China's Labor Cost Problem
Ang, Yuen Yuen
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China's Labor Cost *Problem*

BY YUEN YUEN ANG

And what Beijing plans to do about it.

"It's a dying business," said the owner of a garment factory I met in Zhuhai, a city in Guangdong province. Like many in his line of business, he is packing up. Lured by abundant cheap labor, investors flooded to Zhuhai two decades ago. Gone, it seems, is the heyday of T-shirts, toys, plastic flowers, tiles, hooks, springs, and the like. Today, the costs of manufacturing such items are lower in countries like Bangladesh and Vietnam than in Guangdong.

As labor costs continue to climb, is China set to lose its coveted spot as the world's workshop?

Rising labor costs are inevitable. China's government introduced tough labor laws and a minimum wage in 2008. Recent policies to improve rural economic conditions have slowed the flow of migrants from the countryside. Workers are demanding higher compensation to match the fast-rising cost of living in China's cities, as manifested in an ongoing and high-profile labor strike at a Honda plant based in Guangdong. Salary was the major point of contention.

Workers on strike demanded a raise in pay from the current ¥1,500 renminbi ($234.00) to ¥2,000–¥2,500 renminbi ($373.13) per month. Clearly, Chinese factories can no longer offer dirt-cheap prices.

Apparel production is a prime example of China's declining competitiveness in markets dependent on low-cost labor. According to a study by the U.S. consulting firm Jassin O'Rourke, labor costs in China are higher than in seven other Asian countries. The average cost for a worker is $1.08 per hour in China's coastal provinces and $0.55–0.80 in the inland provinces. India was in seventh place, at $0.51 per hour.

Yuen Yuen Ang is Professor of International Affairs at Columbia University.

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Adding to China's labor woes, the financial crisis during the last two years had a disastrous effect on foreign demand. In 2009, China's export value fell by 16 percent from 2008. Labor-intensive industries were especially hard hit. In the textiles industry, profits declined for the first time in ten years in 2008. In March 2009, exports of electronics and IT products tumbled nearly 25 percent from the previous period. Although Chinese exports have begun to recover in 2010, the impact of the financial crisis remains palpable. By January 2010, the value of exports had returned to its previous level in the same period of 2008. But many factories have already perished.

For Chinese manufacturers, a long-term trend of rising costs coupled with a short-term export slump were unprecedented challenges. But the government and entrepreneurs are not idly sitting by as competitiveness slips. These adverse conditions have inadvertently propelled a long-delayed restructuring of China's labor-intensive industries. As costs surge, Chinese producers are seeking higher value, new niches, and more influence over policymaking.

Along China's dynamic coastal belt, local governments are drafting new economic blueprints to push their firms up the value-added chain. Consider the case of a textiles manufacturing center in Jiangsu province, dubbed the "silk capital" of China. Three-quarters of the city's GDP had been coming from textiles production. Last year, however, exports fell by about 15 percent. For local planners, the export shock was a wake-up call for change.

As a result, officials in Jiangsu are no longer content with sewing clothing. Leveraging a mixture of administrative guidance and monetary incentives, the city government plans to reduce the share of garments in the output of textiles products by 25 percent in three years and to increase the industrial applications of chemical fibers, which promise much higher returns than apparel production. Already, according to local officials, the city's factories have acquired the ability to mass-produce super-thin fibers first designed in Japan.

In fact, the global meltdown may turn out to be a blessing in disguise for industrial upgrading. Slumping orders devastated low-end producers, which barely survived on wafer-thin margins. Half of China's toy factories went bust by the end of 2008. Though alarming in the short term, the eradication of small producers spells good news for those that survived the crisis. As firms consolidate market share, they gain economies of scale. Larger firms are more capable of pooling resources for research and development, which is the key to China's aspirations to climb the value ladder.

Less fragmented industries also lobby better. Traditionally, contract manufacturers in China are scattered and fiercely competitive. They have little if any say over domestic and international regulations. Producers in Jiangsu, for example, were forced to adapt constantly to fickle product-safety and environmental standards in export markets. Compared to producers in the United States and Europe, those in China are weakly organized and passive.

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This could change. As surviving firms gain in size, Chinese businesses may exercise more bargaining power *vis-à-vis* the Chinese government and foreign firms. Exercising a louder voice in politics at home and abroad could mean reduced uncertainty for Chinese exporters. Consider the strategy of Lenovo, China's largest computer manufacturer: It has hired a lobbyist in Washington, reportedly the first Chinese company to do so.

In decades to come, China can no longer sustain the cost advantages that defined its initial period of export success. But it is a mistake to think that China's manufacturing will remain in the doldrums. Compared to many developing countries, China's government is stable and embraces foreign investment. Industrial clusters have been established in many parts of the country, where business connections can compensate for rising costs. Domestic consumption is growing. Further, as low-end, low-cost labor jobs morph towards higher-end, higher-cost jobs, China will move not only into more valuable manufactured goods, but also into the service industries, such as design. This change, too, could give the United States a difficult new run-for-its-money.

When China's labor-intensive industries emerge from their metamorphosis, we should expect to see firms that are larger, that invest more in product innovation and design, and that hold more sway over business and trade policies. So "Made in China" is not losing international dominance yet. It is merely taking on a new—and possibly more formidable—shape. ◆

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