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Essay Series ~ Trade and Supply Chains in Asia

The Political Economy of Supply Chain Transformation in Asia: From "China Plus One" to De-Sinicization

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EXECUTIVE SUMMARY

This essay seeks to provide a guidepost for the future of industrial supply chains in East Asia by looking at the "China plus one" model that Japanese multinationals followed in the 2000s and 2010s and assessing the current geoeconomic environment.

MAIN ARGUMENT

In the 2000s and the 2010s, Japanese firms doing business in China coped with a series of foreign policy crises, including waves of anti-Japanese demonstrations and boycotts of Japanese goods and services in China during diplomatic spats between the two countries. Meanwhile, Japanese direct investments in China continued to be strong. The secret to how Japanese corporations managed to survive these crises lies in what is journalistically called "China plus one": a diversification strategy to expand their supply chains to neighboring countries in Asia. However, the magnitude of the headwinds against Japanese and other multinationals in China began to qualitatively differ in 2017 during the Trump administration. A series of events led the U.S. during the subsequent Biden administration, as well as other advanced economies, to follow a policy of "de-risking": a transformation of supply chains to minimize risks and increase economic security. The current trend pitting the U.S. and China against each other, if it persists, may gradually turn China-plus-one strategies into "de-Sinicization."

POLICY IMPLICATIONS

- China-plus-one strategies allowed Japanese firms in the 2000s and 2010s to maintain their investments and supply chains in China while also expanding into other markets.
- The current economic landscape is more challenging than earlier years of the 21st century in terms of navigating geopolitical tensions and uncertainty, introducing new technologies, and managing China's economic slowdown. An increasing number of firms will switch from China plus one to de-Sinicization: an outright reduction in their business presence in China.
- Chinese corporations are beginning to massively invest in Southeast Asian countries. Hence, the U.S. and Japan must take utmost care to ensure that China will not dominate these Asian countries in the future.

On April 10, 2024, Japanese prime minister Fumio Kishida visited the United States and delivered a speech to a joint session of the U.S. Congress. In his speech, he earnestly stressed that the international order was being severely challenged by China and that Japan would work together with the United States to address this issue. Kishida made it clear that Japan would confront China, which is supporting Russia's aggression against Ukraine and posing major challenges to security in the East and South China Seas. He stated that "China's current external stance and military actions present an unprecedented and the greatest strategic challenge, not only to the peace and security of Japan but to the peace and stability of the international community at large."[1] As a result, Japan's relatively conciliatory diplomatic stance toward China had become unsustainable in the past few years.

How will supply chains change amid the increasingly turbulent geopolitical situation in East Asia? Will business continue as usual, or will it be restructured in line with geopolitical competition? This essay addresses these questions.[2] It should be noted from the outset, however, that the relationship between governments and markets is complex. Government policies are not directly reflected in market realities, nor are market preferences directly reflected in government policies. Governments have their own logic, whereas businesses act according to the logic of the marketplace. Leads and lags, as well as critical disjunctions, are bound to occur. While geopolitics are creating great rifts between Europe, Japan, and the United States, on the one hand, and China, on the other, it is impossible to predict exactly how these conflicts will affect market behavior. Thus, any predictions in this essay should be considered with that proviso in mind. The only thing that can be said with certainty is that the current situation will not likely be resolved by simply taking another small dose of the "China plus one" strategy.

Since "China plus one" is a journalistic term, it lacks a precise definition. To ensure clarity, this essay will define the China-plus-one strategy as a corporate strategy by which a multinational corporation doing business in China continues to maintain substantial trade and investment ties with China while diversifying its business portfolios by investing in other countries (often neighbors) for the purpose of risk diversification. The notion of "continuation" is key in this definition; thus, China plus one

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1 Fumio Kishida, "Address by Prime Minister Kishida Fumio at a Joint Meeting of the United States Congress ('For the Future: Our Global Partnership')," Prime Minister's Office of Japan, April 11, 2024 ~ https://japan.kantei.go.jp/101_kishida/statement/202404/11speech.html.

2 For the political economy of foreign direct investment in general, see Sonal S. Pandya, "Political Economy of Foreign Direct Investment: Globalized Production in the Twenty-First Century," *Annual Review of Political Science* 19 (2016): 455–75.

ceases when the company deliberately plans to reduce its business presence in China.

This essay is organized as follows:

- pp. 74–78 look back on the period of "cold politics, hot economics" from the late 2000s and early 2010s in which Japanese and other multinational corporations began to adopt China-plus-one strategies.
- pp. 78–84 focus on the period since 2017 when U.S.-China relations rapidly deteriorated, reviewing various adverse factors that impede the continuation of economic dependence on China.
- pp. 84–90 consider what could occur if the current trend continues.

FROM "COLD POLITICS, HOT ECONOMICS" TO THE DEVELOPMENT OF CHINA PLUS ONE

The Situation in the Late 2000s and Early 2010s

After China joined the World Trade Organization in 2001, the country experienced rapid export-led economic growth over the subsequent decade and achieved the status of "the world's factory." China has become the largest hub of trade and investment in Asia. During this period early in the new century, Japanese and Western multinational firms began to invest in China and Hong Kong in earnest, transforming their supply chains. Initially, components were sent from the home countries or neighboring countries where these firms had already established operations to China, assembly occurred in China, and then the final products were exported to their home or third countries, including the United States in particular. Eventually, Chinese firms and their joint ventures with foreign companies began to establish bases in China for parts and components, forming huge industrial clusters centered in coastal areas.

From the mid-2000s to the early 2010s, however, a series of political and economic problems began to create headwinds, especially for Japanese companies and their affiliates in China. Large anti-Japanese demonstrations occurred in major Chinese cities in April and May 2005, September 2010, and October 2012. The first wave of demonstrations protested Japan's bid to become a permanent member of the UN Security Council. In September 2010 a Chinese fishing boat collided with two Japanese Coast Guard patrol vessels off the coast of the disputed Senkaku/Diaoyu Islands. When the Japanese authorities detained the ship captain, Beijing remonstrated with various measures, including a de facto embargo on rare earth elements, which are essential for many industrial applications. Another wave of anti-Japanese protests and consumer boycotts were held in China. A third wave of anti-Japanese sentiment occurred in the wake of the Noda administration's "nationalization" of the Senkaku/Diaoyu Islands in September 2012, including demonstrations, some of which seemed to have been engineered by the Chinese government, and vandalism against Japanese-run retail outlets and factories. These incidents led Japanese businesses to assume a more prominent risk perception regarding operating in China.

Economic factors also contributed to these headwinds. In 2007, China changed its policy toward FDI. In addition to making efforts to avoid trade friction with Europe and the United States, Secretary Hu Jintao emphasized the policy of "using foreign capital to advance the sophistication of the industrial structure," which aimed to promote a shift from assembly manufacturing to a higher-tech, more sophisticated type of manufacturing.[3] Firms began searching for alternative locations for their supply chains and product assembly in response to this policy change. In addition, the global financial crisis of 2008–9 caused developed countries to enter a recession, and Chinese exports suffered. While China averted a recession with a 4 trillion yuan fiscal stimulus, its growth has not reached double digits since 2010.

The Development of China Plus One

In the difficult political and economic climate that Japanese companies faced operating in China by the early 2010s, they adopted a China-plus-one management strategy, which they first had implemented during the 2003 severe acute respiratory syndrome (SARS) epidemic. In other words, their strategy was to continue to invest in China but simultaneously to establish production bases in other countries as well—the literal application of the adage "do not put all your eggs in one basket." It is important to note that "one" in the term China plus one should not be taken literally. Many firms invest in multiple countries, although they may still follow a China-plus-one strategy. Indeed, other expressions, such as "China plus two"[4] and "China plus 10%,"[5] have been proposed as alternatives.

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3 Sonoko Watanabe, "Tai Betonamu toshi ni hazumi—'Chugoku purasu wan' haikei ni risukubunsan, kigyo mo mosaku" [Investment in Vietnam Gains Momentum—Against the Backdrop of 'China Plus One,' Risk Diversification Is Also Being Sought by Companies], *Nihon Keizai Shimbun* (*Nikkei*), November 26, 2007, 6.

4 Jeremy Nixon, "Konran tsuzuku kaijo yuso, Nen kohan nimo jukyu seijyoka" [Maritime Transportation Continues to be Confused, Supply and Demand to Normalize in the Second Half of the Year], interview by Takashi Nakano, *Nikkei*, June 6, 2022, 3.

5 Atsushi Nakayama, "Kigyo ni semaru 'seireikeirei'" ["Cold Politics, Cold Economics" Looming over Companies], *Nikkei*, March 2, 2022, 1.

Table 1 shows investment trends over the past decade. The overall trend in East Asia, at least until the late 2010s, was strong FDI into China, despite all the issues discussed above. This seems to support Christina Davis and Sophie Meunier's conclusion that investment flows are immune to political turbulence in international relations.[6] Their explanation is that direct investment is sticky: sunk costs are large enough that companies will smooth out perturbations so that they can continue their business operations in good and bad times.

Apparel companies were among the first to diversify their Chinese operations in the 2010s, with the most crucial factor being rising wage levels. As wages rose in China, the comparative advantage of some Asian countries, such as Bangladesh, Cambodia, and Myanmar—the countries with the lowest

TABLE 1

FDI to China ($ Million)

Year	Japan	United States	Taiwan	South Korea
2014	10,889	14,620	N/A	N/A
2015	10,011	13,830	10,965	N/A
2016	9,534	14,000	9,670	N/A
2017	12,417	14,140	9,248	3,200
2018	11,217	12,530	8,497	4,766
2019	12,021	13,080	4,173	5,848
2020	11,074	8,690	5,906	4,494
2021	12,464	8,500	5,863	6,731
2022	5,611	8,200 (estimated)	5,046	8,539
2023	3,822	N/A	3,037	N/A

Source: Japan External Trade Organization (JETRO), "Outward Direct Investment by Country/Region," Direct Investment Statistics, 2024; Rhodium Group, U.S.-China Investment Hub, 2024; Japan-Taiwan Exchange Association, Economic Data Book 2022, https://www.koryu.or.jp/Portals/0/keizai/databook/2022databook/4.(3)%E2%91%A3.pdf; and "2023-nen no Taiwan no taigai Chokusetsu toshi wa kako saiko-gaku, tainaka toshi no shea wa teika ga tsudzuku" [Taiwan's Foreign Direct Investment in 2023 Will Reach a Record High, and the Share of Investment in China Will Continue to Decline], JETRO, January 31, 2024, https://www.jetro.go.jp/biznews/2024/01/1b07c946a9ce1543.html.

Note: N/A designates data not available.

6 Christina L. Davis and Sophie Meunier, "Business as Usual? Economic Responses to Political Tensions," *American Journal of Political Science* 55, no. 3 (2011): 628–46.

labor costs—increased given that labor is a non-negligible factor of sewing. Honeys, a Japanese company specializing in women's fashion, was heavily dependent on China in the early part of this decade; however, it began to shift to Southeast Asia. Yoshihisa Ejiri, president of Honeys, said in 2013 that the company would increase production in Indonesia and Myanmar and "reduce China's 90 percent production share to 75–80 percent as soon as possible."[7] After the company established production in Myanmar and other countries, its ratio in China decreased to approximately 30% by 2018.[8]

Bangladesh also benefited from the shift away from China in apparel production in the early 2010s, as trading companies and apparel firms increased production in their main sewing factories there. ITOCHU planned to increase its annual production to 20 million pieces in FY2014, approximately 70% above the 2012 level. Sumikin Bussan planned to increase its production in Bangladesh and double its output for Japanese clothing chains.[9]

Based on 2011 balance-of-payment statistics, Japanese direct investments in the countries belonging to the Association of Southeast Asian Nations (ASEAN) increased 2.4 times over 2010 levels to 1.5 trillion yen, surpassing Japanese FDI flows to China (1.0 trillion yen) for a second consecutive year. In terms of the type of industry, consumer-related industries, such as retail and food services, were the most prominent to shift investment away from China, and the most prominent destinations were Indonesia, the Philippines, and Vietnam with their large populations.[10] In some cases, companies delayed the pace of expansion in China. For instance, after the anti-Japanese protests in September 2012, Watami, a Japanese multinational restaurant business, halved its plan to open an additional 40 stores in mainland China within four years to 20 and instead prioritized opening stores in Hong Kong, Singapore, and other parts of Asia.[11]

A more paradoxical example comes from the rare-earth-utilizing sector. As previously mentioned, in 2010 China embargoed the export of rare earth elements to Japan. At the same time, it was promoting domestic

7 "SPA2 Chugoku seisan kara kyoten bunsan ni" [Specialty Retailer of Private-Label Apparel SPA2 from Production in China to Decentralization of Bases], *Nikkei sangyo shimbun*, July 30, 2013, 20.

8 Hirosuke Takeuchi, "Yunyu nichiyohin, nesagari tsuzuku, Tonan-a ni seisan ikan, jinkenhi yasuku" [Imported Daily Necessities Prices Continue to Fall, Production Transferred to Southeast Asia with Lower Labor Costs], *Nikkei*, March 17, 2018, 4.

9 "Bangura de iryo zosan, ITOCHU ya Sumikin Bussan Chugoku izon sageru" [Increased Clothing Production in Bangladesh, ITOCHU and Sumikin Bussan to Reduce Dependence on China], *Nikkei*, December 29, 2012, 10.

10 "ASEAN toshi saikasoku, Chugoku kara risuku bunsan" [ASEAN Investment Re-accelerated to Diversify Risk from China], *Nikkei*, October 18, 2012, 1.

11 "Seicho he, soredemo te musubu" [Toward Growth, Still Hand in Hand], *Nikkei*, November 7, 2012, 3.

processing of rare earths into alloys. Within this context, Japanese firms specializing in processing these elements moved their operations to China, despite political tensions.[12]

For a long time, researchers debated why contradictory "cold politics, hot economics" persisted in East Asia.[13] In a sense, the widespread adoption of China-plus-one strategies can explain the persistence of hot economics. Regardless of the severity of the political situation, firms continued to invest in the Chinese market as before, but they simultaneously searched for and invested in alternative locations as backups. The result was that the amount of investment in China remained large, while investment in other Asian countries also increased, benefiting the region as a whole.

A SHIFTING GEOECONOMIC LANDSCAPE

The Trump Administration Onward

The geoeconomic situation began to change dramatically after 2016 as a result of a series of events all adverse to economic ties between the United States and other Western countries, on the one hand, and China, on the other. First, in 2017 the Trump administration launched a trade war against China under Section 301 of the Trade Act of 1974.[14] Both China and the United States imposed tariffs on each other's products, with many Chinese products receiving additional tariffs of up to 25%. The Trump administration also tried to insulate the emerging 5G telecommunications network from Chinese company Huawei and urged Western countries to adopt similar policies. Initially, the administration implemented a procurement ban, but it later established an export ban on semiconductors to Huawei. Other Western countries have undertaken similar measures. The European Union asked its member states to exclude Huawei products from their 5G telecommunications networks. In 2023 the German government announced plans to exclude Chinese-made equipment from its 5G telecommunications network by 2026. Germany relies on Chinese products for approximately

12 Keisuke Iida, *Japan's Security and Economic Dependence on China and the United States: Cool Politics, Lukewarm Economics* (London: Routledge, 2018), 56.

13 Keisuke Iida, "Political Risks and Japanese Foreign Direct Investment in East Asia: A Case Study of 'China Plus One,'" *Korean Journal of International Studies* 13, no. 2 (2015): 383–410; and Kristin Vekasi, *Risk Management Strategies of Japanese Companies in China: Political Crisis and Multinational Firms* (New York: Routledge, 2019).

14 Bob Davis and Lingling Wei, *Superpower Showdown: How the Battle between Trump and Xi Threatens a New Cold War* (New York: HarperCollins, 2020).

60% of its 5G network.[15] In the United Kingdom, a government directive to exclude Huawei products from the networks of major telecommunications companies and others took effect in January 2024.

Second, around this same time, China's use of economic coercion became more prominent, with Beijing imposing severe sanctions on Australia, Canada, South Korea, Lithuania, and other countries. An Australian think tank report detected as many as 73 instances of economic coercion by China between 2020 and 2022.[16]

Third, the Covid-19 pandemic served as a painful reminder of the vulnerability of global supply chains. With the spread of Covid-19, it became clear, for example, that China was the largest global producer of surgical masks when its supply was suddenly disrupted.[17] In an HSBC 2020 survey of 2,600 companies worldwide, 29% said they would diversify their supply chains in the next one to two years, and 20% were looking to expand their suppliers in the Asian region. "There has always been a 'China plus one' to diversify production bases in China, but the shift to ASEAN will continue," said Ajay Sharma, regional head of Global Trade and Receivables Finance, Asia Pacific, at HSBC.[18]

When the Biden administration assumed office in 2021, not only did it keep the additional tariffs on Chinese goods imposed by the Trump administration, but it took additional measures. The administration has placed particular emphasis on supply chain resilience, notably by seeking to block or reduce Chinese influence in all supply chains. In particular, the Biden administration embarked on a concerted effort to strengthen supply chains in four areas: semiconductors, pharmaceuticals, critical minerals, and car batteries.

During Biden's time as president, the Taiwan Strait has become increasingly tense. During and after U.S. Speaker of the House Nancy Pelosi's visit to Taipei in August 2022, China conducted large-scale drills around

15 Azuho Miyajima and Ryo Sato, "5G tsushinmo datsu Chugoku ni shoki" [5G Communication Network, Commercial Opportunities in De-sinicization], *Nikkei*, February 28, 2024, 15.

16 Fergus Hunter et al., "Countering China's Coercive Diplomacy: Prioritising Economic Security, Sovereignty and the Rules-Based Order," Australian Strategic Policy Institute, Policy Brief, no. 68, 2023 ~ https://ad-aspi.s3.ap-southeast-2.amazonaws.com/2023-02/Countering%20Chinas%20coercive%20diplomacy_1.pdf.

17 "The Face Mask Global Value Chain in the Covid-19 Outbreak: Evidence and Policy Lessons," Organisation for Economic Co-operation and Development, May 4, 2020 ~ https://www.oecd.org/coronavirus/policy-responses/the-face-mask-global-value-chain-in-the-COVID-19-outbreak-evidence-and-policy-lessons-a4df866d.

18 Ajay Sharma, "Kinyu kara mita Ajia boeki, fueru ikinai torihiki, kaifuku hayaku" [Asian Trade from a Financial Perspective, Intra-regional Trade Increasing, Recovery Faster], interview by Yuji Kihara, *Nikkei*, August 31, 2020, 3.

Taiwan, during which five missiles landed in Japan's exclusive economic zone. Admiral John Aquilino testified to Congress on March 20, 2024, that China's People's Liberation Army would be ready to invade Taiwan by 2027 if Beijing so directed.[19]

Given the deterioration in U.S.-China relations and China's increasingly assertive political and security posture, Japan, the United States, and, to a lesser extent, European states are in the process of de-Sinicizing their supply chains, at least in areas that are critical to their national security and decarbonization. Whereas Sinicization refers to the assimilation of Chinese cultural norms in East Asian societies, de-Sinicization is the opposite, used here in a purely economic sense. It is popularly known as "decoupling," although this term has become politically tarnished.[20] These concerns are particularly evident in supply chains for semiconductors (where cross-strait tensions pose a risk to Taiwan, which is currently the dominant supplier of advanced chips), critical minerals, and electric vehicles (EVs). For the purpose of this essay, I will concentrate here on de-Sinicizing efforts targeting critical minerals related to EVs and semiconductors.

Critical Minerals in EVs and Semiconductors

Under the Biden administration, the United States has stepped up efforts to "secure" and stabilize supply chains. In March 2023, Japan and the United States reached an agreement on supply chain resilience in critical minerals, a provision of which delineated that critical minerals extracted and processed in Japan are subject to the same taxes and other preferential treatments as those used in the United States.[21] This ensured that Japanese-made EVs would benefit from tax breaks in the Inflation Reduction Act, discussed in greater detail below. Two months later, on May 27, 2023, ministers from fourteen countries reached an agreement at the ministerial-level meeting of the Indo-Pacific Economic Framework (IPEF), an economic zone initiative led by the United States and Japan, to strengthen supply chains for critical minerals,

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19 Roxana Tiron, "China on Track to Be Ready to Invade Taiwan by 2027, U.S. Says," Bloomberg, March 20, 2024 ~ https://www.bloomberg.com/news/articles/2024-03-20/china-on-track-to-be-ready-for-taiwan-invasion-by-2027-us-says.

20 The word "decoupling" has been largely replaced by "de-risking." See "How 'Decoupling' from China Evolved into the More Moderate Term 'De-Risking,'" *New York Times*, May 22, 2023, A6.

21 "Agreement between the Government of the United States of America and the Government of Japan on Strengthening Critical Minerals Supply Chains," Office of the U.S. Trade Representative, March 28, 2023 ~ https://ustr.gov/sites/default/files/2023-03/US%20Japan%20Critical%20Minerals%20Agreement%202023%2003%2028.pdf; and Rintaro Hida, "EV muke, datsu Chugoku izon saguru, juyo kobutsu Bei ga kyokyumo kakudai" [Exploring Reduced Dependence on China for EVs, U.S. Expands Supply Chains in Critical Minerals], *Nikkei*, June 3, 2023, 4.

semiconductors, and other products.[22] The IPEF Supply Chain Agreement entered into force in February 2024 after ratification by five parties: the United States, Japan, Fiji, India, and Singapore. This is the first time that an international agreement focused on supply networks has come into effect. The agreement creates a system whereby a country experiencing a particular supply shortage can request help from other participants, and each country can move quickly to provide assistance and advice.[23]

In addition, Japan, Canada, Italy, South Korea, and the UK launched a new framework with the World Bank to support emerging economies and strengthen supply chains in the renewable energy sector, which includes many critical minerals. Under the Partnership for Resilient and Inclusive Supply Chain Enhancement, a fund will be established by the World Bank with contributions from each country.[24] The partnership was developed from a G-7 governments' agreement at the May 2023 meeting of finance ministers and central bank governors.[25]

The EU is trying to avoid missing the bus. On November 13, 2023, EU institutions reached a political agreement on the European Critical Raw Materials Act to increase self-sufficiency in rare earths and rare metals. The agreement sets a goal to mine 10% of the annual consumption of strategic raw materials in the region by 2030 and to diversify sources to ensure that dependence on any third country does not exceed 65%.[26] Among these, the ones used for technologies in key fields such as green, digital, defense, and space will be considered as "strategic raw materials" to increase self-sufficiency.[27] The target materials include aluminum, cobalt, copper, gallium, nickel, lithium, magnesium, manganese, and rare earth elements for magnets.

Despite these efforts, de-Sinicizing critical minerals is difficult as China is the dominant market player. According to the International Energy

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22 "Indo-Pacific Economic Framework for Prosperity Agreement Relating to Supply Chain Resilience," U.S. Department of Commerce, September 7, 2023 ~ https://www.commerce.gov/sites/default/files/2023-09/2023-09-07-IPEF-Pillar-II-Final-Text-Public-Release.pdf.

23 Ken Sakakibara, "IPEF, kyokyumo kyoka goi, busshi no datsu Chugoku izon nerau" [IPEF Agrees to Strengthen Supply Chains, Aiming to Become Less Dependent on China for Supplies], *Asahi shimbun*, May 29, 2023, A3.

24 "World Bank and Japan to Boost Mineral Investments and Jobs in Clean Energy," Ministry of Finance (Japan), Press Release, October 11, 2023 ~ https://www.mof.go.jp/english/policy/international_policy/mdbs/wb/20231011.pdf.

25 "G7 Finance Ministers and Central Bank Governors Meeting Communiqué," G-7 Finance Ministers and Central Bank Governors Meeting, Niigata, May 13, 2023, available at https://www.mof.go.jp/policy/international_policy/convention/g7/g7_20230513_2.pdf.

26 "Commission Welcomes Political Agreement on the Critical Raw Materials Act," European Commission, Press Release, November 13, 2023 ~ https://ec.europa.eu/commission/presscorner/detail/en/ip_23_5733.

27 Ibid.

Agency, it accounts for 60%–70% of lithium and cobalt refinement and 70% of graphite refinement. China is also responsible for almost all refining of rare earth elements.[28]

Regarding semiconductors, the U.S. CHIPS and Science Act introduced the idea of "countries of concern": China, Iran, North Korea, and Russia.[29] The "guardrails" in the act forbid the recipients of financial incentives from the legislation to expand their investment in these four countries over the next decade. Washington is tightening its restrictions in the semiconductor sector, and a clear shift away from China is evident. In particular, the Biden administration strengthened export controls on high-end chips, ordering the prohibition of U.S. technology exports of advanced semiconductors to China.[30] The United States has also pressured Japan and the Netherlands to forgo sales of chip manufacturing equipment to China for this class of advanced chips. According to the Rhodium Group, a U.S. research firm, China accounted for 48% of FDI in the chipmaking sector in 2018, but this share dropped to 1% by 2022.[31]

Regarding EVs, the 2022 Inflation Reduction Act attempts to limit the use of Chinese-made batteries and raw materials from Chinese sources. One of the goals of the legislation is eliminating China from EV supply chains. If EVs are assembled in North America and the percentage of locally procured battery parts is 50% or more, a tax credit up to $7,500 per vehicle is available, which is a powerful consumer incentive. The ratio of battery components manufactured or assembled in North America must reach 100% by 2029.[32] To obtain this subsidy, consumers must purchase or rent EVs with batteries containing critical minerals imported only from Japan (which has a supply chain agreement specific to critical minerals) or from countries with which the United States has

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28 "Richiumu saikutsu/Reaasu seiren, datsu Chugoku izon he, saidai 5 wari hojo, Keisansho kyokyumo wo tayoka" [Lithium Mining and Rare-Earth Smelting to Depart from Dependence on China, Subsidized by METI Up to 50%, to Diversify Supply Chains], *Nikkei*, April 23, 2023, 2.

29 CHIPS Act of 2022, Public Law 117-167, 136 Stat. 1372, August 9, 2022 ~ https://www.govinfo.gov/content/pkg/PLAW-117publ167/pdf/PLAW-117publ167.pdf; and see also Inflation Reduction Act of 2022, Public Law 117-169, 136 Stat. 1818, August 16, 2022 ~ https://www.govinfo.gov/content/pkg/PLAW-117publ169/pdf/PLAW-117publ169.pdf.

30 "Commerce Implements New Export Controls on Advanced Computing and Semiconductor Manufacturing Items to the People's Republic of China (PRC)," U.S. Department of Commerce, Press Release, October 7, 2022 ~ https://www.bis.doc.gov/index.php/documents/about-bis/newsroom/press-releases/3158-2022-10-07-bis-press-release-advanced-computing-and-semiconductor-manufacturing-controls-final/file.

31 Iori Kawade and Shunsuke Tabeta, "Chugoku heno toshi 30 nen buri teisuijun, sakunen 8 wari gen gaishibanare senmei ni" [Investment in China Lowest in 30 Years, 80% Decline Last Year, Clear Signs of a Shift Away from Foreign Investment], *Nikkei*, February 19, 2024, 1.

32 "Treasury Releases Proposed Guidance to Continue U.S. Manufacturing Boom in Batteries and Clean Vehicles, Strengthen Energy Security," U.S. Department of the Treasury, Press Release, December 1, 2023 ~ https://home.treasury.gov/news/press-releases/jy1939.

free trade agreements. Currently, Chinese companies control 60% of the world's batteries, which are the key components to building EVs. Toyota is planning to invest approximately $5.9 billion to build a battery plant in the United States.[33] In terms of finding alternative sources of the minerals used in EV batteries, Chile is the world's largest exporter of refined lithium. As a major supplier of raw materials for EVs, the country may hold the key to shifting away from China.

However, the effort to de-Sinicize the EV industry is an uphill battle. Chinese companies already dominate this sector, with three Chinese firms having a combined share of 27.7% of the EV market, reversing the lead held by Tesla (18.9%). In insulators for lithium-ion batteries used in EVs, four of the top five Chinese companies account for 63% of the market. Therefore, Chinese companies control the supply of EVs from upstream to downstream, making it increasingly difficult to break away from dependence on China.[34]

Economic Developments in China

As Western and Japanese companies begin to focus on China-plus-one and de-Sinicization strategies, China's investment climate is meanwhile deteriorating. The country's amended Counter-Espionage Law, broadened in 2023 to include more vaguely the "unauthorized obtaining of 'documents, data, materials, and items related to national security and interests'" as an offense, has made expatriate staff at China-located affiliates extremely nervous.[35] Chinese authorities are placing greater emphasis on national security, including the detection of spies. They have tightened their grip on research firms engaged in market analysis, and foreign firms' employees have reportedly been detained by authorities.[36] Western companies conduct extensive research on the business environment before investing, and the revised Counter-Espionage Law is likely responsible for slowing the operations of many research firms. In 2023, FDI into China sunk to the lowest level in 30 years.[37]

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33 "Bei EV seisan datsu Chugoku mo nandai, daitaichoutatsukoku ni risuku" [U.S. EV Production: A Challenge Even If It Leaves China, and Risks in Alternative Source Countries], *Nikkei*, August 15, 2023, 15.

34 "22 nen sekai shea chosa, Chugoku zei, sentanhin de kakudai, EV denchi ha 6 wari cho" [2022 Global Market Share Survey, Chinese Companies Expanding in Leading-Edge Products, EV Batteries Over 60% of Market], *Nikkei*, September 5, 2023, 1.

35 "China's Sweeping New Anti-Espionage Law Comes into Effect," Agence France-Presse, July 1, 2023, available at https://www.voanews.com/a/china-s-sweeping-new-anti-espionage-law-comes-into-effect-/7162900.html.

36 "The Crackdown on Foreign Firms Will Deter Global Business—and Undermine China's Own Interests," *Economist*, June 15, 2023.

37 Kawade and Tabeta, "Chugoku heno toshi 30 nen buri teisuijun, sakunen 8 wari gen gaishibanare senmei ni"; and "The Mind-Bending New Rules for Doing Business in China," *Economist*, April 3, 2024.

Additionally, the Chinese economy has slowed. Despite China lifting all pandemic-related restrictions in December 2022, economic recovery has been sluggish. The bursting of the country's real estate bubble in 2020 also adversely affected the economy. In August 2020 the government established "three red lines" to control soaring housing prices and overheated housing investments.[38] Owing to these restrictive policies, the real estate market began to lose steam, leaving many developers in dire straits. In January 2024, Chinese real estate giant the Evergrande Group was ordered by a court in Hong Kong to liquidate after the company proved unable to restructure the $300 billion it owed investors. Whereas in 2018 Evergrande was listed as the world's most valuable real estate company, by 2021 it was heavily overleveraged and unable to complete some existing projects. The company has "become symbolic of a Chinese economy that faces some major near-term obstacles: slowing growth, increasing debt and a shrinking workforce."[39] With the departure of foreign money from China, Chinese authorities are eager to stem the outflow of investments.[40]

IS THIS THE BEGINNING OF DE-SINICIZATION?

How have all of the above developments affected supply chains in Asia? First, investments in China have plummeted, driven by concerns over espionage detection measures, U.S. restrictions on foreign investment in China, and the country's slowing economy. According to data on the balance of payments for 2023 that was released by China's State Administration of Foreign Exchange in February 2024, direct investment by foreign enterprises is at its lowest point in the past 30 years. In 2023, FDI into China had a net inflow of only $33 billion. This is the second consecutive year showing a decline and is less than 10% of the peak in 2021 ($344 billion).[41]

Second, Taiwan is moving to reduce its dependence on China. In 2023, China's share of Taiwan's total exports was 35.2%, the lowest in

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38 The debt-asset ratio to total assets, excluding contracts and deposits, should be less than 70%, the net debt-equity ratio should be less than 100%, and the ratio of cash holdings to short-term debt should be greater than one.

39 Scott Neuman, "Here's What to Know about the Collapse of China's Evergrande Property Developer," NPR, January 30, 2024 ~ https://www.npr.org/2024/01/30/1227554424/evergrande-china-real-estate-economy-property-collapse.

40 Kensaku Ihara, "Kaigai mane, datsu Chugoku kasoku" [Foreign Money Accelerates De-Sinicization], *Nikkei*, August 25, 2023, 9.

41 Kawade and Tabeta, "Chugoku heno toshi 30 nen buri teisuijun, sakunen 8 wari gen gaishibanare senmei ni."

21 years. Exports to mainland China, including Hong Kong, fell 18.1% to $152.2 billion. However, exports to Europe increased 2.9% to $42.2 billion, and exports to the United States rose 1.6% to $76.2 billion.[42] As the U.S.-China confrontation has heated up, Taiwanese companies have moved some production of servers and telecommunications equipment from China to Taiwan or to other countries and regions.[43] As shown in Table 1, the drop in FDI to China from Taiwan has been particularly pronounced. The share of outward FDI to China peaked at over 80% of Taiwan's FDI in 2010 but was only about 10% in 2023. According to the Ministry of Economic Affairs, Taiwan's overall outward FDI increased by 87% from January to November 2023 over the same period during the previous year to $25.7 billion. Direct investment to China declined 34% to $2.9 billion, accounting for only 12% of the total, while FDI to the United States in the same period increased nine times year-on-year to $9.6 billion, accounting for 37% of the total.[44] For 2023, Taiwanese FDI in the United States was expected to be approximately three times as high as that in China for the entire year.[45] This reverses the positions of the United States and China for the first time in terms of Taiwanese FDI.

Third, beyond Western and Japanese firms, Chinese companies and investors themselves are also de-Sinicizing. Chinese investments in Southeast Asia are surging, and China is rapidly increasing its direct investment in ASEAN states. Although Japan still has a larger balance of direct investment in ASEAN than China does, the pace of China's accumulation is rapid.[46] This is likely aimed at circumventing U.S. tariffs, but it may not be the only reason.

As China's economy slows, new business avenues and destinations are becoming more appealing to investors. In this respect, India and Vietnam are the most energized countries to attract new business. Although New Delhi's "Make in India" initiative, designed to attract foreign manufacturing firms to produce in India, got off to a slow start in 2014, a surge in investment may finally be happening (**Table 2**). In June 2023, Prime Minister Narendra Modi

42 Hideaki Tatsumoto, "Taiwan yushutu tai Chu hiritsu 35%, 21 nen buri teisuijun, Bei Ou muke kakudai" [Taiwan's Ratio of Export to China at 35%, Lowest in 21 Years, Expansion of E-Exports to U.S. and Europe], *Nikkei*, January 10, 2024, 13.

43 Ibid.

44 Hideaki Tatsumoto, "Taiwan, tai Chu toshi 12% ni gekigen, piikuji 84%, 'datsu keizai izon' susumu" [Taiwan's Investment in China Plummeted to 12% from Its Peak of 84%, Departure from "Economic Dependence" Is Progressing], *Nikkei*, December 29, 2023, 1.

45 Ibid.

46 Minoru Nogimori, "ASEAN datsu Chugoku ni shokyokuteki" [ASEAN Reluctant to Leave China], *Nikkei*, August 16, 2023, 15.

TABLE 2

FDI to India ($ Million)

Year	Japan	United States	China	South Korea
2014	2,419	4,092	317	337
2015	-1,055	3,820	705	365
2016	4,248	4,485	93	337
2017	1,627	3,623	290	516
2018	3,153	656	206	1,072
2019	4,145	2,759	535	453
2020	1,582	643	205	625
2021	3,373	4,117	279	343
2022	3,113	N/A	N/A	286

Source: Japan Institute for International Trade and Investment, "Sekai shuyokoku no chokusetsu toshi toukeishu" [Collection of Direct Investment Statistics for the Major Countries of the World], June 2023.

Note: N/A designates data not available.

and President Joe Biden agreed to comprehensive cooperation on defense and critical technologies. U.S.-based Amazon stated its intention to invest in India, and Germany's Mercedes-Benz Group is also moving to expand production and assembly in the country.[47] Currently, U.S. multinational Apple produces more than 80% of its iPhones in China but intends to shift at least 30% of that production away from the country. Apple doubled its production of iPhones in India in the last fiscal year, assembling $14 billion of the devices there.[48] TrendForce, a Taiwanese research firm, predicts that by 2028, 30% to 35% of all iPhones will be produced outside China.[49] Taiwanese electronics multinational Hon Hai (Foxconn), Apple's largest assembler, has acquired land for factories in the southern Indian provinces of Karnataka and

47 Ganeshan Wignaraja, "Bei no 'datsu Chugoku' ni koki, Indo kyokyumo no chushin ni" [Opportunity for U.S. "De-Sinicization," India to Become the Center of Supply Chains], *Nikkei*, August 25, 2023, 10.

48 Rintaro Hida and Kotaro Hosokawa, "Bei Kantai Kigyo no Yushutu kisei wo Mukigen Yuyo, Handotai 'datu-Chugoku' 5-nen no Kei, Koran kaihi yusen umaranu ana" [U.S. Indefinitely Postpones Export Restrictions on South Korean and Taiwanese Companies, 5-Year Plan for Semiconductor "De-Sinicization," Priority on Avoiding Disruption, Unfilled Gap], *Nikkei*, October 27, 2023, 2; and Sankalp Phartiyal, "Apple's India iPhone Output Hits $14 Billion in China Shift," Bloomberg, April 9, 2024 ~ https://www.bloomberg.com/news/articles/2024-04-10/apple-s-india-iphone-output-hits-14-billion-in-pivot-from-china.

49 Yu Nakamura, Hideaki Tatsumoto, and Yuji Arata, "Taiwan zei 'sekai no kojo' banare, Honhai Chugoku kara Betonamu/Indo he" [Taiwanese Companies Leaving the "World's Factory," Hon Hai to Move from China to Vietnam and India], *Nikkei*, April 29, 2023, 12.

Telangana, and the company plans to increase its number of smartphone-related factories in Chennai and other southern Indian cities.[50]

India's unstable regulatory environment may put a damper on investment, however. For example, Chinese smartphone giant Xiaomi had its offices searched and some of its bank deposits frozen on the suspicion of foreign exchange violations. South Korea's Samsung Electronics is also being investigated for alleged tariff evasion. The Indian government openly discriminates against foreign e-commerce companies such as Amazon. Capricious regulatory changes are the norm. The latest example is the introduction of a licensing system for importing laptops and tablets for sale in India.[51] While the aim is to curb imports from China and encourage local production, such sudden moves discourage foreign investment.

Companies are also investing in Vietnam (**Table 3**). In the northern province of Bac Giang, Hon Hai continues to invest aggressively. In the summer of 2022, the company announced an additional investment of $300 million.[52]

Vietnam may even be doing too well. As a result of the concentration of manufacturing industries shifting to the country as an alternative to China, exports to the United States rapidly ballooned, causing alarm during the Trump administration. On December 16, 2020, the U.S. Treasury Department designated Vietnam as a "currency manipulator," subject to sanctions. The U.S. Treasury dropped Vietnam from this designation in April 2021, but it added Vietnam to its monitoring list in November 2023 after the country's "global current account surplus shot up to 4.7% of GDP during the monitoring period."[53] In 2019, South Korea's Samsung transferred all of its smartphone production from China to Vietnam. The company accounts for one-quarter of Vietnam's total exports.[54] To avoid excessive dependence on China, Vietnam has pursued a policy of attracting Japanese and Korean

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50 Nakamura, Tatsumoto, and Arata, "Taiwan zei 'sekai no kojo' banare, Honhai Chugoku kara Betonamu/Indo he."

51 Ritesh Kumar Singh, "Indo wo keien suru gaikokujin toshika" [Foreign Investors Shunning India], *Nikkei*, September 24, 2023, 8.

52 Nakamura, Tatsumoto, and Arata, "Taiwan zei 'sekai no kojo' banare, Honhai Chugoku kara Betonamu/Indo he."

53 David Lawder, "U.S. Finds No Major Trade Partners Manipulated Currencies," Reuters, November 7, 2023 ~ https://www.reuters.com/markets/currencies/us-finds-no-major-trade-partners-manipulated-currencies-2023-11-07.

54 Tomoya Ohnishi, "Betonamu taibei kuroji Nihon goe, Chugoku kara seisan ikan, Bei ha 'kawase sousakoku' de keikai" [Vietnam's Surplus with U.S. Exceeds That of Japan, Production Transferred from China, U.S. Wary of "Currency Manipulators"], *Nikkei*, December 18, 2020, 11.

TABLE 3

FDI to Vietnam ($ Million)

Year	Japan	United States	China	South Korea
2014	1,446	88	560	1,617
2015	1,654	171	1,279	2,389
2016	2,026	36	764	1,988
2017	1,985	154	1,151	3,353
2018	2,648	-160	1,649	4,615
2019	2,357	115	1,876	2,836
2020	4,214	-18	2,208	2,488
2021	2,878	N/A	N/A	1,781
2022	2,878	N/A	N/A	1,781

Source: Japan Institute for International Trade and Investment, "Sekai shuyokoku no chokusetsu toshi toukeishu."

Note: N/A designates data not available.

companies. Consequently, the country's trade surplus with the United States has swelled because of foreign companies' exports.[55]

Not to be outdone by Vietnam and India (the most fortunate beneficiaries of China plus one so far), other countries are pressuring Western companies to migrate to their territories. One of the most sought after is Tesla, which is struggling in the Chinese market. Indonesian president Joko Widodo visited Texas in May 2022 and made a direct appeal to CEO Elon Musk to build an EV plant in his country. In July 2023, Malaysian prime minister Anwar bin Ibrahim held an online meeting with Musk to discuss investment plans. Thai prime minister Srettha Thavisin also met Musk when visiting the United States to attend the UN General Assembly in September 2023. Currently, Tesla's Shanghai plant is the company's largest outside the United States, with an annual production capacity of approximately 950,000 vehicles, accounting for 40% of its global production capacity. However, China's BYD has overtaken Tesla in global sales, including for EVs and plug-in hybrids.

55 Ohnishi, "Betonamu taibei kuroji Nihon goe, Chugoku kara seisan ikan, Bei ha 'kawase sousakoku' de keikai"

In EV sales alone, BYD overtook Tesla for the first time in the fourth quarter of 2023.[56]

Intriguing research has been done on the effects of decoupling if it were to occur. According to a simulation by Ikumo Isono and Satoru Kumagai at the Economic Research Institute for ASEAN and East Asia, ASEAN countries are likely to benefit from the decoupling of the global economy, but only if they can maintain neutrality and avoid decoupling themselves.[57] If the ASEAN bloc joins either camp, its economic situation will be worse than a baseline where no decoupling occurs. For either China or the United States, the most significant negative impact would occur if ASEAN were to join the opposite side. Therefore, even without considering other geopolitical factors, both the United States and China have incentives to bring the ASEAN bloc into their geoeconomic orbit. Ultimately, for companies it is not politics but the bottom line that determines their decisions. The slowdown of the Chinese economy's growth rate is likely to be the most decisive factor in predicting the future course of FDI and supply chains in Asia.

Therefore, if the current trend continues, a bifurcation of companies into two groups is likely to occur. One set of multinational firms will continue to follow the China-plus-one strategy, albeit in a more systematic and major way than before, while another set of companies will follow the de-Sinicization strategy to try to reduce, if not eliminate, their business ties with China to avert political and economic risks. Currently, the latter set of companies is limited to those related to semiconductors and EVs; however, the current trend is for Western governments to increase the scope of various restrictions on China. If that is the case, the de-Sinicizing group is bound to expand.

Of course, this is close to what the policymakers in the Western world envisaged when they started using such terms as "de-risking" and "friendshoring." More goods are produced in and shipped from like-minded countries, but goods that are shipped from Southeast Asia may be more likely to be produced by Chinese companies in the not-too-distant future. This hypothetical situation has grave implications for the geopolitical strategies of the United States and its allies because it might give rise to a genuine

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56 Kenya Akama, Ryosuke Hanada, and Takafumi Hotta, "Indo/Tonan-a 'Tesla moude,' EV shifuto sekai ni apiru, datsu Chugoku izon ukezara nerau" ["Pilgrimage to Tesla" from India and Southeast Asia, Shift to EVs to Appeal to the World, Aiming to Break Away from Dependence on China], *Nikkei*, January 16, 2024, 12.

57 Ikumo Isono and Satoru Kumagai, "ASEAN's Role in the Threat of Global Economic Decoupling: Implications from Geographical Simulation Analysis," Economic Research Institute for ASEAN and East Asia, Policy Brief, no. 2022-10, February 2023 ∼ https://www.eria.org/uploads/media/policy-brief/FY2022/ASEAN's-Role-in-the-Threat-of-Global-Economic-Decoupling-Implications-from-Geographical-Simulation-Analysis..pdf.

policy dilemma. On the one hand, the United States and Japan want to avoid the increase in ASEAN countries' economic dependence on China; on the other hand, efforts to discourage the inflow of Chinese investments into these plus-one countries might push them into the Chinese orbit instead. The United States and Japan would need to use utmost caution in handling this situation. ◈