Global Research

Special Report

Shop talk – Our annual GBA client survey

- Our 13th annual survey of manufacturers operating in China's Greater Bay Area (GBA) shows positive business momentum from 2021 being carried over into 2022. This was a nice surprise considering that the survey was conducted during peak COVID disruption.
- A closer look, however, shows many reasons to remain cautious, including the underperformance of smaller companies, rising costs, and weak investment appetite.
- We see a broadening range of push factors for relocating factories overseas. The rising need for both reliability and diversity mean that 'China+1' is gaining attention, favouring ASEAN. We expect the region to continue to attract FDI and grow its export share over time.
- Respondents continued to express strong confidence towards what the GBA can offer long-term, despite seeing little urgency to expand operations to new GBA cities for now.

Issuer of Report Standard Chartered Bank (HK) Limited

Important disclosures and analyst certifications can be found in the Disclosures Appendix

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Listening to our GBA clients

We conducted our first annual manufacturing survey 13 years ago to assess China's vulnerability to a worsening labour shortage and rising wages. In more recent years, the survey's focus has shifted to tracking the rise of the Greater Bay Area (GBA), given China's aspiration to create the world's largest city cluster by linking Guangdong, Hong Kong and Macau. The GBA is a microcosm of China's fast-transforming manufacturing landscape, as well as its innovation drive, emerging consumerism, financial opening, and the effectiveness of policy support. As such, looking through the GBA lens allows us to understand China better. This year's survey provides additional valuable insights into how clients have been dealing with recent COVID resurgence, rising non-wage costs, ESG upgrades, etc.

Optimism amid a confluence of headwinds

Faster expansion expected compared with 2021, despite the survey being conducted during peak COVID disruption

Our respondents saw their businesses expand in 2021 and expected that momentum to carry over into 2022 for most performance metrics we tracked (Figure 1). In particular, the increases in sales and orders are expected to improve the most, by an average of 1.0ppt and 1.1ppt y/y, respectively, this year. This in turn translated into (more modest) improvements in hiring, wages, profits and financing scale. All this could come across as either comforting or optimistic, depending on one's views on the global growth outlook amid high inflation, tightening monetary conditions and geopolitical disruptions, as well as local COVID situations and the weak real-estate market. Also, the survey results could have been worse, considering that this year's survey was conducted in the two months (April and May) that COVID resurgence peaked and growth troughed in China. We believe some of the results could be less favourable if the survey were conducted today given how many of the external and domestic headwinds have lingered since.

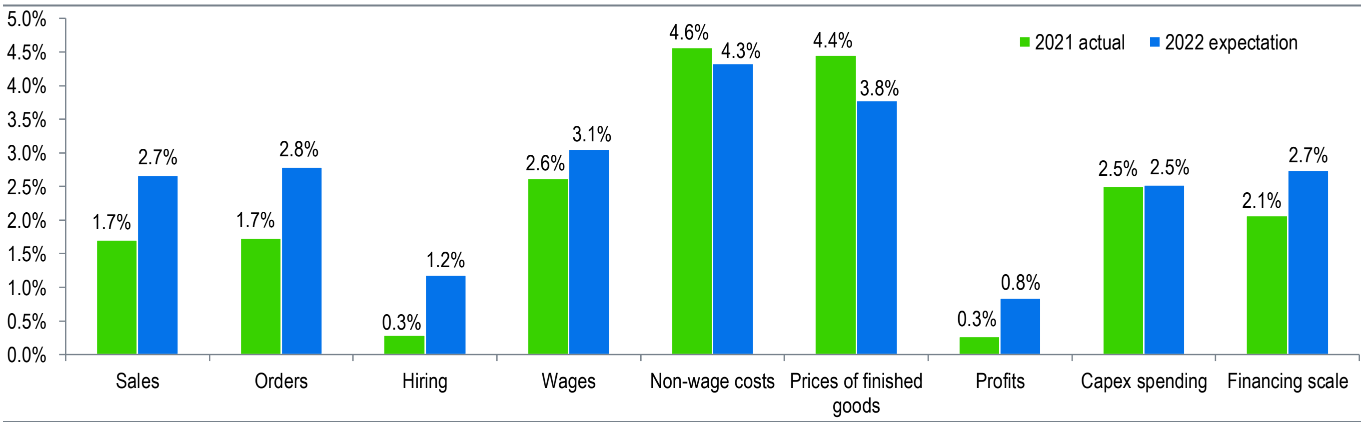
Reasons for caution remain aplenty

A deeper dive into the data sets and responses to the follow-up questions show many reasons to remain cautious.

- **Large versus small manufacturers:** Many signs point to smaller companies continuing to struggle. On average ,they performed materially worse than larger companies last year, across all business performance indicators; expectations for this year are not much better. Larger manufacturers also see labour-market tightness, while smaller ones continue to see slack in the labour market . Smaller companies are less eager to accelerate long-term plans like ESG.

Figure 1: Expectations holding up surprisingly well across business performance metrics

Respondents' average actual (2021) and expected (2022) change, %



Source: Standard Chartered Research

- **Dealing with rising costs:** Expected wage increases this year (3.1%) should remain manageable; the negative impact from high non-wage costs, however, appears broad-based and is expected to linger. 12% of respondents said they achieved full pass-through of higher costs, while another 26% said they were able to pass through over 50% of the cost increases. A majority 41% said they could pass through costs, but by less than 50% of the cost increases. The weak demand outlook could keep pass-through of higher costs difficult for now.

- **Weak appetite for long-term investment**: 34% of respondents said their plans to relocate operations overseas are still under consideration, and another 49% have not started considering a move yet. More respondents also said they would 'decelerate' their technology upgrading plans than those choosing to 'accelerate' this year. Cautious business sentiment implies weak appetite for long-term plans, explaining the absence of a pick-up in expected capex growth.

'China+1' favours relocation to ASEAN

More and more drivers pushing GBA manufacturers to expand their operations overseas, extending beyond their China operations

Although manufacturers seem in no rush to start new relocation projects, the underlying push factors for considering relocation not only remain valid and important but are also broadening in range. 16% respondents chose 'moving capacity out of China' as a means to deal with inflation challenges. On further asking survey respondents if China tensions with the US/EU and the COVID pandemic are driving them towards more actively considering moving capacity out of China, over 50% replied in the affirmative. All this echoes our view that, having been reminded of the weakness of supply chains during the pandemic and the rising uncertainty around US tariffs in recent years, the 'just-in-case' consideration has now gained more attention over 'just-in-time'; we believe 'China+1' is the way to go as GBA manufacturers need to balance between reliability and diversification.

In terms of preferred destinations, respondents continued to favour Vietnam, as in prior years. Of those choosing Vietnam as their investment destination, the majority 37% are in the electronics sector – a reflection of supply-chain robustness. While diversification of production capacity remains a top advantage offered by these preferred destinations, other factors like availability of good labour supply, new markets and incentives remain important too. Also encouraging is that a near-50% of respondents (up from 25% in 2019) now say they are benefiting from free trade agreements (FTAs).

GBA remains a promising long-term proposition

Cross-border flows of factors of production, which are crucial to the GBA's long-term integration and collaboration, have been significantly hindered since the pandemic started; and as our earlier survey findings show, the GBA has not been spared from macro headwinds. This makes Premier Li Keqiang's visit to Shenzhen in mid-August a very timely reassurance, confirming continued policy support to the region's long-term aspirations. Also a relief is that a majority 64% of respondents said the GBA would 'present new business opportunities' to them in the next three to five years, seemingly unaffected by the prevailing economic setbacks. In this report, we also asked clients their plans on expanding their operations in the GBA, and their interest in the Qianhai and Hengqin development zones. We also share how *our quarterly GBA Business Confidence Index* could complement this annual survey and help us track the region's continued evolution and keep a tab on topical issues over time.

GBA survey – 2022

Kelvin Lau
+852 3843 0711
Kelvin.KH.Lau@sc.com
Senior Economist, Greater China
Standard Chartered Bank (HK) Limited

How the GBA coped with disruptions aplenty

Could have been worse, all things considered

We surveyed over 200 GBA manufacturers during peak COVID disruptions in April and May

We recently conducted our annual client survey for a 13th straight year in 2022, over a two-month period in April and May, with over 200 manufacturers answering questions related to their current operations and business outlook. The surveyed companies are mostly headquartered in Hong Kong, Taiwan or mainland China, and all have manufacturing operations in the Greater Bay Area (GBA). Our survey respondents are among the more successful firms in the region, having survived a decade-long labour shortage and wage inflation, and in more recent years, worsening geopolitical tensions and a global pandemic. The strong profiles of our survey's participating corporates usually lend the survey results a positive tilt, and this year is no exception.

This year's survey was particularly well timed, falling right in the two months that COVID resurgence peaked in China; and while COVID restrictions in the GBA might not have been as stringent – and lockdowns not as extensive – as Shanghai's, the pandemic's latest round of impact on the GBA region's manufacturers remained a large driver of business expectations. In addition to gauging business performance and expectations, our clients' leading presence in the region makes them highly representative of the outlook for labour-market conditions, non-wage cost pressures, factory relocations out of China, industrial upgrading, ESG plans, and the effectiveness of policy support.

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

Overall business performance (*page 7*): Our clients said business improved nicely in 2021, and expected that momentum to carry over into 2022 for most performance metrics we tracked, but especially sales and orders. Prices and costs are expected to stay elevated this year. That said, the metric averages drop evidently once larger respondents are removed, meaning that smaller companies continued to struggle. COVID resurgence continued to top the list of concerns and, as per prior years, respondents remained most upbeat on China's market outlook versus other regions. We also asked for respondents' thoughts on the CNY outlook and ease of borrowing.

Labour, wages and other costs (*page 12*): Respondents expect wages to increase by an average 3.1% in 2022 after rising 2.6% last year. In real terms, however, wages appear much weaker adjusted for higher inflation this year. Moreover, while 16% said finding workers this year is less difficult than last year (versus 33% in last year's survey), labour-market slack remains evident among smaller manufacturers. Wages on average account for 17% of respondents' total cost base, exceeded only by raw materials at 23%. Almost 80% of respondents were able to pass on some cost increases to buyers. Investing in automation remains the top choice to deal with the wage and non-wage inflation challenges.

Factory relocation (*page 16*): 16% of respondents chose 'moving capacity out of China' as a means to deal with inflation challenges. 11% said 'COVID-19 pandemic' was a very strong driver for factory relocation overseas, versus 9% for US-China tensions, 5% for the Russia-Ukraine conflict, 4% for labour and wage challenges in the GBA, and only 1% for the launch of the Regional Comprehensive Economic Partnership (RCEP). Wide-ranging drivers suggest still-strong momentum behind the 'China+1' strategy. Diversification is the top benefit for moving, and Vietnam remains the top choice for factory relocation.

Industrial upgrading and ESG (*page 18*): Respondents did not plan to make significant progress on key innovations such as robotics and artificial intelligence this year. In comparison, respondents showed a tad more urgency in ESG, especially larger companies, 67% of which have ESG plans in place. Smaller manufacturers see funding as the main hurdle, versus talent for larger respondents.

Overall business performance

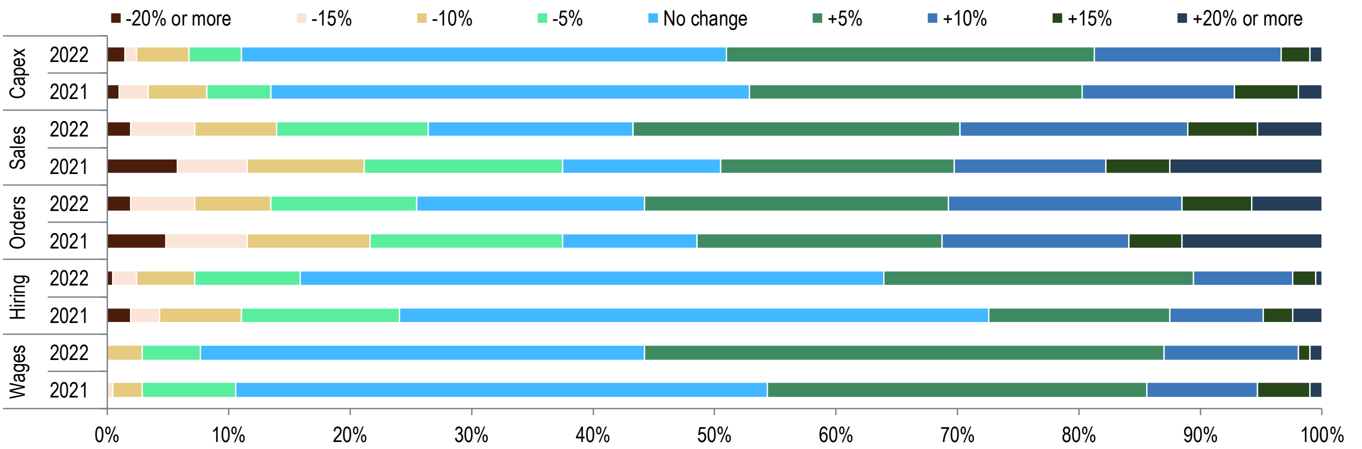
A bird's eye view of 2021 actual vs 2022 expectations

We asked our clients how their businesses performed in 2021 and what they expect for 2022 (Figures 1 and 2). Manufacturers said they recovered well last year, and generally expected the momentum to improve further in 2022. The momentum for 2022 may be better than the survey results suggest, given that the survey was conducted during peak concerns in April-May when respondents faced a confluence of domestic and global macro headwinds, which likely tempered some of the positive expectations.

Sales: Sales rose an average 1.7% in 2021 and are expected to rise 2.7% in 2022. The improvement is also expected to broaden out this year, with 57% of respondents expecting sales to rise (by an average 9.1%), versus 26% expecting a decrease (by an average 9.4%). In comparison, 50% reported better sales in 2021 (by an average 11.1%), versus 38% reporting worse sales (by an average 10.1%).

Figure 1: How did the following metrics change in 2021, and what are your expectations for them in 2022?

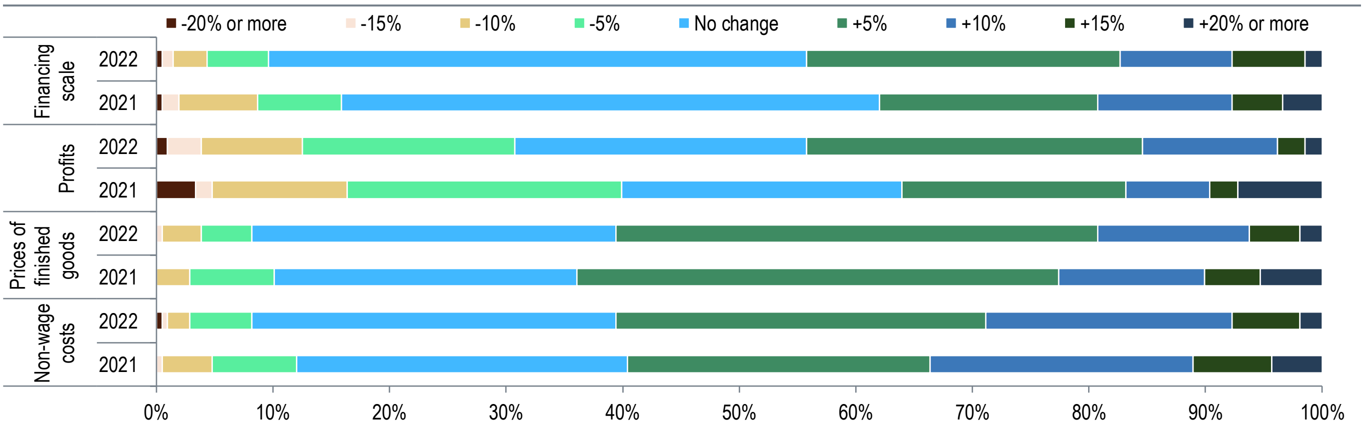
% of respondents



Source: Standard Chartered Research

Figure 2: How did the following metrics change in 2021, and what are your expectations for them in 2022? (cont.)

% of respondents



Source: Standard Chartered Research

Orders: Similar to the responses for sales, respondents reported orders rising an average 1.7% last year, and expected sales to increase 2.8% in 2022. 56% expect sales to rise by an average 9.3% in 2022, while 26% see an average decrease of 9.4%. 51% reported better sales in 2021 (by an average 10.7%), while 38% reported a drop in sales (by an average 10.1%).

Sales and orders expectations held up well despite looming growth challenges locally and globally

Responses on both sales and orders confirm that recovery was strong last year as China stayed open for business, cementing its status as the world's main production base while the rest of the world worked on vaccination rollouts and economic reopening. Responses on expectations were even better, coming across as either comforting or optimistic, depending on one's views on the global growth outlook amid high inflation, tightening monetary conditions and geopolitical disruptions, as well as local COVID situations.

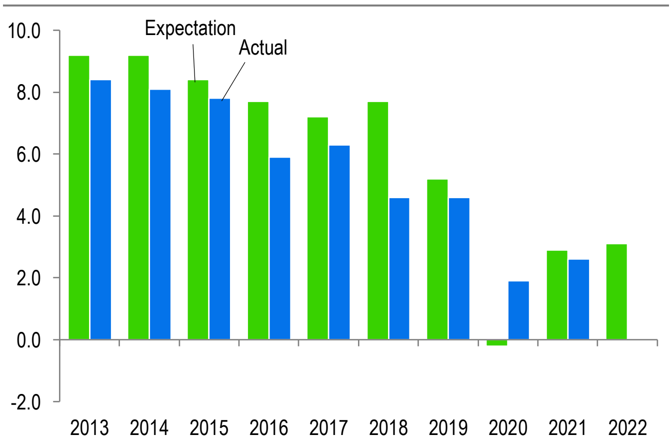
Hiring: On average, hiring is expected to rise 1.2% in 2022, a modest improvement from an actual 0.3% increase in 2021. 36% of respondents expect more (16% expected less) hiring this year, by an average +6.9% (-8.2% for those expecting less); in the year prior, 27% (24%) reported more (less) hiring, by an average +8.6% (-8.6%). We saw greater headcount increases in our pre-COVID surveys, reflecting cautiousness in expanding production capacity amid lingering uncertainty in the growth and orders outlook.

Wages: Respondents expect wages to increase by an average 3.1% in 2022, versus an actual 2.6% increase last year, which largely matched expectations from the 2021 survey (of a 2.9% increase). However, all these numbers are low compared with pre-COVID levels: 2018 and 2019 each recorded actual average wage hikes of 4.6%, based on prior surveys (Figure 3). A further breakdown showed that only 11% respondents lowered wages in 2021, while 46% hiked wages or were willing to hike; the corresponding expectations metric this year improved to 56% expecting an increase in wages and 8% expecting a cut. This modest but steady wage outlook may not be a bad thing – as it is not low enough to suggest excessive slack in the labour market amid recent COVID setbacks, but also not high enough to stoke inflation fears and limit policy headroom for further easing short-term.

Non-wage costs: Inflationary pressure looks likely to remain elevated outside of wages. Non-wage costs on average are expected to rise another 4.3% in 2022 after

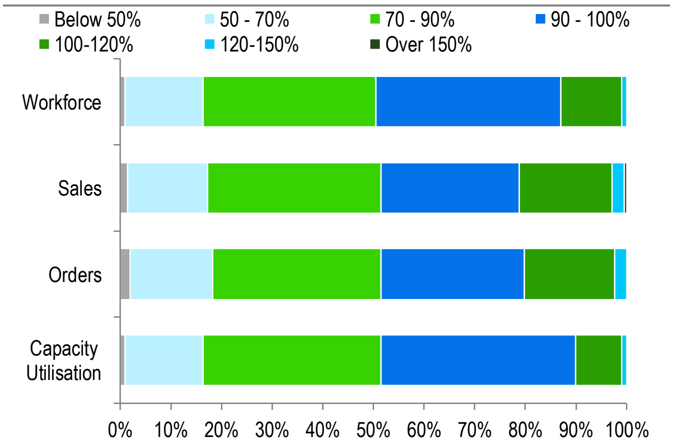
Figure 3: Wage expectations rebounding

Surveyed wage increase, expectation vs actual



Source: Standard Chartered Research

Figure 4: Where do the following metrics currently stand compared with pre-COVID levels? *(% of responses)*



Source: Standard Chartered Research

already picking up strongly by 4.6% in 2021. Around 60% of respondents reported actual and expected increases, while 8% expect a decrease in non-wage costs this year (compared with 12% who reported actual decreases last year).

Prices of finished goods: We see the rise of prices of finished goods in 2021 (4.4%) almost matching that of non-wage costs (4.6%); this cements the general impression that manufacturers likely faced little pushback in passing on higher costs to their buyers when businesses were recovering well last year. However, cost pass-through could face more resistance in 2022 as demand slows, weakening our respondents' bargaining power on price setting. Respondents expect an average 3.8% increase in prices of finished goods this year, lower than that of non-wage costs (4.3%).

Profit recovery looks to lag most other business performance metrics

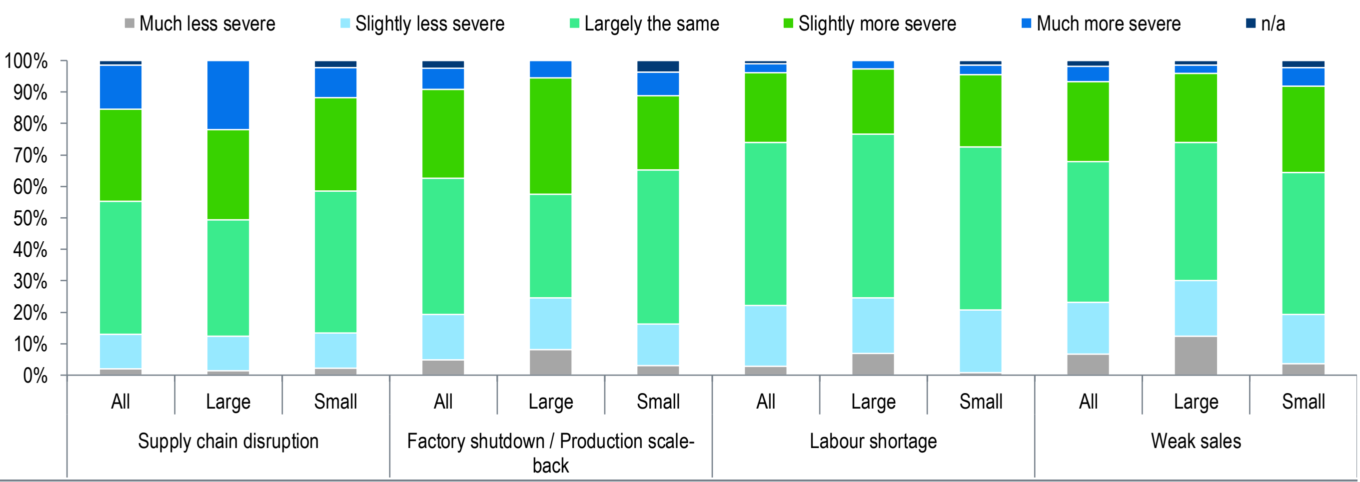
Profits: Even with decent pass-through of higher costs, manufacturers struggled to increase profits despite better sales and orders. 40% reported a decrease in profits in 2021 versus 36% reporting an increase, translating into a meagre 0.3% average increase in profits. Improvement is expected in 2022, with 44% seeing an increase in profits and a fewer 31% expecting a decrease, averaging an anaemic 0.8% rise in profits overall. Moreover, we note that these estimates are prior to the more recent rise in risks of monetary policy tightening and a recession in the West, in addition to lingering COVID-zero policy concerns and housing market challenges locally.

Capex: 47% of companies increased capital expenditure last year, versus 14% reporting a decrease; these numbers are expected to stay strong in 2022, with 49% expecting an increase and 11% a decrease. Both last year's actual and this year's expected change averaged +2.5%. This shows the underlying need for businesses to keep rebuilding their post-COVID production capacity over time.

Financial scale: The majority of respondents expect an increase in financial scale, matching the corresponding rises in other business aspects mentioned above, including sales, orders and capex investment. 38% reported an increase in financial scale last year, versus 16% reporting a drop; this improved to 44% and 10%, respectively, for 2022 expectations. On average, respondents see financing scale rising 2.7% this year, an improvement from an actual increase of 2.1% in 2021.

Figure 5: How severe has your business been affected by the following challenges related to COVID-19 resurgence this year compared with last year?

% of respondents, by size of company



Source: Standard Chartered Research

Gauging COVID disruptions (again)

We asked respondents where they currently stand compared to normal (pre-COVID) operational levels. At least 82% of respondents said they are currently operating at 70% or more of pre-COVID levels across all four business metrics: capacity utilisation, sales, orders and workforce strength (Figure 4). This is a clear (and unsurprising) improvement from 60-70% of respondents from last year's survey. Also, compared with a year ago, more companies are performing at above 100% on orders (20% vs 9% prior), sales (21% vs 10%), capacity utilisation (10% vs 5%) and workforce (13% vs 6%). Compared with these metrics, we noted fewer responses reporting above pre-COVID normal levels for capacity and workforce numbers, which reinforces the view that these usually expand with a lag compared with sales and orders, especially if lingering macro challenges make companies more cautious in committing to longer-term investment.

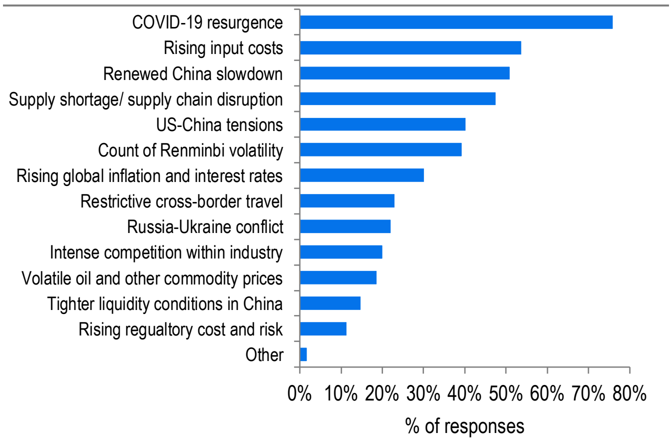
We then asked respondents how severely their businesses have been affected by this year's COVID resurgence specifically, compared with last year. Respondents were most affected by supply chain disruptions caused by COVID lockdowns, with 43% reporting a (slightly or much more) severe impact compared with last year, and only 13% citing a less severe impact. 35% also saw more (19% expected less) severe disruption from 'factory shutdown/production scale-back' this year, and 30% (23%) for 'weak sales' (Figure 5). In comparison, this year's COVID disruptions appeared to have a similar effect on 'labour shortage'. All this makes the aforementioned y/y improvements in business performance expectations even more impressive, especially given a lingering and evident COVID-related impact and the fact that our survey was conducted in April and May when COVID disruptions to production, sales and logistics peaked across many GBA cities, even though they were spared from Shanghai-style lockdowns.

A long list of business concerns for 2022

COVID resurgence unsurprisingly topped the list of concerns for 2022

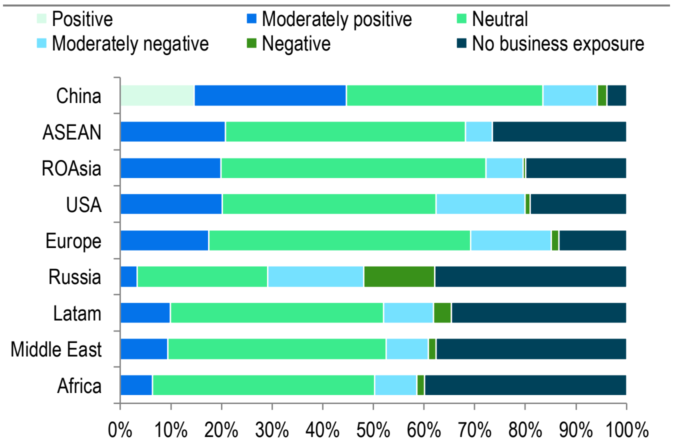
The timing of our survey was also likely the reason 'COVID-19 resurgence' topped the list of business concerns for 2022 (Figure 6). 76% of respondents cited it as a concern, versus the rest of the top five, which were 'rising input costs' (54%), 'renewed China slowdown' (51%), supply shortage/supply chain disruption' (48%) and 'US-China tensions' (40%). If the survey were conducted today, growth concerns may have received more votes (due to lingering domestic housing market weakness and growing

Figure 6: What are your biggest concerns for 2022?
% of responses



Source: Standard Chartered Research

Figure 7: Which other countries/regions do you do business with; what are your views on them in 2022?
% of respondents



Source: Standard Chartered Research

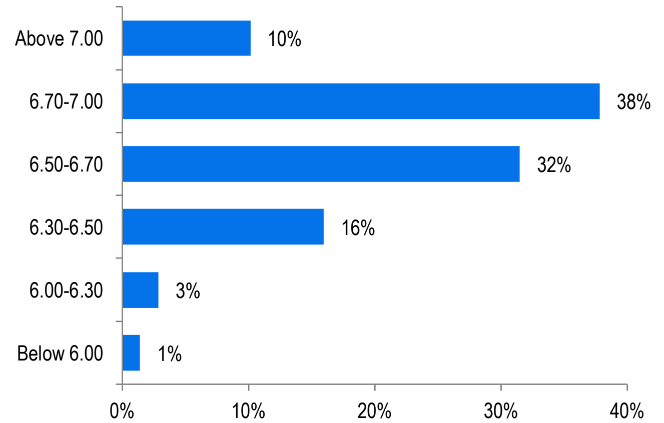
recessionary risk in the West from elevated inflation and tightening monetary conditions) and US-China tensions (following Nancy Pelosi's Asia visit). Instead, when this survey was conducted in April-May, 45% of respondents still held a positive view on China's 2022 outlook as a place of doing business despite the clear growth setback from China's stringent COVID measures (which cut Q2 GDP growth to 0.4% y/y) (Figure 7). This was evidently more positive than the outlook for the US (25%), Europe (25%), ASEAN (26%) and rest of Asia (26%). We believe the scores for China, the US and Europe could be less favourable if the survey were conducted today.

50% of respondents said they are already using Renminbi for settling international trade

'Renminbi volatility' was just outside the top five concerns, with 39% of the votes. As a follow-up question, we asked respondents where they see USD-CNY at the end of 2022 (Figure 8). 38% saw the pair ending the year between 6.70-7.00 (which is where spot is at the time of writing, with risk to the upside), and another 32% expecting 6.50-6.70 (i.e., modest CNY appreciation). This is largely consistent with our view that while USD-CNY may still see modest upside in Q3 because of a hawkish Fed and rising outbound dividend payments from China, beyond that the CNY will likely be supported by normalising growth, still-solid trade and current account surpluses, subsiding capital outflows, and a possible reduction in US tariffs on China imports. We see USD-CNY ending 2022 at around 6.60. A resilient CNY will support China's continued promotion of Renminbi internationalisation, in our view. 50% of respondents said they are already using Renminbi for settling international trade. Within this, 26% (13% of total respondents) said they plan to use more in 2022, versus 15% (7%) saying they would use less. Separately, another 14% of total respondents are currently non-users, but plan to start doing so in 2022 (Figure 9).

We also see some interesting observations at the lower end of the list of business concerns, where challenges like 'tighter liquidity conditions in China' and 'rising regulatory cost and risk" garnered 15% and 12% votes, respectively. Both could be a reflection of loosened policies (or expectations thereof) during April and May to lift growth amid stringent COVID lockdowns. That said, more respondents continued to see borrowing being 'harder' this year (32%) than those saying 'easier' (7%), indicating that (1) bank lending access could remain difficult against a weak economic backdrop despite policy easing; and (2) there are simply many other challenges more immediate/disruptive/concerning by comparison, pushing borrowing difficulty down the list (Figure 10). This echoes *the findings of our Q2-2022 GBA*

Figure 8: Where do you see USD-CNY at the end of 2022?
% of responses



Source: Standard Chartered Research

Figure 9: Have you been using Renminbi in international trade settlement? Do you plan to use more or start doing so in 2022? *(% of responses)*

Source: Standard Chartered Research

Business Confidence Index (GBAI), a separate quarterly survey of ours covering over 1,000 companies operating in the Greater Bay Area (GBA), where the current performance index for credit worsened due to respondents' weaker cash flow position, while the expectations index for credit held up well at 51.7 in Q2 (50 being neutral).

Larger companies more prone to supply/production disruption

Like last year, we once again compare the abovementioned metrics between larger companies (half of which based outside Hong Kong, and which account for c.35% of our 200+ respondents) and smaller ones. For one, larger companies performed evidently better last year across all business performance indicators, but especially 'sales', 'orders', 'profits' and 'hiring', where not only did they have the largest net difference in their average changes in 2021, but they had entirely divergent performances (e.g., a 8.5% increase in sales on average for large companies, but -2.0% for others). This year, we see less divergence for forward-looking survey indicators (even smaller companies expect broad-based improvements, except in 'profits'), but larger companies are still expected to outperform across all metrics (Figures 1 and 2).

COVID impacts supply chains more for large manufacturers, and sales for smaller companies

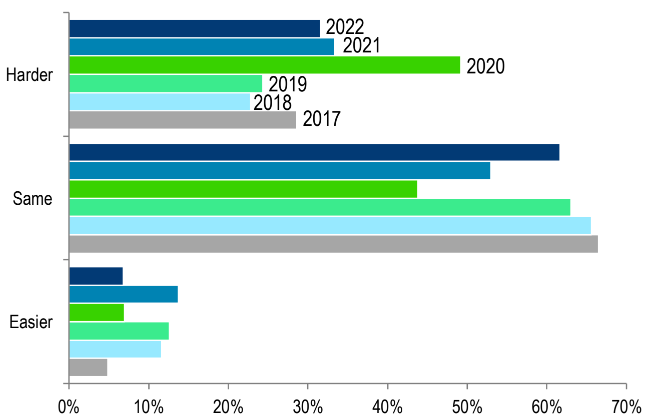
Compared now with pre-COVID levels, larger companies are operating at an average 7.1ppt above smaller companies on capacity utilisation, 11.2ppt on orders, 12.0ppt on sales and 9.8ppt on workforce size. Despite this, larger companies also reported more disruptions due to COVID restrictions this year to their supply chain (51% reporting 'more severe for large companies, versus 39% for others) and scale of production (43% versus 31%). This contrasts with smaller companies being more impacted by COVID-related labour shortage and weaker sales (Figure 5). The more sprawling scale of supply chains and production lines likely made larger companies more vulnerable to related disruptions, while smaller companies tended to suffer more from the broader economic slowdown. In any case, 'COVID-19 resurgence' topped the list of concerns regardless of business size (Figure 6).

Labour, wages and other cost pressures

Job creation remains a key policy focus

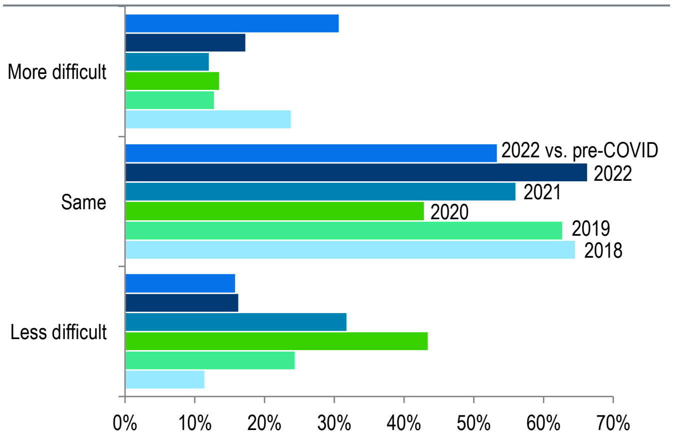
China has been de-emphasising its GDP target ever since the first COVID outbreak, as the target was too high during peak pandemic disruptions (2020, 2022), and too low in the 2021 recovery year off an abnormally low base. The policy focus has turned more towards ensuring quality of growth and supporting employment. This year's economic

Figure 10: How easy is it to borrow money compared with a year ago? *(% of respondents)*



Source: Standard Chartered Research

Figure 11: Is it more difficult for you to find workers this year than at the same time last year? *(% of respondents)*



Source: Standard Chartered Research

slowdown has particularly affected the youth labour market – youth (aged 16-24) unemployment rose to a high of 19.3% in June, with a risk of a further increase throughout summer as over 10mn new graduates enter the job market. At the State Council meeting in July, Premier Li Keqiang said that the government will strive to ensure that at least one person is employed in every family and to increase the hiring of migrant workers in government-funded investment projects. The government has also warned against discrimination against those who have tested positive for COVID and pledged to increase policy support for over 200mn in flexible employment.

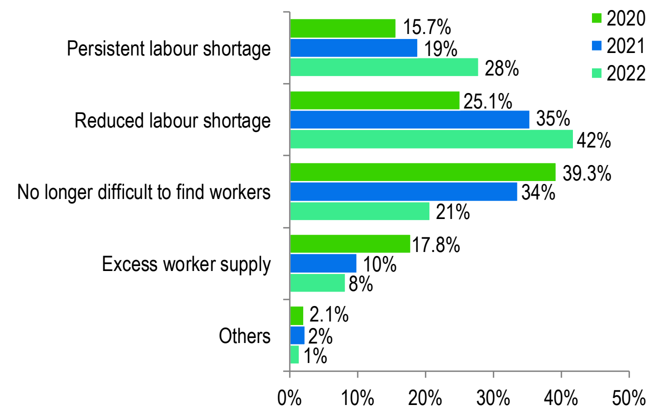
Our survey findings on hiring and wage increases appear less concerning, with respondents seeing a further improvement in labour-market conditions, plus modest acceleration in average wage growth for both last year's actual and this year's expectations. That said, we note that (1) our survey sample tends to perform better than the broader manufacturing population; (2) smaller respondents are still seeing evident slack in the market; (3) real wage growth could be much lower than normal, given the rising trend in CPI; and (4) labour market changes tend to lag the business cycle, meaning that more slack could emerge if more policy support is not forthcoming.

Larger companies see a tighter labour market

16% of respondents said finding workers this year has been less difficult than the same time last year (versus 33% in last year's survey, and 43% in 2020), indicating that COVID resurgence YTD has not led to a material increase in labour-market slack. This matches the 17% reporting more difficulty in hiring, up from 12% a year ago (Figure 11). Company size matters, however, as larger manufacturers generally see labour market tightness (with a net difference of +15ppt when 'more difficult' minus 'less difficult'), but smaller ones still see a slack (-7ppt).

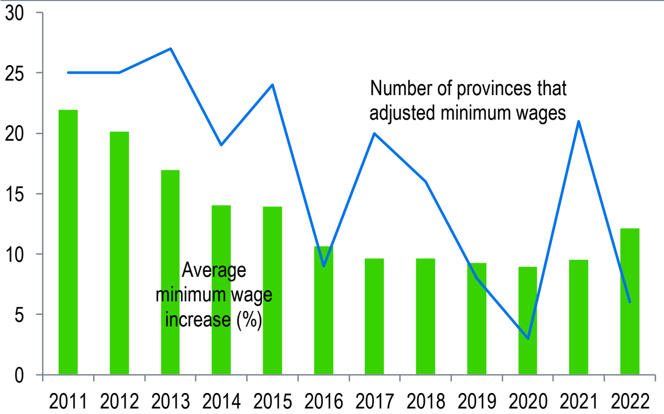
When asked to describe the current labour-market conditions in their respective industries, respondents echoed the finding that the labour market is seeing less slack but is far from returning to tight conditions. 28% see a persistent labour shortage versus 19% in 2021 and 16% in 2020; while still a minority, this is already back above the 23% pre-crisis level in 2019 (Figure 12). More importantly, this number goes up to 41% for just large companies, versus 21% for smaller ones. Separately, another 42% see a 'reduced labour market shortage', up from 35% prior, mainly at the expense of those reporting 'no longer difficult to find workers' (down to 21% from 34% in 2021) and 'excess worker supply' (to 8% from 10% prior).

Figure 12: How would you best describe the current labour market situation of your industry?
% of responses



Source: Standard Chartered Research

Figure 13: 6 provinces hiked minimum wages so far this year, by an average 12.2% *(number of provinces; average % of minimum wage increase)*



Source: Standard Chartered Research

Wages growth looking less attractive in real terms

Rising inflation means less rate growth in real terms

In last year's survey, respondents expected wages to rise by an average 2.9%; this turned out to be rather accurate, as this year's survey showed an average 2.6% increase in wages in 2021 (Figure 3). This year, we see a 11.5ppt increase in respondents expecting wages to rise 5%, mostly at the expense of those choosing the 'no change', 'up 15%' and 'down 5%', which were down 7.2ppt, 3.4ppt and 2.9ppt, respectively, from last year's actual numbers. This points to average expectations of a 3.1% wage hike in 2022, which is still modest versus pre-COVID levels; moreover, we see an implied y/y slowdown in real terms based on our estimate of annual CPI inflation, which rises to 2.2% in 2022 from 0.9% last year.

Policy pressure limited on wages

Government policies, in view of the need to support employment and provide relief to manufacturers amid COVID disruptions and economic slowdown, have been doing their fair share of heavy lifting in easing wage cost pressures. More than 50% of respondents reported 'material pressure' on their business from minimum wage requirements (53%) and social insurance (54%); within that, over 70% (or almost 40% of total respondents) saw policy easing relieve both pressures. Another c.30% of total respondents saw limited pressure from both policy requirements thanks to policy easing (Figure 14).

Only six provinces hiked their minimum wage so far this year, by an average 12.2% (Figure 13). This followed on from 21 provinces hiking last year by an average 9.6%. The reason why many more provinces hiked minimum wages last year was in part due to catching-up, as the policy requires provinces to hike minimum wages once every two to three years, and only a total 11 provinces hiked in 2019 and 2020 combined.

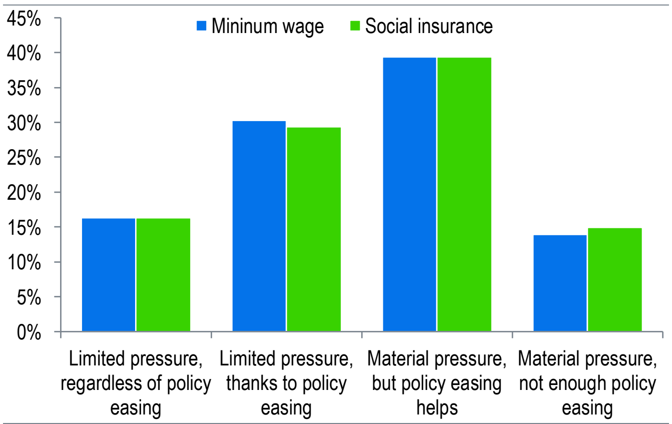
Impact of wages on overall costs

Rising non-wage cost pressure capped wage's share in respondents' total cost base

Wages on average account for 17% of respondents' total cost base (Figure 15). Breakdown shows 15-20% being the largest bracket (22%), followed by 10-15% (20%) and 5-10% (18%). This is in quite a contrast with last year's survey results, when there was a convergence towards the 20-30% range, which accounted for over 50% of all responses (this year's corresponding share is only 26%). We believe this smaller share of wages in total costs is a result of other cost items (raw materials, energy, transportation and logistics) facing much more upward pressure in the past

Figure 14: How great is pressure on business from policy requirements? Has easing helped?

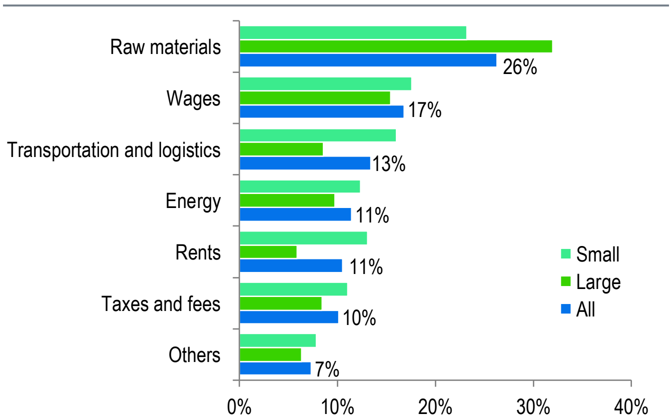
% of respondents



Source: Standard Chartered Research

Figure 15: Composition of respondents' total cost base

*% of total costs, respondent average**



* Does not add up to 100%; Source: Standard Chartered Research

year, as opposed to wages falling. This echoes the broader perception in the market that while any relief from wage pressure is welcome, other cost items remain challenging for manufacturers.

Other, and more worrying, cost pressures

Raw materials account for an average 26% of respondents' cost base. This is followed by wages at 17%, transportation and logistics at 13%, and energy and rent at 11% each. We know from the aforementioned questions that non-wage costs are expected to rise again by an average 4.3% in 2022 after rising strongly by 4.6% in 2021. We followed up by asking respondents how they see various areas of non-wage inflation changing this year. Unsurprisingly, 79% of respondents saw both 'raw materials' and 'transportation and logistics' costs rising either slightly or significantly; 'energy' was a close third at 69%. 'Transportation and logistics' had a particularly large number of votes for 'rising significantly', at 43%. Results were similar when we asked how respondents see such expected changes in costs impact their business this year. 77%, 71% and 67% said they see at least some negative impact from higher costs for 'transportation and logistics', 'raw materials', and 'energy', respectively (Figure 16).

All this matched the results from *our Q2-2022 GBA Business Confidence Index (GBAI)*, which is a separate survey we run quarterly, in which we also asked respondents to identify the biggest source of inflation pressures.

How to deal with higher costs

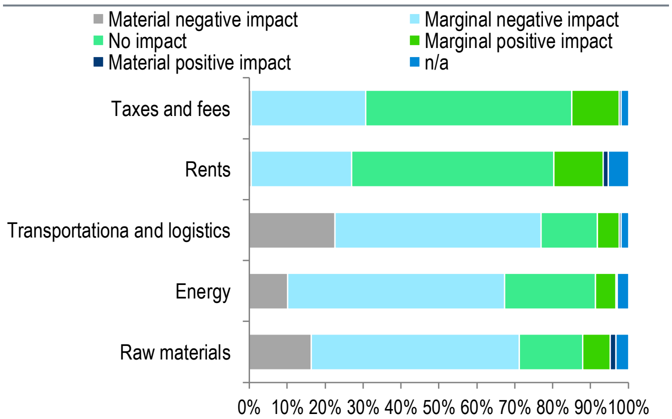
Almost 80% respondents were able to pass on at least some of the rising costs to buyers

We asked respondents whether they have been able to pass the higher costs onto their buyers (Figure 17). 12% said they achieved full pass-through, while another 26% said they were able to pass through over 50% of the cost increases. A majority 41% said they could pass through costs, but by less than 50% of the cost increases. This adds context to why (actual and expected) profit growth, mentioned in the previous section, remained anaemic despite improving sales, orders and even prices of finished goods, which alone should hint at more favourable responses on the pass-through question.

'Investing more in automation/streaming processions', at almost half the votes (48%), ranked at the top on the question of 'what other ways is your company pursuing/will pursue to deal with wage and non-wage inflation challenges'. 'Exploring suppliers who charge lower prices' (38%), 'cutting costs in other areas (e.g., marketing, R&D)'

Figure 16: How do you see each of the expected change in cost items impacting your business this year?

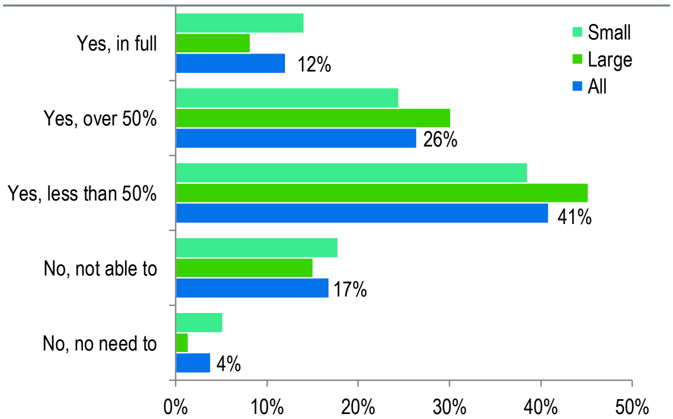
% of respondents



Source: Standard Chartered Research

Figure 17: Has your company been able to pass through higher costs to buyers?

% of respondents



Source: Standard Chartered Research

(33%), and ‘upgrading /diversifying products’ (32%) rounded up the next top three spots (Figure 18). Interestingly, larger companies tended to favour the top pick of automation even more (70%), whereas smaller companies had less variance in votes across the top three choices, echoing views that size matters when it comes to ease of making wholesale upgrades and other investments to boost productivity.

Factory relocation

More reasons to go ‘China +1’

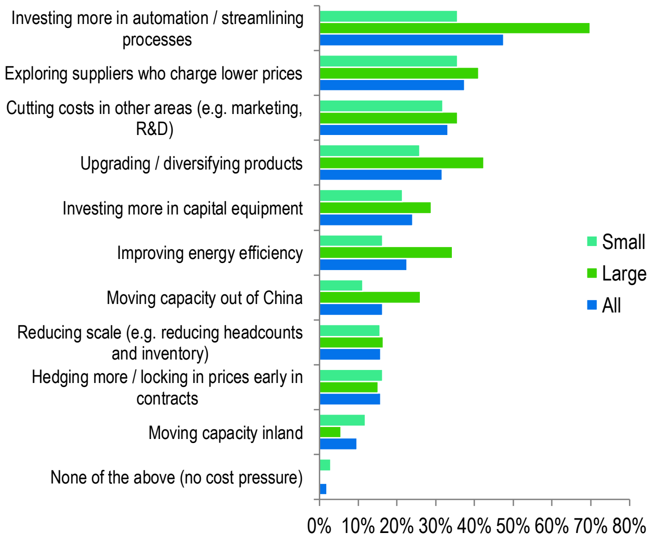
A broadening range of drivers for overseas factory relocation

Interestingly, 16% respondents chose ‘moving capacity out of China’ as a means they are pursuing/will pursue to deal with inflation challenges (or 26% and 11% for large and small respondents, respectively). Separately, we asked respondents whether various factors are driving their companies towards more actively considering moving capacity outside of China. 11% said the ‘COVID-19 pandemic’ was a very strong driver, versus 9% for ‘US-China tensions’, 5% for the ‘Russia-Ukraine conflict’, 4% for ‘labour and wage challenges’ in the GBA, and only 1% for the ‘RCEP launch’. These numbers go up to 50%, 53%, 35%, 47% and 33%, respectively, when we include the ‘yes, this is part of our consideration’ responses (Figure 19). This confirms the general perception that while labour and wage pressures remain a valid and important traditional push factor for GBA manufacturers to consider moving factories overseas, other drivers just as important (if not more) have indeed been emerging in recent years.

All this means that GBA companies likely have an increasing range of reasons to consider relocation, as many of their challenges are likely to stay for longer, including the need to reduce concentration risk to avoid supply chain and/or market access disruption, be it due to COVID resurgence or worsening geopolitical tensions. At the same time, we continue to believe that the continued exploring of overseas options does not necessarily point to an upcoming exodus of existing GBA factories. Instead, the need for business diversity and resiliency means that the ‘China+1’ approach may be increasingly favoured.

Figure 18: What ways is your company pursuing/will pursue to deal with wage/non-wage inflation challenges?

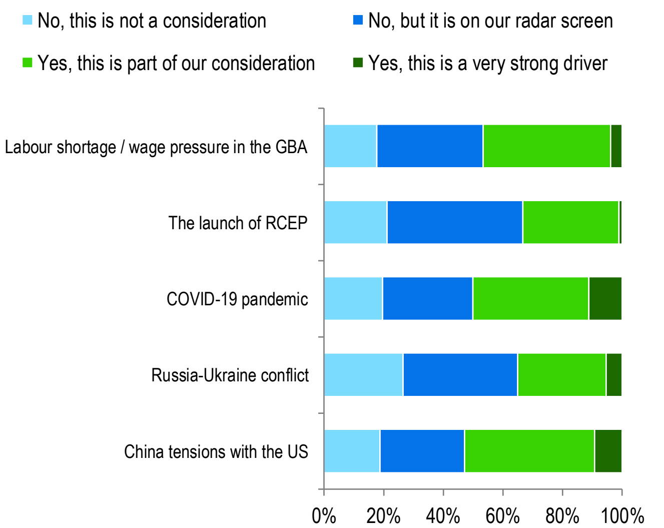
% of respondents



Source: Standard Chartered Research

Figure 19: Are these factors driving you towards more actively considering moving capacity outside of China?

% of responses



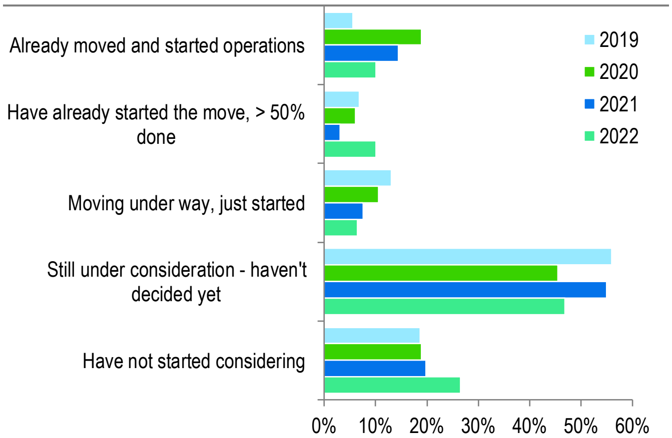
Source: Standard Chartered Research

Manufacturers seem in no rush to start new relocation projects

We asked respondents at what stage of moving capacity they were in. Among our 200+ respondents, only 7% said they had already moved and started operations. Another 7% (4%), said their moves were already more (less) than 50% done. The majority, however, has yet to take action – 34% said their plan to move is still under consideration, and the remaining 49% have not started considering a move yet (Figure 20). All this continues to give the impression that there is little urgency for GBA manufacturers to put relocation plans into action; while prior projects have carried on, companies that have started or completed relocation projects are not apparently rushing to start new relocation moves.

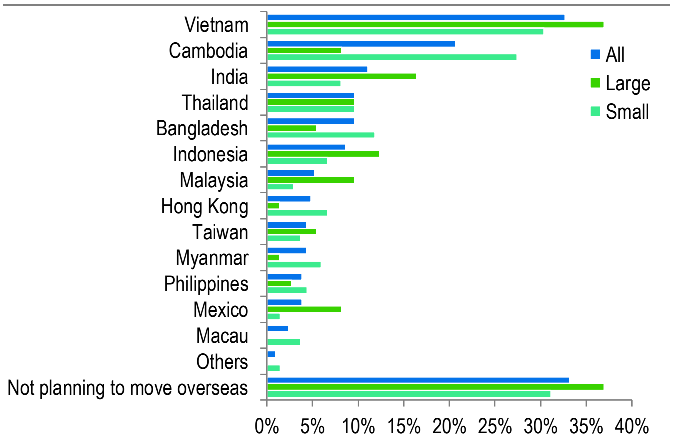
As with our previous surveys, it is worth stressing that the actual proportion of manufacturers who already have operations overseas could be much higher than stated above, given how long factories have been facing labour and other challenges; they simply may not need to relocate more than they already have, likely perceiving themselves as diversified enough to handle trade headwinds and/or COVID disruptions, and deciding to focus more on industrial upgrading for now.

Figure 20: What stage of moving are you at?
% of respondents



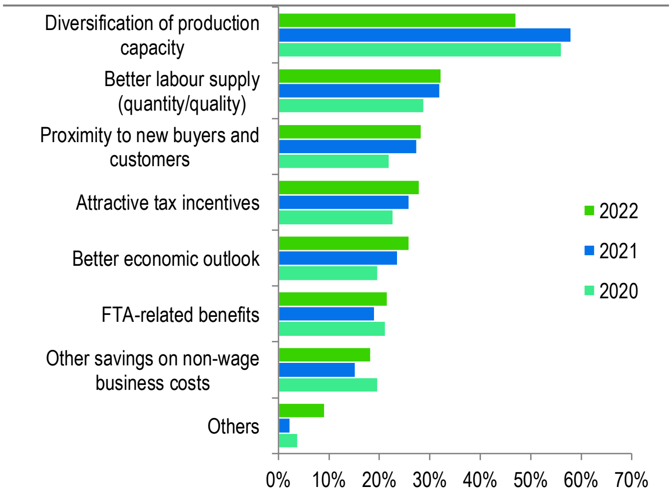
Source: Standard Chartered Research

Figure 21: If you plan to move capacity out of China, to where? *(% of responses)*



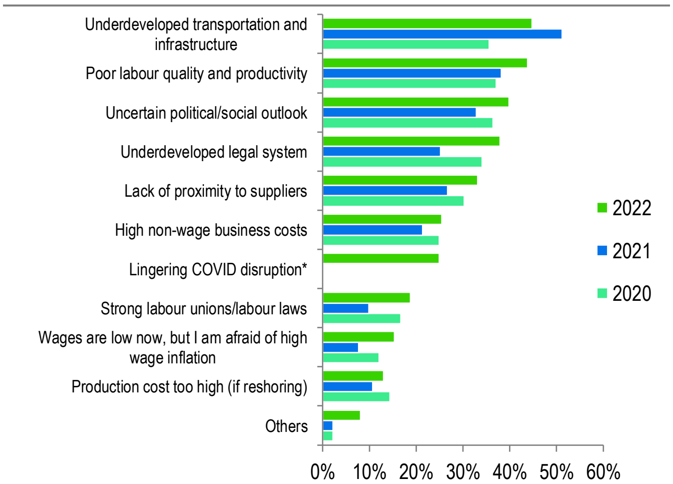
Source: Standard Chartered Research

Figure 22: Non-wage advantages of relocating factories
% of responses



Source: Standard Chartered Research

Figure 23: Concerns about relocating factories overseas
% of responses



* New option added this year; Source: Standard Chartered Research

Location, location, location

In terms of preferred destinations if they plan to move, respondents continued to favour Vietnam, as in prior years (Figure 21). Notably, the top two preferred destinations in prior years – Vietnam at 33% and Cambodia at 21% – gained more votes for a second straight year. Bangladesh also gained 1ppt, but still dropped one place to the fourth, with India overtaking from seventh place. Thailand, Indonesia and Mexico were the other notable gainers this year, up 5ppt, 3ppt and 3ppt, respectively.

The results continue to 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. The exception to this result is Vietnam, which is favoured by a wider range of industries; the rise of the likes of India and Thailand however could be an indication of outbound electronics manufacturing moving up the value chain, while Mexico could be a sign of geopolitical diversification.

47% of respondents picked production diversification as a key non-wage benefit from relocation, a modest drop from 58% in 2021 and 56% in 2020 (Figure 22). All other options gained at the expense of this, but the overall rankings started the same from last year, starting with 'better labour supply' in second place (32%), followed by 'proximity to new buyers and customers' (28%), 'attractive tax incentives' (28%), 'better, 'better economic outlook' (26%), and 'FTA-related benefits' (22%).

The top three hurdles for relocating factories to the preferred locations remains the same this year as last, albeit less varied (Figure 23). 'Underdeveloped transport and infrastructure' came in at 45% (vs. 51% prior), followed by 'poor labour quality and productivity' at 44% (38%) and 'uncertain political/social outlook' at 40% (33%).

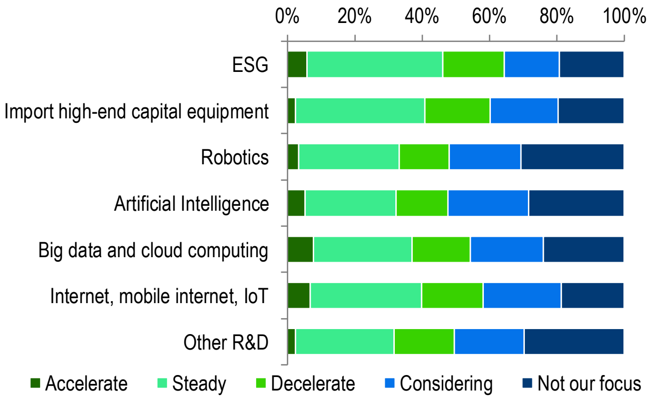
Industrial upgrading and ESG

Technology upgrading remains slow for smaller companies

More companies planning to decelerate than to accelerate technology upgrading plans

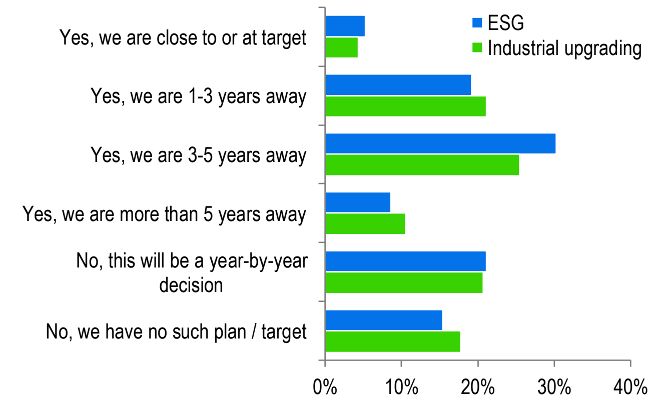
Respondents told us they expect to maintain their capex investment growth in 2022 level with last year's, at an average 2.5%, with 49% expecting an increase and 11% a decrease. This shows the underlying need for businesses to keep rebuilding their post-COVID production capacity over time, possibly aided also by (actual or expected) easing in onshore credit conditions. 'Investing in automation' also topped the list of ways respondents deal with wage and non-wage inflation challenges, meaning more capex is needed. All that said, when asked about their 2022 technology investment plans, respondents choosing 'deceleration' still exceeded those picking 'acceleration' for a third straight year, this time by an even larger margin of an average 13ppt across all upgrading initiatives, versus 6ppt prior (Figure 24).

Figure 24: What are your plans for industrial upgrading and ESG in 2022? *(% of respondents)*



Source: Standard Chartered Research

Figure 25: Do you have a long-term target for ESG and industrial upgrading? *(% of respondents)*



Source: Standard Chartered Research

'Importing high-end capital equipment' posted the largest negative net decrease of 17ppt; this was followed by 'robotics' and 'internet, mobile internet, IoT', both at 12ppt. 'Artificial intelligence' and 'cloud computing' were relative outperformers, with net decreases of 10ppt. All that said, size matters in terms of respondents' appetite for innovation. Looking at larger companies alone, more of them actually chose 'acceleration' over 'deceleration' for four of the five upgrading areas, with the exception being 'importing high-end capital equipment' which had a zero net difference. The flip side, however, means that smaller companies in fact have even larger negative net decreases (in the range of -17ppt to -26ppt) than overall averages.

This indicates that lingering disruptions from COVID and possibly technology regulatory uncertainty have indeed been a drag on China's technology drive in becoming more self-reliant on innovation and establishing a more complete manufacturing ecosystem, which we believe is a crucial part of the 'dual circulation' strategy cited in its 14th Five Year Plan (FYP) in response to potentially persistent US-China tensions and the GBA's ongoing transformation, with high-end manufacturing attracting skilled talent and boosting the region's population. Our findings especially point to the need for more policy support for smaller manufacturers.

Hurdles to industrial upgrading

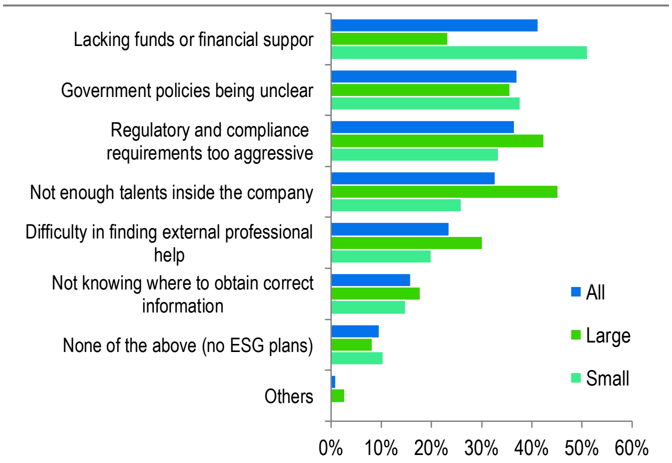
High costs and uncertain outlook are the two main hurdles for technology upgrading

This brings us to the next question of what the biggest hurdles are for respondents' industrial upgrading in 2022 (Figure 27). Smaller manufacturers ranked 'too costly to implement' (53%), 'uncertain economic/business outlook' (51% and 'rising funding costs/difficult to access funding' (41%) as their clear top three, supporting calls for more financial support but also broader policies to restore business confidence in an economic recovery. Larger respondents shared the same top two choices (at 52% and 48%, respectively), but ranked 'lack of expertise/talent to pursue innovation' (36%) instead. Also interestingly, larger companies have higher votes for 'haven't decided/need more strategic thinking' (33%) than smaller ones (20%).

Back to having an upgrading plan

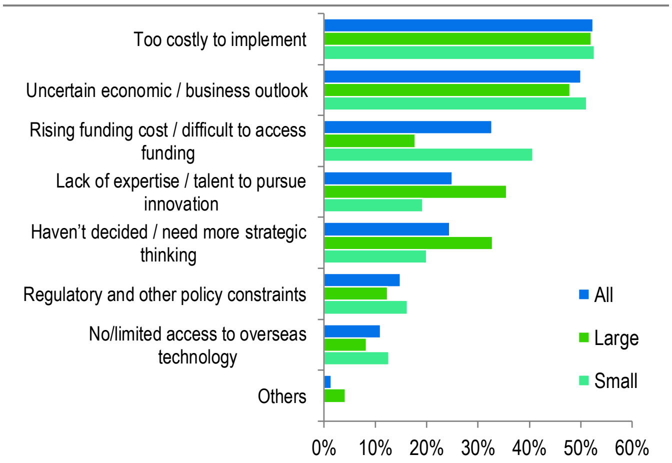
62% of respondents said they have a long-term upgrading target (of which 34% said they are 1-3 years from reaching their target, and another 41% said 3-5 years). This is an improvement from 54% and 53% in 2021 and 2020, respectively, having an upgrading target, returning this year to 2019 pre-COVID levels of 63% (Figure 25).

Figure 26: What are the challenges for achieving your ESG goals? *(% of responses)*



Source: Standard Chartered Research

Figure 27: What are the biggest hurdles to your industrial upgrading? *(% of responses)*



Source: Standard Chartered Research

Some companies making good ESG headway

This year, we added some ESG-related questions alongside those regarding industrial upgrading plans, as they are both long-term investment projects in nature. This also matches the evident rise in awareness and policy push regarding ESG since our last survey; in late October 2021, the Chinese Communist Party (CCP) and State Council *introduced top-level guidance* on achieving carbon neutrality by 2060, along with an action plan to reach peak emissions by 2030. Achieving peak emissions by 2030 would require a cut in carbon intensity by roughly one-third in the next 10 years; we think this is challenging, though feasible, in light of China's track record and gradually declining potential growth. But that also means that, over time, GBA manufacturers will not be spared from such aggressive transformation pains; chances are that the action plan to shift away from energy-intensive industries and a coal-dominant energy mix will start picking up speed again once economic growth stabilises over the course of H2-2022, meaning that manufacturers need to start planning ahead.

Respondents appear slightly more eager to participate in ESG compared with industrial upgrading

18% of respondents chose 'deceleration' when asked about their 2022 ESG plans, versus 6% (Figure 24). While this looks to put ESG on par with various other innovation strategies, a further breakdown shows slightly greater urgency for ESG, with its proportion of 'steady' respondents being the highest, at 40%. ESG also had the lowest responses for 'considering' (16%, versus an average of 22% for industrial upgrading) and 'not our focus' (19%, versus 25%), indicating its broader implications across GBA manufacturers, but also it being more ready to grow from a lower base.

That said, attitude towards ESG varies even more by company size compared with technology upgrading. Larger companies appear eager to accelerate their ESG plans (15% choosing that versus 1% for deceleration), while smaller companies were the extreme reverse, with only 1% reporting acceleration versus 27% reporting deceleration. 51% of smaller companies saw 'lacking funds or financial support' as the main challenge for achieving their ESG goals; this is much higher compared with larger companies, with only 23% citing that as a hurdle (Figure 26). Large companies, in contrast, chose 'not enough talent inside the company' as their top challenge. Both large and small manufacturers had 'government policies being unclear' and 'regulatory and compliance requirements too aggressive' rounding out the top three spots; addressing them would go a long way in sustaining China's long-term ESG drive.

67% of larger manufacturers currently have a long-term target for ESG; within this, 31% and 49% have targets of 1-3 and 3-5 years out, respectively (Figure 25). An overall 5% said they are close to or at target (8% for larger respondents, and 4% for smaller ones); another 21% said this would be a year-on-year decision, plus 15% no having any such plans/targets (the latter at 10% for larger companies, and 19% for smaller ones, again leading back to the call for more financial and regulatory support).

GBA – The long-term project

Kelvin Lau
+852 3843 0711
Kelvin.KH.Lau@sc.com
Senior Economist, Greater China
Standard Chartered Bank (HK) Limited

Playing the long game

Staying committed during rough times

Premier Li's visit confirms continued policy support

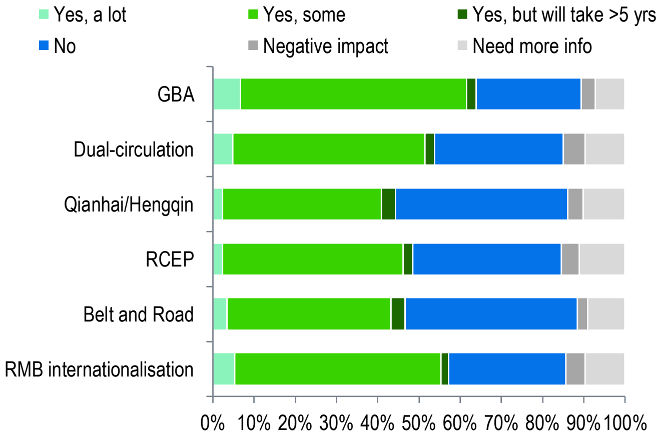
Weathering short-term headwinds while not losing sight of the long-term prospects

In the previous sections of this report, we looked at how manufacturers performed and what their expectations are. Now we turn to how the region's ongoing transformation is shaping up. The COVID outbreak has caused many disruptions in recent years, including extensive hindrance to cross-border flows of factors of production, which are crucial to the GBA's long-term integration and collaboration. This setback to the region's transformation was made somewhat easier to swallow for much of 2020 and 2021 as China recovered from the initial wave of outbreak earlier than the rest of the world. This made the GBA one of the most reliable production centres at a time that other manufacturing hubs were taking their time to reopen. However, 2022 has turned more challenging as other centres have caught up on production, while China's economy faces multiple challenges (COVID resurgence, a weak property market, technology regulatory uncertainty) and a slowdown. For externally oriented industries, plenty of headwinds remain on the horizon, including the Russia-Ukraine conflict, high commodity prices and global inflation, monetary policy tightening by major central banks, and rising recession risk among major Western economies. As seen in the previous section, cautious business sentiment implies a weak appetite for long-term plans such as capex, factory relocation and industrial upgrading.

Premier Li Keqiang's visit to Shenzhen in mid-August was therefore widely seen as timely and reassuring. Li was the first member of the Politburo Standing Committee to make a public appearance since early August, when top leaders had their annual closed-door meeting at Beidaihe. During the visit, Li called for sustained economic momentum, specifically the need to "heighten the sense of urgency so we can consolidate the foundation for economic recovery". Li's call for Shenzhen to "shoulder greater responsibility" in supporting the economy was also viewed as an endorsement of the GBA's importance in driving nationwide growth, and a top-down commitment to the region's further integration, which would allow it to spearhead a nationwide transformation over time. Given the diverse nature of Shenzhen's (and the GBA's) economy, Li's visit likely boosted confidence in not only the export sector but also the recently struggling real estate and technology sectors.

Figure 1: Which of these drivers present new opportunities to your business in the next 3-5 years?

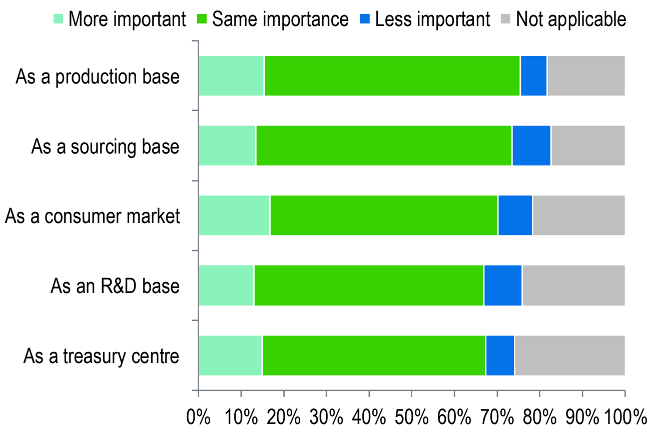
% of respondents



Source: Standard Chartered Research

Figure 2: How will the GBA market's importance to your business group change in the following areas?

% of respondents



Source: Standard Chartered Research

Respondents' long-term optimism towards the GBA unfazed by recent macro setback

GBA tops long-term policy drivers for businesses

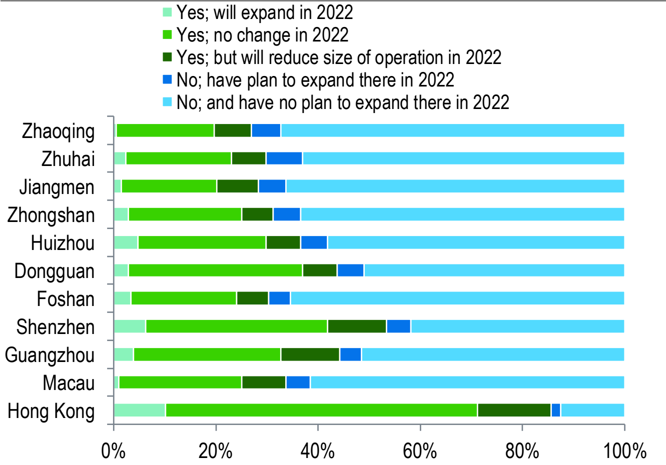
The authorities' commitment to the GBA echoes our clients' still-strong confidence in the region. A majority 64% said the GBA would 'present new business opportunities' to them in the next three to five years (Figure 1). This almost matched last year's 66%, which means that our manufacturing respondents have seen little impact YTD from COVID and economic setbacks on the region's long-term attractiveness as a place to do business. This response was also the highest among other long-term policy drivers, maintaining its lead over 'Renminbi internationalisation' (57% this year vs 60% prior), the 'Belt and Road initiative' (47%, 50%), the 'dual circulation' strategy under the 14th Five-Year Plan (FYP; 54%, 50%), and the 'RCEP' (49%, 49%). We added the 'Qianhai/Hengqin' development zones as a new option, which garnered a decent 44% of votes (more on them later).

Manufacturers are also becoming more familiar with various policy initiatives that will benefit them long-term. Those choosing 'needing more information' remained the lowest for 'GBA' among all options, extending its multi-year drop to 7% this year from 10% prior – helped by the fact that these companies have probably having operated in the region for a long time. Responses for 'dual-circulation', which was first mentioned at the May 2020 Politburo meeting, were also a good demonstration of how familiarity improves over time. Last year, it 'dual-circulation' recorded the highest proportion (19%) of respondents saying they needed to know more, which improved materially to 10% this year. We believe manufacturers are ready to see new policy announcements.

GBA gaining importance supports 'China+1' strategy

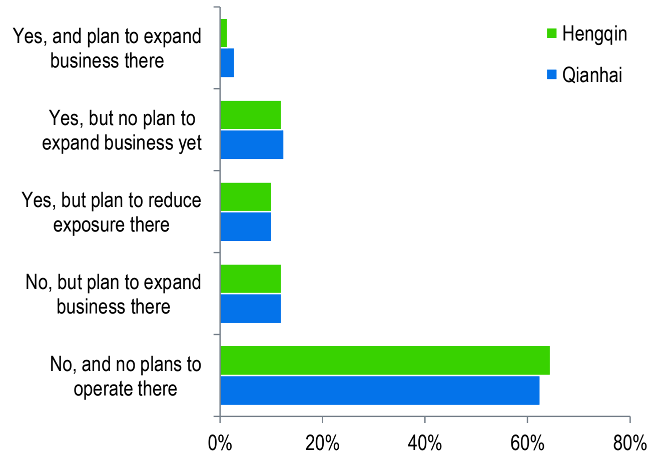
Respondents still see the GBA becoming more important to their business. Netting out those opting for GBA being 'less important' from 'more important', this year's responses showed an average 7ppt net positive change across all five key business functions (Figure 2). The net positive response was largest for the GBA as a production base (+9ppt) and as a consumer market (+9ppt), followed by as a treasury centre (+8ppt), a sourcing base (+4ppt) and an R&D base (+4ppt). This year's solid improvements built on an even stronger set of results last year; this is no small feat considering recent headwinds including COVID-related disruptions, a weakening property market, rising inflation, interest rates and geopolitical tensions globally.

Figure 3: Where do you currently operate, and do you expect that to change in 2022?
% of respondents



Source: Standard Chartered Research

Figure 4: Do you currently operate in Qianhai and Hengqin? And what are your plans for these two zones over the next five years? *(% of respondents)*



* Yangtze River Delta, Beijing-Tianjin-Hebei, Chengdu-Chongqing; Source: Standard Chartered Research

All this is also a testimony to the GBA's ability to stay relevant, adding credibility to the popular 'China+1' strategy among GBA manufacturers; their rising focus on 'just in case' over 'just in time' means that the GBA is unlikely to lose out much to other production bases, despite their still-evident structural need to diversify overseas to reduce risks related to ongoing US-China tensions and supply chain concentration.

Are respondents walking the walk?

Non-core cities more likely to see net increase in manufacturers

More respondents plan to reduce rather than expand their size of operations in GBA cities

We asked our survey respondents where they currently operate in the GBA, and what their plans for each city are for 2022. Much like last year, focusing on just those respondents that already have operations in a particular city, more plan to reduce rather than expand their size of operations (this applies to all 11 GBA cities, with Hong Kong, Shenzhen, Foshan, Dongguan and Huizhou being the 'relative' outperformers). But, regardless of city, a majority (i.e., an average 70% of respondents already operating in a GBA city) are still looking to keep things unchanged (Figure 3).

If we include those that do not currently have a presence in a city but plan to expand there in 2021, five of 11 GBA cities see a net positive change (up by an average 5.6ppt) this year; this is down from 10 cities last year. Zhuhai and Huizhou saw the biggest net gain in absolute terms; this is followed by Foshan, Dongguan and Zhongshan. The absence of core cities among the outperformers could be because (1) they already have a larger presence of manufacturers based there, making it more difficult to grow from a higher base; and (2) they have a larger services sector, which makes them more exposed to COVID restrictions, the weak real estate market and uncertainties surrounding technology regulations.

In Hong Kong's case, the city was only beginning to emerge from its own fifth COVID wave when we conducted the survey; this, together with looming external uncertainties, especially surrounding the evident slowdown in China, may help explain the overall cautious attitude towards business expansion within the GBA for now, especially given how Hong Kong-centric our survey sample is.

Gauging manufacturers' interest in Qianhai and Hengqin

Around a quarter of our respondents are already operating in Qianhai and Hengqin

It has been almost one year since China's government promulgated the new Qianhai and Hengqin development plans. The Qianhai plan, aimed at accelerating the integration and collaboration between Shenzhen and Hong Kong, expands the zone's size to eight times the original size, providing a broader economic base to build on cross-border technology innovation, financial opening and services trade expansion (in household wealth, advance manufacturing or transport infrastructure, for instance). For the Hengqin plan, it aims to accelerate Macau's industry diversification and integration with Zhuhai and other GBA cities, mainly through Macau's more direct participation in Hengqin's policy-making and execution. Both plans could complement the financial initiatives as main GBA policy drivers.

25% and 24% of our respondents are currently operating in Qianhai and Hengqin, respectively (Figure 4), a material improvement over end-2021, *when we asked a similar set of ad hoc questions as part of our quarterly survey to construct our GBA Business Confidence Index (GBAI)*. For our Q4-2021 GBAI survey covering 1,000 companies (with half of the sample being non-manufacturing respondents) operating in the GBA, a mere 6.6% and 5.3% of all respondents had operations in Qianhai and Hengqin, respectively; but over 40% of those already in Qianhai and 33% of those in Hengqin plan to expand their business in these areas in the next five years. Overall, it seems that many companies in the region have since walked the walk by expanding operations into the two zones.

In the current annual GBA manufacturing survey, only 11% and 6% of manufacturers who already have a presence in Qianhai and Hengqin plan to expand their business there in the next five years, versus 40% and 43% planning to reduce their exposure, respectively. While existing operators probably lack momentum to expand further in the near term given that the plan is still rather new, and those who already made their move in the past year may have little need for another round of expansion. However, the sizeable proportion of respondents planning to reduce their exposure in the two zones is concerning, highlighting a need for the authorities to continue to provide new incentives to stamp out potential attrition and also to continue to bring more manufacturers on board. For the latter, 12% of respondents said they are currently not operating in the zones, but plan to expand their business there over the next five years.

Tracking the GBA's evolution

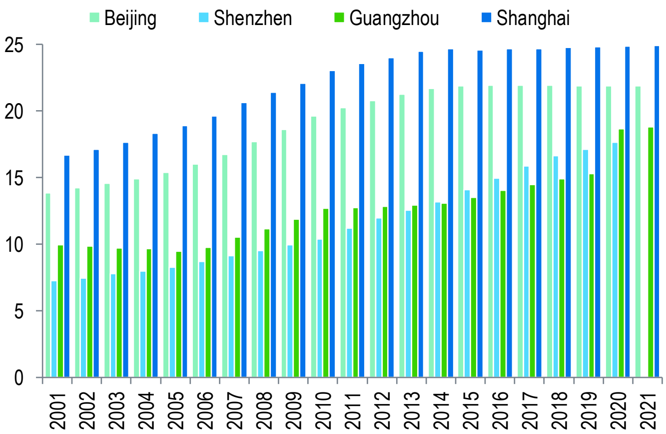
Quarterly GBAI surveys with thematic questions

As the GBA's transformation is a long-term project with many different macro and policy drivers, we need effective ways to keep track of its inevitable ups and downs, representing an extra layer of regionally focused data to complement the official macro data which usually comes with a long lag and lacks granularity. It is for this reason we started this annual GBA manufacturing survey 13 years ago, initially focusing on the Guangdong provinces' labour shortage and wage pressures, before evolving and expanding into this current more encompassing form of a client survey.

Since 2020 we also launched our GBAI, which is compiled based on a quarterly survey of over 1,000 companies operating in the GBA in collaboration with the Hong Kong Trade Development Council (HKTDC). The GBAI provides the indices that allow us to regularly gauge and track the current business situation and credit conditions, and their outlooks on these subjects for the coming quarter. The GBAI also asks respondents thematic questions that help us understand what drives their business decisions and plans, and how this might shape the GBA's future. That was now we got the Qianhai and Hengqin feedbacks back in Q4-2021, which becomes a crucial point of comparison for this annual survey's results. You can find *our latest GBAI report here*.

Figure 5: Shenzhen and Guangzhou growing in size

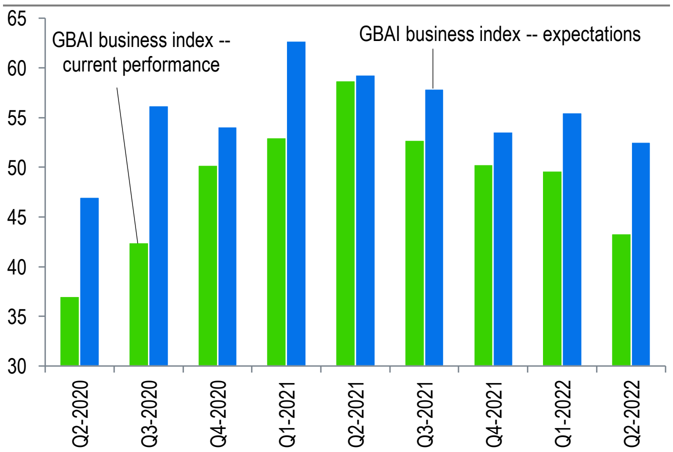
Population, usual residence, mn persons



Source: CEIC, Standard Chartered Research

Figure 6: 'Current performance' vs. 'expectation'

GBA Business Confidence Index (GBAI)



Source: HKTDC, Standard Chartered Research

Here are some of the key takeaways from our recent GBAI reports, and some of the key themes that are worth keeping a close eye on going forward:

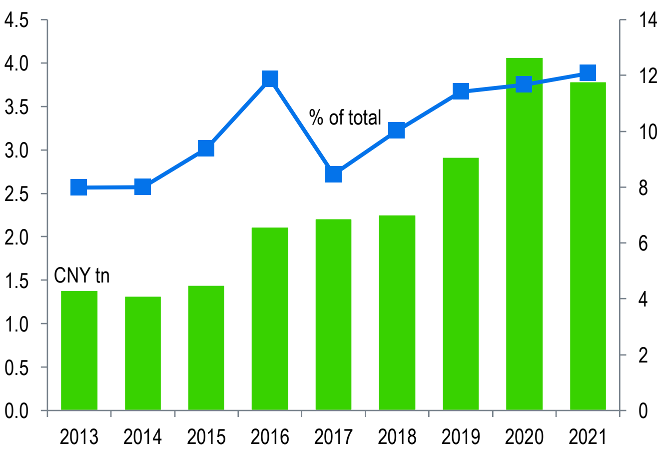
Our quarterly GBAI helps track GBA's transformation over time

- **Setback confirmed, rebound expected**: Much like what we have been saying throughout the previous section, the GBA has not been spared from the headwinds to the broader China economy YTD. The GBAI's current performance index for business activity plunged for a fourth straight quarter to a seven-quarter low of 43.3 in Q2 (50 being neutral). The GBAI's expectations index for business activity also eased to 52.5 in Q2; however, it stayed above 50, implying that some degree of recovery is still expected in the coming quarter (Figure 6). This is in line with our full-year forecast for China's GDP growth at 3.3%, indicating some modest recovery to around 4.0% y/y in H2 after growing 2.5% in H1.

- A shift in industry outperformers: Not all sectors suffered equally from the still-present set of domestic and external headwinds. 'Manufacturing and trading' and 'retail and wholesale' bore the brunt, while 'innovation and technology' outperformed, possibly due to easing regulatory concerns. Going forward, it would be interesting to see which sectors will rebound first as the broader economy bottoms out. The chances for the retail sector to come out on top will hinge on China's success in rolling back its stringent COVID restrictions and lifting its weak housing sector; the manufacturing and trading sector, on the other hand, will ride on (1) traditional export markets weathering their impending technical recessions; and (2) China's ability to revive credit to corporates and implementing infrastructure modernisation, which President Xi has recently called for.

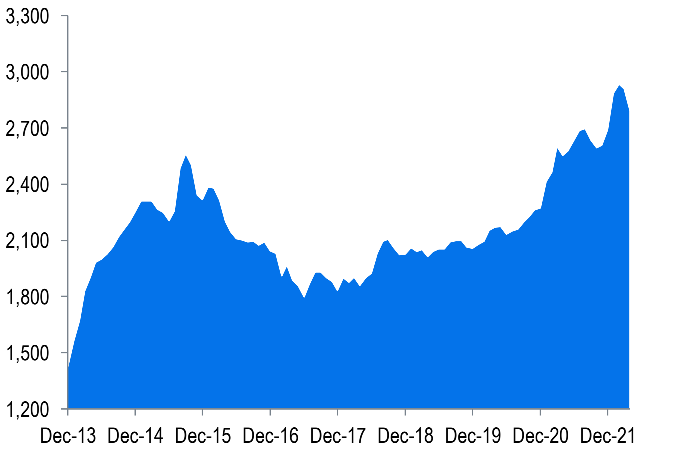
- **Financial conditions expected to improve from here**: Financial conditions stayed challenging throughout H1, in part due to companies' own weaker cash flow positions due to a business slowdown as well as still-cautious bank lending and borrowing costs staying elevated. We shared our concern that the talk of more monetary policy support for the economy has yet to translate into improvements at the company level. But, overall, companies expect better times ahead, either due to a likely improvement in 'banks' attitude towards lending', a long-awaited easing in bank financing costs, or simply a turnaround in businesses' own surplus cash and receivables turnover. The latest round MLF and loan prime rate (LPR) cuts in August should help meet some business expectations.

Figure 7: Financing resources tends to get channelled to high growth areas *(Guangdong's total social financing)*



Source: CEIC, Standard Chartered Research

Figure 8: Tracking international Renminbi usage
Renminbi Globalisation Index, RGI



Source: Standard Chartered Research

What other indicators are on our dashboard?

We also highlight the macro indicators we previously used when gauging whether and how the GBA would grow into a megacity cluster. These are favourable fundamental or structural factors the GBA enjoys, and while they may not change much from year to year, it is worth keeping them on our radar.

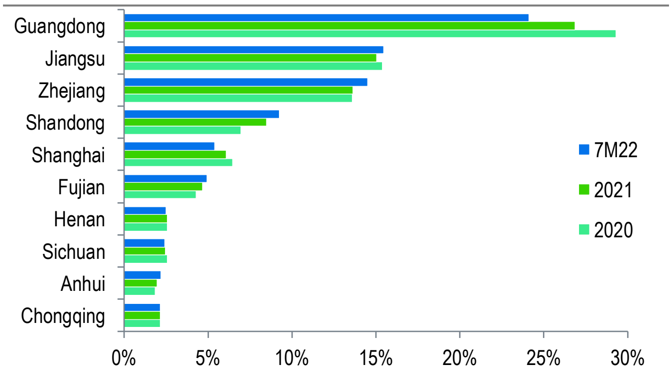
Ability to attract talent and grow its population will be key to the GBA's long-term success

- **Population:** We have noted before the importance of leveraging the GBA's inherent competitive advantages (i.e., diverse growth drivers, ability to garner strong policy support and opportunities from deepening integration between GBA cities) to boost its ability to attract high-end talent via a 'siphoning effect'. This means that the GBA's innovation drive, industrial upgrading trend, higher wages and favourable residential policies should make it competitive in job creation, creating a 'siphoning in' effect for not just rural workers, but also high-end talent from other major cities in China. The population numbers so far support this view: since 2014 Guangzhou and Shenzhen have recorded greater annual increases in their usual resident populations than either Beijing or Shanghai. This has allowed the two core GBA cities to close the gap with Beijing and Shanghai, and we expect this trend to continue (Figure 5).

- **Financing:** Another indication of the 'siphoning effect' at work is a city or province's ability to attract and create credit, as financing resources tend to get channelled to high-growth areas. Unsurprisingly, Guangdong is China's largest province in terms of total social financing (TSF; the country's broadest measure of credit creation). Its share of national TSF has been high through past downturns, reflecting the province's importance in driving overall growth during troubled times (Figure 7). Recent years have been no exception, with the GBA's share of TSF rising to a recent record high of 12.1% in 2021. The GBA, whose core cities are already among the country's most wealthy and financially savvy, is also spearheading China's financial opening; the progress of Renminbi internationalisation will be key in tracking this, using our *Renminbi Globalisation Index* (RGI; Figure 8).

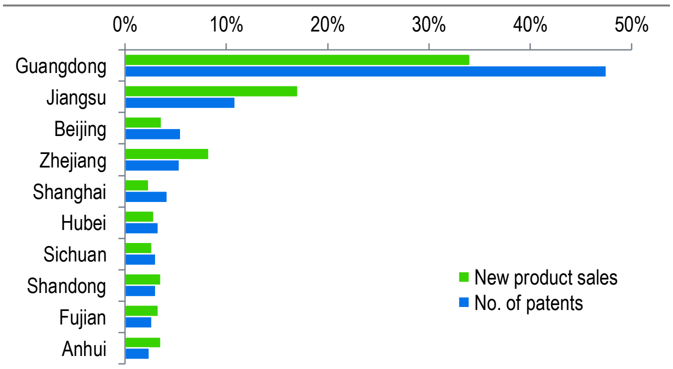
- **Exports and innovation**: But in the end, for the 'siphoning effect' to work, the GBA needs to maintain its edge in being China's leading manufacturing base for exports plus an innovation centre. Using Guangdong as a proxy, in addition to accounting for over 27% of China's total exports, the GBA is also China's leading innovation base, contributing 34% of high-tech new product sales and 48% of patents nationwide (Figures 9 and 10). These will also be good gauges on whether the GBA can keep excelling as more companies adopt the 'China +1' strategy.

Figure 9: Guangdong's disproportionally large export sector *(top 10 province by exports, % of 2021 total)*



Source: CEIC, Standard Chartered Research

Figure 10: Guangdong maintains the lead in innovation
High-tech industry, % of 2020 national total



Source: Wind, Standard Chartered Research

ASEAN – Just in case?

Edward Lee
+65 6596 8252
Lee.Wee-Kok@sc.com
Chief Economist, ASEAN and South Asia
Standard Chartered Bank (Singapore) Limited

ASEAN – Benefiting from the need for resilience

Cost efficiency is not good enough

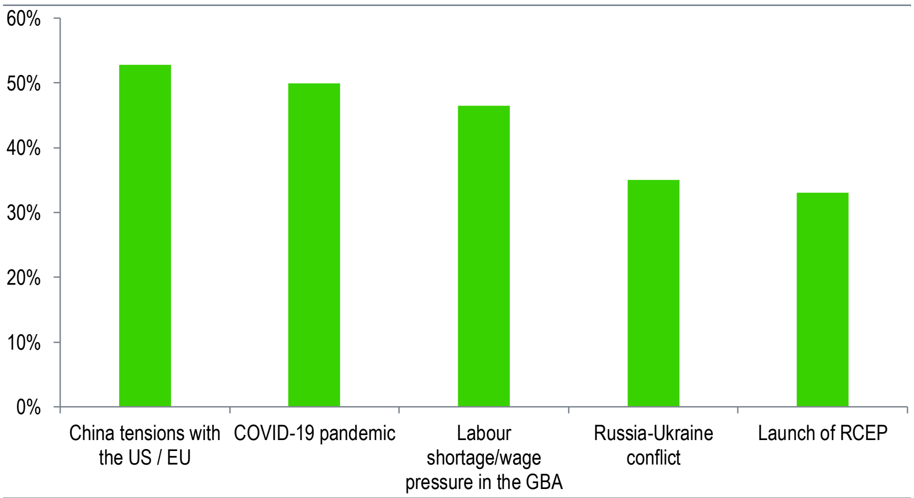
Our latest GBA survey indicates that the 'just-in-time' strategy followed by manufacturing firms globally may now no longer be the only operational guidepost for firms. The 'just-in-case' consideration has now gained more attention. Previously, firms were solely focused on efficiency. Now, the focus on efficiency has to be shared with considerations for resilience. The Trump-led US tariffs against China brought to fore tensions between the US and China, which resulted in tariffs affecting manufacturing operations. The tensions did not subside with President Biden. Subsequently, the COVID-19 pandemic reminded companies of the weakness of supply chains that were optimised to the hilt.

On asking survey respondents if China tensions with the US/EU and the COVID-19 pandemic are driving them towards more actively considering moving capacity out of China, over 50% replied in the affirmative (In Figure 1). Just slightly less than 50% of them chose labour shortage and wage pressure, the typical reason driving manufacturers to ASEAN. That said, we note that firms based in China are not leaving per se but rather investing in alternative production sites to deal with issues such as US-China tensions and resilience of supply chains.

Focus on 'China+1' is increasing

Figure 1: Are the following factors driving you towards more actively considering moving capacity outside of China?

% of respondents selecting "Yes"



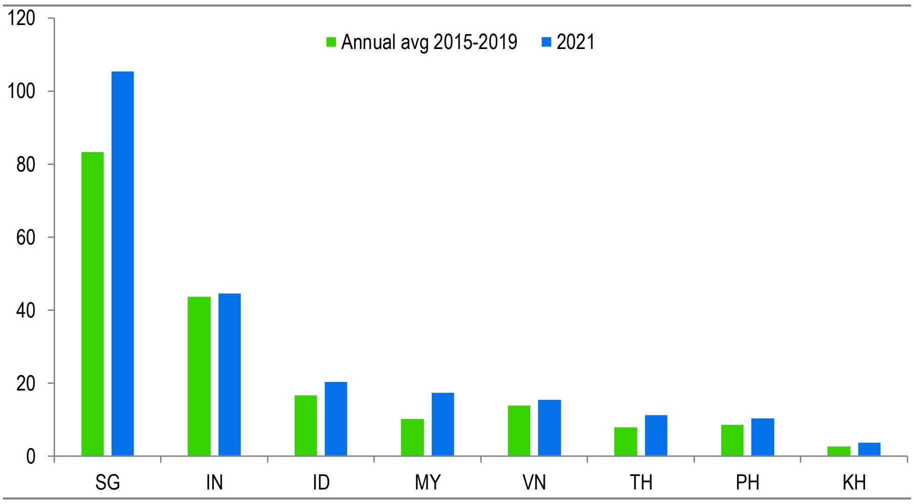
Source: WTO, Standard Chartered Research

As a region, ASEAN continues to draw a significant amount of FDI. It has been attracting more than 10% of global FDI since 2018. This is meaningful considering the region's GDP is less than 4% of global GDP. FDI in 2021 was higher across the region versus annual averages from 2015-19, despite the region underperforming advanced economies in the growth recovery due to the Delta variant wave. According to the ASEAN Secretariat, the top three sectors that saw FDI from 2015-20 were finance and insurance (annual average 31% of total FDI), manufacturing (24%) and wholesale and retail trade (14%). This has not only helped ASEAN become a top global exporter along the ranks of the US and Germany but also a larger exporter for the US and China.

Pandemic has not dampened foreign investor confidence in the region

Figure 2: FDI to ASEAN in 2021 was higher than pre-COVID levels

USD bn

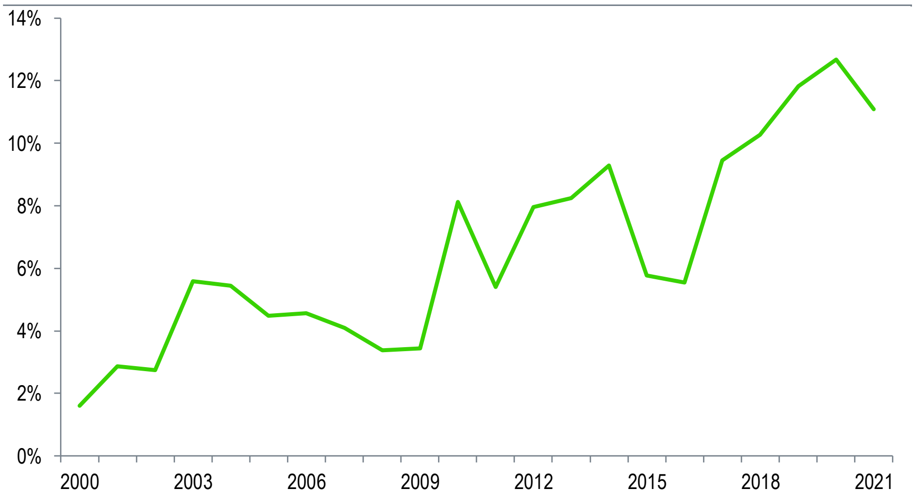


Source: CEIC, Standard Chartered Research

ASEAN accounts for less than 4% of global GDP but attracts c.12% of global FDI

Figure 3: ASEAN continues to attract foreign direct investment

% of global FDI

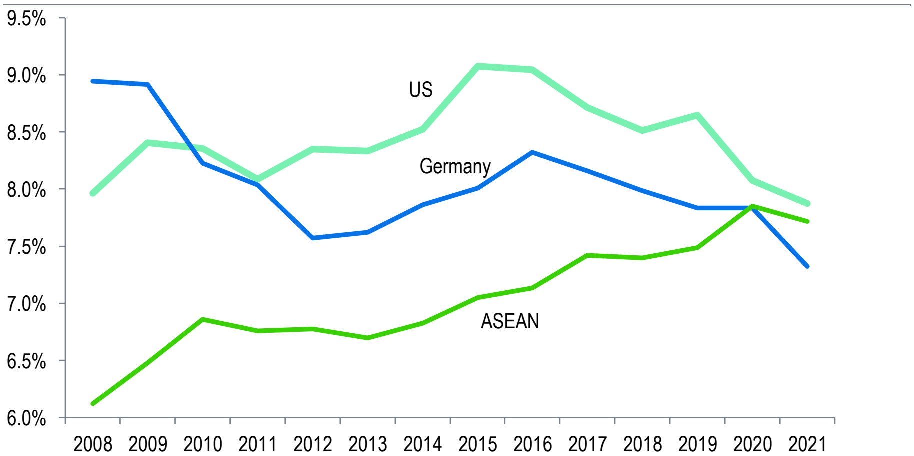


Source: CEIC, Standard Chartered Research

ASEAN has steadily gained global merchandise export share amid increasing FDI

Figure 4: ASEAN gaining in global export market share

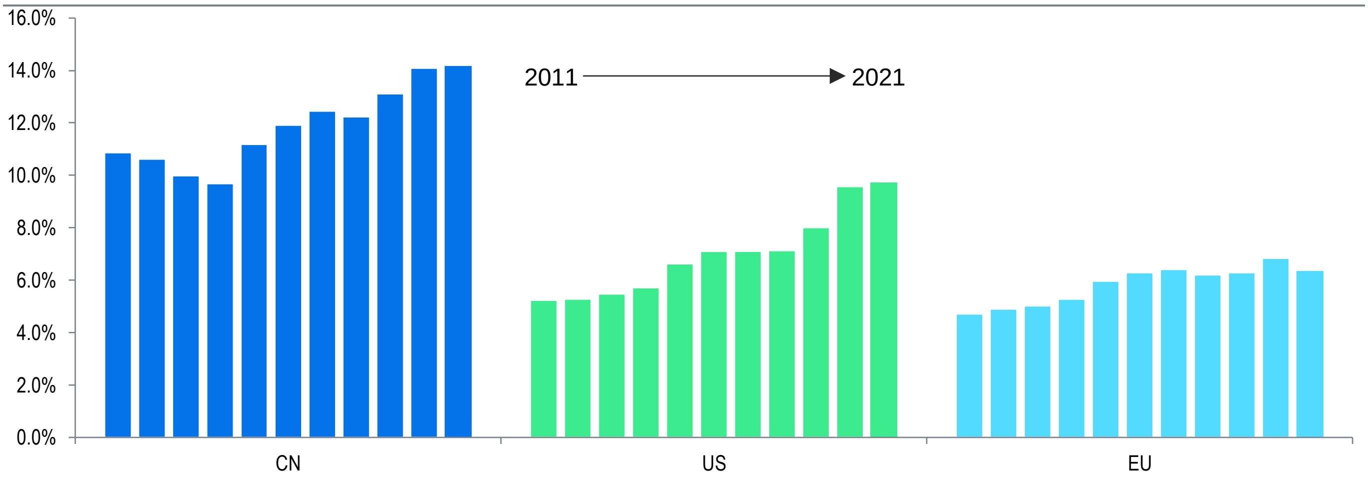
% of world exports



Source: WTO, Standard Chartered Research

Figure 5: ASEAN's trade with the US and China has increased further

ASEAN's share of CN, US and EU total imports, 2011 to 2021



Source: CEIC, Standard Chartered Research

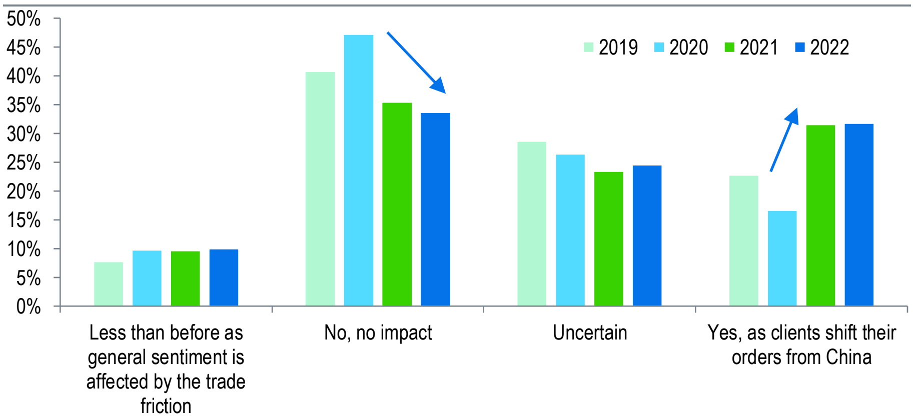
'China+1' strategy

Similar to 2021, our survey respondents with existing production in ASEAN are seeing an increase in orders diverted from China. China's dynamic zero-COVID restrictions may have added impetus to source for production at alternative sites from China.

ASEAN is benefiting as an alternative to China's production

Figure 6: Have you seen more orders for your business in ASEAN due to the China-focused tariffs from the US and China's dynamic zero-COVID strategy?

% of total responses



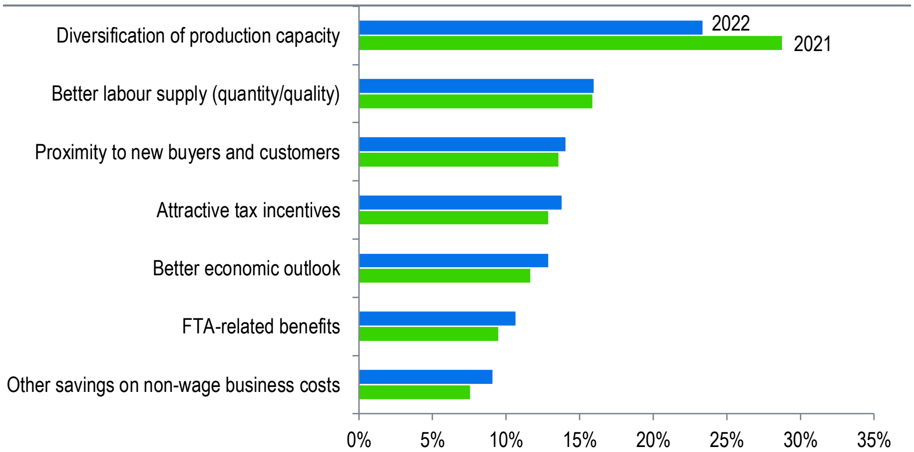
Source: Standard Chartered Research

More reasons to invest in alternative production capacity

Prior to the pandemic, companies already had three primary considerations for increasing production capabilities in ASEAN: efficiency (cost-related issues), diversification (reducing operational risk by lowering geographic concentration of production capacity), and geopolitics (to be able to navigate a potential escalation in US-China rivalry). China's extended COVID controls may have driven more companies to consider investing in capacity outside China. While we think China's strict COVID control measures will not be permanent, companies will now need to look at strategies to mitigate future disruptions to operational ability.

Our annual survey indicates that diversification of production capacity remains a top driver for moving outside China. Other factors, however, remain important too, including availability of good labour supply, new markets and incentives.

Figure 7: What are the non-wage advantages of moving to your selected destination?
% of total responses



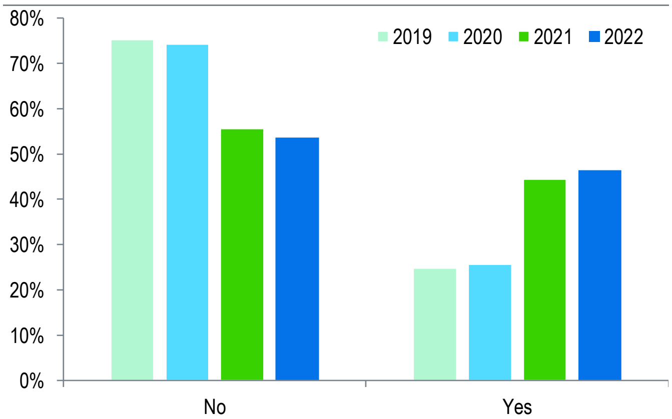
Source: Standard Chartered Research

Familiarity with ASEAN's advantages is increasing

The GBA survey suggests that respondents' knowledge of the region is improving. While FTAs do not feature highly among the reasons attracting companies to the region, a near-50% of respondents (up from 25% in 2019) now say they are benefiting from FTAs. The region's trade openness is a major advantage in setting up shop here. Given that the region is now among the largest exporters in the world, more can be done to educate investors on trade linkages across the region. For example, while near-40% of respondents now think that ASEAN is sufficiently integrated, a good number feels that information is not sufficient.

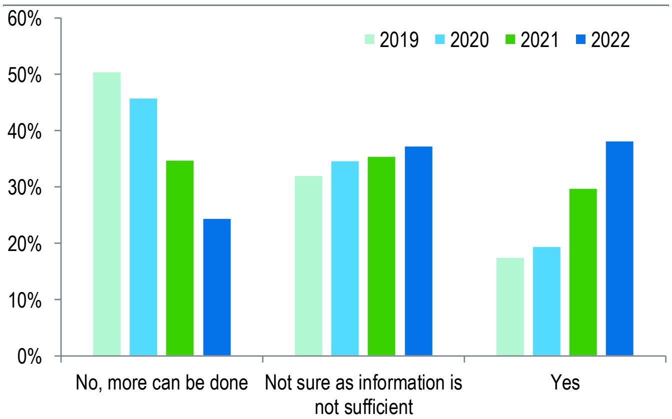
The regional authorities should also take note of the typical concerns highlighted in the survey responses. Top concerns usually revolve around underdeveloped infrastructure, poor labour productivity, political uncertainty and supply-chain issues. Interestingly, only c.35% of respondents said they are satisfied with their investments in ASEAN. Rising labour costs, lack of local financing and bureaucratic requirements are among the top negatives highlighted by survey respondents. Infrastructure ranks low among clients who are already invested in ASEAN, although this concern tends to rank high when asked about main concerns prior to moving to this region.

Figure 8: Do you benefit from FTAs in ASEAN?
% of total responses



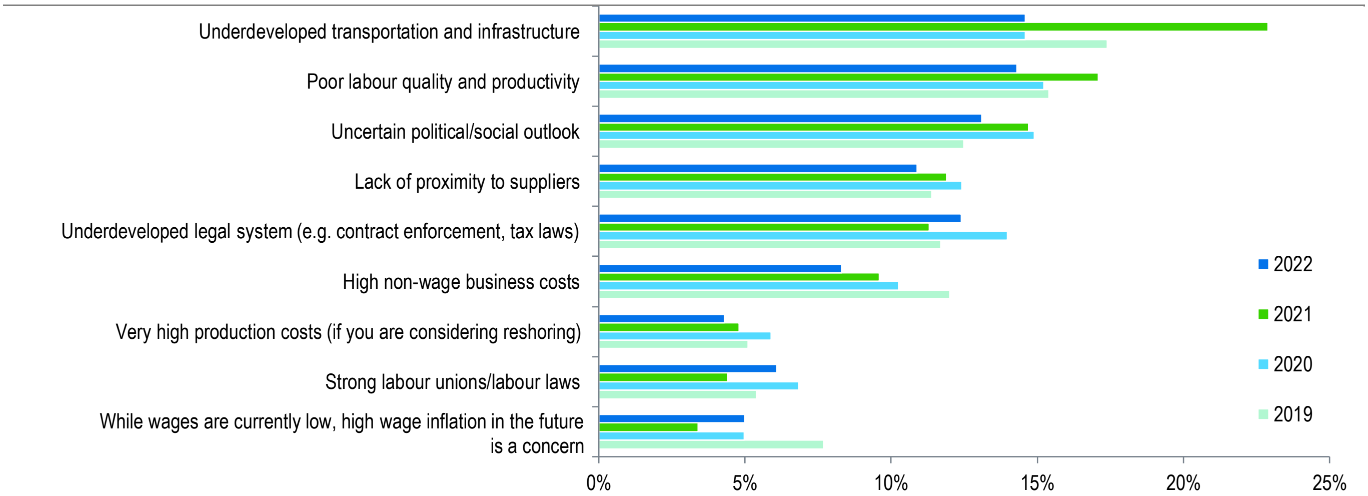
Source: Standard Chartered Research

Figure 9: Is ASEAN sufficiently integrated for your business strategy? *% of total responses*



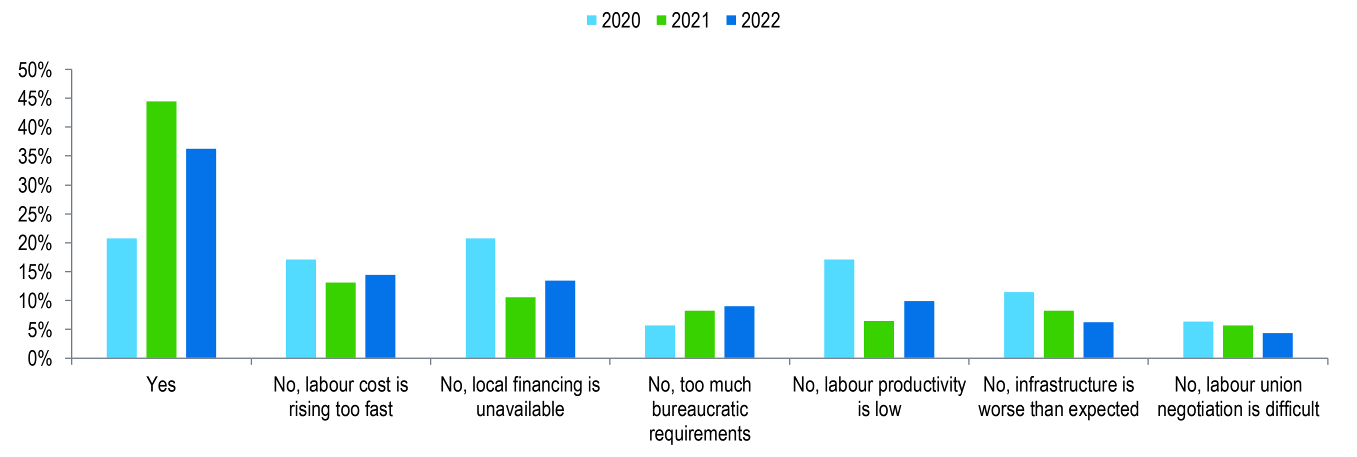
Source: Standard Chartered Research

Figure 10: What are your main concerns on moving factories to the preferred destinations? *% of total respondents*



Source: Standard Chartered Research

Figure 11: Are you satisfied with your investments in ASEAN?
% of total respondents



Source: Standard Chartered Research

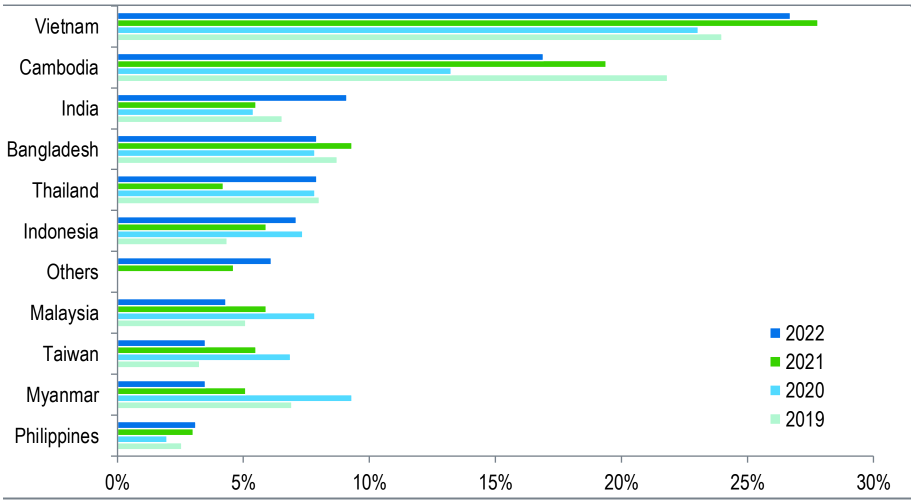
Vietnam remains the top investment destination

In our annual GBA survey, we asked participants where they would move their production capacity if they considered moving out of China. Vietnam has topped the list over the years. Of those choosing Vietnam as their investment destination, the majority 37% are in the electronics sector (including electronics packaging and assembly, component manufacturing, semiconductor fabrication and semiconductor equipment manufacturing). Electronics manufacturing typically requires a closely knit supply chain, and the strong interest from this group suggests that sustained investment over the years has likely led to supply chain robustness. Foreign investors are likely familiar with the business environment. The local labour force is also likely more trained, especially in the growing electronics sector. In fact, Vietnam is now the largest exporter in ASEAN.

Vietnam remains the top investment destination

Figure 12: If you plan to move capacity out of China, where would you choose?

% of total respondents

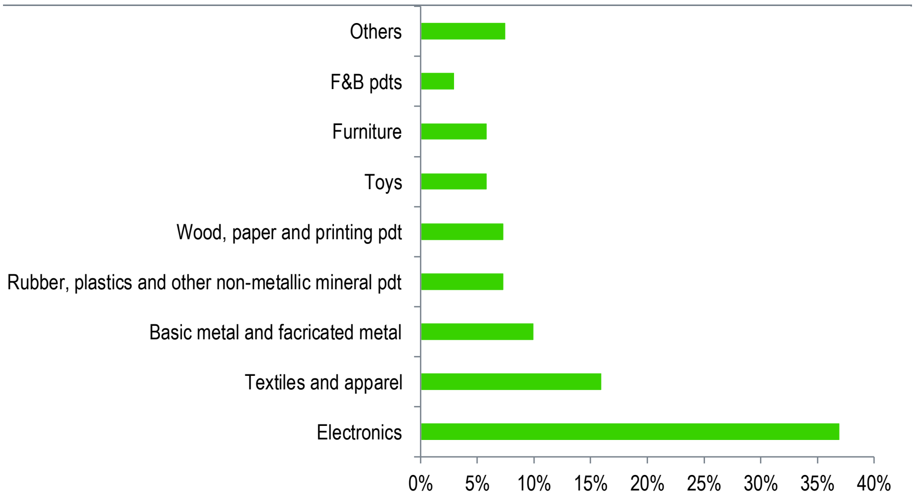


Source: Standard Chartered Research

India has also steadily gained favour among our surveyed manufacturers who are headquartered in Hong Kong, China and Taiwan. Growing familiarity with India, its indisputable sizeable domestic market, and incentives such as the Production Linked Incentive scheme may have attracted companies to set up shop in India. In fact, about 52% of those choosing India as a preferred relocation destination were from the electronics sector.

Figure 13: Electronics manufacturing sector stands out in Vietnam

% of respondent sectors who chose VN as their investment choice



Source: Standard Chartered Research

As more companies relocate production and bolster their regional supply chains, we expect ASEAN to continue to gain an increasing share of the global export pie. The region still offers attractive attributes, including pro-growth policies, regional stability, growing domestic markets, and a still-competitive cost base. It continues to drive its integration with the global economy via trade agreements, and additionally, changing global geopolitical winds should keep the region on course to becoming a larger exporter in the coming years.

Authors

Kelvin Lau
+852 3843 0711
Kelvin.KH.Lau@sc.com
Senior Economist, Greater China
Standard Chartered Bank (HK) Limited

Tony Phoo
+886 2 6606 9436
Tony.Phoo@sc.com
Senior Economist, NEA
Standard Chartered Bank (Taiwan) Limited

Edward Lee
+65 6981 2835
Lee.Wee-Kok@sc.com
Chief Economist, ASEAN and South Asia
Standard Chartered Bank (Singapore) Limited

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Shuang Ding
Chief Economist, Greater China and North Asia

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