

Webinar #6, 10th December 2024: “Domestic demand system”

“My biggest hope is the further build-up of China’s service sector”

A dialogue with Prof. XU Qiyuan, Deputy Director of the Institute of World Economics and Politics at CASS.

This text is transcribed from a webinar hosted by CMG and edited for clarity and brevity.

Markus / CMG: Good morning in Europe and good afternoon in Asia and in China. My name is Markus Herrmann. I'm the Managing Director of China Macro Group, CMG. Very warm welcome to the sixth webinar of our third edition of the webinar series, Staying in Dialogue with China, a European-China initiative, today on “domestic demand system” with Professor XU Qiyuan from CASS, whom I'll introduce shortly.

I'll take a short moment to advertise two contents from CMG. First, we recently published an analytical digest of the Caixin Summit 2024, a slide deck and a Read-Out Webinar recording, plus you find the transcript of our last webinar with Professor Yu from Liaoning University. You can download both resources using the QR Code.

I would like to introduce or remind for those who have been repeatedly joining our webinar series our webinar concept. As you know, we have structured the six webinars in 2024 along six structural transitions. This is a political economy framework that we have created inspired by input from PKU scholars and then further refined. Just briefly, the six structural transitions we think are the most important ones in China's political economy: first, economic transition from an agrarian to an innovation-based service economy plus industrial upgrading, second, market-oriented reforms and market governance, third, economic globalization, fourth, the domestic demand system – which we will discuss today –, fifth, social rebalancing and sixth, economic security or de-risking.

I would like to now introduce you, Prof. Xu. You are the Deputy Director of the Institute of World Economics and Politics, the IWEP at CASS. If you look to the right side, for your easier reference we put the org chart of CASS, so you can see the main six departments including International Studies Department, with the Institute of World Economics and Politics which Professor Xu leads as Deputy Director. He holds a Phd from Northeast Normal University plus a Postdoc from IWEP at CASS. His research focuses on China's macroeconomic policy, global economy and international finance.

Moreover, I would like to highlight four key roles of Prof. XU: first, his membership in expert committees for the Ministry of Finance, the Ministry of Industry and Information Technology (MIIT) and the National Bureau of Statistics. Second, he is a member of the Advisory group of the World Bank's annual report (World Development Report 2024) and the Asian Development Bank Institute. Third, he is an expert member of the 15th Five-Year-Plan of the MIIT that I was mentioning. Fourth and finally, he is also a special expert for a “Chinese Economists Confidence Survey” by the NBS.

Now, turning to Professor Xu: I just learned that you are 2.5h north of Beijing in an offsite venue owned by CASS, where the Great Wall cuts through the premises, thank you very much for taking time to join us, Professor Xu.

So the 1st question is general, what do you think about the framework of these six structural transitions. Do you think domestic demand system is a structural transition? Over to you and thanks for being with us, Professor Xu.

Prof. XU (CASS): Okay, thank you, Markus. Thank you for having me and thank you for our audience's time and interest in China's economy. The domestic demand system in China is heavily related to the other five structural transitions. For the domestic demand, I think China is facing the challenge that was meant to be addressed by the Dual Circulation, where we see a serious issue in the domestic circulation right now with a mismatch between supply and demand.

I can give you an example: In China's economy there are hairdressing services but also the manufacturing sector which for instance produces cars, and you can see the manufacturing sector is very strong, maybe too strong as the supply side—while the service sector is rather weak, including the employment, even though most jobs should be provided by the service sector. I can give you a data in China, the total employment number like more than 700 million. Most of them are in the service sector, but in last 3 to 4 years we know that many policies are favorable to manufacturing while it was less friendly to the service sector.

You can see examples for big tech, gaming industry or for instance FinTech. So when employment in the service sector is affected, then expectations of households is less positive and thus demand is weak. So the people working in hairdressing service can hardly buy cars they need.

If I can briefly link this aspect to the discussion of overcapacity that I know is of interest to an European audience, I believe the real issue is lack of demand, not overcapacity. For example, out of 100 households in China only 20 own a car, while in the US 80 households own a car. So we could in fact quadruple sales of China's capacity. But now even for the 20 we lack demand (in some cases because of administrative purchase restrictions), so we really need to stimulate the demand.

Markus / CMG: Great Professor Xu, you already touch on many interesting topics. If I can come back on the conceptual question related to “domestic demand”. This term was first mentioned in April 2020 after the initial containment of the Covid pandemic. Why does China's economy need such a concept?

Prof. XU (CASS): Yeah, that's a very good question. I wrote a very long column, maybe 10,000 Chinese characters, to explain why China put forward such kind of strategy. We know what happened in China in the years 2009/2010 when there was a 4 trillion RMB stimulus which I think was very successful. But in fact, over the last decade when scholars and policymakers reviewed the recent history including those years, many expressed the critique of over-stimulation which has caused the property market bubble and the overcapacity issue we are facing today.

So in China it is not so popular that when you talk about stimulus via monetary or fiscal policy, it may not be politically “correct”. So people will be cautious in the public debate and be cautious in demanding stimulus to increase aggregate demand. At the same time, it had become very politically “correct” to emphasize the supply side structural reform, the SSR, since the year 2015. So we see what happened since then: More policies just to focus on the supply side, while we now think there has been too emphasis on the supply side.

Some very smart guys said we need to balance the supply and demand side but we don't want to be politically wrong, we just want to balance. So they proposed to make the domestic market stronger as a new slogan. Underlying this concept is the demand side which needs to become stronger. Then, in the year 2020, you see that the official document put these things together and created the “Dual Circulation”. The inner circulation as the core is the domestic market, made up by both the supply side and demand side, and where thus both sides are now conceptually acknowledged as important. That's the story why the concept of domestic demand was created.

Markus / CMG: Very useful explanation, also to have the dynamic of what is “politically correct” as a backdrop for introducing such a top-level concept. As a follow-up: why does it have to be a domestic demand “system”?

Prof. XU (CASS): When we talk about domestic demand, there are three types: consumption from households, corporate investments and expenditures from the government. But let's forget about the government and look at the market, then consumption and investment are most important, but there is some kind of misunderstanding about China's domestic demand. Maybe you read the data that China's household consumption is very weak only occupying ca. 1/3 of total GDP, but actually Chinese people who buy a house look at it as consumption for daily life. If considered this way, the share of household consumption of GDP is probably higher than 50%.

But according to macro economics textbook and CPI handbook (by ILO), we can't. If you buy the new house or apartment, most of which will be counted as a fixed asset investment in the property market. So this is one reason why the investment share in China's GDP is so high. But it doesn't mean per se that households are poor. The income disparity is very large, yes, but the income share of households is nonetheless at ca. 60%, not much lower than for instance Japan, while the US is at around 70%. So China has a 10% gap to the US here.

So I think the problem why Chinese people consume less is because they invested too much in the property market. But we know what happened to the property market in China 3-4 years ago, which is not a benign adjustment, it created a vicious dynamic. 3 years ago one may have thought if the share of investment to the property market is suppressed, then the consumption will increase. But no, because the people thought the property market is declining, then the economic future won't be good, so they save money and consume less.

So this dynamic has to be turned from a vicious to a benign one by not only focusing on the property market. We need to find other solutions, for example, to develop China's service sector especially including education and healthcare to make the GDP growth rate relatively stable. At the same time, you can change the structure of household consumption away from the property markets to more consumption of services, which should be better released as it has been suppressed through over-regulation. This will in turn also lead to more job creation in line with the needs of university graduates who usually don't want to go to the assembly line as a "blue collar" worker, they want to work in the service sector.

Markus / CMG: You mentioned earlier that there is a lot of favorable policy for the supply side, for manufacturing, but little for services. What are policies that can structurally support the service sector?

Prof. XU (CASS): Before answering this question, I want to give you a data point: China's manufacturing employment peaked in the year of 2012, and then declined by nearly 3 million per year, so even in China, in fact we have been losing jobs in manufacturing for last decade, each year ca. 3 million. And then in 2020, it became flat because manufacturing was very strong due to two factors: first is the pandemic and the second are policies favorable to the manufacturing over the last 3 or 4 years. So manufacturing stopped losing jobs and maintained a stable level, even despite sanctions from the US.

If you look at the service sector since the same year 2012, the service sector employment increased by 8 million a year throughout the last decade before the pandemic. Then, since the start of the pandemic in 2020, the service sector stopped to add jobs, which is very bad. Even in 2022, the service sector lost the jobs, ca. 12 million jobs. Only in 2023 came back as a V-shaped recovery, but it still means that in last 3-4 years the service sector on balance did not create any new jobs when it should have created like 30 million new jobs.

We all know that China is suffering from aging population and China's labor supply has been decreasing in the past two years. In fact for China, it's the more normal to be confronted with labor shortage, nonetheless we see this quite high unemployment ratio among the young population. So to conclude, I think it's because the policies are relatively not favorable to the service sector.

So how to unleash the service sector potential in the future? When we talk about the middle class in China, we usually see the following three key burdens: buying an apartment, education and healthcare. And as the property market came to turning point, Chinese people still have very large demand for education and healthcare.

If you look at countries with aging population and you want to increase productivity, education is very important. So we need to expend more on education and healthcare, especially we need to increase the public service in this area. But we know that the more traditional thinking regards China as a developing country, seeing China predominantly as poor and hence believing it is more important to invest more into China's fixed capital formation, and not consumption such as public service.

I think this is one of the distortive factors encouraging too much tangible investments to the supply side. But we tried to persuade people that investing more in education and healthcare is also investment into human capital, which is kind, another kind of capital. I predict that in the near future you will see more and more government documents published with emphasis on consumption and investment into people, and not only into the tangible infrastructure. This would be a very good turning point for our policy framework.

Markus / CMG: Are there service sector friendly policies that have already been announced?

Prof. XU (CASS): In fact, in last August there was a basket of policies announced by the State Council, in which twenty policies relating to support of China's service sector, including gaming and education. In fact, in my mind, some previously existing policies also just come back. An interesting example is a very popular Chinese game, Black Myth Wukong, launched this summer in China. Had it been launched 3-4 years ago, official newspapers such as the “Economic Daily” will not mention or discuss it, but this time, this very official newspaper reports about it as a successful example in its headlines.

So I think the central government has changed its policy stance regarding the service sector. But in a next step we need to know how to develop it. Many, many factors have an influence over the service sector. For example, the VAT tax system, whose last reforms in the year of 2015 or 2016 turned out to be more favorable for manufacturing, not for services. This is an unexpected effect based on recent academic paper by Chinese economists.

Also, the way we produce the statistics of China's service sector is also not as good as for manufacturing. If you want to make assess if a local government has had a good performance, you first need statistics, data. But the statistical system of the National Bureau of Statistics, NBS, is more favorable and simply better at doing the data for manufacturing. For example, the retail data, we always talk about the monthly total social retail data, which most economists would equate to household consumption.

However, in China this indicator does not reflect consumption well, because it does not include healthcare, education and only parts of service consumption like accommodation or restaurants. So when you look at retail data to understand consumption trends, it is actually not correct, but we have no other indicator. So when you review a local government, there is no data you can use, we thus need to develop a new statistical system first.

Markus / CMG: What is the state of private tutoring in China and is it in line with current government policy?

Prof. XU (CASS): I think, for the tutoring sector policies have been loosened significantly, without big formal announcements, but policy execution changed. It now also seems that many companies in the tutoring industry have strongly improved their performance. In 2021/2022, they really suffered a serious shock from both the pandemic and policies, but now the tutoring industry is doing much better than before, especially with the turning point in August I mentioned earlier, where supportive policies were announced by the State Council

Markus / CMG: Is there any specific the role of urbanization in better unleashing domestic demand?

Prof. XU (CASS): Urbanization is mentioned prominently in the “Third Plenum” meeting in July this year. On China's urbanization ratio today, there are two ratios circulating, one is on the basis of the formal “Hukou” system which shows China's urbanization ratio at ca. 45%. But if you calculate on the basis of urban residents, so people who live work in urban space for more than one year, the urbanization ratio records ca. 68%, nearly 70%. So the gap among these two ratios is more than 20%, so more than 20% of China's total population.

In fact, most of them are migrant workers or their families from rural areas or small cities. All these people work very hard, but have not been benefitting from China's welfare system, education, healthcare as public services. Therefore, they work 5-10 years until they earn enough money and then return to their rural home. Their consumer behavior is more like peasants in rural areas, and not like residents in Beijing or Shanghai. If you give them the opportunity to be like a citizen, they will consume much more than before. So there will be great potential to unleash the domestic demand.

Markus / CMG: What about other social security levers for unleashing domestic demand?

Prof. XU (CASS): I see two more.

First, the mandatory education in China is only nine years, whereas in Malaysia – with GDP per capita similar to China – it is 11 years. So I think for China, we need to make the mandatory education longer. Some of our colleagues in CASS suggest that China needs to include the Senior High school into the mandatory education, while others argue that we should first add pre-school into. Personally, I think both are very welcome. People will spend less on education, it will also encourage people to have more children.

Second, we need to better support the “bottom class” of our society. We need to give more money to them, as for instance people who retire in rural areas nowadays get a very little *pension*. I think they are very poor while we need to make people more equal. I think the central government is clear about this and they will carry out some policies for this issue.

Markus / CMG: So should government make a special effort to invest more on medical security for people living in rural areas because their pension income is much lower than that of urban people?

Prof. XU (CASS): It's a very complicated question for China to make solutions. I talked with the people closer to this issue and they told me that in developed countries doctors and nurses are generally all qualified and experienced, regardless if they work in big or small cities, or in rural areas. But in China, we or I would say that the best doctor and nurses are in Beijing, while doctors and nurses in rural areas are simply less trained, maybe because their education is much shorter than in Beijing or Shanghai.

So even if you build many hospitals in the rural countries in remote areas, people will not trust the medical system locally, they will take an airplane or high-speed trains to visit the hospital in the provincial capital, or in Shanghai, Beijing, no matter how much money they spend. So it makes the resources in Beijing and Shanghai extremely tight, while you have oversupply in rural areas. So that we need to do is a reform, not just investments to simply build more hospitals in the rural countries, and the reform needs to tackle the entire medical system as such. We need to find a way that qualified medical personnel is willing to work in rural areas and small cities.

Markus / CMG: This sounds like very challenging reforms requiring broad coordination.

Prof. XU (CASS): I'm not a specialist on the medical system, but I want to say that Chinese policymakers are very smart in finding solutions for concrete, but incremental progress or small adjustments.

For example, if you have read newspapers you will see that China added two holidays for next year. Two holidays are very important. When I talked with American friends, they say Chinese work too hard while American consume too hard. So American should work more and Chinese should consume more. So two additional holidays means at the same time that work days decrease by two days, which means that supply will decrease, while you can use the holidays to travel and consume more, so demand increases at the same time. If possible, we could combine the two new holidays with Labor Day in May, and thus extend that week to a second golden week holiday, so people can travel further and consume more. We know there are more than 200 work days in China. So it means nearly 1 percentage decrease in supply side while the same increase in demand.

Markus / CMG: A very good example. I will formulate a personal takeaway: I think the more Chinese policymaking will shift factors related to the consumption side and service sector, the more we will need to better understand societal behavior and dynamics to actually make sense of what policymakers are trying to fix. Taking a step back from the service sector, isn't growth reliant on manufacturing and exports in principle easier and better "controllable" given China's stage of development?

Prof. XU (CASS): First, from the external perspective, you can see China is facing many trade disputes, not only between US and China, but with many other countries as well. If you look at China's trade partners, we will see that among the 160 trade partners with China, 120 of them suffer from trade deficits with China. And if you look at the total number of trade defense measures employed against China, only ca. 1/3 comes from the US, the rest comes from Brazil, India, Europe and others, so many non-American countries. They employ trade protectionist measures, which means people are dissatisfied with China's trade surplus, maybe not due to geopolitical tensions, rather economic tensions.

When I visited in Vietnam, Thailand or Malaysia in South East Asia, they also concern the trade relations with China, although their business is to import intermediate goods from China for domestic processing and re-exporting to the US. So they need to import more from China to export more, but they are also concerned about the dependence on China's exports and its trade surplus. So China definitely needs to balance the trade, turn from too much dependence on external demand to more dependence on domestic demand.

And if you zoom-in on the domestic demand, you will see there are two choices. First, we can invest more in manufacturing or in infrastructure. Contrary to the general belief, I think China actually needs to invest more in infrastructure. Seven years ago in Beijing there was a heavy flooding, causing casualty of a car driver in the 3rd ring road, because the plumbing system of the city is bad, so we needed to invest more there to. In the past decades we invested a lot in over-the-ground infrastructure, but many under-ground infrastructure is in fact not so developed. Plus, we need to invest more in so-called "new infrastructure" such as 5G or 6G, data centers, etc. Yet, second, we need to emphasize more on the demand side as I explained earlier.

Markus / CMG: Great thanks. To go deeper on your earlier point that Chinese government gives more policy support to manufacturing which is partly of the issue of insufficient domestic demand, isn't a crucial reason driving this also China's self-reliance interest in the face of US policies and geoeconomic factors?

Prof. XU (CASS): First, when China produces too much, it will simply depend more on external demand. With more trade surplus we have to buy more USD-denominated assets for China's foreign exchange reserves. The official reserves were at more than 3 trillion USD, but now they are at 3.2 trillion USD, most of them indeed denominated in USD. So why we are so irrational, we work so hard, sell the products so cheap, while have been

criticized and the US can put sanctions on China's assets anytime. But I also criticize the US: You should enjoy your exorbitant privilege of USD. Why you want to eliminate the trade deficit. If there is no deficit, then the USD is not the world currency. So, both for China and the US, I think we need to adjust our policy framework.

Second, let's come back to the Dual Circulation. Why does China need this new strategy called “Dual Circulation”? Self-reliance in inner circulation is not to close the door, but we know that a super-large economy such as China needs to depend more on domestic demand. I think most of our foreign friends would agree with this. So if China says it wants to depend more on its domestic demand, you should not say that China does not want to open the door to foreign business. Actually, we want to open these doors and realize a win-win economic relations.

Third, now that many other countries carry out their own industrial policies to support their own manufacturing capacity while China has suffered from the weaponization of economic relations by the US, such as sanctions focused on manufacturing companies like Huawei or DJI, this creates pressure for China. Given this pressure we need to produce those things ourselves that we cannot import from other countries. However, I do think that we needed to balance such an approach well. If you exaggerate it, it can lead to further distortions, and I think policymakers know this.

Markus / CMG: Thank you for bringing back the “Dual Circulation”, which we at CMG see as the actual “strategic shift” of the 14th FYP Plan containing elements such as the “domestic demand system” or the “modern industrial system”. Plus, I agree with you that “Dual Circulation” does not mean closing China off from the global economy, there is not even a conflict per se between more opening-up and more self-reliance.

Now, how do you think about the recent government interventions on a high-level? Are they enough to bring back China's economy to its full dynamism?

Prof. XU (CASS): in my mind, there was a first turning point in May this year when Chinese government declared that some apartments need to be bought from the market. The second important turning point is 26th September. And yesterday the Politburo announced new policies, and I think the direction is more and more clear and the direction is right. But we need more policy, and we need both fiscal and monetary policy in a bigger, much bigger volume. As we don't have the volume in detail yet, I think the upcoming Central Economic Work Conference, CEWC, and the government reports in March next year will provide more information to the markets. I think there could be a very remarkable volume of fiscal and monetary policy coming.

Markus / CMG: Great. Thank you, Professor Xu, a quick closing question: What is your biggest concern and biggest hope respectively for China's economy?

Prof. XU (CASS): From a personal perspective, my biggest concern is about China's real estate market, because it is the underlying asset related to both household and local government. If the property market is more stable, local government non-tax revenues will also improve. My biggest hope, you may have realized from all my comments earlier, is the further build-up of China's service sector.

Markus / CMG: Excellent. Professor Xu, thank you so much for your time and being our guest speaker for our closing webinar of the 2024 “Staying in dialogue with China” webinar series.

Prof. XU (CASS): Thank you, Markus, my pleasure.

For reference: CMG's political economy framework: six structural transitions

Political economy: China's pursuit of 'high quality development' taking place amid six structural transitions			
Key structural transitions	Key policy goals	Key issues	Key policies
Economic transition and industrial upgrading	<ul style="list-style-type: none"> Transition to innovation-based economy Climb industrial value chain Digitalization and decarbonization 	<ul style="list-style-type: none"> Service sector contribution to GDP low Manufacturing struggling at mid-end products, low industrial value-added 	<ul style="list-style-type: none"> <i>Made-in-China 2025</i> <i>Opinions on High-quality Development of Service Industry 2019</i> <i>14th FYP 2021 Ch. 8, 10.</i>
Market-oriented reforms and market governance	<ul style="list-style-type: none"> Institutional transition, factor liberalization, SOE reform and "SSSR" Socialist market governance incl. anti-monopoly, / 'social credit' 	<ul style="list-style-type: none"> Low TFP Lower efficiency of state capital Monopolies and overcapacity "Disorderly expansion of capital" 	<ul style="list-style-type: none"> <i>Building Market-Oriented System for Allocation of Factors 2020</i> <i>14th FYP 2021 Ch. 19-22.</i>
Economic globalization	<ul style="list-style-type: none"> Integration into global flow of goods, services, capital, talent and ideas Continued opening-up 	<ul style="list-style-type: none"> Comparatively weak trade of service Comparatively low outbound FDI stock Geopolitics and decoupling policies 	<ul style="list-style-type: none"> <i>14th FYP 2021 Ch. 40</i> <i>Opinion on Increasing Efforts to Attract Foreign Investment 2023</i>
"Domestic demand system"	<ul style="list-style-type: none"> Consumption-boosting policies Rebalancing of public investments Business environment policy 	<ul style="list-style-type: none"> Low consumption share to GDP Demographic shift to aging population Imperfect social security system 	<ul style="list-style-type: none"> <i>14th FYP 2021 Ch. 12-14.</i> <i>Strategic Plan for Fully Expanding Domestic Demand 2022</i>
Social rebalancing	<ul style="list-style-type: none"> Equality and poverty reduction Social fairness and protection Balanced regional development 	<ul style="list-style-type: none"> Inequality: top 1% holds 30% of wealth Vulnerability of social groups (e.g. youth) 	<ul style="list-style-type: none"> <i>14th FYP 2021 Ch. 23-32.</i>
Economic security	<ul style="list-style-type: none"> "Coordinate development and security" 	<ul style="list-style-type: none"> Import dependencies and perceived supply chain risks China's weaker geoeconomic power 	<ul style="list-style-type: none"> <i>14th FYP 2021 Ch. 41-42, 52-53</i>

Longer-term transitions

Trade-off / rebalancing processes



China moved from linear economic development model of reform and opening up under Deng to dealing with strategic trade-offs