

China's 12th Five-Year Plan: *Strategy vs. Tactics*

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I suspect history will judge the 12th Five-Year Plan as a watershed event in the development of modern China. If so, this will be the third time that a plan has triggered a significant shift in the nation's economic strategy. The Fifth Five-Year Plan of the late 1970s ushered in the "reforms and opening up" of Deng Xiaoping. The Ninth Five-Year Plan of the mid-1990s set the stage for an historic ownership transition – leading to an era of state-owned enterprise reforms and the corporatization of China's increasingly marketized economy.

And now another pivotal moment is at hand. The just-enacted 12th Five-Year Plan is, first and foremost, a strategic framework aimed at changing the economy's remarkably successful growth structure of the past 30 years. It shifts the focus away from a powerful export- and investment-led growth dynamic toward an approach aimed at drawing more support from China's 1.3 billion consumers.

This will be a daunting transition. While absolutely essential in order to take the Chinese economy to the next stage, a pro-consumption model also introduces new and important tactical challenges. The key will be for China to strike the right balance between strategy and tactics. The stakes are enormous – for China and for the broader global economy.

The 12th Five-Year Plan

Like all of modern China's plans, the 12th Five-Year Plan is a comprehensive statement of the government's strategic policy priorities over a multi-year time horizon. In his annual address to the National People's Congress on March 5, 2011 (the "Report on the Work of the Government"), Premier Wen Jiabao offered the first public summary of the new plan. The goals and targets

span the gamut – from wheat price subsidies and low-income housing to energy conservation and R&D spending. I counted about 75 separate initiatives in the Premier's overview of the plan and another 150 initiatives in his depiction of the policy agenda for 2011 – the first year in the five-year plan.

But the 12th Five-Year Plan is far more than an all-encompassing compendium of goals and targets. With the help of forensic analytics, a new set of building blocks and priorities for the modern Chinese economy comes into focus. What emerges is a coherent statement of a very different growth model than the one, which has been in place for the past 30 years. The basic goal is clear: A major shift away from export- and investment-led dynamism toward a new recipe that draws increased support from internal private consumption.

FIGURE 1: CHINA'S FIVE-YEAR PLANS

Plan	Dates	Key Feature
First	1953-57	Stalinist Central Plan
Second	1958-62	Great Leap Forward
Third	1966-70	Agricultural Push
Fourth	1971-75	Cultural Revolution
Fifth	1976-80	Post-Mao (Reforms and Opening Up)
Sixth	1981-85	Readjustment and Recovery
Seventh	1986-90	Socialism with Chinese Characteristics
Eighth	1991-95	Technical development
Ninth	1996-00	SOE Reforms
Tenth	2001-05	Strategic Restructuring
Eleventh	2006-10	Rebalancing Alert
Twelfth	2011-15	Pro-Consumption

Source: MSIM, as at March 2011

The logic behind this transition is spelled out very clearly in the Premier's Work Report. Particularly telling is the framework he uses to assess the economic outlook. He examines growth prospects from two perspectives – international and domestic. In doing so, he underscores that the balance has tipped in the post-crisis era – with global constraints now the primary concern. The Premier stresses that although "(t)he world economy will continue to recover slowly... the foundation of recovery is not solid."

For an export-led Chinese growth equation that has long drawn support from vigorous growth in global demand, this is a major concession. With the likelihood of lingering post-crisis sluggishness in external demand, Wen Jiabao leaves little doubt that China now needs to draw increasingly on the domestic demand of its massive population of consumers.

The 12th Five-Year Plan lays out the broad outlines of a daunting transition in the Chinese economy – from export-and investment-led growth to increased support from China’s 1.3 billion consumers.

The Premier also modifies the qualitative assessment he has long offered of China’s growth model (see Figure 2). Four years ago, he framed his concerns in the context of the “Four Uns” – a Chinese economy that was strong on the surface but beneath the surface was increasingly “unstable, unbalanced, uncoordinated, and ultimately unsustainable.”¹ But now in the Work Report of 2011, he breaks the Uns down into two buckets – domestic concerns that he still depicts as unbalanced, uncoordinated, and unsustainable and international concerns that he describes as unstable.

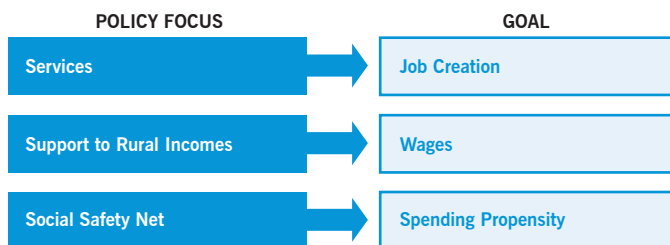
FIGURE 2: CHINA’S REBALANCING IMPERATIVE



Source: National Bureau of Statistics (China), Morgan Stanley Research, as at December 31, 2009

This is a subtle but very important distinction. Stability is China’s ultimate tripwire – whether it is cast in terms of economic, political, or social stability. China will do everything in its power to avoid instability. As such, Wen Jiabao’s characterization of global factors as being unstable – especially, sluggish post-crisis growth, surging global liquidity, rising commodity prices, and mounting protectionist risks – is quite telling. All this leaves China with little choice other than to view internal demand – especially private consumption – as the antidote to the instability of external demand.

FIGURE 3: PRO-CONSUMPTION FRAMEWORK OF 12TH FIVE-YEAR PLAN



The 12th Five-Year Plan provides a reasonably coherent framework as to how China will go about implementing this daunting transition (see Figure 3). The Plan depicts three legs to the consumer-led growth stool – boosting employment, raising wages, and shifting the allocation of the resulting increment in labor income away from saving toward spending. The goal is to generate a windfall of discretionary purchasing power for China’s 1.3 billion consumers – the ultimate sustenance of any consumer-led growth dynamic.

Services-Led Employment

The Premier’s summary description of the new Plan lays out a fairly coherent framework as to how China intends to put each of these key pieces in place over the next five years. In terms of employment, there is repeated emphasis on services and labor-intensive growth. That makes great sense in that China’s tertiary sector generates about 35% more jobs per unit of GDP than its secondary sector (see Figure 4 on page 3).²

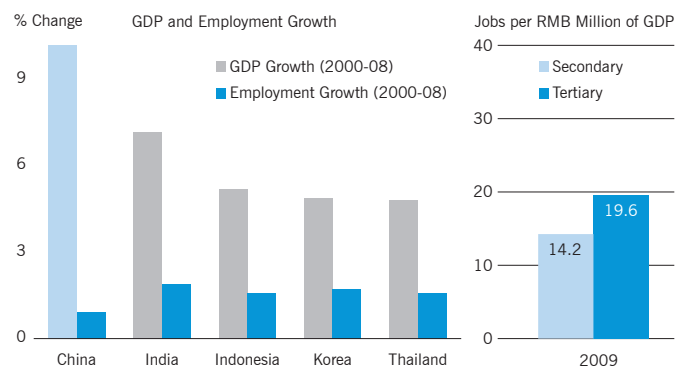
In the Work Report, Wen Jiabao concedes that lagging services sector development was one of the greatest disappointments of the just-completed 11th Five-Year Plan. The new plan is very explicit in attempting to correct this shortcoming by laying out a specific target to boost the services share of Chinese GDP by four percentage points over the next five years (see Figure 5 on page 3). That would take the services proportion from 43%, at present, to 47%, by 2015 – still extremely low by international standards but a major improvement for China.

The Work Report repeatedly emphasizes the need to focus on distributive services industries – wholesale and retail trade. That makes great sense since distribution is the infrastructure for any consumer society. There is enormous upside for job creation in this area. By way of comparison, only 4% of China’s nonagricultural urban workforce was employed in wholesale and retail trade establishments in 2009. By contrast, in the United States – the quintessential services economy – fully 15% of nonfarm employment is in the wholesale and retail trade sectors. If, hypothetically, China were to close just half the gap between itself and the United States in terms of the distribution, or trade, share of total employment – namely, taking its current ratio from 4% to 9.5% – it

1. See Chapter 3 in Stephen S. Roach, *The Next Asia*, Wiley, 2009.
 2. See Qing Wang, Steven Zhang, and Ernest Ho, “The China Files: Chinese Economy through 2020,” Morgan Stanley Blue Paper, November 8, 2010.

would generate over 5.5 million new urban jobs. That would amount to about 12% of the 45 million new urban jobs it is targeting over the next five years.

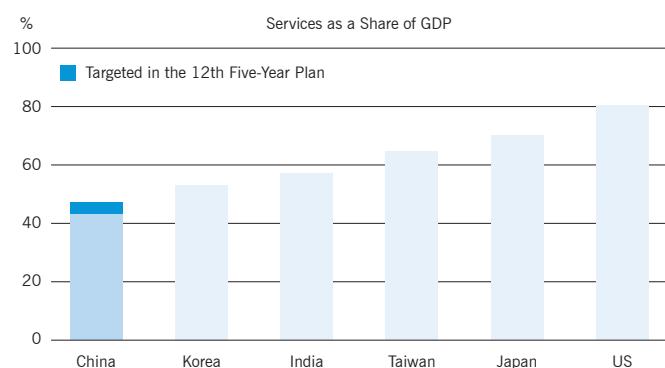
FIGURE 4: FROM LABOR-SAVING TO LABOR-INTENSIVE



Source: Eswar Prasad, "Rebalancing Growth in Asia," Finance and Development, December 2009, Morgan Stanley.

Similar calculations can be made for other services industries, where the Chinese footprint is also surprisingly small – namely, domestic transportation, supply-chain logistics, hospitality and leisure, and healthcare. Unlike more knowledge-intensive industries, which require massive investments in education and human capital, transactions-intensive services can be staffed through relatively short training programs. In short, large-scale, labor- and transactions-intensive services are the low-hanging fruit that China must now pick as it turns to consumer-led growth. Such industries are ideal sources of employment that can play a major role in absorbing the tidal wave of rural-urban migration that China is targeting over the next 20 years.

FIGURE 5: LAGGING CHINESE SERVICES



Source: Morgan Stanley Research, as at March 21, 2011

The services piece of the Chinese growth puzzle is extremely important. Not only does it provide the nation with a new source of employment that is critical for absorbing surplus rural labor, but it also provides an important answer for many of the sustainability constraints that the Premier has long warned of. Unlike resource- and pollution-intensive manufacturing, services are resource-saving and more environmentally friendly. As a result, a shift to services puts

less pressure on worldwide commodity markets and also holds out much greater promise for a lighter, greener, and cleaner Chinese GDP.

Services-led growth enables China to move from labor-saving to labor-intensive development – key for boosting wage income generation.

However, while the Work Report offers a very encouraging endorsement of services-led growth, it fails to address the thorny issue of implementation – that is, how China will actually encourage the growth of such large-scale services industries. For a nation lacking in much of a services culture, deregulation of domestic services and opening up to foreign direct investment and joint ventures seem like the only viable options. The sooner Beijing provides a detailed implementation blueprint for services-led development, the better.

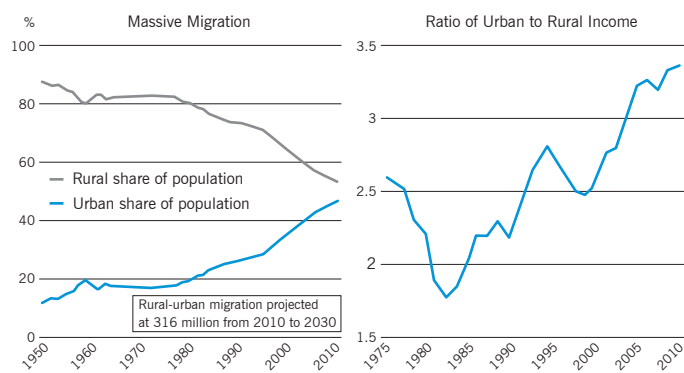
Wages

The 12th Five-Year Plan does not just focus on the quantity, or employment, dimension of the labor income equation. It also draws out a number of aspects of the price, or wage, dimension as well. Two objectives are especially noteworthy in this regard – the first being a commitment to one of the fundamental axioms of market-based economies – aligning gains in real wages with labor’s marginal productivity contribution. This is particularly important for the urban workforce, which accounts for 46% of total employment in China.

In keeping with the Socialist aspirations of a more Harmonious Society, initiatives to boost urban wages will be concentrated at the low end of the pay scale. In accordance with the Labor Reform Act of 2004, this will entail further increases in minimum wages. At the same time, the 12th Five-Year Plan also hints at a further relaxation of the residential registration system (*Hukou*), which would allow for the portability of benefits for China’s large and rapidly expanding population of more than 135 million migrant workers.

But the real impetus to pay rates comes from one of China’s most powerful transformative forces – massive rural-urban migration (see Figure 6 on page 4). The rural share of China’s population fell from 80% in 1980 to 53% in 2009. Conversely the urban share has more than doubled over this same period, from 20% in 1980 to 47% in 2009. Over this same time frame, urban-rural wage disparities have widened dramatically – a source of great consternation to the Chinese leadership. According to OECD research, average per capita incomes in urban areas hit a record of 3.3 times those in rural areas in 2009.

FIGURE 6: TAILWINDS OF RURAL-URBAN MIGRATION



Source: OECD Rural Policy Review: China, 2009

Paradoxically, this income inequality can also work to China’s advantage. With migration shifting between 15 and 20 million citizens a year from impoverished wages in the rural countryside to urban areas where they are making more than three times as much, this transition imparts an enormous windfall to Chinese wage income generation. Moreover, with rural-urban migration expected to total another 310 million over the next 20 years, this trend should provide an enduring tailwind to sustained growth in Chinese labor income.

Over the next 20 years, massive migration to the cities will push over 300 million Chinese into occupations that pay over three times those in the countryside.

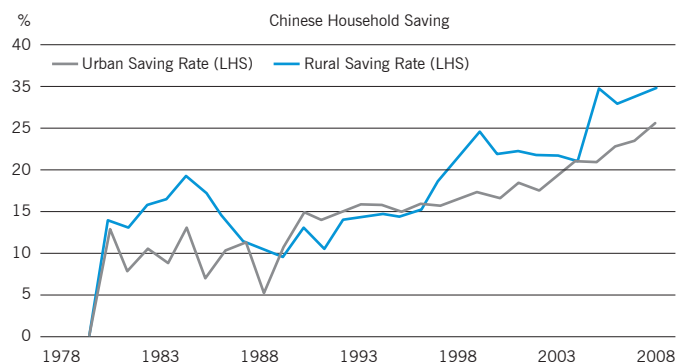
It’s not as if China’s rural income policies are solely based on relocation. The 12th Five-Year Plan also stresses several initiatives aimed more broadly at boosting rural incomes. For example, there are numerous proposals to boost agricultural productivity and efficiency – ranging from rural infrastructure and water conservancy to rural electrification and finance. At the same time, fiscal initiatives focus on expanded subsidies and intergovernmental transfers for agricultural production and farming communities. And, as stressed in the Premier’s Work Report, there are a number of proposals directed at “policy-based financial support for agriculture, rural areas, and farmers.” Missing in this aspect of the agenda are any new initiatives on rural land ownership reforms – ultimately, the key to wealth creation and expanded purchasing power of China’s farming communities.

From Saving to Spending

The employment and wage initiatives are aimed at boosting labor income – the sustenance of consumer purchasing power. For China, there is really nothing but upside on this count. Its personal income currently stands at just 42% of GDP

– literally half the 85% share in the United States. However, while boosting wage income is a necessary step on the road to a consumer-led growth dynamic, it is not sufficient to guarantee a shift toward internal private consumption. The final step requires a reduction in China’s outside saving propensity.

FIGURE 7: FEAR-DRIVEN PRECAUTIONARY SAVING



Source: International Monetary Fund, National Bureau of Statistics (China), as at November 2010

According to recent research published by the International Monetary Fund, the average saving rate for Chinese urban households has essentially doubled in recent years, rising from 15% in the early 1990s to 30% in 2009 (see Figure 7).³ At work, has been a sharp increase in income uncertainty largely brought about by the dismantling of China’s social safety net. Needless to say, if such fear-driven precautionary saving persists, it will be exceedingly difficult for China to convert incremental growth in wage income into increased consumer spending.

An expanded social safety net is key to reducing precautionary saving. The Plan stresses the breadth of coverage, but does not go far enough on the benefits side of the equation.

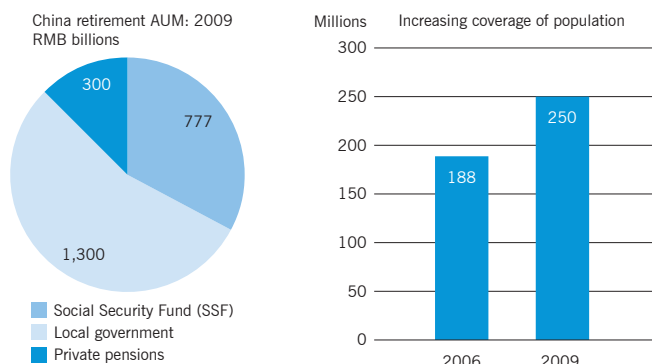
Accordingly, it makes great sense for any pro-consumption policy agenda to stress a rebuilding of China’s social safety net. In that important respect, the broad outlines of the 12th Five-Year Plan as presented in the Premier’s Work Report are encouraging. There is clear recognition of the importance of this issue in shaping China’s long-term development strategy. That’s especially the case with respect to the commitment to boost prospective growth in social security, private pensions, and medical insurance.

Having said that, I do not detect much of a shift in emphasis from previous Chinese policy statements on the safety net. Consistent with past proclamations, the 12th Five-Year Plan seems to focus more on expanded coverage ratios – especially

3. See Marcos Chamon, Kai Liu, and Eswar Prasad, “Income Uncertainty and Household Savings in China,” IMF Working Paper, November 2010.

for social security and medical insurance – rather than address the inadequacy of benefits. In that important respect, there can be no mistaking the serious funding shortfall of the Chinese retirement system. In 2009, total assets under management for the national social security fund, local government retirement plans, and private sector pensions totaled just RMB2.4 trillion.⁴ That amounts to only \$470 of lifetime retirement benefits for the average Chinese worker – leaving little doubt of the inadequacy of China’s social safety net (see Figure 8). The excesses of fear-driven precautionary saving that continue to inhibit the growth of private consumption are a direct outgrowth of this anomaly.

FIGURE 8: SAFETY NET REALITIES: RETIREMENT



Source: Social Security Fund Annual Report 2009

I would have preferred a much stronger signal from the 12th Five-Year Plan on the funding side of the safety net equation. With its outsize surplus of domestic saving, China certainly has the wherewithal to move aggressively in expanding the benefits of its still embryonic social safety net. For reasons that are not altogether clear, China has been unwilling to take such a step in recent years.

The current global climate underscores the urgency of supporting such an initiative. Given the likelihood of a lingering post-crisis shortfall in the external demand for Chinese exports, China needs to move quickly in uncovering a new source of internal growth. Private consumption is the only real antidote to sustained weakness in global demand. Yet that offset will not fall into place until the fear of insecurity fades and precautionary saving declines. For that to happen, China will need to instill a greater sense of confidence over retirement income by upping the ante on its commitment to a secure and well-funded social safety net. That needs to occur sooner rather than later.

Upgrading Manufacturing

It is important not to misconstrue China’s shift to an increasingly services- and consumer-led growth model. The strategy of the 12th Five-Year Plan does not turn its back

on manufacturing. But it does lay out a model of structural change that envisions China shifting its incremental support away from the traditional low value added export-oriented manufacturing sector that has played such a prominent role over the past 30 years.

As previewed through an announcement by the State Council last October, the new plan targets a major move up the manufacturing value chain. It focuses on the development and expansion of seven strategic emerging industries (SEIs): New-generation information technology, high-end equipment manufacturing, advanced materials, alternative-fuel cars, energy conservation and environmental protection, alternative energy, and biotechnology. The goal is to take the SEIs from a current combined share of 3% of Chinese GDP to 8% by 2015 and 15% by 2020.

Such a development can hardly be expected to occur in a vacuum. These are all knowledge-based, leading edge industries that must be built on a foundation of innovation, research, and development. As such, the 12th Five-Year Plan also targets an increase in R&D spending from 1.7% to 2.2% of Chinese GDP over the 2011 to 2015 period. This would be a major accomplishment following the shortfall of such spending in the just concluded 11th Five-Year Plan. At the same time, the new plan recognizes that knowledge-based manufacturing cannot flourish without educational reforms and concomitant investments in human capital. As such, it also calls for numerous initiatives on the education front – ranging from vocational and special education to a focus on the special training of a sharply expanded population of scientists and engineers.

China is moving up the value chain – turning its focus to the development of seven leading edge Strategic Emerging Industries.

The 12th Five-Year Plan is also focused on improving the quality of China’s manufacturing technology. Particularly telling in that regard is the emphasis on energy conservation and environmental remediation – a carryover from the 11th Five-Year Plan. The new plan calls for non-fossil fuels to reach 11.4% of primary energy consumption by 2015. Similarly it targets a 15% reduction in energy consumption per unit of GDP over the next five years and a 17% reduction in carbon dioxide emissions per unit of GDP over the same period. The plan aims to reduce major pollutants between 8% to 10% by 2015. All this implies not just a move up the value chain but also hopeful progress in achieving a more efficient and cleaner manufacturing production technology.

4. See National Council for Social Security Fund, The People’s Republic of China at www.ssf.gov.cn.

If this strategy is well executed, I suspect that by the end of the 12th Five-Year Plan, the manufacturing sector will have declined by 2 to 3 percentage points of GDP – falling from 39.7% in 2009 to around 37% by 2015. That would take the manufacturing share back to that last seen in 1991, just before China began its major industrialization push. But the plan also focuses on a critical transformation within the manufacturing sector. The SEI agenda is more than just a logical progression up the value chain. It is also about re-directing China’s manufacturing prowess toward the increasingly complex and sophisticated requirements of lighter, cleaner, knowledge-based internal demand.

Tactical Challenges

The plan is only a guide to an admittedly uncertain future. It is a conditional framework that must make assumptions about exogenous factors that shape the internal and external environment. As those assumptions are challenged by unexpected developments, the plan needs to be modified. That has certainly been the case for the long progression of China’s five-year plans.

The early plans of the 1950s through the mid-1970s were seriously impacted by internal instability – culminating in the Cultural Revolution. Beginning with the Asian financial crisis in the late 1990s, the more recent plans have been impacted more by external instability. In all cases, exogenous shocks were countered by tactical adjustments aimed toward keeping China on a path of development and improved prosperity.

It is reasonable to expect similar challenges to the broad themes of the 12th Five-Year Plan. Three possibilities are evident at this point in time – domestic inflation, the risks of external shocks, and global rebalancing. Beijing’s challenge is to weigh the probabilities of such outcomes and calibrate risk-adjusted implementation guidelines for the 12th Five-Year Plan.

Inflation

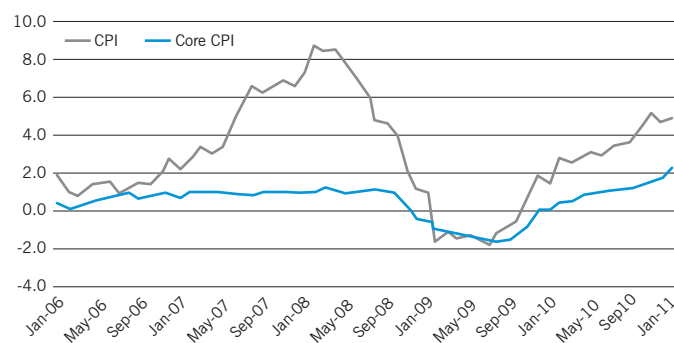
The Premier’s Work Report leaves little doubt as to where the risks lie for China. The final section of the report, entitled “Work for 2011,” lays out ten major issues that China needs to confront in the year ahead. Price stability is listed as number one – just ahead of efforts to stimulate consumer demand. This prioritization is critical. Chinese leaders are, in effect, admitting that the pro-consumption structural agenda is hostage to the cyclical pressures of rising inflation and deteriorating inflationary expectations. However important China’s rebalancing may be to the longer-term sustainability of its economic development, the message in the Work Report is that the decks first must be cleared of cyclical inflation risks.

To date, China has deployed four sets of measures to address its incipient inflation problem: increased bank reserve requirements, gradual currency appreciation, administrative de-bottlenecking measures in the agricultural area, and hikes in policy interest rates. While the Work Report underscores China’s newfound “monetary prudence,” the real emphasis on fighting inflation falls to additional administrative measures – especially in alleviating impediments the grain supply and vegetable basket distribution programs through state-directed stockpiling, reserve manipulation, and other market control measures.

With food having a weight of 30% in China’s CPI (just downwardly revised from 32.5%), such aggressive administrative measures are understandable. But China’s inflation problem goes well beyond the food issue. Excluding food, where price increases are currently running at about a 10% annual rate, China’s so-called core CPI increased 2.3% in January 2011. This represents an acceleration of 1.2 percentage points from the pace six months earlier and an even sharper pick-up from the zero rate of core inflation that had been prevailing just a year ago (see Figure 9).

However, with inflationary pressures increasingly broad-based, it makes sense for the anti-inflationary policy prescription to have a comparable breadth. That suggests that Chinese authorities need to shift more of their efforts to monetary tightening and higher real interest rates – long viewed as the heavy artillery of any nation’s anti-inflation campaign.

FIGURE 9: CHINA’S INFLATION PROBLEM



Source: Social Security Fund Annual Report 2009

While the People’s Bank of China has, in fact, hiked policy rates three times in the past four and a half months, the one-year benchmark lending rate of 6.1% is only about 1.2 percentage points above the headline inflation rate. That is clearly not high enough to rein in excessive growth in credit. Otherwise, Chinese authorities wouldn’t find it necessary to impose quantitative controls on credit and hike bank reserve ratios eight times since the start of 2010. It is safe

to conclude that the real benchmark policy rate remains in the accommodative zone – possibly at least 100 basis points below the more restrictive reading that would be required to cool the economy and temper inflationary pressures.

This underscores one of the long-standing tensions between cyclical and structural pressures as expressed in the framework of China's five-year planning exercise. In recent years, growth overshoots are the rule – not the exception. Year in and year out, the official target for GDP growth is announced at around 7% or 8%. Yet repeatedly, the number eventually comes in at something much closer to 10%. With inflationary pressures now on the rise, China can't afford another growth overshoot. That's where the experience of market-based economies comes into play: Ultimately, macro control cannot be achieved without reliance on the main macro instruments of monetary and fiscal policy. China's incipient inflation problem is not just an administrative challenge in the food area – it needs a much stronger dose of monetary tightening as well.

If China doesn't bring inflation under control, it may be unable to implement its pro-consumption rebalancing agenda. More aggressive monetary tightening is needed.

There is another important element to the tension between cyclical inflation risks and the imperatives of pro-consumption rebalancing. As stressed above, wage increases – and the role they play in boosting labor income – are an essential part of China's consumer-led growth agenda. But if the authorities boost wages at the same time that inflation is getting out of control, there is a worrisome possibility of a wage-price spiral – the same insidious interplay that proved so destructive to the developed world back in the 1970s. Consequently, the sooner China brings inflation under control, the sooner it can put the wage piece of its consumer-led growth agenda into place.

The biggest risk, of course, is that China errs on the side of accommodation and the inflation genie gets out of the bottle. Historically, high rates of inflation have been hugely destabilizing for China. In the event that inflationary conditions continue to deteriorate, then it will ultimately take a far more wrenching monetary tightening to bring price pressures under control than would be the case if the authorities were to take more decisive actions in the months immediately ahead. Under the “wrenching tightening” scenario, the risks of a hard landing in the Chinese economy would most assuredly increase – making it all but impossible

for the government to move ahead with the structural pro-consumption agenda featured in the 12th Five-Year Plan.

Speed of Adjustment

Structural change in any economy does not happen over night. China is no exception. But there are times when unexpected developments put a high priority on an accelerated pace of structural adjustments – and on policy measures required to achieve such an outcome. This is one of those times.

The reason for this urgency is traceable to the financial crisis and its aftermath. With the American consumer in the throes what looks to be a multiyear deleveraging and with European aggregate demand likely to be restrained by a protracted fiscal consolidation in the aftermath of its sovereign debt crisis, the external demand for Chinese exports from these two regions is likely to move to a much slower growth trajectory as a result. Collectively, the US and Europe account for over 40% of Chinese exports. Japan, where the growth outlook is equally poor, accounts for another 8% of Chinese exports. Consequently, with basically half of China's external demand likely to remain under significant pressure in the post-crisis environment, there is a very real risk of a serious shortfall in Chinese exports – long the major driver of overall economic growth.

China has three basic choices as to how to respond to such a development. First, it could attempt to offset the export shortfall by implementing another round of pro-active fiscal stimulus focused on infrastructure and other forms of fixed investment. With such investment now in excess of a record 47% of Chinese GDP and with bank loan quality having suffered as a result, such an option seems neither wise nor prudent. Second, China could push hard to uncover new export markets outside of the major destinations in the developed world. That will not only take time but it could also trigger protectionist actions by other nations. Third, China could elect to do nothing in response – hoping for a resumption of rapid growth in aggregate demand in the developed world or electing to take its lumps in the form of a sustained export-led growth shortfall.

The likelihood of lingering post-crisis aftershocks in the developed world imparts a new urgency to China's pro-consumption initiatives.

The third option is particularly risky and bears elaboration. While it always possible that “this time is different” and crisis-torn economies in the developed world snap back

vigorously from the upheaval of 2008-09, the long record of history is not supportive of such an outcome.⁵ Nor does it seem particularly likely that the Chinese leadership is willing to flirt with a protracted period of downside growth risks and attendant pressures on unemployment and social stability. The bottom line in this case: Inertia is not an option. The Great Crisis and its aftermath are China’s wake-up call that it cannot afford to sit still and simply hope for the best.

Taking a probabilistic risk-adjusted assessment of these alternatives into consideration and remaining ever-mindful of China’s over-arching social stability constraint, there is a very compelling argument for China to turn to internal consumer demand as the requisite offset. And that, of course, means an accelerated implementation of many of the policy initiatives discussed above. Particularly noteworthy in that regard would be the announcement of a large injection of public funds into the social safety net institutions – social security and/or the healthcare system. The announcement effect, alone, would go a long way in instilling greater confidence over retirement income security. And it would also counter, as noted above, what I believe is one of the major drawbacks of the 12th Five-Year Plan.

The five-year plan for China has long been a coherent framework for action. Over the decades, these plans have been very successful in providing broad guidelines for policies and reforms. But no plan can be cast in stone. It must be a living document – adaptive to circumstances and assumptions. When circumstances change, so, too, must the plan. That could well be necessary in the aftermath of the Great Crisis. In China’s case, that does not mean a rethinking of the basic strategy of a consumer-led rebalancing. But it does suggest attaching a greater urgency to the time path of the coming transition.

Global Repercussions

China has long been one of the greatest beneficiaries of globalization. But globalization, of course, is not a one-way street. Shifts in the Chinese macro structure have important implications for the rest of the world. Nowhere could that be more evident than in the United States.

In the end, I am confident that China will make solid progress on the road to rebalancing over the next five years. By the end of the 12th Five-Year Plan, I expect that the private consumption share of Chinese GDP will have risen into the 42% to 45% range – still quite low relative to other major economies but a meaningful improvement from the rock-bottom 35% reading of 2008 (and about 36% at present).

At the same time, I am not nearly as confident that the United States will embrace its post-crisis adjustment

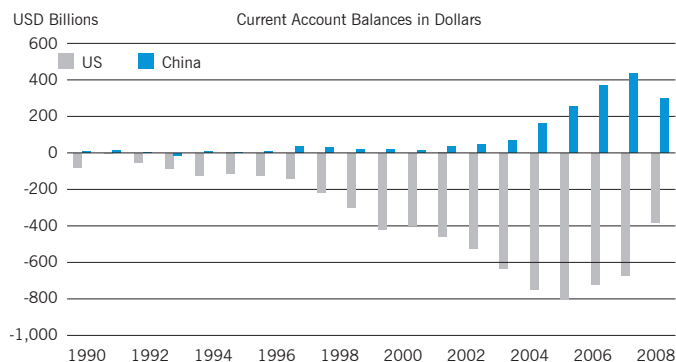
imperatives with equal fervor. Particularly disconcerting is the US saving prognosis – the mirror image of America’s bubble-dependent consumption binge. While household saving rates have moved up a bit – from pre-crisis lows of 1% to around 5½% at present – this improvement has been more than offset by the massive dissaving of outside government budget deficits.

There is a risk of an “asymmetrical global rebalancing” – where China moves more quickly to absorb surplus saving than America moves to reduce its deficits. That could spell trouble for the US dollar and long-term interest rates.

The result is that America’s net national saving rate – depreciation-adjusted saving of households, businesses, and the government sector, combined – remains in rarefied negative territory, averaging -1.2% of national income over the first three quarters of 2010. Notwithstanding Washington’s steadfast assurances, the prospects for deficit reduction and a meaningful revival in domestic US saving are far from encouraging.

Therein lies what could be a critical source of global tension – an asymmetrical global rebalancing scenario (see Figure 10). China, the world’s largest surplus saver, could well rebalance before the United States, the world’s largest deficit saver. Such an outcome could prove quite problematic for the US economy and for world financial markets. As China shifts its macro structure toward private consumption, its surplus household saving will decline – reducing its current account surplus, its accumulation of foreign exchange reserves, and its demand for dollar-denominated assets. At the same time, deficit-prone America will see no slackening of its appetite for surplus saving from abroad.

FIGURE 10: WHAT IF CHINA REBALANCES FIRST?



Source: International Monetary Fund, data to 2008, taken March 20, 2011

In such an asymmetrical rebalancing, two possible outcomes arise: One, saving-short America miraculously comes up with a new source of funding – namely another nation that is willing to suppress domestic demand so that the US can continue to live beyond its means. Or, two, the world demands very different terms on which the US secures its external funding – namely a sharply weaker dollar and/or a rise in real long-term interest rates. Needless to say, the global repercussions of a US funding crisis would hardly be inconsequential. The odds would most assuredly rise for collateral damage in the real economy – a recessionary relapse, or the dreaded global double dip.

Turning Point

China's 12th Five-Year Plan stands to be a major milestone on the road to its development and widening prosperity. It sets the stage for the long-awaited transformation of a production-led economy into one that provides greater sustenance for its 1.3 billion consumers. This is hardly a shocking outcome for any developing economy – let alone, China. After all, there is a reason why this nation is called the People's Republic of China.

The journey has hardly been simple or easy. But enormous momentum has been building for this decisive transformation. China now has now achieved critical mass on many fronts: It has modernized its physical plant – factories, infrastructure, shelter, and offices. It has educated its people. It also built up an enormous reservoir of domestic saving and foreign exchange reserves. And it has broken the mold on poverty reduction and internal migration from the countryside to new cities.

Now it is time for China's next step – and it is, indeed, a giant step. A producer culture must become more attuned to the needs and aspirations of a consumer society. China has both the wherewithal and the will to pull off this daunting transition.

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That's not to say it will be easy. There will undoubtedly be bumps in the road. Whether they are manifested in the form of domestic inflation, external demand shocks, global rebalancing concerns, or some other unexpected development, remains to be seen. These are all problems that China can address and overcome. But it can only do so provided it resists denial and stays the course of reform, opening up, and development that has served it so well over the past 30 years. The 12th Five-Year Plan is an historic step in this direction.

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