Blue Silk Consulting
Global Supply Chains

Manufacturing Companies Move Toward Near-Sourcing

By Frank Lange

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A sustained trend of reevaluating low cost manufacturing strategies has been underway as the cost of manufacturing in China rises, forcing businesses to rethink their global sourcing strategies. Companies that once flocked to China because of its massive pool of cheap labor and attractive government incentives are now finding themselves increasingly at risk of losing the advantages that brought them to China in the first place. A number of factors are to blame: a diminishing population of low-cost workers, rising production costs, and government-controlled incentives to favored industries at the expense of those seen as less vital to China's growth.

Although China's minimum wage rates have been increasing by more than 10 to 15 percent per year according to the China Labour Bulletin, China's overall wage cost remains far lower than that of Mexico, its closest low-cost competitor. It would be logical that companies without a firm understanding of their true landed costs might look at the labor costs per hour between the two countries, which currently average $1.40 and $5.50, respectively, and determine that China is still the preferred manufacturing location. However, manufacturers have seen wage rates in Shanghai jump over 76 % between 2010 and 2013 with similar rates of increase in supporting industries like transportation and logistics. Chinese government statistics would suggest that this trend will continue as lower birth rates, a rising standard of living

and a strong focus by the government to raise wages to combat an increasing income gap continue. Moreover, the growing cost differential between China and its low-cost competitors overall — from supply chain to labor to currency to other less tangibles like regulatory costs or value-added tax (VAT) policy fluctuations — is starting to erode the China advantage.

Companies that know their true landed costs account for factors such as energy costs, currency valuation, shipping costs, transit time, and taxes and tariffs. For example, currently, energy prices in China are three times what they are in the US and are only slight lower than in Mexico. Currency valuation against the U.S. dollar (USD) is also telling. The Chinese renminbi (RMB) is expected to continue to appreciate at an annual rate of 3 to 5 percent for the next three years relative to the USD after falling slightly in 2013, while the Mexican peso continues to depreciate. Finally, trans-Pacific shippers are expected to endure increasing rate volatility over the medium term as carriers continue to struggle with capacity and low profitability. A recent study comparing variable cost components between the United States, China, India and Mexico, conducted by the financial consulting firm Alix Partners, predicts that multiple variables of the costs of production could equal costs in the United States by as early as 2015.

In Mexico, safety and stability issues do exist, but overall there's a business landscape in place that is very appealing to manufacturing companies. The country has a well-educated workforce and a maquiladora system that eliminates tariffs for products exported to the United States.

The situation continues to improve under the administration of President Enrique Nieto, which has attempted to candidly assess the economic and social issues hampering Mexico's growth and instituted a sweeping reform agenda focusing on the labor, education and telecommunication sectors. While the implementation of these reforms is not without its challenges, they have resonated positively with the media and the foreign investment community as a positive step in the right direction.

Moving manufacturing operations to Mexico would seem to have clear advantages — but only if those advantages can be fully leveraged by a particular company. A thorough and objective evaluation of environmental dynamics and company objectives can help determine if a move to a low cost country like Mexico makes sense by asking some key questions in addition to ensuring they understand their total landed costs:

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1. ***How is an increased level of agility going to impact your ability to sell more?*** If you're a garment retailer that has to shift quickly with seasonal changes and you need to be increasingly responsive to the needs of your customer base, a 40-day lead time to accommodate ocean carriage from China can be highly damaging.

2. ***How important is sustainability within your operations?*** More customers are becoming very concerned about green supply chains — they want to know where product is being sourced for both safety and environmental reasons. China doesn't have a reputation for strict environmental regulations, while Mexico has worked closely with the United States to improve environmental standards since signing NAFTA.

3. ***Do you know who your vendors and suppliers are working with at every point in the supply chain?*** If your supply chain involves multiple vendors and suppliers, then the chances are high that those partners are utilizing the services of a network of subcontractors. If those subcontractors begin to have trouble accessing electricity or sourcing raw material as is happening in China today, it could have a damaging ripple effect on your entire supply chain.

4. ***How important are intellectual property (IP) rights to your business and how much control do you believe you should have over them?*** China is notorious for disregarding IP rights, while Mexico is generally seen as being a far more stable environment.

5. ***Are you shipping controlled or protected products?*** A growing number of companies are running into more regulatory issues shipping out of China and would like to keep operations closer to home. Moving operations to Mexico may simplify this for some companies, particularly as the United States has made it very clear that they are going to start to bolster enforcement actions on products that aren't in compliance with U.S. trade requirements.

All signs point to the fact that near-sourcing to low cost alternatives like Mexico is no longer a short-lived trend, but — for the right company — is a strategic business formula that has staying power. The time is right for a reevaluation of growing alternatives to China as shifting economic dynamics present new opportunities for competitive advantage.

About the Author:

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Frank Lange is a Vice President of Blue Silk Consulting, the Principal of Alder Creek Consulting, LLC and has over 25 years of international experience in the supply chain industry, focused on Asia, Europe and Latin America. His most recent overseas posting was leading Menlo Worldwide Logistics' operations in China, based in Shanghai.

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