The New Development Paradigm of Dual Circulation and Financial Reform and Opening-Up

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Abstract: *The CPC Central Committee's Proposals for Formulating* the *14th Five-Year Plan (2021-2025) for National Economic and Social Development and the Long-Range Objectives Through the Year 2035* adopted at the fifth plenary session of the 19th CPC Central Committee stated that the new development paradigm of dual circulation with domestic circulation as the mainstay and domestic and international circulations reinforcing each other is one of the major guidelines on China's social and economic development during the 14th Five-Year Plan period. It also mapped out the tasks of smoothing the domestic circulation and promoting both domestic and international circulations. Dual circulation is a strategic choice to reshape China's competitive edge in the current domestic and international environment. China needs to facilitate the domestic circulation through greater economic self-reliance and improve the international circulation through reforms and higher-level opening-up, to remain on track of the supply-side structural reform in the financial sector and to support dual circulation with the fintech-led integrated innovation in the financial system. Financial reform and development in the new era hinges on China's ability to seize the opportunities in the fourth financial revolution, specifically requiring China to promote the sound development of fintech, enhance its unique pro-technological innovation financial system, and continue to support green finance and inclusive finance. In addition, China needs to build self-reliant and high-quality financial infrastructures, foster a financial system that supports new energy development and the strategic adjustment of the energy supply system, and develop industry chain finance in a way that aligns with dual circulation. To promote high-quality economic development, China needs to ensure that the financial sector serves the people's livelihood, and improve its capacity to manage systemic risks while advancing the high-level opening-up of the financial sector.

Keywords: new development paradigm, supply-side structural reform in the financial sector, high-quality development

The new development paradigm of dual circulation with domestic circulation as the mainstay and domestic and international circulation reinforcing each other was first proposed by General Secretary Xi Jinping in May 2020 and reiterated on numerous occasions ever since. *The CPC Central Committee's Proposals for Formulating the 14th Five-Year Plan (2021-2025) for National Economic and Social Development and the Long-Range Objectives Through the Year 2035* adopted at the fifth plenary session of the 19th CPC Central Committee stated that the new development paradigm is one of the major guidelines on China's social and economic development during the 14th Five-Year Plan (FYP) period. It also mapped out the tasks of smoothing the domestic circulation and promoting both domestic and international circulations. Fostering the new development paradigm will be the top priority for economic development in the years to come. It is also the focus of financial reform and development in the 14th FYP period.

I. Dual circulation is a strategic choice to reshape China's competitive edge in the current domestic and international environment

As General Secretary Xi Jinping stated, the new development paradigm of dual circulation is "a strategic decision made in view of the changes in China's development stage, environment, and conditions", "a systemic, in-depth, and holistic reform" and "a strategic decision designed to ensure China's economy can move with the times and gain new competitive edge in global economic cooperation and competition." In short, dual circulation is both a response to international changes and a necessity for the transformation of China's economic growth model.

The world is seeing major changes never seen in a century that are reshaping the global political and economic landscape. Protectionism and populism are on the rise; global trade, investment, and industries are devastated. Both point to a more severe external environment for China in the coming years. A most effective response to the resulting external uncertainties is to ensure self-reliance in critical areas. Domestically, China's economy is transitioning from high-speed growth to high-quality development. As the socialism with Chinese characteristics has entered a new era and productivity has grown remarkably, uneven and inadequate development, which prevents those affected from living a better life, has become a more prominent issue. It is necessary to smooth dual circulation and thus achieve high-quality development.

In essence, dual circulation is about self-reliance and high-level opening-up. Consistent with China's long-standing strategies and policies, it emphasizes coordination between market supply and demand, domestic and international circulation, as well as economy and finance. Prioritizing the domestic circulation is not about decoupling China from the rest of the world, but about adapting to domestic and international changes by advancing self-reliance and high-level opening-up and promoting the alignment and synergy between the two through reform.

II. Smoothing domestic circulation by enhancing self-reliance

A self-reliant domestic circulation is the mainstay of the new development paradigm, which requires boosting domestic demand and addressing deficiencies and inefficiencies in order to create a free-flowing economy from production to distribution and logistics and finally to consumption.

First, bringing into play the leading role of technological innovation to accelerate the transformation and upgrading of the manufacturing industry. The manufacturing industry is a pillar of the Chinese economy and therefore is critical to a streamlined domestic circulation. While known as the world's factory, China relies heavily on imported high-end capital goods to power its production as it lags behind world leaders in independent manufacturing capabilities. Therefore, China needs to promote technological innovation and encourage indigenous solutions in key manufacturing stages and critical components so as not to be held back by foreign technologies and other weaknesses, and better align the supply side of the manufacturing industry with domestic demands.

Second, improving resource efficiency and optimizing the supply-demand structure of commodities. China imports about 60 percent of the commodity goods; for products such as crude oil, the external reliance can even exceed 70 percent. The sources of some of the commodity imports are highly concentrated. For instance, in 2019, 62.2 percent of China's total iron ore imports were from Australia and 62.1 percent of its total copper concentrate imports were from Peru and Chile. In view of these figures, China should leverage innovative technologies to improve the output and utilization of resources, expand the use of renewable energy, increase production output in western regions, and diversify the source of commodity imports.

Third, firmly implementing the strategy of expanding domestic demand and tapping the potential of domestic consumption. Domestic demand is the biggest driver of growth in major economies. While China is also transitioning to a demand-led economy, there still exist problems in its unbalanced consumption structure. China's final consumption expenditure as percent of GDP is noticeably low compared with other countries, averaging less than 60 percent in the past decade. In particular, the middle-income group is yet to play a bigger role in driving the consumption-driven growth. China's middle class, now at around 400 million according to the National Bureau of Statistics, is expected to double in a decade based on an assumed annual growth rate of 7.2 percent. This will raise the GDP growth rate by an average 0.5 percentage points per year in the next decade. Therefore, China should hasten the reform of its income distribution system, strengthen the social security net, increase the disposable income of residents, and expand the middle class to tap the full potentials of its hyper-sized consumer market and enormous domestic demand.

III. Optimizing international circulation through reform and higher-level opening-up

The new development paradigm calls for an open dual circulation of domestic and international markets. The COVID-19 has highlighted the urgency of protecting China’s position in global industrial chains and climbing up from low- and mid-level manufacturing to high-end market segments. The international circulation is about promoting higher-level opening-up to support and streamline the domestic circulation, optimize structure, and invigorate the economy, so that domestic and international circulations can mutually reinforce each other.

First, improving the quality of going global. China is the world’s second-largest source of outbound direct investment (ODI), but this achievement belies numerous structural issues: low investment in knowledge- and technology-intensive industries, high concentration in Asia, and under-representation in promising regions such as Africa. Addressing them requires China to further optimize the industrial structure of ODI, expand the geographical reach of its overseas investment, and boost cooperation with Africa and Latin America to create win-win outcomes and reduce the dependence on any single overseas market. In addition, China should develop innovative investment approaches and increase its stake in overseas green industries.

Second, optimizing the structure of FDI. China is also the world’s second most popular destination for foreign investment, ranking top among developing countries for 28 consecutive years. However, most of the foreign capital is flowing into China’s largest cities and the provinces along the eastern coast. In 2019, 62.5 percent of foreign direct investment (FDI) went to the five provinces and municipalities of Beijing, Shanghai, Jiangsu, Zhejiang, and Guangdong. Furthermore, there is still plenty of room for FDI growth given the scale of the Chinese economy. China should continue to attract FDI and high-tech, high-quality foreign-invested enterprises in line with its goal of pursuing high-quality economic growth, deepen the opening-up in Central and Western China to optimize the regional distribution of opening-up, and converge with international best practices in improving the negative-list-based foreign investment management framework.

Third, consolidating China’s status and influence as an international trading power. Prioritizing the domestic circulation is by no means seeking development behind closed doors. Whether it is in terms of resources, factors of production, or markets, decoupling is neither in the fundamental interests of China nor feasible. Even though China has been the world’s largest exporter for years, low-value-added processing trade still accounts for a quarter of its export, and in 2019 service exports only amounted to 11.4 percent of the goods exports. The mounting downward pressure on the global economy, rising trade protectionism, and China’s own declining cost advantage have made it a renewed imperative for China to maintain its status as a trading power. This requires the country to transform and upgrade its industries and optimize its export structure to respond to de-globalization and the reconstruction of the global value chain, participate in the global division of labor more efficiently, shift the focus of international trade from quantity to quality, and promote innovation in service trade with the help of 5G, big data, and smart technologies.

IV. Adhering to the strategy of supply-side structural reform in the financial sector and supporting the new development paradigm of dual circulation with integrated fintech-led financial innovation

Accelerating the building of the new development paradigm creates a renewed emphasis on high-quality financial development, which hinges on a supply-side structural reform in the financial sector that holds a people-centered philosophy and takes serving the real economy as its fundamental function. Accordingly, under the central leadership of the CPC Central Committee, the PBC should enhance its cross-cyclical policy designs and adjustments for more effective macro regulation, so as to promote economic development while preventing inflation, debt expansion, asset bubbles and other problems resulting from excessive money supply. We should attain a long-term balance between stabilizing growth and preventing risks so as to create a lasting stable monetary and financial environment for the quality development of the real economy as well as for the supply-side structural reform. In line with the market-oriented and law-based principles, China should develop a modern financial system that is adaptive, competitive and inclusive, build a new financial system with broader openness, and marshal international financial resources to boost the country's high-quality development and modernization progress, so as to provide high-level financial support for the key areas and links in the new development paradigm.

Importantly, such efforts should aim to address the greatest challenge confronting the new development paradigm, namely how the financial sector should better serve the innovative development of the real economy. Looking back in history, the three industrial revolutions have each greatly increased our productivity and profoundly changed the modes of production and social relations. Running parallel to them are the three financial revolutions. The first of these, represented by modern commercial banks, bankrolled the first industrial revolution. The second financial revolution, characterized by modern investment banks, rebuilt the capital base for the second industrial revolution. And the third one, identified by the creation of the venture capital industry, provided the impetus for the third industrial revolution. Today's ongoing fourth industrial revolution has assigned a new historic mission to the financial sector, and this revolution will be characterized by the integrated fintech-led innovation in the financial sector. Whether the financial system is able to accomplish this mission and how financial reforms help foster a growing and innovative real economy, are the key challenges ahead of China and will decide whether China can grow steadily into a financial power. This especially requires us to take a problem-oriented approach, and by means of integrated innovation, to comprehensively support leading innovative enterprises, and enhance the financing support and all-round financial service system for tech-strategy competitions.

Specifically, financial development in the new development paradigm can take a four-pronged approach. First, it should propel integrated fintech-led innovation in the financial system to support the fourth industrial revolution. This entails strengthening the financing system for the industry chain and the innovation chain, and enhancing supports for high-end manufacturing industry, innovative enterprises, and exemplary industrial clusters. Second, it needs to improve financial service capabilities in line with China's new development philosophies as well as the circulation dynamics and strategic vision under the new development paradigm. For instance, we should improve the green finance system, develop a financial support framework that suits the evolving international energy landscape, drive the sustainable development of inclusive finance through digital financial inclusion, and boost domestic consumption by orienting financial products and services to support livelihood development and rural revitalization. Third, financial development should also facilitate the high-level opening-up of the financial sector while preventing systemic risks, so that internal and external circulations can reinforce each other. High-level financial openness can lead to more elaborate financial reforms, and thus attract international financial resources into the dual circulation. Additionally, we need to modernize the governance system and capabilities to achieve better adaptability of regulation, supervision, and the market, and to effectively prevent systemic risks. Fourth, financial development should help optimize the overall plan for financial reform and opening-up in line with China's national strategies. It should accelerate the development of Shanghai as an international financial center, as well as inland financial centers and regional financial-reform pilot zones. It should lead to financial service systems that are tailored to the local economic structure and the needs of local industries and residents, and promote the efficient clustering and appropriate flows of financial factors as well as the synergistic development of financial markets.

V. Ten priorities of financial reform and development in the new era

In view of the historical context and current state of financial reform and development in China, we have ten priorities in adapting to the new development paradigm of dual circulation and in encouraging the financial sector to better serve the high-quality economic and social development.

First, seizing the opportunity of the fourth financial revolution and cultivating a sound fintech industry. This requires context-specific plans that foster a well-regulated fintech industry. Breakthroughs in critical areas can stimulate changes on a much wider scale. In particular, China can experiment with the safe and secure applications of emerging technologies such as big data, cloud computing, artificial intelligence, and distributed databases in the financial sector, and support financial institutions to deploy suitable financial technologies to enhance the quality and efficiency of services. We need to well balance financial development with financial stability and financial security, so that it not only encourages innovation and entrepreneurship, but also strengthens regulation and supervision of all financial activities, effectively prevents risks, and ensures that the same type of business lines or entities are treated equally. At the same time, we should deploy more effective technologies for forestalling financial risks, strengthen cybersecurity risk control and financial information protection, and prevent the risks of new technologies in financial applications. Lastly, we should bolster the top-level regulatory design and prudential regulation of fintech, establish a system of fundamental regulations, and enhance its see-through supervisory capacity.

Second, developing China's unique pro-technological innovation financial system. We should support financial institutions to provide all-round services for innovative companies in accordance with the life-cycle of technological innovations, and foster a network of distinctive, vigorous, market-based, and professionally managed venture capital institutions. The sources of venture capital should be broadened. It is important to empower the Main Boards, the STAR market, the SME Board, ChiNext, and National Equities Exchange and Quotations (NEEQ), and streamline the market-oriented exit channels for venture capitals. We should explore effective ways for the financial sector to support high-tech agricultural industry, and enhance the support for tech-enabled agricultural sectors such as the under-forest economy, under-solar-panel economy, the biological seed industry, modern agricultural machinery, smart agriculture, etc.

Third, building self-reliant high-quality financial infrastructures. We should enhance the legal system building, coordinated management, and planned development of financial infrastructures to create an advanced, reliable, and resilient financial infrastructure system that is properly planned and effectively governed. Work should be accelerated to develop the digital currency DC/EP and conduct its pilot operation in a controllable way to ensure payment security. We should promote the regulated development of the credit reporting market and the credit rating industry. Moreover, we should reinforce research on fintech innovations, enhance their application in financial infrastructure development, expand the coverage of financial infrastructures to bridge the digital gap, and improve both operational and regulatory efficiency in this field.

Fourth, building a green financial system to support green development. We should improve government incentives and make full use of market mechanisms to build a multi-tiered and diversified green financial market system. Work should be done to promote the environmental, social, and corporate governance (ESG) criteria by encouraging banking institutions to speed up innovations in green financial products and services and accelerating the cultivation of intermediary institutions to support the development of green finance. We should strengthen international cooperation actively on the standards for green finance so that they will not only be unified domestically but also be aligned with international practice. At the same time, we should promote regional cooperation in green finance and encourage more international capital to invest in China's green financial assets.

Fifth, building a financial support system to serve the development of new energies and the strategic adjustments of the energy supply system. Financial support should be stepped up for both new energy and energy-efficient industries. We should enhance financial services for energy development in Belt and Road countries and regions, support close cooperation between financial institutions and the enterprises going global, and engage deeply in energy development projects overseas. We should also quicken steps to promote high-quality development of energies and energy derivatives markets, improve the rules for Shanghai crude oil futures, and work for the establishment of an RMB-denominated settlement system for new energies.

Sixth, promoting financial inclusiveness on a sustainable basis to tackle the financing difficulties and costs faced by micro and small businesses and private enterprises. The organizational system of inclusive finance should be improved to feature diversification and wide coverage. We should promote the joint participation of commercial, policy, development, and cooperative financial institutions in microfinance and inclusive finance. There should be more innovative financial products and credit reporting services for target beneficiaries of microfinance and inclusive finance. We should fully leverage digital technologies to develop not only an inclusive financial system that features wide coverage, sustainability, mutual assistance, resource sharing, and synchronized online and offline development, but also a system of credit risk identification, monitoring, early warning, and resolution. Work should also be done to optimize the ecosystem for the development of microfinance and inclusive finance and to enhance financial standard setting in the field of digital inclusive finance.

Seventh, developing industrial chain finance in a way that aligns with dual circulation development paradigm. We should support financial institutions to develop innovative products and to collaborate with industries so that they can provide financial services for the whole industrial chain and offer integrated financial solutions to upstream and downstream companies as well as core companies in the industrial chain. We should encourage the development of supply chain finance products, place emphasis on the confirmation of accounts receivable, improve the issuance of receivables-backed notes, and enhance the transmission of credit from core companies. The development of supporting financial infrastructures should move ahead while the role of the Receivables Financing Service Platform should be further explored. We will enhance the regulation of industrial chain finance and supply chain finance so as to prevent large core companies from infringing on the interests of small and medium-sized companies.

Eighth, orienting finance toward livelihood development. We should improve financial markets and guide financial institutions to develop a wider range of products and services to open up more avenues for residents to increase their property income. Meanwhile, we should vigorously promote old age finance and health care finance, and enhance the three-pillar framework of the old age insurance system. Financial institutions should be encouraged to develop diversified pension financial products and innovative service models, such as senior housing, integrated medical and elderly support, and smart care for the old. Under the premise of effective risk control, we should deeply integrate digital technologies and e-commerce platforms with the development of consumer finance to promote the digital transformation of the economy.

Ninth, advancing high-level opening-up of the financial sector and accelerating international financial center development. We should adhere to market-oriented, law-based, and internationally oriented principles and promote the full implementation of the pre-establishment national treatment and negative list system to achieve institutional and systematic opening-up. With a view to serving the real economy and facilitating trade and investment, we should accelerate the development of Shanghai as an international financial center, optimize the inland financial service system, support the development of the offshore RMB market in Hong Kong, and promote financial market interconnection in the Guangdong-Hong Kong-Macao Greater Bay Area. We will further improve the cross-border RMB policy framework and increase the convenience and acceptance of RMB use through refined management so as to promote RMB internationalization in a steady and prudent manner.

Tenth, enhancing systemic risk management capabilities comprehensively. We should do our part to modernize the governance system and capabilities, further meet the requirements provided by the *Civil Code*, the *Foreign Investment Law*, and other statutes, and achieve more amicable interactions among macro management, regulation, and the market. Macro policy coordination should be strengthened while the monetary policy framework and the base money supply mechanism should be aligned with the building of a modern central banking system. We should work for the establishment of a macroprudential policy framework based on matrix management and gradually expand the coverage of such policies. We will continuously improve the framework of risk monitoring and assessment for banking, securities, and insurance industries and strengthen financial risk monitoring, assessment, early warning, and resolution in key fields. We should conduct on-site assessments of the soundness of financial institutions on a regular basis, and carry out central bank ratings and financial stability stress tests effectively to guide the sound operation of financial institutions. Moreover, we should establish a mechanism for macroprudential management of cross-border capital flows that adapts to the needs of RMB internationalization, and improve financial risk monitoring, assessment, early warning, and resolution mechanisms.