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US-China Decoupling: Risks and Opportunities for Asia

Decoupling comes with risks and opportunities

Steadily escalating economic tensions between the United States and China have given rise to a new term: “decoupling.” Although many trade observers have long assumed that conflict cannot take place between economies that are deeply economically entangled,¹ the over the past three years, this assumption has been sorely tested.

A range of decisions by both countries has pointed to an economic future that is much more disconnected, particularly for products in the technology space. This includes more than just the imposition of tariffs on a growing array of products. It includes prohibitions on working with specific firms and enhanced security screening on all inbound investment. Screening is increasingly being extended to firms operating globally and not just in the US or China.

As the splits between the two sides becomes more entrenched, it is likely to become increasingly challenging for companies to operate using existing footprints. A reshuffling of supply chains, especially, presents a host of new risks and opportunities for companies operating in Asia.

Much of the early focus on decoupling has focused attention on adjustments in semiconductors and other specific products, has been based on arguments about what firms based inside the US or China might do, and has largely ignored companies located in neither country that are bound to be caught in escalating tensions in the future.

This *Policy Brief* begins to consider what decoupling will mean for other types of products, how firms are actually responding to changing economic conditions, and what firms based in “third countries” like the rest of Asia are likely to do in response to increasing pressures from the US or China.

These are still relatively early days of decoupling, with significant uncertainty likely about specific policy

directions in both the US and China and confusion around what firms can realistically accomplish in a radically disrupted economic environment.

This *Brief* sets out some initial thinking on the topic, prompted by a series of interviews with firms in the technology space with operations across Asia. Future installments will continue to track developments as companies gain greater clarity on the likely political and economic landscape in the coming years.

Decoupling has prompted the reassessment of the risks of global supply chains

The trade war between the two economic giants as well as the COVID-19 pandemic have prompted the reassessment of the risks of global supply chains and have led to much speculation about appropriate levels of reshoring and reduced reliance on China.² These twin shocks have pressured many firms to consider relocating at least a part of their supply chains out of China in an attempt to balance resilience with efficiency and reduced costs.

According to a survey of 3000 companies conducted by the Bank of America (BoFA) in February 2020, companies in more than 10 of 12 global sectors in each of North America, Europe and Asia-Pacific (excluding China) have implemented or announced plans to move at least a part of their supply chains from current locations.³ The main drivers cited for the shift include trade disputes, national security concerns, climate change, and automation.

Firms in two-thirds of global sectors in North America have either already implemented or announced plans to pull out at least a portion of their supply chain out of China, with the most impacted sectors being consumer durables and apparel, retailing, technological hardware and equipment, and semiconductor manufacturing.⁴

Another survey of 260 global supply chain leaders conducted by Gartner, Inc. in early 2020 found that 33 percent had moved sourcing and manufacturing out of



China or have plans to do so in the next two to three years.⁵ Companies expressed that their desire to move was due to the tariffs imposed by the US which led to an increase of up to 10 percent of supply chain costs for more than 40 percent of the firms surveyed.

However, US companies are not completely moving out of China just yet

While the COVID-19 pandemic exposed new vulnerabilities in the production and supply strategies of firms conducting business in China, some research suggests that the actual number of companies fleeing China is relatively small and that this shift predates the pandemic. According to a survey conducted by the American Chamber of Commerce in China, over 70 percent of companies surveyed stated that they have no plans yet to relocate production and supply chain operations or sourcing out of China due to COVID-19.⁶

Dr Yossi Sheffi, Director of the Centre for Transportation and Logistics at the Massachusetts Institute of Technology (MIT), argues that the prediction that companies are going to abandon China is misguided and that foreign companies will continue to stay and instead established smaller-scale operations elsewhere as a hedge against total dependency on the Asian country.⁷

A “China + 1” strategy has long been seen as an alternative way to diversify supply chain risks while continuing to tap into China’s market opportunities. Rising costs in China have driven many existing supply chain adjustments which have accelerated under the US-China trade war and pandemic stresses. While firms have shifted some production already out of China, it is economically risky for companies to completely ignore the unique advantages that China offers including its quality infrastructure and sizable domestic market, which serve as strong incentives for firms to stay put.

American firms are not the only ones rethinking their global production and distribution pathways. The latest EY Capital Confidence Barometer report revealed that 67 percent of Asia-Pacific executives are taking measures to change their supply chains.⁸

Shifts in supply chains are not necessarily a win for the US

US President Donald Trump’s aggressive trade policy with China was meant to encourage more companies to

bring manufacturing back to the US. However, it appears that the economic incentive to outsource and not reshore production still prevails.

For many American companies, supply chain resilience means diversifying supply chain production, not concentrating it in the United States. Furthermore, uncertainty in product demand for the future has made many business leaders hesitant to make expensive investments in new factories in the US.

Moving major production facilities takes time and is costly. BofA estimates that it would cost US\$1 trillion in costs over five years for all foreign firms to relocate their manufacturing operations out of China.⁹ Largely as a result of the significant costs involved, many US companies have been reluctant to follow President Trump’s calls to pull out of China and relocate or reshore production and manufacturing of products to the US.

Many companies who are relocating parts of their operations out of China are moving to where wages are low. Southeast Asia and India have been cited as planned destinations for many North American and Asian supply chains.¹⁰ Mexico is another potential destination for American firms as local wages are relatively low and it is in close proximity to American consumers. In 2019, Mexico overtook China to become the US’ largest trading partner.¹¹

A variety of governments around the world are also putting in place a range of policies to help drive supply chain reshuffling. If firms are going to move out of China or adjust chains for better positioning for future growth, governments would like to attract such investment to their own shores. As a prominent example, Japan gave out \$653 million in subsidies to 87 companies to relocate from China to Southeast Asia (including Vietnam, Myanmar, Thailand) or back to Japan. This funding is insufficient to draw all firms, as the cash on hand appears to only affect 1 percent of Japanese investment in China. It does, however, show that governments around the region support efforts to diversify supply chains.

Spotlight has been on semiconductors and pharmaceutical manufacturing

Two sectors that have been under the spotlight for reshoring back to the US are semiconductors and pharmaceutical manufacturing. Semiconductors are one of America’s largest exports, but the US only accounts



for around 12 percent of global semiconductor production capacity.¹² The US government is set to invest tens of billions of dollars in the semiconductor industry, with an emphasis on domestic manufacturing, over the next five to 10 years to give the US an edge over China.

The trade war has also led to some multinational companies to open new facilities in the US. For example, Taiwan Semiconductor Manufacturing Company, the world's largest contract chipmaker whose clients include Apple Inc., announced in May 2020 that it would build an advanced chip factory in Arizona.

While semiconductors have been at the leading edge of many discussions on decoupling,¹³ the pandemic has also revealed the extent of American dependence on China for health care products ranging from personal protective equipment to pharmaceutical drugs. The US International Development Finance Cooperation is looking to offer billions of dollars to help reshore manufacturing of protective equipment and medicine. The Trump administration has also been considering other incentives such as “reshoring subsidies” to attract factories back to US soil.

While the US has its eye on supporting the semiconductor and pharmaceutical manufacturing sectors, attention should also be given to other sectors including technological hardware, software, services and even apparel which are also expected to be disrupted due to the decoupling of the two global superpowers.

Managing Resilience Internally

Reporters from across the globe have been breathlessly reporting on the supply chain diversification and risk mitigation strategies that are presumed to be underway. However, the concrete evidence from the ground suggests some significant challenges with the ideas that firms have already been and will continue to rapidly shift supply chains.

Most companies that believe they may be exposed to an ongoing set of trade tensions between the US and China have engaged in internal reviews and scenario planning. COVID-19 has both put a hold on and, paradoxically, accelerated some of this thinking. While the pandemic has made it difficult for many companies to focus on strategy not directly related to immediate survival and management of a series of supply chain disruptions

caused by market shutdowns, it has also amplified the risks of potential exposure to new challenges.

Every company has begun talking about building more resilience into their systems. What, exactly, such resilience will mean is less clear. For some, it means holding more inventory. For others, it means identifying key chokepoints in the supply chain and looking for additional sources of supply to lower risks in these specific aspects of the chain. For others, it means shifting production closer to final markets to reduce disruptive effects caused by border closings and other specific obstacles.

At this point, however, most firms have already instituted supply chain reshuffling between internal locations, if such options are available. For example, companies that have overlapping capabilities in multiple locations have ramped up production in some markets while lowering production elsewhere. Internal swings to mitigate risks have already been put in place wherever possible.

For many firms, especially those manufacturing more complex technological goods, it is not possible to easily shift production to other locations. It can take years or a decade to start production from scratch and even scaling up existing operations with new functions is rarely immediate.

One key bottleneck mentioned by multiple firms in interviews has been the availability of staff and the right sorts of talent in different markets. The pandemic has made changing supply chain locations more challenging, as it is harder than ever to get key personnel into place to manage supply chain adjustments. This could include, as an example, adding or shifting equipment to plants, sourcing additional warehousing or suppliers or distributors, or managing a flexible workforce on the ground.

The net result is that most firms seem to have thought about supply chain reshuffling, but many have not yet made the decision to implement specific recommendations beyond internal adjustments that are often easier and faster to apply.

What about “third country” markets?

Most of the decoupling focus has been on American firms operating in China (with less attention paid to Chinese firms operating in the United States). This is, however, an unnecessarily narrow view of the



challenges posed by decoupling. Many firms, including American and Chinese companies, operate globally with manufacturing, sourcing, production, sales and distribution in a wide variety of markets including the US and China. What happens to operations outside of the US and China in what might be called “third country” markets if decoupling continues to gather steam?

Firm-level interviews suggest that companies remain uncertain about the impact of operations in such markets. Some firms appear bullish on the opportunities for growth in non-US, non-Chinese locations. This is not just for the domestic or regional markets, but even for the supply of goods and services back into the US or China. By locating in third markets like Singapore, Vietnam, Taiwan, Mexico or Eastern Europe, firms could successfully compete in a range of competitive markets with lowered risks of getting caught in decoupling policy shifts.

Some companies imagine a potentially “decoupled” world operating like a hybrid military/civilian or dual use manufacturing operation today. In extremely simplified form, a factory in Singapore could produce goods for the US market on one side of a building and for the Chinese market on the other. The management of such split operations has successfully taken place for dual-use goods, even for extremely complex and high-tech products already in a wide variety of locations around the globe.

This model, some firms noted, could be managed as long as the extent of decoupling remains manufacturing location based. It gets much trickier if the decoupling spreads deeper into systems such that the US and China are literally operating on different standards. If American standards for data are not compatible with Chinese standards, as an example, there may be less and less scope for managing an overlapping production facility as firms would effectively be manufacturing two entirely different types of goods.

Hence, in an extreme decoupling scenario, firms might have to choose, even if located in third country locations. At the moment, most companies do not seem to be making decisions based on the worst-case outcomes.

The consequences of a complete split can be significant. One company noted that they are preparing to lose up to 30 percent of their global sales by avoiding China altogether in the future and are having to work much

harder in every other market to make up for lost revenue.

How likely is decoupling going to be?

Firms are watching the 2020 US elections carefully, but for nearly all firms interviewed, the election outcomes are not assumed to change the basic trajectory of greater divisions ahead. While the tone and style might adjust and even some of the specific policy levers may change, the overall consensus by companies working in Asia is that decoupling is inevitable.

What form future decoupling will ultimately take does depend in part on election results, but the pressures for less intertwined economic interaction, particularly in many aspects of technology supply chains, are likely to remain in place.

Regionalization: One potential solution

The original intent of many decoupling policies has been to push firms to relocate. However, pressures towards reshoring may not reduce risk. Instead, it could concentrate risk in a different geographic location and may even magnify risks as the new location may not be as resilient to different types of economic shocks.

Firms that are working through various supply chain reshuffling scenarios are increasingly landing on the idea that chains will be regionalized. This will allow companies to maintain distributed supply chains to help lower risks, but also help ensure that products, materials, parts and components remain closer to final markets.

This pressure towards regionalization of supply chains is driving renewed interest in regions and locations that are embedded in denser webs of interconnectedness and engagement across markets. Southeast Asia has long been touted as a potential site for relocation. Firms confirmed that ASEAN remains a favorable destination for production, based partly on the existing links across the ten members and between ASEAN and major markets elsewhere.

Rise of protectionism globally

Not every market in ASEAN is equally attractive to firms looking to shuffle supply chains to increase resilience in the future. Nor is ASEAN unique in struggling with the tensions between keeping markets



open and ensuring that jobs and recovery takes place domestically.

Some markets in the region are increasingly discussing ideas such as “strategic autonomy” or pushing for greater “sovereignty.” These are phrases that companies report hearing with dismay, as it suggests more problematic business practices on the horizon.

As firms shift from discussions and scenario planning to activating various types of supply chain adjustments in the near term, markets that remain open to inbound companies and encourage exports will attract greater investment than those that do not.

The saga is just beginning

The twin shocks of the US-China trade war followed by a global pandemic have placed severe stresses on supply chain operations. Effectively managing these risks will require firms to rethink location decisions and decide whether or not existing footprints are still “fit for

purpose.” The continuing pressures emanating from a US-China decoupling will accelerate these conversations for many firms in Asia.

While most supply chain adjustments have remained at the planning stages during the pandemic, companies say they are ready to pull the trigger to activate new scenarios in the near term. Responding to decoupling and the pandemic is likely to lead many firms to make changes in 2021 and beyond.

The Asian Trade Centre (ATC) is the premier regional thought leader, advocate and educator for trade in Asia. ATC works directly with governments from around the world, companies, think tanks, foundations, non-governmental organizations, aid agencies and serves as the resource for trade-related activities in Asia.

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¹ Thomas Friedman even developed a “Golden Arches Theory of Conflict,” to argue that two countries with McDonalds had never engaged in conflict, as tight economic ties could help prevent war. See Friedman, “Foreign Affairs, Big Mac I,” *New York Times*, accessed at <https://www.nytimes.com/1996/12/08/opinion/foreign-affairs-big-mac-i.html>, on 24 October 2020.

² It may also be worth noting that some firms have watched the increasingly erratic nature of US policymaking and concluded that continued reliance on the US is also problematic.

³ Bank of America, “Tectonic Shifts in Global Supply Chains: What Are the Driving Forces Propelling the Shift?,” February 4, 2020, https://www.bofaml.com/content/dam/boamlimages/documents/articles/ID20_0147/Tectonic_Shifts_in_Global_Supply_Chains.pdf.

⁴ Bank of America, “Tectonic Shifts in Global Supply Chains: What Are the Driving Forces Propelling the Shift?,” February 4, 2020, https://www.bofaml.com/content/dam/boamlimages/documents/articles/ID20_0147/Tectonic_Shifts_in_Global_Supply_Chains.pdf.

⁵ Gartner Inc., “Gartner for Supply Chain Weathering the Storm: Supply Chain Resilience in an Age of Disruption,” 2020.

⁶ AmCham China, “Supply Chain Strategies Under the Impact of COVID-19 of Large American Companies Operating in China,” April 2020, <https://www.amchamchina.org/uploads/media/default/0001/12/5ff364a267fc196b022054da8ddd4c9c0f028a30.pdf>.

⁷ Yossi Sheffi, “Moving Out of China? Not Really,.” *MIT Centre for Transportation and Logistics*, July 2020,

<https://medium.com/mitsupplychain/moving-out-of-china-not-really-50a818ed5b2d>.

⁸ EY, “Strategy and M&A Survey Results: Global Capital Confidence Barometer,” 2020, https://www.ey.com/en_gl/ccb.

⁹ Bank of America, “The USD1trillion Cost of Remaking Supply Chains: Significant but Not Prohibitive,” 2020, https://www.bofaml.com/content/dam/boamlimages/documents/articles/ID20_0734/cost_of_remaking_supply_chains.pdf.

¹⁰ Bank of America, “Tectonic Shifts in Global Supply Chains: What Are the Driving Forces Propelling the Shift?,” February 4, 2020, https://www.bofaml.com/content/dam/boamlimages/documents/articles/ID20_0147/Tectonic_Shifts_in_Global_Supply_Chains.pdf.

¹¹ Congressional Research Service, “U.S.-Mexico Economic Relations: Trends, Issues, and Implications,” June 25, 2020, <https://fas.org/sgp/crs/row/RL32934.pdf>.

¹² Semiconductor Industry Association, “The U.S. Should Be Concerned with Its Declining Share of Chip Manufacturing, Not the Tiny Fraction of U.S. Chips Made in China,.” 2020, <https://www.semiconductors.org/the-largest-share-of-u-s-industry-fab-capacity-is-in-the-united-states-not-china-lets-keep-it-that-way/>.

¹³ See, for example, the series that Alex Capri has developed in conjunction with the Hinrich Foundation specifically looking at semiconductors. Available at: <https://www.hinrichfoundation.com/research/wp/tech/semiconductors-at-the-heart-of-the-us-china-tech-war/>