

# We should keep a close watch of China's dual circulation strategy

India could well take advantage of Beijing's plan to reorient its economy towards domestic demand and sophisticated sectors



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The global economy is expected to rebalance in the coming decade. Most public attention in India right now is focused on what major economies are doing to contain China. There is far less attention on what China plans to do in response. This is something that Indian policy debates will have to also take into account.

The Chinese leadership is meeting this week to decide its policy agenda for the next five years. There are two important economic initiatives that deserve close attention. First, China has already rolled out an ambitious Made In China programme. Second, the Chinese politburo had in May accepted a new strategy called the "dual circulation strategy". How these two pan out will have profound implications for the rest of the world, including India.

Made In China is an ambitious programme to ensure that it dominates production in 10 select sectors, such as artificial intelligence, robotics, new materials, electric vehicles, high-end medical equipment and next-generation transport technologies. Many of these are the building blocks of the Fourth Industrial Revolution. China plans to use credit subsidies, public sector enterprises and intellectual property acquisitions to ensure that it achieves 70% self-sufficiency in these areas by 2025, and global dominance by 2049. It is worth noting that it is targeting the next wave of industries rather than trying to protect failing enterprises of the past.

Consider China's dual circulation strategy. The two circulations are economic exchange within China and economic exchange with the rest of the world, or domestic reliance versus global integration. China wants to shift its balance from the latter to the former, in all likelihood, as it watches the growing international moves to make supply chains less dependent on one country. Two of the key goals of this dual circulation strategy are moving bank lending from services to high-end manufacturing, as well as restricting funds to real estate, and cutting dependence on food and energy imported from the rest of the world.

The Chinese leadership clearly sees the rebalancing of global supply chains as an irreversible trend. The two big shifts in its economic strategy show that the second largest economy in the world is trying to become less dependent on others, largely for geopolitical reasons, just as the rest of the world is trying to reduce its China exposure. These moves should also be seen against the backdrop of massive economic change over the past 15 years.

The size of the Chinese economy has grown from \$2.3 trillion in 2005 to \$14.4 trillion in 2019, with average income going up from \$1,751 to \$10,286 over the same period. Economic growth has nearly



halved as China's labour force peaked and it moved closer to the global technology frontier. A rise in its investment rate, combined with a fall in the savings rate, has shrunk its current account surplus as a percentage of gross domestic product (GDP). Most importantly, its trade/GDP ratio has plunged from 62.21% in 2005 to 35.68% in 2019.

There are three important lessons from the expected shifts in Chinese economic strategy. First, China is telling the world that it is no longer concerned with just the rate of economic expansion, but also the structure of its economy, not just how much is produced, but also what is produced. For many years now, it has been trying to increase domestic demand as a driver of economic growth. The recent moves complement other supply-side interventions to reduce overcapacity in some industries such as metals. It is worth seeing if such structural thinking makes a comeback in other countries as well.

Second, it is trying to build capabilities in emerging industries through domestic industrial policy rather than using the banking system to keep weak enterprises in older industries alive. And there is no indication yet that higher import tariffs are a central part of its strategy. The ability of governments to pick winning sectors is weak, but what

China does needs to be closely watched. Its choice of industries to dominate in the coming years suggests that its friction with the US is a technology war as much as a trade war.

Third, any country aiming for a higher reliance on its domestic market necessarily needs to increase the share of wages in its economy. The ability to build a mass consumption base is crucially dependent on higher wages across the economy. A further drop in savings could also further reduce China's current account surplus—and possibly the excess capital needed to fund its strategic infrastructure building in countries located close to India?

The Chinese move to focus on more sophisticated industrial production could hasten its exit from more labour-intensive manufacturing industries, a process that had already begun as wages began to increase.

India has been a laggard in attracting these industries, but there is still time to take advantage of a big move of labour-intensive manufacturing out of China. Two parallel shifts are expected to take place over the next decade: Deglobalization as well as a shift of supply chains out of China. The former will reduce the Indian export market while the latter will expand it.

## MINT CURATOR



Reece Pickering stumbled upon this coin dating back to 1066 CE HANSONS AUCTIONEERS

### A teenager strikes lucky with a metal detector

A rare King Harold II coin dating from 1066 that was found by a metal detecting teenager has made £4,000 at auction. Reece Pickering, of Great Yarmouth, was 16 when he found the silver penny at Topcroft, in Norfolk, in August. The coin, found while metal detecting with his father, had been estimated to fetch up to £3,000. A Henry I coin sold for £3,100, after it was found in Essex by a 15-year-old, who was also out with his dad... The coins were sold at Hansons' Historica auction. Reece, a catering apprentice who goes metal detecting most weekends, said: "I wasn't expecting to come across such a scarce and remarkable coin. It's a day I will remember forever. "I can't imagine finding something as special as this again. You just never know what's beneath your feet."

BBC

### Don't overlook the menace of zombie batteries

"Zombie batteries" are causing hundreds of fires a year at waste and recycling sites, industry experts have warned. They are urging people to ensure dead batteries are not thrown away in household rubbish or recycling. Batteries discarded with general waste are likely to be crushed or punctured during collection and processing, according to the Environmental Services Association (Esa). Some types, particularly lithium-ion and nickel-metal hydride batteries, can ignite or explode when damaged and set fire to other materials... this leads to incidents requiring dozens of firefighters and the evacuation of residents, potentially putting lives at risk. Lithium-ion batteries are believed to have been responsible for at least 250 fires at recycling and waste facilities across the UK in the year to March 2020.

The Guardian

### A football prodigy up against gender prejudice

Sam Gordon's staggering football skills made her famous at age 9. But they didn't make her fully welcome on the field. As the only girl in a tackle football league in Utah, she heard parents from opposing teams urge their kids to "beat the girl." "I had a target on my back, and it was in the shape of a ponytail," said Gordon, now 17. "It was awesome to prove to them that I'm more than just a girl in pads..." To help change that, Gordon went to court. She sued her school district and two others for refusing to create a girls' football program under Title IX, saying many girls like her don't feel comfortable playing with boys and some are even harassed. One player who testified said she was forced to change in the boys' locker room at away games and often faced discriminatory treatment by her male coach and teammates.

AP

### The kind of witchcraft that wins public applause

Mihaela Minca is one of the most famous witches in Romania. She and her coven live at the margins of European society. There, they make a living through conducting rituals that help their clients find love, money and adequate punishments for their enemies. Sometimes, the witches' endeavours extend beyond the personal: In 2019, Minca cast a spell against political corruption in her country by dumping black liquor outside a Romanian government building. The next day, the state issued a final sentencing for Social Democratic Party leader Liviu Dragnea, who'd used his own power to create fake jobs and appealed prior convictions. "Although many would say it's just a coincidence, this really did happen," Romanian photographer Virginia Lupu wrote to me shortly after, recalling the incident.

CNN

### A data theft that exposed patients to blackmail

Many patients of a large psychotherapy clinic in Finland have been contacted individually by a blackmailer, after their data was stolen. The data appears to have included personal identification records and notes about what was discussed in therapy sessions. Vastaamo is a nationwide practice with about 20 branches and thousands of patients. The clinic has advised those affected to contact the police. It said it believed the data had been stolen in November 2018, with a further potential breach in March 2019. Vastaamo said in a statement it was cooperating with the police. But its media centre's email address is not working. About 300 records have already been published on the dark web, according to the Associated Press news agency. On its website, the clinic calls the attack "a great crisis".

BBC

## THEIR VIEW

# A fresh capital crisis looms over India's banking sector

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The overhang of bad loans in the Indian banking sector has been a major factor behind the economic slowdown in the country. The problem pre-dates the covid crisis. During a downswing in the business cycle, several bank loans turn sour, leading to increased bankruptcies. Bad loans, however, tend to decline with rising incomes during upswings. Regulators expect banks to set aside the minimum mandated capital to provision for bad loans under the Basel norms. These norms have been strengthened further under the new Basel 3 framework in the wake of the global financial crisis of 2008-09. They have been made dynamic and aligned to the business cycle. The Reserve Bank of India (RBI) expects Indian banks to maintain a capital to risk-weighted asset ratio (CRAR) of 9%.

However, when an economic crisis lingers on, such provisioning is usually found inadequate and policy interventions by the state are warranted. There is enough research to show that if a banking crisis is allowed to lin-

ger, it has a negative effect on long-term growth. This is exactly what appears to have happened in India.

Non-performing assets (NPAs) as a percentage of gross bank advances began rising with the economic slowdown after the global financial crisis. They rose continuously from 2.2% in 2007-08 to peak at 11.2% in 2017-18.

These declined slightly, but still stood at a high 8.5% in 2019-20. Since growth was on a downward spiral, the modest decline in NPAs was likely the result of a combination of write-offs and resolution mechanisms arising from the Insolvency and Bankruptcy Code of 2016.

In its latest *Financial Stability Report* of June 2020, RBI has forecast that NPAs would climb to 12.5% in 2020-21 under a business-as-usual scenario, and to 14.7% if the covid-linked crisis were to escalate further and result in more bankruptcies.

India's lingering banking crisis has adversely affected the demand and supply of credit. It is one of the major reasons why private investment has shown a declining trend over the last decade. It has also clogged the transmission channels of monetary policy, having made banks increasingly cautious of supplying loans.

Despite the benchmark real repo rate (the nominal repo rate minus the average of the wholesale and consumer prices indices) declining continuously from 6.4% in 2015-16 to 2.2% in 2019-20, real bank credit growth stagnated at an average rate of under 10% annually between 2014-15 and 2019-20, compared to over 25% during the economic boom of 2003-04 to 2007-08. This is of particular concern, since Indian macroeconomic policy has relied on monetary rather than fiscal levers to address the downward spiral of growth over the last few years.

NPAs had risen during the last boom-bust cycle as well. They had climbed to almost 25% of gross advances in the mid-90s, before falling to 2.2% by 2007-08, thanks to bank recapitalization and an economic boom. Historically, NPAs in the Indian banking sector have been concentrated in public sector banks, which together form about 70% of the banking system. The write-off of NPAs and recapitalization, to adhere to mandated capital-adequacy

norms, has therefore been largely through taxpayer bailouts, both during the 90s as well as now. Thus, ₹3.8 trillion has been infused into 18 public sector banks over the past decade to maintain the mandated CRAR.

Write-offs are the last resort for taking bad loans off bank balance sheets. There are two other mechanisms that have been tried as means to reduce the overhang of bad loans. One, the intervention of a regulator, and two, market mechanisms.

Resolution mechanisms in India were traditionally weak or non-existent prior to the 2016 passage of the Insolvency and Bankruptcy Code (IBC). Some of the decline in NPAs during the last few years can be attributed to this code coming into effect.

Market-based mechanisms to reduce the overhang of NPAs are more recent and derive from the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act of 2002. It enabled asset reconstruction companies (ARCs) to securitize bad loans and sell

them in the market at a discount. While the bank is not repaid the full amount, it nevertheless realizes a portion of the dues upfront, and a portion through marketable securities redeemable over time.

There have been problems with India's market for distressed debt. Banks received only a small amount upfront in cash, with the bulk through securities. The latter remained on their books and became a new source of NPAs. RBI, therefore, mandated a certain minimum to be paid to banks upfront in cash. This has had a dampening effect on the market for distressed debt, as an external injection of additional capital is required to effectively close a transaction.

It is still not clear what role the IBC and market-based mechanisms will play in resolving the banking crisis, and whether they would substantially reduce the need for taxpayer bailouts of the Indian banking system. At ₹9.4 trillion, NPAs were about 5% of India's gross domestic product in 2018-19. With NPAs on the rise again, and national output projected to shrink, the problem will worsen. There is a renewed danger that the entire capital of public sector banks might get wiped out, entailing even larger recapitalization through the Union budget to maintain mandated capital reserves.

### Another pile-up of bad loans could wipe out the capital of banks and call for bailouts with taxpayer money