

Special Report: Chinas Rising Labour Costs

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After years of being one of the cheapest and most red tape-free labour markets in the world, China is beginning to become less competitive in relation to its regional peers. This is in part the result of rising labour costs, as Chinese workers begin to demand greater wage increases. Increased labour costs have already encouraged some foreign firms to exit the country, in search of cheaper working conditions elsewhere within the region.

Key points

China's traditional strengths as an investment or outsourcing destination have been its low labour costs and the government's willingness to facilitate foreign investment;

However, the labour market is becoming less welcoming. Workers are demanding higher wage increases, partly in order to compensate for rising inflation that is eroding their purchasing power;

Additionally, the Chinese government's introduction of minimum wage legislation in January 2008 means that firms are now legally responsible for increasing wages, even if this is not enforced in practice;

These factors are forcing some companies to leave China and invest in cheaper sites within Asia Pacific such as Thailand, the Philippines or India;

However, China has certain advantages that will ensure that it remains competitive, even if it loses the dominance it has enjoyed until now;

The size of the Chinese population and availability of natural resources mean that investing in China offers almost unparalleled economies of scale and will continue to do so in the near term.

Background

Since leading Communist Party of China stalwart Deng Xiaoping initiated the opening up of China's economy in 1979, the country has positioned itself as a major site for investment by foreign companies. China's large population provides a ready work force, while the absence of tight labour legislation meant that companies have been able to pay relatively low wages, increasing profit margins. The Chinese work force now varies between highly-skilled technical workers and low-level manual labourers, ensuring that all types of labour requirements can be met. This has allowed China to become a major manufacturing centre, with products ranging from textiles, to basic manufacturing and high-end electronic goods.

Investment incentives

China has a number of advantages that make it an attractive destination for investment and out-sourcing:

China has a large and growing population. In January 2008 China's population was 1.3 billion, the largest in the world, just above India at 1.2 billion;

China's population grew by 7.0% between 1998 and 2008, despite the one child policy. This provides companies with a ready pool of labour;

China has pursued an educational strategy designed to ensure that it can offer a technically skilled workforce. For example, all students are now required to study English, while technical universities have been established to offer training in engineering and electronics;

Although the largest proportion of the population is still employed in agriculture (43.0% in 2006 according to national statistics) an increasing number are employed in more technically-skilled sectors. In 2006 32.0% of the population was involved in the services sector and 25.0% in industry;

Technical training is improving and highly-skilled workers numbered approximately 6.0% of the population in 2007;

The country also has a supply of natural resources such as iron and steel ore that companies can access, while water and electricity provision is relatively reliable;

China's seaboard location means that goods produced in costal areas can easily be exported to other regions, reducing transport costs.

Rising labour costs

However, China's labour costs are starting to increase, making China less competitive as an investment destination:

Wages are rising for several reasons. Despite the increase in highly-skilled workers, a shortage of highly-skilled labourers continues meaning that they can demand higher wages from companies lacking such skills. This has a knock-on effect on lower-level wages, as these workers feel encouraged to demand higher wages.

In addition, new legislation introduced by the Chinese government in January 2008 introduced a national minimum wage, increasing costs for firms. The minimum wage varies between provinces. For example, in Guangzhou it is US\$43 per month, while in Shenzhen and Zhuhai it is US\$61 per month;

Employers are now also required to sign long-term contracts with workers, pay social security benefits and increase redundancy payments;

This increased bureaucracy and more financial commitment to workers has acted as a disincentive for some firms to continue operating in China, since rising labour costs are reducing their profits;

China is already a relatively difficult labour market. The World Bank's 2008 Ease of Doing Business Report ranks China 86th out of 178 countries in terms of ease of employing workers, below regional peers such as Hong Kong, Thailand, Vietnam and India, with non-wage labour costs being comparatively high within the region;

Furthermore, rising prices for raw materials such as copper, iron ore, steel and oil are increasing. Oil reached US\$126 per barrel in May 2007, increasing import costs for companies, particularly those using large amounts of electricity, such as electronics and high-end manufacturing;

These increased costs will damage immediate financial accounts and medium-term competitiveness, since rising prices will be passed on to consumers and reduce the attractiveness of Chinese-made goods;

Although rising global prices will mean that all countries in the region are affected by higher costs, China in particular is suffering from inflationary pressure. Rising prices for food and utilities within China means that inflation is rising sharply, above historical trends. Inflation reached 8.5% in April 2008, up from 4.8% for 2007 as a whole;

This is eroding worker purchasing power, encouraging them to demand wage increases.

Investment disincentives

Foreign firms are therefore finding China less attractive as an investment and outsourcing destination:

One in six textile firms operating in China made a net financial loss in 2007, according to national industry statistics;

This means that many workers, particularly migrant workers have lost their jobs, reducing the purchasing power of the labour force;

In 2007 FDI flows into China declined slightly to US\$67.3 billion, down from US\$69.5 billion in 2006, although it was still by far the most popular destination for FDI in Asia-Pacific;

By contrast, FDI inflows increased in China's regional competitors such as Thailand, the Philippines, Malaysia and Indonesia, indicating that these economies may be succeeding in attracting investment away from China;

In 2007, Chinese GDP per capita totalled I\$5,575 in PPP terms (Purchasing Power Parity is a method of measuring the relative purchasing power of different countries' currencies over the same types of goods and services), while in Indonesia and the Philippines it was lower, at I\$3,617 and I\$3,434 respectively. This indicates that these countries have lower standards of living and therefore lower wage expectations.

China is beginning to lose some of its investment attractiveness on a regional basis, with consequent negative implications for worker wage and job growth.

Consumer implications

A potential shift in FDI away from China would have negative implications for consumer spending:

With less companies creating jobs, the potential for wage and job growth would be limited, restricting consumer spending. In 2007, private final consumption expenditure totalled 34.8% of GDP;

This impact would be most felt in the higher-wage areas around Beijing and the seaboard ports, since more companies are likely to remain in the lower-wage western regions. This would therefore increase unemployment in the higher-wage areas, reducing consumer spending potential;

Given that consumers are already facing a reduction of purchasing power owing to high food and fuel prices, a wage and job pinch would act as a severe deceleration to consumer spending growth. For example, inflation was running at 8.5% in April 2008, well above historical levels;

Conversely, consumer markets in 'substitute' countries would benefit, since increased investment would create wage growth in these consumer markets.

Future Scenarios

While investment competitiveness might be declining slightly, China will still remain a destination of choice for many firms looking to set up in Asia Pacific:

China is still relatively cheap and has the advantage of a large population and abundant natural resources. This allows China to offer economies of scale that smaller countries in the region cannot match;

Additionally, China's labour market is still relatively unregulated owing to the economy's official status as collectivised rather than capitalist;

The trend for greater labour force regulation will continue, since this is required under the terms of China's WTO membership. China joined the WTO in December 2001. However, with other economies in the region such as India having a more regulated market, China has a comparative advantage;

China's geographical size means there is significant internal wage variation, meaning that some firms may choose to relocate within China itself rather than within the region. For example, of the 206 South Korean businesses that left Qingdao city in eastern China between 1999 and 2007, an estimated 38.0% relocated to western China;

Pressure for wage increases will continue to grow in line with inflation, which is forecast to end 2008 at 5.9%. However, since all countries in the region will be equally affected by rising prices for basic goods, some may feel that the benefits of a slightly cheaper labour environment would not be worth the cost of relocating;

China is targeting real GDP growth of 8.0% in 2008, which represents moderation from 11.4% in 2007 but is still relatively strong. The government has not launched any plans directly impacting on labour costs, since economic policy is reassessed with the formulation of each successive five-year Economic Plan, with the current cycle ending in 2010.

China will remain competitive on a regional basis, although increased labour costs mean that it will be slightly less so than previously. However, there remain enough advantages to ensure that there will not be major relocations by companies, allowing future potential for worker wage and job growth.

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