Urbanization, China’s New Growth Engine

February 28, 2013

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Executive Summary

Urbanization is among the highest priorities for economic development in China. It is expected to help China change its growth engine from export-based to domestic demand-based as exports have become increasingly sluggish due to the global economic recession. Also, urbanization will contribute to the establishment of a harmonious society. Although China has pursued balance, income disparity is still serious. By granting nongmingong with citizenship status, the social class disparity could be reduced.

The potential of urbanization is large, because China’s urbanization rate is significantly low despite recent improvements. China’s strategy for urbanization is based on “decentralized concentration,” forming city clusters and nurturing new growth poles. With this strategy, China expects to avoid the negative side effects or failures of conventional methods such as “large city syndrome.” As a result, small and medium-sized satellite cities centered on main cities will surge.

Investment and demand will increase while the middle class expands and industrial structure changes, raising the importance of the service industry. This will present enormous business opportunities and the demand for construction materials and consumption goods will boost Korea’s exports.
1. Economic & Social Meaning of China’s Urbanization

Chengzhenhua (urbanization) is one of China’s most prominent strategies for economic development in 2013 and is defined by the country’s new leadership as the most highly potential driver of growth and expansion in domestic demand. Li Keqiang, the appointee to the Premier of the State Council from March 2013, said in a meeting with the World Bank president, “China’s potential growth engine for the coming decades lies in urbanization.” He also argued for “assertive and stable urbanization” at the Central Economic Work Conference in late 2012 when the policy direction for 2013 was decided.

Crippled by changes in the external demand, China has been losing its grip on the conventional growth engine. As such, urbanization is a key tool in China’s transition from an export driven to domestic demand driven economic growth. As of 2011, the US and Europe took a 70% share in China’s export, therefore, prolonged low growth in these regions will inevitably slow China’s export growth. Contribution of net export to the economic growth during the same year recorded negative 4.3%.

Worse still, slow exports will further reduce the investment increase rate which has continued to fall, peaking at 30% in 2009 then falling to 12% in 2011. Slow export has already exacerbated excessive investment and production, undermining investment. With weak prospects for export competitiveness based on growing minimum wage (at least 13% a year) and pressure for an appreciation of the yuan, China has no choice but to find a new growth strategy.

Figure 1. Contribution to GDP
Figure 2. Changes in Wage and the Yuan

Source: National Bureau of Statistics of China
Source: CEIC
China has sufficient room to transition from export-driven to consumption and investment-driven economy in cities. But to establish a domestic demand-driven economy, China must reform its income distribution system and improve the social security system, both of which will be hard to achieve in a short period. Against this backdrop, boosting the urban economy is the most realistic alternative as consumption and investments are centered on cities which are the engines for economic growth; rural consumption is one third of urban consumption while cities attract more than six fold of fixed asset investment than rural areas.

<table>
<thead>
<tr>
<th>Table 1. Fixed Asset Investments and Consumption of Cities and Rural Areas</th>
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<tbody>
<tr>
<td><strong>(Unit: 1 billion yuan, x fold)</strong></td>
</tr>
<tr>
<td><strong>Year</strong></td>
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<tr>
<td>----------</td>
</tr>
<tr>
<td>2009</td>
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<td>2010</td>
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Source: National Bureau of Statistics of China; CEIC

Urbanization is also commensurate with China’s political purpose of constructing a “hexieshehui” (harmonious society).” The current fifth generation leadership has inherited the policy goals of a “harmonious society” and “common wealth” from the previous leadership but the income gap between different classes and city and rural areas are still wide. The income disparity between the top 10% and bottom 10% has increased from 7.3 fold in 1988 to 23 fold in 2010, with the Gini coefficient being estimated to be the level of Latin America (0.5).1 The disposable income of urban residents compared to those in rural areas has gradually shrunk from 3.33 in 2009 to 3.13 in 2011. However, this number is expected to jump about six to seven fold when the actual gap is calculated. Although the strategy for balanced national development has narrowed regional gaps, the average per-capita GDP of the Eastern area is still at least double that of the Midwestern area. As such, serious social issues have been prolonged and social instabilities are increasing further with the number of civil disorder cases surging from 54,000 in 2002 to 180,000 in 2011.

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1 According to the National Bureau of Statistics’ announcement in January 2013, China’s Gini coefficient was 0.474 in 2012, declining from the peak of 0.491 in 2008.
The Chinese government plans to narrow the disparity among the social classes by turning “nongmingong” (farmer-turned migrant laborer in cities) into urban residents. This will partly resolve the issue because a main reason for the class disparity is that nongmingong who totaled 250 million and took up 23% of the total urban population in 2011 have not been treated as such. In particular, among the nongmingong who have left their hometowns (159 million), only 0.8% purchased homes while the subscription rate for social security insurance (5.6-23.6%) was only half of that of urban workers, leaving them deprived of social security benefits. In response, the government is considering improvements in the residential environment and social security system, reform of the family register system and increasing the housing supply.²

² Yi Xianrong (December 14, 2012). “What should be the type of urbanization in China” Zhongjingwang.
The urbanization policy is also expected to narrow disparities between cities and urban areas, as well as between cities and other cities. Having a seriously excessive workforce, China needs to urbanize to further encourage rural residents to move to the cities. Indeed, moving to cities is inevitable for rural residents to get a job; in 2011, 150 million to 450 million rural residents among 670 million (48.7% of the total population) were non-regular workers.³ To that end, the Chinese government plans to adjust land expropriation prices to reflect realistic conditions while focusing on developing new small and medium-sized cities. The expropriation price for rural residents is expected to increase from less than 3% of the market price to about 30%.⁴ The purpose is to raise land efficiency in rural areas and provide nongmingong with the basic conditions for establishing themselves in the cities through leases or purchases of homes. The Midwestern areas where urbanization rates are low will be the first destination for the development of satellite cities.

⁴ About 60% of social unrest cases are estimated to be related to illegal expropriation of farmers’ land.
2. Prospects for Urbanization

In 2011, the urban population (690 million) exceeded the rural population (670 million) for the first time. Since, the urbanization rate has continued to climb at an annual average of 1.3% from 1996 to over 51.27%.

**Figure 6. Urbanization of China (1949-2011)**

Source: National Bureau of Statistics of China

China’s potential for urbanization is huge. The country’s urbanization rate is below the world average (57.8%) and much lower than Japan (91.1%), the US (82.4%) and Korea (83.2%). In particular, the real urbanization rate based on those registered in cities (excluding nongmingong) is just 39.5%, far below the nominal rate. The rate is much lower in the Midwestern inland areas which recorded below 50% in 2011, compared to the Northeastern areas which had already posted 52.1% in 2000 and especially the Eastern coastal areas which exceeded the 60% during the same period, suggesting large growth potential.
China’s urbanization rate is low when compared to its industrialization level (the average is 30% industrialization rate to 60% urbanization rate). It does not fit in the average category, with its industrialization rate marking 46.6% whilst the urbanization rate was 51% in 2011. As such, the government has set up goals to push up the urbanization rate by at least 1 percentage point a year to achieve steady growth for the coming 20 years. The United Nations (UN) also forecast China’s urbanization rate will reach 61% by 2020, with the urban population growing from 690 million in 2011 to 820 million in 2020. This means about 10 million to 13 million of the rural population will migrate to cities every year.

**Table 3. Prospect for China’s Urbanization Rate**

<table>
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<tr>
<th>Year</th>
<th>2015</th>
<th>2020</th>
<th>2025</th>
<th>2030</th>
<th>2035</th>
<th>2040</th>
<th>2050</th>
</tr>
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<tbody>
<tr>
<td>Share of Urban Population (%)</td>
<td>55.6</td>
<td>61.0</td>
<td>65.4</td>
<td>68.7</td>
<td>71.3</td>
<td>73.4</td>
<td>75.4</td>
</tr>
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Source: UN, World Urbanization Prospects, the 2011 Revision.

Then, what is the strategy to accelerate city construction? Conventional urbanization strategies such as focusing on large cities and nurturing small ones in various areas without a center have proven to involve serious consequences and to be ineffective. By focusing on developing large cities, China has come to suffer “large city syndrome” which includes environmental pollution, serious traffic congestion and shortage of resources. Seven out of the 10 most polluted cities in the world are Chinese cities and only 1% of the 500 Chinese cities have passed the World Health Organization’s environmental criteria. Decentralized city development plans to nurture

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5 “Seven out of the top 10 most polluted cities in the world are Chinese cities.” (January 16, 2013). *The Chosun Ilbo.*
small and medium sized cities with a population of less than 500,000 was also unsuccessful as residents were unable to adjust to urban life. To form an effective consumer market for the public, the population should be at least 500,000 and per-capita GDP should surpass US$5,000.

Therefore, the Chinese government has come up with a new plan to form city clusters centering on key large cities to nurture new growth poles.\(^6\) The goal is to nurture these clusters, which are formed over an expansive area, a “decentralized concentration” strategy. Through this plan, China expects to establish industrial clusters, specialization and cooperation among large, medium-sized and small cities, enlargement of consumption volume and resolution of the “city syndrome” and “polarization of cities and rural areas.” Currently, 11 city clusters including three high development zones are the main targets and becoming pillars of China’s urbanization.

![Figure 9. Plans to Form Main City Clusters](image)

Source: State Council of China (March 16, 2011). “Key point of the 12th Five Year Program for development of national economy and society.”

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The plan will boost the number of small and medium-sized satellite cities around the main cities. McKinsey forecasts that there will be eight megacities with populations above 10 million, 7 15 large cities with above 5 million, 115 medium size cities with above 1.5 million, 280 small cities with less than 500,000 by 2025.8

3. Implications

China’s urbanization will raise investment and demand. The Chinese government expects urbanization will create 40 trillion yuan (85% of 2011 GDP) of investments by 2020.9 The forecast is based on the assumption that about 400 million farmers or nongmingong will become urban residents in the coming 10 years and 100,000 yuan in fixed asset investment is needed per one extra urban resident. Meanwhile, an increase of 1% in the urbanization rate is estimated to raise consumption by 1.6%.10 In 2011, the annual consumption of urban residents exceeded that of rural residents by more than 10,000 yuan per person. As 10 million to 13 million rural residents are estimated to become urban residents, annual consumption will grow 100 billion to 130 billion yuan.

In addition, the middle class will expand and industrial structure will change. Urbanization will increase the GDP, broadening the middle class. From 1978 to 2010, a 1% rise in urbanization led to a rise of 124.5 yuan in the per-capita GDP based on the constant prices in 1978 and 670 yuan based on prices in 2010. In particular, if the nongmingong settle down in urban areas, their income will jump at least 27%.11 McKinsey predicted that the share of middle class households in developed and newly emerged cities will surge from 5% and 3% in 2010 to 67% and 43% in 2020, respectively.12 Development of cities will also play an important role in raising the share of the service industry and creating jobs. For the past 30 years, every 1% increase in the urbanization rate created 6,638,400 jobs in the service industry. Urban

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7 Eight megacities expected to emerge by 2025: Beijing, Shanghai, Tianjin, Shenzhen, Wuhan, Chongqing, Chengdu and Guanzhou.
8 Mckinsey Global Institute (March 2009). “Preparing for China’s urban billion.”
9 The National Development and Reform Commission will release “Project for development of healthy cities (2011-2020)” with specific plans before the National People’s Congress in March.
10 “Urbanization of population will spark massive domestic demand.” (January 9, 2013).
development will boost the tertiary industry including restaurants, travel, finance and logistics as well as public services that include education, medical care and social insurance.

| Table 4. Prospect for Changes in Shares of Service Industry and Jobs out of the Total Industry |
|-----------------------------------------------|------------|----------|----------|----------|----------|
| Year                                         | 2011      | 2015     | 2020     | 2025     | 2030     |
| Service Industry’s Share in the Total Industries | 43.4      | 46.9     | 51.6     | 56.7     | 62.4     |
| Share of Service Jobs in the Total Industries | 35.7      | 38.9     | 43.1     | 47.4     | 51.8     |


Companies planning to enter the Chinese market need to note massive business opportunities which will be generated by “Citinomics (a compound of city and economics).” Demand for construction materials and consumables for domestic consumption will create another increase in special demand. The Chinese government will construct 40 million new houses by 2015 to supply residential homes for about 10 million to 13 million new entrants to cities every year. The consumption level will grow and selective consumption (personal possessions, leisure, education, medical treatment, transportation and communication) of the middle class will expand following the provision of housing and infrastructure. To respond to the changes, strategies customized by class and area are necessary. Companies also need to develop projects that are commensurate with the government’s policies and create market opportunities. The Central Economic Work Conference last December demanded improvements in the quality of urbanization, stressing concentration, intelligence, eco-friendliness and low-carbon. Accordingly, the focus can be placed on the establishment of smart cities, power grids, Intelligent Transportation System, telecommunication facilities and sophisticated green energy facilities (disposal of wastewater or sewage, waste incineration).

Meanwhile, to enjoy the chance offered by China’s city construction, organic cooperation between the government and companies is more effective than an approach by individual companies.\(^\text{13}\) In China, winning construction contract from the central government is difficult and local governments are reluctant to open the market in order to protect local companies.

Up until 2011, Korean companies had won 676 construction contracts worth US$11.8 billion, a poor performance considering the country’s US$1 trillion a year construction. As city development is a government project, cooperation between national governments is required to help private companies participate in construction projects. In January 2013 the Ministry of Land, Transport and Maritime Affairs of Korea signed a Memorandum of Understanding with the Ministry of Housing and Urban-Rural Development of the People’s Republic of China to cooperate with on China’s urbanization project. With the establishment of an inter-government cooperation platform, Korean companies’ effort to join China’s city development projects will gain momentum. Also, the government’s stable financial support will be bolstered, as city infrastructure business requires large initial investment and long periods to collect revenue.

Meanwhile, companies need to be aware of the possibilities that the business environment may worsen during the project period. Although turning nongmingong into urban residents can raise income and present companies with a new consumer group, it also can boost their management costs. In 2011, the average monthly income (national average is 2,049 yuan) of nongmingong who migrated to other areas rose 21.2% compared to the previous year, which implies that labor costs will grow further. Other obstacles include stronger environmental regulations which may be introduced by the Chinese government in an effort to enhance the quality of urbanization and a cut in preferential benefits to foreign companies.

14 “Seize the 7,200 trillion won opportunity – Can Korean companies hit the jackpot in China?” (December 26, 2012). Money Today.