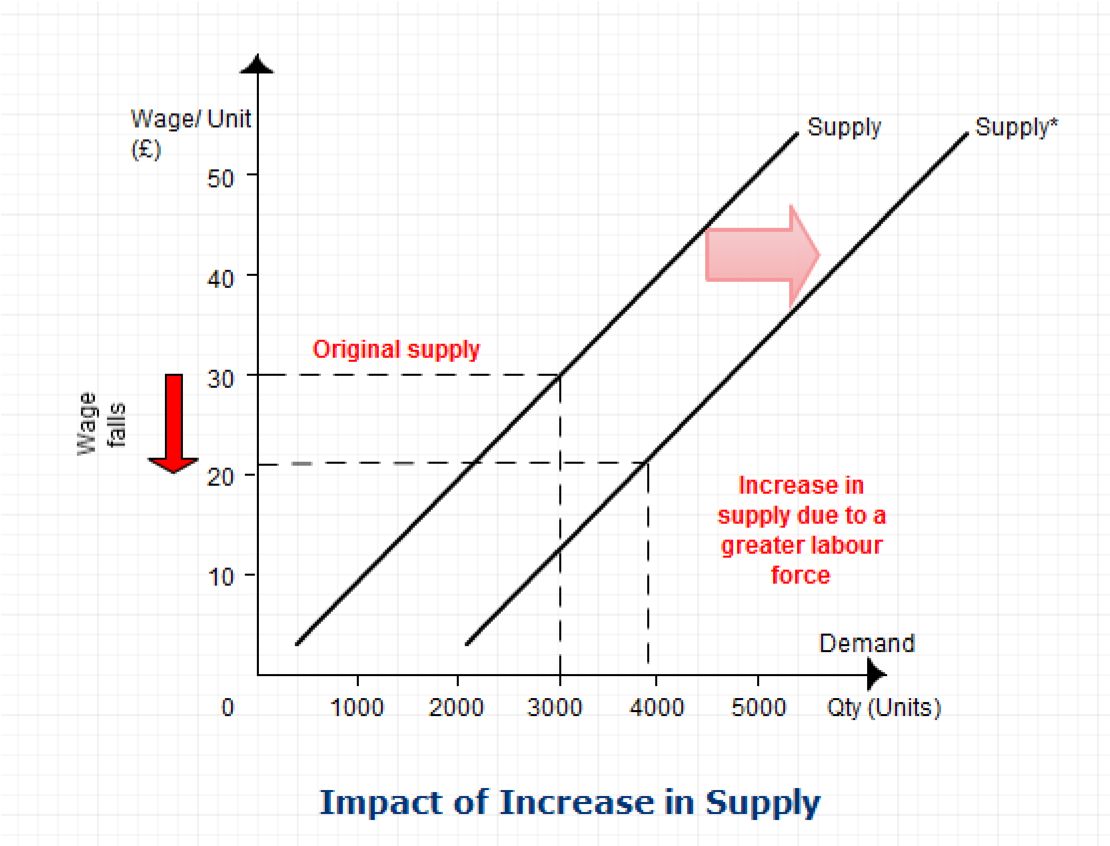
Beyond the Lewis Turning Point

During the 18th and 19th centuries in Western Europe, industrial cities such as Liverpool in UK, Leipzig in Germany, Saint-Étienne in France and Bilbao in Spain started to grow fuelled by thousands of families travelling from the countryside to work in industries which were already leveraging the industrial development across Europe. Consequently, productivity and income per capita began to increase rapidly and the standards of living soon become the envy of the rest of the world.

A similar process has been taking place in China on a larger scale. During the last four decades millions of people have changed their ploughs, draft animals and thatched houses for factories, sewing machines and assembly lines. The abundancy of labour force has spurred the Chinese's economy for nearly half a century, depressing wages and intensifying the quantity of goods produced.

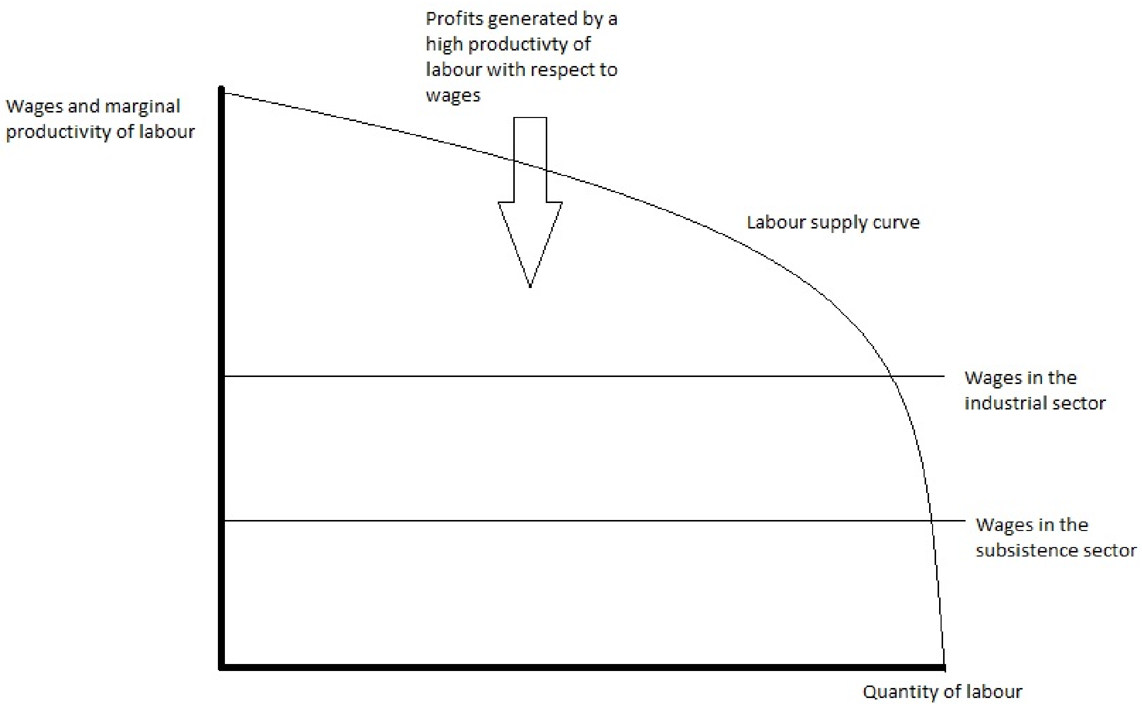


A labour-intense economy with low wages has stoked the export of cheap goods to the rest of the world, transforming China as the main factory house, globally, whilst generating huge surpluses. This trend is highly likely to continue in accordance with the strengthening flow of low-cost labour. However, recent investigations suggest that the Chinese economy has reached the Lewis Turning Point. The Lewis Model (Arthur Lewis, 1954) argues the existence of two sectors:

The first, referred to as the subsistence sector, is made up of primary activities with low productivity of labour due to land constraints.

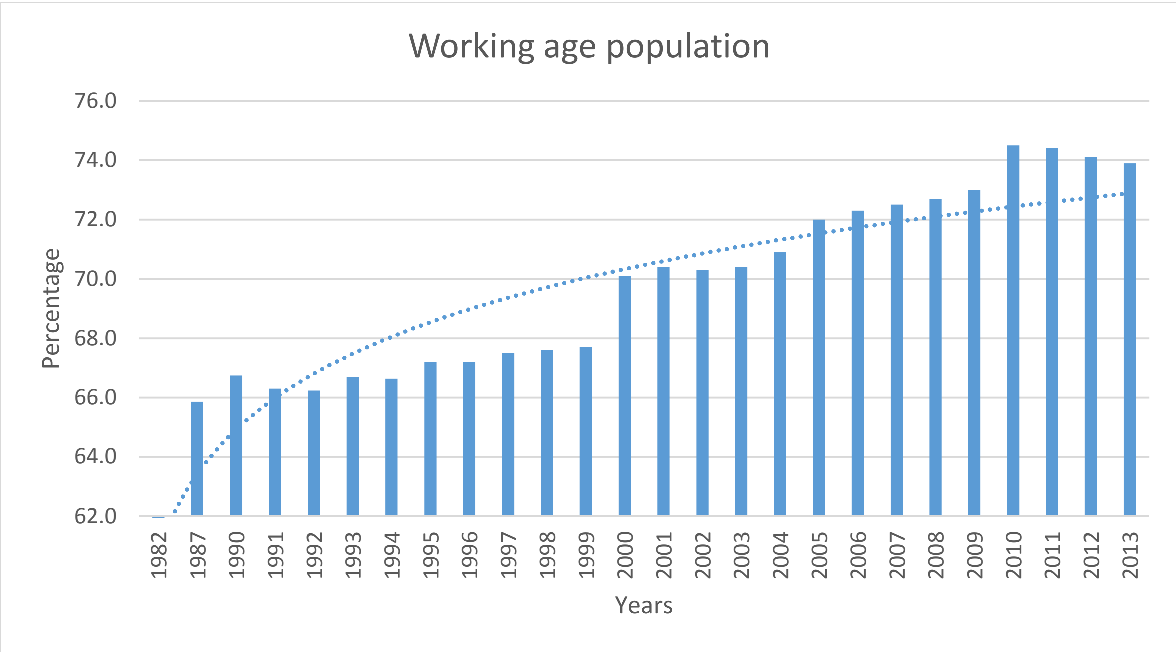
The second one, named the capitalist sector, where the activities involve the manufacture of goods yielding greater outputs.

The model explains that in agrarian economies a large pool of labour lies unproductive in the subsistence sector, and when the process of industrialisation begins workers are lured into cities with prospects of a better life and slightly higher wages. A high productivity of labour and poor wages yield large profits which are invested, expanding the capacity of the economy and generating growth.

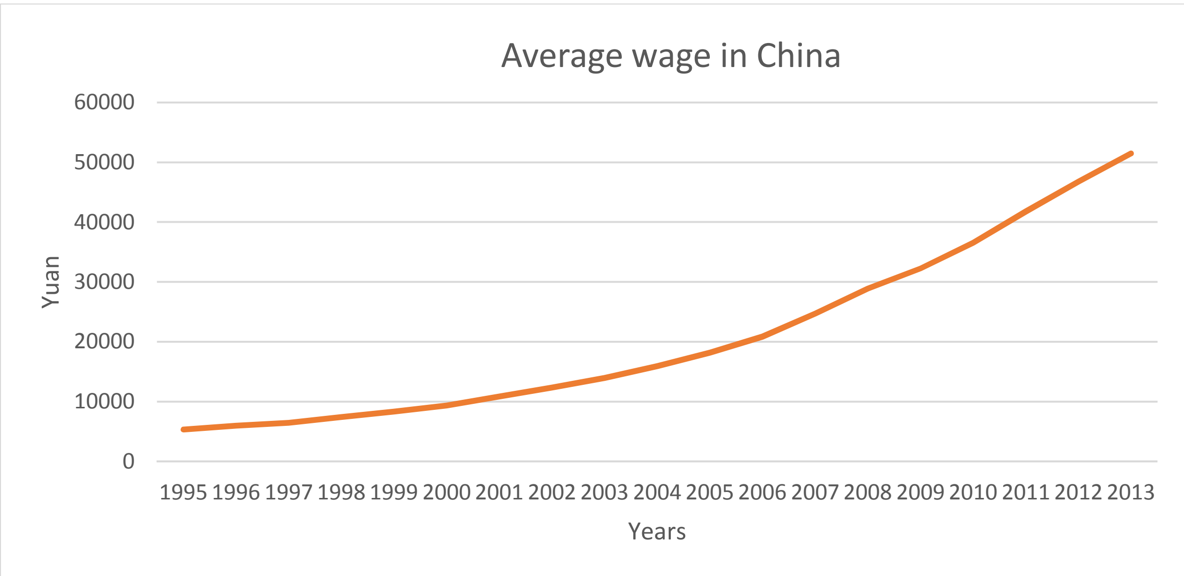


The model claims that once the marginal productivity of labour equals wages in the industrial sector, profits are invested, shifting outwards the labour supply curve and giving room to economic growth by employing more people. The Chinese model is based in abundance of workforce.

The transition occurs when the labour surplus is used up, and wages are therefore bound to increase sharply, converging with those in the industrial sector. According to the Bureau of statistic of China the number of the working population reached its peak in 2010, and has started to decline. Thus, the prominent change took place in 2010.



The exhaustion of the labour surplus and the one child policy adopted by the Chinese government in 1978 are disturbing the demographic tendencies of the country. The effect on wages is clearly seen in the following graph.



Data obtained from the National Bureau of statistic of China.

This hike in salaries will undoubtedly rise the cost of productions and hence prices. The successful story of China is rooted in the manufacture of cheap goods, and a rise in prices can eliminate that advantage significantly.

However, these observed changes are not necessarily bad for some advanced economies. This structural adjustment will alleviate the trade unbalances suffered by some high-income countries, especially The USA. According to the United States census bureau the trade deficit of The US with China is $342,632.5 billion.

A surge in prices in China with no changes in product quality will alter demands patterns, disrupting business behaviour. Furthermore, as workforce becomes scarcer, employees will gain more bargaining power and their natural tendency will tilt towards an improvement in their labour conditions. This might cause companies to move back to their countries of origin. This may be largely seen in high income countries where the labour force, however more expensive, it is better trained.

The cheapness will stop having more weight than quality, and it is precisely this shift which may cause unemployment to decline in some Western economies.

What China faces now is a complete transformation of its model of production, a change from a labour intense to a capital intense economy. The shift in demographic trends will somehow force that change as the wages continue its upward spiral. As labour becomes more expensive, the investment in labour saving technology will befit businesses, increasing productivity and income per capita even further. This will help to create a domestic market, offsetting the expecting fall in exports caused by a rise in prices.

Nonetheless, it can be argued that this shift in the patterns of investment will cause massive unemployment in the manufacturing sector of the Chinese economy as fewer workers are needed. Yet that surplus of labour ought to be employed in the service sector: Financial, health, education and retail. Fully developed economies have only 15% of their labour force engaged in industry activities, even less in agriculture, whereas the bulk of the population work in the services sector. A Chinese society with a greater purchasing power will therefore fuel the foundation of the latter.

In order to kick-start this dynamic, China must step up his investments in R&D. According to the World Bank, the main economic superpowers, such as Germany, Japan or the USA invested in R&D as a percentage of GDP in 2012; 2.92%, 3.39% and 2.79% respectively. On the other hand, China used just 1.98%. Although there is an upward trend in China's investment in R&D, and the country has the potential to develop their economic situation, there is yet much to be done.

Corporations are the key to shake up the economy. Companies can add high value to their products and services and enhance their competitive value through implementing cutting-edge technology. By doing this, China will enable its productive system to move towards a knowledge based economy and compete alongside its western counterparts.

This will allow the country´s political and economic leaders to avoid the middle income trap and going out the 'Lewis turning point' unscathed. China will therefore join those high income economies which have overcome that point in the last century and at the same time, it will balance world's trade.