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RELOCATING PRODUCTIVE CAPACITY TO CHINA? OR ELSEWHERE?

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ABSTRACT

This paper attempts to chart and analyse the phenomenon of delocalisation, which is by no means a novel one, but which is no doubt accelerating in rapidly evolving and globalizing world arena, with a focus on China an the new EU Member States (MS) in Europe. It characterises subcontracting within the same country as *externalisation* whereas 'outsourcing' refers to subcontracting abroad, typically in a lower-cost location. It looks at the two main categories of Foreign Direct Investments, namely those motivated by market-seeking and efficiency-seeking respectively. In recent years, China has become the most important recipient of FDI funds thereby dislodging the USA. China's recent accession to the WTO further stimulates the eagerness of foreign firms -- amongst them almost al large MNE's -- to set up production in China. The opening of great many service sectors to foreign participation appears to uinleash a new round of FDI's such as those of the large supermarket chains. As regards FDI's, China presents a most favourable position, indeed which no other country can probably match, namely the (unbeatable?) combination of low wages and of other costs on the one hand, and of an alluring large domestic market, on the other hand. How does the group of new MS in Central Europe compare with China in terms of its capacity for attracting FDI's? Can they also be turned into an export platform for EU companies and perhaps become another 'workshop for the world'? As these MS now belong to the overall single EU-market exports from one new MS, say from Hungary, to another new MS or one of the EU-15 are no longer subject to import duties. A large number of parameters which would otherwise constrain inter-national transactions are now unified. Central Europe also presents a number of comparative advantages over West European markets with respect to the *cost-minimizing* variety of FDI: close proximity to these markets; much lower wages; cultural affinities and the option to join the Euro currency; a workforce with a hig level of technical skills and the scope for fragmented production to thrive due to an integrated market.

ABOUT THE AUTHOR

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I. Introduction and Conceptual Clarification

Relocation, or de-localisation as a gallicistic synonym, and related words such as ‘outsourcing‘, stir strong emotions in public opinions in West European countries and fuel heated political debate. Fears are running high that productive capacities increasingly migrate to lower-cost countries, thus resulting in a loss of output and of jobs in West European countries (and in the United States). Fingers are pointed at the People’s Republic of China (PRC), which is nowadays pictured as the ‘world’s industrial workshop’. The accession of ten New Member States (NMS) to the EU also evokes concerns about delocalisation. Recently, the emergence of India as a provider of IT-services for Western customers adds to these concerns. And the list of countries to which industrial activities or service activities can be moved is not exhausted.

This paper attempts to chart and analyse the phenomenon of delocalisation, which is by no means a novel one, but which is no doubt accelerating in a rapidly evolving and globalizing world arena. I will thereby focus on China (section III) and on the NMS in Central Europe[1](section IV), which, to quite an extent, are competitors of China in diverting industrial or service units away from the high-income countries; the analysis briefly compares the relative strengths and weaknesses of these two areas. Section V and VI look at the general impacts of relocation and its implications for EU-15 countries.

Firstly, some conceptual clarification is required. As a matter of fact, whenever a firm in the EU-15 announces that it will open a factory, for example in Hungary or China, various circles in Western Europe interpret this as a (harmful) delocalisation –even if the new factory is scheduled to cover only the local market in the ‘host country’. It is obvious, and must be stressed at the outset, that *relocation* involves the genuine move from a ‘home country’ to a given host country; or, more precisely, *the closure of productive capacity in the home country* <u>*and*</u> *the simultaneous establishment of such productive capacity in a ‘host country‘*. It is thereby implied that whereas previously the home country and the foreign markets were served from domestic production sites, henceforth the markets abroad and even the domestic market will be penetrated by products that are henceforth manufactured in a low-cost economy. As will be explained in a moment in section II most variants and cases of Foreign Direct Investments (FDI’s) do not correspond to this definition and cannot be labelled as genuine relocations.

Other terms that are often used in the fierce debates about delocalisations also need to be carefully defined at the outset. This applies particularly to *outsourcing* which carries the connotation that a firm secures its supply of finished goods or intermediate inputs from a production unit located in a low-cost economy. Yet strictly speaking, *outsourcing* means that a given firm entrusts some stages in the production process, or/and a number of ‘services’, that must be performed for the proper functioning of an industrial enterprise, to an outside firm. The latter is not necessarily located in a foreign (‘offshore‘) country. As a matter of fact nowadays many companies re-center their operations on their core business and subcontract a number of activities (e.g the timely supply of components to assembly lines, or the management of IT-facilities), to outside specialized firms, such as TNT Logistics, Accenture or Computer Science Services. To avoid confusion I characterise such subcontracting within the same country as *externalisation* whereas ‘outsourcing‘ refers to subcontracting abroad, typically in a lower-cost location.

1 In the expression ‘Central Europe’, I also subsume the three Baltic States. Cyprus and Malta appear less relevant.

It should also be stressed that the entities, which perform such subcontracting in the host country can be either in-house or 'captive' affiliates of the (multinational) enterprise itself; or legally independent firms[2]. One may add that not only industrial multinational enterprises (MNE's) act as principals but also large distribution chains when they 'source' their supplies in lower-cost countries from local producers.

The confusion in the terminology adopted is also kindled by other phenomena in international business. One consists in the undeniable trend in Western countries but even, and rather surprisingly, in China[3] towards *de-industrialisation* in terms of employment although not as regards the output performance of the industrial sector. This sector undergoes a progressive shrinking of GDP share and in terms of employment, to the benefit of the tertiary service sector(s). Another unmistakable trend is the growing interpenetration of national economies, even outside formalized schemes of integration (such as 'free trade agreements' or EU-type economic unions)[4]. This results in an increasing degree of openness of the economies of individual countries, in a rapidly globalizing world.

II. A taxonomy of foreign direct investment patterns

De-localisation involves a shift in the locus of investments in productive capacities between countries. A brief analysis of the motivations for FDI's and of their formats allows a view of the phenomenon of de-localisation within the broader framework of the dynamics of present-day international business. I thereby look at the two main categories of FDI's, namely those motivated by market-seeking and efficiency-seeking respectively[5].

A. The overwhelming importance of market- seeking FDI's

Statistical data about FDI flows measure the financial resources that are made available to the affiliates abroad of MNE's and which comprise three items; (i) the equity participation by the parent company, provided the parent holds at least 10 percent of the shares of the subsidiary; (ii) reinvested earnings of the affiliates abroad and; (iii) intra-company loans or intra-company debt transactions. This data[6] derived from balance of payments data so far and subject to an important caveat, discussed below under section E show that most FDI-initiatives are market-seeking and are estimated at around 80 percent of all FDI financial flows. Their basic intention consists in capturing a portion of the demand for their products or services in the targeted host country or geographical area. This also explains why FDI's are still predominant between high-income countries and why

2 The Deutsche Bank (2004) distinguishes between 'offshore outsourcing ' to non-related business units, on the one hand, and ' captive offshoring ' when the delocalised production occurs in an affiliate of its own. What I call ' externalisation ' is termed ' onshore outsourcing '.

3 Mc Guckin, R. a.O. , " China's Experience with Productivity and Growth ", The Conference Board ,2004 . This study was conducted in co-operation with the Chinese Statistical Office. Between 1995 and 2002, China shed 15 million industrial jobs, essentially in state-owned enterprises. This was only partly offset by over 6 million in new jobs in the emerging private sector.

4 The rapid pace of economic integration in East ands South East Asia comes to mind. This process would intensify if the intended Free Trade Zone between China and the Asean countries by 2010 were to shape up effectively.

5 FDI's in the primary, mineral or agricultural sectors are not relevant to our analysis, as the locus of the FDI is fixed by nature-given determinants. .

6 The annual 'World Investment report', prepared at the UNCTAD , contains a wealth of data, and in –depth analyses of selected topics as well.

despite a still low per capita income (barely $1.000), China with its impressive growth performance and huge market potential enjoys a large inflow of FDI's.
Most likely such firms would prefer to enter the foreign market by way of exports from the home country. This is a much simpler undertaking than the setting up of one's own production unit in the host country, with all its attendant investment costs and the need to observe the many regulations that apply to the new venture in the host country. But in many cases preference must be given to the FDI entry mode over the export route.

Thus:
- FDI's are often a natural outgrowth of successful exports[7]. When sales in the host country have grown substantially and additional capacity is needed to satisfy the incremental demand it is often advisable to install such additional capacity in the host country itself. Today however, such traditional sequence from exports to FDI no longer provides the only pattern as increasingly firms leapfrog directly into FDI's when entering a foreign market (see UNCTAD's World Investment Reports). As noticed below, this is of necessity the case for most services but occurs equally in industrial sectors.
- When import duties for finished goods are prohibitively high 'tariff jumping' by way of establishing one's own affiliate within the protected host country market is a frequent response. This motivation, while widespread in the era when most developing countries erected high import duty walls, is much less relevant today, as tariff walls for industrial goods have been substantially broken down thanks to the successive multilateral international trade liberalizing rounds and a clear shift in prevailing trade strategies away from import substitution to export orientation. Today tariff walls around the EU and hence, around the NMS in Central Europe, are no longer significant obstacles for imports from outside those areas. China, in the wake of the substantial slashing of import duties, even before it effectively joined the WTO, is no longer heavily protected.
- But even when international trade is freed from tariff and non-tariff obstacles, as in the EU, an internationally-active firm is often led to establish production affiliates of its own in order to improve its position in that other member country by taking better care, for example, of after-sale servicing (as noticed already by Franko, 1976). However, since the advent of the single market, MNE's in the EU have typically rationalized the geographical pattern of their production units, which now no longer serve a single country, but cover larger areas. Such product-wise apportionment of productive capacities also tends to enlarge trade flows between member countries, which furthermore largely occur within the same MNE, thus giving rise to ample intra-firm transactions.
- International trade and investment theories tend to be cast mainly in terms of flows of final goods but a large part of international trade involves intermediate goods sold to producers of end products. It follows that suppliers of components are often led to follow a major customer when the latter has set up production in a given country. Thus, the emergence of a car-manufacturing hub in the Czech and Slowak republics induce the clustering of a large number of foreign subcontracting suppliers in the same area. The same phenomenon is noticeable in China.
- In oligolopolistic markets FDI by one major firm into a given country is often followed by a similar move by its competitors. The car industry has provided examples of such reactive behaviour, even in smallish and protected national markets as in South America. Today almost all major car

7 A purely commercializing affiliate in the host country is typically an intermediary stage in the export-FDI sequence. But the funds spent on such affiliate and the number of their employees tend to be small . It follows that, despite their large number, such affiliates do not represent a high percentage of overall FDI financial flows.

manufacturers have entered into joint ventures in China - they ‘cannot afford not to be present’; the result is that notwithstanding the rapid growth of demand for cars in China, there is already overproduction.

- Most importantly, services offered to the final consumer of necessity imply the presence of foreign direct investors in the host country itself. The ‘production‘ of most services coincides, in space and in time, with its ‘consumption’ by the end-user – were it only because the customer must be approached in his own language. Thus, in Central Europe, state banks from the communist era have typically been taken over by banks from the EU-15. In China, only recently have foreign banks been authorized to acquire a share in the equity capital of state banks. As the relative share of services in the GDP’s of modern economies is rising cross-border FDI’s in the service sectors are also likely to grow in numbers and size (World Investment Report, 2004).
- Today, most countries are eager to act as ‘hosts’ for inward FDI’s, in stark contrast with, for example, the sixties and seventies. A real competition for the attraction of FDI’s is raging; thereto countries unfold the red carpet and are willing to improve the ‘investment climate’ and to grant tax and other incentives. This is so far also the case in China and in the other area on which this paper focuses, namely in the NMS in Central Europe.

Market-seeking outward FDI’s do not stir much reprobation from the public opinions in the ‘home‘ countries. Although they usually imply that exports can no longer be counted upon to conquer market outlets abroad and that domestic output will not be increased accordingly, they nonetheless do not curtail domestic production. Besides, they allow the strengthening of profitability of domestic firms and their competitive position in the international markets, as well. Finally, managing the ventures abroad creates a limited number of additional jobs at the firm’s headquarters.

B. The politically sensitive cost-saving FDI’s

Public reactions in home countries are much more hostile to outward FDI’s that are motivated by ‘efficiency seeking’ or, in more down-to-earth terms, by lower production costs and more particularly lower labour costs. It must be reminded that the term ‘labour cost’ does not refer to the wage level as such but to the wages as weighted by the productivity level of the workforce which is typically inferior in developing countries than in high-income countries because industrial production processes use older-vintage technologies. One should add that besides the labour costs other variables such as political stability, the honesty of governments and bureaucracies and adequate infrastructural facilities (including telecommunications) positively affect the ‘investment climate’ of a country.

Delocalisation in its strict sense relates essentially to this cost-saving category of FDI’s. In the industrial sector relatively labour intensive products, such as clothing toys and footwear provide prime examples.[8] Since the late sixties their production has been shrinking to very low levels in the United States and in most West European countries. As analyzed already in 1973 by Prof Helleiner, production has been moved from industrial countries to Tunisia, the former Yugoslavia, Asian countries, such as Malaysia, Taiwan and in the initial stages Hong Kong and Singapore. In the meantime, these Asian countries have graduated to distinctly higher plateaus of value-adding industrial production. Along its border

8 However, other segments of the textile sector which over the years underwent significant restructuring and capital deepening have seen much less outsourcing and off-shoring.

with the United States, Mexico has welcomed a heavy concentration of such labour-intensive FDI's in the Maquiladora scheme. China became a potent pole of attraction for such inward FDI's once the Dengist 'opening to the world ' strategy took hold and more particularly after 1992—as analyzed in section III. The NMS in Central Europe had the ambition of attracting such investments once they left the shackles of the centrally managed economies; as discussed in section IV, although they hold some strong trump cards, they have not yet overly excelled in attracting such labour-intensive inward FDI's.

Even for some more sophisticated products lower production costs were sought in offshore locations, as long as some components required the inputting of manual labour. Thus, in the sixties Fairchild, Texas Instruments and Motorola were engaged in a tough competitive struggle whereby they relied on their own affiliates or on independent suppliers in East Asia. The rapid technological advances in the electronics sector, and the related short life of novel products forced them to manufacture such products on a massive scale in low-cost locations (Chang , 1971).

Admittedly, the value added in such production processes was most often modest as they occurred within the so-called 'processing trade'. All in all, such inward FDI's in labour-intensive production are beneficial to the countries that are successful in attracting them and have been a first stepping stone in the successful sequence of further industrialisation in a number of East Asian countries and in China as well. They procure jobs for non-skilled workers. The foreign, industrial or distribution MNE himself takes care of the exports which he destines to the world markets. The economic benefits to the host country are even larger when the manufacturing is performed by local subcontractors instead of by affiliates of the MNE. The host countries must indulge in the granting of fiscal and other gratifications to the investing firms. Moreover, in 'footloose' sectors such as clothing the country readily loses its comparative advantage, when its wages rise: it is quite easy for a principal to turn to another supplier in another country with (now) lower wages and satisfactory production levels.

C. Fragmented industrial production

Recent studies -- amongst them at the World Bank (2003) and UNCTAD (2002)-- document that 'fragmented' production nowadays represents the fastest growing segment of direct investment flows. The production process is thereby apportioned over several production units (again operated by non-related subcontractors), which are positioned in different countries in the light of their respective comparative advantages either at the final assembly stage or the intermediary one of manufacturing a component. Such pattern of production generates ample cross-border transactions within the same class of products (= intra-product trade). If the fragmentation remains within the same enterprise, as is often the case, such trade even becomes intra-firm trade. Both the NMS in Central Europe and countries in East Asia, including China, partake significantly in such novel scheme of the 'international division of labour'.

D. The de-localisation of services to low-salary countries

The most recent development in international trade and investment is that of the relocation to an offshore location of services that are part of the normal running of an industrial or service business such as call centers, back-office processing of customers rolls or even software programming. Digitalization and the transmissibility of documents in real time, render such offshore outsourcing technically quite easy.

In section I it was already mentioned that enterprises tend to 'externalize' several of such 'business-related services' and to delegate them to specialised firms. For the services that are not embedded in national regulatory settings – as would be the case for fiscal issues for example – and are standardized to the point of becoming codifiable i.e, "meaning (that) the tasks can largely be reduced to a set of rules or instructions that workers can follow routinely" (Garner, p.16), such outsourcing can be directed to 'captive subsidiaries' or to local non-related firms.

Both types of providers to outside firms are now prominent in India more particularly around Bangalore and Hyderabad. The ample supply of skilled engineers who earn comparatively low salaries and are often obliged to accept jobs below their qualifications and the use of English as the medium of communication with Anglosaxon principals explain the Indian success story. Some other countries also succeed in supplying such services or are trying hard. It is difficult as yet to assess the extent of such relocation of business services and the resulting loss of jobs in the home countries. Fragmentary data suggest that, so far, this phenomenon has remained rather limited, even in the USA where it has started earlier than in the EU but recent analyses foresee a faster pace ahead (Garner, 2004; (The) Economist, 2004). The cost savings tend to be substantial on account of the predominant weight of salaries in the production cost of such business-related services.

E. Non-equity forms of international production linkages

As mentioned under section A, the construction of statistical data about FDI's is predicated on the financial contributions by the parent companies to their affiliates abroad. But this approach underrates the extent of offshoring, i.e of the move of production capacities to lower-cost countries, as it does not account for outsourcing in offshore locations; i.e. the often relatively sizeable output that is generated by independent local firms.

An array of non-equity forms of investments – such as subcontracting, management contracts, turnkey arrangements, franchising, product sharing and licensing -- confer nonetheless some degree of influence on the cooperating business unit even in the absence of a formal participation in the share capital. But only a few of such non-equity links are captured indirectly through the data on royalties and licensing fees in the statistics about FDI's proper (World Investment Report, 2004).

In this article quite a few instances of such non-equity forms of international production linkages have already been mentioned. But nowadays this pattern of cross-border networked production appears to be spreading further. Concurrently the configurations of inter-national production are becoming more diverse. Today, a number of MNE's have already moved away from the so-called system of 'original equipment manufacturers' whereby according to their own specifications, they secure additional productive a capacity through offshore subcontractors. Instead, "they outsource the entire manufacturing function for individual product lines or, in some cases such as Cisco, the entire product range" to so-called contract manufacturers, who specialize exclusively in providing turnkey manufacturing services" (World Investment Report, 2002, p. 213). Solectron (USA) and Flextronics

(Singaporian firms) are prominent examples of such contract manufacturers. The MNE's which turn to them are on their way to becoming 'fabless companies', i.e no longer engaged themselves in production activities.

III. China as the world's industrial workshop ?

Since barely a quarter of a century, China has staged an impressive growth performance with GDP increasing on the average by about 9 percent pa. The strategy of 'opening to the outside world ' master-minded by Deng Xiaoping is undoubtedly a major, though by no means the only, lever of the astonishing economic uplifting of the most populous country on earth. The shift to an export-oriented strategy from the early sixties onwards has benefited other countries in East Asia.too, even though as recent as 1968 they were still condemned to a bleak future in Gunnar Myrdal's " Asian drama". One should add that Deng's opening gambit was at odds with the emphasis on self sufficiency of communist countries and in historical retrospective, with China's haughty seclusion from international life since the 15th century. This had proven to be a major cause of its missing the boat of the industrial revolution[9].

China's trade has skyrocketed. Its exports grew from a trickle of only around $ 2bmn in the late seventies to $ 355 bln in 2003, much faster than overall world trade. Imports have expanded at a similar pace. Moreover, the composition of China's exports has become much more diversified, away from simple labour-intensive goods to commodities with a higher value-added content such as electronics, machinery and transport equipment. For such a large and populous country, China has become a distinctly open economy (as measured by the ratio of exports and imports to GDP), much more than India, Brazil, Japan or the U.S.A. The prospects for the further expansion of export trade appear favourable.

This outstanding performance in international trade must nonetheless be put in proper perspective. First, it is closely linked to the successful attraction of inward FDI's. (Plasschaert, 1997). In a first stage, when large multinational enterprises from the USA, Japan and Europe cautiously initiated their first ventures on the Chinese soil, 'overseas Chinese' from East and Southeast Asia were already actively engaged in setting up production and assembly in China. Their business successes in their countries of adoption afforded them the means to look for profitable opportunities on the mainland and informal networks, based on kinship and geographic origin and their immersion in the Chinese culture greatly facilitated their endeavours (Zhang, 2004). More specifically, the rising wage levels in their countries of adoption inspired them to seek locations across the Chinese border where they could re-locate the production of labour-intensive goods. Thus, almost all of Hong Kong's industrial ventures have since moved just across the border, mainly to the Szenshen 'special economic zone', where they could benefit from some advantages such as lower tax burdens and from a less stringent regulatory framework. This transfer of productive capacities from Hong Kong to Szenshen or other areas in Guandong province is one prime and early example of a vast de-localisation process. More recently, similar large-scale relocation was carried out from Taiwan to Fujien province. Today, Taiwanese firms are operating largely the production of hardware in the electronics sector on the

9 This is a thinly veiled allusion to the episode of the Mc Cartney embassy , when in 1793 *the Manchu emperor Qianlong declined the invitation of the king of England to engage in international relations . Less than 50 years later , a few shells from British vessels opened China to (opium) trade and soon degraded the Middle Kingdom to a semi-colonial status .

mainland but seek to upgrade their own technological level, whereas Hong Kong has essentially become a service-supplying city specializing in middlemen and financiers' functions for activities on the mainland.

Fairly soon, the number of zones offering a preferential treatment to FDI's was officially expanded. In 1983-85, 14 coastal cities and 3 river deltas were 'opened'. The entire island of Hainan became the fifth special economic zone in 1988. Within the open coastal cities special areas were delineated as 'economic and technology development zones'. Amongst them the most impressive is the Pudong New Area in Shanghai, opened in 1990, which has become a major hub of high-tech FDI's -- not to mention a new banking district. As a result of manifold initiatives by local governments often unauthorized from above, zones with special preferential statutes for FDI's proliferated; the activities of a given venture often did not correspond to its official categorisation but were often negotiated upwards to a more favourable treatment (Tzeng and Zebregs, 2002). As Naughton, 1996, p. 302 puts it : " In essence, China created a kind of gigantic export processing zone, defined not geographically, but by the juridical status of the enterprise involved " .

In most recent years, China has become the most important recipient of FDI funds thereby dislodging the USA[10] . The recent accession to the WTO further stimulates the eagerness of foreign firms -- amongst them almost all large MNE's -- to set up production in China. The opening of great many service sectors to foreign participation appears to unleash a new round of FDI's such as those of the large supermarket chains.

The relevant point for our analysis is that about half of China's exports are generated in 'foreign invested enterprises', i.e. joint ventures with Chinese firms or wholly-owned foreign enterprises. Probably nowhere in the world are exports linked so closely with inward FDI's as in China. Hence, a substantial part of those exports from China derives from firms that were relocated from adjacent areas. More generally, the 'made in China ' label which is affixed on such a large array of goods from sporting shoes to personal computers over radio sets, does not at all imply that they are made by Chinese firms proper.

Besides, much of the exports is embedded in so-called 'processing trade', in which the output in China is conditioned by the previous importation of materials and components. Hence, the value added in the processing in China tends to be limited to the (low) wage sum and to the profits made or the fees received by the firm, located in China. This is typical in the clothing branch. But with the rather rapid maturing of Chinese industry, foreign producers tend to source, i.e. to purchase an increasing percentage of their inputs in mainland China.

Another important remark is that the FDI's in China are no longer functioning primarily as export platforms. This was the case in the earlier years of China's opening as also happened in several smaller East and Southeast Asian countries, such as Malaysia, Singapore and Taiwan, which had opted for export-led growth. In China, some specific policies favoured export-oriented FDI's; thus, the commitment to export a portion of the output often conditioned approval of an investment project, whereas the obligation to match the foreign exchange needed for installing and running a FDI project

10 In fact, as much of the inflow of FDI's into the USA derived from take-overs of US firms, and as take-overs by foreign firms were non-existent until recently in China , one may posit that China was already the number one recipient of ' greenfield ' FDI's , which normally are more beneficial to the host country than the entry mode of acquisitions and mergers .

by equivalent earnings also led the investing firms to seek outlets abroad. As against this foreign-invested enterprises enjoyed the benefit of lower tax burdens than those facing Chinese firms. All those various strands of discrimination between foreign and domestic enterprises are scheduled to be abolished as a result of the WHO accession.

Nowadays FDI's are aiming increasingly at serving the domestic market, which is growing rapidly: new strata of consumers, perhaps 15 mln per year, reach an income level of $ 3.000, at which they may entertain hopes to acquire a car and perhaps a flat. Since a few years, import flows directed at the domestic market exceed those importing materials and components for processing trade. In future, FDI's will increasingly be attracted by China's expanding and potentially enormous internal market for goods and services. The impressive production platforms that have emerged and expanded mightily in China, most strikingly in the Pearl River Delta in Guangdong and in the Yangtse River Delta near Shanghai, can be expected to be wedded increasingly to the internal market rather than to function as an export base which the expression ‘ the world's workshop' connotes.

As regards FDI's, China presents a most favourable position, indeed which no other country can probably match, namely the (unbeatable?) combination of low wages and of other costs on the one hand, and of an alluring large domestic market, on the other hand. Despite the already heavy investments of both foreign and also domestic firms, in export-bound production, China will be able to feature low and competitive labour costs. The pressures for wage increases that normally accompany rapid growth, will remain subdued by the availability of a large ‘reserve army' of unemployed and underemployed workers in the countryside, where the number of excess labourers is often estimated at 200 mln.[11] When demands for wage hikes are made in the Pearl River Delta – as they already do -- persons from the interior are willing to work at the going rate; or the firm may move itself more inward, where wages are lower. But at the same time the scope for finding outlets in the domestic market grows rapidly,[12] although the markets for many goods are becoming intensely contested by both domestic and foreign firms. Moreover, if the recently launched projects for a wide free trade area between China and the ASEAN countries by 2010 would materialize, market size in the region would greatly expand further.

IV. The New Member States in Central Europe and the Baltics

How does the group of NMS in Central Europe compare with China in terms of its capacity for attracting FDI's? Can they also be turned into an export platform for EU companies and really become a ‘workshop for the world', although obviously a smaller one? Which are the trump cards of Central Europe as compared to those just mentioned for China? What is the scope of delocalisation of Western firms to the Central European Region? [13]

11 Incidentally, one may remind that the re-allocation of underemployed agricultural manpower to more productive employment in the industrial or the service sectors represents a strong vector of economic growth.

12 Much will depend upon the future growth path of the Chinese economy, which can not be predicted with certainty. The economic and social problems still to be overcome are daunting, and some, such as the risk of bottlenecks in e.g the energy sector, result from the rapid growth rhythm itself. While it is not feasible to embark here upon a discussion of the growth prospects, to most outside observers a rapid further growth , albeit somewhat slowed down from the present pace, is generally viewed as a plausible hypothesis. See e.g Chow, 2002.

13 The insights in this section derive largely from an analysis by a small group of Belgian economists by the present author. See Plasschaert, ed., 2004

Available statistical data and surveys of the intentions of enterprises clearly show that FDI's projects -- actually still dominated by firms from the EU-15 -- are *market seeking* (i.e motivated predominantly by the aim to capture a portion of the local markets). But one may not overlook that the present market size of the NMS is not overly alluring: they only encompass a total population of 75 mln at an average per capita income which stands at only 48 % of the EU-15 average. Yet the NMS are projected to grow further at a rate of 4-5 %. This is by no means a fabulous pace of growth, or comparable to that in China, but one that exceeds the 2 % p.a. growth which is generally anticipated in the EU-15. Many needs, both in consumer goods and in equipment, are still unfulfilled in the NMS region whereas many market segments in the EU-15 are already saturated. This is reflected so far in the trade balance of the EU-15 that has remained well in surplus vis-à-vis the NMS. .

In 2003, FDI inflows in the NMS declined sharply as against previous years but this downturn is attributable to the near-end of the privatisation rounds in the financial and utilities sectors, which involved large sums. But in future an upswing in FDI inflows is expected, as the effective entry into the EU, as of May 1, 2004, further strengthens the regulatory framework for foreign companies thanks to the transposition of the 'acquis communautaire' into the national legislations (World Investment Report, 2004).

An important favourable feature of FDI's in one of the NMS consists in the potentially large geographical reach of such venture. As the NMS now belong to the overall single EU-market exports from one NMS, say from Hungary, to another NMS or one of the EU-15 are no longer subject to import duties and a large number of parameters which would otherwise constrain inter-national transactions are now unified. MNE's from the EU or from the outside which intend to cover large segments of the EU space may opt for a localisation in a NMS if the costs of investment and of operating the firm are found to be lower than elsewhere and if the target market(s) can be easily reached. The establishment of plants by both PSA-Peugeot and by Hyundai in Slovakia is a case in point; they will serve not only the local market but also that of adjacent countries.

This then brings us to the *cost-minimizing* variety of FDI. In this respect, Central Europe does present a number of comparative advantages:

- Wages although already rising – as they did perceptibly in Hungary – are still much lower than in Western Europe and the gap can only be bridged over a great many years. But admittedly, the wage level is already higher than in China; especially for labour-intensive goods.
- As a location, the NMC are much closer to the high-income West European markets, especially to Germany and Austria; serving an increasingly demanding clientele argues in favour of producing close to the market outlets and to produce smaller batches of goods, whereas China offers favourable production platforms for large-scale standardized commodities.
- The cultural affinities with the EU-15 are much stronger in the NMS than in China. However this idea must be tempered by the fact that whereas China presents a very high degree of linguistic and ethnical homogeneity the NMS are generally small and linguistically quite diverse. But as stressed, the regulatory framework for conducting business in the NMS is increasingly similar with that in the EU-15. As full members of the EU, they participate in the evolving construction of a political EU-entity *sui generis*: this link favours cooperative ventures between firms in the new and in the old members of the EU. The prospect of joining the Euro-area in due time will add another cement to the integration process of the NMS – an element that is obviously lacking in China.

- Workers have, on the whole, a rather high level of technical skills; while their productivity is still low it can be upgraded rather fast by appropriate training and more up-to-date equipment. But in China the eagerness to secure a job and learn may well be a compensatory factor except that there is still an inadequate supply of potential managers.
- Finally, fragmented production which has already reached a high percentage of the exports from NMS to Germany (Kaminski and Ng, 2001) can thrive in the NMS thanks to the so-called pan-European cumulation of rules of origin, instituted in 1998. According to this arrangement in order to benefit from preferential import treatment the percentages of value added in each of the countries involved can now be summed up. Components originating from China would not enjoy such favourable treatment and would remain liable to EU import duties on the value added in China.

A recent detailed analysis of cost savings that would derive from relocation either to the NMC area or to Asean countries, China or India reckons that the former would economize more on overall costs[14] in a number of industrial sectors (large white goods, furniture, tires, steel products, motor vehicles). China would score slightly lower production costs in sectors such as computers/laptops, photo cameras, flat panel TV's (Waddell, 2004).

V. The impacts of relocation.

The tremendous growth and 'opening up' in China and the accession of the NMS in Central Europe to the EU open wide scope for EU-15 and third country firms to establish affiliates in production platforms in these two regions—or to turn to indigenous suppliers at low cost. In the first case, one faces the phenomenon of relocation as defined at the outset of this paper: output is curtailed, and jobs are lost in the home country, which is now served by goods that are produced in ("sourced from") an offshore, low-cost country. In the second case, the (more indirect) impact is likely to be the same: the goods produced abroad outcompete domestic output and may equally force the closure of domestic firms in the home country. There is another difference between the two cases: when relocation occurs, the benefit of the relocation initially accrues to the domestic parent company itself which may claim, often justifiably, that the relocation abroad of part of its production process has allowed it to survive in a fierce competitive battle. In the second case, offshore sourcing benefits the production platform country as the local producers appropriate profits. One should add that large importing firms in the Western world such as distribution chains often undertake offshore sourcing.

The above sequences may, at first sight, be interpreted as portending a disastrous outcome for the high-income country from where the relocation is undertaken. The underlying reasoning is nonetheless erroneous in that it portrays a zero-sum world and overlooks the fact, familiar to students of international trade theory, that free international trade enhances overall welfare for the countries involved and for their populations. As a matter of fact goods and services of a comparable quality can then be supplied by lowest cost producers. And, *provided, and to the extent* the lower cost of production percolates into lowered prices for the consumers the latter enjoy an increase in their real incomes; the sums economized thanks to the lower prices can then be expensed on other items, thus feeding effective demand and entailing the creation of new jobs. The resulting re-allocation of productive resources to sectors with better ('sunrise') prospects allows to gratify those new jobs with higher wages than was the case in the ('sunset') sectors which could no longer sustain international competition.

14 Costs savings are thereby related to cargo value, labour cost and content, as well as to logistics

This argument is predicated on the traditional theory of the comparative advantages in resource endowments and productivity levels which nations engaging in international trade are able to muster. There are other benefits as well which at the micro-economic level, act as spurs to enter into trading. Successful exporters reach additional strata of customers and thanks to such economies of scale can spread their fixed costs over more output, thus strengthening their competitive strength. The spectrum of choices for consumers in the importing countries is broadened.

The history of mankind contains numerous illustrations which confirm the global benefits from an open trading environment. In recent decades, developing countries that turned to a growth strategy stressing the export of manufactured goods have unquestionably performed better than countries that remained stuck to a protective import-substitution strategy. Such ‘empirical evidence’, not the least in East Asia, vindicates the analyses of trade theorists, such as Bhagwati 2004, who also stresses that the heavy protection in which a number of developing countries still indulge, harms their own consumers (by way of higher prices) and their domestic producers (who are shielded excessively from the invigorating impact of international competition) .

Paradoxically, although the virtues of international trade theory are solidly proven, (save under a few exceptional assumptions) and are generally accepted, protectionist tendencies and policies are rife. This paradox may be explained by the asymmetry and the non-simultaneity between the benefits and the costs of freer trade. A shift in trade patterns and in the location of productive capacities inflict immediate losses of output and employment on the firms and hence, on the countries at the losing end, which incur ‘adjustment costs’ in order to restructure the industrial or service sectors under attack. In such circumstances protests and clamours for protectionist measures are readily organized. The pains of relocation relate directly to the wage component of the value chain of the traded commodity or service, which represents the very livelihood of the workers and employees of the affected firms. They impose ‘readjustment costs’ on those who have to search for another (and hopefully a better-paid one) job —and on society as well since the authorities may have to support that search. Whereas the benefits of free trade are diffused only slowly among the anonymous mass of consumers and other users; but such benefits are lasting one’s and recurring each year once the shift to a free trade regime has been achieved, whereas readjustment costs must be indulged only once.

Relocation of productive capacity to lower cost regions or countries is not at all a new phenomenon. There is very little new under the sun indeed. Thus, in the late middle ages, the (then un-mechanized) textile industry in Bruges and other towns in the Southern Netherlands was moved, against much opposition, to surrounding rural areas where people were willing to accept lower wages[15]. “The urban textile industry was very unstable and subject to constant geographical movements” (Van der Wee, 1975). Since the end of World War II major changes have occurred in Western Europe. The clothing industry, less susceptible of automation, has lost most of its jobs; the firms that survive have already relocated labour-intensive activities to lower-cost countries and/or found promising niches for new or higher quality products. Diamond polishing, formerly performed in the region south of Antwerp, was relocated to Bombay in the late sixties. The manufacturing of furniture, shoes and toys has been shrinking significantly in most EU-15 member states, especially in terms of employment.

15 The gilds of Brussels and Ypres are recorded as having mounted warlike expeditions to destroy looms in the rural areas.

Relocation today basically reflects the same patterns and dynamic features, except that the phenomenon is accelerating as a result of the cheaper international means of communication, the continuous technological advances and their rapid international transmission of intensifying worldwide competitive pressures. Last not least, on account of the recent vigorous entry on the world scene of China and also India and the insertion of the NMS in the EU.

Examples of relocations nowadays abound in the media, although a comprehensive account of the phenomenon can not yet be assembled. South Korea and Taiwan have over the years built up a strong position in the computer hardware sector. With rising wages and costs they are relocating the simpler tasks such as assembly, to the Chinese continent on a rather large scale but now ambition to emphasize product innovation (Deutsche Bank Research, 2003). The Mexican maquiladora have lost a substantial dose of their attractiveness, especially as regards the consumer electronics: several firms have left for China.(Lowe and Kenney,1999). Recently Philips delocalized an accounting section to Lodz, traditionally the textile centre in Poland. But, in the same period, a textile firms moves from Lodz to Romania (Le Monde , 24/1/04).

Earlier it was stressed that consumers derive benefits from an economically more efficient international division of labour and of border-crossing transactions on the condition that lower production costs are effectively reflected in lower end-prices and do not fully, or largely, increase the profits of the producers or the distributors. Overall, the fierce competition that grips the modern international economy significantly erodes potential monopoly profits[16].

Under the realistic assumption of intense competition such improvement in overall welfare could rather easily be empirically validated. Thus, over the past ten years, in the USA the prices of shoes and clothes declined by 30 % in real terms (The Economist, Oct.2, 2004). Even in the presently spreading cases of relocation of white-collar jobs, say to India, he eventual global benefits cannot fundamentally be denied, although salaries represent a much higher share of total production costs than in the case of shoe manufacturing or even clothing. But the diffusion process of the benefits is then much slower and less transparent and will evoke much stronger opposition from those affected by the loss of their job in the home country.

The initial benefits on both sides -- i.e in the low-cost producing country and in the home country of the western company, acting as principal-- appear biased in favour of the latter. Mc Kinsey (2003 b) has figured out the distribution of the benefits out of the outsourcing of business services to India. Per dollar expensed, the net benefits for India (which mainly comprises salaries, but also the sales of suppliers in India and receipts by the government) would amount only to 33 cents: even skilled people earn very modest salaries in India. The benefits to the USA would then reach 67 cents and result from the lower purchase costs to consumers and higher profits for the providers of capital. Besides, if the services are provided by a captive unit the latter pays dividends to the parent company and may import commodities and services from the USA. The same paper also mentions indirect benefits for the USA that would stem from the re-allocation of employees to better-remunerated jobs and would reach 45-47 cents. While valid in the long run, such optimistic scenario tends to play down the difficulties and pains of adjustment for the dismissed employees.

16 But the ‘Financial Times’ of July,23, 2004, mentions a study, which found that, although wholesale price of specific garments , made in China, had fallen substantially, the prices to the final consumers, barely changed.

Within the same framework a new and open conflict is emerging between the interests of consumers and of producers in the home country. This is exemplified by two recent episodes. Upon the insistence of manufacturers of ladies' lingerie and more particularly of bras, the USA has inflicted safeguard quotas on the surging importation of bras from China. An ironic facet of the dispute is that such products are largely subcontracted to Honduras, where they fetch much lower wages and can be exported duty- free to the USA thanks to a free trade agreement between these two countries. But the American importers of ladies lingerie mainly large distributors protested against the protectionist urges of the American producers (The Economist, Nov. 22, 2003). The other case concerns the imports of bicycles from Vietnam where they are in fact manufactured by Taiwanese firms. Here again, EU producers request the imposition of anti-dumping measures[17] whereas the distributors and vendors protest against such measures (De Tijd, Sept. 23, 2004). These two examples illustrate more eloquently than abstruse models of international trade the antithetic interests of home-country producers, on the one hand, and importers-distributors-- in an implicit 'objective alliance' with consumers-- on the other hand. And beyond that divide, more generally, the conflict between protectionist tendencies and the protagonists of free trade.

VI. Broad Implications for EU-15 Economies

Finally, we should ask ourselves which policies governments in high-income countries, more particularly in the EU, confronted with widespread anxiety in their populations should adopt in the wake of what is likely to be an accelerating trend of relocation of industrial capacity and nowadays also of business services to low cost countries. This can only be attempted here in broad terms.

1/ One should not overlook that today FDI's are still predominantly of the market-seeking variety. As explained earlier, even if as is quite often the case, foreign markets cannot be approached by way of exports but require FDI's such investments abroad do not destroy productive capacity and jobs in the home country. On the positive side, they strengthen the profitability and the competitive position of the home country's enterprises and even create a limited number of additional jobs.

In this context, it is worth repeating that non-business personal services such as retail banking, which imply a direct contact with customers of necessity must be rendered abroad through FDI; and that the relative share of services in GNP's in exports and in FDI's is rising.

2 / It follows directly from the above that there are promising prospects for Western firms to export to, or to invest in, emerging markets primarily with a view to conquer a share of that market. One must thereby refer above all to the fast growing and potentially huge Chinese market increasingly also to India (also to the NMS in Central Europe). This does not guarantee that EU-15 firms enjoy a safe-conduct to an Eldorado as competition in those markets has become intense.

3 / Those who tend to inveigh against what they consider to be the 'unfair' level of low wages in developing countries overlook that for various reasons—especially the modest level of productivity

[17] The PR of China has already been hit by a anti-dumping duty imposed by the EU on the importation of bicycles.

– the low wage level is dictated by economic logic. [18] It would be inequitable to criticizing those countries for their low wage levels, which are in fact one of the few handles they have to compete with countries that have reached high levels of per capita income and of sophistication of their industrial base.[19]

4 / Sections of society, pressure groups and governments which would condemn or oppose outward FDI's by their domestic firms should be reminded that it is not consistent nor acceptable to other trade partners that while outsourcing would be hindered concurrently the same governments actively solicit 'in-sourcing' (i.e the siting of productive capacity by foreign MNE's on their own territory).

5 / Requests for protectionism, more specifically restrictions on outsourcing to lower-cost economies, although they may be supported by wide segments of society, would at best allow rearguard battles. They might perhaps soothe the pains of re-allocation of labour during a short period but apart from their heavy financial burden most often they can not reverse the structural loss of international competitiveness experienced by economies with slow productivity growth.

6/ Western governments may be justified in urging countries which play already a noticeable role in the international economy but surround their domestic industry by high protective barriers to dismantle the latter, as already mentioned in the previous section. Yet, the two areas considered in this paper are no longer heavily protected. In China, along the long march to the door of the World Trade Organisation, import duties and non-trade barriers have been progressively brought down to modest levels and the NMS now operate the moderate EU external tariff.

7/ The trend towards de-industrialisation in Western countries has started already some decades ago and is continuing. This development must nonetheless be properly qualified. In absolute terms, output in the overall industrial sector has increased by 40% over the last 20 years. But it has declined as a share of GDP in favour of the service sectors. The relative weight of industry has been further curtailed by the statistical re-categorisation, on account of the 'externalisation' of business services, mentioned in section II. Employment in the overall industrial sector has been declining steadily as the result of incessant automation. But again, the net loss of 7mln industrial jobs over the last 20 years has been over-compensated by the creation of 36mln jobs in the service sector (Commissioner Lamy, 2004).

8/ As regards the spatial distribution of industrial sectors, a trend towards the outsourcing of manufacturing activities to offshore destinations, while not at all a novel phenomenon, gathers more momentum today. Some top managers of large MNE' s have recently broached (and even extolled) the concept of the 'fabless company' in which the production of unsophisticated products is farmed out to subcontractors in lower-cost countries, whereas the 'high-brow' activities (research and development, design and more generally the origination of new products) remain entrusted to the headquarters and the home country.

18 The adverse effects of the transgression of such logic, has been manifested, when the former German Democratic Republic was incorporated into Germany in 1990. With the local currency fixed at parity of the Deutschmark, the production units in the Eastern Länder were unable to compete.

19 Apart from criticisms of child labour and other conditions that are proscribed by ILO rules. But is would be equally unjust to evaluate conditions in today's developing countries only with the standards reached in rich societies.

But predictions that industrial production is doomed in Western countries are not convincing. Even in sectors which in the West cannot be viewed as ‘sunrise one’s’, such as the textile sector, a number of firms-- as in industrial textiles or carpet manufacturing -- are holding their line thanks to innovation in products and processes. On the other hand, it is questionable that invention and innovation and high-tech will remain the preserve of the USA and the EU. China for example, appears to make big strides towards mastering higher levels of technology. Western firms that practice offshoring of their manufacturing activities must also consider the risk of forfeiting their technological lead to their subcontractors, either because the latter rapidly climb the ‘ learning curve’ or illicitly engage in counterfeiting or pirating.

9/ It would be myopic to focus only on industry proper. Economic activities will increasingly be performed in a large and still expanding spectrum of services, as more needs must be met for example, as a result of an ageing population. In what is, somewhat prematurely, labelled as post-industrial societies jobs will have to be found increasingly in service sectors—although admittedly the relocation of business-related services, say to India, prove that many services which were taught to be firmly anchored in their native soil are now removable across borders far away. Yet, in service sectors there remains ample scope for innovation.

10/ The quickening pace of change in the world economy confronts *enterprises* with wide-open opportunities in an expanding world, but also with threats, in the face of intensifying competitive pressures. This in itself induces them to search for low-cost production platforms. But the fight on the other front that of pro-active innovation towards new products is even more crucial in today’s knowledge economy.

11/ The need for pro-active adaptation to the rapidly changing parameters of a globalizing economy also imposes challenges and hard choices on *societies* at large and their *governments.* Only the Western countries that are capable of reacting flexibly and in a forward-looking way to new developments and geo-political shifts will be able to maintain their high level of well-being and their relative high standing in the league of nations. Such prominence can no longer be taken for granted. A keen awareness that the world is changing rapidly ought to be spread rapidly so as to entice governments – cooperating, whenever useful, more closely within the EU framework-- into action and to prepare public opinions for some painful but vital measures.

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