

Structural transformation and its implications for the Chinese economy

Gaofeng Han

Hong Kong Institute for Monetary Research

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Summary

This paper applies a two-sector model to examine the conditions under which the excess labour force can be reallocated from the tradable to the nontradable sector during structural transformation. We find that to maintain employment stability, output in the nontradable sector should be 1.9-to-3.5 percentage points higher than in the tradable sector, if labour shares in the two sectors approach the level of major developed economies in the next one and a half decades. Such output differentials mean the productivity increment in the nontradable sector should reach as high as 1.5 percentage points at the start, if job loss in the tradable sector is associated with negative investment shocks, or 1 percentage point if job loss is associated with an improvement in process efficiency. In the absence of technological progress in the nontradable sector, the government could increase its consumption of nontradables by as much as 4 percentage points to help maintain employment if the tradable sector faces negative investment shocks. The required government consumption increment is much lower if the tradable sector faces efficiency changes. The fiscal expansion is welfare

improving for households if job switching is not cost prohibitive, although it will increase budget deficit in the short run.

While the pure labour reallocation has a small effect on aggregate output, the shrinking working population and an improvement in efficiency in the tradable sector have larger effects on aggregate output. Price falls only slightly and the real exchange rate change is small during structural transformation. Despite that the structural transformation goal seems achievable, it is important to revive high-end tradable industries through product innovations to reduce employment pressure on the nontradable sector.