Changing Trends and Future Challenges Facing China's Employment Situation

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It seems that the GDP growth rate of China in 2012 will be lower than 8%. If it turns out to be 7.8%, as individual researchers and international organizations have forecasted, the growth rate will be 1.4 percentage points lower than that in 2011 and 3.4 percentage points lower than that of the average level of the 11th Five-year Plan period (2006-2010). Even if that is the case, this year's growth rate is still well above the government's target of 7.5% in 2012 and is much higher than the target of 7.0% set for the 12th Five-year Plan period (2011-2015).

The Chinese government has long taken an 8% baseline growth rate to secure the necessary job creation. However, a growth rate of 7.7% in the third quarter of 2012, compared to the same period in the previous year, did not bring about any notable employment shock as of September of this year. The urban registered unemployment rate was 4.1%, and the job demand-supply ratio—the ratio of jobs available per the number of people searching for jobs in publicly-run employment services—was 105, both of which remained at the same level of the previous year.

Such reality merits a consistent explanation. That is, we need to answer why the Chinese society has become ready for slower economic growth without employment pressure. On the other hand, we also need to answer whether the employment challenges that have long faced China are gone forever. This essay analyzes relevant issues and points out existing and future challenges of the employment situation in China.

1. Labor Market Changes Lower Potential GDP Growth Rate

As a result of a demographic transition phase with a low fertility rate for many years, China has witnessed tremendous changes in its population age structure. According to the 6th National Census, the population aged between 15 and 59 peaked in 2010 and has seen negative growth since then. It is predicted that in the period of 2010 to 2020, this age group will shrink by 29.3 million people, which we consider is a significant decline in the labor supply.

Unlike the commonly utilized working age population proxies of 15 years and 64 years for the labor supply, here we use 15 years and 59 years. The reason is twofold. First, the official retirement ages are 60 for male workers and 55 for female workers. Second, among China's working age population, the older the age, the lower is their educational level. For example, a 20-year-old has an average of nine years of schooling compared to a 60-year-old with 6 years. Subsequently, it is hardly feasible for average workers beyond the retirement age to find jobs.

At the same time, the economic growth has created strong demand for labor. In the period of 2001 to 2011, the total urban employment—the sum of resident employees and migrant workers in Chinese cities—increased by 115 million people. Taking this

quantity as the demand for labor, even if it is halved in the next 10 years, it will be still much larger than what the labor supply can meet.

For more than 30 years, the unprecedented economic growth in China has benefited from demographic dividend generated by changes in the population age structure. That is, (1) the growth in the absolute number and the increase in the proportion of the working age population have guaranteed a sufficient supply of labor, (2) the constant decline in the population dependence ratio—the ratio of dependent population to working age population—has helped obtain a high savings rate, (3) the unlimited supply of labor has helped in preventing diminishing returns to capital investment, and (4) mass labor migration from agricultural to non-agricultural sectors has generated resources allocative efficiency, contributing significantly to the growth of total factor productivity (TFP). With a single change in the population factor, therefore, all valid sources of China's economic growth in the past will be diminished.

Under the assumptions of negative growth of labor, substantial slower growth of fixed assets investments, and slightly lower growth of TFP, we estimate that China's potential GDP growth rate will decline from 10.5% in the 11th Five-year Plan period to 7.2% in the 12th Five-year Plan period and 6.1% in the 13th Five-year Plan period (2016-2020) (Figure 1). It is worth noting that the steep drop in the potential growth rate is due to the fundamental change in the working age population from that of growth to decrease in 2010.

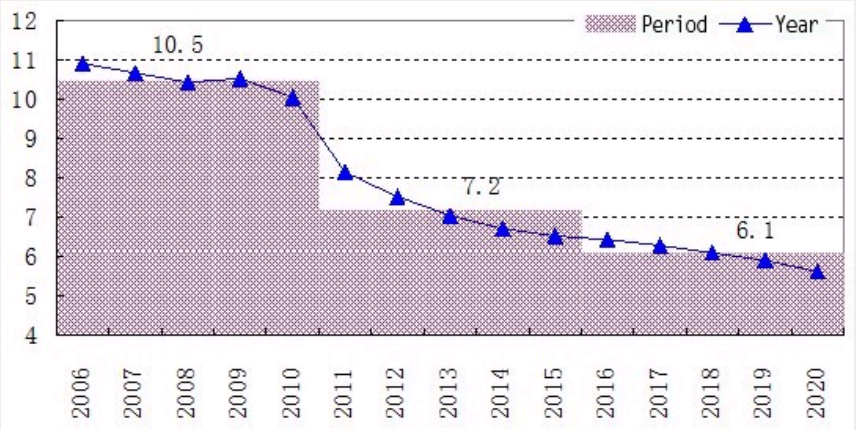

Figure 1 Estimated Potential Growth Rates in Selected Periods

Source: Cai, Fang and Yang Lu, "What Growth Rate Will China Realize in the Next Decade?" in Chen, Jiagui et al. (eds) *Bluebook of China's Economy*, 2012, Social Sciences Academic Press, 2012.

2. Chinese Society Can Afford a Slower Growth

The potential growth rate, by definition, is the rate of economic growth under the assumption of full employment of all factors of production. Therefore, there should not be a cyclical unemployment shock as long as actual growth does not fall below potential growth rate. That is why people have not seen and will continue not to see labor market shocks while the growth rate falls below 8% in 2012.

Do the Chinese policy makers need to do something to influence the growth rate more aggressively? Or, putting it in another way, is a faster growth rate better? The answer is negative. In fact, if we consider the eased employment pressure as good news, it is because it provides a perfect opportunity for China to rebalance its economy. Any act of artificially changing the growth rate to be consistent with China's capacity of potential output will not only lose such an opportunity but also risk policy mistakes that harm the sustainability of economic growth in the long run.

When growth slowdown occurs, both economists and policymakers often tend to make ambitious efforts in order to exceed the potential growth rate. While scholars often suggest a host of "emerging points of growth", such as potential demand for infrastructure construction in urbanization and development in the central and western regions, governments have no lack of policy tools to spur faster growth—that is, implementation of industrial policies, regional policies, and stimulus programs, which lead to massive investments.

All such policy suggestions and implementation focus on expanding demand factors of economic growth. This would be harmful to the economy if actual growth exceeds the potential rate in the long run, as it could result in various distortions including overcapacity, deviation from comparative advantage, inflation, and even economic bubbles, pushing the Chinese economy farther away from rebalancing.

In fact, the existing demand factors can sufficiently rebalance the Chinese economy because they perfectly match the potential growth rate. During the period 2001- 2011, the demand components of China's GDP annual growth rate consisted of 4.5 percentage points from final consumption, 5.4 percentage points from capital formation, and 0.56 percentage point from net exports of goods and services. Roughly assuming that, in the next 5-10 years, net exports to contribute nothing to the GDP growth rate (0.0 percentage point), contribution of capital formation to be halved (2.7 percentage points), and contribution of consumption to remain the same (4.5 percentage points), we can sum up the total demand factors to be 7.2 percent, exactly identical to the potential GDP growth rate that we estimated for the 12th Five-year Plan period.

Since the potential growth rate assumes full employment, its fall will neither hinder expansion of employment nor slow down growth of residents' income, and therefore, an assumption of invariant growth in consumption demand is reasonable. In conclusion, artificially creating demand through policy stimulation is not only harmful, but also unnecessary.

3. Emerging Challenges Facing China's Employment Situation

After the arrival of the Lewis turning point and the loss of demographic dividend, the Chinese economy accelerated its speed of transformation from dual economy development to neoclassical growth. Accordingly, China's labor market is approaching to a neoclassical type; that is, major challenges facing it are no longer an issue of aggregate quantity but of structure and friction. In what follows we discuss two major challenges and their related countermeasures.

The first challenge concerns normalization of the labor supply of migrant workers. Migrant workers have become enormous contributors to urban employment expansion. In 2011, migrant workers comprised 35.2% of the total employment force and 65.4% of incremental employment in the urban areas. The existing institutional constraints, however, have led to insecurity and insufficiency of migrants' employment in the cities. This is well depicted by the difference between the share of the population living in cities for 6 months and longer—the officially recognized urbanization level—and the share of population with non-agricultural household registrations or hukou. In 2011, the official urbanization level was 51%, whereas those who hold non-agricultural hukou only comprised 35% of the total population.

This gap of 16 percentage points implies that migrant workers—defined as those who have left their hometowns for cities for 6 months and longer—are counted into urbanization statistics but are excluded from having equal access to urban public services such as participation in social security programs, entitlement to minimum living standard guarantee programs, children's compulsory

education, and others. This awkward position of migrant workers in the urban areas has made them into an unstable supply of labor force.

There are three types of unemployment in a neoclassical labor market: (1) cyclical unemployment caused by macroeconomic fluctuations, (2) structural unemployment caused by a mismatch of skills held by job seekers and those required by employers, and (3) frictional unemployment caused by asymmetric information in the labor market. Since structural unemployment and frictional unemployment are not influenced by macroeconomic fluctuations, they are collectively referred to as the natural unemployment rate (NAIRU). Estimates show that NAIRU in urban China has been around 4.0%-4.1% in recent years, which, not coincidently, is exactly the same level as that of the urban registered unemployment rate (Figure 2).

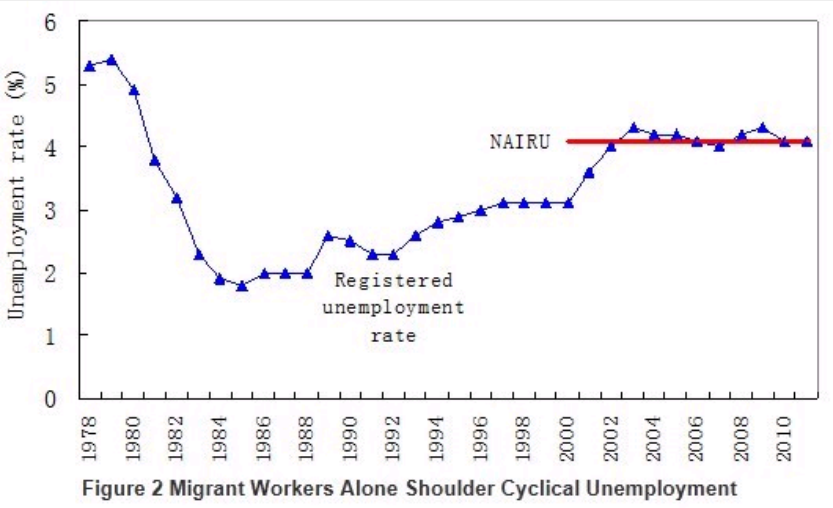

Figure 2 Migrant Workers Alone Shoulder Cyclical Unemployment

Source: National Bureau of Statistics, *China Statistical Yearbook, 2011*, China Statistics Press; Du, Yang and Lu Yang, "The Natural Rate of Unemployment in China and Its Implications," *The Journal of World Economy*, Vol. 4, 2011, pp. 3-21.

Since urban unemployment registration only covers urban residents with local *hukou*, that the urban registered unemployment rate is identical to the urban natural unemployment rate implies that while local residents in urban areas are subjected to structural and frictional unemployment, migrant workers alone suffer from cyclical unemployment risk. In the past decades, particularly during times of macroeconomic ups and downs, migrant workers were accordingly either in badly short supply or forced to go back to their farmland.

The second challenge concerns workers' skills needed by the structural adjustment of industries. In the course of China's move toward becoming a high-income country, industrial structure adjustment at an accelerated pace will be manifested mainly in labor transfer from labor-intensive industries to capital- and technology-intensive industries, and from manufacturing to service sectors. Based on the present distribution of human capital by sector, a worker from the labor-intensive employment in the secondary industry must increase his/her years of schooling by 1.3 years in order to transfer to the capital-intensive employment in the secondary industry, and by 4.2 years to transfer to the technology-intensive employment in the tertiary industry.

The increase in years of schooling takes time. For example, even if accompanied by the fast popularization of compulsory education and the expansion of higher education, the years of schooling of the population over the age of 16 increased from 6.24 to 7.56 between 1990 and 2000, an increase of only 1.32 years. In 2010, this figure was 8.9, an increase of only 1.34 years during this 10-year period.

In conclusion, it is vital for China to enhance workers' education and skills in order to succeed in industrial upgrading and to prevent

young laborers from natural unemployment shocks in the near future. The current labor shortage is bringing about wage convergence between skilled and unskilled workers, which is weakening households' incentive to invest in children's education. Those young workers entering the labor market without the necessary education attainment are finding it easy to get a job today, but they will suffer frequently from structural unemployment tomorrow as their skills become outdated with the industrial structure changing over time.

4. Conclusion and Policy Suggestions

In the course of transitioning from dual economy development to neoclassical growth, employment policy should also shift its focus from creating jobs through spurring economic growth to tackling natural unemployment through developing the labor market and improving public services. In the particular phase in which China stands, it is also important to stabilize and expand the labor supply so that the economic growth can be fueled by adequate inputs of factors of production.

At such a stage of development characterized by relatively full employment, the Chinese economy faces a spacious labor market environment under which the transformation of growth patterns toward rebalancing can be accelerated. On the other hand, employment challenges do not vanish but alter in their form. That is, the principle issue concerning China's labor market is being altered from underemployment to structural and frictional mismatching, which requires public policy responses.

A first response is to create an institutional climate for a stable supply of labor. Labor shortage is a main feature of a neoclassical economy, and it induces an industrial structure characterized by labor-saving technology. However, the characteristic of growing old before getting rich has led China to witness an increase in labor costs but not to gain comparative advantage in technology- and capital-intensive industries. Such uniqueness, on the other hand, allows for China to exploit the potential of its labor supply through institutional reform.

For example, the *hukou* system reform, along with institution building that provides migrant workers equal access to public services such as social security programs, minimum living standard guarantee, job training, and children's compulsory education, will spur labor mobility, enhance the labor force participation rate, and help transfer labor-intensive industries from the coastal to the inland regions. All of those can extend China's demographic dividend.

A second response is to increase public spending on education and training in order to accumulate the human capital necessary for industrial upgrading. The existing contradiction between education incentive in the short run and demand for skills in the long run is a peculiar phenomenon during the transition period. To correct such labor market failure requires the government to spend more public funds on strengthening education incentives. The existing problems in education such as mismatches between skills taught at schools and those demanded by the labor market and dissatisfactory quality of graduates need to be dealt with, but they should not lead to any hesitation in education expansion.

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