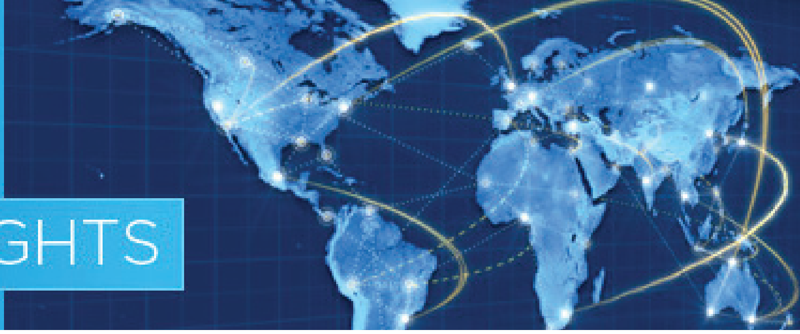
FIFTH THIRD BANK



INTERNATIONAL INSIGHTS

Shifting Manufacturing Trends Require Producers To Reassess Global Strategies

When companies decide where to establish manufacturing facilities, a variety of factors typically are considered. These include the availability of skilled workers, productivity levels, the quality of local infrastructure, political stability, rule of law, market size, proximity to key markets, the ability to repatriate profits, and labor costs.

Based on these factors, the United States, which has the world's 14th highest hourly manufacturing compensation costs[1], remains a major destination of the world's foreign direct investment (FDI). In fact, each year over the last decade—with the exception of 2003 and 2005 when China and the United Kingdom received slightly more—the United States was the world's top FDI destination.[2] And nearly 40 percent was directed into manufacturing.[3]

Offshoring Has a Long History

But when inexpensive labor is vital, typically in the production of labor intensive, low-tech products that are relatively difficult to automate, companies have tended to offshore the manufacturing activities to the next low cost country. This trend, which began with the advent of industrialization, observed low-tech production moving from Britain to the U.S., then to Japan, South Korea, Taiwan, and more recently to China and other developing countries.

For years, for example, Germany established access to low-wage workers in Spain and Yugoslavia. Plus, under its Guest Worker Program, Germany allowed the immigration of foreigners in exchange for low-paying jobs.

Almost immediately after the fall of the Berlin Wall, Western European producers gained access to inexpensive and well-educated labor in Poland, Czechoslovakia, Hungary and, to a lesser extent, former East Germany. The rapid increase in former East German currency valuation artificially raised wages, and in turn, the country became a less attractive manufacturing destination.

Years prior, Japan took advantage of inexpensive labor in South Korea, and eventually established production facilities in Singapore, Thailand, Malaysia, the Philippines, China and, and Vietnam.

But the history of offshoring, as well as the temporary immigration of foreign workers, goes back even farther. Beginning with World War II, Mexican workers were invited to the United States to harvest crops under the Bracero program. And, as early as 1965, U.S. manufacturers had established relatively easy access to inexpensive Mexican labor under various programs that enabled U.S. firms to co-produce in Mexico, and then ship goods back to the United States incurring very low duties. Although the North American Free Trade Agreement provided significant benefits when it took effect on January 1, 1994, American companies already had become very familiar with the Mexican landscape.

China, however, stands out today for a number of reasons. In the 1980s, the Middle Kingdom began manufacturing on behalf of an increasing number of American and European manufacturers. But on December 11, 2001, after 15 years of negotiations, China officially became the 143rd member of the World Trade Organization. This changed China forever.

Almost immediately, China's manufacturing attractiveness greatly improved. As part of its accession agreement, the Middle Kingdom committed to a fairly extensive trade liberalization and reform schedule. Since then, it has significantly opened its markets, slashed import tariffs, eliminated import licenses and quotas, and relaxed ownership restrictions.

Now fast forward to 2009: wherein China surpassed the United States in manufacturing value-added output.[4] Yet, moving forward, China may no longer be the attractive manufacturing location it once was.

The Rise of Backshoring

For the last several years, Chinese labor rates have increased 17 to 18 percent annually. And combined with a slow appreciation of China's currency, employment costs could rise by 20 to 25 percent per year, according to InterChina Consulting, a strategy and mergers and acquisition advisory firm with offices around the world. In addition, China is projected to incur a skills deficit, further driving up labor costs.

But that's not all. The risks associated with Chinese intellectual property theft remain a concern. And China's commercial land costs have risen considerably. Plus, anticipated rises in fuel costs and expenses related to global supply chain logistics and long distance management, as well as capital outlays associated with longer lead times, larger inventories, and duties, further reduce China's manufacturing advantage.

With the understanding that wage differentials with developed countries are shrinking, the Chinese government is encouraging manufacturers of lower-technology goods to relocate further inland, where the labor is more abundant and a variety of production-related costs are lower. In the short-term, however, the skill levels in rural areas present problems and inadequate transportation infrastructure likely will restrain this trend.

Consequently, for American firms producing in China primarily for the U.S. market, as opposed to the Chinese or other Asian markets, it may make sense to backshore or return previously offshored lower-tech manufacturing to the United States. And for U.S. producers interested in moving lower technology production abroad for the first time, it's worth reconsidering the math, and reevaluating global production, sourcing, and supply chain strategies.

Many agree. In fact, the Boston Consulting Group, a business management firm, says by about 2015, when the wage gap shrinks to a tipping point between China and low cost American states, such as Mississippi, South Carolina, Tennessee and Alabama, the U.S. will experience a "manufacturing renaissance." In turn, the production of goods that require less labor and are churned out in modest volumes, such as auto parts, household appliances and construction equipment, most likely will shift back to the U.S. More labor intensive goods produced in high volumes, such as textiles, apparel and TVs, will continue to be made abroad, Boston Consulting says.

In addition, lower-cost countries, like Mexico—assuming it can gain control of its drug war—and those in Central America, likely will benefit due to their proximity to the United States. And utilizing Mexico as a manufacturing location also eliminates the reliance on congested American ports, and significantly reduces transportation time relative to China.

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Footnotes
1. U.S. Bureau of Labor Statistics., 2. United Nations Conference on Trade and Development., 3. Organization for International Investment., 4. United Nations Conference on Trade and Development.