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## **China's Production Costs are Steadily Decreasing, Year after Year**

**Despite near double digit salary increases in the past years, as the New Year begins in Asia, China's producer prices are lower than in 2008 and only 16.4% higher than in 1996.**

### **What is happening? What does it mean for international businesses?**

Europe, the USA, and Japan are faced with stagnating prices. Surprisingly, the same holds true for China where salaries have been increasing in the double-digits every year.

Moreover, China's business growth, in absolute GDP increase, is twice as large in this decade (2011 to 2015) as it was from 2001 to 2010. (See our previous [Analysis](#))

Therefore, one would assume that production costs are increasing, in line with labor costs and the economy.

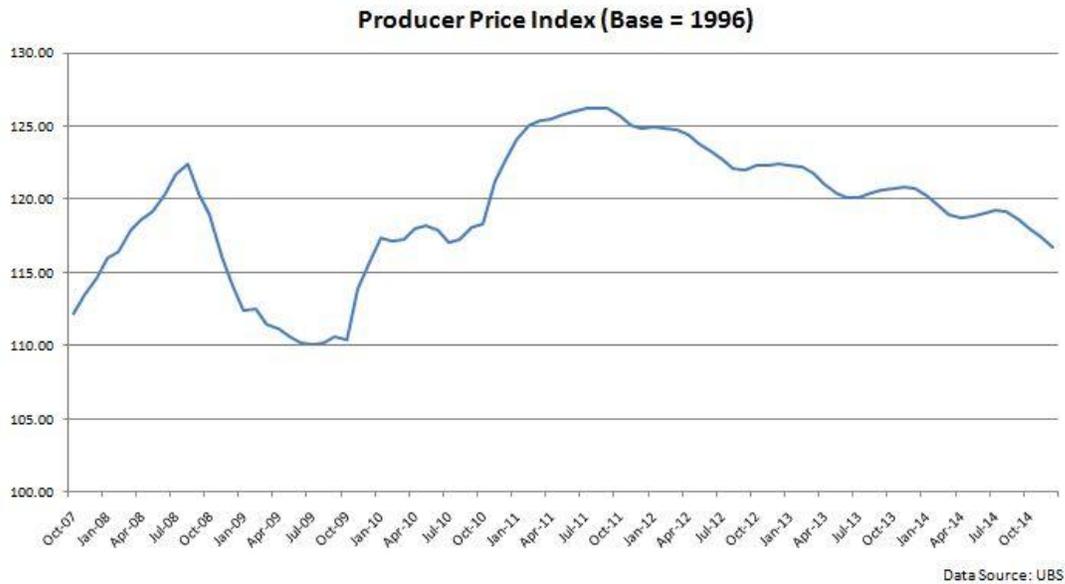
Yet, quite paradoxically, China's Producer Price Index (PPI), which records the price of goods when they are sold by the country's factories, has been going down every year since 2011. Recorded by the PPI, **the average prices paid to producers in China went down by 3.3% year on year at the end of 2014** and are forecasted (by UBS) to go down another 2.6 to 3.2% in this Year of the Sheep. A slow worldwide economy has created a drag on demand, noticeable in the lower producer prices, commodity prices certainly account for the particularly drastic drops in recent months. Nonetheless, lower commodities prices do not explain the steady drop of producers prices from 2011.

The PPI is today at the level it held in 2008 and, very surprisingly, shows an increase of production costs of **only 16.4% since 1996** (which is the base for the index).

This is a critical (and little noticed) element of China's economy, in the current business era when controlling and reducing costs is crucial for businesses leaders to maintain margins.

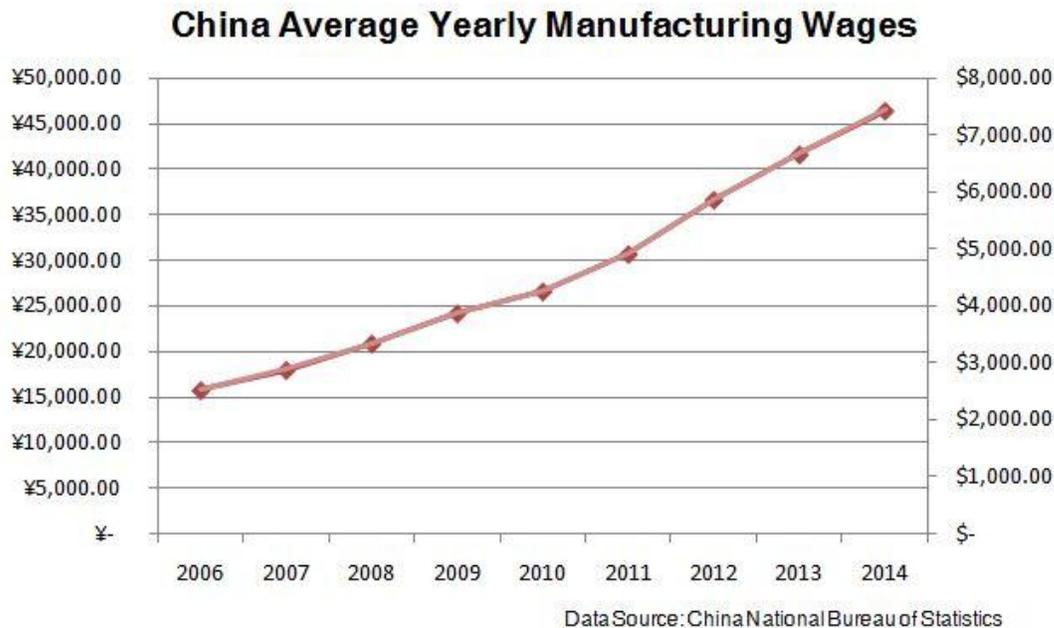
Understanding this appears even more important to us today, when uncontrollable external factors often come into play, such as the currency appreciation that Swiss enterprises experienced a month ago, sending the cost of Swiss products 15% higher on international markets.

How and why is this at all possible?



## The explosion in labor costs is not eroding China's competitiveness

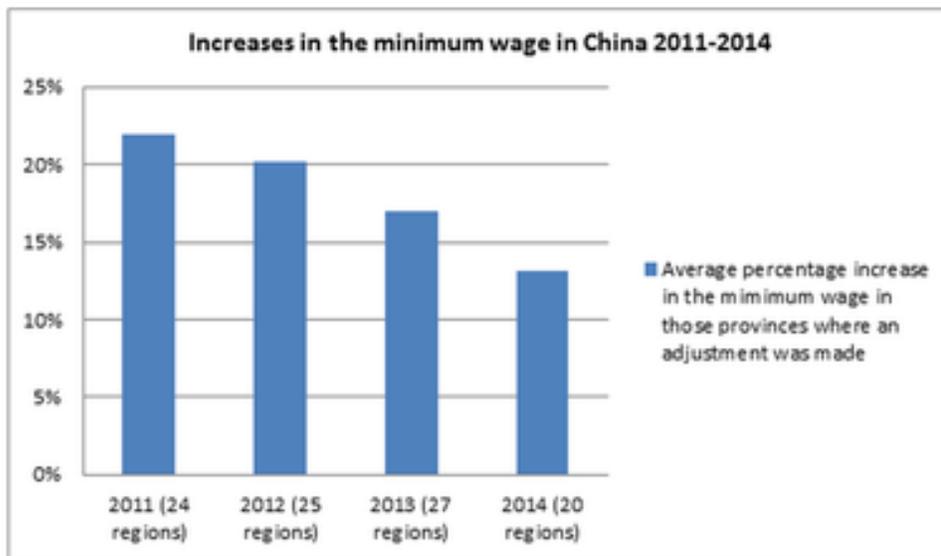
This is a first point to notice, even though from 2006 to 2014, **in just 8 years** that included the worst economic crisis that the world went through since World War II, **China's average manufacturing wages tripled.**



This explosion of labor cost is often mentioned as a defining point in China's overall economic direction and competitiveness, indicating that Chinese producer advantages have already peaked. International businesses moving operations to new low cost countries or back home are presented as examples of a new trend of China's competitiveness erosion.

Sporadic reports of labor shortages in the coastal areas of China are highlighted to indicate that labor cost increases are due to market forces, which in turn are bringing China's manufacturing competitiveness to its limits. As a consequence, many believe that the time has come for businesses to look for new, more profit-friendly production locations.

Most of these reports overlook the fact that manufacturing wages increase for a large part because of government ordered increases in minimum salaries, which are part of China's overall strategy of increasing domestic consumption. Indeed, consumption rises most when those at the lowest salary level get a higher disposable income. The better-off are most likely to save a larger part of their salary. In addition, China's middle class is still today a minority of the consumers, further increasing their buying power will not be the optimal action for increasing the overall consumption in the country.



Data source: [Asia Pacific Industrial Relations Network](#)

The drastic increases in minimum wages represented above are certainly pushing manufacturing for low-cost, large quantity, labor intensive items (such as mass market cotton t-shirts, other similar garments, sports shoes, and plush toys) to lower cost destinations such as Cambodia or Bangladesh. In spite of the talk about this move to lower cost countries, we do not find evidence on a macro level.

It is also a fact that international companies are "reshoring." According to a Boston Consulting Group survey, 21% of US companies in China are relocating production back to the USA or a planning to do so<sup>1</sup>. BCG estimates that at least 200 companies have already moved back.<sup>2</sup>

Japanese multinationals are also making the move. Panasonic's President announced in January that the company will be relocating most of their home appliance manufacturing out of China and back to Japan.<sup>3</sup>

The primary reason cited for moving production back home is fast increasing labor costs.

However, if rising labor costs are the deciding factor, then it would stand to reason that these companies should be moving to lower cost countries such as Vietnam. Indonesia, as an example, has even lower costs than Vietnam (see chart below).

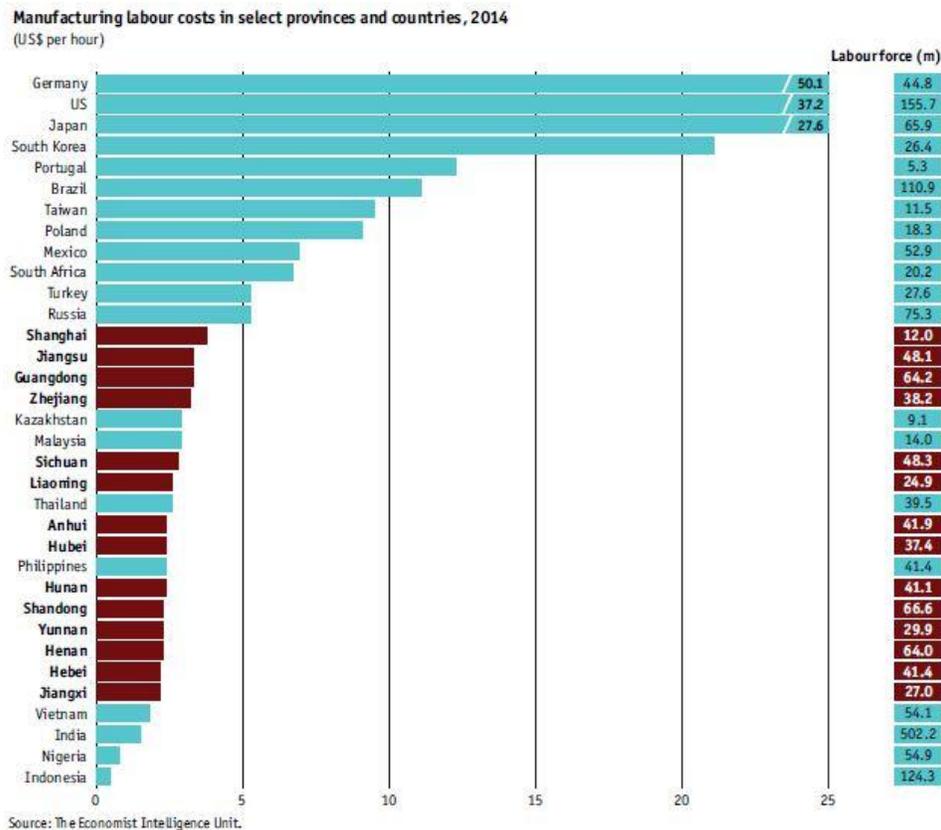
<sup>1</sup> Crooks, Ed. "[US Manufacturers 'Reshoring' from China](#)." *Financial Times*. September 24, 2013.

<sup>2</sup> Northam, Jackie. "[As Overseas Costs Rise, More U.S. Companies are 'Reshoring.'](#)" *National Public Radio*. January 27, 2014.

<sup>3</sup> Wang, Z., Li, X. "[Panasonic Joins Trend of Reshoring out of China.](#)" *China Daily*. January 8, 2015.

Despite the consistent double digit growth of labor costs in China, the inland China wages are still very close to those of Vietnam (as shown below). Anhui, for example, is only a couple of hours away from Shanghai by high-speed train and around 20% higher than Vietnam in terms of labor costs.

Surely other, more determining factors must be at play.



### China's exports continue to gain world market share

If labor cost increases would be critical to the relocation of productions, one would expect Chinese exports to lose ground. Yet, the opposite is happening.

China's export performance has been stellar. After China's entry into the World Trade Organization in 2001, its exports increased at a dizzying rate to nearly 1.2 trillion U.S. dollars by 2009, the same year it eclipsed Germany to become the world's top exporter. China's global share of exports expanded from 4.3% to 9.6% in that same time period.<sup>4</sup>

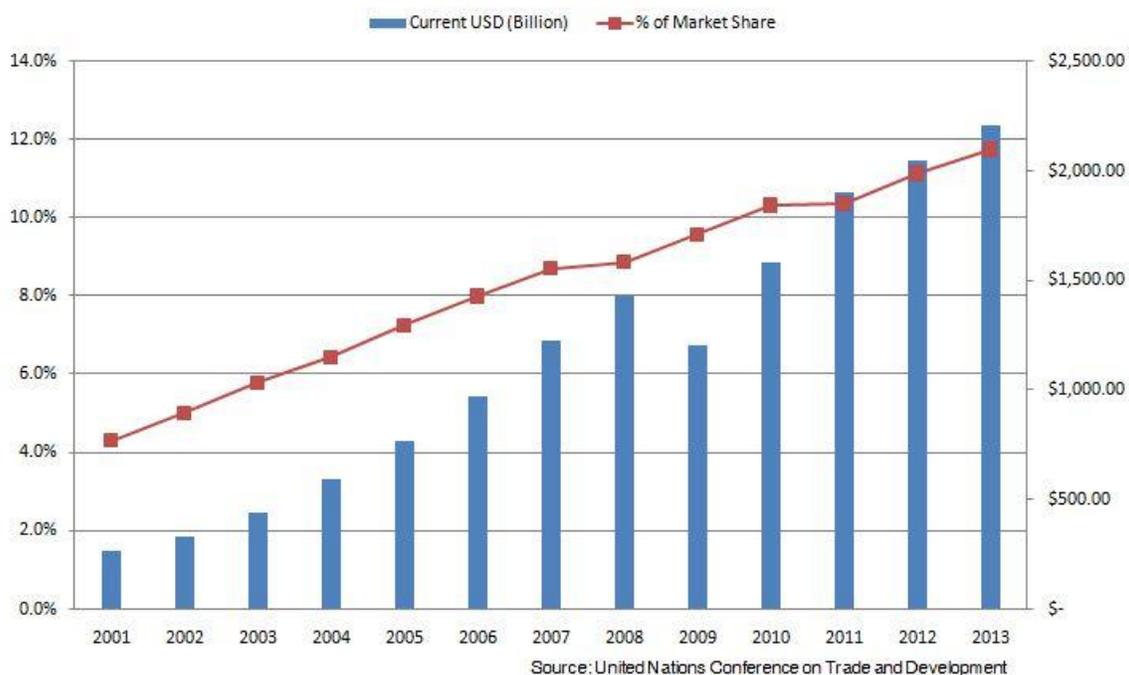
<sup>4</sup> Sirkin, Harold., Zinser, Michael., Hohner, Douglas. "[Made in America, Again: Why manufacturing will return to the U.S.](#)" *The Boston Consulting Group*. 2011, and United Nations Conference on Trade & Development Data

Moreover, these increases occurred in both labor-intensive assemblies and heavy industry/high-tech, increasing China's global share of exports from 17.4% to 32.1% in apparel, 7.5% to 25.9% in furniture, 4.1% to 19.5% in ships, 6.5% to 27.8% in telecom, and 4.9% to 32.6% in office machines and computers.<sup>5</sup>

Since then, China's export share of the world market continued to expand. The country doubled its exports from approximately USD 100 billion worth of goods per month in 2007 to 200 billion monthly at the end of 2014, consistently outperforming average world export growth. In 2009 China accounted for 9.6% of total world exports (in current US\$), while in 2013 it accounted for 11.7%.<sup>6</sup>

	2009	2010	2011	2012	2013	2014	2015 forecast
China Export Growth	-16%	31%	20%	7.9%	7.8%	4.9%	7.5%
China Share of World exports	9.6%	10.3%	10.4%	11.1%	11.7%		

**China Export of Goods 2001-2013**



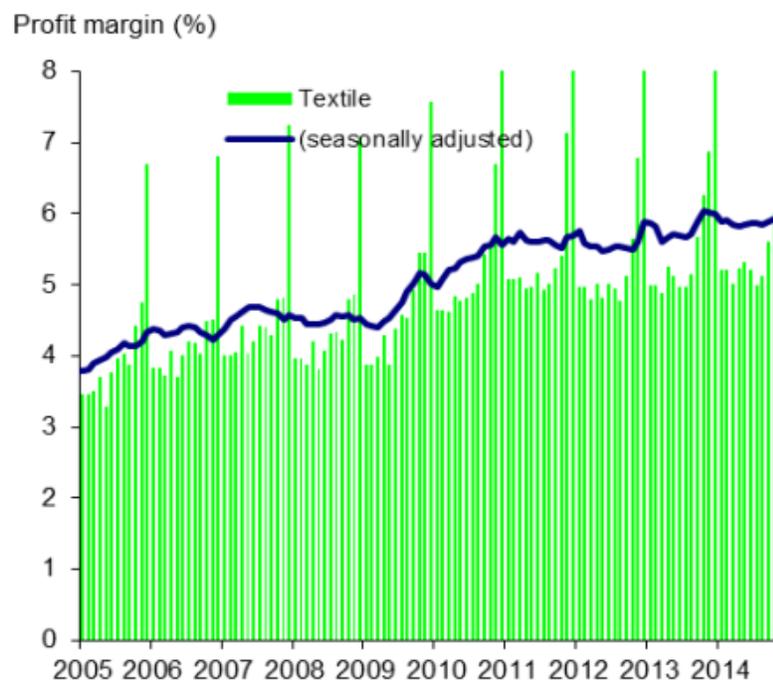
<sup>6</sup> [United Nations Conference on Trade and Development.](#)

## Automation is offsetting labor cost increases

All things considered, it is clear that much higher labor costs have not increased China's production costs or reduced China's export competitiveness. As a result, higher wages should not be a fundamental reason for reshoring or moving production to lower cost countries.

As a matter of fact, the textile industry is showing steadily increasing profits. This is taking place even though textiles are one of the most sensitive industries to labor cost increases. Due to high labor-intensiveness, textiles are traditionally the industries that move first to lower cost locations.

### Figure 36: Textile



Source: CEIC, UBS estimates

Moreover, in 2013 China was responsible for 37.1% of all textiles produced worldwide, and 80 percent of all man-made fibers are also delivered from China. In 2013, China's textiles industry grew 8.3% and it is estimated to have grown 7.4% in 2014.<sup>7</sup>

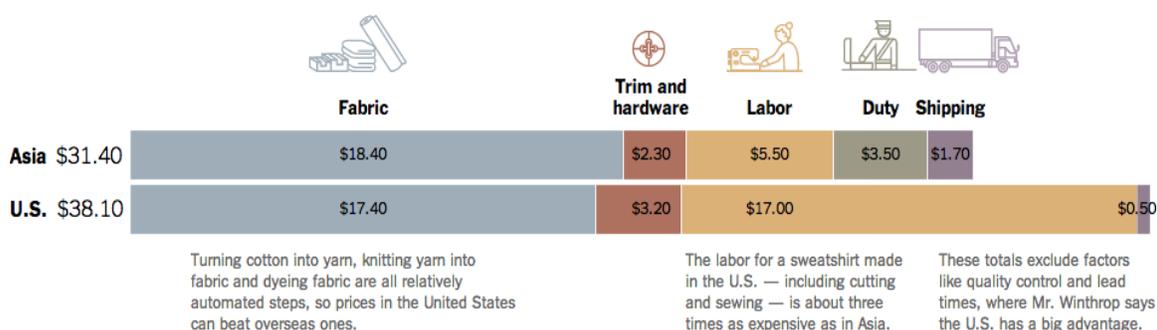
Instead of this growth both in turnover and profits, we should see decreasing profits and a decelerating or stable growth if the industry were under heavy pressure from relocation abroad.

<sup>7</sup> Textile World. "[A New Openness in China.](#)" November, 2014.

Since there is some reshoring to the USA in the textile industry, such examples can provide us more interesting insights.

The cost of making garments, due to the incompressible labor-intensiveness of the activity (no one has invented sewing robots or machines that make garments, up to now), is still significantly more expensive in the USA than in Asia:

**How Much It Costs to Make a Hoodie** Representative wholesale costs, according to Bayard Winthrop, the founder of American Giant.



However, fabrics and the garment accessories (so-called "trims") actually cost less. All in all the total cost difference is still 20% in favor of Asia. It is not high enough, though, to make an Asian production a no-brainer. Indeed, being close to clients and therefore being able to deliver "in real time" allows adaptability to fashion or customer tastes and minimization of risk on inventory, as opposed to weeks spent travelling by sea. As a result, some garment companies are expanding again in the USA and in Europe; **US textiles export increased as much as 37%** in 2012.

A key factor enabling this (still modest) revival is the new competitiveness of textiles materials producers. This competitiveness is even luring Chinese companies to open spinning mills in the USA. The Hangzhou Ke'er Group is an example: it is currently building up a cotton yarn factory in South Carolina.

Spinning cotton in the USA has again become a lucrative activity, even attracting private equity investors. What has changed?

A US cotton spinning mill which was closed in the 90s and has been re-opened in 2010 (by Parkdale Mills, in Gaffney South Carolina) gives us an important clue. There is a fundamental difference in this mills' production of today when compared to its previous life: the factory currently produces 1.1 ton of yarn per week with 140 employees. That **same production would have required over 2'000 people in 1980.**<sup>8</sup>

In the specific case of cotton spinning, the USA has other advantages in addition to efficiency through higher technology. US cotton is competitive internationally and energy

<sup>8</sup> Clifford, Stephanie. "[U.S. Textile Plants Return, With Floors Largely Empty of People.](#)" The New York Times. September 19, 2013.

prices have come down to half the level in China. Land is also cheaper in the US than in China.

Still, the fundamental lesson is that in much of the manufacturing sector, **automation in developed countries is making the cost of labor less and less relevant**, because plants can produce more and more with fewer and fewer workers.

In other words, the key factor providing renewed manufacturing competitiveness to developed economies is not necessarily the increase in labor costs in developing ones. What really is having a stronger impact is the ability of developed economies to replace workers with machines.

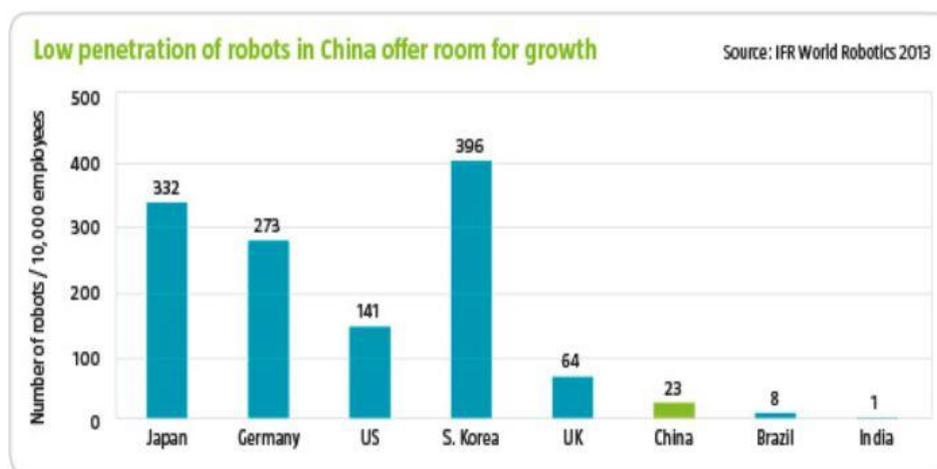
The process of replacing labor with machines is accelerating with technology developments in IT and artificial intelligence, while systems prices are falling fast. Today, a robot performing repetitive tasks **costs 10 times less than 10 years ago**.<sup>9</sup>

Automation is also a fundamental factor allowing China's manufacturing to remain competitive in the face of steep labor cost increases.

Little known is the fact that the People's Republic became the biggest robot market in 2013, accounting for about **20%** of world sales. On average, the **total supply of industrial robots in China has increased by about 36% every year between 2008 and 2013**.

If we were to hope that such large new installations of robots will soon realize China's productivity potential, we would be mistaken:

China had almost **20 times less robots** per manufacturing employee in 2013 than Korea.



<sup>9</sup> <http://www.reuters.com/article/2015/02/10/us-manufacturers-robots-idUSKBN0LE00720150210>

## Looking ahead, what does it all mean for us?

Except for the obvious conclusion that it is the right time to expand in China for robotics and automation companies, here are some consequences that may be useful to most of us:

First of all, **technology is going to matter more** to businesses, not only in developed economies but also in China. Services, too, will gain enormous opportunities through technology thanks to the increasing availability of large sets of consumer data, allowing companies to better serve Chinese customers. Given the importance of this factor, it is crucial to understand what is happening in China on the science and technology scene. We look forward to providing you with more information on the subject in a next analysis to avoid making this one too long.

**Proximity to customers** will also be more essential, provided that well educated people and machines are available. Indeed, when the cost of labor loses its relevance and technology takes over, costs in different locations will tend to get closer. If the capabilities to customize and operate the machines are available, production will be best carried out close to the customers. With similar costs, proximity to customers will allow businesses will provide the advantage of better understanding and satisfying client's needs. (That is additional to saving on customs duties as well as transportation costs and time.)

From this point of view, China's enormous potential market and enormous efforts put into developing technology provide the country the opportunity to become an even stronger manufacturer. (On the other hand, other developing countries with large populations will be slow to catch up, if they cannot keep up in technology development.)

For foreign companies this also means **providing sufficient flexibility to their local operations to take advantage from clients' proximity** and to adjust to local customers. This shows up in our [2014 China Business Survey](#), identifying "lack of support and understanding from the head office" as the second greatest internal challenge of a foreign company in China.

**China will remain cost competitive for production.** The current export competitiveness of China and its enormous potential for automation speak for themselves: wages can keep increasing and workers can be replaced by robots for a long time. (Meanwhile, wage increases are also slowing down. it will be interesting to know what the next 5-year plan, starting in 2016, has in store in terms of minimum wages increase.)

This, however, depends on China being able to train a well educated work force fast enough. Education will be a challenge, but China has the opportunity to draw on an enormous pool of Chinese studying abroad to compensate for the deficiencies of the

local system. We then naturally see improving the education system as a key factor for the successful and long term fast development of the country.

**Businesses, Chinese and foreign, have to become increasingly efficient.** Prices are very unlikely to go up, at least for a few years; meanwhile, costs will still continue to rise. In addition to business growth, every manager will need to constantly have efficiency and productivity increases on her or his mind.

**Swiss companies have additional challenges - and opportunities.** The sudden increase in the Swiss Franc will mean even more efficiency for those who want to keep selling to the very price sensitive China market.

On the other hand, Chinese products are becoming cheaper in many ways. In addition to the exchange rate, the lower cost of production and the Free Trade Agreement (FTA) are reducing the landed costs of Chinese industrial goods in Switzerland and provide an opportunity to expand sourcing and production operations in China to offset the strong Franc.

We certainly live in interesting times. It seems that every new Chinese year brings an even larger number of interesting moments.

The Chinese year of the Golden Sheep that is starting is sure to offer, with all its challenges, more opportunities than can be tackled for those who care to consider them carefully!

Your China Integrated Team

We hope that the above can be of support for your China strategy and plans. For more information about this topic, do not hesitate to contact [n.musy@ch-ina.com](mailto:n.musy@ch-ina.com).

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