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“Decoupling” in Chinese: Challenges for China’s Economy

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In the long-term economic development plans adopted in March this year, the Chinese authorities emphasised the need to expand China’s internal potential to reduce its interdependence on the U.S. and other partners—a decoupling. However, they tend to take a conservative approach to challenges related to indebtedness, lack of innovation, consumption, and demographic changes. Instead of proposing market reforms, the Chinese Communist Party (CCP) is systematically increasing its control over the economy. In foreign cooperation, they find it important to maintain the level of exports in the context of China’s share in global value chains, as well as to acquire technology. For the EU, this means the necessity to implement new market-protection mechanisms, and in the longer term transfer production from China to the EU.

In October 2020, the CCP Politburo approved China's development plans for the periods 2021-2025 and until 2035. In March, the plans were also adopted by the Chinese parliament. In both documents, as in plans from previous years, the authorities emphasised the will to modify the current development model, oriented towards exports and investment. They indicated that the changes are to better account for the potential of the internal market, both in terms of consumption (basing it on the middle class) and production (innovation and modern technologies). The vision of development until 2035 largely copies the assumptions of the "Made in China 2025", a strategic document from 2015, emphasizing, among others, the development of space technologies, artificial intelligence (AI), rail transport, and electromobility. The plans also include investments, among others, into digital infrastructure and ecological solutions. Cooperation with foreign countries remains an important element of the development of the Chinese economy, but mainly in the context of participation in value chains and access to technology. This cooperation is part of the concept of "double circulation", that is, the primacy of internal production, without giving up foreign cooperation. The shape of the plans was influenced by the rivalry with the U.S. and disputes with the UK, Australia, Japan, and the EU. They also stem from the negative assessment of the impact of the COVID-19 pandemic on the condition of the Chinese economy, which has aggravated long-standing structural problems.

Socio-Economic Challenges

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The most important problem is demographic change. By 2025, there will be about 300 million people over age 60 in China (over 20% of the population). This ageing will result in a reduction in the number of workers, an increased burden on the middle class, which will be financing care for seniors and the already inefficient state social welfare system. According to the 2020 census, published in May this year, the authorities stated that the Chinese population continues to grow, but at a much slower pace than expected. However, the data are not very reliable, resulting partly from the suggestion by the National Bureau of Statistics that it review the results before making them public. It is therefore possible that the number of Chinese people is declining. The abolition of the "one-child policy" in 2016 did not improve the situation. The cost of living and high real-estate prices are also not conducive to having more children, which likely contributed to the fertility rate in 2020 reaching the lowest level in many years. Along with restrictions on labour immigration and often a lack of interest in settling in China, including for cultural reasons, this means that there will be a gradual shortage of workers, especially low-skilled ones. To counteract this, the authorities announced, among others, an extension of the retirement age, which currently is 55 for women and 60 for men, and accelerating the entry of new age groups into the labour market by reducing the duration of compulsory education.

The changes in the labour market are also intended to stimulate decisions to have children. Urban unemployment, officially slightly above 6% (in fact rather more than 10%), affects mainly the middle class but also migrant workers—in 2020 a bit less than 400 million people—who move from the countryside to cities to work. During the pandemic, due to the restrictions on movement, the illegal nature of some jobs, and the lack of legalisation of their stay in a given city (*hukou* system), some of them lost their jobs. The authorities are very careful in reforming the *hukou,* except in the largest cities (Beijing, Shanghai, Guangzhou, or Tianjin). The government declared an increase in the limit of "urban" *hukou* by 5%, but only in medium-sized cities where there are fewer job offers and salaries are lower. In other centres, the changes are blocked by local residents and CCP officials who fear that living conditions will worsen.

The situation of the middle class (people earning $7,250-62,500 a year), estimated at 700-900 million people, is to be improved by increasing their purchasing power. This, in turn, is to contribute to an increase in consumption, which is to be the basis of the new model of the development of the Chinese economy. Between 2011 and 2019, consumption was responsible for over 60% of GDP growth, and investments, 30%. For the consumption share to be even greater, it is necessary, apart from increasing the scope of public and social services, to further increase wages. This is complicated because of income inequalities, the lack of preferable job offers, and the little state support for the private sector. Another problem is low productivity, for example, in services, which is not conducive to competitiveness and increasing wages. Higher incomes of citizens, though, likely would favour fertility and lower private debt.

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In China, not only are citizens more in debt but also private, state-owned businesses, and provinces, which often own these large enterprises. In 2020, total debt reached 295% of China's GDP. Among others, this amount of debt lowers the authorities' capacity to intervene in a crisis. In 2020, for example, they used fiscal and debt instruments to support the economy during the pandemic, but to a lesser extent than during the 2008 financial crisis. Problems with debt repayment affect the financial liquidity of companies and even the ability of provinces to fulfil their obligations, such as payments of salaries to officials or provincial employees.

Technological Challenges

China is still heavily dependent on foreign technology solutions. An example of this is semiconductors, which China in 2020 imported more than $350 billion worth. Its dependence on the supply of important components applies mainly to goods from the U.S. but also to countries using American technologies, such as South Korea, Japan, or Taiwan. A total of 80% of global production capacity in the sector is related to the U.S., and most of the supplies to China are Taiwanese and Korean products. The Peterson Institute for International Economics estimates that while in 2020 less than 16% of the production of chips came from China (Chinese producers made less than 6% of the world's supply, and the rest was produced by foreign companies located in China), it is possible that by 2025 China will reach 20%. American sanctions accelerated the Chinese efforts to become independent of semiconductor imports through the development of this sector, which was included in the multi-annual plans. Chinese companies in this sector receive, for example, income tax exemptions for up to 10 years, and special universities educating specialists were established (in 2015, there were nine of them, currently there are 25). Private-sector counterparts (e.g., YMTC) have been created in China to replace blocked leading American producers. These counterparts regularly receive financing from state funds, for example, from the China Integrated Circuit Industry Investment Fund.

China still has a problem with production innovation.

However, a key problem for China is the limited time it has to develop its own products, because its accumulated stocks of semiconductors will not last that long. This development process is also delayed by the low level of know-how and lack of educated engineering staff necessary to build the production infrastructure. Despite the high expenditure on research and development in such areas as 5G or AI, China still has a problem with production innovation, i.e., the production of an original solution that can be implemented on an industrial scale. This is because of the imitative nature of its educational system, among other reasons. The top-down model dominates state development programmes, which means that the demand for research is created by the authorities and not, for example, by the market. This is evidenced by 2019 data from the World Intellectual Property Organisation (WIPO) when China was responsible for over 40% of global patents, but it was estimated that only 1 in 10 of them have any market value. The real level of China's innovation is therefore below countries like South Korea, Switzerland or Germany. China is trying to compensate for these shortcomings by acquiring technologies from outside, including through mergers, acquisitions, financial incentives for specialists, or research programmes implemented jointly with foreign scientific institutions.

Political Context

The CCP consistently strengthens its control over the economy by preventing greater marketisation, for example, by not reforming state-owned enterprises. The heads of these companies, nominated by the Organisational Department of the Central Committee of the CCP, prioritise the political interests of China over business success and profits. Some state-owned enterprises, including the Tsinghua Unigroup or Huachen Automotive Group, are becoming insolvent (e.g., defaulting on bond redemption) and require substantial restructuring, which for political reasons is not taking place, even though it has been declared for a long time. In this period of heightened ideology related to, for example, the rivalry with the U.S. or the propaganda regarding China's civilizational and technological advantages, such deep reform are nearly impossible. From the point of view of the party's interests, the mechanisms included in the multi-annual plans are aimed at limiting losses related to, for example, U.S. sanctions or their expansion.

The CCP also does not want to allow the growth of the importance of the modern technologies sector by liberalising the economy. Established with the approval of the authorities, telecommunications and internet companies are starting to play an increasing political role, including by accessing large amounts of data. The party sees a need to supervise them to, for example, build a centralised social credit system. The rivalry between companies extends to party circles, financing of selected activists, or cooperation with provincial authorities. In a recent example, China's regulatory authorities limited the activities of Ant Group (a subsidiary of Alibaba) in 2020, including blocking its debut on the Hong Kong Stock Exchange. Antitrust proceedings are also pending against Tencent. Since 2020, the creation of party units in companies has also intensified, imposing the obligation of ideological training on enterprises and subordinating them to the CCP, also in the international dimension.

Conclusions and Recommendations

China's concentration in its economic plans on the domestic market results primarily from attempts to neutralise the negative effects of existing circumstances, rather than from striving to implement a new development model. The overarching goal of the CCP is to stabilise the internal situation given the difficult international and internal conditions, especially ahead of the CCP's upcoming congress in 2022, at which its new authorities are to be elected.

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The success of China's plans depends heavily on the policies of the EU and other partners, mainly in terms of access to technology and trade. China is not oriented towards opening its market or introducing principles of sustainable development (e.g., conventions of the International Labour Organisation) in relations with the EU. It will be of key importance for them to obtain the resources of other countries through investments and trade, for example, within the Belt and Road Initiative. To achieve this and respond to restrictions introduced by other countries, China will use political and other pressure on states (e.g., Germany before the parliamentary elections in September this year) and EU institutions.

In response to China's policy, the EU should accelerate the introduction of mechanisms to protect the common market and restrictions targeting violations of international law and human rights. These may include an embargo on goods produced with forced labour (e.g., from Xinjiang) or the extension of the investment screening mechanism. It is worth accelerating work on the implementation of the anti-coercion mechanism, the consultation of which will be conducted by the European Commission until June this year. Another important aspect is the EC's project allowing the refusal of public tenders in the EU or the takeover of an EU company by an entity outside the EU that is subsidised by public authorities. A problem will remain with the verification of data regarding the support provided by the Chinese authorities or other public authorities. Another step in the right direction is the EU industrial strategy published in May this year and efforts to rebuild the EU's potential, for example, in the production of semiconductors, not only as part of in-house production, but in cooperation with more advanced partners such as South Korea or Japan. It is in the EU's interest to support—under transatlantic cooperation—initiatives reducing dependence on China, including focusing on building supply chains resistant to possible political and economic instability in relations with China. The situation in the Chinese economy is also important in this context, as seen in the currently rising prices, which mean that the costs of imports are passed on by businesses to consumers—one of the reasons for rising inflation around the world, including in Poland.

It is in Poland's interest to support both EU-U.S. cooperation in response to China's actions, for example, in the field of technology, and the introduction of mechanisms to protect the common market. In the context of the diversification of supply chains, Poland could become one of the countries where some of the production of companies transferring it from China would go. The creation of protection regulations within the EU against threats from China is also of particular importance in relation to Germany, Poland's most important economic partner, with strong economic ties with China. This situation means susceptibility to the political influence of China, including creation of preferential investment conditions for companies from Germany.