



Understanding China's consumers

September 1, 2010

China's consumers are better understood when looked at as two distinct classes: urban consumers and rural consumers. The urban households are much richer than their rural counterparts and consume three times more. The richest 20% of China's urban households is comparable to the economic size of South Korea or Taiwan.

China's rural sector is a sizeable consumer market on its own. The per-capita income of rural households has grown more slowly than that of urban households, especially after China's WTO accession in 2001. Furthermore, ongoing urbanisation is leading to a reduction in the size of the rural sector. Still, at current income growth rates, China's rural sector will reach by 2020 a size equivalent to India as well as income levels and consumer patterns similar to those in lower to middle income Asian countries.

China could overtake Japan as the world's second largest consumer market over the next decade. China's private consumption today is only around 16% of US consumption and 56% of Japan's. But China's strong GDP growth outlook bodes well for Chinese consumers, since it goes together with a rise in per-capita income and the attainment of consumption thresholds (for instance, the purchase of a car). Moreover, there is an array of active policies oriented towards increasing disposable income and rebalancing China's growth model towards domestic demand. Greater pension and healthcare coverage in urban and rural areas is already an explicit goal. Further initiatives, such as giving households greater opportunities to grow their savings via more diversified financial products, would be welcome. All these efforts are conducive to enhancing the share of private consumption in China's economy. This would not only serve China well in its rebalancing quest but also provide the world with an additional, more sustainable engine of growth.

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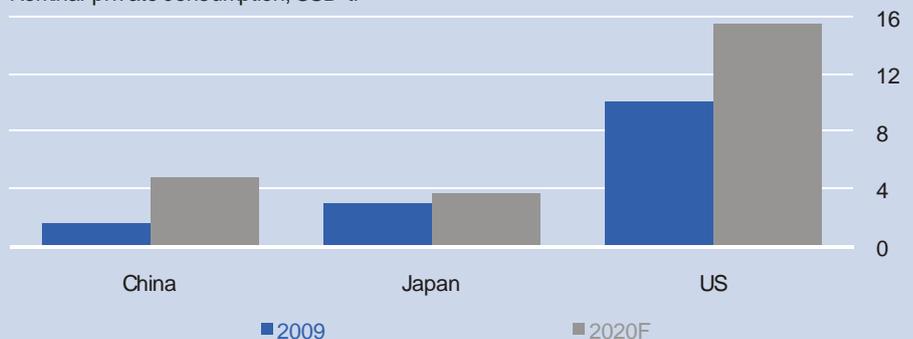
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China's private consumption could overtake Japan's by 2020

Nominal private consumption, USD tr



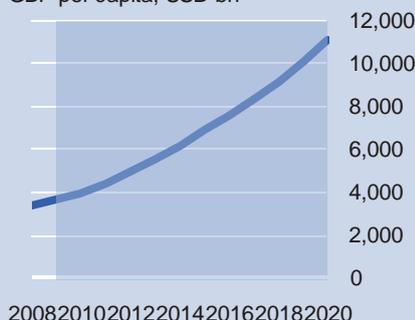
Sources: World Bank, nat. sources, IHS Global Insight



1. Introduction

China's GDP per capita to exceed USD 10,000 by 2020

GDP per capita, USD bn



2008 2010 2012 2014 2016 2018 2020

Sources: IMF, DB Research

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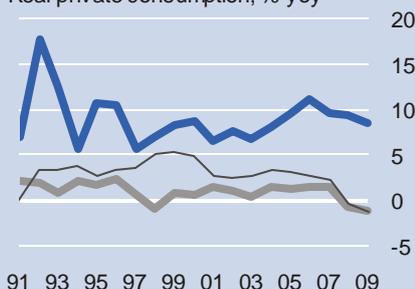
The 2008-09 global crisis has put a spotlight on the need by households in the US and some European countries to rein in consumption and increase savings. The negative impact that this newfound frugality could have on economic growth not only in the respective countries but also in key supplying countries such as China has led to the search for alternative growth pillars for the world economy. Large populations in China and India (among other emerging markets) whose income has increased sharply over the past decade and is expected to continue to do so, are natural candidates to become important consumption and growth drivers on a global scale.

This article seeks to achieve a better understanding of Chinese consumers: their evolution, characteristics, behaviour and consumption patterns. Ultimately we attempt to arrive at an educated guess of how the Chinese consumers will evolve in the future and their possible impact on their own country and the global economy. Many western consumer and luxury brands have expanded into China in recent years and reported brisk sales, posting double-digit growth even during the global recession in 2009. One of the most concrete examples is in the automobile industry. China overtook the US as the world's largest automobile market in 2009, when vehicles sales reached 13.6 million units, compared with 10.4 million cars and light trucks sold in the US¹. Many of these products have penetrated only the high income group of urban households. The potential of other groups such as the high income group of rural households and middle income group of urban households is yet to be fully explored.

The observations and analyses in this paper are based primarily on data from the National Bureau of Statistics of China. The Bureau compiles annual household surveys and provides data on living conditions of urban and rural residents, which included around 65,000 urban households and 68,000 rural households at the end of 2009.

China: Strong private consumption growth

Real private consumption, % yoy



91 93 95 97 99 01 03 05 07 09

— China — Japan — US

Sources: IIF, IHS Global Insight

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2. The urban consumer

Size of China's rich urban households comparable to high income, medium-sized economies

The term "urban population" refers to all people residing in cities and towns while "rural population" refers to people other than urban population². According to official data, the number of registered households in cities totalled 192.4 million in 2008, around 46% of total registered households (403.8 million), mirroring the ratio of urban to rural population. This was 47:53 at the end of 2009 (622 million urban vs 713 million rural people). In 1980 only 19% of the total population was urban (191 million), which is illustrative of the rapid rate of urbanisation and rural-urban migration in China over the last couple of decades. The rural population actually shrank, coming down from 796 million in 1980 to 713 million in 2009.

¹ China car sales top U.S. Reuters news. January 11, 2010.

² The Urban Household survey is organised by the Department of Urban Social and Economic Survey, National Bureau of Statistics. The survey covered only non-farm households until 2001. From 2002 onward, the survey has covered the households in the district areas of all city and county towns.

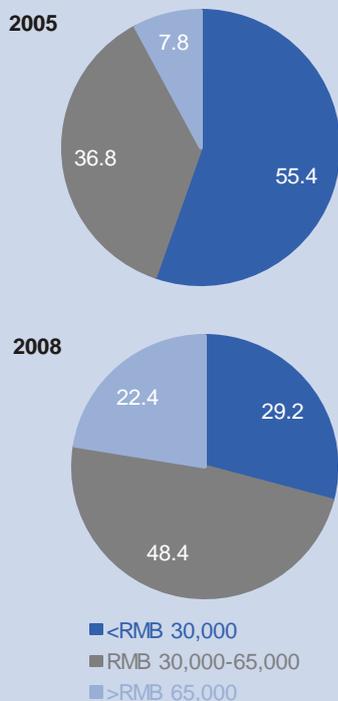
Urban households by income groups

RMB	1st decile 1st-10th percentile Low est income	2nd decile 11th-20th percentile Low income	2nd quintile 21st-40th percentile Lower middle income	3rd quintile 41st-60th percentile Middle income	4th quintile 61st-80th percentile Upper middle income	9th decile 81st-90th percentile High income	10th decile 91st-100th percentile Highest income
1988	682.7	848.5	991.5	1,166.0	1,373.9	1,618.4	2,093.2
1998	2,505.0	3,329.1	4,134.9	5,148.8	6,404.9	7,918.5	11,021.5
2008	5,203.8	7,916.5	10,974.6	15,054.7	20,784.2	28,518.9	47,422.4

Source: China Statistical Yearbook 2009 **3**

Share of urban middle- & high-income households expands rapidly

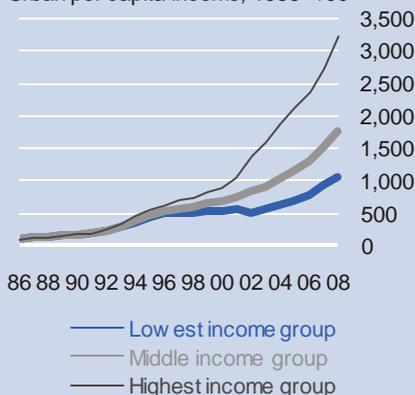
% of urban households grouped by income



Source: CEIC **4**

High-income group paces ahead

Urban per capita income, 1986=100



Source: China Statistical Yearbook 2009 **5**

China's urban consumers are divided into seven groups (see table 3): 1) lowest income; 2) low income; 3) lower middle income; 4) middle income; 5) upper middle income; 6) high income; and 7) highest income. For these urban households, the average income per capita was RMB 18,900 (USD 2,770) in 2009³, around 7% of the US personal income per capita of USD 39,000.

In terms of annual household income, around 22% of China's urban households or around 43 million urban households had an annual income of around USD 10,000 (RMB 65,000) and above in 2008, rising from only 7.8% of total urban households in 2005. (see chart 4). Their number is likely to be close to 50 million households currently. As such, this consumer segment is comparable to medium-sized, high income Asian countries such as South Korea (49 million people with USD 17,000 per-capita income) or Taiwan (23 million people with USD 16,000 per-capita income).

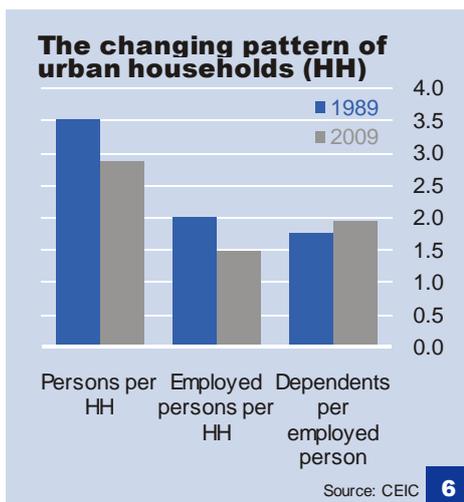
Around 7.5% of urban households (14.4 million households) had an annual income of around USD 14,800 (RMB 100,000) or above as of 2008, a large increase from 2% of households (3.8 million) in 2005 (see chart 4).

All are getting rich fast, but the rich are getting richer faster

Since the urban household survey data became available in 1986, average urban income per capita has risen by 15% yoy annually on average. There were only a few years when annual per capita income growth was in the single digits, in 1990 (after the Tiananmen Square episode) and during 1997-2001 (in the aftermath of the Asian financial crisis). Over the whole period, the higher income groups have seen their income growing faster on average than the lower income earners. The disparity in income growth tends to be wider during the years when nominal GDP growth slowed such as in 2002 (highest-income group growth of 32% vs lowest-income group contraction of 11%) and 1997 (11% vs 0%, respectively). This could be indicative of the asymmetric impact of business closures or downsizing activities, to which blue-collar workers are most vulnerable.

During the latest economic downturn in 2008, growth in per-capita income of the lowest income group was very resilient at 13% yoy compared with the middle income group (16%) and the highest income group (18.5%). An important driver of the low income group's resilience was probably the high priority assigned by the government to the protection of jobs in the design of its stimulus package. For example, in March 2009, PM Wen Jiabao stated the

³ China Statistical Yearbook 2009.



goal of increasing urban employment by more than 9 million persons and keeping urban registered unemployment under 4.6% (it turned out at 4.3%). This priority may also explain the low incidence of much-feared social unrest despite reports about up to 20 millions migrant workers who lost their jobs in the first quarter of 2009⁴.

Business income gaining in importance

The share of wage income in total income of urban households fell to 62% in 2008 from 79% in 1995. Over the same period, income from household businesses increased from 2% to 8.5%, pointing to rising entrepreneurial activities, which could bode well for financial firms providing funds for SMEs and personal loans.

Smaller households, higher dependency ratio

Urban household size has been getting smaller over the years, shrinking from an average of 3.9 persons per household in 1989 to 2.9 persons in 2009 (see chart 6). Another trend worth noting is the declining ratio of employed persons per household, from 2.2 persons per household in 1985 to 1.5 persons in 2009. This could be due to the declining size of the overall household and the shift toward household businesses from wage-earning employment. In addition, the number of dependents per employed person has risen through the years from 1.81 in 1985 to almost 1.94 in 2009, possibly reflecting the demographic trend toward an ageing society.

Urban consumption patterns

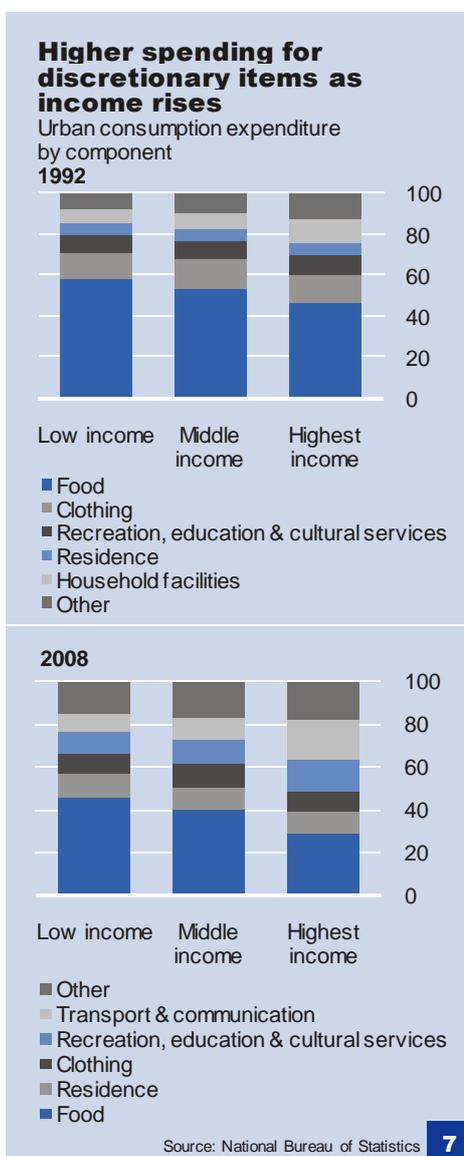
Higher spending for discretionary items as income rises

Urban consumers of all income groups spend the largest portion of their income on food. For the middle class, other significant consumption items are recreation (11.3%), clothing (11%), transport (10.4%) and residence (10.3%). The highest income group spends on transport (18.5%), recreation (14.7%), residence (9.9%) and clothing (9.8%). The low income group, on the other hand, spends on residence (11.1%) clothing (9.7%), recreation (9.6%), and transport (8.6%).

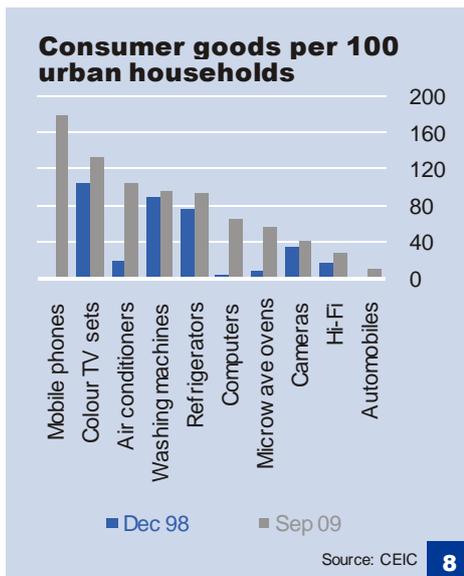
Compared to the early 1990s when data on consumption expenditure baskets first became available, consumption patterns have shown a shift away from basic necessities such as food, clothing and household facilities toward transport, residence and recreation. This shift toward more discretionary items over time is observed across all income groups. Expenditures on transport show the highest jump, from 2-3% of the consumption basket across all key income groups in 1992 to 9% (low income), 10% (middle income) and 19% (highest income) in 2008. In the same vein, expenditures on residence have almost doubled from 5-6% in 1992 to 10-11% in 2008. These observations are in line with the rapid growth in car sales in China in recent years as well as the rise in nationwide real estate prices.

Further good prospects for automobiles and computers

Data on consumer goods ownership have shown solid growth across all key products during the past decade, with the only exception of fixed-line telephones. Ownership of washing machines and refrigerators appear to be nearing the saturation level. On the contrary, automobiles have a lot of headroom ahead as the



⁴ China Estimates 20 Million Rural Migrant Workers Lost Jobs. Bloomberg news. February 2, 2009.



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ownership level is still relatively low at 10.5 cars per 100 urban households. Mobile phones have seen explosive growth from 3.3 phones per 100 urban households in 1998 to 180 phones in September 2009. Multiple ownership in one household is yet to be fully satisfied, so further growth appears possible even from this high level. Computer sets are another consumer product that has seen very strong growth, from 4 sets per 100 urban households in 1998 to 65 sets in September 2009, although, as in the case of mobile phones, demand is expected to remain strong. Consumption of products such as Hi-Fi sets is also relatively low at around 29 units per 100 households. As urban consumer income grows, and discretionary spending rises, this type of product is likely to see robust demand.

3. The rural consumers

Rural population are those people who do not reside in cities or towns⁵. Their number has been steadily shrinking after the peak of 860 million in 1995, standing at 713 million at end-2009, which implies a substantial net migration of people from rural to urban areas during 1996-2009⁶. As of 2008, there were 211 million rural households⁷.

Much poorer than urban households, and income gap is widening

China's rural consumers are categorised into 5 quintile groups according to the China Statistical Yearbooks: 1) low income (1st quintile or the bottom 20%); 2) lower middle income (2nd quintile or 21st-40th percentile); 3) middle income (3rd quintile or 41st - 60th percentile); 4) upper middle income (4th quintile of 61st - 80th percentile); and 5) high income (the top 20% or 81st -100th percentile). The average income per capita of rural household stood at RMB 7,100 (USD 1,050) in 2009, which represented around 38% of the average urban income per capita of RMB 18,900 (USD 2,790).

Rural households by income groups

RMB

	1st quintile	2nd quintile	3rd quintile	4th quintile	5th quintile
	Low income	Lower middle income	Middle income	Upper middle income	High income
2002	1,551.8	2,288.3	3,025.2	4,075.6	7,567.2
2008	3,072.3	4,264.1	5,764.9	7,930.9	14,895.4

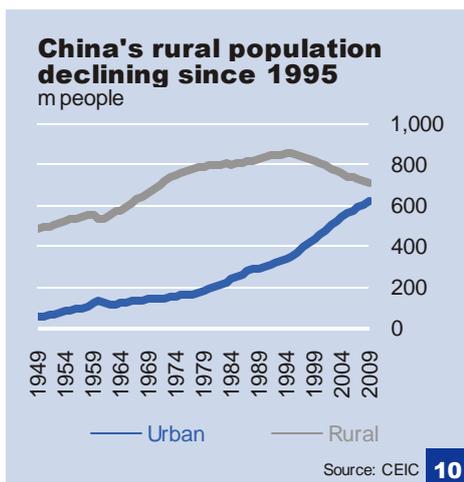
Source: China Statistical Yearbook 2009

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⁵ The Department of Rural Social and Economic Survey, National Bureau of Statistics collects and organises data and surveys on rural households.

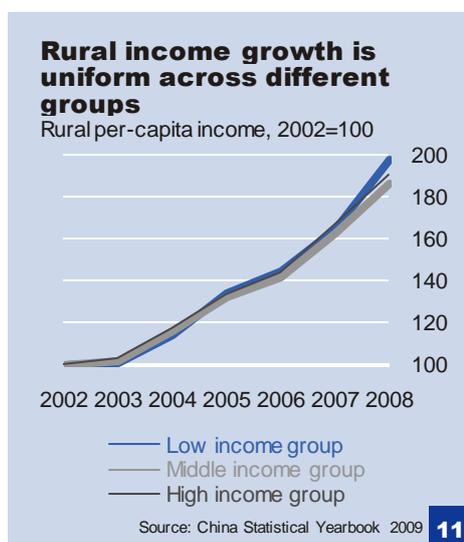
⁶ Even when taking into account the shifting definition of urban population, several research papers on migration in China unanimously acknowledge a net migration from rural to urban areas.

⁷ According to official data from the National Bureau of Statistics, there were 403.8 million registered households in China, 192.8 million were city-registered households.



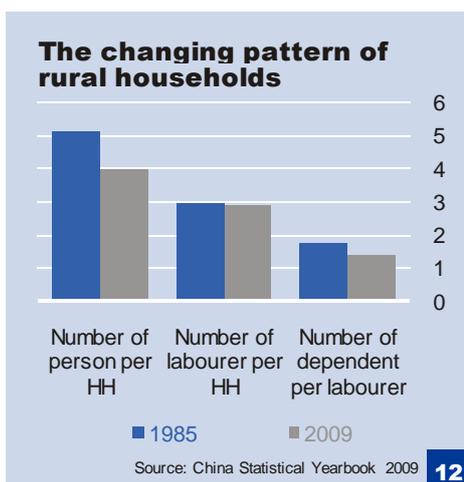
Rural households used to be a major contributor to nominal GDP in previous decades. However, their contribution has declined in importance. It currently contributes around 9% of nominal GDP, a steady decline from the 24% registered in 1990. This contrasts with the contribution from urban household consumption, which currently contributes around 26% of nominal GDP, roughly unchanged from 25-30% in the 1990s.

On average, per-capita income per rural household rose 12% annually during 1987-2009, slower than the 15% growth of urban households. This means that the gap in rural-urban per-capita income increased over time, especially after 2001. The trend was aggravated by a more rapid rate of urbanisation (see chart 10). In 1987, the per-capita income of rural households was RMB 654, around 65% of the urban households' level. In 2009, it was RMB 7,100, or only 38% of urban income per capita. Rural households consumption is now around one-third that of urban households, accounting for 9% of GDP in 2008.



The breakdown of income by quintiles is only available from 2002 onward. There seems to be no big disparity in income growth rates among the different groups (see chart 11). Perhaps surprisingly, the low income group saw a slightly stronger income growth than the high income group in 2002-08. Income of the middle- and low-income groups stayed around 40% and 20%, respectively, of the top group's income. The number of households with net income over RMB 5,000 increased from 14 m (7.5% of total) in 2000 to 83 m (39% of total) in 2008.

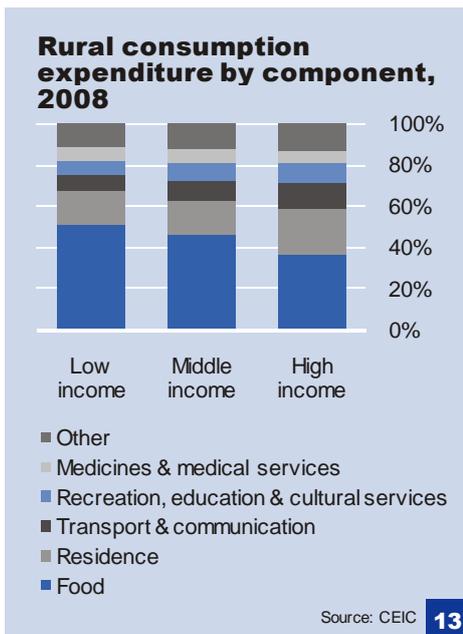
The evolution of income in rural and urban areas has tended to move in tandem. During recent slow-growth periods such as 1998-99 and 2008-09, the slowdown in income growth for rural households was somewhat stronger than that for urban households. This may suggest that the rural sector in China is not shielded from the impact of regional and global factors, and that there are significant connections between rural and urban demand.



Size of rural households is getting smaller, wage share in total income is rising

Similar to urban households, the size of rural households is also getting smaller. The number of members of rural households dropped from 5.12 in 1985 to 3.98 in 2009 (see chart 12). The major source of income for rural households has been household business, which in most cases is farming, contributing 62% of total income in 2009, down from 74% in 1999. The share of wages in income has been rising, reaching 29% of total income in 2009, up from 21% in 1999.

The number of labourers per household in the rural area has remained quite steady since 1985 at just below 3 persons (2.85 persons in 2009, down from 2.95 persons in 1985). Interestingly, the number of dependents per labourer has declined to 1.4 in 2009 from 1.74 in 1985, the opposite of what we observe in urban households. This could be evidence of the migration of young people to urban areas, which would be consistent with the decline in the size of the rural population in the last decade as well as the smaller family size in rural areas.

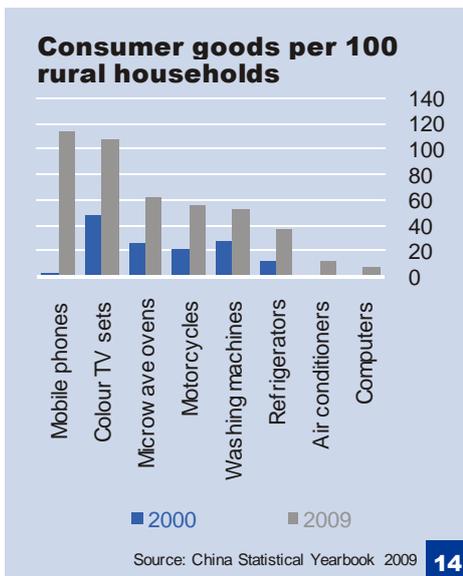


Rural consumption patterns

Food, residence and transport top consumption expenditures

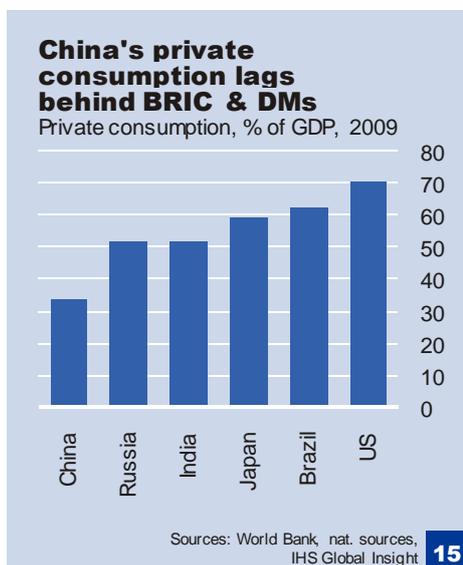
All rural income groups spend the largest portion of their income on food, like their urban counterparts. Historical data for rural consumption only goes back to 2002. Since then, the pattern of consumption by rural consumers has been more uniform than urban consumption, and concentrated on food, residence and transport (see chart 13). Not surprisingly, rural consumers do not spend as much as urban consumers on discretionary items such as recreation or clothing.

During 2002-08, there was an increase in the share of expenditure on residence across all rural income groups by around 2-3%, whereas the share devoted to this item by urban consumers remained constant. This could reflect, among other things, rising house prices in rural areas, the catch-up in private housing in rural areas, and the shifting of spending priorities among rural consumers. Another item that saw an across-the-board rise among rural groups was transport. Among urban households, only the upper middle income and wealthier groups allocated higher expenditure to transport during the same period. This could possibly indicate that the catch-up period for rural consumers in transport spending is still ongoing. If the urban consumers' experience is any guide, the ratio may stabilise over the next 5-10 years among the rural low to middle income groups, but the high income group could still see a higher allocation of expenditure to transport for a longer period.



Consumer goods: Room to catch up with urban households

As is to be expected, consumer goods ownership for rural consumers lags behind urban consumers' across the board, which also indicates that there is still a lot of headroom for growth in consumer products in the rural area. The items that saw the strongest growth in recent years were mobile phones, which rose from 4 per 100 households in 2000 to 115 in 2009 (see chart 14), followed by colour TVs from 49 per 100 households to 109 currently. Ownership of household appliances such as washing machines, refrigerators and air conditioners are still low compared to urban households. Ownership of motorcycles is also still low around 57 per 100 households, although it more than doubled from 22 in the year 2000.



In summary, it seems that communication appliances such as mobile phones and colour TVs enjoy strong demand across both urban and rural households, while other household appliances are much less widespread among rural households. This, however, could change as rural income increases.

4. Outlook for China's consumers and implications

China's private consumption was around RMB 12.2 tr (USD 1.8 tr) in 2009, equivalent to 16% of the US's private consumption and 56% of Japan's. As a percentage of GDP, China's private consumption is small at 36%, compared with 60-70% for the US, Japan and the EU or even vis-à-vis other BRIC countries at 50-60% (see chart 15).

Extrapolating private consumption growth (in nominal RMB terms) during 1980-2009 yields a three-fold increase between now and 2020, to RMB 36 tr (USD 5.3 tr at current exchange rate). Assuming

private consumption growth for the US at 4% p.a. (vs 4.8% in 2000-09) and 2% for Japan (vs 2.2% in 2000-09), China's private consumption will overtake Japan's by 2020 and could reach US levels in the next 2 decades. In % of GDP, private consumption would then rise to 57% of GDP in 2020, on par with Japan's current ratio.

Urban consumers have favourable prospects ...

There are several underlying factors that support a favourable outlook for urban consumers. First, the secular trend towards urbanisation is set to continue. China was only 17% urban in 1970 and that ratio is now 47%, so it is entirely possible that half of China's population will be urban over the next few years. The clout of urban dwellers is likely to increase as they become China's majority group. Second, urban income is set to increase further. China's overall GDP growth prospects (both total and in per capita terms) are robust⁸, and much of this improvement will benefit the urban population. Third, government policies have been actively promoting an increase in disposable income and encouraging private spending, for example by expanding the social safety net and welfare coverage. Again, this could benefit the urban population disproportionately.

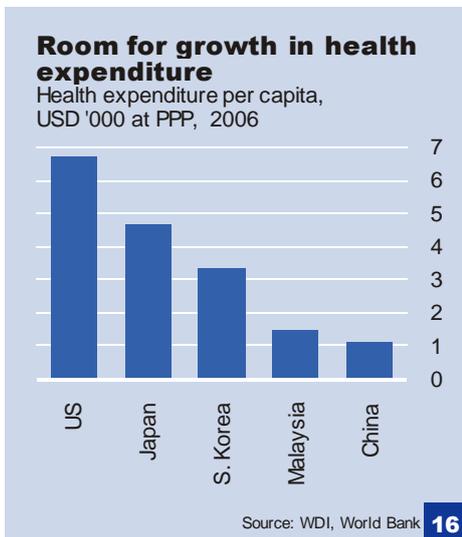
During the past decade urban income per capita rose 12.4% on average. Even if the growth rate halves to 6% on average during 2010-2020, urban income per capita will triple and is likely to exceed USD 10,000 by 2020, making the urban Chinese as rich as the population of some OECD countries.

... but more targeted measures are needed to narrow the rural-urban income gap

How significant China's consumers will be to the global economy will depend crucially on how successfully the rural consumers catch up with their urban counterparts. Though declining, the size of the rural population will remain substantial in the next few decades. Although its per-capita income is low by international standards (RMB 7,100 or USD 1,050 at end-09), the large size of China's rural population (713 million) makes it a large economic group. For example, rural China is equivalent to 60% of India's economy (which has a similar income per capita but 1.2 bn people).

Farming will remain the significant source of income for rural families in the foreseeable future. In this regard, there is plenty of scope to improve farming income. As most farming activities in China are small-scale and family-based, the central government has undertaken a major policy initiative to develop modern agricultural production, which should improve productivity and raise rural income. The recent focus on improving agricultural infrastructure including water sources and irrigation facilities is encouraging.

Efforts to expand pension coverage to rural residents kicked off with pilot projects to cover 10% of rural counties in 2009. The rural pension scheme is expected to cover 23% of all rural counties by end-2010 and provide universal coverage by 2020. This, together with efforts to increase the availability and quality of healthcare services to rural areas, will also go a long way towards increasing disposable income for rural households. Last but not least, accessibility of financial services in rural areas is also crucial. Rural



Plans to modernise agricultural production ...

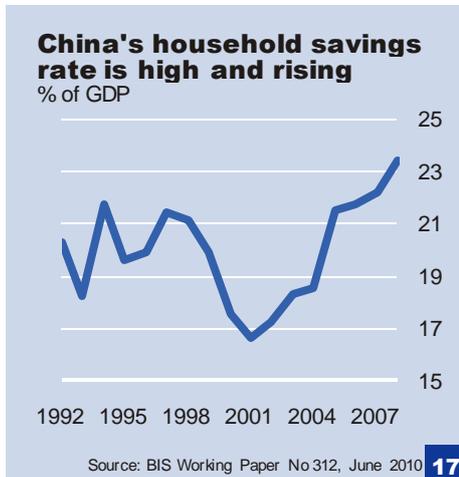
... and increase pension coverage

⁸ For example, the IMF projects China's average real GDP growth at 9.5% p.a. during 2012-15.

residents' access to credit as well as financial products is yet to come close to their urban counterparts. Overall, the "Go West" policy gives hope that rural households will not be neglected in the government's medium-term economic planning⁹.

Investment instruments: Helping households grow their wealth

In addition to higher gross and disposable income, another channel to more robust consumer spending lies in personal or household investment income and the accumulation of wealth. Compared to consumers in developed economies, Chinese consumers are very frugal. The household savings rate is 23% of GDP (see chart 17), compared to rates below 10% in both the US and Japan. While much of this has to do with relatively undeveloped social safety nets, it is also related to the lack of opportunities for financial investment beyond bank deposits and real estate. As of June 2010, there were 167.5 million individual investor accounts at the Shanghai and Shenzhen stock exchanges, and 660,000 institutional investor accounts, rather small considering a population size of over 1.3 billion people. Private banking is a relatively new phenomenon for China, and serves only a very small number of high-net-worth clients with financial assets of USD 1 m and above. This leaves a large portion of the middle and upper middle class relatively underserved. Increasing the availability and the range of investment products such as mutual funds, exchange-traded funds (ETFs) as well as insurance products would be helpful for households to manage their savings and grow their wealth, which should translate into increased consumption.



Concluding remarks

As we have argued, the top 22% of China's urban households (43 million households with an income of at least USD 10,000) is equivalent to the economic size of South Korea or Taiwan. If we assume that the number of urban households increases 2% p.a. (i.e. the average growth rate in the past decade), and that an additional 3% of urban households join the ranks of those with USD 10,000 in annual income (a quite conservative assumption), there will be well above 100 million Chinese households with an annual household income of at least USD 10,000 over the next decade.

The other 78% of China's urban households now numbers around 150 million households. This is a group of low- to upper middle income households whose size and spending power make it comparable to the economy of Indonesia (population 232 million and per-capita income around USD 2,300).

As for rural China, even if a declining population size clouds its prospects somewhat, if income per household continues to grow at current rates of around 6.6% p.a., it will reach USD 2,150 in 2020. This would mean that rural China would be equivalent to the economic size of India today.

Putting aside the potential impact of structural policies to increase urban and rural household income, the continuation of current growth trends is likely to create two powerful groups of consumers in China in the next decade. The urban consumers will expand both in size and spending power and their spending behaviour will increasingly resemble consumers in the high-income Asian

⁹ For a description of the "Go West" policy and its implications on China's provinces see Dyck, Steffen (2010).

economies such as Japan, Singapore, Hong Kong, South Korea and Taiwan. This bodes well for many industries including travel, automobile, real estate, luxury goods, and information/communication equipment. As for rural China, its spending behaviour as income rises will be similar to lower middle income countries in Asia, which should give a boost to the market for consumer staple goods and generate a second pole of private consumption on which China's economy can rely.

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