

## **THE RISING COST OF PRODUCTION IN CHINA**

China's days as the low-cost manufacturing center of the world are over. Increased production and shipping costs are increasing the price of producing goods destined for export from China. Those increasing costs must be passed on to American (and other export markets') consumers already strapped economically by slow recovery. The "Great Recession," that began in December 2007, is still resulting in unemployment levels hovering at 10%, low consumer confidence and reduced sales across all wholesale and retail markets. Additionally, these factors may result in production and shipping delays as labor shortages and shipping capacity are stretched to the limit.

There are several major factors at work in the rising costs of Chinese production including:

- The China Contract Labor Law enacted in 2008
- Shortage of highly skilled Chinese labor
- Domestic economic stimulus projects that are pulling rural Chinese workers out of the cities for large infrastructure construction projects closer to their villages in interior China
- Shortages of shipping containers
- The beginning of organized labor in China and the disruption that normally accompanies the birth of organized labor

These factors could represent big opportunities for snow sports suppliers that have goods in their warehouse. Several suppliers in the snow sports industry have experienced problems due to one or more of the factors listed above. Some suppliers will not be able to ship their goods to retailers until November-December. This presents an opportunity to companies that have stock ready to ship to retailers that are running short of product in the early season.

### **The China Contract Labor Law enacted in 2008:**

The 2008 China Labor Contract Law requires all labor contracts be in writing and imposes significant penalties on employers who fail to comply with the 2008 law. The new law also greatly limits the use of term contracts and probationary periods; previously popular ways to skirt China's existing labor law regime. Under Chinese law, an employee can be discharged either at the expiration of a term contract or for cause. To avoid the need to terminate for cause, employers in China have typically engaged employees under a series of short-term contracts. This practice is no longer possible under the LCL. The employer is permitted to enter into a maximum of two term-contracts with the employee.

If the employee continues on after the expiration of a second term-contract, the subsequent employment contract is deemed to be an "open-term contract." Under an open-term contract, the employee is employed until he chooses to terminate the contract or reaches retirement age. The employer can only terminate the employment contract by discharge of the employee for breach. This means that once the relationship has shifted to an open-term contract, the result for competent employees is effectively "employment for life."

### **Shortage of High Skilled Chinese Labor:**

Early in 2010 factories struggled to rehire enough willing workers at existing wages (see low skill issues below). Then in May, Taiwan's Hon Hai Precision Industry (2317.TW; also known as Foxconn), the world's largest contract electronics manufacturer, said it would double the salaries of its mainland workforce following a rash of high-profile employee suicides. A few weeks later, staff at Honda (HMC.NYSE, 7627.TYO) and Toyota (TM.NYSE, 7203.TYO) plants in China went on strike over wage demands.

It has been suggested that China has crossed a critical threshold in its economic development where its pool of cheap labor has been exhausted and wages inexorably begin to rise.

The real Chinese labor crunch is concentrated almost entirely in the market for more skilled, experienced workers - and it is becoming more acute as manufacturers try to move up the value chain. Virtually all of the high-profile cases where Chinese workers have successfully pressed their demands have involved activities - like automotive or electronics manufacturing - whose skill requirements make qualified employees hard to recruit, expensive to train and difficult to replace.

### **Domestic economic stimulus projects pulling low skill rural Chinese workers into interior China:**

The supply of unskilled migrant labor, which normally floods coastal provinces, has been temporarily bottled up in stimulus-funded construction projects in the interior, designed to support workers laid off last year. Those projects won't last forever, ultimately the workers will be released back into the market. And they will be joined by more rural migrants who exit the farming sector as it modernizes.

### **Increasing Organized Labor in China:**

When workers at a Honda transmission plant in China went on strike for higher wages in May 2010, they touched off a domino effect of high-profile labor disputes.

As the strikes, many of them at foreign-owned plants, rippled through China's southern manufacturing heartland, the government — usually quick to crush mass protests of any kind — did not step in, but allowed them to spread.

Because China does not release official data on the number of strikes that occur annually, there is no way to say for certain whether the recent rash of labor unrest marks an increase from previous years, said Chang-Hee Lee, a specialist on industrial relations at the International Labour Organization's Beijing office.

Domestic media are often barred from reporting on labor strikes, so the recent surge in coverage by Chinese media is noteworthy, he said.

"We see many more reported cases of strikes in the Chinese media. We don't know if it's increasing, but what we do know is that the nature of the strikes are changing," Lee said.

The spiraling labor unrest poses a problem for Japanese companies that shifted production to China in the hopes of taking advantage of lower labor costs. Toyota Motor Corp. and Honda have repeatedly halted production at their car assembly plants in southern China since mid-May after parts suppliers were hit by strikes.

The protests have served to highlight a more effective, organized work force. Unlike past years, when the mostly migrant work force protested over blatant violations, Chinese laborers now are fighting for improved working conditions and higher pay beyond their basic rights.

To illustrate the issue of basic rights, while American and European consumers worry about exposing their children to Chinese-made toys coated in lead, Chinese workers, often as young as 16, face far more serious hazards. Here in the Pearl River Delta region near Hong Kong, for example, factory workers lose or break about 40,000 fingers on the job every year, according to a study published a few years ago by the Shanghai Academy of Social Sciences.

### **Shipping Container Shortage:**

Freight shipping volume has been picking up in 2010 and while that is great news for the world economy it has caused an unexpected shortage of containers. According to the July cover [article in American Shipper](#), this shortage in shipping containers is being sited as one of the main

causes for the rise in freight rates and has led to difficulty in moving product to buyers. Many shippers have complained about signing contracts with shipping lines only to have rates rise the following week or to be denied space completely. The average price for a 20ft shipping container has grown from about \$2,000 to \$2,700.

One of the major reasons for the container shortage was the drop in production of new shipping containers in 2008 and 2009 due to lack of orders from economically strapped European and U.S. markets. From 2004 through 2008, TEU supply grew by an average of 8% per year. Once the world recession hit, trade dropped dramatically and so did demand for shipping containers. There was a 95% reduction in shipping container production in 2008 and almost no containers were built in 2009.

Additionally, Intra-Asian trade has increased significantly. In fact, nearly 30% of Taiwan's exports go to mainland China. And South Korea sends a quarter of its own to China. Both send less than half those amounts to the U.S. It makes sense considering how Chinese consumers bought more cars and cell phones than Americans did last year. All of this movement of product has exacerbated the shortage of shipping containers.

*Sources: China Daily, The American Shipper, Investment U, China Economic Review, NY Times, Stratford.*

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