NUS National University of Singapore

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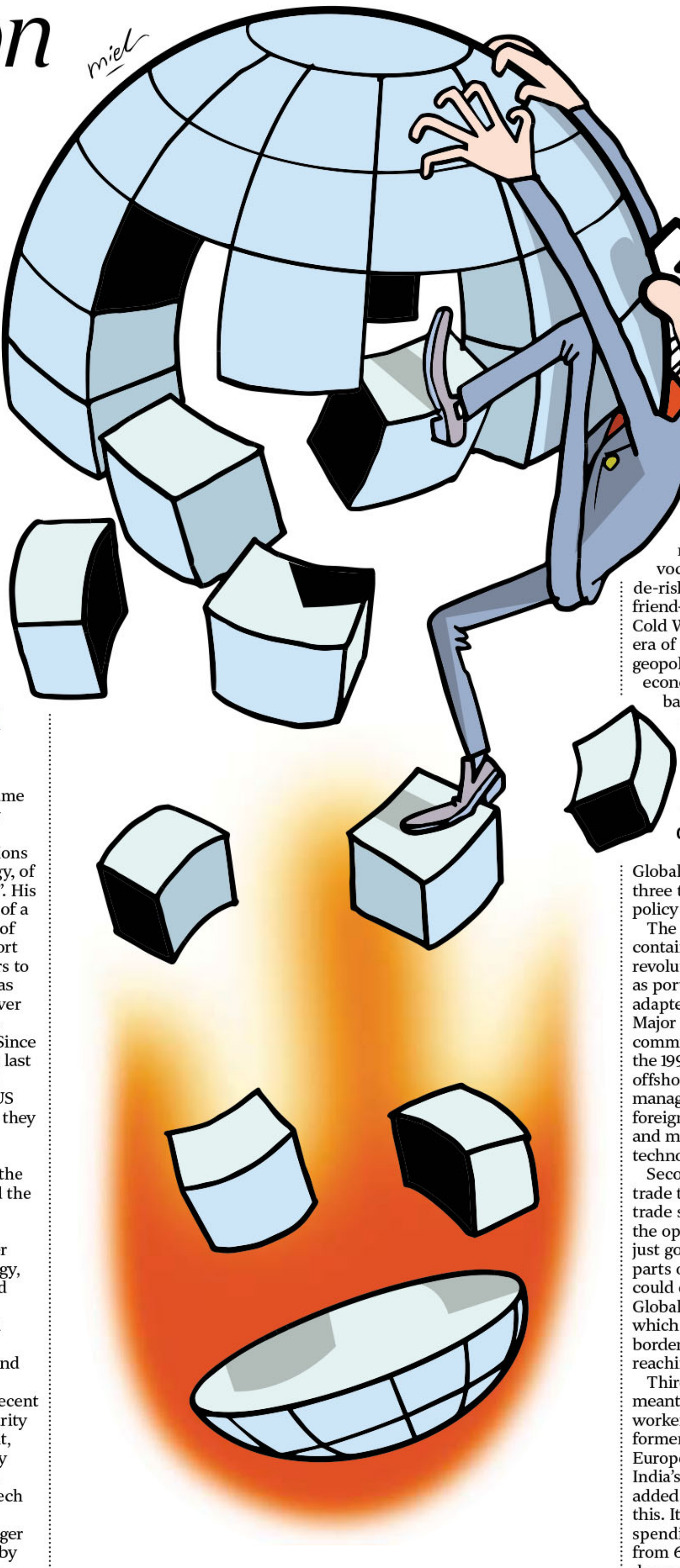
# *Fragmentation – the big threat facing the global economy*




It's not just decoupling. Trade and investment flows are already being hit as the three major economic engines – US, EU and China – put up fences while pursuing national security-driven industrial policies. It could get worse.

**Bert Hofman**

In his latest tour to Europe this May, China's Foreign Minister Qin Gang was on a mission. He had a clear aim: to prevent Europe joining the United States in its endeavour to limit China's access to advanced technology. He called on his German counterpart to "stick to the right path, jointly oppose the new cold war, and decoupling economies or severing supply chains".

He faces an uphill struggle. But beyond that, the world economy is confronting more than the already fraught effects of US-China decoupling. As all three major engines of the global economy – the US, China and the European Union – go about trying to balance national security with trade and investment, the world economy is at risk of fragmentation.

European Commission president Ursula von der Leyen, in a hawkish speech on April 20, had assured China that the EU did not seek to decouple from China, but that it wants to "de-risk" the relationship. What that means is set to become clear in the coming weeks, when the EU is to present a list of goods and technologies that are too risky to hand to China.

US Treasury Secretary Janet Yellen struck a similar tone in a recent speech at Johns Hopkins University. She said that the first principal objective of the US economic approach to China is to secure national interests. The US, she added, wants a healthy economic relationship with a China that "plays by the rules".

US National Security Adviser Jake Sullivan sang from the same hymn book as Dr Yellen a few days later at the Brookings Institute. He spoke of restrictions on a limited slice of technology, of "small yards with high fences". His tone had mellowed from that of a speech last September ahead of the announcement of US export restrictions on semiconductors to China, which put the US aim as keeping absolute advantage over China in critical technologies.

That aim has not changed. Since the US export ban took effect last October, the Netherlands and Japan were asked to join the US efforts on semiconductors, as they are critical suppliers in the industry. It was an offer they could not refuse. Meanwhile, the US Chips and Science Act and the Inflation Reduction Act put money towards the aim of reducing dependence on other countries for critical technology, including semiconductors, and also renewable energy.

In turn, the EU has doubled down on its industrial policy initiatives on Digital Europe and Green Europe. Like the US, European countries have, in recent years, tightened national security reviews of Chinese investment, and together with the US, they have set up a Technology and Trade Council to coordinate tech and trade issues.

China is, of course, no stranger to an industrial policy driven by national security concerns. Its "dual circulation" strategy is aimed at reducing dependence on other countries in critical supply chains while encouraging the dependence of other countries on China. At the 20th Party Congress last October, Communist Party General Secretary Xi Jinping made clear that "national security is the bedrock of national rejuvenation".

China's negative list for foreign investment in part reflects national security concerns. China's cyber-security law, which regulates data transfer across borders, and more recently, the expansions of the definition of espionage are further complicating doing business in China for foreign companies. The recent police raids on the offices of several due-diligence companies have poured cold water on the prospects of foreign investors, which rely on such companies to ensure their suppliers or acquisitions abide by their standards.

The growing geopolitical tensions between China, the US and Europe have given rise to a whole new vocabulary: decoupling, de-risking, onshoring, friend-shoring, near-shoring and Cold War II. We have entered an era of "geo-economics" as geopolitics reshapes the global economy. Depending on how the balance of national security and economy is struck in the end, the damage can be considerable, and even catastrophic.

## THE BENEFITS OF GLOBALISATION

Globalisation has been driven by three things: technology, trade policy and politics.

The invention of transport containers in the 1950s revolutionised international trade as port facilities around the world adapted to the new phenomenon. Major improvements in communication technologies from the 1990s made outsourcing and offshoring cheaper and easier to manage, which enabled a jump in foreign direct investments (FDI) and more rapid diffusion of technology across the globe.

Second, the gradual reduction in trade tariffs reduced the costs of trade significantly. With it came the opportunity to produce not just goods, but also individual parts of goods, in the country that could do so best, or cheapest. Global value chains emerged in which parts of goods crossed borders more than once before reaching final demand.

Third, the end of the Cold War meant that more than a billion workers in China, Vietnam, the former Soviet Union, and Eastern Europe joined the global economy. India's reforms of the early 1990s added another large economy to this. It also meant that global spending on the military declined from 6 per cent of world gross domestic product (GDP) to 2 per cent now.

Together, these three forces drove global trade, growth and productivity in the past five decades. Trade as a share of global GDP more than doubled from 25 per cent in 1960, to 56 per cent now. FDI quintupled from about half a per cent of GDP in the 1960s, to an average of about 2.5 per cent of GDP in the past decade. Import tariffs across the world were slashed from 8.5 per cent on average before the World Trade Organisation (WTO) was set up in 1996, to 2.6 per cent now. Remarkably, growth in income per capita in the 20 years after the founding of the WTO was globally almost 50 per cent higher than that of the 20 years before it, even though it slowed in high-income countries.

The 2007-2008 global financial crisis (GFC) heralded the end of hyper-globalisation. Discontent with the domestic distributions of the gains of globalisation, and concerns about environmental consequences and perceived vulnerability to shocks in global supply chains, have driven a rethinking of globalisation. Since the GFC, global trade as a share of world output has moved sideways, whereas the share of FDI in global GDP went from more than 3 per cent in the 2000s, to less than 2 per cent in the last decade.

Developments in China played a significant role in the changing patterns: Its growing domestic supply chains meant that more and more of what it previously imported was now produced at home. The growing share of domestically produced parts that go into an iPhone is just one example of this phenomenon: China accounted for 3.6 per cent of the production costs of the iPhone 3G; for the iPhone 10, it was 25.4 per cent. While onshoring of supply chains can well be understood as a normal outcome of a country that successfully develops, it may also be a sign that China's dual circulation strategy is leaving its marks already.

## SIGNS OF THINGS TO COME

Signs of decoupling are becoming visible in the numbers. China's exports to the US have declined as a share of US imports. At the same time, exporters, including Chinese exporters, have adjusted. China's exports to Vietnam and Thailand of intermediary goods have sharply increased as exports from Thailand and Vietnam to the US surge. The clear loser was the US consumer that paid for the tariffs or the higher production costs.

FDI is also showing signs of a realignment. Even though FDI inflows in China are still holding up, much of it comes from established firms reinvesting their profits. The number of new investments is way down, though: According to the International Monetary Fund (IMF), the number of greenfield investments from the EU and US into China was down by 20 per cent and 40 per cent in 2022, compared with the average in 2015-2021.

Surveys of the European and American Chambers of Commerce in China suggest that more and more companies are considering moving at least part of their operations to other countries. Some high-profile ones have already done so, including Foxconn, which moved some of its iPhone production to India.

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# The glue that keeps global order

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The Rhodium Group found that investment of the EU into China is increasingly concentrated among the top 10 investors, companies such as BASF and Volkswagen. Smaller investors stay away, awaiting clarity on how geopolitics will work out.

Meanwhile, China's investment overseas is also down: Investments into the US have practically dried up, and the country invested less than €8 billion (S$11 billion) in Europe in 2022, less than one-fifth of the number in 2016. Even though the numbers are clouded by the Covid-19 pandemic, exchange of students and academic cooperation between the US and China are also down, signalling decoupling beyond trade and investment.

**DAMAGE ASSESSMENT**

Things could get worse. In 2020, the Rhodium Group explored a "green list" approach for the EU – the same type of list Dr von der Leyen is now working on.

According to that study, 56 per cent of EU exports to China are completely benign, while 83 per cent of China's exports to the EU qualify as "green". FDI vulnerabilities are larger: 46 per cent of China's FDI in the EU and 32 per cent of the EU's FDI in China in 2019 failed to make the Rhodium green list. If representative of the EU approach to come, this would mean significant disruptions ahead in the EU-China economic relationship.

The IMF has recently estimated what a fragmentation of the world economy into economic blocs would imply. The cost of investment fragmentation could lower global GDP by 1 per cent, and double that for GDP in China.

Trade and technology fragmentation can be more damaging still: The cost to global output from trade fragmentation could range from 0.2 per cent in a limited fragmentation scenario, to up to 7 per cent of GDP. With the addition of technological decoupling, the loss in output could reach 8 per cent to 12 per cent in some countries. China could lose up to 9 per cent of GDP in a decade in the most extreme decoupling scenario.

These are massive costs. To compare, the Asian Development Bank estimates that the benefits of Regional Comprehensive Economic Partnership, a major trade agreement, are about 0.6 per cent of GDP of member countries. Academics estimate the benefits of the WTO for the average country at 4 per cent of GDP. In other words, losses of geopolitical fragmentation could be two to three times larger than the gains the WTO produced.

Economic models are not reality, and politicians and diplomats can still shape the future global economic landscape in times of geopolitical tensions. However, it takes more than the promise of long green lists and small yards with high fences. It takes a restoration of trust between the competing superpowers.

Strategic trust, as Singapore's Foreign Minister Vivian Balakrishnan said recently in a speech at the Australian National University, is the glue that keeps the global order from disintegrating. If a country cannot be reasonably certain that it can import the critical goods and technology it needs, it will strive to make them by itself. This classic prisoners' dilemma will result in a world of trade blocs, and all will be worse off than today.

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