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## Many Factories in China's South Sound Last Whistle

**Plants Shut, Move Amid Competition From Asian Rivals**

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China's Pearl River Delta -- the southern coastal area that in the past two decades has become the world's factory floor for low-end goods -- is losing thousands of factories.

Rising costs and tighter regulations are making the region less competitive than other Asian manufacturing hubs, including other parts of China. New labor laws and higher taxes for foreign-invested companies, combined with tougher environmental rules and a strengthening Chinese currency, are squeezing Chinese companies that make labor-intensive products such as toys, clothing and furniture.

- **The Situation:** Market forces and government policies are squeezing China's low-cost manufacturers.
- **The Outlook:** Many low-cost factories are shutting down or moving away from southern China, shifting inland and refocusing on goods for Chinese consumption.
- **The Impact:** Effects could include increased costs for many companies that source products from China, and longer delivery times.

This year "...will likely mark the year (China) manufacturers were finally forced to take a general hit on profitability," UBS AG economist Jonathan Anderson said in a note Monday.

The Federation of Hong Kong Industries estimates 10% of the 60,000 to 70,000 Hong Kong-owned factories in the delta region will

close this year -- likely the highest rate of closures in 20 years, says Deputy Chairman Stanley Lau. Some of these operations have been closed for good, some moved inland, and some relocated outside China.


In the past year, more than 1,000 shoe factories and related suppliers have closed in Guangdong, which is home to the Pearl River Delta and which has provided about a third of China's exports. That is roughly 10% of the footwear manufacturers in the province, says Li Peng, secretary-general of the Asia Footwear Association.

Most companies shutting factories had relatively small operations in Guangdong province, having invested less than \$3 million each, according to a survey by the International Business Daily, a Chinese newspaper.

Douglas Sheridan, president of Hong Kong-based sportswear supplier Net69, says it is "the first time I've seen so many elements hitting us at once" in China. At a recent trade fair in Munich, Germany, "everyone was talking about who they are working with in south China, and whether they'll still be in business," says the 25-year industry veteran, who is now setting up a joint venture in Vietnam and scouting other locations outside China.

The changes buffeting low-end manufacturers are likely to be long-lasting. They are driven in part by the Chinese government's effort to redress some of the imbalances brought about

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by decades of breakneck growth, such as poor working conditions and pollution. Beijing also changed its corporate-tax rates this year to phase out tax breaks given to foreign companies, which dominate the export sector. And rising prices for oil and other commodities have added to the pain, as has China's strengthening yuan, which gained nearly 7% last year against the dollar, making Chinese goods more expensive for buyers in the U.S.



"This year is a turning point for manufacturers," said F.C. Lo, vice president of the Chinese Manufacturers' Association of Hong Kong, where many of the companies that manufacture in southern China are based. In years past, "many made money," he says, but "things have changed."

The shift in China's light-manufacturing sector is sending ripples around the world. Factory owners are looking beyond Guangdong and the Delta -- where the cost of living, and hence, wages, has become relatively high -- to new locations deeper inside China, where they can enjoy lower costs and investment incentives from local governments eager to attract businesses.

In some cases, they are also turning to poorer countries with lower wage levels. That means new investment and assembly-line jobs in countries such as Vietnam and Bangladesh -- and possibly longer, more-complex supply chains for big buyers such as Wal-Mart Stores Inc.

Those changes are being driven by fierce pressure to keep prices low for overseas buyers. Prices for Chinese exports have already been rising at a quickened pace in recent years, and the new increases in labor and other costs could translate into even more expensive products for consumers and companies in the U.S. and Europe -- just as economists are worried about a possible recession in the U.S. Recently, U.S. toy company **Hasbro** Inc. said it expects costs for the goods it sources in China to jump 14% to 15% this year, although executives said many of Hasbro's suppliers are seeking to shift operations to cheaper locations further inland in China.

China retains a number of advantages in manufacturing that mean the broader impact is likely to be limited. The current pain is concentrated among producers of inexpensive, labor-intensive goods, whereas the majority of China's exports now are machinery and electronics -- goods like auto parts or computers.

Beijing has encouraged manufacturers to switch to such higher-value goods, in which labor costs are less of a driving factor and China's economies of scale make it a formidable competitor. China also boasts roads and other infrastructure that are superior to many other developing countries.

Those factors mean China will remain a force in global manufacturing for years, even if its traditional advantages in light manufacturing along the coast erode.

Perhaps the biggest catalyst behind the shifting climate for light manufacturers is a labor-contract law that took effect Jan. 1. Employers say the law has shifted bargaining power in favor of employees and raised awareness of rights among workers. A labor shortage in southern China -- as workers find more jobs in other parts of China -- has also given workers more clout.

The number of cases filed for labor arbitration has been increasing at a rate of more than 25% a year since 2002. In May, another rule will take effect that makes labor arbitration

free and even easier to initiate.

"The biggest worry is not [the possible U.S.] recession, which is cyclical," says Willie Fung, chairman of brassiere manufacturer Top Form. Instead, he says, it is the "one way" changes in China's operating environment. "Costs, once jacked up, cannot go down."

China's leadership is also bolstering efforts to combat rampant environmental damage from decades of almost unfettered manufacturing that has poisoned skies and rivers in the region. Gordon Yen, executive director at knitwear firm Fountain Set Holdings, supplier to clients such as Wal-Mart and Nike Inc., says the tighter limits on pollutant-generating industries make it "virtually impossible" to set up a new dyeing and finishing plant making goods for export in Guangdong.

The changes are affecting low-end producers in other coastal parts of China, too. But the area hardest hit is the Pearl River Delta. During the two decades when investments poured in from Hong Kong and Taiwan, the area blossomed into a manufacturing juggernaut, responsible for about 8% of the country's gross domestic product as of 2006.

Today, parts of the area around Dongguan, a major manufacturing hub in the delta, are now full of "empty restaurants, factories closed down," says Willy Lin, who heads a knitwear-manufacturing business.

Mr. Lin's company, Milos Manufacturing Co., is moving its factory to Jiangxi province, about six hours by car from Hong Kong. But he is worried about finding skilled workers. "We need nimble fingers, but we're worried we find farmers who...can't work my machines."

Some companies have been preparing to relocate for a while. Electronics manufacturer **Hon Hai Precision Industry** Co., China's single largest exporter by revenue, has been rapidly expanding into other Chinese provinces in recent years from its longtime base in Guangdong. Last August, Hon Hai, which makes personal computers and electronic gadgets for Hewlett-Packard Co. and Apple Inc., said it was quintupling its planned investment in Vietnam to \$5 billion. But analysts still project its costs will increase this year.

"Rising prices in China are going to make it difficult for manufacturing companies in China to survive and compete in the future," said Tom Nelson, managing director of sourcing at VF Corp., which owns apparel labels such as North Face and Nautica. Mr. Nelson says China remains attractive in some ways -- it typically takes 20 to 25 days for goods made in China to get from factory floor to retail shelves in the U.S., compared with 30 days from Cambodia and 40 to 45 days from Bangladesh, he says.

Still, VF is looking to source more products from inland China, and from other countries like Indonesia, Pakistan and Vietnam.

--Ellen Zhu in Shanghai contributed to this article.

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