



BY GARY BOWERMAN AND PETER BACHMANN

# Redefining

## Made in China

A combination of rising input costs and slowing global demand are squeezing China's apparel manufacturing sector. In order to remain competitive in the midst of today's tough economic environment, manufacturers must examine their operations to optimize productivity and ensure efficiency.



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**T**he signs have been imminent for some time, but in July, comments by adidas global CEO Herbert Hainer alerted the world to the cost-based shockwaves running through China's manufacturing heartlands.

"China produces about 50 percent of our shoes. This will change in the future as salaries in China become too high," Hainer said in an interview with German magazine *Wirtschaftswoche*. "We have entered an agreement with one supplier in India

so far. We will jointly open production facilities there. Other countries such as Laos, Cambodia and Vietnam are also on our list." Hainer added that some of adidas' production in China may also shift back to Eastern Europe and Russia.

Chinese manufacturing is being driven towards a crossroads by an appreciating RMB, increasing energy prices and the spreading ramifications of the global financial crisis. Systemic commercial factors are also noticeable, as well as the cyclical nature of capital investment – which in



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manufacturing industries gravitates towards low-cost, high productivity labor locations.

Small Chinese manufacturers have also been squeezed by strict implementation of China's Labor Contract Law, which places stronger emphasis on employee rights such as welfare and benefits. This has raised the cost of labor, since many private Chinese manufacturers were previously able to avoid the costs of social welfare.

These factors are already hitting China's export orders, and Hainer's comments prompted a new examination of whether adidas' avowed shift in sourcing strategy is symptomatic of a 'tipping point' for China's manufacturing economy. Is China's model based on utilizing low-cost labor for the production of cheap items for export redundant? Is the Factory of the World about to be partially dismantled?

### Examining the situation

Adidas' decision to decentralize more of its China-based production is especially surprising given the company's strong retail commitment to China. It aims to have 5,000 standalone stores nationwide by the end of 2008, up from 4,000 last year, and has set a target of 6,300 outlets by 2010. Just before the 2008 Summer Olympics, adidas opened its largest brand center store worldwide at the Village Sanlitun mall in Beijing, while Shanghai is now the location for one of the company's four global design centers. At the same time, Hainer confirmed that adidas was performing well in China, with expected sales growth of 50 percent in 2008 and a revenue target of EUR1 billion for 2010.

Away from the domestic high street, China's manufacturing regions are suffering from global

conditions. Tightening cost pressures and razor-thin margins were further highlighted in August, when Chinese media reported that "thousands of firms" in Zhejiang Province, whose economy is largely driven by privately owned export-driven manufacturing companies employing workers from across the country, have closed down or may soon be forced to do so.

The *21st Century Business Herald* newspaper also revealed in August that 60,000 – or one-fifth – of the 300,000 small- and middle-sized firms in the coastal manufacturing city of Wenzhou have closed this year. Two months later, in October, with the global financial crisis becoming more entrenched, the export situation worsened. Tens of thousands of export-based manufacturers have closed down in Guangdong Province, home to a hub of textile, apparel and home accessories manufacturing centers.

But it is not just the garment and textile industries that are coming under fire. Another manufacturing sector confronting the effects of plummeting export orders is toy production. In October, Liang Mei, vice chairman of the China Toy Association, noted, "It is the most difficult time in decades for the Chinese toy industry."

Some 3,631 Chinese toy exporters, representing over 50 percent of the industry, have ceased trading in 2008, according to Chinese Customs. Small toy producers, with sales of US\$100,000 or less, make up most of the closures – a follow-on result of the contraction of export demand in the U.S. and Europe.

Apparel exports from China to the U.S. dropped to US\$4.8 billion between January and August 2008, down 6.4 percent compared to the same period last year. Meanwhile, apparel exports to the U.S. from Vietnam during the same period grew 23 percent year-on-year, as it leapfrogged Mexico as the second-largest apparel exporter to the U.S.

Strong competition for China's textile export industry is now emerging from elsewhere across Asia. The Bangladesh Garment Manufacturers and Exporters Association recently announced plans to increase U.S. exports, from a projected US\$13 billion in 2008 to US\$25 billion by 2013. Indonesia is also eyeing a growth opportunity. Like China and India, Indonesia also has a large and growing domestic market to service and has worked to expand its overseas markets beyond a historic reliance on the U.S. and Europe.

"No one is immune to the global economic slowdown. However, Indonesia's non-commodity

# Manufacturing Competitiveness

exports [including jewelry and accessories, leather goods, textile products and footwear] for the first three quarters of 2008 are up 23.5 percent year-on-year,” said Indonesian Minister of Trade, Mari Elka Pangestu.

At the same time, the U.S. government is being pressured by textile organizations seeking to place new restrictions on clothing imports from China. The 2005 quota limit agreement, negotiated between Washington and Beijing, expires at the end of 2008 and concerns are being raised in the U.S. about a potential increase of low-cost Chinese imports.

## Combating rising costs

The upshot is “a pretty grim situation” for apparel manufacturing in China, says Paul French, retail analyst for Shanghai-based Access Asia, which works with several international clothing and retail brands. “Input prices are up with the commodities boom, energy and wage costs are up, and logistics and freight rates are rising. All these costs are built into clothing and textile prices, so margins are getting much tighter.”

Chinese export controls to squeeze out low-cost manufacturing and move up the value chain are also having an impact. “This policy was devised when business was good, and China thought that higher-end manufacturing would come in to take up the slack, so every time a t-shirt factory closed in Guangdong or Zhejiang, a Louis Vuitton factory would replace it,” says French.

China’s current manufacturing conundrum is particularly difficult, because in recent years it has developed high-quality apparel and textile production capacities – with skilled workers, fast and efficient delivery mechanisms and an ability to alter production runs and specifications on short notice. This has resulted in high-profile luxury brands like Burberry and Louis Vuitton moving production plants from Europe to China, and myriad other brands sourcing sophisticated apparel products in what was previously considered a nation of bargain-basement goods.

Also in China’s favor has been the ability to tap into its own resources of high-level fibers, says Nicolas Musy, managing director of Ch-ina, a Shanghai-based strategic project management company. “It is the world’s major producer of cashmere and silk, and operates a very large production of linen and some of the best cotton fibers in the world in Xinjiang,” says Musy. “Having

AmCham Shanghai’s 2007-2008 *China Manufacturing Competitiveness* study, published in earlier this year in collaboration with Booz & Company, noted the rising cost pressures on China’s manufacturing industry:

*“The study results indicate that rising costs in China, including labor, combined with appreciation of the renminbi, are among the factors shaping multinational manufacturers’ perception that China is losing its position as the leading low-cost platform.”*

Preliminary results of the 2008-2009 edition of the report will be released in November, and *Insight* spoke to its co-author, Ronald R. Haddock, vice president of Greater China with Booz & Company.

**Insight:** The 2007/08 China manufacturing survey said there has been “a paradigm shift regarding China as a low-cost country.” Can you elaborate?

**Ronald Haddock:** There is now a lot of uncertainty due to the financial crisis. RMB appreciation has slowed, but we believe the trend of declining manufacturing competitiveness in China could very well continue. Export-oriented companies, domestic and foreign, must unleash the latent productivity potential of manufacturing in China.

Another change that we see happening is consolidation in several markets. In October, it was announced that more than half of all toy producers have closed down. But at the same time, toy production volumes from China grew, which means the industry is consolidating on the supply side, with small firms disappearing and large manufacturers leveraging economies of scale to gain share. It is fair to assume that consolidation will also accelerate in other markets as a result of the economic downturn.

**Insight:** What are the key cost drivers in China for manufacturers?

**RH:** Labor cost and commodity inflation are the main cost drivers. Costs are going up as China becomes a more developed economy. Quality continues to improve at a rapid pace. We have seen similar transitions in manufacturing competitiveness in the past, for example in Japan. Some thirty years ago, Japanese products were perceived as cheap and unreliable. Today, “Made in Japan” is a mark of world-class quality. In China, labor costs will continue to rise as people demand higher salaries. Commodity prices are fluctuating and have soared during recent years, but many have come down in recent weeks and months. The combined effects of a slowdown with commodity inflation is difficult to measure, but it is clear that the best approach for manufacturers in China now is to boost productivity in order to minimize further erosion of manufacturing competitiveness.

**Insight:** Given this situation, how can apparel manufacturers control costs and stay competitive?

**RH:** Some very cheap products, such as sports shoes, are already being produced in large volumes in Vietnam, Bangladesh and India. There is a growing trend to select countries other than China for such manufacturing projects. But what we have also seen recently is that Vietnam’s economy is not anywhere near as stable as China’s. Vietnam has recently had double-digit inflation rates, which has created risks for companies who might otherwise seek to invest there. Given this, we would not expect to see as large a percentage of companies exit China this year for Vietnam as we did in last year’s survey.

**Insight:** How do some Chinese manufacturing companies stay more competitive than others?

**RH:** We do see differences across companies. It’s difficult to generalize that country of origin for a company makes a difference in their success. However, there are clearly differences across management teams, where those with more exposure to overseas markets, including operating manufacturing in countries other than China, tend to be much more conscious of and willing to implement best known practices in operations management. Managers who have never worked outside of China tend to have a lower degree of understanding of these best practices and operate more on instinct than based on decisions grounded in analysis of operational trade-offs and the resulting performance.

local materials gives a very strong advantage for speed, cost and quality over other low-cost countries.”

But although higher value garment manufacturing is now widespread in China, it is the mass production of cheap clothing and shoes bound for discount stores in the U.S. and Europe that has underpinned brimming order books and 24/7 production lines. But with an apparent shortage of orders, foreign brands and consumers that have become increasingly reliant on Chinese factory production are searching for other options.

Many overseas firms are casting their eyes around Asia. Nearly one in five manufacturers surveyed by AmCham Shanghai and Booz & Company for the 2007-2008 *China Manufacturing Competitiveness* study revealed concrete plans to relocate or expand China operations to other countries, with Vietnam, India and Thailand seen as the top alternatives.

Those countries are not without limitations, however. Survey respondents noted that the alternative countries lag behind China in both market potential and infrastructure. But shifting production also has other downsides, with respondents commenting on the opportunity cost of China’s huge consumer market potential,

as well as the risks involved in developing a new supply base in a new environment and financial constraints.

Vietnam, nominated by respondents planning to relocate at least some of their production outside of China as the second most attractive alternative (after India), has experienced rising levels of foreign investment and export quotas. Vietnam is viewed as being increasingly vulnerable to a global demand contraction and a falling U.S. dollar, primarily because of its slow growth in manufacturing productivity and resource efficiency. In addition, inflation is running at almost 30 percent.

Diversifying apparel manufacturing strategies away from China is clearly not risk free. Product consistency is another concern. “Anything above a low threshold of quality can’t currently be manufactured in Vietnam and the size of the country seriously limits its capacity. It also has only one main port for shipping exports,” says French. “Western brands will need to carefully manage the potential corporate social responsibility and quality control issues in [other Southeast Asian] countries.”

Another option may be to reduce the geographical remoteness of manufacturing production. A recent McKinsey & Company study stated that, “Against

**PRODUCTION PINCH:**  
Over 50 percent of China’s toy exporters have been forced to close, citing decreased demand from the U.S. and European markets.



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a backdrop of sharply rising supply chain risk, including the prospect of higher energy prices, companies are likely to take a harder look at their manufacturing and supply footprints.”

In some cases, McKinsey says, companies could “even consider localizing elements of their operations now managed in remote – including offshore – locations.” Indeed, some U.S. media reports have raised the possibility that a proportion of offshore manufacturing might return home.

French remains unconvinced, arguing that large apparel brands will continue to source manufactured goods from multiple locations, a strategy that best suits an industry historically run on narrow margins. “People are sourcing from everywhere, and that is a sensible strategy driven by cost factors. They are also realizing that you need to have a China strategy, one that does not mean having all your eggs in one basket,” he says.

### Looking ahead

Analysts agree that rising manufacturing costs in China have been on the radar for some time and should have been factored into long-term business models. But now that the effects of a global recession are spreading, both manufacturers and brands are being forced to reassess their strategies.

The prognosis isn't pretty. Economist Andy Xie spoke in Shanghai in October and warned that the combined slump in export revenues and property prices meant that, in effect, “Guangdong and Zhejiang are both now in recession.” He also added that “China's economy is headed for a big fall from the global financial crisis.” Xie predicts the RMB will stay relatively flat against the dollar for the next six months before starting to rise again. “Exports are going to be in bad shape for the next six months,” he adds.

Although China's manufacturing industry may be suffering at present and seems likely to encounter a difficult year in 2009, it remains pivotal to the economy. Some degree of government support is expected, likely in the form of cheaper financing for small- and medium-sized exporters.

Widespread, long-term manufacturing unemployment concentrated in heartland locations is not a possibility the central government will entertain.

Although some foreign-invested apparel companies are reassessing their China operations, not all companies are considering leaving. Ronald R. Haddock, vice president of Greater China with

Booz & Company and co-author of the *China Manufacturing Competitiveness* report, says that while some labor-intensive production, such as sports shoes, can easily move location within a short period of time, other production models are more entrenched. “I don't see a mass shift of manufacturing out of China,” Haddock says. “The country can become a more productive economy, and the way to stay ahead is to apply best practices.”

Haddock notes the critical influence of manufacturing investment in China. “There is a lot of capital invested here. Companies such as textile machine producers, for example, have invested considerably in production facilities and they won't close down their plants.”

But for apparel brands, keeping all, or even a substantial proportion, of their manufacturing located in China will require an evolution of strategy.

“What these companies need to do is to make sure their assets are more productive by applying operational best practices,” Haddock says. “This includes asset efficiency, optimal machine utilization and a productive workforce. These are crucial steps. If you don't make sure your machines are utilized in the best way possible, and if you don't measure defect rates, you eventually will lose money.”

Musy argues that China's vast internal geography might provide some solutions, including an accelerated domestic relocation for lower cost production. “Sizeable Chinese producers have already been moving to cheaper places in China and not just abroad for quite some years, or moving up their level of quality and service,” says Musy.

“Small Chinese manufacturers have either moved up in quality or are closing. But labor costs inland are 50 percent cheaper on average than on the coast. If logistics services improve along the Yangtze River by becoming easier and cheaper, then that would remove a main obstacle in terms of time and cost. In this way, inland China will become as competitive as Vietnam,” he adds.

The inland versus coastal China debate is not new, but the emergence of diversified approaches to manufacturing in China might bring it into sharper context.



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