China's Gross Domestic Product Dilemma


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With the announcement that China's gross domestic product (GDP) has slowed sharply in the first three months of the year, the unbridled demand for labor will also cool off. It's a tricky time for China, as its previous strategy of pushing hard on the gas pedal to grow GDP at any cost won't work any longer. Now China faces the challenge of growing its economy at a moderate pace. China is now driving with two feet. One foot is tapping the brakes (by curtailing construction) and one foot is gently pressing the gas pedal (through the loosening of credit by banks).

What other avenues can China pursue to grow this now large country at a controllable pace? Let's take a look at a couple of those options, and why they WON'T work in China right now:

Devalue its currency. As China never let the Yuan rise in value in order to fuel growth, it is under tremendous pressure to increase the value of the Yuan from other governments and even its own citizens who desire more global purchasing power. It is politically untenable to devalue the Yuan without expecting economic retaliation from other countries. This option is not available to China right now.

Transfer GDP creation to a different sector of the economy. China turbocharged construction over the last decade to fuel its fast GDP growth and is now slowing that sector down due to excess capacity in the industrial sector and an overheated residential market. Comparatively, as the U.S. exited manufacturing, its transition was buffered by significant consumer demand for services, government subsidized healthcare, and a strong housing market. This allowed much of the employee population previously employed by manufacturers to find new, albeit lower wage, work. The U.S. had a more balanced economy that allowed it more choices. China’s low wage strategy has not enriched the bulk of its population, meaning consumers cannot afford to carry the economy right away.

Offshore jobs to lower manufacturing costs and spur demand. China’s economic success is based on a promise to its citizens that it will increase their standard of living over time. Without a place for those displaced manufacturing workers to go, the promise would be broken and instability would result. Secondly, the difference in wages in neighboring countries isn’t enough to overcome the increase in logistics costs in all but the most labor intensive industries. This was not the case in the U.S. where Chinese wages were a tiny fraction of U.S. wages and the transfer of some jobs resulted in lower cost goods for the majority of Americans.

Reduce wages of employees to spur export demand. Intentionally or not this is what occurred in the U.S. over the last several decades. Reducing wages in China overtly or passively would only reduce China’s already paltry consumer demand. This is one of the areas of GDP that China is trying to grow in order to reduce its dependence on exports. Look at Foxconn to understand what direction wages in China are going. The U.S. transitioned to lower wages because the transfer of manufacturing jobs also lowered the cost of consumer goods. The pain, while noticeable, was manageable as people reduced savings to fund current lifestyle with the expectation that the government and pensions would provide a comfortable retirement as it had for their parents. Americans are now realizing what we did to ourselves with this domestic consumption GDP strategy.

Automate its way into high productivity. While there will certainly be automation projects at individual companies that will occur over time, don’t look for a government strategy that would rapidly automate the plant floor to increase competitiveness. This is simple. While the U.S. rapidly increased productivity through automation, it was able to absorb the workforce in other industries. China can’t do the same on such a large scale.

So what options are left?

Export labor (this is the “government spend” component of GDP growth). China is investing its treasure in building political allies and securing natural resources around the world. For example, it is investing heavily in the Bahamas by building out its infrastructure. And guess who is providing the labor for 8,000 jobs there? This is a technique used frequently by the U.S to invest in other countries for political reasons but ensures that the U.S. receives a share of the economic benefits by requiring U.S. contractors participate in the projects.

Increase the value of what it produces. Exiting out of low value goods such as apparel production and into technology is a goal of the Chinese. This is a slow but traditional path as countries move from agriculture to industrialization. Alternative energy and automobile production are two good examples. Unfortunately this has generated some accusations from global manufacturers and technology providers that rather than develop or license technology themselves, Chinese manufacturers are counterfeiting brands and stealing intellectual property to speed up this transition. How this will play out is unknown.

Increase labor productivity in existing industry to lower costs while increasing standard of living. I can personally vouch for this change in attitude by Chinese manufacturers. During a recent visit to China, I visited factories where young supervisors had implemented sophisticated techniques including active use of kan bans, 5S, and changes in process to effect line leveling. They also exhibited a thorough understanding of how to manage constraints within production. Even the accuracy of payroll is now becoming a hot topic as labor laws are being enforced and wages rise. Increasing productivity was the secret to the U.S.'s success. The challenge in productivity gains is a slow path relative to most other methods of growth because it comes from the bottom up. The upside is productivity gains are a sustainable competitive advantage because it is extremely hard to duplicate. Whether the government will make this a formal strategy is yet to be determined.

This is an interesting inflection point for China's economy and I look forward to seeing if China can exhibit the same tenacity and success in the next phase of its economy as it did in the last one.