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Will Chinese Growth Become Consumption Led in 2-3 Years?

- Weak domestic consumption and a high saving rate have been two of the most-discussed topics regarding the economic model of China. While the sub-par social welfare system of China should be blamed, a deeper problem, we believe, lies at the low labor costs and concentration of wealth. The seemingly infinite supply of labor in the past decade has resulted in cheap labor and an increasingly large income gap. With a small percentage of the population taking away a large share of the gross national income, China's income distribution has been in a configuration such that it cannot fully utilize its purchasing capacity.
- However, as we discussed in our previous reports, China is about to reach a turning point in terms of labor supply (See *2012: Upcoming Turning Point in Labor Market*). A labor shortage will become more visible and labor costs, especially of those low-income populations, will start to accelerate by 2012-2013. With the low-income population, whose saving rate is significantly lower, taking a larger share of the gross national income, China's income distribution will turn into a configuration that has more potential purchasing capacity, i.e. the (nominal) domestic demand is likely to surge 2-3 years from now.
- The surge of purchasing power is likely have two impacts: 1) in the short term, rising consumption demand most likely will lead to structural inflation because the supply of goods and services is not likely to meet the demand; 2) in a longer time scale, however, a stronger domestic demand means more enterprises will start to build up production capacities targeting the domestic market and more consumer goods will be imported to meet the domestic demand. Eventually the higher *nominal* purchasing capacity will result in higher *real* domestic consumption and a more-balanced current account.

Low Income Group Has Higher Propensity to Consume; Wage Growth Helps to Raise Overall Consumption Spending

In theory, the marginal propensity to consume decreases as income improves. Based on this theory, supposing all domestic consumers have the same consumption preference, the low income consumers have higher marginal propensities to consume. Therefore, allocating more wealth to the low income group will not only help to narrow the income gap, also it will also promote the consumption.

To simplify the calculation, we divide consumption spending by disposable income to measure the propensity to consume. We find that the average propensity to consume of the lowest income provinces (7 provinces in total) exceeds that of the highest income provinces (8 provinces in total) by 4%; propensity to consume in western provinces exceeds that in eastern provinces by 4%. And this difference can be as high as 20% when comparing high income groups and low income groups.

We believe the income gap will narrow as labor costs, particularly low-end labor costs, rise gradually. More social wealth will be allocated to low income groups through compensation and transfer payments. In addition, relatively faster income growth of low income group will promote the overall consumption spending.

Chart 1 Propensity to Consume by Provincial Income Levels (2009)

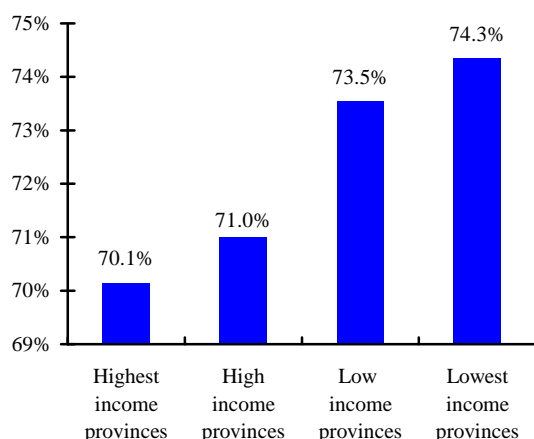
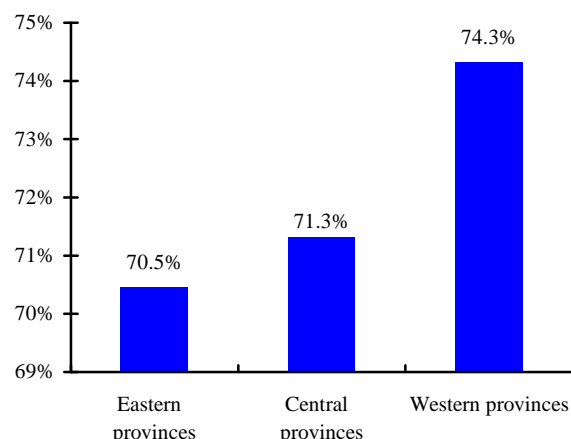
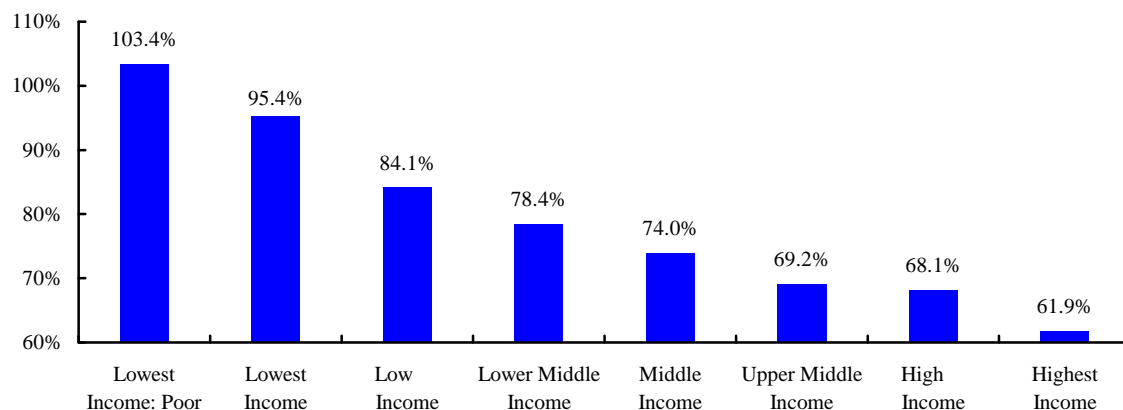


Chart 2 Propensity to Consume by Regions (2009)



Source: CEIC, CEBM

Chart 3 Propensity to Consume by Income Groups (2008)



Source: CEIC, CEBM

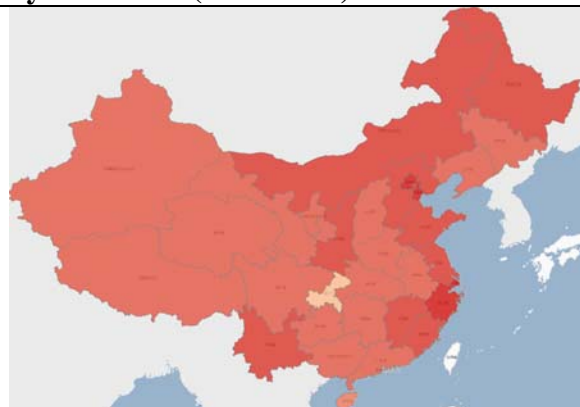
Regional Income Gap Narrows; Low-End Labor Compensation Improves

We have mentioned the overall income gap has been slightly enlarged. However, we find signs that regional income disparity actually has been narrowing recently. We see in recent years, income growth in some central and western provinces has surpassed that in east coastal provinces, which was totally not the case in 1990s. The narrowing of regional income gap benefits from governments' various regional revival planning in central and western provinces. In addition, we believe industry transfer from coastal areas to inland areas also contributes to narrow the gap, as we see higher income growth rate in provinces close to coastal provinces than other inland provinces.

We also compared the income levels in different tier cities. We see higher income growth in medium-small cities than in big cities, which provide further evidence that the regional income differences have been narrowing in recent years.

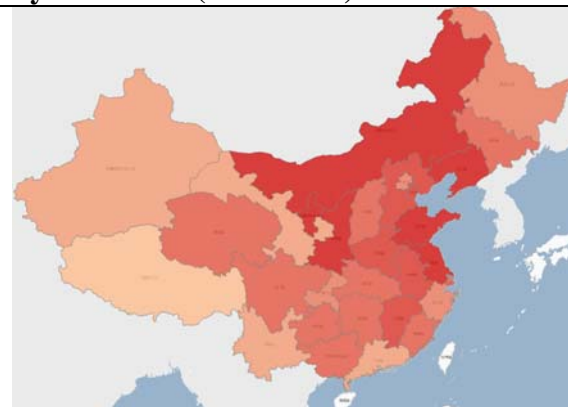
Another phenomenon worthy of discussion is that we find the wage compensation for migrant workers in central eastern areas is approaching that in eastern areas. In 2009, migrant workers earned RMB 1422 per month in eastern areas and 1350 in western areas. This phenomenon coincides well with the fact that the number of migrant workers in eastern areas diminished by over 8 million in 2009. We believe the improvement of migrant worker compensation in central western areas is a sign that the demographic divide is closing up and low-end labor income will improve rapidly in the future.

Chart 4 Average Urban Income Growth by Provinces (1992-2000)



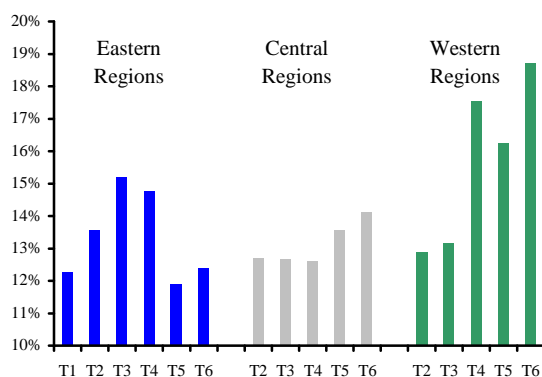
Source: CEIC, CEBM (Darker color signifies higher growth rate)

Chart 5 Average Urban Income Growth by Provinces (2004-2009)



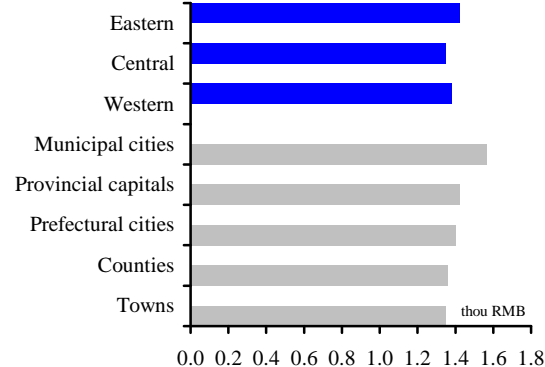
Source: CEIC, CEBM (Darker color signifies higher growth rate)

Chart 6 Average Urban Income Growth by City Tier (2002-2009)



Source: CEIC, CEBM

Chart 7 Migrant Workers' Monthly Income by Regions (2009)



Source: NBS

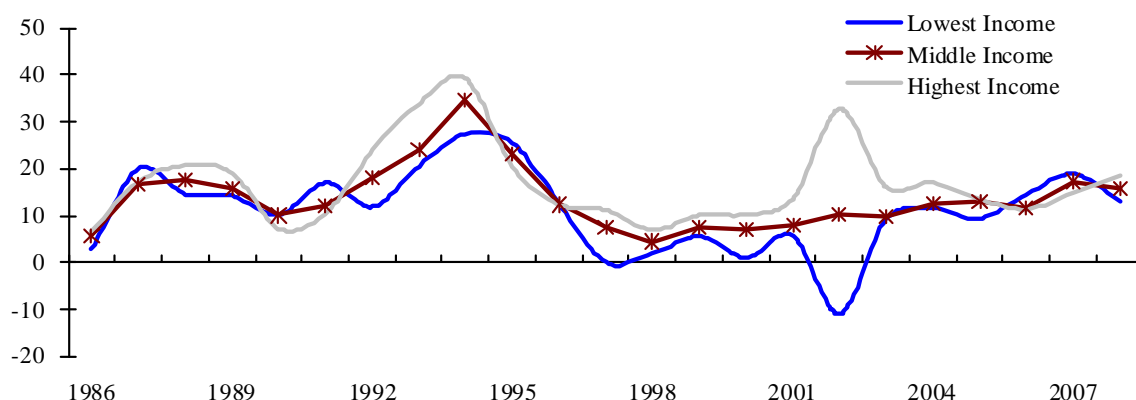
Wage Growth of Low Income Population Creates Additional Demand for Consumption

The high income population has been constantly enjoying higher earnings growth than the poorer group in the past 20 years. However, the difference in the wage growth may shift as the balance in the labor market changes. As the low income population has a higher consumption tendency in general, we believe the change in the wage growth structure may create additional demand for consumption in the future.

Historically, China's income growth has been stable as a result of "Hukou" (household registration system) and other institutional arrangements. The rural area has constantly supplied an unlimited amount of labor to the cities, and the wage growth has been depressed because of the supply pressure. However, we estimate the labor growth in 2010-12 will reach a peak and the wage growth may be much higher than previous years for the low income group. On the positive side, the higher wage growth of low income groups will further improve the balance of society and stop the polarization of the poor and rich.

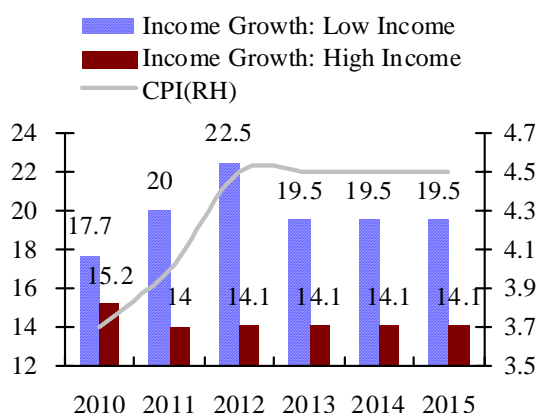
There is no doubt that higher wage growth of lower income population will bring additional consumption demand. The consumption tendency, calibrated by the ratio of consumption spending to income, shows that low income population has a much higher spending tendency. Low income people spend 95% of income, while high income household spends only 62%.

Chart 8 Wage Growth of Highest Income Population Increased Faster



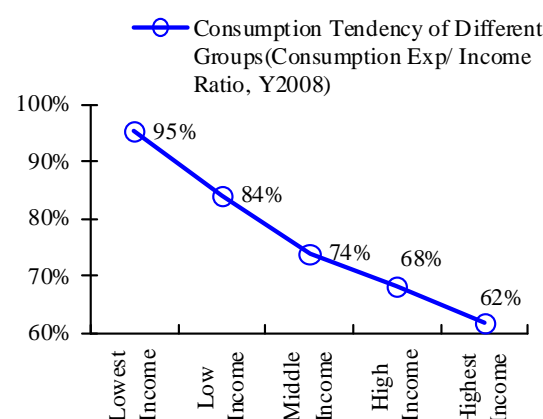
Source: CEIC, CEBM

Chart 9 Low Income Group With Higher Growth In Coming Years



Source: CEIC, CEBM

Chart 10 Low Income Groups Have a Higher Consumption Tendency



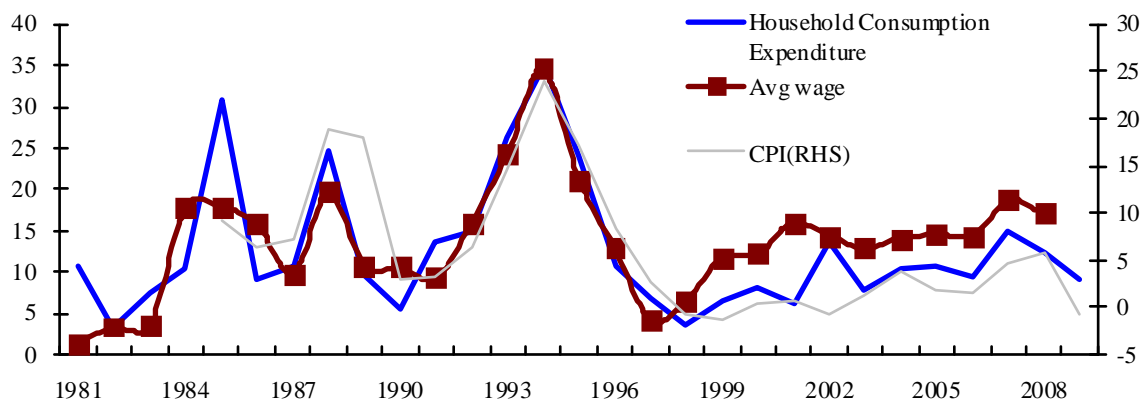
Real Consumption Expansion Or Inflation? Up to Supply

Our analysis shows that the change in the labor cost around the turning point of labor supply is inevitable. And consumption demand may surge, particularly the segment of the market targeted at lower and middle-income population. However, we believe the demand expansion may not necessarily convert to real consumption; inflation may turn out to be the result of the demand expansion in the case of short supply.

It is true that China faces severe overcapacity in the manufacturing sector, but we are not sure whether the country is in a good position to handle the expansion of increasing consumption demand of the low and middle income population because of the mismatch of the production and consumption. Even though the gap can be filled, the increasing demand of the huge population may seek resources and raw materials from abroad. This brings pressure to inflation as well.

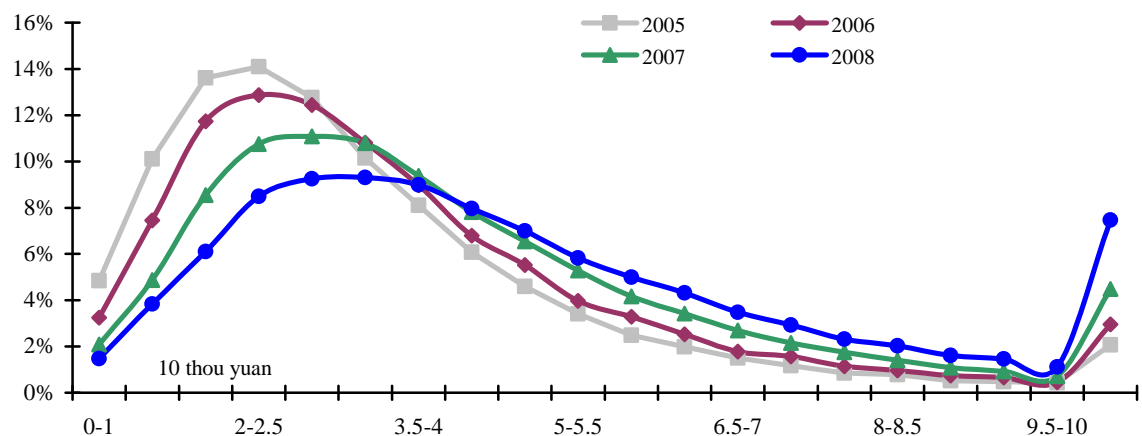
We believe that consumption demand will expand, but it is not certain whether it will be real consumption or inflation that is stimulated during the change in the labor market.

Chart 11 Income, Consumption and Inflation



Source: NBS

Chart 12 Urban Family Income Distribution



Source: CEIC, CEBM

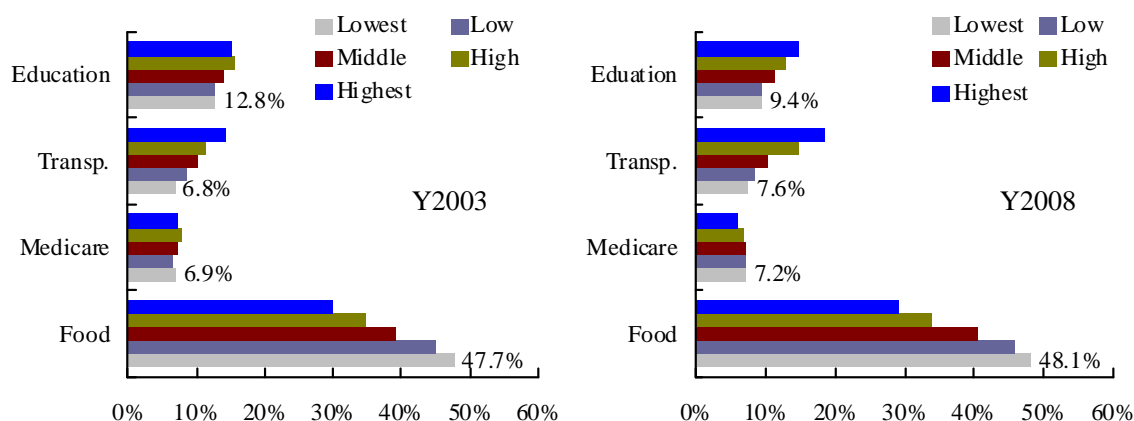
Industrial Structure Needs to Adapt to Structural Change of Consumption

The rising incomes of the mid and low income population will not only result in rising purchasing capacity, but also cause a structural change of consumption demand.

A closer look at the consumption structure shows that the demand for services and durable goods from the highest income populations has been growing, while the demand for foods has been declining. With the lower income population gaining more wages, we expect their consumption demand will go through a similar transition. The current industrial structure may meet the requirements of consumption demand today, but may need to be adjusted in the future. The structural change will require more investments in sectors in which the output of goods and services will see more demand from domestic consumers.

In particular, the healthcare and education sectors are likely to be entering a period of rapid growth, with annual growth rate reaching 18.2%, 20.5% and 23.0%, respectively in 2010-2012, the highest levels since 2000.

Chart 13 Expenditure Structure by Income Level



Source: CEIC, CEBM

Chart 14 Rising Demand for Services (High Income Group)

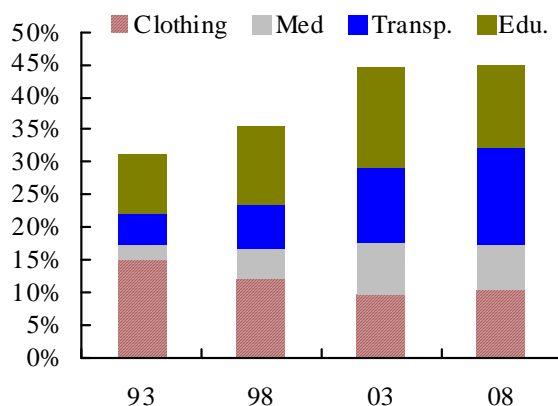
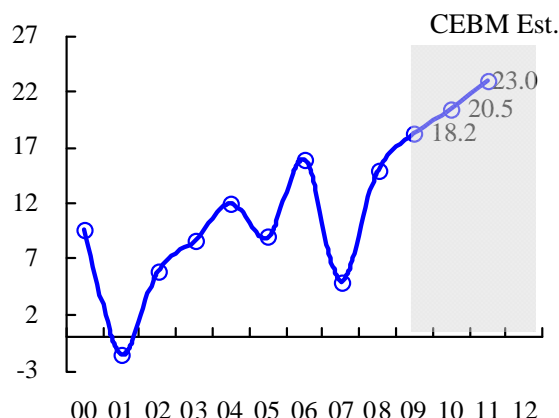


Chart 15 Income in Service Sectors (Healthcare. & Edu., to Low/Mid Income Groups)



Source: CEIC, CEBM

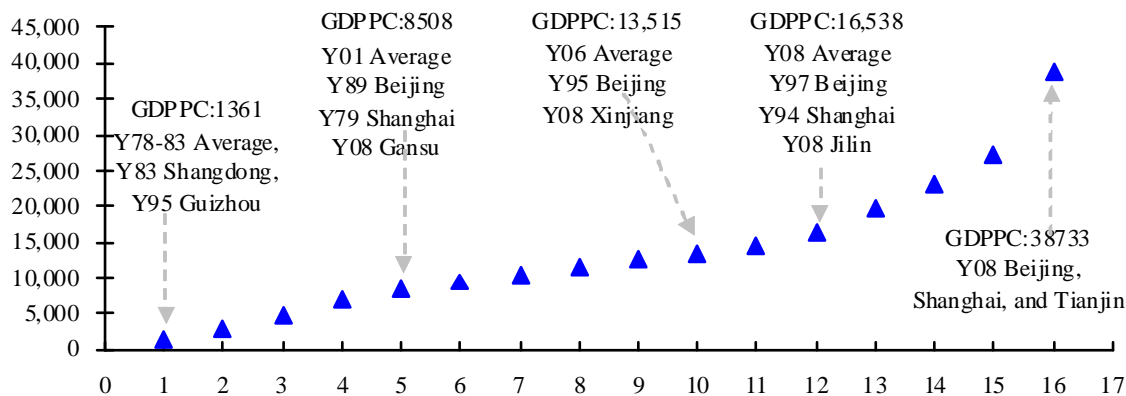
Moderate Investment Growth Needed to Meet Upward Trend of Consumption

As we mentioned, the lower-end consumption and service consumption may pick up more quickly. Historical experience shows that there is a time lag between under-consumption and a warming up of consumption. Moreover, moderate investment growth is a necessary condition for the upturn of consumption as well.

The disparity among different provinces has provided helpful evidence to investigate the development of consumption. The average GDPPC is equivalent to that of developed regions 10 years earlier; therefore, the experience from developed regions can be used to analyze the future development of consumption in less developed regions. Compared with international experience, this method provides a new perspective, because it does not need to take political or cultural differences into consideration.

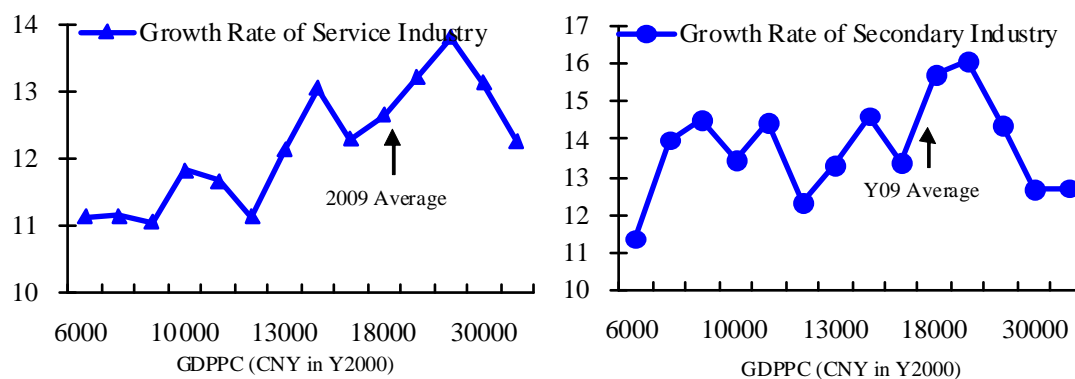
Based on GDPPC at 2000 constant price, we can identify a general development trend at different development stage. The average GDPPC amounted to RMB 16-17 thousand in China. The developed regions whose GDPPC reached this level saw an acceleration in growth of the service industry. Meantime, the growth of secondary industry did not slow down. This phenomenon has interesting implications for policymakers.

Chart 16 Regional Development Differences Measured by GDPPC



Source: CEIC CEBM Group

Chart 17 Further Growth Requires Boom in Both Service and Secondary Industries



Source: CEBM Group

Moderate Investment Growth Needed to Meet Upward Trend of Consumption (cont'd)

Some analysts hold the opinion that the consumption can replace investment as a growth engine to some degree. However, our analysis on the development pattern of regions at different stages shows under current circumstances consumption and investment should be taken as two different engines, rather than regarded as replacements for each other. The upturn of consumption should be supported by further investments and investments will continue to contribute significantly to China's growth in the next few years. However, as GDPPC increases to a certain level and consumption starts to pick up, the growth of investment may slow down in the future, but it will by no means halt.

The historical experience shows that, except in some municipalities directly under the central government where GDPPC surpassed RMB 30 thousand, growth of investment still remains at a high level. Growth of investment may even accelerate if GDPPC is more than RMB 20 and less than 30 thousand. The comparison between the growth of the service industry and FAI shows that the growth of FAI may peak if the growth of service industry reaches 15%-21%. In principal, the upturn of consumption is normally accompanied by the upgrade of expenditure structure, implying a corresponding change in investment and related industry. Compared to previous investment, the investment in this period is more market-oriented, rather than policy-oriented.

Chart 18 Correlation between Growth Rate of Service Industry and Inflation

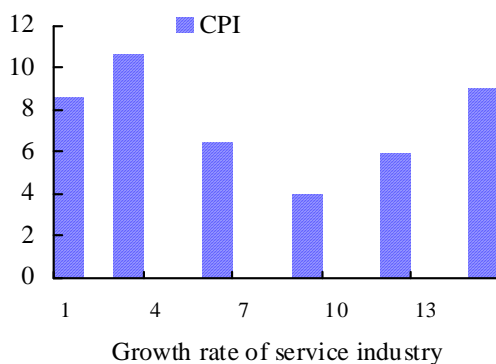
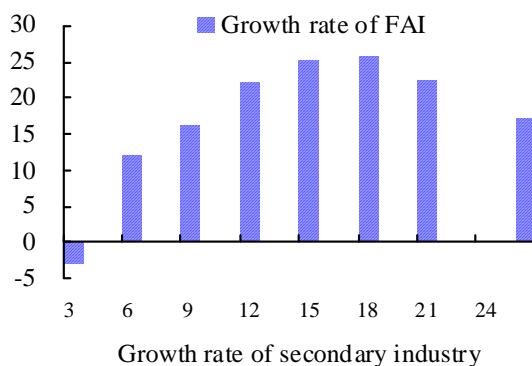
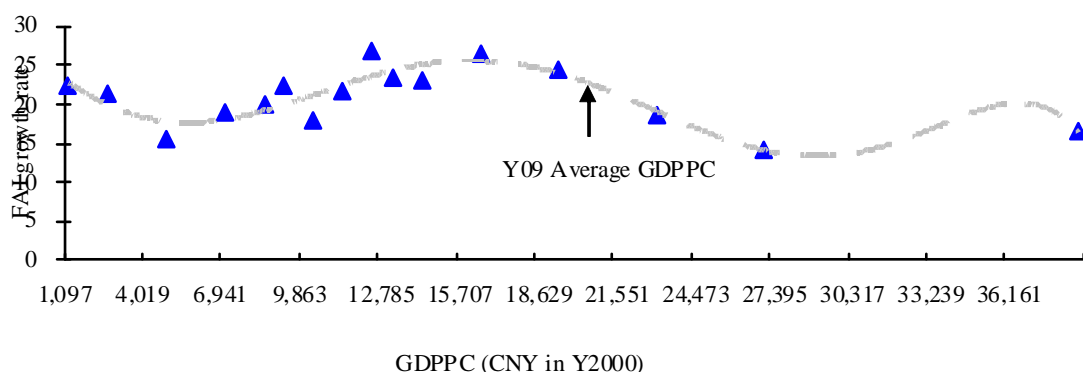


Chart 19 Growth of Service Industry Should Be Supported by Investment



Source: CEIC CEBM Group

Chart 20 Growth of Investment May Slow down, not Halt



Source: CEBM Group

Commentary on Recent News

Positive

MIIT: Industrial investment in the first four months of year increased 21.6% Y/Y.

Minister of Commerce Chen Deming said it is too early to exit fiscal stimulus.

The PBoC increased the offering yield of 3m bills, aims to avoid locking in more liquidity for too long.

NDRC: The prices for vegetables declined further in the third week of May.

The Ministry of Finance: China's central government has allocated RMB 16.7 billion to help local governments solve the housing problems of low-income urban families.

The Ministry of Finance issued RMB 28 billion in 50Y bonds at a yield of 4.03%, lower than expected.

China is planning to reform the resource tax on a trial basis in Xinjiang.

China's Cosco said it would not hold back investments in Greece's largest port Piraeus despite the crisis.

Gary Locke: The US is likely to overhaul the export control policy this summer.

Zhang Guobao, head of China's National Energy Administration, said China's installed power generation capacity will surpass 900 million kilowatts by the end of 2010.

Guangdong's exports rose 32.4% in the first four months, higher than the growth rate of China's exports.

CIC said that the impact of the European debt crisis is less than expected.

China will double investment in Xinjiang in the next five years to boost its economy.

Minister of Commerce Chen Deming said that under the current financial crisis, the exchange rate stability is the most important.

Cross-border RMB trade settlement may be expanded to 20 provinces, helping enterprises to mitigate exchange risk.

USDA chief said that China has become the largest export destination in terms of agri-products in the first half of the fiscal year 2010.

China's No. 2 telecommunications equipment maker ZTE Corp expects revenue to grow by about 30% over the next few years.

Vice Premier Wang Qishan said Beijing hopes Washington can set a timetable to relax the export control policy.

Negative

China's commerce ministry remained cautious about the trade outlook due to complex situation.

China's copper imports declined for the first time in three months in April as domestic stockpiles rose.

The price of raw silk increased to a 15-year high in late April.

Cotton prices surged to a new record high on Wednesday, boosted by a tight supply and low stockpiles in the domestic market.

According to a survey, 20% of college graduates are willing to work for free.

Yao Jian, spokesman of the Ministry of Commerce, said the European debt crisis will hurt China's exports.

Yuan 12 NDF dropped to a 8-month low on speculation China will postpone appreciation as the European debt crisis add more uncertainty to China's foreign demand.

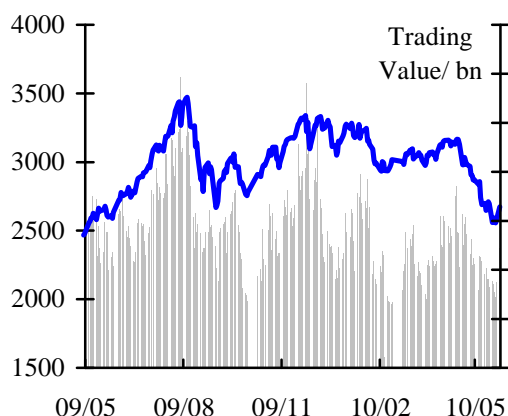
Secretary of State Hillary Clinton said U.S. companies deserve "fair access" to China's government contracts.

The repo rate at the short end rose sharply this week, indicating liquidity withdraw by the PBoC is showing effect.

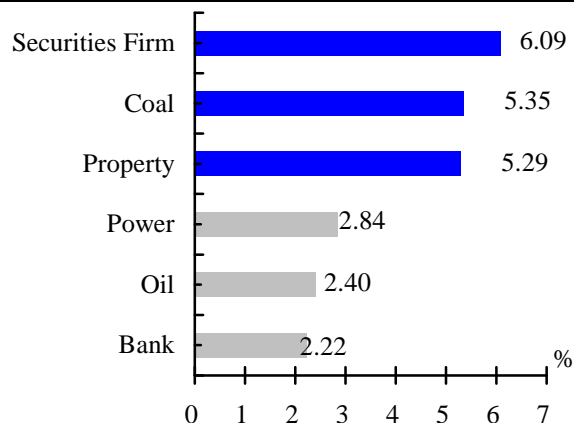
Yao Jian, spokesman of the Ministry of Finance, said China's trade surplus in 2010 will fall steeply.

Daily China A-Share Market Review

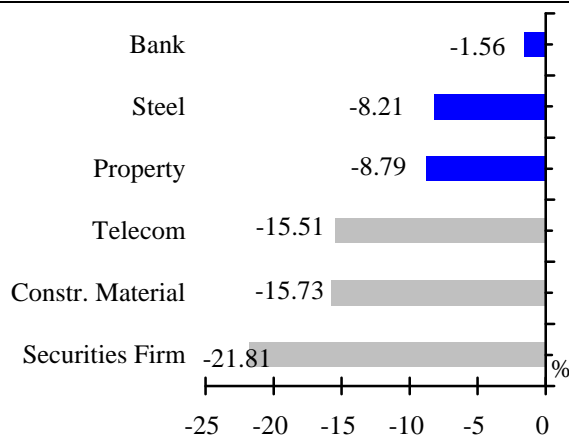
- China's stock market rallied as the Shanghai Composite Index rose by 89.9 points, or 3.48%. It seems the government may temporarily abstain from further measures to curb the property market and other tightening policies, which contributed to the biggest gain in the stock market in almost six months.
- Guangzhou and Chongqing released detailed control measures for the local property market, and the measures are generally looser than expectation. Direct buying restrictions, property tax, and stopping mortgages for third houses are not included in the policies released.
- The State Council has officially approved the "Yangtzi River Delta Regional Planning," according to which the Yangtzi River Delta will be built into an important center of modern service and manufacturing industry in the world.
- An official from the State Information Center said various indicators show China's economy has been fully restored in the first half of 2010.
- CBRC Vice Chairman Jiang Dingzhi said asset management companies will be allowed to set up rural banks.

Chart 1 Shanghai Composite Index


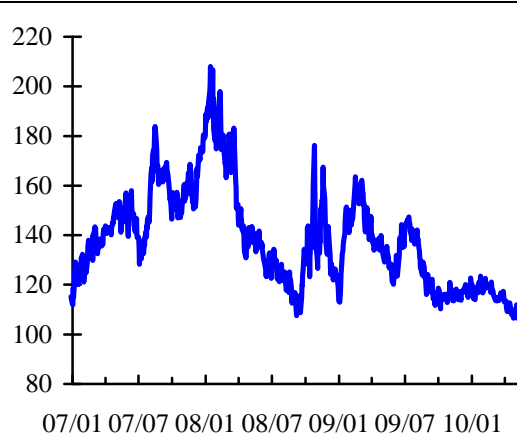
Source: Wind

Chart 21 Daily Best/Worst Performers


Source: Wind, CEBM

Chart 22 1-Month Best/Worst Performers


Source: Wind, CEBM

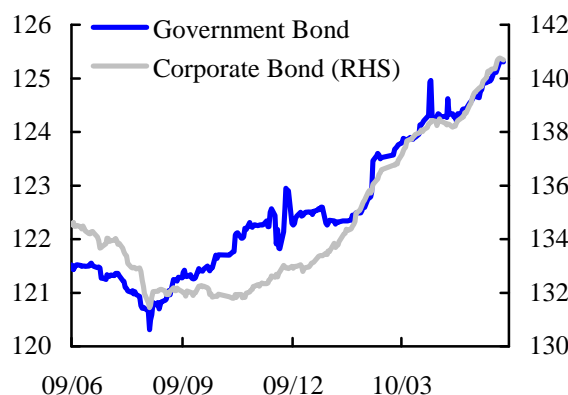
Chart 4 A-H Premium Index


Source: Bloomberg

Daily China Fixed Income Market Review

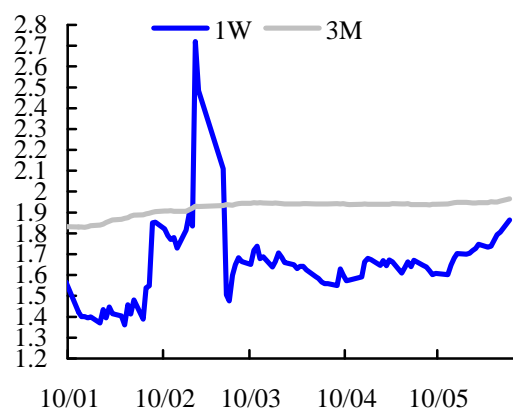
- The Government Bond Index decreased 0.01%, ending at 125.31, while the Corporate Bond Index dropped 0.05%, closing at 140.69. The weak bond market was caused by the rally of the stock market and increasingly tight liquidity.
- Chinese President Hu Jintao said that China will continue to steadily advance the reform of the formation mechanism of the RMB exchange rate. However, the market does not buy into in this remark. The 12M RMB NDF climbed only slightly higher from a 8-month low to 6.7452 as of 17:15 Beijing time.
- The PBoC plans to issue RMB 30 billion in 1Y central bank bills. The market is expecting that the offering yield is likely to be increased to lock in more liquidity at the short end. This means more liquidity could be injected into the market in the near future if the European debt crisis spreads.
- 7-day Shibor rate and repo rate continued to climb higher, indicating liquidity situation still remained tight.

Chart 23 Govt & Corp Bond Index



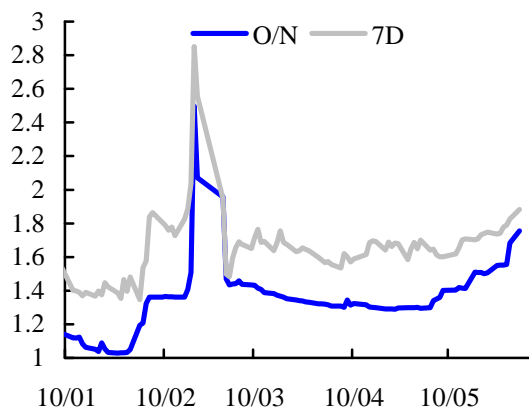
Source: Wind

Chart 6 Shibor Rate (%)



Source: Wind

Chart 724 Interbank Market Repo Rate (%)



Source: Wind

Chart 25 Yield Spread (bps)



Source: Wind

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