26 August 2021

RESEARCH NOTE

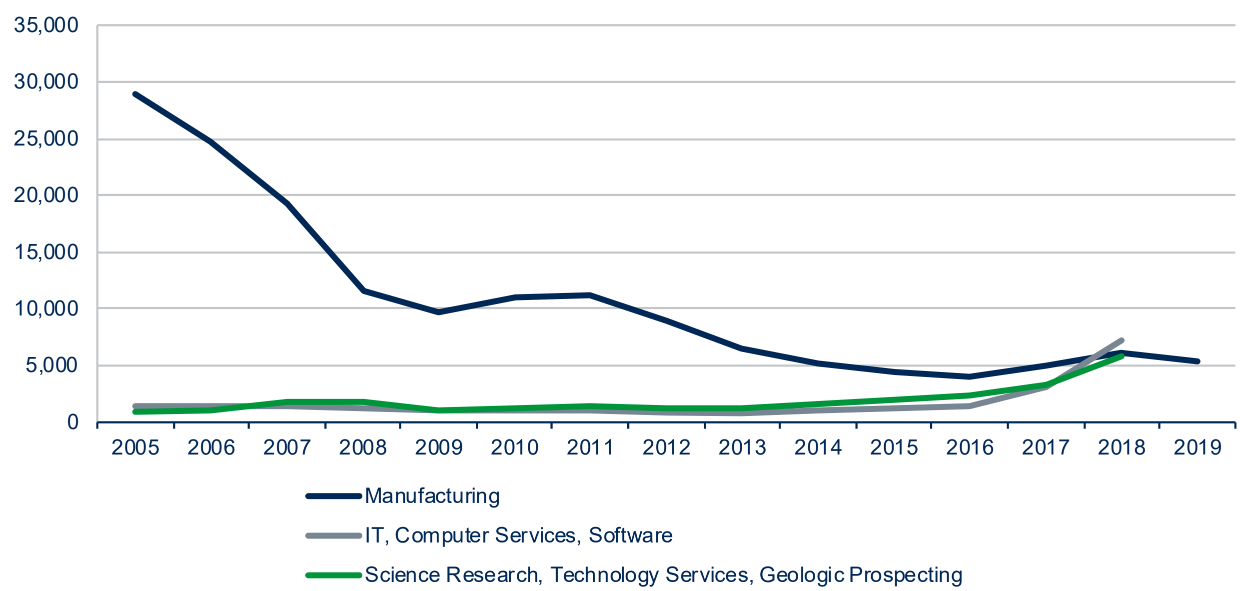
Globalization is Still Strong, But Changing

Christian Floro and Michael Xiao, Barings Investment Institute

Despite fears of decoupling, financial flows seem to be ignoring rising tensions between China and the United States and its allies, as global investment continues to pour into China and Asia. China's own investments have also been rising within its region, even if deals in the U.S. and Europe have fallen dramatically—especially as authorities there block investments in advanced technology. These patterns will continue to evolve as the pandemic ends, but investors should continue to count on a world that seems to be further integrating, rather than falling apart.

Supply chains are shifting, but foreign direct investment (FDI) inflows into China from Organization for Economic Cooperation and Development (OECD) countries have been relatively stable, despite lingering U.S.-China trade tensions and tariffs. FDI flows to Chinese manufacturing sectors—for a long time, a primary driver of the country's growth—are declining as labor costs rise. However, this trend is at least partially offset by increased foreign investment in research, technology, and information sectors.

NUMBER OF INVESTED FDI PROJECTS INTO CHINA BY INDUSTRY SECTOR



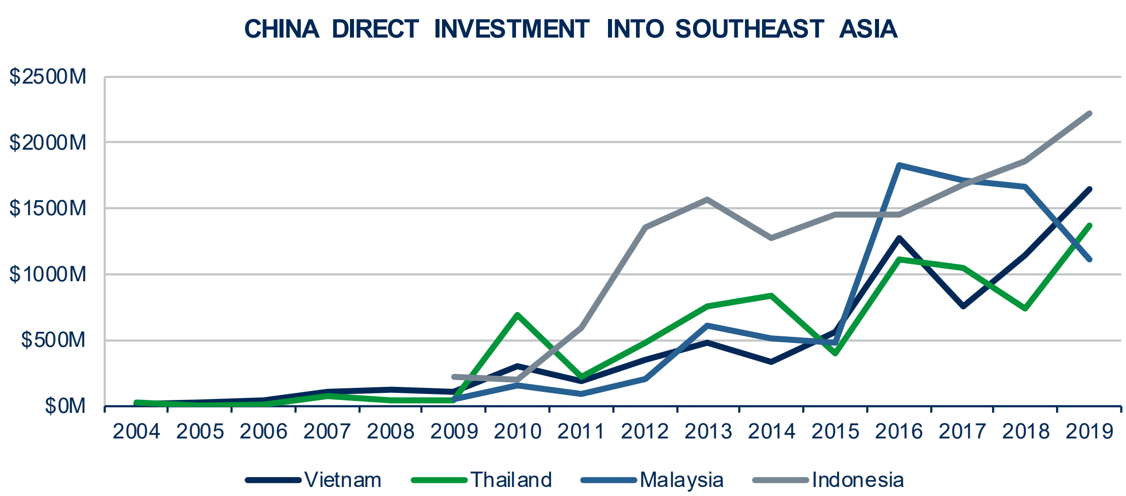
Source: Haver, as of December 31, 2019.

A lot of capital formerly directed towards Chinese manufacturing is instead flowing to other Asian markets. Indeed, the last decade has seen a marked increase in FDI flows towards the region, exacerbated by the U.S.-China trade war and pandemic-driven pressures to diversify investment. Three drivers should keep this trend intact:

- First, investment in certain service industries and technology-related activities is expected to remain robust. Many multinational data center and cloud enterprises are increasing investments or building more facilities in Southeast Asia.
- Second, the Regional Comprehensive Economic Partnership should continue attracting FDI flows to countries in the region—especially as businesses look to improve supply chain resilience during the pandemic recovery.
- Finally, sustained expansion of the Belt and Road Initiative could further stimulate investments towards Asia and Africa.

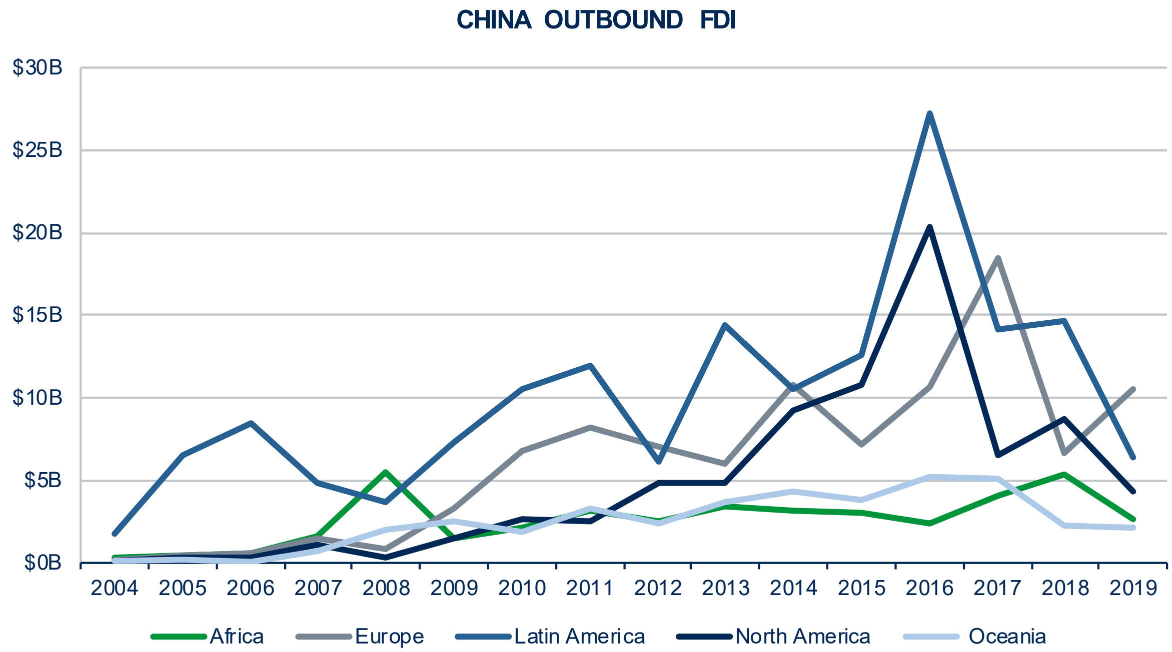
As a result, U.S. importers have also been switching to producers in ASEAN. The U.S.'s share of imports from Southeast Asia rose by over two percentage points between 2017 and 2020, while the U.S.'s share of imports from China dropped two percentage points over the same period. The shift is not leaving China behind, however, because ASEAN is now China's largest trade partner and an increasingly important provider of intermediate goods to the manufacturing process.

The shift also reflects a significant change in global supply lines, as both international and Chinese companies try to diversify their manufacturing facilities beyond China, the so-called "China Plus One" strategy. The share of China's outbound FDI in manufacturing as a percentage of total outbound FDI has been generally increasing, rising from around 3% in 2008 to over 14% in 2019. Likewise, Chinese investment in Southeast Asia has accelerated during the timeframe. Vietnam, Indonesia, Thailand, and Malaysia—all countries with rapidly developing infrastructure and cheap labor costs—have been the primary targets for Chinese manufacturing investment in the region. These countries, in turn, have taken advantage of international interest by passing favorable foreign investment policies, such as streamlining the process for obtaining certain permits.



Source: Haver, as of December 31, 2019.

China's FDI flows towards most non-Asian economies and advanced economies have been in decline since 2016—especially as domestic security concerns, particularly in technology, come into focus for authorities in the U.S. and Europe. As a result, China has pivoted inward, focusing on self-driven growth and "National Champions" to offset the dependency on foreign technology.

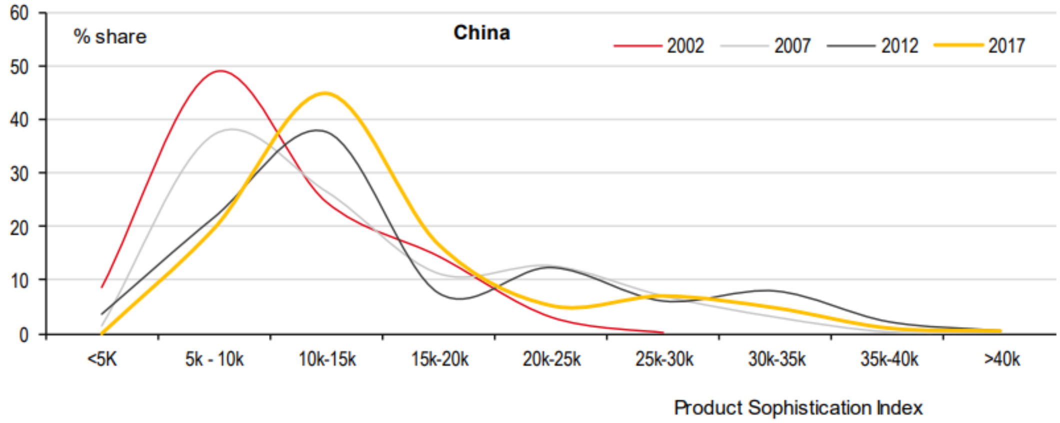


Source: Haver, as of December 31, 2019.

As part of its dual-circulation strategy, China's domestic investment goals have increasingly focused on digital innovation. Indeed, with R&D spending in China now accounting for 2.4% of its GDP, China today represents over 20% of global R&D, ranking second only after the U.S.

Likewise, manufacturing in the country has shifted towards high tech and high value-added products in the last decade, a move that advanced not only by geopolitical pressures, but also higher wages, more sophisticated technology research, and increased capabilities. China's innovations in related sectors will likely continue driving increased capital expenditures and investment and help further incentivize corporations to boost their R&D activity in China.

Chart 9. China moving up the value added ladder (% share, USD)



Note: the export product sophistication index shows the % of exports from China to the US that are also produced by countries that have a similar GDP/capital. Thus, in 2002 (the red line), about 10% of all Chinese exports were products that were also produced in countries with a GDP/capita below USD5,000/ and nearly 50% of all products were exports that were also produced in countries with a GDP/capita ranging USD5,000-10,000.

Source: US Census Bureau, World Bank, HSBC

Source: HSBC, as of February 18, 2019.

Global integration has clearly not stopped, but it is changing in ways investors will want to track. Even with the pandemic's disruption of global supply chains and rising U.S.-China tensions, FDI flows into China have remained robust. Meanwhile, Asia's other emerging markets have been the primary beneficiaries of China's shift away from low-end manufacturing—as countries increasingly look to them for cheap and efficient labor. Finally, as the U.S. and Europe have blocked Chinese investment in their tech sectors, Beijing has turned its efforts—and investment money—inward to accelerate its climb up the global innovation chain.

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