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– Domestic and Foreign

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Domestic Trade

Robust retail sales in 2006. China's retail sales rose 13.7% yoy in nominal terms to 7,641 billion yuan, from a growth of 12.8% yoy in 2005. Throughout the year, retail sales growth remained strong amid robust employment, stable GDP and income growth. The growth rates of retail sales in 1Q06, 1H06 and the first three quarters of 2006 were 12.8% yoy, 13.3% yoy and 13.5% yoy, respectively.

Property prices continued to rise amid government's macro-control policies. Property prices in the 70 surveyed cities grew by 5.5% yoy in 2006, 2.1 pts lower than that of the previous year. Though the momentum is slowing down, positive wealth effect created by the rising property prices should continue to stimulate domestic consumption.

Economic growth is likely to moderate as a result of tightening measures. Though FAI growth eased last year, it is still likely that the government will launch a series of tightening measures this year. The government is, at least, still highly concerned about the speculative bubbles in the property market, the soaring stock prices, the CPI fluctuation, as well as the possible resurgence of high FAI growth.

The economy will gradually become more consumption-driven, less investment-driven. We will continue to see the macro-economic and structural factors leading to consumption growth and consumption upgrading of the Chinese people, as well as more upcoming government policies to strengthen income growth and encourage consumption, especially in the rural areas.

Foreign Trade

Trade surplus hit record in 2006. China's trade surplus in 2006 surpassed last year's total to reach USD 177 billion. Trade surplus in 2006 ballooned as exports continued to outpace imports: China's exports rose by 27.2% yoy to USD 969 billion; and imports grew by 20% yoy to USD 791.6 billion in 2006.

Export growth is likely to moderate this year, due to the following factor: the slower economic growth in the US; the rise in protectionist sentiments and increase in international trade frictions; RMB appreciation; slowdown in FDI (which has been contributing greatly to China's exports); government policies to discourage low value-added export-processing activities; the shifting in growth focuses of the Chinese economy from 'investment-led' and 'export-led' to 'consumption-driven'.

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Part One: Domestic Trade

I. Recent developments

1. Robust retail sales in 2006

In 2006, China's retail sales rose 13.7% yoy in nominal terms to 7,641 billion yuan, from a growth of 12.8% yoy in 2005. It was mainly driven by higher petrol sales (36% yoy), car sales (26% yoy) and sales of housing materials (24% yoy). Urban retail sales of consumer goods grew by 14.3% yoy, 0.7 ppt higher than that of the previous year. Rural retail sales went up by 12.6% yoy, 1.1 ppts higher than that of 2005. By sector, wholesale and retail trade sector increased by 13.7% yoy. The yoy growth of the catering sector was 16.4%.

Throughout the year, retail sales growth remained strong amid robust employment, stable GDP and income growth. The growth rates of retail sales in 1Q06, 1H06 and the first three quarters of 2006 were 12.8% yoy, 13.3% yoy and 13.5% yoy, respectively.

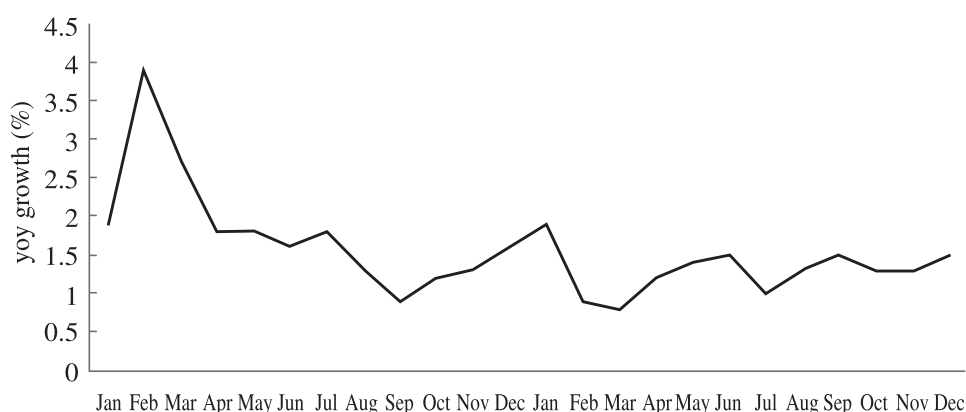
2. Urban and rural residents' income grew with improved employment

In 2006, per capita disposable income of urban households rose to 11,759 yuan, up by 10.4% yoy in real terms. Per capita net income of rural households rose to 3,587 yuan, up by 10.2% yoy. Besides income, employment in urban area also improved: The registered urban unemployment rate by the end of 2006 was 4.1%, 0.1 ppt lower than that of 2005. The high GDP growth (10.7% in 2006), together with the improved employment situation, continued to drive up income growth in both urban and rural areas which, in turn, was conducive to domestic trade. The prosperous domestic market was also supported by the wealth effect created by a bull stock market that boosted consumer sentiment of most domestic investors.

3. Consumer prices grew moderately in 2006

National Consumer Price Index (CPI) grew by 1.5% yoy in 2006, 0.3 ppt lower than 2005. The CPI growth was mainly driven by housing prices (5.5% yoy) and food prices (2.3% yoy). CPI in both urban and rural areas were up by 1.5% yoy. In December, CPI jumped to 2.8% yoy, from 1.9% yoy in November and only 1.3% yoy in the first ten months of the year. The jump in CPI was mainly attributable to the rise in food prices, which were mainly driven up by tight domestic supply, inefficient circulation and a fall in global grain output last year.

Exhibit 1: China's Monthly Consumer Price Indices, Jan 2005 – Dec 2006

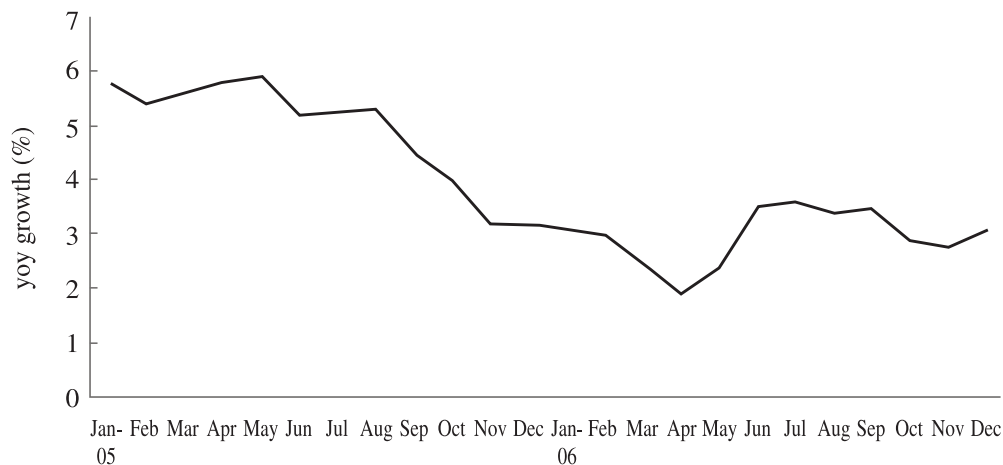


Source: National Bureau of Statistics, PRC

4. Producer Price Index (PPI) rose by 3% yoy

Producer Price Index (PPI), an indicator for upstream prices, registered a growth of 3% yoy in 2006, 1.9 ppts lower than that of 2005. PPI growth has been falling since mid-2004 but rebounded in April 2006 and stayed relatively stable since June 2006. PPI growth reached 3.1% yoy in December 2006 (See Exhibit 2).

Exhibit 2: China's Monthly Producer Price Indices, Jan 2005 – Dec 2006



Source: National Bureau of Statistic, PRC

II. Highlights

1. Automobile sales exceeded 7 million units

National automobile sales in 2006 rose by 25.1% yoy to 7.2 million units, compared to 5.8 million units and the yoy growth rate of 13.5% in 2005. China has now surpassed Japan to become the world's second-largest vehicle market. Passenger car sales rose by 30.0% yoy to 5.2 million units in 2006. After the stable growth in 2005, automobile sales exhibited a rather rapid growth in 2006. The marked increase in automobile sales was largely a result of the price cuts and the record introduction of new models.

With the buoyant sales, China's auto sector registered a sharp rise in profits for 2006: Industry-wide profits, covering vehicles, engines, spare parts and motorcycles, leapt by 46% yoy to 76.8 billion yuan last year, according to statistics from the China Association of Automobile Manufacturers. It should be noted that the price cuts did not squeeze profits since most price reductions were on older models

One of the headline news of the industry was the introduction of new consumption tax in April 2006. As a result of the implementation of the tax, the price of high-emission cars increased noticeably while the price of low-emission cars decreased. However, it turned out that the demand for high-emission cars was not greatly affected, as price was not an important factor for those wealthy Chinese buyers who regard expensive cars as a symbol of their social status.

Inspired by last year's strong performance, many carmakers have set lofty sales goals this year. However, it is widely expected that growth will moderate this year, with the growths of automobile sales and profits slowing to around 20% and 15%, respectively.

2. Property prices continued to rise amid government's macro-control policies

According to the National Development and Reform Commission (NDRC) and the National Bureau of Statistics (NBS), property prices in the 70 surveyed cities grew by 5.4% yoy, 5.2% yoy and 5.4% yoy in October, November and December 2006, respectively. The growth rate has been hovering around such levels throughout the year. Overall, the growth rate for 2006 was 5.5% yoy, 2.1 ppts lower than that of the previous year. It should be noted that the growth was mainly driven by 'luxury residential buildings' and 'general residential buildings', while 'economically affordable housing' only recorded very mild growth.

Among the cities with the highest growth rates of property prices in 4Q06 were Beijing, Fuzhou, Xiamen, Shenzhen, Guangzhou, Qinhuangdao and Chengdu. It is also noteworthy that the growth rates of property prices in Shanghai were -0.6% yoy, -0.1% yoy and -0.1% yoy in October, November and December 2006, respectively.

According to the 4Q06 Survey on Urban Household Savings by the People's Bank of China, urban households' willingness to purchase housing was generally stable. While urban households in Beijing, Shanghai, Tianjin and Chongqing tended to be prudent in housing-purchase activities, the proportion of surveyed households with a plan to purchase housing in the coming three months in other provincial capitals such as Changchun, Zhengzhou, Nanchang, Xian, Hangzhou, Guiyang, Hunming and Xining witnessed increases of different degrees.

The government has continued to curb the price increase in the sector through macro-control policies. After implementing a 20% capital gain tax on property sales and increasing mortgage down payment from 20% to 30% in 2006, the government resumed the collection of land appreciation tax of 30% to 60% on net gains made from all property development deals sales, effective from February in 2007.

However, most economists still forecast that property prices will gain at least 5% in 2007. First, it is a consensus that the government's tightening measures are targeted at preventing excessive speculation in the property sector, not at curbing the 'healthy' growth of the sector. Second, the effectiveness of these central government policies tends to be undermined by local officials who are unwilling to follow the central government's directives, as property sector plays a leading role in boosting local GDP and taxes collected from property development are one of the local governments' major income. Third, according to a survey conducted by Deloitte Touche Tohmatsu, nearly 90% of the 26 Hong Kong listed companies surveyed agreed that their level of Mainland real estate investments would not be affected by the land appreciation tax. Most of them said they have confidence in the mainland's real estate sector, while 33% of them claimed they would increase their investments in the sector by more than 100 million yuan. Some Hong Kong developers said that they have already set aside funds to pay the land appreciation tax.

Though the momentum is slowing down, positive wealth effect created by the rising property prices should continue to stimulate domestic consumption.

3. Urban dwellers earned more and saved more

With increasing income, it is observed that urban households also increased their saving. Asian Sovereign Strategist found that in 1992, urban households, on average, saved 17.5% of their income. The proportion increased to 20% in 1998 and jumped further to 24.5% in 2005. The higher urban households' propensity to save can be explained by the rising cost of social services: if we look at the breakdown of urban household consumption, we will see significant increases in spending since the 1990s on education, healthcare, housing, transportation and telecommunications.

It is also interesting to note some of the latest findings of the 4Q06 Survey on Urban Household Savings by the People's Bank of China: First, households' satisfaction over present income evidently increased and confidence in future income reached a new high. Second, 60% of urban households considered the current level of prices 'relatively high'. Households' price expectation was not optimistic too: 50.8% of households were expecting higher prices, and the future price expectation index reached 48.2%, the highest since the first survey in 1999. Third, more than 40% of urban households regarded the interest rates of deposits as 'appropriate'. However, the proportion of households whose reason of saving were to earn interests decreased, and the proportion of households choosing to 'buy stocks' and funds' reached the highest level ever. Fourth, purposes and uses of urban households' savings have changed modestly, as the traditional precautionary savings for education, retirement and health care, unemployment and accident sharply decreased simultaneously for the first time.

4. Rural households starting to contribute more to domestic consumption than before

In order to create a harmonious society and boost rural consumption, the government accelerated the market building projects such as "thousands of rural villages" and adopted favorable tax policies in the rural area. These policies have greatly improved farmers' income and retail sales in rural areas.

With the expectation of more government's policies to stimulate domestic consumption this year, precautionary saving in rural areas should gradually decline as a result, and rural retail sales is expected to contribute more to domestic consumption. In fact, the saving rate of rural households was at a stable 15% to 16% during 2000-2004 before falling to 11% in 2005 — about the same time when the central government started to implement a series of rural-favoured policies to improve rural living standards.

5. Growths in FAI, industrial output and M2 eased

FAI growth has been slowing down throughout the year, from 29.8% yoy in 1H06, to 27.3% in Jan-Sept 06, to 24% yoy in FY06. Growth of industrial output also decelerated, from 19.5% yoy in June to 14.7% yoy in December.

M2 growth was 16.9 % yoy in 2006, basically matched the central bank's target of 16% yoy. However, banks extended 3.18 trillion yuan of new loans in 2006, significantly exceeding the central bank's original target of 2.5 trillion yuan.

III. Outlook

1. Economic growth is likely to moderate as a result of tightening measures

Though FAI growth eased last year, it is still likely that the government will launch a series of tightening measures this year. The government is, at least, still highly concerned about the speculative bubbles in the property market, the soaring stock prices, the CPI fluctuation, as well as the possible resurgence of high FAI growth. Besides, more and more people are now speculating that, if raising the required reserve ratio for commercial banks is ineffective in curbing excessive growths, the central government will resort to raising interest rates.

The most probable scenario, therefore, is that although the Chinese economy will maintain robust this year, the GDP growth will be a bit lower than last year — slightly below 10% yoy in 2007, with inflation remaining mild, FAI growth declining to around 20% yoy, and M1 and M2 growth rates remaining stable.

2. The economy will gradually become more consumption-driven, less investment-driven

Retail sales in China grew strongly for the whole 2006 and accelerated noticeably in October. Some economists suggested that domestic consumption will gradually become the main growth engine of the Chinese economy, with investment growth expected to decelerate. This view is in line with the government's thinking that consumption, rather than investment, should become the major engine of economic growth by 2020.

Although the economy in 2006 was still more 'investment-driven' than 'consumption-driven' — one important manifestation was the higher growth rates of FAI over retail sales of consumer goods, we are expecting a shift in the balance gradually. FAI growth is likely to slow down steadily in the foreseeable future, against the background of more conservative fiscal policy and monetary policy than before, as well as a series of tightening measures designed to curb 'overheated' and 'non-preferred' investment. On the other hand, we will continue to see the macro-economic and structural factors leading to consumption growth and consumption upgrading of the Chinese people, as well as more upcoming government policies to strengthen income growth and encourage consumption, especially in the rural areas.

3. CPI Jump in December is unlikely to trigger an interest rate hike

December CPI jumped to 2.8% yoy, from only 1.9% yoy in November, raising fears of rate hikes and other tightening measures in early 2007. For example, JP Morgan has predicted that the recent jump in China's CPI, along with the excess liquidity and the growing risks of a liquidity-fuelled asset bubble, would prompt the central government to raise interest rates by 54 basis points in the coming months.

In fact, overall CPI in 2006 remained mild at 1.5% yoy. According to the NBS, the December increase was mainly caused by rising food prices. The implied core inflation (excluding food and fuel) has been extremely stable, not exceeding 1% yoy for the last 5 years, based on the estimation of UBS. Historically, the People's Bank of China has been very slow to raise lending or deposit rates if the core inflation was not moving. However, this does not mean that the People's Bank of China will not raise the rates at all. The inflationary pressures really exist owing to the combined pass-through of wages, food and mid-stream heavy industrial prices.

In January 2007, China's CPI grew by 2.2% yoy. Such a growth rate was 0.6 ppt lower than the December 2006 growth, and was 0.3 ppt lower than the market expectation. Again, the inflationary pressure mainly stems from the increases in food prices. The People's Bank of China warned that inflationary pressure was 'on the rise'.

The odds are that the People's Bank of China will monitor closely the CPI in February for further analysis, before taking any action to cool down the economy. It is suggested that, if the CPI growth exceeds the 3% mark in January and February, the central bank is likely to raise the interest rate.

4. The January PMI suggested a steady growth of the manufacturing sector

The January PMI and its sub-indices indicate that the manufacturing sector, and the economy in general, is growing steadily. It stayed above 50% for the 25th consecutive month, i.e. over two years, since its launch in January 2005. The January PMI rose to 55.1%, with indices of new orders, new export orders, imports, input prices, stock of major inputs, purchases of inputs and suppliers' delivery time expanding. The falling index was stocks of finished goods. High level of input prices and rising transportation costs remained major concerns for manufacturers. Orders for machinery remain strong, largely due to strong demand from infrastructure development.

Overall, PMI indicates that the slowdown in the sector during the summer last year, which was caused mainly by credit contraction and investment curbs by the government, has been reversing. Moreover, the PMI data shows that the driver of economic growth is increasingly shifting away from the more export-oriented industries, such as communications and electronics, garments, and wood and furniture, towards industries more gearing for domestic consumption and investment demand, such as beverages, tobacco, machinery and automobiles.

The PMI provides an early indication each month of economic activities in the manufacturing sector. A PMI reading above 50% indicates an overall expansion in the manufacturing sector; below 50%, an overall contraction.

5. Entrepreneurs become more optimistic

The 4Q06 ECI indicates that most entrepreneurs become more optimistic about their business outlook. The Entrepreneur Confidence Index (ECI) in 4Q06 rose to 135.3, 2.7 ppts higher than 3Q06. The index was the highest in 2006, and was 9.9 ppts higher than 4Q05.

Exhibit 3: Entrepreneur Confidence Index in 4Q06

Entrepreneur Confidence Index (ECI)	4Q06	3Q06	2Q06	1Q06	Compared with the previous quarter
National	135.3	132.6	132.5	133.1	Higher
By sector					
Manufacturing	133.1	128.3	129.7	128.2	Higher
Construction	131.2	132.9	130.9	132.4	Lower
Transportation, storage & post service	129.8	128	123.5	133.8	Higher
Wholesale & retail	136.1	134.2	134.9	137.2	Higher
Social services	130.6	135.3	135.3	133.9	Lower
Information transmission, computer service and software	156.2	154.6	149.7	155.8	Higher
Hotel & catering	134.6	131.3	126.9	127.8	Higher
Property	133.3	131	132.7	134.7	Higher
Electricity, gas & water	141.1	140.2	138.2	138.2	Higher

Source: National Bureau of Statistic, PRC

Part Two: Foreign Trade

I. Recent developments

Exhibit 4: Foreign Trade of China in Jan – Dec 2006

Item	Value (USD billion)	yoy growth (%)
Total of Imports and Exports	1,760.7	23.8
Exports	969.1	27.2
Of which:		
General Trade	416.3	32.1
Processing Trade	510.4	22.5
Imports	791.6	20.0
Of which:		
General Trade	333.1	19.1
Processing Trade	321.5	17.3

Source: Chinese Customs

1. Trade surplus hit record in 2006

China's trade surplus in 2006 surpassed last year's total to reach USD 177 billion. In 2006, China's exports rose by 27.2% yoy to USD 969 billion, up from 26.5% yoy in 1-3Q06; imports grew by 20% yoy to USD 791.6 billion in 2006, down from the 21.7% yoy growth rate in 1-3Q06. Trade surplus in 2006 ballooned as exports continued to outpace imports. Moreover, the policy-induced investment slowdown has widened the trade surplus by reducing imports and diverting some production to export-oriented markets. The strengthening of the yuan over the year seemed to have limited impact on reducing the trade surplus.

China's trade surplus in December was USD 21 billion, stepping down from the monthly record of USD 23.8 billion in October and USD 22.9 billion in November. The decline was attributable to the abolition and reduction of export tax rebate for a range of major export goods that started to take effect in mid-September.

The faster growth of export in 4Q06 benefited partly from the fall in oil prices that boosted the consumption around the world, especially in the US. According to the GDP report by the US government, consumer spending in the US, the biggest importer of Chinese goods, increased at a 4.4% annual rate in 4Q06, much higher than the 2.8% in 3Q06 and the 2.6% in 2Q06, and was much better than the market expectations. Japan, another important export destination of Chinese goods, also saw its consumption rebounding.

Exhibit 5: Foreign Trade of China, 2006 monthly figures

Exports	Value (USD billion)	yoy growth (%)
January	65.0	28.1
February	54.1	22.3
March	78.1	28.3
April	76.9	23.9
May	73.1	25.1
June	81.3	23.3
July	80.3	22.6
August	90.8	32.8
September	91.6	30.6
October	88.1	29.5
November	95.8	32.7
December	94.1	24.8
Imports	Value (USD billion)	yoy growth (%)
January	55.5	25.4
February	51.6	29.6
March	66.9	21.2
April	66.4	15.3
May	60.1	21.7
June	66.8	18.9
July	65.7	19.7
August	72.0	24.6
September	76.3	22.0
October	64.3	14.7
November	72.9	18.3
December	73.1	13.5

Source: Chinese Customs

2. Growth of processing trade¹ in both imports and exports decreased in 2006

In 2006, exports under processing trade grew by 22.5% yoy to USD 362.5 billion, 4.5 pts slower than the yoy growth of 2005; imports increased by 17.3% yoy to USD 321.5 billion, 6.0 pts lower than the previous year. Under general trade², exports grew by 32.1% yoy to USD 416.3 billion, 2.8 pts faster than 2005, while imports increased by 19.1% yoy to USD 333.1 billion, 6.4 pts higher than the yoy growth of 2005. Though the cut in export tax rebate involved both export goods under general trade and processing trade, the policy change had a much stronger negative impact on the latter. The reduction in export tax rebate significantly affected the productions costs and profits of export processing enterprises. Enterprises had to shut down operation lines or raise export prices in order to maintain their profit levels. This largely explained the reduced growth of exports under processing trade last year.

¹ Processing trade refers to the business activity of importing all or part of the raw and auxiliary materials, parts and components, accessories, and packaging materials from abroad, and re-exporting the finished products after processing or assembling by enterprises within the Chinese Mainland.

² General trade refers to the import or export of goods by enterprises in China with import-export rights. According to the Chinese statistics, the scope of general trade covers: imports and exports using loans or aids; the imports of materials by foreign invested enterprises (FIEs) for processing of goods for sale in the domestic market; the export of goods purchased by FIEs or manufactured by processing domestically-produced materials; the imports of food and beverages by restaurants and hotels; the supply of domestically-produced fuel, materials, parts and components to foreign vessels or aircraft; the import of goods as payment in kind in lieu of wages in labour service cooperation projects with foreign countries; and the export of equipment and materials by enterprises in China for their investment abroad.

II. Highlights

1. Exports of coal, crude oil and refined oil declined, but steel continued to rise

Export volume of coal in 2006 declined by 11.7% yoy to 63.3 million tons, as the government abolished the export tax rebate for coal in September. With rising domestic demand for crude oil and refined oil, as well as the change in export tax rebate, China's export volume of crude oil decreased by 21.4% yoy to 6.3 million tons and refined oil by 11.9% yoy to 12.4 million tons.

Export volume of steel increased by 109.6% yoy to 43 million tons in 2006. To slowdown the production of energy- and resource-intensive steel products, the government cut the export tax rebate rate for steel products three times in 2006, from above 15% to 8% in September, and stopped providing subsidies to steel producers. However, steel export growth continued to rise rapidly, from 47.7% yoy in 1H06, to 81% yoy in 1-3Q06 and reached over 100% yoy in FY2006. The surge in steel exports in 2006 could partly be explained by the overheated investment and thus overcapacity in the sector — much of the excess supply was therefore diverted to exports. The NDRC predicted that, in 2007, China will see a more balanced situation of domestic supply and demand for steel, and steel price will remain close to last year's level. Export value of garments & clothing accessories in 2006 grew by 28.9% yoy to USD 95.2 billion, and the growth rate was 1.3 pts higher than that of 1-3Q06. Export of textile materials & products grew by 18.2% yoy to USD 48.8 billion in 2006 — the export was somehow limited by the EU quotas imposition on Chinese textile products. Footwear grew by 14.5% yoy to USD 21.8 billion in 2006, down from 15.8% yoy in 1-3Q06. In October, the EU turned the provisional anti-dumping duties on Chinese footwear to a fixed one for the next two years, which may explain the drop in growth. However, the effect of these protectionist measures on overall exports was limited, as the growth focus of Chinese exports had gradually been shifting from these light-manufacturing sectors to other sectors, in particular, the steel sector. On the other hand, the growing domestic consumption has also been helping to alleviate the potential degree of trade frictions.

Exhibit 6: Exports by category

Exports	Jan-Dec 2006	Jan-Dec 2005	
Volume	million tones	million tones	yoy growth %
Coal	63.3	71.7	-11.7
Crude oil	6.3	8.1	-21.4
Refined oil	12.4	14.0	-11.9
Steel	43.0	20.5	109.6
Value	USD billion	USD billion	yoy growth %
Textile materials & products	48.8	41.1	18.2
Garments & clothing accessories	95.2	73.9	28.9
Footwear	21.8	19.1	14.5
Toys	7.1	6.6	7.5

Source: Chinese Customs

2. Imports of steel continued to slow; vehicles and refined oil picked up

Import volume of steel dropped by 28.3% yoy to 18.5 million tons in 2006, a big contrast to the 18.4% yoy growth rate in 2005. It is noteworthy that, as a net steel exporter in 2006, China had a steel export surplus (i.e. net exports) of 24.5 million tons, which was equal to 57% of the total steel export volume; The steel export surplus in terms of value, however, was only equal to 6% of the total steel export value. This implies that China's steel exports, in general, were still mostly of lower value and lower quality, and imports were mostly of higher value and quality, despite the upgrading structure of China's steel exports in recent years.

In 2006, imports of vehicles and related parts grew by 40.7% yoy to 229,000 units, or by 47% yoy to USD 7.52 billion. The growth was supported by the robust growth of the economy and household income. Imported cars made up 3.1% of the Chinese automobile sales market. Effective from July 2006, tariffs on cars and mini-buses were lowered from 28% to 25%; tariffs on imports of spare parts were reduced from 13.8-16.4% to 10%. Given the lower tariffs, it is predicted that there is much room for growth in China's imported car market, in particular high-end automobiles.

In 2006, China imported 36.4 million tons of refined oil, up by 15.7% yoy, 1.3 ppts lower than 2005. Note that the growth decelerated in 4Q06, compared with the growth rate of 25.5% yoy in 1-3Q06. China also imported 145.18 million tons of crude oil with a yoy increase of 14.5%, 11.2 ppts higher than in 2005. Again, the growth decelerated in 4Q06, compared with the growth rate of 16.3% yoy in 1-3Q06.

The marked acceleration in the growth of imported crude oil in 2006 showed that the domestically extracted crude oil was far from sufficient to fulfill the huge demand of the rapidly growing Chinese economy. In fact, China's dependency for imported oil rose to 47% of its annual demand in 2006, an increase of 4.1 ppts from the previous year, according to the Ministry of Commerce. The decline in oil prices in the latter half of 2006 also contributed to the higher growth in imported crude oil. The decline in oil prices has also helped China in building up its strategic reserves at a lower cost, with storage capacity aimed at three months' worth of consumption.

Some industry observers forecast that, in 2007, China's crude oil output will grow by less than 2%, while demand for both crude and oil products will rise by around 6%. If they are correct, imports will continue to grow fast this year.

Exhibit 7: Imports by category

Imports	Jan-Dec 2006	Jan-Dec 2005	
Volume	million tones	million tones	yoy growth %
Cereal & cereal flour	3.6	6.3	-42.7
Soybean	28.3	26.6	6.3
Iron ore	326.3	275.2	18.6
Crude oil	145.2	126.8	14.5
Refined oil	36.4	31.4	15.7
Steel	18.5	25.8	-28.3
Synthetic yarn (1000 tons)	710.0	750.0	-5.7
Vehicles and related parts (1000 units)	229.0	163.0	40.7

Source: Chinese Customs

3. Trade deficits with Asian countries increased but trade surpluses from the US also increased

China continued to register large trade deficits with Asian countries but huge trade surpluses with the US and the EU in 2006. According to the Chinese Customs figures, total trade deficits with Japan, Korea and Taiwan reached USD 135.8 billion in 2006, up from USD 116.3 billion in 2005. On the other hand, trade surplus with the US and EU reached USD 234 billion in 2006, up from USD 184.3 billion in 2005. Tariff reduction by the government was one reason behind the accelerating growth of imports from those Asian countries. Moreover, as China was actually importing raw materials, components and semi-finished goods from the Asian countries while exporting finished goods to the US and the EU, part of the Sino-US or Sino-EU trade surpluses were actually 'transferred' from the trade accounts of the Asian countries to the trade account of China..

Exhibit 8: Major Export Destinations, Jan – Dec 2006

Country/Region	Export value (USD billion)	year-on-year growth (%)
US	203.5	24.9
EU	180.0	26.6
Germany	40.3	23.9
Holland	30.9	24.8
UK	24.2	27.3
Hong Kong	155.4	24.8
Japan	91.6	9.1
Korea	44.5	26.8
Singapore	23.2	39.4
Taiwan	20.7	25.3

Source: Chinese Customs

Exhibit 9: Major Import Origins, Jan – Dec 2006

Country/Region	Import value (USD billion)	year-on-year growth (%)
Japan	115.7	15.2
EU	90.3	22.7
Germany	37.9	23.3
Korea	89.8	16.9
Taiwan	87.1	16.6
US	59.2	21.8
Malaysia	23.6	17.3
Australia	19.3	19.3
Russia	17.6	10.5
Singapore	17.7	7.0

Source: Chinese Customs

4. Guangdong, Jiangsu and Shanghai accounted for 59% of China's foreign trade

In 2006, total value of exports and imports of Guangdong was USD 527 billion, up 23.2% yoy, accounted for nearly 30% of China's total foreign trade. Total value of exports and imports of Jiangsu was USD 284 billion, up 24.6% yoy, 16.1% of China's total foreign trade. Total value of exports and imports of Shanghai was USD 227.5 billion, up 22.1% yoy, 12.9% of China's total foreign trade.

5. Foreign Direct Investment (FDI) grew moderately

In 2006, China received USD 63 billion of utilized FDI, achieving a 4.47% yoy growth, compared to the -0.5% yoy growth in 2005. However, the number of newly established enterprises with FDI dropped to 41,485, 5.76% lower than in 2005. Rising labor cost in China, competition from India and Russia, increasing international trade protectionist sentiments, and Chinese government policies (such as unification of the tax rates for foreign and domestic enterprises) are some of the factors leading to the drop in the number of newly established enterprises with FDI.

Government efforts to achieve industrial upgrading, especially through better utilization of foreign capital, are also affecting the FDI development in China. In order to match with the target set out in the 11th five-year programme about the utilization of foreign investment, the government has put more emphasis on the quality rather than quantity of FDI. Favourable policies will increasingly be tilted towards foreign investment in new horizons such as R&D, hi-tech, sophisticated design and high value-added services, away from the traditional areas such as simple processing, assembly and low value-added manufacturing.

Exhibit 10: Major Sources of Utilized FDI in China, Jan-Dec 2006

Country/ Region	Utilized FDI (USD million)	Utilized FDI		
		yoy growth (%)	Proportion of Total Utilized FDI (%)	% yoy Change in Proportion
Total	63,021	4.47	100	–
Total of 10 Asian countries/regions³	34,498	-2.37	54.7	-3.8
Of which				
Hong Kong	20,233	12.73	32.11	2.36
Japan	4,598	-29.58	7.3	-3.52
Korea	3,895	-24.64	6.18	-2.39
Taiwan	2,136	-0.74	3.39	-0.18
Singapore	2,260	2.55	3.59	-0.06
EU	5,324	2.51	8.45	-0.16
Of which				
Germany	1,979	29.32	3.14	0.6
Holland	841	-19.41	1.33	-0.4
US	2,865	-6.41	4.55	-0.52
Virgin Islands	11,248	24.67	17.8	2.89
Cayman Islands	2,095	7.6	3.33	0.1
Samoan	1,538	12.99	2.44	0.18

Source: Ministry of Commerce, PRC

³ The 10 Asian countries/regions include Hong Kong, Indonesia, Japan, Macau, Malaysia, Philippines, Singapore, Korea, Thailand and Taiwan.

III. Outlook

1. Stable global economic growth although risks remain

The global economy has been expanding for the past 4 years. According to the IMF forecast, world economy is expected to grow by 4.9% in 2007, down from 5.1% in 2006; world trade is expected to grow by 7.6% in 2007, down from 8.9% in 2006. Although the world economy is expected to grow for the 5th consecutive year, there are still major downside risks around the globe, such as global imbalance, instability of financial markets, possible rising world interest rates, tighter monetary conditions, exchange rate volatility and a sharper-than-expected slowdown in the US economy. However, as the most recent figures shows that the international oil prices remained at a relatively low level, the US economy was still growing moderately, and the rise in the US trade deficits was being contained temporarily, the short-term risk is quite low at the moment.

2. The uncertain status of the US economy

With the US being the biggest export destination of China, its economic performance has significant impact on China's trade performance. According to the estimations by Goldman Sachs, in the worst scenario — a US hard landing, China's export will record negative growth in 2007; while in the most bullish scenario — a US soft landing, China's annual export growth in by the end of 2007 will drop by about 6 pts, compared to the export growth in 1Q06.

The US economy in 4Q06 achieved a better-than-expected growth of 3.5%, compared to 2.6% in the 2nd quarter and 2.0% in the 3rd quarter. In 2006, unemployment rate fell and salary rose at their quickest pace in five years. The rapidly growing service industries, which employ about 80% of the US labour force, add fuel to consumer spending, which accounts for 70% of the US\$13.1 trillion economy of the US.

However, housing is likely to remain a drag on consumption as well as the US economic growth. The US housing market has already showed signs of cooling down after a prolonged period of boom. The slowdown in the housing market, if sustained, could have serious impact on consumers' sentiment and their ability to spend, due to the negative wealth effect and the weakened ability to re-mortgage their houses. China's export growth would be adversely affected, as a result.

3. Eurozone is keeping up its growth pace

The European Union (EU) — another China's major trading partner, is expected to record steady growth this year, with the Eurozone economy — which represents the majority of the EU economy — expected to register much stronger growth this year than previously forecasted. The European Commission Economics Chief recently suggested that expansion in the eurozone economy this year could be far higher than his previous forecast because of the unexpectedly strong growth in Germany. The latest forecast was that the eurozone economy would grow by 2.6% this year — almost identical to that achieved in 2006 — compared with the previous forecast of 0.6% in November 2006. The sustained GDP growth, combined with a relatively low unemployment rate across EU nations, suggests that consumer spending in the EU should remain steady this year.

Factors that might hamper growth in the EU include the fiscal deficits reduction; rising interest rates; the 3 pts increase in VAT in Germany (effective from January 2007); and the inclusions of Bulgaria and Romania into the EU in January 2007.

4. The growth of China's export will moderate, and import will maintain strong growth momentum in 2007

It is unlikely that China's export will post the same high growth this year as in 2006, due to the following factors: the slower economic growth in the US; the rise in protectionist sentiments and the increase in international trade frictions; RMB appreciation, slowdown in FDI (which has been contributing greatly to China's exports), government policies to discourage low value-added export-processing activities; the shifting in growth focuses of the Chinese economy from 'investment-led' and 'export-led' to 'consumption-driven'.

On the other hand, import will continue to be strong this year, supported by factors such as RMB appreciation; the robust increase in household income; the emerging middle class; government policies to boost consumption; the influx of foreign consumer goods (especially branded products) and their increasing popularity in the markets. Therefore, we expect to see import growth catching up or even surpassing the export growth this year – and thus trade surplus will grow slower or even decrease this year.



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The Centre has been actively promoting the application of SCM. In 2003, the Centre published the book “*The Orchestrator of Global Supply Chain Management*”, which is regarded as a very useful reference among businessmen and academics in the Chinese mainland, Taiwan and Hong Kong.

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