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Preserving "Made in China" in deglobalisation

Locking in supply chains requires continued reforms and opening up

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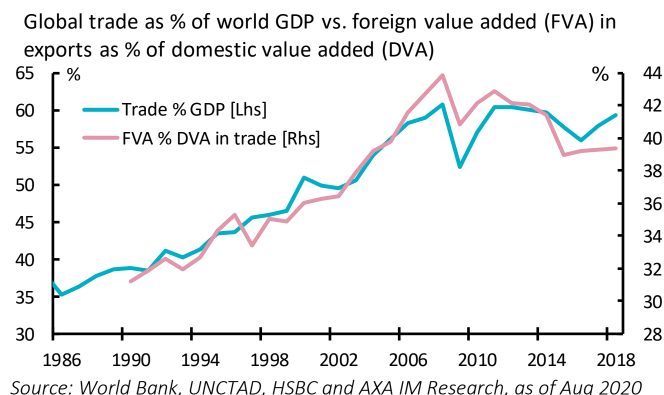
Key points

- After decades of rapid growth, the progress of globalisation has slowed since the global financial crisis, with its fate further complicated by rising protectionism, political interference and the COVID-19 outbreak.
- As the biggest beneficiary, China stands to lose the most in the event of deglobalisation. So far, however, evidence of disruptions has been scant, with some indicators showing that China's market share in trade and manufacturing has in fact risen despite the trade war and pandemic.
- This is not to say that China is immune from any supply chain shifts. Some low-margin businesses have already exited the country in light of rising costs. In contrast, foreign firms seeking to tap China's vast domestic market and supply chain ecosystem are unlikely to leave easily.
- We think the deglobalisation trend will continue but have varying impacts on different industries. In addition, the reshuffling process could be slow and gradual, hampered by the current pandemic and China raising the cost of exits through its own reforms.
- The propagation of the "China Plus One" model could allow China to maintain some influence over the supply chains spreading to other Asian countries, turning "Made in China" to "Made around China" that ends up expediting regionalisation at a time when globalisation is in retreat.

China riding high on globalisation

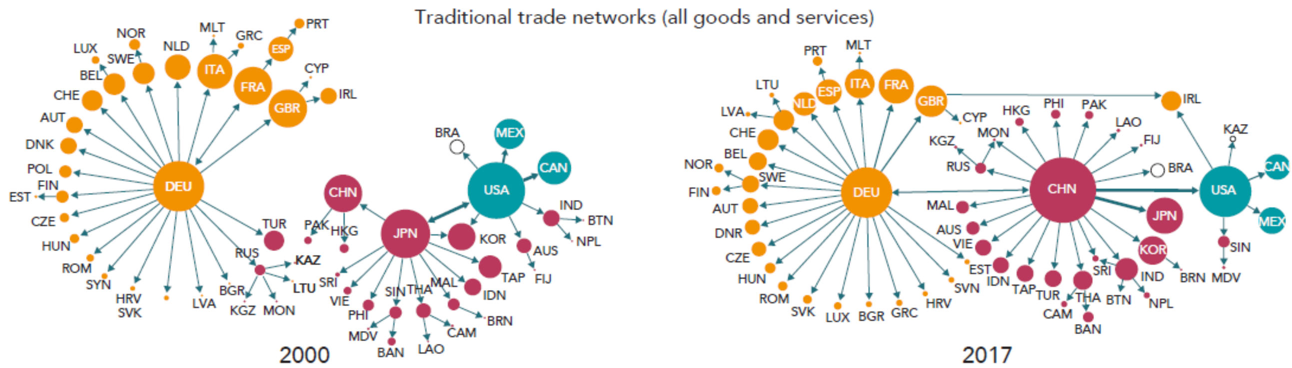
The powerful rise of globalisation has been one of the defining economic developments of our time. By spreading production across multiple countries connected via trade and integrated supply chains, the global economy has achieved momentous efficiency gains and created tremendous values for those involved in the process. As the tissue that connects "economic organs", international trade has experienced a boom since the 1980s. Combined export and import values surged from 35% of the world's GDP to over 60% just before the onset of the global financial crisis (GFC). Exhibit 1 shows that such stellar growth would not have been possible without the propagation of the multi-country production systems that significantly lifted foreign contributions in overall trade value-added.

Exhibit 1: Spreading global supply chains boosts trade



Source: World Bank, UNCTAD, HSBC and AXA IM Research, as of Aug 2020

Exhibit 2: China has transformed from a small to prominent player in global supply chains



Source: OECD and AXA IM Research, as of Aug 2020

China has been among the biggest beneficiaries and drivers of globalisation. Its successful integration into the world's economy – by leveraging its abundant supply of cheap labour, natural resources and pro-business policies – has led to a profound change in China's role from an insignificant regional trade player to one of three vital connectors of global supply chains (Exhibit 2). Today, China is both the world's largest manufacturer and trading nation, backed by the second largest economy with over 800 million workers. Any disruptions to its production system, as recently demonstrated by the COVID outbreak, could send shock waves across global supply chains, affecting economies that would not otherwise be impacted without the integrated web of shared production and trade.

Globalisation already in trouble since GFC

However, the rapid rise of globalisation ran out of steam after the global financial crisis. Global trade as a share of GDP flatlined in the early part of the last decade (Exhibit 1). In part, this reflected a normalisation after a period of exceptional growth, thanks to shifting consumption patterns from easily tradeable goods to services. The decline, however, sharpened more recently as governments around the world tightened trade regulations and pursued protectionist policies that aimed at keeping growth within their borders.[1] The deglobalisation process was, therefore, well underway before it became a widely-debated topic following the Sino-US trade war and COVID-19 pandemic.

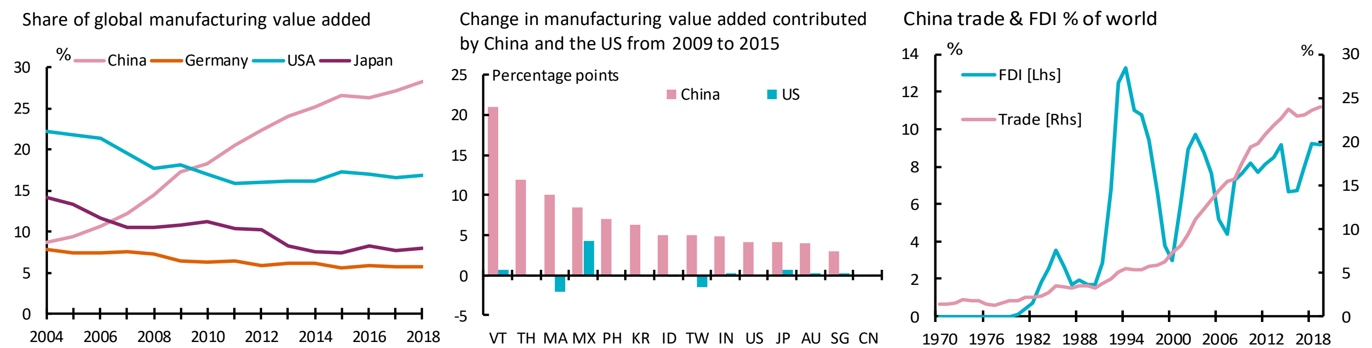
Despite the shrinking pie, China has continued to gain market share in trade and manufacturing. By deploying some of its "RMB4 trillion" stimulus after the GFC to upgrading manufacturing infrastructures, China has managed to buck the declining trends seen in other manufacturing powerhouses and risen to the top of the global league table since 2010 (Exhibit 3). At almost 30% of the global market – doubled since 2008 – China's manufacturing value added (MVA) is now the size of the US, Japan and Germany combined.

While some of these gains were used to meet rising domestic demand, significant growth in manufacturing was also a result of increased production collaboration with others. Exhibit 4 shows that China's contributions to MVA elsewhere have risen strongly, reflecting a strengthening of its production ties with others within its supply chain networks.

Trade war adds insult to injury

Building on the natural protectionist tendency in the period of feeble growth, the Sino-US trade war presented yet another setback to globalisation. Four rounds of tit-for-tat tariff increases saw the average import duties for both countries

Exhibits 3, 4, and 5: China bucks the declining trend in global manufacturing and gains shares in trade and foreign direct investment despite the trade war



Source: World Bank, UNCTAD, WITS, OECD TiVA and AXA IM Research, as of Aug 2020

[1] The Economist, "*Globalisation in Retreat?*" Economist Corporate Network, 2013

Exhibits 6, 7 and 8: China loses market share in the US but gains supply chain connection elsewhere

Source: UN Comtrade, UNCTAD, OECD TiVA, HSBC, AXA IM Research, as of Aug 2020

climb to above 20%, resulting in large declines in bilateral trade flows. With higher tariffs and political frictions creating a hostile business environment, many multinational corporations (MNCs) are under pressure to reconsider their operations in China, leading to fears that a large shift in supply chains could undermine China's economic competitiveness and prosperity.

Contrary to those fears however, the actual trade and foreign direct investment (FDI) flows since 2017 reveal a very different picture (Exhibit 5). It is true that China has lost export market share in the US to the likes of Mexico and Vietnam (Exhibit 6). But its exports to the rest of the world have increased over the same period, with global gains more than offsetting US losses. As a result, China's total export share has in fact risen by about half a percentage point since 2017 (Exhibit 7).

China has achieved this in part due to export diversion. By selling inputs to third countries for assembly before final products are shipped to the US, it has successfully circumvented some of the import duties imposed by Washington. Such a strategy has also pulled China's production partners closer to its supply chain orbits, making them more dependent on its provision of inputs (Exhibit 8).

Winner does not take all

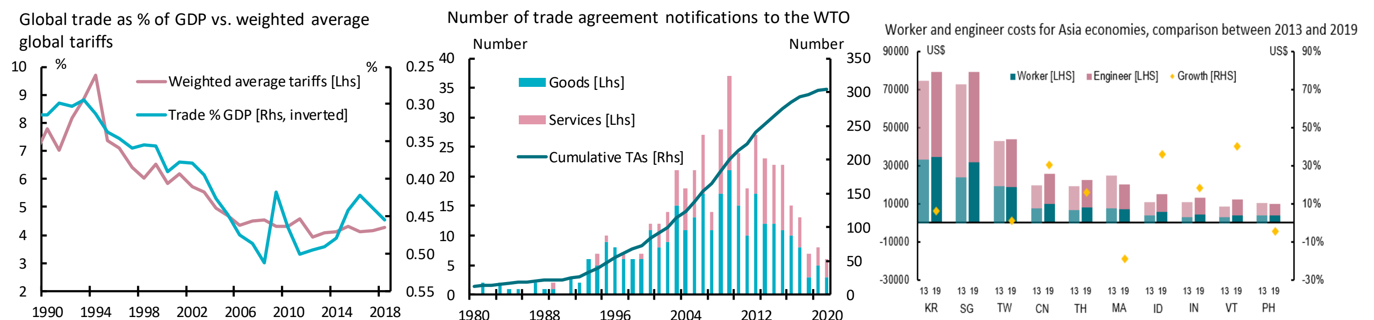
China so far seems to be doing a decent job at protecting its supply chains from the trade and COVID disruptions.

However, deglobalisation is unlikely to prove a cyclical phenomenon. After decades of pursuing free trade and lower tariffs, the world is experiencing a reversal in all these trends (Exhibits 9 and 10). As rising populism and inequality fan scepticism about globalisation, China needs to be prepared for a world that could retrench further into protectionism.

Our previous research[2] offers a framework for thinking about the potential supply-chain moves in and out of China. It puts MNCs into three groups: 1) companies operating in China for its low cost of production; 2) those for its large domestic market; and 3) those for the comprehensive supply chain networks. In reality, these categorisations are not mutually exclusive, with many companies drawn to China by more than one attribute. Still, corporate leaders tend to think in relative importance of their objectives, which makes the above classification still a relevant, albeit simplified, starting point to analyse the issue.

We think the companies that are most likely to exit China are those which are cost-sensitive. Factor costs, including labour, land and utility have risen significantly over the past decade. Within the manufacturing sector, salaries of front-line workers and engineers have risen 30% since 2013 to levels that are now only behind Korea and Taiwan in Asia (Exhibit 11). Not surprisingly, industries with low profit margins have already started to relocate to South East Asian (SEA) countries in recent years, a trend that could be strengthened by higher tariffs and the pandemic.

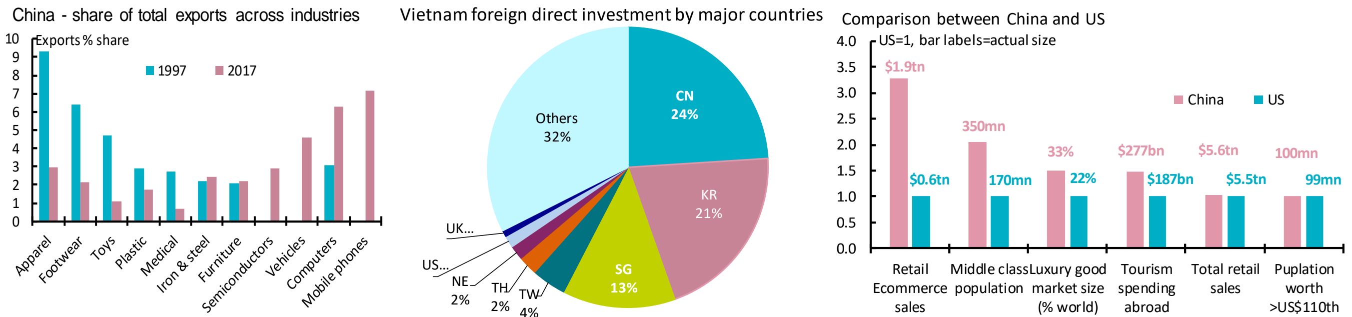
Exhibits 9, 10 and 11: Globalisation in retreat; rising labour costs force supply chain changes in China



Source: WTO, UNCTAD WIPO, JETRO and AXA IM Research, as of Aug 2020

[2] Yao, A., "The world's factory in COVID-19: Can China secure its supply chain kingdom?", AXA IM Research, 18 May 2020

Exhibits 12, 13 and 14: China has moved up the value chain in exports, and become a major source of FDI and the largest consumer market



Source: CEIC, Vietnam government, various sources and AXA IM Research, as of Aug 2020

However, instead of treating this as de-facto evidence of deglobalisation, we see it also as part of a natural progression of the Chinese economy moving up the value chain. One manifestation of the latter has been the changing pattern of Chinese exports, which were dominated by lower-value-added products, such as apparel and footwear some twenty years ago, but are now led by high-margin goods, such as electronics and autos (Exhibit 12). Likewise, China's global market share in footwear and textiles has fallen over the past decade, while that in electronics and machineries has risen.

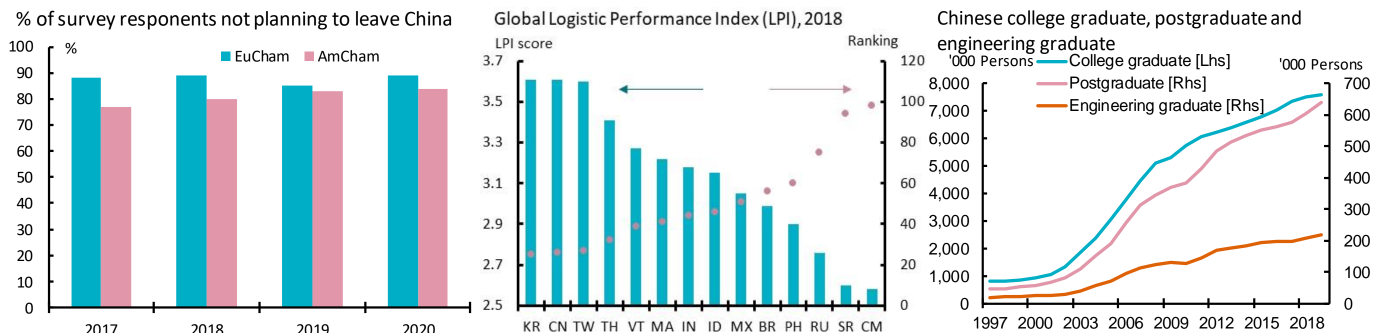
To ensure the commercial viability of low-margin businesses, China has been investing heavily in its neighbouring countries for lower cost of production (Exhibit 13). Anecdotes from the European Chamber of Commerce (EuCham) suggested that it is the Chinese companies – more than foreign firms – that has driven a large portion of supply chain relocation to the SEA region in recent years. But instead of doing so to replace "Made in China", our research[3] showed a rising co-dependency between China and its supply chain partners, suggesting again a broadening of China's production orbits beyond its borders.

Not all are heading for the exit

For the second group of companies, those in China for its domestic market, we think the chance of leaving is quite low. China has now overtaken the US as the world's largest retail market, with higher luxury goods and tourism spending supported by a burgeoning middle class that is already twice the size of the United States' (Exhibit 14). Recent surveys from the American and European Chamber of Commerce in China showed that a vast majority of respondents, who are "in China for China", have no intentions to leave despite the trade war and COVID-19 (Exhibit 15).[4]

Finally, the most uncertain response lies with businesses which are drawn to China by its manufacturing ecosystem. On the one hand, the reasons to stay remain as strong as ever, with China's infrastructure quality, logistic networks and supply of educated workforce unmatched by its emerging market peers (Exhibits 16 and 17). China is also the only country in the world that can produce in all 666 industrial sub-categories of the United Nation's industry classification, creating an unparalleled manufacturing network that can support just about any supply chain configuration.[5]

Exhibits 15, 16 and 17: Many foreign firms do not plan to exit, lured by China's infrastructure quality, logistic networks and skilled workforce



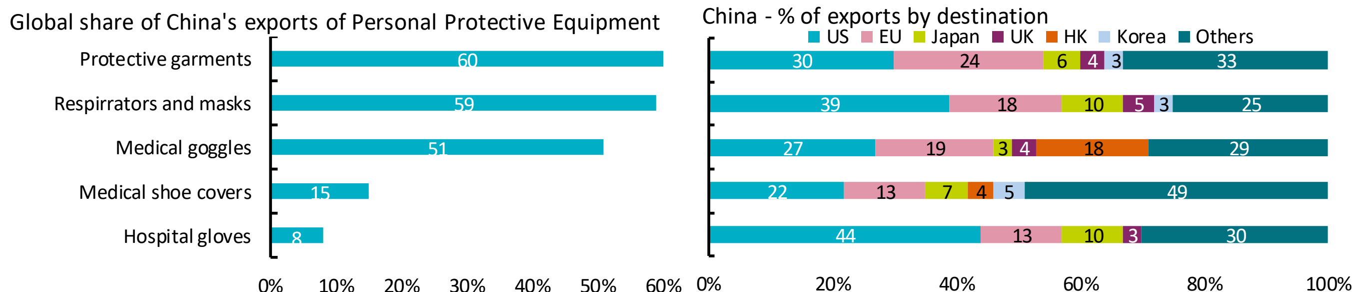
Source: AmCham, EuCham, World Bank and AXA IM Research, as of Aug 2020

[3] Shen, S. and Yao, A., "Asia supply chains: a potential shock to growth", AXA-IM Research Insights, 12 May 2020

[4] Over 80% of surveyed companies in the AmCham and EuCham surveys are in "made in China for China" businesses, which may bias responses. Tesla for example invested over $5bn in 2019 to manufacturing electric cars in Shanghai for the world's largest auto market.

[5] http://www.gov.cn/xinwen/2019-9/20/content_5431714.htm

Exhibit 18: China is the world's largest personal protective equipment manufacturer, with developed countries as its largest customers



Source: UN Comtrade, PIIE and AXA IM Research, as of Aug 2020

However, these merits now need to be weighed against higher tariffs, potential sanctions, technology restrictions and heightened political pressure, which are all parts of the "new normal" business environment that MNCs must adapt to.

So far, the evidence of supply chain shifts by this group is rather mixed. Hard data on trade and FDI is hardly showing any signs of capital flight from China. However, pursuing production diversity and reducing concentration risks are among the key issues facing business leaders, with some surveys[6] of foreign firms indeed indicating a higher propensity to exit China than those shown by the AmCham and EuCham surveys.

We think some supply chain reshuffling – at the expense of China – is inevitable, although this may not occur at the pace and form anticipated by most. We discuss four conjectures on future supply chain changes in the next section.

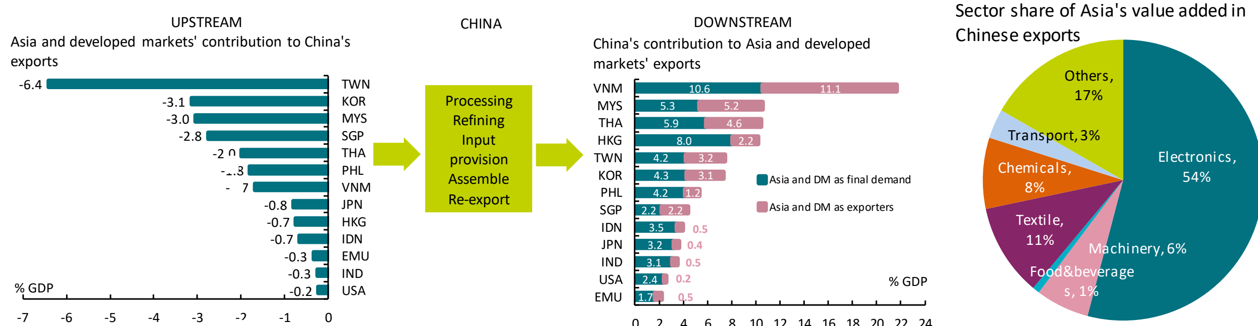
Four prognoses on supply chain reshuffle

Our overarching prognosis is that many companies will not see the supply chain repositioning as an "either/or" decision. The practical choice probably lies in between exiting China completely and maintaining the status quo, with the actual changes more nuanced and sector specific. Below are four conjectures:

First, the Personal Protective Equipment (PPE) industry will likely see some dramatic changes to its supply chains. The COVID-19 pandemic has exposed the vulnerability of countries outsourcing these products from foreign suppliers, compromising security for efficiency. We expect heightened political pressure and tougher regulations to force a reshoring of PPE production globally. Being the largest supplier of these products, with its biggest customers – US and Europe – most wary of national security risks (Exhibit 18), China stands to lose the most from a material shift in these supply chains.

Second, the technology industry is also susceptible to large changes as the global tech war rages on. While conflicts between the US and China have been the most eye-catching, plenty of frictions elsewhere – in tech regulations, digital taxation, cybercrimes and anti-monopoly lawsuits – could also change how the industry operates and supply chains are deployed. Our previous analysis[7] showed that electronic manufacturing accounts for more than half of Asia's export value added, with China at the centre of the production ecosystem (Exhibit 19). The potential losses for China in this area could be substantially larger than that for PPE.[8]

Exhibit 19: China lies at the core of Asia's supply chain ecosystem, which is dominated by electronic manufacturing



Source: OECD TiVA and AXA IM Research, as of Aug 2020

[6] For example, various of USB surveys of MNC CFOs this year showed 60-85% of foreign firms are planning to move parts of their supply chains out of China. See UBS Evidence Lab inside*: Supply Chain Decoupling Accelerating? – China CFO Survey* March 2020.

[7] See Shen, S. and Yao, A., (2020) referenced in footnote 3.

[8] Already, there have been some high-profile moves out of China in recent years, with Foxconn redirecting some operations to India and Samsung reportedly investing large sums in Vietnam to hedge China risks. With the competition around 5G heating up between China and the US/European Union, supply chains centred on these technologies for products, such as autonomous driving vehicles, industrial robotics, and basic consumer electronics, could all be disrupted if tariffs and sanctions are used to get an edge in the competition.

Beyond the manufacturing of electronics lies the more systemic issue of a potential "tech decoupling" on a global scale. As the world's leaders in technology are increasingly competing in what's perceived as a zero-sum game, supply chains built on foundational technologies, such as 5G, could be fractured by multiple technical standards and incompatible networks. With global manufacturing increasingly fused with technology, such tech fragmentation could speed up deglobalisation in the real economy, undermining the prospects for not just China, but the world at large.

Our third prediction is on timing – in the absence of strong political pressure, the supply chain reconfiguration will be a slow and gradual process. With the ongoing pandemic, corporates have significantly scaled back capital expenditure. In China, despite the initial outbreak, the country is now leading the rest of the world in controlling the virus and resuming production. This is not the best time for MNCs to redirect supply chains away from a base where the operational capacity is most secure and reliable.

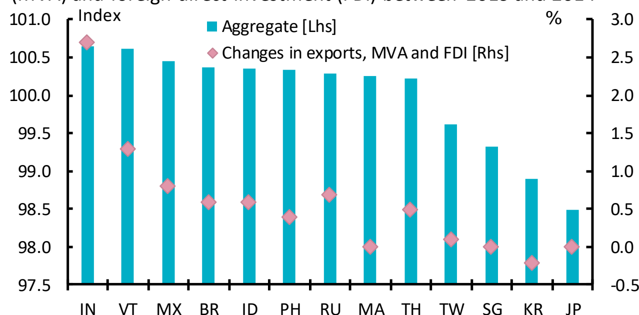
In addition, investors pay close attention to the short-term performance of listed companies. If one decided to shift production while its competitors stayed put, the cost of such a transition could hit the company's bottom line and stock price, forcing decision-makers to think twice before implementing sweeping changes.

Finally, continued reforms in China could raise the opportunity cost of exits. Recent moves by Beijing to reduce FDI restrictions, strengthen intellectual property protection, accelerate financial sector liberalisation, and open up monopoly industries[9] are all aimed at creating a more accessible market and levelling the playing field. While these moves may not prevent supply chains from leaving China, they could slow the process.

Our final conjecture concerns the leavers, among whom few, in our view, will likely abandon China completely. This is consistent with recent surveys showing that a popular approach among MNCs is to develop a "China Plus One" model, whereby only a fraction of their operations in China are moved to another country to serve as China's back-up.

Compared to reshoring or a replacement strategy, the China Plus One model may in fact strengthen China's supply chain linkages with its trading partners. Among those who are most likely to benefit are India and Vietnam in this region, based on our analysis of labour costs, infrastructure quality, ease of doing business, economic competitiveness and political stability. Our relative competitiveness scores, presented in Exhibit 20, have correlated well with recent trade and FDI flows.

Exhibit 20: Emerging market countries in Asia could gain the most from the supply chain reshuffle



Source: World Bank, multiple sources and AXA IM Research, as of Aug 2020

From "Made in China" to "Made around China"?

The upcoming supply chain reshuffle will undoubtedly create winners and losers. China's inevitable losses, particularly in low-value-added segments, could benefit other emerging market countries. Some of those may be from outside the region, like Mexico – given its proximity to the US, but we think the majority of the reshuffle will occur within Asia. Given that no-one in the region can replace China any time soon, they will be dependent on its provision of inputs, which may end up strengthening China's position at the centre of Asia's supply chain ecosystem. With the right reforms and cooperative mindsets, China could orchestrate a transition from "Made in China" to "Made around China" that accelerates Asia's regional economic integration at a time when globalisation is in retreat.

The above version of supply chain reshuffle could have a benign impact on China's long-term growth. Even without the adverse – deglobalisation and protectionist – shocks, China's own maturing economy will require it to abandon some low-margin businesses for higher value-added activities, creating a natural shift in its supply chain compositions.

There are, of course, risks of more pernicious changes, if:

1. A wider political divide forces a greater "decoupling" between China and the US/ the west,[10]
2. A lack of adequate reform by Beijing to lock in foreign investment and supply chains, and
3. A more serious tech fragmentation causes collateral damage to the real economy.

In all these cases, the potential loss in economic efficiency would not only set back China's long-term growth, but also add pains to a global economy that is already struggling to recover from the severest recession in generations.

[9] Yao, A., "US-China: A silver lining in a strained relationship", AXA-IM Research Insights, 15 January 2020.

[10] We do think a Biden administration may approach China differently at least on trade issues by relying more on a multilateral, instead of bilateral, context. For more detail, please see Page, D "US presidential election preview: You're fired?" AXA-IM Research & Strategy Insights, July 2020

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