DECOUPLING CHINA

SEPTEMBER 2022

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Abstract

In this first edition of our RBI Quarterly series, we discuss the political probability and the economic consequences of a possible decoupling of China from other major parts of the world economy. Such a decoupling can happen in various elements of the economic relationships and with different levels of intensity. Ideas and efforts towards a decoupling are driven by Western economies (we use this term as a synonym for developed countries) aiming for more independence from China and seeing the country as a strategic competitor. They are also driven by China having its Dual Circulation Strategy in place to shift its economic focus onto domestic consumption and the production of highly innovative products instead of being "the world's factory." Within our analysis, we first take a deeper look at the motives and drivers of a decoupling. We then briefly analyze the role of China for the global economy. Finally, we examine the mutual dependencies between China and the world economy – this is the core of our analysis from which we deduce three conclusions:

- A comprehensive decoupling of China is neither likely nor desirable
- A balanced reorientation can be to the benefit of all players in the world economy
- China's economic ambitions have the potential to lift the global economy to the next level

Why is decoupling China such an important topic? Because both the West and China have their own plans and views on it

In these times, a decoupling of the Chinese economy from Western economies is widely discussed in the political, business, academic, media, and public domains. An economic decoupling can happen in various elements of the economic relations between the Western world and China, such as in trade, investments, supply chains, and technology transfer. And a decoupling can occur with different levels of intensity – from a very moderate decoupling affecting only select parts of the relationship to a limited extent to a complete decoupling, signifying the cutting of all ties between the West and China.

A main focus of the current debate centers on Western dependencies on Chinese supplies, but China itself is pursuing a strategy of aiming for a certain decoupling from the West. To gain deeper insights into this discussion, we first take a look at the main drivers of a decoupling on both sides, starting with the Western view.

Western economies are seeking greater independence from China and look at China as a strategic competitor

There are three main drivers of Western economies striving for a decoupling from China: the strong dependence on China as a supplier of key resources and goods, the fear of feeding a strategic competitor with Western technology, and the situation with regard to politics and human rights in China.

The disruption of supply chains in the COVID-19 pandemic revealed the West's dependence on supplies from China. When Chinese companies had to shut down their plants during lockdowns, a lot of Western companies had to close plants in their home markets too: Production was impossible due to missing parts from their Chinese plants or partners. As many modern supply chains run through China and the country provides resources for key technologies, Western policymakers and companies are discussing finding alternative suppliers and relocating production.

In recent decades, the Chinese economy has experienced a steep learning curve. China has been successful in reverse engineering, foreign companies – both consciously and unconsciously – transferred know-how to the country, Chinese engineers have been educated at top universities abroad, and the government implemented ambitious, well-funded programs to catch up in key technologies. Nowadays, Western economies see China as a competitor and the country's technological advances as a threat. They don't want to help the country close the technological gap to the West that still exists in several sectors. Stricter control of technology transfer, e.g. through a more restrictive M&A and export policy, is a relevant decoupling tool here.

Finally, the political situation in China drives Western discussions about a certain decoupling. The Taiwan situation has raised questions in the West about how to cope with an escalating conflict. If ties to China were less close, it would be easier to impose sanctions in the event of a violent conflict. How China treats Uyghurs left Western companies producing in Xinjiang caught between the two fronts when Western politicians called on them to withdraw from the province, whereas China rejects all accusations and the politicization of business.

In response to supply chain dependencies and the increasing economic pressure from global competitors, the EU and the US have introduced politics and strategies to strengthen their own economies and reduce dependencies. The EU's "European Industrial Strategy" from 2021 includes a comprehensive plan to improve the EU economy in three dimensions: supporting the digital and green transformation, improving global competitiveness, and strengthening the EU's Open Strategic Autonomy. The goal of Open Strategic Autonomy is particularly important when it comes to the EU's economic relations with foreign countries. It refers to the EU's ability to set its own course in line with its interests and values. Its subgoals are to diversify international partnerships, to develop Europe's strategic capabilities in key areas by supporting industrial alliances, and to monitor strategic dependencies. In its communications, the EU emphasizes that following the path of Open Strategic Autonomy does not mean going its own way alone and that global trade and integrated value chains will remain essential for Europe. In the words of the EU Commission, "Open Strategic Autonomy means cooperating multilaterally wherever we can, acting autonomously wherever we must." Specific actions for the EU's trade policy are to prioritize reforming the WTO and support multilateralism, to rebuild the transatlantic partnership and engage with a range of partners to address common challenges together, to make use of all policies and measures to bring benefits to EU companies and workers, implement and enforce trade agreements, and level the playing field, and to propose and adopt an anti-coercion instrument to respond to coercive practices by non-EU countries.

In the US, beginning in the Trump era, the government has taken several actions to counter the new type of competition with China. The Trump administration was much more direct in its approach to China than the Biden administration, e.g. by imposing high import tariffs to fight the US trade deficit with China. But the Biden administration is also staying the course of strategic competition, just with less aggressive rhetoric. Since Joe Biden was sworn in as President of the United States, the country has implemented several strategies to deal with China. Among the most explicit are the US Strategic Competition Act of 2021 and the Chips and Science Act of 2022. The former defines China as a strategic competitor and addresses foreign relations with China by examining various areas such as politics, economics, the military, and even culture. The Chips and Science Act, on the other hand, focuses explicitly on restrictions to supplying advanced semiconductor technology to China in order to maintain the technological gap between the world's two largest economies. But even though the US is more restrictive in its approach to China than the EU, the country is not aiming for a comprehensive or even complete decoupling from China either: Trade volumes between both countries are still high, as we will see later.

China is shifting its economic focus to producing innovative products and tapping into the vast potential of its domestic market

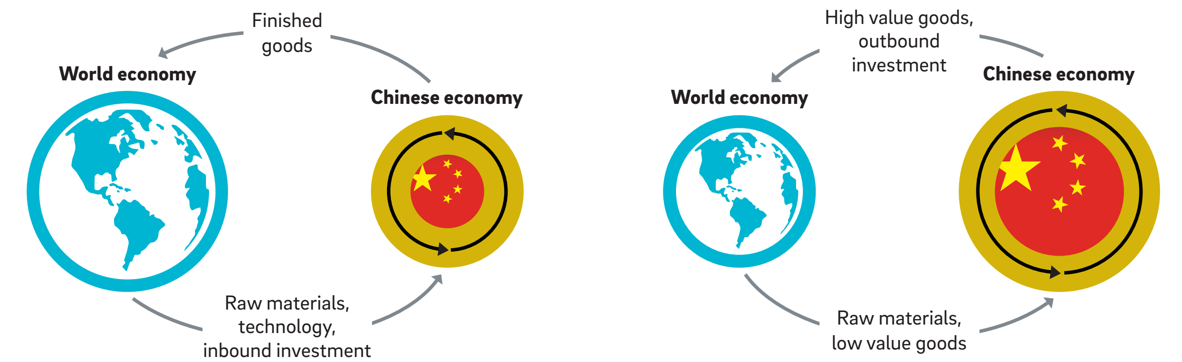
For decades, the Chinese economy's deep integration into global value chains secured its extraordinary growth rates. China was "the world's factory" – and still is. Based on the aforementioned learning curve, the Chinese economy started moving up the value chain. At the same time, household incomes increased strongly. In line with these developments, China initiated two master plans aiming for a shift in its economic orientation, moving in the direction of a certain decoupling of China's dependence on Western economies.

The first master plan was the strategy "Made in China 2025," issued in 2016. The goal of this plan is to turn the country into a production hub for high-tech products, no longer dependent on buying such goods from Western companies. The strategy intends to increase the domestic content of core components and materials to 70% by 2025. The second master plan is the "Dual Circulation Strategy," issued in 2020 and part of China's 14th five-year plan (2021-2025). The strategy's goal is to realign the Chinese economy by focusing more on domestic consumption (internal circulation) and putting international trade and investment (external circulation) second. It aims to take advantage of China's vast and prosperous consumer base and replaces the "Great International Circulation Strategy," which emphasized export-oriented production, i.e. external circulation, as most relevant.

China's shift from the Great International Circulation Strategy to the Dual Circulation Strategy

1990-2020:
Great International Circulation Strategy

2020 ONWARDS:
Dual Circulation Strategy



KEY FEATURE of the Chinese economy:
Labor advantage, investment and export-led growth

KEY FEATURE of the Chinese economy:
Domestic consumption and innovation-led growth

External circulation — Internal circulation — Relative importance to China's economy

Source Merics

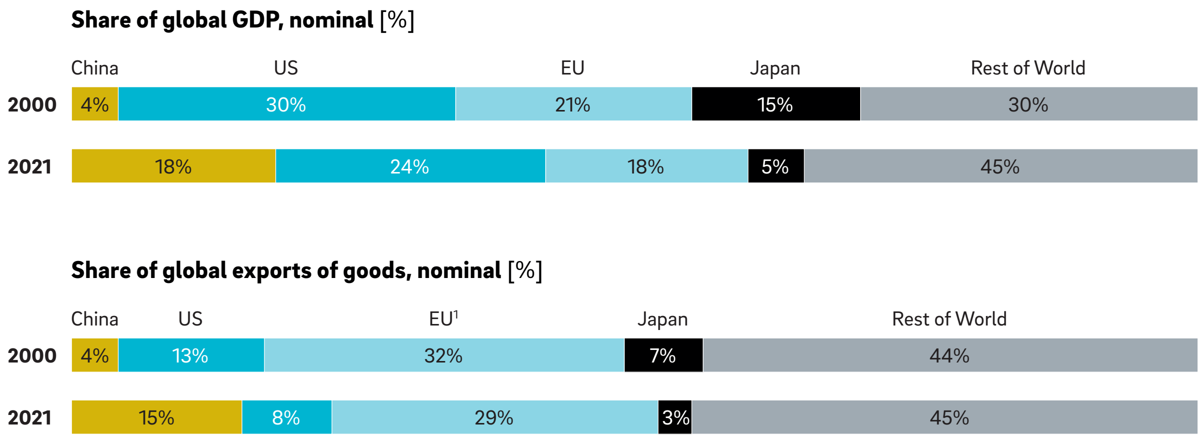
Within China, the country's focus on the domestic market and the production of high-tech products will force foreign companies to increasingly compete with domestic champions, to integrate into China-specific platforms and ecosystems, and to build up or strengthen their local production footprint.

China's role in the global economy: A globally integrated economic powerhouse within two decades

China started its strong economic growth at the end of the 1970s with the implementation of economic reforms under the leadership of Deng Xiaoping. Market mechanisms were introduced and the economy opened to foreign trade, investment, and the exchange of people and know-how. Further reforms have been continuously implemented since then.

The transformation of the economy led to an enormous growth in GDP, with close to double-digit growth rates per annum or even exceeding that. From 2000 to 2021, the global share of China's nominal GDP more than quadrupled to 18%. In PPP terms the Chinese economy has been the world's no. 1 since 2016.

China's growing role in the global economy



[1] Incl. Intra-EU trade

Source Oxford Economics

A main pillar of China's success story has been its integration into the global economy. The country's share of global exports of goods grew, in nominal terms, from 4% in 2000 to 15% in 2021 – nearly twice the share of US exports and five times higher than that of Japan. The high trade flows enabled China's economy to expand, and its trade partners profited from low prices of goods due to the low labor costs in China: The country was a key driver of globalization.

Western dependencies on China

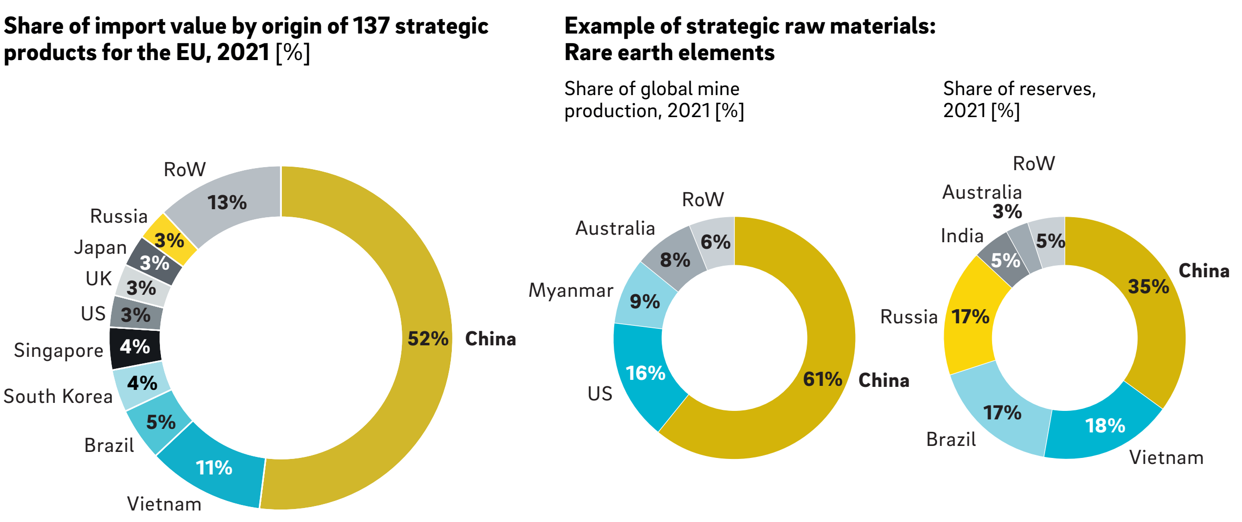
We now come to the core of our analysis. As decoupling aims for a change in the economic relations between Western economies and China, we will examine the mutual dependencies of both. We start with Western dependencies on China.

1 China has a strong position as a supplier – but alternatives exist
China successfully integrated its economy into global supply chains. This is proven not only by the fact that the amount of trade between China and foreign countries has grown to an enormous level, but also when we take a closer look at strategically important products. These are products that are essential for the functioning of an economy. Which products are strategically important depends on the structure of an economy – e.g. for a country like Germany, the automotive sector is crucial as it contributes a lot to Germany's GDP, employs many people, and is deeply connected to other sectors. So, for Germany, automotive parts are strategically important products.

In the first year of the COVID-19 pandemic, factory shutdowns among China's automotive suppliers led to factory shutdowns among automotive OEMs in Germany, contributing to a marked decrease in GDP.

In the aforementioned European Industrial Strategy, the EU defined six categories of strategic products: raw materials, batteries, active pharmaceutical ingredients, hydrogen, semiconductors, and cloud and edge technologies. The categories comprise 137 products. In 2021, 52% of these products came from China.

Suppliers of strategically important products



Source EIU, EC, USGS, Roland Berger

This is a big number and there is no other country on a similar scale. As China has greatly improved in its technological capabilities, the country is able to deliver a broad range of strategically important products. On the other hand, nearly half of the listed products stemmed from other countries. And as there are many other suppliers – among them the US, Japan, and South Korea – it seems possible to shift more focus to those suppliers that are currently smaller.

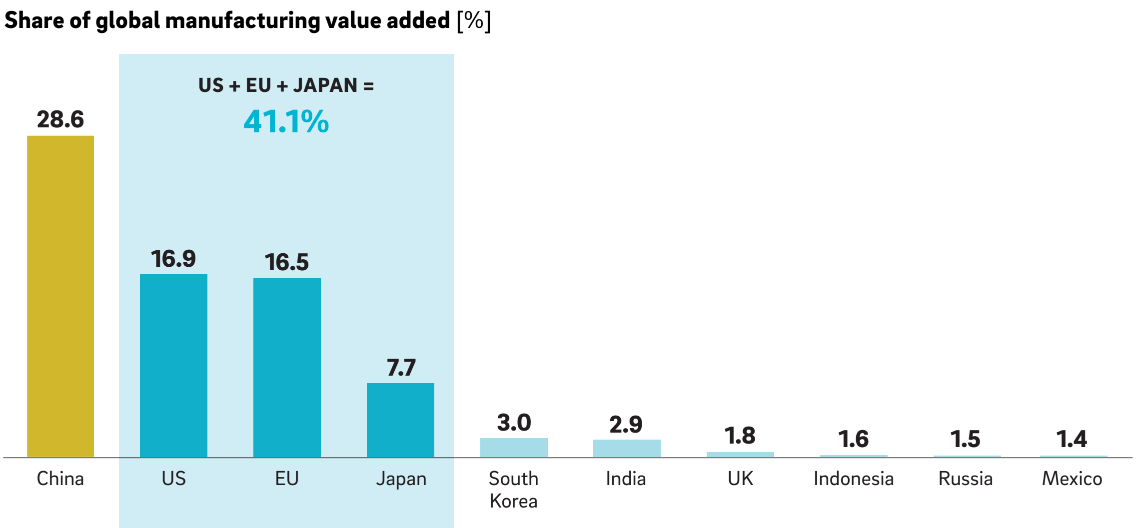
Taking a closer look at one example of a strategic product, rare earth elements (which are needed in many key technologies from catalysts to magnets), reveals a similar picture. In 2021, China was the biggest global supplier: The country's share of global mine production was 61%, followed by the US, Myanmar, and Australia. In terms of reserves (resources that are available but are not yet being used), at 35% China's share is less pronounced. With a share of 17-18% each, Vietnam, Brazil, and Russia have large reserves as well, and there are further countries that can supply rare earth elements.

2 Manufacturing is not only done in China

China's importance as a supplier of intermediate and final products is based on its strength as a manufacturer. And this is not only the case for B2B products but also for a broad range of B2C products: "Made in China" is a very common sight on the label of many consumer products.

In 2020, China's share of global manufacturing value added was nearly 29%, making the country the global manufacturing champion. The US, the EU, and Japan follow. At about 17% (US, EU) and 8% (Japan), their shares are significantly smaller than China's. But together they account for 41%. In other words: In the three economically strongest developed countries/regions of the world, the manufacturing output is – in sum – much higher than in China. This might come as a surprise, as in most developed countries the service sector dominates so strongly. But many known as well as hidden champions in developed countries carry out a significant part of their manufacturing in their home markets.

Top ten global manufacturing locations, 2020



Source UN

The top 10 list also reveals that other emerging markets have considerable potential to enlarge their manufacturing sector. For instance India, having a population nearly the same size as China (1.4 billion) and being experienced in chemicals, pharmaceuticals, textiles, and steel, manages only around a tenth of China's manufacturing output. Mexico is an acknowledged manufacturer of electronics and automobiles, home to production hubs of the biggest players in the world, but its global manufacturing share is only slightly higher than 1%.

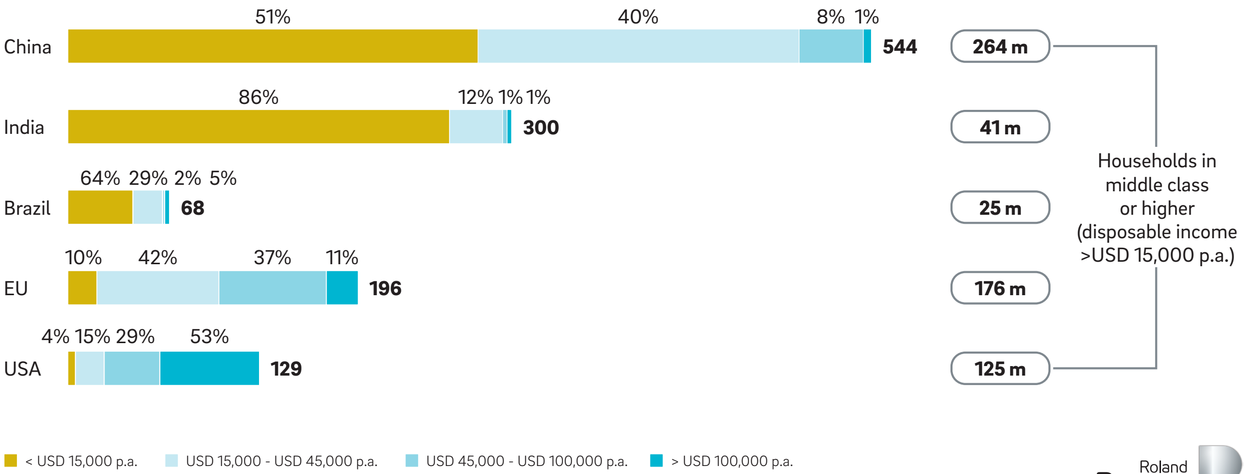
3 China trumps other emerging markets in purchasing power

For many Western industries, the importance of China as a sales market is as strong as China's importance as a major supplier. A lot of Western companies generate a large share, or even the majority, of their revenues and profit from the Chinese market. This is due to the sheer size, growth, and prosperity of the market. China has a population of 1.4 billion people. The nearly 550 million households have enormous purchasing power:

In PPP terms, 40% of Chinese households belong to the middle class, earning USD 15,000-45,000 p.a., and 9% earn more than USD 45,000 p.a. In total, 264 million households have a disposable income above USD 15,000 p.a.

Distribution of disposable income in major countries/regions

Share of households by groups of disposable income (PPP), total number of households and households in middle class or higher, 2022 [%, m]



Source Euromonitor

No other emerging market has a comparable purchasing power. In India, where the average household size (4.7 people) is significantly higher than in China (2.6 people), only 41 million households earn more than USD 15,000 p.a., 12% of households belong to the middle class, and 2% earn more than USD 45,000 p.a. In Brazil, 25 million households earn more than USD 15,000 p.a. – less than one tenth of the number in China. Of course, one has to consider that there are many other big, emerging markets, such as Indonesia, Pakistan, Bangladesh, Vietnam, Philippines, Nigeria, and Egypt. But these countries still have a long way to go to reach the prosperity of China.

As the level of GDP per capita is what differentiates developed from emerging markets, it makes sense that the disposable income of households in developed markets should be higher than that in emerging markets. The figure above shows that the gap between the US and the EU on the one hand and China, India, and Brazil on the other is still huge. In total, about 300 million households in the US and the EU earn more than USD 15,000 p.a. in PPP terms. This is an impressive number demonstrating the enormous purchasing power of these markets. But developed markets are saturated markets – if Western companies want to enlarge their customer base, they have to be active in the big and strongly growing emerging markets, where there are still many households that don't have a car or modern household devices.

4 China's foreign investments follow a strategic path

When investing in Western countries in the last two decades, China followed a strategic path. In the EU, China preferred M&A transactions over greenfield investments, particularly to profit from the know-how of high-tech companies. Recently, greenfield investments, e.g. in electric vehicle batteries, have been increased, as have investments in tech startups. A major motivation for more greenfield investments is to avoid regulatory hurdles. In 2021, target sectors were consumer products and technology-intensive sectors like automotive, health/pharma/biotech, ICT, and energy.

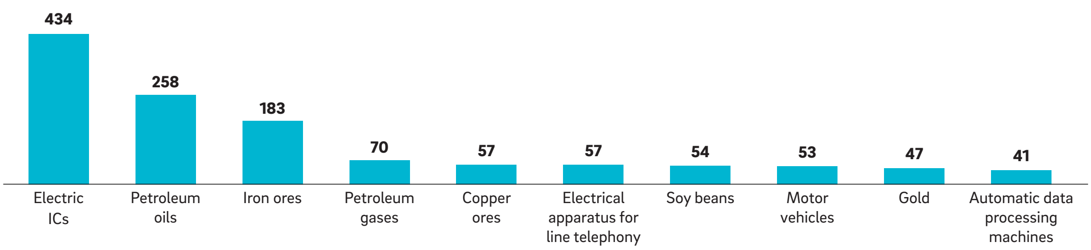
China invests more in Europe than in the US. This might be a result of a mix of factors: stricter US investment rules, the trade conflict between the US and China, and a broader range of investment targets in Europe. In the EU and the UK in 2021, the inflow of foreign direct investments (FDIs) from China and Hong Kong was USD 12.5 bn or about 8% of total FDI inflows. In the US, 2021 FDI inflows from China and Hong Kong accounted for USD 1.1 bn, only 0.3% of all FDI inflows. The data reveal that the EU is much more closely intertwined with Chinese foreign investments than the US economy.

China's dependencies on the West

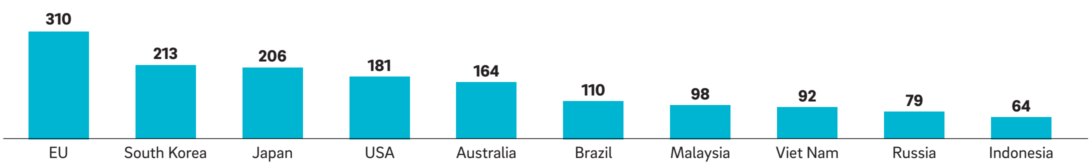
1 China is dependent on the supply of important products and resources
We now switch perspective and look at China's dependence on the West. We start by analyzing China's imports. China is the country with the biggest import volume worldwide. In 2021, China imported goods and services worth USD 3,091 bn, equaling more than 17% of its GDP. The most important import goods are semiconductors and resources, namely energy resources, iron ore, and copper. The five biggest suppliers are developed countries, with the EU in top spot, followed by South Korea, Japan, the US, and Australia.

Key figures on China's imports

Top 10 import goods, 2021 [USD bn]



Top 10 suppliers of goods, 2021 [USD bn]



Source UN

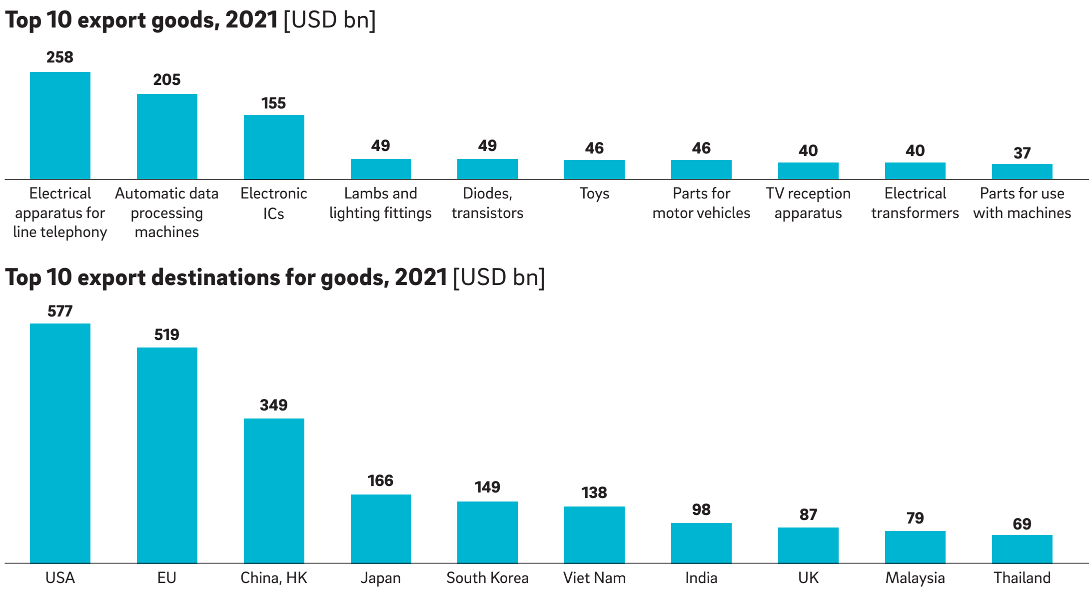
Considering the structure of the major import products, it will not be easy to substitute them, to produce them in China, or to replace the major suppliers. This is particularly the case for China's no. 1 import product, semiconductors, which accounts for more than 16% of the value of China's imported goods. China produces a lot of chips, but so far it does not have the technology to manufacture the ultra-high-performance semiconductors that the country needs to embed in high-tech products. The technology for the production process lies in the hands of a few companies in developed countries (located mainly in Taiwan and South Korea), as does the technology for the machines needed for production.

2 China needs the demand from developed countries

As on the import side, China is also the world's biggest exporter. In 2021, the country sold goods and services worth USD 3,554 bn to foreign markets, equaling 20% of China's GDP. China's export strength was the basis of the country's high growth rates and is still an indispensable element of its economy.

China exports a very broad portfolio of consumer goods, investment goods, parts, and resources. The top 10 product categories together account for less than 30% of the total number. The biggest categories are electrical apparatus for line telephony, automatic data processing machines, and electronic integrated circuits.

Key figures on China's exports



Source UN

China's top export destinations are the US and the EU: In 2021, more than one third of the exported goods went to these markets. Apart from the special case of Hong Kong, six of China's top 10 export destinations stem from Asia, with two developed countries in the lead: Japan, South Korea, Vietnam, India, Malaysia, and Thailand.

3 Foreign investments are essential for China's economy

In 2020, more than 1 million foreign-invested enterprises were registered in China and FDI stocks reached a total of USD 2,440 bn, according to the Statistical Bulletin of FDI in China 2021. Foreign companies are crucial for China's economy as they invest, employ people, and transfer know-how. Since 2017, China is the world's no. 2 destination for FDIs, beaten only by the US.

Many Western-Chinese joint ventures have been operating in China for decades. As of 2020, major EU countries accounted for a share of the number of foreign-invested enterprises of about 4% and for a share of foreign direct investments in China of nearly 5%. The US share is more than 7% in enterprises and nearly 4% in investment value. The shares would be double if Hong Kong were not considered a foreign investor because 47% of foreign enterprises and 53% of China's total FDI volume stem from Hong Kong.

China is particularly interested in foreign investments in high-tech. In 2021, FDIs in high-tech sectors grew by more than 17% compared to 2020, with those in high-tech services rising by about 19% and those in high-tech manufacturing by nearly 11%.

The cost of decoupling

The extensive dependencies between the economies of China and the West suggest that a decoupling would be expensive. A recent study by the Bavarian Economic Association (vbw), using a trade model developed by the German economic research institute ifo, analyzed different kinds of decoupling.

In the case of a bilateral decoupling between Western countries and China – modeled with a 25% increase of import tariffs and a doubling of non-tariff trade barriers on both sides – the Chinese economy would be strongly affected, with a 2.3% decline in real GDP. The US real GDP would shrink by 0.5%, that of Australia by 1.5%, that of Germany by 0.8%, and that of the rest of the EU by 0.5%, reflecting differences in the intensity of the economic relations with China. By way of illustration, if one compares the effect of decoupling on German real GDP with the impact of Brexit, decoupling from China would cause more than five times as much damage.

Looking at the effects on industry, different degrees of impact of a decoupling between the West and China can also be identified. For instance, taking a look at German industries, the automotive industry would be hit the hardest, with a decline in sectoral value added of 8.6%, according to the study. Mechanical engineering (-4.3%) and the transportation equipment industry (-4.9%) would also be hit hard. Due to their size and interdependencies with other industries, these losses in value added would cause great damage not only to the companies working in the specific sector but to the national economy as a whole.

Although economic models are not able to represent the reality exactly, meaning that the resulting numbers have to be viewed cautiously, the message is clear: A decoupling of Western countries and China would lead to significant losses on both sides – and beyond, as the economies in most third-party countries are strongly connected to the economies in the West and China.

Conclusion

1 A comprehensive decoupling is neither likely nor desirable

A comprehensive decoupling of Western economies and China – meaning a significant reduction of economic ties in many aspects like trade, supply chains, sales, and investments – is not likely due to the strong interdependencies we described. Both economies are so deeply intertwined that a comprehensive decoupling would bring the functioning of the economies to a halt.

And as both economies are essential for many other economies as well, a comprehensive decoupling would damage the entire world economy. No Western country, nor China – nor any other country following a rational economic strategy – can be interested in such a scenario.

But what if politicians did their own thing, regardless of the rationality of the facts? Fortunately, they aren't. Policymakers in Western countries and in China are not aiming for a comprehensive decoupling. The economic policies and strategies of the EU and the US strive to strengthen their own economies and lower dependencies on China through diversification. And there are measures to protect key technologies against China. But neither of the Western economic superpowers strives for complete independence from China.

The same goes for China. China's Dual Circulation Strategy is aimed at placing a stronger focus on domestic consumption and the production of innovative goods. Reaching both goals would lead to stronger competition with Western economies – inside of China and on global markets. But the close ties would still be alive.

Finally, company strategies follow a similar path. Western companies are analyzing their dependencies on China and are looking for additional suppliers and manufacturing locations. But there is no big wave of production reorientation. The FDI data have shown that Western companies invest continuously in China – and vice versa, although new investments by Chinese companies in the US are less pronounced, reflecting the cooling of the economic climate between both countries.

2 A balanced reorientation can be to the benefit of all players in the world economy

The aforementioned political and company strategies represent a balanced reorientation of the economic relationship between China and the West. Such a reorientation can be to the benefit of the two parties as well as of third parties.

For China, it is necessary to adapt the nation's economic approach. Whenever a country moves up the value chain, it is natural that it strives to manufacture high-value goods to use its growing skills and know-how. And as China's population is getting more prosperous, the stronger focus on domestic consumption is a natural development as well. For China, following its Dual Circulation Strategy is the next step to catch up to Western economies.

Western companies would profit from an enlargement of their supplier base – particularly in times of crisis this makes them more robust. If they tap into new suppliers from emerging markets with lower wages than in China (as is the case in India, for example), production costs can be reduced. And if they manage to add regional suppliers located near to their sales markets, they would additionally benefit from being able to react faster to market changes, such as new customer needs. The stronger regionalization of supply chains would also reduce carbon emissions caused by the transportation of goods.

In a scenario of a balanced reorientation of Chinese-Western economic relations, the importance of third-party countries would increase. They could expect additional investments, and new manufacturing locations would be established, creating employment and injecting know-how. The development of these countries would be accelerated and prosperity would grow.

3 China's economic ambitions have the potential to lift the global economy to the next level
China's move from the world's factory to a serious competitor in crucial product categories would increase global competition. For companies, stronger competition means that they are forced to innovate more, have more efficient processes, and offer better products at affordable prices. This leads to higher consumer satisfaction. For policymakers, stronger competition means that they have to formulate ambitious frameworks for industrial policy to further develop existing sectors and enter new markets. This can already be seen with actions like the European Industrial Strategy on the part of the EU.

In the long run, greater efforts by companies and policymakers can lead to more employment, more growth, and higher prosperity. Triggered by China's ambitions, the global economy would be lifted to the next level.

A prerequisite for functioning competition between China, the US, the EU, and other countries is that the competition is fair. Thus, China's objectives can be a push for new efforts to achieve progress in multilateralism. In times like these, this is needed more than ever before. Institutions such as the WTO need to be strengthened. In the Trump era, China saw itself as an advocate for multilateralism. Not only would world trade and world prosperity profit greatly from revitalized multilateralism, but so would the efforts to cope with the biggest challenge the world faces – climate change.

There will be both stronger competition and ongoing collaboration: In the end, we will see a landscape of coopetition. Compared to the situation today, there will be tougher competition, particularly for Western companies, who will be forced to keep hold of their technological advantage against the emerging players from China. But there will also be new possibilities for fruitful cooperation when Chinese companies have climbed to the next rung of the innovation ladder.

Further reading

- THE NEW CHINA STORY
- AFTERMARKET OPPORTUNITIES IN CHINA
- BIFURCATION AND RELOCALIZATION – DISRUPTIONS IN THE MARKET FOR SEMICONDUCTOR CHEMICALS

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We thank Ole Strothmann for his contribution to both research, data, and storyline.