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REINVENTING SHENZHEN ■ MADONNA'S MISSION

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THE BIRTH AND REBIRTH OF SHENZHEN

The city that has driven China's manufacturing boom must now bank on innovation, not sweatshops, for continued economic growth

By **MICHAEL SCHUMAN** SHENZHEN

THE CITY OF SHENZHEN, CRADLE of China's industrial revolution, is usually associated with impoverished migrant workers and cheerless gray factories churning out cheap toys, T shirts and sneakers for the world. While that gritty image represents Shenzhen's past, entrepreneur Pony Ma is a harbinger of its future. The 34-year-old Ma is an Internet tycoon with a fortune of nearly $500 million, thanks to the success of the Shenzhen company he founded in 1998, Tencent, China's largest instant-messaging service with 532 million registered users. The company's home is a tidy, landscaped campus where employees, the best and brightest from universities in Beijing and Shanghai, come to work in blue jeans instead of sewing them together in sweatshops. Some of the software engineers at Ma's R&D center earn $5,000 a month, 50 times a typical Chinese factory salary.

Through the wall-sized windows behind his slick, black desk, Ma overlooks steel-and-glass office towers that house similar companies, including an online-music outfit and a "virtual university" where colleges from around the country have conference centers and research labs. This small enclave of white-collar knowledge workers is a model the rest of Shenzhen must rapidly emulate if it is to continue to prosper, says Ma: "In Shenzhen, we really have to move faster than before, and take the right direction." His vision—and his sense of urgency—is shared by city officials, who have launched an effort to move the local economy to a higher plane. The government is promising tax breaks and land concessions to tech firms, and has said it expects to invest $1.25 billion over the next five years to support high-tech start-ups and research projects. "Shenzhen is at an important strategic turning point," the city government said in a policy statement issued earlier this year. "We must not waste time and opportunities in establishing a new, high-tech development strategy."

Those words may have globe-rattling implications. If Shenzhen can leap from assembling basic products with low-wage, poorly skilled labor to nurturing the innovations of lavishly paid talent, it could blaze a trail for the rest of corporate China, which must increasingly develop its own brands, designs and technology to rival those of America, Japan and Europe. It would not be the first time Shenzhen has led the way.

The city, located in southern China's Pearl River Delta, has been at the forefront of China's free-market reforms for 25 years. In 1979, late Chinese leader Deng Xiaoping designated Shenzhen as one of the country's first special economic zones (SEZs), offering privileged terms to foreign companies wanting to invest there.

That experiment was a remarkable success. Eager to tap Shenzhen's low costs—especially for labor—foreign companies rushed into the SEZ, led by factory owners from nearby Hong Kong. The result was a decades-long boom, with Shenzhen's economy expanding at an average rate of 28% a year from 1980 to 2004, according to Hong Kong-based consulting firm Enright, Scott & Associates. Exports from Shenzhen reached $101.5 billion in 2005—13% of China's total. Today the city is home to some of China's most important electronics manufacturers, such as telecom-equipment firm Huawei Technologies and mobile-phone maker ZTE. (Electronics products make up about 60% of Shenzhen's industrial output, according to Enright, Scott & Associates.)

The economic miracle has had its limits. Parts of the city are industrial and drab, and in recent years petty street crime has

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NOW AND THEN
Shenzhen, pictured in 1984, left, and today, has led China's transformation—and must do so again

“We really have to move faster than before.” —PONY MA, Shenzhen-based tech tycoon

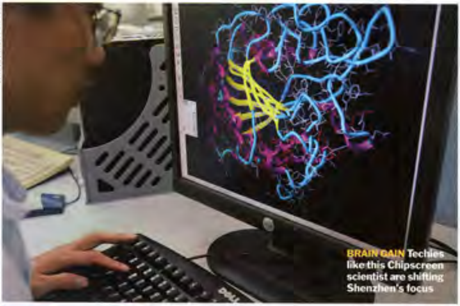
become so bad that some Hong Kong residents no longer shop there for cheap household goods and knock-off designer clothes. But with per capita GDP of almost $7,500, Shenzhen is among the richest cities in China. Today's downtown is a jumble of traffic-clogged streets, luxury hotels, Hugo Boss and Louis Vuitton stores, and foreign eateries like Pizza Hut and Taco Bell. At the Portofino housing complex on the city's outskirts, golf carts carry residents from their lavish condominiums to the development's pricey European restaurant.

Why, then, do city officials feel a pressing need for a new economic vision? Because Shenzhen is discovering that the same forces of globalization that made it successful can also work against it. As the city prospered, wages went up, along with a host of other expenses. According to Chinese government statistics, the average annual salary in Shenzhen has surged by about 40% since 2000 to more than $4,000 last year. That's twice the average wage in other major cities like Chongqing. Higher costs are undercutting the profit margins of labor-intensive industries that have been the backbone of Shenzhen's economy. Greg Gong, CEO of Taiwan-based Further Tech, opened a factory in Shenzhen three years ago to make consumer-electronics gear, but he's already getting squeezed. Gong says his costs are rising by 10% annually, driven mainly by higher wages, and tough competition prevents him from increasing the price of his products. Gong says falling component costs are helping him maintain profit margins, but saving money by relocating his factory to a less expensive part of China is out of the question because he needs to stay close to the component suppliers clustered in Shenzhen. “If I moved to Hunan or Hubei, it would be hard to find the parts we need,” he says.

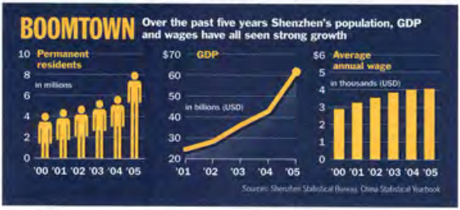
Plenty of factory owners feel less constrained. Garment makers and other low-tech manufacturers are increasingly shifting production from Shenzhen to cheaper locales, often the poor provinces of western China or, on occasion, other Asian countries like Indonesia and Vietnam. When companies moved into Shenzhen, “they never thought they'd have

FROM LEFT: XINHUA; HAIBO YU FOR TIME

to leave a few years later," says Ruby Zhu, senior China economist for the Hong Kong General Chamber of Commerce.


ZHANG HAIER FOR TIME

BRAIN GAIN Techies like this Chipscreen scientist are shifting Shenzhen's focus



One reason for Shenzhen's rapidly rising labor costs is a shortage of workers. Millions of poor Chinese who in the past sought work in southern China's factories can now find jobs closer to home, and Shenzhen is becoming less of a migrant-worker magnet. That means there are fewer workers to fill the lowliest jobs, and employers must pay more to attract them. At a large job market in downtown Shenzhen, hundreds of positions are posted on bulletin boards and rows of recruiters wait to collect applications, but the trail of employment seekers is frustratingly short. At one booth, recruiter Zhong Man says entry-level salaries at her Shenzhen-based apparel company have doubled in the past two years to $250 a month, but that hasn't alleviated a chronic staff shortage. "It's a little harder to find average workers these days, because the development of the interior is getting better," she says. The government has tried solving the problem by raising the minimum wage to attract more workers from outside Shenzhen. After a 13% increase last year, the government recently boosted the minimum wage within the city's special economic zone by 17% to more than $100 a month—the highest minimum wage in China.

Add in the rising cost of property, lofty electricity prices, water and power shortages and stricter environmental regulations, and Shenzhen has become one of the most expensive places in the country for factory operations. Adaptation is the order of the day. For example, Hong Kong-based Top Form, the world's largest bra maker, has transferred much of the manufacturing of basic bras from its Shenzhen factory to other facilities such as its plant at Long Nan in Jiangxi province, where labor costs (including benefits) are 60% lower. Top Form's Shenzhen factory is now focused on manufacturing high-fashion bras featuring delicate fabrics and complicated designs, which require more talent to produce, but also fetch higher prices in European boutiques. Last year, Top Form also opened a product-development center in Shenzhen to create its own bras. "Shenzhen is not a place for low-skilled manufacturing any more," says Kevin Wong, Top Form's manager for corporate development. "We're moving up the value chain."

Shenzhen's manufacturers are facing many of the same problems that bedevil South Korea and Taiwan, where makers of low-end products, beset by competition and eroding margins, have in recent years been trying to make the transition to more sophisticated products. Shenzhen is trying to jump-start that transition by removing obstacles facing inventive startups. Six years ago, Xian-Ping Lu left his job as director of research at an R&D center for a pharmaceutical firm in the U.S. and, with other researchers, planned to set up their own company in China. Although they considered cities like Shanghai, Lu and his team chose Shenzhen. "We really felt there was a strong market-driven atmosphere in Shenzhen," compared with other cities in China, he says. It was easy to set up his firm and import the advanced equipment he needed for his labs. He has also received about $2.5 million in government research grants, a chunk of which came from the city. Today, Lu's drug-development firm, Shenzhen Chipscreen Biosciences, employs about 45 people working to develop cancer and diabetes treatments in a university-style building at a research park designated for biotech outfits and other advanced start-ups. "If we built this company somewhere else," says Lu, "I don't think we'd have such good luck."

What's good for Lu is good for Shenzhen—and all of China. As the nation's economy roars ahead, growing 11.3% in the second quarter, more parts of the country will face the same challenges of rising costs, labor shortages and aggressive competition. Chinese employers "cannot forever have cheap labor," says Hong Liang, chief China economist at Goldman Sachs in Hong Kong. "They cannot just count on low-cost manufacturing." Soon the entire Chinese economy may be faced with the painful transition Shenzhen must confront today. Shenzhen is "trying to do what the country needs to do," says Chipscreen's Lu. Perhaps this hard-working, ever-mutating city will provide the answer for China, once again. ***—With reporting by Austin Ramzy/Shenzhen***