

The Unsettled Chinese Citizen

Survey Reveals Concern about the Future

CRC has completed a short survey of consumer expectations for the Chinese economy. The survey polled 120 residents in a cross-section of ten representative Chinese cities. We asked residents about a number of key economic issues, including the expected trend for inflation, GDP growth, property prices and unemployment. We conclude that there is a significant amount of concern about the future of the Chinese economy that could impact everything from property values to inflation expectations to purchasing decisions. Among the conclusions:



- Inflation Seen Rising Above Current Levels

More than half of our survey respondents believe inflation in the next 12 months will exceed 20%. A smaller subset sees inflation topping 30% with a few seeing prices doubling in the coming year. This is substantially higher than the Chinese government's official estimate of inflation of 5.3% in April 2011.

- Food Prices are the Biggest Concern

A large majority, 68%, of respondents, anticipate higher food prices in the coming year, with a minority 23% expecting food prices to remain unchanged. The average expected change is 12.38%, higher than the 11.5% YoY rise in April and even the 11.7% in March. Food accounts for one-third of China's Consumer Price Index.

- Bullish on Property

Reflecting the general optimism on economic conditions, three-quarters of respondents believe property prices will increase, at least in the next 12 months. The average estimate is 15.9% but the maximum is as high as 120%. However, the survey did not ask about property prices after 12 months.

- Rich are Optimistic But Not the Middle Class

Despite well advertised social programs for low-income residents, and much discussion about the rising affluence of the middle class, the the most optimistic cohort is the rich. Half of all respondents say they are better off financially than a year ago and about the same number thinks their financial situation will improve a year from now. However, by income nearly 50% of the well-off see themselves better off in a year, but 15% - 20% of middle income people believe they will be worse off in a year. This confirms data about rising income inequality in China but flies in the face of central government policies designed to improve the welfare of the general population.

- Real Confusion Over the Future of Employment

The data on employment mirrors split views among western investors about the Chinese economy. Just above 40% think unemployment will rise, 37% think it will be flat, and 21% think it will decline. Clearly, there is no consensus on this, at least in our survey.

Summary: The Rich Poor Divide

We have conducted a survey of local Chinese to find out their attitudes toward a number of important social and economic issues, including inflation, GDP growth, unemployment, and faith in government policy. While the survey population was relatively small – 120 – their median income puts them in the mainstream and their homes were geographically dispersed and thus representative of much of China. In future surveys, we expect to expand the polled population. There were 75 questions with multiple choice answers, so it was relatively comprehensive. Our methodology is discussed below in more detail.

The study debunks the widespread optimism about China’s future in the minds of many westerners, an optimism that flows from a general perception in the west that the rising consumer class in China comprises a buying public for Western and Chinese goods.

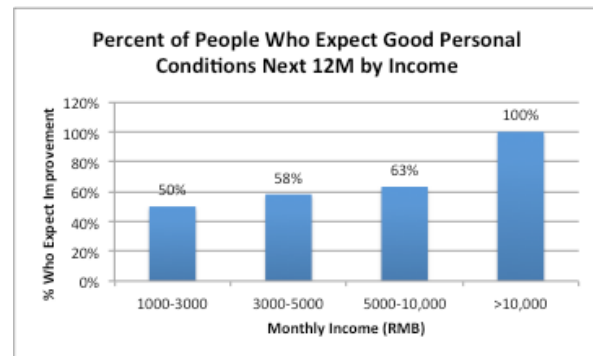
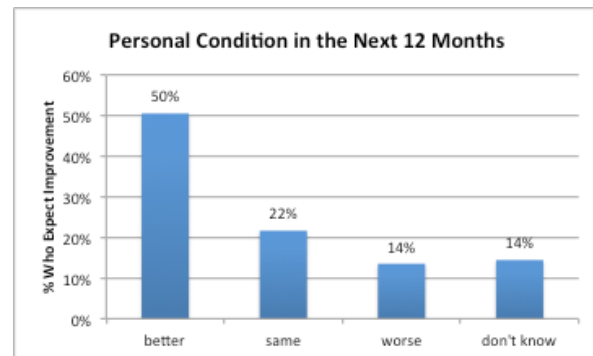
However, many of our survey respondents are surprisingly downbeat about their financial future and that of the country. While they are bullish about certain trends, such as property prices, and generally say they have experienced positive economic conditions over the past 12 months, the survey also hints at a deep schism in Chinese society, a schism primarily between rich and poor. Many of the questions are easily split into two camps: those with incomes above RMB5,000 a month and those below. The rich clearly feel they are well insulated from any hiccups in Chinese growth over the coming years.

In the past decade Beijing has put in place a number of programs designed to reduce the income gap and provide a social cushion to the less well-off. These include increasing subsidies for medical care, a degree of unemployment insurance, and the much discussed economic housing program (whose exact size is not yet clear).

However, despite these “dibao” (guaranteed minimum income) programs, there remains a great deal of concern – particularly among the middle class – about their economic security. Many Chinese are very aware

that there is a widening disparity in the distribution of income over the past decade. **Investors should pay heed as these attitudes inevitably will impact purchasing decisions on everything from real estate to refrigerators.**

We outline the data below. As a summary example, below are two charts. The first chart shows that 50% of the population expects financial conditions to improve in the coming twelve months, one-third expect things unchanged or declining. Broken down by income, outlook among different economic classes differs. The wealthiest two tiers (monthly income of 5,000 – 10,000, and above 10,000) are most upbeat about their prospects. A little more than half of the middle class (3,000 – 5,000 per month) are hoping for a modest improvement, and less well off are evenly split.



Other conclusions from carry equally unsettling messages about the confidence among citizens in the future. Many see inflation rising more than double current estimates; almost half see unemployment rising in the coming year with only a minority seeing it falling. Only on property does there appear to be general optimism – at least for

the next 12 months. Three-quarters expect prices to rise, with only 20% seeing prices flat.

This study comes on the heels of the approval in March 2011 of the 12th Five Year Plan and ahead of the 18th Party Congress next year. As noted by economist Barry Naughton of the University of California, its key points included:

- Steady, relatively fast growth with price stability and a reduction in the external surplus.
- Rising share of consumption in GDP, while labor income should increase at least as fast as labor productivity; the share of services in production should increase. (The consumption item was also noted in the 11th plan)
- Energy consumption and carbon emission per unit of GDP should decline.
- Expansion of basic social services and improvement in educational levels.

However, there appears little progress on increasing the share of consumption in GDP as infrastructure lending remains at high levels.

A Cautionary Tale for Investors

For investors, we draw several conclusions.

First, **Beijing is making valiant attempts to control the economy and improve economic conditions but it is not succeeding as well as the authorities would like**, at least in the views of most citizens. On inflation, unemployment and other key issues, many people seem to believe the central government needs to do more. There have been many policies from Beijing to reduce infrastructure investment and increase the share of consumption in GDP. However, these policies aren't always enacted locally. This reinforces the lesson we have learned from visiting a dozen hinterland cities in the past two years – when Beijing speaks, the provinces listen with only one ear. Ascertaining local implementation is important. Any investment decision has to take into account not just the macroeconomic policy as announced in the center, but how it impacts individual

companies and industries in different geographic locations. Savvy domestic property investors know this; I have noticed that the Hong Kong property companies always seem to be purchasing land one city tier ahead of the bubble; they were in Tier Two when western investors were buying listed companies in Tier One; lately, they have begun buying land in Tier Three Cities while many fund manager are exploring Tier Two. (Of course, there are not many tiers left).

Second, **the middle class is not really rising but treading water, albeit at a higher level than before**. The notion of a middle class in China is arguably a bit of a myth. Is it the young consultant in Shanghai making \$3,000 a month? Is it the recent college graduate in Wuhan borrowing money from his parents to buy an apartment and getting her first job at Wuhan Iron and Steel as a translator? The cost of living varies so widely within China that an income in one area puts you in the top 10% while in another you are in the bottom third. These subtleties influence buying patterns for clothes, white goods, real estate, fast food and other consumables.

More important, for those who view themselves as middle class, this survey suggests they aren't terribly optimistic about their future. Given the instability of the property market, the lack of job protection, weak health care and retirement systems, their concerns are not surprising. This will be reflected in their savings and purchasing habits.

Third, **Chinese citizens are upbeat about the property market**. This was the biggest surprise to us as we are convinced that there is a property bubble in many (but not all) Chinese cities. However, upon reflection, the survey is asking about conditions in the next 12 months. This carries us up to the 12th National Congress in the spring, when the leadership changes. Few people expect any significant policy shifts prior to the Congress. Also, there is some evidence that the recapitalization of the banks (not a given but likely) will not be necessary until loans can no longer be rolled over, some time at

the end of 2012 or into 2013. This timeline may explain the relative optimism of the middle class about the property market.

Inflation

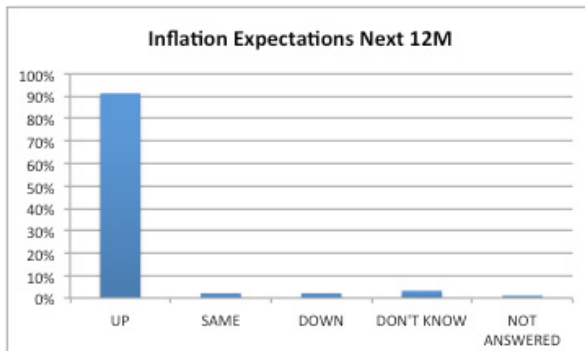
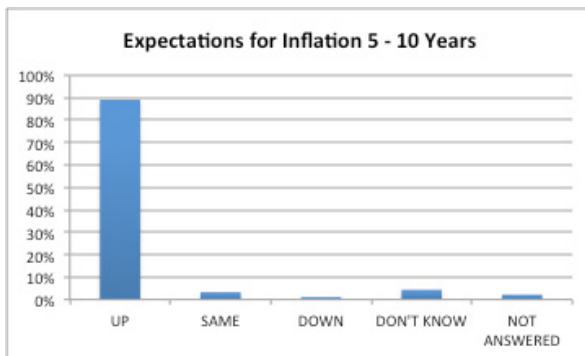
The data on the breakdown of expectations for the inflation rate is particularly striking as it shows that the Chinese have either an optimistic or a pessimistic view – there seems to be very little middle ground.

To summarize:

- There is significant agreement that inflation will exceed 20% over the next 12 months and more than 50% in the 5 to 10 year period.
- The biggest expected increase will be for food, followed by housing and transportation.
- There appears to be a gap between overall estimates of inflation and individual sectors. This is due either to differing perceptions among citizens about the direction of the country versus their day-to-day purchases, or possibly simply measurement errors within the survey.

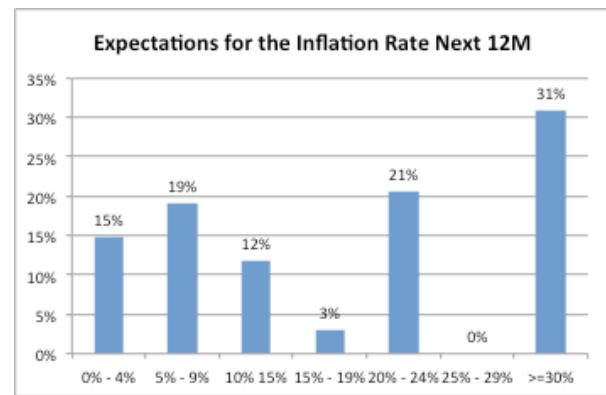
No One Sees Deflation on the Horizon

First, there is widespread agreement that prices will go up, both short- and long-term. This is not surprising.

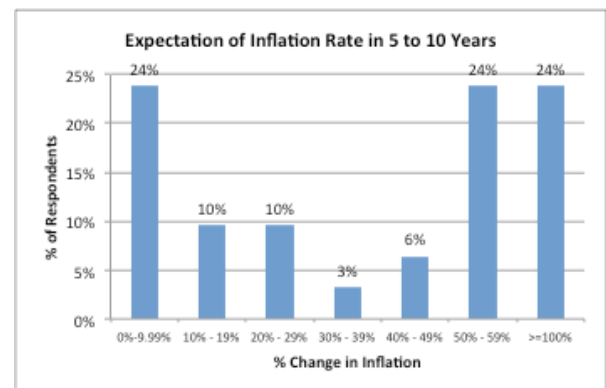


However, the amount of the increase and the dispersion of answers is more striking. As the chart below indicates, the largest group – 31% – see inflation rising at least 30% in the coming year. The next largest group, at 21%, also sees rapid inflation of 20% to 25%. **Combined, more than 50% of the interviewees see inflation rising more than 20%, far above the official government estimates of the current rate of inflation.**

However, expectations drop off quickly, with the next two groups at anticipating a much more moderate 0% to 10%.



The outlook for the next 5 to 10 years is equally alarming although there is confusion, here, too. **About half of respondents expect inflation over the next 5 to 10 years to exceed 50%, with one-quarter forecasting a rate over 100%.** Oddly enough, another one-quarter see very moderate inflation of less than 10%.



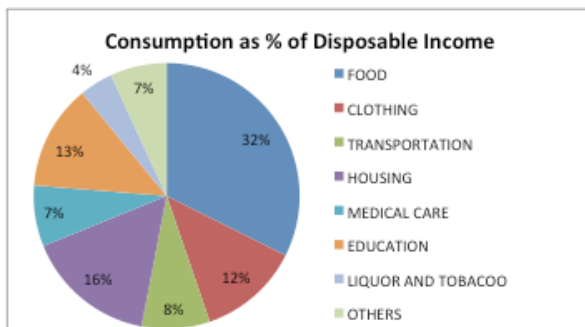
Overall, the mean expectation is for an inflation rate of 22.5%. However, the upper

end of the range goes as high as 100%!

According to Chinese Bureau of Statistics, CPI, which is the measure of the change of the price of consumption goods and services, consists of eight major categories. These categories are food and beverages (34%), housing (13%), apparel (9%), transportation and communication (10%), medical care (10%), education (14%), family equipment and services (6%), and liquor and cigarettes (4%).

We also asked our survey participants about their price expectations for different categories of goods.

In order to do this, we first asked interviewees about the proportion of consumption in each category. From the next two charts, we can observe that food is the largest portion of consumption, which is 27.2% of total household consumption per month. The second biggest part is deposit and investment, which is 15.9% of the total consumption of households. Housing is the third biggest part, with the percentage of 13.3%, following by education at 10.8% and clothing at 10.4%. The expenditure on medical care and transportation are similar, at 6.2% and 6.9 respectively. The purchase of liquor and tobacco constitutes the smallest portion, at 3.4% of the total expenditure.

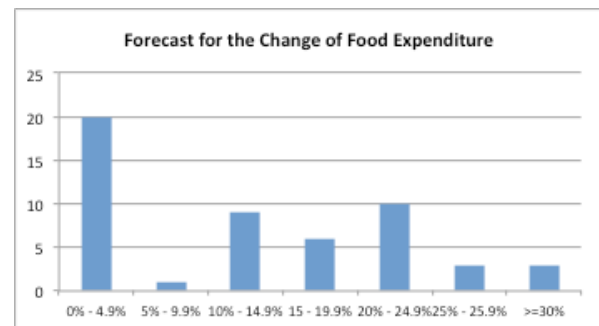


Next, we looked at the individual plans for expenditure on the different consumption categories.

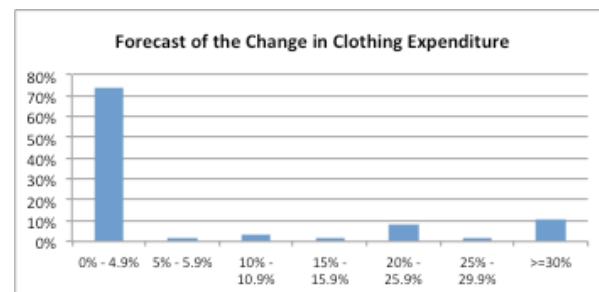
Food

Food accounts for about one-third of total consumption. **In our survey, 62% of respondents expect to spend more on**

food in the coming year, with only 21% forecasting no change. The increase in expenditure on food appears relatively mild given the forecast for inflation in general. Although only half of our sample provided an answer on this question, close to 40% of them see their food purchases rising less than 5%, with nearly 20% seeing a much higher increase of 20% to 25%. That split mirrors what we see elsewhere – the vox populi are either unconcerned or concerned, with little middle ground.



Clothing



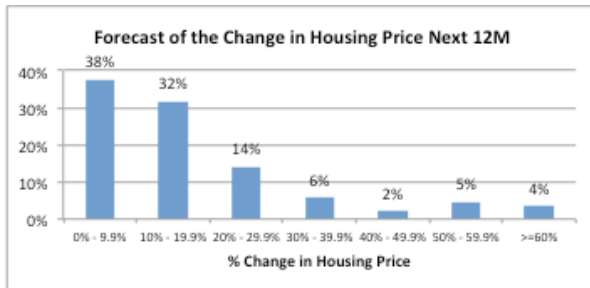
Why such diversity of opinion about inflation? It could be that some citizens disbelieve the official data and are expecting a huge runup in prices. Others, perhaps, read the official estimates of inflation and are pegging their opinions around that. Alternatively, people working in certain sectors – manufacturing with rising labor costs, or labor intensive segments such as healthcare – may see high inflation as part of their working life and factor this into their estimates. The wide variety, alone, would confirm the uncertain environment in which the average Chinese citizen is functioning. This confusion will make it all that much harder for the central government to implement policy efficiently as there seems to be little agreement on the fundamental outlook for key indicators such

as inflation.

Property Prices – Bullish Consensus, at Least for the Near Term

The question about housing prices in the coming year yielded one of the few spots of consensus in the survey among all income groups. Every group expects housing prices to rise in the next 12 months. Two-thirds expect prices to rise up to 20%, with half seeing a 0% to 10% increase and half a 10% to 20% increase. Another 14% are more bullish yet, anticipating a 20% to 30% increase. Only 11% see an increase greater than 30%.

The results are surprisingly optimistic given the widespread concerns about a potential housing bubble, at least among western investors and some Chinese commercial bankers I have spoken to. One Chinese bank official told me everyone in his branch assumes there is a property bubble that will reverse course in the near future. Apparently, the general population doesn't agree with this theory.



Part Two: The Rich Are Cheerful; Others, Less So....

In the second part of our survey, we asked more general questions about consumer attitudes about the Chinese economy and their place within it. There was a stark split between the optimism of the well off and the relatively pessimism of the poor. The middle class appears quite uncertain about how they will fare in the future, while leaning toward pessimism.

•**Rich Expect More Gains.** Although half of respondents think they will be better off in the coming year, that optimism was felt

by two-thirds of the wealthier group, one-quarter of the middle class and just 12% of the poor.

•**Less Enthusiasm for the Economy.** More than half of interviewees expect overall business conditions to improve for the country as a whole this year. However, one-third of the rich take this view, but just one-quarter of the middle class and 19% of the poor.

•**Unemployment is a Significant Concern.** The participants were evenly split on unemployment. Half see it rising and 41% say it will remain flat. The group most concerned are the middle class – 48% say unemployment will rise.

Personal Financial Condition

Overall, the respondents were generally optimistic about their personal financial condition in the coming year, with half saying their situation will improve.

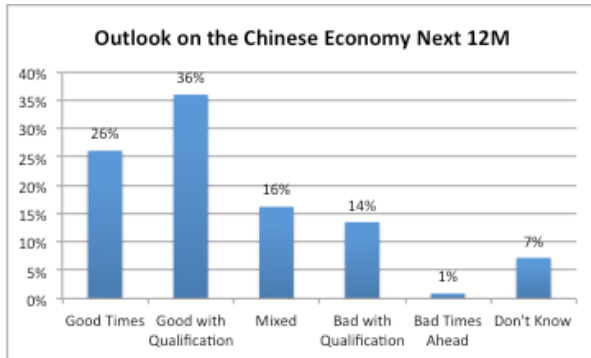


While the financial breakdown provides a limited sample, all of the wealthy respondents expect their personal situation to improve. Surprisingly, a significant majority of the other income cohorts share this view. This contradicts the general negative sentiment about the future of the economy. It is difficult to tell if people are fooling themselves or think they are in the privileged minority.

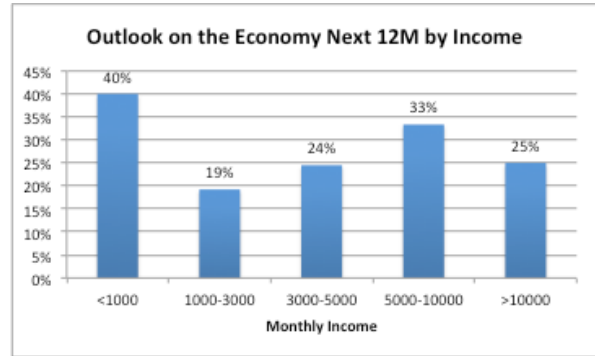


Sentiment about the Country's Financial Condition

More than one-third of respondents believe the Chinese economy is on the right track and conditions will be good "with qualifications." Note that this question asks only about the next 12 months, a period that ends about the time of the Party Congress in the Spring of 2012, when new policies will be announced. Thus, any potential change in policy, along with potential efforts to mitigate the impact of a property bubble, may not be part of the current mindset of most citizens. Also, the implication is about half of the respondents expect conditions to worsen.



By income, the upper income strata is most upbeat (we can discount the poorest as there were few respondents at this income level). Surprisingly, the wealthiest cohort is not quite as optimistic as others – are they more knowledgeable about policy or is the data skewed? It is hard to tell.

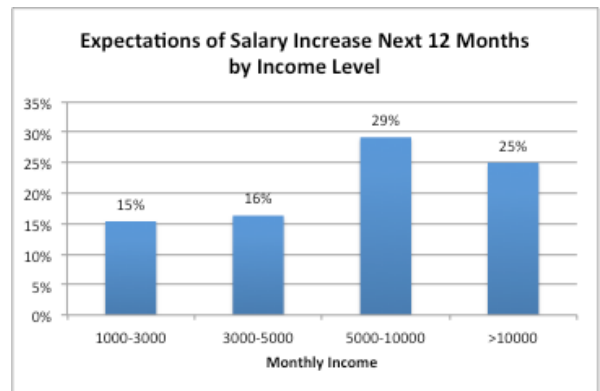
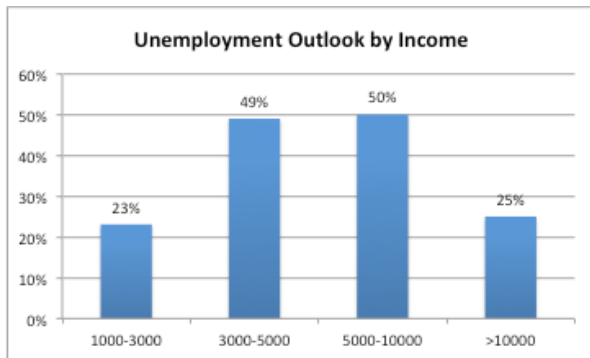
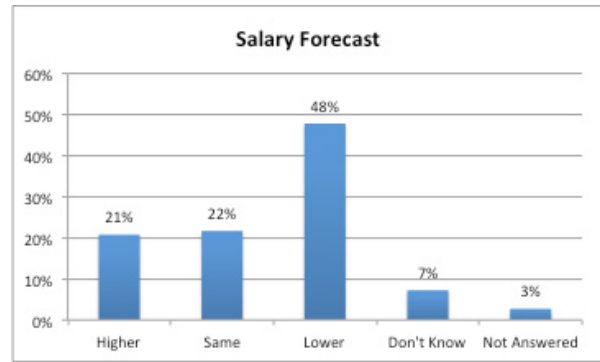
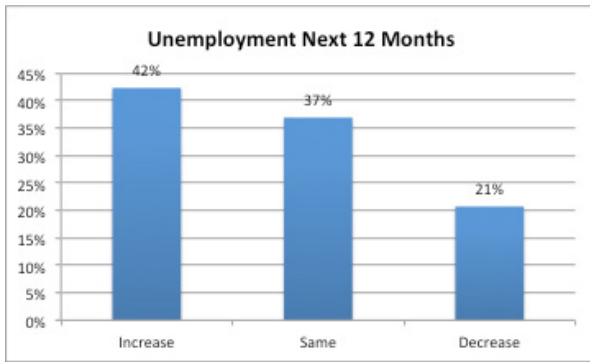


Outlook for Unemployment: Confusion and Uncertainty

Attitudes about the outlook for employment over the next 12 months are decidedly mixed. Most people, 42% of respondents, expect unemployment to rise. However, a significant minority, 37% of respondents, expect it to remain flat.

By income, the data falls within the split we have seen throughout the analysis: the very rich and the poor are not terribly worried about unemployment. Arguably, the poor are so far out of the mainstream they are unaffected by larger changes (although the contrary view that they are hugely sensitive could also be argued), and the rich have wealth that is unaffected by the overall state of the economy.

The most important point is the feelings of the middle class. This group, which comprises the largest number within our survey, are significantly more worried about a rise in the unemployed than the two outlying groups. A full 49% of those with incomes of RMB3,000 to 5,000 per month expect employment to rise, and 50% of those with incomes of RMB5,000 to 10,000.



Little Optimism about Future Income
 Next, we looked at opinions about income in the next 12 months. There is little faith in the future of individual incomes. **About half of all respondents expect their income to decline in the next 12 months.** That is a important indicator of a lack of faith in the ability of the country to deliver growth.

Once again, it appears the upper stratum that is most upbeat about their potential to profit from the country's economic future. Even there, this group of income from RMB5,000 to 10,000 - which I characterize as the upper class -- is not overly optimistic, with only 39% anticipating higher income in the coming year. The more mainstream group of RMB3,000 to 5,000 is decidedly concerned, with only 16% seeing higher income.

Appendix Methodology

This survey employed a number of techniques to improve statistical validity. However, we acknowledge certain shortcomings and hope in future surveys to expand the number of respondents from 120 and to make other changes in the methodology.

First, we selected 10 typical Chinese cities based primarily on the GDP per capita on the prefecture level. The cities represented Tier One, Two and Three, and thus are a valid cross-section of the country.

Then, we used a random process to distribute the questionnaires in each city. It is preferable to use a list provided by a government department that can be cross-checked but this was not available to us. However, as the data on the respondents showed, their income levels and job classifications make them relatively representative of the population as a whole. The sample average monthly income was RMB3,072, which is similar to the national

average of RMB3,000 to RMB5,000. (Some respondents did not answer the salary question)

