Interprovince Investment Revives China’s Growth Rate

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China’s growth rate of 6.9% in the second quarter beat the expectations of analysts, who expected the economy to continue to slow. Equally surprising is the rebound in manufacturing sentiment. The Caixin purchasing managers index for June edged above 50 into expansionary territory last week.

The recent resurgence is likely more than a temporary blip. In part it reflects better global demand for Chinese products. But it’s also the result of longer-term shifts in China’s manufacturing landscape that will increase productivity.

Chinese industrialists began to move production to poorer interior regions, away from the more developed coastal cities, in the early 2000s. This process, known as industrial transfer, is now in full swing. It encompasses not only the physical relocation of factories, but also investment in inland businesses, creation of new distribution chains and so forth.
One example is Li-Ning, a privately owned athletics-goods company founded by former Chinese Olympian Li Ning in Guangdong province. In 2008, Li-Ning invested 10 billion yuan ($1.48 billion) in a large production facility in Hubei province's Jingmen city. The factory produces 30 million pairs of shoes and 67 million athletic suits annually, most of which are sold to Chinese consumers.

Industrial transfer is hard to measure because, unlike industrial output, it is dynamic and multifaceted. Even officials at the National Development and Reform Commission, China's top economic-planning agency, acknowledge that they lack systematic measures of the migration.

One commonly used estimate of industrial transfer is interprovince investment, a term that first appeared in some provincial-government reports in the 2000s. It is a novelty compared to foreign direct investment, which has been recorded in Chinese statistics since the 1980s.

The scale of interprovince investment is impressive. In 2015, the value in five central provinces alone—Anhui, Henan, Hubei, Hunan and Jiangxi—was 2.5 times that of FDI throughout China. In 2011, Hubei received 333 investment projects from the coast, of which 70% were in manufacturing.

Industrial transfer injects new growth opportunities into poor inland regions, but it also frees up resources for high-end manufacturing and services on the coast. Chinese policymakers term this dual structural shift “emptying the cage to change the bird.”

But Beijing didn’t predict, let alone plan, this wave of industrial migration. It occurred spontaneously among coastal producers, primarily in the private sector and in response to market pressures.

During the 2000s, labor and land costs rapidly rose and local governments stiffened environmental regulations, killing the profits of low-end manufacturers. Some headed overseas, while others moved inland. In central China, labor costs are less than a quarter of those in Shanghai, and enforcement of regulations is also lax.

China’s cabinet, the State Council, reacted belatedly to the bottom-up surge of industrial transfer, making it a top priority in 2010. Earlier policies of regional development centered only on providing financial assistance to and building infrastructure in the poor interior. After 2010, the leadership actively encouraged industrial transfer, primarily by creating “special recipient zones” throughout central China. These enjoy preferential policies similar to the special economic zones on the coast.

As a result, central and western provinces are now in the midst of an “investment frenzy.” Belatedly mimicking the practices of coastal governments in the 1980s and 1990s, inland governments are mobilizing their civil servants to attract domestic investors using attractive benefits.

Li-Ning, the sporting goods company, was fiercely courted by several competing cities. It ultimately chose Jingmen for its “dedicated services.” The Jingmen government took care of the company’s every need, from land and labor supply to electricity.

If the interior takes over low-cost, labor-intensive manufacturing while the coast advances technologically, China will command both the low and high ends of production within a single market. That would give it a formidable competitive advantage.

Yet China’s process of industrial transfer faces some obstacles. Coastal investors run into corruption and weak property rights in inland locations. Large companies like Li-Ning fare well but smaller ones falter. Environmentalists worry whether pollution will migrate from rich to poor regions. While labor costs are lower in the interior, they too are rising.

Nevertheless, China’s manufacturing landscape is undergoing a sea change. Domestic investors are eclipsing foreign ones. Domestic consumption is surpassing exports.
Supply chains are being remade. The regional shifts in manufacturing may allow China to grow faster for longer than many analysts thought possible.

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