10 KEY CHALLENGES FOR THE CHINESE LOGISTICS INDUSTRY

BY JOHN KERR

Moving freight in and out of China is a dizzying mix of the promising and the perplexing. Here's a snapshot of what shippers are up against in one of the world's fastest-growing economies.

CHINA'S ECONOMIC GROWTH SEEMS UNSTOPPABLE. Almost every statistic points to increasing momentum in sales revenues and market share; nearly every headline trumpets greater opportunity for foreign investors, much of it the product of the central government's deregulation initiatives.

It should come as no surprise, then, that China's logistics sector also is enjoying a period of spectacular growth. "China Logistics 2004," a new report from research firm Transport Intelligence Ltd., predicts compound annual growth rates of 33 percent up to 2007. This will be supported by the outsourcing of logistics functions to third-party logistics companies (3PLs) as the practice gradually gains credibility and as more sophisticated logistics-service providers enter the market.

For shippers, rapid growth and development of logistics offerings in China is likely to mean better access to the higher-quality services they need. Now that Beijing is opening that sector to foreign companies, providers are entering the Chinese market at an unprecedented rate.

Yet China's logistics picture isn't entirely sunny: The Transport Intelligence report also warns of the strong possibility of macroeconomic upheaval. Soaring labor costs and consequent unemployment, particularly affecting state-owned enterprises, could badly hurt logistics companies that have made significant investments in China.

Even as the availability of logistics services increases and the service quality and level of sophistication improves, providers still must overcome a number of challenges if they are to meet their customers' requirements. "China Logistics 2004" lays out 10 fundamental, structural problems that logistics service providers and their shipper customers must be prepared to confront:

1. POOR INFRASTRUCTURE

The modern road and rail systems seen by visitors to Shanghai and Beijing are a world away from what's available to those moving goods to and from inland China. Although the central authorities are plowing $30 billion into the nation's rail network and $120 billion into new roads, the patchwork of freight systems west of the coastal economic zone is archaic, bureaucratic, and very inefficient compared to what European, U.S., and Japanese logistics managers are used to.

Aside from a few large-scale projects, there is little integration of transport networks, information technology, warehousing, and distribution facilities. Rail systems, designed largely for transporting bulk materials such as iron ore, are unlikely to be carrying finished goods or components anytime soon. Few manufacturing and port facilities have rail sidings, while truly integrated multimodal operations lie in the future.

There are a few bright spots, however. For one, container-handling capabilities are making their way inland. Long-established ocean carriers, including OOCL and APL, are investing significantly in related facilities, such as reefer-on-rail intermodal terminals, deep in China's interior. According to the *South China Morning Post*, 18 container-distribution centers are to be built in major coastal and inland cities and will be linked by rail lines capable of handling double-stack container trains. Also encouraging is China's inland waterway transport sector—the most developed in the Asia-Pacific region—which forms a solid transportation backbone across much of the country. In fact, 1,000-ton deadweight ships can navigate almost 2,000 miles of the Yangtze River, and inland waterways tonnage is increasing year on year.

Air cargo development holds promise, too. Reports predict that domestic air cargo volumes will grow by more than 10 percent annually for the next 15 years. Although this sector will remain restricted for foreign aviation firms, the long-term signs look hopeful now that Beijing has mandated consolidation among 10 domestic airlines. China Southern Airlines and Air China are emerging as dominant carriers—good news for shippers of such high-value parts as electronic components.

The trucking sector will undergo dramatic changes as well. Currently, there are no major national trucking firms in China. But China's World Trade Organization (WTO) membership requires openness to foreign investment, and experts foresee waves of consolidation among the one- and two-vehicle private firms that dominate regional trucking.

2. ENTRENCHED REGULATION

China's accession to the WTO brought with it the promise of less regulation and more foreign ownership of business ventures. For example, as of mid-December, overseas companies can now own all of a Chinese road-transport subsidiary and a majority stake in rail transport enterprises. By December 11, 2007, rail companies can be wholly owned by foreign businesses. The same is happening in express mail service—witness the recent move by UPS to buy out its Chinese partner.

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Yet shippers and service providers must still push their way through a thicket of regulations, especially at local levels. Despite the WTO rules, the Chinese transportation and logistics market is one of the most highly regulated anywhere. Regulations exert tight controls on business activities at provincial levels and even at the city level, hindering the creation of national networks.

Local rulings are often frustratingly vague, a situation that also acts to restrain the development of national service networks. A recent report by Armstrong & Associates, a consultancy specializing in logistics outsourcing, notes that the regulatory patchwork is a prime reason why China's small haulage firms rarely travel beyond their own regions' boundaries.

3. PERSISTENT BUREAUCRACY, DEEP CULTURE

Newcomers to China often underestimate how much red tape they must negotiate to get what they need. Persistent cronyism calls for businesspeople to forge links with members of the Chinese Communist Party at various levels. According to Richard Armstrong, president of Armstrong & Associates, getting the go-ahead for any logistics project in China still depends on the strength of a company's contacts within the Chinese bureaucracy.

The necessary relationships with local power brokers—a city mayor or a regional business titan—can often hinge on cultural nuances. At a business dinner, for example, a person's status determines how high he or she can raise a glass during a toast. "Understanding the culture, the people, and the business practices is critical to doing business successfully in China," says M.K. Wong, marketing director at ocean carrier OOCL (USA).

Veteran observers of China's business milieu say the country's cultural and bureaucratic realities imply two interrelated imperatives for foreign managers: (1) China cannot be managed from a home office in Nashville or Düsseldorf; and (2) strategic business decisions cannot be delegated as easily as they are at home. If there is no active face-to-face involvement by senior managers, especially in the early stages of business development, a foreign company will fail to build "corporate citizenship"—an important element of business equity.

4. POOR TRAINING

Training remains a "black hole" in China. In the logistics business as well as in the

TO LEARN MORE ABOUT LOGISTICS IN CHINA...

Several research organizations have recently produced reports on the state of logistics services and conditions in China. Some extremely detailed reports are available for sale, while other, shorter papers can be accessed for free.

"China Logistics Report 2004" can be purchased from Armstrong & Associates, Inc. as a download for $995. For more information, go to *www.3Plogistics.com*.

"High Growth, But No Shortage of Third-Party Logistics Challenges in China" and a slide presentation are available in the Fall 2002/Winter 2003 edition of Mercer Management Consulting's **"Mercer on Transport and Logistics"** newsletter. Find it at *www.mercermc.com*.

The Logistics Institute—Asia Pacific in Singapore has posted the results of its **"2003 China Logistics User Survey"** and **"2003 China Logistics Provider Survey"** on its Web site, *www.tliap.nus.edu.sg*.

Drewry Shipping Consultants Ltd. offers its **white paper on logistics in China** for GBP 250. For more information on the report, go to *www.drewry.co.uk* and choose "logistics" under "search catalogue."

tain such growth rates, though, China's logistics firms will have to adopt and implement globally recognized business processes and metrics.

7. HIGH TRANSPORT COSTS

It can cost as much as 50 percent more to transport goods in China as it does in developed regions such as the United States, Europe, and Japan. One culprit is high local road tolls and other hefty transportation fees.

CHINA'S LOGISTICS SECTOR IS ENJOYING A PERIOD OF SPECTACULAR GROWTH.

Overall logistics costs, including warehousing, distribution, inventory holding, order processing, and so forth, can represent as much as 20 percent of a company's revenues—two to three times the norm in industrialized economies. This imbalance is reflected in the economy at large: Hong Kong's General Chamber of Commerce notes that China's logistics spending comes to about a fifth of its gross domestic product, about twice the level in the United States.

8. ANTIQUATED WAREHOUSING

Ocean carriers and global 3PLs are scrambling to build world-class warehousing in special industrial areas. For example, OOCL is opening large new facilities in Shanghai's Waigaoqiao Free Trade Zone. APL Logistics, meanwhile, has opened the 14,000-square-meter first phase of a sophisticated flow center in the same zone. Businesses can expect much more foreign investment in storage and storage management when, under WTO rules, China opens up its warehousing sector by the end of this year.

And it's about time. The typical warehouse in China has low ceilings, poor lighting, and abundant manual labor. Dock-leveling is rare, while poor facilities and unskilled management are to blame for high levels of loss, damage, and deterioration of stock, especially in perishable goods. Armstrong & Associates reports that 30 percent of China's fruit and vegetable harvest is damaged every year by the inability to store and move it appropriately.

9. BIG IMBALANCES BETWEEN REGIONS

The flow of goods in China is largely from the economically developed eastern section of the country to the less-developed west. The consequences are significant for logistics providers—and for their customers' costs. For example, it is difficult for Chinese haulage companies to find backhauls. At an international level, the net outflow of goods from China leads to costly inefficiencies in repositioning empty containers.

The Beijing government is attempting to address some of these major structural issues. Its "Go West" policy is designed to move economic prosperity toward "heartland" cities such as Chongqing. And under its "Dong Bei" strategy—translated as "Revitalization of Northeast China"—that region is beginning to draw manufacturing investment from global automotive players.

10. HIGH DOMESTIC TRADE BARRIERS

The kinds of tariff structures that were a daunting cost of doing business in Europe and North America before the landmark European Union and NAFTA trade agreements are still very much at work in China today.

China's accession to the WTO may have lowered tariffs and quotas on international shipments, but there are still problems related to moving goods within China itself. For example, goods may be subject to unofficial border tolls when moving between provinces. That's particularly evident when shipping from an inland manufacturing location to a port city or vice versa, according to Armstrong & Associates. Agrees Craig Rawlings, supply chain practice director with consultancy Capgemini: "Local governments consider it important to protect their local economies by limiting trade."

Over all of these challenges hangs an economic cloud: the prospect that China may float its currency. The yuan is now pegged to the U.S. dollar, but China may see more long-term merit in changing the exchange rate. When that happens—and it's more likely to be "when" than "if"—its effects will radiate rapidly throughout the global trading system.

Seasoned China manager Rick Moradian, president of international logistics services for APL Logistics, urges shippers to look hard at their sourcing approaches in light of their overall business strategies, and in the context of international patterns of economic and political activity. He fears that five years from now mainland China will be suffering from a significantly higher cost structure, particularly as labor costs rise. It's a good reminder of the need to do as the Chinese have always done: Think and plan for the long term. ■

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