China’s Dual-Circulation

- China’s “dual circulation” strategy, in which internal and external parts of the economy will complement each other, will dominate Chinese economic plans for the next five years and beyond.

- We assess that the government’s plan to bolster the Chinese consumer does not signify that China is turning inwards; instead, the strategy helps with China’s ambitions to reach a higher level of economic development and increase the country’s global economic power.

- The inevitable emergence of China as the world’s largest economy and a major consumer market will require the rest of the world to adopt an attitude shift and an increased aptitude for multilateral engagement.

The term “dual circulation” is currently receiving increased attention in China and globally. Though a new expression, it will unlikely be a short-lived catchword, as it is set to characterize China’s economic development strategy for years to come. China’s 14th five-year plan for 2021–2025—discussed at the Fifth Plenum of the Chinese Communist Party at the end of October and to be finalized at the next National People’s Congress, mostly likely to be held in March—will largely center on the concept of dual circulation. While official details of the plan remain scant, this report will try to shed some light into the dual circulation concept and assess what it means for the Chinese economy and the rest of the world.

Under the dual circulation strategy, China will increasingly focus on utilizing its large internal market and domestic demand. China’s export-led growth model, which has been a key driver of the economy since the country’s accession to the WTO in 2001 (chart 1), will now officially be replaced by an approach that simultaneously pays attention to both the domestic and external sides of the economy. Indeed, the dual circulation means that the internal and international “circulations” complement each other (chart 3 on next page).

The timing of the new strategy has triggered some concerns regarding rising protectionism in China. We acknowledge that Chinese policymakers’ focus shift toward internal demand dynamics follows escalated tensions between China and the US and a wave of protectionist biases around the world as economies try to cope with the repercussions of the COVID-19 pandemic. Nevertheless, we do not think the strategy implies that China is turning inwards. The reality is that the Chinese economy is—and has been for several years already—in the midst of a structural transition toward a more consumer- and services-oriented economy. We consider the dual circulation strategy to be a pragmatic and important element in the country’s quest for reaching a higher level of economic development and per-capita income. In fact, we assess that increasing the role of the consumer in the Chinese economy over the next five years will be critical in order to avoid the “middle-income trap” that threatens many newly-industrialized export-oriented countries. At the same time, we acknowledge that the COVID-19 pandemic has revealed many weaknesses in global supply chains, and the internal circulation part of the strategy will help improve China’s self-reliance in strategically important industries, such as technology.
INTERNAL CIRCULATION

Policies that relate to internal circulation will primarily focus on raising household incomes and the role of the consumer in the economy. Higher wages can be achieved by reforms of the land and residency system that would support urbanization. Improvements to the social safety net would lower China’s relatively high savings rate (chart 2), further supporting consumer spending prospects.

In our assessment, another key element of internal circulation is technological advancement that will be critical to move the country higher in the global value chain. China aspires to be a global technology powerhouse, underpinned by domestic innovation. Moreover, given various other countries’ concerns regarding China’s security and intellectual property practises and resultant restrictions on China’s access to technology resources, the country’s focus on internal technological capabilities, such as domestic production of semiconductors, will provide it with some protection from external tensions. Related to China’s technological aspirations is another core element of internal circulation—the country’s industrial strategy. China aims to strengthen and diversify its industrial supply chains and push for higher-end manufacturing. Simultaneously, the nation aims to further develop the services sector and support services-oriented manufacturing, thereby assisting the economy’s climb to a higher level of development that is more in line with major advanced economies.

INTERNATIONAL CIRCULATION

It seems clear to us that China aims to remain relevant in the global market. In fact, the Chinese leadership has continued to promote further global and regional trade integration and deeper investment ties; we expect such efforts to remain in place in the coming years, forming a key aspect of China’s international circulation. We assess that this approach will help China to increase its global economic might, particularly against the backdrop of the US having turned inwards over recent years. The Regional Comprehensive Economic Partnership (RCEP)—the world’s largest free trade agreement, covering 30% of global GDP—is a prime example of how China will be able to increase its influence in regional and global affairs. The RCEP was signed by its 15 members (China, Japan, South Korea, Australia, New Zealand as well as the 10 Southeast Asian nations forming the ASEAN group) on November 15 and is waiting for ratification by the member nations over the course of 2021.

The implementation of structural reforms is a fundamental part of China’s dual circulation strategy. While reforms will underpin the development of the domestic economy, they will also be imperative from the international circulation viewpoint as they assist with China’s integration into the global economy and financial markets. Indeed, Chinese policymakers have stated their continued commitment to the economy’s further liberalization. In our view, the list of needed reforms is long, yet we assess that the internationalization of the renminbi (RMB), deepening of capital markets, strengthening of financial markets’ regulatory standards, and continued gradual relaxation of the capital account will remain the government’s priorities over the next five years. Further trade and investment integration with the rest of the world along with financial market reforms will help with the internationalization of the RMB. At the same time, to strengthen the renminbi’s global role China’s capital controls need to be relaxed further. We
expect Chinese policymakers’ capital account opening measures to primarily focus on portfolio inflows in the foreseeable future (as liberalizing portfolio outflows prematurely poses significant risks to domestic financial stability); therefore, we expect the Chinese renminbi to face a gradual strengthening bias vis-à-vis the US dollar over the coming years, as international investors readjust their portfolios to include a larger share of Chinese assets. Structural changes tend to be interconnected; we consider that reforms centered on the financial markets and regulatory transparency will also help with the development of China’s services industry, one of the government’s priorities.

THE ROAD AHEAD

The dual circulation strategy is intended for China’s long-term development, though we note that it will likely bring about some short-term benefits as well. Policies that fall under the strategy and simultaneously strengthen confidence and boost domestic demand—such as tax and fee cuts for the consumer and the higher-value-added manufacturing sector—will assist with China’s economic recovery. A supportive policy backdrop is important, given that prospects for external demand remain uncertain as several of China’s trading partners continue to struggle with containing COVID-19.

Based on the information currently available about the five-year plan for 2021–2025, the Chinese leadership has not specified a real GDP growth target for China. We assess that China’s output will expand by 5–6% y/y through the next five years following a forecasted COVID-19-related rebound of over 8% y/y in 2021. While China’s economic growth is expected to decelerate gradually over the foreseeable future, the country will likely continue to outperform the US. Based on our calculations, China is set to surpass the US as the world’s largest economy by the end of the decade. As this change in economic power will be accompanied by China’s structural transition toward a consumer- and services-based economy, China is increasingly positioning itself as a market rather than a source for cheap goods. The change in China’s status will not be without its challenges, however, as large differences in ideology as well as in political and economic structures will remain in place between advanced economies and China. We are of the view that China’s continued economic development is inevitable. Against this context, we highlight that it is essential for advanced economies to engage in multilateral dialogue with China in order to reach consensus on shared rules and standards so that all participants can be better off in the new world order that awaits us.
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