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How will China's Dual Circulation Strategy impact the global economy?

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Introduction

As explained in the first paper of this series, China's Dual Circulation Strategy (DCS), announced in May 2020, is Beijing's new policy direction that emphasizes domestic rather than international drivers of the economy. The implementation of the strategy gives formal substance to several established trends and policies that are now being pursued by the Chinese Communist Party (CCP) with renewed vigor.

Firstly, post the Global Financial Crisis (GFC) of 2009, China's economy has grown more dependent on domestic demand for economic growth – a trend that will likely continue.

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Secondly, China's policy priorities appear to be moving even further away from a market driven, growth maximization inspired allocation of resources. Planned allocation is emerging as more important, driven by the twin goals of quality growth and "National Rejuvenation," instead of high growth or economic efficiency.

Finally, viewed through the prism of "Great Power Competition", international economic engagement is becoming increasingly politicized and viewed as an instrument of state craft.

This begs the question: how will DCS change the way China's economy engages with the rest of the world? Is China likely to succeed? Furthermore, how will this approach impact the multilateral trading system and the global economy more generally?

This report is divided into three parts. Part one examines the evolution of linkages between China and the global economy. We assess how recent trends and policy moves that might be considered part of DCS are changing the extent and nature of this engagement.

Part two explores how these dynamics might shift going forward. Finally, part three explores some of the macroeconomic implications of DCS under various scenarios.

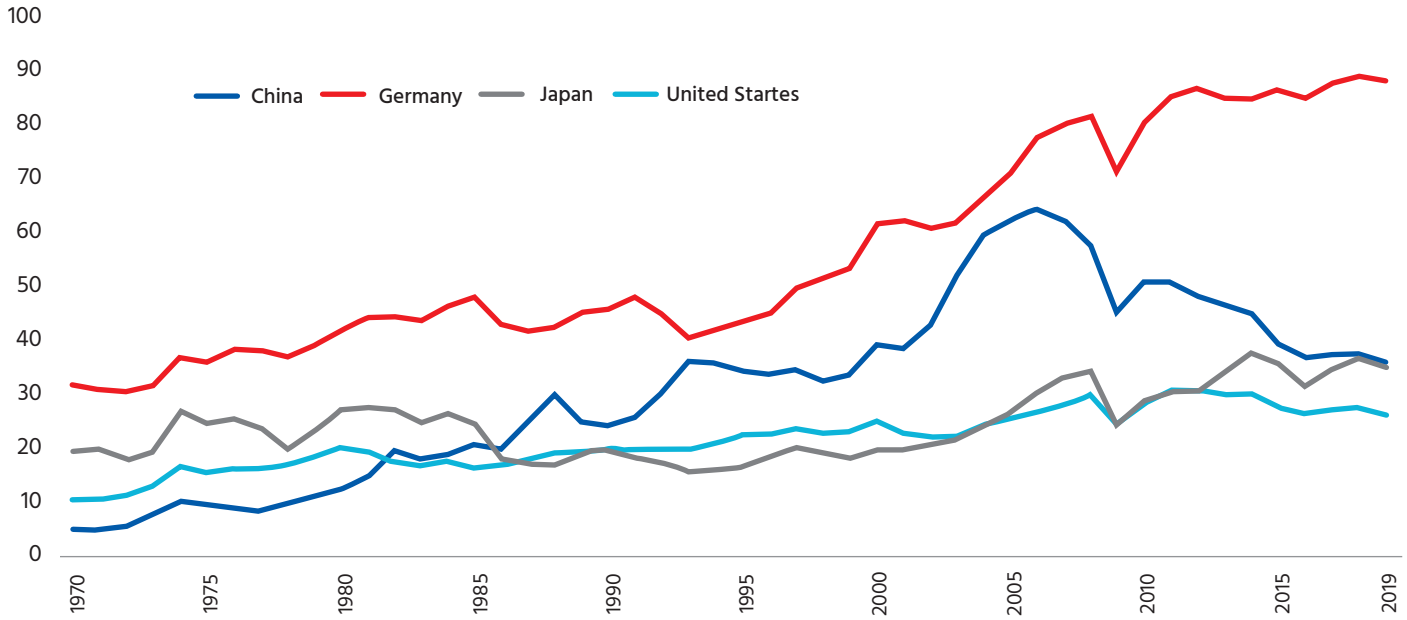
How broad and deep are China's economic linkages with the global economy? How are they changing under President Xi?

A period of trade intensity

Fifty years ago, China's ratio of trade in goods and services to GDP was at a nadir. The Sino-Soviet split in the early 1960s had reduced China's already meager trade with the outside world. As Figure 1 indicates, China's trade to GDP ratio stood at only 4.9% in 1971, overshadowed by the 10.8% trade to GDP ratio of the United States, considered by some as relatively autarkic. The export-orientated manufacturing economies of Japan and Germany enjoyed trade to GDP ratios of 20% and 30%, respectively.[1]

China's position began to shift in the 1980s. By 1986, China had overtaken the United States and Japan in terms of trade intensity. On the eve of its accession to the World Trade Organization (WTO) in 2001, China's share of global exports reached 3.2%. The country's trade to GDP ratio continued to rise, peaking in 2006 at 64%. Among the major economies, only Germany was more trade intensive than China.

Figure 1 – Trade to GDP ratio %



Source: World Bank open database

As China's economy has grown, however, its trade intensity has dominated the global context. As Figure 2 indicates, in 2019, the country's share of global exports of goods and services combined stood at 10.6%, making the country the world's largest exporter. In contrast, US share of global exports has fallen, from 15.6% in 1970 to 10.1% in 2019.[2]

The dynamics are shifting. After the GFC, China's trade to GDP ratio has fallen dramatically. Exports and imports have risen slower than GDP growth itself, due to the state-led investment model and the boom in residential property development driving the country's GDP growth. The remarkable degree of dominance of China's strongest exports also make further gains in market share more difficult.

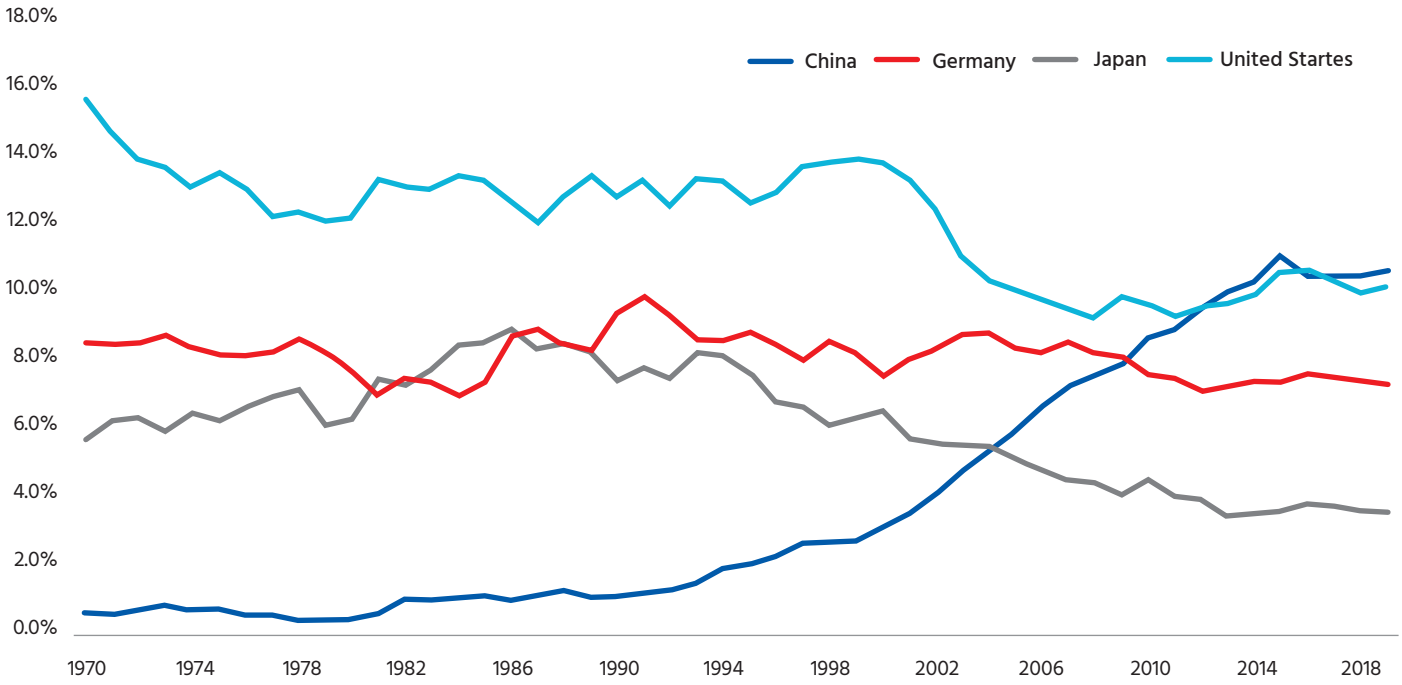
Observing merchandised exports only, as of 2020, China's global share now stands at 14.7%. The US and Germany trail significantly, with 8% and 7.9% share, respectively. China exports nearly more merchandised goods as Germany and the US combined.[3]

China's exports and imports combined account for 20.1% of global exports; one fifth of global exports are either from China or destined for China.

China's imports of goods and services have grown rapidly too. In 2019, the country's imports were valued at US$2.35 trillion, or equivalent to 9.5% of global exports of goods and services.[4] Thus, China's exports and imports combined account for 20.1% of global exports; one fifth of global exports are either from China or destined for China.

Because of this rapid accumulation of market share, China has become the most important trading partner for more than two-thirds of the world.[5] China's role is also strengthened by the fall in market share of its imports and exports from Japan, South Korea, and the US.

Figure 2 – Share of global exports, goods and services



Source: World Bank open database

In 2000, the US, Japan, and Korea supplied 39% of China's imports. This number has fallen dramatically to 24%. Similarly, while the three countries accounted for 42% of China's exports in 2000, two decades later the figure is 27%.[6] China's trading relationships are now far more diversified, and its size predicates its dominance in those trading relationships, especially in goods trade.

Today, China is the world's second largest importer and imports from a wide array of countries. Several countries – particularly smaller nations in Asia and commodity exporters – have found their exports highly concentrated towards China.

As Figure 3 shows, there are now 15 countries in the world for whom China accounts for more than 15% of exports. For a few nations, the concentration ratio is even higher. Consequently, freedom of action for these countries is constrained when it comes to international relations with the People's Republic of China. These countries may also become vulnerable should DCS result in a dramatic change in the size or pattern of trade with China.

China's role in global value chains

China's ascent to the world's biggest trading nation in part reflects its centrality to global supply chains. China has combined a huge pool of low-cost labour with high functioning infrastructure to produce massive scale in manufacturing.

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Figure 3 – Countries with high export concentration to China

	% of exports to China & Hong Kong
Australia	42.8%
Dem. Rep. of the Congo	42.1%
Namibia	35.5%
Brazil	33.5%
Myanmar	32.3%
Rep. of Korea	31.8%
New Zealand	29.7%
Philippines	29.3%
Laos	29.0%
Japan	27.0%
Singapore	26.1%
Malaysia	23.1%
Viet Nam	21.1%
Uruguay	20.9%
Indonesia	20.7%
Zambia	19.3%
Thailand	17.7%
Qatar	15.7%

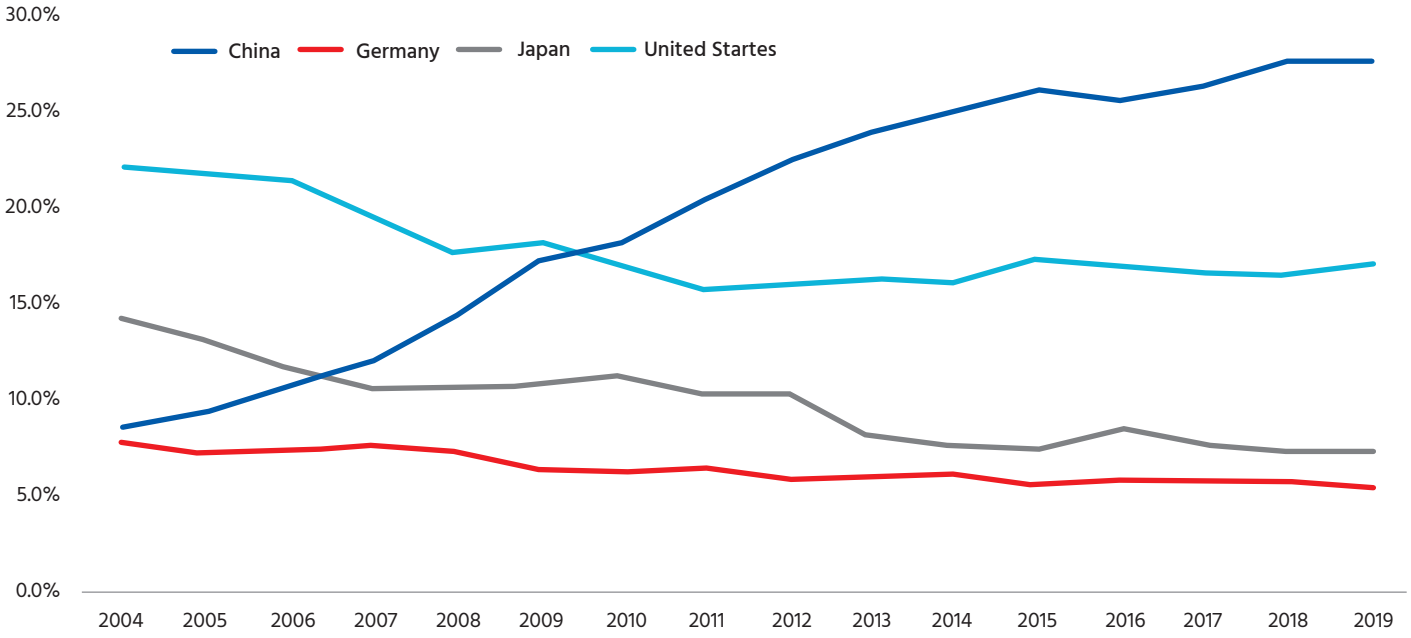
Source: Commtrade database

In the past fifteen years, China has increased its share of global manufacturing value added by nearly 20 percentage points, from 8% to more than 27%. By this measure, China is only two percentage points short of being as large as the United States, Germany, and Japan combined.[7]

This virtuous circle created by economies of scale in manufacturing has enabled China to grow its market share, even amidst rising labour and land costs. While some low-cost manufacturing is migrating to other parts of the world, Beijing hopes its Made in China 2025 industrial policy will ensure its prominence in the high-tech industries of the future.

At the same time, China's corporate sector is globalizing, resulting in its control of the offshored lower echelons of the manufacturing chain. This is especially true where offshored manufacturing feeds into the country's value chains, giving China the ability to determine from whom it sources these inputs.

Figure 4 – Share of global manufacturing value added (%)



Source: World Bank open database

Foreign direct investment and multinational activity

Trade is the largest linkage between China and the world economy – but not the only link. Multinational corporations (MNCs) have built substantive operations in China. Many Chinese companies have started to globalize too.

Following Deng Xiaoping's "opening up" of the economy in 1979 and prior to WTO accession, China was the recipient of modest but highly productive foreign direct investment (FDI). The efficiency of that early FDI was a function of China's relatively small capital stock and underdeveloped technology, management, and corporate ecosystem.

In the last twenty years, more than US$3 trillion of FDI has flowed into China; that is approximately 9% of world FDI flows.

FDI grew dramatically after China joined the WTO. In many ways, FDI served as the fuel for China's ascent to manufacturing dominance. In the five years prior to accession, FDI inflows totaled just US$220 billion compared to US$407 billion received from 2002 to 2006.[8] In the last twenty years, more than US$3 trillion of FDI has flowed into China; that is approximately 9% of world FDI flows.[9]

As China's economy has grown, FDI inflows have continued. In pure numerical terms, however, FDI's relative importance to China's economy has diminished substantially. In 2002, FDI inflows amounted to US$53 billion out of total gross fixed capital formation of US$515 billion – that is a 10.3% share.[10] In contrast, US$187 billion of FDI in 2019 paled in comparison to US$6.1 trillion of total gross fixed capital formation. FDI had fallen to just 3% of total investment.

The comparison is significant. China's US$3.2 trillion of cumulative FDI sits alongside the country's total capital stock of between US$60 to US$75 trillion.[11] FDI is responsible for a mere 3 to 5% of China's capital stock.

Despite slowing FDI inflow, the ongoing cumulative contribution to China's export development, GDP growth, and employment of all the FDI received in China to date is surprisingly large.

Much of this FDI inflow has been channeled to fund foreign companies operating in China. According to the National Bureau of Statistics (NBS), there were only 117,000 foreign invested enterprises (FIEs) in 2020, plus a further 134,000 with funding from Hong Kong, Macau, or Taiwan.[12] Therefore, 12% of China's 2.1 million enterprises are foreign funded, including some sourced from Hong Kong, Macau, and Taiwan.

In 2019, foreign invested enterprises accounted for US$1.8 trillion of China's total US$4.57 trillion of trade in goods – a 39% share.

FIEs grew their exports rapidly from a zero base in 1979. By the late 1990s, FIEs accounted for about half China's exports. By 2006, the number had risen to 60%. The ratio has fallen since. In 2019, FIEs accounted for US$1.8 trillion of China's total US$4.57 trillion of trade in goods – a 39% share.[13]

The role of FIEs in employment is significant. In 1993, FIEs employed just 2.8 million people. On the eve of WTO accession, the number had risen to 6.7 million. As of 2019, some 23.6 million were employed by FIEs.[14] Hence FIEs account for about 3% of overall employment and 14% of urban corporate sector employment.

The industrial sector is the most prominent. The roughly 43,000 FIEs operating in the industrial sector employ about 17 million people.[15] The sector's overall role is significant. In 2019, this sector controlled the equivalent of US$3.5 trillion of assets, produced US$3.6 trillion of revenue, and made a profit of US$253 billion.[16]

However, a closer examination of FIEs in China is less encouraging. Even before the pandemic, the profits made by industrial FIEs in 2019 were almost the same as in 2014. Revenue also shows a similar stagnation, which stands in stark contrast to the period between 2006 to 2011. That period saw the profits of industrial FIEs rose from a mere RMB538 billion to RMB1.55 trillion, effectively tripling in a five-year period.

Interestingly, the stagnation in profits seen by industrial FIEs since 2014 is not unique. The overall industrial sector saw a similar pattern.

Thus, while FDI flows brought huge benefits to China in the early years of its economic rise, in numerical terms it is now far less important. In the aggregate, foreign companies operating in China have seen their revenue and profits stagnate in recent years. What remains important to China's economy is the cumulative investment and the employment brought by foreign companies.

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The bigger change in recent years is in the linkages that bind China's economy with the rest of the world. These linkages have come from the level of Chinese corporate engagement with the outside world rather than foreign engagement with China. Outbound FDI from China is rising and Chinese corporations are globalizing. This is particularly true of state-owned enterprises and ostensibly private companies with close state links such as Huawei.

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Today, China's MNCs are amongst the world's biggest firms. In 2005, *Forbes* magazine's list of the 500 largest MNCs featured 175 US companies compared to 16 firms from China.[17] In 2019, the two superpowers were in a near tie: the US had 121 companies on the list and China had 119.[18]

China was also dominant by sector. China had no banks in the top five in 2005 but occupied four of the top five slots in 2019. China did not occupy any of the top slots in the construction and engineering sector in 2004 but took all five in 2019. Combining oil production and mining, metals, and oil refining, China had no representation in the top five in 2004 but took seven out of fifteen slots in 2019.[19]

NBS data on China's foreign contracted projects confirms the rise of its MNCs. In 2000, Chinese companies struck 2,597 overseas contracts with a value of just US$11.7 billion.[20] Turnover that year was just US$8.4 billion, and some 56,000 Chinese workers staffed the operations. In 2014, nearly 8,000 contracts valued at US$191 billion enjoyed a turnover of US$142 billion and employed some 400,000 overseas Chinese workers.[21]

The number rose again by 2019, which reported some 12,000 contracts. But the pace of growth was slower. The US$260 billion worth of contracts saw a turnover of US$173 billion. The number of overseas Chinese workers fell to 368,000.[22]

According to State Administration for Foreign Exchange (SAFE) data, China's stock of non-financial foreign direct investment reached US$2.5 trillion at the end of 2020.[23] This represents a 40-fold rise on the US$60 billion level of 2004. More than half the growth has come in the last five years.[24]

On a cumulative basis, China's FDI stock is heavily tilted towards high income countries in Europe and North America. Yet incremental flow in recent years has been more orientated to lower- and middle-income countries closer to home. This can be seen as a reflection of the changed geopolitical environment and a trend that is likely to continue.

Under Xi's Belt and Road Initiative, FDI is being concentrated closer to home and in economies where China is the dominant partner.

For example, China's FDI into the US in 2019 amounted to about US$3 billion. China has invested more or less a similar amount in Brazil, India, Indonesia, Cambodia, and Peru, respectively.[25] Under Xi's Belt and Road Initiative, FDI is being concentrated closer to home and in economies where China is the dominant partner.

Portfolio investment and cross-border lending

Due to China's capital account restrictions, portfolio flow linkages between China and the global economy have been a more recent and highly controlled development. As such, they are relatively small when compared to the trade and direct investment linkages.

Learning from the Asian financial crisis of the late 1990s, Beijing has not allowed foreign ownership of financial assets to reach levels from which a sudden outflow might pose a systemic risk to the economy.

Nevertheless, in recent years foreign inflows into Renminbi-denominated financial assets in China have increased. According to SAFE, foreigners now own US$1.9 trillion of portfolio investments in China.[26] Portfolio investment, in this sense, includes direct investments where the stake is less than 10% and hence does not qualify as FDI. As such, the number would include unlisted private equity and debt investments, for example. It also includes Chinese assets listed abroad.

The stock of foreign owned portfolio investments amount to about 60% of China's foreign exchange reserves, potentially limiting the country's ability to defend the exchange rate, should the need arise.

Assuming that the holders will be allowed to exit at will without facing capital account restrictions, these inflows increase the potential vulnerability of the exchange rate. The stock of foreign owned portfolio investments amount to about 60% of China's foreign exchange reserves, potentially limiting the country's ability to defend the exchange rate, should the need arise.

Chinese outbound flows of portfolio investment fall into three categories. Almost half the total of US$900 billion of cumulative flows have taken place under highly regulated schemes.[27] For example, China Stock Connect has enabled mainland flows into the Hong Kong stock market, which accounts for 45% of the total.[28] The remainder represents either minority stakes in overseas companies that do not qualify as FDI or purchases of debt or equity by semi-official institutions.

Figure 5 – China's overseas economic linkages and a comparison with the United States (all figures in US bn)

	China	China	Growth	USA	USA	Growth
	2009	2019	%	2009	2019	%
GDP	5,102	14,280	180%	14,449	21,433	48%
Exports goods & services	1,263	2,640	109%	1,582	2,515	59%
Merchandise exports	1,202	2,499	108%	1,056	1,432	36%
Imports goods & services	1,043	2,476	137%	1,978	3,125	58%
Merchandise imports	1,006	2,078	107%	1,605	2,567	60%
Total trade	**2,306**	**5,116**		**3,560**	**5,640**	
Trade to GDP ratio	45%	36%	-21%	25%	26%	7%
Inbound FDI flow	131	187	43%	161	351	118%
Inbound FDI stock	1,314	2,796	113%	3,618	10,486	190%
Outbound FDI flow	43	136	216%	312	188	-40%
Outbound FDI stock	263	2,236	750%	4,945	8,702	76%
Inbound portfolio flow	29	147	407%	357	177	-50%
Inbound portfolio stock	394	1,452	269%	10,463	21,565	106%
Outbound protfolio flow	2	89	4350%	357	-13	-104%
Outbound portfolio stock	243	657	170%	6,058	13,364	121%
Total overseas assets	3,454	7,846	127%	19,427	29,108	50%
Total overseas liabilties	2,150	5,546	158%	22,054	40,339	83%
Net international investment position	1,304	2,300	76%	-2,627	-11,231	328%
Overseas assets & liabilities to GDP	**110%**	**94%**		**287%**	**324%**	

The final linkage between China and the rest of the world is through the banking system. Chinese banks, in particular China Development Bank, have been aggressive lenders outside of China. According to the Bank for International Settlements (BIS) the Chinese banking system has cross border lending claims (assets) of US$2.6 trillion, an 80% increase since 2015. Meanwhile, foreign banks have US$2.4 trillion of claims on China.[29]

In summary, China's linkages with the global economy have grown in depth and range. The linkages have also been reoriented both by geography and purpose. At the geographical level, outbound lending and FDI have been directed more towards the developing world at the expense of Europe and North America. While the People's Bank of China share of overseas assets has fallen, this has been offset by state directed lending and state-led FDI.

The table above summarizes the relative size of the global linkages that have been discussed above and how they have evolved in the ten years running up to the pandemic (which has distorted recent data).

Clearly, China's global linkages have grown very fast – far faster than those of the United States with which we draw the comparison. However, relative to the growth and size of China's economy, the shrinking of linkages is very noticeable. This is true of both the trade and capital account linkages.

Furthermore, when it comes to capital account linkages, China has remained relatively autarkic, despite reforms aimed at opening up. Nevertheless, due to China's economic size, even a relatively autarkic China has significant linkages with the global economy. Consequently, DCS may have substantial global ramifications.

How will Dual Circulation Strategy change the size and nature of China's economic engagement with the world?

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

Ironically, the *extent* of China's overseas economic engagement going forward will likely be determined by the success or failure of the domestic dimension of Dual Circulation Strategy. As the Party becomes even more central to the economy and as goals such as common prosperity and national rejuvenation compete with economic expansion in the policymaking agenda, it is possible that China's overall economic growth will suffer, with spillover effects on the international dimension.

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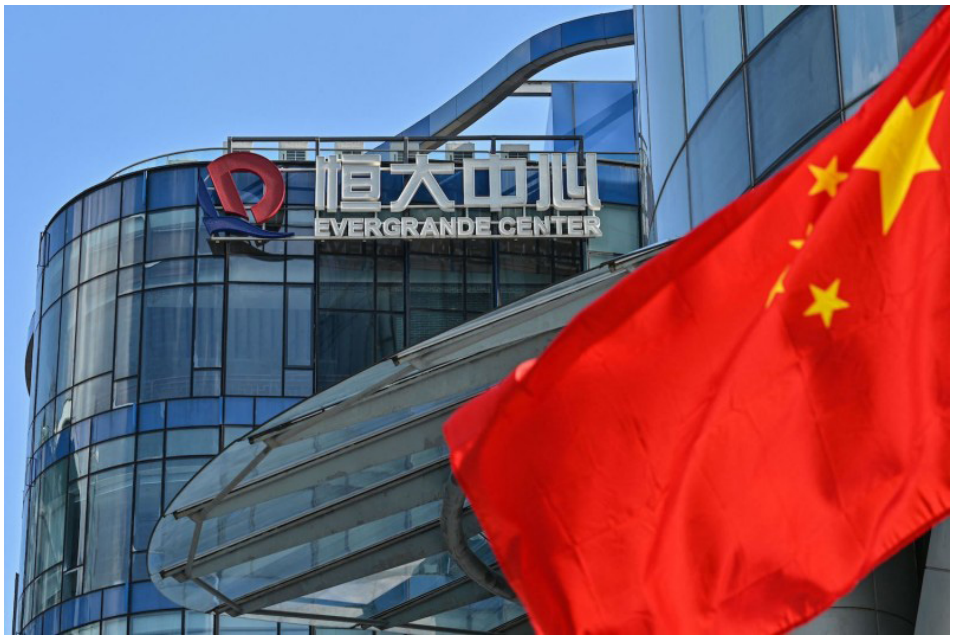
Some policies, such as the clamp down on monopolistic behaviour by technology companies, may well prove successful and stimulate growth. However, incentive structures and expectations have changed, and Party interference may dampen dynamism. If the private sector shrinks as a result, these policies may backfire spectacularly.

While it seems eminently sensible to encourage deleveraging in the property sector, policy makers are walking a tight rope when trying to deflate the property bubble. Their actions may cause serious ramifications for the real economy, given that, directly and indirectly, the real estate sector accounts for about 25 to 28% of GDP.[30]

In addition to property sector deleveraging, and the dampening impact of policy on private sector entrepreneurship, China's working age population is peaking.



While it seems eminently sensible to encourage deleveraging in the property sector, the actions of Chinese policymakers may cause serious ramifications for the real economy.

Furthermore, as explained in our previous report on Dual Circulation, capital output ratios continue to decline as over-investment reduces incremental returns on capital.

Dual Circulation's international objectives

China's deepening economic entanglement with the global economy has been driven by its spectacular growth and the prospect of future growth. If that growth reverses, it is highly likely that the external economic linkages will shrink too as China becomes a less attractive destination for capital.

The international dimension to DCS, however, will likely determine the nature of the changes to international linkages.

The international dimension to DCS has five potential objectives. First, to secure China's import needs, particularly to ensure energy, water, and food security through diversified supply. In addition, China needs to secure supplies of key minerals used in advanced technology and the components and technology that will go into its advanced manufacturing as it moves up the value chain.

DCS will likely entail a continued reorientation of China's trade patterns to "the economic south" and its neighboring countries. This will likely come at a cost. In some cases, this will represent a politically expedient source of supply rather than necessarily the best value source of supply.

Continuation of supply can further be secured by trading with likeminded countries or those for whom good relations with China are too important to disrupt. Thus, DCS will likely entail a continued reorientation of China's trade patterns to "the economic south" and its neighboring countries.

This will likely come at a cost. In some cases, this will represent a politically expedient source of supply rather than necessarily the best value source of supply. Energy and minerals, for example, are globally traded commodities with deep, liquid, and transparent markets. Welfare losses stemming from politically motivated preferential purchases are therefore very transparent.

Secondly, DCS aims to open new markets for China's MNCs and exporters. The Belt and Road initiative is the main plank of policy aimed at this objective. To some extent, outbound FDI and cross border lending patterns reflect this goal and are likely to continue to do so, but with perhaps more intensity. Where subsidies are used to win business, there is a cost to the domestic Chinese economy and a distortion in the allocation of resources.

A third objective is to achieve "the China dream" or national rejuvenation, which involves increasing China's centrality in the world. In this framework, economic dependencies bolster Beijing's power and ensure acquiescence to its own interpretation of world order. The role of trade and FDI is augmented by China-coordinated lending from multilateral development banks and by cross border lending from domestic institutions with an international remit, such as China Development Bank. All these elements have a role.

So do regional trade arrangements. For example, dominance of the Regional Comprehensive Economic Partnership (RCEP), where China makes up half of the bloc's aggregate GDP, could enable a reorientation of trade patterns to China's advantage. The regionalization of the renminbi in its digital form brings seigniorage benefits to China and ties regional players more deeply into its financial system.

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Such geopolitical ambitions could prove enormously expensive. In a country with an average per capita GDP of just US$10,000 per year, such a burden will potentially prove unpopular if the costs become sufficiently transparent.[31] Furthermore, the G7 and others are responding with their own programs to push back against China. This could benefit recipient countries but could also increase the costs of soft power projection.

A potential fourth objective is to exclude – or obtain the potential to exclude – other global powers from the Indo-Pacific economy, or at least to make their presence there highly conditional and subsidiary to Beijing's power. The dominance of Chinese SOEs in the construction sector in Asia – achieved through price undercutting as a result of China's domestic excess capacity in construction resources and the use of state subsidies – is a good example of these efforts to preclude international competition.

Lastly, in terms of technology and standard setting, China aims to acquire or develop leadership in advanced technologies and establish its own standards at a global level. While the policies directed towards this objective are largely domestic, there is clearly an international dimension too. Acquisition through FDI is one route to achieve this goal. Academic exchange is another. China is likely to engage more aggressively in multilateral standards-setting organizations and utilize its economic strength to help obtain acceptance of its standards.

The costs of technological self-sufficiency will be enormous. It entails large state spending in the hope of producing the innovation necessary to replicate (and then surpass) existing expertise. This shift to import substitution and away from trade and specialization is a high-risk strategy.

Arguably, this path is one China has been forced to embark on as the rest of the world pushes back against its aggressive accumulation of intellectual property. In the geopolitical climate created by China's rise and the methods of its ascent, self-sufficiency has become increasingly necessary.

Arguably, this path is one China has been forced to embark on as the rest of the world pushes back against its aggressive accumulation of intellectual property. In the geopolitical climate created by China's rise and the methods of its ascent, self-sufficiency has become increasingly necessary. Failure to achieve this goal may result in China being isolated from cutting edge technology.

It could be argued that the international dimension of DCS marks a simple continuation of policies that date back many years. Since the announcement of the BRI, however, Beijing's politicization of its international economic relations has intensified and become more overt. As its intentions become more apparent, China faces increasing resistance, creating a vicious cycle of ever-increasing tension. As a result, we can expect significant ramifications at the macroeconomic level.

In assessing the ramifications, it is important to distinguish between those intended by DCS and those that are not. Since the election of former US President Donald Trump and under the administration of his successor Joe Biden, a remarkable change in attitude towards China has taken place among much of the international community. DCS is being implemented not in isolation but in parallel with the global response.

The macroeconomic ramifications of DCS

The exchange rate is the most obvious macroeconomic variable that links China with the global economy. While no longer technically fixed, it is highly managed and tightly controlled. Capital controls have been the key instrument in enabling China to choose its exchange rate and run an independent monetary policy at the same time.

Historically, this policy has delivered growth and afforded freedom of policy action. Hence current capital account liberalization could be reversed if necessary. It also calls into question the degree to which China will further open its capital account. Indeed, the pace of outbound liberalization and even the periodic reversal of reforms has been closely linked to pressures on the exchange rate, suggesting that reforms are highly contingent.

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Hence, when the regulatory environment allows, exchange rate stability coupled with China's growth may be a major driver behind the deepening of the capital account economic linkages between China and the rest of the world. The question then arises: Will DCS or any element of DCS lead to a new exchange rate regime that would shrink or grow these capital account linkages?

As China's capital account has opened in recent years, portfolio flows have accelerated and provided support for the RMB. The desire to stamp out property speculation and improve the affordability of housing to the masses is part of the Common Prosperity drive.[32] Currently, the key policy instrument is the Three Red Lines policy.[33] Because real estate accounts for such a large portion of GDP, the desired deleveraging of developers to build resilience into the financial system is likely to be highly deflationary in China. Low interest rates and easier monetary policy are likely outcomes. Combined with the diminished economic growth that is likely to ensue, this could act as a force to reverse capital account inflows.

Should this happen, we could be looking at the prospect of severe downward pressure on the RMB, an unintended consequence of DCS policies.

Should RMB devaluation come to pass, the global trading system will face increasing political pressure. Global trade has become highly unbalanced. The manufacturing economies of Germany, Japan, and China have run a near perennial

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current account surplus of significant size.[34] The controlled RMB exchange rate has been a barrier to allowing the international adjustment mechanism to work. Should the RMB weaken, such a move may spark a renewed round of trade friction and countervailing measures that would further fragment the global trading system. Such policies would be designed to thwart the potential spread of a weaker RMB's deflationary impact.

The DCS policy framework amounts to the elevation of politics over economics in decision making. Income distribution is becoming more important than income growth. Resilience in supply is becoming more important than efficiency of supply. As cost pressures mount, such decisions will likely lead to inflation.

Thus, the world may face two diametrically opposed forces gathering momentum. On the one hand, deflationary pressure stemming from significantly slower growth in China and potential RMB weakening may put downward pressure on Chinese export prices while diminishing the demand for Chinese imports. On the other hand, the global economy may continue to bifurcate and become more politicized, exacerbating the additional costs and inefficiencies that follow.

Conclusion

The international dimension to DCS could be interpreted as a more vigorous implementation of policies that have been in place for a while. However, the domestic dimension marks a meaningful deviation from the more liberal economic policies of the past. The domestic DCS policy direction will have a marked impact on the extent of China's international linkages, while the international policies will further shape their nature.

Potentially slower Chinese growth will de-emphasize China among the foreign business community and weaken investment and trade linkages.

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on the RMB and result in a greater need to "dump" excess capacity overseas, in contrast to the stated aims of DCS. In turn, this will put unwelcome pressure on an already strained framework for multilateral trade.

Such tension will be rising at a time when the geopolitical ramifications of the linkages between China's capital account and the global economy have become increasingly evident. Consequently, this may add fuel to the bifurcation of the global economy along ideological lines.

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About the author

Stewart Paterson is a Research Fellow at the Hinrich Foundation and the author of *China, Trade and Power: Why the West's Economic Engagement Has Failed*. He spent 25 years in capital markets as an equity researcher, strategist and fund manager. Paterson has worked in London, Mumbai, Hong Kong and Singapore in senior roles with Credit Suisse, Credit Suisse First Boston, CLSA and more recently, as a Partner and Portfolio Manager of Tiburon Partners LLP.

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