LAUNCH EVENT: ADJUSTING TO RISING COSTS IN CHINESE LIGHT MANUFACTURING – 4 DECEMBER 2017

Event report

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On 4 December 2017, the Overseas Development Institute (ODI) and the Center for New Structural Economics (CNSE) at Peking University, Beijing, hosted the launch of the ODI–CNSE joint report, ***Adjusting to rising costs in Chinese light manufacturing: what opportunities for developing countries?***

The report presents the **findings of a survey of 640 light manufacturing firms** in China's Pearl River and Yangtze River Deltas, in an effort to understand the pressures facing Chinese light manufacturing firms and such firms' responses to these challenges, and especially their interest in investing 'out' into countries in Africa and the rest of Asia.

Regional launch events were held in Ningbo in the Yangtze River Delta region and in Guangzhou in the Pearl River Delta on 11 and 12 December 2017.

SUMMARY

- As China continues its progress towards high-income status, rising costs have put pressure on the country's manufacturing sector. With relocation abroad one option open to firms, this could represent an opportunity for the poorest countries to attract investment and jobs, spurring the industrial development required for economic transformation.
- Researchers from ODI and CNSE explained the motivations for the firm-level survey, the methodology and the sampling strategy, and presented key findings:
    - Rising wages are firms' biggest concern.
    - Most firms' preferred strategy for coping with rising costs is technological upgrading.
    - Only 6% of firms surveyed point to overseas relocation as their preferred strategy.
    - Southeast Asia remains a more popular relocation destination than Africa.
- Policy suggestions included a need for realism about the likely numbers of jobs moving out of China and into Africa, and a suggestion that investment promotion agencies and governments focus their efforts on those firms most likely to relocate: foreign-owned, large, footwear firms in the Pearl River Delta.
- Discussants confirmed there was much to be done to promote Chinese outward investment to Africa and other parts of Asia, given the other options open to firms.
- Challenges in relation to relocation, such as profound cultural differences, were highlighted, but so too were the opportunities for expansion, growth and 'win-win' outcomes for those firms willing to 'go global'.
- It is hoped that this work will inform and support those working to drive Chinese investment abroad for the benefit of low-income countries.

INTRODUCTIONS

To open the event, attendees were welcomed to Peking University by the event's Chair, Dr Jia Yu of CNSE. Dr Roli Asthana, Head of the Department for International Development (DFID) in Beijing, followed, welcoming the report and confirming DFID's ongoing interest in working in partnership with China towards the shared goal of global development.

KEYNOTE SPEECH: PROFESSOR JUSTIN LIN, DIRECTOR, CNSE

Professor Lin asserted that he was pleased to be able to share his views on how to jump-start industrialisation in Africa. He noted that the survey in the report put to the test many ideas under discussion in the launch event.

First is **the rationale for industrialisation**. Many countries are struggling below the poverty line; Africa is the continent with the highest percentage of the population in poverty. However, the experience of countries, like Taiwan, which in the mid-20th century was in many ways similar to some African countries today, shows countries can change their fate within one or two generations.

When a country is poor, its income typically comes largely from the agriculture, mining or fishery sectors. Towards the end of the 18th century and at the beginning of the 19th century, emerging economies in Europe began to shift focus from these sectors to manufacturing; eventually, they became high-income nations. Meanwhile, the fiscal income of many African countries still comes largely from mining.

So, **how can countries move up the ladder?** Structural transformation is made possible through infrastructure development (roads, ports) and then through industrial development. The initial, 'pioneer', countries that follow this path are not guaranteed success, but their efforts drive others to follow suit. Despite occasional failures, it is crucial to remember that, throughout history, no country has ever successfully developed without an industrial policy.

Professor Justin Lin.

What is the opportunity for industrialisation for Africa? The coming two decades could represent a ‘golden age’ for African industrialisation. However, for this to be the case, developing countries must first identify a ‘benchmark’ country whose successful development path they could follow. Mauritius is an example of a country that has done this: having taken Taiwan as its benchmark, Mauritius is now Africa’s most successful economy, with a gross domestic product per capita of $10,000.

So far, there have been a number of **case studies of success** where Chinese manufacturers have relocated partially or fully to Africa:

- **Huajian Shoes (Ethiopia).** Since this footwear manufacturer relocated to an industrial park near Addis Ababa, its exports have doubled, and Ethiopia has defied expectations to become a global manufacturing hub.
- **C&H garments (Rwanda).** Encouraged by the successful model of Ethiopia, President Kagame has been working to secure foreign direct investment (FDI) in the manufacturing sector. Following the creation of an industrial park, C&H garments relocated to Rwanda.
- **Dongao garments (Tanzania).** Dongao has invested in an export processing zone in Dar es Salaam. The firm plans to expand to employ 5,000 workers in the next five years.
- **Rebecca wigs (Ghana).** Rebecca wigs, one of China’s largest wig companies, invested in Ghana in 2009. As of 2017, it employs 1,800 workers.

The problem is not whether opportunities exist for African countries; rather, it is whether they will seize these opportunities. The survey report explored how Chinese manufacturers were responding to the pressures on the sector, how many would ‘go global’ and how many would stay. The reality, seen in the past experiences of Taiwanese and Hong Kong firms, is that, when costs rise, firms eventually relocate.

The survey showed that Southeast Asia remained a popular overseas destination for Chinese firms. However, wages are rising across this region, too, which means Chinese firms must now look to Africa.

THE RESEARCH

INTRODUCTION TO THE STUDY, DR STEPHEN GELB, SENIOR RESEARCH FELLOW, ODI

ODI is a London-based think tank, independent of the government; the Supporting Economic Transformation (SET) programme is a programme focused on work in a range of countries to support economic transformation (as explained by Professor Lin). SET works in nine countries, with a focus on how these countries can industrialise and how to promote manufacturing. The programme seeks to advise governments and development partners in terms of what they can do in this regard.

This programme grew naturally from SET's work in Africa and other parts of Asia, as it became increasingly clear that Chinese investment was critical for promoting economic transformation, and manufacturing specifically. It became important to look at China to understand what the potential for FDI in developing countries was, and how Chinese firms made the decision to invest abroad or to not. Knowing this would allow the programme to better advise African and Asian governments on how they could attract Chinese FDI.

The key issue the study highlighted was that firms have choices in terms of how they respond to rising costs: they can move within China, they can make adjustments to existing operations or they can 'go global'.

The survey looked at four sub-sectors in light manufacturing: toys, garments, footwear and household appliances. All firms surveyed were exporters and thus part of global value chains, so they could in theory move operations abroad to the developing world.

From l-r: Dr Stephen Gelb, Zuoxiang Zhao, Jiewei Li.

SAMPLING STRATEGY, DATA COLLECTION AND FIRM CHARACTERISTICS, JIEWEI LI AND ZUOXIANG ZHAO, CNSE

Three conditions applied to the firms selected for the survey:

1. They were labour-intensive light manufacturing firms in the four sectors.
2. They were 'above-scale' firms.
3. They were export-oriented (with at least 50% of their value originating from exports).

The Pearl River Delta and Yangtze River Delta were chosen as regions, and the Chinese Industrial Enterprises Database 2013 was used as the framework. Firms were selected for the sample taking account of the distribution of Chinese light manufacturing industries within clusters in specific cities and towns.

Most firms (either owners, senior managers or heads of department) were interviewed face to face, and, where the study had the support of local government bureaux, town meetings were organised to gather firm owners, at which they completed the survey in person. The overall response rate was 40%.

- **Type of manufacturer:** The bulk of the firms (two-thirds) were original equipment manufacturers. The rest were split between original brand manufacturers and original design manufacturers, with a small number of 'mixed' firms.
- **Age of firms:** Most firms began operation between 2000 and 2009.
- **Ownership structure:** The most important finding was that, in the Pearl River Delta, 73% of firms were foreign-owned. In the Yangtze River Delta, 77% were domestically owned.
- **Size:** 'Small' firms accounted for 50% of the total.

- **Wage growth:** At 11% per year, the average wage rise was not huge compared with for other industries across China (the range being 10% to 20% per year).

The following were some of the key trends in the responses from the survey:

- Wage growth was the greatest challenge facing firms; other concerns cited by firms were rising insurance costs and market demand.
- Firms in home appliances and toys opted overwhelmingly for technological upgrading as their preferred strategy. Toy firms were most likely to choose overseas relocation.
- Garments and footwear firms put greater emphasis on tightening cost controls than firms in appliances or toys.

FIRMS' RELOCATION STRATEGIES AND POLICY IMPLICATIONS, DR STEPHEN GELB

Most of the firms surveyed wanted to upgrade their technology or use cost control mechanisms to address rising costs, rather than to relocate.

With regard to those firms that had invested abroad, or had expressed an interest in doing so in the coming three years, **around 6% pointed to overseas relocation as their primary strategy** to address rising costs. The aim was to look closely at these to better understand what they were doing and why, and how others could be encouraged to follow this path.

Adding together those firms that had invested abroad in the past and those planning to do so in the near future gave a **total of 62 firms, 10% of the sample, investing out of China.**

The following may be reasons for the smaller-than-expected percentage of firms relocating abroad:

- The survey did not include firms that had already moved their entire operations abroad.
- Some foreign-owned firms may not have informed the team of existing plans to relocate because their parent company, rather than their specific operation in China, could be considering the move.
- The common trend of cluster grouping of firms means they are interdependent and would struggle to relocate alone.

It is important to note that, while 10% is not a large proportion, if this is applied to the full number of above-scale exporters (almost 5,000), this could mean 500 firms relocating. This, in terms of potential jobs, is not an insignificant number.

So, who is most likely to relocate?

- Firms in the Pearly River Delta (90% of them);
- Foreign-owned subsidiaries;
- Large firms;
- Footwear manufacturers (note: 85% of footwear firms interviewed were foreign-owned);
- Original design manufacturers.

In terms of relocation destination, most firms had invested or planned to invest in Southeast Asia (Vietnam was the most popular destination, followed by Cambodia and then Bangladesh). Only three had invested in Africa (all of which had invested in Ethiopia).

What policy suggestions can be drawn from this?

- Governments should be realistic about the potential job shift to Africa; Southeast Asia remains a more popular destination.
- Government and investment promotion agencies should target those firms most likely to invest – foreign-owned, footwear, large firms in the Pearl River Delta.
- They should also consider targeting clusters of firms, rather than individual firms.
- They should focus more on easing the entry barriers to individual migrant entrepreneurs who might be interested in moving their businesses entirely out of China.
- African countries seeking FDI from China must focus on their location-specific advantages *and* on marketing those advantages to firms in China. Some of the reasons cited for firms' location choices and their preferring Southeast Asia to Africa as an investment destination were:
    - Lower cultural and linguistic barriers;
    - Better macroeconomic conditions;
    - Better access to finance.

From l-r: Dr Jia Yu (Chair), Professor Xiaobo Zhang, Dr Sherry Tao Kong, Jiewei Li, Jie Zhang, Aimin Liu, Zuoxiang Zhao.

PANEL DISCUSSION

PROFESSOR XIAOBO ZHANG, NATIONAL SCHOOL OF DEVELOPMENT, PEKING UNIVERSITY

The ODI–CNSE survey illustrated what was already suspected – that the wage rise being seen in China's manufacturing sector is very significant, and it seems it will shrink the level of employment and slow China's economic growth. Faced with this problem, enterprises must seek counter measures.

Firms have four options: up, down, in or out.

- Up (the upgrading of equipment to substitute labour);
- Down (shutting down operations entirely and moving into other sectors such as services);
- In (relocating further inland where costs including wages are lower);
- Out (going global).

The survey showed that only 10% had gone, or were considering going, global, which is somewhat lower than expected. A recent similar study by Standard Chartered also found that technological upgrading and investment in equipment were more popular strategies than overseas relocation (though it also found that interest in relocation appeared to be growing). In a recent survey of 1,000 firms in Henan province, only 0.33% expressed an interest in relocation abroad. So there is much still to do.

DR SHERRY TAO KONG, ASSOCIATE RESEARCHER, INSTITUTE OF SOCIAL SCIENCE

In terms of methodology, some points are as follows:

- The survey faced many challenges. The sample framework used had not existed in the past.
- Real random sampling should come from the whole population, but, as this is unfeasible in practice, a cluster sampling approach was taken.
- In each area, the maximum number of firms was reached.

Overall, the sampling procedure was academically sound, and realistic in light of the resource and time constraints of the project.

JIE ZHANG, DEPUTY PRESIDENT, CHINESE CHAMBER OF COMMERCE (LIGHT INDUSTRY CRAFTS IMPORT AND EXPORT)

China’s exports and imports are going from strength to strength: this year, imports increased by 55%. However, light manufacturing is facing challenges including labour cost increases, higher raw material costs and environmental and forex rate issues (which impact exports). In response, firms are increasingly turning to new technologies to reduce their costs.

Promisingly for China’s light manufacturing industry, increasing numbers of original brand manufacturers are thriving. In the past, European companies looked to China not for design but for manufacturing. Now, more and more Chinese companies are designing their own, world standard, products. Profits for these firms are increasing year on year by up to 15%.

For those firms that have relocated, or want to relocate abroad, there are many possible motivations: cost, exports, markets and resources. South Asian countries such as Bangladesh, where wages are very low and in some ways the economy resembles that of China in the 1970s and 1980s, have a great deal of potential for firms driven by these motivations.

AIMIN LIU, PRESIDENT OF THE BOARD, CHINA-EGYPT TEDA SUEZ ECONOMIC AND TRADE COOPERATION ZONE

Professor Lin’s keynote and the authors’ presentations explored the detail of the survey findings. What is left to discuss is how, and then why, firms go global?

The survey explored firm-level reasons (such as rising wages) as to why manufacturers choose to relocate overseas, but not the ‘higher-level’ reasons. These are, first, the fourth industrial revolution and its impact on Chinese industry; and, second, growing global competition: if firms do not go global, they will increasingly struggle to compete.

Aimin Liu.

Aimin Liu runs an industrial park in Egypt, which started with only eight firms. Since its inception, it has gone through three phases, with many small- and medium-sized enterprises (SMEs) phased out over time. A third batch, now some 30 firms, is thriving and providing services.

How can SMEs go global?

- Industrial parks in developing countries that can address fundamental issues of poor infrastructure and lack of equipment;
- Clustering with other firms;
- Flagship enterprises, which help reduce costs.

The ODI–CNSE report is significant; however, further work could be done to help us understand the difficulties facing those firms that have relocated operations abroad and to analyse why many have struggled to evolve and grow outside China.

It is to be hoped that it will be possible to cooperate further with CNSE so more SMEs can go global and successfully survive and thrive abroad.

Q&A AND FINAL REFLECTIONS

Below are a selection of questions and comments raised by audience members and the panel; comments are not attributed to individuals.

- While there are many stories of Chinese firms thriving in Africa, not all relocated firms experience success. Some of the challenges foreign firms encounter are related to the policy or legal environment – such as laws around land ownership by non-nationals.
- Firms looking to relocate should seek to have strong collaborative ties to local trade and investment promotion agencies in the destination country to address these issues. Changes are never made immediately – but dialogue can help shift the policy environment.
- There are cultural challenges inherent in relocation to Africa. This is less the case with Southeast Asia. However, there are connections and parallels to be drawn between African and Chinese cultures, and mutual respect and tolerance for local custom and culture is crucial for the success of any relocated operation.
- Relocating firms must ensure their enterprise not only is beneficial for the firm itself but also generates local jobs to benefit the local community.

- It is important to remember that 'going global' is only one of many options available to manufacturing firms. Firms must also consider their individual capabilities.
- The Chinese government continues to encourage and advocate foreign-owned firms to remain in China rather than relocating, but also recognises these companies' global trajectory may lead them elsewhere.

From l-r: Dr Roli Asthana, Professor Justin Lin, Dr Stephen Gelb.

REGIONAL WORKSHOPS

LAUNCH IN NINGBO, UNIVERSITY OF NOTTINGHAM BUSINESS SCHOOL

This workshop was opened by Professor Martin Lockett, Dean of the Faculty of Business, University of Nottingham, Ningbo. The report was presented by researchers, and this was followed by a roundtable discussion, featuring academics, officials of Ningbo local government agencies, representatives of firms surveyed and journalists. Panel speakers included the minister of integrated economic development at the Ningbo Municipal Government Advisory Committee and the chief economist of the Ningbo Development and Planning Research Institute. Several of the panellists made reference to the difficulties faced by small firms relocating out of China, particularly given their limited access to finance in comparison with large firms. Interest was expressed in more detailed work to build on the research and draw out more detailed policy recommendations for firms in Ningbo.

LAUNCH IN GUANGZHOU, GUANGDONG ACADEMY OF SOCIAL SCIENCES (GASS)

This workshop was chaired by Shengping Feng, Director of the Guangdong Investigation and Research Center. Following the presentation by the authors, the meeting was addressed by the Deputy Director of the GASS, Professor Zhang, who remarked on the value of the report in providing analysis and advice for government and firms. This was followed by a set of reactions from a panel:

- Professor Pinghan Liang, Sun-Yat Sat University, commended the report's analytical strengths.
- Mr Li Jinsi of the Guangdong Province Economic and Information Committee noted the provincial government's work on innovation, enhancing the value of the report's focus on the province's traditional industries.

- Ms Wang from the Guangdong Bureau of Statistics noted the report's value, as her agency had not conducted firm surveys before. She noted that clusters of firms had moved from the province, and that outward relocation had increased following the global financial crisis.
- Professor Chen Zai Qi of the GASS argued that the recent trend of overseas relocation by Chinese firms should be viewed differently to the historical move by Korean and Japanese firms into China, as Chinese firms today have more options available to them; they can relocate within China given its vast size – not an option open to Korean or Japanese firms in the past.

SET is an applied research and advisory programme at ODI, funded by DFID. The programme's reports, dialogue sessions and events cover four dimensions of a country's experience in economic transformation: 1) what is happening? 2) why is it happening? 3) what should be done? and 4) how to make it happen? For more information, visit set.odi.org.