



FOR PROFESSIONAL INVESTORS – 22 May 2019

Chi on China

WHAT DON'T WE KNOW ABOUT CHINA'S DEMOGRAPHIC PAINS?

A fool thinks himself to be wise, but a wise man knows himself to be a fool.

William Shakespeare

SUMMARY

- China passed its demographic golden age, or saddle point, in 2010 when its dependency ratio¹ was at the lowest. It has suffered from a “demographic tax” since 2014 when the working-age population (15-64 years old) started shrinking. The UN projects that the total population would contract by 2030.
- Meanwhile, China has a much lower retirement age (60 for men and 50-55 for women) than most countries. So raising the retirement age sounds an easy way to lessen the demographic pains in the medium-term. But this is easier said than done due to an incentive incompatibility problem.
- Most observers seem unaware that China can find another 100 – 200 million workers easily in the next 20 years. So labour *per se* will not be a constraint on China's growth as conventional wisdom suggests, though it is an inevitable long-term challenge.

From an investment perspective, 20 years are a long-term horizon. If China's population problem that the world is fretting so much about is not imminent and not so dire for another two decades, this should be food for thought for long-term investment strategies.

WHAT DO WE KNOW ?

The driving force of China's ageing population is its low fertility rate², which has fallen well below the replacement rate of 2.1³. At around 1.5, China's fertility rate is among the lowest in the world. What's more,

¹ This is the ratio of the dependent (0-14 years and 65+ years) population to the total population.

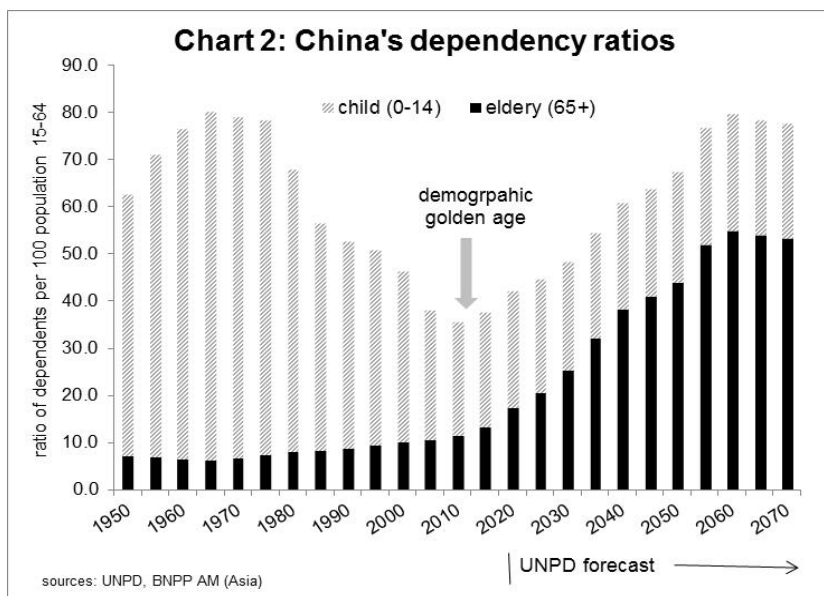
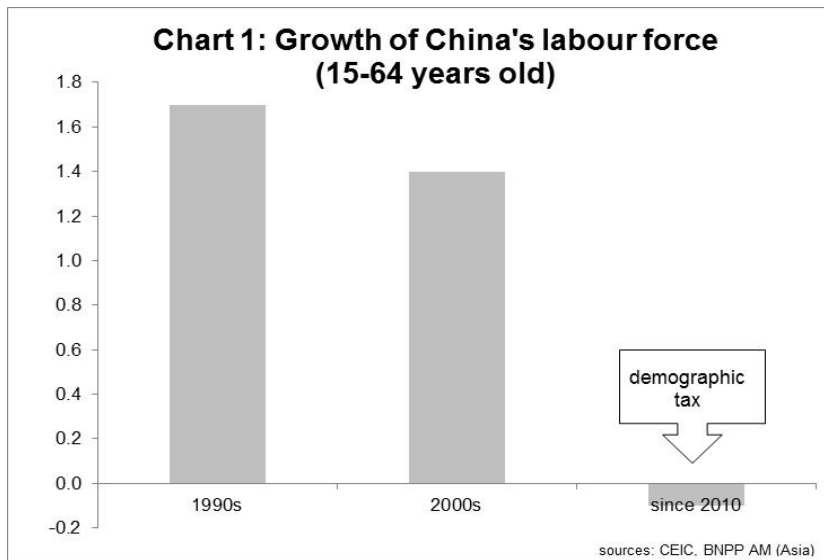
² The fertility rate of a population is the average number of children that would be born to a woman over her lifetime if she were to survive from birth through the end of her reproductive life.



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China's ageing process is happening much faster than in most other countries, despite its developing economy status. Hence, the demographic dividend that China enjoyed for nearly four decades has turned into a demographic tax (Chart 1) when its dependency ratios started rising again in 2010 (Chart 2).

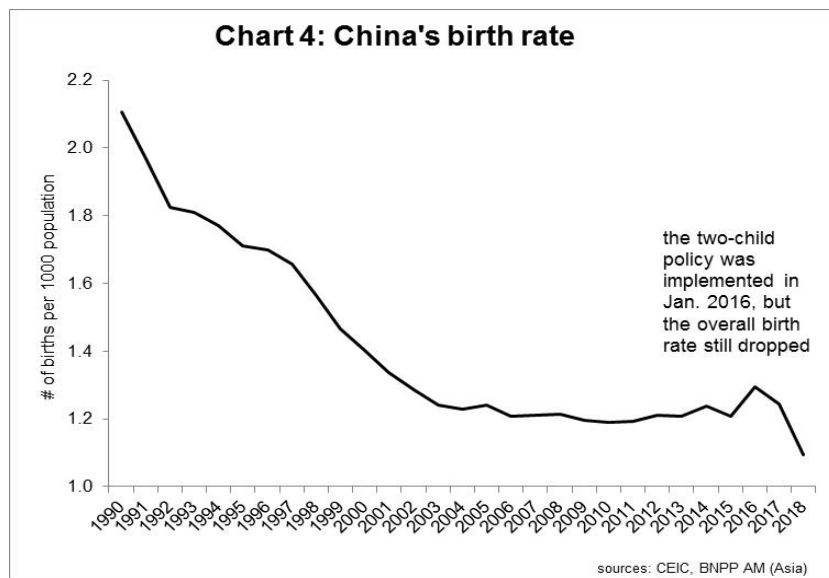
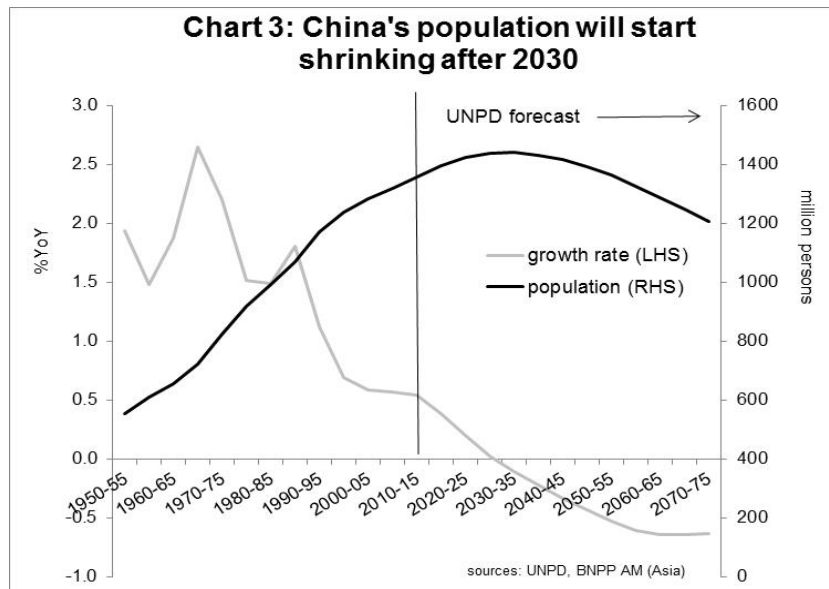


Such a fast demographic transition from high death and birth rates to low death and birth rates is a serious concern as the ageing population will pose a challenge to China's fiscal and macroeconomic stability through increased government spending on pension, healthcare and social benefits programmes for the elderly. The negative impact on growth of a shrinking labour force is obvious. The emerging labour shortages imply that much of China's labour-intensive manufacturing will either have to restructure or move out of the country to

³ The replacement rate is the fertility rate at which a population exactly replaces itself from one generation to the next without migration. Simply put, this is the fertility rate at which women give birth to enough babies to sustain the size of the population. This rate is roughly 2.1 children per woman for most countries.

cheaper production bases; and this is already happening. On public finance, China faces a daunting pension burden before it can develop sufficient means to looking after the old!

If the current trends continue, the UN projects that China's population would start to contract by 2030 (Chart 3). Fewer people means less consumption and, thus, slower economic growth. And despite the government's denial, the two-child policy that came into effect in 2016 with an aim of raising the birth rate did not seem to work as intended (Chart 4).



The latest UN projections⁴ also shows that there would be about 118 million people in the 45-49 age cohort by 2020 and another 127 million in the same age cohort by 2035. Assuming they are all working, this workforce will retire in 10 years' time, suggesting that China would lose 245 million workers between 2030 and 2045. China's official estimates echo this projection.

⁴ As of May 2019.

WHAT DON'T WE KNOW ?

While the world seems to be fixated on worrying about China's daunting demographic problem, two issues have escaped the public eye so far – China's retirement system and an extra 100 – 200 million workers that China can easily find in the next 20 years.

Early retirement and the incentive problem

The retirement age of the Chinese workers, 60 for men and 50-55 for women, are much earlier than most countries in the world. The average effective retirement age is even younger at 54, according to the OECD, due to the government's practice of asking unwanted workers to retire earlier than the official age⁵.

Official data shows that there were 83 million people in the 60-64 age cohort in 2018. Theoretically, they should still be in the labour force, but practically they may have already retired. Early retirement is certainly a negative force that adds to the economic growth drag due to the demographic tax.

If that is the case, can the government not simply extend the retirement age to deal with the demographic tax? Actually not because of an incentive incompatibility problem that exists between the local and central governments. Since the pension reform in the 1990s, the responsibility of paying the pensions has been shifted from the central government to the local governments, which also have the authority to approve applications for early retirement.

Here lies an incentive problem, which has become more pressing under Beijing's excess-capacity reduction and structural reform efforts. On one hand, the central government wants to keep pension payments down as pension funding is already strained. So it does not want to encourage early retirement. On the other hand, the local authorities want to approve more early retirement (thus increasing pension payments) during the process of industrial retrenchment so as stabilise the local labour markets and reduce the risk of social unrest.

In addition, corruption aggravates the problem. In theory, early retirement is only available to workers in the industries affected by industrial retrenchment, or in certain dangerous and arduous occupations. In practice, there are always "exceptions" granted by the local officials to allow early retirement contingent upon bribery payments.

Thus, Beijing is caught between a rock and a hard place. It knows that extending the official retirement age and discouraging early retirement are medium-term measures to counter the negative growth effects of the demographic tax. But it cannot implement them effectively due to resistance from the local authorities. Nevertheless, extending the retirement age is still technically the easiest way to encourage labour participation to counter the impact of deteriorating demographic dynamics on GDP growth. Expect some regulatory actions on this front later.

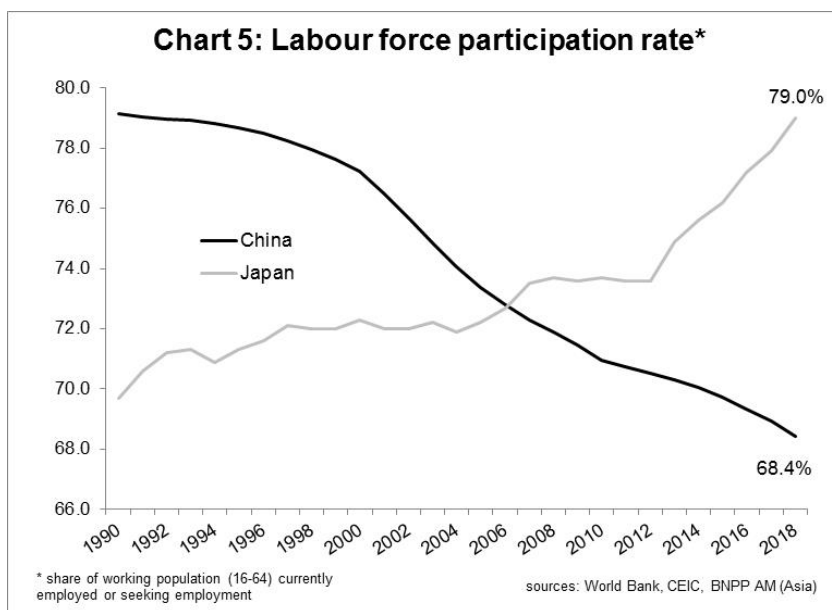
Finding another 200 million workers

The good news is that China can still find another 200 million workers quite easily in the next two decades. Firstly, there are those "forgotten" labour. There were 250 million 0-15 year-olds in 2018. If we assume the urban/rural distribution of this age cohort follows the national distribution, where 41% of the population is rural, in the next 16 years these 100-million-plus (250 x 41%) people will all be in the labour force who can be urbanised.

⁵ Based on the 2010 census data, 10% of the retired population was below official retirement ages. However, this figure underestimated the true early-retiree group because it only captured people who retired early at the time of survey. There were many who retired in the previous years but had since passed retirement age at the time of the survey, and hence were not captured by the survey. The survey data from the Ministry of Human Resources and Social Security put the early retiree group at 56.8% of the retired population!

Further urbanisation of the adult rural population (15-64 years old), estimated at 402 million in 2018, will augment the labour force in the coming years. Assuming half of this population was aged between 15 and 30 in 2018, there will be more than 200 million of the rural working-age population that can be urbanised in the next 20-plus years.

Secondly, raising the retirement age to 65 for both men and women will increase the labour force by 9.1%, using the 2018 data for estimation. In addition, if China's 68.4% labour participation rate were to rise to match Japan's 79% (Chart 5), China's labour force would increase by 26% (or 162 million). Successful industrial restructuring may lead to higher labour force participation by increasing the incentive for people to work longer to take advantage of new opportunities offered by the private sector.



It is also possible that industrial restructuring may create redundancies and unemployment. This downside risk will be reduced if the labour market can be made flexible, through the removal of institutional and other barriers to occupational and geographical mobility. In this regard, Beijing is working on relaxing the *hu kou* restriction to increase rural-urban migration. It is also increasing spending on education and research development to improve inter-sectoral labour movement and increase industrial value-added.

Thus, apart from policies to raise productivity, there are dynamics for expanding China's labour force to counteract its contraction under the current static framework. The estimated increase in the labour force can more than offset the expected loss of 200-million-plus workers between 2030 and 2045. Any change in the population policy that could boost the birth and urbanisation rates would add to these dynamics.

Contrary to conventional wisdom, labour *per se* will not be a constraint on China's growth in the medium-term, though cheap labour is history. Together with the trend of industrial migration towards the inland poor provinces⁶, which will employ cheaper and untapped resources, China's annual GDP growth may be able to sustain at an average rate of 6.0% for a much longer period than most players are expecting. Want to bet?

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⁶ "Chi on China: Progress on China's Structural Rebalancing and Reverse Migration", 8 November 2017.

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