New Challenges for Foreign Producers: 'China's Manufacturing Competitiveness Is at Risk'

The recent sharp rise in China's inflation rate sent a fresh wave of concern through the country's manufacturing community, because even before that, the costs of running a factory in China had been steadily increasing. The consumer price index jumped 8.7% in February, year on year, the biggest increase in almost 12 years. Speaking at the closing session of the National People's Congress, Premier Wen Jiabao called inflation the country's most serious problem, and admitted that the target rate of 4.8% for 2008 would be difficult to meet.

For factory owners, inflation raises operating costs, as raw materials, transportation, energy, labor and land become more expensive. And for those owners, the timing of the inflationary surge could not have been worse. As the Chinese New Year ended, the workers returned to their jobs with more strident calls for higher wages. In China, the end of the Lunar New Year holiday is when workers negotiate and sign new one-year contracts. The rising prices of key goods – food prices rose 23% in February, led by pork at 63% – fuelled a renewed urgency in the workers' demands.

"At New Year's time, the workers went home, compared notes and discussed new opportunities," says the American owner of a factory in Pudong who asked not to be identified. His factory has 35 employees, most of them from Anhui province. "They came back and dissatisfaction with our wages erupted. Two [men] came in and said, 'You have to give us more money or we're going to leave.' They influenced all the other workers in the factory, who came to us and [issued] an ultimatum [to give] them more money, which we had to do." Overall, he says, wages have risen 30% to 40% for skilled workers, and almost 50% for unskilled workers, since he opened the factory in mid-2004. Because there is such great China-wide demand for low-level factory workers, unskilled laborers have received bigger increases in pay.

Clearly, China is losing its luster as a location for low-cost production, as rising costs, inflation and the steady appreciation of the renminbi (RMB) have increased factory operating expenses. Many labor-dependent companies are already leaving China for India and Vietnam, especially those from Taiwan and Hong Kong, and more are considering the move.

A new report called China Manufacturing Competitiveness 2007–2008 -- produced by the American Chamber of Commerce (AmCham) Shanghai and conducted by consulting firm Booz Allen Hamilton -- surveyed 66 manufacturing companies, most of them foreign-owned, and found that almost one out of every five will move some of their manufacturing to other countries. The top destinations, in order, are India, Vietnam, Thailand, Malaysia and Brazil, and the reasons for leaving China were rising costs and an appreciating RMB. "The vast majority, 83%, don't have any plans to leave China," says Ron Haddock, greater China vice president for Booz Allen Hamilton, which conducted the study. "They still see advantages in China, but what's disturbing here is that 17% actually do have concrete plans to move manufacturing capacity to other neighboring countries."

The companies surveyed said wages are rising 9% to 10% per year, with the cost of raw materials up more than 7% per year. "China's manufacturing competitiveness is at risk," says Haddock. The bilingual report was released in early March. Most of the companies surveyed are in the Yangtze River Delta area.

Rising Costs across the Board

Since the fixed peg was removed in July 2005, the RMB has appreciated 15% against the U.S. dollar, and there is near-unanimous agreement that it will continue to rise. Further

appreciation would mirror the trend in other Asian countries that followed a similar path to industrialization, including Japan, Korea and Taiwan, and to a lesser extent, Thailand and Malaysia. Those countries, which started out decades ago as low-cost, export-oriented economies and evolved into producers of high-value goods, all logged large annual trade surpluses for many years, causing a steady rise in their currencies.

The rising RMB is the most serious worry for the 66 companies that participated in the study, but it is not the only worry, says Haddock. "In companies that have concerns about China losing its competitiveness, number one was the appreciation of the RMB, number two was inflation price increases both in commodity prices and cost of property and facilities, and number three was wage increases."

In Pudong, where the American owner has his factory, lease prices for land have more than doubled in fewer than four years. "Not only are wages going up, but all the migrant workers have to be fed and housed, and those rates are going up a lot, too," he says. "You can't just rent a dormitory next door for cheap anymore. When I started out, 4 mao (RMB 0.4) per square meter per day in Pudong was the going rate -- not on the main roads, on the lesser roads. Now it's double that, 8 mao to 1 kuai (RMB) per meter per day. And it's the food prices. You used to be able to give each person 6 or 7 kuai a day. Now it's 10. That's hit us all."

The companies most at risk are those that are labor intensive and rely on the export market. Not coincidentally, those are the same companies that are leaving China. "Companies that are focused on markets that put them in a high labor content, low value-added area are going to be under an increasing amount of price pressure," says Ted Hornbein, managing director Asia Pacific for Richco China, a manufacturer of plastic injection molded parts that are used in electronics and other industrial goods. "And given what we've seen in local media recently, in fact those are the companies that are closing down and leaving China."

A lot of these companies are from Taiwan and Hong Kong, which were also the first to set up factories in China in the late 1980s and early 1990s. "Many of the Taiwanese and Hong Kong companies are trend setters, and are also low value-added, export-oriented" firms, says T.T. Chen, chairman of the Manufacturers' Business Council at AmCham Shanghai. "They are definitely leading the trend of moving out of China, or moving inland, although we still have to track them." The exodus of those companies means that the economic cycle that took four decades to complete in Taiwan and Korea – from the 1950s to the 1990s – has accelerated in China, with the cycle now lasting less than 20 years.

The most appealing countries for relocation represent a global spread of opportunity, according to the study. Aside from the top destinations of India and Vietnam, followed by Thailand, Malaysia and Brazil, companies in the survey also cited Mexico, the Philippines, Singapore, Indonesia, Romania, South Korea, Russia and Poland as places with considerable potential.

"The alternative countries generally allow for better profitability, despite lagging China in market potential as well as infrastructure," says Haddock. "So where India and Vietnam rank favorably compared to China, it would be in labor costs, some of the tax benefits that they would get, a less competitive landscape, better IPR (intellectual property rights) protection, or better utility costs."

Another option is to move somewhere cheaper in China. "There's a movement back from this area to home," says the American factory owner. "My workers are from Anhui province, and I've heard of several manufacturers who are going to do their manufacturing in Anhui, open a showroom here and truck their products to Shanghai, or export from Anhui."

These internal moves have the unexpected side effect of raising labor costs near Shanghai, because most workers would prefer to work in factories in their home provinces, and Shanghai-area owners have to raise their own wages to compete. In addition, there is growing evidence that the hinterlands are not as cheap as they used to be, because the same trends are at work everywhere in China. "The wage gap closed drastically last year

between Anhui wages and here," says the factory owner. "Wages in Anhui are rising."

China's Advantages
The extent of China's declining competitiveness should not be overstated. It remains an excellent place to do manufacturing and it has a huge domestic market. In addition, say experts, for the country as a whole, a shake-out of cheap production may not be such a bad thing. "When the yuan (RMB) gradually appreciates, those low-margin, labor-intensive, heavily polluting and low-value-added industries will be forced out of China, and enterprises will start upgrading themselves into high-value-added businesses while also trying to improve their efficiency," says Scott Chu, head of strategy and business development for Pioneer Investment. "Mainstream enterprises still have room for profit growth."

As an example, Chu cites Zhenhua Harbour Infrastructure Company, a Shanghai-listed exporter of heavy harbor equipment. "It is trying to make high-value-added products with more technical elements to improve its profit margin, and at the same time, it is listing its price in yuan to promote exports," he says. "On the other hand, it is also managing to improve efficiency and reduce costs. Therefore, you still see this export driven enterprise increasing its profit by 30% every year, even though the yuan is appreciating. China's consumption, exports and investment are all healthy, which makes 10% or above growth for 2008 to be expected."

There are strong reasons for factories not to leave China: Moving a production base is expensive and time consuming, and new markets, especially those outside China, have their own unique and unknown risks. "One part of the survey showed that there was reluctance to exit because of the fixed assets that were already in place," says Haddock.

Another strong reason to stay in China is the size and scope of the domestic market. A third reason is the high quality of Chinese labor. In the AmCham study, China's labor quality scored well, compared to some of its other manufacturing variables. Companies were asked: How do you evaluate these parameters in China compared with your existing footprint around the world? In response, IP protection in China received a low score, as did government efficiency, logistics infrastructure, and legal compliance. Labor quality, by contrast, received a high score.

The quality of the Chinese workforce is often cited by factory owners, especially those with experience in other countries. "In Indonesia, the workers are much cheaper now, about half as much as here – that's a guess – and in Burma, they get about 25% of what they get in China," says the American factory owner, who has also sourced his products in Burma and Indonesia. "But there are risks to moving overseas. The workers in China are better than in Indonesia."

That sentiment is echoed by Weng RongJin, president of Langsha Group, another Shanghai-listed company that specializes in making socks and stockings, and has 40% of its annual revenues in exports to international markets. Like the American factory owner, Weng is not convinced that a move out of China would translate into bottom-line profit.

"I have a client from Italy who visited me yesterday. He was talking about Bangladesh as an option, but it's hard for him to move," Weng says. "We have the best machines for sock manufacturing in the world." Bangladesh and India present other problems to manufacturers, he added, including poverty, widespread religious zeal and a huge disparity in wealth. He also believes that Chinese workers are among the best in the world.

As a result, Weng thinks the transfer of factories from China to other countries in Southeast Asia will proceed slowly. "The labor cost in Cambodia or Vietnam is only 20% or 30% lower than ours," he says. "Wages are rising in China, but they are also rising in those countries."

In addition, despite recent rises, wages in China are still quite low by global standards. "I think about how little we were paying -- 80 cents an hour for a really skilled carpenter (in 2004)," says the American factory owner in Pudong. "Back home, it would be $20 an hour. And even those huge factories are still really competitive. They are still getting workers for US$100 a month."

Blueprint for Success

Among the companies that excel in China are those that not only manufacture here, but also sell their products to the domestic market. In selling locally, those companies are more insulated from the rising RMB and rising labor costs, because sales are in RMB and because paying higher wages creates more disposable income. In addition, the domestic market is fast-growing and increasingly wealthy. "Companies that are here sourcing, manufacturing and getting involved in the domestic market, as well as leveraging China's competitiveness into exports, are much more profitable," says Hornbein, the managing director of Richco.

The underperformers, on the other hand, are either too sales centered or simply prefer to source and manufacture products for export, while ignoring the potential of the domestic market. That puts them more at the mercy of the rising currency.

Successful companies are also good at what they do. Their operations are efficient, they have smooth supply chains and they make use of "global best practices," such as Lean Six Sigma. Companies that wish to move up the value chain, says Haddock, should become more efficient. "Some companies are just starting to realize that you have to be pretty good in China manufacturing to succeed," he adds, "because the days of low cost manufacturing are increasingly coming to an end. In fact, the game has changed."

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