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# INTERCHINA INSIGHT

## ASSESSING THE CHINA RISK: Geopolitics, Ukraine and Covid

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Global boards are justifiably concerned and confused about China right now. For most companies, their Chinese operations are still going well and represent a major contributor to global sales and profits. However, the risks seem to be multiplying and the sense of insecurity deepening.

The combination of the geopolitics, the impact of China's zero covid policy on the economy, and zealous domestic politics has many boards asking how the country should fit into their future strategies. This has been compounded by the travel restrictions of the past 2 years, with the lack of visits to and from China impeding the development of understanding and trust between HQ and China teams during these changing times.

In this article, we present our read of the risk factors and their implications for international companies operating in China. We argue why, in our view, cautious positivity is warranted. And we conclude by offering multinational HQs our seven tips for operating in China today. These include incorporating geopolitics into the decision-making process, assessing how to de-risk your China balance sheet, the importance of scenario planning, managing the growing HQ-China Gap, taking good care of expatriate and local executives in China, and the importance of taking advantage of the new wave of positive policies to retain MNC by local and

national officials.

## Risk Factor 1: Geopolitics

Over the last few years US-China relations have become tense and contentious. Initially the focus was on transactional issues such as tariffs and the reduction of the US trade deficit with China, but now the discussion between the two countries has shifted to values such as human rights, political systems and sovereignty.

It is clear that this no longer constitutes a real negotiation as both sides are stuck to their positions with little possibility of change or compromise. Political relations between the two are therefore likely to remain tense for the foreseeable future, and we do not consider that a return to the past is likely.

### *Relationship shaping trends*

A number of specific trends are shaping these relations. The first is the increasingly intense and strategic rivalry. It is not just about the economy, but also about technology, and values such as democracy, freedom and human rights. However, the sense of interdependence is still very deep. This mitigates against a hard decoupling, and is leading to a more selective or constructive decoupling instead.

Secondly, there is the domestic politics agenda. In the US, China is considered a threat and there is a sense that one cannot afford to be soft on China. While in China, there is a growing feeling of nationalism and pride and a desire to stand up for its own interests. These two fundamental attitudes will not change, fueled further by media and political stakeholders in each country.

Thirdly, there is a growing tolerance for risk and friction. Many red lines have already been crossed in recent times and this will continue, while there is growing scepticism about the value of cooperation and engagement.

And finally, there are today less checks and balances to mitigate against all of the above. A good example is the business community itself which used to have a role in acting as a bridge between both governments. Contrast this with today, where there is a feeling that the western business community is actually part of the problem.

### *China's strategic autonomy*

Since the shock of US sanctions against Huawei, one of China's most successful technology companies, China has made a firm decision to accelerate and deepen its efforts to achieve 'strategic autonomy'. This is a vague concept which refers to the

ability of the Chinese government to control strategic sectors such as finance, telecoms and energy, and to ensure that these sectors cannot be disturbed or sabotaged by outside countries such as the US.

Based on all the benchmarks we use in our business, we follow a “70%-30% China” approach, based on the idea that 70% of China’s economy will continue to open up and follow market rationale, while 30% will be more restricted than in the past.

The strategic sectors subject to such restrictions account for around 30% of China’s economy. But even in these sectors, the Chinese government does still allow some scope for western or US participation. This remains possible either as a transitional measure (i.e. for lack of Chinese alternatives) or in such a way that supply cannot be interrupted by actions from outside China (e.g. requiring local production or control, local IP and Joint Ventures etc).

It is important however to understand that the situation in each strategic sector can vary, and even within the same sector can differ depending on the criticality of the equipment or component. Combined with additional shifts over time, this presents a dynamic and complex environment for those western companies active in these sectors.

### *Globalization is changing*

While globalization is here to stay, it is morphing into a more ‘fragmented’ structure, based broadly on the creation of three specific spheres.

The first is Europe and associated countries, the second is NAFTA (North American Free Trade Agreement) and associated countries, and the third is China/Asia. We see the emergence of a “non-aligned” country block, that the other blocks will court (broadly, southern hemisphere countries, most of them with deep economic relations with China for the past 15 years).

Within the model there is a degree of fluidity, for instance in terms of how regions such as Africa and South America are considered, and how specific countries such as Japan, Korea and Australia/New Zealand fit into the model.

There are multiple reasons for the emergence of this model now, but there are three key drivers. Firstly, the aforementioned decoupling between the US and China. Secondly, the continued supply chain and logistics issues in the wake of the pandemic with the elimination of single source supply arrangements. And thirdly, the growing impact of increasing populism (and related protectionism) in western countries.

### *Impact of Ukraine war*

The Ukrainian conflict has only further complicated this picture. China has adopted a neutral position since the war started although it has also been very careful to stay away from sanctioned areas such as collaboration with Russian banks and trade credit.

This is dictated by its interests. It has no interest in upsetting its largest neighbor while there is little upside (if any) in condemning Russia and aligning with the west. However, China does also not wish to be considered a global pariah and will continue to be very careful in the way in which it supports Russia in order to avoid any possible sanctions itself.

In terms of China’s views on foreign investment, we do not expect any basic shift. However, the swift decision of many global companies to leave the Russian market or to temporarily stop operations in the country is likely to strengthen the determination of China to achieve strategic autonomy as we describe above.

## Risk Factor 2: Covid impact on economy

China's zero Covid stance will not change fundamentally until after the Party Congress, expected in October/November this year. However, we are beginning to see some minor and subtle policy adjustments.

For instance, international borders are gradually opening up, and we have seen some relaxation in quarantine periods and visa requirements for visitors to China. In 2023 we could possibly see more flexibility on business travel, although the belief is that China will not open its borders to outbound tourism for at least two to three years. The idea for China is ultimately to buy time to protect its population (ie. Looking at the opening of Taiwan, the closest benchmark to China, millions would die in China), to develop its own mRNA vaccine and increase vaccination levels, to build up its healthcare infrastructure, and to also see how the rest of the world opens up again.

However, this comes with a very strong caveat. The above presents a positive scenario where there are no major Covid outbreaks and/or lockdowns. If they do occur, which is a reasonable possibility, the easing of restrictions would be delayed, and the economic recovery impacted.

### *Forecast*

Until March 2022 the economy was recovering well, with a Q1 GDP growth of 4.8%. However, there was a drastic setback in April. Industrial output dropped from 8% growth in Q1 to 2.9%, exports from 20% to 4%, and the service sector turned negative. For May, while the situation is still shaky, the figures are better than expected: industrial output was basically flat, there was a smaller drop in retail sales, while exports returned to healthy growth.

The government is still aiming for 4~5% growth in 2022, with investment and aggressive incentive programs. These range from focused investments in solar panel installation in the west of China, to infrastructure investments in water and irrigation, to investment in high-speed rail and roads in east and south China focusing on bridge building and new connections. We will also see consumption driven policies (tax cuts, subsidies, lending easing, etc).

Our view is that consumption might partially recover faster than infrastructure/Capex, since central government has made it clear they do not want to increase dramatically the debt level of the country. The most likely outcome will be a push focused on high-end products such as offering shares in stock market flotations, real estate purchases, and

luxury goods. The stimulation of car consumption will be a particular driver with incentives to replace old cars and motorcycles, while there will be a relaxation of some restrictions around property and real estate.

The timing of the economic recovery is unclear as this will be strongly conditional on the policy direction and absence of large Covid breakouts. As such, although we foresee a positive scenario for the second half of 2022 and 2023, this comes again with a strong caveat.

## Risk Factor 3: Zealous domestic politics: Ideology vs pragmatism

There is a narrative in the west that China's domestic policy making has been overtaken by politics and ideology, forsaking the focus on pragmatic economic development of the past. The reality however is much more complex.

It is true that the China Equation is getting more complex. In the past you could understand most of domestic policy making based on two fundamental principles that the government would look to sustain: "Economic Growth" and "Social Stability". Today, we need to add "Ideology" to this mix.

This new element will coexist and interact with the others. Critical here is to understand the position of China's leadership and its social contract with the Chinese people, which give up a range of individual rights in return for the leadership ensuring social stability, economic progress and improving quality of life. Measures like limiting the excesses of tutoring services, online gaming and freewheeling internet services, have to be seen against this background. Indeed, along with the zero Covid policy, these measures have been generally welcomed by the Chinese population.

However, 2022 is a succession year for China's leadership. This is a particularly sensitive time, and as a result, the strengthening and safeguarding of the leadership has taken precedence, even over the social contract. The excessive influence of politics has been evident in certain events, such as the implementation of the zero Covid policy in Shanghai from late March to June.

For the future, we certainly expect more complexity but still a very pragmatic and flexible interaction between the elements of the China Equation.

## Implications for multinationals

There remains a push to retain and encourage multinational investment in China and we do not expect any shift in policy. On the contrary, in "The 70% China", policy is actually likely to become more supportive, and local governments may provide more substantial incentives.

For those companies operating in the strategic sectors ("The 30% China") subject to restrictions as detailed above, the focus will remain on market access through Joint Ventures and partnerships. For those operating in more open sectors, the focus will be on competitiveness in the face of stronger local competition.

From our day-to-day dealings we know that multinationals are committed to continuing operations and further investing in China. We do not see or expect any exodus, possibly apart from those companies which have been increasingly under-performing and suffering in China. Even in a more decoupled or fragmented world, China will still be the largest economy worldwide and largest market for many companies.

Nevertheless, in light of the increased uncertainty and associated risk, we are seeing many conduct scenario planning on five to ten year timelines.

A typical consideration is the geographic diversification of supply chains to build in resilience. Investments that would have gone to China in the past for export manufacturing could be switching to home countries instead.

Meanwhile, having senior expatriates stationed in China will be more important than ever to strengthen communication and trust between HQ and China operations. With the ongoing restrictions under China's zero Covid policy, the appetite of senior expatriates to live in China has diminished, making retention and recruitment a particular challenge.

## Summary: Seven steps for China

In this complex and fast-changing environment we have seven key tips for multinationals operating in China.

ONE: Stay calm. Right now we are probably experiencing the worst moment for multinationals and we expect the situation to start improving very soon. Do not rush into making decisions.

TWO: Make an effort understand Geopolitics and Domestic policy making in China. Try to get the right facts, understand the issues and have an open mindset. Geopolitics and the New China Equation have intruded into business and will stay, so include it in the decision-making process.

THREE: Assess your China risk and think how to de-risk the balance sheet. Some key words: China for China/ China for Asia; China local financing against local assets; New Investment Models (more use of Joint Ventures; China IPO of China BUs).

FOUR: Work on medium- to long-term scenario planning and weave this into a clear Road Map. Most companies are completely reshaping their China strategy and Road Map for this decade.

FIVE: Manage the increasing HQ- China CEO Gap. Spend time educating yourself and communicating with your China CEOs. Build China Advisory Boards; Invite China knowledge to your global boards; Conduct regular meetings and build bridges to fully understand

the reality of China.

SIX: While becoming more local, focus on keeping your global DNA. Take good care of people expatriate executives in China who are becoming increasingly important and more difficult to retain in China. Spend a lot of resources to make your China based executives align with your global practices.

SEVEN: Prepare a "Wish List" to communicate with local and central government. They are likely to more aggressively promote and support FDI and will likely approach your China CEO in the incoming months. think about what types of requests and proposals you could make to local and central government to consolidate your position in China.



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