EXECUTIVE SUMMARY

Dual circulation is an economic strategy which seeks to achieve self-sufficiency, fostered through import substitution and domestic demand expansion.

FOUR FACTORS DRIVING THE SHIFT TO DUAL CIRCULATION

1. Natural evolution of the growth model: We believe that China’s historical model of investment and export-led growth has run its natural course. As the economy has evolved, reforms are needed to transition the growth model.

2. Avoiding the middle-income trap: Many emerging economies have suffered the so-called middle-income trap whereby they stagnate as the country’s labour costs increase and the country struggle to shift into higher value-add activities. China should be able to avoid this fate, and the authorities are actively trying to ensure that is the case.

3. Supply-side factors: China’s declining workforce due to a shrinking population necessitates a shift in economic growth strategy.

4. Political motivation: As US-China relations become increasingly more strained, China will seek to become ever more self-sufficient.

DUAL CIRCULATION POLICY IMPLICATIONS

1. Shift to high-end manufacturing: China seeks to develop high-end manufacturing capabilities by designing policies and incentives to channel capital towards these areas.

2. Achieving self-sufficiency in food and energy: China relies on external sources for much of its food and energy needs but has scope to increase domestic production. On the energy front, China is already a world leader in many areas of the renewables production value chain and will continue to funnel investment in this area. On the food front, China will seek to increase the country’s total cultivated farmland and has set targets to build additional ‘high standard farmland’ in the coming years.

3. Ongoing urbanisation and hukou reform: China’s hukou household registration system has long constrained urbanisation growth. While the authorities have regularly discussed reform plans here, action has tended to be lacking. We expected more concerted efforts to promote urbanisation going forward.

4. Mass market consumption: China’s high savings rate leaves ample scope to increase and stimulate domestic demand. Several policies could be implemented to achieve greater levels of consumption.

GLOBAL ECONOMIC IMPLICATIONS OF DUAL CIRCULATION

Generally speaking, we expect those countries with ongoing high economic linkages to continue to do well as China continues to grow at a moderate pace, however, exporters of high-value manufacturing, food and energy goods that China currently relies on will be notable losers as this activity is onshored.

CHALLENGES TO SUCCESSFUL CHINESE ECONOMIC GROWTH

China is becoming more inward looking, potentially harming its potential growth rate. There are also no assurances that the misallocation of resources experienced under previous economic regimes will not be repeated as focus is shifted to new sectors in the economy.
UNDERSTANDING CHINA’S DUAL CIRCULATION ECONOMIC STRATEGY

DUAL CIRCULATION, AN ECONOMIC APPROACH WITH AN OVERALL GOAL OF ACHIEVING SELF-SUFFICIENCY THROUGH IMPORT SUBSTITUTION AND DOMESTIC DEMAND EXPANSION HAS BECOME CHINA’S OFFICIAL NATIONAL GROWTH STRATEGY UNDER PRESIDENT XI JINPING.

INCREASE SELF-SUFFICIENCY WHILE MAINTAINING A GLOBAL OUTLOOK

Dual circulation is an economic strategy which seeks to achieve self-sufficiency, fostered through import substitution and domestic demand expansion. It aims to place greater emphasis on growing the domestic economy – internal circulation – while reducing the reliance economic relationship with the rest of the world through international trade and investment flows – external circulation.

Whilst there is an inherent desire to rely more on internal circulation to drive growth in the future, Chinese policymakers have been quick to downplay the idea that China is “turning its back on the world” under the dual circulation strategy. This has, to some extent, been backed up by recent actions: opening key sectors to foreign competition and investment and signing the Regional Comprehensive Economic Partnership (RCEP)\(^1\).

WHEN WAS IT FIRST INTRODUCED?

Dual circulation was first introduced by President Xi Jinping at a Politburo meeting on 14 May 2020. It has since become an official national strategy, frequently appearing in key policy speeches and it lies at the heart of the 14th Five Year Plan which covers the period from 2021-2025.

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Dual circulation has become an official national strategy, lying at the heart of China’s 14th Five Year Plan.

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\(^1\) The RCEP is a trade agreement between 15 countries that includes members of the Association of Southeast Asian Nations (ASEAN) as well as five regional partners, that was signed on the 15 November 2020.
CHINA HAS BEEN TRYING TO REDUCE RELIANCE ON EXTERNAL DEMAND FOR TO TWO DECADES

The broad policy goals of dual circulation and a desired shift in China’s economic model is not new. China has been trying to reduce reliance on external demand and move up the value chain for the best part of the last two decades. This fits in within an ongoing transition from the export- and investment-led growth model to a model where domestic demand and consumption plays a larger role (Figure 1) – a key component in escaping the middle-income economy trap, whereby the economy stagnates as labour costs increase and the country struggles to shift into higher value-add activities (including microchips and other high end manufactured goods).

To some extent this has been driven by China’s evolving external balances. ‘Made in China 2025’ was the most recent iteration; a blueprint for growing key strategic and hi-tech sectors in order to reduce China’s reliance on imports. The key sectors were identified as electrical equipment, farming machines, new materials, new energy vehicles, numerical control tools and robotics, information technology, aerospace equipment, railway equipment, ocean engineering equipment, high-end sea vessels and medical devices.

Figure 1: China real GDP growth breakdown (% year on year)²

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China has been trying to reduce reliance on external demand and move up the value chain for the best part of the last two decades.

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FOUR FACTORS DRIVING THE SHIFT TO DUAL CIRCULATION

THERE ARE FOUR KEY FACTORS DRIVING THE SHIFT TO A DUAL CIRCULATION APPROACH IN OUR VIEW:

1. NATURAL EVOLUTION OF THE GROWTH MODEL
2. AVOIDING THE MIDDLE-INCOME TRAP
3. SUPPLY-SIDE FACTORS
4. POLITICAL MOTIVATION

1. NATURAL EVOLUTION OF THE GROWTH MODEL

China’s investment and export-led growth model has been very successful since it joined the WTO in 2001, due to its cheap labour force and market-based reforms. However, its dependence on external demand has been steadily declining. China has started to face export markets in which it is the dominant player and began to see its share of world exports stabilise in 2014 (notwithstanding the recent boost from the COVID-19 pandemic) (Figure 2). China has a limited ability to gain further market share in goods and services in which it previously had a competitive advantage, in part due to rising labour costs given the depletion of surplus labour and shrinking workforce. Although it has been calling for a transition of the growth model for quite some time, so far this has been relatively mild and the country’s demand imbalance is still among the highest globally. There is also significant imbalance across regions within China. This has continued to elevate the risk of excess macro leverage and misallocation of resources.

Figure 2: Share of world goods and services exports

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3 Source: OECD (Organisation for Economic Co-operation and Development as at 10 January 2021.)
2. AVOIDING THE MIDDLE-INCOME TRAP

These characteristics are common when an economy faces the ‘middle income trap’. This is typically observed when a country loses its competitive edge in exports due to rising wages but is unable to keep up with more developed countries in higher value-added markets. Newly industrialised economies such as South Africa and Brazil are examples of countries that have been stuck in the ‘middle-income’ range of GDP per capita for decades.

To escape the middle-income trap a country will typically need to find new markets to maintain export growth and/or increase domestic demand, to increase purchasing power in order to buy higher quality innovative products which help drive growth. This is essentially what dual circulation is trying to achieve. We think it unlikely that China will succumb to the middle-income trap, primarily due to its size as the second largest economy in the world with 1.4bn inhabitants. China has a greater capability to successfully realign its economic model to increasingly rely on internal demand since it benefits from both economies of scale, and economies of scope\(^4\), options which are not available to most smaller economies as they develop.

![Figure 3: GDP per capita\(^5\)](image)

3. SUPPLY SIDE FACTORS

There are several supply-side factors which necessitate a development of China’s growth model – notably worsening demographics (aging population) as well as a shrinking labour force which is structurally reducing its natural growth rate. In terms of capital inputs, aggregate debt levels are currently at elevated levels.

4. POLITICAL MOTIVATION

China desires to become more self-reliant from a political perspective. Its relationship with the US and other major trading partners has been deteriorating in recent years. Dual circulation fits naturally with the US-China decoupling theme we expect to persist. If external relationships continue to worsen, China could face potential difficulties sourcing key factor inputs it relies on – such as semiconductors and commodities – while also having domestic companies shut out of foreign markets e.g. Huawei.

China is celebrating the 100th year anniversary of the Chinese Communist Party in 2021 and will celebrate its goal of building a ‘moderately prosperous society’. Dual circulation will play a central role if China is to transition to become a ‘moderately developed’ economy, which is a national target by 2035.

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\(^4\) A proportionate saving gained by producing two or more distinct goods, when the cost of doing so is less than that of producing each separately.

\(^5\) Source: Insight Investment, Macrobond, March 2021.
POLICY IMPLICATIONS

IN THIS SECTION WE OUTLINE FOUR KEY POLICY IMPLICATIONS RESULTING FROM A SHIFT TO A DUAL CIRCULATION MODEL:

1. SHIFT TO HIGH-END MANUFACTURING
2. ACHIEVING SELF-SUFFICIENCY IN FOOD AND ENERGY
3. ONGOING URBANISATION AND HUKOU REFORM
4. MASS MARKET CONSUMPTION

1. SHIFT TO HIGH-END MANUFACTURING

China seeks to develop high-end manufacturing capabilities, including the manufacture of microchips. The authorities are seeking to design policies and incentives to channel capital towards these areas.

Access to capital: Historically, limited access to stock markets has been a hinderance, as have high credit market funding costs. To resolve this, the authorities are seeking changes or improvements in several areas. They have developed special boards in China’s two stock exchanges in a bid to help high-tech companies raise funds in capital markets. One example is the registration-based STAR market at the Shanghai Stock Exchange. They have also sought to standardise listings and improve ease of access for start-ups on the Shenzhen stock exchange, while those tech companies listed overseas or yet to list, are encouraged to do so in Hong Kong or domestically. As lower funding costs are targeted, bank profit margins could be impacted while we expect to see ongoing reform of the interest rate and policy rate framework.

Self-sufficiency in microchip making: The semiconductor industry is both knowledge-intensive and capital intensive. Developed economies have had an edge in accumulating sizeable technological capabilities resulting in a higher barrier to entry for later entrants. China is highly reliant on importing microchips (Figure 4).

China’s investment in the microchip industry has been growing rapidly. There were 170,000 integrated circuit related start-ups in Q2, 30% more than last year. The authorities have established an existing pledge to increase China’s self-sufficiency rate in manufacturing to 70% by 2025 from 30% in 2019.

Focus on renewable energy: China is already the world’s largest producer of solar panels, wind turbines, batteries and electric vehicles. To reduce energy imports, China may further strengthen its lead in renewable energy in coming years.

Increase investment in other high-end manufacturing: This covers key technologies such as 5G, data centres, artificial intelligence, the industrial internet, new energy vehicle charging infrastructure.
2. ACHIEVING SELF-SUFFICIENCY IN FOOD AND ENERGY

China relies on external sources for much of its food and energy needs but has scope to increase domestic production.

**Food security**: China is heavily reliant on imports for soybeans, barley and sorghum. Few substitutes exist for soybeans in pig feed as they provide necessary protein. China could scale up agricultural mechanisation to improve farming efficiency, provide more subsidies, improve livestock farming technology to reduce demand for soybeans, enhance reserve systems and reduce food waste. The authorities have set a minimum level of 120 million hectares set aside for cultivated farmland, and are lacking to build over 100 million hectares of ‘high standard farmland’.

**Energy security and policy**: China’s energy demand has surged in recent decades, with 72.6% of crude oil and 42.9% of natural gas net imported. While China could enhance domestic capacity in oil and gas and raise strategic reserves, we believe it is far more likely to further increase clean energy investment and promote use of energy saving tech and equipment. China’s goal to derive 20% from non-fossil fuels by 2025 and to cut share of coal in energy mix to 52% by 2025.

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Source: Bloomberg, as at January 2021.
3. ONGOING URBANISATION AND HUKOU REFORM

China’s hukou system is a government household registration system used to restrict where a person can live. It prevents most migrants from moving to cities on a permanent basis, institutionalising population inequality in the process. Reform has been discussed for decades, but implementation has been slow. Proper reform of hukou, increased inter-regional cooperation and land reforms will promote urbanisation, boost income and consumption and drive economic growth. Specifically:

- **Hukou reform to drive further urbanisation**: China’s economic conditions today resemble Japan in the 1980s, Korea in the 1990s, the US in the 1950s/60s and Germany in the 1970s, suggesting further urbanisation remains a way to enhance incomes and stimulate further growth in consumption. Higher income remains the strongest incentive for rural residents to work in cities. The rural cohort is still significant at 56% of total population and 63% of workforce as of 2019.

- **Increase cooperation and equality between regions**: Better development coordination between regions, cluster economies, free trade zones, better integration, connectivity and stronger diffusion of capital/talent with favourable policy initiatives.

- **Land reform**: Implementation of land reform to boost income and consumption, and to allow farmers to be better compensated.

4. MASS MARKET CONSUMPTION

China maintains a high savings rate leaving ample scope to increase and stimulate domestic demand. Several policies could be implemented to achieve greater levels of consumption:

- **Reduce savings rate and provide greater safety net**: This could be achieved by increased government spending in healthcare, pensions and unemployment insurance to promote a safety net and by reducing household savings which remain elevated to global peers.

- **Encourage ‘Buy China’ spending**: There are substantial localisation opportunities in domestic travel, discretionary consumption, entertainment, education and drugs and medical devices.

- **Expand middle class**: Stimulate domestic consumption through expansion of middle class and faster income growth of lower income groups.

- **Policy incentives / targeted policy through households**: The authorities have run trials where vouchers have been issued to households which could be spent on certain products.
GLOBAL ECONOMIC IMPLICATIONS OF DUAL CIRCULATION

WE EXPECT THAT THE CHANGE TO A DUAL CIRCULATION MODEL WILL RESULT IN ‘WINNERS’ AND ‘LOSERS’ RELATIVE TO THE CURRENT ECONOMIC MODEL. WE SUMMARISE THESE IN TABLE 1. THOSE WITH HIGH ECONOMIC EXPOSURES TO CHINA WILL LIKELY REMAIN AS RELATIVE WINNERS. THIS IS LARGELY DUE TO EXPECTATIONS THAT CHINESE ECONOMIC GROWTH WILL REMAIN AT 3-6% FOR AT LEAST THE NEXT DECADE.

Theoretically, dual circulation would appear to fit well with China’s economic fundamentals and should boost medium-term growth prospects but there remain risks around implementation of the policies. Import substitution may be inflationary in the near term in the products identified, but in the medium term if China is successful at developing capabilities in these sectors it may ultimately be disinflationary to the rest of the world, as we have seen with manufactured goods over the past 20 years (providing China retains access to these overseas markets).

Table 1: Potential winners and losers from the shift to a dual circulation economy

<table>
<thead>
<tr>
<th>Winners</th>
<th>Losers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Those with exposure to China’s growing status as the end consumer of products – generally developed markets</td>
<td>Taiwan (also likely biggest losers from RCEP deal), Malaysia, South Korea and Singapore likely to be most affected given the key products it exports to China as per the below.</td>
</tr>
<tr>
<td>Products where import substitution is more difficult</td>
<td>China to become competitor in third markets as it gains new capabilities. 5G / data centres / AI / new energy vehicles</td>
</tr>
<tr>
<td>Those who benefit from other countries continuing to diversify supply chains out of China – including South East Asian manufacturers</td>
<td>Food and energy exporters to China – Australia, Brazil, Chile, New Zealand.</td>
</tr>
<tr>
<td></td>
<td>Semiconductor exporters to China – Korea, Taiwan.</td>
</tr>
</tbody>
</table>
CHALLENGES TO SUCCESSFUL CHINESE ECONOMIC GROWTH

While the dual circulation strategy aligns well with China’s broader economic and political objectives, there is a risk that it may foster further ‘turning inwards’ over time, which could ultimately hurt its potential growth rate.

We think that the efficient allocation of resources within key sectors will remain a challenge. The negative side effects of previous growth models have been all too apparent, manifesting in highly indebted local governments and the presence of inefficient ‘zombie’ state owned enterprises. It is likely that misallocations of resources will continue to be a problem as they are shifted towards whatever the new key focus sectors are. The property market will be a keen area of concern for policymakers.

The key question looking forward is whether or not we are going to see sufficient action this time, rather than just words of intent. We note that China’s response to the COVID-19 shock was to quickly turn on the ‘old engines of growth’, namely industrial production and local government infrastructure investment.

Another area of concern relates to historical precedent. China’s current economic structure shares some similarities to the US in the 1960s, Japan in the 1980s and Korea in the 1990s. Given China’s current demographic and leverage profile, we need to ask whether a balance sheet recession similar to Japan’s experience remains a risk. And whether China will be able to keep total factor productivity high enough.

CONTRIBUTORS

Harvey Bradley, Portfolio Manager, Fixed income Insight Investment

Derek Traynor, CFA Senior Investment Content Specialist Insight Investment
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