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Chi on China

FROM US TARIFFS TO CHINA DECOUPLING – EVIDENCE AND IMPLICATIONS

Hurt me with the truth but never comfort me with a lie.

Unknown author

SUMMARY

- Decoupling is a mutually inclusive incentive of China and the US aiming at de-risking. However, despite rising Sino-US trade tensions and falling foreign direct investment in China, there is no clear evidence that economic decoupling has become a trend.
- Increasing investment outflows from China reflect Beijing's efforts to boost regionalism to counter de-globalisation and the rise of geopolitical risks. They also mark a change in the global supply-chain structure with China further integrating into the regional supply chains but not decoupling.
- A new paradigm of regionalism may be emerging, encompassing onshoring, reshoring and friend-shoring. These developed world de-risking strategies will increase global competition and collaboration, simultaneously, with China and have profound global implications.

In May this year, the US imposed new import tariffs on Chinese solar panels and electric vehicles (EVs). The prospect of more US (and developed world) tariffs on a wider range of Chinese imports have revived the market's concern that an escalation trade war would force China to decouple from the developed world. This has also renewed fears about global supply chains disruption, fuelling risk aversion and driving investors away from investing in China and even Asia.

While decoupling has happened in some piecemeal fashion, with anecdotal evidence showing that some foreign investment has been leaving China, there is no evidence that a decupling trend has developed (see Chi on China: China Decoupling or the Rise of Regionalism, 17 November 2023). Crucially, local investors are also leaving China, significantly eroding China's net foreign direct investment (FDI) inflows and contributing to investor's negative sentiment on China.

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DECOUPLING, A MUTUALLY INCLUSIVE INCENTIVE

Contrary to conventional wisdom, decoupling is not only an American incentive to reduce its risk exposure to China. It is also a Chinese incentive to reduce its dependence on foreign technology. This bilateral incentive also underlies the drive for de-globalisation.

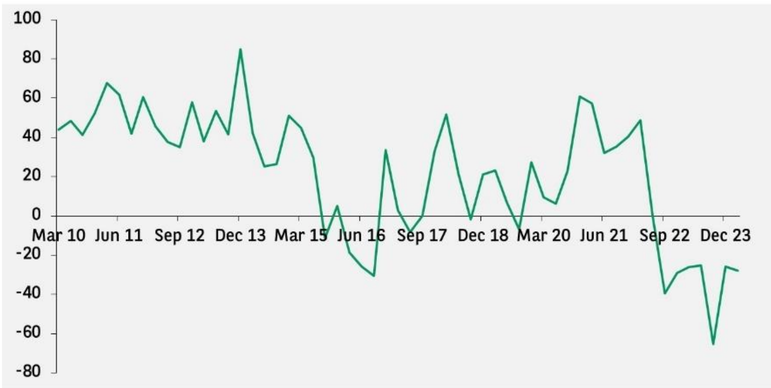
The new tariffs on Chinese imports have reinforced the common view in the US that decoupling is about reducing imports to safeguard or repatriate US jobs, and to ensure the national security of the American civil and military infrastructure. Contrary to its former "constructive engagement" policy, the US now sees China as a strategic competitor and is thus seeking to reduce what it sees as the risk of its economic dependence on China.

China has countered this change in US foreign policy with its "dual circulation" strategy (see Chi on China: China's "Dual Circulation" Strategic Pivot to Counter External Exigencies and Global Demand Shift, 16 September 2020). Arguably, this is China's decoupling effort through a strategic policy shift to hedge against the US risk by switching its policy focus to economic control from economic growth. Beijing's goal here is to boost the domestic sector as the key growth driver, reduce dependence on foreign technology and products by import substitution, and draw upon its domestic economic powerbase to achieve dominance in global competitiveness, overseas investment and global supply chains, and to drive regional (especially Asian) growth.

NET FDI DROPS

The sharp drop in China's net FDI from inflows (Exhibit 1), according to China's balance of payments (BoP) data, has contributed to the market's fear about the world decoupling from China. Some observers also argue that the FDI outflows were a sign of foreign firms de-risking or friend-shoring their businesses; in other words, leaving China for good.

Exhibit 1
Net FDI flows (USD bn, BoP data) to China have dropped sharply



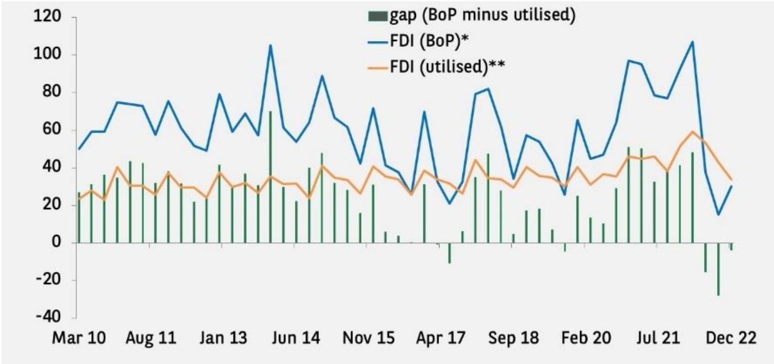
sources: CEIC, BNP Paribas Asset Management 30 May 2024

However, there is more than meets the eye. China has two FDI data series. The State Administration of Foreign Exchange (SAFE) reports quarterly BoP data which includes foreign firms' undistributed profit and unremitted profits. The Ministry of Commerce (MoC) reports monthly utilised FDI data which does not include the profits numbers.

Hence, the value of the BoP FDI data is usually larger than the utilised FDI data. Some research estimated that reinvested earnings of foreign firms accounted for 80% of the data gap between BoP and utilised FDI. Evidence shows that this data gap has been narrowing since 2016 and turned negative since mid-2022 (Exhibit 2). What is happening?

Exhibit 2

A narrowing gap: foreign firms repatriating more profits than reinvesting or new investment in China



sources: CEIC, BNP Paribas Asset Management 30 May2024

The data gap between these two FDI data series gives a clue as to whether foreign firms are deserting China. BoP FDI dropped more significantly than utilised FDI in 2022, suggesting that a big part of the negative data gap likely reflected foreign firms repatriating profits (hence the plunge in BoP FDI) to a greater extent than they reinvested their earnings or increased investment (represented by utilised FDI) in China.[1] Furthermore, monthly data (which has yet to be incorporated in the quarterly BoP numbers at the time of writing) shows that utilised FDI flows rebounded in 2023 (Exhibit 3).

So there is no evidence for significant asset sales (i.e. investment withdrawal) by foreigners.

Exhibit 3

Utilised FDI* (USD bn) has rebounded since 2023

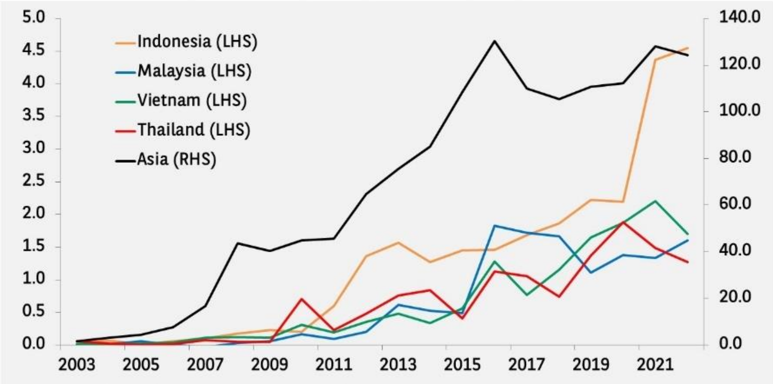
* 12-month rolling sum
sources: CEIC, BNP Paribas Asset Management 30 May 2024

OUTWARD DIRECT INVESTMENT

Also eroding China's net FDI inflows is the sharp rise in China's outward direct investment (ODI) in recent years, as China tries to secure its supply chains and diversifies its manufacturing base by shifting production to countries where exports are not subject to US tariffs. China's ODI is notably apparent in the ASEAN region (Exhibit 4).

[1] The exception year was 2021 when the pandemic stopped international capital flows including MNCs' profit repatriation, thus boosting the data gap.

Exhibit 4
China has been increasing investments (USD bn) in Asia significantly



sources: CEIC, BNP Paribas Asset Management 30 May 2024

By increasing their investments in Asia, these overseas Chinese firms have been able to source components and inputs from China for making exports to the US that are shipped from Asia. Hence, the Chinese content of US imports from Southeast Asia is rising, offsetting the decline in direct US imports from China. This indirect route for Chinese exports to the US (via Asia) arguably defeats the US's purpose of replacing Chinese imports by Asian imports in the trade war.

Crucially, this increase in China-Asian connection reflects a structural change in the global supply-chain with China integrating further with the regional supply chains but not decoupling (see Chi on China: China Decoupling or the Rise of Regionalism, 17 November 2023). This approach also vindicates China's "dual circulation" strategy to boost regionalism to counter de-globalisation and the rise of geopolitical risks.

Thus, there is no conviction that China is decoupling. Cyclical factors and an increase in risk aversion during the pandemic could have caused FDI inflows to fall in 2022 and 2023. Once the dust is settled, FDI flows will likely return. Furthermore, there are new sources of FDI inflows, notably from the Middle East, that will replace outflows led by the US (see Chi Time: Is Foreign Direct Investment Leaving China, for good, 7 December 2023).

THE COST OF DECOUPLING

Decoupling China is easier said than done, just as multinational corporations' (MNCs') "China + 1" strategy is easier proposed than implemented. The experience from the Covid-19 pandemic lays bare the truth that when China shuts down, Asia (to where many MNCs have diversified their production bases) also shuts down because of the close integration of China in the regional supply chains through intraregional trade and Chinese ODI in Asia.

China is not perfect. However, as many MNCs can attest, the regional countries lack size, scale, skills and efficient infrastructure, among other shortcomings. In contrast, China offers advantages that make decoupling impractical, including its size, well-financed infrastructure network, educated labour force, an efficient transportation and communication networks, a safe system and improving quality control etc.

Take Vietnam, whose economy is less than 3.0% of China's. Should MNCs move their production from China to Vietnam, it would quickly exhaust Vietnam's capacity. Companies could go to India. Those who have done so can attest that India's infrastructure is not capable of replacing production and distribution in China. Labour quality is another major factor. World Bank research shows that 97% of Chinese aged 15 and older were literate as of 2020 (the latest data available), but India's literacy rate was only 76% in 2022.

The incentive to decouple from China will remain as countries strive to avoid China-related risk. However, the extensive interdependence between the economies of China and the US and other countries argues that complete decoupling would be both impractical and implausible.

The German ifo Institute research estimates that a decoupling between the West and China, based on a 25% increase in import tariffs and a doubling of non-tariff barriers on both sides, would cost all countries dearly in terms of economic growth. China's real GDP growth could fall by over 2 ppt and those of the developed countries, including the EU (excluding Germany), the US, Germany and Australia by between 0.5 ppt and 1.5 ppt, depending on their intensity of the economic relations with China.

Granted, economic models do not necessarily represent the reality, but the message is clear: A decoupling of China and the developed world (led by the US) would lead to substantial losses on both sides and beyond as the world economies are closely connected to both China and the West.

NEW PARADIGM OF "COLLABETITION"

It is likely that neither the West nor China are going for complete decoupling. The US and European economic strategies are striving to strengthen their economies and reduce dependency on China through diversification. The same goes for China, whose dual circulation strategy aims at boosting domestic consumption and internal production capability (especially in the tech sector) to de-risk the West.

Implementing these economic strategies will lead to stronger competition between China and the West. However, the close ties between the economies will remain, resulting in ongoing collaboration. Ultimately, a landscape of "collabetition" (collaboration-cum-competition) will likely arise on the back of regionalism.

This new paradigm will involve tougher competition between countries, with players in the West striving to keep their technology edge over emerging players from China. However, there will also be new possibilities for cooperation as Chinese companies move up the innovation and high value-added ladder.

MARKET IMPACT

The most consequential aspect of even a partial US-China decoupling is likely in technology. Sino-US security competition is increasingly embedded in the two countries' domestic industrial and technological policies.

From a macroeconomic perspective, technological decoupling could hurt global growth in the long-term by reducing international trade flows, misallocating resources to production when the country does not have a comparative advantage, and restriction of cross-border knowledge diffusion. These could take the forms of reshoring, onshoring and friend-shoring, trade fragmentation and even protectionism.

From an investment perspective, there could be short- to medium-term benefits on, and disruption to, the commodities sector. Sino-US tech, and especially AI, competition means large investments in the high-tech sector and data centres and a subsequent surge in power consumption. The rise of EVs, for example, could lead to a surge in power consumption around the world, creating stress on the existing power infrastructure in the major economies.

The West pursuing de-risking through onshoring/reshoring/friend-shoring will lead to relocation of the world's manufacturing, resulting in a steady rise in capital investment in the manufacturing sector. The trend has already been driving a cyclical manufacturing recovery after the pandemic (Exhibit 5) and increasing demand for industrial commodities. If the momentum is sustained, it could provide a strong support for commodity prices, *ceteris paribus*.

Exhibit 5
Global manufacturing* bottomed out since late 2023

* Approx. by weighten averages of PMIs of China, the US and Eurozone
sources: CEIC, S&P Global, BNP Paribas Asset Management 30 May 2024

On the back of technology decoupling initiatives, US and China's electricity consumption will likely rise sharply in the coming years to satisfy the expected explosive growth of energy-intensive AI data centres and other high-tech development. The natural gas and nuclear power industries are well-primed to meet this surging energy demand as renewable energy solutions have yet to sufficiently scale up to replace fossil fuels.

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