China's economic recovery and dual circulation model

SUMMARY
After a delayed response to the outbreak of the novel coronavirus in late 2019, China has expanded its sophisticated digital surveillance systems to the health sector, linking security and health. It has apparently successfully contained the virus, while most other countries still face an uphill battle with Covid-19. China emerged first from lockdown, and its economy rapidly entered a V-shaped recovery. As in 2008, China is driving the global recovery and will derive strategic gains from this role.

However, China's relations with advanced economies and some emerging markets have further deteriorated during the pandemic, as its aggressive foreign policy posture has triggered pushback. This has created a more hostile environment for China's economic development and has had a negative impact on China's hitherto almost unconstrained access to these economies.

The need to make the Chinese economy more resilient against external shocks and the intention to tap into the unexploited potential of China's huge domestic market in order to realise the nation's ambitions of becoming a global leader in cutting-edge technologies have prompted the Chinese leadership to launch a new economic development paradigm for China. The 'dual circulation development model' still lacks specifics but is expected to be a key theme in China's 14th Five-Year Plan (2021-2025) to be officially approved in March 2021. The concept suggests that, in future, priority will be given to 'domestic circulation' over 'international circulation'.

China's more inward-looking development strategy geared towards greater self-reliance in strategic sectors requires major domestic structural reform and investment to unleash the purchasing power of China's low-end consumers and the indigenous innovation efforts to achieve the technological breakthroughs needed. These innovation efforts are expected to be largely state-driven.

For the EU the envisaged shifts create challenges and opportunities. On the one hand, competition with China will become fiercer and, on the other, the EU can pursue openings for supply chain diversification with like-minded countries and thus boost its open strategic autonomy.

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Tackling the pandemic amid growing bilateral friction

The coronavirus pandemic has forced societies around the world into lockdowns and has required countries to launch comprehensive economic stimulus packages, which will be a drag on their future economic wealth and international status. China, however, is part of a very small group of economies, including South Korea and Taiwan in particular, that have successfully contained the virus in a sustainable manner, so far preventing large new waves of infections.

According to the IMF October 2020 World Economic Outlook report, projected growth in gross domestic product (GDP) for China of 1.9% in 2020 and 8.2% in 2021 is set to make the country an outlier among its peers. Major advanced economies are heading towards a negative GDP change for 2020: Canada -7.1%, the Euro area -8.3%, Japan -5.3%, the United Kingdom (UK) -9.8% and the United States (US) -5.8%.

However, pandemic-induced sluggish global demand poses major challenges for China given the traditionally low consumer demand generated from its domestic market that is unable to offset the global trend. In addition, unlike during the global financial crisis in 2008/2009, China's future economic and technological development faces a more hostile external environment that has emerged from China's geopolitical and geo-economic tensions with several advanced and emerging economies, exacerbated by the pandemic (see box).

The uncertainties of an unprecedented global economic downturn and the economic and technological implications of a deteriorating geopolitical environment for China's future development are important considerations the Chinese leadership is taking into account as it fine-tunes the direction of China's future economic and social trajectory under the 14th Five-Year Plan for the 2021-2025 period and under other long-term development plans for the years up until 2035 to be adopted by China's National People's Congress in March 2021.

Exemplary economic recovery in China?

In the wake of the outbreak of the coronavirus pandemic in the Chinese city of Wuhan at the end of 2019, China went into a strict lockdown in February 2020 to contain infection numbers. This entailed an unprecedented economic contraction of 6.8% in the first quarter of 2020 according to China's National Bureau of Statistics. However, the world's second largest economy, whose gross domestic product (GDP) totalled approximately US$14.8 trillion in 2019, has quickly rebounded, entering a V-shaped recovery (Figure 1). In the third quarter of 2020, China's economy recorded a 4.9% GDP growth rate year on year, up from 3.2% in the second quarter.

What are the key features of China's recovery?

China's rapid economic recovery provides evidence of strength, but there are structural weaknesses. While supply-side constraints have eased, weak domestic and external demand have restrained the pace of recovery, despite the wide range of measures taken to mitigate the economic fallout.
In September 2020, overall **industrial output** increased by **6.9%**, contrasting sharply with a modest 1.2% growth year on year during the first three quarters. It is noteworthy that high tech manufacturing and equipment manufacturing have proved very resilient. Their figures soared by 5.9% and **4.7%** respectively year on year during the first nine months of 2020.

The industrial products with the biggest output growth rates – trucks (23.4%) and **excavators** and shovelling machinery (20.2%), a barometer for infrastructure construction activity – industrial robots (18.2%), and integrated circuits (14.7%) suggest a dual-track trajectory of the recovery combining traditional state-backed infrastructure construction with market-driven demand for equipment for the digital economy. Lockdown-induced demand for home office equipment for instance has sustained a constant rise in micro computer equipment output of over 5%.

In September 2020, **urban fixed asset investment** returned on a growth trajectory of 3.37%, while the increase between January and September 2020 year on year remained at a modest 0.3%. In the first three quarters of 2020, this rebound was predominantly driven by investment from state-owned enterprises (SOEs) and state holdings, the main beneficiaries of favourable credit conditions. Investment by SOEs grew 4% year on year, while private-sector investment dropped by 1.5%. Moreover, it is interesting to note that foreign investment expanded by 5.3% and investment from Hong Kong, Macao and Taiwan grew by 4.9% year on year. This trend contrasted with sluggish growth in domestic-funded investment, at 0.7% for the same period.

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China has adopted a fiscal stimulus package of approximately US$506 billion, accounting for about 4% of its GDP (much lower than the 2008 stimulus package of US$757 billion during the global financial crisis that corresponded to a GDP share of 13%) ultimately also including **cash handouts** for unemployed workers not covered by unemployment insurance. In addition, a US$1.4 trillion public spending programme is being rolled out which – unlike that of 2008 – focuses on digital infrastructure. It includes seven key areas: 5G networks, industrial internet, an intercity transport and rail system, data centres, artificial intelligence, ultra-high voltage power transmission, and new-energy vehicle charging stations. The programme also seeks private investment, however, not all elements of the scheme are equally accessible to foreign firms. 5G networks for example, **for obvious reasons**, have equity caps in favour of Chinese firms.

Whereas during the first three quarters of 2020 overall investment in the manufacturing industry decreased by 6.5%, investment in high-tech industry was an outlier that grew by **9.1%**. Investment in pharmaceutical manufacturing and in manufacturing of telecommunications equipment,
computers and office devices – sectors directly linked to the pandemic – grew by 21.2 % and 11.7 % respectively. In the area of high-tech services, strong investment growth was recorded for e-commerce services (20.4 %), information services (16.9 %) and services for the commercialisation of research findings (16.8 %).

Retail sales of consumer goods in the first three quarters suffered a drop of 7.2 % year on year. In September 2020, however, they grew 3.3 % year on year suggesting that domestic consumption is now gradually picking up, underpinned by the provision of experimental Covid-19 vaccines to hundreds of thousands of Chinese, instilling confidence into the government’s handling of the pandemic thanks to the proliferation of high-tech surveillance tools on consumers’ mobile phones. Over 637 million Chinese citizens, almost half of China’s population, benefited from the one week National Day holiday in October 2020 for travel across the country, spending US$92.9 billion.

The trade picture for the second quarter (Q2) of 2020 (Figure 2) shows that the drop in mainland Chinese imports and exports is significantly lower than declines suffered by China’s major trading partners, with Taiwan, following its excellent handling of the virus, standing out with both positive imports and exports.

Chinese data for September 2020 show an increase in exports of 13.2 % to US$203 billion. Export items (by SITC classification) with the biggest increase included textile yarn (33.4 %), chemical materials and products (21.7 %), and medical and pharmaceutical goods (9.3 %). Exports of OLED (organic light-emitting diode) screens, tablet computers, textile products, battery electric passenger cars, and non-plug-in hybrid electric passenger cars saw particularly high growth rates.

Total imports in September 2020 increased by 9.9 % to US$240 billion. The top three Chinese imports (by SITC classification) were iron and steel (55.8 %), paper (34.8 %) and non-ferrous metals (33.1 %). Imports of several agricultural commodities such as meats and grains as well as unwrought aluminium and aluminium products grew by three digits. While the sharp increase in imports in agricultural commodities can be linked to China’s purchase commitments under its Phase One Deal with the US of early 2020, other commodities are most likely needed for infrastructure construction.

What are some of the challenges in China’s economic recovery?

A major concern is that China’s economic recovery so far is underpinned by an imbalanced growth pattern. Given that exports from most economies have plummeted, as they are still deeply mired in the pandemic, China has bridged disrupted export capacities. However, China’s economic recovery will need to be driven more by domestic demand, consumer spending and public spending. Consumer spending is traditionally weak in China and has remained modest during the pandemic, only gradually catching up. This slow recovery has been led mainly by the more affluent Chinese income brackets and differs widely across regions. A broad-based domestic consumption pattern has not (yet) emerged, since the pandemic has hit low-income brackets in China disproportionately harder, notably rural migrant workers unable to find new jobs in cities, with 63.35 % of migrant workers surveyed in 2020 stating that they had no job prospects if they returned to their rural home towns, against 35.3 % during the 2008 financial crisis. With household expenditure, on services in particular, still in decline in September 2020, the government’s focus was on public spending.
As China's economic recovery is bolstered by public and foreign fixed-asset investment, while private domestic investment has remained constrained, another vulnerability therefore is that government investment in infrastructure accelerates credit growth and favours large SOEs, with the risk of misallocating resources to and sustaining Chinese zombie enterprises. According to the IMF, China's total debt ratio reached 258% of GDP at the end of 2018, a level that was approaching the average for advanced economies, i.e. 265%. China's rising corporate debt levels are looming large. The increasing number of high-profile SOE bond defaults may suggest a gradual departure from long-standing implicit government bail-out guarantees for SOEs, as China sets new rules for its financial markets, including rules for its sprawling fin-tech companies. It remains to be seen whether growing domestic concerns about the sustainability of overseas investments might prompt China to become more selective in its infrastructure funding in Belt and Road countries.

Another concern is the potential for growing overcapacity in China. Since the recovery is mainly being fuelled by government demand for infrastructure construction, with strikingly high imports of steel and aluminium – key elements in China's overcapacity problem – and as China is building up new capacity and is shifting trade patterns, a new round of trade disputes may be looming on the horizon.

Chinese exports have benefited from foreign pandemic-related demand for pharmaceutical products and home office equipment, and possibly from additional demand arising from disrupted supply chains elsewhere. To the extent that the pandemic will disappear and global value chains will be reshaped by China's trading partners, demand is likely to shift and influence Chinese export opportunities. Overall, this begs the question as to how sustainable this recovery will be in the long term and how major uncertainties linked to the further evolution of the pandemic will be tackled.

Another concern is the environmental impact of China's economic recovery. As the recovery appears to be relying strongly on heavy industries driven by coal power, contributing to a rebound in CO2 levels, there are concerns about the global impact of a coal-heavy recovery in China. China’s CO2 emissions are indeed expected to be higher in 2020 than in 2019. The International Energy Agency’s World Energy Outlook 2020 is reported to estimate that ‘China continues to build an average of 17 GW of new coal-fired plant(s) per year through to 2025, with many new projects in progress despite a current excess of power capacity, weakened electricity demand outlook and recognition of the imperative to reduce coal use to address climate change’. This adds to recurring concerns about China’s support for the construction of new coal-fired plants along its Belt and Road Initiative (BRI). According to Chinese BRI energy investment for 2018, recorded by the American Enterprise Institute, fossil-fuel projects accounted for 57% and renewable energy projects for 42%. In 2019, this ratio improved only moderately to reach 52% to 48%.

On the other hand, China is also a world leader in installing solar and wind energy. China’s recent pledge to achieve carbon neutrality by 2060 is regarded as having positive consequences for greening Chinese long-term economic planning. While the IMF deems China’s fiscal measures to have the third highest positive climate relevance as a share of its GDP among G20 countries after France and Germany and the highest positive climate relevance as a share of the total (Figure 3), analysts of the...
Climate Change Tracker have identified China’s phasing out of subsidies for renewables and EVs and its unabated reliance on coal as challenges when it comes to achieving the 2060 goal.

Towards a new economic development model?

In a Chinese Communist Party (CCP) Politburo meeting of 14 May 2020, the Chinese leadership coined a new term, the 'dual circulation' model. The mastermind behind the new concept is believed to be Vice-Premier Liu He: President Xi Jinping’s top economic advisor, chief negotiator of the Phase One Deal with the US, and Chinese interlocutor in the annual EU-China High-Level Trade and Economic Dialogue. The term describes the future direction of China’s economic development, and will feature prominently in China’s 14th Five-Year Plan for economic and social development (2021-2025) and long-term objectives until 2035, including the China Standards 2035 Plan.

The latter sets benchmarks, e.g. for increasing the number of Chinese standards becoming international standards and boosting China’s influence and leadership in international standardisation bodies such as the China-led International Telecommunication Union (ITU). The plan has sparked concerns that China’s growing participation in international standards-setting bodies may lead to the country dominating the new generation of emerging technologies, and that exports of the latter may serve as a means of Chinese international power projection. Concerns also relate to the fact that standard setting is industry-driven in the EU and the US, but top-down and state-driven in China.

Dual circulation development model – What is behind the new buzzword?

The term 'dual circulation development model' refers to the inter-play between 'domestic circulation' of production, distribution, and consumption (i.e. the domestic economic cycle) and international circulation (i.e. the international economic cycle), and most importantly to the weight each of the two cycles is given in the model. International circulation has been the focus of China’s export-oriented development model since the launch of Deng Xiaoping’s reform and opening up policy in 1978. Shifting the focus of China’s development model more to the domestic market is, however, not an entirely new idea. It has been pursued for the last 15 years, although this objective has only been achieved within certain limits.

Official descriptions of the dual circulation model as ‘a new development pattern where domestic and foreign markets can boost each other, with the domestic market as the mainstay’ suggest that the Chinese leadership is now more decisively intent on giving a major role to ‘domestic circulation’ as a future growth driver. If China aspires to become a high-income country by 2022, that requires a gross national income (GNI) per capita of US$12,535 according to the World Bank (July 2020). Figure 4 shows that in 2019, China’s GNI per capita stood at $10,410, still very low compared with $41,690 for Japan and $65,760 for the US. China is seeking to avoid the middle-income trap, while prerequisites for growth are disappearing with China’s rapidly aging working population and rising wage levels, which have led to government-supported industrial offshoring to low-cost Asian neighbouring countries.

At 2.25%, China’s productivity growth has declined steadily since the 2008 global financial crisis, owing to shrinking returns on infrastructure investment and deteriorating resource misallocation linked to the growing role of the state. Against this backdrop technological innovation and improving the efficiency of resource allocation are ideas crucial to raising total factor productivity.
China’s economic recovery and dual circulation model

Since international markets are less likely to drive China’s economic growth in the near future than they have done in the past and the protection of cutting-edge technologies of advanced economies has become more sophisticated, the Chinese leadership is determined to tap more into the growth and innovation potential of its own market. This, however, will mean boosting domestic demand, notably for services, by raising domestic income levels.

China has taken steps to realign its economic growth model several times. Since the mid-2000s, and notably following the 2008 global financial crisis, an earlier effort to reduce the export-dependence of China’s economy has become known as the strategy of ‘rebalancing’ the Chinese economy. China’s economy was supposed to shift away from an excessively export- and investment-oriented double-digit growth model to a ‘new normal’ of lower but more sustainable growth rates with a greater emphasis on domestic consumption, services and indigenous innovation. This rebalancing approach has included supply-side structural reforms, notably to reduce overcapacity in areas such as steel and aluminium, but the demand-side reform has clearly lagged behind.

During the last decade, China has managed to halve the share of exports of goods and services in its GDP from 36.0 % in 2006 to 18.4 % in 2019 according to World Bank data, thus becoming less reliant on exports. However, in 2018, China’s final consumption expenditure as a share of its GDP was 55 %, down from a peak of 67.4 % in 1983. This is extremely low compared with other big emerging economies (Figure 5) such as Brazil and India (85.7 % and 70.4 % respectively) and with advanced economies such as Canada, Germany and the US (79 %, 72 % and 82 % respectively). At 38.8 % (2019), the share of Chinese private household consumption in nominal GDP is particularly low. Therefore, there is a huge unexploited potential for both Chinese and foreign companies to tap into.

China’s more inward-looking dual circulation development paradigm, geared towards greater self-reliance, also builds on and accelerates the implementation of state-led indigenous innovation programmes such as Made in China 2025 launched in 2015 and which may be seen as a much earlier form of Chinese ‘de-coupling’. In 2020, however, the new idea is on the one hand to make the Chinese economy less vulnerable to and more resilient against external shocks, such as the pandemic and a hostile geopolitical environment, and on the other to make it more reliant on the economies of scale of its large domestic market. It is also about increasing control over Chinese supply chains, notably for food, energy and high-tech inputs where import dependencies exist. In 2019, a mere 16 % of the integrated circuits China needed for domestic use came from indigenous production, despite the considerable funds China invested in its 2014 National Integrated Circuit Plan. The objective is thus to reduce China’s import dependence on advanced economies by replacing foreign cutting-edge technologies with indigenous ones, with strategic emerging industries playing a vital role, as in the past.

While the previous reform effort concerned the reduction of exports that benefited foreign players, the objective of this policy alignment is to reduce imports through an import substitution policy, while keeping world markets as open as possible for Chinese exports, foreign technologies, foreign direct investment (FDI) and the internationalisation of China’s currency. Although the details of the new strategy have not been unveiled, it is likely to have a far-reaching impact on high value added exporters to China, as they will increasingly be in competition with domestic technologies. Chinese pledges back in 2013 to give the market ‘a decisive role’ in resource allocation, albeit recently repeated, appear remote against the need for SOEs to undergird the innovation push. The dual circulation model will cement the role of the state in the economy, as the ‘state strikes back’.

![Figure 5 – China’s final consumption expenditure](data:image/png;base64,iVBORw0KGgoAAAANSUhEUgAAA...)

Data source: World Bank.
What are the domestic challenges for a bigger focus on domestic circulation?

This is not the first time that China has sought to boost domestic consumption, but to date it has not materialised equally across the population. Academics have highlighted tensions between the objectives set out by the Chinese leadership. They argue that an increase in domestic circulation will not work without profound changes in wage distribution and political power shifts in order to increase the purchasing power of low-income brackets. This, however, would be detrimental to China's international competitiveness and its position in international circulation. China would need to carry out structural reforms, including expanding as yet insufficient social safety nets, enhancing citizens' confidence in them and allowing citizens to save less.

However, as 40% of Chinese low-income households hold only about 5% of total financial assets, these income brackets currently lack the funds to offset their pandemic-induced income losses. Since less than half of urban workers and less than 20% of migrant workers are covered by unemployment insurance, many of them hold back on spending. Therefore, some commentators have taken the view that the dual circulation strategy could break down domestic institutional barriers. Such a barrier exists for instance in the labour market, where the mobility of workers is restricted owing to a separate household registration system for rural and urban workers ('hukou') introduced by Mao, as well as stalled land reforms.

After acknowledging that consumer spending, which has failed to increase despite government transfers including ad hoc vouchers (Figure 6), is a weak link in the Chinese recovery, in October 2020 the Chinese leadership released a work plan to expand domestic demand and boost consumption. It lists 19 measures in four key areas: promoting online access to offline services, developing new service models, upgrading physical goods consumption, and increasing support for manufacturers.

How is the Chinese 'de-coupling' from the US unfolding?

The Chinese leadership understands that China's strategic rivalry with the US is here to stay and that its hedging strategy needs to address this reality. In the semiconductor area, de-coupling from the US creates significant problems for the Huawei ecosystem and other national champions. US export control rules, in particular the entity list, which restrict access to crucial US chip supplies for listed companies, pose a major challenge for China's semiconductor industry. In addition, the US has imposed sanctions on several Chinese telecommunications companies, including Huawei, ZTE and Xiaomi. These companies have been added to the US entity list, which means they are now subject to more stringent export controls. The US government has also imposed sanctions on several Chinese officials and companies, including the Chinese ambassador to the US, Cui Tiankai, and several Chinese companies, including Huawei and ZTE. In response, China has imposed counter-sanctions on US officials and companies, including the US ambassador to China, Terry Branstad. Despite these efforts, it is clear that de-coupling from the US is no easy task for China, and that it will take time and effort to achieve.
Chinese companies, have led Taiwan Semiconductor Manufacturing Co. (TSMC), for instance, to halt new orders from Huawei subsidiary HiSilicon. Moreover, China's top chip-making manufacturer, Semiconductor Manufacturing International Corporation (SMIC), which is crucial to China's chip self-sufficiency aspiration, was blacklisted by the US as a company allegedly owned or controlled by the Chinese military.

Since the declared objectives of the dual circulation model are to create independence and controllability in the areas of science and technology and to prioritise domestic research and development, domestic manufacturing and the domestic market, local governments are poised to provide lucrative incentives for Chinese tech companies to use domestic components. Despite great enthusiasm for the strategy among its main beneficiaries, such as China's telecom giants, which have started to replace US components with Huawei components, there are also concerns about the emergence of a technological bifurcation into mutually incompatible Chinese and Western technological ecosystems and that technological isolation may have adverse implications for China.

Nonetheless, Chinese de-coupling from the US is going ahead, notably in the tech area. A recent example is the robotics start-up Cloudminds, which was included on the US export control entity list, with a host of other Chinese tech companies. Therefore rather than going public in the US, the start-up moved to Shanghai, where state entities have flooded the firm with financial support and contracts. China has also switched from US nuclear power technology to an indigenous alternative.

However, China is not de-coupling from the world. The signature of the Regional Comprehensive Economic Partnership (RCEP) by China and 14 negotiating partners in the Asia-Pacific on 15 November 2020 is testimony to China's continued global economic integration, committing it to trade rules it has shaped from the outset. RCEP strengthens China's ties with its periphery in the Asia-Pacific, adding to its growing comprehensive power, as measured for instance by the Australian Lowy Institute's power index for the Asia Pacific. China has been able to enhance its regional positioning over the US since in 2017 the Trump Administration decided to withdraw as a party from the former Trans-Pacific Partnership (TPP) agreement, now in force as the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) with 11 parties of the Asia-Pacific, excluding China. The Chinese leadership recently made known that it is actively considering joining the CPTPP. As a result of China's engagement with its Asian neighbours, in the first half of 2020, the 10 members of the Association of Southeast Asian Nations (ASEAN) countries collectively replaced the EU as China's first trading partner.

What impact for the EU?

China's economic recovery and the EU's selective over-reliance on China

China's rapid economic recovery had a positive effect on extra-EU trade in the first three quarters of 2020. As was the case in the 2008 global financial crisis, in 2020 China has once again helped to mitigate the dramatic downturn in the EU economy, the caveat being that this further engrains China's conviction that its economic and political governance system is superior to that of the EU and other Western democracies. Eurostat data show that EU exports to China between January and September 2020 remained constant in value compared to the 2019 reference period. EU exports to a set of other major trading partners, by contrast, showed consistent negative growth rates
Imports to the EU from China, driven by pandemic-induced demand for protective gear and home office electronics, increased by 4.5%. Imports to the EU from other major trading partners, by contrast, decreased across the board (e.g. -16.0% from the UK and -11.4% from the US). The pandemic has thus further increased the weight of China in extra-EU trade, as the country emerged first from the initial lockdown and managed to get its export manufacturing quickly back on track. In 2020, China is therefore likely to replace the US as the EU’s largest trading partner. This may exacerbate EU concerns about the degree of economic interdependence between the EU and China, which has led to heavy EU reliance on China in certain sectors.

Figure 7 displays the exposure of EU-27 global value chains to Chinese inputs and more specifically the top 10 sectors most reliant on inputs from China as a share of the EU’s total imported inputs. The size of the bubbles visualises the total output value of the sector in the EU27. The highest degree of reliance on Chinese inputs exists in textiles (46.2%), electrical equipment (46.1%) and electronic products (39.7%). These economic sectors typically source their largest share of inputs from abroad.

The EU is intent on addressing the issue of supply chain resilience by diversifying, re-shoring or near-shoring EU supply chains as appropriate. It is seeking to cooperate in this process, notably with like-minded countries wishing to modify their own economic exposure to global supply chains. Alongside the debate on the EU’s overreliance on China for pandemic-related imports such as personal protective equipment (PPE) – and on China and India for pharmaceuticals, such as crucial intensive care drugs – a long-standing debate about the EU’s dependence on China for critical raw materials has garnered particular attention in the context of the technologies required to implement the EU Green Deal and achieve the EU’s goal of becoming climate-neutral by 2050. A recent foresight study reveals that supply chain risks exist for almost all critical raw materials, notably for robotics, drones and ICT. In the framework of the European Alliance on Raw Materials, the EU is seeking to build its capacities along the entire value chain from extraction to processing and recycling, thus strengthening its resilience and thereby boosting its strategic autonomy.

China’s technological ambitions and US–China de-coupling

China’s ambitions of becoming a global leader in cutting-edge technologies under a dual circulation development paradigm and US policies of economic and technological ‘de-coupling’ from China under the Trump Administration, present the EU with challenges but also with opportunities.

A significant challenge for the EU is the pace at which China is catching up in its technological development and outcompeting the EU in high-value added products, as Chinese companies are being nurtured in an ecosystem insulated from competition under a state-led economic model before expanding into third markets. China’s more inward-looking dual circulation strategy and the incipient technological de-coupling from the US are accelerating massive Chinese state-funded efforts to support Chinese firms in making quick technological breakthroughs in strategic emerging industries, based on leap-frogging policies that exploit the scale of the large Chinese market.

Given that the pandemic is continuing to hit the EU economy much harder than it is the Chinese economy, it will be a tall order for the EU to compete with the significant resources China devotes
to the technological race, especially in the digital economy, on which the Chinese leadership has put a clear focus in terms of future growth prospects. Rather than operating with fewer state subsidies, the Chinese ecosystem will double down on state funding, including to align the private sector’s interest in economic gains with the political objectives of government policies. The lines between the public and private sectors are likely to become even more blurred.

The Chinese ecosystem offers also opportunities, notably for EU companies that have developed advanced technologies that can be used to build up Chinese capacities and for those EU firms that produce high-quality products and services for an increasingly affluent and demanding Chinese middle-class. However, it also poses challenges, since China is a difficult market place that does not provide a level playing field for foreign companies and is shaped by state policies explicitly geared towards replacing foreign technologies.

Experts assume that exporters of high-end products such as Germany, Japan and the US will have lower substitution vulnerability than for instance Malaysia, Singapore and Thailand, based on their current value-added contribution to China’s total final demand and their innovative capabilities as measured in the number of patents filed. The former countries are thus expected to benefit in the medium-term from the innovation drive on the Chinese market until Chinese industrial autonomy has been achieved.

As China is leveraging the size of its domestic market, implicit pressure may grow on foreign firms to transfer technologies, for example through a requirement to set up research centres in China, in areas in which China still has technological gaps, such as in aircraft manufacturing, industrial robotics and semiconductors, to the extent that China’s access to foreign technologies will increasingly be restricted by proliferating foreign export controls and FDI screening mechanisms.

These developments are reminiscent of how rapidly the Chinese solar panel and wind turbine industries replaced their initially thriving foreign peers not only on the Chinese market but also in third markets, as they have become world leaders. It also serves as a reminder of where the technology behind Chinese high-speed trains originated; technology that large Chinese SOEs are now exporting to countries such as Indonesia, Hungary/Serbia, Laos and Thailand often in fierce competition with Japan. The Comprehensive Agreement on Investment (CAI), which the EU has been negotiating with China since 2014, is set to contain provisions on forced technology transfer, transparency of industrial subsidies and SOEs. However, only the future will tell whether the deal, if concluded, will be effectively enforced on the ground.

**European Parliament position**

In its resolution of 7 October 2020 on the implementation of the EU’s common commercial policy, Parliament stresses the importance of the EU’s trade relations with the US and China, which taken together account for about 30 % of the EU’s external trade. It nonetheless emphasises ‘the need to avoid overdependence of the EU economy on supply chains of a few major trading partners’ and instead to ‘diversify and improve its trade relations with all partners, including developing countries and least developed countries (LDCs), and work towards a multipolar world order’. Alluding to the Australian Strategic Policy Institute report ‘Uyghurs for sale’ which ‘shows evidence of exploitation of Uyghur workers in Chinese factories, including in factories belonging to EU companies’ value chains’, Parliament ‘insists that Uyghur forced labour must be excluded from the supply chains of products imported into the single market’.

In its resolution of 11 November 2020 on the EU-China agreement on cooperation on and protection of geographical indications Parliament recalls ‘the need for significant and ambitious progress in the negotiations on the EU-China Comprehensive Agreement on Investment, in order to address the current market asymmetries’. It underlines ‘the importance of including an ambitious chapter on trade and sustainable development to protect human rights, including core labour standards, promote sustainable development and fight against climate change in line with the Paris Agreement’. It emphasises that ‘ensuring the level playing field, reciprocity and non-discriminatory treatment of the respective parties and their business communities, citizens and civil society are key’. Parliament urges ‘the parties to improve transparency and to establish a parliamentary dimension with regard to the implementation of the agreement’. It also points out that the current rush to contain the economic fallout of the pandemic will be an opportunity for Chinese strategic investments in key sectors such as telecommunications, transport and technology.
Establishing a level playing field in China for foreign companies would enable EU firms operating in the renewable energy sector to benefit from the greening of China’s long-term economic planning, which will require far-reaching transformations of the still massively fossil-fuel reliant Chinese economy on the basis of renewable energy technologies in the decades to come. Such a level playing field, however, would require equal access to public procurement markets for foreign firms in China, which currently is not the case. China has still not acceded to the WTO Government Procurement Agreement as promised at its WTO accession in 2001. The CAI does not tackle public procurement and the European Commission proposal for an EU international procurement instrument, to level the playing field in the EU internal market with respect to bidders from countries with closed public procurement markets, is still gridlocked in Council. Meanwhile, competition from Chinese renewable energy companies going global is intensifying on other markets. A recent example is the expansion of the Chinese State Power Investment Corporation (SPIC) into Latin America’s clean-energy market by acquiring Mexico’s largest independent renewables company Zuma Energía. SPIC is a Chinese SOE, one of the country’s five power generation utilities and the largest renewable power producer in the world in terms of combined wind and solar capacity.

As the US-China strategic rivalry unfolds, the growing arsenal of US mechanisms providing for extraterritorial secondary sanctions, coupled with the recent trend in China to pass legislation with extraterritorial reach, is likely to set significant limits on the business opportunities and choices of EU firms, notably in sectors that are increasingly affected by US-China decoupling. As an addition to the existing EU toolbox, to preserve the EU’s strategic autonomy, in its 2021 work programme the European Commission has pledged to submit a legislative proposal for an instrument to deter and counteract coercive actions violating international trade rules by third countries, by the end of 2021.

FURTHER READING

*China’s Dual Circulation Economy*, Zhu V., China Trends #7, Institut Montaigne, October 2020.


*Dual circulation: China’s way of reshoring?* Euler Hermes/Allianz, 29 October 2020.


ENDNOTES

1. China’s Covid-19 figures do not take into account asymptomatic infections. In October 2020, when a small outbreak of the virus in a factory in Xinjiang province occurred, the figure stood at 85,810 cases.
2. Already back in 1988, Chinese researcher Wang Jian coined the term ‘great international circulation’ to decode the export-led development model from which China has gradually moved away to expand its domestic market.

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