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China's Chances of Winning in the “Local Production, Local Consumption” Regional Industry Chain

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Recently, in a conversation with Tatsuro Ueda, CEO of Toyota China, the author noticed a repeatedly mentioned concept: “local production, local consumption”. In the first half of 2020, amid the COVID-19 outbreak, escalating tensions between China and the US, and severely impacted global supply chains, Toyota’s global sales decreased by 31.8% in the second quarter compared to the previous year. Specifically, its sales dropped by 30% in Japan and by 60% in North America. The only exception to these declining sales was Toyota’s performance in the Chinese market, where it saw a 14% growth in sales, and 30% and 57% increases in profits for Toyota’s joint ventures and affiliate companies in China, respectively. Ueda claimed: “Toyota has established a comprehensive industry chain in China and realized the goal of “local production, local consumption.” Toyota’s achievements in the Chinese market are probably adequate proof of the effectiveness of the Chinese government’s recent policy proposition of ‘forming a development model centered on internal

circulation, and speeding up a dual circulation growth model in which internal circulation and international circulation promote each other.”

“Local production, local consumption” is originally a Japanese phrase, but it has the same meaning in Chinese. “Local production, local consumption” relies on China’s “internal circulation.” For China’s industries, “local production, local consumption” used to be much less appealing than imports and exports, but the terminology has long been familiar to Japanese companies in China. The phrase itself reflects the essential condition and primary goal of Japanese companies’ development in China: China has all the industrial sectors, identified by the United Nations industry classification system, and a megamarket. Very few countries in the world have both.

When talk of “decoupling” is in the air, “regional internal circulation,” centered on a single consumption zone and multiple “local production, local consumption” industry chains and supply chains, is taking shape. With such a trend, China can utilize its advantages to not only become a core in the regional industry chain, but also optimize its industrial structure, move upstream in the industry chain, and build a more resilient and sustainable industry chain and supply chain.

I. China’s Strength: “Local Production, Local Consumption”

According to the World Bank, China’s imports and exports value comprised 0.7% of global GDP in 2000; these figures rose to 2.5% and 2.9% in 2018, respectively. Over the same period, China’s imports and exports of intermediary products increased from 6.1% to 11% and from 4.1% to 9.4% of the global sum. These data demonstrate China’s vital role in the global manufacturing industry. Among individual countries, the US and Japan have high dependence on the import and export of intermediary products from China. In 2017, the US imported 16.3% and exported 8.8% of its intermediary products from and to China, and Japan’s imports and exports of intermediary products from and to China were as high as 21.1% and 24.7% of its total.

In view of the above, although China was the first country to bring COVID-19 under control and resume work and production, the US and Japan were still hit hard due to their deep connections with China's industry chain. In March 2020, the Association for Supply Chain Management in the US surveyed its members and found that 86% of companies experienced difficulties in importing intermediary products from China. In the same month, Japan's Nikkei magazine published a survey of Japanese manufacturing companies, showing that 48.5% of respondents experienced similar difficulties and more than half of companies' normal production was impacted as a result.

Despite these difficulties, most American and Japanese companies have not yet decided whether to decouple from China completely. In April 2020, the Japan External Trade Organization surveyed Japanese companies in southern China, finding that only 2.9% of companies were considering relocation due to the pandemic, and that 5.4% of companies had already considered relocation before the pandemic and wanted to accelerate the process. In a survey conducted by the American Chamber of Commerce in Shanghai and PwC in March 2020, among 25 American companies with annual sales over 500 million dollars, 12% considered partially relocating their production sites and supply chains out of China while only 4% planned to relocate entirely. Surveys of other foreign companies show that only 10% to 20% of them plan to relocate their production sites or supply chains out of China. The so-called "accelerated decoupling" from China is far from being a reality.

Regardless of the intentions of certain companies or a single state, in practice, it would be difficult to decouple from China completely. The Chinese manufacturing industry is comprehensive and well-developed. According to the Economic Complexity Index compiled by Harvard University's Center for International Development, China, with a comprehensive and enormous industrial manufacturing system, ranks 19th globally. It would be difficult to find a production site to replace China. In addition, China has a megamarket that can realize "local production, local

consumption,” and foreign companies can hardly abandon it.

With regard to the current situation, China brought COVID-19 pandemic under control early on and has quickly resumed work and production, whereas most developed and developing countries are still troubled by the pandemic and are struggling to reopen their economies. This situation is an important reason why many companies cannot decouple from China. Many observers only notice when companies decouple from China but ignore the fact that many companies are also seizing the opportunity to “couple” with China’s industry chain. According to a survey conducted by the Japanese Chamber of Commerce and Industry in southern China, because many companies in Japan and Southeast Asia experienced supply shortage, 4.6% of Japanese companies have already relocated or plan to relocate their industry chain to China. To the surprise of observers, “decoupling” has provided many transnational corporations with the opportunity to reevaluate their relations with China, and many have realized that their production, sales, or even technological innovation sectors are already deeply integrated into China’s economy and society⁷ – decoupling will not be easy, if not unthinkable.

II. The Accelerated Restructuring of the Global Industry Chain and Supply Chain Amid the COVID-19 Pandemic

The US and other Western countries are the designers of the global industry chain and supply chain. Because Western countries possess core technologies and are located upstream of the global industry chain, they are well-positioned to plan in advance and maximize their own interests. However, as the global economy continues to develop, it is inevitable for China and other developing countries to move upstream in the industry chain. The COVID-19 pandemic has exposed the vulnerabilities of the global industry chain. Regional natural disasters, epidemics, and military conflicts have the potential to disrupt global industry chain and supply chain. For example, in March 2011, the Tohoku earthquake – the most powerful earthquake ever recorded in Japan – unleashed a tsunami and caused the Fukushima Daiichi nuclear disaster, resulting in the halt of

production in many automobile parts factories in Fukushima. This, in turn, impacted the global auto manufacturing industry.

After the COVID-19 outbreak, the Japanese government proposed the allocation of 220 billion yen to help Japanese companies in China shift production to Southeast Asia or back to Japan. However, after scrutiny, only the following categories of Japanese companies are “evacuating from China”: (1) companies that can fill a vacuum in Japan, especially manufacturers of personal protective equipment (PPE) and medicines (the shortage of such products early on during the COVID-19 outbreak made the Japanese government feel overdependent on Chinese production and thus believe it is necessary to move production back to Japan); (2) “decoupling” opportunists, i.e., some small-and-medium-sized companies that already experienced difficulties operating in China prior to the pandemic due to rising costs and other reasons, and utilized the Japanese government’s subsidies to move their production down the industry chain to Southeast Asia; and (3) companies that had no choice but to relocate due to pressure from the US.

Despite such measures, many excellent companies saw China’s advantages in “local production, local consumption” through the COVID-19 pandemic and, as a result, sought to expand and increase their production capabilities there. According to Ueda, the CEO of Toyota China, Toyota learned from the lessons of the 2011 Tohoku earthquake and built comprehensive industry chains in China, protecting the dual circulations of two parallel industry chains in Japan and China. In the first half of 2020, Toyota not only had an outstanding performance in the Chinese market but also protected the health of its employees in China – among the more than 700 Japanese employees and more than 40,000 Chinese employees in eight wholly-owned Toyota subsidiaries, twenty-one joint ventures, six auto assembly plants, and four auto engine plants across eight provinces, none contracted COVID-19.

In the second quarter of 2020, Japan’s GDP dropped by 27.8%,

marking the largest economic decline ever recorded in its history. Notably, its export of industrial products, including automobiles, declined significantly by 18.5%. However, achievements in the Chinese market bolstered Toyota's total sales. Despite talk of decoupling, Toyota aims to double the production of its factories in China and has announced that it will establish a joint venture company in fuel battery system research in China.

The restructuring of the global industry chain and supply chain already began prior to the COVID-19 outbreak, and the pandemic only accelerated this process. Countries are actively or passively shortening and regionalizing their industry chains in order to build safer and more resilient industry chains and supply chains. China is doing this as well - it seeks to be more than just the "factory of the world." Therefore, China should urgently optimize its industrial structure, move up the industry chain, and welcome a certain degree of "survival of the fittest" mentality among foreign companies competing in the Chinese market.

III. China Should Actively Forge an East Asian Industry Chain and Supply Chain

On May 14, 2020, the Politburo Standing Committee of the Chinese Communist Party first proposed the idea of "forming a development model centered on internal circulation, and speeding up a dual circulation growth model in which internal circulation and international circulation promote each other." President Xi Jinping points out that "China has the world's biggest and most comprehensive industrial complex and a middle-income population of more than 400 million; there is enormous potential for investment demands." However, this does not mean that China will abandon the global industry chain and supply chain. Instead, China will utilize the potential of domestic demands to explore a new approach combining multiple "local production, local consumption" regional industry chains into a single consumption zone. In order to achieve more robust and sustainable development, it should rely on its advantages to

carefully build regional industry chains while protecting global industry chains, fix loopholes in supply chains, and better connect domestic and international markets.

In the first half of 2020, trade between China and the Association of Southeast Asian Nations (ASEAN) increased by 5.6%, making up 14.7% of China's total global trade. ASEAN has replaced the European Union as China's largest trading partner. ASEAN Plus Three countries (the ten ASEAN member countries plus China, Japan, and South Korea) have outperformed other regions in the world in both epidemic control and economic recovery. According to the International Monetary Fund's forecast, East Asia may be the only region in the world that will still have positive economic growth. With China's 3.2% growth in the second quarter of 2020, East Asia's GDP growth is estimated to be 1.3% in 2020 and 6.6% in 2021. Under these circumstances, East Asia has the opportunity to lead the global economic recovery.

Restructuring the regional industry chain and supply chain will be the main task of post-COVID East Asian cooperation. According to the Joint Statement of the Special ASEAN Plus Three Summit on COVID-19, participating countries will reaffirm their commitments to keep markets open for trade and investment, strengthen joint efforts toward post-pandemic recovery, maintain necessary interconnectedness in the region, strengthen the resiliency and sustainability of regional supply chains, and maintain the smooth operation of logistics networks inside and outside the region.

China, Japan, and South Korea account for 70% and 90% of East Asia's population and economy, respectively. China is Japan and South Korea's largest trading partner, and Japan and South Korea are, respectively, China's second- and third-largest trading partner. Due to the COVID-19 outbreak, China-Japan and China-South Korea bilateral trade remain roughly the same level as last year, but the three countries are deeply connected via industry chains and supply chains. The East Asian value chain's "megamarket" is characterized by not only substantial

market demand but also considerable room for innovation. Japan and South Korea's roles in the East Asian value chain also demonstrate the importance and feasibility of technological innovation cooperation. Along with the emergence of new industries, China's burgeoning digital economy promises to bring the three countries' cooperation in technological innovation to a new stage.

China is committed to building infrastructure for and expanding trade with countries participating in the "Belt and Road Initiative" (BRI). This will help form a "trapezoid structure" in the regional industry chain and supply chain. It is also important to enhance infrastructure interconnectedness, foster cross-border production and trade, reasonably arrange human resources, and raise the technological level of participating countries. All these measures can push forward the reasonable arrangement of different sectors of industry chains among BRI participating countries and build a more resilient and diverse regional industry chain.

An effective cooperation mechanism will be necessary to maintain the stability and smooth operation of regional cooperation and to realize the new approach of forming multiple "local production, local consumption" regional industry chains and supply chains, that are centered on the Chinese consumption zone and exert influence on surrounding areas. With such goals, China should (1) further exert its roles of mediation and facilitation; (2) seek the finalization and signing of the Regional Comprehensive Economic Partnership (RCEP) agreement by the end of 2020; and (3) create ideal conditions for signing the China-Japan-South Korea Free Trade Agreement and for elevating the level of cooperation among the three countries.

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