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The Yangtze Dragon?

This article draws in part on selected recent findings of a study being conducted by Chreod Ltd. on the Yangtze Basin for the World Bank and China's State Development Planning Commission. The purpose of the study is to establish priorities for urban infrastructure investment over the next ten years from among 910 cities and counties in the Yangtze Basin, stretching from Shanghai to the border with Myanmar. Chreod has done similar work for the World Bank in the Yangtze Delta Region, comprising Shanghai and Jiangsu, Zhejiang and Anhui Provinces, and in Sichuan Province and the new Chongqing Municipality.

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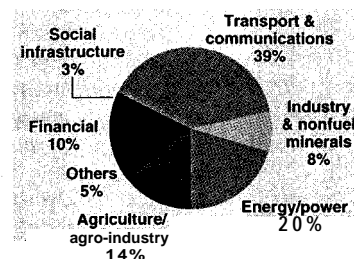
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The Yangtze dragon

Part of the problem in encouraging foreign firms to move inland is the lack of information on market conditions and opportunities in the interior

Edward Leman in Chongqing

After almost two decades of market experimentation in coastal regions - and often spectacular growth as a result - China's central government is now intent on shifting economic development to the country's poorer, inland provinces. This represents both a move towards greater equity and pragmatic recognition that inland areas hold vast pools of natural resources that need to be tapped to power the domestic economy and to increase exports, and that millions of rural migrants are beginning to overburden coastal cities in search of jobs. With its fiscal capacities already strained, the government is now strongly encouraging foreign investors to look inland, particularly within the Yangtze Basin that stretches from Shanghai to the border with Burma. However, to many foreign companies, China's interior is largely unknown territory with undetermined market risks. In this, the first in a series of articles, *China Trade Report* will explore opportunities in the Yangtze Delta, the Middle Yangtze region, and the Western Yangtze region, in an attempt to detail some of the principal market risks for foreign companies.

The Yangtze is China's longest river with a basin covering 1.8 million square kilometres - the same land area as Indonesia - and containing nine provinces and two of China's four provincial-level municipalities. It holds 45% of China's population, produces 42% of its GDP, and consumes just over 43% of the country's total investment in fixed assets. Over half of China's industrial output is now created within the Yangtze basin. Of the country's estimated 400 million urban dwellers, 180 million live in the basin's 250 cities and create almost a quarter of China's total GDP.

Despite its apparent homogeneity, the Yangtze basin is not a single market. It consists of three quite distinct economic regions: the Yangtze delta, anchored on Shanghai, and including Jiangsu, Zhejiang and Anhui provinces; the Middle Yangtze region, comprised of Hubei, Jiangxi and Hunan; and the Western Yangtze region containing Chongqing, Sichuan, Guizhou and Yunnan. These three regions are comparable in size and market importance to national economies in East Asia. The basin's total population of half a billion people is the size of all of Southeast Asia's and the two Koreas' populations combined. Both the Yangtze delta and the Western Yangtze region each hold as many consumers as Indonesia; the Middle Yangtze's consumer base is

almost three times the size of Thailand's.

In terms of size of economies, the GDP of the Yangtze delta in 1995 approached that of Thailand and was 80% of Indonesia's GDP. The Middle Yangtze's economy was about the size of the Philippines', and the Western Yangtze had a GDP at least three times larger than Vietnam's. Given recent contractions in Southeast Asia, and the moderate yet sustained growth of the Chinese economy over the last three years, the basin's economic performance has improved considerably relative to much of Southeast Asia: The Yangtze delta has by now likely surpassed Indonesia in terms of GDP.

Although covering large land areas, the actual consumer markets, in the three regions are quite concentrated. Population in the delta is concentrated along the coast and upstream along the Yangtze as far as Nanjing: Densities in this area are the highest in East Asia after Taiwan. The Middle Yangtze's consumers live in a band of cities and towns anchored on Wuhan, in a series of valleys and plains around Changsha, and, to a lesser extent, around Nanchang in Jiangxi province. In the Western Yangtze, population is heavily concentrated in the Sichuan Plain anchored on Chengdu and Chongqing.

The Yangtze's diverse market regions

There are considerable differences in levels of development among the three regions that suggest diverse market risks. The delta holds 35% of the basin's population but produces 53% of its total GDP and just over half of its economic output from industry. It is by far the largest regional economy in the basin, and clearly its industrial heartland. Growth in the delta has averaged 14% in real terms so far this decade which compares, for the first time since the start of market reforms in China, with growth rates in southern Guangdong province. Per-capita GDP in Shanghai is now more than double that in Indonesia and the Philippines. Not surprisingly, economic growth has been at lower levels further inland: The Middle Yangtze has averaged 12% annual GDP growth in real terms since 1990, and the Western Yangtze as a whole has pulled along at around 10%. However, these regional figures mask a huge diversity among the basin's 250 cities, the loci of consumer demand and economic production. There is a twenty-fold difference in per-capita GDP among cities, ranging from a high of over 25,000 renminbi (\$2,930) in Hangzhou, Wuxi, and several other coastal delta cities to under 1,500 renminbi in Sichuan's Guangyuan and several other smaller cities in the Western Yangtze region. Of the top 25 basin

cities in terms of per-capita GDP, 22 are in the Yangtze delta with the remaining four in the Western Yangtze region (Shanghai ranks sixth behind smaller coastal cities).

The highest ranking city in the inland Western Yangtze region - Mianyang, just north of Chengdu - ranks 40th in the basin in per-capita GDP; Chengdu ranks 66th, and Chongqing 101st at 7,807 renminbi in 1996, less than 30% of Hangzhou. Per-capita urban incomes reflect the same general ranking, although with narrower spreads due to subsidies and nonwage earnings from the informal sector that increasingly supplement household incomes in urban areas.

Industrial and commercial development among regions is similarly mixed: per-capita gross value of industrial output in the Yangtze delta in 1996 was around 3,000 renminbi, compared with 950 renminbi in the Middle Yangtze, and 610 renminbi in the Western Yangtze region. Clearly, higher value-added manufacturing is focused in the delta while inland provinces continue to rely more on heavy industry, much of which is lodged within ageing state-owned enterprises. Retail sales on a per-capita basis confirm the different levels of development in the three regional markets: sales in the Middle Yangtze were 55% of per-capita sales in the delta, while sales in the West were 40% of those attained along the coast.

Of perhaps greatest importance in terms of economic trends during this decade is the apparent deepening of the basin's economy compared with China as a whole. While the primary sector decreased from 27% to 20% of China's economy from 1990 to 1996, the entire shift in the national economy was attributed to the secondary sector with virtually no growth in the role of tertiary services. This pattern does not hold true in the basin where both the secondary and tertiary sectors grew quite considerably, particularly in the delta where the tertiary sector's role grew from 26% to 33% of GDP. The diversification of the basin's economy relative to the rest of China bodes well for increasing purchasing power, for the capacity of the regional economies to withstand external shocks, such as major downturns in manufacturing exports, and for their varying resilience in the face of the upcoming dramatic restructuring of the state-owned enterprise sector.

Investment trends

The development of inland provinces in the Yangtze basin will depend to a large extent on investments in infrastructure (power, roads, rail, municipal utilities, environmental protection) and industrial upgrading. In 1995, almost 620 billion ren-

minbi was invested in fixed assets in the delta, compared with 194 billion renminbi in the Middle Yangtze, and 176 billion renminbi in the Western Yangtze region. Relative to GDP, investment in the delta stood at 40% of GDP, while hovering around 27% in both the middle and western parts of the basin.

The central government has very few instruments left with which to shift this investment focus on its own. Capital is not one of them: central government appropriations for capital construction in China has declined by more than 50% since 1990 to less than 1% of GDP; and state allocation of bank credit was terminated at the start of this year. The principal tools still available for influencing investment decisions are channelling official development assistance to inland provinces, including low-cost borrowings from the World Bank and Asian Development Bank,



and allowing inland cities to offer foreign investors the same fiscal incentives introduced earlier along the coast. Annual ODA has never exceeded \$4 billion since 1989 for China as a whole: The bulk of new investment must come from the nonstate sector. So far incentives are not proving particularly effective. In 1995, the delta used \$12.7 billion of foreign capital compared with \$2.2 billion in the Middle Yangtze and \$1.5 billion in the western part of the basin. Direct foreign investment accounted for 6.8% of GDP in the delta, compared with 2.5% in the middle provinces and 1.4% in the West.

Changing regional advantages

Part of the problem in encouraging foreign firms to move inland is the comparative lack of information on market conditions and opportunities in the interior. Government agencies in the delta have become quite proficient at marketing their locational advantages to foreign firms. Their investment promotion messages have shifted over the past few years

from emphasizing tax and other incentives (which can change overnight, and are by now very similar across competing locations) to focusing on the size and purchasing power of local markets, factor endowments that contribute to the efficiencies of new manufacturing and commercial facilities, and locational advantages that provide for rapid access to domestic and export markets. Similar advantages exist in some inland cities, but are not being properly communicated with verifiable data. This makes investment decisions more difficult as disadvantages - both real and perceived - cannot be accurately balanced.

Many inland cities have well-educated yet low-cost work forces. While post-secondary graduates constitute 3% of the workforce in the delta, compared with 2.3% in the middle and 2.1% in the western regions, the proportion with senior secondary school education is 11.3%, 11.4%, and 7.9% respectively. The proportion with junior level education - considered the base level required for much manufacturing - is 37.8% in the delta, 35% in the Middle Yangtze, and 29% in the Western Yangtze region. However, official wage rates in inland provinces are on average 75% those of the delta. Again, city variations are much greater ranging from a high of 11,000 renminbi in Shanghai to just under 4,000 renminbi in some cities in Sichuan province, and even lower in Guizhou and Yunnan.

Respite the relative wealth of the delta, the basin's other two economic regions represent substantial markets. The Middle Yangtze has a population more than twice the size of Vietnam with double Vietnam's per-capita GDP. The Western Yangtze, with a population the size of Indonesia's, has a GDP just 10% smaller than the Philippines. There are 21 cities in the Middle Yangtze with per-capita GDP higher than \$1,000; they have a combined population of 20 million consumers, the population of Malaysia. In the western part of the basin there are seven cities with per-capita GDP over \$1,000 holding almost 10 million consumers, the total population of Cambodia. Unlike Southeast Asian markets, these regions share a common language, a common currency, and an improving national regulatory framework. They are cushioned from external shocks by the assimilative capacity of China's national economy, including high production levels in coastal areas, huge foreign currency reserves, and the established creditworthiness of the Chinese government.

However, despite their market potential there are still significant constraints to economic growth in many inland portions of the Yangtze basin. Basic infrastructure in some cities is poor, with uncertain water supply, poor road services, and extremely high air and water pollution levels. Inter-city transport access is also difficult in many areas: the national railway system has very few east-west links to coastal markets and ports, and the highway network is now quite rudimentary with no links to the delta or to

coastal ports in southern China.

The isolation of inland markets is being addressed through major, focused transport investments by the central and provincial governments. As part of the Three Gorges dam project, waterway improvements along the Yangtze will enable 10,000-tonne vessels to reach Chongqing for the first time. The railway system is being upgraded and extended. However, it is expected to decrease in importance relative to planned new inter-city highway linkages: The World Bank estimates that the national freight task of roads will overtake rail sometime between 2005 and 2010; in the Yangtze basin, this will likely occur well before 2005.

By 2000, China's National Trunk Highway System will connect the Yangtze delta to both Shandong and north China markets, and to the Middle Yangtze as far as Yichang, site of the Three Gorges dam. High-quality expressways are expected to link Hong Kong and the Pearl River delta to the Middle Yangtze, and a major expressway corridor will be completed in the Sichuan Plain linking northern Sichuan to the recently completed Chengdu-Chongqing highway, thereby consolidating access to 130 million consumers.

By 2005, the entire basin will become connected by expressway from Chengdu to Shanghai: this will for the first time open up high-speed access by bulk road transport to a domestic market of over 700 million consumers. In addition, the Western Yangtze region will become linked by expressway to coastal ports in Guangxi and Guangdong provinces, providing exporters with a wide choice of ports.

The National Trunk Highway System will have as far-reaching an impact on the Yangtze basin as did the construction of the inter-state expressway network in the United States in the 1950s and 1960s, and the international autoroute/autobahn network in Europe during the same period. Inland cities with good factor endowments and low costs - but with very poor access to markets and coastal ports - will become much more attractive to both domestic and foreign investors. Those that are particularly well-located will experience sustained economic booms similar to those in many coastal cities over the past decade. It is useful to note that such an expansion of market access has never occurred before anywhere in Asia. The new expressway connections along the Yangtze basin will invariably redefine the market structure - and market opportunities for foreign companies - throughout the entire Asia-Pacific region. ■

Edward Leman is President of Chreod Ltd., a consultancy based in Canada that has worked in the Yangtze basin since 1988. Chreod has advised multilateral agencies and foreign companies on market risks associated with over \$8 billion of capital investment in China, and is now working on a portfolio of \$15 billion in the Yangtze basin.