

# HOW LONG WILL THE EAST-WEST TRADE IMBALANCE LAST?



## There are a multitude of factors that could influence the outcome

By David Jacoby

Everyone knows there's an East-West trade imbalance, and if you don't, well, you probably haven't been paying attention. But the more pressing question is: How long is it going to last? Well, that depends on a variety of things — specifically, the fact that Asian manufacturers are now competing on higher quality as well as low cost. Here, we take a look at what that means for you.

### Manufacturers in low-cost countries becoming more and more capable

China's competitive advantage in technologically advanced manufacturing has improved dramatically between 1987 and 2005, according to a study by the University of London. Using a metric that reflects the proportion of exports of a single good compared to the exports of all goods, China's advantage has become surprisingly strong in high tech. It exported 2.2 times more high-tech goods than regular goods, as a share of world consumption in 2004.

Strategic industries in China have especially high ratings. These industries are already competitive on a global scale and capable of reliably delivering good quality in industries such as consumer electronics, office machines, computers, instruments and telecommunications equipment.

With time, today's low-cost countries will join the ranks of the developed nations. "Chinese companies will do the same thing that the Japanese did," says the executive director of a major

automotive distributor, referring to Toyota, Nissan and other Japanese carmakers' migration path in the US auto market.

### Asian governments are establishing pro-Western foreign investment institutions and frameworks

China joined the World Trade Organization (WTO) in 2002 and recently instituted labor regulations and restrictions on pollution. The bureaucrats are well aware of the importance of the impact that such legislation and institution has on its ability to attract Western manufacturers.

In fact, serving the off-shoring wave has become an industry in itself!

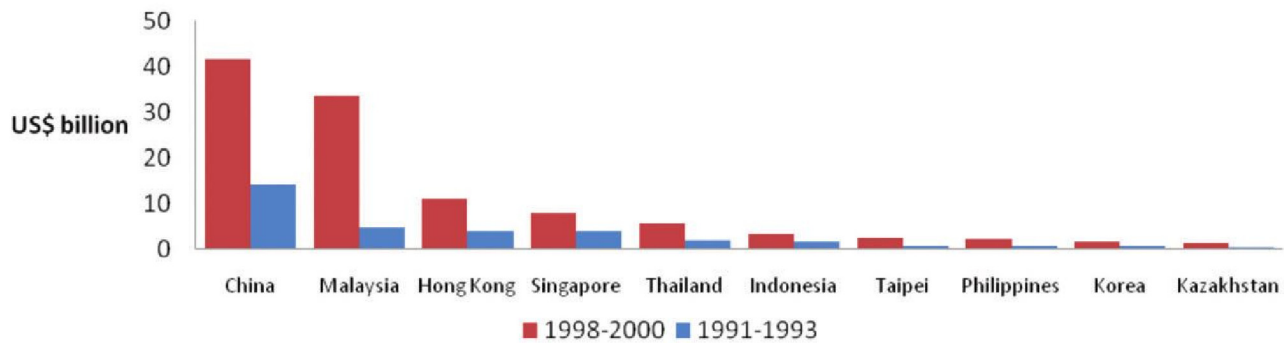
- Vietnam is working hard to foster a receptive environment for manufacturing. Its approach is to protect intellectual property rights and offer tax breaks.
- China and other nations are using joint-venture legislation to ensure that local partners acquire the intellectual property in business ventures over time.
- China is stimulating creativity amongst its youth, which includes the establishment of an advertising and graphic arts social effort. "Design is one of the most popular majors at Chinese universities today, and hundreds of design consulting firms have sprung up in Shanghai, Beijing and Guangzhou," according to *BusinessWeek*. "Design is the way companies improve their competitiveness," says a vice-president who oversees design at a major appliance maker.

These policies seem to be working. Asian countries are receiving billions of dollars of foreign direct investment, and China tops the list of total inflows of foreign direct investment.

### Asian logistics infrastructure is getting even better

Many of the developing countries are making massive investments in both physical infrastructure and intellectual and

## TOP 10 DESTINATIONS FOR FOREIGN DIRECT INVESTMENT (FDI) IN DEVELOPING ASIA



Source: Boston Logistics analysis of UNCTAD data

human capital. Some examples capture the extent to which these countries are building physical infrastructure:

- The Chinese government has built a \$4.2 billion rail line between Beijing and Lhasa.
- Taiwan has built a \$15 billion high-speed line between Taipei and Kaohsiung
- India is investing over a billion dollars in airports in Bangalore, Mumbai, Delhi and Hyderabad

### Should US manufacturers and logistics providers invest in infrastructure based on the continued growth of Asian imports?

The shift toward Asia has long-term implications for staffing, logistical design, and infrastructure investment. Everybody — absolutely everybody — has a stake in the ultimate answer.

- Western manufacturers, surviving mostly on thinner margins, have been busy defining a growth strategy that can succeed in the face of competition from low-cost sources. Boston Logistics' fifth annual State of Supply Chain study explored service, technology and pricing strategies that can help them differentiate from low-cost competition (the full study can be requested at [www.bostonlogistics.com](http://www.bostonlogistics.com)).
- West Coast states, as well as regional consortia and public-private partnerships, have committed over \$7.7 billion to fund infrastructure and freight mobility between now and 2020, and Tacoma plans to quadruple container capacity by then.
- The Panama Canal is investing in a \$5+ billion expansion to serve burgeoning Asia-US and Asia-Europe traffic — and increasingly, global trade in general.
- Ocean carriers took vessels out of other trade lanes and deployed them to Asia to the Trans-Pacific over the last decade; many of them are now reviewing these vessel deployments in light of decreased West Coast volume connected with a devalued US dollar, decreasing margins on the trade connected with higher bunker fuel prices and opportunities to redeploy them in the booming intra-Asia and Asia-Europe trades.
- US shippers have invested in distribution networks built on the assumption of continued growth of eastbound import volume through the West Coast.
- Rail and intermodal operators have invested in equipment, infrastructure, information systems and de-bottlenecking to increase eastbound throughput to handle surge of the Asian imports.

### Five factors will impact China's future competitiveness, and shippers and carriers should consider them when making operations and infrastructure plans

Supply chain planners should consider the potential impact of five variables that could affect China's advantage as a low-cost country source moving forward. These include:

- Chinese labor cost inflation
- Devaluation of the US dollar
- Increasing shipping costs
- Dual sourcing
- Environmental regulations

### China's rising labor cost will divert imports to other regions

The main reason attributed to China's growing share in the global markets is that it can produce goods at relatively lower cost than its competitors due to lower wages. The average Chinese wage is three to four times lower in China than in the Latin American countries.

However, rising wages have started to change how companies operate in China. US corporations and their suppliers are starting to rethink where to locate facilities, whether deeper into the interior (where salaries and land values are smaller), or even farther afield, to lower-cost countries such as Vietnam or Indonesia. Already, higher labor costs are beginning to price some manufacturers out of more developed Chinese cities such as Shanghai and Suzhou. "There is a break point where people will say this is too expensive," says a general manager at the Suzhou plant of an American manufacturing company.

Already, Boston Logistics sees companies taking an active interest in sourcing from other Asian countries, Latin America and Eastern Europe as alternatives to China. The list of newcomers includes Mexico, Brazil, Costa Rica and the Philippines, just to name a few.

### Exchange rate changes are tempering the benefits of off-shoring to American companies and making US exports to Europe more competitive.

Over last three years, the dollar has devalued by 12% against the Euro and 13% against the Chinese Yuan. This has helped US manufacturers' export competitiveness and dampened the thirst for off-shoring. Conversely, Europe's export competi-





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tiveness has been challenged by a rising Euro. If the US dollar continues to depreciate against the Chinese yuan, this could begin to tilt the balance in favor of sourcing from domestic US companies.

**Higher fuel costs are driving freight rates higher and profitability lower**

Fuel cost has increased by 15%, and steel cost has increased dramatically over the last several years, both of which have affected ocean shipping rates. If current trends continue, the cost of shipping could begin to make Chinese goods less attractive to American and Western importers. "The delta is no longer as advantageous," observes the Supply Chain Manager for an US importer.

**More companies are dual-sourcing to ensure continuity of supply**  
9/11 caused many companies to design resilient supply chains that would survive a terrorist attack. This led to the use of deliberate redundancy in the form of dual-sourcing — using suppliers on both sides of the Pacific instead of being dependent on an overseas supply line. The dockworkers' strike in 2002 reinforced the use of multiple ports to safeguard supply in the face of possible port shutdowns, and the memory of that strike was recently reawakened with the threat of an ILWU strike. Dual-sourcing dampens the economic effect of off-shoring.

**Asian environmental and social regulations are increasing off-shore costs**

Several regulatory and social changes that are underway are increasing the cost of off-shored goods and services.

Environmental concerns and regulatory measures could increase Asian costs and reduce the gap.

If China and other nations take air pollution more seriously, the "free ride" that manufacturers are currently getting may end up costing money. That money would further reduce the differential between Chinese and Western delivered costs. Whether it comes from factories or from transportation, pollution controls could affect the overall competitiveness of Chinese goods.

One interviewee living in China adds "a CO<sub>2</sub> emissions and future introductions of emission quotas may become significant. I don't believe shipping things back and forth across the world will be feasible in the long run. Sooner or later reality will catch up with us, and I wouldn't be surprised if in the future there will be a reversal in trends, with some manufacturing being moved back to the West."

All parties in the supply chain need to understand the economics of the Asian Sourcing Boom (the subject of another one of Boston Logistics' annual studies) in order to make wise plans and investments. Our infrastructure adequacy, cost-competitiveness and supply continuity depend on an accurate reading of these tea leaves.

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