



China's dual-circulation model is a plan for a hostile world but a catchable US
Domestic production gets priority in a strategy that seeks to boost China's 'soft power'.

Sir Arthur Lewis (1915-1991) was an economist from Saint Lucia in the Caribbean who was awarded the Nobel Prize in Economics in 1979 for his theories on development. His 'dual sector model' suggested that economies can modernise without triggering inflation because the growing industrial sector can rely on a large supply of farm workers to work for low, but not subsistence, wages. This allows industry to earn, then reinvest, excessive profits. But one day the stream of peasants dries up. When a developing economy reaches this 'Lewis turning point', wages growth exceeds productivity, industrial profits decline, investment drops and inflation stirs.[1]

A big challenge for China is that the country is approaching a Lewis turning point at the same time it faces a 'demographic time bomb', a term that describes the rapid ageing of its 1.4 billion population due to the three-decades-long, but now abandoned, one-child policy. Another test is that China is confronting the 'middle-income trap'. This is a term for when a country's initial and successful drive to industrialise becomes bogged at middle-income levels unless the country can develop the skilled workforces, sophisticated manufacturing, financial sectors, institutions, governance standards and rule of law that advanced countries possess. On top of these challenges, another has emerged for Beijing – along with an opportunity. China's growing political and economic clout has created a hostile global environment but a relatively weaker US.

China's policymakers have long seen the first two challenges coming.[2] Along with some institutional reform, their answer was to make domestic demand a bigger driver of economic growth. But the pivotal market reforms of the past 15 years to rebalance the economy away from exports and investment appears too inadequate a solution for Chinese leaders in a harsher world but one where it senses the US is vulnerable. Beijing's response to help double the economy's size from 2020

to 2035 and to ensure its global influence? A "dual circulation" strategy, which marries the 'external circulation' of global demand with the 'internal circulation' of domestic demand.[3]

The split-economy strategy emerged from a Politburo meeting in May last year and appears deliberately ambiguous.[4] Official pronouncements since indicate the plan aims to reduce China's reliance on other countries for national-security reasons while boosting the country's 'soft' global power to approach (thus nullify) that of the US. While the previous rebalancing aimed to lessen China's dependence on exports, the dual-circulation strategy seeks to limit China's reliance on imports and the US-dominated global financial and trading system. The strategy's essence is prioritising domestic production, innovation and self-sufficiency. It is a call to turn China into a sophisticated manufacturing hub, form China-centred global production networks that multinationals come to rely on, develop a yuan-based international financial network, and possibly turn China into a military-technological complex. The means to these goals include subsidies, export controls, data restrictions and dangling China's consumer market as an enticement to attract foreign capital and technology.

Just as important is what Beijing's dual-circulation strategy does not do. The policy lacks any unleashing of market forces. It is not a retreat into North Korean-style autarky. The strategy heralds no easing of the Communist Party's political control. Nor is it a plan to break the international order.

The dual-circulation strategy, in many ways, might seem a partial shift. But it is poised to drive China's economy, boost its regional hegemony, make China a leader in industrial, technological and financial spheres and advance China's global influence. The strategy is likely to challenge some of the countries and industries dependent on China as an export destination and offer a fresh competitor to industrial powerhouses such as Germany that export capital goods. It foretells of renewed pushes to internationalise China's financial system and promote use of the yuan to rival the US-dollar-based global financial network. The plan signals more significant trade agreements such as the China-EU investment treaty signed in December (but not ratified by the European Parliament) rather than any drive to liberalise world trade.[5] It flags further Chinese efforts to dominate global bodies so it can influence the rules-based global order and set global technology standards. As China's just-released 14th five-year plan (2021-2025) shows, it likely means an intensification of



the clash with the US to dominate the technologies of tomorrow. China's dual-circulation strategy signals that an era approaches when international linkages are more an overt means to enhance global power rather than a cooperative way to boost economic efficiency.

To be sure, China's new strategy might not be that noticeable over time and Beijing's reluctance to provide details means it could morph into anything. It's too early to emphatically rebut those who dismiss it as just the old rebalancing strategy. Same goes for responding to those who say it's just an extension of the Made in China 2025 drive for technological leadership and the Belt and Road Initiative to tie (so far about 100) countries to China. There are major developments that don't sit easily within the strategy. Beijing's aggression in the South China Sea, crackdown on Hong Kong, intimidation of Taiwan and 'wolf warrior' diplomacy risk a backlash that would nullify any advancements in soft power. The dual-circulation strategy might come with a larger-than-expected cost to efficiency, especially if Beijing veers too far towards self-sufficiency or the authoritarian nature of the regime stifles innovation. The strategy relies on a certain level of foreign participation and human-rights abuses might deter some western companies.

But if developments 'follow the money' as they often do, China's supersized economy will be enough of a magnet to tie much of the world to China. There's every chance Beijing will engineer a partial decoupling from the US-led world on its own terms. Such a separation would form the next phase of China's modernisation, the next leap in its global power, perhaps even the next 'China shock', where China's industrialisation so far formed the first shock.[6]

A DOMESTIC-DRIVEN SHIELD

Maybe the biggest advance in communications in the 19th century was the invention of underwater cables. The first was laid across the Channel in 1851 and one across the Atlantic followed 15 years later. An unusual feature of the proliferation of ocean cables was that it was a Scotsman, John Plender (1816-1896), who connected London to its colonies, rather than the UK government. At his death, Plender's companies controlled one-third of the global telegraph system.[7]

The UK thus had a huge advantage come World War I. At the outbreak of hostilities in 1914, a UK cable ship cut Germany's underwater link to the US and thereafter UK intelligence intercepted Berlin's messages to North America as they passed through a relay station in Cornwall. The information gleaned proved decisive in 1917 when Berlin's communications urging Mexico to reconquer Arizona, New Mexico and Texas helped prompt the US to enter the war against Germany.[8]

China is at a similar disadvantage to Imperial Germany because US private enterprise dominates the global financial system and the worldwide web that gives the US unrivalled power. Using the US dollar's reserve status and the threat of exile from US-led capital markets, Washington can force countries to support its will. If China needed a reminder, Canada in 2018 arrested Meng Wanzhou, the deputy chair and chief financial officer of Huawei Technologies, over allegations the daughter of Huawei's founder violated US sanctions on Iran, a country that at the very least is no enemy of China.[9]

To counter Washington's ability to weaponise US economic and financial muscle, the dual-circulation strategy is likely to see Beijing boost the international use of the yuan currency, develop capital markets to expand trading in yuan-denominated securities in and outside China, investigate a sovereign digital currency, create a Chinese-controlled cross-border payments system for banks, and openly boost everyday use of China's Alipay and WeChat Pay payments systems in Asia and other emerging regions.[10]

An even-bigger focus of the dual-circulation strategy is better capabilities and "greater self-reliance" in technology. China's 14th five-year plan aims to boost government spending on research and development by 7% each year over 2021 to 2025. Beijing's goal is to increase its research and development from 2.2% of GDP in 2019 to about 3% of output – closer to the 3.3% the US spends[11] – to bolster key technologies such as artificial intelligence, microchips and supercomputing.[12]

The risk for the world as the US and China compete for global tech leadership that bestows the setting and enforcement of global standards is that their rivalry increases the value of dominating Taiwan, the world's microchip hub that China views as a renegade province (and to where the losing side of China's civil war fled in 1949).[13] US thinktank the Council on Foreign Relations warns that Taiwan "is becoming the most dangerous flash point in the world" for a possible war that involves China, the US and other major powers and one that could be previewed by cyberattacks.[14] In 2019, Xi said China would "not promise to renounce the use of force" to achieve the popular desire for Beijing to gain control of Taiwan.[15] The dual-circulation strategy, at the very least, will do nothing to ease tensions between Beijing and Washington over Taiwan. Conflict between the pair is a possibility and would negate China's drive to boost its global influence.

As a sign China's government accepts that a more hostile world comes with a hit to the economy, Beijing said it would achieve only an economic growth target of "above 6%" for 2021, well below expectations of a target of about 8.4%.[16] China's lower-growth target acknowledges that global demand for its manufactured goods is likely to stall due to the damage to economies wrought by the pandemic, trade frictions and decisions by other countries to ensure the supply of essentials.

Beijing's attempt to insulate China from a tougher export environment will depend on Beijing's ability to boost consumption's role in driving the economy (while meeting the demands from the Chinese for a cleaner environment and fulfilling China's recent pronouncement the country would reach carbon neutrality by 2060.)[17]

As a guide to how much China has to achieve to function more like a modern economy, US household spending comprised 68% of US GDP in 2019 whereas China's household consumption stood at only 39% of output.[18] The challenge for Beijing is that boosting consumer spending entails freeing the price of land and money (interest rates and the exchange rate) and allowing wages to rise – changes that threaten vested interests in China (such as the state sector) and make China's manufacturing exports less competitive.

Beijing's dual-circulation strategy is a bet that foreign companies will bring technology and capital to China to capitalise on the country's huge consumer market and that foreign consumers will keep buying Chinese products. The Chinese and US economies are too intertwined on many levels to enact a complete 'decoupling'. As neither side is likely to risk moves that lead to conflict, China is bound to receive the know-how and money that will help bolster the domestic economy. Once multinationals are embedded in China their home-country governments will find it much harder to act against China's interests.

In response to China's technological push, Washington is gearing up to help US private enterprise maintain the country's tech edge over China. Such rivalry is bound to intensify under China's new strategy that from Beijing's perspective, amid Lewis turning points, middle-income traps and trade wars, is as defensive as it is offensive.

By Michael Collins, Investment Specialist

[1] Lewis, W. A. "Economic development with unlimited supplies of labour." The Manchester School, 22. 1954. Pages 139 to 192.

[2] The IMF in 2013 warned China it was approaching a Lewis turning point, while the government abandoned the one-child policy in 2015, the same year then-Premier Li Keqiang warned China was approaching the middle-income trap. See IMF Working Paper. Research Department and Asia and Pacific Department. "Chronicle of a decline foretold: has China reached the Lewis turning point?". Prepared by Mitali Sas and Papa N'Diaye. January 2013. imf.org/external/pubs/ft/wp/2013/wp1326.pdf

[3] One official Chinese definition is that the dual-circulation model is 'a new development pattern where domestic and foreign markets can boost each other, with the domestic market as the mainstay'. See XinhuaNet. 'Xi focus: Xi explains new development pattern.' 3 November 2020. xinhuanet.com/english/2020-11/03/c_139488445.htm

[4] Other Chinese political slogans include 'Let 1,000 flowers bloom', 'Smash the four olds', 'Have fewer children, raise more pigs', 'Peaceful rise', 'One country two systems' and 'New great power relations'.

[5] See European Commission. 'EU-China comprehensive agreement on investment: Milestones and documents. 22 January 2021. trade.ec.europa.eu/doclib/press/index.cfm. EU lawmakers have refused to ratify the deal in response to sanctions against members of the bloc and are set to pass a motion that formally halts the agreement..

[6] Mark Leonard. Project Syndicate. 'The new China shock.' project-syndicate.org/commentary/the-new-china-shock-by-mark-leonard-2021-03

[7] Niall Ferguson. 'The square and the tower.' Allen Lane 2017. Penguin Books 2018, pages 160 to 162.

[8] Ferguson. Op cit. Pages 197, 198 and 213.

[9] BBC. 'Huawei finance chief Meng Wanzhou arrested in Canada.' 6 December 2018. bbc.com/news/business-46462858

[10] XinhuaNet. 'Full text: Report on China's national economic, social and development plan.' 13 March 2021. See pages 44 to 46 for outline of China's fiscal, financial and pricing systems. xinhuanet.com/english/2021-03/13/c_139807950.htm

[11] Jingshan Report. 'Release of China's new advantage of the super-large market.' 2020. Page 11. new.cf40.org.cn/uploads/2020_Jingshan_Report.pdf

[12] XinhuaNet. Op cit. See pages 35 and 36 for outline of China's technological goals. xinhuanet.com/english/2021-03/13/c_139807950.htm

[13] See EastAsiaForum (that is linked to the Australian National University). 'Supply chains critical to Taiwan's security.' 10 March 2021. eastasiaforum.org/2021/03/10/geoeconomics-and-the-security-of-taiwan/

[14] Council on Foreign Relations. 'The United States, China and Taiwan: A strategy to prevent war.' February 2021. cfr.org/report/united-states-china-and-taiwan-strategy-prevent-war

[15] Reuters. 'China's Xi threatens Taiwan with force but also seeks peaceful 'reunification'' 2 January 2019. reuters.com/article/us-china-taiwan-idUSKCN1OW04K

[16] Bloomberg News. 'China's modest growth target signals policy shift from world.' 5 March 2021.

[17] ChinaDaily. 'Five-year blueprint paves way for 2060 carbon neutrality.' 15 March 2021. chinadaily.com.cn/a/202103/15/WS604eb6b3a31024ad0baaf1aa.html. See too, Chatham House. 'Beijing sets new course.' 5 February 2021. chathamhouse.org/publications/the-world-today/2021-02/beijing-sets-new-course

[18] OECD data. 'Household spending.' data.oecd.org/hha/household-spending.htm

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