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China Outlook

Prepared for **Business Finland**

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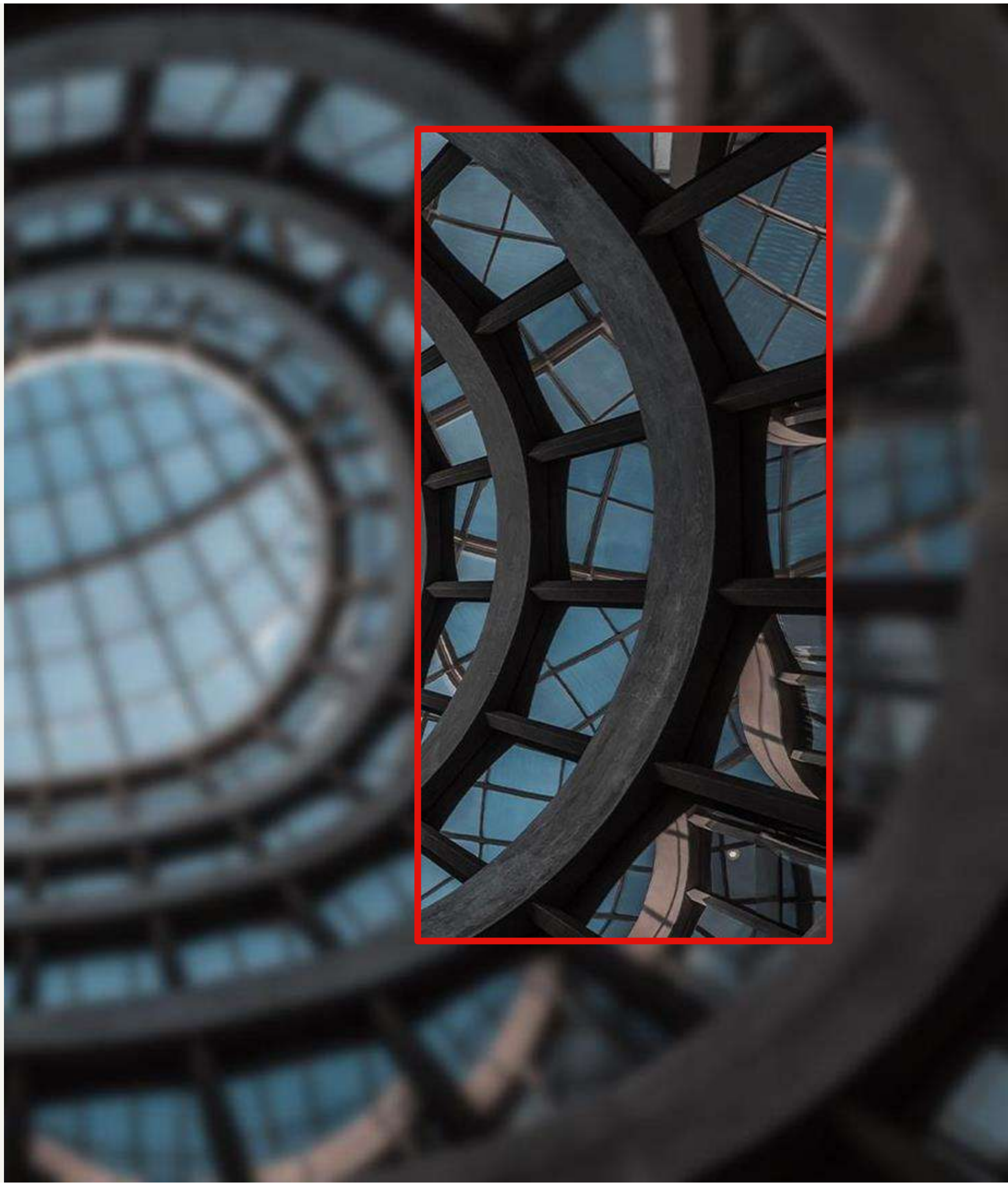
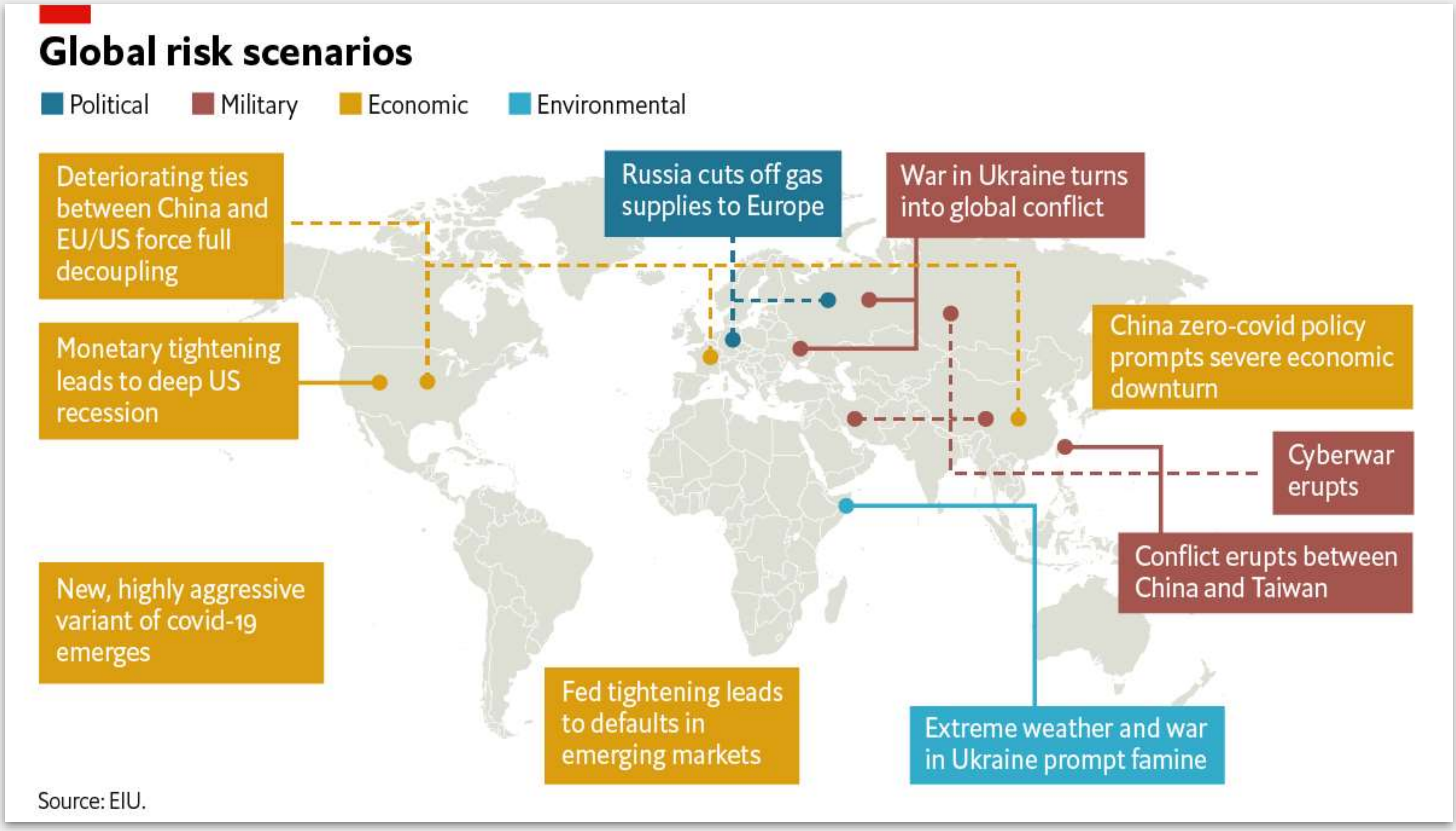
November 22 2022



What are the top ten risks for the global economy?



Other business risks:

Spikes in input prices, volatility

Great resignation and talent shortages

“Friend-shoring” trend, diversifying supply sources

Greater need and importance of localisation

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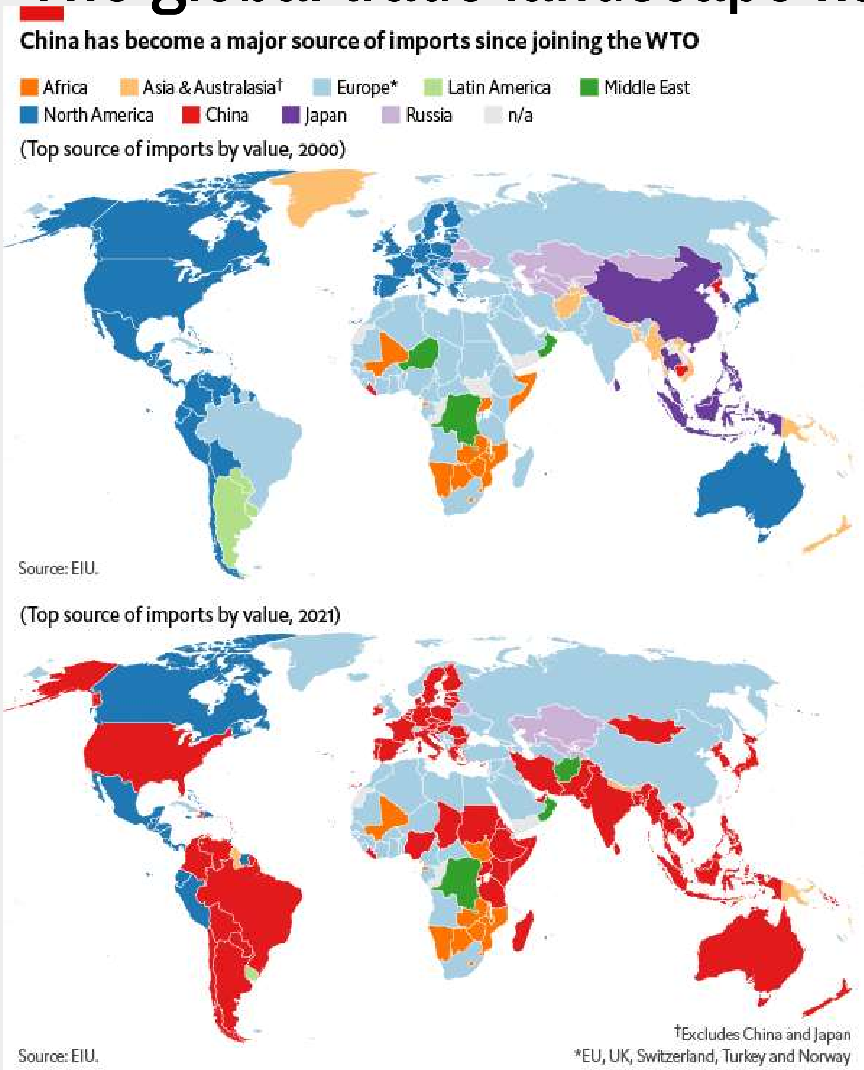
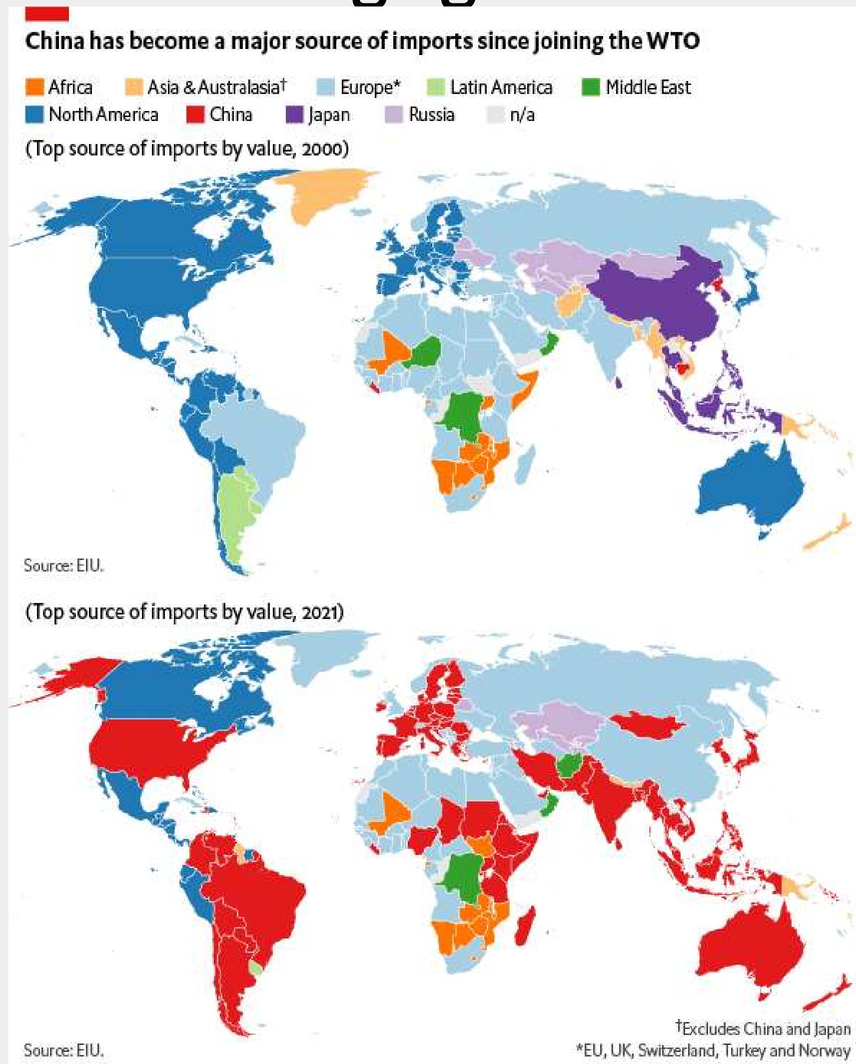
China and the world

The global trade landscape has been changing





China's trade clout is still rising

17.5% of the world's goods exports will originate from China by 2026 (up from 14.5% in 2022

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Could the US-China rivalry derail the Asian century?

Asia is starting to look similar to late 19th-century EU

Territorial disputes among neighbouring economies

Intensified competition between a rising power (China) and the incumbent (US)

Lack of a recognised arbitration framework

US-China tensions and decoupling will accelerate

Watch out for:

Formation of competing cold war-type blocs, unwinding of trade and supply chains

Systemic bipolarity between US and China that leads to bifurcation and "choosing sides"

Rise of nationalism / populist policies

For industry:

Separate supply chains could develop

Risk of high tariffs / import barriers due to differing standards and regulations

Higher input costs complicating production

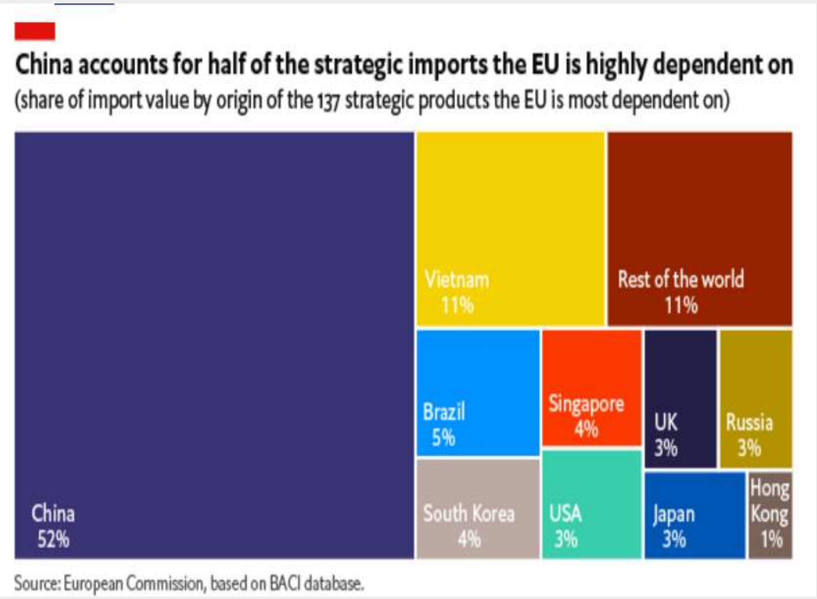
EU-China relations are challenging

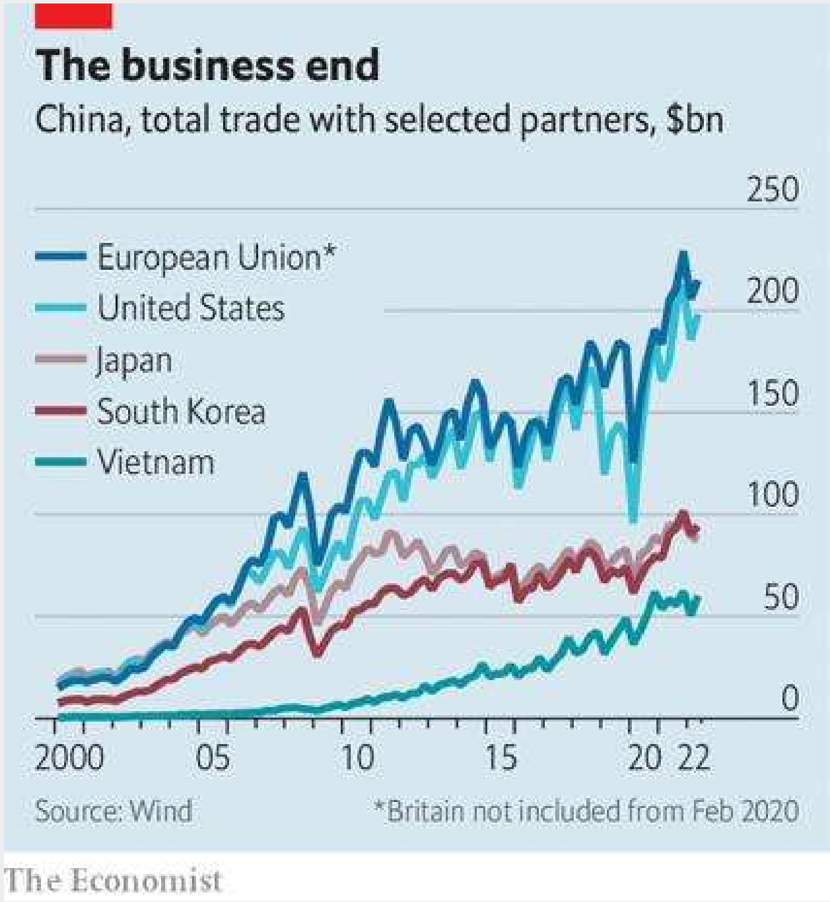
Ties with Europe matter to China for two main reasons.

Economic: the EU is China's biggest trading partner and has technology that China craves.

Political: China hopes its economic clout will deter European governments from supporting American policies that China resents, on everything from human rights to dealings with Taiwan.

The downturn in relations is a blow to China's broader ambitions.





Slowed global growth of 2.7% in 2022...

US growth downgrade to **1.5%**, due to high inflation

Global inflation: from 5.6% pre-war to **8%** now

LatAm will suffer from higher global inflation, but higher commodities prices beneficial to some countries

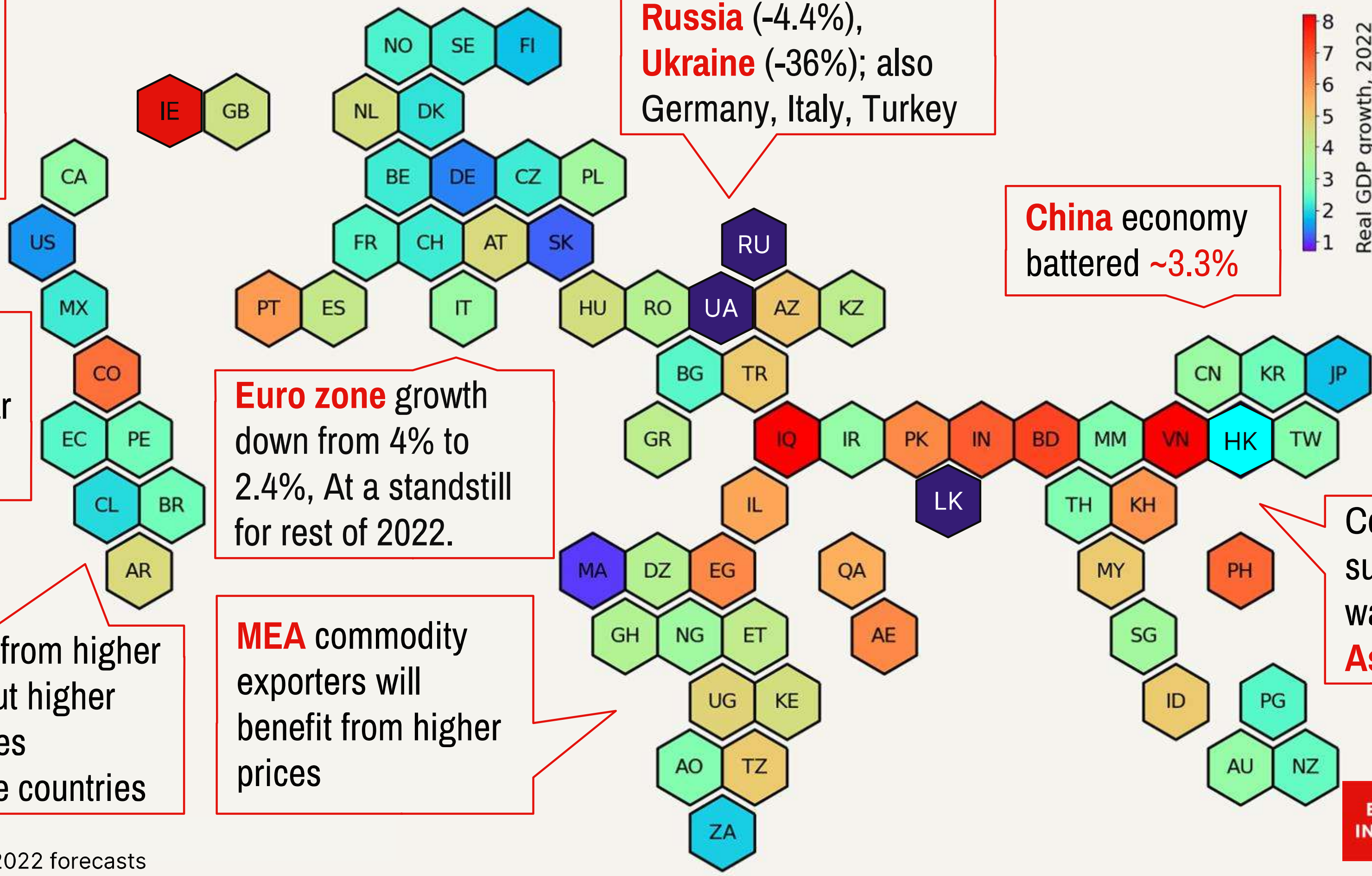
Euro zone growth down from 4% to 2.4%, At a standstill for rest of 2022.

MEA commodity exporters will benefit from higher prices

Recessions in **Russia** (-4.4%), **Ukraine** (-36%); also Germany, Italy, Turkey

China economy battered **~3.3%**

Commodity and supply chain waves across **Asia**



Source: EIU November 2022 forecasts

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...does not translate to a rebound in 2023! (World GDP growth: 1.6%)

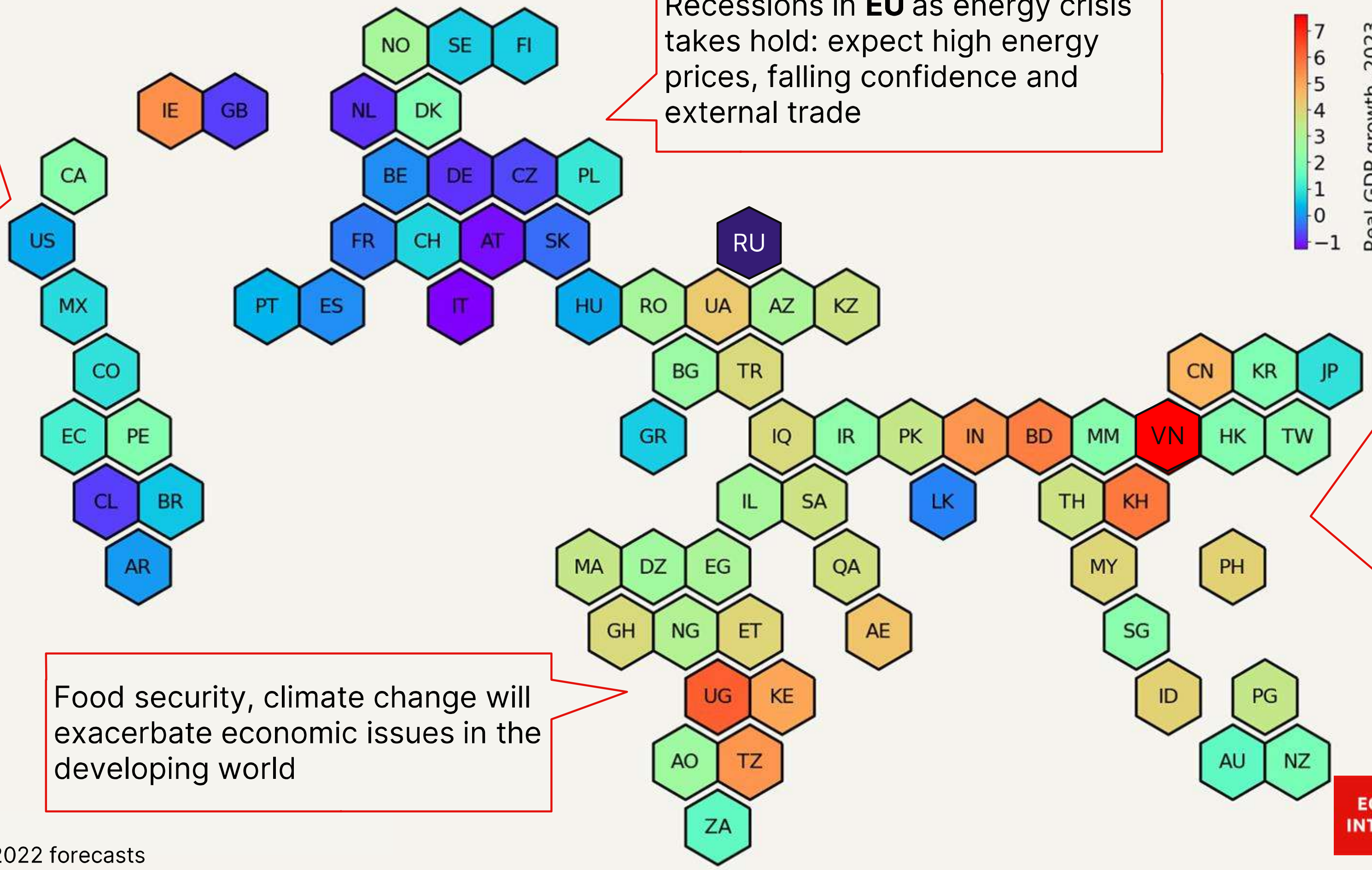
US:
Strong labour market will keep inflation and rates high (**3.75 - 4%** by Dec 2022)

-> Another inflation spike

-> An overly aggressive Fed

-> Collapse in asset prices

Recessions in **EU** as energy crisis takes hold: expect high energy prices, falling confidence and external trade



Outlook in **China** also not looking bright

-> Zero-covid stays on

-> Credit crunch & looming liquidity trap

-> Weakening external demand and domestic consumption

-> Power crisis

Food security, climate change will exacerbate economic issues in the developing world

Source: EIU November 2022 forecasts

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China’s outlook – current challenges and priorities

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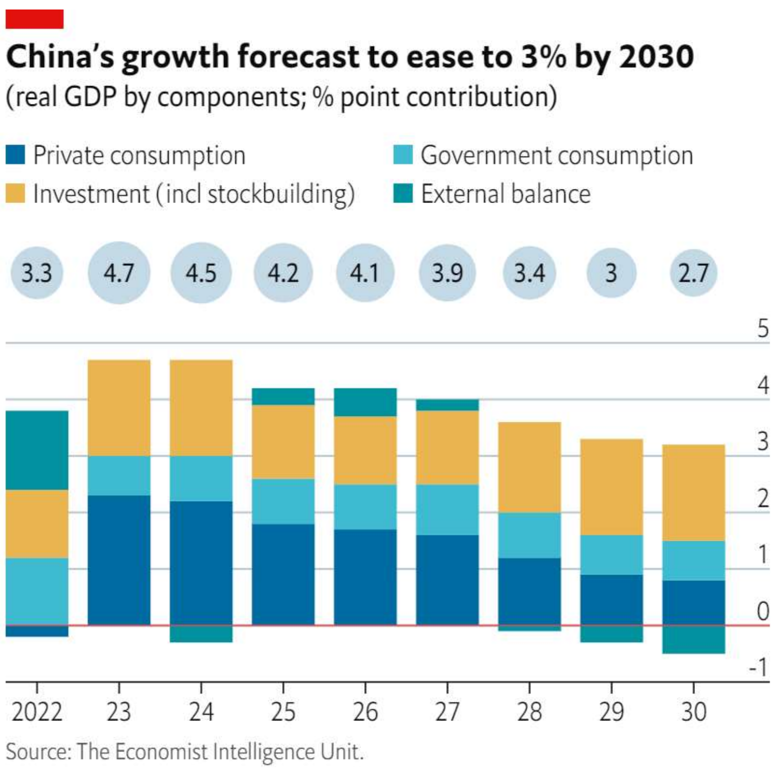
China’s growth story is not over, but it is changing



The glory days of fast, easy growth are over

- Rebalancing investment and consumption
- Maintaining China's advantages as a global manufacturing hub
- Diversifying import sources for energy, food and technology for security concerns

Last year Liu He stated that China is moving into a new phase of development that prioritises social fairness and national security, not the growth-at-all-costs mentality of the past 30 years. The government will guide the “orderly development of capital”, he noted, the better to suit the “construction of a new development pattern.”

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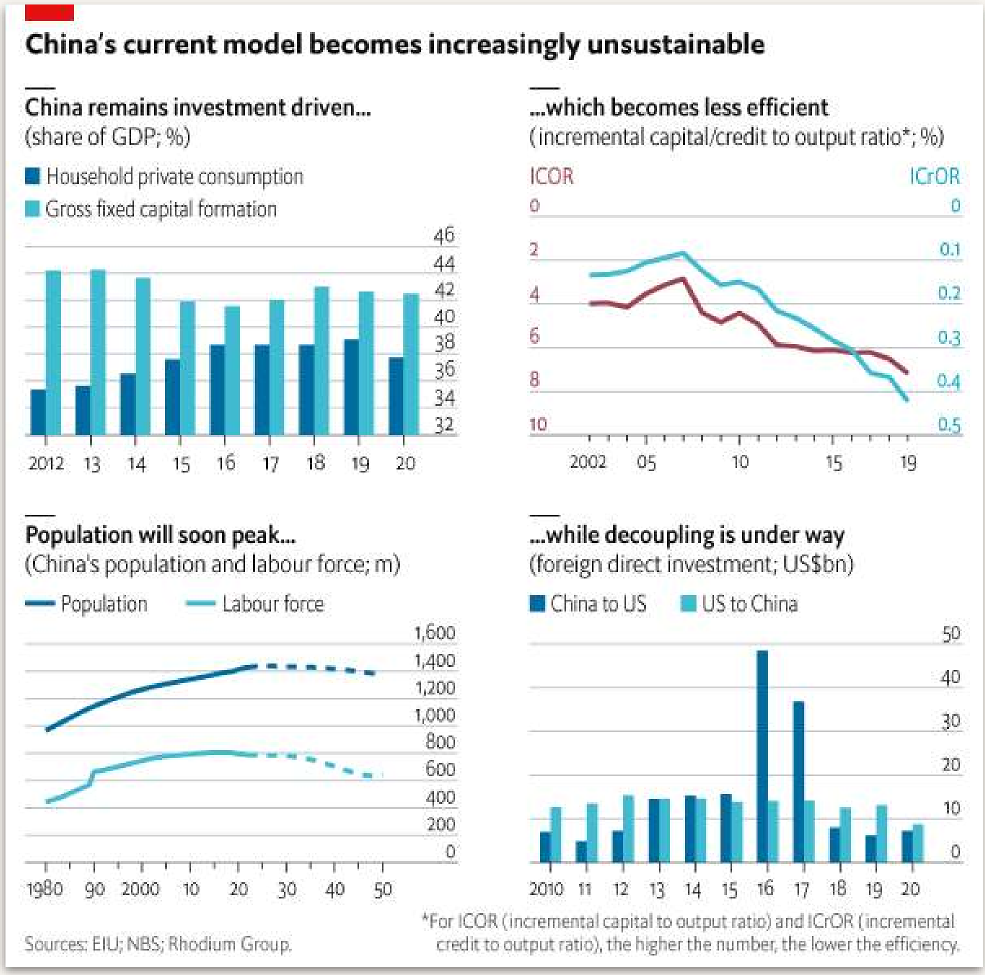
China's economic rebalancing is complicated



In search of self-sufficiency

Emphasis on domestic manufacturing and technology self-sufficiency could slow regional supply-chain integration, energy and food security a priority

Backtracking from over-construction

No longer relying on property sector to super-charge growth, property crisis will change sector, infrastructure investment will play a less important role in the economy to come

Investing in green

Even with energy security the focus over energy transition short-term, going green remains a long-term policy priority

Will a third Xi administration manage to undertake the reforms needed to address imbalances in China's economy? Or will preoccupation with pressing issues like mean that Mr Xi's administration could—once again—fall short of overdue reforms aimed at improving China's long-term competitiveness?

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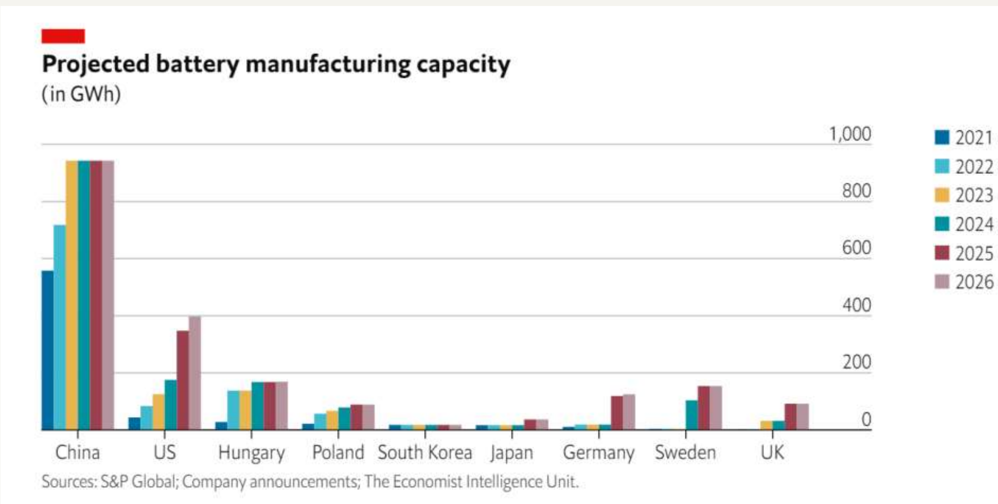
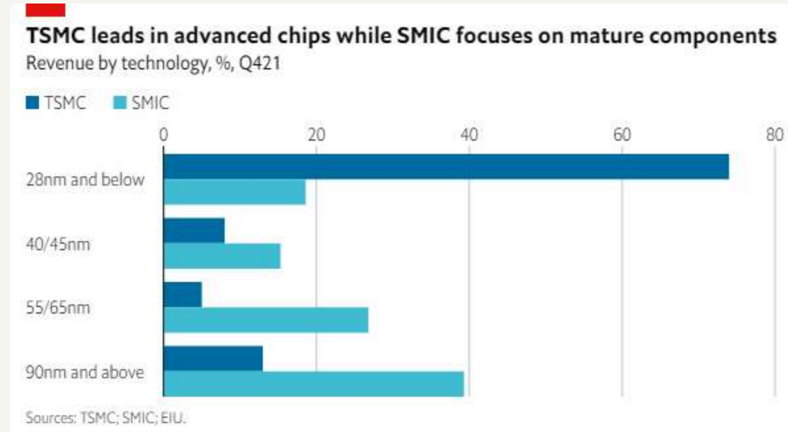
Sectoral landscape: winners vs losers

Winners will benefit from China's pro-industry model and selective industrial policy…

- *Green manufactures* (solar cells, inverters, EVs, energy storage solutions, etc.)
- *Defence* (arms, aerospace)
- *Advanced manufacturing* (machinery, chemicals, biomedicines)





…while **losers** will be affected by unfavourable developments/policies at home and abroad

- Semiconductors, with spillovers to other sectors
- Financial: the next target of common prosperity?
- Others: property, consumer goods

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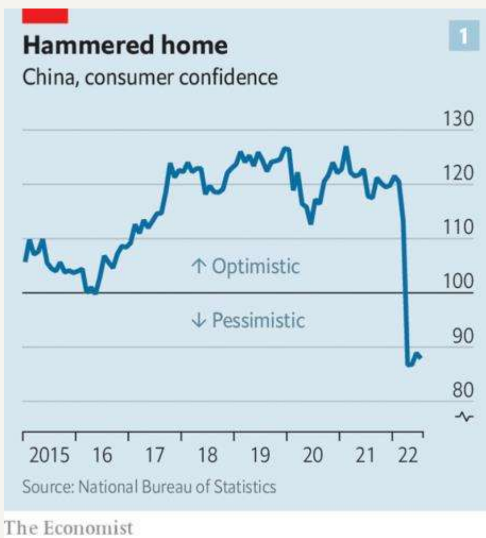
The spectre of long “zero-covid”

- Suggestions of “people first” hints at persistence with the “zero-covid” policy throughout 2023, possibly beyond
- China seems to set a high bar for relaxing covid-related controls (a sharp reduction in both transmissibility and virulence is a likely prerequisite)
- Avoid interpreting piecemeal relaxations (partial resumption of outbound tourism, shortened quarantine time) as signs of an imminent removal of “zero-covid”



What to expect in late 2022 and 2023

Policy tool	Potential developments
Mobility control	• Most measures, including the health code and mask mandate, will remain in place • Regularised covid-19 screening will be institutionalised • Cross-provincial travels will be made easier • Shanghai-style lockdown unlikely to be repeated
Quarantine facilities and makeshift hospitals	• Further construction of makeshift hospitals, alongside expansion of public health budget • Further relaxation of quarantine time for close contact of covid-19 cases, down to five days at government-run facilities
Border control	• Further relaxation of visa policy, including issuance of student visas and reduction of paperwork required • More international flights will be made available and relaxation of “circuit breaker” policy • Further relaxation of quarantine time for inbound overseas travellers, down to five days at government-run facilities
Vaccination milestone	• Rollout of mRNA vaccine

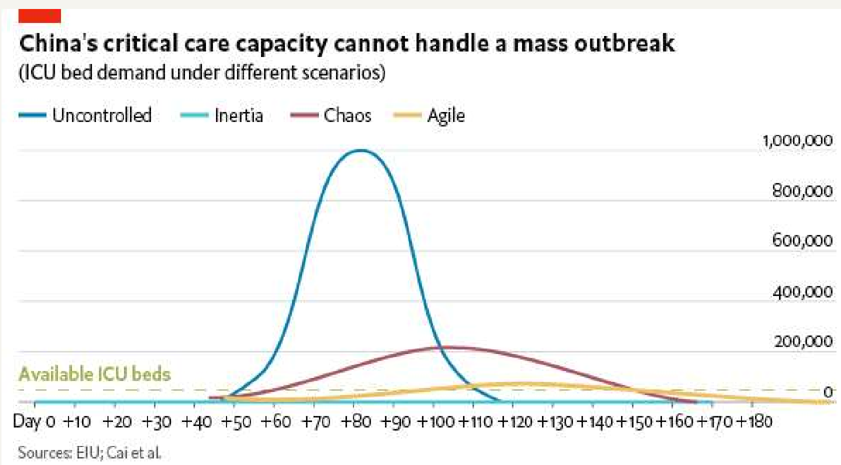
Source: EIU.

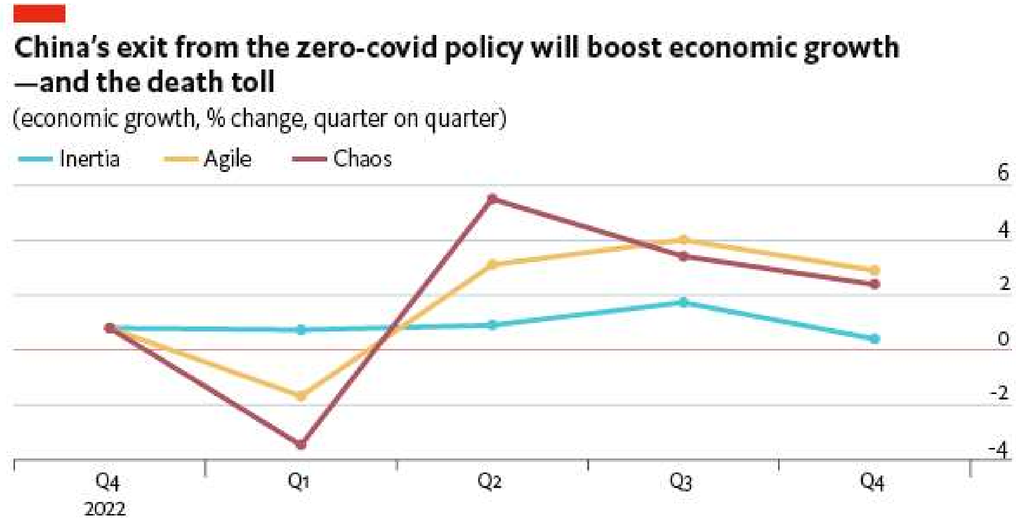
Scenarios for China’s zero-covid strategy in 2023

Inertia (baseline) – China's zero-covid policy will last well into 2023—and potentially beyond.

Chaotic end – There is a high risk that a large-scale, uncontrolled outbreak will occur in 2023, bringing an end to carefully choreographed plans.

Agile exit – Under this alternative scenario, China will accelerate the exit process in 2023. A change in propaganda messaging could bring this about.





(Economic and health consequences under different scenarios)

Scenario	Probability	Economic impact	Peak ICU bed occupancy	Death toll
— Uncontrolled*	N/A	N/A	1m (15.6 x capacity)	1.6m
— Inertia	50%	4.7% growth in 2023. Depressed economic vigour throughout 2023-24.	Below capacity	Lower than average annual influenza-related excess deaths (80,000)
— Chaos	35%	Boosting economic growth by about 0.5 percentage points in 2023 (to 5-5.5%), with momentum more consequential for 2024 and beyond. Heavy disruption followed by improvement in private consumption and investment, and stimulus.	190,000-220,000 (2.8 x capacity)	460,000-490,000
— Agile	15%	Boosting economic growth by about 1 percentage point in 2023 (to 5.5-6%), with momentum more consequential for 2024 and beyond. Disruption followed by recovery in confidence, boosting private consumption and investment.	60,000-90,000 (1.2 x capacity)	130,000-160,000

Source: EIU.

* For reference only

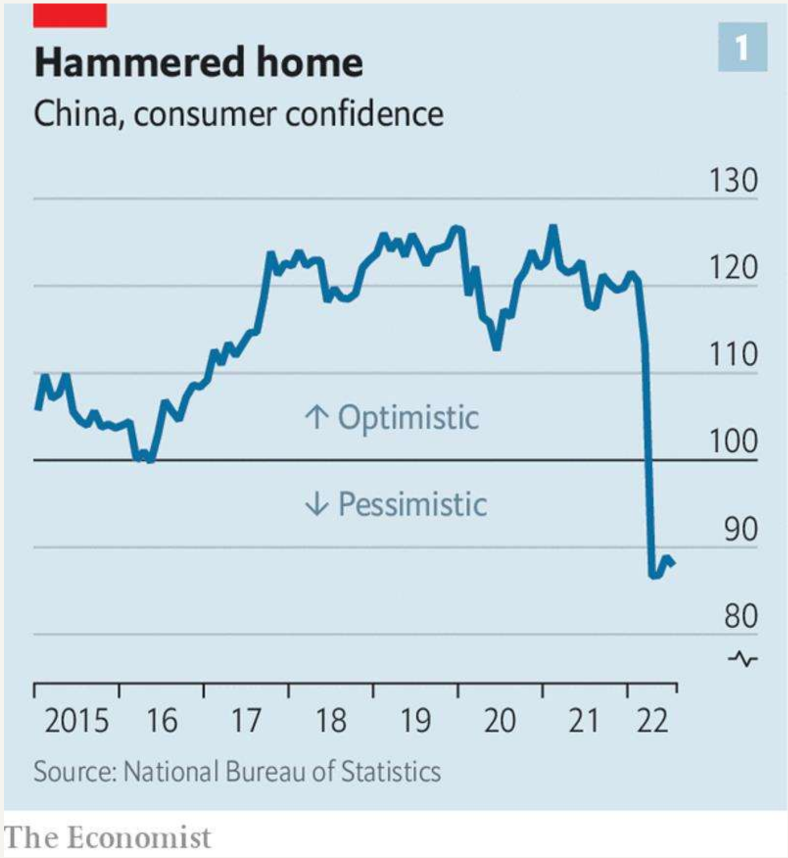
Property sector distress contributes to consumer, investor concerns

The property slump is **shaking overall confidence** in China's economic foundations. Developers have run out of cash, projects have stalled, home-buyers are boycotting mortgages.

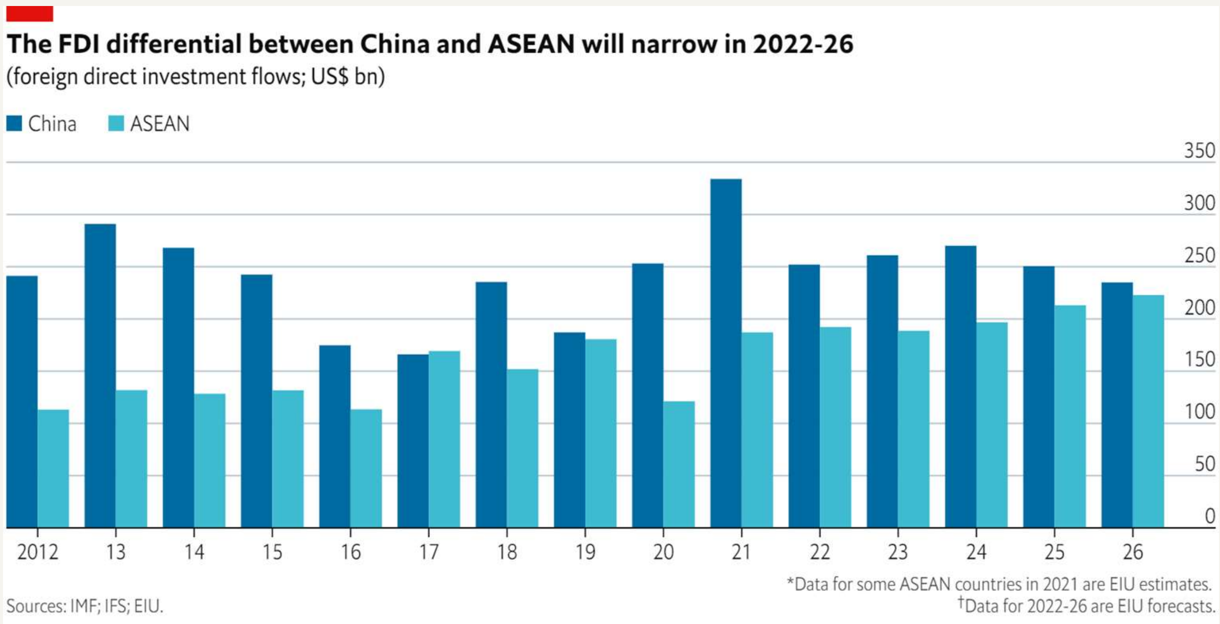
This poses a **challenge to consumer confidence, investor confidence, industry, local governments** (land sales contributed 43% of their revenues in 2021), and the country as a whole (the property sector previously accounted for over 25% of GDP and a remarkable 70% of household wealth is tied to real estate).

September data showed modest improvement (medium- and long-term household loans). **We still expect the stabilization in the property sector to be gradual and uneven.**

Will we now see more comprehensive action from Beijing?



Why should foreign investors in China care?



Political and diplomatic developments have important implications for supply chains and trade/investment links

- A direct invasion of Taiwan or the formation of a "cold war"-style bloc between China and Russia is not in our core view
- Tightening political controls domestically, including democratic values, will keep China on a collision course with the West
- FDI differential between China and ASEAN will narrow, as investors seek to diversify their risks
- Contingency plans for the likelihood of future trade and investment restrictions are a good idea!

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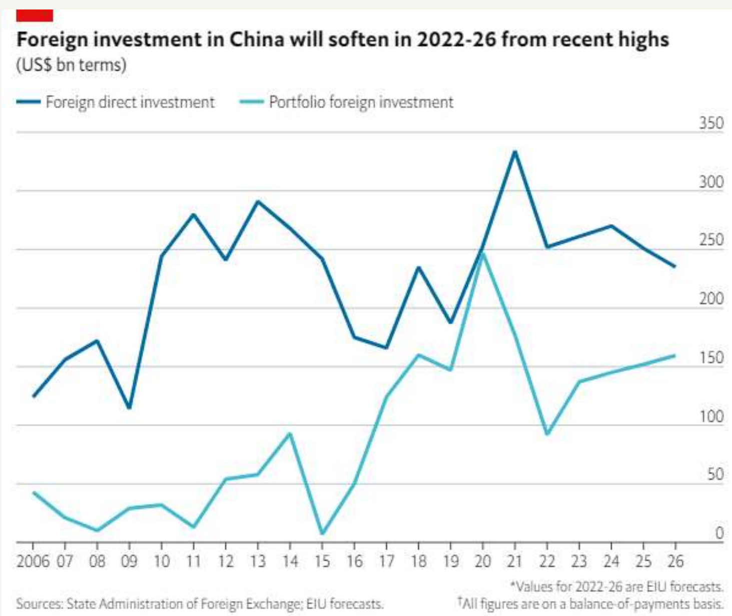
MNCs concerned, but not departing

We expect **a fallback in FDI inflows** for 2022-23. **China's FDI differential with ASEAN will narrow.**

We do not, however, anticipate a mass corporate exodus from China. The attractiveness and size of the consumer market and the centrality of China in global supply chains will make complete withdrawals difficult and costly. **Supply chain diversification and contingency planning now key boardroom themes.**



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China opportunities

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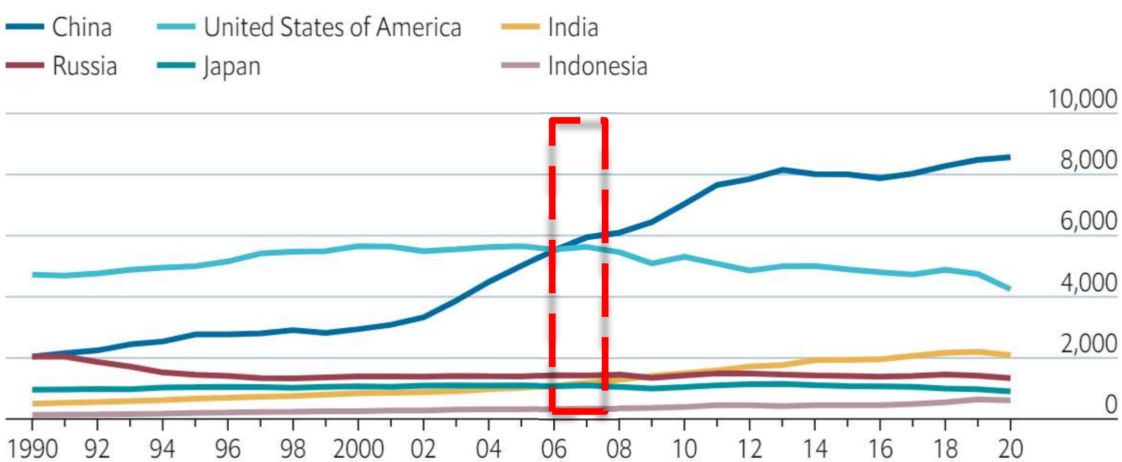
Carbon neutralisation is tough but necessary for China

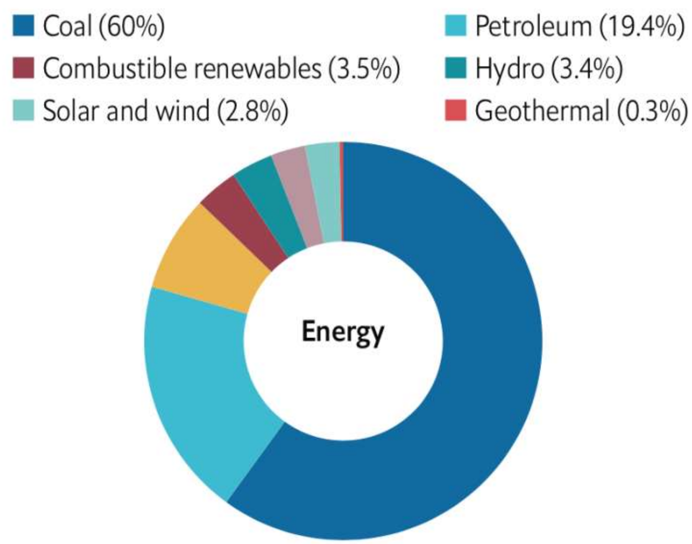
Total CO2 Emission from Fuel for Selected Countries:1990 - 2020

in millions of tons of CO2



Source: Economist Intelligence Unit, International Energy Agency.

China's Energy Consumption Mix in 2020



Source: Economist Intelligence Unit.

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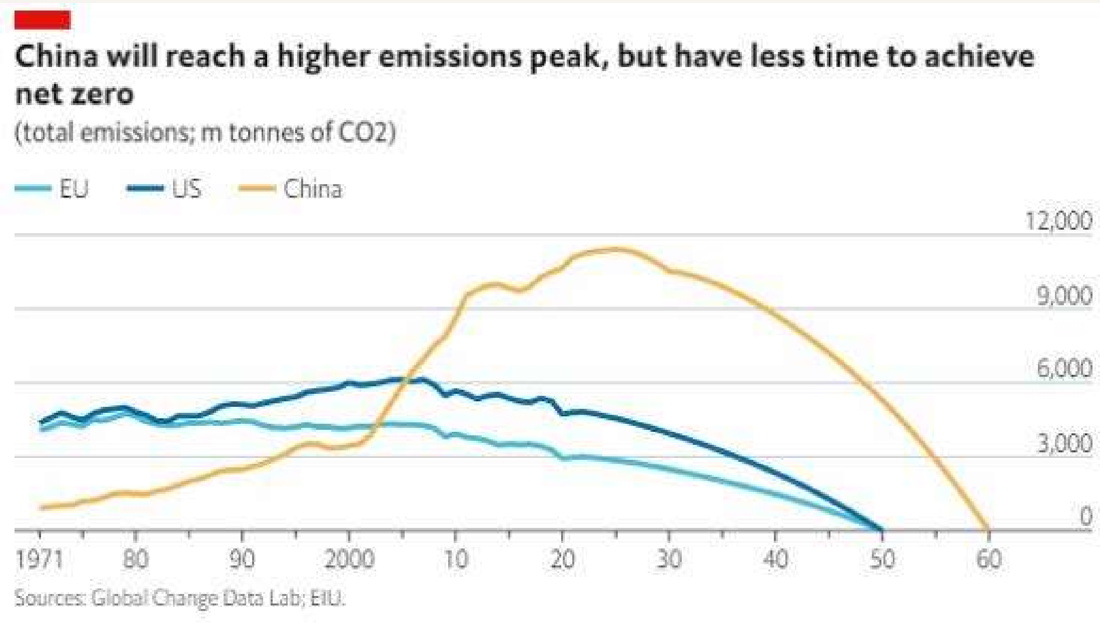
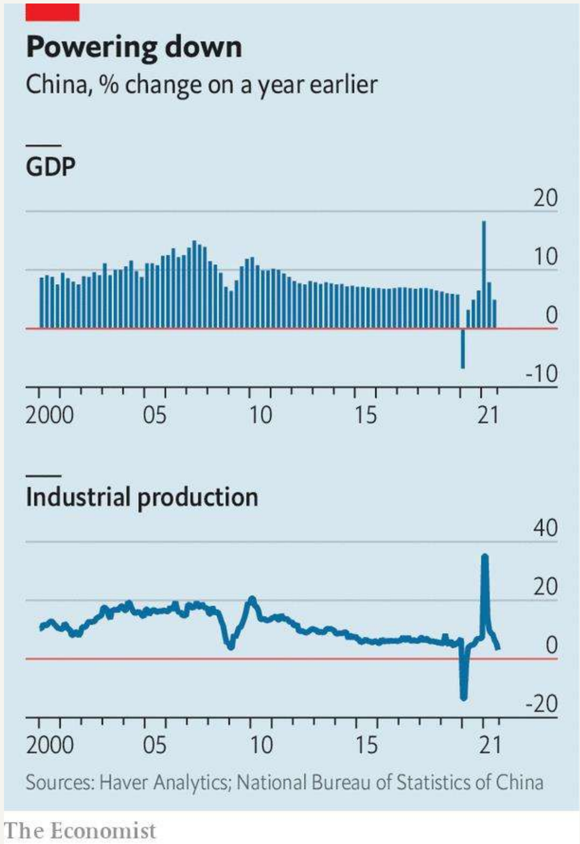
Balancing sustainability and growth is complicated

Peak carbon by 2030, carbon neutrality by 2060

Until recent crises, it was expected that China's total energy consumption will be flattened by 2027, even without further policy/regulation changes, so a 2030 peak was highly likely. That is now going to be more challenging and the greater challenge will be achieving carbon neutrality.





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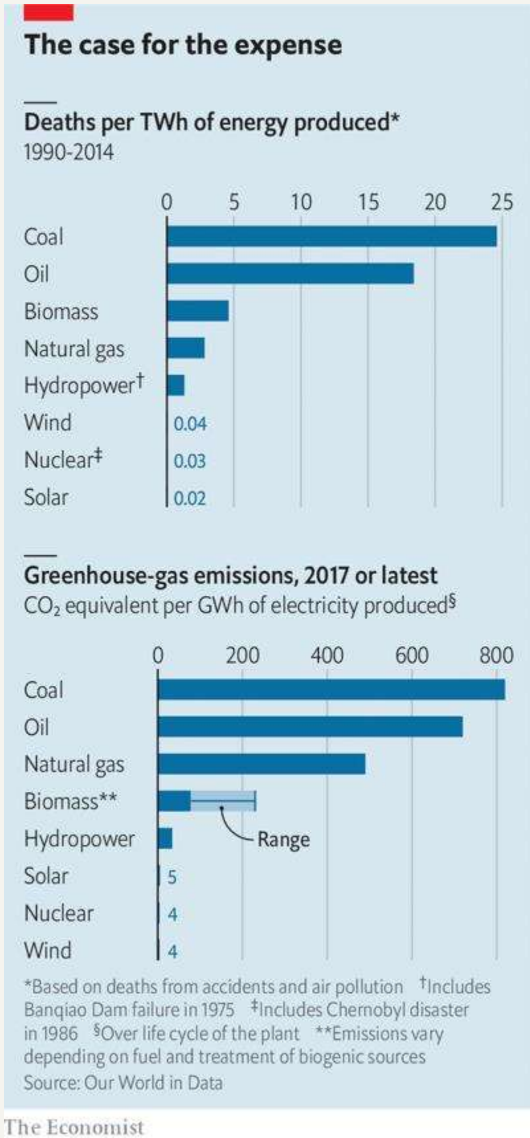
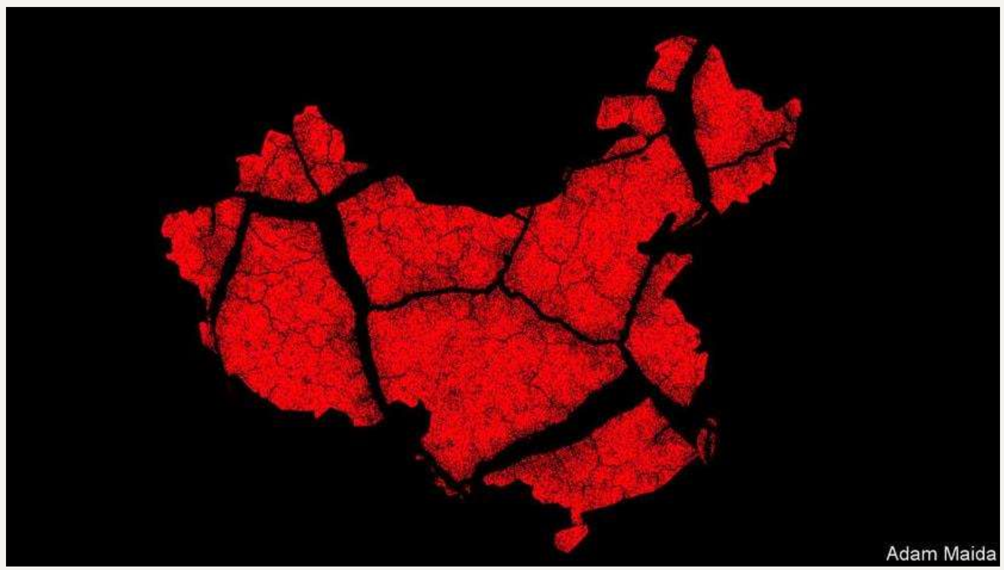


From energy transition to energy security

The shift in conversation is global, not unique to China.

China's shift away from coal has been stalled in light of recent energy challenges and slowing growth, even as climate-related threats to public and economic health continue rise.



The immediate pace of China's energy transition is slowing amid an energy crisis and a focus on energy security.

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Think central, act provincial / local

On 14 September 2022, China's Ministry of Ecology and Environment issued new guidelines to "all provinces", instructing them to start drafting their action plans for adapting to climate change "as soon as possible."

The importance of provinces in China's pursuit of its climate goals partially comes from the fact that they are the ones that turn general statements from the leadership into action.

The central government breaks down the national climate targets and allocates them among provinces. The targets include "legally binding" ones, such as the carbon peaking time, carbon-intensity reduction rate and energy-intensity reduction rate. They also include "non-binding" indicators, such as the total energy consumption and total carbon emissions. Some provinces might then assign climate tasks further down to the cities within their jurisdictions.

More instructive that the national plan, provincial climate change 14FYPs not only include detailed targets for CO2 emissions and energy consumption, but also lay out a series of local decarbonisation efforts, such as industry-based transition plans and support for provincial carbon emissions trading.

Innovation is at the top of China’s agenda

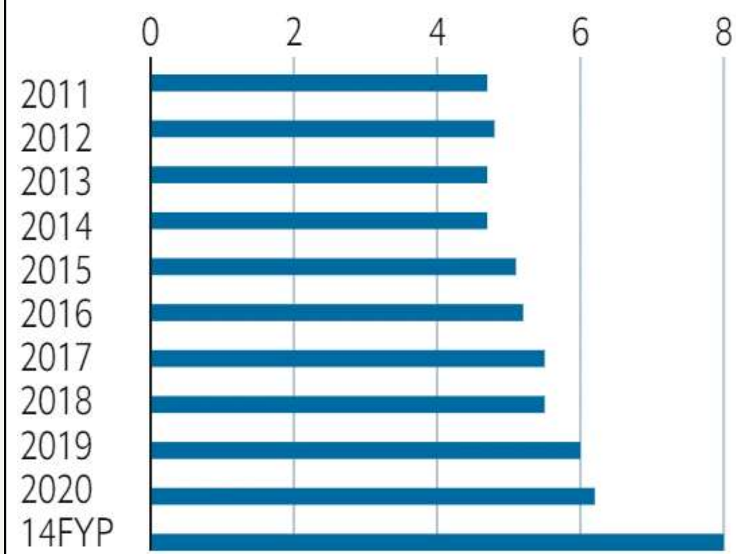
Selected economic development targets in the 14th Five-Year Plan

		12th five-year plan targets (2011-15)	Actual data 2011-15	13th five-year plan targets (2016-20)	Actual data 2016-2020	14th five-year plan targets (2021-25)
Economic Development	Annual average real GDP growth	7%	7.8%	>6.5%	5.5% (2016-2020)	
	Labor productivity		6.60%		2.5% (2020, estimation)	Higher than GDP growth
	Urbanisation rate	51.50%	56.1%	>60%		65%
Innovation	Annual average R&D spending growth					>7%; reach a higher share of GDP than in the 13th FYP period
	Number of high-value patents per 10,000 population				6.3 (2020)	12
	Digital economy (share of GDP)				7.8% (2020)	10%
Green development and ecology	Reduction in carbon emissions per unit of GDP	17%	20%	18%	18.3% (2020)	18%
	Reduction in energy consumption per unit of GDP	16%	18.2%	15%	13.7% (2020)	13.5%
	Days of good air quality		76.7%	81%	87% (2020)	87.5%
	Class III or above surface water (share of total)		66.0%	70%	83.4% (2020)	85.0%
	Forest coverage (share of total land area)	21.66%	21.7%	23%	23.2% (2019)	24.10%
Security	Grain production (m tons per year)		660		670 (2020)	>650
	Energy Production (m tons of standard coal equivalent per year)					>4600

Note: This is not an exhaustive list.

Sources: Xinhua News Agency; The Economist Intelligence Unit.

China’s share of basic research in R&D expenditure (%)



Source: EIU

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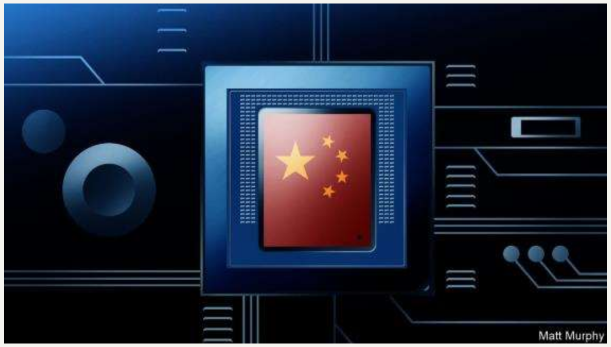
Strengthening domestic resilience through innovation

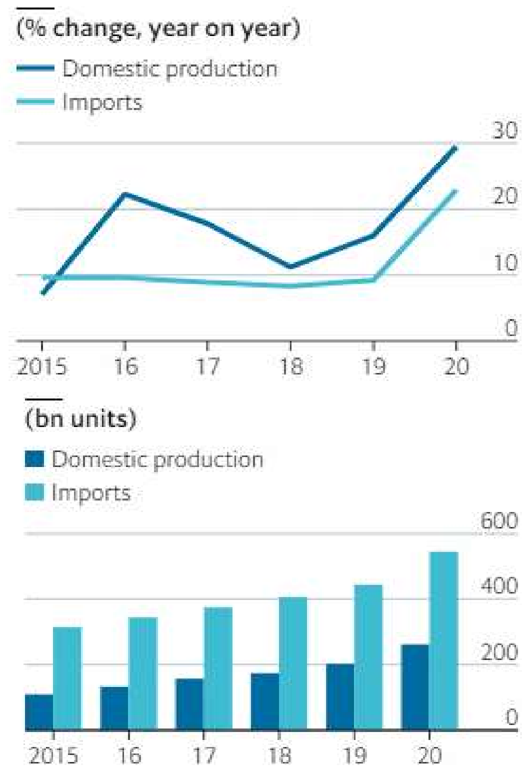
Move fast and regulate things

Despite last year's "techlash", China is looking to innovation, especially in critical technologies as part of its focus on national security and quest for self sufficiency.

China is pushing these new national champions and others to innovate in areas aligned with national priorities, including: AI, quantum computing, hydrogen, ICs, etc.



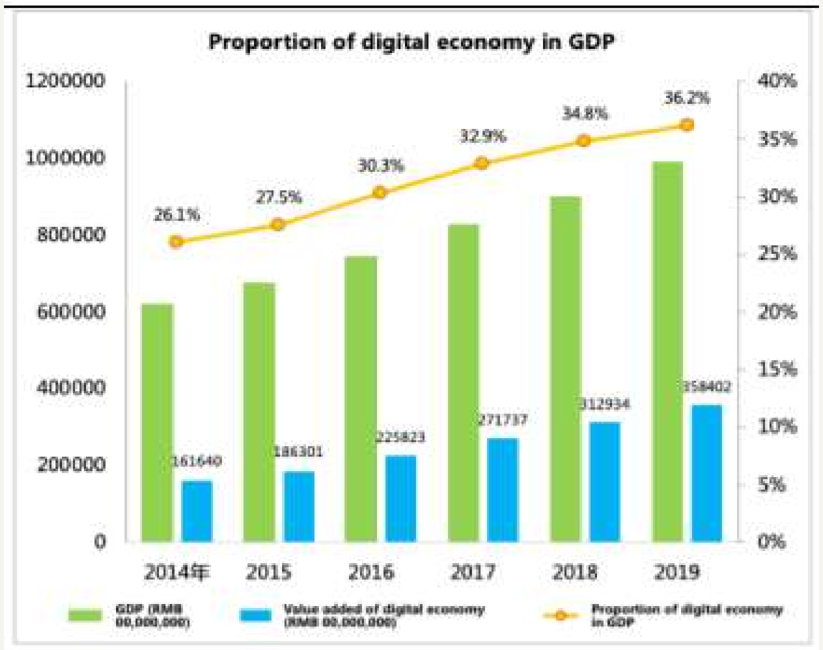
China's reliance on imported ICs remains high, despite growth in domestic production

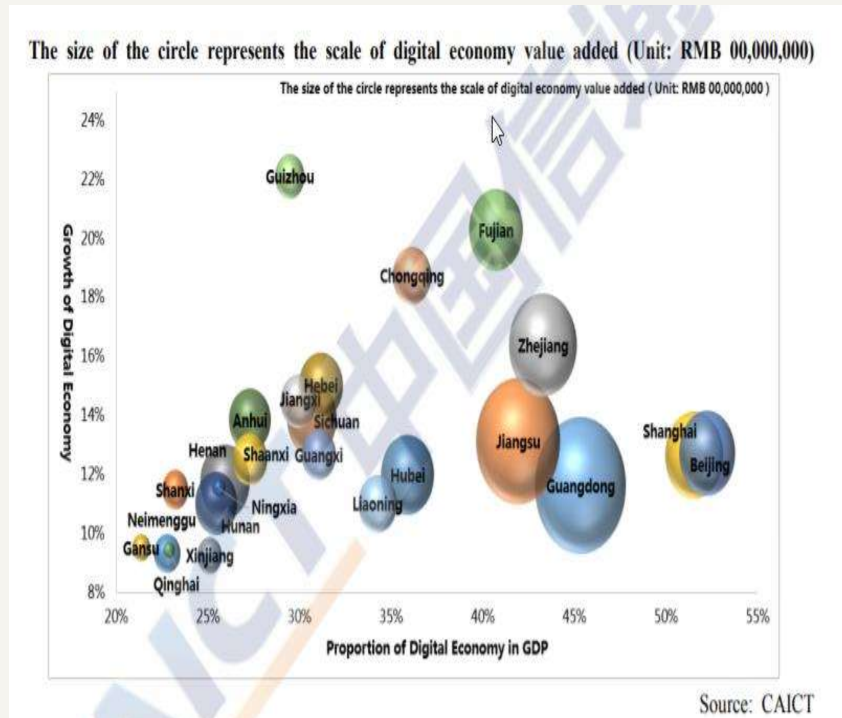


Source: EIU

China is turning to a digital economy to drive quality growth

The digital economy is still concentrated in Tier 1 and 2 cities, and predominantly in manufacturing clusters; China's goal is to raise the proportion of the added value of core digital economy industries in its GDP to 10% in 2025, up from 7.8% in 2020.





New geography of global business

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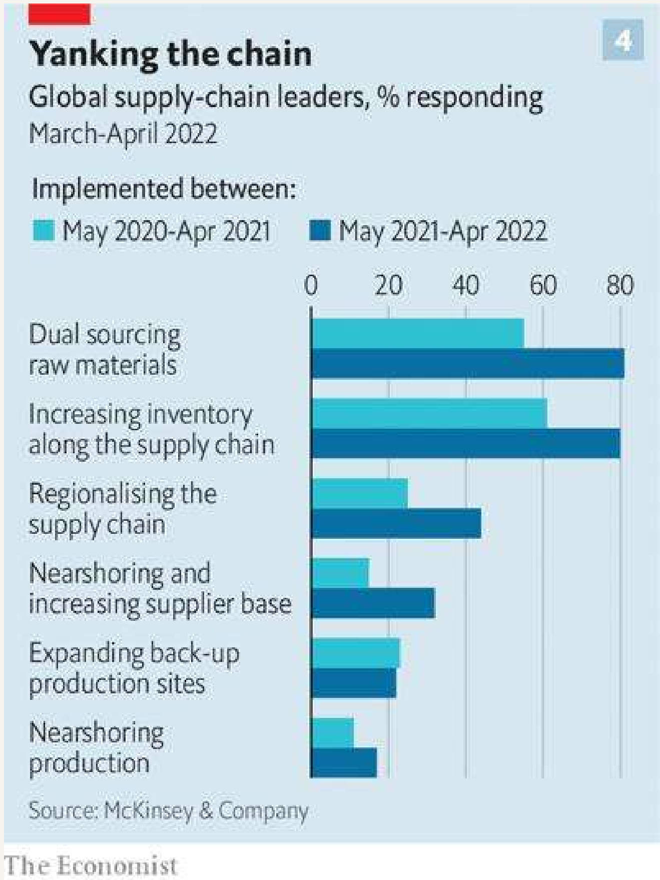
Supply chain general trends – rhetoric v reality

While "reshoring" in the rich world is minimal, what happens off which shores is changing, as companies come to their own conclusions as to whether the risk of trying a new model exceeds the risk of sticking with the old.

81% of supply-chain leaders are now sourcing raw materials from two suppliers, rather than depending on merely one.

Companies are also building up inventories—half-finished or finished products, left in reserve, which can be sold if demand suddenly ramps up or if fresh supply fails. This has big costs in terms of tying up money.

The fact that industries are bearing those costs shows that they fear supply problems more than they used to. They may be paying for time to weigh their options and see how others respond before taking hard-to-reverse decisions such as moving plants or people. Some may think that larger inventories are a necessary response to supply-chain risks in perpetuity.



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Supply chain diversification is back as a boardroom theme

Some Asian economies will benefit more quickly from supply chain shifts than others

(score out of 10 in The EIU's Business Environment Rankings)

Country	Political effectiveness	Macroeconomic environment	Market opportunities	FDI policy	Foreign trade & exchange controls	Labour market	Infrastructure	Technological readiness
Singapore	9.0	7.8	6.0	10.0	10.0	7.6	9.0	9.2
Taiwan	7.8	8.6	6.5	8.2	9.1	6.9	8.0	9.2
Japan	8.1	6.6	6.4	6.9	9.6	6.9	8.3	9.2
South Korea	8.1	8	7	6.4	8.7	6.4	7.8	9.2
Malaysia	6.1	7.5	7.2	7.8	8.7	6.9	7.0	7.8
Thailand	5.5	7.2	6.7	6.9	8.2	6.5	6.0	7.2
China	4.9	6.9	7.8	5.5	6.9	6.3	7.3	8.9
Indonesia	4.5	6.6	7.2	6.0	7.8	6.4	5.3	5.8
India	4.9	6.3	6.9	6.0	7.3	6.3	5.5	6.1
Vietnam	4.9	7.2	6.6	6.0	8.2	6.3	4.5	5.5
Philippines	4.2	6.6	6	6.9	7.3	6.5	4.5	5.8
Bangladesh	4.2	6.3	6.2	5.1	6.0	5.7	4.3	3.3
Sri Lanka	3.9	4.1	4.4	6.0	6.0	6.4	4.5	4.7
Pakistan	3.6	4.4	5.5	6.0	5.1	5.1	4.3	2.4

Key: ≥9 ≤8.9 but ≥7 ≤6.9 but ≥6 ≤5.9, but ≥5 ≤4.9

Note: Score categories are non-exhaustive, and cover the forecast period of 2022-26; up to date as at Q2 2022.
Source: EIU Business Environment Rankings.

Are companies really quitting the Chinese market? And is Southeast Asia winning?

No mass corporate exodus from China.

More "both/and" than "either/or" approach to risk resilience

The market opportunities and infrastructure quality in China will support its continued attractiveness in the long run. So China cannot be easily replaced.

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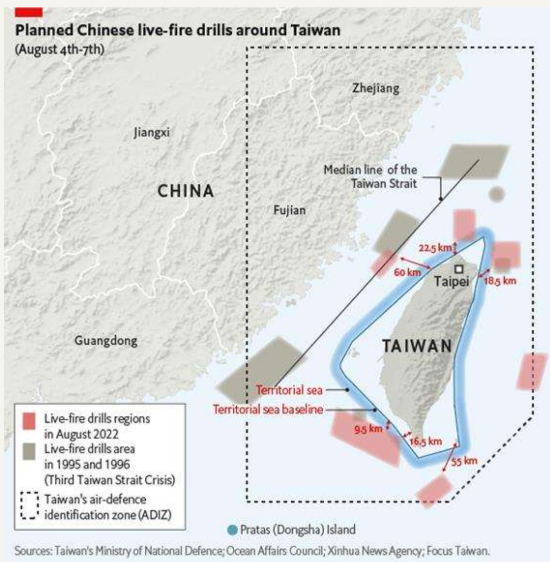
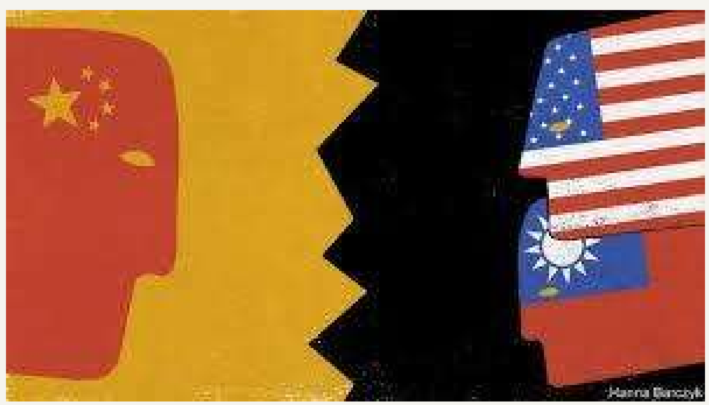
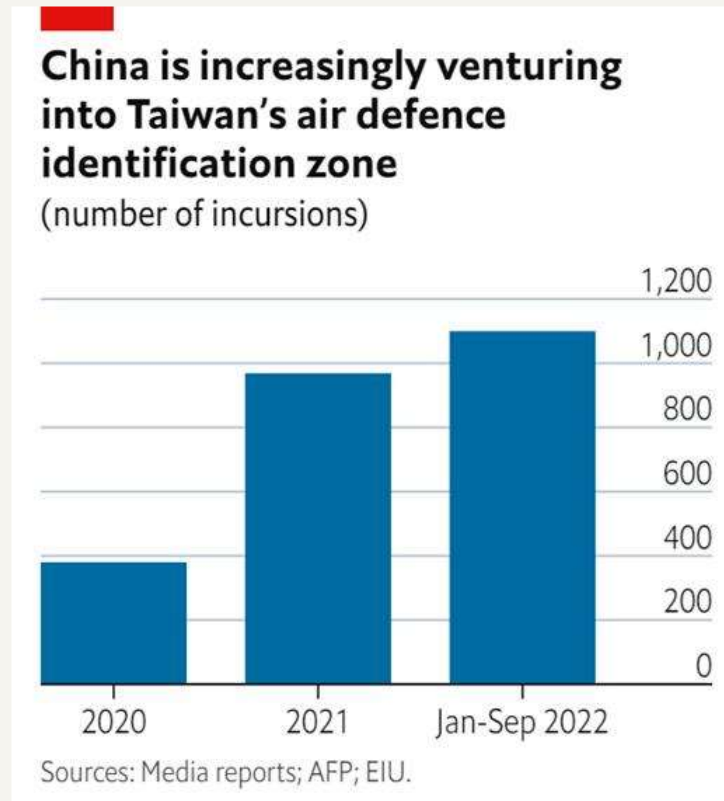
Taiwan remains a focal point for US-China tensions

- A direct invasion of Taiwan remains unlikely; neither side wants conflict
- The risk of an ***unintended conflict*** could be the trigger point for a wider conflict
- Enhanced Chinese harassment of Taiwan will lift this probability; every time China conducts a military operation, Taiwanese forces scramble in response
- **Elections in Taiwan may be a trigger**; also elections US – November 2022 (midterms) and January 2024 (presidential and legislative)







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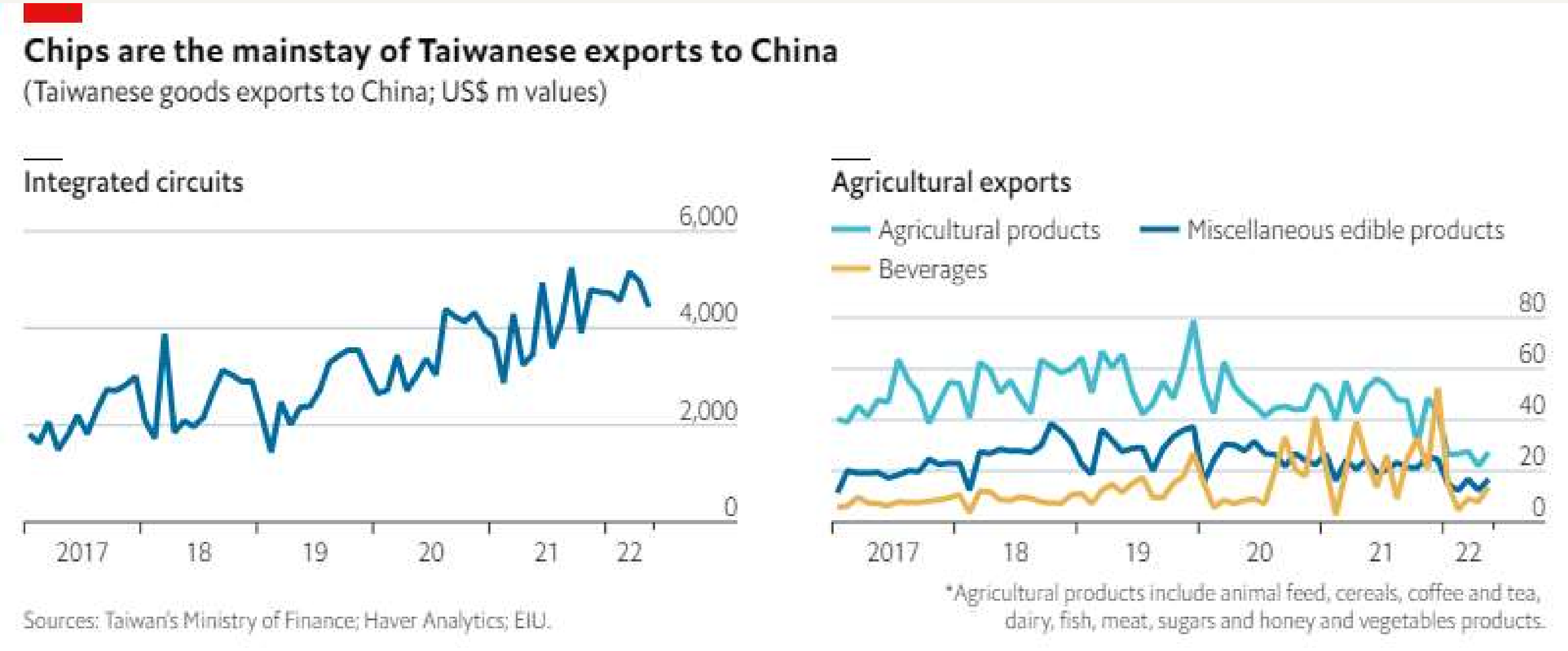
What's TSMC got to do with it?



TSMC, the world's most valuable chipmaker, etches 84% of the most advanced chips. Halting production at TSMC would bring the global electronics industry to a standstill, at incalculable cost. The firm's technology and expertise are a decade ahead of its rivals. Neither the US nor China can hope to catch up any time soon.

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Geo-economic deterrence – business in the middle

Some in Washington are encouraging the US to create credible "geoeconomic deterrence", as well as to shore up the military kind. This would involved the US and allies making clear that China will be expelled from dollar-based financial and trading systems if it attacks Taiwan. China observed keenly the ferocious sanctions imposed on Russia for invading Ukraine and the weaponisation of SWIFT.

So long as China and Russia share a belief that they cannot be secure in a US-led system, they will continue to deepen their cooperation. In the months since the invasion of Ukraine, they have carried out joint military activities and worked to develop alternatives to the US-controlled financial system.

What to watch:
- Efforts at influence, alliances, blocs
- Diverging tech, standars
- Work to develop alternatives to US-controlled financial system

Ultimately, Chinese-Russian relations will be shaped by how Beijing weighs its need to resist the United States against its need to preserve ties to international capital and technology that foster growth.

For MNCs with global operations, these are challenging times.

Ideological rule and implications for business

- The business community is concerned about **a harder shift to ideological, as opposed to pragmatic, rule.**
- **Bolder policy innovations can only come (or appear to come) from the centre.** This stifles more creative or responsive policy choices at the local level and instead encourages tightly taking cues from Beijing.
- **Economic nationalism** is an animating force encouraging local governments, SOEs, and even private businesses and consumers to buy Chinese. This poses additional challenges for foreign businesses.
- We may see a move away from the focus on GDP growth. Perhaps bolder economic and foreign policy initiatives, including efforts to develop alternatives to the US-controlled financial system.
- MNCs assessing how to define being **"In China for China"** in the new era

It seems clear that politics and security come above economics in Mr Xi's administrative hierarchy. A third term secured, might Mr Xi recover his pragmatic touch? A return to pragmatism and predictability in the Chinese market would be welcomed by business.

Brave new 2022 continues – geopolitical tensions and business challenges

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Any questions?

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