# Reconfiguring Your Supply Chain in Asia

## An Urgent Imperative

April 2020

AVALON Consulting

ASIAN TRADE CENTRE

## *Over the past three decades China has consolidated its dominant position as the "Factory of the World"…*

This has been driven by China's focus on world class infrastructure, cheap labour and industry-friendly policy. As a result, China's share of world merchandise exports and global manufacturing GDP grew exponentially

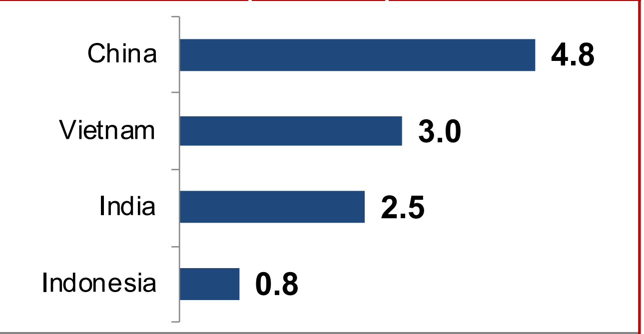
| Share of World (Current USD) | 1990 | 2000 | 2010 | 2015 | 2018 |
|---|---|---|---|---|---|
| China's Share in World Manufacturing GDP | | | 18.2% | 26.6% | 28.2% |
| China's Share in World Merchandise Exports | 1.8% | 3.8% | 10.2% | 13.7% | 12.7% |

*Source: World Bank Data*

## *However, the China story has been losing its sheen of late and is facing significant headwinds….*

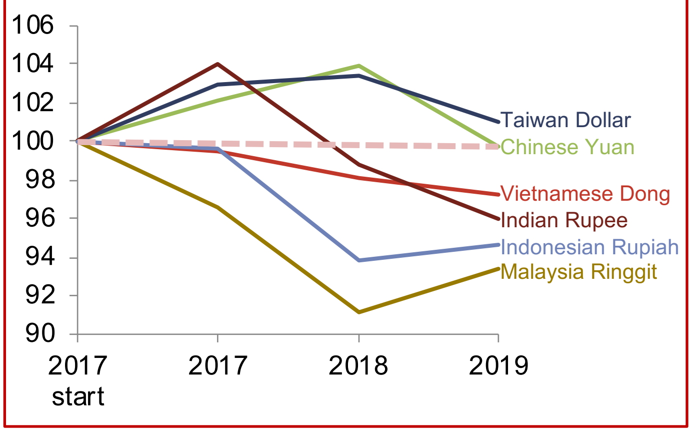
China is facing declining competitiveness on account of rising costs as well as currency appreciation relative to other countries in Asia

**Manufacturing Labour Cost, 2019 (USD / Hr)**




Higher Labour costs in China & more competitive currencies of other countries such as Vietnam, Indonesia & India make them more export friendly locations

**Relative Currency Movement vis-à-vis US Dollar**




***Note:** Labor cost values are composite figures across various sectors*

*Source: Industry Research, MarketTrends.net*

## *Two other recent developments have further worsened the situation – the headwinds have now turned into a hurricane…*

**US-China Trade War:** While China's attractiveness was based on costs, the Trade War introduced the dimension of 'risk' into the equation – based on increased tariffs and the threat of disrupted imports from China. In 2019 US imposed additional tariffs on Chinese imports worth USD 360 bn whereas China retaliated with tariffs on US imports of USD 110 bn. Chinese exports to US witnessed a drop of 25% in first half of 2019. This has fundamentally re-set the magnitude of trade between the two largest economies.

The US-China trade war is still ongoing, even if it has moved off the front pages of newspapers, with tariffs remaining in place on both sides. Even if there are relaxations in future (e.g. in a non-Trump administration) it is unlikely to revert to the pre-Trade War levels.

**Covid-19 Pandemic***:* Even as buyers were responding to the implications of the Trade War, the Covid-19 pandemic brought in an additional dimension of "Resilience" – the ability of firms to adapt to unforeseen systemic shocks. 94% of Fortune 1000 companies have reported that their tier 1/2 suppliers have been affected by the pandemic. China saw trade drop by 56% in a single week in February 2020. Their customers in the west were struggling to operate at anything close to regular operating capacities and resume operations

## *Meanwhile other Asian countries have emerged as manufacturing powerhouses over the past few years…*

Several countries in Asia (e.g. ASEAN / India etc.) have emerged as attractive manufacturing destinations based on large capacity creation and low-cost labor as well as industry friendly policies. These include Vietnam, Thailand, Malaysia, Indonesia, India etc.

## *Besides growing cost competitiveness these countries also have the advantage of Regional Trade Agreements plugging them into global supply chains…*

A series of recent blockbuster trade deals have lowered barriers to trade and improved market access across Asia. New FTAs have enabled flows between 15 countries in Asia through RCEP, Asia and the Pacific through CPTPP, and Europe and Asia through EU agreements with Singapore, Japan, Vietnam and Korea. The USMC agreement between US, Mexico and Canada is also significant in this regard.

Optimally leveraging FTAs can help lower the risk from sudden shifts in government regulations, policies, tariff levels and investment restrictions.

| No. of Agreements (Bilateral + Regional) | Total | FTA & EIA | FTA | PSA |
|---|---|---|---|---|
| China* | 15 | 15 | - | - |
| Singapore | 25 | 22 | 2 | 1 |
| Mexico | 22 | 12 | 1 | 9 |
| Australia | 14 | 12 | 1 | 1 |
| India | 16 | 5 | 3 | 8 |
| Malaysia | 14 | 9 | 4 | 1 |
| Thailand | 13 | 7 | 2 | 4 |
| Vietnam | 12 | 7 | 3 | 2 |
| Indonesia | 10 | 5 | 3 | 2 |

***Note:*** *All FTA & EIA covers Goods & Services; All PSA/FTA covers Goods only; EIA- Economic Integration Agreements; PSA- Partial Scope Agreement*
** excluding Hong Kong*

*Source: WTO Data*

## *Such Trade Agreements are a significant competitive advantage and are already driving a shift away from China towards alternative locations…*

A recent example of FTA-driven supply chain shift is evident in the footwear industry. In the wake of the Trade War, US imposed 10% tariffs on footwear imports from China – this led to an accelerated shift to alternatives like Vietnam. Furthermore sourcing from Vietnam has led to additional benefits of lower duties in supplying to several of the world's largest footwear importers – as evident from the following table

**FTA Benefits for Vietnam Manufactured Footwear – Sports Footwear**

| | | | Origin | | |
|---|---|---|---|---|---|
| | | | **WTO Members** | **China** | **Vietnam** |
| Destination | **Canada** | FTA | GATT | N/A | CPTPP |
| | | Tariff | 18% | 18% | 0% |
| | **EU** | FTA | GATT | N/A | EU-VTN |
| | | Tariff | 16.9% | 16.9% | 0% |
| | **Japan** | FTA | GATT | N/A | JP-ASEAN |
| | | Tariff | 8% | 8% | 0% |
| | **Korea** | FTA | GATT | CH-KR | KR-ASEAN |
| | | Tariff | 13% | 9.1% | 0% |
| | **Mexico** | FTA | GATT | N/A | CPTPP(1) |
| | | Tariff | 30% | 30% | 25.3% |

[1] Under the CPTPP tariffs of the product from Vietnam to Mexico will be 0 within 12 years.

*Source: Developed using Thompson Reuters OneSource*

## *The trend of de-risking of the supply chain is accelerating – towards alternatives in Asia as well as towards 'near-shoring' or 'localisation'*

China's share of US-bound manufacturing exports from Asia has dropped from 67% in 2013 to 56% in 2019. China lost USD 31 bn of manufactured exports to US in 2019 and 67% of this was captured by Vietnam, Taiwan and Mexico.

As a result ASEAN countries have grown their share of world trade over the past few years e.g. Vietnam's share of global merchandise exports has quadrupled in last 10 years – from 0.3% in 2008 to 1.2% in 2018. Further evidence of the increasing importance of these alternative destinations is visible in the strong growth of FDI (Foreign Direct Investment) into these countries

For US the shift is not only towards ASEAN but also to locations closer home. The USMCA (US-Mexico-Canada Agreement) signed in 2018 has driven significant increase in share of Mexico in US manufacturing imports – from USD 278 bn in 2017 to USD 320 bn in 2019.

Another visible trend is the renewed thrust and support for domestic manufacturing – especially by 'strong' political leaders like Trump and Modi ("Make America Great Again" and "Make in India"). This has accelerated in specific categories in the wake of Covid-19 e.g. medical equipment and pharmaceuticals wherein various countries have imposed export restrictions. This will also drive some level of 're-shoring' supported by favorable govt. policies

***Thus the big picture is not of a complete abandonment of China but of a calibrated diversification towards other countries and suppliers. This should be based on a systematic evaluation of costs and risks at a country and supplier level.***

***Now is a good time to re-evaluate your supply chain strategy for the region and build a resilient chain capable of resisting, absorbing, recovering and adapting in an increasingly complex economic and regulatory environment.***

***You need an agile supply chain strategy which can respond proactively to changing costs structures across suppliers and countries as well as emerging country-level risks including trade agreements and barriers etc.***

**Such an exercise needs to address the following questions:**

**1**
What are the costs of operating out of various locations – including China and its alternatives – under various operating models (manufacturing / outsourcing / trading)?

**2**
What are the risks of your current supply chain and its alternatives – including country-level risks as well as risks of specific suppliers?

**3**
What are the opportunities / advantages offered by FTAs in specific countries?

**4**
Based on the above - What is the right supply chain model for you ? Which are the appropriate countries / site(s) to locate in / source from ?

**5**
Finally how do you proactively respond to emerging changes in costs / risks / trade regulations etc.? How do you make your supply chain nimble enough to adapt to these changes?

# How Can We Help

**Asian Trade Centre (ATC) and Avalon Consulting** can help you through the journey of reconfiguring your supply chain. Our expertise and regional networks ensure that we provide strategic and implementation advice to our clients at every step of their supply chain assessment and transformation process.

*Our approach broadly involves the following:*

**A**

**Map existing supply chain** from end-consumers to multi-tier suppliers: including channels, warehouses, transportation modes etc.

**B**

**Develop a model to evaluate costs and risks** across existing supply chain alternatives – at country level and supplier level

**C**

**Assess the impact of trade agreements / FTAs** on alternative supply chains and opportunities emerging from these

**D**

**Prioritise the relative attractiveness of supply chain alternatives –** based on Costs / Risks and impact of specific trade agreements / FTAs

**E**

**Implement the selected configuration**

- Assistance in setting up operations
- Partner Selection / Vendor Selection
- Site Location

**F**

**Ongoing monitoring and evaluation** of the supply chain to respond to changing costs / risks / regulations

- ATC is the premier regional thought leader, advocate and educator for trade in the Asia-Pacific. Besides economic and policy research and policy advisory, it also provides trade and supply chain strategic advice to leading multinationals and MSMEs across the region.
- Avalon Consulting is a leading consulting firm operating out of India and APAC – its offerings span Strategy, Performance Improvement, Organisation Transformation and Transactions. It has strong expertise across sourcing, supply chain optimization and logistics optimization.

# The Asian Trade Centre

- Strategic and creative thinking to complex policy and regulatory challenges;
- Design or redesign supply chains to use trade agreements or avoid trade barriers;
- Solutions for both government and companies to vexing trade problems;
- Practical advice and suggestions for improving bottom line performance for companies trying to make sense of complicated trade agreements;
- Sensible knowledge and input to government officials grappling with crafting modern trade agendas for the future.

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