



China's 12th Plan: Big Challenges, Vast Opportunities

Shahid Yusuf*

China's 12th Five Year Plan (FYP) is off to a strong start with growth in 2011 of 9.2 percent,¹ a solid 2 percent in excess of plan targets, but in line with recent trends. Growth was sustained by extraordinary levels of investment in housing, real estate, and infrastructure, amounting to almost 30 percent of GDP, and by investment also in industrial capacity for a total of 49 percent of GDP, the highest figure ever recorded for any country (Japan invested 35.5 percent of GDP at its peak in 1970). Consumer spending also rose, albeit not as strongly as expected by planners, and at 34 percent of GDP (in 2010) remains unusually low (it was 60 percent in Japan in 1970). China's commodity trade surplus shrank significantly (from \$315 billion in 2007 to \$210 billion in 2011). For the year 2011 as a whole, the country's estimated current account balance was 2.9 percent of GDP, which meant that the tradable sector generated less growth than in the recent past.

This growth performance was underpinned both by increased fiscal spending (equal to 13 percent of GDP) and by a massive increase in credit. Credit rose from 121 percent of GDP in 2008 Q4 to 147 percent

1. However, growth slowed during the course of the year from 9.7 percent in the first quarter of 2011 to 8.9 percent in the final quarter.

of GDP in 2011 Q2, far in excess of other countries in China's per capita GDP bracket. Credit financed the building of almost two billion square meters of floor space (half the world's total for the year); the expansion of China's transport and energy networks; and household purchases of homes, automobiles, and consumer durables. Looking ahead, credit could be tighter so as to contain the risk of housing bubbles and related financial crises, but no so tight as to precipitate a crisis. There will also be continuing effort to promote structural change that weans growth away from an excessive reliance on fixed investment and exports and increases the contribution of domestic consumer demand.

To bolster China's growth as the contribution of investment declines, the 12th FYP also envisages gains in productivity stemming increasingly from innovation. The goal is to stimulate innovation by incentives for R&D and the deepening of research capital in seven pillar activities: biotechnology, new energy, high-end equipment manufacturing, energy conservation and environmental protection, clean-energy vehicles, new materials, and next-generation information. China expects to spend RMB 4 trillion on these industries so as to raise their share of GDP from 5 percent in 2010 to 8 percent in 2015, the final year of the 12th FYP.

*Chief Economist, The Growth Dialogue, George Washington University School of Business. Send comments to shahid_yusuf@hotmail.com, copied to info@growthdialogue.org.

Relative to other BRICS² and neighbors in the East Asia Region, China's economic future appears more assured. Few expect its growth rate to dip below 7 percent per year over the 12th FYP period or even during the course of the decade.³ Recent estimates by Arvind Subramanian (2011) show China pulling ahead of the United States as measured by nominal GDP by 2020 at the latest. In fact, the 7 percent target is not just an economic but also a political benchmark. It is viewed as the minimum rate needed to achieve a steady improvement in welfare countrywide, absorb new entrants to the labor force, and maintain unemployment at politically tolerable levels.

Three years ago, few raised doubts about China's economic prospects, but the financial crisis and its lingering aftermath have drastically changed trends in global growth and trade. A weakening of demand for exports in the second half of 2011—coupled with rising wages—has dampened manufacturing activities in China's key coastal provinces, which for the first time in almost three decades have seen their growth fall short of the national average. Inflationary pressures (the CPI rose by approximately 5 percent in 2011) and fewer jobs than anticipated for university graduates have deepened uneasiness regarding the country's economic future. Strategy and policies are being reappraised in the light of dramatically altered external circumstances and a sharpening of the challenges confronting the Chinese economy. The 12th FYP provides an opportunity to begin addressing four of the most urgent challenges.

Structure of Demand

For too long, China's growth has been pegged to the fortunes of export-depen-

dent manufacturing industries. China has emerged as the world's leading exporter and as long as foreign demand was expanding rapidly, the economy hummed along. However, now that Chinese producers are encountering resistance in their principal overseas markets, there is an urgent need to partially substitute domestic for foreign demand. Furthermore, investment in infrastructure and real estate needs to be scaled back as it is sometimes wasteful, subject to decreasing returns, and is imperiling the banking sector by storing nonperforming loans. Rising incremental capital output ratios (ICORs) and declining returns underscore these problems, similar to Japan's experience in the 1970s. By a rough estimate, expenditure switching amounting to as much as 15 percent of GDP is desirable from investment and net exports to domestic consumption. This process should raise the share of consumption in GDP to about 50 percent,⁴ and it implies very slow or negative growth of investment and of exports over the next decade.

To implement such a process, China may need to substantially modify its policies in four areas. First, a faster appreciation of the renminbi would be required to augment household spending power. Second, the repression of deposit rates and preferential access of state-owned enterprises (SOEs) to low-cost financing would need to be curtailed. Third, the excess profits and the high investment rates of large and favored SOEs would have to be scaled back through reforms that exposed them to competition and required a distribution of profits to shareholders and, in significant amounts, to the State-owned Assets Supervision and Administration Commission (SASAC). Fourth, China would need to reconsider

2. Brazil, China, India, Russia, and South Africa.

3. Justin Lin (2011) projects a growth rate for China over the next two decades averaging 8 per cent per annum.

4. For consumption's share to reach even 40 percent by 2020, consumption spending would need to increase by 10 percent per year with GDP growing by 8 percent. Consumption spending rose by 8.9 percent in 2011.

and significantly moderate its investment in infrastructure, which in some areas is well in excess of likely demand over the medium run.⁵ These policies are likely to face stiff opposition, as they would be immensely painful for the export sector, the construction industry, banks, and large, highly profitable SOEs.⁶ Moreover, even if policy makers successfully cut back investment spending and export dependence, consumer spending might not rise fast enough to fill the gap in demand because the dislocation, the adjustment lags, and localized unemployment would magnify household uncertainties. If the additional domestic demand materializes with a lag, then growth could slow sharply and even fall below 7 percent to the 5 percent levels that are now the norm in South East Asia.

The preferred solution is to introduce all these policies gradually so as to protect demand and the growth rate. The downside of this politically safe approach is that delay will compound the waste of resources on “bridges to nowhere,” preserve redundant production capacity, and further entrench those interest groups seeking to prolong the status quo. Unsettled global economic conditions could also expose China to even greater pressures from its Western trading partners, who are already chafing over trade deficits.

Inequality and the Middle Class

Since the late 1990s, income inequality has been on the increase, mainly because of a widening gap between rural and urban incomes (the Gini coefficient stood at 47 percent in 2010). The appearance of free-spending, wealthy urban elites is exacerbating the trend with worrisome social and po-

litical implications in a country accustomed to an egalitarian distribution of income and modest lifestyles. Declining employment in manufacturing and technological changes (evident in other advanced countries) are likely to limit the growth in demand for unskilled and semiskilled labor and threaten the growth of China’s urban middle class. If entry into the middle class slows while the numbers of the super rich continue to grow,⁷ inequality will widen and the increase in household consumption will fall below expectations. Diminishing employment in manufacturing is probably unavoidable and might even be accelerated by slowing exports. China will need to embrace a more progressive tax and transfer system if income inequality is to be contained or even reversed. Among the well-known steps for ameliorating inequality that could be more vigorously implemented during the 12th FYP, three policy areas stand out: (i) fiscal reform, (ii) government social programs, and (iii) benefits for migrant workers.

Fiscal reform. An overhaul of the fiscal system is overdue—the last major tax reform was in 1994—and such reforms are best done comprehensively. Such an overhaul would not only need to comprehensively address tax equity, effort, and buoyancy, but also intergovernmental transfers and the allocation of taxing and spending responsibilities across lower levels of government so as to weed out numerous distortions.

Government social programs. Fiscal reform would complement a second policy strand that pertains to the government’s health, education, and social security programs. These have all been the focus of intense effort spanning several plan periods. However, China remains at a distance from efficient and affordable outcomes that

5. Infrastructure investment could be a source of resource misallocation that could affect future gains from total factor productivity. See Pettis (2012), Flyvbjerg (2009), and Jones (2009).

6. See also Lardy (2012).

7. China counted 1.11 million millionaire households in 2011, compared to 5.22 million in the United States and 1.53 million in Japan.

factor in the experience of other countries. Effective leverage of technological advances, especially in information technology, could help close the gap.

Benefits for migrant workers. In the context of ameliorating inequality, a third policy strand is the treatment of 128 million urban migrants without an urban *hukou* (or residence permit). These workers lack access to the social and welfare services available to urban residents. Extending *hukou* benefits has long been resisted because of the costs it would impose on municipalities and because urban planners fear that it would increase the flow of migrants.

These three policy strands are interlinked and the 12th FYP provides an opportunity to decisively tackle a critical set of issues and rein in income inequality.

Urbanization

One half of the Chinese population is now classified as urban and there can be no doubt that cities will be absorbing millions more in the coming decades. With urban areas accounting for up to 80 percent of all global greenhouse gas emissions, the design of cities and the greening of urbanization take on a superadded importance. China passed the United States as the largest emitter of carbon in 2009 and urban pollution takes a heavy toll on the populace, with China sacrificing as much as 6 percent of GDP annually.⁸ Furthermore, inattention to urban planning, zoning, and land-use regulations has led to sprawling, low-density development that eats into valuable arable land adjacent to cities. Sprawl has been exacerbated by heavy reliance on land leasing to mobilize municipal revenues (40 percent nationwide on average). With so much urbanization still in the offing, environmental imperatives, energy security, and growth economics argue for a greening of urbanization with

8. See World Bank (2007).

a focus on design (to encourage compactness and mixed use of urban facilities) and energy efficiency standards for buildings, equipment, and transport. Some of the technologies already are at hand, while others can be developed.

The bottlenecks to be eased have little to do with technology or knowledge. Rather, they are created by the interests of major industries and politically powerful groups. For example, municipal governments derive revenues from land leasing, the community of developers is reluctant to shoulder the additional costs of urban greening, and the auto industry is highly committed to sprawling urbanization that generates demand for cars. Overall, there is strong resistance to tough new standards, innovative urban design, and the development of multimodal public transport.

Green growth is assigned a prominent role in the 12th FYP. Clearly there is rising awareness in China that future growth and urban welfare hinges on implementing costly and far-reaching policies, but top-down imposition of reforms is becoming steadily more difficult. Much will depend upon the strength of dispersed initiatives, as in most advanced countries.

Becoming Innovative

The 12th FYP puts much store on enhancing national innovation capabilities so as to sustain growth and achieve technological parity with leading industrialized countries. Typically the emphasis is on raising numerical indicators in activities such as:

- spending on R&D (1.76 percent of GDP in 2011)
- patenting by Chinese residents
- publishing in major refereed journals
- encouraging firms to introduce new products
- creating world class universities

- increasing Chinese representation in the Forbes 500 and other listings of top corporations
- setting domestic standards to induce localization
- using government procurement to provide a market for innovative products.

With regard to published papers and patents, China has made spectacular progress in less than a decade and is one of the highest-ranked countries. It has also climbed in the innovation rankings constructed by the European Institute of Business Administration (INSEAD), the World Economic Forum (WEF), and the World Bank. However, the challenge for China lies in improving the quality of patents and papers and introducing breakthrough (or disruptive) innovations, which, for example, make a substantial impact on GDP growth or urban greening.

The payoff from a further increase in R&D spending during the 12th FYP (to 2.2 percent of GDP) is uncertain. By all accounts it could be fairly modest, partly because it takes time for the innovation system to mature and make the best use of resources. Payoff also depends in part on the global strategies and organizational capabilities of corporations. Looking beyond the 12th FYP, innovativeness will strongly buttress total factor productivity, possibly by as much as one percent per year. Hence, a lot hangs on China's use of top-down policies to nurture innovation capabilities, complemented by decentralized efforts to create an open learning and networked environment.

Other Challenges

The discussion above presents a subset of the internal and external challenges China will face during implementation of the 12th FYP, but arguably they are among the most important. Another challenge is managing

macroeconomic policies and the indebtedness of local governments so as to minimize the risk of shocks. Yet another is managing China's external relations as its footprint expands and it becomes an even more active player on the global stage. Energy and food security concerns will also be important; and with global warming, conserving and efficiently using water will become a higher priority.

Conclusion

The world economy has been subjected to a great deal of tension in the past three years and the problems that arose following the financial crisis of 2008–09 are not behind us. In fact, a return to earlier trend rates of growth may lie some distance in the future. Thus, as the 12th FYP period unfolds, China will need to come to grips with some knotty domestic issues. It must also cope with and help calm, as well as restore, a turbulent international environment.

Web Sites

Information on China's 12th Plan can be found at the following Websites:

http://www.apcoworldwide.com/content/pdfs/chinas_12th_five-year_plan.pdf

http://www.uscc.gov/researchpapers/2011/12th-FiveYearPlan_062811.pdf

http://cbi.typepad.com/china_direct/2011/05/chinas-twelfth-five-new-plan-the-full-english-version.html

<http://www.nzte.govt.nz/features-commentary/In-Brief/Documents/China's%20%20Five-Year%20Plan%202011-2015.pdf>

Further Reading

Flyvbjerg, Bent. 2009. "Survival of the Fittest: Why the Worst Infrastructure Gets Built—and What We Can Do About It." *Oxford Review of Economic Policy* 25(3): 344–367.

- Jones, Charles I. 2011. "Misallocation, Economic Growth, and Input-Output Economics." Paper presented at the 10th World Congress of the Econometric Society, Shanghai, China.
- Lardy, Nicholas R. 2012. *Sustaining China's Economic Growth After the Global Financial Crisis*. Washington DC. Peterson Institute of International Economics.
- Lin, Justin Yifu. 2011. "China and the Global Economy." Paper presents at the Hong Kong University of Science and Technology. March 23rd.
- Pettis, Michael. 2012. "Building Debt in China." *EconoMonitor*, January 23rd. <http://www.economonitor.com/blog/2012/01/building-debt-in-china/>.
- Subramanian, Arvind. 2011. *Eclipse: Living in the Shadow of China's Economic Dominance*. Washington, DC: Peterson Institute of International Economics.
- World Bank. 2007. *Cost of Pollution in China: Economic Estimates of Physical Damage*. Washington, DC: World Bank.