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Left behind – can China learn international lessons to revitalise its rust belt?

NAB Group Economics

When we examine the transition currently underway in China's economic model – away from investment (particularly in heavy industry) and towards a modern consumption based economy –we tend to focus on the net gains to the broader economy. However, periods of transition typically produce winners and losers, with the potential for negative impacts in some regions – an experience exhibited in many once prosperous industrial centres in many Western economies (the so-called rust belts).

THE GRADUAL DECLINE OF CHINA'S RUST BELT

China's traditional rust belt is centred on three provinces in the country's northeast – coastal Liaoning and landlocked Jilin and Heilongjiang. At the start of the People's Republic, these provinces were comparatively well developed, benefiting from access to natural resources and a comparatively higher level of industrialisation– in particular two major steel mills at Anshan and Benxi (both in Liaoning province) that were established during the Japanese occupation.

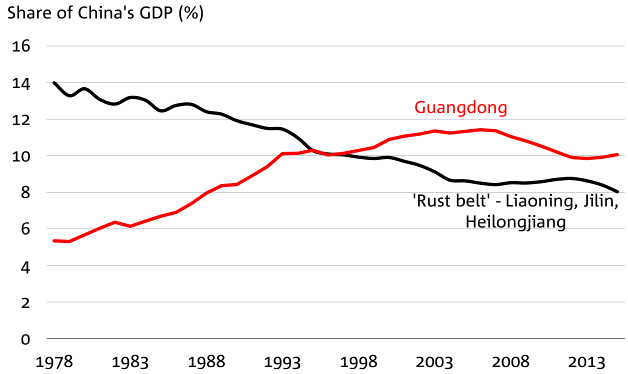
CHINA'S RUST BELT

Three key provinces north east of Beijing

Provincial GDP measures are often considered unreliable – given that the sum of these measures exceeds the national total – however the data points to the changing importance of the rust belt to China's overall economy. In 1960, the region accounted for around one-fifth of China's economic activity. By the start of the reform period in 1978, this share had fallen significantly, to around 14% – as national security concerns had contributed to the geographic diversification of industry centres – albeit these remained primarily located in the northern provinces of the country.

A LONG SLOW DECLINE

Rust belt's falling share of China's GDP



Source: CEIC, NAB Economics

The period of reform and opening up that commenced in 1978 provided considerable benefit to southern regions of the country – which had been underdeveloped until this time. Most notable was the development of Guangdong province (and in particular the Pearl River Delta region) – which quickly became a key manufacturing hub for consumer products (commonly dubbed 'the factory to the world'). The relative performances of Guangdong and China's rust belt since 1978 are stark – the former recorded a sharp increase in its share of GDP (from

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around 5% in 1978 to 10% in 2015 – albeit this level is off peaks in the mid 2000s), while the latter diminished – down from 14% of GDP in 1978 to around 8% in 2015.

In particular, the region suffered during the 1990s reforms to State Owned Enterprises (SOEs) – which saw around 30 million workers lose their jobs across the country. Around one-quarter of these job losses were in the rust belt provinces (The Economist).

The region remains an important steel producer – accounting over 9% of China's output in 2015 – however it has long since been overtaken in importance by neighbouring Hebei – which produced nearly a quarter of the total. It is also a major producer of motor vehicles – at around 16% of the total in 2014.

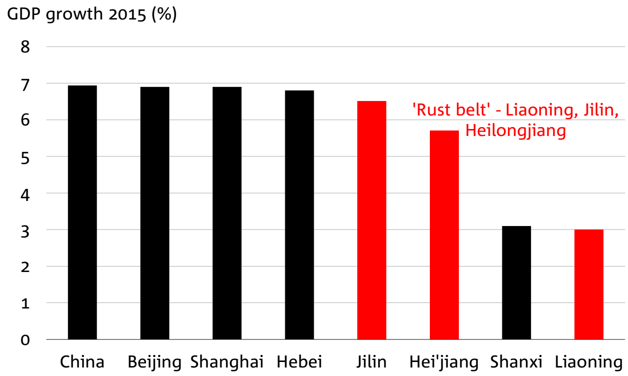
The reliance on heavy industry is somewhat problematic for the rust belt, as China's transition towards a consumption driven economy means that it is increasingly reliant on the faster growing services sector.

RUST BELT REGION POORLY STRUCTURED FOR TRANSITION

The rust belt region has continued to underperform in recent times – as service focussed provinces have driven a greater share of China's growth. In 2015, the three rust belt provinces were among the four weakest growing regions – along with coal-rich Shanxi. Liaoning reported the lowest level of real economic growth, at just 3.0% in 2015, and recorded a decline of 1.0% in the first half of 2016.

ECONOMIC GROWTH IN 2015

Rust belt among the weakest performers



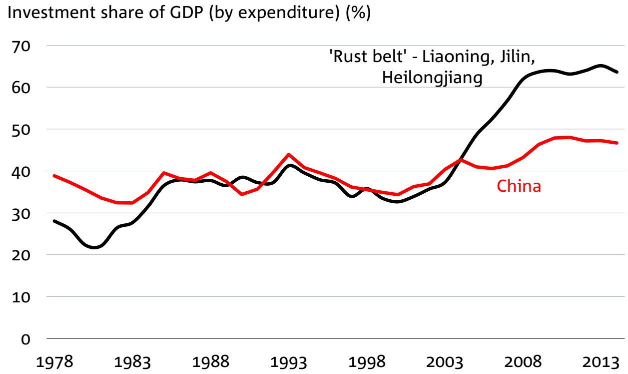
Source: CEIC, NAB Economics

In part, the poor economic performance of the rust belt region reflects an inability to successfully transition to China's new growth model. The rust belt's economic growth has remained overly dependent on investment – with investment's share of GDP at around 64% in 2014 (the most recent data available) – compared with the national share of 47%.

Average wages in the region have lagged the national trend (particularly in Jilin and Heilongjiang), limiting the capacity of consumers to contribute to the broader economic transition.

INVESTMENT SHARE OF GDP

Rust belt over-reliant on investment



Source: CEIC, NAB Economics

Similarly, there are institutional hurdles that prove resistant to change. We have previously highlighted the challenges around reforms to the broader SOE sector, and SOEs represent a larger share of the rust belt economy (at around 50% of regional GDP in 2014) than the national average (around 30%) (The Economist).

CONCLUSION

The experience of rust belts in Western economies highlights the challenges facing Chinese authorities during the economic transition. These regions have typically under-performed in terms of economic growth and have had higher rates of unemployment and social disadvantage. Sustained underperformance could have significant political implications in China – as highlighted by the rise of populism in a range of Western rust belt regions.

The partial reforms to the household registration (hukou) system limit the capacity of rust belt residents to relocate to more prosperous regions. Authorities – particularly at the local level – will have to continue the drive for reform in the rust belt provinces, to reduce the importance of industrial SOEs and support service sector growth.

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