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BRIEFING PAPER

Adjusting to rising costs in Chinese light manufacturing

What opportunities for developing countries?

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Key messages

- A survey of 640 Chinese light manufacturing firms in the Yangtze River Delta and Pearl River Delta has found that the greatest pressure on firms is wages, which rose around 11% annually between 2014 and 2016.
- Firms' preferred strategy to address higher labour costs is to use more and better machinery: this was the top response for 38% of firms surveyed, and among the top three responses for 78%.
- Only 6% of firms responded that relocation within China or abroad was their first response to rising costs – many firms are interdependent, and relocation can be challenging unless a number of firms move together.
- Investment promotion should first focus on large, foreign-owned firms in the Pearl River Delta, particularly those in footwear, and second on mechanisms to assist smaller firms to relocate abroad together with others.

Introduction: the issue

Accelerating real wage growth in China since the mid-2000s has raised the possibility of the relocation of large numbers of jobs from export-oriented labour-intensive light manufacturing (LILM) industries on China's east coast to low-income countries. In Africa and other parts of Asia, such an influx of foreign investment would contribute significantly to manufacturing employment and economic growth and transformation. But do Chinese firms see outward investment as their preferred strategy to address the challenge of rising labour costs?

The Overseas Development Institute and the Center for New Structural Economics investigated this question by undertaking a survey of 640 firms in four sectors – home appliances, garments, footwear and toys – in which approximately 16 million workers are employed, and for which real wage increases ranged from 9% to 11% annually over 2005-2014.

The survey found that Chinese LILM firms most often respond to the challenges of rising costs and tighter demand by making adjustments to their existing operations – upgrading technology, controlling input costs, and expanding their markets or product range. Some 10% of firms had invested abroad or planned to do so by establishing production operations in a new location at some point over the next three years which may be promising for developing countries seeking foreign direct investment (FDI). However, investment promotion efforts need to be focused on firms most likely to migrate – those that are large, foreign-owned, and in footwear. Furthermore, efforts should be made to encourage groups of firms to relocate together by working with large buyer firms.

The firms

640 firms, with turnover above RMB 20 million (US$3 million) and which export more than half their turnover[1] – that is, firms involved in global value chains – were interviewed. A cluster-based sampling strategy was used, as industrial clustering is crucial in Chinese manufacturing. The survey covered the Pearl River Delta (PRD) and the Yangtze River Delta.

All firms surveyed were privately-owned, but only 42% by domestic Chinese owners, with 52% being wholly-owned foreign subsidiaries. Just over half were small and one-third were medium, with only 15% being large. Two-thirds of firms were original equipment manufacturers (OEM) ,17% original design manufacturers and 13% original brand manufacturers. During 2014-2016, annual wage growth in the firms was 10.8% and annual turnover

[1] The survey sample is representative of all above-scale exporters in the four industries in the two regions.

growth 6%. However, turnover grew only 0.1% per annum in footwear versus 9.4% in home appliances.

Main challenges and responses

Rising wage costs were identified by 38% firms as their greatest challenge, with another 40% rating it second or third. 27% of firms in home appliances were most concerned about wages, while 24% pointed to rising input costs. In footwear, 22% saw shrinking markets as the top challenge.

'Technology upgrading' – more and better machinery – was firms' preferred response to rising costs and shrinking markets; 31% of firms ranked it highest and 54% in the top three. Tighter cost control over inputs and in production was next (27%), and changing product lines or expanding markets the third most common response (24%). Closing operations was the top response of 8% of all firms, but 17% of footwear firms.

Some 6% (36 firms) identified relocation of operations as their top response, with half of those preferring relocation abroad to within China. In footwear, however, 14% of firms preferred relocation abroad. Only 8% of foreign-owned firms preferred relocation, but they were four times more likely to choose this than were domestic-owned firms.[2]

Firms investing abroad

62 firms (10% of those surveyed) indicated they had invested abroad in the past or planned to do so in the next three years. Findings on this small group should be treated with caution, but suggest outward investment is more likely if firms are large, foreign-owned, in footwear and located in the PRD. Southeast Asia remains a far more likely destination than Africa, where only three surveyed firms have invested to date (all in footwear in Ethiopia); only two planned future FDI in Africa. Nearly three-quarters first undertook FDI after 2010. For more than half, low-cost labour was the primary factor in location choice, over which major customers (buying firms) have significant influence.

Policy implications

Large and foreign-owned firms are more likely to invest abroad as they are more likely to have the necessary resources – management, business networks and finance – to bear the costs and demands of operating across multiple jurisdictions (foreign-owned firms are already doing so). For small and medium single-plant OEM firms (the most common in the survey), establishing a production operation in another location is costly and difficult. There is a 'collective-action problem' – firms are unlikely to relocate unless other firms do the same.

Footwear firms' responses were distinct from those of other sectors. The survey confirms the difficulties in China's footwear industry, with many firms relocating abroad. This could be explained by the fact that mechanisation in footwear may be more difficult than in toys, while larger footwear firms with some design capabilities may favour independent internationalisation compared with garments where most firms are small OEM producers.

The survey suggests a need for realism on the potential for jobs transfer from China to low-income countries, though a greater level of FDI in recent years and still-rapid wage growth in China could increase future FDI and firm relocation.

Investment promotion by China or potential host countries should focus on large foreign-owned firms in the PRD, particularly in footwear. In the longer term, cluster-focused strategies are needed to support relocation by groups of firms. 'Anchor' firms in clusters, supply-chain managers, and global brands and retailers can facilitate the co-movement of groups of OEM suppliers; promotion efforts with them have begun but should be stepped up.

Greater emphasis should be placed on attracting individual entrepreneurs who may close OEM operations in China and restart elsewhere. This group often faces significant barriers to entry in potential host countries. Though addressing small potential entrants is burdensome for promotion agencies, mechanisms for economies of scale and scope within these agencies should be investigated.

References available in report by the same name: Xu, J. et al (2017) *Adjusting to rising costs in Chinese light manufacturing: what opportunities for developing countries?* London: ODI and CNSE. Available from set.odi.org.

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[2] The survey inevitably excluded firms that had already relocated in their entirety and probably under-reported investment abroad undertaken by the parent company of the surveyed firm.