

Economic Watch

China | Understanding China's new growth model

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China's new growth model is underpinned by "three pillars": common prosperity, self-sufficient technology under "Dual Circulation" and carbon neutrality

In the aftermath of Covid-19 pandemic, China's authorities promulgated a flurry of policy initiatives this year, including: enhancing the regulations of internet giants, clamping down the after-school tutoring business, setting restrictive targets of carbon emission for industries and promoting "common prosperity" etc. Many market observers including us believe that these recent policy moves will usher in a new epoch of China's economic and social development. The timing of these policy initiatives should not be a surprise, given that the Chinese Communist Party just celebrated its 100-year anniversary this year, and 2021 is also a good time window to press ahead these reforms as China "first-in, first-out" of the Covid-19 pandemic.

On the economic side, we anticipate that China will pursue a new growth model in the following decade, underpinned by "three pillars": common prosperity, self-sufficient high technology under the "Dual Circulation" strategy and carbon neutrality. Indeed, these three pillars can be regarded as China's strategies to tackle a number of global challenges to the entire world. They are expected to profoundly shape the landscape of China's and the world's economy in the post-Covid-19 era.

These "three pillars" of China's new growth model are also following the trend of the new time. First, after a decade-long double-digit growth and elimination of absolute poverty, Chinese authorities are shifting their policy priorities from pursuing headline growth figures to balancing growth and sustainability, particularly, to promote "common prosperity" to ensure that all the society members can share the fruits of economic development. The previous "growth first" strategy in the past decade indeed led to polarization of the rich the poor, due to lack of regulations on some booming sectors thus allowing disorderly capital expansion dominates social equality, pointing to the importance of "common prosperity" measures as a complement to economic growth. China's recent regulatory storms on monopolistic behaviors of tech giants, on excessive commercialization of several sectors such as after-school private tutoring as well as on overheating real estate market all demonstrate this major regulatory reset.

Second, to promote self-sufficient high technology and to solve the bottleneck supply chain problem under the "Dual-Circulation" strategy is also keeping the pace of the time of China-US decoupling and the long-term technology competition between the two largest nations. Although the bilateral relationship has been eased through the recent high-level conversations between the two countries, the long-term ideological conflicts and technology war are set to continue in the foreseeable future. Thus, self-sufficient high technology, particularly to prioritize high-end manufacturing sector and high-tech advancement, indicates Chinese economy is transitioning from the previous consumption-oriented US model to high-end manufacturing oriented German model to deal with the de-globalization and superpower relationship in the new time.

Last but not least, carbon neutrality, again, is the requirement of the time. Carbon neutrality and environmental protection has already been a global unanimous agreement. Against the backdrop of carbon emission reduction

and at the same time the new wave of new energy technology development, China, with its previous coal-centric of large carbon emission growth model, has always been at the forefront of this global wave. The aggressive carbon neutrality target at 2060 and carbon emission peak at 2030 pledged by Chinese authorities to the world will lead to two important transformations of Chinese economy: the reduction of capacity of fossil fuel driven industries and at the same time the staggering development of new energy sector. It is well believed by the market that China's previous real estate driven business cycle will give way to the new energy and green economy driven cycle.

Altogether, these three “pillars” of China's new growth model are never isolated with each other. Instead, they are tightly correlated, coherently witnessing China's economic transformation in the following decade. In particular, technology self-sufficient and carbon neutrality target collectively indicate the policy priority transformation from promoting consumption-driven growth to high-tech and new energy driven growth, from the previous real estate driven business cycle to high tech and green economy driven cycle, and from coal-centric brown economy to new-energy-centric green economy. At the same time, “common prosperity” policy initiatives, interpreted both as an income redistribution method and the way to curb disordered capital expansion, will make sure the achievements of the high tech and new energy oriented “new economy” will be shared by everyone in the society.

In this report, we attempt to de-mystify China's regulatory reset and explore which business models could be affected and which will benefit under the new policy paradigm. We also try to clarify some global investors' misperceptions of these “three pillars”. Under the new governance paradigm, we see regulatory headwinds for sectors associated with rising tensions of social inequality, environmental sustainability, as well as data and national security risks; on the other hand, the new growth model provides policy support to high-end manufacturing, high-technology advancement and new energy sector to promote green economy.

“Common prosperity” and social equality: old political slogan with new substances

The concept of “common prosperity” is not new for China. It has been always defined as the ultimate goal of China's socialist market-oriented economy. As early as 1953, this concept was first raised by Chairman Mao on the Decision to Develop Agricultural Cooperative, and then widely used in Deng Xiaoping's reform and opening-up policy initiatives in 1980s when he wanted to allow a small group of people become rich through market-oriented reforms and finally achieve “common prosperity” of the entire society.

However, Western mass media and some global investors tended to equalize “common prosperity” with “robbing the rich to help the poor”, or the nationalization of private enterprises in China. Such an entrenched prejudice might stem from the orthodoxical tenets of communism, which is obviously no longer applicable in China's context today. Above all, the prejudice has had led to global investors' knee-jerk reactions of dumping their China-related assets to China's recent waves of regulatory storms, chief among which are regulating monopolistic behaviors of tech giants, clamping down excessive commercialization of some sectors such as after-school private tutoring, video gaming industry and the private medical sector, to name a few.

In our opinion, these policy initiatives are progressivism in nature, attempting to tackle a number of challenges to all the countries in the world: tech-induced market monopoly, ever-widening wealth gap, housing affordability, etc. For instance, the clampdown on Ant Finance and other Fintech companies reflects China's efforts to curtailing shadow banking activities; tightening regulations on monopoly behaviors of internet giants are in essence not different from US and Europeans authorities' ever-increasing vigilance on Google, Facebook etc.; and eliminating after-school tutoring business and limiting adolescent time of video game are responding to the parents' calls to lessen burdens of children and protect their health.

However, there are potentially a lot of side-effects of the recent regulatory storms as the way to pursue “common prosperity”.

For instance, frequent governmental interventions could expand the size of public sector and crowd out private sector thus it is set to increase the government’s debt level; moreover, domestic entrepreneurs will feel discouraged and confused when they are unable to tell which sector will be the next clampdown target. And even worse, many of them could feel threatened if they (mis)interpret that China’s authorities will nationalize their enterprises. By the same token, international capital could shun China’s market or require for a higher premium for their investment return in China. And separately, brain drain and capital exodus could take place if the country fails to retain its talents, in particular entrepreneurs.

Even worse, these policy initiatives are at the cost of growth. However, China cannot abandon growth at the current stage. The authorities’ legitimacy is largely based on continuous economic prosperity. The competition with the US requires for a remarkable performance of the economy as well. Thus, China needs to walk on a fine line between growth and regulatory storms targeting on common prosperity.

Regarding the method to achieve “common prosperity”, instead of the blunt regulatory storms which scare global investors, tax scheme reform should become one of important levers. To a certain extent, China’s current tax scheme is more “capitalist” than many other countries in the world. (Table 1) In particular, capital gain tax, property tax and inheritance tax, which are deemed to be the effective way to re-distribute people’s wealth and to narrow wealth gap, get zero tax rate on all of these three categories. By contrast, some typical advanced economies, such as the US, UK, Spain, Germany and France, have imposed certain although diversified tax rates for income redistribution.

Based on the recent market turmoil led by regulatory storms and the gap of China’s tax scheme with the advanced economies, we believe that the “common prosperity” blueprint should be achieved more through tax scheme reforms, rather than through bluntly clamping down targeted private enterprises.

Table 1. **COMPARING CHINA’S CAPITAL GAIN, PROPERTY AND INHERITANCE TAX WITH THE ADVANCED ECONOMIES**

	Headline individual capital gains tax rate (%)	Property tax rate (%)	Inheritance tax rate (%)
China	20%	No	No
US	20%	Varied across states, e.g. New Jersey: 2.13% New Hampshire 1.89%	No inheritance tax. However, there is an estate tax with a top rate of 40%.
UK	Range from 10% to 28%	28%	40%
Germany	25%	No taxes on wealth or capital employed, only minor local authority tax on property, but could be offset by an additional trade tax deduction.	50%
Spain	26%	3%	34%
France	30%	3%	60%

Source: BBVA Research and related websites

“Dual circulation” strategy and technology self-sufficient

Many people simply interpret “dual circulation” as being equivalent to “closed door policy” and self-sustaining everything domestically. We agree that technology self-sufficient is an important component of this new fashionable slogan, but we do not agree to narrow down this strategy to be technology self-reliance only. “Dual-circulation” should have much broader and comprehensive policy implications than technology self-reliance, as the authorities labelled it as the principle policy guidance throughout the 14th Five-Year Plan.

Think about the broad background of raising the “dual-circulation” strategy in the 14th Five-Year Plan, one is Trump's trade and technology war with China since 2018, and the other is the global Covid-19 pandemic. The “dual circulation” has two indispensable parts: “Internal circulation” and “External circulation” (see our recent report [China | Understanding the 14th Five-Year Plan and the 2035 long-term development target](#)). Except for technology self-sufficiency, the “internal-circulation” has at least another two important meanings: (i) “consumption internal-circulation”, indicating China needs to focus on stimulating domestic demand in the near-term amid the global pandemic when other countries are grappling against virus, and (ii) “factor market internal-circulation”, indicating to continue the factor market reform to promote factor mobility domestically.

Undeniably, China is planning to solve the “bottleneck” technology and try to be self-sufficient in key tech sectors which particularly related to national security and supply chain independency. Table 2 lists the 35 items of “bottleneck” technology of China announced by Chinese authorities. (Table 2) This is also in line with the previously announced “Made-in China 2025” and the recent important industry policy transformation from the previously advocated US and UK type of “prioritizing consumption” to Japan and German type of “prioritizing high-end manufacturing”.

Table 2. **35 ITEMS OF CHINA’S BOTTLENECK TECHNOLOGY ANNOUNCED BY CHINESE AUTHORITIES**

1	Lithography machine	19	High pressure plunger pump
2	Chip	20	Aviation Design Software
3	Operating system of computers and smart phones	21	Photoresist
4	Aviation engine nacelle	22	High pressure common rail system
5	Tactile sensor	23	Transmission electron microscope
6	Vacuum evaporation machine	24	Roadheader main bearing
7	Mobile radio frequency device;	25	Microspheres
8	iCLIP technology	26	Underwater connector
9	Heavy-duty gas turbine	27	Key materials for fuel cells
10	Lidar	28	High-end welding power supply
11	Airworthiness standards	29	Lithium battery separator
12	High-end capacitance resistance	30	Medical imaging equipment components
13	Core industrial software	31	Ultra-precision polishing process
14	ITO shooting material	32	Epoxy resin
15	Core algorithm	33	High-strength stainless steel
16	Aviation Steel	34	Database management system
17	Milling cutter	35	Scanning Electron Microscope
18	High-end bearing steel		

Source: BBVA Research and related website

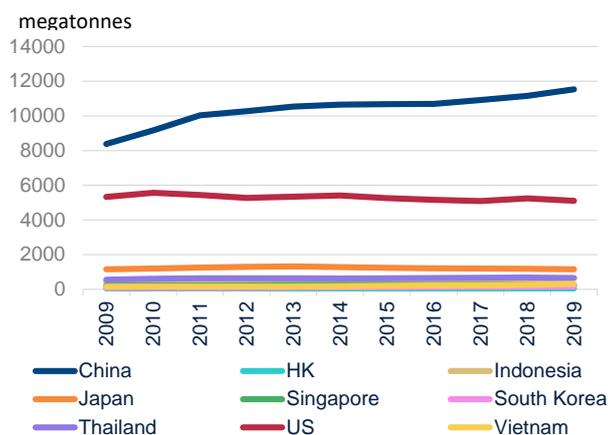
However, technology self-reliance does never mean going back to the “closed-door” policy to be self-reliant on everything. After all, under the framework of global trade and ever-tightening economic linkages, “closed-door” policy has proved to be low efficient by history. Instead of decoupling with the rest of the world, we understand “self-sufficient” technology indicates China only wants to make some Plan B in some very specifically tech sectors, such as chips, 5G and new energy tech, to guarantee its supply chain security and national security in a bid to better prepare for the long-term tech war with the US.

More importantly, in order to avoid the market's misperception of "internal circulation", the authorities particularly included "external circulation" into "dual circulation" model at the same time to continue to stick to the opening-up policies and financial liberalization reforms to involve into global markets. Last year's RCEP in Asia, EU-China CAI and the One-Belt One-Road initiative, as well as the recent high-level talk of China and the US to seek cooperation on Carbon neutrality and lift tariffs etc. and the plan to join The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) are the best illustrations of China's continuation of opening-up policies and financial liberalization.

Carbon neutrality and the booming clean energy sector

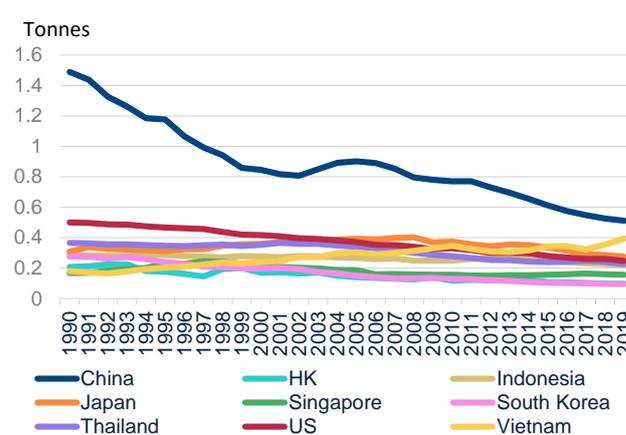
China is at the frontier of battling climate change as it is the largest carbon emission country and has suffered huge economic consequences by climate change and pollutions. Due to its large economic size, China has the largest amount of fossil CO2 emission among Asian economies, and also doubles of the US's aggregate CO2 emission. In terms of CO2 emission per USD 1,000 of GDP, China also ranks the highest in Asia and the main economies in the world, although this figure has been declining over time. (Figure 1 and 2)

Figure 1. **DUE TO THE LARGE ECONOMIC SIZE, CHINA HAS THE LARGEST AMOUNT OF FOSSIL CO2 EMISSION AMONG ASIAN ECONOMIES**



Source: CEIC and BBVA Research

Figure 2. **FOR FOSSIL CO2 EMISSION PER USD 1,000 OF GDP, CHINA STILL RANKS THE HIGHEST, ALTHOUGH IT HAS BEEN DECLINING OVER TIME**



Source: CEIC and BBVA Research

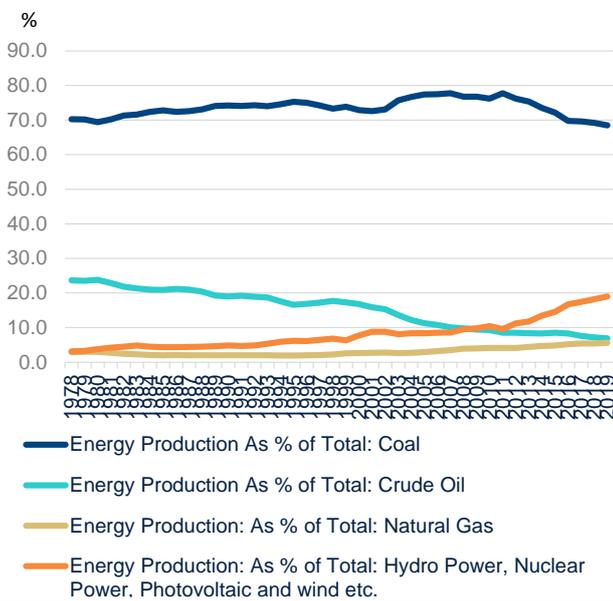
Against the backdrop of global effort on carbon neutrality and environmental protection, China is one of the leading countries in the growth model transformation, from the coal-centric brown economy to new-energy-centric green economy. Chinese government pledged to achieve carbon emission peak in 2030 and carbon neutrality in 2060. At the national level, the four key areas that are subject to increased green development include industrial sector, energy structures, transportation and agricultural infrastructure. Under this aggressive target, there have been two main directions to achieve this goal: one is to reduce the capacity of the high carbon emission traditional industries and the other is to staggeringly develop new energy and clean energy.

China has been coal-centric for electricity generation for a long period of time. Figure 3 illustrates for the past decades, electricity generated by coal has taken around more than 70%, while the share of clean energy such as hydro, wind, solar and nuclear etc., although has been increasing recently, only takes around 20% at the current stage. (Figure 3) The authorities anticipate zero usage of coal electricity while 47% of solar and 31% of wind

electricity in 2060 when China is expected to achieve carbon neutrality, which looks quite challenging given the current energy structure. (Figure 4)

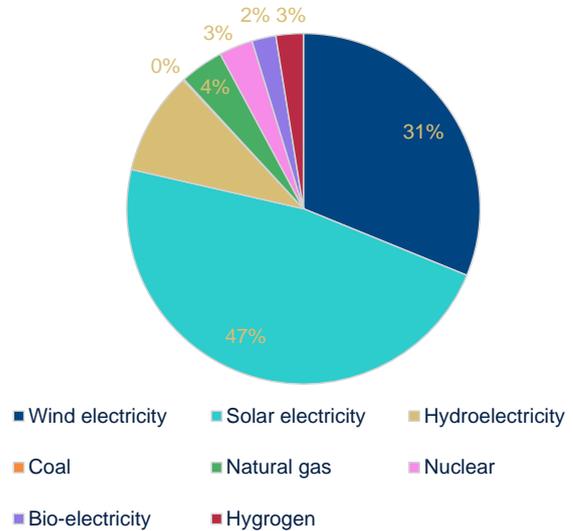
This huge transformation of energy structure urges China to arduously pursue the technology advancement of new energy and clean energy. From taking use of clean energy to generate electricity, to the electricity storage and transformation, to the end-usage of new energy generated electricity such as new energy vehicles etc., all require a series of new technology advancement and R&D investments.

Figure 3. CHINA'S ENERGY STRUCTURE IS COAL-CENTRIC, THE NEW ENERGY SECTOR, ALTHOUGH GROWING OVER TIME, TAKES SMALL SHARE



Source: CEIC and BBVA Research

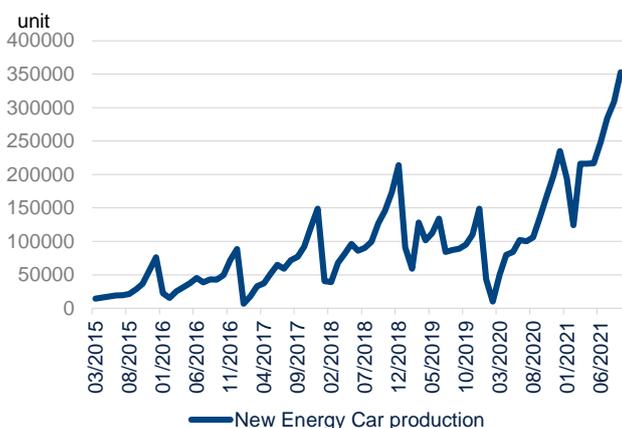
Figure 4. THE OUTLOOK OF ENERGY CONSTITUTE FOR ELECTRICITY PRODUCTION IN 2060, WHERE COAL ELECTRICITY WILL REDUCE TO 0



Source: CEIC and BBVA Research

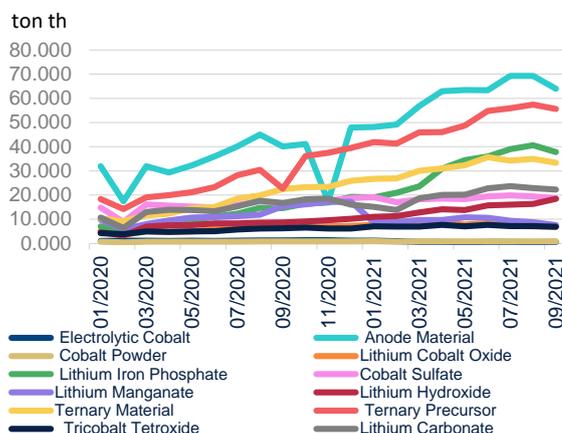
Regarding the clean energy, hydro, wind, solar and nuclear etc. have always the choices for China. However, to significantly increase their share of electricity generation and to take place of coal, natural gas and petrol oil, is very challenging not only for China but also for the world. Most of these clean energies such as wind and solar are instable and are subject to specific weather conditions. In addition, how to reserve the electricity provided by wind and solar and how to transport it to the end-users is the future research direction. On the other hand, hydroelectricity depends largely on the geographical conditions. In China, it has already been explored every possible geographic location with significant altitude difference of falls to construct hydroelectricity stations, thus, the room to further increase hydroelectricity is quite limited. Based on these restrictions on clean energy development, the new energy development and reservation technology become the future focus to facilitate the carbon neutrality target. (Figure 5 and 6)

Figure 5. CHINA'S NEW ENERGY VEHICLES PRODUCTION HAS GROWN RAPIDLY OVER TIME



Source: CEIC and BBVA Research

Figure 6. CARBON NEUTRALITY TARGET DEPENDS ON THE ADVANCEMENT OF NEW ENERGY DEVELOPMENT



Source: CEIC and BBVA Research

Last but not least, how to balance environmental protection and economic growth is also a large challenge to Chinese authorities. The recent electricity crunch in many provinces of China and the economic slowdown led by capacity reduction of polluted industries all proved that striking the balance between pressing ahead new energy and maintaining growth momentum is not easy. Compared with advanced economies that have already achieved the high-level economic prosperity which allows their policymakers to put more efforts to environmental-protection issues, China has to maintain the growth pace at certain levels so as to continuously promote the living standard of their people and safeguard economic prosperity while pushing forward low-carbon economy concurrently.

Conclusion

A flurry of China's new policy initiatives and regulations has caused deep confusions and concerns of global investors. We summarize China's new growth model to be underpinned by "three pillars": common prosperity, self-sufficient high technology under "Dual Circulation" strategy, and carbon neutrality. The "three pillars" of China's new growth model conform to the trend of the times and are inter-dependent with each other.

Despite the bluntness of policy promulgation and the lack of market communications, these measures or reforms are deployed to tackle a number of challenges faced by almost all the countries: tech-induced market monopoly, ever-widening wealth gap, global climate change, housing affordability etc. However, it remains an open question whether these Chinese approaches will succeed. At least one consequence is foreseeable over the medium term: government interventions will become more frequent than before.

Under China's new growth model and the transformation from "growth first" to social sustainability, we anticipate that China's long-term potential growth will gradually decline from currently 6% to 4% in 2035, depending more on total factor productivity progress rather than capital and population.

China's new policy direction will create new winners and losers at the sector level. We identify that there will be regulatory headwinds for sectors associated with rising tensions of social inequality, environmental sustainability, and data security and national security risks; while the new policy framework provides support to high-end

manufacturing, “bottleneck” technology advancement and new energy and clean energy sector. Thus, these policy-supported sectors should be the future directions of foreign capitals invested in China.

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