers losing their jobs and was the main reason for the release of Beijing's aggressive stimulus package. Last year, when GDP cooled to 7.4% y-o-y in 3Q the employment index dropped to a cyclical trough of 49.3 in July. This year, when growth is likely to continue to slide in 2Q following the downside surprise in 1Q, employment started to weaken again. All in all, every time GDP growth slows to below 8%, the employment index tends to slide slightly below 50. When GDP has dropped to below 7% there has been obvious stress in employment growth. But the previous episodes of labour market weakness did not last long thanks to Beijing's stimulus to revive growth in a short period of time.

Chart 5. PMI employment contracts when GDP growth slows to below 8%



Source: Markit, CEIC, HSBC

Composition of GDP growth: This matters for job elasticity. The tertiary sector is perceived as being more labour intensive and represents 54.4% of the non-farm payroll in China. However, the elasticity in secondary industries is higher than tertiary industries, at around 0.28 and 0.25 respectively over 2008-12.

So, if slower employment growth is accompanied by a shrinking or slowing labour supply, the slowdown in economic growth is not a big concern. However, the labour supply is unlikely to slow meaningfully in the coming years despite the demographic changes. The Ministry of Human Resources and Social Security stated at a press conference in January 2013 that China still faces a rise in the working age population in the coming years – an average of 25m new job seekers per year during the 12th FYP period (2011-15). The new job seekers comprise the following: 1) college graduates, 7m; 2) graduates from secondary and vocational schools, 7m; and 3) rural surplus labour, 8m.

Where we are now? We think 2Q growth faces more downside risks as HSBC manufacturing PMI eased to an eight-month low below -50. There are growing signs of labour market deterioration. The employment sub-index in the HSBC manufacturing PMI recorded the second consecutive month of contraction in May, while the employment sub-index in April's HSBC services PMI showed the first contraction since 2009. The 7m college graduates face a tough job market with less than 30% getting a job offer by April (or around 10ppt lower than the same period last year).

What can Beijing do to secure the minimum growth level?

With 7% likely to be the lowest growth rate Beijing needs to prevent labour market instability; what level of policy flexibility is there to rescue growth if needed?

On fiscal policy, Beijing still has room to manoeuvre given that there has been a RMB960bn fiscal surplus for the first five months of this year (compared with a RMB1200bn budget deficit target for the whole year) and over RMB3trn of fiscal deposits. With a still strong fiscal position, policymakers have several options if they want to make targeted measures to lift growth and employment.

For example, the current pilot programme of VAT reform will effectively lower the tax burden for the service sectors, which are more labour intensive. Beijing could roll out this programme to the whole nation and the whole services industry, which is likely to save RMB400bn in tax for service enterprises.

Meanwhile, the revenue from launching a property and resources tax is likely to offset the loss from VAT. In addition, to resolve the problem of graduate unemployment, policymakers can give preferential policies to college graduates who start their own business after graduation. Local governments could provide interest rate discounts for these start-up graduates applying for bank credit.

As we have argued on many occasions, despite the recent infrastructure boom there is room for more infrastructure investment. For instance, OECD data show that rail density in the 10 largest Chinese cities is only one-fourth of urban areas in the developed world. At around 25% of GDP, the size of local government debt is still manageable and the expansion of the bond market can help provide sustainable finance for local infrastructure projects.

Credit growth is already strong, and there is not much room for further acceleration. But interest rates are high and the PBoC can cut them while further liberalising interest rates if needed. The recent slower-than-expected CPI reading implies that the real deposit interest rate has turned negative again and the contraction in PPI implies that the real lending rate is rising.

China macro forecasts

	2008	2009	2010	2011	2012	2013f	2014f
Production, demand and employment							
GDP growth (% y-o-y)	9.6	9.2	10.4	9.3	7.8	7.4	7.4
Nominal GDP (USDbn)	4,535	4,990	5,938	7,320	8289	9228	10228
GDP per capita (USD)	3,432	3,758	4,428	5,431	6120	6779	7476
Retail sales (% y-o-y)	21.6	15.5	18.5	17.1	14.3	12.5	12.0
Fixed Asset Investment (nominal, % y-o-y)	26.1	30.5	24.5	23.8	20.6	20.0	19.0
Industrial production (% y-o-y)	12.9	12.9	15.7	13.9	10.0	9.3	9.2
Gross domestic saving (% GDP)	51.4	51.8	52.6	51.5	51.0	51	50.5
Unemployment rate, average (%)	4.2	4.3	4.1	4.3	4.1	4.3	4.4
Prices & wages							
CPI, average (% y-o-y)	5.9	-0.7	3.3	5.4	2.7	2.5	2.6
CPI, year-end (% y-o-y)	1.2	1.9	4.6	4.1	2.5	2.7	2.3
Core CPI, average (% y-o-y)	0.9	-1.1	0.9	2.2	1.5	1.7	1.7
Core CPI, year-end (% y-o-y)	-0.4	0	1.7	1.6	1.6	1.5	1.5
PPI, average (% y-o-y)	6.9	-5.4	5.5	6.1	-1.7	-1.5	0.7
PPI, year-end (% y-o-y)	-1.1	1.7	5.9	1.7	1.9	0.1	1.2
Manufacturing wages, nominal (% y-o-y)	15.8	9	13	13	13.0	12.5	12.0
Money, FX & interest rates							
Central bank money M0, average (% y-o-y)	12.4	12.1	14.9	16	9.6	12	12
Broad money supply M2, average (% y-o-y)	16.7	26.5	23.7	14.7	13.4	13.9	14.0
Policy rate, year-end (%)	5.31	5.31	5.81	6.56	6.00	5.75	5.50
5yr yield, year-end (%)	5.76	5.76	6.16	6.85	6.40	6.15	5.90
Real private sector credit growth (% Yr)	15	13	15.5	13.7	14	14	14
RMB /USD, year-end	6.82	6.83	6.62	6.3	6.23	6.16	6.16
RMB /USD, average	6.93	6.83	6.76	6.46	6.27	6.20	6.16
RMB /EUR, year-end	9.48	9.77	8.81	8.16	8.22	7.64	7.52
RMB /EUR, average	10.08	9.55	8.97	9.00	8.19	7.93	7.58
External sector							
Merchandise exports (USDbn)	1,429	1,202	1,578	1,899	2,049	2213	2412
Merchandise imports (USDbn)	1,133.10	1,005.60	1,394	1,741	1,816	1965	2122
Trade balance (USDbn)	295.5	196.1	184.5	157.9	233.0	248	290
Current account balance (USDbn)	426	284	250	201.1	193	205	220
Current account balance (% GDP)	9.4	5.7	4.2	2.7	2.3	2.2	2.2
Net FDI (USDbn)	108.3	90	105.8	116	111.7	115	121
Net FDI (% GDP)	2.4	1.8	1.8	1.6	1.4	1.3	1.2
Current account balance plus FDI (% GDP)	11.8	7.5	6.0	4.3	3.7	3.5	3.3
Exports, value (% y-o-y)	17.2	-15.9	31.4	20.3	7.9	8.0	9.0
Imports, value (% y-o-y)	18.5	-11.3	38.6	24.9	4.3	8.2	8.0
International FX reserves (USDbn)	1,946	2,399	2,850	3,181	3,312	3,650	3,650
Import cover (months)	18.9	27.9	24.8	23.1	20.6	22.0	21.4
Public and external solvency indicators							
Commercial banks' FX assets (USDbn)	181.3	115.3	128.1	147.5	167.3	186.4	207.2
Gross external debt (USDbn)	390.2	428.6	548.9	653.9	885.0	1025.0	1165.0
Gross external debt (% GDP)	8.6	8.6	9.3	9.2	10.7	11.1	11.4
Short term external debt (% of int'l reserves)	11.6	10.8	13.2	15.0	19.7	20.6	23.3
Consolidated government balance (% GDP)	-0.4	-2.2	-2.5	-2	-1.5	-2.1	-1.8
Public Sector Debt (% GDP)	34.5	44.0	43.4	38.9	38.7	37.8	36.7
Macro-prudential indicators							
Capital adequacy ratio	12	11.4	12.2	12.7	13	n/a	n/a
Non-performing loan ratio	2.4	1.6	1.1	1.0	1.0	n/a	n/a
Household Debt/ GDP (%)	11.8	16.2	18.9	18.8	20.1	n/a	n/a
Total Credit/GDP (%)	96.6	117.2	120.4	115.8	121.3	n/a	n/a
Residential House prices (% y-o-y)	-1.7	23.2	7.4	-0.7	8.7	n/a	n/a
Loan/Deposit ratio	65.1	66.9	66.7	68.0	69.0	n/a	n/a
Stock market capitalisation/GDP (%)	38.6	71.6	66.7	45.4	44.4	n/a	n/a

Note: Industrial production is the output of all industrial companies with annual sales over RMB20m.
Source: CEIC, IMF, ADB, HSBC estimates

Notes

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