

CHINA'S ECONOMIC OUTLOOK POST-COVID-19 AND BEYOND

China's economy was the first to suffer from the COVID-19 pandemic but also the first to recover. However, its strong recovery has been short lived as China is entering a rapid cycle of deceleration, which is speeding up its structural one. Beyond the short-term economic shocks, the consequences of the pandemic could impact medium-term growth due to the acceleration of rising debt and financial risks. Looking beyond, China's structural deceleration is bound to intensify due to its aging population and a rapid slowdown in labor productivity. Also, the radically deteriorating environment with foreign countries, notably with the US, will also hamper China's growth. Finally, China's new "common prosperity" mantra also has an important bearing on China's growth prospects.

El panorama económico de China en la era pos-COVID-19 y más allá

China fue la primera economía en sufrir la pandemia de la COVID-19, pero también fue el primer país en salir de la misma, aunque la fuerte recuperación ha tenido poco recorrido dado que China está entrando en una rápida desaceleración cíclica que contribuye a incrementar una desaceleración de tipo estructural. Más allá de las perturbaciones económicas a corto plazo, las consecuencias de la pandemia podrían afectar al crecimiento a medio plazo debido a una aceleración del crecimiento de la deuda y de riesgos financieros. Yendo más allá, la desaceleración estructural de China está encaminada a acentuarse debido al envejecimiento de la población y a la rápida desaceleración de la productividad del trabajo. Además, el rápido deterioro de la situación exterior, sobre todo con los Estados Unidos, también va a ser un elemento que dificulte el crecimiento de China. Por último, el nuevo mantra chino de «prosperidad compartida» también tiene una importante influencia en las perspectivas de crecimiento futuro en China.

Keywords: COVID-19, Chinese economy, population aging, US-China strategic competition.

Palabras clave: COVID-19, economía china, envejecimiento de la población, competición estratégica entre Estados Unidos y China.

JEL: E00, E42, F51, F52, I15, O11, P21.

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1. Introduction

China's economy suffered from the COVID-19 pandemic from January 2020 before anybody else did, but it also managed to recover sooner, thanks to extremely severe measures to restrict mobility, which were then lifted domestically —although not fully— and still remain in place for foreign travel. This paper analyzes the impact of the pandemic on the Chinese economy in the short run and also in the long run. This is particularly important given China's structural deceleration. This paper is organized in the following order: Section 2 covers the post-pandemic recovery of the Chinese economy and the performance of different sectors. Section 3 analyzes the cyclical headwinds for the Chinese economy. Section 4 focuses on the structural headwinds for the Chinese economy in the longer term with a focus on its aging population. Section 5 looks into the geopolitical risks for the Chinese economy and their potential impact. Section 6 is the conclusion.

2. China as the frontrunner in post-COVID-19 recovery, but not without risks

As the first country hit by the COVID-19 pandemic but also the first out of it, China was the only major economy to deliver positive growth in 2020 at 2.3 %. Still, this is the worst GDP (Gross Domestic Product) growth since the 1980s. The sudden outbreak of COVID-19 in Q1 2020 spread all over the country, pushing the government to call a halt to most economic activities, notably the lockdown of Hubei province to avoid further dispersion of the disease. The harsh measures resulted in a sharp fall in the economic growth rate in Q1 and a contraction of -6.8 %, even though the virus was contained relatively quickly, and the revival of the economy had already begun.

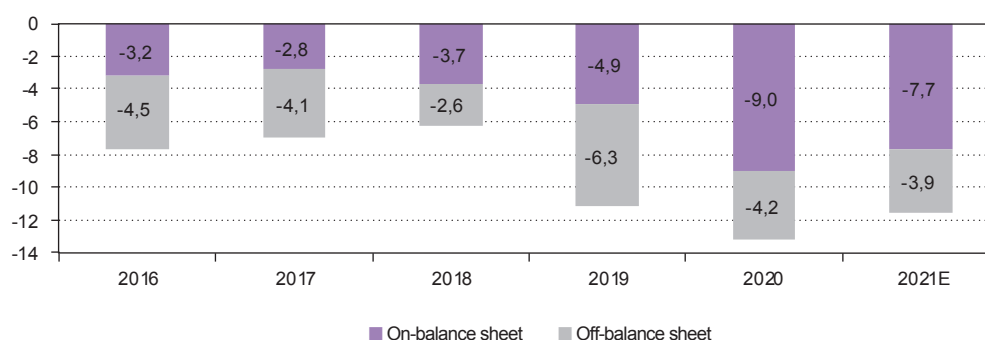
The recovery of economic activity was led mostly by exports and fixed asset investment. For the former, China has benefited from the early resumption of factory activity, whereas factories were closed in most parts of

the world. As such, China's trade surplus with major developed economies, including the US and the EU-27, widened sharply thanks to the demand for personal protective equipment and working-from-home related products. The latter was mainly driven by state-owned investment as well as property investment, whereas manufacturing investment has lagged considerably. The reliance on investment and exports for China to grow is reminiscent of China's old growth model. But for a shock as huge as a pandemic, it is probably not the best moment to be picky about the sources of growth; however, we should be aware of the medium-term consequences of such a growth model with an increasingly lower return on investment and, thereby, lower potential growth.

Conversely, the recovery has leaned much less on consumption. While the recovery from the pandemic has been led by the property sector fueled by easing monetary policies and industrial production for exports, consumer spending has remained relatively weak and has not yet fully returned to pre-pandemic levels. This is in contrast with many developed economies where private consumption has led the economic rebound —there were hardly any direct cash handouts in the stimulus package, as opposed to western economies—. Also, the recovery of labor market conditions was also slow, as indicated by the sluggish rebound in the unemployment rate, which has only lately returned to the pre-pandemic level. Beyond that, while the pandemic situation is mostly well-contained in China, the sporadic outbreak of COVID-19 infections still forces local government to impose containment measures as China is still adopting a zero-COVID strategy, which is poised to suppress service activities to some degree and thus a full recovery of domestic demand.

To counter the negative impact from the pandemic, the government has introduced a series of stimulus measures, both fiscal and monetary. Based on International Monetary Fund (IMF) estimates, a sum of USD711 bn (4.8 % of GDP) of fiscal support, which

FIGURE 1
BREAKDOWN OF CHINA'S AUGMENTED FISCAL DEFICIT
(% of GDP)



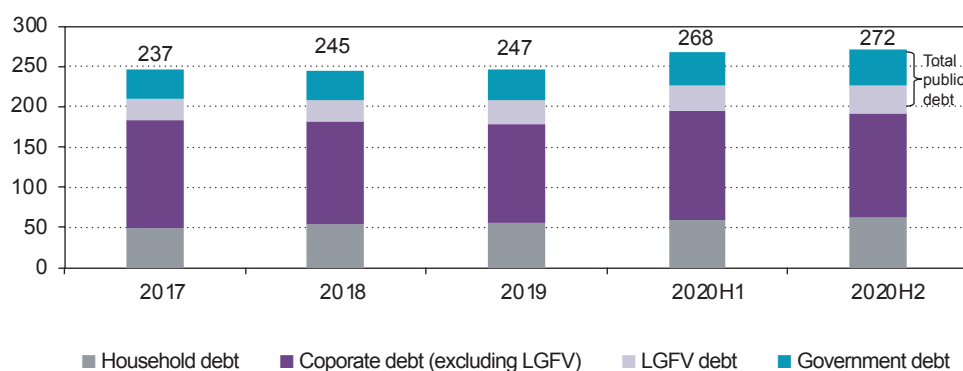
NOTE: We assume the same absolute number for off-balance sheet deficit in 2021 as in 2020.
SOURCE: Natixis.

accounts for both additional spending or foregone revenue, have been announced by the Chinese government. Beyond that, USD193 bn (1.3 % of GDP) of liquidity support was also offered. On a national level, China's fiscal policy response to counteract the negative impact of COVID-19 started with the expansion of the scheduled official government budget deficit from 2.8 % to 3.6 % of GDP. It was not announced until the Two Sessions that was postponed until May—as opposed to March in normal times—and the package was comparatively modest in size as the pandemic was contained within a short period of time. However, the overall fiscal deficit is much larger if all of the four government accounts are considered. Specifically, China has lifted the quota of local government special bond issuance to RMB 3.75 trillion for 2020 from the scheduled amount of RMB 2.15 trillion in 2019. The government also resorted to the issuance of Special Treasury bonds, which had not been used since 2007 and raised RMB 1 trillion. These efforts pushed the official on-balance government deficit, which is the sum of the four government's official accounts, to reach 9 % of GDP in 2020. This, together with the additional

4.2 % off-balance sheet deficit stemming from local government financing vehicles (LGFVs), has pushed China's augmented fiscal deficit to 13.2 % of GDP (Figure 1).

As for monetary policies, the response of the People's Bank of China (PBoC) seems to be a lot more cautious when compared to the massive quantitative easing adopted by key developed economies like the US and the Eurozone during the pandemic. In fact, immediately after the outbreak of the COVID-19 pandemic, the PBoC intensively used a series of monetary policy tools to inject liquidity into the interbank market to combat the slowdown of the economy due to the lockdown measures. These measures drove the 3-month Shanghai Interbank Offered Rate (SHIBOR) all the way down to a record low of 1.4 % during April and May. But later, as the government successfully contained the virus and the economy recovered, the PBoC slowed its liquidity injection and has kept policy rates unchanged. But as the economy started to gradually recover, the PBoC's stance has become more cautious, causing the 3-month SHIBOR to rebound rapidly. At the same time, the PBoC—along with the other

FIGURE 2
CHINA'S DEBT SECTORS
(% to GDP)



NOTE: The LGFV debt only includes the marketized value for all the entities that publicly report financial statements or issue bond.
SOURCE: Natixis.

regulatory authorities— has taken a cautious stance in macroprudential regulation and window guidance to control risks within the banking sector. These policies finally led to a slowdown in money supply from the second half of 2020. That said, a slower money supply does not necessarily mean credit tightening, as the latter is determined not only by credit supply but also by fundamental economic growth which matters for credit demand. Against the backdrop of China's fast economic recovery since H2 2020, the need for very lax money supply may have already been lower.

Overall, the expansionary fiscal policy and the slower economic growth rate pushed China's overall debt to rise drastically in 2020 (Figure 2). A primary source of the debt surge was the government-led fiscal expansion. Because of the rise in the budget deficit and the additional issuance of special treasury and local government special bonds, both the central and local government debt increased by more than one fifth compared to 2019. Household debt also experienced faster expansion, which was mostly contributed by mortgage debt. The risk associated with the fast-growing household mortgage debt also

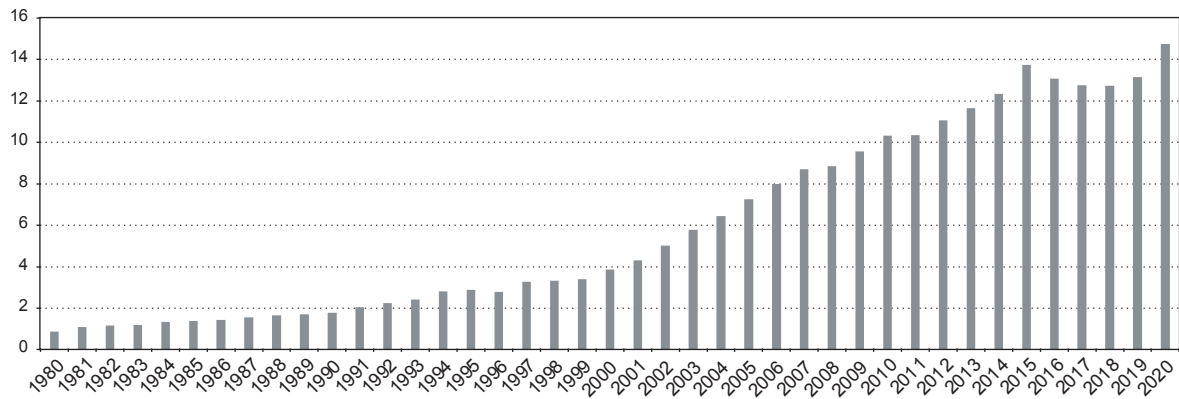
triggered the Chinese regulator's concern. The increase in corporate debt (after excluding LGFV debt) was also massive during H1 as the authorities tried to unleash liquidity to support corporates. However, the pace of corporate debt accumulation slowed significantly in H2 after the Chinese government successfully contained the spread of the virus and turned to a more cautious attitude toward financial liquidity.

The good news is that the very rapid growth rate in H1 2021 has helped to stabilize the increase in the debt-to-GDP ratio, which underscores the importance of economic growth to contain debt accumulation. But to maintain the momentum of economic growth, China will need to allow for a relatively stable credit environment, which implies debt accumulation even after the pandemic.

3. China's growth has clearly peaked in its post-COVID-19 business cycle

After the 2007-2008 global financial crisis, it took five quarters (from Q4 2008 to Q2 2010) for the Chinese economy to reach the peak of the post-crisis recovery

FIGURE 3
CHINA'S GLOBAL MARKET SHARE IN EXPORTS
(In %)



SOURCE: Natixis, United Nations Conference on Trade and Development (UNCTAD).

cycle. This time around, China seems to have peaked again about five quarters after taking a severe hit in Q1 2020. Notably, the Chinese economy lost steam across the major sectors in both consumption and investment although this was partly due to a less favorable base effect than at the start of the year. Beyond that, the main drivers of the post-COVID-19 recovery, namely exports and fixed asset investment, are starting to lose steam.

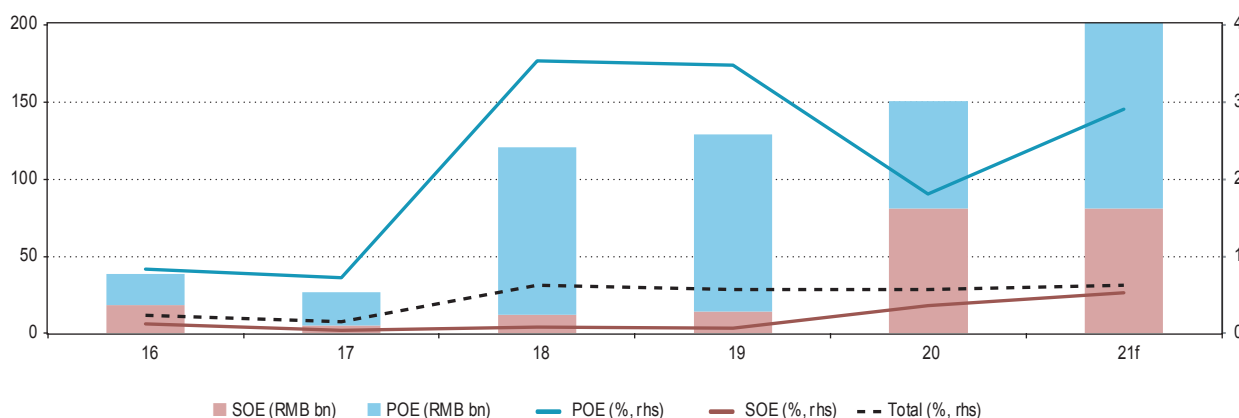
Regarding exports, China's export strength is set to slow as the advantage of its early recovery from the pandemic fades. After taking a hit from COVID-19 and experiencing a sharp production slump, China's exports started to recover from the second half of 2020, and 2020 even ended with positive growth. Also, China's market share in the global export market rose to 14.7 % in 2020 from 13.1 % in 2019 (Figure 3), which was mostly led by a robust external demand for three specific types of goods: electrical machinery; textile yarn and related products; and office machinery and automatic data-processing machines, which contributed to nearly 98 % of the total increase in export in 2020. Beyond the increase in demand for protective products and working-from-home equipment during the pandemic,

China's gains in the global export market share has also benefited from the substitution effect as the activity of the vast majority of factories was halted by the pandemic. But such a substitution effect may fade in the second half as production resumes in the rest of the world and the demand shifts towards more services. In short, the sustainability of China's exports in the post-pandemic era is concerning. This is not only true for textile goods—which might lose further momentum as the world finally overcomes the pandemic—but also for electrical and office machinery that might not see pent-up demand as the transition to working from home has been completed.

For fixed asset investment, SOE and infrastructure investment has decelerated visibly compared to previous years. While the cyclical slowdown has been an important reason, the fact that the Chinese government was also not pushing too hard to boost growth through the State-owned enterprise (SOE) and infrastructure projects is a more important reason. As a consequence of this, the utilization of fiscal deficit was also smaller than before. Such a slowdown in state-led investment is in sharp contrast to still highly expansionary fiscal policies in the developed world.

FIGURE 4

CHINA: ONSHORE BONDS WITH REPAYMENT PRESSURE BY OWNERSHIP



NOTE: NCDs, financial bonds and short-term bonds are not included for calculation. Bonds with repayment pressure include defaults, technical defaults and bonds with payment within the grace period. Technical defaults include events in violation of financial covenant. Estimated based on data from January to June 2021.

SOURCE: Natixis, Company Announcements, WIND.

The government seems to have tilted its policy priority from boosting the post-COVID-19 recovery to containing financial risks accumulated from the stimulus during the pandemic. China's fiscal stimulus, especially from the local government, has been rather conservative and local government bond issuance was at a much slower pace compared to earlier years. Similarly, the PBoC has also taken a prudent tone in maneuvering market liquidity and interest adjustment since last year. As such, both fiscal and monetary bullets have been largely reserved in China's policy making. While the government seems to indicate more expansionary policies to boost fiscal investment, the time remaining for infrastructure investment to make a difference is limited, so most of the impact on economic activity will only be seen in the near term.

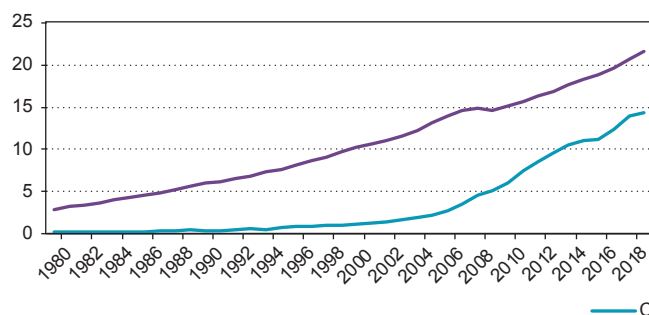
Also, financial stability remains an important risk: Offshore and onshore defaults have continued to climb with higher pressure for both State-owned enterprises (SOEs) and Privately-owned enterprises (POEs) (Figure 4). For the former, the dynamics for SOEs have worsened. In fact, SOEs were the major contributor to

the wave of onshore bond default at the end of 2020. While support from the government has long been seen as the major factor differentiating SOEs from POEs in bond payments, the fact that the fiscal situation of local governments has worsened from the COVID-19 shock has challenged this assumption. For the latter, while the epicenter is still within a small group of firms, the defaulters are increasingly large—spanning from Huarong to Evergrande—and is adding to the risk of contagion. The increasing number and importance of bond defaults has raised the concern that the cyclical improvement in the repayment ability of Chinese firms is clearly not enough to reduce credit risk.

All in all, the Chinese economy will slow down in line with the expectation of a much lower growth rate due to the less favorable base effect as well as decelerating support from external demand. So, the question is really whether China will considerably ease its policy stance after the post-COVID business cycle has peaked. On the positive side, there are plenty of reasons for the government to do so. First, the policy bullets are intact so that debt

FIGURE 5

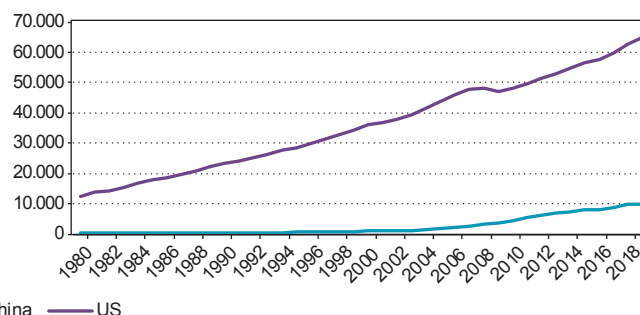
NOMINAL GDP SIZE (USD, tr)



SOURCE: UNTACD.

FIGURE 6

GDP PER CAPITA (USD)



dynamics have improved this year as the debt-to-GDP ratio decreased with the support of growth. Second, some easing on the monetary front has started with the PBoC cutting the Reserve Requirement Ratio (RRR) in early July. Also, fiscal spending is likely to accelerate as the Politburo Standing Committee in July specifically mentioned a step-up in the use of local government's special purpose bonds. Still, the time remaining for infrastructure investment to make a difference in 2021 growth is short, so most of the impact will only be seen in 2022. Beyond that, it is difficult for the government to backtrack on its earlier targets of containing financial risks. With such pros and cons in mind, smaller policy steps could become the norm, as summarized in China's policy makers' new buzzword, cross-cyclical policies. The latter differs from the counter-cyclical policy mantra, and echoes China's intention to reach a decent growth rate while avoiding long-term financial risks.

4. Where is China's growth heading in the longer term?

While China is set to deliver fast growth in the post-crisis business cycle, such fast growth may create

the false impression that China's economy will not decelerate. In fact, China's growth rate has been on a downward trend for the last decade in what is generally considered to be a structural trend which will continue for decades to come. In this section, we review the forces behind China's structural deceleration but also possible ways to counter such processes, especially through human capital investment and "effective" innovation.

Thanks to the positive overall population growth rate and rural-urban population migration, China's GDP grew massively even before it joined the WTO (World Trade Organization), with its GDP size expanding from 0.3 trillion USD as of 1980 to 1.2 trillion USD as of 2000 (Figure 5). Since stepping into the 21st century, China has sustained its growth at a rapid pace boosted by international trade. The convergence with the US in terms of GDP per capita has been obvious. China's per capita GDP has increased more than threefold from less than 1,000 USD to over 3,000 USD (Figure 6). But the situation seemed less favorable after the global financial crisis, as evidenced by a consistent slowdown of the Chinese economy. This is not hard to understand as it reflects a wealthier China. While lower growth as a consequence of "economic convergence" is a given

TABLE 1
A SELECTION OF EXISTING ESTIMATES FOR CHINA'S LONG-TERM
ECONOMIC GROWTH RATE

	2021-2025	2025-2030
World Bank: <i>Innovating China</i> (2019) - Limited reform	4	4
IMF (International Monetary Fund): <i>World Economic Outlook</i> (October 2019)	6.2*	-
Albert <i>et al.</i> (2015)	4.5	2.3
Bai and Zhang (2017)	6.3	5.6
Lin <i>et al.</i> (2016) - under favorable conditions	8	8

NOTE: * Means that forecasted figure have already taken into consideration the big rebound in 2021 from the low base in 2020 so the figure is slightly higher than long-term potential growth.

SOURCE: World Bank, International Monetary Fund, Journal of Comparative Economics, Banque de France.

phenomenon, the question is whether China's structural deceleration might be faster than one would expect because of China's fast aging population but also from a lower return of assets stemming from too rapid an increase in fixed asset investment.

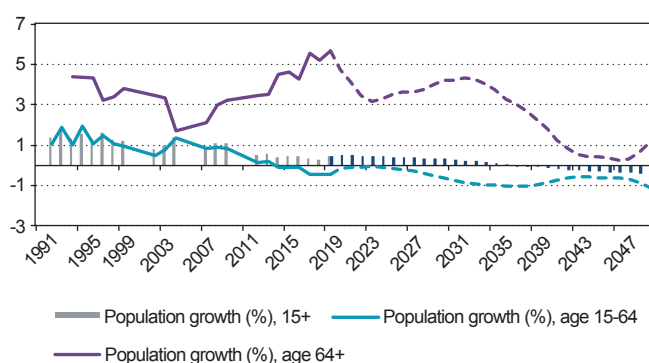
Against this backdrop, most of the existing quantitative estimates of China's future growth point to much lower growth, especially from 2035. This is even more the case for those projections if limited reform is taken into account, which is arguably where we are today (Table 1). For example, the World Bank and DRC (2019) predict average growth below 4 % from 2021 to 2030. This echoes an earlier study by Albert *et al.* (2015) which points to a steady deceleration to 4.5 % until 2025 and a much faster one thereafter (2.3 %). The IMF's World Economic Outlook seems more optimistic but it only covers the next five years and it has already incorporated the massive likely rebound in 2021 after COVID. Bai and Zhang (2017) are much more optimistic, with expected growth above 6 % and 8 %, respectively. Still, Justin Lin and co-authors make it clear that this is more an aspiration than a baseline projection as favorable conditions are needed to achieve it, which might have been the case at the time of their publication, when China was blessed by a very favorable external environment, which radically changed in 2018 with President Trump.

There are two key variables for China's growth potential in the future. The first one is aging. China's labor force is bound to grow less over time (from 0.5 % during 2011 to 2019 to 0.4 % on average from 2020 to 2030 (Figure 7). While this change is tiny, as China begins to age the overall labor participation rate will also shrink beyond what it already is. In fact, China's labor force participation rate has decreased significantly over the past decades from nearly 79.0 % in 1990 to 69.4 % in 2019 (Figure 8). Still, technology upgrading could enable more room for the elderly to work and push up the labor participation rate. In that regard, China is likely to raise retirement age from its current very low level compared to international standards (60 for men, and 50/55 for women depending on whether they are blue or white-collar workers).

Much more significant than aging, when explaining the rapid deceleration of the Chinese economy, is the slow-down in labor productivity. One of the key reasons for this trend might be aging since both aging and labor productivity have decelerated in tandem in the last few years although this was not the case in previous decades (Figure 9). There are other important factors behind the rapid slowdown in labor productivity. An important one is China's turn towards more labor-intensive sectors in the past few years as the growth

FIGURE 7

CHINA'S POPULATION GROWTH FOR DIFFERENT AGE GROUPS

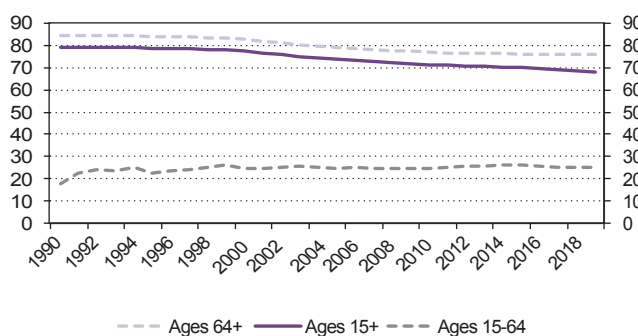


NOTE: Because of the fluctuation of population data in 2000, 2005 and 2010 reported in WIND because of the population census and sampling survey, we remove the data for related years and smoothed the data.

SOURCE: WIND, Natixis.

FIGURE 8

LABOR FORCE PARTICIPATION RATE IN CHINA (In %)

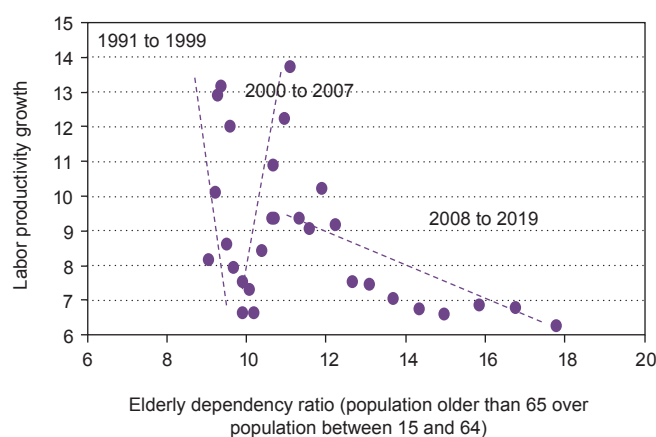


NOTE: Labor force participation rate for ages 64+ is based on the author's own estimation using the other series.

SOURCE: WDI database, Natixis.

FIGURE 9

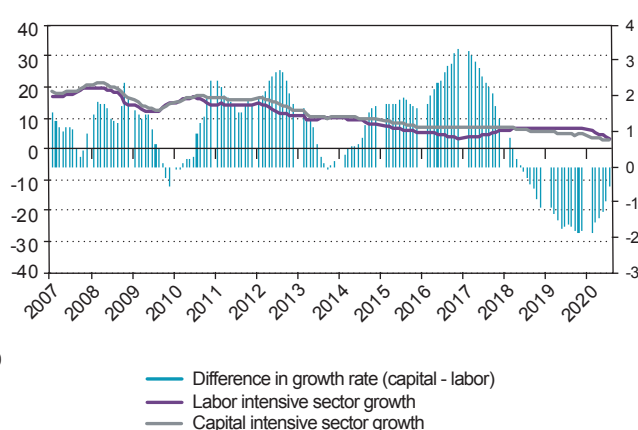
POPULATION AGING AND CHINA'S LABOR PRODUCTIVITY (In %)



SOURCE: WIND, Natixis.

FIGURE 10

INDUSTRY VALUE ADDED GROWTH (12-month moving average %)



NOTE: We define the sectors with higher labor-to-value added as labor intensive sectors whereas those with lower labor-to-value added are defined as capital intensive sectors. The classification is based on relative criteria across sectors.

SOURCE: CEIC data, Natixis.

model turns to services which requires more labor at a time of relatively larger labor scarcity (Figure 10). Another potential, perhaps even complementary, reason for this is whether China's push for technological upgrade through research and development (R&D) and investment in human capital can stop, or at least mitigate, the slowdown in productivity. To date these efforts have not yet been fruitful since neither labor productivity nor total factor productivity growth are giving signs of a lift. Beyond the counterintuitive push for labor-intensive innovation, there is a more general issue which is the rather inefficient allocation of resources, dragging down total factor productivity.

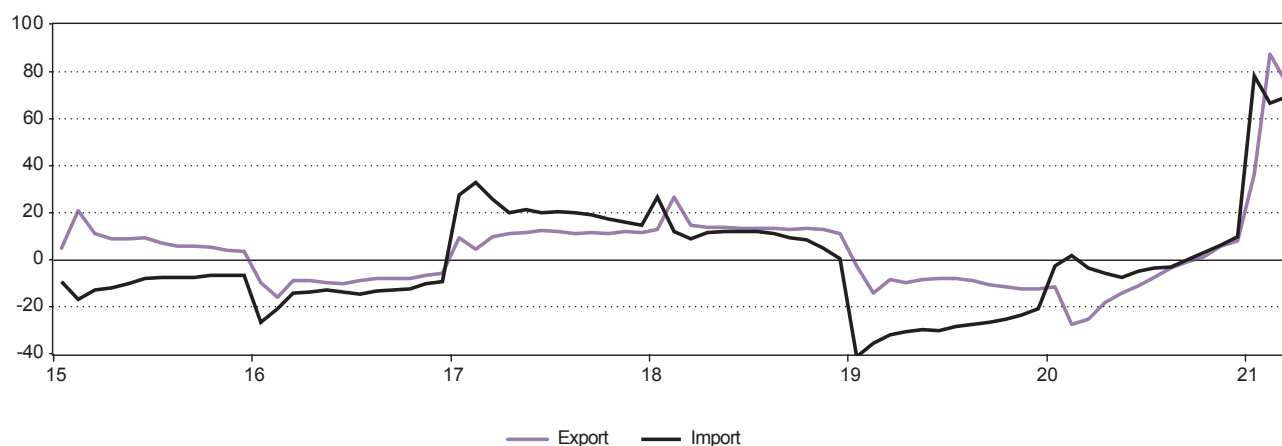
5. Beyond the baseline scenario: Geopolitics is increasingly important

Beyond the baseline scenario, characterized by an aging population and lower productivity, geopolitical risk is a key factor that could change the baseline scenario. Obviously, the US-China relationship has shifted dramatically since late 2017, when the Trump administration officially labelled China to be a strategic competitor. The Biden administration does not seem to have changed that rhetoric regarding China. As such, geopolitical risks, especially the confrontational relationship with the US, may also push China's medium term lower the more the two economies bifurcate their path from their still important economic relations, whether we look at trade or investment (García-Herrero & Tan, 2020). In this section, we zoom in where we stand in the US administration's efforts to contain China, especially as regards bifurcation in their trade, technology and financial relations. We also look into China's actions, some of which started even before the US-led trade war in 2018. For trade and technology, dual circulation seems to be China's main strategy. For finance and the extraterritorial role of the dollar as the reserve currency, a renewed effort to internationalize the renminbi (RMB), possibly with the help of China's Central Bank Digital Currency (CBDC) seems key.

US-led bifurcation

Since the announcement of the seemingly untargeted measures in early February 2018 for solar panels and washing machines, the US has moved to increasingly targeted action against China, with trade flows between the two contracting massively (Figure 11). The most obvious case in point was the announcement of an additional 25 % on import duties to be applied to the equivalent of USD 50 billion of imported goods from China on the basis of China's infringement of intellectual property rights (García-Herrero, 2018a). The US' speedy introduction of the announced import tariffs, without allowing for much time to negotiate a deal between China and the US, shows that the US resolved to move away from the status quo in terms of the functioning of the global trading system, at least as China is concerned (García-Herrero, 2019). China retaliated with equivalent import tariffs on US goods. In that regard, even with a truce reached on the sidelines of the Buenos Aires G20 summit in late 2018, the US-China trade war re-escalated in May 2019 with former US President Trump's unexpected announcement to ramp up tariffs from 10 % to 25 % on products covered by the September 2018 action. In January 2020, right before the outbreak of the pandemic, a Phase 1 deal was finally reached as an interim agreement between China and the US. This, together with the US' massive need for imports during the pandemic, explains the return to immense trade flows between the US and China in 2020. It should be noted, though, that neither the Phase 1 deal nor COVID-19 have resulted in the US eliminating its import tariffs on Chinese goods. All the more worrisome is that the Biden administration has passed legislation to enhance the resilience of US supply chains for key strategic sectors, including semiconductors and rare earth metals (The White House, 2021a). This legislation's ultimate objective is to reshuffle some critical US value chains away from China in light of heightened geopolitical tensions and the risk of China

FIGURE 11
CHINA'S TRADE IN GOODS WITH THE US
(YTD, YoY %)



SOURCE: Natixis, WIND.

retaliating. China's recent anti-sanction legislation that makes retaliation against any target legally feasible has not only increased the concerns of the US and other Western countries' governments but also the private sector.

Beyond trade, the Trump administration stepped up measures for China's containment, but these were not fully unexpected, especially with regard to technology. In fact, the Obama administration had already increased scrutiny through stricter export controls, especially after China announced its industrial policy landmark, namely Made in China 2025. This long-term plan made it increasingly clear that China would be aggressively pursuing rapid technological upgrade and ambitious objectives in terms of the substitution of key imports for domestic components. In other words, the idea of self-reliance being a desirable objective for China did not actually start with the dual circulation strategy but earlier, especially since Made in China 2025 was launched in 2015 as President Xi came to power (García-Herrero, 2018b). Against this

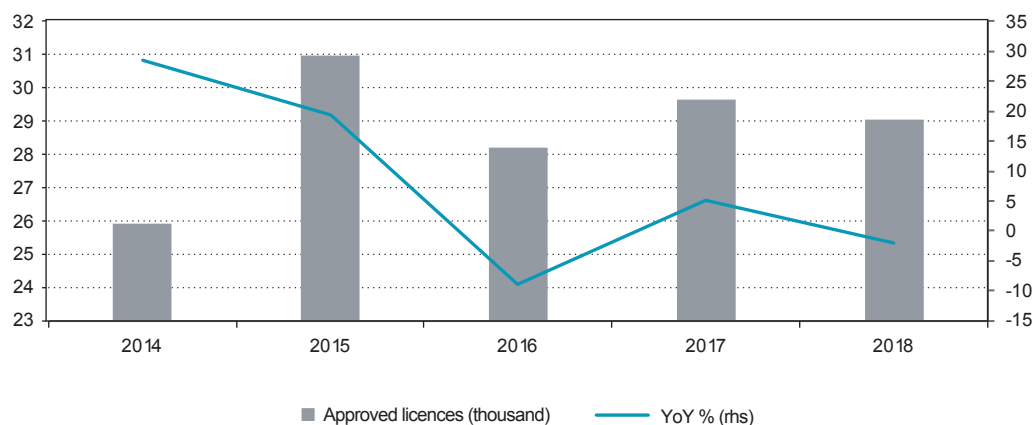
backdrop, the transfer of technology has become increasingly restricted by tightening export controls on high-end technology products (Figure 12). In turn, China has recently introduced export licenses for key technologies, such as drones and artificial intelligence.

One important measure taken by the Trump administration to contain China's technological rise is the expansion of the so-called "entity list".¹ This tool effectively forbids US companies to conduct business with the Chinese companies on the list. In fact, the US Bureau of Industry and Security (BIS) published a list of such entities deemed risky to US national security as early as 1997. But the names on the list have expanded quickly since 2019 with the addition of Huawei as well as a couple of its affiliates and other Chinese corporations. In 2020, China also announced the release its own identity list as retaliation (Ministry of Commerce of the People's Republic of China, 2020)

¹ See <https://www.bis.doc.gov/index.php/policy-guidance/lists-of-parties-of-concern/entity-list>

FIGURE 12

BIS APPROVED LICENSES FOR TANGIBLE ITEMS, SOFTWARE AND TECHNOLOGY



SOURCE: US Department of Commerce the Bureau of Industry and Security, Natixis.

but it only offers a framework with the names of the targeted companies and has not been made public yet.

A key sector where the impact of tech bifurcation might be most serious is the semiconductor industry, which has become apparent with the ban on sourcing semiconductors to Huawei. In fact, it affects not only American producers but also Taiwanese ones, among others. Furthermore, the US identity list has expanded further from Huawei to the largest producer of semiconductors in China (SMIC). Targeting semiconductors is all the more understandable as China only represents 35 % of the global demand, up from 29 % for the same period (Figure 13) while it hardly produces semiconductors as end products, and certainly not at the highest end which is what is needed for new technologies like electric vehicles, etc. In fact, China imports more semiconductors than oil.

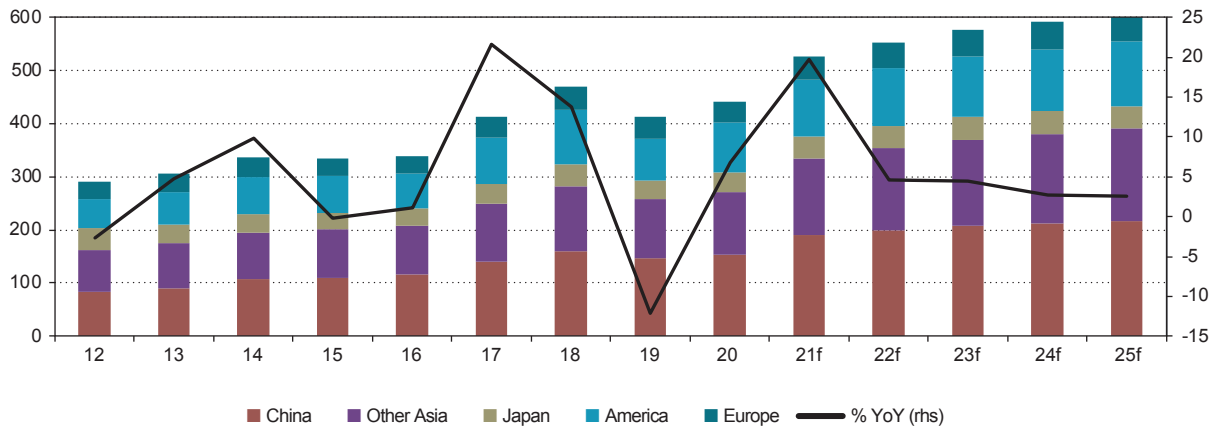
Interestingly, the US containment on Chinese technological expansion is also moving into software. Before the 2020 US election, the White House published an executive order targeting Chinese owned

social media platforms TikTok as well as WeChat. The measures threatened to impose penalties on US residents or companies engaging in any transactions with these firms after the order comes into effect. While the Biden administration has revoked Trump's order seeking to ban TikTok and WeChat, the new order requires Chinese apps to take stricter measures to protect private information if they want to stay in the US market (The White House, 2021b). In other words, Chinese apps could still face bans because of their data practices. One should not forget that China was the first to create a great firewall to block the free flow of information back in 2009.² But as the US follows China's lead, the internet and thus the exchange of global information will become increasingly divided. If, in addition, we consider China's push to enhance its independence in a standard setting, with China Standards 2035, one can already see that the

² See <https://www.nytimes.com/2009/03/25/technology/internet/25youtube.html>

FIGURE 13

DEMAND FOR SEMICONDUCTORS BY REGION (Usd bn)



SOURCE: Natixis, SEMI, International Data Corporation, Bloomberg, WIND.

creation of two major —but rather independent— ecosystems might not be as far-fetched as some may think. This could include hardware and software and possibly other technologies.

The increasing constraints for the free flow of investment, especially as regards Chinese acquisitions of companies in key tech sectors, points in the same direction. The constraints are particularly evident from the US, after the granting of increased powers by Trump to the Committee on Foreign Investment in the United States (CFIUS) in 2018. The EU also set up its own investment screening process on an EU level in April 2020 to beef up coordination among national investment screening agencies. These moves show the unease in the West about China's technological upgrade. One should also realize that, beyond the containment of technology, the lack of reciprocity, as regards Western companies that still have very limited access to the Chinese market, is another factor pushing for bifurcation. In fact, although China has finally approved a negative list for inward foreign

direct investment, as many as 33 sectors remain on the negative list, which means that no foreign investor can gain control in such sectors. In other words, in the investment space, the lack of full openness by China and its rapid tech upgrade are additional factors pushing bifurcation.

An area where the push for decoupling appears much less obvious is portfolio investment. An exception to this is for the US towards China as reflected in the growing presence of the US and —more generally— foreign financial institutions in China, and also the rapid increase in portfolio flows into China. In fact, US investors have flocked into China's equity and bond markets in the last few years following a general trend by foreign investors. One key factor behind this trend has been the massive quantitative easing by the FED (Federal Reserve System) and the very cheap cost of funding in the developed world. In turn, China's interest rates have remained stubbornly high and equity performance has been very positive in the light of China's stellar recovery from COVID-19 compared

to the rest of the world. These factors have lost steam recently given the regulatory crackdown affecting the equity market and an increasingly lax monetary policy pushing interest rates down.

China's response: self-reliance under the logo of "dual circulation"

The West's, and especially the US', move from engagement to containment have come in tandem with a much more assertive China. In fact, China has announced retaliatory measures for close to every announcement made by the US. Those, however, are bound to be less effective as trade and tech relations between the US and China remain unbalanced in the US' favor. At the same time, China has taken measures to accelerate its quest for self-reliance, which already existed as the China Manufacturing 2025 plan patently exemplifies. This quest, clearly enshrined in the 14th Five Year Plan (National Development and Reform Commission China, 2021a) through the dual circulation strategy (National Development and Reform Commission China, 2021b), can have much longer lasting consequences both for China and the rest of the world.

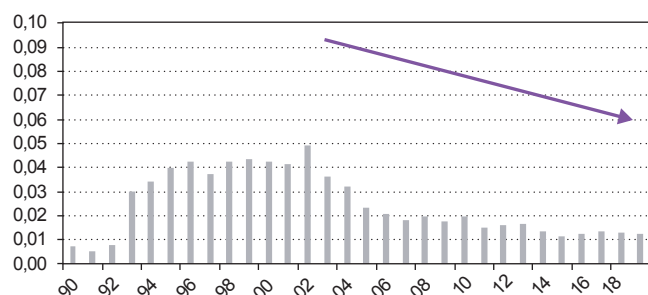
The dual circulation strategy basically stands for China's quest to insulate the domestic market from the rest of the world by eliminating any bottleneck—whether natural resources or technology—for China to vertically integrate its production and achieve self-reliance served by China's huge domestic market. A relevant consequence for the world, though, is that China will no longer need to import high-end inputs, with obvious negative consequences for major exporters of technology like Germany, Japan, South Korea or the US. As if this were not enough, the second aspect of dual circulation, boosting external demand, in a context of Western containment, will increase the importance of the Belt and Road Initiative (BRI) to ensure open markets in the emerging world. In essence, dual circulation is part of China's masterplan to become self-reliant in resources, technology and also demand through its

huge market as well as that in third markets through the BRI. In other words, as China becomes more vertically integrated, major exports of manufactured inputs will suffer. The semiconductor sector, though, remains a bottleneck for China, which explains the buying spree by Chinese companies over the last few years. Interestingly, in geopolitical terms, Taiwan could hold the key for China to achieve self-reliance in semiconductors, given its companies' strength—especially Taiwan Semiconductor Manufacturing Co. (TSMC)—in the most difficult steps of the semiconductor supply chain, namely foundry and lithography.

Against this backdrop, it is important to note that not only will China's growth decelerate further in the future but it will also be increasingly less shared with the rest of the world due to its dual circulation strategy. Those governments or companies expecting manna from China in terms of exports—as happened when China announced its rebalancing towards domestic demand in 2008—may be proven wrong. In other words, while the old rebalancing was designed to move China away from excessive external imbalances, the dual circulation strategy aims at self-sufficiency, though with a continued push on exports as long as it is feasible. In fact, this new dual circulation is nothing more than an important substitution strategy while trying to keep foreign markets for Chinese goods (García-Herrero, 2020). This change in strategy is not a capricious move by the Chinese leadership but a hedging response to the changing nature of Beijing's relations with the US as the leading global power. In sum, the dual circulation strategy is a crucial policy that reflects China's view of the world and its place in it (García-Herrero, 2020). China is seeking to become a fully integrated market with no need for help from the rest of the world, though still benefiting from export markets. As for global imbalances, the dual circulation strategy might result in another trade surplus for China as imports would be controlled so as to reduce overdependence on the rest of the world. In other words, the dual circulation strategy can be understood as an important substitution that keeps foreign markets open for Chinese goods.

FIGURE 14

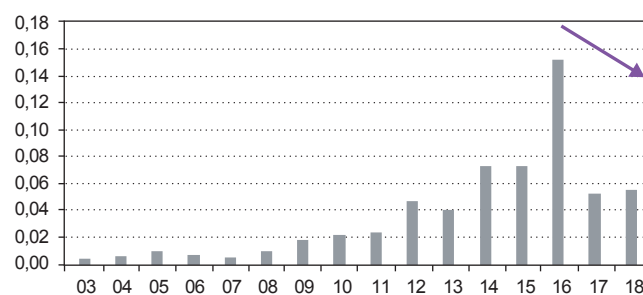
US FDI FLOW TO CHINA (% to GDP)



SOURCE: Natixis, UNCTAD, WIND.

FIGURE 15

CHINA FDI FLOW TO THE US (% to GDP)



SOURCE: UNCTAD, WIND.

In fact, overseas acquisition has become an important channel for China to become self-reliant and ease the bottleneck in high-end manufacturing. Even though the number of China's announced overseas mergers and acquisitions has significantly reduced since 2020 due to cross-border restrictions and the still uncertain global economic outlook, the breakdown by destination and sector still points to China's intention to move up the value chain through outbound acquisition. By destination, although the US rises to be the top destination when measured by deal value and takes up 44 % of the total due to a large deal (Tencent's additional purchase of 10 % of Universal Music), the latter was related to Europe —the French parent company Vivendi— and Europe remains a major target for China's overseas M&A when measured by the number of deals from Chinese companies. This is especially true for China's acquisitions in the industrial sector since the EU remains an important manufacturing hub of the global production chain and a high-technology supplier, which could help China in moving the value chain. But the relatively smaller share in deal value indicates that the industrial deals were smaller in size, so attracted less attention in the market.

Another important threat is financial decoupling

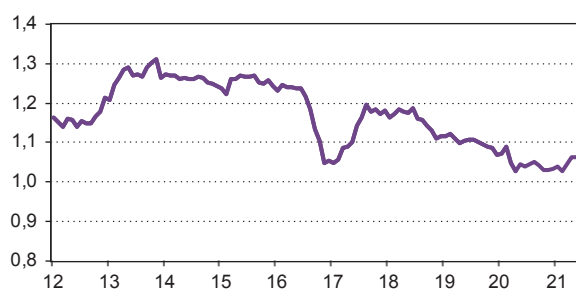
Beyond trade and technology, US containment has also moved into finance. For a start, US financial sanctions on China are now in place as the Biden administration finally passed the Trump-era list of military-related Chinese companies banned from receiving US-based investment. China's response with its Anti Foreign Sanction Law (AFSL) and forcing Chinese companies to delist from the US on the grounds of unwarranted data sharing is a further push towards financial decoupling.

The reality is that financial linkages have been waning for years, at least as Foreign Direct Investment (FDI) flows are concerned. US FDI flows into China peaked in 2002 after China joined the WTO but have been decreasing since then (Figure 14). Chinese FDI into the US grew until 2016 (Figure 15) and has remained low since President Trump came to power.

Portfolio flows are a different story. While China's holdings of US treasuries are clearly on a downward trend, US holdings of Chinese assets have increased very rapidly, notwithstanding the US sanctions on the same specific names (Figure 16 and 17). The web

FIGURE 16

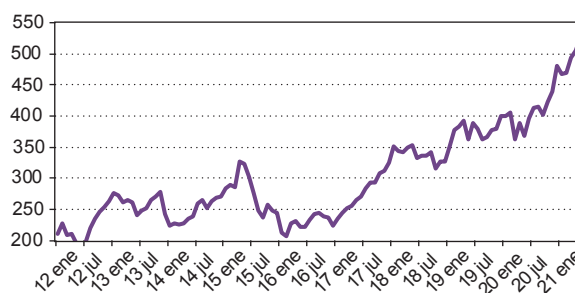
CHINA'S HOLDING OF US TREASURIES (USD tr)



SOURCE: TIC.

FIGURE 17

US HOLDING OF CHINESE LONG-TERM SECURITIES (USD bn)



NOTE: Chinese long-term securities include both Mainland China and Hong Kong.

SOURCE: TIC.

of sanctions is becoming increasingly complex (The White House, 2021c). Some are Xinjiang or Hong Kong related but the most important ones are the Pentagon list of Chinese military companies via the Office of Foreign Assets Control (OFAC) for which an investment ban for US investors is in place. There are by now about 60 companies, some of which are of a very relevant size like ChemChina or Xiaomi. China's retaliation, namely the anti-foreign sanctions law passed in June 2021 could increase costs for foreign firms operating in China and thus further deter investment flows. Such costs may stem from additional compliance-related costs but also reputational ones if the perception exists that companies are too dependent on China.

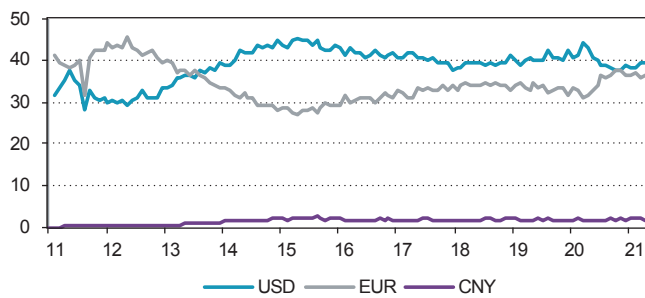
In line with the reduction in cross-border lending, cross-border financing has become more difficult. For example, Chinese technology firms listed in the US have opted for secondary listings to avoid the risk of being delisted from the US stock market. This is the case of Alibaba Group, JD.com and NetEase Inc. At the same time, the Chinese government has meanwhile adopted

policies to encourage the domestic funding of technology companies, including the launch in 2019 of the Science and Technology Innovation Board (SSE STAR Market). Based in Shanghai, the aim of the STAR Market is to support promising technology start-ups in their equity financing, helping to avoid US equity markets. As if this were not enough, the Chinese government is also resorting to penalizing Chinese listings in the US market, as the case of Didi shows.

Beyond specific retaliation measures, China's grand strategy to respond to financial bifurcation is for the RMB to eventually become an international currency. This used to be a long-term objective but it has become more urgent as a consequence of the US' extraterritorial use of the US dollar to target China. The fact that the RMB only captures a tiny share in either global payments or reserve currency (Figures 18 and 19), roughly 2 %, adds to the urgency. In fact, the Cross-Border Interbank Payment System (CIPS) was set up in 2015 to enhance clearing and settlement services for cross-border RMB payments and trade. But CIPS is clearly not an alternative to the Society for Worldwide

FIGURE 18

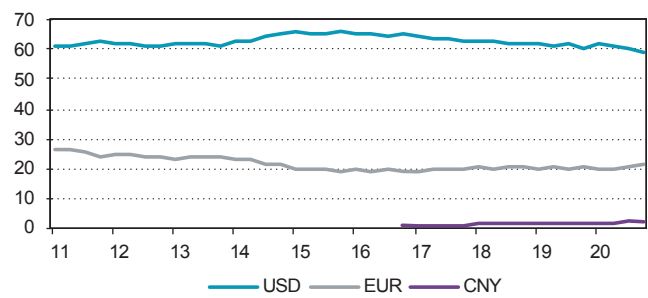
SHARE AS INTERNATIONAL PAYMENT CURRENCY (In %)



SOURCE: Natixis, SWIFT, Bloomberg.

FIGURE 19

SHARE AS RESERVE CURRENCY (In %)

NOTE: RMB has been recorded separately since 2016 Q4.
SOURCE: Natixis, IMF.

Interbank Financial Telecommunication (SWIFT) since it still relies on the SWIFT system to connect with SWIFT's members.

The first attempt by China to internationalize the RMB was centered on facilitating Hong Kong as the global hub for offshore RMB business, then extended to other offshore centers, which did not work out well after the 2015 Chinese equity and currency shocks. Now, China is trying again by fostering cross-border acceptance of its digital currency, profiting from a first-mover advantage (García-Herrero, 2020). This is not only important in the long run but also immediately as it can help China bypass the use of the dollar if and when needed. But the internationalization of a currency needs more than just technical preparation. It also requires certain conditions to be fulfilled for its global acceptance, namely preserving its value through price stability, offering a large pool of highly liquid assets, and allowing full capital account convertibility for money to instantly flow in and out of the RMB. This means that the Chinese government will need to take additional steps toward the liberalization of the capital account so as to enhance the full convertibility of the RMB. As such, a key question is whether the digital

renminbi, the E-CNY, may help Chinese authorities to square the circle, namely to allow for more capital account openness while still being able to trace capital flows and act accordingly. This explains why E-CNY's traceability under the design of "controlled anonymity" is key as it allows China to control seemingly free financial flows. In other words, the digital currency could offer a way to promote the RMB as an international currency, while still keeping control of cross-border flows. Another important objective is for China to further project soft power by using its own currency for trade and investment exchanges, particularly in areas under China's influence that tend to coincide with the BRI's geographies.

While the E-CNY is a master plan at a time in which big uncertainties exist about the US' ballooning debt, there are serious technical barriers for a cross-ledger solution and institutional differences make it easier said than done. Data sharing of financial transactions is also an important stumbling block. Another important factor that needs to be improved is the liquidity of RMB financial assets. While the size of the bond market has grown rapidly since the global financial crisis, it is dominated by corporate and FI credit. More liquidity on

central government paper is needed with a longer yield curve and clearer benchmarks. But whether the E-CNY can help on this front remains a question.

How the new “common prosperity mantra” can affect long-term growth

China's new “common prosperity” mantra has received worldwide attention lately. The impact of such an idea could be sensed as early as last November when Ant's financial IPO was stopped. The idea behind this is simple and relates to Wen Jiabao's famous description of the Chinese economy as “unbalanced, unstable, uncoordinated and unsustainable.” After years of strong growth, part of which had been fed by financial leverage, better income distribution needs to become the key objective of Chinese policy makers. To achieve this goal, not only will billionaires have been asked to be more generous and philanthropic, but the tax system will also need to become more progressive. At the same time, antitrust regulations are being introduced to avoid an excessive market share by just a few companies. One could argue that this should be good news for China's long term growth in as far as more balanced growth should help in the long run. However, there are also doubts as to whether a much stricter regulatory environment, which so far seems to have affected private companies much more negatively, may harm the entrepreneurial spirit which has characterized the Chinese economy since Deng Xiaoping's time. In short, the new “common prosperity” mantra was clearly key when assessing the future of the Chinese economy, but the jury is obviously still out on the final impact of the policies surrounding “common prosperity” goals, especially given the fact that common prosperity has different goals and tasks from stage to stage (Fulin, 2021).

6. Conclusions

China was the first country hit by the COVID-19 pandemic but also the first out of it. The early containment

of the virus has made China the only major economy to deliver positive growth in 2020. The rapid rebound in economic activity was led by exports as well as SOEs and property investment, whereas the recovery of consumption has considerably lagged. But the reliance on investment and exports for China to grow are reminiscent of China's old growth model and its medium-term consequences; namely a lower return on investment and, thereby, lower potential growth. Beyond that, China's debt burden reached a record high during the pandemic even though China's policy responses to the pandemic were more measured compared to the West. While the strong cyclical rebound has helped with debt dynamics, the momentum of economic growth has already slowed as property and infrastructure investment decelerate as the government tries to contain financial risks and its export engine slows as global production resumes.

Looking beyond COVID-19, China's structural deceleration is a reality, which is bound to intensify due to an aging population as well as a rapid slowdown in productivity. Also, China's external environment has radically changed since 2018, when President Trump embarked on a trade and technology war. Since the Biden Presidency started in 2021, the pressure on China continues unabatedly but with a different focus. First, Biden is clearly leveraging the US' long-term allies and taking the attention away from import tariffs to reduce dependence on an increasingly China-centric supply chain. At the same time, preserving technological hegemony and keeping the role of the US dollar as a reserve currency remain key for the US and are the biggest problems for China to achieve global economic hegemony. This explains why banning China's hardware (especially 5G technology) and software (social media, but not only that) has continued under Biden, as have financial sanctions. China's response to the former is a dual circulation strategy to achieve self-reliance. As for sanctions and any other form of extraterritorial power related to the reserve currency role of the dollar, China's bold —as yet untested— response is an official digital

currency, the E-CNY. Whether China will manage to counter the US' efforts to contain China's rise will also influence the speed at which China's growth rate slows. Finally, China's new stance to attach greater importance to a more balanced distribution of income and less to growth—as part of its common prosperity goal—also has an important bearing on China's growth prospects.

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