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## **Sourcing in China**

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**Abstract.** This paper will be ask the question: Is it worthwhile to source inputs, as well as finished manufactured products, in China? The objective of this study is to examine a Europe Company in the telecommunication industry that had set up a localization project headed by a global sourcing director. The telecommunication industry is a high-tech and frequently changing industry that illustrate the current localization process in China. Finally, we illustrate the current investment opportunities to foreign investors and potential chance in western development in China.

**Keywords.** Sourcing, Localization, China.

**JEL.** M10, M11.

### **1. Introduction**

“**O**ne Belt, One Road” created to open new routes for commercial exchange between China and Europe. That will help China redefine the rules of international direct investment in its favor (TIME, 2015).

If you go to supermarkets, you can find that many articles, especially large and small home electrical appliances, garments, small machine tools, foods, telecom items and more, are made in China but the manufacturers’ name are western companies such as General Electric, Phillips and many overseas and China telecommunication industry giants such as Alcatel, Siemens, Sony, Samsung, Zhong Xing, Ju Long, Hwa Wai, Da Tang are facing a severe battle of cutting down the cost in their network establishment in order to win market share. Network establishment refers to the telecommunication parts and finished goods such as cables, fiber and radio base station (RBS). In order to win, they have applied modern logistics and management theories: for instance, Just In Time (JIT), Vendor Management Inventory (VMI), localization, outsourcing, decentralization and so on. Products localization – parts, semi-finished goods or finished goods – is a main step to move their (foreign-invested enterprises) targeted supplying base to China. Many multinational companies source from China for parts, semi-finished goods and finished goods. The following are their general plans:

- i. To close overseas (e.g. Europe, U.S.) factories but to re-open in China – cost savings.
- ii. To keep some last manufacturing steps to make sure global quality standard – brand management.
- iii. To sell certain percentage of their finished goods in China – and the rest will be shipped to their overseas targeted markets – earn profit globally.

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They have changed their strategic plan to build their plants in China to make what they need to fit overseas and local markets. The objective of this study is to examine a

Europe Company in the telecommunication industry that had set up a localization project headed by a global sourcing director. Dean (2007) predicted that the earth will have only two manufacturing bases in future – India and China. The two countries have many similar strengths: for example, huge populations, low labor costs and huge land supplies.

The paper is organized as follows. Section 2 reviews the literatures. Section 3 examines localization process in China. Section 4 describes the reactions from foreign-invested enterprises. Section 5 provide the conclusion.

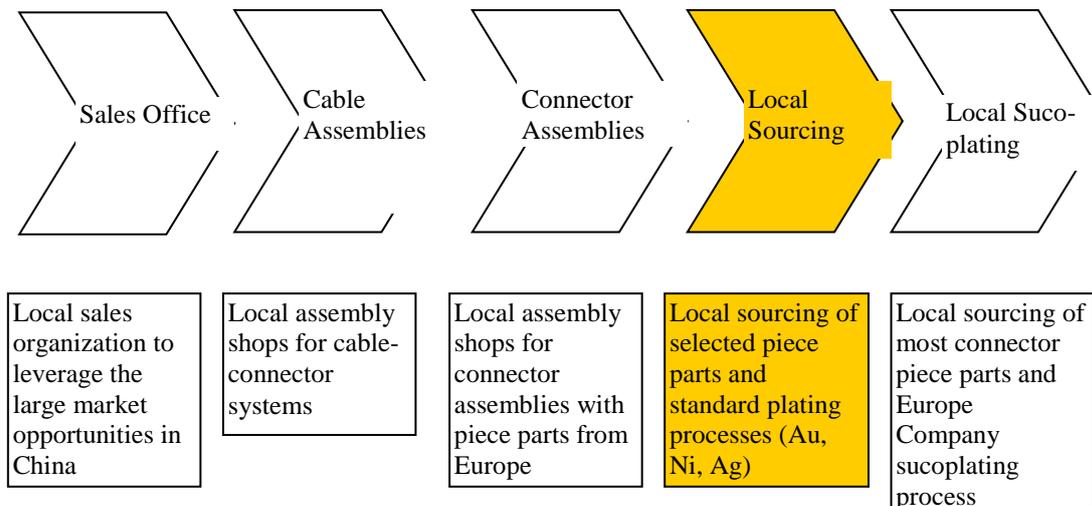
### 2. Literature Review

Cantwell and Zhang (2013) show that foreign-owned multinational corporations' recent propensity for open network structures has enabled subsidiaries in China to develop technological capabilities by searching diversified inter-organizational knowledge sources beyond the geographically local context to compensate for internal limitations and deficiencies of their host environment. Xu (2011) found that China's trade and foreign direct investment (FDI) policies lead to different forms of internationalization: ordinary exports, processing exports, majority FDI, and minority FDI. Both exporting and FDI stimulate process innovation; ordinary exports, processing exports, and FDI have strong, weak, and no effects on stimulating product innovation, respectively. Exporting firms source technologies both internally through R&D and externally from foreign and domestic sources. FDI firms have a lower tendency of internal of technology development and domestic technology sourcing, but much higher tendency of foreign technology sourcing than exporting firms. Towers and Song (2010) revealed that there has been an increasing trend of retailers sourcing their garments from China. This growing trend has been further influenced by the removal of national and regional tariff and trade quota restrictions, such as the multi fiber agreements in 2005 that have opened up the global textile and apparel market. The challenges in the near future can be explored based on some reasonable assumptions: (1) challenges with high grades (highly challenging) are disadvantages for sourcing from China, some of which may still exist in the near future, although others may develop and improve; (2) challenges with low grades (low challenging) are advantages for sourcing from China. Fang et al. (2010) found that sourcing in china is becoming both cost- and strategy-driven. Companies purely chasing the cheapest production would most probably consider leaving China, whereas companies with a long-term strategic intent and a high level of business ethic and corporate social responsibility practices will retain all or most of their sourcing activities on the Chinese soil despite the rising costs. Sartor (2006) attempt to underline the country-specific factors linked to the creation of an International Purchasing Office (IPO) in China. They have seen that the IPO can carry out numerous activities: quality control, transfer of know-how and technology, the search for new supplier and negotiations with them, managerial/ organization/ administrative tasks, the management of the different transport modalities, and the management of contacts with logistics carriers. Wilkinson et al. (2005) found that human resource (HR) barrier to partnership sourcing is corruption. While many firms were aware that under table deals were going on, exposing and proving their existence in order to be take disciplinary action was commonly reported as extremely difficult.

### 3. Localization process in China

In 1979, the army strongman Mr. Deng Xiao Ping announced that China had to open to the World after getting the absolute power and he also decided to set four Economic Special Zones (ESZ) along the southern seacoast mainly in Canton province. His idea was to utilize these four ESZ as the windows to absorb foreign investments and to let partial populations become rich to improve their living environment. In 1986, the State Council, the highest governing body of China, issued the Regulations on Encouraging Foreign Investment (namely the “Twenty Provisions”), to grant preferential policy to foreign investors investing in advanced technological and export-oriented industrial projects. Due to these regulations, foreign investment input their money in the secondary industry started to grow to a large proportion of the total. In 1992, China set to open financial, insurance and commercial sectors to foreign investors on a trial basis. In the southeastern and coastal regions, foreign trade is a very important sector in providing employment opportunities. The manufacturing industry is the priority for foreign direct investment (FDI) in China. Furthermore, foreign investment in capital and technology intensive enterprises is also on the rise. For example, Shanghai GM, Chongqing BP Chemicals and Ericsson group had contributed to the upgrading of the technology and structures of China’s related industries. In October 2001, Ericsson opened a branch factory in Chongqing (see Appendix) in Sichuan province. A Europe Company was the global first tier supplier of Ericsson, their China person-in-charge announced to increase their local source amount in China up to RMB 10.00 billion per annum they had set up a localization project headed by a global sourcing director. The Europe Company is a leading global supplier of components and systems for electrical and optical connectivity in communications, industrial and transportation markets. The Europe Company opened a contractual harness shop for cable assembly in Shenzhen and a whole owned foreign-invested enterprise in Shanghai to serve their buyers. Besides, they decided to build a plating line in Shanghai as well due to some formulas cannot disclose to third party. They should find some spare parts suppliers in China to make goods locally in order to reduce inventory level and to make cost down to offset the price reduction pressure from the giants in telecommunication market. The following diagram is their localization project.

As part of the market entry strategy localization would lead to a local supply base for turned parts in China.



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First and foremost, there should have push and pull reason which mainly due to business depression. Sales and orders reflected adverse business conditions. Europe Company can see that sales were very weak in Americas and are growing in Asia. They need a clear target to go. Corporate purchasing focuses on five strategic goals: 1. achieve cost savings; 2. reduce stocks of purchased materials and goods; 3. drive localization for connector piece parts in China; 4. roll-out e-procurement application; 5. enhance group-wide procurement network. The management of seven key dimensions drive successfully the transformation to strategic procurement.



Assessment of leadership practices in procurement	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <th colspan="2" style="padding: 2px;">Management of seven key dimension of strategic procurement</th> </tr> <tr> <td style="width: 50%; padding: 2px;">1. Strategy</td> <td style="width: 50%; padding: 2px;">4. Supply base management</td> </tr> <tr> <td style="padding: 2px;">2. Organization</td> <td style="padding: 2px;">5. Day-to-day purchasing</td> </tr> <tr> <td style="padding: 2px;">3. Strategic sourcing process</td> <td style="padding: 2px;">6. Performance management</td> </tr> <tr> <td></td> <td style="padding: 2px;">7. Information management</td> </tr> </table>	Management of seven key dimension of strategic procurement		1. Strategy	4. Supply base management	2. Organization	5. Day-to-day purchasing	3. Strategic sourcing process	6. Performance management		7. Information management
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Afterward, the Europe Company targeted vendors, initial visiting, analysis, schedule and so on. Europe Company found a Taiwanese implant that has state of the art Computerized Numerical Control (CNC) and Came machines for body parts. Europe Company think that standard plating can be subcontracted in China. But sourcing of parts at a large scope would require a decision upon an own sucoplating operation.

- i. Plating operations for Silver (Ag), Nichel (Ni) and Gold (Au) seem to be available in China.
- ii. Piece parts sourced in China might be plated locally.
- iii. Many piece parts would require Europe Company sucoplating.
- iv. Sucoplating is a clear core competence of Europe Company.
- v. Subcontracting of sucoplating in China would be no strategic option.
- vi. Europe Company would have to decide upon an own sucoplating operation in China.
- vii. Otherwise localization would lead to significant logistic costs.

Localization of piece parts has to support local content as well as local pricing requirements.

- i. The project team agreed to set the target sourcing prices for piece parts at a level of about 60% to 70% of the European prices.
- ii. The price level would be established through request of quotations with a limited number of pre-qualified suppliers.
- iii. Main cost drivers of a relatively capital intensive piece part production may not necessarily benefit China.
- iv. Raw materials may be locally sourced but at global commodity price level.
- v. Europe Company's high quality standards require state of the art Computerized Numerical Control (CNC) machines with global prices.
- vi. Semi-automated machines may take advantage of low labor costs.
- vii. Suppliers would have to invest in additional state of the art equipment at international prices.
- viii. Costs for labor and shop floor space are very low.

ix. Utility costs are still high.

The localization would cover the following phases and would take two to three years. Europe Company need to identify and select potential supplier firstly; second, Europe Company visits pre-selected supplier and assess technology; third, Europe Company place sample order and approve quality of piece parts; fourth, Europe Company establish commercial supplier relationship; fifth, Europe Company kick off series production; finally, Europe Company carry out second sourcing wave. Like anything else in life, the first phrase is the hardest. Europe Company choose just one or two components for sourcing. These parts should be carefully selected according to the following criteria:

- i. Pick a part where a price reduction would have major impact.
- ii. Pick a part that is mature and has been in production for some time.
- iii. Pick a part that is now being successfully produced by a domestic suppliers.

Europe Company need to submit the drawings and estimated annual usage and quality concerns to the Chinese factory. Also, Europe Company need to submit multiple samples, if possible, so that each of the Chinese factories under consideration can work with a sample.

#### **4. Reactions from foreign-invested enterprises**

China has become the procurement base for many multinational giants. All of them also set up their factories to make what they want. The main benefit is to low their cost to increase their market penetration. Furthermore, we discuss why foreign-invested enterprises want to buy from overseas – low cost, market competition, and speed are the main factors to decide a company can survive. In order to fit the new economic conditions in China, multinationals have comprehensively adjusted their development strategies in China towards diversified investment and all-round competition. Main contents include to restructure their investment in manufacturing industry and make China “a factory catering to the world’s demand”. China’s market became more difficult than before and many products have become oversupplied. However, there is still space for investment in some raw materials and spares and fittings projects. In fact, some multinationals are not satisfied with the performance of their investment projects in China. They are adjusting and rectifying the existing projects, have slowed the investment in ordinary manufacturing project, and would increase purchases rather than invest in already oversupplied projects. Some multinationals have even shifted their production to China. Toshiba Company of Japan had begun to produce digital and wide-screen color TV sets in China through the joint venture of Dalian Toshiba Television Co., Ltd. More than that, multinationals are also busy constructing spares and fittings production and purchasing networks in China. As globalization of the world’s economy accelerates, together with China’s World Trade Organization entry, many multinationals have taken China as an important production, processing and source base. To open research and development centers in China and make China a regional R&D center. A lot of multinationals find that the Chinese market bears many unique characteristics, and Chinese consumers have unique consumption demands. Without the aid of R&D centers, manufacturing sector projects would lack competitiveness. To energetically invest in the knowledge-intensive service sector and make China their operations and management center. Multinationals have demanded entry into China’s knowledge-intensive service market. With the opening of the service sector, multinationals are very likely to shift their operation and management functions to China, and the country is very likely to become a management and operations center of multinationals in the North Asian area, or even in the Asian and Pacific region. To

adjust the way of investment and start purchasing and annexing local Chinese enterprises. Most projects foreign investors launch in China were either sole foreign capital firms or joint ventures with Chinese partners. This kind of investment must go through land use, construction of factory building and installation of equipment procedures, which take a long time to complete. But, on the other hand, the shelf life of products in information age is very short and the speed of replacement is very fast. Then the problem of investment risks occur and some foreign investors resort to the method of purchasing and annexing, now prevailing abroad. Many foreign-invested enterprises have shown great interest in privately owned enterprises. It is because they find the private enterprises are subject to standard management and have advanced technology and equipment, and the most satisfactory fact is that they follow the market-oriented operation mechanism, which is the step with that of the multinationals. To increase the investment in high-tech industries. Multinationals are paying increasing attention to the development of high and new technology and have made them a main means to sharpen their competitive edge. All signs indicate that multinationals have begun their third round of investment in China as well as a new round of economic co-operation. The country's new round of economic growth will present a platform for multinationals to vie with each other. To participate in China's new round of economic growth is "in fact" to join in the competition of multinationals in China. Localization of human resources is the most fundamental needs currently. A former chairman in Alcatel China Ltd. used to say: "once a Chinese employee had been found to be competent in doing the same job would be told to leave" and he went back to France later. Every foreign employee in Alcatel in China has a task – to train Chinese employee who seem capable of replacing him/her. Motorola had committed to increase its Chinese employee to 10,000, raise the proportion of local managers to 80%, and provide 27,000 training programs for local employees every year in which 170 courses oriented at localization would be offered. In a word, localization of human resources including appointment of Chinese chief executive officers (CEO) has become a secret weapon for multinationals that want to succeed in the China market.

### 5. Conclusion

Sourcing in China is worth but how to maintain good relation with suppliers and different governmental departments is an "arts". How do we make the first step in China? We need to have detailed planning, cautious progress, and retreat all investments immediately if something cannot control. The factor of making profit by taking advantage of the foreign investment utilization system, market and preferential policies will gradually fade away. Before 1998, there were many benefits for Chinese enterprises to use foreign investment, such as change of operating mechanisms, greater autonomy in income distribution and pricing, raising capital, and making profit by taking advantage of existing traditional systems and administrative consumption and investment. In particular, the differential in preferential policies was able to generate huge profit margins. These factors would gradually fade away and some have already disappeared. The foreign investment in the manufacturing sector may decrease. Market competition and technological upgrading in China have reduced the possibilities for making money by taking advantage of the system difference and market space. As a result, newly arrived foreign investors find it difficult to capture a market share and make profits. In the manufacture sector, the local industries are already in severe competition and there is no room for foreign investors to invest massively in these industries. Furthermore, the manufacturing industry has gradually become aware of seeking

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development potential from the capital markets at home and abroad. The foreign investment in the form of intellectual property is limited and domestic enterprises prefer to raise capital on the capital market. Whether or not to enter the domestic and international capital market for financing has already become a vital factor to affect the development of enterprises. Chinese enterprises do not need foreign direct investment, equipment investment or even import of technology. The service industry is the main area for foreign investment, but the scale is also limited. Accordingly, profitability will drop quickly and thus the investors will be cautious before going ahead. Small and medium size foreign investments will face strategic adjustment. Foreign-invested enterprises set factory in China hope to save costs, give good service to customers, focus on China market, and follow their main customer to build factory to provide just in time (JIT) service. For instance, a Europe Company ( a leading global supplier of components and systems for electrical and optical connectivity in communications, industrial and transportation markets) set their factory in Shanghai due to Ericsson compelled them to make it and Europe Company would lose business if they denied following.

Foreign-invested enterprises got their expectation to certain extent but not 100%. It is because they faced a plenty of issues in processing their investment in China at the initial especially to deal with governmental officers. Moreover, they had been asked for some unexpected requests from somebody which costed a lot of times and money. Foreign-invested enterprises think that the cost was reduced and profit increased but not up to their forecast. Foreign-invested enterprises spent a lot of time to train China workers but the outcome was not so outstanding. A lot of local regulations, a plenty of requests from local government after they set up factory such as donation to improve green belt in that area. They would give sometimes but not every time. They know the local regulations are illegal if compare to central government law but they will not question in order to avoid any problems in future. Everybody knows it is a big problem because customs regulations are huge, complicated and, they do not know who have authority to give approval.

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