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Strategies of Chinese manufacturing enterprises and sourcing businesses in the face of the global financial crisis

Executive Summary

China is regarded as one of the most important sourcing centers in the world given its abundant skilled but cheap labor, thousands of vibrant industrial clusters, political stability, relatively well-developed infrastructure, etc. However, the financial tsunami in September 2008 marked the start of a difficult period for Chinese manufacturers: The financial tsunami has dragged down the global economy, which in turn has led to contraction in global trade. China's manufacturers have been facing significant drop in export orders from their foreign customers. Added to the poor business is the liquidity crunch: Banks have become unwilling to lend and the capital strain has threatened the survival of manufacturers; The rise of protectionism across the globe makes the business environment even tougher. Production suspension and factories closures within China have thus become commonplace.

Strategies for the Chinese manufacturing enterprises to cope with the financial crisis

- Cost reduction
- Diversifying export markets and at the same time developing the domestic market
- Industrial upgrade and transformation
- Taking full advantage of government policies which aim at reinvigorating the economy and helping the enterprises

Implications for sourcing business

- China remains a favourable place for sourcing
- Supplier management has become increasingly important
- Green sourcing is gaining wide attention
- Outsourcing the sourcing functions has become a more popular trend
- "Selling to China" now makes China sourcing even more appealing

I. Introduction

China is deemed one of the most important sourcing centers in the world given its abundant but cheap skilled labor, thousands of vibrant industrial clusters, political stability, relatively well-developed infrastructure, etc. However, the financial tsunami in September 2008 marked the start of a difficult period for Chinese manufacturers.

The financial tsunami has dragged down the global economy, which in turn has led to contraction in global trade. Many countries across the globe are sufferers and China is no exception. China's export fell by 21.3% yoy in the first three quarters of 2009, reflecting that China's manufacturers have been facing significant drop in export orders from their foreign customers.

On the other hand, the liquidity crunch problem has been compounded by banks' unwillingness to lend. Since bank loans are manufacturers' major source of credit¹, the capital strain brought about by the financial crisis has threatened the survival of enterprises. Besides, protectionism has been on the rise across the globe, as governments of most countries now find themselves under huge political pressures to save jobs through protecting domestic industries from import competition. Production suspension and factories closures are therefore commonplace.

In this paper, we will first look at various strategies adopted by the Chinese manufacturing enterprises to cope with the financial tsunami. We will then analyze the implications for sourcing businesses in China in the face of global financial crisis.

II. Strategies of the Chinese manufacturing enterprises to cope with the financial crisis

The deterioration of the macroeconomic environment has led to profit squeeze for many enterprises. As mentioned above, some of them even had to suspend production or shut down. Even for those enterprises which have survived the credit crunch, they are still struggling to cope with the challenging business environment. According to the survey conducted by the Chinese Manufacturers' Association of Hong Kong (CMA) in April 2009², most of their members operating in the Pearl River Delta (PRD) chose cost reduction (94.0%) as the main strategy to overcome current difficulties. Other major strategies include strengthening marketing (89.2%), improving product designs (74.1%) and upgrading technologies and equipment (57.8%).

¹ According to the International Chamber of Commerce (ICC), around 90% of the US\$ 13.6 trillion in world merchandise trade was funded by trade finance. See *Trade Finance in the Current Financial Crisis: Preliminary Assessment of Key Issues*, The International Chamber of Commerce, November 2008.

² The Chinese Manufacturers' Association of Hong Kong (CMA), *2009 Survey on CMA Members' Operation in the PRD*, April 2009. The respondents are Hong Kong manufacturers operating in the PRD.

1. Cost reduction

Owing to the weakening global demand, China's export orders from foreign buyers have contracted dramatically. Buyers now tend to place smaller orders and sign short-term contracts in a more frequent manner, trying to avoid the risk of holding excessive inventories. Many manufacturers who own many production lines in the Chinese Mainland have to partially idle their production capacity or temporarily suspend production as well as to lay off workforce to cut costs. In addition, because of the drop in commodities prices, manufacturers tend to request their suppliers to reduce the prices for raw materials. Other cost cutting approaches include Business Process Reengineering (BPR) and outsourcing production processes.

Take Lenovo as an example. Lenovo announced in January 2009 a resource redeployment plan to help boost the company's efficiency and competitiveness in the face of the global economic slowdown. The company expected to reduce the number of its employees by 2,500 worldwide during the first quarter in 2009, approximately 11% of its total workforce. Management and executive were also included. The company would also cut expenses in departments such as finance, human resources, and marketing. Moreover, Lenovo also plans to reduce executive compensation by 30-50%, including salary adjustment, long-term incentives and performance bonus for this year. ³

2. Diversifying export markets and developing the China market

The EU, the US and Japan are China's top three trading partners. Since most Chinese-made products are mainly exported to these advanced economies which have been hit hard by the financial tsunami, their economic downturn and weakening demand has led to steep decline in export orders for the Chinese manufacturers. To cope with this, export-oriented manufacturers in China have been diversifying their export markets and exploring new markets.

Despite the dwindling exports to the advanced economies, China's exports to the emerging markets such as the Middle East, Africa, Latin America and ASEAN have actually increased. For example, according to Guangzhou Customs, Guangdong exported 1.1 billion pairs of shoes during January-April 2009, up 6.1% yoy. The export value of shoes for this period reached USD 3.1 billion, grew by 0.6% yoy. The export value to Latin America and Africa climbed by 47.2% yoy and 83.7% yoy respectively; and the export value to the Middle East and ASEAN markets even surged 1.1 times and 1.9 times. According to Shantou Customs, Shantou's toy exports to ASEAN countries accounted for USD 15.2 million during January-February 2009, up sharply by 140% yoy.

³ <http://www.lenovo.com/news/us/en/2009/01/Redeployment.html>

The city Yiwu is famous for its largest small commodities⁴ wholesale market in China. Many international organizations, including the United Nations Refugee Agency (UNRA), are also attracted and set up sourcing centers in Yiwu. According to statistics of Administration for Industry & Commerce of Yiwu, the total transaction volume of commodities reached 49.2 billion yuan in 2008, up by 6.8% yoy. According to the people in the industry, the reason for the increase despite the weakening global demand was market diversification. In 2008, exports from small commodities wholesale markets in Yiwu to the EU increased by 22.3% yoy; while exports to Latin America and ASEAN markets grew by 29% yoy and 25.4% yoy respectively.

Apart from diversifying the export markets, an increasing number of enterprises are also eyeing the China market. A population of over 1.3 billion people in China represents huge purchasing power. China has achieved tremendous economic success since the economic reform and opening up 30 years ago: the average income of the Chinese people is on continual rise and the living standard is also constantly improving. However, the Chinese consumers do not have access to many of the high quality yet price competitive Chinese-made products. The reason is that these products were produced by export-oriented manufacturers who do not have immediate access to the domestic market due to various institutional and regulatory constraints such as taxation. Nevertheless, changes are taking place. Now the Chinese manufacturers are more eager than ever to develop the domestic market.

From the view of the enterprises, China's market has great potential. In May 2009, Li & Fung Research Centre paid a visit to the Guangzhou Nantian International Hotel Facility Trading Centre⁵ and Shunde Furniture wholesale market in Guangdong province. Their businesses, as observed, had not been seriously affected by the global financial crisis as their products were mainly sold in the domestic market. By contrast, their counterparts who were export-oriented have confronted great challenges posed by the global slowdown and export contraction. The Chinese apparel sector is another example. The export value of the export-oriented apparel enterprises above designated size⁶ during January-May 2009 shrank by 8.2% yoy. By contrast, the trade value of the apparel enterprises above designated size engaging in domestic trade still kept a steady growth of 9.4% yoy during the same period⁷.

In fact, many Chinese export-oriented enterprises did not actively explore the domestic market in the past when the export market was still flourishing and the domestic market not well-developed. Besides, there are huge differences between domestic and foreign trade in terms of method of payment, mode of operation, business registration and the applicable regulations, etc., barring these enterprises from exploring domestic trade (see exhibit 1 for more information). However, increasing efforts have now been made by Chinese exporters to tap into the home market.

⁴ Generally, small commodities are those light consumerables including stationery, hardware, etc.

⁵ The Guangzhou Nantian International Hotel Facility Trading Centre is the largest hotel supplies wholesale market in China.

⁶ All state-owned enterprises and those non-state-owned enterprises with annual sales revenues over 5 million yuan.

⁷ Speech at "Joint Launch Conference of Sustainability Reports of Chinese Textile and Apparel Enterprises", Du Yuzhou, Chairman of China National Textile And Apparel Council (CNTAC), June 2009

Exhibit 1: Engaging in domestic trade vs. foreign trade

	Domestic Trade	Foreign Trade
Order Volume	Smaller order volume, but orders are generally placed in a more frequent manner	Larger order volume
Method of payment	Case by case for each manufacturer. Usually late payments by the buyers/customers.	Using letters of credit which are internationally accepted. Buyers usually pay deposit in advance and pay in full upon delivery of products.
Operation	Buyers require manufacturers to produce the products first, and they usually determine the order volume after examining the products. It increases risks such as excessive inventory to manufacturers.	Buyers provide manufacturers with designs and other technical requirements when placing orders.
Marketing & Aftersale services	Buyers require manufacturers to work together for better sales performance, by asking them to take part in the promotion and advertising activities which involves manpower and financial resources.	Manufacturers are not involved in such aspects as marketing and aftersale services.

Source: Compiled by Li & Fung Research Centre

The American Chamber of Commerce in South China⁸ conducted a survey in 2009 and found that 72.5% of respondents⁹ said that their main objective was to provide goods or services to the China market, up from 46% in 2006. The above-mentioned CMA's survey in 2009¹⁰ also demonstrated that the importance of the China market to Hong Kong-owned enterprises was escalating. Over half of the respondents (53.6%) have business operations in Chinese Mainland in 2009, up from 44.0% in eight years ago. The China market accounted for 15.5% of their business, up from 10.3% when compared eight years ago.

⁸ The American Chamber of Commerce in South China, *2009 Special Report on the State of Business in South China*, 2 March 2009

⁹ The respondents of the survey are companies (mainly US companies) that set up their headquarters or main offices in South China.

¹⁰ CMA, *2009 Survey on CMA Members' Operation in the PRD*, April 2009

Let's have a look at Yiwu again. The small commodities wholesale market implements a series of policies and measures to develop domestic market apart from diversifying their markets overseas. Examples include setting up showrooms in Heilongjiang, Sichuan and Xinjiang displaying Yiwu's small commodities. Indeed, great efforts have been made by many enterprises to reduce their reliance on traditional export markets and diversify their market structure through developing new markets facing the financial crisis.

3. Industrial upgrade and transformation

The Chinese government sees industrial upgrade as a strategic step to push forward economic restructuring and have launched an array of policies to promote industrial upgrade and transformation. As for the manufacturers, they also realized that the golden era of low value-added production had come to an end. Even before the financial tsunami, China's manufacturing sector has already been hit hard by factors like processing trade policy change, renminbi (RMB) appreciation, promulgation of Labor Contract Law and production cost hikes. All these had pushed these processing trade enterprises, which work on the low value-added part of the international supply chain, to their limits. For instance, the profit margin of some manufacturers in the PRD was largely slashed. Some production was even forced to suspend or close down. Most enterprises in the PRD opted for improving the technology, promoting the value-added of products, upgrading the production plants and equipments and reducing current scale of business in the PRD as their major strategies to cope with the deteriorating business environment.

Since the second half of 2008, the business environment was even worse due to the financial crisis. In the first half of 2008 or earlier, the number of orders did not reduce even though the production costs were soaring. Yet, weakening global demand since 2H08 had led to a collapse in orders. At the same time, buyers also want to cut the purchasing costs further amid the global downturn. Facing the above challenges, processing trade manufacturers engaging in low value-added production are difficult to survive. The above-mentioned CMA's survey revealed that amid the financial tsunami, nearly three quarters of the respondents had improved product quality and modified the product mix to meet current market needs. Moreover, nearly 60% of the respondents stated that they would upgrade their production technology and equipment to cope with the tough business environment (see exhibit 2).¹¹

¹¹ CMA, 2009 Survey on CMA Members' Operation in the PRD, April 2009

Exhibit 2: Strategies to cope with the global recession - industrial upgrade and transformation

Strategies adopted	% of respondents
Improving product quality and modifying the product mix to meet the market needs	74.1%
- To develop more new products	53.6%
- To develop high-end products	41.0%
- To produce lower price products	16.3%
Upgrading production technology and equipment	57.8%

Source: 2009 Survey on CMA Members' Operation in the PRD, The Chinese Manufacturers' Association of Hong Kong, April 2009

Facing external shocks, enterprises who are still engaging in low value-added production will be at higher risks of closures since they are less competitive. Most toy makers in Dongguan, a prefecture-level city in Guangdong, are Original Equipment Manufacturers (OEMs), which hardly innovate and improve designs of their products. Their products are in general of low value-added and without much differentiation. Huangpu Customs' statistics showed that toy export in Dongguan during January-August 2009 was down by 19.8% yoy.

Toy makers in Shantou, which is also situated in Guangdong, head for a different direction - innovation. They have introduced new technologies and developed a large number of new products in response to the market demand for high value-added products. Additionally, many large toy manufacturers have established toy laboratories for safety tests to meet the increasingly stringent safety requirements set by overseas buyers. In fact, after years of development, Shantou has developed a competitive industrial cluster to provide various parts or accessories for toys (except some core components with highly advanced technology). This kind of industrial cluster not only reduces the purchasing costs for toy accessories, but also lowers the total production cost, as well as enhancing the competitiveness of Shantou's toy production. During January-April 2009, Shantou has enjoyed a total toy exports of USD 136 million, representing a growth rate of 49.0% yoy, 18.1 percentage points more than the yoy growth rate of year 2008.

BYD Company Limited (BYD) is another case in point. It is a Chinese company that produced rechargeable batteries at the beginning and then stepped into the automobile business. BYD has long placed much emphasis on the advancement of technology and promotion of quality. The company applied their leading technology of battery manufacturing on their research and development (R&D) of environmental friendly electric automobiles. The products have so much potential that they even attract attention of international investors: Warren Edward Buffett, one of the world's most-renowned investors, acquired a 10% of BYD's equity interest in 2008 in view of BYD's potential.

As the financial crisis develops, protectionism has been on the rise across the globe. One of the mostly used measures is to raise technical and environment protection requirements for imported goods, which are more price-competitive, in order to protect domestic industries. Facing the rising tide of protectionism, manufacturing sector in China should enhance product quality, including promoting technological advancement and safety standards of the products, so as to add value to the products, increase the profit margin as well as overcoming the trade barriers.

4. Taking full advantage of government policies to reinvigorate the economy

On 9 November 2008, the State Council announced to implement a massive fiscal stimulus package for 2009-2010 to boost domestic demand. The total investment amounts to 4 trillion yuan, roughly 13.3% of China's annual GDP in 2008 (see exhibit 3 for details).

Exhibit 3: The breakdown of the 4 trillion yuan fiscal stimulus package

Breakdown	billion yuan
Investment in infrastructure such as railways, expressways and energy	1,500
Post-earthquake reconstruction	1,000
Investment in low-rent housing	400
Investment in rural infrastructure such as water and electricity	370
Fiscal incentives for industrial upgrade and R&D	370
Spending on environmental protection and waste treatment	210
Spending on healthcare, education and cultural development	150
Subtotal	4,000

Source: National Development and Reform Commission (NDRC), PRC

In response to the marked drop in industrial production growth, the State Council announced rejuvenating programs for ten “pillar industries”. The ten industries identified were steel, auto, textile, heavy machinery, shipbuilding, petrochemicals, light industry, non-ferrous metals, electronics information and logistics. The key takeaways of the rejuvenating programs are summarized in exhibit 4.

Exhibit 4: Key takeaways of the rejuvenating programs for ten pillar industries

1. Supporting industrial upgrade and development of domestic brands; setting up special funds or granting interest subsidies for promoting R&D, innovation and quality improvement;
2. Granting tax breaks to relieve cost burdens on enterprises. Examples include increasing export VAT rebate rates, granting tax breaks for buying equipment or for importing certain raw materials and parts that cannot be purchased in China, etc;
3. Supporting mergers and acquisitions within the industry, in particular, supporting major players to acquire enterprises in difficulties;
4. Encouraging processing enterprises to relocate from the eastern part of China to the central and western regions; positioning the coastal region as a production base of high value-added, high quality products;
5. Granting credits to enterprises in financial difficulties; improving credit guarantee and financing services especially for small- and medium-sized enterprises;
6. Accelerating the phasing out of backward production capacity; preventing overproduction and strictly controlling the increase in supply;
7. Encouraging enterprises to sell to the domestic market. Stimulating domestic consumption through providing consumer credits or subsidies, and through developing the rural market.

Source: Compiled by Li & Fung Research Centre

Such programs are believed to provide financial support for the Chinese enterprises that are affected by the global recession. It can also help them develop the domestic market as well as speeding up industrial upgrade. For instance, Zhejiang province-based Zhejiang Geely Holding Group Co., Ltd announced that, thanks to the rejuvenating program for auto, the automobile sales of its subsidiaries in March 2009 climbed nearly 15.9% yoy or 29.4% mom to reach 24,089 units, breaking the record made in January 2009.

In view of the hard-hit enterprises engaging in imports and exports, the General Administration of Customs of the PRC introduced a bunch of policies in November 2008 to support these enterprises. Examples include facilitating customs clearance, granting policy and law support, promoting the development of special customs supervision zones, facilitating the transformation and upgrade of processing trade, strengthening statistics monitoring and enhancing protection of intellectual property rights for domestic enterprises.

On 27 May 2009, the State Council also unveiled a series of measures to support the export sector. Some of the measures announced were already in place. Among the new measures unveiled, particularly noteworthy is the initiative to bolster export demand through lending money to overseas buyers. Exhibit 5 gives you more information on the measures.

These supportive measures may look contradicting when tightening policies of the processing trade was still the top concern of the export-oriented manufacturers before the outbreak of subprime. However, we should bear in mind that the Chinese government still sees discouraging low value-added processing trade yet encouraging industrial upgrade and transformation as a strategic step to push forward economic restructuring and achieve balanced growth of different regions. Therefore, these supportive measures should be regarded as short term measures rather than long term ones.

Exhibit 5: The list of measures to support export sector

1. To improve export credit insurance policy and its coverage; To reduce premium rates; To provide USD 84 billion liability guarantee for short-term export credit insurance to trading enterprises in 2009; To improve the risk compensation mechanism for export credit insurance;
2. To improve export tax policy; To support the export of labor-intensive products and high-tech products; To curb the export of energy-intensive products, resource-intensive products, and highly-polluting products;
3. To resolve enterprises' difficulties in raising funds; To provide better financing access and expand credit guarantee for enterprises; To speed up the implementation of the pilot program for using RMB for cross-border trade settlement¹²; To maintain the stability of RMB exchange rate;
4. To relieve cost burden on export-oriented enterprises; To review fees and charges on enterprises; To halt arbitrary fee collection;
5. To improve processing trade policy; To facilitate domestic sales of products produced by processing trade enterprises, through simplifying customs procedures and improving taxation policies;
6. To support outward investments by Chinese enterprises in a bid to boost export demand; To provide USD 10 billion preferential credit for overseas enterprises to buy Chinese products in 2009.

Source: State Council, PRC

¹² The pilot program for using RMB for cross-border trade settlement was launched on 6 July 2009.

The sound development of the small- and medium-sized enterprises (SMEs) is deemed critical for maintaining economic growth and social stability especially amid the financial crisis. On 22 September 2009, the State Council unveiled a series of measures to support the development of SMEs.¹³ Below is a list of the major measures:

Exhibit 6: The list of major measures to support SMEs

1. To grant tax breaks for SMEs: Starting from the year 2010, for low-profit enterprises with annual taxable income below 30,000 yuan, their taxable income will be halved, while the 20% corporate income tax rate will continue to apply;
2. To strengthen financial services for SMEs: To encourage private capital to participate in the reform of rural cooperatives and the establishment of rural banks and loan companies, in order to give small businesses more financing options. The central government will also cover part of the bad loans banks incurred from lending to SMEs to encourage lenders to boost their small business credit;
3. To strengthen training of staff of SMEs, through fostering training institutions to serve the needs of SMEs, increasing financial support, enhancing the use of internet channels, etc; To offer training to managerial staff of one million selected enterprises over the next three years;
4. To set up special funds for SMEs to promote R&D, industrial upgrading and generate employment; To halt arbitrary fee collection;
5. To improve the business environment and legal framework for SMEs; To relax the market entry requirements; To extend the effective period of the measures announced previously for relieving cost burdens on enterprises;
6. To resolve SMEs' financing difficulties by such means as setting up special funds for risk compensation and accelerating the development of the Growth Enterprise Market for SMEs to raise funds in the stock market;
7. To increase funding to support SMEs for technological advancement; To support SMEs to develop producer services including R&D and industrial design, and new industries such as software development industry and online entertainment industry;
8. To select a batch of SMEs to participate in the rural subsidy program for home appliances, agricultural machinery and automobiles as well as the subsidy program for replacements of home appliances and automobiles; To improve export tax policies such as the export VAT rebate policy, to help SMEs to develop overseas market;
9. To provide better services for SMEs: By nurturing various types of organizations serving the needs of SMEs, building a platform for public services and developing an information network for SMEs; To simplify the administrative procedures for SMEs.

Source: State Council, PRC

¹³ http://www.gov.cn/zwggk/2009-09/22/content_1423510.htm

Apart from the measures introduced by the central government, local governments are also trying their best to help enterprises get through the difficult time. Take Guangdong province as an example. The PRD region in the province is largely affected by global recession due to its highly open economy and heavy reliance on exports. At the beginning of the financial tsunami, the export performance of Guangdong was worse than the national exports: The total export value of Guangdong was USD 24.2 billion in January 2009, posting a yoy decrease of 23.6%, a steeper decline than that of the whole country (17.5%). In fact, most of the factories in the PRD are Hong Kong-, Macau- and Taiwan-owned. Therefore, Guangdong announced 30 measures (as of 1 March 2009) to help these enterprises cope with the financial crisis and promote the industrial upgrade and transformation (see exhibit 7).

Exhibit 7: Supportive measures for enterprises promulgated by the Guangdong government

Policy Area	Supportive measures
a. Strengthening financial support	1. Strengthening support for processing trade enterprises to transform and upgrade
	2. Strengthening support for distribution sector
	3. Strengthening support for enterprises for energy saving
b. Alleviating financial burden for enterprises	4. Reducing or waiving fees and charges
	5. Tax concessions
	6. Relieving the social insurance burden for enterprises
c. Simplifying administrative procedures	7. Simplifying procedures for processing trade enterprises to transform and relocate
	8. Simplifying procedures for the enterprises to do outward processing
	9. Simplifying procedures for processing trade to sell the bonded goods in the domestic market
	10. Simplifying procedures for Hong Kong- or Macau-owned enterprises to invest in commercial and retail sectors
	11. Simplifying procedures for investment in food and pharmaceutical industries
	12. Streamlining procedures for settlement of foreign exchange
	13. Streamlining procedures for export VAT rebate
d. Encouraging innovation	14. Reinforcing the construction of platform for innovation
	15. Reinforcing the service for intellectual property rights protection
	16. Encouraging and supporting enterprises to upgrade their technology
	17. Encouraging and supporting enterprises to develop R&D
e. Improving financial services	18. Encouraging financial institutions to increase credits

19. Promoting direct debt financing instruments
20. Encouraging financial institutions to provide innovative services
21. Encouraging financial institutions to expand export credit business
22. Strengthening financial cooperation among Guangdong, Hong Kong and Macau
- f. Ensuring water, power and gas supply
 23. Boosting capacity of power supply
 24. Boosting capacity of gas supply
 25. Expediting the price reforms of water and electricity
- g. Strengthening employment service
 26. Assisting laid-off workers in reemployment
 27. Enhancing manpower training for the workforce of the enterprises
- h. Creating a favorable business environment
 28. Strengthening intellectual property rights protection
 29. Establishing a comprehensive credit system for enterprises
- i. Actively striving for policy support from the central government
 30. Seeking further policy support from the central government for Hong Kong-, Macau- and Taiwan-owned enterprises in developing processing trade and innovation; and guaranteeing the supply of refined oil, etc.

Source: Hong Kong and Macau Affairs Office of Guangdong Province

As mentioned earlier, many enterprises, especially export-oriented enterprises, wish to develop the domestic market. It was difficult for these enterprises to engage in domestic trade before the financial crisis. However, as the export sector is going downhill, enterprises had been conveying their wish of developing domestic trade to the government through various channels. As a matter of fact, if the export-oriented enterprises manage to sell to domestic consumers, it will not only relieve the burden of the enterprises, but also stimulate domestic consumption. Minister of the Ministry of Commerce, Chen deming, had promised in March 2009 that actions would be taken to facilitate the transformation of Hong Kong-owned processing trade enterprises to foreign-invested enterprises (FIEs)¹⁴ so that they could enjoy autonomy in domestic sales.

¹⁴ To enjoy autonomy in domestic sales, enterprises engaging in processing/ assembly operations and compensatory trade (TFPs) have to transform their registrations into foreign-invested enterprises (FIEs). In general, FIEs are eligible to import and export their goods, and trade their finished goods in the domestic market. In the past, the procedure of transformation was long and costly.

On the other hand, Guangdong also works very hard to support the enterprises in exploring the domestic market. In 2008, as a pilot scheme, Dongguan enterprises were allowed to sell the goods in the domestic market before paying tariffs and value-added tax¹⁵. This policy has been expanded to other areas of Guangdong province in 2009. In this way, reputable Hong Kong-owned enterprises in Guangdong with good track record are allowed to pay the tariffs and value-added tax after the goods are sold in the domestic market. Under the new arrangement, enterprises can develop the China market so as to offset the loss of business due to the sharp fall in exports.

III. Implications for sourcing business

1. China remains a favourable place for sourcing

China has one of the most competitive manufacturing bases in the world. Amid the global downturn, consumers cut back on spending and trade down on purchases ranging from daily groceries to automobiles. They prefer cheaper products with better quality. China as a well-established production base is capable of producing price-competitive products of relatively good quality in large quantity in a short period of time. The quality of Chinese-made products is also constantly upgrading facing the tightening safety and environmental-friendly requirements set by overseas markets. Furthermore, many Chinese manufacturers are increasing their R&D spending on products. Therefore, it is expected that more innovative products and Chinese brand names will emerge in the future and China will continue to be a favourable place for sourcing.

For instance, according to the Adidas Group, China continued to be its largest sourcing country in 2008. 36% of its apparel and 44% of shoes were sourced in China in 2008. Branded hardware products relied even more on China: 65% of this category including balls and bags were sourced in China last year. As for Li & Fung Limited, one of the largest global supply chain management companies, China remains its most important sourcing market. In 2008, 52% of its global sourcing was from China, up from 48% in 2007.

2. Supplier management is increasingly important

China's manufacturing sector has been hit hard by factors like processing trade policy changes, production costs hikes, etc since 2007. Cases of closures were observed. After the outbreak of the financial crisis, more and more enterprises went bankrupt or closed down. It is now more difficult for buyers to ensure the reliability of suppliers. On the other hand, suppliers are also very cautious in selecting clients (buyers), fearing that they will be affected if their clients are suffered from capital strain.

¹⁵ Before the implementation of the pilot scheme, TFPs engaging in export processing must obtain prior approval from the foreign trade department at provincial level if they want to sell their finished products domestically. Upon approval, they have to clear all the tariffs and value-added tax (VAT) payable at Customs before they sell in China. Any violations would be viewed as smuggling.

Maintaining good and interdependent relationship is undoubtedly important for both buyers and suppliers. To strengthen their relationship, buyers should have a good understanding of the suppliers' operation and keep in touch with the suppliers at all levels. Moreover, buyers should share market trend and information such as change in consumer preferences with the suppliers.

3. Green sourcing is gaining attention

Global warming tops the agenda of many countries. Carbon emissions, renewable energy and new materials are commonly discussed issues concerning environmental protection. As for sourcing enterprises, customers' concern over green issues makes them practise green sourcing. Green sourcing can be practised through using environmental friendly raw materials, packaging, transportation as well as energy savings in daily operation.

Green sourcing brings benefits to enterprises in many ways. First, production costs and social costs (less pollution and exploitation of resources) can be brought down and revenue can be boosted through energy savings and emission reduction during the production process. The environmental friendly products can easily enter the overseas markets with environment-related trade barriers. Besides, it can also contribute to a better public image and reputation of the enterprises.

4. The trend of outsourcing the sourcing function has emerged

In order to compete efficiently in today's globally competitive business environment, outsourcing business processes is one of the options. By outsourcing non-core functions to professionals providing quality services, enterprises can focus on their core competences. Sourcing is one of the business processes to be outsourced. For instance, retailers in the US could focus more on product design and development, selling and marketing after outsourcing their sourcing functions to professional sourcing firms. These professional sourcing firms, working on a large number of sourcing deals, could achieve economies of scale and reduce the sourcing costs. Profit margin is improved due to cost reduction in sourcing. The overall competitiveness of both the retailer and the sourcing firm is therefore enhanced.

Amid the financial crisis, enterprises have an even stronger drive to reduce costs and strengthen their core businesses. Outsourcing the sourcing functions is becoming more popular. For example, the American apparel brand Mexx entered into an outsourcing deal with Li & Fung Limited in the latter half of 2008. Mexx can focus on its core business activities such as retailing and marketing while Li & Fung Limited provides responsive and professional sourcing service for the brand.

5. To source and sell in China makes China sourcing even more appealing

China has witnessed remarkable economic growth since the economic reform in the late 1970s. Chinese people's income increases a lot and the consumer market has been growing rapidly. According to the National Bureau of Statistics (NBS), the urban households disposable income per capita was 15,781 yuan in 2008, up by 8.4% yoy in real terms; while per capita net income of rural household was 4,761 yuan in 2008, grew by 8.0% yoy in real terms. China's total retail sales of consumer goods reached 10,848.8 billion yuan in 2008, with a nominal yoy growth of 21.6% (see exhibit 8). The compound annual growth rate for the last five years is 16.2%. Facing the global recession, the retail market in China is still relatively robust when compared to the sluggish retail market in the US and the EU. The total retail sales of consumer goods of China in the first eight months of 2009 was 7876.3 billion yuan, representing a nominal yoy growth of 15.1%.

Exhibit 8: Total retail sales of consumer goods, 1999-2008



Source: National Bureau of Statistics (NBS)

Seeing the huge potential of the Chinese consumer market, many buyers who originally source in China and sell in overseas markets are now paying attention to the China market. According to the 2009 White Paper on the State of American Business in China¹⁶, 63% of their member companies (US companies in China) indicated that they are in China to produce or source goods and services domestically for the Chinese market, rather than for export. The figure represents a significant increase from 51% in 2008, indicating the companies are more interested in the maturing Chinese consumer market. Since the foreign retail markets are experiencing weakening demand, enterprises who produce and source in China could regard the Chinese consumer market as a way out for their products.

On the other hand, some export-oriented buyers want to tap into China's lucrative consumer market but often found it difficult as many of their suppliers in China are processing trade enterprises with no domestic selling right. However, this situation is improving as, amid the financial crisis, the central and local governments are now encouraging these factories to transform to FIEs with domestic selling right. Therefore, increasing presence of Chinese suppliers with domestic selling right is expected. This could no doubt help buyers and retailers to develop the China market.

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¹⁶ The American Chamber of Commerce in the People's Republic of China (AmCham-China), *2009 White Paper on the State of American Business in China*, May 2009