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Friends of stars meeting
De-coupling versus De-risking: the Future of Foreign Business in China
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10 August 2023, 17.30-20.00
Widder Hotel, Zurich

Summary

Baidaihe meetings – preparing a new economic agenda, or not?

- Baidaihe conclave this year primarily serves the purpose of pre-deciding outcomes of the upcoming Third Plenum (usually sets a new economic agenda for China)
- The economy should thus be at the top of the agenda, but there are **rumors that no real decisive action will be taken or that the Third Plenum in November might not even happen**
  - So far a complete **lack of usual consultations** with think tanks, industry associations as well as the World Bank of IMF which usually take place ahead of Baidaihe
- **More clarity only in October or November** at the convening or non-convening of the Third Plenum of the Central Committee

China's economy in a bad state – Risk triangle

- He Lifeng, possible the most trusted economic advisor of President Xi, even higher than Premier Li Qiang, has coined the so-called **risk triangle clouding China's economic prospects:**
  - **Real estate crisis**
    - Evergrande with a debt load of 300B USD, similar to Greece in 2014
    - 80-90M apartments that are empty in China
    - No real long-term solution in sight
  - **Local government debt**
    - "Big" differences between provinces and cities: Shenzhen in good shape, while Tianjin, Shenyang and Dalian are in a really dire state (e.g. 1M people have left Tianjin in the past year and 40% of tax income is spent on interest payments)
    - Zero-Covid cost China around 230B USD, carried largely by local finance vehicles
  - **Bad/nonperforming loans of commercial banks**
    - 50% of overall assets are in 3000 small commercial banks with worrisome balance sheets, versus 50% of assets in 5 largest banks which are very solid → Thus, although a risk, a financial crisis or collapse still very unlikely

Risk of a military escalation – Taiwan escalation unlikely, but other potential hot spots

- Taiwan: "**I don't see a war on the horizon, at least not in the next 10 years**"
  - Invasion would be almost impossible and the costs for China incredibly high. And even if the US does not intervene, **Beijing has learnt from both the US' wars and Russia's war in Ukraine that "starting a war is easy, but winning a war is difficult"**
  - Blockade also unlikely → would massively hit the Chinese economy, especially due to Taiwan's important role in the **advanced semiconductor value chain which gives it a "silicon shield"**
- To maintain the status quo, (1) **EU and US need to help Taiwan uphold deterrence** (i.e., keep costs of a war very high) and (2) **both sides need to give mutual assurances:**
  - EU/US: respecting the One-China Policy and not unnecessarily provoking China
  - PRC: assuring that it will abstain from risky missile launches and maneuvers around Taiwan

- **"South China Sea (SCS) as a greater hot spot than Taiwan"**

    - Historically a key area of contention between the US and China → Xi's promise at the Sunnylands summit not to militarize the SCS was subsequently broken
    - China's approach in the SCS has even upset countries that were originally much more friendly towards it (e.g., Duterte's Philippines)
    - "The SCS is a hotspot because **accidents might well happen which will be very difficult to deescalate**"

What does the Covid pandemic tell us about China and about Xi Jinping?

- "**We need to take Xi more seriously** than we are currently doing" → Generally tells us what he thinks and also does what he says, we are just not taking it serious enough
    - "**For Xi Jinping ideology trumps the economy**"
- "The perception has always been that Xi is changing China, but during Covid this became clearer":
    - Xi is willing to sacrifice some of the economy, if it serves to enhance control and security, putting **China on a trajectory of "growing under its potential"**

Foreign business sentiment in China – "desire is gone, for those not in the automobile sector"

- **European companies currently holding back their investments** (EU27 FDI in China down 80%)
    - Automobile as the notable exception: As there is a binary choice between "fight or flight", **either you go home** (e.g., Renault, Peugeot, Mitsubishi, Hyundai, Ford) **or you need to invest big to stay relevant** (e.g., German big 3 or Tesla)
    - "80 per cent of recent EU investments made by 10 companies"
- Overall, sentiment currently suggesting that **China remains important for the chemical, automobile and machinery industry, but for the rest there are a growing number of question marks**
- Companies like the German automobile giants or BASF will continue to **expand their footprint in China given the deep talent pool in chemical, engineering, and bio disciplines** (50 out of the world's 100 best engineering universities are in China)

On investing in China as a European company

- Overall, "**the greatest risk is not to be in China**" → China is like the key fitness center, which is key to maintaining competitiveness and relevance through the Chinese market's scalability, its excellent engineers and very demanding customers
    - "**If you lose China out of your sight, as competitor or partner, you have already lost**"
- However, also increasingly depends on the sector a company is in, as it is **becoming more difficult to compete in industries where foreign companies have become dispensable for China**:
    - "Where China needs us, they are rolling out the red carpet, but in sectors where they don't need us anymore, they are turning their back towards us"
    - In sectors like medical equipment where Xi Jinping has called for a 30% local content requirement it is becoming very difficult
- Mixed signaling from the Chinese government whether foreign investment is really welcome or not:
    - "**In the provinces the red carpet is being rolled out for international investors, but then at the same time in Beijing nothing is happening"**
- 63% of EUCCC companies saying that they would like to invest more if they could and if conditions were better

While dependencies in a few critical areas should be reduced, more interdependence is needed

- "Overall, we are not dependent on China. **In fact, we are not dependent enough on China, we want to have interdependency with China, but the Chinese are not letting us in their market** – what we need is reciprocity."
    - 6.4 M shipping containers are shipped from China to Europe each year, 1.6M from Europe to China, resulting in a large trade imbalance. **In terms of value, EU only exporting 23% more to China than to Switzerland**

- "**There are indeed some 30 strategic products where we are dependent on China and where we should protect ourselves via industrial policy** (e.g., API, rare earths, magnesium, vitamin B etc.). But that doesn't mean dependence in other areas are all bad."

China's position in Russia's war in the Ukraine

- What we can expect from China is "**glorious fence sitting": Nice rhetoric, but no significant actions**
- "The Chinese de facto believe that they hardly have any influence on Putin" and they believe that they have **nothing to gain by intervening in any way except loss of face**

Advice for Investors in China

- **Become member of the EUCCC**
    - In this difficult, politicized and opaque situation it is key to have a unified and strong voice of European business in China
- **"Don't overestimate the risk, don't underestimate the opportunities"**
    - Don't panic and do a sober analysis of the dynamics in one's own niche in China
    - China will continue to grow at least 2% and a collapse is unlikely
- **Participate in the China fitness center to improve your products and services in this demanding and dynamic market**
    - "We have to learn to unlearn how to do things our way" and thus to learn from the Chinese what they are already doing better than us

This summary was written by Nick Winkler, Analyst, China Macro Group.

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