



HANDS-ON CHINA REPORT
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China's Fast Track to Modernity: New Economic Priorities

The following is an abridged transcript of Jing Ulrich's recent presentation to J.P. Morgan clients in London and Paris.

We are now at the start of China's twelfth five-year plan period with the nation's leaders having defined their medium and long-term development priorities and established fiscal and monetary policies for the year ahead. In a regional context, Mainland Chinese equities have outperformed, but now the market is again at an uncertain juncture as a result of the tragic events in Japan.

China is Japan's biggest trade partner; China accounts for 7.7% of Japan's imports, while Japan accounts for 12.7% of China's purchases from abroad. The natural concern is that disruptions from Japan's massive earthquake could become a drag on China's economy, at a time when recent economic indicators have given some investors cause to turn more optimistic on the effectiveness and extent of China's policy tightening.

It is still early to assess the full impact of Japan's crisis. The immediate earthquake zone is generally not thought to be a major manufacturing base; however some degree of short-term pressure on exports and industrial production is conceivable considering the integrated nature of regional supply chains and China's close trade links with Japan.

Some Chinese manufacturers might experience delays in component imports—much of China's imports from Japan are inputs required for manufacturing and final product assembly in the automotive, electronics and machinery sectors. The affected Chinese importers will likely respond by seeking other sources of inputs either domestically or regionally.

China and Japan are often compared and contrasted – both because of parallels in the two countries' development trajectories, and also because of the similar size of their two economies in recent years. China's \$5.88 trillion economy surpassed Japan's in size last year, and if the Chinese economy continues expanding at this pace, it could surpass the US in another decade.

But this does not mean that the average Chinese citizen is living a quality of life that is comparable with the average Japanese. As China's Ministry of Commerce has been quick to point out, China's per capita GDP for 2010 — at about US\$4,000 — ranks it only 93rd in the world. Essentially, China is a rich country with poor people. It is this fact that underlies the government's interest in diversifying the nation's economic structure and its concern about the social ramifications of inflation.

Chinese policymakers are now acting in a much more sophisticated manner as compared to the more one-dimensional post-crisis approach of fueling growth. Pockets of overheating and imbalances will arise, and the government will have to be nimble in tackling such areas without affecting the overall economy.

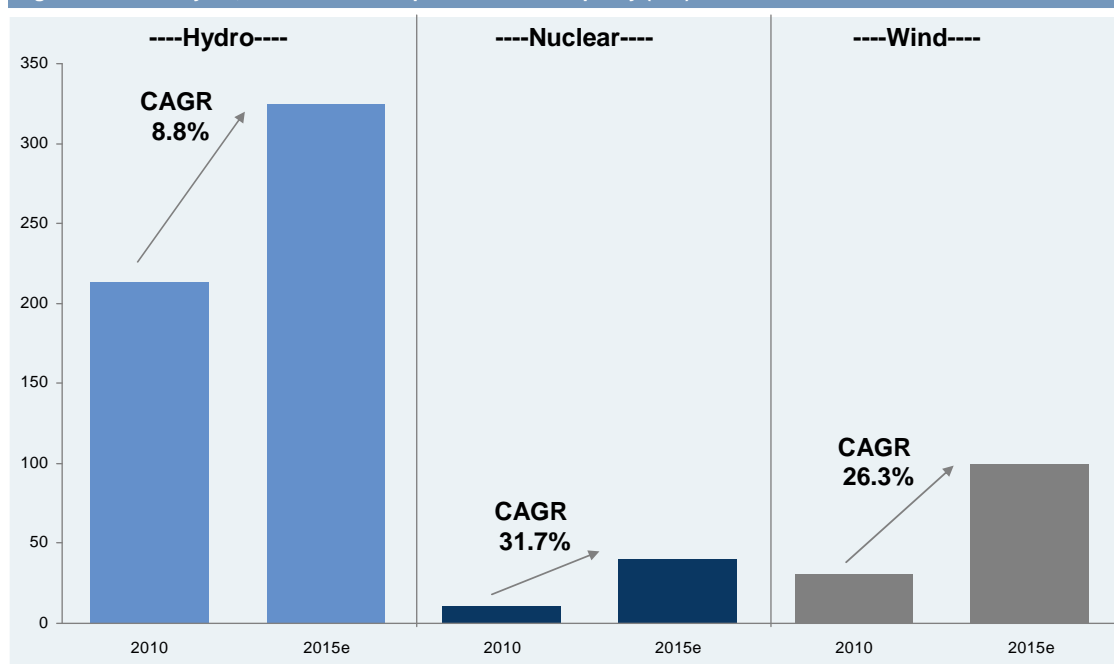
Energy Security and China's Nuclear Power Program

Rebalancing towards consumption, narrowing the income gap and promoting equality are some of the government's obvious objectives as it transitions towards a more sustainable economic model. However, energy security is an imperative that underlies everything that China is trying to achieve and extends to nearly every sector of the economy. It is perhaps in the area of alternative energy that China has made the most remarkable advances. Quietly yet steadily, China has now moved to the vanguard of carbon capture technology, surpassing other countries with its organically developed GreenGen, carbon capture technology which promises lower emissions from coal-generated power.

But China's authorities have also recognized that the country's effort to meet its increasing energy demand will require substantial investment in nuclear power. China is in the process of rapidly expanding its nuclear power capacity, with 25 plants under construction in addition to 13 in operation. Government plans call for the installation of 40 additional GW of nuclear capacity by 2015 compared to just over 10 GW of capacity at the moment (see Figure 1). If China were to achieve 70-80 GW of installed capacity by 2020, it would have the world's highest installed capacity of nuclear energy.

Nuclear power can serve an important role in coastal areas of China that are remote from coal resources and where energy demands are greater. Accelerated nuclear energy development is thought to be a foregone conclusion in China, however the crisis in Japan has clearly drawn deep scrutiny of these ambitious plans. China recently ordered safety inspections of its nuclear facilities and temporarily suspended plant approvals pending the formulation of new safety rules.

Figure 1: China's hydro, nuclear and wind power installed capacity (GW)

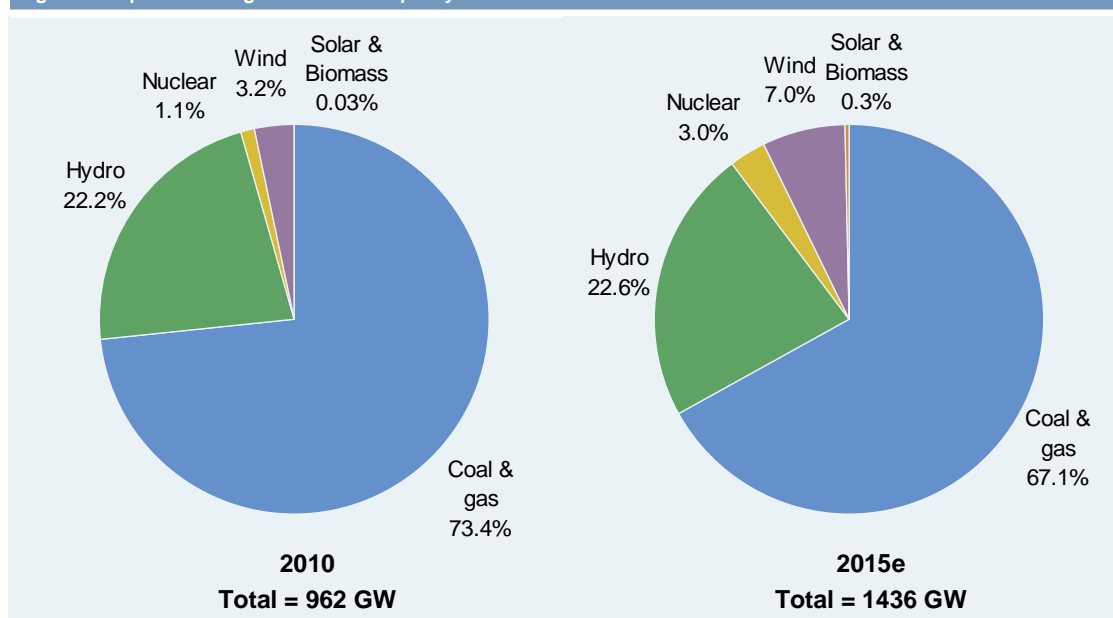


Source: NDRC, CEC, J.P. Morgan Research

However, it is unlikely that China will significantly slow down its pace of national nuclear development, given the imperative of energy security and the massive investments already made to acquire and master technologies related to reactor design and construction, as well as other aspects of the fuel cycle. In this sense, we do not think that the tragic events in Japan will cause the Chinese government to alter its long-term energy diversification targets. If there is one positive aspect to emerge from this crisis, it is that authorities will place even greater emphasis on safety standards and supervision.

Among the main sources of renewable energy used in China, nuclear has the lowest installed capacity, but is projected to grow the fastest. From the announced measures, it was clear that the development of the nuclear sector in China has met with some headwinds. Given that the target of increasing renewable energy to 15% of total energy supply has not changed, any near-term slow down in new capacity will likely be taken up by hydro and wind.

Figure 2: Expected change in installed capacity mix 2010 and 2015e



Source: NDRC, CEC, J.P. Morgan Research

Five-year plan priorities

Despite heightened concerns regarding nuclear safety, our talks with industry experts have indicated that the target of 70-80 GW of newly installed nuclear capacity by 2020 will likely remain intact. As mentioned, the government is implementing heightened safety measures, which may slow the development of the sector in the short-term, but has left its long-term goals unaltered. This is indicative of the government's resolve in realizing the 12th five-year plan (see Figure 3). Premier Wen Jiabao presented the government's annual work report during the recent National People's Congress, wherein the main focus was on key economic targets formalized for the 2011-2015 period. China's moves to achieve a more sustainable growth model will have far reaching impact on domestic and global markets. Despite the many uncertainties about the restructuring of the Chinese economy, we must not lose sight of the fact that China's economic fundamentals remain extremely strong.

Figure 3: China's 12th FYP Priorities – a snapshot

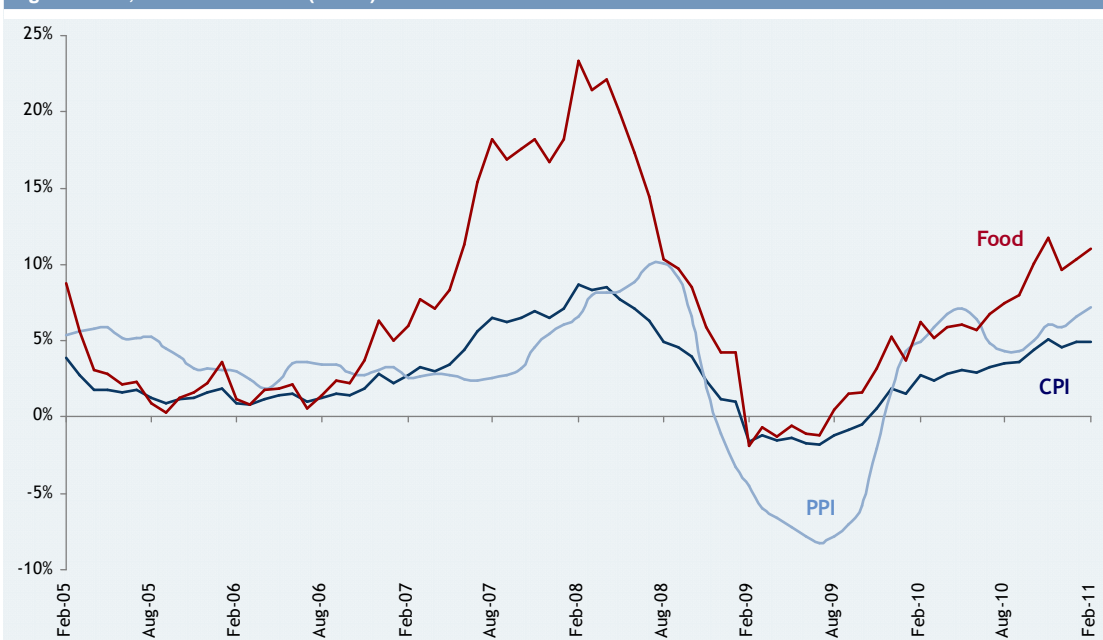
- **Economy:** Average annual GDP growth of 7%
- **Housing:** 36 million units of policy housing to be constructed in the next five years
- **Urbanization:** proportion of urban residents to reach 51.5% vs. 47.5% at end-2010
- **Energy:** consumption per unit of GDP to be reduced by 16%
- **Pollution:** 17% reduction in carbon emissions per unit of GDP
- **Agriculture:** annual grain production capacity of at least 540 million tons
- **Income:** raise urban disposable income and rural income by at least 7% (in real terms)
- **Employment:** creation of 45 million urban jobs

Source: J.P. Morgan

Rising inflationary pressures have prompted vigilance

China's consumer price index (CPI), a main gauge of inflation, was slightly higher than expectations at 4.9% in February, remaining at the same level as in January (See Figure 4). The rise in food prices accelerated from 10.3% YoY in Jan to 11% in February, compared to 9.6% in Dec. It is generally expected that inflation will remain elevated in the next several months due to a number of factors, including rising food prices, as well as inflation passed through from increasing wages and commodities prices.

Figure 4: PPI, CPI and Food CPI (YoY%)

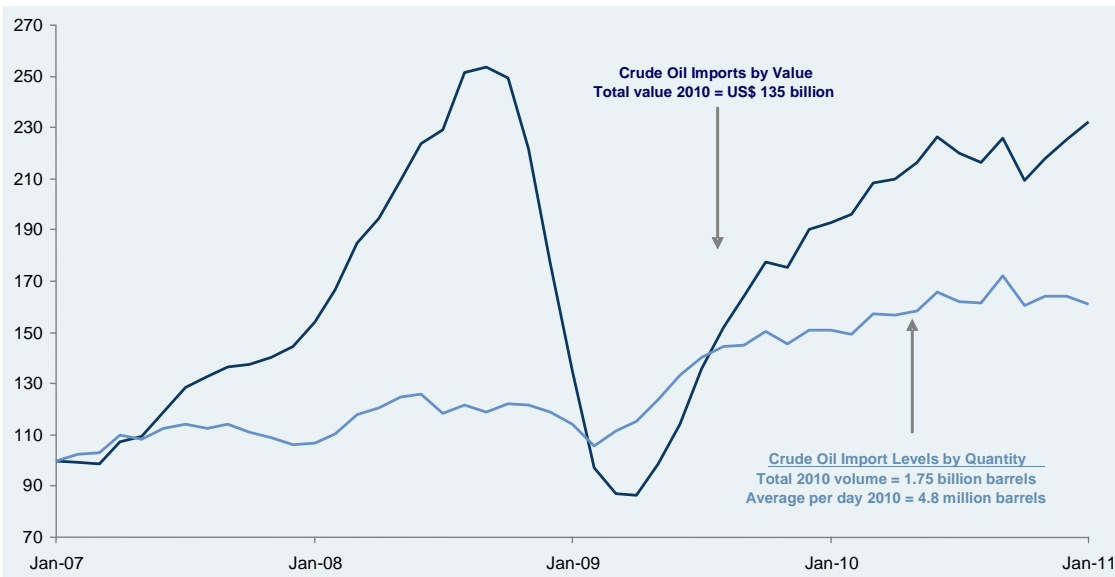


Source: CEIC

The recent strength in oil prices has recently emerged as another source of inflation concern, as the impact at the producer price-level can be quite significant. The fuel and power sub-index of PPI rose 8.9% YoY in February. Crude oil prices rose dramatically in mid-2008, however China's import

dependency was 48.0% in 2008 and has since increased to 53.7% in 2010. On average, China imported 4.8 million barrels of oil per day last year (see Figure 5).

Figure 5: Change in crude oil import volume and value (based: Jan 2007 = 100)



Source: CEIC, J.P.Morgan

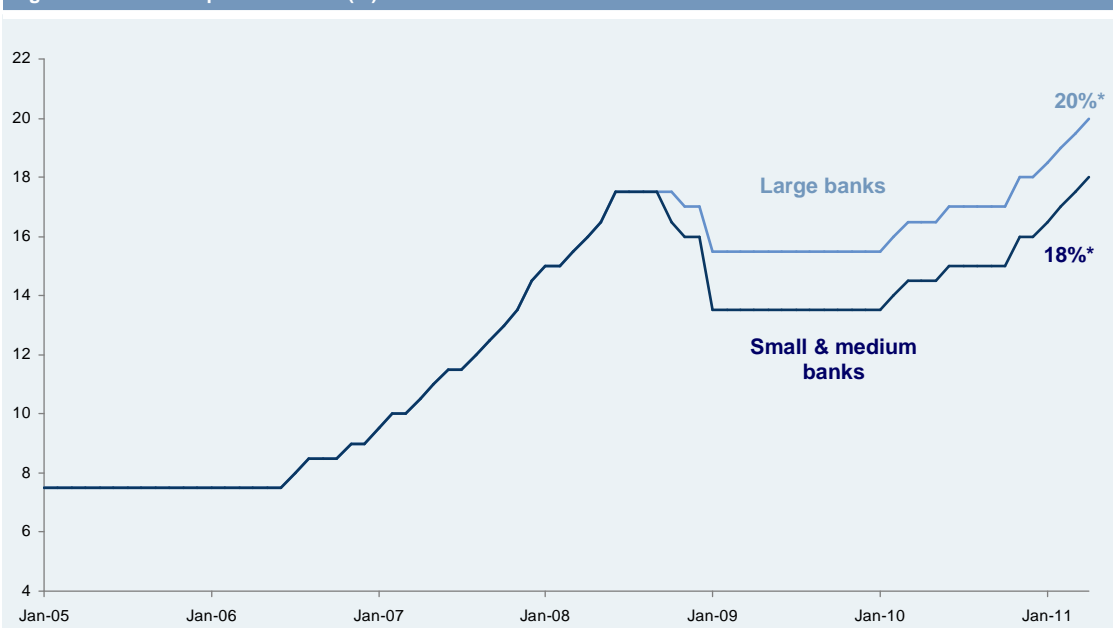
The current bout of inflation also coincides with a period when labor costs in China have surged quite dramatically. The minimum wage in China rose by an average 15% in the years preceding the 2009 slowdown, during which further increments were suspended. Last year, the minimum wage in some provinces was hiked by as much as 28% to offset the one-year suspension. Although we are still in early-2011, announcements by some major cities suggest that minimum wages will continue to surge in 2011.

So far this year, the city of Beijing has raised its minimum wage by 21%, while the mayor of Shanghai has indicated that the minimum wage will increase by 14%. Minimum wages in Jiangsu, a region adjacent to Shanghai, will rise by 15%. Guangdong has announced to hike its minimum wage by an average of 18.6%. Tianjin also plans to increase the minimum wage level by 16%.

Following the end of Chinese New Year, local media reports described companies experiencing difficulties recruiting workers in traditionally labor-surplus regions such as the inland provinces of Sichuan, Anhui and Hubei. In Chengdu, the capital of Sichuan province, the local labor authority has indicated that 400,000 jobs are due to be created in 2011 with the launch of major industrial projects; however the registered number of unemployed people in the city was only 60,000 at end-2010. As part of the recruitment effort, media accounts tell of local companies sending recruiting teams to camp out at local railway stations to persuade would-be migrants to remain in their home province.

Although wage inflation in recent years has been compensated for by similar gains in labor productivity, the impact of dramatic salary increases in the past 15 months may gradually emerge as a significant source of domestic inflation. Chinese exporters may also be starting to pass on the rising cost of labor and other manufacturing inputs as might be suggested by the 0.9% rise in the China import price index in 4Q10 after virtually no change since 2Q09.

Figure 6: Reserve requirement ratio (%)



Source: PBOC, CEIC *New rates take effect on Mar 25, 2011

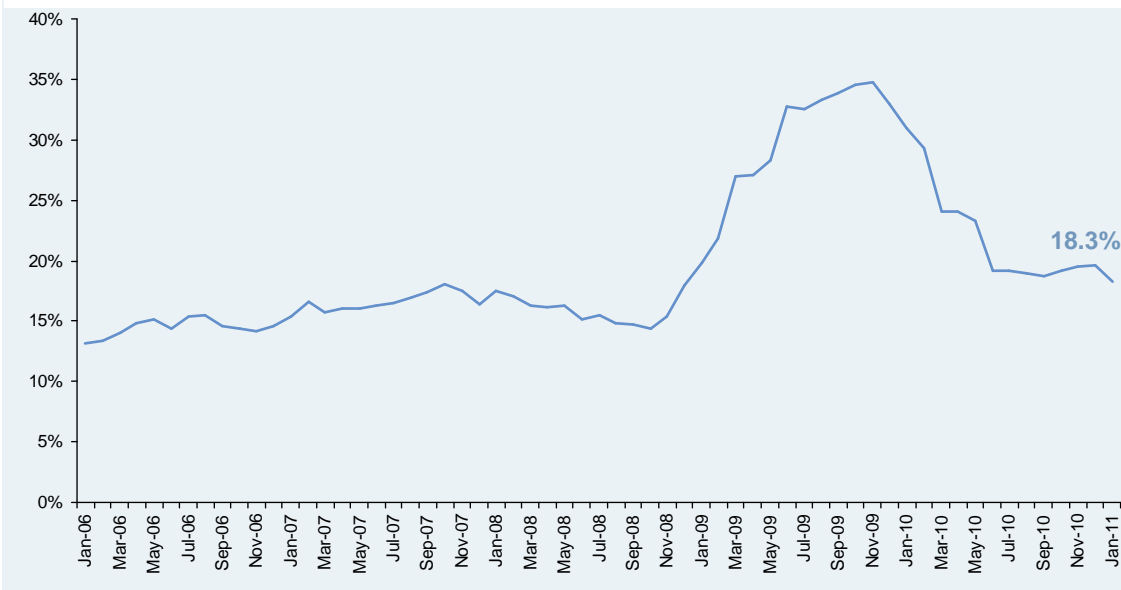
RRR hikes and PBoC bill issuance are primary tools for controlling liquidity

Since the start of the new calendar year, officials have hiked interest rates by 25bps and RRR by 50bps on two occasions to contain inflationary expectations. (See Figure 6) A third increase in RRR of 50bps was announced on Mar 18, and scheduled to take effect starting on Mar 25.

China needs to rein-in credit growth in 2011

New loans in February eased to RMB 535.6 billion (down from RMB 1.04 trillion in January), as did China's M2 money supply growth, which registered at 15.7% YoY compared to 17.2% YoY a month earlier. (See Figure 7) These figures were somewhat lower than market expectations and seem to indicate that the government's administrative tightening measures have had the effect of bringing lending to a more normal level. Banks in China have been instructed to gradually retire and bring trust loans back onto their balance sheets over the course of 2011, from an outstanding balance of RMB 1.66 trillion in trust loans at the end of 2010.

Figure 7: Loan growth (YoY%)

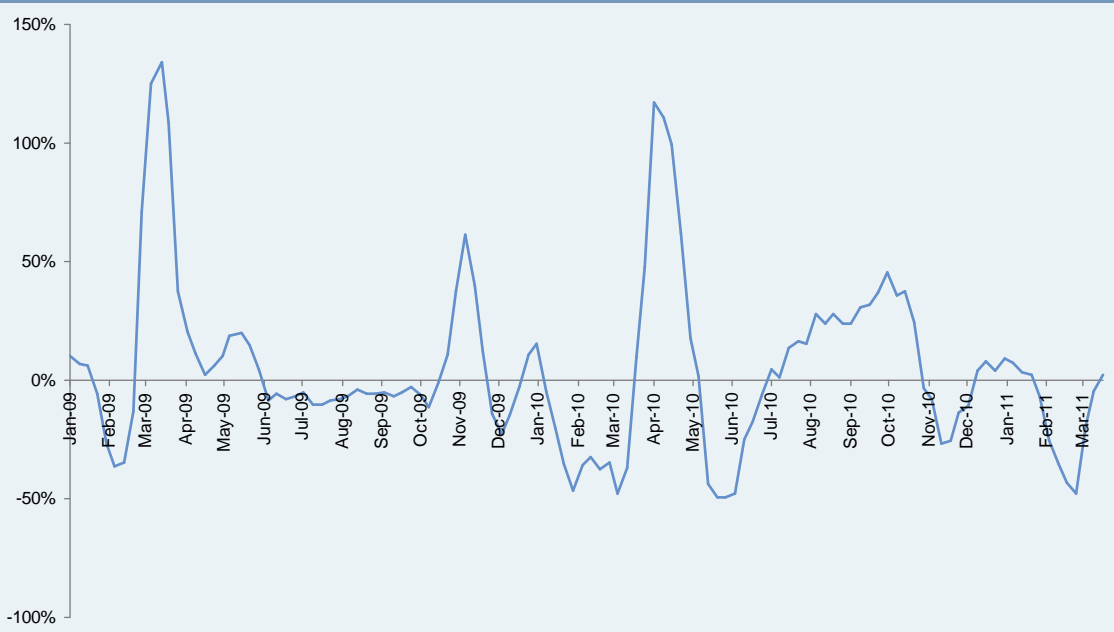


Source: CEIC

Property tax for luxury residences

After years of anticipation, China introduced its first property tax trials for homebuyers in late-January in the cities of Shanghai and Chongqing. Shanghai has set the rate at between 0.4 and 0.6%, with Chongqing setting the bar higher at 0.5 to 1.2 percent. But it is not as simple as that, since living space allowances for each family member and numerous exemptions reduce the effective tax rate. In Shanghai, for instance, the tax only applies to new home purchases, and as long as the total living space attributed to a family of three is below 180sqm, no property tax is levied.

Figure 8: Primary transaction volume in 8 major cities (4-week moving average)



Source: Centaline, City real estate trading centres, J.P. Morgan Research



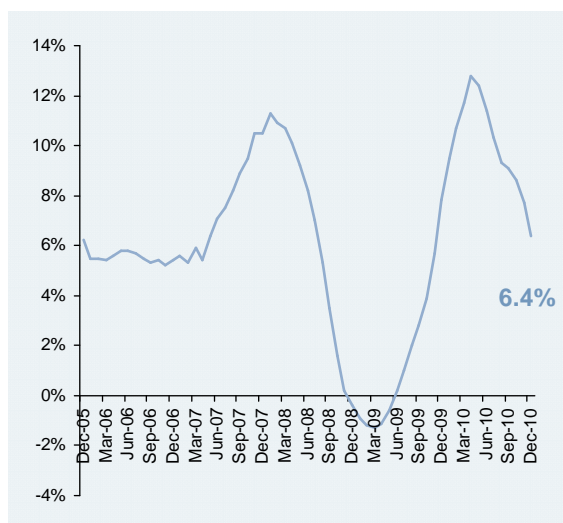
Source: State Council, J.P. Morgan research

China's central government has demonstrated flexibility in its management of the economy. As is evident in housing policy, the government has taken a very gradual approach, releasing successively stronger sets of measures, and now a pilot program to experiment with a property tax. Even between the two cities where the tax was implemented, there was a great level of differentiation in policies, and the measures in Shanghai showed careful design to target high-end speculation, while sparing legitimate middle class homebuyers. Home-purchase restrictions have also now been drawn up according to local market conditions by governments in 34 Chinese cities.

Pace of property price increase moderating

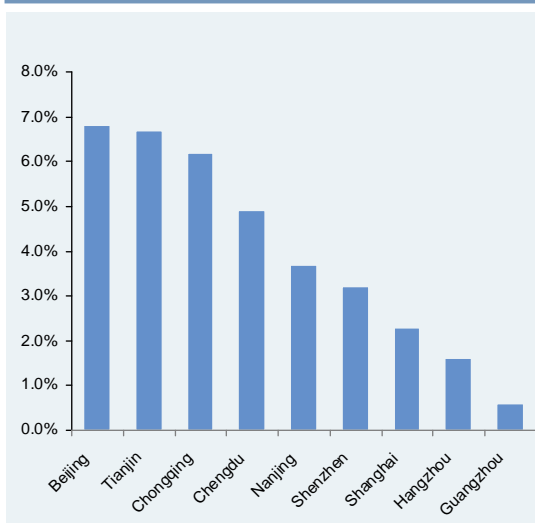
Average property prices in China have continued registering year-over-year gains as well as sequential gains, although the pace of growth is moderating (See Figure 9a). On a year-over-year basis, new home prices in February rose in 68 out of 70 major cities in China. Sales volumes in some cities have registered recent strength, likely due to the post-Chinese New Year effect and buying in advance of the anticipated introduction of home purchase restrictions. In cities where local restrictions have already been introduced – e.g. Beijing and Chengdu, sales volumes have dropped more significantly. J.P. property analysts believe that prices could begin to retreat in March, after primary (commercial) residential prices began to decline on a month-over-month basis in 8 lower-tier cities in February, compared to 2 cities in January.

Figure 9a: Change in 70 cities' average property price (YoY%)*



Source: CEIC *Last updated to December 2010.

Figure 9b: Growth in primary home price for major cities – February YoY (%)



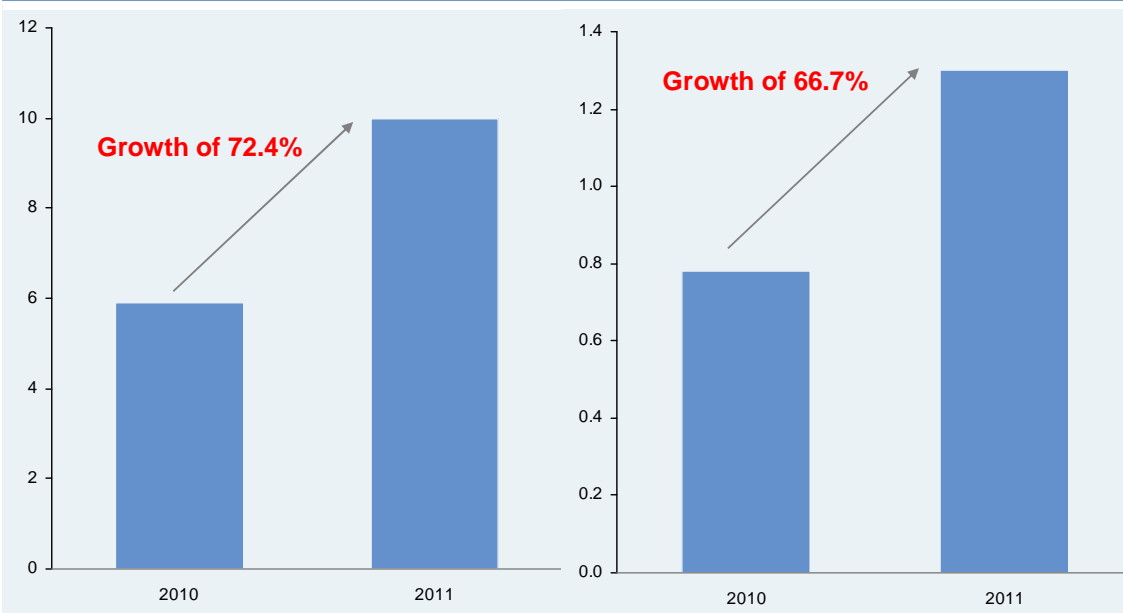
With Premier Wen citing price stability as the government's overriding policy objective, our property analysts believe more policies could be on the way if Beijing is unsatisfied with local governments' progress towards achieving price targets. The property tax should gradually have a cooling effect in the two trial cities, but overall, the long-awaited property tax was milder than expected, and is targeted towards speculation on higher-end residences. The introduction of property tax was well anticipated and although it is generally thought to be milder than expected, the cumulative cooling impact of recent measures (especially the earlier announced home price restrictions and increases to second-home down-payment requirements) should not be underestimated.

Surge in targeted affordable housing starts in 2011

Although 2010 was already a record year for policy housing construction for most provincial governments, the 2011 campaign is set to be still more aggressive with a target of 10 million units. (See Figure 10) Affordable housing starts are expected to represent more than 35% of construction starts in 2011. According to the twelfth five-year plan, construction on an additional 10 million units will be started in 2012, and a further 16 million starts are due in the remaining three years of the five-year plan period.

In our view, the ramp up in affordable housing construction will offset the potential decline in retail housing projects. Given that both types of housing employ the same basic materials, the real estate sector will continue to provide strong demand for commodities and materials like steel, cement, and glass. The key impediment in affordable housing construction has been a lack of local government funding and misaligned incentives. For the first time, the government is taking steps to address these issues, throwing much more weight behind their pledges to increase social housing than ever before.

Figure 10: Targeted affordable housing starts and budgeted spending (mn units, RMB trn)



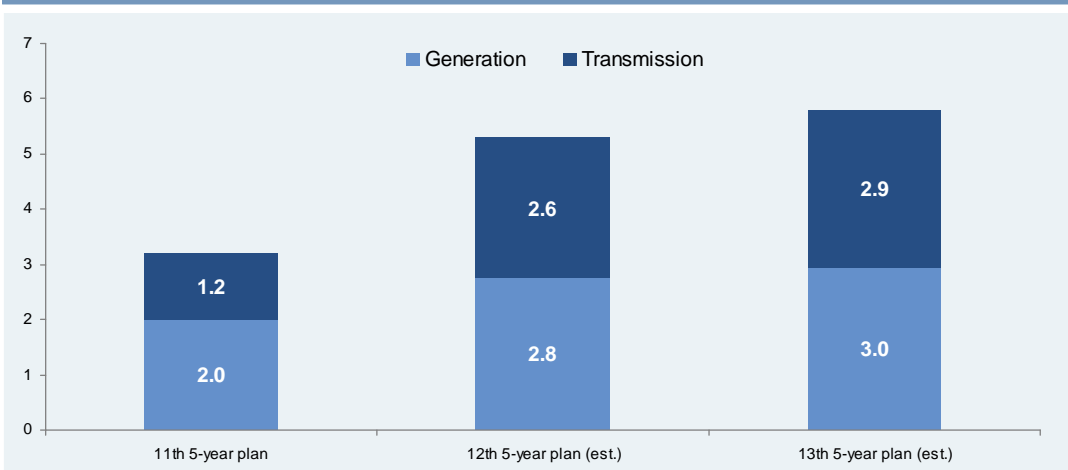
Source: Ministry of Finance

RMB 1.3 trillion in spending is expected for policy housing in 2011. According to officials, this will entail: i) central government subsidies of ~RMB100bn, ii) China Development Bank loan of RMB100bn, iii) enterprise and individual owners of slums contributing ~RMB340bn towards renovation, and iv) 10% of net land transfer tax revenue from local governments.

Power transmission investments expected to surge

To meet an aggressive target of 45% reduction in carbon emissions per unit of GDP by 2020, the power industry will need to increase non-fossil fuel electricity generation and improve transmission efficiency. Investments in the industry could amount to RMB 5.3 trillion and RMB 5.8 trillion respectively over the 12th and 13th 5-year plan, compared to RMB 3.1 trillion over the last 5 years. (See Figure 11)

Figure 11: Investment in power industry (RMB trillion)



Source: China Electricity Council

Railway investment could reach RMB 3-4 trillion in 2011-2015

In particular, the government has recently focused on the expansion of the railway system. (See Figure 12a and 12b) The project value of the bids awarded by the MOR for 2011 represented an increase of 49% from 2010. The announced capex budget of RMB 700 billion is conservative, given that expenditures amounted to RMB 709 billion for 2010, when the value of projects were much lower. Railway capex in the 12th five-year period should exceed RMB 3-4 trillion for civil works (which excludes purchases of rail vehicles and other equipment). This would represent approximately three times the amount spent during the 11th 5-year plan. Outside of a national railway system local governments are also embarking on metro subway projects in at least 33 Chinese cities to ease road congestion and increase the mobility of urban residents. According to NDRC officials, total investments are estimated to reach RMB 1.2 trillion by 2015.

Figure 12a: Railway operating length (km)

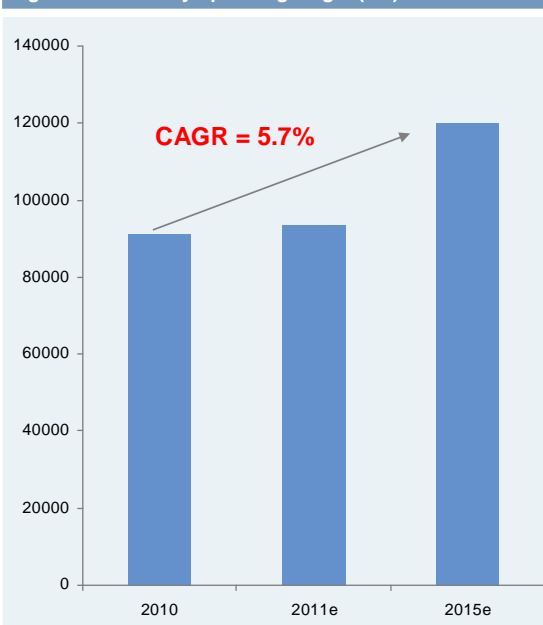
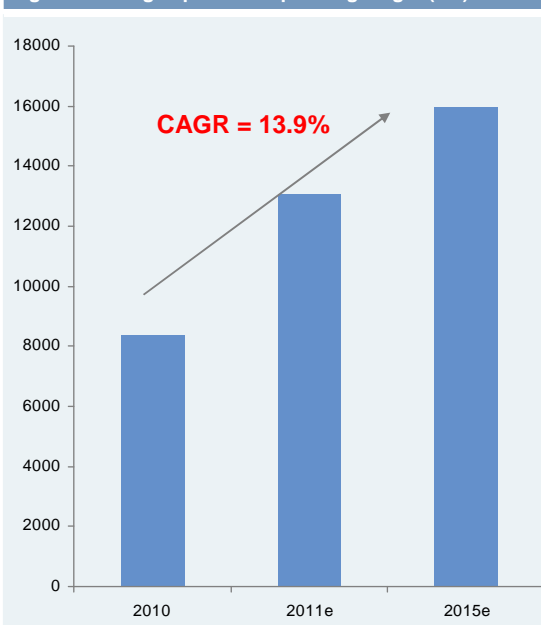


Figure 12b: High speed rail operating length (km)

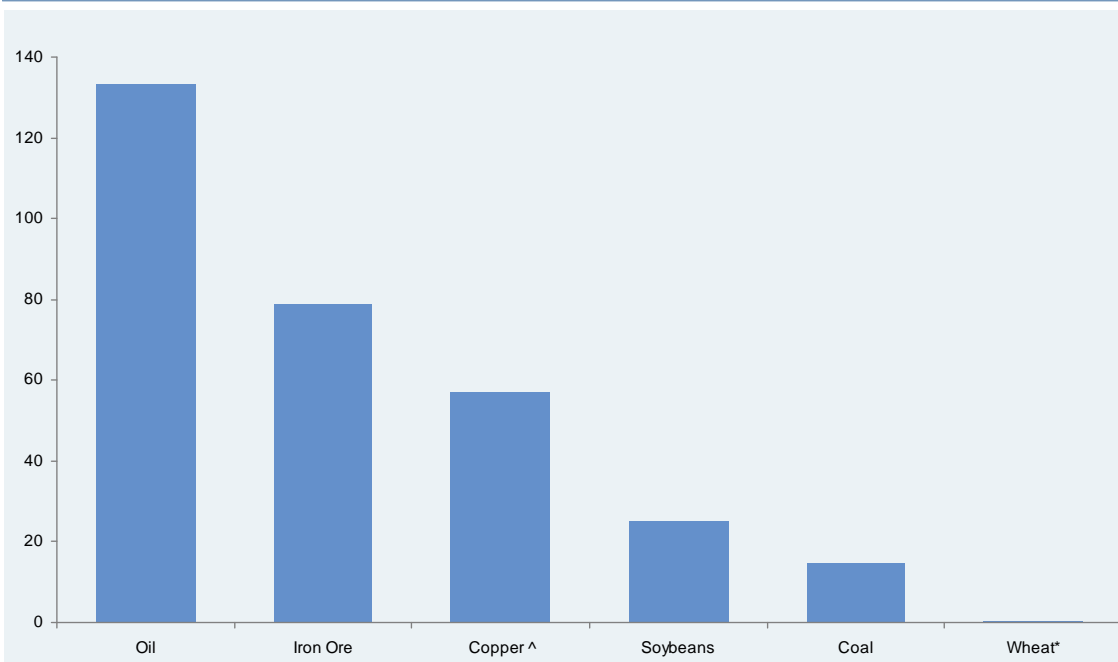


Source: Ministry of Rail, CEIC, J.P. Morgan analyst Karen Li

Increasing dependence on imported commodities

China now has abundant human resources, advanced technology and a vast pool of capital, but it has limited natural resources within its national borders and this resource base is unevenly distributed. For a number of years, Chinese leaders have been acutely concerned about the nation's increasing reliance on imported commodities (See Figure 13) and so have encouraged state-owned enterprises to secure supplies of raw materials and invest in foreign resource companies.

Figure 13: 2010 Net imports of crude oil, iron ore, copper, coal, soybeans and wheat (US\$ bn)



Source: CEIC ^ Includes unwrought copper, copper products, ores & concentrates, scrap * Wheat imports totaled US\$316 million in 2010

The biggest challenge to China's economic rebalancing is access to resources, including agricultural resources.

Conclusion

As we consider China's latest economic indicators and the government's recent actions, we find that we are several months into a tightening cycle, with policymakers trying to achieve economic expansion without allowing prices to overheat. Although we must acknowledge underlying inflationary pressures - from last year's lax lending, to agricultural disruptions, to double-digit wage growth, to rising commodity prices, it is encouraging to see that i) the sequential growth in inflation seems to be peaking, ii) agricultural prices seem to have moderated in the past month, iii) China's money growth and bank lending slowed sharply in February (RMB535.6bn in new loans, below consensus forecasts of RMB650bn), and iv) the recent decline in property transaction volumes suggests that speculative activity is being deterred, with home price appreciation likely to moderate as supply increases.

That said, we should not underestimate the government's determination to counter inflation through subsidies to vulnerable segments of society, as well as pricing and supply directives to companies that operate in key sectors of the economy. Policymakers stepped up intervention in the monetary system from late-2010, but the uncertain situation in Japan and the recent decline in the trade surplus could mean less aggressive tightening for the time being. Although China's blueprint for growth is very much oriented towards increasing consumption, much of the growth in GDP is still being derived from large government-backed infrastructure initiatives, and by all accounts, strong infrastructure spending will be maintained during the new five-year plan period.

China will continue to lead the developing world during an extended period of commodities-intensive growth, propelled by ongoing urbanization and the unbending commitment by its capital-rich government to facilitate internal mobility, energy efficiency and affordable housing. The need for raw materials is a common denominator across these national priorities, and we believe that commodities will be a particularly bright spot for the near future.

In the weeks ahead, investors will continue to analyze developments in Japan in relation to supply chain disruption and the effects on Sino-Japanese trade. The short-term impact on bilateral trade is difficult to forecast. On one hand, the disaster is highly likely to have inflicted substantial damage to

the manufacturing facilities and equipment of a section of Japanese industry, which suggests a decrease in exports. However, it is also possible that domestic consumption could decrease, reducing Japan's demand for final goods. The reconstruction process will likely drive demand for materials such as steel, aluminum, timber, which could translate into higher imports of these materials from China.

In terms of the impact on China's energy policy, - we expect China to introduce a more stringent nuclear safety regime in response to the greater public concern that has obviously developed. But it is important to note that China's nuclear energy program primarily focuses on third-generation technology as compared to second generation technology used in the troubled Japanese reactors.

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