Economics & Strategy

Understanding China – Self-Sufficiency 2.0

Group Research

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- *Self-Sufficiency 2.0 aims at*
  - (1) develop technology without over-reliance on the west;
  - (2) radiate influence on allies via Belt and Road Initiative (BRI)
- *Against the backdrop of trade war and tech war, Hong Kong will be positioned as the 'core-of-the-core' within the GBA, in our view.*
- *China has already begun recalibrating the BRI by pivoting to South East Asia.*

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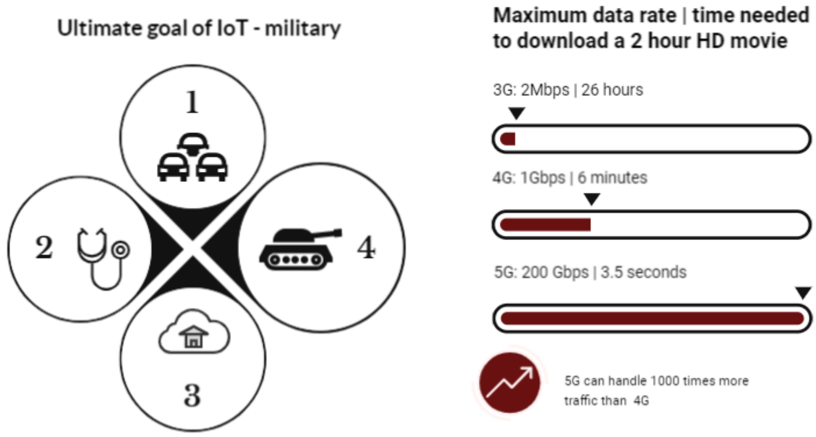
China: Self Sufficiency 2.0

Ever since the escalation of trade tension with the US since 3Q18, President Xi Jinping has highlighted the importance of "self-sufficiency". Historically, this notion is pictorially associated with chronic economic hardships of the "Great Leap Forward" in early 60s. China hardly traded with partners and allies. However, the context of the same notion in the 21st century is much more aspirational in scope and depth.

Self-sufficiency means China must be able to (1) develop technology without over-reliance on the west and (2) radiate influence on allies via Belt and Road Initiative (BRI). These long-term visions in turn drive (1) the establishment of the Great Bay Area (GBA) and the recalibration of BRI to improve project sustainability. The goal is to build a "community with common destiny" in Asia.

Figure 1: 5G – more than high speed network



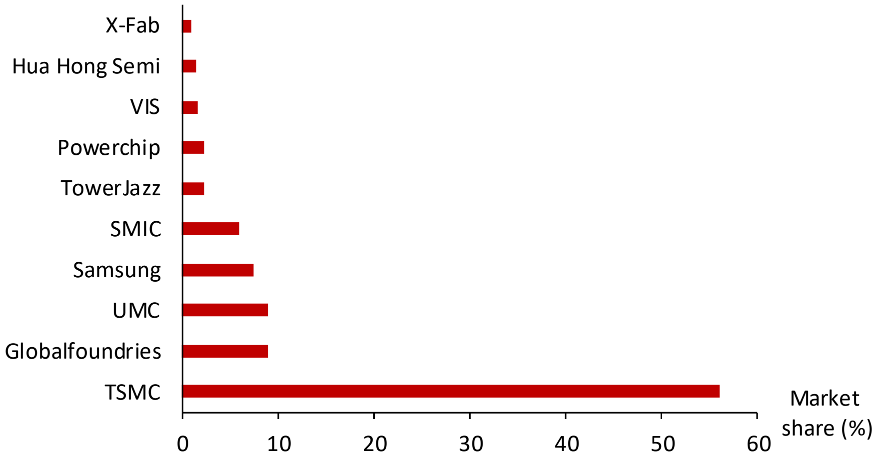
Tech war matters

From trade war to tech war.

Tech war is the prime determinant behind the new conceptualization of self-sufficiency. Restrictions on Chinese companies' access to key US technologies alongside intermittent threats of export bans are the new normal. Elsewhere, competition between China and the US in the space of 5G telecommunication technology is particularly intense. This is because such technology will enable enormous civilian and military applications, from smart-city to unmanned weapons (Figure 1). Many western nations have already decided not to use Huawei technologies due to national security concerns.

China consumes 40% of the world's chip market by value, but the rate of self-sufficiency is only between 10% and 20%. As a result, Beijing aims to increase China's semiconductor self-sufficiency to 40% in 2020 and 70% in 2025. (Lately, a partnership between Intel and a Chinese chipmaker has been terminated as well.) Chinese tech companies are now willing to pay up to 3 times the existing salary of Taiwanese engineers to work in China, according to various news report. Reportedly, Huawei has also been engaging Taiwan Semiconductor Manufacturing Company (TSMC) (Chart 1) over a prospect of relocating some chip production to a site in Nanjing. However, these are short term solutions. For the long haul, China aims at recreating the GBA as "Silicon Valley of the East".

Chart 1: Top 10 Worldwide semiconductor foundries by revenue for 1H18 (E)



The core of GBA – Hong Kong

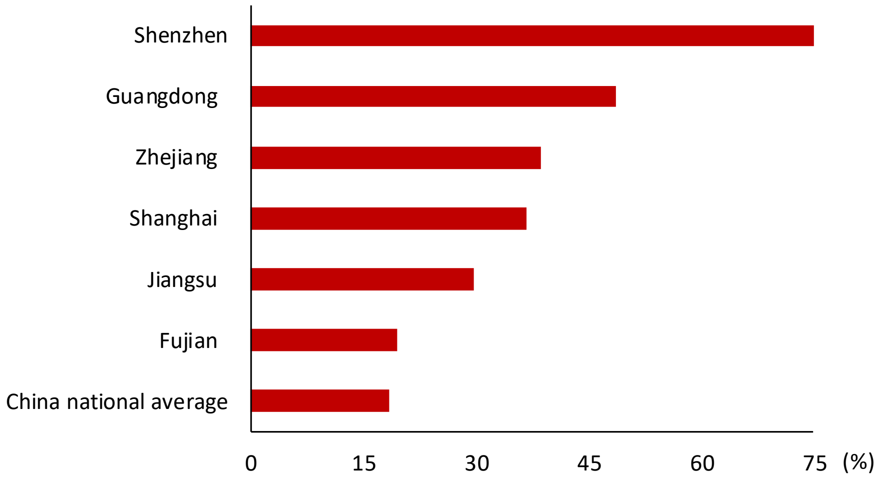
Competition over the subject of AI, Robotics, and Big Data between China and US will likely persist regardless of the Sino-US trade deal outcome. There is an urgent need for China to step up technological development to the next level. Division of labor amongst the Pearl River Delta (PRD), Macao and Hong Kong are always clear: PRD in manufacturing, Macao in entertainment and Portuguese-speaking business centre, and Hong Kong in banking/finance and professional services. This configuration remains unchanged. The novel highlight of the latest GBA blueprint is to further position Hong Kong as an innovative technology hub, which is not the traditional strength of Hong Kong. Then why?

Hong Kong is lesser affected by the trade war.

There are three fundamental reasons behind the new positioning of Hong Kong. First, from the economic resilience perspective, it makes tactical sense to position Hong Kong as the core. The potential negative economic impact on Guangdong and Shenzhen should trade war with the US persist, or intermittently continues over the medium term, will be much more substantial than Hong Kong based on a thorough study by Lawrence J. Lau of Stanford University in his new book – "The China-US Trade War and Future Economic Relations".

For instance, export as a share of GDP (Chart 2) in Guangdong is 51.8% and the corresponding share of exports going to the US is 8.7% of total exports, compared with the national average of 18.7% and 3.4%. He estimated industry-wide domestic value-added is 25%. Assuming imposition of 25% US tariff will halve the province's total exports, headline GDP will fall by 1.125% (8.7%/2 x 0.25 = 0.0125). That is the first order impact. When subsequent disruption on intermediate suppliers are taken into consideration, the total cumulative impact will shave almost 3% from the province's headline GDP. That is not insignificant. Based on the same set of assumptions applying to Shenzhen, the cumulative knock-on impact on GDP is a hefty 3.7%. It is because export as a share of GDP reached 73.7% and 11.3% of exports went to the US in 2018. In the case of Hong Kong, the direct impact is almost non-existent given the absence of domestic value-added. Nowadays, 99% of HK's total exports are re-exports.

Chart 2: Exports as % of GDP in 2018



Of course, results vary with different set of assumptions. But such thorough studies offer valuable empirical references to policymakers. Survey data echo the empirical studies. According to the China Institute for Employment Research, the supply of new jobs across all industries in 3Q18 fell 27% on year, the first ever decrease in the survey recorded since 2011. The most visible impact fell on trade related sector. Job openings shrank consecutively for three straight quarters last year. It fell 53% on month in Q318. To compare, the labor market in HK has remained very robust. The seasonally adjusted unemployment rate stood at a 20-year low of 2.8% in Jan 2019.

Second, the solid institutional foundation of Hong Kong complements the integrity of data and patent protection for tech ventures. Moreover, Hong Kong is classified by

Western countries as a free market economy without capital flow restrictions fortified by an independent judicial system. For example, the U.S. still deliberates the city as a separate export destination ever after 1997. On the contrary, Macau is subject to the same restrictions as mainland China. Hong Kong companies can procure new machinery, equipment and electronic parts either for domestic consumption or re-exports to other destinations freely.

The Hong Kong Policy Act enables free trade between the city and the US.

The Hong Kong Policy Act Report released (annual report to update Congress by US Department of State) on May 29, 2018 reported "Hong Kong still generally maintains a high degree of autonomy under the "one country, two systems" framework in most areas – more than sufficient to justify continued special treatment by the United States for bilateral agreements and programs per the Act. The impeccable institutional quality of Hong Kong safeguards this unique relationship with the US.

Third, the choice of Hong Kong as the core of GBA embeds a deep political metaphor – to embrace Hong Kong (a former British colony) into adjacent Chinese cities to foster deeper economic and cultural ties. The construction of the Hong Kong-Macau-Zhuhai bridge (HKMZ) alongside the inclusion of Hong Kong into the National High-Speed Railway network signify the same idea.

China is making an intelligent strategic move by putting Hong Kong at the forefront of the GBA. For more details of the blueprint, please refer to "Hong Kong – Core of the Greater Bay Area" published on March 07, 2019.

Recalibration of the BRI to improve sustainability

At its inception, the BRI is a vision. It is not exactly a concrete program with clear budget planning and systematic timetables for execution. The area of coverage is also too broad lacking focus. The constant flow of bad news in 2018 naturally raises concerns over the sustainability of China's flagship project.

In retrospect, it was also difficult for Japan to penetrate South East Asia from the 50s to 70s due to the legacy of World War II. It took them over 3 decades to crack it. Besides, these infrastructure projects are gigantic and complicated to manage far-field in nature. The intertemporal setbacks of BRI reported in Sri Lanka, Maldives, Malaysia, Myanmar and Pakistan should be viewed as natural course of evolution learning for China. (Arguably, some of these cases are partially derived from the local governments urge to renegotiate better business terms with China ahead of local election). The Washington-based RWR Advisory Group estimated problematic BRI projects to be around 14% to total since 2014. This number does not seem too high. China is learning fast from these field experiences.

According to the Asian Development Bank, Southeast Asia will need to spend US$2.8 trillion on infrastructure through 2030 to sustain economic growth. Indeed, the areas in which China has made the most progress since 2014 with its BRI projects are in South East Asia, followed by Eastern Europe. Given the massive funding requirement of the region and difficulty of borrowing from World Bank/Asian Development Bank (let alone enticing private funding given the risks), the space for China's BRI remains immense.

China started to scale down the BRI projects and partner with the World Bank to improve project quality.

China has already begun recalibrating the BRI strategy. Please refer to: "Recalibration of BRI strategy?" published on July 04, 2018. China's development banks have reportedly been told to partner with the World Bank to improve project quality by raising lending requirements. As a result, the number of BRI contracts fell by 27.5% on year in the first eight months of 2018. Moreover, the Chinese government is proceeding to use more local labor/machinery for BRI projects instead of solely exporting Chinese labor/equipment. Newly incorporated local companies will change to joint-partnership model from sole Chinese ownership.

In fact, Pakistan just announced the creation of a new working group on "social economic development to assist with livelihood projects in Pakistan." Both China and Pakistan agreed to a joint statement "dismissing the growing negative propaganda against the China Pakistan Economic Corridor". In another example, Myanmar signed an agreement in Beijing to create the "China-Myanmar Economic Corridor" in September last year. Likewise, Malaysia has repeatedly stressed the importance of Chinese investment, while expressing concerns over their own repayment capability concurrently. As of today, Malaysia has not made a firm decision regarding the cancellation of the East Coast Rail Link project. Rather, they have suggested options are open for a common solution benefiting both countries.

Some of the current BRI projects will probably be scaled down or even canceled. Chinese banks will have to swallow some non-performing loans. But these are parts of the learning journey. As China re-calibrates the strategy accordingly, it is reasonable to assume there will be some successful examples soon once the focus is articulated with improved execution guided by economic interest rather than political. The re-calibration strategy will likely pivot to SE Asia because it is a low hanging fruit relative to projects far field. ASEAN will stand to benefit the most from it.

Eventually, the high-speed railway will run through North-South Economic Corridor from Kunming in China through Laos to connect with Thailand's Eastern Economic Corridor (EEC). Southern China will then be able to reach the Gulf of Thailand by rail. After completion, Laos and Cambodia can access Thailand's deep-sea port "Laem Chabang Port" to enhance regional trade. China's high-speed railway project defines long term economic prospects between China and ASEAN (Please refer to "China's BRI tactics for SE Asia" published on March 26, 2018).

Conclusion:

At a time of mounting China-US trade tension, the rise of a new "Self Sufficiency" concept is inevitable. The execution of the GBA and BRI is testament to it, with the former embedded in the latter, serving the common interest of Asia in the long run. The recent establishment of a HK Economic Trade Office (HKETO) in Thailand is a solid example signifying the linkages of the two projects. This office in Bangkok is also responsible for Myanmar, Cambodia and Bangladesh. It plays an important role in supporting Thailand's regional policy imperatives. It also highlights Hong Kong's creative role as a "connector, investor, and operator" for the GBA and BRI, serving a crucial link to connect Southern China with other countries in the Mekong River Subregion and ASEAN.

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Sources: Data for all figures, charts and tables are from CEIC, Bloomberg, Visme, and DBS Group Research (forecasts and transformations).