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The Rise of Chinese Labor

Wage hikes are part of a virtuous cycle of development.

The recent strikes at Honda factories in southern China represent another data point in an emerging trend: Cheap labor won't be the source of the Chinese economy's competitive advantage much longer.

The automaker has caved and given workers a 24% pay increase to restart one assembly line. Foxconn, the electronics producer that has experienced a string of worker suicides, has also announced big raises. This is all part of the virtuous cycle of development: Productivity increases, which drive wages higher, forcing businesses to adjust, leading to more productivity growth.

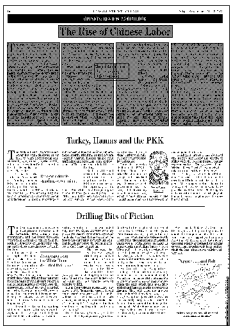
The supply of Chinese migrant workers from the countryside, once thought to be endless, is running dry, and that is giving workers leverage to demand bigger pay packets. The brief drop-off in orders brought on by the global financial crisis provided a respite, as did a recent drought in southwest China that spurred extra migration to the coastal factory zones. But shoe manufacturers are the canary in the coal mine. An American industry association recently polled its members and found that 88% saw a labor *shortage* in China, and almost as many had experienced late deliveries as a result.

While higher wage costs could mean more expensive sneakers for consumers and squeezed profit margins for the big brands, it has some silver linings. For instance, tamping down protectionism.

New York Senator Charles Schumer is again threatening to impose punitive tariffs on Chinese goods unless there is progress toward revaluing the yuan. The senator says that currency manipulation holds down the cost of Chinese labor, at the expense of "millions" of American jobs. If wages rise in southern China regardless of the fixed exchange rate to the dollar, it undercuts the protectionist claims.

Jobs are hardly going to flood back to the U.S. merely because final assembly costs in China rise by 20%—just as they didn't after the yuan appreciated by 21.2% from 2005-08. More likely, some labor-intensive operations will shift to other countries like Vietnam or Bangladesh.

However, rising wages would hasten the long-awaited "rebalancing" of the Chinese economy toward greater consumption. The high savings rate has been a function of profits being reinvested by both private and state-owned companies, not the savings decisions of households, whose income has lagged behind the stunning GDP figures. Government spending and bank lending have been geared toward investment, which remains the main driver of growth. Greater spending power for individual Chinese would make for more sustainable growth and also encourage imports, lessening the trade surpluses



that cause tension with the U.S.

Some investors may question to what extent Beijing is encouraging workers to be more assertive in demanding higher wages from foreign companies to favor local producers, as competition for the domestic market heats up. However, the trends that are making labor more costly will ultimately force all employers to adjust, including less efficient state-owned enterprises.

No doubt the government would prefer that foreign firms go first, which is reflected in the fact that state-owned media have been allowed some freedom to report on the Honda strikes. But as China leaves behind the era of cheap labor, the quality of management will become ever more critical to success in the marketplace. That should favor foreign companies honed by global competition, and drive China's next round of state-owned-enterprise reform.