2013-2014 Agricultural Policy and Outlook Conference Series

"Do China's rising wages mean the end of its competitive edge?"

Presented by Ian Sheldon, Andersons Professor of International Trade

By the end of the 2000s, the value of China's total trade (exports plus imports) grew to 45% of its GDP. This expanded participation in international trade, a significant factor in China's economic growth, has been driven by its transition to a market-oriented economy involving: rural-urban migration of over 150 million workers, industry gaining access to foreign technologies, capital and intermediate inputs, entry of multinational firms, and accession to the World Trade Organization. At the same time, China maintained a trade surplus averaging 5% of GDP throughout the 2000s, contributing to global economic imbalances, and friction with countries with whom it continues to have a substantial bilateral trade surplus.

China's competitive edge in labor-intensive industries such as apparel and electrical appliances has partly been due to the availability of cheap labor. As a result, multinational firms have outsourced assembly to China, triggering fast employment growth and rural-urban migration. By the end of the 2000s, average real wages had risen by 13.8% per annum, outstripping China's average real GDP growth rate of 12.7% per annum. If this continues, average real wages will rise to $20,000 by 2020, with the potential of reducing China's competitive advantage. This has already shown up in China's real exchange rate which has strengthened by almost 50% over the past decade. In the future, multinational firms may outsource production to lower wage countries such as Vietnam.

There are three explanations for China's rising wages: first, reforms to urban labor markets have meant the private sector is now setting industrial wages such that there is a much stronger connection between wages and productivity; second, the "one-child" policy along with demographic transition, has seen a decline in China's birthrate, resulting in lower growth in the labor force; and third, rural-urban migration continues to be influenced by the *hukou* system, whereby every Chinese citizen's residency status - rural or urban - is dictated by their place of birth. Even though rural residents have been allowed to migrate to the cities since the mid-1990s, they are unable to take advantage of public services such as education, medical insurance, housing and pensions because of their *hukou* status, thereby raising the costs of migration. This has resulted in simultaneous surplus labor in rural areas and rising rural migrant wages in urban areas.

Of course China's competitive edge also depends on its productivity. Over the past decade this has been increasing at 11.3% per annum, due to increased investment in R&D and the amount of physical capital per worker. In addition, greater access to college education has raised the quality of labor. If productivity growth continues, it is likely China will switch to manufacturing more skill-intensive, and higher value-added goods. Already there is evidence for China capturing more links in global production chains, Lenovo now being ranked as the world's largest seller of PCs.

Irrespective of increased productivity, if China wants to transition smoothly to a more skill-intensive, middle-wage economy, labor and rural land market reforms are essential. Restrictions on rural-urban migration should be removed along with establishment of land ownership rights allowing farmers a way to sell up in the countryside, and thereby lowering the cost of migration to urban areas. Holders of rural *hukou* also have higher savings rates than those who hold urban *hukou*, and are therefore a potential source of increased consumption – releasing such potential is a necessary step in rebalancing of the Chinese economy.