labor strikes in china: shifting demographics & economic rebalancing

By Joseph Taylor, Senior Emerging Markets Analyst

may 2014

In April, Yue Yuen, the world's largest branded footwear manufacturer, experienced a nearly two-week labor dispute at its 45,000-worker factory in China's Guangdong Province. Employee grievances centered on unpaid employee benefit insurance. Strikers accused the company of basing employer contributions on lower salaries than what employees actually earn. In the settlement, Yue Yuen agreed to raise both the "living allowance" for employees and employee benefit contributions—subject to appropriate documentation, a requirement that will likely be burdensome on employees to limit payments. In an update filed with the Hong Kong Stock Exchange, the company stated that the costs of the work stoppage were $27 million and the additional employee benefit payments would amount to $31 million for the calendar year 2014, determined by the level of retroactive benefit payments.

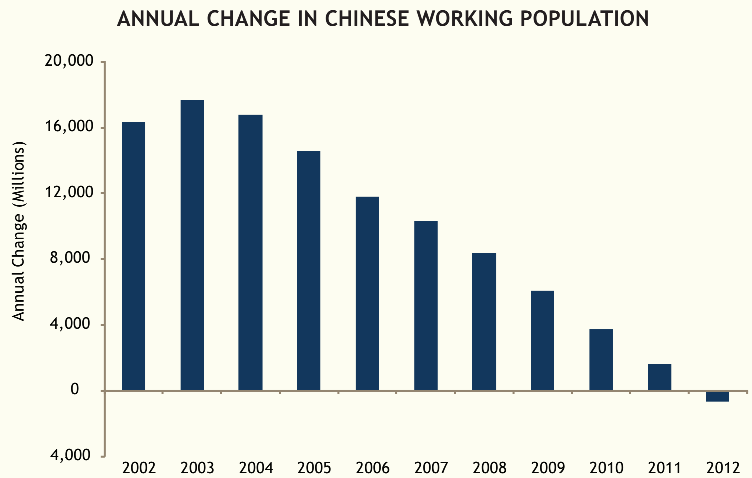
KEY TAKEAWAYS

- The labor dispute at the Yue Yuen factory in Guangdong Province illuminates broader labor issues in China.
- China is no longer the low-wage paradise it once was, and employees will continue to press for higher wages and better benefits.
- Rising wages should encourage consumer spending, but there is no quick fix for economic rebalancing. Our outlook for GDP growth is below consensus.

When seen as a microcosm, this strike provides a window into the broader labor issues facing China, including a change in labor attitudes and demographics. The cost of labor has been rising and should positively affect the spending habits of Chinese consumers, but we do not believe rising wages, on their own, will be a sufficient catalyst for economic rebalancing.

CHANGING LABOR ATTITUDES & DEMOGRAPHICS

What made this strike remarkable? Strikes are commonplace in China, but the scale of this one was noteworthy. Labor unrest spread to other sites and employers in Guangdong, and important strikes have occurred at WalMart and IBM facilities in the last couple of months. The Yue Yuen settlement is relatively modest but is sure to have a continuing ripple effect. Basically, employees can and will press for higher wages. Yue Yuen is not unique; many other Chinese employers shave costs by reducing the employee benefit payments, claiming that employees prefer larger upfront cash payments to "hidden" payments into the social security fund. But without employee benefit payments, migrant workers have no pension or medical coverage when they return to their home villages. Labor attitudes about social insurance are changing.

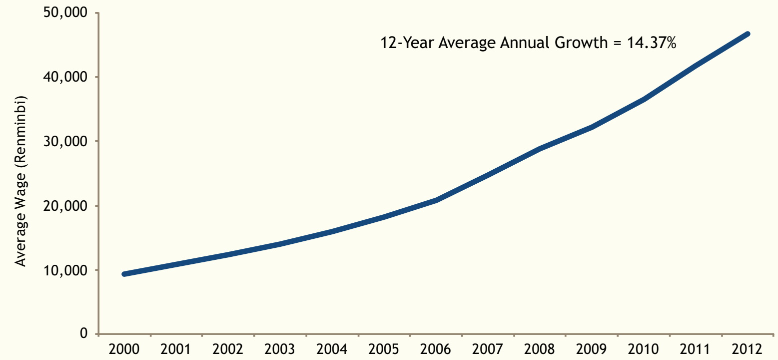


Source: Haver Analytics and United Nations, data through 12/31/2012. Working age defined as 15 to 59.

The Government Reaction: Notably, the government did not intervene for more than ten days, and when they did, officials cited Yue Yuen for underpaying its social benefits and directed the company to take corrective action. While the strike was peaceful, the local government did not pressure the workers to return to work for many days. Is the local government supporting the national policy of rebalancing toward greater consumption? Possibly, but demographics also play a big role. Labor shortages have become a problem in China. As shown in the chart on the previous page, the country has reached a point where there are net annual declines in the labor force, implying faster rising wages to accommodate the labor shortage.

BIG FACTORIES ARE STUCK & FACE RISING WAGES

Structure of Chinese Manufacturing: The consolidation of manufacturing into mega-plants in China has taken place over the last 10 to 15 years. Companies have realized benefits from access to low-wage labor. But labor costs have been rising, increasing nearly 15% annually over the past decade, and these manufacturing behemoths are simply too large to relocate. As employees continue to push for higher wages and better benefits, higher prices for exported Chinese goods are inevitable.

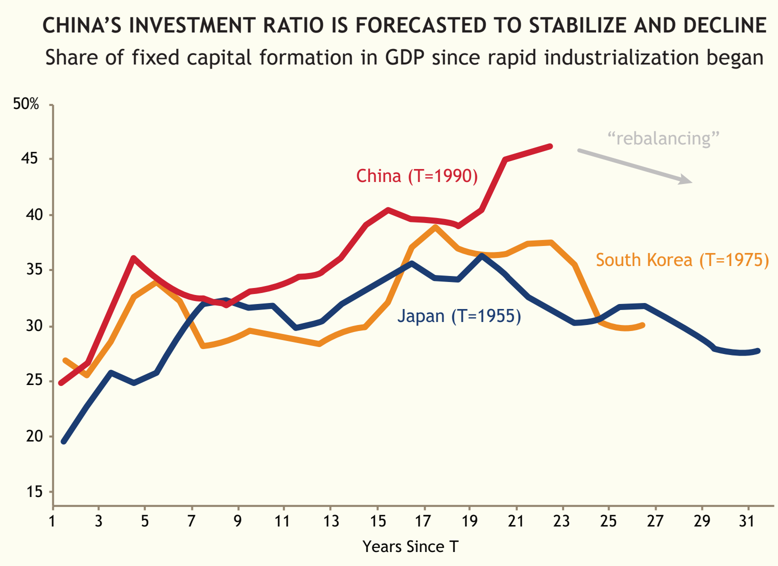


Source: Haver Analytics, Ministry of Labor and Social Security, data through 12/31/2012.

The Squeeze of Higher Wages: Manufacturing on the margin is shifting to Vietnam, Indonesia and India, but none of these is likely to replicate the size and benefits of the Chinese supply chain. For expanding US companies, Mexico is more and more attractive since the relative wage difference between Chinese and Mexican manufacturing is now minimal. Clearly, there are many factors in setting up production facilities, but China is no longer the low-wage paradise it once was.

IMPACT ON ECONOMIC REBALANCING

The bigger rebalancing story, that is the shift from an investment-based to a consumption-based economy, cannot take place in a couple of years, as many observers seem to believe. It will play out over the next decade. For the last two decades, the principal driver of GDP growth in China has been investment spending—spending on new plants and equipment, housing and infrastructure. Investment spending accounts for more than 45% of GDP in China, higher than either Japan (where it peaked at 35% in 1975) or South Korea (peaked at 38% in 1994) during their rapid



Source: GaveKal as of March 2013. T represents the beginning of rapid industrialization for each country shown. Forecasts are as of date indicated, reflect subjective views of the author(s) and are subject to change.

growth phases. Two major problems with the scale of investment spending in China have emerged: first and more recently, it has been debt financed, forcing a rapid rise in the country's debt burden, and second, the expected return on investment has sharply declined. Wages will continue to rise, but economic rebalancing has no quick fix. Investment spending will slow, but consumer spending cannot take up all the slack, which is why our outlook for GDP growth is lower than consensus.