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HANDS-ON CHINA REPORT  
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## Urbanization, Hukou Reform and Investment Implications

During China's first three decades of economic reform, internal migration surged as poorer rural residents from the country's interior sought better-paying jobs in China's coastal areas. Although work in urban settings has lifted many migrant families from poverty, migrant workers' rural household registration often limits their access to social benefits such as healthcare, pensions and free education for their children. These disadvantages are generally thought to increase the need for precautionary saving and thus limit household consumption for this large segment of the population. Several developments in recent weeks suggest that momentum toward reform of the household registration system (referred to as "hukou" in Mandarin Chinese) is accelerating:

i) In late-February, the State Council released a circular on hukou reform (dated a year earlier), stating that migrant workers and their families should be entitled to apply for permanent residence permits or urban hukou in all county-and prefectural-level cities, provided that they meet basic criteria relating to employment, residence and social insurance contributions. The notice also stated that no new rules pertaining to hukou conversion should require that people relinquish their claims to rural land.

ii) In his government work report at the opening of this year's National People's Congress (NPC), Premier Wen Jiabao emphasized that the government would "prudently carry forward the reform of the hukou system" and also deepen reforms of land, household registration and public services in the year ahead. At the National Rural Work Conference in December, the Premier indicated that regulations for implementing a national land compensation system would be issued in 2012.

iii) On the sidelines of the NPC, China's Vice Minister of Public Security said that his ministry is circulating a draft regulation for a new nationwide residence permit system for consultation, and intends to submit it to the State Council for approval within the year. A senior official of the National Development and Reform Commission (NDRC) also said that China should establish a cost-sharing mechanism to grant migrant workers equal access to social benefits and public services in cities.

The government's policy to narrow the rural-urban divide and boost migrant workers' wages raises questions as to whether this sizable segment of China's population will transition from saving to spending – and how attempts to reform the hukou system are likely to impact consumption. In this report, we approach these questions by examining recent survey findings on the demographic characteristics of China's migrant workers and consider the implications of hukou reform plans on migrant workers' consumption.

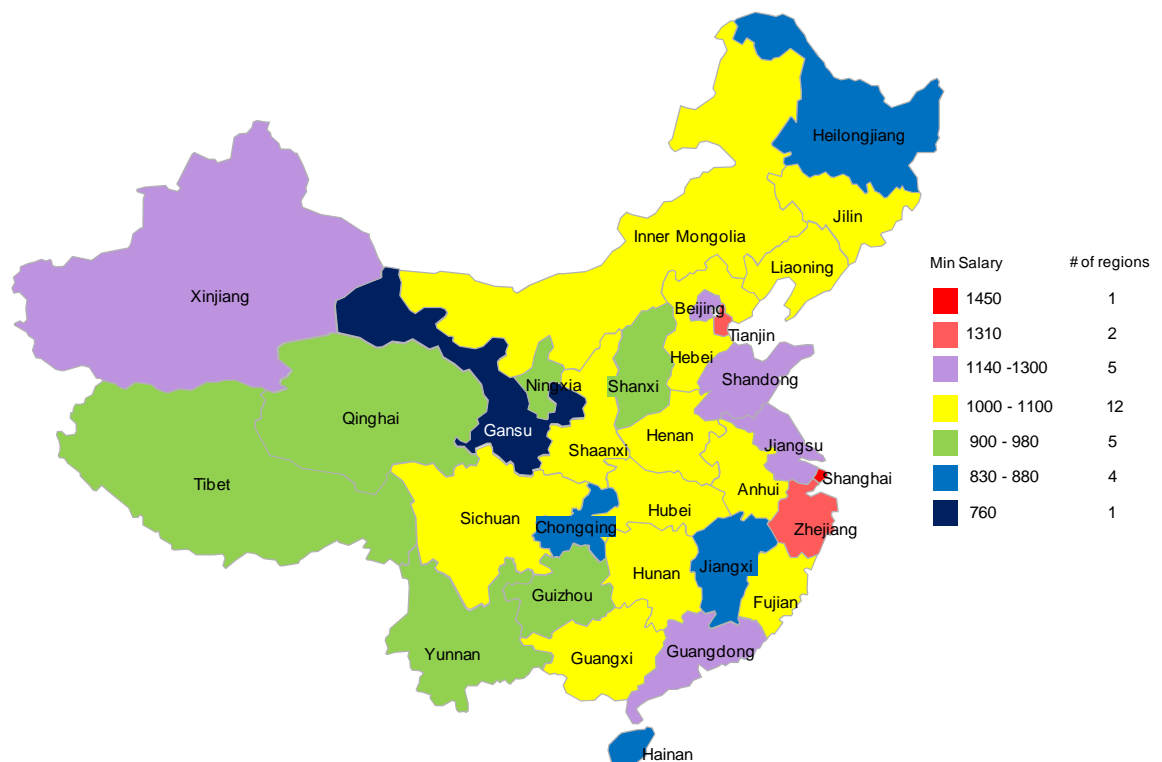
- **Most of today's migrant workers are from the post-1980 ("ba-ling hou") generation.** About 60% of today's inter-province migrant workers were born after 1980, and unlike the preceding generation, they have limited or no experience with agricultural work and are likely to remain urban residents. According to a recent survey, about three-quarters of this younger migrant generation have no intention of returning to their home regions. However, without an urban hukou, they often do not receive the same access to subsidized health care, affordable housing, better education for their children and other social benefits. While the threshold for acquiring an urban hukou has been lowered in many cities, most rural residents have deep reservations about giving up their claims to rural land.

- **Government leaders have been signaling new initiatives on hukou reform.** Although new initiatives relating to residence and migrant workers' benefits can be expected in the coming year, we believe that hukou reform is likely to be a lengthy and complex process, predicated on the progress of rural land rights reform. Various local hukou reforms trials exist with vastly different characteristics, however it appears the central government's preferred approach is to establish a national residence permit system that will gradually serve to delink social entitlements from a person's hukou status. Implementation will occur at a faster rate in small and medium-sized cities in inland China, which are receiving a growing proportion of migrant workers, in line with the trend of manufacturing relocation to the central regions of the country.
- **A narrowing of the rural-urban divide will support domestic demand.** Three areas stand out as first-order beneficiaries of government efforts accelerate urbanization, improve migrants' social welfare and reduce the income gap will support: i) mass-market consumption, especially durable goods, basic services and higher-end staples such as dairy products; ii) a steady increase in healthcare spending will broadly benefit the entire sector (however J.P. Morgan analyst Sean Wu prefers medical device makers over drug producers); iii) the development of modern agriculture will be a central component of promoting growth in rural areas, with agricultural technology (especially seeds) receiving special emphasis in this year's policy document for the sector.

## I. What are the trends in rural-urban migration?

Over the last several years, rapid economic development in China's hinterland has given the country's migrant worker population the option of working closer to home and to establish themselves in smaller cities where the cost of living is much lower. As Figure 1 shows, minimum wages in some inland provinces now approach the minimum salary level in coastal areas. Reflecting improving employment prospects in inland regions, a major shift in labor migration patterns has been occurring in China's more populous provinces.

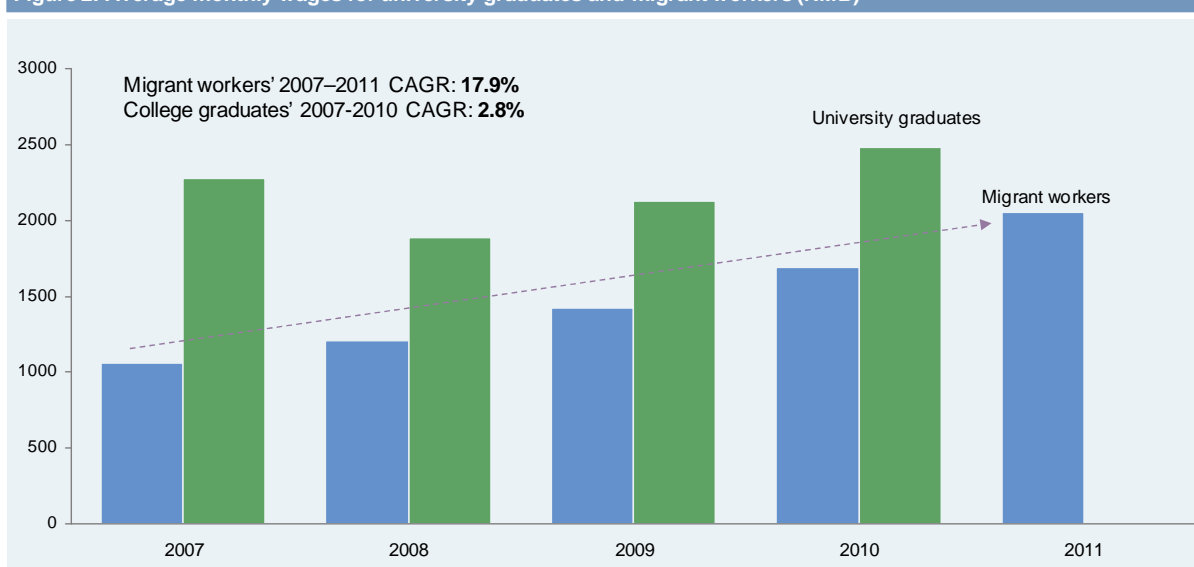
Figure 1: Mainland China monthly minimum wage allocation map



Source: CEIC, J.P.Morgan

In Henan, for example, 12.7 million migrant workers took jobs within the province last year, the first time that this number exceeded that of migrants who left to seek work outside the province. At Foxconn's recently opened plant in the provincial capital of Zhengzhou, ~95% of the facility's 130,000 workers are local. In Sichuan province, which traditionally produces more migrant workers than any other province, the number of migrants seeking work outside the province has exhibited zero growth since 2009. Yet while more migrants are opting to work in lower-tier cities that are closer to home and where the threshold for obtaining urban household registration is lower, urban-rural divisions continue to impact their prospects for upward mobility. This is evident in the disparity between China's urban-rural population mix on the basis of physical residency, as compared to hukou registration. In 2011, China's urban population exceeded its rural population for the first time, accounting for 51.3% of the total population; however, academic studies have indicated that only ~35% of the nation's population holds urban hukou registration. This implies that some 220 million rural migrants are residing in urban areas without the same access to social benefits and public services that their urban co-inhabitants are entitled to receive.

Figure 2: Average monthly wages for university graduates and migrant workers (RMB)



Source: National Bureau of Statistics of China, MyCos Institute

To keep their cities competitive as employment destinations, local governments have steadily increased minimum wages, while the central government has enacted regulations to make pensions portable from province to province. Although in nominal terms, migrant workers' salaries fall at the lower end of the urban income range, as Figure 2 shows, the growth in migrant workers' average wages has far outpaced the growth in university graduates' salaries. According to the Ministry of Human Resources and Social Security, the average monthly salary for Chinese rural migrant workers rose 21.2% YoY in 2011 to reach RMB2,049, while the average monthly wage for the nation as a whole rose 14.9% in 9M11 to reach RMB3,201. In another measure to support migrant workers' spending power, the central government last year raised the minimum monthly personal income tax threshold from RMB2,000 to RMB3,500, thereby removing personal income tax obligations for ~20% of the country's population.

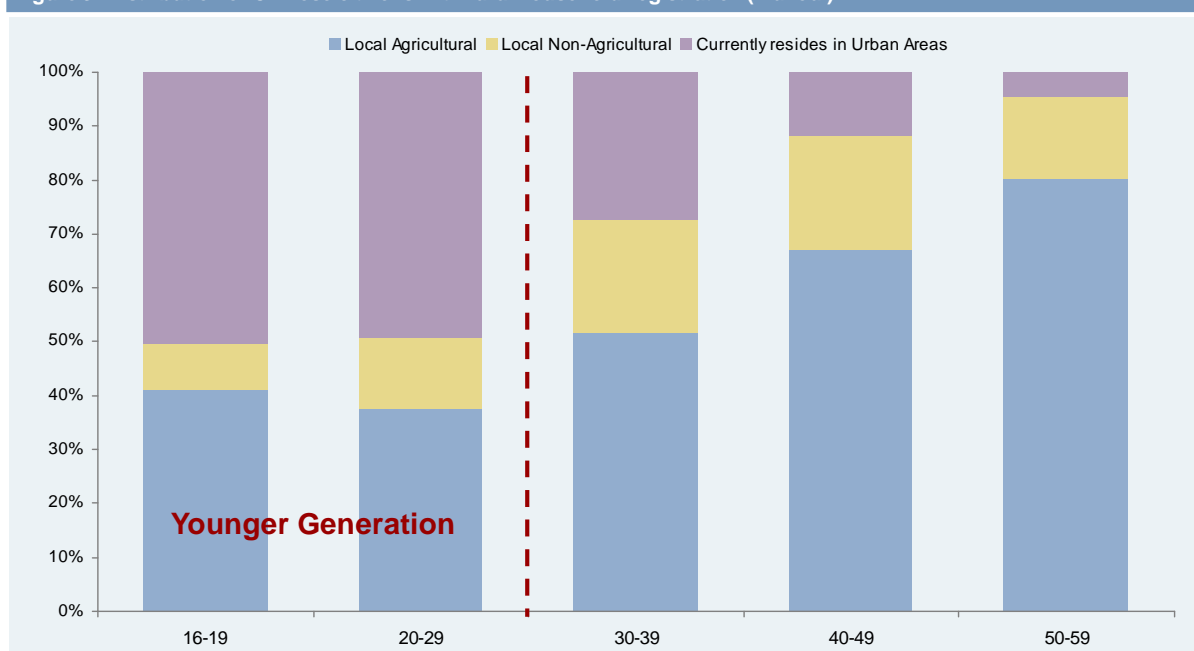
## II. What are the characteristics of today's migrant workers?

According to a 2010 survey of 68,000 migrant worker households conducted by the National Bureau of Statistics (NBS), workers born after 1980 (a total of 84.9 million people) accounted for 58.4% of all workers occupied outside of their home province. As Figure 3 shows, only 39% of the younger generation of rural hukou holders (those under the age of 30) is engaged in local agricultural activity and nearly two-thirds of those in their twenties work outside the agricultural sector. Only 40% of younger migrants have experience in agricultural work and 24% have none, suggesting that this population segment is more likely to settle permanently in cities than their older cohorts. Younger

migrant workers have 9.8 years of schooling on average, one year more than the previous generation; 6.4% hold a university degree (compared to 1.4% of workers above 30 years old) and over 30% have acquired professional training (compared to 26% of the older generation).

According to a study jointly conducted by Tsinghua University and Gzhong.cn, 69.7% of migrant workers under the age of 30 have changed jobs within the past year, suggesting a high level of opportunism in pursuing improved occupational positions and higher wages (although frequent job changes may limit opportunities to develop skills and reduce their long-term earning potential). Migrant workers born after 1980 are more likely to be employed in manufacturing than older generations (44.4% of the sample vs. 31.5%), and also more likely to work in the service sector (21.6% vs. 16.9%). However, the older generation of rural migrant is better represented in the construction workforce (18 percentage points higher than the younger generation).

Figure 3: Distribution of Chinese citizens with rural household registration ('hukou')



Source: National Bureau of Statistics of China, the Department of Rural Social and Economic Survey, "New Generation Migrant Workers" on March 11, 2011

#### ▪ Younger migrants gravitate to the cities

68.6% of migrants under the age of 30 originate from China's central and western regions and although most (72%) still work in the eastern regions of the country, the proportion of workers moving to regions closer to home has been rising since 2008. The option of working inland has become more attractive in recent years as traditional wage differentials have been eroded – for instance, the average migrant worker's monthly wage in Hunan province last year (RMB1,887) already exceeded the average wage that migrants from the province were earning elsewhere (RMB1,744). The same was true in Anhui, Jiangxi and Sichuan provinces. Our review of various employment websites also found that the wage differential between Eastern and Western provinces is now almost non-existent, especially for major companies such as Foxconn.

#### ▪ Obtaining urban hukou is not a top priority

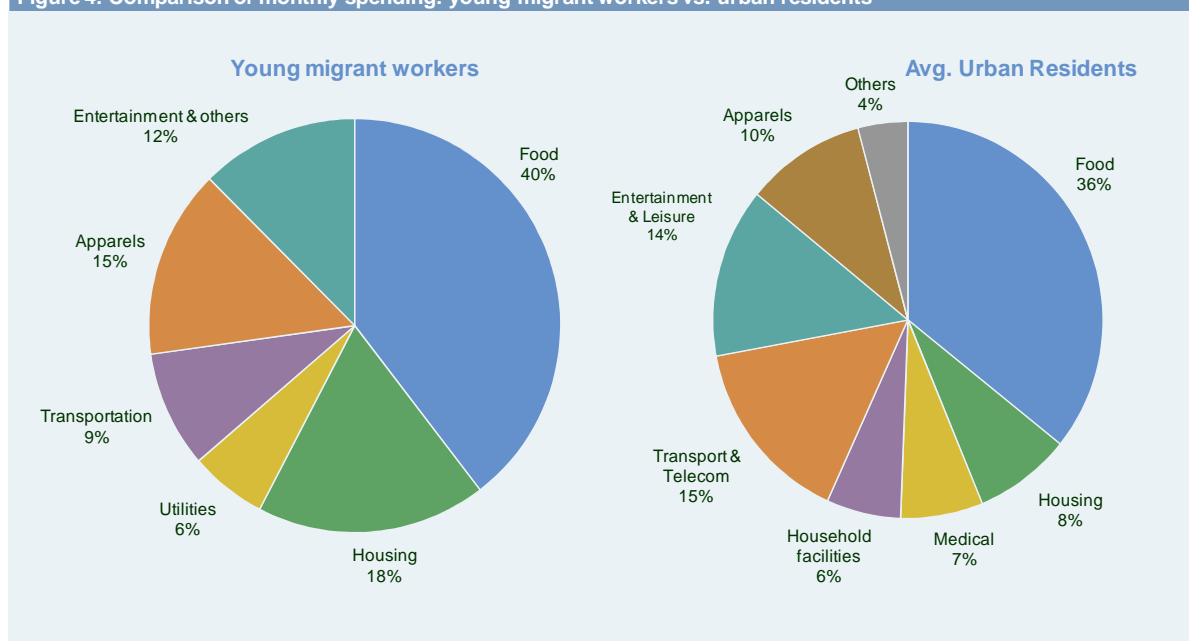
About three-quarters of younger rural hukou holders are not willing to return to work in their home counties, and only 13.2% indicated they would be willing to return to any rural region. Despite a strong preference for urban life, 72% of these younger migrants were not inclined to convert from a rural hukou to an urban hukou. The main reasons cited were that "housing prices are too high" and "urban hukou does not have significance". As we discuss in *Section V*, migrant workers'

apparent attachment to their rural hukou status likely stems from the value that they place in their rural land use rights. Of the portion of young rural hukou migrants who did desire an urban hukou, more than two-thirds aspired to reside in bigger cities (i.e. population >1 million) or top-tier cities – which tend not to be at the forefront of hukou reform.

- **Younger migrants are more willing to spend**

On average, migrants from the post-1980 generation bring home RMB2,600 less in savings per year than older migrant workers. They also spend twice as much on entertainment and leisure than older migrants (much of this is likely on internet and gaming). Even so, younger migrants' nominal spending on entertainment and leisure is low at RMB16.5 per month on average.

Figure 4: Comparison of monthly spending: young migrant workers vs. urban residents

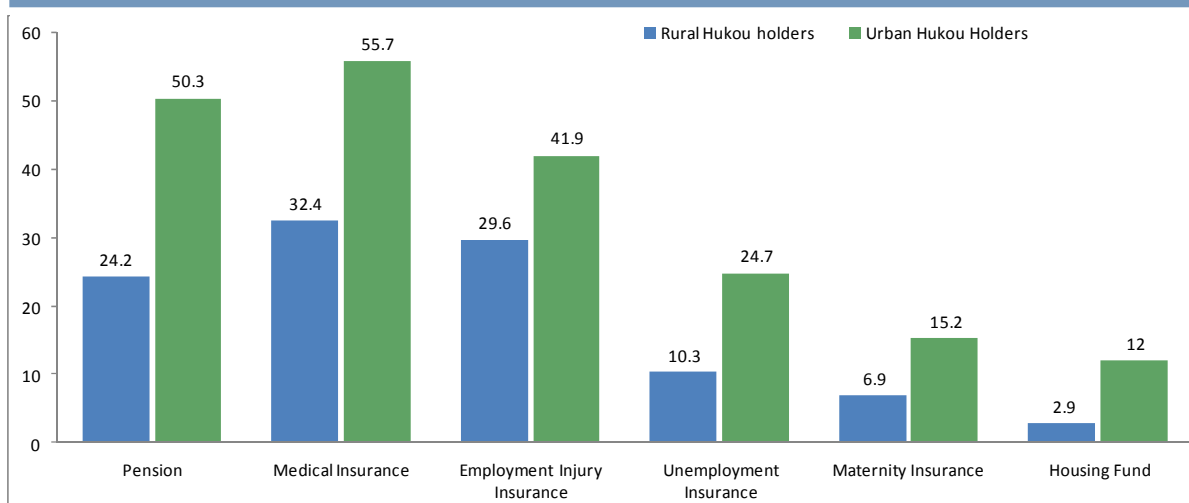


Source: 2011 Report on Development of China's Migrant Population, National Population and Family Planning Commission

- **Labor and social welfare protections remain low**

A 2011 study by the National Population and Family Planning Commission (NPFPC) projected that a further 100 million rural residents will move to urban areas in the coming decade, bringing the total urban population to above 800 million people by 2020. Since the enactment of the Social Insurance Law in July 2011, rural migrants' have been entitled to transfer their pension, medical and unemployment insurance from one city or province to another when they take up new employment (i.e. their past premium contributions in different locations will be treated cumulatively). Even so, the study found that 74% of migrant workers had not transferred their rural pension to their current place of residence. Meanwhile, 52% of the total migrant population did not possess any form of urban social insurance.

Figure 5: Percentage of migrant population that receives social insurance coverage (%)



Source: 2011 Report on Development of China's Migrant Population, National Population and Family Planning Commission

Another study recently conducted by the Chinese Academy of Social Sciences found that urban residents with rural hukou had a much lower rate of pension and medical insurance coverage: 63.1% of the urban residents with urban hukou had pension coverage, while only 30.2% of urban residents with rural hukou had coverage. Only 17.6% of urban residents with rural hukou had subscribed to urban medical insurance (employee health insurance or basic medical insurance for urban residents).

Younger migrant workers in China tend to have vastly lower access to welfare and basic social protections. More than half of the younger migrant workers surveyed by NPFPC were without a formal labor contract, and on average, fewer than 20% had urban social insurance coverage, including pension, injury, medical and unemployment insurance. Also worryingly, younger migrant workers typically also have less rural social insurance coverage than their elder peers.

### III. China's hukou reform agenda – what is changing?

China's hukou system was first instituted in 1958 as a means of regulating internal migration by assigning different employment rights, benefits and obligations according to a person's rural or urban classification, and by their official place of residence. Initially, the system's primary function was to maintain a sufficient agricultural labor force, while preventing excessive strain on urban resources. Typically, urban hukou holders have been entitled to housing, education, health and other social benefits, while rural hukou holders have been entitled to usage and residential rights for land belonging to their agricultural cooperatives. Additionally, residents of rural areas have often been permitted to have two children.

Aside from being widely criticized as a source of social inequality and a source of disincentives to higher consumption, the hukou system (together with the prohibitive cost of living in major cities) contributes to the phenomenon of scattered rural families. Studies in the past several years have found that two thirds of Chinese rural wives lived apart from their husbands and estimated that over 40 million children nationwide are left behind in rural areas while both parents work elsewhere.

Over the years, reforms to the hukou system have accompanied wider economic reforms in China:

- Implementation of the hukou system has gradually become less stringent after the initiation of economic reforms in 1978. In the mid-1980s, the State Council issued two documents ("Notification on the Question of Peasants Entering Towns" and "Provisional Regulations on the Management of the Population Living Temporarily in Cities") that allowed rural hukou holders to relocate to cities under temporary residence permits if they had local employment, housing and could provide their own food rations. This reform allowed millions of surplus rural



laborers to migrate and take up manufacturing employment, with their companies typically providing food and basic accommodation.

- In 1997, the State Council initiated a pilot scheme in 382 towns and small cities, whereby urban hukou became available to rural migrants who held stable employment and who had resided in the locality for at least two years. In 2001, this reform was expanded to cover all small towns provided that stable income and residence requirements could be satisfied.
- Over the years, various local governments have made it easier for better skilled/educated migrants to obtain a local hukou, provided that they can demonstrate stable employment, regular income and a regular place of residence. Generally speaking, the threshold to qualify for full hukou conversion has been higher in China's larger cities (which in turn tend to provide better social benefits). Increasingly in the late-1980s/early-1990s, local governments began to introduce schemes that allowed rural residents to acquire urban hukou for fees ranging from a few thousand to tens of thousands of yuan.

Starting in the 2000s, several first and major second-tier cities undertook hukou reform trials with distinctive attributes. Some notable examples:

- **Shanghai** introduced a residence permit system with strict criteria relating to employment and place of residence. The system prioritized applicants who hold university degrees, have special skills, do business or invest in Shanghai, or are being reunited with family who hold Shanghai hukou. Shanghai's residence permit grants equal access to public services and entitles the holder to apply for hukou after seven years of social insurance contributions. In 2010, the number of conversions was relatively low at 71,700, a number that increased the urban hukou population by only 0.5%.
- **Guangdong** introduced a scoring system in 2009 that assigned points depending on an applicant's educational background, skills, years of social insurance contribution, place of origin and other criteria. Although the province set a target of 1.8 million conversions, only ~100,000 migrant workers reportedly acquired hukou in Guangdong's urban areas in the first year. Separately, all migrants in the province were encouraged to apply for residence permits that entitled them to additional public services and welfare.
- **Chengdu's** hukou reform is considered by many to be the most ambitious in the country. Following a series of reforms that started in 2003, more than 2 million people have become permanent residents of the city – while following the 2008 Wenchuan earthquake, rural hukou holders have been allowed to register as urban residents without relinquishing their existing rural property rights. The Chengdu government announced in 2010 that it aimed to unify rural and urban hukou systems across the municipality by 2012, under a plan where local migrants in the city will either hold temporary or permanent residence permits. Temporary permits are issued in cases where a migrant stays for 1-12 months, while permanent residence permits are issued in cases where a migrant will work for over a year. Permanent residence permit holders are entitled to a wider array of public services and benefits and are eventually eligible for full hukou conversion. It has been reported that several Chinese ministries have conducted investigations into the Chengdu reform model to determine if it can be replicated in other cities.
- **Chongqing's** latest round of hukou reform was initiated in 2010, with the aim of turning 10 million rural hukou holders into urban citizens by 2020, bringing the municipality's urbanization rate to 70% (the rate according to urban hukou would be 60%). The key features of the policy are embodied in the slogan “exchanging three rural clothes for five urban clothes”, meaning that farmers stand to obtain eligibility for pension benefits, housing, employment, education and healthcare benefits in exchange for relinquishing their residential land rights, farming land rights and any contracted forest land. Residents who convert from rural to urban hukou may retain their rural land rights for three years, but must relinquish these rights thereafter to retain their urban hukou. After an initial tepid reception, it was

reported that by the end of 2011, 3.2 million people had converted to urban hukou status.

Figure 6: Local Hukou reform at a glance

Criteria	Guangdong	Shanghai	Chengdu	Chongqing
<b>Year of most recent reform</b>	2010	2009	2010	2010
<b>Years of residence required for conversion</b>	7	7	2	3-5 (location-based)
<b>Qualification system</b>	Point-based system	Point-based system	Favors owners of local property >70 sqm and graduates of local universities	Income tax payments of RMB50-100k in last 3 years or RMB 20-50k in past year
<b>Education</b>	Children of migrants who have lived in the city for five years may enter public schools	Migrants who have urban residence permits have equal education rights	Urban and rural hukou holders have equal rights to public education	Equal rights to public education after conversion
<b>Rural land rights</b>	Rural residents relinquish land rights upon conversion	N/A as most applicants are from other jurisdictions	Chengdu's rural residents do not need to exchange land for hukou	Rural residents retain land rights for three years
<b>Rural-Urban conversion*</b>	690,000	71,700	210,000	3.2 million (2011)

Source: Local bureau of Social Security; Zhao and Fu (2010) ;

\*J.P. Morgan estimates based on local statistics bureau, Chongqing's 2011 figure based on press reports.

Local governments have had a high degree of autonomy in determining the level of non-hukou migration to their cities, and there is now considerable variation among different city jurisdictions in the allocation of social security benefits and public services to hukou and non-hukou holders. However, a controversial aspect of hukou reform has been the tendency for local governments to require that rural residents relinquish their rural property rights in order to obtain urban hukou. In many cases, the underlying motivation for this lies in a national policy that forbids any reduction in the total area of agricultural land. In order to generate revenue from land sales while complying with this policy, some local governments have targeted a higher rate of hukou conversion while also seeking to convert rural land into land for urban construction.

### ***An issue of land – the State Council's recent circular***

In the late-2000s, many local governments attempted to convert rural villages into urban neighborhoods by moving the original rural inhabitants into apartment buildings in exchange for some urban welfare benefits. This phenomenon of local government “land grabs” has been denounced for depriving rural residents of their property rights. In places like Chengdu and Chongqing, recent reforms to the hukou system no longer require rural residents to immediately give up their rural land claims in order to obtain urban registration, however a long-term resolution to the issue has not yet materialized.

China's State Council recently released new guidelines for hukou reform, that ostensibly make it easier for migrants to obtain permanent urban hukou in small and medium-sized cities. Although the circular was released on Feb 25, it was originally issued to local governments on Feb. 26, 2011, suggesting that the rules have now been in effect for a year. Notably, the circular stated that:

- In small cities (county-level and below), people who have maintained stable employment and residences in small cities (county-level and below) may apply for permanent residence permits, together with their spouses, parents and unmarried children.
- In medium-size (prefectural-level) cities, people who have maintained stable employment and residences for a period of three years, and have paid social security insurance for at least one year can apply for permanent urban hukou, together with their spouses, parents and unmarried children



- No *new* rules pertaining to hukou conversion should require that people relinquish their claims to rural land.

At the same time, the circular stated that local governments could take into account their local circumstances in implementing this policy, and that the central government would continue to regulate the population of major cities.

Considering that the 1997-2001 reforms already extended hukou reforms to all small cities and that various local governments have initiated their own reforms, the main incremental impact of the State Council's recent circular is to i) offer explicit support for rural residents' land rights and deter forcible conversion into urban hukou status, and ii) expand hukou reforms to prefectural-level cities (thus all cities below the tier of provincial capital are effectively covered by the nationally-directed hukou reform). The incremental extension of hukou reform to a larger number of small and medium-sized cities is consistent with the recent trend of greater migration to smaller cities that are situated closer to migrants' places of origin.

### ***Upcoming developments – hints from the NPC***

In his government work report at the opening of this year's National People's Congress (NPC), Premier Wen Jiabao emphasized that the government would "prudently carry forward the reform of the hukou system" and also deepen reforms of land, household registration and public services in the year ahead. Subsequently on the sidelines of the NPC, China's Vice Minister of Public Security said that his ministry is circulating a draft regulation for a new nationwide residence permit system for consultation, and intends to submit it to the State Council for approval within the year. A senior official of the National Development and Reform Commission (NDRC) also said that China should establish a cost-sharing mechanism to grant migrant workers equal access to social benefits and public services in cities.

We believe these remarks suggest new initiatives in the year ahead, which may be consistent with a recent proposal to reform the hukou system in a supplement to the *China 2030* report jointly published by the World Bank and the Development Research Center of the State Council. The proposal calls for establishing a national population registration system, while gradually diminishing the relevance of hukou as a determinant of social entitlements:

**1st phase** – Establish a national framework for a residence permit system and begin the process of delinking social entitlements of non-local residents from their hukou status. During this phase, it is important to establish common indicators (e.g. period of local residence) that local governments can adapt to their own conditions, while also establishing national standards for information systems and the exchange of population data across jurisdictions.

**2nd phase** – Gradually expand the residence permit system across the nation; expand eligibility for residence permits and hukou conversion, beginning with all rural residents of a prefecture, then extending to all people with hukou within a province, and ultimately making residence permits available to people from beyond the province.

**3rd phase** – Creating a pathway within local residence permit systems for gradual acquisition of the same social entitlements as local [hukou] residents, prioritizing rights such as children's' education. Further lower the threshold for hukou conversion.

**4th phase** – Rollout of the residence permit nationally, with equal entitlements for local hukou holders and local residence permit holders.

In their proposal, the World Bank and State Council Development Research Center argue that under such a common national framework, the residence permit system could be rolled out nationally by the second half of the decade, while by 2030, social entitlements could be equalized between local urban hukou residents and residence permit holders. As such, a resident's original hukou status becomes of vastly diminished relevance as a determinant of social entitlements. The authors, however,

acknowledge that complex negotiations will be needed between the local and central levels of government to determine the financing responsibilities of social services and the sharing of fiscal burdens, especially in cases where migrants originate from beyond the province. A 2011 study by the Development Research Center of the State Council estimated incremental costs of ~RMB80,000 that arise when a migrant worker converts into urban hukou (see Figure 7).

Figure 7: Conversion to urban hukou – incremental costs per migrant (RMB)

Items		Chongqing	Wuhan	Zhengzhou
<b>1.Mandatory education</b>	Primary School	3,021	7,898	3,252
	Secondary School	3,078	10,068	4,931
	School Renovation	2,773	2,919	3,016
<b>2.Urban Residents' Medical Insurance (per annum)</b>		62	52	31
<b>3.Pension Insurance</b>		35,816	29,754	42,049
<b>4.Other Social Insurance</b>	Accident Insurance	NA	5	NA
	Minimum allowance	86	81	59
	Medical Assistance	9	49	16
	Maternal/Nursery help	14	6.3	NA
	Childless Elderly	NA	NA	8
<b>5.City Administration Fee (per annum)</b>		491	401	260
<b>6.Housing Assistance</b>		8,570	9,976	8,697

Source: State Council Development Research Center 2011 Study on Rural Migrant Workers

#### IV. How a narrowing of the urban-rural divide will support domestic demand

In his Government Work Report at the National People's Congress, Premier Wen Jiabao stressed that the government would pursue urbanization in a "proactive and prudent" manner and facilitate the assimilation of migrants into small and medium-sized cities. The Premier also called for strengthening the social welfare of migrant workers – in terms of employment services, social security, education (for migrant workers' children) and housing. Jia Qinglin, Chairman of the Chinese People's Political Consultative Conference (CPPCC), also emphasized that more rural migrant workers should urbanize "locally", in order to facilitate the integration of urban and rural regions.

We believe the key to unleashing the macroeconomic benefits of urbanization lies in narrowing the welfare gap between urban and rural residents by improving social security, especially for rural hukou holders. Various aspects of the proposed fiscal budget for 2012 support this view:

- **Healthcare:** The government intends to raise annual health insurance subsidies for both the Rural Co-op and Urban Resident Schemes from RMB200 to RMB240 per person. Moreover, China will raise subsidies for health insurance offered to farmers and unemployed urban residents to over RMB360 by 2015. Reimbursement rates for in-patient care will increase from 60% at present to 75% by 2015. China's Health Minister also said recently that a health scheme will be launched to cover migrant workers' medical insurance when they seek treatment outside of their jurisdiction of hukou registration.

- **Housing:** This year, construction of another 7 million units of social housing is due to commence, while 5 million units are expected to be completed to increase the stock of affordable housing for the sandwich class in cities, including many migrants.

- **Agriculture:** The central government this year plans to allocate RMB1.23 trillion (an increase of 17.9% from last year) for developing the agricultural industry, rural areas and improving farmers' livelihood. This year's "No. 1 document" on agricultural policy issued by the Central Committee of the

Communist Party emphasized investments in agricultural science and technology, increased credit for purchases of agricultural machinery, and even emphasized the need to attract some young rural migrants back to the countryside to undertake modern farming.

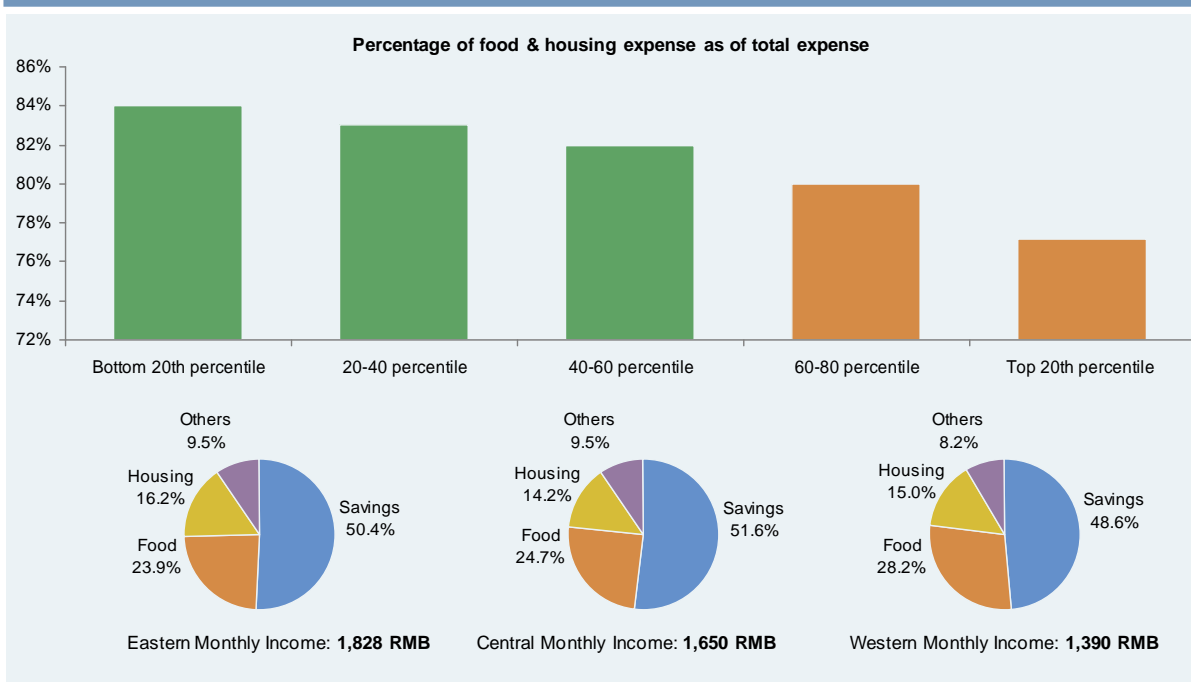
The total budgeted spending on social welfare in 2012, including education, medical care, social housing, and culture amounts to RMB1.4 trillion, or 19.8% higher than last year's budgeted spending. Yet even with the boost in spending on rural development and social welfare, the vast income and welfare gap between urban and rural residents cannot be rectified within a single Five-year plan, given the complexities of reforming China's hukou and land rights systems, and the reluctance of many rural hukou holders to sever their formal linkages with the countryside. Nevertheless, government policies to accelerate urbanization and improve the social welfare of migrants should be supportive of the following investment themes:

- **Rapid wage growth and improving social benefits will support mass-market consumption**

In 2011, the average monthly salary for migrant workers rose ~23% to RMB 2,049. A 2011 survey of rural migrant workers' income and expenditure by the Ministry of Housing and Urban-Rural Development found that food and housing together accounted for the vast majority of migrant workers' expenses, with even the top twentieth percentile earners spending more than 77% of their total monthly expenses on food and housing. Migrant workers' savings rates were very elevated, due to their need to make remittances, as well as the need to save in lieu of making pension and social insurance contributions.

According to the study, a 50% increase in migrant workers' spending on non-food and housing items (from less than 10% of their monthly income at present) would result in a 1.7 percentage point increase in overall retail sales, based on 2011 data. Thus, improvements in wage growth, access to affordable housing and social insurance stand to have a significant impact on consumption. In light of the tight labor market and supportive policies, we expect the annual wage growth for rural migrant workers to continue outpacing general wage growth in the next several years, and as such, rising incomes should support efforts to rebalance the economy away from excessive reliance on investments and net exports.

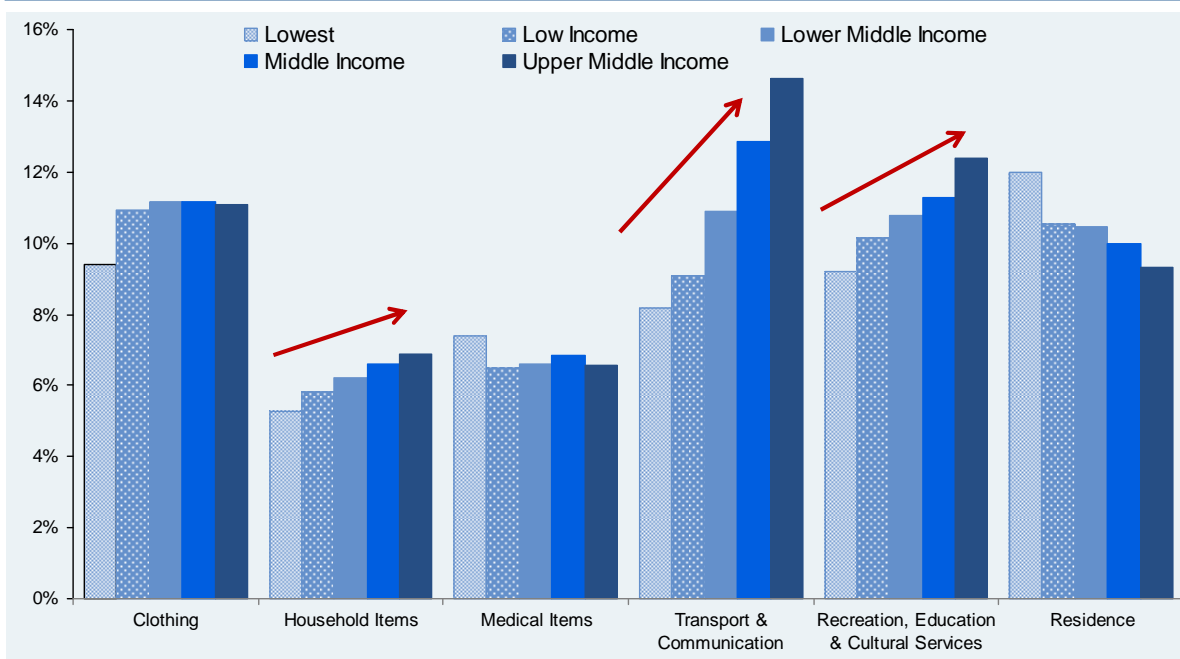
**Figure 8: Migrant Workers' expenditure according to income group and region of residence (2010)**



Source: 2011 Report on Development of China's Migrant Population, National Population and Family Planning Commission

As Figure 9 shows, when Chinese consumers progress from low to middle income, spending on “Clothing”, “Household Appliances and Services”, “Transport and Communications”, “Education & Recreation” typically experience meaningful growth.

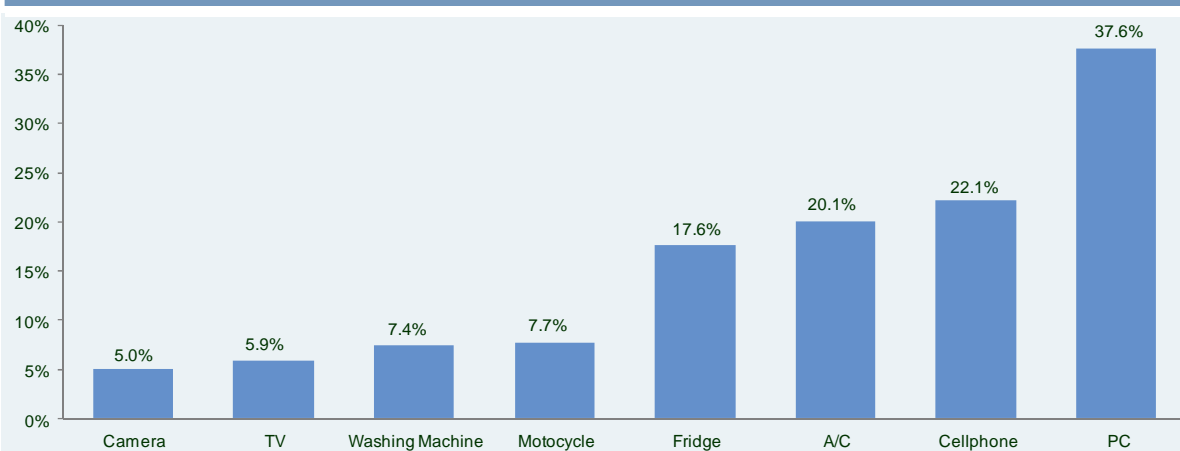
Figure 9: Composition of Private Consumption of Urban Households in 2010 (%)



Source: CEIC

Specifically looking at **durable goods** – strong double-digit 2005-2010 compound annual growth rates have been observed in several categories such as PCs, mobile phones, air conditioners and refrigerators (see Figure 10). However, ownership rates are still modest in comparison to urban norms – for instance the frequency of refrigerator and washing machine ownership for urban households is almost double that of rural households. For air conditioners, PCs and cameras, the frequency of ownership for urban households is nearly seven times that of rural households.

Figure 10: Durable goods ownership in rural regions: 2005-2010 CAGR



Source: CEIC

We believe that the prevalence of policies aiming to support rapid wage growth, strengthen migrant workers' social welfare, and safeguard rural land rights will bolster mass market consumption. This has already been evident in the relative resilience of same-store sales growth for retailers catering to the mass-market (e.g. Yum Brands returned 21% SSS growth in 4Q2011), whereas retailers of higher-end goods such as Belle and department store operator Golden Eagle

have seen SSSG decelerate from the high-teens to high single-digits. In the staples space, J.P. Morgan's consumer research team expects 22% earnings growth for covered stocks in 2012, with top picks being China Mengniu Dairy (2319.HK) and China Foods (506.HK), the leading manufacturer and distributor of edible oils, wine and beverages. However, J.P. Morgan analyst Ebru Sener Kurumlu is generally cautious on staples, finding that the extent of near-term upside is limited, given the high base of comparison in the first quarter, and also considering that companies may steer better-than-expected savings from input costs into advertising and promotions.

- **Steady increase in healthcare spending**

The Ministry of Health (MOH) has released its key objectives in 2012, with RMB203.5 billion budgeted for medical and healthcare spending, an increase of 16.4% over last year's actual expenditure. China will also raise the per capita contribution to the New Rural Cooperative Medical Scheme from RMB 240 to RMB 300, as well as initiate a pilot scheme of county-level hospital reform in 300 counties or county-level cities. Healthcare spending in rural areas last year stood at only 23% of that for urban areas according to the MOH.

J.P Morgan healthcare analyst Sean Wu believes this year's healthcare budget demonstrates the government's continued commitment to increase healthcare spending, which broadly benefits the entire sector. He also expects the expansion in the number of local community health centers and rural medical facilities will lower the burden on large urban hospitals, and that this should benefit low-end medical equipment and consumable makers. Sean Wu prefers medical device makers such as Mindray Medical (MR.US) over drug makers, which may face policy-directed price cuts as part of the essential drug list system. He is also overweight on Concord Medical (CCM.US), the operator of cancer treatment centers, Sino Biopharmaceutical (1177.HK), which focuses on medicines to treat cardio cerebral diseases and hepatitis, drug distributor Sinopharm (1099.HK) and Shandong Weigao Group Medical Polymer (1066.HK), which produces medical consumables.

- **Modernizing the agricultural sector**

Since the ultimate goal of urbanization and hukou reform is to bridge the rural-urban divide, the development of modern agriculture is a central component of promoting growth in rural areas. The State Council's recent "No.1 document" – an annual policy guideline for the agricultural sector – places special emphasis on the development of agricultural technology, with particular emphasis on innovation in the seed industry and improving agricultural infrastructure and mechanization. As such we believe that agricultural equipment producers and seed producers stand to benefit from the central government's plan to allocate RMB1.23 trillion (+17.9% YoY) in spending this year for agriculture, rural areas and farmers. The State Council expects the sector's mechanization level to rise by 8% CAGR during the 12th Five-year plan.

## **V. Why haven't more rural residents converted to urban hukou?**

Despite an array of central and local government measures to increase urbanization, a 2010 survey of rural hukou holders living in cities by the Chinese Academy of Social Sciences found that 80% were not willing to switch to urban hukou. In our view, the major reasons behind this apparent attachment to rural hukou status are i) an unwillingness to surrender rural land rights, ii) recent improvements in rural welfare and benefits (that become more meaningful as migrants increasingly reside in small cities near their place of origin), iii) prohibitive costs associated with urban social insurance schemes.

- **Unwillingness to surrender rural land rights**

Because of the potential for agricultural income, the perceived market value of rural land, and the security of having a place to return to, many migrant workers hold deep reservations about giving up their claims to rural land. Thus, it is difficult to see how comprehensive hukou reform can be achieved without reform of the system of land transfer and contract. Since Chinese farmers don't

legally own their land, but possess land-use rights through rural cooperatives, rural hukou holders have typically been compensated for their land on the basis of crop yield rather than the much higher development potential of the land. This standard of compensation is derived from Article 46 of China's 2004 Land Administration Law, which specifies that compensation for land should be made according to its original usage.

A recent 17-province wide study by researchers at Renmin University found that over 43% of farmers in the country had experienced land expropriations by local governments. Of this group, 64.7% received a lump sum payment that averaged RMB18,739 per mu (the Chinese unit of land area equivalent to 0.16 acres); 12.8% were paid in annual installments, 9.8% were still waiting for their promised payment, while the remaining 9.8% were not offered any compensation. Of all the land expropriation cases, 17.8% were mandatory and twice as many farmers were dissatisfied as those who were satisfied. The average compensation offered to farmers was dramatically lower than the average price of RMB778,000 per mu that local governments obtained from land sales.

In his address last December at the National Rural Work Conference, Premier Wen Jiabao emphasized that farmers' land rights should no longer be sacrificed for the sake of lowering the costs of industrialization and urbanization, and that "we must, and also have the conditions to, dramatically increase the share of gains that goes to farmers from enhancing the value of land." The Premier also emphasized that rural people have rights to the income from their land (i.e. from their allotment of farm plots, the land occupied by their house and from forestry rights) regardless of whether they reside on the land or have moved to cities. This statement affirms that in the central government's view, land compensation standards have been too low. Premier Wen indicated that a national land compensation system must be established and that regulations for implementing such a system would be issued in 2012.

- **Rural welfare and benefits have been improving**

The major objective of China's hukou reform agenda is to lower barriers to urban residency for farmers, but another component is to improve social security benefits for rural residents. In the past decade, China has introduced a number of policies that offer farmers a range of benefits to improve their livelihoods and some that are more typically associated with urban residency. For instance, the government scrapped the agricultural tax in 2006 and has steadily increased agricultural subsidies. Until recently, rural residents had no access to free or inexpensive medical care and received no pension coverage. Today ~200 million Chinese rural residents have joined the country's rural pension insurance program (launched as a trial in August 2009) and China has emphasized support for the development of county level hospitals and clinics in rural areas during the 12th Five-year plan. In February 2009, the government launched a massive nationwide subsidy program to encourage rural purchases of home appliances; as of the end-Jan 2012, the government had issued RMB60.59 billion in subsidies on the sales of about 220 million sets of home appliances valued at RMB519.66 billion, according to the Ministry of Commerce.

- **Cost of urban social insurance coverage**

Various factors contribute to the low penetration of urban social insurance coverage for rural migrant workers: i) the inherently unstable nature of employment for most migrants and prevalence of uncontracted labor, ii) employers are reluctant to see labor costs increase as a result of higher insurance coverage, and iii) local governments are concerned about the increased burden on fiscal budgets and urban services that would result from improving social insurance for migrants.

A 2010 study on Wuhan's social welfare coverage by the Development Research Center of the State Council found that employers were responsible for 31% of social insurance scheme contributions (including pension, medical, unemployment, birth control and employment injury), employees themselves were responsible for 10%, with the Wuhan government responsible for the remaining 59% of contributions. This amounted to an average monthly employer contribution of RMB516 for each covered employee, while employees contributed RMB165 per month on



average. Since social insurance contributions are benchmarked to a level equivalent to 60% of the average city-wide wage, the additional burden of covering relatively low-earning migrant workers is very substantial for the local government, employers and the migrant workers themselves.

Although rural social insurance coverage is very modest, heavy government subsidies make them affordable to rural hukou holders. In Wuhan, rural hukou holders need only pay RMB30 per year for medical insurance and RMB200~1200 per year for pension coverage. The elderly in Wuhan are entitled to a minimum monthly pension payment of RMB100 and medical insurance coverage.

In a recently-published study of migrant workers in Beijing and Chifeng City, Inner Mongolia (authored by Johns Hopkins University researcher Shaohua Zhan), unemployment compensation and minimum living support (“dibao”) were the two areas of social welfare in which migrant workers experienced the highest degree of exclusion. Exclusion from these benefits, however, was not believed to play a major role in migrants’ decisions to settle in the cities, since the benefit entitlements are very small in real terms. Migrant worker’s degree of exclusion from accessing health insurance, retirement insurance and employment services were said to be “moderate”, because possession of an urban hukou does not necessarily guarantee health or retirement benefits. Moreover, migrant workers in the study were found to favor purchasing medicine in drug stores, receiving inexpensive treatments in private clinics and saving for their own retirement rather than to participate in relatively expensive social programs.

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