Busting the decoupling myth

China's deepening integration with the world

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Economics - China

- China's exports and imports have been growing at a pace that's roughly five times the global average since 2018
- FDI into China has also continued to rise, even as global FDI has dropped sharply amid the pandemic
- We expect structural forces and more policy support to strengthen China's global economic links in the coming years

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Despite the commonly-held assumption that China is facing increased decoupling with the rest of the world, we have found the opposite to be true. In the last three years, China's exports and imports have risen roughly five times faster than the global average (based on CAGRs). Meanwhile, FDI into China has continued to rise in recent years while global FDI has shrunk, attesting to China's strong pull factors that compel companies to keep expanding in the world's second-biggest economy.

While there are some cyclical considerations that have helped China's trade to surge, particularly last year with both exports and imports rising by 30%, it's the underlying structural factors that are the ultimate driver. During the pandemic, China benefited from maintaining high levels of production as other economies closed or slowed factories. A gradual global recovery has also given way to stronger global demand. But even beyond the impact of the pandemic, we find that China's continued rising share in trade has stemmed from its ability to climb up the value chain. China has been increasing its market share in medium and high-tech manufacturing products such as in machinery and equipment, electronics like smartphones and laptops, as well as new growth areas like green technology. China also has the largest annual supply of tertiary graduates anywhere in the world, which includes 4m who have studied science, technology, engineering, and mathematics (STEM) subjects. Rising innovation capacity from decades of investment in R&D has also been paying off, as China tops the global patent application rankings. Meanwhile, a dynamic home market allows for firms to iterate and develop high quality products, which can also lift export quality.

Beijing will likely bolster its efforts to support manufacturing upgrading and roll out policies geared towards opening up and reforms. These are likely to include measures such as tax incentives and credit support for manufacturing firms, as well as continuing to close trade deals and opening up more service sectors to foreign investors. In all, the combination of China's strong structural foundation and continued policy support are set to offset the impact of supply chain reshoring and other headwinds, deepening China's economic links with the world in the coming years.

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Deeper links with the world

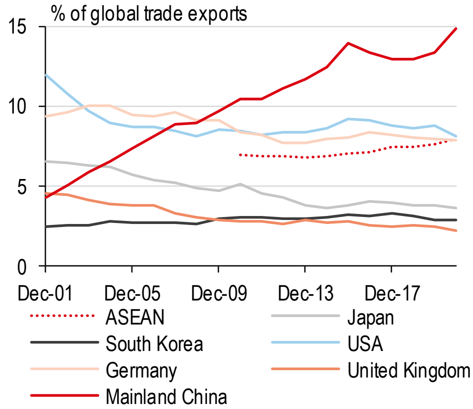
- Despite the common assumption that China's trade and investment links have diminished, we've found the opposite to be the case
- China's share of exports and FDI inflows climbed to 15% or more of the global total, showing increased integration rather than decoupling
- Continued policy support aimed at developing China's manufacturing upgrading, as well as further opening up and reforms, will sustain the trend of rising trade and closer global investment links

Still a heavy hitter on the global trade stage

It has been a volatile few years for China's exporters. From geopolitical tensions with trading partners to pandemic woes, manufacturers have faced both ups and downs in global demand. There is a commonly held assumption that China will lose market share in exports to other emerging markets as its labour costs rise. But contrary to this, China's global market share of both exports and foreign investment into the country has been increasing, reaching 15% or more based on the latest data. This was helped by last year's exports boom, with goods sold to overseas buyers rising by 30%, the fastest pace since 2010.

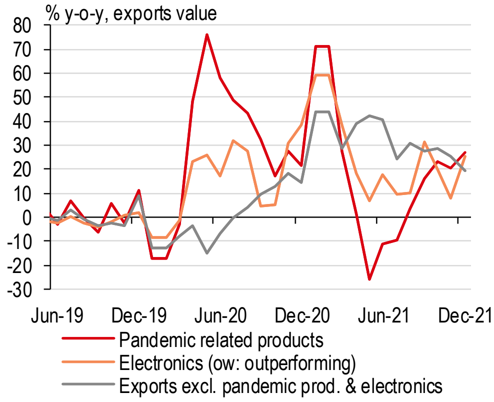
In this report we delve into the main factors driving China's exports boom in 2021, namely a fast recovery in domestic production and a gradual recovery in global demand. Even before the pandemic, China's trade was rising rapidly, which shows that the decoupling story is likely more fiction than fact. In 2019-21, the CAGR of China's trade flows rose by about 10%, which is five times the global average of 2%. China's exports have remained competitive, underpinned by

Chart 1. China's share of exports is the largest in the world



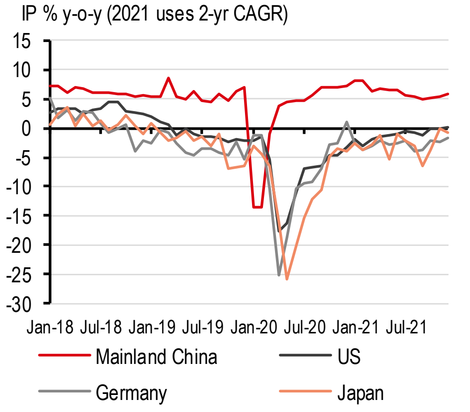
Source: ITC, HSBC

Chart 2. China was a key supplier amid demand for pandemic-related products and general consumer goods



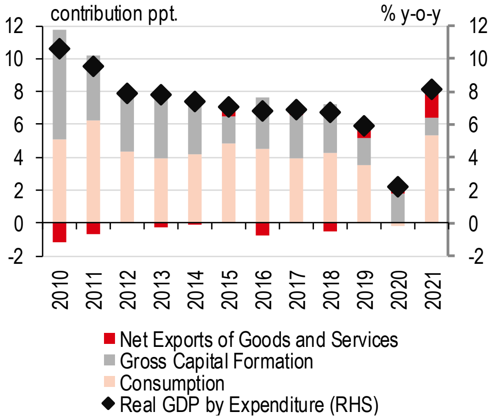
Source: CEIC, HSBC

Chart 3. China's IP rebounded faster due in part to successful containment of COVID-19



Source: Refinitiv, HSBC; 2021 uses CAGR to take out the impact of base effects.

Chart 4. Net exports saw the largest contribution to growth since 2006



Source: CEIC, HSBC

structural factors. We assess these longer term drivers for China's global linkages and why we think they will continue to climb. While there are risks to China's ongoing exports dominance, eg from reshoring of production back to developed markets, increased automation in home markets, increased competition from other emerging economies and continued geopolitical uncertainty, we see that China's links with the world, particularly with Asia, are holding firm and even strengthening, as it continues to move up the value chain.

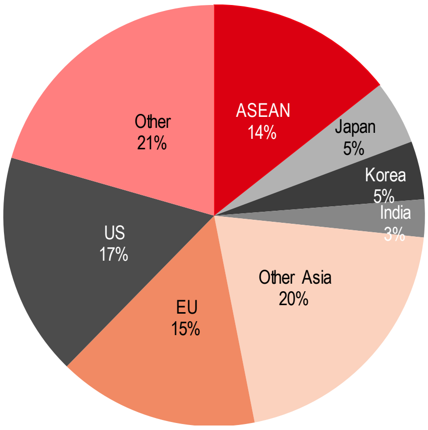
Strong exports in 2021 was no fluke

With the onset of the pandemic back in early 2020, China engaged in a nationwide lockdown that forced factory closures and in turn led to a steep drop in exports growth. But since then, China has been better able to manage the spread of COVID-19 domestically. Although strict COVID-19 containment policies have weighed on the recovery in domestic demand, they have also allowed China to maintain relatively high levels of production akin to pre-pandemic levels of growth. Comparatively, other regions have grappled with waves of the virus as well, but have faced more disruption to production. The combination of strong Chinese production and comparatively weaker production in a number of other markets allowed China to maintain its share. Chart 3 shows that China's rebound in industrial production occurred much sooner than in the other top three global export markets.

Meanwhile, demand for China's exports has also shifted. At the beginning of the pandemic, medical products like masks, protective gear, and medical equipment were in high demand, but this gradually started to give way to more general consumer products like electronics amid the increased demand for working remotely. There's also been rising demand for goods like toys and furniture as people shied away from consuming services given COVID-19 restrictions around the world. Compounding all of this, strong fiscal support in developed markets through direct cash stipends or employment subsidies helped to fuel stronger goods demand. Towards the end of 2021, the resurgence of COVID-19 cases on account of the Omicron variant further kept global goods demand strong and delayed an expected rotation towards services. At the same time, demand for pandemic-related products picked up again, further contributing to strong exports growth in 2021. Net exports ended up being a strong buffer for China's growth last year, contributing 1.7ppt to the 8.1% GDP growth, the largest boost to growth since 2006.

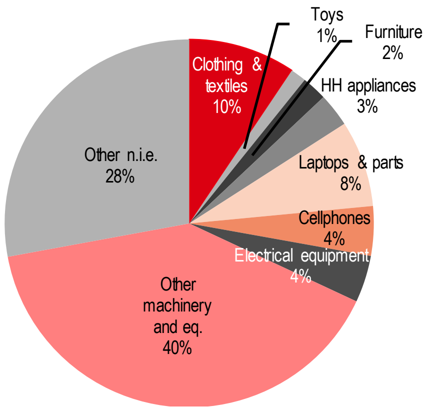
A high base, continued restoration of production capacity in other economies, and an expected rotation in global demand from goods to services are expected to dampen the growth rate of exports in this year to 3%. However, this would still mean exports climb at record high levels, and we still see a number of structural factors that are supportive of China's exports dominance, even while there may be continued uncertainties such as from geopolitical tensions.

Chart 5. China's exports breakdown by country, 2021



Source: CEIC, HSBC

Chart 6. China's exports breakdown by product, 2021

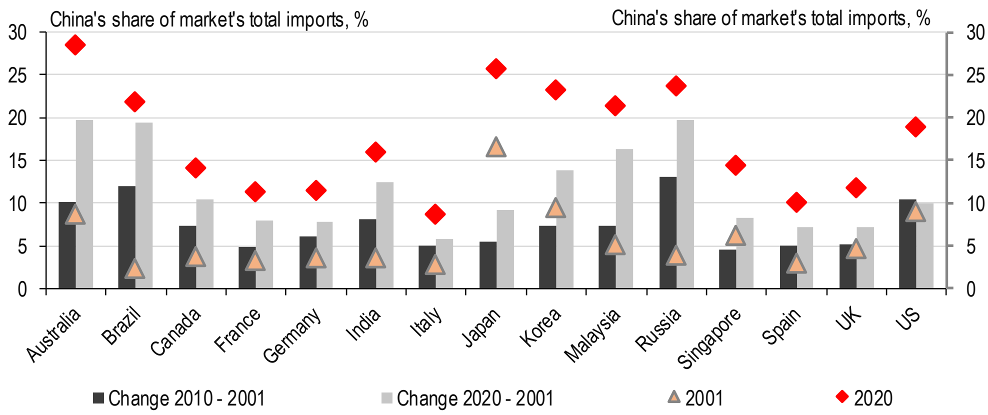


Source: CEIC, HSBC

Climbing up the value chain

Beyond the impact of COVID-19, which saw increased demand across a broad range of products, China's rise in exports share has been increasing even during the years of increased trade tensions. The share of global exports for China has risen since 2017 on account of more structural factors stemming from continued manufacturing upgrading. We think China's exports will continue to climb up, especially as it moves up the value chain. It's helpful to take a quick assessment on how we got to the current high levels of China's exports market share. From chart 7, we can see that China's share of other countries' imports has more than doubled since its entry into the WTO. Among these key global importers, we found that China typically accounted for the largest share or second largest share of their imports.

Chart 7. China has more than doubled its share of other markets' imports over the last few decades

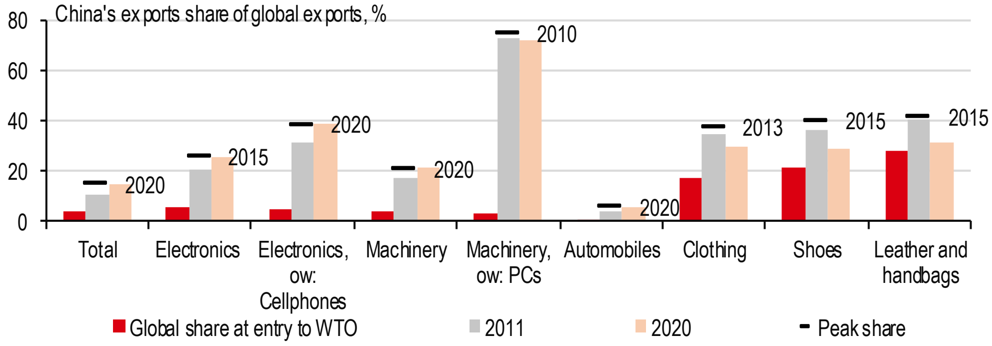


Source: ITC, HSBC

Part of the reason for this dominance in trade share was that China had a large supply of relatively cheap labour as more rural workers moved into urban areas to work in factories. This in turn allowed China's exports to be very price competitive as manufacturing wages have been less than a third of most developed nation's manufacturing wages and capture a larger amount of market share.

China's low labour costs in lower skilled manufacturing provided the push for its development in less technology-intensive products like clothing and textiles in the ensuing years after entry into the WTO. However, with China's continued economic development, labour costs increased and it began to lose some market share to other emerging markets. The orange bars in chart 8 for clothing, shoes and leather goods show a noticeable dip from the peak market share over the last several years. Conversely, China has been increasing its market share in more medium and high-tech products such as electronics and machinery, showing a transition has been underway. Its global market shares in electronics and machinery were relatively low compared to those of clothing and shoes: over the last decade, China's market shares in the former two have continued to rise but dropped in the latter two. In our view, this is a result of a confluence of structural factors that have contributed to the development of China's manufacturing sector to make it more competitive, and will likely continue to grow (see the section on structural factors).

Chart 8. China has transitioned from lower end goods exports towards higher end manufacturing exports



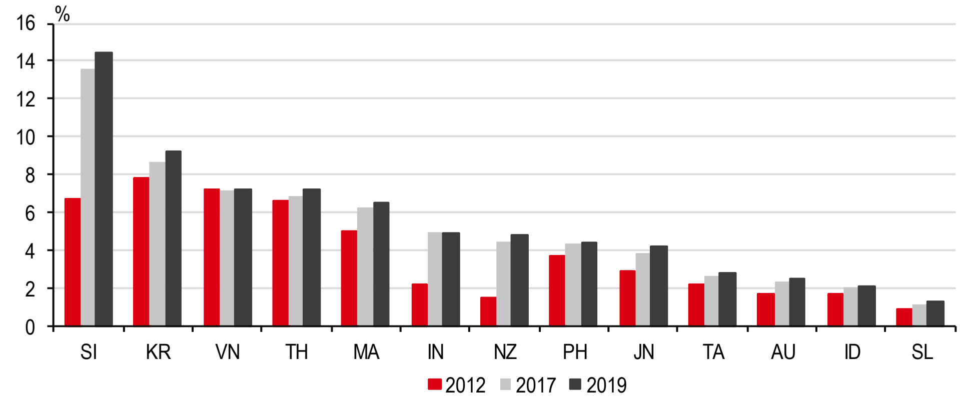
Source: ITC, HSBC

Deeper integration, not decoupling

Meanwhile, even as some lower-end demand is diverted towards other emerging market economies, we do not think this means that decoupling between China and Asia will accelerate. On the contrary, China has been contributing more in manufacturing value-added to other countries over the last few years, especially in Asian economies. Even despite increased trade tensions, the rising share of China's contribution to other countries' exports shows deepening linkages in Asian supply chains.

Additionally, another factor to consider is that moving supply chains is easier said than done. It is hard to immediately replicate decades of investment that have gone into building up China's trade infrastructure which have contributed to strong network effects. In the 2021 China Business Report from the American Chamber of Commerce, 72% of manufacturing survey respondents said they had no plans to move production out of China, and only 1.6% of companies were planning to move out all of their production in the next three years (AmCham, 2021 China Business Report).

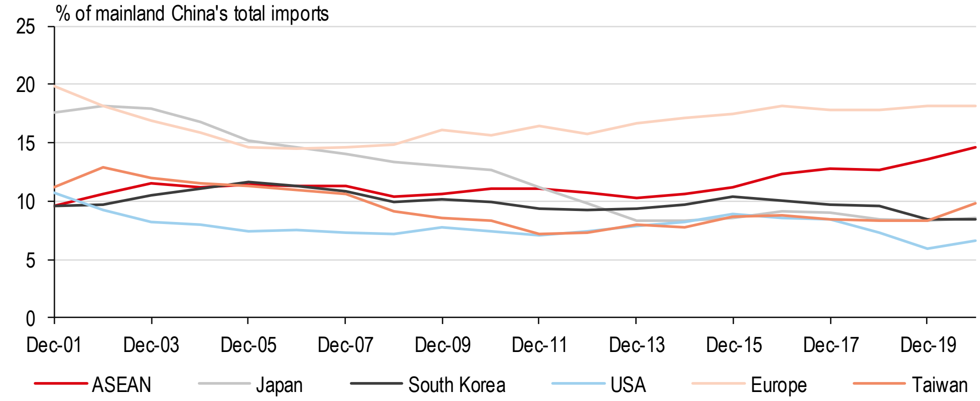
Chart 9. Share of manufacturing value added contributed by mainland China in an economy's exports



Source: UNCTAD-EORA, HSBC; ISO country code

Meanwhile, deeper integration is a two-way street as China's imports from Asian partners has also increased. While the introduction of tariffs and export bans by the US in recent years has played a role in dampening some direct trade flows between the US and China, this has been supplemented by imports from other economies. Increased US-China tensions has meant that China has turned towards developed market for imports of high-tech components, particularly semiconductor chips and advanced machinery. Additionally, China has been importing more from ASEAN economies in recent years. This has primarily been manufacturing products, partly a result of deepening supply chains, but commodities also remain a key share of imports from ASEAN given their relative abundance. As China engages in its green transition, this may prompt further demand for imports of commodities as domestic production faces certain constraints.

Chart 10. Mainland China's key import partners over time

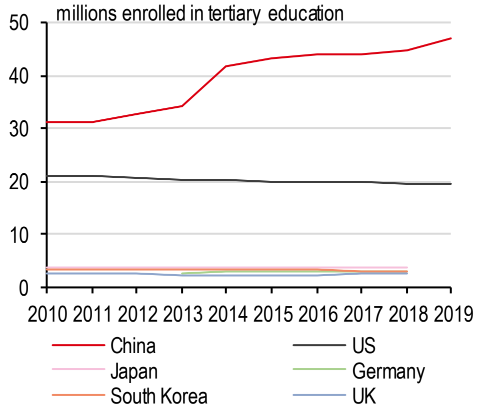


Source: ITC, HSBC

Structural factors will keep middle and high-tech exports strong

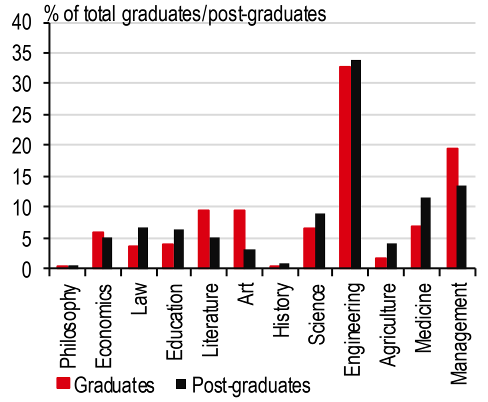
Looking ahead, we see structural factors keeping China's exports competitive, especially those that will allow the country to move higher up the value chain. China has continued to develop more medium and high tech products. For one, China has the largest supply of tertiary graduates (including STEM graduates) anywhere in the world. With roughly 4m STEM graduates per year, this influx of talent not only helps companies to innovate, but the sheer size of the new skilled workforce will also act as a deflationary force for keeping costs of manufacturing new products relatively low compared to global peers.

Chart 11. China has the most students in tertiary education; numbers are growing



Source: UN, Digest of Education Statistics, HSBC

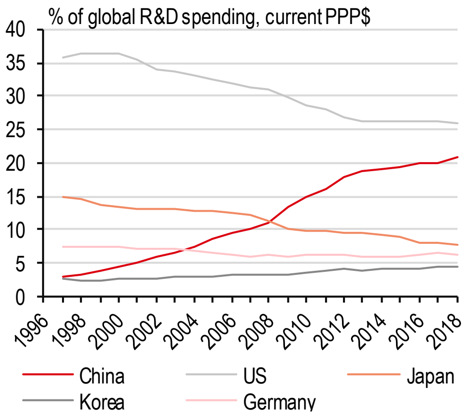
Chart 12. China's university graduates are mainly concentrated in STEM fields



Source: Wind, HSBC

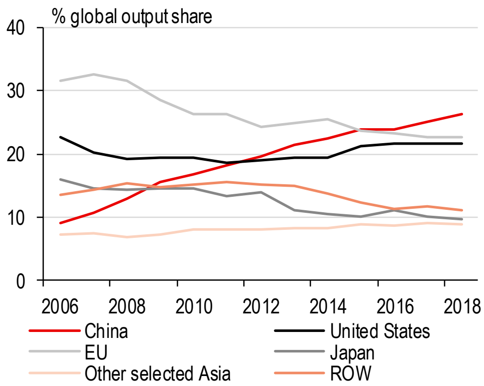
Additionally, China has been highly invested in developing its innovation capabilities, with the highest number of patent applications globally and consistently high levels of spending on R&D, which accounts for over 20% of global R&D spending and ranks second largest in the world (chart 13). Meanwhile, a large and highly dynamic domestic market that is willing to try out new technologies provides an ideal environment for continued iteration of products. Lastly, continued policy support to allow for more manufacturing upgrading will further support the development of China's middle and high-end exports. All of this has led to strong sustained growth in China's output in medium and high-tech products, where in 2019, China accounted for over 25% of the share of global output (chart 14).

Chart 13. China's share of global R&D spending has climbed to the second highest globally



Source: OECD, HSBC

Chart 14. Mainland China has a growing output share of medium-high R&D intensive products

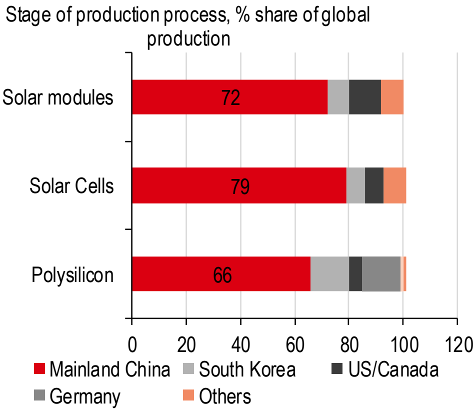


Note: Medium-high R&D intensive industries include weapons and ammunition; motor vehicles; medical and dental instruments; machinery and equipment; chemicals and chemical products; electrical equipment; railroad, military vehicles, and transport; and IT and other information services. Other selected Asia includes India, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan, Thailand, and Vietnam.
Source: NSF, HSBC

Green investment will be a new exports driver

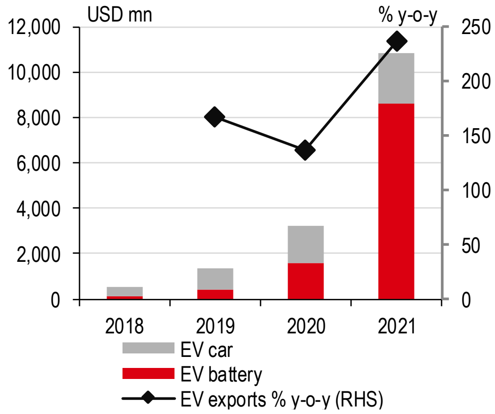
China's ambitious decarbonisation goals, which include reaching carbon emissions by 2030 and carbon neutrality by 2060, have led it to double down on its investment into greener development. We estimate that the combination of both increased demand for green projects such as investment into renewable energy, as well as policy and credit support from Beijing, means green investment should top growth of over 30% per annum over the next few years. This not only has the benefit of helping China reach its decarbonisation goals but also presents opportunities to share this technology through exports amid a global campaign for green development. China is already a leader in exports of solar panels which account for about 70% or more of global production across production verticals (chart 15) and accounts for the largest global share of renewable energy patents at 29% (WEF, 19 June 2019). Meanwhile, China is also now a leading producer of EV batteries and cars, which has seen its exports more than double in growth in recent years (chart 16). We expect that increased investment into green technology will further lift China's exports strength even as demand for lower end manufactured products from China diminishes. Currently, green exports are still relatively low with solar panels and EV cars and parts accounting for less than 2% of China's total exports, but we expect green exports will continue to rise as global green demand rises and green technology products in China continue to improve.

Chart 15. China has the largest share of solar panel production



Source: Bloomberg NEF, Statista, HSBC

Chart 16. China's exports of EV cars and batteries have skyrocketed in growth



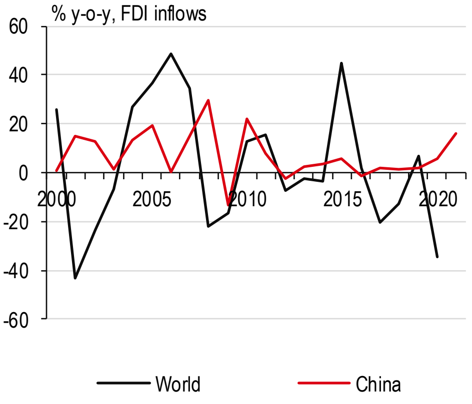
Source: CEIC, HSBC

Still a compelling destination for foreign investment

With still strong structural forces for China's manufacturing sector that will support its exports development, we have also seen a stronger uptick in FDI inflows over the last few years, particularly in high-value added services, which can in turn boost China's services products both domestically and globally. Despite the onset of the pandemic, China remained a favourable investment destination as FDI rose by 5.7% in 2020, yet global inflows contracted by 35% (chart 17). In 2021, FDI into China continued to climb by 16.2%, the fastest pace since 2010. China currently ranks second for global FDI inflows after the US, accounting for 15% of 2020 FDI global inflows, climbing up from an average of 7% in the decade after entering the WTO.

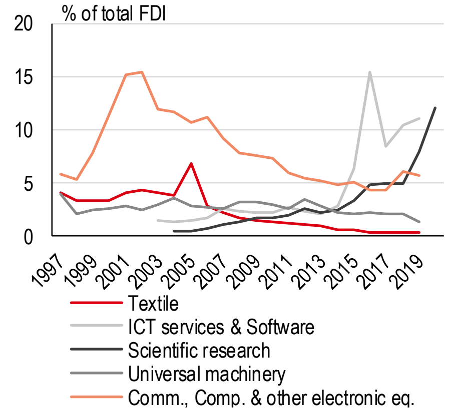
The mix of investment has also tilted along the lines of its industrialization pathway and has notably moved towards areas aside from goods and into high value-add services. While at the start, FDI into manufacturing was strong due to favourable policies and encouragement of collaboration between foreign companies and domestic manufacturers, as these industries have been maturing, more FDI has been turning towards areas like R&D spending and information and communications technology (ICT) software (chart 18). This is also the result of favourable investment policies that have opened the door for foreign investment into services sectors in recent years (such as the implementation of clearer guidance regarding the foreign investment "negative list" and subsequent reductions in the list).

Chart 17. China's FDI inflows have risen during the pandemic, but global flows contracted



Source: UNCTAD, HSBC

Chart 18. China's FDI breakdown



Source: CEIC, HSBC

Policy support for deeper global linkages

China's "dual circulation" policy focuses on deepening cooperation with the world, or "external circulation," to complement higher quality growth at home. Deepening trade ties with other countries will also be a welcome boon to trade and investment growth. External uncertainties may persist, which could cast some clouds on China's integration with the rest of the world, particularly in certain areas. Increased international cooperation could buffer this to some extent, though there are still challenges in some aspects of further trade liberalization, as seen in the delays on the EU-China Comprehensive Agreement on Investment as well as a possible lengthy road for China's entry to the CPTPP. In all though, we expect the key boost to exports growth in the coming years to come from stronger policy support for manufacturing development which will allow companies to develop more high quality products that can then be offered to global markets. Meanwhile increased opening up and reform policies will further strengthen China's pull factors for global markets as it becomes better incorporated with regional trade deals and has more favourable domestic conditions which are conducive for increased innovation development.

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