



# China: Top Global Supply Chain Partner

As it expands its presence and influence around the world, China is becoming a major participant in international commerce and a preeminent partner in the global supply chain.

Amita Jhangiani and Carl Stocking

**G**o to any conference or meeting among companies anywhere in the world and a question will soon arise: “What’s your China strategy?” Another prominent phrase heard along corporate corridors these days is “supply chain management.” Here, again, China is playing a prominent role, both as a supplier and, increasingly, as an end user. As it expands its presence and influence around the world, China is becoming a major participant in international commerce and a preeminent partner in the global supply chain. It is also establishing itself as a prototype for emerging markets worldwide, which, following China’s leadership, seek the economic benefits of active participation in the global marketplace.

### Trading giant

China has already achieved great economic success in a short time. Especially over the past decade, the country has grown explosively primarily because of the rapid expansion of international trade and the migration of manufacturing (mainly, but not only, from the rest of Asia) to China. As a result, China’s importance in the global supply chain has grown tremendously.

According to the US Department of Commerce and the International Trade Commission, US-China trade increased nearly fivefold from 1995 to 2005, rising from \$57.5 billion to \$285.3 billion, as did China’s global trade, which jumped from \$280.9 billion to \$1.4 trillion during the same period. According to the Yale Center for the Study of Globalization, China is currently the world’s third-largest trading nation and the fourth-largest export market for US goods; its ratio of imports to GDP was 30 percent in 2005, twice that of the United States and three times that of Japan.

Its overall economic prospects are just as remarkable. Citigroup expects the world’s largest emerging market economy to post GDP growth of 7.5 percent per year over the medium term. In the next 20 years, the Cato Institute forecasts that China could surpass Japan as the world’s second-largest trading nation and could emerge as the world’s biggest economy between 2020 and 2030.

### The global supply chain

To succeed in the global marketplace, China—and all economies around the world—must engage in cross-border

collaboration on an unparalleled scale. The primary instrument for this cooperation is the global supply chain. Technology has equalized the world of commerce to such an extent that the smallest sub-assembler in an emerging market economy has the same speed-of-light access to financial and market data and identical entrée to cost-effective sources of liquidity as the world's largest companies. The resultant transparency benefits participants across the global supply chain by mitigating risk, improving efficiency, and generally facilitating the cross-border flow of goods and services.

In recent years, most companies have seen the emergence of two supply chains in their organizations: the physical chain, which encompasses the entire procurement process (i.e., ordering, manufacturing, shipping, logistics, and distribution), and the financial chain, which includes purchase order finance, pre- and post-shipment finance, supplier finance, forfeiting, receivables purchasing, channel finance, and distribution finance. The two chains have developed at separate rates. Sophisticated technology drives the physical supply chain at every step, whereas the financial supply chain remains largely tradition-bound, relying, for example, on historically popular labor-intensive payment methods like letters of credit. But as these intra-company supply chain organizations develop on their separate paths, companies are realizing that these internal "silos" are causing issues: trade partners are caught in the middle, and bottlenecks in internal protocols have a negative impact on external processes, to name just two examples.

Fortunately, global market forces are diminishing the physical/financial supply chain dichotomy within companies. Because the extremely competitive marketplace places a high premium on operating efficiencies, leading to a more streamlined management of the financial supply chain, the physical and financial supply chains are increasingly being pressured to perform in sync.

### Renminbi Draft Discounting Programs

A major challenge for foreign trading companies in China is obtaining tightly controlled and expensive renminbi (RMB) financing. RMB draft discounting programs provide cheaper, faster, and more efficient financing than RMB loans. Under these programs, buyers pay sellers with endorsable drafts that are presented to banks for immediate, discounted payment. Funds can be obtained in as little as one day thanks to clear laws, minimal documentary requirements, and simple processes.

China's RMB draft discounting market is huge; Shanghai alone accounted for \$21 billion in outstanding funds as of June 2006. For foreign companies seeking trade finance in the China market, RMB draft discounting programs offer an obvious, solid solution.

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As China's prominent role in the global marketplace continues to grow—and with it the responsibilities of World Trade Organization membership—the thousands of exporters and importers operating there will benefit from the dynamic transformation of the global supply chain. Chinese importers, like their counterparts around the world, will view their supply chains as premier corporate assets. By being "vertically aware" of their supply chain partners—conscious of and alert to their suppliers' financial conditions, for example—Chinese importers will improve visibility throughout the purchasing cycle and reduce risk.

Chinese suppliers and vendors will also benefit from the growing importance of the global supply chain. Because of technological advances on a global scale, they will have financial information about importers, pre- and post-shipment funding sources, and competitive intelligence to a degree previously unavailable to them. This improved end-to-end transparency likewise leads to more efficient risk management.

### Getting started

Companies considering importing and exporting to and from China should keep a number of points in mind.

China regulates its foreign exchange flows tightly via the State Administration of Foreign Exchange (SAFE). Foreign exchange flows related to import and export trade, as well as any form of trade-based import or export financing and repayments, are required to follow specific SAFE regulations. These regulations require the submission of various documents, and foreign companies work closely with their banks in China to comply and submit the appropriate documentation for trade-related payments into and out of the country.

Foreign companies operating in China, or trading with entities in China, also need quick and easy access to low-cost financing. Financing can be in US dollars and in China's currency, the renminbi (RMB). For example, a US subsidiary or joint venture in China will want access to low-cost financing for its operations in China. It will also want to make sure that its manufacturers and vendors have access to financing to ensure viability of the supply chain. To resolve this need, companies can obtain loans or, more commonly, use RMB draft discounting programs, which are offered by many banks in China (see Box).

One challenge that companies need to be aware of is that PRC regulations stipulate that local currency letters of credit may be valid for a maximum of 180 days. Alternatively, companies can obtain US dollar-denominated import letters of credit.

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As regulations and documentary requirements are subject to change and can be open to interpretation, it is important for companies to work with a bank that has a strong local presence and has gained experience serving a sizeable trade customer base. The bank should also have a RMB currency license, allowing it to provide local currency cash management and trade services in major cities across China. Most foreign banks have gained RMB currency licenses only after years of operating in China.

### A smoother future

As China's economy and its global trade continue to expand, the country's importance in the global supply chain will also grow. Technological advances should help companies make their supply chains more efficient and reduce risk. Though the dual financial and physical supply chains are beginning to merge within many companies, the services of international banks located in China can make the financial supply chain operate more smoothly for companies new to the China trade. 完

## Remarkable Progress

China's remarkable economic growth in recent years has been fueled by a number of factors, from its large labor pool to reforms undertaken by the government in sectors ranging from infrastructure to finance.

### Large labor pool

Though China has a shortage of managerial and skilled talent, including in the logistics sector, the country has an almost inexhaustible labor supply. Rising wages, particularly on China's east coast, have boosted costs in recent years, but they are still just a fraction of those in developed countries. In addition, Chinese workers tend to have a higher level of education than those in less-developed countries where wages are even lower. Over the next 15 years, PRC government sources project that China's population above the age of 16 will expand by about 5.5 million people annually. By 2020, the total working age population will reach 940 million.

### Improving infrastructure

China's road, rail, river, and airport links are far from ideal, but the country has made many improvements since it launched the Great Western Development Strategy in 2000 and its 10th Five-Year Plan (2001–05), which focused on infrastructure improvements. The PRC Ministry of Finance estimates that in 2010, total annual investment in infrastructure in real terms will reach ¥2.3 trillion (\$287.6 billion), more than double the ¥1.1 trillion (\$137.6 billion) invested in 1999, with aggregate infrastructure spending over the 10-year period totaling ¥17.1 trillion (\$2.1 trillion) (see the July–August 2006 *CBR*, p.21).

### Welcoming environment for foreign direct investment (FDI)

According to the United Nations Conference on Trade and Development, China received \$60.3 billion in FDI in 2005. It is now the third-largest recipient of FDI—after the United States and the United Kingdom—with a total accumulation of more than \$600 billion. At nearly 33 percent, China's ratio of FDI to GDP is three times higher than the US ratio.

### Financial services infrastructure

Building a modern banking system has been one of China's key policy objectives since its economic reforms began in 1978. Within a relatively short time, it has built a banking system that includes four state-owned commercial banks, three policy banks, a dozen joint-stock banks, numerous city and rural commercial banks, urban and rural credit cooperatives, and foreign banks. Also, the country has established domestic stock markets and opened them to listings by foreign-invested firms. Through the qualified foreign institutional investor (QFII) program, foreign securities firms can gain limited access to the renminbi-denominated A-share market by applying for QFII status with the PRC government. As of December 2005, 32 foreign firms had been granted QFII status, and 31 of them had been issued QFII investment quotas totaling more than \$5.6 billion.

### WTO-related improvements

Since its 2001 World Trade Organization (WTO) entry, China has taken significant steps to implement its WTO commitments. Beginning in 2002, it reduced tariff rates

on many products and the number of goods subject to import quotas, expanded trading rights for Chinese enterprises, and increased the transparency of its licensing procedures. To implement the WTO-required liberalization of trading rights, China has also established a registration system that allows firms to register, instead of having to seek approval, for trading rights.

### Benefits at home and abroad

Multinational corporations are expanding their Chinese subsidiaries, boosting employment in China's export sector. China's demand for imported goods is also supporting employment elsewhere in the world. For instance, the country has become an important source of growth for its neighbors in Asia and elsewhere, as China buys capital equipment and technologies from places such as Japan, South Korea, Taiwan, and Germany to build a modern economy.

### Future outlook

Citigroup expects China's growth to continue at a pace above the world average—at about 7.5 percent per year over the medium term. China's growth trajectory can be expected to continue as long as it maintains the competitiveness of its manufacturing sector, improves its manufacturing efficiency, and—because goods are currently produced at relatively low cost, in part because of an abundant supply of labor—retains the competitiveness of its labor force.

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