CHINANALYTICS

A First Look at the 12th Five Year Plan
18 October 2010

Beijing - New Poly Plaza - (86) 10 8419 3340 (86) 186 010 59093 research@chinanalytics.com Hong Kong - Pacific House - (852) 6624 2191

KEY THEMES: Expanding domestic demand, improving the distribution of national income, reducing inter-regional economic disparities and upgrading the industrial base will be dominant themes in the 12th Five-Year Plan (FYP) that is sent to the National People's Congress (NPC) in March for approval. Efforts to strengthen domestic demand will be the most intense during the opening two-years of the Plan, with the government apparently building some pretty pessimistic assumptions on the external environment into its plans. More important, however, is the goal of reducing the vulnerability of China's economy to external demand shocks, as Beijing believes economic strength must come from within China's own borders. Many believe that the objectives spelled out in the 12th Five-Year Plan (FYP) represent themes that may extend for as long as 30-years, especially those related to China's global economic clout. China will retain its export-oriented ambitions, but where it comes to the cultivation of new domestic industries and boosting private consumption, there are hints that policy makers would like to steer China's domestic economy inward.

Whither political reform? We think it is unlikely that a government that believes strongly incrementalsim will introduce any political uncertainty during a period of economic transition. Dual-track reform is undesirable for the Party, especially ahead of a leadership transition in 2012. Hu Jintao's new slogan of "inclusive growth" for the 12th FYP and efforts to better distribute the gains from growth will probably be primary mechanism for addressing social pressures.

In this note:

The 12th Five-Year Plan in a few words: "accelerating the transformation of the pattern of economic growth in relation to reform and opening and the construction of the modern socialism"

CONTACT CHINA ANALYTICS:

For queries related to custom research and the contents of this report, please contact William Hess at whess@chinanalytics.com.

For media queries, contact Ms Judy Zhang at jzhang@chinananlytics.com or (86) 10 8419 3340.

For more information about China Analytics please see our website at **www.chinanalytics.com**, or recent additional writing by our team at **http:\\chinanalytics.wordpress.com**

GDP GROWTH TARGET: "Above 7, below 8"

The GDP growth target for the next 5 years most often cited in domestic reports is 7-8% per annum. Given the additional goal of doubling per capita GDP from around US$ 4,000 to $8,000-$10,000 by the end of 2020, a slightly lower target rate of growth is assumed for longer-term forecasting (as well as RMB appreciation). This number has to be evaluated in perspective: the target for the 10th FYP was 7%, but the actual average number came in at 9.5%, with the 7.5% target set for the 11th FYP having turned into average annual growth of 10%. Policy makers always like to set targets that they can exceed with relative ease, but this time around there is good reason to believe that they are sincere in their efforts to rein in excessive industrial capacity and inefficiency investment agendas by provincial governments. There are, of course, significant institutional barriers to doing so, but the opening salvo of forced industrial consolidations begun by the State Council in September looks like a promising start.

As mentioned above better distributing national income to increase the household share and reduce various measures of income inequality will be priorities under the 12th FYP. This will take the form of doubling down on regional development initiatives to reduce inter-regional economic disparities, such as the Great Western Development Project and Revitalization of the Northeastern Industrial Rustbelt (both of which have been in place for about 10 years), and the Rise of Central China. Provinces included in these schemes are expected to grow at 10%-12% annual rates given the probably scale of government-led investment initiatives. Another dimension will be to reduce the rural-urban income gap: according to official figures, which are wildly inaccurate, urban per capita disposable income was 9,757 RMB for 2009, compared to just 3,078 RMB for rural per capita cash income. This gap has been widening because of the relatively faster pace of price increases in rural areas for a range of reasons. According to great research by Wang Xiaolu with China's National Economic Research Institute,once "grey income" is factored into this equation, the actual gap is probably well over 20x, compared with the 3.2x based on the official figures.

This inevitably means taxes. According to our analysis the bulk of this burden is going to fall on state-owned enterprises (SOE) and other companies, rather than households. Yes, a property tax of some form is likely, but in general the government does not want to reduce household spending power any more than it has to at a time when it wants to encourage consumption. A larger share of the mountain of retained earnings on SOE balance sheets will be paid out annually to the Ministry of Finance in the form of dividends, and companies will probably have to expand some contributions to social welfare and retirement programs in the form of payroll taxes.

All in all, economic planners would like to see private consumption account for 55% of GDP by 2015. Greater planned investment in social services, such as efforts to make basic medical services universally accessible, may help to increase household confidence, but with so much uncertainty about the actual level and distribution of household income a policy gambit closer to "Friedman's helicopter" might be more effective.

R&D SPENDING TARGET: *As discussed below as part of efforts to create an "experimental economy", policy makers would like to increase the current level of R&D spending economy wide from the current level of around 1.5% of GDP to 2%-2.5% by 2015. For "new and emergingindustries reports indicate that they would like to see this figure come in at around 5%-6% of total industry sales. If output growth averages 8% during the next 5 years, then this would mean that in 2015 overall R&D spending could top RMB 1 trillion.*

Qianlong in a letter to King George (1793): "As your ambassador can see for himself, the celestial empire abounds in all things and lacks nothing. I set no value on objects strange or ingenious and have no use for your country's products…I have even shown the greatest condescension to the tribute missions of all states which sincerely yearn after the blessings of civilization so as to manifest my kindly indulgence."

POLICY SUPPORT FOR THE "NEW AND EMERGING INDUSTRIES DEVELOPMENT PLAN

Media reports in China have cited "more than RMB 4 trillion" (US$ 606 billion) as the amount that the central government is preparing to spend on its "new and emerging industries plan" during the 12th FYP. This news came out on the same day as trade figures showing that the US deficit with China is not getting any smaller. Taking these news items and broader political realities into account, it would seem that additional trade tensions between China and major foreign partners may be a foregone conclusion. We don't say that lightly, and believe that this will be a function of irreconcilable differences between China's industrial policy ambitions and aspirations for greater exports in the US and other advanced economies.

In economic terms this kind of industrial support program is indistinguishable from stimulus. With this in mind, we might infer from the size of this likely spend that economic planners are counting on a relatively large level of support necessary to balance out other aspects of China's pending structural transition. This includes the consolidation of the automotive, steel, cement and other sectors already underway, and could also mean that new regulations targeting environmental protection and energy efficiency are also in the works.

As was the case with the financial crisis response stimulus plan, RMB 4 trillion will probably easily turn into RMB 10-15 trillion once regional governments announce their own plans. As a regional economy Shanghai is reasonably small, but has announced its own plans to spend RMB 100 billion on its own industrial policy package. With 30 more administrative regions yet to go, a number of which have populations pushing 100 million people, the overall RMB 10-15 trillion level should not be difficult to achieve.

Focal points: Industries set to receive support under this plan include: new energy, new and composite materials, IT, biotech, new energy, environmental protection, aerospace, marine technologies and non-specific advanced manufacturing. Related "productive services" will also receive some level of support.

NEW ENERGY: China is going to remain highly reliant on fossil fuels for at least the next few decades, but opportunities for developing non-carbon alternatives to coal and oil will receive additional policy support through 2015. The solar and wind power sectors, for example, have already received substantial central and provincial government support in the form of cheap land and direct fiscal support, to the extent that major trade partners are mulling WTO cases related to prohibited subsidies for the sectors. Nevertheless, these sectors offer the potential for innovation, job creation and new sources of exports, and are set to receive a second wave of preferential treatment despite their small overall contribution to China's energy supply. Nuclear power is included in this category despite the fact that it relies on mature technologies. According to estimates quoted in energy sector specific plans that have made their way into China's domestic media, investment in nuclear power will occupy a large share of overall investment targets given the cost/scale.

COMPOSITE MATERIALS: Breakthroughs in China's aerospace and automotive sectors will not happen without the development of new materials to give domestic producers an edge over foreign rivals. The construction market is also an enormous ready market for more energy efficient and less environmentally unfriendly materials than those commonly used at present.

INFORMATION TECHNOLOGIES INDUSTRIES: The definition of information industries in China given the extent of regulation of this space. It includes anything digital, online, non-manufacturing and many non-hospitality services industries. This plan could well include the incremental convergence of phone and internet services, as well as the expansion of 3G networks and services. The overwhelming market demand for foreign gadgets, such as Apple products and related apps, is a clear signal to industrial planners that more has to be done than enabling producers of knock-off cell phones and replicating the functionality of important applications.

BIOTECH AND BIOCHEMISTRY: The surge in social welfare spending, as well as the rising incidence of prosperity-related illnesses in China, has policy makers looking for innovations that will lead cost savings and the retention of economic value to domestic patent holders for the related drugs and technologies. As a result the medical sciences sector will receive a funding boost, as will investment in medical facilities and hospitals. .

ENVIRONMENTAL PROTECTION: The annual cost of cleaning up China's environmental woes could easily exceed 2% of GDP in the coming years. There are difficulties, however, in forcing local governments to tackle these legacy problems because such these projects represent capital expenditures with no real prospect of cost recovery. That said, new opportunities for private capital will probably arise, along with more rational pricing for the utility services provided. The idea of retro-fitting" existing waste treatment sites, for example, with domestically developed technologies will receive significant emphasis.

SHANGHAI AS CHINA'S COMMERCIAL CAPITAL:

Shanghai mayor, Han Zheng, has recently pledged to invest 100 billion yuan (assumed to span several years) in support of the city's key industries: IT, bio-tech industries, high-end equipment manufacturing, new energy and the new materials sector. By the end of 2015 mayor Han will probably no longer be Shanghai, but his stated hope is that by that time Shanghai's overall contribution to China's GDP will have increased and that the region will have been the leader for realizing the objectives in the "new and emerging industries development plan". Han's plan is backed by initiatives to build 3 pieces of "great national sci-tech infrastructure", including: 10 national "project laboratories", 10 national project technology research centers, 20 nationally recognized enterprise research and technology centers, not to mention creating 100 strategic industrial alliances for technological innovation. This last item sounds a bit like a call for the proliferation of industrial cartels, similar to the one emerging in the electric vehicle sector, but we will reserve comment on that for later.

REDUCING INTER-REGIONAL ECONOMIC DISPARITIES

We have noted earlier that for all intents and purposes most of non-coastal China was covered by one or more regional development initiative under the 11th Five-Year Plan (2006-2010), and in addition to deepening the political commitment to these schemes we expect the central government to single out a handful of poorer provinces for extra support in the coming years. Most often talked about are Guangxi, Henan and Inner Mongolia, Guizhou, Xinjiang and Yunan. Some, if not all, of these regions will be slated for priority zones for the transfer of mature manufacturing industries from coastal regions. In exceptional cases they might have a city or two written into the central government plan as a "production base" under industrial development plans.

ENGINEERING EQUIPMENT AND INDUSTRIAL RELATIONS:

The engineering machinery and equipment industry is not an "emerging industry" written into the State Council's "New and Emerging Industries Plan", but will still receive extensive policy support. This includes sectors at the heart of "red" heavy industrial economy, most of which are not the least bit flashy but represent the backbone of China Inc. Economic planners have big aspirations for its capital goods manufacturers and by 2015 want to see Chinese brands among industry leaders.

The Engineering Machinery Industry Association has leaked some details of its designs for the coming 5-years, most notable of which is the desire to see the 100 top domestic firms account for 85% of annual sales in China by 2015, which the group hopes will reach 900 billion RMB by that time. In the year 2000 this industry reported sales of just 48 billion RMB, and it has boomed along with the sustained explosion to fixed asset investment growth. Industry forecasts are based on assumed annual FAI growth of around 20%, and given the policy/social nature of much of this spending, it is not hard to imagine coordination between regional heavy industrial firms and governments.

Reports citing industry association executives name specific firms: Zoomlion, Xugong and Sany Group companies are expected to achieve annual combined sales of 100 billion RMB by 2015. Guangxi Liugang and Shandong Heavy are expected to pull in annual sales of 50 billion RMB per annum by 2015, while a group of the next dozen or so firms, including Xiamen XGMA and Shanghai Longgong are expected to capture around 60% of the domestic market. Foreign producers of cranes and other construction equipment beware.

In support of related objectives China's Ministry of Information Industry, Ministry of Commerce and the machinery industry association will encourage consolidation and reorganization of related industries. Low-end producers in Shandong, Jiangsu and Hebei are rumored to be on top of the list for coordinated restructuring. Regulatory efforts will also include tightening up quality standards for domestically produced goods and going after purchases of second-hand equipment from abroad. Given the large contribution of spare parts and maintenance to life cycle costs for industrial equipment and capital goods, reports from the industry association cite the current reliance on imported spare parts as "strangling" domestic industrial purchasers. Regulators do not want the development of domestic suppliers to follow the path of the spare auto parts industry, for example, and will attempt to maintain some level of rationality to overall productive capacity in this space.

Chinese exports presently account for roughly 20% of some related market segments, a figure which industrial planners want to rise. Fellow BRIC countries – Brazil, Russia and India – have been identified as prime export targets, a strategy that will run up against the ambitions of competitors in the EU and elsewhere. Add cheap export financing from China Ex-Im into this equation, and it could well look from the outside as if industrial policy in China's engineering and industrial equipment sectors violates rules on subsidies and non-tariff barriers to competition. Given the importance of these sectors to China's future industrial security and the depth of their political legacy, it is unlikely that China will cede much ground here.

One final caution: watch out for in the role of industry associations as agents of industrial policy in China. Although everyone knows that industry groups in China are closely linked to government, but where it comes to trade-related cases their unofficial status provides the cover of deniability where it comes to potentially anticompetitive policies.

OTHER NOTABLE THEMES:

In addition to industry or sector specific preferences, policy advisors that we have spoken with have cited additional supporting areas that create the possibilities for theme-related investment strategies for the Plan. These big ideas include the following:

DEVELOPING AND MASTERING CORE TECHNOLOGIES: China has consistently sought to increase the share of total value added created and retained within its borders. So far the initiative in support of "indigenous innovation" has not been much more than a slogan, and policy advisors critical of the present approach cite the simple logic that if industrial firms can only replicate but not create new core technologies in a wide range of industries, they will rarely innovate. With this in mind there will likely be a large volume of investment devoted towards traditional R&D, basic scientific research and technological innovation. This will probably include financial incentives, and increased tax breaks for corporate investment activities. It will also inevitably lead to a wave of new R&D industrial parks at the local level, as well as the common package of incentives local leaders use to lure new investment. Industrial planners in China at any level of government are not accustomed to failure, but one feature of new development plans will be to create an "experimental economy". For decades a web of industrial, financial and political interests has generally prevented industrial failures ("creative destruction") at the expense of overall economic efficiency. This goes against the prevailing policy culture, where experiments are expected to produce quick gains, and will face significant institutional resistance.

HUMAN CAPITAL AND HUMAN TALENT: There is no shortage of highly qualified and skilled personnel in SOEs, private firms, and think-tanks in China, but too few are engages in R&D, preferring the security of sheltered environments. The development of human talent and a stronger culture of risk taking are essential for innovation and creating globally competitive firms.

PRIVATE CAPITAL SHORTAGES: Despite some progress in recent years, not to mention the explosion to the number of private equity firms in China, small private sector firms still suffer from capital shortages. In order to resolve this, the government is likely to follow what it identifies as a "European model of development", where a government firm or policy leads and private businesses follow. This would seem to be like the Airbus model. This will be a tough policy to advance, however, given the realities of interest group politics and the dominance of SOEs and state-connected firms in many areas. For example, in the grand scheme of things, the RMB 5 trillion that the State Council appears ready to allocate to new energy through 2020 is a tiny figure relative to the scale of annual capital investment in China. The implication, however, is that the central government is leaving a large role for private capital.

NOTES ON POLICY HOUSING

China's Ministry of Housing and Rural-Urban Development is reported to have set a target of 6 million units for residential housing construction for the 12th FYP, with an additional target of 5 million units for "guaranteed housing" programs through 2012. This comes after the relative failure of similar programs from 1998-2007, and many see these policies in the 12th FYP as catching up with overdue promises. By 2012 the government (including the MHRUD and six other ministries) would like to resolve urban housing issues for around 15.4 million low-income households and by 2015 would like to achieve a per capita residential space target of 13 square meters. Urban housing planners estimate needing to absorb 10 million people into major cities each year, and "guaranteed housing units" should address up to 10% of this demand in the coming years. How well centrally designed plans will be implemented at lower levels of government is subject to some level of doubt, as inconsistent enforcement and other irregularities have been the undoing of earlier policy housing initiatives.