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Manufacturing Paradoxes: Foreign Ownership, Governance, and Value Chains in China's Light Industries

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Summary. — Utilizing Chinese industrial data and detailed transactional trade data, this paper finds two paradoxes. First, the distribution of FDI across value chains in light industries is the opposite of many extant explanations. Second, China's dominance as an exporter is belied by the weaknesses of its domestic firms within the governance of value chains, with important implications for firm upgrading. By analyzing millions of US Customs Bureau trade transactions, the paradoxes are resolved by examining intermediary contractors in East Asian value chains. Even 30 years after reforms began and in the technologically simplest industries, Chinese firms continue to struggle to break through substantial 'contractual' barriers to entry.
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Key words — foreign direct investment (FDI), global value chains, governance, China, East Asia, production networks

1. INTRODUCTION

There is a fairly straightforward narrative about China's recent industrialization and export-oriented development. First, it is widely known that over the past three decades and particularly since World Trade Organization (WTO) accession in 2001, China has transformed into a manufacturing juggernaut, dominating the import markets of many advanced countries and sparking protectionist backlashes. Although there is sharp debate over China's capabilities in high-tech industries (Breznitz & Murphree, 2011; Steinfeld, 2010), its manufacturing and export prowess still is nowhere more evident than in light, consumer goods industries—something easily verified by trade statistics or a trip to the shopping mall. In 2011, China captured over 70% of total US imports in products like handbags, luggage, toys, footwear, and wood products and over 50% in items like furniture, tableware and glassware (UN Comtrade). [1]

Second, the logic behind China's dominance in consumer goods industries is also uncontroversial. They are easy to produce, require only standardized, low-tech machinery, and are overwhelmingly reliant on a large, cheap, and disciplined labor force, trained in basic manufacturing skills. While many countries remain incapable of forging such a workforce, once China's disciplined labor force was combined with efficient infrastructure and trade-assisting tariff and currency policies, it came to dominate export-oriented light industries, employing millions of Chinese workers.

Third, unlike in technologically sophisticated industries like automobiles or electronics in which foreign firms hold a dominant position in China, light industries ought to be the domain of domestic entrepreneurs. [2] Given the low entry barriers endemic to light industries, it is extremely difficult for foreign firms to compete with native producers, which partly explains the critical role of light industries as an early foothold in the ladder of development.

In summary, then, the prevailing wisdom is that China has become an industrial world-beater in consumer goods industries, largely on account of its workforce, built-up infrastructure, trade policies, and driven forward by highly competitive domestic firms that retain home-country advantages in the technologically simplest light industries. These appear to be relatively incontrovertible statements backed up with both straightforward evidence and academic theories.

Surprisingly, they are mischaracterizations. The data in this paper show that light industry production and trade, especially in downstream sectors in China, are dominated by foreign firms and their advantage is not predominantly based on China's workforce, since domestic firms are even more capable of exploiting the domestic labor force, evidenced by their lower average wages across industries.

These data highlight two, interconnected paradoxes. First, there is an *ownership* paradox, in that it raises questions about why, in comparison to other industries, foreign firms are more dominant in the technologically simplest light industries in which native Chinese entrepreneurs ought to be most competitive, especially after China's 30 years of international integration. This paper applies extant explanations of FDI to the unusual patterns of foreign investments in China, including John Dunning's programmatic "eclectic" or OLI paradigm, which asks, *inter alia*, the simple question "why do firms invest abroad?" [3] OLI stands for "ownership," "location," and "internalization" which are the three critical factors in the decision-making of firms' investments abroad, namely—"what advantage do they possess over rival firms," "why do they choose a particular location to invest," and "why do they internalize the function rather than contract for it." As the paper shows, many extant explanations of foreign direct investment (FDI) have difficulty accounting for China's unusual up-downstream structure of foreign investments. Utilizing detailed industrial data and transactional trade data, the paper resolves the paradox by finding that in light industries in

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China, foreign firms are firmly entrenched and retain advantage within the international division of labor as "intermediary contractors" between China-located production and foreign buyers.

The data raise a second paradox, incorporating a cognate literature on global value chains (GVC) and the governance role of transnational buyers in their operations with foreign suppliers. Despite China's clear dominance in the manufacture and export of light industry goods, this paper shows that Chinese domestic firms occupy a weak and passive position in the division of labor within light industry value chains, largely because of the continued prominence of East Asian intermediary contractors, which GVC scholars have long argued occupy weak middlemen positions in global value chains.

On the one hand, scholars have pointed out the declining importance of manufacturing in development (Arrighi & Drangel, 1986; Arrighi, Silver, & Brewer, 2003; Kaplinsky, 2005; Wood, 1997). Globally, these trends are evident in cross-national, large-n studies which illustrate a disjuncture between convergence in industrialization, and a simultaneous divergence in manufacturing incomes and export prices between developed and developing economies. Common explanations for the declining importance of manufacturing point to the commodification or routinization of manufacturing knowledge and technology, inducing a precipitous fall in barriers to entry—problems particularly acute in light industries.

To counter these global forces, developing country firms must continually upgrade their manufacturing capabilities to retain entry barriers. One large, interdisciplinary literature on GVC, has gone far in theorizing the prospects of developing country supplier upgrading. [4] GVC research focuses on the de-verticalization of large transnational corporations (TNC) or "lead" firms which have increasingly concentrated on their core competencies that add the most value (like design, engineering, logistics, and marketing), while off-shoring manufacturing functions abroad to countries like China. The value chains are then re-integrated through networks of trade, foreign investments and non-equity ties. Within these value chains, the prospects for firm upgrading is heavily conditioned by the lead firms and their modes of governance. Thus, in contrast to the ownership focus of literature on FDI, GVC research is most concerned with issues of *inter-firm governance* and the balance of power between lead TNCs and suppler firms, linking advanced and developing countries.

The data in this paper support the notion that manufacturing has commodified and lost much of its developmental potential. At the same time, it reveals that China's dominance as a manufacturing juggernaut in light industries is accompanied by weaknesses among its domestic manufacturers whose upgrading potential is hampered by intermediary contractors within the value chain. This is because intermediary firms, largely from the prior generation of East Asian Newly Industrialized Countries (NICs), persist in their dominant role as the *direct* suppliers to transnational buyers, which research has shown reduces the possibilities for industrial learning and upgrading in the value chain (UNCTAD, 2013). The persistence of intermediary contractors, however, runs *contrary* to GVC literature which has long predicted that intermediary firms would be eliminated in East Asian production networks.

This paper refines GVC literatures in two important ways. First, the transactional trade data used in this paper are able to *systematically measure* variation in the strength of different suppliers across industries and hence, the degree to which a gap exists between China's dominance as a "country of production" and its weakness as a "country of contracting." Unlike most trade data which aggregate *trade between countries*, transactional trade data consist of shipping data from bills of lading to record all waterborne *transactions between companies* that pass through US Customs. This paper culls through millions of US import transactions to examine how specific US corporations organize off-shoring production, which countries and companies they favor for contracting, and the nature of the hierarchical relationship they establish with different suppliers. The large gap between China as a location of "manufacturing" and as a location for "contracting" indicates that notwithstanding China's manufacturing and export dominance, most native Chinese firms are positioned in passive, dependent, and weak roles within the global organization of industry. [5]

Second, the stability and endurance of East Asian firms as commercial intermediaries contradicts much GVC scholarship, which has long argued that intermediary firms conducting "triangular trade" between East Asian producers and US retailers, occupy a weak and unstable position in the value chain, and were long predicted to be eliminated (Gereffi, 1996, 1999; Gereffi & Pan, 1994; Gereffi *et al*., 2005; Schmitz & Knorringa, 2000). The transactional trade data suggest that contrary to expectations, commercial intermediaries occupy a very robust "link" in the international division of labor, and are more widespread than prior research suggests, with important implications for the upgrading prospects of domestic manufacturers.

The paper's insights are particularly applicable to regions of the world which have been most deeply integrated into TNC production networks. With its finely articulated regional division of labor and its proliferation of preferential trade agreements, East and Southeast Asia have been at the forefront of transnational production networks (Bernard & Ravenhill, 1995; Borrus *et al*., 2000; Hiratsuka & Uchida, 2010; Kawai & Wignaraja, 2011; Yeung, 2009) China serves as a critical case since it increasingly lays at the epicenter of manufacturing outsourcing and East Asian production networks (WTO & IDE-JETRO, 2011). The following two sections examine the anomalous data on FDI in China and evaluate extant explanations of FDI. The paper then turns to GVC theories on inter-firm governance and finally utilizes transactional trade data to examine the position of East Asian commercial intermediaries in the China–US value chain.

2. FOREIGN DIRECT INVESTMENT ALONG CHINA'S VALUE CHAINS

This section closely examines detailed Chinese industrial data on the influx of FDI into China. [6] It illustrates that the distribution of FDI across Chinese industries presents a paradox. Compared to technologically sophisticated and capital-intensive industries, foreign firms are most dominant in China's technologically simplest industries. This raises questions about extant theories and explanations of FDI, issues addressed in the next section.

Compared to earlier industrializers and current large emerging economies, Chinese industrialization is distinctive in the degree to which it has relied on FDI and exports. By the 1990s, China was absorbing as much as one third of total FDI flows to all developing and transitional economies, causing China's exports and imports to skyrocket from 25% to over 40% as a share of GDP during 1989–94, and then to 65% after WTO accession, outpacing other large, emerging economies (Naughton, 2007, p. 377–378; Unctadstat). However, while much has been written on the determinants, effects and performance of FDI in China in the aggregate and its

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