Market Insights

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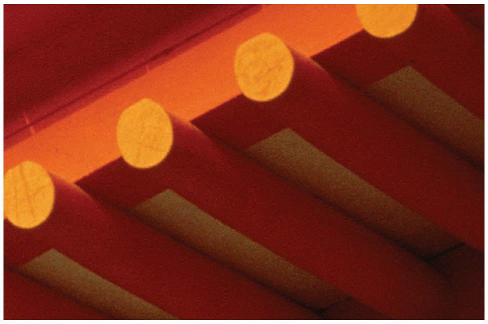

China's Changing Workforce Creates Problems and Opportunities

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Executive Summary

The recent labor unrest in China highlights significant demographic changes in China's workforce, which could have important implications for new growth areas and investment opportunities. Workers successfully striking for higher pay and better conditions in several regions of China in May and June reflects the changing balance of supply and demand for semi-skilled workers to man the thousands of manufacturing facilities throughout the country, but especially those concentrated in the southern Guangdong province. While there is no actual head count shortage in China, a structural and regional imbalance in the workforce is leading to labor shortages in certain parts of the country and in certain industries. This is pushing up wages and strengthening workers' bargaining power. At the same time, government efforts to jumpstart development in the more remote western provinces is giving workers there better options for working closer to home. As China's workforce becomes more educated and more affluent, the country is evolving from the world's manufacturing assembly line into one of the most promising consumer markets. We believe all of this is having an important effect on where the new growth and investment opportunities are developing.

China's Changing Talent Pool

After the Chinese New Year this year, factories in the Pearl River Delta in Guangdong discovered that many migrant workers did not return from home following the holiday. That drop in the supply of workers forced factories to raise wages by around 20% to attract new workers. Workers who struck at Honda's factories in May and June were demanding a 50% increase.[1] The global financial crisis and collapse in consumer demand from developed countries had forced many factories in the south to lay off workers in 2008 and 2009. But as the economy recovered, when many factories reopened they found it more difficult to attract workers, especially as improving conditions in the western provinces reduced the incentive for many migrant workers in the west to leave their families to work in the factories of coastal areas.

With a steady urban unemployment rate under 4.5%, China does not necessarily have an overall head count shortage.[2] Instead, it faces a regional structural imbalance of supply and demand within its current talent pool. The current shortage of low-skilled

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1 David Pilling, "Change Is Finally Afoot for China's Workers," *Financial Times*, June 2, 2010.

2 Xinhua, July 23, 2010, quoting Yin Chengji of the Chinese Ministry of Human Resources and Social Security (MHRSS).

workers in some areas stems from a number of factors. First, China's one-child policy has slowed the pace of population growth overall. In addition, rising education levels and falling illiteracy rates have created higher-skilled workers who prefer to seek higher paying jobs with better conditions in the country's growing, higher-value service industries. At the same time as migrant workers are becoming more reluctant to migrate, the need to relocate is diminishing as the overall economy expands and growth is no longer focused solely in the coast areas. The short-term challenges of labor-intensive sectors reflect these structural changes in China's economy.

These latest changes are part of a long evolution in China's workforce over the last 30 years. Before the introduction of the "socialist market economy," China's so-called "iron rice bowl" system guaranteed cradle–to-grave security that included jobs, steady salaries, housing and social benefits. This culture was deeply entrenched in China's state-owned enterprises (SOE), which were economically inefficient but politically important. By the 1980s, Deng Xiaoping's labor reforms began phasing out the "iron rice bowl" system, which was scrapped altogether when China entered the World Trade Organization in 2001.

To ward off possible social discontent, the government instituted various tax, agricultural and land reforms to help western farmers raise their income and reduce the wage gap. Along with higher wages in western provinces, rising living costs in the east and south quickly diminished incentives to move towards the coast.

As a result of reform, special economic zones (SEZ) developed in several cities along China's eastern and southern coastal provinces, where targeted reform helped to develop industry and enhance distribution channels to developed markets. The rapid growth of the eastern cities naturally attracted labor from rural and western areas, where work was mainly limited to subsistence farming. Migrant workers increasingly travelled east to earn salaries of up to three times what they could earn at home, albeit at the cost of leaving their families.

With the rise in wealth in eastern provinces, the income gap between inland and coastal provinces began to grow as well. To ward off possible social discontent, the government instituted various tax, agricultural and land reforms to help western farmers raise their income and reduce the wage gap. Along with higher wages in western provinces, rising living costs in the east and south quickly diminished incentives to move towards the coast. A few years ago, there were already some signs of decreasing migrant labor traffic; at the time, however, few could imagine labor shortages in the world's most populated country.

In 2008, those coastal provinces that had prospered under direct exposure to developed markets and benefited from foreign direct investment and the export of locally manufactured goods were unable to control the contagion of the global financial crisis. As factories closed and job opportunities disappeared, China's workers moved back west. An estimated 23 million people, more than the total population of Australia, were laid off work.[3] Social stability appeared threatened.

As a result, China's central authorities immediately funneled infrastructure spending to rural areas to create jobs and prevent social unrest. Under the RMB 4 trillion stimulus program, China implemented various programs to improve rural development, including improving transportation infrastructure networks, agricultural and land reforms, as well as introducing social welfare subsidies to alleviate concerns about medical and household expenses. Together these measures were able to spur household consumption as they helped decrease the focus on saving.

3 Pieter Bottelier, "China's Astonishing Rebound Is for Real, but Prospects Remain Uncertain," Carnegie Endowment for International Peace, September 2009.

China has seen tremendous changes in the last 20 years. We believe the changing demographics of its workforce as well as the migration of its economy up the value chain will provide the backdrop for China's next phase of growth and development.

From Assembly Lines to Shopping Malls

The most recent worker discontent shows that the former model of China as a manufacturing center for the world fueled by unlimited low-skilled, highly productive and inexpensive labor is giving way to a new generation of better educated workers who are either abandoning the factories and moving into the services sector or demanding higher wages and better work conditions.

As China develops more sophisticated kinds of production and services, salaries and living standards should rise. China's workers may increasingly become affluent consumers, with significant implications for the next wave of growth and investment opportunities. We believe the changing demographics of China's workforce will benefit several sectors in particular.

Technology

The labor shortage presents a double-edged sword for technology industries: on the one hand, it hurts downstream and labour-intensive industries, but it also prevents the likelihood of overcapacity or inventory corrections. At the same time, tech demand remains strong, especially from emerging Asian markets, and will grow as Chinese consumers grow richer. Demand for new products is expected to remain high, pushing many tech companies to increase investments in automation. We believe automation companies and higher upstream companies focused on the tech sector's supply chain could be attractive areas for investment.

Retail Sectors

We believe rising incomes and improving social welfare support will not only increase household disposable income but will encourage Chinese consumers to spend more. Retail names with good consumer exposure throughout second-tier and rural cities will likely be key beneficiaries of the growing wealth of workers looking to convert their earnings and savings into consumer goods.

Infrastructure

As the government continues to develop western provinces, we believe infrastructure investments will increase. Building and improving roads and transport as well as improving telecommunication systems may be the pillars of government efforts to modernize rural areas and develop inland hubs. Also, as the cost of living in developed coastal areas rises, manufacturers may move to lower cost centers and develop new markets.

Vietnam as the New China?

As traditional manufacturing becomes a smaller part of the Chinese economy and worker wages rise, we believe manufacturers may look to new low-cost areas to develop. Vietnam is already attracting investors who have chosen to set up businesses there as well as in China. Like China ten years ago, Vietnam boasts a similarly competitive low-cost, highly productive workforce. We expect attractive investment opportunities in Vietnam as the country starts to compete with China for exports to the West.

China has seen tremendous changes in the last 20 years. We believe the changing demographics of its workforce as well as the migration of its economy up the value chain will provide the backdrop for China's next phase of growth and development. In our opinion, this will be marked by the growing affluence and confidence of billions of Chinese workers who could fuel one of the biggest periods of consumer growth over the next 10 years.

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