Building Resilient Global Supply Chains

The Geopolitics of the Indo-Pacific Region

By Hiroyuki Suzuki

Global supply chains have evolved in recent decades with the aim of maximizing efficiency. However, rising labor costs in China and protectionist trends globally, especially in the United States, have forced a shift in approaches to international commerce, and the Covid-19 pandemic and acceleration of strategic rivalry between the United States and China have made the restructuring of supply chains an urgent task. Global companies are now searching for responses to supply chain challenges such as “reshoring,” “near-shoring,” and “China+1,” while the United States and China devise strategies to protect their own industries and improve their international competitiveness. The risk for companies being drawn into U.S.-China strategic competition, including the potential violation of U.S. sanctions, will also increase. For the global business community, a careful strategy to rebuild a resilient supply chain is indispensable, and nowhere is that more important than in the Indo-Pacific, the center of dynamism in the global economy.

Covid-19 Has Accelerated Supply Chain Restructuring

During the era of globalization over the last two decades, companies of all sizes have been building domestic and international supply chains that prioritize efficiency. However, rising labor costs in emerging economies, including China, and growing geopolitical uncertainty due to U.S.-China strategic rivalry, including the strengthening of protectionist policies in the United States, forced a reassessment of global business models—such as multinational corporations announcing plans to relocate their manufacturing operations to Vietnam and Mexico in 2018–19. The Covid-19 pandemic has greatly accelerated this trend and reaffirmed the importance of protecting citizens’ livelihoods by strengthening supply chains. In particular, the impact on essential commodities such as food and medicines and on social infrastructure, coupled with political tensions, provided an opportunity to promote policies of homeland security in many countries.
In response to an increasingly complex global economic environment, global corporations are taking the following measures to reduce supply chain risk:

- **Reshoring**
  In short, this is a strategy to redirect manufacturing operations back to the home market. This trend has been evident since 2019, particularly in the United States due to tariff increases in the wake of the U.S.-China trade conflict that have caused the U.S. manufacturing import ratio (imports as a percentage of total domestic manufacturing output) to fall for the first time in almost a decade. In addition, the Covid-19 pandemic has increased awareness in the United States of the vulnerability of supply chains for critical items such as health care products and food, further encouraging policies that allow companies to repatriate their supply chains back to their home countries. However, in the case of developed countries, reshoring entire supply chains is not practical due to additional labor and overhead costs, so it is important to focus on strategic sectors for reshoring from a national security and industrial policy viewpoint.

- **Near-Shoring**
  This is a strategy to restructure supply chains in the same region as major consumer markets, such as Mexico and Central American countries for the U.S. market, and Central and Eastern European and North African countries for the European market. Regionalization is expected to facilitate communication by reducing the distance between markets and the risk of being drawn into trade wars and protectionist policies by strengthening political, social, and cultural ties among regional neighbors. From a cost-benefit perspective, companies producing high value-added products can benefit by regionalizing their operations.

- **China+1**
  This strategy entails trading with other countries in addition to China, where companies leverage already established supply chains to maintain access to the Chinese market while limiting the risk of over-dependence on China. This trend was also evident before the Covid-19 pandemic due to growing trade friction between the United States and China. In fact, in 2019, imports of electronics from mainland China to the United States declined, while imports from suppliers in Vietnam, Malaysia, and Taiwan increased. Due to Covid-19, China+1 has become one of the most important strategies for supply chain vulnerability reduction in Asia.

However, these shifts will not resolve supply chain vulnerabilities overnight, and a mid- to long-term perspective is also necessary. In addition to the unavoidable restrictions on corporate activity caused by Covid-19, companies whose balance sheets have been ruined will also have limited resources for major investments that would significantly alter their supply chains. Moreover, in some sectors, the size of the manufacturing base in China is quite large, making short-term substitution to other markets particularly difficult for multinational corporations. For example, China's share of global exports in the machinery and electrical equipment sector is over 20 percent, and China's share in the garment sector is over 40 percent—larger than the combined export shares of the other five countries (Bangladesh, Vietnam, India, Germany, and Italy).

Above all, the business community must be aware of geopolitical dynamics. Companies around the world need to keep a close eye on trends and assess the international situation—especially the strategic rivalry between the United States and China—to build more resilient supply chains.
The United States Presses Its Allies to Encircle China

The United States has launched a flurry of policies and measures aimed at hindering China’s industrial competitiveness, the source of its geo-economic power, while at the same time encouraging the growth of U.S. industries.

A typical example is the crackdown on Huawei. In May 2020, the U.S. Department of Commerce’s Bureau of Industry and Security (BIS) placed Huawei and related companies on the entity list (EL) managed by the BIS under a regulatory framework, including the Export Administration Reform Act, which in principle prohibits the export and re-export of U.S. products (goods, software, and technology) to certain companies.

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BIS also announced measures to require BIS’ prior permission for products designed by Huawei and manufactured outside of the United States using U.S. technology and software to not only be exported from the United States but also to be re-exported or transferred to Huawei. The re-export restrictions effectively prevent foreign companies from doing business with companies on the EL, in cases that include a certain level of products and technologies of U.S. origin.

Furthermore, in August 2020, the BIS announced tighter restrictions on Huawei’s access to U.S.-made technology and software and also strengthened its blockade of Huawei’s workarounds to replace its own semiconductor chips with products from foreign semiconductor manufacturers that utilize U.S. products in their supply chains. Then, beginning on September 15, 2020, the United States suspended semiconductor shipments to Huawei.

The U.S. crackdown on Huawei goes beyond export bans and calls for a “test of loyalty” for allied countries. In April 2020, the U.S. State Department announced the “Clean Path” initiative, which promotes the protection of telecommunications infrastructure on five fronts (carriers, apps, app stores, cloud, and cable) from Chinese telecom companies that are believed to have ties to the Chinese government in mind. Clean Path called for communications using the next-generation communications standard (5G) to pass through U.S. diplomatic facilities without any equipment or services from unreliable vendors such as Huawei and ZTE. In addition, in August 2020, the U.S. government issued new guidelines to protect U.S. communications technology and infrastructure from vendors of concern, including calls for removing foreign vendors of concern from allied countries as well as the industry globally.

Huawei is not the only target. The United States has also stepped up its efforts to apply sanctions to Chinese companies and individuals linked to other issues. In July 2020, President Trump signed the Hong Kong Autonomy Act and issued an executive order suspending preferential treatment for Hong Kong. The Hong Kong Autonomy Act allows for sanctions against individuals involved in violating Hong Kong’s autonomy and financial institutions that do business with those individuals. Identified individuals are subject to revocation of their entry visas to the United States and deportation, as well as a freeze
on assets subject to U.S. jurisdiction. In the case of financial institutions, this includes not only the suspension of loans from U.S. financial institutions but also a ban on banking transactions. The BIS has also added Chinese companies to the EL for their involvement in human rights abuses against ethnic minorities in China’s Xinjiang Uygur Autonomous Region, which is having a significant impact on trade in textile products.

The United States also criticized China’s territorial claims in the South China Sea as unlawful and criticized the construction of artificial islands and the creation of a military base in the region. In August 2020, the BIS announced the addition of 24 Chinese companies, including China Transportation and Construction Corporation (CCCC), to the EL because of their support for the construction of military bases in the South China Sea. The State Department also announced the suspension of U.S. entry visas for Chinese nationals associated with supporting the construction of military bases. In a statement, former Secretary of State Mike Pompeo referred to the CCCC, noting that the company plays an important role in China’s Belt and Road Initiative (BRI) and that the United States will act until Beijing stops its coercive actions in the South China Sea, and will work with allies and friends to counter threats to stability. Multinational corporations will increasingly have to consider the risk of violating U.S. sanctions by dealing with companies even tangentially involved in BRI projects.

The Trump administration tried to maximize the government’s authority to prevent certain Chinese companies from entering the U.S. supply chain and doing business with its allies. It is worth noting that the law on which the Trump administration based its decisions reflects bipartisan consensus to take a tougher approach against China. In light of these circumstances, it is important to consider the possibility that U.S. views could evolve under the Biden administration to potentially include sanctions against U.S. allies that deviate from a hardline approach, which could further affect corporate decision-making with respect to restructuring supply chains.

China’s Shift to Prioritizing Its Domestic Economy

China, too, is not sitting on its hands and has been smoldering with the use of harsh rhetoric—dubbed “Wolf Warrior Diplomacy”—to defend its interests. The country recently introduced the National Defense Law and Coast Guard Law to further its maritime sovereignty claims and steadily rebuild its supply chain.

At the National People’s Congress in May 2020, Premier Li Keqiang called for a concentrated response to the “Six-Points” (guaranteeing employment, people’s livelihood, economic agents, food and energy security, industry and supply chains, and end-of-line administrative operations) to achieve the “Six Moderations” (stability in employment, finance, trade, foreign investment, investment, and mindset) necessary to stabilize the domestic economy and protect Chinese society—all to overcome the Covid-19 pandemic under President Xi Jinping’s “Bottom-line Thinking.” This is exactly the picture that overlaps with bipartisan U.S. support for domestic industry to the exclusion of China. The policies that the United States and China are pursuing to protect their domestic economies and the livelihoods of their citizens are clashing head-on, and there is a strong possibility that the situation will continue to heat up until the social unrest caused by Covid-19 is alleviated.

The Xi administration also launched a new industrial policy called the “Dual Circulation” strategy. This policy is still ambiguous, and it is likely that the details of this policy will be determined in the next five-year plan to be formulated this year. But in light of the significant decrease in overseas demand due to the Covid-19 pandemic and the aforementioned moves by the U.S. government, it is assumed that, broadly
speaking, “external circulation” (emphasis on exports and imports) will be redefined to support “domestic circulation” that prioritizes economic growth based on domestic consumption as the top priority to achieve the aforementioned “Six Points” and “Six Moderations.”

Even if China pursues a strategy focused on domestic consumption, it will still rely on the so-called “Yangtze River Delta” region around Shanghai (including the Anhui, Jiangsu, and Zhejiang provinces, which are considered the engines of development) for sustainable economic growth. With the introduction of the Hong Kong National Security Law in 2020, the function of Shanghai’s financial center is likely to become even more important for China in the future. China is expected to rebuild its global supply chain with the Yangtze River Delta and Shanghai at its center while trying to counter U.S. efforts to promote decoupling from China. In that context, trade across the Eurasian continent and maritime transport to increase connectivity between the Yangtze River Delta and Southeast Asia and Europe is considered essential, and the BRI will likely remain a priority with an eye towards rebuilding China’s supply chain.

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Another important region for China’s economy is the northeast, which includes the Liaoning, Jilin, and Heilongjiang provinces. Liaoning is an important industrial base for the steel and automobile industries, but Jilin and Heilongjiang provinces have been called “China’s Rust Belt” and have not yet benefited from the economic growth that has resulted from globalization. In the future, China will likely try to increase connectivity with the Beijing-Tianjin hub; improve the efficiency of the Eurasian economic corridor straddling China, Russia, and Mongolia; and rebuild the supply chain with the Republic of Korea (ROK) to incorporate East Asian supply chains into the economic development of Northeast China. Finally, there is Japan, the world’s third-largest economy, just across the Sea of Japan. China could also try to rebuild regional supply chains by encouraging more Japanese trade and investment in Northeast China.

China’s diplomacy is also arguably designed to support its supply chain strategy. For example, the overseas trips to Asia and Europe by Foreign Minister Wang Yi and Yang Jiechi, Politburo member and director of the Central Foreign Affairs Commission of the Chinese Communist Party, in late 2020 (Wang Yi: Italy, the Netherlands, Norway, France, and Germany; Yang Jiechi: South Korea, Myanmar, Greece, and Morocco) should be understood as “supply chain diplomacy.” And, surprisingly, at the end of 2020, China and the European Union tentatively agreed to the EU-China Comprehensive Investment Agreement.

In what ways might China foster ties with the Association of Southeast Asian Nations (ASEAN) and Europe to develop the Yangtze River Delta, the engine of China’s economic growth? How will China think about its relationship with the ROK and Japan considering its economic development goals in northeast China? The business community will need to take these geopolitical considerations into account when devising supply chain strategies in a rapidly evolving regional economic environment.
Building a Stable International Supply Chain Strategy

Other countries are also reacting to the impact of Covid-19 and U.S.-China strategic competition on global markets. With a view to diversifying its economic dependence on the Chinese market, Europe is turning its attention to trade and investment with Indo-Pacific countries. Capturing demand from “Beyond China” is becoming an urgent issue for European industry as well. In fact, the United Kingdom has expressed interest in joining the Japan-led Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), and Germany’s cabinet approved “Indo-Pacific Diplomatic Guidelines” in September 2020 designed to engage more actively in developing a rules-based regional market. In the future, it is likely that more European companies will join the movement to rebuild supply chains in the Indo-Pacific region. ASEAN countries have also introduced incentives to attract investment from developed countries, furthering international competition to rebuild and access supply chains in the Indo-Pacific region.

The Japanese government is also moving forward with support for companies that prioritize domestic manufacturing, diversify overseas production away from China toward ASEAN and other countries, and utilize digital technologies to strengthen the global supply chains of Japanese companies. The Ministry of Economy, Trade, and Industry (METI) is promoting subsidies for domestic investment promotion projects for supply chain measures and subsidies for projects supporting the diversification of overseas supply chains. On the financial side, the Japan Bank for International Cooperation (JBIC) has established the “Emergency Window in Response to the New Corona Crisis,” a menu of emergency financial support for Japanese companies including the restructuring of supply chains. Such prompt responses have been well received by Japanese industry.

While there is a high expectation that the United States will rejoin the international economic integration arena, the Biden administration will likely first concentrate on domestic issues. In the meantime, the international business community will focus intently on building an international cooperation framework that is less susceptible to friction between the United States and China. In this context, it should be noted that Japan, together with ASEAN, presented the ASEAN-Japan Joint Initiative for Economic Resilience in April 2020 and subsequently formulated an action plan that included the strengthening of supply chains. Mini-lateral government dialogues, such as those between Australia, India, France, and Australia and Indonesia, are also gaining momentum. The Supply Chain Initiative launched by Japan, Australia, and India is another good example of middle power counties initiating momentum. In the Indo-Pacific region, there is a possibility that such multilateral government dialogues will also develop in a way that avoids direct involvement of the United States and China. Japan will be expected to play a leading role in this process, too.

In addition to the agility described above, flexibility will also be important in responding to developments in the United States, China, and other countries. As the links between companies in the supply chain vary—especially in the initial phase of recovery from the Covid-19 pandemic—there will be a phase in which financial support will be expected to be provided not only to multinationals but also local companies and local governments. In this context, a new initiative of JBIC launched in January 2021, the Post-COVID-19 Growth Facility, encourages not only Japanese firms but also the region’s host governments and local industries by supporting projects to enhance supply chain resilience.

Japan needs to demonstrate that it will take the lead in creating a trade and investment environment that is free, fair, inclusive, transparent, and stable without excluding any particular country to create an open, rules-based market critical for developing a resilient supply chain. While maintaining cooperation with the
United States is at its core, Japan is expected to involve other countries including competitors from Europe and possibly China. Organizing a series of multilateral and bilateral dialogues on norms for regional investment and supply chain resilience could be an important means toward that end.

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