China's Export Machine Threatened by Rising Costs Orders Drop, Shops Idle in Sweater City; Losing Wal-Mart

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HONGHE, China -- As a sign over its main boulevard proclaims, Honghe is "China's Famous Town for Sweaters." But the economy of sweater town is unraveling, providing an early sign that China's manufacturing sector may be entering middle age.
Over the past two decades, this city about 90 minutes' drive from Shanghai built a comfortable niche in the global economy. At the industry's height in recent years, more than half of Honghe's 100,000 residents worked in 100 factories and 8,000 shops that knitted, dyed, packaged and shipped some 200 million sweaters a year. The local government says the enterprises brought in $650 million a year in revenue.

Not Cheap Enough?

• The Situation: China's manufacturing sector is absorbing rising costs for labor, energy and materials. Makers of low-cost goods are hit hardest, their thin margins giving them little wiggle room.

• The Impact: Workshops and factories are closing in one-industry towns like Honghe, a sweater-making center.

• What's Next: Many of the low-cost makers that drove China's growth will have to shut down, consolidate or compete on strengths other than price.

Now many exporters and workshops here have shut their doors. Others, their work floors partly idle, are cutting costs. Some of the migrant workers who came here for jobs are returning home.

Manufacturers say their profits have dwindled as they pay out more for raw materials and energy. China's strengthening currency has made Honghe's products more expensive for important markets such as the U.S., where the price of Chinese goods surged a record 4.6% in May from the previous year, according to the U.S. Commerce Department. Foreign buyers, used to inexpensive Chinese products and nervous about economic weakness at home, are often refusing to pay more.

Beijing, too, has contributed to the squeeze: Companies say the government's tougher protection for workers and the environment has made it more expensive to do business.

Foreign buyers say tighter visa policies have made it harder for them to visit Chinese factories or attend trade shows.

These pressures are felt by enterprises across China. But none have been hit harder than the companies that feed the vast global appetite for inexpensive goods such as toys, household goods, shoes and clothes. Manufacturers of low-cost products have been a key engine of China's economic miracle, helping to turn the country into the world's No. 2 exporter after Germany. For years, these companies continued to grow by expanding their volumes and trimming margins to undercut the competition. As material and labor costs rise and China's currency strengthens, these manufacturers are among the least able to absorb the costs.

The transformation is most apparent in the boomtowns that tied their fortunes to making one product cheaply, from Guangdong province in the south to Honghe's environs in the Yangtze River Delta. Many of these manufacturing centers have seen hundreds if not thousands of factories and workshops close in recent months, industry executives say. In Shengzhou, a city near Shanghai that claims to make one-third of the world's neckties, manufacturers are trying to hold a united front to boost prices. Dongguan, in Guangdong, is seeing makers of toys, shoes and brushes close shop.

Shift in Fortunes

"This is the year when things finally changed," says Peter Shay, a fashion-industry consultant in Hong Kong at Marketing Management Group Inc. "For the first time in memory, prices are going up."

The shift in fortunes has been swift for entrepreneurs such as Yao Herong, chairman of Jiaxing Yishangmei Fashion Co., one of Honghe's biggest exporters. The family-owned company was booming in 2005, when Mr. Yao landed the biggest customer of them all, Wal-Mart Stores Inc. The U.S. market soon accounted for 20% of his business, he says.

But big orders from Wal-Mart and other U.S. customers are drying up, he says. In the workshop floor below his office on a recent day, dozens of knitting machines stood idle. A Wal-Mart spokesman said in an email that the company currently doesn't source at Honghe factories but declined to offer additional comment.

"We are very worried in this business," Mr. Yao says.

While painful, such difficulties could usher in a more mature phase of China's economic development. The country's sweater industry, like many others, is arguably overbuilt: Honghe is one of at least six Chinese cities claiming to produce more than 100 million sweaters annually. In such low-cost sectors, analysts predict a coming wave of consolidation that could boost efficiency. They say companies will also be forced to innovate so they can compete on factors other than price.

Many Chinese economists and officials think the country has relied too much on cost-cutting and simple production models to boost exports. "Such a high dependence on foreign trade is not good for China," says Yu Yongding, a Beijing-based researcher at the Chinese Academy of Social Sciences, a government think tank. For the U.S. and Japan, he says, trade is equivalent to around 20% the value of gross domestic product. For China, it is about 75%.

China, of course, is sure to remain an export powerhouse for many years. Export figures from China remain strong because the country also supplies industrial machinery and other higher-value products that are less vulnerable to factors such as rising wages. Plus, the country's roads and ports, and its spectrum of suppliers and businesses that support manufacturers, are a draw that few other developing countries can match.

And China's domestic market of 1.3 billion people is attractive for companies that want to both export and sell within China. In a survey late last year by the American Chamber of Commerce in Shanghai and consulting firm Booz Allen Hamilton, 83% of the responding companies said they planned to keep their production in China. But with rising costs weakening China's appeal as a manufacturing location, some 17% said they would shift at least some operations to other low-cost countries, like India and Vietnam.

For centuries, people in the Yangtze River Delta have been spinning silk into garments. In the 1970s, on the eve of China's jump from central planning to market-oriented reforms, the government opened two big sweater factories in Honghe, a section of Jiaxing City, a flat expanse of factory towns 70 miles southwest of Shanghai.

As the reforms took off in the 1980s, those operations upgraded by importing spinning equipment from Japan and Germany. They placed sales representatives in Beijing to trade with dealers from border nations like Russia and Kazakhstan.

By the late 1990s, industry veterans like Mr. Yao began leaving Honghe's state-run enterprises to set up their own companies. In 1999, Mr. Yao and two brothers started making sweaters with 20 employees. Two years later, China joined the World Trade Organization, a step that gave foreign buyers new confidence in Chinese suppliers. By 2002, Mr. Yao says he was receiving orders from Italy and elsewhere in Western Europe.

Four years ago, the Yao brothers expanded, outfitting new factories with imported machines that could make tight, intricate knits. They formed a joint venture with an Australian company and boosted annual production capacity to three million sweaters. With 400 employees of his own, Mr. Yao says he also farmed out work to more than 100 businesses specializing in everything from dyeing wool to packing sweaters into shipping containers.

Honghe's storefronts were stuffed with rolls of yarn and strips of elastic. Couriers peddled tricycles piled high with knitted cotton, acrylic and wool through narrow alleyways. Massive steam-powered machines in central Honghe cooked pigment into yarn. The town's success attracted migrants from poorer, inland provinces, who could earn better money doing piecework than farming fields back home. They rented houses in the villages near town and often brought their children.

High Point

The high point for Mr. Yao came three years ago when Bentonville, Ark.-based Wal-Mart ordered 160,000 sweaters. The U.S. buyers kept coming back, he said, pushing him to find efficiencies. "The orders are big and the price is cheap and it's hard," says Mr. Yao.

Yet just as business in Honghe was heating up, policymakers in Beijing were setting new hurdles. In July 2005, China bowed to pressure from global trading partners to ease its rigid grip on the yuan's exchange rate. The currency had been effectively pegged to the dollar for a decade, despite China's bulging trade surplus. That had created stability for exporters and their foreign buyers, but also angered Western critics who felt it gave Chinese factories an unfair advantage by keeping their prices low in dollar terms.

The yuan's appreciation was slow at first. But last year, it accelerated. The currency has now risen 20% in value against the dollar. The yuan has been losing value against the euro, on the other hand, making Chinese goods more affordable in Europe. But the advantage hasn't been enough for many manufacturers to offset other difficulties.

Like many exporters world-wide, those in Honghe executed their contracts in dollars. As the U.S. currency has fallen, exporters here say they no longer know how much they might earn -- or lose -- when it comes time to deliver sweaters three or four months after they ink a contract. "We want to be very careful with U.S. dollar orders," Mr. Yao says.

Beijing, meanwhile, began implementing policies that supported economic growth that was sustainable and modern, not merely fast. This year, the government implemented a labor law that capped factory overtime, limited temporary employment and raised the minimum working age two years, to 18. The new rules were a blow to small operations like those in Honghe that traditionally hired and fired with each production cycle. China has also tightened its environmental oversight, which means Honghe's dyeing companies must now pay to dispose of the chemicals they use, instead of dumping them into the creeks that run through town.

Mr. Yao declined to provide details about how new costs have affected his business. But a buyer for a large U.S. apparel company says that on items like wool cardigans, profit margins for Chinese manufacturers have collapsed to about 30 cents, from $2 a few years ago.

Mr. Yao, 50 years old, says he is now looking to other export markets -- often smaller and less lucrative -- and trying to shift sales to the domestic market he once ignored. On a recent day, packers in his main warehouse put "Mr. Price" brand sweaters in plastic bags destined for South Africa. They were already marked with a retail price of 49.99 rand each, or about $6.25.

Remaining Hopeful

This should have been a banner year for Honghe. The $1.68 billion, 22-mile Hangzhou Bay Bridge opened last month, halving travel time to the booming container port at Ningbo. Minutes from downtown Honghe, Wal-Mart is building a large distribution center. And in December, a complex system of textile quotas will expire, unshackling China from annual limits on exports of clothing to countries like the U.S.

The Honghe Township government, responding to questions, says it remains hopeful for the local industry. Job losses have come mainly in less technologically advanced workshops, it says. Sales at some of the town's biggest sweater companies grew about 25% in the first five months of 2008 from a year earlier, it says, though with significant erosion to profit margins.

Locals point out numerous workshops that never reopened after February's Chinese New Year holiday. Companies that remain in business are cutting costs, including dyeing companies whose skeleton staffs now work exclusively at night when electricity isn't as expensive. In a hotel that once catered to buying delegations, the manager scowls at a question about occupancy rates and returns to mopping the floor himself.

Enrollment at Honghe Town Central Primary School, once soaring with sons and daughters of migrant laborers, is off 5% from a 2006 peak, to about 2,200 students, according to Principal Zhang Guopei. A mock-up for an expansion that would have about doubled the number of classrooms now collects dust on an air conditioner in Mr. Zhang's office.

Motorized Tricycle

Migrant workers have started going back home. Cao Jiulin, a 20-year-old native of Anhui province, had in recent years persuaded her sister, brother and both parents to join her in Honghe. They rented a small farmhouse, bought five circular knitting machines and a motorized tricycle for deliveries, and hired farmers to till their land back home.

Operating one of Honghe's thousands of small workshops, the Cao family is an example of the fragmentation in many of China's export-oriented industries. Each morning, a family member rides to the town's main market and, if there is work, returns with the tricycle loaded with sweater parts. Working in a room with a bed on one side and electric knitting machines on the other, they would attach the sleeves to torsos and return them, collecting about 23 cents per finished piece. Recent jobs have paid about half as much, family members say, as orders dwindle and competition stays tight.

Ms. Cao's father and mother returned this spring to Anhui, laid off the farmers they'd hired earlier and completed their own harvest for the first time in years. "There is not much business" in Honghe, her father, Cao Mingfu, says by telephone from Anhui. "We can hardly make any money every month."

Sweater-factory boss Mr. Yao, over a lunch of steamed fish and generous sips of yellow wine, says he has gotten hypertension -- "the boss disease," he calls it -- trying to figure out how to redirect his output away from weakening markets like the U.S.

Mr. Yao says one idea is to sell more sweaters in China. But he lacks contacts among Chinese retailers. "We've always been an export company," he says.

--*Ellen Zhu contributed to this article.*