

# For, by, and from the Party: Defining the parameters of Dual Circulation

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## Introduction

When the phrase “Dual Circulation Strategy” (DCS) entered the lexicon of China’s economic policy in May 2020 following the meeting of the Politburo standing committee, it was not clear what the strategy might entail. Consequently, substantive commentary about the potential impact of DCS on China’s growth or engagement with the outside world has been scarce.

A plethora of more recent policy announcements provide the world a better idea of what Dual Circulation Strategy might mean. Consequently, this paper sets out to answer several questions.

What is Dual Circulation Strategy? What are its objectives? What are the ramifications of its implementation for China and the rest of the world?

To answer the questions, we divide the paper into four parts.

First, we set out to define Dual Circulation Strategy and assess the types of policies implied by the approach. To do this, we place China’s economic planning and policy making process in the context of the country’s overall political and economic structure.

Then we briefly look at previous policy drives and their slogans, and their impact on the direction of economic development.

Finally, we examine the strategy and the different directions DCS could take China, as well as its likely impact on growth and the sustainability of the economic and political system.

## For, by, and from the Party

*“Party, government, army, society, education – east and west, south and north, the party leads on everything.”*

– 2017 CCP (Chinese Communist Party) Constitution<sup>1</sup>

Economics, it is often said, is the study of the allocation of scarce resources to meet unlimited demands. Therefore, the big questions that arise in economics are: how to allocate scarce resources; what to produce with them; and for whose benefit?

In the ideal of the market economy, individuals sell their labor in a competitive marketplace for their skills. Land and capital are allocated by the market to where the returns are highest. Consumption and therefore production patterns are determined by the purchasing decisions of sovereign consumers.

When viewed through this prism, it becomes apparent that China is far removed from being a market economy.

In China, all land is collectively owned, and all urban land belongs to the State. Land use is planned; local governments decide land use rights and their allocation. Indeed, the Party-State dominates the allocation of capital, through ownership of the major financial intermediaries and suasion over those that are privately owned. State control over the development and diffusion of technology is near absolute. Where factors of production are deployed in combination with one another – and they always are – State control over the three gives them effective control over the fourth: labor.

The supply and direction of labor is further controlled by the *hukou* system, which stipulates where someone is entitled to live and the benefits accrued to migrants, if they are eligible. In addition, there are substantial controls on collective wage bargaining.

Each component of control over the factors of production is not unique to China. Indeed, some are common in mixed or market orientated economies. In aggregate, however, the controls in China amount to an extraordinary level of state authority.

The commanding heights of the economy remain in State ownership with State-owned enterprises (SOEs). China's SOEs dominate, among others, energy production, telecommunication services, and transportation (both domestic and international.)

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In aggregate, central and local SOEs account for 22% to 28% of China's GDP.<sup>2</sup> In 2020, the State-owned Assets Supervision and Administration Commission (SASAC), which oversees SOEs, had total assets exceeding US\$32 trillion.<sup>3</sup>

To ensure its alignment with Party goals, the tentacles of the Party-State extend into the private sector both formally and informally. In 2016, many Chinese SOEs began to formally codify the Party's role in their corporate charters. This codification was subsequently made mandatory. In 2020, the General Office of the Central Committee of the Chinese Communist Party (CCP) issued the "Opinion on Strengthening the United Front Work of the Private Economy in the New Era," which called for an increase in the CCP's influence in the private sector.<sup>4</sup> Today, all companies listed on the mainland must by law include a Party committee.

If control over the factors of production is the foundation of Party control over the economy, then the five-year plan is its architecture. The plans dictate the overarching direction of the production pattern to be pursued. The latest iteration of the plan – the fourteenth – envisions China's economy from 2021 to 2025.



A batch of 38 vehicles manufactured by China's first automobile factory in the Northeastern province of Jilin, as part of the country's first Five-Year Plan, were transported to Beijing in preparation for the National Day parade in 1956.

Over the past four decades, the introduction of market orientated reforms has been instrumental to China's economic success. China's per capita GDP has risen considerably and is now US\$10,500, in line with the global average of US\$10,925.<sup>5</sup>

But the toleration of private enterprise; the use of price as a mechanism to send signals to planners, and even the acceptance of large concentrations of private wealth, should not be taken as an indication of surrendering State control over the allocation of resources. Nor should it be understood as loosening the grip of the CCP on the direction of China's economy.

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Rather, the incentive structures of free enterprise have been used to implement a Party-determined agenda. At the heart is a social contract with China's population that, in return for a monopoly of political power, the CCP will deliver ever higher living standards through technocratic competence.

Indeed, the tenfold rise in per capita income in the past two decades is a significant achievement.<sup>6</sup> This increase has reduced the absolute level of poverty.

Politics also poses important questions to economics. How are decisions made? Who chooses the decision makers? Who are the beneficiaries? In China, the answer to all three is "the Party." China's political economy perpetuates one party rule for the benefit of the State.

There have been times since the early 1990s when the above assessment of China's socio-political-economic construct looked as if it were being challenged. A civil society was growing, and a plurality of opinion within the CCP was being tolerated. Furthermore, there seemed to be growing private sector autonomy from the State.

But under President Xi Jinping, China has moved substantially back towards its Maoist origins in terms of ideology. It is within the context of this reversion to type, that Party-inspired and State-led economic policies need to be analyzed.

### Slogan-led planning and growth

Since 1949, the centrality of the Communist Party has been a permanent feature in China's political economy. However, economic policy does change periodically. These changes in direction are driven in part by ideological oscillations and in part by the evolving demands the CCP places on the economy to meet national objectives. Direction originates from the top of the Party hierarchy or its planning apparatus.

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Hence, from the "Four Modernizations" first mooted in the 1960s to the "Made in China 2025" campaign, significant changes in direction have been instigated from the top downwards. These changes are outlined in the five-year plans that articulate the rails for implementation.

From the central plan follow a series of regional, industry, and policy specific plans in which the detailed modus operandi is elaborated.

Therefore, while it is perhaps tempting to dismiss seemingly ambiguous slogans as being without substance, this would be a mistake.

In 1979, Deng Xiaoping re-launched the "Four Modernizations" policy initiated in the 1960s by Zhou Enlai, as its implementation had been obstructed by the Cultural Revolution. These reforms were aimed at modernizing agriculture, industry,



national defense and science, and technology. The modernization of agriculture met with spectacular success and facilitated the rise of rural industries, which in turn laid the foundations for China's industrialization.

The late 1970s also saw the start of Deng's "Open Door" policy. Intended to attract foreign direct investment to China, primarily through special economic zones relatively free from bureaucracy and control, the policy sought to bring much needed foreign exchange into the country. China also needed foreign expertise to promote its embryonic industrial base and facilitate its export orientated growth model.

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The "grand international circulation strategy" was the brainchild of Chinese researcher Wang Jian. In 1987, Wang laid out the export orientated growth model that proved successful in catapulting China to the pinnacle of global trade within a generation. In doing so, living standards rose dramatically in the coastal provinces, which saw most of the benefits from China's export success.

The "Open Door" policy later found its counterpart in 1999 with the "Going out" policy, aimed to internationalize the activities of China's SOEs.

Following the global financial crisis of 2009, domestic investment has overtaken the export sector in driving China's economic growth. First announced in 2015 by Premier Li Keqiang, the 'Made in China 2025' campaign is China's latest iteration of industrial policy. This time, the goal is to promote advanced manufacturing and enhance national self-sufficiency in the industries of the future.

The history of China's rise makes clear that what ostensibly appears to be mere slogans can and do mark substantive turning points in direction. DCS is likely such a turning point.



In 1979, former Chinese President Deng Xiaoping's relaunch of the "Four Modernizations" policy laid the foundations for China's industrialization.

### China's political economy under Xi Jinping

The growth of China's economy has had a displacing impact on both the regional and the global order.

The sudden and dramatic increase in China's national power has elicited a range of responses from neighboring countries as well as the EU and the US, as they grapple with the redistribution of global power. Their reaction has been accelerated by an uncompromising assertiveness on the part of China and its willingness to weaponize its economic clout in support of geopolitical objectives.

As a result, a reassessment of their policy towards China has begun, which involves a cost-benefit analysis of current economic engagements.

From China's perspective, the global community's new circumspection towards its rising power and ambition raises several potential issues to address around its strategic vulnerabilities.

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In the economic sphere, China finds itself uncomfortably dependent on imports to ensure energy and food security as well as for advanced technology, particularly semiconductors.

A logical policy direction to overcome this challenge is to enhance self-reliance where possible. Where self-sufficiency is not possible, an option is to accumulate as much leverage as possible to secure outside provision by imposing high costs on those who might be tempted to disrupt supply. South Korea, Australia, and Japan exemplify countries whose actions at various times have prompted China to try to coerce a modification of behavior.

Reorientation is also taking place on the export front. Although net exports have been in structural decline, the export sector remains a large employer and accounts for around 18% of China's GDP.<sup>7</sup> Under Xi, China has reorientated exports



In 2018, "Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era" were enshrined into the country's constitution, elevating his power to that of former leaders Mao Zedong and Deng Xiaoping.

away from the developed world and towards its immediate neighbors and smaller economies, where the balance of power is dramatically asymmetric. Diversification of export markets to reduce vulnerability makes perfect sense.

The less benign international environment facing China has its counterpart at home. Historically, party legitimacy has rested on the twin pillars of perceived technocratic excellence, which in turn helped to manifest rapidly rising living standards. Yet, as China's per capita GDP grew to reach global average levels, economic growth has slowed. Potentially this slowdown in growth is more dramatic than the official statistics imply.<sup>8</sup>

China's growth model is looking challenged in many ways. As Figure 1 shows, total factor productivity is falling because of increasing levels of low-yielding investment. As a result, more investment is required to generate additional growth.<sup>9</sup> When combined with China's demographic challenges, the data implies slower growth going forward.

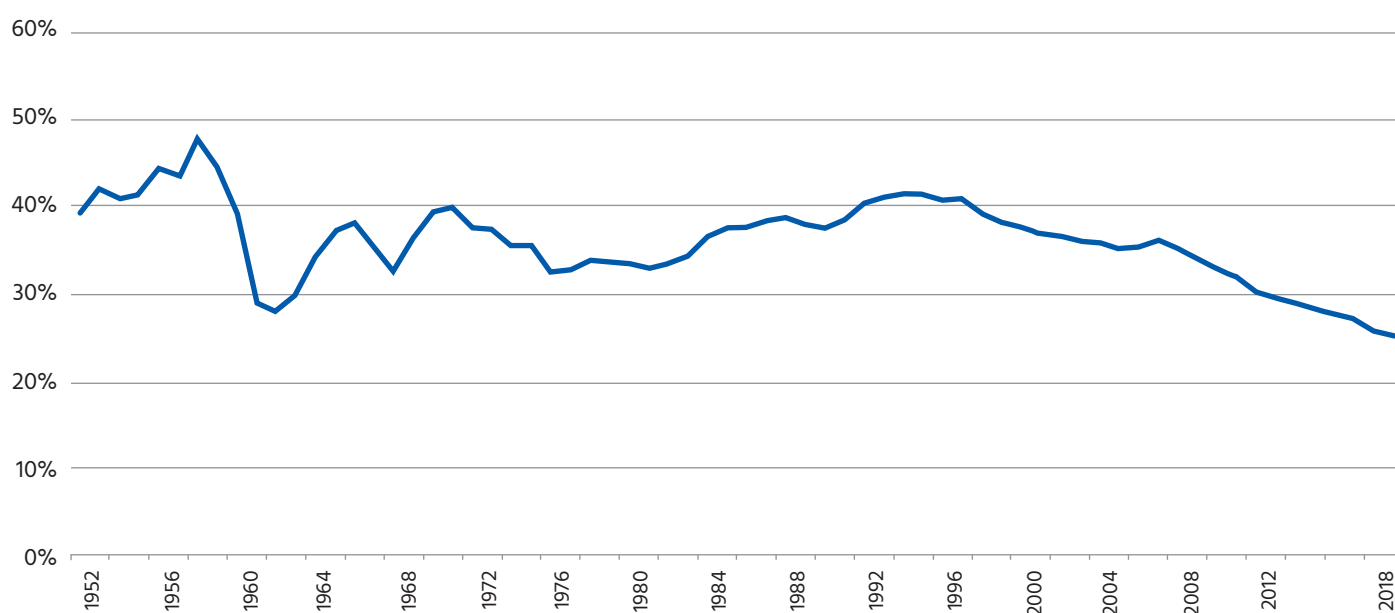
When one considers the above factors in conjunction with China's fragile financial system, the country's economic outlook potentially poses a significant threat to the CCP's reputation for technical excellence in policy making.

Furthermore, inequality of wealth and income distribution has risen.<sup>10</sup> For example, housing costs are a challenge for the younger generation, limiting family formation and curtailing consumption. The average apartment now costs nearly nine times the average household income in urban areas.<sup>11</sup>

When one considers the above factors in conjunction with China's fragile financial system, the country's economic outlook potentially poses a significant threat to the CCP's reputation for technical excellence in policy making.

In addition, Xi's emphasis on ideology has arguably stifled policy debate. Internecine politics has perhaps reduced the coherence of policy making as party

**Figure 1 – The falling efficiency of China's capital investment**



**Source:** Penn world tables. The figure shows the GDP of China at constant national prices divided by the capital stock of China at constant national prices. The capital stock has grown faster than GDP reflecting the falling returns on capital investment- what might be termed "over-investment."

loyalty has been conflated with individual loyalty to Xi. The expulsion of retired CCP official Cai Xia from the Party is a recent prominent example.

Against this changed backdrop, the Party is redefining its contract with the people and its vision for the country's future. The objective of rapidly rising living standards is being replaced with a more egalitarian distribution of economic spoils and a more broadly defined goal of "National Rejuvenation."

"National Rejuvenation," or the China dream,<sup>12</sup> should be thought of as restoring China to what the leadership perceives as its rightful place at the center of global affairs. It is a phrase often used by President Xi to describe the nation's aspiration towards global leadership.

Technocratic excellence is giving way to ideological purity as a yard stick for governance. Only one in seven of the leadership born after 1948 come from an engineering background. Before 1948, the ratio was one in three.<sup>13</sup> There is perhaps an implication that political alignment with the core leadership is more important than technocratic expertise.

The Party is exercising more influence in the private sector to ensure alignment with Party goals.

This change of direction is manifesting itself in economic policy making. The Party is exercising more influence in the private sector to ensure alignment with Party goals. Recently this is most evident in the technology and education sectors.

In the case of technology companies, issues such as the challenge to state seigniorage from Alipay, minimum wage levels at Meituan, data ownership and control at Didi, and the concentration of private wealth have all been motivating factors for state action aimed at harmonizing corporate policy with state priorities. An increasing focus on domestic industrial policy, technology-related foreign acquisitions, and industrial espionage is aimed at delivering self-sufficiency in advanced technology. In addition, there are efforts to increase the resilience of China's import supplies through the Belt & Road Initiative (BRI) and overseas investments to secure natural resources. Launched by Xi in 2013, the BRI may well provide a good indication as to what the international dimension of DCS may entail.

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### What exactly is Dual Circulation Strategy?

At the heart of DCS is the bifurcation of China's economy between a domestic circulation of production, distribution and demand, and an international circulation. In this sense, China already has a dual circulation, along with other economies.

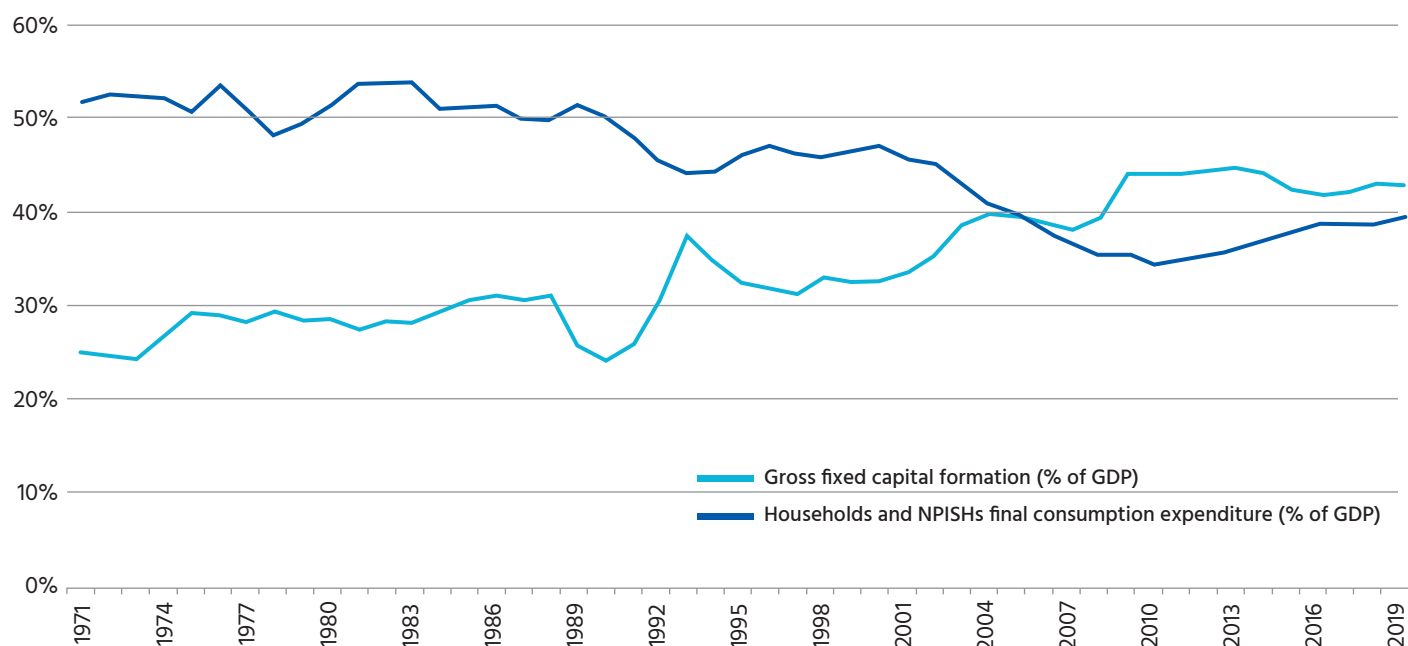
"Opening up" emphasized the international dimension. China pursued an export orientated growth model, with all the tax incentives and industrial policy that such a model entailed. The proceeds from the exports were repatriated to the central bank and boosted foreign exchange reserves. The corresponding increase in money supply drove the "domestic circulation."

Dual circulation emphasizes the need for the domestic circulation to be a sustained driver of economic growth, with the international dimension reinforcing domestic growth but playing a subservient role.

This concept will resonate with long-time observers of China's economy who have called for a rebalancing towards domestic consumption for many years. Indeed, the 11th five-year plan of 2006 called for a rebalancing towards domestic demand. In fact, net exports have fallen relative to GDP.



**Figure 2 – Investment (Gross fixed capital formation) as a % of GDP & Household consumption as a % of GDP**



**Source:** World bank database. Investment in China, at more than 40% of GDP remains well above even the excessive levels reached in Japan prior to its economic bubble bursting in the early 1990s and the consequent lost decades of growth.

Trying to rebalance the economy towards domestic demand and away from export dependency is not a new idea. However, much of the progress so far has come from government investments in hard infrastructure and urban real estate development rather than household consumption.

This approach has produced some spectacular improvements in transportation and similar achievements. However, the law of diminishing returns is rendering further investment in this direction fruitless. Excessive investment in this area is proving a big drag on productivity, as reflected in capital-output ratios.

The domestic dimension to DCS puts the emphasis on softer infrastructure, such as digital and communications systems, where productivity gains may be higher than in the over-built hard infrastructure sector.

The domestic dimension to DCS puts the emphasis on softer infrastructure, such as digital and communications systems, where productivity gains may be higher than in the over-built hard infrastructure sector. In addition, a renewed emphasis is being placed on advanced manufacturing, vertical integration of domestic production, and greater domestic value added. The objective is in part a recognition of rising costs in China and the subsequent loss of competitiveness in lower value-added industries.

More importantly, China recognizes its dependence on foreign technology, and that prohibitions on exports to China of specific goods (such as semiconductors) can impose large costs and hinder its ability to develop. DCS entails a vigorous push in State-led technological innovation to close the technology gap with developed countries. In other words, DCS potentially marks a profound shift from China's export orientated growth model to a model based on import substitution.

What should be read into the downplaying of the international circulation? The global financial crisis appears to have had a profound impact on Chinese policy makers. In essence, the event was seen as a vindication of economic planning over unbridled market economics and led to a reevaluation of overdependence on

export orientated growth. After all, China's major export markets were debt-ridden and likely to stagnate.<sup>14</sup>

The international dimension to DCS should not be thought of as a wild lurch to autarky.

Add the global fallout from the pandemic and the deteriorating geopolitical environment, and it becomes unsurprising that China's policy makers are calling for an audit of China's external linkages. The international dimension to DCS should not be thought of as a wild lurch to autarky. Instead, it may be seen more as a set of policies designed to reorientate China's economic relations to fit with the evolving international climate and the broad goal of National Rejuvenation.

An emphasis on domestic demand, however, should not be confused with household or personal consumption. Domestic demand can come in many forms. State sponsored research & development, state provision of services to households, and centrally-led fixed capital formation are equally plausible ways of growing the domestic circulation.

### How might Dual Circulation Strategy evolve in the future?

The imperative to perpetuate Party rule and Xi's vision of National Rejuvenation provides the goals for China's economic policies. The changed domestic and international environment provide the catalysts for a policy rethink.

But how will DCS evolve? What can we see in the economic plan and policies under Xi that indicate the most likely policy direction?

Within China's domestic economy, three objectives emerge.

The first goal is to redistribute income and wealth, with a view to achieving "common prosperity."<sup>15</sup> Policy is being aimed at reducing the cost of housing, education, and healthcare, which will involve more progressive taxation, given fiscal constraints.

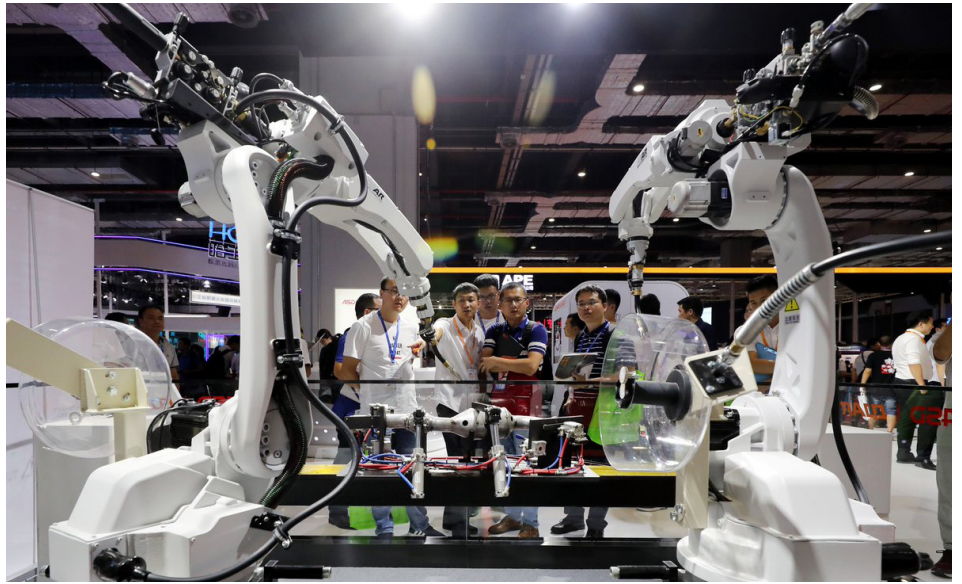
The second objective is to increase the quality (rather than the quantity) of growth, by focusing on "softer" goals such as improving the quality of life and the environment. The recent clamp down on for-profit education companies is a recent example.

The third objective is to build resilience into the domestic economy. At one level, this means circumventing China's vulnerabilities, such as its reliance on foreign technology, through import substitution.

The third objective is to build resilience into the domestic economy. At one level, this means circumventing China's vulnerabilities, such as its reliance on foreign technology, through import substitution. It also involves building resilience into economic institutions through deleveraging and better governance. A prime example is the Three Red Lines real estate policy aimed at reducing financial leverage in property companies.<sup>16</sup> Tighter oversight of peer-to-peer lending also falls into this category. Meanwhile, "Made in China 2025" is the flagship program for import substitution in the high-tech sector.<sup>17</sup>

These goals could be met through policy in various ways. At one end of the spectrum is an emphasis on rebalancing through greater household consumption. This would reduce the savings rate and imply potentially smaller external surpluses. It would give a much-needed boost to the private corporate sector, which is presumably best placed to meet the demand of household consumption.

Supportive microeconomic policy towards rebalancing might include a shift in the burden of taxation away from indirect taxes on consumer goods. The sectors most prime for heavier tax burdens could be residential real estate (albeit targeted



One of the key objectives for China's Dual Circulation Strategy is to build resilience into the domestic economy. At one level, this means circumventing the country's vulnerabilities, such as its reliance on foreign technology, in particular semiconductors.

at higher end properties and second homes) and sectors that currently earn excessive economic profits but are not aligned with State objectives. Consumer technology companies represent a good example.

Though increased social welfare provisions to encourage household spending would be needed, these fiscal adjustments would boost domestic spending through the state and the household sector.

A rebalancing towards household consumption, accompanied by progressive redistribution policies, are in keeping with the themes of "common prosperity" and "harmonious development" that have been key motifs of the Xi era.<sup>18</sup>

An alternative approach could see the further relegation of the private sector as State-led investment aims to advance China's ambitions for technological leadership.

However, such a rebalancing is only one possible approach or dimension to the domestic circulation. An alternative approach could see the further relegation of the private sector as State-led investment aims to advance China's ambitions for technological leadership. Such programs would be possibly more centralized than the infrastructure investment financed by local governments following the global financial crisis.

In other words, domestic demand may not come from consumption but rather a reorientation of investment expenditure. Likely areas of focus might be the military-industrial complex and advanced manufacturing.

There seems to be a widespread belief among China's policy makers that western economies have been substantially weakened by their move away from manufacturing and the dominance of service industries.

China is keen to move up the value chain to rival Germany and Japan, while shedding lower value-added areas to other countries, such as Vietnam and Bangladesh. There seems to be a widespread belief among China's policy makers that western economies have been substantially weakened by their move away from manufacturing and the dominance of service industries.

The BRI – and policies that place China at the center of global supply chains – may enable China to maintain a degree of control over the lower echelons of the manufacturing chain while it moves up to dominate the higher value-added sectors.

### Conclusion

China's policy slogans matter – they can mark significant turning points in policy direction.

China's policy slogans matter – they can mark significant turning points in policy direction. The Dual Circulation Strategy seems to be pointing towards a greater emphasis on domestic rather than international drivers of the economy.

DCS also seems to prioritize the quality of growth over the quantity. One of the key measures of growth quality is the degree of wealth and income dispersion. A more egalitarian “common prosperity” is being pursued.

DCS does not necessarily mean that China is lurching to autarky. However, it does probably indicate that the international dimension to China's economic policy will be more rather than less mercantilist.

China's goal of National Rejuvenation requires a greater degree of self-sufficiency. This means that to some extent China will be turning its back on the core principles of trade, comparative advantage, and specialization that have accompanied its export orientated rise.

China is likely to move towards import substitution wherever possible in the pursuit of economic resilience. Such a move will likely come at a cost, in terms of the efficiency of resource allocation and therefore economic growth.

Instead, China is likely to move towards import substitution wherever possible in the pursuit of economic resilience. Such a move will likely come at a cost, in terms of the efficiency of resource allocation and therefore economic growth.

Inevitably there will be an emphasis on domestic industrial policy to immunize China from potential geo-economic policies.

Combined with a more geo-strategic approach to other linkages such as foreign direct investment, the politicization of China's economic policy is likely to increase even more going forward. The ramifications of this could prove very far reaching for the global economy, the domestic private sector, and foreign companies doing business in China. The Dual Circulation Strategy may be ushering a new era for the global economy in which economic activity becomes highly politicized.

## About the author



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## Notes

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10. <https://www.theguardian.com/world/2021/jul/01/xi-jinping-gap-between-rich-and-poor-poses-biggest-threat-to-china>
11. Based off 39 square meters per person, per capita urban disposable income of RMB39K per year and an average selling price of RMB9,900 per square meter. All numbers from the NBS.
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