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US-China economic decoupling:

How far have we come and how far could decoupling go?

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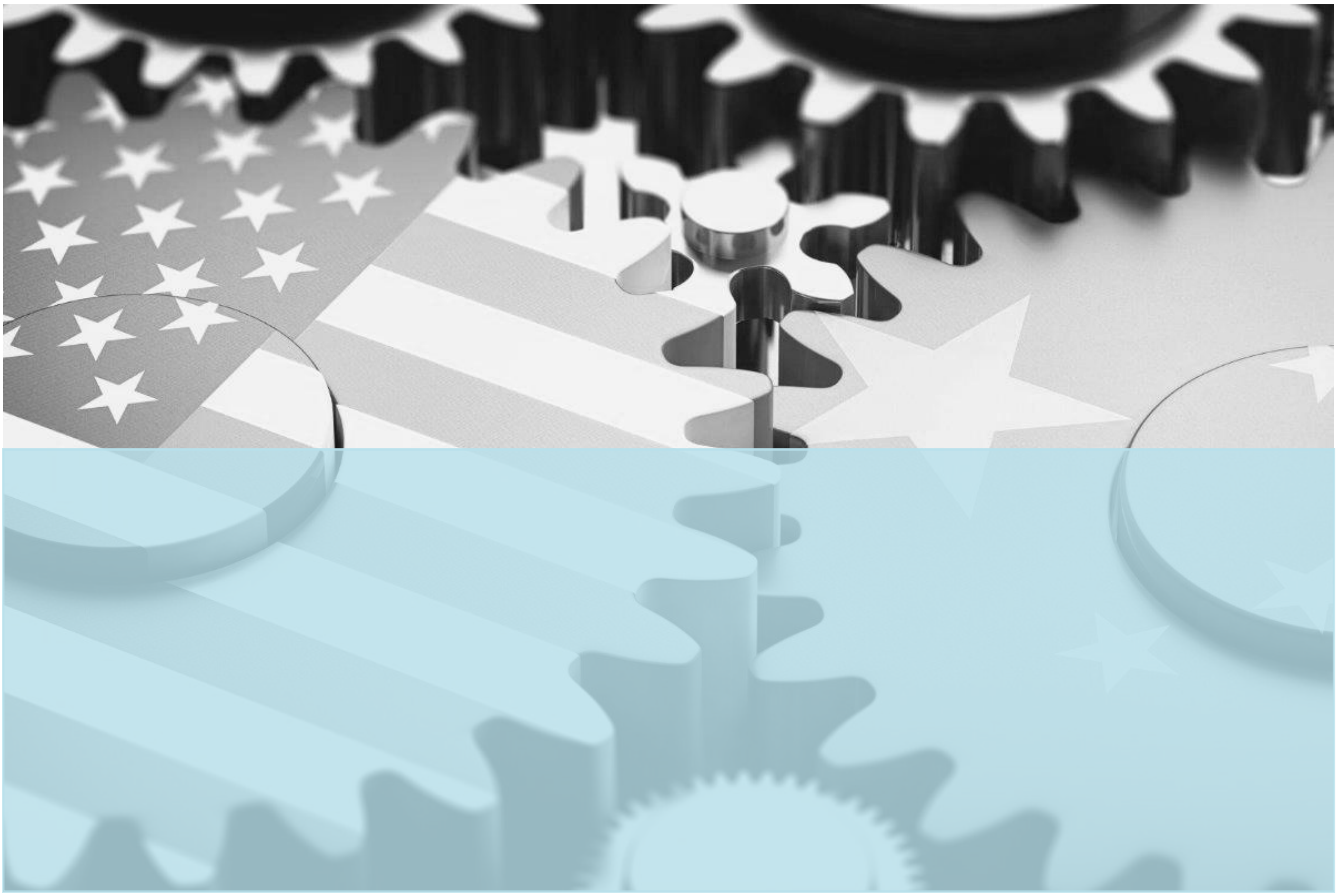

The world has changed dramatically since the imposition of the first China-specific tariffs by the United States in July 2018. The Covid-19 pandemic has plunged the world into a deep economic recession which makes analysis of the trade war, and of the broader economic confrontation between China and the US, difficult.

Nevertheless, geo-economic[1] confrontation has progressed with a speed that has surprised many and the economic conflict is broadening in its scope. What to some observers was a trade war, now appears more like a broader clash of systems, entailing all the elements of great power rivalry. This paper assesses the likely scope of economic confrontation in trade, foreign direct investment (FDI), capital markets and payment systems.

Strategic objectives: moving goal posts?

To answer the question "how far could the decoupling go?", it is imperative to understand what the two sides are setting out to achieve. From an economic perspective, China's aim is, as far as possible, to maintain the ex-ante status quo. The economic arrangements prior to the implementation of tariffs – what one might call the pre-Trump environment – served the Chinese economy well. In particular, uninhibited access to the US market, little scrutiny of its US acquisitions, freedom to pursue its industrial policy and an ability to extract intellectual property by both legitimate and nefarious means, played a major role in its economic rise. In addition, the prospect of access to China's huge domestic market gave it a means to influence foreign companies both to cooperate with its domestic economic agenda and to lobby for its interests in foreign capitals. Under these conditions China captured a 28% market share in global manufacturing, giving it significant global clout, and has raised domestic living standards to global averages. Its steady rise in power went largely unchallenged and unquestioned.

From the American perspective, the initial aim of the tariffs was to bring China to the negotiating table with a view to making the economic relationship more sustainable: creating deep but symmetric economic engagement with reciprocity being the guiding principle. More specifically, the US was seeking equal market access, a bilateral investment treaty, a market-determined exchange rate together with agreement on the limits of state aid and state-owned enterprise (SOE) activity, and the application of law with regard to intellectual property. While tariffs have brought the Chinese to the negotiating table, an equitable economic relationship on market-economy lines will always be incompatible with Communist Party of China (CPC) control over the direction of the Chinese economy. Anything other than a fudge would be unacceptable to either side, and the phase one trade deal was that fudge. The process of negotiating the deal has, however, brought to the attention of a wider audience the incompatibility of the two economic systems.

Moreover, the Covid-19 pandemic and a range of further issues including the emergence of so-called "wolf warrior" diplomacy and the imposition of the National Security Law in Hong Kong have served to shift the nature of US engagement with China. The idea that Chinese expansionism requires perhaps a more assertive form of economic statecraft has acquired greater currency in Washington.

The policy aim, therefore, seems to have morphed from being one of trying to bring pressure to bear on China to renegotiate a deep but fair economic relationship, to one aimed at bringing about a strategic decoupling. This has so far been couched in terms of a defensive strategy: to protect the US economy from potential geo-economic actions by China, by increasing resilience in supply chains for example, and limiting the ability of China to weaponize the various economic interconnections. It is perhaps a small step to a more robust policy stance aimed at containment by inflicting economic damage on China's economy and hence limiting its ability to pursue its expansionary ambitions.

Further escalation targeting regime change as an economic objective cannot be ruled out, especially given Xi Jinping's constitutional changes that mean there is no legal time-limit on his tenure.

While the section 301 tariffs may have been the first high profile measure the US took to put pressure on China, the geo-economics of the rivalry were always unlikely to be limited to just trade. Other areas of economic engagement between the two powers – direct investment, portfolio investment, and technology transfer – have also been brought into the fray. In addition, the economic competition will likely be fought on some of the global commons, such as the US dollar settlements system, the international monetary system and the institutions that oversee the global economy – standard setting in the technology sphere being one[2].

Trade & FDI

Bilateral trade between the two superpowers peaked in 2018. In the 12 months to September 2018 bilateral trade in goods reached US$668 billion. The bilateral deficit peaked a few months later (again on a 12 month rolling basis) at US$420 billion when the ratio of US imports to exports with China stood at over 4:1. Few, if any, bilateral trade relationships between major economies have ever been so asymmetric.

In the 12 months to December 2019 (pre-Covid), bilateral trade shrank by 16% to US$558 billion. The bilateral deficit also contracted sharply, by 18% from its peak at the end of 2018. The pandemic has obviously made it difficult to isolate the impact of the tariffs but bilateral trade has continued to contract, falling to its current level of US$519 billion – 22% off its peak – and the goods deficit stands at US$311 billion, down 27% from its peak.

A number of commentators have suggested that FDI flows could be a key indicator of US success in reducing dependence on China for critical products. A more circumspect approach from The Committee on Foreign Investment in the United States (CFIUS)[3] towards outbound Chinese FDI destined for the US, coupled with a general atmosphere of uncertainty as to the future relationship with China, which has raised the cost of capital of doing business there, could have been expected to damage bilateral FDI flows. Possibly offsetting this would be reform measures in China purportedly aimed at leveling the playing field for foreign companies in China.

Accurate FDI numbers are hard to come by, given the propensity for FDI to be routed through offshore centers. For many years the British Virgin Islands was the both the largest foreign investor in China and the biggest recipient of Chinese outbound investment. For example, The US Bureau of Economic Analysis (BEA) estimate cumulative US FDI into China at about US$116 billion while Rhodium Group, attempting to correct for indirect channels, put the number at US$269 billion.

The opacity makes detecting a change in trend difficult but for what it is worth, the China FDI project[4] estimate that Chinese FDI into the US has dropped from US$30 billion in 2017, to US$5.4 billion in 2018 and US$4.8 billion in 2019. This is a level last seen in 2011 and is best described as negligible in the context of overall flows and stocks (the total US capital stock is over US$60 trillion). US FDI into China grew slightly in 2019 to US$14.1 billion from US$12.9 billion in 2018, but has been running in the range of US$15.5 billion to US$12.5 billion since 2010, implying no dramatic drop or acceleration as a result of the changing environment.

What is clear, however, is that there is an asymmetry in the FDI relationship in terms of quantity, quality and intention. US multinationals have been investing in China since the 1990s, initially to avail themselves of a labor cost arbitrage and hence gain competitiveness in global markets (including exporting back to their home market). FDI was a key driver of China's economic and export success[5]. More recently, FDI into China has been driven by a desire to access China's domestic market. At least in part, and arguably largely, this has been driven by tariff and especially non-tariff barriers to market access from outside. China's desire is to have as much value-added activity take place onshore as possible to secure employment, investment and productivity enhancing management know-how.

FDI has also resulted in the significant transfer of intellectual property. Importantly, therefore, if the US aim is to reduce dependence on China for critical products, reduced US FDI into China is not an important measure of success since much of it is aimed at accessing the domestic market.

In contrast to Rhodium's estimate of a cumulative US$260 billion inflow of FDI from the US to China, Chinese investment in the United States is estimated at just US$140 billion (the BEA put the number at US$60 billion). Given the imbalance of trade flows, one would expect China to have acquired a far greater stock of FDI and the fact it has not demonstrates the degree to which it has been official, central bank flows, that have recycled China's current account surpluses.

The drivers here have been very different and largely boil down to two: private sector Chinese FDI into the US has been driven by a desire to park money out of reach of the Chinese regime, while SOE (or state-sponsored private company) or otherwise state-connected FDI has been aimed at acquiring technology. The former motivation was particularly evident in 2016, when FDI more than tripled from US$15 billion to US$46 billion with the acquisition of trophy US assets by Chinese companies such as Anbang. The later motivation was evident in such Chinese acquisitions as Magnaquench, ATOP or Motorola Mobility.

The fall in Chinese FDI to the United States (and on BEA numbers it turned negative in 2019 with a net divestment) is therefore perhaps a function of greater awareness of the need to protect home grown technology and keep it out of Chinese hands. The lack of a fall in US FDI into China does not mean that the US is becoming more dependent on Sino-centric global value chains (GVCs) or that attempts at de-sinification of GVCs are failing. Compared to total levels of FDI globally or the respective domestic capitals stocks, bilateral FDI is exceedingly small.

Capital markets and payment systems

A key area of potential escalation in the economic rivalry can be found in capital markets and payment systems. Moves to delist US-listed Chinese companies, the opening up of Chinese capital markets to foreign savings and the trialing of the Chinese digital currency (Digital Currency Electronic Payment or DCEP) all provide evidence that this is the direction in which policy is heading. The speed and scale of such a move will likely again be determined by the objectives of policy. If the strategic objective is to inflict economic damage, then a deep bifurcation of capital markets is more likely since, in isolation, policies mooted to date will not achieve this aim.

Take the delisting of US-listed Chinese companies for example. One plausible motivation is to enhance or maintain the integrity of US capital markets. Since the Chinese authorities will not allow Public Companies Accounting Oversight Board (PCAOB) inspections of Chinese auditors, investors in Chinese firms listed on US exchanges are exposed to risks not associated with other companies, although US companies with substantial Chinese operations fall into the same boat.
If, however, the real aim is to deny Chinese companies access to US capital and/or protect US investors from potentially hostile geo-economic policies, then the delistings will be ineffective as US

capital can find its way to Chinese companies, either through their listings in Hong Kong, the mainland or indeed, third countries. Nothing short of a prohibition on US investment in China based enterprises would achieve that aim. In addition, what applies to equity markets will need to be applied to debt capital markets, too.

Recent moves by China to open up its domestic capital markets to foreign inflows of investment, accompanied by moves made by various index providers to increase Chinese weightings, and therefore drive capital towards China, potentially serve three purposes from a Chinese perspective: to professionalize domestic capital markets where the free-float is heavily dominated by retail investors, to provide a steady, and potentially huge, inflow of hard currency, and to deepen China's interconnectivity with the global financial system in a way that raises the future cost of any attempt by the US or others to isolate or sanction the country. With this in mind, limiting the exposure of US investors to the Chinese market may well become a policy goal of this or future US administrations.

The trialing of China's digital Yuan, viewed through the prism of widening and deepening economic rivalry, looks like an attempt on the part of the Chinese to limit the efficacy of potential economic sanctions. Limiting or prohibiting access to the international payments system has proved an effective tool when it comes to inflicting economic damage on adversaries. The impact of such moves on Iran and Russia are testimony to its potential. In the case of an open economy such as China, where the variety and complexity of its international trade is far greater than the hydrocarbon centric economies, the impact would be potentially devastating.

American control over the institutions that make up the systemically important financial infrastructure such as CHIPS, SWIFT, Fedwire and CLS Bank is a cause of huge concern to those countries that find themselves with national interests that conflict with those of the US. The importance of these institutions stem from the dollar's continued dominant role in international transactions and capital flows and the network effects that serve to reinforce the existing hegemony.

The rise of China in terms of economic importance, the (in some people's view) excessive use of sanctions and the punitive fines levied against financial institutions found to have helped actors evade sanction, have combined to produce discomfort among even American allies at this monopoly of power. This presents US policy makers with a dilemma. On the one hand, if, with time, this power is eroded as the Yuan is internationalized and alternative infrastructure is built, then, if it needs to be used, sooner is better than later. On the other hand, overly frequent or aggressive use of the international payments system as a means of sanction will only encourage others to invest in ways to circumvent it as has happened in Russia and recently in the EU with regard to Iranian sanctions.

The "ticking clock" and the power of network effects suggest that, if it is to happen, escalation of the rivalry through means of the international payments system could happen a) soon and b) with secondary sanctions against any third country that co-operate with the construction and popularization of alternative infrastructure. In other words, third countries will be forced to choose between being co-opted into helping cut China out of the international payments system or risk being cut out themselves at a time when there is no viable alternative. In the absence of being able to have a foot in each camp, alternative systems, such as CIPS, could well be stillborn, as survival depends on a wide degree of adoption.

Conclusion

The decoupling of the world's two largest economies is expanding in terms of depth and breadth. This appears to be being driven by a change in strategic objectives. From initially wishing to inflict costs on China through tariffs to bring it to the negotiating table with a view to renegotiating the terms of economic interaction, US objectives now appear to lean towards outright disengagement with a view to limiting the potential for China to gain strategic advantages by weaponizing economic interdependencies.

China has, of course, been preparing for such push-back for many years. Made in China 2025 is all about self-sufficiency in high-tech industries and the innovations around the digitalization and internationalization of the Yuan are aimed at immunizing the Chinese economy from financial sanctions. It appears unlikely that a change of US administration following the November elections will alter the course of action but regardless of whoever is leading the United States in 2021, the next phase of decoupling may well require considerable buy-in from US allies to be effective.

Footnotes

[1] Geo-economics is defined here as "the application of economic means of power by states so as to realize geostrategic objectives." See Wigell, M., Scholvin, S., and Aaltola, M. (Eds.), Geo-economics and Power Politics in the 21st Century: The Revival of Economic Statecraft. Routledge Global Security Studies

[2] See Capri, A., "Strategic US-China decoupling in the tech sector", Hinrich Foundation, https://www.hinrichfoundation.com/research/wp/tech/us-china-decoupling-tech/

[3] The Committee on Foreign Investment in the United States (CFIUS) is an inter-agency committee of the United States Government that reviews the national security implications of foreign investments in U.S. companies or operations

[4] https://www.us-china-fdi.com/

[5] See Enright, M., "Developing China: The Remarkable Impact of Foreign Direct Investment", Hinrich Foundation, https://www.hinrichfoundation.com/research/book/developing-china-impact-of-foreign-direct-investment/

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