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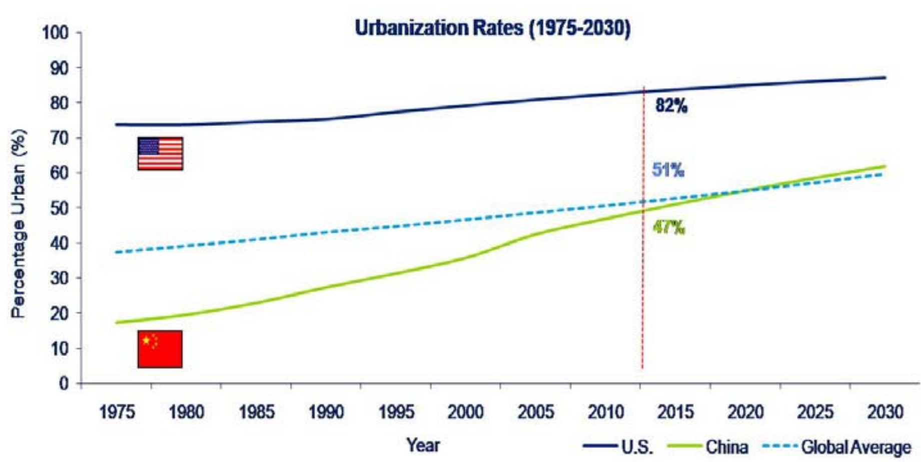
The Chinese Services Group of Deloitte LLP provides a monthly commentary on cross-border investment with China reflecting on key trends in the marketplace. For further information or to explore the broader implications, please contact us at uscsg@deloitte.com or vist www.deloitte.com/us/csg.

Foreign executives visiting China's huge coastal cities are sometimes surprised to learn that China is still a predominantly rural country. According to China's National Bureau of Statistics, China had 622 million urban residents at the end of 2009 – a population well over twice the size of the entire U.S. but still just 47% of China's total. China's urbanization rate is still below the global average and much lower than what executives are accustomed to seeing in U.S. and European markets. China's current plans to achieve a 67% rate by 2030 - *shifting 280 million people to cities within two decades* – is set to become a signature event in shaping the global economy this century.[1]



Sources: Population Division of the U.N.'s Department of Economic and Social Affairs (which estimates China's urbanization rate to reach 62% by 2030 vs. 87% in the U.S. and 60% global)

[1] Chinese Academy of Social Sciences, Blue Book on Micro Economy, April 2010

Chinese economic development for the past three decades has been closely tied to rural-urban migration. From just 18% in 1978, China's urbanization rate has increased at .9% on average each year. Natural population growth has been essentially flat since the 1970s, so almost all of this increase has come from the flow of millions of rural workers to Chinese cities each year. On paper, China's 50 year-old system of urban-rural household registration was meant to strictly control this movement.[2] In reality, migrant workers have come to represent nearly 30% of China's urban population today, even though lack of permanent urban status denies them many of the rights and privileges of city life (i.e. property ownership, access to services etc.).

In recent months, China has begun signaling that it is preparing to wind down the household registration system, removing the primary barrier to much faster rural-urban migration. For example, in his remarks before the National People's Congress (NPC) in March, Premier Wen Jiabao pledged to begin phasing out restrictions on permanent residency in smaller cities by year's end. What has already been the most remarkable urbanization experiment the world has ever seen – the only comparable event is the leap in U.S. urbanization rates from 20% to 40% during the second half of the 19th century – now seems poised to move into hyper-drive.

U.S. businesses have already been deeply affected by the urbanization of China's workforce - first in terms of low-cost production and more recently, in terms of top-line revenue growth - but what are the implications of acceleration? Tens of millions of new permanent residents will generate tremendous demand for housing and modern infrastructure of every kind – transport, power, water & sewer systems etc. Higher disposable incomes associated with urbanization will also be critical to finally unleashing latent consumer demand. China's Academy of Sciences recently estimated that for every 1% increase in urbanization, China can expect a 1.6% increase in the contribution made by domestic demand to China's GDP. So as urbanization helps rebalance the Chinese economy, U.S. investors will discover vast new reservoirs of potential customers for their goods and services, from basic consumer items to advanced healthcare services and financial products.

On a very practical level, U.S. investors face the challenge of choosing where to focus their future investments in this expanding urban landscape. From just 198 cities in 1978, the number of Chinese cities - defined as population centers with at least 100,000 inhabitants not engaged in agriculture - has risen to 655 and is expected to climb to over 1,000 as urbanization accelerates. Of these 655, China's National Development and Reform Commission estimates that over 120 have populations exceeding 1 million, with a similar number claiming 500,000 to 1 million inhabitants. Given this complexity, which of China's urban centers are best poised for short-term takeoff?

As a rough illustration of how a U.S. investor might tackle the problem, consider the three-step approach below. By avoiding reliance on historical data, we've tried to peer around the corner by tracking where investments are currently being made – sort of a "follow the money" approach.

[2] Established in 1958 to control internal migration and rationalize the distribution of scare resources, the *hukou* system (城乡户籍制度) strictly classifies China's population according to non-agricultural and agricultural status, roughly corresponding to urban and rural residency. Status is determined at birth, with few avenues for change. In the latest example of growing pressure to end the system, thirteen state-owned newspapers ran front-page editorials on March 1 calling for its abolishment.

Sources: PRC State Council, Ministry of Railways, Ministry of Transportation and State Grid

1) The map above depicts the 26 cities that China's Ministry of Transportation reports will either break ground or add track to urban mass transit systems during 2010. In December, China's State Council approved US$130 billion funding for these projects, an effort critical to enabling growth in China's most promising urban centers. To qualify, Chinese planners set three criteria – population in excess of three million, GDP of more than RMB 100 billion (~US$15 billion) and fiscal revenue of more than RMB 10 billion (~US$1.5 billion). All are suggestive of favorable markets for goods and services, so it seemed like a good place to start.

2) We next compared these 26 cities against the Ministry of Railway's grand plan to build a high-speed rail network across China. China plans to invest approximately US$300 billion over the next five years to connect 70% of Chinese cities with populations exceeding half a million. Again, we were only interested in rail lines under construction during 2010 – the 20 to make that cut are circled in green. So if urban transit gives us a pretty good indication of where markets may be set to take off, cities slated to become major high-speed rail hubs may signal that Beijing is targeting a location for deeper integration into the national, as well as global, economy.

3) Finally of the 20 cities with subway systems under construction in 2010 and soon to be located on high-speed rail routes, we looked at estimates by State Grid, the largest electric power transmission and distribution company in China, of where they expect demand for power will grow fastest between 2010 and 2020. Of the 20 cities, seven emerged as locations where demand is anticipated to grow more than 6% annually. China is weighing plans to invest nearly US$600 billion to meet rising urban power demand through 2020. Whether the electricity is ultimately used to power homes or industrial plants, these projections can serve as an excellent barometer of the future vitality of an urban economy.

So from a dizzying universe of 655 cities, in this example, we have managed to quickly winnow it down to just seven – Changsha, Chengdu, Chongqing, Fuzhou, Nanchang, Xi'an and Wuhan. All are provincial capitals, all but one are located in China's interior and all have populations that would easily place them among the top five largest cities in the U.S. And when we compared several recent indicators, such as growth in urban disposable income, against national rates and those of the four Tier I cities familiar to most U.S. investors – Beijing, Guangzhou, Shanghai and Shenzhen – we found strong validation for our selections.

This is obviously a simple example and every business will have its own criteria for developing a short-list of potential locations for its next investment. Yet for many U.S. executives, such exercises will become increasingly commonplace as companies try to get out in front on one of the most critical business opportunities of the 21st Century.

About the Chinese Services Group

The Chinese Services Group ("CSG") of Deloitte LLP ("Deloitte U.S.") co-ordinates with Deloitte China and subsidiaries of Deloitte U.S. to assist U.S. companies investing and operating in China. Whether contemplating market entry, M&A, or optimization of existing operations, subsidiaries of Deloitte U.S., in collaboration with Deloitte China, can help U.S. companies implement cross-border investment strategies and navigate the associated risks.

The CSG also co-ordinates with Deloitte China and subsidiaries of Deloitte U.S. to assist Chinese companies seeking access to U.S. markets. Bilingual professionals from the appropriate subsidiary of Deloitte U.S. work closely with colleagues in Deloitte China to deliver seamless service to globalizing Chinese companies.

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