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Week in Focus

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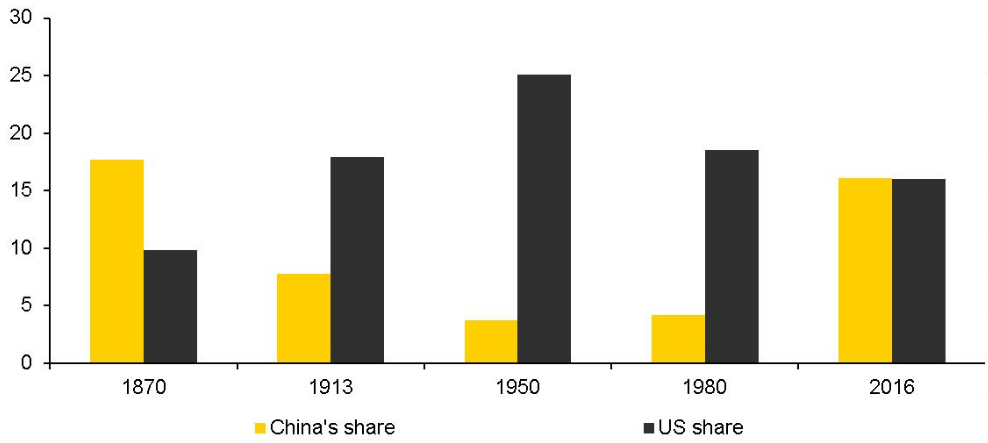
China on autarky course

In order to become less vulnerable in its conflict with the US, China is striving to gain more independence from the global economy, focusing on the domestic market. This strategy, however, poses significant risks to China as well as to the Western industrialised economies. **Page 2**

China on its way back to former greatness
Share in global GDP, in percent



Source: Maddison Project Database, version 2018, Commerzbank Research

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China on autarky course

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China has become increasingly assertive politically and economically in recent years, almost inevitably putting it on a collision course with the US. In order to become less vulnerable in this conflict, China has presented a new economic policy, the "Dual Circulation Strategy". This autarky strategy, however, poses significant risks to China's long-term prospects, but also to the US and Europe.

China's "dual circulation strategy"...

China's government has unveiled a new strategy for the further development of the economy recently. With the 'Dual Circulation' strategy, the government is increasingly focusing on the internal market. At the same time, synergies of the internal market ("internal circulation") and the world market ("external circulation") are to be realised. In the longer term, China wants to create a largely self-sufficient system.

... to become less vulnerable in its conflict with the US

Rising tensions with the US are likely to be an important motive for this new strategy. Under President Xi Jinping, China has set itself ambitious policy objectives to become a regional, and then a global superpower. The basis of this development should be the fast-growing economy.

As in similar cases in the past, the emergence (or, in the case of China, the re-emergence – see front page chart) of a new great power triggers tensions with the established powers trying to defend their place in the sun. Almost inevitably, China thus comes into conflict with the US. The US has therefore embarked on a policy of containment of China. One element of this is securing the US lead in the high-tech industry. Another is an increased security focus on the Pacific – the long-announced US pivot to Asia may finally happening.

The trade war with the US and the halting of the supply of high-tech goods have once again brought the vulnerability of its economy to the Chinese government's attention. Against this backdrop, China's efforts to strengthen the domestic economy and become self-sufficient in critical sectors are not too surprising.

New priorities to achieve "self-reliance"...

In the upcoming 14th Five-year plan (to be expected in late October) where Beijing will provide a high-level development plan for 2021-2025, China is planning a sweeping set of new government policies:

- It plans to develop its domestic semiconductor industry and counter US restrictions, conferring the same priority on the effort it accorded to building up its atomic capability. President Xi also stressed the importance of mastering key technologies and of building strong domestic automobile brands. In line with long-standing practice, China will support strategically important sectors with cheap loans and tax breaks. In particular, high-tech investments (especially in the 5G network) can count on extensive government assistance.
- China will prioritize food and energy security. On food security, China will not only secure food supply domestically, the authorities have recently launched an initiative to reduce food waste.
- China has accelerated regional integration. Domestically, it plans to promote economic cooperation between Hong Kong, Macau and nine cities in Guangdong province (the 'Greater Bay Area'). Other regional plans center around the regions around Shanghai the region around Beijing.

... especially from the "West"

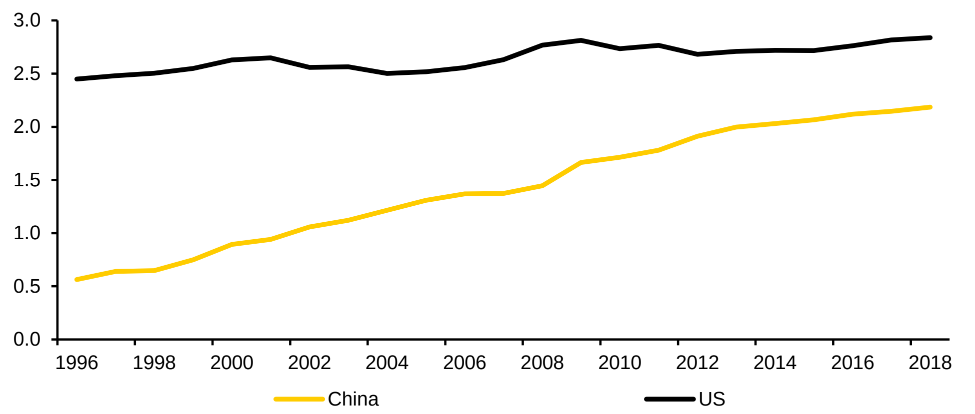
However, China is unlikely to completely turn inward. After all, China is already the world's largest trading nation, so it has a lot to lose. In particular, China is therefore likely to try to decouple from the West and, as a partial compensation, to expand or dominate cooperation with neighbouring countries. The external circulation would then primarily encompass "Greater Asia" and not the entire world. Indeed, ASEAN replaced the EU as China's largest trading partner earlier this year. To forward this process, China is pushing hard for the signing of a Free Trade Agreement with ASEAN countries, Japan, South Korea, Australia, New Zealand, and India (the RCEP). However, many of the neighbouring countries may not want to be drawn further into the Chinese economic empire. India is unlikely to sign this agreement any time soon.

The costs: lower productivity...

The decoupling from the US, the EU and other Western countries is not without risk. For China's economic success since 1978 is undoubtedly based on the policy of reform and opening up initiated by Deng Xiaoping. As a result, China is likely to lose economic dynamism in the long run if it turns inward.

In the short term, Chinese companies are being threatened by further restrictions on their global supply chains if the confrontation with the US continues. For example, the US sanctions against Chinese tech giant Huawei will completely stop the company's supply of sophisticated microchips from September 15. To make up for this and catch up technologically with the US, China will have to invest heavily (chart 1). However, it will certainly take some time for these investments to bear fruit.

Chart 1: China's R&D spending is catching up gradually
Research and development expenditure, in % of GDP



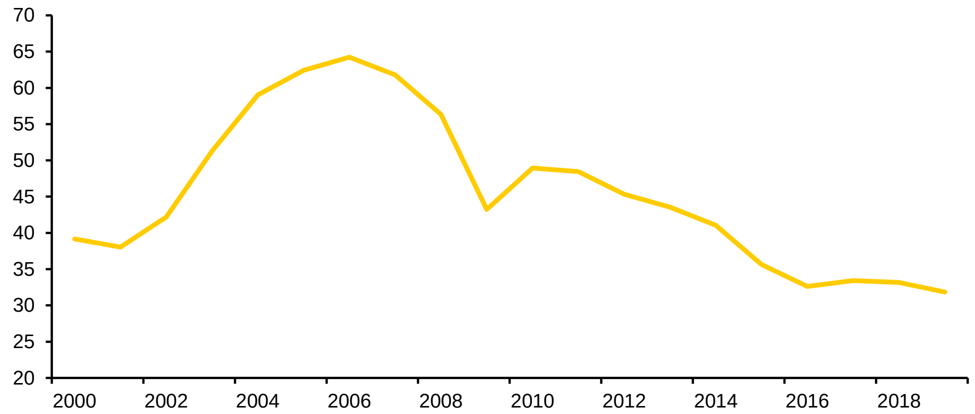
Source: World Bank, Commerzbank Research

This strategy also entails considerable costs in the long term. If China wants to become more independent and partially withdraws from the international division of labour, it will also lose the benefits of globalization. China may be able to produce most, if not all, of things domestically, but at a higher cost, and probably not all of them with the same quality. This will depress macroeconomic productivity and thus economic growth. This effect would be reinforced by the decreasing competitive pressure if China reduced competition (especially from foreign firms) to build up the industries necessary for autarky.

... and threats of a debt bubble

On the demand side, there has already been a shift in recent years from the long-dominant export orientation to a strengthening of domestic demand. For example, the ratio of foreign trade to gross domestic product has fallen markedly since the global financial crisis (chart 2). However, this shift went hand in hand with a significant increase in corporate debt. This is already very high and is likely to continue to rise significantly as investment continues to be boosted, with all the risks involved.

Chart 2: China is increasingly less dependent on foreign trade
China's foreign trade as % of GDP

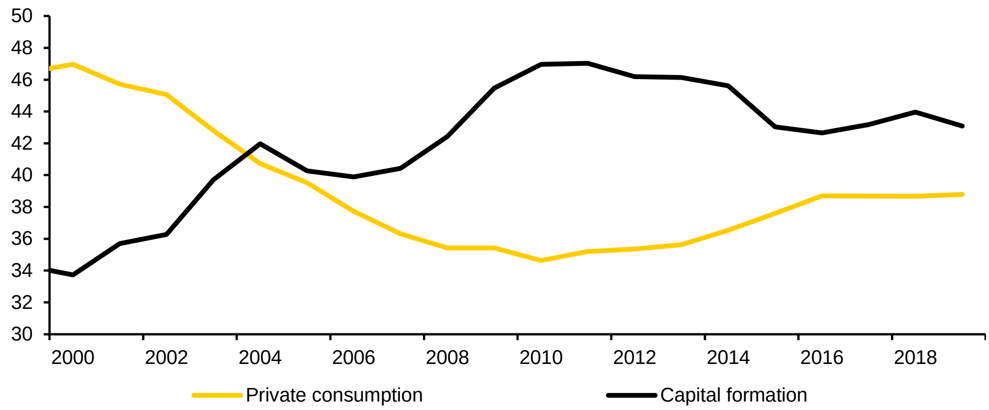


Source: WIND, Commerzbank Research

In the last decades, China has repeatedly tried to boost personal consumption to facilitate the "rebalancing" of the economy. For example, the government has launched several rounds of subsidy programs to boost automobile consumption since 2008. In recent year, the tax cut measures have been used aggressively to increase the households' dispensable income. The success so far has been limited. For example, the share of private consumption in gross domestic product fell by more than 10 percentage points in the years before the financial crisis; since then it has recovered somewhat, but is still significantly lower than at the beginning of the millennium (chart 3).

China is unlikely to morph into a "consumer economy" anytime soon. Severe income disparities and demographic challenges, such as the shrinking work force, suggest that the household consumption is unlikely to catch up with the pace of GDP growth as Chinese citizens will still feel inclined to save for the future since the government's provision for old-age pensions are still deficient.

Chart 3: China's private consumption picks up modestly
China: Private consumption vs Capital formation, as % of GDP



Source: WIND, Commerzbank Research

Costs for the rest of the world too

Containing China is a bi-partisan demand in the US. This is unlikely to change even if Mr. Biden wins the Presidential election in November. The US will continue their protectionist policies – "protectionist" meaning anti-Chinese – in key areas. Intensive domestic competition might mean that the US might be spared some of the adverse consequences of these policies. But this is unlikely to make big inroads on the trade deficit of the US. This has more to do with domestic savings decisions than "unfair" Chinese competition. Thus, the US will probably source imports from other countries and not replace them with domestic production.

Europe has also moved to see China as a strategic competitor, and the EU High Representative for Foreign Affairs, Josep Borrell, has been even more outspoken in some recent opinion pieces. Europe is now giving a higher priority to security aspects (see the discussion on the G5 networks). In the longer term, Europe will not be able to choose sides in the conflict between China and the US – and thus between one of the two markets. In the end, Europe will probably take the US side. Headwinds for European companies which bet heavily on the Chinese market – whether through exports or through direct investment – are set to increase significantly.

Fed preview: First meeting after strategy revision

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At next week's meeting, the Fed will confirm the target corridor for the fed funds at 0.00% to 0.25%. However, the FOMC could somewhat adjust the statement to bring it in line with the new strategy. Further details – for example, on the upper tolerance limit for inflation – are not to be expected.

Next week's FOMC meeting is the first since the adoption of the new monetary policy strategy. From now on, the new strategy provides the framework for the decisions of the central bank. With regard to the longer-term objectives, the central bank is particularly concerned about falling short of the full employment target and about the consequences of persistently low inflation. The risks are therefore mainly seen as downside risks, which implies an asymmetric orientation of monetary policy.

For now, the Fed is clearly missing its target (chart 1):

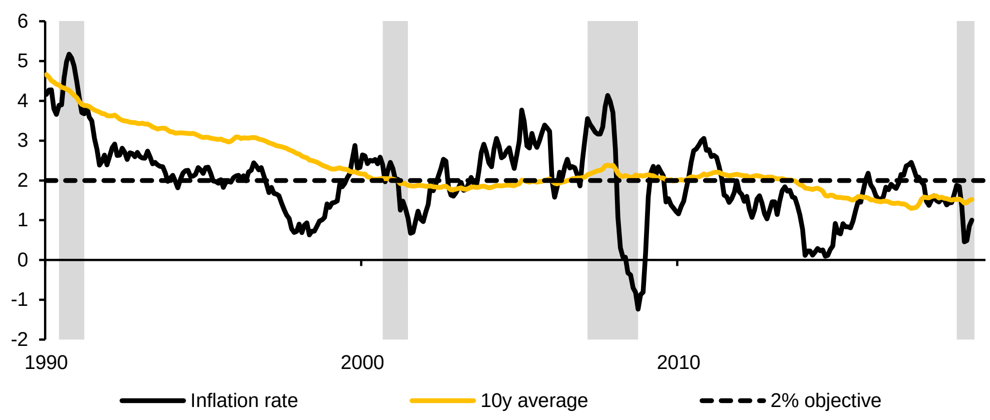
- Non-farm payrolls were 7.6% below the February level in August. While the Fed has not specified its full employment target, the current level is undoubtedly well below the maximum level.
- Since November 2008, when inflation fell well below the 2% mark for the first time – the average inflation rate has been 1.5%. The new strategy of an average inflation target requires that this shortfall is gradually be made good over the next few years, i.e. the Fed aims for an inflation rate that is slightly above 2%.

The conclusions are clear: monetary policy will remain expansionary, interest rates will remain at zero for years to come. The Fed will confirm this accordingly and maintain its benchmark interest rate corridor from 0.00% to 0.25%. The pace of bond purchases ($65 billion per month) will not change either. Emergency credit measures remain in place, but are no longer central for monetary policy – demand for these loans has remained low until the very end.

The Fed will presumably not detail its "tolerance threshold" for inflation, i.e. the extent of overshooting the inflation objective the Fed will accept.

To ensure the economic recovery, the Fed now sees fiscal policy doing the heavy lifting. Once again, Fed officials have called for new fiscal packages; Most recently, Fed Chairman Powell stressed the need for more government spending to accelerate the recovery. On the other hand, the Fed clearly sees few additional options for monetary policy. After the announcement of the new strategy, the FOMC obviously prefers to step back and wait how things play out.

Chart 1 - Inflation - "The trend is not your friend"
Deflator of personal consumption expenditures, annual rate of change in % and 10-year average of inflation rates. Grey areas: Recessions as defined by the NBER.



Source: Fed, Global Insight, Commerzbank Research

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