The Shakeout Continues in Chinese Manufacturing

For manufacturers in China, "business as usual" no longer exists. Just one year ago, according to the 2007-2008 China Manufacturing Competitiveness Survey conducted by the American Chamber of Commerce (AmCham) in Shanghai and Booz & Company, the main concerns of manufacturers in China were the rising costs of labor, raw materials and land, and the growing strength of the renminbi (RMB). Those factors were forcing some manufacturers to move to the country's hinterlands, while others moved to Vietnam, India and other locations where land and labor are cheaper. As a production base, the 2007-2008 report concluded, China was losing its competitive advantage.

Just one year later, much has changed, and the manufacturing landscape in China looks altogether different. According to the just-released 2008-2009 China Manufacturing Competitiveness Survey by AmCham and Booz & Company, fewer companies are planning to move, either within the country or overseas, either because they are focusing on the domestic market, or because they cannot afford to move. Exports are down sharply, and domestic sales have declined as well, although not as steeply as exports. Commodity prices have fallen, and rising wages are less of an issue, with more than 20 million Chinese laborers out of work and unemployment also on the rise among white-collar workers. In the latest survey, just 35% of respondents cited wage increases as a problem, compared with 52% in the previous survey.

But new problems have arisen to take the place of the old ones. "There are new challenges," says Ronald Haddock, vice president of Booz & Company. "Before, rising costs and the rising RMB were the key concerns, and now declining demand, tight credit conditions and currency fluctuations are at the top of the list." While the RMB has remained relatively stable at about 6.8 to the U.S. dollar since mid-2008, other currencies have bounced up and down, making forecasting difficult and in some cases further eroding overseas sales. And although the RMB is now stable, analysts say it might soon rise against the U.S. dollar, as increases in U.S. dollar liquidity and rising inflation in America may weaken the greenback.

The only companies likely to survive the new conditions are those that are efficient in their manufacturing practices, and that market their goods both inside China and overseas, according to the new report. "The economic collapse makes everything interesting," says Ted Hornbein, a governor of AmCham Shanghai and managing director for Asia of Richco Inc., a Chicago-based manufacturer of plastic parts that are used in electronics and many other industries.

The annual AmCham-Booz & Company report, which relies on online surveys, site inspections and detailed interviews, is regarded as an excellent barometer of manufacturing in China. This year, 108 China-based manufacturers were surveyed, and of those, 82% were wholly owned foreign companies, 11% were joint ventures, and 7% were categorized as other. A follow up survey was conducted in late December, after the U.S. credit crisis crippled the global economy and caused exports from China to the U.S. to plunge.

Declining Sales

One of the biggest problems facing manufacturers is the decline in exports, and with the end of the global economic slowdown nowhere in sight, most do not foresee any recovery in the near future. "In terms of exports, I want to be optimistic, but it is very difficult," says T.T. Chen, formerly of Avery Dennison, a global leader in the production of adhesive products and office supplies, and now an operating partner of L-M-Consulting, which specializes in advising companies on doing business in China.

That sentiment is echoed by Ed Salatka, a partner at Atlas Industries, a Shanghai-based company that sources and ships kitchen interiors from China to the U.S., including cabinets from Shanghai, granite countertops from Xiamen, stainless steel sinks from Guangzhou, and vinyl flooring from Hangzhou. "I was concerned last year about rising costs, and that my suppliers would cut corners, especially with the materials," says Salatka. "But that is no longer an issue. Now I am 100% worried about sales from my customers."

Many companies had hoped to make up for declining exports by increasing domestic sales, but it is now clear that sales to the Chinese market will not make up the shortfall. Although China's domestic market has not suffered the same sharp sales declines as in the U.S. and Europe, consumer demand in the country is nonetheless soft, particularly among middle class buyers.

Yet access to the domestic market remains a key goal for manufacturers in China, and the survey uncovered a sharp new focus on it. According to 77% of respondents in the latest survey, a key reason for locating production in China was to increase access to Chinese consumers, a figure that was up 6% compared with the earlier survey. China now plays a pivotal role in manufacturing sales and is a bellwether of success for manufacturers, as most of the successful companies in the survey both manufacture and sell in China.

In one of its more remarkable findings, the survey shows that China is no longer losing its competitive edge in manufacturing to other countries. This is due to broad changes in the production environment, including a surprising slowdown, and possibly even a plateau, in wage inflation. That slowdown represents a sharp reversal of a five-year trend that began in 2004, when wages first began to rise in Guangdong province, and then increased rapidly throughout China. The trend reached a zenith a year ago, and in the earlier 2007-2008 AmCham survey, rising labor costs were one of the biggest problems for manufacturers. In that earlier survey, 52% of respondents listed wage increases as a primary concern, while in the just-released 2008-2009 survey, only 35% of respondents listed rising wages as a top concern.

At The Elm Workshop, a Shanghai-based company that makes hardwood furniture primarily for the local market, wage pressure has eased considerably this year. "Two years ago, there was a big push for wage increases, and wages went up 30%, and there was still pressure for higher wages even after that," says owner Christopher Curran. "But this year, during the Lunar New Year, none of our workers even mentioned wages." In China, contracts and wages are normally negotiated once per year, usually at the Lunar New Year. Some of The Elm Workshop's competitors are struggling or closing down, and labor is becoming more plentiful, says Curran.

Material costs are also coming down, Salatka notes. "Prices last year were going up, and they have flattened this year for sure, and we have actually been able to get discounts on some of our products," he says. "Last year, it was like, 'tough luck,' and this year the cabinet guys came down on one job 8%, and the granite guy came down about 5%."

With costs no longer rising as fast, fewer companies are planning to move to a cheaper location, either inside China or overseas. "The reality is that companies don't have the money this year to move their operations to another country," says Haddock of Booz & Company. In the latest survey, only 10% of the companies had plans to leave China this year, compared with 15% last year. This represents a dramatic change in the manufacturing environment in China.

One previously unseen problem cited in the latest AmCham survey was tight credit, and that has proven to be a serious obstacle for Atlas Industries. "My slowdown in exports is 100% the result of financing," says Salatka. "There is a huge housing shortage in Houston, it is a booming area, and there is huge demand. They sell these projects out as soon as they build them, and now [business] has ground to a halt because banks aren't lending the money to build them. My customer in Houston has eight projects on hold, they've bought the land, they've got the approvals from the city, and they are ready to roll -- but the funding has just dried up."

The Strong Get Stronger

Rising wages, land prices and commodity prices over the last five years, combined with the brand-new problems of declining sales and tight credit, have accelerated the weeding-out of uncompetitive manufacturing firms. Many of the "weak sisters" – manufacturers that rely on cheap labor rather than on modern production practices – have already left China or closed down altogether.

Meanwhile, the strong companies are getting stronger, as most of the survivors are continuing to invest and are working to improve their efficiency. According to the latest 2008-2009 survey, more than half of the 108 companies surveyed plan to pour further investment into their China operations within the next two years. "We may see a beneficial impact from the crisis – there will be more attention paid to how we manufacture in China, versus how much we manufacture in China," says Edward Tse, a senior partner at Booz & Company.

The 2008-009 survey also uncovered a deep reservoir of optimism regarding the future of manufacturing in China. "[Manufacturers] have experienced a sizable decline in exports and a drop in domestic sales, but 56% are still positive," says Haddock. Many of the successful companies – efficient manufacturers that sell both domestically and overseas – plan to expand their production in China. That suggests that survivors of the current downturn will be well positioned to thrive when prosperity eventually returns.

In addition, companies are still moving to China, although their reasons for doing so have changed. The latest influx of companies is driven not by the lure of cheap labor, as in the past, but by the potential market. "Despite the economic downturn, China is still a growth market," says Hornbein of Richco Inc. "Companies are looking to China to make a profit, and they are continuing to invest in China despite the downturn."

The survey also uncovered some constants that were largely unchanged from one year to the next. One was the protection of intellectual property rights, as 73% of respondents listed the enforcement of their intellectual property as either important or very important. Finding qualified white-collar personnel remains a challenge, while employee retention, the ease and expense of logistics, and the quality and safety of Chinese-made products and materials are still listed as problems, just as they were in the past.

The China government earned generally high marks in the latest survey. According to respondents, Beijing has made noticeable progress in improving the country's infrastructure, and incremental progress in protecting intellectual property rights, and it also gets credit for the speed and size of its US$586 billion stimulus package.

The stimulus spending will directly benefit manufacturers, as the railroads, roads, ports and other public works will make it easier to move goods within the country, and will help open up new sales markets in provincial cities. In addition, a second stimulus package is now being prepared, in case first-quarter economic numbers disappoint. Yet there is also pressure on the government: As margins are squeezed by declining sales, manufacturers are calling upon Beijing to ease cost pressures, and to focus further on training and educating the work force.

A Portrait of Success

At the end of the current shakeout, a clear picture has emerged of what a successful China-based manufacturer looks like: the successful company produces goods in China using efficient factory-floor production methods, and it deploys a range of modern management and sales tools. It exports some of its production, and sells an increasing amount to the domestic market.

Reaching Chinese consumers is neither cheap nor easy – serving the current soft domestic market requires expanding product offerings – but it is essential. “In terms of management, you need to bring your ‘A team’ to China to be successful,” says Hornbein. “Companies that invested wisely in China are reaping the rewards.”
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