



FOR PROFESSIONAL INVESTORS – 19 August 2021

Chi Time

WHAT DECOUPLING FROM CHINA? A NEW THESIS FROM ASIA'S SUPPLY-CHAIN SHIFT

You cannot control what happens to you, but you can control your attitude toward what happens to you, and in that, you will be mastering change rather than allowing it to master you.

Brian Tracy

“Decouple-from-China” has been a prevalent thesis since the Sino-US trade war in 2018, with some large developed countries pushing for re-shoring of their global production. This has led to the concern about the breaking up of Asia's supply chains that accentuate China's role in global trade and shaken the argument for investment in the region, including China. Yet so far, Asia's supply chains have simply shifted, but not broken or shrunk and, contrary to conventional wisdom, have integrated more with China through a different way from what the market understands.

Restriction on technology transfers, among other trade disruption, amid the Sino-US trade war are creating the biggest uncertainty for Asia, where a third of its exports are electronic and tech products. The Covid-19 health crisis has aggravated the worry about Asia's manufacturing outlook by disrupting the global supply chains and creating shortages of everything from car, and even bicycle, parts to semiconductors.

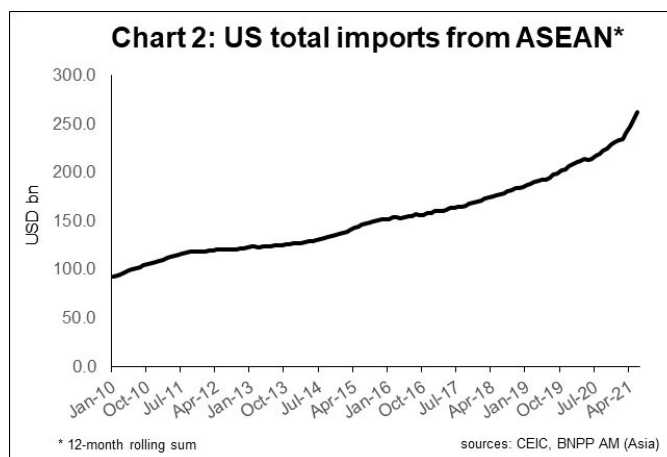
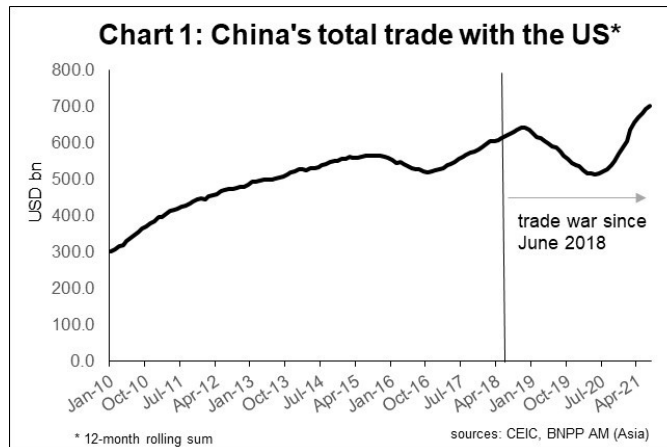
ASIA'S SUPPLY CHAINS NOT BREAKING, BUT ONLY SHIFTED

Though these worries have driven some large companies to cut their sourcing from or manufacturing operations in Asia and shift them elsewhere, there is no trend of decoupling from both the region and China. Firstly, despite the trade war and the pandemic, which severely depressed demand, Sino-US bilateral trade has continued to rise (Chart 1), defying expectations. This is partly because US shipments to China picked up, even though Chinese purchases fell short of the Phase One deal. Secondly, rather than reducing their reliance on Asian supply chains, US importers have increased imports from ASEAN (Chart 2).

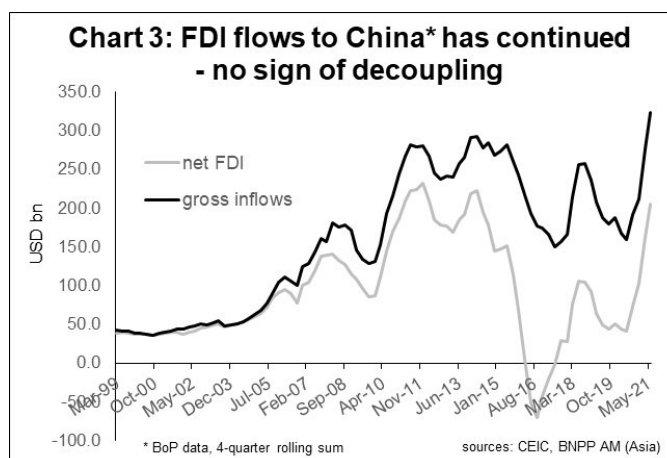


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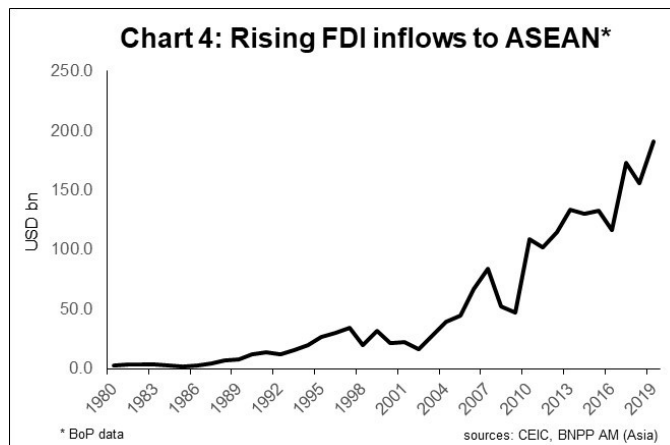


Hence, there is a shift rather than a shrinkage or breaking of Asia's supply chains. Take the tech sector, the epicentre of Sino-US competition. While policy risk has prompted companies to re-evaluate their production locations, there has been no trend of exodus from China. On the contrary, FDI flows to China have continued to rise, both in gross and net terms (Chart 3).



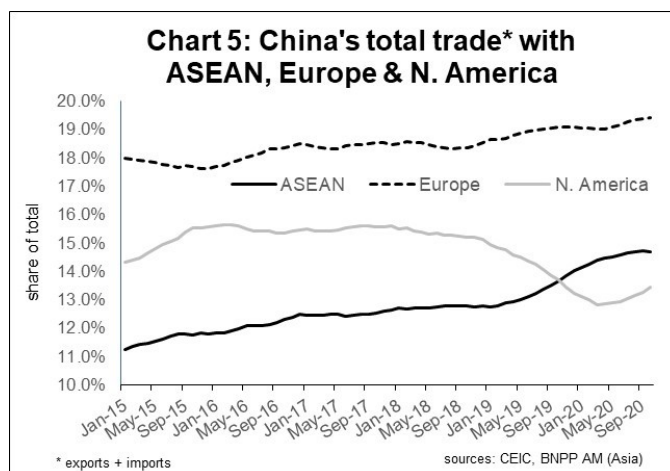
NO DECOUPLING

Buying more from ASEAN does not mean buying less and/or decoupling from China. Rather, that shows a so-called “China + 1” strategy, in which companies keep producing in China for the local market while move some capacity elsewhere, notably to ASEAN. The relocation move is a means to manage the supply chain disruption due to economic, political and most recently Covid-19 considerations, and is reflected by the rising FDI trend to ASEAN (Chart 4). The China inertia underscores my long-held “Invest in China for China” view since the US shifted its China policy from constructive engagement to strategic competition in 2016.



Crucially, a large share of the FDI flows to ASEAN comes from China, which accounts for 40% of the total now as compared to only 10% a few years ago. This only strengthens the supply chain integration between ASEAN and China, which is an obvious defiance of the decoupling thesis but in a different way.

Components used to be shipped from ASEAN to China which then sold to the world markets. That made China the world's factory. Now the process seems to be reversing, with China supplying ASEAN products that power the region's exports to the world. This shift in the supply-chain integration process has expanded the world's factory to include both China and Asia. Indeed, Sino-ASEAN trade has exceeded the size of the Sino-US trade (Chart 5), reflecting not only the huge potential of economic linkage between the two sides but also their cooperation through the pandemic despite shrinking global demand and increasing protectionism.



IMPLICATIONS

Asia's supply chain shift also reflects China's "dual circulation" policy to use its internal growth impetus to drive domestic and regional growth and, as I argued recently, forms a basis for long-term investment in EM Asia and China¹. From the regional perspective, Asia's supply chains have proven highly resilient to starve off disruptions to the global system.

From the macroeconomic perspective, this development will lead to the rise of regionalism with strong intra-regional economic linkages against a de-globalisation backdrop, in my view². With inflation concerns now rising in the developed world and companies facing rising input price pressures, the cost advantages of sourcing from Asia, whose supply chains have integrated further with China, are becoming more crucial than before.

In the post Covid-19 world, domestic demand growth, import substitution and technological self-sufficiency would drive investment decisions and opportunities in China. For the regional economies, sectors and companies catering for Chinese demand and those leveraging on the supply-chain shift process to cater for world demand should be favoured, *ceteris paribus*.

In a nutshell, subtle shifts are underway to make Asia, ASEAN in particular, an emerging production hub for the world markets. There is little evidence of global and regional decoupling from China, which remains the key player in the global supply chains; one can run but cannot hide from the Middle Kingdom.

Chi Lo, Senior Economist, BNPP AM

¹ See "Chi Flash: China and the Bullish EM Asia Story", 6 January 2021.

² See reference in footnote 1.

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