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The Business of China's 12th Five Year Plan

Executive summary

China's 12th Five Year Plan represents an ambitious new path for the country and its economic growth trajectory. The plan will create a host of risks and opportunities for companies doing business in the country. More than any other five year plan, this one focuses on quality of life over quantity of GDP. It stresses the need to boost domestic consumption, develop the country's interior, and promote clean energy. The government will make considerable headway in shifting the locus of growth and investment inland and promoting urbanization, which will open up important opportunities for businesses servicing China's countryside. Likewise, higher wages and better benefits for workers will encourage more household spending across the country, which could lead to consumption windfalls for foreign firms that are appropriately positioned. In other areas, firms will face a more challenging environment. Labor and production costs can be expected to rise in the coming years, as can energy prices. Higher costs will be particularly steep along the country's more affluent eastern seaboard. In addition, a major part of the new plan is the promotion of seven emerging industries: alternative energy, biotechnology, new information technology, high-end equipment manufacturing, advanced materials, alternative fuel vehicles, and energy and environmental conservation technologies. Chinese firms in these industries will receive preferential treatment, meaning that foreign companies will face a skewed competitive landscape.

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Overview

China's 12th Five Year Plan (FYP), which the government released on 15 March, is an aggressive and wide-ranging document that calls for major shifts in the country's economic growth model. The plan trumpets quality of life over quantity of GDP growth. It emphasizes boosting incomes and domestic consumption, shifting industrial activity away from coastal provinces, and promoting clean energy, innovation, and human capital as new sources of growth and productivity.

It is unlikely that every component of Beijing's ambitious agenda will meet with equal success. The government will make considerable headway in shifting the locus of growth and investment inland and promoting urbanization. And many of the FYP's industrial targets will likely be met, which will help the government reach its environmental goals as well. But the central priority of increasing household incomes faster than economic growth will likely be slowed by concerns about lower profits, especially in China's powerful state-owned corporate sector. Likewise, the financial sector remains mostly immune to reforms and is therefore a major impediment to some of the economic goals that the government has said it will pursue. Put simply, in pursuing a transformation of such magnitude, even the Chinese government will fall short in certain regards.

Understanding the 12th FYP plan is nevertheless vital for any firm hoping to succeed in China in the decade ahead. The plan will set the country's course for economic policymaking, and the business environment will shift in fundamental ways as Beijing executes needed reforms. Labor and production costs will rise as the government works to make Chinese families richer, encourage household consumption, implement more robust environmental protections, and move domestic industry up the value-added production chain. Added costs will be particularly steep along the country's more affluent eastern seaboard, where living expenses are rising rapidly and provincial governments are looking less favorably on low-value-added production.

Higher wages and better benefits for workers will encourage more household spending and generate so-called consumption windfalls in various parts of the country. Foreign firms that are appropriately positioned to benefit from these windfalls should reap meaningful profits. At the same time, the competitive landscape in which those firms operate will become more challenging as Beijing spends massively to promote Chinese-style innovations among its national champions.

The 12th FYP (2011–2015): Ups and downs for business

Ups:

- Urbanization, rising wages, and a wider social safety net will fuel private consumption growth, especially in health care products and services.
- The expansion of China's service sector will generate new market opportunities and new possibilities for foreign firms to collaborate with domestic companies.
- $1.5 trillion in "emerging industry" industrial spending will create new opportunities for foreign firms.
- Tax incentives and other preferential policies will be rolled out in the interior to attract foreign investment.

Downs:

- Industrial and "indigenous innovation" policies will push Chinese firms up the value chain and create new competitors for international firms, especially in high-tech sectors such as aviation and electric vehicles.
- The mounting cost of labor, energy, and other inputs will make some manufacturing in China more expensive or drive it inland.
- The lack of financial liberalization will limit the growth of small and medium-sized enterprises and create barriers for foreign insurance companies and financial institutions.
- The growing political clout of state-owned and state-backed companies will reinforce the unequal playing field for foreign businesses.

Analysis

Production costs will rise

As Beijing seeks to implement the goals outlined in the 12th FYP, the cost of doing business in China will escalate. The two biggest drivers of these cost increases will be labor, as the government seeks to make families richer and encourage consumer spending, and energy, as Beijing experiments with more market-based pricing systems to move the economy toward sustainable growth.

Labor

Authorities will rely on wage hikes to bolster household consumption and improve living standards. Twice in the past two years the central government has directed provincial governments (equivalent to US states) to implement sizable mandatory minimum wage hikes within their borders (15%–16% on the low end, and upwards of 20% in most provinces) and to encourage local companies to raise wages for workers who were already paid more than the minimum wage.

This sort of government-directed pressure is likely to persist. Beijing will ensure steady pay increases for workers and expand social welfare coverage in the hopes that these steps will free up more disposable income and encourage consumption among average Chinese families.

Even without state intervention, rapid economic growth will mean significant upward wage pressure throughout the country over the next five years. Already, rural per capita gross income in China has been growing at an annual average of roughly 9% over the last five years, while average urban per capita disposable income has grown close to 10% per year over the same period. In 2010, rural per capita gross income stood at $895 and urban per capita disposable income at $2,895 (based on the current exchange rate of about 6.6 renminbi to the dollar). The National Bureau of Statistics reports these two figures without really reconciling or comparing them. This variance likely reflects the enormous differences in purchasing power and consumption behavior between urban and rural residents in China. But if Beijing is even halfway successful in pursuing the aims of the 12th FYP, these discrepancies should start to diminish.

Energy

The price of energy will continue to rise in China over the next five years as well, increasing costs for businesses that are reliant on internal logistics networks and making production more expensive. Currently, most energy prices in China—including that of electric power—are manipulated by the government. Beijing's default tendency is to keep energy prices low to protect industry (especially those with razor-thin margins), as well as the relatively poor and highly price-sensitive public, from inflationary pressures.

But Chinese policymakers are determined to minimize price distortions that seek to protect end users—both industry and consumers—to better reflect energy supply and demand. Skewed energy prices are a major impediment to the government's efforts to restructure the economy: Subsidizing low electricity prices, for example, has made it more difficult to achieve energy efficiency, provide incentives for investment in energy infrastructure such as gas pipelines and transmission, and pursue renewable energy deployment. While market pricing reforms will proceed gradually, companies should expect higher energy prices over the next five years.

Taxes on energy use will rise, as well. Chinese policymakers view the tax imposed on gasoline in 2009 as a success, particularly because it pumped revenue into Beijing's coffers. This has prompted leading agencies, such as the Ministry of Finance, to push for different types of resource-based taxes that would effectively "price" energy sources such as coal and oil at higher rates. More policy stakeholders seem to favor leveraging these kinds of tax schemes to curb "dirtier" energy while expanding revenue at the local level. Some of the new revenue would then be funneled into emerging sectors that the government wants to promote as part of the 12th FYP, such as nuclear power, renewable energy, and unconventional gas.

Beijing will strengthen the social safety net to encourage household spending

In addition to mandatory wage hikes, more state spending to bolster China's insufficient social safety net (including pensions and healthcare) is guaranteed over the next five years. The government hopes that these benefits—along with higher wages—will start to alleviate costs for workers and their families, freeing up more money for discretionary spending.

Targets in the 12th FYP

Average annual GDP growth rate	7%
Annual growth in per capita urban disposable income and per capita rural net income	>7%
Total new units of affordable housing to be built	36 million*
Urban basic pension participation	357 million*
Urbanization rate	↑ 4 percentage points (to 51.5%)
R&D spending as percentage of GDP	↑ 0.45 percentage points (to 2.2%)
Patents per 10,000 people	3.3
Reduction in energy intensity per unit of GDP	16%*
Reduction in carbon intensity per unit of GDP	17%*
Share of non-fossil fuels in primary energy mix	11.4%*

* Indicates that the target is politically binding

Government revenue grew by more than 21% in 2010, partly attributable to Beijing's slow but successful push to raise taxes on energy and resource use. This should give Beijing more firepower to back up its spending plans. For example, resource taxes will provide additional revenue streams to local governments in resource-rich provinces such as Xinjiang, Sichuan, Shaanxi, and Inner Mongolia. Moreover, the long-debated property tax—currently being piloted in Chongqing and Shanghai—will likely extend to more cities after a series of trials and thereby transfer more funds to municipalities, including in the interior.

The 12th FYP also calls for more rural education initiatives, improvements to China's skewed agricultural product pricing system, an expansion of agricultural subsidies, and new opportunities for innovative finance in an effort to develop non-agricultural enterprises in rural areas. Policies that rely on increased spending—for instance, education initiatives and subsidies for agricultural production—are likely to expand meaningfully over the next five years. But rising inflation expectations will likely strengthen resistance to a more market-based pricing system from political bodies such as the National Development and Reform Commission, the high-level agency tasked with controlling food-price inflation. Neither will the transition to more efficient farming come easily: The idea raises sensitive policy issues ranging from agricultural production quotas to land reform.

State-supported industries will receive heavier backing

A major part of the 12th FYP will be a ten-year, $1.5 trillion industrial policy to promote seven emerging industries: alternative energy, biotechnology, new information technology, high-end equipment manufacturing, advanced materials, alternative fuel cars, and energy and environmental conservation technologies. Chinese firms in these industries will be eligible for preferential financing from state-supported banks, and demand for their products will be bolstered by government subsidies.

Foreign companies competing with these firms will face a skewed competitive landscape. Already, China's ability to compete with international technology firms has improved faster than many had anticipated. And China's capacity to digest foreign technologies, reengineer them to Chinese specifications, and then produce them at a lower cost has unnerved foreign companies, which increasingly question the wisdom of transferring technology to China. But there will also be opportunities to collaborate with exceedingly cash-rich and globally oriented Chinese companies, especially in undeveloped sectors such as finance and services (including marketing and global public relations). And while some private Chinese firms will benefit from Beijing's aggressive spending plans, others will be put at a competitive disadvantage relative to their state-supported counterparts.

Hastening the development of the interior

Economic growth in China's countryside has been rapid since 2002, when President Hu Jintao and Premier Wen Jiabao came to power with a clear mandate to ease the massive development disparities between provinces on the east coast and those in the rest of the country. Policies included in the 12th FYP will likely accelerate this process even further.

For one, the trend of rising wages and input costs, as well as more robust consumption and a gradual shift of preferential tax policies for corporate investment inward from the coast, will likely make corporate activity in China's interior more attractive. Provincial governments in central China, for example, are offering investors exemptions or reductions to value-added taxes, import taxes, and urban land taxes for industry. In addition, the central government is using fiscal transfers to subsidize emerging industries and is encouraging companies in those industries to relocate to the interior. Infrastructure development will also help. The expansion of roads and rails across continental China, as called for in the 12th FYP, will create a more integrated national transit system to facilitate the movement of goods both inside the country and toward the coast for export.

Urbanization will be another major driver of interior development in the 12th FYP period. Chinese demographic and urban planners believe that more than 300 million citizens will migrate from rural areas to cities over the next several decades. As companies look inward for investment, third- and fourth-tier cities will get bigger, and less-developed cities in China's countryside will become more appealing to workers. As coastal provinces move up the value chain and promote the development of more robust service sectors, many cities in the interior will grow precipitously. Some, not least those that border more affluent eastern provinces, will reinvent themselves as special investment zones. Other major cities, municipalities, and provinces—such as Chongqing and Changsha—will become attractive investment and consumer hubs. Resource-rich interior provinces such as Xinjiang and Inner Mongolia will capitalize on their natural endowments and become wealthier as Beijing rolls out more taxes on energy and resource use.

Business implications

- **Low-skilled labor will accumulate in the interior:** Low-skilled and cheap labor will become more concentrated in China's central provinces, given continued rapid development in the east and government incentives for corporate investment in the interior. As jobs are created away from the prosperous coast and wages rise throughout the country, there will be fewer incentives for workers to migrate to the traditional coastal manufacturing hubs in provinces such as Guangdong. Recent policy changes allowing migrant workers to transfer pension benefits more easily should also facilitate a greater willingness on the part of workers to avoid China's megacities.

- **Labor tension could emerge:** Provincial governments will face difficult choices: They will try to contain strikes and any social tension that arises from worker dissatisfaction or from escalating food prices, but will be reluctant to implement wage hikes or introduce legislation that scares off investors. The most significant pressure will come from recent graduates who face severe job competition and low pay. Beijing will respond by intensifying efforts to create new jobs for them—primarily by executing its plan to foster emerging industries. But as expectations soar among the Chinese workforce, Beijing will continue to grapple with demands for better conditions and representation—which will push up labor costs.

- **Freer trade in Asia:** As Beijing moves to bolster household spending, China will become an ever more important source of demand for countries throughout the region. Recognizing this trend, Beijing has successfully led a number of preferential trade and tariff reduction agreements in Asia, including the landmark pact between China and the Association of Southeast Asian Nations (ASEAN), which came into effect at the beginning of 2010. That agreement slashed average tariffs on most goods traded between China and ten Southeast Asian countries to nearly zero. And it helped spur a flurry of other pan-Asian free trade negotiations. This reflects a larger regional trend: Negotiations on trade, financial swaps, and technical standards are increasingly being conducted on a pan-Asian basis, usually without US participation.

- **Inflation will persist:** The 12th FYP calls for higher energy costs and better pay for workers. As the government pursues these aims, the cost of producing goods in China will increase and eventually be passed on to consumers. Inflation is already worrying the government, and the central bank is promoting higher reserve requirements for banks and will ultimately raise interest rates further in order to tame it. But over the 12th FYP period, authorities will have to become more tolerant of inflation given that it is an unavoidable consequence of the structural reforms Beijing hopes to effect. For companies, continued inflation will drive wage-hike pressure and make production in China more expensive.

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