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China Ahead of the 13th Five-Year Plan: Competitiveness and Market Reform

Key views:

- Beijing has made important progress on reform during the 12th Five Year Plan (FYP) period—with the most seismic shift being a growing political acceptance of slower economic growth.
- But many of the structural reforms needed for long term sustainability in the economy remain incomplete.
- Even so, reform momentum is accelerating in 2015 and the Chinese leadership is poised to tackle at least some more significant structural economic reform over the 13th FYP period (2016-2020).
- In the state-owned sector, Beijing is "resizing the state," by doubling down on support in strategic industries while pushing other sectors toward privatization and market forces.
- The US Congress should look favorably on a pending US-China Bilateral Investment Treaty if concrete, binding commitments to reform, new market openings, and a reduction in informal investment barriers are included in the agreement.
- The US Congress should strengthen and clarify regulations surrounding Chinese corporate investment in the US, and support IMF reform to more fully integrate Beijing into the global economic architecture.

Questions/Discussion:

- **Assess whether China will meet the key targets of the 12th Five-Year Plan. What have been the greatest successes? Where are the partial successes? What are notable failures?**

The most significant success of the 12th FYP has been underpinning a growing acceptance of slower economic growth by the Chinese government. The key theme of the 12th FYP was prioritizing the quality of growth over its quantity; since the plan's announcement the economy has slowed from 9.2% in 2011 to 7.4% in 2014. Moreover the pace of growth continues to slow in 2015. Slower growth is also looking more sustainable, as the resource and energy intensities of growth have fallen in line with the government's 12th FYP targets.

To be sure, the economy's downward shift is hardly attributable to the 12th FYP alone, but is instead emblematic of China's economic and fundamental realities. The constraints on growth are broadly recognized, even by the government itself: growth has been too resource and capital intensive, driving massive socio-economic inequalities and unparalleled environmental degradation. Heightened default potential now plagues the financial system as a result of unprecedented stimulus in response to the global financial crisis, while an explosion in local

government debt levels constrains Beijing's ability to use any further stimulus to defend the economy.

The government is mostly on pace to hit the 12th FYP's key targets. Below is an assessment of specific targets in the plan, and the progress in hitting those targets over the 2011-2014 period (the first four of the five years of the plan). Growth has outpaced the government's official target, as have urbanization rates and growth in the services sector and R&D. Addressing environmental degradation by reducing the resource intensity of growth and increasing the role for non-fossil fuels were also key goals of the plan. On those fronts, while China still has very far to go, key energy and carbon intensity reduction targets are on pace to be met by year-end 2015:

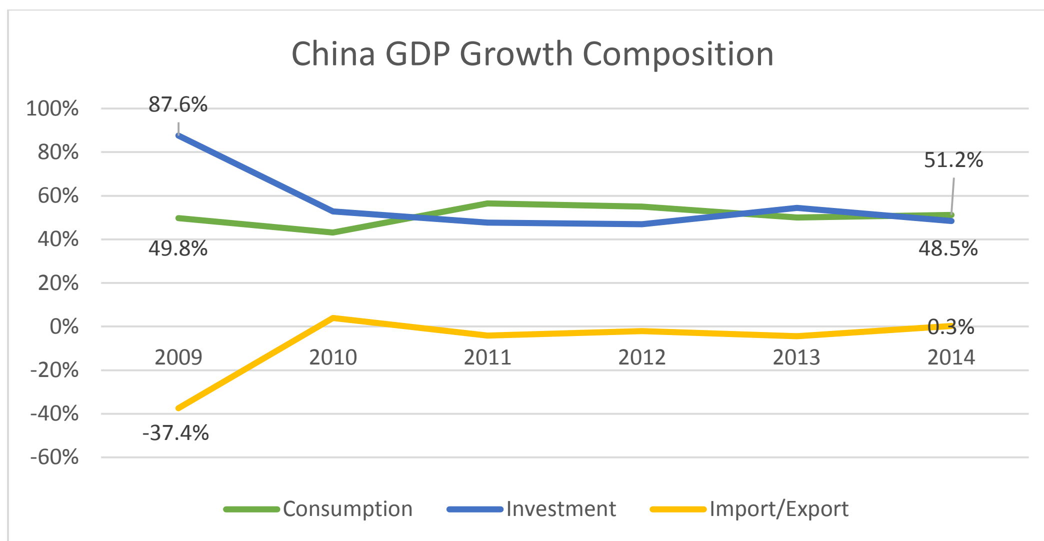
Progress on key targets of the 12th Five Year Plan		
Category	*12th FYP Target*	*2014 Data*
GDP growth	7% yearly (nonbinding)	7.4%
Urbanization rate	Increase to 51.5% (nonbinding)	54.77%
Services sector value added as % of total GDP	Increase to 47% (nonbinding)	48.2%
R&D spending as % of GDP	Increase to 2.2% (nonbinding)	2.1%
Patents/10,000 people	3.3 (nonbinding)	4.9
9-year mandatory education rate	93% (binding)	92.6%
High-school enrollment rate	87% (nonbinding)	85% (2013)
Average urban disposable income	Increase by 7% yearly (nonbinding)	8.4% (2011), 9.6% (2012), 7.0% (2013), 6.8% (2014)
Average rural gross income	Increase by 7% yearly (nonbinding)	11.4% (2011), 9.6% (2012), 9.3% (2013), 9.2% (2014)
Urban registered unemployment	Decrease to 5% (nonbinding)	4.1%
Energy intensity per unit of GDP	Decrease by 16% (average 3.4% per year)	-12.79%
Carbon intensity per unit of GDP	Decrease by 17% (average 3.4% per year)	-10.62% (2013)

Non-fossil fuel in primary energy mix	11.4% (binding)	11.1%
Forest coverage	21.7% (binding)	21.63% (Feb 2014)

Sources: Chinese government data, Eurasia Group research
*Yellow signifies target already met or exceeded

In terms of partial successes or even failures: Another overriding theme of the 12th FYP was to increase the role of consumption in growth. On this front, based on available data from the Chinese government at least, the overall composition of growth has not materially changed during the period at hand—in 2014 investment and consumption both contributed roughly 50% of incremental economic growth, with net exports essentially flat. Structurally, investment is decreasing and consumption is increasing, but the pace of change is quite moderate.

This only moderate pace of change in the economy's underlying structure suggests that many fundamental reforms remain unaddressed in this last year of the 12th FYP. China's financial sector remains broadly state controlled, for example, with the government setting the terms in which capital is allocated via set interest rates. Growth remains too resource intensive and the return on capital is worsening. The value of the RMB remains controlled by the central bank, though it has been allowed to appreciate significantly in recent years. To be sure, there has been important progress during the 12th FYP period, and based on the government's policy designs on issues like environmental policy and industrial consolidation, investment growth will likely slow even further in 2015. But many necessary structural reforms in the economy remain incomplete and Beijing still has much reform work to do in the coming 13th FYP period.



Source: China's National Bureau of Statistics

- **Are China's Five-Year Plans still relevant, and why or why not?**

The FYPs are still relevant on two fronts. First, they are used by the central government to broadcast the orientation of policy throughout the bureaucracy and to local levels of government—where resistance to the central government's intentions can often be quite high. Second, the planning process for the FYPs continues to absorb months of bandwidth and attention throughout each of China's major ministries and commissions.

Still, it is important to recognize that the plans themselves are more like guidance for policy than binding blueprints. While the plans have always been called "plans" in English, since the 11th FYP Beijing no longer refers to them as plans but as guiding documents. Moreover the economy is becoming less state-driven, and a key theme for Beijing is to find ways to unwind government overreach and control over the economy. So the FYPs are less relevant over time, but they are still major undertakings by Beijing.

- **President Xi Jinping has announced a number of economic reforms, most notably outlining an ambitious agenda in the Third Plenum. What are these reforms?**

The Third Plenum reforms call for the market to play a "decisive" role in resource allocation, for a "deepening of financial and fiscal reform," for a greater role for private firms across the economy, and for a relaxation of investment barriers for foreign firms. At the Plenum the Communist Party promised to "consolidate and develop the publicly owned economy" and develop "fair, open, and transparent" market-based rules for the economy. The Plenum also rolled out administrative and governance changes that should strengthen the leadership's hand in driving reform. Those included the formation of a leading small group within the Party led by President Xi Jinping to drive reform efforts, and commitments to empowering the judiciary and the Party's anti-corruption investigative body.

- **In your judgment, what reforms and/or targets will be included in the 13th Five-Year Plan, and why? What facets of the 12th Five-Year Plan might be retained/strengthened, deleted, and modified as priorities in the 13th Five-Year Plan, and why?**

China's National Development and Reform Commission (NDRC)—the super ministry with broad responsibilities for the economy—began the drafting process for the 13th FYP in April 2014. The NDRC is expected to complete the draft by the end of this year. Provincial governments are also drafting local FYPs to be completed by year-end. In public statements, the government is already characterizing the next plan as a key period for China's economic transition and a pivotal moment to achieve a longer-standing goal to "become a moderately prosperous society by 2020." Key themes will be: innovation, economic transition, and reform.

In general terms, the 13th FYP will be less focused on "hard" infrastructure and manufacturing, and more focused on "soft" innovation, social benefits, and quality of life. The plan will again emphasize GDP quality over quantity, enshrining President Xi's "new normal" framework for growth into official policy. There is a looming debate over whether

the 13th FYP will set a growth target at all—many are calling for the administration to abandon the practice of setting growth targets. Reflecting this trend the city of Shanghai did not issue a growth target at all in its work report for 2015. If the 13th FYP does set a target it will likely be reduced at least to 6.5% yearly (the 12th called for 7% growth per year).

In terms of concrete policy, the 13th FYP will commit the government to increased outlays for education and healthcare. It will reinforce attention to environmental degradation and sustain the government's intention to "resize" or refine its role over the state-owned corporate sector by moving more industries toward the market while sustaining support for key strategic industries (discussed at greater length below). It will commit to further progress on capital account, currency, and banking sector reforms. As in past plans, regional integration will also be a key theme—with increased attention to pending development targets including: One Belt One Road, the Yangtze River Economic Belt, and the Beijing-Tianjin-Hebei Joint Development Strategy.

- **What is the outlook for the actual implementation of these reforms? What do the Five Year Plans mean for Chinese competitiveness and US-China competition?**

The Xi administration has sufficient bandwidth and political strength to move forward with reform through 2020, the end of the 13th FYP. While this process will not be easy or smooth, President Xi and his closest policy advisors believe that time is not on their side given the unsustainability of the current growth model, and that they have little choice but to pursue significant structural economic reform during the course of their tenure, which runs through 2022. The administration will have two political windows to implement reform: from 2015-2016, and again from 2018-2021. Major political transitions in 2017 and again in 2022 will otherwise distract the administration and absorb their political capacity.

Beijing will make the most significant progress in areas where it faces the sharpest political vulnerabilities, including social and energy/environmental policy. On social policy, Beijing will strengthen social welfare support (pensions, healthcare, education) and push for fiscal reforms to strengthen the government's ability to fund such efforts. On environmental issues and climate change, Beijing will increasingly fine polluting industries and tax fossil fuels, especially coal and oil as it makes concerted, and visible, efforts to tackle environmental degradation. A primary feature will be resource pricing reform, as the government removes energy subsidies and allows market forces to play a greater role in resource allocation.

The outlook for financial sector reform is also brightening through 2020. The administration will make significant progress on capital account, interest rate, and currency reforms in that time period, with seismic changes in China's currency and capital markets afoot by 2020. Interest rate reform, key for reducing the state's role in resource allocation, now appear poised to move the most substantially and quickly (this year) following a new commitment from Central Bank Governor Zhou Xiaochuan to lift the deposit interest rate cap for banks by the end of the year. The reform, long sought by the central bank, would mark a historic change in China's interest rate regime.

The government will also make progress on opening its capital markets and liberalizing its currency regime by 2020. On the capital markets, the leadership will use nascent "through trains" with Hong Kong to allow more international currency flows in to and out of the domestic equity markets, and it will allow foreign securities firms to play a bigger role in the opening of the capital account broadly. On the currency, Beijing will also likely expand the trading band for the RMB, allowing it to become more responsive to market forces by 2020. The government will engage less on foreign exchange markets to defend the currency's value, but concerns about the RMB's value will not be completely erased: the government will still have significant flexibility to control the currency's value with its massive forex reserves.

China's financial regulators will also broaden private sector participation in the banking sector with significant new opportunities for private financial institutions. The role for foreign firms in the domestic financial sector will also improve, but openings will move more gradually and could be only small and sporadic through 2020.

"Resizing the state"

Significant state-owned enterprise (SOEs) reform is also expected through 2020. But Beijing's intentions regarding SOE reform have been confused in the West: recent media coverage simplifies the government's agenda by arguing either that Beijing intends to liberalize and reform SOEs, or that it wants to double down on state-support for industry while boxing out foreign firms from the domestic market.

The truth is more nuanced: Beijing is pursing a two-pronged strategy that will tighten state control over strategic sectors of the economy, particularly those earmarked for greater international expansion or identified as strategic for national security reasons, while reducing state control over sectors where market competition is higher and security concerns lower. The policy marks an attempt to "resize the state" – meaning that the government will essentially ring fence its SOE space by doubling down and intensifying support support for and control over some sectors, while opening others to more market competition and even foreign competition. Beijing is currently drawing up lists categorizing its SOEs along these lines, and the end result will be that various industries move toward either increased market orientation or increased state support, as in the graphic below.

In terms of competitiveness and US-China competition, a primary focus will be to use forced mergers and stronger management oversight to create more globally competitive national brands in strategic industries. The expectation is that larger companies will be more globally competitive and better able to help the economy move up the industrial value chain. Chinese firms will continue to struggle with inefficiencies and weak domestic intellectual property protections. But the government's willingness to invest significantly in new and emerging technologies will indeed mean greater competitive capabilities for Chinese firms in a range of high-tech sectors. It will also mean continued regulatory preferences for SOEs in key sectors in ways that sustain advantages for those firms vis-à-vis US or other foreign firms in the China market.

On the upside, Beijing is also likely to open more sectors for more private and foreign investment. The government recognizes that foreign expertise, capital, and technology is needed as it navigates slower economic growth, and the slowing economy also raises incentives to open up more channels for inbound investment. Sectors that see greater openings will be those where the government sees continued need for foreign expertise, and those that have been classified as "market competitive" and where Beijing is more interested in reducing the state's role.

The recent 21 April 2015 announcement of a common "negative list" of restricted sectors for four new free trade zones underpin these views and give some indication of those sectors that are likely to be more open: the lists offer new openings in construction, numerous segments of advanced manufacturing (including auto electronic equipment, aviation engines, certain classes of pharmaceuticals), retail, water and environment, and real estate. Yet each sector will have a distinct story about how the government balances the need for new investments against the desire to protect local firms. Resistance from vested interest groups will remain substantial, especially in strategic sectors such as energy and finance.

The new negative list will also facilitate progress on the US-China Bilateral Investment Treaty (BIT) which is currently under negotiation. The current version of the negative list (as of 21 April 2015) does not offer the kinds of sizable trade barrier reductions that US negotiators will want to see out of negotiations, but is a firmer starting point for those dialogues than previous iterations.

Source: Eurasia Group China Research

- **The Commission is mandated to make policy recommendations to Congress based on its hearings and other research. Assess the implications of China's 12th and 13th Five-Year Plans for United States. What are your recommendations for Congressional action related to the topic of your testimony?**

Use oversight and approval powers to shape a bilateral investment treaty agreement that benefits US industry and the US economy. And if a good deal is finalized, move forward with speedy passage. The US Congress has an important role to play in motivating China to double down on and follow through with its reform commitments. The looming conduit for that influence is the US-China Bilateral Investment Treaty (BIT), which is currently under negotiation. The treaty would ideally better protect and facilitate US corporate investments in China, give Chinese firms more clarity and reciprocal treatment in US national security review and other regulatory processes, and ultimately pave the way for increased bilateral investment flows. An increase in Chinese corporate investment in the US market will also give the US government more leverage over China's corporate business practices—firms that are seen as benefiting from intellectual property theft, or those seen to be negligent in food or product safety considerations, will be subject to prosecution and liability claims in US courts, for example.

In its oversight and approval functions, the US Congress should look favorably on passage of the treaty--if, and only if, the agreement includes concrete, binding commitments to reform and new market openings from Beijing. In particular, the agreement must be shaped around sizable explicit reductions in investment barriers from Beijing across a range of sectors under the framework of a negative list approach. In addition, Beijing must make explicit commitments to reducing the multitude of informal barriers that are too-often placed on US firms across a variety of industries.

To be sure, there is a chance that these aspirations are not achieved and that Beijing is not willing or able to guarantee sufficient new openings in order for the BIT to make sense. But to strengthen the US negotiating position the Congress should give clear assurances that, if those criterion are met, it will move forward passage of the agreement without delay.

Strengthen and clarify foreign investment and national security laws that affect investment from China. In tandem with overseeing the BIT process, the US Congress should strengthen and clarify US foreign investment and national security laws and review processes, particularly those that surround the issue of state-owned corporate investment in the US economy. The guiding principles of reform should be that investments from Chinese private companies are welcome across a range of industries, but investments from private firms in strategic sectors, or direct investments by SOEs, will be subject to strict national security review in many instances. Ultimately these stipulations should be made more explicit and transparent in the Committee on Foreign Investment in the US (CFIUS) oversight process. Criterion for national security should also be laid out more clearly by delineating specific strategic sectors (as will be done via the US negative list in BIT negotiations) and mandating more openness from Chinese firms about their ownership structures before investments are approved.

To be sure, strict regulations or even investment restrictions will remain appropriate in many instances. But these regulations are currently too opaque and should be clarified and strengthened

so that they do not dissuade investments (particularly those from private firms) that would otherwise be deemed acceptable in national security reviews.

Approve IMF reform. The US Congress should approve pending reforms for the International Monetary Fund (IMF) in order to give emerging markets, including China, a greater say in that institution. The Chinese economy is now highly integrated into the global economic architecture and has significant global economic influence. The Congress must use its considerable influence to find ways to shape China's engagement within that architecture rather than excluding China from it. As the recent formation of the China-led Asia Infrastructure Investment Bank (AIIB) makes clear, Beijing does have sufficient capability to create alternative institutions that would risk further global economic fragmentation and undermine the US role in global economic governance.