11th Five-Year Plan Plots Future Course for the Chinese Economy

In March 2006 the National People’s Congress formulated and adopted specific guidelines for China’s 11th Five-Year Plan (through 2010), based on an outline proposal adopted by the Chinese Communist Party Central Committee in October 2005. In China the five-year plan is an important indicator of the government’s view of the current situation and its future course for the economy. It is significant not only for China’s economic outlook, but also for the business environment in China. The following analysis focuses on key issues confronting China and the measures introduced to deal with them in the 11th Five-Year Plan, and tries to identify new opportunities and risks for foreign companies.

1. Grim Analysis of Current Situation

Under the 10th Five-Year Plan (2001 to 2005), China targeted high growth, based on the perception that development was the most important priority and the solution to all of China’s problems. This clearly reflects the stance of a government whose first priority was to lift China out of the economic recession caused by a tight economic policy under 9th Five-Year Plan and the effects of the Asian currency crisis (Figure 1).

Figure 1: Growth and Inflation During the Five-Year Plan Period

Notes: Average Real GDP growth rates in squares.
Source: Compiled by the Economic Research Office, Bank of Tokyo-Mitsubishi UFJ on China Statistical Yearbook, etc.
However, while this policy direction brought accelerated growth under the 10th Five-Year Plan, it also resulted in significant distortions, including a tendency toward excessive investment, and a pattern of growth reliant on mass exporting of low value added manufactured goods. Despite soaring raw material prices, an over-supply situation forced prices of manufactured goods down (Figures 2, 3), and depressed corporate earnings. China’s drive to export cheap manufactured goods also triggered increasingly serious trade friction. Furthermore, China was criticized for pursuing growth based on resource consumption at a time when world resource prices were rising. Fears that resources would be exhausted in the medium- to long-term future started to appear extremely realistic, and serious environmental problems also began to emerge.

The 11th Five-Year Plan represents a shift away from this problem-ridden growth course and signals an end to quantitative expansion. Instead China will target balanced and sustainable development under a “scientific approach to development.” This is reflected in the growth target, which calls for real GDP growth averaging 7.5% per annum. This is quite modest compared with the 9.5% growth record achieved under the 10th Five-Year Plan.

Starting with the 11th Five-Year Plan, the government has also separated the numerical targets into initial targets and binding targets. The initial targets are those that should be achieved by the market, and the government will work to create an environment in which this
is possible. The binding targets are defined as goals that the government must achieve through the efficient allocation of public resources and the effective utilization of government powers.

2. The Challenge of Sustainable Growth

Among the policies included in the 11th Five-Year Plan are measures to correct the harm caused in many areas by growth based on excessive investment and mass exporting of low value added manufactured goods.

(1) Responding to Resource and Environmental Limitations

When the Five-Year Plan was still at the drafting stage, the government had already identified land, water, energy, mineral resources and the environment as key growth-limiting factors. This awareness is reflected in efforts to foster the development of a cyclical economy and the establishment of a resource saving and environment-friendly society.

Energy Conservation

The low level of energy efficiency in China is apparent from the fact that its consumption of energy per unit of real GDP in 2004 was four times greater than in the United States, eight times greater than in Germany and 11 times greater than in Japan. While China’s energy consumption tended to decline after the two oil crises, it bottomed out in 2000 and has now started to increase again (Figure 4). This pattern is attributed to an investment boom weighted toward energy-intensive basic materials industries, especially iron and steel, non-ferrous metals and non-metal products. Improvements in living standards, including the start of motorization, are also reflected in an upward trend in per capita energy consumption.

![Figure 4: Energy Consumption in China and Advanced Economies](image)

Per real GDP

Per capita

Notes: GDP by 1995 year price
Source: Compiled by the Economic Research Office, Bank of Tokyo-Mitsubishi UFJ based on BP statistics.

One of the targets included in the Five-Year Plan at the drafting stage was the reduction of energy consumption per unit of GDP by 20% compared with the 2005 level. (This has been designated as a binding target in the guidelines.) In line with this policy, the government began to introduce measures to curb consumption in industry, transportation and the consumer sector.

Under the Interim Regulation on Promoting the Adjustment of Industrial Structure
introduced in December 2005, technology, equipment and products will be categorized into three types: ‘encouraged’, ‘restricted’ or ‘to-be-eliminated’, and different measures will be applied in order to adjust the industrial structure. The government has produced a ‘Guiding Catalogue’, which contains 539 items in the ‘encouraged’ category, 190 in the ‘restricted’ category and 399 in the ‘to-be-eliminated’ category. Items selected for the ‘restricted’ or ‘to-be-eliminated’ categories include many energy-intensive industries, such as cement, metals and chemicals, as well as small-scale equipment in the machine tools sector, and low-value-added products. The focus here is on the reduction of energy use.

Measures in the transportation sector are expected to focus mainly on incentives for the use of compact vehicles. In the past regional governments have limited the use of compact vehicles by banning them from city centers and expressways and stipulating minimum engine sizes for taxis. When the restrictions were introduced in the late 1990s, compact vehicles were mainly produced by local manufacturers, and frequent breakdowns made them a common cause of traffic jams. While these measures were intended in part as a way of reducing traffic congestion, however, they were also used by regional governments to support local manufacturers by encouraging people to buy large vehicles with higher profit margins. In January 2006, six government agencies, including the National Development and Reform Commission, the Ministry of Construction and the State Environmental Protection Administration, issued a joint directive to all regional governments instructing them to remove restrictions on compact vehicles by March and instead implement measures to promote their use.

The government also plans to modify the vehicle tax system in favor of compact vehicles. Currently there are three tax levels: 3% for vehicles under 1,000cc, 5% for vehicles between 1,000 and 2,200cc, and 8% for those over 2,200cc. The tax scale will be divided into five or perhaps seven levels, with the rate for vehicles under 1,000cc falling to 1%, and that for vehicles over 4,000cc increasing to 20-25%.

The key to energy conservation in the consumer sector will be energy-efficient construction. At a press conference in February, Qiu Baoxing, Vice Minister of Construction, estimated that one-third of existing buildings in China would require improvements at a cost of over 2.6 trillion Yuan. During the period covered by the 11th Five-Year Plan, the Chinese government aims to achieve energy savings equivalent to 101 million tons of coal through the construction of energy-efficient buildings with a total area of 2.16 billion square meters. This target represents about 5% of total energy consumption in 2005. If achieved, it would be a significant contribution to the achievement of the goal of reducing energy consumption by 20% compared with the 2005 level during the period of the 11th Five-Year Plan.

The World Bank’s assessment is that a 20% reduction in energy consumption will be difficult to meet in spite of these wide-ranging policies. However, the World Bank has higher hopes for the energy-savings benefits of increases in energy prices, which have been kept artificially low through government regulation. The government has already reviewed the price-setting system for oil to reflect international prices and has also indicated that it will introduce new fuel taxes. Of course, even if the targets are reached, China will merely be returning to the level that existed around 2000 and will still lag far behind the advanced economies in terms of energy conservation.

Environmental Protection

Concerning environmental protection, the proposals in the 11th Five-Year Plan show a recognition of the fact that countermeasures are introduced after pollution problems have
already occurred and that while these measures are being introduced, new sources of pollution are emerging. The proposals show a strong sense of crisis about environmental pollution, placing particular emphasis on the protection of drinking water resources.

According to the State Environmental Protection Administration, 90% of groundwater in urban areas is contaminated with toxic substances. About 70% of China’s people drink groundwater, which also accounts for about 40% of water used in agriculture. These figures suggest the health effects may be widespread. In recent years, there have also been numerous cases of major river pollution caused by toxic effluent from factories. A particularly serious incident occurred in November 2005, when benzene was released into a river following a chemical factory explosion in Jilin Province. Water supplies in the downstream city of Harbin were cut off as a result of the contamination, which later flowed further downstream into Russia. Since then another 45 cases of toxic spills into rivers and seas have further heightened public concern.

On February 7, 2006, the State Environmental Protection Administration responded by publishing a list of 21 companies and projects that were known to have caused major environmental problems, such as toxic effluent outflows. It also announced that it would take action, including orders to cease production, unless the organizations concerned complied with remedial directives. The public naming of polluting companies in this way is unprecedented in China.

On February 15, the government announced a comprehensive environmental policy for the period covered by the 11th Five-Year Plan. The policy includes a range of environmental improvement initiatives based on loans and tax policies. Though the worth of the policy itself is recognized, there is considerable concern that its effectiveness will be limited by opposition from regional governments, and a persistent tendency to put growth first. One of the binding targets in the guidelines is a 10% reduction in total discharge of major pollutants, defined as sulfur dioxide released and the level of chemical oxygen demand [NOTE] (COD). A similar target was included in the 10th Five-Year Plan, but it was one of the few targets that were not reached. The government will need to reflect on this and exercise strong leadership.

Note:
Chemical oxygen demand (COD) is the amount of oxidizers consumed during the breakdown of organic substances in water. It is a representative indicator of the level of organic contamination in seawater and lakes. Because major pollutants were not identified in the 10th Five-Year Plan, it is difficult to ascertain precisely what was achieved. However, the government has itself acknowledged in the guidelines for the 11th Five-Year Plan that the target was not reached.

(2) Initiatives to Raise the Level of Industry

Basic Policies and Reasons for Urgency

China has long regarded the development of a more advanced industrial structure as an important priority. Faced with increasingly serious trade friction triggered by mass exports of low-value-added goods, it has now become an urgent priority. This change reflects the fact of a rapid increase in China’s exports of machinery and electrical equipment in recent years, in addition to labor-intensive goods, such as textiles and footwear (Figure 5). Many of China’s export electronics are finished products assembled in China from key parts supplied from Asian countries. Though the amount of added value generated in China is small, the value of exports has expanded dramatically. This has caused China to amass large surpluses in its trade with the United States and the EU, leading to trade friction (Figure 6).
The government is urging Chinese companies to switch from imitation to innovation, and to create their own intellectual property under a concept named “independent innovation.” This policy was reflected in the guidelines announced by the State Council on February 9, 2006 for the long-term science and technology development plan, which covers a 15-year period ending in 2020. Indicators for the plan include the expansion of research and development investment to at least 2.5% of GDP (1.3% in 2005, initial target for 2010 under the 11th Five-Year Plan: 2.0%), the reduction of reliance on foreign science and technology to 30% or lower (currently around 50%), and a position within the top five in the world in terms of the number of patents obtained and the number of citations in scientific papers. China aims to lay the foundations on which it can build itself into a science and technology superpower by the middle of this century. Specific measures announced by the government for this purpose include deductibility of employee education expenditure from corporate income tax, a two-year exemption from corporate income tax for companies in high-tech development zones that meet certain criteria, and facilitated lending to companies that develop their own technology.

Pessimism at Home and the Pursuit of Homegrown Standards

However, the manufacture of high-tech products currently entails massive payments of patent royalties to other countries, and there is growing pessimism that it may already be too late for China to catch up with the advanced nations in science and technology. One solution to this problem is the development of original Chinese standards, including standards for third-generation (3G) mobile telephones.

The existing 3G standards are W-CDMA, which is used mainly in Europe, and CDMA2000, which is more common in North America. The Chinese government has delayed the introduction of 3G services until TD-SCDMA technology, which is being developed mainly by Chinese companies, can be improved. TD-SCDMA has taken longer to develop than TD-SCDMA and W-CDMA, and commercial products have not yet been developed, so it is generally assumed that it will be adopted as complement to these other two standards, rather than as the basis for independent networks. However, in January 2006 the Chinese government announced TD-SCDMA would be adopted first on a stand-alone basis. The government is expected to issue licenses after a TD-SCDMA network has been built and shown to be operating properly, and to issue licenses based on the other two standards after that.

China is also developing its own wireless LAN encryption standard (WAPI), and in 2004 it tried to make the use of the standard compulsory for all wireless LAN equipment sold in
China. However, other countries reacted angrily to this plan, which was postponed indefinitely after trade talks with the United States. However, in January 2006 the government issued a notice concerning its intention to give preference to WAPI-based products when purchasing wireless LAN equipment for government use. There are also indications that Chinese manufacturers were given advanced access to the encryption technology, something that is likely to cause further international friction.

In February 2005, the Chinese government approved EVD, a next-generation DVD standard developed by Chinese companies, as a national standard. The aim was to introduce the new standard ahead of other next-generation standards, such as HD DVD and Blu-Ray. Currently even Chinese manufacturers are delaying the introduction of the technology because of issues that include a lack of software. There has also been criticism that the EVD technology is not really innovative.

3. Significant Moves toward Correction of Income Gaps

Ever since its transition to the reform and open-door policy, China has pursued a policy that allows those who are able to become affluent first, and then seeks to raise living standards for impoverished groups. This policy brought rapid development for some, while others were left behind. The result was major development gaps between urban and rural areas, between industry and agriculture, and between coastal and inland regions.

From its inception, the present administration has worked hard to correct these disparities, and this commitment is strongly reflected in its first Five-Year Plan. In contrast with former President Jiang Zemin and former Premier Zhu Rongji, who made Shanghai their main power base, President Hu Jintao and Premier Wen Jiabao both have long experience in rural posts and have strong sympathy for those who have not shared the benefits of development. In addition, there is a real threat that increasing protest activity by farmers and the unemployed could trigger social unrest. This transition from "Getting Rich First" to "Common Prosperity" will also have important implications, in the sense that it will drive a shift from growth led by exports and investment to growth led by consumption.

(1) Action to Overcome Three Agricultural Problems

In China the wretched state of agricultural due to the combined effects of low productivity, rural poverty and low farmer incomes is referred to as the “three agricultural problems.” The present government sees this situation as a particularly serious issue and has made agricultural problems the first priority in its initial policy documents (policy documents published at the beginning of the year) in three successive years (2004-2006). The last time that agricultural problems were mentioned in the initial policy document was over a five-year period from 1982 to 1986. During that period the income gap between urban and rural residents shrank to 1.86 times in 1985, reflecting the transition from communes to farms independently operated by individual farmers.

However, the government’s subsequent preoccupation with industrialization was accompanied by a continuing rise in the income gap, which is now very large and has been above the 3.0 level since 2002 (Figure 7). There are also major gaps between urban and rural residents in terms of ownership ratios for durable consumer goods (Table 1). Reasons for this situation include the fact that while urban residents benefited from industrial development due to foreign capital investment, rural residents faced a heavy tax burden. The agricultural tax rate was 8.4%, but this was applied to total farm production. The percentage of crops sold
as commodities was low, and farmers were not allowed to deduct the cost of chemical fertilizers, pesticides, seeds and other inputs. The effective tax rate, adjusted for these factors, was around 20%. Under the tax system for urban salary income, people were allowed to deduct 800 Yuan (raised to 1,600 Yuan in 2006) from their income, which was then subject to progressive taxation over a 5-45% range. Only about 60% of salary earners paid tax, with the largest number paying the 10% rate. These figures translate into effective tax rates ranging from just 4.99% to 8.75%.

Premier Wen Jiabao said in March 2004 that the agricultural tax would be phased out over five years. In fact, the schedule was brought forward, and the tax was totally abolished at the start of 2006. Moreover, in 2004 the government introduced income policies, including direct subsidies to food producers, as well as additional payments to farmers growing improved crop varieties or purchasing farm equipment. However, these measures have failed to bring a significant reduction in the urban-rural income gap, and much still remains to be done.

In the guidelines for the 11th Five-Year Plan, the first specific item listed is rural reform based on a “new socialist countryside”, reflecting the government’s commitment. The guidelines call for a wide range of measures including the improvement of productivity through advances in agricultural technology and increased agricultural investment, the diversification of farm ownership formats, such as through market sales of ownership rights, the expansion of comprehensive reforms in such areas as taxation, finance and public administration, improvements in access to nine-year compulsory education, and the expansion of public services, such as public health and basic medical services. In another policy announcement, the government has introduced a policy designed to promote participation in nine-year compulsory education through the exemption of school fees and miscellaneous expenses in rural areas over a two-year period starting in 2006.

China is taking all possible steps to improve rural incomes. Another move that is attracting intense interest is the government’s commitment to promote an orderly shift of surplus labor into non-agricultural sectors and urban areas. Despite strict restrictions on migration to urban areas under the household register system, it is estimated that over 200 million farmers work as migrant laborers in cities. In 2002, the Ministry of Public Security announced new rules allowing rural residents to migrate to small cities, provided that they have secure accommodation, and reliable employment and income. In January 2006, the government
adopted the opinions of the State Council regarding the solutions to problems affecting rural migrant workers in guidelines for the protection of these workers’ rights and interests. The guidelines call for the solution of the problems of low wages and unpaid wages, the strict enforcement of labor contract laws and regulations, the provision of employment support and job skill training, the abolition of discriminatory regulations, the solution of social security problems, and the reliable provision of public services, including compulsory education for migrant workers’ children.

However, some urban residents are antagonistic toward rural migrants, while regional governments have been reluctant to increase their spending in such areas as social security, education and transportation infrastructure. Some cities, notably Shanghai, have actually tightened their household register rules.

(2) Prospects for Social Harmony

As disparity increases, there is a growing risk of social unrest in China. The government has responded to this risk by adopting President Hu’s goal of building a harmonious society as part 10 of the guidelines in the 11th five-year plan. The first priority identified is the expansion of employment. Related measures include the development of labor-intensive and service industries, and SMEs - all of which have a high labor absorption capacity - , the introduction of fiscal and financial policies to encourage job creation, and the establishment of job training schemes.

This emphasis reflects the fact that China still has a serious unemployment problem, despite its high growth. The National Development and Reform Commission estimates that there will be 14 million surplus workers in 2006, taking into account workers laid off by state-owned enterprises and collective-owned enterprises, new graduates, and workers migrating from rural areas. There seems to be a logical contradiction between this situation and an increasingly serious labor shortage in certain areas, especially southern China. However, this contrast simply highlights the potential for mismatching in terms of regions, job categories and other criteria. Some observers also warn that China’s future growth may be impeded by shortages of managerial and technical workers. The most effective response to these issues will probably be the provision of re-education opportunities for job seekers.

The next priority is the improvement of social security systems. During the 1990s, responsibility for social security shifted from state-owned enterprises to social security systems. However, slow progress on the improvement of related institutions has left the Chinese people with a sense of disquiet about the future. At the end of 2005, 160 million people were registered for pensions, 110 million for unemployment insurance, and 140 million for health insurance. When compared with China’s total population of 1.3 billion and working population of 760 million, these figures represent an extremely low coverage ratio. Moreover, most of those covered by the systems are concentrated in a small number of cities. Social security coverage in rural China is thought to stand at just 13%.

Looking at individual systems, we find that the pension insurance scheme is affected by numerous problems, including the inadequate accumulation of funds during the transitional phase, as well as issues relating to the management and investment of funds, despite China’s rapid transformation into an aging society with a low birthrate under the one-child policy. Together with soaring medical costs and regional disparities in the standard of medical facilities, China’s underdeveloped medical insurance scheme has become a source of problems in the medical sector.

There is considerable scope for improvements leading to the creation of social security
systems worthy to be described as “safety nets.” The guidelines call for accelerated improvements targeting all social security systems. It also sets binding goals, including an increase in the number of urban people covered by pension insurance to 223 million, and an increase in the coverage ratio for a new rural cooperative medical care system (a health insurance scheme in rural areas) from 23.5% to 80%.

4. Opportunities and Risks for Foreign Companies

Through the 11th Five-Year Plan, the Chinese government has demonstrated its awareness of the crisis caused by development that is reliant on investment and exports and results in a waste of resources under the growth-first policies, and also that caused by public dissatisfaction with expanding disparities. Instead of resting on the laurels of high growth, the government has instead shown its willingness to search for solutions to these problems. Of course, there is unlikely to be unanimous support for the shift away from growth-first policies, even within the central government. It will be even more difficult to change the attitudes of regional governments, enterprises and the public, and the improvement of systems is likely to take time. Nevertheless, the new course onto which the government is about to launch the Chinese economy will have a major impact on foreign companies, and they will need to understand the changes properly.

There will be business opportunities in various fields, including energy conservation, environmental protection, and the transition to a cyclical economy. There is also the possibility of preferential treatment for companies that promote their contribution to the Chinese economy. Because of their ability to draw on Japanese experience in these areas, Japanese companies are the focus of strong expectations from the Chinese side. However, companies will also need to be aware of local conditions. While Japanese companies offer high quality, they have irritated buyers by selling expensive facilities on a stand-alone basis. European and North American companies have made many sales by packaging their facilities with management systems, by marketing integrated projects under which the equipment itself is supplied cheaply and profits are recovered through running costs, allowing buyers to spread their expenditure evenly. The proposal of integrated utilization plans designed to raise the overall economic benefits of projects is also seen an effective approach. For example, desulfurization systems offer an effective way to prevent air pollution in China, where coal is the main source of energy. Research carried out at a Japanese university has shown that gypsum, which is produced as a by-product in these systems, can be used to improve alkaline soil, thereby helping to prevent desertification. If this research could be put into effect through industry-academia cooperation, Japan could earn considerable recognition in China. There is scope for the development of approaches based on these examples.

In the passenger vehicle market, consumers traditionally preferred larger vehicles. However, sharp increases in gasoline prices since last year have been reflected in an accelerating shift to smaller vehicles. This has allowed Japanese and Korean companies, as well as local Chinese manufacturers, to increase their market shares at the expense of European and American manufacturers. The government is offering incentives for the use of compact vehicles. It is also tightening energy conservation and environmental standards, including exhaust gas and fuel efficiency regulations, and stepping up its efforts to promote recycling. Though local manufacturers have an advantage in the production of inexpensive compact vehicles, they could be pushed out of the market because of their inability to cope with these new requirements. This will also work to the advantage of Japanese
manufacturers.

Efforts to correct disparities by raising the income levels of low-income groups could also lead to accelerated development in rural and inland areas. However, it will probably take time for these regions to become attractive markets for foreign companies, which unlike local companies have an advantage in the manufacture of high-value-added products.

From a risk perspective, foreign companies could suffer from pressure to transfer technology, and also from cost increases resulting from the use of homegrown Chinese standards as a consequence of China’s efforts to raise the level of its industries by developing its own intellectual property. While moves to provide stronger protection for intellectual property are laudable, there is also a tendency to accuse foreign companies of abusing their intellectual property rights. While China’s antimonopoly law is still at the draft stage, there is already concern that this area will become a target for regulation.

Behind this risk is a tendency to see foreign companies as a threat, a phenomenon that has expanded rapidly in recent years. Some critics have accused foreign companies of preventing the development of Chinese companies by building monopoly position in the Chinese market. A paper published by the State Asset Research Center of the National Development and Reform Commission went so far as to assert that foreign investment is not contributing to the improvement of technology in China. Clearly some aspects of the situation are viewed with increasing frustration on the Chinese side, including the fact that foreign companies account for 58.3% of exports at a time when trade friction is escalating, and the low level of added value generated within China.

However, the prevailing view among both government officials and academics is that foreign investment is making a positive contribution. Even so, the era in which foreign investment was welcomed indiscriminately is coming to an end, in part because of resource problems. In fact, foreign investments are now classified into four categories: ‘encouraged’, ‘permitted’, ‘restricted’, and ‘prohibited’. There are reports that approval is taking longer, even for ‘encouraged’ projects that are able to enjoy tax incentives. The possibility that tax incentives for foreign companies in general will be phased out was raised some time ago. This became a more distinct possibility recently when Vice-Minister of Finance Lou Jiwei predicted that a bill would be submitted for deliberation by the Standing Committee of the National People's Congress in August of this year.

China is moving into its 11th Five-Year Plan, and the government has begun to review its growth strategies of the past. These changes will naturally create new and different opportunities and risks that will need to be figured into the strategies of foreign companies in China.

(Yoko Hagiwara, March 16, 2006)