

# CHINA ECONOMIC UPDATE APRIL 2021



## Don't forget about me: lower skilled workers could be left behind by manufacturing's evolution

NAB Group Economics

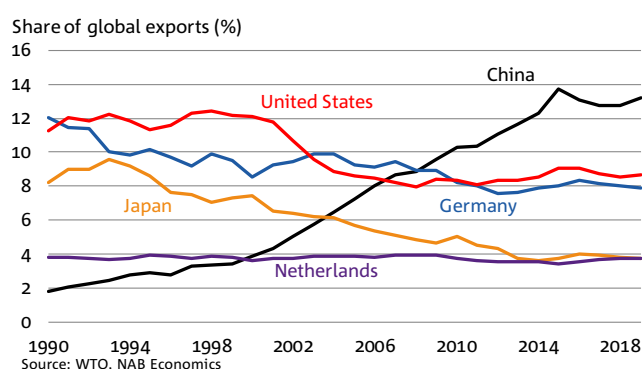
China's industrial sector continues to evolve, as the country's producers move higher in global value chains, reflecting a range of factors including capital deepening and rising labour costs. While this can broadly be seen as a positive development, with aggregate measures of wealth and living standards having risen, this evolution also creates some risk for lower skilled workers, who could find substantially reduced demand for their labour. How China addresses the needs of this cohort could have an impact on its economy and social cohesion in coming years.

## CHINA IS NO LONGER A CHEAP PLACE TO MANUFACTURE

Decades of rapid industrialisation saw China transform from being a relatively small producer of low value goods to becoming the factory of the world. Between 1990 and 2019, China's share of global exports rose from less than 2% to over 13%, in turn becoming the world's largest exporter in 2009.

### CHINA'S INDUSTRIALISATION

**World's largest exporter since 2009**



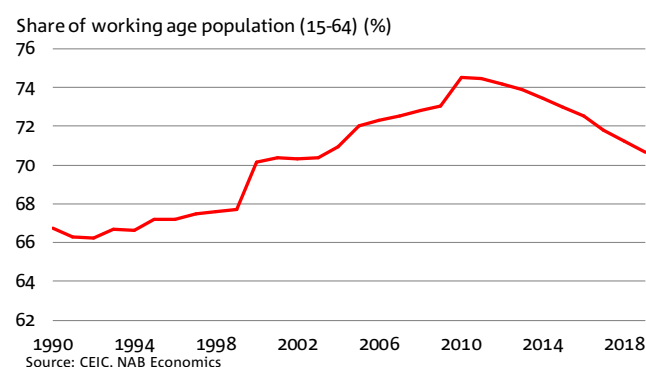
The growth in China's manufacturing output over this period was supported by a massive pool of low cost workers, including internal migrants moving from poorer rural areas to major cities. China's migrant population was estimated at around 290 million in 2019, but subsequently fell slightly in 2020 due to the COVID-19 pandemic and restrictions on movement within the country. These workers provided manufacturers with considerable competitive

advantages – particularly when compared with labour costs in advanced economies.

However, the pool of low cost workers has gradually dried up. China's working age population peaked in 2013 and has subsequently fallen – a legacy of the country's falling birth rate since the early 1970s that was exacerbated by the One Child Policy. The declining pool of labour has contributed to a steady increase in wages within the manufacturing sector.

### DEMOGRAPHIC PRESSURES IN CHINA

**Working age population in decline**



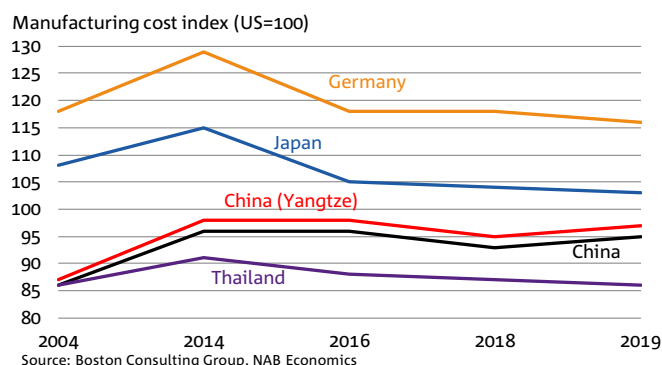
Like a range of other labour market indicators, China's wage data are notoriously opaque, making comparisons between different sectors (such as private versus non-private) or China and other countries extremely difficult. However, different wage measures show steady increase in recent years – frequently more rapidly than overall economic growth.

The Boston Consulting Group produce a comparative measure of global manufacturing cost

competitiveness, based on labour and energy costs, adjusted for relative productivity. This measure shows that Chinese manufacturing costs were around 14% lower than the southern United States (BCG’s reference location) in 2004, however this narrowed to just 5% in 2019 (and 3% lower in the Yangtze River Delta region – which encompasses Shanghai and its surrounding area). In contrast, manufacturing cost in regional neighbour Thailand were 14% lower than the southern US in 2019 – the same relative cost position for China in 2004.

## LOSS OF COMPETITIVENESS

### China no longer a cheap manufacturer



## MOVING UP THE VALUE CHAIN RISKS LEAVING PEOPLE BEHIND

In response to rising labour costs, Chinese manufacturers have attempted to move higher in the value chain. This process evolves over time and is evident in long run data around manufacturing exports. Exports of basic textile, clothing and footwear products has been in decline in China since 2015, as pressure from other lower cost producers in Asia has seen supply chains relocate. In contrast, exports of higher technology products have continued to trend higher.

## CHANGING SHAPE OF CHINA’S OUTPUT

### Moving higher up the value chain

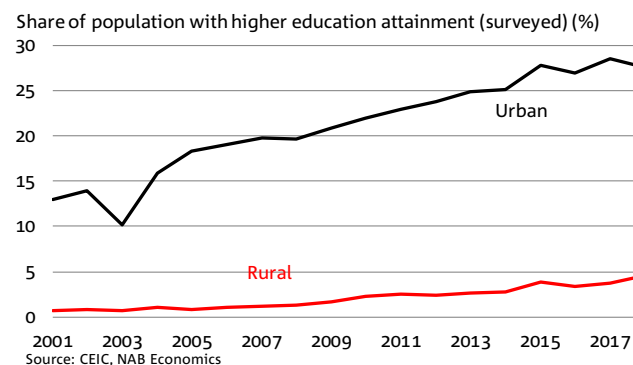


However, higher value added manufacturing processes are typically more capital and less labour intensive, particularly with regard to lower skilled labour. A lack of transferable skills means that the shift higher in the value chain can lead to structural unemployment.

This appears a much higher risk for China’s migrant workforce. In part this reflects education standards. Despite having a national curriculum, the standard of education in China’s rural areas is typically lower than that of major urban areas, and rural areas produce fewer higher education graduates (around 4.6% of the rural population in 2018, compared with 28% of the urban population). According to research by Scott Rozelle and Natalie Hell, China has the lowest level of educational attainment for any country at its level of development, and many less developed economies exceed it for educational levels.

## HIGHER EDUCATION BY REGION

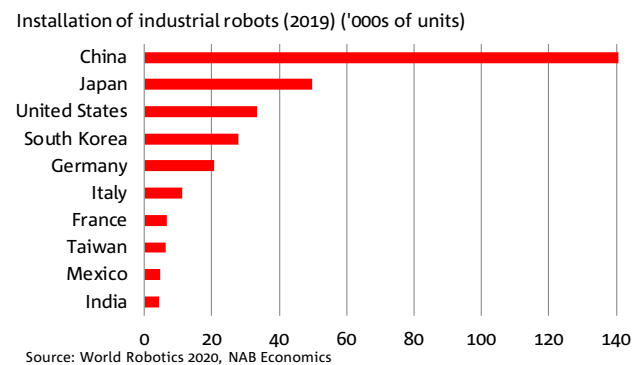
### Massive disparity between urban & rural



However, the push up the value chain could also impact more educated workers as well, as China has become one of the world’s largest purchasers of robots and automation technologies, dwarfing purchases by other countries in 2019.

## CHINA LEADS ROBOT INSTALLATIONS

### Automation adds further threat to labour



## CONCLUSIONS – WHAT DO THESE TRENDS MEAN FOR CHINA?

Income inequality has been a major issue within China for many years, and a problem that Chinese authorities are seeking to address. The loss of employment opportunities for lower skilled workers risks intensifying this inequality, which could negatively impact social cohesion.

Further education could be a critical component to successfully addressing these issues – equipping the pool of less skilled workers with the necessary capabilities to transition either into higher skilled manufacturing roles or the growing services sector.

In addition, there could be further reform to the household registration (or hukou) system – which divides the population between rural and urban areas. Rozelle and Hell<sup>1</sup> note that due to differing policies under the One Child Policy (despite recent reforms) around 70% of the country's current children have a rural hukou – effectively locking them into the disadvantaged pool of the country's workforce.

The latest Five Year Plan – which was released in March – proposes to lift hukou restrictions and provide social services for rural residents settling in cities with populations under 5 million, while the more economically powerful megacities would retain a points based eligibility criteria. It is not clear that this would resolve concerns – as there could be a significant divide between those eligible for the most prosperous cities, and those only able to settle in less advantaged locations. In some instances, residents may be better off retaining their rural hukous due to the value of land holdings.

Finally, China's central government could expand and strengthen social safety nets. Currently these are largely implemented by local governments, who are incentivised to minimise the number of residents covered under these programs, while there is considerable variation across the country in the scope of these services.

## CONTACT THE AUTHOR

Gerard Burg

Senior Economist – International

[Gerard.Burg@nab.com.au](mailto:Gerard.Burg@nab.com.au)

+61 477 723 768

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<sup>1</sup> Rozelle, Scott and Hell, Natalie, 2020, Invisible China: How the Urban-Rural Divide Threatens China's Rise, University of Chicago Press

## Group Economics

Alan Oster  
Group Chief Economist  
+(61 0) 414 444 652

Jacqui Brand  
Personal Assistant  
+(61 0) 477 716 540

Dean Pearson  
Head of Economics  
+(61 0) 457 517 342

### Australian Economics and Commodities

Gareth Spence  
Senior Economist – Australia  
+(61 0) 436 606 175

Phin Ziebell  
Senior Economist –  
Agribusiness  
+(61 0) 475 940 662

Kaixin Owyong  
Senior Economist  
+(61 0) 436 679 908

### Behavioural & Industry Economics

Robert De Iure  
Senior Economist –  
Behavioural & Industry  
Economics  
+(61 0) 477 723 769

Brien McDonald  
Senior Economist –  
Behavioural & Industry  
Economics  
+(61 0) 455 052 520

Steven Wu  
Economist – Behavioural &  
Industry Economics  
+(61 0) 472 808 952

### International Economics

Tony Kelly  
Senior Economist  
+(61 0) 477 746 237

Gerard Burg  
Senior Economist –  
International  
+(61 0) 477 723 768

## Global Markets Research

Ivan Colhoun  
Global Head of Research  
+(61 2) 9237 1836

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