

### Managing the changing face of Chinese manufacturing

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**C**hina is not looking as cheap as it used to. The renminbi (or Chinese yuan, ‘CNY’) recently reached a record high against the euro and is up around record highs against the dollar.

Historically, a weak CNY – combined with cheap labor and highly subsidized land – have been key drivers of the Chinese ‘economic miracle’ that has transformed China into the world’s workshop. However, a relatively strong renminbi, soaring labor costs per hour, and restrictions on local government’s ability to offer cheap or free land are forcing many companies to rethink their China manufacturing strategies<sup>1</sup>. A number of issues surrounding this trend, in addition to the responses companies can take, are worth considering.

China, as a manufacturing hub, offers a different value proposition than it did even five years ago. Rising costs have meant that labor-intensive textile and apparel industries, for instance, have long been shifting to new locales. Nonetheless, China increasingly offers a wider set of attractive attributes, including proximity to the world’s fastest growing consumer market, a highly adaptive supply base, increasing importance as an R&D hub, and quality infrastructure. As China moves up the value chain these factors represent considerable advantages for Chinese manufacturing that may outweigh cost inflation in some industries. Chinese operations need to be considered in light of their revised place in the global value chain, as opposed to just a low-cost location.

Scope for further cost savings within Chinese manufacturing is apparent. Operational improvements through investment in more capital-intensive equipment and improved operational processes such as Lean and Six Sigma can enhance competitiveness. Investment in capital-intensive equipment is a relatively simple, if imitable, method to increase productivity. Fully implemented Lean and Six Sigma processes could attain the significant cost savings achieved in the developed world. Yet they have proven difficult to implement in China to date, owing to cultural barriers.

1. Economist Intelligence Unit data 2005-2014, accessed Feb. 2014; 2. Rethinking China’s Globalization, KPMG (Jun. 2013); 3. China trade data shows impact of commodity price slump, Reuters (Feb. 2015); 4. China Leads Global Manufacturing Output, Euromonitor (Jan. 2012); 5. Economist Intelligence Unit data 2004-2014, accessed Feb. 2014; 6. World to gain from an innovative China, *The Business Times* (Jul. 2011); *Business China Org. Singapore*

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4x

*Increase in Chinese labor costs per hour since 2005<sup>1</sup>*

>25%

*Global industrial output from China<sup>4</sup>*

9.5%

*Average annual productivity growth over 10 years<sup>5</sup>*

1,300

*Foreign-invested R&D centers in China<sup>6</sup>*

Besides operational improvements, decreasing competitiveness presents a golden opportunity for China-based manufacturers to re-evaluate their business models. For MNCs, this depends on how important China is (or will become) as an end market. For local players, more sustainable competitive advantage will occur as they move upstream or into adjacent industries to avoid price-based competition.

Once a strategy is decided upon, acquiring a foreign player can be one vehicle for Chinese players to rapidly attain brands, technology and know-how. A recent KPMG survey of 162 Chinese CEOs found that the main objectives of outbound investment were: to become internationally competitive global companies (16% of respondents); new business lines (8.2%); and brands (4.7%)<sup>2</sup>. The key challenge is identifying, acquiring and successfully integrating targets to deliver this strategic outcome in the long term.

Regardless whether today’s lower global commodity prices are here to stay, a strong renminbi – with increasing labor and land costs – most likely is. Despite this, China’s manufacturing volumes are holding up relatively well<sup>3</sup>. While China is not as cheap as it used to be, its manufacturing proposition is changing. If managed effectively and proactively, China will remain a source for competitive advantage, albeit for new reasons.

*We help MNCs adjust their existing business and operating model focus in China, and increasingly, work with Chinese firms as they pursue outbound investments to achieve their own competitive advantages.*

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