What to expect from China’s 13th Five Year Plan?

The members of the 18th Central Committee of the Communist Party convened in Beijing on October 26 to discuss the formulation of China’s 13th Five Year Plan (FYP) for the period 2016-2020. Although the content of the 13th FYP may not be finalized until next March, after it is ratified by the National People’s Congress, a series of official communiqués published last week will set the tone for China’s economic policy making over the next five years. The implications are all the more important at this juncture, as China’s growth is subject to increasing growth headwinds from the debt-laden corporate sector, volatile domestic financial markets and accelerated capital outflows.

Review of the 12th FYP

China’s FYPs establish a social, economic and environmental blueprint for Chinese policy. The targets outlined within are determined by consensus through the plenary sessions of the Central Committee and the National Congress. The 12th Five Year Plan (2011-2015) has delivered on a number of fronts (Table 5.1). On the economic front, assuming a 6.9% y/y growth rate in 2015, this means that China’s economy grew by an average 7.8% annually during the 12th FYP period, above the 7.0% target. China’s rebalancing towards a service oriented economy is also underway, evidenced by the higher-than-expected service sector’s share in aggregate output. Finally, the level of urbanisation in 2014 was 55.2%, surpassing the target of 51.5%.

<table>
<thead>
<tr>
<th>Category</th>
<th>Indicator</th>
<th>Target</th>
<th>Forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic growth</td>
<td>Average GDP growth</td>
<td>7.0%</td>
<td>7.8%</td>
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<tr>
<td></td>
<td>Service sector’s share of aggregate output</td>
<td>47.2%</td>
<td>58.4%</td>
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<td></td>
<td>Increase in urbanization rate</td>
<td>51.5%</td>
<td>55.2%</td>
</tr>
<tr>
<td>Research and education</td>
<td>R&amp;D expenditure to GDP ratio</td>
<td>2.20%</td>
<td>1.98%</td>
</tr>
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<td></td>
<td>Patents per 10,000 people</td>
<td>3.3</td>
<td>4.5</td>
</tr>
<tr>
<td></td>
<td>Increase in coverage of nine-year primary education</td>
<td>3%</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>Gross enrolment rate of secondary education</td>
<td>87%</td>
<td>93%</td>
</tr>
<tr>
<td>Resources and environment protection</td>
<td>Average loss of arable land</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>Decrease in energy per unit GDP</td>
<td>16%</td>
<td>16%</td>
</tr>
<tr>
<td></td>
<td>Total stock of forest</td>
<td>14.3 Bn m³</td>
<td>15.2 Bn m³</td>
</tr>
<tr>
<td></td>
<td>Increase of non-fossil fuel’s share in primary energy consumption</td>
<td>3.10%</td>
<td>2.0%</td>
</tr>
<tr>
<td></td>
<td>Decrease in CO₂ emissions per unit GDP</td>
<td>17%</td>
<td>n/a</td>
</tr>
<tr>
<td>People’s livelihood and population</td>
<td>Average increase in disposal income of urban residence</td>
<td>7%</td>
<td>7%</td>
</tr>
<tr>
<td></td>
<td>Average increase in disposal income of rural residence</td>
<td>7%</td>
<td>7%</td>
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<tr>
<td></td>
<td>Urban registered unemployment rate</td>
<td>5%</td>
<td>4%</td>
</tr>
<tr>
<td></td>
<td>No. of people covered by urban basic pension system</td>
<td>357 million</td>
<td>n/a</td>
</tr>
<tr>
<td></td>
<td>Construction of social housing</td>
<td>36 million units</td>
<td>n/a</td>
</tr>
<tr>
<td></td>
<td>Total population</td>
<td>1.39 billion</td>
<td>1.37 billion</td>
</tr>
<tr>
<td></td>
<td>Increase in life expectancy</td>
<td>1 year</td>
<td>1 year</td>
</tr>
</tbody>
</table>

Source: BBVA Research

Not everything has gone smoothly. In fact, China has paid a high price in order to meet its growth targets. Primarily, we believe that the authorities’ commitment to put growth ahead of reform has brought about a
number of structural problems. Amongst these, rising levels of indebtedness in the corporate sector – particularly SOEs – as well as incipient asset bubbles in the housing sector and equities market pose significant risks for the economy in the years to come.

Overemphasis on high growth target could delay necessary reforms

The new leadership has a mandate to double China's 2010 real GDP level by 2020, an ambition which requires an average growth rate of at least 6.5% y/y. While this growth rate is considerably below the previous target of 7%, it still looks high given the current headwinds. China needs relatively high levels of growth in order to generate sufficient employment, maintain order and avert falling into a middle income trap. But focusing on growth alone could aggravate things in the long run by diverting attention away from necessary structural reforms.

In October this year, the State Council issued a set of measures that aim to “modernize SOEs, enhance state assets management, promote mixed ownership and prevent the erosion of state assets”. However these were underwhelming and generally lacked substance. The 13th FYP gives the authorities another chance to clarify their plan for reform, thereby reinforcing people's confidence. Some progress on this front has already been made since the Fifth Plenum. On November 4, the State Council unveiled guidelines to establish an investment firm to manage and restructure SOEs. The guidelines also mentioned, albeit not in detail, plans to curtail overcapacity amongst SOEs and dispose of inefficient assets. But again, this will not be possible if there is excessive pressure to maintain high growth rates.

Improvements in people’s livelihoods in line with urbanization plans

Shortly after the conclusion Fifth Plenum, the government unveiled its "Opinion Concerning the Enactment of the 13th Five-Year Plan for Development of the National Economy and Society", where they unveiled an urbanization target of 60% by 2020. This is rate is still below that of developed economies (US 81%, Japan 93%), so China's on-going urbanization could still provide quite some impetus behind the economy in the midterm. But while China has managed to make some progress on this front, official figures can be misleading, as much of the urbanization process has happened through the redrafting of urban boundaries as opposed to migration to cities.

China’s population is ageing, which not only leads to a tighter labour market, but also adds pressure on the country’s welfare and pension systems. Not surprisingly, one of the outcomes of the Fifth Plenum was a relaxation of the “one-child” policy. According to the new plan, all couples will be allowed to have two children, but fertility rates, particularly in urban areas, have been falling consistently since the 1970s as a result of a greater female participation in both labour force and education; in combination with rising costs of rearing children. The move could fall short of addressing concerns related to China’s demographic ailments unless it is accompanied by reforms to the hukou system.

The hukou system distinguishes between urban and rural citizens – Migrant workers are denied access to public health, education and other welfare services in urban areas and vice-versa. This situation created an inequitable distribution of the national welfare services which can’t possibly favour population growth, not to mention the 60 million children that are left behind in the countryside while their parents seek better employment opportunities in cities. Relaxing the hukou system would expand labour force participation and would facilitate China’s rebalancing towards consumption by freeing up savings and through upward pressure on migrant worker’s wages.
Boosting “green economy” and promoting innovation

In keeping with the drive to shift towards slower growth of better quality, the 13th FYP could introduce an avenue for addressing looming pollution concerns. In addition to a coal consumption cap and more clarity regarding the establishment of a national emissions trading system in 2017, the 13th FYP will also result in more support for the development of China’s green industries. According to the People’s Bank of China and the United Nations Environment Programme, in order for all pledges under the 13th FYP to materialize, green infrastructure will require investments upwards of US$ 320 bn, with most of it being financed by the private sector.

Similarly, the 13th FYP will also elevate the importance of achieving higher levels of endogenous innovation in order to move up global value chains. We expect the support to follow the “Made in China 2025” plan, announced earlier this year. This plan seeks to pursue innovation-driven and green development, apply smart technologies and enable China to transition from being a manufacturer of quantity to one of quality.

Accelerating China’s “going-out” policy in order to alleviate overcapacity

We anticipate that the 13th FYP could include the acceleration of the “One Belt, One Road” (OBOR) strategy as one of the targets. China has amassed an impressive amount of foreign reserves, equivalent to roughly USD 3.8 trillion in 2014. An estimated two-thirds of these reserves are held in USD denominated assets, primarily low-yielding government bonds and institutional bonds. Beijing could use foreign investments via the OBOR as an alternative to holding government debt securities. Finally, Chinese ODI is a relatively new phenomenon, so its global stock remains underrepresented compared to other major economies. In addition, the OBOR could help China to export part of its overcapacity, particularly in the construction, steel and equipment sectors.

Financial liberalization is likely to be completed over the next five years

One area where there has been significant progress is that of financial reform. Interest rate liberalization has been advanced very successfully, with the deposit rate ceiling completely lifted as of October this year, in line with our expectations. But reforms in the financial sector are still on-going. In particular, we expect that the 13th FYP will highlight the need to move towards a free floating currency and fully liberalize the convertibility of the RMB under the capital account by 2020. This would enable a more efficient allocation of capital; however rapid capital account liberalization is unlikely in the short term given the recent acceleration of capital outflows.
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