China-CEE Institute
中国—中东欧研究院

ISSN 2786-2860
Vol. 2 No. 43
December 2022

CHINA WATCH

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XU Qiyuan

Kiadó: Kína-KKE Intézet Nonprofit Kft.
Szerkesztésért felelős személy: Chen Xin
Kiadásért felelős személy: Feng Zhongping

1052 Budapest Petőfi Sándor utca 11.
E-mail: office@china-cee.eu

China's Status as the World's Factory: Who Is the Real Challenger?

XU Qiyuan[1]

Professor and Deputy Director of the Institute of World Economics and Politics, China Academy of Social Sciences

Since 2018, China has faced increasing pressure to move its industrial chains, especially to Southeast Asian, South Asian, and Latin American countries. In particular, could the countries of Mexico, which is in the United States' nearshore outsourcing strategy, and Vietnam and India, which are in the friendly-shore outsourcing strategy, form a real challenge to China's status as the world's factory? The present article explores this issue.

Over the past decade or so, economic and geopolitical factors have impacted China's status as the world's factory. In 2017 and the previous decade, changes in economic factors were the main factors, which were manifested in rising labor costs, appreciation of the RMB exchange rate, rising land and environmental costs, and excessive expansion of capacity in some industries. These factors have played a certain role in promoting industrial relocation.

Since 2017, the international geopolitical landscape has undergone major changes, and the United States has been continuously adjusting its industrial chain policy. After the Trump administration came to power in 2017, it tried to reshape the US domestic tax system and introduced investment promotion policies to attract the return of industries, but the results were not at all satisfactory.

Since then, the United States has tried *"nearshore outsourcing"* to promote the return of industrial chains to its neighboring countries (such as Mexico). However, it is difficult to shake the existing global production division system. Therefore, the United States further turned to *"friendly-shore outsourcing."*

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[1] This article was first published in *Qinghua jinrong pinglun* (Tsinghua Financial Review), 2022(10) .

Speaking to the Atlantic Council in April 2022, US Treasury Secretary Janet Yellen said, *"We cannot allow other countries to use their market position in key raw materials, technologies, or products to disrupt our economy."* She further suggested reducing the risk to US supply chains by concentrating them in "trusted trading partners."

It is evident that the United States' strategy to reshape global industrial chains has gone through three stages: industrial repatriation, nearshore outsourcing, and friendly-shore outsourcing. It is possible that these practices will not only have an impact on China's status as the world's factory, but also cause China to gradually become isolated in the global industrial chain system.

In addition, the Biden administration has adopted a "small yard, high fence" policy in technology regulation to try to promote a "targeted decoupling" from China. Since the COVID-19 outbreak swept the world in early 2020, the Japanese government has also proposed the "China + 1" and "China + N" strategies, and the EU has also begun to link supply chain issues with human rights, environmental and other issues.

In this context, China has been under greater pressure to transfer its industries to Southeast Asian, South Asian, and Latin American countries, especially Mexico, which is in the United States' nearshore outsourcing strategy, and Vietnam and India, which are in its friendly-shore outsourcing strategy.

Can these countries pose a real challenge to China's status as the world's factory?

1. Mexico: Still in the Middle-income Trap, Poses the Least Challenge to China

Mexico, which borders the United States, has Latin America's second largest economy after Brazil. *Since the start of Sino-US economic and trade frictions in 2018, Mexico's development environment seems to have improved to some extent.* In recent years, as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the *United States-Mexico-Canada Agreement (USMCA)* successively went into effect, Mexico's economic and trade relations with Japan, the United States, and other major economies have become closer. With the United States' imposition of tariffs on China due to trade friction, some trade has been diverted to Mexico. All of these factors have brought new opportunities for Mexico's development.

The United States has been Mexico's most important trading partner. Exports to the United States account for 80% of Mexico's total exports, and *there is a clear competitive relationship with China's export of goods to the United States.* Among US imports of transportation equipment, electrical equipment, and computers and electronic products, Mexico accounted for 31%, 25%, and 17%, respectively. Because of the close US-Mexico trade ties, and because Mexico's US-bound exports are strong substitutes for China's exports to the United States, Mexico seems likely to be a beneficiary of the shift in trade and investment patterns.

However, if Mexico wants to replace China in manufacturing, it still faces huge challenges. Mexico is still in the middle-income trap and faces many structural problems. In constant 2015 US dollars, Mexico's per capital gross domestic product (GDP) was $9,255 in 2021, barely up from $9,214 in 2007.

Specifically, Mexico's business system is not friendly enough to foreign capital; its infrastructure, electricity, and transportation capacity are seriously insufficient, and serious corruption especially also hinders economic development.

In addition, part of the USMCA is actually not beneficial to Mexico's business environment. For example, the United States has proposed "requirements on the proportion of added value of domestic products" or demands that "some of the production of cars, trucks, and their parts be done in the United States." This makes it difficult for Mexico to attract foreign investment from China through the agreement.

Mexico has not escaped its existing middle-income trap development model, so it will be difficult for Mexico to experience an economic miracle in the context of the Sino-US game. Overall, Mexico's trade growth from the Sino-US trade friction is relatively small.

In 2021, Mary Lovely and David Xu of the Peterson Institute for Economic Research in the United States estimated that Sino-US trade friction would increase Mexico's exports to the United States by 3.4%. In terms of market share, Mexico's market share in the United States has increased by an average of 1.6 percentage points in industries where the United States has imposed tariffs on China, while in industries where tariffs have not been imposed, Mexico's market share has even slightly declined.

In terms of investment, there has been no positive change in foreign direct investment (FDI) attracted by Mexico. According to Lovely and Xu's observations, except for the sharp drop in FDI in 2020 due to the pandemic, Mexico's FDI did not show significant growth from 2018 to 2021. Moreover, most of Mexico's FDI flows went to tertiary industry (represented by financial and insurance services); the growth of investment in manufacturing was less than ideal. If we look at Mexico's FDI in 2021, we can see that except for the machinery and transportation manufacturing industry, which remained at the 2018 level, the FDI in major manufacturing industries like computer manufacturing has shown a significant decline. In recent years, due to the effects of the pandemic and the unfavorable provisions of the USMCA, Mexico's investment environment has not been bright.

Generally, Mexico's economic growth rate has also been quite weak. In 2019, before the pandemic, it was only -0.2%, and its performance after the pandemic has also been very weak. Although the growth rate in 2021 will reach 5.7%, that is because the 2020 rate was -8.3%. Its economy still has not returned to the pre-pandemic level.

2. Vietnam: Obvious Advantages but Limited Long-term Challenges

Vietnam's biggest advantage lies in the significant improvement of its domestic and foreign policy environment. With regard to domestic policy environment, Vietnam is in the midst of an important historic reform process, with the government focusing on opening up, deregulation, and marketization. In this context, Vietnam has created a better investment environment by simplifying laws and cleaning up its bureaucracy, so that its attractiveness for domestic and foreign investors has increased significantly.

In a survey on FDI policy conducted by *The Economist*, Vietnam scored 6, which was higher than China and India's 5.5. At the same time, in the areas of foreign trade and foreign exchange management policies and the actual tax burden of enterprises, Vietnam's scores were also significantly higher than those of China and India. In this context, except for certain periods of time, *Vietnam's attraction of FDI has risen sharply in recent years.*

With regard to international policy environment, from 2017 to 2022, Vietnam has made significant progress in opening up to the outside world. It has successively launched or joined the CPTPP, the Europe-Vietnam Free Trade Area, and the Regional Comprehensive Economic Partnership (IPEF for short). In addition, Vietnam itself has always been in the Association of Southeast Asian Nations (ASEAN). These international economic and trade cooperation agreements cover almost all of the major economies, such as China, the United States, the European Union, Japan, and ASEAN. This provides a unique policy environment for Vietnam's deep participation in the global division of labor.

In addition, Vietnam's position in global value chains is higher than India's. Vietnam's top exports include electrical machinery and equipment, clothing, footwear, and mechanical equipment. These products account for more than 60% of its exports. By contrast, India's main exports are low-tech manufactured products such as mineral fuels and precious stones.

However, in the long run, Vietnam's ability to challenge China is limited. The biggest constraint is that Vietnam's population and economic size are small. Vietnam's population is less than 100 million—not only less than Mexico's 130 million, but also an order of magnitude smaller than the respective populations of China and India. Vietnam's economic hinterland is relatively small and narrow, which restricts its development space within the global production network. *Related to this issue is the unevenness of Vietnam's industrial sectors—there is a preference for light industry and a lack of heavy and chemical industry capabilities.*

At the same time, Vietnam seriously lacks local world-class enterprises. As of 2021, Vietnam had no Fortune 500 company of its own, while India had seven and China had 143. This means that while facing the influx of foreign-funded enterprises, Vietnam has lacked the external spillover capacity to undertake work for the foreign enterprises. *In these circumstances, the influx of foreign-funded enterprises may actually inhibit the growth of Vietnamese local enterprises.* At present, the proportion of foreign-funded enterprises' exports in Vietnam's export trade has been around 70%, while the proportion of processing trade in Vietnam's exports is even higher.

And in fact, a considerable part of Vietnam's FDI comes from mainland China, which also means that the interdependence of supply chains between Vietnam and China has actually been strengthened.

From the Sino-Vietnam two-way export competition indexes that I have calculated, one can see that Vietnam's competitive pressure on China is still at a relatively low level. Among these indexes, the competitive pressure index of China's exports to Vietnam is 85.5%, while the competitive pressure of Vietnam's exports to China is only 9.3%.

That is to say, for each of the more than 5,000 kinds of commodities classified on the customs' HS six-digit code, on average, for every 100 yuan of commodities exported by Vietnam, China exports 85.5 yuan of commodities of the same kind of commodity. Furthermore, for every 100 yuan of goods exported by China, on average, Vietnam exports only 9.3 yuan similar products. Even part of that 9.3 yuan comes from the exports of Chinese-funded enterprises in Vietnam.

In the competition between China and Vietnam, China is in an absolutely dominant position, so there is no need to worry too much about Vietnam's competitive pressure.

The complementarity of Sino-Vietnamese economic and trade relations is also very conspicuous. Vietnam is an economy whose GDP is almost 20% smaller than that of Guangxi Province, but in the past 21 years, China' exports to Vietnam have expanded from US$800 million to US$126 billion in 2021, and Vietnam has become China's fourth largest export destination country, behind only the United States, Japan, and South Korea.

The large quantities of China's exports to Vietnam, as well as China's huge trade surplus with Vietnam, also show that Vietnam is more like an important buffer zone between China and the United States, rather than an economy replacing China's role as the world's factory.

3. India: Many Practical Difficulties, but Great Potential for Long-term Development

India is the only country that can match China in terms of population size, and its biggest advantage lies in its huge economic scale. Although India's per capita GDP in 2020 was only US$1,930, due to its large population base, its GDP that year was US$2.7 trillion, nearly 2.5 times that of Mexico and 10 times that of Vietnam.

According to the forecast of the International Monetary Fund (IMF), India's GDP will surpass that of the United Kingdom in 2022 and become the fifth largest economy in the world in dollar terms after the United States, China, Japan and Germany.

Although India has a low level of general educational attainment and its adult literacy rate (74%) is significantly lower than the world average, and much lower than the 95% level of China, Vietnam, and Mexico, India has a large population, so it still has ample cheap labor.

In addition, the Indian government is aware of the advantages of this huge economic volume, so it is working hard to promote the formation of a unified domestic market in terms of administration and taxation. In 2021, despite the huge impact from the pandemic, India still achieved a growth rate of 8.1%, and its GDP further expanded and exceeded US$3 trillion, with a per capita level close to US$2,300. With the 2021 performance as a basis, India's economic growth rate in the first half of 2022 will further increase to 8.4%.

The huge population and market size also support India's strong R&D capabilities and world-class enterprises. According to *The Times* 2021 World University Rankings, India has 56 universities in the top 1,200, which is far behind China's 92. But in comparison, Vietnam and Mexico have only three each, and all of them rank low among the top 1,200. Relatively speaking, India's technological and innovation capabilities should not be underestimated.

In addition, there were already nine Fortune 500 companies in India by 2022, and its infotech industry is mature; its elites are widely dispersed overseas, and its English language advantage is obvious. Therefore, Indian local companies, overseas elites, and American private companies are deeply integrated. Information technology (IT) services in almost every industry in the United States depend to varying degrees on Indian companies. Moreover, India's economic self-sufficiency is strong, its dependence on the supply of intermediate goods from China is low, and it is better equipped to form supply chains that are isolated from China.

But India also has its obvious shortcomings, and the biggest problem lies in India's religious and cultural factors. The religious beliefs, which originated in India, make people's hearts more tranquil, and their desire to develop the economy is not strong. In addition, the solidification of classes due to the caste system also forms an obstacle to economic development. In contrast, Vietnam, which belongs to East Asia's Confucian cultural circle, has a relatively strong this-worldly orientation and a relatively strong desire for development.

Meanwhile, India's administrative efficiency is low and its infrastructure development is seriously lagging behind. Changing these development conditions is not at all easy. From a spatial point of view, the three major production networks in the world today include Europe, North America, and East Asia, but India is far from any of these poles. Although India is somewhat closer to East Asia's production network, India's transportation costs are also significantly higher compared to countries in the core East Asia region, so will be difficult for India's neighboring countries, excluding China, to form a strong support for its production system, and it will also probably be difficult for India to stand out by itself and support the world's fourth largest network.

At the same time, the current Modi government overemphasizes domestic circulation and lacks the determination and practical action to open up to the outside world. In 2020, the government proposed the "Self-reliant India Programme," hoping to make the local market bigger and stronger. But what it actually adopted was an import substitution strategy, which means raising import tariffs and subsidizing relatively backward domestic production methods. But import substitution has been proven by Latin American countries to be a failed development strategy, while East Asian countries have risen by adopting export-oriented strategies and encouraging local enterprises to participate in international competition and continuously improve their international competitiveness.

When the World Economic Forum (WEF) surveyed global business leaders for its 2020 Global Competitiveness Report on their views regarding the globalization trends in the value chains of 19 major economies, they ranked India last among the 19.

In general, for India to achieve a real rise, it needs to carry out a profound revolution in its religion and culture, and on this basis, carry out a subversive round of reform and opening up. However, India's old religious culture enables its society to remain relatively stable. If the original religious and cultural system is broken, determining how to rebuild a self-stabilizing, logical system in Indian society may be a more challenging issue.

4. China: Deepening Reform and Opening up, and Doing Its Own Thing Well

First, doing our own thing well remains China's most important policy focus. A country cannot maintain its core position on global supply chains mainly by suppressing competitors, but by doing its own thing well and enhancing its industrial competitiveness.

The same is true for the United States. For example, starting in 2018, even though the US government has been suppressing China's export trade, China's share of global exports has continued to rise and hit record highs repeatedly.

Likewise, to cope with the pressure of industrial chains moving out, China needs to take a pro-active, responsive perspective and continue to do its own thing well, continuously upgrade its industries, and improve industrial competitiveness.

All along, Chinese entrepreneurs have been particularly good at facing new challenges, adapting to new environments, and taking advantage of new technologies. According to data compiled by the China Passenger Car Association (CPCA), in 2021, China's new energy passenger vehicle sales will account for 53% of the global market share and 61% of global sales of purely electric vehicles. According to data provided by Solarbe Consulting, shipments by China's photovoltaic module companies accounted for 75% of the total global demand. In these green and new energy industries, Chinese companies have demonstrated strong international competitiveness. In 2022, these industries have still been developing rapidly.

As long as its own technological innovation and industrial upgrading are done well, China's central position on global supply chains will remain stable. Even if India and Vietnam fail to replace China's position, this will not directly help China to achieve more breakthroughs in cutting-edge technologies and industries.

Therefore, my country must maintain an open and inclusive mentality, strengthen international cooperation, further improve its business environment, and improving the macroeconomic environment for industrial upgrading by a strategy of expanding domestic demand.

Second, from an international perspective, China needs to continue to adhere to the basic national policy of opening up. In the United States, the Biden administration is leveraging allies and some intermediary countries in an attempt to change the layout of global industrial chains and even impact China's status as the world's factory. But in fact, the practice of expanding the united front is an important "magic weapon," both for the CCP and for realizing the great rejuvenation of the Chinese nation. This will help consolidate China's important position in the global industrial chains.

In the face of changes of a kind not seen for a century, China must coordinate the relationship between development and security. At the same time, in the field of foreign economic work, it must be more future-oriented, seek common ground while reserving differences, and seek common development, so as to create a favorable external environment for China's economic development.

As General Secretary Xi Jinping said in an important speech at the Symposium of Experts in *Economic* and Social Fields on August 24, 2020, *"We must actively carry out cooperation with any country, region, or enterprise willing to work with us, including individual states, localities, and companies in the United States, in order to form an all-round, multi-level, and diversified pattern of open cooperation."*

Third, we must follow trends and strengthen economic and trade ties with countries in the intermediate buffer zone such as Vietnam. We should promote extensive economic and trade cooperation between China and these countries, promote the integration of Vietnam's economy into China's production network, and enable Chinese companies to share more of Vietnam's development dividends.

In the short and medium term, Chinese enterprises will be moving rather swiftly to Vietnam, but there is no need to worry too much. Since Vietnam faces the practical constraints I have described above, it is more likely that Vietnam in the future will form a pattern in which foreign-funded enterprises are dominant.

Chinese enterprises can actively invest in the layout and promote the formation of this economic pattern in which foreign-funded enterprises, including Chinese-funded ones, play an important, influential role. At the same time, we should promote the development of the "Great Western Corridor," especially the sea-route from Guangxi, and develop it into a new regional industrial chain cluster with positive interaction with the Pearl River Delta and with Vietnam, making full use of Vietnam's role as an economic buffer zone between China and the United States.

Finally, to consolidate China's position in global production networks, it is necessary to strengthen its own advantages and further deepen the industrial chain cooperation in East Asia. Europe, North America, and East Asia have the world's three major regional production networks. To a certain extent, the deepening development of East Asia's regional production network and the deepening of interdependence will also positively interact with China's status as the world's factory.

In fact, when India gave up being one of the founding members of RCEP, it actually gave up the opportunity to participate deeply in the East Asian regional production network. We must learn from India's lesson and actively promote cooperation in the industrial and supply chains in East Asia, and further improve the level of economic and trade cooperation in East Asia. At the same time, we should actively align with higher-standard international economic and trade rules, and force the domestic economic system to further deepen reform and opening up by benchmarking against the higher-standard rules.

Translated by Thomas E. Smith