

China's Economic Challenges beyond COVID-19



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The Chinese economy is showing signs of recovery from the shock of COVID-19 as it shifts to positive growth in the first three quarters of this year. Experts in China say that if domestic demand factors such as investment and consumption, as well as production, start to recover, the Chinese economy may approach pre-Covid-19 levels. Some even predict that if the growth continues, China will become the world's largest growth engine in the next few years. To understand more about the future direction of the Chinese economy, we need to look at the 14th five-year plan for 2021–2025.

The 14th Five-Year Plan focuses on the "dual circulation" strategy, which involves developing a new circulation system integrated into the international economy by strengthening the internal economic cycle function. There are five key aspects to the domestic circulation – namely a "unified market," "boosting domestic demand," "digital infrastructure," "industrial restructuring" and "regional reshuffle" – all of which are related to strengthening 5G networks, AI, industrial Internet, data centers, cloud computing, and the digital and intelligent upgrading of traditional infrastructure, which are the key areas of "new infrastructure" investment.

Earlier, the "Unified Market" version 1.0 emphasized by China signified the alignment of many domestic laws and regulations, market management, and industrial norms with the requirements of WTO rules. This round of "dual circulation" is again engaging the unified requirements of the domestic market, surpassing version 1.0, and has new upgrade requirements in terms of social security uniformity, smooth flow of production factors, improving efficiency and reducing logistics costs.

This strategy helps to restructure the industrial supply chain. Originally, due to changes in the business environment in some parts of China, some of its industries were transferred or spilled over to Southeast Asia and Central and South America. However, through the dual circulation strategy, the efficiency of domestic industrial operations and the business environment are improved, and more industries will tend to remain in the country.

There are some challenges and difficulties in promoting the dual circulation strategy. First, it can serve as an obstacle in export transfer to domestic demand. Many local industrial clusters in China are mature, and provinces and cities tend to support local enterprises in order to improve their own industrial development. However, there are phenomena such as local protection, industry barriers, and monopoly, which lead to certain problems in the areas of production and sales, logistics and accounting. Therefore, it is difficult for export-oriented enterprises to integrate into the domestic market immediately, and having a large number of enterprises transition from exports to domestic sales in a short period of time will inevitably increase competition in the domestic demand market and hinder the orderly development of enterprises. In addition, the R&D costs of high-tech industries may be boosted by the government's high emphasis on relying on the local market, capital, and supply chain; the process of technological upgrading may also slow down due to weakening of external exchanges, which instead hinders industrial upgrading in China.

Second, the increase in the consumption power of the people is limited. There is a large income gap among the people in China, and the resulting M-type structure of consumption limits the consumption potential that can actually be released to lower than imagined. If the government adopts methods such as raising social security levels and suppressing housing prices to increase the consumption power of low-income populations, this could cause labor costs and commodity prices to increase. Additionally, hurting the housing industry may lead to asset bubbles, which would be even more detrimental to the positive cycle of domestic consumption and industry.

Third is the risk of overcapacity. "New infrastructure" has a positive effect on improving China's technological innovation capabilities, increasing domestic demand and investment. However, in the initial stage of construction, it must rely heavily on local government special debt. A high proportion of local government financing may bring financial pressure and eventually lead to overcapacity.

Fourth, intense local competition could lead to waste in resource allocation. Currently, China's new infrastructure projects are mostly deployed in first-tier cities, which may lead to excessive competition for resources between cities, or large amounts of investment being concentrated in competitive industries without investment in education and medical industries that are vital to people's livelihood, with the result of resources not being reasonably allocated. Moreover, these new infrastructure projects are mostly in the field of emerging industries with high uncertainty and risk, which carries the potential to trigger a new debt crisis for local governments.

Lastly, the development space of small and medium private enterprises is limited. New infrastructure mostly involves highly capital-intensive and technology-intensive industries. It has been designated as public property by public opinion in China. Therefore, in addition to the investment and development of central enterprises and local state-owned enterprises, large enterprises are more capable of participating. The Chinese economist Guan Qingyou and the Institute of Financial Research have compiled the participation of about 500 companies in the seven major industrial chains of the New Infrastructure campaign, of which 10 core representative companies include Huawei, Alibaba, Tencent, Lenovo, CATL, and BOE. Most of them are leading private land companies with advantages in technology research and development and industrial application. For small and medium-sized private enterprises, it is difficult to directly invest in the new infrastructure projects, but when starting from upstream (equipment manufacturing) or downstream (software development) of the supply chain, there may be room for development, especially in new technology manufacturing and various fields.

Since 2020, the U.S.-China trade war, economic de-globalization, and global epidemic outbreak have exacerbated the instability of the external environment in China. In response, the Chinese government has put forward the dual circulation strategy, striving to activate and expand domestic markets, and combined with the new infrastructure strategy to strengthen independent technological innovation and continue to upgrade the industrial chain. Undoubtedly, the launch of the "dual circulation and new infrastructure" strategy in China means that its current economic development model will usher in a new wave of adjustments, and bring fundamental changes to the international industrial division of labor and the global economy. It is necessary to conduct an early response assessment to ensure that we can still maintain the supply chain in the process of global industrial supply chain reorganization. **KIEP**