

Has the China Sourcing Balloon Popped?

Executive Summary

There is a large hissing sound going on right now and it's coming out of China. The double whammy of increased export trade tariffs and the reduction/elimination of Chinese value-added tax (VAT) rebates are starting to confuse buyers and suppliers as to what the new rules are. From umbrellas and plastic flanges to watch parts and transmission belts, nearly 3,000 commodities have been affected by changes that will increase the China price worldwide. And this has come on top of what appears to be a smear campaign over China quality in the U.S. media.

What's Really Going On Here?

To understand the magnitude and background of the recent changes, let's examine the Chinese cement market. China is already the largest cement market in the world and is projected to grow to more than the next two largest consumer countries combined -- India and the U.S. China's export restrictions of a product, which are so desperately in need for domestic growth should be seen less as an attempt to reduce the trade imbalance. Rather, it is a common sense move to contain domestic inflation in the construction industry.

But none of this is new. In fact, this recent news marks the fifth change in rebates since 2005. However, the current changes will likely have the most profound impact on the global supply market for certain commodities, many in the manufacturing world. The Chinese government has all but eliminated its export support for high energy consumers like cement, fertilizers and certain non-ferrous metals and metal products.

Moving From China Sourcing to Global Sourcing

We believe the effect of these changes for North American manufacturers will be a rapid shift to other producers in Central & South America and Asia, particularly India for many commodities. However, companies should look at impacts beyond just price. Since the supply market for many of the products affected is already tight globally, lead times will get extended. But the effects will be felt more extensively than just in these products. As exports are choked off, the domestic China price for these raw or basic materials will become depressed. Steel prices are already lower in China than the world market, which makes Chinese consumers of basic commodities more competitive on the world stage in regards to selling their higher value add finished products. Given this, look for China to attempt to own more of the global supply chain for manufactured products, investing more to produce higher-value finished assemblies and products.

It's Déjà vu All Over Again

Haven't we seen this happen before? Didn't Korea and Japan follow similar paths; exporting low value-add products and eventually turning out some of the world's highest quality cars and electronics? In our view, China is merely following a similar, well-paved path.



We believe that manufacturers of all sizes should follow a successful low-cost country sourcing (LCCS) path as well, regardless of their current China exposure. Here are three tips we suggest:

1. If you aren't saving at least 35% on your parts/products from China as of June 2007, make sure you have two additional qualified suppliers -- one domestic (if possible) and one in another country/region. Take the time now to benchmark regional and global pricing using MFG.com or other means.
2. If you have only one source of supply and your product/category was unscathed by these changes, consider yourself lucky, but take the time now to identify alternative global suppliers. MFG.com can be a rapid way to develop alternative options.
3. Larger manufacturers with dedicated sourcing teams should re-align their sourcing organization. Rather than organizing by country, organize by skill. Centralize a core group of "global sourcing experts" and opportunistically hire folks by region. Make sure that new folks are specifically trained to execute the sourcing program (e.g. hire a QA resource in China); they must make the sourcing decision to source from China part of the core team's responsibility.

China Sourcing: It Ain't Over, But ...

In the chaos of the current China sourcing changes, it would be easy to dismiss China as a long-term sourcing partner. But this is wrong. We believe, as do many of the world's largest manufacturers, China is here to stay. Rather than serve as the industrial breadbasket for low-value commodities and categories, the country is shifting gears.

We expect that rather than see a decline in China exports in the coming months and years, we will see a shift to higher-value product areas. China is not so much reducing its presence as the first choice supplier on the world manufacturing stage. Rather, it is deliberately re-positioning itself towards the higher-value add markets where the west had traditionally felt more secure.

But regardless, the China price is rising across many categories for Western companies. And if you're not prepared, you'd better start developing your options.

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