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How China Gets Our Business

By George Stalk and Dave Young

China's emergence as one of the world's leading export nations is driven by a huge disparity in the cost of producing goods, caused primarily by hourly wages that are a fraction of those in the United States and Western Europe. This is not news. What is news is that the cost disparities are likely to expand rather than to shrink.

Typically, a U.S. or Western European factory worker costs an employer $15 to $30 per hour. A Chinese factory worker earns the equivalent of less than $1 per hour. If, over the next five years, wages in China increase at a rate of 15 percent annually, while they increase at 3 to 4 percent a year in the United States (a healthy growth rate), in 2009 the average hourly wage will be $2 in China and $18 to $35 in the industrialized West. So, despite the disparity in growth rates, the hourly wage gap will have widened to $16 to $33. Government-mandated labor costs in the West, such as workers' compensation, will make the difference bigger still.

That assumes no dramatic change in relative currency values. Predicting exchange rates, especially over the long term, is hazardous. But Japan's experience may help set expectations. Largely as a result of Japan's success with industrial exports, the yen-dollar exchange rate went from a low of 360 in the early 1970s to about 100 today -- an almost fourfold increase in the value of

the yen relative to the dollar over about 30 years. If China's yuan were to strengthen against the dollar at a similar rate over the next five years, the wage gap would narrow significantly. But Chinese wage rates would still be less than half those in the United States.

Wage rates are driven, first and foremost, by supply and demand. As China's industrial sector and middle class grow, wages and other labor costs will increase. But they will not increase enough to close the gap with -- and improve the competitive positions of the labor forces in -- the United States, France, Germany or Japan. The gap is just too wide -- and the Chinese labor pool too deep -- for this to happen.

China still has 800 million people living in the countryside -- nearly three times America's entire population. The migration of China's rural labor force to manufacturing jobs will mitigate any steep rise in low-skilled wages in this decade. Although higher-skilled workers will demand higher wages, the supply of candidates for these positions is also great and increasing. According to the National Science Board, every year three times as many students are graduating with bachelors' degrees in engineering in China as in the United States.

The story only gets worse. Wage rates are just one factor driving China's cost advantage. The productivity of the labor force is another. Productivity is gauged in many ways, including quality, output per unit of labor cost, and output per unit of capital and support costs. Here, too, the Chinese are excelling. Often (although not always), once a Chinese plant's initial manufacturing problems are worked out and it has moved along its learning curve, it

can achieve quality equal to that of leading plants in the West.

In terms of capital requirements, Western companies operating in China are finding they can reduce their investments compared with their home countries. For example: Western companies often pay up to 50 percent less to purchase machines and tooling in China than at home.

Moreover, companies operating in China can cut capital costs by replacing expensive machinery with inexpensive labor. One leading manufacturer of large kitchen appliances has stopped using conveyors in its Chinese factories in favor of manual material handling. The firm achieves quality comparable to that at home, but at lower cost.

China also offers other incentives to Western companies: low-cost land, low import duties and tax breaks. One major corporation claims to have received so many incentives for one of its factories that its construction was virtually cost-free.

These initial savings are only the beginning. Leading companies buying from Chinese firms and operating in China have been able to lower their costs over time, achieving annual reductions that rival or exceed what is considered usual in the West. Ten percent improvements in cost per unit per year are common for goods after their production is moved to China. These improvements stem from expanded scale, deepening of relationships with indigenous suppliers and an extremely competitive environment.

What's next? The cost advantages of manufacturing in China are not likely to shrink anytime soon. In fact, our experience suggests that the gap will increase before it decreases. We're convinced that as many as 15 percent to 20 percent of industrial products now made in the United States -- together with their associated jobs -- will migrate to China and other countries.

Another 20 percent to 30 percent of jobs are up for grabs, depending on the ability of U.S. corporate and government leaders to come up with ways to secure America's competitive advantage. The longer Western managers wait to sort out their China strategies -- whether by competing, moving or outsourcing -- the greater risks their companies face. Sitting this one out won't work.

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