IMPACT ANALYSIS

Issues Impacting Global Business

A Publication Serving Orlando and the Region

May-June 2011

Dear Friends:

Recent events in the Middle East will shape the region's future for decades. Yet greater economic integration is key to a brighter future (p1-2).

Chinese labor costs are surging. In turn, domestic firms and their foreign competitors will focus on productivity and innovation (p3-5).

The National Export Initiative's goal of doubling exports by 2014 may be on track. But the current pace of export growth is unlikely to continue (p6).

Many believe U.S. multinational are trading their technologies for access to the Chinese market. The data may surprise you (p7-8).

Packing optimization may not be the sexiest subject, but it has the potential to save companies millions of dollars (p9).

I hope you find this issue informative and, as always, we welcome your comments.

Sincerely,

Byron Sutton
President and CEO
World Trade Center Orlando

Greater Economic Integration Will Benefit the Middle East

Living in a post-bin Laden world

By John Manzella

A primary economic problem poor countries typically incur is not too much global economic integration, but rather, their lack of it. This coupled with the absence of freedom is a recipe for poor growth prospects, high unemployment, hopelessness, and ultimately, revolution. History is replete with examples.

One Came Tumbling After

The disintegration of the Soviet Union and the fall of the Berlin Wall in 1989 illustrate the impact of economic isolation combined with the lack of freedom. Today, we are witnessing a similar phenomenon in the Middle East and North Africa.

We're beginning to see a fundamental change in the Middle East, says Fareed Zakaria, host of CNN's GPS and author of several books, including his most recent entitled *The Post-American World*. "This is the region's 1989," he continued. For a variety of reasons, however, Zakaria says the changes in the Middle East will occur at a slower pace than what was experienced in Eastern Europe, and not every country in the region will be affected.

The Reality of Repression

In addition to economic prosperity, globalization brings new ideas, customs, institutions and attitudes that originated in the West. This is dangerous to dictatorial regimes that typically place restrictions on the flow of information in an attempt to control their populations. The Middle East and North Africa are no exception.

Freedom House, an independent organization that supports the expansion of freedom around the world, consistently identifies nearly every country in the Middle East and

North Africa as either "partially free" or "not free." The region is full of totalitarian regimes that not only deny their citizens freedoms Americans cherish, but also utilize trade barriers to isolate themselves from the world, as well as from each other. As a result, the region's unemployment rate is nearly twice the world average, and an astonishing 25 percent for its young population, according to the Democratic Leadership Council, a Washington, D.C.-based think tank.

Thomas Barnett, author of *The Pentagon's New Map: War and Peace in the Twenty First Century,* says regions or countries lacking economic and cultural connectivity with the rest of the world are those countries where you find instability, threats to the international system and terrorist networks. Many agree.

Barriers to Economic Integration Are Barriers to Liberty

The death of Osama bin Laden on May 1, 2011 is unlikely to significantly alter the state of global terrorism. Yet economic integration and greater freedom in the Middle East and North Africa likely will have a major positive impact.

Globalization, Poverty and Inequality, a report published by the Progressive Policy Institute, a Washington, DC-based think tank, says "no country has managed to lift itself out of poverty without integrating into the global economy." Why does global integration hold such promise for the Middle East and North Africa? Look at the facts.

East Asia and the Pacific, a region that has welcomed global integration, has generated annual growth rates among the highest in the world. Plus, in the short span of 1990 through 1998, the number of people living in extreme poverty there decreased 41 percent—one of the largest and most rapid reductions in history.

If global integration is accepted in the Middle East and North Africa, the region will be positioned to absorb new ideas, technologies and a myriad

of other benefits from the world trading community. This will help the region diversify its exports toward agricultural goods and higher-value manufactured products, and in turn, create new jobs.

As trade and investment increases, the incomes of ordinary people also will rise. This will lead to higher standards of living and a better-educated

ing economic liberty and openness."

Open Markets Open Minds

The goals of ultimately establishing democracy in the Middle East will, no doubt, be difficult to achieve. But open economies help. Once markets are liberalized, their political systems follow. The adage "open markets open minds" is true.

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and politically-involved population. In turn, despair and hopelessness will slowly turn to hope, and those who were angry and disenfranchised are more likely to strap on money belts than bombs.

Stated by Daniel Griswold of the *Cato Institute* (see his article on page 4), "Economic stagnation in the Middle East feeds terrorism... Young people who cannot find meaningful work and who cannot participate in the political process are ripe pickings for religious fanatics and terrorist recruiters. Any effort to encourage greater freedom in the Middle East must include an agenda for promot-

According to Zakaria, George W. Bush deserves some credit for what has happened in the Middle East. "Bush put the problem of the Middle East's politics at the center of American foreign policy. His articulation of a 'freedom agenda' for the Middle East was a powerful and essential shift in American foreign policy." ■

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The Impact of Surging Labor Costs in China

New strategies are required

By Kim Woodard

For at least the past three years, general managers of China-based manufacturing operations have been sharply aware of tightening labor supply and rapidly increasing labor costs. Indeed, qualified labor availability and sharply increasing wage levels have risen to the top of the list of operating challenges across a wide range of industries and sectors.

In fact, seventy-one percent of respondents to a recently released 2011 Business Climate Survey by the American Chamber of Commerce in China reported that increasing salary and wage expense has had a negative impact on their business operations, while 69 percent report difficulty attracting, developing and retaining qualified employees.

Adding to the mounting evidence of soaring employment costs, the U.S. Bureau of Labor Statistics (BLS) has just released an update of a landmark 2006 study showing surging growth in hourly manufacturing compensation across a broad range of Chinese industries. The study illustrates that growth in average hourly manufacturing compensation jumped from 7.9 percent per year (pre-inflation) in the 2002 to 2005 period to 16.4 percent per year in the 2005-2007 periods. Furthermore, the trend is accelerating.

The growth rate was a sizzling 17.6 percent year-on-year in 2008 and may well have accelerated to over 18 percent per year in the 2009-2010 periods, despite the impact of the global recession in 2009. If sustained, this implies a doubling time for nominal manufacturing labor costs of about five years. Measured in U.S. dollars and driven by appreciation in the value of the RMB, Chinese exporters face comparative employment cost increases of 20-25 percent per year.

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The data and analysis, which were prepared by leading China demographer Judith Banister and economist George Cook of the BLS, confirm a trend that global manufacturing companies have reported for the past five years. The data include both urban manufacturing units and rural "Town and Village Enterprises" and cover some 100 million manufacturing workers.

Many Factors Are Responsible

According to Banister and Cook, "…the youth population ages 0-14 has shrunk to an unusually small proportion of the population for a developing country. Indeed, a key determinant of China's paradoxically tightening labor market is low fertility." Despite the popular image of China's huge reserve of available rural labor, government surveys at the village level indicate the supply of qualified manufacturing labor, considering such factors as age range, literacy and skill level, health, and physical characteristics such as manual dexterity and eyesight, may already be tapped out at about 100 million manufacturing workers.

InterChina Consulting, a strategy and M&A advisory firm based in China, has conducted manufacturing cost research suggesting the recent run-up in manufacturing labor compensation is structural in nature. According to InterChina's Managing Director for Strategy, James Sinclair, "The sharp rise in manufacturing costs in China reflects basic and persistent underlying factors in the Chinese economy: growing labor

shortages in the manufacturing sector, rising worker expectations and educational levels, higher levels of unionization, minimum wage increases in many provinces, government labor contract and social benefits policies, pressure to keep up with rising housing and living costs, and growing employment opportunities in lower tier cities.

Indeed, the BLS data support the proposition that China has reached a classic “Lewis Turning Point” in urban wage levels driven by tightening rural labor supply and continuing rapid growth of the urban economy. If true, this trend will also drive up employment costs in high growth non-manufacturing sectors, such as the health care sector.”

Faced with rising costs, the new winners will be able to sustain margin and profit levels through higher efficiencies, capital and technology intensive investment, and higher value products and services.

What Needs To Be Done

InterChina is betting that rising employment and delivery costs will have a major impact on development strategies of global players in the China market. Corporate development strategy in China has been driven almost exclusively by top-line factors for the past two decades—market access, customer share, distribution channels and revenue growth. Faced with rising costs, the new winners will be companies that can sustain margin and profit levels through higher efficiencies, capital and technology intensive investment, and higher value products and services in a competitive environment more typical of more advanced economies.

There are many signs that rising employment costs and a tightening rural labor supply are having a direct impact on manufacturing operations. Electronics manufacturer Foxconn Technology, which last year doubled worker pay following a sudden wave of suicides in its operations in Shenzhen and Kunshan, recently announced that it would transfer 200,000 jobs to plants in inland areas and third tier cities. In the coastal enclave of Yantai, which is host to the largest General Motors vehicle assembly plant in China, average employment costs for automotive parts suppliers rose more than 20 percent last year. They are competing head-to-head for skilled workers with a huge new Foxconn plant in the Yantai Economic Development Area. When Foxconn moves into a new industrial zone, it advertises for as many as 80,000 jobs at a time.

InterChina believes that multinational strategies to address rising manufacturing costs will include both “re-mapping capacity” by focusing new investments on lower-cost inland cities and also a shift toward more capital-intensive mechanized production. Bell-weather technology companies Intel and Hewlett Packard are examples of “capacity re-mapping” within China. Intel is relocating chip assembly and testing facilities from Shanghai to Chengdu, eliminating 2,000 jobs in Shanghai. HP is building a large new laptop assembly plant in Chengdu. Both companies cite labor costs as part of the rationale for the new inland locations, along with government incentives to “Go West.”

Japanese companies that had relatively high levels of labor intensity in their Chinese plants are starting to move to semi-automatic and integrated mechanized assembly lines. For example, NSK has recently introduced automated transfer lines into Chinese bearing plants while SMC is reportedly mechanizing assembly of pneumatic equipment. Even traditionally labor-intensive domestic Chinese industries like textiles are moving toward a higher level of mechanization to remain competitive, creating a surge in demand for automated textile production equipment.

The Wages of Migrant Workers

Migrant workers support the very bottom of the urban wage structure in the construction and service sectors as well as manufacturing. Migrant worker wages have also risen dramatically in the last two years, doubling from an average base wage of RMB 781 per month in 2003 to RMB 1,348 in 2009 and over RMB 1,500 (US$220/month) last year. Hunan Governor Xu Shousheng has estimated that 500,000-800,000 fewer Hunan workers will migrate to coastal city jobs in 2011 than in previous years, suggesting that tight supply will lead to even greater migrant worker wage increases over the next few years.

Adding fuel to the fire, provincial and municipal governments across China have been raising minimum wage levels at 15-20 percent a year to offset high inflation in food prices, housing prices, and other living costs.

Manufacturing Will Remain Competitive

Despite these dramatic changes in employment costs, China's manufacturing sector will remain highly competitive for some time to come. Employment costs are rising quickly, but will take decades to overtake Japan, South Korea or Taiwan, let alone the U.S. or European Union countries. Meanwhile, China likely will move up the value-add chain and will reduce the economic impact of labor shortages and rising labor costs through productivity improvements.

What Companies Likely Will Do

Multinationals likely will continue to invest in their China-based manufacturing and service delivery platforms to tap into burgeoning domestic demand and to leverage mature and integrated regional supply chains. Some labor-intensive light industries—toys, apparel, shoes, leather goods, and furniture—have already experienced migration of capacity to lower-cost countries. Luxury leather-goods manufacturer Coach is gradually shifting capacity from China to Vietnam and India. There will even be occasional instances of "re-shoring" of China-based capacity to North America or Europe, such as the recent decisions by Masterlock, General Electric (water heaters), and Wham-O to move some capacity back from plants in China to U.S. production lines. But the basic driver for continued investment in the manufacturing sector in China—access to the fastest growth large market in the world—will remain.

Both domestic Chinese enterprises and their multinational competitors will be forced to focus their investments and operations on productivity, innovation and cost control to remain competitive and profitable at recent levels. Price increases will be difficult to sustain against overcapacity in many industries and the weakness of global growth. Consolidation of highly fragmented industries will accelerate through M&A activities and rising bankruptcy rates among sub-scale enterprises that compete primarily on price.

The China story going forward will be all about sustaining margins in an environment of high cost growth. ■

Multinationals likely will continue to invest in their China-based manufacturing and service delivery platforms to tap into burgeoning domestic demand and to leverage mature and integrated supply chains.

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Are We on Track To Double Exports in Five Years?

It's unlikely that the current pace of export growth will continue

By Daniel Griswold

If you haven't heard the news, the U.S. is "on track" to double its exports by 2014, just as President Obama promised to achieve with his National Export Initiative (NEI). Launched in his State of the Union address in January 2010, the NEI is the centerpiece of the president's trade policy. His stated goal is to double U.S. exports of goods and services from $1.57 trillion 2009 to $3.14 trillion in 2014, creating an estimated 2 million well-paying jobs in the process.

So far, so good. Since the trough of the recession in 2009, U.S. exports have been growing at a robust annual rate of 17 percent, faster than the compound rate of 15 percent needed to reach the goal. From the secretary of commerce to the Council of Economic Advisers, the president's team has been on message that exports are so far "on track" to meet the 2014 target.

Why the Pace Will Slow

Strong export growth is good news in anybody's book, but it is unlikely that the current pace of export growth will continue much longer, never mind for the next four years. The exponential export growth of 2010 was more of a one-time phenomenon than a policy achievement of the administration. Exports were bound to grow rapidly after plunging 18 percent in 2009. All the growth in 2010 achieved was to return exports to their pre-recession level. Exports in 2011 will now be compared to the more normal levels of 2010, rather than the depressed levels of 2009, making a 15 percent growth rate far more difficult to maintain.

A recent report from Wells Fargo Securities, titled *Can America Double Its Exports in Five Years?* threw some needed cold water on the administration's heady talk. "The global economy was recovering from its deepest recession in decades in 2010, so rapid export growth from a relatively low base was not a particularly impressive achievement," the report concluded.

The recent Economic Report of the President made clear that success would be judged by the nominal value, not the actual volume, of U.S. exports. Here again, the Wells Fargo report offers a more sober assessment: "Although government officials may declare 'victory' regarding the export goal, an increase in prices alone would do little to create new jobs, which seems to be the ultimate aim of most economic policies at present. Therefore, we think it is more relevant to focus on real exports of goods and services, which tend to be more highly correlated with employment growth, than on the dollar value of exports."

If exports are measured in real terms, the mountain of doubling exports in five years just became an even steeper climb. Real U.S. exports have not doubled in a five-year period since immediately after World War II. The best real growth in more recent decades, according to the Wells Fargo study, was a 70 percent increase in the last half of the 1980s, and a 48 percent jump during the recent expansion from 2003 to 2008.

Measured in actual volume, U.S. export growth in 2010 was 11.8 percent, somewhat below the pace needed to double by 2014, and that was largely a one-time rebound from the recession.

A Valuable Goal

The NEI is still a valuable exercise. It has provided a framework for progress on trade policy for an administration under pressure from its union base to resist trade liberalization. In the name of promoting exports, the Obama administration has embraced the free-trade agreement with South Korea and, it is hoped, soon the agreements with Colombia and Panama. It has reached a tentative agreement with Mexico to restore safety-certified cross-border trucking, which will remove sanctions on $2.4 billion in U.S. exports.

The NEI is still a valuable exercise. It has provided a framework for progress on trade policy for an administration under pressure from its union base to resist trade liberalization.

Those are all good steps, but doubling exports by 2014 will remain an elusive and overly ambitious goal. I predict that as 2011 rolls on, fewer and fewer members of the president's economic team will describe U.S. export growth as being "on track." ■

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Are Multinationals Trading Technology for Sales in China?

The evidence may surprise you

By Theodore H. Moran

Many believe American companies are trading U.S. technology for access to the Chinese market. To determine what is really occurring, four important questions need to be answered:

1. What is the relationship between foreign manufacturing multinational corporations (MNCs) and the expansion of indigenous technological and managerial technological capabilities among Chinese firms?

2. How are foreign manufacturing MNCs changing the skill intensity of activities and the extent of value-added of operations within the domestic Chinese economy?

3. To what extent might foreign direct investment (FDI) be helping to propel China to become an export superpower, displacing Japan as the predominant economic power in East Asia?

4. Are multinationals trading technology for sales in China?

A Faustian Bargain?

China has been remarkably successful in designing industrial policies, joint venture requirements, and technology transfer pressures to use FDI to create indigenous national champions in a handful of prominent sectors. These include high-speed rail transport, information technology, auto assembly, and an emerging civil aviation sector. Prominent North American, European, Japanese and Korean manufacturing multinationals rightly fear that they may find themselves launching rivals to their own market position when they weigh access to the vast Chinese market

against technology acquisition and management imitation on the part of Chinese partners and other indigenous competitors.

Bringing in new technology to gain access to the Chinese market—whether for domestic market penetration or as a base for exports—may therefore often appear to individual foreign multinationals as making a Faustian bargain with the devil. "China can strike deals," asserts Steven Pearlstein of the *Washington Post*, "that may provide short-term profits to one company and its shareholders but in the long run undermine the competitiveness of the other country's economy."

It is striking how relatively thin the layer of horizontal and vertical spillovers from foreign multinationals to indigenous Chinese firms—and consequent export externalities—has proven to be.

The Evidence Is Striking

But what is striking in the aggregate data is how relatively thin the layer of horizontal and vertical spillovers from foreign manufacturing multinationals to indigenous Chinese firms—and consequent export externalities—has proven to be.

Despite the large size of manufacturing FDI inflows, the impact of multinational corporate investment in China has been largely confined to building plants that incorporate capital, technology and managerial expertise controlled by the foreigner. Within this foreign firm-dominated production array, moreover, FDI payments for Chinese materials and labor used in the operations of the foreign plants have increased as domestic value-added has increased, as Nicholas Lardy of the Peterson Institute for International Economics shows. But Robert Koopman of Georgetown University, Zhi Wang of North Carolina State, and Shang-Jin Wei of Columbia University find that the expansion of domestic content (and, conversely, decline in the import content) is concentrated at the low-skill-intensive sectors of processing trade exports.

As the skill-intensity of exports increases, the percentage of the value of the final product that derives from imported components rises sharply.

From a novel comparative perspective, the share of domestic value-added in FDI operations in China in high-skill-intensive sectors such as computers and telecommunications ranges from less than one-half to slightly more than one-half of what is found in other developing countries where comparable measurements can be made, such as Mexico. Econometric analysis and survey data show that neither horizontal spillovers from—nor strong and vibrant vertical supplier relationships to—the vast FDI presence in China have yet taken place in any dramatic way, and difficult and complicated reforms are likely to be required before they do. These reforms include improving the doing-business climate for private Chinese domestic firms, submitting state-owned enterprises to competitive market forces, upgrading worker skills, creating engineering and managerial talent, reforming financial institutions, and improving infrastructure.

Across the expanse of the Chinese domestic economy, the accumulated evidence simply does not show FDI to be a powerful source for indigenous-controlled industrial transformation. In the case of exports, the production of increasingly sophisticated goods destined for international markets from China has been remarkably well constrained to and contained within the plants owned and controlled by foreign multinationals and their international suppliers. China has remained a low value-added assembler of more sophisticated inputs imported from abroad—a "workbench" economy largely bereft of the magnified benefits and externalities from FDI enjoyed by other developing countries.

How Does China Benefit?

Where do the gains from FDI in China end up? In their dissection of the "value-capture flows" for Apple's iPod—that demonstrates no more than $4 of the final sales price of $299 (2005) remains in China—Greg Linden, Kenneth L. Kraemer, and Jason Dedrick of the University of California suggest that the value-added attributed to the parent company that contributes a component or performs an integrative function to a product in China flows directly back to MNC headquarters. This is almost surely too simplistic—especially for U.S. MNCs—given the American territorial tax system with the foreign tax credit and deferral that encourage U.S. MNCs to use transfer pricing to keep accumulations of earnings offshore.

Rather than try to track down capital flows and hiding places within integrated MNC networks, the more sensible approach is to ask a slightly different kind of question: If MNC headquarters use earnings from China, like earnings from elsewhere, to fortify their corporate position in world markets, what kinds of activities will those earnings help maintain or expand, and where will they be located?

In coming to an answer for this question, it is striking to note—even in today's globalized world—how remarkably home-based MNCs from developed countries have remained.

For the United States the most recent data show that U.S.-headquartered MNCs have 70 percent of their operations, make 89 percent of their purchases, spend 87 percent of their R&D dollars, and locate more than half of their workforce within the U.S. economy. This predominant focus on the home economy has persisted over time, and changes only very, very slowly at the margin.

The home-market-centered orientation for MNCs across the developed world is not dissimilar.

Thus, while manufacturing MNCs may build plants in China—or shift production to Vietnam, outsource to Mexico, take a chance in Costa Rica or the Czech Republic, develop a new application in Israel—the largest impact from deployment of worldwide earnings is to bolster production, employment, R&D, and local purchases in their home markets. ■

The share of domestic value-added in FDI operations in Chinese high-skill-intensive sectors ranges from less than one-half to slightly more than one-half of what is found in other developing countries.

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Packaging Is a Supply-Chain Issue

Packaging optimization offers an exceptional opportunity to save money

By Jack Ampuja

Designing or selecting the basic corrugated shipping case is typically considered to be a job for marketers and engineers. While the marketing department concerns itself with the appearance and utility of the consumer package and the engineering group typically focuses on cost effective packaging, neither group usually considers logistics or supply chain issues adequately. As a result, most firms end up with less than optimal packaging and higher total costs.

The shipping carton or bag for products, such as dry pet food or flour, has a significant impact on warehouse storage, materials handling, damage losses and transportation costs. And it's all part of logistics. The biggest impact is on transportation which is the largest cost segment within logistics.

Unfortunately, many companies continue to drive down their packaging cost without considering how the shipping case impacts the bigger cost segments of warehousing and transportation. Supply Chain Optimizers, the consulting firm I've headed for the past 10 years, specializes in reducing supply chain costs by optimizing packaging. In the past 25 years, we've completed over 500 packaging projects for some of the largest businesses in North America, including General Electric, Office Depot, Toys-R-Us, Nestle, H J Heinz, and Acco Brands. We achieve our results through a combination of vast experience and proprietary software. So how does the process work? Here are a few examples:

A regional ice cream company asked us to analyze its packaging because it had continuous damage. Lab analysis of the boxes showed they were constructed to stack one pallet high. Unfortunately, the client tried to double stack all pallets for truckload shipping.

When we asked the company owner why he thought his firm was experiencing so much damage, he said they must have cheap boxes. When we explained that his shipping cases were inadequate for double stacking, he recalled a few years earlier asking the purchasing manager to reduce packaging cost. In turn, the purchasing manager had specified cheaper, weaker boxes, and in turn, received a nice bonus. The owner was much less happy when we demonstrated how the cheaper packaging had driven freight cost up considerably higher than what was initially saved.

In another case we analyzed textile products for one of the largest U.S. retailers. The products included shoes, shirts and bath towels which all came from Asia via ocean freight. The shirts were packed 12 in a shipping case. The complexity of selecting the right box for 12 units (that can be laid flat or stood up in the box) resulted in 384 possible boxes and each one had a different logistics cost profile. To remedy this, we selected a redesigned shipping case which retained the same 12 units in each box, but increased the number of cases in an ocean container from 5,600 to 7,200. This saved our client 30 percent in freight costs.

The biggest issue or opportunity, depending on one's viewpoint, is in the mail order and e-commerce category. We all are familiar with receiving virtually empty shipping cases from some of the biggest retailers in the country. Many of these companies stock 15,000 products in a distribution warehouse. But since customers purchase different combinations of products, the varieties of shipments (based on weight and cube) expand to over one million per year. We even have seen clients with over two million annual varieties.

The bottom line: packaging optimization offers an exceptional opportunity for cost reduction for virtually any company shipping corrugated shipping cases. The key to success is to recognize all associated costs and assemble a multi-functional team—which includes marketing, manufacturing, purchasing, logistics, quality control, and other internal functions which all have a vested interest in packaging—to derive solutions. ■

The shipping carton or bag for products has a significant impact on warehouse storage, materials handling, damage losses and transportation costs.

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