

China's Manufacturers Move Upstream

Are Chinese manufacturers losing their global competitiveness? Like companies everywhere, Chinese factories must contend with high raw material and energy prices. A new labour law as well as stricter enforcement of environmental regulations are increasing costs. Many export tax rebates have been eliminated and an appreciating RMB is increasing the prices of goods made in China. Does this spell the end for China as the "workshop of the world"?



by Jack Perkowski

The answer is a resounding "No!". In fact, these changes are signalling that China is moving into a new phase of its economic development. The very forces that are putting upward pressure on the China price and forcing many of the country's factories to close or re-locate, are causing others to forsake low technology, highly labour intensive products where profits are low and being squeezed, and move up to higher technology, more sophisticated products with higher profit margins. These companies want to sell China's "brains" and not just the country's "brawn". As a result, the fundamental transition that is taking place in China's manufacturing economy promises to make China an even more formidable competitor in the years ahead.

As a manufacturer in China, I have taken a number of steps to counter rising costs:

- First, we constantly review our products and customers with an eye to eliminating those that are no longer profitable.
- Second, we have accelerated lean manufacturing initiatives to reduce waste in our manufacturing processes and business systems.
- Third, we have emphasised "value engineering" and product re-design to reduce the content of expensive raw materials.
- Fourth, we have passed along higher costs to our customers wherever possible.

But, of all the measures we have taken, the most important is our increased new product development activity. The reason is quite simple: profit margins are highest at the beginning of a product's life cycle. As a product matures and more competitors enter the picture, prices and margins inevitably decline. Companies all over China are doing likewise, causing China's manufacturing sector to move steadily upward. Examples of this trend can be found in one industry after another, but the development of China's auto industry provides as good an illustration as any.

In 2008, China-based assemblers expect to produce 10.0 million passenger cars, trucks and buses and to export 1.0 million units, or 10 per cent. As recently as 2000, China produced just over 2.0 million vehicles, and exports were a miniscule 27,000 units.

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In eight short years, China has become one of the largest players in the massive, technologically sophisticated, global automotive industry. Even in what many consider to be the most complicated product of all to manufacture – passenger jumbo jets – China has made the commitment to develop its own brand. In the largest and most ambitious start-up of all time, China announced in May that it has established a new company to make large passenger jets, funding the new company with registered capital of RMB 19 billion. While many hurdles need to be overcome before the first Chinese jumbo jet takes to the skies, there is no question as to China's direction. The country is in a race with developed economies to the top of the value pyramid, not with less developed countries to the bottom.

Aiming high makes sense for China's continued development. With low technology products, China can only sell its labour. Higher technology products, however, enable Chinese manufacturers to take advantage of the lower cost of Chinese engineers and equipment made in China, as well as China's lower overheads and indirect manufacturing costs. It is the reason that Chinese companies will become even more cost competitive globally as they climb the technology ladder.

China's manufacturers must move upstream for two very important reasons. First, the Chinese government no longer wants to make low technology products that pollute the environment, use increasingly scarce natural resources and abuse workers. China's new labour law, the reduction or elimination of export rebates for certain products and tougher enforcement of environmental laws are meant to discourage manufacturers that do.

“Products that were profitable to produce eight years ago when income levels were considerably lower can no longer be produced profitably”

The second and most compelling reason lies in China's economic development itself. After five years of double digit economic growth, incomes have increased across the board in China. At the beginning of this century, China was a USD 1 trillion economy with a per capita income under USD 1,000. By 2007, the country's GDP had grown to over USD 3 trillion, and average per capita incomes had increased to approximately USD 2,500.

For the approximately 400 million people who reside in China's most developed, industrialised areas, average incomes run as high as USD 7,000. Per capita incomes in major cities are even higher. Shenzhen is now almost USD 11,000; Guangzhou over USD 9,000 and Shanghai over USD 8,000. Clearly, products that were profitable for Chinese factories to produce eight years ago when income levels were considerably lower can no longer be produced profitably today.

China's economy and its manufacturing sector are in transition. As China moves on to this next stage of its economic development, the country will take its place among the most developed and industrialised economies of the world. By embracing this trend and emphasising innovation and product development, Chinese companies will move upstream and become even more formidable and cost competitive players in the global marketplace. ■

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