# Friendshoring is reconfiguring global trade

**From the Field**
October 2024


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## Key Insights

- As countries seek closer trading relations with geopolitical allies, opportunities will arise for friendly nations that can fill deficits in goods and services.
- Central and Eastern European countries will likely benefit from increased foreign direct investment, as will India and Vietnam.
- China may lose dominance in goods exports as companies shift production abroad.

Reports of globalization's death were, it seems, exaggerated. Despite claims that supply chain issues following the coronavirus pandemic would result in large-scale "reshoring," there is little evidence of an overall increase in companies bringing their manufacturing bases back home. There is, however, evidence that geopolitical concerns are continuing to reconfigure global trade patterns in other ways. We believe these changes will produce winners and losers, with clear portfolio implications.

Analysis by T. Rowe Price of data collected by McKinsey & Company reveals that "trade intensity" has been mostly flat in recent years, indicating that there is little evidence for countries preferring to produce domestically what they previously sourced from overseas, and indeed that geographic distance between trade partners has continued to increase. Crucially, however, our analysis shows that geopolitical distance between trade partners has been decreasing, suggesting that "friendshoring" (trading more with friends and less with perceived foes) is occurring.

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>
> – Ivan Morozov
> Sovereign Credit Research Analyst

### “Friendly” suppliers sought to plug U.S.’s gap in electronics and pharmaceuticals

(Fig. 1) China requires minerals and energy support from allied nations

| | | U.S. and Friends | | China and Friends | |
|---|---|---|---|---|---|
| | | Is there a deficit? | Do my friends make it? | Is there a deficit? | Do my friends make it? |
| **Resources** | Minerals | Yes, Small | Yes | Yes, Medium | Yes |
| | Energy | No | No | Yes, Medium | Yes |
| | Food | No | Yes | Yes, Small | Yes |
| **Manufactured Goods** | Electronics | Yes, Small | Yes | No | Yes |
| | Pharmaceuticals | Yes, Small | Yes | No | No |
| | Basic Metals | Yes, Medium | No | No | Yes |
| | Chemicals | Yes, Small | Yes | No | Yes |
| **Services** | Financial Services | No | Yes | No | No |
| | Professional Services | No | Yes | Yes, Small | No |
| **Intangibles** | Intellectual Property | No | No | Yes, Large | No |

As of August 31, 2024.
Source: McKinsey Global Institute. Analysis by T. Rowe Price.

The data show that the U.S. and China are clear geopolitical antipodes, with most other countries aligning primarily with one or the other. Europe is clearly aligned with the U.S. and has the highest concentration of like-minded partners, while Latin America shades toward the U.S. but less obviously than Europe. The Middle East and North Africa and sub-Saharan Africa shade toward China. Asia Pacific, Central Asia, and Eastern Europe differ widely at the country level.

## Geopolitical “gaps” carve out opportunities for friendly countries

How can we expect these trends to develop over the next few years? One way to answer this question is through “gap analysis,” which looks for gaps between what countries import and what their friends export and identifies possible future shifts in trade patterns. By mapping trade flows between countries and overlaying it with the concept of geopolitical distance, we can see which countries take what they need from their friends as opposed to from others (Figure 1).

Broadly speaking, the U.S. and its friends have a geopolitical gap in basic metals, whereas China and its aligned countries have gaps in intellectual property (IP) and professional services. This suggests that trade in these areas could be at risk, which in turn could mean that the U.S. and its friends may need to accept having less basic metals, while China may have to make do with less IP and professional services.

Where there are deficits that may be filled by friendly nations, opportunities may arise. For example, the West’s deficit in electronics may be met, at least partially, by exports from friendly partners. Similarly, China’s deficit in food production may be partially met by its allies. In these instances, friendly nations may gain share in key markets.

The opportunities arising from these geopolitical gaps are underpinned by changing macroeconomic conditions. China became the “workshop of the world” by exploiting its large and cheap labor force, but as it has become richer, that labor force is no longer so cheap. This has created opportunities for other countries (notably Vietnam and India) to use their own cheap labor supply to plug the gap.

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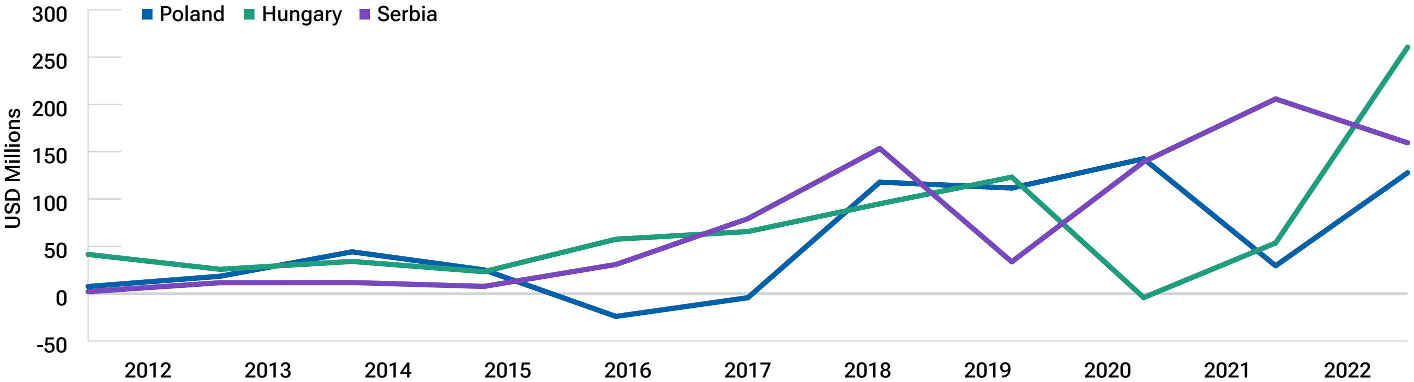
Another important consideration is foreign direct investment (FDI) flows, which are regarded as a key indicator of future trade patterns. One of the biggest developments in the aftermath of the pandemic has been a major shift in patterns of greenfield investment (whereby a parent company establishes a subsidiary in a foreign country and builds operations from the ground up). Since the pandemic, greenfield FDI has collapsed in China and Russia but surged in Africa, Europe, developed Asia, and India. This is consistent with the trend of the U.S. and European countries trading more with friends and less with perceived foes.

## China boosts investment in Hungary, Serbia, and Poland

(Fig. 2) Electric vehicle production is being shifted closer to final market in developed Europe.




As of December 31, 2022.
Source: China Ministry of Commerce/Haver Analytics.

## Shift in FDI flows could benefit Eastern Europe and India

Inevitably, these changes will produce winners and losers at both the country and sector level. At a country level, the winners are likely to include Central and Eastern European (CEE) countries that benefit from increased FDI flows from neighboring European countries and from China. The indications are that European firms will continue moving their production and value chains into lower-cost areas of Europe, predominantly CEE and the Balkans. At the same time, Chinese firms have boosted their investments in the region as they seek to move the production of electric vehicles closer to the final market in developed Europe. In 2022–2023, Chinese battery and component manufacturers announced more than EUR 10 billion (USD 11 bn) of investment in Hungarian factories alone, while Serbia has also been a major beneficiary (Figure 2).

India's geopolitical position between the U.S. and China, combined with its proximity to Asian markets and its low labor costs, make it an attractive destination for new FDI and production that has been redirected away from China. Indeed, there are signs this is already bearing fruit: Apple doubled its Indian iPhone production in the fiscal year 2023/24 alone, and now the company makes one in seven of the devices in India.

The Indian government's dedication to infrastructure investment has improved growth and kept inflation low, boosting investor confidence in India's macro stability. Since the pandemic, multinational companies have been shifting their middle- and back-office operations to India because of rising labor costs elsewhere, and we expect this trend to continue—improving India's current account over the long term.

Vietnam and other ASEAN countries are beginning to export more laptops and cellphones to the U.S. as manufacturers seek to reduce their exposure to China. So far, this has been largely symbolic as little production has actually been shifted to the region—the U.S. is likely just importing more goods that were produced in China but rerouted through other countries. However, as trade tensions between the U.S. and China show no sign of abating, it is likely that greater U.S. investment in production capacity in ASEAN countries will occur, probably at China's expense.

Overall, China looks set to be one of the biggest losers of shifting trade patterns as both changes in the competitiveness landscape in Asia and the global friendshoring trend are pushing investments away from the country. China has lost its cost advantage as unit labor costs have more than doubled, reaching or exceeding those of many other countries in the region, including South Korea, Taiwan, and Thailand. At the same time, growing concerns over supply chain stability are persuading major global producers to consider shifting their operations elsewhere.

We believe China may lose its dominant role in global goods exports as companies, including some Chinese firms, move production abroad. And while China will continue to play a major role in electric vehicle production, a large part of that production will be moved away from China to be closer to final markets in the U.S. and Europe.

Another loser likely will be Russia. After it invaded Ukraine, Europe's urgent need to diversify its energy supplies resulted in an 80% drop in trade between Russia and the European Union. There is no prospect of Europe sourcing oil and gas from Russia again at any scale, which will force Russia to reroute its energy exports through closer geopolitical partners such as China and India.

## New protections may boost U.S. auto parts manufacturers

At an industry level, U.S. auto original equipment manufacturers (OEMs) could be among the beneficiaries of an increasingly bifurcated global trade environment. Chinese OEMs are not currently selling into the U.S. market, but they are likely to try to do so within the next few years (they are expected to open plants in neighboring Mexico soon). New protections against these entrants would be positive for U.S. OEMs—if Chinese OEMs were allowed to operate freely in the U.S., it would effectively destroy any hopes that U.S. OEMs would be competitive in the electric vehicle market. And if Chinese auto OEMs face further barriers to operating in Europe (admittedly a big "if" at this stage), it could even create new opportunities for U.S. OEMs in what is currently a small market for them.

U.S. energy exporters may benefit from continuing focus on energy security following Russia's invasion of Ukraine and the subsequent reorientation of trade flows. With geopolitical distance of trade shortening, U.S. energy producers should have a larger slice of the pie from their aligned nations, even in a world in which energy transition is slowing the growth of the pie—or even shrinking it.

Pharmaceuticals and other medical-related sectors may also benefit from shifts in global trade. Most new drugs are developed in the U.S., western Europe, and Japan. China historically has not been a major pharmaceutical research hub, but it could become one over time as it has been investing heavily in domestic life science industries. U.S. and European biopharmaceutical companies have also begun to increase their research and development presence in China and in-license drugs discovered in China.

European auto OEMs—particularly those in Germany—may be among the losers from the push toward closer geopolitical proximity among trading partners. German auto OEMs have significant exposure to China, although this has been diminishing in recent years. Any moves to protect the Chinese market against European entrants could hit German OEMs hard. However, this could be offset to some degree if Chinese OEMs were also prevented from selling in Europe, which is a growing market for them.

European industrials, which have a relatively larger exposure to China than their U.S. counterparts, also appear at risk. Many firms operate joint ventures in China, and these could be under threat if tensions escalate to the point at which owning assets in China is regarded as politically unacceptable. There has already been an increase in political pressure on firms with operations in the Xinjiang region, including Volkswagen and BASF, amid heightened international scrutiny on forced labor using predominantly Muslim ethnic groups. If this proves to be the direction of travel, more European firms may be forced to review their operations in China.

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