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ASIA'S NEW TRADE BLOC MAKES IT EVEN STRONGER

Despite de-globalization fears, China and Asia are back at the center of global supply chains. The RCEP Asian trade-integration plan has big global implications.

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IN A NUTSHELL

- Global supply chains have been on a rollercoaster ride for the past two years. First the U.S.-China trade conflict, then the global pandemic, raised fears about decoupling and disruption of Asian and Chinese supply chains. But the year ends with Asia forging tighter regional trade links that should further strengthen the region.
- For the first time ever China, Japan and South Korea will be members of the same free-trade zone. This is likely to have important implications for their competitors in Europe and the U.S. There will likely be a strong incentive to shift production into the region.
- Who loses, who gains? India and Taiwan are not involved. The biggest winner could be Japan.

INTRODUCTION

The golden days of globalization, after China's World Trade Organization (WTO) entry in 2001, are distant. Initially, globalization brought mutual advantage. China supplied cheap, labor-intensive goods to advanced economies and bought consumer and capital goods from them, fueling global growth. When China's wages started to grow at double-digit rates, the first shift in global supply chains took place. Global firms moved production out of China, mainly into smaller, cheaper ASEAN countries. In China, meanwhile, better education and technological advances generated strong productivity gains, allowing the country to move up the value chain, and shift to production with higher tech input.

That's why, though this is not the widespread perception, some aspects of production have been moving out of China into cheaper Indonesia, Thailand, Vietnam and other countries for many years. The U.S.-China trade conflict which began almost three years ago, accelerated the trend as newly imposed U.S. tariffs made Chinese exports more expensive. The 'trade war' found an interim end (the 'Phase-One' deal that froze tariffs) in January 2020 after bilateral tariffs had increased from lower-single-digit levels to roughly 20% on average.

CHINESE DECOUPLING

However, as the U.S.-Chinese 'trade war,' with punitive tariffs as the main weapon, has shifted to a conflict about future technological leadership, global firms have become more worried about the security of their supply chains out of China. In addition to higher costs because of the higher tariffs, global exporters and importers now face worries about disruptions to supply chains and the need to make a forced choice between the U.S. and China – for example, where allowing China to build 5G infrastructure is concerned.

Many U.S. restrictions on technological inputs have been introduced, initially damaging severely one Chinese telco giant, and later targeting China's computer-chip firms and even financial ones. ¨

COVID-19: NEW WORRIES OVER DEPENDENCE ON SUPPLY CHAINS

The questions and worries about economic dependence on China were exacerbated in the first quarter this year when China was severely affected by Covid-19 and security worries about the supply of crucial goods from China came into focus. When the pandemic shifted to Europe and the U.S., their dependence on hyper-sensitive imports from China, such as medical gear and medicine, fostered a global desire to reduce dependence on China.

ENTER RCEP

In the midst of all this anxiety about China, long-held Korean-Chinese tension, and even the emergence of fresh, serious tension between China and Australia, it is quite remarkable that China and other Asian countries have taken a far-reaching treaty on Asian integration on November 15.

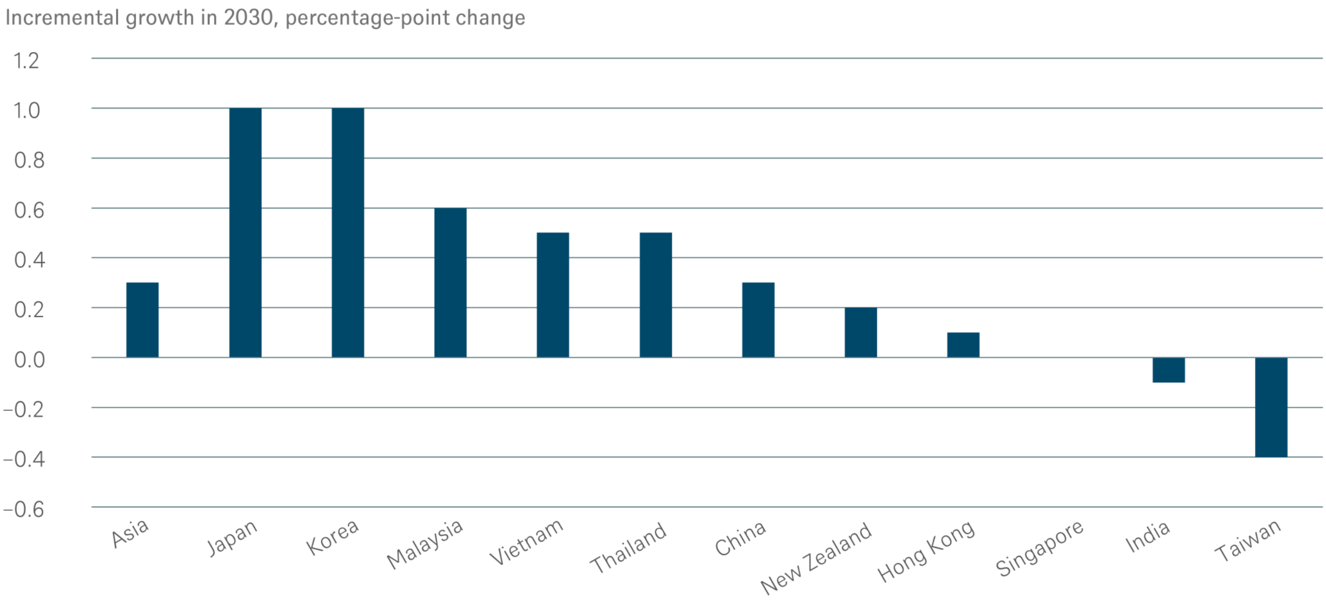
The so-called Regional Comprehensive Economic Partnership (RCEP) includes countries that have tense relationships with China on certain issues. But they have all unified behind the idea of strong economic links between their 15 economies. And as RCEP member countries have a combined economy that represents about 30% of global gross domestic product (GDP)[1], it will be the largest free-trade bloc globally. Parliaments are expected to ratify the treaty in the course of the next year. Finalization of the RCEP treaty follows eight years of negotiation and the final version falls short of more ambitious earlier attempts at broader cooperation. The free-trade zone leaves out the much more complicated service sector and concentrates on drastically reducing tariffs on more than 90% of traded products. The abolition of most tariffs is expected in stages over the next couple of years. We believe global firms will begin to prepare for the more open market much earlier: we expect production and supply chains to shift into the region, in order to benefit from the future tariff advantages. Long-term foreign-direct-investment (FDI) flows into the trade zone are also likely to be triggered.

INDIA MISSES OUT – FOR NOW

India left the RCEP talks a year ago due to internal political resistance. Uncompetitive agriculture and small firms in the informal sector are ill-prepared for tough competition from neighboring countries. The idea that the initial economic fallout could be cushioned by fiscal measures has proven too ambitious given the limited room for fiscal maneuver – worsened by the pandemic in 2020. But RCEP has left the door ajar: India could join later.

WHO COULD BENEFIT MOST?

The RCEP will create winners and losers. **Japan** seems set to benefit most. The RCEP connects China to Japan, and Japan to South Korea, thus creating two links that were missing. In particular, since Japan and China are the only two countries in RCEP that had not entered into a free-trade agreement with each other, China offers Japan the largest tariff reductions. And Japan is the RCEP member country that exports the most to China. We believe ASEAN countries should also benefit greatly from regional integration but as they have free-trade agreements with China the additional tariff advantage from RCEP is likely to be limited (see chart below). They may, however, benefit more from shifts in production locations and higher FDI inflows.



Sources: Sources: Peterson Institute for International Economics (PIIE), P. Petri & M. Plummer, "East Asia Decouples from the United States: Trade War,COVID-19, and East Asia's New Trade Blocs", June 2020, Citi Research, DWS Investment GmbH as of 11/2020

WHO COULD LOSE?

For India, not being a member is a clear disadvantage in our view. While **India** is less export driven than other Asian countries, with a low share of exports to GDP, competing for FDI inflows from China, Japan and South Korea, may be tougher in the future. Similarly, multinational companies from Europe and the U.S. should have an incentive to shift production into RCEP to benefit from low/no tariffs.

RCEP member countries account for nearly 70% of **Taiwan's** exports.[2] As links between China, Japan and South Korea deepen, Taiwan may find itself ill-positioned to maintain a presence in these markets.

[1] Source: The Economist as of 11/15/20

The petrochemical sector, upstream textiles and machine-tool industries will probably suffer most from not being an RCEP member. We expect Taiwan to make use of its own manufacturing advantages to cut into the supply chain alliance system and adopt flexible region-to-region and industry-to-industry cooperation as a way to deal with the disadvantages of non-membership.

WHY IS CONTINUING ASIAN TRADE INTEGRATION SO IMPORTANT?

We believe the RCEP is important, not only for Asia but for the global economy. The planned tariff cuts should generate still more competition and put Asian firms at an advantage vs. U.S. and European firms. Trade linkages are strong, and in particular export exposure to China is high. China is the most important trade partner for most of the Asian countries.

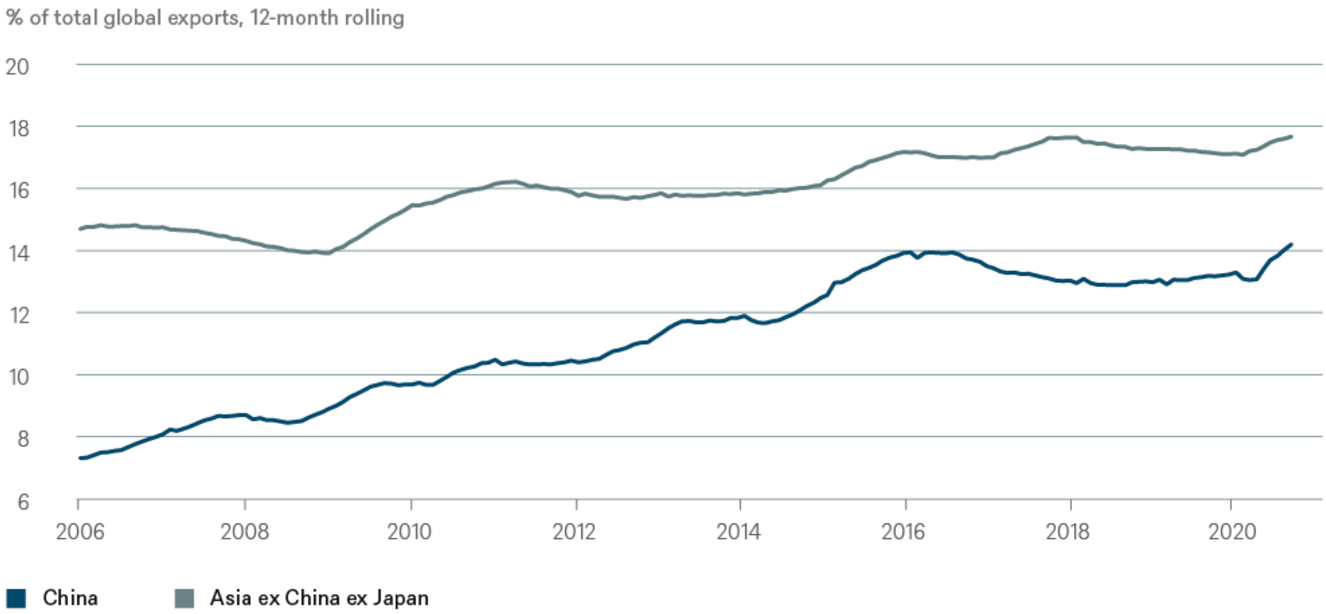
Asian countries are competitors but complement one another. The technological goods structure of even Taiwan and South Korea differs, and ASEAN countries find themselves in different parts of the global electronic supply chains. In addition to their differences in production structure, the region has countries, such as China, Japan and South Korea, with substantial savings and 'old' populations financing 'young' economies with large capital needs, in ASEAN. Japan and China are important sources of FDI in the region.

A further unifying force is a common focus on innovation, technological upgrading and digitization. Throughout the region, medium-term development plans, such as China's 5-year plan, Korea's large extra budget 2021/22 and Indonesia's broad Omnibus reforms, put the focus on innovation and digital advances.

THE WEST NEEDS TO TAKE NOTE

1. Countries outside Asia need to take note of the RCEP. All the talk has been of decoupling but we believe the new treaty will, if anything, lead to further concentration of supply chains in Asia. Shifting production into the region will probably become still more attractive. Reduced tariffs could enhance the advantage of local labor costs and make a still larger consumer market readily accessible.

2. A further factor is that competition in important future sectors could rise even further. As China, Japan and South Korea will, for the first time, join together in a free-trade zone, European and U.S. companies will face a fresh challenge. The three countries compete already now, particularly in technologically intensive sectors, with European and U.S. firms. The latest data show that China's share and that of Emerging Asia in global export markets has climbed back recently to its early 2016 peak (see chart below).



Sources: IMF database, DWS Investment GmbH as of 11/2020

3. How should European countries respond? We believe they will negotiate bilateral trade agreements where possible. The long awaited EU-Chinese investment agreement, which was originally intended to be finalized in 2020 but was held back by political demands on China, would be an important start. But recent free-trade agreements with Vietnam and Japan are positives. The U.S. appears to be worse off than the EU due to its recent retreat from multilateral treaties and shift to bilateral relations.

4. Another lesson is that multilateralism and trade integration are going to happen with or without Europe and the U.S. We believe the only way not to fall even further back in terms of corporate revenues and welfare is to restart the global-trade-integration initiatives that stalled when the U.S. government changed hands four years ago.

5. The final lesson is that reforms and innovation are essential. The long-term economic plans and structural aspects of fiscal agenda in various Asian countries shows that China

[2] Source: Taiwan News as of 11/16/20

might not be the only competitor in the future. South Korea is embarking on the strongest innovation initiative, from an already high base, and Japan, still a major world exporter, looks to be the biggest beneficiary of RCEP.

GLOSSARY

The Association of Southeast Asian Nations (ASEAN) is a political and economic organization of 10 countries located in Southeast Asia.

The European Union (EU) is a political and economic union of 28 member states located primarily in Europe.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Foreign direct investment (FDI) aims at establishing or having control of an enterprise in a foreign country, unlike indirect investment in a sector through financial instruments.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The World Trade Organization (WTO) is an international organization based in Switzerland, which regulates commerce between nations through mutually agreed rules.

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