

CHINA PLUS ONE

Implications for Danish businesses



Survey report prepared by DI Sense China

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PREAMBLE

Foreign companies are reassessing investments on the Chinese market. It is a development that started when rising labour costs put China's status as 'the factory of the world' under pressure. It accelerated during the US-China trade war and Covid-19. Now a weak economic recovery coupled with geopolitical tensions are adding another dimension.

Danish companies have until recently remained committed to China. This changed in 2022, when trade and investment levels dropped for the first time in decades. It is a tendency that is expected to continue, and it could have significant consequences for the Danish economy. How to deal with the China business is being eagerly discussed in boardrooms and policy committees.

This report presents the findings of a recent survey conducted by DI Sense China. It examines if and how Danish companies are prepared to pursue a *China Plus One* (C+1) approach. C+1 refers to a supply chain strategy that encourages companies to reduce dependency on China by expanding the countries they source from.

The report includes three sections:

- ✓ Factors for reducing China dependency
- ✓ Market alternatives
- ✓ Perspectives

A total of 85 Danish companies with existing activities in China contributed to the survey. We appreciate your support!

DI Sense China's survey plays a central part in a comprehensive study about C+1 implications. A URL link to access the study's full data set is available on request.

A special thanks to the Danish Industry Foundation for financial support.

Danish companies have started to exit China.

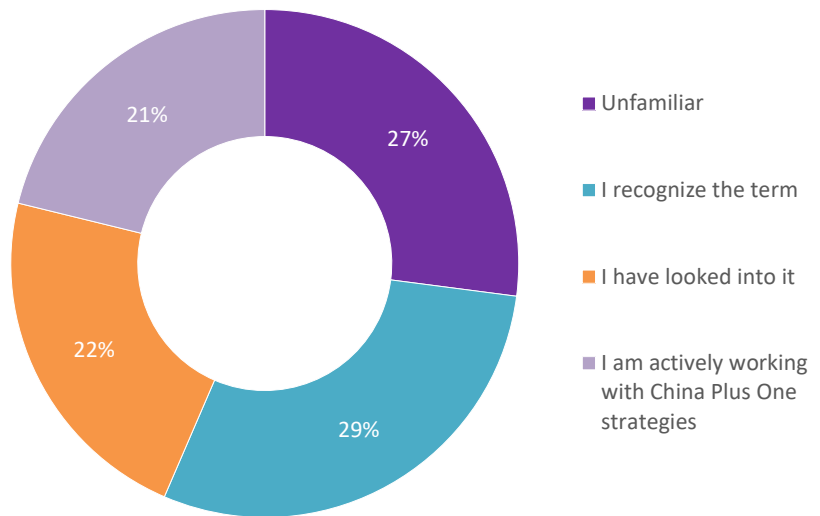
85 companies participated in survey.

FACTORS FOR REDUCING CHINA DEPENDENCY

To what extent are Danish companies reducing their engagement in China? What are the underlying considerations? This section presents key findings from the survey. Please observe that companies responding “it is not a present consideration to reduce activities in China” in question C were not asked questions D-J.

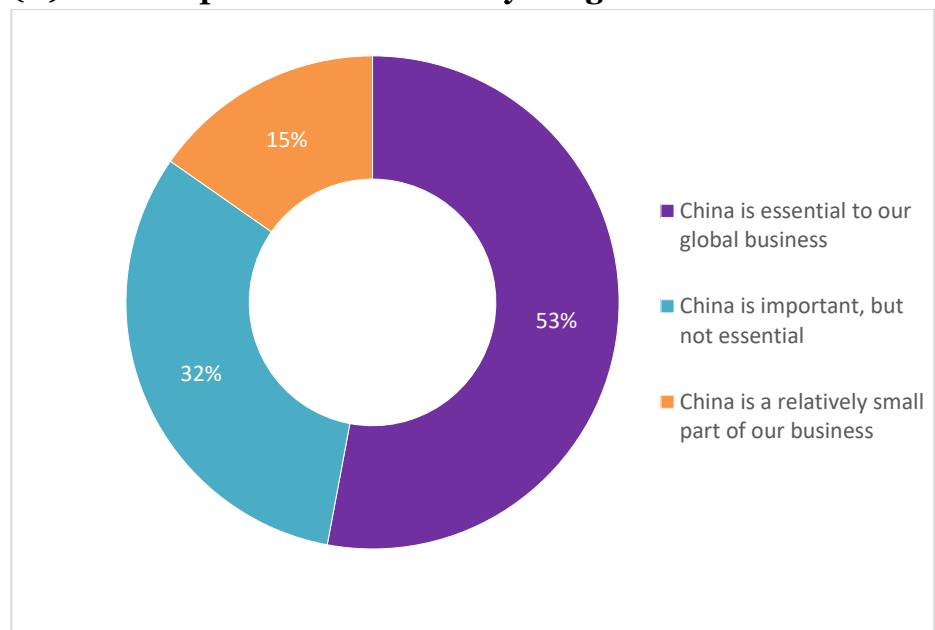
(A) What is your familiarity with ‘China Plus One’?

73% are familiar with C+1 concept.
21% are actively working on C+1 strategies.



(B) How important is China to your global business?

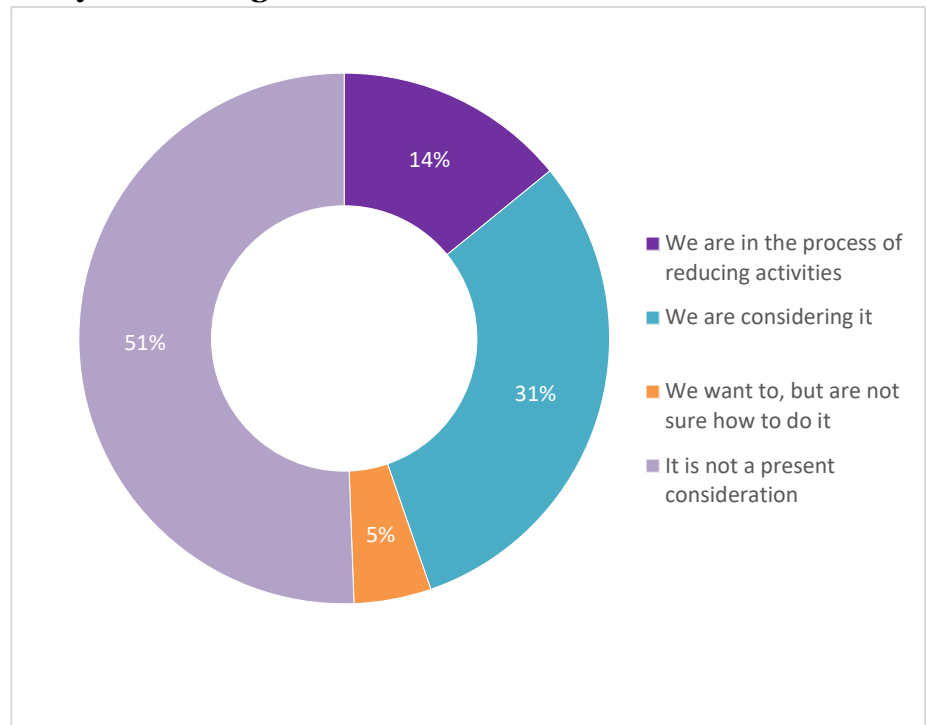
53% consider China an essential part of their business.



(C) Is reducing activities in China part of your strategic considerations?

49% may move activities away from China.

14% have already started the process.

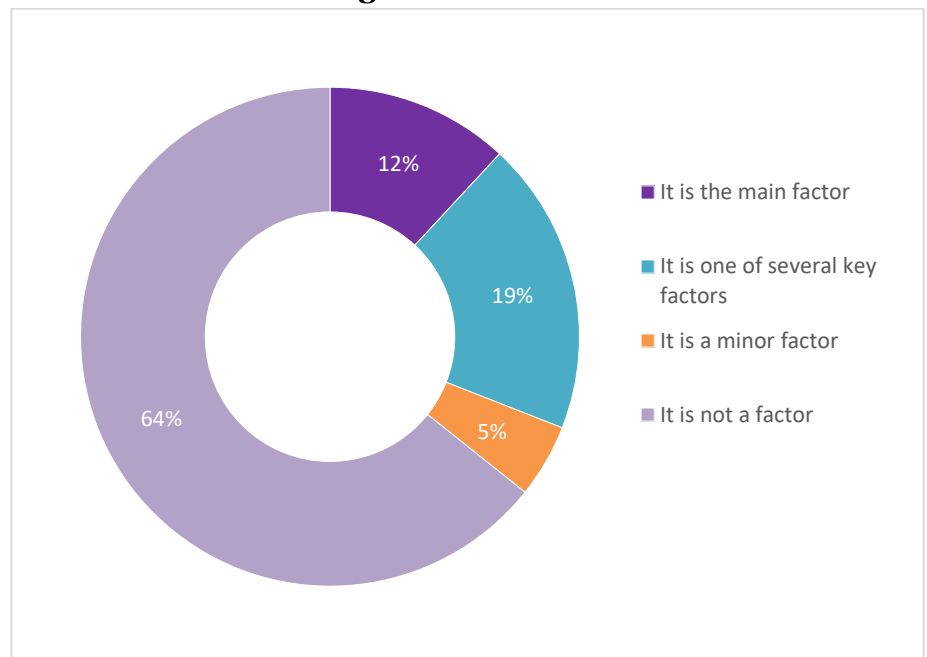


(D) Are lower sales expectations in China a factor for reducing activities?

64% do not think lower sales expectations has any influence on their situation in China.

12% report it is the main factor for reducing dependency.

Impact on C+1 considerations? **LOW**

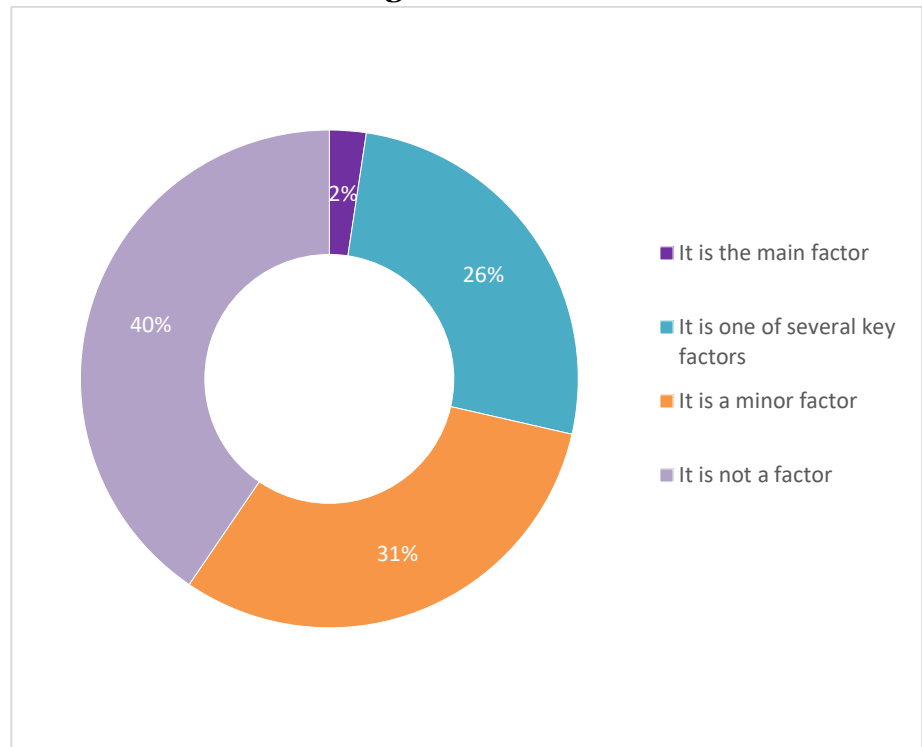


(E) Are promising business prospects in other markets a factor for reducing activities in China?

71% do not think business opportunities in other markets has significant influence on their China situation.

2% report it is the main factor for reducing dependency.

Impact on C+1 considerations? **LOW**

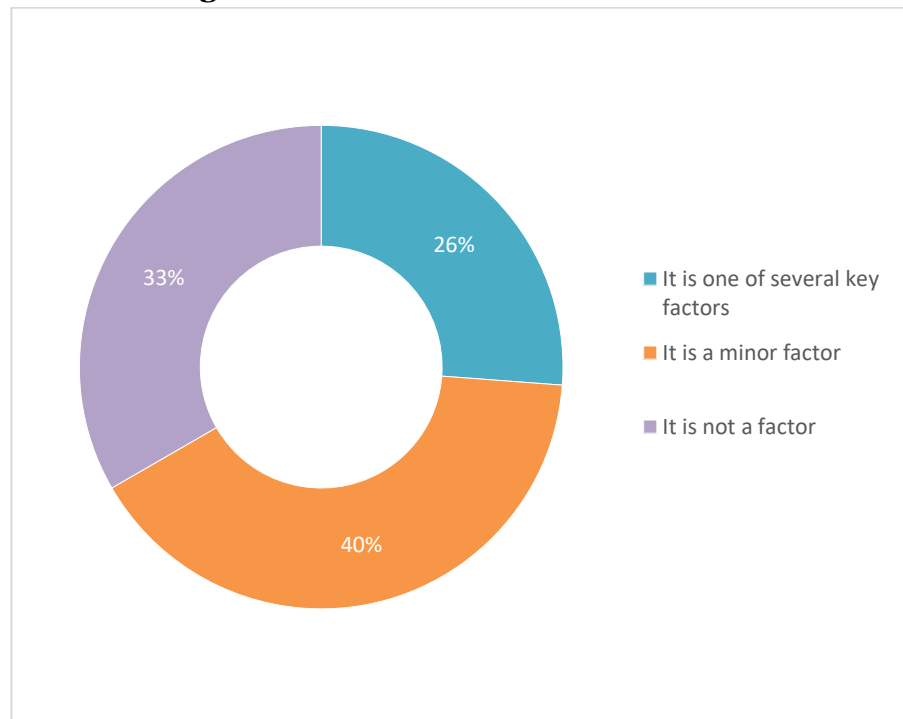


(F) Are increasing costs in China a factor for reducing activities?

73% do not think growing costs has significant influence on their China situation.

0% report it is the main factor for reducing dependency.

Impact on C+1 considerations? **LOW**

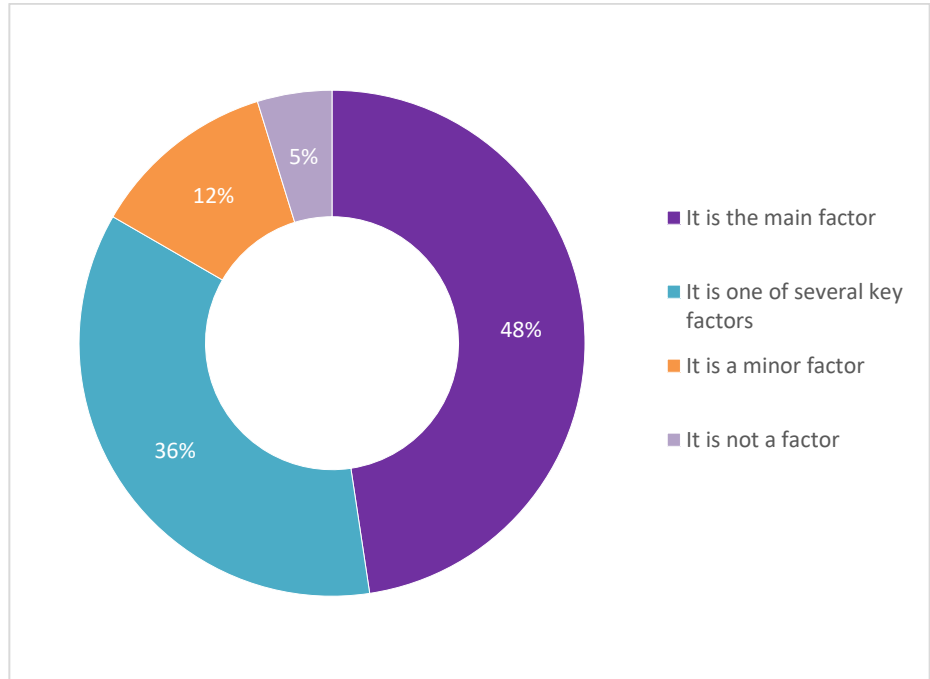


(G) Are geopolitical considerations a factor for reducing activities in China?

84% think geopolitics has significant influence on their China situation.

5% label it a non-factor for reducing dependency.

Impact on C+1 considerations? HIGH

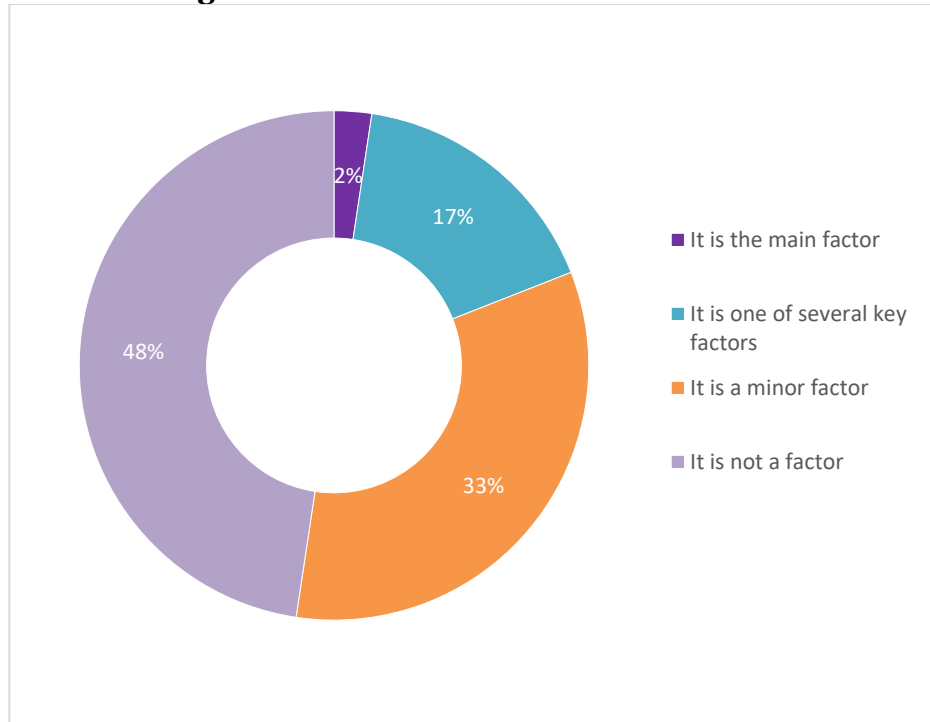


(H) Is public opinion in Denmark a factor for reducing activities in China?

81% do not think Danish public opinion has significant influence on their China situation.

2% report it is the main factor for reducing dependency.

Impact on C+1 considerations? LOW

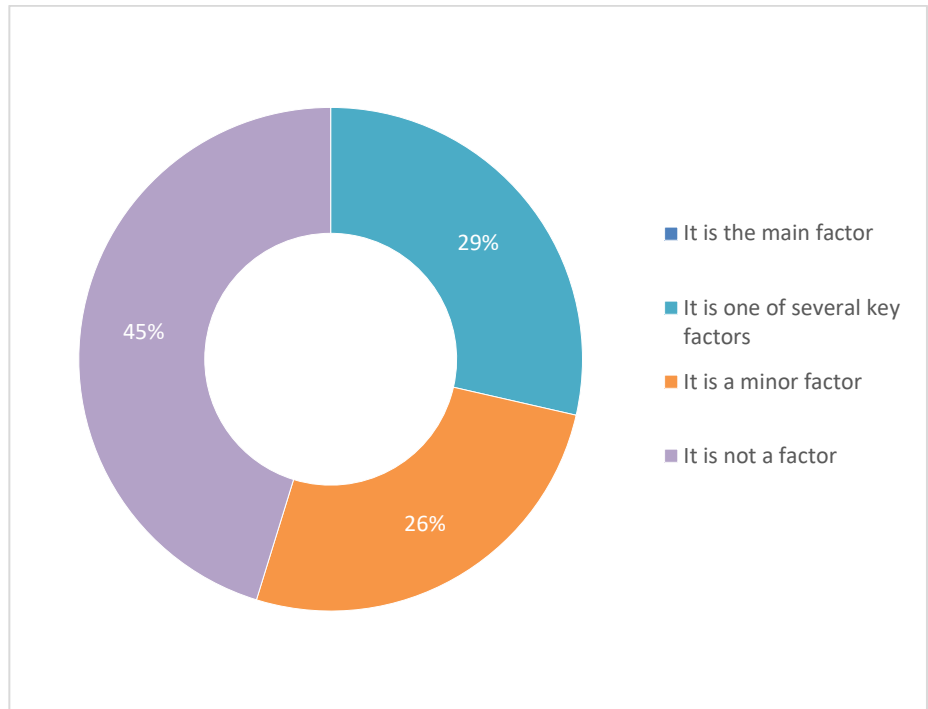


(I) Is customer pressure a factor for reducing activities in China?

71% do not think customer pressure has significant influence on their China situation.

0% report it is the main factor for reducing dependency.

Impact on C+1 considerations? **LOW**

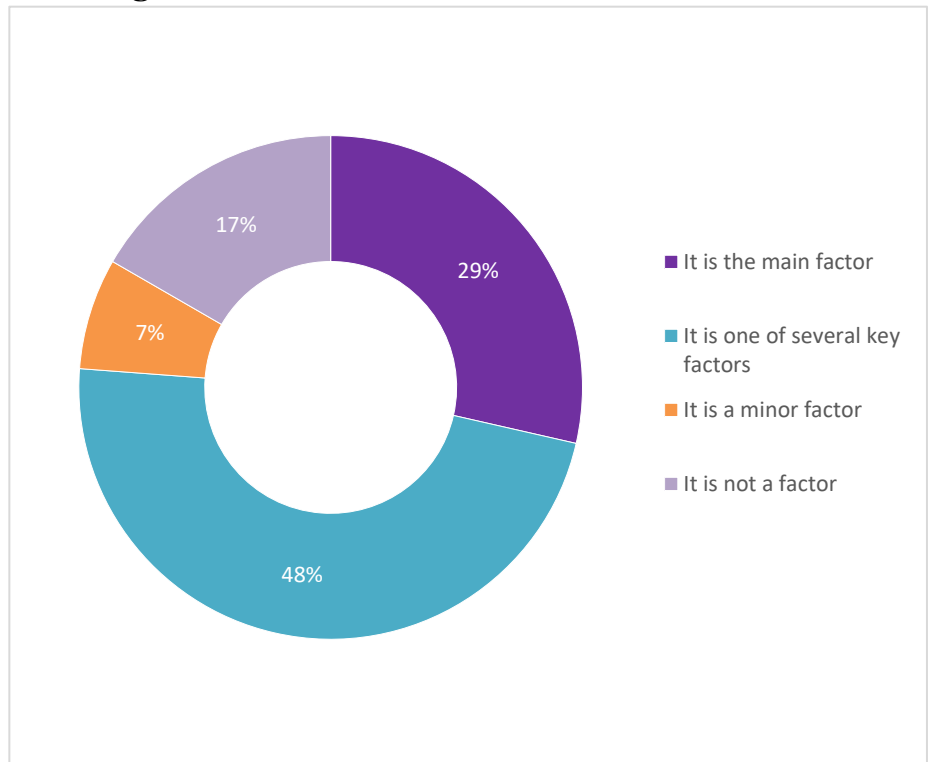


(J) Is diversifying your supply chain a factor for reducing activities in China?

77% thinks supply chain diversification is a significant factor for reducing dependency on China.

17% label it a non-factor for reducing dependency.

Impact on C+1 considerations? **HIGH**

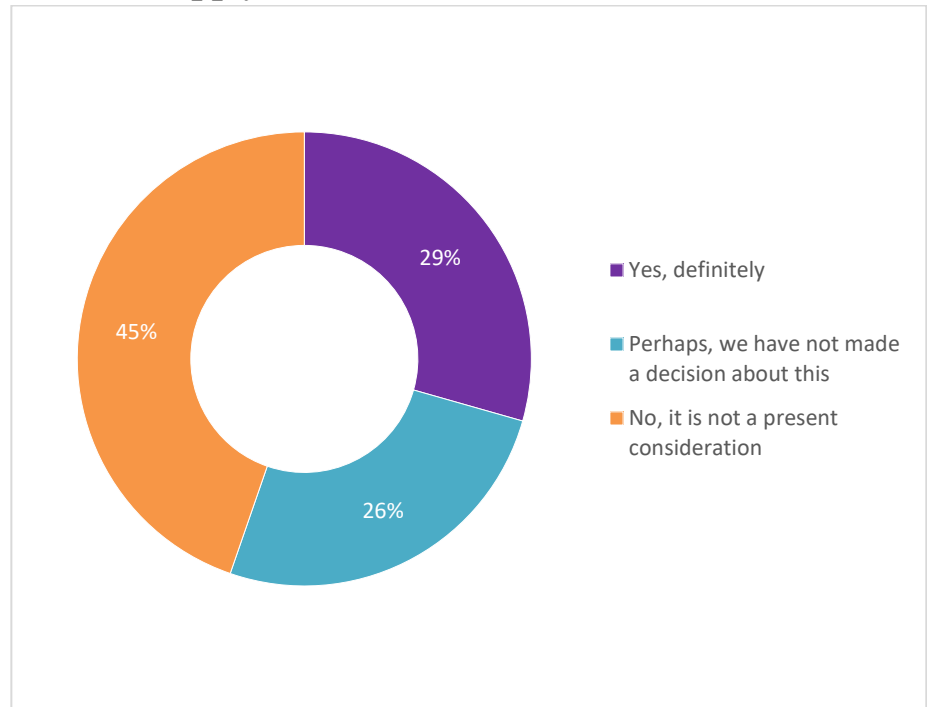


MARKET ALTERNATIVES

With China losing some of its attraction to Danish companies, the next big question is how and where to find alternatives. Which markets offer viable conditions to replace current China functions fully or partially? Questions K-N present the findings from our survey.

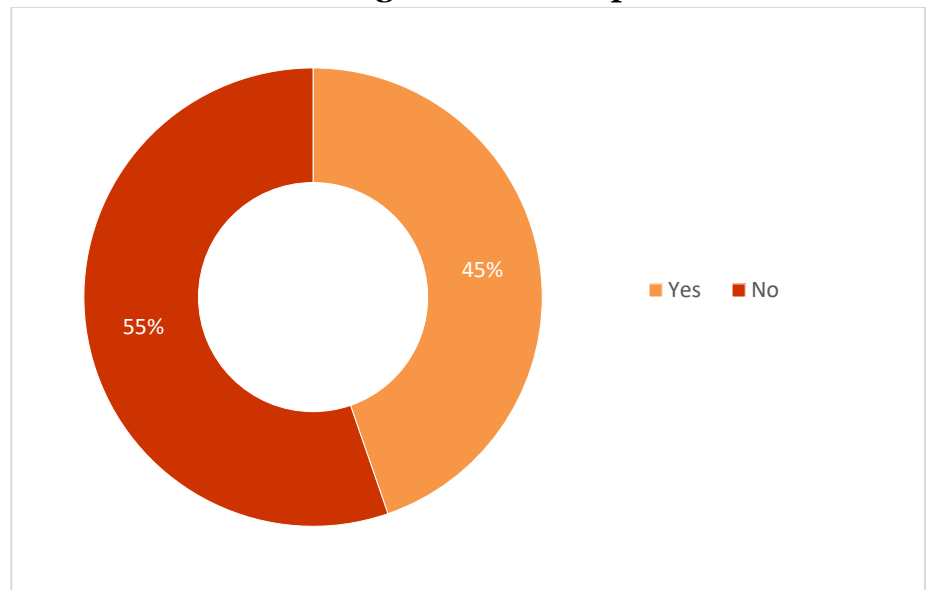
(K) Do you consider mixing new investments in China with supply-chain investments in other markets?

55% may combine new investments in China with supply chain investments in other markets.

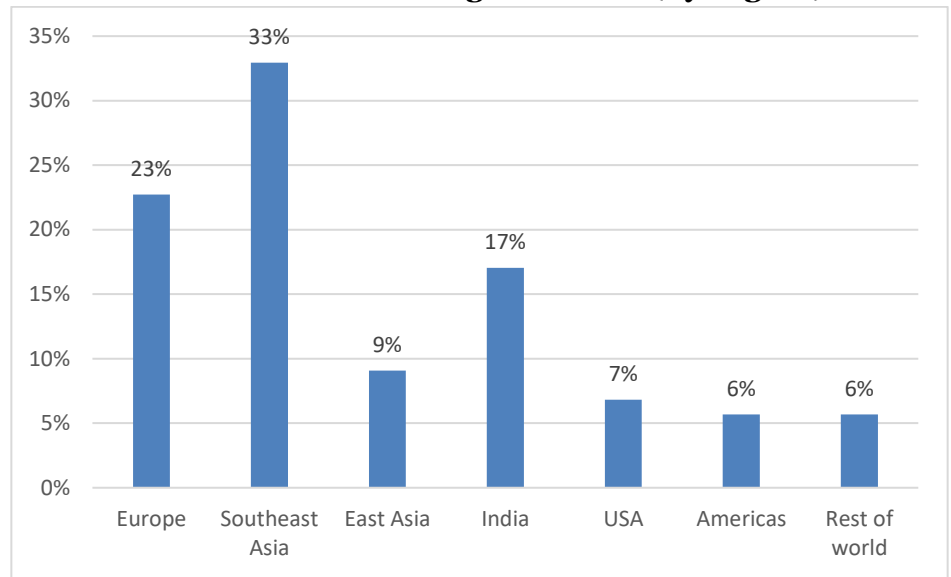


(L) Is China replaceable to your company as a sourcing market for critical goods and components?

45% report that China is replaceable as a sourcing market for critical goods and components.



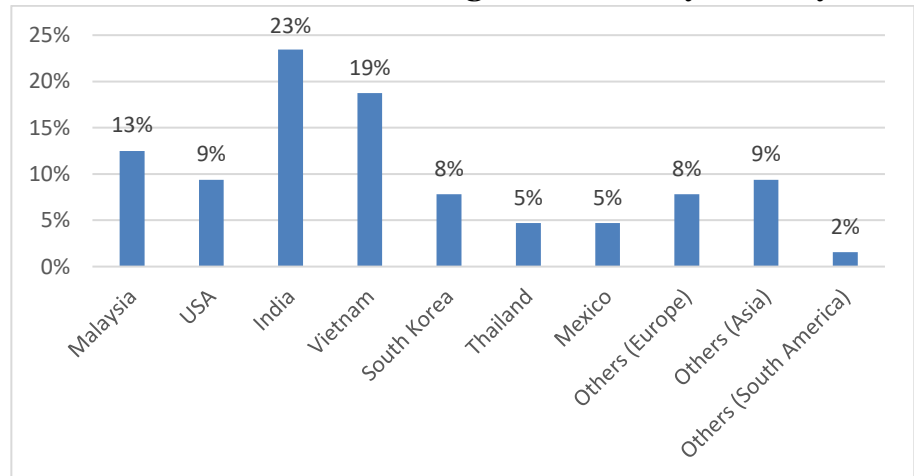
(M) Which markets are your company considering as an alternative to sourcing in China? (by region)



Note: This figure counts the frequency of regional markets mentioned by the respondents. The percentage is the combined sum of markets indicated individually (e.g., Vietnam for Southeast Asia, South Korea for East Asia), and markets indicated regionally (e.g., Europe, East Asia).

Southeast Asia is the key regional alternative to sourcing in China.

(N) Which markets are your company considering as an alternative to sourcing in China? (by country)



Note: This figure only counts the frequency of individual markets mentioned by the respondents and do not include regional market mentioned by the companies (e.g., Eastern Europe, MEA). Country-specific markets mentioned less than two times are aggregated as 'Others' according to their geographical region.

India and Vietnam are the two preferred country alternatives to China.

PERSPECTIVES

China’s economic and political development is transforming business conditions for many Danish companies with activities in the country. C+1 is gaining ground as a strategic framework for mitigating risks. But moving existing functions to other markets presents opportunities as well as challenges. This section puts the survey findings into a broader perspective. We examine developments that either support or question the considerations expressed by respondents. We also compare China’s competitive situation with Asian +1 markets mentioned in the survey.

Geopolitics is the new gamechanger

During the golden years of globalization, China was often praised by business executives as a haven of political stability. Whether they appreciated the government system or not, foreign investors could rely on a solid foundation, uninterrupted by changing domestic and foreign politics.

That is no longer the case. Geopolitical concerns now stand out as the primary risk consideration for investors. Companies are forced to factor in the potential impact of trade sanctions, export controls, and logistical disruptions. Some risks were always present, but the lessons learned after Russia’s invasion of Ukraine have made them considerably more tangible. One scenario in particular is cause for concern. If China decides to take aggressive action towards Taiwan, the impact on trade and investment is bound to be immense.

As a consequence, the hot question in Danish and other international boardrooms is whether the financial reward outweighs the political risks of investing in China? The survey results suggest that many companies do not think this is the case anymore. Small and medium-sized enterprises are the most likely to consider geopolitics a gamechanger for investing in China, whereas large-scale corporations are susceptible to the threats, but less likely to disengage from China.

The advantage of being “in China, for China”

The position of large companies coincides with a growing tendency to pursue a *China-for-China* strategy (also referred to as “in China, for China”). From a risk mitigation perspective, it offers the benefit of isolating the China operation from geopolitical interference and negative public opinion outside China.

Geopolitics is now the primary risk factor for investors.

Committing to a China-for-China strategy does not, however, mean decoupling the China subsidiary from global headquarters. Rather, the subsidiary is granted a certain level of autonomy to become integrated into the local market and capitalize on available resources. It streamlines the value chain to meet a specific objective instead of fulfilling a broad set of obligations.

China-for-China strategies are gathering momentum. A recent survey by the American Chamber of Commerce showed that 30% of over 300 respondent companies planned to invest more, not less in China. Almost all of them with the specific purpose of exploiting domestic business opportunities. Instead of building factories to produce goods that are ultimately sold elsewhere, these businesses aim to draw on research and development facilities in China to make products for a vast domestic audience.

MNCs want to invest more to capitalize on local demand.

Does your value proposition fit China's priorities?

While the China-for-China approach have inherent advantages, it may not be sufficient to justify further investments. The Chinese government has clearly stated its ambition for the economy to be more self-reliant. This objective is becoming a central factor of operating in China, particularly for foreign investors with a production set-up targeting the domestic market.

According to the European Chamber of Commerce, companies can be divided into three classes based on the expected value they bring to national and local development plans.

Business class covers solutions that are critical for China's next stage of development. Companies in this class are encouraged to grow their market share to solve bottlenecks and provide critical inputs. They are mainly found in strategically important industries highlighted in Five-Year Plans and industrial policies such as Made-in-China 2025. Danish companies in business class can be expected to receive very favorable treatment by industry supervisors. They are, however, also expected to demonstrate their commitment to the Chinese market by large investments.

Economy class covers solutions in politically neutral territory. Companies in this class are not prioritized by authorities but are accepted stakeholders in their industry. It has little impact on China's industrial ambitions if an economy class company exits the domestic market, as they are non-essential from a technological perspective. However, they contribute to other aspects of the economy, e.g. by creating jobs and stimulating competition. Danish companies in the economy class can be expected to receive relatively favorable treatment by industry supervisors.

Danish companies with highly value-added solutions are very welcome in China.

Companies with a strong contribution profile are encouraged to stay.

Companies with a weak value proposition should look for new markets.

The *cargo class* covers solutions with waning importance for China's economy. Danish companies in this class will find it difficult to stay competitive. The category mainly consists of businesses investing in low-margin sectors, where Chinese companies are dominant and the value-added effect on other industries is limited. Danish companies in the cargo class will not receive much attention from industry supervisors. If they pursue a China-for-China strategy, competition with local players will almost certainly push them out of the market.

Size and sophistication matters

China is becoming a market for big players and niche leaders.

In addition to the value proposition, scale and sophistication play an increasingly important role for the success rate of foreign investments. Danish companies with a small presence in China are facing tougher competition as many sectors are seeing high levels of post-pandemic consolidation. In this sense, China is becoming a market for big players and for SMEs in certain market niches.

From a pure supply chain perspective, rising labour costs have gradually eroded China's competitive advantages over the past 10-15 years. Interestingly, the survey finds that the cost factor does not play a major role in C+1 considerations. The explanation could be that the number of Danish companies in the *cargo class* is already small. In other words, investing in China to maximize savings is a thing of the past.

China's rapid improvements in labor productivity has been an efficient bulwark against losing competitiveness compared to Asian +1 markets. It is also the main catalyst for China's upgrade from being a low-end supplier base into a center for R&D activities and high-end manufacturing. Millions of blue-collar workers in China have learned to work with sophisticated production systems integrated with automation, whereas other Asian markets are still in the process of cultivating a skilled work force.

Public opinion has modest impact so far

Criticism of Denmark's bilateral relationship with China is becoming more vocal in the public debate. The main point of controversy is whether Denmark can sustain close economic ties with authoritarian regimes such as China, while at the same time advocating for universal human rights and democracy.

Companies are aligned with Danish government on taking a pragmatic approach.

The survey suggests that Danish companies are not overwhelmingly affected by negative public opinion. Only 2% of respondents list it as the main factor for reducing activities in China. This attitude reflects the official Danish policy of focusing on common interests between the two countries, rather than on differences in values.

Lex Russia remains a concern.

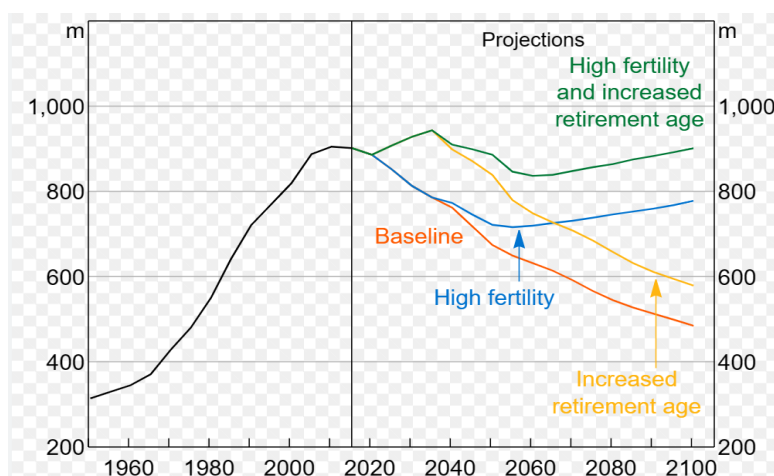
Regardless, political pressure to ‘de-risk’ from China will persist. Opposition parties on both sides of the aisle in Denmark’s parliament sense a winning case targeting the government’s China policy. They point to China’s close cooperation with Russia as evidence that common values and interests are intertwined. In line with most other non-Western countries, China has declared a neutral stance in the Russia-Ukraine conflict. Its economic relationship with Russia has, however, deepened significantly since Western sanctions were imposed on Putin & Co. This is interpreted as a sign that Beijing’s economic interests ultimately go hand in hand with its political priorities and alliances.

China’s labour force in projected steep decline

Demographic bottlenecks are lurking

China’s demographic challenges are not directly addressed in the C+1 survey. The development is not an imminent concern, but the projections for China’s labour force makes it an important long-term consideration. In 2019, the working population peaked at around 900 million people. By 2050, it is estimated to have declined by over 200 million people unless the country’s fertility rate improves, and the retirement age is increased. China already has a median age that is among the highest in Asia. As the proportion of children also continues to drop, nearly 1 out of 3 Chinese people will be aged 65 or older in 2050.

Scenarios for China’s working age population



Source: Reserve Bank of Australia

Will an ageing society cause internal turmoil in China?

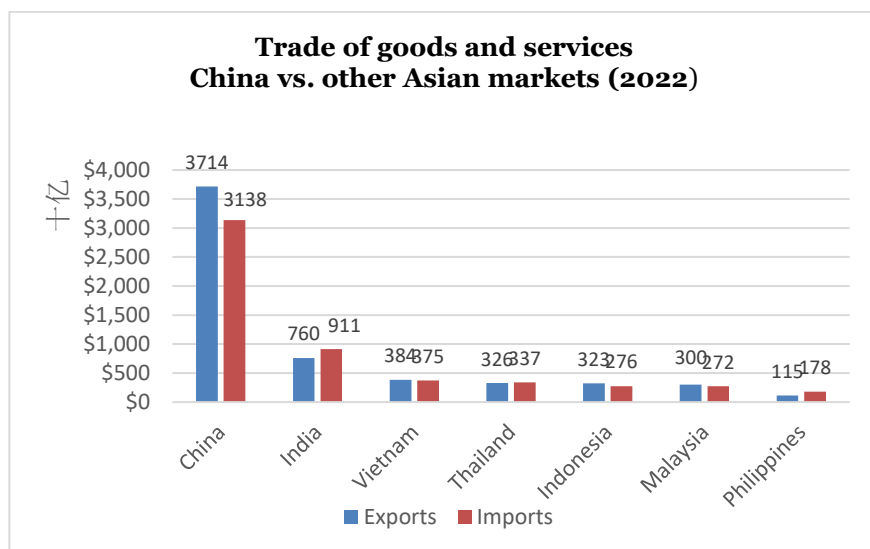
The sheer volume of China will likely mitigate some of the impact caused by a shrinking and ageing population. The country will remain an attractive sales hub. And the Chinese labour force will still have a size and caliber that offers opportunities from a supply chain perspective. The biggest risk from China’s demographic development could be societal. Will China grow old before it gets rich? If so, who is going to take care of the millions and millions of old people that are insufficiently covered by pension schemes? The introduction of a public welfare system is not realistic. Local governments do not have the funds, and the central government has other priorities. The outcome could be civil unrest, which has always accompanied economic turmoil in China’s long history.

China’s economy dwarfs other Asian +1 markets

C+1 strategies are preoccupied with supply chain considerations. As such, comparing China’s overall business potential with +1 markets is not always relevant. However, as the China-for-China trend suggests, companies are prone to invest in markets with a high degree of scalability.

Presently, China contributes substantially more to international trade than any other Asian country. In 2022, foreign trade of goods and services in China were over four times higher than India, the second largest Asian market. The collective exports of India and Southeast Asia were less than two-thirds of China, while the imports made up just below 75%.

The volume of China’s foreign trade is almost the same as aggregate for rest of region.



Source: World Bank

The survey lists India as the preferred supply chain alternative to China. Several Danish companies have established produc-

India is 15-20 years behind China on key parameters.

tion facilities in dynamic Indian business centers such as Mumbai and Bangalore. But there is still a long way to go. According to a recent Bernstein Research Report, India lags far behind China on most performance indicators – e.g. 20 years in FDIs, 17 years in export capacity, and 15 years in GDP per capita.

China is also far ahead of its southern neighbors. Its GDP per capita is nearly double that of Thailand, and roughly three times as high as Indonesia, Vietnam, and the Philippines. In terms of capacity, most +1 markets cannot absorb large investment inflows anywhere close to the level in China. Partly because of weak industry cluster formations, but mainly due to the lack of skilled labour.

China is not easily replaceable in Asia

Whereas a C+1 strategy offers a soft landing for companies looking to reduce China dependency, more aggressive strategic options entail a complete replacement of China as supply chain hub. This presents significant challenges. China is a major supplier for almost all +1 markets, in addition to being an important destination for finished goods. Breaking away from decades of economic integration and specialization will likely disrupt existing supply chains, particularly in Asia.

From an operational perspective, a full-on transfer from China to other Asia markets is laden with challenges. China has spent the past four decades building a world-class infrastructure in all corners of the vast country. Indeed, most +1 markets depend on Chinese equipment and knowhow to upgrade existing infrastructure. Moreover, local Chinese authorities have rich experience in facilitating special economic zones, industrial clusters, and an attractive regulatory framework. Asian +1 markets are in an infant stage in terms of supervising foreign investors.

Diversification is correct, but unfortunate

Besides geopolitical considerations, most survey respondents point to diversifying their supply chains as the main factor for reducing dependency in China. Diversification is becoming the new mantra in a less predictable world. On one hand it is a collective response to all the other considerations mentioned in the survey. But it is also a strategic choice in itself. As regionalization is gaining ground at the expense of globalization, it is becoming increasingly difficult for companies to benefit from specialization. Producing your inputs in country A, assembling

Rest of region is highly dependent on China.

Diversifying supply chains is making global operations more difficult.

them in country B, selling them in countries C and D, are no longer a viable option for many companies.

The era with China as flagbearer for globalization is over.

This is an unfortunate development. It clashes with the laws of comparative advantage, it makes it a more costly affair to be a global business, and it weakens the interdependence between nations. It is not a coincidence that China reached its peak as the world's factory during one of the most prosperous and peaceful eras in modern history. The immediate future could be a lot more challenging.