



## China's new growth strategy

China is striving to reduce its dependence on Western technologies and markets. In addition to rising competition from Chinese corporates, national security concerns as well as trade and investment restrictions from both sides are creating a new set of challenges for Western corporates. Meanwhile, China's renewed focus on manufacturing may help it overcome some of its own challenges, but such supply-side strategy may not be met by enough domestic and global demand.

| Tommy Wu

### The Chinese economy lost its main growth engine...

The Chinese leadership has to cope with the effects of the deflating real estate bubble and local government debt clean-up. With the end of the construction boom, China's economy lost its most important growth driver and is currently going through restructuring. It will take time for the emerging industries such as tech, new energy, advanced manufacturing, and biological engineering to replace the property sector. The emerging industries together account for about 13% of GDP, according to the Chinese government. That is, compared to the property sector which at one point accounted for about a quarter of GDP directly (through construction) and indirectly (through upstream and downstream industries such as construction materials and home appliances).

### ... and foreign investors their enthusiasm

In addition, China has lost favor with Western investors as a location for direct investment.

Western companies have long been concerned about their ability to compete fairly in the Chinese market. They are also worried about Chinese regulations on cross-border data transfer which keep data from leaving the Chinese borders, as well as China's newly revised Counter-Espionage Law which may give the Chinese government more access to, and control over, corporate data. On the latter, the worry is that what companies considered normal business activities, such as market research, could become criminal activities. Crackdown on Western consultancies over Chinese national security concerns has been hampering foreign investment. More generally, reduced transparency of policymaking and regulatory uncertainty over data transfer, cybersecurity, and national security have made it harder for foreign firms to navigate Chinese markets. This already had significant effects on foreign direct investments (FDI) in China.

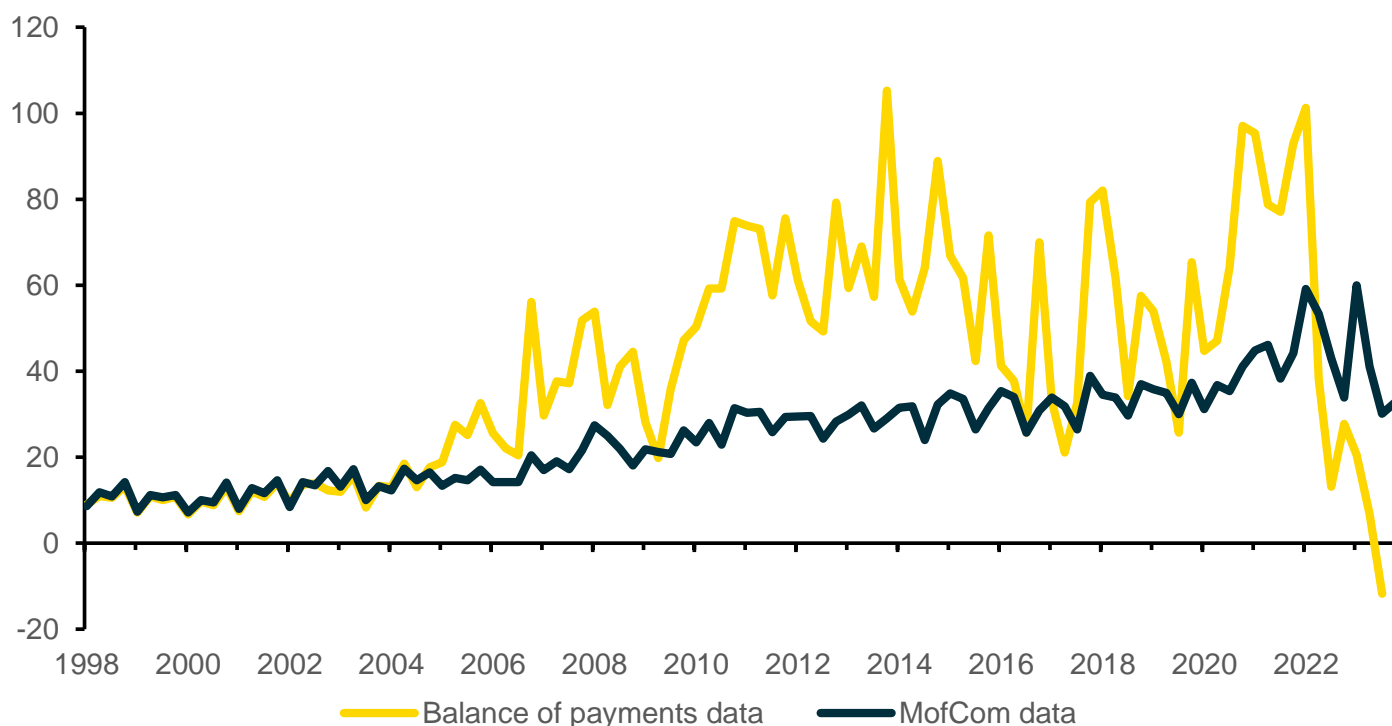
There are two official data series on FDI, which differ in several respects. The most important difference is that the figures from the Ministry of Commerce (MofCom) only show gross inflows and do not take into account investments in the financial sector, reinvested earnings, and some other items. The FDI data from the current account (balance of payments), on the other hand, is a net figure, i.e. the balance of inflows and outflows of inward FDI:

- MofCom figures show a 10% decline in (gross) FDI in dollar terms in 2023, the biggest drop since the global financial crisis (Chart 1).
- The balance of payments data is more spectacular. They show a net outflow in the third quarter of 2023 for the first time in the data history. This was likely caused by foreign companies having withdrawn their direct investment from China.



### Chart 1 - China: Net foreign direct investment fell in Q3 2023

The MofCom definition only measures FDI inflows excluding the financial sector. The BoP definition includes all FDI inflows including re-investment of profits, offshore IPOs, and foreign VC and PE investment, subtracting all FDI outflows; in USD billion.



Source: SAFE, MofCom, Commerzbank Research

### "China + 1" - Companies diversify their supply chains

Obviously, falling excess return on FDI amid China's economic slowdown and high global interest rates, as well as the increasingly complex geopolitics, have important roles to play in Western companies' investment decisions. Also, Western companies are already seeing increased competition from Chinese enterprises, and the competition will likely become stiffer in the future.

More western companies have been, or are considering, ring-fencing their operations in China instead of integrating them with their global businesses due to regulatory problems. In addition, more and more companies now employ the "China plus one" strategy to diversify their supply chains. Of course, most intermediate goods and critical materials will still come from China even if more and more products will be further processed in Southeast Asia, India, Mexico, and Eastern Europe. In other words, even though less and less goods will have a "Made in China" label, a significant amount of product content will still come from China.

The decline in China's attractiveness for direct investment and relocation of production is an important indicator that China is experiencing problems as a business location. This not only affects foreign companies, but also Chinese ones. The confidence of domestic companies has obviously been affected by domestic issues. In this environment, it seems all the more difficult to increase China's economic growth again.

### President Xi's solution: It's manufacturing, stupid!

For the Chinese leadership, the solution to the various challenges seems to be a renewed focus on manufacturing, bolstered by homegrown technology. Chinese President Xi Jinping called manufacturing the "lifeline" and "foundation" of China:

- The Chinese government is doing everything it can to achieve full employment. It seems to assume that promoting the manufacturing industry can directly and indirectly create more new and well-paid jobs than expanding the service industries.



- Manufacturing is also seen as having a bigger "technology multiplier", i.e. moving up the technological ladder and boosting the economy's productivity is assumed to be a by-product of investing in new manufacturing facilities. Relatively slow productivity growth and low return on capital investment have long been a problem of the Chinese economy.
- A strong manufacturing base also has clear defense-related advantages – with the US wailing about the hollowed-out defense industry base lending support to that argument.

However, increasing manufacturing's share of the Chinese economy is perhaps an uphill struggle. Experience from regional peers suggest that once an economy moves beyond the middle-income group, there is not a lot of room to increase its share of manufacturing. For instance, Japan's share of manufacturing has declined after its per capita GDP reached the USD10,000 mark, while South Korea's share has only increased slightly (Chart 2). Taiwan is an exception, as it only focuses the technology development and global dominance in one specific industry – semiconductor.

### Chart 2 - China may not have a lot of room to increase its size of manufacturing

Percent of GDP. T is the year when an economy reached USD10,000 GDP per capita: Japan in 1981, Taiwan in 1992, South Korea in 1994, China in 2019. T+5 (T-5) stands for 5 years after (before) time T. Similar logic applies to other time notations.



Source: Economic and Social Research Institute (Japan), Directorate-General of Budget (Taiwan), Bank of Korea, National Bureau of Statistics (China), Commerzbank Research

### ... but China needs to find markets for larger manufacturing output

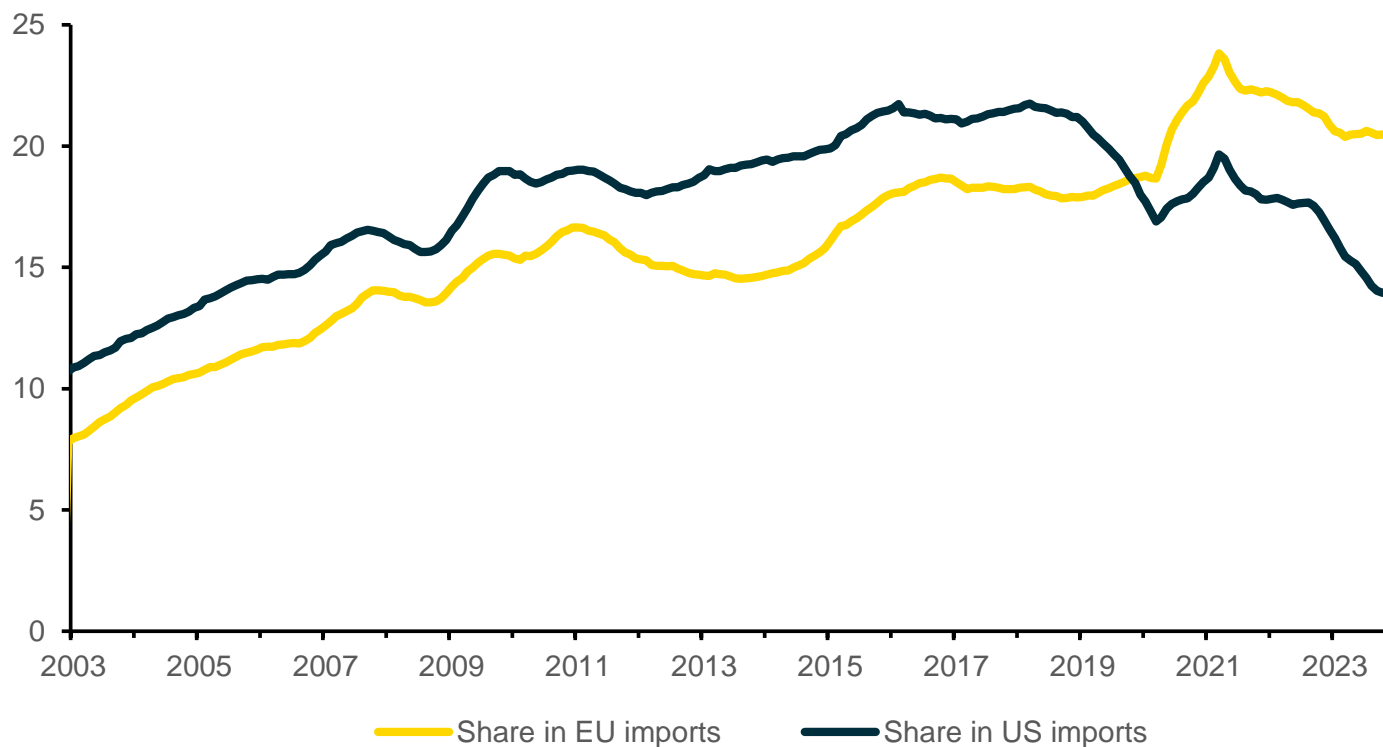
A larger manufacturing base needs to find outlets for its products. Otherwise, the strategy would only lead to even larger overcapacities. It will presumably not be easily achievable exporting most of the additional Chinese products, the recent surge of auto exports notwithstanding. After all, the EU is contemplating additional anti-dumping measures to prevent "cheap" Chinese imports.

It is therefore unlikely that China can increase much its EU and US import shares. China currently accounts for over 20% of EU imports and 14% of US imports (Chart 3). China's share of US imports declined sharply again in 2023 as US-China relations turned sour. This reflects the shifting of supply chains out of China to Southeast Asian countries, most notably Vietnam, as well as some nearshoring, notably to Mexico.



### Chart 3 - China remains an importance source of direct imports for the EU, but less so for the US

China's shares in EU and US total imports, 12-month moving averages in %



Source: Eurostat, US Census Bureau, Commerzbank Research

### ... perhaps by reorienting towards the Global South

With Western markets not welcoming enough and also increasingly due to national security considerations, China is reorienting its focus towards the Global South. China has been pushing to trade more with countries under the Belt and Road Initiative (BRI) which consists of over 150 countries in Asia (excluding Japan and India), Middle East, Africa, Eastern Europe, and South America (excluding Brazil, Argentina, and Colombia). China boasts over 45% of total foreign trade with BRI countries, and 25% of outward direct investment from China.

Meanwhile, the recent expansion of BRICS to include six new members (also known as BRICS Plus) is a signal by developing nations that stronger cooperation is needed to put the interests of the Global South on the world's agenda. China also tries to expand its global influence through three key initiatives - Global Development Initiative (GDI), Global Security Initiative (GSI), and Global Civilization Initiative (GCI). While BRICS Plus and the other initiatives by China may not result in direct economic impact, they may nevertheless strengthen the ties among the countries in the Global South, where China could gain influence.

### ... and by boosting domestic consumption

China's focus on manufacturing - a supply-side strategy - also intends to generate domestic demand by raising the share of household income through the creation of higher income jobs. Serious reform of the weak social safety net is also much needed to reduce the need for precautionary savings by households.

### Can China succeed?

The Chinese leadership is aware that relations with the West are at risk and wants to stabilize them, not least in order to maintain access to Western markets and secure technical expertise from the West. The Chinese government has therefore tried to approach Western companies and allay their concerns. However, more concrete measures and improvements are probably required to achieve real success here. Still, a possible Chinese export offensive - an aggressive push in exports to absorb excess capacity - makes a sustainable improvement in relations with the West more difficult.



It is also uncertain whether the Global South will really be able to replace Western markets for Chinese products. After all, these countries have quite disparate interests and the level of prosperity cannot be compared with the EU or the US. Furthermore, these countries may not be the final destination for Chinese products, but merely a stopover before they are shipped to the West.

Finally, while the Chinese domestic market still has a lot of potentials, with household consumption only accounting for less than 40% of GDP, the history suggests it is unclear whether and how long it will take to reorient the economy away from investment and exports towards consumption. First of all, it will be challenging to significantly increase the share of household income in China if the private sector continues to lose ground. Second, many local governments are reluctant to undertake major reforms to significantly ease household registration restrictions and improve the social safety net, which in principle should boost consumer spending. Some wealthier coastal provinces have recently taken bolder reforms, but most other local governments fear the impact of such reforms on social stability and fiscal burden.

All in all, the reorientation of economic policy will be a rough ride. A continuation of the trend towards lower growth rates is to be expected.



## Fed preview: discussion about QT?

The Fed will not change its interest rates at next week's meeting, leaving the target corridor for Fed Funds at 5.25%-5.50%. However, it is possible that the Fed will gradually enter into a discussion about how long and at what pace it wants to continue reducing its balance sheet.

| Bernd Weidensteiner

### Federal funds target range to remain unchanged

The Fed is unlikely to see any reason to change its key interest rates next week. The target corridor for Fed funds is therefore likely to remain where it has been since July 2023, namely at 5.25%-5.50%. The Fed will try to avoid fueling hopes of rapid rate cuts. First, it wants to be sure that inflation will actually fall to the 2% target on a sustained basis. The data, at least, are by and large moving into the right direction – and that is what matters in the end, as the Fed repeatedly emphasizes:

- The inflation rate (calculated on the basis of the Fed's preferred personal consumption deflator) fell to 2.6% in November, while the core rate declined to 3.2%. Over a shorter period, the Fed's target has already been achieved: in the last six months, prices have risen by 2% overall on an annualized basis, with the core rate even slightly below the 2% mark at 1.9%.
- The economy's growth eased in Q4, but the growth rate of 3.3% was probably still too strong for the Fed's taste. More to the Fed's liking is the fact that demand pressure on the labor market has eased significantly. The number of new jobs created each month has fallen continuously in 2023, from an average of 312 thousand in the first quarter to 165 thousand in the fourth quarter. At the same time, the number of vacancies fell and the average number of hours worked per week declined. This also reduces the risk of a wage-price spiral.

The fight against excessive inflation is therefore no longer the dominant issue. Instead, the Fed is now likely to focus more on facilitating a soft landing for the economy and preventing a recession.

According to the projections updated in December, the Fed itself expects three rate cuts in 2024. In order to allow the economy to continue to grow, the Fed will have a keen interest in avoiding unnecessary volatility on the markets. A premature rate cut should therefore be avoided. After all, if inflation were to pick up again, the Fed would also have to change course again. We therefore still believe it is likely that the Fed will wait until May before cutting interest rates for the first time in order to be certain about the inflation trend.

### And what about QT?

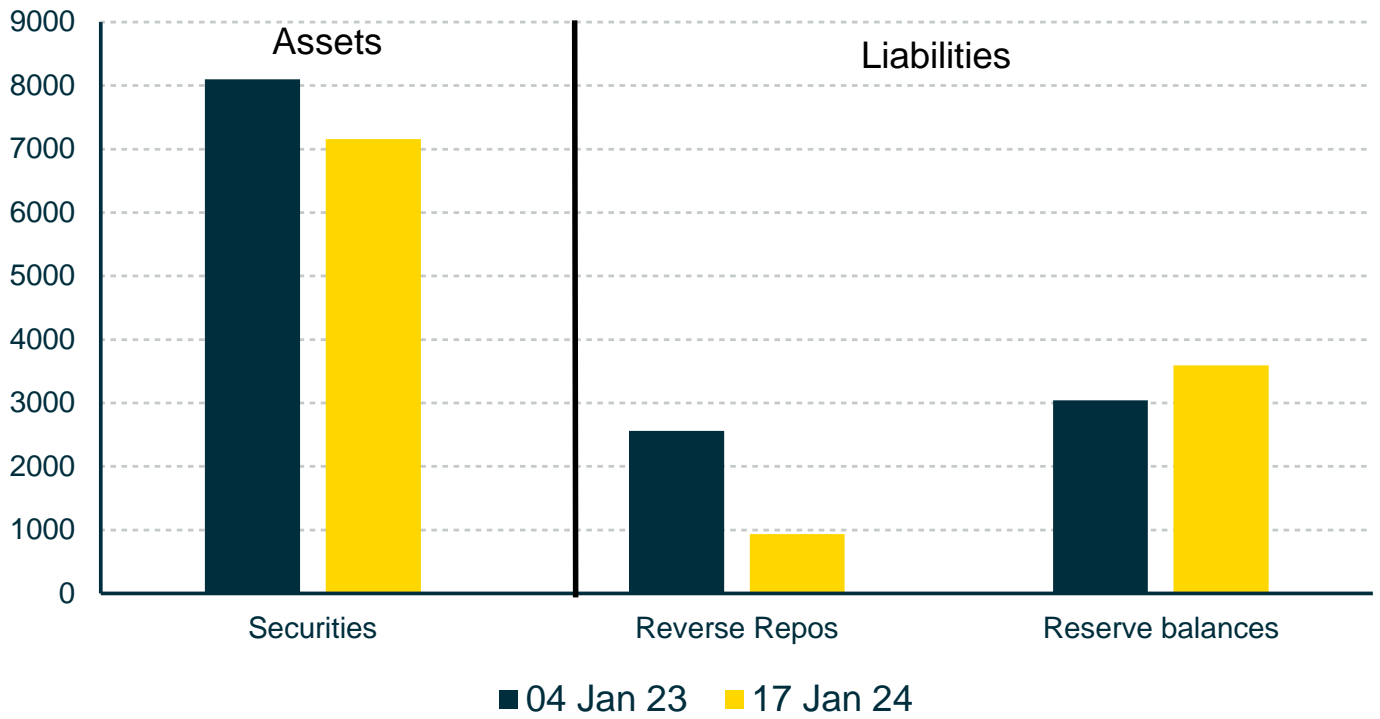
The Fed has reduced its securities portfolio by an average of almost 80 billion dollars per month over the last six months. Since the start of quantitative tightening (QT) in summer 2022, the bond portfolio has been reduced by a total of 1.3 trillion dollars to 7.2 trillion dollars. In the minutes of the last FOMC meeting, the meeting participants suggested that the technical details of slowing down the balance sheet reduction should be clarified in good time. The decisive factor for the Fed is the volume of bank reserves (bank deposits at the Fed, a liability item on the Fed's balance sheet). The balance sheet reduction will end when these reserves have fallen to a level that is compatible with the "ample" reserve regime. Fed Governor Waller sees the target figure at 10%-11% of GDP. This corresponds to around 3 trillion dollars.

The Fed's balance sheet currently shows bank reserves of a good  $3\frac{1}{2}$  trillion dollars. These are even higher than at the start of 2023 despite the continued reduction in the balance sheet (Chart 1). The shrinkage of the liabilities side of the balance sheet was facilitated by a significant reduction in reverse repos – a facility used by money market funds, among others, as a parking lot for their liquidity. However, this parking lot has now pretty much emptied, so that continued QT will cause bank reserves to fall in the coming months. It is therefore to be expected that the Fed will increasingly discuss the modalities of ending QT at its upcoming meetings. An abrupt end to the balance sheet contraction is not to be expected, but rather a "tapering" of QT. This tapering is likely to begin in the second half of the year, i.e. probably only after the first rate cut.



**Chart 1 - Rough target for bank reserves: 3 trillion dollars**

Important assets and liabilities of the Federal Reserve, in billion dollars



Source: Fed, S&P Global, Commerzbank Research



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