THE CHALLENGE OF RESHORING FROM CHINA

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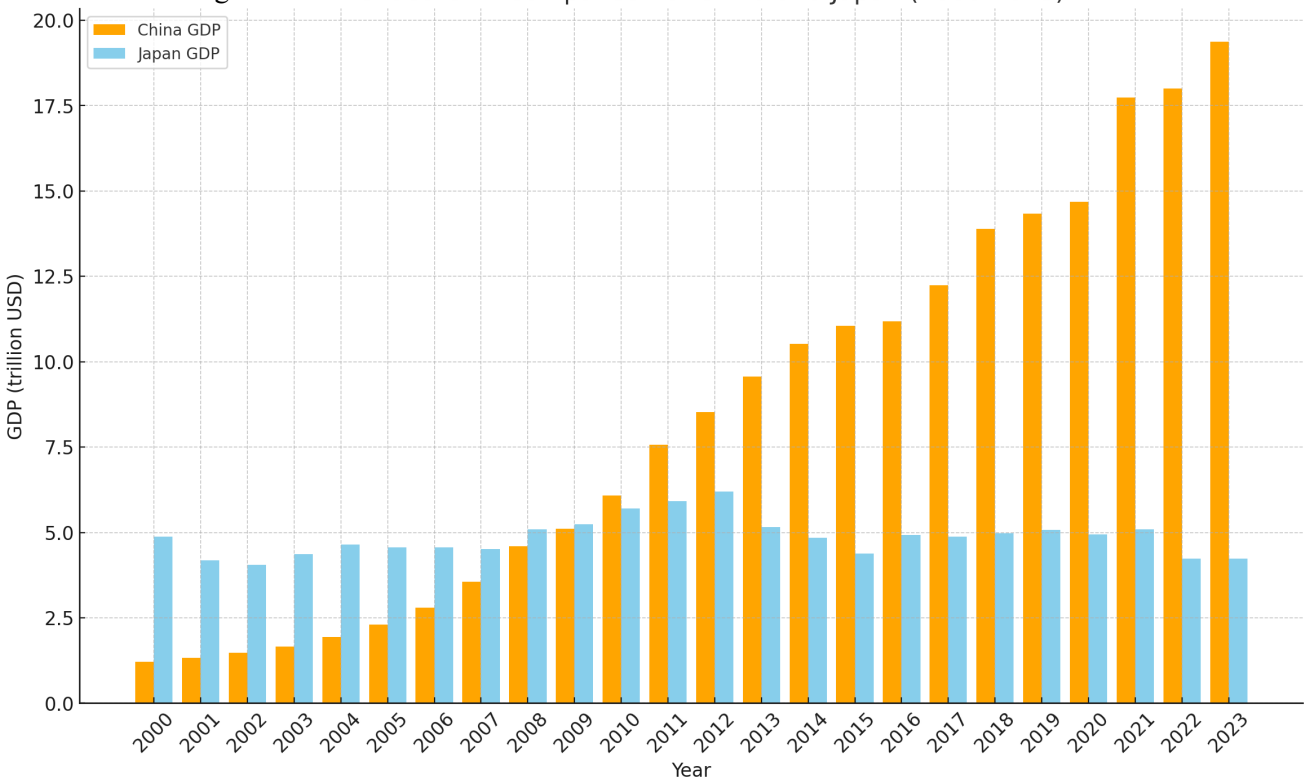
Japanese companies with production sites in China have the difficult challenge of choosing to continue producing in China; bringing back their production to Japan; or moving their production to other regions such as Southeast Asia due to geopolitical risks. This section provides an overview of the comparison of the Japanese and Chinese markets. Overall, the Chinese market is much larger, and the growth prospects are higher than the Japanese market. Although rising wages in China can be one negative factor for manufacturers, they are still lower than in Japan.

GDP

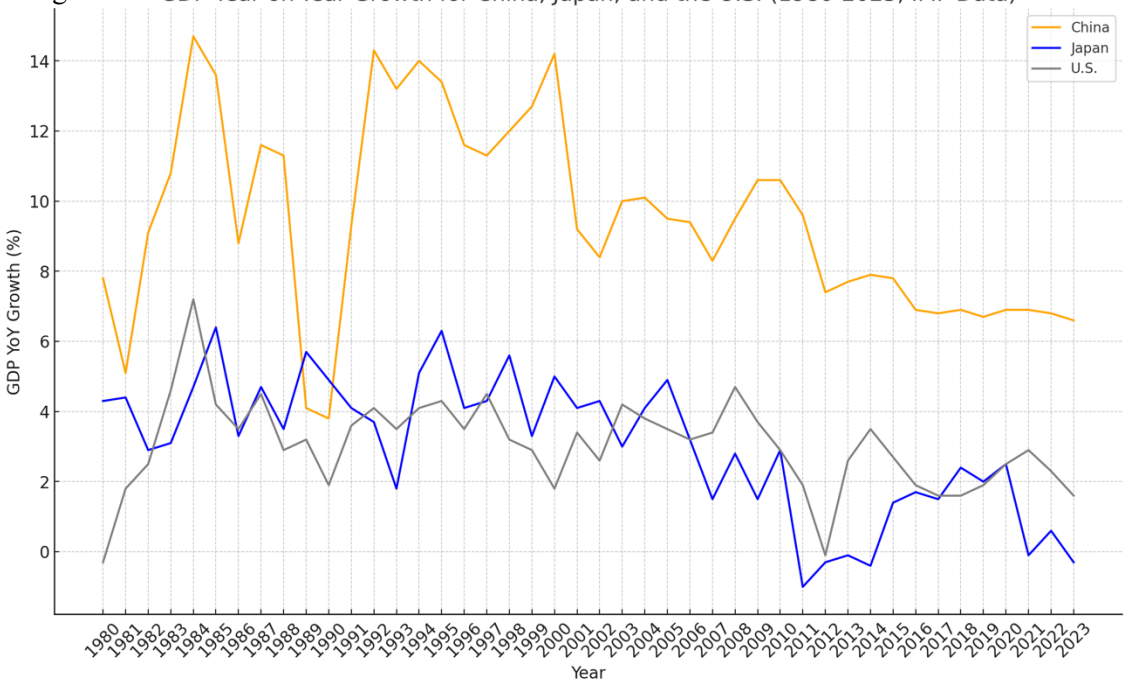
According to Statista data, China’s GDP was $19.37 trillion in 2023, which is approximately 4.6 times Japan’s GDP of $4.23 trillion. After surpassing Japan’s GDP in 2010, China’s GDP grew at an average annual growth rate (CAGR) of 6.1% over the past decade, according to the IMF. However, growth has recently slowed to a more moderate pace. Despite this deceleration, China demonstrated significant resilience during the COVID-19 pandemic, managing to avoid the severe contractions seen in other major economies. China’s real GDP grew by 2.3% in 2020, making it the only major economy to register positive growth that year. In contrast, Japan's GDP contracted by -4.8% in 2020. Growth rates have increased in both countries since the pandemic. The IMF forecasts China’s GDP to grow by 5% in 2024, while Japan’s GDP is expected to expand by 0.7% during the same period.

Figure 1: Extended GDP Comparison of China and Japan (2000-2023)



Source: Statista

Figure 2: GDP Year-on-Year Growth for China, Japan, and the U.S. (1980-2023, IMF Data)

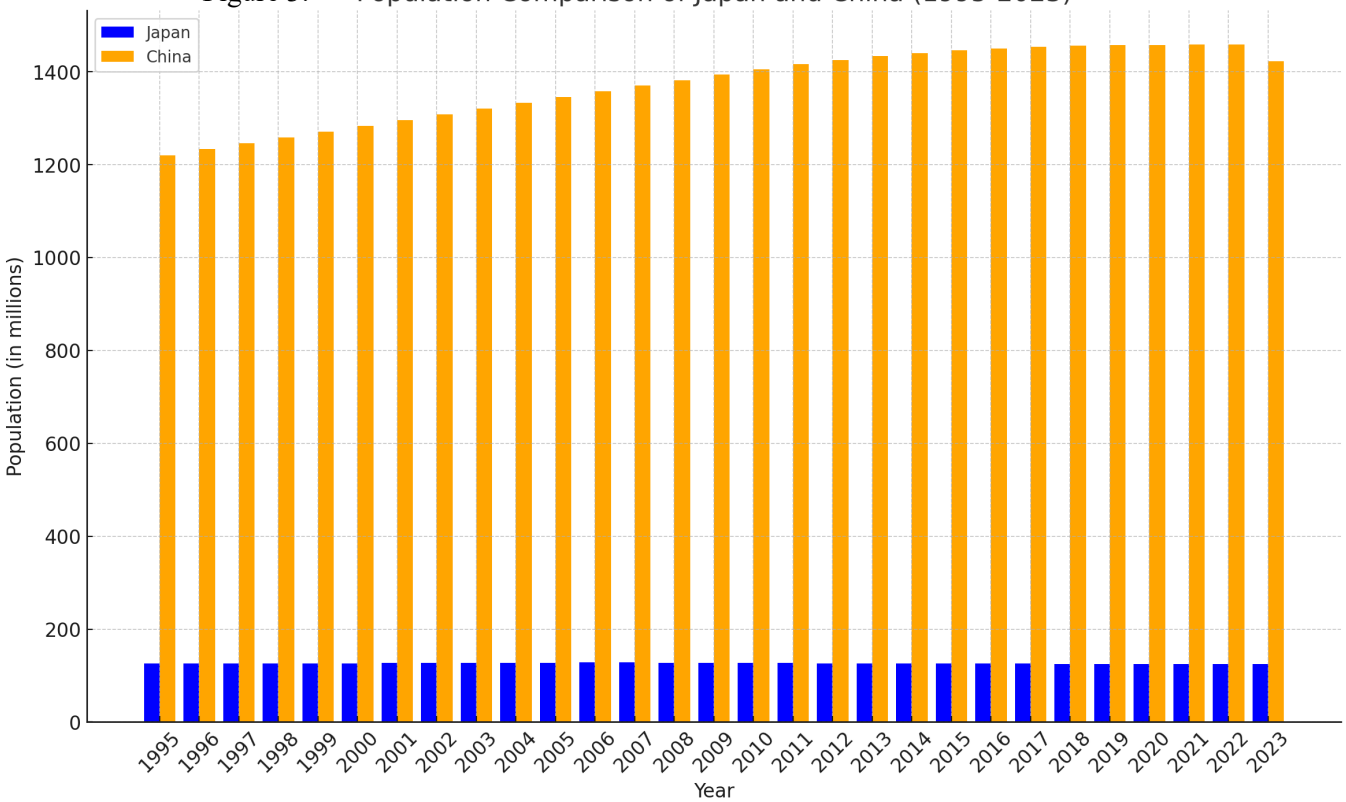


Source: IMF

Population

In 2023, China's population remained significantly larger than Japan's, with China's population at around 1.46 billion, over eleven times that of Japan, which stood at approximately 123 million. Over the mid-to long-term, population size continues to be one of the most critical indicators of growth. China and Japan will face similar challenges in maintaining economic growth over the years to come, even as their respective population growth rates continue to decline, and their populations continue to age.

Figure 3: Population Comparison of Japan and China (1995-2023)

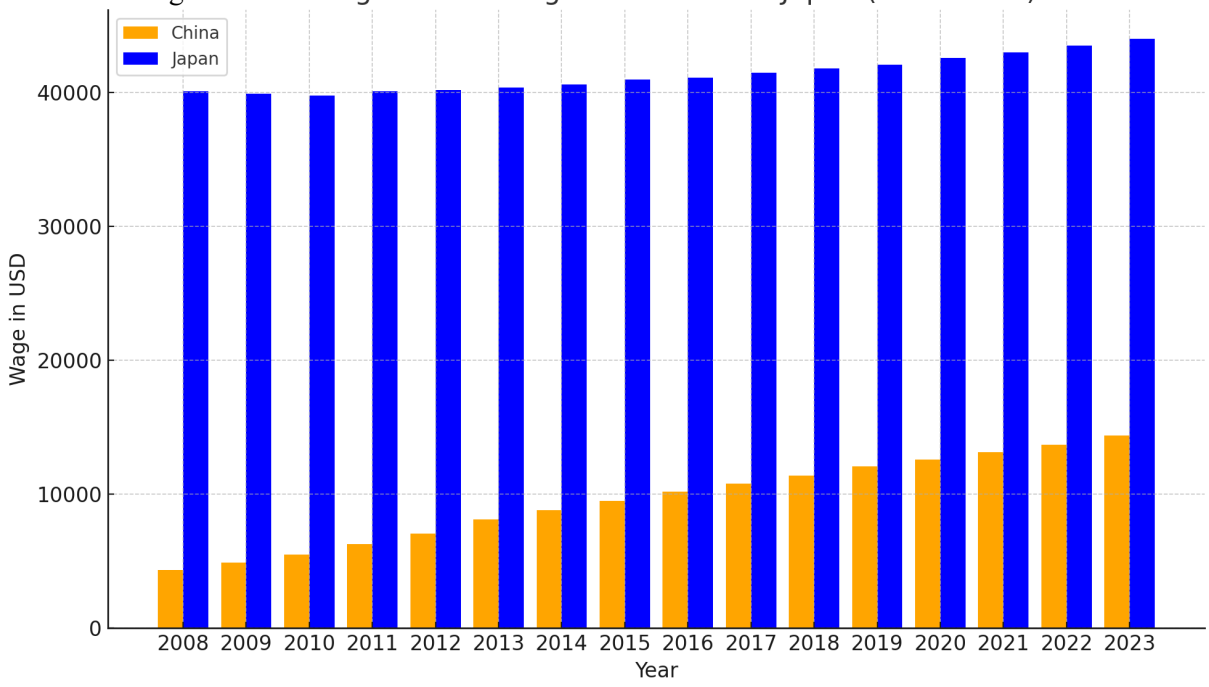


Source: Japan Statistics Bureau, Statista

Wages

Although China's average wages are rising rapidly, they still lag far behind those of Japan. In 2023, China's average wages were less than one-third of Japan's average wages. Based on the population and GDP data shown above, it is clear that the Chinese market has huge growth potential for Japanese companies. Having production sites in China gives Japanese companies the advantage of producing efficiently, which is reflected in their cost of production. Production in China also captures growth in the Chinese market, which is naturally reflected in local sales.

Figure 4: Average Annual Wages in China and Japan (2008-2023)



Source: National Bureau of Statistics of China, OECD

[1] Challenges – Missing the growth opportunity? Or risking future profits?

Tokyo's policy implies its willingness to diversify supply chains

Japanese companies with factories in China face a tough decision: whether to relocate their operations or remain. Their biggest challenge stems from the ongoing uncertainty of the geopolitical landscape. Despite this, two significant trends have emerged: Tokyo's reshoring subsidy and its efforts to create new supply chains with like-minded countries.

On July 17, 2020, Japan's Ministry of Economy, Trade, and Industry (METI) named the first group of companies that would receive subsidies to move production out of China to Japan or Southeast Asia. Among the 87 approved projects, 57 involved relocating from China to Japan, and 30 focus on shifting operations to Southeast Asia. The government targeted industries with a high concentration of production and those essential to public health. Reports from METI and the Japan External Trade Organization (JETRO) show that the initial reshoring projects primarily involved the medical and chemical sectors. This shift reveals that the pandemic, rather than strategic competition with China in the tech sector, drove the first round of subsidies.

Although Tokyo initially focuses on the medical and chemical sectors, it likely plans to extend these subsidies to other industries for strategic purposes. In the first phase, the government allocated 57.4 billion yen out of the 220 billion yen it approved in April 2020. Through this effort, Japan aims to diversify the production bases of Japanese companies operating in ASEAN countries, including Malaysia and Vietnam. The government's "Basic Policy of Economic and Financial Management and Reform 2020" outlines the need to create new supply chains with like-minded nations from an economic security perspective.

In addition to reshoring, Japan has partnered with India and Australia to reduce their collective reliance on China. This initiative addresses vulnerabilities that the COVID-19 pandemic exposed and aims to cut the three countries' dependence on China for critical goods and manufacturing. Early talks focused on reducing risks in the pharmaceutical and electronics industries. Japan's trade minister also emphasized including ASEAN nations in future discussions, as they offer viable alternatives for companies relocating from China. Japan intends to digitalize trade procedures and support capital expenditures as part of the trilateral reshoring initiative.

After the pandemic, Japan shifted its reshoring efforts toward preparing for a potential Taiwan contingency. The economic fallout from such a situation would be enormous. An 80% drop in Chinese imports, for example, could slash Japan's production value by nearly ten times the import loss. To counter this, Japan has encouraged Taiwanese companies, especially those producing critical goods like semiconductors, to diversify their production bases. Taiwan Semiconductor Manufacturing Co. (TSMC) responded by building a new plant in Kumamoto. Japan has also intensified its push for "friendshoring," actively increasing joint production activities and intellectual cooperation in critical sectors with friendly nations, particularly in Europe, North America, and Southeast Asia. For example, Samsung Electronics plans to build a research center in Japan focused on developing next-generation semiconductors.

Through reshoring subsidies and supply chain initiatives, Japan demonstrates its commitment to diversifying its supply chains. However, Tokyo's willingness to fully decouple from China or adopt a more adversarial stance remains unclear, leaving the business environment uncertain for Japanese companies.

Reshoring Pros and Cons

There are clear pros and cons to reshoring. Although the weight of each point may differ by industry, it is essential for Japanese companies to understand their opportunities and risks among all possible options.

If businesses relocate from China, they could benefit from reshoring subsidies provided by METI, and enjoy a more stable business environment. This stability is particularly important when considering production locations, which significantly influence cost structures, profits, and FX sensitivity due to transaction currencies. Additionally, proximity to local production facilitates easier sales and local market understanding. A lesser-discussed but important advantage of reshoring is the environmental impact. By producing goods closer to home, companies can reduce their carbon footprint, as shipping distances and related emissions decrease, contributing to greener, more sustainable operations—a factor that resonates with growing global consumer expectations for environmental responsibility.

However, reshoring comes with considerable costs. The process itself is expensive, as it involves scrapping old factories, building new ones, relocating equipment, and adjusting workforce structures. Companies could

also face higher production costs, particularly in Japan, where labor and operational expenses are generally higher. Even if the financial burden is manageable, finding and training new skilled workers can be difficult, particularly in specialized sectors like electronics. Furthermore, the opportunity cost of moving production out of China is significant. Maintaining or expanding market share in China becomes more difficult without a local production base, as shipping products back into the country increases costs and reduces competitiveness. Losing the ability to directly monitor local market demands can further weaken a company's position in China, even if they manage to cover the initial reshoring costs.

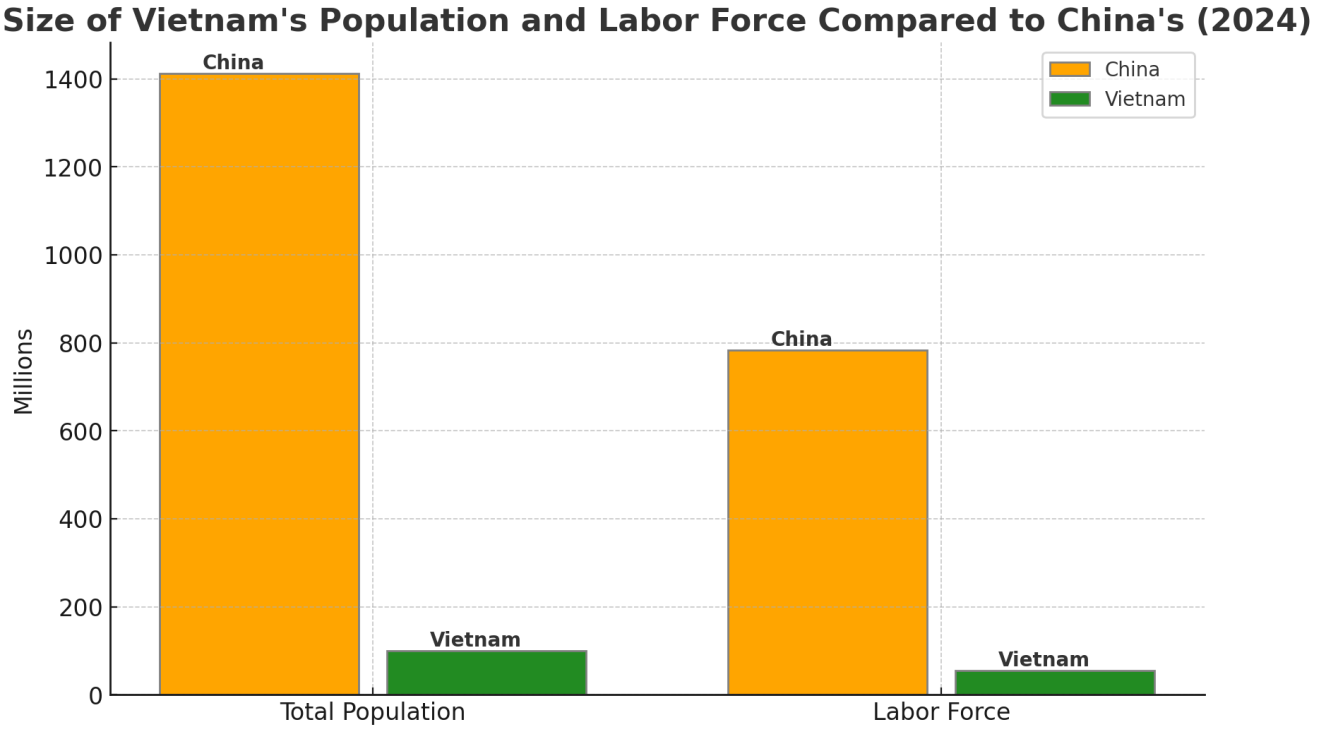
If businesses choose to keep their production lines in China, they avoid the high costs of reshoring and maintain strong market competitiveness in a rapidly growing economy. However, this option is not without risk. The business environment remains unstable due to the possibility of shifting regulations, both from China and other countries like Japan or the U.S., including potential sanctions. Additionally, companies may face data security risks in China, where intellectual property or competitive data could be compromised, potentially damaging their long-term competitiveness.

The Nearshoring Option

Nearshoring is another option for Japanese companies, apart from remaining in China or reshoring to Japan. Although the decision-making process for nearshoring may look similar to that of reshoring, nearshoring generates different concerns. This section illustrates key issues that companies should keep in mind when considering the nearshoring option, using Vietnam as an example. While Vietnam is successfully increasing its trade partners, there are various fundamental factors to consider.

The quantity and quality of the labor force are one of the key differences between the Chinese market and the Vietnamese market. Vietnam's labor force is only 7% the size of China's labor force, meaning that it may be difficult for companies in industries that require mass labor to relocate their production to Vietnam. In addition to the size of the labor force, Vietnam's demography, which is becoming top-heavy (that is, relatively elderly), is also a disadvantage. Moreover, workers' skills are critical for high-skill industries. For instance, the electronics industry finds it difficult to move production due to the required skills and suppliers.

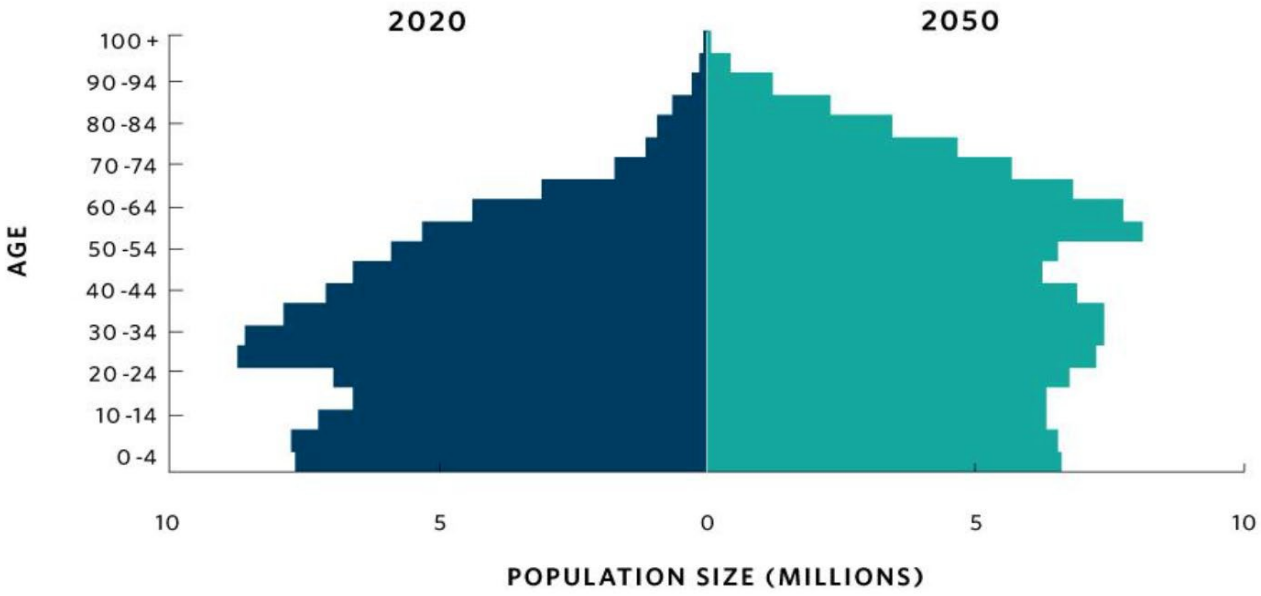
Figure 5:



Source: World Bank Data

Figure 6:

Vietnam's Population Projection by Age Group



SOURCE: "World Population Prospects 2019," United Nations Department of Economic and Social Affairs: Population / Dynamics, accessed June 16, 2020, https://population.un.org/wpp.

Infrastructure is another critical factor for production. According to the World Bank's Logistics Performance Index, which measures logistic friendliness both qualitatively and quantitatively, China ranked at 19th and Vietnam ranked at 43rd in 2023.

Figure 7:

Country	Year	LPI Rank	LPI Score	Customs Score	Infrastructure Score	International shipments Score	Logistics competence Score	Tracking & tracing Score	Timeliness Score
Singapore	2023	1	4.3	4.2	4.6	4	4.4	4.4	4.3
Finland	2023	2	4.2	4	4.2	4.1	4.2	4.2	4.3
Denmark	2023	3	4.1	4.1	4.1	3.6	4.1	4.3	4.1
Germany	2023	3	4.1	3.9	4.3	3.7	4.2	4.2	4.1
Netherlands	2023	3	4.1	3.9	4.2	3.7	4.2	4.2	4
Switzerland	2023	3	4.1	4.1	4.4	3.6	4.3	4.2	4.2
Austria	2023	7	4	3.7	3.9	3.8	4	4.2	4.3
Belgium	2023	7	4	3.9	4.1	3.8	4.2	4	4.2
Canada	2023	7	4	4	4.3	3.6	4.2	4.1	4.1
Hong Kong SAR, China	2023	7	4	3.8	4	4	4	4.2	4.1
Sweden	2023	7	4	4	4.2	3.4	4.2	4.1	4.2
United Arab Emirates	2023	7	4	3.7	4.1	3.8	4	4.1	4.2
France	2023	13	3.9	3.7	3.8	3.7	3.8	4	4.1
Japan	2023	13	3.9	3.9	4.2	3.3	4.1	4	4
Spain	2023	13	3.9	3.6	3.8	3.7	3.9	4.1	4.2
Taiwan, China	2023	13	3.9	3.5	3.8	3.7	3.9	4.2	4.2
Korea, Rep.	2023	17	3.8	3.9	4.1	3.4	3.8	3.8	3.8
United States	2023	17	3.8	3.7	3.9	3.4	3.9	4.2	3.8
Australia	2023	19	3.7	3.7	4.1	3.1	3.9	4.1	3.6
China	2023	19	3.7	3.3	4	3.6	3.8	3.8	3.7
Greece	2023	19	3.7	3.2	3.7	3.8	3.8	3.9	3.9
Italy	2023	19	3.7	3.4	3.8	3.4	3.8	3.9	3.9
Norway	2023	19	3.7	3.8	3.9	3	3.8	3.7	4
South Africa	2023	19	3.7	3.3	3.6	3.6	3.8	3.8	3.8
United Kingdom	2023	19	3.7	3.5	3.7	3.5	3.7	4	3.7
Estonia	2023	26	3.6	3.2	3.5	3.4	3.7	3.8	4.1
Iceland	2023	26	3.6	3.7	3.6	3.3	3.5	3.7	3.6
Ireland	2023	26	3.6	3.4	3.5	3.6	3.6	3.7	3.7
Israel	2023	26	3.6	3.4	3.7	3.5	3.8	3.7	3.8
Luxembourg	2023	26	3.6	3.6	3.6	3.6	3.9	3.5	3.5
Malaysia	2023	26	3.6	3.3	3.6	3.7	3.7	3.7	3.7
New Zealand	2023	26	3.6	3.4	3.8	3.2	3.7	3.8	3.8
Poland	2023	26	3.6	3.4	3.5	3.3	3.6	3.8	3.9
Bahrain	2023	34	3.5	3.3	3.6	3.1	3.3	3.4	4.1
Latvia	2023	34	3.5	3.3	3.3	3.2	3.7	3.6	4
Qatar	2023	34	3.5	3.1	3.8	3.1	3.9	3.6	3.5
Thailand	2023	34	3.5	3.3	3.7	3.5	3.5	3.6	3.5
India	2023	38	3.4	3	3.2	3.5	3.5	3.4	3.6
Lithuania	2023	38	3.4	3.2	3.5	3.4	3.6	3.1	3.6
Portugal	2023	38	3.4	3.2	3.6	3.1	3.6	3.2	3.6
Saudi Arabia	2023	38	3.4	3	3.6	3.3	3.3	3.5	3.6
Turkiye	2023	38	3.4	3	3.4	3.4	3.5	3.5	3.6
Croatia	2023	43	3.3	3	3	3.6	3.4	3.4	3.2
Czech Republic	2023	43	3.3	3	3	3.4	3.6	3.2	3.7
Malta	2023	43	3.3	3.4	3.7	3	3.4	3.4	3.2
Oman	2023	43	3.3	3	3.2	3.4	3.2	3.9	3.1
Philippines	2023	43	3.3	2.8	3.2	3.1	3.3	3.3	3.9
Slovak Republic	2023	43	3.3	3.2	3.3	3	3.4	3.3	3.5
Slovenia	2023	43	3.3	3.4	3.6	3.4	3.3	3	3.3
Vietnam	2023	43	3.3	3.1	3.2	3.3	3.2	3.4	3.3

What Are the Options for Companies?

For Japanese companies that have their production facilities in China, there are three options to deal with this challenge. **Option 1** is to move all of their production out of China. **Option 2** is to move part of their production out of China. **Option 3** is to do nothing – that is, to remain in China.

Option 1: Moving all production out of China: This approach involves a combination of reshoring, or friendshoring to countries in Southeast Asia or elsewhere. By doing so, Japanese companies can mitigate the risk posed by escalating trade tensions, the uncertainty of future regulations from the Chinese government, or U.S. sanctions in the event of a Chinese invasion of Taiwan. This option comes with significant costs, including higher labor expenses, logistical challenges posed by moving complex operations to new regions, and regulatory challenges involved in adjusting operations to meet the legal standards of the new host countries. For companies heavily reliant on the Chinese market, this option could also lead to reduced market access.

Option 2**: **Moving some production out of China: A more moderate strategy option is to shift only a portion of production to Japan or friendly partner countries. This dual-location approach allows companies to diversity their production base, which can protect against supply chain disruptions or geopolitical issues such as a Taiwan contingency. However, this approach still involves significant logistical and financial hurdles similar to those mentioned in Option 1, above.

Option 3: Keeping production sites in China: The third option is to maintain the status quo of production in China, with no plans to reshore or nearshore. Companies may choose this option if their survival depends on China's unmatched manufacturing scale, as well as Japan's relative proximity to Chinese suppliers and the Chinese consumer market. This option may also be the best one, for companies who believe that the costs of moving operations overseas would be more disadvantageous than the costs of being caught in geopolitical crossfire, in the event of a Taiwan contingency or other geopolitical clash in the East or South China Seas.

In order to decide which of these options is most suitable, Japanese companies should conduct political risk analysis on the ***international*** and ***domestic*** levels:

International level – This involves assessing global dynamics such as the U.S.-China relationship, the trend toward economic decoupling, and new initiatives like the Japan-India-Australia supply chain partnership.

Domestic level – This requires a deep dive into the specific business policies of Japan and China, including export controls and legal considerations, which may influence long-term operations.

Cost-benefit analysis should weigh the pros and cons differently depending on the company's industry, market positioning, and competitive advantage. For instance, electronics companies with sensitive technology may prioritize mitigating the risk of data theft, while clothing manufacturers may be more focused on maintaining cost-efficient production. Additionally, companies with strategic goals to grow in the Chinese market may find it crucial to

maintain local production facilities despite the risks. The weight of each factor will vary depending on the specific business strategy and competitive landscape of each company.

APPENDIX: THINKING ABOUT POLITICAL RISK

Political risk is a critical factor for Japanese companies to consider when evaluating reshoring or near-shoring options. A comprehensive political risk analysis, such as the Integrated Interest Group Analysis from Stanford Business School, provides a relevant framework for such decision-making processes. This method involves several steps, starting with identifying the most likely alternative to the current strategy. and listing all interest groups that may gain or lose from the decision. Each respective group's 'demand' for political mobilization and their potential 'supply' of political support or opposition must then be assessed. Based on these evaluations, companies can predict the likely levels of influence of each group, and plan for potential coalitions. The benefit of using this method for the reshoring case is that it can lead to a precise prediction if the analysis is done accurately. The difficulty of using this method in the reshoring case is that identifying the interest groups and assessing their motivations may be very complicated for the Chinese market, given its political system and business environment. Moreover, understanding and predicting Chinese regulations maybe another strenuous task for companies.

Political risks can be categorized into macro-level and micro-level risks. Macro-level risks, which are non-project specific, can arise from broader international concerns or grassroots and elite-level conflicts within a country. Micro-level risks are project-specific and may stem from interest group opposition. For instance, international risks in China have been highlighted by recent developments: in 2020, the country amended its criminal code to include trade secrets theft by foreign businesses, which could serve as retaliation against the U.S. for economic espionage accusations. Similarly, initiatives like the Inter-Parliamentary Alliance on China and U.S. legislative actions, such as the EQUITABLE Act of 2019, reflect mounting geopolitical tensions that could impact foreign businesses operating in China.

Finally, companies must consider a range of critical factors when conducting a political risk analysis for their operations in China. One of the foremost considerations is the sensitivity of the industry in which they operate. For example, companies involved in industries such as semiconductors, critical minerals, or advanced technologies face heightened scrutiny due to the geopolitical importance of these sectors. These industries

are likely to be affected by trade restrictions or export controls, among other potential targeted regulatory actions. The company's position within its industry is equally important. Market leaders or companies with fast-advancing technologies may face more significant risks, as they are often under greater scrutiny by both local and international regulators.

Another crucial factor is the capital intensity and mobility of the industry. For companies in highly capital-intensive industries, such as heavy manufacturing or energy, moving production facilities out of China may be prohibitively expensive and time-consuming. In contrast, some light manufacturing or service-based industries may find it easier to relocate part or all of their operations to other countries. For example, an apparel manufacturer can shift production to Southeast Asia more easily than a company with vast, specialized machinery used for semiconductor fabrication.

The strength of a company's government relations also plays a pivotal role in mitigating political risks. In China, where governmental institutions are relatively opaque and regulatory changes can come with little notice, it is crucial for companies to have cordial relations with local and

national authorities. Having a dedicated government relations division or strong ties to key decision-makers may in some cases help companies anticipate avoid sudden policy changes.

In closing, here are some recent, concrete examples of international risk calculations:

In 2023, BCG reported that more than 90% of North American companies have shifted production and sourcing since 2018, due to the challenges posed by geopolitical uncertainties and tariffs. The trend toward "decoupling" from China has led many companies to relocate manufacturing to Southeast Asia, India, or back to North America, in an attempt to reduce their exposure to supply chain risks tied to political volatility in China. (BCG)

In July 2020, SCMP reported that China is amending its criminal code to cover trade secrets theft by foreign businesses, a change that could give Beijing a tool to retaliate against the U.S. for alleged economic espionage. (SCMP)

In June 2020, legislators from a dozen like-minded countries launched the Inter- Parliamentary Alliance on China to help counter

challenges China poses to global trade, security, and human rights. (Bloomberg)

In 2019, the Senate passed the Ensuring Quality Information and Transparency for Abroad-Based Listings on our Exchanges (EQUITABLE) Act to ban Chinese and foreign firms that flaunt the U.S. laws from U.S. exchanges. (Legislation)

IN CONCLUSION

Since the escalation of trade and broader geopolitical tensions with China, one common option for companies concerned about supply chain risks has been to relocate back to the home country—Japan, for example. A second option has been to "nearshore" to a nearby nation such as Vietnam.

Although reshoring and nearshoring may have a compelling logic from a national geo-economic perspective as tensions between China and the world intensify, important complications for foreign investors in China nevertheless remain. The Chinese market is large, and relatively high-growth, although future growth prospects now appear more uncertain than they appeared before the covid crisis. Wages there also remain relatively low, compared to Japan and the United States. Investors also have substantial sunk costs, in job training and the development of supplier networks.

Rapid movement to reshoring has been supported by the Japanese government from an economic-security perspective in certain strategic sectors, such as pharmaceuticals and electronics. Government subsidies have eased the transition to reshoring, but overall cost considerations and availability of

infrastructure, in some instances, still inhibit the process. Near-shoring to countries such as Vietnam thus emerges as an attractive alternative, although risk factors and inefficiencies also complicate that alternative as well.

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