

East Asia and China compete in manufacturing

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The scale of China's growth and China's integration into East Asian production networks is generally seen as a positive element in East Asia's trade and economic growth, lifting trade and growth throughout the region.



One measure of China's positive impact is its growing importance in regional export markets, as China has outstripped the US and Japan as the major market for most East Asian economies, including Australia.

Though it is no less beneficent, the dynamic of East Asian growth was never so simple. As China's manufacturing has forged ahead, there were bound to be competitive pressures on other producers along production chains within the region, as Chinese manufacturing productivity leapt ahead of wage growth and brought unit costs tumbling down. Without investment, especially in human capital and entrepreneurial infrastructure, China's established Southeast Asian competitors in markets for labour-intensive components and manufactures are left in the low-skilled end of the market, struggling to upgrade their manufacturing into higher

value-added activities where China is gaining strength.

Malaysia is a classic example, where failure in up-skilling the manufacturing workforce and ill-judged industrial policies have raised the spectre of being caught in the so-called 'middle income trap'. The challenge is not the spectre of Chinese competition, which provides the opportunity to lift manufacturing productivity, upgrade trade and industrial structure, and lift national incomes: the challenge is national failure in investment and reform to achieve that outcome. Many in Indonesia also worry about how to find a way in international markets for manufactures around the juggernaut of growing Chinese competitiveness; the more Indonesia closes off competition and back-tracks on openness and reform the more likely Indonesia's respectable growth and industrial transformation are likely to splutter to a halt.

Yukon Huang, in this week's lead essay, makes the important point that North Asian economies that are higher on the economic value chain, like Japan, Taiwan and South Korea, have benefited greatly from China's low-end-manufacturing strengths in the past decade or so. Southeast Asian economies that are more like China in terms of their labour endowments and skills structure are less well positioned to cope with the new competition. That's not true for all of them, one should add, as Vietnam and Singapore demonstrate in different ways. Huang argues that as East Asia emerged from the Asian financial crisis, China's rise was viewed by many of its neighbours as a potential threat, rather than an opportunity. But when economies from South Korea to Thailand revived and the regional production-sharing network matured, and China embraced an activist economic (ASEAN+1) diplomacy to open its markets toward Southeast Asia, everyone seemed to benefit from China's demand for specialised components and primary products.

But, in the second half of last decade, Huang suggests, regional production patterns have affected capital flows, investment rates and wage trends in ways that have benefited some East Asian countries more than others. 'The more developed North Asian economies are likely to benefit the most from China's industrialisation process because they have managed to strengthen their position at the high end of the consumer electronics and IT product lines. Meanwhile, production patterns in the region are affecting investment and labour markets in Southeast Asia, thus complicating the sub-region's efforts to moderate widening income disparities, increase productivity and escape the middle-income trap'.

China has continued to upgrade its technological capacity and has made massive investments in infrastructure, especially in response to the global financial crisis. Location within China is now the issue, as the rising costs of production along the industrial coast and an expanded interior transport network encourage firms to move inland. The complexities of a dispersed

supply chain are also encouraging some firms that had previously outsourced components to Southeast Asia to relocate their operations and associated research-and-development activities within China.

Huang observes that 'processing-related imports have fallen from over 40 per cent of China's total imports to 30 per cent over the past decade. And as a share of its exports, they have declined from 55 per cent to about 40 per cent as production has become more integrated within China'.

China's success in industrial upgrading, of course, is already sowing the seeds of a new structure of economic relationships with the rest of Asia, as Chinese and China-based firms look to manage the pressure of higher labour costs by heading into production offshore.

China and the middle-income Southeast Asian countries both face the same challenge of constantly innovating to achieve high-income status and move up the value chain. This is not just a matter of letting markets work in churning out low-end labour-intensive manufactures: it requires high levels of investment in human capital and the next round of fundamental economic and institutional reforms. As they succeed in this, competition across East Asia in higher-end production will intensify as the whole region lifts itself close to industrial-country income levels.

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