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BULLETIN

The U.S.-China Rivalry is Changing International Supply Chains

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While the U.S.-China economic rivalry has been intensifying for years and is closely linked to the deterioration in political relations, the sudden collapse of supply chains caused by the COVID-19 pandemic has highlighted the increased role of security considerations in economic relations and the interdependencies between China and developed countries. The American actions to reduce those links will have long-term consequences for U.S.-China relations and the economies of other countries.

U.S.-China Strategic Rivalry. China's rapid economic growth and its failure to adhere to fair competition rules have led to the gradual recognition of it by American elites as a strategic threat to the U.S. position as the world's top economy. In 2018, a tariff war broke out, with the reciprocal imposition of tariffs on selected products by the U.S. and China—these are still in force despite the change of administration in the U.S. After the start of the COVID-19 pandemic, the disruptions in international trade and manufacturing activity, especially in China due to its "zero-COVID" policy, meant developed countries faced shortages of goods imported from China. This led politicians and businesses to pay more attention to potential difficulties in supply chains. The role of the security dimension of economic relations was then further highlighted by Russia's aggression against Ukraine in 2022. The U.S.-China rivalry is intensifying, as can be observed, for example, in U.S. efforts to limit China's chipmaking capacity and in support for the development of domestic American industry. In August, the U.S. authorities banned investment in selected high-tech sectors (advanced computing chips and microelectronics, quantum technology, artificial intelligence) in China and implemented partial outbound investment screening. These and other developments have led to a reduction in trade between the U.S. and China, whose share of American imports fell from 21.6% to 16.3% between 2017 and 2022. In the first half of this year, it was lower than imports from both Mexico and Canada. According to full-year data, China has been the largest U.S. import partner every year since 2009.

Consequences of the Tensions. The decline in the share of China's imports in total U.S. imports since 2017 has been accompanied by an increase in the share of other countries: Vietnam (up by 1.9 percentage point), Taiwan (1 p.p.), Canada (0.75 p.p.), Mexico (0.64 p.p.), India (0.57 p.p.), and South Korea (0.53 p.p.). According to a study by researchers from the University of California San Diego, the World Bank, and the International Monetary Fund, the predictors of U.S. import growth from a given country in categories in which China's position has been declining were country size (larger countries recorded higher growth), sharing a border with the U.S., a comparative advantage, and, crucially, the level of integration into Chinese supply chains. This suggests that a decline in direct imports from China to the U.S. might not proportionally reduce U.S. dependence on China.

However, a change in attitude towards doing business in China is evident among companies. According to data from the American Chamber of Commerce in China, in 2022, about 25% of companies were actively relocating production out of China or were considering doing so, up from about 18% in 2020. The use of "China plus one" strategies (i.e., opening facilities outside China to diversify sources, but without terminating operations in China) or "China for China" (i.e., separating production for the Chinese market carried out locally from production for markets in other countries) are increasingly popular.

Nevertheless, China retains a strong position in U.S. supply chains and businesses seek to use simple solutions to bypass the restrictions, hence the apparent preference for moving some production to countries linked to the Chinese economy, visible in the statistics. One can detect Chinese goods being repackaged or minimally processed in other countries and then exported onwards to the US. In August, the U.S. Department of Commerce confirmed that such practices were taking place in the sector of solar panels, which were entering the U.S. via Vietnam, Malaysia, Thailand, and Cambodia. An increasing dependence on China by countries ultimately exporting to the U.S. is also apparent (e.g., exports of car parts from China to Mexico have doubled in the last five years; Vietnam's imports from China have also increased in value). Moreover, China is an important and hard-to-replace supplier of metals (e.g., lithium, cobalt, gallium, germanium, or rare earths), both in their raw and processed forms. These metals are then used to produce commodities essential for national security and the energy transition (e.g., batteries, semiconductors, electronics) manufactured in other countries. China is already using exports of these metals to put pressure on developed countries—after restrictions were placed on gallium and germanium exports (in response to the U.S. restricting China's access to advanced technology), exports fell to zero in August this year. These phenomena lengthen supply chains, thereby reducing their transparency and making them more difficult to control by authorities and businesses, which tend to monitor only the last links.

Attempts to reduce U.S. import dependence on China may be beneficial for other countries. The stronger positions of developing Southeast Asian countries or Mexico in U.S. imports is an opportunity to develop their industries and eventually to replace China as a supplier to the U.S. market. Although at present at least some of the imports from these countries are goods based on Chinese inputs, this is a first step to developing their own industrial competences. The existence of assembly plants in these countries creates favourable conditions to start manufacturing intermediate goods. This process will take time, but with rising production costs in China, it will be possible for other countries to start competing with China (especially if the U.S. introduces appropriate incentives). This would lead to a lasting and profound change in U.S. supply chains. Should tensions continue to escalate, however, the reluctance of South and Southeast Asian countries to unequivocally support one side in the U.S.-China rivalry may be a problem. China's position as an investor in the region remains important, which could lead to the emergence of dependencies on China at the level of specific companies or sectors.

Conclusions and Recommendations. Although the measures taken by the U.S. do not reduce dependence on China as much as bilateral trade statistics would suggest, this is not evidence of their total ineffectiveness. U.S. trading partners need time, and perhaps additional incentives, to develop their industrial competences to allow them to replace China in U.S. supply chains. It will be crucial for the U.S. to build stable trade relationships and offer their partners opportunities for long-term substitution of China in American trade, for example, through a possible return to agreements similar to the Trans-Pacific Partnership (TPP), the ratification of which was abandoned in 2017 by President Donald Trump. It is also advisable to support the development of local industry so that it is not dependent on imports of production inputs from China. This would solve the current problem of the increasing dependencies on China by countries replacing it in U.S. supply chains. In a crisis, this would result in difficulties similar to those experienced during the COVID-19 pandemic. The solution to this problem may lie in greater government emphasis on supply chain monitoring (and inducing companies also to do so), without which the strategies employed—diversification, nearshoring or friendshoring—will not produce the desired effects.

Poland can act in the area of international trade through the EU and seek to promote the perception of the U.S.-China rivalry not only in terms of the economy but also security, especially in the context of Sino-Russian relations. Moreover, as the examples of Taiwan or South Korea show, industrialised countries can also benefit from changes in supply chains. It is advisable for Poland to seek to further integrate into U.S. supply chains, as seen in the coming construction of an Intel factory, announced in mid-2023. American investments, especially those of strategic importance (e.g., in the new technologies and energy transition sectors), will be beneficial from both an economic and security perspective.