Avoiding the export crush

By Alan Beattie

Being a developing country used to be easy. You followed leaders – Japan, Hong Kong, Taiwan, South Korea – up a well-trodden ladder from agriculture through manufacturing to services. Starting with tilling the soil, you moved on to turning out T-shirts, then toys, then tractors, then television sets, and ended up trading Treasuries.

The rise of China has made that less straightforward. Not only is the first rung harder to reach, thanks to the hundreds of millions of rural migrants to Chinese cities still willing to work for low wages stitching garments, but also exports of goods from China’s coastal industrial fringe are rapidly becoming more sophisticated, threatening those halfway or more up the ladder. While the shoemakers of Italy and the steelmakers of Pennsylvania may complain loudly about Chinese competition, those with more to worry about are middle-income Asian countries geographically and economically close to the Middle Kingdom.

As Frederick Burke, a lawyer in Ho Chi Minh City, says of south-east Asia: “Looking around the region, you can see a lot of countries with a bright future behind them.” Economies such as Indonesia and the Philippines – and, further afield, Brazil and Egypt – risk being stuck in what the World Bank has called a “middle-income trap”, having achieved basic industrialisation but struggling to find new areas of high growth where they can compete with the Chinese.

The Philippines is a good example. Having slipped from one of the richest countries in Asia 50 years ago to one of the poorer ones at the beginning of the 1990s, the country’s trend economic growth, unusually in the region, has increased following the 1997-98 Asian financial crisis. But it is a long way from catching up with Malaysia and Thailand, let alone with Taiwan or Singapore.

Economic growth has recently averaged about 4-5 per cent, respectable but not dramatic for a country with nearly 2 per cent population growth a year. The economy remains well short of the 7-8 per cent growth that would give the Philippines the roar of an Asian tiger.

Business people and politicians in the Philippines are acutely aware of the need to find niches in the global economy. They closely scan the various competitiveness indices published by the World Economic Forum and others that give international benchmarks for costs and productivity.

While economists spend a great deal of time trying to correct the misapprehension that countries compete with each other in the same way that companies do, Philippine businesses still have to spend much time searching for somewhere they have a relative advantage. World Bank research confirms anecdote: other east Asians do least well when they compete head-to-head against Chinese exporters in European or American markets. They do better by complementing them, going up the value chain in existing industries and creating high-value sectors in which China is relatively weak. The Philippines has found some such activities, but so far not enough of them.

Sanjiv Mehta, head of Unilever in the Philippines, says the quality of the workforce has kept much manufacturing in the country despite the rise of China, although power is among the priciest in Asia and minimum wage rates are high. Unilever has closed its manufacturing operations in Malaysia, a richer country with higher labour costs and a relatively small market, but retained about 80 per cent of its historical production in the Philippines.
Thanks to cheaper transport and lower trade barriers, it is now easier to supply an entire region from a single manufacturing base. But Mr Mehta warns against trying to do everything from one place: “It used to be said that Unilever was hopelessly local, but we don’t want to go mindlessly global.”

Unilever has established an international supply centre in the Philippines for deodorant sticks, whose manufacture requires little power but good quality management. “It helps that the Philippines is the texting capital of the world,” Mr Mehta says – Filipinos’ obsessive need to stay in mobile phone contact with each other means ideas to boost productivity and feedback on hitches flit quickly around the shop floors.

The Philippines has exploited its relatively good education system and high standards of English, a legacy of American occupation, to develop service industries at which China is poor. It is a growing centre for outsourced business processing, writing and editing websites for foreign companies and teaching English as a foreign language. As well as language skills, the Philippines’ press freedom and democracy give it an edge over China, where internet sites are heavily monitored and censored.

But by no means have these bits and pieces added up to the kind of mass-employment, high-growth engine that a country of 90m people needs – and the threat of Chinese competition remains potent. Manila has long regarded itself as a hub for transport and communications, but FedEx of the US is moving its regional distribution centre from the Philippines to Guangzhou in China, citing trends in manufacturing and trading. The country attracts little foreign direct investment and Filipinos still go in their millions to work abroad. Remittances form more than 10 per cent of gross domestic product, the highest ratio in the world.

Business people say high telecommunications and transport costs and the persistence of government-sanctioned cartels and regulation prevent the economy adapting. “The electronics industry we have remains competitive despite everything, even against China,” says Donald Dee, chairman of the national chamber of commerce in Manila. But it does not create as much value as it could. “Our strongest asset, our labour, still goes abroad, and when they come back they say: nothing works properly in the Philippines.”
Yet the limits to the remedies prescribed by Manila’s business community are telling. With the exception of farmers undercut by Chinese imports, few think trade protection or outright subsidies are the answer.

**The rise of China has stoked an old debate in trade and development economics: whether governments should intervene to nurture nascent industries.** For fans of such “industrial policy”, the urgent need to go up the value ladder only increases the argument for intervention to help create clusters and new industries with a competitive edge. For its opponents, the rapid changes in technology and fragmentation of global supply chains mean that, even if such a system worked in the past, no ministry will now be sufficiently nimble to spot market openings and protect or subsidise their own companies to help exploit them.

![The electronics industry: South Korea’s relationship with China](image)

The pattern of globalisation has changed and, with it, the strategies that governments might follow. East Asia, whose very open economies put it at the front line of globalisation, traditionally followed a pattern known as “flying geese”, whereby entire industries migrated from richer to poorer countries as they developed.

Clothing, for example, started off in Hong Kong and migrated to South Korea, then to Malaysia and then to China. Whether industrial policy helped or not is debatable, but governments could plausibly try to seize a dominant position in such an industry by subsidising and protecting their producers.

But more recently, rather than industries moving en bloc, cheaper transport and digitalisation have sliced up supply chains and distributed the various stages of production around several countries. China has seized the final assembly stage for a large number of electrical products, for example. An end-product such as a computer or MP3 player may bounce back and forth between a dozen countries adding different components or performing different functions. The process of industrialisation across economies has become much more complex than the “flying geese” progression.

Nicholas Kwan, head of Asian research at Standard Chartered, says: “Those governments with an industrial policy have encountered the problems of looking at whole industries. You need to look within industries, at where you can find a niche – and businesses are better at doing that than governments are.”

He points at the differing experiences of the first generation of the Asian “tiger” economies and how they have coped with competition. Hong Kong and South Korea have both largely allowed manufacturing companies to accept the inevitable and outsource the low-cost part of their operations abroad, frequently relocating them to mainland China; Taiwan, partly for political reasons, has made a bigger effort to keep them intact at home.

A huge proportion of Hong Kong’s manufacturing, which was low-cost and labour-intensive, has migrated to the mainland in the past 20 years. Instead the territory developed services, particularly finance.

South Korean manufacturing, meanwhile, although it has lost a lot of routine assembly jobs abroad, has maintained a steady share of GDP over the past decade thanks to vertical
specialisation, retaining and expanding the high value-added parts such as product development and design.

By contrast, Taiwan tried to hold on to whole companies and sectors – and both the productivity and the GDP share of its manufacturing have declined markedly. “Restrictive cross-strait barriers have forced many mainland-destined investors completely to migrate from the island, leaving little connection with and benefit feedback to Taiwan,” Mr Kwan says.

The World Bank recently published a new counterpart to its famous 1993 study The East Asia Miracle. It argues that economies require different and more sophisticated strategies to move from middle- to high-income than from low-income to middle, including attracting or creating a critical mass of high-growth companies near the frontier of a technology or process.

Even supporters of government intervention say the game has changed. Dani Rodrik, a Harvard economist and influential critic of free-trade fundamentalism, says: “The need for industrial policy is bigger than ever, but this cannot be the heavy-handed industrial policy of old – trade protection through tariffs, subsidised credit to priority sectors or tax holidays.”

Instead, he says, governments can make relatively small investments or other interventions to help existing industries improve productivity and, on occasion, try to create high-end industries from scratch. One such experiment is under way in Dubai, which is seeking to replicate its success as a Gulf financial centre by throwing money at other sectors, including striving to create a biotechnology cluster from nothing by building facilities and attracting talent from abroad. But Dubai is a special case: few emerging market governments have big reserves of wealth to try conjuring up a world-class high-technology industry out of the desert.

For countries such as the Philippines, without a big arsenal for public investment, policy recommendations from most business people for competing with China involve no magic elixir. Governments should improve logistics, infrastructure, the business climate and education; try, possibly, to spot specialities emerging and support them, but otherwise get out of the way. They warn against governments crashing into the market having decided what the economy is likely to be good at and then promoting it at all costs.

The development ladder has not been pulled away. But the rungs may have got slippier and wider apart, and governments need agility rather than brute force to propel their economies towards the top.

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