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China is choking on its success at attracting the world's factories. That has handed its Asian neighbours a big opportunity

AS A vote of confidence in Vietnam, the decision by Intel early in 2006 to spend $350m building a new factory in the emerging South-East Asian economy was hard to beat. And yet, before the year was out, the American chipmaker went further and raised its investment to $1 billion. In eight months Intel had committed as much money to Vietnam as it had to China in the previous ten years.

In the Johor region of Malaysia, another global firm, Flextronics, has fired up the production lines of a new M$400m ($110m) factory to make computer printers for another American firm, Hewlett-Packard. One of the largest contract electronics manufacturers, Flextronics already has vast facilities in China. But it chose Malaysia as the site for its latest investment.

Further east, in Indonesia, Yue Yuen, a Hong Kong-based shoemaker, has been ramping up its output of trainers and casual footwear for brands like Nike and Adidas. Production is increasing at the firm's factories in China and Vietnam too, but output in Indonesia is growing the fastest.

Although all three companies had different reasons for their decisions, the outcome was the same: they chose to avoid China's thundering economy in order to put their factories elsewhere in Asia. These companies are not alone. In the calculus of costs, risks, customers and logistics that goes into building global operations, an increasing number of firms are coming to the conclusion that China is not necessarily the best place to make things.

With its seemingly limitless supply of cheap labour and the rapid acquisition of technological prowess, China appears to be unstoppable. Indeed, the perception is that every factory closing in America or Europe is destined to reopen in China. Many have, helping China's share of the world's exported goods to triple to 7.3% between 1993 and 2005. In comparison, every member of the G8 group of rich nations, with the exception of Russia, saw its share fall. It is a similar story with manufacturing output. Whereas China doubled its share of global production to almost 7% in the decade to 2003, most of the G8 saw their shares fall. Interestingly, only the United States and Canada saw their shares rise—with just over a quarter between them. Most things nowadays might seem to be made in China, but North America remains the true workshop of the world.

Yet it is not only China that is booming as a base for low-cost production. Manufacturing and exports are growing rapidly in other parts of Asia (see chart 1 on next page). Taken together, South Korea, Taiwan, India and the Association of South-East Asian Nations (ASEAN) increased their share of global manufacturing from less than 7% to more than 9% in the decade to 2003. Exports also rose across the board. China is the emerging giant, but the investments that are being diverted away from the Middle Kingdom present the rest of Asia with a huge opportunity to become manufacturing hubs in their own right. The question is whether they can seize it.

Scott Brixen, an analyst at CLSA Asia-Pacific Markets, a Hong Kong-based investment bank, gives two big reasons why China has not found itself at the top of the list for some new factories: "Rising costs and a natural desire by companies for diversification."

So far, most industrial development in China has taken place in the country's eastern coastal regions, particularly around Shanghai and the Pearl River Delta near Hong Kong. But costs in these centres are now rising sharply. Office rents are soaring, industrial land is in short supply and utility costs are climbing. Most significant of all are rocketing wages. In spite of the mass migration of workers from China's vast interior to the coast, pay for factory workers has been rising at double-digit rates for several years. For managers, the situation is worse still.

"China has become a victim of its own success," sighs Peter Tan, president and managing director of Flextronics in Asia. He finds it especially hard to hire and retain technical staff, ranging from finance directors to managers versed in international production techniques such as "six sigma" and "lean manufacturing". There are not enough qualified workers to go around, causing rampant poaching and extremely fast wage inflation. "China is definitely not the cheapest place to produce any more," he says.

An analysis of labour rates across Asia by CLSA's Mr Brixen supports that view. Average wages for a factory worker, combined with social security costs, came to almost $350 a month in Shanghai in 2005 and almost $250 a month in Shenzhen. By comparison, monthly wages were less than $200 in Manila, around $150 in Bangkok and just over $100 in Batam in Indonesia. Although the productivity of Chinese workers is rising, in many industries it is not keeping pace with wages.

One solution is for companies to move inland where many costs are much lower than on China's heavily developed coastline. Indeed, the government has been promoting such a policy since 2000, to spread the benefits of development to China's poor interior. Domestic Chinese companies have led the charge into the hinterland and a small, but growing, number of foreign firms have followed them.

Intel is one. In 2004 it decided to invest $525m in a new plant in Chengdu, the capital of Sichuan province, to complement its existing factories on the coast in Shanghai, 1,600km (994 miles) away. Brian Krzanich, general manager of Intel's test and assembly business, says the company's decision was based on cost. The government was keen to promote its "go west" policy, so it offered Intel generous incentives. Needless to say, being so far inland raises transport costs for exporters. But Mr Krzanich reckons there are compensations, because labour and utilities are much cheaper than on the coast.

But not everyone is convinced. At Flextronics, Mr Tan's China factories are all located in eastern coastal provinces. "We have no interest in going west," he says, because it is too expensive to get products to America and Europe from there. Other observers add that the shortage of management talent inland is even greater than on the coast. And it is not easy persuading expatriate workers to take their families to places like Chongqing and Chengdu, where foreign companions and international schools are thin on the ground. So many firms decide they would rather invest elsewhere in Asia.

Costs are only part of the equation. Just as important is diversification. Having already moved a big chunk of their production to China, many firms are reluctant to put any more of their eggs in the same basket. A research report written last year by the Japan External Trade Organisation concluded: "Due to the country's increasing business risks and rising labour costs...Japanese firms employing a 'China-plus-one' strategy—in which they invest in China and another country, namely in ASEAN—should consider placing more emphasis on the 'plus one' country."

Japanese companies may be particularly wary, but such nervousness is now shared by managers from other countries. Some of their firms are concerned about growing unrest in China as swathes of the country's rural population, particularly in the west, fall behind the thriving east. Official figures record 87,000 incidences of rioting and social disturbance in 2005, much of it following the forced appropriation of farmers' land in the name of development. The actual number of cases of civil unrest could be far larger.

Equally important are concerns about growing protectionism. The United States and the European Union are becoming more assertive in holding China to account over its World Trade Organisation obligations. Companies worry that this could lead to sudden interruptions to trade.

Ask Yue Yuen, the world's largest contract shoe manufacturer. The company produces more than 180m shoes a year from factories in China, Vietnam and Indonesia, most of them bound for America and Europe. So when the European Union imposed anti-dumping duties in October 2006 on leather shoes imported from China and Vietnam, the

firm was quick to raise its production in Indonesia. "Trade relations with other nations and the tariff and quota situation are vital considerations for where we invest," says Terry Ip, a spokesman for the company.

So too are wage rates. With each shoe passing through up to 200 pairs of hands on the production line, Yue Yuen's operations are highly labour-intensive. In China the firm is experiencing rapid wage inflation. Although this is partly offset by productivity improvements which mean that overall unit labour costs are rising by 8% a year. Pay for factory workers is rising in Vietnam and Indonesia too, notes Mr Ip, but labour costs there are as much as 35% lower than in coastal China.

Another company with a China-plus-one strategy is Uniqlo, a Japanese clothing retailer. Last year it decided to reduce the share of clothes it sources in China from 90% to 60% as a hedging strategy against future trade disputes. New factories in Cambodia and Vietnam will make up the shortfall. Intel, with facilities in Vietnam, the Philippines, Malaysia and China, is creating a diversified portfolio also.

China also has other risks, notably a lack of protection for intellectual property rights. Stories abound of foreign investors finding local companies churning out identical goods to their own, but under a different brand. For that reason a number of companies in industries such as medical devices have instead set up shop in Singapore. Often these products are capital-intensive, so labour costs are less important than strong intellectual property laws. Several chemical companies have even built facilities in Singapore with the intention of shipping most of their products to China. Feedstock is more easily available in Singapore, but just as important is confidence that valuable industrial processes will not be stolen.

Managers also worry about the rising value of the Chinese currency. Although nobody expects sudden leaps, the yuan does appear to be on a steadily upward trajectory, having risen by a further 4% against the dollar since the government first revalued the currency by 2.1% in July 2005. Pundits expect it will continue to rise by around 5% in the year ahead, which will do little to bolster China's attractiveness for export-based manufacturing.

Of course, cost and risk are not the only considerations in choosing where to put a factory. The quality of a country's infrastructure, the presence of suppliers and the size of the local market all count. For such reasons, China will remain an attractive place to invest.

Kumar Bhattacharyya, a professor of manufacturing at Britain's University of Warwick, believes the lure of China's burgeoning domestic market will outweigh the various concerns over cost. "Why do people go to India and China? The standard answer is for cheap labour, but most big technology companies go there for the market," he says.

Naturally, industries such as textiles and clothing will always seek places with cheap labour, hopping from country to country as wages rise and equalise. However, for more

complex and capital-intensive manufacturing, it is clear that foreign direct-investment flows are aimed at accessing local markets rather than low costs.

In emerging Asia markets simply do not come any bigger than China, with its 1.3 billion people. Individual wealth is still extremely low compared with figures for the United States and Europe, but a vibrant middle class is emerging in the big cities. With growth rates of more than 10% a year, China offers huge potential. Transport and other infrastructure in China is also in better shape than many other Asian countries and the quality and availability of suppliers is improving all the time, enabling highly integrated supply chains to develop within the country.

Yet other parts of Asia also offer sizeable markets. India has 1.1 billion people, an emerging middle class of its own and will grow at around 8% this year, although the country is a good deal poorer than China. To date, foreign investment in manufacturing has been limited—total investment inflows in 2005 amounted to a meagre $7 billion, compared with more than $70 billion for China (see chart 2 on previous page). Hugely inadequate infrastructure is one of the chief obstacles in India, as is a business climate famous for its bureaucracy. Yet even there, more foreign companies are starting to open factories.

The car-parts industry is a good example, with both Toyota and Hyundai investing recently to take advantage of the almost 700,000 engineering and science graduates that India produces every year. It has even been suggested that Indian technicians could re-engineer some of the West's highly automated car-production lines to make them more labour-intensive for the Indian market. Firms making specialty chemicals are keen to combine technical expertise with low costs and a growing market. Even low-technology industries are interested: Yue Yuen is close to building its first shoe factory in India, attracted not only by the country's vast pool of cheap workers but also by efforts to set up special economic zones that offer tax breaks.

Most observers reckon India's manufacturing evolution is ten years behind China's, but progress is unlikely to be as swift or as smooth. A country that puts a higher value than China does on democracy and the rights of the individual will inevitably find it harder to push through infrastructure projects and reform to sensitive areas such as the rigid labour market.

With 560m people, the ASEAN trade bloc also offers a big population. South-East Asia has been the chief beneficiary of companies' decisions to diversify out of China. The problem is that the ten ASEAN nations have yet to form a single market. Although the region offers plenty of opportunity for export-based manufacturing, as a single market it remains highly fragmented. Companies want to be able to set up one factory to serve the whole region, but numerous barriers prevent them from doing so.

Governments in the region have announced bold plans to create the ASEAN Economic Community by 2015, with a free flow of goods, services and investment. Following a free-trade agreement in 1992, tariffs on the majority of goods traded in the region have

fallen below 5%. Much harder to achieve will be the removal of non-tariff barriers, which would call for harmonising thousands of industry standards and customs regulations, and setting up independent bodies to govern regional trade and mediate in disputes.

Few believe that the ASEAN Economic Community will come about as its architects hope. Less developed nations, such as Myanmar and Laos, will integrate at a slower pace than countries like Singapore and Malaysia—if they integrate at all. Nonetheless, progress is being made and the rapid rise of China and India has added urgency to the process. Twelve areas, including electronics, health care, textiles and logistics, have been singled out as the first to be worked on.

In the meantime, governments must also think how to get their industries into higher-value manufacturing. Although ASEAN received record levels of foreign direct investment in 2005, at $37 billion, much of the manufacturing coming into the region is basic, labour-intensive assembly work that adds only a little value.

"I get worried about ASEAN," says Roland Villinger, a Bangkok-based partner at McKinsey, a consulting firm. He thinks the region urgently needs to add to the sophistication of its manufacturing—partly because India and China are improving so fast. He agrees that a lot of factories in ASEAN are part of a "China-plus-one or plus-two" strategy. However, he believes South-East Asia needs to be more than just a hedge against risk in China. And ASEAN has its own share of risks. Thailand's new military government seems to be doing its utmost to deter investment, including tighter curbs on foreign ownership and botched currency controls.

Bright spots do stand out. Singapore has a highly educated workforce, although its population is only about 4m. The country has a solid history of attracting sophisticated manufacturing that calls for strong technical skills and often involves extensive research and development. Malaysia too has had some success in moving into higher-value manufacturing. In May last year, for example, Intel opened a new research centre in Kulim employing 900 people to design microprocessors, chipsets and motherboards for use in its products worldwide. And in Thailand efforts to make the country the "Detroit of the East" are starting to pay dividends—at least they were until the present troubles. Thailand was set to overtake the United States last year as the world's largest maker of one-tonne pick-up trucks. Toyota recently set up a new research-and-development centre in Thailand for its light truck business.

Elsewhere in the region, though, governments talk a good game, but have yet to make enough progress. For the moment, as foreign investors choke on their China investments and look elsewhere, that does not matter too much. But as India sorts out its problems and as China grows into an ever bigger market, South-East Asia needs to integrate its own markets or see its newly found popularity among manufacturers slowly fade.

GRAPHIC: Trainers to peddle harder

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