

The Twelfth Five-Year Plan for Economic and Social Development and the Macroeconomic Outlook

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The Ongoing Transformation of China's Growth Pattern

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Outline

- ◆ The Twelfth Five-Year Plan for National Economic and Social Development
- ◆ The Macroeconomic Outlook
- ◆ Concluding Remarks

The Eleventh Five-Year Plan for National Economic and Social Development

- ◆ The 11th Five-Year Plan for National Economic and Social Development officially ended on 31 December 2010.
- ◆ Most of the targets were achieved or exceeded, including the reduction in energy consumption per unit GDP by 20 percent compared to year end 2005.
- ◆ The 11th Five-Year Plan provided for a target rate of growth of real GDP of 7.5% per annum between 2005 and 2010. The actual rate of growth achieved was 11.2% per annum.
- ◆ The only other major target not achieved was the percentage of GDP expended on R&D—the target was 2% and the actual achieved was 1.8%.

The Twelfth Five-Year Plan for National Economic and Social Development

- ◆ The Twelfth Five-Year Plan for National Economic and Social Development was approved by the National People's Congress a week ago. It is mostly an indicative plan rather than a mandatory plan.
- ◆ The most remarkable feature was that the target growth rate was lowered from 7.5% per annum of the 11th Five-Year Plan to 7% per annum. I am sure that this target will be exceeded, just as the target was exceeded in the last Plan. However, what the reduction in the target growth rate signals is the determination of the Chinese Government to de-emphasise quantitative economic growth and to focus on the quality of the economic growth.

The Twelfth Five-Year Plan for National Economic and Social Development

- ◆ The Plan provides for increased expenditures for education and healthcare, especially in the rural regions, environmental preservation and protection, and air and water pollution control. It also has mandatory targets for improvement in energy efficiency and reduction in carbon emission.
- ◆ It also provides for improvements in the income distribution through taxation, transfer payments and targeted government expenditures on education and health care.

The Twelfth Five-Year Plan for National Economic and Social Development

- ◆ One principal theme of the Twelfth Five-Year Plan is the transformation in the mode of Chinese economic development—firstly, from export-oriented to domestic demand-oriented and secondly, from input-driven to technical progress-driven or innovation-driven.
- ◆ The Plan aims at essentially balanced international trade, and I believe it is achievable.

The Twelfth Five-Year Plan for National Economic and Social Development

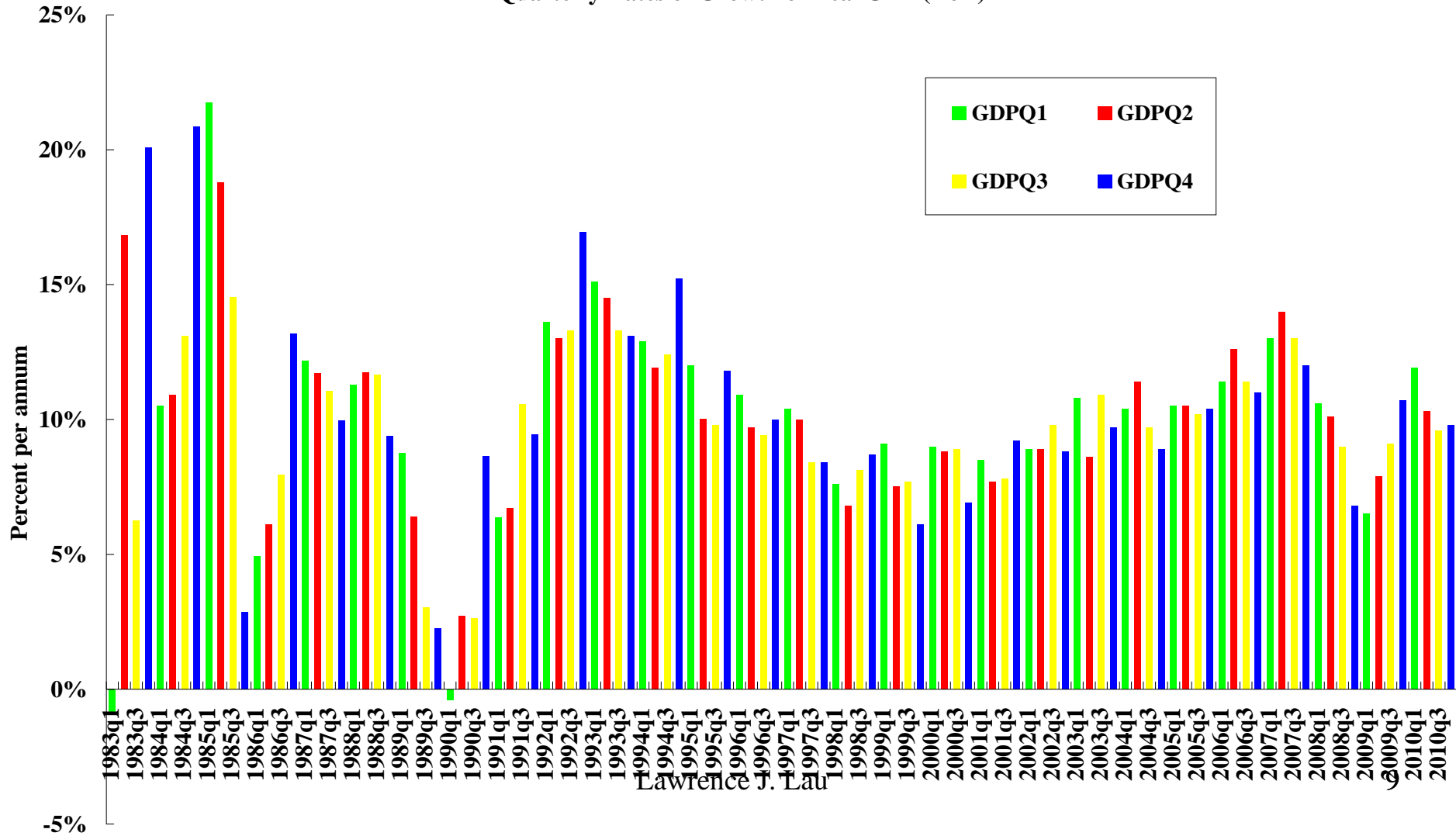
- ◆ While many problems have arisen in the Chinese economy within the past decade—for example, income disparity, environmental degradation, inadequate infrastructure and corruption—it is fair to say that everyone has benefited from the economic reform and opening since 1978, albeit to varying degrees, and few want to return to the central planning days.
- ◆ The Chinese Government leaders have also demonstrated their ability to confront important challenges and solve difficult problems.
- ◆ China is one of the very few socialist countries that have made a smooth transition from a centrally planned to a market economy. It is a model for other transition economies such as Vietnam and potential transition economies such as Cuba, Laos, and North Korea.

The Macroeconomic Outlook

- ◆ The Chinese economy grew 9.1% in 2009 and approximately 10.3% in 2010 even as the European and U.S. economies remained in recession.
- ◆ The outlook is that there will be a gradual slowdown of the economy in 2011, to perhaps around 8%, which is actually a positive development for the Chinese economy.
- ◆ While this may seem like a significant slowdown from 10.3%, but there are reasons to believe that the impact of the slowdown on Chinese employment is not that severe.

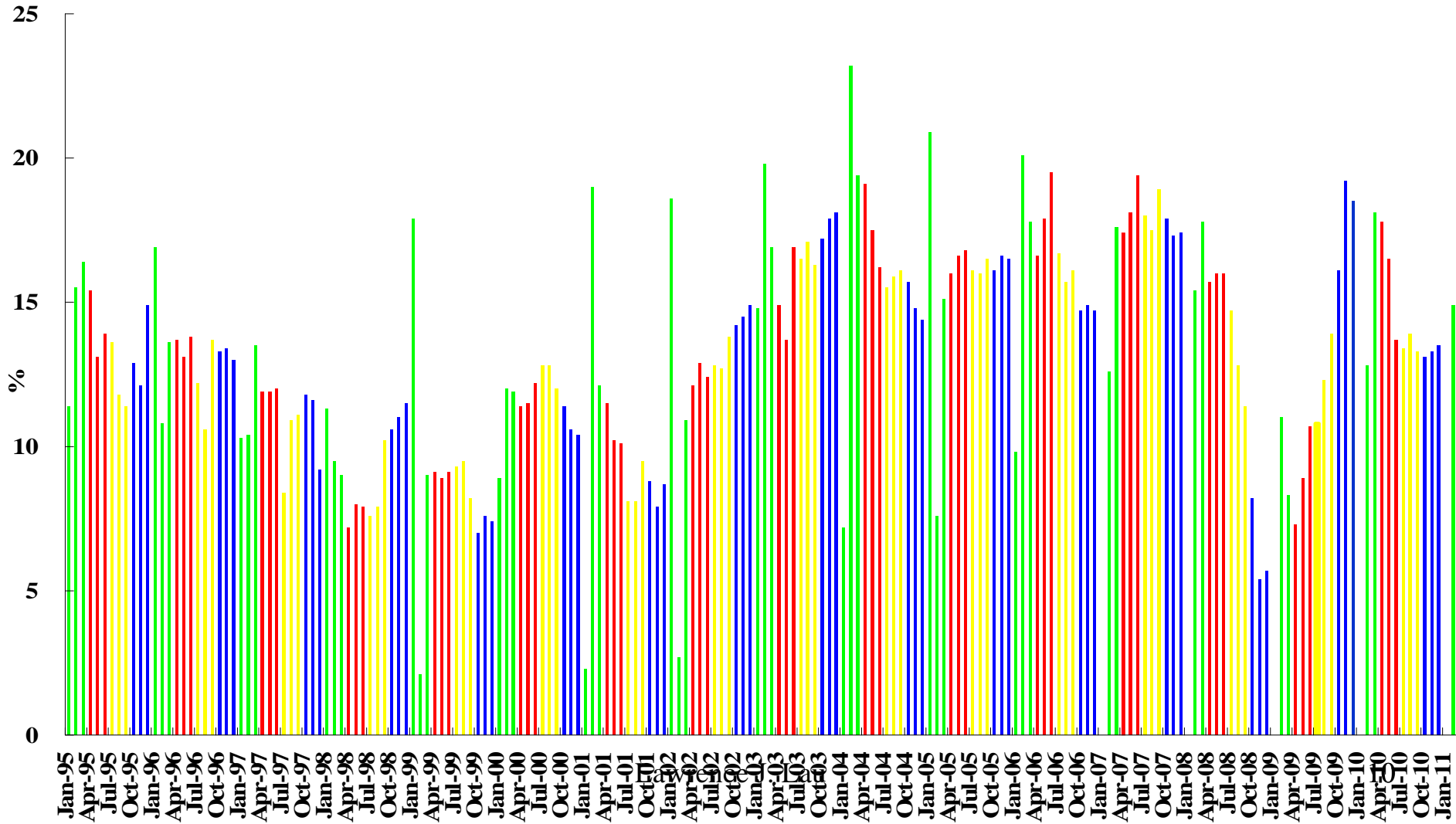
Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y

Quarterly Rates of Growth of Real GDP (YoY)



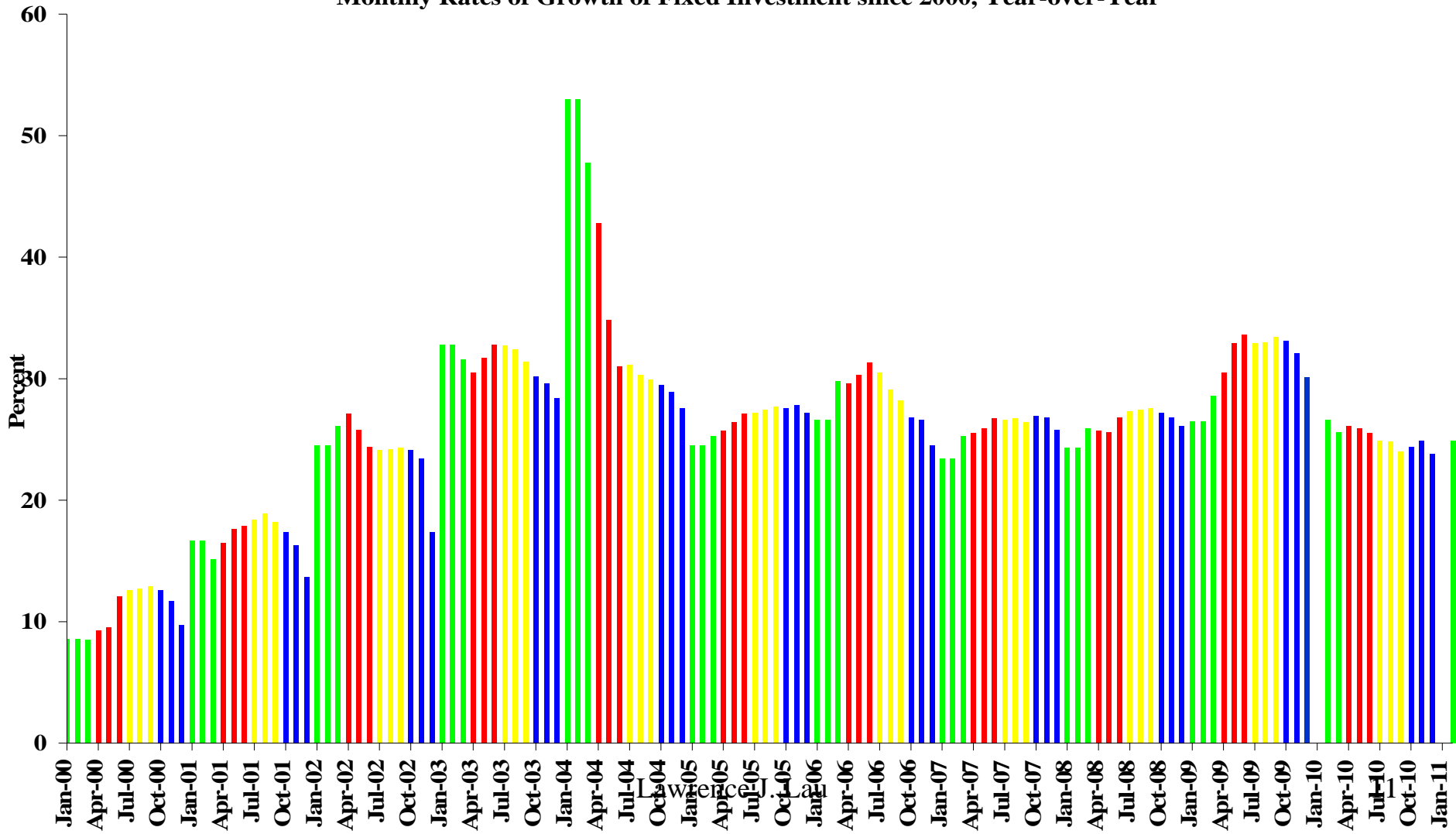
Monthly Rates of Growth of Real Value-added of the Industrial Sector, Y-o-Y

Monthly Rates of Growth of Real Value-Added of the Industrial Sector, Year-over-Year



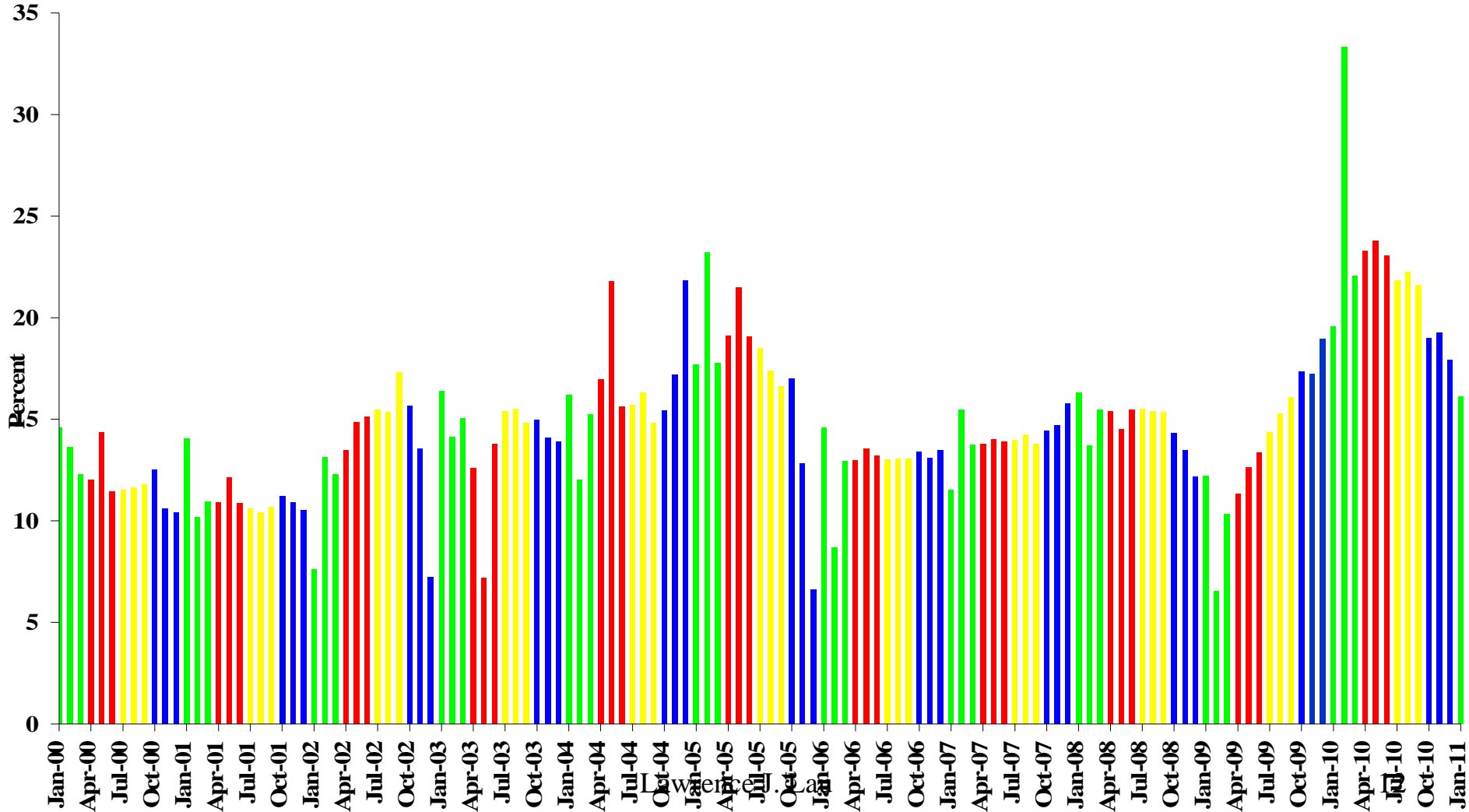
Monthly Rates of Growth of Chinese Fixed Assets Investment, Y-o-Y

Monthly Rates of Growth of Fixed Investment since 2000, Year-over-Year



Monthly Rates of Growth of Chinese Real Retail Sales, Y-o-Y

Monthly Rates of Growth of Real Retail Sales since 2000, Year-over-Year

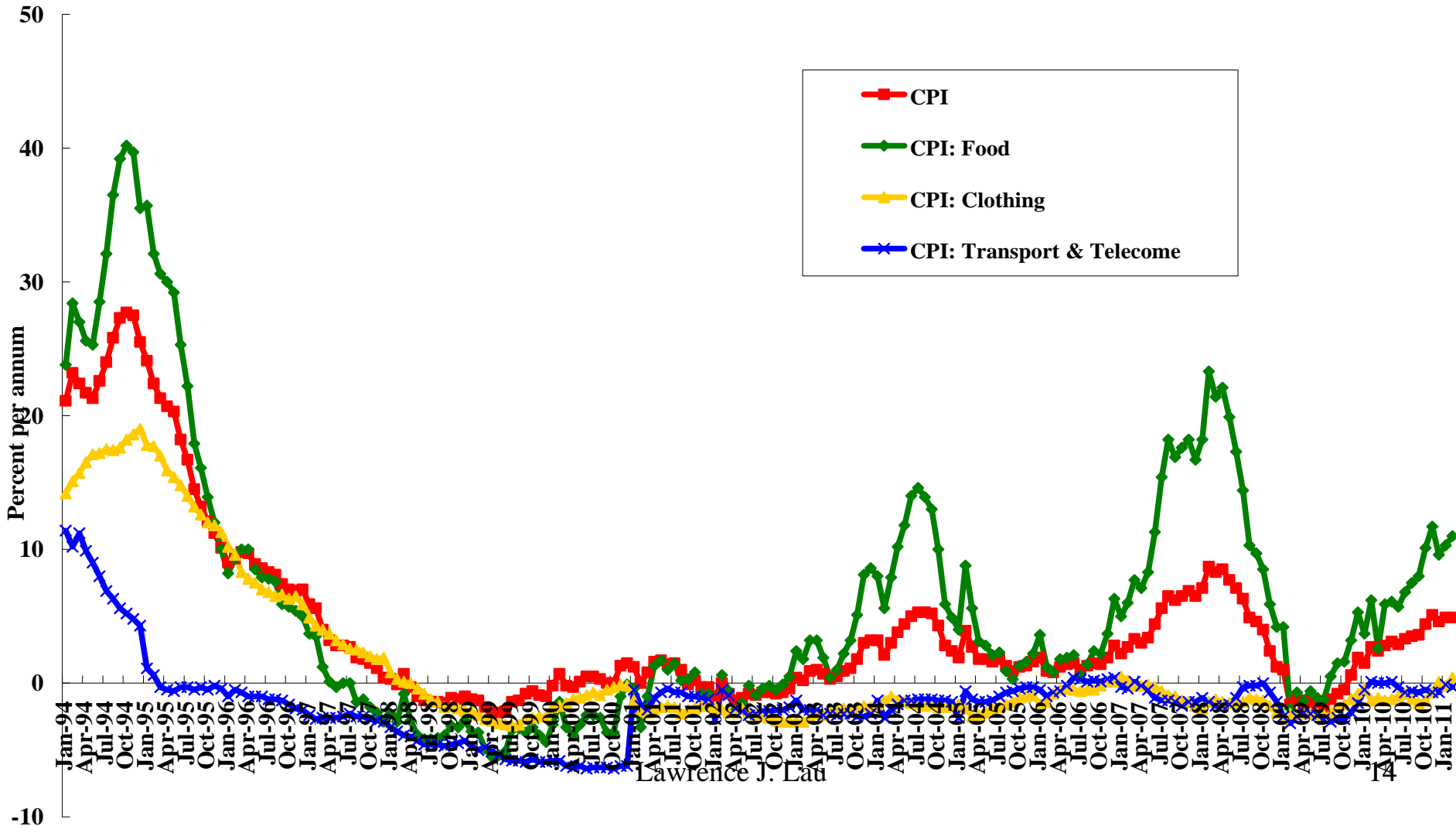


The Macroeconomic Outlook

- ◆ The rate of inflation of goods and services, as measured by the consumer price index, reached a peak of 5.1% year-over-year in November, 2010.
- ◆ For 2010 as a whole, the rate of inflation exceeded the objective of the Chinese Government of 3% slightly, at 3.3%.
- ◆ However, the bulk of the increase in the consumer price index (approximately 70%) was caused by the increase in food prices (principally vegetables), due mostly to weather and not to monetary factors. The core rate of inflation, that is, the rate of inflation net of the changes in the prices of agricultural and energy goods, has remained relatively tame at the 1-1.5% per annum level, as has been the case in the past few years.
- ◆ Moreover, given the excess production capacity in many key industries, such as steel, cement, and glass, it is unlikely that there will be much inflation in the prices of goods.

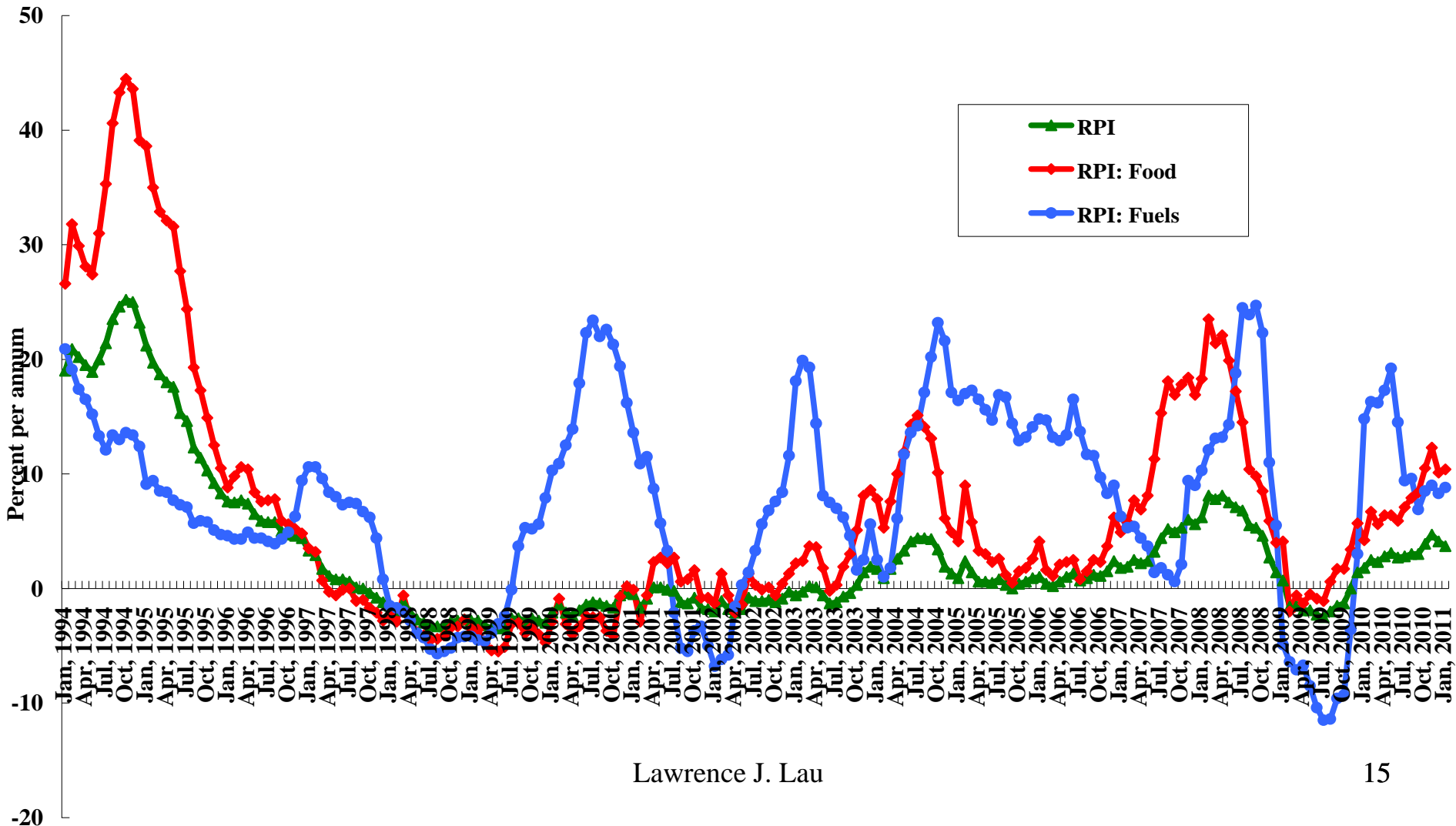
Monthly Rates of Change of the Consumer Price Index (CPI), Y-o-Y

Monthly Rates of Change of Consumer Price Index and Its Components Since 1994, Y-o-Y



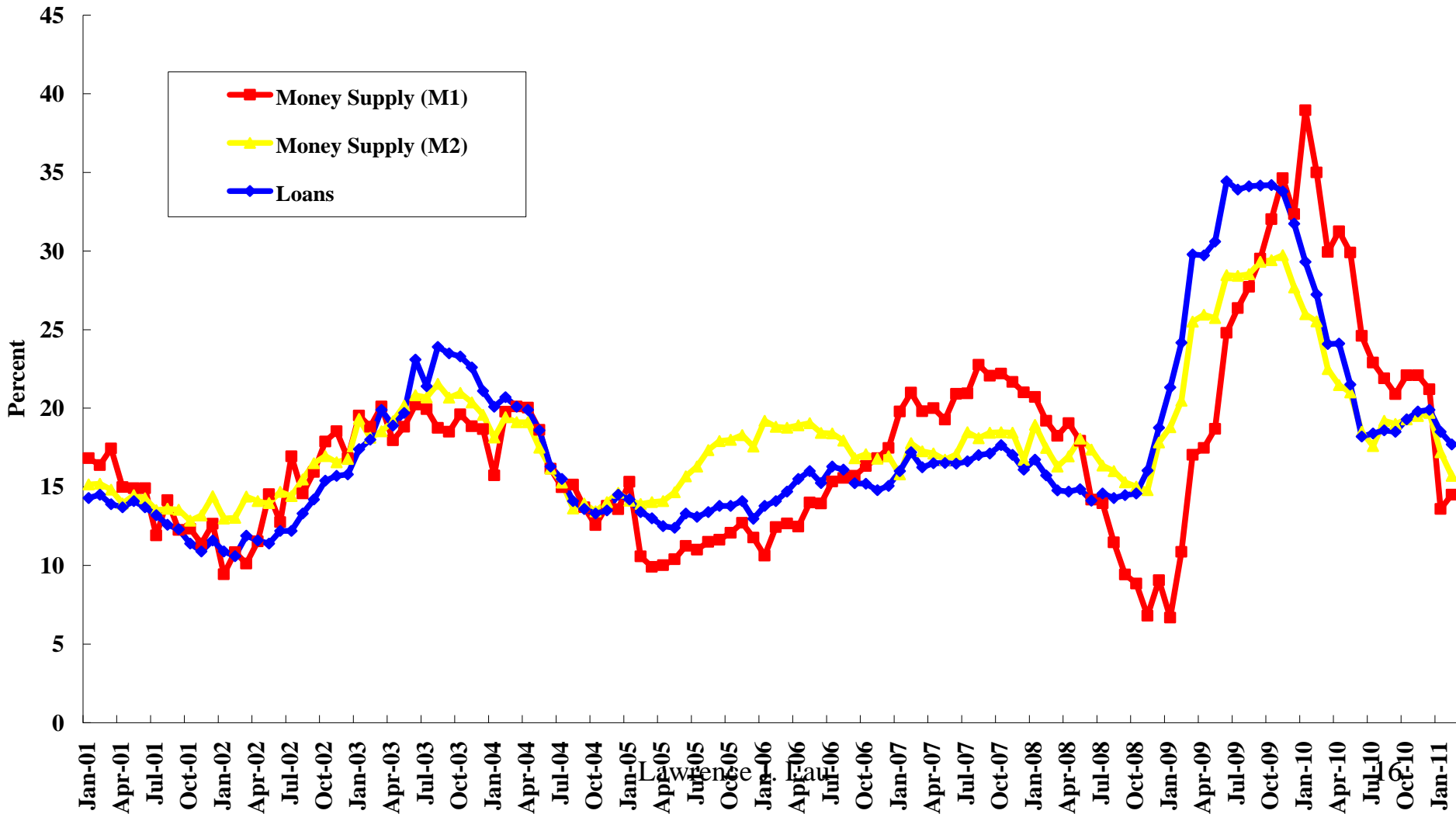
Monthly Rates of Change of the Retail Price Index, Y-o-Y

Monthly Rates of Change of Retail Price Index and Its Components Since 1994, Y-o-Y



The Rates of Growth of Money Supply and Loans, Year-over-Year

The Rates of Growth of Money Supply and Loans, Year-over-Year

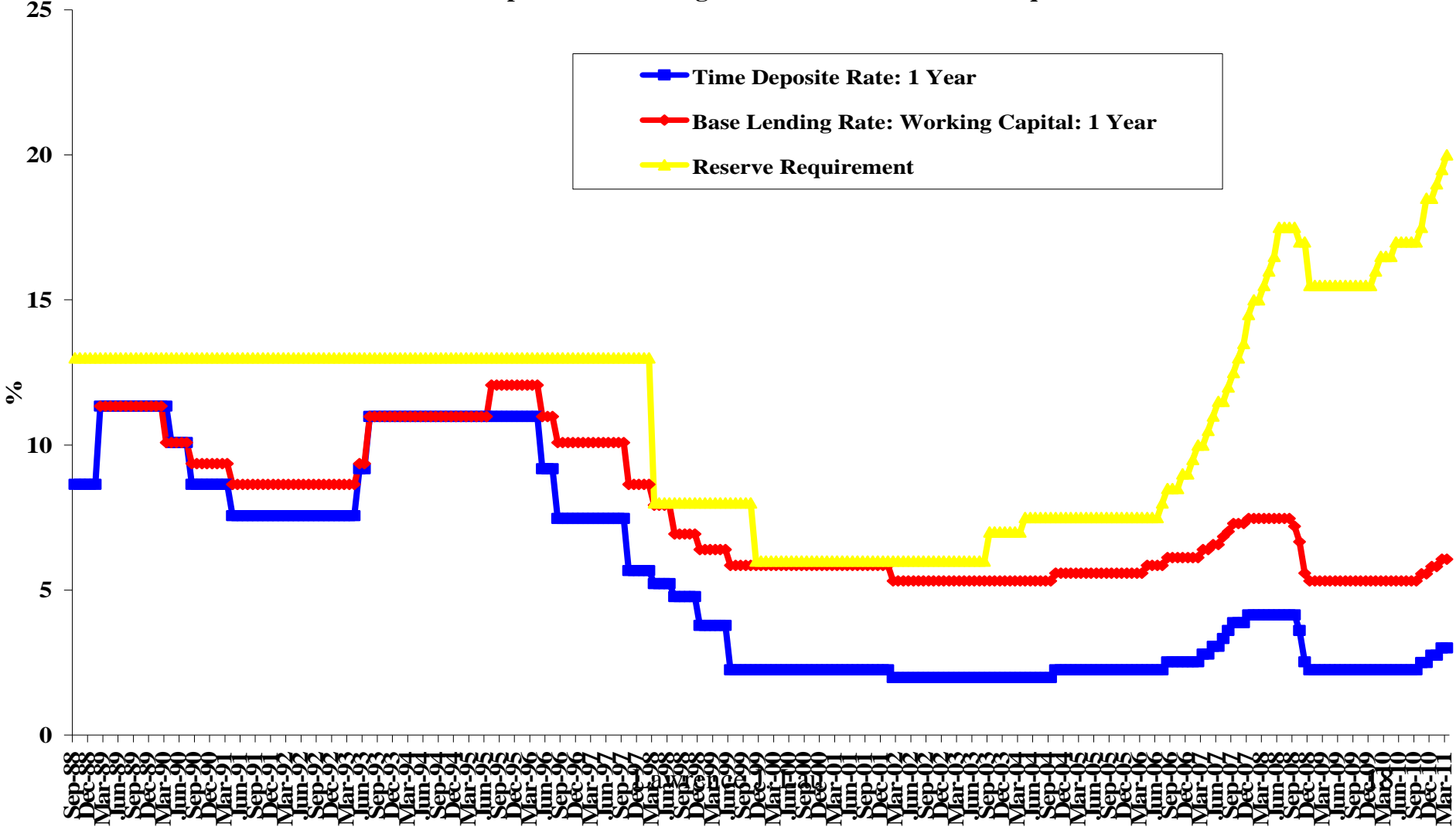


The Macroeconomic Outlook

- ◆ However, there has been significant inflation in the prices of assets such as real estate in the last year or two due to the implementation of the economic stimulus package and the significant increases in the rates of growth of money supply and commercial bank credit.
- ◆ Measures have been taken recently to contain the asset price bubble. State-owned enterprises that have not been explicitly authorised are now forbidden to invest in real estate. Bank lending rules have also been tightened so as to discourage the purchases of more than one residential unit by a single household. Recently, the People's Bank of China, the central bank, has increased the rate of interest and also the reserve requirement ratio a few times.

Short-Term Deposit and Lending Rates and Bank Reserve Requirement

Short-Term Deposit and Lending Rates and Bank Reserve Requirement



The Macroeconomic Outlook

- ◆ There is not much any central bank can do about agricultural prices. No head of a central bank anywhere in the World has been able to control the weather.
- ◆ The key in reining in asset prices, especially real estate prices, is to assure that there is a continuing dependable and steady supply going forward. Only the expectation of supply availability can change price expectations. The Government must therefore try to create the expectation of regular increases of actual and potential supply through its policy and its actual behaviour.

The Macroeconomic Outlook

- ◆ If the public expects that residential units will be just as available next year, and hence concludes that there is no need to rush out to buy something now, the real estate price bubble can be more readily contained.
- ◆ Other instruments in addition to the rate of interest include the strict control, perhaps even prohibition, of financing of any non-owner-occupied residential unit, and increasing the equity (down payment) ratio. The introduction of a property tax as a source of revenue for local governments will also help to discourage speculation as well as reduce the dependence of local governments on revenue from the sale of land leases and hence on maintaining high and rising expectations of land prices.

The Macroeconomic Outlook

- ◆ Even with increases in the levels of minimum wage rates in the different provinces, regions and municipalities, the real wage rate of unskilled, entry-level labour has basically remained stable and is expected to be stable for a long time because of the continuing existence of significant surplus labour in the Chinese economy.
- ◆ However, there is upward pressure on the real wage rates of skilled and experienced labour, which is actually in short supply, especially as Chinese enterprises move up the value-added chain. The recent high-profile wage settlements made by Honda and Foxconn plants in China provided for wage increases of 24 percent and 30 percent respectively.
- ◆ But given the trend of rapid expansion of Chinese tertiary education in recent years, with 6 million new graduates projected annually, the increase in the real wage rate of even skilled labour is likely to be relatively limited going forward.

The Relative Unimportance of International Trade

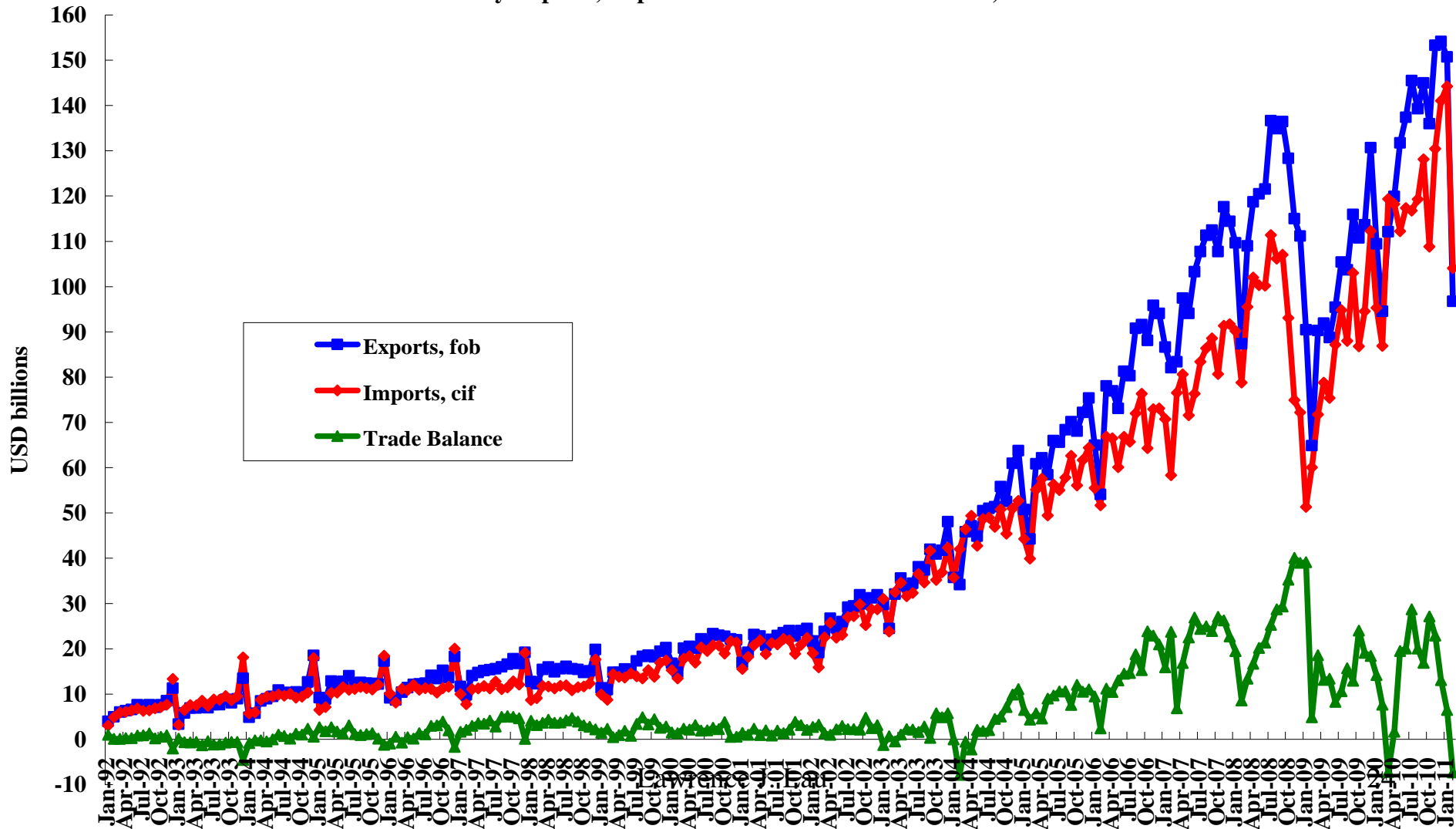
- ◆ There is a common mis-impression that the Chinese economy is highly dependent on exports, and in particular, on its export surpluses, as a source of growth.
- ◆ The facts are that China only began to have a significant trade surplus vis-a-vis the World in 2005, whereas the Chinese economy has been growing at an average real rate of approximately 10 percent per annum since 1978.
- ◆ It should therefore be clear that the trade surpluses could not have been an important source of growth for the Chinese economy during the past three decades. Chinese economic growth does not depend on Chinese trade surpluses.

The Trade Surplus has been Declining

- ◆ The Chinese trade surplus has continued to decline, especially as a percentage of GDP. This trend is expected to continue. I expect Chinese international trade vis-à-vis the whole world to be essentially balanced in a couple of years, without necessarily any large adjustments in the Yuan exchange rate.
- ◆ One reason that this is possible is the gradual closing of the savings-investment gap in China, as well as the substantial real appreciation of the Yuan versus the U.S.\$ that has occurred since mid-2005, to the tune of 25%.

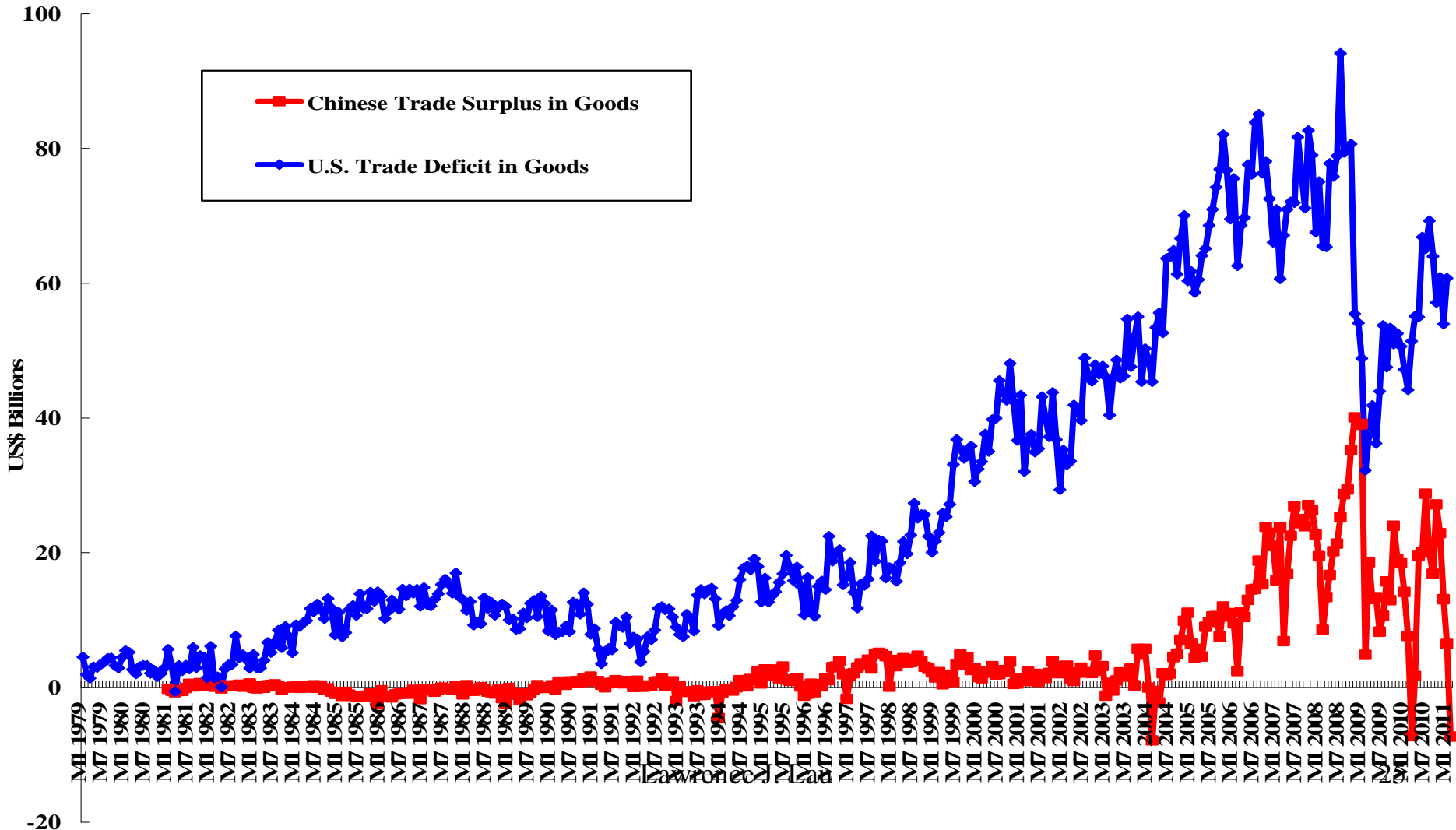
Chinese Monthly Exports, Imports and Trade Balance, US\$

Chinese Monthly Exports, Imports and Trade Balance of Goods, in U.S. Dollars



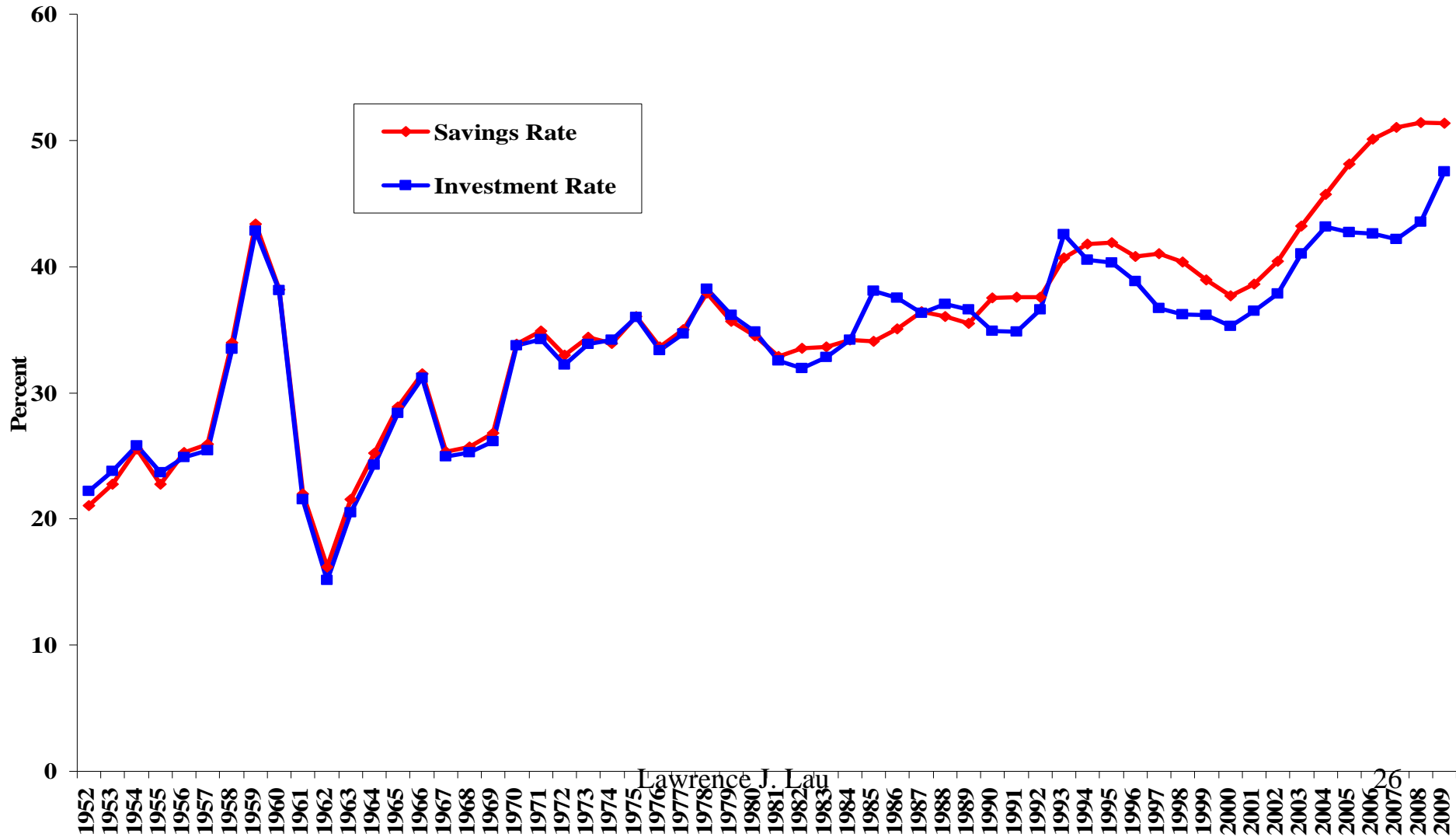
Monthly Chinese Surplus and U.S. Deficit with the World, Trade in Goods, Bill. US\$

Monthly Chinese Surplus and U.S. Deficit with the World, Trade in Goods, Billion US\$



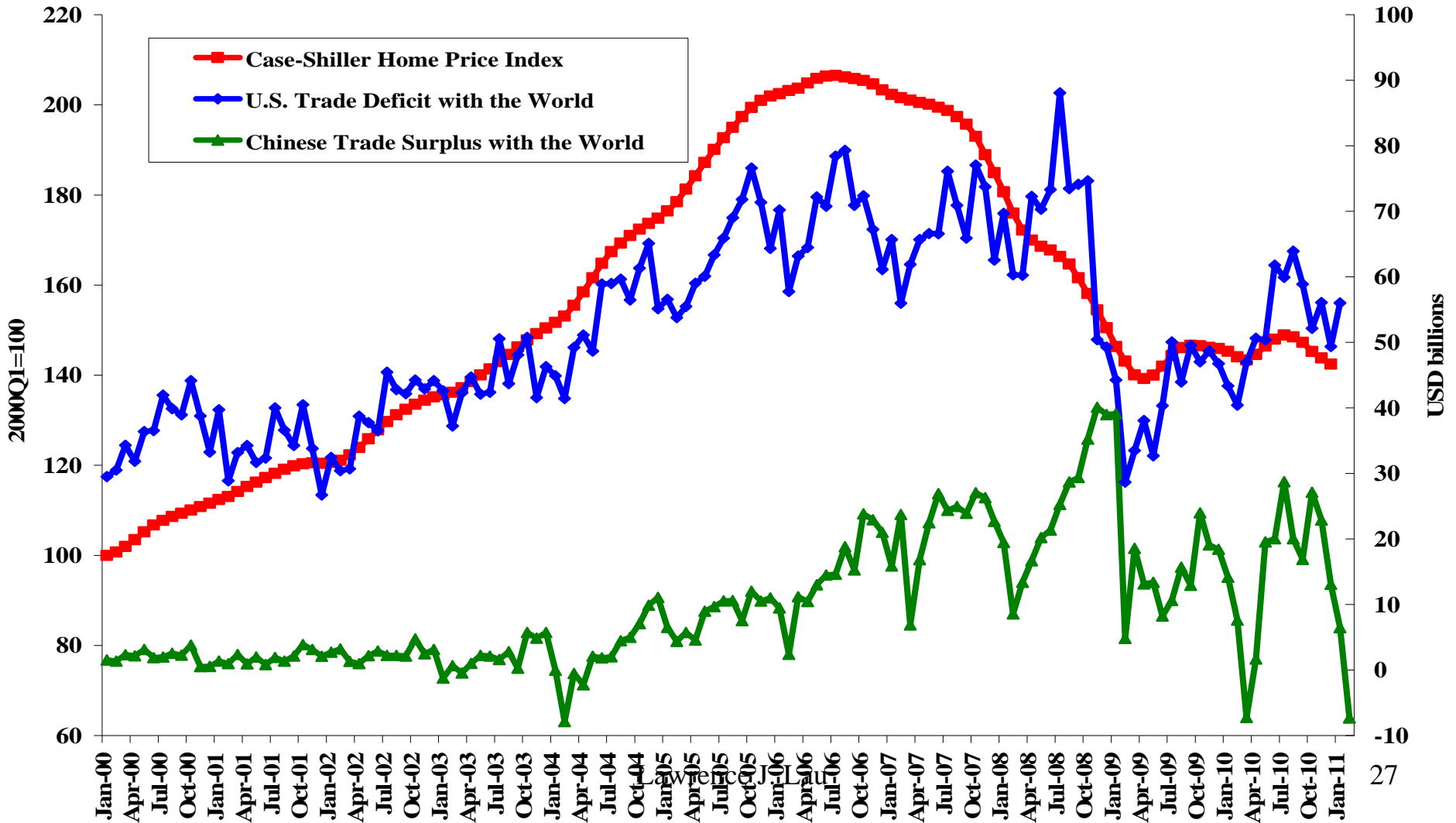
Chinese National Savings and Gross Domestic Investment as Percents of GDP

Chinese National Savings and Gross Domestic Investment as a Percent of GDP since 1952



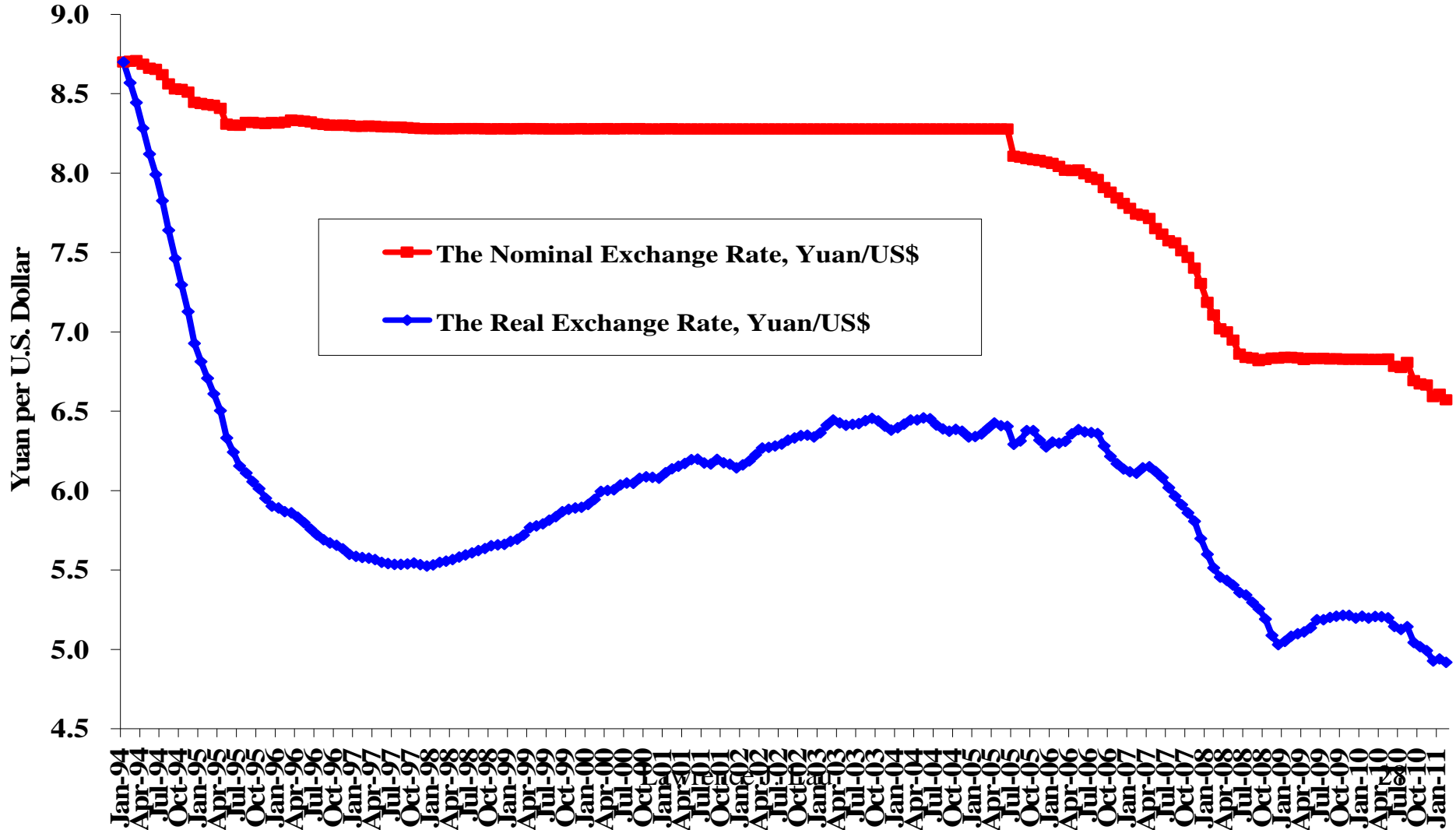
Case-Shiller U.S. Home Price Index, Chinese Trade Surplus & U.S. Trade Deficit, Bill. US\$

Case-Shiller U.S. Home Price Index, Chinese Trade Surplus and U.S. Trade Deficit



The Nominal and Real Yuan/US\$ Exchange Rates

The Nominal and Real Yuan/US\$ Exchange Rates (1994 prices)

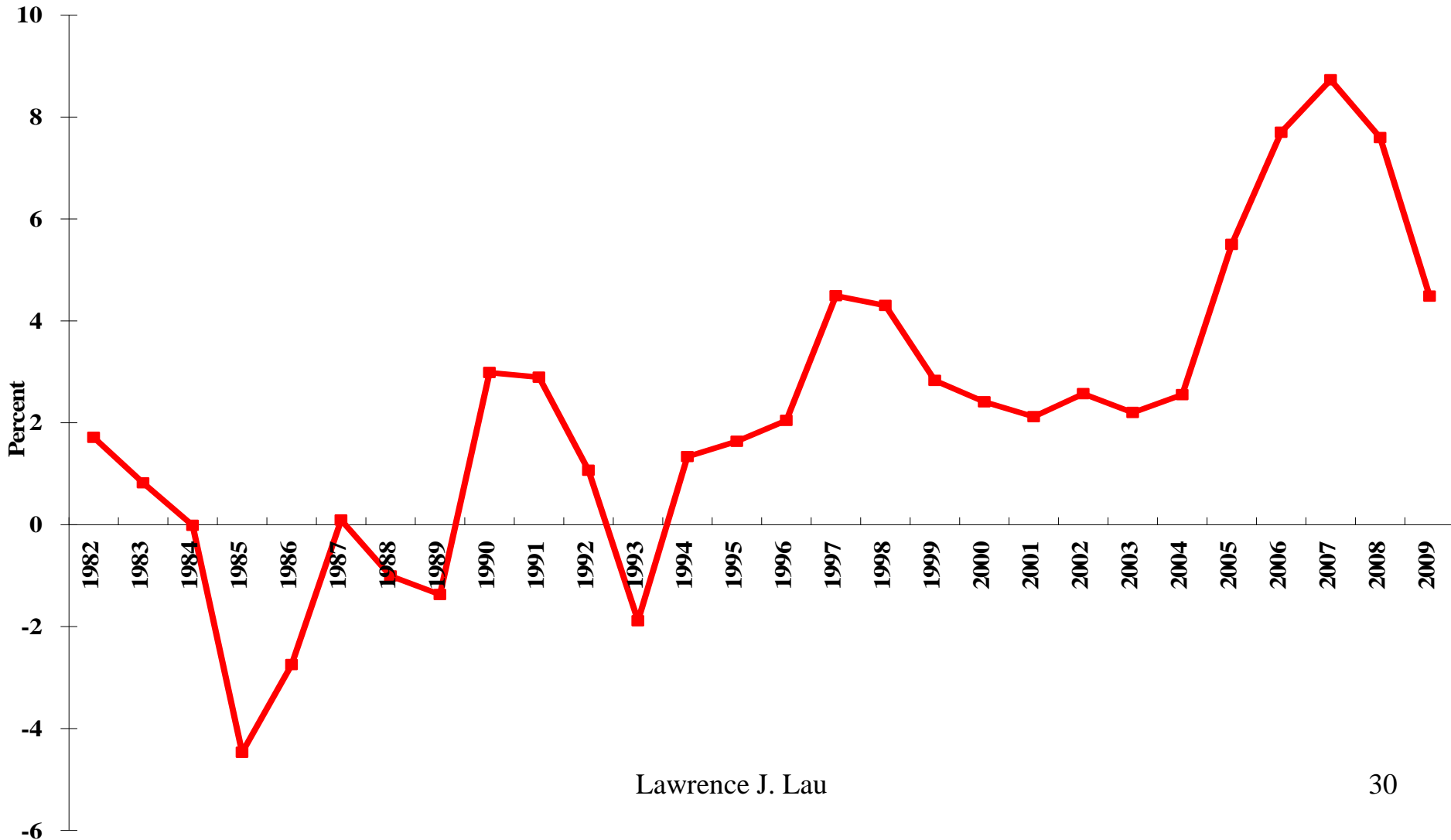


The Relative Unimportance of International Trade

- ◆ Chinese trade surplus as a percent of Chinese GDP fluctuated between -4.5 percent and 4.5 percent between 1982 and 2004 with an average of less than 2 percent of GDP. It then rose to almost 9 percent in 2007. It has since declined significantly and is around 3 percent. It is expected to continue to decline over the next few years.

Chinese Trade Balance of Goods & Services as a Percent of GDP, 1982-

Chinese Trade Balance of Goods and Services as a Percent of GDP

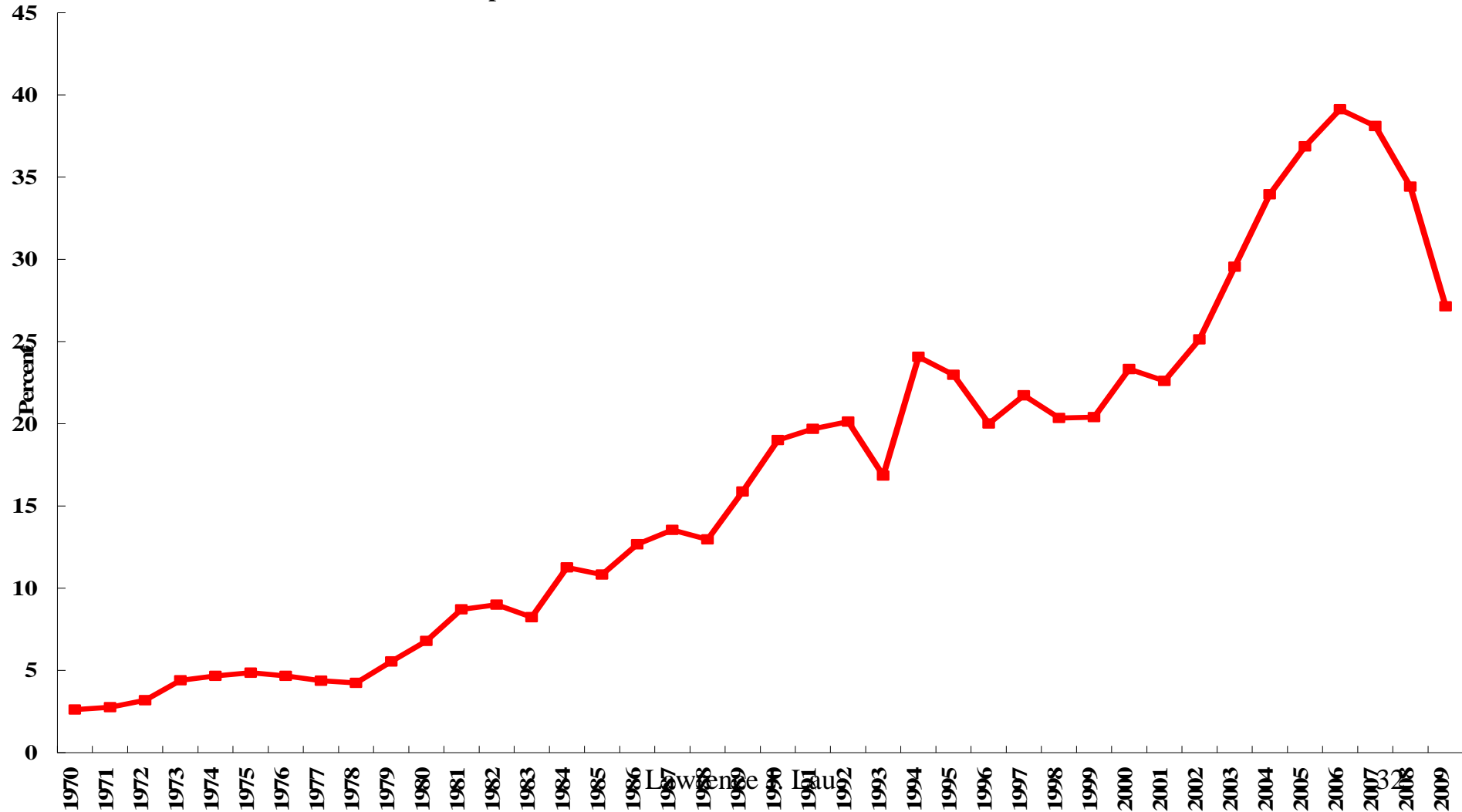


The Relative Unimportance of International Trade

- ◆ Chinese exports as a ratio of GDP rose steadily beginning in 1978 and reached a peak of almost 40 percent in 2006 and then began to decline to approximately 25 percent in 2009.
- ◆ While this ratio appears large, it is not when compared to Hong Kong, Singapore, South Korea and Taiwan, where exports are more than 100 percent of the respective GDPs.
- ◆ And the Chinese Exports/GDP ratio actually exaggerates the importance of exports in the Chinese economy because it fails to take into account the low domestic value-added content of Chinese exports.

Chinese Exports of Goods and Services as a Percent of GDP, 1970-present

Chinese Exports of Goods and Services as a Ratio of GDP since 1970



The Relative Unimportance of International Trade

- ◆ The fact that the Chinese economy has continued to grow at an average rate of approximately 10% per annum since the beginning of the global financial crisis in 2007 is ample proof that the Chinese economy has been at least partially de-coupled from the rest of the World, and in particular, from the United States and Europe, both of which have been and still are mired in economic recession.

Concluding Remarks

- ◆ The long-term sustainable sources of Chinese aggregate demand will be internal: household and public consumption, investment in infrastructure, including high-speed inter-urban trains, owner-occupied residential housing, investment in education and health care, urbanisation (building new cities), urban mass-transit systems, environmental protection and preservation, energy conservation and renewable energy, and the green economy.
- ◆ Consumption will rise, as GDP per capita and wage rate rise and the social safety net is gradually perfected. But savings rate will remain high for a long time.

Concluding Remarks

- ◆ International trade will continue to be somewhat important, but not critical, to the growth of the Chinese economy. Exports as a share of Chinese GDP will probably continue to decline over time, as befitting a large, continental economy. Chinese economic growth will be marginally, but not critically, affected by a large decline in its exports, as demonstrated by its experience in the past couple of years as well as during the 1997-1998 East Asian currency crisis. Thus, it will be able to survive even prolonged economic recessions in the European and U.S. economies.

Concluding Remarks

- ◆ For 2011, the short-term economic targets are to achieve a rate of growth of 8 percent and a rate of inflation of 4 percent. I am confident that both targets are achievable.