



## Procurement -- Subcontracting and Product Quality in China

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### The Importance of Procurement in a Global Environment

Until recently, procurement was a necessary, but seldom celebrated, component of multinational corporations. But times have changed: These days, procurement organizations within companies are playing pivotal roles in the success of global firms in ways that old-fashioned purchasing managers could never have imagined. In this special report, Wharton faculty and procurement experts at The Boston Consulting Group discuss why the procurement function has risen to such prominence in a highly competitive global environment, and how, as supplies of critical commodities tighten and prices rise, companies can strategize to mitigate these and other risks.



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### Part 6: Subcontracting and Product Quality in China

*Marshall W. Meyer, professor of management at Wharton, has made many trips to China to research the rapid growth of its economy and the successes and difficulties it has had in growing so quickly. In this interview, Meyer discusses the recent controversy surrounding China's exports of substandard toys and pharmaceuticals to the United States, and the implications for supply-chain management.*

**Knowledge@Wharton:** As you know, there's been no shortage of press reports in recent months about the questionable quality of many of the products that are coming out of China. What is your take on this issue? How serious a problem is this?

**Meyer:** Any time a product poses risks to children and poses risks to people who are seeking medical treatment it's a serious problem. So the magnitude of the problem may be limited, but still I think we have to take all of these issues quite seriously.

**Knowledge@Wharton:** In your view do the press reports that we have been seeing on China's products parallel in any way the products that were produced, say, by Japan back in the 1950s when it was emerging from World War II and trying to get its economy going. Are there historical parallels to these issues with China?

**Meyer:** There are and there aren't. The parallel is this: If you look at Japan prior to the 1960s or Korea prior to the 1980s, a lot of the products they were producing were inexpensive products. People would sometimes joke about them. I don't think that the products coming out of Japan and Korea at those times posed threats to kids, but my memory could be wrong on this.

I do have a distinct recollection, however, ... from the early 1970s when model railroad shops were retailing some HO trains from Korea [that] were marketed as "the disaster series." They were so bad that they were a joke. But of course, things have changed very, very rapidly for Japan and for Korea.

**Knowledge@Wharton:** And in the case of China, would you say that the experience of these shoddy products, for lack of a better word, has been limited? Is there something inherent in manufacturing systems in that country or in the way that companies in China approach manufacturing that has led to these kinds of problems? Is there anything inherently awry in China that would cause this kind of thing?

**Meyer:** I don't know if it's inherently awry in China, but I think there are some differences between Chinese and U.S. systems that U.S. firms and U.S. distributors don't fully appreciate. Let me start

**with an example close to home. We've all been reading about the Boeing 787, and as of this morning, Boeing promises that the Dreamliner will be delivered on time.**

Still, they have encountered some difficulties in meeting schedules. And what you read suggests that their very lengthy supply chain is getting in their way. There are countless numbers of suppliers that are involved in putting together all of the components on a 787 and it's possible that Boeing underestimated the complexity of managing all of them simultaneously to a single deadline.

Now let's turn to China. It's very interesting in China. First of all, Chinese firms are very small compared to U.S. firms and most people don't appreciate that. Second, the Chinese prefer to operate through arm's-length contracts rather than building large firms. There's a term for it. It's called "cheng bao" sometimes, and it literally means "contracting."

And that means, to give you an extreme illustration of it, that you get into a taxi in Shanghai and say, "Take me up to Suzhou," which is a good long ride. It would normally be about 300 to 350 RMB on the meter. Let's say that would be about \$45 to \$50. You agree with the cabdriver on a fare and say, "Don't do it on the meter. I'll just give you 400 RMB, tax, tips, tolls all included."

And you hop in the cab and he goes three blocks and then waves down his friend and says to him, "Will you take these folks up to Suzhou for 300 RMB?" And the next thing you know you are transferred to the other taxicab. The first driver pockets the difference and you'll get your ride up to Suzhou. That's not a problem. It's interesting how transactional so many events are in China.

Now let's go to manufacturing -- the large manufacturers. Let's look at toy manufacturers like Mattel. They normally forbid second- and third-tier subcontractors. And yet when you look, what you will see in many instances is that in violation of contract terms sometimes second-, third- and fourth-tier subcontractors are used. All this [is] aimed at getting the cost down.

So the issue is partly whether this conforms to contractual arrangements. But it's also partly whether you can administer this effectively, whether you can control it, whether you know the ingredients or the components going into your products. I think that's where a special kind of problem lies in China.

**Knowledge@Wharton: The Bush administration recently signed some product safety agreements with China that place added responsibility on China to regulate exports of some pretty important products, drugs, medical devices, food for people and animal feed. What is your reaction to these agreements?**

**Meyer: This is part of the ongoing strategic economic dialogue. It's the third meeting that they started a year ago in December, had a May meeting in Washington, and are having their December meeting again in China. I have a couple of reactions to it. The first reaction is: good progress, moving in the right direction here.**

China is clearly interested in maintaining an open door, I think, on both sides of the water. They talk about it as if it's on both sides of the water. And I think this administration is interested in the same thing, and I think all parties acknowledge that a little bit of supervision is going to be very helpful here.

What really interested me -- and we are getting very, very early reports because the talks were only today [Dec. 21, 2007, and] of course it is 13 hours later over there -- ... is that the talks are described as heated, and they are described as going past the deadline or the time limit set on the agenda.

They went late an hour or so today. I think this is a very, very positive sign. I learned from some of my Chinese friends almost a year ago, at the end of January, who had observed these talks, that the participants dropped all pretense and began speaking with one another very, very frankly and have been constantly e-mailing if not talking with one another on the phone since. So I see all of this as good progress.

Now here is the caveat. The issue in China is always the ability of the central government to control things on the local level. Will the central government be able to carry out the inspections promised? Will they delegate this to the provinces in the larger municipalities and, if so, with what impact? I think we need answers to these questions and we need constantly to monitor this.

**Knowledge@Wharton:** Now, given everything that you have said so far, let's talk a little about the specific focus of our podcast series on procurement. Again, as you well know, many, many U.S. firms and firms in Western Europe, in Asia even, rely on China for products. What steps should be taken to deal with this quality issue by companies that rely on Chinese firms to make their products?

**Meyer:** First, it's urgent that they take these steps. Second, these steps may be more important in the end than the strategic economic dialogue. Third, here are the steps I think they are going to have to take. As everyone knows, in China transactions occur between people who know one another. You have dinner three or four times and do a transaction. [It's] not the other way around. As a consequence, in order to be sure that contracts are carried out as written, you have to have people over there.

You have to have people in-country. You have to have people who are actively monitoring the execution of contracts. I think Western firms have underestimated the need to have people on the ground actually watching what their suppliers are doing. I don't think the suppliers would take this as a burden. They would take it as a compliment -- someone's there, they want to talk with us, they want to be our friend, and they want to eat meals with us.

This will cost money. But I think in the end, the cost to the firms -- also, most important, the cost to the consumer -- is going to be a heck of a lot less. So I would strongly urge firms to reconsider their policies encouraging arm's length and low-cost transactions and investing more in putting their own people on the ground over there with their suppliers and subcontractors, if there are any, so that they can be sure who is producing the goods for which they are ultimately responsible.

**Knowledge@Wharton:** Are there any impediments in place within China, perhaps imposed by the government or maybe just cultural impediments that would not permit procurement people outside China from going into the country?

**Meyer:** I think quite the opposite. I think that it would be encouraged over there because people are always complimented when someone comes to visit them. You know, so many conversations with folks in China end up, "Come visit Beijing. Come visit Shanghai. Come visit Suzhou." So I think quite the opposite. I think that would be welcome by all parties. I think that at the end of the day it's going to be far more effective than relying on the central government to take care of these issues.

**Knowledge@Wharton:** Let's assume for example, that a firm, someone listening to our podcast, his or her company is thinking of sourcing from China, or if they already are maybe increasing the amount of business they do there. What specific people, employees, should be going to China to do the things that you suggest? Should they be people who are well-versed in procurement? Or should they be more senior company managers in order to show the Chinese that they have a great interest in working with suppliers?

**Meyer:** If senior people have time, a courtesy visit or two always is very helpful. You get your picture taken, your picture is on the wall, [and] you become a presence. But I think some operational people should take a look alongside the procurement people. The procurement folks are motivated by cost, the operational people more likely by quality.

So I think it is very important that people have deep familiarity with a production process. Look at the contractors' and subcontractors' processes in order to verify that those processes are going to produce products to the standard you are expecting.

**Knowledge@Wharton:** Does this mean that folks from outside China, who are going there, should expect to spend, what would you say, days, weeks, months at a time at a given site? Or should they be traveling back and forth frequently? As a practical matter, how much time do you think would be involved in this?

**Meyer:** I don't think weeks are required. I think days are required on-site. It would depend on the industry: the more complicated the technology, the more time. But a single visit is not going to do it. You've got to go and renew those relationships every four months [to] six months. Probably once a

year is not enough. So it's not extended travel, but it's perhaps more frequent travel that's in order.

**Knowledge@Wharton:** Do you think that there are any lessons that can be learned by procurement people who are perhaps sourcing from other countries, from countries other than China, whether it's in Latin America or India that can be applied to the Chinese experience?

I guess what I am saying is, if Company X has been sourcing from, say, India for a while and decides that they want to increase their activity in China, is there anything that's transferable from one country to another?

**Meyer:** It's hard to say. You know people develop a general savvy about working outside their home country and that's always quite valuable. But I think that China is almost unique in the extensiveness of subcontracting. India, which has very, very large firms, may not be similar. My guess, but I don't know, may be that Latin America is also going to have much larger companies than China and not be so involved in subcontracting.

**Knowledge@Wharton:** In terms of the Chinese experience with quality issues, do you think that it's going to take a long time for a lot of those issues to be resolved, in terms of China bringing its processes up to snuff, etc., educating the right people and finding the managers to run these smaller companies that you have talked about? Is this going to be a long time coming or are we going to be reading about quality issues in China for many years to come?

**Meyer:** I think that the issue will always be with us, but I also think its significance will fade a bit because the market will punish firms bringing inferior goods into the U.S. or any Western country. In the U.S. we have strict liability. Everyone in the supply chain is liable. And, as a consequence, firms like Mattel again will pay a lot more attention than they used to to the quality of goods that are coming out of China. I think the longer-term issue is going to be the quality of goods available to the Chinese consumer because the laws in China are not enforced with the same rigor as they are in the U.S.

And so it's going to be a longer time, I think, before the Chinese public can be as confident of what they are buying as can the public in the U.S., Western Europe and the like.

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