China's New "Dual Circulation" Strategy: *Two Views*

I. "Dual Circulation" Is China's Strategic Pivot to Prepare for Long-Term Competition With the United States

BY CHI LO

The emergence of a new paradigm.

Beginning in May 2020, China launched a so-called "dual circulation" strategy to counter geopolitical hostility by strengthening the domestic sector while still engaging, but reducing reliance on, the external sector in order to sustain stable growth and resilient investment in the face of strategic competition with the United States. This move reflects China's new worldview that de-globalization is forcing a structural shift in the global supply chains and prompting it to counter de-coupling by industrial upgrading and import substitution. Such an inward policy shift will create disruptions to the global markets. This new policy is reminiscent of China's supply-side reform that started in 2015 and is an evolution of Beijing's reform motto of using the market *Continued on page 20*

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II. The Same Old Wine in New Bottles

"Dual circulation" represents no meaningful change.

BY DEREK SCISSORS

Chi Lo is right that Chinese policy matters to the world, in particular financial markets. He's at least partly right in characterizing this policy, especially the use of markets as tools. But "dual circulation" does not represent any meaningful change. It's merely Xi Jinping's latest stamp on a direction he set in 2013, which itself was only a moderate shift of direction after liberalization ended the previous decade. China will continue to distort competition in what it considers strategic sectors, borrowing to do so, and continue to coerce technology transfer. American policy has meant little to these choices to date and likely will again mean little in 2021.

Economic policy can be suspiciously wordy. Economic analysis, thankfully, is still mostly supply and demand. Beijing likes production and is suspicious of (true) consumption—dual circulation preserves this. "Domestic demand" has been trumpeted since 2007. Thirteen years later, as China claims to be recovering from Covid fastest of any large economy, its goods trade surplus is large and growing. Chinese production is outpacing the world, while its consumption lags. Again. Chi points specifically to dual circulation as rerouting $250 billion spent overseas by tourists. While this may hurt small foreign economies, it is just a drop to add to inadequate 2019 domestic consumption of $5.3 trillion.

On the supply side, this autumn's call for breaking industrial monopolies repeats one made soon after Xi took office in 2013. Actions since have featured repeated mergers of very large state-owned enterprises exactly to create quasi-monopolies, for instance China Ocean Shipping with China Shipping. More are in process now.

Chi correctly sees dual circulation succeeding the previous "supply side reform" and also affecting the global economy. *Continued on page 23*

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GETTY IMAGES

An engineer checks solar panels in China. Since 2015, China has been the largest producer and buyer of solar panels. It is number two in producing the most solar energy, just behind Germany and ahead of Japan, Italy, and the United States.

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as a strategic tool for making changes under the guidance of the Party. This has far-reaching political and economic implications for the world.

THE "DUAL CIRCULATION"

China's dual circulation policy reflects Beijing's new belief that China has entered a new paradigm of increasing global uncertainties and geopolitical hostility that, ironically, would create new opportunities for China as U.S. global leadership flounders. The dual circulation framework has two elements: the "external" and "internal" circulations.

The external circulation is a paradigm focusing on the United States as the global demand hub which is built on globalization and reflects America's post-World War II global leadership and international cooperation. But this model is failing, in China's view, due to the withdrawal of the United States from the global stage.

Experience shows that China's top-down policies mean business.

This has led China to believe that de-globalization, leading to economic de-coupling and breaking up of the global supply chains, had become a secular trend that could threaten its long-term stability. Rising geopolitical tensions and exogenous shocks such as Covid-19 have aggravated this global structural change. Hence, China can no longer rely on global integration as a growth driver; it must focus on domestic demand, or the internal circulation, to hedge against external risks.

China's new worldview sees the country moving into a new paradigm where the global system would be divided into three main regions: Asia, North America, and Europe, with each region led by a regional superpower. This will lead to the rise of regionalism with strong intra-regional economic linkages on the back of de-globalization and weak inter-regional linkages, in my view. The rest of the world will fit in somewhere among these regions. China also sees its internal circulation sit in the center of Asia, engaging regional and global capital, financial, and technological markets for enhancing domestic growth and driving regional growth, hence, the dual circulation strategy.

IMPORT SUBSTITUTION AND SUPPLY-CHAIN STABILIZATION

Arguably, the dual circulation policy is Beijing's effort to balance between self-sufficiency and internationalization to deal with an increasingly volatile world. It strives to engage global forces, including capital and technology, to gain advantages for domestic development while simultaneously boosting indigenous capabilities in order to minimize the impact of global volatility—notably the U.S.

China's dual circulation is a strategic pivot of its policy to prepare for long-term competition with the United States.

technology sanctions against Chinese tech firms—on the domestic system.

However, reducing reliance on the global economy does not reflect a loss in China's competitiveness. It has still gained global export market share, even though it has lost market share in the United States due mainly to the trade war. In recent years, China's changing role in global trade has already prompted changes in the global supply-chain structure and reshuffled country winners and losers. China's move to reduce reliance on global trade will aggravate this disruptive force.

The external circulation is not just about China's exports. It also encompasses China's imports. And this is linked to the internal circulation through reducing dependence on certain imports and boosting indigenous capabilities to counter export controls by the United States and its allies. In the short term, the policy efforts are focused on import substitution, especially in the semiconductor industry that is under increasing pressure from U.S. sanctions, and redirection of Chinese outbound tourist spending back to China.

Crucially, stabilization of supply chains (partly to counter the U.S. decoupling, tariff, and sanction threats) lies at the heart of the internal circulation. Since China's recovery from Covid-19 in April, Beijing has created a "heads of industry value chains" system to supervise local governments in order to identify the local firms and technologies critical to the industry value chains and boost their development. The local governments are asked to adopt bespoke policies to finance public investment in these industrial value chains. The investment focuses on technologies such as integrated circuits, 5G, electric cars, biomedicine, cloud computing, and artificial intelligence.

In this effort, Beijing has asked the state-owned enterprises to take a leading role. President Xi Jinping has placed great importance on the state-owned enterprises playing a strategic role in China's long-term economic transformation. He has significantly enhanced the Party's control over the state sector since 2013. In my view, this supply-chain stabilization effort is an evolution of China's structural reform motto that the market is a strategic tool for making changes under the guidance of the Communist Party. Now that the Party has a tight grip on the state-owned enterprises, it can mobilize their resources more easily than ever before, including in implementing Beijing's dual circulation strategy.

CHINA'S SUPPLY-SIDE REFORM AND DECOUPLING

The dual circulation policy is reminiscent of China's supply side reform that started in 2015, which most observers dismissed in the beginning as a set of vague and vacuous policy statements that would lead to nowhere. But these uninformed views were proven wrong. In subsequent years, Beijing has shown persistent reform efforts to cut excess industrial capacity (notably in steel and cement, which played a major role in creating bottle-neck supply conditions and sent key commodity prices soaring between late 2016 and 2017) and de-risk the financial sector aggressively, even at the cost of slowing GDP growth.

To fortify the internal system, the dual circulation seeks to bolster the strengths and correct the weaknesses of the domestic economy in order to improve economic resiliency and self-sufficiency. That means boosting domestic demand while simultaneously finding ways to reduce reliance on external inputs in key areas, notably food, technology, and energy. Thus, the policy emphasis is on import substitution and high-end manufacturing and industrial upgrading in order to boost domestic growth impetus.

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Arguably, the dual circulation was born out of China's new worldview that decoupling, especially from the United States, is not a question of if, but of when and how fast. The policy is, in my view, a proactive strategy of Beijing to prepare for political and economic "divorce" while it still has control, rather than react to what would be imposed on it by external forces in the future.

THE GLOBAL IMPACT

While China does not want a total withdrawal from global economic integration, even a small policy shift away from the external circulation could significantly shock global trade and investment flows due to China's sheer size. So the dual circulation strategy, if successfully implemented, will have far-reaching effects on the global markets. The internal circulation's emphasis on high-end manufacturing and technology implies that China would continue to shed low value-added activities and move up the value chain to compete with the developed world in economic, political, and military terms.

Indeed, in recent years China has been squeezing developed economies' exporters in other markets outside the United States and supplying a third of the world's demand for intermediate goods. This suggests that China is posing an increasing challenge to the industrialized economies, with its production scale beginning to disrupt a range of new market segments, as has happened with solar and lithium batteries in recent years.

Since 2015, China has been the largest producer and buyer of solar panels. It is number two in producing the most solar energy, just behind Germany and ahead of Japan, Italy, and the United States. In 2019, of the world's five largest lithium battery producers, China's CATL and BYD were ranked the second and the third, behind Korea's LG Chem and ahead of Japan's Panasonic and the United States' Tesla.

The strategy of redirecting Chinese consumers' overseas spending (US$250 billion a year just by those outbound Chinese tourists) to the domestic market is clearly positive for domestic retailers. It also implies that preferences of domestic consumers would become more important than foreign consumers in shaping corporate decisions. This makes "investing in China for China" an increasingly important force affecting foreign direct investment decisions.

So the dual circulation strategy, if successfully implemented, will have far-reaching effects on the global markets.

To switch Chinese tourist spending abroad back to China, Beijing has cut import duties for many tourist-favored products to narrow the tax gap, which is a major tourist spending incentive. It has also planned to open up more duty-free stores and duty-free zones, like the Hainan duty-free zone established in June 2020 in China to attract domestic and foreign tourists. The pandemic has enabled China to speed up this expenditure-switching by grinding international travel to a halt. Companies catering to Chinese buyers who previously bought items abroad will benefit. But this will be bad news for countries and companies, especially in Asia, whose retail business depends on Chinese tourists.

China would continue to move up the value chain to compete with the developed world in economic, political, and military terms.

Experience shows that China's top-down policies mean business. So it would be rewarding to follow the government's lead when investing in China. This also argues for an investment strategy to cut exposure to firms that have high overseas exposure, such as consumer electronics, and increase allocation to companies and sectors that are related to state investment in the priority sectors on the dual circulation policy agenda, such as aerospace, defense, and domestic high-tech industries.

From a macroeconomic perspective, the dual circulation strategy could help China's equities better withstand external market volatility, and thus attract global investors seeking to diversify returns. As China steps up efforts to substitute imports and strengthen self-sufficiency, domestic brands in technological and financial innovation, industrial consolidation, and consumer-upgrading should drive the long-term trend of China's equity market.

In political terms, all this means that just as the U.S. administration has shifted its China policy from constructive engagement, as pursued by the previous administrations, to strategic competition, as promulgated by the Trump administration, China's dual circulation is a strategic pivot of its policy to prepare for long-term competition with the United States. ◆

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However, Beijing has called for curbs in sectors such as steel since the 2003 explosion in fixed investment. And Chi's claim that China has persisted in efforts to cut capacity, especially in steel and cement, runs afoul of the data. In 2019, China's share of global steel production rose to 53 percent, and share of global cement production rose to 57 percent. Stir in increases in aluminum at 56 percent and coal at 47 percent. Supply-side reform was either a miserable failure or, more likely, intended to concentrate output rather than reduce it at all.

Xi Overhypes the Threat of U.S. Competition

Tariffs are endlessly discussed, but the impact on bilateral goods and services trade from 2016 to 2019 was almost trivial, for example a $2.5 billion or less than 1 percent drop in the U.S. deficit. Over the same period, American portfolio investment into China more than doubled, a gain of $125 billion.

—D. Scissors

China's President **Xi Jinping**

Nor is dual circulation much of a change with regard to technology. As Chi says, China will continue to use import substitution to climb the value chain. Policy goals will shift whenever Beijing deems new sectors strategic and targets new chains. Such a process was begun in energy in the 2000s, with China successfully switching from importing refined products to importing raw material. It was 2011 when technology became the focus, with the twelfth five-year plan. Xi confirmed that emphasis five years ago, of course, with "Made in China 2025." As in previous years, the state will lead and markets will be warped to achieve political goals, for example global solar output dominance coinciding with bailouts of multiple extraneous firms.

China will continue to distort competition in what it considers strategic sectors, borrowing to do so, and continue to coerce technology transfer.

China's most important economic problems are also untouched by dual circulation. Structural excess supply will gradually fade as the labor force shrinks. While this process unfolds, though, state-owned enterprises will invariably overproduce compared to market actors and, as Chi indicates, dual circulation clearly emphasizes the role of the state. The combination makes sustained deleveraging essentially impossible. At the end of 2019 (pre-Covid), the Bank for International Settlements put credit to the non-financial sector at 259 percent of GDP, compared to 139 percent at the end of 2008. Risk can be lowered, but the bank loans needed to support state-owned enterprise overproduction will consistently outpace nominal GDP, as they have since 2002.

It is not at all surprising that Xi wants to hold to the course he adopted in 2013, well prior to the supposed Sino-American trade war. It would be more surprising if competition with the United States matters much, at least to this point. Tariffs are endlessly discussed, but the impact on bilateral goods and services trade from 2016 to 2019 was almost trivial, for example a $2.5 billion or less than 1 percent drop in the U.S. deficit. Over the same period, American portfolio investment into China more than doubled, a gain of $125 billion, even excluding indirect investment through the Caymans. The "technology cold war" to date consists largely of American companies facing the terrible burden of having to apply for a license before selling to China as usual, plus repeated promises of new export control regulations which have never appeared.

The United States may be slowly moving toward actions that can force China to change important economic policies. Even if so, this will be an extended, arduous task, as American trade negotiators appreciate. In the meantime, Chi notes that "it would be rewarding to follow the government's lead when investing." While possibly a very unpleasant recommendation, this certainly could prove lucrative. Same as it ever was. ◆