

ONLINE FEBRUARY 25, 2013

Is China the World's Next Rust Belt?

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According to a growing number of media and analyst reports, China's days as the world's largest manufacturing nation are already numbered—only two years after ending the United States' 110-year reign. This conclusion has left Chinese business leaders understandably concerned. At last year's World Economic Forum in Tianjin, the chairman of one of China's largest firms spoke (off the record) of the worst manufacturing crisis in the country's history. Labor costs are on the rise, the demographic dividend is dissipating, and rising oil prices are making long-distance transportation costs to China's major export markets in the U.S. and Europe unsustainable. At the same time, U.S. firms are developing a new respect for the art of manufacturing, and breakthroughs in shale gas conversion have significantly lowered the costs of operating plants domestically. As a result, Gordon Chang wrote in a recent *Forbes* article, China may soon replace Detroit as the world's rust belt.

I think that may be an overreaction—the future of manufacturing in China has more room for opportunity than many Western pundits would like to believe. For starters, although rising labor costs will indeed undermine China's export-led development model, they are also a natural by-product of the country's economic success, and, therefore, to be celebrated. In addition, at least

five factors will likely more than offset the impact of China's eroding labor cost advantage.

1. Domestic demand. China's rapid economic development will continue to add millions of new consumers to its already huge customer base. The country is, or soon will be, the world's largest market for a wide range of goods, many of which need to be manufactured close to where they are consumed. In addition, Chinese tastes are sufficiently particular for it to often be necessary to design (and manufacture) products specifically for local customers. Technological developments, such as miniaturization and 3-D printing, will further enable these trends.

2. Urban-rural divide. China remains a highly diverse country with a wide gap between urban and rural incomes. In fact, almost two-thirds of its people still earn less than US\$5,000 per year. In contrast to the nation's more developed coastal regions, China's less-developed inland regions continue to have low labor costs—suggesting that manufacturing activities could be shifted to retain the country's labor cost advantage.

3. Operational excellence. To date, few firms have truly optimized their Chinese operations. This leaves substantial room for productivity improvements through, for example, more efficient machines and production setups, minimization of defects, leaner supply chains, and improved labor productivity.

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4. Frugal manufacturing. China's competitive advantage already goes far beyond cheap labor. For example, Chinese firms are often quite innovative in reducing costs by redesigning manufacturing processes, substituting cheaper "good enough" materials, and using simpler off-the-shelf components.

5. Investment versus comparative advantage. Economic theory dictates that when labor costs rise, businesses move elsewhere. However, countries can offer investment incentives to attract or keep businesses, and I believe that such incentives often trump the underlying comparative advantage. China, like Singapore—the country it most seeks to emulate—has the financial means and the will to wield this tool effectively.

Instead of leaving the country en masse, China's manufacturing base will likely begin to fragment. Some shifts are inevitable. For example, the manufacturing of lightweight, labor-intensive products, including garments and shoes, may indeed migrate to lower-cost countries, such as Vietnam. But China will continue to manufacture many products, for example, those designed specifically for local tastes and those for which freshness is a requirement. China is also likely to continue making products that require strong logistics networks, the ability to manufacture at very large scale, and the presence of local supply chains. China offers advanced capabilities in these areas, whereas Vietnam may not. It would likely take a lot for Apple to walk away from Foxconn's expertise in manufacturing large volumes at high quality levels.

The eventual outcome will in no small measure be determined by the Chinese government itself. It must invest heavily in supply chain infrastructure and logistics to connect the interior to the rest of the country and to

its current export hubs in particular—Shanghai, Shenzhen, and Tianjin. In addition, it must incentivize multinationals to relocate their activities to China's interior regions instead of moving them abroad. At the same time, China must continue to upgrade its remaining manufacturing base, especially in so-called sunrise industries. Not surprisingly, this is exactly what the government's most recent five-year plan calls for.

China's transition from an emerging to a developed economy will undoubtedly be challenging. But the country has an enviable track record in successfully implementing its five-year plans, and the financial resources to override other considerations, if necessary. In fact, the U.S. should give serious thought to adopting a more coordinated industrial policy itself to encourage investment in domestic manufacturing. Otherwise, those Midwestern rust belts may very well stay right where they are. +

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is published by Booz & Company Inc.
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