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China's consumption revisited

China's consumption rate has been steadily declining since the early 80s. It has dropped even further to below 60%—well below the world average of above 70%—since the turn of this century. The flip side of low consumption rate is high investment to GDP ratio in China, and the problems entailed have prompted the central government to try to shift the growth model to a “consumption-led” one. (The problems are discussed in our previous newsletter issue 30, *The 10th National People's Congress—Highlights of the 11th Five-year Program and Other Economic Updates*).

Despite the low consumption rate, many economists believed that the strength of consumption in China is actually stronger than statistics imply, as retail sales data—the most commonly used data for China's domestic consumption trends—provides an incomplete picture of domestic consumption. It excludes most service consumption and private housing purchases. The latter is classified as investment and has been growing rapidly for the last few years. Consumption is understated also because of the rapid increase of service consumption in recent years and the inadequate coverage in retail sales data of many newly emerging consumer items, spawned by the rapidly changing consumer behaviours and consumption structure in China.

This issue discusses China's domestic consumption and its role in the economy, as well as China's changing consumer behaviours, consumption hotspots, the two-tier consumer market and the different consumption structures.

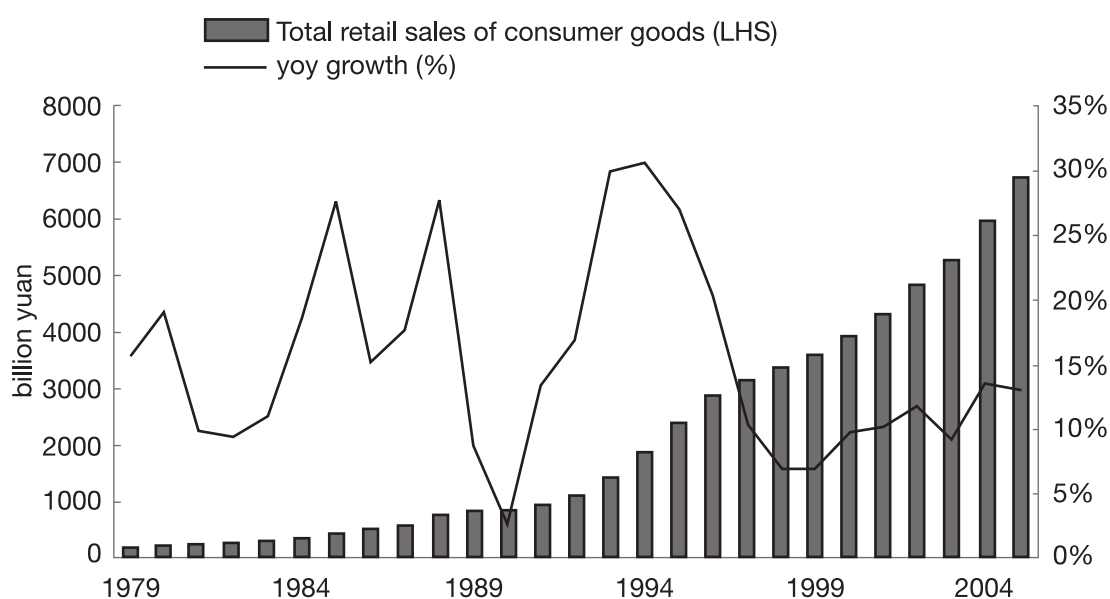
I. Consumption and its role in the Chinese economy

1. Looking at the recent development through retail sales data

There are three commonly used data series for domestic consumption trends in China: retail sales of consumer goods, consumption expenditure by GDP accounting and household expenditure survey. Of the three series, retail sales data is the most commonly used indicator for domestic consumption trends. (See Appendix 2 for the strengths and weaknesses of each data series as indicators of consumption trend).

Over the past decades, China's retail sales of consumer goods have been growing impressively, from 214 billion yuan in 1980, to 6,717 billion yuan in 2005. Growth rate of retail sales has averaged above 10% for the past 5 years (2001 – 2005) (See Exhibit 1). In the first half of 2006, retail sales of consumer goods rose by 13.3% in nominal terms or 12.4% in real terms over the same period last year to 3,645 billion yuan.

Exhibit 1: Growth of Total Retail Sales of Consumer Goods, 1979-2005¹



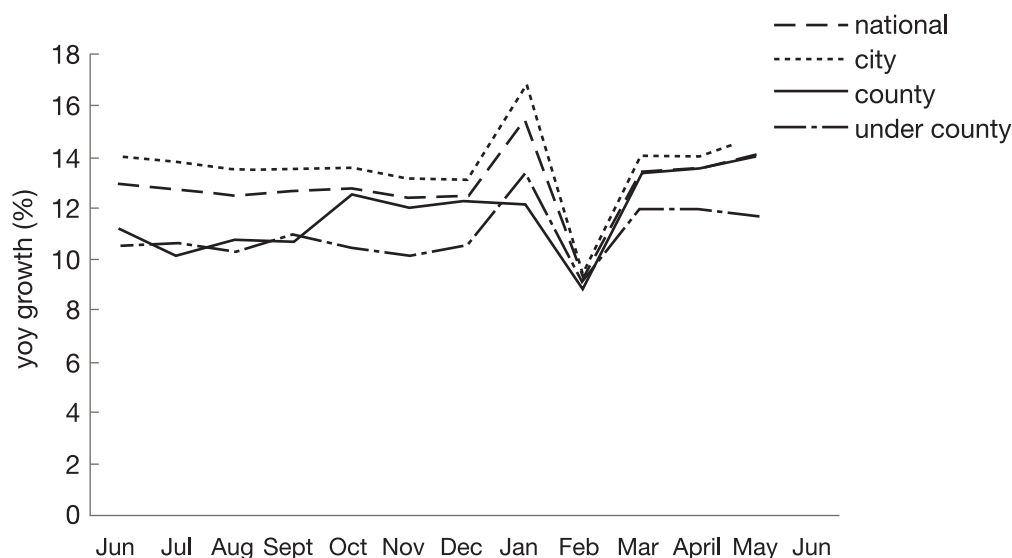
Total Retail Sales of Consumer Goods refers to the sum of retail sales of consumer goods sold by all sectors of the national economy to urban and rural residents and social groups. This indicator is used to show the supply of consumer goods through various channels to households and institutions, and is commonly used for the study on changes at the domestic retail market, and on economic cycles.

Source: National Bureau of Statistics, PRC

Looking at the monthly growth figures since June 2005, the yoy retail sales growth rose sharply in February, and then maintained at a rather steady level throughout the remaining period. The sharp rise in February was mainly due to the Chinese New Year effect and the drop in March 2006 was mainly due to the aftershock of high spending during the Chinese New Year. (See Exhibit 2)

¹ In April 2006, the NBS released the revised figures of retail sales from 1993 to 2005. Figures before 1993 were not revised.

Exhibit 2: Growth of Retail Sales by Month, Jun 2005 – Jun 2006



Source: National Bureau of Statistics, PRC

Rural consumption lagged further behind. In 1H06, the proportion of rural retail sales in total retail sales of consumer goods further decreased to 32.5%, down from 32.9% in 2005, 34.1% in 2004 and 35.0% in 2003. Retail sales of consumer goods in urban areas reached 2,462 billion yuan, up by 14% yoy. Retail sales of consumer goods at and under county level reached 1183 billion yuan, up by 12% yoy, 2 pts lower than urban growth (See Exhibit 3).

Exhibit 3: Total Retail Sales of Consumer Goods by Locality and Sector, 1H06

	(billion yuan)	yoy growth (%)	Proportion of the total (%)
Total retail sales of consumer goods	3,645	13.3	100
By locality:			
City	2,462	14.0	67.5
County and Under County Level	1,183	12.0	32.5
By sector:			
Wholesale and Retail Trade	3082	13.4	84.6
Catering Services	493	15.3	13.5
Others	70	0.8	1.9

Source: National Bureau of Statistics, PRC

Looking at total retail sales by sector, in 1H06, wholesale and retail trade sector grew by 13.4% yoy; catering sector rose by 17.7% yoy. By item, petroleum and its related products surged by 38.4% yoy, mostly due to the high level of oil price. Automobiles increased by 27.7% yoy; communication appliances by 25.5% yoy, building and decoration materials by 24.4% yoy; household appliances and video appliances by 19.2% yoy; cosmetics by 17.5% yoy.

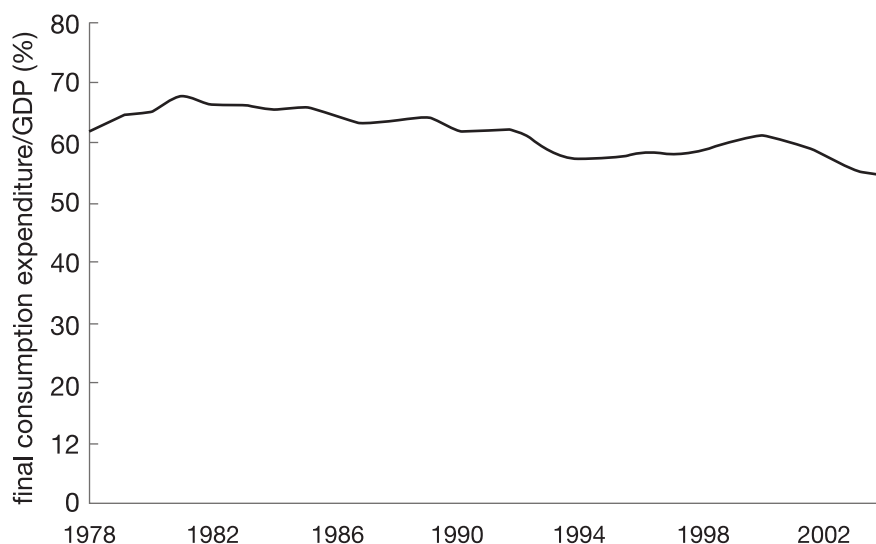
2. Role of consumption in the Chinese economy

(1) Low consumption compared to the world's average

Under the GDP by expenditure approach, GDP are divided into three parts: consumption (final consumption expenditures), investment (gross capital formation) and net exports. To find out the role of consumption in an economy, the ratio of final consumption expenditures to the GDP is used as an indicator. This ratio is called final consumption rate.

The role of consumption in China has been diminishing as China's final consumption rate has steadily declined from around 70% in the early 80s to below 60% in 2004—well below the world's average of over 70% (See Exhibit 4). The flip side of low consumption rate is high investment to GDP ratio in China, meaning that the growth of Chinese economy is largely driven by investment. However, the increasing reliance on investment to drive the economy has concerned the government deeply, as over-investment in sectors such as power, steel, aluminium and cement has resulted in energy wastage, pollution and price hikes in raw materials. Therefore, the central government is now trying to shift the balance of China's economic growth towards consumption (For details, please refer to *China Distribution & Trading, issue 30, The 10th National People's Congress — Highlights of the 11th Five-year Program and Other Economic Updates*).

Exhibit 4: Final Consumption Rate, 1978 – 2004² (%)



Source: National Bureau of Statistics, PRC

Final consumption refers to the total expenditures spent by permanent units on goods and services in a certain period, namely the expenditure of permanent units for goods and services within domestic economic territory and abroad to meet the requirements of material, cultural and spiritual life. Final consumption can be broken down into household consumption and government consumption.

Household consumption refers to the total expenditure of households on goods and services.

Government consumption refers to the expenditure on the public services provided by the government to the whole society and the net expenditure on the goods and services provided by the government to the households free of charge or at low prices.

² Earlier this year, the NBS released the revised figures of 2004 GDP by expenditure approach, which includes final consumption expenditure, gross capital formation and net exports of goods and services. But revised figures for 1978 to -2003 were not published.

(2) However, role of consumption stronger than statistics imply

a. Retail sales data provides an incomplete picture of domestic consumption

Despite its popularity as a consumption trend indicator, retail sales data provides an incomplete picture of consumption trend in China. It excludes most service consumption—experiences of other countries show that the share of service consumption rises as the economy develops—and private housing purchases, which are classified as investment and have been growing rapidly for the last few years.

b. China's domestic consumption understated

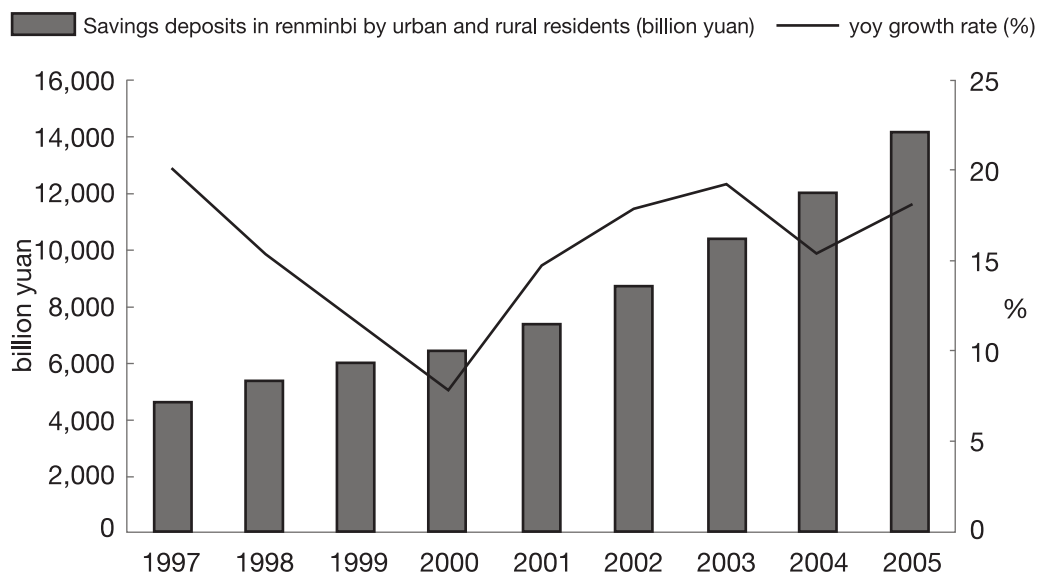
Many economists have long viewed that the strength of consumption has been understated. The revised figures of the components of GDP by expenditure in 2004 verify this point: after the GDP revision, China's final consumption rate in 2004 was revised upward to 54.3% from 53.0%, while the fixed capital formation / GDP ratio — an internationally comparable measure of investment — was revised downward to 43.2%, from 44.2%.

The understated strength of consumption is due to the rapid increase of service consumption in recent years. The GDP revision for 2004 exemplifies this view: China's GDP in 2004 was revised upward by nearly 17% and most of the upward revision came from a big upward revision of the services sector output. Another reason of the understated strength is the inadequate coverage of many emerging consumer items — finance, information technology, health services, transportation and communications. Official statistics simply cannot catch up with these emerging consumer items — spawned by the rapidly changing consumer behaviours in China. (Please refer to Part III, The changing Chinese consumer behaviours)

(3) Looking ahead, consumption will take up a bigger role in the economy

Domestic consumption will be underpinned by the central government's policies to boost consumption, and narrow the economic and social gap between rural and urban areas. In addition, policies to alleviate the financial burden of rural population on education and medical insurance should effectively help to reduce the currently high households' precautionary savings — urban and rural residents' savings deposit in renminbi reached 14.1 trillion yuan in 2005, 77% of China's GDP for 2005 — which in turn will unleash enormous spending potential, as indicated by the huge residents' savings (See Exhibit 5).

Exhibit 5: Savings Deposits in RMB by Urban and Rural Residents, 1997-2005



Source: National Bureau of Statistics, PRC

3. Consumer price index (CPI) rose mildly in 1H06

National Consumer Price Index (CPI) rose mildly by 1.3% yoy in 1H06, 1 ppt lower than 1H05. The mild increase of CPI growth was mainly driven by the rise in food price, which grew by 1.9% yoy, the same growth as in 1Q06, and housing price, which increased by 4.7% yoy in 1H06, 0.3 ppt lower than 1Q06. The urban CPI growth was 1.3% yoy in 1H06 and rural CPI, 1.2% yoy (See Exhibit 6).

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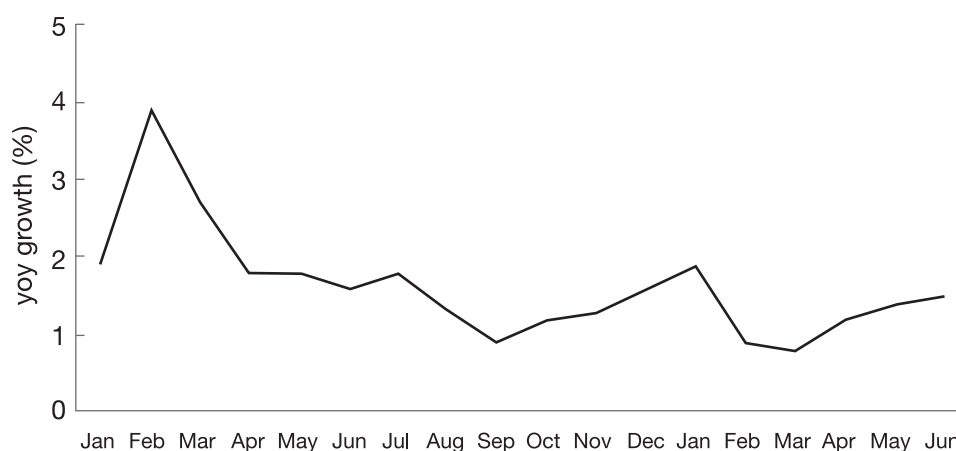
Exhibit 6: Monthly Consumer Price Index Breakdown, Jun 2005-Jun 2006, yoy change (%)

Item	Jun-05	Jul-05	Aug-05	Sep-05	Oct-05	Nov-05	Jan-06	Feb-06	Mar-06	Apr-06	May-06	Jun-06
CPI	1.6	1.8	1.3	0.9	1.2	1.3	1.9	0.9	0.8	1.2	1.4	1.5
Urban CPI	1.3	1.6	1.2	0.8	1.2	1.3	2.0	0.9	0.8	1.2	1.4	1.6
Rural CPI	2.2	2.2	1.5	1.0	1.3	1.4	1.7	0.8	0.7	1.1	1.2	1.3
Consumer goods	1.0	1.2	0.5	0.2	0.7	0.9	1.7	0.7	0.6	1.1	1.2	1.3
Service price	3.7	3.9	4.0	3.0	3.1	2.7	2.5	1.4	1.6	1.7	2.0	2.2
Non-food price	1.3	1.5	1.5	1.2	1.2	1.2	1.0	0.7	0.8	0.9	1.1	1.2
1. Food	2.1	2.3	0.9	0.3	1.3	1.6	3.6	1.2	0.8	1.8	1.9	2.1
Grain	(1.1)	(0.9)	(0.8)	(0.9)	(0.8)	(0.1)	1.0	1.0	0.9	1.2	1.7	2.2
Vegetable	8.9	15.5	7.7	4.9	17.5	22.0	34.9	14.6	10.0	15.6	14.6	13.5
Aquatic products	1.6	2.3	3.5	4.3	4.4	4.7	4.1	(1.5)	(2.4)	(1.1)	0.8	1.5
Meat, poultry and related products	4.0	0.9	(2.1)	(3.7)	(4.9)	(6.3)	(4.6)	(6.6)	(7.8)	(8.7)	(9.3)	(9.0)
2. Tobacco, liquor & articles	0.3	0.3	0.3	0.3	0.4	0.3	0.2	0.2	0.2	0.4	0.4	0.5
3. Clothing	(1.9)	(1.8)	(1.6)	(1.4)	(1.1)	(1.0)	(1.6)	(1.4)	(0.8)	(0.5)	(0.4)	(0.5)
Garment	(2.1)	(2.0)	(1.7)	(1.5)	(1.3)	(1.2)	(2.0)	(2.0)	(1.3)	(1.1)	(0.9)	(1.0)
4. Household facilities & services	0.0	0.0	0.2	0.3	0.4	0.5	0.6	0.6	0.6	0.7	0.8	1.2
5. Medical care & personal articles	(0.3)	(0.9)	0.2	0.5	0.6	0.5	0.3	0.5	0.7	1.0	1.3	1.5
Medical service	3.9	4.1	5.4	6.6	7.4	6.6	3.4	3.4	3.8	4.0	3.8	3.8
6. Transportation & communication	(1.3)	(1.0)	(0.7)	(0.6)	(0.4)	(0.3)	(0.5)	(1.0)	(0.7)	(0.6)	(0.2)	0.4
Transportation vehicles	3.0	(2.5)	(2.3)	(2.0)	(1.8)	(1.8)	(2.0)	(1.9)	(1.8)	(1.9)	(2.1)	2.2
Communication equipment	(16.1)	(15.9)	(15.6)	(15.2)	(15.0)	(14.6)	(17.8)	(17.8)	(17.8)	(10.1)	(17.9)	(17.9)
7. Recreational, educational and cultural articles	2.7	2.9	3.0	1.3	1.3	1.1	0.9	(0.5)	(0.2)	(0.1)	(0.1)	(0.1)
Tuition	6.6	6.6	6.7	3.9	3.6	3.2	1.8	1.0	0.7	0.8	0.7	0.7
8. Residence	5.8	5.9	5.0	5.2	4.8	4.7	5.2	5.2	4.6	4.3	4.5	4.3
Renting	2.2	2.2	1.7	1.4	1.2	1.3	0.6	1.4	1.5	2.0	2.5	2.6
Water, power & fuel price	8.9	8.9	7.7	7.5	6.6	7.1	8.4	8.4	7.4	6.8	6.1	5.3
Building materials	2.9	2.9	2.6	2.7	2.7	2.7	2.5	2.6	2.5	3.0	3.6	3.9

Source: National Bureau of Statistics, PRC

CPI has been fluctuating within the range of 1-2% since April 2005 (See Exhibit 7). Despite the high oil price and other commodity prices, domestic overcapacity and relatively low food prices have been keeping the CPI growth at a low level. Although the government has hinted that administrative control over the prices of oil, electricity and water — these are all part of CPI components — will be loosened gradually, strong investment in China since 2004 indicates that the overcapacity problem will continue to put downward pressure on prices. Thus, CPI is not expected to rise sharply for the rest of 2006.

Exhibit 7: China's Monthly Consumer Price Indices, Jan 2005–Jun 2006



Source: National Bureau of Statistics, PRC

II. The changing Chinese consumer behaviours

1. Background

As new groups of consumer and spending culture emerge, remarkable changes have occurred in the consumption structure of both urban and rural consumers. China's urban consumers now tend to spend more on cars, IT products, mobile phones, healthcare products, personal care, fitness equipment, educational products and vacation. Rural consumers, on the other hand, are spending more on durable goods, education and healthcare products. They no longer focus solely on improving basic living conditions, but are also keen to upgrade their overall quality of life.

(1) Rapid economic growth and rising household income

The most significant factor of these changes is, of course, the rapid economic growth of China. Since the opening up policy, China has achieved an average annual GDP growth of 9.6%. Over the past 3 three years, GDP growth accelerated to an average of 10%, according to the National Bureau of Statistics (NBS). The result is greater wealth accumulation and spending power among the Chinese consumers.

Incomes of both urban and rural areas in China have also been increasing at a fast rate. The annual per capita disposable income of urban households increased from 478 yuan in 1980 to 10,493 yuan in 2005. During the same period, per capita net income of rural households rose from 191 yuan to 3,255 yuan.

(2) Upgrading consumption structure

The rapidly growing economy, rising disposable income, urbanization and the influx of foreign brands have led to the upgrading of consumption structure, illustrated by the falling Engel Coefficient, a living standards indicator measuring the proportion of food expenditure to the total living expenditure — the lower the Coefficient, the higher the living standards.

Despite being quite far from a developed economy, China's Engel Coefficient has dropped substantially in the past two and a half decades. The urban Engel Coefficient fell from 57.5 in 1978 to 36.7 in 2005. The rural Engel Coefficient remained high at 45.5 in 2005 but had progressed from 67.7 in 1978. These figures show that Chinese consumers, both urban and rural have been upgrading their consumption from “basic necessities” to something more “luxurious”.

(3) The rise of the middle class and female consumers

The growing economy has also resulted in quick expansion of the group of middle class consumers. The middle class, according to NBS, refers to those with annual household income of 60,000 yuan to 500,000 yuan. This group of people has stable income, can afford privately-owned houses and cars, and have extra money to spend on vacation and high-priced items. They have higher expectations than other consumer groups and pursue a life with “style and taste”. Generally speaking, they are less price-sensitive, but demand higher product quality or even a better shopping environment. They are also brand-conscious. Many of them are employees of multinational firms.

The NBS predicted that by 2020, the middle class would increase from the current proportion of 5% to 45% of total households. They will expand exponentially in major cities such as Beijing, Shanghai, Guangzhou and Shenzhen, and will become an influential group in the society. The rising middle class will become one of the most active consumer groups in the next 10 – 20 years.

Another emerging consumer group is the female consumers. Mainland women, especially those office ladies, are now increasingly appearance- and image-conscious. Being more financially independent, the proportion of their spending on items such as cosmetics and accessories in their expenditure is on the rise and their demand for cosmetics and other higher-priced items will be greater than ever.

2. Changing consumer behaviours

Surging purchasing power have prompted Chinese consumers to spend more on durable goods, services and luxuries which allow them to show their social status. Chinese consumers are also increasingly aware of product quality, performance and brands, instead of looking solely for low prices. Besides, they give more priority to education now and have started to spend more on intellectual and personal development. There are also growing demand for convenient and time-saving solutions among urban residents who lead a fast-paced life and are more time-conscious. Spending on eating out, vacation, health and fitness and housing are taking up larger proportions of Chinese consumers' expenditures.

(1) Spending more on durable goods and services

In tandem with the surging disposable income and rising living standards, Mainland consumers' spending on durable goods such as consumer electronics, apartment and home furnishings has been on the rise (See Exhibit 8). At the same time, they are spending more on services such as healthcare and medical services, financial services, education, cultural and recreation (See Exhibit 9).

Exhibit 8: Chinese Consumers Consuming More Durable Goods

	Number owned per 100 urban households			
	1999	2000	2003	2004
Automobile	0.3	0.5	1.4	2.2
Motorcycle	15.1	18.8	24	24.8
Color Television Set	111.6	116.6	130.5	133.4
Video Disc Player	24.7	37.5	58.7	63.3
Washing machine	91.4	90.5	94.4	95.9
Mobile phone	7.1	19.5	90.1	111.4
Air conditioner	24.4	30.8	61.8	69.8
Refrigerator	77.7	80.1	88.7	90.2
Computer	5.9	9.7	27.8	33.1
Oven	12.2	17.6	36.9	41.7

Source: National Bureau of Statistics, PRC

Exhibit 9: Composition of living expenditure of urban households (%), 1990-2004

	1990	1995	2000	2003	2004
Food	54	50	40	37	38
Clothing	14	14	10	10	10
Housing	7	8	11	11	10
Household appliances and services	10	8	8	6	6
Health care and medical services	2	3	6	7	7
Transport and telecommunications	1	5	9	11	12
Education, cultural and recreation	11	9	13	14	14
Other goods and services	1	3	3	3	3

Source: National Bureau of Statistics, PRC

(2) Demanding quality and branded products

Mainland consumers—in particular city dwellers and those living in coastal areas, are increasingly affluent and becoming more discerning and brand-conscious. The ability to purchase up-market brands is regarded by many as a symbol of elevated social status. According to Ernst & Young, China is the world's third largest consumer of high-end fashions, accessories and other luxury goods, with sales value of more than USD 2 billion a year.

China Association of Branding Strategy estimated that the luxury goods market of China has up to 170 million potential consumers, or 13.5% of the total population. Of which, 10 to 13 million are active purchasers. There are two major luxury goods consumer groups in China. One group is comprised of wealthy consumers who are crowd-averse, seek personalized services and frequently visit luxury retail outlets for the newest and most fashionable products offerings. Another group consists of white-collar employees, usually employed by foreign companies, who will spend an entire month's salary on a single purchase.

(3) Changing dietary culture

Along with the rising living standards, Mainland consumers are now health- and hygiene- conscious. Organic products, and products with low fat/sugar content or with other health benefits are gaining popularity. There is also a growing demand for packaged food. The quickening pace of life, the increasing number of working women, the elderly and single person households, and the prevalence of refrigerator and microwave have led to the boom of packaged and convenience food, such as frozen food and canned food, as consumers continue to look for ways to reduce cooking time and to alleviate cooking burden.

Moreover, eating out has now become increasingly affordable and popular in China, especially in developed cities. Eating out accounted for 7.4% of urban residents' total living expenditure in 2004. Catering services sector also witnessed strong growth with total retail sales hitting 888.7 billion yuan in 2005, up by 17.7% yoy. The Ministry of Commerce expects retail sales in the catering sector to hit one trillion yuan (US\$123.4 billion) in 2006, and further grow to two trillion yuan (US\$246.9 billion) by 2020.

The quickening pace of life and the growing number of working women, the elderly and single person households make it necessary for busy city dwellers to eat out more often. Besides, social gatherings are increasingly popular among Chinese people and a large variety of restaurants have been opened to cater to the tastes of different consumer groups. Booming tourism also provides a good boost for food service sales. In China today, hotpot restaurants, fast food restaurant, food courts, cafes and tea houses are becoming more prevalent.

(4) Credit card usage gaining popularity

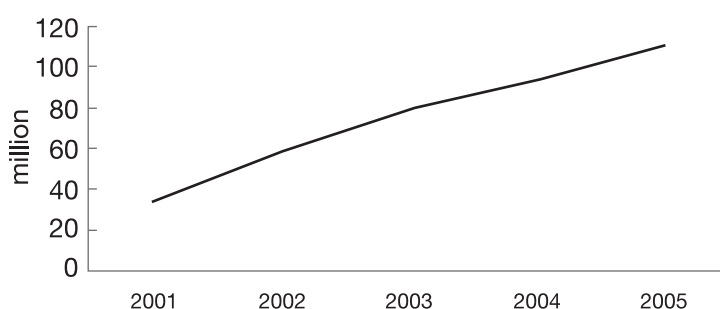
Shopping with credit cards is becoming trendy today, especially among urban young consumers. More than two decades after the Bank of China issued its Great Wall card—China's first credit card—the market has become crowded with big and small competitors. Starting with a small base, China has witnessed an exponential growth in credit card business. In 2004, Visa more than tripled its cardholder base to 2.9 million from 0.9 million in 2003. Many large foreign credit card companies are also negotiating with Chinese partners to issue more foreign currencies and renminbi credit cards. According to MasterCard—the world's second-biggest credit-card company, China will have about 75 million credit cards by 2010, from the current figure of over 3 million.

According to a report by Mckinsey, 90% of China's credit cardholders belong to either the mass-affluent—consumers with annual household income of between USD 4,000 and USD 6,500—or affluent—consumers with household income exceeding USD 6,500—consumer segments. Note that 35% of mass-affluent and affluent consumers reside in China's four big coastal cities, namely Shanghai, Beijing, Guangzhou and Shenzhen. (For a detailed update on credit card usage in China, please refer to *issue 31, China's Retail Sector, 2005-06, Part I: Market Developments and Trends*)

(5) Online shopping also gaining popularity

According to a survey released by the quasi-governmental China Internet Network Information Centre, in 2005, nearly 20% of Chinese Internet users shopped online at least once. Given that there were about 110 million Internet users in China in 2005 (See Exhibit 10), the number of online shopper in China was estimated at 22 million. In addition, the percentage of population that has Internet access is only about 8.5% in China (See Exhibit 11), compared to 67% of the U.S. This implies tremendous potential for organic growth in online shopping, as more and more Chinese people have Internet access.

Exhibit 10: Number of Chinese Internet Users, 2001 – 2005



Source: China Internet Network Information Centre

Exhibit 11: Still, Most of the Population have No Internet Access in China

Number of Internet users (million)	111
Per 100 population	8.5
Number of computers with Internet access (million)	49.5
Per 100 population	3.8

Source: China Internet Network Information Centre (CINIC)

In 2005, China had around 49.5 million computers hooked up to the Internet, compared with 41.6 million the previous year. Most of China's Internet users are well educated and have relatively high purchasing power. In addition, more people in China are surfing the Internet by broadband rather than dial-up. Listening to music and watching movies online is becoming more popular, adding that e-mails, news and search engines still top the list of the most frequently used services.

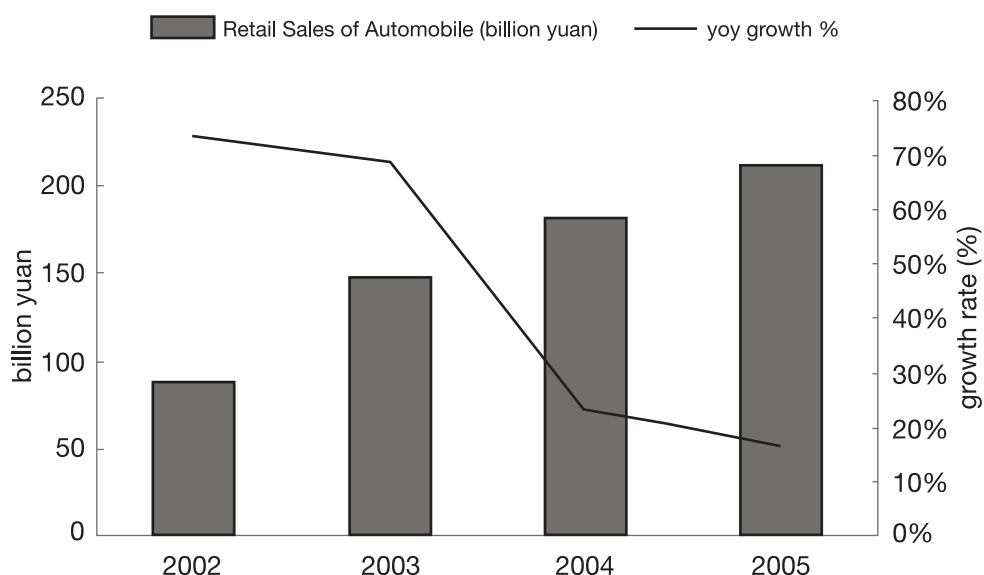
The survey also found an increasing number of people using the Internet to search for maps and locations, and most users use search engines to look for websites, software and songs. While the penetration of online shopping and Internet are still in the fledgling stage, there is huge potential for growth.

3. Consumption Hotspots

(1) Automobiles

China's auto market has seen remarkable growth for the past few years but are showing signs of slowing down. According to the NBS, the total retail sales of automobiles by wholesale and retail enterprises above designated size³ grew at an average annual rate of 54.9% over 2002 — 2004. Sales growth of automobile started to slow in 2004 and further dipped in 2005: it grew by 16.6% yoy to reach 213.0 billion yuan in 2005 (See Exhibit 12). Although sales growth picked up in 1H06 to 27.7% yoy, it is still far below the above 50% growth recorded previously.

Exhibit 12: Total Retail Sales of Automobiles, 2002-2005



Source: National Bureau of Statistics, PRC

³ Enterprises above designated size refer to all state-owned enterprises and the non-state-owned enterprises with an annual sales income of over 5 million yuan.

The slowing growth of auto sales was mainly due to banks' controls on auto loans. At the beginning of this century, banks were very aggressive in offering auto loans—without focusing on credit quality—to capture market share of this fast emerging auto loan market stimulated by the growing desire of many Chinese urban dwellers of owning a car. However, increasing non-performing loans on auto loans began to surface in 2004 and banks began to tighten auto loans. The impact on automobile demand was substantial—sales growth of automobile slowed to around 20% yoy in 2004 and further down to 16.6% yoy in 2005 from a high of around 70% yoy in 2003.

Looking ahead, the government's policy to raise consumption tax on automobiles with capacity of more than 2.0 litres from 1 April 2006 should further hinder the growth of auto sales, and therefore the auto market is not expected to record the same rapid sales growth as in 2002-2004. However, the growing economy, urbanization and Chinese people's growing desire of owning automobiles would continue to support a steady sales growth in 2006. (For more details on the latest consumption tax reform, please refer to Part III Appendix 1)

(2) Housing

In 2005, the total sales of commercial buildings rose by 26.9% yoy to reach 1,808 billion yuan. The growth is attributable to a number of reasons. First, since the cease of the housing distribution system (under which lodging was provided for employees by their work units) in 1998, more and more Chinese people buy their own residence by obtaining mortgages from banks. Second, with the speeding up of the urbanization process—the government plans to increase urbanization rate to 47% by 2010 from the current 43%, more people are migrating to urban areas, which has driven up the sales of housing. Third, the lack of investment channels in China, and the prospect of gaining enormous profits from the surging property prices are driving more people to invest or even speculate in the housing market.

However, the 26.9% yoy growth recorded in 2005 was 3.1 and 7.2 percentage points lower than that of 2004 and 2003 respectively. The moderated growth in 2005 is attributable to a number of tightening policies by the government announced in May 2005: first, residential flats sold within two years of the initial purchase would be subject to a sales tax; second, developers who do not develop land within a year of purchase would face a tax penalty; third, commercial banks are required to tighten controls on lending to the property sector. Another reason for the moderate growth was the People's Bank of China's decision to raise mortgage interest rate in March 2005.

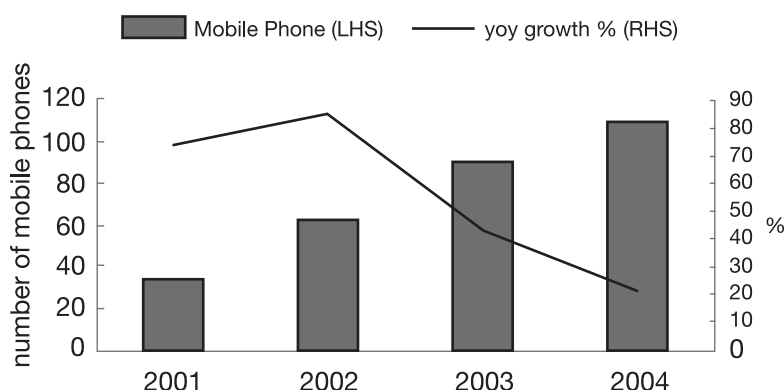
Despite the moderation of growth and the government's recent measures to curb rising property market — effective from 1 June 2006, the government has raised mortgage down payment from 20% to 30% and imposed a 5.5% property tax on properties resold within five years of purchase; previously the time frame was two years — housing consumption is expected to record steady growth in the next few years underpinned by the rapidly growing economy and urbanization. The steady growth of housing consumption will increase demand for housing-related consumption such as housing decoration, furniture and household appliances. According to the NBS, the total retail sales of building and decoration materials by wholesale and retail enterprises above designated size in 2005 was up by 22.1% over the previous year; household appliances and video appliances by 14.8%; and furniture by 13.3%.

(3) Mobile phones

The ownership of mobile phones has witnessed tremendous growth in the last few years, from around 10 per 100 urban households in 1999 to over 100 in 2004 (See exhibit 13). According to the Ministry of Commerce, the number of mobile phone subscribers in 2005 increased to 392 million, from 334 million in 2004. The prevalent usage of mobile phone is well demonstrated during the showing of one of the most popular TV programs in China—Super Girl (超級女聲), the Chinese version of ‘American Idol’, as millions of TV viewers used mobile phones to ‘text message’ their vote for their favourite female singer after each showing.

The mobile phone market is expected to grow further for the next few years. With the persistent price cuts of mobile phones in China, more people will buy or renew their phones. Consumers are also demanding more personalized designs and functions, and mobile phone has become more of a fashionable product than a mere communication tool.

Exhibit 13: Number and Growth of Mobile Phone Ownership per 100 Urban Households, 2001 - 2004

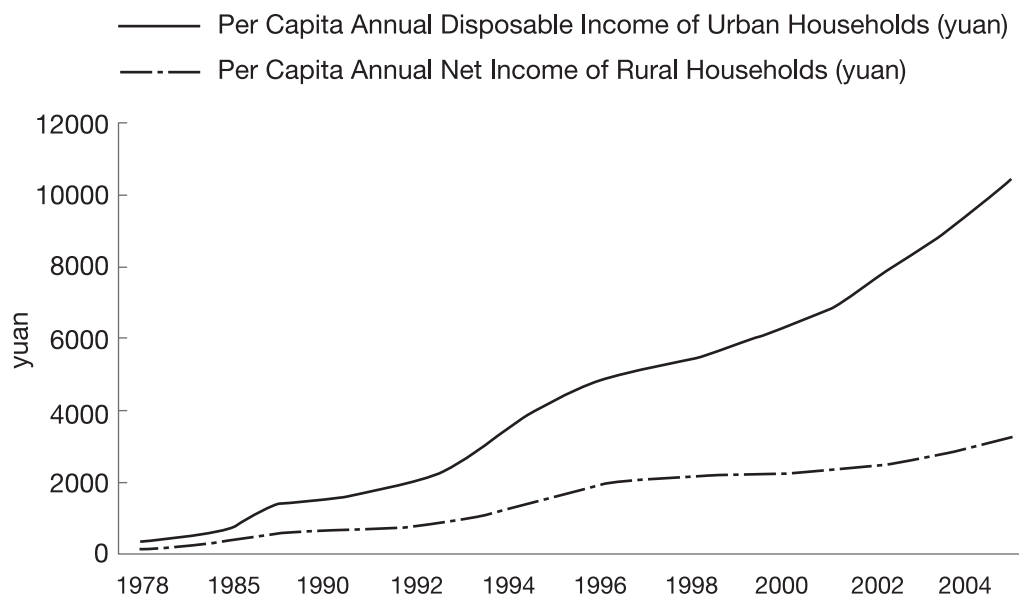


Source: National Bureau of Statistics, PRC

4. The rural-urban and regional disparity

According to NBS, the current consumption level of rural residents is 10 years behind the urban residents. In 2005, rural residents accounted for 57% of the total population, but constituted only 33% of the total retail sales. There are several reasons behind. First, farmers’ earnings still lag behind those of city dwellers and the gap is widening (See Exhibit 14). Second, unlike urban households, rural household do not enjoy subsidized medical services, unemployment protection, pension funds and many other social welfare. For example, while many urban education institutes receive government funding, the majority of schools in the rural areas have limited government support. Taking these factors into accounts, the income gap between rural and urban households could be four to six times more and is one of the highest in the world.

Exhibit 14: Per Capita Annual Income of Urban and Rural Households, 1978-2005



Source: National Bureau of Statistics, PRC

However, the government's plan to construct "a new socialist countryside" for the next five years will help reduce the gap between urban and rural areas, which in turn should stimulate rural consumption. Policies to improve logistics services and infrastructure, streamline bureaucracy and improve efficiency of local governments, provide medical services and compulsory education will be implemented. The government has also promises to spend more on these items for each successive year for the next five years. It is anticipated that rural households will increase their expenditure on durable goods such as home appliances and motorcycles, or replacing old home appliances.

In addition to the rural-urban disparity, regional disparity is another distinctive feature of the consumer market in China. With a population of 1.3 billion people, China's consumer market is not one, big, united market, rather, it consists of a number of smaller, fragmented markets, each of which has its distinctive consumption habits and preferences. Fundamental differences in development level, living standards, climate, culture and customs are evident among regions. (For details, please refer to *issue 31, China's Retail Sector, 2005-06, Part I: Market Developments and Trends*).

5. Different Consumption Structures

Urban households, in general, spend proportionately less on food than rural households. Households with higher income levels in both urban areas and rural areas, according to NBS, also tend to spend proportionately less on food and spend more on items such as "transport, post and communication services", "residence", "education, cultural and recreation services" (See Exhibit 15 and 16).

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Exhibit 15: Composition of Living Expenditure of Urban Households by Income Group, 2004 (%)

	Lowest Income (first decile)	Low Income (second decile)	Lower Middle Income (second quintile)	Middle Income (third quintile)	Upper Middle Income (fourth quintile)	High Income (ninth decile)	Highest Income (tenth decile)
Total Living Expenditures	100	100	100	100	100	100	100
Food	49.7	46.4	43.2	39.7	37.5	34.8	29.2
Clothing	7.5	8.9	9.6	10.2	10.2	10.0	8.7
Household Facilities, Articles & Services	3.4	3.9	4.6	5.4	5.8	6.4	7.1
Medicine & Medical Services	6.5	6.9	7.0	7.2	8.0	7.6	7.2
Transport, Post & Communication Services	6.9	8.4	9.4	10.7	11.2	11.9	16.8
Education, Cultural & Recreation Services	12.4	12.4	13.3	13.9	14.2	15.6	16.1
Residence	11.3	10.5	10.1	9.9	9.7	10.2	10.8
Miscellaneous Commodities & Services	2.3	2.7	2.8	3.1	3.4	3.6	4.2

Source: National Bureau of Statistics, PRC

Exhibit 16: Composition of Living Expenditure of Rural Households by Income Group, 2004 (%)

	Lower Income	Lower Middle Income	Middle Income	Upper Middle Income	High Income
Living Expenditure	100	100	100	100	100
Food	55.6	53.2	50.5	47.5	39.1
Clothing	5.3	5.3	5.5	5.5	5.6
Residence	12.3	12.6	13.0	14.1	18.4
Household Appliances & Services	3.5	3.6	3.7	3.9	4.9
Health Care & Medical Services	5.7	5.8	6.0	6.1	6.1
Transport & Telecommunication Services	5.9	6.9	7.9	8.8	11.4
Education, Cultural & Recreational Services	9.9	10.6	11.3	11.9	11.9
Miscellaneous Commodities & Services	1.7	1.9	2.2	2.2	2.6

Source: National Bureau of Statistics, PRC

III. Appendix 1 Policy development: Consumption tax reform

The consumption tax reform—announced by the Ministry of Finance in March 2006—comes in line with the strategic priorities of the 11th Five-year Program which emphasize wealth sharing, boosting consumption, energy conservation and environmental protection.

Effective from April 1, 2006, China imposed consumption tax on refined-oil products, luxury goods, disposable wooden chopsticks and wooden floor panels. Consumption tax rates on small vehicles, motorcycles and tyres were adjusted while consumption tax on shampoo and skin care products was scrapped (See Exhibit 17)

The tax reform is designed to: (1) narrow the gap between the rich and the poor by collecting consumption tax on luxury items; (2) boost consumption by scrapping consumption tax on daily necessities; (3) control and regulate energy usage and; (4) help protect the environment by reducing the exploitation of timber.

After the announcement, there were concerns that the government will further impose consumption tax on other high-end goods, such as high-end furniture and clothing. However, it is unlikely the government will take such actions in the short term for several reasons. First, since it will take a while before the effects of the tax reform and responses from the general public kick in, the government will 'wait and see' before taking further actions. Second, the government admits that it is difficult to define the term 'luxury' for other high-end items. Third, imposing consumption tax on other consumer goods may subdue domestic consumption, which contradicts the government policy to boost domestic consumption.

Exhibit 17: Consumption Tax Rate after April 1, 2006

Items	Consumption tax rate
Luxury goods	
Golf balls and equipment	10%
High-end watches	20%
Yachts	10%
Refined-oil products	
Aviation fuel	0.1 yuan per litre
Naphtha	0.2 yuan per litre
Solvents	0.2 yuan per litre
Lubricants	0.2 yuan per litre
Disposable wooden chopsticks	5%
Wooden floor panels	5%
Small vehicles	
Displacement <1.5 litre	3%
1.5 to 2 litre	5%
2.0 to 2.5 litre	9%
2.5 to 3.0 litre	12%
3.0 to 4.0 litre	15%
> 4.0 litre	20%
Motor cycles	
Displacement<250cc	3%
>250cc	10%
Tyres	3%

Source: Ministry of Finance, PRC

1. Shampoo and skin care products no longer taxed but luxury items added to the list

Consumption tax on shampoo and skin care products was scrapped. Of which, high-end skin care products were re-categorized and taxed under the cosmetics category. On the other hand, luxury goods including yachts, high-end watches, and golf balls and equipment were taxed for the first time.

At the time of the implementation of consumption tax in 1994, consumption pattern in China was quite different from now. Shampoo and skin care products were luxury goods for ordinary people and therefore were taxed for wealth redistribution purpose. After more than a decade of rapid economic growth, shampoo and skin care products have become daily necessities and consumption tax on these items no longer serves its previous function of wealth redistribution. In addition, taxing daily necessities contradicts the government's policy to stimulate domestic consumption, which is why the government scraps consumption tax on goods that are no longer luxurious items, and imposes consumption tax on goods that are increasingly fashionable among wealthy people in China.

2. Refined-oil products, disposable wooden chopsticks and wooden floor panels taxed

This is the first time the government imposes consumption tax on refined-oil products. But for the time being, the government would collect only 30% of the planned consumption tax on naphtha and solvent (equals to 0.06 yuan per litre for both items), and delay its tax collection on aviation fuel, due to the high level of international oil price.

The imposition of consumption tax on disposable wooden chopsticks and wooden floor panels follows one of the government's objectives of the 11th Five-year Program to increase the national forest area share to 20% by 2010, from the current 18.2%. According to the Ministry of Finance, each year, China sells roughly 10 million boxes of wooden chopsticks, which equals to 2 million square metres of forest area, and in 2004, China produced around 85 million square metres of wooden floor panel. The government hopes that the consumption tax can reduce the use of timber and preserve more forest areas.

3. Imposing progressive tax rate on vehicles

The government also adjusted the consumption tax rate on vehicles and motorcycles to promote the use of low displacement vehicles. The tremendous growth of vehicle consumption in recent years has created fuel shortages and serious pollution due to the emission of carbon dioxide by vehicles, in particular large vehicles. In addition, the current tax regime applies the same tax rate on high-displacement and low-displacement vehicles, therefore consumers do not have much incentive to purchase low-displacement vehicles that consume less fuel and emit lower concentration of carbon dioxide. Effective from April 1, 2006, progressive tax was imposed on vehicles consumption, ranging from 3% for vehicles with displacement of less than 1.5 litre to 20% for vehicles with displacement of over 4 litres. With the implementation of the new tax regime and the high oil price, consumption growth of high-displacement vehicles is likely to moderate in 2006.

The usage of low displacement motorcycles is concentrated in rural area, therefore, the reduction of tax rate for motorcycles with displacement of less than 250cc from 10% to 3% should relieve some of the financial burden on rural households and increase their consumption power.

IV. Appendix 2 Comparing the three data series for consumption trends in China

1. Retail sales data covers the purchasing of consumer goods by households, firms and government. It is based on comprehensive reporting by firms above the minimum threshold and sampling for sales made by firms below the minimum threshold. Annual data are available since 1952 and monthly data since 1993.

Strength It is published with high frequency and breakdown by products available for sales made by firms above the minimum threshold.

Weakness It is not compiled on a value-added basis and does not include most of the services consumption except catering.

2. Household expenditure surveys cover most of the expenditure on goods and services by households. It is based on survey questionnaires to urban and rural households. Data availability: annual rural data available since 1985, urban data since 1991; quarterly rural data since 1996, urban data since 1999; monthly data of major cities since 1992.

Strength Its coverage is better than retail sales as it includes services consumption.

Weakness It has a shorter history compared to retail sales data and has lower data frequency. It is difficult to compile accurate data, in particular because high-income groups tend to under-report their spending. Also, its breakdown of expenditure is limited to 8 categories only.

3. Household consumption by GDP accounting covers the consumption of goods and services by households. It incorporates both retail sales and household survey data. Annual data available since 1952.

Strength Its coverage is better than retail sales.

Weakness There is no breakdown of subcomponents within the expenditure category. In addition, it is only available on an annual basis with significant time lag—usually released in April/May of the following year.

Source: Goldman Sachs, NBS

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