

Shop Talk – GBA, COVID-19 and shifting supply chains



- Our annual survey of manufacturers operating in China's Greater Bay Area (GBA) sheds light on the damage caused by COVID-19. Respondents expect contractions across sales, orders, hiring and investment in 2020.
- Wages in the GBA are likely to fall in 2020 for the first time in the survey's 11-year history. Our survey respondents have a less pessimistic outlook on Asia than other regions, but remain cautious on capex.
- The absence of wage pressure does not appear to be stopping GBA manufacturers from actively considering moving production to ASEAN as US-China trade tensions and COVID-19 drive diversification out of China. Vietnam remains the most-preferred destination.
- Respondents remain confident in the GBA's long-term future, backed by strong policy support via the promotion of financial reforms and cross-border integration. Hong Kong's crucial role within the GBA appears to be intact despite the recent political upheaval.

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Contents

Insights into a fast-changing GBA	3
Feeling the COVID pain	3
Growing labour-market slack	3
Limited appetite for capex	3
Moving overseas for diversification	4
Diversification continues to favours ASEAN markets	4
Positive outlook on the GBA's future	4
GBA survey 2020	5
Feeling the GBA pulse amid the pandemic	6
Survey shows worst sentiment in 11 years	6
COVID impact and more	7
Labour and wages	11
Factory relocation	14
Industrial upgrading	16
GBA in post-COVID world	18
Through the post-COVID lens	19
Short-term challenges vs long-term optimism	19
Megacity clustering still offers benefits	20
Policy commitment remains strong	21
Nobody said it would be easy	22
No immunity for ASEAN	23
ASEAN – More needs to be done	24
Vietnam – Still numero uno	29
Authors	31
Global Research Team	32



Insights into a fast-changing GBA

Our annual survey offers an on-the-ground look at topical issues such as the COVID-19 impact, factory relocation and long-term industrial upgrading

We conducted our first annual manufacturing survey 11 years ago to assess China's vulnerability to a worsening labour shortage and rising wages. Since then, our survey has become a key channel offering unique insights into China's fast-transforming manufacturing landscape – as well as its more recent aspiration to create the world's largest city cluster, the Greater Bay Area (GBA), linking Guangdong, Hong Kong and Macau. This year's survey is particularly relevant, allowing us to gauge the macro and micro impact of the COVID-19 outbreak and US-China tensions. We continue to look at the growing China-ASEAN connection, which we think has increasing relevance as companies remain interested in relocating production out of China for not only cost-saving but also diversification purposes.

Feeling the COVID pain

Respondents view 2020 as a very challenging year, headlined by order losses due to COVID

Our survey confirms that COVID-19 has weighed significantly on GBA manufacturers' business performance and expectations. Almost three-quarters of our respondents see a negative impact on their businesses. Because the GBA – China's largest manufacturing hub – has a substantial migrant worker population, it was particularly vulnerable to the impact of the outbreak. Workers were slow to return after the Lunar New Year holidays, disrupting the region's operations and supply chains. However, looking ahead, our respondents are most concerned about order losses given the risk of a prolonged global recession. Some 56% and 52% of respondents who operate in the US and euro area, respectively, have negative views on these markets. This compares to 29% with negative views on China, 17% on ASEAN and 27% on the rest of Asia; we share the view that Asia is likely to lead the recovery from COVID.

Growing labour-market slack

Survey confirms a weak labour market, supporting the need for more policy easing to boost growth

44% of respondents reported less difficulty in hiring workers compared to a year ago (versus 24% last year). Almost 40% no longer face difficulties in hiring, and 18% reported excess labour supply. This may explain the absence of wage-hike expectations this year (that is, wages are expected to be down marginally after rising 4.6% in 2019). These results suggest growing labour-market slack, which likely underpins the authorities' decision to commit to explicit job-creation targets (9mn new urban jobs and an urban unemployment rate of around 6%) and refrain from setting a GDP growth target this year. As long as labour-market slack remains, we expect the authorities to maintain an accommodative policy stance to support growth and ensure economic and social stability. Our survey echoes the need for more monetary easing; 49% see more difficulty in borrowing compared with a year ago.

Limited appetite for capex

Manufacturers have little appetite to invest in 2020 – a setback to the GBA's long-term upgrading plan

Economic and geopolitical uncertainty will likely continue to weigh on manufacturers' investment appetite, even though automation remains the most preferred way for those that need to address wage pressure. More respondents see a 'deceleration' than an 'acceleration' in key forms of industrial upgrading in 2019, including artificial intelligence, robotics, big data and internet-related investment. This suggests that the recovery in manufacturing investment will continue to lag that in infrastructure and real estate in H2-2020. Beyond 2020, a solid 53% of respondents have a long-term target for industrial upgrading – a key driver of the GBA's ongoing transformation.

Overview

GBA survey 2020

GBA in post-COVID world

No immunity for ASEAN



GBA manufacturers are eyeing ASEAN increasingly for diversification reasons

Moving overseas for diversification

Every year, we ask respondents whether relocating production is an attractive proposition to counter rising wage costs. This year, respondents see other, more compelling reasons to move capacity overseas. 43% said they would more actively consider relocating due to persistent US-China trade tensions and/or COVID-19. These developments may have unnerved companies facing high concentration risks in China due to operational or national security concerns. However, rather than replacing their China-based production, we see a trend of manufacturers diversifying capacity, with 56% choosing 'diversification of production capability' as the main reason for relocation.

Diversification continues to favours ASEAN markets

Vietnam is again our respondents' top relocation choice (see '*Vietnam – Still numero uno*'), followed by Cambodia, Myanmar and Bangladesh. Even so, respondents appear cautious on the near-term outlook for ASEAN (even though they perceive it as better than that of most other regions), as no market seems immune to COVID-related disruption. This tepid outlook may explain why only a handful of respondents already operating in ASEAN plan to increase production capacity in the region this year. In the long run, we expect ASEAN to remain an attractive destination for FDI; however, we think the region needs to raise productivity levels to continue to benefit from the trend of relocation from China. Our respondents highlighted issues in ASEAN, including a lack of local financing, poor productivity, rapidly rising labour costs, and the need for more active promotion and facilitation of the region's free trade agreements.

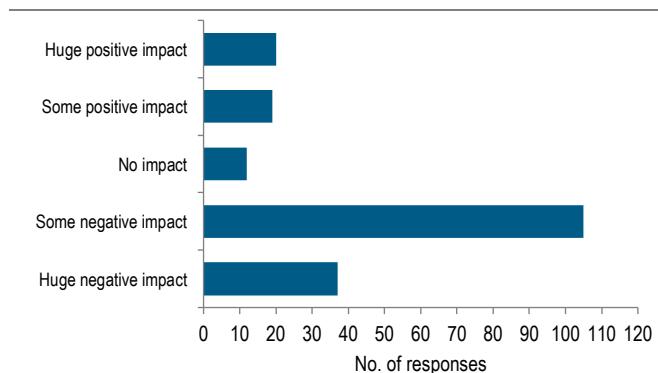
No lack of policy support from China in creating a megacity cluster

Positive outlook on the GBA's future

Despite short-term headwinds, respondents continue to express long-term confidence in the GBA. 58% see the GBA presenting new business opportunities in the next three to five years, marginally exceeding expectations for China's Belt and Road Initiative, Renminbi internationalisation drive and multilateral trade pacts. We believe the GBA will become increasingly important to China in the post-pandemic world given the region's (1) leadership in driving China's innovation, (2) ability to attract highly skilled talent and (3) high infrastructure investment needs. The risk of persistent US-China tensions may push China to become more self-reliant and to establish a smarter, more complete manufacturing ecosystem.

New guidelines released by China's financial regulators in May to promote the GBA's financial-market opening reiterated a commitment to the region's long-term development and to Hong Kong's continued collaboration and integration, notwithstanding political uncertainty. We believe Hong Kong is crucial to China's GBA plan, but note that more work needs to be done to reverse the perception of damage to the 'one country, two systems' system.

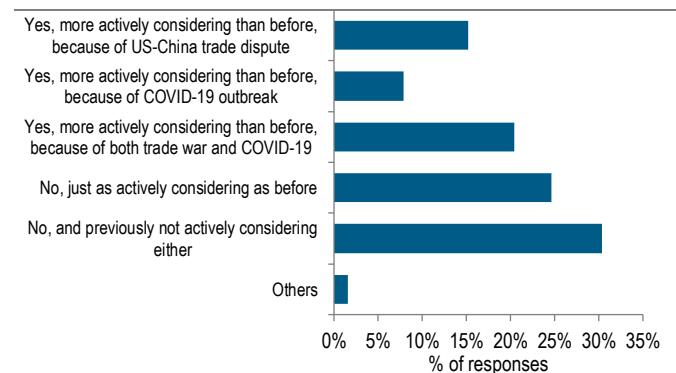
Figure 1: How do you see COVID-19 impacting your business in 2020? (no. of responses)



Source: Standard Chartered Research

Standard Chartered Global Research | 29 June 2020

Figure 2: Are you more actively consider moving capacity outside China? (% of responses)



Source: Standard Chartered Research

GBA survey 2020

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Feeling the GBA pulse amid the pandemic

Survey shows worst sentiment in 11 years

Over 190 manufacturers tell us their views on the impact of COVID and its longer-term implications

We recently conducted our annual client survey for a 11th straight year in 2020, with over 190 manufacturers answering questions related to their current operations and business outlook between late March and early May. The surveyed companies are mostly headquartered in Hong Kong, Taiwan or mainland China, and all have operations in the GBA. Our survey respondents are among the more successful firms in the region, having survived a decade-long labour shortage, wage inflation and, in more recent years, escalating trade headwinds and a global slowdown. However, these challenges have paled in comparison to extensive disruptions as a result of the COVID-19 outbreak in 2020. The strong profiles of our survey's participating corporates usually lend the survey results a positive tilt, but this was likely not a factor this year. In addition to providing valuable insights into the COVID shock, these corporates' leading presence in the region makes them a key guide to the outlook for factory relocation, industrial upgrading and the effectiveness of policy support.

There are four parts to our survey findings; we list the key takeaways below.

COVID impact and more (page 7): Respondents expect a material deterioration in business performance in 2020 from an already-challenging 2019. Almost 75% see a negative COVID impact on their business; over 80% list the outbreak's global impact as a top concern, predominantly due to order losses. Respondents are generally less pessimistic on Asia than the rest of the world and prefer policy support with a more immediate and direct impact on their business (such as tax cuts and fee reductions). Almost half said borrowing money is more difficult than a year earlier, suggesting room for further monetary easing. A majority of respondents expect USD-CNY to end 2020 within a narrow range of 7.00-7.20.

Labour and wages (page 11): Respondents expect wages to fall marginally by an average 0.2% in 2020, the first decline in the survey's 11-year history, versus a 4.6% (actual) increase in 2019. 60% lowered their wage expectations compared with a year ago. Emerging labour-market slack has likely contributed to downward wage pressure: those reporting less labour tightness jumped to 43.5% from 24.4% in 2019 and 11.5% in 2018. Almost 40% no longer see difficulty hiring; another 17.8% report excess labour supply. This explains the authorities' emphasis on preserving jobs as one of their top priorities this year at the NPC session.

Factory relocation (page 14): 43% of respondents said they would more actively consider moving capacity overseas due to US-China trade tensions and/or COVID-19. Among those considering, or planning to actively consider, moving overseas, 19% have already moved and started operations, up from only 6% a year ago. Vietnam remains the most favoured destination, followed by Cambodia, Myanmar, Bangladesh and Thailand. Diversification of production capacity is now listed as the top driver of relocation overseas, as wage savings have become a less compelling reason due to labour-market slack in the GBA.

Industrial upgrading (page 16): Manufacturers report weak capex appetite with less urgency to reduce wage costs but also an uncertain economic outlook. The percentage of those reporting 'deceleration' in 2020 exceeded those reporting 'acceleration' by an average 7.6ppt across all main upgrading initiatives. Beyond 2020, a solid 53% of respondents maintain a long-term target for industrial upgrading.



Majority of our c.200 respondents saw material COVID disruption weighing on their expectation

COVID impact and more

How much worse will 2020 be?

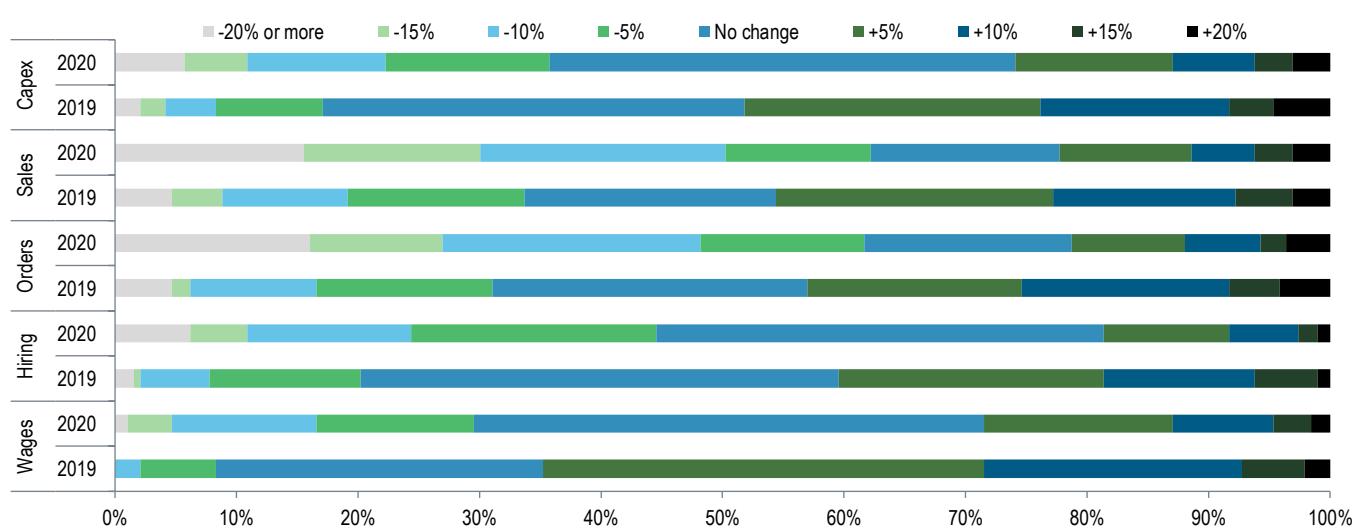
We asked our clients how their businesses performed in 2019 and what they expect for 2020 (Figure 1). The message from our respondents is loud and clear: 2020 looks to be a very different and difficult year compared with 2019.

Orders: 61.7% of respondents expect orders to fall by an average 12.4% in 2020, against only 21.2% expecting an average increase of 10.0%. This is a significant deterioration compared with actual 2019 performance, where 43% reported more orders (by an average 9.4%) – a decent showing against the backdrop of US-China trade tensions – versus 31.1% reporting an average drop of 9.4%.

Sales: Similar to orders, 62.2% of respondents expect sales to fall by an average 12.7% in 2020; meanwhile, 22.3% expect an average increase of 9.7%. Last year, 45.6% reported better sales (by an average 8.7%), more than the 33.7% that reported a drop (by an average -9.8%).

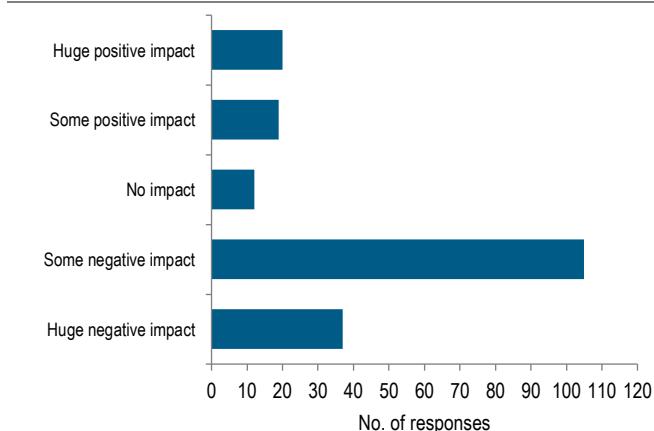
Figure 1: How did the following metrics change in 2019, and what are your expectations for them in 2020?

% of respondents



Source: Standard Chartered Research

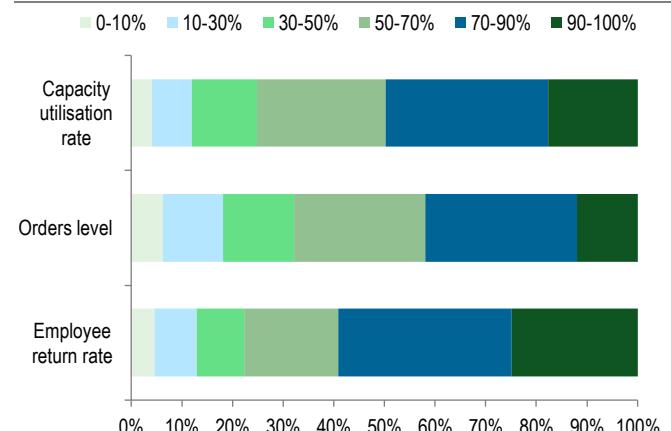
Figure 2: How do you see COVID-19 impacting your business in 2020? (No. of responses)



Source: Standard Chartered Research

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Figure 3: Where do the following metrics currently stand compared with normal levels? (% of responses)



Source: Standard Chartered Research



For every textile and garment respondent that benefited from COVID, three reported a negative impact

Hiring: The negative spillover from a poor business outlook to hiring is evident. Almost half of our respondents (44.6%) expect less hiring this year; only 18.7% of them say they will hire more. Last year, 40.4% reported an actual increase in headcount, while 20.2% reported a contraction. On average, the group expects hiring to fall 2.8% in 2020, versus an actual increase of 1.7% in 2019.

Wages: Our respondents expect wages to fall slightly by an average 0.2% in 2020, the first yearly drop since the start of the survey. 28.5% see wages going up, almost matching those expecting a fall (29.5%). This is in stark contrast with last year's actual wage changes: almost 65% hiked wages, versus only 8.3% reporting cuts. The 4.6% average wage hike in 2019 was the same as in 2018, based on last year's survey.

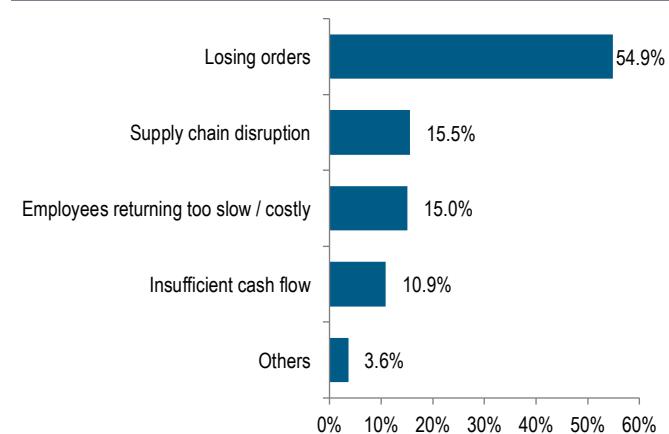
Capex: Companies are not rushing into adding investment any time soon. Capex turned from an average 2.7% expansion in 2019 to an expected 1.3% reduction this year. 35.8% of respondents see a fall in capex this year (from just 17.1% in 2019), versus 25.9% expecting a rise (down from 48.2% in 2019).

How damaging is COVID to business?

The COVID outbreak is a key reason for the stark deterioration in the business outlook this year from an already-challenging 2019, which was marred by escalating US-China trade tensions. 19.2% of respondents see a 'huge negative impact' from COVID on their business, and another 54.4% see 'some negative impact' (Figure 2). Conversely, 20.2% see at least some positive impact on their business, led by 'textile and garments' (presumably for their ability to pivot and produce masks and other protective gear), 'food, beverages and tobacco products', 'electronics packaging assembly' and 'semiconductor manufacturing equipment'. We note that the positive responses are exceptions rather than the rule for their respective industries: for example, for every textile company that responded positively, three saw a negative impact from COVID.

Many of our respondents are still recovering from COVID disruptions earlier this year. Just under 60% and 50% see both their employee return rate and capacity utilisation at 70% of normal levels or more (Figure 3), whereas in last year's survey, 41% reported 100% workforce utilisation and another 57% reported at least 70% utilisation. Order losses are our respondents' biggest concern, with 54.9% picking

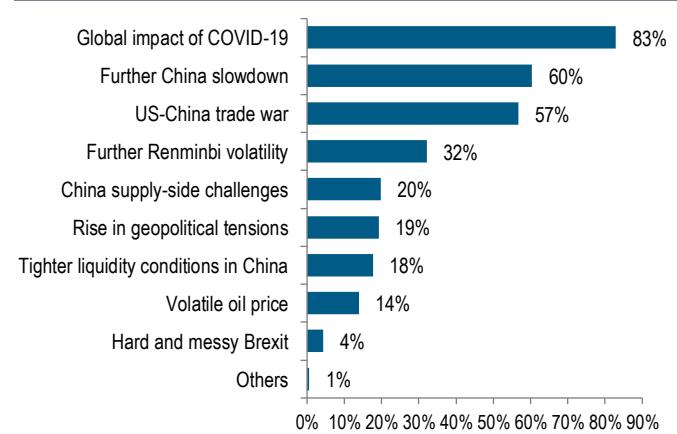
Figure 4: What is the biggest challenge currently to your business from COVID-19? (% of respondents)



Source: Standard Chartered Research

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Figure 5: What are your biggest concerns for 2020? % of responses



Source: Standard Chartered Research



On regional outlook, respondents appear least worried about Asia

this option as their top challenge from COVID, materially more than supply chain disruptions, a slow employee return rate and insufficient cashflow (Figure 4). With more than half our respondents (58%) still facing orders at least 30% below normal, we do not see near-term relief. A likely persistent global recession and looming risks of a second-wave outbreak are also key concerns.

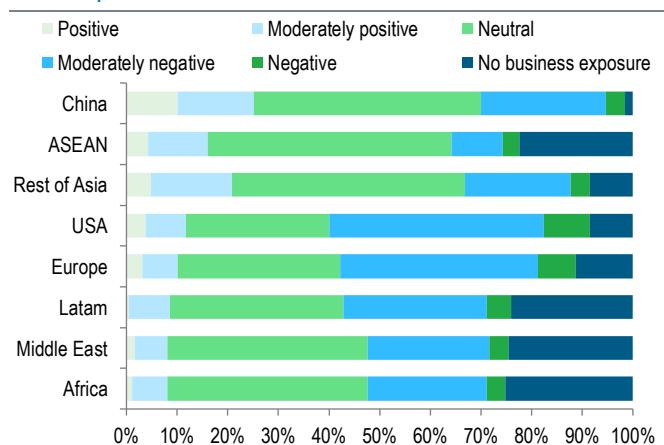
Plenty more reasons to stay worried

Unsurprisingly, 83% of respondents chose 'global impact of COVID-19' as one of their biggest concerns for 2020. 'Further China slowdown' and 'US-China trade war' rounded up the top three spots, both receiving more than half of the votes (60% and 57% respectively (Figure 5). Despite China being a common denominator among these top concerns, respondents remain more upbeat on China (and, more generally, Asia) than on Western economies. Those with positive views on China, ASEAN and the rest of Asia account for 26%, 21% and 23% of total respondents that do business with these markets, respectively (Figure 6). While down from last year's levels (35%, 29% and 39%, respectively), they are still higher than the positive responses on other regions, which fall in the low teens.

However, it is clear that the US and euro area have the largest shares of negative responses (56% and 52%, respectively), more than any emerging markets. This matches the broad perception that these more-developed economies face a greater struggle against the COVID outbreak, which led to widespread lockdowns and therefore substantial production disruptions and job losses in recent months. While China appears to enjoy a 'home court advantage', our clients' business ties and exposure to traditional export markets lend credibility to their assessment of the outlook for US and euro-area markets.

We share the view that while extensive shutdowns and weak sentiment imply a long and difficult recovery for the global economy, China is leading in its recovery from the outbreak given its earlier emergence from lockdown. Strong policy support is also likely to help it withstand a continued economic drag from a potentially persistent global recession, which we see bottoming out only in Q2 this year, at the earliest.

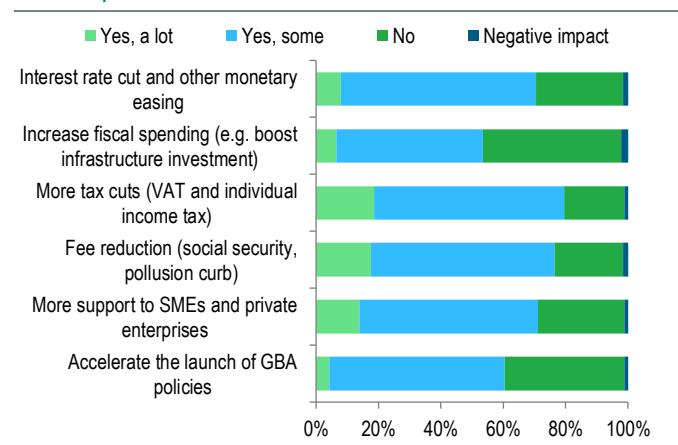
Figure 6: Which other countries/regions do you do business with; what are your views on them in 2020?
% of respondents



Source: Standard Chartered Research

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Figure 7: Do you see the following types of policy support helping your business in 2020?
% of respondents



Source: Standard Chartered Research

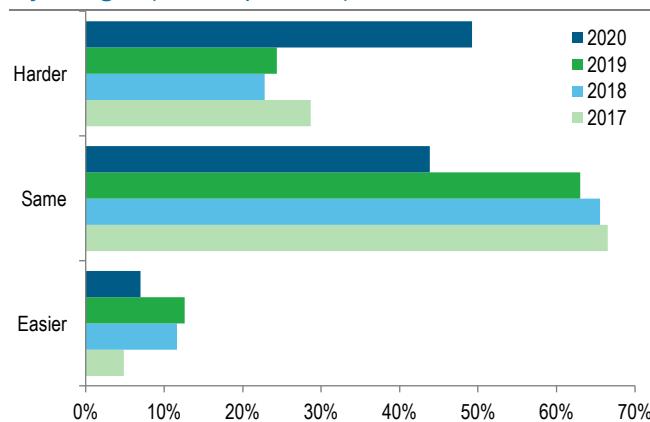


Policy response expectations

We asked respondents about the impact of policy support measures on their business in 2020. We see a clear preference for measures that offer more immediate relief, reflecting the current challenging business environment. 80% see 'more tax cuts' helping their business in 2020, closely followed by 'fee reduction' (76%); see Figure 7. Similar strong responses for 'more support to SMEs and private enterprises' and 'interest rate cut and other monetary easing' (both at 70%) reflect key stress points in the economy. SMEs are generally more vulnerable to economic downturns and slower to benefit from broad-based policy stimulus, such as the lagged transmission of monetary easing to an actual reduction in funding costs.

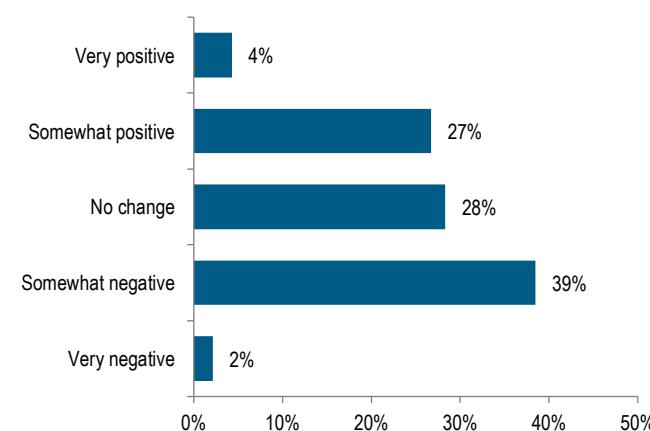
Almost half of our respondents (49.2%) expect borrowing to be more difficult than a year ago, up from 24.4% based on last year's survey (Figure 8). This is despite multiple rounds of interest rate cuts YTD to the 7-day open market operations (OMO) rate, 1Y medium-term lending facility (MLF) rate, 1Y loan prime rate (LPR) and reserve requirement ratio (RRR). The implied need for more easing matches the recent findings of *our monthly proprietary China SME index (SMEI) survey*. The SMEI shows that SMEs' bank credit costs improved but remained under upward pressure for much of H1 (financing cost sub-indices below 50); see Figure 9.

Figure 8: How easy is it to borrow money compared with a year ago? (% of respondents)



Source: Standard Chartered Research

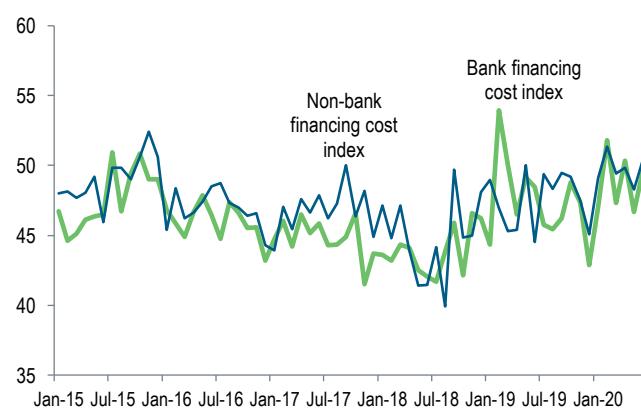
Figure 10: Did Renminbi volatility impact your business in 2019? (% of responses)



Source: Standard Chartered Research

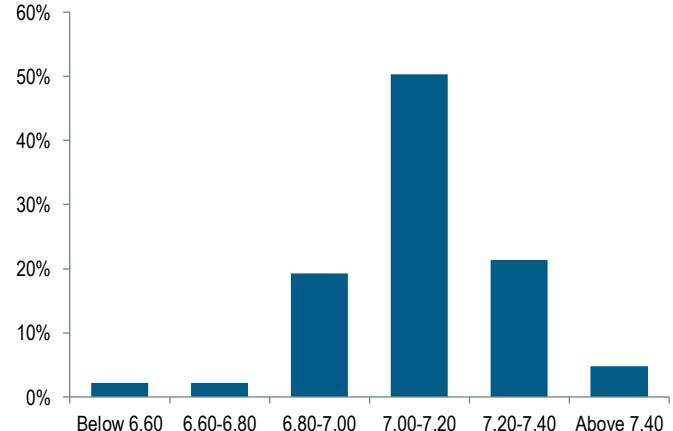
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Figure 9: Rise in SMEs' borrowing costs starting to be contained (China SMEI's current performance sub-indices*)



*Note: Index above 50 indicates lower cost. Source: Standard Chartered Research

Figure 11: Where do you see USD-CNY at the end of 2020? % of respondents



Source: Standard Chartered Research



Respondents favoured fiscal easing measures, such as more infrastructure spending, less than monetary easing measures, with only 53% responding positively (Figure 7), possibly because of the extensive lag in impact from infrastructure spending. More respondents (60%) see GBA-related liberalisation measures, if accelerated, as more effective in supporting business, possibly in hopes of geographical or industry-specific benefits boosting market access.

No strong case for CNY depreciation

Majority of respondents expect USD-CNY to end 2020 in the 7.00-7.20 range

The Chinese yuan (CNY) weakened by a modest 1.2% against the USD in full-year 2019 and more evidently by 3.6% from Q2- to Q4-2019. The Q2- to Q4-2019 period of CNY weakening coincided with the rising threat of US-China trade tensions and was perceived as helping China offset some of the damage from the US' punitive tariff hikes. However, only 31% of respondents reported higher CNY volatility as helping their business in 2019; in contrast, 40.6% saw the impact as negative (Figure 10). This illustrates respondents' preference for certainty and stability over potential FX gains, especially given high concerns over US-China relations. Excessive volatility could also fuel talk of capital outflows and renew worries over capital controls. Respondents' aversion to CNY volatility aligns with the fact that a majority of respondents expect USD-CNY to end 2020 close to prevailing spot levels, i.e., within a narrow 7.00-7.20 range (Figure 11).

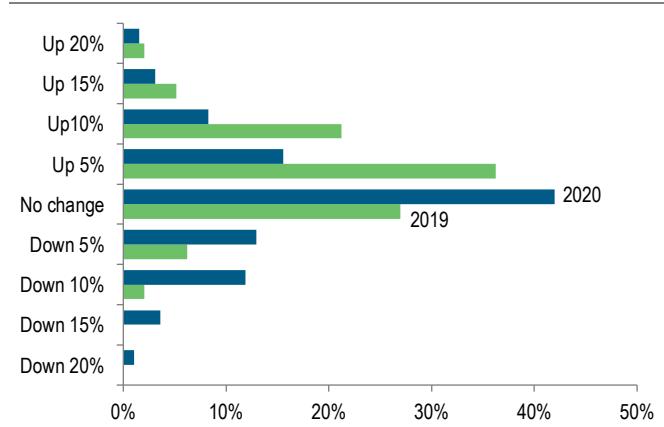
Labour and wages

Job creation an important gauge for economic health

Our survey shows the weakest hiring environment over the past decade

The authorities did not set an explicit GDP growth target at the recent National People's Congress (NPC) meeting, but set explicit targets for the labour market, indicating China's focus on job creation during challenging times. Therefore, in addition to expected wage changes, we asked our respondents about slack in the labour market currently. The surveyed responses suggest the weakest hiring environment in the past decade as China's economy continues to face the impact of local COVID outbreaks and the threat of a persistent global recession. We believe the NPC's labour-market targets of creating 9mn new urban jobs this year (versus 11mn last year) and a surveyed urban unemployment rate of c.6% (5.5% last year) are well justified.

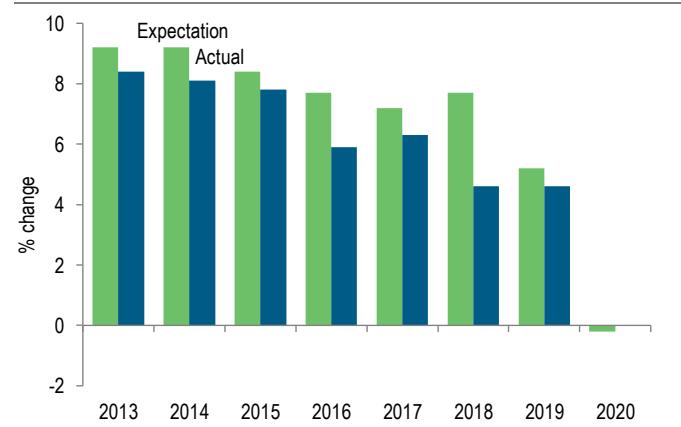
Figure 12: Wages to fall 0.2% in 2020 vs up 4.6% in 2019
Actual and expected wage increase, % of respondents



Source: Standard Chartered Research

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Figure 13: First expected wage fall in 11 years
Surveyed wage increase, average, expectation vs actual



Source: Standard Chartered Research



Almost half of respondents said it was 'less difficult' to hire compared with a year ago

60% lowered their wage expectation vs 2019

Our respondents expect wages to fall marginally by an average 0.2% in 2020, versus an actual 4.6% increase in 2019. 60% of respondents shifted to a lower wage-change bracket this year compared with their 2019 actual, while a mere 8% reported the opposite (Figure 12). 28.5% of respondents see wages going up this year, almost matching those expecting a fall (29.5%). This resulted in the first yearly decline in wage expectations since the survey's start 11 years ago, with risk to the downside as prior estimates have tended to overshoot actual full-year numbers (Figure 13). The expected wage drop appears larger in real terms (-3.1%, based on our CPI inflation forecast of 2.9% in 2020), reflecting the weak domestic demand story.

No more difficulty hiring

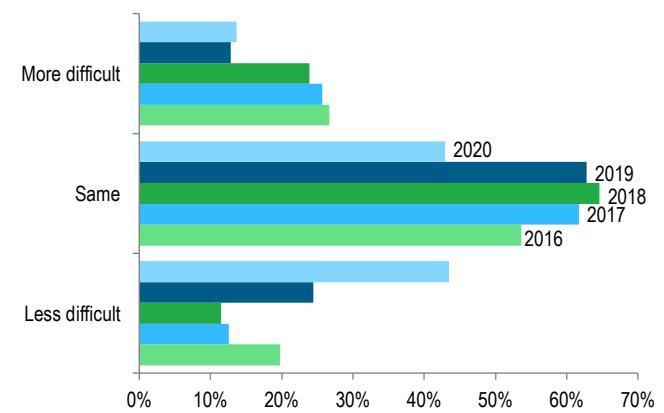
Emerging labour-market slack is likely contributing to downward wage pressure. Only 13.6% of respondents said the labour shortage worsened in the past 12 months (marginally higher than last year's 12.8%, possibly due to a slow employee return rate post-COVID lockdowns) – much lower than pre-2019 levels (Figure 14). Those reporting less labour tightness jumped to 43.5% from 24.4% in 2019 and 11.5% in 2018. This confirms the near-term negative cyclical demand shock from COVID-19; the GBA (along with the rest of China) is susceptible to demand shocks, as the region is prone to longer-term labour supply challenges due to an ageing population.

When asked to describe the current labour-market conditions in their respective industries, only 15.7% see a persistent labour shortage versus 22.8% a year ago (Figure 15). Another 25.1% see the labour shortage easing. Almost 40% no longer see difficulty in hiring workers, and the remaining 17.8% see excess worker supply, implying the labour market is no longer 'tight', as these respondent groups taken together form a majority for the first time in the survey's 11-year history.

Relieving wage pressure on costs

Earlier we mentioned that respondents picked tax cuts and fee reductions as their preferred policy support measures. Guangdong province has already deployed such measures to preserve jobs and support enterprises – cumulative tax cuts and fee reductions of CNY 82bn in the first four months of 2020, of which CNY 43bn was towards 'anti-epidemic' initiatives launched this year and the rest being measures continued from last year. As of end-May, over 6,000 enterprises were allowed to delay tax payments worth almost a total of CNY 20bn, and from February-April, 900,000 enterprises delayed social insurance fee payments worth a total CNY 16bn,

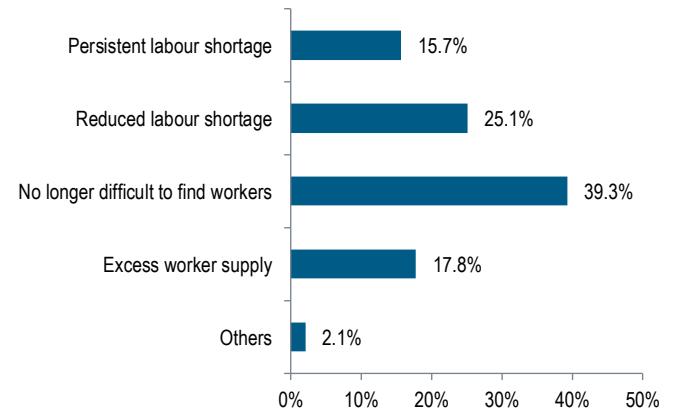
Figure 14: Is it more difficult for you to find workers this year than at the same time last year? (% of respondents)



Source: Standard Chartered Research

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Figure 15: How would you best describe the current labour market situation of your industry? (% of responses)



Source: Standard Chartered Research

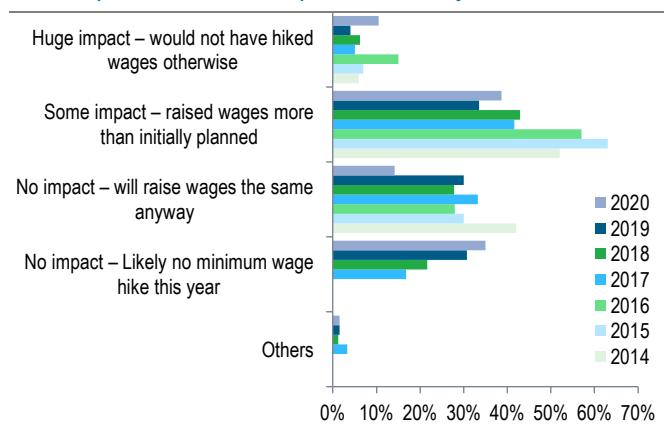


according to the provincial tax bureau. Other measures to support employment are similarly indirect in nature, supporting the continuation of companies' operations (for example, through SME loans), rather than directly subsidising wages.

The pressure to create jobs and relieve companies also means few provinces can afford to hike the minimum wage, including Shenzhen and Guangdong, both of which last hiked in 2018. Since 2016, provinces have been allowed to hike minimum wages once every two to three years (from at least once every two years). The enforcement of this rule may be relaxed further this year, as a number of provinces last raised minimum wages in 2017. Only three provinces have raised minimum wages YTD (Fujian, Guangxi and Qinghai) by an average 9.0% (Figure 17).

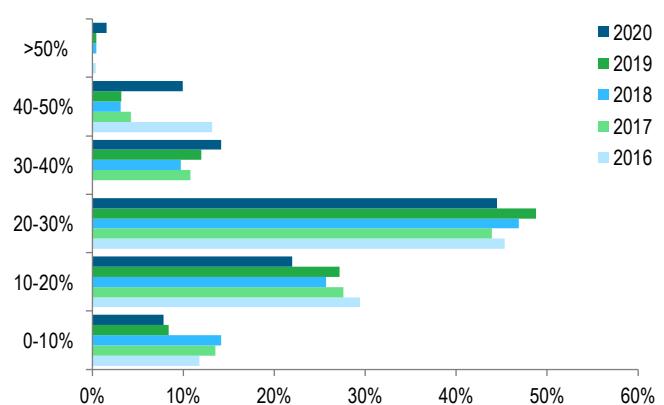
Our survey echoes this low level of expectations of minimum wage hikes, with 35.1% of respondents seeing no impact on their wage decision and minimum wage hikes as unlikely this year (up from 30.8% in 2019 and 21.7% in 2018); see Figure 16. More respondents actually expect at least some impact from minimum wage hikes (49.2%) compared with last year (37.6%) – a reflection of their increased vulnerability to higher wage costs if minimum wages rise. Wages also appear to be taking up a larger share of respondents' cost base (25.0% versus 22.5% prior), confirming worries that job losses worsen if the downturn persists (Figure 18).

Figure 16: Impact of minimum wage hikes
% of respondents, this and previous surveys



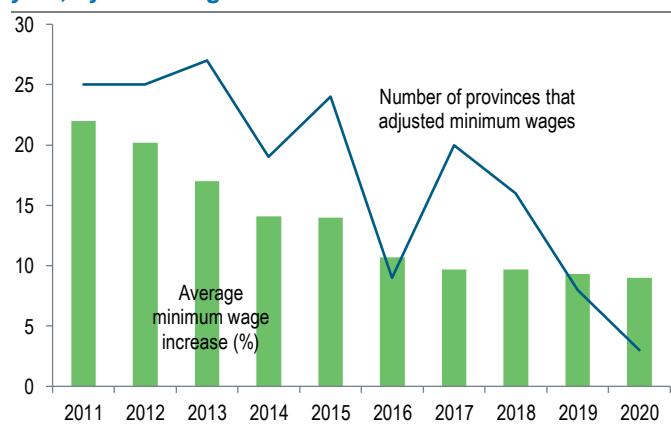
Source: Standard Chartered Research

Figure 18: What share of your total costs are wages?
% of respondents, this and previous survey



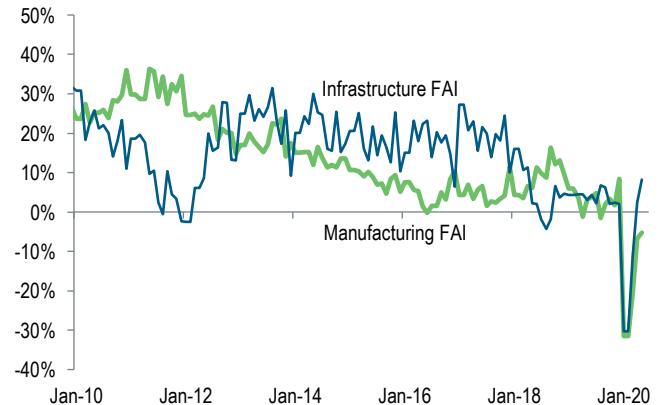
Source: Standard Chartered Research

Figure 17: Eight provinces hiked minimum wages last year, by an average 9.3%



Source: CEIC, Standard Chartered Research

Figure 19: Manufacturing FAI lags infrastructure FAI in rebounding (Fixed asset investment, % y/y)



Source: Standard Chartered Research



Many respondents are more actively considering moving capacity overseas due to trade tensions and/or COVID

Factory relocation

More companies actively considering moving capacity out of China

Growing job-market slack gives GBA companies one less reason to relocate overseas or to choose alternative strategies to deal with a labour shortage; almost 30% of respondents this year chose no action, up from 22% a year ago (Figure 20). Of the remaining 70%, those choosing automation (29.8%) and moving capacity out of China (12.6%) still had an increase in their share despite the dilution from votes for no action. While the prevailing macro backdrop may not be conducive to taking such big investment decisions, the underlying momentum for such structural changes appears to be strong. This is especially true for relocation out of China, recently listed as for diversification purposes due to lingering US-China tensions and COVID.

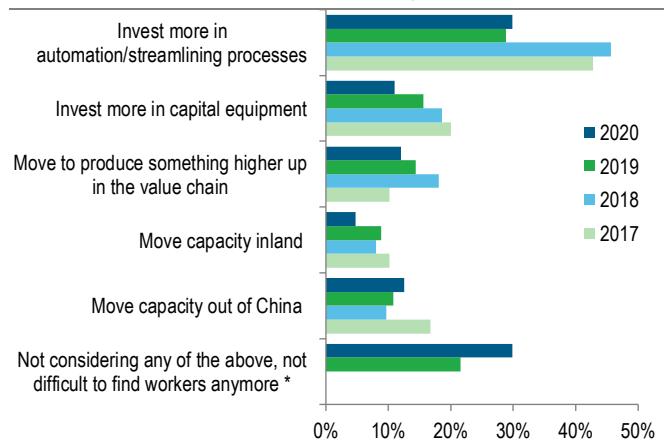
43% of respondents are more actively considering moving capacity overseas due to US-China trade tensions and/or COVID-19 (Figure 21). These developments have raised worries that manufacturers operating in China face a high concentration risk; however, respondents are motivated by diversification of operations rather than a total relocation of their existing China production, which is seen as not realistic. If we add to this another 24.6% of respondents who are not swayed by the trade war or COVID, but are still actively considering relocating overseas, a sizeable majority (68%) are thinking of 'going out'.

Structural transformation continues

Among the 68% that are considering, or that plan to actively consider, moving overseas, 19% have already moved and started operations, up from only 6% a year ago (Figure 22); another 6% are more than halfway through the relocation process; and 11% said they have just started moving. Those in the 'still under consideration' phase fell to 45% from 56% prior, indicating that some companies started to put their plan into action over the past year. We see little change from last year for those who have not yet started considering moving (same at 19%).

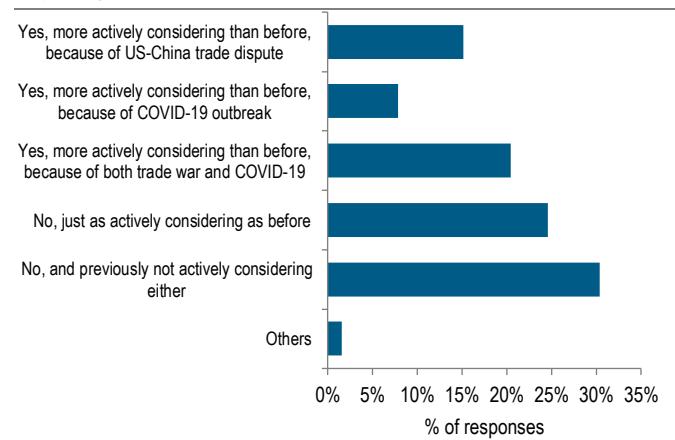
The actual proportion of manufacturers who already have operations overseas could be much higher than stated above, given how long factories have been facing labour and other challenges; they simply may not need to relocate more than they already have, likely perceiving themselves as diversified enough to handle trade headwinds and deciding to focus more on industrial upgrading for now.

Figure 20: How do you respond to labour shortages?
% of respondents, this and past surveys



* new option since last year; Source: Standard Chartered Research

Figure 21: Are you more actively consider moving capacity outside China? (% of responses)





Diversification of production capacity is a strong driver for factory relocation

Vietnam remains the favoured destination

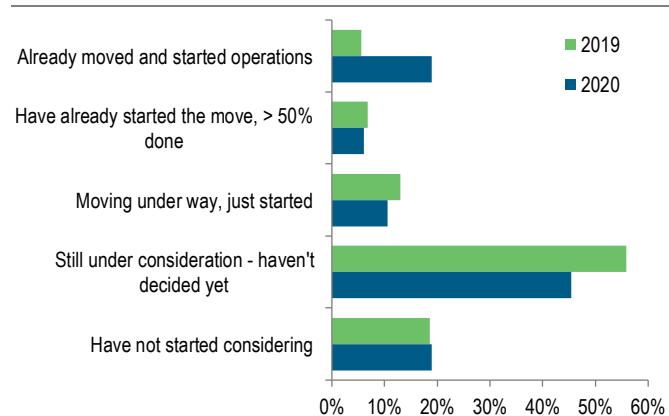
In terms of preferred destinations, among those that would consider moving capacity overseas, Vietnam remains the most favoured destination, as in prior years (Figure 23). Cambodia, Myanmar, Bangladesh, and Thailand round out the top five spots, also much like last year, though Cambodia appears to have lost some votes to Malaysia (6th), Indonesia (7th) and Taiwan (8th). These choices may indicate that those considering relocating from China are mostly low-end producers in sectors such as textiles and garments, commodities, and electronics packaging and assembly. Exceptions to this conclusion are Vietnam, which is favoured by a wider range of industries, and Taiwan, which benefits from the reshoring of electronics production.

Unsurprisingly, respondents see their choice of overseas destinations as offering a substantial advantage in diversifying their production capacity, with 56.0% of them picking this reason as a key non-wage benefit (Figure 24). The rest of the options are all in the 20-30% range, led by labour quality and quantity, attractive tax incentives, favourable trade agreements, and more potential buyers. In comparison, with wage pressure no longer a primary concern, we believe these non-wage advantages may become more important to manufacturers than outright wage savings when deciding whether and where to move their factories.

Our survey shows that expected average cost saving from moving capacity overseas (15.7%) is not that different from, say, investing more in capital equipment (15.5%) or moving the product up the value chain (15.1%), although moving overseas does have a longer tail in terms of response distribution (Figure 26). ‘Automation’ offers less cost saving (10.2%); however, cost saving is only one of many reasons for improving productivity, with a bigger reason likely being the strong policy push towards innovation and industrial upgrading.

In terms of concerns about relocating factories overseas, ‘poor labour quality and productivity’ (37.1%) and ‘uncertain political/social outlook’ (36.4%) took over the top spot occupied by ‘underdeveloped transport and infrastructure’ (35.6), albeit only by small margins (Figure 25). ‘Underdeveloped legal systems’ and ‘lack of proximity to suppliers’ were also a close fourth and fifth respectively; these responses reflect deterrents preventing production from moving out of China *en masse*. This tracks our view that while the continued rise in anti-globalisation sentiment is likely to keep the spotlight on concentration risks in supply chains, *China’s central role in supply chains is too important to be reduced rapidly*.

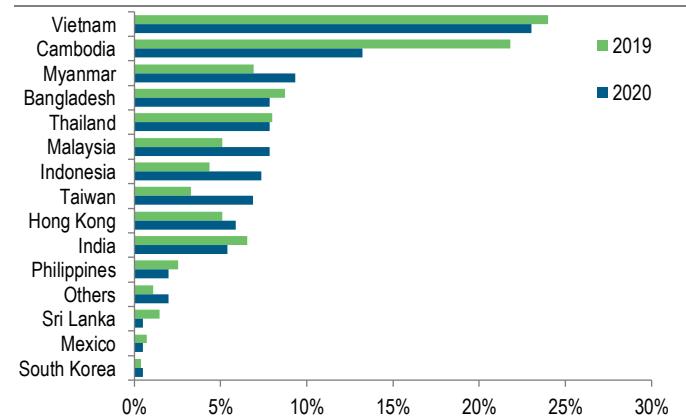
Figure 22: What stage of moving are you at? % of respondents



Source: Standard Chartered Research

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Figure 23: If you plan to move capacity out of China, to where? (% of responses)



Source: Standard Chartered Research

15



Industrial upgrading

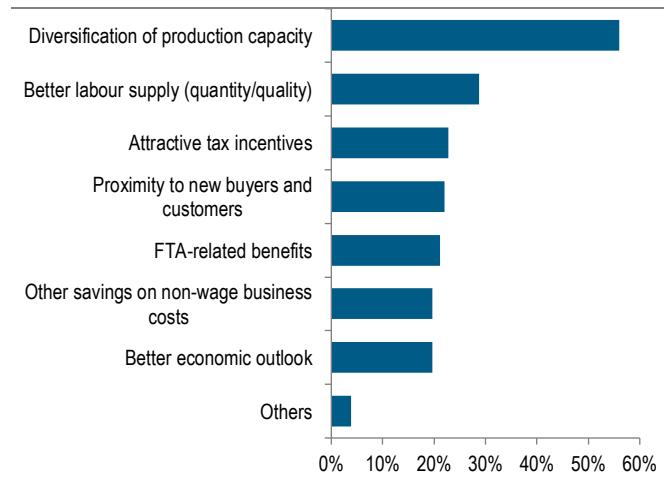
Contracting manufacturing investment

Official data shows that manufacturing investment has been weak YTD because of the COVID outbreak – it was down 5.3% in May when infrastructure and real estate investments were already back to growing at faster than 8% (Figure 19). This tracks our prior survey responses that showed capex appetite as likely to stay low in 2020. 35.8% of respondents expect a capex contraction in 2020, versus 25.9% calling an increase; this represents an evident weakening from last year when a mere 17.1% reported fewer capex but 48.2% reported an increase (Figure 1).

An uncertain economic and political outlook may be a key reason for weak capex appetite. In addition, while access to credit is improving, credit costs remain high. The absence of a labour shortage further reduces manufacturers' urgency to boost productivity and lower per-unit costs. As shown in Figure 20, while 29.8% of respondents – similar to 2019 – choose automation and streamlining processes as the main way to tackle wage pressure, those that chose 'invest more in capital equipment' fell to 11% from 16% prior and 'move to produce something higher up the value chain' to 12% from 14%. We maintain that the prevalent challenges of labour shortage and wage pressure – which China faced persistently before 2019 – can be

Figure 24: Non-wage advantages of relocating factories

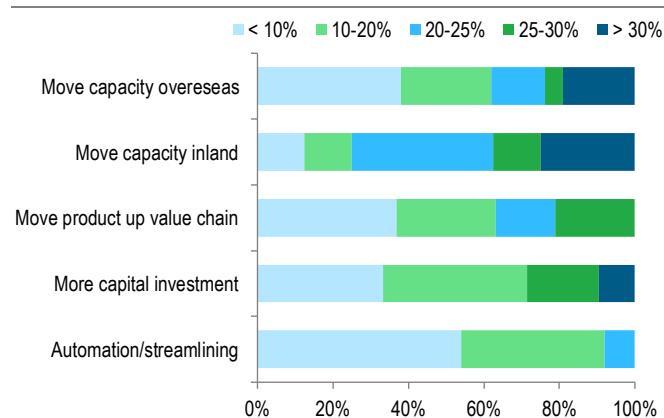
% of responses



Source: Standard Chartered Research

Figure 26: How much would your choice save you?

Wage savings, %; % of respondents

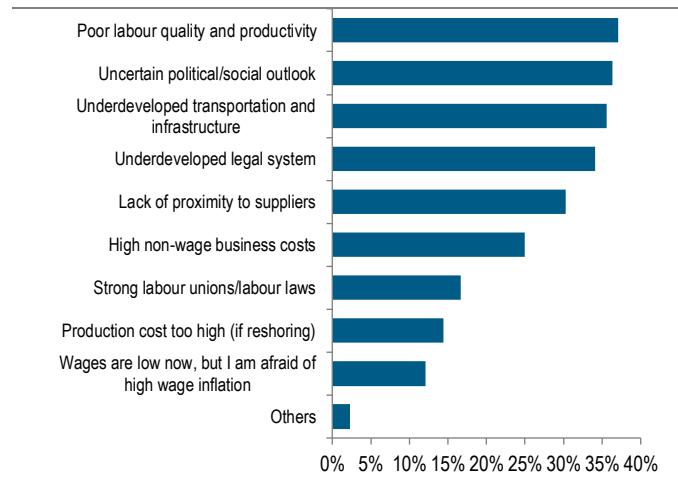


Source: Standard Chartered Research

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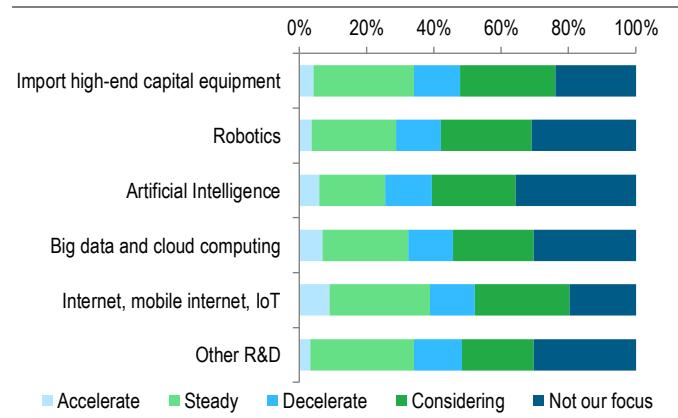
Figure 25: Concerns about relocating

% of responses



Source: Standard Chartered Research

Figure 27: What are your plans for industrial upgrading in 2020? (% of respondents)



Source: Standard Chartered Research



positive if they force the right behavioural changes at a micro level, i.e., through more investment towards improving the cost structure, productivity and competitiveness.

Weak appetite across key innovations

The twin headwinds of deteriorating US-China trade relations and the COVID-19 outbreak could push China towards greater self-reliance in terms of technology and innovation and establishing a more complete manufacturing ecosystem. Industrial upgrading would fuel the GBA's ongoing transformation, with high-end manufacturing attracting skilled talent and boosting the region's population.

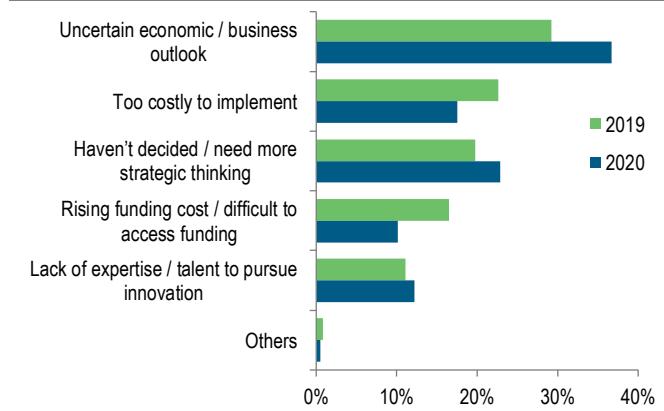
A small setback to industrial upgrading in 2020

Unfortunately, our survey respondents appear to have become less involved (those responding accelerate, steady or decelerate in Figure 27) in all key areas of innovation industrial upgrading versus a year ago: 52% in 'internet, mobile internet and Internet of Things' (versus 59% prior), 48% in 'importing high-end capital equipment' (63% prior), 46% in 'big data and cloud computing' (54%), 42% in 'robotics' (46%), and 39% in 'artificial intelligence' (45%). however, an average 26% say they are actively considering such investment, up from 18% last year.

The short-term momentum for technological investment appears weak. When asked about 2020 investment plans, the proportion of respondents choosing 'deceleration' exceed those picking 'acceleration' by an average 7.6ppt in all upgrading initiatives. 'Robotics' and 'importing high-end capital equipment' have the largest negative net value of 9.6ppt, versus the least negative 4.9ppt for 'internet, mobile internet and IoT'. Much like last year, 37% saw an uncertain economic and business outlook as the biggest hurdle to industrial upgrading in 2020 (Figure 28), up from 29% last year, echoing the growing risk of a technological decoupling of China from the US. Rounding out the top two spots, 23% are still in the consideration stage, i.e., who are undecided on upgrading or say they need further strategic planning.

Beyond 2020, a solid 53% have a long-term target for industrial upgrading (Figure 29). However, this is down from 63% a year ago, as more now see this as a year-by-year decision (32% versus 24% prior); these respondents are mostly likely to hit pause in the event of short-term hindrances like COVID this year. We believe the remaining 14% who have no plans to upgrade – the same as last year – will have to play catch-up later if they want to participate in the GBA's transformation.

Figure 28: What are the biggest hurdles to your industrial upgrading in 2020? (% of respondents)



Source: Standard Chartered Research

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Figure 29: Do you have a long-term target for industrial upgrading? (% of respondents)



Source: Standard Chartered Research

17

GBA in post-COVID world

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Through the post-COVID lens

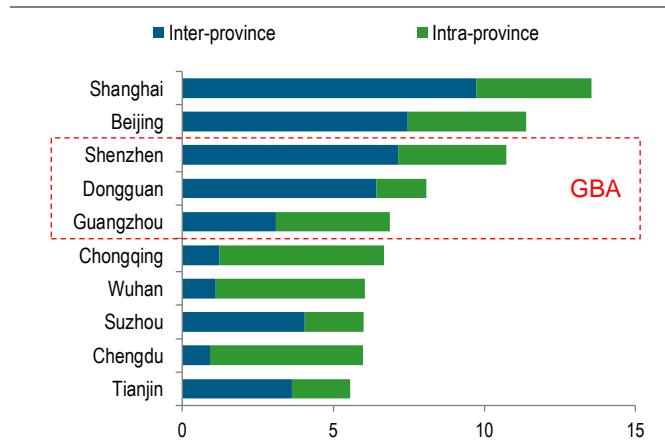
Short-term challenges vs long-term optimism

The COVID-19 outbreak has materially weighed on GBA manufacturers' business performance and expectations (see previous section). This is not surprising, given the region has one of the country's largest migrant worker populations supporting its most extensive manufacturing hub (Figure 1 and 2). The slow return rate of workers to factories after COVID-related lockdowns and travel bans were highly disruptive to the GBA's supply chains. In addition to a sizeable population of 70mn, the GBA's population density is seven times the national average, the highest across regions. Being export-oriented makes the region prone to headwinds from a global recession, with an added hurdle to a return to normal operations from a slow reopening of borders between Guangdong, Hong Kong and Macau in returning to normal.

In short, what makes the GBA unique and competitive has likely also exacerbated the impact of COVID-19 on the region; that said, our survey respondents continue to express long-term confidence in the GBA. A majority 57.8% see the GBA presenting new business opportunities a few years down the road, marginally exceeding expectations for China's Belt and Road initiative (56.1%), Renminbi

Figure 1: GBA among top 10 cities by floating population

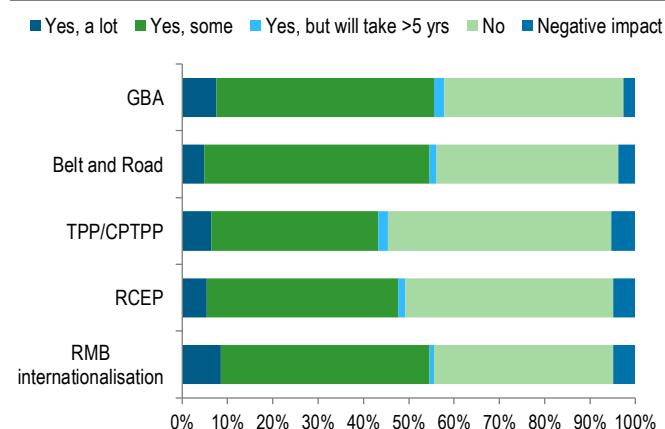
Mn persons



Source: NBS, UNFPA, UNICEF, Standard Chartered Research

Figure 3: Which of these drivers present new opportunities to your business in the next 3-5 years?

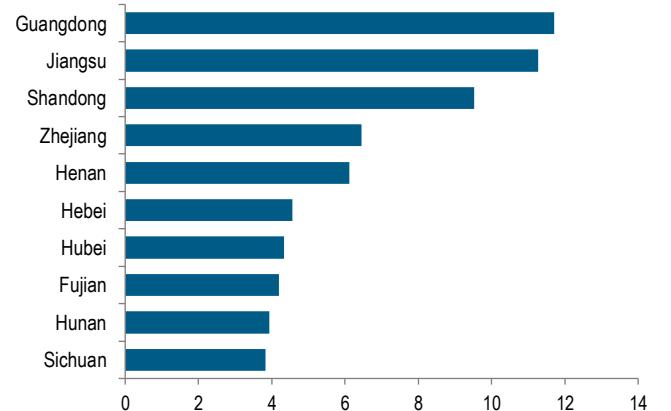
% of respondents



Source: Standard Chartered Research

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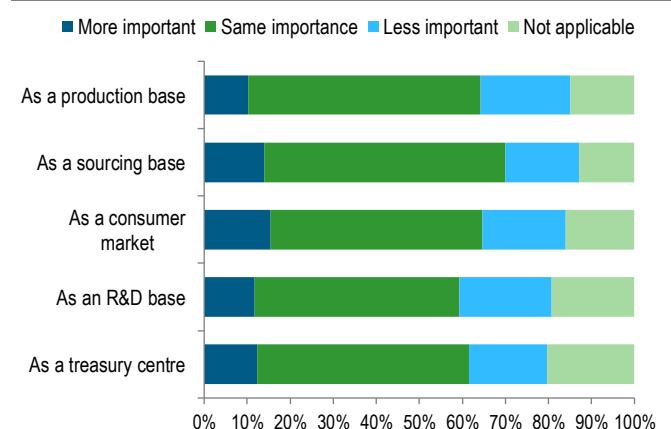
Figure 2: Guangdong is China's biggest manufacturing hub (Top 10 province by industrial production, % of 2017 total)



Source: CEIC, Standard Chartered Research

Figure 4: How will the GBA market's importance to your business group change in the following areas?

% of respondents



Source: Standard Chartered Research

Overview
GBA survey
2020

GBA in post-COVID world
No immunity for ASEAN

GBA in post-COVID world
No immunity for ASEAN



Survey shows optimism towards GBA over multi-year horizon

internationalisation (55.6%), and other multilateral trade pacts (Figure 3). The GBA also recorded the least negative overall response among all the options.

15.5% said the GBA would become more an important consumer market for their business, matching last year's results, followed by 13.9% as a sourcing base and at least 10% as a production base, R&D base and treasury centre (Figure 4). While these numbers do not seem substantial, we note that the surveyed companies have probably already operated heavily in the GBA for several years; c.60-70% see the GBA as remaining at least as important as before across all business functions. Those choosing 'less important' (19% average) may be influenced by factors beyond what the GBA offers short-term and long-term. For example, more GBA manufacturers are considering relocating/diversifying overseas due to persistent US-China trade tensions and concerns over high concentration risks in supply chains.

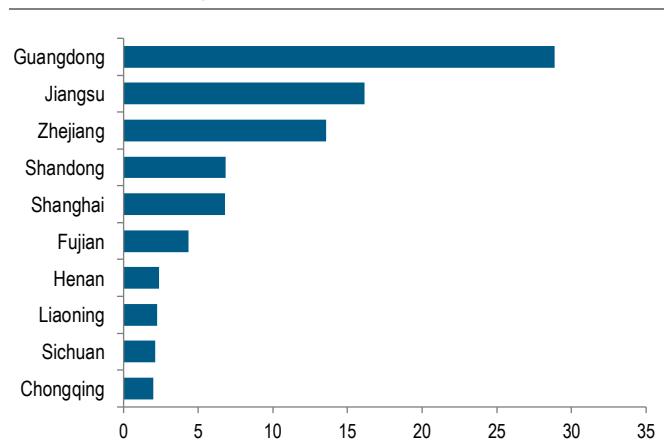
In [last years' report](#), we outlined many reasons supporting China's lofty expectations for the GBA's transformation in the medium to long term. We briefly revisit some of them below, but through the post-COVID lens.

Megacity clustering still offers benefits

Although China is the first country to begin recovering from COVID-19, the likely economic impact from the damage to the global economy from the outbreak is forcing it to seek internal growth drivers. The risk of deteriorating trade and geopolitical tensions with the US may push China towards reducing its reliance on foreign technology and other imported components for its expansive supply chains, possibly through creating its own 'smart' and complete manufacturing ecosystem. The GBA is poised to play a key role in this effort, given its ability to achieve scale and innovation through clustering; its ability to attract high-end talent (boosting consumption and productivity growth), and its intensive need for infrastructure investment to promote integration. We therefore believe it is even more important for China to establish its megacity cluster in a post-COVID world.

There are many reasons for China to establish the GBA in the likeness of San Francisco's Bay Area model. First, Guangdong province is already a well-established industrial and innovation base in southern China, from which the 'bay area' concept can be extended. Guangdong accounts for 29% of China's total exports, 12% of industrial production, 37% of high-tech new product sales and 49% of patents

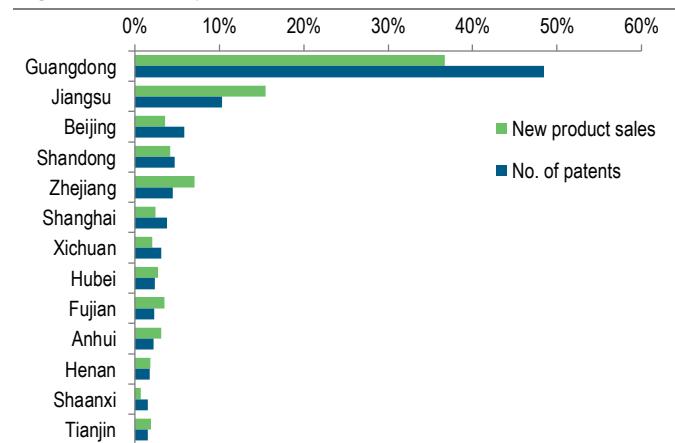
Figure 5: Guangdong is China's biggest export province
Top 10 province by exports, % of 2019 total



Source: CEIC, Standard Chartered Research

Standard Chartered Global Research | 29 June 2020

Figure 6: Guangdong leads the way in innovation
High-tech industry, % of 2018 national total



Source: Wind, Standard Chartered Research

20



nationwide (Figures 5 and 6). It is also the largest province in terms of total social financing (TSF) – China's broadest measure of credit creation – whose share of the national total tends to rise during downturns, reflecting the province's additional importance in driving overall growth during troubled times (Figure 7).

Second, the GBA's high-tech nature is likely to better attract highly skilled talent to the region. Notwithstanding stagnant growth in China's working population due to ageing, the trend of the rural population moving to megacity clusters such as the GBA is likely to continue as people seek better job opportunities and living standards. Residents will also probably migrate from other urban China cities to the GBA in a so-called 'siphoning effect'. The idea is that the GBA, with its innovation drive, industrial upgrading, higher wages and favourable residential policies, could become so competitive in job creation that it will start 'sucking in' not just rural workers, but also high-end talent from other major cities.

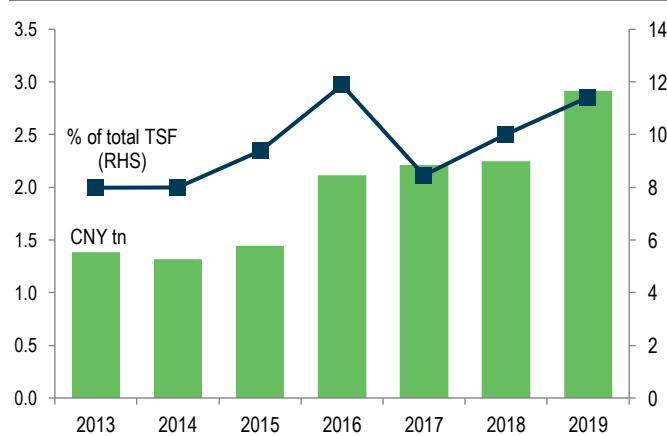
Guangzhou and Shenzhen have been successful in growing their population over the past five years

The residential populations of Shenzhen and Guangzhou have grown 2.7mn and 2.2mn, respectively, in the last five years, compared with just 20,000 in Beijing and 25,000 in Shanghai, as shown in Figure 8. This supports our projection that the GBA's population will reach 100mn by 2035, up from c.70mn currently; a larger population should generate more economic activity, labour productivity and infrastructure needs. The latter is key to make a sprawling project such as the GBA manageable in the long run – for example, more efficient transportation links are needed for the adequate dispersion of residential zones while maintaining acceptable commute times. We expect China to lean heavily on infrastructure investment to support an economic recovery from COVID short-term and to accommodate longer-term transformations such as speedier customs, higher data connectivity and *the shortening and regionalisation of supply chains*.

Policy commitment remains strong

We believe China's authorities will remain focused on the larger GBA plan even amid the ongoing fight against COVID. On 14 May, financial regulators (i.e., the People's Bank of China and regulators of the banking, insurance, securities and forex industries) *jointly issued a new set of guidelines* to support the financial reform and opening up of the GBA. The announcement covered four general principles (serving the real economy; cooperating for mutual benefit; being market-oriented; and preventing systemic financial risks) and 26 new measures. The measures include but

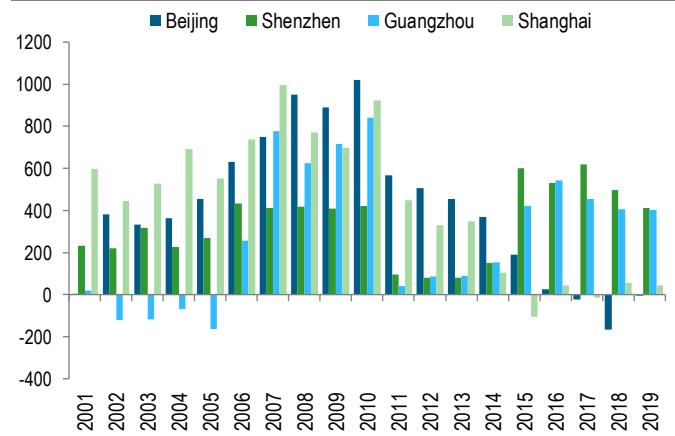
Figure 7: China leans on Guangdong during credit easing
Guangdong province's total social financing



Source: Standard Chartered Research

Standard Chartered Global Research | 29 June 2020

Figure 8: Strong population growth in Shenzhen and Guangzhou (Annual change in usual residents, '000s)



Source: Standard Chartered Research

21



New GBA guidelines call for further integration with Hong Kong

are not limited to the continued exploration of more cross-border channels (Wealth Connect and Insurance Connect), the launch of pilot projects for cross-border investment of private equity and venture capital funds, and the expansion of existing schemes (cross-border lending and cash pooling). The guidelines also mention explicit support for further developing the offshore Renminbi market, enhancing the Stock and Bond Connect schemes, promoting green finance, and strengthening fintech cooperation.

The announcement offers much needed reassurance to investors that despite increased social tensions in Hong Kong over the past nine months, China remains committed to supporting Hong Kong and its collaboration with other GBA cities. The guidelines specifically mention supporting Hong Kong's deep integration into the national financial reform plans, exemplifying the unique advantages of Hong Kong's financial system under the 'one country, two systems' policy and promoting the city's status as an international financial centre.

As outlined in our recent report answering *the 10 frequently asked questions on Hong Kong's special status and the HKD*, we believe changes to one bilateral relationship (in this case, with the US) are not enough to undermine Hong Kong's unique competitive advantages – and by extension those of the GBA. Hong Kong still offers free flow of capital, the rule of law, a talented pool of people, and a simple and low tax regime; these advantages will not suddenly disappear, in our view.

Hong Kong's importance as the primary gateway between China and international financial markets is likely to continue or even increase as US-China tensions persist. As China's foreign-listed companies face increasing international scrutiny, and some potentially face the threat of being delisted, Hong Kong can provide them with a large and familiar alternative platform to raise capital and manage their treasury operations. Worries about a looming financial war between the two superpowers could also speed up demand for Renminbi as an alternative payment, settlement and investment currency. We expect Hong Kong, as the largest offshore Renminbi centre and the testing ground for China's capital account opening, to get a boost as Beijing renews its Renminbi globalisation efforts, cementing Hong Kong's international financial status.

Nobody said it would be easy

Learning from the slow border reopening despite improvement in COVID cases

We acknowledge that the US' declaration that Hong Kong is no longer "sufficiently autonomous" is bound to have reputational ramifications. If the perception of China not acting in accordance with the 'one country, two systems' principle is unaddressed, this could continue to erode Hong Kong's competitive advantage and unique contribution to the GBA over time. We cannot stress enough that the GBA's synergies stem largely from Hong Kong and Macau's continued ability to be economically open and market oriented, as well as the strength of the cities' institutions and rule of law.

Practically, we also believe much more needs to be done to develop cross-border connectivity across all factors of production. As reflected in Hong Kong's slow progress so far in reopening its borders with the mainland and Macau despite benign COVID cases on all sides, policy coordination and implementation across multiple legal and social systems is no easy task. We hope more post-COVID energy will refocus on overcoming the physical, social and regulatory boundaries to promoting freer cross-border flow of people, goods, services, capital and information, while preserving the 'one country, two systems' principle.

No immunity for ASEAN

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ASEAN – More needs to be done

Near-term challenges abound

We conduct our GBA survey this year in the midst of the COVID-19 situation. As a result, some survey questions elicited increased cautiousness from the respondents. Our focus remains on deciphering the medium-term views of FDI investors in ASEAN. Nevertheless, some of the responses highlight likely challenging months ahead for FDI in the region and the need for ASEAN to raise its game, including through addressing existing bottlenecks and increasing productivity levels (Figure 5).

Uncertainty on the economic front is palpable and lingering: 2019 was affected by the US-China trade war and 2020 is being depressed by the COVID-19 outbreak. It is no surprise therefore that survey respondents are more cautious on ASEAN's near-term outlook, though a majority maintain neutral projections, similar to 2019 (Figure 1). Given the tepid outlook, only a handful of respondents said they may increase production capacity in ASEAN this year, despite expectations of demand shifting to ASEAN from China due to trade tensions and a diversification trend.

ASEAN is not immune to geopolitically led disruptions

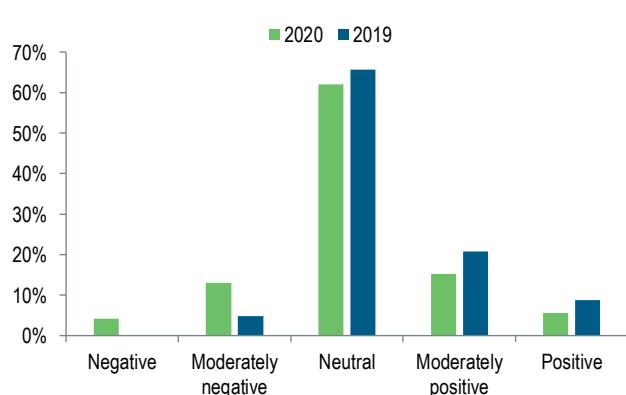
While ASEAN has continued to enjoy FDI interest particularly due to the trend of diversification of capacity out of China, the region is not immune to short-term challenges. COVID aside, worsening US-China relations pose downside growth risks to ASEAN. The region is one of the most open economic areas in the world, with a trade-to-GDP ratio of c.100%.

During the US-China trade war, there was keen interest to determine the relative winners and losers of the deterioration in US-China relationship. ASEAN was often touted as a potential beneficiary. We found that there were indeed some countries in ASEAN exporting more to the US (imports market-share basis) due to US-imposed tariffs on China on an absolute basis (see [US-China trade war – Tracking the impact](#)). However, no ASEAN country has been an absolute winner (Figure 2). After seeing an initial increase in the region's exports to the US, overall exports to the US and other major economies started to decline as the US-China trade war intensified.

Given this, even as talks of FDI moving out of China gather pace we remain cognisant of near-term cautious investment sentiment due to worsening geopolitics, which has already been dented severely by COVID-19.

Figure 1: What is your view on ASEAN for 2020?

% of total responses

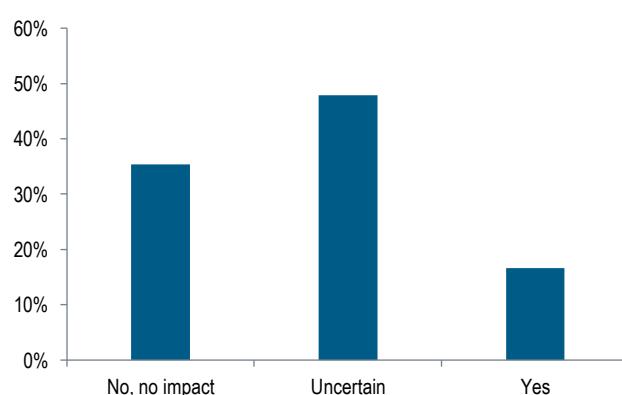


Source: Standard Chartered Research

Standard Chartered Global Research | 29 June 2020

Figure 2: Will you be adding more capacity in ASEAN given US-China trade war and COVID-19?

% of total responses



Source: Standard Chartered Research

24



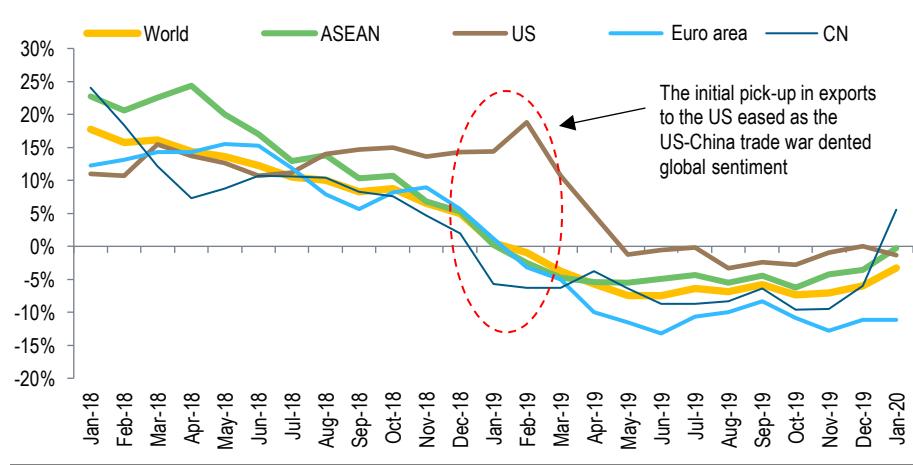
ASEAN needs to increase productivity

Near-term challenges aside, a more pressing issue in attracting investment is the region's low productivity levels; it needs to boost productivity medium-term to address investing companies' cost concerns. This year, when asked for feedback on their investment in ASEAN, our survey respondents were less than satisfied. Only c.20% of the aggregated responses (more than one option could be chosen) provided a positive response.

The remaining c.80% highlighted issues such as a lack of local financing, poor productivity, and labour costs that are rising too fast. While these responses may be related to investment in the less-developed parts of ASEAN, we still see a need for all ASEAN economies to be more proactive though increased training for workers/employees to compete on savings through productivity versus wages.

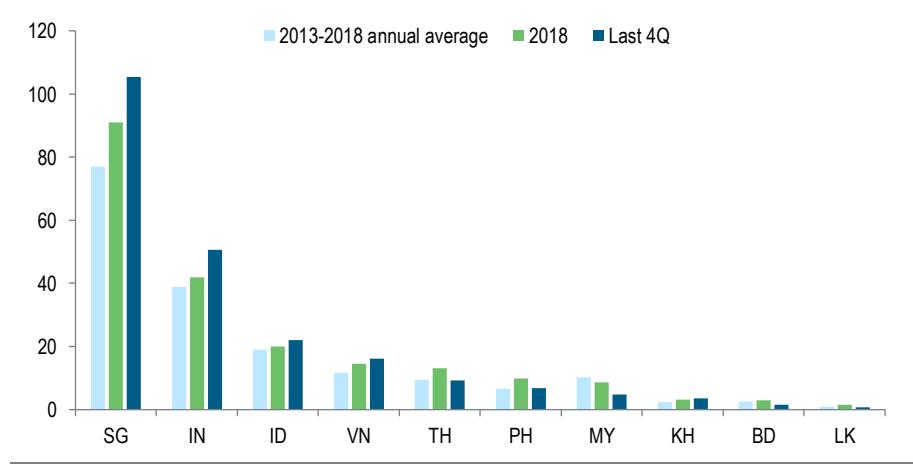
The region also needs to actively promote and facilitate the utilisation of its free trade agreements (FTAs) by investors. Other than the intra-region ASEAN Free Trade Area agreement, the region has five FTAs with six dialogue partners, including China, India, Japan, South Korea, Australia and New Zealand.

Figure 3: ASEAN is not immune to weaker global sentiment
ASEAN exports, % y/y



Source: CEIC, Standard Chartered Research

Figure 4: FDI in ASEAN likely already impacted by US-China 2018/19 trade war
USD bn



Source: CEIC, Standard Chartered Research



ASEAN now attracts more FDI than China

However, our surveys consistently highlight limited usage of such FTAs – only a quarter of respondents said they benefited from FTAs in the region (Figure 6). In addition, ASEAN integration appears to be a persistent issue. Around 46% of respondents think the region is not sufficiently integrated, while another 35% are unsure due to the lack of information. Only c.19% think the region is sufficiently integrated for their businesses (Figure 7).

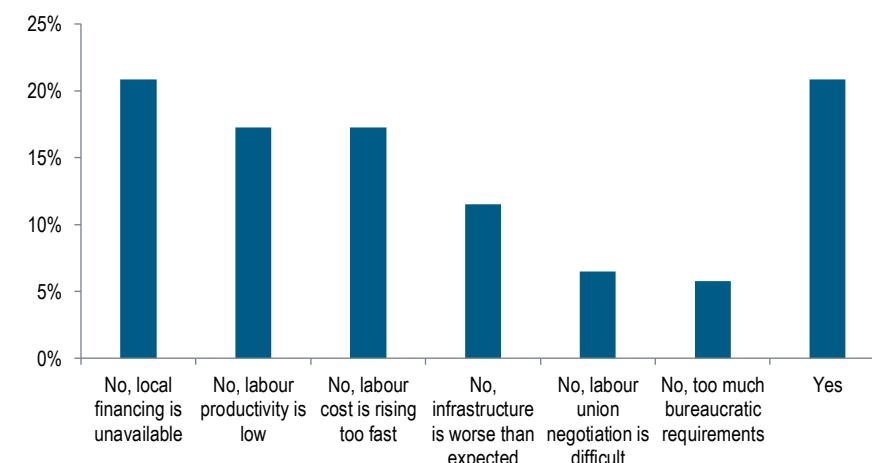
ASEAN remains an FDI magnet

Short-term challenges aside, ASEAN continues to attract FDI. According to the World Investment Report 2019, FDI in ASEAN reached USD 149bn in 2018, surpassing China's for a second consecutive year. As a proportion of global FDI, inflows to ASEAN reached a high of 11.5% in 2018 (Figure 8).

For this year's survey, we found that diversification of production capacity (Figure 9) was the top reason for companies moving to ASEAN. Other reasons such as better labour supply, tax incentives and proximity to new markets remain valid. However, the popular choice of 'diversification' as a reason highlights companies' increasing motivation to act on their geopolitical and operational concerns.

Figure 5: Are you satisfied with your investments in ASEAN?

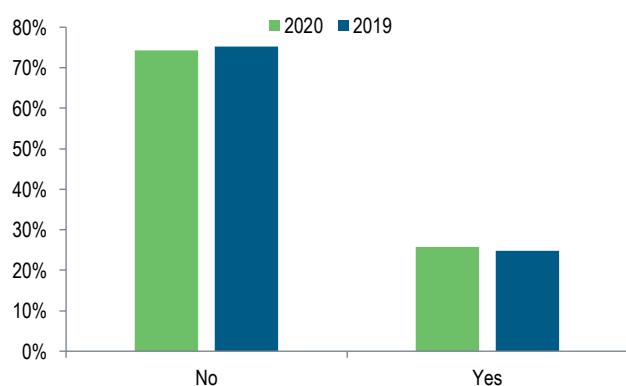
% of total responses



Source: Standard Chartered Research

Figure 6: Do you benefit from FTAs in ASEAN?

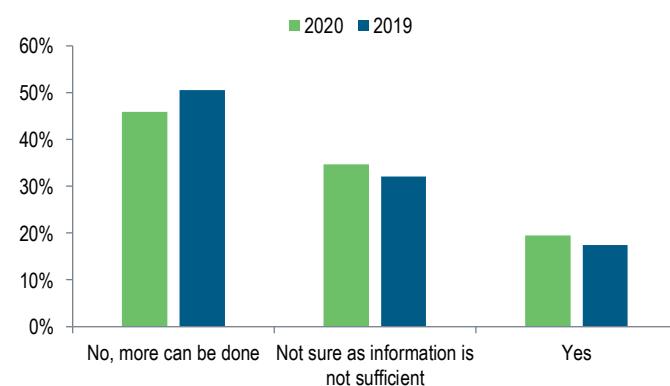
% of total responses



Source: Standard Chartered Research

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Figure 7: Is ASEAN sufficiently integrated for your business strategy? (% of total responses)

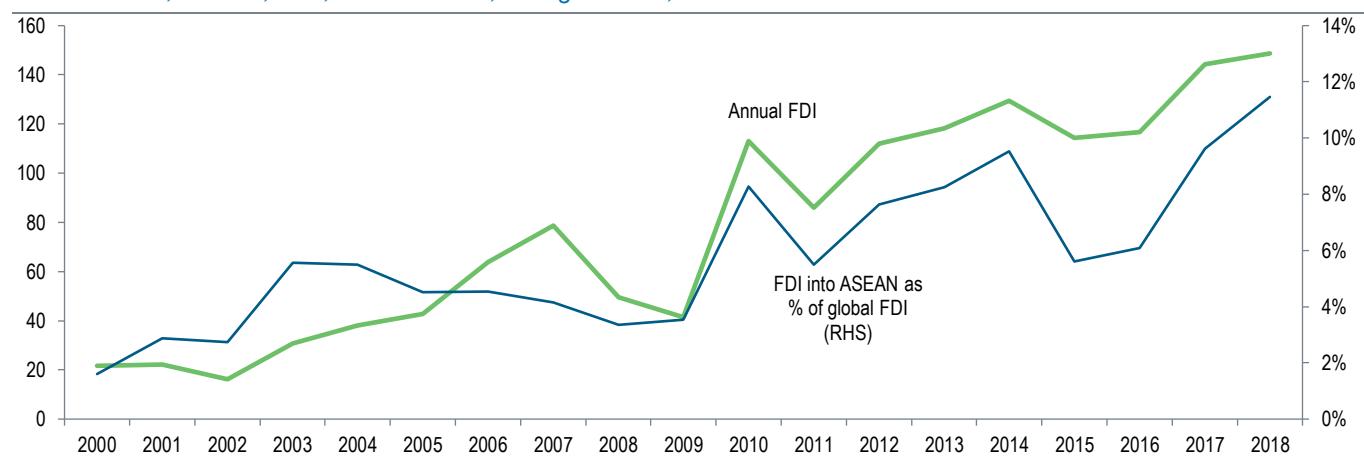


Source: Standard Chartered Research



Figure 8: ASEAN continues to receive strong global FDI interest

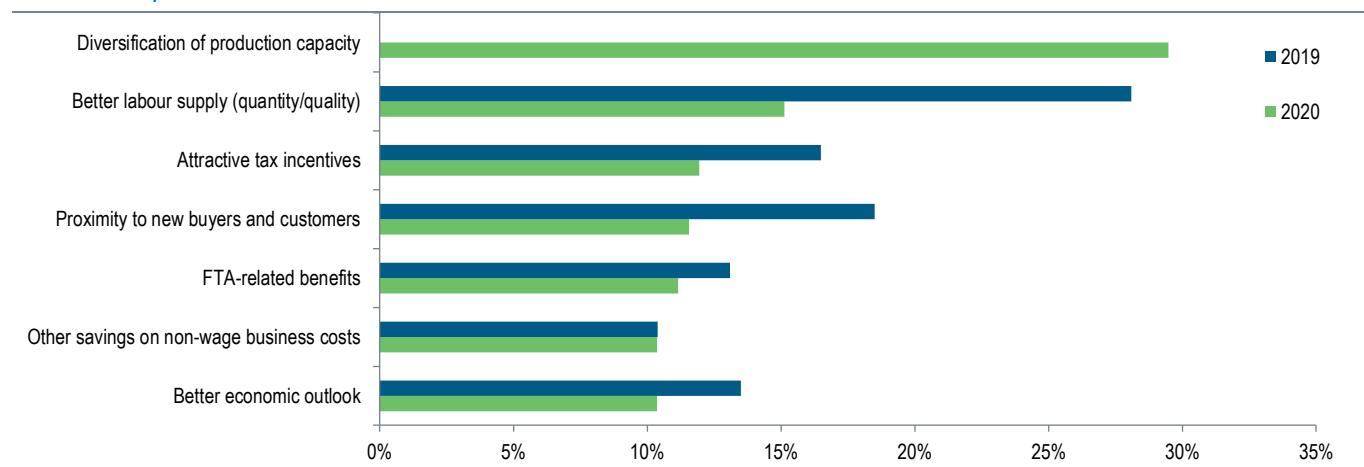
FDI to ASEAN, USD bn, LHS; FDI to ASEAN, % of global FDI, RHS



Source: UNCTAD, Standard Chartered Research

Figure 9: What are the non-wage advantages of moving to your selected destination?

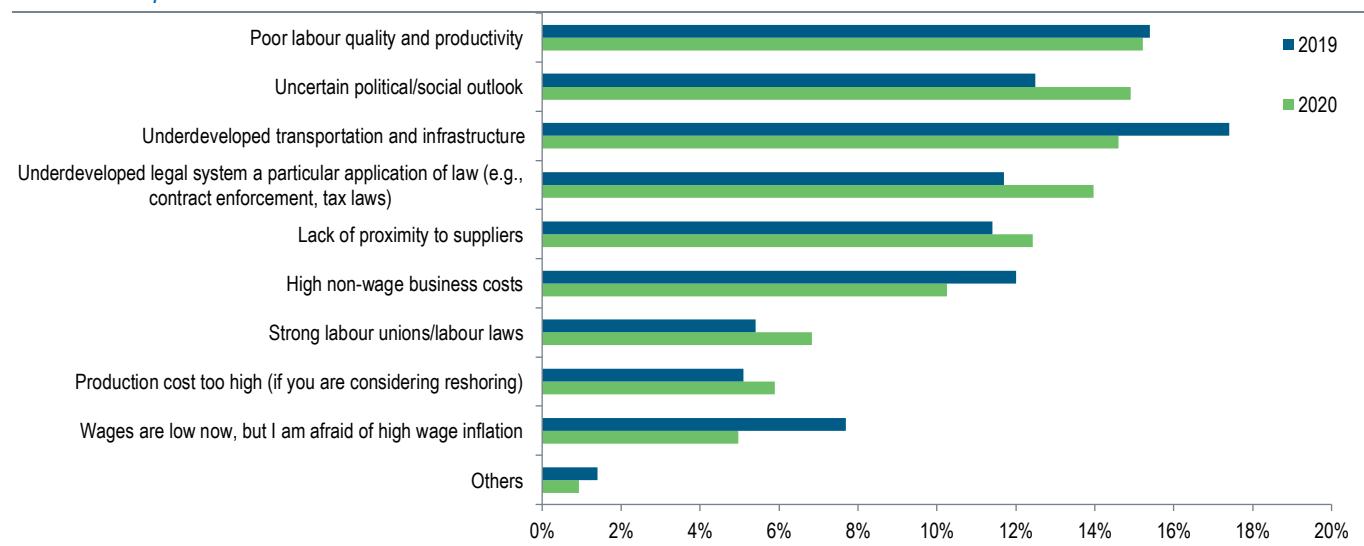
% of total responses



Source: Standard Chartered Research

Figure 10: What are your main concerns for moving to your preferred destinations?

% of total responses



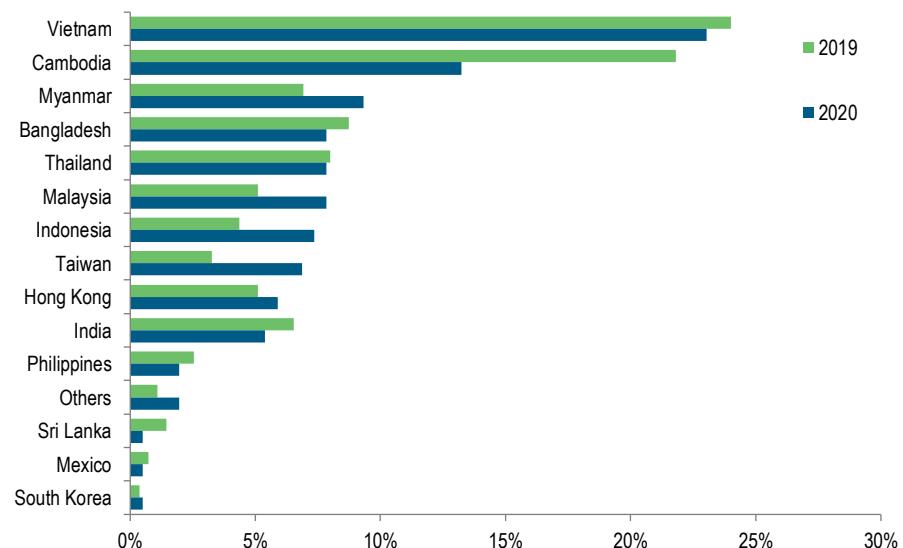
Source: Standard Chartered Research



For this year's survey, Vietnam remains a top destination for survey respondents looking to move out of China, followed by Cambodia and Myanmar (Figure 11). The breadth of clients choosing to move to Vietnam is varied. Respondents from electronics-related sectors account for 23% of those choosing to go Vietnam, followed by c.19% from the textile and apparel industry. Other sectors include metal fabrication, wood products, food, beverage and tobacco manufacturing, and rubber and plastics. Investors choosing Myanmar are also from varied industries, including textile and apparel, food, beverage and tobacco manufacturing, furniture making and metal fabrication. Comparatively, there is a strong skew of textile and apparel-related investors (c.43% of total responses) choosing Cambodia.

Mekong remains a top choice for FDI

Figure 11: If you plan to move capacity out of China, to where? (% of responses)

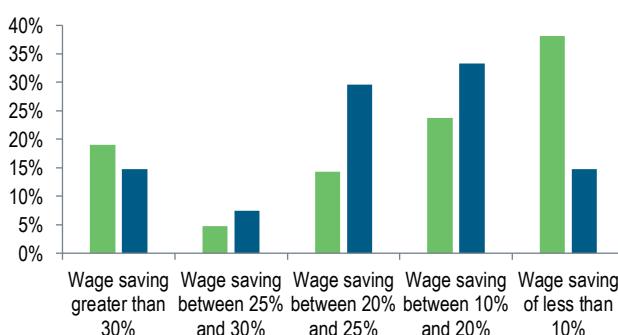


Source: Standard Chartered Research

Figure 12: How much would your response save you?

Wage savings, %

■ 2020 ■ 2019



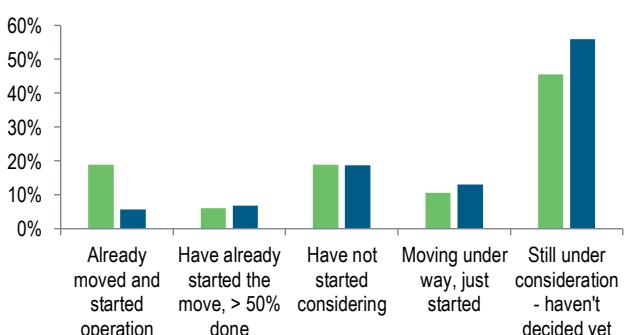
Source: Standard Chartered Research

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Figure 13: What stage of moving are you at?

% of respondents

■ 2020 ■ 2019



Source: Standard Chartered Research



Vietnam – Still numero uno

Remains an attractive investment destination for different reasons

Vietnam has been the preferred destination for corporates looking to move their manufacturing out of China for several years now. The country's combination of a large supply of low-cost labour, geographical proximity to China and a favourable relationship with both China and the US has led to its emergence as a significant regional trade centre. Vietnam's trade/GDP ratio is c.200%, up sharply from 120% in 2009, due to an increase in both imports (primarily from China) and exports (primarily to the US and euro area).

This transformation has been driven largely by substantial FDI in the past 10 years. Vietnam has received over USD 140bn of FDI since 2011, clocking in at over 50% of its 2019 GDP. Over 50% of this inward FDI has gone to the manufacturing sector and a large chunk to export-oriented manufacturing.

Peak FDI probably reached, but inflows to remain strong

The primary driver behind the increase in FDI inflows to Vietnam has been significant wage cost savings for companies; this factor is becoming less of an incentive, however. While in 2014 our survey respondents estimated c.20% wage cost savings on moving manufacturing to Vietnam, they estimated wage cost savings of c.12.3% this year, less than average overall 15% savings from moving manufacturing overseas.

Several manufacturers have highlighted Vietnam's rapidly increasing wages as a concern. Wages in its FDI-supported manufacturing sector have risen an average c.10% per year for the past five years. A manufacturing worker in Vietnam earned an average c.USD 236 per month in 2019, according to a Japan External Trade Organisation (JETRO) 2019 survey, up from 185 per month in 2015. This puts Vietnam roughly in the middle of the regional wage spectrum, well above Cambodia, Laos, Myanmar and Bangladesh. Wages in the country increased by c.10% in 2015, broadly in line with our clients' feedback of 10-15%.

Vietnam received USD 20bn of implemented FDI in 2019, likely representing the peak in FDI inflows. Rising domestic wages are likely to reduce the country's attractiveness as a low-cost manufacturing hub. However, we still see FDI remaining strong near-term, though lower than 2019 levels; we forecast average annual FDI inflows of c.USD 10-15bn over the next five years.

Focus on investment in hard and soft infrastructure

Vietnam will need to focus on upskilling its still large and growing labour force through better-quality education and more vocational training to move up the manufacturing value chain and continue to attract FDI. The process has already begun; the government has invested significantly in improving education standards, which has driven Vietnam's rise in the Programme for International Student Assessment (PISA) rankings. The education sector has also received significant private foreign investment, further raising education standards.

Wage cost savings are becoming less of an attraction for FDI in Vietnam

Further investment in hard and soft infrastructure should help sustain FDI inflows

In addition, the government has focused on improving hard infrastructure, making significant investments in roads, ports and railways. Vietnam has two of the world's 50 busiest ports, which saw a cumulative 9.5mn TEU of volume in 2018; Malaysia is the only other ASEAN-5 economy to have more than one port in the top 50. Vietnam ranked 39 in the world in the World Bank's Logistics Performance Index in 2018, up



from 53 in 2010. It now ranks behind only Singapore and Thailand in ASEAN, and has seen the most improvement in the region.

The government's investment in both hard and soft infrastructure is likely to support Vietnam's position as an attractive investment destination near-term. Vietnam has benefited from the 'low-hanging fruit' trend in low-cost manufacturing; the next few years will likely be key in its transition into a more value-added manufacturing base.

FDI inflows should remain robust, but have likely peaked

Shifting to a domestic consumption-driven economy from an export-oriented one

In 2014, we had forecast a sharp increase in FDI in Vietnam driven by a rising trend of relocation of low-cost manufacturing from China. In addition to the factors highlighted above, Vietnam provided a large, growing and increasingly affluent domestic market for foreign manufacturers to cater to. Low-cost manufacturing alone is generally unlikely to sustain FDI long-term, as wages tend to rise over time due to the availability of better-paying jobs, which supports urbanisation and increased consumer affordability. We believe Vietnam is now close to the inflection point where it is starting to attract FDI for its increasingly affluent domestic consumer base and not only because it offers cost savings.

According to a Japan External Trade Organisation (JETRO) survey, over 50% of Vietnam's sales are export oriented – the highest ratio among major ASEAN economies (barring the Philippines) – suggesting that it is still predominantly an export-oriented manufacturing base. However, this share declined to 53.1% in 2019 from c.60% in 2010-11, and we see it continuing to drop over the next decade as the country's evolution to a more domestic consumption-driven economy from an export-oriented manufacturing hub continues.



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