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**NATO DEFENSE COLLEGE FOUNDATION**

**STRATEGIC TRENDS**

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**CHINA**

**Labour shortages and rising wages are undermining China’s low-cost manufacturing**

Three years ago, a study commissioned by the International Monetary Fund, suggested that within a few years China’s working age population would reach a historical peak and would then begin a precipitous decline. The study, based on demographic data, raised questions whether China was poised to cross the so-called Lewis Turning Point, a point at which it would move from a vast supply of low-cost workers to a labour shortage economy with potentially far-reaching implications domestically and externally.

This trend has not only been confirmed by more recent data analysis, but it is changing China’s economic reality sooner than the IMF study had predicted. Despite its large population, China is in fact already experiencing labour shortages and real wages have seen strong double digit growth for the past five years.

China’s total labour force is about 800 million – of which more than one third are migrant workers from poor rural areas. It is the world’s largest labour force – almost twice that of America, the EU and Japan together. The factors that have boosted China’s economy over the past three decades – fast growth, high savings and investment, big trade surpluses – can be traced in large part to the waves of migrants that flowed into China’s factories and construction sites from small towns and villages. The real wages of workers hardly moved during the 1980s and 1990s but in recent years have constantly risen. For the country’s 270 million migrant workers, the average wage in 2014 was over $500 a month. In Guangdong, the industrial heartland of China, skilled technicians can earn as much as 100.000 Yuan or $18.000 a year. Though these figures are still well below the wages in the advanced economies, the gap is steadily shrinking and its effects both in China and globally will not take long to materialize.

China’s economic growth will slow down and higher wages will result in lower profits and less investment. Labour in Asian countries such as India, Indonesia and Vietnam is now about half the cost of China’s minimum wage and companies are already responding to these cost shifts. US chip-maker Intel and Taiwan manufacturers Hon Hai and Compal have opened factories in Vietnam while General Electric and Apple have moved some production back to the US.

The decline of migrants is only one cause for China’s shrinking labour force which is also due to a rapid aging of the population as a consequence of the one-child policy introduced in 1979 and the household registration system, known as hukou, which discourages people from leaving rural villages by not allowing them to receive social welfare benefits like healthcare, education and pensions.

Economists say a full dismantling of the hukou system cannot happen without broader fiscal reform. In any case for older migrants, who have spent most of their lives away from home but were never fully integrated into the big cities, any hukou reform is likely to come too late.

The rest of the world and particularly the US and Europe will gain overall from China producing at higher costs and Chinese having more money to spend. Consumer and capital imports will increase to such an extent that China will become a country with constant current-account deficits instead of surpluses, a transformation that will herald a major rebalancing in the world economy.