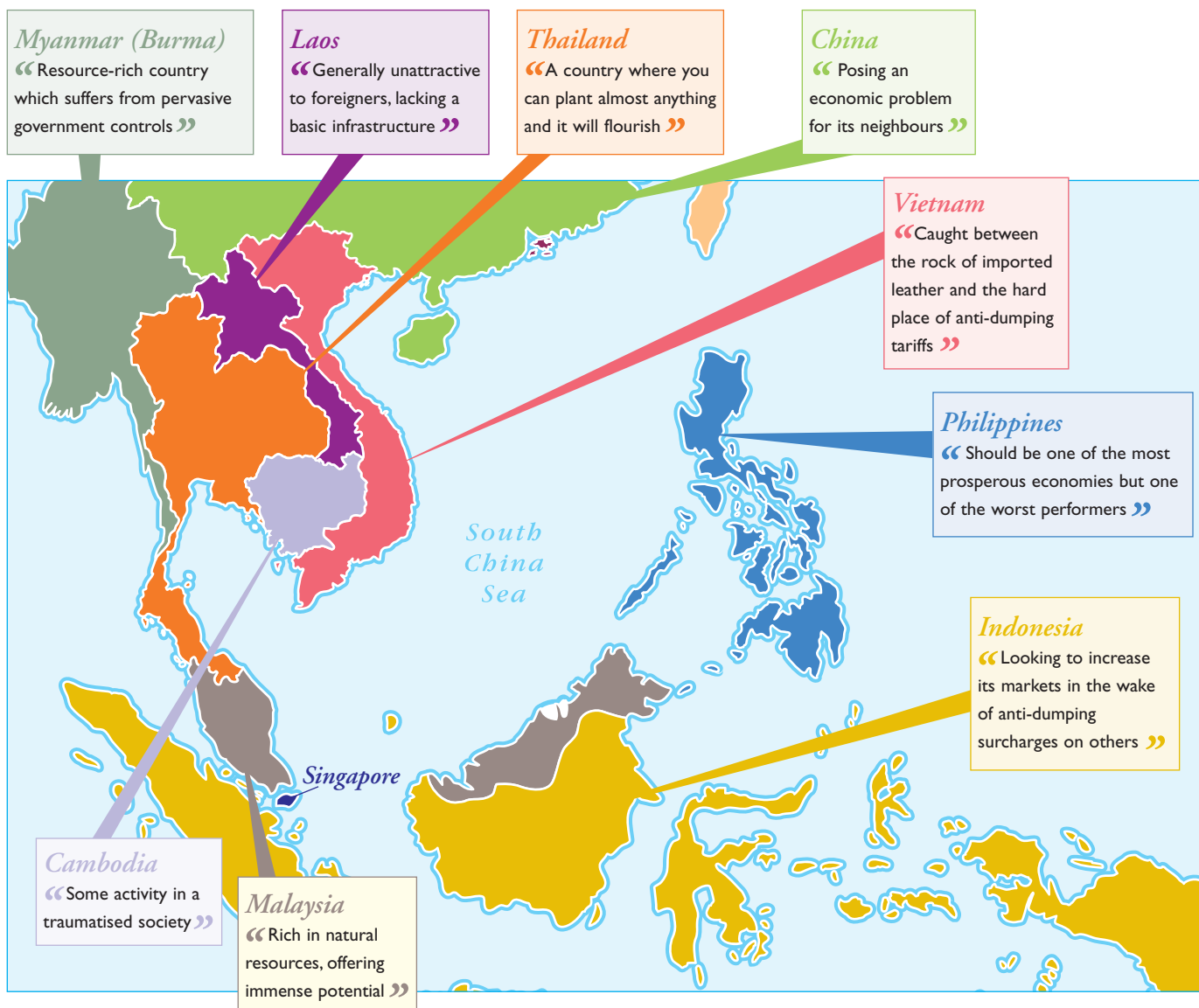




Regional Commentary: South East Asia



Neighbours facing diverse challenges in the global marketplace

Trapped in time between the early development of South Korea and Taiwan and the more recent development of China, the countries of South East Asia such as Indonesia, Malaysia and Vietnam looked ready to take on the mantle of volume production for the leather industry. Now they have found themselves squeezed between the apparently unstoppable growth of China and the emergence of the Indian subcontinent—arguably also part of SE Asia but covered with in a recent *World Leather* survey—as long overdue powerful players. This survey examines the strategies

and outlook in the region since the post-1997 economic crash.

China plus one—a new mantra

Pioneered by the textile industry the concept of balancing a Chinese sourcing policy with a strategy of taking smaller but sizeable amounts from one other country has become a favoured approach for many brands. Other countries in the region, within ASEAN, are at the forefront of this battle for second place although some are looking even further into the burgeoning knowledge economy to build their future prosperity.

Anne Putz, team leader Corporate PR, adidas-Salomon AG, told *World Leather* that South East Asia was an important region for the adidas Group's sourcing strategy stating that it will remain an important region in the future. “In 2005, Asia continued to be our most significant sourcing region. 96% of our total footwear volume was produced in this region, with China representing our largest source country with approximately 55% of the total volume followed by Indonesia and Vietnam with 20% each. Production in the Americas and Europe represented a total of 4% of our sourcing volume,” Putz discloses

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and adding that in apparel, “78% of our production takes place in Asia. China and Indonesia were the largest sourcing countries, representing 25% and 17% of total apparel production, respectively, followed by Europe with 16% and the Americas with 6%.”

From a Western perspective China is often perceived as a real and present economic danger. Which it is. Often overlooked is the threat that China also poses to non-Western economies, such as those in Asia, and its ‘neighbours’ in particular. In simple terms they cannot compete easily on price, on special expertise, and certainly not on internal market development potential.

In certain sectors the South East Asian countries can stand their ground. Singapore offers financial services that will take a time for China to develop, plus, there’s the trust factor—which takes even longer to develop. Indonesia, with a population of some 400 million makes it the fifth most populous country in the world, which allows internally generated growth. But compare this with the 1.3 billion population of China and it is not difficult to guess which one overseas investors will choose when they come looking for somewhere to place their cash in a market with potential.

ASEAN is a collection of ill-matched economies but they all have one thing in common: they are all keeping a wary eye on their vast northern neighbour. Do they try to carve a niche and compete, or become low-end suppliers?

The danger with each strategy is that they will end up with the crumbs left over from China’s feasting.

Pulling together

ASEAN is probably the best known and most effective talking shop for the countries that comprise South East Asia. Formed in 1967 the original membership was made up of Indonesia, Thailand, Malaysia, the Philippines and Singapore. Brunei joined in 1984, Vietnam in 1995, Laos and Myanmar in 1997 and Cambodia in 1999. ASEAN’s objective at the outset was economic cooperation but, in practice, it worked as a vehicle to oppose communist expansion in the region. These days, with Vietnam involved, along with Laos, the association has moved back to its original stated economic purpose.

The founding members are mainly sophisticated economies. Indeed, Singapore is one of the original Asian ‘Tiger’ economies. Other than Brunei, whose wealth is based on oil, the newer

members are still very much at the development stage.

It’s this inequality which makes economic cooperation difficult. The Asian financial crises of 1997 effectively knocked the wheels off tariff and trade agreements that had been concluded previously. Trying to resuscitate such cooperation now—with communist Vietnam and Laos, and fairly basic economies in Cambodia and Myanmar—can only be an uphill struggle.

Recent years have seen ASEAN getting to grips with the realisation of living with an 800 pound gorilla in the living room. Then, no sooner had they taken that on board when another appeared in the kitchen, i.e. India. The sad fact is that South East Asia is squeezed between these two vast countries that are both seeing enormous economic growth and have huge populations with which to expand domestic markets. South East Asian countries have two choices economically: either compete head-on, or expand niche markets. Three ASEAN economies, Indonesia, the Philippines and Thailand also have a third option. Their population levels and/or economic superstructures would also permit them to develop their economies by building domestic markets. Unfortunately, this is easier in theory than in practice.

Thailand remains independent

Thailand is the only ASEAN member never to have been colonised. With a population of some 64 million it is a country where you can plant almost anything in the ground and it will flourish. Agricultural produce remains a major export earner.

Thailand enjoys a reputation for tolerance which is largely justified. Whereas in other Asian countries with sizeable ethnic Chinese populations that dominate commerce where racial tension is never far below the surface, in Thailand it is not a major issue.

Politically, the story is less encouraging. A long history of military coups appeared to have come to an end in the early 1990s and, until earlier this year, it seemed as though Western style democracy was finally becoming the default option. That will probably remain the case although matters are up in the air at present, with the Prime Minister Thaksin Chinnawat



first standing down after calling a snap election (which the opposition boycotted) and then returning to office before new elections could be held.

Nonetheless, despite the politics, Thailand has a free and open society, which is generally well-ordered and the infrastructure is good. There is a low-level of insurgency by Islamists in the four southern provinces which is a cause for concern, not least because of Bangkok’s heavy-handed response that has possibly acted as a recruiting agent for the rebels.

On the economic front, efforts to promote traditional creative skills to enter ‘niche’ markets overseas have had a fair level of success. In certain sectors manufacturers prefer the more discerning markets of Europe and Japan to the huge, but unprofitable, USA. An earlier government campaign to promote the ‘Made in Thailand’ label was well-received.

A feature of the Thaksin administration has been the attempt to develop the domestic Thai market for local manufacturers and with a population of some 65 million this is feasible. Moreover, and unusually, this policy is not being conducted behind tariff barriers.

Leather industry looking up

Figures show that the Asian subcontinent, excluding China, had a share of 21% in footwear production around the world during 2004 and that Thailand was ranked seventh with production of 270 million pairs out of total ten leading producers.

To avoid the new anti-dumping duties imposed by the European Union on footwear from China and Vietnam, a number of countries and brands are reportedly relocating their supplies and factories to various South East Asian countries including Thailand, accelerating the ‘China plus one’ policy.

Thailand’s leather industry has developed into an important player on the world map over the last two decades despite fierce competition from high-end manufacturers based in Europe and low-cost manufacturers in China, Indonesia and Vietnam.

Thailand’s leather industry draws support from the extensive leather tanning sector present in the country. While imported leather is used extensively for the highest quality exports, over 130 tanneries supply a large portion of the processed leather used in the production of a variety of products including luggage, shoes and boots, gloves, toys, pet accessories, ➤



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handbags, apparel, belts and purses. Tanneries in Thailand boast an annual production capacity of approximately 15,000 tons of leather, largely produced from cowhide and buffalo. Importing hides for processing is common, with over 50% coming from China and premium quality hides shipped from America.

According to the Federation of Thai Industries, the major tanning industry is located in the Bangpoo area where strict control is exercised on waste management. The industry is now transforming its production in an attempt to move to high-end finished leather products in a sector which is now highly developed. Modern tanning technology allows its members to also develop leather for high grade footwear and of course Thailand is well known for using the waste for producing rawhide dog chews.

The Thai finished leather products industry has already largely shifted from producing low quality mass products for the EU and USA into highly fashionable leather bags and other products. With some incentives from the government the industry is now developing highly fashionable designs and is producing for some of the most famous brand names around the world. The latest plan is for the industry to establish its own brands. There are over 50 brand names of products exported out of Thailand into the world market, especially to the EU, the Middle East and other ASEAN Markets.

Inefficiencies in Myanmar stunt growth

From just about any perspective whether that be economic, social, or political, there is little positive to report. Calling it Myanmar rather than Burma—as the ruling military junta decreed—doesn't alter a thing.

The military allowed free elections in 1990 and seemed genuinely shocked when their candidates were resoundingly defeated by the National League for Democracy (NLD), headed by Aung San Suu Kyi, who won 392 seats out of 485. The junta's reaction was to declare the results invalid, kill a large number of people who supported the NLD, and imprison Ms Aung San Suu Kyi. On the political front nothing has changed.

Myanmar is a narco-economy. It is a resource-rich country which suffers from pervasive government controls, inefficient

economic policies, and rural poverty. The main reason for inviting Myanmar to join ASEAN—pushed by Malaysia's then Prime Minister, Dr Mahathir Mohamad—was that it would impose the need to reform on the junta. This has not happened. Nonetheless, given its 48 million population and natural resources Myanmar does have potential which might be realised quite rapidly if it were freed from the burden of supporting a massive military.

Cambodia unable to compete

Cambodia had a relatively stable society of some 14 million people, albeit little developed economically, until it was dragged into the Vietnam conflict and then devastated by the genocidal Pol Pot regime. Not surprisingly Cambodia today remains a traumatised society. There is little industry and infrastructure development involves mine clearance even now. There is some activity in manufacturing (mainly low-end) garments and footwear, which account for over 70% of total exports. Cambodia did manage to develop these industries under special quota arrangements with the US but, when quotas were finally phased out, local manufacturers simply could not compete with Chinese and Indian suppliers. Wage rates are low. Annual Gross Domestic Product (GDP) per head is under \$300 while GDP per head in purchasing parity power (US = 100) is 4.2.



Indonesia has potential

With a population of over 220 million—which makes it the fifth most populous in the world—and oil wealth, Indonesia has considerable potential. It has the world's largest Muslim population—which may be viewed as a concern through today's lens—but the general religious practice is moderate and mosque and state don't interfere with each other as a general rule.

Unfortunately, Indonesia does have factors which make for political, social and economic problems. First, Indonesia is spread over some 13,700 islands and contains a multitude of ethnic groups. Second, it is subjected to natural disasters on a regular basis. The massive tsunami of December 2004 caused fearful destruction, especially around Aceh, while the recent earthquake has caused extensive damage and death in

Java. An active volcano near-by is in danger of erupting on a daily basis. Third, a tradition of corruption exists at all levels.

President Susilo Bambang Yudhoyono, the country's first directly elected president (his two predecessors were elected 'indirectly' by the parliament) has certainly made an effort to curb the problem of corruption, but his attention has inevitably been diverted by natural disasters and the myriad of difficulties in balancing the interests of such a diverse country.

In terms of exports Indonesia sells about \$4.6 billion worth of garments and related items, well below the \$6.4 billion of electrical goods (or the \$7.7 and \$6.6 billion of petroleum products and natural gas respectively it exports.)

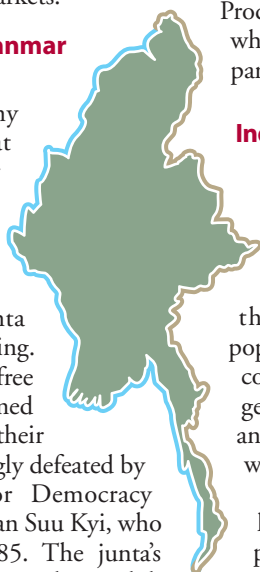
Fighting to pull back footwear from China

Indonesia began manufacturing goods in the early 1960s. The main manufactured exports include wood products (veneers, plywood, and furniture), textiles, clothing, and footwear.

Much of the new manufacturing is located on Java, especially in Jakarta and the surrounding parts of the West Java province. Despite Jakarta's congestion and other problems caused by rapid growth, it remains a very attractive location for manufacturers. The city and surrounding villages provide a large supply of labour, and the city's roads, airport, and port are the best in the country.

Indonesia's shoe industry peaked in 1996 just before the East Asian economic crisis initially triggered by the devaluation of the Thai baht. Back in 1996 Indonesia was the world's second largest shoe producer after China and in that year exported \$2.2 billion of footwear. Since that time and in the wake of the economic crisis, Indonesia's footwear industry has declined and the country's export performance has fallen to \$1.3 billion, a fall of \$900 million in eight years. Many international companies set up production facilities in Indonesia in the context of the globalisation of the footwear industry, notably Nike and Reebok. However, when the average cost of sports shoes could be manufactured for \$4 in Vietnam compared with a unit manufacturing cost of \$4.60 in Indonesia, manufacturing facilities were gradually moved to Vietnam and China.

According to Indonesia's Central Board of Statistics, the country's footwear sector earned \$1.429 billion in 2005 compared with \$1.326 billion in 2004, translating into growth of 8.18% in terms of value and 2.87% in terms of quantity. The ➤





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country's footwear exports during 2003 stood at \$1.182 billion, with Japan, United States, Singapore, China, Netherlands, Germany and the UK as the major importers of non-petroleum and natural gas products including footwear during 2001-2005.

Ansari Buchari, director general of Metal and Textile Machinery in the Indonesian Ministry of Industry expressed hope that Indonesia would increase its share of the EU footwear market after the EU slapped anti-dumping surcharges on shoe products from China and Vietnam.

Buchari said he is optimistic that Indonesia can benefit from the EU action, and hopes that major companies such as Puma, adidas and others will invest in production facilities in Indonesia.

Indeed in May of this year nine footwear manufacturers set up factories in East Java, which are set to generate 20,000 jobs. Another 15 foreign investors have already made plans to visit Indonesia in July.

Foreign companies are opting for Indonesia as a new location as the EU has also relaxed tariffs on Indonesian-made footwear products. According to Nugraha Sukmajaya, director for Miscellaneous Industries, EU import duties have already been cut to 14% from 17% and the government is hoping for a 20% increase in footwear exports this year, from \$41.5 billion to \$2 billion.

Trade Minister Mari Elka Pangestu told local media, "This year, footwear exports are estimated to hit \$1.8 billion. The figure could more than double to \$4 billion in 2008 if we can fully tap the European market and encourage more investment in the industry." He noted a shift among giant footwear companies in their outsourcing strategy from single-country sourcing—mainly concentrated in China and Vietnam—to global sourcing. "For the global companies, single-country sourcing is now becoming more risky, particularly if there are trade sanctions affecting the specific country. That is why more footwear producers are now turning back to Indonesia."

The Indonesian footwear industry accounts for 3% of the economy's total non-oil exports, after textiles and wood industries. It is concentrated on Java Island, Surabaya, Jakarta and some of the surrounding areas and is a hub of outsourcing for international producers. It currently employs about 400,000 workers, excluding those working for supporting industries such as plastic, leather and lasts. Before the 1998 financial crisis, the industry employed some 850,000 workers.

The United States and the European Union remain the largest markets for Indonesian shoes.

The tanning industry battles on

A cursory report states that the Indonesian tanning industry comprises 47 medium-sized and large tanneries, with a total production capacity of 72.5 million square feet per year. This is a substantial fall from 1998, when 112 tanneries had a total output capacity of 210 million square feet. The number of tannery employees has also been reduced from 12,560 in 1998 to 8,670 in 2000 and further still to 5,620 in 2001. It is believed that the tannery sector is operating at only 22% of its actual capacity.

The recent earthquake has caused considerable damage to the sector, especially in glove production. Indonesia is one of few countries with good quality sheepskins suited for superior gloves and there is a sizeable industry around Yogyakarta. The strength of the earthquake was only 5.9 (some data states 6.2) but the devastation was huge because it happened at 5:54 am before people were out of bed. The airport was closed due to a crack in the runway and telephones, electricity and the Internet went down. However, all were back in operation well before the start of June.

There was considerable interruption to work not just because of the damage to plant and the infrastructure but also because many small houses collapsed in the suburbs of Bantul and Craton, both of which were where workers lived.

The timing and the location of the quake meant that more deaths and damage occurred in the housing sector than to the tanneries and manufacturing plant, where cracks and work interruption were common, although some tanneries, such as ASA, did suffer considerably and will be out of production for some time.

Laos growing at 6% per annum

As with Cambodia, Laos was hit severely by the shock waves generated by the Vietnamese conflict. A tiny population of just over six million lives in a rural economy, of which one of the principal crops is heroin. Laos is land-locked. The communist government has made some concessions to attract investment, but its geographical location, form of government, and limited population make it generally unattractive to foreigners.

However, the economy has in fact grown by over 6% a year from 1998, but this was from a very low starting point. Laos lacks a basic infrastructure such as roads, railway and telecommunications.

Vietnam—a pause in its expansion

The Vietnamese leather and leather products industry has grown since the late 1980s. Until 1992, the industry served East European countries and the former Soviet Union, under bilateral agreements signed with governments of these countries. In 1992-93, when the bilateral agreements broke down, the Vietnamese footwear industry shifted its focus to exploring new markets and began supplying newly industrialised countries such as Hong Kong, South Korea, Taiwan.

Vietnam has developed at a phenomenal rate since 2000 to the extent that, after China, it has become the second most feared competitor for the remainder of the world's footwear producers.

Looking at this short time scale, by the end of 2003, more than 750 complete production lines had been installed with the capability to produce various types of finished shoes with a total capacity of 520 million pairs per year. Most of these new companies have built up a stable relationship with foreign partners and customers aimed at maximising existing production capacity.

More than 380 companies throughout the country are involved in producing finished leather, footwear and components. Of these, only 55 are state-owned, 177 are private companies, 134 Foreign Direct Investment (FDI) and there are 14 joint ventures. Between them, they employ almost 500,000 workers directly with a corresponding number working in related support industries and services.

The industry is mainly based in Ho Chi Minh City with a number of large footwear and leather companies established around the region. It

concentrates on processing of raw leather and producing finished leather goods. Ho Chi Minh City has over 104 enterprises and hundreds of household businesses in the footwear trade. The area produces nearly half of the nation's footwear output. Some of the successful companies are Biti's, Sao Vang, Thuong Dinh, Phuc Yen, Huu Nghi Danang and Thai Binh.



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Footwear exports surge

According to the Vietnam Statistics Bureau the country exported footwear worth \$3.005 billion during 2005 compared with \$2.893 billion in corresponding period last year—showing an increase of \$111.7 million. During this period, Vietnam also exported leather goods worth \$465 million—up by \$112.5 million from 2004. However, the footwear sector's export turnover for the first four months of 2006 began to fall because of the threat of the import tax which was finally applied by the EU market in April.

While the EU provisionally hit China with a 19.4% tariff on leather shoes, it also slapped 16.8% on Vietnam. The former is regarded by all other footwear manufacturing countries as the major threat to their production, but one they can do little about it, such is the sheer scale of the Chinese industry. Vietnam is perceived as being weaker and more vulnerable. While the tariff does not affect high-tech sports shoes, it hits the very products—leather shoes—which Vietnam needs to produce more of if it is to raise its export profile. It is therefore caught between the rock of imported leather and the hard place of anti-dumping tariffs.

The fact that the Vietnamese government places such strategic importance on its footwear industry is a further grievance for foreigners who have used it to support their claims that the dumping they allege has taken place has government blessing. Whether these tariffs will stay in place in the long-term is debatable. Markus Cornaro, head of the EU Commission in Vietnam, declared in May that the 16.8% duty rate on leather shoes was a temporary solution and that the Commission was considering a final decision based on the interests of the relevant parties.

This is important for Vietnam since the EU is the key export market for its footwear, accounting for 70.6% of the total and way ahead of the USA at 12.5%, Japan with 2.7% and other countries absorbing the remaining 14.2%. Estimates for 2005 suggest that the export value of footwear was set to rise to \$3.1 billion and by 2010 to double to \$6.2 billion. This again demonstrates the Vietnamese government's intention to throw its weight behind investment and further development of this important foreign currency earner. It also explains why it has reacted so bitterly over recent EU tariff proposals.

The Vietnamese leather and footwear industry manufactures goods under contract for famous international leather

and footwear brands such as Nike, adidas, Timberland, Reebok, Clarks, Diadora and FootJoy.

The biggest problem the industry faces in Vietnam is the lack of locally produced raw materials and, in particular leather. This is the complete opposite of India. While so many shoes are at the cheaper end or use textile and synthetics, it is not too serious. But, as the industry continues to break away from producing cheap sports shoes on a contract basis for large overseas buyers, it will have to upgrade in terms of quality and styling. This will inevitably also increase its need for quality leathers at world prices. The only advantage it will then have will be in terms of labour costs and they will rise in just the same way as they are in China.

Vietnam's top six footwear export markets
(2004 - million pairs)

Germany	83.4
UK	82.0
France	45.8
USA	43.7
Italy	21.3
Spain	16.4

The Vietnamese domestic market

Vietnam's domestic market is fragmented, with many small retailers, and it does not have the large proportion of artisans able to supply the small quantities they need. Vietnam's footwear manufacturers have gone in one quantum leap from nothing to either medium or large mechanised operations, making it difficult to supply such small customers and make a profit. The result has been a marked reluctance to supply the domestic market by factories that export over 90% out of a total production that is fast approaching 500 million pairs of shoes per year.

At the same time, its people need shoes and this hole has been filled by imports from China and Taiwan. These two provide the bulk of the three million pairs Vietnam imports every year in the form of a wide range of relatively cheap footwear. Demand, however, is growing in line with increasing disposable income and it is thought that the total annual domestic consumption is approaching 160 million pairs based on each consumer needing two pairs. The fact that Vietnamese exporters are now facing tougher competition due to rising costs and protective trade barriers may cause them to take more interest in

the local market.

Indeed, there are changes occurring that may encourage them further. Local quality standards are lower than on export markets and there is no domination by large branded buyers. More flexible production planning would take out many of the small volume problems. With imports gathering pace and with improvements in logistics taking place, Vietnam is becoming a far more attractive footwear market for local manufacturers. The proof lies in the fact that while imports remained steady at an estimated 1.6 million pairs between 2000 and 2002, they fell 12.5% in 2003 and were predicted to be a further 28.5% down in 2004.

Malaysia blessed with natural resources

The Federation of Malaysia is blessed with rich natural resources and offers immense potential. During the late 1980s and 1990s the economy grew at a smart pace as it moved from primarily agricultural to industrial. Not that the agricultural side should be overlooked as exports of foodstuffs is substantial. Even so, the principal export sector today is electronics and electrical machinery at \$61 billion compared with textiles, clothing and footwear which collectively manage just \$2.7 billion. This is no accident, because the government has deliberately followed a policy of encouraging investment in higher-value manufacturing processes.

The 24 million population comprises some 60% indigenous Malays, 30% Chinese, and 18% Indian. They enjoy what can best be described as a 'managed democracy'. In practice what this comes to is that the National Front party representing indigenous Malays wins any national election. Draconian legislation, left over from the communist uprising of the 1950s, is still used to quieten dissenting voices that get too loud although the media is free to report favourably on the government.

The Malaysian economy is robust and sophisticated despite a lack of transparency and government meddling. The government does encourage investment in some industrial sectors, but textiles, clothing, leather and shoemaking are generally not amongst them.

The Philippines—corruption on a grand scale

The Philippines should be one of Asia's most prosperous economies. It has ►



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abundant natural resources and a literate, hard-working labour force. Instead it is one of the worst performers. There was a brief improvement under President Ramos in the 1990s but things started sliding downwards again when film star Joseph Estrada won the next election.

Beneath a quite modern exterior the Philippines, at heart, still has a fairly feudal society. It lacks a really stable political system. Corruption, practiced on a grand scale, adds further to the problem. The current president, Gloria Macapagal Arroyo, a US-trained economist, is herself the daughter of a previous president. When she took over from the impeached Joseph Estrada (she was vice-president) hopes for a cleaner government were high. Those expectations did not survive accusations of vote rigging while her husband moved out of the country in self-appointed exile so his activities would not embarrass her further.

While the Philippines does suffer greatly



from natural disasters—typhoons, tsunamis, volcanoes amongst others—most of the social, political and economic disasters are self-inflicted.

Singapore is a true tiger

One of Asia's so-called 'Tiger' economies Singapore, with a population of some four million, enjoys one of the highest standards of living anywhere. Economic and social stability has been the over-riding purpose of Singapore—a contrast with more volatile economies elsewhere in the region. Singapore's obvious competitor has been Hong Kong with which it shares similarities and differences in equal number. But, unlike Hong Kong with its largely unregulated entrepreneurial spirit, Singapore is tightly controlled by a government that claims to know what's best. And to judge by results, it does (on the economic front at any rate). Like its northern neighbour Malaysia, Singapore has a 'managed democracy'. It also has the

only family dynasty running a democratic, free market, country.

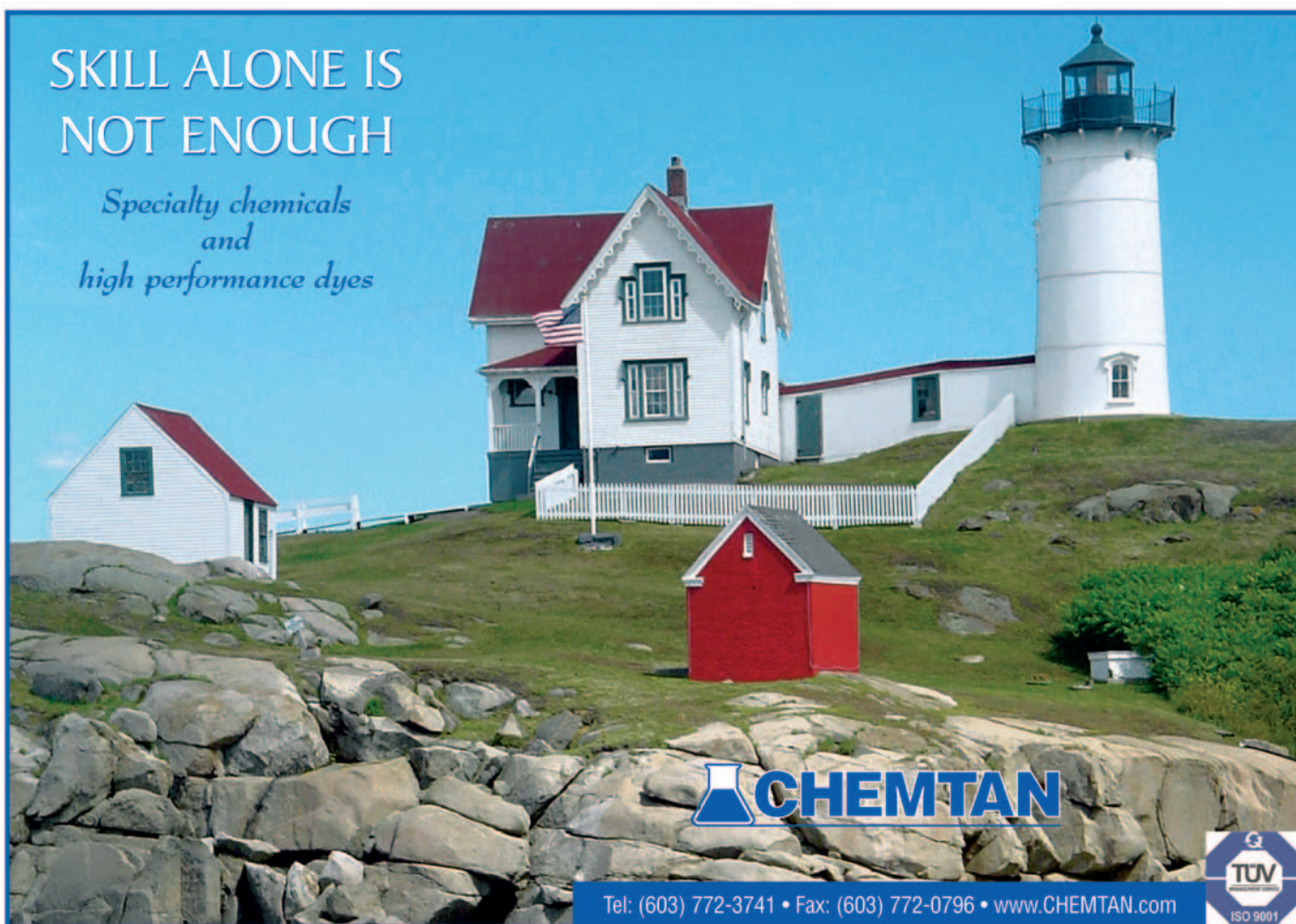
A key distinction from Hong Kong—whose economic structure is completely market driven—Singapore has maintained a more diverse economy and the government will intervene to ensure that there is a ratio of manufacturing activities in addition to the main service sector. But, needless to add, the manufacturing sector that does exist is exclusively high-end.

Variety in every respect

On the whole most of the South East Asian nations have hard working populations but, unfortunately, little else. Some have abundant natural resources while others are host to natural hazards of every kind. Government systems vary too, from old-style communism to open democracies. Yet the challenges they face are remarkably similar and the main one is finding an economic role for themselves in a global marketplace that is being increasingly dominated by two countries—China and India. 🌐

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