



Raising the Bar: Can China Meet the Quality Challenge?

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Stung by consumer backlash and stiffer penalties for piracy, counterfeiting and contamination, China is working hard to overcome its reputation for poor quality. Scandals involving contaminated food and drugs, and toys tainted by lead paint, have made quality a Chinese government priority.

Although the government is building stronger regulatory agencies and writing tougher standards, spotty enforcement means quality will need to be addressed both by Chinese suppliers and foreign buyers. The challenge for Chinese manufacturers is how to invest in quality control and processes without losing their advantage as a low-cost producer. For their foreign partners, the challenge seems simpler: How to set and enforce effective quality benchmarks.

In this article, part of a special report on Chinese manufacturing, experts from The Boston Consulting Group (BCG) and Wharton examine how quality standards are being introduced and how China's manufacturers and their foreign business partners might meet those goals.



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Misplaced Assumptions

China's quality challenge begins with misplaced assumptions and perceptions on both sides, attributable in part to the speed with which many companies from developed countries embraced offshoring. The result was an inescapable "trade-off between cost and quality" says David Lee, partner and managing director in BCG's Beijing office, and a supply chain and procurement specialist. He recalls executives at a Chinese ball bearing company offering three prices: top quality at high prices, "acceptable quality" at lower prices, and, at the lowest price, "something that will turn and not freeze by the time the customer gets it."

Foreign buyers often tend to make strategic mistakes that end up hurting quality. For instance, many assign procurement managers to lead contract negotiations with suppliers, says Benjamin Pinney, a principal in BCG's Shanghai office. "They have a procurement mentality and focus purely on price negotiation, and it's an arm's-length transaction," he says. Because their expectations are based on their experiences with home-country suppliers, they don't always follow up with their Chinese vendors to monitor processes and quality testing.

This enthusiasm for cost-saving deals can impede buyers' ability to correctly gauge the risks or understand the context of operating in China. "Companies were in a rush, working with whichever suppliers were at hand or feeling their way in the dark, not knowing what they were getting into," Pinney says. With little to lose, Chinese suppliers would readily agree to meet quality standards. "In the great rush to China over the last 10 years, players on both sides of the fence were incompetent."

Many foreign companies didn't understand how much support a Chinese supplier often needs, and many expected to achieve quality benchmarks without investing in their suppliers. Few stepped back to ask what incentives their suppliers had to adopt the desired production systems and practices. So it wasn't surprising that some Chinese suppliers took shortcuts that compromised quality. One recent controversy over quality defects in Chinese-made toys came about because of design flaws and the use of raw materials that weren't approved by the foreign buyer, Lee says. Such defects can be difficult to prevent, especially if only a few suppliers are performing badly. But it adds to a perception of China as a source of poor quality. "It is a small drop in the bucket, but it is still a drop," Lee notes.

Blame shouldn't automatically be ascribed to Chinese contract manufacturers, some experts caution. [Marshall Meyer](#), a Wharton management professor whose research focuses on China, points to a 2008 paper by Paul Beamish of the University of Western Ontario and Hari Bapuji of the University of Manitoba, titled, "Toy Recalls and China: Emotion Vs. Evidence." The authors write that the "vast majority" of toy recalls in the United States from 1988 to 2007 "were due to flaws in product designs conducted in the corporate headquarters of toy companies, rather than to poor manufacturing by factories in Asian countries." The researchers note that "the recalls have increased over the years, due both to design and manufacturing flaws." Meyer says he is "not sure" whether he agrees with Beamish and Bapuji's assessment. "There is a fair amount of design work done in China, including original equipment design."

The Role of Regulation

Meyer traces quality issues to another sort of decentralization: the traditional Chinese subcontracting system that has "multiple layers, with fourth- and fifth-tier subcontractors," making it difficult to control supply-chain networks. "Multiple tiers of subcontracting introduce lots of uncertainty into the system, and the costs in terms of quality can exceed those savings," he says.

Regulation can be effective if it is enforced nationally and locally, Meyer says. The overarching problem is that Beijing "cannot easily enforce regulations ... and the ability of the central government to impose regulations locally remains limited." Meyer attributes that to "centuries of [running a] decentralized economy." He notes, for instance, that China doesn't have national courts except for its Supreme Court. "Imagine trying to resolve an IP dispute with parties from different provinces."

Eager for redemption, China's regulators nevertheless are becoming more aggressive. In a recent statement, China's cabinet outlined plans to strengthen the food-monitoring system, for example. The effort includes representatives from government departments on health, agriculture, quality supervision, industry and commerce administration, and food and drug supervision, according to the Xinhua News Agency. That follows a global consumer backlash last year that forced the government to raise safety standards for toys. Regulators inspected the facilities of 3,000 toy-makers and revoked the export licenses of about 600, dramatically narrowing the playing field. Chinese toy companies worked with the government to strengthen their quality control, but the changes pushed up costs and forced many suppliers to close down. A total of 3,631 Chinese toy exporters -- 53% of the industry -- closed shop in the first seven months of 2008 because of a stronger yuan and increased production costs, Xinhua reports.

More generally, a groundswell of public concern over quality has catalyzed the government's reforms. Public sentiment inside the country -- aided by technology -- also is driving efforts to improve quality. "You have increasingly aware consumers in China," says David Michael, a senior partner and director of BCG's Beijing office. "For instance, the company which is at the center of the recent controversy around baby formula [Shijiazhuang Sanlu Group Co.] is being brutally attacked by bloggers within China on the Internet. It is being punished much more within China than it would have been five years ago, because of the Internet."

The scandal over baby formula tainted by the chemical melamine outraged many especially because it hurt a particularly vulnerable part of Chinese society. "It's not rich people in the big cities buying that baby powder, it's poor people in the rural areas being exploited by counterfeiters," Michael says. "Low-income people feel the most exploited," he adds, when quality is compromised in such a way. The government acknowledged the severity of quality issues. China's food industry still suffers from the use of dangerous illegal additives, Vice Health Minister Chen Xiaohong told Xinhua. He spoke of underground markets for additives that still exist in some regions, and "unspoken secrets" in the food industry.

China's Risk Profile

Supply-chain quality issues raise China's risk profile, Boston-based think tank AMR Research noted in a survey of 130 global companies this year. China was the top contributing region for nine of 15 risks examined, including supplier and internal product quality failure, security breaches and intellectual property infringement. Other risk factors for China cited in the survey include volatile energy and commodity prices. Noha Tohamy, vice president of research at AMR, notes that this "creates a dilemma" for many global companies. As those companies continue to enjoy the advantages of cheaper material and

labor costs, as well as the potential to reach vast consumer markets, they must continually reassess the pros and cons of operating in China," she says.

"There is a cost to low cost," says Harold Sirkin, senior partner at BCG in Chicago and global leader of the firm's operations practice. "The key is to bring suppliers up to your standards. Given the potential cost advantages of 10% to 30% that China sourcing can deliver, it's well worth it for companies to invest in their suppliers," he adds. A good start would be for buyers to educate their Chinese suppliers on the value of brands and how quality issues could hurt them.

Chinese companies, such as white-goods giant Haier and telecommunications equipment-maker Huawei, have shown "demonstrable success" in ensuring quality control, Pinney says. Companies that have years of experience in procuring from China are also "on top of this quality issue," says Michael.

Chinese suppliers, meanwhile, watch and learn from their foreign customers, Sirkin says. "In the 'old days' of globalization ... while the multinationals were outsourcing their production to the developing countries, something unexpected happened," he noted in a blog post after the release last year of a book he co-authored, *Globality: Competing with Everyone from Everywhere for Everything*. "Their suppliers and vendors, little companies in China and India and Brazil and elsewhere, watched carefully and learned well."

But not all Chinese companies have learned the right lessons, especially those behind the recent quality scandals, and a reorientation appears to be in order. Managing supplier relationships is one critical area. Setting up small, on-the-ground procurement teams with weak local relationships isn't as effective as adapting to local conditions, Pinney says. Companies that succeed with China sourcing "invest in localizing their teams, processes and quality controls," he notes. "They become more flexible and adapt their operations to local conditions." As a result, local suppliers and manufacturers absorb the right systems and processes either as joint venture partners, by watching and learning, or by hiring select talent from foreign companies.

Incentives and Penalties

Buyers from developed countries must get more realistic about what it takes to improve the quality of their Chinese imports, Pinney says. Western companies have a tendency to "copy-paste" in China the sourcing and manufacturing practices they're accustomed to in the United States or Europe, he says. But quality improvement carries a price tag, and companies sourcing from China must realize it. Embracing advanced management techniques, such as root-cause analysis, would also help, he adds.

With combined efforts from several quarters, quality is getting "dramatically better" and is being policed much more aggressively, Michael says. Stricter regulatory enforcement would help, but the most important regulations may not be in China. A direct correlation seems to exist between Chinese suppliers' adherence to quality specifications and the degree to which their industry is regulated in the West. For instance, pharmaceuticals and foods tend to be more advanced in quality control "largely because of the pressures and incentives at the client end," Pinney says. Similarly, Pinney sees significant quality improvements in the automobile and white-goods industries. Where the consequences of failure are less dire, quality levels are generally lower. "Quality improvements are the least far along as you move down the food chain into low-end electronics and toys," he notes. "The downside to quality mess-ups is relatively small in shoes and textiles."

Companies must make it abundantly clear to suppliers -- verbally and contractually -- that meeting quality expectations is as important as meeting cost and delivery targets. In other words, buyers must provide incentives to Chinese suppliers to do the right thing. Incentives may not be effective, however, without corresponding penalties. Foreign buyers need to understand what "skin in the game" their Chinese suppliers have in ensuring quality, Pinney says.

The general push toward higher-value products "over time will lead to a restructuring of industries and a shift away from high labor-low value products," Pinney says, and Michael agrees that quality levels are on the rise in China.

Many experts seem confident that quality issues are just the growing pains of an accelerating economy. China "can make high-quality products" and often already does, Meyer says. "Look at an iPod made in

China. It has the highest standards of quality. It says 'Designed in California, Assembled in China' on the back of the package."

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