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China Has a Plan for That

By Bert Hofman

While in the United States the ruling Republican Party decided not to bother with writing a party platform for the coming four years, China's communist party (CCP) is gearing up to discuss the 14th Five-Year Plan (FYP). The "Outline" of the plan will be discussed from 26 to 29 October at the fifth plenum of the 19th Central Committee of the CCP that gathers in Beijing. Technically, it is the government that prepares the plan for approval by the National People's Congress (NPC) next March, but party guidance is rarely ignored. China has had a longstanding tradition of planning going back to the 1950s—the first plan was issued in 1953, but was quickly overtaken by Mao's "Great Leap Forward". The nature of the plan has radically changed since those days of central planning.

Nowadays, the FYP is predominantly a strategic plan that covers a wide range of issues like economy, population, technology, education and environment, outlining key policy goals to be achieved in the coming years. Gone are the days of central planning when long lists of commodities and their planned quantities were included in the FYP. The Plan is coordinated by the Long Term Planning Department of the National Development and Reform Commission, the department that was once led by Vice Premier Liu He. The NDRC takes its cues from the Party Congress held most recently in 2017, and incorporates inputs from all walks of life, including government, academia, international organisations and even the general public. Drafting starts after the mid-term evaluation of the current plan and takes some two years to complete.

The main issues of the FYP are further discussed among the leadership in August.[1] Subsequently, the CCP Central Committee members and alternates, some 370 people in all, discuss the draft at the forthcoming Plenum. After approval by the NPC the following spring, the FYP will become the basis for many other plans of the ministries, provinces and municipalities, each of whom makes its own plans. That is a lot of plans, but as they say, the plan is nothing, but planning is everything. The plan is an opportunity for the government to take a step back from the day to day activities and focus on the medium term, coordinate across

[1] Traditionally this happened at a retreat in the coastal city of Beidaihe, but such retreats appear to have gone out of fashion and instead a Politburo meeting on the Plan was held in July.

departments that normally do not work together, and build political consensus for the main programmes and policies in the years to come. Finally, it is a means by which the government communicates to the non-state sector on the foci of economic policy in the coming years. Paying attention pays off: many policies (and government money!) will move in the direction that the plan spells out, so the plan also aligns both the public and private sectors.

While the focus of the Plan is on socioeconomic developments, it is intended to be a comprehensive plan for the government. Areas such as culture, governance and defence are also covered in the plan. Though the plan is increasingly a strategic one, it does contain targets. The 13th FYP approved in 2016 had set 25 targets, about half of them indicative and half of them "obligatory" or binding for the government. Among the most important indicative ones were the GDP (gross domestic product) growth rate, productivity, new urban employment and urbanisation rate. The most important obligatory ones included elimination of extreme poverty, reduction in energy and CO_2 emission intensity of GDP, and reduction in air and water pollution. Though COVID-19 made things harder for the authorities, it seems that most of these goals will be achieved, or "basically" achieved, as Mao Zedong used to say.

One important (indicative) target likely to be missed is that of **GDP growth**: Because of COVID-19, growth is unlikely to surpass three per cent this year, which is still stellar compared to other major economies in the world, but not enough to achieve the 6.5% average growth rate for the 13th FYP. Average growth 2016-2020 is likely to slip below six if the current consensus growth forecast of about 2.5% prevails for this year. Disposable household income was equally targeted to grow by 6.5% on average in the past five years, and while until last year China was ahead of schedule, it may also fall short by a bit. COVID-19 or not, the government is determined to eliminate extreme poverty, which is defined as people consuming less than some RMB2,300 per year in 2011 prices (or some RMB3,500 per year in current prices, a poverty line that is higher than that of the World Bank), and is likely to do so by the end of the year, or soon thereafter.

On the 14th FYP, this was the **first plan in the "New Era"** announced by Xi Jinping at the 19th Party Congress in 2017. That congress proposed a two-stage plan for the period ending 2049 when "China has become a global leader in terms of composite national strength and international influence" according to Xi Jinping's report to the congress. While this has been portrayed as China's bid for hegemony, it is more of a statement of fact: barring major disruptions, by mid-century it will be the largest economy in the world according to the OECD. Making a good start towards that goal is undoubtedly a key objective of the 14th Plan and even though the government has been de-emphasising GDP growth targets, there is little doubt that the next plan will still include an indicative target, probably in the order of 5-6% per year.

The 14th Plan is formulated against an **external environment** that is far less favourable to China than previous plans going back to the ninth FYP of the mid-1990s. The US-China strategic competition and the shape of the global economy after COVID-19 are clouding the outlook, and both are likely to play a major role in the FYP. China's policymakers are now convinced that the US shift in policy towards China is there to stay, and that, together with COVID-19, will see the world in a phase of de-globalisation, a trend that has already begun since the middle of the past decade. China's answer to these external challenges is "**Dual Circulation**".

This framework, first announced in a May 2020 Politburo Standing Committee meeting and reiterated in a July meeting, is China's solution to lacklustre external demand and geopolitical tensions. Though the concept is still somewhat vague, something not unusual for new Chinese

policy concepts, it seems to imply greater reliance on the domestic economy—domestic supply chains and domestic demand—as compared to "international circulation" of overseas demand and technology, which has been a focus since the mid-1980s as a means to create growth and employment. For China, this means greater reliance on domestic supply chains, indigenous innovation and domestic demand.

Xi Jinping's speech at a meeting with nine economy and society experts on 24 August to discuss the plan clarified dual circulation: "In the coming period, the domestic market will dominate the national economic cycle and the domestic demand potential of economic growth will continue to be released. We must adhere to the strategic direction of supply-side structural reform, twist the strategic basis of expanding domestic demand, make production, distribution, circulation, and consumption more dependent on the domestic market, improve the adaptability of the supply system to domestic demand, and form demand-driven supply. Supply creates a higher level of dynamic balance of demand".

Xi goes on to say that this by no means implies that China will become a closed economy again. In fact, in his speech during his third "**Tour to the South"**[2] to celebrate 40 years of Shenzhen as a special economic zone he reiterated: "China's economy is transitioning from high growth to high quality, and towards the "dual-cycle model" of domestic-led growth. But engaging with the external economy will also be the key to future development", implying that "Reform and Opening Up" [China's shorthand for the reforms since Deng Xiaoping] remains important.

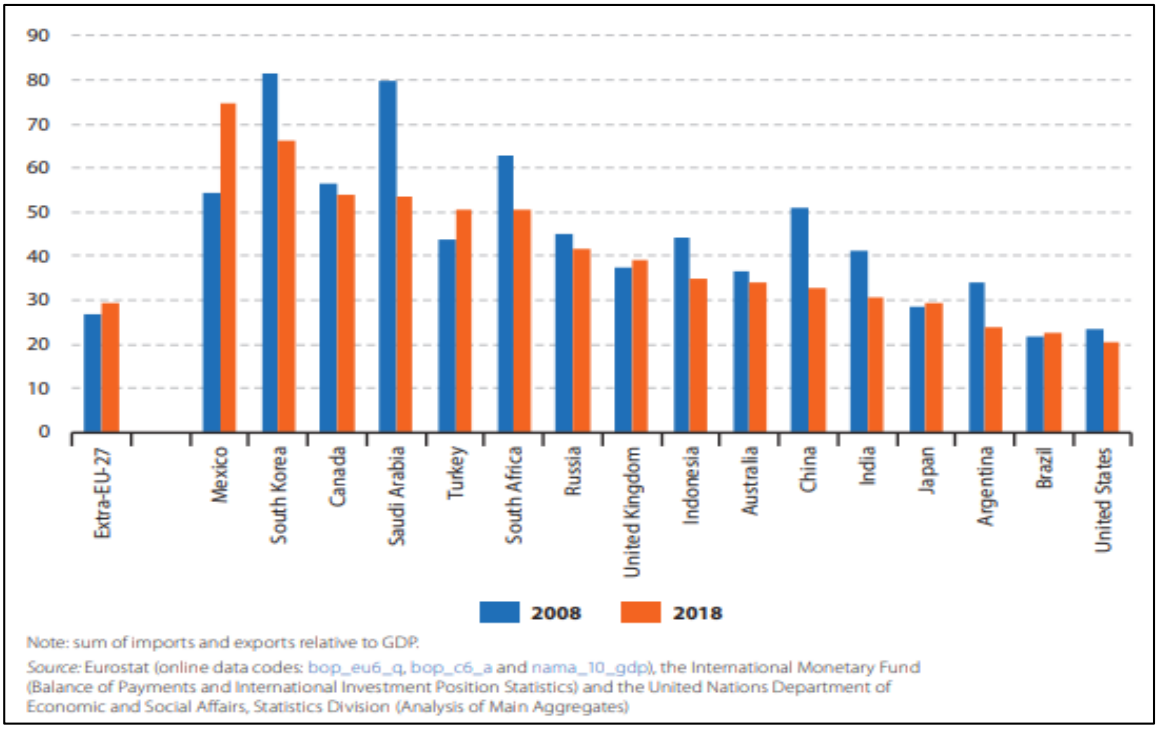
It is a fact, though, that **foreign trade and investment are becoming less important for China**. China's share of trade in goods to GDP has come down from almost 50% in 2008 to a little over 30% now. This is not much different from that of the EU-27 and Japan (Figure 1), but still about 10 percentage points higher than the United States, like China a continental size economy. China's current account surplus has also come down sharply, from nine per cent of GDP in 2007 to less than one per cent last year. In the past decade, China has also expanded its domestic supply chains, while divesting from the more labour-intensive production it specialised in before. Both led to less reliance on trade. Finally, China's economy is increasingly dependent on services and less on manufacturing, which tends to lower the share of trade to GDP; the relative price of services also tends to increase as countries become richer.

On the demand side, China has been trying for more than a decade to **rebalance demand**, external versus internal and investment versus consumption. Externally, this goal has been more or less achieved. However, internally, consumption demand continues to lag: though consumption as a share of GDP increased from 34% of GDP in 2010 to 38% last year, it is far below that of more advanced countries such as the United States (68%), the Eurozone (54%) and Japan (56%). As a result, investments remain uncomfortably high in China at 43% of GDP, and it is hard for any country to invest such amounts without waste.

Rebalancing demand towards **consumption** is not trivial and requires major policy changes. Expansion of social safety in China could help reduce household savings, but both the functional and interpersonal income distribution need to change. China's households still receive less than half of what is being produced, so even if the household savings rate goes down, consumption would not rise to the level of OECD countries.

[2] Deng Xiaoping's famous 1992 tour to the south restarted "reform and opening up".

FIGURE 1 EXPORT AND IMPORTS OF GOODS, SHARE OF GDP



Source: Eurostat.

Moreover, richer households tend to save more. While **income inequality** in China has stopped rising, it remains as high as in the United States; on the other hand, wealth inequality, driven largely by housing ownership and housing prices, has been rising since the late 1990s. Unlike more advanced countries, the government redistributes little because social welfare spending is still low as a share of GDP and the tax system relies predominantly on indirect taxes, in particular VAT. While the latter is efficient in raising revenues, it is not an equalising tax. As a recent IMF research paper concludes: "In particular, fiscal policy reforms have the potential to enhance inclusiveness and equity, both on the tax and expenditure side".

Finally, **urbanisation**—a key driver of domestic demand—has continued apace currently at 60% of the population. However, only 45% of the population has urban *hukou*, or household registration. Those without it have less opportunities in the labour and housing market and their families less access to social services and social security. This once again became clear during COVID-19 when some 50-100 million migrants lost their jobs and many of them fell through the cracks of the social safety net. Abolishing the *hukou* system in the coming 14th FYP period would be a bold move, but one that according to a report of the World Bank and the Development Research Centre of the State Council, is entirely affordable and one that will boost domestic consumption.

A second plank of the Dual Circulation, and undoubtedly of the 14th FYP, is **innovation**. Though nothing new, innovation has taken on further importance and urgency in light of US moves against China. The US Commerce Department has not just banned the sale of high tech to numerous Chinese companies such as Huawei and SMIC, but also prevented any company that uses US technology to sell the same. It is also discouraging R&D cooperation between Chinese universities and companies with US universities. The United States is making it harder for Chinese researchers and Chinese students to work and study in the United States.

In response, China is doubling down on its efforts to promote "**indigenous innovation**". Moreover, the emphasis seems to have shifted from more applied innovation to fundamental research so as to become less dependent on foundational technologies from abroad. Xi's speech at the China Academy of Sciences emphasised science as a basis for innovation, as well as the need for China's science to deliver in the current context: "in the face of intense international competition, and against the broad backdrop of growing unilateralism and protectionism, we must march an innovation path suited to our national circumstances, we especially must put enhancing our original innovation capabilities in a more prominent position, and we must strive to make ever more 'from zero to one' breakthroughs".

China is well under way to becoming a technological powerhouse. The country now spends some 2.2% of GDP on R&D and the 2.5% target of the 13th FYP may still be reached this year. This adds up to the second largest absolute amount globally, after the United States. Though quality issues remain, the number of patents and academic papers originating from China is rising fast. China's talent pool is deep: some eight million students graduate a year and more than half are STEM majors. In some areas of technology, such as fintech, e-commerce, 5G, solar and wind energy, power transmission and electronic vehicles, Chinese companies are already cutting edge. However, even those companies depend on foundational technologies from elsewhere, notably the United States, as the sanctions on Huawei and others make clear. It has been a longstanding ambition of China to reduce that dependency and to create indigenous innovation, with the current tech war with the United States catalysing more investments in R&D. Undoubtedly, China will set a higher target for R&D spending in the 14th FYP—perhaps in the order of three per cent of GDP.

Following the FYP, the next major plan due is the "**Medium and Long Term Plan for Science and Technology 2021-35**", which will focus on those foundational technologies. The previous plan, for 2005-2020, was the basis for the Made in China 2025 industrial policy, which many read as China's attempt to dominate new industries. While this plan is barely mentioned anymore, the policies underlying it continue apace. The latest in this is a policy document of the NDRC, reiterating support for priority sectors, including the next generation IT, biotech, high-end manufacturing, new materials, new energy, electric vehicles, environmental protection and digital creative. This list pretty much looks like the industries in the Made in China 2025. Dragonomics, a consultancy, calculated that the financial support for these sectors not only attract government support, much of which through "government guided funds", but also get leveraged many times over through the capital market and banks. Indeed, most funding for R&D in China comes from the non-state sector, not from government budgets. More than 80% is done in industry, not in government organisations such as universities and research institutes. This balance is likely to shift somewhat as China's emphasis is shifting to more fundamental science, not just applied R&D.

One sector in particular is of interest: **Integrated Circuits** ("chips"), the prime battleground in the US-China tech war. It has been the focus of attention for a long time in China's technology policies and IT was featured already in the "863" technology plan of 1986. Despite the billions of dollars spent, China has not been able to catch up with the leading producers in this area and its most sophisticated chips are still a generation behind. However, this time may be different: necessity is, after all, the mother of invention. This year, the Chinese government has allocated some RMB200 billion to the industry and this will be leveraged many times over by local governments and, as discussed, private capital. It is in the nature of innovation that much of that money will not deliver results, but some of it will, and once China has found alternatives to the Qualcomms and Intels of the world, it will not be coming back.

Finally, the environment, and more specifically, **China's greenhouse gas emission** will no doubt feature prominently in the 14th FYP. Xi surprised the world at the UN general assembly in September by committing to carbon neutrality by 2060. China's current commitment under the Paris Accord is a major reduction in CO_2 *intensity* of its economy by 2030 and a peak emission before that. Carbon neutrality, which a number of western countries target for 2050, is a major boost for the efforts to keep global warming within two degrees of pre-industrial levels. Though the government has not released any detail on the commitment, researchers at Tsinghua have released a scenario that illustrates what it takes to get there, as Bloomberg reported. For China, this means a radical turn away from coal, by far the dominant source of energy in the country (Table 1). Renewables will have to make up for the bulk of the energy infrastructure by 2060, alongside nuclear. Since hydrocarbon sources cannot be fully done away with, even by 2060, carbon capture will have to play its role. China's new climate pledge is expected to be translated into more forceful mitigation actions in the 14th FYP and period beyond that.

TABLE 1 A SCENARIO FOR ZERO CARBON BY 2060

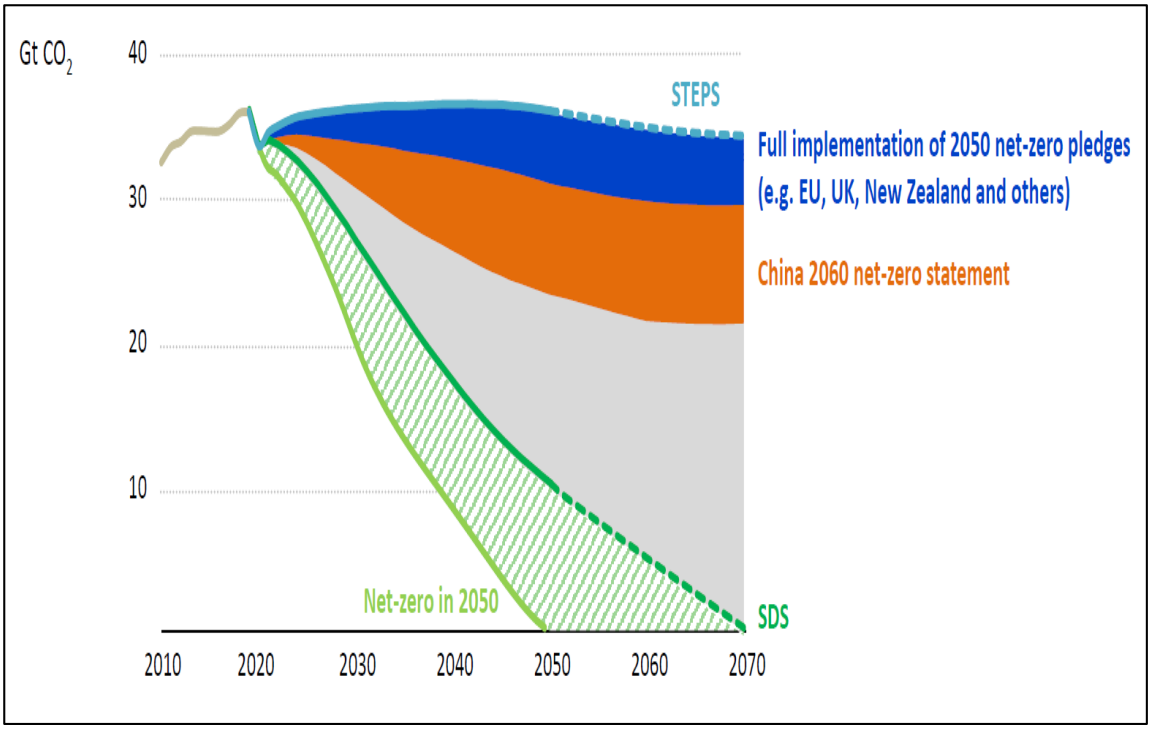
Energy Source	2025 (tons of coal equivalent)	2060	% Change
Coal	2.86 billion	110 million	-96%
Natural gas	560 million	140 million	-75%
Oil	980 million	340 million	-65%
Hydro	440 million	660 million	+50%
Biomass	110 million	220 million	+100%
Wind	240 million	1.07 billion	+346%
Nuclear	170 million	820 million	+382%
Solar	150 million	1.03 billion	+587%

Source: Tsinghua University's Institute of Energy, Environment and Economy via Bloomberg.

Achieving the goal will require technical progress in a whole range of fields, including high voltage power transmission, storage, hydrogen production and distribution, new materials and more. Tsinghua experts estimate that the carbon neutral plan will require some $15 trillion in investment for the coming 30 years. Not a trivial amount, but it is some 15% of cumulative GDP for the 14th FYP, which is entirely affordable for a country that invests more than 40% of its GDP. Frontloading this investments during the 14th FYP period rather than the next 30 years would dramatically bring forward China's carbon neutrality goal. Aside from money, it will also require a major institutional change: China's current emission targets are undermined by the continued approval of coal-fired power stations, most of which will be obsolete and expensive to retire. Finally, China's power purchasing arrangements are still geared towards coal power. A shift to a competitive spot market would immediately bring already existing renewable power capacity online and entice investment to come.

According to the International Energy Agency, even these very ambitious Chinese targets will not be enough for the world to achieve its "Sustainable Development Scenario" (see Figure 2), let alone the "net zero 2050" scenario. The good thing about China focusing on the goal, though, is that China's manufacturing might and growing R&D budgets will be targeted towards China's net zero goals. The rest of the world can benefit from the innovations it takes China to get there. So it is a good thing for the world that China has a plan for that.

FIGURE 2 CHINA'S NET ZERO COMMITMENT HELPS, BUT IS NOT ENOUGH



Source: International Energy Agency, World Energy Outlook.

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