US CHINA SERIES

REPORT
The Fourteenth Five Year Plan. The Path to Preeminence.

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China's Fourteenth Five-Year Plan

China and Asia are leading the world out of its self-induced economic depression but is anyone truly surprised that Asia's economic dominance is shining through and that China's quest to supplant the United States as the world's biggest economy is inevitable? COVID-19 didn't establish this trend. China has four times the population of the United States. That is why China will sooner rather than later have output that exceeds that of the USA. While China's political model may have enabled them to handle COVID-19 better than liberal democracies, the sheer scale of China's population is the reason for its eventual economic supremacy.

As China charts its course for the next five years in the form of the Fourteenth Five-Year Plan, questions arise on China's priorities in modernizing the country through innovation, replacing high-speed growth with high-quality growth, rebalancing its economy, and tackling issues of climate change.

In a recent US-China Series virtual forum, an expert panel discussed the potential economic and environmental targets that China may have for the 14th Five-Year Plan. The speakers were:

Michal Meidan — Director of China Energy Programme at the Oxford Institute for Energy Studies

Mayank Mishra — strategist at Standard Chartered Bank, Singapore

China's path to economic prominence is hardly without its challenges. Demographic hurdles often prompt the simplistic yet accurate question of can China get rich before it gets old. The trade dispute with the US, the semiconductor embargo, and the sanctions on the few global brands emanating from China has created structural headwinds. While progress has been made on debt sustainability, climate, and corruption, they remain a constant overhang, and income inequality is a social scourge.

Still, with a goal to double GDP in the next 15 years (an achievable target given GDP per capita is at $17,500), China's economic preeminence will come to the fore. Chinese growth rates have been on a glide path lower as the quality of output has improved. Like the West, Chinese growth in 2021 will spike to compensate for the lost demand in 2020 but will quickly normalize back to a long term trend that is closer to 5%, a rate that will lead it to quickly surpass the US as the world's largest economy. How China uses that economic might remains to be seen, but we all must prepare that Western economies are about to be dwarfed by China.

The Fourteenth Five Year Plan creates the foundation of whether inevitable growth is sustainable and in line with Xi Jinping's visions for a modern China. When investing in Asia, this vision should always be taken into account.

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14th Five-Year Plan: An Overview

Mayank Mishra: Proposals for the 14th Five-Year Plan strikingly lack any concrete growth targets. That marks a broader shift in focus from the quantity of growth to the quality of growth in several aspects.

The popular phrase floating around is the *dual circulation economy*, which China has quickly noted as not an attempt to decouple from the global economy. Instead, China wants to boost domestic demand as a critical driver of growth while using external demand as a type of reinforcing driver.

How will China do this? Some proposals focus on boosting domestic goods and services consumption, as well as making growth more equitable. That means emphasizing income redistribution and reducing disparities, increasing household incomes, and improving its network of social security services. In turn, it's hoped that people will save less, thus engaging in more consumption. In addition, there's a focus on greater self-reliance on the technology front. Technology self-reliance has become a nationally strategic pillar.

Finally, there's a focus on not letting the economy overheat — i.e., not allowing credit impulses to boost growth, which has implications for monetary and fiscal policies as well as the path forward for China's credit growth and interest rate settings in the future.

Dual Circulation

Discuss the idea of dual circulation within the context of globalization, the US-China trade war, and other factors.

Mayank Mishra: While there were concerns that China would become more inward-looking and decoupled from the global economy, it's more so the case that China faces growing headwinds within the context of globalization over the past few decades in the following four aspects:

- China's share of global exports is already relatively high, and it's unrealistic to expect exports to continue driving China's growth. Thus, it's evident that it tries to focus on boosting domestic demand.
- Recent developments have alerted China to its critical supply chain, and semiconductors is one key industry: I believe China is trying to minimize those risks and ensure its growth model is free of influence from unfavorable foreign dynamics.
- China is keen to recover ground or even become leaders in several key technological fronts, such as semiconductors. The country faces a significant lag in a very critical sector.
- China is alarmed by a continued dependence on the US dollar and US dollar payments system, especially given the Hong Kong situation.

Growth Targets

Is China's target of becoming a "moderately developed economy" — which entails growth of roughly 5% a year — realistic, given its pivot to more organic and domestically-focused planning? Could China double the size of its economy by 2035?

Mayank Mishra: China grew in 2019 at about 6%, which serves as a guidepost on potential growth. The final plan from the National People's Congress next March may suggest a range of around 5.5 to 6% growth rate as a guideline. We think that that growth level over the next five years is doable and will propel the Chinese economy into the next income bracket.

Next year we are actually forecasting 8% growth for China, and from 2022 onwards, China would have to grow by 4.5% or thereabouts to double its GDP by 2035. Growth is expected to slow down gradually, but we think China will reach its target in 15 years.

Energy Considerations

In the past five years, China has accomplished much in tackling climate-related issues, pollution problems, and the transformation into a cleaner energy economy. What may the energy priorities be in the new Five-Year Plan? How will it differ from the previous one?

Michal Meidan: Energy policy does depend on the broader macroeconomic framework. Issues such as the environment and climate, energy security, and others tend to rise and fall in priority depending on the larger picture.

I'm not convinced that the 14th Five-Year plan can and should be regarded as a bellwether of China's climate ambitions because of the timeline needed for such change. Indeed, the Five-Year Plan is gearing up against an external macroenvironment that is more hostile than it has been in a very long time. Several macro trends that are important to energy exist:

- The shift from quantitative to qualitative growth does entail slower growth, but China, like other developing economies, requires more energy to do so. That's in contrast to Europe, where decarbonization occurs in economies whose energy demands have all but peaked.
- The dual circulation strategy — which I'd agree is not a decoupling — impacts energy in the form of supply security, i.e., ensuring ample supplies that keep the economy going. We will see how a diversity of supply sources of clean energy could outpace and gradually replace fossil fuels for a country with an increasingly urbanized middle class.
- China is hedging against the US, which is willing to use financial tools and tariffs in a punitive way. Chin wants to de-dollarize the system, even if the RMB may not replace the dollar anytime soon. In one instance, US sanctions on Chinese shippers who trade with Iran and Venezuela have created tremendous headaches for Chinese traders, the Chinese system, and global markets.

- Domestically, technologically-advanced energy storage capabilities are high on the agenda. China is becoming a leader in hydrogen, batteries, carbon capture, and storage technologies writ large. Fossil fuels will still play a role in the Chinese energy mix, but I think this will receive greater attention.

Given Xi Jinping's announcement in September that China will be carbon neutral in 2060, that was huge news and came as a surprise to both Western observers and people in China. However, that target means realistically there's little the system wants to put into the 14th Five-Year Plan.

Yet when it comes to energy priorities in the upcoming Plan, I think the winner will be renewables. In other words, there will be a higher share of renewable energy policymaking than we would have otherwise seen, in the form of storage technology — hydrogen, batteries, storage solutions — but also the kind of software and environment that enables a digital ecosystem of electric vehicles, as well as sharing platforms for e-scooters and e-bikes.

On the other hand, I think coal may not be allowed to grow in this coming Five-Year Plan, but there will still be room for coal, oil, and gas. Fossil fuels won't be going away. Gas market liberalization has gained a considerable amount of momentum that will continue. In conclusion, I would look take on a 15-year vision to see some of the energy transition taking form and the winners and losers that could come out of it.

What's the current state of the coal industry, and how influential is it today? Will coal lose in the next few years?

Michal Meidan: In the long-haul projection of 2060, we know that China will have very little coal and a lot of renewable energy. Yet, I would argue that coal won't fade away as quickly in the next ten years. China's bureaucracy doesn't change overnight, and just months ago, there were advocates for increases to the electrical grid in the form of an additional 200 gigawatts of installed coal capacity, on top of its already-existing 1,000-gigawatt coal capacity.

In the wake of COVID-19, stimulus efforts mean that lower governments support the construction of smokestack industries and infrastructure. Building coal-fired powerplants on the local level is a way of generating growth. The banks are still lending to these coal-fired power plants because they create employment and economic growth. Since China's electricity system makes it difficult for provinces to trade between them, renewables can't be shipped from one province to another. Moreover, renewables are now cost-competitive in many provinces, but local officials are looking to protect their infrastructure rather than phasing out coal.

The other point is that some coal provinces are looking to adapt coal, going from coal in power or coal in industry to coal in chemicals and coal as a basis for hydrogen. New technologies could enable the use of fossil fuels while capturing the carbon, hence extending the life of fossil fuels. But right now, no one in China will shut down coal-fired power plants that could result in a lack of energy supplies.

Electric Vehicles

Discuss China's automobile innovations and its ambitious electric vehicle targets in the next few years.

Michal Meidan: Whether China hits its electric vehicle targets is less important than its overall goals in this area, and it's apparent that there are strong policy signals in this direction. The question becomes what sort of tools the government uses to enable this transition. In short, the government wants both domestic consumption and a domestically-driven economy, while it plays a decisive role in it.

In the case of electric vehicles, the whole model of energy transition where EVs are connected to the grid depends on consumption and market signals, which require a certain degree of decentralization. China seems to reluctant to give that up at this point. We should adjust the metrics by which we measure success or failure and focus more on the EV transition process.

We're seeing a shift from encouraging vehicle manufacturing to building more charging stations. Hydrogen fuel cell vehicles are now highly valued, which were always part of plans for new energy vehicles (NEVs), but it's becoming more of a predominant factor. The pilot programs envision an entire ecosystem that includes fuel cell manufacturing and hydrogen supply chains within these cities.

There's also been a vast effort to encourage electrification in government fleets and buses, which again, involves building out the underlying infrastructure in addition to batteries and cars.

Keys to Innovation

Michal Meidan: Can China produce the next Tesla? EVs are different from semiconductors, which already has an industry and sets of standards for manufacturing. But I think the question doesn't matter so much. China has been more successful in commercializing EVs; even if they're not at the top of the quality or the top of the range, it has been more successful than any other country.

China is attractive because, to a certain degree, it is a blank slate. Companies in China are creating new models of transportation: cars that, for instance, can communicate with your home so that when you're 20 minutes away, the vehicle can turn on the heating or the rice cooker. It's an entirely digital system that is exceptionally innovative.

Discuss how China's ability to commercialize innovations could be applied to other sectors.

Mayank Mishra: It may be more difficult or impossible to do so in some sectors. In the case of semiconductors, China's current technology is not good enough for next-generation 5G phones and mobile stations, which require a certain degree of performance and power consumption. The same is true for AI, where computing requirements have to be elevated to a minimum level. In the case of semiconductors, it'll be challenging to catch up to the latest technology offered by industry leaders in Taiwan and South Korea.

The semiconductor supply chain is complicated: it's not enough to set up new factories and pour in money. If China were isolated, it would be difficult for the country to domestically create each of the supply chain components from scratch. Although Chinese players like SMIC are trying to work at the cutting edge, some semiconductor equipment still has to be supplied by very few countries in the world: the US, Japan, and the Netherlands. ASML's equipment is critical; for instance, it's impossible to fabricate semiconductors at a 5 nanometer and below scale without UV equipment.

Tangible Targets

Are there tangible targets we should be looking for in determining the success or failure of certain parts of the Five-Year Plan?

Michal Meidan: Process is more important for these questions of new technology. In the context of a dual circulation strategy, it's important to create new areas of growth. Yet if we look at the 13th Five-Year Plan, many targets were met, including pollution alleviation, improvements in air quality, energy efficiency, and the reduction of carbon emissions. They've also pursued market liberalization in oil and gas by allowing new actors, which was a softer target.

That said, cutting carbon emissions will be very important in the 14th Five-Year Plan, not just for China but for the whole world. I think we are going to get emission reduction targets, carbon intensity reduction targets, energy efficiency reduction targets, as well as targets for more renewables. I'm not expecting to see a huge degree of environmental ambition, but it'd be a good surprise to see a cap on emissions. China hasn't pledged an absolute level of peak emissions, but if it does give an actual cap on emissions or coal consumption, those would be the right signals for the 14th Five-Year Plan.

Mayank Mishra: I agree that it's about the trajectory and how China achieves the soft targets it has laid out for itself. One goal that appears in the 14th Five-Year Plan proposal is to keep monetary policy conventional for as far as possible, maintaining positive rates and avoiding quantitative easing. In terms of macro imbalances, the question is whether they can contain those of the past in terms of systemwide leverage, answer concerns about local government debt profiles and the overall fiscal deficit.

Conclusion

When looking at asset allocation/investment decisions in the months ahead, never lose sight of the mega-trends. Issues around energy security and climate, dual circulation, and China's technology independence are vital inputs to investment decisions across every asset class.

It is so easy to think of 2020 as a disruptive year that upended everything. I think differently. It merely accelerated change that was destined to happen. This gets tossed around a lot, but investors are behaving differently. If the Chinese economy will dominate the globe in the next 25 years, why is the average global investors so structurally underweight? Chinese equity, credit, and sovereign bonds deserve to have weightings in global indices comparable to its economic dominance. While there are valid yet nuanced reasons for a measured approach, the Chinese economy will not wait for investors to organically catch-up.

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