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Economic Watch

China

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Economic Analysis

Asia

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New 5-year plan and budget set to support China's growth

- **China's long-awaited 12th Five-Year Plan was endorsed by the National People's Conference (NPC) held during March 5-14, along with the 2011 budgetary plan.**
  The Plan has a number of key objectives, some of which are a continuation of elements of the 11th Five-Year Plan, and some are new ones.

- **One of the key objectives is to rebalance the economy toward domestic consumption, and away from external demand and investment.**
  To that end, the Plan places a target on the growth of household income of as much as 7%. Another related – and also binding – target is a 4% increase in the service sector (compared to a 2.5% rise during the period covered by the 11th Five-Year Plan).

- **Another key objective is to refocus the attention to "sustainable" growth and not so much on "how much" growth.**
  In fact, the annual growth target has been reduced to 7% for the next five years while several targets have been set to improve people's livelihood and social welfare. Examples are environmental protection, education, and pension coverage.

- **Finally, this 12th 5-Year Plan attaches high importance to industrial policy by selecting seven key sectors which will be supported by the Chinese authorities during the next five years.**
  These sectors are non-fossil energy, environmental technology, new materials, high-end manufacturing, bio-tech pharmaceuticals, IT (including internet-based services) and New-fuel powered vehicles. The Plan also states clearly that moving up the value scale is a must for China. To that end, expenditure on R&D becomes a binding target (2.2% of GDP compared to the actual expenditure during the last 5 years of 1.8%).

- **For 2011, taming inflation will be treated with top priority by adopting a combination of "prudent" monetary policy and "pro-active" fiscal policy.**
  The budget for 2011 turns out to be growth supportive even though the deficit shrinks from that of last year as the anti-crisis stimulus package phases out.

12th five-year development plan targets a balanced growth

Upon extensive consultation and discussion among various parties before and during the Fourth Session of the 11th National People's Congress (hereinafter referred to as "the Conference"), China's long-awaited 12th Five-Year Plan on National Economic and Social Development (hereinafter referred to as "the Plan") was concluded and approved on March 14, 2011.

The final version of the Plan is largely in line with market expectations, putting forward the principles for China's economic and social development during the period 2011-2015. Such principles focus on ensuring a more balanced growth, accelerating economic restructuring, improving people's livelihood and promoting social harmony (a euphemism for reducing income inequality).

The Plan sets out 24 main targets encompassing the various aspects of economic and social development. (Table 1) The targets are classified as binding and non-binding. In general, the 12 binding targets of the Plan are focused on public service and interest of common people, including education, pension, healthcare, housing and sustainable development.

Lower growth target with emphasis on economic rebalancing

One highlight is that the target for average GDP growth during the period 2011-2015 has been reduced to 7% from the previous 7.5% target for the 11th Five-Year Plan. As for the previous plan, the new target should be viewed as a floor. In fact our projections are closer to 8%-9% for the same period. Solid public investment, on-going urbanization and strengthening private consumption will ensure that the economy expands at a faster pace. Experience tells us that GDP growth targets in the previous Five-Year Plans are always outperformed by the real average GDP growth (Chart 1). The reasons for such overperformance mainly lie in the incentive structure for local governments will tend to favor growth more than other objectives.

According to the Plan, domestic demand will be boosted to achieve the growth target so that the dependence on external demand is reduced. The Plan emphasizes economic restructuring to help China embark on a more independent and more innovation-driven growth track. Such economic restructuring is based on four aspects: optimizing the current industrial structure, ensuring balanced regional development, promoting urbanization, and boosting energy-saving and environment-friendly industries. Specially, the Plan attaches high importance to industrial policy by selecting seven key sectors which will be supported by the Chinese authorities during the next five years. These sectors are non-fossil energy, environmental technology, new materials, high-end manufacturing, bio-tech pharmaceuticals, IT (including internet-based services) and New-fuel powered vehicles.

The Plan also highlights the need to support the service sector so that its share of GDP is raised by 4% over the five-year period (from an average of 2.5% during the previous 5 years). Meanwhile, China will transform the coastal regions from the world's manufacturing base to a hub for R&D, advanced manufacturing, and servicing. Although the determination shown by the government is encouraging, it is by no means an easy task to restructure a large economy like China. In fact, among the few missed targets during the 11th Five-Year Plan one was the objective for the proportion of the service sector's added value and job opportunities created by the service sector

Environmental protection and income distribution

The Plan also shows that China is striving for a more environmental friendly growth model. Energy intensity is set to fall by 16% per unit of GDP and carbon intensity by 17% per unit GDP in the next five years. The former is a target which already existed in the 11th year plan (20% reduction) and over 19% reduction was achieved according to the Chinese government. The latter is a new target as others for the total stock of forest land, the share of non-fossil fuels in primary energy consumption, and the carbon intensity.

The Plan also places the improvement of people's livelihood as a priority. Specific targets have been taken to lift the share of household income in the overall economy, enlarge the urban and rural employment, improve the minimum wage, build urban social housing, and increase the coverage of basic and medical insurance system. In this regards, the government's action to improve worker's income can be demonstrated through the wave of minimum wage increase in various provinces since the beginning of 2011. As for housing, the target for the number of new social housing is enormously high: 36 million additional low-income housing units. It is also worthy noting that Family Planning will remain as the country's fundamental state policy and that there is no mention to relax the *hukou* policy (i.e., there will still be limitations to labor mobility in China).Finally, to narrow the income gap between rural and urban residents, agricultural taxes and various sub-charges to the agriculture sector will be abolished.

2011: the starting point for the Plan

2011 is widely considered as a year of vital importance for the Plan. For this year, the Chinese government aims at the stability and continuity of overall macro policies, as well as the maintenance of stable and relatively fast growth and economic restructuring. Managing inflation and inflation expectations will be given top priority. A combination of "prudent" monetary policy and "pro-active" fiscal policy will constitute the policy stance announced by the Chinese government.

Overall, economic and social development targets for 2011 are the following:

- Real GDP growth is set at 8%;
- Headline CPI target is raised to 4%;
- Nine million urban new jobs will be added and registered urban unemployment rate should stand below 4.6%;
- Domestic demand will be supported, especially household consumption, during the whole year;
- Monetary policy will be prudent for 2011 with a target for M2 growth of 16%;
- The overall fiscal policy stance will remain 'pro-active' as the 2011 budget deficit is set at RMB 900 billion; and
- The surplus of the balance of payments should be reduced.

2011 budgetary plan remains growth-supportive

The 2010 fiscal outturn was estimated at a deficit of RMB 1 trillion, equivalent to 2.5% of GDP. This was somewhat below the original deficit target of RMB 1.05 trillion, or 2.8% of GDP. Looking into the details, we find that the outturn of total national expenditure in 2010 still exceeded the budgetary target by 6 percentage points, equivalent to a 17.4% increase from the outturn in 2009. That said, the low outturn of deficit to GDP ratio in

2010 is mainly due to the faster-than-expected tax revenues arising from strong economic activities.

For 2011, China's deficit target has been announced at RMB 900 billion, equivalent to 2.0% of GDP. China thus joins other Asian economies in aiming for a further narrowing of fiscal deficits in 2011 as fiscal support is withdrawn given robust growth momentum (China's overall public debt ratio is modest at only 17% of GDP, although it is somewhat higher once local government debt is taken into account) (Chart 2). Infrastructure investment of the central government is to decline to around RMB 850 billion in 2011 from more than RMB 1 trillion in 2010, which, to a large degree, explains the difference in the deficits between 2010 and 2011.

Total expenditure in 2011 is nevertheless projected to increase by a nominal 11.9% over the 2010 outturn, with a focus on social spending, including a further strengthening of the social safety net. On the revenue side, new cuts of the income tax are in the pipeline while the details have yet to be disclosed. It is expected to take form of raising the threshold of income exempted from taxes and simplifying tax brackets.

The budget is also oriented toward achieving a number of ambitious medium-term goals, especially on the provision of public housing (10 million new units are targeted in 2011) and infrastructure investment, such as high speed railways and water distribution facilities. However, the authorities are prone to laying the financing responsibility of these projects on the local governments and inviting private fund to finance them while conservatively maintaining the deficit and debt of the central government at a low level. For example, an investment of 1.3-1.4 trillion is needed to construct those 10 million units of public housing, whereas the central government will only provide RMB 100 billion. The local governments are instructed to provide at least RMB 300 billion while the rest have to be financed by private sector. (China Development Bank committed to provide earmarked loans of RMB 100 billion on public housing.)

One side effect of this practice is to add further budgetary pressure on local governments, which have already accumulated substantial amount of off-the-books debts via so-called 'local government finance vehicles' (LGFVs) during the anti-crisis investment boom of the past two years. The most recent estimate of the LGFV debts is around RMB 9 trillion, 19.4% of which are exposed to high risk. Currently, the authorities have already forbidden the local governments to provide guarantee for LGFVs with the exception of the public housing programs.

Overall, the new budget of 2011 shows that the fiscal stance remains growth supportive. Along with monetary tightening, fiscal policy will help to achieve a soft-landing and prevent overheating. However, the new budget does little to solve the long term problem that the local governments shoulder a disproportionately higher share of public spending responsibility, compared with their revenues. As a result, the local governments are significantly dependent on their revenue of land sales, which amounts to RMB 2.9 trillion in 2010 and accounts for 39.8% of total revenue by local governments. This point can largely explain the reluctance of local governments toward reining in the property market and containing the asset bubbles. Therefore, in the long run, the tax revenue sharing system should be overhauled to align the expenditure duty with revenue right at various tiers of governments while further fiscal consolidation is needed to deal with the LGFVs problem over the medium term.

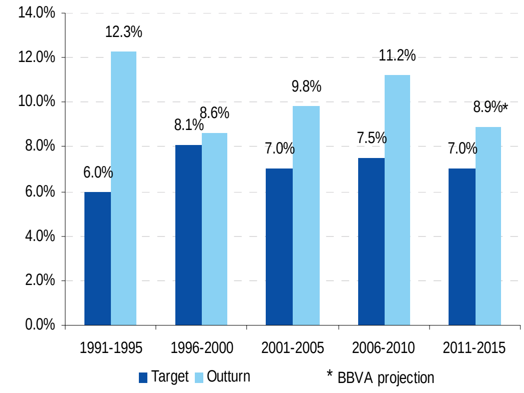
Table 1

New targets of economic and social development over 2011-2015

Category	Indicator	Target	Nature	Target of the 11th FYP	Outturn of the 11th FYP
Economic growth	Average GDP growth	7%	Forecast	7.5%	met
	Increase in service sector's share of added value	4%	Forecast	3%	not met (2.5%)
	Increase in urbanization rate	4%	Forecast	4%	met
Research and education	R&D expenditure to GDP ratio	2.2%	Forecast	2%	not met (1.8%)
	Patents per 10,000 people	3.3	Forecast	NA	
	Increase in coverage of nine-year primary education	3%	Binding	NA	
	Gross enrollment rate of secondary education	87%	Forecast	NA	
Resources and environment protection	Average loss of arable land	0%	Binding	-0.3%	met
	Decrease in water consumption per unit of industrial added value	30%	Binding	30%	met
	Increase in water-use efficiency of irrigation	0.03%	Forecast	0.05%	met
	Decrease in energy intensity per unit GDP	16%	Binding	20%	not met (19.1%)
	Decrease in chemical oxygen demand / sulfur dioxide emissions / ammonia nitrogen emissions / nitrogen oxides emissions	8%/8%/ 10%/10%	Binding	10%/10% /NA/NA	met
	Increase in forest coverage/ total stock of forest	1.3%/ 14.3 billion cubic meters	Binding	1.8%/ NA	met
	Increase of non-fossil fuel's share in primary energy consumption	3.1%	Binding	NA	
	Decrease in carbon intensity per unit GDP	17%	Binding	NA	
People's livelihood and population	Average increase in disposal income of urban residence	7%	Forecast	5%	
	Average increase in disposal income of rural residence	7%	Forecast	5%	met
	Urban registered unemployment rate	5%	Forecast	5%	met
	5-year newly added urban employees	45 million	Forecast	45 million	met
	No. of people covered by urban basic pension system	357 million	Binding	223 million	met
	Increase in coverage of basic health insurance	3%	Binding	NA	
	Construction of social housing	36 million units	Binding	NA	
	Total population	1.39 billion	Binding	Increase by 0.8%	met
	Increase in life expectancy	1 year	Forecast	NA	

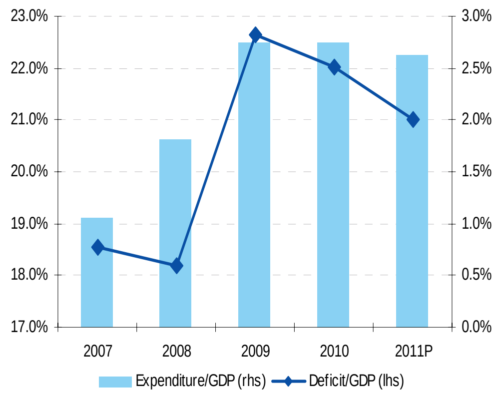
Source: BBVA Research

Chart 1
GDP growth targets and outturns



Source: CEIC and BBVA Research

Chart 2
Sustainable debt and deficit levels



Source: BBVA Research

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