

Market Commentary

November 5, 2020

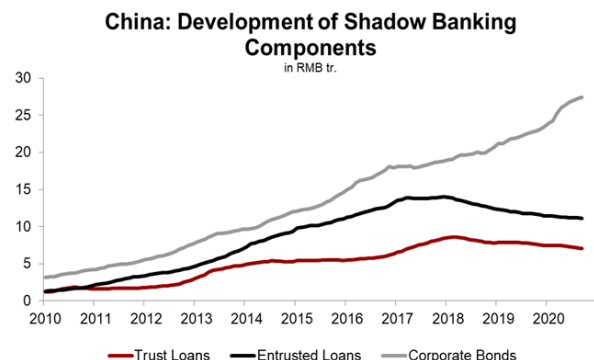
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China's new "Dual Circulation Strategy"

- End of last week, China approved its "Dual Circulation Strategy" which is the new five-year plan from 2021 to 2025.
- The plan intends a shift in the basic growth engine from exports to domestic demand. It also intends to further tackle the high credit-to-GDP ratio. Moreover, in the long run demographics will become a headwind.
- For private consumption this implies to lower the still high savings rate, increase urbanisation and to improve human capital.
- For investments, there is the need to raise productivity and to "clean-up" the past misallocation of credit. A focus will lie on technological advances which will be supported by infrastructure modernisation.
- Finally, China does not want to close its doors but "learn" from abroad which warrants a further opening up of the corporate sector and financial markets amid a strengthening of property rights.

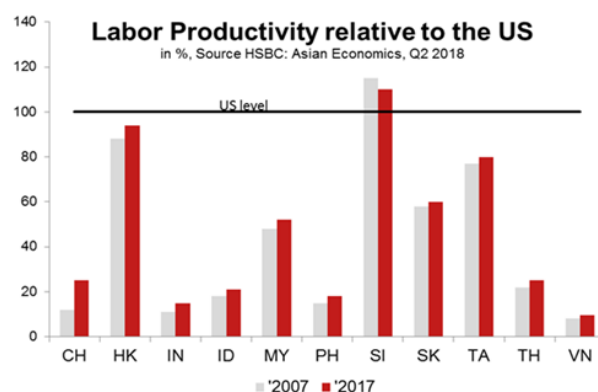
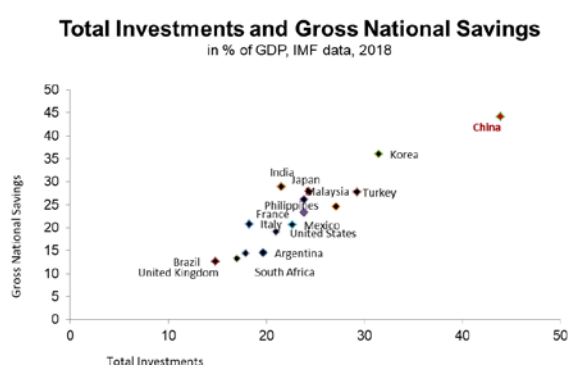
At the end of October, China approved its "Dual Circulation Strategy" which is the new five-year economic plan (2021 – 2025). The concept has been under discussion for quite some time and President Xi highlighted it already in May. In a nutshell, the concept promotes **domestic demand as the central growth engine**. It foresees more independent and resilient supply chains while at the same time it intends to further opening-up the corporate sector and financial markets.

Why has this shift become necessary? China's development has long been driven by exports and export-induced investments, exploiting its **comparative advantage in cheap labour**. However, this model has reached its limits amid rising wages and fierce competition from other low-cost countries (like Vietnam). Moreover, in order to generate rising incomes it is necessary to **move up the value chain** and embark on more complex and technologically advanced products and services. In the electronics sector, China has already made substantial progress in this regard. But thereby Beijing also prompted the resistance of other countries like the US, which feels unfairly treated and exploited by non-reciprocal market access as well as an insufficient respect for property rights. Consequently, protectionism has been on the rise and China cannot rely on global exports as the main driver for growth any longer.



Moreover, to fight the 'Great Financial Crisis' (GFC) China set up an extraordinary fiscal support package in 2008, officially worth 12.5% of GDP, but *de-facto* even larger. The **debt programme went to some extent out of control** on the local government level (including the Local Government Investment Vehicles) and Beijing struggled to clean them up. However, the government was obviously not willing to accept the growth-reducing base effect from the end of fiscal support. Other sectors, mainly state-owned enterprises (SOEs) stepped in which resulted in a further significantly rising debt level. The allocation of credit deteriorated and consequently, the return on investment began to shrink and efficiency to slow. Shadow banking activities grew significantly, implying rising risks to the **stability of the financial sector**. The IMF estimated the non-financial sector debt at 256% of GDP in 2018. China has already embarked on a de-risking strategy two years ago and the PBoC supports this de-risking strategy with facilitating the shift from shadow banking back into the traditional banking sector.

On top, China's working-age population has peaked. Thus the demographic dividend to GDP growth will diminish over the longer-term.



The new “Dual Circulation Strategy”: Against this background, the new five-year plan promotes domestic “circulation” to be in the centre of development:

- For private consumption this implies to boost incomes, **reduce the still high savings rate and promote urbanization**. To increase income, China will further foster the service sector, as well as promote education and vocational training. One reason for the high savings rate is precautionary saving due to loopholes in the social safety net, another is a strong preference for real estate. The social safety net could be broadened especially to cover fatal illness. It could also improve the different access to social benefits between rural and urban citizens as well as SOE and private sector employees. Urban households not only enjoy a 2.6x higher per capita disposable income but have also easier access to social benefits which are local and often coupled to an urban household registration (hokou). The majority of the about 290m migrant workers are still excluded, providing a large potential for a lower saving rates (which is double the size of their urban counterparts). Facilitating urbanization would also imply a rural land reform but likely increase the pressure on the urban real estate markets. Thus, the government will continue to slow down speculative housing demand.
- With regard to investments, it is necessary to **enhance productivity growth**. SoEs will continue to play a central role in strategic areas but their role will be reduced in competitive sectors. The deleveraging target implies SoE debt to be further consolidated. Overall, the government will go on with establishing an orderly bankruptcy mechanism, allowing to restructure “zombie” companies. Boosting productivity also warrants an intensification of the technology catch-up. R&D spending is intended to go up further. Technology advances will be facilitated by investing in new infrastructure like 5G networks, the internet of things and artificial intelligence. At the same time supply chains shall be made more secure, in part reflecting the treatment of some companies by US restrictions as well as the Covid-19 experience. Last but not least, production shall become “greener”.
- Developing domestic markets does not mean to close China from abroad. Technological advances still imply to “learn” from abroad. China will continue to play a dominant role in global value chains. To move up the ladder also warrants **attracting FDI**. This in turns depends critically on further opening up domestic sectors to foreign companies as well as further **capital market and capital-account liberalisation**.

All in, the “Dual Circulation” confirms the “China 2025 strategy” which is de-facto just a step to the long-term target to develop into a high income country over the long term.

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