

Creative disruption

Asia's winners in the US-China trade war

A report by The Economist Intelligence Unit



Contents

Creative disruption	
Asia's winners in the US-China trade war	2
Tariff targets	3
Information and communications technology products	4
Automotives	6
Apparel and readymade garments	8
A new wave of interest	10

Creative disruption

Asia's winners in the US-China trade war

The US and China are rapidly discovering how wrong Donald Trump was when he said that trade wars are good and easy to win. The two countries have so far imposed tariffs covering roughly US\$360bn of merchandise trade between them. A breakdown in negotiations suggests that neither side is yet seriously looking for an “off ramp” in the dispute. The Economist Intelligence Unit expects that by early 2019 tariffs will have been introduced on the vast majority of US-China merchandise trade.

The US-China trade war will have a significant adverse impact on the world economy. By distorting global trade flows, the conflict will push production to more expensive locations, forcing up prices and reducing efficiency. The end-price of products will be higher than it would have been otherwise, adding to inflation and potentially forcing faster tightening of monetary policy in many markets. Global trade flows are also set to slow, particularly in the short term, as mounting US-China tensions disrupt existing supply chains and dampen investor confidence. The greatest impact will of course be felt in the US and China, but many other economies are likely to experience collateral damage.

Still, there will be winners as well as losers. Tariffs tend to shift trade more than they reduce it and, as importers in China and the US look for alternative suppliers, new opportunities will open up for exporters in third-party markets. Some of those beneficiaries will be in countries such as Mexico (where the US-Mexico-Canada Agreement may facilitate auto parts imports to the US) or Europe (whose agricultural exporters should benefit as US produce becomes more expensive in China). However, the lion's share of the gains from the trade war will fall to countries in Asia.

Using our world-leading expertise in economic forecasting and analysis, and leveraging our team of country and industry analysts across Asia, we have produced a report that examines which countries in the region will emerge as the key winners from the supply chain shifts caused by the trade war. We focus in particular on the impact on three important sectors: information and communications technology (ICT) products; automotives and automotive parts; and apparel and readymade garments (RMGs).

Tariff targets

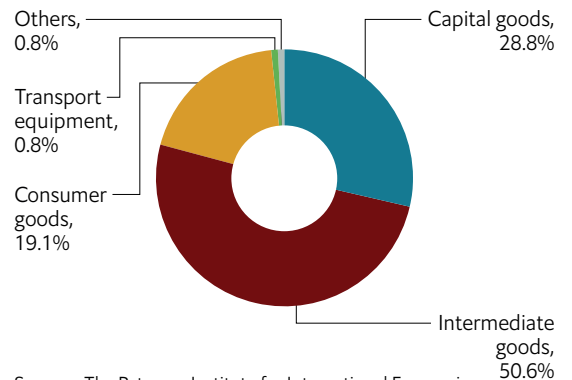
The trade war has largely been driven by US tariff measures, with China responding in kind. As of October 2018, the US tariffs in effect have largely targeted intermediate components, primarily in the electronics and machinery sectors. In response, China has largely targeted US automotive and agricultural products, which represent China's largest merchandise imports from that country.

We expect the trade war to escalate further in the coming months, ultimately covering finished consumer products including mobile phones, laptops and other electronic goods, as well as apparel and RMGs. In addition to automotive products, which have already been targeted, these three product categories make up an important segment of US-China bilateral merchandise trade. The importance of these industries to the broader Asian supply chain has made them the focus of our report.

Winners from the trade war will benefit primarily from the US tariffs, which target broad swathes of the Chinese manufacturing industry. However, countries in Asia will struggle to benefit significantly from China's reciprocal tariffs on US imports, which largely target automotive and agricultural products, including soybeans (China's most important agricultural import). Although earlier this year China cut tariffs for soybean imports from regional trading partners such as India, Laos and South Korea, production capacity for soybeans in most Asian countries cannot match that in Brazil or Argentina. Some US soybean shipments originally destined for China may ultimately be rerouted through certain South-east Asian countries, such as Thailand and Vietnam, but China will largely turn to Latin America to make up its soybean supply shortfall. Similarly, countries such as Germany, Spain and Canada are likely to make up for any shortfall in pork imports.

In addition, the trade war exists against a background in which firms have already been diversifying their export manufacturing out of China for many years. This largely reflects concerns about rising land and labour costs within China, as well as a growing awareness of the risks that excessive concentration of production can create for global supply chains. The trade war will accelerate this trend, which has particularly favoured countries in the Association of South-East Asian Nations (ASEAN), where in many cases burgeoning local consumer markets, the presence of existing industrial clusters and acceptable infrastructure have helped to draw investment. A strong network of free-trade agreements (FTAs) further enhances the attractiveness of these markets as bases for production. The recently agreed Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which Malaysia, Singapore and Vietnam will be part of, represents the latest iteration of this trend.

US tariffs on US\$250bn of Chinese goods, 2018
(%, US\$ terms)













Sources: The Peterson Institute for International Economics; The Economist Intelligence Unit.

Information and communications technology products

The ICT industry has been a particular focus for the US government as it has moved to increase tariffs on imports from China. This is partly because it is by far the biggest category of US imports from China, with electronics and related component imports alone amounting to some US\$150bn of the total US imports from China of US\$526bn in 2017. It is also because one of the aims of the US tariff strategy is to hamper the Chinese government’s Made in China 2025 development agenda—an initiative focused on cultivating the country’s key high-technology sectors.

Winners and losers

Information and communications technology

Strong benefits		Mild benefits		Disruption	
Malaysia		India		Philippines	
Vietnam		Indonesia		Japan	
		Thailand		Singapore	
				South Korea	
				Taiwan	

Vietnam and Malaysia will benefit the most from the US-China trade war, particularly in low-end manufacturing of ICT products, such as intermediate components and manufacturing of consumer goods like mobile phones and laptops. Major electronics companies have existing operations in these countries. Dell (US), Sony and Panasonic (both Japan) have plants in Malaysia, for example, while Samsung (South Korea) and Intel (US) have a presence in Vietnam. This means that they would be able to re-deploy investment and production relatively smoothly. In addition, both countries have strong road, rail and port infrastructure, which has in turn helped to develop strong local logistics and shipping networks to support merchandise trade. Both countries are also signatories of numerous FTAs, including the CPTPP and the ASEAN Economic Community. Positive business environment considerations—such as the existence of a clear and stable system for corporate law in Malaysia, and strong investment promotion policies in Vietnam through that country’s new special economic zones—will add to the two countries’ attractiveness for firms considering them as potential sites for ICT investments.

India, Indonesia and Thailand should also be able to secure some benefits from the relocation of export-oriented ICT manufacturing. However, this type of export production is more limited in these markets than it is in Vietnam and Malaysia at present, meaning that international trade links in these markets may be underdeveloped. Of the three, Thailand has perhaps the most potential. It exported electronics worth around US\$35.6bn in 2017 and boasted a significant strength in such manufacturing in the past. The Thai government’s policies to promote industrial upgrading, such as the Industry 4.0 programme and the Eastern Economic Corridor special economic zone, may also lower the cost for foreign companies seeking to establish a presence in that country.

CREATIVE DISRUPTION

ASIA'S WINNERS IN THE US-CHINA TRADE WAR

The Philippines will see mild disruption stemming from the trade war, owing to the importance of the Chinese market for shipments of ICT intermediate components from that economy. However, we do not expect the Philippines to benefit massively from any shift in ICT export supply chains, owing to its weak regulatory and business environment. The country's underdeveloped digital ecosystem will also be a further hindrance to investment, with internet speeds the slowest in Asia.

Japan, Singapore, South Korea and Taiwan are set to experience even greater disruption from the trade war, particularly in the short term, owing to the importance of the Chinese market to exporters in those economies. China is a major destination for intermediate and final ICT goods from all four economies, meaning that companies in that sector will be heavily exposed to the impact of tariffs on demand for these products. Several of Taiwan's most important industrial conglomerates, including FoxConn and Taiwan Semiconductor Manufacturing Company, also have massive operations within China. Although companies from Japan, South Korea and Taiwan will seek to mitigate the dispute by expanding new and existing operations in South-east Asia, the scale of China's market means that it will be very difficult for those companies to replicate that production in other countries.

High taxes, limited land and expensive labour will prevent significant reshoring of ICT manufacturing operations from China back to these four markets. However, the impact of the trade war on exports from South Korea, Japan, Taiwan and Singapore will be limited by the fact that all four tend to produce high-end ICT components that are not easily replaceable through import substitution. Thus, although the Chinese operations of companies from these economies may be disrupted, their domestic exports will be less vulnerable.

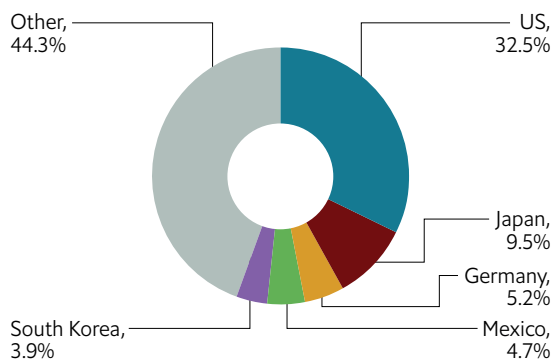
Automotives

We believe that the impact of the trade war on China's vehicle manufacturing sector will be modest. This is largely because much of the country's automotive supply chain has been localised, with most local vehicle production geared for local consumption. ITC statistics indicate that finished vehicle exports accounted for only 0.3% of China's total exports in 2017, at a value of US\$7.2bn.

The impact of the trade war on Chinese auto parts exports, which were worth US\$31bn over 2017, will be greater. Although this figure accounted for only 1.4% of total Chinese exports that year, the absolute scale of these auto components exports is important. ITC statistics indicate that Chinese auto parts exports were 8% of the global total in 2017. This was behind Germany (16.1%), the US (11.6%) and Japan (8.9%), but they are still big enough to have an industry-wide impact. Moreover, the US represents the largest destination of Chinese auto parts exports by value, meaning that disrupted access to that market will be particularly painful for China-based exporters.

For its part, China accounted for almost 20% of US finished vehicle exports by value in 2017, equivalent to goods worth US\$10.3bn. Chinese tariffs on US auto imports will exert pressure on certain automakers exporting finished vehicles from the US into China, including BMW and Mercedes-Benz (both Germany). Most of these shipments are in the luxury sector, however, and major US automakers retailing to China's mass market, such as GM and Ford, produce units overwhelmingly via their local

China's top auto parts markets, 2017
(%, US\$ terms)













Sources: International Trade Centre; The Economist Intelligence Unit.

joint ventures. US auto parts exports are also less exposed to the US-China trade dispute, as they ship mostly to Canada or Mexico; shipments to China accounted for only 5% of the total in 2017.

Thailand and (to a lesser extent) Malaysia will benefit the most from dislocation caused by the trade war. Thailand is an important regional automotive and parts manufacturing hub, with over half of its production geared towards exports. Trade links in the auto sector are well diversified, with exports going to the US, Japan and other parts of ASEAN. With this history, local parts producers should be able to win market share from Chinese rivals in the US as the trade

Winners and losers

Automotive

Strong benefits		Mild benefits		Disruption	
Thailand		India		Japan	
Malaysia		Indonesia		South Korea	
		Philippines		Taiwan	
		Vietnam		Singapore	

war escalates. In addition, a number of luxury marques, including BMW and Mercedes-Benz, already have operations in Thailand, and we expect these companies to ramp up their local output to support shipments to China. Although finished vehicle and auto parts exports are a small part of its total exports, Malaysia has over 800 auto component manufacturers, as well as a similarly diversified auto component export network. This should position it to be another beneficiary of the disruption.

India, Indonesia, the Philippines and Vietnam will see more modest impacts. India is home to several foreign automotive brands (including luxury marques), but the country's auto exports are small. Difficulties in land acquisition and other business environment challenges will make it hard for firms to redeploy production and investment from China to India. Finished vehicles and auto parts are also a small part of Vietnam's total exports. The country is looking to attract more foreign investors in the sector, but the relatively protected nature of its automotive market and the small size of its domestic vehicle market make it less competitive compared to regional alternatives. Indonesia is ASEAN's largest passenger car market, and the country has a strong presence in auto parts exports, but issues with infrastructure and the business environment more generally will serve as a deterrent to increased foreign investment. The Philippines similarly has a strong auto components manufacturing and export sector, built largely to support Japanese supply chains, but its legal and foreign investment regimes are not particularly attractive.

Japan, South Korea, Taiwan and Singapore will see relatively low levels of trade-war related disruption in the automotive and parts sectors. Finished vehicles are generally a small percentage of total exports from Taiwan and Singapore, while only a small portion of Taiwanese and Singaporean auto components shipments are destined for China. The US is a much larger market for Taiwanese auto parts producers, while Singapore's auto parts exports are well diversified to Malaysia, Australia, Hong Kong and Thailand. The small scale of these export industries, however, means that any economic opportunities for Taiwan and Singapore will be limited.

Japan and South Korea have important automotive operations in China and both countries count China as their second most important auto components export destination. These supply chain networks suggest vulnerability to the US-China tariff war. However, while a small proportion of these components may be subsequently re-exported to the US within other products, most are likely to end up being used in the domestic Chinese market. As a result, demand shocks from the tariffs may be limited. Although Japanese and South Korean auto parts manufacturers may benefit in China from tariffs on rival US auto parts manufacturers, benefits in the US from tariffs on Chinese auto parts makers will be limited: auto parts from Japan and South Korea are likely to be more advanced than components being shipped from China, making them poor substitutes for any tariff-hit Chinese parts.

For Asian producers in the auto sector more generally, there are bigger concerns than the US-China trade war, including the existing tariffs on steel and aluminium imposed by the US in early 2018, as well as the looming Section 232 report from the US Department of Commerce. The latter threatens to slap tariffs on all vehicles and auto parts exported to the US, based on national security concerns. That would pose more significant risks for producers in Japan and South Korea.









Apparel and readymade garments

Although low-end apparel and RMG manufacturing has been diversifying out of China for some years now, China still dominates the sector. China's textile and apparel exports amounted to some US\$257bn in 2017 (not including footwear, worth a further US\$48.2bn). Of this total, US\$38.7bn went to the US market, according to data from the US Office of Textiles and Apparel. Meanwhile, 2016 data from the World Trade Organisation show that China accounted for 36.2% of global textile exports and 34.5% of global clothing exports. The imposition of tariffs on Chinese garments exported to the US will thus create significant opportunities for rival producers that are able to position themselves as cost-competitive alternatives.

The impact of this redistribution is likely to be modest over the short term, but will increase as the trade dispute rumbles on. China's declining interest in producing low-value exports such as garments, as it prioritises higher-value products such as electronics and machinery, will give a further tailwind to the trend. One potential risk for gaining market share in the US could emerge in relation to China's role as a supplier of textile and other inputs to RMG producers in countries like Bangladesh. This could be problematic if insufficient value is added in the final production stage, resulting in these exports being treated by US customs as Chinese products. However, we believe that this risk is relatively low, especially given the likelihood that more of the apparel production chain will shift towards locations outside of China over time.

Winners and losers

Readymade garments

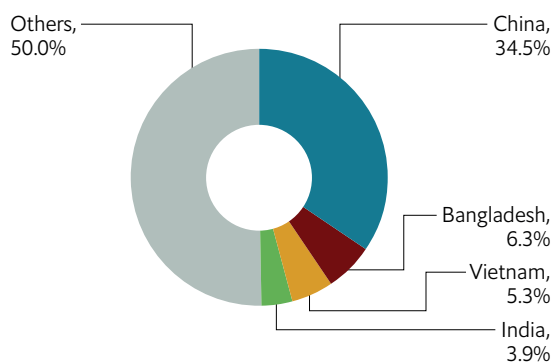
Strong benefits	Mild benefits	Disruption
Bangladesh 	Sri Lanka 	Indonesia 
Vietnam 	Pakistan 	Cambodia 
India 		Myanmar 

We expect the trade war to result in strong benefits for three major garment exporting players in Asia. Bangladesh has a well-established RMG industry, and is the second-largest exporter of RMGs in the world after China, with the US and the EU as its largest export markets. Even before the trade war, Bangladesh's share in global RMG exports had been growing, owing to its low-cost production credentials. Major international fashion brands—such as H&M, GAP, Levi's and Zara—already have manufacturing facilities in Bangladesh, meaning that these brands can easily divert orders to Bangladesh if tariffs on imports from China make such products more expensive in the US. However, it will take time for local operators to build production capacity to fully absorb these shifts.

The garment industry in Vietnam will be another big beneficiary of the US tariffs. Vietnam is the world's third-largest exporter of RMGs and has strong trade ties with the US. Vietnam exported garments worth US\$12.3bn to the US in 2017, representing almost 50% of its total RMG exports. Vietnam is in many respects an easier market to operate in than Bangladesh, but wages in Bangladesh will continue to be the lowest among the major garment-exporting nations, giving it an edge in the highly cost-sensitive apparel sector.

Although Vietnam and Bangladesh are already important garment production centres, in the longer term neither will be able to produce at a scale that matches China, both in terms of volume and integration of supply chains. Within Asia, India is the only country that could potentially achieve this level of output. Although countries like Bangladesh enjoy a cost advantage similar to India, owing to relatively lower wage rates, India's industrial sector has the upper-hand when it comes to integration of production processes involved in the manufacture of apparel, from weaving to spinning to final product. This makes it an attractive alternative destination after China for garment manufacturing investment. Additionally, India is a major producer of cotton, which means that it does not depend on imports of the raw material to feed its garment industry, as Bangladesh does. However, India's outdated labour laws will represent a powerful obstacle to achieving its potential in RMG export manufacturing.

Top clothing exporting countries, 2016
(% of global share)



Sources: World Trade Statistical Review; World Trade Organisation.

Sri Lanka and Pakistan will see milder benefits from the trade war. Although textile and garment exports play a significant role in Sri Lanka's economy, accounting for almost half of the country's total outbound shipments, the country's apparel output has not risen as fast as its rivals in recent years. Wages in Sri Lanka are relatively competitive (though not as low as in Bangladesh), and the business environment is favourable compared with those of its regional peers. However, the country is more likely to remain a relatively niche provider of slightly higher-value garment products, compared with other countries

in the region. Producers shifting export production from China are more likely to consider other markets first. For Pakistan, the benefits from the trade war will also be more modest, in part owing to the strained diplomatic relationship between Pakistan and the US, which will impede exports to that market. Moreover, garment manufacturers in China are likely to be deterred by the high operational risks in Pakistan, both in terms of security and broader macroeconomic instability.

The apparel sectors in Indonesia, Cambodia and Myanmar, although important for the domestic economies of the three countries, are unlikely to be able to make a dent in the global market. In Indonesia, this is mainly owing to antiquated technology and underinvestment in the sector, whereas in Cambodia rapid increases in wage rates will hold the sector back. Moreover, Cambodia stands to lose its important preferential trade benefits under the EU's Everything But Arms deal owing to the government's crackdown on the political opposition ahead of a general election in July 2018. (There is also a risk that Indonesia's access to the crucial US export market could be curtailed if it fails to address US concerns over tariffs and barriers to entry in its own market). Meanwhile, although Myanmar's apparel exports are growing fast, it is not yet a major player in global terms, and like Cambodia faces pushback from its major Western trade partners over rights concerns. These factors will constrain greater foreign investment in the RMG sectors of these countries.

A new wave of interest

Even before the start of the US-China trade war, multinational companies were becoming increasingly wary about the risk of becoming over-dependent on China as a manufacturing base. Such fears have been aggravated by a combination of rising labour and land costs in China. Meanwhile, markets in South and South-east Asia have looked increasingly attractive in their own right, as their consumer markets have developed.

The trade war will result in a significant shift in export-oriented manufacturing from China to other markets in Asia, a relocation that is likely to have a net positive impact for many countries in the region. (In some ways, this will represent a reversal of the trend seen in the early part of this century, when China's rise as an export powerhouse diverted investment from ASEAN economies that were still reeling from the 1997 Asian financial crisis.) The shift will help to drive the development of the local automotive, ICT and apparel sectors in South and South-east Asia, bringing in more advanced equipment and technical expertise.

However, for a majority of the countries involved the impact of these changes will not be felt overnight. Indeed, it is likely to take at least two to three years for the effects of the trade war to be fully realised. Multinational companies will need time to draft new global and regional strategies, find new partners, navigate different legal systems and secure the required licences and permits for new production facilities. As a result, the negative, disruptive effects of the trade war will predominate in the short term. Even under the most optimistic scenario, the benefits for Asia's winners in the trade war are unlikely to be seen before 2020.

Understand, prepare for and navigate the forecast disruption of the US-China trade war

In response to this new era of trade uncertainty, The Economist Intelligence Unit has put together an analysis to help clients understand the impact of the trade war on China, both in terms of the country's broader economy and on a sectoral basis. The report is intended to help stakeholders to understand, prepare for and ultimately navigate the forecast disruption across a broad swathe of the commercial landscape.

The report is divided into the following four sections:

- 1) The history and macroeconomic factors leading up to the dispute
- 2) The EIU's forecast of the economic impact on the US, China and the wider Asia region
- 3) The EIU's forecast of the impact of the US-China trade war on selected industries
- 4) Scenarios for de-escalation and plotting for the future

For the purposes of this report, we have identified the following industries for this study:

- The agricultural industry (including grains, and animal and food products)
- The automotive industry (include whole vehicles as well as automotive components)
- The information and communications technology (ICT) industry (including intermediate and final components)

The three industries above were chosen for their outsized importance in US-China trade flows, as well as for their related political importance—considerations regarding agriculture, the automotive industry and ICT occupy a significant place in the political calculations of both China and the US as they strategise their future moves within the trade dispute. The focus in this report will be primarily on the impact of the trade war on these industries in China (rather than in the US, although the impact on US investment and employment will be referenced where relevant).

To purchase this report, please visit [eiu.com/trade-monitor](https://www.eiu.com/trade-monitor)