

Reconsidering post-coronavirus China investment strategies

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API Geoeconomic Briefing is a series provided by the Asia Pacific Initiative, an independent think tank based in Tokyo. The series will look into geopolitical and economic trends in the post-COVID-19 world, with a particular focus on four areas: technology and innovation, global supply chains, international rule-making, and climate change.

During a meeting of the advisory council for the Beijing-based leading independent media group Caixin in March 2019, former U.S. Treasury Secretary Lawrence H. Summers made a remark that left quite an impression on me. Summers said that because the U.S. and China have their pride as great powers, these countries will not embrace opinions of third countries with grace. He went on to express concern that U.S.-China friction could worsen.

His worries became a reality. Since Summers' remarks, there have been twists and turns in the bilateral trade talks, followed by Washington's exclusion of Chinese firms such as Huawei Technologies Co., from the domestic market. Amid the coronavirus pandemic, the issue of the responsibility for the crisis has surfaced. The confrontation between the two countries has extended into geopolitical arenas that China considers core interests, including problems related to Hong Kong and Taiwan. It is fair to say that the world has entered a "new Cold War" with the U.S.-China rivalry at its center.

Reading a White House report released on May 20 under the title "United States Strategic Approach to the People's Republic of China," I believe the essence of a new Cold War lies in the understanding that

Beijing is seeking to establish a security framework in Asia and spread its influence around the world — moves Washington sees as a challenge to the international order.

The square-off between the U.S. and China would hence focus on military power and technologies that shore it up, and is expected to last long. In March 2016, the U.S. Department of Commerce placed telecom equipment maker ZTE Corp. on what is known as the “Entity List,” which restricts the sale of American goods and technologies to companies over activities perceived to threaten the national security or foreign policy interests of the U.S. The Entity List later included Huawei and other entities deemed to have links with the Chinese military.

The inclusions have signaled a U.S.-China decoupling on technology. The Entity List also covers firms which are connected to the restricted companies, affecting Japan and other advanced nations. These countries are now forced to reconsider how they do business with China.

So what is going to happen to trade with and investment in China? In the early 21st century, China’s participation in the World Trade Organization accelerated the speed of economic globalization. The value of trade more than tripled from \$6.4 trillion in 2001 to \$19.2 trillion in 2018, with a massive China-centered supply chain network in place on a global scale.

Japan benefited from the system. Due to the trade dispute between the U.S. and China, and the coronavirus pandemic, “globalization revisionism” is gaining ground in Japan, but restructuring the global supply chain in a short period of time is not realistic. Instead we should focus on the new reality — the U.S.-China decoupling that mainly revolves around fifth-generation, or 5G, high-speed wireless networks and other advanced technologies. Totally ditching China’s market of 1.4 billion people is not a wise path for Japan, the U.S. and

Thinking this way, Japan's ties with China should be characterized by a tense geopolitical relationship based on the U.S.-China rivalry and a mutually complementary economic relationship over the long term. Japanese companies will need wisdom and the capacity to survive in this severe — and seemingly conflicting — double layered environment.

More growth opportunities in China

The future of the Chinese economy does not allow for much optimism, given the stern environment abroad and the structural problems within the country, including lower birth rates and a fast-graying population, sizable debts held by companies and local governments, and dire social inequalities.

Nevertheless, China may experience an economic recovery faster than any other major nation, having contained, at least for the moment, the spread of COVID-19 and rolled out stimulus measures by the National People's Congress, the country's parliament. As urbanization, the integration of the internet and industries, and applications of information technology are all advancing, it is certain that the country's high savings rate would steadily support the demand for new infrastructure, spending and services. Information from the 1.4 billion people in the country will be accumulated as big data, which will be analyzed by artificial intelligence to create an abundance of new businesses. There would be no future for Japanese companies that fail to capitalize on such an enormous market.



Toyota Motor Corp., in a joint venture with Tianjin FAW Xiali Corp., saw passenger car production begin in China in 2002. | KYODO

There is enough room for growth for Japanese companies in many areas, not just in the manufacturing of electronics and machinery. The growth potential also lies in service industries such as health care, nursing care and tourism; consumer goods sectors like food, beverages and cosmetics; financial businesses, including insurance and securities; and the environment conservation-related sector. The companies should even see a possibility in the information industry, such as telecommunications, software and content, so long as they follow rules regarding the Entity List and avoid the development of high-end products and technologies that can be diverted for military use.

What matters more is that Japanese companies realize their own strength, use it for their business in China and have the capacity to win in the market.

What are risks for Japanese companies?

There are four broad categories of conceivable risks in China: geopolitical risk; geoeconomical risk, in which countries use economy as a means to achieve a geopolitical purpose; policy risk concerning the government's industrial policies, tax system, among other examples; and management risk pertaining to corporate management of products, technologies, finance, clients, human resources and IT.

The important thing in a new Cold War era is to handle geopolitical and geoeconomical risks.

The key to managing geopolitical risk is “bottom-line thinking.” This way of thinking would allow us to answer the question of whether we could keep our company afloat if the Chinese business became inoperative in the event of a war.

One possible answer is to adopt strategies that have been discussed recently: Move supply chains back to Japan or shift to a “China Plus” concept, or produce locally only as much as is consumed, among other options.

Based on a lesson learned from the coronavirus crisis, the excessive reliance on foreign supplies and concentration on one manufacturing base for strategic materials in areas such as health care, grain and energy should be rectified. A government support policy of some sort may also be needed.

Incidentally, the increased friction between the U.S. and China since 2018 has accelerated the shift of manufacturing mainly in the electric and electronic equipment industry from China to Southeast Asian countries like Vietnam, Thailand, Malaysia and Indonesia. There has been a dramatic increase in this trend among Chinese private-sector firms. It is such an ironic reality at a time Beijing has been sensitive to foreign companies relocating their bases to countries outside China. It is, however, only natural for Chinese companies to make such a decision for their survival.

Due to rising labor costs and other factors, Japanese and South Korean companies began pushing ahead with the re-balancing of their focus on China a few years ago, according to the Japan Research Institute. What is notable at present are the shifts away from China of big Taiwanese high-tech companies such as Taiwan Semiconductor Manufacturing Co., which supplies chips to Huawei and other Chinese firms, and contract manufacturing company Hon Hai Precision Industry Co. The U.S.-China high-tech decoupling will become conclusive when the repatriation of U.S. and Taiwanese companies is complete.

One of the important ways to handle geoeconomical risk is to strictly adhere to the rules of the U.S. Entity List, which is reminiscent of the Coordinating Committee for Multilateral Export Controls (COCOM) established during the Cold War to control export of strategic materials and technology to Communist countries. In the 1980s, Japan's Toshiba Machine Co. violated the agreement by selling sophisticated milling machinery to the Soviet Union. A scandal like this one could deliver a fatal blow to companies.

The second measure is to thoroughly enforce the separation of politics and the economy as a strategy. This means that companies focus on economic activities and distance themselves from sensitive political issues. Personally, I don't think this strategy alone will enable companies to hedge geoeconomical risks, but at least it will not create any risk.

Lastly, a particularly important thing in risk response is to make an assessment of each risk as specifically as possible and remain committed to adapting to ever-changing dynamics. The development of local human resources and tapping into their talents also hold great significance.

Enhancement of leadership ability

The formula for companies to succeed in China comes down to constantly providing goods and services that Chinese consumers want at a reasonable cost.

To realize that in a new Cold War era, endless efforts by organizations and leaders to enhance their abilities are necessary. Specifically, they need to work on: developing the ability to obtain precise information swiftly and analyze it; building a strong and reliable network of contacts with people in the government and industry as well as clients; drawing on experts in and outside the company; establishing an organizational structure with emergencies in mind; and adopting a humble attitude and willingness to learn from China.

Toyota Motor Corp. serves as the model case of a successful Japanese company in China. Since Japan and China normalized their diplomatic relations in 1972, the automaker has proactively engaged in China. Not all of its efforts have paid off, for a number of reasons. Still, Toyota's China business has transformed considerably over the past 10 years, and the company's annual unit sales in the country surpassed those in Japan in 2019, with 1.63 million cars sold.



Much of the recent negativity between China and the West has related to Huawei Technologies Co. and its 5G technology. | KYODO

In terms of sales growth, Toyota has been by far the top player over the past few years. In May, the automaker saw a 20 percent growth in sales compared with the same month last year, having sold 166,300 cars, in a sign the company is enjoying brisk performance after the coronavirus crisis subsided in China. This feat is grounded mainly on the improvement of abilities as I mentioned earlier, though other success factors include a playbook for the Chinese market as part of a clear global strategy, foresight and the power of execution, a perpetual sense of crisis, the persistent effort to create Toyota fans and the ability to keep offering cars that customers want. After all, the key to success is that the leader takes the initiative in execution.

I have had connections with Toyota for over 20 years in relation to China, and I'm deeply impressed at the transformations that the company is constantly making, despite being a corporate giant. I want Japanese companies, regardless of their size, to learn from Toyota's success story in China.

The future role of Japan

After World War II, Japan's economy grew exponentially in the free and open international order centered on the Bretton Woods system of fixed exchange rates. The rise of China fueled by rapid globalization is calling for the need to adjust the free and open international order to the new changes. Unfortunately, a new Cold War that revolves around a collision between the U.S. and China has intensified paradoxes and problems in the international society and fomented a sense of disorder. In such a circumstance, what is the role of Japan?

The answer could be to act as a shepherd in establishing the order based on international cooperation and rules, as stressed by Yoichi Funabashi, the chairman of think tank Asia Pacific Initiative.

In 2017, the U.S. pulled out of the Trans-Pacific Partnership (TPP). Despite the odds, Japan worked with 10 other countries to conclude the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). A year later, Japan and the European Union signed an economic partnership agreement after tough negotiations. Both deals are comprehensive EPAs which allow for the highest degree of freedom in trade, such as scrapping tariffs, and the strictest intellectual property rights protection and investment rules in the world. Many countries have praised Japan's leadership in realizing these arrangements.

It is fair to say that the CPTPP and Japan-EU EPA have demonstrated a new direction toward building the international economic order as an alternative. Yet the international economic

order is complete only when both the U.S. and China are involved. Will Japan be able to continue to take on such a heavy responsibility — the role of shepherd for the rules-based new international order? We are now in an era where Japan's capabilities — including not only Japanese politics but corporate leaders — are being put to the test.