



FOR PROFESSIONAL INVESTORS – 17 November 2023

Chi on China

CHINA DECOUPLING OR THE RISE OF REGIONALISM

To know what you know and what you do not know, that is true knowledge.

Confucius

SUMMARY

- China decoupling from the US (and global system) is not happening so far. Not only is Sino-US trade continuing to rise, but there is also a significant increase in trade and investment between ASEAN and China, despite geopolitical, regulatory, and economic shocks.
- The increase in China-ASEAN connection reflects a change in the global supply-chain structure. This vindicates China's 'dual circulation' economic strategy to boost regionalism to counter de-globalisation and the rise of geopolitical risks.
- The recent fall in net foreign direct investment (FDI) inflows to China may be temporary, so it is not a sign of China decoupling. The decline also reflects China's 'external circulation' tactic by increasing outward direct investment to capture the shift in global demand and supply-chain structure.

China's scrutiny of foreign firms on corruption, fraud, espionage, and national security grounds since May 2023 has not only hurt foreign sentiment in China but also revived discussions about China decoupling from the global system. Such talks have revived fears about the breaking up of the global supply chains and fuelling the arguments against investment in China and Asia.

What is the evidence telling us?

DECOUPLING, WHERE?

Despite the trade war with the US, Covid health crisis, US-led restrictions on tech exports and technology transfer to China, and other trade restrictions such as tariffs, China's total trade with the G3 economies (Japan, Europe, and the US) has continued to rise, defying market expectations (Exhibit 1).

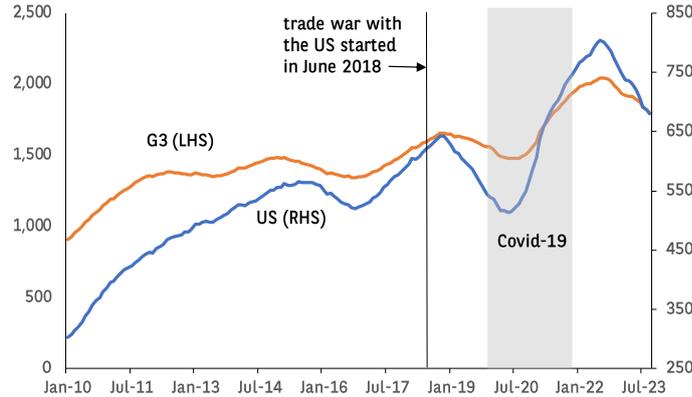


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Exhibit 1

China's total trade (USD bn) with the G3 (Europe, Japan & US)*



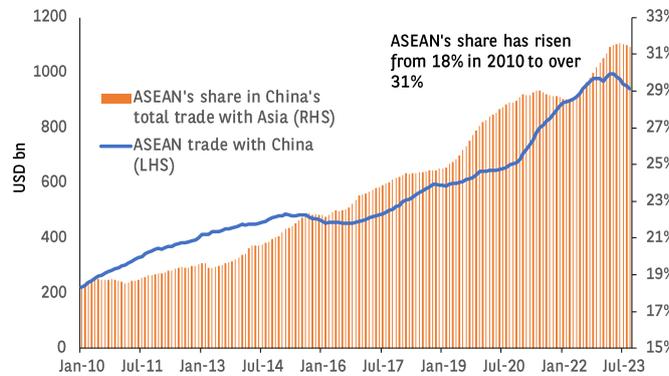
* exports + imports with Japan, Europe & US, 12-month rolling sum
sources: CEIC, BNPP Asset Management 10 Nov 2023

In Asia, China's trade with ASEAN has not only risen steadily but also accelerated after the Sino-US trade war. This has raised ASEAN's share in China's total trade with Asia to over 30% from around 18% in 2010 (Exhibit 2), suggesting that the region has become more reliant on China trade.

All this is not evidence of decoupling. China's sticky trade relationship with the G3 and its increase in trade with ASEAN have happened because of 1) China's development policy that sees itself as a driver for Asian growth, 2) China's reaction to the global demand shift, and 3) the change in the global supply chain structure.

Exhibit 2

China's trade* with ASEAN



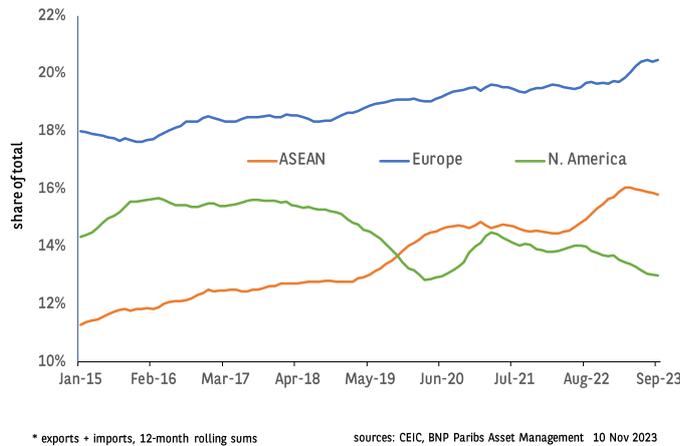
* exports + imports, 12-month rolling sum
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CHINA'S DEVELOPMENT POLICY

In its 'dual circulation' development framework, adopted since May 2020, China sees itself moving into a new paradigm where the global system would be divided into three main regions: Asia, North America and Europe, with each region being led by a super-regional power. Naturally, China sees itself as the leader in Asia.

The dual circulation strategy aims at using China's domestic growth impetus (the 'internal circulation') to drive both internal and regional growth and leveraging on intra-regional trade and capital flows (the 'external circulation'). This regional strategy has manifested in the increase in trade with ASEAN, with has surpassed North America since 2019 as China's second largest trading partner after Europe (Exhibit 3).

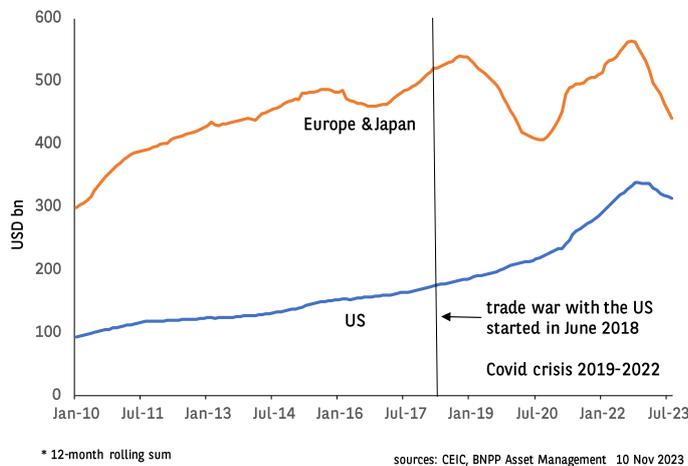
Exhibit 3
China's total trade with ASEAN, Europe & N. America



SHIFTS IN GLOBAL DEMAND AND SUPPLY CHAINS

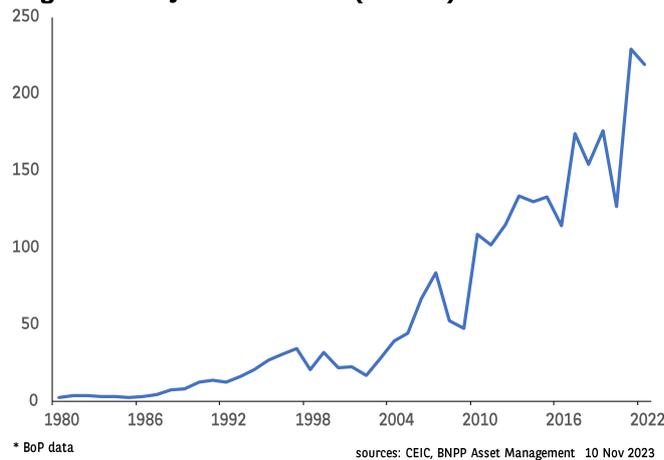
Since the Sino-US trade war, the G3 economies, especially the US, have increased imports sharply from ASEAN to reduce reliance on Chinese imports (Exhibit 4). So far, the trade war has resulted more in trade diversion than trade destruction. This is also not evidence for ‘re-shoring’ or even ‘friend-shoring,’ but instead reflects a shift (not a breakage) of Asia’s supply chains. The depth and scale of existing manufacturing operations in Asia, along with continued cost-competitiveness and network externalities prevailing in the region have prompted such shift.

Exhibit 4
G3's imports from ASEAN*



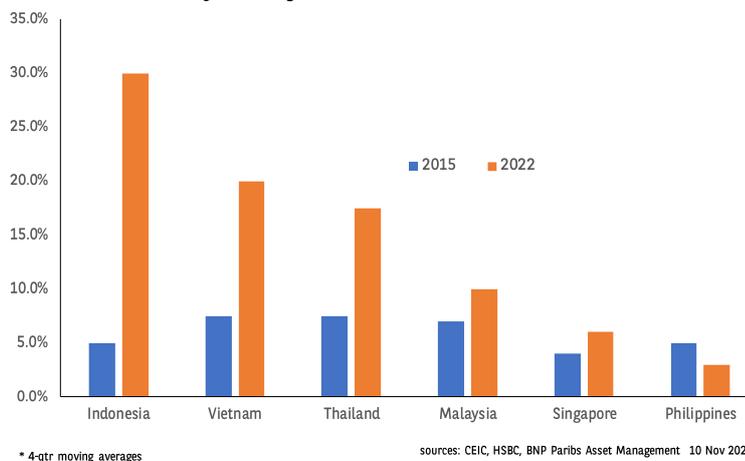
Buying more from ASEAN does not necessarily mean buying less or decoupling from China due to the so-called ‘China + 1 strategy’. This is a corporate strategy for multinational companies to keep producing in China (which was the top FDI destination in 2022) for the local market and move some capacity elsewhere, notably to ASEAN, to manage potential supply-chain disruption due to economic, political, and other considerations, such as the Covid-19 health crisis. The rising FDI trend to ASEAN (Exhibit 5) underscores such strategy, with the Sino-US trade war further boosting the incentive to relocate.

Exhibit 5
Rising net FDI inflows to ASEAN (USD bn)



Over a third of FDI flows to ASEAN's manufacturing sector comes from Northeast Asia, with China's share rising quickly, especially in Indonesia, Vietnam, and Thailand, in recent years (Exhibit 6). This highlights the growing connectivity between the Chinese and ASEAN economies and reflects further supply-chain integration between China and ASEAN, but not decoupling.

Exhibit 6
China's FDI share of country's total FDI*



In the conventional supply chains, ASEAN ships components and goods to China, which then sells to the world markets. That makes China the world's factory. However, the supply-chain dynamics have reversed in recent years, with China supplying ASEAN with products that power the region's exports to the world. This shift in the supply-chain integration process has expanded the world's factory to include both China and Asia that, in turn, boosted Sino-ASEAN trade to more than the amount of the Sino-US trade (see Exhibit 3).

REGIONALISM VERSUS DE-GLOBALISATION

In addition to using its internal growth impetus to drive domestic and regional growth, China's dual circulation policy also seeks to cooperate with ASEAN in the digital economy and promote the 'Health Silk Road' initiative by establishing a regional China-ASEAN public-health cooperation mechanism to fight diseases, such as Covid-19.

To leverage on the regional capital flows and investment opportunities, China encourages its domestic companies to increase investment in ASEAN, thus reducing the amount of net FDI inflows to China at any given level of gross FDI flows. To address geopolitical concerns, especially in the South China Sea, Beijing is seeking regular dialogue with the regional governments and trying to speed up the negotiations on the code of conduct in the region and maritime cooperation.

From the macroeconomic perspective, all this development will lead to the rise of regionalism with strong intra-regional economic linkages against a de-globalisation backdrop. Asia's supply chains have proven highly resilient to starve off disruptions to the global system. Their shift, as discussed above, is an adaptation to the global demand change and geopolitical tensions. This resilience forms the basis for long-term investment in EM Asia and China which remains in the core of the supply chains.

In the post Covid-19 world, domestic demand growth, import substitution and technological self-sufficiency would drive investment decisions and opportunities in China. For the regional economies, sectors and companies catering for Chinese demand and those leveraging on the supply-chain shift process to cater for world demand should benefit more than those market that fail to capture these structural shifts, *ceteris paribus*.

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