VALE COLUMBIA CENTER
ON SUSTAINABLE INTERNATIONAL INVESTMENT
A JOINT CENTER OF COLUMBIA LAW SCHOOL AND
THE EARTH INSTITUTE AT COLUMBIA UNIVERSITY

Columbia FDI Perspectives

Perspectives on topical foreign direct investment issues by
the Vale Columbia Center on Sustainable International Investment
No. 28, August 17, 2010
Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)
Editor: Lisa Sachs (Lsachs1@law.columbia.edu)
Managing Editor: Amanda Barnett (ab3089@columbia.edu)

Will China relocate its labor-intensive factories to Africa, flying-geese style?

by

Terutomo Ozawa and Christian Bellak[*]

China has developed increasingly close economic relations with Africa in its quest for oil and minerals through investment and aid. The World Bank recently called upon China to transplant labor-intensive factories onto the continent. A question arises as to whether such an industrial relocation will be done in such a fashion to jump-start local economic development—as previously seen across East Asia and as described in the flying-geese (FG) paradigm of FDI.[1]

Many studies have examined China's—and other countries'—investments in Africa's light industries (notably leather goods and textiles) and pointed out a host of difficulties they face because of poor local institutional conditions.[2] Hence, this *Perspective* evaluates mostly China-side factors that may decisively induce a transmigration of labor-intensive factories, specifically to the sub-Saharan region.

Judging from Asia's FG model, three factors are the crucial inducements for FDI in low-end manufacturing: (i) labor costs, (ii) exchange rates and (iii) institutions.

Labor costs

[*] Terutomo Ozawa (T.Ozawa@colostate.edu) is Professor Emeritus of Economics, Colorado State University, and Research Associate, Center on Japanese Economy and Business, Columbia Business School, U.S.A. Christian Bellak (Christian.Bellak@wu-wien.ac.at) is Associate Professor of Economics, Vienna University of Economics and Business, Austria. The authors wish to thank Deborah Brautigam, Daniel van den Bulcke, and Stephen Young for their helpful comments on this *Perspective*. **The views expressed by the individual authors of this *Perspective* do not necessarily reflect the opinions of Columbia University or its partners and supporters. *Columbia FDI Perspectives* is a peer-reviewed series.**

[1] For the essentials of the paradigm, see Terutomo Ozawa, *The Rise of Asia: the 'Flying-geese" Theory of Tandem Growth and Regional Agglomeration* (Cheltenham: Edward Elgar, 2009).

[2] See, inter alia, Deborah Brautigam, *The Dragon's Gift: The Real Story of China in Africa* (New York: Oxford University Press, 2009).

Successful catch-up growth necessarily leads to a rapid rise in wages, rendering labor-intensive exports uncompetitive. But how fast wages rise depends on the size of rural labor reserves that need to be shifted to industry. In this respect, unlike Japan and the newly industrialized economies (NIEs) that had a relatively limited reserve of rural labor because of their small geographical size, China has a massive rural labor force yet to be tapped. 750 million people still live in China's countryside with the average rural income only one third of its urban counterpart. Nevertheless, the recent labor unrest and the sharp wage hikes in the coastal provinces will prompt a shift of factory jobs elsewhere. Here, China's present income-doubling plan (by 2020) for its rural regions will promote intra-country industrial migration. Thus, China's own vast interior seems more attractive as new production sites than any faraway countries.

Exchange rates

Currency appreciation in effect "taxes" exports but "subsidizes" outward FDI and imports. Japan and the NIEs submitted to swift and sharp rises in their currencies as they succeeded in catch-up growth. True, the yuan has considerably appreciated over recent years – but only slowly and not drastically enough to trigger a massive relocation of labor-intensive manufacturing overseas—largely because China is not quite ready to dismantle labor-intensive industries that still provide much-needed jobs at home. This *gradual* pace of appreciation gives exporters more time to raise productivity or to relocate inland, thereby allowing them to hang on a while.

Institutions

Institutional factors weigh on both sides. Infrastructural deficiencies (e.g., unreliable power and water supply, transportation, communication, poor governance, inhospitable regulatory environments, work ethic) in Africa are well known. This explains why foreign multinational enterprises (MNEs) in general, let alone China's, have not yet seriously advanced into the continent in search of low-cost labor. The governments of the Asian NIEs quickly realized the potential of Japanese and Western FDI and thus were prepared to provide relevant infrastructure, particularly special economic zones (SEZs).

Since 2006, as part of its strategy to assist sub-Saharan Africa in attracting manufacturing, China has been helping establish SEZs, a scheme modeled on its own SEZs. Currently, the Chinese SEZ in Zambia serves as a model for such zones in Africa. At the moment, nevertheless, there exists China's tendency toward ethnicity-bound groupism, as evidenced in the employment of Chinese construction workers in large numbers for aid projects, the settlement of Chinese migrants and petty merchants/caterers in host countries and the one-sided presence of Chinese consortia for overseas investments without much participation of local and other countries' MNEs.

In contrast, Asia's SEZs succeeded in hosting not only foreign MNEs but many local firms as well, and host governments took proactive measures to use their SEZs as a learning conduit for modern technology and advanced business practices, a situation not yet commonly observable in sub-Saharan Africa. Lest China-sponsored SEZs that are presently in the early stages of development turn into "industrial Chinese diasporas," so to speak, they would need multi-national participation, especially by African manufacturers themselves. South African MNEs, in particular, ought to participate in such zones. Recently, the International Finance Corporation decided to fund $10 million as a joint financier of a commercial complex project (worth about $33 million) in Tanzania with a Chinese company and a local non-profit organization, inviting a third party to fund an additional $6.5 million[3]—an arrangement designed to encourage multi-national participation and adherence to internationally acceptable social and environmental standards. In addition, the New Partnership for Africa's Development (NEPAD) - OECD Africa Investment Initiative aims to strengthen the capacity of African countries to design and implement reforms that improve their business climate and to unlock investment potential in the continent. Also, the U.S.'s African Growth and Opportunity Act (AGOA) may nudge China to invest more in democratic and market-based economies.

Conclusion

All in all, even though China may be serious about relocating low-cost factories to sub-Saharan Africa, there are hurdles to clear on both sides. In the near term, China still can relocate labor-intensive manufacturing inland or to its low-cost neighbors, and sub-Saharan Africa itself is institutionally not quite ready to host labor-seeking FDI on a scale substantial enough to spark catch-up industrialization, flying-geese style, as has happened in Asia.

For further information please contact: Vale Columbia Center on Sustainable International Investment, Lisa Sachs, Assistant Director, (212) 854-0691, Lsachs1@law.columbia.edu.

The Vale Columbia Center on Sustainable International Investment (VCC), led by Dr. Karl P. Sauvant, is a joint center of Columbia Law School and The Earth Institute at Columbia University. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. VCC focuses on the analysis and teaching of the implications of FDI for public policy and international investment law.

Most recent *Columbia FDI Perspectives*

- No. 27. "Political risk insurance and bilateral investment treaties: a view from below" by Lauge Skovgaard Poulsen, August 2, 2010.
- No. 26. "FDI incentives pay -- politically," by Nathan M. Jensen and Edmund J. Malesky, June 28, 2010.
- No. 25. "The response to the global crisis and investment protection: evidence ," by Kathryn Gordon and Joachim Pohl, June 17, 2010.
- No. 24. "Foreign direct investment and U.S. national security: CFIUS under the Obama Administration ," by Mark E. Plotkin and David N. Fagan, June 7, 2010.
- No. 23. "Thinking twice about a gold rush: Pacific Rim v El Salvador ," by Gus Van Harten, May 24, 2010.
- No. 22. "How BRIC MNEs deal with international political risk ," by Premila Nazareth Satyanand, May 5, 2010

All previous *FDI Perspectives* are available at http://www.vcc.columbia.edu/content/fdi-perspectives

[3] "World Bank unit to finance Chinese Africa venture," April 22, 2010, *Financial Times* (www.ft.com/cms).