The **China Integrated** Analysis
March 2012

Rising Costs: the End of China as a Production Base?

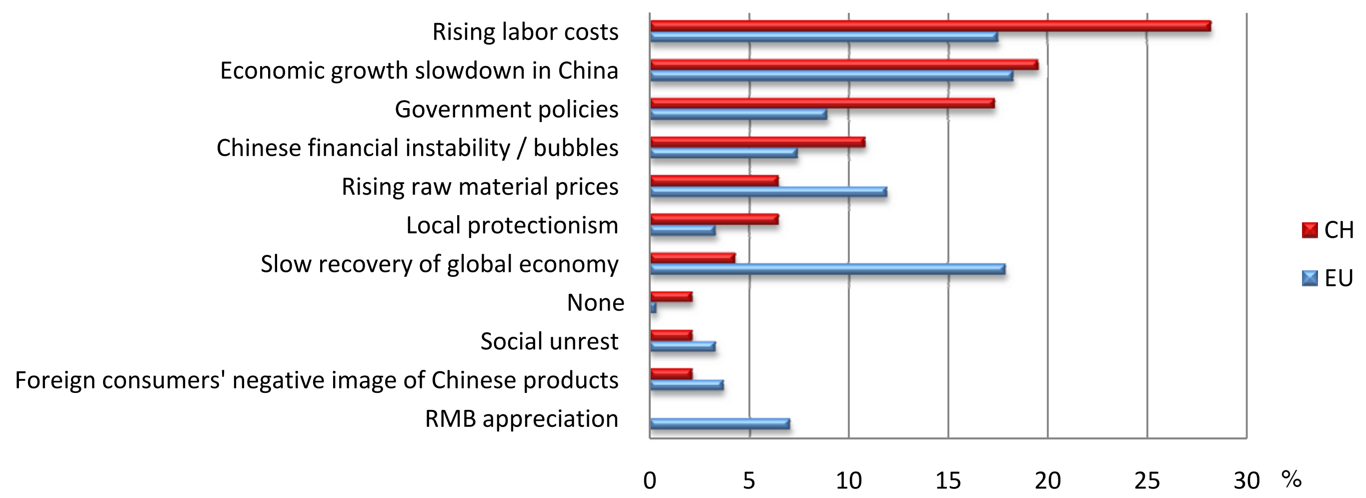
What to Expect from the Year of the Dragon – Part II

In our last analysis featuring the results of the CEIBS - China Integrated/Swiss Center Shanghai survey of Swiss and EU companies, we saw foreign companies battling with competitors and with building the necessary human resources to grow and invest as fast as they intend. For the first time, a group of respondents (the Swiss) see private Chinese companies posing a bigger challenge than their international competitors, a very interesting development.

This may turn into a double challenge when taking rising costs into the equation: it is of common knowledge that Chinese companies are very astute at cutting costs - and often the corners that go with them, as well!

Together, Swiss and EU companies currently see rising labor costs as the main risk to their business in China:

Which are the main challenges facing your company in the coming years?



Looking at the most recent Five Year Plan published last year, rising labor costs will not go away: it is an explicit target of the central government to raise minimum salaries by 13% each year. Compounded over 5 years this makes 84%, **almost a doubling of minimum wages** from 2011 to 2015!

Though this is not a small deal it has not been picked up much by the international press, maybe because we are not used to governments setting explicit and measureable targets (or meeting them).

Yet, China's track record at making decisions and pushing them through is well established and we should expect these increases to happen. In fact, according to the Ministry of Human Resources and Social Security, at the end of September last year, local authorities in 21 of China's 31 provincial-level regions had increased minimum wages by an average of 21.7%, quite some more than the targeted 13%.

Minimum Salaries & Increases for Selected Locations in China

Location	2011 Minimum Salary [RMB per month]	Increase 2011 over 2010 [%]
Chongqing	710 to 870	27.9 on average
Guangzhou	1’300	18.2
Shanghai	1’280	14.3
Zhejiang	950 to 1’310	19.0 on average
Jiangsu	800 to1’140	16.2 to 18.7
Beijing	1’260	20.8
Tianjin	1’070	16.3
Hubei	600 to 900	20.3
Anhui	680 to 1’010	27.1 on average
Hefei	1’ 010	40.3

Even though the minimum wage increases already announced for 2012 have been more moderate, they will most probably happen: Beijing 8.6%, Shanghai 13% (to RMB 1’450 per month), Shenzhen 13.6% (to RMB 1’500/month), Sichuan 23.4% on average (to RMB 800 – 1050/month)[1].

This is part of a concerted effort to reduce income gaps between the coast and the interior (minimum wages increase faster where they are lowest) as well as to reduce differences between richest and poorest in one location (average salary increases for 2012 are around 10% in Shanghai). Additionally, minimum wage increases intend to turn the domestic market into a bigger contributor to growth and reduce China’s economic dependence on exports.

Does this policy spell the end of China as a production base for the world?

It may not happen as soon as many expect:
Looking at the past, between 2005 and 2010, China’s average yearly minimum salary increase was 12.5%, yet the price of goods exported to the USA rose less than 5%, even with an appreciating RMB[2].

Obviously, productivity increase are getting harder to achieve as the economy is more developed; still, manufacturing in China is practically not automated and the potential for efficiency gains is enormous. Foxconn (maker of all the iPhones and iPads, among others) employs about 1.2 million people in China working essentially in manual assembly lines, of the kinds that Ford developed in the 1900s. Only middle of last year did Foxconn’s Chairman, Terry Gou, announce the group is planning to use more robots (one million of them in the next three years!).

Yet, before automating, Mr. Gou embarked in an aggressive migration plan, building 19 factories in Central and West China, including Zhengzhou, Chengdu and Chongqing, highlighting that going inland is still favorable compared to venturing to other low labor cost countries such as Vietnam or India. Foxconn’s investment plans in Vietnam have actually been postponed and Indian factories are being closed. Indeed, even if minimum wages increase by 100% in China’s poorer locations in the next 5 years, they will barely have caught up with Guangdong’s current level. And that is without taking productivity gains through automation into consideration.

At the same time, inflation in other Asian low cost locations is about twice China’s rate. In 2012 economists expects 3.5% inflation in China against 7% in Vietnam, 6.8% in India and 10% in Pakistan. In addition, due to China’s increasing imports and stabilizing exports, the RMB appreciation against the USD is expected to end this year[3].

Finally, China’s infrastructure, logistics and supply chain is improving, so that materials and components made in China (capital rather than labor intensive) remain most competitive. Thus,

[1] All minimum wages information is from Chinese media quoting government announcements.
[2] Alan Tonelson, Research Fellow, U.S. Business and Industry Council in New York Times, 24 Feb. 2012
[3] UBS economic forecast

when taking into consideration all elements, even though costs are rising in China, it is difficult to identify a contender as new "Workshop of the World", and we expect China to remain a very competitive production base for mid to high-level products in the next 10 years. Meanwhile it will become an extremely interesting consumption market, even though growth is slowing.

Slowing growth actually, the second most important challenge reported by European companies, might however have its advantages. GDP increases of close to 10% a year, resulting often in sales growth of over 30% for foreign companies, strains the organization and does not allow for the efficiency improvements that foreign companies are good at implementing.

The other good news is that the 8.6% growth expected till 2015 may finally go towards easier recruitment and retention of the skilled human resources that foreign companies badly need, starting to alleviate the key concern of the past years.

We are therefore very much looking forward to another highly successful China year!