China Economic Update July 2023

Any significant change to global supply chains will take time

NAB Group Economics

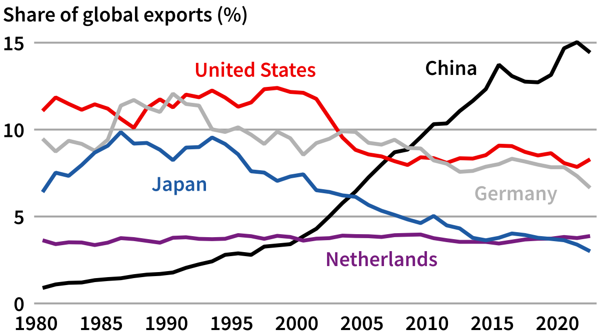
Various disruptions to global trade in recent years – including the impact of the US-China trade war and the COVID-19 pandemic – have raised questions about how global supply chains will be structured over the longer term, particularly the potential for a shift away from China as a key link in the delivery of goods to advanced economies. While there have been some high-profile examples cited in recent times, any significant realignment of global supply chains will be a slow process (assuming that it does not prove impractical).

Can firms really remove China from its central role in supply chains?

China's central role in global supply chains was a gradual development over multiple decades. The country accounted for less than 1% of global merchandise exports in 1980, with the initial stages of industrialisation (associated with the period of reform and opening under Deng Xiaoping) pushing this share up to 3.8% in 2000. However, it was China's entrance into the World Trade Organization in 2001 that saw more rapid growth in export-oriented industry – as tariffs and other trade barriers in major export markets were reduced. This supported a substantial increase in China's share of global exports – which peaked at 15.1% in 2021.

Global exports

China's share of trade expanded following entry into the WTO



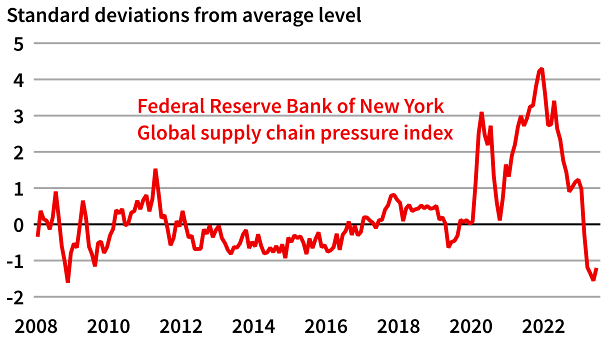
Source: Macrobond, NAB Economics

This increase in share came with considerable controversy, with various countries accusing China of unfair trade practices over time. This came to a head during the Trump Administration, when the imposition of tariffs by the United States triggered a tit-for-tat trade war between the two countries. This raised concerns among global multi-nationals around the longer-term viability of China-centric supply chains.

These concerns were intensified by the COVID-19 pandemic, when the initial wave of the virus exposed the fragility of these supply chains. Closures to China's industrial capacity, disruptions in global transport and logistics, and limited inventories (due to just-in-time management practices) constrained the flow of goods to advanced economies, just as the measures to control the virus in these countries increased demand for goods due to restrictions on services.

Global supply chains

Initial COVID-19 wave and zero-COVID policies contributed to disruptions



Source: Macrobond, NAB Economics

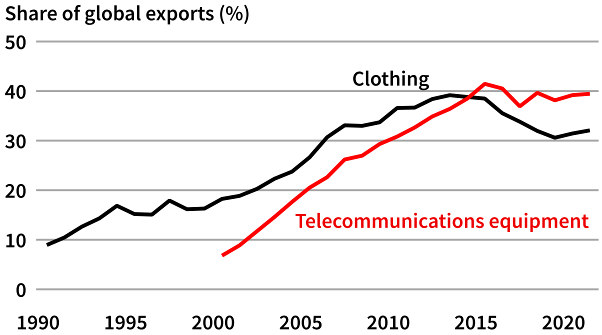
The trade war and pandemic raised debate around the future structure of global supply chains – including the scope for a further shift in production from China to its near neighbours in East and South Asia. Other potential developments include "near-shoring" or "friend-shoring" – moving production to closer and/or more diplomatically aligned countries to major advanced economies – or indeed bringing production capacity back to the major consuming nations.

A high-profile example of the shift away from China is the proposed increase in production of iPhones in India. Apple and its manufacturing partners started assembling lower-end versions of the iPhone in India in 2017, while cutting edge models started assembly in 2022. JPMorgan estimate that around 5% of iPhones are now produced in India, and this share could rise to around one-quarter by 2025. However, this estimate overlooks the full value chain of manufacturing, as the Indian plants are responsible for the Final Assembly, Test and Pack phase of production and still rely on components manufactured in China.

Relatively simple or low value-added manufacturing (such as clothing) shifted away from China from around 2013 onwards – prior to the US-China trade war – as lower wages in other East and South Asian economies and low capital costs made the shift in supply chains highly profitable.

China exports

Lower value output already declining



Source: Macrobond, NAB Economics

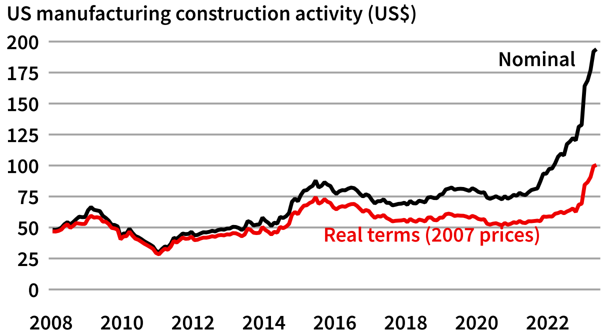
In contrast, higher value-added manufacturing (such as electronics or motor vehicles) typically has more intermediate processes within the value chain and are more capital intensive. Other emerging economies frequently lack the necessary industrial base and infrastructure necessary to support large scale end-to-end production in these sectors (when compared with China), including insufficient transport and logistics facilities to manage distribution of components and finished products or the engineering services necessary to rapidly address complex problems when they emerge or upgrade products over time.

More generally, the relatively smaller size of the labour force in other emerging markets is likely to constrain a rapid transition away from China. Only India can match China in terms of the scale of its workforce, but India faces various regulatory and administrative constraints that makes it less attractive to investment – with India ranked at 62 in the most recent (2021) World Bank Doing Business report, well behind China at 32.

That is not to say that a realignment in global supply chains is impossible, rather that it will take concerted effort and substantial investment over many years to accomplish. Various reports have suggested that US firms are seeking to expand investment in the northern states of Mexico, however this is yet to conclusively appear in foreign direct investment data (albeit this may be a lagging measure). There are clearer signs of firms investing within the United States – reflecting incentives in recent policy measures such as the Inflation Reduction Act and the CHIPS Act – with real manufacturing construction increasing by over 52% year-on-year in the first five months of 2023.

US manufacturing construction

Surge in building activity in early 2023



Source: Macrobond, NAB Economics

Conclusions

Despite the hype generated by high profile shifts in manufacturing away from China – such as iPhone production in India – China will remain a key player in global supply chains in the near term, reflecting legacy investment in complex integrated manufacturing processes and associated services that are difficult to efficiently circumvent. Longer term, the willingness of multinational firms to invest in alternative supply chains may depend on a range of factors – including the relative costs of labour and other inputs as well as government policies (including trade barriers and other populist anti-globalisation measures, industry or tax support) that could impact decision making.

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