Reshaping the map: Friendshoring in Asia

Recent events trigger a rethink on globalisation

Macroeconomic Research

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Key points

- Globalisation, characterised by the rapid flow of goods, services and capital across international borders, is at a crossroads
- Recent geopolitical events have prompted a reconsideration of globalisation's trajectory
- Many nations are contemplating decoupling from any partners deemed unfriendly, giving rise to two new trends – friendshoring and nearshoring
- The future of friendshoring in Asia depends on sustained economic integration, good governance and the ability to attract foreign investments
- Given the ongoing tension between China and the US, Asian countries are likely to continue expanding capabilities further solidifying their role in the global manufacturing hub, potentially increasing the region's long-term investment appeal

Trade winds of change

In recent years, a recurring theme has captured the attention of economists, policymakers and industry leaders worldwide: deglobalisation. The once-unstoppable force of globalisation, characterised by the rapid flow of goods, services and capital across international borders, seems to have hit a roadblock. While global trade experienced a temporary dip in 2020, it rebounded sharply in 2021, only to face new challenges that have raised questions about its future trajectory.

The first notable resistance to globalisation emerged around 2015. Back then fears over competition to imports from domestic state-subsidised producers – particularly in China – sparked debates about the impact on local labour markets. Subsequently, the pandemic exacerbated concerns around global supply chain security as shortages of essential goods exposed vulnerabilities. As a result, the call for greater resilience led to discussions about reshoring economic activities and reducing reliance on foreign production.

However, unforeseen geopolitical events in recent years have provided perhaps the most compelling argument for rethinking globalisation: concerns about national security. The Russia's invasion of Ukraine in 2022 sent shockwaves through the international community and highlighted the fragility of a global supply system built on hyper-specialisation. It wasn't just Russia; many countries began contemplating decoupling from any nation deemed unfriendly, giving rise to new terms in the world of international trade: friendshoring and nearshoring.

In an earlier article, we examined trade data, foreign direct investment (FDI) statistics and microeconomic indicators to gauge the extent of Mexico's potential gains from nearshoring[1]. Our findings suggested that while there were certain microeconomic signs, these benefits had yet to emerge prominently in the macroeconomic data. However, the data suggested that emerging markets in Asia (EM Asia) had seen greater benefit than other regions from the shifting global supply chain landscape. In this research note we investigate whether friendshoring is indeed occurring in EM Asia.

We begin by examining claims of deglobalisation and defining the concept of friendshoring, distinguishing it from nearshoring. We then look at why EM Asia has proven an attractive destination for the relocation of global supply chains away from China and investigate the extent to which these developing countries are currently benefiting from friendshoring. Finally, we investigate the notion of China potentially rerouting exports through neighbouring countries like Vietnam to bypass US tariffs imposed on Chinese goods.

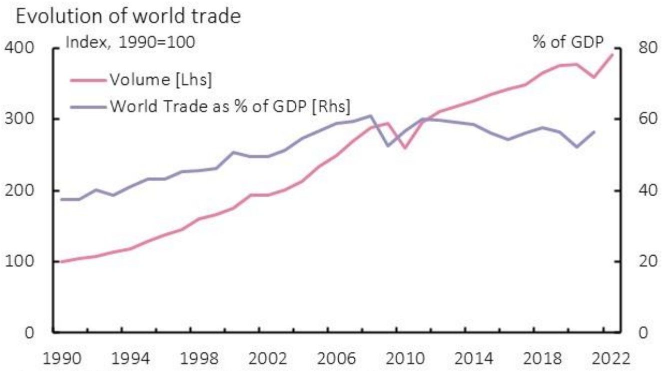
Deglobalisation demystified

Concerns surrounding globalisation are not a recent development. They first surfaced following the global financial crisis of 2007-2008 when international trade, measured as a percentage of the world's GDP, remained stagnant. In 2007, global trade accounted for 59% of the world's GDP, and by 2021, it had declined to 56%. Factors like increasing protectionism and the impact of the pandemic contributed to this decline. However, it's crucial to recognise that the 1990s witnessed rapid trade growth due to the collapse of the Eastern Bloc and China's economic liberalisation and that a stabilisation – and even partial reversal – of this trend was inevitable.

While trade as a percentage of GDP has declined, this is not the only signal of deglobalisation. However, the past three years have also witnessed significant shifts in trade policy and geopolitical landscapes, further underlining this perspective.

Exhibit 1 shows that global trade has shown remarkable resilience and has continued on an upward trend despite temporary setbacks such as the financial crisis and the pandemic. Nevertheless, the pace of trade growth has notably slowed since 2015. On average, world trade has expanded by 2.3% per year since 2015, compared to a growth rate of 5.2% from 1990 to 2014. Trade patterns have changed, even if this does not necessarily equate to deglobalisation. From a trade perspective, friendshoring is compatible with ongoing globalisation, even if it's less efficient.

Exhibit 1: Unrelenting growth



Source: LSEG Datastream and AXA IM Research, September 2023

Friendshoring versus nearshoring

Friendshoring and nearshoring have become buzzwords in recent times as strategies for managing global supply chains. Both methods aim to streamline supply chain operations and mitigate risks. Yet they differ in some key aspects.

Nearshoring involves outsourcing production to neighbouring countries; the geographical proximity allows for lower transportation costs, faster shipping, easier communications and reduced carbon emissions. For example, for US companies, Mexico is often an attractive option. On the other hand, friendshoring is about building long-term relationships with trusted suppliers, regardless of their location. This approach helps reduce supply chain disruptions by working with partners in countries seen as friendly and is likely to be more efficient, while also being open to broader competition than just between those nearby. This not only minimises the risk of conflicts or trade disputes but could also enhance a company's reputation in its target markets.

While Mexico remains an ally of the US and a trade partner in the US-Mexico-Canada Agreement, fiery anti-business rhetoric from President Andrés Manuel López Obrador and institutional weaknesses have cast doubt on Mexico's appeal as a nearshoring destination. By contrast, Asian countries have emerged as attractive choices for friendshoring due to their more stable political and economic environments.

Asia's appeal

Asia's emerging economies have many advantages to increasingly attract supply chain partnerships to the region, but perhaps the main draw is its high degree of economic integration. In 2018, 11 countries including Brunei, Japan, Malaysia, Singapore and Vietnam signed the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). This trade agreement evolved from the Trans-Pacific Partnership, which was never approved following the US's withdrawal.

[1] Lopez-Vivas, L., "Nearshoring in Mexico: Mirage or the real deal?", AXA IM Research, 7 June 2023

This economic synergy is set to be boosted by the recent approval of the Regional Comprehensive Economic Partnership (RCEP). This agreement brings 15 Asia-Pacific nations (including some CPTPP signatories) and China into the world's largest free trade block. Together, the 15 member countries represent a total gross domestic product (GDP) of around US$39bn, or around 30% of global GDP.

The RCEP trade deal will reduce tariffs on a wide range of goods and services, further facilitating cross-border trade. This level of integration significantly reduces trade barriers, making it increasingly cost-effective for companies to source inputs from within the integrated region. It's a gamechanger for supply chains, as it simplifies cross-border operations and provides a fertile ground for companies to optimise production processes. This high level of economic integration fosters an environment where supply chains can operate seamlessly and efficiently.

Alongside this high economic integration, Asian nations boast extensive manufacturing capabilities, in some cases similar to China's (Exhibit 2). For example, Thailand's manufacturing sector accounts for a notable 30% of its GDP (nearly double that of Mexico). This situation offers several advantages, including economies of scale and synergistic opportunities that can greatly benefit new businesses.

Exhibit 2: Big industry in Asia*

Source: LSEG Datastream and AXA IM Research, September 2023

An important benefit of nearshoring lies in the potential for cost reduction, primarily stemming from reduced shipping expenses due to geographic proximity. On the other hand, friendshoring in Asia also presents cost-effective opportunities, thanks to its comparatively lower unit labour costs.

In most emerging Asian countries, manufacturing hourly wages are notably lower than those in China, with the exceptions of Taiwan and Korea (Exhibit 3). The trend is a direct result of China's successful transition up the value chain in global trade. As China moves up the value chain, it gradually phases out the lower value-added, labour-intensive sectors, leading to higher wages in China and reduced competitiveness in those industries. Similarly, wages in Asia remain below those in major Latin American countries such as Mexico and Brazil.

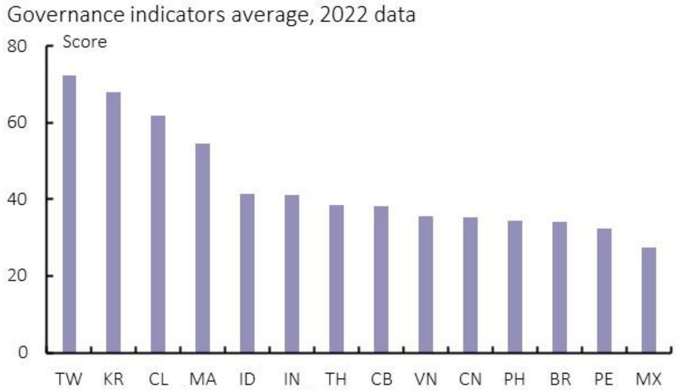
Exhibit 3: The wage factor

Source: LSEG Datastream and AXA IM Research, September 2023

Asia's attractiveness also goes beyond purely economic factors; the region's strong governance also plays a pivotal role in attracting and retaining foreign investments. Investors are drawn to countries with robust governance practices. This includes transparent institutions, efficient regulations and reliable dispute resolution mechanisms, all of which boost investor confidence and reduce risks associated with their ventures.

The World Bank offers a series of governance indicators covering six dimensions: Voice and Accountability, Political Stability, Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. In most of these categories, Asian nations tend to outperform both China and key Latin American economies including Brazil, Mexico and Peru. Calculating average scores across these dimensions, it becomes evident that all Asian countries surpass Mexico (Exhibit 4). This underscores the region's suitability for long-term investments, a critical aspect of friendshoring.

Exhibit 4: Governance gurus*



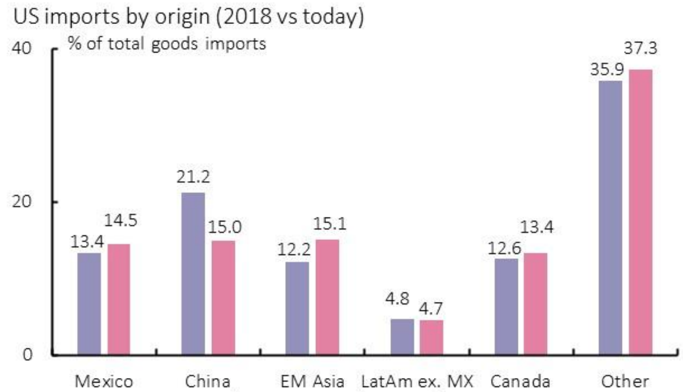
Source: World Bank and AXA IM Research, September 2023

Trade struggles, but US import penetration rises

Asia's many advantages for friendshoring sharply contrasts with the current state of its trade sector. Exports in the region have declined considerably in the first half of 2023, mainly due to weak demand in the United States (US) and Western Europe and a slow economic recovery in mainland China. The downturn in global electronics orders has been a significant factor affecting Asian exports, given the substantial role of electronics manufacturing in many Asian countries' exports. Nonetheless, it's essential to recognise that this decline in exports is largely cyclical. To gain a perspective on the potential for US friendshoring in Asia, we shift our focus to examine US goods imports by country of origin.

Using 2018 as a reference point, the data reveals a notable shift in the share of US goods imports (in value terms). China's share has notably decreased, dropping from 21% to 15% (Exhibit 5), reflecting the impact of trade tensions that began in that year. Conversely, Mexico has seen a more modest increase of one percentage point, but EM Asia has substantially expanded its share, gaining nearly three percentage points (ppt). This data suggest that EM Asia has reaped greater benefits than Mexico from China's declining share in US imports.

Exhibit 5: US imports in flux



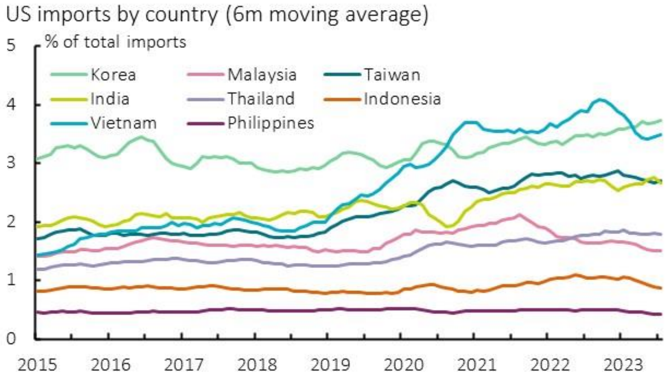
Source: LSEG Datastream and AXA IM Research, September 2023

The evidence becomes more compelling when examining US manufacturing imports by source. Focusing on manufacturing imports is key for understanding production relocation since friendshoring mainly involves moving manufacturing activities. The data shows in this case that China has lost 5ppt of its share in US imports of manufactured goods while EM Asia has gained three points. Mexico's share increased marginally. However, it's worth noting that EM Asia comprises diverse countries, each with varying success in outpacing China's share in US imports.

Who's pulling the weight?

Exhibit 6 provides a breakdown of US goods imports from Asian countries since 2015. While several nations have seen modest increases in their share of US imports, Vietnam emerges as the biggest beneficiary of the US-China trade war. Vietnam has significantly elevated its share of US imports from 1.5% in 2015 to an impressive nearly 4% in 2022. This remarkable growth has propelled Vietnam to be the largest of EM Asia's share of exports to the US. In fact, a recent World Trade Organization (WTO)[2] paper estimates that Vietnam's exports by value increased 27% between 2017 and 2020 as a direct result of US tariff hikes on Chinese products (73% of the observed increase in Vietnam exports during the same period). Korea, Taiwan and India have all made significant gains. By contrast, less industrialised nations like the Philippines and Indonesia have seen minimal growth in their shares during this period.

Exhibit 6: From conflict to commerce



Source: LSEG Datastream and AXA IM Research, September 2023

Vietnam: Export hub or tariff trickster?

While it is evident that Vietnam has benefitted from shifting supply chains, observers have questioned the origin of this recent surge. Anecdotal evidence suggests that Chinese producers are simply rerouting exports through Vietnam to evade US tariffs while in 2019 the Vietnamese government acknowledged that some Chinese exporters had been illegally rerouting orders through the country. Likewise, the government had found fake 'Made in Vietnam' labels on a myriad of Chinese goods and promised to increase fines on trade-related fraud as a result.[3]

Trade data does indicate a significant surge in Chinese exports to Vietnam after the imposition of former US President Donald Trump's tariffs, nearly doubling from $6bn in 2017 to $11.5bn in 2020. However, from this data alone it is challenging to distinguish between trade that resulted from this rerouting and trade that represents conventional, legitimate transactions – that is, Vietnam increasing imports from China to produce finished products to be exported to the US. To try to resolve this puzzle, the WTO also examined the effects of Trump's trade policies on Vietnam's labour market. Its research reveals that employment in sectors directly affected by Trump's policies had risen, accompanied by an increase in both working hours and wages. This implies a discernible impact in Vietnam's manufacturing output in the last few years, which should quieten some of the concerns over China export rerouting. However, there remains some ambiguity around the precise mix of developments.

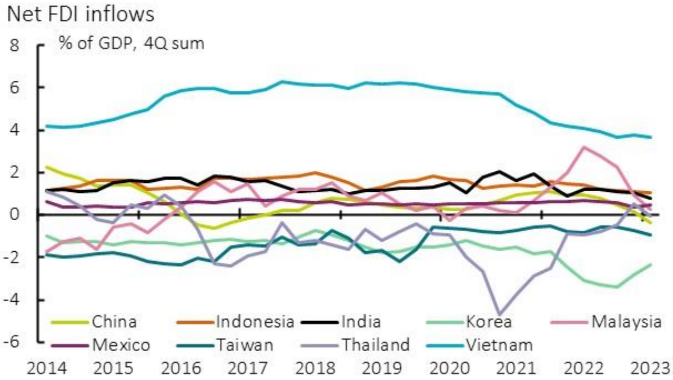
[2] Trade Policy and Jobs in Vietnam: The Unintended Consequences of Trump's Trade War

[3] Chinese Exporters Dodge Tariffs With Fake Made-in-Vietnam Labels - Bloomberg; Vietnam to crack down on Chinese goods relabelled to beat U.S. tariffs | Reuters

FDI flows and the future of friendshoring

While there is strong evidence of Asia's gains in trade over the last few years, it is likely that we have not yet witnessed the full effects of friendshoring. Strong net FDI flows continuing into the region would imply increased exports of goods in the future. We thus analysed FDI flows into Asian countries and Mexico for comparison.

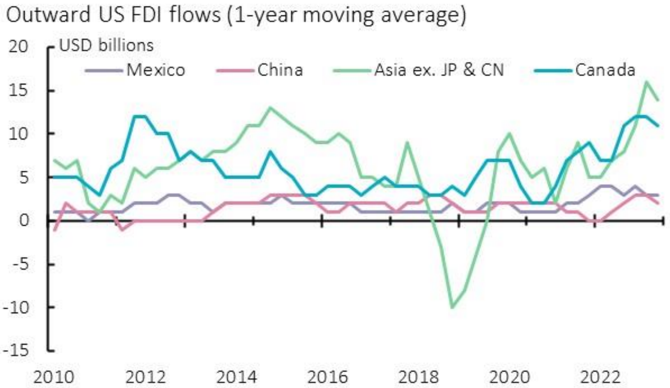
Exhibit 7: Vietnam, a darling for foreign investors



Source: LSEG Datastream and AXA IM Research, September 2023

Exhibit 7 highlights several crucial aspects. First, the more developed countries in the region, such as Korea and Taiwan, show net FDI outflows as a percentage of GDP. Moreover, Malaysia is the only country that has witnessed a material increase in foreign investment in recent years, but this surge has since subsided. The data also indicates that FDI flows into China reached their peak in 2021 and have now turned negative for the first time in recent years. Lastly, Vietnam once again leads the pack in this dimension, although its position predates discussions of friendshoring. Nevertheless, it underscores Vietnam's success in attracting FDI.

Exhibit 8: The bald eagle finds a nest in Asia



Source: LSEG Datastream and AXA IM Research, September 2023

This success should come as no surprise. Beginning in the 1980s, the nation set in motion a series of market-oriented reforms that enabled Vietnam's evolution into an export-oriented hub. This transformation was made possible by the establishment of Special Economic Zones with a clear emphasis on attracting foreign investments. Furthermore, the country provides foreign companies with a range of tax incentives and simplified regulatory procedures.

In contrast to the declining FDI inflows into EM Asia, there has been a notable surge in outward US FDI flows into the region over the past few years, significantly surpassing flows into Mexico or China (Exhibit 8).

The future of friendshoring in Asia

The shifting landscape of global trade has given rise to debates about deglobalisation, driven by concerns about national security, supply chain vulnerabilities, and changing trade patterns. While trade as a percentage of global GDP has stabilised at around 56%, recent geopolitical events have prompted a reconsideration of globalisation's trajectory.

Friendshoring, a strategy focused on building long-term relationships with trusted suppliers, has emerged as a response to these challenges. In this context, emerging markets in Asia have become attractive destinations for friendshoring due to the region's highly integrated economies, extensive manufacturing capabilities, and competitive labour costs. Asia's strong governance practices further enhance its appeal to foreign investments.

Analysis of trade data reveals that EM Asia, led by Vietnam, has gained a larger share of US imports in the last few years, particularly in manufacturing, at the expense of China. However, suspicions of Chinese exports rerouting persist, although some data clearly points to increased manufacturing ouput by other exporters.

The future of friendshoring in Asia depends on sustained economic integration, favourable governance and the ability to attract foreign investments. Strong outward US FDI flows into the region suggest the potential for further growth, making Asia a pivotal player in the evolving landscape of international trade. However, risks such as trade disputes and geopolitical tensions should be closely monitored, as they could impact the trajectory of global supply chains in the years to come. As tensions persist between China and the US, Asian countries are likely to continue expanding their production and exports, further solidifying their role in the global manufacturing hub – and potentially increasing the region's long-term investment appeal.

*** International country codes used for the charts in this paper are as follow** – Brazil (BR); Chile (CL); China (CN); Colombia (CB); Indonesia (ID); India (IN); Malaysia (MA), Mexico (MX); Peru (PE); Philippines (PH); South Korea (KR); Taiwan (TW); Thailand (TH); Vietnam (VN).

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