Employees at a factory that makes lithium batteries for laptops and other uses, in China's eastern Jiangsu province. China is home to the largest, deepest and most advanced manufacturing sector in the world. Many products, including very advanced ones such as high-end machines and equipment, electric cars and batteries, can only be produced in China on the scale and at the quality and level of sophistication that the global market demands. PHOTO: AFP

# The geopolitical waters are turbulent but don't count China out yet

Falling FDI figures are grim but they don't provide the full picture of how companies are reacting to political pressures.

**Bert Hofman and Frank Pieke**

Foreign direct investment (FDI) into China was down to US$30 billion (S$40.3 billion) in 2023, a level not seen since the 1990s and almost 90 per cent less than the peak inflows of 2021. Forward-looking indicators, such as announced greenfield investments and mergers and acquisitions, also show a distinct move away from investment in China.

Clearly, attitudes towards investing in China are changing. Numbers from fDi Intelligence, a service that tracks announced FDI deals, suggest that China will continue to lose share in global FDI – and that India, Vietnam, Mexico and others are gaining. Surveys of the European and American chambers of commerce also reveal a growing share of companies that seek diversification away from China.

What to make of these numbers? Are they a sign that the end of the China miracle has finally come?

Not quite.

China remains crucial to the world economy. Rather than declining, its exports are shifting away from advanced markets towards emerging markets, particularly in South-east Asia, the Middle East and Central Asia. Emerging economies now take up almost half of China's exports – compared with 40 per cent for Group of Seven countries plus the European Union.

China is also home to the largest, deepest and most advanced manufacturing sector in the world. Many products, including very advanced ones such as high-end machines and equipment, electric cars and batteries, can only be produced in China on the scale and at the quality and level of sophistication that the global market demands.

This is reflected in the evolving nature of its exports. 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.

The fall in FDI could be seen as 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.

Most of all, though, the drop in FDI and shifting supply chains are a result of the current geopolitical climate, with Sino-US tensions driving efforts by governments to restrict trade and investment with potentially hostile third countries, which for many countries of the developed world includes China.

## CORPORATE PERSPECTIVES

For foreign companies operating in China, these geopolitical developments are fundamentally changing the economic and political risks of doing business there.

A new report by the East Asian Institute of the National University of Singapore and the Leiden Asia Centre in the Netherlands investigates the implications of geopolitical shifts for foreign businesses in China from four countries - the Netherlands, Singapore, Germany and Japan. These four are among the world's most connected with the Chinese economy, yet they are bystanders in the US-China conflict.

Along with an analysis of statistics on global trade and investment, the research carried out in 2023 is based on in-depth interviews and a structured survey of 78 companies across diverse sectors, such as machine building, chemicals, food and agriculture, real estate, finance and business services. Together, they provide a detailed and bottom-up view of the implications of geopolitics for those most directly involved.

All the companies considered geopolitics a critical risk for their operations, the study found. Their views and strategies, though, vary greatly according to the sector they operate in, their home country's relationship with China, and especially their position in the supply chain, for instance as producer of upstream components, final assembler or distributor of intermediate finished products.

Dutch, German and Japanese companies are usually critical of their home country's governments siding with the US, and favour a more balanced approach to relations with the US 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, their assessment of opportunities in China took a turn for the worse in 2022 and 2023, in part because of the economic slowdown in China. Nevertheless, the general outlook on China remains positive.

Companies whose business requires a long-term view, coupled with a considerable capital outlay and extensive product development and research and development 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 US with its partners in Europe and Asia to contain China. The worries about US sanctions or tariffs on China are often less about what is already 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 moves of BASF and Volkswagen to withdraw their operations from 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 adviser Vanguard Group, have publicly or privately made known that they are seeking to reduce or even eliminate their presence in or exposure to China. This growing "financial decoupling" will not only make it harder for Chinese companies to find funding, but also might make it more difficult for investors from third countries to maintain a presence in China and the US simultaneously.

Foreign companies in China are also concerned about the impact on their business of Chinese government retaliation, in particular 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 the US and Chinese operations from each other.

## STRATEGIES TO COPE WITH GEOPOLITICS

For many companies, China is simply too big to walk away from. As such, company strategies are more about diversification than about leaving China totally.

Several decoupling and recoupling strategies often go together. Investments outside China are often complemented by investing in China to reduce the dependence of operations there on foreign suppliers or export markets.

The most common strategy companies pursue is a combination of diversifying production and supply chains to other countries, together with localising operations in China, often called "China for 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 measure, to meet Chinese compliance requirements and to localise R&D, development or marketing.

Where downstream production is relocated as part of "near-shoring" or "friend-shoring", China often still supplies core intermediate inputs for products destined for third-country markets, typically the US or Europe.

Companies can also choose to diversify their upstream supply chains to reduce their dependence 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, in a "China+1" strategy, keeping the China operations, but setting up a parallel one in another country. Another common strategy is to do nothing at all while making sure to develop contingency plans in case the company has to pull out of China. This strategy usually applies to two types of companies, either those that mainly rely on direct exports of non-strategic goods to China or smaller companies with all or most of their operations in China that cannot afford the costs of establishing themselves elsewhere.

## WHAT IT MEANS FOR SINGAPORE

Singapore has benefited from business decoupling from China in areas such as financial and business services, the hospitality industry and the relocation of production facilities and regional headquarters. Moreover, Singaporean businesses in China are seen as less at risk from possible Chinese hostile measures than US and Japanese (and, in future, possibly European) companies.

That said, a greater sense of caution is setting in, with some Singapore companies moving to ringfence their China operations to protect them from possible geopolitical fallout. In 2023, Singapore's Temasek and GIC announced a reorientation of their investments away from China to other markets in South-east and South Asia.

Several smaller or more recent players in the Chinese market from Singapore say geopolitics has made deepening their commitment to China difficult. Western-educated younger entrepreneurs also tend to be less gung-ho about China as they lack the existing strong ties and cultural affinity as older generation businessmen. In contrast, some of the more established Singapore companies indicate that they are prepared to forgo their US businesses if forced to choose.

Overall, Singapore companies continue to emphasise the opportunities that China offers for growth in trade and manufacturing even if they are now proceeding with greater care.

## FDI: READING THE TEA LEAVES

Geopolitical tensions are not the sole cause of China's faltering FDI figures for 2023; with high interest rates to combat inflation in most of the developed world, many foreign companies that used to invest their profits temporarily 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.

China has also scored some own goals in recent years, including the heavy restrictions on cross-border data transfers, a tightening of the anti-espionage law and state secret law, and raids on companies that perform due diligence on Chinese companies at the behest of foreign investors.

For all its setbacks, China's economic strengths and importance to individual companies and the world economy at large remain largely undented. What's more, as the country continues its transition to an advanced, innovation-driven economy, its large domestic market and, increasingly, its technology ecosystem such as in electric vehicles and new energy, make a presence in China practically mandatory for global companies.

The bottom line? Don't count China out as a pivot of the world economy and a prime destination for foreign investment just yet.

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