

Dealing with Decoupling from China: Business Strategies in a Changing World

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Executive Summary

General

1. This report discusses the findings of a research project of the Leiden Asia Centre in the Netherlands and the East Asian Institute in Singapore on the extent and impact of economic decoupling from China. In particular, we have investigated the awareness and mitigation strategies of firms trading with or investing in China, and their views on the options and costs of (partial) decoupling from China.
2. China's challenge to the supremacy of the United States has fundamentally upset the geopolitical balance of power, posing new risks to foreign businesses in China. Awareness of geopolitical risks has become much more pronounced since Russia's invasion of Ukraine in February 2022. The war revealed the potentially enormous consequences of dependency on a country that might turn hostile in the future and the potential losses on investment that foreign investors could face. Reflecting increasing geopolitical tensions, governments around the world are becoming more active in implementing policies that restrict trade and investment with third countries, including China.
3. Despite an economic policy that is increasingly driven by national security and geopolitical conflict, China's economic strengths and importance to the world economy remain largely undented. The country continues its transition to an advanced, innovation-driven economy, dominated by a strong market sector and backed by a powerful state. Moreover, China is energetically increasing its self-reliance in sectors important for national security, specifically in critical technologies, reflected in a growing onshoring of global supply chains.
4. 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.
5. As a neutral country in the US-China conflict, a global hub of business services and trade and with a highly advanced economy, Singapore has actually profited from certain

aspects of business decoupling from China. This includes financial and business services, the hospitality industry and the relocation of production facilities and regional headquarters, not only of foreign companies but also those of Chinese (private) companies. Moreover, Singaporean businesses in China are less at risk from Chinese measures and hostility than American and Japanese (and, in future, possibly European) companies.

Trade and investment flows

6. Long-term problems of doing business in China are aggravated by the politicization of business in China, geopolitics and a rising awareness of the dangers of one-sided dependence on China. Signs of the effects of geopolitical tensions on trade and investment are starting to emerge. There is a growing readiness to move at least part of production out of China, not just for business but also for political reasons. Perspectives at company headquarters about investing in China are more negative than at offices and subsidiaries in China.
7. Globally, China has been losing market share in global foreign direct investment (FDI) in recent years. It has also, for the first time since data began to be collected, seen a negative flow of FDI in the third quarter of 2023. In 2023 as a whole, the total net FDI into China (Balance of Payments definition) was only US\$33 billion, barely a fifth of the year before, and 90 percent below the peak of 2021. While this in part reflects diverging macroeconomic policies between China and the West, and a dearth of Chinese initial public offerings (IPOs) abroad, it also reflects changed risk perceptions. *Utilized* FDI, a measure that excludes asset sales by foreign investors and Chinese IPOs abroad, is down by far less, though, indicating that some foreign investors are solidifying their position in China.
8. Forward-looking indicators, such as announced greenfield investments and mergers and acquisitions, also show a distinct move away from investment in China. India, Vietnam and Indonesia are alternative destinations on the rise. Meanwhile, China's overseas investment has come down from its peaks in 2016, although less so in Association of South-East Asian Nations (ASEAN) countries. Outflows totalled US\$185 billion. in 2023, far outpacing inflows.

9. Global trade patterns are also shifting rapidly. The swift growth of China's exports to ASEAN and of ASEAN's exports to the US suggests that at least part of China-US trade is being diverted via ASEAN countries. This is largely a consequence of (former US President) Trump's tariffs, although their full effects only started to show after the COVID-19 pandemic.
10. China's exports are, more broadly, shifting away from advanced markets towards emerging markets. Growth in exports to the EU, Japan and the US is declining, whereas growth in exports to ASEAN, the Middle East and Central Asia is booming. China's exports to Russia have more than tripled since the Russian invasion of Ukraine.
11. Meanwhile, China has become more central to all its trading partners' economies: most countries saw the share of China's value added in total imported value added rise since the country's entry into the WTO, whereas the share of the EU, the US, Japan, and other countries' value added in China imports saw a decline. ASEAN, in contrast, saw its share increase.

Foreign businesses and the 'China risk'

12. Foreign companies no longer value China simply as an export-processing hub for imported intermediate inputs that are assembled in China into final products, largely for export to foreign markets. Production in China has moved up the value chain. China's manufacturing sector has become unparalleled in the world in terms of size, diversity and its advanced level.
13. China's manufacturing base and its large and growing market have become the main attractions. Companies in China invest in innovation and automation of production to save labour and other costs, while moving labour-intensive production to other locations. For foreign companies, research and development (R&D) in China has become an important driver of their strategy now that China has become an innovation hub in its own right.
14. During their often long and deep exposure to China, foreign companies have adapted to the many challenges posed by operating in China. They hope that some of the more damaging problems – such as intellectual property (IP) theft and the absence of a level

playing field, in particular – can be resolved and they emphasize the very considerable opportunities that China still has to offer. Nevertheless, many foreign firms fear the current Chinese government’s drive to build a fully Chinese software environment. If the ban of iPhones in Chinese government institutions were to be extended to Windows-based software across the whole of China, company operating costs and international integration would suffer enormously.

15. The disruption of the COVID-19 lockdowns has added to the structural economic problems that China is facing. The current slowdown of China’s economy and the direction of its industrial policy are creating much uncertainty. Under its national security legislation and the ‘dual circulation’ policy, the Chinese government has stepped up its efforts to make China less dependent on imports, and even on foreign-owned suppliers based in China.
16. When discussing a company’s outlook and investment plans in China, positive responses predominated, despite the US–China conflict and the Chinese economic slowdown. This was true for companies from all four countries (the Netherlands, Singapore, Germany and Japan), although for many companies the bullish assessment of 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. However, particularly companies whose business requires a long-term view, coupled with 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.

Impact of decoupling

17. The emerging alliance of the US with its partners in Europe and Asia to contain China worries many of our respondents. 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.
18. Concerns about the US go beyond trade measures and technology sanctions. They include growing worries about potential financial sanctions, as debated in the US

Congress. Several large US investors have publicly or privately announced that they are seeking to reduce or even eliminate any exposure to China.

19. Foreign companies are also worried about the impact on their business of Chinese government retaliation to US sanctions, in particular 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.
20. Despite mounting geopolitical risks, for many companies China is too big to walk away from. Company strategies are more about developing options than about leaving China totally. Several decoupling strategies often go together and complement each other. Investments outside China are often complemented by investing in China to reduce the dependence of operations there on foreign suppliers or export markets.
21. The most common strategy among interviewed companies was the combination of diversifying production and supply chains to other countries, together with localizing the 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 (chiefly from profits made in China) in R&D, product development, production 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 localize R&D, product development or marketing.
22. Where downstream production is relocated to other, safer countries (known as '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 dependency on just a very few foreign suppliers. Alternatively, autonomous operations can be established in countries with a large and promising market, thus fully moving production away from China.
23. A further strategy that we encountered is to do nothing at all, although even some of these companies are already developing contingency plans in case they have to pull out

of China. This strategy usually applies to two types of companies. The first type is companies that mainly rely on direct exports of non-strategic goods to China, so such companies only have (often very extensive) marketing, sales and servicing operations in China. The second type is smaller companies with all or most of their operations in China, which have nowhere else to go and cannot afford the costs of establishing themselves elsewhere.

Recommendations

Policy options

1. China has the ambition to become a superpower that can deal on an equal footing with the other superpower, the United States. In this context, aspects of China's increasing global role and footprint are bound to threaten the specific interests of other countries. When considering decoupling from China, the focus is on strategic dependencies that might potentially present a danger to a country's security and prosperity. This is understandable and right, but discussions and policy should also address the negative effects that decoupling will have. Governments should *factor in the risks from the fallout of the China-US conflict*, by which foreign companies operating in China are likely to be the most immediately affected.
2. The main concern of foreign companies in China is being caught in the middle of the US-China conflict. The risks from sanctions, restrictions or tariffs against China are often less about what is already in place than about what might happen in the future. Companies that are active in China currently operate in a highly uncertain and potentially volatile policy environment, not just in China but also in their home countries and the US. They would benefit from *clear, specific and especially stable rules and regulations* about what can and cannot be done in business with China.
3. Decoupling comes with a very considerable price tag, both for individual companies and the economies of their home countries. To help reduce such policy costs, companies should receive adequate *guidance and assistance* to limit the impact of new, more restrictive policies. Governments should also specify which sectors and products should be repatriated or reshored, when and under which conditions, and subsidies to reduce the costs should be given, if only to attach a clear price tag to wilful policy changes. In this regard, the example of Japanese measures should be studied. This includes, but is not limited to, the impact of future outbound investment screening and export restrictions placed on critical, highly specialized products supplied from abroad that foreign companies depend on for their business in China.

4. Governments of home countries should more carefully and explicitly *assess the costs and potential benefits* of specific decoupling measures for their economy and be prepared to base their decisions as much on the outcome of such assessments as on the broader political and strategic goals of such measures. The risk of decoupling is more than simply higher costs, higher prices and less consumer choice. The transfer of R&D and product development face much higher barriers, for instance, and limit technological progress overall.
5. A particular source of uncertainty is the extraterritorial application of US law or sanctions to the global company. Home country governments should seek to *minimize the consequences of US actions* for their own companies and economy where these actions do not align with their own strategic interests. *An explicit policy on third-party sanctions* would be desirable to help companies reduce policy uncertainty. Such a policy should include discussions with the US and China to avoid unintended damage to the interests of home countries done by the two superpowers' trade measures.
6. A further risk for European companies is the possible escalation of measures regarding China by the EU, for instance if policy regarding Chinese unfair trading practices or 'corporate sustainability due diligence' in particular sectors were to spill over into policies (or Chinese countermeasures) in other, unrelated sectors. Governments of EU countries should ensure that the EU develops and implements its approach to China with a view to *minimizing the risks and damage* to individual countries, economic sectors and individual businesses.
7. Heightened great-power conflict and deglobalization are not a temporary setback, but the new normal in the international arena. For heavily trade and foreign investment-dependent countries, the current state of affairs might actually be the best option. Therefore, such countries could actively explore ways to *benefit from decoupling*, and not just limit their losses. This includes taking advantage of new investment opportunities by the US, the EU or Japan, which are seeking to build up their own capacity in strategic sectors. The example of Singapore could be reviewed in-depth for examples and pointers in this regard. Similarly, the experience of Japan, which dealt with pressures to diversify from China earlier than most, would be instructive.

8. Decoupling and diversification mean that companies need to look for alternative locations to near-shore or friend-shore (part of) their business. This is an ongoing process and *governments can support companies by regularly reporting on trends in the relocation of supply chains*. Furthermore, home country government should ensure that *free-trade agreements* and *agreements to avoid double taxation* with emerging new investment locations are negotiated or entered into force as soon as possible.

Geopolitical outlook

9. A policy focus on the *'systemic' nature* of the competition or conflict with China is not in line with the reality that companies are facing. China's lack of compliance with the rules of the international trade order continues to require attention. However, dividing the world into democracies and autocracies does not capture the nature of global power competition. The current shift towards decoupling is part of a *realist rivalry among competing geopolitical powers*, rather than being determined by the incompatibility and conflict between their systems.
10. The *'China for China'* strategy of foreign companies integrates them further into the Chinese market. This adds to a reduction of globalization and the *emergence of separate economic spheres*: one focused on China and the other on the US. In such a world, Chinese subsidiaries of foreign companies might even conclude that belonging to a global company is less of an asset and more of a liability, and thus opt to become fully independent. Some investment banks and funds have already made moves in this direction.
11. Ultimately, decoupling could well end up *strengthening the resilience and self-sufficiency of China's economy* as much as that of countries that seek to de-risk from it. While a degree of decoupling from China may make sense politically and strategically for some countries, this may well create an autonomous trend towards further decoupling that will be hard to stop once it has gained sufficient momentum. In the final analysis, prioritizing national security might reduce the barriers to confrontation and could make the world less, rather than more, secure.
12. Hard decoupling will therefore increase the *likelihood that China-US relations may take a turn for the worse, in extremis* leading to an armed conflict. The impact of such a conflict

will be most damaging to the Chinese economy because of its continued heavy dependence on exports. Europe and Japan will also be strongly affected, but will be able to rely on their connections with the US market, which are vital to their economies. The United States, as the largest economy and market in the world, will be least affected, but will still face an economic downturn.

13. There is thus an urgent need for home countries to balance decoupling from China with continuing engagement with China where it benefits them. Such strategizing will require a *positioning in the world based on realism* rather than liberal ideology. This is particularly true for the European Union. Is Europe a desirable partner for a broad range of countries, especially those that might be sceptical about what they perceive as Western dominance and tutelage? Should Europeans try to talk less about ethical–political issues and how we think countries should organize and govern themselves, and instead talk more about shared interests and common strategies?

Topics for further research

Our project has raised many topics and questions regarding decoupling from China that are currently insufficiently understood. The most urgent of these are the following:

1. The impact of decoupling from China on the business and economy of Taiwan, and how this will influence the future of relations across the Taiwan Strait.
2. Decoupling strategies by Chinese companies abroad, and how third countries could optimize the benefits and minimize the risks that this new flow of Chinese investments might bring.
3. Mapping the Chinese government and Communist Party stakeholders involved in impact mitigation strategies for decoupling from the West.
4. Country case studies and business climate analysis for relocation to third countries, such as Vietnam, Singapore, India, Mexico and Poland.
5. Company case studies on the relocation of supply chains.

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1. Introduction

1.1 Rationale and questions

The deepening rivalry between China and the US has been dominating headlines during the last five years. At the same time, China itself is also rapidly changing. As economic growth is running out of steam, the Chinese Communist Party (CCP) has tightened its grip over Chinese society, governance and the economy. National security, national greatness and superpower ambitions override growth-oriented and social policy-making.

We are living in an era of rising geopolitical tensions in which governments and companies must reassess the benefits and risks that come with what is often considered excessive globalization. Both in China and elsewhere in world, the interdependencies of global supply chains driven only by considerations of efficiency are now seen as vulnerable to international disruption and weaponization by hostile powers. Decoupling has given rise to a whole new vocabulary of de-risking, friend-shoring, near-shoring, China-for-China, China-plus-one and so on. In light of this, international investors and companies are being forced to reassess their commitment and exposure to China. The crucial question here is to what extent foreign companies involved in China should base their China strategy on this bleak picture of deglobalization and China. Should they stay or should they go, or should they find other ways to hedge their exposure to China? More simply put, how bad a bet has China become?

The COVID-19 pandemic affected many global supply chains, causing shortages of goods and disruptions of production the world over. However, geopolitical shifts have been even more important and the war in Ukraine has fundamentally raised awareness and a sense of urgency about geopolitical risks. The trade war between China and the US that started in 2017 has deepened into a nascent cold war over global supremacy. The US has focused on a whole range of what it perceives as Chinese weaknesses in its dependency on globalization in general and the US in particular. Both the US and China have deepened or created alliances, partnerships and international institutions in order to contain or restrain the other. Two power blocs are beginning to emerge, shrinking the space for countries that cannot or do not wish to choose between them.

For countries and companies alike, shortening supply chains by bringing production closer to 'home' now seems the wiser and safer choice, even if it increases economic inefficiencies and

requires a doubling up of effort in multiple locations across the world. Excessive dependency on China specifically, especially in 'strategic' sectors, has become seen as a severe geopolitical risk. While a full decoupling from the Chinese economy is unrealistic, 'de-risking' dependency on China in order to strengthen 'resilience' against geopolitical risk has become a widely shared consensus in many countries, particularly in the developed world.

This report will take stock of the perception and impact of risks of China in the changing international order for firms and specific sectors of the economy. We will focus in particular on the awareness and mitigation strategies of firms trading with or investing in China, and their views on the options and costs of (partial) decoupling from China. We will seek to answer the following questions:

1. What is the impact of decoupling on foreign investment in China?
2. What risks of decoupling from China are foreign business facing?
3. What measures to mitigate such risk are currently taken or being considered?
4. Where do decoupling strategies lead?

For foreign-invested companies, geopolitical developments are fundamentally changing the economic and political risks of doing business in China. Business relations with China are increasingly affected by political considerations and strategic risks. Companies trading with or investing in China have to reckon with disrupted or even severed supply chains, export and import quotas, tariffs and bans, investment screening, increased scrutiny of financial transactions, IP protection and restrictions on research and development, and reputational or political fallout from their links with China. Much more than before, China is viewed through a political rather than an economic lens of rivalry and reciprocity, national security and human rights abuses. US-China competition is fundamentally changing many aspects of the global economic order, with major implications for business. Flows of trade, investment, finance and even human resources are increasingly constrained by trade barriers, sanctions and national security considerations, impacting companies and countries around the world.

1.2 China and the Netherlands, Singapore, Germany and Japan

This report will discuss and compare the implications of geopolitical shifts for foreign businesses in China from the Netherlands, Singapore, Germany and Japan. The intention

behind this choice is to understand the consequences of the US–China conflict for third countries. These countries are not directly parties to the conflict, but are nevertheless affected by it. The selection of the Netherlands, Singapore, Germany and Japan has in part been pragmatic, because of our access to businesses there, but more importantly all four are among the most connected with the Chinese economy in the world. A comparison of these four countries allows us to home in on the differences between European and Asian countries, the relevance of cultural and linguistic connections with China, different types and sizes of business and sectors of the economy and the depth of business connections with China.

Business from *the Netherlands* has been a relative latecomer to China. Like many other Western European countries, the Netherlands only established full diplomatic relations with the People’s Republic of China (PRC) after the PRC became a member of the United Nations in 1971. Since then, relations have suffered repeated diplomatic setbacks, often caused by the importance given to human rights in Dutch foreign policy. In general, however, the Dutch government takes a pragmatic view and its 2019 China strategy sought to give full scope to constructive cooperation with China, while also pointing out China’s poor human rights record and the need for vigilance in areas where China might be a threat to Dutch interests.¹

Since then, relations have soured but not been ruptured. Together with other European countries, the Netherlands has become increasingly outspoken about the threat that China poses, or might pose, to national interests and national security. Strengthened transatlantic ties since the war in Ukraine began have made the Netherlands more inclined to align relations with China rather than with the US, which in 2023 led to the further tightening of the export ban to China of the Dutch company ASML’s lithography machines, after pressure from the US government.

After China’s accession to the World Trade Organization (WTO) in 2001, China became an important trading partner for the Netherlands, especially because Rotterdam is Europe’s largest harbour, serving as a major hub for foreign trade for much of Western Europe and particularly Germany. After Germany, the Netherlands is China’s second-largest trading partner in the EU, with 42 billion euros worth of imports and 18 billion euros worth of exports in 2020, making China the Netherlands’ seventh most-important export destination. Almost

¹ Dutch Ministry of Foreign Affairs and Trade, *Nederland–China: een nieuwe balans* (The Netherlands–China: A New Balance), The Hague (2019), <https://zoek.officielebekendmakingen.nl/blg-883780.pdf>.

half of Dutch exports to China consist of food products and machines, while imports are dominated by machines, electrical machinery and appliances, clothing and furniture. The Netherlands' trade gap with China is much less serious than it looks. About 60 per cent of Dutch imports from China are directly re-exported again to other countries. Exports to China, however, are dominated by products and services produced in the Netherlands itself.²

Dutch investment in China is less important than trade. In 2018, China ranked only 26th among Dutch investment destinations; in 2019, the year before the COVID-19 disruptions, the stock of Dutch investments in China stood at just 12.8 billion euros. Compared to Germany and Japan, the Netherlands has relatively few large multinational companies; moreover, not all of these are involved in China to a significant degree. However, Dutch companies in China often have a very long-standing presence there in sectors like chemicals and coatings, industrial and agricultural equipment, nutritional supplements and foodstuffs, lighting, semiconductors and logistics.³ Like the other three countries included in this report, smaller companies make up an important part of the Dutch presence in China. They often produce highly specialized and technologically advanced machines, equipment and intermediate or finished products, either for export or more commonly for the Chinese market.

Singapore is unique in the world because of its deep cultural, linguistic and historic ties with China. Singapore is a small country with a population of just 6 million people, including 1.8 million non-permanent foreign residents. Singapore's government maintains proportions among the four officially recognized races of the population (Chinese, Malays, Indians and 'Others') through its immigration policy. Of Singapore's permanent population (citizens and permanent residents) of 4.1 million, 3.6 million (73 per cent) are ethnic Chinese, the majority of whom are descendants of migrants who came to South-East Asia in the nineteenth century.

2 Centraal Planbureau and Centraal Bureau voor de Statistiek (Central Planning Bureau and Central Bureau of Statistics), *Economische verwevenheid met China via handel: twee kanten van een medaille* (Economic Interwovenness with China through Trade: Two Sides of the Same Coin), The Hague (2022), chapter 2, <https://www.cbs.nl/nl-nl/maatwerk/2022/25/economische-verwevenheid-met-china-via-handel>.

3 Sarah Creemers, Marjolijn Jaarsma, Tom Notten and Janneke Rooyakkers, *De handels- en investeringsrelatie tussen Nederland en China* (Dutch Trade and Investment Relations between the Netherlands and China), The Hague: Central Bureau for Statistics (2020), chapter 2, <https://longreads.cbs.nl/im2020-2/de-handels-en-investeringsrelatie-tussen-nederland-en-china/>.

In addition, 436,000 recent immigrants from mainland China and 88,000 from Hong Kong or Macao live in Singapore.⁴

For older Singaporean Chinese, China is seen as their ancestral homeland and centre of the Chinese world. This view, however, is less commonly held by later generations of Singaporean Chinese. In its foreign relations, the Singapore government maintains a very careful balance between the two superpowers – the US and China – despite periodic frictions, especially with China. Good relations with China are of great importance, not only because of Singapore’s demographics, but also because of its geography. Singapore has the world’s second largest harbour and is a major financial and business services hub, in large part because of the volume of trade between China and the rest of the world. Singapore is one of China’s largest sources of foreign investment, while China is Singapore’s largest trading partner. In 2021, the stock of Singaporean investment in China was SG\$195, which amounted to 16.6 per cent of Singapore’s total foreign investments.⁵ Moreover, Singapore is also a global financial centre and a hub for investment into China for many other countries as well.

Singaporean investment in China is dominated by so-called ‘state-linked companies’ wholly or partially owned or controlled by Temasek (the government’s investment company), including the Government Investment Corporation (GIC, the government’s sovereign wealth fund).⁶ Several of these state-linked companies are among the largest Singaporean investors in China in banking, portfolio investment, engineering and especially the real-estate sector. Most of the other Singaporean companies in China are much smaller and often family-owned businesses active in services, information technology (IT), logistics, retail, construction and light industry. Many are thoroughly integrated in the Chinese economy and focus primarily

4 For these and other more demographic statistics, see Statista, <https://www.statista.com/topics/5763/demographics-of-singapore/#topicOverview>.

5 Department of Statistics Singapore, Singapore Foreign Direct Investment 2021, https://www.singstat.gov.sg/-/media/files/visualising_data/infographics/trade_and_investment/singapore-direct-investment.ashx.

6 See Wendy Leutert, Singapore and the Evolution of China’s State-Owned Enterprises and State Asset Management, Singapore: East Asian Institute, Background Brief No. 1712 (2022); Isabel Sim, Steen Thomson and Gerard Yeong, The State as Shareholder: The Case of Singapore, Singapore: Centre for Governance, Institutions and Organizations (CGIO) at NUS Business School and the Chartered Institute of Management Accountants (CIMA) (2014), <https://state-owned-enterprises.worldbank.org/sites/soe/files/reports/The%20State%20as%20Shareholder-%20The%20Case%20of%20Singapore.pdf>.

on the Chinese market, although some also produce for export, usually to South-East Asia and less commonly to North America.

Germany's relations with China run almost as deep as Singapore's. Some East German state enterprises were present in China as early as the 1950s. West Germany established diplomatic relations with the PRC in 1972, shortly after the latter's membership of the United Nations in 1971, but relations only really took off after German reunification in 1990. From the 1970s, West Germany's *Ostpolitik* (the normalization of relations between West Germany and Eastern Europe) actively engaged the Soviet Union, often creating friction with West Germany's main ally, the United States. In the 1990s and especially the 2000s, a similar policy orientation informed Germany's relations with China, again often against the wishes of the US, particularly after the China-US rivalry intensified in 2017. Despite a significant cooling of the relationship with China since 2019 and a tightening of the transatlantic bonds, the German government – like the Dutch government – continues to emphasize partnership as much as 'systemic rivalry' and the imperative of 'de-risking' the dependency on China as part of an active economic security policy.⁷

Germany's trade and investment with China are very important for both countries. In 2022, total trade with China stood at 300 billion euros, of which 193 billion were imports and 107 billion were exports, making China Germany's largest trade partner.⁸ Foreign direct investment to China is equally important. In 2021, the stock of German investment in China stood at a little over 100 billion euros. In 2022, foreign direct investment increased further as the flow of foreign direct investment grew from 9 billion to 12 billion euros, dropping again to 10 billion euros in 2023.⁹

7 German Federal Foreign Office, 'Speech by Foreign Minister Annalena Baerbock during the Bundestag Debate on the Strategy on China' (28 September 2023), <https://www.auswaertiges-amt.de/en/newsroom/news/-/2618978>. On the evolution of Germany's China policy stance, see Hugo Meijer, *Awakening to China's Rise: European Foreign Policy and Security Policies towards the People's Republic of China*, Oxford: Oxford University Press (2022), chapter 5.

8 Statistisches Bundesamt (German Federal Statistical Office), 'Die Volksrepublik China ist erneut Deutschlands wichtigster Handelspartner' (The People's Republic of China is again Germany's most important trade partner) (2023), <https://www.destatis.de/DE/Themen/Wirtschaft/Aussenhandel/handelspartner-jahr.html>.

9 'Deutsche Bundesbank Direct Investment Statistics 28-04-2023', in Deutsche Bundesbank, *Direct Investment Statistics* Updated Issue (2023), p. 35, <https://www.bundesbank.de/de/statistiken/aussenwirtschaft/direktinvestitionen/direktinvestitionsstatistiken>

Investment and trade with China are dominated by the automotive industry and a few other large multinational companies. Several other very large companies and financial institutions, and thousands of smaller companies (which may still have an annual revenue of several billion euros) are also invested in the Chinese economy. Like their Dutch and Japanese counterparts, many produce high-level equipment and intermediate or finished products, most commonly for the Chinese market, including for other foreign companies in China. Like their Japanese counterparts, German companies are found in virtually any sector of the Chinese economy that is open to foreign business.

Economic interdependence between China and *Japan* has been a vital feature of their relationship. Even before the establishment of diplomatic relations between the two countries in 1972, economic exchanges had been taking place through semi-official trade agreements. After 1972, a dramatic increase in bilateral economic trade took place, from US\$1.1 billion in 1972 to US\$335.4 billion in 2022. China is now Japan’s largest trading partner. E-commerce is driving the further development of relations. In 2021, Chinese consumers purchased US\$14.8 billion from Japanese companies via e-commerce.

China is a key manufacturing base and market for Japanese companies. After the start of China’s reforms in 1978, Japanese companies were among the first to invest in China. Direct investment from Japan into China in 2022 was US\$4.6 billion, up 17.7 per cent from the previous year.¹⁰

In the last decade, a cooling has taken place in the economic links between Japan and China. Rising labour costs in China have incentivized Japanese companies to diversify their manufacturing base. They have added facilities in third countries to reduce their reliance on production in China. In 2010, China imposed restrictions on the export of rare-earth elements to Japan amid a dispute over the Senkaku–Diaoyu Islands. The regional security challenges

-804078; and Sarah Marsh, ‘Exclusive: German Investment in China Eases in First Half after Record High’, Reuters (20 September 2023), <https://www.reuters.com/world/german-investment-china-eases-h1-after-record-high-2023-09-20/>.

10 ‘中国側統計 2022 の日本の対中投資実行額は前年比 17.7%増’ (Chinese statistics show a 17.7 per cent year-on-year increase in Japanese investment in China in 2022), JETRO (10 July 2023), <https://www.jetro.go.jp/biznews/2023/07/85e5acaaf8133b50.html#:~:text=%E4%B8%AD%E5%9B%BD%E3%83%BB%E5%9B%BD%E5%AE%B6%E7%B5%B1%E8%A8%88%E5%B1%80%E9%81%8B%E5%96%B6,%E6%9C%8813%E6%97%A5%E8%A8%98%E4%BA%8B%E5%8F%82%E7%85%A7%EF%BC%89%E3%80%82>.

posed by China were the trigger and main focus of Japan's National Security Council, established in 2013.¹¹ Sino-Japanese trade and FDI peaked in 2011–2012 and has since steadily declined. This has been at least in part because the dispute alarmed the Japanese government about its overdependence on China, particularly in the critical area of resources and equipment. The Japanese government has since taken steps to support companies that produce strategic goods, such as aircraft parts and medical equipment, to shift manufacturing from China to South-East Asia or Japan.¹²

These concerns increased during the COVID-19 pandemic and because of the US–China conflict. In 2020, the Japanese government allocated 70 billion yen (US\$653 million) to shift production from China to South-East Asia or back to Japan.¹³ Given the deep historical and strategic mistrust between Japan and China, Japan is now one of the countries most affected by the heightened Sino-US rivalry. In 2022, Japan passed a law to promote economic security and works closely with like-minded countries to counter coercive measures. Conversely, China's new security-related legislation has deepened the concerns of Japanese companies operating in China. Moreover, the boost to Japan's semiconductor industry resulting from knowledge and technology transfers from Taiwan's TSMC shows that Japan can also benefit from decoupling. However, like the EU, Japan continues to be dependent on China and its policies and practices will thus not be completely aligned with the US.

The four countries included in this research project have highly developed economies with very extensive trade, investment and financial connections to the global economy. As the world's second largest economy, China is and will continue to be essential to them. They thus have to approach decoupling from China with a great deal of circumspection.

Beyond their broad similarities, our four countries also represent very different histories and degrees of involvement with China. The two Asian countries, Japan and Singapore, are geographically nearer and culturally more similar to China, and more attuned and vulnerable

11 Ken Moriyasu, 'How Japan's National Security Council Rewrote China Strategy', *Nikkei Asia* (11 April 2023), <https://asia.nikkei.com/Spotlight/Asia-Insight/How-Japan-s-National-Security-Council-rewrote-China-strategy>.

12 Yuqing Xing, 'The Chinese Economy and Sino-Japanese Economic Relations', in Tomoo Kikuchi and Masaya Saguragawa (eds), *China and Japan in the Global Economy*, London: Routledge (2018), pp. 84–90.

13 'Japan Reveals 87 Projects Eligible for "China Exit" Subsidies', *Nikkei Asia* (17 July 2020), <https://asia.nikkei.com/Economy/Japan-reveals-87-projects-eligible-for-China-exit-subsidies#15>.

to the opportunities and risks that China presents. Japan, as a US ally and a regional competitor, has a relatively fractured political relationship with China, while Singapore is close to China and maintains a careful balance between China and the US. Germany, the Netherlands and other countries located farther from China are well advised to take their experience and approach as an indication of the direction that their own relations with China might go in the future.

The two industrial heavy-hitters, Germany and Japan, see China in ways that are different from Singapore and the Netherlands with their more trade and services-based economies. Germany and Japan are taking full advantage of China's unique manufacturing base. For them, decoupling is likely to take the form of limiting only critical dependencies, while their companies will double down on their China exposure. For Singapore and the Netherlands, decoupling would be relatively easier and can be done quicker and at a lesser cost. However, Singapore's unique relationship and greater degree of exposure to China than the Netherlands puts much greater potential limits on the extent of any decoupling that is politically feasible and economically possible.

1.3 Approach, methods and data

The research project on which this report is based took place in two parts. The first part provides a quantitative assessment of trends in global trade and investment with a focus on China. This part uses a variety of sources, including International Monetary Fund (IMF) data on trade and investment, United Nations Conference on Trade and Development (UNCTAD) data on FDI, national data from China, Germany, Japan, the Netherlands and Singapore, as well as data on announced investments from FDI, the latter being a service from the *Financial Times*. Not all of these data are consistent, and it is beyond the scope of this report to establish such consistency. Trend analysis is hampered by the large disruptions in trade and investments caused by COVID-19, and to a lesser extent by Russia's invasion of Ukraine. Nevertheless, there is sufficient evidence to draw some initial conclusions.

The second part of the project consisted of interviews, including both open questions and a survey with pre-coded standard questions. We interviewed a total of 47 foreign companies with extensive production or sales and service operations in China: 22 from the Netherlands; 14 from Singapore; and 11 from Germany. In addition, we conducted a total of 17 background interviews with business organizations, trade associations and government. In Japan we were

unable to conduct in-person interviews, and instead sent out our questionnaire survey. In the end, the survey was filled out and returned by 31 companies. In about two-thirds of the cases, the Japanese questionnaires included more extensive narrative answers to the qualitative questions. To supplement our own data, we have also drawn on a 2022 survey of Japanese companies operating in Asia and Oceania by the Japanese Economic and Trade Organization (JETRO), although it does not include the most recent developments of 2023.¹⁴

We interviewed or surveyed members of the board or managers directly below the board. The interviews took place either at the main office in the home country or the office in China; in about ten cases we interviewed both. The interviews were conducted either on-site or on Zoom or Teams, depending on the availability of the interviewee. Twenty of the interviews were done in China by Tabitha Speelman; the remainder were done by Frank Pieke in Singapore, the Netherlands and Germany. The qualitative interview data were analysed with iterative reading and coding, ultimately yielding consolidated files on approximately 30 discrete topics. The quantitative data from the survey were analysed using multivariate linear regression, logistic regression and single-variable descriptive statistics.

Getting people to agree to talk to us was challenging. Decoupling from China is one of the most sensitive topics for businesses to speak about and several of our interviewees mentioned having bad experiences with the media. We could only do the interviews on the condition of full anonymity and refraining from giving direct quotes or other information in the report that would make it possible to identify the interviewees. This report therefore gives no names, nor references to specific interviews. In the few cases where names of individual companies occur in this report, they do not refer to our interviewees and the information was taken from publicly available sources. We have also not given a list of interviews in this report. We understand that this might create doubt about the veracity of our findings, to which we can only reply that all our descriptions, analyses and conclusions are fully based on the interviews, together with publicly accessible information. They provide what anthropologists call ‘the natives’ point of view’ on the implications of geopolitics on foreign businesses in China, without judgement on our part.

¹⁴ Japan External Trade Organization (JETRO), *2022 Survey on Business Conditions of Japanese Companies Operating Overseas (Asia and Oceania)* (2023), https://www.jetro.go.jp/ext_images/en/reports/survey/pdf/2022/EN_Asia_and_Oceania_2022.pdf.

Given the difficulties in getting people to agree to an interview, our original targets for a sample of companies had to be adjusted. In many ways we had to settle for what we could achieve, although in the end both the number and the diversity of the companies approximated what we had originally set out to achieve. The exception is the semiconductor sector, for although we spoke to several companies active in the sector, given its strategic and political importance in the current US–China conflict, we ideally would have liked to speak to a few more.

The diversity of the interviewed companies is robust enough to be indicative of the larger population of foreign firms in China from our four countries. Nevertheless, when interpreting our findings, the selection bias (mostly companies that are committed to staying in China) and small size of our sample need to be taken into account. Moreover, our sample was not created to be representative in a statistical sense. Our analysis of the interview data in chapters 4 and 5 therefore refrains from providing specific numerical values to our qualitative or statistical findings, but only discusses the strength or weakness of the association or correlation between variables and the patterns that we gleaned from the content analysis of the interviews. The quantitative data from the survey were analysed using multivariate linear regression, logistic regression and single-variable descriptive statistics. A full account of the statistical analysis of our data is given in Appendix 3 of the report.

Finally, we conducted background, online and documentary research on the activities in China of the companies we interviewed and, more generally, of the trade and investment trends, events and policies regarding China of the Netherlands, Singapore, Japan and Germany.

Frank Pieke, as principal investigator, was responsible for the overall coordination and execution of the project and also led the interview-based part of the project. Bert Hofman was in charge of the research on investment and trade data. Specific parts of the project’s research were carried out by Rumi Aoyama of Waseda University in Tokyo; Emma Burgers and Eric Siyi Zhang of the Leiden Asia Centre in the Netherlands; and Kong Tuan Yuen, Tan Chia How and Ryan Ho of the East Asian Institute in Singapore. Funding for the project was provided by the Dutch government’s China Knowledge Network (CKN), the Dutch Ministry of Economic Affairs and Climate and the East Asian Institute at the National University of Singapore.

1.4 Outline of the report

This report proceeds as follows. The next chapter, chapter 2, will describe the main challenges to foreign companies in China arising from the realignment of the global economy, rising policy risks in China and geopolitical tensions. This chapter serves as a background for the presentation of our research findings in subsequent chapters. Chapter 3 then presents our analysis of trade and investment data between China and the world, focusing in particular on the Netherlands, Singapore, Germany and Japan. The chapter shows that a trend towards decoupling is becoming clearer in the data. As for trade, the main shift has taken place between China and the US, resulting in a rapid decline of China's share in US imports. Some of that trade has been diverted to other countries, including ASEAN countries and India. In recent decades, China has reduced its dependence on trade overall, in part because of onshoring, but its importance as a supplier of intermediate goods has increased, and with it China's centrality in global supply chains.

The subsequent two chapters will describe how rising geopolitical tensions and risks have impacted the operations and strategies of foreign-invested companies in China. We will mainly draw on the survey and interviews with trade associations, business federations and (semi-)governmental institutions from the Netherlands, Singapore, Germany and Japan. Chapter 4 discusses the opportunities, risks and problems of doing business in China and how these have been impacted by the COVID-19 pandemic and the slowdown of the Chinese economy since 2023. Chapter 5 describes, first, how the changes in the Chinese economy have incentivized companies to restructure their supply chains, production, investment and sales. We then consider the impact of geopolitical tensions on business decisions, with a focus on the differences in such impacts across countries of origin, sectors of the economy and the size of the company's exposure to China. The final chapter, chapter 6, sums up our main findings and presents the conclusions that follow from our research.

2. The new China risks

During the last five years, both perceptions and the reality of the risks of doing business in China have mounted. Some of these risks have to do with the long-term slowing of globalization since the Global Financial Crisis in 2008, which has accelerated since the start of the US–China trade and technology war in 2017. Other kinds of risks are intrinsic to China’s political and economic system, but have become more pronounced or urgent under the CCP leadership of Xi Jinping. Finally, and most importantly, China’s challenge to the supremacy of the United States has fundamentally upset the geopolitical balance of power, posing a whole new range of risks to foreign businesses in China, particularly those from the US and its allies in Europe, North America, East Asia and Oceania. This chapter will discuss these three types of challenges as a background to presenting our research findings on the impact of the new China risks on global trade, investment and business strategies in chapters 3, 4 and 5.

2.1 Risks from the slowdown of globalization of the world economy

Over the past decade, companies around the world have been confronted with rising geopolitical tensions and a more complex international economic and political landscape. Geopolitical considerations are starting to shape the flow of goods, capital and people across the globe. At the same time, several other factors are also reshaping global supply chains, including China’s diminishing cost advantage, the drive to make supply chains more robust to withstand shocks such as COVID-19 and natural disasters, and efforts to render global supply chains more environmentally sustainable. Disentangling these factors is at this stage not possible, not least because COVID-19 caused a temporary disruption of the normal patterns of investment and trade, making distilling geopolitical effects from trade and investment data even harder.

The flow of goods, services and finance around the globe made great strides in the post-Second World War era, driven by a reduction in transport costs and a gradual decrease in tariffs under the General Agreement on Tariffs and Trade (GATT). The dramatic reduction in communications costs allowed for goods production to be increasingly fragmented into parts – and each part of the supply chain to be produced in the country that can do so best. This was increasingly China, with its cost advantage, large labour supply, and growing quality and quantity of infrastructure that allowed it to become the centre of many of these

global supply chains. These trends accelerated after the end of the Cold War, in particular since China opened up and joined the World Trade Organization (WTO) in 2001, as well as after India's reforms and the inclusion of Russia and Eastern Europe in the world economy in the 1990s.

Globalization has slowed considerably, however, since the global financial crisis in 2008 (see Figure 1, all figures in Appendix 1). Politically, the support for further globalization became weaker, particularly in the West. Major trade agreements at the global level failed to be concluded, and instead regional and bilateral trade agreements have become more prominent. Economically, China's rising labour costs and stricter environmental policies have gradually made the country less attractive for labour-intensive production.

2.2 Policy risks in China

After coming to power in 2012, Xi Jinping instantly returned to the original principles of Leninism: hierarchy, discipline, secrecy, unity, and the unconditional correctness of the central leadership's political line. Xi emphasizes not growth and prosperity as economic policy aims, but strategic strength, national self-sufficiency and national security. This translates into investment in infrastructure, innovation and industry, in the belief that this will strengthen the fundamentals of the economy, only later on leading to growth and a higher standard of living. Xi has little faith in Keynesian consumption-driven growth policies, the welfare state and other 'wasteful' expenditure. Internationally, the CCP leadership is preoccupied with the demands that China's new great-power ambitions pose.

The price for this was paid when the post-COVID economic recovery suddenly collapsed in April 2023. Projected growth rates for the economy repeatedly had to be adjusted downward and currently stand at 5 per cent for 2023, which would not be bad at all, but seem overly optimistic and might very well be based on massaged data. For fifteen years now, the Chinese government has focused on supply-side economic growth generated by infrastructural investment, local-government debt and the real-estate sector. Unlike in Western countries, during the COVID-19 pandemic the Chinese government refused to allocate funds to the population to back up their purchasing power in times when many people saw their income dwindle. Consumption and consumer trust nosedived and have still not recovered to their pre-pandemic levels, a key reason for China's sluggish economic performance. A much-needed economic stimulus package and fiscal reform have not happened. Foreign and

Chinese private companies are urged to invest again, and it was emphasized that the market would remain the leading force of the Chinese economy, but strong and concrete measures remain few.

However, not all is wrong in China, and indeed much is still right. A policy transition has been happening away from the real-estate sector in favour of investment in infrastructure, innovation and industrial state-owned enterprises as the engines of long-term economic growth. Unlike Japan in the 1990s, the much-debated debt trap that China faces is very unequally distributed across the country and the economy. The central government is only lightly indebted and could (or should?) easily take on more debt. Local governments that are most indebted tend to be in China's poorer and least-developed regions. Businesses that are heavily indebted tend to be in the less-productive sectors of the economy. The real-estate sector is also heavily in debt and remains strongly involved in local government. Restructuring debts in these sectors is currently being worked on, although this will take years to complete and many companies will no doubt go into bankruptcy. As a consequence, local-government finances will continue to be very tight. The services, pensions and social security they provide will no doubt suffer from strained public finances.

These transitions will be painful to many. Nevertheless, it is more likely than not that they will ultimately make the Chinese economy leaner and stronger, rather than trigger a long period of stagnation. State and private enterprises that operate in China's innovative and advanced sectors and regions have much less debt and continue to prosper. With the exception of the real-estate sector, investment has started to grow again, driven by both state and private investment in advanced sectors of the economy.

Manufacturing in general continues to grow, innovate and move up the value chain. The poster child of this is the electric vehicle sector, with China within a few years of becoming the world's largest exporter of vehicles. China is home to the largest, deepest and most advanced manufacturing sector in the world. Many products, including very advanced ones, 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 China's exports. Twenty years ago, China's exports were dominated by low-value-added consumer goods produced by foreign-invested companies. Now, high-value-added Chinese intermediate goods produced by Chinese

companies constitute an increasing share of the inputs for production in East Asian and Pacific countries destined for export to third countries like the US.¹⁵

However, the structure of the Chinese economy and the direction of policy keep consumer demand down. China will therefore continue to be dependent on the world market, not only for exports but also as an outlet for capital that faces gruelling competition and insufficiently profitable investment opportunities at home. Despite the talk of ‘dual circulation’ that seeks to bring supply chains back to China and insulate China from the risks that the world poses, China will continue to need the world market. This makes China fundamentally different from the US and therefore much more vulnerable to the risks of geopolitical competition. This vulnerability is the deeper reason—beyond geopolitical posturing and the need to attract foreign capital—that lies behind China’s ‘clear-cut stand against protectionism, decoupling and supply chain disruptions’.¹⁶ Embedded in Xi’s growth model thus lies a fundamental contradiction between the imperative to rely on the world, on the one hand, and the mercantilist need to be self-reliant in order to insulate China against foreign liabilities caused by its rising superpower ambitions, on the other.

China’s economic policy is often contradictory with no fundamental change in direction in sight. Nonetheless, China’s economic strengths and its importance to the world economy remain largely undented. The country continues its transition to an advanced, innovation-driven economy, dominated by a strong market sector and backed by a powerful state. The strength and size of China’s manufacturing industry, the magnitude of its market, the depth of its financial markets and its innovation power are all intact. Despite a mercantilist policy driven by national security and geopolitical conflict, there is still every chance that China will

15 See, among others, World Bank, *Braving the Storms: World Bank East Asia and the Pacific Economic Update*, Washington, DC (2022), pp. 32–34, <https://openknowledge.worldbank.org/server/api/core/bitstreams/3f1e8677-a3aa-555c-a145-ee6c30d23fae/content#page=58>.

16 C.K. Tan, ‘China Vows to Curb Decoupling as US Adds Supply Chain Safeguards’, *Nikkei Asia* (29 November 2023), <https://asia.nikkei.com/Politics/International-relations/US-China-tensions/China-vows-to-curb-decoupling-as-U.S.-adds-supply-chain-safeguards#:~:text=China%20vows%20to%20curb%20decoupling%20as%20U.S.%20adds%20supply%20chain%20safeguards,-At%20supply%20expo&text=BEIJING%20%2D%2D%20China%20this%20week,reliable%20energy%20and%20critical%20technology>.

find ways to continue its economic growth and development. However, China’s challenge of American hegemony will continue to generate severe risks and will hold its economy back, making it much more difficult to realize its full potential in creating not just ‘common prosperity’ but a genuine ‘prosperity for all’.

2.3 Geopolitical risks

Geopolitics emerged as a factor in trade in the 2010s when China’s authorities placed increased emphasis on self-sufficiency in critical supply chains. They also embarked on the ‘Made in China 2025’ initiative, which aimed for self-reliance in many sectors of the economy, including emerging technologies such as new energy, electric vehicles and autonomous driving, semiconductors and nanotechnology.

Xi Jinping has regularly expressed the need for self-sufficiency in sectors important for national security, specifically in critical technologies. Since the global financial crisis, China’s share of imported value-added content in its exports has been on the decline,¹⁷ reflecting a growing onshoring of global value chains. Meanwhile, China is using trade increasingly as a tool for international politics. Most notably, this occurred after Japan’s government nationalized the Senkaku islands, which China saw as undermining its claim to the islands. Australia, Lithuania, Norway, South Korea and Taiwan have also been subject to trade sanctions by China.

China’s policy aim to onshore a larger share of global supply chains has reduced the trade intensity of global GDP (Figure 2). Trade as a share of China’s own GDP peaked before the 2008 global financial crisis, and halved in the decade after that, only to rebound temporarily with the COVID-19 pandemic. The decline in cross-border finance was even more pronounced: both FDI and cross-border bank exposure saw a decline as a share of global GDP.¹⁸ In turn, the reduction in cross-border financing fed back into a reduction of trade intensity.

¹⁷ OECD, ‘ICIO-TiVA Highlights: GVC Indicators for China’, (November 2023), https://www.oecd.org/industry/ind/CN2023_CHN.pdf.

¹⁸ For developments in cross-border bank exposure, see Hyun Song Shin, ‘Global Value Chains under the Shadow of COVID’, presentation at the Columbia University CFM-PER Alternative Data Initiative virtual seminar (16 February 2023), https://www.bis.org/speeches/230216_shin.pdf.

In the US, the Trump administration came to office in early 2017 on an anti-China and anti-trade agenda. President Trump's early actions included withdrawal from the Trans-Pacific Partnership agreement (now the Comprehensive and Progressive Trans-Pacific Partnership, CPTPP) and trade actions against China and several other economies, including close allies like the EU and Canada. In the Trump administration's 2017 national security strategy, China was for the first time characterized as an adversary, after which the tariffs imposed on Chinese exports and the sanctions on companies like Huawei and ZTE were increasingly motivated by national security concerns and the aim to contain or slow down China's technological rise.¹⁹ Meanwhile, the review process for foreign investors into the United States was tightened.

In its 2019 China strategy, the European Commission described China as a competitor, a partner and a systemic rival.²⁰ After long-standing negotiations on the Comprehensive Agreement on Investment (CAI) were concluded in 2020, the European Parliament suspended ratification of the agreement in May 2021, in the wake of counter-sanctions from China in reaction to EU sanctions related to Xinjiang. Earlier in 2019, the EU had also released a framework for the screening of FDI into the European Union; subsequently, several EU member states issued their own regulations with the aim to protect critical technologies from being acquired by foreign companies, notably state-owned companies.

Awareness of geopolitical risks became much more pronounced after Russia's invasion of Ukraine in February 2022. To European countries in particular, the war revealed the potentially enormous consequences of dependency on a country that might turn hostile in the future. Regarding Russia, this focused on oil and gas, but for China – the world's second-biggest economy – these dependencies run much deeper and wider. They include not just the rare-earth minerals that are now subject to the EU's recent Critical Raw Materials Act,²¹ but much more importantly also China's central position in the world's industrial supply chains, advanced technologies in strategic sectors and large monetary reserves. Moreover, many of

19 National Security Strategy of the United States of America 2017 (December 2017), <https://trumpwhitehouse.archives.gov/wp-content/uploads/2017/12/NSS-Final-12-18-2017-0905.pdf>.

20 European Commission, EU-China-A Strategic Outlook, Strasbourg, 12 March 2019, <https://commission.europa.eu/system/files/2019-03/communication-eu-china-a-strategic-outlook.pdf>.

21 European Commission, 'Critical Raw Materials: Ensuring Secure and Sustainable Supply Chains for the EU's Green and Digital Future' (16 March 2023), https://ec.europa.eu/commission/presscorner/detail/en/ip_23_1661.

the largest companies from the advanced economies depend on the Chinese market for a substantial part of their revenue and profits.

The weight of the Chinese economy is indeed so great that a full decoupling, like with Russia, will simply not be possible, unless a country is willing to pay a very heavy price indeed. The potential damage of decoupling would be greatest in countries in Western Europe and East and South-East Asia, which are heavily dependent on the Chinese economy; by contrast, the much more self-contained American economy would be affected less. Nevertheless, unlike some other voices in the US,²² the US government does not seek a full decoupling from China, but rather professes to create ‘small yards and high fences’,²³ meaning to build up a strong resilience only against China’s adversarial actions and attempts to gain the upper hand in specific sectors that are vital for strategic or national security reasons. The EU’s more restrained counterpart to this is captured by the word ‘de-risking’²⁴ – that is, to mitigate risks in areas where trade and investment pose risks to economic and national security, particularly in the context of China’s explicit fusion of its military and commercial sectors. This includes preventing the transfer of technology and intellectual property to China, coupled with an industrial policy to strengthen competitiveness and limit the EU’s dependence on China.

Despite the increasing convergence in their views on China, the US and the EU have started from very different places. This continues to inform their approaches and policy goals. For the US, China is principally seen as a geopolitical challenger and threat to national security that has been abusing the world trade system to the detriment of the America economy.²⁵ For the EU, unfair trade practices are also a long-standing issue, but since the war in Ukraine, critical dependencies on third countries and strategic autonomy have become the main concerns.

22 For instance, Select Committee on the Strategic Competition between the United States and the Chinese Communist Party, *Reset, Prevent, Build: A Strategy to Win America’s Economic Competition with the Chinese Communist Party* (2023), https://selectcommitteeontheccp.house.gov/sites/evo-subsites/selectcommitteeontheccp.house.gov/files/evo-media-document/reset-prevent-build-scc-report.pdf?utm_source=substack&utm_medium=email.

24 Ursula von der Leyen, ‘Speech by President von der Leyen at the European Parliament Plenary on the Need for a Coherent Strategy for EU-China Relations’ (18 April 2023), https://ec.europa.eu/commission/presscorner/detail/en/speech_23_2333.

25 For a collection of essays on the US–China rivalry, see Evan S. Medeiros (ed.), *Cold Rivals: The New Era of US–China Strategic Competition*, Washington, DC: Georgetown University Press (2023).

Regarding China, the focus is on critical technologies like semiconductors and green technologies, on which the EU's strategy for decarbonization of the economy and reduction of dependency on fossil fuel rests. As a self-ascribed rising geopolitical actor, the EU increasingly views these dependencies in terms of security but, unlike the US, stops short of a zero-sum approach in which China's gain is seen as Europe's loss and vice versa.²⁶

Reflecting increasing geopolitical tensions, governments around the world are becoming more active in implementing policies that restrict trade and investment with China and other high-risk countries. Data from Global Trade Alert, a think tank that follows trade policy developments around the world, show a steady increase in harmful measures ever since the start of its monitoring (Figure 5). From a count of 1,200 harmful measures in 2012, the total number of harmful measures has risen tenfold to almost 12,000 in 2023. It is noteworthy that the US is leading this development with more than 1,600 measures. European countries are active in implementing harmful trade policies as well, with Germany (840), France (578) and the Netherlands (372) all ahead of China, which implemented 338 measures over the period 2009–2023 (Figure 6). A growing share of these trade interventions have been motivated by national security concerns. According to the WTO, between 2012 and 2023, the number of trade measures reported to the WTO invoking Article XXI of the General Agreement on Tariffs and Trade (GATT, specifically the National Security Clause) more than quadrupled.²⁷

The Chinese economy is currently presenting risks that are making it less attractive, but the reasons for this are many and the responses of foreign companies are not uniform. As we have seen, only one of these reasons is the political tensions between China and the US. Other reasons are more structural. The slowdown of the Chinese economy has also created a lot of uncertainty about the future. Chinese and foreign-invested companies move their labour-intensive operations and exports to other, mainly non-Western, countries to reduce costs and to be closer to other promising markets. In addition, global supply chains have recently proven themselves to be much more brittle than they were thought to be in the past. For all

26 See, for instance, 'EU Budget: Commission Proposes Strategic Technologies for Europe Platform (STEP) to Support European Leadership on Critical Technologies' (20 June 2023), https://ec.europa.eu/commission/presscorner/detail/en/ip_23_3364; and Von der Leyen's 'State of the Union Address, 2023', https://ec.europa.eu/commission/presscorner/detail/en/speech_23_4426. For an analysis of the evolution of European China policy, see Meijer, *Awakening to China's Rise*.

27 WTO, *World Trade Report 2023: Re-globalization for a Secure, Inclusive and Sustainable Future*, Geneva (2023), https://www.wto.org/english/res_e/publications_e/wtr23_e.htm.

these reasons, engaging multiple suppliers and clients and setting up multiple supply chains for different parts of the world therefore does not just make good business sense, but for many companies is imperative.

3. Decoupling global supply chains

Signs of the effects of geopolitical tensions on trade and investment are gradually starting to emerge. A word search in Factiva, a large collection of newspapers and magazines, suggests a gradual increase in concerns on the emergence of a new cold war and the prospect of decoupling (Figure 3). Although the talk on decoupling started to rise in the late 2000s after the 2008 global financial crisis, the frequency of its mention increased sharply after 2017, peaking, for now, in 2023. More closely related to business is the mention of geopolitical risks and ‘decoupling words’ in business briefings, as recorded by Bloomberg (Figure 4). It is noteworthy that, from these data, it appears that businesses were less concerned about geopolitics than the general public until Russia’s invasion of Ukraine, which brought decoupling to the fore. Even the rise of ‘fragmentation’ keywords, as defined by the IMF, saw only a mild rise until the war in Ukraine, after which the count in keywords spiked. Thus, until recently, business concerns lagged behind those of the general debate on decoupling, but are now rapidly catching up.

These concerns are also reflected in surveys of business leaders. The 2023 EU Chamber of Commerce in the *China Business Confidence Survey* marks the US–China trade war as its third most important concern, after China’s economic slowdown and the global economic slowdown. Decoupling as a concern is listed fifth. For the members of the US Chamber of Commerce in China, rising tensions in US–China relations top the concerns in the Chamber’s 2023 *Business Climate Survey*. Similarly, for think tank The Conference Board’s report on CEO confidence for China, geopolitical tensions were the top concern in the second half of 2023.²⁸

Survey-based data are starting to show changes in companies’ preferences with regard to production location. The surveys of the European Chamber of Commerce and the American Chamber of Commerce in China show a growing willingness to move production out of China (Figure 7). This willingness is more pronounced for US-headquartered companies, especially since 2017, the year when the Trump administration took office. The perspective on investing

²⁸ European Union Chamber of Commerce in China (EUCCC), *European Business in China: Business Confidence Survey 2023* (2023), <https://www.europeanchamber.com.cn/en/publications-business-confidence-survey>; AmCham China, *2023 Business Climate Survey Report* (2023), <https://www.amchamchina.org/2023-china-business-climate-survey-report/>; and The Conference Board, *Confidence Among CEOs of Multinational Corporations Wanes as Economic Weakness Persists* (2023), <https://www.conference-board.org/pdfdownload.cfm?masterProductID=49490>.

in China differs considerably between those on the ground in China and those from headquarters. UBS, an investment bank, conducts regular surveys among chief financial officers of multinational companies. These show a much higher tendency to move out of China (Figure 8). The surveys themselves do not directly indicate the reasons for moving or planning to move, although both China’s business environment and geopolitical tensions are increasingly mentioned as concerns.

The diminishing enthusiasm for investing in China is also apparent in data on the *announcements* of investment projects in China. The *Financial Times* ‘fDi Intelligence’ service monitors announcements of greenfield investments worldwide,²⁹ which can be considered leading indicators of the actual investments that follow after such announcements are made. Globally, the trend has been down since the start of the COVID-19 pandemic. The year 2022 was particularly poor for announcements of foreign investment projects in China (Figure 9), whereas the rest of the world recovered. The number of announced foreign investments in China fell by more than half from 780 in 2019 to 314 in 2022. Unlike other destinations in the Asia-Pacific region, the number for China did not recover in 2022, in contrast to the numbers for India, Australia and, to a lesser extent, Vietnam. The IMF, using the same data but over a longer time period, shows a decline of investment numbers into China across practically all geographic origins (Figure 10).³⁰

3.1 Trends in FDI into China

Data on FDI comes from two sources in China: the Ministry of Commerce; and the People’s Bank of China, the central bank. The difference between the two lies in reinvested earnings and proceeds from initial public offerings abroad done by Chinese firms, which are included in the People’s Bank of China data, but not in the Ministry of Commerce’s figures. Comparing the two provides an interesting perspective: throughout most of the years since 2002, FDI as measured by the People’s Bank of China were larger than those measured by the Ministry of Commerce, which implies that, until recently, companies were comfortable in reinvesting

²⁹ Greenfield investments exclude mergers and acquisitions (M&A). These are relatively small in the case of inward investments into China, but relatively large for China’s investments abroad. Irrespective, the number and volume of announcements of greenfield investments can be seen as an indicator of investor sentiment *vis-à-vis* a country.

³⁰ IMF, *World Economic Outlook*, chapter 4, figure 4.5, Washington, DC (2023), <https://www.imf.org/en/Publications/WEO/Issues/2023/04/11/world-economic-outlook-april-2023>.

their earnings to fund expansion of their operations in China. Since 2022, however, the reverse is true. FDI as measured by the Ministry of Commerce is larger than that measured by the People's Bank, showing that foreign companies are increasingly taking out their profits to a larger extent. The most recent data suggest that, for the first time since data began to be collected, there has been a negative flow of FDI in the third quarter of 2023. For 2023 as a whole, the total Net FDI into China was only USD33bn, barely a fifth of the year before, and 90 percent below the peak of 2021. While this in part reflects diverging macroeconomic policies between China and the West, it also reflects changed risk perceptions. *Utilized* FDI, a measure that excludes asset sales by foreign investors, is down by far less, though, which may indicate that some foreign investors are solidifying their position in China.

Globally, China has been losing market share in global FDI in recent years. Its share peaked in 2020 at 26 per cent of total global FDI, whereas it was down to ten per cent in 2022 (Figure 12). The EU's share also declined sharply in 2022, down to five per cent of total global FDI, whereas the US, which traditionally receives the largest share of global FDI, rebounded after a dip in 2020. ASEAN countries have seen a steady increase in their global share over the past decade and are now, at 12 per cent in 2022, a larger destination for global FDI than China.

Within the FDI flows into China, there has been a marked shift towards flows originating from Hong Kong (Table 3.1). China's Ministry of Commerce data, available until 2021, shows that Hong Kong's share increased from 53 per cent of China's total inward FDI in 2010 to 73 per cent of the total in 2021, or US\$131 billion. Singapore is the second largest investor in this count, with US\$10 billion. Singapore's share has remained relatively constant since 2010 and stood at 5.7 per cent of the total in 2021 (Figure 13). ASEAN countries, excluding Singapore, have maintained only a small share of FDI into China. Shares for Japan saw a strong decline from a peak of 5.7 per cent in 2013 to 2.2 per cent in 2021. Similarly, the EU's share of China's inward FDI halved from a peak of 5.6 in 2018 to 2.7 per cent in 2021. Within the EU, the German and Dutch shares experienced similar declines. Germany declined from 2.6 per cent in 2018 to 0.9 per cent in 2021, while the Netherlands declined from 1.6 per cent in 2014 and 1.7 per cent in 2020 to 0.6 per cent in 2021.

Table 3.1. Shares in China’s inward FDI flows, 2010–2021, as percentages

Year	SG	HK	JP	KR	US	EU	EU, excl. DE and NL	DE	NL	ASEAN, excl. SG
2010	4.7	52.8	3.6	2.3	2.6	4.2	2.6	0.8	0.8	0.8
2011	4.9	56.9	5.1	2.1	1.9	3.7	2.1	0.9	0.6	0.7
2012	5.2	54.2	6.1	2.5	2.1	4.0	1.9	1.2	0.9	0.6
2013	5.8	59.2	5.7	2.5	2.3	4.9	2.2	1.7	1.0	0.9
2014	4.5	63.2	3.4	3.1	1.8	4.0	1.9	1.6	0.5	0.4
2015	5.1	63.7	2.4	3.0	1.5	4.1	2.4	1.1	0.6	0.6
2016	4.5	60.9	2.3	3.6	1.8	5.5	3.1	2.0	0.4	0.4
2017	3.5	69.3	2.4	2.7	1.9	5.2	2.5	1.1	1.6	0.2
2018	3.8	65.0	2.7	3.4	1.9	5.6	2.0	2.7	0.9	0.4
2019	5.4	68.2	2.6	3.9	1.9	4.1	1.7	1.2	1.3	0.2
2020	5.1	70.8	2.3	2.4	1.5	3.8	1.2	0.9	1.7	0.2
2021	5.7	72.8	2.2	2.2	1.4	2.7	1.2	0.9	0.6	0.1

Source: Authors’ calculations based on China’s Ministry of Commerce (MOFCOM) data.

The composition of the stocks of FDI in China reflects the aggregate flows of FDI, but changes less rapidly than flows (Table 3.2). Again, Hong Kong was by far the largest investor in 2021 at 54 per cent of the invested stock of FDI, followed by the EU (6.7 per cent), Singapore (4.7 per cent) and Korea (2.7 per cent). The United States has, by the latest data, only a 2.5 per cent share, compared to a 4.0 per cent share in 2010.

Table 3.2. Shares in China's inward FDI stock, 2010–2021, as percentages

Country	2010	2015	2020	2021
Hong Kong	45.3	48.0	53.7	54.4
ASEAN, excl. Singapore	0.9	0.7	0.5	0.5
Singapore	4.0	4.3	4.6	4.7
US	4.0	3.0	2.7	2.5
EU	5.5	6.1	6.5	6.7
EU, excl. Germany and the Netherlands	2.7	2.3	2.6	2.6
Germany	1.8	2.6	2.7	2.7
The Netherlands	1.0	1.2	1.3	1.4
India	0.0	0.0	0.0	0.0
South Korea	2.6	2.4	2.6	2.7
Japan	6.8	5.9	6.0	5.9
Rest of the World	30.9	29.6	23.3	22.5

Source: Authors' calculations based on IMF FDI data.

The large share of Hong Kong in China's inward FDI (stock and flow) considerably distorts the overall picture of FDI composition in China. There are two effects that drive this. On the one hand, Hong Kong, like Singapore and to a lesser extent the Netherlands, is a financial centre through which companies channel investments with a different final destination. Second, Hong Kong has often been used for 'roundtripping' investments by Chinese firms into the mainland, which are disguised as FDI because FDI receives preferential treatment over domestic investment. Using the methodology as spelled out by Damgaard and his co-authors, which corrects for phantom FDI flows as well as tracks FDI through financial centres to its origins, we can proxy the true shares of origin countries into China.³¹

Using adjusted numbers (Figure 14), several observations can be made. First, a considerable part of FDI, especially from Hong Kong, is in reality Chinese mainland investment. This need not be roundtripping, but could be a means to repatriate the earnings of foreign subsidiaries

³¹ Jannick Damgaard, Thomas Elkjaer and Niels Johannesen, *What Is Real and What is Not in the Global FDI Network?*, IMF working paper 19/274 (2019).

or finance raised on international markets. Whatever the case may be, more than one-quarter of FDI stock falls into this category. Second, Hong Kong’s share is dramatically reduced from 54 per cent of the total in the unadjusted numbers to 15 per cent in the adjusted numbers. Third, the shares of three of our four focus countries – Japan, Germany and Singapore – is higher in the adjusted than in the unadjusted numbers. In contrast, the share of the Netherlands drops from 1.4 per cent of the total to 0.9 per cent, reflecting in part that the Netherlands is hosting FDI for tax reasons, in particular FDI from the US.

3.2 Shifting trade patterns

Global trade patterns are shifting rapidly. The changes can be because of COVID, economic factors or geopolitics – although no individual factor can be singled out at this point. It should be noted that overall trade growth has been in negative territory during the last two years, which exaggerates the shifts observed (Figure 15). As with FDI, there is a clear cooling of exports to China from the EU, Japan and South Korea: the EU saw a decline of 14 per cent in value between the first quarter of 2021 and the first quarter of 2023, whereas Japanese exports even dropped by 24 per cent and South Korea’s by 19 per cent. In contrast, China’s exports to those economies kept expanding by 14 per cent, 5 per cent, and 22 per cent, respectively. China’s exports to the US, in contrast, saw a drop of 3 per cent over the same period, while China’s exports to ASEAN countries jumped by a whopping 32 per cent. Growth in EU exports was concentrated within the EU itself, whereas US exports since 2021 saw strong growth in the EU, which reflects largely a recovery from the COVID pandemic era.

The clearest decoupling of trade and investment is taking place between China and the United States, especially since the Trump administration imposed tariffs on China’s exports (Figure 16). The share of US goods in China’s imports has been declining since the early 2000s, while the US’s share in China’s total exports has declined since the late 2000s. The Trump administration’s measures have hastened those declines. Meanwhile, China’s share of US imports saw a steady rise from the early 2000s, to peak at some 21 per cent in 2018, after which it declined rapidly to 16 per cent now, a decline that was only briefly interrupted during the COVID-19 pandemic. The main beneficiaries of this decline were the ASEAN countries, which saw an increase in their share of US imports of 4.6 percentage points between the first half of 2016 and the first half of 2023. Mexico saw an increase in its US imports’ share of 2.8 per cent over the same period and an increase of 3.8 percentage points since China’s share peaked

(Figure 17). It is noteworthy that China was not the only country losing share of exports to the US: Japan lost more than China alone, although less than China and Hong Kong put together.

The rapid growth of China's exports to ASEAN coupled with the rapid growth of ASEAN's exports to the US suggest that at least part of China-US trade is being diverted via ASEAN countries. The composition of China's exports to ASEAN, which increasingly consist of intermediary goods, indicates that China increasingly exports value-added goods to the US (and the EU) via third countries, notably Vietnam.³² This is more than a relabelling to avoid US tariffs, as sufficient value needs to be added in the intermediary country to be able to avoid US tariffs against Chinese-origin imports.

China's exports have rapidly moved up the value chain, and its current trade contains more value added than before (Table 3.3). This means that, for most advanced countries, dependence on China has increased in terms of value-added goods. For instance, 10 per cent of total Japanese imports came from China in 1995, which constituted 6 per cent of imported value added at the time. By 2020, China's import share was 26 per cent, whereas its value-added share was 23 per cent. This points to a conclusion with important political implications. As China has moved up the global value chain, the country has become much more important for global supply chains than its share in only global trade suggests. Any possible disruption would have more significant implications for its trading partners than before.

³² See, among others, World Bank, *Braving the Storms* (2023).

Table 3.3. China’s share in countries’ imports and in foreign value added in final demand

Country	1995	2005	2015	2020
<i>Imports from China, percentage share of total</i>				
Germany	2.5	5.6	7.3	8.0
The Netherlands	1.4	8.8	14.5	17.7
Japan	10.7	21.0	24.8	26.0
Singapore	3.2	10.3	14.2	14.5
EU	1.7	4.6	7.1	8.5
US	6.3	15.0	21.5	18.6
<i>Value added from China in final demand, percentage share of total</i>				
Germany	1.3	3.8	7.5	9.4
The Netherlands	0.6	2.1	4.2	4.8
Japan	6.0	14.6	21.1	23.0
Singapore	2.6	5.0	9.9	11.7
EU	2.2	6.7	12.6	15.9
US	3.3	10.0	16.7	16.5

Source: IMF Directions of Trade; and OECD TiVA data version 2023.

Note: 2020 is the last year for which figures are available.

Table 3.4. Manufacturing, value added (share of world total)

Country	1997	2005	2015	2020	2022
China	n.a.	9.4	25.9	28.2	30.1
Germany	7.4	7.3	5.5	5.3	4.5
India	1.1	1.7	2.6	2.8	2.8
Indonesia	1.0	1.0	1.5	1.5	1.5
Japan	17.4	13.3	7.3	7.4	n.a.
South Korea	2.3	3.1	3.2	3.0	2.6
The Netherlands	1.0	1.1	0.7	0.7	0.7
Russian Federation	n.a.	1.5	1.4	1.5	1.7
Singapore	0.4	0.4	0.5	0.5	0.6
United States	22.9	21.7	17.2	16.4	n.a.
European Union	22.7	24.2	16.8	16.5	15.2
World	100.0	100.0	100.0	100.0	100.0

Source: World Bank World Development Indicators, <https://databank.worldbank.org/source/world-development-indicators>.

Table 3.5. Share of imported industrial value added in total industrial value added (2018, in percentage)

	USA	CAN	MEX	DEU	GBR	<u>FRA</u>	<u>ITA</u>	CHN	JPN	KOR	IND
USA		15.0	12.5	1.8	3.0	2.4	1.2	1.0	2.1	2.7	1.6
CAN	1.9		0.9	0.2	0.6	0.3	0.1	0.2	0.4	0.3	0.1
MEX	1.6	1.7		0.2	0.1	0.1	0.1	0.1	0.2	0.2	0.2
DEU	0.8	1.1	1.3		3.1	4.1	3.3	0.6	0.8	1.1	0.6
GBR	0.4	0.5	0.2	1.0		1.3	0.7	0.2	0.3	0.4	0.3
FRA	0.3	0.4	0.4	1.8	1.6		1.9	0.2	0.3	0.4	0.3
ITA	0.3	0.5	0.6	1.6	1.0	2.1		0.2	0.2	0.3	0.3
CHN	3.3	4.2	7.8	2.7	2.2	3.1	2.5		4.2	7.0	3.6
JPN	1.0	1.2	1.4	0.7	0.6	0.6	0.3	1.0		2.5	0.7
KOR	0.6	0.8	1.5	0.4	0.4	0.3	0.3	1.3	1.0		0.9
IND	0.4	0.4	0.4	0.3	0.4	0.4	0.4	0.2	0.2	0.5	

Source: Baldwin et al., *Horses for Courses* (2022).

Note: The seller countries are in the first column; the buyer countries are in the first rows. The numbers signify the share of the buyer’s total usage of intermediate inputs that come from the seller, evaluated on a gross production basis.

Reliance on China is even higher in manufacturing. The difference between imports and inputs in manufacturing is the coverage: imports cover all uses, whereas inputs in manufacturing cover those imports from source countries that are used in manufacturing in the destination country. This is not surprising by itself, given the sheer share of China’s manufacturing in the world – some 30 per cent compared to 16 per cent for the United States and 7 per cent for Japan (Table 3.4). What is striking, however, is the large imbalance in dependency. Baldwin and his co-authors dissect this for major manufacturing countries in the world. They show that for each of them, reliance on China for inputs in manufacturing far

outpaces China's reliance on inputs from those countries themselves (Table 3.5).³³ For example, the US imports 3.3 per cent of manufacturing output as inputs from China, whereas China imports 1 per cent from the United States; and Germany imports 2.7 per cent of manufacturing output from China, whereas China imports 0.6 per cent from Germany. In an update, Baldwin shows that reliance on China fell a little in the period 2018–2020 for the US and India, but not for Germany. The discrepancy seems to suggest that China, overall, is significantly less dependent on other countries for their manufacturing than other countries are on China.³⁴

33 Richard Baldwin, Rebecca Freeman and Angelos Theodorakopoulos, *Horses for Courses: Measuring Foreign Supply Chain Exposure*, NBER Working Paper 30525 (2022), <http://www.nber.org/papers/w30525>.

34 'How Asymmetric is the G7's Reliance on Chinese Supply Chains?' (5 January 2024), <https://www.linkedin.com/pulse/how-asymmetric-g7s-reliance-chinese-supply-chains-richard-baldwin-rcofe/>.

4. Company experiences with business in China

This chapter and the next describe how rising geopolitical tensions and risks have impacted the operations and strategies of foreign-invested companies in China. We will mainly draw on our survey and interviews with foreign-invested companies in China and background interviews with trade associations, business federations and (semi-)governmental institutions from the Netherlands, Singapore, Germany and Japan.

The current chapter starts with a description of the nature of the firms we interviewed. We then proceed with these firms' perceptions of the opportunities, risks and problems of doing business in China and how these have or have not been affected by the COVID-19 pandemic, geopolitics and the slowdown of the Chinese economy.

The next chapter will look at how the changes in the Chinese economy have incentivized companies to restructure their supply chains, production, investment and sales. We will then move on to the impact of geopolitical tensions on business decisions, with a focus on the differences in such impacts across countries of origin, sectors of the economy and the size of the company's exposure to China.

4.1 Foreign businesses in China

Foreign businesses in China inevitably vary greatly in size, location in China and their products, activities and internal organization. Moreover, some already have a long history in China, whereas others are relative newcomers. The large majority have committed very large investments to China and are in the country for the long haul, but some others tread more lightly and would be able to leave relatively easily. The relative importance of revenue and profit from China varied considerably, but usually did not exceed 25 per cent of revenue of global totals, even for those with very extensive China operations, making China either the second or the third-largest market for the company.

Table 4.1. Revenue from China of global company

Company's China revenue as percentage of global revenue	Percentage
10% or less	46%
10%–25%	33%
25%–50%	13%
50%–75%	3%
More than 75%	5%

Source: 2023 project survey.

German and Japanese companies in our sample are on average much larger than their Dutch and especially Singapore counterparts, as is reflected in their number of employees in China.

Table 4.2. Average size of staff by country

Location of HQ	Average size of staff in China
Germany	5,930
Japan	3,636
The Netherlands	1,622
Singapore	417

Source: 2023 project survey.

With the exception of most Japanese companies and a few companies from the other three countries, the personnel and management of foreign companies in China consist largely or even fully of local Chinese employees or ethnic Chinese with a foreign passport. In most cases, only one or two members of the senior management team (typically the CEO and/or CFO) are non-Chinese, usually but not necessarily expatriates from the company's head office. Other non-Chinese are usually specialized maintenance or installation staff. Larger companies in China tend to have more non-Chinese staff than smaller companies, either because they can afford the extra costs or are attractive enough for foreigners to work for.

Table 4.3. Non-Chinese employees by country

Location of HQ	Non-mainland Chinese employees
Japan	65%
Germany	11%
Singapore	7%
The Netherlands	7%

Source: 2023 project survey.

Table 4.4. Non-mainland Chinese employees by size of staff

Size of staff in China	Non-mainland Chinese employees
Fewer than 10	8%
10 to 100	20%
100 to 1,000	29%
More than 1,000	30%

Source: 2023 project survey

The transition to local staff has taken place over many years and is part of the decline in the number of foreign residents in China in general, which, after fifteen years of explosive growth in their number since the year 2000, started to drop in the second half of the 2010s.³⁵ In 2020, the COVID-19 pandemic created a genuine exodus of foreign residents from which China is still only slowly recovering.

Many of our respondents mentioned that after the COVID-19 pandemic, it has become very difficult to persuade employees of the global company to work for a period of time as an expatriate in China. Reasons usually given include the disappearance of the vibrant foreign communities in cities like Shanghai, Beijing and Shenzhen and the closure of many foreign-

35 Frank Bickenbach and Wan-Hsin Liu, 'Goodbye China: What Do Fewer Foreigners Mean for Multinationals and the Chinese Economy?' *Intereconomics*, 57(5) (2022), pp. 306-312, [https://www.intereconomics.eu/contents/year/2022/number/5/article/goodbye-china-what-do-fewer-foreigners-mean-for-multinationals-and-the-chinese-economy.html#:~:text=According%20to%20preliminary%20results%20of,2020%20\(NBSC%2C%202021\);](https://www.intereconomics.eu/contents/year/2022/number/5/article/goodbye-china-what-do-fewer-foreigners-mean-for-multinationals-and-the-chinese-economy.html#:~:text=According%20to%20preliminary%20results%20of,2020%20(NBSC%2C%202021);) and Frank N. Pieke et al., *How Immigration is Shaping Chinese Society*, MERICS (2019), <https://merics.org/en/report/how-immigration-shaping-chinese-society>.

language schools. Furthermore, a sense of unease in the home country about the perceived anti-foreign attitude of the Chinese government also plays a role, including the fact that foreigners from several countries have not been allowed to leave China.

The latter is especially true for Japanese companies. More than any other country, Japan is suffering from apprehension that its citizens could be arrested in China on espionage charges.³⁶ One respondent even mentioned that the company's expatriates in China would heave a sigh of relief every time their plane back to Japan had taken off.³⁷ Nevertheless, according to the 2022 JETRO survey, roughly the same percentage of Japanese companies in North-East Asia (that is, mostly in China) and elsewhere in Asia plan to decrease their numbers of expatriates. This is an indication that the specific human resource challenges in China are not yet having a negative impact on the number of Japanese expatriates in China. Instead, a more general trend exists for Japanese companies across Asia to localize further their human resources.³⁸

The situation for Singaporean companies is very different from the other three countries. Several respondents said they had little difficulty in recruiting people to work in China after the lifting of the COVID-19 restrictions at the end of 2022, citing the close cultural and linguistic affinity of Singaporean Chinese with China as the main reason.

4.2 Why China?

The integration of foreign-invested companies into China goes much further than just personnel. Over the decades, the reasons for being and staying in China have evolved from cheap labour and land, favourable government policies, a decent infrastructure and a potentially huge market. Companies in China invest in innovation and automation of production to save labour and other costs, while moving labour-intensive production to other locations. This is also borne out by the findings of the 2022 JETRO survey. Japanese companies

36 'China Formally Arrests Japanese Man for Alleged Espionage', Nikkei Asia (19 October 2023), <https://asia.nikkei.com/Spotlight/Society/China-formally-arrests-Japanese-man-for-alleged-espionage>.

37 On the impact of anti-espionage legislation among foreigners in China, see 'A Battle against Spies in China is Spooking Locals and Foreigners', The Economist (23 May 2023), <https://www.economist.com/china/2023/05/04/a-battle-against-spies-in-china-is-spooking-locals-and-foreigners>.

38 JETRO, 2022 Survey (2023), pp. 21, 26 and 29.

in China or North-East Asia were ahead of their counterparts in other Asian regions regarding cost increases as the most common reason for both downsizing or relocation/withdrawal of business and the drive of automation and digitization of production.³⁹

China is now no longer valued simply as an export-processing hub of intermediate inputs produced abroad that are assembled into products largely destined for foreign markets. In our survey, we asked about the most important opportunities of doing business in China (Table 4.5.). The prospect of continued growth of the Chinese market topped the charts, followed by the benefits of technological R&D in China. The hope or expectation of a further opening of the Chinese market, however, is no longer an important consideration for most firms.

Table 4.5. Opportunities of business in China

Reason for doing business in China	% of companies
Growth of market	73%
Technological R&D	37%
Competition from globalization of Chinese companies	32%
Continued support for infrastructure investments	30%
Urbanization	27%
Continuing economic and market reforms	21%

Source: 2023 project survey.

Production in China has moved up the global value chain. According to the World Bank, between 2001 and 2010 alone, China’s knowledge-intensive goods exports increased by 700 per cent; since then, China has become the world’s second-largest hub of global value chains.⁴⁰ In the past 25 years, especially the Pearl River Delta and the Yangtze River Delta regions have

³⁹ JETRO, 2022 Survey.

⁴⁰ Christine Zhenwei Qiang, Yan Liu and Victor Steenberg, *An Investment Perspective on Global Value Chains*, Washington: International Bank for Reconstruction and Development / The World Bank (2021), <https://www.worldbank.org/en/topic/competitiveness/publication/investment-perspective-on-global-value-chains>.

developed a vast manufacturing base of companies embedded in dense networks of supply chains that can produce virtually anything, and at a price, volume and quality unparalleled anywhere else in the world. For example, the percentage of Japanese companies in China that planned an expansion of ‘high value-added’ production soared from 37 per cent of total sales in 2018 to 45 per cent in 2022, while the number of companies that planned an expansion of ‘general purpose’ production dropped from 25 per cent to 17 per cent in the same period. Although a similar pattern away from general purpose to high value-added production also applied to other Asian regions, China clearly led the way in both trends.⁴¹

For many companies, R&D in China has become an important driver of their China strategy. China is no longer simply living off the science and engineering prowess of the developed world, but has become an important hub of innovation in its own right. Like elsewhere, market competition drives development and innovation, which in many sectors is actively supported by the government and by a deep pool of researchers, especially in science and engineering. Lest they fall behind both in China and ultimately also abroad, foreign companies need to tap into China’s R&D base and need exposure to the Chinese market to drive their own R&D. One good example is electric vehicles, where China is now at the cutting edge in terms of technology.

China’s manufacturing base and its increasingly sophisticated market have become the main attractions, either for products produced and imported from abroad or for products produced in China itself. This is also in evidence in the 2022 JETRO survey of Japanese companies, among which North-East Asia is ahead of other Asian regions in the shift to the local market.⁴²

Among the companies we interviewed, several distinct (but not necessarily fully exclusive) ways of operating in China can be distinguished. First, some companies serve the Chinese market exclusively or largely from abroad, usually backed by very extensive in-country marketing and sales operations. For some, this is something they have always done, while others have more recently given up production in China, usually because of increasing competition from local companies. For many of these companies, the Chinese market is essential to the global company’s results and long-term growth. Others are relatively new entrants in the Chinese market, so with relatively low sales volumes, China was still relatively

⁴¹ JETRO, *2022 Survey*, p. 19.

⁴² JETRO, *2022 JETRO Survey*, p. 24.

unimportant for these companies and had not yet reached the level that would make production in China worthwhile.

The second way of operating in China is for foreign-invested companies to embed themselves even more fully in Chinese supply chains. Some of these companies act as a final assembler and exporter of machines or other products to markets abroad, usually in the home country or elsewhere in the developed world. More often, foreign firms have become part of local supply chains, producing intermediate goods for Chinese or foreign customers. For instance, several of the companies we interviewed had started in China as suppliers of parts or machines to foreign manufacturers, but now count Chinese as much as foreign companies among their clients. Given the integration of many foreign-invested firms in the Chinese economy, it is often increasingly artificial to distinguish foreign products from Chinese goods, which is something that policy-making in other countries could factor in more.

The third way of operating in China is more commonly found among very large foreign companies with a long history in the country. Their China operations have developed brands and products tailored to serve the demands of the Chinese market. Production, marketing and R&D in China itself are essential parts of their presence in China. As R&D in China has become stronger, it also plays a more important role in the global company's R&D strategy. While strategic decisions remain subject to the global company's direction, the size of its investments and operations in China, coupled with its strong integration in supply chains and the market in China, would make it virtually impossible for a global company to disentangle itself from China, except at a very high cost.

4.3 Challenges of doing business in China

During their often long and deep exposure to China, foreign companies have adapted to the many challenges that operating in China poses. The long list of challenges and problems are many and well documented, for instance in the reports of the European Union Chamber of Commerce in China and the American Chamber of Commerce in China.⁴³ In our interviews, we also asked about some of the larger and more generally perceived challenges, including

⁴³ European Union Chamber of Commerce in China (EUCCC), *European Business in China: Position Paper 2023–2024*, https://www.europeanchamber.com.cn/en/publications-archive/1167/European_Business_in_China_Position_Paper_2023_2024; EUCCC, *European Business in China: Business Confidence Survey 2023*; and American Chamber of Commerce in China, *2023 Business Climate Survey Report*.

unfairly enforced regulations and legislation (including data protection, national security, anti-espionage and cybersecurity); unfair competition from Chinese companies and government preference for local companies; intellectual property (IP) leakage and IT/data security threats; CCP party building and the social credit system; and pressure to refrain from 'anti-China' statements.

Some of these issues were only rarely experienced or were felt to have little impact (party building, social credit and pressure to conform to CCP orthodoxy), but others were raised more frequently. Most commonly, companies reported on the extra costs and time caused by China's increasingly strict regulations on auditing and finance, product standards, environmental protection, employment, data security and other business-related issues. However, for many interviewees this was also a good thing, creating a more-level playing field and giving foreign companies an advantage.

Quite surprisingly, only Japanese companies reported serious effects of China's national security-related legislation, while very few companies from other countries mentioned this as an issue for them. IP leakage, government protectionism and unfair competition from Chinese companies received mixed responses. IP leakage, in particular, was often mentioned and sometimes even considered a major issue that required constant vigilance, expense and the need to continue to innovate faster in order to stay ahead of the competition.

Companies were often less sanguine about the Chinese central authorities' real support for foreign investment and business and the fact that national security and international rivalry are now considered to trump economic growth and development.⁴⁴ Local governments in China, however, were often seen as very supportive and helpful and seem quite convinced that foreign businesses were and would remain essential to their region. Protectionism in

⁴⁴ In November 2023, the Chinese authorities took steps to accommodate foreign business, but it is doubtful that these will swing perceptions among foreign companies if not backed up by a package of clear pro-growth economic policy measures. A trial was launched for two-week visa-free travel to China for a handful of European countries and Malaysia in order to encourage foreign business and tourism to pick up; see 'China Trials Visa-free Travel for Six Countries', *BBC* (24 November 2023), <https://www.bbc.com/news/world-asia-china-67516777>. In addition, a pilot was announced to further open up Beijing to foreign investors and service providers; see Sylvie Zhuang, 'China Backs "Around 170 Measures" to Open Up Services Sector in Beijing as Capital Outflows, Sluggish Recovery Bite', *South China Morning Post* (26 November 2023), <https://www.scmp.com/news/article/3242830/china-backs-around-170-measures-open-services-sector-beijing-capital-outflows-sluggish-recovery-bite>.

strategic sectors of the economy was seen as more of a central-government than a local-government concern.

In sum, foreign companies in China are well aware of the challenges of doing business in China, but remain confident that they know how to navigate the rocks and shoals of China’s system. They hope that some of the more damaging problems (including IT theft and the absence of a level playing field, in particular) can be resolved. They emphasize the still very considerable opportunities that China has to offer.

4.4 Impact of the COVID-19 pandemic and economic slowdown since 2023

The COVID-19 pandemic has had a very uneven impact on the foreign companies we interviewed. During the 2022 lockdowns in particular, some companies suffered supply chain problems or production slowdowns, usually because employees could no longer go to work. For many companies, however, the impact of lockdowns on business had been fairly minimal or relatively short-lived, although quite a few respondents said it had been challenging on a personal level. Some companies actually profited from the pandemic, usually because of the nature of their business (for instance, medical supplies, logistics or home decoration).

Table 4.6. Financial performance of surveyed companies in China

Financial performance in China in 2022	
Great loss	9%
Loss	21%
Break even	20%
Profitable	32%
Very profitable	18%

Source: 2023 project survey.

During the pandemic, international travel restrictions meant that many expatriates could not, or did not want to, return to China. Their work had to be done remotely, or taken on by the remaining staff or by local hires. Even more importantly, the Chinese operations were partially cut off from the main office for three years. Although communications obviously had not ceased, site visits from headquarters (HQ) and visits by local management to HQ became impossible. Many felt HQ no longer really knew what was happening in China and

increasingly perceived their China operations through the negatively biased lens of the perception of China in their home country.

After a brief fillip to the economy in early 2023, the disruption of the lockdowns and their sudden abolition at the end of 2022 caused unemployment and bankruptcies that added to the structural economic problems that China is facing. For many companies, the current slowdown is creating a good deal of uncertainty about whether the company will be able to continue to grow and invest. Many firms, for instance, are suffering from the knock-on effects of the slump in real estate (building materials, home appliances, furniture and architecture) or the car industry (car parts, coatings and machinery, including robotics). Others are part of supply chains in sectors hit by American tariffs or sanctions, such as semiconductors, or of highly cyclical sectors driven by consumer demand (such as high-end foodstuffs and luxury items).

Table 4.7. Forecast growth of surveyed companies in China

Forecast of growth in China in 2023 versus 2022	
Much lower	9%
Lower	26%
Same	17%
Higher	41%
Much higher	4%

Source: 2023 project survey. Note: this table does not include Japanese companies.

In general, only companies largely or wholly producing for export remain unaffected by the economic slowdown, while some even profit from it, for instance because of the downward pressure on labour costs or more spare capacity among upstream suppliers. Certain business services from Singaporean companies (including banks and lawyers) are benefiting from the internationalization of Chinese firms, the relocation of supply chains and capital flight spurred by economic and political uncertainty in China.

4.5 Investment plans and expectations for the future

When discussing the company's outlook and investment plans in China, positive responses predominated, despite the economic slowdown and lacklustre policy response from the

Chinese government. This was true for companies from all four countries. However, for many the bullish assessment of the opportunities in China that had already cooled since the start of the US–China trade conflict in 2017 had taken a turn for the worse in 2022 and 2023.

This pattern is also evidenced in other research. In a 2020 Leiden Asia Centre research project about Dutch companies in China, the researchers already reported on a negative turn among some of their interviewees. Long-term problems of doing business were being aggravated by the politicization of business in China, geopolitics and a rising awareness of the dangers of a one-sided dependence on China.⁴⁵ According to The Conference Board, in the second half of 2023 only a slight majority of foreign CEOs in China remained positive about prospects in China (54 per cent, down from 72 per cent in the first half of 2023), while 71 per cent said that demand had not returned to pre-COVID levels.⁴⁶

A similar pattern prevails in the 2022 JETRO and the 2023 EUCCC surveys. Business confidence among Japanese companies in China nosedived in 2022, but then made a decent recovery for 2023. Nevertheless, only 33.4 per cent of companies selected ‘expansion’ as their future business plan, the lowest level ever since the 2007 survey, while a large majority of firms (60.3 per cent) said they planned to stay the same in China. This contrasts sharply with many of the countries of South and South-East Asia and Oceania, where expansion plans by Japanese companies predominate.⁴⁷

Among European companies, 53 per cent of businesses had no plans to expand their operations in China in 2023. The proportion of businesses that rank the Chinese market as a top-three destination for *future* investments dropped by 13 per cent to 55 per cent – the lowest figure on record. Factors causing the change in business confidence included the increasing politicization of doing business in China, the higher degree of politicization of consumer demand *outside* China (for example, Xinjiang or forced labour, no China product content) and geopolitics (such as the US–China trade conflict and war in Ukraine). In addition, long-

⁴⁵ Ardi Bouwers and Alex Krijger, *The China Challenge: Impact of the Politicised Business Environment on Dutch Companies in China*, Leiden: Leiden Asia Centre (2020), <https://leidenasiacentre.nl/the-china-challenge/>.

⁴⁶ The Conference Board, *Confidence Among CEOs of Multinational Corporations Wanes as Economic Weakness Persists* (2023), <https://www.conference-board.org/pdfdownload.cfm?masterProductID=49490>.

⁴⁷ JETRO, *2022 Survey*, pp. 6–7, 9 and 13–16.

standing issues over market access, unfair competition, regulatory barriers and technology transfer also continue to play a role.⁴⁸

Nevertheless, we found that particularly companies whose business requires a long-term view, coupled with 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. Even with China growing much slower, the sheer size of its economy still means that there is a lot of room for expansion. The same applies for companies that have built up sizeable sales, marketing and service operations for products produced abroad and exported to China. Such a positive take on China is particularly pronounced among the largest, most R&D and technology-intensive companies in sectors such as chemicals, machinery and tools, cars, medical equipment and processed food products. Smaller, highly specialized companies that supply parts, tools or machinery for the car or semiconductor sector, for instance, take a very similar view. However, only a few firms are embarking on wholly new projects in China. Similarly, only a few new foreign firms are investing in China. This long-term trend, which already started with the financial crisis in 2008–2009, has been amplified by the current geopolitical problems, but was not triggered by it.

Although some companies have decided to put their investments in China on hold, the majority we interviewed said they would continue with their long-term investment plans and were optimistic about the prospects for long-term growth.

Table 4.8. Company forecasts for long-term growth in China

Forecast for growth in China	
Much lower	6%
Lower	15%
Same	27%
Higher	48%
Much higher	4%

Source: 2023 project survey.

⁴⁸ EUCCC, *Business Confidence Survey 2023*, p. 1.

Table 4.9. Estimated change in level of investment in China for 2023

Change in level of investment in China for 2023	
Much lower	4%
Lower	19%
Same	45%
Higher	32%
Much higher	0%

Source: 2023 project survey.

Even more than before the COVID-19 pandemic, many foreign companies are investing to become more independent and less exposed to global supply chains, a strategy that can be summed up as ‘local-for-local’ investments, including the acquisition of Chinese companies, back-office functionalities, production facilities, R&D facilities and sales. We will return to this in the next chapter. Perhaps the most prominent case is provided by Volkswagen, which has decided to take Chinese competition in the electric vehicle (EV) market head on by launching a new range of EVs specifically targeted at Chinese customers, produced entirely in China and primarily with local suppliers.⁴⁹ Much of this investment comes from reinvesting profits that the China operation makes, but particularly the larger companies are also prepared to invest fresh capital from abroad.

There is often a difference in perception between a foreign company’s headquarters in the home country and the China-based office. In interviews, the latter were much more optimistic about China and often expressed the need to invest more and deepen the company’s integration into the Chinese economy. At headquarters, however, respondents were often more concerned about China’s plummeting reputation abroad, the political shift away from reforms and opening up, the slowdown of the Chinese economy and the impact that this

⁴⁹ ‘Volkswagen to Launch China-specific Entry-level Electric Platform’, *Reuters* (24 November 2023), <https://www.reuters.com/business/autos-transportation/volkswagen-launch-china-specific-entry-level-electric-platform-2023-11-24/>. Another prominent case is Sony, which decided to produce cameras in China solely for the Chinese market, shifting production for export to Japan, Europe and the US to Thailand; see Keiichi Furukawa, ‘Sony Separates Production of Cameras for China and Non-China Markets’, *Nikkei Asia* (29 January 2023), https://asia.nikkei.com/Business/Electronics/Sony-separates-production-of-cameras-for-China-and-non-China-markets?utm_campaign=IC_asia_daily_free&utm_medium=email&utm_source=NA_newsletter&utm_content=article_link&del_type=1&pub_date=20230130123000&seq_num=3&si=80637e02-cf70-41dc-a3fd-7a24dde6f26b.

might have for the company's exposure to China. In particular, the need to strengthen the company's resilience in the face of adverse changes in the United States' attitude towards China was often raised.

The emerging alliance of the US with its partners in Europe and Asia to contain China worried many of our respondents. The issues most often raised were the possibility of a war over Taiwan or the South China Sea and increasing US sanctions against China. Much less prominent were changes within China itself, as it was felt that China would continue to be a very important and lucrative market to be part of. Discussions of political risk rarely focused on, for instance, the authoritarian turn in China, the containment of the private sector, China's long-term economic and social problems, or even China's increasingly assertive international role. The next chapter will discuss the consequences of these issues for foreign-invested firms in China and the ways in which they are dealing with them.

5. Dealing with geopolitical risks

Chapters 3 and 4 discussed how China's moving up the value chain in the global economy has had a profound impact on foreign-invested companies. Many intermediate goods, machinery and services that previously had to be imported for processing and assembling are now produced in China, either by Chinese or foreign-invested companies. For many years now, the localization of global supply chains in China has also been encouraged by government policy and funding, in an effort to make China more self-sufficient and less vulnerable to external shocks or pressure.

Many Chinese and foreign companies are relocating part or all of their production to other countries, including Vietnam, Bangladesh, Myanmar, Indonesia, Malaysia, India or Mexico. Much of this trend is driven by China's rising costs for labour, land and the environment. Another driver of relocation is the growth of these countries' economies. Producing in or close to their booming markets helps to cut costs, shortens the time to market and enables targeted product development and marketing.

In this new international division of labour, China is becoming a producer and exporter of higher value-added products. Many of these goods are intermediate products that are exported to cheaper countries for final assembly or processing and for export of the finished products to more developed countries, including China itself. Often, smaller companies that supply large first-tier companies follow these companies in their strategy. This is not only true for Chinese suppliers to large foreign companies, but also for foreign suppliers to large Chinese companies.

In recent years, this long-term development has acquired a much greater urgency. The COVID-19 pandemic disrupted many global supply chains, causing shortages of goods and affecting production the world over. However, the trade war between China and the US has been even more important than the pandemic shock. The strategic imperative to shorten supply chains and avoid excessive dependency on China is now deeply felt not just in governments, but also among businesses the world over. Since the Russian invasion of Ukraine, attention to geopolitics increased, with many companies fearing that a future crisis regarding Taiwan may lead to major sanctions on China and effectively a ban on doing business there. Conversely, under its national security legislation and the 'dual circulation'

policy, the Chinese government has further stepped up its efforts to localize supply chains and make China less dependent on world markets.

For foreign companies involved in the Chinese economy, these geopolitical changes are altering the nature of doing business in China. This chapter will discuss their perceptions and strategies to ascertain what these companies can and would be prepared to do to strengthen their resilience, and how this may impact their business in China.

5.1 The US-China conflict and foreign companies in China

To China-invested businesses, the conflict between the two superpowers is an external event that they can do little about. They have to learn to adjust to it as best as they can. They do not see decoupling in terms of their vulnerability to a ‘China risk’, but as the need to strengthen their resilience against fallout from the conflict between the US and China, including attempts at limiting strategic dependencies on China by the US, their home country or other countries.

Table 5.1. Importance of China–US bilateral relations to company business growth in China

Importance of China–US relations	% of companies
Highly unimportant	3%
Unimportant	6%
Neutral/ do not know	9%
Important	43%
Very important	40%

Source: 2023 project survey.

As discussed in chapter 4, many companies are thoroughly integrated in the Chinese economy and know what can and cannot be expected from the Chinese government. Except for Japanese companies, they do not believe that they would suffer from possible anti-foreign measures taken by the Chinese government, despite concerns about the recent anti-espionage law and other national security legislation. In our interviews, we also did not hear much about negative consequences of the Chinese government’s countermeasures to US sanctions and restrictions, including China’s trade and FDI regulations and strengthening legislation such as China’s List of Unreliable Entities and the Anti-Foreign Sanctions Law.

However, there are some exceptions. Some Japanese companies pointed out that the ‘buy China’ campaign might impact their sales in China, possibly forcing them to reconsider their

‘China risk’. The strong anti-Japanese feelings of many Chinese, often encouraged by official media, also played a role here. Another exception is caused by China’s expansive preoccupation with ‘comprehensive’ national security. Several companies we spoke to have decided to focus more on other Asian countries because of the Chinese government’s emphasis on self-sufficiency on national security grounds.

China’s broader ‘dual circulation’ policy of promoting self-sufficiency impacts foreign companies that rely on imported products that could also be produced in China. However, most foreign companies are already heavily connected to domestic supply chains in China. They do not usually depend—or depend only relatively little—on supplies from abroad, although, if they do, the components that are still imported are usually critical, highly specialized and sometimes also susceptible to the risk of civil–military dual use. Moreover, some companies, especially from Singapore, operate in sectors like retail, business services, health care, education or real estate, without international supply chains or other international vulnerabilities. For many foreign companies, dual circulation might actually expand their market in China. In a similar fashion, the government’s drive to develop and buy Chinese brands for high-tech products can be, or already has been, dealt with by certifying products as ‘Made in China’ or by creating separate Chinese brands.

A theme that occurred time and again is that foreign companies’ main worry about geopolitical risk does not lie with China, but with the measures taken by the United States to contain, blunt or roll back China’s strategic threat to US dominance. Almost all of the companies express a deeply felt belief in the benefits of globalization, although they also see that in some areas this might have gone too far and that countries are right to strengthen their resilience to vulnerabilities in supply chains, especially of strategic goods. However, their overriding wish is for stability in international politics. Dutch, German and Japanese companies are usually critical of their home country’s government siding with the US. They hope for a more balanced approach in dealing with both the US and China. Meanwhile, Singaporean companies praise their government for exactly this and strongly support its refusal to pick a side in the conflict.

The risks from US sanctions or tariffs against China are often less about what already is in place than about what might happen in the future. Moreover, and even more importantly, companies worry a great deal about the likelihood and impact of open hostilities between China and the US, especially over Taiwan and the South China Sea. A comparison with the

Russian invasion of Ukraine is often made. Such an event would be hard, if not impossible, to prepare for fully. Many companies profess that a major armed conflict might compel them to leave China altogether, despite the very heavy financial losses that this would entail, although some Singaporean companies state that even under these circumstances they would be prepared to remain in China and sit out the conflict. Some companies are already trying to build conditions into their China operations that would allow them to exit China in the event of an emergency. However, a more common response is that they are not planning to do anything at all, because their investments and operations in China are largely fixed and would simply have to be written off entirely, no matter what they do.

Businesses are internally very diverse, and geopolitical risks will vary from case to case and from product to product. A company's risk-mitigation strategies will have to be targeted rather than applied across the board. For instance, reliance on certain specific supplies from abroad constitutes a risk for the future. Companies would suffer if the home country were to decide to ban their export on strategic grounds or if these components also have a US content that would make them subject to future US sanctions.

Even supplies from China would have to be scrutinized for foreign content that could be liable for future sanctions. This is not only limited to foreign (especially US) measures. Heightened tensions have also led the Chinese government to purchase fewer American products, even if these are produced in China. In turn, this has negatively affected the business of some other foreign firms in China that are involved in the production, sales or servicing of these American products. Foreign businesses may also suffer if they have American customers in China, who at some point in the future might be compelled to reduce their operations in China. Such knock-on effects of 'hard' US-China decoupling would have a strong impact across a wide range of sectors, from the food industry to logistics to consumer electronics. In certain sectors, such as semiconductors, this is in fact already happening.

Other foreign companies import critical inputs or machinery for Chinese customers in strategic sectors, including semiconductors, artificial intelligence, batteries or electric vehicles. These sectors are the main battlefields where the US-China competition is playing out. Under intense American pressure, in June 2023 the Dutch government further tightened restrictions on export to China of the Dutch company ASML's high-end lithography machines, which are

used in the production of semiconductor chips.⁵⁰ This measure was widely criticized during our interviews. Respondents felt that this new export ban sent a message to China that the Netherlands is firmly on the side of the US, damaging their relations with Chinese businesses and government.

To foreign companies supplying strategic sectors in China, it is very important to know which of their Chinese customers are likely to be put on the US entity list in order to avoid getting on the radar of the US government. European governments are also creating more uncertainty, although they are currently stopping short of full sanctions or tariffs. Export licences for high-end lasers from Germany, for instance, now take six months instead of three weeks. A final China risk for foreign companies that does not yet feature prominently in the discussions is the high degree of dependence on China for the construction and maintenance of vessels used for transportation. For example, only China and South Korea can build large container ships and liquified natural gas (LNG) carriers. According to international rules, such ships must be docked once every two to three years for maintenance.

Some companies have already been barred by the US government or their home country from supplying certain strategic products or services to China. Moving production of these inputs out of the US is often prohibitively expensive. Many companies are likely to exit from the Chinese market for these products if the situation becomes much worse, for instance with an open military conflict over Taiwan or the South China Sea.

Smaller start-up companies may decide to avoid China altogether and focus entirely on the US and countries not subject to current or future sanctions. In other cases, reducing the US or even European content of their Chinese products is under active consideration, even though this might be extremely costly, politically dangerous and take years to achieve. In general, though, it is clear that for many companies the relative importance of the US outstrips China's. We have not heard of any company making the opposite decision, namely focusing entirely on China, in response to sanctions.

⁵⁰ Cheng Ting-Fang, Lauly Li and Rhyannon Imadegawa-Bartlett, 'Netherlands Unveils Chip Tool Export Curbs in Fresh Blow to China', *Nikkei Asia* (30 June 2023), <https://asia.nikkei.com/Business/Tech/Semiconductors/Netherlands-unveils-chip-tool-export-curbs-in-fresh-blow-to-China>.

Geopolitical risks have created a lot of uncertainty for foreign firms in China. This is especially so for companies operating in strategic sectors, but many other products are vulnerable as well. A big part of the problem here is that the landscape is highly unstable. Certain products may contain US components that can currently still be shipped to China, but in the future the US government might decide that these components are dual use or even simply may give China a strategic advantage. Conversely, products with production relocated from China to third countries often contain many parts produced in China and thus these might still be subject to future US tariffs or sanctions. Disentangling global supply chains is not an easy matter. For some products it might actually prove almost impossible.

Other vulnerabilities concern exposure to accusations of complicity in human rights abuses, especially in Xinjiang. Although most companies that had a presence in Xinjiang have already shuttered their operations there,⁵¹ dependence on supply chains with a possible Xinjiang component remains an issue, not least because it is often very hard to know what (if anything) has been sourced from Xinjiang and whether this involved any human rights abuses, particularly because it is currently impossible to undertake full and independent due diligence in China. In this regard, shipping to the US is different than shipping to Europe. The United States' 2022 Uyghur Forced Labor Prevention Act means that a company must prove up front that their products are without a restricted Xinjiang content. Exporting to Europe may only be a problem if the issue of a possible Xinjiang content is flagged, for instance by government, in the media or by a non-governmental organization (NGO).

Despite these worries, the majority of the firms say they would not relocate all or part of their business outside of China, and only one-quarter had already done so. The continued optimism about business in China that we encountered in chapter four clearly continues to trump the worries that foreign companies doing business in China may have.

⁵¹ In the EUCCC 2023 *Business Confidence Survey*, for instance, only 4% of respondents reported that they have been or expect to be impacted by the US 2022 Uyghur Forced Labor Prevention Act, which imposes additional restrictions on imports from Xinjiang; see EUCCC, *European Business in China: Business Confidence Survey (2023)*, p. 21.

Table 5.2. Response to sanctions and impact of decoupling: relocating outside China

Relocating business outside of China	% of companies
No	56%
No, but we are thinking about it	13%
We are preparing to do so	6%
We have shifted or are shifting some supply chains	23%
We have shifted or are shifting all or most of our supply chains	3%

Source: 2023 project survey.

This is also reflected in the fact that the majority of the companies expect a future relocation to have a negative impact on the global company’s overall performance.

Table 5.3. Impact of diversification or relocation on the company’s performance

Impact of diversification	% of companies
Very negatively	18%
Negatively	43%
Not really	24%
Positively	7%
Very positively	9%

Source: 2023 project survey.

A large majority of the companies will therefore continue to be committed to China, even after relocating part of the business to another country.

Table 5.4. How essential must China remain to the company’s business even after relocating or diversifying your supply chains?

How essential must China remain to the company	% of companies
Very unessential	17%
Unessential	6%
Neutral/do not know	13%
Essential	42%
Very essential	23%

Source: 2023 project survey.

5.2 Determinants of decoupling

In order to detect any possible patterns in our survey sample about decisions to stay, leave or diversify from China, we measured three distinct variables that serve as proxies for ‘decoupling’. These are: 1) decision on diversifying away from or staying in China; 2) how essential China would be to the company’s business in the future; and 3) expectations of the impact on performance of diversification or relocation. Our analysis correlates these variables with a total of eleven independent variables that describe the characteristics of individual companies. We have given further information on this statistical work in Appendix 3 of this report.

On many of the background variables, we did not find a statistically significant correlation with one or more of the ‘decoupling’ variables. Not even is the perception of bilateral relations between China and the US statistically significantly correlated with a (possible) decision to stay, relocate or diversify. The absence of expected correlations might in part be an artifact of the selection bias (mostly companies that are committed to staying in China anyway) and small size of our sample. Nevertheless, we can only conclude that the challenges and strategies of decoupling are limited and fairly diffusely distributed across foreign businesses in China.

However, we did find a few interesting patterns. Company size is positively correlated with decisions to diversify or relocate from China. Large companies are more likely to have the means and scale to operate globally; conversely, smaller companies are more likely to put all their eggs into just one or a few baskets. Furthermore, the more mainland Chinese staff a company has, the more severe it expects the impact on performance of diversification or

relocation to be. As is to be expected, a company's perception of the outlook of the Chinese market is negatively associated with any decisions on relocation.

The financial, IT and other service sectors all show a smaller intention of relocating or diversifying their business outside of China. A similar tendency pertains to real-estate companies. The similarity between these sectors is very likely caused by opposite considerations. In services without extensive fixed assets in China, relocation is fairly easy and quick to realize. Proactive planning in case of a future geopolitical deterioration is therefore less urgent. By contrast, companies in the real-estate sector own highly immobile assets. Moreover, real estate is not a strategic sector that is vulnerable to sanctions or other measures. Staying in China while preparing to sit out a possible future conflict is thus the sensible thing to do.

Lastly and most importantly, a company's outlook—a compound variable that we constructed to capture to what extent business in China will remain profitable—is the single most statistically significant variable correlated with company decisions on staying, relocating or diversifying. Despite the widely expressed concerns in the interviews about politics in the home country, the US and China, company strategies remain largely driven by business rather than political considerations.

The following sections will discuss these patterns of decoupling that we found in more detail. However, we can already conclude that geopolitical risks for most foreign companies in China remain real but limited, at least for the time being. The large majority of foreign companies we approached already mainly produce in China for the Chinese market or export to countries in Asia or Europe, rather than to the US. Yet they are more generally concerned about the ramifications of US-China tensions for the growth prospects of the Chinese economy. Furthermore, among heavily internationalized companies, there is considerable apprehension about the possible application of US sanctions or other measures on their operations or investments in the US itself. Even worse would be the extraterritorial application of US law or sanctions to the global company or even individual members of its management team. If this were to become reality, these companies say they would be compelled to go along with the US's wishes, even if this means shutting down in China.

Decoupling strategies

Several of the interviewed companies have undertaken internal reviews of their possible vulnerabilities to current or future US sanctions, especially when some of their final products are exported to or from the US. Some companies have decided that – even with the current 20 per cent tariffs – exporting to the US still makes business sense. However, for others the high tariffs make exporting to the US too expensive and we found that most finished purchasing contracts are not being renewed. New orders might go to Vietnam or Mexico, or in certain cases to Singapore. Other companies are investigating whether critical components of products destined for the US market could be sourced from outside China, thus avoiding US trade restrictions. A few have ceased shipping to the US entirely, usually because for them the US market constituted only a small part of their total production anyway.

In order to understand how companies have reacted or will react to any future worsening of relations between China and the US and its allies, in our survey we asked companies to indicate which of a set range of approaches they would be most likely to take. Their answers are summarized in table 5.5. below. The table shows that the vast majority of companies would stay in China, but would seek ways to minimize their risks. In order to do so, they in particular would cancel further investment in China, would further localize operations in China, and would adjust their supply chains or establish separate supply chains for China and the US.

For many, China clearly is ‘too big to walk away from’. The market is too large and lucrative, wholesale relocation of production facilities would be prohibitively expensive, and R&D in China is integral to the global company’s development. In general terms, the overall strategy is not to overestimate the risks and not to underestimate the opportunities of China. However, foreign-invested companies (like many Chinese firms as well) have already started to double down on their long-term business-driven strategy of diversifying and shortening supply chains to reduce their dependence on China. Establishing new operations in South-East Asia, India, Mexico or, in some cases, Eastern Europe to serve markets in the US or Europe has been accelerated. Moreover, some companies have started investing in production capacity directly in the US.

Table 5.5. Impact of a further deepening of geopolitical tensions on business strategy

Strategy	Important (% of companies)
Delaying or cancelling China investment decisions	38%
Localizing more production/services/IP in China to access local sales opportunities	35%
Adjusting supply chains by seeking to source components and/or assembly outside China	24%
Establishing a dual supply chain: one for China, the other for the US	23%
Pursuing joint ventures with Chinese entities that would not normally be considered	23%
Increasing investments in China	17%
Adjusting supply chains by seeking to source components or assembly outside the US	15%
Considering relocation of some or all manufacturing outside China	13%
Considering exiting the Chinese market	10%
Considering onshoring some manufacturing/operations to the US	6%
Shifting away from certain industry or customer segments in China	6%
No impact	4.23%

Source: 2023 project survey.

Note: Included here are all companies that considered a particular option either ‘important’ or ‘very important’. Multiple positive answers were possible.

Particularly for smaller and highly specialized companies, shifting production to other countries is having an impact on their operations in China. Expansion plans in China have been shelved and production has been shifted abroad. Because of the risk of future sanctions

by Europe, more recent European entrants in the Chinese market are now hesitating to move from import and direct sales in China to investing in local production.

The scale of decoupling is also evidenced in the 2023 EUCCC Business Confidence Survey. The longer-term pattern of decoupling from China among its members had clearly sped up by early 2023 when this annual survey was done, with 59 per cent of respondents reporting that China remains a top-three destination for investment (down 7 percentage points). The percentage of members with plans to expand their operations in China dropped by 14 percentage points to just under half, at 48 per cent. However, it must also be observed that these drops, so far, largely remain within the long-term bandwidth of changes in the years since 2012.

Nevertheless, the sentiment among many businesses has clearly changed for the worse. The acute push of China's increased risks has become more important than the long-term pull of changes in the international division of labour. The most important (44 per cent) and second most important (42 per cent) reasons given in the EUCCC survey for diversifying away from China are 'to mitigate the impact of decoupling between China and third countries' and 'China's business environment is too uncertain', rather than the opportunities for business elsewhere or the need to make supply chains more resilient.⁵²

Geopolitical risk management has not caused a run for the door in China. In general, diversification is more about developing options than about leaving China altogether. Geopolitical decoupling can also increase business for foreign companies in China. Several decoupling strategies often go together and complement each other, creating not outright winners or losers but just a more fragmented, insecure and uncertain world in which companies are driven less by the current situation than by what might happen in the future.

The large majority of the companies we spoke to are determined to stay in China and adjust their investment, production and sales strategies in response to China's changing relationship with the US and its allies. Investments outside China are often complemented by investing in China to reduce the dependence of operations there on foreign suppliers or export markets. In general, diversification is more about developing options than about leaving China altogether. Geopolitical decoupling can also increase business for foreign companies in China. Several decoupling strategies often go together and complement each other, creating not

⁵² EUCCC, *European Business in China: Business Confidence Survey (2023)*, p. 11, tables 11 and 12.

outright winners or losers but just a more fragmented, insecure and uncertain world in which companies are driven less by the current situation than by what might happen in the future.

These company strategies are very diverse. Strategies range from (1) a full withdrawal from China to (2) ringfencing China operations, (3) limiting further exposure to China, (4) diversifying supply chains or production to other countries, or (5) doing nothing at all. Conceptually, companies follow a pattern of analysis and action in a context of rising geopolitical risks and other factors, including economic factors. Companies will first become aware of geopolitical issues. They will then start to incorporate geopolitical considerations in their plans and strategies, which will gradually be reflected in their communications with stakeholders. These plans then translate into actions with regard to trade and investment. Some of these actions are driven by political factors such as tariffs and sanctions, while others are taken in anticipation of future policy directions. Implementing these decisions may take time, which varies across industries. For some industries, for example semiconductors, the decisions are more urgent than for other industries that are less affected by geopolitics. Some investors may act on information regarding future policy actions, such as an asset manager who fears that national regulations may make it impossible to continue in China and may face steep losses if forced into a fire sale of assets.

Many companies would simply not be able to move away from China without paying a heavy price. However, on this point there is often a clear difference in perspective between headquarters in the home country and its China subsidiaries. At headquarters, there is quite naturally much greater awareness and wariness about the direction in which the political wind is blowing and the need for global rebalancing of the company. At the company's Chinese subsidiaries, however, there is much more faith in the health and sustainability of their business in China.

The normal response, particularly by larger companies, is to 'ringfence' or 'silo' their operations in China, often referred to as 'China-for-China'. Strengthening the autonomy of the company's subsidiaries in China may include not only their leadership, strategy and finances, but also further investment (chiefly from profits made in China) in research and development (R&D), product development, production, 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 localize R&D, product development or marketing.

For only a minority of companies, a China-for-China strategy includes a reduction in the contribution of the Chinese operations to the company's overall revenues. Reliability, rather than cost-efficiency, of suppliers is paramount. Supply chains are further diversified and localized in China in order to limit dependence on foreign inputs as much as possible. Alternatives for imported core inputs are sought, either in China itself or in other countries that are less likely to impose trade restrictions on China. Dependence on exports from China to the US (and often the home country as well) is further reduced or stopped altogether. In some cases, trade restrictions by governments combine with pressure from customers who demand to be supplied with 'China-free' (in the US) or 'America-free' (in China) products.

Supplementary or alternative strategies are usually called 'near-shoring' or 'friend-shoring'. Downstream production is relocated to other, safer countries, typically in South-East Asia, North America or Eastern Europe. In these redirected global supply chains, China often still supplies core intermediate products for products destined for third-country markets, typically the US or Europe. Alternatively, companies can also choose to diversify their upstream supply chains to ensure that they are not dependent on just one or a very few foreign suppliers, thus reducing complementary reshoring. Fully autonomous operations are set up in other countries with a large and promising market, usually in South-East Asia or India, thus moving all or part of the production from China. 'China-for-China' and diversification away from China often complement each other rather than being alternative strategies.

Other companies are beginning to get cold feet and are looking for ways to sell off their China interests, usually to one of their Chinese competitors, a strategy that could be called 'reshoring'. These tend either to be companies whose exposure to China is less essential or are no longer able to cope with their Chinese competitors. Some recent start-ups have also decided not to go ahead with their plans regarding China, because they find their current or future business in the US, Europe or elsewhere to be easier and less politically risky. This is particularly the case for (but is not limited to) smaller Singaporean companies. The main argument normally is that they either do not want to jeopardize their business opportunities in the US or that business in South-East Asia or the Middle East is more promising. Others, however, continue their interests in China in other ways. Some support their China business from other locations. Others ceased production in China, but continue to supply their sales operations in China from abroad.

A further common strategy that we encountered is to do nothing at all. This usually applies to smaller companies with all or most of their operations in China. Such companies either service the Chinese market, or mainly or wholly produce in China for export. In the first case, geopolitics are thought to have little impact on their business, unless the Chinese economy were to slow down and thus their market. Companies fully dependent on export often feel that they have little choice and will simply have to wait and see how things pan out, leaving China only if they really must. Although they are not doing anything as yet, some companies are developing contingency strategies to pull out of China with a minimum of losses if needed.

Finally, a few companies we interviewed produce all or most of their products abroad, exporting directly to China, where they often have very extensive marketing, sales, servicing and maintenance operations. Those that produce non-strategic goods or services do not feel the need to do very much at all, although their business would of course suffer in the case of a full-fledged conflict between China and the US. Companies that produce and export strategic or military goods, however, are in a totally different position. They are often already in the thick of US sanctions and bans and European ‘de-risking’. However, a global decoupling in their line of business would not necessarily be all negative. The drive to build up separate supply chains for strategic goods would also present opportunities to invest in new operations in Europe or the US and often on very favourable terms. Setting up separate production facilities in China would be a very different proposition. Although tempting, it would also be politically devastating for the global company’s survival and therefore would not be a realistic option.

5.3 Staying or leaving?

Developments in the financial and investment sector may very well foreshadow what could happen elsewhere if the situation becomes more serious. With the exception of a few Singaporean banks with a strong retail-banking presence in China, the foreign banks in China that we interviewed have relatively small operations in China. Their main focus is international transactions of foreign and Chinese businesses or individuals. In that business, foreign banks face growing competition from Chinese banks for China-bound transactions, and they have thus shifted their focus to outbound financial services for Chinese or foreign clients. Banks – and other business service providers such as law firms – from Asian countries

have been very active in this regard; for them, hedging geopolitical risks with the moving of supply chains from China to South-East Asia and India has been a clear business opportunity.

European banks have been less proactive, adopting more of a wait-and-see attitude with the COVID-19 pandemic and economic slowdown. They, too, must consider the risks of possible current and future sanctions against China in the US or Europe. This makes doing business in China riskier for a bank, even in non-strategic sectors. Moreover, with US-China tensions rising, Chinese firms (especially large state-owned enterprises, SOEs) are limiting or reducing their business with Western banks. Danske Bank already left China in 2021.⁵³ Other European banks are at least likely to reduce their presence in China as well, servicing their remaining clients from their offices in Hong Kong or Singapore.

A similar trend is even more visible among asset managers and venture capital funds. In asset management, capital can be moved with relative ease and speed and, here, the shifting perception of China translates most quickly into changing investment decisions, likely foreshadowing developments in other sectors that have a slower reaction time. However, other factors are also at play. Inflation in the West has pushed interest rates higher, making investing in riskier emerging markets less attractive, especially in countries with low inflation (or even deflation) and low interest rates like China.

For several years now, China has become much less attractive to Europe's asset managers, whose largest clients are usually pension funds. In the last decade, Western pension funds have become much more discerning about where their money is being invested. As environmental, social and governance (ESG) investing and sustainability become the norm, China is seen as an increasingly less-desirable proposition, and no new money is being put into China. The fear of possible (US or European) sanctions and the greater political risk in China add to, but do not cause, this perception. Asset managers are risk-averse and driven by their clients, and they would never invest in a sector that is subject to sanctions. Moreover, the US and the dollar market remain much more important to large asset managers than China. Nevertheless, full divestment from China is still not on the cards and would need a large-scale conflict, for instance over Taiwan. If that were to happen, asset managers from Europe would opt for the US without hesitation.

⁵³ 'Towards a More Efficient and Simple Bank: Office in China Is Closing', Danske Bank website (15 October 2021), <https://danskebank.com/news-and-insights/news-archive/news/2021/15102021>.

5.4 Singapore as a weathervane and exception

Like the financial and real-estate sectors, Singaporean business might foreshadow the direction that foreign companies from other countries might go in China. State-linked real-estate companies constitute a substantial slice of Singaporean investments in China. They have suffered from the crisis in China’s real-estate sector, although perhaps less so than one would imagine, as they managed to shift their focus from residential housing developments to other types of real estate such as business parks, shopping malls and golf courses.⁵⁴ Property is not a strategic sector targeted by the US government, but financial investors are becoming jittery about investing in China because of the slump in the real-estate sector and the impact that US sanctions might have on the Chinese economy generally. Although Singaporean real-estate companies are not planning on a withdrawal from China, investing fresh capital is more difficult because their co-financiers from the West, Japan and South Korea are much less keen than before. Instead, real-estate developers are looking to other countries for investment partners for their China investments, including the Middle East and domestic Chinese investors.

Foreign architecture firms are also affected by the crisis in Chinese real estate. As their business shrinks, they have been forced to reduce their presence in China and service more of their clients from the head office abroad. However, the producers of building and home improvement materials that we interviewed did not report a drastic reduction in business and were quite content to stay and even increase their operations in China.

Singapore, as a whole, benefits from the current US–China conflict. In China, Singapore is viewed positively given its neutrality, excellent business climate and infrastructure, and its position as a hub for entry into South-East Asia. Chinese companies and wealthy individuals are moving activities and capital to Singapore, although this is often not flight capital from China but instead assets that have been shifted from other overseas territories (Hong Kong or Europe) to Singapore. However, Singaporean banks are experiencing some pressure to ‘fall in

⁵⁴ Dylan Loh, ‘Singapore’s Keppel Cuts China Property Focus in Strategic Refresh’, *Nikkei Asia* (10 November 2023), <https://asia.nikkei.com/Spotlight/Global-Management-Dialogue/Global-Management-Dialogue-2023/Singapore-s-Keppel-cuts-China-property-focus-in-strategic-refresh#:~:text=Singapore's%20Keppel%20cuts%20China%20property%20focus%20in%20strategic%20refresh,-Temasek%20backed%20asset&text=TOKYO%20%2D%2D%20Singaporean%20asset%20manager,the%20mainland's%20troubled%20property%20sector>.

line' with American demands. If tensions intensify, it might not be easy for Singaporean banks or even the government to stay fully neutral, and Singapore may be forced to adhere to possible US financial sanctions because of the dominance of the dollar in international finance.

Although the Singaporean economy is a net beneficiary of current US–China tensions, this is not the case for Singaporean companies in China. Despite their strong cultural ties with China, companies and investors from Singapore are becoming more hesitant. In 2023, Singapore's Temasek (the government's investment company) and the Government Investment Corporation (GIC, the government's sovereign wealth fund) announced a reorientation of their investments away from China to other markets in South-East 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.⁵⁵ However, they will not go as far as the US venture capital firm Sequoia, which fully and formally split off its China and South-East Asia/India branches as two independent firms.⁵⁶

More generally, and with the exception of some of the largest state-linked enterprises, Singaporean businesses are becoming too small for China. The investments they bring are not of the magnitude that local governments in China are seeking, while the 'Singapore model' has lost its attractiveness to a country that now sees itself as a great power and a model that other countries should emulate.⁵⁷ Several smaller or more recent players to the Chinese market from Singapore told us that geopolitics made deepening their commitment to China difficult. Some have even decided no longer to be involved in China at all. The long-established links of ethnic Chinese Singaporeans with China are still important, but the younger generations of entrepreneurs are often educated in English and in the West and do not have the strong ties and affinity with China that the older generations still have. Operating in China is simply one of the options that they have, on a par with the US, India, the Middle East and, especially, South-East Asia.

⁵⁵ Tsubasa Suruga, 'Singapore's GIC Eyes India, Indonesia, Vietnam amid China Pivot', *Nikkei Asia* (26 July 2023), <https://asia.nikkei.com/Business/Finance/Singapore-s-GIC-eyes-India-Indonesia-Vietnam-amid-China-pivot>.

⁵⁶ Kane Wu, Julie Zhu and M. Srinam, 'Sequoia to Split Off China, India/Southeast Asia Businesses amid Geopolitical Tension', *Reuters* (2 August 2023), <https://www.reuters.com/business/finance/sequoia-separate-china-india-southeast-asia-by-march-2024-2023-06-06/>.

⁵⁷ Wendy Leutert, *Singapore and the Evolution of China's State-Owned Enterprises and State Asset Management*, Singapore EAI Background Brief No. 1712 (2022).

However, we would not want to overstate this trend. The Singaporean government continues to encourage trade and investments in China and many Singaporean private and state-linked companies are well established in China. Many are even prepared to forego their US business if it were to come to that. Companies are definitely more cautious now, but on the whole they emphasize the opportunities that China continues to offer as a growth market, both for trade and production. Many have consumer-facing businesses in retail, food, IT, education and business services. More than foreign companies from other countries, in many ways Singaporean companies operate much like Chinese private enterprises and they are in China to stay.

6. Conclusions: continuity and change in China's place in the global economy

The geopolitical risks for foreign companies of doing business in China have become much more acute and diverse. Risks include US tariffs and sanctions, Chinese retaliatory actions and home country efforts at decoupling from China. Other risks include the proven brittleness of global supply chains after the COVID-19 pandemic and the environmental and climate-change load on international trade. Also thrown into the mix of company decision-making are rising labour costs and land prices, as well as tighter environmental and other regulations in China. On the positive side, China still presents a favourable business climate, a huge and growing market and a manufacturing base that is unparalleled in the world. In this final chapter, we will pull together the most important findings of this study, address the research questions presented in the introductory chapter and present a forward view of developments.

6.1 What impacts is decoupling having on foreign investment in China?

Geopolitical tensions are increasingly being reflected in trade measures. The number of these measures has risen sharply in the past decade, in particular since the beginning of the Trump administration in 2017, and the US is taking the lead in issuing such measures. WTO data reveal that trade measures are increasingly motivated by national security concerns, as is permitted by article 21 of the GATT 1994. US measures against China in the semiconductor sector are most prominent, but the general rise in such measures is broader.

The actions taken by companies with regard to sourcing, location and clients are starting to show in statistics on trade and investment. The dominant story is still the US–China trade war, which has diverted trade flows in several ways. First, Chinese companies are now exporting more to third countries, notably in East Asia but also to Mexico. These countries, in turn, export more to the United States. Second, because of the US tariffs, some Chinese exports are now diverted from the US to other destinations, most notably in Europe.

Second, FDI to China is cooling off since reaching a peak in 2018. In the third quarter of 2023, FDI as measured on China's balance of payments was even negative, the first time since data were recorded. Data on 'utilized FDI' still show a positive balance of FDI, but these are on a declining trend as well.

Third, data on *announced* FDI deals – an indicator of future actual investments – suggest that China would still attract FDI in future, but that its share in total global FDI will decline. There are three groups of countries that gain from these trends. First, India is attracting a lot more investment, some of which is from foreign investors in China like Foxconn, which seek to reduce the ‘China risk’. Second, South-East Asian countries are receiving more investments from China, as well as from other parts of the world, including Europe and Japan. Third, G7 countries, and the US in particular, are receiving more FDI.

Fourth, China has seen an outflow of portfolio investment since 2022. This is partly a reflection of diverging macroeconomic policies. Whereas the US and Europe increased interest rates to control inflation, China reduced them in order to boost economic growth. Geopolitical considerations are playing a role here as well. US–China tensions have made it harder for investors such as pension funds and investment funds to allocate money to China. The size of China-focused investment from such funds has suffered as a result, especially in 2023.

The data show that China has become a more difficult place to invest and conduct business, making the country less attractive. The total capital outflow from China in September 2023 was US\$53.9 billion, the highest since 2016. Capital has started to leave China, and this is not only foreign money. The flight of private wealth from family offices has also shot up, with Singapore a favourite destination, pointing to insecurity among wealthy Chinese. Capital outflow also includes Chinese companies, either as regular foreign investment or to establish separate operations abroad as a hedge against future fallout from US–China tensions.⁵⁸

6.2 What risks of decoupling from China are foreign businesses facing?

The majority of the companies that we interviewed never mentioned problems such as national security, anti-espionage and decreased personal security as factors that might cause them to leave China. These are often mentioned in discussions of China’s economic downturn as a systemic problem that is now coming home to roost, but this was not borne out by our interviews. An important exception is companies from Japan, with its dozen or so arrests and

58 ‘Chinese Companies are Moving Supply Chains out of China to Manage Risks, with India, Malaysia and Indonesia Benefiting’, South China Morning Post (23 April 2023), <https://www.scmp.com/news/asia/south-asia/article/3218025/chinese-companies-are-moving-supply-chains-out-china-manage-risks-india-malaysia-and-indonesia>.

strong anti-Japanese sentiment in China, which have had a clear impact on Japanese companies' perception of the risks of doing business in China.

Global financial asset managers are beginning to become jittery about the Chinese market. Much of this might be driven by our current conditions of high inflation, making emerging markets much less attractive. In interviews, asset managers made it clear that they have no plans to increase their exposure to China without having plans to reduce their assets in China drastically. Moreover, certain heavily exposed asset managers are taking steps to fence off their operations in China as autonomous businesses as a precaution against US pressure or even sanctions. In general, asset managers persist with a 'country-blind' assessment of their operations in China on the basis of profit, security and sustainability. As such, China has certainly become less attractive, but not radically so.

Banks that we interviewed presented a more mixed picture. Those with a heavy presence in China may, in fact, expand their China operations, especially if they are also working for Chinese clients. Smaller operations that are working only with foreign clients are prepared to close and move away from China if foreign business in China shrinks.

Real-estate investors are in China for the long haul and will continue to feed and even expand their projects. The current slump in the real-estate sector has, of course, affected their business, but they have responded by moving into other types of projects, such as shopping malls, that do not share the malaise of the residential housing market.

The same is true for large industrial businesses invested in or exporting to China. Many of them have been present in China for decades. They own very extensive production facilities, distribution and service networks and Chinese brands. They also have long-standing political contacts that help them navigate Chinese politics and regulations. They are very heavily invested in R&D in China itself and are fully integrated in China's vibrant industry and innovation system, including government subsidies in key innovation sectors.

Innovation in China has a considerable spillover for innovation in home markets as well. Cutting themselves off from China would not only affect foreign businesses' bottom line here and now, but will also set back their global competitiveness in the future. Their staff in China are often almost fully Chinese or of Chinese-origin. Finally, they draw on a net of suppliers – or are suppliers themselves – of the deepest and most extensive industrial system in the world,

for which there is no real alternative. Not producing in China would mean not producing at all, or at much greater cost and effort.

A similar attitude was evident among many smaller companies whose operations were wholly or in large part located in China. Like the China operations of large foreign companies, these smaller companies to a certain extent behave like Chinese private firms. While diversification away from China for business reasons often makes sense to them, they would not want to cut their ties with China and would simply weather the storm should it happen.

The possible wrath of the US and Chinese retaliatory actions were points that interviewees returned to time and again. Geopolitical risks, they insisted, have less to do with China than with the US. For many companies, the US rather than China remains the most important market. If forced to choose between China and the US, they will have to choose the US. What has happened in the semiconductor sector in recent years has sent a powerful message across the world. An armed conflict over Taiwan or in the South China Sea is, for almost all interviewees, the nightmare scenario that they are now seriously contemplating as a possibility, with the ultimate consequence of being shut out of either the US or China. What companies are thus trying to hedge against is American sanctions or pressure that would threaten not just their Chinese subsidiaries, but their US-based operations and the company globally as well.

Foreign businesses do not see China as an existential enemy that must be contained at all costs for the 'free world' to survive. Foreign firms continue to sell to, operate in and export from China. Their strategy is not about continuing to participate in and profit from the enormous opportunities that China still has to offer, while at the same time not jeopardizing their operations in the US, Europe or elsewhere. They are doing so by decoupling not just their dependency on China, but also on the US. The strategies of particularly the larger companies are intended to insulate the global company as a whole from geopolitical risks by relocating supply chains, ringfencing their operations in China, or even leaving China where they must. Many companies, however, are at present not affected and continue to sit on the fence while they are already developing strategies to deal with any further deterioration of US-China relations.

Nevertheless, the China-US conflict has changed the nature of doing business in China. The most common strategy among the interviewed companies has been the combination of diversifying production and supply chains to other countries, together with localizing their

operations in China ('China for China'). In general, the interviewed companies seem to have made more progress with diversification than localization. Localization is expensive, inefficient and often quite difficult to achieve. It creates few – if any – returns on investment in the short term. For most companies, strengthening the autonomy of their operations in China is limited to hiring more Chinese staff and localizing production and supply chains. Several companies also mentioned that Chinese regulations require them to store customer data on local servers in China. However, at the moment more drastic steps – such as making their China operations fully autonomous entities or even independent companies – are not yet being taken, although this scenario could very well start to play out if the situation deteriorates further.

6.3 Conclusion: where will decoupling lead?

There is no doubt that Xi Jinping is convinced of the superiority of the Chinese communist system and that he is eager to show this to the world. China has the ambition to become a superpower that can deal on an equal footing with the other superpower, the US. In this context, aspects of China's increasing global role and footprint are bound to threaten the specific interests of other countries.

Decoupling from China focuses on the vulnerabilities to excessive globalization of the world economy and strategic dependencies on countries that potentially present a danger to a nation's security and prosperity. This is understandable and right, but discussions and policy should also consider the negative effects that decoupling will have.

Foreign businesses in China understand these potentially threatening developments for Asia, Europe and elsewhere. They agree with the need to de-risk their own and their home country's dependencies on China, which they believe ought to be done selectively, carefully and proportionally.

The price of decoupling is potentially very significant. A company's China-for-China strategy, for instance, makes geopolitical sense, but reduces a global company's advantages from its economies of scale and internal specialization. R&D transfer is another major victim of decoupling. China's drive to set its own standards and data localization requirements make compliance increasingly onerous and create barriers between China and other countries. The protection of domestic intellectual property rights (IPR) in China and other countries is explicitly intended to create barriers to the transfer of IPR. Ultimately, this will limit the

product range and quality that can be made available to customers in each separate location. A similar logic applies to a China-plus-one strategy. The risk of these strategies is more than simply higher costs, higher prices and less consumer choice. The transfer of R&D and product development between these locations face much higher barriers, especially when these products may contain potentially strategic components or conform to different standards, limiting technological progress overall.

Foreign companies' doubling down on China integrates them further into the Chinese market, contributing to the reduction of globalization and the emergence of separate worlds: one focused on China; the other on the US. Looking further into the future, Chinese subsidiaries of foreign companies might even find that belonging to a global company becomes less and less of an asset and might even be a liability, for instance when applying for Chinese government support for R&D in strategically important sectors. Further trade and investment restrictions for China (such as export licences and outbound investment screening) will only strengthen this. Severance of Chinese subsidiaries' ties with the global company, however, would further cut off their home countries from the benefits of integration with what is still one of the most dynamic economies in the world, particularly because, at the same time, Chinese foreign investments are increasingly treated with suspicion abroad.

Ultimately, decoupling will strengthen the resilience and autonomy of China's economy as much as the countries that seek to de-risk. While decoupling from China makes sense politically and strategically, there is a distinct possibility that this will create a trend towards further decoupling, which will be very hard to stop once it has gained sufficient momentum. In the final analysis, prioritizing national security strengthens the opposition, reduces the barriers to confrontation and makes the world less, rather than more, secure.

More limited near-shoring and friend-shoring strategies have fewer but still some negative consequences. The reduction of the global division of labour and the duplication of effort in multiple locations increase costs and may reduce the quality of products. On the positive side of the ledger, these strategies may shorten and diversify supply chains and reduce transportation costs and import charges. However, a recent study on this point has shown that the opposite is actually the case, especially for supply chains from China to the United States. Other countries in Asia have inserted themselves in the supply chains, processing

Chinese intermediate goods for export. Friend-shoring thus lengthens the chain without increasing source diversification.⁵⁹

Companies that are active in China currently operate in a very uncertain and potentially volatile policy environment, not only in China but also in their home countries and the US. They would benefit from clear, specific and stable rules and regulations of what can and cannot be done regarding their business in China. Companies fear the possibility that something that has been done without a problem for many years suddenly becomes out of bounds. Equally seriously, companies may be treated as guilty unless they prove themselves innocent. Under these circumstances, long-term planning is difficult and uncertain. To help reduce such policy risks, companies should receive adequate compensation if a country decides to limit, or altogether sanction, certain activities in China, if only to attach a clear price tag to wilful policy changes.

The main hazard facing foreign companies in China is being caught in the middle of the US–China conflict. More specifically, the operations of companies in China, and globally, are already suffering the consequences of US sanctions, bans and the weaponization of US–China relations and are apprehensive that much more is still to come. Although their home countries can only do so much here, efforts should be made not only to de-risk from China, but also from the fallout of the US–China conflict.

To help think through the options that governments and companies have, it might be useful to outline two possible future scenarios for China business: one a continuation of the *status quo*; the other a sharp deterioration of US–China relations. A third scenario—the return to constructive relations between China and the US—seems sufficiently unlikely at this point to give it no further thought.

The first scenario assumes that the current geopolitical situation with a limited US–China conflict persists. This includes the current level of US sanctions and bans, Chinese countermeasures and national decoupling strategies that essentially amount to what the US administration has called ‘small yards and high fences’. In addition, the Chinese government will continue to facilitate foreign investment at the current or even a somewhat higher level than today.

⁵⁹ Han Qiu, Hyun Song Shin and Leanne Si Ying Zhang, *Mapping the Realignment of Global Value Chains*, *Bank of International Settlements Bulletin* no. 68 (2023), <https://www.bis.org/publ/bisbull78.htm>.

Under this scenario, only limited decoupling will take place. Foreign asset managers, venture funds and banks will refrain from expanding their investment in China any further and might in time even reduce their exposure to the financial and reputational risks of China. Most foreign companies will stay in China and many will continue to invest in their local operations. Company strategies will further prioritize a focus on the Chinese market and building resilience against external shocks or pressure. Export abroad will increasingly be routed through third countries, while for certain growth markets (India and South-East Asia) production and sales will be further localized at the expense of the company's Chinese subsidiaries and suppliers. Although it is still too early to tell with certainty, in the US, Europe and Japan, near-shoring and friend-shoring will dominate. Only a certain amount of investment will seek to create localized production capacity to replace direct imports from China. In sum, the current realignment of trade and investment flows will continue, but these will not significantly separate China from the main economies of the developed world.

Under the second scenario, China-US relations take a sharp turn for the worse, *in extremis* leading to armed conflict. The US and at least some of its allies will try to cut China off from the world through a financial, trade and investment ban and may ultimately even attempt a blockade of China's ports and air traffic. Chinese assets in the US will be frozen and Chinese companies required to leave. The Chinese government will retaliate in kind, forcing a retreat or fire sale of companies from enemy countries. Companies from other countries such as Singapore will be able to stay, but will find their business severely affected. The impact of the conflict will be most damaging to the Chinese economy because of its heavy dependence on exports. Europe and Japan will also be strongly affected, but will continue the connections with the US market that are vital to their economies. The US – as the largest economy and market in the world – will be least affected, but will still face an economic downturn.

Such a hard and full decoupling will have devastating consequences for many businesses, including some of the world's largest and most innovative companies in the US, Europe and Japan. Many will sustain heavy losses for years to come; others might even go bankrupt. In order to make up for the loss of China, companies will have to cut back on operations in their home country and elsewhere, creating large-scale unemployment and negative growth of the economy, particularly in Germany and Japan. Singaporean companies may continue in China, but they – and the Singaporean economy as a whole – will also be strongly affected because of the extent of their dependence on China. Of the four countries considered in this report, the Netherlands will probably be affected least. While not insignificant, exposure to China is not

vital to most Dutch companies and the Dutch economy. The most severe consequence for the Netherlands is most likely to come not directly from China, but from the shock that the German economy and trade will experience from a hard decoupling from China.

A further hardening of the conflict between China and the US serves neither party's interests, but the damage done will be unevenly distributed, with China very likely suffering the most and the US the least. The US may therefore be least inclined to avoid a deepening of the conflict from happening, particularly given the current broad anti-China consensus across American politics and society.

Despite this unsettling conclusion, our research also suggests that the current state of affairs might actually be the best we can currently hope for, at least for the time being. Foreign businesses in China can continue to thrive, although they will not expand very much anymore. Redirecting trade and investments away from China is mostly in line with the demands of China moving up the global value chain anyway and will benefit rapidly growing economies elsewhere in Asia and, to a lesser extent, the developed economies in North America and Europe. Although worldwide economic growth will be reduced by decoupling from China, a more targeted European, Japanese, Singaporean and even American involvement in the Chinese economy guarantees that their economies continue to benefit from China but with lesser risk of excessive strategic dependency. Other countries, particularly in Asia, will see their transition to middle-income economies sped up by a further shift of supply chains in their direction.

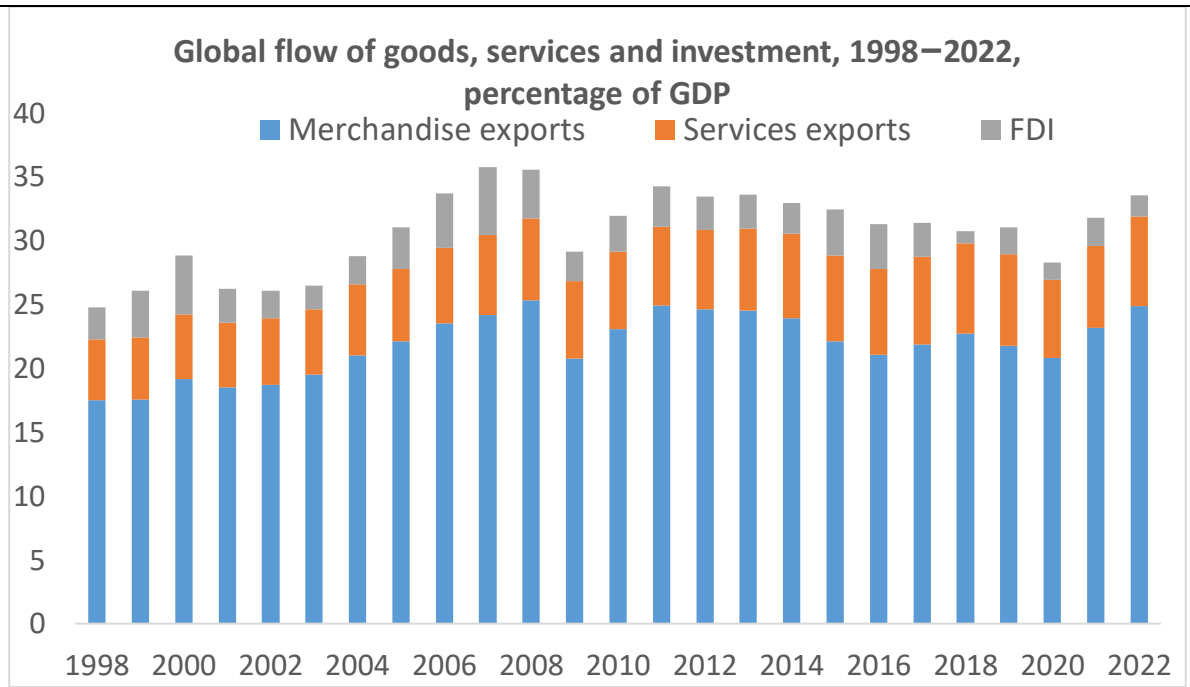
European and Japanese concerns about dependency on China are catered for by building up capacity in strategic sectors, which might ultimately help them achieve greater strategic autonomy, not just from China but – in the longer term – also from the US. American interests are also served. The conflict with China and the war in Ukraine have aligned the developed world much more with the US than has been the case in the recent past. While fully containing China remains a fantasy, China will suffer enough from US sanctions and other hostile measures to inspire confidence in America that the US will remain the world's leading superpower for at least a decade to come, if not considerably more.

Finally, there is no doubt that China has been hit by the conflict and its wider fallout across the world, but no fundamental damage to its system or economy has been done. The road ahead has most definitely become a great deal bumpier, yet provided that the right economic policy choices are made, there is still ample space for continued growth of the Chinese

economy. There is even still every chance that China will achieve full superpower status, on a par with the US, in the long term.

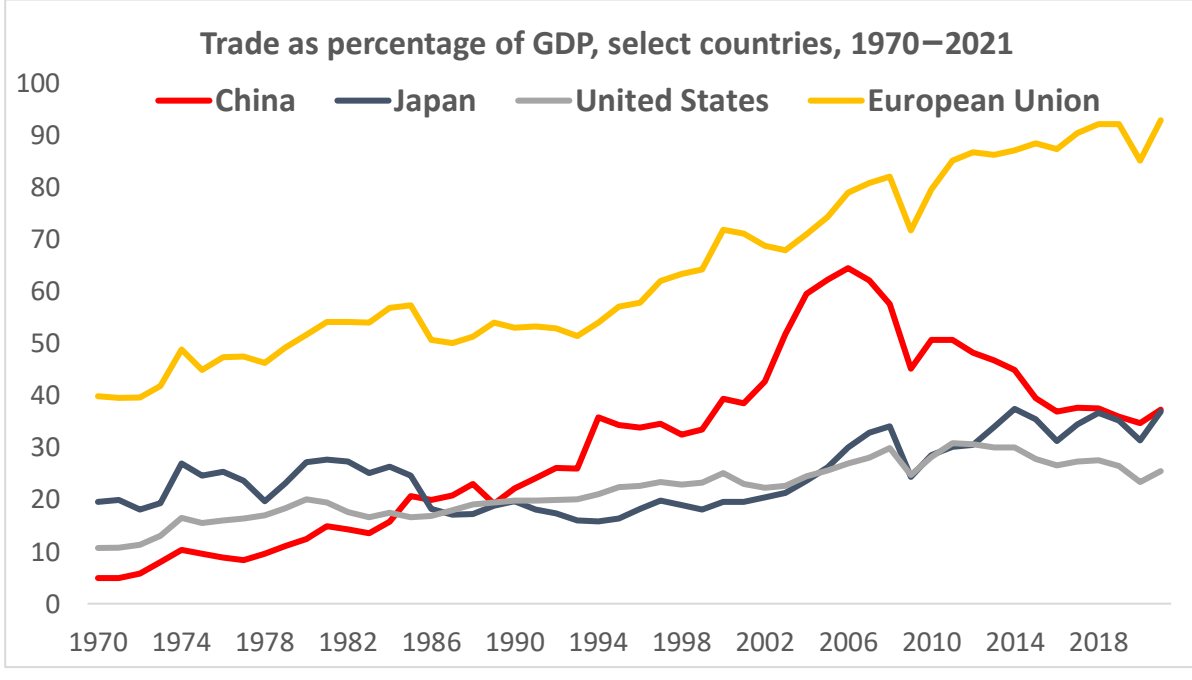
Appendix 1: Figures

Figure 1: Global flows have been moving sideways since the global financial crisis (GFC)



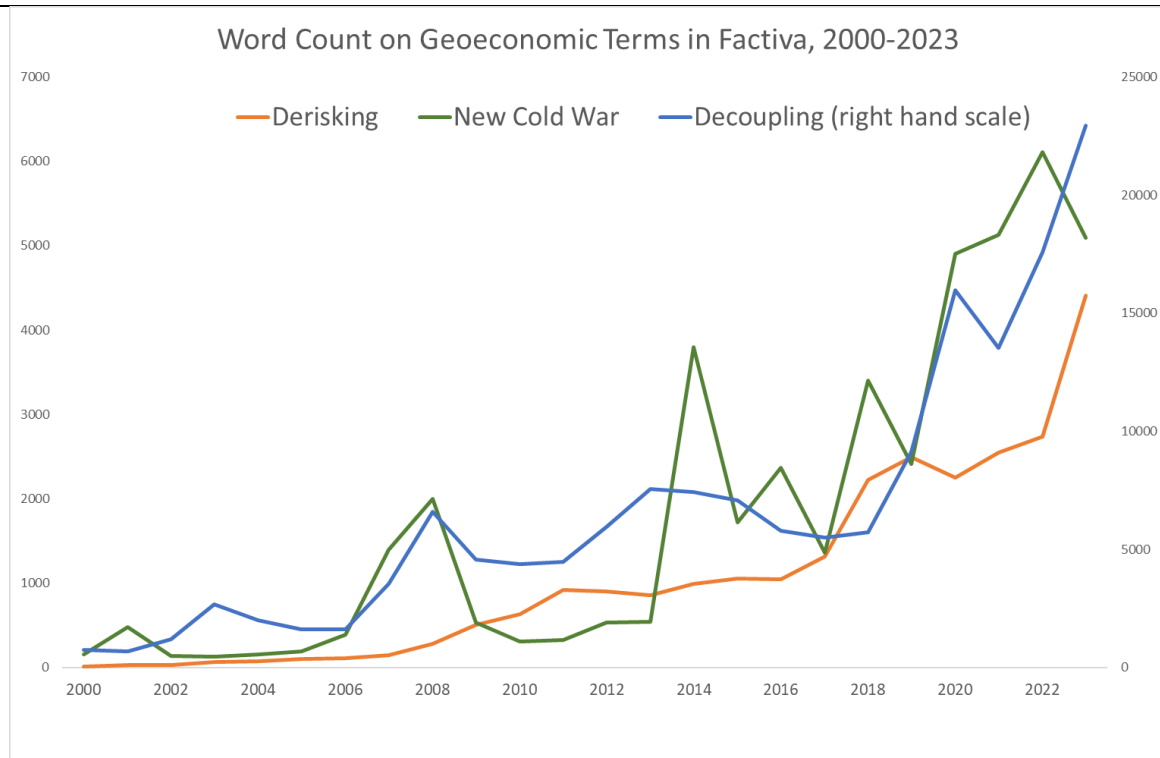
Source: World Bank, World Development Indicators.

Figure 2: China's share of trade in GDP has declined since the GFC



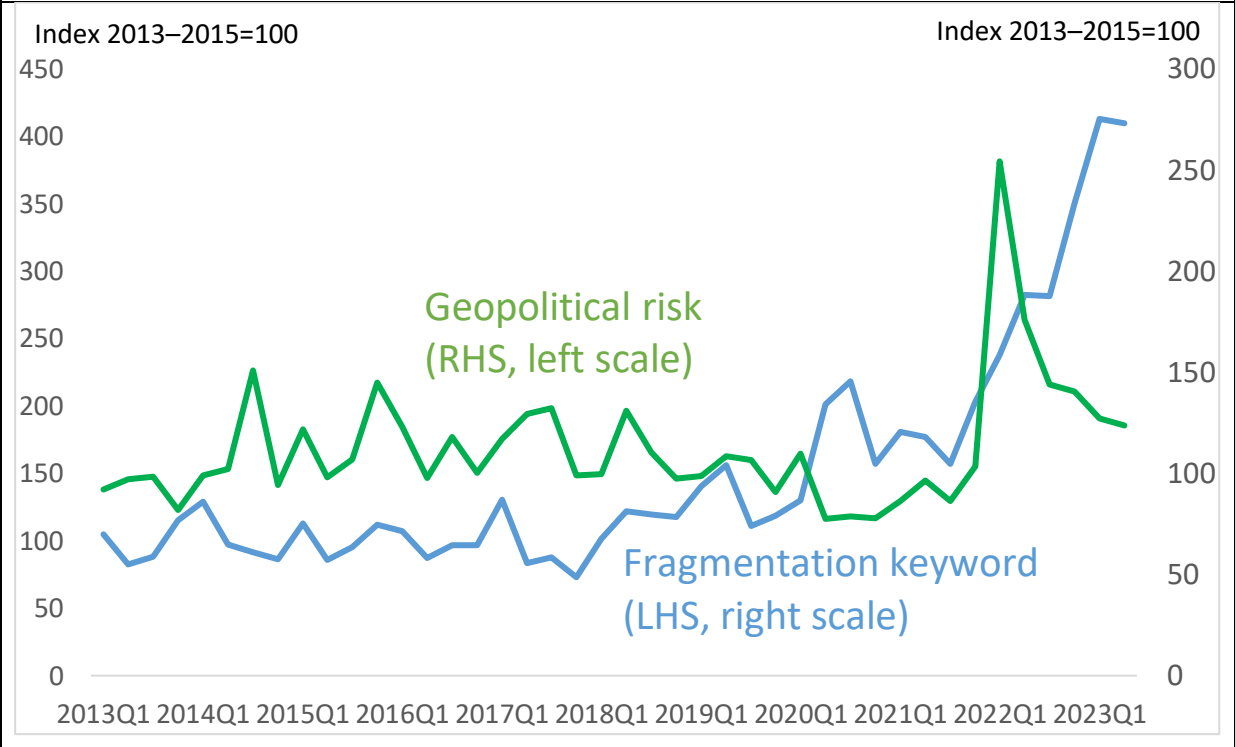
Source: World Bank, World Development Indicators.

Figure 3: Growing public debate on geopolitics



Source: Authors' calculations, based on Dow Jones Factiva, search on 20 January 2024.

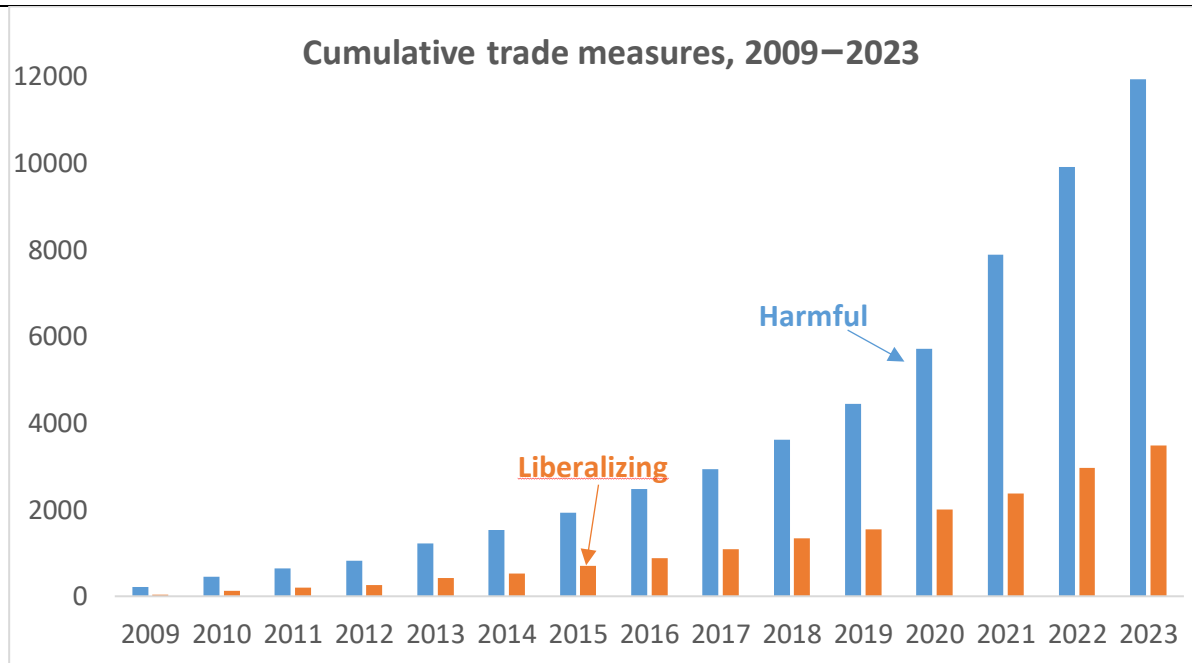
Figure 4: Geopolitics increasingly a boardroom issue



Source: Adapted from IMF, *World Economic Outlook (WEO)*, October 2023, chapter 3. The chart depicts keyword use in companies' earnings calls, <https://www.imf.org/en/Publications/WEO/Issues/2023/10/10/world-economic-outlook-october-2023>.

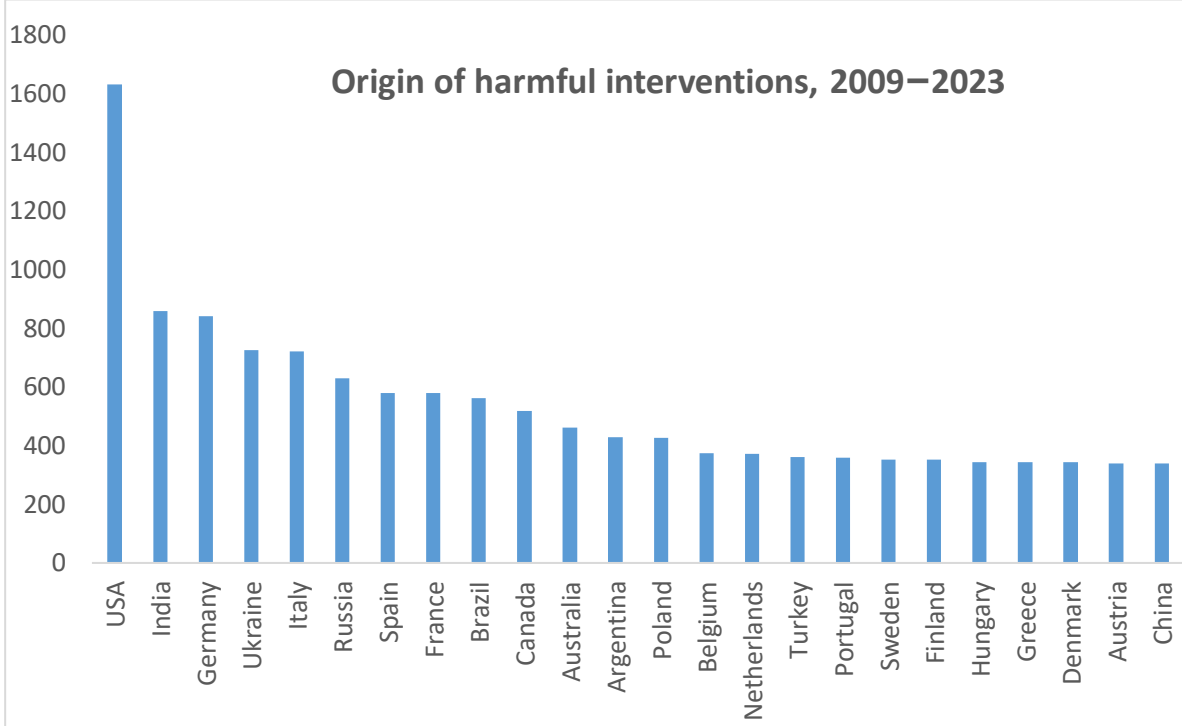
Note: Fragmentation is the word count in earnings calls of major companies on deglobalization, reshoring, onshoring, near-shoring, friend-shoring, localization, regionalization.

Figure 5: A rising tide of harmful trade measures



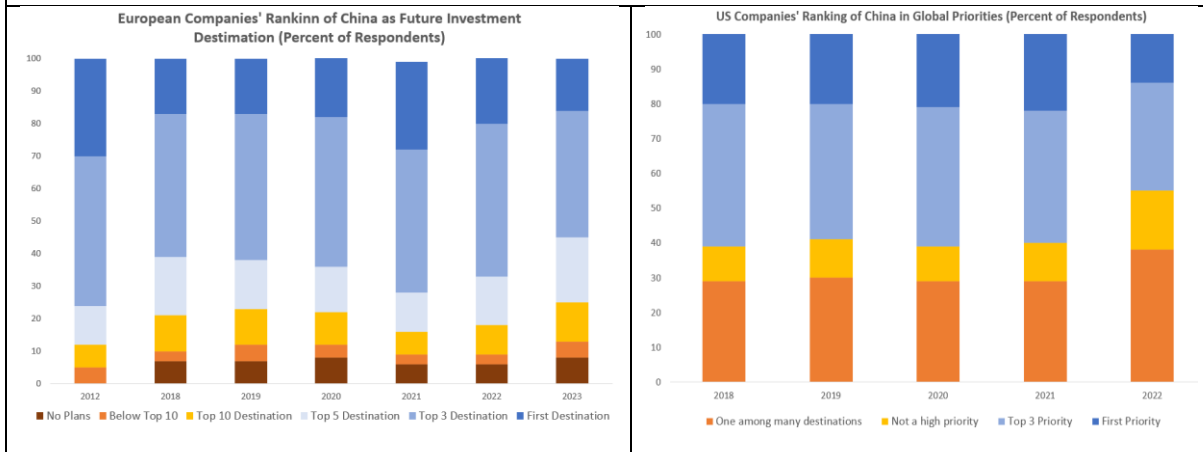
Source: Global Trade Alert, 'Global Dynamics', https://www.globaltradealert.org/global_dynamics/day-to_0913.

Figure 6: Origin of intervention harmful to trade, 2009–2023



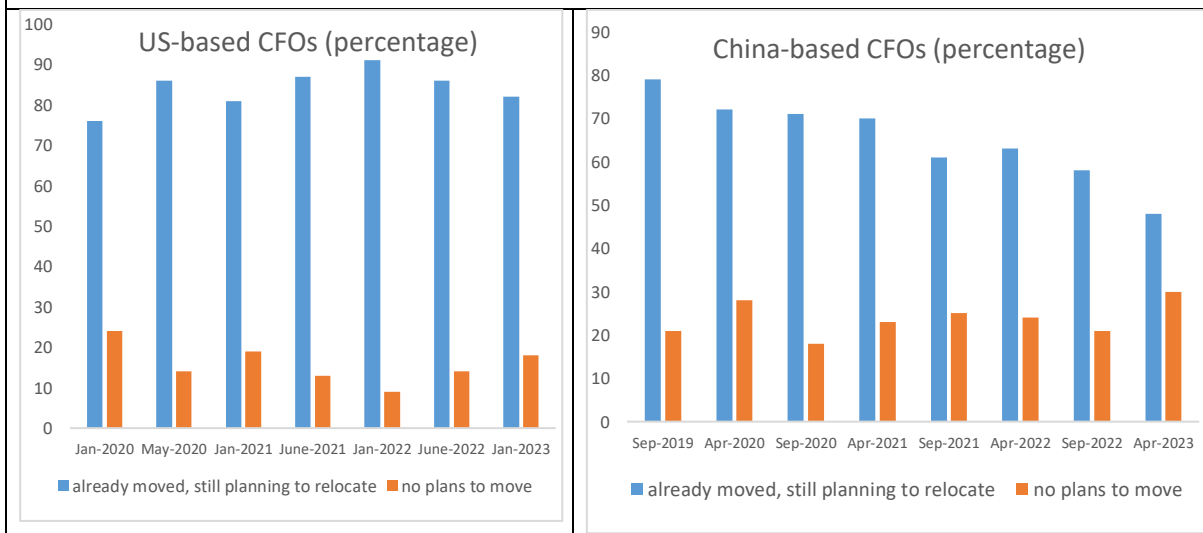
Source: Global Trade Alert, ‘Global Dynamics’, https://www.globaltradealert.org/global_dynamics/day-to_0913, accessed 15 November 2023.

Figure 7: China as an investment destination is on the decline in the perception of US and EU companies



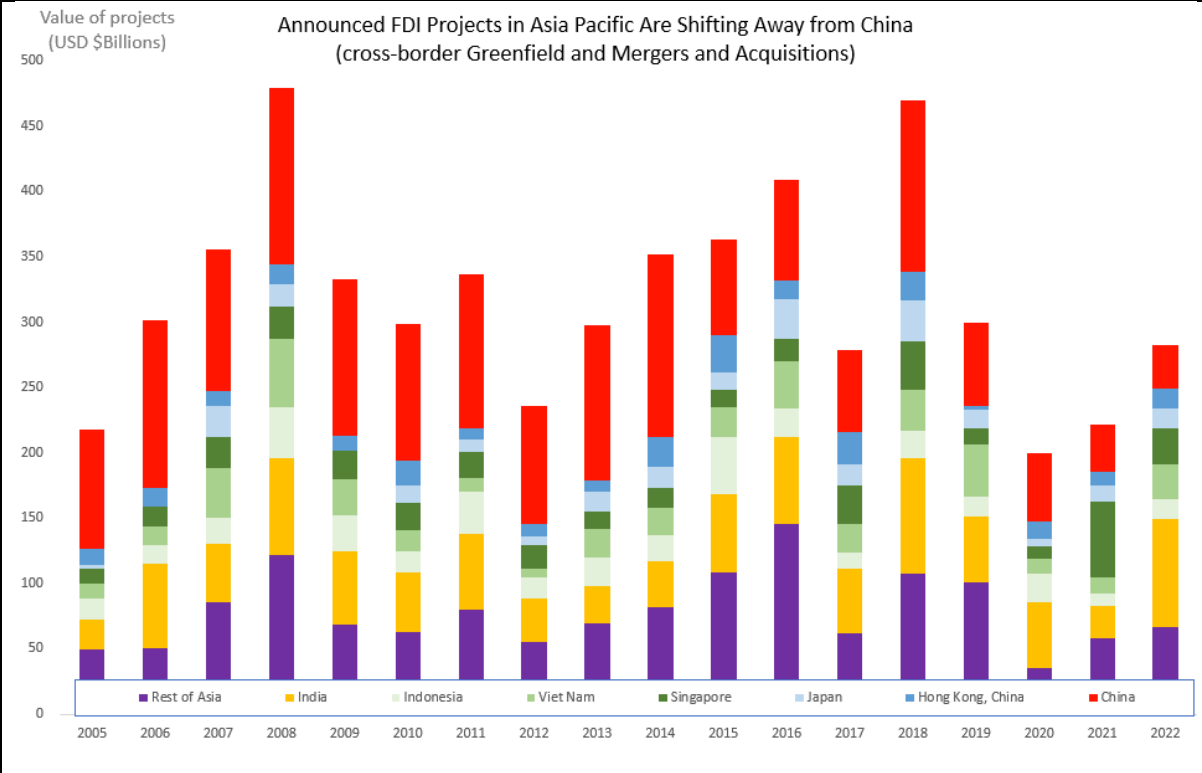
Sources: European Union Chamber of Commerce in China, 'Business Confidence Survey 2023'; and American Chamber of Commerce in China, 'China Business Climate Survey 2023'.

Figure 8: Diverging perceptions of the need to move



Source: UBS, 'Asia's Supply Chain Shifts: Who Benefits, How Much, and What's Priced In', 2023, client note 24 July.

Figure 9: Announced FDI projects in Asia-Pacific are shifting away from China (cross-border greenfield and mergers and acquisitions)



Source: UNCTAD, based on information from the *Financial Times*, 'fDi Markets', www.unctad.org/fdistatistics.

Figure 10: Major shifts in origin and destination of announced greenfield FDI

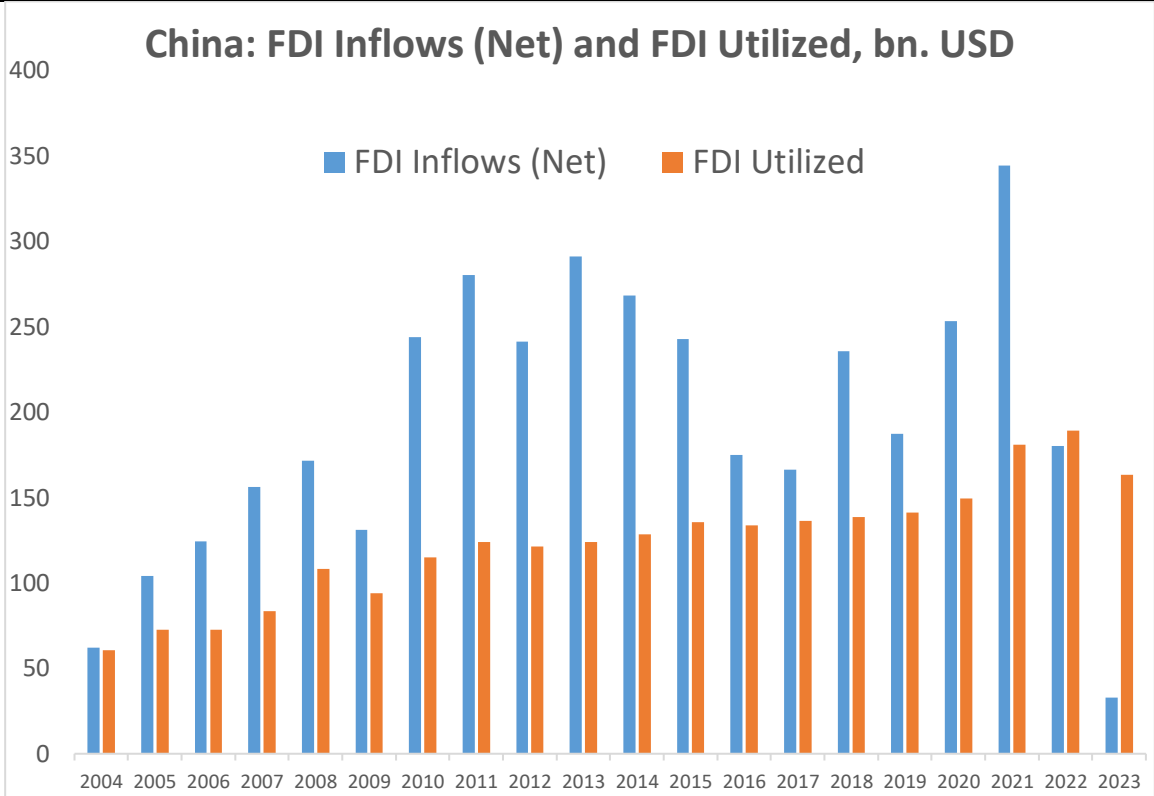
(2020:Q2–2022:Q4 versus 2015:Q1–2020:Q1, Percentage point deviation from aggregate change)

Source regions	Rest of the world	26.4	7.1	5.3	11.4	-3.7	-24.7	18.6
	China	-22.1	-6.9	-17.8	-31.3	-44.3		-31.9
	Asia excl. China	-3.2	-8.7	-11.7	-2.4	-23.7	-49.2	-4.4
	Emerging Europe	27.6	2.9	9.9	18.1	-22.3	13.9	-11.5
	Advanced Europe	7.5	-11.7	9.3	-0.9	-9.8	-19.7	8.6
	Americas excl. US	18.6	27.3	14.9	34.0	5.9	-13.3	27.6
	United States		9.2	0.6	19.4	2.3	-40.6	21.6
		United States	Americas excl. US	Advanced Europe	Emerging Europe	Asia excl. China	China	Rest of the world
		Destination regions						

Source: IMF, WEO, April 2023, chapter 4.

Note: Figure shows deviation of regional FDI change from aggregate change (19.5 per cent decline). Changes are computed using the *number* of greenfield FDIs from 2020:Q2–2022:Q4 and the average number from 2015:Q1–2020:Q1.

Figure 11: Net Foreign Investment has fallen sharply from its peaks, though *Utilized* Foreign Investment held up better

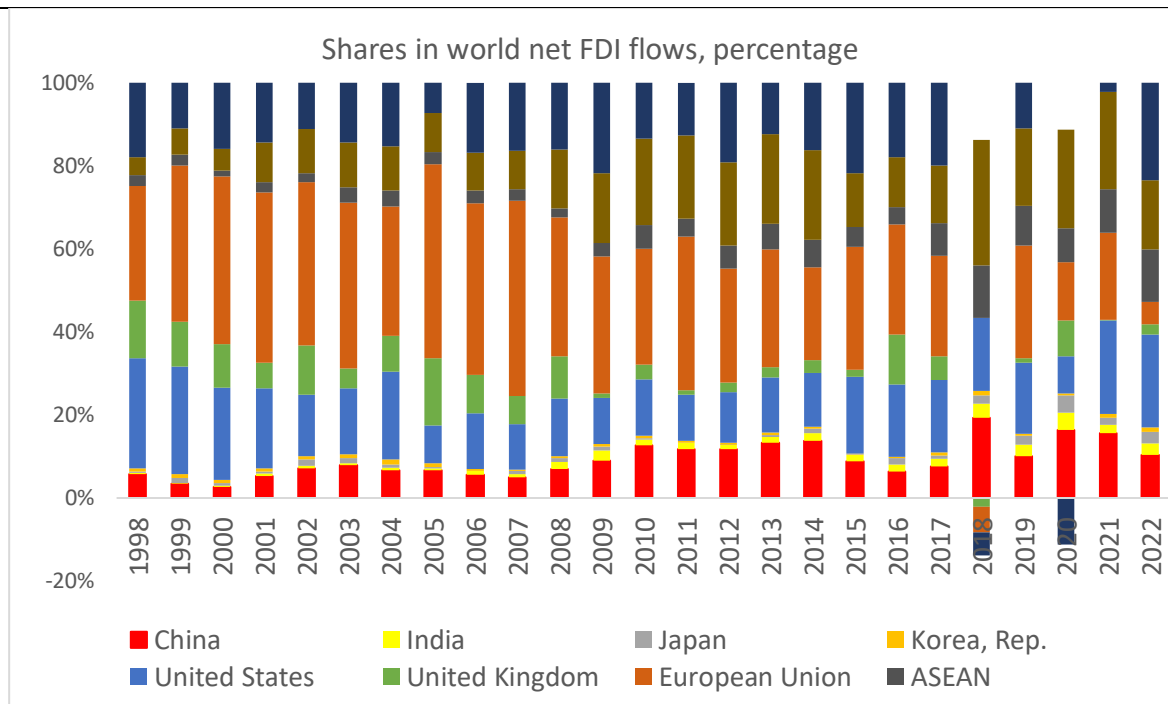


Source: State Administration of Foreign Exchange and Ministry of Commerce via CEIC Data.

Note: 2023 data on Utilized FDI from:

https://english.www.gov.cn/news/202402/20/content_WS65d48491c6d0868f4e8e42ed.html

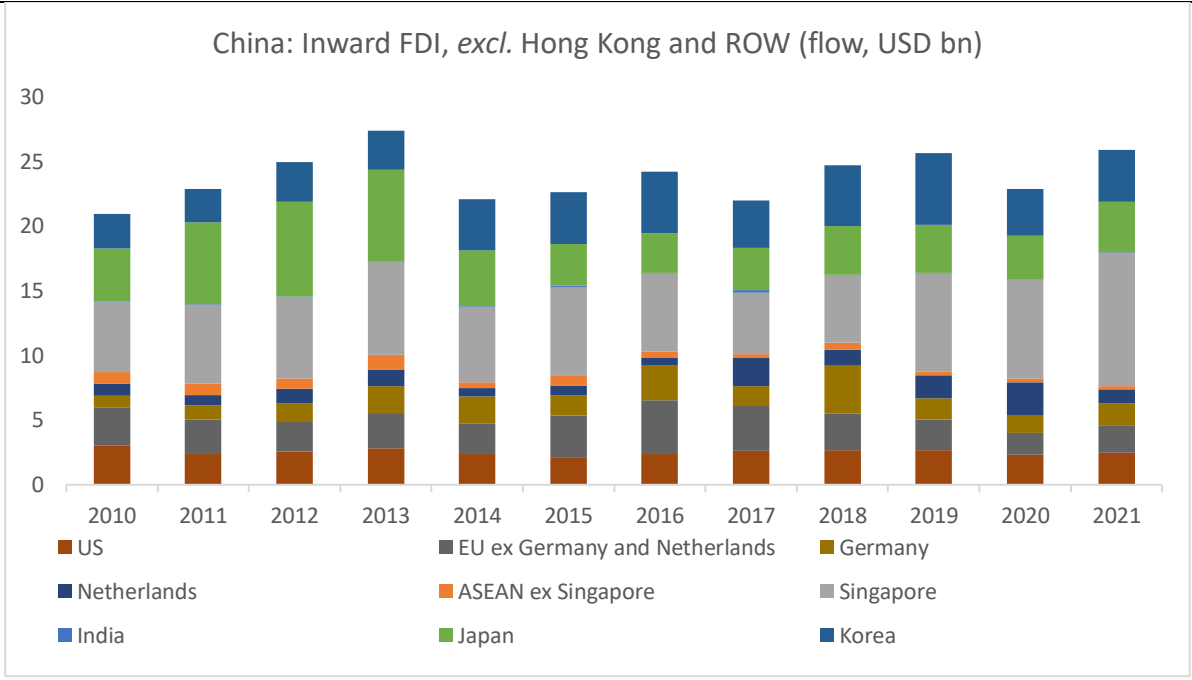
Figure 12: China's share in global FDI has declined from peaks in 2018



Source: World Bank, 'World Development Indicators'.

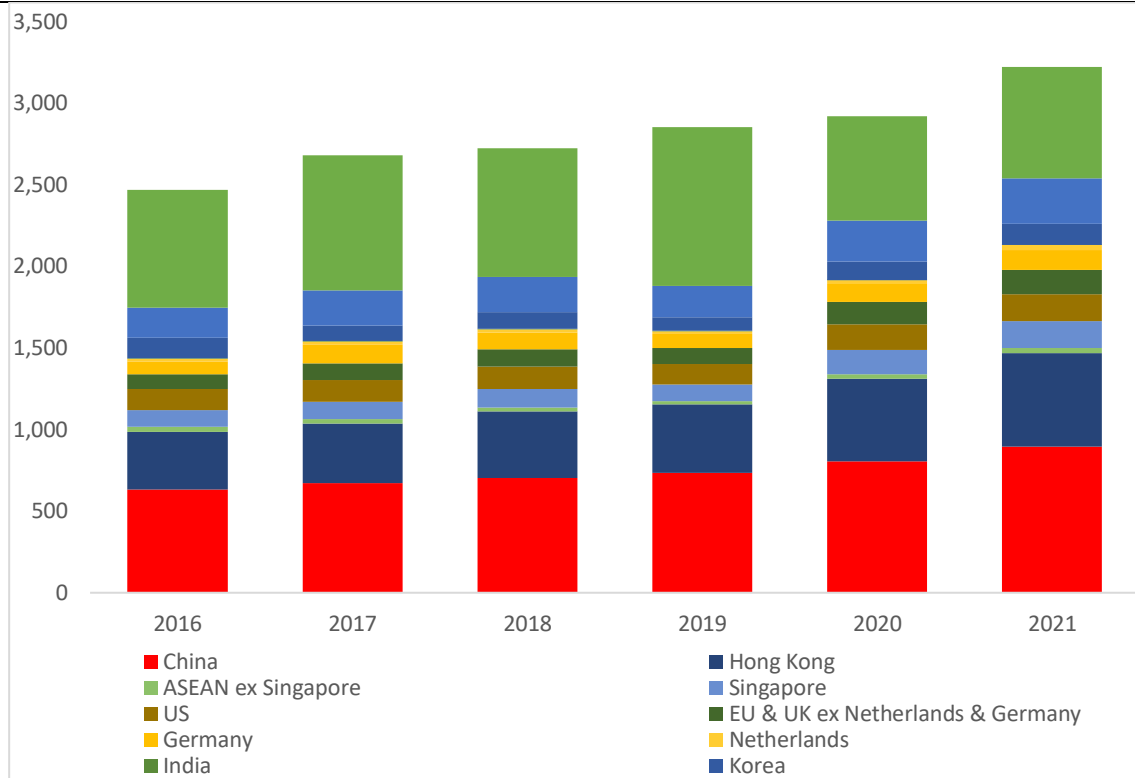
Note: a negative share implies that net inflows were negative in a particular year.

Figure 13: Shifting shares in China’s inward FDI flows, excl. Hong Kong and rest of world (ROW)



Source: China’s Ministry of Commerce, via CEIC Data.

Figure 14: Adjusting the composition of China's FDI stock for financial centre effects and roundtripping



Source: Authors' calculations based on IMF data on FDI stocks, using the methodology in Jannick Damgaard, Thomas Elkjaer and Niels Johannesen, *What is Real and What is Not in the Global FDI Network?*, IMF working paper 19/274, 2019.

Figure 15: Shifting global trade patterns

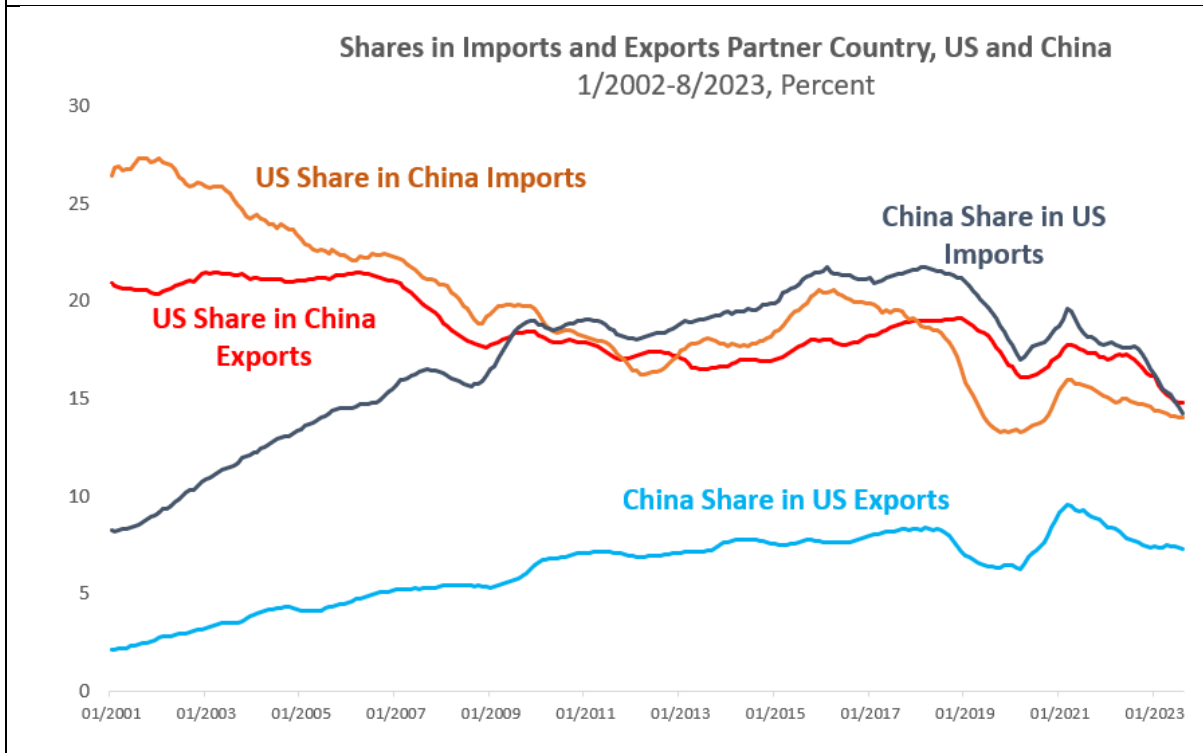
Global Trade Value Matrix (Q1 2023 trade value, growth rate over Q1 2021) (Millions USD, %)

Export \ Import	World									<Legend>
	World	USMCA		EU	Japan	Korea	Taiwan	China	ASEAN	
			U.S.							
World	5,810,903	999,965	732,576	1,834,502	184,704	151,018	78,964	514,490	448,873	
	16.5	16.0	14.0	20.6	15.3	16.4	1.3	0.3	18.4	
USMCA	793,495	399,316	226,400	107,395	23,259	18,612	10,238	47,480	28,350	
	25.7	26.3	29.2	49.3	12.1	2.2	10.3	10.9	18.1	
U.S.	508,764	167,295	-	95,315	19,073	15,848	9,726	38,892	26,028	
	25.9	22.9	-	53.8	9.6	1.2	13.1	10.8	17.0	
EU	1,802,674	143,098	118,268	1,153,314	16,324	13,213	8,809	56,321	23,394	
	13.1	7.6	5.4	17.8	- 7.1	- 11.5	12.6	- 14.2	2.7	
Japan	173,906	38,655	33,148	17,491	-	12,580	11,434	28,946	27,040	
	- 3.9	5.8	4.9	1.0	-	- 1.1	- 7.9	- 24.0	0.1	
Korea	151,353	32,052	26,977	17,765	7,055	-	4,289	29,560	26,324	
	3.4	18.3	18.1	9.8	3.1	-	- 17.1	- 18.8	11.9	
Taiwan	90,906	16,480	14,901	7,979	6,637	4,314	-	19,554	15,867	
	- 0.6	12.1	12.1	24.8	24.4	1.2	-	- 25.1	3.1	
China	821,891	144,509	115,474	126,120	40,775	38,834	15,879	-	139,075	
	15.8	0.4	- 3.3	14.3	5.3	22.4	- 7.2	-	32.3	
ASEAN	459,900	77,701	70,141	42,594	32,347	19,090	12,108	72,127	103,264	
	16.5	19.8	18.3	15.1	15.6	20.5	5.2	19.9	16.0	

Source: JETRO, *JETRO Global Trade and Investment Report 2023: International Business Facing Fragmentation Risks*, July 2023, https://www.jetro.go.jp/ext_images/en/reports/white_paper/trade_invest_2023_rev2.pdf accessed 27-11-2027.

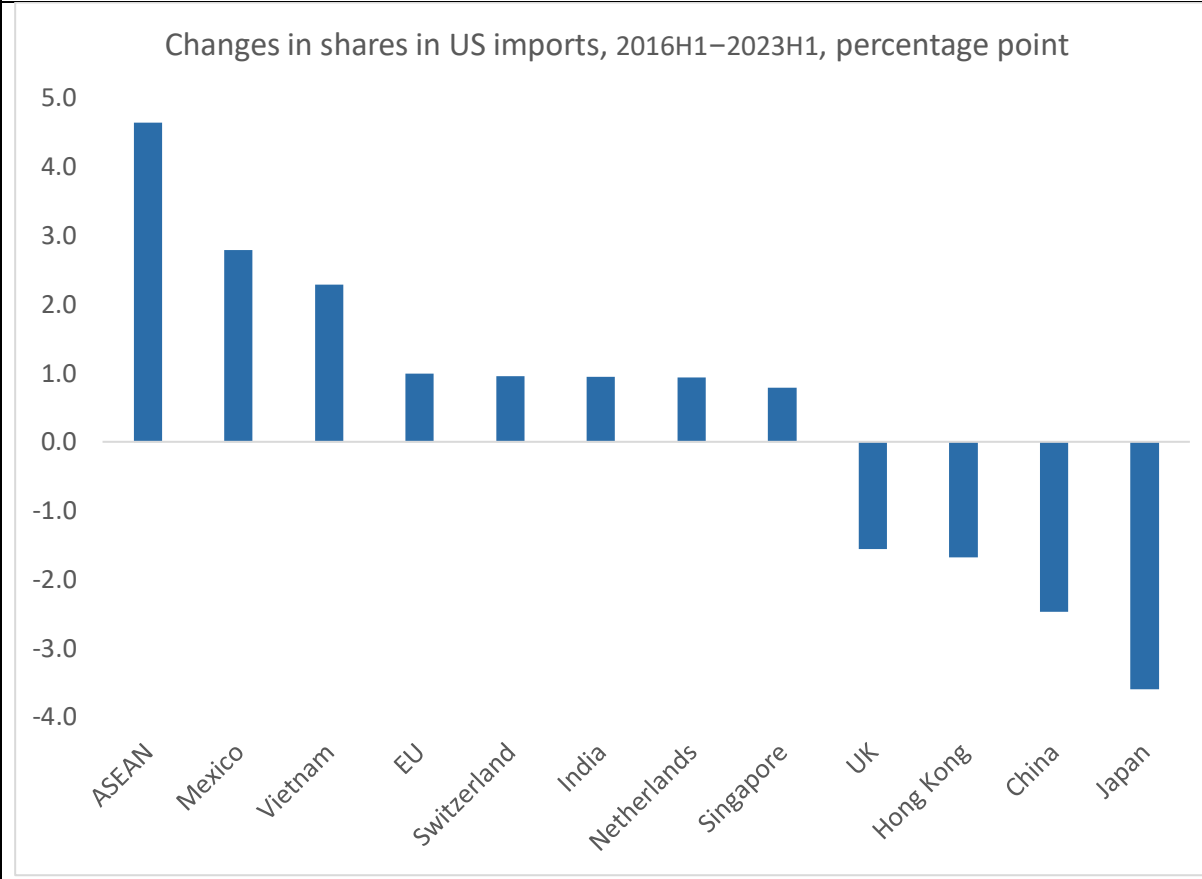
Note: From export data. Compiled by JETRO from IMF, 'Direction of Trade Statistics (DOTS)' data, June 2023 edition, and the Global Trade Atlas (Taiwan data only). USMCA stands for the US–Mexico–Canada.

Figure 16: 'The Long Goodbye': share of US and China in each other's trade



Source: Authors' calculations based on data from China's Ministry of Commerce and the US Census Bureau, via CEIC Data.

Figure 17: Shifting shares in US imports



Source: Authors' calculations based on IMF, DOTS data.

Appendix 2: Company survey, ‘Dealing with Decoupling: Business Strategies in a Changing World’

Interview protocol

Name of company:

Name and position of interviewee(s):

Date of interview:

Place of interview:

Interviewers present:

1. Background questions

1. In which sector or sectors does your company operate in China?

1) Tech and R&D; 2) Resources & agriculture; 3) Consumer products; 4) Services

2. Number of employees in China.

3. Number of employees globally.

4. Percentage or number of top (country) management in China who are not native mainland Chinese.

5. Respondent’s own position.

6. Total company revenue in China (million 2022 USD).

7. Total company revenue globally (million 2022 USD).

8. What percentage of your company’s global revenues did China account for in 2022?

1) 10% or less; 2) 25% or less; 3) 50% or less; 4) 75% or less; 5) more than 75%

9. Where does your company in China have a legal presence?

10. Detailed discussion of the kind of products or services, and the main customer base in China. How do the activities in China relate to the business of the main company in the home country or elsewhere in the world?

2. State of doing business in China

11. How does the estimated 2023 revenue of your company's China operations compare with 2022 results?

1) Much worse; 2) Worse; 3) Same; 4) Better; 5) Much better

12. How would you characterize your company's financial performance in China in 2022?

1) Great loss; 2) Loss; 3) Break-even; 4) Profitable; 5) Very profitable

13. How does the 2022 revenue of your company's China operations compare with the 2022 global results?

1) Much worse; 2) Worse; 3) Same; 4) Better; 5) Much better

14. To what extent were 2022 revenue results impacted by the COVID-19 pandemic, specifically intermittent lockdowns to control local outbreaks within China?

1) Very negatively; 2) Negatively; 3) Not really; 4) Positively; 5) Very positively

15. Forecast of your company's growth (market share, revenue) in China in 2023 vs. 2022:

1) Much lower; 2) Lower; 3) Same; 4) Higher; 5) Much higher

16. Forecast of your company's long-term growth (market share and revenue in the next five years) in China:

1) Much lower; 2) Lower; 3) Same; 4) Higher; 5) Much higher

17. China's rank in near-term global investment plans of company:

1) First; 2) Second; 3) Third; 4) Lower

18. Estimated change in level of investment in China for 2023:

1) Much lower; 2) Lower; 3) Same; 4) Higher; 5) Much higher

3. Business climate and the impact of politics in China

19. Rank the following top important opportunities for China business:

1) growth of market; 2) globalization of Chinese companies and increased outbound investment; 3) continuing economic and market reforms; 4) technological R&D; 5)

urbanization; 6) continued support for infrastructure investments; 7) other (please specify)

20. Rank the following top business challenges in China:

1) regulatory environment; 2) labour costs; 3) US–China relations; 4) competition from Chinese companies; 5) domestic and expatriate talent recruitment; 6) other (please specify)

21. How are foreign companies in your industry treated by Chinese government policies and enforcement actions relative to domestic companies?

1) Much worse; 2) Worse; 3) Same; 4) Better; 5) Much better

Please explain.

22. Importance of positive bilateral relations between China and the US to your company's business growth in China:

1) Highly unimportant; 2) Unimportant; 3) Neutral/do not know; 4) Important; 5) Very important

Please explain.

23. What impact does, or will, further deepening of geopolitical tensions have on business strategy? Present the interviewee with the following options or choices:

- 1) Delaying or cancelling China investment decisions;
- 2) Adjusting supply chain by seeking to source components or assembly outside the US;
- 3) Considering exiting the China market;
- 4) Adjusting supply chains by seeking to source components and/or assembly outside China;
- 5) Establishing a dual supply chain: one for China, the other for the US;
- 6) Increasing China investments;
- 7) Localizing more production/services/IP in China to access local sales opportunities;
- 8) Considering onshoring some manufacturing/operations to the US;
- 9) Considering relocation of some or all manufacturing out of China;
- 10) Pursuing joint ventures with Chinese entities that you would not normally consider;
- 11) Shifting away from certain industry or customer segments in China;
- 12) No impact.

24. How movable are your supply chains?

1) Very immovable; 2) Immovable; 3) Neutral/do not know; 4) Movable; 5) Very movable

Please explain the costs and other barriers to diversification of the supply chains.

25. Which departments or individuals take the investment, diversification or relocation decisions for your company? What is your own role in this?

26. Have you or your company started to work on a new investment and business strategy for China in view of the changing geopolitical environment?

1) No; 2) No, but we are thinking about it; 3) We are preparing to do so; 4) We have shifted or are shifting some supply chains; 5) We have shifted or are shifting all or most of our supply chains

If so, please provide details about the volume and type of products/services, locations or sources involved, and what were the main reasons for these choices?

27. Has your company already begun the process of relocating manufacturing or sourcing outside of China?

1) No; 2) No, but we are thinking about it; 3) We are preparing to do so; 4) We have shifted or are shifting some supply chains; 5) We have shifted or are shifting all or most of our supply chains

If so, please provide details about the volume and type of products/services, locations or sources involved, and what were the main reasons for these choices?

28. How essential must China remain to the company's business even after relocating or diversifying your supply chains?

1) Very unessential; 2) Unessential; 3) Neutral/do not know; 4) Essential; 5) Very essential

Please explain.

29. What do you expect the impact on the global company's performance will be of diversification or relocation decisions?

1) Very negative; 2) Negative; 3) No real change; 4) Positive; 5) Very positive

Please explain.

30. Which actions do you know of that the home country government has taken to encourage/discourage/mitigate decoupling from China? How have or will these impact your company's business in China?

31. Which actions do you know of that the Chinese government has taken to encourage/discourage/mitigate decoupling from the world? How have or will these impact your company's business in China?

32. Which actions do you or your company hope to see from the Chinese, US and home country governments?

4. Additional issues in doing business in China

33. Impact of China's recent regulatory and legal actions (e.g. regarding anti-trust/data privacy/CSR; national security law; espionage law; cybersecurity law) on business.

1) Very negative; 2) Negative; 3) No real change; 4) Positive; 5) Very positive

Please explain how and to what extent this has impacted your company's business in China, and whether this may be a reason to diversify away from China.

34. Do you encounter barriers to doing business caused by local or national protectionism?

1) Highly unimportant; 2) Unimportant; 3) Neutral/do not know; 4) Important; 5) Very important

Please explain how and to what extent this has impacted your company's business in China, and whether this may be a reason to diversify away from China.

35. Have you experienced IP leakage and IT/data security threats in China?

1) Highly unimportant; 2) Unimportant; 3) Neutral/do not know; 4) Important; 5) Very important

Please explain how and to what extent this has impacted your company's business in China, and whether this may be a reason to diversify away from China.

36. Have you encountered difficulties in recruiting foreign talent for your operations in China? Have these become worse since the COVID-19 pandemic? How do you intend to deal with these problems?

37. Has the CCP's party-building efforts among foreign-invested companies been noticeable in your company?

1) Highly unimportant; 2) Unimportant; 3) Neutral/do not know; 4) Important; 5) Very important

Please explain how and to what extent this has impacted your company's business in China, and whether this may be a reason to diversify away from China.

38. Has the introduction of the social credit system impacted your company and its business (including suppliers and business clients)?

1) Highly unimportant; 2) Unimportant; 3) Neutral/do not know; 4) Important; 5) Very important

Please explain how and to what extent this has impacted your company's business in China, and whether this may be a reason to diversify away from China.

39. Have you received pressure to make (or not make) statements or take action about politically sensitive issues? What were the sources and reasons for any increased pressure:

- 1) Global company leadership
- 2) Business partners
- 3) Customers or suppliers
- 4) NGOs
- 5) Chinese government
- 6) Chinese media
- 7) US government
- 8) US media
- 9) Home country government
- 10) Home country media
- 11) Public/social media in home country
- 12) Other governments or media

Please explain how and to what extent it has impacted your company's business in China, and whether this may be a reason to diversify away from China.

Appendix 3: Statistical analysis of company survey

The inferential statistical analyses used the data-set compiled during the interviews, which included 78 companies: 22 from the Netherlands; 14 from Singapore; 11 from Germany and 31 from Japan. The aim was to evaluate the association between company background characteristics (independent variables) with company performance, business strategies and decisions regarding China (dependent variables).

The independent variables were the following:

1. Location of company's headquarters (nominal)
2. Sector of business in China (nominal)
3. Number of employees in China (ratio)
4. Percentage of number of non-mainland Chinese employees (ratio)
5. Number of employees globally (ratio)
6. Total company 2022 revenue in China (ratio)
7. Revenue in China as percentage of global 2022 revenue (ratio)
8. Perception of performance in 2022 (ordinal)
9. Forecast of company's growth in the next five years (ordinal)
10. Estimated change in level of investment in China for 2023 (ordinal)
11. Importance of positive China-US relations to the company's business growth in China

The dependent variables were the following:

1. Decision on diversifying away from or staying in China (ordinal)
2. How essential China would be to the company's business in the future (ordinal)
3. Expectation of the impact on performance of diversification or relocation (ordinal)

We have also computed two composite independent variables: 'Size' (size of company's presence in China); and 'Outlook' (how the company assesses its long-term prospects). 'Size' is a composite variable that combines the independent variables 'Number of employees in China' and 'Total company revenue in China in 2022'. 'Outlook' combines 'Forecast of company's growth in the next five years' and 'Estimated change in level of investment in China for 2023'. The composite variable 'Outlook' was computed simply by averaging the two independent variables that it combines, as both variables are survey responses in the range of 1 to 5 with similar variances. However, the composite variable 'Size' was computed with the standardization of the original variables on their z-scores, as both original variables are of ratio scale with vastly different variances.

$$Outlook = \frac{ID_9 + ID_{10}}{2}; Size = Z_{ID_3} + Z_{ID_6}, \text{ where } Z_i = \frac{x_i - \bar{x}}{sd}$$

There are both conceptual and statistical motivations for doing so: on one hand, there are no differences between the two groups of original variables meaningful to the research question. To illustrate with the example of the composite variable ‘Size’, we are interested in how the size of a company is associated with its business decisions regarding decoupling, rather than revenue or the size of staff specifically. Statistically, Pearson’s R correlations analysis showed that the two pairs of original variables are highly correlated; retaining those variables in the regression model without combining them would lead to multicollinearity.

Lastly, we found that the relationships between the composite variable ‘Size’ and the dependent variables are non-linear, and we therefore transformed the variable ‘Size’ to its cube.

We performed three Ordinary Least Square (OLS) linear regression models with the three dependent variables. As all dependent variables are of ordinal scale, a more appropriate/conservative statistical approach would be reducing the dependent variable to a binary variable (yes/no), and apply logistic regression models. However, this would have come at the expense of explanatory power of the models. Logistic regression models have been performed in our study to check the robustness of the results from OLS linear regression models. The results of our statistical analyses are given in the three tables below. We have only given statistically significant results ($p < 0.05$), as follows: *** $p < 0.001$; ** $p < 0.01$; * $p < 0.05$.

Table 1: OLS linear regression results for a company’s decision on relocation

	N=53
(Intercept)	5.07 ***
	(1.14)
Sector	-1.20 *
finance	(0.58)
Size	0.05 *
	(0.02)
Outlook	-0.71 **
	(0.25)
R ²	0.43

This model explained 43 per cent of the variation in a company's decision on relocation. The company being in the finance sector is negatively correlated with its decision on relocation ($p = .045$), i.e. it is less likely to prepare for relocating its business outside of China. The company's size is positively correlated with its decision on relocation ($p = .021$), and its outlook of the mainland Chinese market is negatively associated with its decision on relocation ($p = .007$).

Table 2: OLS linear regression results for a company's perception of the essentiality of the mainland Chinese market

	N=67
(Intercept)	2.23 **
	(0.71)
Sector	-1.54 **
finance	(0.52)
Sector	-2.18 *
IT	(0.88)
Sector	-1.39 *
Other services	(0.61)
Importance of China-US relations	0.33 *
	(0.14)
R ²	0.36

This model explained 36 per cent of the variation in a company's perception of the essentiality of the mainland Chinese market. The company being in the finance sector is negatively correlated with its perception of the essentiality of the mainland Chinese market ($p = .004$), i.e. it is likely to perceive to a lesser extent that China must remain essential to the company's business even after relocating or diversifying its business. The company being in the IT sector is negatively correlated with its perception of the essentiality of the mainland Chinese market ($p = .017$). The company being in the sector 'other services' is negatively correlated with its perception of the essentiality of the mainland Chinese market ($p = .028$). The company's perception of the importance of China-US relations for its growth in China is positively correlated with its perception of the essentiality of the mainland Chinese market ($p = .023$).

Table 3: OLS linear regression results for a company’s expectation of the impact on performance of diversification or relocation

	N=51
(Intercept)	3.32 ***
	(0.82)
Importance of China-US relations	-0.32 ⁶⁰
	(0.18)
Percentage of non-mainland Chinese employees	1.92 **
	(0.69)
R ²	0.22

This model explained 36 per cent of the variation in a company’s perception of the essentiality of the mainland Chinese market. The company’s perception of the importance of China-US relations for its growth in China is negatively correlated with its perception of the expectation of the impact on performance of diversification or relocation ($p=.0746$), i.e. the more important the company sees China-US relations, the more negatively it expects relocation or diversification to have an impact on performance. The percentage of the number of non-mainland Chinese employees is positively correlated with its perception of the expectation of the impact on performance of diversification or relocation ($p = .008$), i.e. the more non-mainland Chinese staff the company has, the less severe it expects the impact on performance of diversification or relocation to be.

⁶⁰ The p-value of the variable ‘Importance of China-US relations’ in this model is 0.0746, thus not statistically significant enough for the $p<0.05$ threshold. We retain this variable in this table because of the construct’s importance for this research.