FOR PROFESSIONAL INVESTORS – 22 July 2020

Chi on China

DECOUPLING FROM CHINA EASIER SAID THAN DONE

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

Confucius

SUMMARY

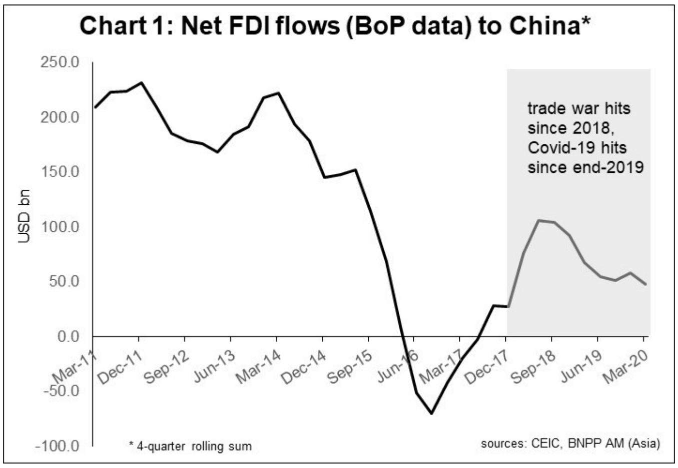
- China continues to receive net FDI inflows, including those from the US, despite rising geopolitical tensions. This is not a sign of economic decoupling. Evidence shows that foreign firms were repatriating profits but not capital (i.e. not leaving China).
- Despite all the political and market noises, the US seems to be integrating further into China's financial sector rather than decoupling from it. Meanwhile, China's integration into the global financial markets has also deepened as it opens up the onshore market to foreign investors.
- Although the incentive for global supply chains to decouple from China is high, it is easier said than done due to the deep crisscrossing supply chains network centred on China. The experience of Japan, Taiwan and South Korea can attest the decoupling difficulty.

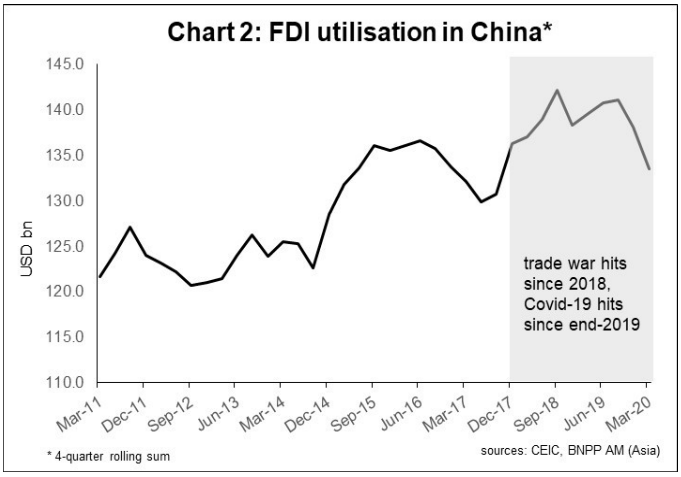
Foreign direct investment (FDI) has kept flowing into China despite the escalation of Sino-US tensions and the pandemic that have prompted many countries and international companies to consider cutting exposure to China for risk management purpose. Since 2018, Beijing has been trying to balance between fighting the trade war and keeping China as a benign FDI destination. Though it can easily resort to regulatory power to retaliate against America's trade war tactics[1], so far Beijing has refrained from doing so. The continuation of FDI inflows seems to vindicate that this balancing act is working.

[1] See "*Chi Flash: China's 'Nuclear Option' in the Trade War*", 3 July 2018.

DECOUPLING, NOT YET

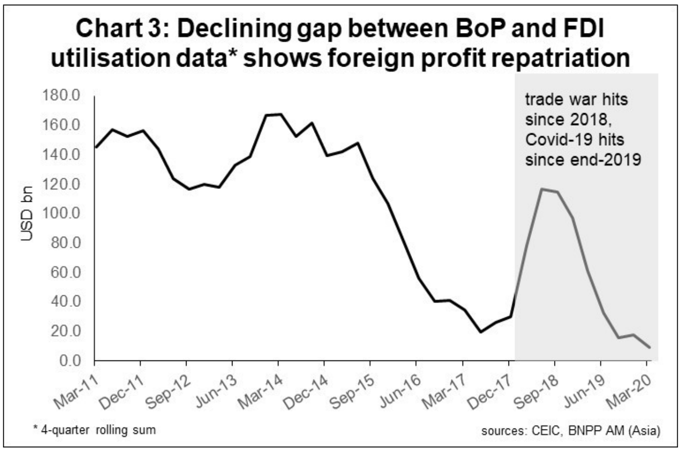
China's balance of payments (BoP) data, as reported by the State Administration of Foreign Exchange (SAFE), shows that net FDI inflows had continued despite the trade war and the pandemic, though the inflow trend has slowed recently[2] (Chart 1). The slower trend is likely a result of foreign firms restructuring their supply chains in response to rising cost in China, higher tariffs on Chinese exports due to the trade war, rising geopolitical risk and, most recently, the risk of China shutting down due to the pandemic. Meanwhile, FDI utilisation data, as reported by the Ministry of Commerce (MoC), shows the same trend (Chart 2).

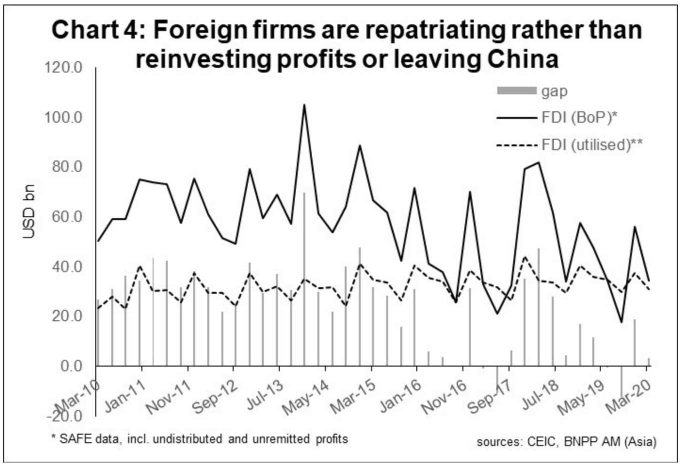




Crucially, the difference between the BoP data and the FDI utilisation data shows a trend of profit repatriation by foreign firms but not decoupling from China. The BoP data includes foreign firms' undistributed and unremitted profits while the FDI utilisation data does not. So the value of the former is usually larger than the latter. But this gap has been narrowing since 2016 (Charts 3) due to a fall in the BoP data on the back of relatively stable FDI utilisation (Chart 4). This phenomenon suggests that foreign firms were repatriating profits rather than reinvesting their earnings or withdrawing investment from China.

[2] The sharp drop in net FDI flows to China in 2015 and 2016 was due to massive outward direct investment by Chinese firms in those years that put significant downward pressure on the renminbi and finally triggered Beijing's capital control response at the end of 2016.





FINANCIAL MARKET INTEGRATING

Despite all the US tariff battles and investment restrictions on China, notably the recent US move to delist Chinese companies from US stock exchanges if they fail to comply with US accounting regulations, China-US financial integration has deepened since 2019 instead of decoupled. This has been a result of China accelerating financial liberalisation, prompted in part by the US trade war tactical pressure on China to open up its financial sector.

Formerly, foreign financial firms in China were only allowed to operate joint ventures with minority ownership stakes. But the liberalisation since 2019 has led to a sharp increase in the number of majority or wholly foreign-owned financial institutions operating in China. They include many large US firms such as PayPal, Goldman Sachs, JP Morgan, American Express, Fitch Ratings and S&P Global[3].

Meanwhile, China has also deepened its integration into the global financial markets, as seen in the sharp rise in foreign portfolio inflows to its onshore stock and bond markets. The strong inflows have not abated (although equity inflows are more volatile than bond inflows) despite the trade war and the pandemic (Charts 5 and 6). These inflows are set to grow as Chinese assets are being added to international benchmarks, prompting global investors to increase the weighting of China assets in their portfolios.

[3] Lardy, Nicholas and Tianlei Huang (2020), "*Despite the Rhetoric, US-China Financial Decoupling Is Not Happening*", China Economic Watch, Peterson Institute for International Economics. July 2.

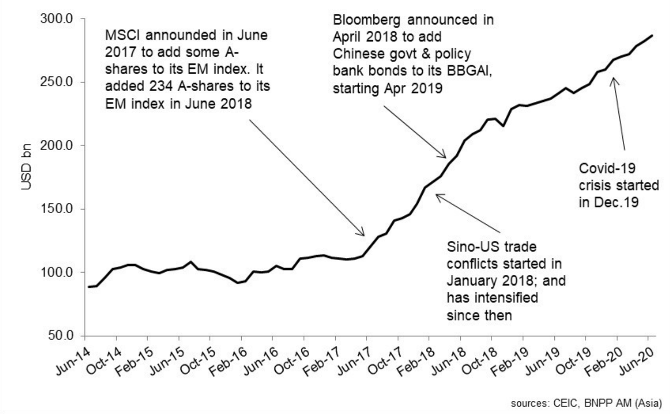


Chart 5: Foreign holding of Chinese onshore bonds

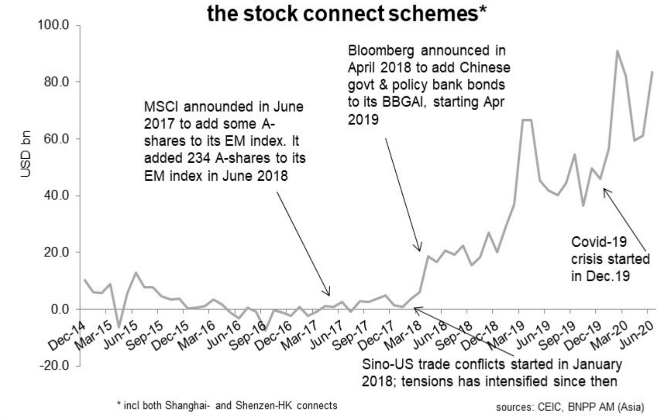


Chart 6: Net portfolio inflows to A-shares via the stock connect schemes*

SUPPLY CHAINS' INCENTIVE TO DECOUPLE

Nevertheless, the risks of a prolonged Sino-US trade war (which is mutating into a long-term tech war, in my view) and the pandemic have prompted considerations at both country and company levels to move supply chains away from China to diversify risks. For example, the Japanese government announced in April 2020 a JPY243.5 billion fund to assist Japanese companies to leave China[4]. Though the amount is small (about 3.5% of estimated total Japanese investment in China), the signal and incentive of decoupling are loud and clear.

US President Donald Trump has threatened to decouple from China[5] and this threat may turn out to be a long-term US foreign policy because if there is one thing Democrats and Republicans agree on, it is that they both want to check the rise of China, and decoupling from China is seen as a means to that end. Indeed, some US companies, including Apple, Google and Microsoft, have recently moved some productions to other Asian countries, such as Vietnam and Thailand, and are considering to make further moves to India and Mexico.

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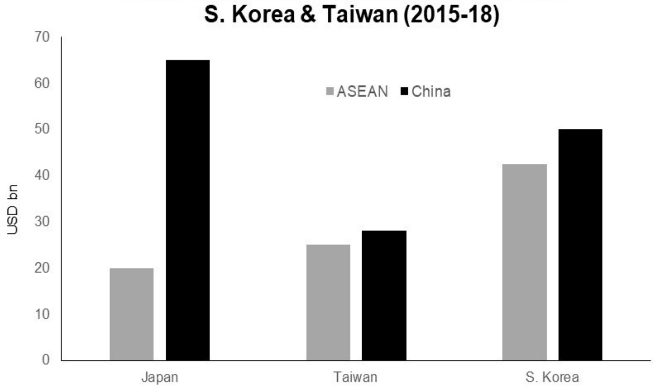
[4] Reynolds, Isabel and Emi Urabe (2020), "*Japan to Fund Firms to Shift Production Out of China*", Bloomberg, April 9.
[5] Lawder, David (2020) "*Trump Threat to 'Decouple' U.S. and China Hits Trade, Investment Reality*", Reuters Business News, June 24.

EASIER SAID THAN DONE

However, decoupling is easier said than done. This is because the world's integrated supply chains are centred on China and many FDI's strategy is targeting China's domestic market, as vindicated by recent US-China Business Council surveys[6]. Its 2019 survey found that 95% of its member companies invested in China for its domestic market and 87% had no intention of moving out of China[7]. Though these opinions may change, decoupling is not an imminent and quick process, as experiences of some countries can attest.

In recent years, despite efforts by Japan, South Korea and Taiwan to reduce concentration risk by decoupling from China and by increasing investments in SE Asia, their stock of FDI in China has remained very large (Chart 7). Furthermore, SE Asia is deeply integrated into the global supply chains that are dependent on China, relocating productions there does not deliver much diversification benefit. So China's shutdown during the Covid-19 outbreak hit Japan, South Korea and Taiwan's production lines both directly and indirectly through shutting down their supply chains in SE Asia which rely on Chinese inputs for production.

Chart 7: Foreign direct investment* by Japan, S. Korea & Taiwan (2015-18)



* accumulated FDI flows between 2015 and 2018

sources: CEIC, BNPP AM (Asia)

Arguably, decoupling from China is part of the de-globalisation trend that has been unfolding for some time already. International trade was stagnating before the pandemic, and global FDI had fallen by 31% in 2019 from its peak in 2007 (Chart 8). Covid-19 has sped up the process by providing a justification for reshoring as a risk management measure, especially for the production of strategic goods.

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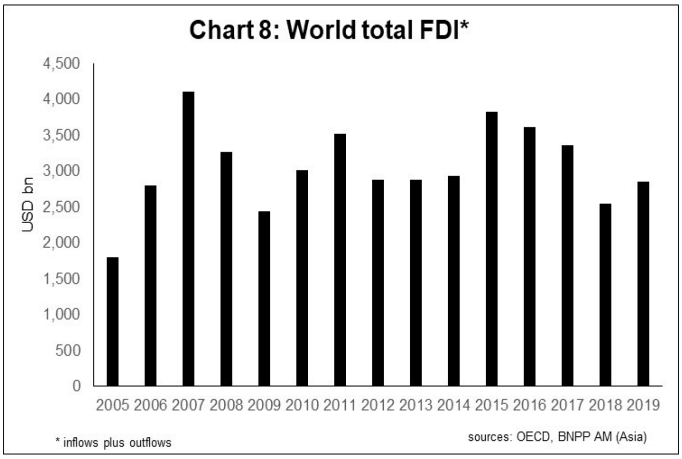
[6] See "*Member Survey – US-China Business Council 2019*" https://www.uschina.org/sites/default/files/member_survey_2019_-_en_0.pdf , and "*Most U.S. Firms Have No Plans to leave China Due To Coronavirus: Survey*", Reuters Business News https://www.reuters.com/article/us-health-coronavirus-china-business/most-u-s-firms-have-no-plans-to-leave-china-due-to-coronavirus-survey-idUSKBN21Z08K

[7] A February 2020 survey of Japanese companies by Tokyo Shoko Research showed that only about 4% of Japanese companies were considering to exit China https://www.tsr-net.co.jp/news/analysis/20200220_04.html



The process of de-globalisation forcing supply chains restructuring and decoupling from China may well continue, but it will only unfold slowly. The development may lead to the emergence of two competing trading (and technology) blocs in the long-term, with one led by China and the other led by the US. Such a potential outcome will re-shape the landscape of global trade and technology with far-reaching investment implications.

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