



PC16

The Post-China 16

July 2013

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CONTENTS

- INTRODUCTION TO THE PC16 3
- INDIAN OCEAN BASIN 9
 - Ethiopia 9
 - Kenya 10
 - Tanzania 12
 - Uganda 14
 - Bangladesh 16
 - Sri Lanka 18
 - Indonesia 20
 - Myanmar 22
- SOUTHEAST ASIA/SOUTH CHINA SEA 25
 - Cambodia 25
 - Laos 26
 - Philippines 28
 - Vietnam 30
- LATIN AMERICA AND CARIBBEAN 33
 - Dominican Republic 33
 - Mexico 34
 - Nicaragua 36
 - Peru 37

PC16

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INTRODUCTION TO THE PC16

As a maturing China moves beyond the low-end manufacturing and export-led model that defined its dramatic three-decade rise, a new group of countries is emerging to assume that role in the global economy. The outlines of this group, what we call the Post-China 16, or “PC16,” are only now coming into focus. Indeed, the specific countries may change and the precise roles they play in this transition – their success in following the path China has trod – remain to be fully seen. Even though the movement of two indicator industries – garment manufacturer and mobile telephone assembly – signals change, this is a transition that is as yet pre-statistical; few if any reliable trade numbers or volumes now exist to plot the contours of this shift. But it is, Stratfor has concluded, a shift that is already well underway.

The Post-Cold War world rested on three pillars: the United States, Europe and China. China played a unique role in that world. Starting between 1978 and 1980, China entered the global market; it became the center for the fabrication of low-cost consumer goods, feeding the United States and Europe products at substantially lower prices than if the products were manufactured domestically. China’s advantage was lower labor costs. As a result, more and more of the world’s industrial base shifted to China over time and products that fed industrial production, particularly energy and industrial commodities, flowed into China at increasing rates.

It is important to understand the rough sequence of China’s emergence, as it will help understand what is happening in the countries that Stratfor has designated as the candidates to succeed it: the PC16. China layered industrial growth, aligning it with the capabilities of its workforce. At the beginning, the focus was on entry-level production, requiring limited workforce sophistication. Thus, China excelled in garment manufacture and simple assembly work in electronics, for example. Success in this area generated more sophisticated workers, more investment capital and, over time, significant foreign direct investment. It was the layering process that made China the center of global industrial growth for a generation.

China was not the first country to play this role. Japan preceded it, but it reached the point around 1990 that it could no longer sustain its industrial growth and export model. In a real sense, the United States also played this role between 1880-1900, importing low-cost labor from Eastern and Southern Europe and building a massive industrial plant in a generation, then shifting into a different mode in due course. This cycle has driven the global system since the beginning of the Industrial Revolution. Some countries, such as Germany in 1860, emerged as Great Powers. Berlin hurtled to the top by taking advantage of low wages and a disciplined approach to capital formation. And all of these countries shifted from commodity production driven by wage advantages into more complex and sophisticated economies.

China has now reached the same transformation point its predecessors reached. As with the other countries, it has reached this point in a unique fashion, but the process began when it started to lose its advantage on cheap labor to other countries. Other factors played a role, from a decline in demand for exports, underconsumption in China in favor of investment, rising land prices, increasing costs and so on. But essentially, China's strategy of exploiting its wage advantage has encountered its limits. China remains a significant economic power, but it is no longer operating as before. As with Japan before it, its time as the high-growth, export-driven engine of the global economy is drawing to a close. We will now have a different China.

But the economic niche must be filled. Advanced industrial powers, now including China, take advantage of the law of competitive advantage by focusing on products and services their high-cost, high-expertise workforce can produce efficiently. These more advanced places in turn need countries that can provide low-cost products for their consumption. There is also a segment of Western capital prepared to pursue extremely high returns on substantial risk. As part of their global portfolio, these capital markets need countries at various stages of development in order to both calibrate risk globally and pursue high returns. Outside investment drives industrial development after the first phase establishes viability. For both economic

POST-CHINA 16: EMERGING ECONOMIES



and financial reasons, the new low-wage, high-growth, export-oriented countries inevitably emerge with the slowing of China, the previous generation's leader.

We are now in a position where the main candidates to succeed China have emerged. It is not possible for any one country to replace China. India might have done so, but it has had a more moderate growth pattern, perhaps more sustainable, but one that has already pushed China up the scale. Instead, 16 countries display indicators of becoming China's successors.

Statistics are a lagging indicator. For many of the countries we looked at, they are of little use at this stage of development for two reasons. First, the countries involved invariably maintain extremely poor statistical records in large part because their economies are so primitive. Second, many of the movements we are looking for are so small that they would not register even in the best statistical systems. What we are looking for is the movement of the most basic industries into these countries. Some are brand-new businesses. Others come from China or other countries. These are countries where extremely low wages exist and minimal infrastructure to house workers and transport products are in place.

These are also countries where corruption abounds, political and criminal violence is frequent, and operating a business is difficult. Consider China in 1978. It was less than a decade from civil war in the Great Proletarian Cultural Revolution. After Mao's death in 1976, a power struggle broke out between Mao's widow and her Gang of Four versus Deng Xiaoping. Deng appeared to have won that fight in 1977, but the country was in terrible shape. Disorder was still common, corruption rampant and the rule of law unknown. That is the environment in which this process begins, for many of the PC16 share China's origins.

While no one country can replace China, these 16 have the combined potential to absorb manufacturing that would have gone directly to China in the past decade. Their combined population exceeds a billion people. (We selected these countries without taking population into account, only to later notice the rough equivalence in populations.)

What we were looking for was the movement of garment and footwear manufacture and mobile phone assembly. We were looking for countries where the process had already begun. Both garment and footwear manufacturing and a great deal of electrical assembly are managed by smaller, but still global, contractors. Much larger global corporations farm out major portions of the production process for clothing and mobile phones, and these firms operate several layers down from the ultimate producer. Many of these, interestingly enough, are firms based in India, but there are Chinese and other firms that know how to operate in this space.

In a niche that is always under cost pressure, these companies need to find places where wages are at the lowest. For a long time, this was China, but that stopped being true a few years ago – pinpointing exactly when is impossible. We looked at these two product sets for a number of reasons. First, they are not capital intensive, and the cost of movement is so low that it is highly sensitive to price pressures, and they are first to move. Second, it involves products that can be produced by workers in entry-level countries. Garment manufacturing is usually the first in because the production of garments is familiar to the workforce and there are lower hurdles to organizing into mass production. Mobile phones are a step harder, but build on the experience of garments. Finally, these businesses

compete but information flows easily between them. Where one takes root, several will follow. Where several take root, dozens will move in. We were looking at the countries that were at the “several” stages, as that indicated proof of concept.

It also indicated that infrastructure was sufficiently robust to support exports. In addition, several years of operation indicated enough dynamism and order in the society to recruit and retain workers. It is at this stage that decisions on capital investment are made, in acquiring land, buildings and so on. These are not vast investments on any scale. While ones these firms can afford, they are significant to these firms and therefore a sign of confidence. It is the takeoff point from which more business in these fields will arrive and others in other entry-level business will seriously consider coming. There are other business types we would consider, and when we look at 16 countries as diverse as these, that is inevitable. We discuss that in our country reports.

It is interesting to note the unexpected clusters that emerge. Sub-Saharan East Africa has become a center of activity. Ethiopia, Kenya, Tanzania and Uganda form a contiguous bloc. The northern shore of the Bay of Bengal – Bangladesh and Myanmar – has become another such hub. All of Indochina is active, including Laos and Cambodia. Finally, the southern archipelago of Asia – the Philippines and Indonesia – is active. We also see scattered activity in Latin America, including Peru, Nicaragua, the Dominican Republic and Mexico. When we add Sri Lanka to the cluster, we see that 12 of the 16 are in the Indian Ocean Basin. We believe that the Indian Ocean Basin will emerge as a major area of economic activity, perhaps overseen by an India farther along the curve and therefore in a position to outsource. But the South China Sea is also interesting.

It is important to note that we are not including countries that are showing increased development only because of energy or mineral development and have moved past low-end manufacturing to more advanced industries. Such countries behave differently than industrial developing countries inasmuch as the utilization of labor is much lower and the price of commodities more dynamic. We are also excluding countries that are already well along in development: Their early start has benefitted them, but probably limited their dynamic takeoff.

Mexico is an important exception to this list. Mexico is already heavily developed north of Mexico City. But south of Mexico City, particularly south of Puebla, Mexico is a different country, more part of Central America than North America. We are seeing early-stage manufacturing moving into this region and it appears to be intensifying. Mexico will be an interesting test of a dual-stage country developing. Indonesia shares some of these characteristics with Mexico, but in its case the industrial development is largely confined to Jakarta and a small number of other locations, while much of the rest of the country has the attributes we are looking for. We could obviously also include China in this role, given its underdeveloped interior, but we note that primarily Chinese companies are deploying into the interior, that the types of industries vary widely in level of development, and much of the movement is political rather than economic. So we include Mexico and Indonesia, but not China.

We would be surprised if all of these nations surged and not surprised if other nations joined the group. What we are providing here is an overview of what is happening, and what we think can be sustained because of other considerations.

We have identified what have historically been the necessary conditions and have evaluated them against other needs, like infrastructure and minimal chaos. Out of this has come the PC16, which we now consider in detail.



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