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In Turbulent Waters: Corporate Strategies in Times of Geo-economic Tensions

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In 2023, foreign direct investment (FDI) into China slumped to US$30 billion, a level not seen since the 1990s and almost 90% down from peak inflows in 2021. Even before 2023, China had also been losing market share in global FDI. Forward-looking indicators, such as announced greenfield investments and mergers and acquisitions, also show a distinct move away from investment in China. Beneficiaries of this shift include India, Vietnam and Indonesia.

China had been among the top recipients of FDI for decades since its entry to the World Trade Organisation (WTO) in 2001. The trickle of investment last year was seen by some as yet another indication of the end of the China miracle. For others, the drop in FDI was just the latest sign of a world that has been slowly decoupling since the global financial crisis in 2008, reinforced by the supply-chain disruptions of the COVID-19 pandemic and the growing demands for safer and sustainable (i.e. shorter) supply chains.

Findings from surveys of the European Chambers and American Chambers of Commerce likewise suggest growing hesitations to invest as more and more companies are seeking to diversify away from China. Moreover, the mood at company headquarters is often more negative with respect to China than at the subsidiaries in the country.

However, as the largest exporter in the world, China remains crucial to the world economy. While exports to advanced markets are declining as a share of total, China's exports are shifting to emerging markets, particularly ASEAN, the Middle East and Central Asia. China's exports

to Russia have also more than tripled since the war in Ukraine. China is now home to the largest, deepest and most advanced manufacturing sector in the world, accounting for 30% of global manufacturing, double the share of the United States of America or European Union (EU), and four times as large as the share 25 years ago. Many products, including very advanced ones, can now only be produced in China on the scale and at the quality and level of sophistication that the global market demands.

China has evidently moved up the value chain. Twenty years ago, China's exports were dominated by low-value-added consumer goods produced by foreign-invested companies. Now, high-value-added intermediate goods produced in China constitute an increasing share of the inputs for production in East Asian and Pacific countries destined for export to third countries like the United States. Even for the majority of advanced countries, dependence on China in terms of value-added of imported goods has surged, whereas China has reduced its dependence on imported value added from traditional sources such as the United States, the EU and Japan.

TALK OF THE TOWN

The drop in FDI in China and shift in supply chains are seen as a result of the current geopolitical climate, especially the tensions between the United States and China, which, according to warnings of the International Monetary Fund, could have the adverse effect of an economically fragmented world, one that is less connected, less efficient and less prosperous.

Decoupling, de-risking and even a New Cold War have become the talk of the town, according to *Dealing with Decoupling from China: Business Strategies in a Changing World*, a new report by the East Asian Institute (EAI) of NUS and the Leiden Asia Centre (LAC) in the Netherlands.[1] While mentions of decoupling in the press started to rise in the last decade and intensified after the Trump administration's trade and technology sanctions, Russia's invasion of Ukraine elevated geopolitics to the top of the political and corporate agenda. Reflecting increasing geopolitical tensions, governments around the world are implementing policies to restrict trade and limit investment with potentially hostile third countries, which for some industralised countries include China.

CORPORATE GEOPOLITICAL HEADACHES

Foreign companies operating in China are now assessing the economic and political risks of doing business in China. The EAI LAC report investigates the implications of geopolitical shifts for foreign businesses in China from the Netherlands, Singapore, Germany and Japan, the four advanced Asian and European countries that are among the most connected with the Chinese economy and yet are bystanders in the US-China conflict. The report analyses statistics on global trade and investment together with data from in-depth interviews and a structured survey of 78 companies, providing a detailed and bottom-up view of the implications of geopolitics for those most directly involved.

All companies surveyed considered geopolitics a critical risk for their operations, but the views and strategies they have developed differ according to the sector they are in, their home country's relationship with China, and especially their position in the supply chain.

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[1] East Asian Institute and Leiden Asia Centre report, *Dealing with Decoupling from China: Business Strategies in a Changing World*, 2024, available at https://leidenasiacentre.nl/dealing-with-decoupling-from-china-business-strategies-in-a-changing-world/.

Dutch, German and Japanese companies are generally critical of their home country's governments siding with the United States, preferring instead a more balanced approach to relations with the United States and China. Singaporean companies praise their government for exactly that balance, and strongly support its refusal to pick a side in the conflict.

For many companies, opportunities in China, which had already cooled since the start of the US-China trade conflict in 2018, took a further turn for the worse in 2022 and 2023 because of the deepening of US-China conflict and the economic slowdown in China in 2023. Nevertheless, companies remain positive on prospects and investment in China. Companies whose business requires a long-term view, a considerable capital outlay and extensive product development and R&D tend not to be put off by what they see as manageable or temporary problems.

What worries many companies much more is the emerging alliance of the United States with its partners in Europe and Asia to contain China. The risks from US sanctions or tariffs on China are often less about what already is in place than about what might happen in the future. The issues most often raised were the possibility of a war over Taiwan or in the South China Sea—which could lead to catastrophic losses on investments in China. Western concerns on human rights play their part as well, as demonstrated by the recent withdrawal of BASF and Volkswagen from their operations in Xinjiang.

Fears about US policies go beyond trade measures and technology sanctions. They include potential financial sanctions, as debated in the US Congress. Several large US investors, including the US$800 billion Federal Employee Pension Fund and giant investment manager Vanguard Group are seeking to reduce or even eliminate their presence in or exposure to China. This growing "financial decoupling" will make it harder for not only Chinese companies to find funding, but also investors from third countries to maintain a presence in both China and the United States simultaneously.

Foreign companies in China are also concerned about Chinese government retaliation, particularly under the recent Chinese anti-foreign sanctions law. Like American sanctions, this law also allows for extraterritorial applications, potentially creating an escalatory spiral that will make it ever more difficult to silo off US and Chinese operations from each other.

STRATEGIES TO COPE WITH GEOPOLITICS

Despite mounting geopolitical risks, many companies consider China too big to walk away from. Company strategies are more about diversification and assessing options than about leaving China totally. Several decoupling and recoupling strategies often work in tandem and enhance each other. Investments outside China are often complemented by investing in China to reduce the dependence of local operations on foreign suppliers or export markets.

The most common strategy companies pursue is the 'China for China' approach, a combination of diversifying production and supply chains to other countries, together with localising the operations in China. Strengthening the autonomy of the company's subsidiaries in China may include not just their leadership, strategy and finances, but also further investment in R&D, product development, production, marketing and servicing in and for China. Cooperation with, or shareholding in, one or more Chinese companies is another important aspect to meet Chinese compliance requirements and to localise R&D, development or marketing.

While downstream production is relocated to other less impacted countries (known as 'near-shoring' or 'friend-shoring'), China often remains the supplier of core intermediate inputs for

products destined for third-country markets, typically the United States or Europe. Companies can also choose to diversify their upstream supply chains to reduce their dependency on just a very few foreign suppliers of crucial, high-end components. Alternatively, autonomous operations can be established in countries with a large and promising market, thus fully moving part of production away from China ('China-plus-one').

A further common strategy is to do nothing at all and to develop contingency plans in case the company has to pull out of China. This strategy usually applies to two types of companies, namely those that mainly rely on direct exports of non-strategic goods to China and smaller companies with all or most of their operations in China that cannot afford the costs of establishing themselves elsewhere.

RELEVANCE FOR SINGAPORE

Singapore has benefitted in some respects from business decoupling from China. This includes financial and business services, the hospitality industry and the relocation of production facilities and regional headquarters. Singaporean businesses in China are also less at risk of possible Chinese measures and hostility than American and Japanese (and, in the future, possibly European) companies.

Despite Singapore's neutrality and strong cultural ties with China, some Singaporean companies and investors are becoming more reluctant. In 2023, Singapore's Temasek and Government Investment Corporation announced a reorientation of their investments away from China to other markets in Southeast and South Asia. They will also ringfence their operations in China to make them autonomous from the headquarters in Singapore and protect them from possible geopolitical fallout.

Several smaller or more recent players in the Chinese market from Singapore also said that geopolitics made deepening their commitment to China difficult. Moreover, younger entrepreneurs are often educated in English and in the West and do not have the same strong ties and affinity with China as the older generations.

Nevertheless, many Singaporean companies are well-established in China. If necessary, they are even prepared to forgo their US business. While companies are definitely more cautious now, the emphasis remains on the opportunities that China could offer as a growth market both for trade and production.

WHERE DOES THIS LEAVE CHINA?

The most recent FDI numbers are not all bad news for China: the lockdowns during COVID had greatly impacted the country's FDI numbers for 2023, making it impossible for corporate decision makers to travel to China and do their due diligence. Moreover, the low numbers are in part the result of factors that have little to do with the investment climate or geopolitics. With high interest rates to combat inflation in most of the developed world, many foreign companies that used to invest their profits in China now can make higher returns abroad, which is reflected in lower FDI flows. Utilised FDI—a different measure of foreign investments that excludes such flows—was down by far less than the headline FDI measured on the balance of payments. Some of the slowdown is a result of China's own policies, not geopolitics. China has recently changed its legal framework affecting foreign investors including imposing heavy restrictions on cross-border data transfers, tightening the anti-espionage law and state secrets law and carrying out raids on companies that perform due diligence on Chinese companies at the behest of foreign investors. Despite the increasing risks, many foreign companies are not prepared to

pull out of China. They are developing new strategies to protect their China operations and the global company as a whole against the vagaries of geopolitical competition and conflict.

Regardless of the slowdown in China, China's economic strengths and importance to individual companies and the world economy at large remain largely undented but are changing. The country continues its transition to an advanced, innovation-driven economy dominated by a strong market sector and backed by a powerful state.

China remains central to all its trading partners' economies: for most countries, including the most advanced ones, the share of China's value added in total imported value added has increased in recent decades. China's growing domestic market and, increasingly, its technology ecosystem, such as in EVs and New Energy, make a presence in China practically mandatory for global companies.

China's move towards self-reliance in sectors important for national security makes it even more important for foreign companies to be present in China itself. It is also doubling down on policies that make the country more attractive for foreign investors in response to the recent decline in FDI. Therefore, it is still premature to write off China as a pivot of the world economy and a prime destination for foreign investment.

Note: An earlier version of this commentary appeared in The Straits Times.

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