BEA
The Bank of East Asia, Limited

Economic Analysis

April, 2011

A Publication of the BEA Economic Research Department

The 12th Five-Year Plan and its Implications to Hong Kong Economy

Since China adopted the open door policy in 1978, it has relied on exports as the main engine of economic development. Leveraging on low labour and energy costs, as well as preferential policies including tax rebates, China quickly emerged as the factory to the world. Private consumption, meanwhile, has fallen as a share of GDP. In the period from 2001 to 2005, private consumption accounted for some 49% of GDP; in 2010, private consumption made up only 38.1% of GDP.

While China's development model is justifiably the envy of the developing world, there are growing signs that the pace of economic development will not be sustained unless changes are made. Among the emerging constraints on growth are labour shortages, trade imbalances, rising energy consumption and pollution. Hence, the 12th Five-Year Plan (2011-2015) (12th FYP) has unveiled an ambitious programme to engineer a transformation of China's economic structure in favour of a more balanced and sustainable development model.

Promoting Consumption

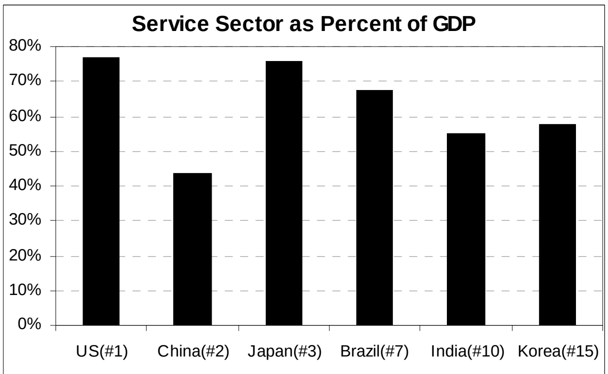
A major target of the 12th FYP is to put more money into the pockets of middle and lower income groups, in order to promote greater discretionary spending. This policy is being pursued on a number of levels, including higher income growth, new employment, a better social safety net and higher investment income.

A wave of pay rises swept across the country last year. By the end of 2010, 30 provinces had raised their minimum wage, with the average rise amounting to 22.8% year-on-year. This trend is expected to continue over the course of the Plan period.

The 12th FYP also calls for the creation of 45 million new jobs, which translates to a rate of growth of 2.75% per annum. This rate of employment growth is lower than the 3.3% attained during 2005-2009, partly due to the fact that the 12th FYP is understood to emphasise quality of employment growth rather than quantity. The current dilemma is that coastal manufacturers complain of a shortage of workers, while university graduates face difficulties in finding well paid jobs.

The imbalance is evidenced in the shrinking wage gap between university graduates and rural labour working in the cities. There is thus a clear need to create more knowledge-intensive jobs that are commensurate with the increasing skill level of the labour force. The challenge is severe, as in 2011 there will be 6.6 million university graduates, representing a rise of around 200,000 over a year ago.

Two strategies have been adopted to provide improved employment opportunities for graduates. Firstly, the government will nurture the development of the service industry. The service sector accounts for 43% of the country's GDP, which is low compared to other major economies. The 12th FYP aims to raise the ratio by four percentage points to 47%.



Source: IMF; Note: numbers in the bracket refer to the rank of economy size in 2010

Secondly, the government will encourage investment in new high-tech industries, such as energy-saving and environmental protection, high-end equipment manufacturing, and new energy and materials. It is hoped that these efforts will lead to more knowledge-intensive and higher value-added jobs. Investment and tax policies are being revised to support these efforts, while financial institutions are being encouraged to lend to this segment.

The 12th FYP also addresses the need to provide a better social safety net. With the reform of the state-owned enterprises, the system whereby the company provided health care, education, housing and pensions was dismantled. This in turn induced a rise in household saving, from 17.5% of GDP in 2000 to 23.4% in 2008. Including corporate and government savings, total saving as a percentage of GDP has increased from 37.3% in 2000 to 53.2% in 2008. The government will step up initiatives to strengthen the coverage of the social safety net in order to reverse this trend and encourage greater consumption. For example, the government has planned to build 36 million units of affordable housing during the 12th FYP period to meet the housing demand.

And lastly, the government hopes to improve investment returns to provide more disposable income. Zhou Xiaochuan, Governor of the People's Bank of China (PBOC), has said that China will make significant progress in interest rate liberalization during the 12th FYP. This should lead to higher deposit rates. Moreover, the narrowing interest rate spread will give banks greater incentive to offer a broader range of investment products to their clients.

According to the PBOC, the estimated yield of 12-month personal finance products was 3.55% as at the end of 2010, higher than the equivalent deposit rate (2.75%). As more investment products become available, households will no longer face the stark choice between a low-yield deposits account and the highly volatile stock or property market.

Implications for Hong Kong

While Mainland China seeks to boost its domestic consumption, the voracious spending power of Mainland tourists has had a dramatic impact in Hong Kong. Mainland visitor arrivals rose by 66.9% during 2006-2010, while retail sales volume rose by 32.6% during the period, outpacing the 18.3% increase in real GDP.

A recent survey[1] suggests Chinese citizens prefer to buy luxury goods overseas rather than at home – 56% of the value of luxury spending by Chinese in 2009 was carried out overseas. Hong Kong is a favourite destination, due to lower price, broader product selection and better availability of new products.

Most foreign products are more expensive on the Mainland. A survey by the Ministry of Commerce on 20 high-end brands of watches, bags, clothing, alcohol and electronic products showed that prices on the Mainland outstripped those in Hong Kong stores by a whopping 45%. One reason accounting for this is the high import taxes on consumer products, as the cumbersome aggregate tax (including consumer tax, value added tax and import tariffs) often accounts for up to half of the selling prices on the Mainland.

There has thus been a backlash against high import duties, with rising calls for a reduction in import tariffs in order to narrow the price differential with overseas markets and stimulate more domestic consumption. Moreover, international brands are keen to expand their operations on the Mainland. Domestic luxury spending in China grew at 14% in 2009, outstripping the 8% growth in overseas luxury spending by Chinese. These developments should ring alarm bells for Hong Kong. Despite having long served as a shopping paradise for Mainlanders, Hong Kong needs to be aware that the city's edge may disappear if import tariffs are lowered and its price advantage is eroded.

As mentioned above, one of the priorities of the 12th FYP is to encourage the development of the service sector. This is an area in which Hong Kong excels. However, service suppliers often encounter barriers that make it difficult to enter the Mainland market. Efforts should be made at all levels to break these barriers, especially in Guangdong, our nearest and closest neighbour. The Guangdong government has set a goal to raise the ratio of tertiary industry in the Pearl River Delta from 47.3% of GDP in 2008 to over 60% by 2020. Mainland enterprises will need to undergo significant upgrading to achieve this goal. Seen in this light, the initiatives under CEPA and the Qianhai cooperation effort take on new urgency.

Conclusion

With China now the second-largest economy in the world, the 12th FYP aims to transform this wealth into domestic consumption and steer the country away from export dependence. The key to success lies in the ability to bring in competition, both domestic and foreign, to nurture the development of the service industry. This is where the Hong Kong's first class business services industry could contribute. As a matter of fact, the 12th FYP makes specific mention of supporting Hong Kong's development of high-value-added services and further integration with Guangdong Province.

The possibility of diverting luxury spending to Mainland through adjusting import tax could hurt Hong Kong's consumer industry. But overall speaking, the 12th FYP will nurture a strong consumer demand, and will benefit Hong Kong's consumer services sector. The recent ballooning demand from Mainlanders for Hong Kong's consumer goods, medical services and asset investments spell our very distinctive advantage in delivering quality services. However, to capitalize on these opportunities, Hong Kong must promptly expand its infrastructure and industry capacity to meet the surging demand. For example, China enters an era of high-speed rail that will link up all its major areas, covering 80% of cities in the Mainland. The slated completion of Hong Kong section of Guangzhou-Shenzhen-Hong Kong Express Rail Link by 2015 is a critical step for Hong Kong to tap into the hinterland's service market. These initiatives will help to uplift our competitiveness, and hence cement our position in the national economic development.

[1] "China Luxury Market Study 2010", Bain & Company (November 2010).