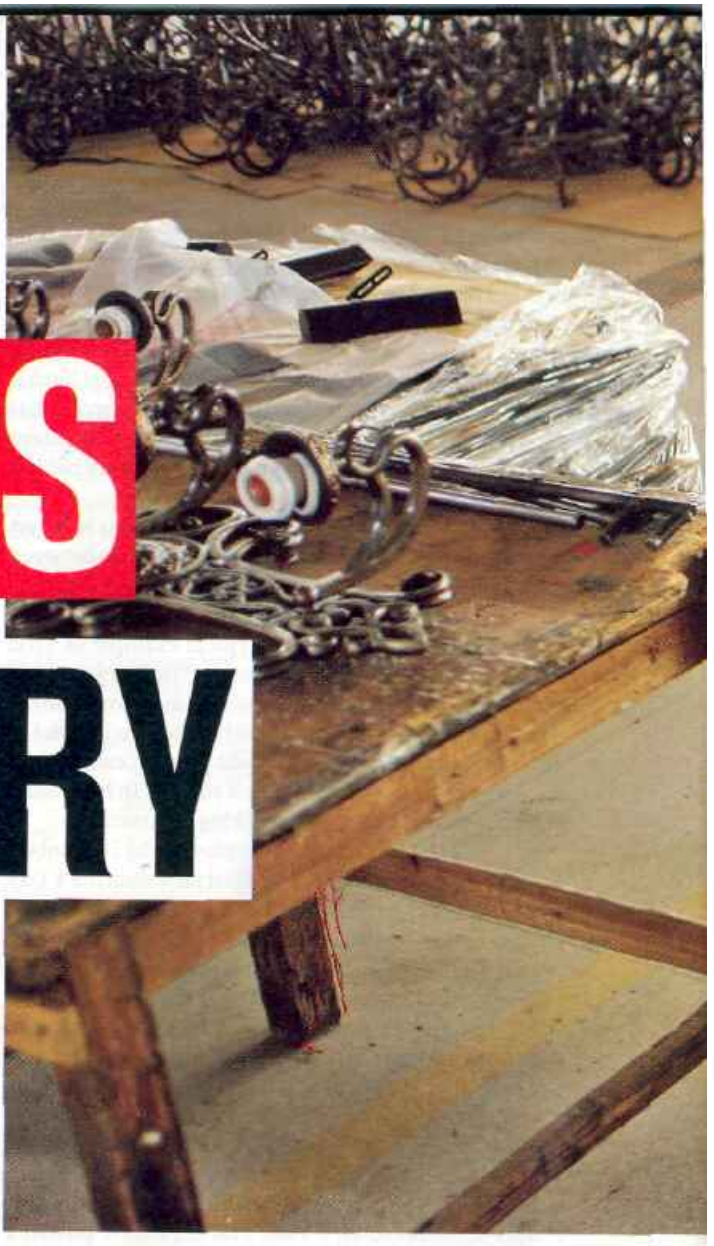

CHINA'S FACTORY BLUES

By Dexter Roberts

The days of ultra-cheap labor and little regulation are gone. As manufacturers' costs climb, export prices will follow

Entrepreneur Tim Hsu first started making lamps more than 20 years ago in Taiwan. And like tens of thousands of other factory owners in Taiwan, Hong Kong, and Macau, he later moved operations to the Pearl River Delta region of Guangdong in South China, setting up his Shan Hsing Lighting in a sleepy hamlet of rice fields and duck farms called Dongguan. Since then the region has grown into the largest manufacturing base in the world for a host of industries, including electronics, shoes, toys, furniture, and lighting. The combination of low wages, minimal regulation, and a cheap currency was unbeatable. Hsu was so confident of Guangdong's future as the world's workshop that he spent $7 million on a much larger factory, which opened earlier this year. Now many of China's manufacturers—including Shan Hsing—are undergoing the kind of restructuring that tore through America's heartland a generation ago. The U.S. housing market, which generated demand for everything from Chinese-made bedroom sets to bathroom fixtures, has plummeted. A new Chinese labor law that took effect on Jan. i

Shan Hsing Lighting's new $7 million factory is running at just 60% of capacity

has significantly raised costs in an already tight labor market. Soaring commodity and energy prices, as well as Beijing's cancellation of preferential policies for exporters, have hammered manufacturers. The appreciation of the Chinese currency has shrunk already razor-thin margins, pushed thousands of manufacturers to the edge of bankruptcy, and threatened China's role as the preeminent exporter of low-priced goods.

Hsu's new factory, it turns out, is running at just 60% of capacity, and he predicts that half of China's lighting factories —almost all based in Guangdong—will have to close their doors this year. "Shoe factories, clothing, toys, furniture, everyone is shutting down," he says. Hsu's not alone in his alarm. "We spent 20 years building up our industry from nothing to one of the biggest in the world," says Philip Cheng, chairman of Strategic Sports, which produces half the global supply of motorcycle, bicycle, and snowboarding helmets out of 17 plants in the Pearl River Delta. "Now we are dying." Cheng says he once earned 8% margins. His margins now? Almost zero.

CHINA'S ROCKETING PRODUCTION COSTS

Average one-year rise in 2007 among 66 companies surveyed

Management compensation	9.1%
Support-staff wages	10.3
Blue-collar wages	7.6
Raw materials	7.1

Data: Booz Allen Hamilton, American Chamber of Commerce in Shanghai

Comprehensive statistics on shutdowns are hard to come by. But the Federation of Hong Kong Industries predicts that 10% of an estimated 60,000 to 70,000 Hong Kong-run factories in the Pearl River Delta will close this year. In the past 12 months, 150 factories making shoes or supplying shoemakers have closed in Dongguan, says the Asia Footwear Assn. More plants will disappear as demand slows: UBS analyst Jonathan Anderson expects overall export growth of just 5% or less for China this year.

Chinese policymakers so far profess

Adidas supplier Apache Footwear recently opened a plant in India

little concern. The closures are mainly hitting lower-value, labor-intensive exporters that pollute heavily and use energy inefficiently. Beijing now wants cleaner industries that produce higher-quality items for the local market, from cars and planes to biotech products and software. That emphasis not only helps boost domestic consumption—a key national goal—but also reduces frictions internationally from the ever-swelling trade surplus. "We are not abandoning the [exporters]," said Guangdong Governor Huang Huahua on Mar. 8. "[But] selling domestically is good for the country, good for the collective, and good for the people."

Still, the shift in the manufacturing base is likely to hit harder and be felt more widely than officials expect. So far, most shutdowns have been in Guangdong, but the pain is hardly limited to the region. When more than a hundred South Korean-owned factories closed over the Chinese New Year in the eastern province of Shandong, 1,200 miles from the Pearl River Delta, thousands of workers were left without jobs—and without unpaid wages.

LOSING ITS ALLURE

The bigger multinationals may be having second thoughts, too. A report by the American Chamber of Commerce in Shanghai found that more than half of foreign manufacturers in China believe the mainland is losing its competitive advantage over countries like Vietnam and India. Almost a fifth of the companies surveyed are considering relocating out of China. "The big story here is that globalization is for real—and China is no longer what it was," says Ronald Haddock, a vice-president at consultant Booz Allen Hamilton, which wrote the report.

The rise of the yuan may be the biggest single factor driving companies to relocate. But other government policies are contributing to the crisis. Last year, Beijing decided to cut or cancel tax rebates on more than 2,000 items used to make exported goods. The impact has been huge. "The end of rebates has raised the cost of manufacturing many goods by 14% to 17% at the factory level," says Harley Seyedin, president of the Guangzhou-based American Chamber of Commerce in South China.

Now a tough new law requires companies to provide employee benefits including pensions; to guarantee collective-bargaining rights; and to hire for the long term. It's "wreaking havoc" says Ben Schwall, president of Aliya International, a Dongguan company that does quality inspections for China's lighting industry. The law is raising operating expenses by as much as 40% when you add spiraling wages in almost every sector. "We knew it was going to be a more difficult year, but no one foresaw 40% more in costs," says Willy Lin, vice-chairman of the Textile Council of Hong Kong. "So when everything exploded in our face, we started to ask: 'What can we do?'"

For many companies the answer lies outside China. In early March, Hebei Yong Jin Cable opened a factory in Vietnam's Tay Ninh province, near the Cambodian border. "In Hebei prov-

ince in China, it costs more than 1,000 renminbi a month [to pay relatively unskilled workers]" says Qu Huijun, Vietnam project director at Hebei Yong Jin. "But in Vietnam, it is about 500 RMB. So the cost of labor is cheaper by half."

BEIJING SAYS CLEANER, HIGHER-QUALITY PRODUCERS WILL REPLACE THE CLOSED PLANTS. BUT THE SHIFT MAY HIT CHINA HARDER THAN OFFICIALS EXPECT

Rising costs are also affecting sourcing decisions by big apparel and footwear labels. Adidas has told its suppliers in Guangdong to look at lower-cost regions in China as well as abroad. So Taiwan-run Apache Footwear, whichhas 18,000 employees in Qingyuan, Guangdong, is considering setting up smaller plants on the Guangdong border with Hunan and Guangxi, where costs are lower. It recently opened a second factory in India. "We will reduce our percentage produced in China because of growth in other countries," says Bob Shorrock, Adidas' global director for sourcing.

Shifting manufacturing abroad, though, takes time and money. Complicated logistics networks that have grown over more than a decade to support everything from computer makers to shoe factories will have to relocate as industries move. "We have more than 100 suppliers in the Dongguan area " says Shan Hsing's Hsu. "Moving is not easy."

Even in countries like Vietnam, labor costs are already rising, and shortages are emerging. Other costs may far outpace those in China. The bill for constructing Apache's India

THE MIDDLE CLASS FEELS THE SQUEEZE

Food and fuel prices are forcing Chinese consumers to scrimp

By Dexter Roberts and Chi-Chu Tschang

For the Wei family, times should be good. The 41-year-old Wei Bing makes $634 a month teaching computer science at a local university. His wife, 39, makes $986 working at the civil aviation agency, while her parents, who live with them, receive a combined monthly pension of $845. They have their own four-bedroom, 600-sq.-ft. apartment close to key Olympics facilities. From the balcony off their nine-year-old son's room, they can just make out the Bird's Nest stadium where the opening and closing ceremonies will be held.

Nevertheless, the family of five is feeling the squeeze like never before. Monthly living expenditures have doubled from a year ago, to $282. While last year consumer price inflation was 4.8%, it reached 7.1% in January and 8.7% in February—the highest in China in 11 years. "Oil, milk, [and meat]—the price of things that we can't do without—they have all gone up," laments Wei. Pork alone has doubled in price in the last year. Salary increases have not matched inflation, with Wei's wages up only 10% or so over the last three years.

The Weis have cut back on meat and fried food to save money

So the Weis are economizing wherever they can. The family is eating less fried food (vegetable oil has more than doubled in price, to almost $10 a cask) and more boiled foods—which are healthier anyway, points out Wei. What about meat? Simple: "We put less inside our dumplings and add more vegetables," says Wei.

With gas prices up, too—they've more than doubled, to 75¢ a liter in the past six years since the family bought their Volkswagen Jetta—the Weis are trying to drive less. That means fewer trips to the giant Carrefour hypermart that require a 30-minute drive. Now eager to buy a new car (the family has planned this purchase for years), the Weis are considering what was once unthinkable—getting a Japanese model. (Japan's invasion of China in the 1930s has prejudiced some Chinese against Japanese products.) "Originally, I didn't like Japanese cars. But now I'll consider them because they are fuel-efficient," says Wei.

Higher prices for goods made from petroleum products—including toys, clothes, and running shoes—are having an impact. The Weis are wearing their clothing and shoes longer and holding off on new toy purchases. That creates some friction in the family, concedes Wei. "My son likes the brand-name soccer shoes. I keep telling him to wait. Nike shoes are pretty expensive—children's shoes are $70 to $85."

It's tough, yet 67-year-old grandfather Huo Bailing offers some perspective. "In the '60s, we weren't afraid of an increase in prices," he says. "There was nothing to buy!"

factory was almost three times what it would be in China, the company estimates, because the Indian government required that it be built to strict British specifications on the materials used. Frequent power and water shortages mean Apache has had to provide its own expensive backup systems for its Indian plant as well. "Adidas says we should move as fast as we can to India. But productivity in India is *65%* to *70%* the level of China," says Charles Yang, Apache's executive general manager. "If we ramp up too fast in India, we may shoot ourselves in the foot."

This shuttered Dongguan factory is one of many, with more to come

KINDERGARTEN AND CAMP

Fear of stumbling abroad has led many manufacturers to seek even more productivity gains in China. "The most important thing we can do to cope is to raise our efficiency," says Li Dongsheng, chairman of top Chinese electronics maker TCL. Some are trying automation. Reducing employee turnover—which nears 75% annually at many Guangdong companies—is another way. That's why Apache offers perks like a kindergarten and even a summer camp for employees' children to learn English. It has just finished building 280 apartment units it will sell at below-market prices to its married employees. "We are trying to make it feel like home here," says Yang. "It stabilizes your workforce."

"THERE WILL BE A RISE IN THE PRICES OF SHOES, TEXTILES, AND ALL KINDS OF HOUSEHOLD PRODUCTS," SAYS AN AMERICAN CHAMBER OF COMMERCE EXEC

Will these efforts keep a lid on the prices of products coming out of China? Probably not. For years manufacturers have met the demands of U.S. retailers to lower their prices. But their backs are finally to the wall, says Charles Swindle, a senior vice-president at Hong Kong's Flora Forte, which uses 20-plus China factories to make home decor items for Bed Bath & Beyond, Wal-Mart, and major U.S. department stores. "I know factories are turning down millions of dollars in orders because they will lose money if they take them."

The next step is inevitable, says the American Chamber's Seyedin: "There will be a rise in the prices of shoes, textiles, and all kinds of household products." Geoffrey Greenberg, president of Creative Designs International, saw the cost of toys and costumes he acquires from Guangdong factories rise as much as 25% last year. He recently passed on price hikes of up to 10% to his customers, including Wal-Mart and Kmart.

Some manufacturers will try to avoid those increases by finding cheaper locales deep inside China. "The answer to high prices in China is more China," says William Fung, Hong Kong-based group managing director at the world's biggest consumer-goods sourcing company, Li & Fung. "There are still places like Sichuan or Hunan that are cheaper."

But there are plenty of signs that labor costs are rising in cities such as Chengdu in Sichuan and Changsha in Hunan. And no matter where they relocate on the mainland, manufacturers face the same newly stringent labor law, high commodity prices, and pressure from the ever-climbing currency. That has major implications for the global economy. "Unlike in the last 20 years, when China exported deflation, from now on, China will export inflation, " says Peter Lau, CEO of Hong Kong retailer Giordano International, which has extensive operations in China. "Consumers will have no choice but to accept the new reality. They should get psychologically prepared." BW

-With Chi-ChuTschang in Beijing

LINKS

Sell Local, Sell Global

China Manufacturing Competitiveness 2007-2008, a study prepared in March by Booz Allen Hamilton for the American Chamber of Commerce in Shanghai, details the state of manufacturing on the mainland and how it compares with global rivals. The big conclusion is that the most successful multinationals in China use their operations there both to export back home and to sell to local customers. This approach generates profitability two-thirds higher than that of companies focusing solely either on exports or the China market. Yet only one out of four companies surveyed uses this dual strategy.

Fonte: Business Week, n. 4078, p. 78-82, 7 Apr. 2008.