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Breaking chains – will Chinese manufacturers lose in the post-COVID world?

NAB Group Economics

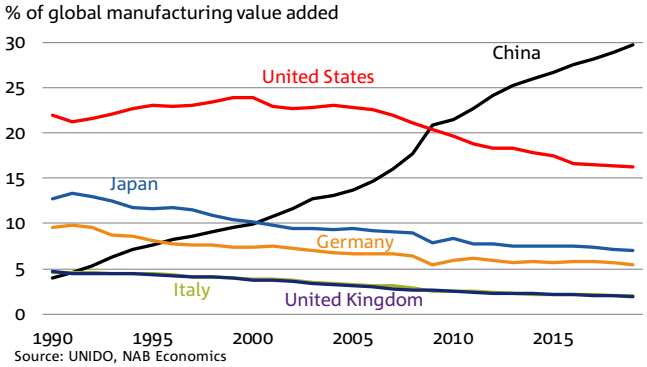
Recent years have witnessed significant disruptions to global supply chains – initially due to tariffs implemented during the US-China trade war and more recently due to the COVID-19 outbreak. These disruptions highlighted vulnerabilities that had developed in these networks over recent decades, as China has become a dominant force in global manufacturing. However, competitive pressures and the response of multinational corporates to recent supply chain disruptions and government policies could see Chinese manufacturers lose share in a post-COVID world.

CHINA DEVELOPED INTO THE CENTRE OF GLOBAL SUPPLY CHAINS...

China's industrial led development over recent decades coincided with a period of rapid globalisation. Multinational corporations sought to take advantage of lower manufacturing costs in Asia, with China a major beneficiary of investment due in part to its vast pool of migrant workers. In 1990, China accounted for around 4% of global manufacturing value added, making it the sixth largest producer overall – trailing far behind the United States, Japan and Germany. In 2019, China was by far the largest global manufacturer – with a share of almost 30% of total output – having overtaken the US in 2009.

GLOBAL MANUFACTURING BY COUNTRY

China has come to dominate the sector



Source: UNIDO, NAB Economics

This highlights the fact that China has become a critical link in global supply chains – taking in raw materials and semi-manufactured products from near neighbours to produce consumer and capital goods for domestic and international consumption. The development of these supply chains was largely based on efficiency – attempting to drive costs as low as possible – with little focus on other considerations, such as flexibility or resilience.

While these supply chains – particularly between East Asia and China – suffered as a consequence of US tariffs on Chinese exports during the trade war in 2019, the lack of resilience was exposed by China's countermeasures in response to COVID-19. Industrial production plunged as factories in several key regions were closed, impacting supplies of auto parts to international manufacturers (most notably Hyundai in South Korea), as well as segments such as high-tech electronics and pharmaceuticals.

Although the supply side of China's economy has driven its recovery from COVID-19, the damage caused by these disruptions could accelerate some changes that were already underway in global supply chains.

...BUT SUPPLY CHAINS ARE EVOLVING

Changes to supply chains generally occur slowly, meaning that it can a long time to identify shifts in trends. One such trend that has gradually become more apparent in recent years is that supply chains have become more regional and less global. In part, this reflects the increasing amount of consumption in emerging market economies – particularly in China and other emerging Asia. Growing domestic consumption is evident in long run data on emerging

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market industrial production and exports – with export growth slowing relative to production.

EMERGING MARKET EXPORTS

Export growth slowing as domestic consumption rises

Source: CPB, NAB Economics

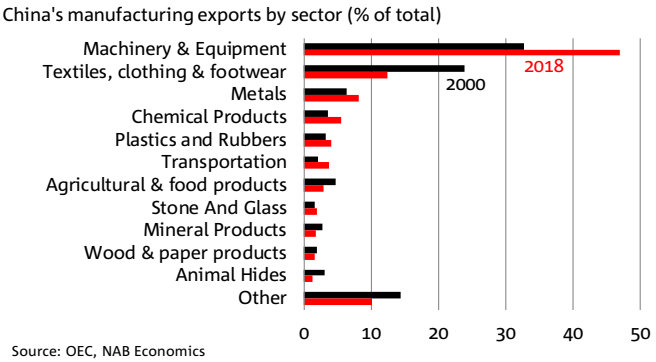
However this also reflects manufacturing and sourcing decisions, such as increasing the speed to market, reducing transport costs and managing supply to reduce the risk of overproduction. In addition, the increasing adoption of automation can reduce the benefits of lower labour costs in offshore markets.

Despite China's rising importance over multiple decades to become the world's largest manufacturer and exporter, exports are becoming less important to China's economy. Exports as a share of GDP peaked at around 36% in 2006 and has subsequently declined – falling to around 18.4% in 2019. Similarly, China's import share of GDP has fallen, as Chinese manufacturers have gradually replaced other suppliers of intermediate inputs.

A high level overview of Chinese manufacturing overlooks the significant shift in the composition of China's production and exports in over recent decades. In part this reflects Chinese manufacturers moving up the value chain. It also reflects the loss of competitiveness in lower value areas, such as basic textiles, clothing and footwear production. Global production of these goods has been shifting towards other economies in South and East Asia.

CHINA'S MANUFACTURING EXPORTS

Shift to higher value goods over time



Source: OEC, NAB Economics

That said, disruptions caused by the US-China trade war and COVID-19 lockdowns could accelerate the loss of higher value export production. One high profile example in Foxconn, a Taiwanese electronics firm that is a major assembler for Apple and other electronics brands. Foxconn is expanding non-Chinese production capacity – in part to avoid trade barriers – with the proportion of its manufacturing capacity outside China rising to 30% in mid-2020, from 25% in June 2019. A range of countries, including the United States and Japan, have announced or are considering policy incentives to bring manufacturing back onshore.

CONCLUSIONS

The evolution of global supply chains has been broadly negative for export oriented Chinese manufacturers in recent years – with increased regionalisation and trade barriers encouraging development away from China. The shocks created by COVID-19 related disruptions could result in more diversity in global sourcing to minimise the risk of a similar outage, as well as accelerating developments around automation and other technologies that could reduce demand for Chinese produced goods in global markets.

Despite the partial trade deal between the United States and China that was signed in January, trade tensions between the two countries could be reignited. The Trump Administration has prohibited US firms from transacting with a range of Chinese corporations – particularly in the tech sector – and recently commented about "decoupling" the two economies.

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