



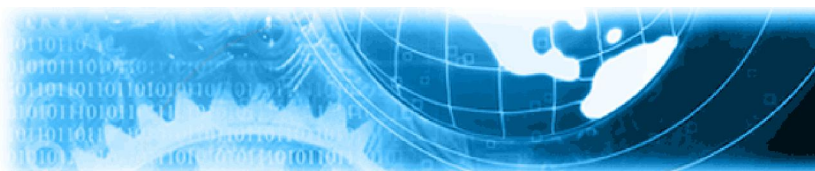
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#### China: no longer only a low-cost haven

*The costs of Chinese goods are increasing, but so also are quality and the expertise of manufacturers.*

By Peter A. Buxbaum, AJOT

Sourcing products from China used to be motivated by a singular consideration: lower costs. That motivation is still present, despite competition from still lower-cost manufacturing venues like Vietnam, Indonesia, and Thailand. But China is increasingly manufacturing higher value-added products and its manufacturing companies are developing expertise in product development, design, engineering and marketing that may be of use to U.S. companies.

China's reputation for quality has suffered several blows in recent years, after the discovery of tainted products that had been exported to the United States, everything from pharmaceuticals to children's toys to pet food additives. China's response to these incidents, in the form of more stringent regulatory controls, say experts, is a testament to the value China's leaders place on their brand.

The incidents of tainted exports "definitely have not played favorably for Chinese companies," said Francesco Duina, director for North America of J.L.J. Group, a China-based consultancy that helps companies do business with and in China. "At the same time, these situations have acted as a deterrent, and has meant that companies in and outside of China are much more concerned with ensuring quality standards."

"It is hard to tell at this point if there is any long term impact" to the tainted products incidents, said Z. John Zhang, a professor of marketing at the University of Pennsylvania's Wharton School. "They are, by and large, isolated events, which do not suggest a systematic failure in Chinese export control."

The fact that the Chinese take these incidents seriously is marked by the measures they have taken to counter them, including regulatory changes and public relations campaigns. "The Chinese government has every incentive to protect the Made in China brand to keep its growth engine humming and big importers and outsourcers have every incentive to put safety before profits," said Zhang. But, he added, there are always exceptions to that rule, so a company sourcing products "can never take a hands-off approach anywhere and certainly not in China."

Duina noted that the Chinese government is about to launch a new regulatory scheme for chemicals

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safety which is based on, and more stringent than, those which prevail in the European Union.

There are several methods for sourcing product from China, each with its pros and cons. Several factors determine the approach taken by an individual company. "Many factors would determine whether you would take a more direct versus an indirect approach in outsourcing such as order size and profit margin," said Zhang. "Most importantly, if you need to control and monitor the production process and quality, you need to take a more direct approach. If you want to prevent any mishaps that might taint your reputation, you need to be on the location overseeing the whole production process."

Developing a relationship with a China-based sourcing agent is perhaps the easiest way to get started sourcing. But such an approach does not provide the full benefit of cost savings and yields little in the way of knowledge and know-how about China to the sourcing company. Companies that take the next step by sourcing products through a representative office in China provides the benefits of a hands-on approach and the development of local expertise but also increases management demands and costs.

Setting up a joint venture or wholly foreign-owned subsidiary allows a U.S. company to be better positioned to capitalize on China's growing manufacturing strengths and requires a large fixed investment. Creating a full manufacturing, distribution, and sales network in China is a reasonable approach for larger companies for which China is a major growth market, but a decision to implement such a strategy must be taken at the highest levels of a company and requires long-term investment and exit plans.

Chinese companies are increasingly available for what Duina call "strategic sourcing," in which the Chinese manufacturer aids its U.S. counterpart in designing and engineering new products and also in advising the company about selling the products in China or elsewhere in Asia. "Suppliers are becoming more sophisticated," he said. "This was much less of a possibility ten years ago. Sourcing companies are now asking their suppliers to sell for them in China and other markets such as Indonesia and Southeast Asia. Chinese companies are doing more research and development in areas such as pharmaceuticals."

Zhang also sees Chinese products moving up the value chain, as a result of the experience gained by Chinese manufacturers combined with Chinese government policies. "China has gained a lot of technologies and confidence through years of experience as the manufacturing hub for the world," Zhang said. "Now, we see signs where Chinese firms are acquiring abilities to develop and market their own products outside of their domestic markets. The Chinese government has been taking a deliberate approach in promoting indigenous innovations. The west will see the impact of that policy when high quality, low cost products made in China flood western markets, in much bigger a scale than Japanese products in 1970s and 1980s." Zhang expects this phenomenon to be most pronounced in the area of proliferating environmentally friendly green technologies.

The new emphasis on higher value added products is related to the fact that the cost of doing business in China have gone up in recent years while other countries, such as Vietnam, Indonesia, and Thailand, have presented themselves to the world as lower cost manufacturing sites. "The realization is slowly emerging that China may no longer be the cheapest sourcing spot on the planet," said Duina.

Labor costs have increased, as have transportation costs, as some manufacturing has been moving to inland locations. "There is no question that the costs of Chinese goods are on the rise and will continue to rise in the foreseeable future," said Zhang. "Labor costs have been low for many reasons including the fact that there is an army of migrant labor from the agricultural sector to be tapped and there is no collective bargaining for labor. Now, there are signs that the labor market is tightening up in some parts of China and that migrant workers are no longer satisfied working on hard or tedious jobs for food. They are becoming increasingly more assertive in expressing their desires in participating in the prosperity that they have labored for."

The global financial crisis has helped the cause of workers in an unexpected way by forcing China to create domestic demand. The only way to accomplish that feat is to increase the disposable income of average Chinese. That is likely to be accomplished by revaluing upward the value of the Chinese currency, the renminbi, or RMB, which has already been done to a limited extent under pressure from the U.S. government.

Further increases in the value of the RMB will likely yield at least two results: Chinese workers will have more buying power and the prices of Chinese made goods will increase. Chinese workers will be buying more of the output of domestic factories but they will also have more to buy from the U.S., Duina noted.

"The Chinese don't want to be perceived as the bottom of the world's supply chain," he said. "The upward revaluation of the RMB will be good news for everyone including them."

This is not to say that China is giving up on its attractiveness as a low-cost manufacturing location. On the contrary, many companies are moving their manufacturing operations westward to the inland of China as costs, especially labor costs, along the coast rise. "China remains the biggest sourcing country in the world," said Duina.

This presents a new level of challenges relating to the logistics and costs of getting products from inland factories to export gateways along the Pacific coast. "The domestic logistics infrastructure in China is developing but it is not up to American or European standards," said Duina. "The freight forwarding and transportation businesses are fragmented with many local providers. That means that products moving for one part of the country to another may have to go through different hands. Quality control in the logistics industry is also relatively weak, partly as a result of a poor and fragmented regulatory framework. The industry is not terribly sophisticated. They haven't figured out yet how to maximize their logistics."

On the positive side, the Chinese government is pouring billions of dollars into rail and air networks as well as water transportation. "The Chinese are adding thousands of miles of roads every month," said Duina. "They will catch up eventually."

Today's China presents a complex picture, but it is doubtful that China as the manufacturing hub will soon become a thing of the past. "There is every reason to believe that it will continue for the foreseeable future for a number of reasons," said Zhang. "Labor costs, for many western outsourcers, are only a small part of their total costs. Uneven economic development throughout the country gives cost-sensitive outsourcers some room to maneuver. Most importantly, no other country has the kind of scale economies in manufacturing as in China to insure low overall manufacturing costs and supply reliability."

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