

2nd Stage Keynote Address

Transforming the Global Supply Chain

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I would like to speak on five issues: COVID-19 and the issue of US-China friction, policy developments in China, the direction of overseas expansion in Japanese companies, the business operations of Japanese companies in China under the context of these issues, and finally, the state of supply chain reorganization.

First of all, I would like to touch on changes observed in the Japanese economy. In the past 20 to 30 years, the lead earner within Japan's economy has shifted from trade to investment. Comparing 1999 and 2019, Japan's national trade balance decreased significantly from 14.1 trillion yen to 0.4 trillion yen, while the balance of investments increased sharply from 6.5 trillion yen to 21.0 trillion yen. In other words, in the process of expanding their investments overseas, Japanese companies have formed a highly complex global supply chain. Currently, COVID-19 and the issue of US-China friction are significantly impacting this supply chain.

When the spread of infection of COVID-19 occurred in China last January, many people likely associated it with the SARS outbreak in China from 2002 to 2003. Had the COVID-19 infection been contained at the level of SARS, there would have been fewer issues with the supply chain. However, as the coronavirus became a global infectious disease risk, it was no longer a problem that could be solved simply by lowering the weight of operations in China.

As for US-China friction, we all know that since July 2018 the two nations have imposed additional tariffs on the other resulting in a trade war. The fourth round of additional tariffs was to be initiated in two installments. Had the excises been triggered in December 2019 as proposed, concerns about the substantial impact on both economies would have been realized, especially since US imports from China include many consumer goods such as smartphones, personal computers, and game consoles. Fortunately, last-minute negotiations resulted in the suspension of these tariffs.

Also, on January 15, 2020, the US and China signed the first phase of an economic and trade agreement. The agreement was extremely hard on China, in particular, the increased protection and enforcement of intellectual property rights, a ban on pressure tactics on foreign companies over technology transfers, and China agreeing to increase US imports by more than US\$200 billion in two years.

No one expected this agreement to end the conflict between the nations, but a truce in the US-China trade war continued for 18 months until the COVID-19 pandemic hit.

Let me try to organize the composition of the US-China trade war in my own way. China recently avoids public use of the term

“Made in China 2025” to describe its policy on industrial sophistication after considerable criticism from the US, however the strategy is continuing. The goal is to realize the Chinese Dream, or the great revival of the Chinese people, while also upgrading its industries and avoiding the middle-income trap.

In contrast, the US's substantial aim is to prevent China from gaining economic hegemony and maintain its own security advantage. Therefore, the US considers intellectual property infringements or cyberattacks by China as a major issue, and while it presses for concessions through tariff increases, etc., it also strengthens restrictions on exports and investments based on the National Defense Authorization Act.

China, on the other hand, has agreed to concessions such as expanding imports because at present it cannot meet the US on an equal footing economically or militarily, but it is difficult to compromise on “Made in China 2025”, and in exploring ways to seek greater self-reliance, it has recently tightened trade and investment regulations, expressly against the United States.

In this way, there is limited latitude for compromise between the US and China, and it is hard to find a middle point. In the first place, the essence of US-China friction is a struggle for supremacy between two major powers, and I, like many people, feel that a long-term conflict is inevitable.

Next, I will look at recent policy developments in China. In October 2020, a crucial meeting of the Communist Party of China, known as the Fifth Plenum, was held in China. At the meeting, the Communist Party of China's Central Committee introduced and deliberated on proposals for the formulation and adoption of the 14th Five-Year Plan, starting in 2021, and the Long-Term Goals through 2035. The 14th Five-Year Plan will be officially initiated after deliberations at the National People's Congress scheduled for March 5, and these proposals will form the base of policy.

Among the 60 total proposals, one closely related to the supply chain is to “accelerate the development of modern industrial systems, and promote the optimization and sophistication of economic systems” (Table 1). The beginning of this item mentions “raising the level of industrial chain and supply chain modernization,” which was not listed in the proposals of the 13th Five-Year Plan five years ago.

The point is that the strengths of China's industrial and supply chains will be refined, and its fragile areas complemented. In other words, as an area of advantage, China will build an emerging industrial chain, promote the high-end, smarting, and greening of traditional industries, and develop a service-based manufacturing industry. Conversely, it is said China will implement projects to rebuild industrial infrastructure, now

Table 1 Composition and items of proposals from the 5th Plenum (Excerpt)

Items	
1	Establish a well-off society in an all-round way, and embark on the new journey to make China an all-round modernized socialist country.
	1) Decisive achievements have been made toward victory in establishing a well-off society in an all-round way 2) Our development environment faces profoundly complex changes 3) Fundamentally realize the long-term objective of socialist modernization by 2035
2	Guiding directives and main objectives for economic and social development during the 14th Five-Year Plan period
	1) Guiding ideology for economic and social development during the 14th Five-Year Plan period 2) Principles that economic and social development must adhere to during the 14th Five-Year Plan period 3) Main objectives for economic and social development during the 14th Five-Year Plan period
3	Seek innovation-driven development, and comprehensively fashion new development advantages
	1) Strengthen China's strategic science and technology capabilities 2) Improve the technological innovation capability of enterprise 3) Stimulate the innovative vitality of talents 4) Refine the mechanism for scientific and technological innovation
4	Accelerate the development of modern industrial systems, and promote the optimization and sophistication of economic systems
	1) Raise the level of industry chain/supply chain modernization 2) Develop strategic emerging industries 3) Accelerate the development of modern service industries 4) Coordinate promotion of infrastructure construction 5) Accelerate the development of digitalization
5	Form a strong domestic market, and build a new development framework
	1) Facilitate domestic circulation 2) Promote domestic and international dual circulation 3) Comprehensively promote consumption 4) Broaden the space for investment

Source: Based on "Proposals of the Communist Party of China Central Committee on the Formulation of the 14th Five-Year Plan for National and Economic Development and the Formulation of Long-Term Goals through 2035"

regarded as a vulnerable area, focus on the challenging strategy of key products and core technologies, develop advanced applicable technologies, and promote the diversification of industrial chains and supply chains.

Another of the items, to "accelerate the development of digitalization," was absent from the 13th Five-Year Plan. This time, the global digital economy is distinctly listed as one of the proposals. Here, it is advocated to promote the industrialization of digital and digitalization of industries, promote an advanced fusion of the digital economy and real economy to build an internationally competitive digital industry and cluster. Also, the directions of developing data resources, known as the oil of the 21st century, and strengthening the protection of personal information by securing national data have been laid out.

Another noteworthy item is to "form a strong domestic market, and establish a new development framework." Here, based on the facilitation of domestic circulation, the policy of promoting dual circulation in both its domestic and international markets is advocated. Recently, the terms "domestic circulation and dual circulation" are often used to describe Chinese policy. The image of this policy, according to Professor ZHANG Yunling in his keynote address at the first stage of 2021NICE, is that in the next 20 years China will stimulate its domestic economy, thanks to its world-leading domestic demand, and as the world's second largest trading power, will construct a U.S.-

like economy connecting it to the world and globally and making China the largest economic power externally.

Furthermore, in relation to domestic demand, there is an item to "comprehensively promote consumption", especially "new forms of consumption". In addition to online shopping, which has developed due to COVID-19, these "new forms of consumption" foster fields such as live commerce, which is now extremely popular, online education, and medical care. "Broadening the space for investment" refers to the catchphrase coined at the National People's Congress in May 2020, "Liang xin yi zhong (Priority given to new infrastructure, new urbanization initiatives and major projects)", which takes the first Chinese character of new infrastructure, new urbanization, and major project construction, although new infrastructure is now gaining particular attention. According to a white paper released by a government think tank, China will invest in 7 areas of infrastructure such as inter-city high-speed rail, 5G, big data, and new-energy vehicle charging stations. By 2025, direct investment in these areas should reach almost 10 trillion yuan, with related investment set to soar beyond 17 trillion yuan. (Table 2)

Next, we will look at the direction of overseas expansion by Japanese companies.

According to surveys results of Japanese companies conducted by the Japan External Trade Organization (JETRO),

Table 2 Investment scale of new infrastructure construction (2025)

Field	Direct Investment	Related Investment
Inter-city high-speed rail; rail traffic	4.5 trillion yuan	5.7 trillion yuan
5G	2.5 trillion yuan	5 trillion yuan
Big Data Center	1.5 trillion yuan	3.5 trillion yuan
Industrial internet	650 billion yuan	1 trillion yuan
Ultra-high voltage network	5 trillion yuan	1.2 trillion yuan
Artificial Intelligence (AI)	2.2 trillion yuan	4 trillion yuan
New energy vehicle charging stations	900 billion yuan	2.7 trillion yuan
Total	9.9 trillion yuan	17.7 trillion yuan (about. 273 trillion yen)

Source: Created based on the "White Paper on The Development of New Infrastructure Construction" by the China Electronic Information Industry Development (CCID), March 2020

over half the respondents planned to increase overseas expansion in the future, and many Japanese companies have already mapped out the direction of their overseas expansion activities.

With increased overseas demand the most common reason given, followed by a decrease in Japan's domestic demand, companies are looking abroad to find what they desire. The fall in local demand is due to Japan's population decline stemming from a low birthrate and aging population. United Nations projections predict that its population will plummet by more than 20 million in the next 30 years, with the working-age population and group responsible for consumption and production also set to tumble. During this period, Japan will face the severe structural problem of population decline. It will be hard to solve in the short term, so Japanese companies will be forced to find an alternative in overseas markets for the time being.

The US and China are both essential economic partners for Japanese companies. They are Japan's first and second largest trading partners, with Japanese companies investing heavily overseas to turn a profit, but in terms of the profit from their direct investment, little separates the US and China, which rank first and second respectively.

In fact, a JETRO survey shows that China (48%) ranks first for countries and regions where companies are looking to expand business operations, followed by Vietnam (41%), Thailand (36%), and the US (32%), and with each country totaling more than 30%, the US and China are certainly important economic partners for Japan.

However, with the issue of friction between the US and China intensifying and the risk of decoupling being mentioned, how to restructure the strategy of Chinese business going forward is a pressing issue for Japanese companies.

Therefore, I will explain the current state of Japanese companies' business operations in China. According to results of JETRO's latest survey released in December 2020, 36.6% of companies said they would expand business developments in China, 55.6% would maintain the status quo, 1.0% would release or withdraw, and 6.7% would scale down, meaning that

more than 90% of Japanese companies have stated their intentions to continue or expand operations in China.

The main motivation behind business expansion is increased sales in the local market as well as in China, followed by high growth potential and market potential. Conversely, some companies expressed a desire to downsize, release or withdraw operations, with a fall in local market sales and increased costs such as labor being the key reasons. Very few respondents cited impacts of the US-China friction or trade restriction measures.

This can be explained by the structure of Japanese companies expanding into China. Their sales include domestic sales or exports in China, but there are overwhelmingly more domestic sales in China, which account for just under 70%. A little over 30% of sales are exported, and more than 60% of those are to Japan. Only 5% of sales from Japanese companies expanding into China go to the US, and exports directly from China to the US are just under 2%. Therefore, the direct impact of additional tariffs between the US and China is limited.

Finally, we will look at the future state of supply chain reorganization. A white paper on trade published in July 2020 made recommendations on this issue. One is the supply system and countermeasures, especially for masks and other emergency supplies that have become an issue due to COVID-19, but since it is impractical to maintain 100% supply capacity from usual times, it has been deemed important to build a reliable supply system that is unaffected by international situations during times of emergency. In fact, it is necessary from a security perspective to return the production of masks and protective clothing to Japan.

China is Japan's largest import partner, accounting for a quarter of imports, and Chinese imports make up a very high percentage for many products. More than 90% of imports of goods with six-digit HS code systems are from China, including 99% for laptops, 99% for video game consoles, and 91% for air conditioners, thus we depend on China for many items.

Debate on returning the production of these items to Japan exists, but Keidanren (Japan Business Federation) Chairman NAKANISHI Hiroaki says it is not a case of returning

everything to Japan, nor that it is even possible. In fact, Japan’s population is set to fall by 20 million in the next 30 years, so returning all production bases to Japan is not a realistic option.

According to a JETRO survey on supply chain restructuring, 7.6% of respondents had already implemented or planned to do so. Of these, 2.8% of production sites were transferred, which is a very low figure. As for how the transfer of production sites was reorganized among the few, most common was from China to Vietnam (24.5%), followed by China to Thailand (14.5%). The return of production from China to Japan is about 7%.

The reason for this is the manufacturing cost of the Japanese manufacturing industry. Labor accounts for about 20% of manufacturing costs, and material costs make up about another 60%. Within the manufacturing industry, cost competitiveness equates to the quick and cheap procurement of materials, but according to a JETRO survey, Japanese companies expanding into China can procure almost 70% of raw materials and parts locally, which highlights China’s superiority as a production base over other Asian countries. Therefore, it is not easy to pick up and leave China. (Figure)

Under these developments, two directions are afforded Japanese companies. One is local production for local consumption. An example from Komatsu Chairman OHASHI Tetsuji cites ‘production in the market = demand area’, whose benefits include easier access to customer needs, increased customer confidence through committing to the local area, and

reduced transportation costs and periods. Among them, technological innovation is continued by concentrating production of key components and core parts in Japan, and the quality of finished products is guaranteed by maintaining their quality. Conversely, the organization pursues the world’s best procurement process for other parts.

The other option is ‘selection and dispersion’, which Omron President YAMADA Yoshihito believes are vital keywords these days. Omron began dispersing its supply chain a year or two ago when the US-China friction was first divulged, saying that production of electronic sphygmomanometers sold in the US was transferred to Vietnam from a factory in Dalian, China. In this way, in the huge Chinese market, what is sold in China will be produced there. Alternatively, instead of considering China as a global factory and positioning it as a global supply base, we are also seeing a direction that promotes selection and dispersion.

To finish, allow me to summarize my talk into 3 points.

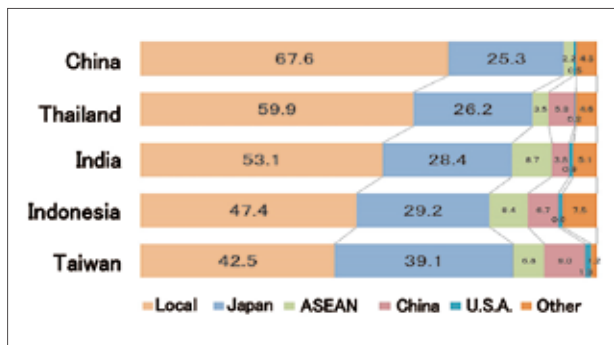
First, the two most pressing risks facing Japanese companies are COVID-19 and the US-China friction. However, since this virus is now an infectious disease risk on a global scale, the problem can no longer be resolved simply by reducing the weight of operations in China. On the other hand, because US-China friction is a battle for supremacy between two economic superpowers, medium- to long-term responses are required, including recent moves to tighten restrictions on exports and investments.

Secondly, with regards to restructuring China business strategy, it is difficult to stem the tide of globalization, especially against the backdrop of Japan’s population decline due to a falling birthrate and aging population, thus Japanese enterprises have no option but to look abroad to find a way out. The US and China are vital economic partners for Japanese companies, and there is little to separate the two, but they must consider reshaping their China business strategy based on the decoupling associated with this US-China friction.

Finally, while the reorganization of the global supply chain is considered necessary to some extent from a security perspective, particularly for the return of emergency supplies such as medical supplies, it is hard to say whether returning all production bases to Japan is a realistic response. Therefore, local production for local consumption, and selection and dispersion are future directions expected to advance.

[Translated by ERINA]

Figure Procurement sources for raw materials and parts



Source: Created based on JETRO Survey on Japanese Companies Expanding Overseas (Asia, Oceania), Dec 2020
 English: www.jetro.go.jp/ext_images/_News/releases/2021/69b41fe-59a5b2299/rp_firms_asia_oceania2020.pdf (p.56)