

Tokyo's China “De-Risking”

BY RICHARD KATZ

*Japan's pull-back is
not just because of
China's slowdown.*

Step by step, American, European, and Japanese companies are implementing a “de-risking” policy toward China. This goes beyond the normal pullback due to China’s economic slowdown.

Some de-risking is a response to China’s geopolitical actions, including seizures of islands belonging to other countries. Also taking its toll are years of corporate espionage, requirements that foreign companies transfer technology to Chinese firms, and discrimination in procurement.

More recently, tensions have been exacerbated by police raids on foreign companies and arrests of foreign nationals, including seventeen Japanese so far. Many are charged with espionage where the definition of the latter is unspecified in a new, harsher version of the law.

And not least, the U.S.-China Business Council noted that certain state-owned enterprises involved in joint ventures had pressured some of their foreign partners “to allow critical matters to be approved by the [Communist] party organization before they are presented to the board.”

Responding via complete “decoupling”—a Donald Trump term implying a huge reduction in economic interaction—would mean absolute disaster for all. In the worst case, says the

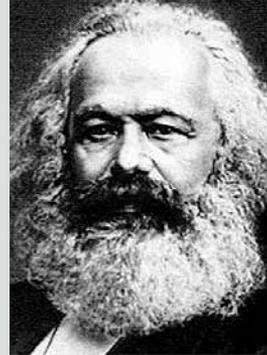
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A Terrible Marxist

China's President Xi Jinping may be a good Maoist, but he's a terrible Marxist. Mao famously declared, "Power grows out of the barrel of a gun." Karl Marx would have pointed out that someone must pay for and build that gun. In China, foreign companies are a big part of that "someone." Yet Beijing is alienating them.

—R. Katz



Karl Marx



Xi Jinping

International Monetary Fund, global GDP could drop by 7 percent—double the drop from Covid-19. None of the players, including Beijing, wants to see that.

And yet, governments are less inclined to tolerate China's behavior than they were when business was

of every five will redirect some investments originally planned for China to other countries. European firms are acting similarly. A 2022 government survey reports that only a third of Japanese companies will expand their operations in China in the next few years. Foreign direct investment into China from all countries plunged by 8 percent in the first eight months of this year.

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booming. So the midway course is what the Europeans call "de-risking," a term now adopted by Washington. That means maintaining basic interdependence but cutting China off from certain key technologies, diversifying sources of critical minerals and products, and lessening risks to foreign firms.

A fifth of American companies in China will reduce their presence in the coming few years, according to the American Chamber of Commerce in Shanghai. Two

DRIVING AWAY THE GEESE THAT LAID THE GOLDEN EGGS

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China still needs technology from overseas, despite its visions of technological independence. Beijing's Made in China 2025 plan calls for the country to become largely self-sufficient and globally competitive in ten advanced manufacturing sectors, including commercial aircraft, robotics, 5G mobile phone communications, and computer microchips. The effort is falling short.

Xi "may believe that the Chinese market is so large that foreign companies will keep on producing there," no matter how he treats them, Scott Kennedy of the Center for Strategic and International Studies told me. Chinese sources told me that Xi often declines to hear from those warning of the cost of his policies.

Half of all international trade these days consists of many companies in many countries playing their role in a global supply chain for any given product. China is just one of forty-three countries involved in making Apple's iPhone. Having become dependent on this system, China cannot turn back time without doing itself grave damage.

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Xi can have an excessively authoritarian, ideological, and internationally bellicose state or he can have a healthy economy, but not both.

CHINA STILL NEEDS JOINT VENTURES

No matter how rich, all countries grow better with more well-managed foreign direct investment and international trade. At its level of development, China needs them even more.

What makes foreign direct investment so powerful is its spillover effects. In joint ventures in China, the presence of a foreign partner raised not only a company's own productivity, but also that of its suppliers, and even unrelated firms in the same industry. Partnering with American firms provides twice as much productivity gain, mainly because of America's lead in getting the most economic benefit from new technology.

When China joined the World Trade Organization in 2000, it had to loosen its requirements that foreign firms invest primarily through joint ventures. So firms quickly switched to 100 percent foreign ownership. It turns out that the looser the joint venture rule in any industry, the bigger the productivity gains. That's because, once

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foreign firms felt more able to protect their intellectual property, they upped their activities, automatically leading to more spillover effects.

As European companies recently warned, Xi's actions reduce China's access to such benefits. In response to corporate espionage, a stunning three-quarters of European companies have segregated Chinese operations from those at global headquarters, while 16 percent no longer employ any non-Chinese.

All this comes at a time when problems at home make the efficiency benefits of foreign direct investment

Socialism with Japanese and Singaporean Characteristics

If not for the advice that Chinese leader Deng Xiaoping sought, and received, from Japan and Singapore, China's economic miracle would have been a lot less miraculous.

When Mao Zedong died in 1976, he left China with the second-lowest per capita GDP among 140 countries. Deng called for "reform and opening up" to foreign countries, but how to translate that into concrete policies? In 1978, he invited one of the chief architects of Japan's economic miracle, Saburo Okita, to become China's first official foreign economic advisor.



Deng's team learned how to use a combination of Japan-style industrial policy and export-led growth to

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achieve rapid modernization, without the white elephants seen elsewhere. Private enterprises increasingly supplanted inefficient state-owned ones and, as measured by return on assets, they were five times as efficient.

Foreign countries had to provide much of the market since China's people were too poor to buy what modern factories could make. But how could backward China make products good enough to compete? Singapore provided the model: inviting foreign companies to produce on Chinese soil. Amazingly, Deng convinced Communists to accept what came to be called market-Leninism.

By 1996, a third of factory output was exported. The higher the technological content of a product, the more likely it was made and exported by a foreign company, for example, 40 percent for clothing versus 100 percent for digital products. Just by being in China, foreign firms automatically raised Chinese know-how.

Today, however, President Xi Jinping is reducing the role of both foreign firms and Chinese private firms while resurrecting the state-owned enterprises. There is a price to be paid.

—R. Katz

and trade even more pivotal. China is suffering both a fall in the size of its labor force and limits to investment growth. Consequently, its overall growth in GDP per worker depends on total factor productivity—how much growth in GDP a country gets for every 1 percent growth in capital and labor inputs. Annual total factor productivity growth has plunged from 3.1 percent per year in the past to only 1.1 percent during 2010–2019, the Xi era. Consequently, by 2028, says the International Monetary Fund, per capita growth will fall below 4 percent.

XI'S "DUAL CIRCULATION" CAMPAIGN

Nonetheless, Xi is pressing on with a policy Beijing calls “dual circulation.” One facet is to increase domestic demand so as to be less dependent on exports. This is, of course, impossible as long as wages keep being suppressed. Beijing would argue that Donald Trump’s unilateral tariffs, such as 25 percent on autos, and the continuation of all of them by President Biden, make it necessary to reduce its vulnerability.

Another facet is giving financial rewards to companies that replace foreign technology with domestic. Even before Xi’s ascension, foreign companies complained about discrimination in procurement. Under Xi,

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discrimination and cyber-spying have greatly worsened. Many foreign executives have even stopped bringing cell phones into, or out of, China. From time to time, various Chinese government bodies concerned with economic policy promise to fix these problems, but usually fail to do so. Security-oriented leaders insist that China needs to bolster its economic independence.

China’s nationalistic actions and others’ de-risking will each reinforce the other. Beware the law of unintended consequences. ◆