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Measuring Value®

The 12th Five-Year Plan: What it is, how it works and its impacts

This issue of Measuring Value discusses what kind of impact the 12th Five-Year plan ("the 12-5 plan" for the period 2011-2015) is intended to have and likely to have, and how the plan can serve the interests of domestic and foreign investors.

By the end of 2010, virtually all of the 12-5 plans had been "leaked" in the State media, although its formal ratification did not come until March 2011. Much has been written about the plan, which presents 62 chapters of ambitious goals for the next stage of China's economic development.

Though many would argue that China's development planning is opaque, the tradition of five-year plans began in 1953, with a Stalinist Central Plan. The second in 1958 launched the Great Leap Forward. After a four-year gap in the wake of the economic disaster that ensued, the third plan was launched in 1966 and was the last to focus on agriculture. Few countries do that.

The 12-5 plan represents a significant departure in form and substance from its predecessors but it continues the process of setting out what is on the mind of China's leaders for the economy in the half-decade ahead

The plan has three major sections, one on general strategy, one on industries, and one on regions

The one on general strategy lays out the goals of the "Inclusive Growth" campaign, the intent to grow out of chronic imbalances with slower but higher quality, sustainable growth, consolidate industries, improve regulation and enforcement and reduce energy intensity of future growth.

The industry section points generally to China's goals of higher value manufacturing, and rationalisation or marketisation of supply chain costs, including basic inputs like commodities and energy. It also introduces seven strategic industries, focused on energy, biotech, IT and manufacturing that are to serve domestic needs and establish market dominating export platforms.

The regional plans highlight the different development stages and needs of China's major economic territories, consistently setting the goal of improved agricultural productivity for all, and emphasising the need to accelerate urbanisation, improve resource management, build logistic infrastructure and mitigate income maldistribution.

What the plan is and is not

The plan is a "guihua" (roadmap), not a "jihua" (plan). That is to say it is not a commitment of investment or a budget in any sense, although it is ambitious in setting forth broad targets. It is a consensus document that represents over a year of debate and discussion among an unprecedented number of interest groups. As such, the sum of its parts is formidable and it is not without internal inconsistencies.

The plan serves several purposes, in addition to documenting a consensus among both political and commercial interest groups, and is an important communication up and down the party and government verticals.

It provides an indication of the kind of investment projects that will be allowed and funded, not only through direct central government distributions but through the banks and centrally controlled investment funds

It is also a kind of career guidance to State-Owned Enterprises (SOEs) and Large National Enterprises (LNEs) leaders and to cadres at all levels, about the kind of achievements that will lead to career advancement. Finally, it is a detailed menu of areas where China as a whole has not achieved the results it needs, whether in energy, water, social development, technology, regulation, capital efficiency or physical infrastructure.

As a list of areas where the development results need improvement, we read the plan in conjunction with the two current catalogues published by the National Development and Reform Commission (NDRC), the "2011 Guiding Catalogue for Industrial Structure Adjustment" and "2011 Guiding Catalogue for Foreign Investment Industries." Each has lists of specific projects that are encouraged, restricted or eliminated (prohibited), without reference to finance or scale. These are assembled in close coordination with China's industry associations, agricultural organisations and research institutes. As such, they are technically specific and represent the highest development priorities set forth by key sectors of the economy.

The NDRC catalogue lists cover areas spanning everything from water conservation to goldmine trailing recovery to high precision machining, but they are not about specific projects, budgets, scale or numeric targets. They relate closely to the seven strategic industries identified in the 12-5 plan. Sections on machinery in the NDRC catalogues provide detail on what is needed for both the hardware and software elements of the high technology manufacturing, biotech and new material strategic industries.

Here is a partial list for encouraged projects, providing some idea of the organisation of these catalogues.

- Basic machinery related to all aspects of metal refining, forming, mineral and energy extraction, new energy products, etc. (98 items)
- Special-use machinery including energy-related (78 items)
- Transportation equipment and infrastructure, including new energy vehicles, components, rail beds, etc. (24 items)
- Non-metallic mining-related materials and manufacturing (23 items)
- Primary chemicals and chemical products (19 items)
- Electricity, coal gasification, and water production (15 items)
- Power generation, storage, distribution, and control equipment manufacturing (15 items)
- Pharmaceuticals (8 items)
- Non-ferrous metal smelting and forming industries (5 items)

In reforms, which way is forward?

Under the overall theme of "Inclusive Development", the plans commit to continuing reform and to increasing the role of domestic consumption in future growth. In the current hard-landing or soft-landing discussion, the focus is on how and when the State and its agents, primarily the banks, will seriously curtail the very high levels of fixed asset investment (FAI) China mobilised in the wake of the global crisis.

In contrast to the headlines about anticipated reduction in fixed asset investment, especially infrastructure and real estate, the aggregate FAI targets in the plans are of staggering dimensions. In most cases, capital requirements and sources of investment associated with these targets are not clear, but it is not difficult to make estimates.

> At the top of the list is the Guaranteed Housing initiative, a commitment to build 36 million affordable housing units by the end of the plan, with 10 million underway by November 2011

The ticket for that will be in the order of RMB 1.4 trillion this year. Our next issue of Measuring Value will focus on the Guaranteed Housing initiative.

Among the most significant plan components in terms of investment levels:

- 36,000,000 Guaranteed Housing Units
- 83,000 km of new highway
- New urban rail systems in at least 20 cities
- 28,000 km of new high speed rail (connect all cities with populations over 500,000)
- 42 national integrated traffic hubs
- 8 new large airports
- 440 shipping berths over 10,000 tons
- 200,000 km of new high voltage power lines (>330Kv)
- 150,000 km of oil and natural gas pipeline
- 120 GW of new hydro power
- 70 GW of new on-shore and off-shore wind power
- 40 GW of new nuclear power
- 5 GW of new solar power
- 10 massive coal power bases
- 5 massive oil and gas bases

Typically, all but the extremely large central projects would require a substantial contribution from local governments. For the Guaranteed Housing initiative, for example, the proposed RMB 500 billion (bn) government contribution is to be split RMB200bn for central and RMB300bn for local. Given that expectation, the local government debt situation becomes relevant to a discussion of funding for these projects. Local debt at end of 2010 is estimated by China's National Audit Office at RMB10.7 trillion, 27 percent of GDP for 2010. 80 percent of this is from bank loans. More than 50 percent comes due between 2011 and 2013, and the China Banking Regulatory Commission (CBRC) has estimated that 50 percent is invested in projects that do not produce sufficient return to service the loans.

What does this mean for the overall outlook of these critical FAI drivers of growth? First, something significant will have to be done to rebalance the distribution of resources between local and central governments, and the local government revenue structure requires attention. Secondly, channels of capital will need to be established to redirect resources from areas of high liquidity in China, which would include quite a number of SOEs, into areas of critical need.

There will be intense pressure on these goals, and intense pressure to improve the efficiency of capital used to approach them

How does the 12-5 plan impact private investors, foreign and domestic?

The plans are important documents for non-State investors. They align with emerging signs in policy and markets that signal changes in China's investment environment.

First, the plans are explicit about a role for private capital, especially in many of the strategic sectors, where "social capital" or funds from overseas investors have played an historic role already. Secondly there is a new emphasis on technology acquisitions, and that along with other activities we have observed, signals a decline in the commitment to indigenous innovation. The concept is already in retreat in new energy automotive, agriculture, biotechnology, alternative energy and a number of other forward-looking sectors.

The plan is without reserve in its support for growing the activity of China's renminbi outside of China

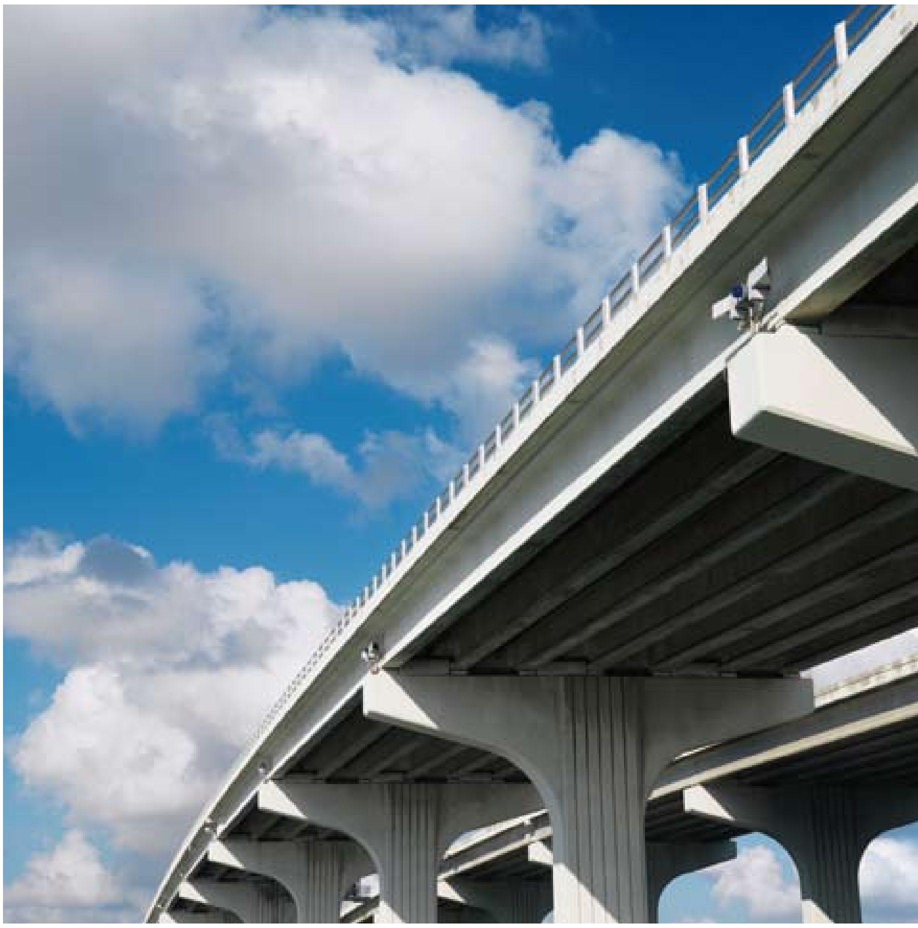
It aims to optimise trading and investment activities, especially with China's regional neighbours and with economically linked emerging economies around the world. With the uncertainty in global markets created by the US debt ceiling debate and downgrade of US government paper, China's promotion of the Renminbi abroad aligns with its broader call for an end to exclusive dependence on the US dollar as the global reserve currency.

As we have argued in earlier editions of Measuring Value, the accumulation of substantial sums of RMB outside the Chinese Mainland not only provides an alternative source for RMB for companies that have depended on Chinese Mainland sources or the State Administration of Foreign Exchange (SAFE) conversion. It also creates a sense of competition for cities like Shanghai, that will need to catch up in the development of RMB products and services suitable for a more liberalised policy regimen in the future.

Perhaps the most important use of the 12th Five-Year Plan is not in the specifics of the policies and industries but in the language of the plan and the overall sense of priorities it provides

There is no better guide for investors to check the language and overall impact of the value propositions they present to regulators, partners, investors, local government and party officials. Whatever the details and reality of specific projects launched in the five years of the 12-5 plan, whatever sector they are in and whatever scale they achieve, much of the external and internal discussion will be framed by the plan and its language.

There is no better guide to ease the progress of specific proposals through the labyrinth of agreements, approvals and permissions they will continue to face



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