Is Chinese Manufacturing's Low-Cost Run Coming to an End?

An in-depth look at the key factors that are expected to push the low-cost pendulum away from China

For years, manufacturers have benefitted from China's low labor rates as a critical benefit of outsourcing production to the region. That attraction could be coming to a close as wage rates in China continue to grow at an accelerated speed that's expected to outpace countries like Indonesia, Vietnam, and Mexico through the end of the current decade.

Currently only 10 percent of the average U.S. manufacturing wage, China's wages will grow until they equal ***25 percent of U.S. wages*** by 2015. Combine this fact with growing concern over supply chain risk and it's clearly time for at least some of the world's manufacturers of low-cost, low-value goods to source their products elsewhere.

"Recent studies suggest that China will lose its low-cost status over the next three years," says IHS Senior Industry Economist Laura Hodges. "With wage rates in China growing at an accelerated rate, we predict that the country will lose its low-cost edge for high-labor intensive products in the near term."

The trend could have a significant impact on global organizations. According to the *2013 Global Outsourcing & Supply Chain Risk Survey,* conducted by Supply & Demand Chain Executive magazine, 26.9 percent of organizations have plans to increase sourcing and manufacturing to Asia-Pacific Rim countries (outside of China and Japan), while 32.5 percent are still looking at China and 44.7 percent at the U.S.

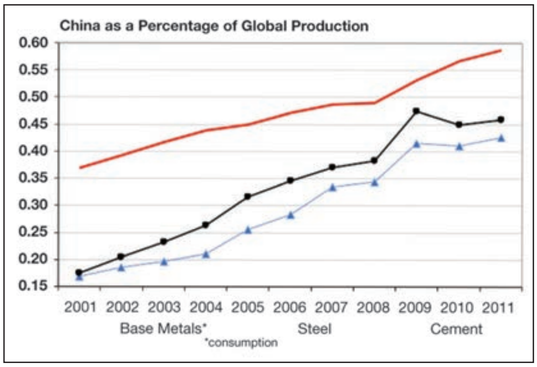
Just 25.4 percent of organizations plan to *decrease* their current levels of sourcing and manufacturing in China, with the primary drivers being the desire to move operations closer to home, work with a more diverse pool of suppliers and operations, and move to a lower-cost region.

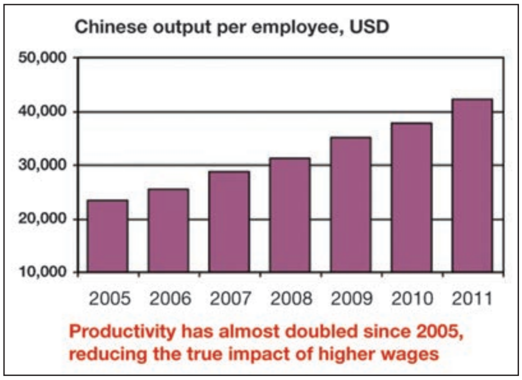
China as a Production Powerhouse

China's role in U.S. trade has grown tremendously over the past decade. As its prowess among U.S. firms has increased, China has also played a much larger role in the end-to-end supply chains that it participates in. "Over the past decade," says Hodges, "a larger and larger share of materials have been produced in China." For example, the country currently produces almost 50 percent of the world's steel, just over 40 percent of base metals, and nearly 60 percent of cement.

"China has truly emerged as a manufacturing powerhouse," says Hodges, noting that the country also overtook the U.S. as the world's largest car producer in 2009. In 2010, China passed Germany as the largest exporter and by 2020 it will take over the top spot as the world's largest economy. Right now, for example, the U.S. represents 23 percent of the world GDP and China claims 9 percent. By 2020, the latter will rise to 19.6 percent and the U.S. GDP will fall to 16.9 percent. Clearly, China established a manufacturing advantage.

Additionally, other factors play an important role when assessing the total cost of doing business in China. Productivity gains, for example, have been strong and are often overlooked when developing complete manufacturing cost pictures. Real manufacturing output per worker in the country is currently $42,000 at an average hourly wage of $2.50, compared to $120,000 at $27 an hour in the U.S. "Productivity in China has nearly doubled since 2005," says Hodges, "thus reducing the true impact of higher wages and making Chinese workers among the most productive in the world."





The fact that shipping rates have stabilized and capacity has increased in the wake of the economic recession is also helping China's cause. According to the Baltic Dry Index (BDI), shipping prices skyrocketed from 2005-2008 and then fell when the market crashed in late 2008. "Rebound in trade and even fuel costs haven't pushed the BDI any higher," says Hodges. "There's plenty of capacity and new ships coming online. Abundant supply has kept rates low and will continue to do so in the near future."

However, rising wages will threaten its low-cost status. The average Chinese manufacturing worker earns approximately $3 per hour or more than $6,000 per year in base pay. This reflects a more than 12.5 percent growth over the last decade, according to Hodges, who sees strong upward pressure on wages beginning to surface in China.

"Minimum wages are rising by more than 20 percent annually in some provinces, where inflation is increasing along with higher food and energy costs," Hodges explains. Wages in China are expected to more than double in the next 10 years and grow 8-11 percent annually over the next decade. "This year we expect growth to be on the lower end of that range and then pick up as we move closer to 2015," Hodges adds.

Still Intact, but Slowly Changing

Using the steel casting sector as an example, Hodges uses material costs, worker productivity, and average manufacturing wages to estimate a 23 percent cost advantage currently in China versus in the US. And while exchange rate appreciation and supply chain risks do cut into these double-digit savings, the offshoring trend continues as companies seek out affordable manufacturing options.

That trend will level off as China becomes a less attractive target for companies, and as organizations look to other countries for less expensive labor and/or closer proximity to home. Right now, Bangladesh and Cambodia are estimated at 25 percent of the average Chinese wage. And while such countries often pose new challenges for firms that do business there, companies like IHS provide organizations with a complete picture when evaluating a country during the sourcing decision process.

"It's important to be aware of each country's unique risks *before* setting up operations there," advises Hodges. "Right now, it's the high-labor, low-margin organizations that should be using tools like IHS and the World Bank's Annual Cost of Doing Business Survey to analyze global labor markets and find good sourcing targets."

It's Time to Start Sourcing Elsewhere

With China on track to become less competitive for basic manufactured goods by the end of the decade, Hodges says global firms must acknowledge the fact that it's time to diversify sourcing options by taking a closer look at other countries.

What you need to know:

- China is on track to become less competitive for basic manufactured goods by the end of the decade.
- Over the next decade, Chinese wages are expected to increase from 10% of U.S. wages to 25% of U.S. wages.
- While it still may make sense to source from China, the margins are narrowing.
- China does retain manufacturing advantages, and manufacturers need to look at the complete picture before making their next sourcing decision.

And the *2013 Global Outsourcing & Supply Chain Risk Survey* suggests that they are. While China is still seen by many as a low-cost front-runner the next 12-24 months, there is a significant number who have begun to say the opposite.

"China will retain its low-cost status, but it does depend on the labor intensity of the manufacturing process itself," she says, noting that labor remains the primary advantage to operating in China, and those costs are rising. "Brace yourself for wages to grow nearly 10 percent this year."

As China's labor prices rise, its low-cost manufacturing status will decrease. "It's time for producers of high-labor, low-margin goods to start looking for alternative, low-cost countries, such as Indonesia or Vietnam," says Hodges, "or options that are closer to home, like Mexico." ■