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Long-Term Side Effects: Why Southeast Asia Should Be Cautious about Western Industrial Policy

Kevin Chen Xian An

SYNOPSIS

Southeast Asian economies may be benefitting from ongoing supply chain realignments, but they should keep an eye on the future as Western countries embrace industrial policy. The policy and its geopolitical drivers can hinder the growth of regional economies at best or expose them to punitive tariffs at worst. There are serious longer-term challenges that Southeast Asian governments must reckon with, as ***KEVIN CHEN XIAN AN*** *argues.*

COMMENTARY

In a recent Bloomberg interview, Malaysian Minister of Investment, Trade and Industry Tengku Zafrul Tengku Abdul Aziz observed that ASEAN member states have emerged as the biggest beneficiaries of supply chain realignment amid rising geopolitical tensions.

Tengku Zafrul's views on investments are likely to be welcomed by his fellow Southeast Asian trade ministers. After the economic doldrums caused by the COVID-19 pandemic, Southeast Asian countries would be happy to attract more investments to boost their economies. A similar opportunity arose during the 2019 trade war, where countries such as Vietnam benefitted handsomely as manufacturers embarked on "China+1" strategies.

Yet, the Malaysian minister also made an important qualification: that there are challenges in the longer term. The rise of industrial policy in the United States and the

European Union could disrupt the flow of investments into Southeast Asia, while the fragmentation of the global trading order along political lines threatens to undermine future partnerships.

Just as they benefitted from the earlier trade war, Southeast Asian governments should continue to attract new investors. However, they must also be clear-eyed about the broader threats that Western industrial policy and geopolitical competition pose to their economic well-being.

Reaping the Benefits of the 2019 Trade War

The US-China trade war began in earnest when the United States placed 25% duties on US$34 billion of Chinese imports in 2018, sparking a tit-for-tat cycle that left companies scrambling to relocate their manufacturing operations. American personal computer makers such as HP and Dell explored moving up to 30% of their notebook production out of China, and Chinese firms such as electronics company TCL planned similar moves.

Southeast Asia was a key destination for these investors. With low labour costs and friendly regulations, the region accounted for US$177 billion out of US$1.39 trillion in global foreign direct investment (FDI) in 2019, far ahead of other developing economy regions such as Africa. Vietnam, in particular, was a major beneficiary, with Chinese FDI into the country growing 5.6-fold year-on-year to US$1.56 billion between January and May 2019.

This is not to say that the trade war was wholly positive for Southeast Asia. The conflagration was an early sign of Washington's turn away from free trade and towards what then-President Donald Trump called "fair trade" – a model that claims to be reciprocal, but ultimately prizes US trade balance over comparative advantages. Trump also had a tendency to lash out at countries that crossed his path, labelling Vietnam the "single worst abuser of everybody" for allegedly allowing Chinese companies to reroute their exports. There were fears that a prolonged trade war would have severe consequences for the global trade environment.

Industrial Policy Strikes Back

These immediate concerns faded as Trump left office and a new wave of investments into Southeast Asia began. Tesla is planning to establish a regional headquarters in Malaysia. Indonesia is leveraging its nickel resources to pursue aspirations to account for over 75% of global nickel supplies from 2022 to 2029. GlobalFoundries opened a US$4 billion fabrication plant for semiconductor chips in Singapore, expecting a rebound in global demand.

However, early tremors from the Trump-era trade war have intensified. One of the most notable developments is Washington and Brussels' embrace of industrial policy, or government efforts to shape the economy by targeting specific industries, often going against market forces. While shunned for decades as an inefficient doctrine, "the Policy That Shall Not Be Named" was given a new lease on life as climate ambitions and geopolitical tensions intensified.

The US Inflation Reduction Act (IRA) was a key symbol of this change. The act offers US$7,500 in tax credits for each EV assembled in or containing battery components from the United States or one of its free trade partners, while excluding "foreign entities of concern", evidently referring to China.

While the IRA was criticised by the European Union, it also led to Brussels implementing its own tax breaks and benefits to support the European EV industry. The European Union has also started viewing China's EV imports with suspicion, even launching an investigation to determine whether they should implement tariffs.

Southeast Asian countries are poised to benefit from ongoing supply chain realignments, just as they benefitted from a rise in investments during the US-China trade war. However, regional governments should also be wary of a rise in industrial policy in the West, such as the US Inflation Reduction Act (IRA) on the assembly of EVs. While current trends can bring some short-term benefits, the West's turn towards industrial policy creates long-term challenges. *Image from Wikimedia Commons.*

Making the Best of a Bad Situation

As more major economies adopt industrial policies, their deeper pockets may create an FDI shift away from Southeast Asian economies as manufacturers clamour for better deals. Moreover, the increasing fragmentation of the global trading order along political lines poses significant risks.

Many Southeast Asian economies rely on Chinese expertise or funding to develop their industries, and they may find their market access restricted by wary Western governments. If manufacturer attitudes turn insular, moving from "China+1" to "anyone but China" to escape tariffs, it will be difficult for Southeast Asian economies to continue business as usual. At best, this turn would hinder their growth; at worst, a bad decision could expose them to punitive tariffs.

As such, while manufacturing realignment may bring abundant opportunities, Southeast Asian economies should prepare for stormy weather ahead. Economies that secure investments should leverage them to upgrade their workforce and industrial capacity. Intra-regional economic integration efforts such as the Digital Economic Framework Agreement (DEFA) should be prioritised at the ASEAN level, both to share economic strengths and enhance ASEAN's collective appeal to external investors.

Above all, Southeast Asian governments should understand that the global trading order that supported their growth for decades may be a thing of the past. They can still benefit from the ongoing supply chain realignment but should also make plans to prepare for the coming turbulence.

Kevin CHEN *is an Associate Research Fellow with the US Programme at the S. Rajaratnam School of International Studies (RSIS).*