

#28 Dealing with Decoupling from China

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Key Takeaways

- Geopolitical tensions, especially the US–China rivalry and Russia’s invasion of Ukraine, have heightened awareness of dependency risks, prompting firms to reassess exposure to China and explore mitigation strategies.
- Despite politicization and rising risks, China remains central to the global economy, with a strong manufacturing base, growing innovation capacity, and increasing self-reliance in critical technologies.
- Evidence of partial decoupling is emerging: declining FDI inflows, shifting trade patterns (notably via ASEAN), and increased diversification of supply chains toward countries like India, Vietnam, and Indonesia.
- Companies are not exiting China wholesale; instead, they combine diversification with localization strategies (“China for China”), reflecting China’s continued importance as both a market and production hub.

Policy Recommendations

- Provide clear, stable, and specific regulatory guidance on trade, investment, and sanctions to reduce uncertainty for companies operating across jurisdictions.
- Assess the economic costs and benefits of decoupling measures more explicitly and align policy decisions with both strategic and economic considerations.
- Offer targeted support (guidance, subsidies, and strategic direction) to help firms manage the high costs of diversification, reshoring, or compliance with new restrictions.
- Strengthen international coordination by addressing extraterritorial sanctions and expanding trade agreements, while supporting firms in identifying alternative supply chain locations.

Executive Summary

This report presents the findings of a joint research project by the Leiden Asia Centre in the Netherlands and the East Asian Institute in Singapore on the extent and impact of economic decoupling from China. The study focuses on firms’ awareness of geopolitical risks, their mitigation strategies, and their assessment of the costs and feasibility of partial decoupling.

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China's challenge to US supremacy has fundamentally altered the geopolitical balance of power and introduced new risks for foreign businesses. Awareness of such risks has intensified since Russia's invasion of Ukraine in February 2022, which exposed the vulnerabilities associated with economic dependence on potentially hostile states. Governments are increasingly intervening in trade and investment, often restricting ties with China. At the same time, China's economic strength remains largely intact: it continues its transition toward an innovation-driven economy with a strong market sector supported by an active state, while pursuing self-reliance in critical technologies and onshoring supply chains.

Patterns of trade and investment are shifting. China has seen a decline in foreign direct investment inflows and a gradual loss of share in global FDI, alongside growing outward investment. Supply chains are being reconfigured, with production diversifying toward countries such as India, Vietnam, and Indonesia. Trade flows suggest partial rerouting through ASEAN economies, while China's exports increasingly target emerging markets rather than advanced economies. Nevertheless, China has become more central in global value chains, reflecting its deep integration into the world economy.

Foreign firms increasingly view China not merely as an export-processing hub but as a high-value manufacturing and innovation center. Its large domestic market, advanced industrial ecosystem, and R&D capabilities continue to attract investment. At the same time, risks have intensified due to politicization, regulatory uncertainty, intellectual property concerns, and the Chinese government's focus on national security and self-reliance. Companies remain broadly positive about long-term prospects, particularly those with significant sunk investments and long-term strategies, although sentiment has deteriorated since 2022.

Decoupling strategies reflect caution rather than withdrawal. Firms combine diversification of production and supply chains with localization in China, often strengthening the autonomy of Chinese subsidiaries and adopting a "China for China" approach. Alternative strategies include near-shoring, friend-shoring, and developing contingency plans. However, for many companies, China is too important to abandon entirely.

The report concludes that decoupling entails significant economic costs and risks reinforcing global fragmentation into separate economic spheres centered on China and the United States. While some degree of decoupling may enhance resilience, it could also accelerate self-sufficiency in China and heighten geopolitical tensions. A balanced approach—combining selective de-risking with continued engagement—is therefore essential, particularly for Europe and other highly trade-dependent economies.