

ARTICLE FOR THE EDGE

WILL SUPPLY CHAIN DISRUPTIONS DAMAGE THE GLOBAL RECOVERY?

A flurry of concerns about bottlenecks in production and transportation has sparked concerns over lower growth and higher inflation, or stagflation, a combination of miseries we thought we had left behind in the 1970s. However, as we examine where the hold-ups are and what is causing them, our view is that much of these supply chain disruptions are likely to ease in coming months. Sure, as the global economic recovery gathers pace, there probably will be occasional glitches in the internal plumbing of the world economy. But we do not believe that they will be serious enough to set back the recovery or to generate a permanent rise in inflation. In the longer term, however, we could see some reconfiguration of supply chains as companies learn lessons from these recent challenges.

Where are the disruptions and what is causing them?

The supply chain mess has many, separate dimensions to it, each with its own dynamic.

First, semiconductors have been in short supply. And, because most appliances now have some chips in them, the lack of these components dislocated production a lot more than before. Initially, when the covid-19 pandemic first hit, semiconductor producers scaled back production capacities in anticipation of lower demand. They missed the surge in demand for chips generated by the widespread adoption of work-from-home practices which drove up the need for all kinds of electronic and communications devices. They may also have underestimated the structural rise in demand for semiconductors because of the technological revolutions in artificial intelligence, robotics and the internet of things. Demand for automobiles also rose as consumers avoided public transport: that meant that chips shortages held back production of cars as the shutdowns by almost all the automobile giants showed.

More recently, pandemic-related lockdowns in economies with semiconductor facilities in Malaysia, Vietnam, and the Philippines have also constrained productive capacity. Few had realised just how important these countries were in semiconductor testing, assembly and packaging.

The latest developments suggest that the worst is over. Toyota's planned production cutbacks in November, for example, are noticeably less than that in September and October. Malaysia and Vietnam appear to have succeeded in bringing infections down and are therefore easing restrictions that kept workers from reaching factories. Some of the stress in the semiconductor supply chain is therefore easing. However, the big increases in production capacity to service the technological revolutions will only start coming on stream at the end of 2022 or early 2023. So, while the drag on current production is easing, the growth of many industries reliant on semiconductors may continue to be held back for some time to come.

A second area of stress has been in transportation. Congestion and delays have hurt operations in major ports such as Long Beach and Los Angeles in the US and Shanghai, Yantian

and Ningbo–Zhoushan in China. The implications for businesses have been painful. The average duration of end–to–end transit between the US and China skyrocketed to 73 days at the end of September, almost double the pre–pandemic level of 40 days. Costs have spiked up as well – the Shanghai Containerised Freight Index of shipment rates from China to other major ports reached 4588.07 last week; more than four times the October 2019 levels.

As with semiconductors, the crisis is now easing. Part of the reason for the port congestion in China was bad weather (Typhoon Kompasu and Typhoon Canthu) and government restrictions to combat covid–19 infections. These issues have receded and port operations have now normalised in China. Consequently, the average price of 40–foot containers has dropped by 22.5% since end–September to USD6,598 at the end of last week. In the US, the Biden Administration has persuaded port operators to extend working hours to 24 hours from 18 hours, so there will be some improvement at the margins. However, until wages rise to attract more workers, shortages of truck drivers could persist in the US and Europe: the American Trucking Association has estimated the labour shortfall at 80,000 truckers.

The third dimension of the problem was deficient supplies of coal that caused power outages which curtailed output in China and could cause dislocations in India as well. Not only did demand for coal bounce back faster in Asia, floods shut 9% of coal mines in Shanxi, China’s main coal producing area, in early October. Downstream industries such as magnesium was hit with production down 70% at one stage. In India, the major utility NTPC has been forced to dip into imports to meet domestic energy requirements for industry. In addition, European inventories of natural gas fell to abnormally low levels after last year’s colder–than–average winter and Russian supplies not making up for this deficiency. LNG demand from South America has also spiked due to a drought slashing hydroelectricity output, as well as from China due to COVID demand recovery.

The Chinese authorities have acted swiftly to tackle their energy challenges, bringing many coal mines that had been shut as part of its decarbonisation effort to return to production. Pricing mechanisms have also been reformed to provide more incentives to power generation companies to increase electric power generation. This should help ease the power crunch. In Europe, too, the crunch should ease as the rush to rebuild inventories eases.

A final source of supply chain disruptions has been labour shortages. Vietnam saw a mass exodus of about 1.3 million migrant workers from Ho Chi Minh City between July and September because of covid–19 related restrictions. The number of foreign labourers in Malaysia has also reportedly fallen to 1.1 million from the 2018 level of 1.9 million, with 77% of the labour shortfall in the manufacturing sector. Similarly, in Thailand, many of the roughly 2.3 million Myanmar migrant workers have been unable to return to work in Thailand due to delays in work permit renewals and the political convulsions in Myanmar. Singapore has also not escaped a labour crunch as restrictions on movement have left Malaysian workers who used to commute into Singapore daily stuck behind the border. In all these cases, relief is at hand. Malaysia’s success in reducing the covid–19 infections has resulted in many restrictions being lifted, which should help to alleviate the labour shortages. The economic crash in Myanmar after the coup should result in a wave of Myanmar migrant workers taking refuge in

Thailand and being available to work there. The restrictions on travel between Malaysia and Singapore are also likely to be eased soon.

What to expect: growth recovery, some cost pressures and reconfiguration of supply chains

The gradual resolution of these bottlenecks should allow global growth to recover its march out of the pandemic-induced recession. As productive capacities bounce back to match the pent-up demand, it is likely that global growth will resume its firm recovery from 1Q22 onwards. However, shortages of components and production glitches will not go away entirely. Some plants in China are not likely to be able to resume production at optimum levels as occasional power outages are still likely. There will still be some issues with production capacity not matching demand. Unisem, for example, already has its Chengdu plant fully booked for the whole of 2022. The Malaysian Semiconductor Industry Association does not see supply matching demand for at least another two years. Still, none of these issues will be grave enough to stall global recovery.

What about cost pressures? The Freightos Baltic Index of shipping costs has soared from USD1,238 in the third week of October 2019, to USD10,275 in the third week of October 2021. The good news is that prices appear to have peaked and are easing. The net effect of these recent supply chain challenges will be higher cost levels, but the rate of increase in those cost levels will ease so that by early 2022 inflation rates will be coming down again.

However, financial markets are worried that the price increases induced by the supply chain challenges might encourage central banks to tighten monetary policy earlier than markets expect. Certainly, such a decision by the Federal Reserve would throw Asian currencies into a tailspin and force Asian central banks to raise interest rates to defend their currencies and put their economic recoveries at risk. While it is the case that some Fed officials have raised their concerns about higher inflation and called for pre-emptive action to be taken, we do not expect a significant deviation by the Fed away from the course it has already signalled to the markets – a reduction in the pace of quantitative easing starting soon but a rise in the policy rate only likely at the end of 2022 or early 2023. The Fed, together with the European Central Bank and the Bank of Japan, remains wary of premature monetary tightening and seems prepared to take the risk of higher inflation.

The longer term consequences of recent events could be more substantial. The supply chain dislocations will reinforce the lessons learnt during the pandemic. In the past, there might have been an excessive focus on cost-minimisation and profitability in building supply chains with not enough emphasis on the resilience of supply. This was brought home harshly to corporate leaders and policy makers in the early stages of the pandemic, when countries struggled to acquire critically needed medical supplies such as personal protective equipment or even face masks.

Pressures to reconfigure supply chains were evident even before the pandemic. Rising costs in China had persuaded many producers, including Chinese ones to move low-value production out of China, to countries such as Vietnam with low wages. The trade war between

the US and China had given a further incentive for producers to diversify their production bases so that they did not rely solely on China. So, once the recession induced by the pandemic is over, we will see another phase of supply chain restructuring. This is all the more likely because countries such as India and Indonesia did not waste the pandemic crisis – they have enacted reforms that will help boost their competitiveness over time and make them more attractive as production bases.

The process is likely to be complex and not just be a simple mass relocation of activity out of China. Just take the following as examples of the complex considerations that will influence companies:

- Where producers are in China mainly to serve the domestic market – as many are – there will be little incentive to relocate. This is shown in surveys of American and European manufacturers in China.
- Where strategic items – critical medical equipment or vital pharmaceuticals such as anti-biotics are concerned, there will be very strong pressure within countries to manufacture domestically. Thus, there could be some degree of movement out of China.
- Where companies have located factories in China to produce items for export to third countries, then the cost and trade war calculations may persuade some of them to relocate production. But even here, China has a tremendous advantage in having a diverse set of highly efficient component producers and sub-contractors that few other countries can currently match.

Conclusion

In short, the current supply chain disruptions will certainly cause slower growth to be reported across the globe in the second half of this year. But many of these challenges are beginning to be overcome and global growth will resume in early 2022. In the longer term, though, an added incentive has been provided for a reconfiguration of supply chains.

**Prepared by Manu Bhaskaran
CEO, Centennial Asia Advisors**