No end in sight

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China's new leadership is more willing than ever to raise the pain threshold for the economy to push through long-term reforms, despite a protracted slowdown that has sparked calls for looser monetary policy.

Grim trade data for June on July 10 fanned market talk of fresh steps to support an economy heading for its weakest growth this year in more than two decades. The rumors increased after remarks by Premier Li Keqiang that the government will safeguard the "lower limits" for economic growth and employment.

But China has no plans to budge.

Financial markets may have underestimated the new leadership's tolerance for slower growth as it pushes to wean the economy off a reliance on exports and investment with reforms and deregulation to encourage more consumption, analysts say.

"The focus is still on reforms," said Xu Hongcai, senior economist at the China Centre for International Economic Exchanges (CCIEE), a well-connected think tank in Beijing.

"The chances of a cut in interest rates or banks' reserve ratio look slim," Xu said. "Previously, when the economy was not good, local officials held out their hands for money from the central government. But now they have to embrace reforms as no money will be given."

China's Finance Minister Lou Jiwei appeared to back that view, suggesting the government would not step in as it has done in the past.

"Structural adjustment is a painful thing," Lou was quoted by the China News Service as saying on the sidelines of US-China talks in Washington. "It's impossible to adjust structures if you still want to feel very comfortable and maintain a very high growth rate."

However, Lou also sowed confusion over where the government's bottom line on growth might be. He was reported by the Xinhua News Agency on July 12 as saying the 2013 target was 7 percent, implying a level below the official goal of 7.5 percent. However, the Xinhua report was later changed to show Lou said 7.5 percent.

GDP data released Monday showed that economic growth slipped in the April-June quarter to 7.5 percent from 7.7 percent in the previous quarter. Growth has already slowed in eight of the last nine quarters, data shows, as the economy hits the brakes after three decades of double-digit expansion.

"Even if we get some negative data surprise," said Wei Yao, China economist at Societe Generale in Hong Kong, "it wouldn't really change the policy stance immediately."

Many analysts believe the government will step in to support the economy if year-on-year growth slips in a quarter to 7 percent.

But London-based macro-economic research company Capital Economics argues the government is no longer so fixated on targets, noting that the 2013 target is "about 7.5 percent," not strictly 7.5 percent.

"If Lou was confused, this perhaps tells us something about how strictly we should interpret the annual growth target," it said in a note. "Officials may simply be less concerned with meeting the target than they were in the past."

What might change the government's mind is a sudden increase in unemployment. For now though, government officials have said employment is stable, citing the fast-growing services sector and a demographic shift that reduces surplus rural workers.

Pressure on local officials

At the end of June, President Xi Jinping said local government officials would not be judged solely on their record in boosting GDP but by achievements in improving people's livelihoods, social development and environmental quality.

The State Council on July 5 announced new measures to choke off fresh funding for industries gripped by excess capacity, channeling more funding toward advanced industries.

Premier Li Keqiang, during a recent trip to South China's Guangxi Zhuang Autonomous Region, also said that the government will focus on reforms so long as growth stays within a reasonable range.

Lu Ting, an economist at Bank of America/Merrill Lynch, said one reason behind the government's resolve is that it is still dealing with the lingering hangover of a 4 trillion yuan ($652 billion) stimulus package implemented during the 2008-09 period, which resulted in piles of local government debt.

"For Premier Li and his cabinet, they will have to complete the unfinished 'exit strategy' in their first couple of years. In this regard, 'deleveraging' is unavoidable," he said in a research report.

If needed, Beijing has ample room to expand fiscal spending, by tapping into a war chest of about 3 trillion yuan in savings, he said.

Reforms continue

A recent interbank cash crunch underscored the central bank's reluctance to pump more money into the economy.

Banks have been told to make better use of existing credit through financial innovations such as asset securitization.

"The liquidity crunch raised the government's concerns about financial risks and the problem of credit mis-allocation," said Zhang Bin, an economist at the Chinese Academy of Social Sciences (CASS), a top think tank in Beijing.

High on Beijing's reform agenda is to liberalize interest rates, which proponents say would help resolve deep-seated financial distortions, including a sprawling non-bank lending industry.

China's rigidly controlled interest rate regime is a major factor behind the rapid rise of shadow banking, as it suppresses returns on bank deposits, spurring savers to plow cash into higher-yielding off-balance-sheet wealth management products.

On the other hand, State firms with easier access to bank loans have been re-lending the money they raise to cash-starved private businesses at much higher interest rates, fanning shadow banking activity.

As a vital step paving the way for freeing up rates, the government is set to unveil a long-awaited deposit insurance system later this year despite resistance from some State banks.

"The interest rate reform will be pushed forward. Banks' concerns won't stop it," said Guo Tianyong, an economist at the Central University of Finance and Economics in Beijing.

An insurance system is seen as laying a foundation for interest rate liberalization, as market-oriented interest rates could make it harder for smaller banks to compete with larger, better funded rivals, potentially putting depositors at risk.

The government may remove the floor on bank lending rates and further raise the ceiling on deposit rates, analysts say.

The key factor that will indicate a change in government thinking, analysts say, is if the slide in economic growth leads to big job losses. That could set off alarm bells for policymakers, worried about any threats to social stability.

"They face a dilemma - increasing leveraging will fuel debt risks. But if you allow the economy to slow further, the jobless problem will occur sooner or later," said Zhang at the CASS.