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CHINA WORLD

China, Inc. Goes Global

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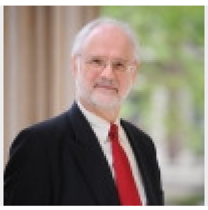

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China, Inc. Goes Global

NEW YORK – China's economy is now taking its next great leap forward: parts of its manufacturing sector are now moving up the value-added chain and out of the country. The China challenge is now a global one.

The reasons are not difficult to fathom. Production costs (wages, office rents, land, capital, etc.) in China's coastal provinces – where most of the country's manufacturing and service production, as well as foreign direct investment, are located – have been rising fast. Since last year alone, minimum wages in nine of twelve coastal provinces (including Beijing) rose by an average of more than 21%.

At the same time, the renminbi is appreciating, making domestic production of export-oriented goods and services even more expensive. This matters, especially for labor-intensive activities (ranging from toy manufacturing to data-entry services), whether by affiliates of foreign multinational enterprises (which account for more than half of China's exports) or by local firms, which are losing competitiveness in international markets.

To maintain its export-oriented production base, output must move up the value-added chain, toward more sophisticated products. Multinational enterprises can do that within their integrated global production networks, which allow them to organize an international intra-firm division of labor. Any part of these production chains can be located wherever it suits the firms' international competitiveness best. And such firms have the experience to scout the globe for the right investment locations.

Domestic Chinese firms, too, need to respond to these pressures. They are helped in this effort by the rapid deepening of China's skills and technology base. This partly reflects training in foreign affiliates, but the main reason has been the Chinese government's sustained effort to foster education and training, encourage technology transfers from foreign to domestic firms, and, in particular, to build up research and development capabilities.

In short, producers of more sophisticated goods and services in developed and emerging-market countries need to be prepared for growing competition from China.

At the same time, China's labor-intensive production will increasingly move to countries with lower labor costs – including Bangladesh, India, Indonesia, and neighboring Vietnam (where Chinese firms have already established about 1,000 affiliates), as well as various African countries. This process has already begun, and has been supported since the beginning of the last decade by the government's "Going Global" policy, through which it encourages outward FDI from China.

The data bear this out: FDI outflows more than doubled in 2008, to $52 billion, from $23 billion in 2007, and rose even further in 2009 (when world FDI flows collapsed by about 50%, owing to the Western financial and economic crisis), before reaching $68 billion in 2010. Not counting Hong Kong, this made China the world's fifth largest outward investor that year.

This development creates new opportunities for other developing countries to reap the trade benefits of inserting themselves into the international division of labor. These countries' investment-promotion agencies – indeed, those of all countries, including developed ones – should increasingly target firms in China to lure them to their shores. In so doing, they should aim not only for big state-owned companies, but also for the rising number of vibrant, private small and medium-size enterprises in China that can be found in all sectors of the economy.

But an important caveat is in order: China has a vast interior that is far less developed than the coastal provinces. The government is making special efforts to develop these areas in the framework of its "Great Western Development Strategy," including by building modern infrastructure, promoting high-quality education, supporting science and technology (all key determinants of the location of production), and encouraging investment there. As a result, firms based in the coastal provinces that have to move their production (and see no need to diversify away from China) can choose to relocate to China's interior, rather than going abroad.

The pattern is clear: this sort of transition away from labor-intensive manufacturing happened before in today's developed countries, when firms headquartered in Europe, Japan, and the United States moved production to developing countries. In Asia, Hong Kong, South Korea, Singapore, and Taiwan were (and have been) among the beneficiaries.

When costs for labor-intensive goods and services became too high in these countries, production was shifted elsewhere. This relocation of manufacturing has since been accompanied by the off-shoring of services whose information-intensive components have become tradable.

China itself has benefited from today's open international trade and investment regime, which allows firms to locate production where it is most beneficial for their international competitiveness – and is now beginning to shed labor-intensive industries itself.

Governments need policies to adapt to this global shift in production. They should help their countries' firms to adapt to the departure of some producers by establishing training programs, stimulating innovation, and maintaining or creating a competitive environment that encourages "creative destruction" while providing for a social safety net.

Likewise, governments that attract the production that was shed elsewhere need to have policies in place that enable them to benefit as much as possible from this global shift, thereby furthering their own economic development.

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