

China Begins to Lose Edge as World's Factory Floor

By Yajun Zhang: January 16, 2013

BEIJING—China is losing its competitive edge as a low-cost manufacturing base, new data suggest, with makers of everything from handbags to shirts to basic electronic components relocating to cheaper locales like Southeast Asia.



Workers package Nescafé at a Nestlé factory in Dongguan in southern China's Guangdong province.

The shift—illustrated in weakened foreign investment in China—has pluses and minuses for an economy key to global growth. Beijing wants to shift to higher-value production and to see incomes rise. But a de-emphasis on manufacturing puts pressure on leaders to make sure jobs are created in other sectors to keep the world's No. 2 economy humming.

Total foreign direct investment flowing into China fell 3.7% in 2012 to \$111.72 billion, the Ministry of Commerce said Wednesday, the first annual decline since the fallout from the global financial crisis in 2009.

Then, a 13% fall in foreign investment into China reflected dire conditions for business in the U.S. and Europe, and global risk aversion, which choked off capital flows. Economists say the drop in 2012 is partly cyclical, driven by slowing overall growth in China and Europe's prolonged debt crisis.

But it also is the result of a long-term trend of rising wages and other costs that have made China less attractive, especially for basic manufacturing, economists say.

By contrast, foreign direct investment into Thailand grew by about 63% in 2012, and Indonesia investment was up 27% in the first nine months of last year.

Coronet SpA, an Italian maker of synthetic leather with production in the southern Chinese province of Guangdong, plans a new factory in Vietnam to take advantage of lower labor costs and to be closer to its customers in the shoe and handbag businesses, many of which have already moved there.



"A lot of our customers are already moving a part of their business in Far Eastern countries with lower working cost," said Jarno Tagliarini, Coronet chief executive. "Considering all the countries available, we think that Vietnam is the most developed one."

Electric cars are manufactured near Beijing.

Foreign capital helped build China into a low-cost

manufacturing powerhouse and global growth engine. But its increasingly urban population now has higher expectations in terms of wages and working conditions and louder objections to the pollution that often comes with low-level manufacturing — demands that have eroded China's cost advantage.

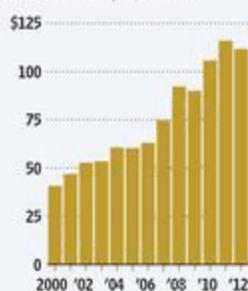
China's leaders are moving to shift the economy away from its traditional reliance on low-end manufacturing and heavy investment spending, seeking to build a stronger consumer base at home. A breakdown of Wednesday's figures suggests a tentative move in that direction: While foreign direct investment in manufacturing contracted by 6.2% in 2012, investment in the service sector excluding the property market rose 4.8%.

Losing Luster

Foreign direct investment into China is down as higher costs drive some companies away.

Pullback from Asian firms accounts for much of the drop. Europe's crisis also is a factor.

FDI into China, in billions



FDI into China, by source

	2012	Annual change
Group of 10 Asian economies*	\$95.7 billion	-4.8%
EU	6.11	-3.8
U.S.	3.13	+4.5

Note: FDI excludes banking, securities and insurance industries. *Includes Hong Kong, Taiwan, Macau, Japan, Philippines, Thailand, Malaysia, Singapore, Indonesia, South Korea. Source: China's Ministry of Commerce. The Wall Street Journal

"We know we can't keep relying on a low-cost competitive advantage. We need to accelerate the value-added upgrading of our products," said Commerce Ministry spokesman Shen Danyang at a news briefing Wednesday.

Mr. Shen acknowledged the trend of companies investing elsewhere, though he attempted to play it down.

"We have noticed some migration by companies, but this is a normal migration. It's not accurate to say there has been a large-scale shift of manufacturing [foreign investment] to other countries," he said. But he added, "You couldn't

say we are happy to see this development. We still hope to actively attract foreign investment."

Commerce Minister [Chen Deming](#) on Tuesday gave a tepid forecast for investment in 2013, saying it will likely be about the same as last year.

China's foreign-investment data come with some uncertainty. Another set of numbers from China's central bank that includes profits that foreign firms reinvest there shows growth in the first nine months of 2012, according to an analysis by Thilo Hanemann, research director at Rhodium Group. But the figures, which he said may be subject to significant revisions, also show investment growth close to zero over the past two years.

With the lion's share of investment in China now coming from domestic sources, the impact of falling foreign investment on growth will be limited. But an erosion of manufacturing's importance underlines the challenge for China's leaders in finding new sources of growth in domestic consumption and higher-level industry.

For China's neighbors, the trend means more opportunities. Southeast Asian nations, which claimed 2% of global foreign investment in the wake of the 1997 Asian financial crisis, now account for about 7.6%, approaching China's 8.1%, according to HSBC calculations.

Asian firms accounted for much of the investment drop in China. Investment from 10 Asian economies—Hong Kong, Taiwan, Macau, Japan, the Philippines, Thailand, Malaysia, Singapore, Indonesia and South Korea—fell 4.8% last year and accounted for about 82% of the total. Hong Kong was the single biggest investor, reflecting in part money from mainland investors being recycled back into the country.

One country that could play a decisive role in speeding up the shift away from China is Japan. Japanese investment into China rose 16% from a year earlier, but worsening relations over a set of disputed islands could prompt Japanese firms to look elsewhere. In September, Japanese cars and businesses were ransacked by rioters in anti-Japan protests across China.

Many Japanese companies are already looking for a second production base to hedge their China exposure. For example, while foreign investment into Vietnam declined by 15% in 2012, a reflection of macroeconomic challenges there such as high inflation, investment from Japan into Vietnam more than doubled due in part to Japanese companies' efforts to look for alternatives to China.

In Thailand and Vietnam, Japan was the single largest source of investment last year. In Indonesia, it was second behind Singapore.

Minoru Ikeda of the Shanghai office of the privately funded Japan-China Economic Relations and Trade Centre, says the center—which encourages Japanese investment in China—has seen inquiries about new ventures dry up; as of Wednesday his team hadn't handled any new investment-related inquiries since tensions peaked.

In an October survey of Japanese companies by the government-linked Japan External Trade Organization, 52% of respondents planned to expand business operations in China over the next one to two years, down from 67% in the survey the previous year.

Yoichi Maie, director of Jetro's China and North Asia Division, said there were several reasons for the decline, notably rising labor costs, and that political tensions were not the most important factor.

Mr. Maie also stressed that there are limits to the ability of Japanese companies to diversify away from China. "There is no alternative to China for Japanese companies," he said. "No other country—except for the U.S.—offers such a large market and highly established production networks."

A shift to other countries doesn't mean companies are abandoning China. In a survey of about 300 members of the American Chamber of Commerce in China, 58% said the country remains in the top three investment priorities, up from 47% in 2011. But only 20% said China was their No. 1 investment priority last year, compared with 31% in 2011.

Many are also looking at moving from China's coastal manufacturing cities to its lower-cost inland regions. A poll in May by the Federation of Hong Kong Industries showed that about 10% of Hong Kong companies located in China's Pearl River Delta are considering a move to Southeast Asia due to rising costs, while 13% are considering moving to inland provinces.

HSBC economist Trinh Nguyen estimates that Chinese manufacturing wages rose by around 20% per year between 2005 and 2011, giving companies a strong incentive to start looking elsewhere for labor-intensive production.

"The total amount of capital flowing in China will be still robust, but the growth will decelerate. The nature of [foreign investment] will become more domestic-market-oriented than export-oriented," Ms. Nguyen said.

Not all of the shift out of China involves low-end industries such as garment-making. [Wintek](#) Corp., a Taiwanese company with about 50,000 workers globally that makes smartphone components for companies including Apple Inc. said in October it will invest \$930 million in four new plants in Vietnam to make displays and touch screens.

A Wintek spokesman said the company is still committed to expanding its existing facilities in the southern Chinese city of Dongguan and the province of Jiangsu, two traditional hubs for Chinese manufacturing. "To mitigate the impact from rising labor and rental costs, we are producing more value-added products in our Dongguan and Jiangsu factories," he said.
