Choosing Locations to Build Profits

Companies engage with China to reach a simple goal: growth in profitability. Over the last two decades, many companies from around the world have met this goal in one of three ways: by breaking into China's distinct regional markets to produce final goods for China or offshore; by improving productivity using more efficient and cost-effective factor inputs; and, more recently, by tapping into selected clusters of innovation to raise the value of final products and to diversify product and service offerings to meet the needs of China's corporate and household consumers.

Cities play a crucial role in all three of these forms of commercial engagement. Using North American definitions of urban markets, China's 668 cities and over 19,000 major towns and suburban areas hold around 45 percent of the country's population, not the 32-36 percent that official statistics define as urban using outdated conventions. (North American urban market statistics include suburban populations; China's do not because of the antiquated household registration system, which severely undercounts real urban consumers who, with a very few exceptions, cannot change their official registration from agricultural to non-agricultural.)

Consumers in urban and suburban areas—largely in the eastern provinces but also in some central and western provinces often generalized as "poor"—have the highest purchasing power in China. China's cities are the country's engines of production; they account for over 72 percent of GDP, have taken in more than 93 percent of actual foreign direct investment, and have attracted over 85 percent of fixed-asset investment during the past decade. Some cities, such as Beijing, Shanghai, and Shenzhen, are becoming the nation's incubators of innovation in technology, marketing, and management.

The sheer number of cities and towns, their diverse economic, social, and institutional characteristics, and the rapid pace of urbanization in China over the last decade have made locational decisionmaking by foreign companies increasingly difficult. The challenges will increase as China implements World Trade Organization (WTO) commitments over the next five years and more of the country, and more sectors, open up to foreign direct investment. Companies are now asking: Should production be focused in Beijing, Guangzhou, Hong Kong Special Administrative Region (SAR), Shanghai, Shenzhen, or Tianjin? How competitive are central and western cities—such as Changsha, Hunan; Chengdu, Sichuan; Chongqing; Wuhan, Hubei; and Kunming, Yunnan—for which more reliable information is becoming available? What advantages do smaller cities—such as Changde, Hunan; Deyang, Sichuan; Foshan, Guangdong; Kunshan, Jiangsu; Shunde, Guangdong; Suzhou, Jiangsu; Wuxi, Jiangsu; and Zhengzhou, Henan—have over their larger counterparts? These questions are as important to established foreign companies in China as they are to new entrants; under the WTO regime, firms are facing a much larger and more diverse China market than during the last two decades, when policy and poor infrastructure tightly circumscribed sectoral and geographic access.

Answers to locational questions depend on what companies see as the role of China's cities in their efforts to improve profitability and the timeframes for such improvements. Many established companies are gradually factoring next quarter contributions into global operations after years of patient business development. For others, medium- and long-term timeframes are most relevant, which means firms will need to project how far and fast individual cities will progress in meeting corporate expectations.

Competitiveness depends on a city's capacity to support a firm's profitability growth—within timeframes set by the company—in seven ways. A city can be competitive as:

- A market for imports of finished goods,
- A local market for domestic production,
- A production node for domestic markets,
- A production node for export markets (export processing),
- A source of intermediate inputs for production in other cities in China,
- A distribution node for domestic or export markets, and as
- A center for supporting services, including those fostering technological, marketing, and management innovation.

Shanghai is one of very few cities in Asia that can reasonably aspire to global competitiveness in all seven roles. Though 12 years ago such aspirations appeared naive, Shanghai has since undergone major changes that have altered the basic structure of the Asian regional economy. Strong momentum for continuing reforms, the growing empowerment of increasingly sophisticated consumers and enterprises, and major planned developments in infrastructure and supporting services could lead Shanghai to become a major node in the global economy by the end of this decade—if it can strengthen its inherent competitive advantages in contributing to profitability growth for both domestic and foreign companies.

—Edward Leman