made in south-east asia

STORY **DANIEL ALLEN**

Higher wages in China are stimulating a manufacturing migration to elsewhere in Asia, where labour is more affordable. The issue now is to lift manufacturing standards and improve infrastructure and supply chains in the broader region.

Steel mill worker in China (left), and (opposite, from top): Hana Microelectronics semi-conductor plant in Thailand; ABC President drinks plant in Indonesia; inspecting a coil of copper rod at the Luvata Malaysia plant in Pasir Gudang; garment manufacturing in Indonesia.

ASIA'S MANUFACTURING LANDSCAPE is changing dramatically. As regional superpower China moves up the value chain, the increasingly integrated region of South-East Asia is poised to rival its northern neighbour as the world's factory of choice. Production networks that once focused on cities such as Shenzhen and Guangzhou could, over the next decade, encompass locations as diverse as Mandalay, Jakarta and Phnom Penh.

With the balance of China's maturing economy shifting from exports to domestic consumption, the country's era of low-cost manufacturing is drawing to a close. The 10 members of the Association of Southeast Asian Nations (ASEAN) may boast a combined population less than half that of China, but the bloc's abundant cheap labour, improving infrastructure and investment environment, and increasingly affluent consumers are now catching the eye of many a multinational.

The most significant driver of regional change is the rise in production costs in China's traditional manufacturing centres. Thanks to increasing urbanisation, skewed demographics and deliberate government policy, the country's once seemingly limitless supply of cheap labour is now a thing of the past.

"Wage hikes mean Chinese and foreign companies are already moving their low-cost manufacturing operations to countries such as Vietnam and Cambodia," says Rajiv Biswas, Asia chief economist at IHS Global Insight. "Other South-East Asian countries with low manufacturing wages are likely to benefit from this trend over the medium term, including Indonesia, the Philippines, and eventually even Myanmar."

Chinese manufacturing wages, which have risen annually by over 10 per cent for the past few years, are already significantly higher than those in Thailand, Indonesia and Vietnam. Workers' wages in Ho Chi Minh City, for example, averaged US$148 a month in 2012, a third of the average figure in Guangzhou. Seeking to sustain the trend, Beijing has targeted a 13 per cent annual rise in minimum wages over the course of the current 2011-2015 Five-Year Plan.

"Many manufacturers have already left China because their business models are no longer compatible with the country's emerging commercial dynamics," says Chris Devonshire-Ellis, managing partner at Dezan Shira & Associates Asia. "Over the next seven years the number of Chinese middle class consumers will rise from 250 million to 600 million. The question more manufacturers are asking now is: 'Where do I place >

additional manufacturing capacity to service this burgeoning market?' The answer for many is into ASEAN."

Shishir Sinha, a Singapore-based senior analyst with Frontier Strategy Group, agrees. "It's the companies involved in low value manufacturing that have chosen to completely relocate," he explains. "However, most of the smarter manufacturing companies are now employing a 'China + 1' strategy when it comes to expanding their manufacturing capacity. And '+ 1' generally means ASEAN."

Investment and trade flows

The ongoing shift in manufacturing from China into the ASEAN bloc is obvious in recent production and investment figures. According to information service Frontier Strategy Group, South-East Asia's manufacturing output has grown by 5.5 per cent over the past decade, while the region is now responsible for almost 4 per cent of global manufacturing output.

This impressive growth has been driven by domestic and international companies, with the manufacturing sector receiving a significant slice of investment funds. More than 30 per cent of all the foreign direct investment (FDI) that flowed into ASEAN between 2005 and 2010 went into manufacturing, and this is likely to increase over the coming years.

Reflecting the changing dynamic, FDI flows into ASEAN exceeded those into China last year. According to figures from Bank of America Merrill Lynch, the ASEAN-5 economies of Indonesia, Malaysia, the Philippines, Singapore and Thailand received a collective US$128.4 billion in FDI in 2013, up 7 per cent year-on-year. Conversely, China's FDI dropped to US$117.6 billion, a year-on-year decrease of nearly 3 per cent.

"China's FDI advantage has been eroded by rising manufacturing wages, which have outpaced ASEAN," says Bank of America Merrill Lynch economist Chua Hak Bin. "Less favourable demographics (a result of China's one child policy), stronger GDP growth and a steadily appreciating renminbi have widened the wage gap with ASEAN. These structural forces are likely to persist."

Satish Lele, vice president Asia Pacific for global business consultancy Frost & Sullivan, adds that: "Manufacturing investment in ASEAN will continue to grow over the next five to 10 years. The creation of the ASEAN Economic Community (AEC) in 2015 will have an additional positive impact on this investment. Multinationals can increasingly treat ASEAN as one region with no intra-country trade barriers and tariffs."

Looking to leverage cheap labour and booming local markets, and increasingly leery of the fallout from simmering Sino-Japanese geopolitical disputes, Japanese manufacturers have been some of ASEAN's heaviest investors. According to the Japan External Trade Organization (JETRO), Japan's direct investment in ASEAN was up nearly 90 per cent in the first six months of 2013 at nearly US$10 billion, while Japanese FDI into China fell 18 per cent to around US$4.6 billion over the same period.

As the ASEAN bloc has become more integrated, intra-ASEAN FDI has also witnessed a sharp increase. From just US$762 million in 2000, it had soared to over US$20 billion by 2012, reflecting a new stage in the development of the ASEAN corporate sector. Over the past decade, ASEAN companies have actually invested a larger amount outside their own borders than companies from China and India.

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RAJIV BISWAS, IHS GLOBAL INSIGHT

"The concept and creation of the AEC is really helping South-East Asian countries think more locally," says Sinha. "Intra-ASEAN FDI flows now exceed those into the bloc from the European Union and Japan. The majority of investors are multinationals from Singapore, Malaysia, Indonesia and Thailand, and we expect development of this trade and investment 'quadrilateral' to be a significant force within ASEAN manufacturing over the next few years."

China has also begun putting in money. Multinationals such as SAIC and Great Wall have made major investments in car manufacturing in Thailand and Malaysia, while chambers of commerce from north-eastern Thailand have been hosting road shows in China, hoping to benefit from a growing Chinese interest in agricultural processing.

Despite competition in many areas, there is a growing complementary relationship between ASEAN and China, especially within more specialised manufacturing sectors.

Working in a factory in an industrial zone in Yangon, Myanmar. In January 2014, the World Bank announced a US$2 billion development program for the country, including projects to improve access to energy and healthcare.

"China is still one of the most productive assembly locations in the world," says Sinha. "A growing number of companies are now manufacturing their parts and components in cost-effective locations across ASEAN, conducting final assembly in China, and then shipping the end product onward to the customer. One of ASEAN's biggest goals, and challenges, is to develop the region as a single manufacturing base, with parts sourced from different South-East Asian countries."

Labour costs are rarely the only relevant factor when manufacturing companies choose where to locate, or relocate their business. Criteria such as the state of local infrastructure, access to local markets, political stability and supply chain risk, workforce skills and tax incentives all frequently come into play.

"With ASEAN's trade barriers disappearing and the general business environment improving, most prospective manufacturers are looking to take advantage of existing industrial clusters," says Patrick Lohlein, a South-East Asia specialist with Go East Consulting. "These offer skilled workers, good infrastructure and an established supply chain.

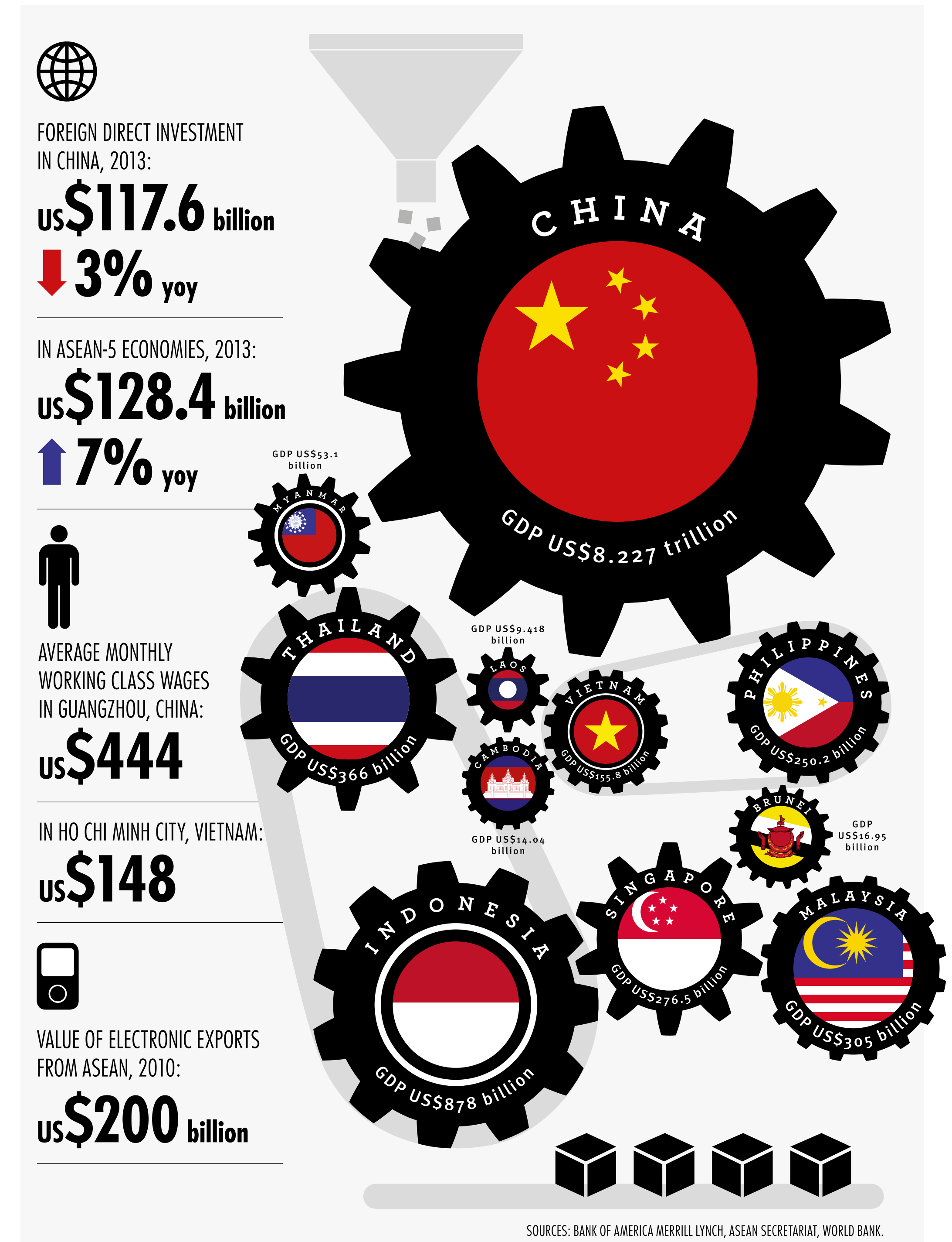
"If these factors are not a priority, then companies may be swayed by other incentives such as tax breaks," continues Lohlein. "Local infrastructure is problematic everywhere except Malaysia, Thailand and Singapore. For Indonesia, which is currently seen as the most attractive destination in terms of access to local markets, this may mean high supply chain risk and distribution costs that potentially overrule the advantages of low cost labour."

The ASEAN bloc comprises 10 nations at wildly varying stages of development. In 2013, per capita GDP levels in these countries ranged across a huge spectrum, from Singapore, at US$54,000, down to Myanmar, at just US$930. This socio-economic disparity is clearly reflected in each country's manufacturing and human resources environment.

Today Singapore competes at the very high end of valued-added processing, in industry segments such as aerospace engineering, advanced electronics and pharmaceuticals. Malaysia and Thailand are middle-income countries whose competitive advantage in low-cost manufacturing is gradually being eroded as they attempt to emulate Singapore. Labour costs in other ASEAN countries such as Indonesia, the Philippines, Vietnam and Myanmar remain very low, offering significant opportunities for multinationals seeking profitable new manufacturing bases.

While many ASEAN countries implemented minimum wage increases in 2014, labour costs will continue to remain favourable in most countries, with the exception of Singapore, Thailand and Malaysia. >

COMPARING THE NUMBERS IN SOUTH-EAST ASIA



GDP FIGURES FROM 2012

GRAPHIC: SOUMALI CHITDAMRONG

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SHISHIR SINHA, FRONTIER STRATEGY GROUP

"Many ASEAN countries remain some of the cheapest places on the planet to manufacture," says Sinha. "FDI increases in the manufacturing sector across ASEAN came after the recent minimum wage increases, so they were clearly not high enough to deincentivise investment. While salaries will undoubtedly continue to creep upwards, there are still huge pools of untapped labour in countries such as Laos, Myanmar and Cambodia."

Cheap, unskilled labour may be perfect for low-end manufacturing, but clearly does not lend itself to sophisticated manufacturing processes. The Singapore government has long understood the importance of working with industry to develop workforce skills and create the necessary education and training to provide skilled workers to key industries. Singapore also has a sophisticated system of incentives to encourage innovation and research and development (R&D) in local companies.

While Malaysia and Thailand are not as advanced as Singapore, they are also working to develop good education and training infrastructure to support economic development. Focusing on the production of semiconductors and electronics, the Philippines is similarly seeking to add value to its manufacturing industry.

At the other end of the scale, one of the key challenges that countries such as Cambodia and Myanmar face in accelerating their own economic development is the lack of educational and vocational training, currently a major constraint on foreign manufacturing investment.

"As the ASEAN region attempts to move up the manufacturing value chain, one of the most critical issues is the development of indigenous technology," says Lele. "In many countries there is negligible capability in local machinery and equipment manufacturing. To date ASEAN does not have credible investment in R&D and innovation, and only a few countries like Singapore and Malaysia are taking a lead."

"As the ASEAN region attempts to move up the manufacturing value chain, one of the most critical issues is the development of indigenous technology."

SATISH LELE, FROST & SULLIVAN

Hundreds of employees of the Sritex textile and garment company sew military uniforms at the factory in Solo in Central Java province. Indonesian company Sritex is one of the largest textile makers in South-East Asia.

Manufacturing breakdown

In recent years export-oriented manufacturing has been a significant driver of economic growth for many ASEAN countries. The ASEAN Secretariat says total group electronics exports in 2010 accounted for nearly US$200 billion, or around 18 per cent, of the region's total exports. Thailand's electronics-related FDI more than tripled over the same period.

Vietnam, too, has witnessed strong electronics manufacturing growth, with substantial investments from global giants Mitsubishi and Samsung. Automotive manufacturing is now the second largest industry in Thailand, and is an increasingly important sector of the Indonesian economy, with recent investments of US$250 million from Nissan, US$800 million from Suzuki, US$246 million from Daihatsu, and US$100 million from Chrysler. Indian carmaker Tata Motors is also set to establish Indonesia as its manufacturing and distribution base for South-East Asia, localising assembly and at least 40 per cent of component production.

While many ASEAN countries can now outcompete China on labour costs, it is those that can leverage strong infrastructure and supply chain networks that will be the main beneficiaries of China's move out of low-end manufacturing.

Cambodia and Vietnam will continue to attract investment in the textile, garment and light machinery industries (garment manufacturing accounted for 85 per cent of Cambodia's exports in 2010), while Indonesia is steadily emerging as a manufacturing destination for consumer products. Taiwan's Foxconn Technology Group, the major supplier of Apple's iPhones and iPads, has recently announced a decision to switch its low-end manufacturing from China to Indonesia.

Risks and rewards

Despite the highly publicised anti-China riots in Vietnam earlier this year, ASEAN is actually enjoying a period of great political stability, with the obvious exception of Thailand. While the issues over national government there have remained unresolved for the past decade, the Thai business environment has become practised at isolating itself from any volatility.

Ongoing territorial disagreements in the South China Sea have so far had a limited impact on business between China and ASEAN's 10 member states, of which half – Brunei, Indonesia, Malaysia, the Philippines and Vietnam – dispute China's sovereignty claims. While the issue is likely to remain unresolved for the foreseeable future, experts have generally played down the risk to mutually beneficial economic relations.

"Some global investors may be more cautious about the Thai outlook due to the political turmoil, and some Chinese investors may postpone investment plans in Vietnam until bilateral tensions have subsided," says Biswas. "However, ASEAN remains a very attractive destination for manufacturing-oriented FDI. It is more a case of multinationals being aware of and managing the situation than radically changing their investment plans."

Over the course of the next decade, manufacturing across the ASEAN region will continue to evolve, as consumption continues to rise, free trade agreements come into effect, supply chains proliferate and strengthen, labour resources are tapped, regional infrastructure develops, and investment into and between bloc members deepens.

From their previous concentration in traditional FDI destinations such as Thailand, Malaysia and Singapore, manufacturing facilities will burgeon across the region as multinationals look to exploit ever shifting competitive advantages.

"Operational and economic trends dictate that the cost of Chinese labour will continue to rise over the next few years," says Devonshire-Ellis. "At the same time, the China-ASEAN infrastructure gap is narrowing. With consumer markets booming in both China and ASEAN, for many multinationals the establishment of a secondary manufacturing facility within the ASEAN bloc is not just a theory, it is an economic necessity." ■

The Philippines government is keen to encourage foreign investment in mining and manufacturing industries.