Outsourcing to China not so cheap anymore

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The China Price used to be the global standard for low-cost manufacturing. It shut thousands of factories across North America, put tens of thousands of Canadians out of work and drove down the price of consumer goods around the world.

Now China's cost advantage is being eroded by soaring oil prices, rising wages and an appreciating currency. Canadian companies that outsource their manufacturing to China are already feeling the pinch and some are even bringing production closer to home.

Could globalization be reversed in an era of high oil? What would that mean for Canadian companies that have come to depend on the China Price?

Levon Afeyan flew to China this week to find out the answer to these questions for his mid-size Montreal company. He's the president of Seatply Products Inc., a manufacturer of molded plywood for use in commercial seating.

About half of Seatply's products originate in China and Malaysia and he's becoming increasingly uneasy about soaring freight costs that have seen the price of a shipping a standard container from China hit as much as $6,000 from $4,000 a year ago.

"People are taking a second look at everything because the costs are becoming prohibitive," said Afeyan, whose company's efforts to cut costs through lean manufacturing techniques were featured in The Gazette in 2006. "It goes right to the bottom line."

On his trip, Afeyan will try to get price concessions from his Asian suppliers to help cover his rocketing freight costs. But he's not expecting an easy time because his suppliers have their own problems and want to raise prices.

Inflation has already risen 8 per cent this year in China and the government just lowered subsidies on gasoline, resulting in an increase of roughly 20 per cent at the pump. Meanwhile, the Chinese currency has jumped about 17 per cent against the U.S. dollar, making exports more expensive.

And wages are rising fast. Depending on the industry and skill-level, wages are up by 10 to 25 per cent a year and labour shortages have developed in some regions.

CIBC World Markets economists, who predict oil is heading to $200 U.S. a barrel, believe the cost of maintaining a supply chain that reaches to the other side of the world is outstripping the benefits for many North American sectors.

"In a world of triple-digit oil prices, distance costs money," CIBC economists Jeff Rubin and Benjamin Tal wrote in a report at the end of May. "Soaring transport costs suggest trade should be both dampened and diverted as markets seek shorter, and hence, less costly supply lines."

Rubin and Tal note there remains a huge differential between Chinese and North American wage rates but have found evidence that companies are already looking for production closer to home in capital-intensive manufacturing such as steel where there's a high ratio of freight costs to final selling prices.

"Furniture, apparel, footwear, metal manufacturing and industrial machinery -- all typical Chinese exports, incur relatively high transport costs."

The CIBC economists expect Mexico with its maquiladora plants along the U.S. border to be a prime beneficiary of the high freight phenomenon as companies seek low-wage centres closer to home.

Competition Pools Inc. has already moved a third of its production of pool accessories and fixtures from China to a new plant in Mirabel.

The rising price of shipping, along with lower tax credits on exports and rising Chinese currency, is making it uneconomical to move bulky products like pool filters from China, said Mario Lampron, co-founder of Competition, a firm that ships pool products to 40 countries.

"Importers and distributors will have to relocate their supply chain," Lampron said. "It's already happening."

Myer Deitcher of Montreal steel trading firm Novosteel North America said his firm has imported more than 50,000 tonnes of steel product from China in some years, but freight costs have almost doubled, making foreign steel too expensive to import.

Jayson Myers, president of Canadian Manufacturers and Exporters, said the cost of producing goods in China has risen 30 to 40 per cent for many Canadian companies over the last couple of years.

"A lot of Canadian manufacturers are going to have to reassess their outsourcing strategies," Myers said. "What we may be seeing for some industries and companies is a contraction of supply chains back to North America."

But Myers added many companies will just have to find ways of absorbing the cost increases because they have no immediate alternative to Asian factories. That's a bitter pill to swallow at a time when raw material prices are also soaring and the economy is slowing.

"There's been a rapid swing in prices around the world," he said. "When you're a business, you can't move that quickly."

Other economists cautioned that the impact of higher costs in China will slow, but not stop, the outsourcing trend for mass production goods although some companies are moving to even lower wage countries in the region, notably Vietnam.

"People might rethink their plans for outsourcing, but I don't think were at the point of reversing the outsourcing phenomenon," National Bank Financial economist Stéfane Marion said. "The foot is coming off the accelerator."

Yuen Pau Woo, president of the Asia Pacific Foundation of Canada, said there was a slowdown in the torrid pace of Asian shipments to North America last year and 2008 may be the year when there is a decline.

But he doesn't foresee a large scale return of outsourced manufacturing to Canada and the U.S., noting investments and expertise in such industries as consumer electronics will not be easily displaced.

"The infrastructure and production networks in Asia are well established and represent a significant investment that will not be dismantled in a hurry."

Indeed, China received almost $83 billion U.S. in foreign industrial investment last year, tops in the world.

It's not clear that companies now outsourcing to Asia will want to make investments to ramp up manufacturing capacity in North America in response to what may turn out be short-term factors, Woo said.

But rising costs in China will give a push to manufacturers in North America who make advanced, high-value goods that require rapid product cycles or have a high design or marketing requirement, he said.

The way ahead for Canadian manufacturers looks difficult. After investing time, money and effort on building networks in China, the rising price of oil and higher costs may force another round on tough decisions.

Levon Afeyan of Seatply said: "It's hurting but we don't know how far the pain is going to go."

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