CHINA PLUS ONE – WHERE IT STANDS?

No other country is as relevant as China when it comes to world's need for manufactured goods, but the question is how long it will sustain.

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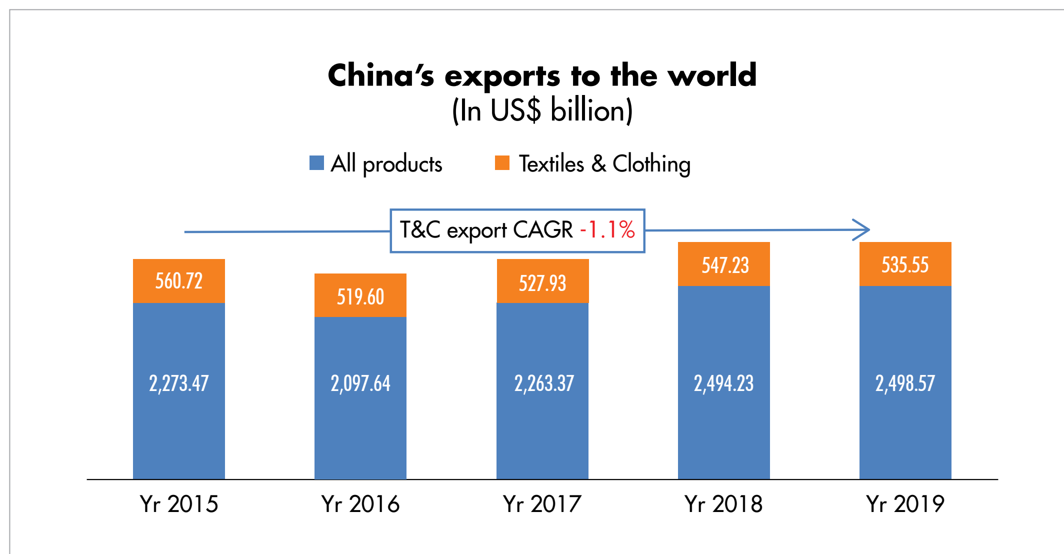
by **SANJAY BAKSHI**

Today's China has no rival in the field of manufacturing. China accounted for 28.7 per cent of global manufacturing output in 2019, putting the country more than 10 percentage points ahead of the United States which used to have the world's largest manufacturing sectors until China overtook it in 2010. Domestically, Chinese manufacturing sector contributes 30 per cent of the country's total economic output. Chinese dominance in the global industrial sector can be gauged by the fact that among the world's more than 500 major industrial products, China ranks first in output of over 220. China has become the only country in the world to obtain all the industrial categories listed in the United Nations industrial classification. The country's industrial added value saw an average annual growth of 11 per cent from ¥12 billion in 1952 to over ¥30 trillion in 2018. In the past 70 years, China's small and medium companies and private companies played an important role in increasing employment, keeping stable growth and stimulating innovation. By the end of 2018, the number of small and medium companies surpassed 30 million and the number of self-employed

The tension created by trade war in general, and pandemic in particular, exposed heavy reliance of many companies on China for raw materials, contract manufacturing and production facilities. There arose an urgent need to rethink and redraw a supply chain strategy that would facilitate uninterrupted functioning in adverse times.

FIGURE 1 **CHINA'S EXPORTS TO THE WORLD**



SOURCE: World Bank

industrial and commercial households exceeded 70 million. These contribute over 50 per cent of the country's tax revenue, over 60 per cent of the GDP, over 70 per cent of the technological innovations, and more than 80 per cent of workforce.

CHINESE EXPORTS

China manufactures for the world at large scale. Overall Chinese exports have grown from ~$2.3 billion in 2015 to ~$2.5 billion in 2019, at a CAGR of 2.4 per cent. Textiles and clothing exports forms around 23 per cent of its total exports and has declined at a CAGR of 1.1 per cent during the same period. As per the General Administration of Customs, exports of China-made apparel, clothing and accessories from the country grew 51.7 per cent year-on-year to $44.41 billion in the first four months of 2021. Yarn and fabric exports too surged 18 per cent to $43.96 billion during the same period. In the month of April 2021 alone, apparel and accessories export brought $11.12 billion to China, while textile yarns, fabrics and related products earned $12.15 billion. According to another data from the Ministry of Industry & Information Technology, Chinese textile and clothing exports increased 9.6 per cent to $291.22 billion in 2020 on yearly basis despite the COVID-19 pandemic and global economic slowdown. In terms of segments, textile export jumped 29.2 per cent y-o-y to $153.84 billion, while garment export declined by 6.4 per cent to $137.38 billion.

MANUFACTURING REVOLUTION

China, a case study in manufacturing economy, became the leading manufacturer of goods in the world owing to various factors. It all began with the availability of cheap labour that helped its emergence as 'world's factory'. Initially, China was an agrarian economy with large rural population. When this large rural and lower-middle class population began migrating to industrial areas within the country few decades back, it provided abundant supply of labour that was willing to work in multiple shifts at low wages, providing cheap labour for factories in China. The low labour cost attracted a consistent flow of foreign orders that eventually resulted in expansion of Chinese manufacturing sector. With growth in China's industrial production, related networks of suppliers, component manufacturers, distributors, government agencies and customers also expanded, creating a self-evolved business ecosystem.

Although cheap Chinese goods came at the cost of compromising human rights, health and safety norms, child and involuntary labour, fair wages, and environment protection standards in the factories, foreign buyers continued importing goods from China, unabashedly. China's growth story continued. Earlier in 1985, the Chinese government had introduced Export Tax Rebate Policy which abolished double taxation on exported goods. Additionally, consumer products from China were exempted from any import taxes. This kept the cost of production low and enabled the country to attract investors and companies looking to produce low-cost goods. Simultaneously, China kept 'positioning-repositioning' its yuan against dollar from time to time to benefit its export. All these factors together made China the global sourcing hub that it is today.

WINDS OF CHANGE

However, things have started changing in the past few years owing to economic changes in the country. The wages of Chinese workers have more than doubled in the last ten years forcing the companies to seek new countries where worker wages are still low. Labour costs have risen because of population changes. Today, China is an aging nation whose one-child policy has derailed regular supply of next generation of young workers. Lack of next generation workers to replace

FIGURE 2 **CHINA'S AVERAGE REAL WAGE INDEX**

the ones that are currently retiring or will be retiring in the coming years is a serious concern. Both options – whether it is retaining current workers by paying them higher wages or employing labour from other countries – tend to increase the labour cost. At the same time, the adoption of a consumption-oriented economy by the Chinese government has led to wage increase in all jobs, pushing local governments too to raise minimum wages from time to time. Therefore, many overseas companies which moved to China lured by low labour cost have been forced to re-evaluate their setup in the country as well as diversify manufacturing strategies.

Additionally, a variety of events over the past several years caused a ripple effect in the manufacturing industry. First it was the trade war between two global economic superpowers – US and China, that casted its shadow on global supply chain. Then it was the pandemic that impacted the already-stressed situation further due to China shutdown to contain COVID-19 spread. The tension created by trade war in general, and pandemic in particular, exposed heavy reliance of many companies on China for raw materials, contract manufacturing and production facilities. There arose an urgent need to rethink and redraw a supply chain strategy that would facilitate uninterrupted functioning in adverse times. Such needs could be addressed only by having geographically diverse supply base that would ensure access to markets in multiple countries. The geographic spread could also well empower the companies to protect their business interests against a wide range of risks. This builds the case for a strategy called “China Plus One”.

CHINA PLUS ONE

So, what is “China Plus One”? To put it simply, it is a business strategy that aims to avoid investing only in China, and instead diversify business into other countries. In other terms, it may also mean continuing using the resources allocated in China but also adding other sourcing hubs having lower wages to the mix. There are two strategies that are gaining popularity under this. The first one is to meaningfully streamline supply base in existing sourcing base by leveraging business with fewer suppliers. The second one is to increase the supplier base in fewer countries that are reliable. The key is to establish stronger strategic supplier relationships across the entire matrix so as to continue building flexibility and dual (or multiple) sourcing options. The strategy appealing to all sorts of businesses began taking shape few years back.

It was thought better to adopt China Plus One strategy and relocate only a part of the business to other countries such as Bangladesh, India, Indonesia, Malaysia, Myanmar, Thailand and Vietnam with Africa and Latin America being other alternatives. Even prior to COVID in 2019, over 50 multinational companies had decided to move their manufacturing either in part or completely from China to Southeast Asia and Mexico.

According to a 2019 survey on tariffs conducted

In January 2021, US banned all imports of Xinjiang cotton and the products made from the material citing ‘genocide’. The ban impacted 1.5 billion garments imported annually by American brands.

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The prime drivers of China Plus One strategy are high labour cost, pandemic experience and political gamesmanship triggered by trade war. While pandemic-affect will subside sooner or later and labour cost will also undergo correction in due course of time, it is the US-China trade war that is expected to play long-lasting role in fuelling China Plus One strategy.

by AmCham Shanghai and the Chinese government, around 40 per cent of companies were found to have relocated or were considering relocating their manufacturing out of China, mostly into emerging low-cost countries as their target destination, especially Southeast Asia (25 per cent opted for the region as next hub). Many added new operations to the region to supplement their current production. The destination countries were also more than happy to welcome these companies and began streamlining the setup process for their entry. A case in point is Vietnam which targeted IT industry and secured deals from both Samsung and Intel. Other prime candidates for manufacturing especially in textiles included Malaysia, Singapore, Thailand, Indonesia and the Philippines.

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US-CHINA TRADE WAR

As of 2019, US-China bilateral trade reached $559 billion, leading US into a large and growing trade deficit with China. The US trade shortfall rose to $375.6 billion in 2017 from $103.1 billion in 2002, and by 2018 it escalated to $378 billion. To contain further trade deficit, US imposed tariffs on more than $360 billion worth of Chinese goods by the end of 2019. China retaliated with import duties of its own worth $110 billion on US products, triggering a trade war. These decisions made the buyers in both countries to pay higher import taxes to bring purchases into the country. To justify their respective decisions, the US accused China of unfair trade practices and intellectual property theft, while China perceived the US move as an attempt to curb China's rise as a global economic power. The war took its toll on fashion too.

Retailers like GAP reduced its manufacturing exposure to China from 25 per cent in 2016 to 21 per cent in 2019. The company had been moving sourcing out of China for the last several years and announced to continue curtailing it further. The trade war had increased costs for GAP consumers and tempered growth in its third largest market – China. The supply chain agreements emanating from China are another sore spot. Specifically for China, the company worked diligently to mitigate the potential problem for consumers by incrementally moving away from reliance on the region. Including only apparel, its penetration is approximately 16 per cent, which is significantly lower than the relevant portions of the industry. That level is lower than that of peers like Abercrombie & Fitch, one quarter of whose goods are manufactured in China. By March 2021, there were speculations of GAP mulling over selling its China business as part of revamping its business in the country. Morgan Stanley was roped in to study options and reach out to the prospective suitors. GAP had entered China in 2010 with offline as well as online presence.

The luxury retailer Ralph Lauren sources about one-quarter of its products from China which got

affected by 25 per cent tariffs when the US proposed levies on about $300 billion of goods. Though it makes many of its high-end products in Italy, some of its Polo and Lauren brands are still made in China. The brand had options of dealing with the tariff changes, including working with Chinese suppliers to drive down costs and further diversifying the supply chain out of China. It had already lowered its dependence on Chinese manufacturers to about 25 per cent from earlier share of one-third. This was in line with its decision of not wanting any of its market to represent 30 per cent of its total sourcing.

FASHION DRAGGED IN WAR

US-China trade war heated up international politics involving blame game and retaliatory actions. Western media accused China of exploiting Muslim minority – Uyghurs, in its Xinjiang region through coercive labour programmes. Xinjiang, in China's north-west, produces a fifth of the world's cotton. When media reports linked the supply chain of world's best-known fashion retailers including Adidas, Lacoste, H&M, Ralph Lauren and the PVH Corporation with sourcing from the region where Uyghurs are said to be in forced detention, the brands had to reassess their relationships with suppliers from the region.

Australian Strategic Policy Institute also accused Nike of the same charge forcing the world's largest sportswear brand to assess potential forced labour risks in its supply chain. Similarly, American Ralph Lauren had to disassociate itself from sourcing any yarn, textile or products from the region as well as prohibit its suppliers from using cotton grown in the region. As part of its long-term global supply chain strategy Ralph Lauren continues to diversify sourcing locations and prioritise responsibly sourced materials to create a more agile and sustainable supply chain.

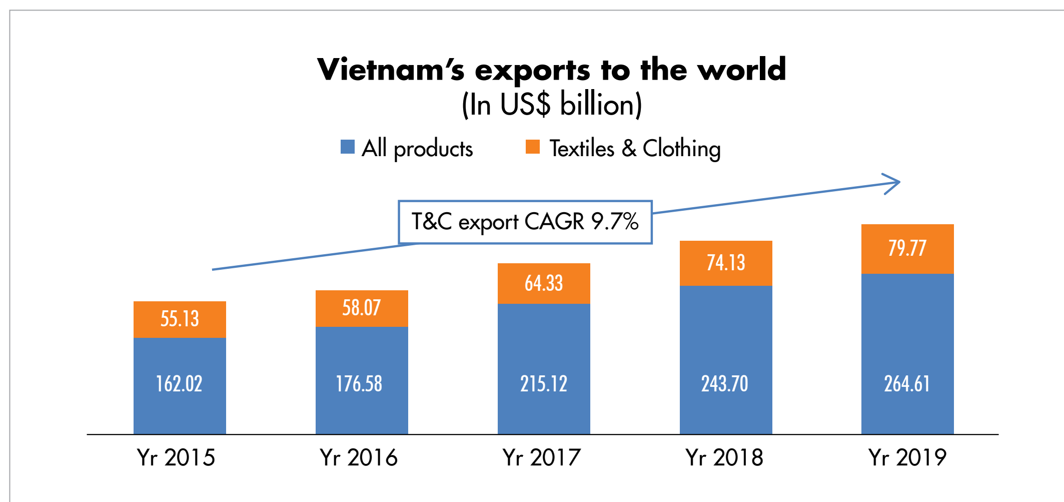
In September 2020, H&M cited 'deep concerns' and stopped buying cotton from growers in the region provoking local sentiments that resulted in boycott of the brand. Result: H&M products vanished from China's most popular e-platforms such as Alibaba's Tmall and JD.com. Within hours, other global fashion brands like Nike and Burberry began trending on social media for the same reason. The situation further deteriorated with celebrities and influencers also severing the ties with many global fashion brands. The video games bounced Burberry-created 'virtual looks' from their platforms. Even before the ban, companies like Patagonia, PVH, Marks & Spencer and GAP had disassociated themselves with sourcing material from Xinjiang region. However later on, some companies announced their plans to continue buying from the region. In fact, brands like Japan's Muji and Uniqlo proudly touted their use of Xinjiang cotton on their Chinese websites. In January 2021, US banned all imports of Xinjiang cotton and the products made from the material citing 'genocide'. The ban impacted 1.5 billion garments imported annually by American brands.

Cascading effect of trade war still continues. However, there are other sourcing destinations especially in South and Southeast Asia which are getting orders that have shifted from China's clients.

VIETNAM

When production began moving out of China with COVID-19 outbreak, the Southeast Asian nation of Vietnam became the first choice and got many diverted orders. Vietnam also benefitted by its successful containment of virus spread in 2020. According to a survey in the same year, 29 per cent of companies sourced from Vietnam, while it was 25 per cent in 2019. However, combined sourcing from China and Vietnam was 20-40 per cent down from 40-60 per cent a year earlier, which meant that only 60 per cent of business is now between these two countries for many retailers and the rest 40 per cent have gone to new destinations.

FIGURE 3 **VIETNAM'S EXPORTS TO THE WORLD**



SOURCE: World Bank

The China Plus One strategy with firms venturing into other Asian nations has become a popular trend that is likely to continue over the long run, even if some firms focus production more on China in the short run.

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Pakistan is reported to be doubling down to boost textile export through measures including tax breaks, cheap loans and supplying electricity at rates that are comparable with rivals in South Asia. A 60 per cent decline in the local currency against the dollar since 2018 has also helped.

FIGURE 4 **PAKISTAN'S TEXTILES & CLOTHING EXPORTS**

SOURCE: World Bank

In 2021, even Vietnam took a beating during the second wave with factories closing down.

PAKISTAN

Pakistan is a textile export hub in the Indian subcontinent which is expected to reap benefits of China Plus One. Its textile industry supplies everything from denim jeans to towels for buyers in the US and Europe. Textile and clothing exports amount to about 60 per cent of Pakistan's total exports. The Government had allowed factories to open ahead of India and Bangladesh when the pandemic first emerged in 2020, drawing orders from global brands including Target Corporation and Hanes Brands Inc. Pakistan's textile export is expected to reach $21 billion by June 2022. Pakistan claims that a lot of orders actually shifted from Bangladesh and India to that country during the pandemic. To support the segment, Pakistan government is incentivising textile export to new markets such as Africa, South America and Central Asia. The nation is reported to be doubling down to boost textile export through measures including tax breaks, cheap loans and supplying electricity at rates that are comparable with rivals in South Asia. A 60 per cent decline in the local currency against the dollar since 2018 has also helped. Among many reasons for Pakistan's exports to have become competitive over the past few years is the fixed energy tariff regime

that keeps in mind South Asian regional prices. The government is much quicker in refunding the money it owes to the exporters. The nation is pushing to intensify trade with Central Asian nations by signing agreements and allowing free movement of trucks.

BANGLADESH

Bangladesh, another south Asian country, is said to be catching up with Pakistan in terms of value of total textile and apparel export combine. The country is still able to offer lowest sourcing cost despite increase in various costs, including that of transportation. However, its ability to market its potential at world stage and flexibility in adjusting to acute demand are still not so impressive. But factors like superior product quality, competitive pricing and prompt delivery have made some textile merchants in the EU, UK and US to shift their sourcing from China to Bangladesh.

The Bangladesh textile and clothing export can be understood under three key segments – knitwear, woven garments and home textiles. As millions of people switched to work from home during the pandemic, Bangladesh's home textiles export benefitted with the surge in demand. The reported export of the segment to US alone was $23.04 million in January 2021, $22.47 million in March 2021 and $47.39 million in December 2021. On the other hand, its home textiles exports to the EU and UK combined stood at $45.56 million in January 2021, $42.03 million in March 2021 and $52.41 million in December 2021. During the period, UK's apparel retailers remained sceptical in increasing their orders due to Brexit. Nevertheless, UK business is expected to improve as the country is offering duty-free market access to Bangladesh under a new scheme. Entering into the current fiscal year (FY22), home textiles exports during the first four months i.e., July-October 2021 surged by 16.5 per cent year-on-year to $412.78 million. On half-yearly basis i.e., the period from July 2021 to December 2021, home textiles exports increased by 30.1 per cent to $715.95 million over the same period of previous fiscal.

Readymade garments (i.e., knitwear + woven garments) exports from Bangladesh increased by 20.78 per cent to $12.62 billion between July 2021 and October 2021. Of this, knitwear exports increased by 24.27 per cent to $7.2 billion, while the increase in woven export for the period was reported at 16.1 per cent to $5.4 billion. Readymade garments export data for the extended six months period i.e., July-December 2021, changed to 28 per cent at $19.9 billion. Of this, knitwear rose by 30.9 per cent to $11.16 billion, and woven apparel by 24.5 per cent to $8.74 billion. Together apparel and clothing accessories exports contributed 80 per cent of Bangladesh's total export earnings.

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INDIA

When some textile companies began boycotting China owing to the origin of COVID-19, India was expected to gain. However, that neither resulted in doing away with China completely nor benefitting India's textile and clothing export much. While total export from India has grown at a CAGR of 5.2 per cent between 2015 and 2019 the textile and clothing export has been on a decline, growing negatively at a CAGR of 1.2 per cent from 2015 to 2019. Things started changing with revival of India's economy.

After the deceleration in FY21 due to pandemic-induced disruption in the supply chain and demand, India's textile export began showing signs of recovery when its exports exceeded imports. During the period between April 2021 and December 2021, the total textile and apparel export was $29.8 billion against previous year' $21.2 billion for the same period. Cotton yarns, fabrics, made-ups and handloom products rose 43 per cent on yearly basis during the period while jute products export increased 33 per cent. According to the reports, the export target for FY22 was set at $44 billion, of which 67 per cent has already been achieved until December 2021. Export in December surged to a record of 37 per cent y-o-y to $37.29 billion – the highest-ever monthly achievement of exports so far. Exports stood at more than $27.22 billion in December 2020.

TABLE 1

India's exports (in US$ billion)	2015	2016	2017	2018	2019
All products	264.38	260.33	294.36	322.29	323.25
Textiles & Clothing	75.45	71.91	75.49	75.01	71.98
Share of T&C	29%	28%	26%	23%	22%

SOURCE: World Bank

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The adoption of a consumption-oriented economy by the Chinese government has led to wage increase in all jobs, pushing local governments too to raise minimum wages from time to time. Therefore, many overseas companies which moved to China lured by low labour cost have been forced to re-evaluate their setup in the country as well as diversify manufacturing strategies.

Merchandise export in April-December was at $299.74 billion – an increase of 48.85 per cent over $201.37 billion recorded in the year-ago period.

A SPECIAL MENTION

Not all companies are adopting China Plus One to cut down reliance on China. Spain's fashion Group Inditex, the owner of Zara, wants 'production in proximity'. Working on the strategy, Inditex shrunk its production by 17 per cent in 2020 and took a step back in China for the first time to accelerate proximity on its production with 49 per cent of total suppliers. The Group stopped working with 65 suppliers in China.

Spain's fashion behemoth operates with twelve clusters of global supply, namely Spain, Portugal, Morocco, Turkey, India, Bangladesh, Pakistan, Vietnam, China, Cambodia, Argentina and Brazil, of which China is the largest cluster. The Group ended 2020 working with 412 suppliers in China as against 477 in 2019 – a decrease of 13.6 per cent. These suppliers used to work with 1,414 garment factories in 2020, a number which was 1,465 factories in 2019. The Group reduced the number of suppliers to work with larger companies which reflected a 26 per cent increase in the number of manufacturing workers the company recorded in 2020, up to 635,532 employees. With production in China on standby during the pandemic there arose a need to adjust to demand pushing most of fashion companies to Turkey as their primary supplier. So, by 2020 Inditex was working with 215 suppliers in Turkey, up from 6.44 per cent more than in 2019. At the same time, the company operated with 906 garment factories in the country (959 in 2019) and 828 factories associated with other processing units (747 in previous year). Overall, factories working for Inditex in Turkey employed 364,201 people in 2020 which was 9.5 per cent more than in 2019.

This is an interesting case of production-in-proximity to balance a company's global supply and spread out the risk. This production-in-proximity is estimated to have accounted for 49.4 per cent of total suppliers in 2020. The far-off sourcing hubs are progressively losing volume within Inditex, at least in terms of number of suppliers. The Group's business in India, Bangladesh, Vietnam, Cambodia, China and Pakistan accounted for 49.6 per cent of the total in 2020 compared to 51.5 per cent a year earlier and 52 per cent in 2018. The only Asian country that ended 2020 with rise in number of Inditex's suppliers was Bangladesh. The company had purchased from 118 suppliers at the end of 2020. These factories in Bangladesh employed 811,603 people, up by 13.98 per cent from 2019. In contrast, the number of suppliers with which company works in Vietnam fell by 12.5 per cent, Cambodia by 25 per cent and Pakistan by 12.37 per cent.

WHAT'S NEXT

For over 20 years, many businesses from the West have relied on China making it an overtly dependent sourcing hub due to China's growing manufacturing power. However, as of today, world order is changing economically, politically and commercially. For businesses to adjust to these changing dynamics there is an urgent need to spread around the risk factors by creating a portfolio of hubs that may compensate for loss of one in case of any eventuality, as was experienced during COVID time.

The China Plus One strategy with firms venturing into other Asian nations has become a popular trend that is likely to continue over the long run, even if some firms focus production more on China in the short run. Therefore, despite rising wages, companies are not uprooting their operations from China completely as there is still a strong supply chain network, infrastructure and knowledge base there. For instance, even though Intel opened a new facility in Vietnam the company still has several assets in China. Vietnam has simply been added as an assembly and testing operation. Also, the wage increase has not caught up on the inland portions of China, and the coastal regions are witnessing most of the growth. China Plus One is apparently a viable option for many companies and is a trend that won't go away anytime soon. Many companies are diversifying across Southeast Asia and even bringing some operations back home. This will require Southeast nations to quickly build suitable infrastructure to accommodate such companies. However, companies that choose to diversify into Southeast Asian nations will continue to be able to take advantage of the varied and easily accessible suppliers from other Asian nations. In addition, Regional Comprehensive Economic Partnership (RCEP) signed among members states of ASEAN and its FTA partners will allow firms with supply chains distributed among several Asian nations to take advantage of common rules of origin for the entire block. This will allow RCEP countries to use only a single certificate of origin. FF