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Editor
Arthur Kroeber

Managing editor
Tom Miller

Researchers
Alanis Qin, Rosealea Yao, Janet Zhang, Will Freeman

Sales manager
Julien Guillaume

Production
Big Brains Ltd

Dragonomics Beijing office
15D Oriental Kenzo Office Building
48 Dongzhimenwai Dajie
Beijing 100027 China
Tel 86 10 8454 9987
Fax 86 10 8454 9984

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Main economic indicators

Values	2005	2006	2007	2008	2009f
GDP, Rmb trn	18.4	21.2	25.7	30.1	32.8
GDP, US$ trn	2.2	2.7	3.3	4.2	4.8
GDP per capita, US$	1,700	2,000	2,500	3,200	3,600
Fixed asset investment, Rmb trn	8.9	11.0	13.7	17.2	19.3
Industrial value added, Rmb trn	6.6	8.0	9.5	10.7	11.5
Retail sales, Rmb trn	6.7	7.6	8.9	10.8	12.0
Deposits of financial institutions, Rmb trn	28.7	33.5	38.9	46.6	53.6
Loans of financial institutions, Rmb trn	19.5	22.5	26.2	30.3	34.9
Government revenue, Rmb trn	3.2	3.9	5.1	6.1	6.4
Government expenditure, Rmb trn	3.4	4.0	5.0	6.3	7.5
Exports, US$ bn	762	969	1,218	1,429	1,357
Imports, US$ bn	660	792	956	1,133	1,076
Trade balance, US$ bn	102	178	262	296	281
Net foreign direct investment, US$ bn	68	60	121	100	80
Foreign exchange reserves, US$ bn	819	1,066	1,528	1,946	2,200

Growth rates (%)	2005	2006	2007	2008	2009f
GDP (nominal)	15.0	15.3	21.4	16.9	9.0
GDP (real)	10.4	11.6	13.0	9.0	7.0
Fixed asset investment (real)	23.7	21.0	19.4	15.2	10.0
Industrial value added (real)	16.4	16.6	18.5	12.9	8.0
Retail sales (real)	11.1	12.6	12.5	14.8	10.0
Deposits of financial institutions	19.4	16.8	16.1	19.7	15.0
Loans of financial institutions	13.2	15.7	16.1	18.8	15.0
M2	17.6	16.9	16.7	17.8	16.0
Government revenue	19.9	22.4	32.4	19.5	5.0
Government expenditure	19.1	18.5	22.6	25.9	20.0
Exports	28.4	27.2	25.7	17.2	(5.0)
Imports	17.6	20.0	20.8	18.5	(5.0)

Price indices (%)	2005	2006	2007	2008	2009f
Implicit GDP deflator	4.2	3.3	7.4	7.2	1.9
Consumer price index, (avg of monthly rates)	1.8	1.5	4.8	5.9	1.0
Producer price index (avg of monthly rates)	4.9	3.0	3.1	6.9	(2.0)
Urban house prices, year-end	7.5	6.2	7.6	6.5	(5.0)
1-yr deposit interest rate, year-end	2.25	2.52	4.14	2.25	1.98
1-yr loan interest rate, year-end	5.58	6.12	7.47	5.31	5.31
Exchange rate, Rmb/US$, year-end	8.1	7.8	7.4	6.8	6.8

Key ratios (% of GDP)	2005	2006	2007	2008	2009f
Budget balance	(1.3)	(1.2)	0.7	(0.4)	(3.2)
Government debt	17.9	17.3	17.0	16.8	18.5
Current account	7.2	9.4	11.0	10.0	8.0

Growth rates nominal unless otherwise indicated
f = forecast, e = estimate
Source: NBS, CEIC, IMF, Dragonomics estimates

Economic survey

China's economy grew by 9% in 2008, according to official figures – the slowest rate since 2001. The year-on-year growth rate in the fourth quarter, 6.8%, was also the lowest in seven years. The downturn resulted from a combination of two factors: a collapse in the property market early in the year which then fed through to a severe reduction in demand for heavy industrial materials, and a dramatic slowdown in export growth as a result of the global financial crisis and recession.

The government response has been a substantial monetary and fiscal stimulus, designed to meet the goal of "*bao ba*" or "protecting eight [percent growth]." Despite this, most private analysts are skeptical that China will be able to generate that level of growth when the rest of the world is in severe recession, and the most pessimistic forecasters suggest China will be hard pressed to grow at all in 2009. There is also a widespread view that official growth numbers this year will be untrustworthy, since the government has a strong incentive to paint an overly rosy picture (as it did during the recession of 1998-99 when official GDP growth never fell below 7% despite abundant indirect evidence that the true growth rate was closer to 5%). At a time of much uncertainty and heated debate about details, it is worth stepping back and separating out the essential issues from the incidental ones.

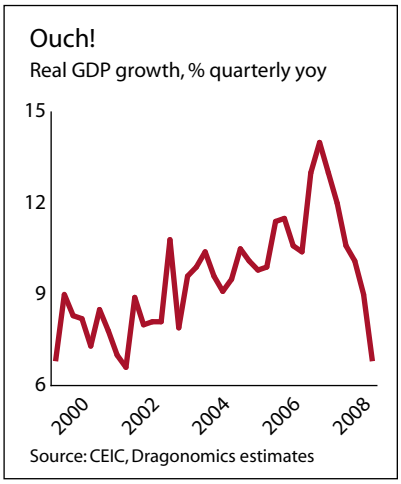
Structure of GDP, 2008

	% share of GDP	Real growth %
Production		
Agriculture	11	5.5
Industry	49	9.3
Services	40	9.5
Expenditure		
Capital formation	44	12.1
Consumption	49	8.6
Net exports	8	5.0

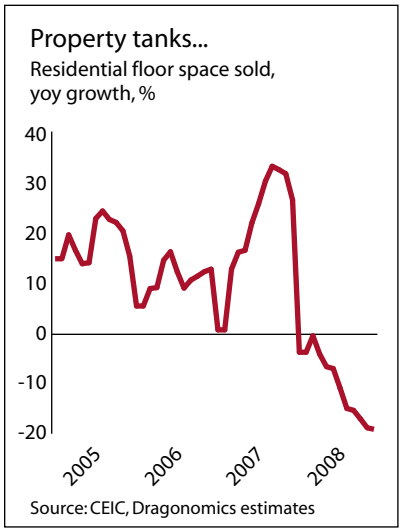
Source: NBS, Dragonomics estimates

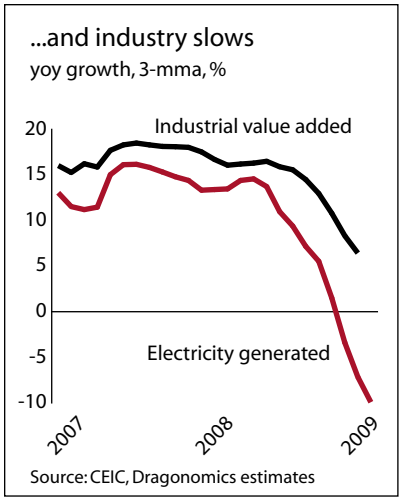
Downshift

First, obsessing about the exact rate of GDP growth is not terribly useful. GDP in all countries is at best an estimate, and in China an extremely rough one. The key point is to identify at which of its three normal gears China's economy is growing: slow (below 7%), fast (7-10%) or insanely fast (above 10%). In 2003-07 China was in third gear, in 2008 it slipped into second, and since the fourth quarter of 2008 it seems to have been running in first. The main question is whether growth will stabilize in first gear, or at the lower end of second.



Second, comparisons with past episodes are perilous because global conditions are quite unlike what they have been at any previous point in China's economic reform period. For the past 27 years, global trade on average has grown at nearly twice the rate of global GDP; this year, it will contract for the first time since 1982. Since 1978, China has never once experienced a year in which its exports fell; this year its export value will almost certainly fall. This matters because China's trade dependence has never been higher: in 2008, the ratios of total trade and net exports to GDP were 60% and 33% respectively, both figures about double what they were in 1998. The trade surplus averaged 7% of GDP in 2006-08, the highest figure ever. We assume that we are entering a period of at least two or three years during which global trade will be at best flat and it will be difficult for Chinese exports to grow. This introduces a significant new constraint on the Chinese economy and makes a return to third-gear growth (or even the higher end of second) extremely unlikely.





Third, China's domestic credit and fiscal position is far stronger than that of virtually any other major economy. Total official government debt, including the informal borrowings of local governments, is probably around 20% of GDP. Over the last decade, the government ran a sensible counter-cyclical fiscal policy, expanding deficits in 1998-2002 when times were tough and then moving into a surplus by the end of the 2003-07 boom cycle. There is plenty of room for a sustained fiscal expansion. On the monetary side, Chinese banks have considerable ability to expand lending, given that recognized non-performing loans are low (2% of assets), capital ratios are strong (above 10% at most banks) and required reserve ratios are high (15%), meaning that substantial funds can be unlocked simply by reducing required reserves to their historic lows of 6-7%. In this respect China is in a completely different position from most other major economies, in which credit is contracting. This fiscal and monetary capacity has not been adequately accounted for in the ultra-pessimistic private forecasts.

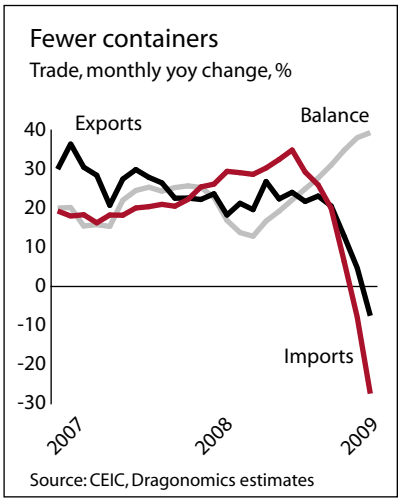
Bring back Zhu Rongji

Fourth, fiscal and monetary stimulus are adequate to stabilize growth at a socially acceptable level, but they cannot keep China's motor running in second gear for more than a couple of years unless accompanied by structural reforms to boost productivity growth. During the last fiscal expansion in the late 1990s there were two major structural reforms: privatization of the housing market, which created the commercial real estate industry; and a drastic pruning of the state-owned enterprise sector, which excised one of the least efficient parts of the economy and enabled the growth of a highly productive private sector. Real estate and private enterprise were two of the main growth engines in the 2003-07 boom. One analogous opportunity today lies in liberalizing domestic service industries that remain bastions of administrative state-owned oligopolies. Unfortunately, there is little evidence of any serious proposals in this regard.

There is more hope in the other main structural opportunity, which is boosting domestic consumption through aggressive expansion of the government-provided social safety net, which should encourage households eventually to reduce their saving rate. In January, the government announced a three-year, Rmb850 bn plan to create a universal basic health insurance system. This is a good start, but it needs to be followed up with other large-scale social welfare spending programs; and these programs should ultimately replace traditionally favored building projects (which generate quick jobs but have relatively few multipliers) as the main focus of fiscal stimulus spending.

Fifth, employment creation will be a very serious issue, but China is nowhere near an Armageddon of joblessness. Much recent attention focused on a survey by the Ministry of Labor and Human Resources estimating that 20m migrant workers (out of 130m or so) lost their jobs in coastal China and returned home. Another survey by the Ministry of

Agriculture put the number at 12m; it is not clear why one should favor one survey over the other since the sampling techniques of both were likely defective. Moreover, neither survey provided a year-earlier baseline figure, leaving people to assume that migrant unemployment had suddenly zoomed from zero to 20m. This is almost certainly false: it is quite common for migrants to quit jobs just before the lunar new year and then re-enter the workforce afterwards. More broadly, the Chinese labor market is extremely flexible and much of the job gap can be filled by people accepting lower wages. This adjustment will take a bit of time, but it is likely that by the end of 2009 a new and lower market-clearing wage will have been established, enabling a reasonable rate of job creation.



The Party will go on

Lower wages – or at any rate sharply lower annual wage growth – will, however, bring two troubling consequences. Household consumption will obviously be weakened by reduced income growth, and this will stymie efforts to shift the economic center of gravity away from investment and toward consumption. This underscores how crucial it is for the government to reduce the calls on household cash by vigorously expanding social services. Another, more subtle point is that a reduction in wages and unit labor costs will engineer a depreciation in China's real exchange rate relative to any country with a less flexible labor market – that is to say, just about everyone. This means that Chinese exports will increase in competitiveness and the trade surplus could hold steady or rise even if absolute exports fall (because everyone else's exports will fall even more). This is good for China in the short run, but any increase in the Chinese surplus at a time of global recession risks creating serious protectionist pressures elsewhere.

Finally, no one should assume that a period of severe economic stress poses any serious threat to the stability of the government. The state has ample resources and highly developed skills at directing them where

Agriculture and industry

Key indicators

	2005	2006	2007	2008
Total sown area, m ha	122	122	122	na
Grain production, m tons	484	497	502	529
Oil production, m tons	181	184	187	189
Oil imports, m tons	127	145	163	179
Steel production, m tons	356	425	493	498
Vehicle sales, m units	5.8	7.2	8.8	9.4
Passenger car sales, m units	2.8	3.8	4.7	5.0
Coastal port throughput, m tons	2,928	3,420	3,850	4,280
Electricity production, bn kWh	2,415	2,756	3,181	3,392
Electricity capacity, gW	517	624	713	760
Fixed telephone lines, m	350	367	365	341
Mobile telephone lines, m	393	461	547	641
Teledensity, lines per 100 people*	57	63	69	74
Internet users, m	92	108	148	198

Source: NBS, Mofcom, MII, CNNIC, Ministry of Communication, China Electricity Council, Dragonomics estimates

*Fixed and mobile

Migrant workers should be able to cope with this year's difficult times

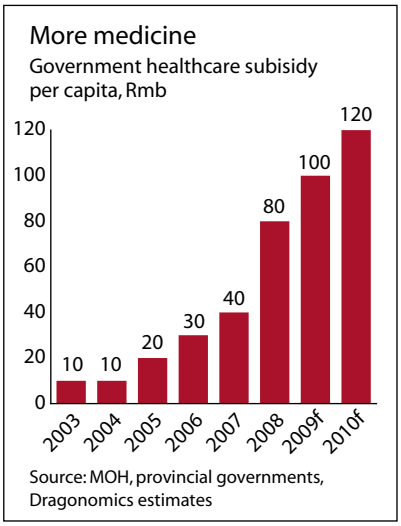
they are most needed. Despite the current problems, most people are materially far better off than at any point in the past, and these gains are almost certain to continue albeit at a significantly slower pace. The worst-hit group today, migrant workers, is also the group of people most accustomed to dealing with difficult and changing circumstances, most attached to an ideology of self-reliance, and least interested in or capable of political organization (anyone with lingering doubts on this score is advised to read Leslie Chang's excellent new book *Factory Girls*, the best description of the lives and thoughts of Chinese migrant workers). With luck, the coming period of economic stress will force significant structural reforms in China. But regime change is unlikely to be one of them.

Social services

Healthcare for all - but how much?

by Will Freeman and Janet Zhang

In January, Beijing announced a new medical reform plan – a central plank in its long-term social reform agenda. The plan, which promises to extend basic health coverage to a minimum of 90% of the population by 2011 at a headline cost of Rmb850 bn, is in theory a major step towards establishing a modern healthcare system. Like so many of Beijing's spending initiatives, the details are murky: significant questions remain over what constitutes "basic" healthcare, how non-basic services will be funded, and how much of the headline figure is new spending. But the commitment to a universal scheme is nonetheless a significant advance, and large increases in government health expenditure are likely for several years.



Basic health indicators, such as life expectancy and infant mortality rates, have improved steadily over the past decade. But China's healthcare system faces mounting problems: demand for healthcare is rising in volume and complexity, primary care infrastructure is inadequate, and detection and treatment of chronic diseases is poor (see "Health care: Time for a check-up," *CEQ* 2007 Q3). Most healthcare is dispensed by hospitals that frequently prescribe unnecessary drugs and procedures to increase revenues. Insurance schemes reimburse rather than pay hospitals directly, which means they have no power to rein in unethical practices, and reimbursement rates are low. As a result, the burden of rising healthcare costs falls inordinately on individuals. Exorbitant healthcare costs are a big reason for high Chinese household saving, and are therefore a major drag on private consumption.

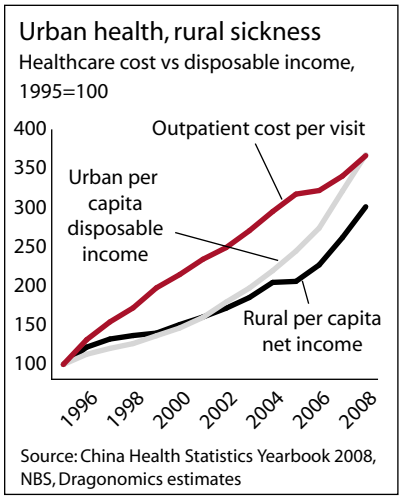
The third way

Free for all or insurance backed?

When the State Council began deliberating healthcare reform in 2006, two opposing factions emerged. The Ministry of Health (MOH) argued for re-nationalizing the system to provide free basic healthcare for all citizens. The Ministry of Finance (MOF) argued for increasing coverage and reimbursement rates within the system, and for creating a third-party purchase mechanism whereby insurers could refuse to pay hospitals for undue expenses.

The new plan takes the middle road, promising to "provide universal medical service" as well as "basic medical security" for all citizens. Initially, universal coverage means extending the present government health insurance programs to 90% of the population by 2011. Fifty-two percent of urban residents and 92% of rural residents were covered in 2008, so the new plan implies a major increase in urban coverage. (The high rural coverage rate disguises the fact that the value of coverage is very low, and

Will Freeman and Janet Zhang are Dragonomics research analysts based in Beijing.



most rural residents live out of easy reach of hospitals and clinics.) The minimum subsidy for all individuals covered by the scheme will rise from Rmb80 to Rmb120 by 2010. MOH will also increase the number of drugs for which patients receive the highest level of insurance reimbursement, but the plan makes no move toward third-party purchase.

Instead, MOH will launch a pilot program for "public hospital reform," which has two major components. First, MOH plans to remove margins on drug sales to take away the incentive for hospitals to over-prescribe. About 40% of public hospitals' revenues come from drug sales, with sales margins capped at 15%. That means that hospitals face a maximum loss of about 6% of revenues. MOH plans to replace these lost revenues with prescription and service fees, and government subsidies. Second, MOH will assess the performance of health facilities to ensure they are acting in the "public interest," which likely means providing affordable care to everyone who needs it instead of only to those who produce the largest wad of cash. Other assessments will focus on the quality of care and management, as well as malpractice and safety issues.

The cost of life

Details on the Rmb850 bn slated to fund the plan are minimal. Average annual growth in government healthcare expenditure over the last five years was about 25%. If the entire RMB850 bn package represents new, previously unbudgeted spending, healthcare spending will grow by at least 45% over the next three years. But if the figure includes already budgeted spending, this implies a growth rate of below 10% through 2011. In practice, the headline figure probably includes both previously budgeted and new spending. A very conservative estimate of additional healthcare spending would amount to about Rmb300 bn, or one-third of the headline figure. Assuming ordinary growth of a modest 10%, total healthcare spending for the next three years should total at least Rmb1.2 trn.

The central government paid for no more than 3% of health care in the last decade

A minimum of around Rmb150 bn will be spent on increasing the subsidy for individual insurance premiums and expanding basic health care in urban areas. It is impossible to calculate the exact increase because the new Rmb120 subsidy is only the minimum amount that must be spent on each citizen: in practice, local governments shoulder the vast majority of public healthcare spending and often add to minimums set by central government. The central government paid for no more than 3% of public expenditure on healthcare operations over the last decade. As a result, healthcare quality varies widely among provinces: per capita health expenditure of the five richest provinces was five times that of the five poorest in 2007. Reimbursement ratios also vary considerably among provinces. While media reports suggest Beijing will pay for more than a third of the new plan, vast regional disparities in healthcare spending and quality will certainly continue.

Another major portion of additional spending will go to boosting primary care. The government will support the construction of 2,000 new county-level hospitals and 29,000 township health centers, according to

health minister Chen Zhu. This should cost around Rmb200 bn, but it is unclear how much of this expenditure will come out of the Rmb850 bn package. Professor Gu Xin, a health policy expert at Peking University, estimates that an additional Rmb24 bn will be invested in urban community health centers.

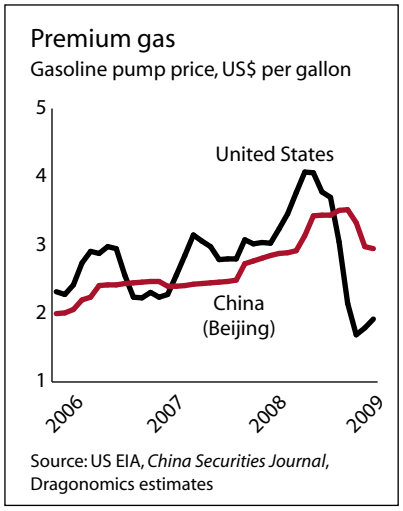
The new medical plan is China's first ever commitment to universal health care

For all its lack of clarity, the new medical reform plan is the first explicit commitment to universal, government-provided healthcare. In theory, the plan marks a historic step toward making healthcare affordable for all Chinese citizens. It should lower drug costs, raise medical reimbursement rates and, in essence, nationalize a system of primary care. Above all, it will lessen the crippling economic burden of medical treatment currently shouldered by households. In the long term, this should chip away at the high household saving rate, boosting consumption and helping to rebalance the economy.

Energy

Fuel prices: new, improved – and higher

by David Stanway



Following energy price reforms implemented on January 1, the era of artificially low oil prices in China appears to have ended. After a decade of paying lip service to market-based pricing, Beijing thinks it has finally created a pricing system designed to reflect supply and demand, as well as the environmental cost of oil. But while the market will play a bigger role in determining the price of fuel, the government will still have the final say. The real test of the new regime will come if and when the price of crude oil returns to the stratospheric levels of July 2008.

The new pricing system has three major elements. First, the retail price of gasoline and diesel will track changes in the price of international crude (prices of kerosene, jet fuel and fuel oil were already fully deregulated). Second, wholesale price formulas are rearranged to ensure a reasonable margin for oil refiners at any crude oil price up to US$130. This means refiners will no longer be compelled to sell their products below cost. Finally, a new fuel tax will promote resource efficiency and help to smooth out price volatility by putting a buffer between international crude prices and the domestic pump.

The still visible hand

This price system is somewhat more market-oriented than its predecessor, which created negative margins for refiners when the crude oil price rose in 2008, with the result that many refiners shut down production and shortages of gasoline and diesel emerged. But the government will still mandate maximum retail and wholesale prices, and will reserve the right to buck the market when necessary and adjust prices in a way that serves its various policy agendas.

Domestic refined oil prices will move in step with international prices when crude is below US$80 a barrel

In practice, sources suggest, domestic refined oil prices will move in step with international refined prices when crude is below US$80. From US$80-$130 a barrel, refiners will be guaranteed a modest profit rate but distributor margins will be cut, allowing retail prices to rise less than would be required under full price pass-through. When crude breaks above US$130 a barrel, retail prices may continue to move up, but with a lag and subject to caps. At that point, however, the refiners' guaranteed profit margin will be removed.

With the current crude price around US$40 a barrel, high prices are a purely hypothetical problem. In January, the National Development Reform Commission (NDRC) cut gasoline and diesel prices twice to reflect the decline in global crude prices. But the pump price for gasoline is still nearly 60% above the average US price, and the State Council is explicit that Chinese prices will remain higher than in the US. There

David Stanway is a journalist in Beijing specializing in energy issues.

are two possible reasons for this stance. First, the government wants to encourage resource efficiency, and to promote alternative transport technologies – such as coal-based liquid fuels or electric cars – that will enable it to cut its import dependence (China imports about half its oil). Maintaining a relatively high oil price allows more market space for these technologies to grow.

Beijing may be compensating Sinopec and PetroChina for last year's losses

Second, and more practically, Beijing may be deliberately fattening refining margins to compensate Sinopec and PetroChina for the policy-induced losses they incurred last year. According to calculations made by Citigroup, Sinopec's gasoline margins were around US$20 per barrel even after January's price cuts. Average refining margins vary from company to company but normally stand at about US$5-10 per barrel. China's refining margins were negative for much of 2008 but surged to over US$40 in November after the price of crude collapsed.

At some point, Beijing is likely to decide that the refiners have skimmed off enough cream and will cut prices. Just when this occurs will have something to do with how long the economy remains in its current weakened state. In fact, the failure to include any price floor in the new system has already resulted in competitive retail price cuts in most of China's major cities. Led by smaller retailers, both Sinopec and PetroChina were forced to slash their pump prices to remain competitive and to reduce their bulging stockpiles. Industrial oil consumption has declined by 5% since November, leading Credit Suisse to predict a 2-3% fall in overall Chinese oil demand this year. There is still considerable room for the government to cut prices further.

Bureaucratic tug-of-war

With 13 government bodies responsible for energy, coordinating policy is a struggle

Pushing through the price reforms took considerable political will. For years, the State Council's Energy Leading Group, chaired by Wen Jiabao and responsible for China's overall energy strategy, looked on in frustration as its instructions dissolved amid bureaucratic confusion. With 13 separate ministries and government bodies responsible for different aspects of energy policy, NDRC struggled to coordinate policy. But last year's establishment of the National Energy Administration (NEA) – a high-level group including many agency bosses – provided a mechanism for thrashing out conflicts and knocking heads together.

The thorniest issue was the fuel tax hike. China has long had a fuel tax, but at such a low level that it had no impact. NDRC has for years championed a proposal to increase the fuel tax substantially (mainly to meet the long-term resource efficiency and new technology goals mentioned above), with offsetting cancelations of highway tolls and road maintenance fees to assure revenue neutrality. But because the fuel tax is be collected by the central government, and local governments collect highway tolls and road maintenance fees, localities opposed the move. The Ministry of Transportation (MOT) also fought hard to maintain its share of the sundry taxes charged on China's vehicles and roads.

When Beijing finally levied the new fuel tax on January 1 – raising tax on gasoline by 25% and tax on diesel by 14% – it canceled six road maintenance fees and announced that it would begin removing the charges levied to pay for the construction of second- tier highways. Once all road maintenance fees are canceled, the expected revenue shortfall will be Rmb120-150 bn. According to local media reports, the central government has agreed to hand Rmb26 bn of the total fuel tax receipts to local authorities to help compensate the 100,000 toll booth workers expected to lose their jobs. Local governments are also concerned about how they will repay the considerable debts incurred during the process of road construction, which MOT estimates to be as much as Rmb500 bn.

Tolls on second-tier roads will be abolished – but gradually

But compromise is already evident. In the first stage, the tolls on second-tier highways – which account for around 60% of toll roads in China – will be abolished only gradually. While some provincial governments have canceled all charges immediately to gain access to central government compensation, others in central China are claiming they need five years to dismantle their toll systems. Local governments also remain in negotiations about their precise share of the new tax receipts.

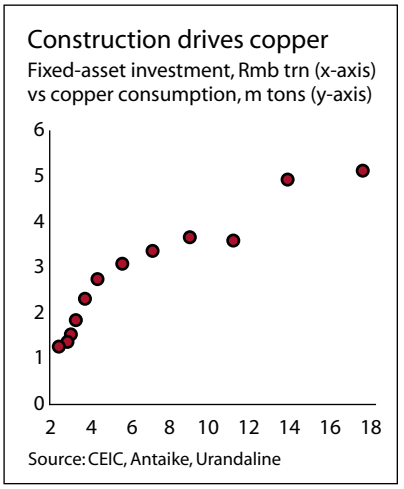
As ever, social stability remains the government's top priority. Beijing will not worry about squealing local officials so long as the reforms appear to be working and ordinary consumers remain happy. Thanks to the subsidies dished out to farmers, truckers and taxi drivers over the last few years, there has been little public outcry about high fuel prices, with most of the unrest actually caused by supply disruptions. So far, consumer fuel demand has remained relatively resilient. If the new pricing system can help alleviate the chaotic shortages that have hit China in the last few years, the regulators will be satisfied.

Metals man

Copper-bottomed

by Michael Komesaroff

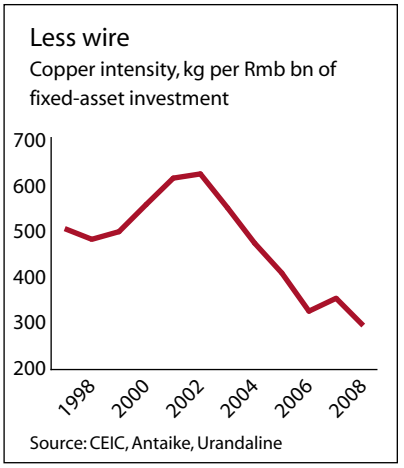
Over the past five years, despite falling consumption in the developed world, China's demand for copper kept global prices high. China alone accounts for 30% of global demand and, between 2004 and 2008, it absorbed three-quarters of the increase in world copper consumption. But in the second half of last year, local prices collapsed from Rmb61,000 a ton on the eve of the Beijing Olympics to Rmb24,300 by year-end, a decline of 60% in just five months. With fixed-asset investment this year likely to grow at its lowest rate in eight years and China's copper intensity declining, there is little reason to expect an uptick in demand. Yet, strangely, the opposite appears to be happening.



Tarnished metal

There are three reasons to be pessimistic about the copper market this year. First, copper demand in China is unusually reliant on the construction industry, which accounts for nearly three-quarters of annual consumption – far more than in developed markets. Last year's construction collapse, precipitated by Beijing's crackdown on the property market, hit the copper market hard. With the construction sector still on its knees, the strong correlation between China's level of fixed asset investment (FAI) and its consumption of refined copper suggests little prospect of renewed demand for the metal. Real FAI fell to 11% by the end of last year on a monthly basis, and there are signs that this year's figure may fall as low as 7.5%.

Second, there has been a decline in China's copper intensity – the amount of copper consumed per Rmb1 bn of fixed asset investment. Between 1997 and 2002 copper intensity steadily increased from 500kg per Rmb1 bn to a little over 600kg. But from 2003-07 intensity plummeted to around 300kg, where it has remained. This fall means that China must invest twice as much capital to consume the same amount of copper as it did seven years ago. A back of an envelope calculation shows that a 7.5 % increase in FAI at a copper intensity of 300kg would see apparent copper consumption grow by less than 7.5 % this year, close to the slowest growth in a decade.



Third, mounting stockpiles of copper at the Shanghai Futures Exchange are further evidence of weak demand. Since the beginning of the year, the exchange's stocks of copper have almost doubled from 18,000 to 34,000 tons. In short, the outlook for the copper market looks extremely gloomy.

Yet this doom-laden analysis ignores a significant bright spot on China's copper landscape: strong copper imports. Imports – which account for around a quarter of China's copper consumption – have grown in five of

Michael Komesaroff is principal of Urandaline Investments (www.urandaline.com.au), a consultancy specializing in China's capital intensive industries.

the past six months. In December they leapt to 210,000 tons, the highest level since April 2007 and the second highest ever. Preliminary data for January suggest that imports declined by about 20% on a monthly basis, but they were still twice the average monthly level of the previous five years.

Copper prices are still higher in China than abroad

Imports are likely to remain strong because, while Chinese copper prices are low, they are still significantly higher than the international benchmark price set by the London Metal Exchange (LME). Historically, a Chinese price premium has been a powerful magnet for consumers to import copper more cheaply from abroad. February's premium of Rmb1,580 per ton is more than sufficient to encourage strong imports in the coming months. Indeed, with the exception of several days either side of China's National Day celebrations last October, copper sold on the Shanghai exchange has traded at a premium over LME since the end of last September.

Another factor driving the surge in imports of refined copper is a huge drop in demand for scrap copper, with January's trade of 180,000 tons the lowest figure in at least five years. Lower refined copper prices mean that it is no longer profitable to collect scrap from developed countries such as the United States and ship it to China. In turn, this means that Chinese consumers need to use a greater proportion of pure metal in their final product. Because China is such a large copper consumer, this will support global refined copper prices and push up prices in China even more.

National demand

China is rumored to have been increasing its strategic copper reserve

A further reason for market optimism is evidence that Beijing has decided to increase the country's strategic copper reserve. Details of the reserve, which is managed by the State Reserve Bureau (SRB), are confidential. But rumor has it that buying has already begun, and that by mid-year the authorities could have accumulated 300,000-400,000 tons of copper – equivalent to around two months of national production. It is possible that some of these purchases for the strategic reserve have already been delivered, which could account for the strong December import volume.

SRB has two good reasons for replenishing its copper stocks. First, SRB is believed to have sold some 500,000 tons from its copper stockpile during 2006 as it worked to recover from a disastrously mistimed bet that the copper price would fall. When prices rose that year, SRB was forced to sell physical material to cover its short position. The current round of buying is therefore likely aimed in part at restoring SRB's stocks to their 2005 levels.

The Rmb4-trn stimulus package will generate strong metals demand – especially for copper

Second, China's announced Rmb4-trn stimulus package will generate strong demand for all metals this year, especially copper. A large slab of the package is slated to bolster the national power transmission and distribution grid, which is the weak link in China's power network. Since high-voltage transmission cables are extremely copper-intensive, this will generate enormous demand for copper. SRB's intervention in the market

is therefore also designed to ensure that copper stocks are sufficient. All told, SRB could buy more than 1m tons this year.

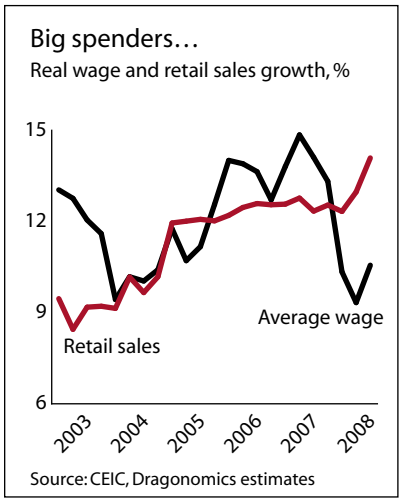
Copper consumers appear to be restocking

There are no reliable data on the volume of copper held by Chinese consumers, but most analysts expect that stocks are already fully depleted. Over the past two years, China's copper consumption was greater than the combined supply from domestic production and net imports, so the shortfall was made up by drawing down inventories. Consumers were naturally reluctant to replenish their stocks while prices were high. But with the stimulus package now kicking in and signs that prices are already bottoming, they are likely to begin restocking. Suddenly, the copper market looks a little shinier.

Retail markets

Spending up, malls down

by Paul French



Despite doom-laden forecasts that the mainland economy is going down the tubes, the retail market is holding up surprisingly well. As usual, urban and non-food sales were the strongest segments of the retail economy in 2008. By the second half of the year – after the retailing "dead zone" of the Olympics had passed – food sales picked up as price inflation receded, and annual urban retail consumption grew 21%. Although rural consumption was a little weaker, rural growth rates were not significantly affected by the downturn in the coastal economy.

The new year also started with a bang. During the January 1-3 holiday, Shanghai commercial sales revenue hit a 10-year high, Tianjin saw a dozen of its major retail shops record a 100% rise in sales, Beijing topped a respectable 16%, and commercial sales revenue in Chongqing (long a tough retail market for anyone selling more than basic items) grew by over 50%, also a 10-year high. The Ministry of Commerce claimed 13% growth year-on-year across China. Credit may finally be boosting sales growth; UnionPay reported that bank card transaction value increased by 70.5% year-on-year to Rmb59 bn.

One explanation for these figures is that leading Chinese retailers are learning to balance new store investments and sales revenue. For the top-10 listed retailers, profit margins were no worse in Q3 2008 than they were in Q3 2005, Q3 2006 or Q3 2007. Indeed sales turnover growth was actually better in 2008 than in 2007 or 2006. Retailers appear to have realized that scale is not the be-all and end-all of success in China: you need to control rental and purchasing costs, and streamline logistics too.

Retail sales are growing faster inland than in coastal regions

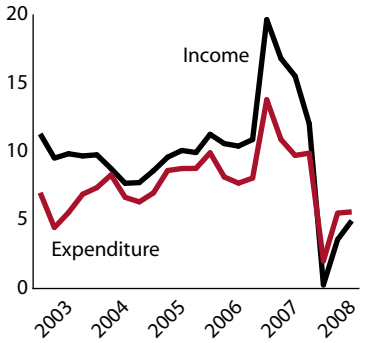
Retail therapy

Nobody will have been more pleased with early January's robust sales figures than the central government, which has staked its reputation on delivering continued economic growth through rising consumption. In particular, strong growth numbers in semi-rural areas indicate that "sales promotions" on appliances in the countryside (effectively waiving VAT on a range of appliances from refrigerators and air conditioners to small heaters and microwaves) are lifting sales and thus creating an unprecedented number of first-generation purchasers. They also helped clear the persistently high inventory levels of the Chinese domestic brands chosen to participate in the promotion. Moreover, retail sales are now growing faster in the hinterland than along the eastern coastal strip, where sales are traditionally stronger. Sales growth in early January was a healthy 16-26% in eastern coastal cities but a much higher 29-50% in inland cities. This suggests the domestic continental economy has retained higher

Paul French is the principal of Access Asia, a Shanghai-based retail consultancy.

levels of consumer confidence than the export-dependent eastern coast. With Beijing touting robust retail sales as evidence that the stimulus package is working, retailing has suddenly taken on a positive political hue. The upside to this for retailers is that permits to build new stores are easier to obtain. Expansion is being boosted by local government support for greater investment in new suburbs to create a veneer of service provision. One of the big complaints of new suburbanites is a lack of social infrastructure (clinics, hospitals, and so on). A new mall, some 24-hour convenience stores and a hypermarket partially fill this vacuum without any state spending. Many rental contracts for suburban stores stipulate that all store front and shop window lighting be left on 24 hours a day, presumably to help create an illusion of activity and life in otherwise drab dormitory estates. The benefit for retailers is that sales are growing, especially at the weekends when many new suburbanites no longer head downtown to shop. Cheaper suburban rents also help squeeze back some margin.

… or sensible spenders?
Household income and expenditure growth, yoy real growth, %



Source: CEIC, Dragonomics estimates

For most of the major retail chains in China, the last few years were about the race to roll out as many new stores as possible. Consequently, retailers paid more attention to expanding their "footprint" than raising sales at existing stores. The rush to secure locations for everything from Starbucks outlets to petrol stations with attached convenience stores pushed up rental costs across the country. This process has now largely come to an end as some large chains such as Gome (appliances) and Li Ning (sportswear) realize they need to pay more attention to existing stores.

Brands on top

Mall over-development has given retail brands the upper hand

Department store and mall retailing is always a tussle between the department store/mall owners and the retail brands. Store owners want the best rents and high commissions; brands want low rents and reasonable commissions. The over-development of malls has given brands the upper hand. Projections of the department store groups are weak and the department stores are largely crying tough times ahead. Same store

What's real and what's not in the retail numbers

Retail demand appears to be holding up well in face of the economic slowdown. But we counsel against drawing firm conclusions about private consumption from official retail numbers for two reasons. First, "retail sales" includes a lot of non-consumer purchases, notably by government. Second, the number is usually reported on a nominal not a real basis. We estimate that real retail sales grew 14.8% in 2008, up from 12.5% in 2007. But this is hard to explain given that income growth was substantially weaker last year than in 2007.

Our conclusion, as usual, is that the retail sales number is a poor proxy for private consumption. In 2005-06, real retail sales grew about 2.5 points faster than real urban incomes. In 2007 incomes grew slightly faster. Yet in 2008, real retail sales grew 6 points faster than urban incomes. The government's explanation for this gap is that households are spending down their savings on items like houses and cars; but this is highly implausible because the household survey data give no hint of this.

Moreover, growth in purchases of houses and cars fell dramatically last year; so the gap between spending and income should have narrowed, not widened. A more plausible explanation is that the retail sales number includes government purchases, which likely accelerated in the second half of last year as Beijing boosted spending to prop up the ailing economy.

sales at Parkson, the only genuine nationwide department store chain in China, slumped into low single digits in December. A closer examination shows that it is their commission earnings that are taking the biggest hit: brands are enjoying more sales in the department stores, but they are passing along a smaller cut to the store owner.

Filling malls is a major headache for developers

One problem is that many cities – especially Beijing – have massively overbuilt both in terms of the number of malls and the size of those completed. Filling them is a major headache for the developers. The only answer is either to leave them uninvitingly empty or to give the space away to retailers. Brands are increasingly in a p osition to demand rent-free mall space on which they agree to pay commission, effectively saying: "If we sell anything, we'll give you a cut; if we don't, we won't." Property developers are finally learning the limits of the "build it and they will come" business model. Exorcizing China's infamous "ghost malls" – faux-marble palaces devoid of shops and customers – will require greater attention to market reality.

This reflects a difference between Chinese and European/American retail: department stores are simply malls writ small. There are no American-style "merchandisers" (men's trousers third floor; ladies' dresses second floor, and so on). Both department stores and malls are simply places where retail brands rent space; if the customers do not come, they simply cut their losses and leave the developer bereft of tenants. Extravagant malls such as Beijing's 80,000-sq-m The Place are losing retail tenants while not adding consumer traffic – the death spiral of mall retailing.

Mall oversupply will continue to worsen

And the oversupply situation is going to get worse – especially in Beijing, where a new 5,000-sq-m InTime-Lotte department store has opened on the main retail drag of Wangfujing, and two new gigantic malls are planned around the corner on Jinbao Street. All target luxury customers, even as high-end retail brands close stores in existing malls! At the same time, the SOHO projects at Shangdu and Chaowai are clamoring for tenants, and that's without mentioning SOHO's new 470,000-sq m project in Sanlitun. The mall developers of Beijing can expect the brands to squeeze them on both rents and commissions – and they have no one to blame but themselves.

Stock markets

Don't bet on it

by Chao Gupiao

Shanghai's latest rally is not for real

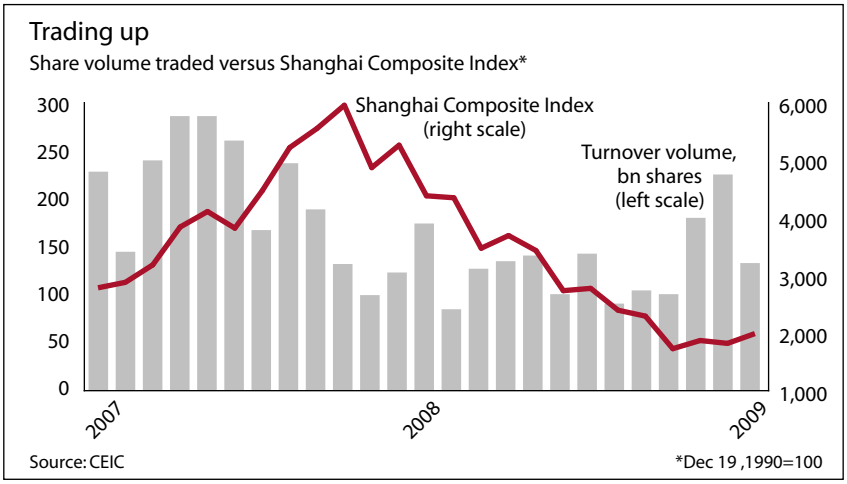
Just in case you missed it, Chinese stocks had a dreadful 2008. The Shanghai Composite Index finished at 1,820 points, down over 65% for the full year and back to a trough not seen since 2005. Most retail investors were well under water as mutual fund redemptions remained reasonably muted all year. After the regulator's year-long efforts to prop up the market failed, signs of stability returned in November when the state – via the National Social Security Fund, Central Huijin and state-owned enterprises – stepped back into the market. The subsequent rally pushed the market up to 2,300 in late February. So far this year, Shanghai is up nearly 25%, making it once again the world's outperformer. Is the rally for real? In a word, no.

Corporate earnings are generally bad

Corporate earnings reports have begun to come out and are generally bad. Even Chinese companies cannot make profits rise while the economy slumps. But punters appear to have stopped betting on company profits and started betting instead on the government's Rmb4-trn economic stimulus package. The stimulus package is the envy of the developed world: that China can simply decide to spend Rmb4 trn without any public discussion is awe-inspiring to policy makers in other countries who are subject to checks, balances, and fiscal and political constraints. Some foolhardy economists claim that thanks to the stimulus China is already coming out of its slump. But with Chinese data so skimpy and factory workers being laid off by the day, it is far too early to conclude that the country has emerged from the economic woods.

Don't believe the hype

What is really impressive about the rally is the high turnover: given that the value being traded is so high while the index level is so low, there are



Chao Gupiao is the alter-ego of correspondents in Chinese stock markets.

actually more shares being bought and sold now than at the market's peak in October 2007. In the second week of February, the Shanghai exchange traded more value than the rest of Asia ex-Japan combined.

Sky-high trading volumes appear to be fuelled by bank lending

Sky-high trading volumes strongly suggest that what we are seeing is a short-term liquidity effect. Sure, mutual funds have switched back into stocks and QFII interest has picked up, but that cannot explain the boom in volumes. Nor is there any evidence that the fabled retail investor has returned. Bank lending gone haywire provides a better explanation. In December and January, Chinese banks lent an astonishing Rmb2.5 trn, in effect quadrupling monthly loan volume from its average level in the first 11 months of 2008. At least one-third of this credit has taken the form of short-term commercial bill discounts, which is lending for cash flow rather than investment. It is likely that a good bit of this cash found its way into the stock market. With no sign of new listings, no word of the promised index futures and still no launch of margin financing, there is precious little evidence of genuine confidence returning to the market, either from investors or from the regulator. Fundamentals remain unchanged – and your correspondent senses a market still vulnerable to collapse.

City populations

Measuring the urban millions

by Kam Wing Chan

"Virtually overnight, Chongqing has become the largest city not only in China but in the world," *Time* magazine proclaimed in 2005. This is an odd statement because Chongqing is not generally considered the largest city in China – at least not in the meaning of "city" as we normally understand it. Common confusion over the true population size of Chongqing and other Chinese cities reflects the fact that China has highly complex and confusing urban and city statistical data. Making sense of these statistics – the basis for calculating per capita urban incomes and therefore estimating the size of consumer markets – is essential for producing an accurate analysis of China's economy and business environment.

Understanding Chinese definitions of what constitutes a city is vital for all economic and business analysis

What is clear enough is that China has the world's largest urban population. The National Bureau of Statistics (NBS) reports that the urban population grew to nearly 600m by the end of 2007, accounting for about 45% of the nation's 1.32 bn inhabitants. The statistics become murkier, however, when we move down to individual cities. Two major causes of the statistical confusion are the multiple indicators used to define city/urban populations and a rather complicated urban administrative system. The situation is entangled further by the continuing rapid economic and social changes in the country and the periodic adjustments of its administrative and statistical systems.

China already has the world's largest urban population

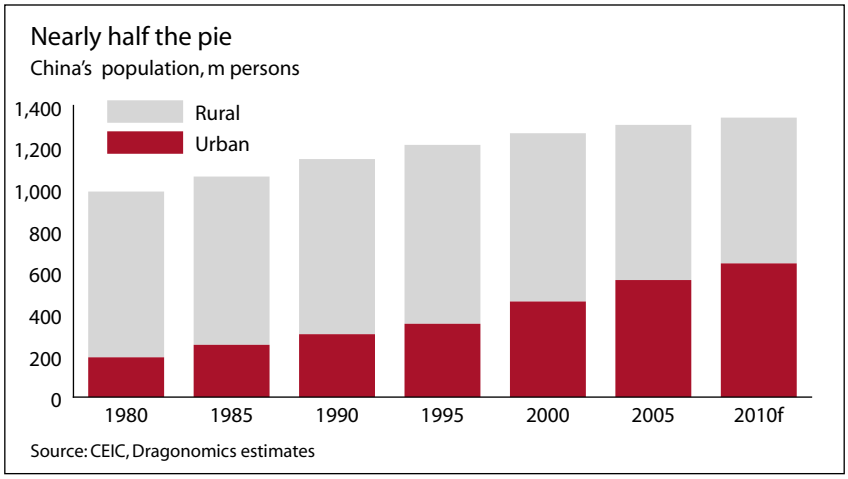
Studying city development requires delimiting cities within meaningful geographical boundaries. All cities of any size contain a continuous built-up area, and many have nearby residential and industrial suburbs. Many large cities, especially in developed countries, also have an extensive daily commuting zone closely related functionally to the urban core. The urban core and the commuting zone combine to form the metropolitan area.

Cities made of grass

As in other countries, a Chinese city or municipality (*shi*) is an administrative unit. Confusion over urban population sizes arises because the boundaries of large Chinese cities typically encompass an urbanized core (high-density built-up area) surrounded by numerous scattered towns and large stretches of rural territory, usually with dense farming populations. These cities are so large in area that they are more aptly called regions. The most extreme example is Chongqing, which has an administrative area of 82,300 sq km (about the size of Austria) and a resident population of around 32m. Clearly this figure does not represent the true metropolitan population because more than two-thirds of the employed workers in Chongqing are engaged in agriculture.

Many Chinese cities include large agricultural populations

Kam Wing Chan is professor of geography at the University of Washington.
He gratefully acknowledges the help of Richard L. Forstall for his comments and assistance.



There are two main ways to define urban areas in China: by administrative boundaries or by objective criteria such as the density of population and buildings. In Chinese cities, administrative boundaries and objectively urbanized zones overlap, often confusingly. A Chinese municipality comprises two types of administrative jurisdictions, "city districts" (*shiqu)* and counties (*xian*). Typically, most of the *shiqu* are objectively urbanized. The counties are mostly rural but may contain urbanized pockets, often referred to as "towns."

For most big cities, the actual population is significantly bigger than the registered population

The situation is complicated further by the important official distinction between two groups of individual Chinese citizens, those with local residence permits or *hukou* and those without (see "*Hukou* system: still going strong"). Although population statistics based on the number of local *hukou* holders are issued every year and are widely available, they do not show the actual population of cities. The numbers are, however, often mistakenly used as such. For almost all major cities, the *hukou* population is smaller than the actual population, which includes migrants whose *hukou* remains back in their original community. In some cases, such as in the well-known migrant city of Shenzhen, the differences are huge. Shenzhen's 2000 population with local *hukou* was only 1.3m, whereas the 2000 Census, based on exactly the same geographic boundary, reported a *de facto* resident population of 7m. The gap between Shenzhen's *hukou* and actual population continues to expand, rising from 5.7m in 2000 to 6.3m in 2005.

In summary, a Chinese city's population number may refer to any one of the following:

- The entire administrative municipality, including both city districts and counties.
- The city districts alone.
- The urbanized areas within the city districts.
- The population of city *hukou* holders (for any of the three geographic definitions above).

Four ways to slice it

Actual and registered (*hukou*) populations of China's 10 largest cities in 2000, m persons

		Municipality (city districts plus counties; actual)	City districts (actual)	City districts: urban areas (actual)	City districts (registered)
1	Shanghai	16.4	14.4	13.5	11.4
2	Beijing	13.6	11.5	9.9	9.7
3	Guangzhou	9.9	8.5	7.6	5.7
4	Wuhan	8.3	8.3	6.8	7.5
5	Tianjin	9.9	7.5	6.8	6.8
6	Shenzhen	7.0	7.0	6.5	1.3
7	Chongqing	30.5	9.7	6.2	9.0
8	Shenyang	7.2	5.3	4.6	4.9
9	Chengdu	11.1	4.3	4.0	3.4
10	Dongguan	6.5	6.5	3.9	1.5

Source: 2000 Census

The third definition, which is closest to the concept of "urban agglomeration" used by the United Nations, is considered a reasonable way to define the population of a city. This definition clearly supports the commonly held view that Shanghai is China's biggest city. Chongqing (6.2m), far from being the world's largest city, only ranked seventh in China with a population less than half that of Shanghai (13.5m) in 2000.

A question of definition

Officially, the national urban population is the aggregate of the urbanized areas of cities and towns. This approach yields an urban population of 562m (43% of national population) in 2005, up from 459m in 2000 – implying an annual increase in the Chinese urban population of about 21m. The vast majority of experts agree this is a reasonable way to define the urban population, although some consultants have raised serious doubts about that claim (one extreme survey estimated China's true urban population at 350m in 2005).*

New counting methods have led to major revisions of city populations

In 2006, the National Bureau of Statistics (NBS) adopted a new urban definition to give a better estimate of the actual urban population. The new definition uses smaller population units to differentiate more precisely between urban and rural areas, and relies more on urban physical extent than on administrative geography. This change had limited net statistical impact at the national level: under the new definition, the urban population reached 594m (45% of the population) in 2007, an increase of 32m or 5.7% over the 2005 urban population. But some individual cities showed greater sensitivity to this definitional change. One example is Dongguan, a major export-processing city in Guangdong with a dispersed urban-industrial spatial pattern. Based on the population of the city's urbanized areas, Dongguan's population grew from 3.9m in 2000 to 4.8m in 2005 under the 2000 definition, averaging about 4.3% per year. The urban population based on the new definition leapt by 20% to 5.7m in 2006. However, most cities are likely to show smaller population growth under the new definition.

*UBS, *How to Think About China,* Part 7 (2008 Edition), p.9.

Seeking the average Zhou

Per capita GDP of China's 10 largest cities, Rmb

	2000 Calculated using registered pop'n	2000 Calculated using actual pop'n	2006 As reported in yearbook
Shanghai	36,100	28,600	59,300
Beijing	23,900	20,300	52,000
Guangzhou	38,200	25,400	67,400
Wuhan	16,100	14,500	45,500
Tianjin	20,400	18,600	52,000
Shenzhen	133,300	23,800	69,500
Chongqing	8,800	8,100	17,100
Shenyang	19,300	17,700	45,800
Chengdu	19,900	15,500	39,300
Dongguan	32,100	7,600	39,500

Source: China City Statistical Yearbooks 2001 and 2007

Definitional changes and different statistical approaches to calculating urban populations matter because they can have a huge impact on economic planning and investment decisions. Multiple city population statistics in use in China serve different administrative, fiscal and statistical purposes – and failure to differentiate or interpret them correctly can result in highly distorted, if not outright erroneous, analysis.

Most new additions to urban populations are low-income migrants from the countryside

Many business analysts, for example, see the large and growing urban population as a potentially enormous mass consumer market. But since the bulk of China's present and likely future urban population growth comes from net migration from rural areas (including reclassification of the rural environs as cities expand), most new additions to the city population are low-income migrants from the countryside. Their situation is often aggravated by institutional discrimination and exclusion through the *hukou* system. Equating the expansion of the urban population with the growth of the middle class is simplistic. On the contrary, one could argue that since the urban newcomers are mostly poor migrants with little chance of assimilating into the urban population, China may well face an urban underclass rising to 250m within 10 years if the past trend continues.

Dodgy data

Choosing carefully the appropriate population statistics to represent the city is critical when generating per capita indicators. City population itself can represent market size, while per capita GDP is frequently employed as a yardstick of a city's economic well-being or its average consumer purchasing power. Since per capita GDP in China is a major indicator used to assess the performance of local government officials, there is also considerable political incentive to skew the per capita GDP numbers upwards (which can be done by understating the population).

Many efforts at calculating citizens' wealth have been seriously flawed by using the wrong population measure

Numerous studies comparing the competitiveness or productivity of cities in China have used the wrong city population numbers to generate per capita GDP and other measures. Many have applied the *hukou* population to compute per capita urban GDP, unaware that this population statistic

does not encompass all city residents and in some cases may include only a minority of the true population. According to calculations based on official data, for example, GDP per head in Shenzhen in 2000 was an astronomical RMB133,305 (US$16,097) – a ludicrous figure derived by counting only registered residents in a city largely populated by migrant workers.

All per capita GDP figures must be treated with caution

In an attempt to solve this problem, NBS demanded that all per capita GDP statistics published from 2005 onwards be based on the actual rather than *hukou* population. Judging from the data for the 10 largest cities for 2005 and 2006 published in *China City Statistical Yearbooks*, this move has successfully pulled Shenzhen's and Dongguan's per capita GDP numbers into line. Yet problems remain with the data for many other cities. Per capita GDP for Guangzhou (2005), Tianjin (2006) and Shenyang (2005 and 2006) was still calculated on the basis of the *hukou* population, producing inflated results. Even more unsystematic, Wuhan's 2006 per capita GDP actually used a base that excluded four of its city districts.

All this is evidence that, while national urban population figures are broadly accurate, individual city population numbers remain a statistical

Hukou system: still going strong

The industrialization strategy pursued by China during the Maoist era was based on strictly controlling rural-to-urban migration. The major means for doing this was the *hukou* or household registration system, set up in 1958. Under this system, all citizens were classified as either urban or rural residents. Urban residents (also called "non-agricultural population") had state-guaranteed food, jobs, housing and access to an array of subsidized welfare and social services. Rural residents had very few of these perquisites and had to rely on themselves or their collectives. In essence, the *hukou* system functioned as an internal passport system, similar to the *propiska* system used in the former Soviet Union.

Since the early 1980s, development of markets and the demand for cheap factory labor led to easing of some migratory controls. Rural migrants are now allowed to work in cities, mostly in low-end jobs shunned by many urban residents, but they are not eligible for basic urban social services and education programs. This group (called "rural migrant labor") was estimated at about 132m in 2006, most of whom lived in cities. This two-tier system of urban citizenship and the unequal treatment of the migrant population have drawn much concern and criticism both within China and outside.

In response, in recent years China has initiated a number of reforms to the *hukou* system. Those reforms have been widely interpreted as steps toward abolition of the *hukou* institution. For example, a *New York Times* headline in 2005 proclaimed: "China to Drop Urbanite-Peasant Legal Differences." This is a misunderstanding: most of the changes in the *hukou* system since the late 1990s have had only a marginal impact on the system's foundation – the separation of the population into two segments (loosely, rural and urban) – and discrimination based on that.

Actual changes in recent years include some devolving of the *hukou* system to local control, and the partial opening of city *hukou* to those with money or professional skills. Instead of the central government, city governments now approve the granting of local *hukou* for their jurisdiction. Cities have granted *hukou* mostly to wealthy individuals able to purchase a high-end apartment or make large business investments, or to those who have a degree or professional qualifications. Spouses and children of existing residents with local *hukou* may also be eligible. This has produced some easing in the *hukou* migration system for these select groups. Moreover, in some cities farmers in the urban periphery who have become landless through requisitioning are compensated by city *hukou* with partial welfare benefits. A handful of cities also experimented with plans in the early 2000s to allow some qualified migrant laborers to acquire city *hukou*. But these experiments were very limited in scope and were all soon withdrawn.

For the 100m-plus mostly poor rural migrant laborers, the chance of getting city *hukou* has not improved. The criteria for gaining city *hukou* set by local governments under the more "entrepreneurial" approach are clearly beyond the reach of most peasant migrants.

minefield. The result is that per capita GDP figures cannot be taken at face value in China. For economists and businessmen alike, careful research to understand what such numbers really represent is crucial before cranking the data.

How many houses?

The combination of strong urban population growth and the birth of the commercial housing market in the late 1990s created a housing boom that has been one of the principal drivers of China's economic growth over the past eight years. A severe slowdown in the housing market in early 2008 was one of the main contributors to the sudden economic slump later in the year.

To estimate the likelihood of a property market recovery – a crucial component of a more general economic recovery – we need to know the underlying demand for housing. In general terms, of course, a lot of people will move into the cities over the next couple of decades and this will create demand for new housing. But how many units, exactly, will need to be built? And is the current rate of construction higher or lower than the underlying demand? Unfortunately, available data make it hard to answer this question.

A simple way to estimate urban housing demand is to take the annual increase in urban population and divide by three (the average urban household size). Official data show that the average annual increase in the urban population in the years 2000-05 was 21m; in 2006-07 this figure dropped to 16m. This implies that through 2005 average underlying new housing demand could have been as high as 7m units, but that it dropped to 5.3m units in the latter two years.

This is unlikely to be correct. Chinese statisticians changed the way they counted urban population in 2006, to exclude people who had previously been classified as city-dwellers (because of expanding urban administrative boundaries) even though in reality they still lived in the countryside. In other words, the apparent decline in the rate of urban population growth in 2006-07 may simply have been the result of the adoption of a more accurate – and more restrictive – statistical definition of "urban." The true rate of people taking up urban residence may have stayed the same or even increased. Or it may have decreased – but by a smaller amount than the official numbers suggest. Since the urban population data before and after 2005 are non-comparable, it is hard to know for sure.

The bad news is another piece of data suggests the rate of true urban population growth may indeed have declined sharply in 2006-07. The annual rise in the number of people holding non-agricultural *hukou* fell from an average of 17m in 2000-05 to just 11m in 2006-07. The vast majority of people with non-agricultural *hukou* are urban, and so far as we know this annual data series is more consistent over time than the urban population figure because it is based on actual registrations (although coverage has changed somewhat because of recent *hukou* reforms).

But there are problems with this calculation too. The non-agricultural hukou count fails to capture more than a quarter of the true urban population: migrants who have retained agricultural *hukou*, or people with no *hukou* at all. The slowdown in the rise of non-agricultural *hukou* holders could simply mean that city governments were making it more difficult to swap one's original agricultural *hukou* for a non-agricultural one. And it is hard to square these statistics with the widespread on-the-ground impression in the boom years of 2006-07 that villages were emptying out and all their residents were moving to the cities. The questions of how many new urban households are created each year, and how much new housing they require, still await a definitive answer.

– Kam Wing Chan & Arthur Kroeber

Development models

Big cities, small cities

by Tom Miller

By 2030, the population of China's towns and cities is expected to swell to 1 bn. The pace of urbanization in China, driven by rural migrants fleeing the penury of the fields for a better life in the city, is unprecedented. In 1980 a paltry 20% of Chinese citizens lived in urban areas, a figure associated with the poorest countries on earth. By 2030, urban residents will make up 70% of China's population, more than in Japan or Italy today. Beijing views economic growth and urbanization as two sides of the same coin, and is pumping cash into creating the infrastructure needed to accommodate 400m new city dwellers. But managing this vast migration in a sustainable manner will require more than steel and cement: creating patterns of urban growth that use resources efficiently and avoid irreversible urban sprawl will determine whether the country's cities are paved with gold or fugged up with exhaust fumes.*

Over the past 20 years, the built-up area of Chinese cities expanded threefold to around 37,000 sq km, roughly the size of Switzerland. The biggest driver of this physical expansion was rural migration. According to the World Bank, almost 150m migrant workers had moved to the large coastal cities by 2005, mostly living in cheaper rural or semi-rural areas at the city's edge. Although the majority of these workers are only temporary residents, the dormitories, shops and roads built to accommodate them expand the urban boundary and leave behind low-density sprawl. To take one extreme example, the built-up area of Dongguan, a manufacturing centre in the Pearl River Delta with a predominantly migrant population, increased almost 18 times from 14 sq km to 246 sq km between 1990 and 2003.

Increasingly, however, migrant workers are moving to the cities permanently – and not only to the export centers of the east coast. As economic prosperity pushes inland, many are choosing cities closer to home, such as the rapidly growing powerhouses of Wuhan and Chongqing (see "Wuhan: future megacity" on page 32). Simultaneously, rising property prices in city centers are forcing city residents to join them at the urban periphery where housing is more affordable. This flight from the urban core is exacerbated by government attempts to convert high-density city centers into modern business districts, which often requires kicking the original residents into the suburbs. The upshot is better living conditions – residential per capita floor space in urban areas jumped fivefold over the past 25 years – but also inefficient and wasteful urban sprawl.

*Urbanization statistics and forecasts are drawn from the National Bureau of Statistics, from the United Nations Population Division, and from a report by the McKinsey Global Institute, "Preparing for China's Urban Billion," published in March 2008.

Tom Miller is managing editor of the *China Economic Quarterly*.

Getting bigger

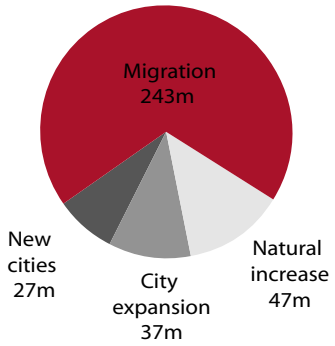
Number of cities by size

	2005	2025f
Mega (>10m people)	2	8
Big (5m-10m)	12	15
Mid-sized (1.5m-5m)	69	115
Small (0.5m-1.5m)	173	280
Big town (<0.5m)	602	521

Source: McKinsey Global Institute

Migrant surge

Sources of forecast urban population increase, 2005-25, persons



Source: McKinsey Global Institute, Dragonomics estimates

Urban obesity

The government's greatest fear is that the rapid physical expansion of China's cities is gobbling up precious farmland, thereby threatening national food security. With the urban population forecast to swell by 400m by 2030, requisitioned farmland needs to be used as efficiently as possible. Greater intensity of land use – which would mean denser, more compact cities – would also generate huge savings of energy and construction materials.

McKinsey likes them big

But a recent study by the McKinsey Global Institute analyzing likely patterns of urban growth found that China is largely moving towards a dispersed model of urbanization. The next 15 years will witness a "distributed" pattern of growth as more than 100 new cities with populations of 500,000 to 1.5m mushroom across the country; these will be joined by a further 60 new mid-sized cities with populations of 1.5m-5m. Current trends suggest that small and mid-sized cities will become the primary engines of economic growth. By 2025, the study predicts that 70% of the urban population will live in urban areas with populations below 5m, which will generate more than half of urban GDP. McKinsey argues that it would be far more productive for China to pursue a more concentrated urban development model, with growth focused mainly in a smaller

Municipal finance: a black hole

Local governments in China are frequently vilified for stealing land from farmers and selling it on to developers for a massive profit. The greed of officials anxious for skim-offs is one explanation for this practice. But another is fiscal pressure: municipal governments have enormous expenditure requirements and scanty budgetary resources. Off-budget land sales are often used to finance legitimate investments in urban infrastructure and services.

Most cities set up Municipal Development and Investment Companies (MDIC) to fund infrastructure projects. Since local governments are technically prohibited from borrowing, these nominally independent companies borrow and invest funds on the government's behalf. Appropriated land is typically passed to the MDIC, which is government-owned but operates outside the municipal budget. Although the land is usually sold to private developers, it is common for construction work to be sub-contracted to quasi-private arms of the government. Sometimes government departments are even required to buy the developed land themselves. The result is a tangle of grey financing that makes it impossible to establish the true budgets and debt positions of city governments.

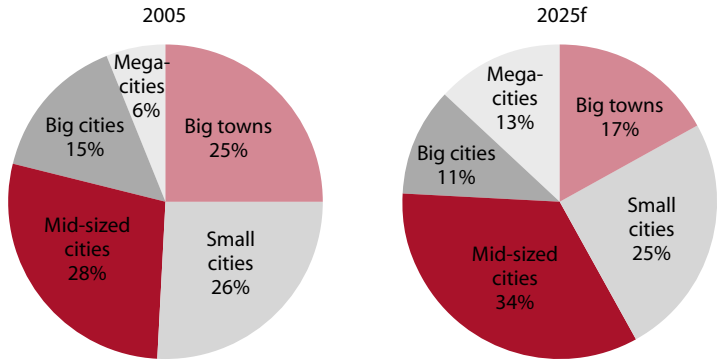
According to Tony Saich at Harvard University, China assigns far greater financial responsibility to local governments (70% of total government expenditure) than most other Asian countries. Responsibilities are spread among provincial, municipal and county governments; municipal governments must fund all social welfare services in their respective cities, including health and education, on top of most infrastructure spending.

As ever more migrants move into China's cities and begin to demand better social services, pressure to fund this activity will increase. All but the biggest cities find it tough to raise sufficient capital: Suzhou – one of the country's wealthiest cities in the country – already has a budget deficit of about 16% of its GDP.

One solution is to allow cities to issue bonds, which would bring greater transparency to local government financing and lower borrowing costs. Rumor has it that Beijing may initiate pilot projects for the most creditworthy cities later this year. As a first step, the Ministry of Finance has committed to issuing Rmb200 bn in bond finance on behalf of cities, with the proceeds sent straight to municipal governments. More private investment is also needed to take some of the burden off the public purse. Finally, the central government may be forced to increase fiscal transfers to urban governments. If more legitimate funding sources are not found, the whole project of sustainable urbanization risks grinding to a halt.

Middle-sized spread

Distribution of China's urban population, by city size, %



Megacity: >10m people; Big: 5m-10; Mid: 1.5m-5m; Small: 0.5m-1.5m; Big towns: <0.5m

Source: McKinsey Global Institute

number of very large cities. There are two possible directions for more concentrated urbanization: a "super-cities" model built around 15 cities with populations of 20m; and a "hub-and-spoke" model with clusters of smaller cities developing around larger ones. Both of these models, McKinsey estimates, would result in a per-capita urban GDP in 2025 that is 23% higher than likely under the current distributed growth model.

The government appears to have opted for distributed urbanization

This analysis is interesting but probably beside the point. China is already well down the road to a pattern of mainly distributed urbanization – lots of small and medium-sized cities – punctuated by the occasional megalopolis. The arithmetic of China's gigantic population makes this almost inevitable: even if, guided by McKinseyite wisdom, China succeeds in creating 20 mega-cities of 30m people by 2030, that will still leave another 400m urban residents to be housed in much smaller towns. Moreover, the Chinese government seems to have plumped fairly decisively for distributed widespread urbanization, on equity grounds. It is widely viewed as unfair that China's coast hogged all the fruits of development in the 1980s and 1990s, and the current administration has invested a lot of resources in encouraging the development of urban growth centers in the central and western hinterlands. To some extent, this is an example of a well-entrenched Chinese policy habit of trading away efficiency to achieve more equitable distribution. But one can also make an economic case: it may be that a comprehensive network of mid-sized cities blanketing the whole country will create a healthier and more stable domestic national consumer market than an archipelago of giant urban islands.

China should have eight megacities by 2025

Current trends suggest that six new cities – Tianjin, Guangzhou, Shenzhen, Wuhan, Chongqing and Chengdu – will join Beijing and Shanghai with real urban populations exceeding 10m by 2025. These so-called "megacities" will generate about one-quarter of national GDP. Although China's biggest cities are projected to grow, municipal governments are keen to cap the population in the urban core and move citizens to suburbs and

satellite towns. Both Shanghai and Beijing, for example, are lowering the population density in their respective city centers. Whether suburbs such as Jiading in Shanghai or Tongzhou in Beijing become absorbed into the city proper will determine how China's biggest cities develop.

The bigger, the better governed

China's huge population dictates distributed urbanization, with a few megacities

China's dual model of concentrated *and* distributed urbanization is almost unique. In other developing countries, the megacity model predominates: migrants overwhelmingly head for the big smoke, be it Lagos, Mumbai, Mexico City or Bangkok. By contrast, China in 2005 had nearly 800 small cities and big towns with populations below 1.5m, and these are not going to disappear. The sheer size of China's rural population means that smaller cities, as well as megacities, will be needed to accommodate the influx of new migrants from the countryside. (India, with five big metropolitan areas and a plethora of mid-sized cities, is the only country with a chance to replicate China's dual urbanization model.)

Yet while China's general trend towards distributed urbanization may be irreversible, improving resource efficiency remains a goal. It will almost certainly be beneficial if China's second- and third-tier cities ultimately grow substantially bigger, even if they do not achieve megacity status. Aside from using energy more efficiently and reducing the loss of farmland, larger cities benefit from a strong center of gravity: they are generally much better at attracting educated labor and investment than smaller cities. They also do better at absorbing new technology and providing a nucleus for the development of business and industrial clusters. All of this stimulates higher economic growth. As World Bank consultants Shahid Yusuf and Karou Nabeshima note: "Cross-country experience shows that good land planning, regulation, and coordination by bureaucracies as well as administrative subdivisions can enable cities to reap the benefits of size and avoid most of the pitfalls … Larger Chinese cities tend to be better managed than smaller cities."*

Land policy needs another look

Encouraging the creation of large cities and preventing urban sprawl requires stricter, yet more flexible, land policies. New developments at the urban edge typically have lower building intensities than existing towns and cities, but the World Bank estimates that stricter floor space requirements could reduce the conversion of agricultural land by almost 50%. Major culprits for inefficient land use are factories, often driven from city centers by industrial relocation policies, which require huge areas of land for low-rise buildings. Strict quotas used to protect unproductive farmland close to built-up areas are pushing suburbs further into areas of the countryside officially designated for non-agricultural use. This creates a pattern of fragmented development. Isolated urban clusters on the urban periphery add to infrastructure costs and commuting time.

Perhaps the biggest factor in shaping the physical development of China's cities is road design, which can quickly scupper compact urban planning

*"Optimizing Urban Development," in *China Urbanizes: Consequences, Strategies, and Policies*, Shahid Yusuf and Tony Saich, eds. (World Bank, 2008).

Act locally

Sub-national share of government expenditure, selected Asian countries

	Subnational expenditure % of total	Responsibility by level of government		
		Education	Health	Welfare
China	69	Local	Local	Local
Indonesia	32	Local	Local	Local
Thailand	10	Central, provincial	Central, provincial	Central, provincial
Vietnam	48	Provincial, local	Provincial, local	Provincial, local

Source: White and Smoke (2005)

goals. Massive urban road building programs coupled with the explosion in private car ownership (which enables people to commute to work from the suburbs) risk creating spread-out cities like Los Angeles. As more infrastructure springs up to serve these new communities and growing motorization pushes the city's boundaries ever outward, the process of suburbanization becomes self-reinforcing. "Chinese cities are creating a pattern of development that is unfriendly to public transport. Once you create this, it is hellish to fix," says Shomik Mehndiratta, a transport specialist at the World Bank in Beijing.

Ring roads: enemy of efficient transport

The problem is exacerbated by strong financial incentives for city authorities to sell farmland for development (see "Municipal finance: a black hole" on page 28). Although the worst land grabbing abuses have now largely been stamped out, urban authorities earn an estimated 25-40% of their income from selling or leasing land. Local transport, financial and urban planning policies are intertwined because officials use road projects to mandate the conversion of agricultural land for construction – and funding – purposes. This goes a long way to explaining local officials' unwavering faith in the value of ring roads: Beijing, the most egregious offender, already has five of them. "What's the best way to take the land?" asks Mehndiratta. "You draw a circle around the city and call it a ring road. It's the most efficient way of circumscribing rural land. This means you have all the incentives for urban sprawl." Preventing the migrant dream from sinking into urban dystopia will require both tighter planning policies and reform of local government finance.

Case studies

I. Wuhan: future megacity

by Tom Miller

At Wuhan's northern edge, behind vegetable patches tended by bent-backed farmers, loom the giant smoke stacks of the city's steelworks. Surrounded by a patchwork of tiny fields, fetid streams and roadside markets selling building materials, Wuhan Iron and Steel sprawls across the district of Qingshan – a rural-industrial no-man's-land that the city government plans to transform into a shiny new suburb. Between the steelworks and the mighty Yangtze River, demolished buildings and hoardings advertising "Qingshan Logistics Center" show that development is on its way. Down the road, a giant railway station (Wuhan's third) and a 6-km bridge (the city's fifth to cross the Yangtze) are both nearing completion. By the river bank, where freshly planted grass lies forlornly under a fine layer of grey dust, workmen hammer at apartment blocks for the suburb's new residents.

Wuhan's population? A moving target

Wuhan, the largest city in central China, is one of eight Chinese cities expected to have a population in excess of 10m by 2025. Depending on whom you talk to, the current figure is anywhere between 5m and 10m. "We don't know exactly how many people are in Wuhan," admits Zeng Juxin, professor of urban management at the city's Huazhong Normal University. "The real city population is under 5m; when people talk about 8m plus they're including all the non-city residents in the suburbs and the countryside." Add in a temporary population of up to 2m – mainly college students and migrant workers from the surrounding central provinces of Hubei, Hunan, Henan, Jiangxi and Anhui – and 10m is already a realistic figure for the municipality, although the truly urban population is substantially less.

Migrant magnet

Wuhan's geographical position at the heart of China, roughly 1,000 km from Shanghai, Chongqing, Xi'an and Guangzhou, makes it a magnet for migrants from all over the country. This includes temporary manual labor, but also long-term migrants looking for commercial and business opportunities. Growing numbers of local farmers are also moving into the city's outskirts, some clutching city *hukou* gained as compensation for having their land requisitioned. In addition, Wuhan is a major education center, hosting some 700,000 college-level students. Although graduates have traditionally left the city to find better paid work nearer the coast, they are increasingly attracted by the growing local economy, especially in the batch of high-tech industries located on the southern fringe of Wuhan's attractive lakes area.

Controlling the city's expanding population is a major headache for the municipal government, which lacks the financial muscle of similarly large

Tom Miller is managing editor of the *China Economic Quarterly*.

coastal cities like Guangzhou and Tianjin. Planning officials argue that the rising population is already putting too much pressure on the city's infrastructure, to the potential detriment of living standards. There is general agreement that the city proper cannot absorb more than 5m residents, so further population growth will necessitate outward expansion. "As the population grows, the pressure also grows to provide transport, employment and sanitation. Providing for more than 5m people is tough. We need suburbs and satellite cities to take pressure off the city center," says Xie Wei of the Wuhan Housing Bureau.

Hubbed and spoked

Wuhan plans a trim city center, but lots of suburbs

In 2006, Wuhan launched a city plan for 2020 based on a hub-and-spoke model of urban development. According to the plan, the population of the city center (defined by the city's central ring road) will be kept to 5m, barely more than the current figure of 4.8m. But the overall population of the city center plus suburbs will rise to nearly 12m. The majority of the city's residents will live in six gherkin-shaped spokes protruding from the city center, surrounded by "hills and water." The plan envisages suburbanites living, working and playing on the city's outskirts without needing to commute into the city center, although every suburb will also be linked to the urban core by expressway and rail. In addition, new transport links will bring six to seven smaller satellite cities into Wuhan's economic orbit, enabling some Wuhan residents to move out of the city and commute to work – a classic hub-and-spoke "megacity" model.

The plan includes strict regulations to prevent urban sprawl and protect the suburban greenbelt, plus zoning and density targets, varying according to area and property type, to keep the urbanized areas compact. "We do not want limitless urbanization and industrialization; we need to control the spread of the city," says Ying Yi, head of Wuhan's urban planning department. But Ying, who admits the plan will be "hard to implement", says "flexibility" will be allowed for extra expansion where it is needed. This raises the prospect that, for all the government's laudable aim to prevent urban sprawl, Wuhan's satellite cities will eventually merge with its suburbs to form a giant megalopolis. "It is impossible to control the spread of the city as the population expands," warns Luo Jing, director of Huazhong Normal University's College of Urban and Environmental Science.

Building the new China

Investing in infrastructure is the city's top priority

Constructing a modern city center and viable commercial hub, not to mention new suburbs and transport links, requires an enormous investment in infrastructure – roads, public transport, housing, sewage systems, etc. And Wuhan's position at the confluence of the Yangtze and the Han Rivers requires further outlay on bridges and tunnels to relieve traffic bottlenecks between the three old towns (Hankou, Hanyang and Wuchang) that constitute the modern city. "Future development comes from investing in infrastructure first. We do not want to be like India," says Chen Juxin, vice-secretary of Wuhan Finance Bureau.

Wuhan is working hard to catch up with the infrastructure and living standards of wealthier coastal cities, with large swathes of the city under reconstruction. In 2005, only 50% of the city's waste water was treated; this year that figure should rise to 80%. A massive house-building program has boosted average living space to 30 sq m per head, an increase of more than 10 sq m over the past decade. The city's first tunnel under the Yangtze opened to traffic on January 1, while the new Rmb11 bn bridge in Qingshan will open to vehicles and trains later this year. But keeping up with population growth and the heady speed of development is an almost impossible task. In 2000 there were 350,000 vehicles on Wuhan's roads; this year that number will approach 1m. "The pace of new road planning and construction cannot match the growth of new cars. Often we need to make changes to a road as soon as the planners and the construction company have completed it," says Cai Jing, deputy head of Wuhan police transport department.

Wuhan's light rail – a US$1 bn white elephant

Officials say public transport is a priority to reduce chronic road congestion. The first line of a planned 72-km subway system will open within two to three years, joining up with an existing 11-km light rail that is generally regarded as a failure. "Wuhan's light rail system is spectacularly bad – a white elephant built for US$1 bn that doesn't go anywhere," says Shomik Mehndiratta, a transport specialist at the World Bank in Beijing. Another problem is making mass transit attractive to a public that increasingly aspires to private car ownership. Although Wuhan's public transport stacks up favorably against many cities in China, it is used by only one-quarter of the city population – a figure the government hopes to push up to 45% by 2020. "Public transport in China, to put it frankly, is poor people's transport. Taking public transport means losing face. But unless white collar workers and professionals choose to use it, it will be a failure," says Zhang Jianwu, director of transport engineering at the Wuhan Transportation Science Research Institute.

Where's the money?

Borrowing money to build roads, and more roads

Perhaps the biggest sticking point, however, is financial. Although local governments are technically prohibited from borrowing, they all do so in practice (see "Municipal finance: a big black hole" on page 28). Chen Juxin at Wuhan's Finance Bureau says the city government uses future income streams earned from infrastructure projects as collateral for bank loans. All loans, he insists, must be paid back. Other income comes from central government transfers and local tax revenues. Beijing also helps to finance large infrastructure projects; both Wuhan's new railway station and new bridge were partly financed from central funds. "The city government used to be very short of funds, but the situation is much better than before. The financial pressure remains intense, but we can now afford to invest in a lot of infrastructure projects that we could not in the past," says Chen.

Indeed, from a financial point of view, channeling funds into steel and cement is considerably less daunting than addressing the much thornier

Keeping rural dwellers at bay

issue of social security. Building new schools and hospitals is one thing; paying for teachers and doctors is another. Despite widespread migration, the *hukou* system retains an important function for preventing farm families from moving en masse into cities. Although some small cities with poor social welfare services sell urban *hukou* to farmers to boost their revenues, a huge influx of migrants demanding full social security would financially cripple large cities like Wuhan. "Instead we are investing in rural infrastructure and services so that farmers do not need or want to move to the city," says Chen, who admits that providing social security for urban residents is the city government's toughest task.

But as more and more migrant workers begin to settle permanently in cities, the demand for fair treatment and equitable access to social services will grow. This intractable problem is not addressed by Wuhan's urban plan for 2020. "If there is no social security network for these people, the city will be unstable. We need to sort out the *hukou* issue, but there has been almost no progress anywhere in the country. No-one knows what to do about it," says Huazhong Normal University's Professor Zeng.

Home, sweet home

Crossing over the Han River from Hanyang into Hankou gives a view of decrepit, tumbledown housing as poor as anything in urban China. But Wuhan, like hundreds of other cities in China, is engaged in a monumental effort to give urban residents a decent place to live. Across the city, old apartments are being bulldozed to make way for higher quality residential compounds. One example is the Huangpu Renjia housing complex in north Hankou, a so-called "economic" housing unit built by a private developer but designed for lower income families. The complex, which stands on the grounds of a demolished factory, is an oasis amid a sea of squalid tenements – freshly painted in fresh colors, with a large goldfish pond, tree-lined garden and children's playground. Retired residents sit in the garden or sip tea on their balconies. Outside, crumbling grey concrete housing blocks with grimy, open staircases mark a striking juxtaposition.

According to the residence manager, 40 of the complex's 768 households receive the government's minimum living allowance (*dibao*). Every economic housing project in the city has a set proportion of apartments reserved for low-income families, which the government rents out at a subsidized rate. For ordinary buyers, the price of apartments is fixed at a maximum of Rmb2,900 per square meter, around half the average price of an apartment in the city. Just two years ago, only 1,278 households in Wuhan lived in public housing, according to the city housing bureau. This year 5,000 new public units are due to be built, on top 1,500 units constructed last year.

Tang Yonghua, a divorced woman in her 50s, moved into a new apartment in the Huangpu complex with her mentally disabled daughter three years ago. She pays rent of just Rmb33 (US$5) per month for a 60-square-meter, two-bedroom apartment. "You can't compare our new home to where we used to live; this is heaven for us," she says, gesturing to the light and airy rooms with a view onto a pleasant courtyard. Her old flat, which she had to share with another family, cost four times as much and had no private lavatory. "Lots and lots of people queued up to receive new apartments, so we were very lucky. But I believe that everyone will live in a place like this eventually. Society is progressing," she says.

II. Luliang: up-and-comer

by Will Freeman

By 2025, according to McKinsey's study of Chinese urbanization, more than 40% of the urban population will live in towns and small cities with populations below 1.5m – roughly 400m people. A further 30% or more will live in mid-sized cities with populations of less than 5m, taking the total number of urbanites in smaller urban agglomerations to more than 700m. Luliang is one such place: a new, rapidly growing city in southwest Shanxi, about two hours west of the provincial capital Taiyuan. Depending on your point of view, its build-first, populate-later ethos is either a harbinger of China's urban future, or an exemplar of the unsustainable excesses of China's unbalanced, investment-driven economy.

A city of nearly 4m – in name only

Luliang is a typical new Chinese "city": it covers an area the size of Israel, is overwhelmingly rural, and two-thirds of its 3.6m inhabitants are farmers. Of the remaining 1.2m who do not work the land, two-thirds still live in the countryside. Luliang's primary urban center is Lishi, a 1,300 sq km district – about the size of Hong Kong – of which only 3% is actually urbanized. That urban core was mostly farmland and state-owned factories until the mid-1990s when rural families began moving into the fledgling city. The city center holds a mere 200,000 residents.

Welcome to Coketown

Until 2004, when it was granted prefecture-level city status, Luliang was not officially a city at all. As a prefecture – the administrative unit below a province and above a county – it was an administrative unit of the Shanxi government. With city status came administrative and fiscal independence; but getting that status was an arduous, five-year process that required meeting a series of economic, cultural and infrastructure standards. The Shanxi government (via Luliang) invested Rmb30 bn from 2001-05 to fulfill prefecture-level city standards, almost twice as much as it invested in the previous 50 years.

Private companies flourish – with a lot of state help

To meet the economic requirements, Luliang let underperforming state-owned enterprises (SOEs) fail and promoted private industry. Today most of the city's GDP comes from resource-based industries like coal, iron and aluminium, which are almost entirely in private hands. Luliang's natural resource endowments were attractive enough that it did not have to offer the outlandish tax breaks or free land that many cities use as inducements for investment. The prefecture government helped entrepreneurs find distribution and marketing channels, adopt new technology and diversify into new products. In the early 2000s, city officials roped in a group of Shanghai investors to set up Hongte Group, which is now China's largest producer of coal tar (a coal by-product used in making medicine, shampoo and construction materials). "We used to just mine and sell coal. But then we progressed to coke, and then expanded into the

Will Freeman is a Dragonomics research analyst based in Beijing.

coal chemical industry," says Li Haiyu, director of the Luliang branch of the National Development and Reform Commission (NDRC).

These stimulus efforts boosted Luliang's economy: in 2000 the city ranked last in GDP and fiscal revenues among 11 Shanxi cities; in 2008 it ranked fourth and second respectively, with a GDP of Rmb63 bn. But reliance on resource extraction and processing remains almost total: officials freely admit most efforts to develop manufacturing and services have failed. But they hopefully add that Luliang's urbanization growth has only recently taken off and that new industries may sprout in due course.

Build it and they will come…

Once city status was attained in 2004, Luliang officials were free to plan their own development programs, and urbanization took off. The new government invested Rmb3 bn in over 100 projects, mostly within Lishi: new roads and the city's first waste water treatment plant topped the list. Like almost everything in Lishi, the waste water plant is a work in progress. The first phase is up and running, but a gaping pit and remnants of brick farmhouses wait to be transformed into phase two. The plant processes up to 10,000 tons of water a day, but a further 5,000 tons of the city's waste water ends up in the nearby river.

Rmb3 bn has been spent on infrastructure since 2004

Like many small Chinese cities, Luliang faces a stark trade-off between economic development and environmental protection. But in the past few years, pressure from higher levels of government – and abundant funds – meant that environmental goals were not entirely ignored. In 2004 Luliang replaced 70% of household coal furnaces with central heating and converted coal stoves to natural gas, at a cost of Rmb400m. But air quality remained terrible until the State Environmental Protection Agency halted all new industry and construction until environmental improvements were made. Luliang shut down a number of polluting factories and now claims to have the best air quality of any city in Shanxi.

Prospects for the new city's development improved when the provincial government, with funding help from Beijing, connected Luliang to a nearby expressway. Previously the main route in and out of the city was

Abandoned villages: starve-acre places

Hanjiashan village, a handful of stone houses set in the dusty brown mountains above Lishi city, is one of many nearby villages where only the elderly remain. Over half the village population has moved to Lishi or to other towns. Most Hanjiashan residents left after village classrooms were shut down and merged with schools in more populated regions over the last decade. Wang Weizheng, a Hanjiashan native in her thirties, moved 25 km away so her children could attend school. "Those of us with children have all left the village," she says.

Almost no-one under the age of 40 now lives in the village, says Wang Jincai, a lifelong resident of Hanjiashan in his 60s. Young people leave in search of employment and a better standard of living in more developed areas like Lishi. But the elderly have no job prospects and cannot afford life in the city, so they remain in the village. "We don't have any place to go out, and we don't have any security staying here," says Mr Wang.

Villagers say agricultural incomes are too low to sustain even the most basic standard of living, while two new coal mines in the next village have polluted and killed many of Hanjiashan's crops. Unable to make ends meet, villagers depend on financial assistance from their wealthier relatives in the cities.

a two-lane provincial road constantly clogged by coal trucks. "Luliang's is a resource economy, which depends on railways and roads. But in the past nothing could get in or out because the transportation system was so poor," says Mr Li. The new expressway cut travel time to the provincial capital Taiyuan in half and allowed faster access to the port of Tianjin, about 600 km away.

A doubling of the population...

All this building attracted new residents: Lishi's population doubled in the past eight years. Most new residents are farmers from nearby counties in search of employment or better schools. A few of these were local farmers whose land was incorporated for development as the city's area expanded two-fold over the last decade: such farmers receive cash compensation for their land and apartments scaled to family size. But long-distance migrants are also common in Lishi. Zhang Yingxian, from Yunnan, has sold tea in Lishi for the last eight years. "We came here because there is a good market for tea," she says. "But we left our children back at home because Lishi is too dirty to raise children."

Social services have struggled to keep pace, bar some notable exceptions and the odd aspirational building project. Hospitals are overcrowded and understaffed, but one of the largest new structures in town is a medical school for nurses and medical practitioners. Luliang recently installed medical clinics in each of its 12 counties to boost rural health care and take some of the burden off urban hospitals. Schools are also overcrowded: classes average 50-60 students, far more than in big cities like Beijing. In 2005, the city convinced a local coke magnate to invest Rmb400m in a new school, an enormous facility that will eventually hold more than 5,000 students.

Tapping private entrepreneurs to finance development projects is a common practice, says Li, necessitated by dire public funding constraints. Like small cities across China, Luliang hands over almost all tax revenues to higher levels of government. In 2008 Luliang collected Rmb16.4 bn in taxes, but was allowed to keep only Rmb900m. The coke baron who funded the mega-school also paid for much of Luliang's central heating infrastructure in 2004.

…or will they?

... a quadrupling of house prices

Public infrastructure may be inadequate, but house building is excessive. Total residential floor space grew from 4m square meters in 2004 to 10m in 2008. Developers were tempted by fat profits: local residents complain house prices have quadrupled (albeit from a very low base) since 2000. Until recently, incomes seemed to keep pace, but the property market looks decidedly shaky: unfinished concrete apartment-house skeletons are common, and 10,000 apartments sit vacant.

In short, Luliang is the very model of a modern Chinese town, in which investment precedes population, industry and a consumer economy. The city has a paucity of retail shops (open-air markets and street-side stalls still prevail), no manufacturing to speak of, and a barely functioning

service economy – but later this year it will get a stop on a new high-speed rail line running from Tianjin on the coast to Ningxia in the west, and (bizarrely) is slated to receive an Rmb900m airport, paid for by the provincial and central governments. All the building seemed easy enough over the past six years, when higher-level governments were flush with cash and property prices only ever went up. But this year China's governments are likely to run a budget deficit of Rmb1 trn, and the heavy industries on which Luliang depends are facing a few years of severely reduced profits. Luliang did well in boom times; how it manages the bust will determine whether it really does have a bright urban future or is destined for small-town penury.

Commodity and retail markets

Hungry cities?

by CEQ *staff*

A specter is haunting brokerage commodity and retail analysts: the specter of China. For the past several years, China's fast-paced urbanization has been used to justify all manner of stories about future demand for hard commodities (ores and fuels), soft commodities (grains and other foods), and consumer goods. Some of these tales were spun of pure, though often weighty, fantasy; *CEQ*'s favorite example was a two-volume, *War and Peace*-length opus by a famous investment bank claiming the Chinese consumer would supplant the US consumer as the main engine of world growth by 2014. Despite the American consumer's well-publicized woes, that forecast looks dottier with each passing day. Others blended good analysis with a bit of PR hyperventilation: for instance the "commodity super-cycle" argument promoted by Goldman Sachs.

In treating these matters we have generally tried to steer readers away from such gusts of persiflage and into the safe harbor of common sense. It is fairly obvious that China is following a path of industrial and urban development broadly similar to that pioneered by its neighbors Japan, South Korea and Taiwan; and it is equally obvious that China's enormous size renders this growth even more significant for global markets than was Japan's in the 1960s and 1970s. We expect that Chinese growth and urbanization will continue for another couple of decades, and that Chinese demand for commodities and consumer goods will rise substantially. But the implications of this rise in demand are not straightforward, thanks to variable factors such as patterns of urbanization and income distribution. Rather than devise our own forecasts for the China's urbanization-driven demand for commodities and consumer goods (which in the manner of all forecasts would certainly be proved wrong in any case) we here provide some general guidance for assessing the credibility of other people's forecasts.

I. Commodities

The most common explanation for the seven-year global boom in raw materials, energy resources and agricultural products that ended last August was, simply, China. As the world's top consumer of aluminium, copper, lead, nickel, tin, iron ore, steel, coal, wheat, rice, palm oil, cotton and rubber, China was thanked and blamed in equal measure for heralding a new era of inflated raw material and food prices. Because commodity prices were considered to be essentially a simple function of Chinese demand, and Chinese demand was a function of a long-term process of urbanization and rising incomes (and because India was seen lurking just offstage with the potential to create a similar demand profile), the proponents of the so-called "commodity super-cycle" suggested that commodity prices were in for a run of two or three decades of more or less continuous increases. Skeptics replied that the China boom was simply

Super-cyclist

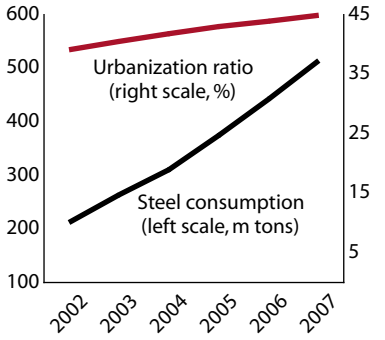
China's commodity needs

	Share of global refined consumption 2008 %	Share of global demand growth 2000-08 %
Steel	33	61
Aluminium	33	60
Copper	28	101
Zinc	33	97
Nickel	28	114

Source: Macquarie Securities

Girding the cities

Chinese steel consumption versus urbanization ratio



Source: World Bureau of Metal Statistics, CEIC

the latest in a series of inflationary episodes that periodically interrupt a two-centuries-long secular decline in commodity prices.

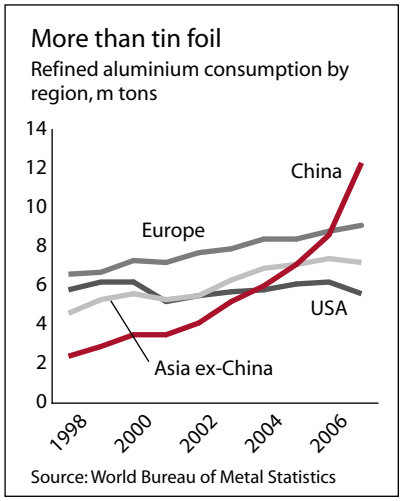
Demand from China and India could still result in a rebound in commodity prices

The collapse last year, which sent most commodity prices tumbling by 40-80% and slashed bulk shipping rates to less than a tenth of their peak, would appear to have decided the matter in favor of the skeptics: most metals prices have given back five years of gains, and in some cases are trading barely above the levels of the moribund 1980s and 1990s. But in fact the case is not so clear: depending on what time scale you choose, the super-cyclists and the skeptics can both be right. Jim Lennon, head of commodities research at Macquarie Securities, notes that while the copper price has declined from US$6/lb (in 2008 prices) in the 1860s, this long-run decline has been punctuated by rising price cycles lasting 30 years or so (1890-1915 and 1930-65). Each of these previous "super-cycles" was highly volatile and contained episodes of dramatic price falls. It is therefore far from ridiculous to imagine that the boom of 2000-08 was simply the first phase of an uptrend in commodity prices that could last until 2025 or 2030, driven principally by the urbanization of 20m-30m Chinese and Indian citizens each year.

In the short term, things do not look so rosy. Lennon points out that while over the past several years we have got used to thinking that Chinese demand was the only thing that mattered, over the next few years Chinese demand is likely to be almost irrelevant because it is overwhelmed by the collapse in demand everywhere else. Furthermore, since prices are a function of both demand and supply, the large increases in supply brought on in recent years to cater to Chinese demand are now weighing down prices. Only after the rest of the world stabilizes and excess production capacity is absorbed – somewhere between 2010 and 2013 – will China again emerge as the key driver of both demand and prices.

Heavy metal

That Chinese demand will re-emerge is almost beyond doubt. China is now at the most commodity-intensive stage of urbanization, with metal intensity four times higher than in developed countries and twice as high as in other developing countries, according to the World Bank. The uptick in metal intensity, which began in the mid-1990s and accelerated at the beginning of the 2000s, correlated with an increase in the urbanization rate from 30% to 40%. In 2007, more than 50% of Chinese steel and 44% of copper demand was gobbled up by the construction and infrastructure industries. Per capita steel consumption in Shanghai, which reached 78kg last year, now approaches the highs seen in Japan and South Korea, according to mining firm BHP Billiton. (The corollary is that Shanghai's steel consumption growth is likely to slow markedly, although plenty of other Chinese cities still have a lot of catching up to do.)



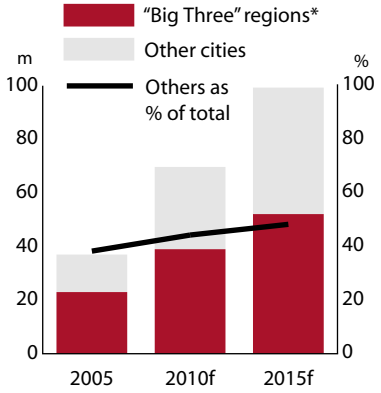
Metal intensity growth is projected to peak along with the population growth rate around 2015, and then slow gradually. Nevertheless, industry forecasts expect intensity to remain high through 2030. The major variable is whether the rest of the country follows Shanghai's high-inten-

sity model. "It's not so much that urbanization is metal intensive; it's the kind of urbanization that takes place," says Robin Bordie, BHP Billiton's China economist. Even if China follows a generally dispersed model of urbanization, smaller cities are likely to be fairly densely built because of the premium on farmland and the sheer concentration of people along the coast. Since buildings above eight stories require proportionately more steel for reinforcement than lower structures, this should keep metal consumption high. The hungry dragon is not yet sated; he's just pausing between courses.

Urbanization does not automatically entail a jump in consumption

II. Retail markets

Chinese officials generally view cities as efficient drivers of investment, but when it is politically expedient they also argue that rapid urbanization will boost consumption and ease the country's dependence on investment and exports. We have long been profoundly skeptical of the exaggerated claims made for the consuming power of China's supposed "rising urban middle class" (see "A billion customers, or six Malaysias?", *China Economic Quarterly*, Q4 2006, pp. 44-48). There is little doubt that, in the long run, China's hope for prosperity – like its East Asian neighbors' – lies in transferring the majority of farmers into higher-productivity jobs in the cities. But simply moving a farmer into a factory does not make him an economically significant consumer. Moreover, urbanization's impact on retail markets depends on the spatial distribution of cities and their size, as well as migratory patterns and policy.



Finding a market
Consumers, m households
*Yangtze River Delta, Pearl River Delta, Beijing-Tianjin corridor
Source: CEIC, Dragonomics estimates

Chinese households with annual expenditure below US$5,000 – ie about 90% of the population – spend most of their money on subsistence items like housing, clothing and food. But the level of consumption needed to drive China's economy, make possible a strong organized retail sector, or provide a viable market for higher-priced foreign goods kicks in above that income level. These "consumption households" with annual expenditure above US$5,000 primarily reside in three regions – the Yangtze River Delta, the Pearl River Delta, and the Beijing-Tianjin corridor – all of which surround megacities. Although there are a growing number of consumption households dispersed across the rest of the country, they are not concentrated enough to justify a sales and distribution presence for many products and services. Research by MasterCard suggests that multinational consumer goods companies require a concentration of at least 200,000 consumption households to establish a viable market. The vast majority of China's second- and third-tier cities have nothing close to such concentrations. China's transportation system has improved markedly in the last decade, but distribution costs remain a barrier to setting up in the hinterland. Logistics costs account for 20% of average goods prices in China compared to 10% in the United States, according to the US Department of Commerce.

A lower middle class

McKinsey's urbanization study projects that China's urban growth will follow a dispersed model, with most urbanites spread among hundreds

of small cities across the country. This would be a worst-case scenario for urban consumption, exacerbating distribution problems and preventing the development of concentrated consumer markets. Residents of small, inland cities are frugal: they save money for infrequent purchases of durable goods like washing machines, microwaves and refrigerators, but have little discretionary spending power. "The share of consumption in cities below the county level is actually shrinking, because incomes in large urban centers are growing much faster," says He Yupeng, director of the National Development and Reform Commission's Center for Town Reform and Development. "Almost no small cities have an average GDP per capita above US$5,000." A highly dispersed pattern of urbanization, made up of hundreds of little cities at the county level or below, means a consumer economy that will permanently punch below its weight.

In theory, more concentrated urbanization would give the largest boost to incomes and therefore consumption. "Urban agglomeration benefits are high – real incomes per worker rise sharply with increases in city size," say Brown University urban economists Chun-Chung Au and J. Vernon Henderson.* But the fact that larger Chinese cities have higher average incomes does not mean new migrants to those cities will also receive fat paychecks (or spend them). Migrant workers in large cities tend to live in tenements outside the city and have little disposable income. Urbanization's contribution to consumption depends on incomes at the margin, and the living standard of the vast majority of new migrants in big cities is well below that of the average urbanite. Over time, average per capita incomes will rise and urban retail markets will grow. But if more effort is not made to give migrants better access to social services – giving them basic security and greater incentives to settle with their families in the city – China may wind up with an urban underclass, not a middle class. And that would hardly be the recipe for an urban consumer boom.

Fast-forward 2025

Between now and 2025, China's urbanization is likely to produce the following results, according to McKinsey's urbanization study:

- 5 bn square meters of road will be paved
- 28,000 km of metro rail will be built
- 170 cities will meet the criteria for mass-transit systems
- 5m buildings new buildings with 40 bn square meters of floor space will be built
- 20,000-50,000 of these buildings could be skyscrapers (30 stories or more) – the equivalent of 10 New Yorks
- China will account for around 20% of global energy consumption and up to one-quarter of growth in oil demand
- China will need 700gW of new coal-fired power plants

*"Are Chinese cities too small?", *Review of Economic Studies*, Vol. 73, No. 3 (July 2006), pp. 549-576

Urban-rural continuum

The future of the Chinese city

by Peter Rupert Lighte

Chinese cities need to return to their rural roots

From the Neolithic period, when the very notion of the city took shape, to the 19th century, almost half of all people who ever lived in cities lived in Chinese ones. But that Chinese urban experience always fell within the context of the rural fabric, creating an urban-rural continuum. We may think we know what a city is, but we might not know what a *Chinese* city is. And the future of the Chinese city is intimately connected to its past – to the possibility of repairing the urban-rural continuum that has been ruptured by a century and a half of tumult.*

Traditional Chinese cities, suspended within a surrounding rural environment from which they differed only in intensity, functioned in a way reflecting a concept of the relationship of phenomena articulated in the *Yi jing* or "Book of Changes." Events are not free and strung together in linear fashion like beads, as in Western thought. Instead they are seen to be interwoven in a net: tug at a strand and there is sure to be movement somewhere.

The Chinese city, very much of its surroundings, could never be parted from them. Even when a wall was erected around a city, occasioned by its designation as a seat of government administration, the structure was in a fashion invisible to those passing through its gates. Walls, their strategic value long lost in time, became badges of government, ennobling their enclaves without separating them from the countryside. They did not define corporate entities, preclude rural life within, or prevent urban concentrations beyond their shadows. In stark contrast to feudal Europe where serfs were tied to the land, pre-modern Chinese society was one in which land was alienable and change of residence from country to city possible. There was nothing island-like about the city nor was there a city akin to Rome, Constantinople, Paris or London with which civilization became singularly associated.

Fabric unraveled

Chinese cities only became "urban" after the arrival of foreign powers

It took the coming of the West in the 19th century to disrupt the rhythms of the continuum. The dreaded Treaty Ports, presided over by occupying foreign powers, were deliberately hived off from the hinterland: discontinuity between city and country was, by design, institutionalized. A distinctly non-Chinese urban environment was created in which industry and finance could flourish, alienated from the surrounding natural environs. The breach between city and countryside only grew deeper when, after the establishment of the People's Republic, Chairman Mao intro-

*I am grateful to my teacher, Princeton historian F.W. Mote, for introducing the idea of the urban-rural continuum to me.

Peter Rupert Lighte is the chairman of JP Morgan Chase Bank (China).

duced the *hukou* (household registration) system, permanently binding each individual to an urban or rural location and thereby universalizing a means of social control at odds with traditional society.

Mao built walls between city and country, then hurled his enemies over them

Ironically, Mao himself later undermined his own *hukou* system, but not out of any respect for the old continuum. He realized that urban-to-rural mobility, ostensibly at odds with social control, could be used in aid of his own political survival. During the chaos of the Cultural Revolution, he closed schools and gave free railroad passage to students, letting them loose across China to disrupt power structures and spread his cult of personality. Urban political enemies were "sent down" to the countryside, removing them as adversaries. Subsequently, in yet another twist, Deng Xiaoping created a vision of a modern China based on special economic zone enclaves – returning, in effect, to the treaty port model which remains so darkly associated with western imperialism.

But Deng's miraculous urban enclaves have been gradually prised open by an epic, one-way migration of people from rural areas to the cities. The migrant or "floating" population is estimated at 130m-170m – 10-13% of China's population, or half that of America. This mass movement of people is hollowing out the countryside, and belies the myth of a unified, integrated country presided over by a centralized, all-pervasive state. Thanks to the heritage of Mao's *hukou* system, and the practices of Deng's enclave economy, approximately 70% of these floating workers – who are literally building the new skylines of urban China – have been disenfranchised by it. Without *hukou*, a migrant has no access to state schooling, welfare and health care. Meeting the demands of these nomads while trying to protect the cities from inundation is an obvious and daunting challenge for the government.

Rural migrants live in the city but do not belong to it

The population of Beijing, for example, is over 17m, having roughly doubled since the early 1980s. More than a quarter of its residents are migrants. Who are these people? They are usually in their late 20s, 69% male and 31% female. They have been in Beijing on average for about seven years, with no plans of returning home to the countryside. Their concerns? Education for the single child, upon whom they will rely for retirement; providing for the health of parents left behind in the village; and buying a home in Beijing. Most of these needs they must fund themselves, with little or no assistance from public education or social insurance systems.

Past is future

Despite their alienation from the services of the state, it is commonplace for migrant workers to own mobile phones, and spend more money and time on them than longer-term urban residents. Special bank cards for migrant workers enable them to make urban deposits, with funds then made available at their native rural credit cooperative branches. Mobile telephony and bank cards create half of a nascent urban-rural financial network, helping those left behind in the hinterland to benefit from urban prosperity. But the establishment of the other half of this network – with

rural areas themselves becoming sources of prosperity – will be a tall order. What is envisioned is not a return to some rural idyll. Rather, the rural areas themselves must become targets for investment by individual entrepreneurs – migrants returning home and setting up businesses – and by rural banks taking stakes in local enterprises. Just as technology in the prospering urban space now provides a bridge enabling the floating population's growing wealth with the countryside, the introduction of technology and investment can provide a kindred catalytic opportunity for the hinterland's regeneration. No longer simply a source of domestic emigrés bound for the cities, rural China could become a source of prosperity itself, pulled along into modern times by the very people who had abandoned it.

Healthy economic development requires repairing the urban-rural breach

In other words, what is required is the repair of the urban-rural breach caused by the dramas of post-imperial China – the restoration of the traditional Chinese urban-rural continuum in which city and country are part of a single economic fabric rather than separate worlds. To achieve this, the government must explicitly recognize the now stable floating population, and facilitate technological and financial means for their new-found prosperity to flow back into the countryside whence they came. The government must cope with the migrants already in place in the big cities. But it ought not to encourage future migration into these very same cities: they are filled. Incentives must be created to draw migrants into smaller, newer cities closer to the migrants' original homes. In this way the geographic and financial distance between city and village will be diminished and a dynamic process of integration can be unleashed throughout the land.

When China was at its greatest in the pre-modern world, it was also by far the most urban society in the world; yet the nature of its urbanism was profoundly different from the type which later emerged in Europe. The urban-rural continuum was a defining element of Chinese culture; and restoring it in the modern world is not only a matter of pragmatic economics – the best way to deal with an enormous population and pressing development needs – but an essential means by which China can again assume its role as a major world culture, with value reaching far beyond that of an economic miracle. China's future does not lie in becoming a littoral nation of treaty ports – glistening cities of posh watering holes, Lamborghini dealerships and sovereign wealth funds – with its back turned on a hollowed-out and destitute countryside. Only by linking the economic and technological promise of the 21st century to the cultural heritage of centuries past can China realize its full promise.

Economic propaganda

Making the news fit to print

by Anne-Marie Brady

This year is likely to be very uncomfortable for China's ruling elite. The current global economic crisis is hitting the country hard, with scores of factories closing down as export markets dry up and domestic demand slows. China's share index plummeted 65% in 2008 from a record high in 2007 and property values declined sharply. Chinese society is also reeling from the tragedy of close to 300,000 infants being injured from consuming tainted milk products. Public confidence in food safety is at an all-time low. Popular frustration with official corruption is at dangerously high levels. And it will be a year of sensitive anniversaries – including the 20th anniversary of the massacre in Tiananmen Square – dates that protesters traditionally use as rallying points for demonstrations.

China's current troubles will be a test of the country's crisis management skills

Gloomy forecasts have haunted the Chinese Communist Party (CCP) for the past 20 years, ever since the protest movement of 1989 and the collapse of communism in the Eastern bloc in 1989-91. Although the CCP weathered crisis after crisis in the intervening years, the "collapse thesis" remains strong in Western analysis of China. China's current troubles will indeed be a test of the CCP's crisis management skills. But wishful predictions that the global economic crisis will bring down the government are far off the mark. In contrast to other turning points in modern Chinese history – 1911, 1949 and 1989 – the central leadership is united and broadly supported by the majority of the population. And, crucially, it is backed by a sophisticated propaganda machine well-versed in dealing with internal and external catastrophes.

Growth + propaganda = political legitimacy

Many Western analysts assume China's current political legitimacy and stability rests solely on economic performance. But the government long ago recognized that this was a very unstable foundation on which to base its political authority. Within days of the military crackdown in 1989 the Party leadership announced a new formula for China's political management: a joint emphasis on *both* economic development *and* "propaganda and thought work." The two are interlinked: in a clear about-face from the Mao years, one of the tasks of China's propaganda activities in the last 20 years has been to promote economic development, while one of the tasks of economic development has been to ensure the population maintains its faith in the existing political system.

The Communist Party has long extended its claims to legitimacy beyond economic performance alone

In the years since 1989, the Party has led a concerted effort to develop a modern propaganda system matching the needs of China's modern-

Dr Anne-Marie Brady is an associate professor of political science at the University of Canterbury in Christchurch, New Zealand. Her most recent book is *Marketing Dictatorship: Propaganda and Thought Work in Contemporary China* (Rowman and Littlefield, 2008).

ized economy. The modernized propaganda system now plays a crucial role in the party-state's crisis management strategy, as well as its daily governance. It should be noted that, while the Party adopts a hands-off approach in relation to many aspects of government policy, when it comes to the propaganda message all state organizations must "sing with one tune" and follow Party instructions. In internal publications, Party propaganda theorists continually stress that guiding public opinion is the key to political stability in China, as indeed it is in other societies.

Persuasion is China's most potent propaganda tool

With this knowledge in hand, it is possible to predict how Beijing is likely to handle economic and other crises. The government will use a number of tools to manage the problems it is facing, including both economic bailouts (carrot) and force (stick). But the most important tool will be persuasion. The Chinese people must continue to believe that the current system is the best one for them and that there is no alternative, whatever hardships the country may suffer. China's trading partners must also be encouraged to maintain their faith in the strength of the Chinese economy and the government's ability to deal with the current problems. Since 1992, talking up the Chinese market has been the primary task of China's foreign propaganda specialists.

Tentacles of persuasion

China's propaganda system (*xuanjiao xitong*) – a web-like network of controls that links up the whole of Chinese society – is guided by the CCP Central Propaganda Department (CPD) and incorporates propaganda offices installed in Party committees and branches at all levels of organizations in the state bureaucracy, as well as all enterprises with Party cells. Although government departments and large state-owned enterprises are not technically controlled by the Party, the CPD provides them with "leadership" and "guidance" for dealing with politically sensitive issues to ensure they toe the Party line. In the event of a run on state-owned banks, for example, the CPD would collaborate with the banks' individual propaganda sections to set a uniform public response. The CCP's propaganda strategy today is a matter of information management and damage control rather than direct censorship. Party propagandists are concerned with *macro management*, not micro control, of the public sphere.

Different sectors of the propaganda system are managed to different levels. As the main propaganda tool for communicating with the masses, television remains strictly controlled. The Internet, which is dominated by China's educated urban youth, is carefully guided but allowed somewhat more freedom of debate. Certain newspapers are tightly controlled, while others are given more leeway. Academia is allowed even more latitude, as long as it keeps to accepted boundaries such as not questioning the Party's leadership of Chinese society.

Since 2003, in a major shift from previous practice, the CPD has begun to release some negative news, as well as following the more traditional positive propaganda line that everything is under control. The CCP learned the lesson of the advantages of releasing selective negative information

Verboten!

Central Propaganda Department guidelines for financial reporting

- No reporting of bank runs
- No reporting of bank fraud
- Control reports on the stock market and exchange rate
- Promote domestic brands and companies
- Promote the expansion of the capital markets
- Protect social stability

after the disastrous media gagging of reports on the SARS (severe acute respiratory syndrome) epidemic in 2003, which was widely blamed for helping the disease spread worldwide. Government advisers say the model for the new approach was the Blair government's handling of British public opinion during the BSE/mad cow crisis in 2000-01. After the SARS debacle, the Party set about training a legion of government spin doctors to handle any future political crisis. The leadership's awareness of the risk of popular protests threatening the regime is not a sign of weakness – rather it is an indication of the CCP's determination to survive and its ability to absorb new methods and technologies to enable it to do so.

Governing with the news

Expect to see a relatively open discussion of China's economic problems this year

When Beijing deals with economic crises this year, we can expect to see a fairly open discussion of some of China's current problems – balanced by lots of positive stories about how people are "finding new opportunities" in the current economic environment. Television will contain mostly upbeat information; newspapers will be allowed to write up factual descriptions of problem issues, omitting politically sensitive details when necessary; the Chinese Internet will feature fierce debate of the issues that will be tolerated as long as it does not go beyond certain boundaries; and academics will be allowed to explore a relatively wide range of approaches aimed at resolving the problem. But no one will be permitted to raise issues suggesting that the existing political and propaganda systems help create economic problems – such as the role played by the existing political system and propaganda controls in the tainted milk tragedy of 2008.

The government has also learned that allowing the domestic media to break news before foreign reporters can put a more positive spin on news coverage abroad. The media are now allowed to report factually on many economic concerns and most (but not all) demonstrations; this is considered preferable to allowing rumors to circulate on the Internet. Recent domestic reports covered taxi driver strikes, riots in Gansu and Sichuan, and a mass petition in Beijing. But investigative reporting is still a risky business in China: in 2007 the CPD banned for life a journalist at the *China Economic Times* for his report on corruption in rail construction.

Media management extends far beyond censorship

Encouraging the Chinese media to scoop the foreign media is an indication of the government's increased confidence in its ability to manage the Chinese public sphere. In the last 15 years the CPD has also overseen a series of dramatic reforms in the means of control in the public sphere. These include: punishing offending journalists with libel laws or even trumped-up charges on non-related matters; establishing a management system for journalists that only grants registration to those who meet political criteria; creating commercial advantages for the Chinese news media to cooperate with government authorities; and forming "readers groups" consisting of senior academics and editors to monitor the Chinese media and report back on concerns to propaganda officials.

The Party controls the public sphere to prevent alternative voices from entering it. But it does not necessarily want to fill it with political messag-

es or, in a time of economic crisis, to over-emphasize economic matters. Instead the propaganda machine redirects public attention to more positive topics. These campaigns of mass distraction incorporate as much of Chinese society as possible in a wide range of activities, aimed at building positive public opinion for the political system. The eight-year hoopla surrounding China's hosting of the Beijing Olympics was one such campaign; the 2010 World Expo in Shanghai and its ongoing space program are two likely focuses of future such campaigns.

Disaster: crisis plus opportunity

A further means of redirecting popular attention from systemic issues is conducting propaganda campaigns around natural disasters to boost government approval ratings. This was a very effective tactic during 2008 when China experienced prolonged snow storms in January and a devastating earthquake in May. This propaganda theme also meshes with the content requirements of China's market-driven media to report people-focused stories. Every year China suffers serious earthquakes, floods and other natural disasters. From the Party propagandists' point of view, the human tragedy element of these events is helpful for uniting the population (see "All news is good news").

Keep waiting for the collapse…

Outside observers are continually looking for incidents or movements that threaten to bring down China's party-state. Yet when protests erupt in Western nations over various economic or political concerns, we do not see them as indicators that the whole political system is about to crumble. Instead we regard them as normal expressions of dissent in a society that, despite its flaws, is basically acceptable to the majority of the population. After 20 years of successful economic development and the assiduous molding of public opinion, the CCP-led political system is now as entrenched as the political systems in Western countries. The average Chinese citizen would no more contemplate overthrowing the CCP than the average American citizen would think of overthrowing the government of the United States.

Chinese citizens, with very few exceptions, accept the current political system – though they may be critical of certain politicians or policies of

All news is good news

Party propagandists have long viewed natural disasters as a valuable means of boosting government approval ratings. In August 1998, severe floods along the Yangtze River prompted a major propaganda campaign: promoting national unity in the face of danger, selfless courage, and the spirit of struggle. This campaign was a useful distraction to the millions of layoffs caused by the restructuring of state-owned enterprises.

Last May's devastating earthquake in Sichuan was another good test of the Party's propaganda machine. Domestic media reports focusing on heart-rending stories of personal tragedy human and selfless acts of bravery brought the nation together and built support for Beijing's handling of the emergency.

Senior government leaders made a series of high-profile visits to the disaster sites – given saturation coverage by the media – while ordinary individuals were singled out as heroes of the disaster. The media coverage had a single goal: national unity. The outcome of the quake was a resounding propaganda coup for the government.

that system. There have certainly been increasing numbers of popular demonstrations in recent years, but all have focused on specific points of concern rather than criticism of the political system itself. Chinese propaganda is effective because it is basically true: the CCP government has made major progress in improving economic livelihoods and it continues to be the only viable political force to lead and unite China. This will be a tough year for the Party's leaders, but it certainly will not be their last.

Yangtze River Delta

Stalled dynamo

by Tom Orlik

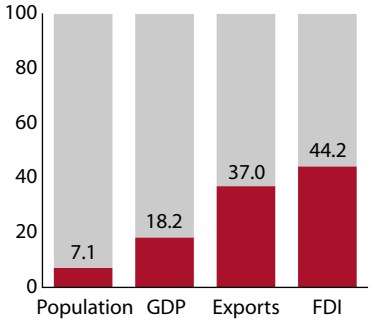
The 16 cities of the Yangtze River Delta

The Yangtze River Delta (YRD) is the dynamo of China's export economy. The region – encompassing the municipality of Shanghai and fifteen other cities across southern Jiangsu province, and eastern and northern Zhejiang province (see map) – accounts for 18% of China's GDP, almost twice that of Guangdong's Pearl River Delta. Its economy is larger than Turkey's. Local officials and business representatives say they are confident the YRD will emerge from the current export crisis more dynamic and productive than it went in. But with the latest trade figures indicating a deeper decline than was previously feared, and the local government reluctant to let struggling enterprises fail, more than confidence may be required to achieve ambitious targets for the development of an innovative, service-driven regional economy.

The collapse in foreign demand has hit the YRD's export machine hard. With just 7% of the national population, the region accounts for 44% of foreign direct investment and 37% of exports. When China's export growth fell into negative territory last November, YRD exporters led the nationwide slump. After bucking the national trend in December, Zhejiang's exports collapsed in January, while total trade in Jiangsu declined by a shocking 32%. Port throughput in Shanghai, the regional powerhouse, has shriveled. Domestic consumption may be holding up better, but empty shopping malls in Hangzhou and canceled Spring Festival office parties in Suzhou suggest that retailers and restaurants are not escaping the downturn.

Outward looking

Yangtze River Delta's share of national total, %, 2007



Source: CEIC; Statistical Yearbooks of Shanghai, Jiangsu and Zhejiang 2008; Dragonomics estimates

Returning to the home market

Huang Guozhong, general manager of Kumho Tires in Nanjing, one of China's largest automotive tire manufacturers, confirms that external demand has fallen sharply. Exports, which account for almost 50% of the company's sales, dropped by 66% year on year in October and Huang sees further trouble ahead. "Our factory has not yet stopped production but our stockpile has grown to twice its normal size. We expect to start limiting production in the coming months," he says. Huang is watching the policy announcements coming from Beijing, including support for exporters and the declining pace of appreciation of the renminbi, but does not believe these changes will be of any immediate help. "The problem is there is no demand at even the lowest price."

Local manufacturers fear that foreign firms, which previously steered clear of the fiercely competitive Chinese market, may be tempted to dump cut-price products in the world's last bastion of demand. Wu Shengdi, the chairman of Hangzhou Aichi Engineering Vehicles Company, which is China's leading manufacturer of hydraulic platforms used by heavy

Tom Orlik is a freelance journalist based in Shanghai.

trucks, believes that foreign competitors will be attracted by the demand for heavy machinery generated by the government's massive Rmb4 trn rescue package, much of which is focused on infrastructure spending. "We have seen 15-20% growth in profits every year since 1995," Wu says. "But in 2008, thanks to the snowstorm, the earthquake, the capital spending control by the government, and now the financial crisis, we have seen falling sales every month since September. We have already dropped our prices, but if foreign firms come into the market they will have to drop even further."

Nevertheless, city officials in the YRD are confident that locally-based enterprises are sufficiently flexible to emerge from the economic crisis intact. Hao Jian, the vice director of the Bureau of Trade and Economic Cooperation in Nanjing, cites the example of an international electronics manufacturer that has moved rapidly from exporting 70% of production to selling 70% into the Chinese domestic market, lowering prices to gain greater market share. This strategy – shifting the focus from foreign to domestic markets and cutting prices – is being widely applied by the YRD's exporters. The consequence is greater competition in the domestic market, with a surge in supply just as domestic demand growth loses its rapid upward momentum.

Survival of the fittest

As exporters turn their attention to domestic markets and foreign competitors join the chase for Chinese demand, competition is intensifying. Inevitably, some companies will go to the wall. But that might be no bad thing: in many sectors of the YRD economy, as in the Chinese economy as a whole, the market is extremely fragmented. Multiple suppliers, each with a tiny share of the market, operate at sub-optimal levels and cannot afford the investments in technology that would improve productivity, reduce pollution and enable them to compete abroad. Kumho Tires is a case in point: although one of the largest tire companies in China, it only controls a tiny percentage of the national market.

In strategic sectors like steel, Beijing has pushed industrial consolidation. During the boom years, however, the YRD's many small, dirty and unproductive companies (often with the support of local government) could thumb their nose at the would-be economic optimizers in the central government. Now, with demand falling away, the pips are starting to squeak. In theory, the current crisis should usher in a period of the survival of the fittest as small producers with backward technology and limited market share are faced with the choice between merger or bankruptcy. The firms that survive will command larger market share, better technology and may be ready to elbow their way to the table for a share of the global pie.

But how that process plays out in reality will be conditioned by the willingness and capacity of local governments to step in and support troubled local firms. The YRD is often seen as a bastion of private enterprise and self-reliance. But the Sunan region – the area of Jiangsu province south

A plumper turkey

YRD vs other countries, 2007

	GDP US$ bn	GDP per capita US$
South Korea	970	20,015
Australia	909	43,163
Yangtze River Delta	**685**	**6,649**
Turkey	659	9,569
Pearl River Delta	374	6,938

Source: IMF; CEIC; Statistical Yearbooks of Shanghai, Jiangsu and Zhejiang

of the Yangtze River including the cities of Suzhou, Changzhou and Wuxi – found its early success in the willingness of local authorities to provide land, credit and tax breaks to "collective" firms, which tended to be formally owned by local governments even if run by entrepreneurial bosses. Collective has now largely given way to private ownership, and domestic firms jostle alongside the many foreign enterprises that have arrived to take advantage of the preferential treatment that collectively-owned firms once enjoyed. But the Sunan model remains one of large firms benefiting from a hand-in-glove relationship with local officials and commercial banks.

Suzhou's over-reliance on foreign business will hurt it this year

Suzhou is now paying the price for an approach to development based on government intervention and preferential treatment for foreign firms. Cheap land, labor and tax breaks enticed foreign enterprises to the city but did little to encourage them to build meaningful ties with the local economy. The business model this encouraged, unkindly dubbed "borrowing the chicken and selling the egg" because of the very low operating costs faced by Suzhou's foreign firms, did little to catalyze indigenous economic growth. Indeed, small local firms, starved of finance as capital was directed to their big collective cousins and foreign-invested neighbors, are the stunted babies of the YRD. In 2007, foreign-invested firms accounted for 90% of Suzhou's imports and exports. With the flow of foreign investment drying up and some foreign firms closing their doors, Suzhou in particular, and Jiangsu in general, will be playing catch up to create an indigenous industrial base.

What Zhejiang model?

In contrast, Zhejiang – particularly in the province's coastal region – has a flourishing private sector and a government traditionally content to let entrepreneurs work things out for themselves. Yet Zhejiang's firms may be less self-reliant than their reputation suggests. According to Yao Xianguo, the director of Zhejiang University's School of Public Management, a willing coalition of strong capital and strong government has dealt a deathblow to Zhejiang's widely-touted "small government" model. Pliant local banks plump up firms with no viable business model other than their reliance on cheap land and cheap labor. As demand has fallen away and the cost of land and labor has risen, these bloated prodigals have found themselves unfit to compete.

Zhejiang's reputation as a hotbed of private enterprise may be ill-founded

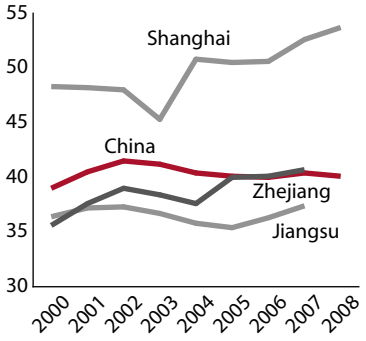
Compounding their previous errors, local government is now stepping in to rescue the failing companies their policies helped to create. In Shaoxing, for example, the government has set out "3 No's" for local banks to avoid: no calling in existing loans; no increasing collateral requirements on loans; and no imposition of additional requirements for companies wanting to take out new loans. An Rmb1.5 bn rescue package for Zhejiang Hualian Sunshine PetroChemical Co to restart operations after financial difficulties shut it down demonstrates the willingness of the Shaoxing government to support troubled local firms. (In fairness, though, industrial cities like Shaoxing and Hangzhou always had a strong

state hand; Zhejiang's reputation for entrepreneurship was built in more isolated coastal cities like Wenzhou, which lie well outside the YRD.)

That is bad news for a region that has ambitions to develop world-class services, advanced manufacturing, and research and development (R&D) capacity. According to a State Council-backed development plan aimed at pushing the YRD up the value chain, local governments should be encouraging competition and consolidation among companies in the region. But with local governments showing an increased willingness to step in to protect local business, more than stern words from the State Council will be required to effect genuine reform.

Shanghai shows the way

Services as % of GDP, 2000-08



Source: CEIC, Dragonomics estimates

Poor service

Max von Zedtwitz, vice-president of PRTM Management Consultants in Shanghai, agrees that developing world class innovation is a long-term challenge. "Only a minority of the 1,000 or so foreign R&D facilities located in the country have reached the level of maturity seen in equivalent facilities in the US and Europe," he says. That means the capacity both for engaging in genuine innovation and for setting independent research agendas. Von Zedtwitz says it will take YRD research facilities 15-20 years to catch up with their US counterparts. But with only a few foreign firms locating leading facilities in the region, the development of a world class innovation base is not an immediate prospect.

The immediate outlook for services is little more promising. Shanghai has succeeded in dragging services as a share of GDP up to 53%, but

Rooted by the river

Unrivaled infrastructure and human capital, a straightforward and relatively even-handed approach from government, easy access to international markets, and the prospect of selling to increasingly sophisticated Chinese customers make the Yangzi River Delta the most attractive Chinese destination for most foreign firms.

As the region moves up the value chain, foreign firms that help local officials meet their objectives for attracting research and development (R&D) and advanced manufacturing enjoy substantial benefits. "A good working relationship with local officials can help R&D leaders find additional subsidy opportunities, provided there is some benefit for the local community. If this is done well, then grants and subsidies from local governments could cover as much as 5-10% of an R&D center's operating costs," says Martin Daffner, head of product innovation at Avery Dennison, which operates a large materials R&D facility in Kunshan.

Although costs of labor, land and utilities are higher in the YRD than in neighboring Jiangxi and Anhui, foreign firms focused on higher value-added services and advanced manufacturing, or on manufacturing for export, show no inclination to leave. Bill Dodson, general manager of Asia Base A/S, a consultancy that provides services for foreign companies investing across China, says that many firms are looking at smaller cities within the region but few are willing to go further afield.

"A city like Xuzhou in [northern] Jiangsu, which has good links to Beijing and Shanghai and easy access to Lianyungang port, but operating costs 20-30% below Suzhou, will do very well. But for lots of foreign firms, going much further inland is like entering a different country," says Dodson.

Foreign firms are also turning their attention to the YRD's increasingly wealthy consumers and sophisticated companies. "As Chinese firms enter international markets their customers and partners are expecting them to meet higher standards, and that means they are interested in products which can help improve the efficiency and transparency of their operations," says Tim Farey, Asia general manager of Softbrands, a producer of enterprise resource planning software for manufacturers and hotels.

the change was painfully slow. The other two YRD provinces are more industrial: services account for 40% of Zhejiang's GDP (the national average) and just 37% of Jiangsu's. Plans for the region envision transforming Nanjing into an R&D and outsourcing center, Suzhou into a center for business process outsourcing, and Hangzhou into a back office for Shanghai's financial services firms. But years of tardy progress suggest that additional measures will be required if the government wants to achieve a decisive shift towards an innovative manufacturing and service-sector driven economy.

Few businesses plan to leave the region

The good news for the YRD is that the region is building on a solid base, and few businesses – domestic firms, joint ventures and foreign firms – say they have any intention of going anywhere else. Neither the rising cost of labor and land, nor the lure of financial incentives offered by governments in China's less prosperous inland provinces, appear enough to tempt business away from the YRD. For Zhang Xuening, the deputy director of the Hangzhou Economic and Technological Development Area, the reason is simple: "The infrastructure is here, the skilled workers are here, the market is here, and the other businesses are here. Where else do you want to go?"

Fire-water

The fall and rise of China's moonshine

by Will Freeman

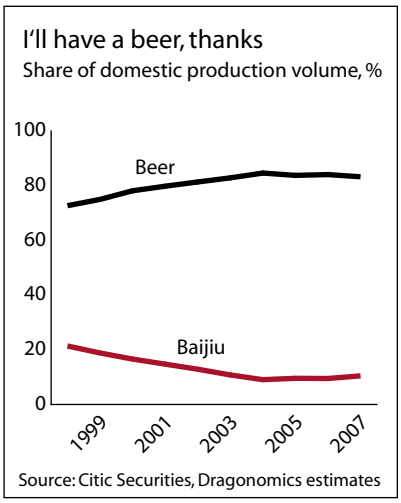
With revenues rising, baijiu is once again giving beer a run for drinkers' money

One of the attractions in the dilapidated Shanxi town of Xinghuacun is a museum of *baijiu* – China's infamous genre of distilled spirits. The crowning exhibit is a long glass display case filled with ostentatiously decorated bottles of all shapes and sizes, and the jewel in the crown is a small oval bottle of a brand called *Tanyue* ("Explore the Moon"). The tour guide is ecstatic: "Two thousand and seven bottles of *Tanyue* were produced in 2007," she exclaims, "each with seven diamonds encrusted in the glass." A bottle costs US$4,500; the guide would need to work for five years to buy one.

Baijiu, the world's largest spirits category by volume, traditionally dominated the domestic booze market. "It's not a banquet without baijiu," runs the customary refrain. But in recent years, sales volumes of China's national liquor declined as beer, a foreign upstart, gulped up market share. Now baijiu makers are fighting back with a proliferation of new luxury varieties designed to appeal to the country's growing band of big spenders. Revenues are shooting up at major distilleries and baijiu (which literally means "white alcohol") is giving beer a run for its money.

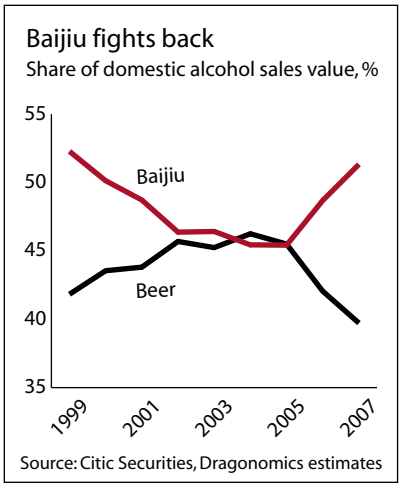
Solvent abuse

For foreign businessmen and journalists forced to drink the stuff at countless banquets, baijiu provides an infamous challenge for the unconditioned palate (see "Hacks' sick bag"). But this potent spirit – generally 40-60% alcohol by volume, but sometimes 70% plus – is a mainstay of Chinese culture, first popularized during the Xia dynasty 4,000 years ago. Made from a mash of sorghum, rice, unhusked barley and other grains, baijiu is produced via an unusual process of "dry" fermentation: yeast is applied to the mash, which is dampened, put in a hole, covered with clay, and left to ferment for 75-120 days. The clear alcohol extracted after distillation comes in two major varieties, classified by fragrance: *nong xiang* (strong fragrance), which connoisseurs consider to have a sweet and mellow taste; and *jiang xiang* (sauce fragrance), described by Wikipedia as having "solvent and barnyard aromas."



For the first 15 years of the reform period, sales volumes of baijiu rose along with personal incomes. But after peaking in the mid-1990s, sales went into reverse as rural residents switched to beer and increasingly health-conscious urban consumers cut down on the hard stuff. This trend solidified in 2001 when Beijing slapped two new consumption taxes on baijiu, driving many small, low-margin producers to the wall. Although inadequate government statistics make it impossible to know how many distilleries closed their doors, analysts reckon that anywhere between 50-90% of the estimated 37,000 distilleries operating in the late

Will Freeman is a Dragonomics research analyst based in Beijing.



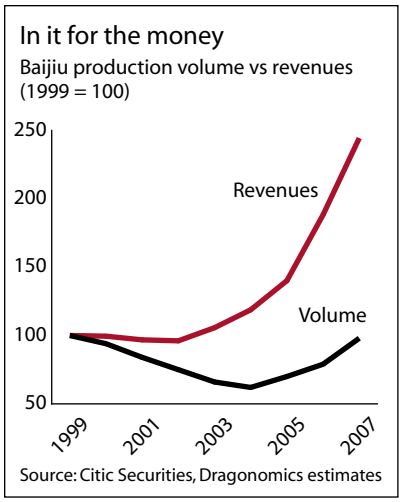
1990s went out of business. The brutal consolidation process allowed 50-60 major players to grab 70% of the market.

The government's tax had three objectives: improving product quality, promoting consumption of healthier alcohol, and limiting baijiu's impact on the domestic grain market. "Small distilleries often use dodgy ingredients to flavor edible alcohol to taste like baijiu, so cheaper baijiu may be more hazardous to health," says Zhang Shidi, an expert on the baijiu industry at the Chinese Academy of Sciences. Baijiu production, like many other Chinese food processing industries, was highly fragmented and impossible to regulate. Consolidating the industry into larger production units made inspections easier and pushed some of the most toxic brews off the market. The tax also increased baijiu prices compared to lighter alcohols, encouraging more sensible drinking.

The government justified the crackdown on small producers by citing the rising number of farmers substituting sorghum (of which 60-70% is consumed by the baijiu industry), for more important food grains like corn, wheat and rice. In reality, sorghum accounts for just a tiny fraction of total grain production, and even at its peak the baijiu industry had a minimal impact on grain markets. Professor Zhang says the government's unfounded concern was a relic of a pre-reform agricultural economy that struggled to produce enough grain to feed the population.

After the hangover

Battered by the breweries and government-driven consolidation, the baijiu industry reached its lowest ebb in 2002. But in 2003 distilleries began to fight back, raising prices and reinventing baijiu as a luxury product. Following the model blazed by famous and expensive brands such as Guizhou's Moutai – the official tipple at government banquets, whose former general manager Qiao Hong recently admitted to taking Rmb12m in bribes – the proliferation of new premium brands pushed up prices and boosted revenues across the industry. Sales revenues for premium baijiu (Rmb100-300 per 500ml bottle) and super-premium baijiu (over Rmb300 per bottle) grew roughly 16% and over 30% per year respectively from 2003-2007. The explosion in luxury sales and prices kept baijiu's share of domestic alcohol revenues steady, even as its volume share dropped.



With margins for premium baijiu around 60-70% and super-premium at over 80%, the premium business is now a huge money spinner. The priciest baijiu available in supermarkets costs around Rmb2,000 for a 500ml bottle. But at a Shenzhen auction in 2006, a connoisseur bought a 90-year-old bottle of Wuliangye – a famous Sichuan brand – for Rmb880,000. By comparison, a bottle of ordinary baijiu can cost as little as Rmb4. However, blind taste tests and chemical analysis suggest there is no discernible difference among differently priced baijius.

However bogus it may be, luxury baijiu has spawned a luxury baijiu culture. Super-premium baijiu has become *de rigueur* for elite business din-

ners. "In Shanghai, some companies refuse to drink a brand priced at less than Rmb800 a bottle when entertaining customers" says Johan Simonsson, who manages international spirits giant Pernod Ricard's partnership with domestic baijiu producer Jiannanchun (JNC). Price and brand, rather than taste or quality, are the elements that dictate consumption of top-end baijiu. "There is a price game going on; one company increases prices and then the others follow," says Simonsson. Raising prices has actually boosted consumption, as price is the primary measure of an entertainer's regard for his guests.

Hacks' sick bag

Foreign correspondents share their baijiu experiences.

Jes Randrup Nielsen (*Jutland Post*)
Compared with other kinds of alcohol, save absinthe, baijiu has a frighteningly liberating effect on the brain and gives severe physical and moral hangovers. The one time I did get drunk on the stuff, in Yunnan, I found myself in close physical proximity to two girls who were designated drinkers at a minority restaurant somewhere along the Nu River. The tradition was to drink with two girls out of one cup and it would have been impolite to refuse. The girls – who periodically left the room, probably to vomit – managed to drink the entire minibus of NGO workers and three journalists under the table. In the process several of the passengers got off with each other. I concluded the evening in a seedy karaoke joint in the company of three prostitutes and a bullhorn that I had somehow managed to snatch from a tour guide.

Mure Dickie (*Financial Times*)
Back in 1990, I was cycling across Guangxi and got stuck for a night in a town somewhere south of Guilin that the inhabitants claimed was famous for its fine baijiu. My traveling companion and I had a chance to try it when we were invited to join a table of other diners at a local restaurant. It was absolutely vile, much smoother going down than *Erguotou* [an infamous Beijing baijiu] but with a rancid sulfurous aftermath. But our hosts couldn't get enough of it. One fellow next to me actually turned at one point to vomit reasonably neatly over his own shoulder onto the floor, and then kept on drinking. This pales into insignificance compared with the dinner participated in by former Reuters Beijing bureau chief David Schlesinger in Shandong, during which one participant actually vomited on the table but others went on eating dishes around the mess.

James Kynge (*Financial Times*)
My baijiu moment came in a county town in Shandong called Zhangqiu. As we began lunch, the county boss asked if we would like some baijiu, and our reply was a definite "No, thank you." But he insisted, saying that the baijiu was a local product, one that everyone was very proud of, and that to refuse would be rude. I looked at the table settings and, seeing the smallest, Lilliputian thimble of a shot glass, thought we would be OK if we had one, just one. But you can never have just one because the question that comes after you've downed it is: "Did you like it?" And the answer to that can only be affirmative and enthusiastic. Most of what I remember after shot number two began to merge into shot number 25 is that I tried to explain how the British queen could be queen but not the most powerful person in the country, that when I sang our national anthem of "God Save the Queen" everyone was nonplussed, and that my colleague, whose name was Rahul, got a Chinese name "*La Hu*," meaning "Spicy Tiger."

Matthew Forney (*Wall Street Journal, Time*)
Weeks after I arrived in Beijing in 1993, I met William Hinton, whose brilliant book *Fanshen* had documented the Chinese revolution in one village in Shanxi province. Hinton, a well-built 73-year-old American farmer with overalls and a nimbus of white hair, drove me in his Volkswagen to visit some peasant friends of his outside Beijing. We spent three sweltering, noon-time hours on a harvester, and then his friends threw a banquet. I was desperately thirsty, and Hinton must have been too, but the peasants served only baijiu and haw nectar, a thick red juice that tasted like sugary ketchup.

Politeness demanded that we drink to incapacitation, and since Hinton would drive us home, I resolved to take his bullet. I emptied a respectable number of tiny green baijiu bottles so that Hinton wouldn't have to, but at some point I realized my ploy was failing. Hinton toasted and drank the vile stuff until every peasant quit the table. Then he helped me spraddle across the back seat of his car, drove us home and, while I dry-heaved in his bathroom, poured glasses of gin and tonic. "The bubbles help," he said.

Sami Sillanpaa (*Helsinki Sanomat*)
I never liked baijiu. It's not strong enough for me.

Advertising has also been a significant driver in the development of the premium market. Wuliangye and Jiannanchun, two of the top three baijiu producers, respectively spent US$140m and US$70m on advertising in 2006. Even after the recent industry consolidation, top brands still have to compete with scores of local producers. Chinese television commercials, particularly at lunar New Year, are dominated by baijiu manufacturers battling to show the superior heritage and provenance of their brands. Luzhuo Laojiao, for example, markets a brand called 1573, denoting the age of its fermentation pits. If international standards are anything to go by, baijiu advertising has plenty of room for growth: Citic Securities analyst Bo Guanhui reckons big baijiu companies spend just 6-7% of revenues on advertising, significantly less than top international spirits companies.

Stronger than beer

Foreign interest has been strong since investment restrictions were lifted in 2006

Western spirits companies such as Pernod Ricard had been drooling over margins in premium baijiu for years when Beijing finally scrapped restrictions on foreign investment in the industry in 2006. UK-based Diageo led the charge, grabbing a 43% stake in the parent company of premium brand Shuijingfang. French conglomerate LVMH followed with a majority stake in Sichuan distillery Wenjun. Their eye is firmly on the domestic market: attempts to popularize pricey Chinese moonshine abroad have failed.

If the experience of foreign breweries holds, international investors may soon learn that it pays to compete on quality (or more precisely, image) rather than quantity. Many of the foreign players who came to China's beer party 10 years ago left with formaldehyde-induced hangovers, bludgeoned by competition from low-end domestic breweries with razor-thin margins. Anheuser-Busch (acquired last year by Inbev) bucked the trend by buying into China's largest premium brewer, Tsingtao, and marketing Budweiser as a "super-premium" brand. Although Budweiser ranks only 19th by sales volume, it is China's fourth most profitable brand. Inbev, by comparison, bought up a handful of small local breweries, controls a large volume share of the market, and makes meager profits. On this evidence, Pernod Ricard and Diageo's partnerships with national, premium brands should give them the edge over LVMH, which bought a stake in a local distillery with no premium heritage.

Books

Shanghai blues

by Victor Shih

Capitalism with Chinese Characteristics: Entrepreneurship and the State
by Yasheng Huang
Cambridge University Press, 2008

The 1990s are usually regarded as a time when a new generation of leaders took a much-needed stick to China's ailing state-owned enterprises and the country's cities finally regained their mojo. But Yasheng Huang's new book is a stinging indictment of China's state-directed reforms in that decade. Dismissing the "deepening reform" descriptor used by the government, he instead views the decade as a "great reversal" of the promising, rural-based reform trajectory of the 1980s. *Capitalism with Chinese Characteristics* is a must-read for anyone considering long-term investment in China because it unearths a story of China's growth that is more sobering and unsettling than the orthodox one.

Huang, a professor at MIT's Sloane School of Management, begins by systematically casting doubts on the conventional view held by many economists that the urban-based reform of the 1990s logically followed the rural reforms of the 1980s. Marshaling an impressive array of evidence, Huang contends that China's private economy reached its pinnacle in the 1980s when the political elite encouraged private growth, and privately owned township and village enterprises (TVEs) thrived. The spectacular growth of TVEs was fueled by credit made available to rural private entrepreneurs. But this dried up in the 1990s as banks began to channel funds away from the countryside to urban state-owned enterprises (SOEs) and construction projects. Aside from a mountain of bad loans, the result was a staggering opportunity cost: Zhejiang province is the only survivor of the 1980s model, from which we get a glimpse of China's alternative present, sadly forgone.

Shanghai: grand illusion

City of state support

Huang then launches a systematic attack on Shanghai, often touted as a model city for the developing world. Far from being an energetic incubator of private firms, Shanghai has one of the lowest levels of indigenous private entrepreneurship in China. Few residents own businesses or private assets, with most households relying on wages for their income – in stark contrast to entrepreneurial hotbeds like Zhejiang and Guangdong. Huang makes a convincing case that, despite its reputation for business savvy, Shanghai is a model of state capitalism, systematically discriminating against genuine private entrepreneurship.

Several quibbles can be made with Huang's arguments. First, his contention that the indigenous private sector continues to make up a relatively small share of output and employment is dubious. Many of the foreign-invested enterprises (FIEs) excluded from Huang's analysis are in reality domestic firms taking advantage of the preferential policies conferred to

Victor Shih is assistant professor of political science at Northwestern University.

foreign companies; his estimate of the domestic private sector is almost certainly too low. Second, Huang contends that the centralization of fiscal and financial resources in the 1990s contributed to an urban bias that channeled funds to large cities, depriving rural entrepreneurs of capital. But he fails to point out that this was a reaction to the perceived chaos in the 1980s when decentralization led to a precipitous decline in central revenue and bouts of high inflation, resulting in major urban demonstrations. Moreover, greater central control gave Beijing the financial resources to douse a host of fires over the past two decades, ranging from the Asian financial crisis to SARS. Huang is overly harsh in implying that China got little in return for its centralization policies of the 1990s.

China's urban-centric growth model has cost the countryside dearly

But Huang's core argument on the enormous explicit and opportunity costs of the urban, state-centric growth model in the 1990s remains convincing. The 1990s saw rural incomes stagnate and momentum lost on improving literacy rates and health care.

What does this tell us about growth in China into the future? According to Huang's ominous prediction: "The Shanghai model will come back to haunt Shanghai if there is an external shock." Not just in Shanghai, he implies, but much of China. That external shock is arguably happening as the global recession batters exports and foreign investment, previously the two genuine bright spots in the economy. If Huang is right, the coming months may test the limits of capitalism with Chinese characteristics.

Waiting for the fifth modernization

by Arthur Kroeber

China Modernizes: Threat to the West or Model for the Rest?
by Randall Peerenboom
Oxford University Press, 2007

Randall Peerenboom makes two important arguments in *China Modernizes*, a thorough critique of China's Western liberal critics. First, China's many well-documented problems are largely a function of the country's relative poverty, rather than the deficiencies of its political system. In particular, China's comparatively poor performance on measures of civil and political rights is not unusual for countries of its income level, and the experience of other developing countries gives strong reason to believe that civil and political rights will strengthen as China grows richer.

Second, much Western criticism of China's lack of civil and political rights is either outright unfair, or based on unexamined and overweening assumptions of universalist liberalism. The messy reality of China is too often compared to an idealized version of Western liberal states that ignores both the present shortcomings and largely non-democratic history of the latter. Or there is a Fukuyamaist "end of history" presupposition that the natural destiny of all states is to end up as European-style social democracies, and that any deviation from this course must result from the illegitimate suppression by an authoritarian elite of the popular will.

Arthur Kroeber is editor of the *China Economic Quarterly*.

There is a lot of merit in these arguments. Much Western criticism of China is unbalanced, ill-informed, sanctimonious, based on double standards or selective use of evidence, and occasionally just racist. As Peerenboom repeatedly points out, some quarters of the international human rights community seem to think the only rights that matter are civil and political ones, and that a dearth of these rights nullifies any achievements in broadening access to food, shelter, education and economic opportunity. A fair chunk of *China Modernizes* is devoted to documenting the extraordinary progress China has made in improving a range of social and economic rights for large swathes of its population. Marshaling an impressive amount of comparative data, Peerenboom makes a strong case that China has generally outperformed countries in its income bracket on most measures of economic and social rights, and that this success must be balanced against China's underperformance on many measures of civil and political rights.

China has outperformed countries in its income bracket on economic and social rights

Yet for all its argumentative panache, *China Modernizes* strikes me as unlikely to convince anyone who does not already agree with its basic view. And even as someone who sympathizes with much of what Peerenboom has to say, I finished the book with a feeling of unease. Why?

A missing Chinese voice

The main reason is that Peerenboom tackles only two of the three tasks required to make a complete book on the subject of the balance between economic, social and political rights in China. He provides a broad and detailed analysis of China's achievements and failures across a range of social indicators. And he delivers a sharp and uncomfortable critique of the Western human-rights discourse about China. But he has virtually nothing to say about the arguments *within* China about political and civil-rights reform. There are numerous citations of Western criticisms of China, and of government documents and reports defending the state's accomplishments, but the extensive bibliography is bereft of references to the enormous *Chinese* literature of social criticism.

The failure to take account of the Chinese debate is not a small omission. The debate began thirty years ago, at the very beginning of the "reform and opening" era, with Wei Jingsheng's brilliant essay *The Fifth Modernization*, which argued that without political democracy, social and economic modernization would be an empty achievement. It continues down to this day with vast amounts of reportage, social science research and polemic, some of it available only in the shadowy world of samizdat but much of it in the public domain. The most prominent recent manifestation is Charter 08, an outline for governance reform signed by thousands of Chinese intellectuals last December which not only demands competitive elections, free speech and fair trials but also asks for open and accountable budget procedures and insists that the military be made subordinate to the government, rather than to a political party as at present. Charter 08 incorporates many aspects of the international human rights critique of the Chinese party-state, but is grounded in a

From Wei Jingsheng to Charter 08, China has debated its need for political change

well-informed and urgent domestic view that political reform is required to prevent China from running off the rails. It cannot be dismissed as biased, unbalanced, or based on a double standard or naïve liberal universalism. Charter 08 was, of course, unthought-of when Peerenboom wrote his book, but its many precursors were widely available.

The decisions of China's oligarchy must be judged in the light of critiques from Chinese thinkers

By structuring his argument as a debate between biased foreign critics and a Chinese party-state which is tacitly granted the right to speak on behalf of all its subjects, and whose decisions he usually presents as aspects of a rational development strategy rather than as expressions of elite self-interest, Peerenboom makes things too easy for himself. Polities evolve not through debates between their rulers and foreigners, but by arguments (or battles) between the rulers and the ruled. Defending China's development record against ill-informed foreign critics is a useful task. But the larger, more difficult and vastly more important task is to judge the political choices of China's oligarchy in light of well-reasoned critiques by domestic thinkers. That could well be the subject of another interesting book.

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GaveKal Research
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Dragonomics Research & Advisory
15D Oriental Kenzo Office Bldg
48 Dongzhimenwai Dajie
Beijing 100027 China
www.dragonomics.net