



2023 Outlook: China

Presentation

May 2023

Build strategy and manage risk through the lens of geopolitics and macroeconomics.

Understand the forces shaping the future of your organization

Assess their economic impact

Separate noise from signal

Find better options



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Executive summary

China's economy faces a bumpy recovery

- China's **economic recovery will be bumpy** given its hasty exit from zero-COVID. Beijing's stimulus, vaccination, and property sector policies will determine the extent and pace of economic growth for this year
- Beijing's **strategy to drive growth through consumption will be limited** by the reality of tight local government finances and lingering headwinds
- Instead, local governments will face pressure **to revert to traditional drivers of growth** that are unsustainable

New leadership to manage long-term vulnerabilities

- China's domestic policy priorities of **tech self-sufficiency and raising productivity remain the same** with a new Politburo Standing Committee in power
- Officials aim to reform industrial funds to improve market allocation and hasten labor and productivity reforms
- However, existing **demographic challenges and fiscal obstacles will limit the effectiveness** of these policy interventions

China struggles to limit decline in relationship with the West

- **Decline in US-China relations inbuilt into 2023**, providing momentum for more US restrictions on China
- Beijing has **few viable policy responses** to existing and incoming restrictions
- China will struggle to improve ties with the EU due to its economic support for Russia and unfulfilled investment commitments, **precluding a revival of the CAI** investment deal

China pivots to Southeast Asia and LATAM

- Given the downturn in ties with the West, China will focus on **deepening relations with LATAM to secure new markets** but Chinese state lending unlikely to reach 2010s levels
- Trade and FDI in ASEAN will **remain on upward trajectory**, although South China Sea tensions will drive trust deficit
- China will seek to expand trade with these two regions through major trade deals like RCEP and CPTPP, but China's progress in trade with RCEP partners is uneven and its CPTPP bid is unlikely

China maintains pragmatic ties with India and Russia

- India will likely impose barriers to trade with China this year in view of a growing trade deficit, but India's **reliance on China for intermediates will limit the pace of decoupling**
- **Russian dependence on China is expected to grow** given that sweeping sanctions has made China the dominant import partner for Russia and a key destination for Russia's mineral fuel exports

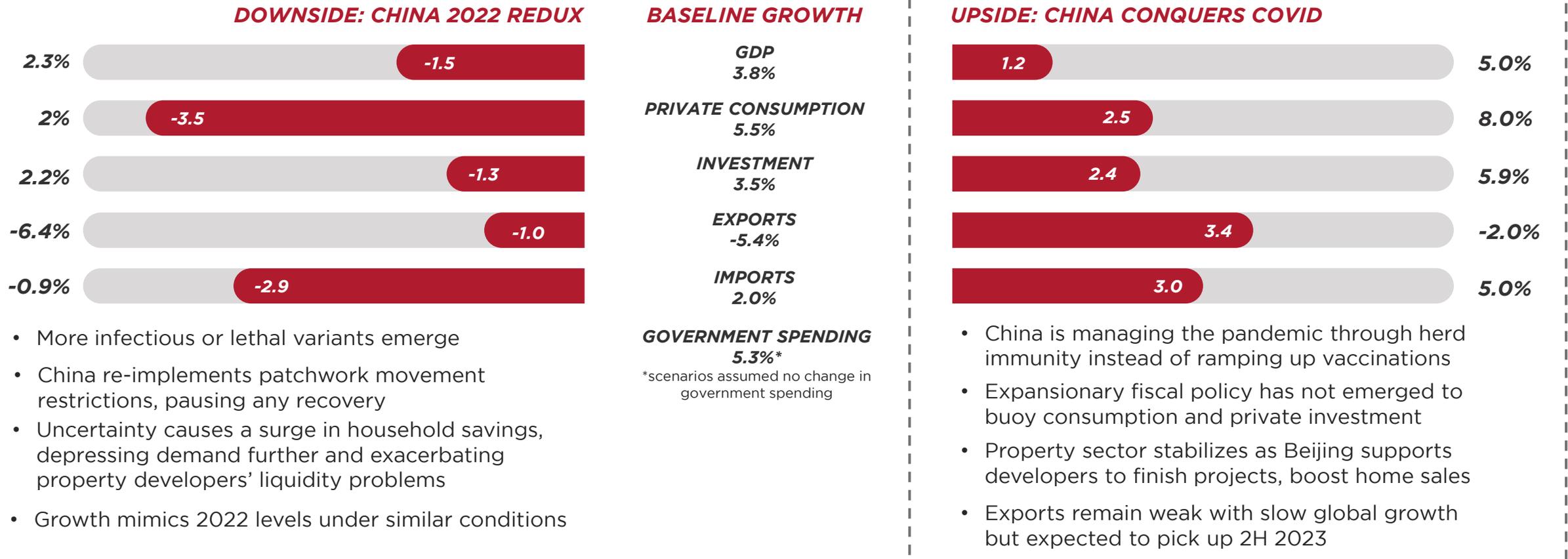
SECTION I

China's economy faces a bumpy recovery

Growth is trending to our upside case

Q1 GDP suggests annual growth will hit 5%

GROWTH COMPARED TO BASE CASE
percentage point difference from base case



- More infectious or lethal variants emerge
- China re-implements patchwork movement restrictions, pausing any recovery
- Uncertainty causes a surge in household savings, depressing demand further and exacerbating property developers' liquidity problems
- Growth mimics 2022 levels under similar conditions

- China is managing the pandemic through herd immunity instead of ramping up vaccinations
- Expansionary fiscal policy has not emerged to buoy consumption and private investment
- Property sector stabilizes as Beijing supports developers to finish projects, boost home sales
- Exports remain weak with slow global growth but expected to pick up 2H 2023

China's economy is off to a good start

But many headwinds remain

BASELINE: 5.0% GDP GROWTH, BELOW CONSENSUS

CONSUMPTION

- Consumption has **recovered more rapidly** than expected
- However, further growth will be limited by **excess savings, the property sector downturn** that strains household balance sheets, and high household debt levels.

INVESTMENT

- **Real estate investment growth will remain weak** as Beijing maintains lending caps on some developers and limited easing measures fail to raise home sales
- Although, **public infrastructure investment** will be a growth driver with policy support from Beijing

GOVERNMENT SPENDING

- China will **maintain prudent monetary policy** and credit growth to support what Beijing considers a natural rebound in the economy
- Therefore, Beijing is also **unlikely to unleash large scale financial stimulus** due to debt concerns in local governments

NET EXPORTS

- Softening global demand in 2023 will result in **weak export orders**, capping a major growth driver for China
- Potential **US trade restrictions** on China remain a wild card in capping China's exports

Main strategy to drive growth faces difficulties

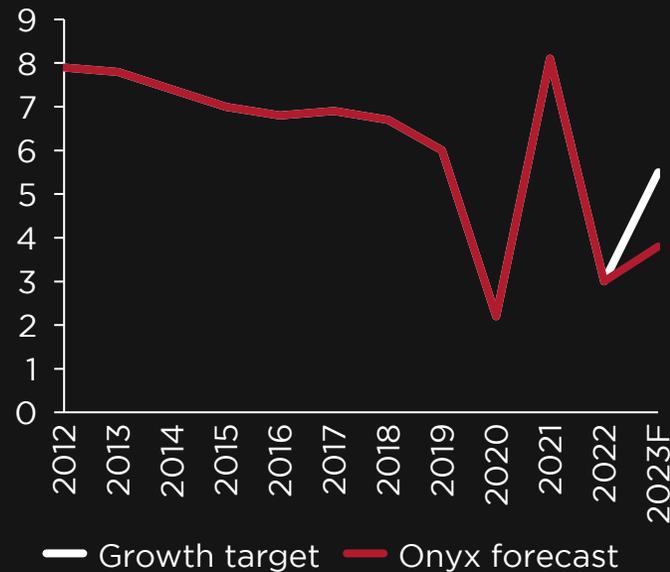
Historical and short-term factors limit rise in private consumption

Return to growth *through private consumption* is a top priority in 2023...

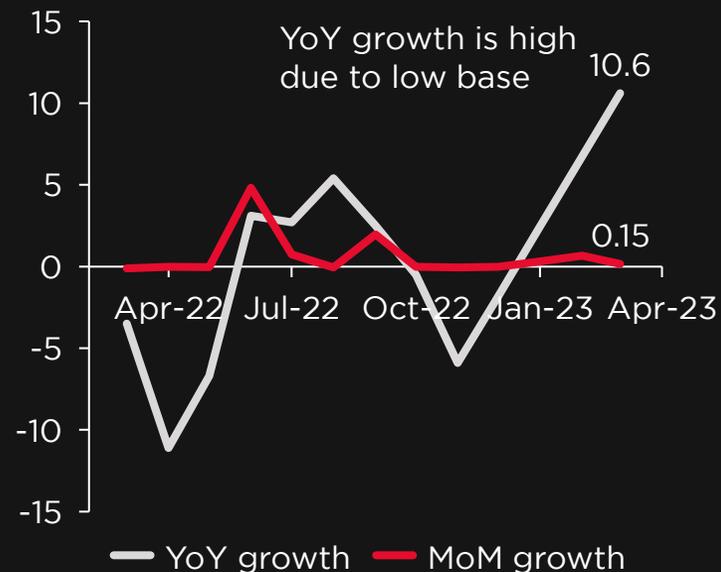
... and consumer confidence has *picked up in Q1*...

... but there is a heavy structural economic bias *in favor of savings, investment, and exports* at expense of consumption

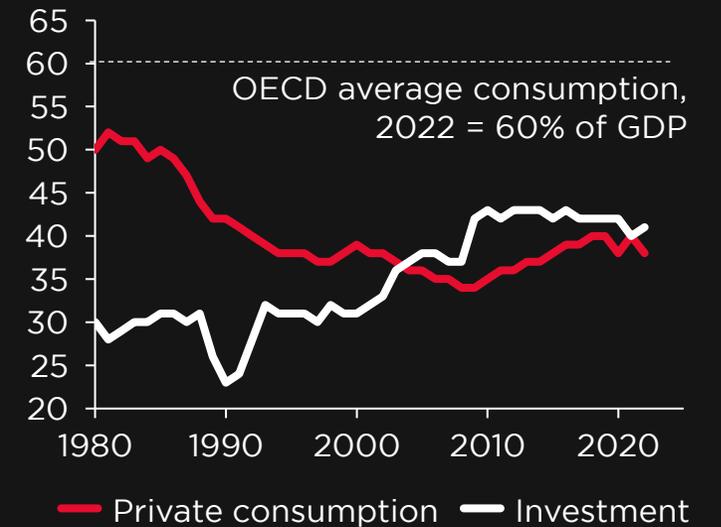
CHINA'S GDP GROWTH (%)



GROWTH IN RETAIL SALES (%)

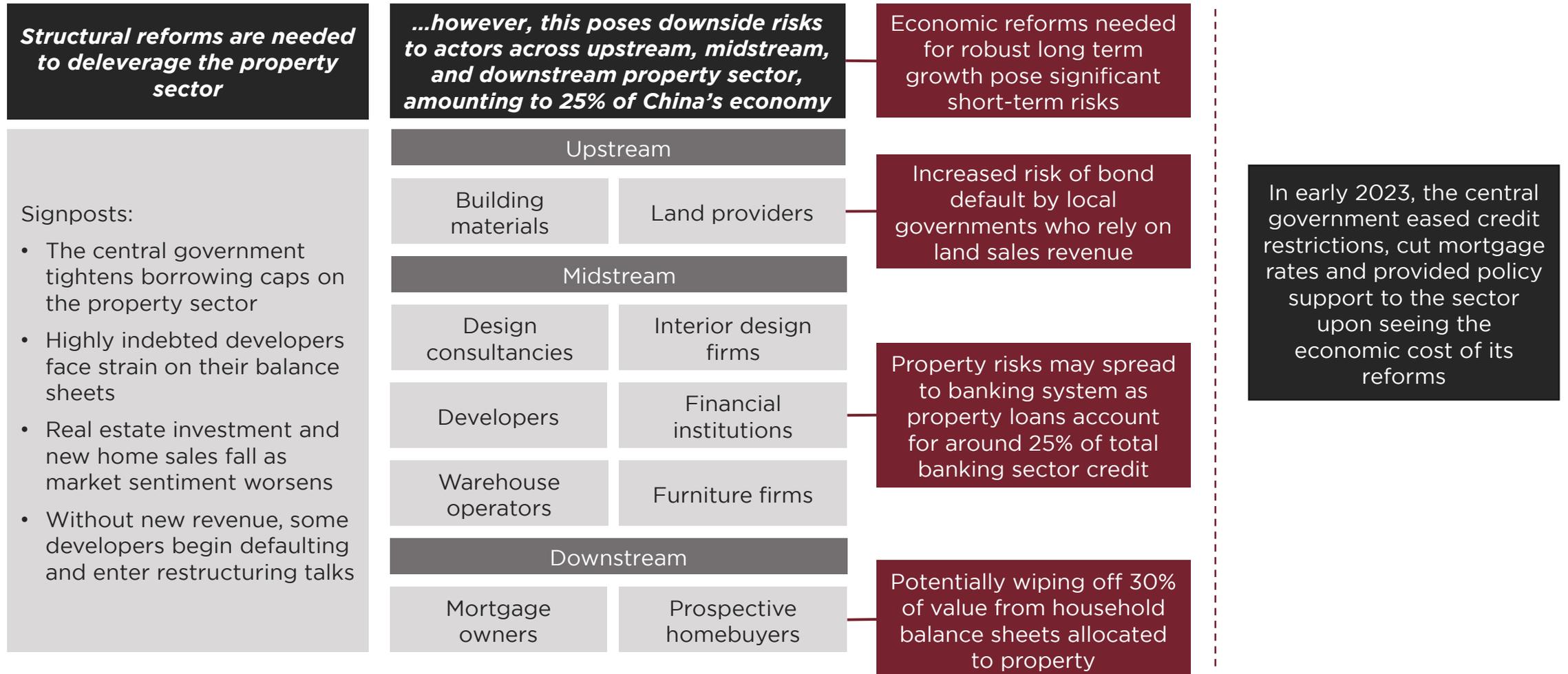


PRIVATE CONSUMPTION AND INVESTMENT AS SHARE OF GDP (%)



Officials delay structural reforms for growth

Government unwilling or unable to tolerate cost of reforms



SECTION II

New leadership to manage long-term vulnerabilities

Domestic policy priorities remain as-is

New PBSC to focus on implementing Xi's priorities

1 SELF-RELIANCE IN SCIENCE AND TECH SECTOR

Rationale

- Reduce dependence on foreign core technologies
- Raise domestic productivity

Made in China 2025

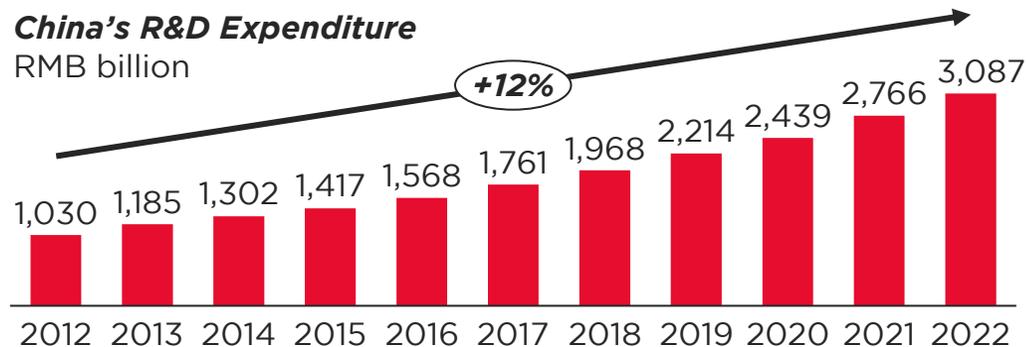
Aims to have Chinese firms be global leaders in ten high tech industries by 2025 and for China to be a global tech superpower by 2049

Dual circulation

Encourages Chinese firms to rely on strong domestic demand (internal circulation), while continuing to attract global production resources (external circulation)

China's R&D Expenditure

RMB billion



Source: Asia Society, Statista, Onyx

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2 RAISING PRODUCTIVITY

Rationale

- Maintain high level of growth as rising labor costs diminish attractiveness of low-value add manufacturing model

Agriculture

Consolidate farmland, introduce large-scale farming to increase agri. productivity

Urbanization

Improve hukou system, expand urban social benefits for migrants to encourage urbanization

Education

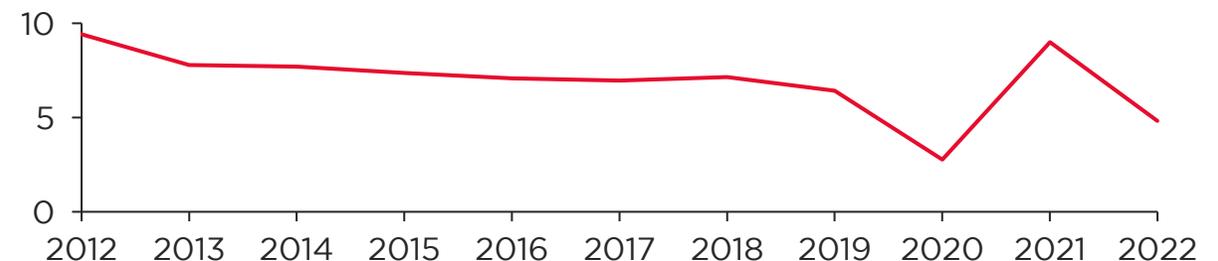
Expand preschool and compulsory education, emphasize STEM curriculum

Aging

Raise retirement age, restructure pensions, incentivize new births

China's Labor Productivity Growth

YoY % growth

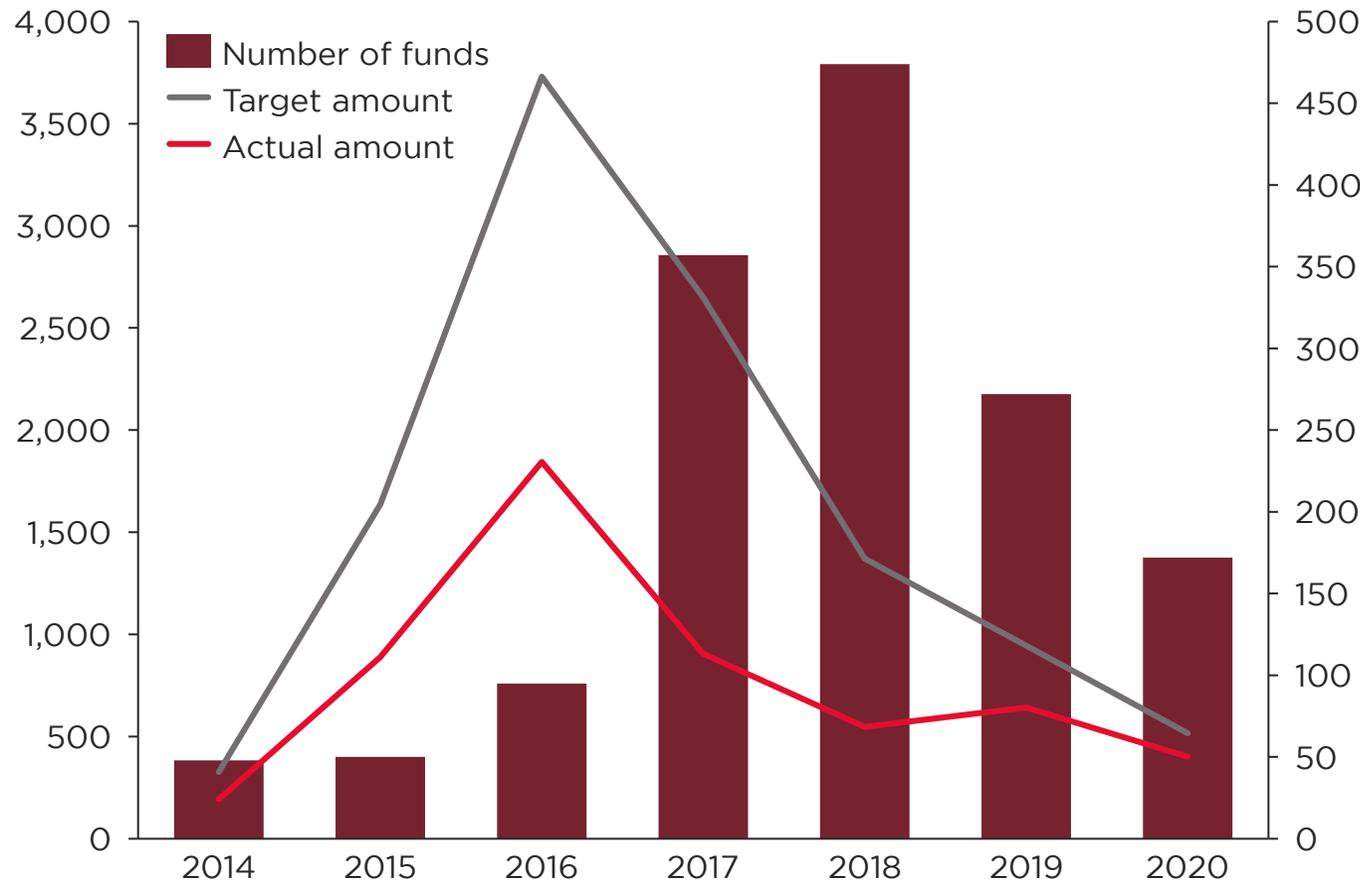


1. High-tech self-sufficiency remains critical to new leadership

Officials to reform industrial funds and improve fund allocation

Number and Investment Amount of New Industrial Guidance Funds

Primary axis: RMB billion, secondary axis: number of funds



Policy direction unchanged

New leadership remains committed to MIC 2025 and dual circulation goals as drive for self-sufficiency took center stage at the 20th Party Congress. Beijing pledged to increase spending on science and tech by 2% in 2023.

Funds to be streamlined and disciplined

Drop in no. and amount of new funds does not mean China is scaling down its industrial subsidies.

Instead, China will streamline funds into more disciplined instruments and increase party oversight of fund allocation, given historical issues of overcapacity, redundancy between funds, and poor management.

Case study on fund reform

Beijing appointed a former government official as the new head of the Big Fund and provided a \$1.9 billion yuan capital infusion into YMTC after an anti-graft campaign last year.

2. China to hasten labor and productivity reforms

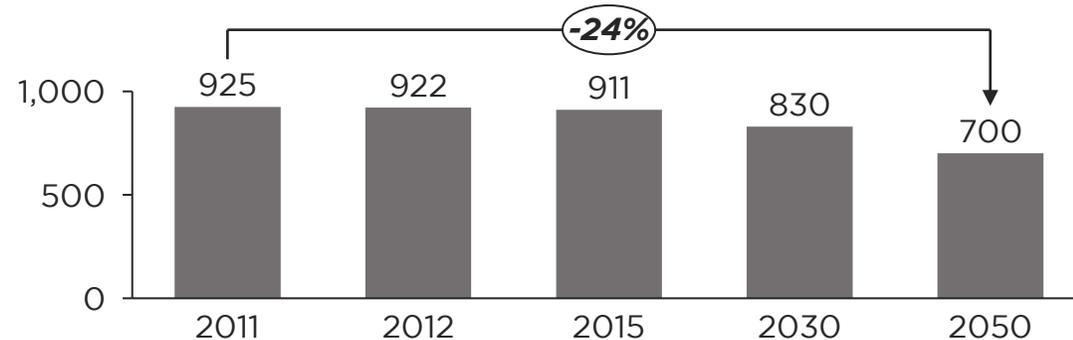
But unlikely to fully mitigate rising wages and aging workforce

Rising labor costs and aging population threatens viability of low-cost manufacturing model

China hastens labor and productivity reforms, but they are insufficient to reverse existing demographic trends

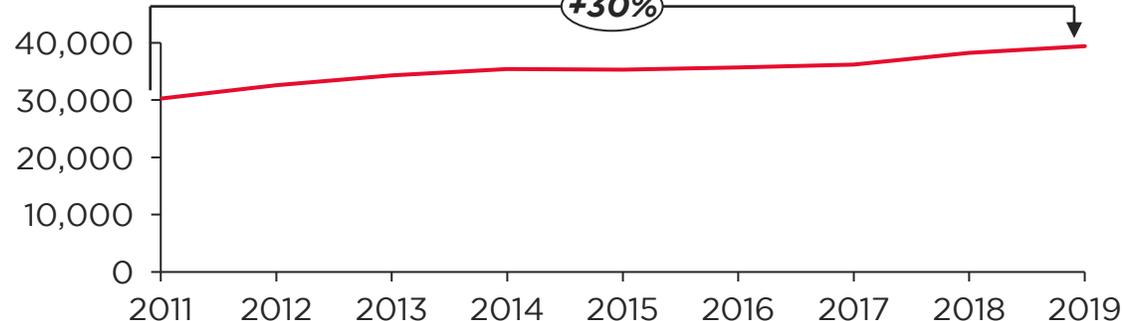
China's Estimates of Working Age Population (Age 15-59)

Million persons



Average Wage Levels in Labor-intensive Manufacturing

RMB



Labor reforms

- China will progressively extend retirement age from 2025 to 2055. Yet, labor force unlikely to substantially increase
- Over 2/3rd of elderly population intend to remain in or re-enter workforce, according to a recruitment survey in Oct
- However, they face re-employment challenges such as age discrimination and lack of professional skills that are not addressed by retirement age reforms

Demographic reforms

- Despite the three-child policy in 2021, high costs of child raising preclude an increase in the birth rate. In 2022, raising a child in Shanghai or Beijing averaged around a million RMB

Productivity reforms

- China plans to improve rural education, liberalize the hukou policy, and develop megacity clusters to boost urbanization
- But effectiveness of productivity reforms set back by local fiscal obstacles and priorities

2. ... however, fiscal obstacles seem to limit policy effectiveness

Local priorities in the balance

CENTRAL DIRECTIVE: Hukou Liberalization

2014-2020

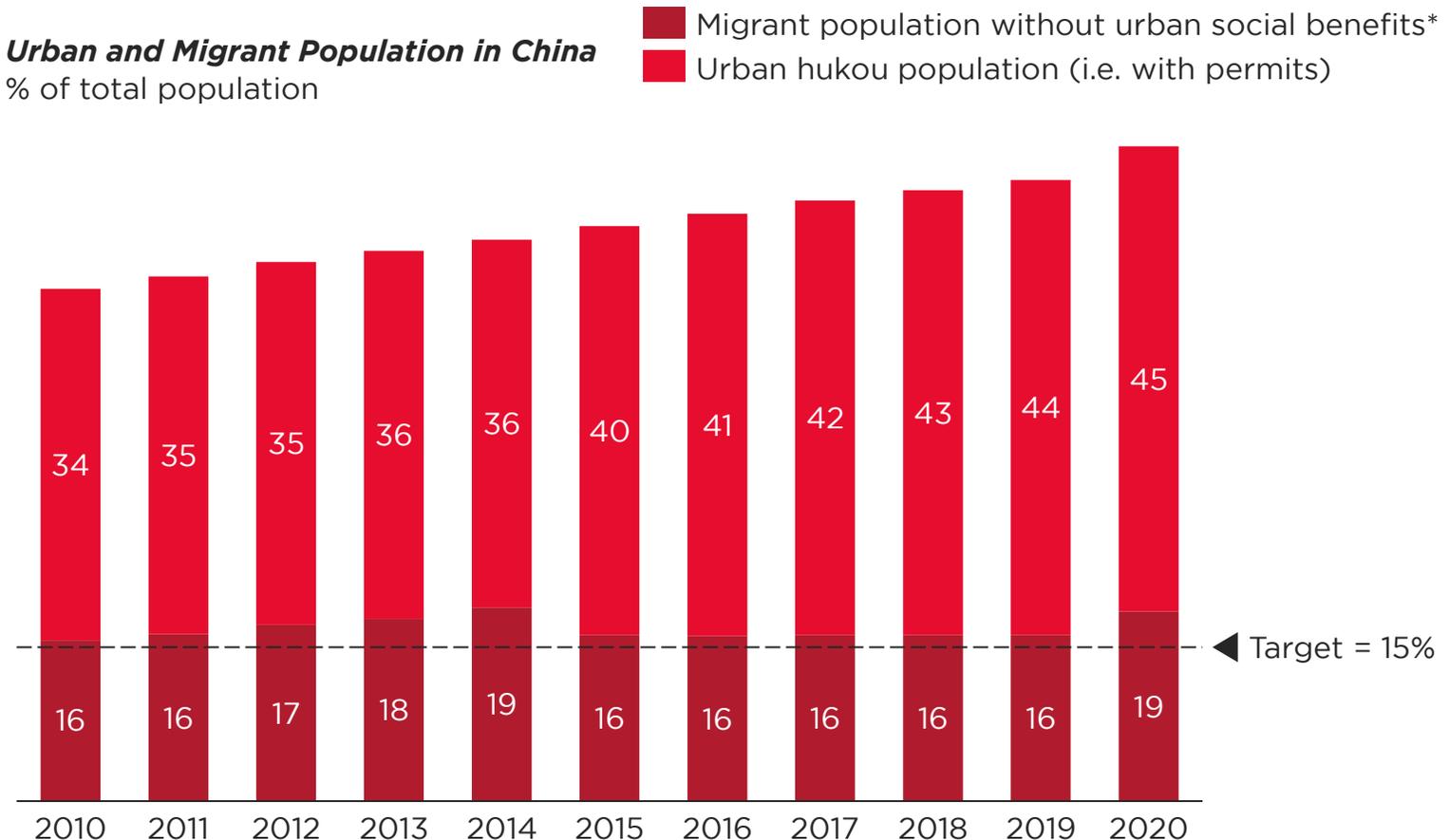
State Council released the National New-type Urbanization Plan (2014-2020) to guide the transition of 100m migrant workers from rural to urban hukou and reduce the urban social benefits gap from 17.2% in 2012 to 15%.

2021-2022

National Development and Reform Commission (NDRC) called on cities with populations <3 million to remove all hukou restrictions

However, local governments are disincentivized from granting urban hukous because of limited fiscal resources for public goods for non-locals

Urban and Migrant Population in China
% of total population



*Migrant population = urban population – urban hukou population

Source: Kam Wing Chan (2021), CSIS, Onyx

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SECTION III

A fraught external environment

China attempts to limit worsening ties with West

And turns to other regions in search of trade and investment

Attempts to limit decline...

US AND EU

China-US ties

Decline in US-China relations inbuilt into 2023, providing momentum for more US trade and investment restrictions on China

China-EU ties

China will struggle to improve ties with EU due to economic support for Russia and unfulfilled investment commitments, precluding revival of CAI investment deal

...pivots to ASEAN and LATAM for market access, trade, FDI...

LATAM AND ASEAN

China-LATAM ties

China will focus on deepening ties with LATAM to secure new markets for Chinese firms, but Chinese state lending will unlikely recover to 2010s levels

China-ASEAN ties

Trade and investment in ASEAN will remain on upward trajectory, although tensions in the South China Sea will drive trust deficit in the region

MAJOR TRADE DEALS

RCEP

While China-RCEP partner trade has grown, progress is uneven and some countries remain cautious about the influx of Chinese goods into local markets

CPTPP

China has prioritized its CPTPP bid but admission will be complicated by its existing policies and priorities

...maintain trade dependence

INDIA AND RUSSIA

China-India ties

India wary of high trade deficit in China and may impose trade barriers this year, but decoupling unlikely since India relies on China for intermediates

China-Russia ties

Russian dependence on China as an import partner for advanced goods and key destination for fuel exports will increase as the war persists

1. Decline in US-China relations inbuilt into 2023

Confrontational dynamics between China and US to persist

Even with the change in Chinese leadership, the PBSC will continue to be wary of perceived attempts by the US to constrain its growth

At the 20th National Party Congress, Xi Jinping stated that China would not yield to “external attempts to blackmail, contain, blockade, and exert maximum pressure on China”.

This view of US behavior adds to tense dynamics between both countries, which can provide momentum to fresh proposals.

Existing proposals fall across three categories: 1) trade, 2) investment, and 3) other restrictions. As of Q1, there are 9 potential and incoming proposals

<i>Category</i>	<i>Initiative</i>	<i>Industry</i>
Trade	Total ban on sale of American technology to Huawei	Telecoms
Trade	Enhanced enforcement of Uyghur Forced Labor Protection Act (UFLPA)	All sectors
Trade	Additional export license requirements for unspecified chip-making equipment	Semis
Trade	Ban on export of crude and refined oil to China	Oil and gas
Investment	Ban on all American investment in high-end Chinese technology	Technology
Investment	Screening outbound investment from US to “countries of concern” including China	All sectors
Investment	Ban on Chinese purchases of US agricultural land	Agriculture
Others	Ban on oil from US Strategic Petroleum Reserve from being exported to China	Oil and gas
Others	Total ban on TikTok	Social media

1. China has few viable responses to US restrictions

Few trade and investment policy options available

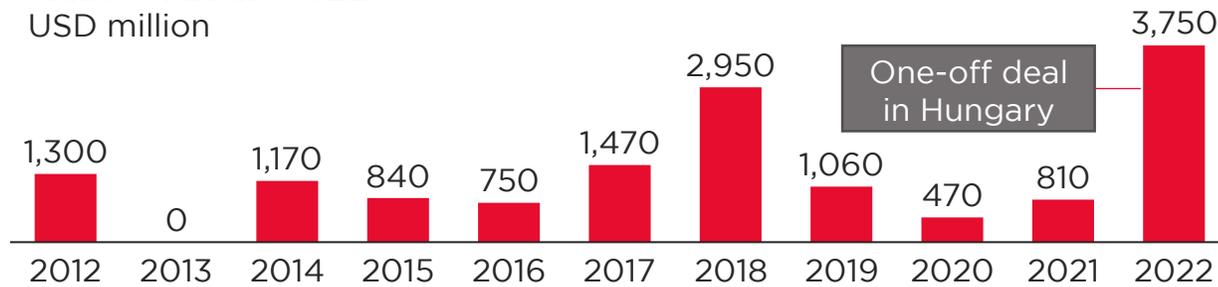
POLICY OPTION	RATIONALE	LIKELIHOOD
<p>Retaliate against specific firms, citing national security reasons or through the Anti-Foreign Sanctions Law (AFSL)</p>	<ul style="list-style-type: none"> • Officials can cite national security reasons, regulatory deficiencies, and other administrative reasons to impose fines, investigate business operations, freeze assets, and impose travel bans on executives of foreign firms • Under the AFSL, PRC entities affected by foreign sanctions can also sue for compensation 	<p>MEDIUM</p> <p>Targeting foreign firms operating in China can shake investor confidence and risk the inflow of FDI into the country, which Beijing is trying to encourage this year. Even though FDI inflows into China in 2021 are the highest since 1979, this is matched by record MNC divestments from China.</p>
<p>Restrict exports of critical inputs where China controls a significant percentage of global production</p>	<ul style="list-style-type: none"> • China can delay, restrict the exports of critical or even prohibit them entirely to place pressure on American supply chains • Industries that are more vulnerable to export restrictions from China include: EV batteries, rare earths, downstream chip testing and packaging, solar energy 	<p>MEDIUM</p> <p>These restrictions will likely accelerate reshoring and onshoring processes. Chinese firms who mine, process and manufacture these materials are also likely to shoulder the economic burden of a sudden loss of sales.</p>
<p>Indirect Response: China focuses on decoupling its critical supply chains from the West</p>	<ul style="list-style-type: none"> • China accelerates efforts to build up domestic tech supply chains to progressively insulate Chinese firms from the trade and investment restrictions. 	<p>ALREADY IN PLACE</p> <p>This is the current status quo. China has emphasized self-reliance in strategic technologies as a national priority in the 20th party congress.</p>

2. Ongoing decline in ties with the EU

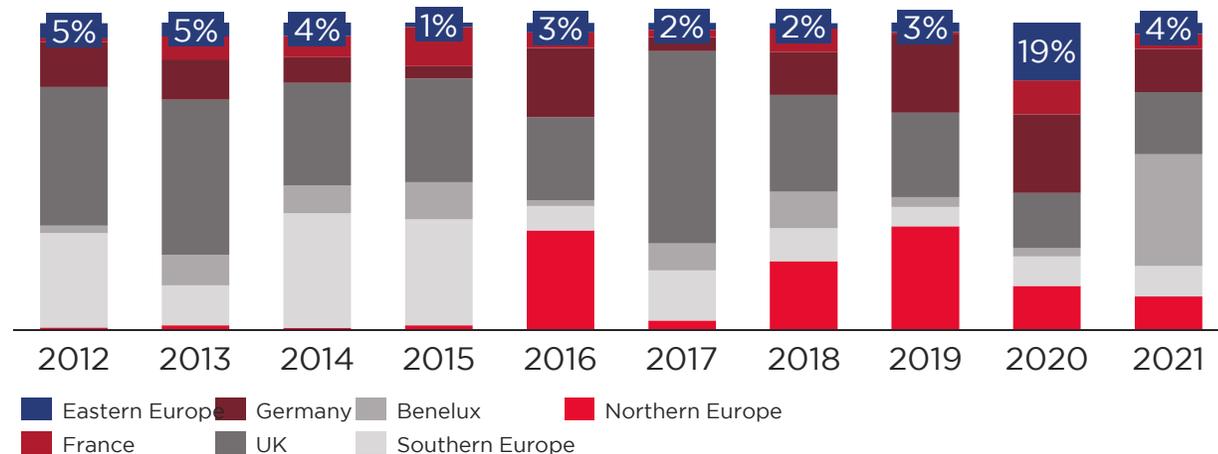
Past and present actions heighten EU concerns with China

China has not met its 2012 commitments to increase investment in Central and Eastern Europe...

Chinese FDI into CEE
USD million

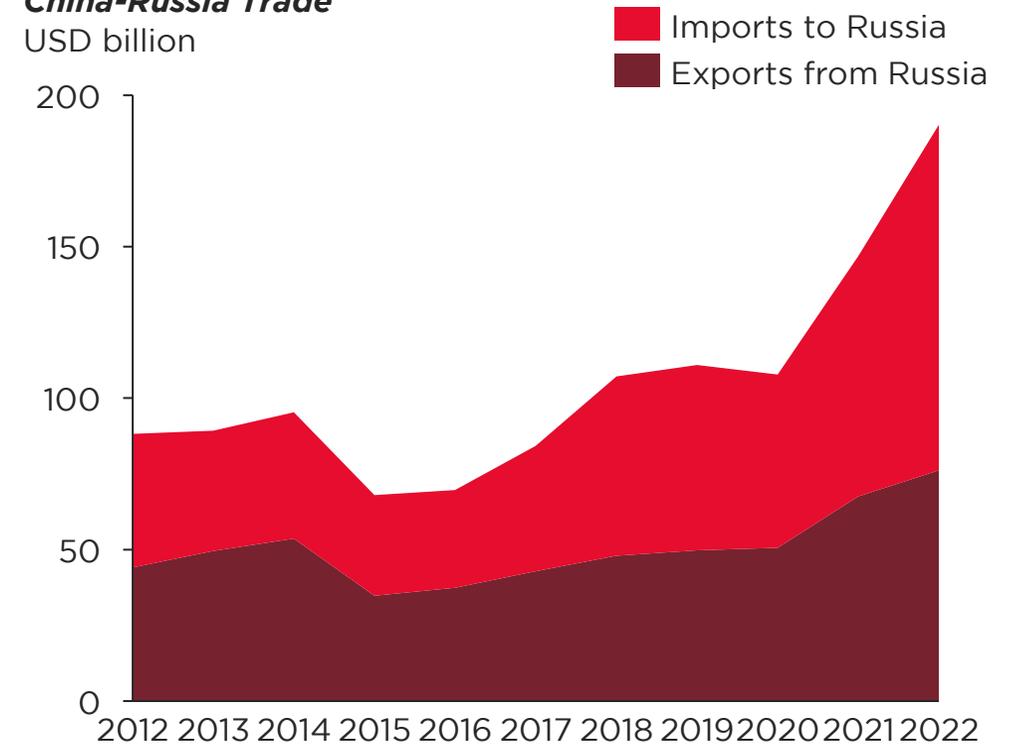


Chinese FDI by Country Groups



... and it continues to provide economic support to Russia

China-Russia Trade
USD billion



Source: Rhodium Group, Bruegel, Onyx
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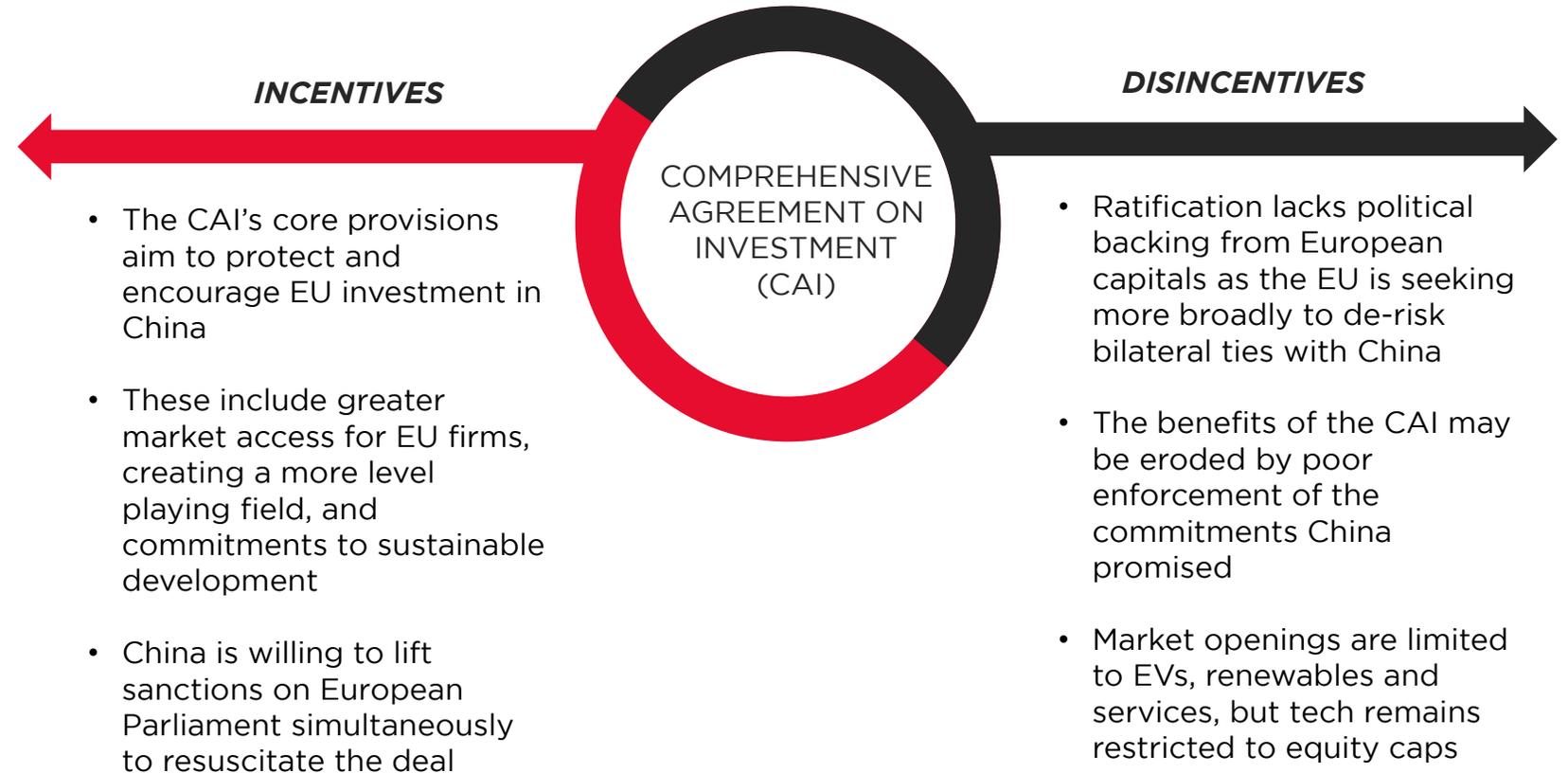
2. While the EU seems unlikely to ratify its investment deal with China

Even as China renews calls to revive it

China has repeatedly called for the revival of the CAI for two motivations:

- 1) to **attract inbound FDI** into China, a major 2023 aim and
- 2) To **improve ties** with the EU

However, EU ratification of the CAI is unlikely as it faces more disincentives than incentives...



3. China turns to LATAM to secure new markets

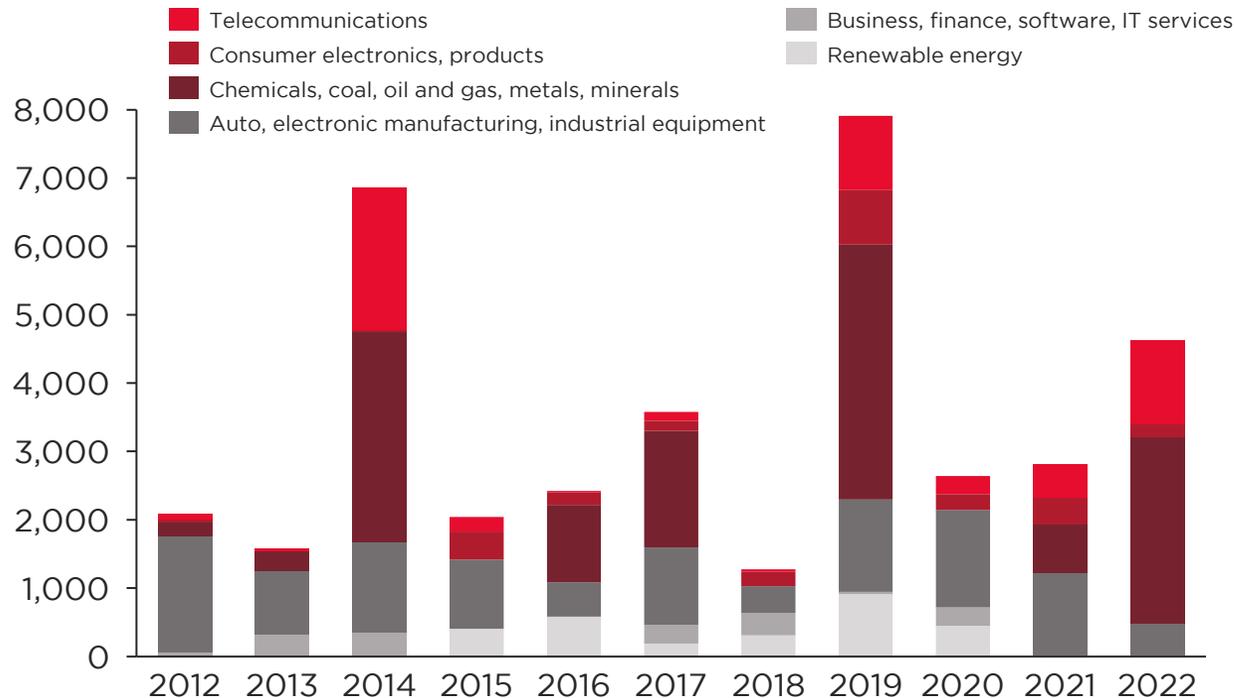
However, Chinese state lending unlikely to reach 2010 levels

Chinese FDI is pivoting to telecoms and consumer as players seek to capture market share where recipient countries are less competitive, although raw materials and manufacturing remain the largest sectors...

...however, Chinese state lending to LATAM is unlikely to reach 2010s levels as policy banks are becoming more selective in overseas projects

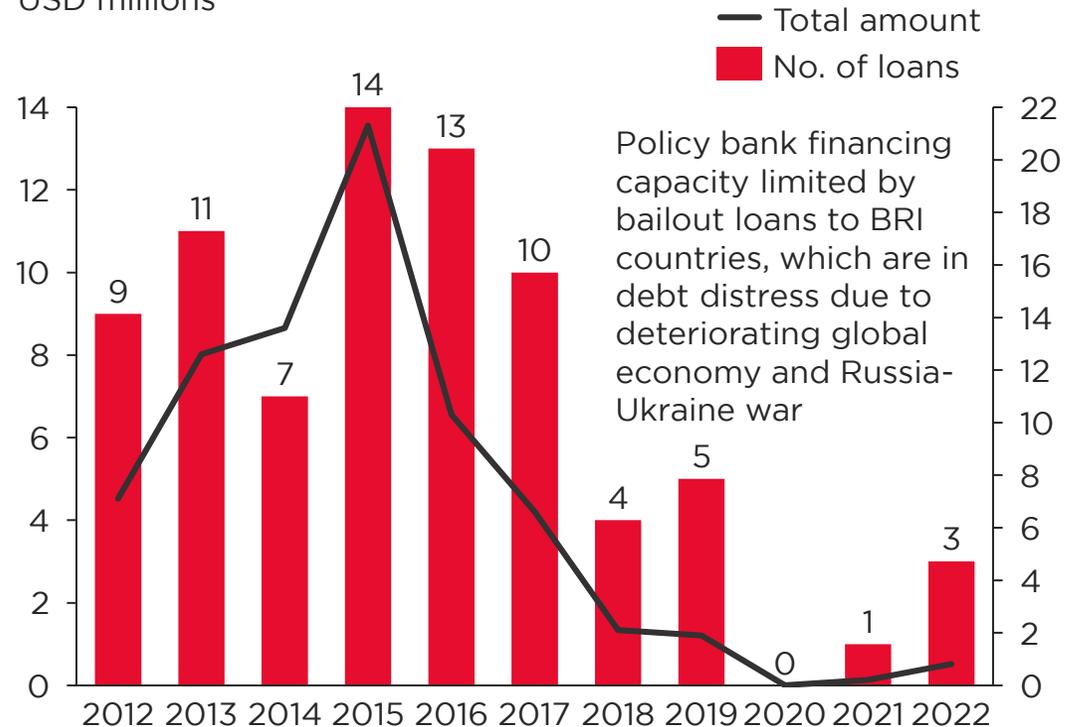
Value of Chinese Greenfield FDI Projects in LATAM by Sector

USD millions



Policy Bank Loans to Latin America and the Caribbean

USD millions



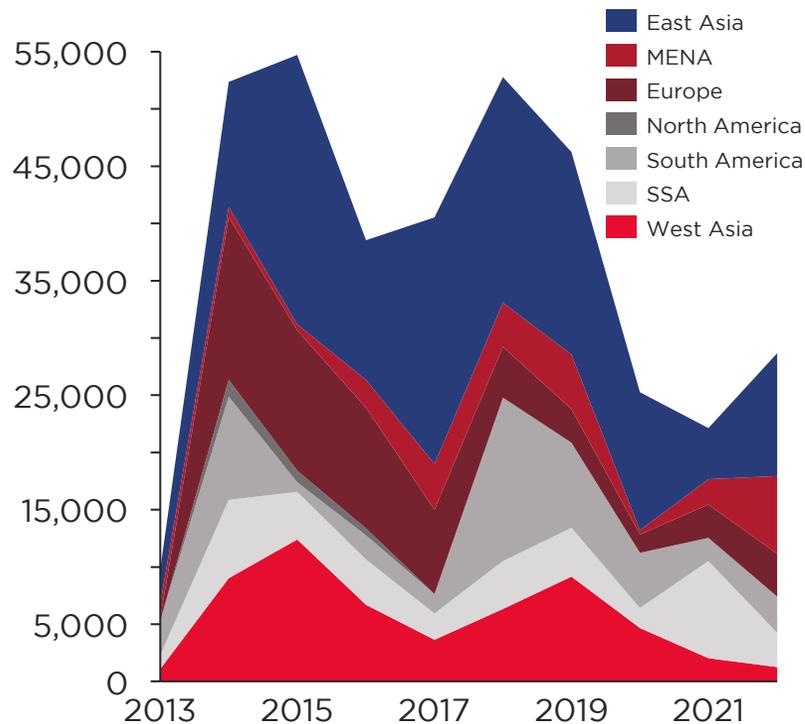
Source: fDi Intelligence, IMF, Onyx
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3. China-Southeast Asia trade and investment on upward trajectory

But China's influence limited to economic, diplomatic relations

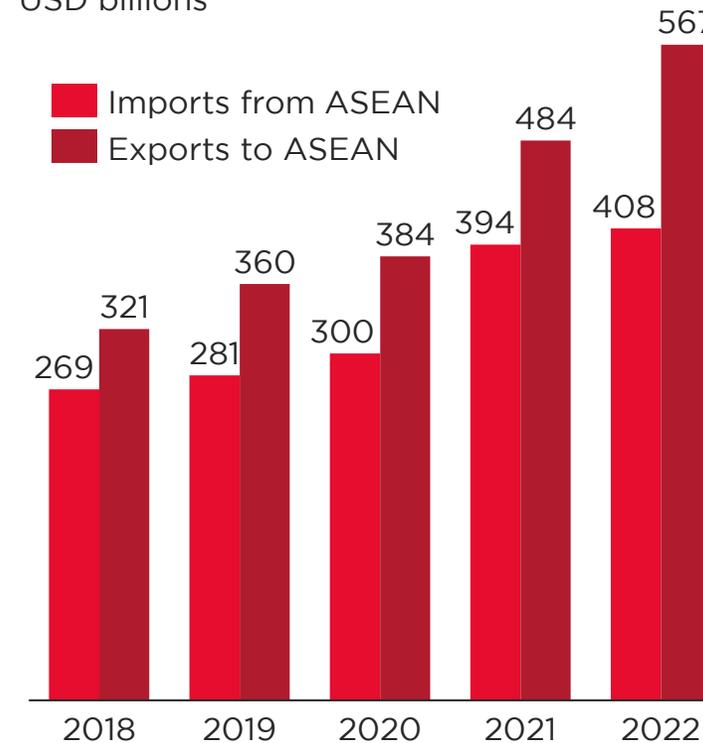
Southeast Asia is likely to continue being the **largest recipient of Chinese BRI investment** despite overall global decline in BRI funding

BRI Investment Across Regions
USD millions



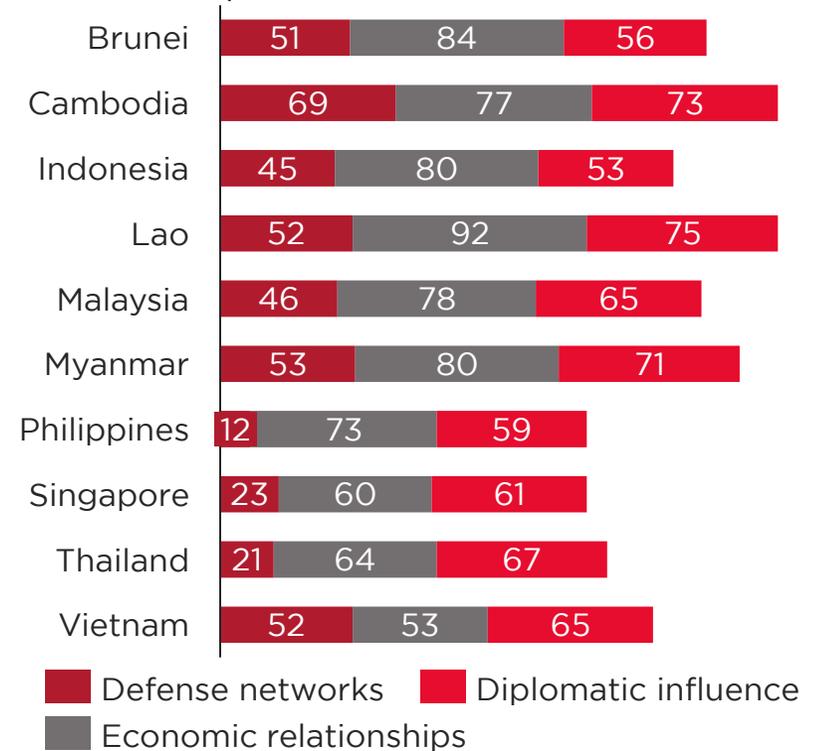
China-Southeast Asia trade is similarly on a **consistent upward trajectory**, buoyed by RCEP implementation

China-ASEAN Trade
USD billions



However, China's influence mainly **limited to economic and diplomatic ties**; Southeast Asia wary on working with Chinese defense

China's Influence in Southeast Asia
Out of 100 points



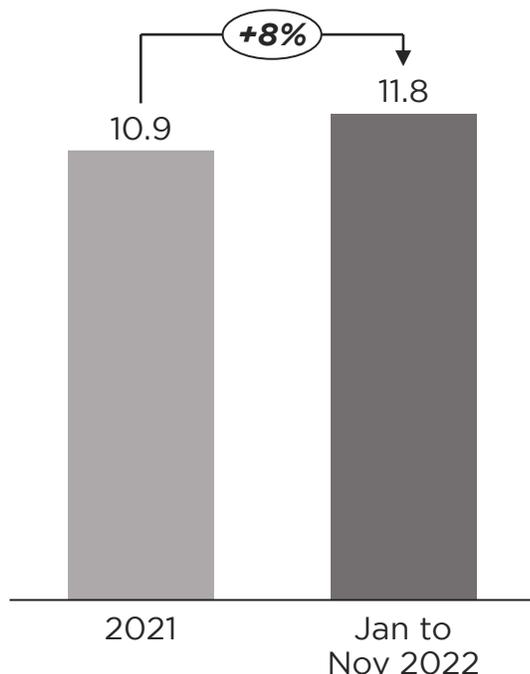
Source: American Enterprise Institute, ITC Trademap, Lowy Institute Onyx
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4. However progress in RCEP implementation is mixed

Increase in trade with RCEP participants uneven across regions

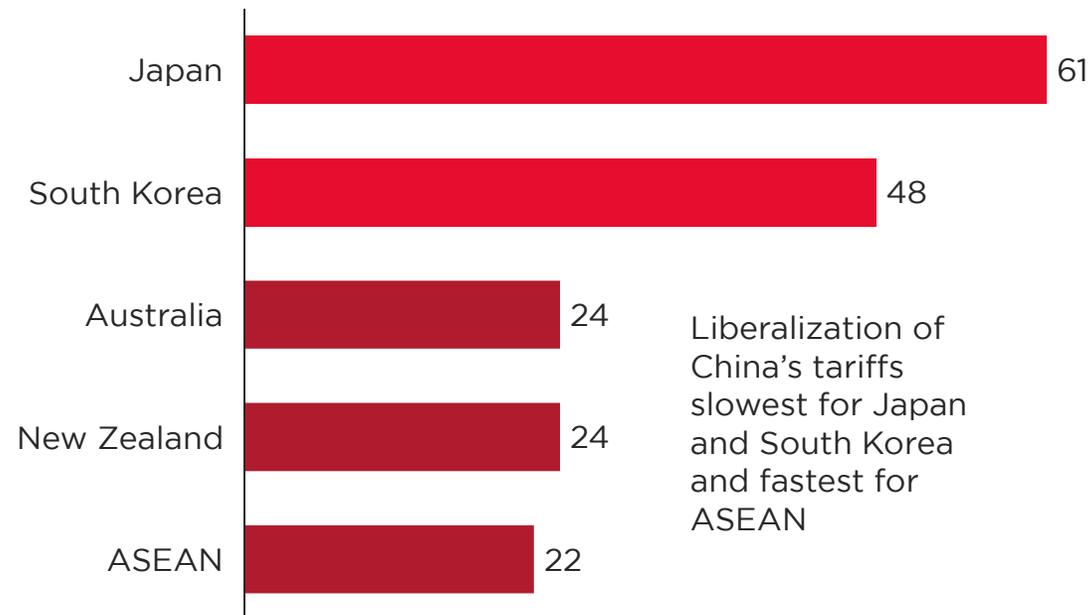
Trade with RCEP partners has grown in just the first 11 months

China Trade with RCEP Partners
RMB trillion



...but China's trade with East Asian RCEP participants will grow at a slower rate relative to other partner countries

Tariff Lines Fully Liberalized After 10 Years or Longer
% of total tariff lines



... and RCEP partners remain wary of Chinese goods flooding into their markets

Philippines

- Federation of Free Farmers called on Marcos to meet with agriculture stakeholders to stem RCEP's potential negative impacts

Indonesia

- Lawmakers raised concerns in late 2022 that local firms not prepared to face new competition and lacked capacity to join global supply chains

4. China to prioritize CPTPP accession bid

But admission complicated by existing policies and priorities

CPTPP membership was elevated to policy priority after mention at 14th National People's Congress...

However, accession faces more constraints

DRIVERS	CONSTRAINTS
<ul style="list-style-type: none"> Southeast Asian CPTPP members expressed interest or support in China's accession to CPTPP, namely Malaysia, Singapore, and Vietnam. 	<ul style="list-style-type: none"> China's policies and priorities deviate from CPTPP standards. However, China will likely push for exceptions to CPTPP rules such as those on SOE regulations that Mexico and Vietnam currently enjoy. Admission is dependent on the consent of all member countries; sentiment around China is divided China's accession bid will conflict directly with Taiwan's. As Taiwan is closer to CPTPP standards, its potential admission will almost certainly exclude China's

China will struggle to meet CPTPP standards

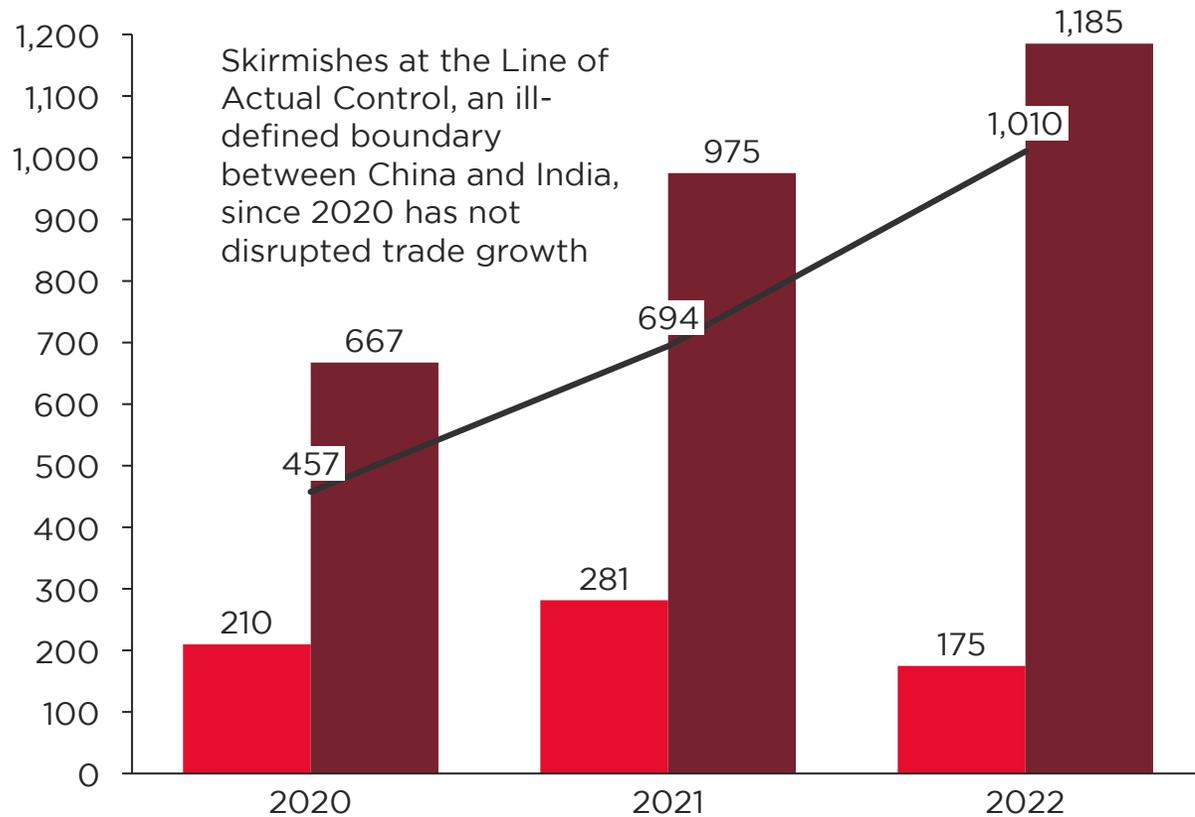
POLICY AREA	CHINA'S POLICIES AND PRIORITIES	CPTPP STANDARDS
DATA FLOWS	Data localization requirements, restrictions on cross-border data transfers, data security laws	Open data flows with broad exceptions for national security, government data, and data for public policy purposes
LABOR RIGHTS	Alleged poor labor conditions in China's factories and Belt and Road projects	National laws provide protection for workers including the elimination of forced labor.
ROLE OF SOES	State support to SOEs , which serve industrial policy aims and retain government control over strategic sectors	A level playing field between SOEs and private competitors, including information disclosures and non-discrimination guidelines

5. China-India trade to remain on upward trajectory

Despite protectionist measures from India

Manufacturing Value Added Output
USD million

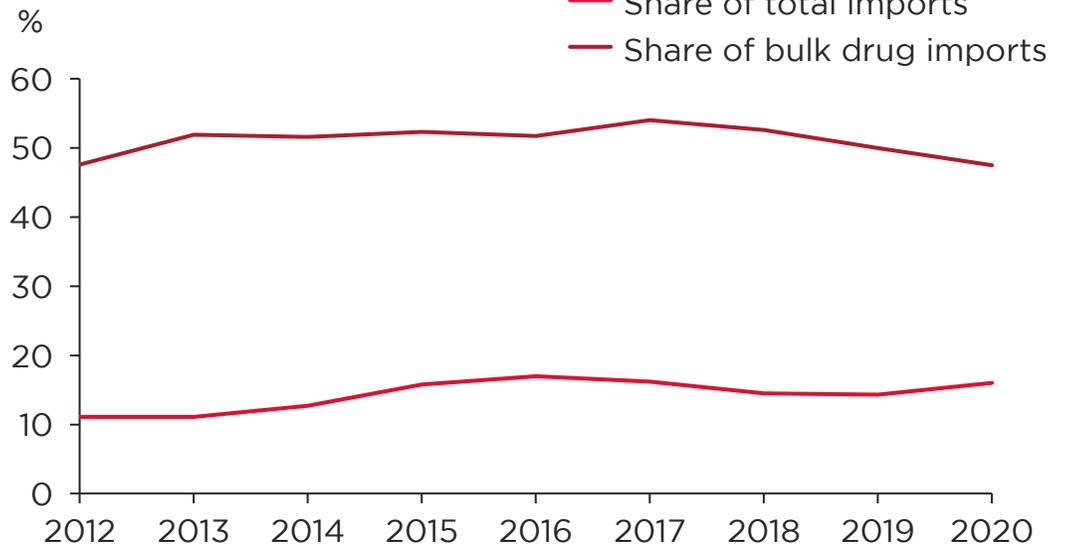
■ China's imports from India
■ China's exports to India
— China-India trade balance



However, India is poised to introduce barriers to trade with China in coming months due to large trade deficit

- India considering tariffs and non-tariffs barriers to cut imports of non-essential consumer and electronic goods from China
- But decoupling unlikely to occur in short term because India relies on China for intermediate and higher value goods such as pharmaceuticals

China's share of India's imports



Source: ITC TradeMap; Onyx, Sudip Chaudhuri (2021)
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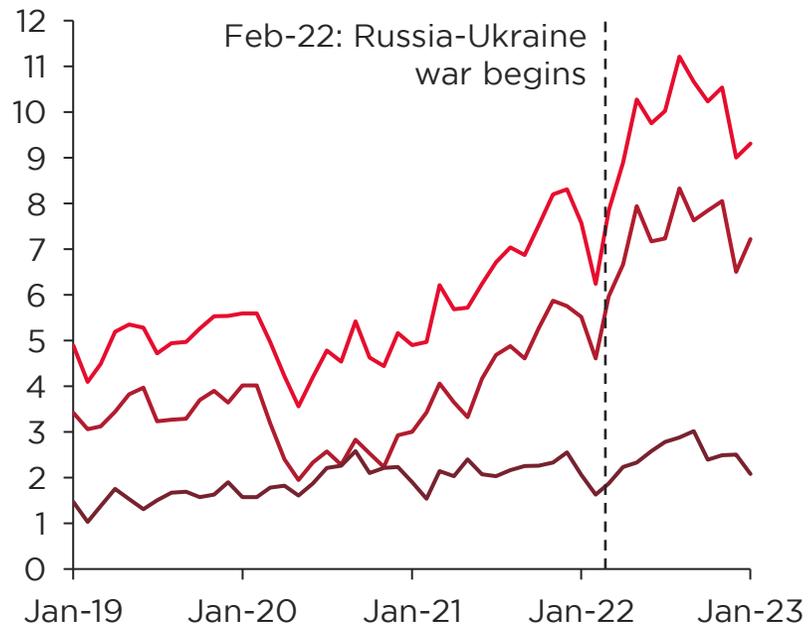
5. China seeks economic benefits from Russia

As Russia's isolation makes it increasingly dependent on China

Russian mineral fuel exports to China has expanded rapidly since the war began, as Russia seeks to offload its crude supply

Russia Exports to China

USD billion



— Total
— Mineral fuels
— Goods other than mineral fuels

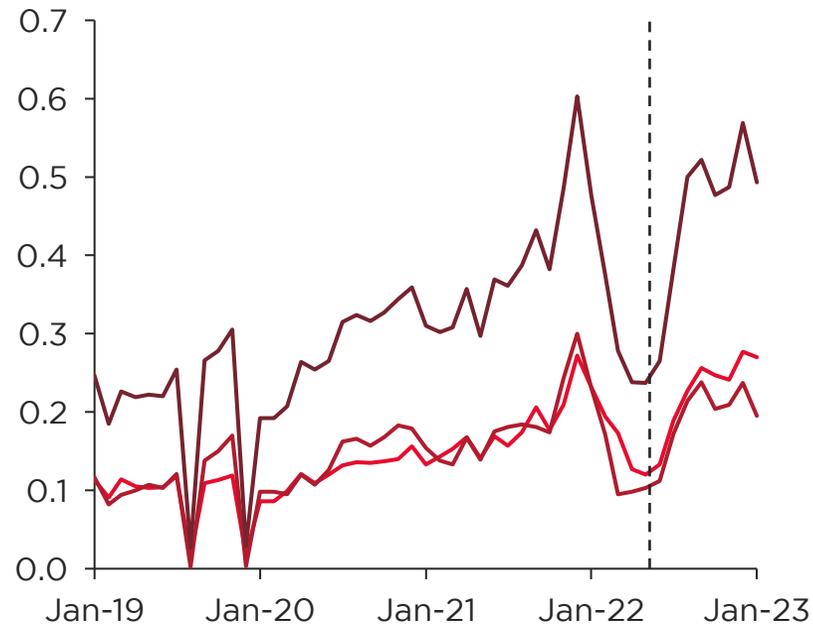
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In return, Russia relies heavily on Chinese exports of advanced goods, given that Moscow has limited access to Western tech

Russia Imports of Advanced Goods from China

USD billion



— Office and automatic data-processing machines
— Telecoms and sound recording equipment
— Electric machinery (including semiconductors)

Russian dependence on China is expected to increase as the war persists

Dominant import partner

- China's economic leverage over Russia will increase as sanctions continue to prohibit Russia's main import partners, Germany, Netherlands, and South Korea from trading with it

Chinese military aid unclear

- Potential Chinese exports of weapons and military technologies to Russia will bolster Moscow's reliance on China beyond trade
- It remains unclear if China has or intends to provide military aid to Russia

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