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Watch For Likely Labor Market Turning Point In 2012

- We estimate that the total labor force in China between the ages of 20-65 will start to decline in 2020 and the core labor force (aged 35-55) share will decline to 30.3% by 2012. While China at present is still facing strong unemployment pressure, the newly-increased labor force will be just enough to meet labor demand with 8% annual GDP growth until 2012.
- The structural shortage of the labor force will be more severe in the low-income population because: 1) the demand-to-supply ratio is significantly larger for the low-income population at present, and 2) roughly 8 million previously laid-off female workers, most of whom are now holding low-income positions, will reach the official minimum age of retirement by 2013 and further boost the demand-to-supply ratio in the low-income labor market.
- The shortage of labor forces is likely to: 1) pose additional downward pressure on the economic growth, and 2) cause a surge in wage growth, especially in the low-income population, which, in turn, may translate into long-term inflation pressure. We hold our previous outlook that China may enter a period from 2012 to 2020 in which average Y/Y economic growth for the period declines to 7% and long-term inflation rises to 5% Y/Y.

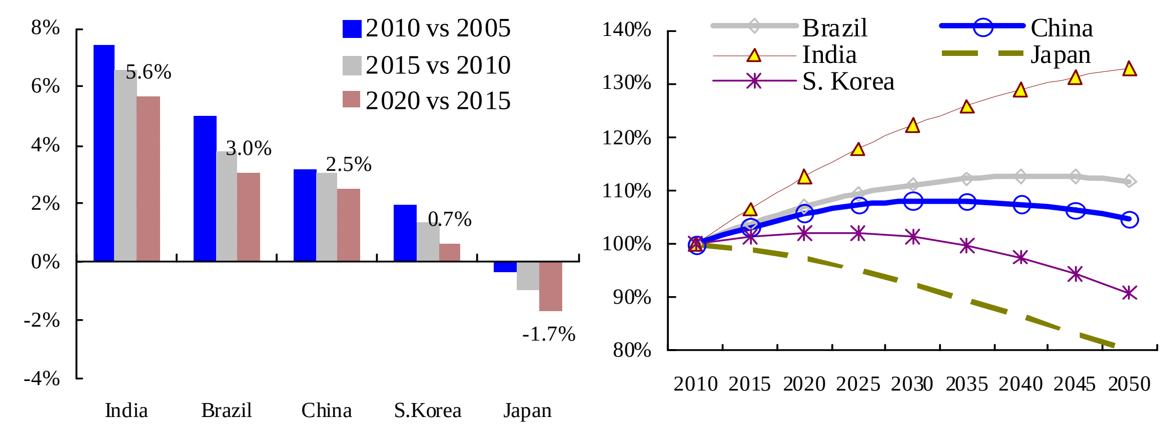
Population Is the Key to Global Growth, Especially in China

Population will play a key role among macro variables in the global growth in the years to come. The industrialized countries have been stepping down from their population peaks in recent decades. Because of globalization, the population constraints have not resulted serious inflation problems worldwide. Going forward, as most of the world population has already participated in the global economy, the marginal impact of further globalization may become minor. In turn, population growth again will be an important constraint in global growth.

Globally, the fast-growing population groups, such as in emerging market countries, face declining growth in the years to come. In 5-year terms, the population growth in India, Brazil and South Korea was 7.4%, 5.0% and 1.9% in 2010, compared with 2005. However the rates will decline to 5.6%, 3.1%, and 0.7% respectively in 2020. China's population growth will decline to 2.5% in 2020, while it was 3.1% in 2010. Population growth alone cannot support the trend of high economic growth.

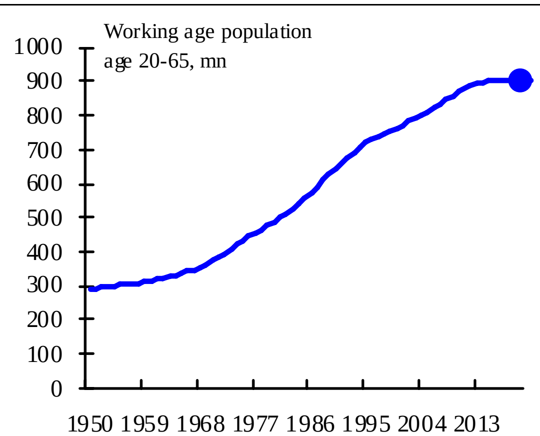
China, in particular, faces a severe decline in the growth of the working-age population. The working-age population between 20-65 years will peak in 2020; the growth rate will peak much earlier in 2012. In addition, the core working-age (between 35 and 55) population proportion will fall much more sharply, shrinking, by our estimation from 33.9% in 2008 to 30.3% in 2012.

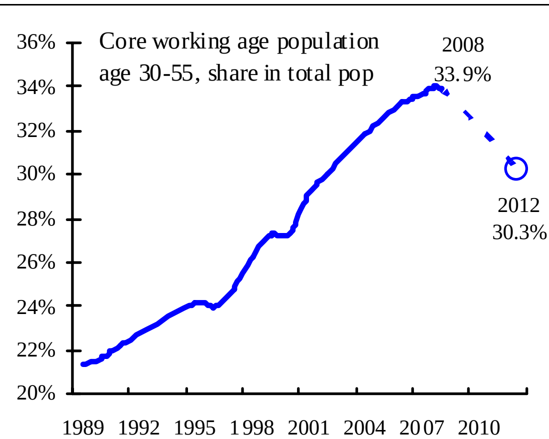
Chart 1 Population Growth in Selected Countries



Source: UN, CEBM

Chart 2 Working Age Population in China **Chart 3 Core Working Age Pop in China**





Source: UN, World Bank, CEBM

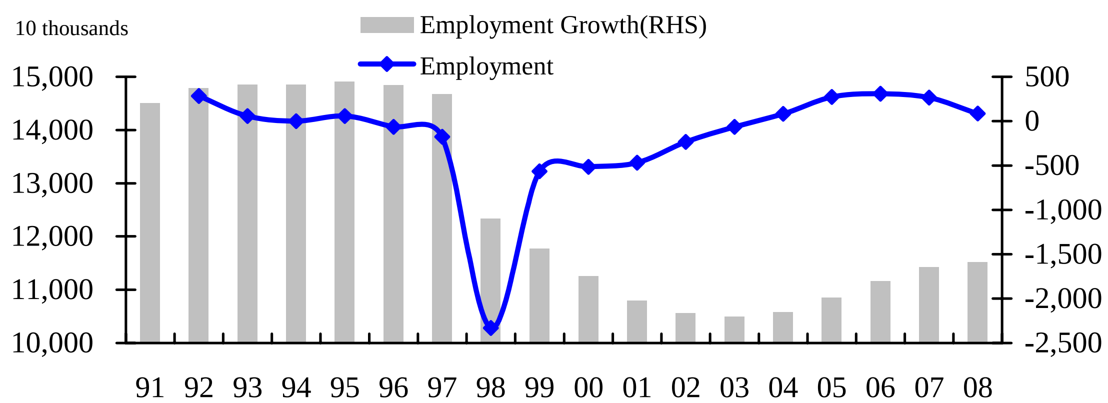
Low-end Labor Market Has Been Tightening

In a stable pattern of economic growth, the labor demand for different jobs should increase proportionally. By expanding public colleges and industrializing the private education system, China has provided growth for the medium and high-end labor populations. However, the low-end labor market has been neglected and has been tightening for years.

The low-end labor comes mainly come from rural areas. Migrant workers have flowed into cities at the rate of 12 million per year since 2000. Meanwhile, laid-off workers in the SOE reform in the late nineties to earlier 2000's provided supplementary supply to the low end labor market. The combination of migrant workers and laid-off workers formed a peak in the low-end labor supply between 1996 and 2003.

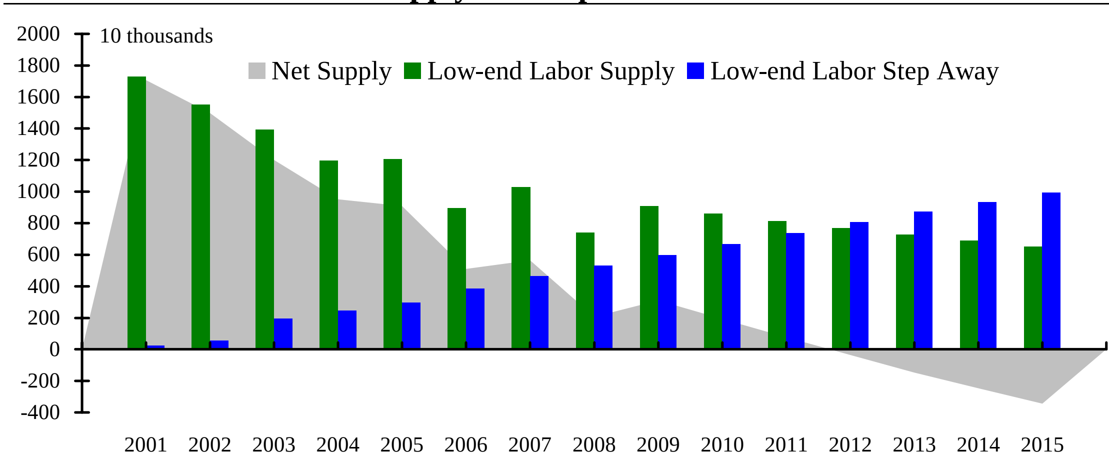
The peak is behind us now. As most laid-off workers will exit the labor market in retirement, it is likely the retirement may bring additional pressure to the low-end labor supply. Most of the laid-off workers in the SOE reform were between 40-50 years old, and it is possible that this part of labor supply will have left the market in 20 years. The one-off labor supply cannot solve the medium-term low-end labor shortage problem. Consequently, we are likely to see the peak of low-end labor supply in 2012.

Chart 4 SOE Reform Supplied One-off Additional Low End Labor



Source: NSBC

Chart 5 Lower-End Labor Supply Will Top in 2012



Source: CEBM Group

Structural Change Updates (1)
Low-end Labor Market Tightening Further

The latest quarterly labor market survey shows signs of market further tightening, and the crisis has not changed China's domestic labor market pattern much.

The survey investigated 100 cities in the 1Q this year. Taking the group of labor with less than 9 years of education (with lower-secondary education and below), the gap between demand and supply in the lower-end labor market is about 7,300 people per city on average. The gap emerged in 2001 and has been widening ever since. Although the financial crisis made the shortage less severe in 2008-09, the strong recovery again pushed the shortage back to trend. Looking at the labor market, the crisis never appears to have happened. Comparing with the supply of lower educated labor in 1Q01, The supply of less-educated labor is now is 3.17 times what it was in 1Q01, while demand has rocketed to 4.80 times.

The higher-educated labor group, however, is slightly oversupplied. Even in the post crisis era, the survey shows the higher-educated labor force is oversupplied by roughly 5,200 persons per city on average.

Chart 6 Low End: Gap Widening

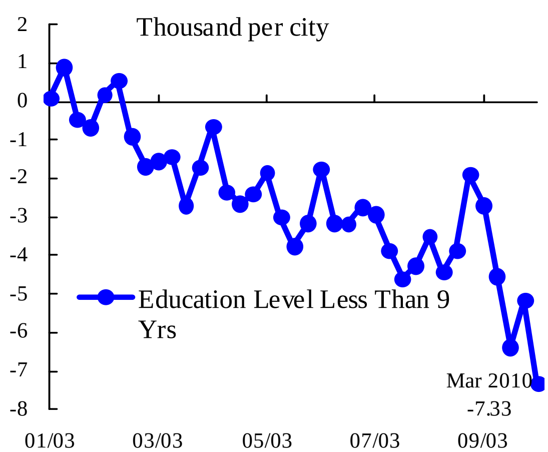
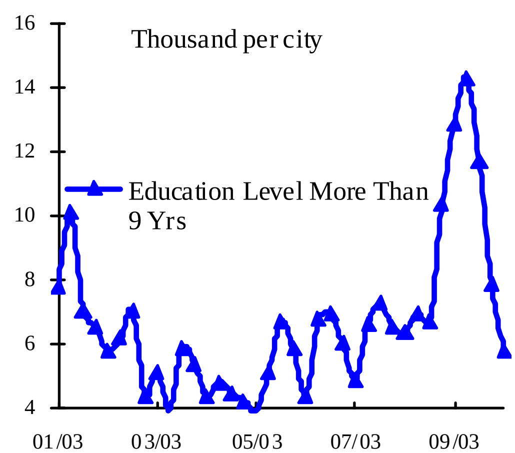


Chart 7 Higher End: Oversupply Remains



Source: CEIC, CEBM

Chart 8 Low End Market Change

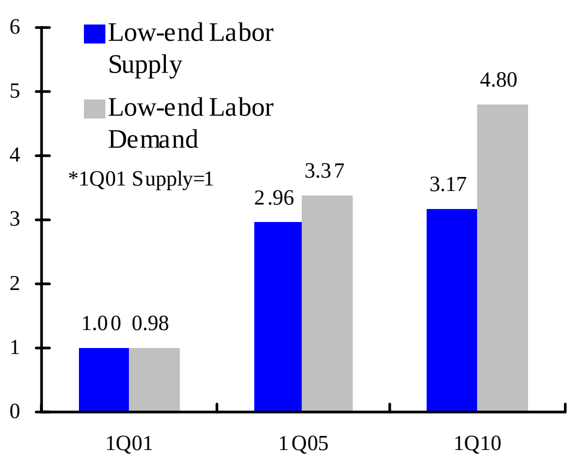
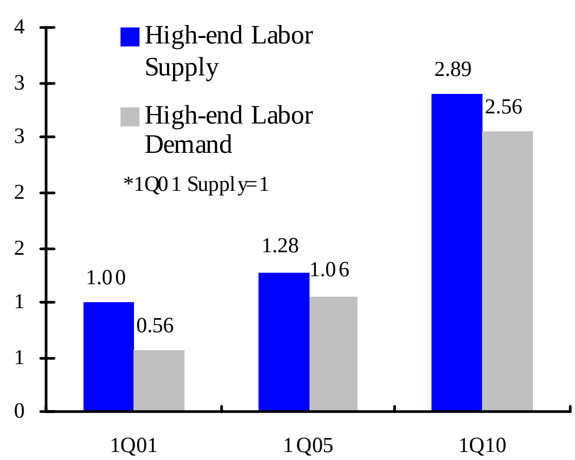


Chart 9 High End Market Change



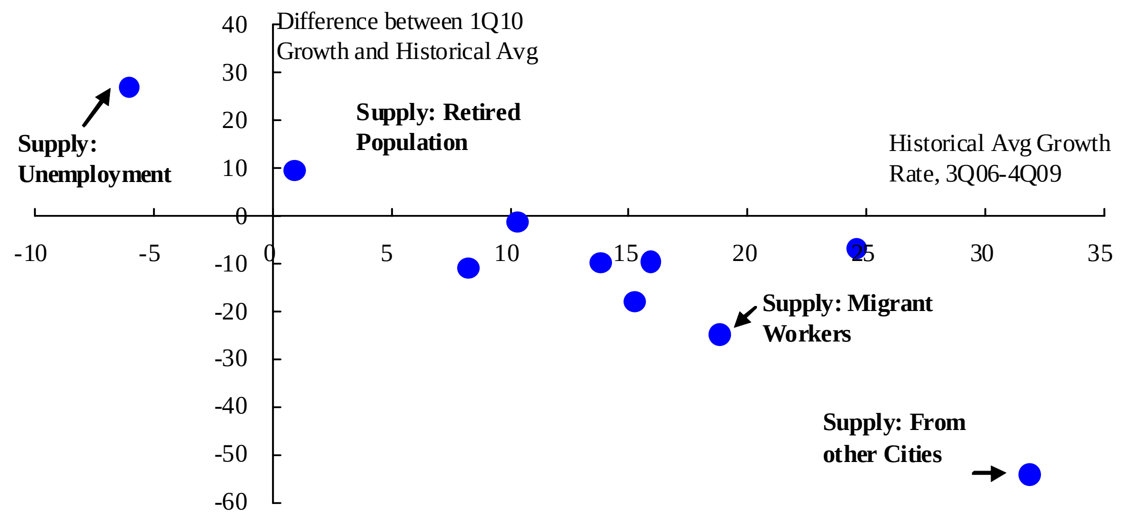
Source: CEIC, CEBM

Structural Change Updates (2)
Growth of Migrant Workers Slows Down in the Post-crisis Era

The structure of the labor supply has changed in post-crisis years. Since 2006, the growth rates of the subgroups of workers, including college graduates, migrant workers, and workers from other cities have been much higher than the average growth of the labor supply. However, the latest survey shows that the conventional engine of supply growth did not perform robustly, and the growth rate of labor supply from graduates, migrant workers and workers from other cities has fallen below the historical average. The slowdown of the traditional supply engines indicates that a structural change is taking place quietly.

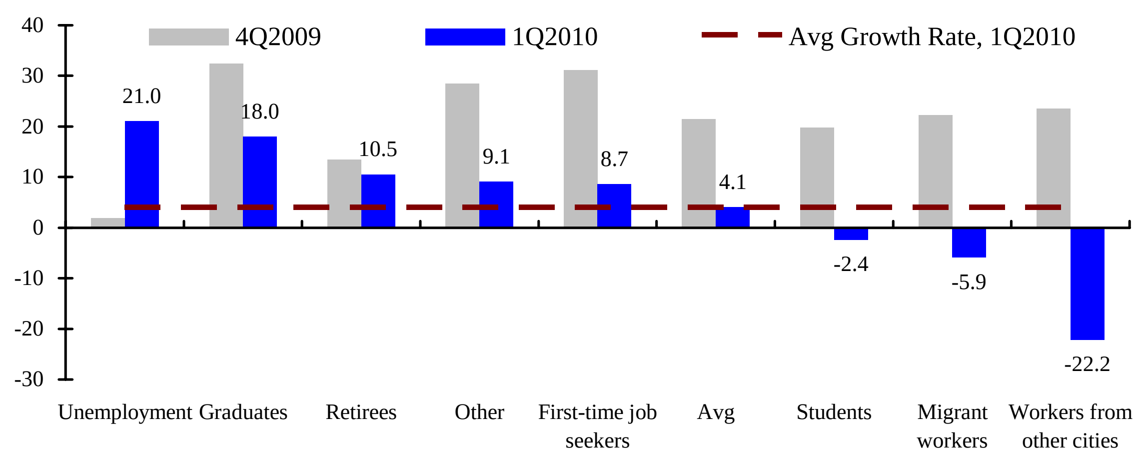
Latest survey shows that the growth of migrant workers and workers from other cities fell to 5.9% and -22.2% Y/Y, more than 20 percent below the historical average growth rate. The migrant-worker rich environment is changing quietly in the cities. In the meantime, the wage gap between coastal cities and inland cities has been narrowing, and the cost of living has widened because of rocketing housing prices. The intercity labor flow appears to be depressed.

Chart 10 Structural Change in the Labor Supply in 1Q10



Source: CEIC, CEBM

Chart 11 Labor Supply Growth (Breakdown by Source of Supply)



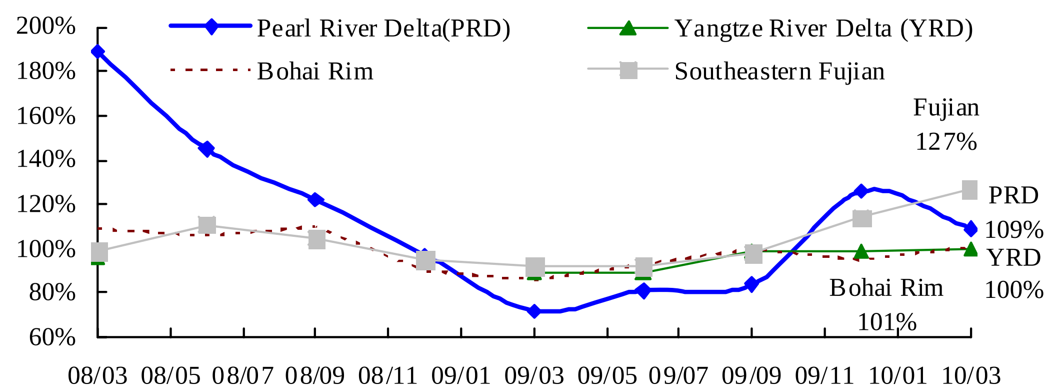
Source: CEIC, CEBM

Structural Change in Labor Market (3) Labor Shortage Emerges Even in Western Region

We see the labor market shortage as broad in scope, reaching across different levels of education, different regions of employment, and different locations of worker origin. The shortage in migrant workers eased somewhat as workers returned to the labor market after the Chinese New year, consistent with a decreased demand-supply ratio. However, this ratio remains above 100% in all four regions that are major economic powerhouses, indicating labor demand still exceeds supply, and regional analysis shows that labor shortage has actually worsened. Even the western region, we see a sharp increase in the demand-supply-ratio, meaning that the undersupply of labor has become significant.

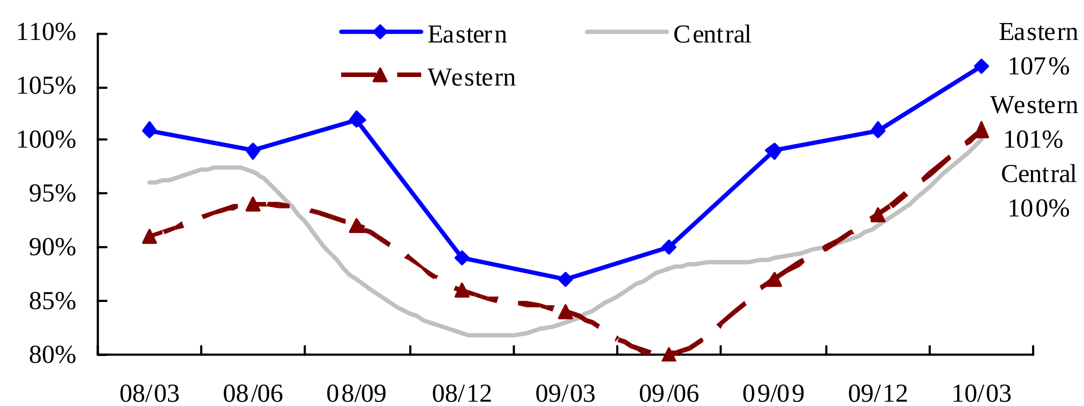
Against the backdrop of the undersupply of labor in western and central regions, labor migration among different regions may start to slow down. Structural change in labor market is likely to occur, namely the central and western region may not be able to transfer significant amount of migrant workers to the eastern region. This will certainly make the situation of labor market in the eastern region even worse.

Chart 12 Migrant Workers Come Back after Chinese New Year, but Shortage Remains (Demand-Supply Ratio)



Source: CEIC CEBM Group

Chart 13 Labor Shortage Emerges in Western Region (Demand-Supply-Ratio)



Source: CEIC CEBM Group

Overall Labor Supply Outlook Not Positive in the Post Crisis Era

Overall, China's labor supply may see a peak around 2020. According to an optimistic forecast, China is likely to still enjoy demographic dividends for another 10 years, indicating that China can benefit from low labor cost and achieve rapid growth in this period.

A closer look at the growth rate of the working age population shows, however, that the newly-added working-age population already peaked in 2008. The newly-added labor supply and demand may reach equilibrium in 2012, considering that China is likely to maintain targeted 8% GDP growth through then.

Given the overall labor market equilibrium, China may realize relative full employment, and the actual growth rate may surpass the potential growth rate. In this case, the labor cost may start to increase significantly as undersupply at the low-end labor market sector may further worsen and the wage increase is likely to be higher than that of the high-end sector. The wage increase may reduce the corporate profits if the industrial upgrade does not take place to a significant degree in this period.

Chart 17 GDP Growth and Employment

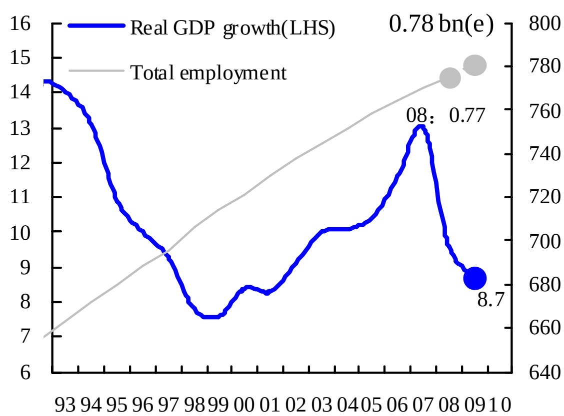
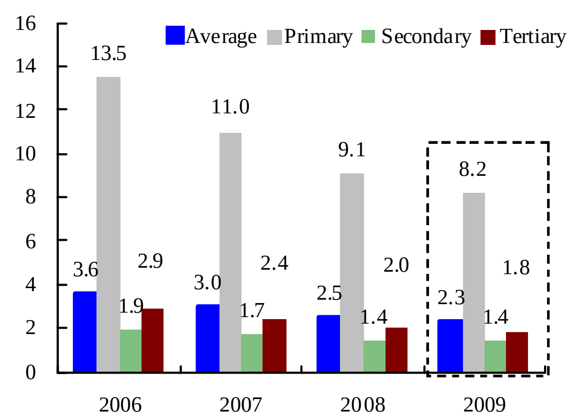
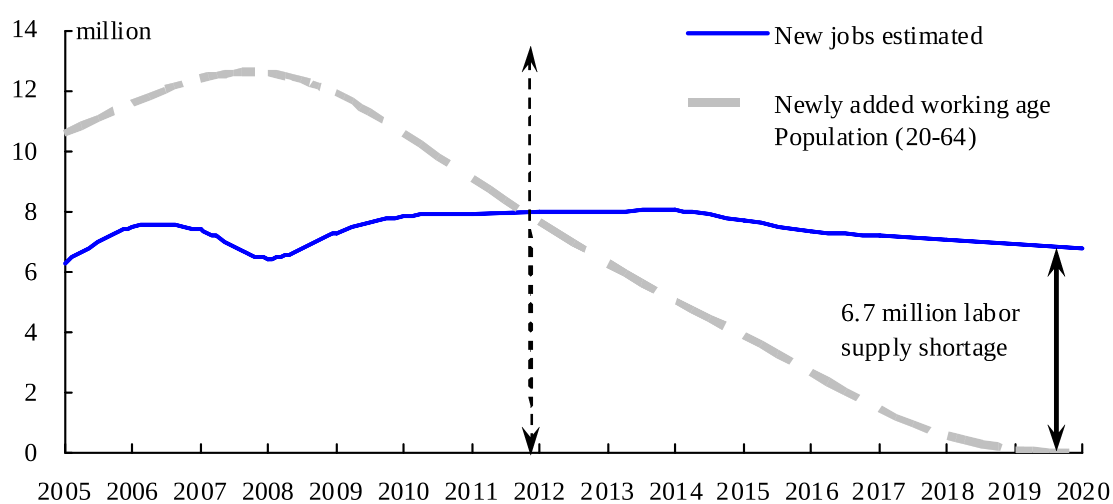


Chart 18 GDP Growth and Employment Elasticity



Source: CEIC CEBM Group

Chart 19 Labor Shortage Emerges in Western Region (Demand-Supply-Ratio)



Source: CEIC CEBM Group

Impact of SOE Reform in '90s: 35 to 38 mn Workers Laid off

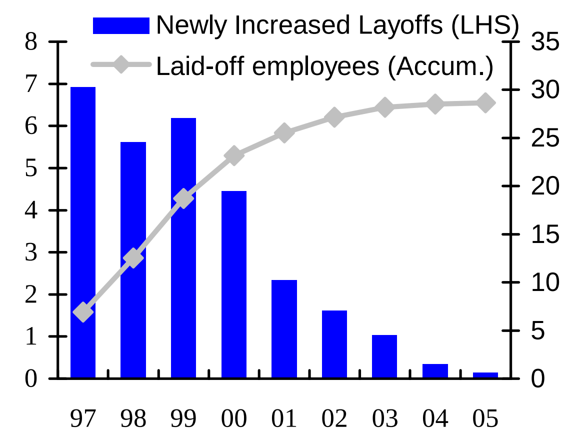
The state-owned enterprises (SOEs) in China went through a major campaign of structural reform in the late '90s in an effort to improve their competitiveness. One major aim of the reform was to cut down the number of excess employees. Because there are no official statistic on the total number of layoffs, we could only triangulate the actual number via various estimations.

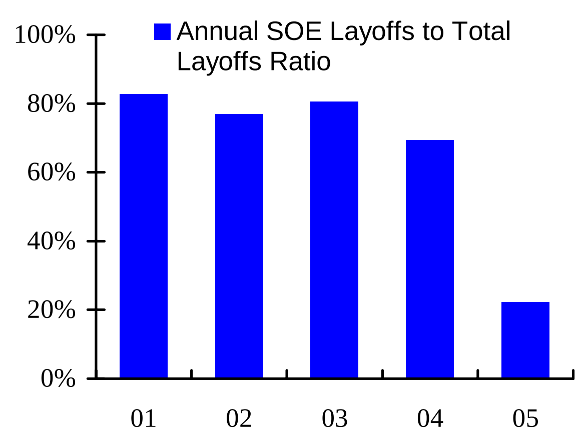
According to the data released by the Ministry of Human Resources and Social Security (MOHRSS), the accumulated layoffs from SOEs between the year of 1997 to 2005 reached 28 million, which, combined with the relatively stable ratio between layoffs from SOEs and the overall laid-offs, means the total number of layoffs from all enterprises was around 35 million. Another way to estimate the total layoffs is to track the number of registered urban employees, which indicates the number of total layoffs was around 38 million between 1997 and 2005. From the above two approaches, we estimate that the total layoffs were 35-38 million, of which 55% were male, according to the data released by the MOHRSS.

Although the total registered employees declined sharply during the reform, the total production capacity did not drop by noticeable margin because of the improving in productivity and production efficiency. In addition, the re-employment of the 35 to 38 laid-offs later further boosted the gross output.

Total laid-off employees were estimated to reach 35 to 38 million between 1997 and 2005.

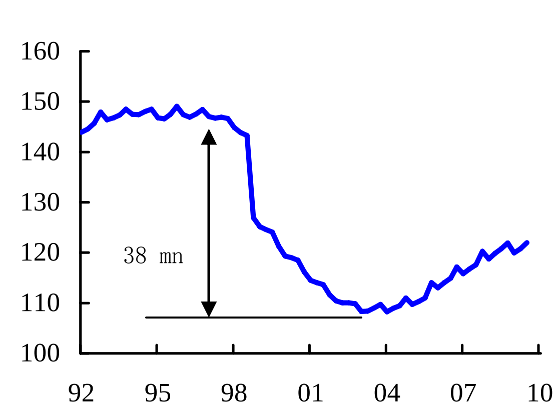
Chart 20 97-05 SOE Layoffs (mn people) **Chart 2 Total Layoffs**

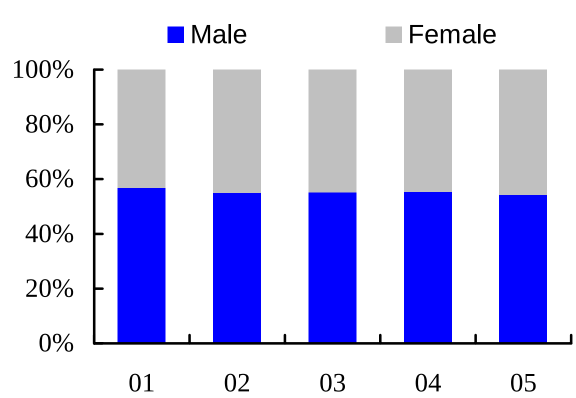




Source: MOHRSS, CEBM

Chart 21 Urban Registered Employees (mn people) **Chart 22 Year-end Layoffs**





Source: NBS, MOHRSS, CEBM

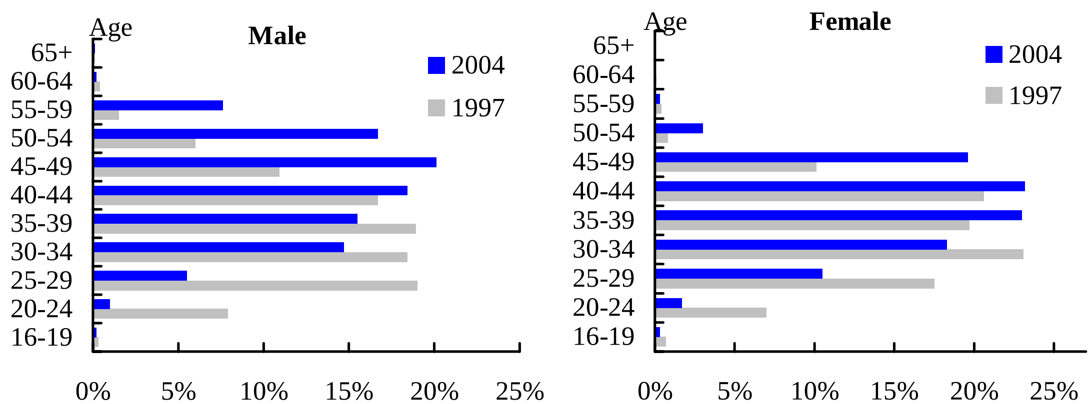
8 Million Female Laid-off Female Workers to Retire Before 2013; 10 Million Males before 2020

It is worth nothing that the age at which employees were laid-off increased steadily between 1997 and 2004. While in 1997 the average workers being laid-off were 36.7- and 35.6-year-old for male and female workers, respectively, the ages rose from to 43.1- and 38.8-years in 2004. Based on the official minimum retirement ages of 50 for females and 60 for males, starting from which one can receive social security payments, we estimate that half of the 16 million female workers laid off during the SOE reform may retire and exit the labor market before 2013, and 10 million male workers will before 2020.

Many of people laid off previously later entered the low-income labor market. The retirement of this population means that the demand-to-supply ratio will increase considerably in 2013 and 2020 in the low-income labor market. The shortage of low-income labor forces is likely to lead to surge of wages, which in turn will pose additional inflation pressure.

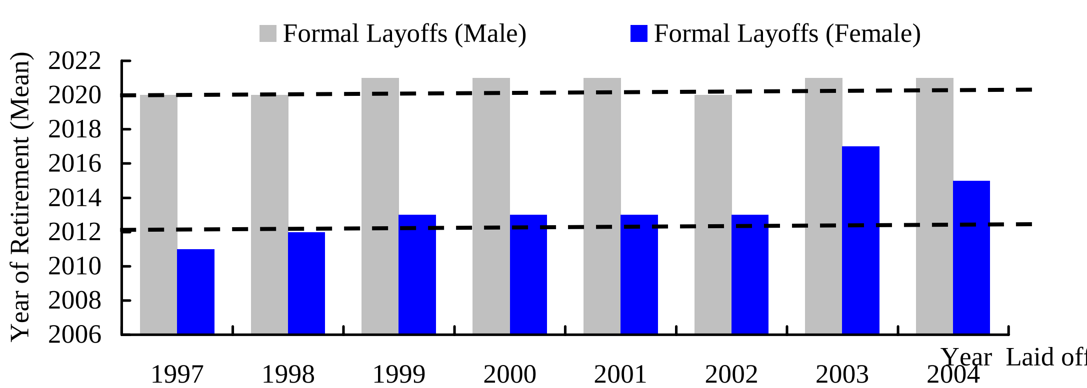
It is worth noting that the aforementioned scenario is based on the assumption that the government will keep the minimum age for retirement unchanged. Although we believe the government will have strong incentive to raise of the retirement age when the shortage of labor forces become more noticeable, it is likely to face an uphill battle trying to achieve such a goal without drawing backfire by workers who have been looking forward to retirement.

Chart 23 Newly Laid-off Employees（by Sex and Age）



Source: MOHRSS, CEBM

Chart 24 Half of Female Formal Layoffs Will Retire by 2013, and Males by 2020



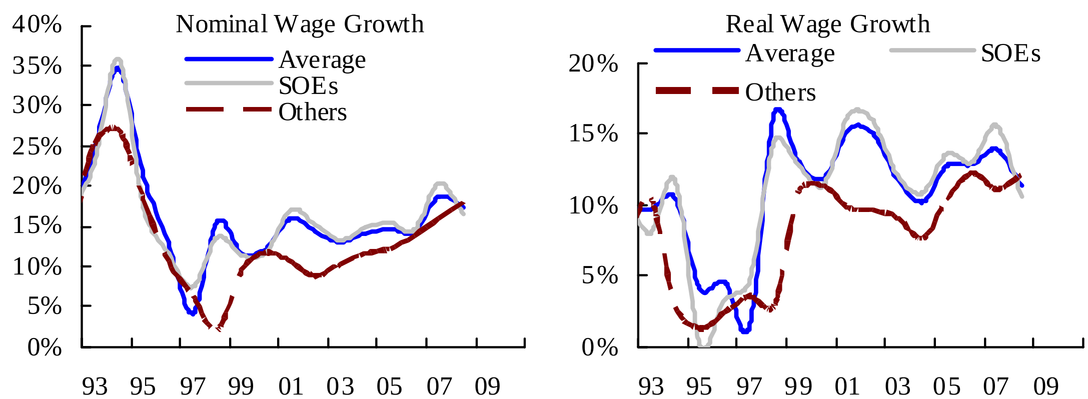
Source: MOHRSS, CEBM

Wages of Low-income Labor Forces Likely to Surge

Over the past 15 years, wage growth has been relatively stable in China. Although the wage growth of SOE employees was noticeably higher than that of the non-SOE workers, the gap of growth has been shrinking. Looking forward, we expect the above changes in the labor market to significantly boost the wage growth of current low-income labor forces while the wage growth of the current high-income populations will be less affected. Overall, we expect the wage of current low-income workers to grow by as much as much 22-23% Y/Y by 2012 before declining below 20%, while the wage growth of current high-income populations will remain around 14% Y/Y. In other words, we expect the accumulated growth of wages between 2009 and 2015 to reach 290% and 220% for current low-income and high-income populations.

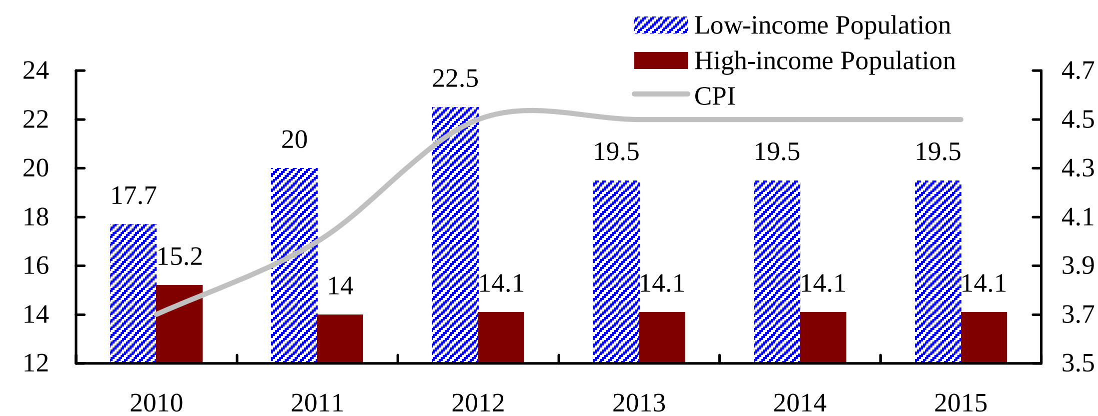
It worth noting that the surge in wages may lead to considerable inflation pressure. In addition, because of the slowdown in labor force growth, it is also very likely that China will face considerable downward pressure on economic growth. We hold our view that the long-term inflation of China may rise to 5% and the long-term GDP growth may transition to 7% in 2012 because of the systematic change in the labor market.

Chart 25 Wage Growth (By Type)



Source: CEIC, CEBM

Chart 26 Nominal Labor Cost Growth and CPI（Y/Y, %, Est. by CEBM）



Source: CEBM

Commentary on Recent News

Positive

Chinese consumer confidence in the first quarter reached the highest level since 2007.

Premier Wen Jiabao said China's 1Q energy use per unit of GDP rose.

Peugeot to build 3rd China plant.

Retail sales of major categories of goods grew faster in 1Q compared with the same period of 2009, said Ministry of Information and Industry Technology.

The output of China's environmental protection industry will grow at an average annual rate of 15% and will reach RMB 900 billion by 2015.

China's policy of actively attracting foreign investment will not change, said vice minister of commerce Ma Xiuhong.

EverGrande Real Estate is reported to offer a 15% discount to push sales of apartments in Guangzhou.

China's subsidy program for home appliance purchases in rural areas continued to boost sales in the first four months of the year, said the Ministry of Commerce.

Ping An plans to acquire Shanghai Securities.

The scale of China's culture industry in the global market hit RMB 800 billion in 2009.

BOC, ICBC may make A, H share rights issue

Ba shusong, a senior officer at state council's DRC, said that China has little room to hike the interest rate.

China's trade balance turned to surplus in April.

Mainland's Haier start JV with Taiwan firm to to produce LCD TV modules

China SAIC's April auto sales rose 34%; growth slowed.

NDRC: China's 1Q coal use rose, wind power output jumped

Bank of Taiwan plans to open first branch in Shanghai as ties improve.

China's economy is expected to gain further momentum in 2Q, with the GDP likely to grow by 10.7 %, the State Information Center said.

Negative

China's economic growth may slow later this year, which is necessary to avoid overheating, said Liu Shijin, vice president of the Development Research Center.

Xia Bin，PBoC's advisor, said China should keep tightening monetary policy and "strictly" control investment projects to avoid asset price inflation and overheating the economy.

China's raw steel production in 2009 accounted for 47% of world total production, facing increased cost pressure.

China Cotton Production Outlook `Not Optimistic' on Sowing, China Cotton Association Says.

SAFE: capital account control must be maintained; however it will turn out to be less efficient as capital inflow becomes more complicated .

The PBoC issued RMB 110 billion in 3Y central bank bills to withdraw liquidity.

China many struggle to repeat bumper harvests of recent years as adverse weather affects crops and planting, an official from the National Development and Reform

Li Daokui, PBoC's advisor, said systematical financial risk caused by high property and stock prices due to abundant liquidity.

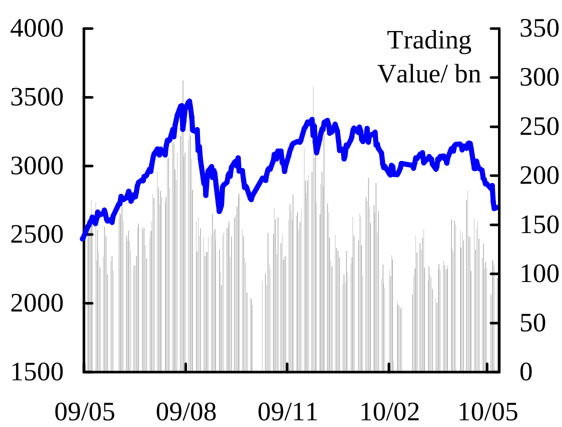
NBS: Sharp increase in property depressed the willingness to consume.

SAFE: foreign exchange inflow has sped up.

Daily China A-Share Market Review

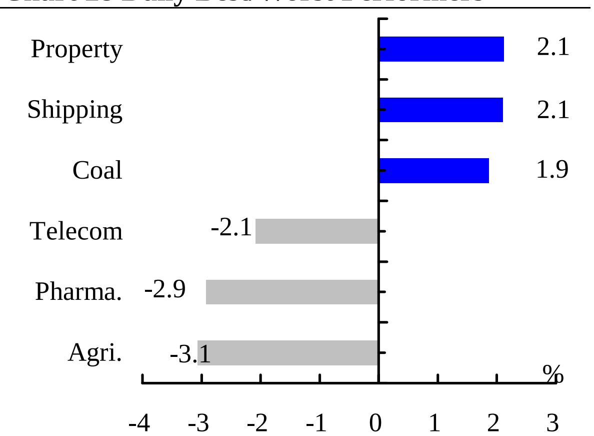
- China's market fluctuated to a high degree and closed at 2698.76, a 0.4% increase. Some investors bought in at the eight month low and supported the index from further decline. Some heavy sectors, such as property stocks, picked up today.
- The trade figures are strong and show no signs of weakening. The export and import growth, 30.5% and 49.7% were in line with our estimation.
- Chongqing, the only directly-controlled municipality in southwestern China, announced today a minimum wage increase. The min. wage of painters was raised the most, by more than 50%. Among 323 jobs, about 85% of min. wages were lifted.
- When there is drought in some regions of China, there is flood in others. Continuous strong rain brings floods in some regions in Hunan province. As of today, around 730,000 people have been deployed to patrol the dams, and roughly 60,100 people have been transferred to safe zones. In addition, Guangdong province also reported heavy rains and floods in some areas. In addition to the previous inflation expectation, abnormal weather conditions make households worry more about the supply.

Chart 27 Shanghai Composite Index



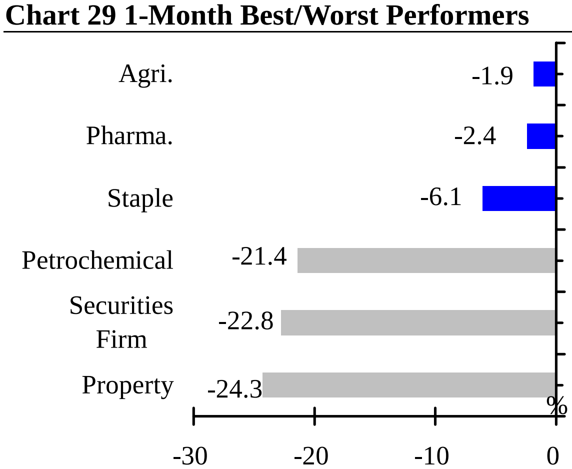
Source: Wind

Chart 28 Daily Best/Worst Performers



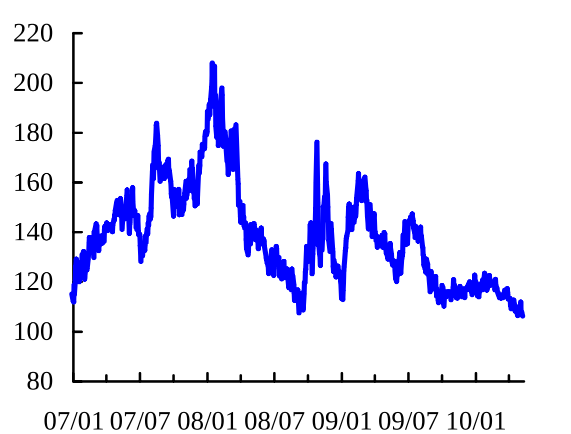
Source: Wind, CEBM

Chart 29 1-Month Best/Worst Performers



Source: Wind, CEBM

Chart 30 A-H Premium Index

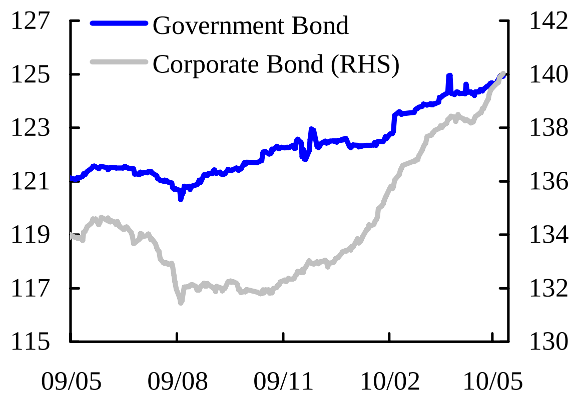


Source: Bloomberg

Daily China Fixed Income Market Review

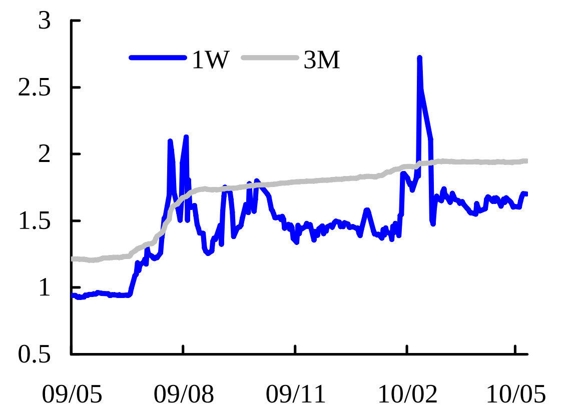
- The Government Bond Index rose 0.1%, ending at 124.92. The Corporate Bond Index was up 0.1%, closing at 140.03, setting a new record high. The trading volume fall sharply as the market was waiting for the data to be released tomorrow. We believe that the CPI will reach 2.6%, slightly lower than the market consensus 2.8%.
- The PBoC plans to issue RMB 14 billion in 1Y central bank bills tomorrow. The offering yield will be followed closely by the market since it may have some indication regarding the PBoC's interest rate decision.
- Twelve-month non-deliverable yuan forwards increased 0.5% to 6.6776 per dollar as of 18:00, the biggest jump since Dec. 22. The move was due to the strong trade balance data and the European loan deal.
- It is reported that the issue amount of government bonds is likely to reach RMB 550 billion in 2Q, more than twice as much as that in 1Q.
- Ba Shusong, a senior officer at the State Council's Development Research Center, said China has little room to raise interest rates.

Chart 31 Govt & Corp Bond Index



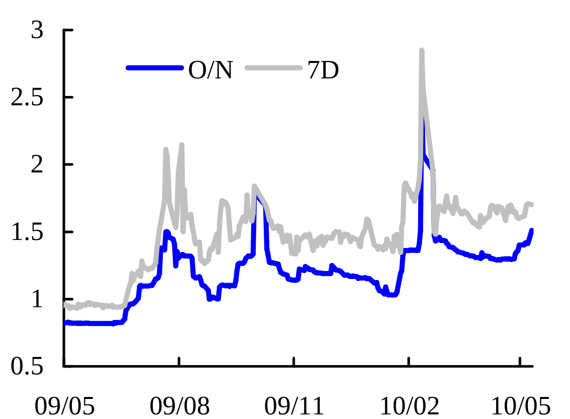
Source: Wind

Chart 32 Shibor Rate (%)



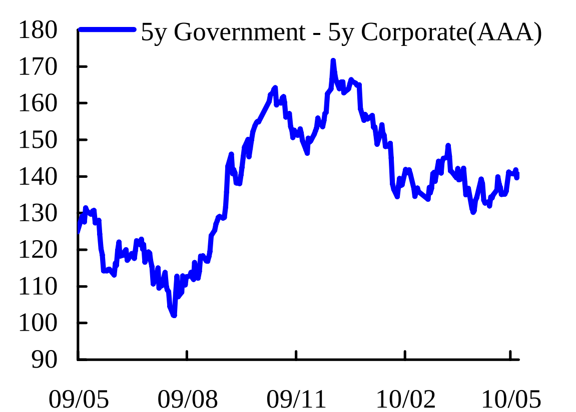
Source: Wind

Chart 33 Interbank Market Repo Rate (%)



Source: Wind

Chart 34 Yield Spread (bps)



Source: Wind

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