12 October 2020

China's new five-year plan

One growth engine is not enough

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Economics – China

- A gloomy global outlook post COVID-19 is prompting Beijing to prioritise domestic demand and innovation to drive growth
- Yet an internal engine is not enough; expanding trade and investment is a must for China to climb the technology ladder
- Levelling the playing field to close trade deals with the EU and in Asia is crucial to keeping the engines humming

Qu Hongbin
Co-Head Asian Economics Research, Chief China Economist
The Hongkong and Shanghai Banking Corporation Limited

Erin Xin
Economist, Greater China
The Hongkong and Shanghai Banking Corporation Limited

Shanshan Song
Economist, Greater China
The Hongkong and Shanghai Banking Corporation Limited

Madhurima Nag
Associate
Bangalore

China's post-pandemic economic recovery is well under way; however, the prospects for the global economy look gloomy amidst the lasting impact of COVID-19, rising protectionism and China-US tensions. These are prompting Beijing's policymakers to prioritise domestic demand and innovation to drive growth in the years ahead. We expect the five-year plan, covering 2021-25, to be outlined later this month and to lay out the following policy agenda:

- Speed up household registration (*hukou*) reform to give the roughly 290m rural migrant workers access to urban social welfare. This will likely lower their precautionary savings, which are double the average of urban households, and, in turn, lift their spending, leading to a 0.6ppt boost to GDP per year.
- Accelerate land reform to allow rural households to have a bigger share of the gains from land revaluation, which will likely lift the income of 551m rural consumers and, as such, consumption, leading to a 0.4ppt boost to GDP per year.
- Lower the corporate tax burden, especially the high social security taxes, which account for 78% of a company's taxes, to revitalise business investment.
- Deepen financial reforms and liberalisation, while expanding the role of the capital markets to reduce the misallocation of credit.
- Develop major city clusters to serve as the main hubs for high-tech industries and innovation.
- Boost investment in R&D to make breakthroughs in key technologies, particularly in the digital economy, and expand the innovation ecosystem.

That said, the domestic growth engine alone won't be enough. Expanding international trade and investment is also a must for China to narrow its substantial technology gap with developed economies. To counter the headwinds, including rising protectionism, we expect Beijing to take concrete action to level the playing field, strengthen intellectual property protection, and close key trade deals with the EU and Asian countries. The further opening up of China's domestic markets – the world's largest for products ranging from cars to commodities and chips – can go a long way to luring more foreign companies, including US companies, to China in the years ahead.

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Decoding the new economic strategy

- All eyes are turning to the next five-year plan
- We lay out the key policy priorities
- Domestic markets won't be the only focus – one growth engine is not enough

"Dual circulation" to drive the next five years

Geopolitical tensions between the US and China are set to continue

China's Fifth Party Plenum is scheduled to take place on 26-29 October 2020. All eyes will be on the 14th Five-year Plan, which lays out China's social and economic strategy. As China plans its road map, there is increased uncertainty as the global recovery remains tenuous. Meanwhile, elevated geopolitical tensions between the US and China are set to continue. To help counter the increased external uncertainty, there has been a call for a "dual circulation" strategy. This will focus on strong domestic independent growth – "internal circulation" as it is described by policymakers – to offset the still weak global backdrop. The emphasis will be on moving up the value chain. However, domestic markets will not be the only focus. "External circulation" through increased international engagement will help China to continue its productivity growth through an increase in innovation and access to technology.

In this report, we lay out the key policy priorities in the next five-year plan. Driving increased domestic demand through structural reforms to lift domestic consumption by both urban and rural households will help drive domestic consumption, while a boost from private investment growth will further support jobs growth and feed back into consumption; however, an economy running solely on a domestic engine will not be enough. The external engine is just as important for China to continue improving its labour productivity and catch up with other developed economies through deeper collaboration and increased technology gains.

Unleashing domestic demand through structural reforms

The COVID-19 shock has hit the global economy hard

The COVID-19 shock has hit the global economy hard. Strengthening domestic demand from consumption and investment will be a key growth driver. In this section, we take a look at how China is likely to use structural reforms to unlock both urban and rural consumption, as well as boost private investment to spur domestic activity.

Urban household registration reform to continue

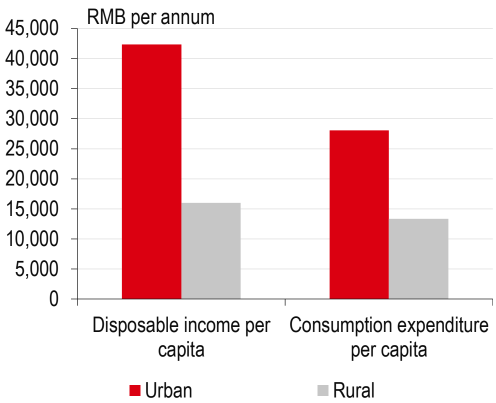
China has become an increasingly urbanised society, with around 60% of the population now living in cities, based on the general population; however, not all urban residents have a *hukou*. Accounting for registered households, the urbanisation rate was 44.4% in 2019, just shy of the 13th Five-year Plan's target of 45%. Urban households enjoy more job opportunities and higher pay, with over 2.6 times higher per capita disposable income than their rural counterparts, providing a large boost in income to migrant workers who enter cities (see Chart 1). As of 2019, over 90m migrant workers have received urban household registrations.

Reforms to help migrant workers obtain a *hukou* will give them more opportunities

However, with a total of 291m migrants as of end-2019, this still leaves a sizeable population, who continue to face a number of hurdles due to lack of a *hukou*. Further reforms to help migrant workers obtain a *hukou* will provide more opportunities for migrant households to buy homes, obtain stable job contracts, and receive standard social security benefits (including pensions, education, health care, worker injury insurance, and maternity benefits). Comparatively, migrant workers have lower participation rates in most social protection programmes (see Chart 2). For example, based on the latest available data for migrant workers, since 2014, only 15.7% of migrant workers had pension benefits compared with over 60% of the general population.

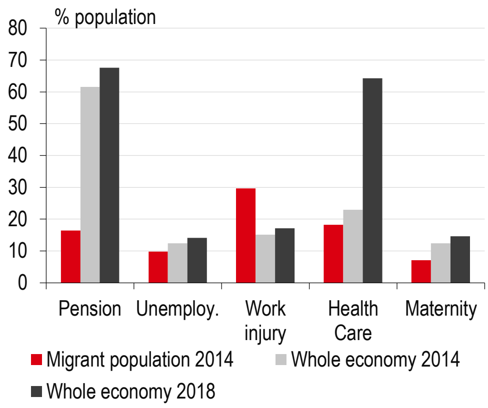
Without social protection, migrant households are induced to save at higher rates to make up for the shortfall in benefits. Increasing the scope of inclusion in social protection will increase stability for these households and help reduce their precautionary savings, as well as costs, thereby likely increasing their consumption.

Chart 1. The urban population has 2.6x more disposable income than the rural population



Source: CEIC, HSBC

Chart 2. Migrant workers have lower participation rates in most social security benefits



Source: Wind, HSBC

Shanghai has lifted some restrictions

Recent developments in *hukou* reform include the elimination of barriers to registrations in small- and medium-sized cities with a population of under 3m and the lifting of restrictions for cities with a population of 3-5m, based on the National Development and Reform Committee's directive in April 2019. On 23 September 2020, Shanghai lifted some restrictions by allowing graduates from the four leading universities in the city to obtain *hukous*. However, despite progress being made, further reforms are still needed to help support the migrant population.

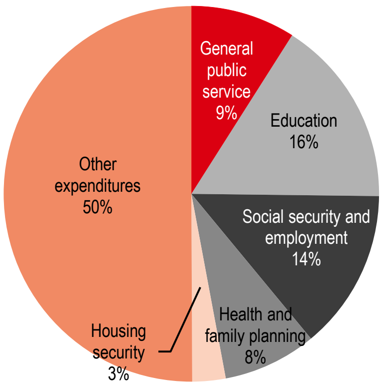
Given the relatively large gap in social protection coverage, one solution would be to expand the reach of public service benefits to all urban residents, regardless of their *hukou* status. This would help address the costs borne by the migrant population and encourage them to unleash their pent-up savings. The second solution would be to continue relaxing *hukou* restrictions to make it easier for migrant workers to change their registration status, if needed, as well as continued relaxation of restrictions in larger cities.

With increased public benefits coverage, this increases the cost burden on local governments, as the bulk of social security benefits are borne by local governments rather than the central government. In addition, there is also a disproportionate distribution of tax revenue between the two. Local governments accounted for over 85% of total government expenditure but only received 53% of total tax revenue in 2019 (see Chart 4).

A more balanced distribution of funding will help relieve the cost burden

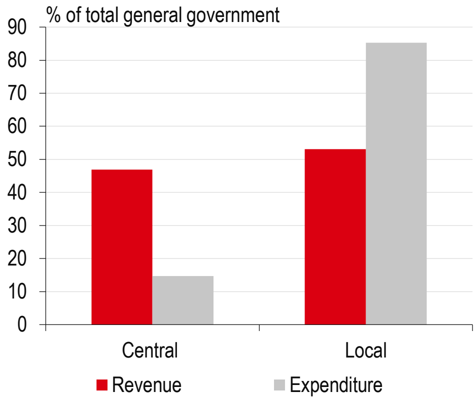
Instead, local governments must rely on central government subsidy transfers and local government debt issuance to make up for the shortfall. Public benefits borne by local governments accounted for a significant proportion of total local government expenditure, with 41% of the expenditure going towards education, social security, employment, health care, and housing security benefits, in 2019 (see Chart 3). Without further measures to lessen the burden on local governments, their ability to extend welfare benefits or to be incentivised to accelerate household reform is likely to be reduced. A more balanced distribution of funding through transfers of central government funds to local governments will help relieve the cost burden and allow them to expand coverage of social security benefits to residents, including more migrant households.

Chart 3. Local government expenditure breakdown in 2019



Source: CEIC, HSBC

Chart 4. Local governments account for over 85% of total government expenditure



Source: CEIC, HSBC. Note: Central government expenditure omits transfer subsidies to local governments, which are instead reflected in local government expenditures, else there will be double counting.

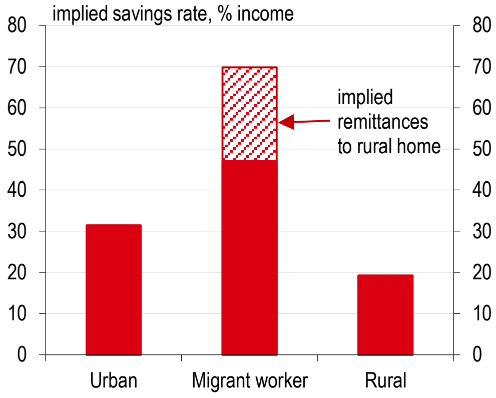
Unlocking a 0.6ppt GDP boost per year from *hukou* reform

What would be the potential economic benefit of further *hukou* reform? A simple "back-of-the-envelope" estimation – taking the average income and consumption levels to get an implied savings rate – suggests that migrant workers have more than double the savings rate of the urban workers, at c70% versus c30% (see Chart 5). Part of this higher savings rate is due to remittances sent to migrant workers' rural homes and higher precautionary savings from a lack of social security benefits.

Migrant workers send around 22% of their income to their rural homes

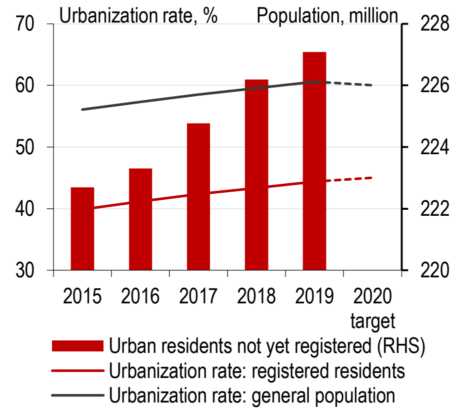
While a country-wide average remittance rate is not available, city surveys from Hainan show that migrant workers send back roughly one-third of their implied savings to their rural homes. Applying this to our economy-wide scenario suggests migrant workers send around 22% of their income to their rural homes, but this would still leave them with a significantly elevated savings rate of almost 50% of their income. Further *hukou* reform will likely bring the migrant savings rate closer the urban average savings rate, or a difference of roughly 16ppt of income will likely be unlocked from precautionary savings. Assuming China sets a similar urbanisation target of 5% for the 14th Five-year Plan and all of these new urbanites are able to receive a *hukou*, this would mean an additional 70m migrant workers receiving their *hukous*. In all, this could result in additional consumption of roughly RMB584bn per year (based on 2019 average migrant worker salaries), or a 0.6ppt boost to GDP per year.

Chart 5. Migrant workers have high levels of precautionary savings



Source: CEIC, NBS, HSBC. Note: Savings rate = (Income - consumption) / income; The implied migrant savings rate includes remittances to rural home.

Chart 6. Increased urbanisation can help lift domestic consumption



Source: Wind, HSBC

Rural land reform will likely increase flexibility for rural households

Roughly 40% of the population still reside in rural areas

The other side of the domestic consumption picture lies in tapping into rural household consumption through further land reform. While the trend of urbanisation has meant a declining share of rural residents relative to the total population, roughly 40% of the population, or 551m people, at the end of 2019 still reside in rural areas. Rural households have a significant percentage of their wealth locked in land use rights (which are collectively owned), which still face onerous restrictions in terms of transfer and in effect limit the mobility of rural households. Further reforms to integrate both urban and rural land markets and allow market forces to play a larger role in the determination of prices and the distribution of land rights will create efficiencies through the redistribution of wealth to rural households, as well as help increase urban-rural mobility. The urban and rural land markets are separated by different legal structures, which reduces the ease of transfer between the two markets and leads to price asymmetries. Further reform to unify the urban and rural markets will allow for more efficiency and flexibility.

Currently, rural land must first be acquired by the government to be converted to land for construction. This presents inefficiencies. Land prices offered by the government are often lower than those on the open market, effectively providing less monetary benefits to rural collective land owners. Further reform is needed to allow for more market-driven dynamics in the determination of land prices, which would help provide larger returns for rural collective land owners. Additional streamlining of the approval process, which still has a complex structure requiring multiple layers of consent to convert rural land to construction land, will also help make land use transfers more efficient.

The rules were relaxed in April 2020

Additionally, when governments acquire rural collectively-owned land for construction, they are required to develop an equal size of arable land. Previous limitations restricted new arable land from being developed in the same province, but the rules were relaxed on 9 April 2020, which allowed for more even distribution of development across provinces. This more flexible approach will allow areas with rich land resources (e.g. western and inland regions) to help meet higher demand in more urban developed areas (e.g. coastal regions) and increase the mobility of rural land rights owners. However, there are still physical limitations on the transfer of land between provinces and further improvements in the secondary markets for the sale of arable land rights will help increase the efficiency of land markets.

Rural households have a higher level of sensitivity to changes in income

Additional reforms to help redistribute wealth (so that more of the proceeds from land sales go directly to farmers, instead of mostly remaining with the rural collective) will help to increase the income of farmers, allowing for higher spending. Anecdotal evidence suggests that, while rural collectives are able to receive the bulk of the proceeds from land sales, these are not being passed on directly to farmers (*FT*, 25 November 2019). Moreover, rural households tend to have a higher sensitivity to income changes, or a higher marginal propensity to consume of 0.85 versus 0.78 for urban households for each additional unit of income. This means a boost to rural household incomes can help unlock higher levels of consumption and, as such, support further domestic demand growth.

Revenue from the transfer of land use rights to the government totalled RMB7.3trn in 2019. Of this, it is estimated that less than 7% was directed to rural areas, or less than RMB500bn. Moreover, the amount going directly to farmers was likely far lower than this, based on anecdotal evidence. If, with further land reform, the amount of revenue directed to rural areas can be lifted to 20% of land usage revenue and an additional 30% of the rural land proceeds can be directly passed on to farmers, then this would lead to an estimated boost of RMB435bn in income for rural households. Applying the rural household's marginal propensity to consume of 0.85, this would then translate into an additional RMB370bn of spending, or a 0.4ppt boost to GDP per year.

Boosting private investment

Supporting domestic demand will need robust growth in investment

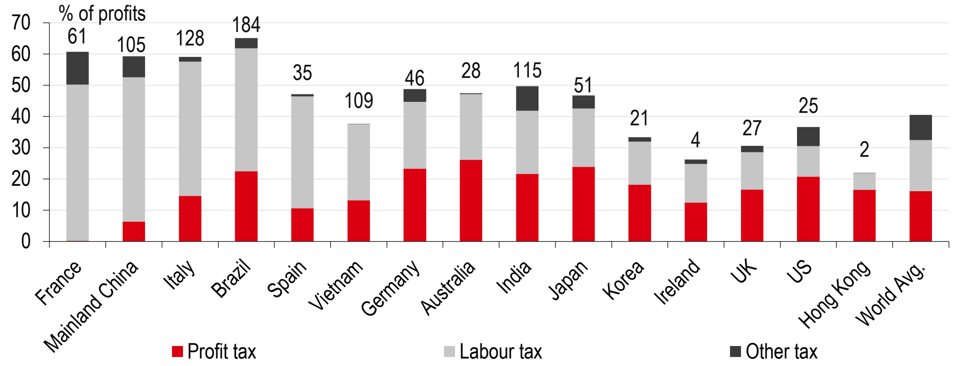
Supporting domestic demand will also need robust growth in investment, particularly from the private sector, which accounts for over 75% of total fixed asset investment. Private investment has also slowed in the recent years, with manufacturing investment, the bulk of which is driven by private investment spending, falling to 3.1% in 2019 from over double-digit growth in 2014. This means it is high time to revitalise private sector capex to increase industrial upgrading. Aside from the benefits of increased spending through investment, expansion of private sector development will mean support for higher quality jobs and increased wages as the private sector accounts for over 85% of urban employment.

Lowering the corporate tax burden

Companies in China face some of the highest taxes in the world, impeding their ability to invest (see Chart 7). China has implemented VAT reforms in 2019, including lowering the VAT rate – the higher end of the VAT rate was lowered to 13% from 16% – as well as simplifying the structure by reducing the number of tax brackets to three from four. Yet there is still scope to do more as the bulk of the corporate tax burden lies in social security contributions. China's labour taxes accounted for 78% of the total corporate tax burden in 2018, based on data from the World Bank's *Paying Taxes 2020* report. Further reforms to help lower the social security tax would help reduce firms' costs and encourage spending and investment.

This year, in response to the pandemic, tax reductions have been implemented for smaller firms. They include VAT waivers and reductions for smaller firms, resulting in 92% of small-scale taxpayers (50m total) receiving waivers and the remaining 8% seeing a reduced VAT rate of 1%, down from the usual 3% (*China Daily*, 7 October 2020). Additionally, micro-, small- and medium-sized firms have been able to waive social security contributions to pension, unemployment, and worker injury insurance schemes, which were extended through the rest of the fiscal year during the 2020 NPC meeting in May. In all, the continued reduction in taxes, particularly social security contributions, as well as fee reductions can lead to cost savings for corporations, further encouraging private investment and spending.

Chart 7. China's corporate tax burden stems from high labour taxes



Source: World Bank Paying Taxes 2020, HSBC. Note: Ranking for ease of paying taxes denoted above bar. Tax data are from 2018.

Make tax cuts smarter and increasing tax compliance

In addition to reducing social security contributions, introducing more targeted measures to encourage certain types of spending, such as R&D investment through tax breaks, will also help to boost productivity. China also has a complicated process for paying taxes, with a global ranking of 105 out of 189 economies for the ease of paying taxes. Therefore, simplifying the tax payment process can help increase the rate of compliance, which would help boost government revenue.

Lowering barriers to entry for services sector to accelerate private investment

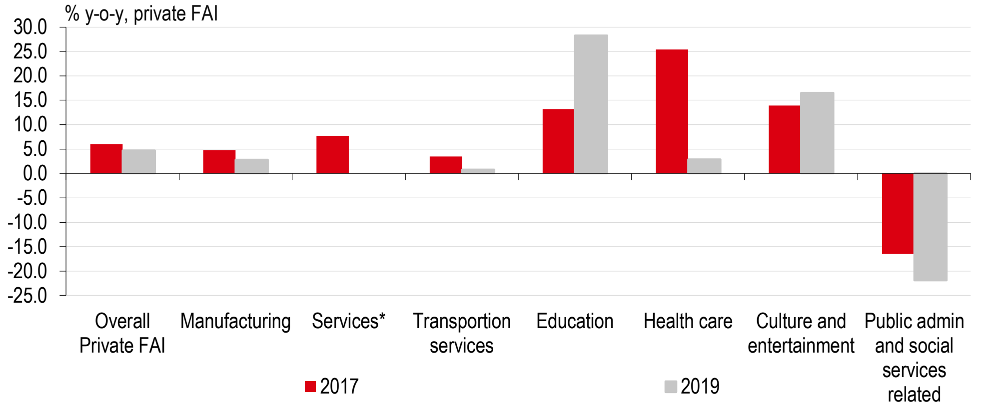
There are still areas that remain restricted for the private sector

China has increasingly turned towards a services-oriented economy, with the tertiary sector accounting for over 55% of GDP in 2019. However, there are still areas that remain restricted for private sector development. As the private sector is relatively more efficient, further reforms to help open up these services sectors can lift productivity and spur development, as well as lead to beneficial spill-over effects into auxiliary industries.

In this regard, China is likely to continue reducing its nationwide market access 'negative list' – the list that prohibits entry or places additional restrictions on specified sectors. Since being piloted in 2016 with 328 items, the list has been reduced substantially. When rolled out nationwide in 2018, there were 151 items, a 54% reduction from the initial pilot. The list was reduced again in 2019 to 131 items, of which over half were in the services sector. Key areas that may be loosened further include financial services, transportation services, telecommunications, social services, and public utilities.

Services sector investment has historically accounted for roughly two-thirds of total private investment. It has grown at a faster pace than private investment within the industrial sector, which has slowed, with manufacturing private investment reaching only 2.8% y-o-y in 2019 (see Chart 8). However, certain sectors like transportation and social services have been relatively weaker; therefore, further loosening the restrictions can help lift private investment in these sectors.

Chart 8. Private investment in services tends to pick up faster than in manufacturing

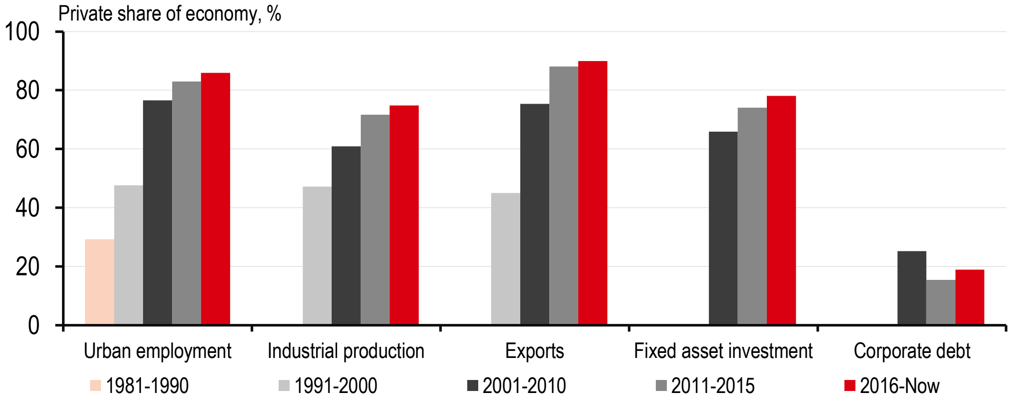


Source: CEIC, HSBC. Note: *Services private FAI data was discontinued after 2017.

Structural reforms to lift productivity growth

In addition to boosting domestic demand, there are still areas in which further reforms can be implemented to help tap into further productivity growth, especially to address the asymmetries between the private and public sectors. The private sector accounts for over 60% of GDP, 70% of innovation, 85% of urban employment but receives less than 30% of the total credit. Further reforms to open roadblocks facing private firms' access to financing will help lift productivity and economic activity (see Chart 9).

Chart 9. The private sector is a larger driver of growth but receives a small share of credit



Source: CEIC, HSBC

Unblocking the financing channels for SMEs to address credit misallocation
Smaller firms have had longstanding difficulties in receiving preferential financing through the traditional banking system, given the implicit preference of directing credit to SOEs. This leads to higher financing costs and lower credit growth for SMEs. Financial reform to open up more channels of financing for SMEs will help boost credit growth for the private sector.

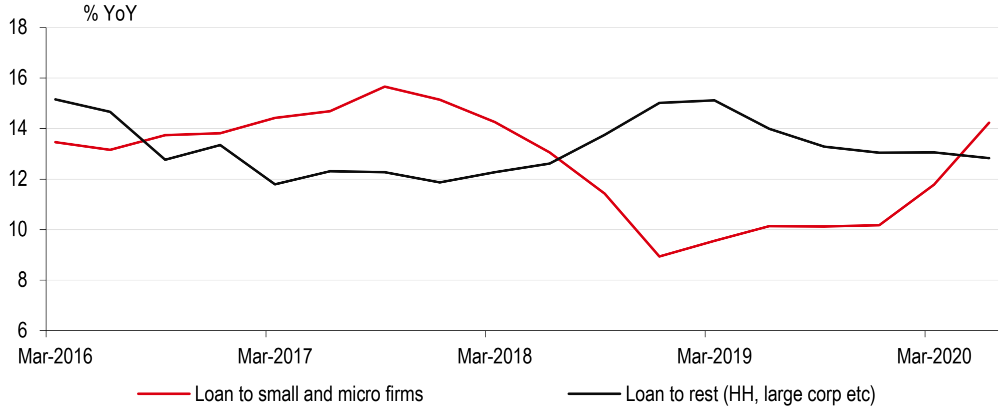
Improving access to equity financing through IPO registration streamlining
China has set up targeted equity markets through ChiNext (opened in Shenzhen in October 2009) and the Star Market (opened in Shanghai in July 2019). They have made it easier for technology firms to get access to equity financing as the restrictions for listing are less stringent than on the standard markets. Further improvements through registration-based IPO listings, which are currently being piloted on ChiNext, will help speed up the approval time and increase the transparency of the review process.

Smaller banks face more difficulties in terms of recapitalisation

Supporting smaller banks capital replenishment

Small- and medium-sized banks face more difficulties with regards to recapitalisation due to their size. They have also faced a relatively higher NPL ratio as they tend to finance private SMEs, which are more sensitive to economic shocks and business cycles. Reforms to allow these smaller banks to raise funding through various channels (e.g. through local government bonds) will help them to provide credit support to underfunded SMEs. Further reforms to streamline and better regulate mergers and acquisitions amongst banks, particularly smaller banks, will help allow more bank M&A transactions. This can spread out financial risk, replenish bank capital, and improve corporate governance, enhancing the efficiency of issuing credit to the private sector.

Chart 10. Financial reforms should help increase lending to small- and micro-sized firms



Source: CEIC, HSBC

Further development of city clusters

Going hand in hand with increased urbanisation from both *hukou* reform and rural land reform is the further development of city clusters. Despite the myriad of benefits from increased urbanisation, there also numerous problems, especially in large cities (population above 5m). Increasing housing prices, high living costs, traffic congestion, and deteriorating water and air quality can lower the quality of life. Manufacturing and service businesses also face the dilemma of choosing between operating in a city to reduce costs or being away from their supply chains.

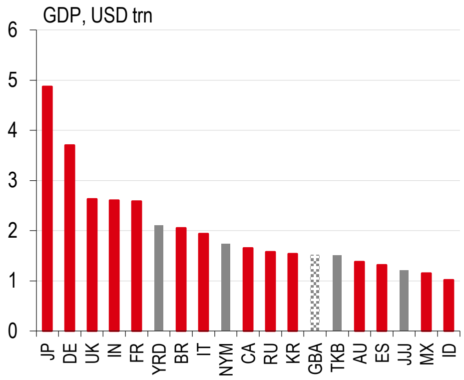
All these issues increasingly threaten the sustainable development of cities. City clusters provide a way to solve the problems, while promoting urbanisation. The promotion of city clusters can help alleviate the high population burden in tier 1 cities such as Beijing and Shanghai. This will also increase connectivity with peripheral cluster cities, boost urbanisation rates, and help increase incomes and unlock spending. The three largest city clusters – Jing Jin Ji, Yangtze River Delta, and the Greater Bay Area – have a total population of over 300m residents.

As many policies are determined at the local level, streamlining policies at a broader regional level would allow greater mobility for urban workers, as well as make it easier for businesses to operate regionally. Not only will increased urban mobility lead to further support of income levels and boost consumption, but there will also be increased efficiency gains from the development of regional clusters. Network effects mean that larger pools of labour and operating companies are better able to fulfil market needs, leading to a positive feedback loop of economic activity.

Regional infrastructure projects lower transport costs

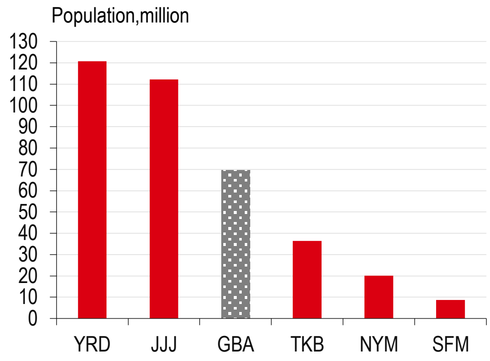
The development of regional infrastructure projects also leads to lower transportation costs, as well as increased spill-over benefits, which would lead to more efficiency and productivity gains such as time savings and increased capacity for technology development and innovation. In addition, increased urbanisation from city clusters accompanied with *hukou* and rural land reforms will help further increase urban-rural mobility. A full set of rules and regulations should also be developed to provide a legal foundation to coordinate the responsibilities between rural and urban local governments, as well as between local-central governments to help streamline the development of these regions.

Chart 11. GDP size, 2017[1]



Source: CEIC, IMF, HSBC

Chart 12. Population, 2017[1]



Source: CEIC, HSBC

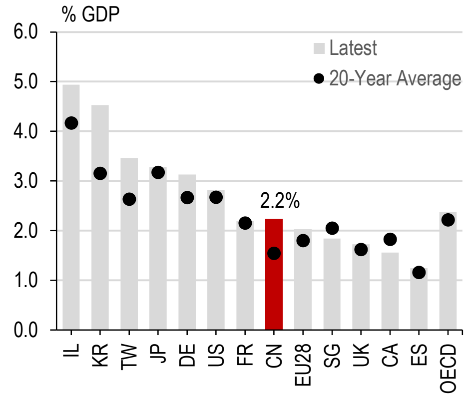
Boosting R&D to support indigenous innovation

The escalation of tensions between the US and China has highlighted the increased risks of disruptions due to highly globalised supply chains, particularly for high-tech firms. The case of Huawei showed that US restrictions on exports of technology and materials could extend beyond just predominantly US-produced goods. The US Department of Commerce announced in May 2020 that any firm, using US-origin technology to produce goods, would need to obtain a licence to export to Huawei. This effectively curtailed foreign exporters' ability to supply key components (i.e. semiconductor chips), given the high levels of specialisation and integration in global supply chains.

To hedge against possible future restrictions in high-tech areas, China will likely support key strategic industries and increase R&D spending to support domestic innovation and promote higher levels of self-sufficiency. We expect high-tech industries such as semiconductor development, telecommunications (5G), big data and AI to receive more focused policy support. For example, China has already implemented large-scale funding for its semiconductor development fund – RMB138.7bn in 2014 for Phase 1 and RMB204bn in 2019 for Phase 2.

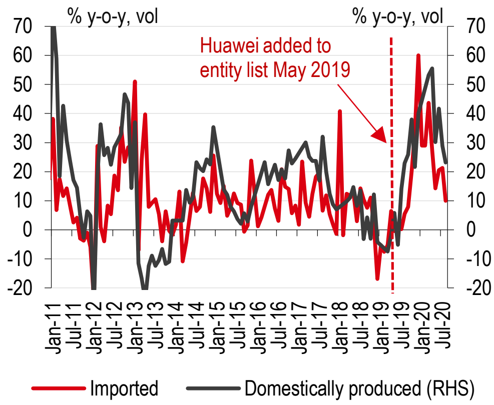
[1] The above abbreviations are ISO country codes, apart from the following: YRD – Yangtze River Delta, NYM – New York Metropolitan Area, TKB – Tokyo Bay Area, GBA – The Greater Bay Area, JJJ – Jing-Jin-Ji, SFM – San Francisco Bay Area.

Chart 13. China's R&D spending is set to accelerate



Source: OECD, CEIC, HSBC. Data from 2018, except for China, which are from 2019. IL – Israel, KR – Korea, TW – Taiwan, JP – Japan, DE – Germany, US – USA, FR – France, CN – Mainland China, EU28 – EU, SG – Singapore, UK – United Kingdom, CA – Canada, ES – Spain, OECD – OECD.

Chart 14. Domestic semiconductor development is picking up

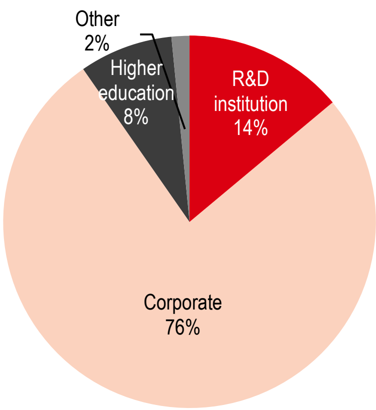


Source: CEIC, HSBC

R&D spending to increase to 3% of GDP

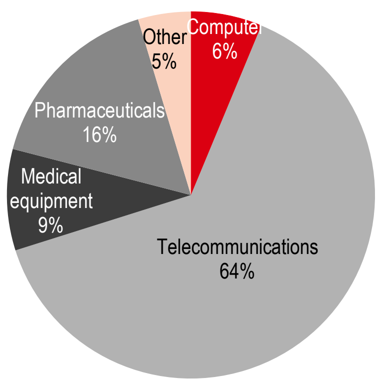
The 13th Five-year Plan included a target to increase R&D spending to 2.5% of GDP by 2020; however, by 2019, it had reached only 2.2% (see Chart 13). Given the US-China trade tensions, we expect the 14th Five-year Plan to raise the target to roughly 3% of GDP, putting China well above the OECD average R&D spending of 2.4% of GDP. We expect to see more R&D spending on think tanks, research institutions, and higher educational institutions. New infrastructure (e.g. 5G, electric vehicle (EV) charging stations, AI, etc.) will also support further development in innovation in high-tech fields. Meanwhile, as over 75% of R&D spending stems from firms, we think a smarter tax policy will play a large role in incentivising investment through tax breaks for R&D investment.

Chart 15. R&D spending breakdown in 2019



Source: CEIC, HSBC

Chart 16. High-tech R&D spending breakdown in 2018



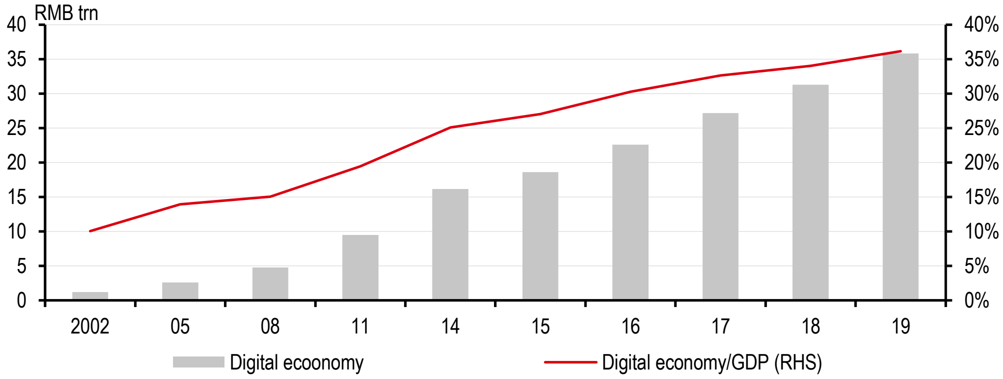
Source: CEIC, HSBC

The digital economy will be in focus, with new infrastructure set to pick up

China will continue to develop its digital economy and the pace of digitalisation is set to accelerate. The size of China's digital economy has grown rapidly and accounted for around 35% of GDP in 2019, according to the *China Academy of Information and Communication Technology's* (CAICT) broad definition (see Chart 17).[2] Moreover, 64% of all high-tech R&D spending went to telecommunications development in 2018, highlighting the outsized focus on digital development (see Chart 16).

Previously, infrastructure development focused on building roads and airports. We now expect new infrastructure to have a larger role in public spending, with a focus on 5G and other areas of information and communication technologies (ICT) such as AI, EV infrastructure, and big data. The strengthening of intellectual property (IP) rights will also help foster healthier competition and drive innovation. In all, this will help increase China's innovation capacity in related high-tech fields and amplify the positive spill-over effect on productivity in the years ahead.

Chart 17: China's digital economy now accounts for around 35% of GDP



Source: China Academy of Information and Communication Technology (CAICT), HSBC

Engaging the external engine

"External circulation" is needed for China to climb the technology ladder

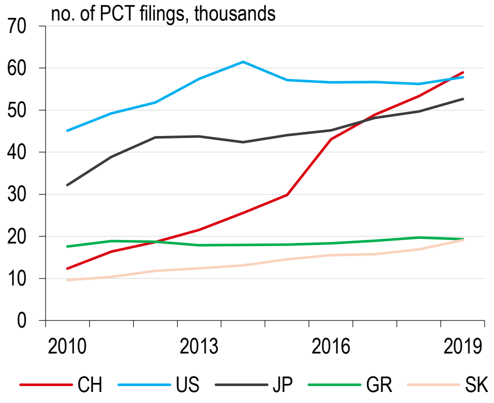
While developing the domestic market is one side of the growth coin, it alone will not be enough. Further engagement with other economies through deeper trade and investment ties will still be needed for China to climb the technology ladder. Deeper ties can lead to increased collaboration and technology diffusion, which would help lift China's productivity growth. While China has made great strides in a number of areas such as 5G development and AI development, there are still sizable gaps in technology between China and other developed economies. Moreover, continued uncertainty due to increased tensions between the US and China will persist. It is clear differences have spilled over beyond trade disputes into broader areas of technology and finance. This should prompt China to deepen ties with other regions. As such, "internal circulation" needs to be complemented with further engagement with "external circulation".

The pace of innovation is accelerating

China's innovation development has made great strides, with R&D growth averaging over 14% y-o-y since 2010, a much faster pace than GDP growth. In 2019, China topped the ranking for global IP patents, a reflection of its investment in R&D (see Chart 18). However, there are still sizable technology gaps with other economies. For example, at an overall level, the quality of innovation still has room to catch up as the ratio of granted patents to total applications remains below 30%, lower than other developed economies, giving China ample room to learn from others (see Chart 19).

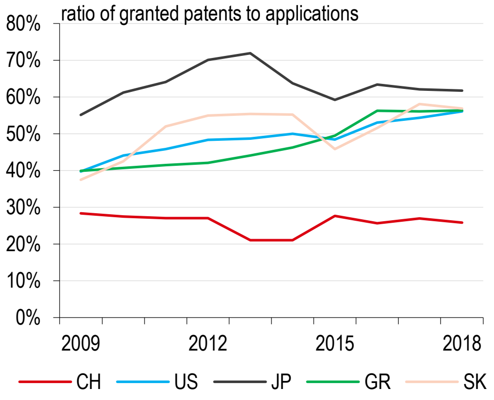
[2] The digital economy can be defined in a narrow or broad sense. The narrow definition refers to the ICT sector only, including telecommunications, internet, IT services, hardware and software, etc. The broad definition includes both the ICT sector and parts of traditional sectors that have been integrated with digital technology. The CAICT applies the broad definition to national accounts and measures the size of the digital economy.

Chart 18. China was No 1 in global IP patents in 2019 for the first time…



Source: WIPO, HSBC. Note: CH – China, US – USA, JP – Japan, GR – Germany, SK – South Korea.

Chart 19. …but still has room to increase the quality of its patent applications



Source: WIPO, HSBC. Note: CH – China, US – USA, JP – Japan, GR – Germany, SK – South Korea.

Technology gap shows that there is room to learn from others

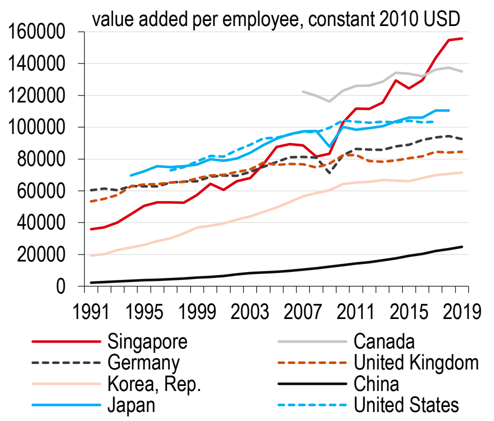
China's labour productivity reached RMB115,000 per capita in 2019, within reach of the 13th Five-year Plan's goal of RMB120,000 per capita in 2020. However, relative to other developed economies, China's labour productivity was still only 25.5% of Japan's and 32.3% of Korea's total labour productivity in 2019 (according to *The World Bank*). This demonstrates that there is still a considerable technology gap between China and developed economies.

China lags behind in both manufacturing and services labour productivity

When broken down further by industries, China lags behind in both manufacturing and services labour productivity. It has reached only 21.4% of the level of US's manufacturing labour productivity and 13.3% of services labour productivity (see Charts 20-21). While self-sufficiency can help hedge against external risks, it would be far more efficient to learn from other economies to increase productivity growth through enhanced collaboration and technology upgrading.

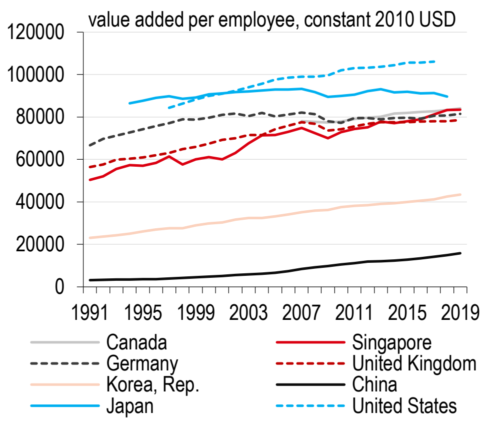
Deeper cross-border trade and investment linkages between China and developed economies is a primary means to increase technology adoption, helping to boost China's overall labour productivity. As there are still sizable gaps between China and developed economies in high-tech areas, it would be more efficient for China to leapfrog its technology development through increased collaboration and learning from other economies, rather than try to "reinvent the wheel". As such, China should "lean in" to the global economy, in spite of continued uncertainty.

Chart 20. Labour productivity of the industrial sector (including construction)



Source: World Bank, HSBC

Chart 21. Labour productivity of the services sector



Source: World Bank HSBC

A solid footing in global trade and supply chains

Deeper global integration can help to lift China's technology levels

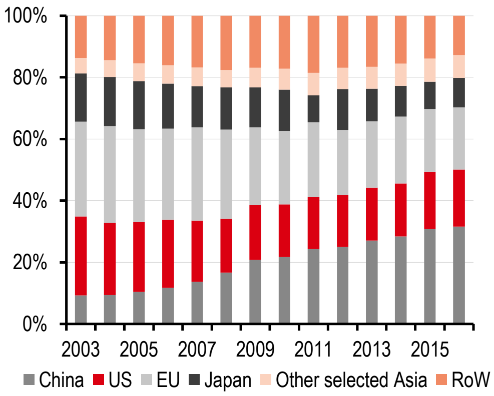
Deeper global integration can help lift China's technology levels. However, recent US-China trade tensions and COVID-19 have brought into focus the reshuffling of supply chains away from China. However, in our view, the relocation argument is overblown, and there is still scope for China to deepen global collaboration and move up the value chain. Globally, supply chain reconfiguration has been ongoing for many years, but China continues to play a dominant role in global value chains. China's share in global manufacturing output rose from 12% to 33% from 2003 to 2017, showing a deepening integration in global trade. In our view, "external circulation" will focus on both the depth and breadth of trade linkages to further support China's industrial upgrading.

Moving up the value chain through stronger global links

China maintains strong pull factors, including a large pool of highly skilled labour, well-established infrastructure network and an integrated network of supply vendors and production facilities. These factors not only make China attractive for automated and higher value-added industries, but they are also difficult to develop in a short period of time. This means China will likely still maintain a competitive edge in the near term.

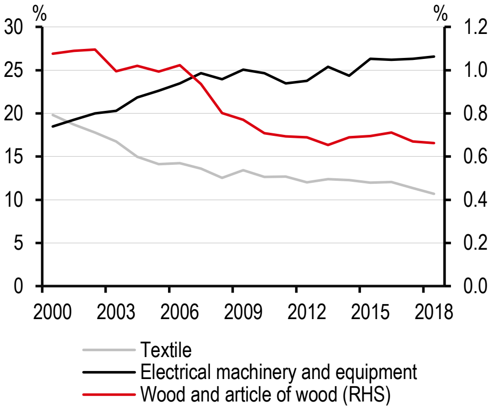
These pull factors as well as increased learning by catering to advanced markets have helped China to advance its manufacturing sector from low-end product development to more high-tech related products. Indeed, China's external sector has shown evidence of industrial upgrading. For example, more labour-intensive industries such as textiles and wood exports have seen a declining share of total exports, while electrical machinery and equipment exports have increased (see Chart 23).

Chart 22: China's share in global medium, high-tech manufacturing output still rising



Source: US National Science Board, IHS Global Insight, World Industry Service database (2017), HSBC

Chart 23: Industries' share in total China's exports



Source: CEIC, HSBC

Meanwhile, FDI flowing into China's high-tech industries in recent years has also increased, allowing for further learning from foreign firms. In 2019, FDI flowing into high-tech industries accounted for c28% of total FDI and rose by more than 25% in 2019, significantly faster than the 5.8% growth in total FDI. In fact, China's global share in medium- to high-tech industries has nearly tripled in the past decade to 31.5%, surpassing the US in the late 2000s and the EU in the last decade (see Chart 22). A further focus on increasing cross-border investment flows will help lift China's technology adoption.

Beijing will likely continue to open up its markets

How will Beijing deepen its global ties? For one, this can be done through more regional free trade agreements with developed economies (i.e. the EU, Japan, and Korea). Additionally, Beijing will likely continue to open up its markets and implement more structural reforms to help attract more foreign firms. Additionally, strengthening the protection of IP rights (IPR) will help attract more high-tech companies to operate and invest in R&D in China. The combination of IPR protection and reforms will also promote healthy competition, which will help lift innovation. Overall, Beijing's reforms and China's resilience in terms of attracting investment and dominance in global trade should lay the foundation for further technological advancement and allow it to move further up the global supply chain.

Deeper regional economic integration can go a long way

In light of the recent escalation in tensions with the US, it has become more important for China to diversify more towards neighbouring economies in Asia as well as the European Union. We expect there to be an increased focus on more regional trade and investment agreements with regions such as the EU, Japan, Korea and ASEAN. Deeper integration will benefit China both by lifting external demand for China products as well as by increasing collaboration and help increase technology diffusion, thereby lifting labour productivity.

Historically, China has significant relationships with Asia and the EU, and we expect these to deepen in the coming year. In 2019, 49% of China's total exports went to Asia and 20% to Europe. Also, inflows from Europe, Korea, and Japan accounted for 23%, 10% and 8% of FDI into mainland China (excluding Hong Kong) in 2018.

Regional trade agreements to come into focus

China has been a key advocate for the Regional Comprehensive Economic Partnership (RCEP), a proposed free trade agreement in the Asia-Pacific region. This would establish a regional trade agreement between China and 15 other economies and remove trade barriers and encourage cross-border investment. The RCEP agreement highlights strengthened cooperation in health care, smart manufacturing, 5G and other fields of high-tech growth, which would help boost productivity gains.

Additionally, China has been in discussions about a free trade agreement with both Japan and South Korea. Using the current Most Favoured Nation (MFN) weighted average tariff rates, we estimate a regional trade agreement can lead to cost savings of roughly 3% of total export value for non-agricultural exports to Japan and Korea, if all tariffs are removed for non-agricultural products. Lower prices can help increase the market share of China's exporters. Aside from the direct tariff cost savings, deeper integration with Japan and Korea would be important from a technology development perspective, given the labour productivity gap remains sizeable.

China-EU relations to deepen

China and the EU have been in discussions to deepen economic integration

While the relations with the US may continue on an uncertain trajectory, China and the EU have been in discussions since 2013 to deepen economic integration through the China-EU Comprehensive Agreement on Investment (CEAIC). Both sides have expressed their intention to reach an agreement by the end of 2020, which would strengthen ties and deepen collaboration. However, points of contention centre on China allowing fair market access to foreign firms.

Further reforms to level the playing field and increase market access for foreign firms to enter China will help encourage collaboration, build goodwill and increase FDI flowing into China. Following the principles of competitive neutrality – such as increasing mixed-ownership reform, fair market access, competitive bidding for projects and resources, strengthening intellectual property rights, and allowing markets forces to play out when firms go bankrupt – will help address these issues. Furthermore, a more level playing field will increase healthy competition, which can also help increase innovation and productivity.

Further reforms and opening up

China has also recognised the value of more open markets

China has also recognised the value of more open markets. It has continued to reduce its foreign investment negative list and, in June 2020, the list was further reduced to 33 items from 40 items in 2019, with a number of foreign equity ownership caps being lifted for the financial services sector (e.g. futures, securities, and life insurance firms). However, financial services aside, this still leaves areas where foreign investors face restrictions, including telecommunications, legal, and education, which can be further opened up to foreign investors.

In addition, policymakers have continued to open up the domestic financial market to foreigners. The Stock Connect (established in November 2014) and the Bond Connect (established in July 2017) offer a gateway for investors to invest in mainland China's equity and bond markets through Hong Kong. Stock Connect access has expanded to over 2,000 equities. Northbound Stock Connect total monthly turnover value has increased by over 9 times so far in 2020 compared with 2017. Northbound Bond Connect monthly average trading turnover volume has increased almost 400% compared with 2018, reaching an average of RMB400bn per month so far in 2020.

Meanwhile, on 1 November 2020, the QFII and RQFII programmes will be combined. This will streamline the foreign investor approval processes, as well as increase the scope of financial products available to foreign investors. China is also likely to continue conducting pilot programmes to expand access to foreign investment in free trade zones (in particular the Shanghai Free Trade Zone) to test drive more areas for further opening up and reforms.

China-US relations: Focusing on areas of mutual benefit

There are still areas where there can be mutual benefit and dialogue

While US-China relations have continued to sour in recent months with further bans on technology companies and flows of people, there are still areas where there can be mutual benefit and dialogue. Recently, around 3,500 American companies filed a lawsuit against the US Trade Representative and US Customs and Border Patrol stating that the continued escalation in tariffs placed on Chinese imported goods was unlawful (*Reuters*, 25 September 2020). This shows that from an economic and business standpoint, the increased ramp-up in tensions is clearly hurting all sides. This also means there is scope for areas where both sides can agree. By focusing on areas of mutual benefit, both sides can help smooth some of the increased tensions in other areas. Further dialogue such as through the regular meetings of top leadership as a part of the Phase 1 trade deal, as well as other channels, will be important to keep tensions from escalating.

The 2020 China business report from the American Chamber of Commerce, Shanghai, asked US firms about their intentions of remaining in China; 15.3% of the respondents indicated that they were planning to move production out of or partially out of China. Of these firms, only 1.8% indicated that they would move all production out of China, or effectively less than 0.2% of the total surveyed companies (*American Chamber of Commerce, Shanghai*, September 2020). This highlights that there are still strong pull factors for US companies to stay engaged in China, due to its large domestic market, relatively skilled and cheap labour force, and integration in global supply chains.

Disclosure appendix

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Issuer of report
The Hongkong and Shanghai Banking Corporation Limited
Level 19, 1 Queen's Road Central
Hong Kong SAR
Telephone: +852 2843 9111
Fax: +852 2801 4138
Website: www.research.hsbc.com

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