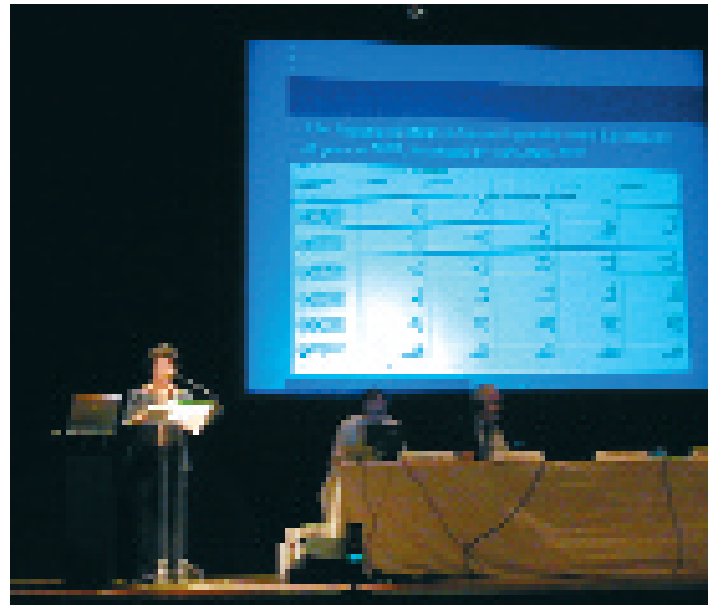




Overwhelmed and overwhelming: Madame Zhang Shu Hua of the China Leather Industry Association was one of the principal speakers at the World Footwear Congress held in April. The statistics presented by her did little to allay the fears of many of the representatives from other footwear producing countries attending the event in Brussels, which had been organised by CEC, the European Confederation of the Footwear Industry. This slide illustrated the fact that China was importing in excess of eight million pairs of footwear a year. Another slide, however, highlighted the fact that China had exported more than five billion pairs in 2003.

Official statistics claim the number of enterprises in the leather industry is now 16,000, the number of shoe manufacturers is 7,200 and employees involved in shoe production number 1.36 million. It should be noted, however, that many enterprises do not come into official statistics because of their size or because their turnover does not meet official thresholds.

Environmental issues were also a cause for concern at the Congress. Under current regulations in China, the annual capacity of any newly opened tannery must be a minimum of 100,000 hides and a CETP installed for tanneries with an annual production capacity below 100,000 pieces and over 30,000 pieces of cowhide.



Where will it end?

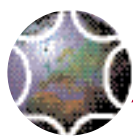
After some 40 years, quota restrictions on textiles and garments into developed markets, primarily the US and western Europe, were abolished, finally, on January 1 of this year under terms negotiated by the World Trade Organisation (WTO). This followed a five-year lead-in period during which members could lessen restrictions gradually.

The argument favouring quota restrictions was that domestic industries inside the protected economies would use the time to become competitive in the global market place. So, after almost four decades behind tariff walls what happened when the veil was lifted and the chill wind of unrestricted access arrived?

Well, within 40 days of January 1, 2005, garment imports from China to the US rose by 1,300 per cent. This isn't just someone else's problem. For example, according to the National Association of Italian Footwear Manufacturers (ANCI) imports of shoes into the European Union (EU) from China rose a whopping 600 per cent (that's not a mis-print, it's 600 per cent) within the same 40-day timespan.

There were no prizes for predicting what followed. After no more than a couple ➤





Country Commentary: China

For the 12 month period from January to December, 2004, exports from China of leather goods amounted to \$19.21 billion, up 16.5 per cent over the previous year and accounted for 3.2 per cent of China's overall exports.

During this period footwear exports reached \$14.6 billion, an increase of 17.1 per cent over 2003.

China imported \$5.25 billion of raw hide, leather and leather goods, a 23 per cent year-on-year growth and which accounted for one per cent of the country's total import value.

Table 1: Overall export of leather goods from China, 2004

Item	Unit	2004		2003		% +/-	
		Volume	Value	Volume	Value	Volume	Value
Leather shoes	10,000 pairs	115,310	6,317,594	103,738	5,355,942	11.2	18
Luggage			6,238,361		5,057,720		23.3
Leather garments	10,000 pcs	6,128	2,304,851	6,898	2,342,409	-11.2	-1.6
Fur garments	1,000 tons	12	1,341,975	5	484,026	147.1	177.3
Leather & Raw Hides (Excluding fur)	1,000 tons	238	1,401,558	234	1,149,113	1.7	22
Leather gloves	10,000 pairs	77,896	854,906	96,863	1,503,402	-19.6	-43.1
Footballs, etc	10,000 pcs	12,025	161,501	9,635	127,242	24.8	26.9
Components	1,000 tons	154	576,724	124	464,991	24.1	24
Leather equipment	10,000 sets	2	11,564	1	6,123	50.8	88.8
TOTAL			19,490,968		16,490,968		16.5

Value in US\$1,000

Table 2: Export of footwear from China

Item	Unit	2004		2003		% +/-	
		Volume	Value	Volume	Value	Volume	Value
Leather shoes	10,000 prs	115,310	6,317,594	103,738	5,355,942	11.2	18
Rubber/Plastic shoes	10,000 prs	330,617	5,708,592	272,456	4,790,689	21.3	19.2
Textile shoes	10,000 prs	93,227	1,858,348	81,845	1,595,103	13.9	16.5
Other shoes	10,000 prs	49,325	741,899	44,461	748,081	10.9	-0.8
TOTAL	10,000 prs	588,479	14,626,433	502,500	12,489,814	17.1	17.1

Table 3: Footwear imports into China

Item	Unit	2004		% +/- over 2003	
		Volume	Value	Volume	Value
Leather shoes	10,000 prs	391	107,641	65.8	83.1
Rubber/Plastic shoes	10,000 prs	311	28,946	-37.5	71.2
Textile shoes	10,000 prs	177	18,650	59.3	41.4
Other shoes	10,000 prs	12	2,205	-7	63.5
TOTAL	10,000 prs	892	157,442	4	74.5

In US\$1,000

Table 4: Leather and leathersgoods into China

Item	Unit	2004		2003		% +/- Value
		Volume	Value	Volume	Value	
Raw hides	1,000 tons	828	1,247,566	691	903,099	38.1
Leather	1,000 tons	1,080	3,352,950	944	2,962,791	17.1
Shoe components	1,000 tons	39	317,504	36	283,374	12
Leather equipment	Set	12,864	87,492	16,146	81,613	7.2
Machinery parts	Ton	1,031	5,758	1,119	4,713	22.2
Travel goods			113,311		63,021	79.8
Leather shoes	10,000 prs	391	107,641	236	58,802	83.1
Leather garments	1,000 pcs	6	11,067	6	5,561	99
Leather gloves	1,000 prs	40	969	19	463	109.3
Fur garments	Ton	7	839	6	888	-5.5
Footballs, etc		107	1,307	108	1,643	-20.5
TOTAL			5,246,402		4,265,967	23

Value in US\$1,000

of months both the US and the EU are looking to impose new restrictions: which will be quotas in all but name. All that they are waiting for is the discovery of the legal loophole which will permit imposing such limits. ANCI president, Rossano Soldini, was quoted as saying that the flood of imports will destroy the Italian industry. "We expect an urgent reaction from the Italian government and from Brussels," and Mr Soldini will probably not be disappointed on that score.

But there is a difference. This time the actions are aimed at China specifically, rather than developing (low cost) economies in general. China has become the super heavyweight, the '800 pound gorilla', in the corner of the ring and how other economies adapt to that fact may determine their future prospects to a large degree.

Making sense of China

It is hard to conduct a conversation in the leather industry that does not get round to China sooner rather than later. For many tanners the figure they have been quoting for the total value of the leather making industry globally, for the last few years, has been \$40 billion. So, when the 2004 statistics were published showing that the total value of Chinese imports and exports of leather, fur and products reached \$31.25 billion, over three-quarters of the worldwide total, it has become impossible to pretend the 'gorilla' simply isn't there. The rate at which the Chinese leather industry continues to grow is also either alarming or a boon, depending on where one stands, for the 2004 figures were themselves an increase of 19 per cent over 2003, with that year's export figure coming in at \$27 billion, itself an 18 per cent jump on the previous year.

China's share of global footwear production alone is now over 50 per cent, and they have over 80 per cent of the US market in both leather and non leather footwear.

For many areas of the world, what Italy has seen in 2005 has been reality for some time. We have already reported in these pages that Africa's largely nascent shoe industry is already suffering under a welter of low cost Chinese imports. Eastern Europe, which had been hoping to gain via entry to the EU, finds its shoe industry being diminished by even faster-growing Chinese footwear imports.

It is a similar story, too, on raw materials since large volumes of output demand large raw input. It could be argued as supply chain security, or just the fact that



Table 5: Top 10 exporters of leather and hides into China

Country	Value US\$ 1 million	% of total	% increase over 2003
Hong Kong	903	64.4	29
South Korea	116	8.3	19
Italy	71	5.1	-2
Vietnam	48	3.4	53
Taiwan	47	3.3	-33
USA	46	3.3	43
Spain	43	3.1	1
Thailand	23	1.7	46
Japan	12	0.8	13
Singapore	11	0.8	0
Others	82	5.8	
TOTAL	1,402	100	22

Table 6: Top 10 export markets for leather and raw material from China

Country	Value US\$ 1 million	% of total	% increase over 2003
USA	775	16.8	25
Taiwan	612	13.3	-1
South Korea	596	12.9	2
Australia	365	7.9	46
Italy	354	7.7	19
Brazil	304	6.6	70
Canada	129	2.8	14
India	107	2.3	62
Argentina	106	2.3	16
Thailand	94	2	17
Others	1,162	25	19
TOTAL	4,601	100	22

US\$ 1 million

Chinese leather-using businesses do not like importing finished leather, which has led the Chinese to adopt what might be called 'predatory' buying tactics. There are allegations of raw material, in some markets, being driven up by Chinese buyers to monopolise the purchase and drive local wet blue tanners out of business. Although not always fully proven these complaints come from locations as far apart as Australia, the US deerskin market, and the Ethiopian hair sheep tanners.

Inexhaustible demand

China's Gross Domestic Product (GDP) continues to grow by about eight per cent annually. Statistics in China should be treated with a degree of scepticism—no less a body than the Bureau of Statistics concedes the point—but few doubt that give or take a percentage point the figure is about right. Economic growth seems pretty well dispersed across the board with increases in everything from garments and textiles through to white goods, electronics, and automobiles. Demand is being fed both by a steady increment in domestic consumption and a seemingly inexhaustible demand from overseas. It is this two-fold demand that gives China's economy such momentum. Moreover, it would seem that the process could continue for a decade or two before anything approaching saturation of either local or global demand is reached. This is an extraordinary prospect. And it is unlikely to peak anytime soon.

There are problems, both actual and potential. Bottlenecks are developing in areas such as energy. For example, during the second half of last year, many factories in the Shanghai area were instructed to "take their holidays early" in an effort to reduce power consumption. The availability of skilled

personnel is another area of concern. It's already driving wage levels upwards in several industries. The shortage of skilled labour was identified as a major factor behind Shenzhen (the mainland city that abuts Hong Kong) reporting a fall of 20 per cent in leather goods exports in 2004 compared with 2003. Labour costs increased yet again by over 20 per cent following the decision by the Guangdong provincial government to introduce a new minimum wage level in December 2004. According to statistics released by the Shenzhen Leather Industry Association, around 200,000 people are currently employed in the 800 leather or leather goods manufacturing factories in Shenzhen. The key leather goods are shoes and leather bags, of which 70 per cent is exported.

Actually, it's not always just the supply of skilled labour that can prove problematic. The nation's footwear capital, Wenzhou, reported that, with the Spring Festival falling late this year, a ready supply of peasant (read 'unskilled') labour was not available as people returned to their villages to be with the family during this most important of Chinese holidays.

Valuing education

It's probably not wise to make too much of labour shortages. They may cause temporary glitches along the way but the fact remains that some 80 per cent of China's 1.3 billion population still live in the countryside: offering a vast reservoir for future labour requirements. As for skilled staff one can only note that the Chinese have a reputation for valuing education of any sort and any such shortage is probably quite short lived.

Transport and logistical factors continue to hold back Beijing's efforts to open up the country's vast hinterland to development. But the government seems

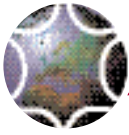
committed to the policy and there is some success. In the North-East the number of companies involved in leather making or related industries is on the increase and it is forecast that by the end of 2008 there will be more than 6,500 leather-related enterprises in the region and business will exceed \$1.83 billion annually. Companies from eastern cities such as Wenzhou have started to invest in the area. Northeast China's provinces of Liaoning, Jilin and Heilongjiang were the bases of heavy industry in the past, but in recent years economic growth in eastern areas such as Guangdong and Zhejiang have surged ahead. This is set to change. A new leather trade mall has recently been built by a Wenzhou group in Shenyang, the provincial capital of Liaoning province, and is scheduled to open in June this year.

And then there are the political and social issues that threaten to cause instability at some point in time. Yet, in the short term none of these promises to upset the applecart to any great degree.

The problem of bankruptcy

The insolvency of the nation's banking system might prove the exception. On paper it's right alongside the twin trade and federal deficits of the US as an issue containing the elements for a global financial upheaval. But China has an economy enjoying buoyant growth and while that lasts the widespread bankruptcy can remain hidden.

While financial meltdown may be avoided the practical implications are real: especially to those competing with Chinese manufacturers—which is just about everyone. Simply stated, Chinese manufacturers can offer prices others cannot match because the money they borrow to finance their operations will never be repaid.►



The cost of money

Here's how it works. According to Bulent Hazer, a board member of the Turkish Leather Industrialists Association, Chinese tanners have broadly similar costs as everyone else: around 60 per cent is raw material and 20 per cent for chemicals. Add in overheads such as energy and the difference between China and other developing economies is not that great. Sure, labour is cheap, but not that much cheaper than many other countries. And tanning is not a labour intensive industry. Chinese firms have to pay for machinery, chemicals and, most importantly, raw materials at the same price as everyone else. If hide prices in the US rise Chinese tanners have to dig deeper into their pockets along with buyers in Taiwan, Italy or Brazil. In short, comparing like for like in terms of quality, Chinese tanners have, at best, only a marginal advantage. So how come they can sell so much cheaper than everyone else?

The difference between tanners in China and elsewhere, Mr Hazer makes clear, is the cost of money. Or, put another way, the non-cost of money.

China's banking system is overwhelmed with bad debt. Behind the modern face of China's manufacturing façade lies a financial edifice only now emerging from the Maoist era. Vast sums of money have been laid out by the banks with little or no thought of how they might be repaid. The result inevitably is that the finance never is repaid, probably never will be. Any serious attempt to call in delinquent loans would simply expose the magnitude of the problem. It really is an example of the old saying, "Owe the bank \$10,000 and the bank owns you. Owe the bank \$10 million and you own the bank."

It's worth looking briefly at how China's banking system works (or, fails to work). Outsiders see China as a monolithic society, with vast power held by the leaders in Beijing. It's a bit more complicated than that. Sure enough Beijing does exercise absolute authority in matters of national security and foreign affairs but China is a vast country—virtually the same size as the US (minus Alaska)—and almost all decisions are made at a local level. The large

Chinese banks—all state owned (although some outside shareholders are being invited to participate)—may be headquartered in the capital but local decisions are still made by local branch managers who, in theory, answer to two masters: regional head offices in some far-off provincial capital, and the local Party officials and power brokers he rubs shoulders with every day. No prizes for guessing to whom he feels his first loyalty.

All of which explains, to some degree, how the country's financial system can continue with its old bad habits. Whatever Beijing may attempt by way of financial reform it can be totally frustrated at a local level. When government sources in Beijing claim they do not condone practices that permit manufacturers to 'dump' goods they are probably being truthful. But that's not much consolation to the likes of Mr Hazer. His own country is hardly a high labour cost centre yet, as he says, "Turkish tanners simply cannot compete with Chinese manufacturers. We don't know where it will end."

Hands up anyone who does. 



When you start using your phone for taking photographs, and the internet VOIP for calling your business partner on another continent then you know you are dealing with convergence. Something not dissimilar has been happening between leather and synthetics for many years as synthetic makers produce products ever closer in look, feel, and performance to leather and tanners use up the low end by making it more and more like plastic.

For many in the leather industry, this is an untouchable area where the value of leather is demeaned and no tanner or leather user should go. Yet Nike was founded as much as anything on its ability to adapt and develop great synthetics which worked well in its product line, and fitted the pockets of its customers. And today even the top brands in leathergoods mix leather and non leather in creative ways to produce good looking bags.

Finding a niche

It is in this area that the Taiwanese business Chifa has found its niche in the world market for many years and some of its recent productions saw acceleration in this convergence.

First, in conjunction with Invista, they have developed a Lycra leather, using the help of a local contract tanner whom they subcontract to dye the splits. Since its initial introduction Lycra leather has considerably developed. There are now strict levels of stretch required for various end uses, which make for quite complex engineering. For footwear this is between 15-30%.

While controlling the stretch in this way brings leather and synthetic properties closer together this is even more apparent in Chifa's new "Leather Like" leather finishes, which are put on one of their advanced microfibre materials. These finishes are fully breathable and healthy according to Chifa's Ricky Kuo (*pictured*).

A convergence of interests

They are designed for shoe leather also and run from 0.8mm to 1.5mm. Any grain pattern can be embossed and appears not to pull out and Chifa also achieves a rich finish and brightness on pull ups.

Chifa produces a full range of PU coatings for splits, which make leathers well suited for certain ranges in sports footwear, golf, and outdoor footwear. With high abrasion resistance Kuo indicates that these finishes which can go from a 'Crazy Horse' look to an oiled nubuck are liked by the safety footwear makers.

These products show how leather and synthetics are converging and forcing shoemakers to consider more carefully which material is appropriate in price and performance for each specific use. It is not surprising to see a Taiwanese company at the leading edge of this work as industry in Taiwan struggles to find its place while China relentlessly sucks in more and more of Taiwanese leather and footwear manufacturing.

It was not long ago when Taiwan produced over 800 million pairs of shoes annually, and now this has dropped below 40 million. Indeed now a very significant

number of shoes consumed in Taiwan are actually imported.

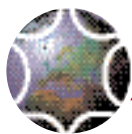
A defensive survival strategy

Against this depressing background local producers have to decide on a defensive survival strategy. According to Kuo only very high technology products can survive in Taiwan. Sooner or later simpler things like shoes and leather will all move. "There is a very strong trend in all industries, even electronics, to move to China. China is really very attractive."

Somehow China is able to import the most-expensive raw materials and to sell products made from them at very cheap prices. In line with many in the leather industry, Mr. Kuo relates the Chinese ability to survive with this pattern to the way the economy handles its finances. He is clear that much Chinese business "mostly would not make money", but that since the government wants to keep business running it is willing and able to provide an exchange rate benefit, giving many exporters a major boost in this way, perhaps managing the exchange rate between RMB 8 and 8.60 to the US dollar to the advantage of the exporters.

So, while Chifa and many of its competitors fight to use technical advances and innovation to find products which they can still make in Taiwan, the relentless move to China continues. Nike has remained faithful to some production in Taiwan and some tannery and shoemaking capacity remains in Taiwan to service this business. Chifa itself counts Nike as a major customer.

Otherwise for the shoe industry, what remains in Taiwan is mostly a research and development sector, with small groups of staff helping to develop new ranges using the skills of a wide variety of Taiwan-based component suppliers, but where the shoes and nearly all volume components are in fact made on mainland China. 📍



Not expanding, not collapsing

The leather industry in Japan reflects the general sense of the country's economy—it isn't expanding, but then it's not really collapsing either. After more than a decade in the economic doldrums that's probably what many would settle for right now.

Although Japan boasts the second largest economy in the world, behind only the US, it is increasingly dependent upon China, both as a market and as a production centre for Japanese goods. Of course, it is not alone in this respect but political factors cause this to be a potentially vulnerable relationship. The recent spate of anti-Japanese rioting in several major Chinese cities underscores just how vulnerable.

Although some commentators maintained that the riots were controlled by Beijing the fact remains that there is a widespread and genuine sense of grievance among the Chinese population going back to the 1930s and the Japanese occupation of China. The single most common source of anger is what the Chinese feel is a lack of any remorse for acts by Japan during that period: indeed, passion is fuelled by what is perceived as further efforts by Japan to simply expunge all records of them.

Add to this Japan's apparent willingness to begin flexing its military muscle which is seen—in China—as a response to a potential military threat from China. In

diplomatic speak North Korea is identified as the threat because it is, after all, very undiplomatic to openly name your major trading partner as someone you may be at war with sometime down the line.

It is worth being aware of this volatility and the potential for further rifts. Vast sums of Japanese capital are tied up in China and it does act, to a degree, as a hostage to events.

This investment in China continues to impact upon leather production within Japan. The number of tanneries associated with the Tanners' Council of Japan (TCJ) continues to fall. From 781 in 1979 there has been a steady decline to 593 in 1995 and 473 in 2002. Only in the Tatsuno area, which specialises in bovine and equine leather, has the fall been light: from 199 member tanneries in 1979 to 176 in 2002. The nearby Himeji area, by contrast, saw numbers drop from 239 down to 154 over the same period.

Even more telling is the decline in the number of people employed in the industry. It stood at just over 10,000 in 1990 but 12 years later was under 5,000. Sales topped \$2,179 million in 1990 but registered just \$790 million in 2002.

The demand for domestic hides remains one consistent statistic among a sea of declining numbers. In 2004 domestic hide consumption stood at 125 million units (of 10,000 pieces): pretty much the same as

for every year since 1996 and not that much lower than the 149 million units recorded in 1994. But, during the same period, imported hides fell from 449 million units to less than half, 192 million units, last year.

The US, by far the largest supplier, exported almost 48,500 tons of cattle hide in 2001. This was down to some 35,000 tons three years later in 2004. Australia, the second largest supplier in this category exported over 6,000 tons in 2001 but just 4,500 tons last year. Only Canada, among the major suppliers, recorded a boost in sales: 3,700 tons in 2001 and 4,700 in 2004.

There's a similar picture in the supply of calf and kid skins. New Zealand supplied 1,130 tons in 2001 and managed 1,170 in 2004.

Variable exchange rates (the US dollar has declined steadily against the Yen) and fluctuating (typically upward) raw material prices make value comparisons difficult. Nonetheless Japan imported some \$210 million of leather in 2001 and \$172 million in 2004. Imports of leather products, of all types, including luggage, etc. totalled some \$3 billion in 2001 and registered a slight improvement with \$3.3 billion last year.

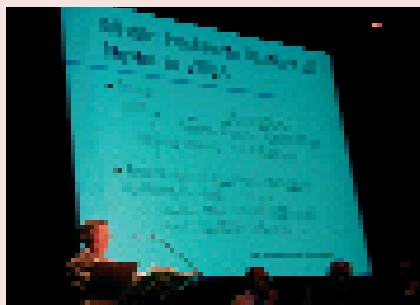
Japan's export figures are reasonably stable, especially when viewed through the prism of a dearer Yen. Leather exports were \$124.5 million in 2002 and \$128.1 million last year. There was a slight improvement in the export of leather products: \$41.5 million in 2002 (of which footwear accounted for \$11.3 million and 356,000 pairs) and \$47.3 million in 2004 (of which footwear accounted for \$10.2 million and 300,000 pairs).

A major consideration in any forward planning concerning the Japanese market is that the final end of the decade-and-a-half recession is heralded every six months or so. After a while this sort of good news loses much of its credibility. Japan remains an important market for most Asian countries, especially for upmarket products, and it is still a significant supplier of high end goods.....but if its leather industry manages to more or less retain its present position that is probably success enough. 

Whatever the politics Japanese products are still well regarded by Chinese buyers. Japanese car maker Toyota recently discovered that the Toyota insignia on their best selling SUV in China was being targeted by thieves. Not the vehicle itself: just the logo.

Co-incidentally a booming market for the insignia was discovered among owners of the SUV offered by Great Wall—a leading Chinese vehicle manufacturer. The Great Wall SUV bears a truly remarkable resemblance to the Toyota SUV—but sells at half the price.

With the recent anti-Japanese riots threatening to overspill into boycotting Japanese products maybe Toyota owners will be clamouring for Great Wall insignia to stick on their vehicles.



Shigemi Osawa, chairman of the Japanese Leather and Leather Goods Industries Association, explains the state of the country's footwear industry at the recent World Footwear Congress. Imports dominate: in 2003 of the 602,820,000 pairs required, just under 500 million were imported. The retail market was worth \$14 billion.