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From Crisis to Consolidation – How the Chinese Government Makes Strategic Use of the Health Crisis

China's leadership is convinced that Covid-19 will not stop China's economic rise. While the government did not set a growth target for 2020, it adopted an approach of strategic crisis management to further advance the vision of an economic and innovation superpower: in addition to generating short-term growth, economic policies and stimulus measures also serve long-term goals. This reflects the belief that China can make use of the crisis and has a chance to win the upper hand in hegemonic competition and technological progress. Beijing fully understands that a worldwide crisis can shift the global economic power balance and therefore sees this as an opportunity for China, write stars Alumnus ***Markus HERRMANN*** *and Dr.* ***Jost WUEBBEKE*** *of Sinolytics.*

In the view of China's leadership, Covid-19 is no reason to initiate any systemic shifts, such as transitioning towards a free market economy, major SOE privatization or a structurally improved level-playing field for foreign companies. Rather China's strategic crisis management is reinforcing and accelerating existing policy directions.

China's policy and stimulus measures are currently taking place on many levels: support for SMEs, monetary easing, consumer vouchers, employment, and social security measures, and so on. In this article, we focus on five areas characteristic of China's strategic crisis management with a clear impact on foreign companies.

1. New Infrastructure: Linking stimulus measures to future ambitions

China's long-term strategy can especially be seen in the infrastructure stimulus. The current measures still focus very much on "traditional" infrastructure as a proven element of China's policy toolbox.

However, by coining the term “new infrastructure”, the strategic crisis management also closely links the infrastructure stimulus with China’s long-term plans. Its exact scope is still unclear – various definitions include 5G, electric vehicle charging and data centers. The innovative turn is that it does not only consider physical infrastructure. The plan also focuses on software “infrastructure” for new digital applications, such as AI. Ideally, the stimulus will generate growth and accelerate the rollout of innovative technologies.

Many provinces have launched “new infrastructure” investment plans this year. Incomplete figures of local plans in five provinces suggest investments worth 1.4 trillion CNY in new infrastructure in the coming years. Shanghai, for instance, plans to spend 60 billion CNY over the next three years, plus an additional 210 billion in private capital.

Taking 5G as an example, new policies have intensified these efforts over the last months: An MIIT policy promotes construction of 5G base stations. Various provinces have announced ambitious investments to boost the technology. If these plans are realized, China could have 4.6 million base stations by 2025, 600.000 more than in pre-pandemic estimates. A faster deployment of 5G will mean faster adoption of business models using 5G such as smart city solutions and autonomous driving.

The effectiveness of the stimulus, however, is not yet clear. Infrastructure investments now generate less growth than back in 2008. “New infrastructure” represents only about 10-15% of total infrastructure investment. Fast roll-out can cause quality problems. Local governments such as Guangdong have increased local debt by issuing special-purpose bonds and others are planning to do so.

2. Companies have to operate in a highly dynamic policy environment

In addition to infrastructure stimulus, the strategic crisis management triggered a highly dynamic policy situation. New policies and regulations are coming out at a high speed, in some cases resolving previous policy deadlocks. Within days, the government is taking decisions that substantially affect entire industries.

A case in point is the dynamic in the automotive industry. In early February, the standing committee of the Politburo decided to support the car industry, with two major consequences:

- The government extended the purchase subsidy for electric vehicles until end-2022. The subsidies were originally to be phased out by end-2020. In 2019, however, a partial rollback of subsidies had already brought about a steep decline in sales. Now as Covid-19 kicked in, extending the subsidies was a natural option. However, the subsidies suddenly set new strict requirements, such as a minimum e-range of 300km. Vehicles would only be subsidized up to 300.000 CNY. The speed at which the decision was taken has not left much time to react. Those not meeting the requirements will be disadvantaged compared to their competitors. Tesla, for instance, decided to decrease the price of its Model 3 Sedan to qualify for subsidies.
- The government extended the transition period for complying with the China 6 emission standard. As the emission standard creates significant pressure to reduce vehicle emissions, this step brings some relief for automotive companies.

The two cases of the automotive industry show that for Chinese and foreign companies, Covid-19 means more uncertainty and surprises. In some cases, these have clear negative impacts on business, in others, they can be positive.

3. Grown regulatory capacity drives more foreign market access

An obvious area of high policy dynamism during the crisis has been public health, where China's new Corporate Social Credit System (CSCS) became an instrumental regulatory steering tool: mere weeks into the Covid-19 crisis, a substantial number of tailored local and central government CSCS policies were issued, introducing operational relaxations, incentives, and restrictions to guide companies to support public health objectives. While the CSCS has proven its effectiveness as a tool able to respond to newly emerged and comprehensive market steering needs, this accomplishment falls under the broader trend of the Chinese government's rapidly improving regulatory capacity.

We predict that this regulatory capacity will accelerate foreign market access. Shanghai Municipality's recent acknowledgment that 20% of employment, 27% of GDP and 33% of tax revenues are contributed by foreign companies; this is a timely reminder of the importance of foreign investors for the Chinese market. In recent years, many foreign equity restrictions have been slashed and more relaxations announced, but an even faster and more comprehensive revision of the negative list both on national level and for FTZs can be expected.

This dynamism will also spill over to a more consequential implementation of recent policies to improve the business environment. However, fundamental behind-the-border challenges for foreign companies will not disappear such as access to licenses and public procurement will not disappear.

4. Covid-19 strengthens ambitions for self-sufficiency and decoupling

On the technological level, Covid-19 will also cause faster decoupling. For many years, Made in China 2025 has been calling to increase self-sufficiency and to replace foreign technology with Chinese versions. With new rules for "secure and controllable" products and the 3-5-2 policy, China is pushing an agenda for using domestic products. This has been further reinforced by the U.S.-China trade war and the export ban placed on a dozen Chinese tech companies.

Covid-19 is intensifying decoupling for two reasons:

- After some relaxation in January, a spiral of mutual recriminations has led to further deterioration in U.S.-China relations. That the U.S. president would even consider cutting diplomatic ties with China or countenance the possibility of a "Cold War 1.5" further pushes the technological divide into two different economic and technological ecosystems.
- As Covid-19 has revealed the vulnerability of global supply chains, we see an initial trend towards the localization of manufacturing. In Europe, the discussion revolves very much around the production of pharmaceuticals and medical equipment at home. In China, calls for localizing production are also intensifying. As production is ramping up again in China, the country faces supply shortages of core components from abroad.

Decoupling is visible in many efforts. Huawei is developing its own Harmony OS as an alternative to Android. Huawei subsidiary HiSilicon will start to source systems-on-a-chip (SoC) from the mainland foundry SMIC. According to unverified media reports, its original supplier, the Taiwanese TSMC, may have to stop sales to Huawei to comply with the U.S. trade ban. On another note, domestic carmakers start to source more from domestic suppliers as prices of imported parts rise due to Covid-19.

At the same time, however, decoupling has its limits on the Chinese side. Replacing foreign technology is easier in some industries, such as railway, than in others, such as semiconductors. Although there have been some achievements in chip production, China has fallen behind cutting-edge chip design in the U.S. Chinese chipmakers account for only roughly 6% of the domestic market, far away from the 70% target in 2025.

For companies doing business in China, Europe and the U.S., accelerated decoupling means they must operate in increasingly separate technology ecosystems that are more and more disconnected. Choosing one of the two can lead to being excluded from the other. Catering to both systems will increase costs of adaptation.

5. Shaping an adverse external environment in China’s interests

While self-sufficiency policy addresses the U.S.-China technology decoupling, China is further confronted with a fracturing global trading system. Despite reaching a fragile “ceasefire” in January, the Chinese economy has suffered from trade diversion caused by the U.S.-China trade war.

The Covid-19 health crisis adds two dimensions: one, an international demand disruption with unclear recovery period and two, calls from European and Japanese leaders for less supply chain dependence on China, and in some cases, for reshoring of critical supplies, such as vaccines. In response to this challenging trade environment, we expect the Chinese leadership to reinforce three priorities:

- A top priority will be a quick signing of the Regional Comprehensive Economic Partnership (RCEP), as evidenced by a recent MOFCOM statement in March 2020. Aside from the geopolitical value of counterbalancing the CPTPP, signing the RCEP will strengthen China’s trading relations with ASEAN, which in Q1 2020 emerged for the first time as China’s largest trading partner. It will also help to consolidate existing value chains in the face of calls for diversification.
- Chinese trade diplomacy will expedite processes for ongoing FTA feasibility studies and negotiations. MOFCOM statements already call for acceleration of the tariff-centered negotiations with Cambodia, Israel, Norway, Sri Lanka and the Gulf Cooperation Council, among others. There are also clear signs of momentum in the China-Japan-South Korea FTA negotiations.
- Another policy direction we expect – inferring from a recent Politburo meeting – are China’s efforts to regionalize its own industrial supply chains for more secure and resilient supply. Thereby, China will focus on those trading partners among economies participating in the Belt and Road Initiative (BRI) that feature solid political trust and alignment on trading rules – with an actual “Sino-centric trading community” taking clearer shape.

To support these priorities, we further expect the BRI to scale back its connectivity programs from far-flung Latin America, the politically instable Middle East, and from

Central Asia, due to its underdeveloped manufacturing capacities, and reinforce its focus on ASEAN.

Key implications for the post-Covid-19 era for foreign corporates doing business in and with China

China's strategic crisis management as portrayed above has two fundamental implications for foreign business:

- The high dynamic of new policies and regulations exposes foreign enterprises to additional risk. Detailed assessment of these dynamics will be key to successful operation in the Chinese market.
- The disruptions of global trade and China's policy response will require corporate boards to review their strategic footprint in the Asia Pacific region.

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