

China Macro View

Urbanization Revisited

- **Sentiment and growth positive** – The Chinese government has finally released the long-awaited New Urbanization Plan. If fully implemented, it would imply an addition of 110mn migrant workers to shore up the residency-based urbanization rate to 60% by 2020. The *hukou*-based urban population would be topped up by 150mn, to 45% of total population. This implies an additional 2-4% urban annual population growth in the next seven years. Proposed reforms on *hukou*, land, and funding are not ambitious, but should help unveil urbanization dividends gradually and boost sectors including urban infrastructure/commodity, property, services/consumption, agriculture, and environment protection.
- **Policy/reform initiatives** – The *hukou* reform is set to follow a differentiated approach, removed in smaller cities but partially relaxed in larger cities. Land reform is in line with the guidance of the Third Plenum. The funding of urbanization could be more innovative, including the issuance of municipal bonds by local governments, introducing longer-term funding instruments, and putting up policy banks to fund investment in infrastructure and social housing. The environment policy shall focus on green energy, green construction, green transportation, and reducing the pollution of air, water and soil.
- **21 mega regions proposed to harbor the urban population** – The government plans to spread the 260mn population boost to mega regions nationwide. International experience suggests that in developed countries, more than 40% of the country's population resides in the top three mega regions. In our view, the population flows will follow the jobs and quality of services that a region can offer. China's top three mega regions consist of only 18.2% of the total population by 2012, and this could be doubled in coming decades.
- **What to expect next?** – We expect local governments to launch *hukou* reforms shortly. The collateralization of residential property should follow with a pilot. Longer-term financing instruments could be introduced, including possibly an infrastructure investment bank or a social housing investment bank to meet the demand for funding.
- **What's missing here?** – The core of the New Urbanization Plan should be a plan for reform, not a plan about how resources are to be allocated. Service sector deregulation, land monetization, fiscal support to urbanization, and removing administrative segmentation are necessary reforms before urbanization can take place at full speed.

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Urbanization Revisited

China has released the long-awaited New Urbanization Plan today. It has highlighted detailed goals for urbanization by 2020. If fully implemented, the plan implies about 110 mn new jobs in the urban area, and another 150 mn migrant workers would permanently settle in cities with urban *hukou* under the current household registration system. This plan is slightly less ambitious than the previously announced 300 mn urbanization. The land reform is likely to be the key obstacle to urbanization in the next seven years.

Urbanization could potentially be the driver of domestic demand in the next decade or beyond. We revisit our note titled *"The Urbanization Dividend"*, Citi China Macro View, Oct 23, 2012, and assess the effects on the Chinese economy and investment opportunities.

Policy summary

In the Central Rural Work Conference in late Dec 2013, Chinese leaders rolled out the plan to urbanize the population of 300 mn by 2020: 100 mn migrant workers would obtain the hukou and become permanent urban residents, 100 mn people who reside in urban villages and slums would be renovated, and another 100 mn would settle in central and western China. This plan was reiterated by Premier Li Keqiang in the NPC annual session.

The New Urbanization Plan (NUP) is slightly different from the above targets (Figure 1). The plan has recognized the gap between migrant worker-led urbanization and hukou-based urbanization (Figure 2). The former is based on residency, and anyone who spends more than six months a year in the cities is deemed part of the urban population. The latter is based on hukou, an identity dividing rural and urban by birth, not by occupation or residency. The migrant worker-based urbanization rate was 52.6% in 2012, 17.3ppts higher than the hukou-based rate of 35.3%. The plan is only to narrow the gap slowly to around 60% vs. 45% by 2020.

Figure 1. The government's goals of urbanization, 2014-2020

Indicators	2012	2020
Urbanization level		
Urbanization rate based on residency (%)	52.6	≈ 60
Urbanization rate based on hukou (%)	35.3	≈ 45
Basic public services	2012	2020
Compulsory education coverage among migrant workers' children (%)		≥ 99
Free vocational training coverage among unemployed, migrant workers and new labor force (%)		≥ 95
Basic pension coverage among urban residents (%)	66.9	≥ 90
Basic medical insurance coverage among urban residents (%)	95	98
Affordable housing coverage among urban residents (%)	12.5	≥ 23
Infrastructure	2012	2020
Urban public transport utilization (in City population > 1mn) (%)	45*	60
Urban public water supply coverage (%)	81.7	90
Urban sewage treatment rate (%)	87.3	95
Urban life garbage harmless processing rate (%)	84.8	95
Urban households broadband access (Mbps)	4	≥ 50
Urban community service facilities coverage (%)	72.5	100
Resources and environment	2012	2020
Urban construction land per capita (square meter)		≤ 100
Share of renewable energy consumption (%)	8.7	13
Urban green buildings % of newly constructed buildings (%)	2	50
Urban greening rate (%)	35.7	38.9
Share of prefecture-level city that air quality reached the national standard (%)	40.9	60

Note: * for 2011 data.

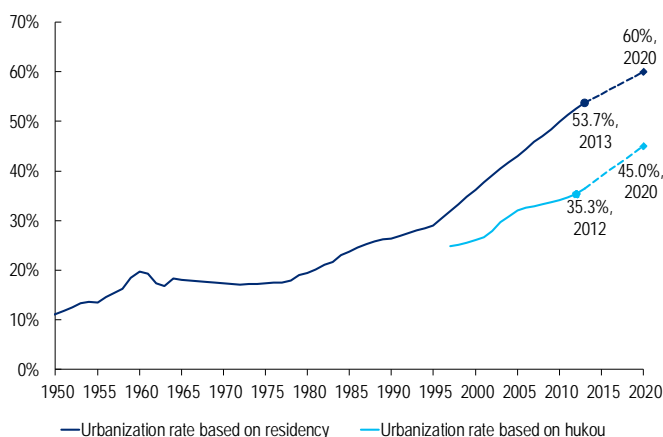
Source: "New Urbanization Plan 2014-2020" and Citi Research

According the NUP, the residency-based urbanization rate would rise 7.4ppts in 7 years, implying roughly 110 mn farmers newly employed in the non-farming sector (assuming 1.4 bn total population by 2020). The hukou-based urbanization rate would increase 9.7ppts, meaning about 150 mn migrant workers are about to obtain urban hukou. In other words, part of the 100 mn in urban villages and slums won't change their jobs and residency.

Key policies and reforms addressed in the NUP cover a broad range of issues including social security benefits, hukou reform, land reform, and environment protection.

- Migrant workers should enjoy the same benefits as urban residents, e.g., having access to tertiary education for their children, training, basic pension, and healthcare, and social housing should cover more than 23% of migrant workers by 2020, up from 12.5% in 2012.
- Urban infrastructure should be extended to more people, covering 95% of urban population with waste water treatment and garbage processing, up from 87.3% and 84.8%, respectively. More than 50% of urban households should have access to broad-band networking, up from 4% in 2012. The government will give priority to develop an urban public transportation system.
- Environment protection shall increase the share of renewable energy consumption from 8.7% to 13%, and the share of green construction from total new construction will rise from 2% to 50%. The construction land per capita will be restricted and should be less than 100 square meters.
- The government will adopt differentiated approach on hukou reform (Figure 3). The hukou will be orderly removed in cities with population between 0.5-1 million, relaxed in cities between 1-3 million, conditionally relaxed in large cities with 3-5 million population, and restricted in mega cities with population above 5 million. For large cities, one of the criteria could be years participated in urban social securities but this requirement should be no more than five years. For mega cities, a score scheme should be established to change the hukou identity, including years of employment, residence and so on.

Figure 2. Urbanization rates until 2020



Source: CEIC and Citi Research

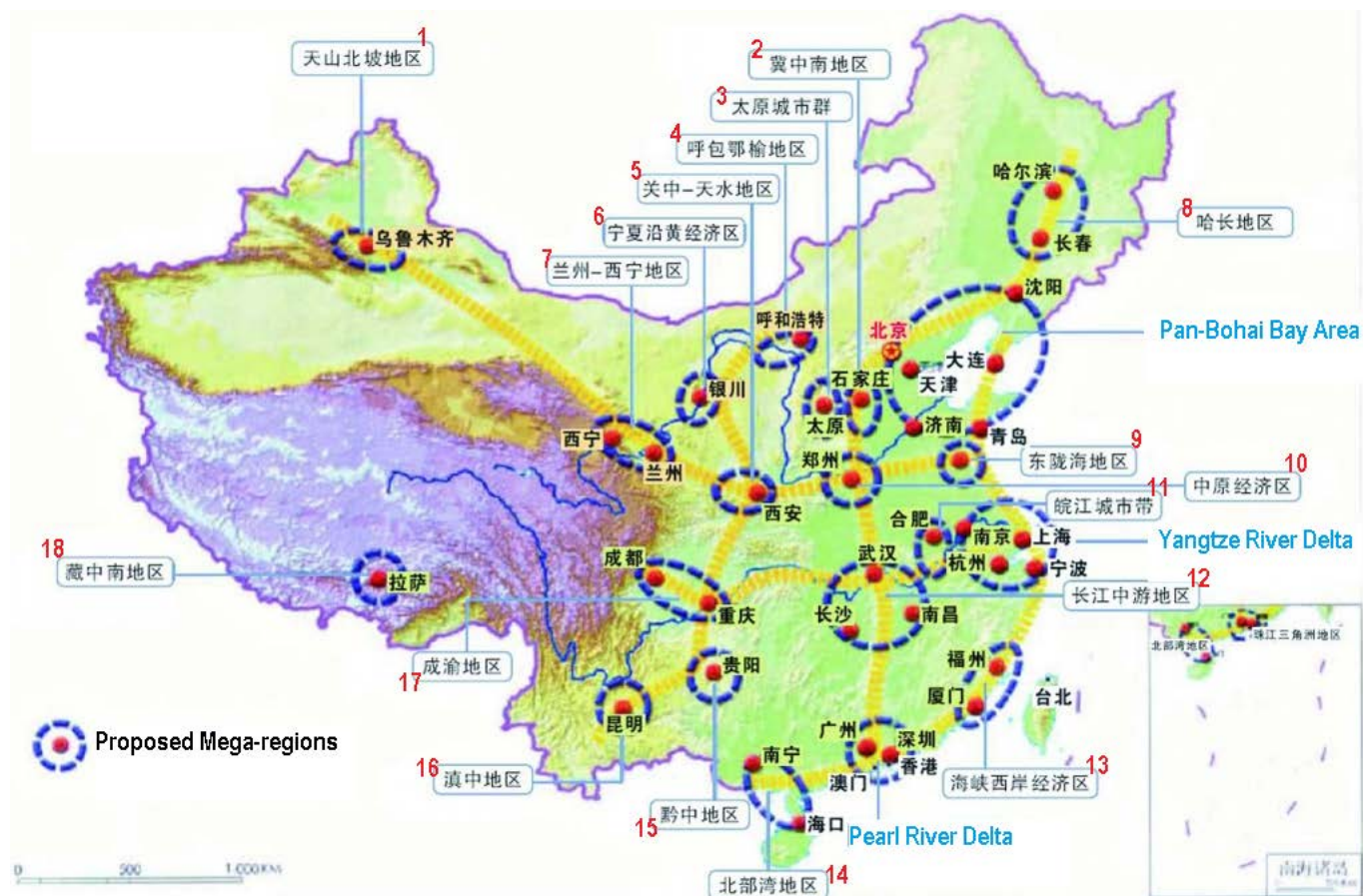
Figure 3. The distribution of Chinese cities

	1978	2010	Hukou Policy Restrictions
City	193	658	
10mn above	0	6	restricted
5mn - 10mn	2	10	restricted
3mn - 5mn	2	21	conditionally relaxed
1mn - 3mn	25	103	relaxed
0.5mn - 1mn	35	138	orderly removed
0.5mn below	129	380	removed
Town	2,173	19,410	

Source: "New Urbanization Plan 2014-2020" and Citi Research

- Related parties (i.e., the government, firms, and individuals) should share the cost of urbanization. The government should provide tertiary education, jobs, basic pension and healthcare, social housing, and urban infrastructure, firms shall treat migrant workers equally to urban residents, provide job training, and bear the cost of employee pension, healthcare, accident, unemployment, maternity, and other social insurance, and migrant workers shall participate in the social security system and vocational training.
- The government will restrict the land use and regulate land use by dividing it into three areas: construction prohibited, construction restricted, and construction area. And four lines are to be drawn to control over-expansion of cities: green lines for grassland and parks, blue lines for river protection, purple lines for historical and cultural sites, and yellow lines for urban infrastructure.
- The land reform part reiterated what had been proposed in the Third Plenum. Rural commercial construction land will be allowed to be sold, leased, and used as an equity investment with the same rights and same prices as urban construction land. The government will also launch a pilot to allow rural residential property to be collateralized, transferred, and used as a guarantee device.

Figure 4. The New Urbanization Plan has proposed mega-regions nationwide to harbor urbanized population



Note: 1. Tianshan northern slope area; 2. Middle and South of Hebei Province; 3. Taiyuan metropolitan area; 4. Hohhot-Baotou-Erdos-Yulin area; 5. Guanzhong-Tianshui area; 6. Ningxia (Yinchuan)-Yellow River economic zone; 7. Lanzhou-Xining area; 8. Harbin-Changchun area; 9. Dong Long-hai area; 10. Zhongyuan economic zone; 11. Anhui-Yangtze River area; 12. Yangtze River midstream area; 13. West coast economic zone; 14. Beibu gulf economic rim; 15. Central-Guizhou area; 16. Central-Yunnan area; 17. Chengdu-Chongqing area; 18. Central-Southern Tibet area. Source: "New Urbanization Plan 2014-2020" and Citi Research

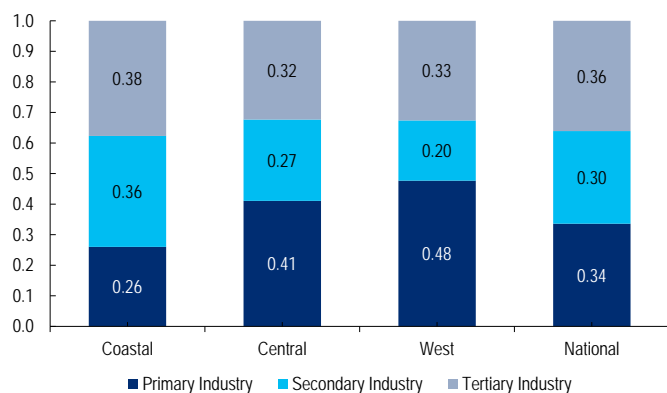
- The plan initiates 21 mega regions to harbor urban population (Figure 4).
- Lastly, how to fund urbanization? First, the fiscal transfer system shall be improved to share the public cost of urbanization (i.e., education, basic healthcare, and social securities). Second, the government will introduce a transparent system to guide the investment and financing of urban construction. There are a few possible initiatives: allowing local governments to issue municipal bonds, and studying the possibility of putting together special financial support policies and policy banks on urban infrastructure investment and residential property investment. Third, the government will open the infrastructure sector to private-sector investors and encourage public funds and insurance money to participate in projects (both investment and operation) with stable returns.

Population flow under urbanization

Where will the 260 mn people move with the new urbanization plan? The government hopes that the population would spread to the rest of China. In our view, it shall depend on jobs and also the quality of services a city can offer.

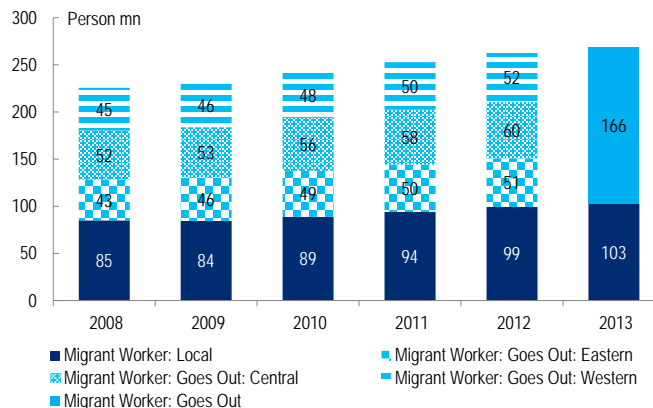
The service sector had employed a larger portion of workers in recent years (Figure 5). In the coastal areas, the service sector provided about 38% of jobs, higher than 32% in central China and 33% in western China. When China rebalances its economy, the labor-intensive service sector shall be the center of job creation.

Figure 5. Job structure by coastal, central and west China (2010)



Source: CEIC and Citi Research

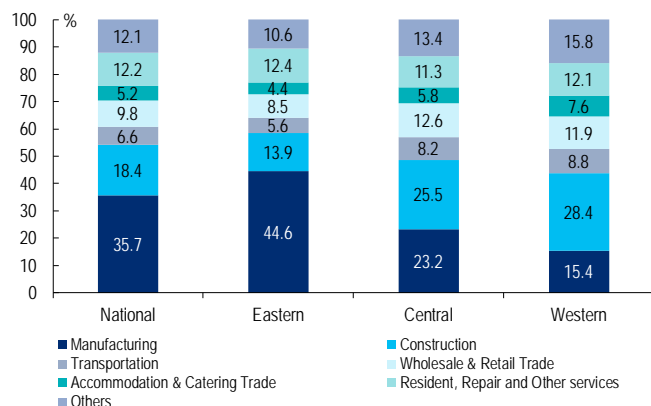
Figure 6. Flows of migrant workers



Source: CEIC and Citi Research

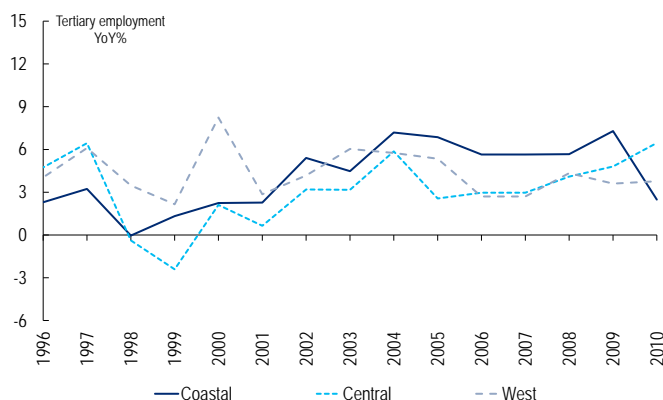
In recent years, partly due to the relocation of labor intensive firms to the non-coastal area and partly because of the “Go West” policy-driven investment, the inland China had absorbed more migrant workers than the coastal area (Figure 6). This trend could be reversed as investment in the construction sector slows in the non-coastal region (Figure 7). Coastal area's job growth in the service sector had been constantly faster than in the inland areas between 2004 and 2009 (Figure 8). This trend had changed in 2010. We believe it's temporary and the service sector deregulation shall benefit the coastal area more than other regions.

Figure 7. Job structure of migrant workers, 2012



Source: NBS and Citi Research

Figure 8. Job growth in the service sector by coastal, central and west

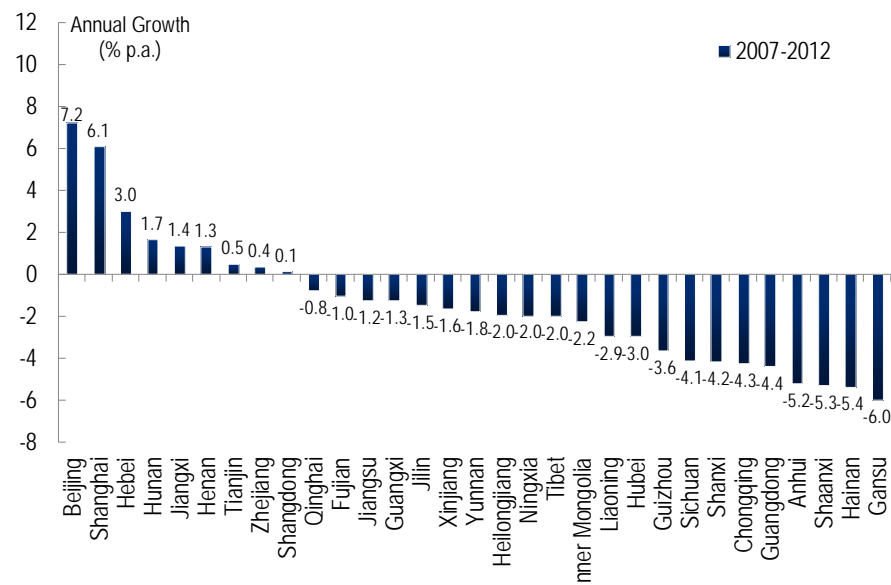


Source: CEIC and Citi Research

The change of student population enrolled in elementary schools is indicative of the trend of population flows (Figure 9). The coastal provinces had recorded relatively positive annual growth between 2007 and 2012. Guangdong province is exceptional here because of its local policy to shake out labor-intensive enterprises. The gap could be widened if we consider the fact that non-coastal areas have a large rural population with a higher fertility rate.

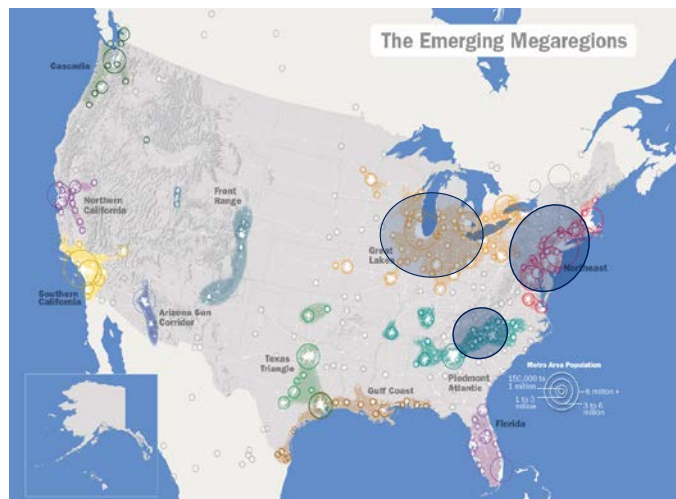
In the developed world where urbanization is complete, the population is much more concentrated into top mega regions. In the US and Japan, top three mega regions consist of 41.5% and 85.8% of the total population, respectively (Figure 10 and 11). There are only a few mega regions in the world located in land-locked areas (Figure 12).

Figure 9. The change of student population enrolled in elementary schools



Source: CEIC and Citi Research

Figure 10. Top 3 mega-regions in the US: Bos-Wash, Chi-Pitts, Char-lanta account for about 41.5% of total population



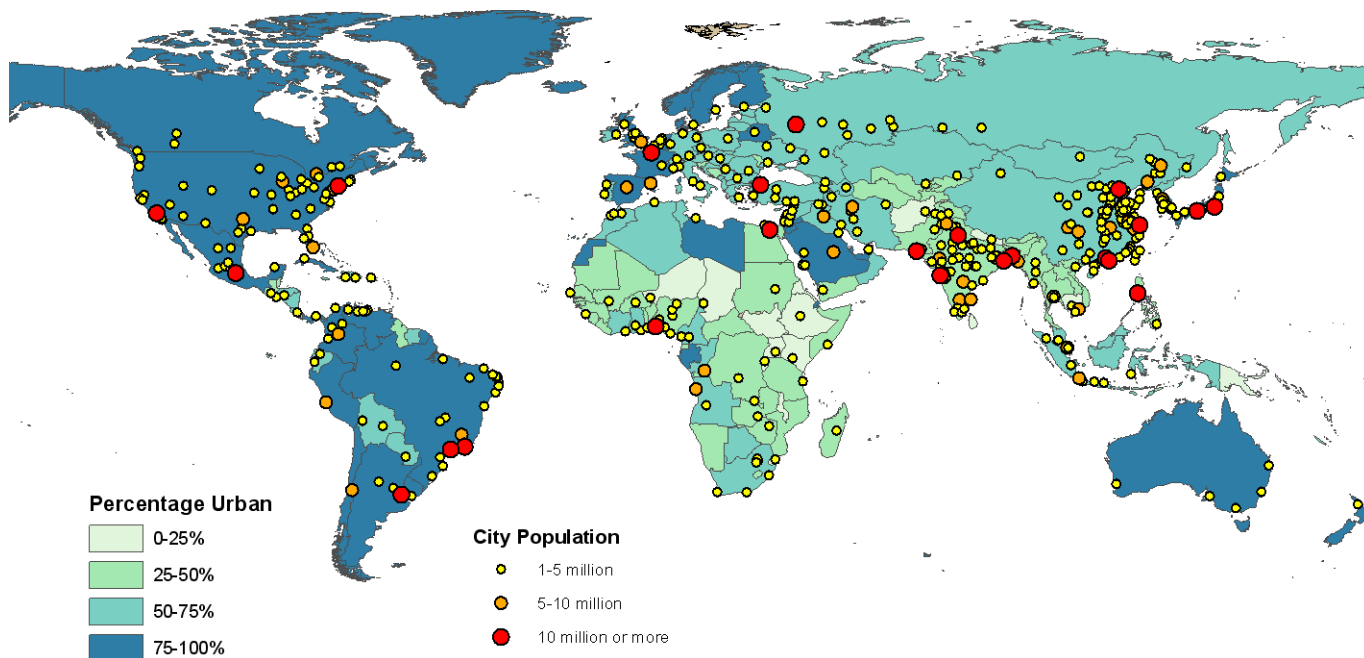
Source: "The Rise of the Mega-Region" Richard Florida, Tim Gulden and Charlotta Mellander, April 2008, and Citi Research

Figure 11. Top 3 mega-regions in Japan: Greater Tokyo, Osaka-Nagoya, Fuku-kyushu account for about 85.8% of total population



Source: "The Rise of the Mega-Region" Richard Florida, Tim Gulden and Charlotta Mellander, April 2008, and Citi Research

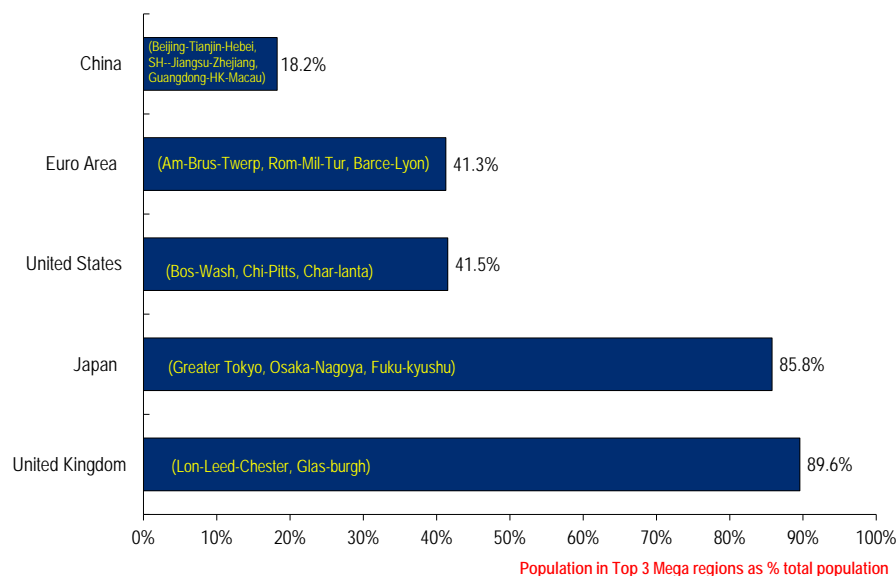
Figure 12. Mega-regions in the world



Source: UN and Citi Research

China will have to abolish the hukou system gradually and allow migrant workers to decide where to settle by themselves. International experience suggests that in industrialized countries, the top three mega-regions consist of above 40% of total population in these countries (Figure 13). In China, this ratio was only 18.2% by 2012. According to NUP, these three mega regions occupied about 2.8% of total land, but produced 36% of national GDP.

Figure 13. Population share in top three mega regions, selected countries



Source: "The Rise of the Mega-Region" Richard Florida, Tim Gulden and Charlotta Mellander, April 2008, Haver and Citi Research

Incremental demand and investment opportunities

China's urban population expands steadily after urbanization: 260 mn population would find jobs and settle in urban areas. This implies urban population (residency based) would grow 2% p.a., while the hukou population may increase 4% p.a. The needs of these newly urbanized citizens are expected to dominate the growth of domestic demand in coming years, rebalancing the Chinese economy away from external demand.

These incremental demands may be originated in areas of urban infrastructure investment, property, and services/consumption. The agricultural sector and environment sector should be winners too.

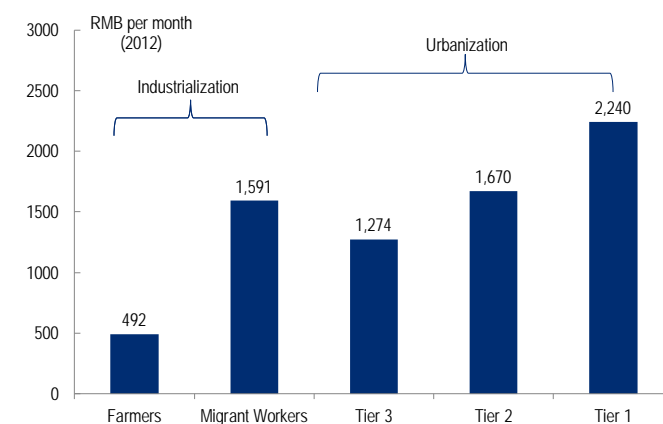
- **Urban infrastructure investment:** This includes water, gas, road construction, light rail/subway construction, education, and healthcare services (Figure 14). The number of hospital beds doubled between 2000 and 2013 while GDP per capita surged 3.9 times. Investment in smart cities is also highlighted. Related commodity sectors may also benefit from fresh demand for urbanization.
- **The residential floor area per capita** increased from 20.3 square meters in 2000 to 32.9 square meters in 2012. If the NUP can be fully implemented, the residency-based urban population would increase 15% in seven years and the hukou-based urban population could expand by 30%. The population growth should be much faster in the center of urbanization. For example, the population size in the top three mega regions in China could be doubled in the next decade. These should lay out the demand floor for the property sector.

Figure 14. Upgraded urban infrastructure and services facility, 2000 vs. 2012

Indicator	2000	2012
Water usage (% of population)	63.9	97.2
Gas usage (% of population)	44.6	93.2
Road area per capita (square meter)	6.1	14.4
Residential floor area per capita (square meter)	20.3	32.9
Sewage treatment rate (% of total)	34.3	87.3
Park green space per capita (square meter)	3.7	12.3
No. of Middle schools	14473	17333
No. of hospital beds (10,000)	142.6	273.3

Source: "New Urbanization Plan 2014-2020", Citi Research

Figure 15. Monthly consumption expenditure per capita: Farmers, migrant workers and urban residents (2012)



Source: CEIC, FT Chinese and Citi Research

- Our updated monthly expenditure per capita by different groups of consumers indicates that China may continue to benefit from industrialization and urbanization. On the industrialization front, another 110 mn of farmers moving to the group of migrant workers could triple monthly spending per capita. On the urbanization front, if migrant workers decide to settle in tier 1 cities, monthly spending could step up 40%, with probably less of an impact if they settle in lower-tier cities. Of course, here the spending of migrant workers could also vary across the regions and if expenditures on property, education, and durable goods are considered, the impact could be larger than the numbers have shown here.
- Modernizing the agriculture sector is part of the urbanization process. The government shall facilitate the transfer of land user rights from small farmers to specialized farms, family farms, rural cooperatives, and agricultural firms. This should lead to further consolidation in agricultural production. The aggregated mechanization rate in farming is set to rise to 70%.
- The environment policy shall focus on green energy, green construction, green transportation, and reducing pollution in air, water and soil.

What to expect next?

In our note on "The Urbanization Dividend", we highlighted that a full speed of urbanization with the population of around 300 mn in the next decade may add roughly 0.7-1.3 ppts to annual real GDP growth going forward. The NUP is roughly in line with our expectation. This urbanization dividend shall take time to be effective and is thus more positive to the economic outlook if frontloaded.

A set of pilot reforms is likely to kick off in the near term, including:

- **Hukou reform:** Local governments may launch a simple version of the score card or similarly green card for migrant workers to settle in medium-sized cities gradually. This speed of hukou reform matters to the pace of urbanization.
- **Land reform:** Residential property and the user right of farmland could be used as collateral. It is worth noting how farmers are able to benefit from the wealth effect of land.

- *Financial reforms:* Longer-term financing instruments could be introduced including construction funds or infrastructure investment bank and social housing investment bank.

Several key reforms are missing from the New Urbanization Plan. They are likely to be obstacles to fulfilling the urbanization plan by 2020.

- Service sector deregulation is the key to meet the rising demands alongside urbanization. This should include reforms in financial, education, healthcare, and transportation.
- It's not an option for farmers-to-be-urbanized to find to exit from their land positions. Land reforms fail to address what farmers would do with their small plots of land once they decide to settle in cities. The urbanization process could speed up if residential plots are able to be monetized.
- The role of the fiscal policy in urbanization is not well defined. The public cost of urbanization will be shared between central and local governments. It's possible that local leaders may resist hukou reforms due to unbearable fiscal burden or resource dilution.
- Regional coordination remains a challenge for developing mega regions in China. Breaking down the administrative segmentation is necessary to allow more resources to be allocated based on commercial merits rather than the government's visible hand.

Appendix A-1

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