Spillover Effect of US-China Trade War: Case Study of Vietnam and Malaysia

Yunqi Dong*
Ulink College of Shanghai, Shanghai, China
*Corresponding author: yunqi_dong__ulink_cn@ulinkedu.cn

Abstract. This paper focuses on the comparison of the spillover effects brought by the US-China trade conflict on industrialized and emerging economies classified by different sectors and research of possible policies that would improve FDI absorption abilities of emerging economies. The proposed method to solve the problem is through desk research on secondary sources and import and export data of each country provided by the World Bank. The results obtained in this research include Japan and Germany lost the most in automobile industries while Vietnam and Malaysia reaped profits from diverted demand of commodity manufacturing and foreign direct investment.

Keywords: US-China trade war; Germany; Japan; Vietnam; Malaysia; FDI.

1. Introduction

The world's two largest economies, the US and China, engaged in a trade war in 2018 and 2019. In early 2018, the United States raised tariffs on a number of important imports, including solar panels, washing machines, steel and aluminum. While there was no origin discrimination in the tariffs, it was soon obvious that China is aimed as the target of US trade policy. The United States then raised tariffs on tens of thousands of Chinese goods over the course of 2018 and 2019, ultimately focusing on about $350 billion in Chinese imports. China responded to the multiple levies by targeting approximately $100 billion worth of American goods. Trade flows totaling around $450 billion were eventually covered by reciprocally increasing tariffs. In January 2020, the two sides agreed to cease further tariff increases, but the previous tariffs remain in effect as of 2021. The fierce competition between China and the United States will undoubtedly lead to many spillover effects all over the world. However, the impacts on developing countries and developing countries are distinct. In this paper aims to classify and summarize them in terms of the most affected sector in each country and the future trend through desk research on secondary sources and import and export data of each country provided by the World Bank. It is hypothesized that industrialized economies will be hit in high-end manufacturing and more FDI will flow to emerging economies due to relatively cheaper cost of production.

Germany and Japan are selected as the study's developed nation subjects. Both nations, which are known for their auto manufacturing and have strong trading relations with China and the US, have witnessed significant losses to their sectors as a result of the trade war and are reportedly considering moving their plants. The two developing nations selected in this paper—Vietnam and Malaysia—were the areas that were mentioned as potential relocation locations. In this essay, the contents primarily concentrate on the two countries' diverted capital inflows and the state of their FDI, assessing their capacity to absorb FDI.

2. Spillover Effects on Different Industries

2.1 Automobile Industry

Consumer goods manufacturers in Europe are expected to seize the opportunity and increase their market share in both the US and Chinese markets. According to research by UNCTAD, exports from EU will account for $70 billion of total bilateral trade between the United States and China, substituting $50 billion of Chinese exports to the US and $20 billion of US exports to China, indicating that the EU would earn more money relying on tariffs from the US rather than Chinese protectionism. Furthermore, the report estimates that the European Union will be able to attract up to US$ 90 billion in value chain trade [1]. Germany is the most likely EU member state to benefit from this trade substitution [2].

China is Germany's most important trading partner. Germany's cooperation with it generates EUR206 billion of trade which is 8.5 % of Germany's total trade. From a German perspective, however, it is unlikely that the Chinese market will stabilize the main market as it has been, ensuring German economy to combat and withstand negative economic events over the past decades. German exports to China grew only 3.2 % in 2019, compared with an average annual growth rate of about 12.7 % between 2006 and 2018 [3]. Therefore, it is not impossible that Germany exports towards China will be negatively affected when China's economy slows down due to pressure from the US and the COVID-19 pandemic. Germany exports about 9 percent of its goods and services to the United States while 7 percent of them to China, relying heavily on the trade with those two markets. Trump's tariffs forced Germany to faces economic consequences.

This is especially true for German automakers. The German automotive industry in China has already been directly affected. Germany sales of cars to China is steadily declining due to higher import tariffs in the US and China. In August this year, this figure was 7.4 percent lower than the previous year [4]. Car companies like BMW and Daimler automobiles are also affected since they are produced in the United States and then shipped to China. Meanwhile, exports of cars and auto parts to the United States are expected to fall by 49% and 59%, respectively [5].

However, Japan is expected to lose more than Germany in the automobile industry because vehicles account for a much larger share of Japan's total exports to the US, about 64% than 8% of EU. The Japanese car and car component exports to the US are expected to fall dramatically, of 72.0% and 69.8% respectively, while in comparison Germany is expected to suffer losses of 49.0% and 58.9% in the two same products, respectively [5].

2.2 Commodity Manufacturing

On the other hand, developing economies, particularly those in ASEAN, are benefiting greatly from the trade war. The consumer goods manufacturing industries of Southeast Asian countries such as Vietnam and Malaysia will be discussed in this paper.

Both foreign and US importers targeted Vietnamese companies already in a bid to avoid Donald Trump's taxes. More specifically, mobile phones and components saw the fastest growth, up 92 percent to $4.18 billion, In the first four months of 2019, Vietnamese exports to the United States more than doubled compared to the same period in 2018. Sales of computers, electronic products and components rose 72 percent to $2.3 billion, while exports rose 79 percent in the same period, according to the U.S. International Trade Commission. Moreover, there is evidence that Chinese-made mobile phones and electronics are being substituted: exports of these two categories of Chinese goods to the United States are down 27 percent and 13 percent, respectively. There has also been a significant gain in the production of clothing, agricultural products and furniture for export to the United States, which were mainly processed in China initially before tariffs were raised. [6].

In the first half of 2019, Vietnam's other exports to the United States increased, including machinery, equipment and parts, which reached $2.07 billion, up 54%; wood and wood products, $2.25 billion, up 35%; footwear and related products, which reached $3.18 billion, up 13%; and textiles and apparel, $7.03 billion, up 11% [7].. Exports to the US market totaled US $20.7 billion, an increase of nearly 40% over the same period in 2018 [8].

Meanwhile, Malaysia stands to profit handsomely from the trade dispute. The country is heavily reliant on the Chinese economy. With 13.7% of total trade in 2018, China is Malaysia's most important trading partner, and a major source of international tourism, with tourism expenditure of RM12.3billion in the same period, the second highest [9]. This suggested that China's economic growth slowdown will have a profound negative impact on Malaysia's economy.

Electronic and electrical components such as diodes for semiconductors, storage components for electronic integrated circuits are among the products most affected by tariffs, benefiting from the trade war in Malaysia. The data showed a small increase in exports of Malaysian products affected by the Listing 2 tariffs, mainly chemicals, machine parts, electronic circuits, diodes and electronic parts, with US imports from Malaysia increasing by an average of about 5% per month after the tariffs. However, this was mostly offset by a decline in US demand of Malaysian agricultural products and other uninfluenced products, which fell 11% and 4% month-on-month, respectively [10].

2.3 Tourism

The EU's service sectors, particularly tourism, benefited greatly from the intense relationship between the US and China so far. Along with the Chinese government's propaganda efforts to incite hatred and negative images of the United States, such as the Chinese embassy in the United States has warned potential Chinese tourists of the potential dangers that may encounter during their stay, such as unexpected shootings and high cost of medical care services [11]. With hard work paying off, Chinese visitors travelling to the United States fell below 3 million in 2018, according to data compiled by the I&A department of ITA in the US [12].

According to statistics, EU countries have surpassed the United States as popular vacation destinations. In 2018, the tourism industry contributed 782 billion euros to the EU economy's GDP, and travel spending increased 3.9%, compared to 3.2% global economic growth [13]. From 2018 to 2019, Vietnam's tourism revenue increased by 16.8%, from US$10.1 billion to US$11.8 billion [14]. In comparison, Malaysia tourism experienced slow growth during this period, with revenue of US$84.1 billion in 2018 and US$86.1 billion in 2019, representing a 2.4% growth rate, which was below average [15]. However, the advantages of tourism did not last long. The Covid-19 epidemic caused countries to restrict people's mobility and access to their borders at the end of 2019, bringing tourism to a halt.

2.4 Foreign Direct Investment (FDI)

Despite the fact that the majority of revenue is generated by trade diversion and substitution of Chinese products, high tariffs on Chinese products have assisted Vietnam in attracting more foreign direct investment (FDI) into its industries, resulting in the creation of more production factories and jobs, as well as an improvement in Vietnam's trade balance with other countries. Total foreign direct investment rose 6.3 per cent year-on-year to $12 billion in the first eight months of 2019, according to the data from Vietnam government, newly registered projects rose 25 per cent to over 2,400 in the same period last year [16]. Vietnam is now Samsung's biggest manufacturer in terms of mobile phones, producing 240 million units estimated on average annually. However, due to high labor costs and the trade war between the United States and China, Samsung plans to reduce its Chinese production by approximately 40 million units.

Another effect is that Chinese companies may look to invest in Vietnam, in order to produce goods which will be exported to the United States. China's registered capital in Vietnam totaled $2.02 billion in the first five months of 2019 in terms of investment value, making it the fourth largest foreign investor. In the same period of 2019, newly registered foreign direct investment from China rose to $1.56 billion for the first time, the highest in the world. According to a survey conducted by the Japan External Trade Organization (JETRO) and other organizations, wages in Vietnam are approximately two-thirds lower than in China [17]. Despite the fact that labor quality is comparable. Because of this, Vietnam has become the primary recipient of diverted FDI.

However, if large groups start moving factories from China to Vietnam at about the same time, or are planning to do so, it will be more difficult to shift their production to Vietnam, especially for Chinese S&MEs. Due to Vietnam's limited infrastructure for production and poor raw material quality, Concerns arises about the country's absorption ability to adequately absorb and make full use of the increasing FDI inflows from other countries. In order to meet the demand formulated by foreign companies, the country requires time and finance to expand its production capacity, as well as new infrastructure, especially logistics-related ones such as roads and warehouses. Furthermore, structural unemployment is widespread in Vietnam's economy, in 2018, labour that had received vocational training or higher education only accounted for21.9% of the total Vietnam workforce [18]. Meanwhile, Vietnam started to face the problem of rapidly aging population which causes labor costs to becomw higher and higher, according to a report by the JICA [19]. According to the report, which studied and surveyed more than 1,000 public and private institutions, in 2015, 70 percent of the country's labor belonged to legal working age population (15-64 years old), but with a rapidly aging population, this proportion is expected to drop to 60 percent by 2050. While the workforce will shrink, wages will undoubtedly rise, causing Vietnam to lose its current advantage of cheap labour cost in labour-intensive industries", the report said. Increasing labour productivity is required to solve this problem.

In fact, Vietnam has realized that the reality of the FDI absorption in the country has deviated largely from their expectationa, since the number of companies complaining about congested ports and roads, inadequate deregulations and soaring costs of production are rising [20]. At a meeting of the Binh Duong Provincial People's Committee and the business community, business representatives complained that many employees of companies living in Ho Chi Minh City have quit because their commuting time cost on the road which is only a few dozen kilometers away, exceeds four hours per day, there are also directors of international trading companies claiming that logistics costs in Vietnam are now 21% of GDP. This figure is incredibly high compared to the one of Japan, the United States, and other Southeast Asian countries [21].

Similarly, Malaysia, another counterpart, experienced a surge in FDI. In the first six months of 2019, total approved manufacturing investments in the state stood at RM5.9billion, 90.3% higher than the RM3.1billion in the same period last year [22].

Malaysia's FDI issues are serious and must be addressed immediately. According to a recent US Department of State report, despite gradual progress in reducing some constraints, corruption remains a significant barrier to attracting foreign investment in Bangladesh. Slow adoption of dispute resolution methods and sluggish judicial processes, according to the report, impede contract enforcement and business dispute resolution. According to the report, scarcity of land, depletion of natural gas reserves, and insufficient power distribution continue to be major impediments to investment [23]. Skilled labor is also in short supply. According to the NCCIM's Quick Take Survey, which included 835 companies, there was a 77,721-worker shortage, with the manufacturing sector accounting for 77.1 percent of total manpower required. Furthermore, with 7.3 million unemployed and 840,000 graduates, employers have a pool from which to draw [24].

3. Policy Recommendation

Vietnam is advised to improve infrastructure, particularly transportation, in order to reduce production costs even further. The three transportation infrastructure plans should be implemented in stages between April 2021 and 2030. Vietnam plans to build new high-speed railroads of thousands of kilometers in length, more international airports and deep-water ports for shipments. The Vietnamese government aims for a cargo transportation capacity of 4.4 billion tons per year and a road transportation capacity of 2.76 tons of cargo and 9.43 million passengers per year [25]. Quote from several findings of a study conducted by the University of Notre Dame, primary roads have critical and positive impacts on FDI into Vietnam. It is estimated that each additional unit of primary road leads to an additional $674.2 billion in foreign direct investment in each province [26]. This implies that the Vietnamese government should prioritize the construction of transportation infrastructure, particularly primary roads, in order to attract more FDI.

Furthermore, policies on labor quantity and quality are required in the current situation. More training and education are required for workers to perform their duties properly. Although this takes time and money, attracting foreign workers can be beneficial in the short term. Vietnam's new immigration law can serve as a model. The legislation issues a new type of visa designed for foreigners visiting Vietnam to carry out business's activities of international agreements or cooperation contracts signed by Vietnam. Further deregulating labor mobility and providing more subsidies and benefits to foreign skilled labor to work in Vietnam can assist the country in filling key vacancies that are critical to production [27]. In the long run, however, the most reassuring guarantee of production is the technical knowledge and strength of the domestic country's people. According to Azoulay et al2020.'s study, immigrants are 80% more likely to become entrepreneurs and create jobs in the country [28]. Most of the migrants are young people and most of them are women. Their efforts led to a significant contribution that propelled Vietnam from one of the five poorest countries in the world to a prosper country with more than $1,000 per capita income in 2010 [29].

Malaysia is advised to maintain its current tax policy in order to reduce the cost of production for foreign firms operating in the country. As a key step in the national economic recovery plan, the Malaysian government has announced several tax exemptions to encourage investment. For new disbursed foreign direct investments in the manufacturing sector with capital investments of at least RM300 million, a 10-to-15-year tax exemption is available. This has already demonstrated empirically positive effects on stimulating FDI. According to the latest data, due to tax exemptions, in the first nine months of 2020, Malaysia has reaped RM109.8 billion in new investments altogether in economic sectors, involving almost three thousand projects, creating approximately 65 thousand jobs. Among all the sectors, the manufacturing sector attracted largest amount of investment fund during this period, beinging over a half of the total FDI with RM65.3 billion worth investments [30]. According to studies of cross-border flows, a one percentage point increase in the FDI tax rate reduces FDI by an average of 3.7 percent. However, estimates vary widely, with most studies finding decreases ranging from 0% to 5% [31].

Finally, both countries are advised to be more selective in accepting FDI projects. Instead of accepting everything that comes their way in terms of FDI capacity and ability, the two countries should prioritize projects that best fit their wishes and conditions.

4. Conclusion

In conclusion, Germany and Japan are the hardest hit in the high-end automobile manufacturing industry, while emerging economies such as Vietnam and Malaysia can be seen as winners in this trade war, with sufficient product demand and foreign direct investment diverted to them due to low production costs. Because the two countries' FDI absorption capacity is limited, I focused on two key issues. Because Vietnam lacks infrastructure, more public transportation must be built as soon as possible to form a network. In the short term, the only way to solve Vietnam's labor problem is to attract foreign talent. In the long run, it still needs to improve its labor force education and training. Malaysia's current tax relief has had a significant impact on attracting investment and should therefore be maintained. Admittedly, the main limitation is only obvious correlation can be identified while correlation cannot be ruled out by other factors. Another concern about the findings was that only main problems in FDI absorption of developing economies are mentioned but inconspicuous problems, possibly and potentially serious weaknesses, are omitted, that may complement the entire policy if resolved. Considerably more work will need to be done to explore further into the supplement policies that would further increase the effectiveness of the main policy or mitigate possible fluctuations when implemented.

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