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 engines – US, EU and China – put up walls despite 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 efforts 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 battle. 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 hardsell speech on April 20, had assured China that the EU did not seek to decouple from China, but that it serves “to defend national interest”. What that means is now at the heart of the ongoing talks, 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 Advisor Jake Sullivan sang from the same tune book as Dr Yellen a few days later at the Brookings Institution. He spoke of restrictions on a limited list of technology, of “small peaks 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 at an advantage 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 to limit supplies to semiconductors, as they are critical suppliers to 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 technology.

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, reviewed 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, of course, is no stranger to an industrial policy driven by national security concerns. Its “dual circulation” strategy aimed at reducing dependence on other countries for supply chains while encouraging the development of domestic industries on China. At the 26th Party Congress last October, Communist Party General Secretary Xi Jinping made clear that “national security is the backbone 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 blue-chip defense companies have panned cold water on the prospects of foreign investment, which rely on such companies to ensure their suppliers or acquisitions abide by their standards. Growing geopolitical tension between China, the US and Europe have given rise to a new vocabulary: decoupling, de-escalating, friend-shoring, near-shoring and Cold War II. We have entered an era of “geo-economics” as geopolitics reshape 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 irreversible.

THE BENEFITS OF GLOBALISATION

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

The invention of transport containers in the 1960s revolutionised international trade as port facilities around the world adapted to the new phenomenon. Major improvements in communication technologies from the 1980s 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 a 10% to 20% levy on what used to be just goods, but also individual parts of goods, in the country that produced them, it was much cheaper, and more profitable, to produce goods in countries that had lower tax rates. Global value chains emerged in which parts of goods travelled from country to country before reaching final demand.

Finally, the Cold War meant that more than a billion people, in the former Soviet Union, and Eastern European countries, were cut off from the global trade. After the fall of the Iron Curtain, the Cold War meant that more than a billion people, in the former Soviet Union, and Eastern European countries, went from being cut off from the global trade. After the fall of the Iron Curtain, they found that what they could produce was sold to the USSR, or sold to other countries. The Soviet Union, the former Soviet Union, and Eastern European countries, in the 1990s and the early 2000s, became a large and large economic powerhouse. This also meant that global companies could now compete with the world’s largest companies.

THE CHALLENGES OF GLOBALISATION

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

First, the trade wars of the 1980s and 1990s. China’s accession to the World Trade Organization (WTO) was set up in 1995, to 2.6% per cent now. Remarkable, 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 distribution of the gains of globalisation, and consequential responses, and perceived vulnerability to shocks in global supply chains, has driven a rethinking of globalisation. Since the GFC, global trade as a share of world output has declined, whereas the share of FDI in global GDP was more than 2 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 chain 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 34.7% of the production costs of the iPhone 5G for the iPhone 10, it was 31.4% per cent. While outsourcing of supply chains can yield an unexpected outcome of a country that is not a country, it can also be a sign that China’s dual economy is losing its marks already.

SIGNS OF THINGS TO COME

Signs of decoupling are becoming visible. China’s imports of US exports 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 household goods have sharply increased as exports from Thailand and Vietnam to the US surged. The clear loser was the US, who paid for the tariff or the higher production costs. FDI outflows, signs of a rise in the circulation of a realignment. Even though FDI inflows in China are still rising, much of it comes from companies that want to protect their profits. The number of new companies from the US has declined. According to the International Trade Center, the number of new companies from the US that went to China was down by 20 per cent and 40 per cent in 2022, compared with the average in 2010-2013.

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The glue that keeps global order

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, 86 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 is 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 tension. 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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