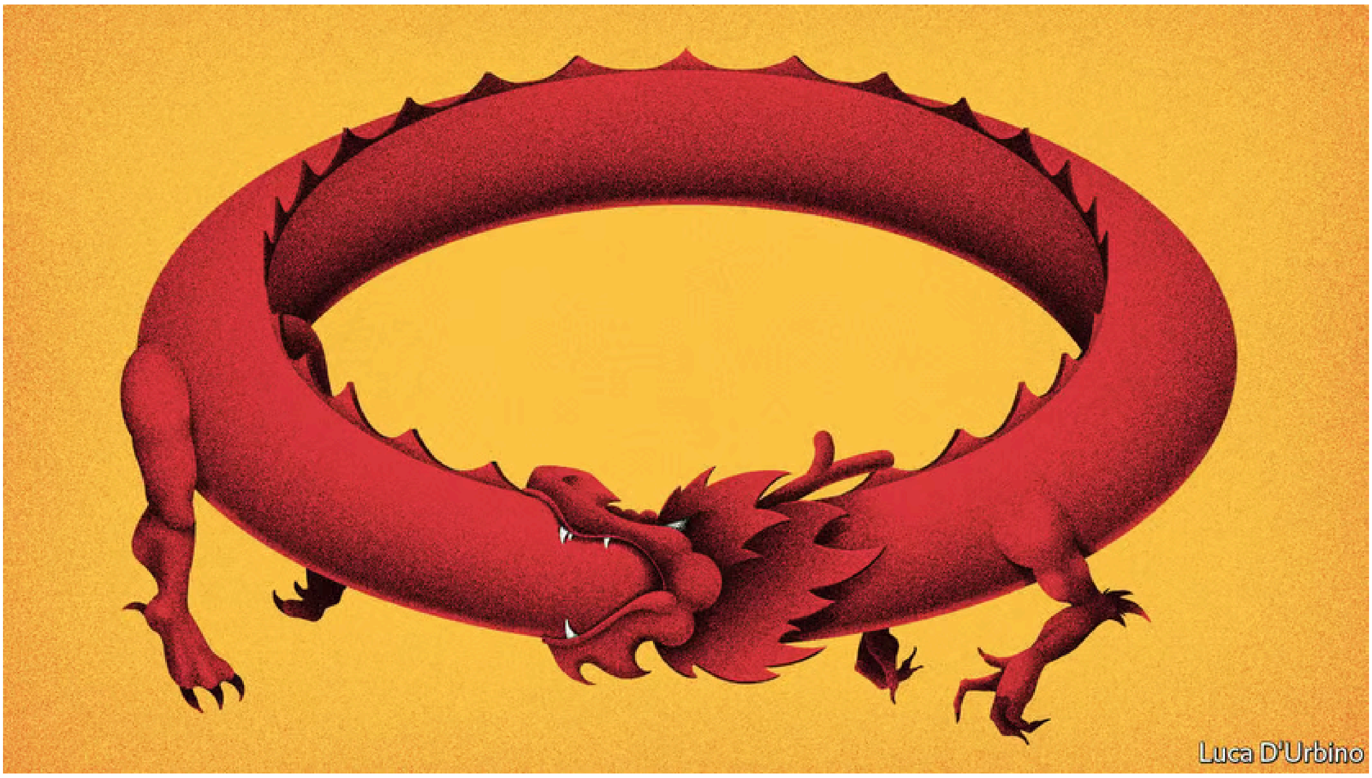
China | Circling back

China’s “dual-circulation” strategy means relying less on foreigners

Xi Jinping sees the creation of fully domestic supply chains as a matter of national security



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AT THE HEADQUARTERS of Deli, one of China's biggest makers of glassware, display shelves hold hundreds of drinking glasses of all shapes, sizes and colours. Some are stubby. Others are impossibly thin wine goblets, marketed as having a "feminine body curve". But it is another curve—the steep upward one that Deli's mastery of the business has traced—that ought to command more attention. Founded in 1996, the company initially churned out cheap, easily chipped glasses. Little by little it has raised its game, nearly tripling its exports over the past decade. It once had no choice but to import equipment for crafting its finest glassware. Now it can use China-made machinery. "Apart from branding, there's not much that separates us from the world's best," says Cheng Yingling, a senior executive.

Deli's evolution—which has involved getting better and more Chinese at the same time—is what the government wants for the broader economy. These are not exactly novel ideas. For years officials have declared that China must grow more innovative and more resilient. To a certain extent it has achieved this naturally, as a result of its fast-paced economic development. But these goals have taken on far greater urgency as tensions with America have mounted. American restrictions on exports of critical components, notably semiconductors, have shone a harsh light on the gaps in China's industrial abilities. Drinking glasses may be much simpler to make—requiring not much more than sand and sodium carbonate plus some relatively basic machinery—but China is not about to stop there. Xi Jinping, China's leader, has described the creation of fully domestic supply chains as a matter of national security.

The question is how to build them. Chinese officials know that they cannot turn their backs on the world. Exports are still an important source of revenue for many firms such as Deli. And China must attract technology and investment from abroad. Pushing too transparently for "indigenous innovation", a term once bandied about by the government, only makes foreigners wary. Striking the right balance is tough.

Enter the newest of China's big economic policies: the "dual-circulation" strategy. At its most basic it refers to keeping China open to the world (the "great international circulation"), while reinforcing its own market (the "great domestic circulation"). If that sounds rather vague, it is: the government has not spelled out the details. Nevertheless, it has fast emerged as the most talked-about economic policy in China, with analysts and businesspeople jostling to put their spin on it. The strategy lies at the heart of the five-year plan for 2021-25, an outline of which was released by the Communist Party on November 3rd. Its implementation—

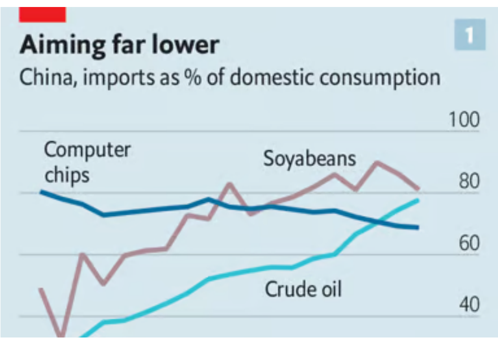
especially how China resolves the tension between the two kinds of circulation—will be critical to the way that China's economy develops.

The term "international circulation" was coined in 1988 by Wang Jian, a government researcher who argued that China should pursue an export-led growth strategy, plugging its vast pool of cheap labour into global production networks. Well into the early 2000s, this was a guiding principle for China's economic planners. Yet circumstances have changed. Exports have shrunk as a share of GDP—from 36% in 2006 to 18% last year. The government has repeatedly vowed to make consumption within China a bigger engine of growth. So scholars have been turning their attention more to the domestic kind of circulation.

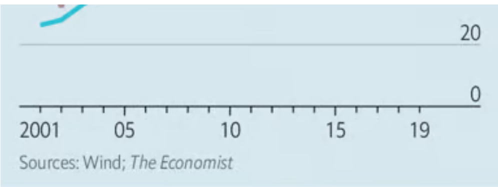
In May it became evident that this academic debate had reached official ears. At a meeting of the Politburo, Mr Xi described dual circulation as the framework for economic policy. Initially, jaded veterans of Chinese official rhetoric were tempted to dismiss this as just another way of phrasing the long-stated goal of rebalancing towards domestic demand. But it has become clear that something bigger is afoot. More recent comments by Mr Xi on the economy have been less about promoting consumption and more about bolstering China's defences. China needs "self-developed, controllable" supply chains, with at least one alternative source for vital products, he said in a speech published on October 31st. Even more striking was his inversion of the idea of international circulation. Instead of talking about it in terms of the economic benefits China reaps from globalisation, he emphasised only the strategic purpose of opening China's doors to foreign firms, ie that making them more dependent on the Chinese market would deter foreign powers from putting pressure on the country.

That combination—the pursuit both of economic self-reliance and of greater economic leverage over foreign countries—now describes much of what China is doing. Mr Xi refers to changes "unseen in a hundred years" sweeping the global order—a way of saying that, while China is rising, America is declining and trying to stop the new power (see Chaguan). "Where linkages with the global economy create vulnerabilities, China wants to minimise them," says Andrew Polk of Trivium China, a research firm. "Where the linkages create benefits, China wants to expand them."

Chinese officials tailor their remarks on dual circulation to please foreign ears. In a video address on November 4th at the opening of the China International Import Expo, an annual jamboree in Shanghai, Mr Xi said the concept would involve opening China more widely to the rest of the world. "This is not just what China needs for its development, but something that will enrich the people of all countries," he said. But businesses in China see the concept more as an indication that the government will step up support for favoured industries at home, says Zhu Ning of the Shanghai Advanced Institute of Finance. They are hungry for news of handouts.



In its outline of the new five-year plan (a fleshed-out final version will be adopted next year at the annual session of China's parliament, probably in March), the party did not specify industries to be coddled. Instead it referred more generally to a need to develop critical technologies at home. But other policies already in train suggest that China will prop up any high-tech sector threatened by global vicissitudes. In August it announced tax breaks and loan support for semiconductor and software



The Economist

firms. China currently produces about 30% of the chips it consumes (see chart 1). Its goal is to reach 70% by 2025. Another focus is on green technology and renewable energy. That is not just for the sake of the environment (China recently pledged to halt the rise of its carbon emissions by 2030). Investment in such businesses will also limit China's thirst for imported oil.

In the past, when publishing outlines of five-year plans prior to their adoption by parliament, the party has often announced a goal for average annual GDP growth during the plan period (see chart 2). There was no such figure this time. In separate comments, Mr Xi said it was entirely possible that China could double the size of its economy by 2035. That would require average annual growth of 4.7% over the next 15 years. Such a rate would be readily attainable for the first half of that period, but may become much harder thereafter.

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China has good reason to abandon such targets. They lead to an overemphasis on investment in infrastructure and other short-term measures to boost growth, rather than on social policies such as those relating to health care or education which can promote growth but may take longer to show results. But de-emphasising targets may relate to the new dual-circulation strategy in a way that the government has left unspoken. Making the economy less reliant on global supply chains could crimp its ability to grow.

Arguably China has been the world's main beneficiary of globalisation, which has enabled it to dominate ever-bigger segments of manufacturing. Turning inward could be costly. It may result in less foreign technology flowing into China, less of the competition that has spurred on Chinese firms, and more wasteful investment as the government throws money at favoured industries. Shaun Roache, an economist with S&P, a credit-rating agency, forecasts that China's average annual growth will be 4.6% in the 2020s. But he reckons it could be about 3% if the drive for self-reliance is overdone. The country's "tolerance for slower growth may well be tested in the years ahead", he says. The party, ever fearful that a stagnating economy could trigger social unrest, may find it hard going.

Optimism is a stubborn trait, so some inveterate China-bulls think that emphasising domestic circulation may create a new wave of reforms aimed at making the country's markets function more efficiently. Take the semiconductor industry. *Caixin*, a Chinese financial magazine, reported last month that Huawei, a tech giant, was rushing to create a "not-made-in-America" supply chain by 2022. Initially, however, that would enable it to make chips with transistors spaced 28 nanometres (billionths of a metre) apart, far less dense than the most advanced ones. The bullish case is that China, realising how long it will take to catch up in such areas, will try to boost productivity by cracking on with hitherto slow-moving reforms. Analysts with Huatai Securities, a brokerage, think that could include doing more to loosen the household-registration system known as *hukou*, which impedes the movement of rural labour to the country's biggest and most productive cities.

In the meantime, companies are getting on with their work. Mr Cheng at Dell, the glassware firm, says he will not give up on foreign markets despite the pandemic's impact on demand. But he will mainly focus on brighter prospects at home. His team is refining their product range for younger consumers, who are pickier about style and more demanding about quality than their parents. That mix of emphasis, your correspondent ventures, sounds a lot like a corporate version of the dual-circulation strategy. "We're not too clear about what all that means," he says with a sigh. "We're just following the market." ■

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