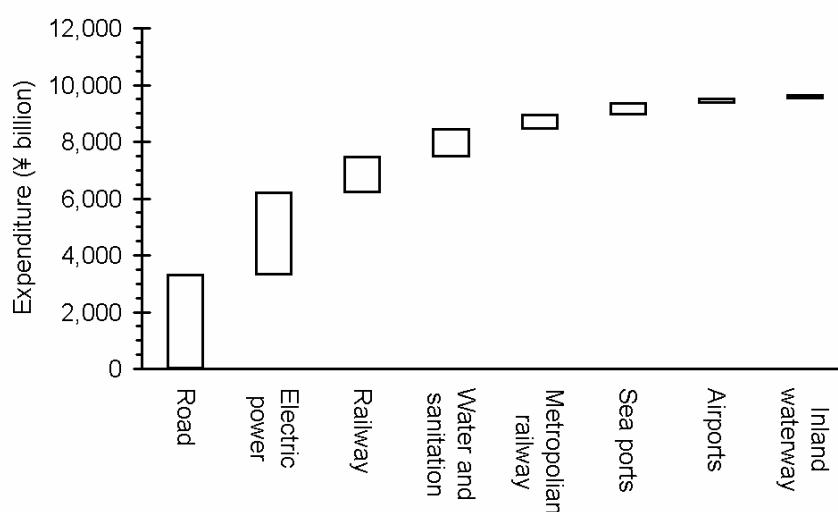


Chapter I: Executive summary

Introduction

Strong economic growth accompanied by sustained urbanisation has created a massive boom in China infrastructure over the last three decades. But the sector still has a long way to go to meet the demands of the economy. Although the current Five Year Plan (FYP), which covers the period 2006-10, gives no single figure for infrastructure spending, the total has been estimated at ¥2,450 billion but figures from individual ministries suggest that the true amount is much higher. *Urandaline* has used various news reports as well as discussions with key officials to form an estimate of the expenditure for the main sectors (Exhibit 1.1). It suggests overall spending of ¥9,640 billion, some five times the amount during the previous FYP (for the period 2001-05). The total includes an estimate for reconstruction in Sichuan following the earthquake in May 2008.) Although most of the work will be done by state enterprises, the programme will provide investment opportunities for the private sector both directly and, more important, indirectly. In some areas, foreign companies will be able to bring expertise to bear in helping to move Chinese infrastructure forward technologically.

Exhibit 1.1 Investment in infrastructure in China's 11th Five Year Plan



Source: *Urandaline*

Why infrastructure?

This report examines five key infrastructure sectors. It provides detailed analysis of each and lists investment opportunities at the end of each section. The sectors are:

- Sea ports
- Electric power
- Railways
- Water
- Inland waterways.

While state enterprises will do much of this infrastructure work, private companies are gaining increasing access to construction and operations, and foreign companies have been able to find niche roles. Large state groups are likely to delegate work to more specialised firms as the ongoing reform process redistributes operational responsibilities within the communist state system, if only in order to get the job done.

For instance, although it continues to act as both operator and regulator, even the monolithic Ministry of Railways (MOR) is allowing the participation of private capital through joint-venture project investment, bonds and equity finance as it pursues a huge investment programme following a long period of underinvestment. Major sea ports have welcomed foreign investors, and a similar pattern is likely for river ports as they are developed to open up China's interior. The five leading independent power producers (IPPs) are quoted on the Hong Kong and Shanghai stock exchanges, while foreign providers of water services have won contracts, in competition with domestic firms, to provide badly needed services in Chinese cities.

Infrastructure spending has been a big contributor to the large fixed-asset investment which characterises China's economy. The authorities are anxious to balance this (and earnings from exports) by increased consumption, but fixed-asset investment has defied government efforts at restraint. Input costs are rising quite sharply – notably for steel, which will be further affected by future iron ore and coking coal price settlement. Although controls have held down energy prices, they will have to give at some point; but at present the government seems ready to commit itself to a policy of subsidies for energy companies and refiners hit by rising oil and coal prices. Wage levels are also rising. However, abundant funding is available, both through high levels of liquidity bred from the trade surplus and flourishing

government tax revenue. So the impact of the higher input costs is unlikely to slow down the infrastructure programme to any significant degree. Moreover, any reduction in implementation would increase the threat of excess capacity in steel and concrete.

Despite current concerns about inflation, the Communist Party and the government are committed to continuing strong growth and job creation. This was underlined by the Party leader, Hu Jintao, at the 2007 Party Congress, and by Prime Minister Wen Jiabao after the annual session of the National People's Congress (NPC) in March 2008.

Infrastructure development has been closely linked to the vision of the new China that the Communist Party has aimed to create since the first FYP was launched under Soviet inspiration in the 1950s. From the construction of Tiananmen Square and the Great Leap Forward, building in all forms and on a massive scale has been seen by the leadership as proof that China has arrived in the modern world and will enjoy continuing modernisation. In his Congress speech in October 2007, Hu placed the need to improve infrastructure in the broader context of moving towards more efficient industrialisation.

Accordingly, the leadership has shown that it recognises that, besides requiring major expansion, infrastructure should be made more efficient, particularly in the transport and power sectors, to eliminate bottlenecks and shortages. Concern about pollution levels means that environmentally friendly and energy-saving technologies will be favoured. The devastation of the Sichuan earthquake and, in particular, the collapse of thousands of schools has underlined the need for better building standards. In personnel terms, the old generation of officials, for whom big was automatically beautiful, may now be replaced by more discriminating planners.

Where will the money go?

Some 30 per cent of the government's infrastructure budget has been allocated to the power sector, with equal shares being spent on generation and on transmission and distribution (Exhibit 1.1). Railway transport accounts for 18 per cent of the budget; 13 per cent of total spending will be targeted at mainline passenger and cargo services and 5 per cent on metropolitan transit lines. Although it has attracted much publicity, construction for the Beijing Olympics is a relatively small part of total spending so the end of that effort

will not have a major national effect. In addition, much of the development in the capital has been integrated into modernisation of the city's infrastructure, which was needed in any case.

The 2006 to 2010 FYP allocates around 5.3 per cent of infrastructure investment to water transport, with 4.1 per cent of the total intended for seaports, principally container terminals and bulk cargo facilities. At the same time, 1.2 per cent of overall spending will be devoted to expanding the inland river transport network.

For the first time, China has planned to spend a large portion (10.4 per cent) of its infrastructure budget on water and sanitation services.

Why the boom will continue: opportunities for investment

The overall outlook is, therefore, for continued high infrastructure spending, which will help to buttress government policies in favour of growth, economic modernisation and job creation. Infrastructure deficiencies in some of the sectors covered in this report constrain general growth, quite severely in some cases. But the following specific factors have special relevance and point to investment opportunities which will open up as state groups seek outside participation:

- Improved rail links are needed to speed up the movement of coal to ensure energy supplies for industry and households. Urbanisation requires enhanced intercity passenger links and better metropolitan transport. While the Ministry of Railways has defied significant reform, the importance to the economy of modernising and expanding the railways is likely to lead to major contracts for construction and engineering companies, new joint venture opportunities and major demand for rolling stock and equipment. Niche areas, such as international container trains, represent potential avenues for private and foreign investment. Strong coal demand will boost dedicated lines from mining areas.