

# LI & FUNG China Trade Quarterly

## – Domestic and Foreign

May 2007 Issue 6

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### Domestic Trade

**Robust retail sales in Jan-Apr 07.** In the first quarter of 2007, China's total retail sales grew by 14.9% yoy in nominal terms to 2,118 billion yuan, higher than the average growth of 13.7% yoy in 2006. In April, it recorded a growth of 15.5% yoy. Government efforts to promote the service sector and the Beijing Olympic Games will bring huge potential for the domestic service trade.

**Urban and rural residents' income grew robustly.** In 1Q07, the per capita disposable income of urban households rose to 3,935 yuan, up by 16.6% yoy in real terms. The per capita net income of rural residents was 1,260 yuan, up by 12.1% yoy. The rural income growth rate was the highest in 10 years, due to strong economic growth and government policies to boost income.

**Government directions to build a "harmonious society"** under the guidance of the "scientific development perspective" will improve economic structure and people's livelihood which, in turn, will boost domestic consumption in the longer run.

**Accelerating expansion of the service sector.** In 1Q07, the proportion of the value-added by tertiary industry in GDP increased to 41.9%, up from a weight of 39.5% in FY2006. The service sector is playing a more important role in the economy. This also meets the goal of the party leadership to restructure the economy towards the more environmental-friendly tertiary industries, at the expense of the energy-intensive and highly polluting secondary industries.

### Foreign Trade

**Trade surplus continued to grow strong but showed downward trend.** Contrary to earlier predictions that the growth of trade surplus would slowdown, China's trade surplus widened to USD 46.4 billion in 1Q07 from USD 23.3 billion in 1Q06. The April surplus hit USD 16.88 billion, up 63% yoy. Export growth continued to outpace import growth in Jan-Apr 07.

**The EU surpassed the US to be the biggest importer of Chinese goods** in 1Q07, registering USD 51.5 billion in the amount of imports from China, up by 34.5% yoy. Such a growth rate was much higher than that of China's export to the US in the same period (20.4% yoy). Note that China and the EU is experiencing robust trade relations: The trade volume between China and the EU topped USD 75.4 billion in 1Q07, up 32% yoy. This is attributable to the strong Eurozone economic expansion (3.1% yoy in 1Q07).

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## Part One: Domestic Trade

### I. Recent developments

#### 1. Strong retail sales in the first quarter

Retail sales has been keeping up its robust momentum. In the first quarter of 2007, China's total retail sales grew by 14.9% yoy in nominal terms to 2,118 billion yuan, higher than the average growth of 13.7% yoy in 2006. In April, recorded a growth of 15.5% yoy. It marked a high of 16.9% yoy growth in February due to the Lunar New Year effect – higher than the yoy growth in any single month in 2006.

Urban retail sales of consumer goods grew by 15.5% yoy to reach 1,433.3 billion yuan; and rural retail sales by 13.7% yoy to 685.5 billion yuan. By sector, wholesale and retail trade rose by 14.7% yoy to 1,784.2 billion yuan, accounting for 84.2% of the total retail sales. Catering services sector grew by 17.4% yoy to hit 298.36 billion yuan, accounting for 14.1% of the total retail sales. Earlier the Ministry of Commerce forecasted that the retail sales of the catering services sector would hit 1.21 trillion yuan in 2007, the year before the Beijing Olympic Games. Government efforts to promote the service sector also bring huge potential for the catering services sector.

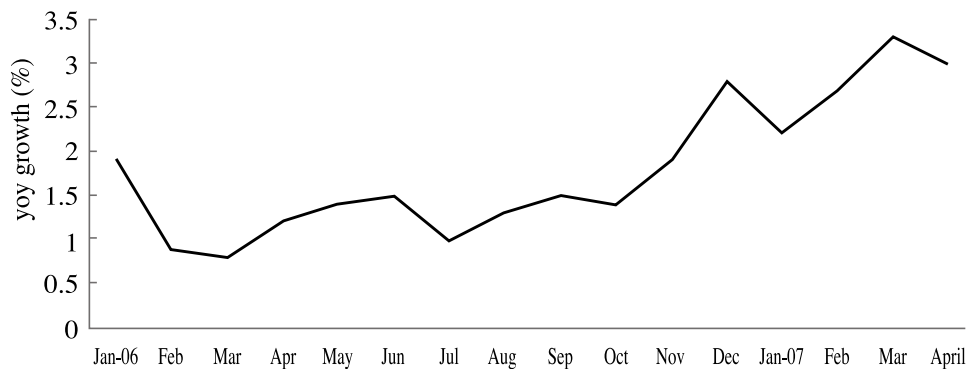
#### 2. Urban and rural residents' income grew robustly; the latter made a record growth in ten years

Both urban and rural residents' income grew in an accelerating rate, posting double-digit growths for the 5<sup>th</sup> quarter in a row. In the first quarter of 2007, the per capita disposable income of urban households rose to 3,935 yuan, up by 16.6% yoy in real terms. It was 5.8 ppts higher than that of the same period last year. The per capita net income of rural residents was 1,260 yuan, an increase of 166 yuan, up by 12.1% yoy, 0.6 ppt higher than the same period in 2006. The rural growth rate was the highest since 1997. The rapid income growth was a result of both strong economic growth and government policies to boost income. A variety of subsidies in education, social security and medical reforms, as well as the basic cost of living allowance system have lifted the financial burden of low-income people in both urban and rural areas. Last year, a system to provide basic cost of living allowances to rural residents introduced in 25 provinces. This year, the government is gradually setting up a nationwide basic minimum cost of living allowance system for rural residents, one of the major measures in the work to resolve issues related to agriculture.

#### 3. Consumer Price continued to rise since the beginning of the year

National Consumer Price Index (CPI) grew by 2.7% yoy in the first quarter of 2007, 1.5 ppts higher than that in the same period last year and 1.2 ppts higher than the average CPI growth in 2006. CPI growth has been on an upward trend since the beginning of the year: It grew by 2.2% yoy in January; 2.7% yoy in February; jumped to 3.3% yoy in March, higher than the official warning line of 3%. The April CPI remained high at 3%. The CPI growth was mainly driven by rises in food prices (6.2% yoy in 1Q07) and housing prices (3.8% yoy in 1Q07). The growth of food price has been accelerating: rising by 5.0% yoy in January, 6.0% yoy in February, 7.7% yoy in March and 7.1% yoy in April. According to the National Bureau of Statistics (NBS), excluding the food price would bring the CPI growth to 1.2% yoy in 1Q07; excluding the food and energy prices would bring the CPI growth to 0.9% yoy in 1Q07.

**Exhibit 1: China's Monthly Consumer Price Indices, Jan 2006–Apr 2007**

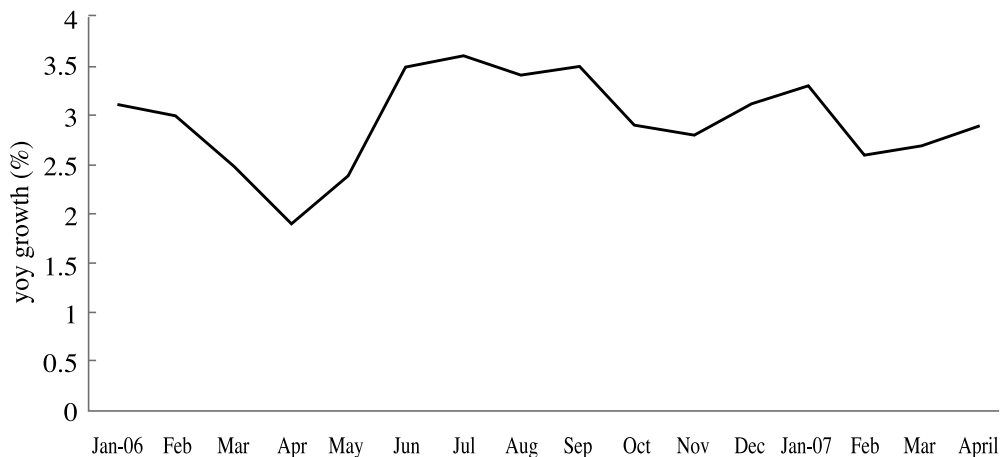


Source: National Bureau of Statistics, PRC

#### 4. Producer Price Index (PPI) rose by 2.9% yoy

Producer Price Index (PPI), an indicator for upstream prices, in the first quarter of 2007 registered a growth of 2.9% yoy, 0.1 ppt slower than the average growth of 2006 but 0.3 ppt faster than the same period in 2006. The monthly PPI growth has been steadily falling since mid-2004, rebounded remarkably in 2Q06, and stayed relatively stable in the range 2.8-3.6% yoy in Jun-Dec 2006. In 2007, monthly PPI growth reached 3.3% yoy, 2.6% yoy, 2.7% yoy & 2.9% yoy in January, February, March and April respectively. The PPI momentum was mainly driven by strong domestic demand and investment growth.

**Exhibit 2: China's Monthly Producer Price Indices, Jan 2006–Apr 2007**



Source: National Bureau of Statistic, PRC

## II. Highlights

### 1. Automobile sales steadily grow up

In the first quarter of 2007, national automobile sales rose by 22.2% yoy to 2.12 million vehicles. It continued the robust trend last year, which registered sales of 7.22 million units with a growth rate of 25.1% yoy.

According to the China Association of Automobile Manufacturers (CAAA), strong sales in March achieved a yoy growth of 17.0% and hit a record high of 847,200 units, which contributed most to the sales in 1Q07. The mom growth rates were -5.47%, -22.83% and 52.2% in January, February and March, respectively. Note that the negative mom growth in February was partly due to the week-long lunar new Year holiday and the fact that February had only 28 days.

A recent report by the CAAA observes four trends in the automobile industry:

- **Internationalization:** Over 10 giant, multinational companies have entered the market, and the majority of the 50 biggest auto-parts enterprises have set up factories in China.
- **Sustainable market growth:** After China's WTO entry in 2001, the market exhibited explosive growth in 2002-03. Though growth decelerated in 2004-06, it was still higher than the international average growth. In 2006, both production and sales of automobile grew by above 25%. The trend of growth has persisted, and is likely to persist in the foreseeable future.
- **Intensification of competition:** Price wars broke out due to fierce competition among the large number of competitors, both domestic and abroad. Besides, price, product quality and after-sales service have become more important in attracting customers.
- **Demand for individualized consumption:** Consumers are becoming more individualized, with multifarious demand. In the past two years, there were over 100 models per year sold in the market, with different design or functions. However, some industrial experts blame this phenomenon for harming the economies of scale in the industry.

It is also noteworthy that major car companies view China not only as a huge market but also an important base for manufacturing, outsourcing, export and research. In late April, General Motors (GM) announced in Shanghai that the company would double its production capacity in China by 2010.

According to a survey conducted by the central bank in February, the proportion of households (among 20,000 households surveyed) willing to buy automobiles in the next 3 months increased to 11.4%, a record high. Income groups with monthly income of CNY 2,000-5,000 and CNY 5,000-10,000 accounted for 37.5% and 30.9%, respectively, of the residents planned to purchase automobiles. These are the main groups of consumers that automobile sellers should be targeting.

Automobile sales in China are expected to keep its robust growth into the rest of 2007, boosted by the country's rapidly growing economy, rising household income, as well as foreign investment in enhancing production quality and capacity. It is estimated to reach over 8 million units in sales in 2007.

## **2. Property price rises, driven by capital inflow, especially foreign investment**

Despite a series of cooling measures, both fiscal (taxation) and monetary, the real estate market still recorded strong growth in the first quarter. According to the NBS and the National Development Reform and Commission (NDRC), property prices in the 70 surveyed cities grew since the beginning of 2007: 5.6% yoy in January, 5.3% yoy in February and 5.9% yoy in March. The prices were driven up by capital inflow, as well as the housing demand created by urbanization and income growth.

The cities recorded the highest growth rates of property prices in March were Shenzhen (12.8% yoy) and Beijing (9.3% yoy). Property prices in Shanghai recorded negative growth in 4Q06, but then recorded a mild growth in February (0.1% yoy) and March (0.4% yoy).

Prices of new homes in the 70 cities were up by 5.9% yoy and 6% yoy in February and March. Price rises for new homes in March were markedly higher in some big cities – 10.7% yoy in Shenzhen, 9.9% yoy in Beijing and 8.6% yoy in Guangzhou.

According to the NDRC, real estate investment totalled 354.38 billion yuan in the first quarter. The figure represents a first-quarter growth of 6.7% compared to the same period last year. Some central provinces, Henan and Anhui for example, saw jumps of 59.1% yoy and 52.4% yoy respectively. According to the NBS, urban investment in factories and real estate went up 25.3% yoy in 1Q2007, sustaining the 24.5% yoy growth of FY2006.

China's excess liquidity was driving up real estate development projects and housing prices. It is also noteworthy that foreign investors are buying commercial properties and high-end residential properties in China for investment purposes at an accelerating pace. Statistics from the NBS said that the real estate sector absorbed a record of USD 8.23 billion in foreign direct investment in 2006, up by 51.9% yoy over 2005. The influx of foreign capital into China's real estate market is one of the main reasons for the soaring prices.

It has been recognized by the government that curbing the rising housing prices through increasing the housing supply, building more economically affordable housing estate in particular, should be the emphasis of the macro-control measures in the real estate sector. For example, Beijing will build 10 million square meters of economical housing and 10 million square meters of price-limited housing in the next three years.

Other reasons for the high real-estate price rises in recent years lie in the defects of the policies involving market management, real-estate loan expansion, taxation in the land property sector and divergence of central and local interest. It is these maladies that have triggered the expansion of investment-oriented and speculation-gearred housing consumption. Heavy fines, therefore, is to be imposed on illegal acts. In late April, a draft law stated that developers in China property could face fines of up to 10% of the total budget of their projects if they try to build without permission or do not follow their plans. In addition, local government officials would be held responsible for improper property construction in their area directly. The central government would place emphasis on the accountability of local officials in maintaining an affordable level of property prices in the region. We foresee that administrative measures will play a more active role in curbing elevation of property prices.

Moreover, the surprisingly high growth in GDP and investment has led the central government to consider the next wave of tightening measures to cool down the economy, and property prices is very likely to be one of the main targets.

Looking ahead, fast growth in fixed asset investment, money supply and loans would still be the major factors fueling housing price rises for the rest of the year. The passing of private property protection law in March also boosts people's confidence in buying properties. As China's economy keeps growing and people with high and medium income are still keen to buy houses, housing prices is expected to rise in the second quarter of 2007.

### **3. China's Corporate Income Tax reform**

On 16 March 2007, the National People's Congress of the PRC approved and promulgated the Corporate Income Tax Law. The new tax law will come into effect on 1 January 2008.

Before the reform, domestic enterprises and foreign-invested enterprises (FIEs and thereafter) are subject to different tax rates, preferential policies and tax deductions. This places domestic enterprise in an unfavorable condition against foreign competitors in both domestic and international marketplace. The new tax law now standardizes the tax rate at 25%. It also unifies the tax deductions and preferential treatment, which will become industry-specific, rather than regional-specific.

Under the new tax law, the tax burden of the domestic manufacturers will be reduced, making them more competitive and giving them more room to cut prices. This, in turn, will benefit local consumers and facilitate domestic trade.

#### **4. Inflationary pressures exist but still under control**

In March, inflation accelerated to 3.3% yoy, the highest rate in more than two years. Inflation then decelerated a bit but still touched the 3.0% warning line in April. The PBOC has raised interest rate four times since April last year and increased required reserve ratios eight times in one year. Apart from that, it sold bills to soak up liquidity in the banking system and stem price increase. However, banks still made 1.4 trillion yuan of new loans in the first quarter alone, nearly half of the total for 2006. PBOC commented that the recent acceleration in inflation in China was normal because prices of primary goods and labour cost had increased substantially, and that inflationary pressure indeed existed but was not very unexpected. Based on the NBS figures, the CPI growth in 1Q07 should be reduced to 1.2% yoy, if the food price increase is stripped off.

As wholesale prices of agricultural goods in China soared by 7.8% yoy in March, the government has taken measures to slowdown the increase of food price, such as selling grains in auction and subsidizing farmers to boost the supply of food in the market.

If the CPI continues to stay above 3% warning line in May and June, coupled with loan acceleration and investment growth, new tightening measures are not unlikely to be implemented. At least one more interest rate hike and a few RRR increases are expected in 2H2007, if the inflation rate remains at similar levels. As rising inflation will result in a negative real interest rate environment that induce the flow of capital into the stock and property market, the government will try to control the price level within a tolerable limit, or increase the nominal interest rate in order to maintain the real interest rate level.

#### **5. Urban residents highly satisfied with income and optimistic – a record ever**

According to the results of a survey conducted by the PBOC in 50 large, medium and small cities with 20,000 questionnaires collected in February, in the first quarter, the proportion of urban residents that had perceived an increase in income was 8.7 ppts higher than that in 1Q06. Such an increase in proportion was the biggest since the launch of the survey. This is mainly due to the effects of a series of policies that help to raise people's income such as the minimum living allowance, salary reform of civil servants and those who will retire soon.

However, nearly 90% of the residents felt prices unreasonably high. Low- income group with monthly income below 2,000 yuan was more sensitive to price change than the higher income group, and was more dissatisfied with the higher price level. The proportion of urban residents surveyed with expectation over rising prices slipped to 44.3% in 1Q07, down from 50.8% in 4Q06, but still much higher than that of 1Q06 (28.7%).

The 1Q07 survey on urban household savings by the central bank also showed that, among 20,000 Chinese households surveyed in February, a record high of 30.3% said that they intended to invest their money on stocks and funds given the existing interest rate and price level, 11.7 ppts higher the previous quarter, consistent with the robust trend of the capital market. For the third quarter in a row, the proportion that treated deposited money in the bank as the primary financial asset declined to 59.4% in 1Q2007, the lowest record since the survey was launched. It was attributable to the negative real interest rate as well as the bullish stock market. 58.4% of households agreed that the interest rate for deposits was too low to attract their savings.

Overall the willingness to purchase properties in the future 3 months decreased in the first quarter. It was down to 16.5%, from 17.5% in the previous quarter. However, only households with monthly income below 2,000 yuan in some

cities revealed a drop in expectations to buy properties in the survey. The groups with monthly incomes of 2,000-5,000 yuan and 5,000-10,000 yuan showed the strongest will to buy properties. 43.6% of households in the former group and 22.1% of households in the latter group were preparing to purchase their properties.

The 1Q07 survey suggested that the domestic stock and property market would still keep growing for quite a while to come, as households are highly optimistic and satisfied with their rising income and, at the same time, the negative real interest rate and inflationary pressures make saving in the bank not an attractive option.

## **6. The economy was running a little bit faster, not overheating, but earlier tightening policy in the cycle would be preferred.**

In response to the robust economic growth and the strong figures for FAI, industrial output, money supply and export, China, the People's Bank of China on 18 May ordered banks to set aside more money as reserves for the eighth time, each time by a margin of 0.5 ppt, in 12 months to try to absorb money pumped into the economy by the export boom. Besides, the central bank also raised the benchmark deposit and lending interest rates for the fourth time since April last year. However, with the strong exports that keep pumping in liquidity and the negative real deposit rate, there is increasing concern that the asset bubbles are building up faster and faster. It is therefore suggested that the required reserve ratio has to be raised to, at least, 13% by the end of 2007 in order (just) to control the excessive liquidity.

To maintain the investors' confidence, both domestic and abroad, in the sustainability of China's market cycle, it is believed that the tightening policies would set in relatively early, given the determination of the Chinese government shown in its recent macroeconomic control measures. When we look back the announcements of the several interest rate elevations and reserve ratio hikes since the beginning of this year, the government seems more willing to resort to multiple strategies, both market and administrative, to cool down the economy, at a relatively earlier stage of the economic cycle. Based on the chosen dates (often weekends or a few days before long holiday) of the releases, the government also has the intention to exert minimal impact on the public psychologically. In brief, the Chinese government has become more mature in managing the macro-economy and the market.

## **III. Outlook**

### **1. Rural income would manage to increase against the background of favorable government policies**

Despite a remarkable leap in farmers' cash income in the first quarter, 12.1% yoy, the highest record since 1997, there is a question about the sustainability of the increase in rural income, as well as the growth in rural consumption.

Some Chinese academics estimate that the rural-urban gap would expand to 3.3:1 in 2007 from the ratios of 3.28:1 in 2006 and 3.22:1 in 2005, as urban income continues to grow faster than rural income. The per capita disposable income of urban households in 1Q07 grew by 16.6% yoy, 5.8 ppts faster than a year ago. In comparison, the per capita cash income of rural residents was 1,260 yuan, up by 12.1% yoy, 0.6 ppt higher than 1Q06. It is also noteworthy that, while urban CPI grew by 3.1% yoy, rural CPI rose by 3.6% yoy in 1Q07. Thus, rural residents have been facing slower income growth but faster inflation than urban residents.

Besides, the rise in grain prices late last year might not occur again this year. A significant increase in the grain harvest would also be difficult because last year's harvest was due to the extraordinary weather. The engine of rural income growth last year was fuelled by the wages of rural migrants working in cities – the monthly wages of rural migrants in cities rose by 9.9% yoy last year, but such kind of growth is sort of one-off. However, still, a brighter picture for the rural households is envisaged in the future, given the strong support from the central government such as subsidies and infrastructure development.

During the NPC held in March, the central government launched a series of measures to improve rural people's livelihood and support rural development. In fact, the Chinese government has released for the fourth year in a row its first set of government documents (the No. 1 document in 2007) focusing on the rural development solely.

Major policies to help the rural areas include: developing the rural finance, promoting rural cooperatives, reducing the access threshold for financial institutions into the rural market, continuing the shareholding reforms of the Agricultural Bank of China, conserving land use in rural area, guaranteeing the steady development of grain production, setting up a sound grain security warning system, expanding the logistics network of agricultural produce with the help of information system, training rural people to match the local needs, and strengthening agricultural science and technology to boost output. In brief, the government has explored multiple ways to increase rural incomes.

With the increase in income, rural people would contribute more to the domestic consumption, as well as facilitating the urbanization process.

## **2. Restructuring of the economy and the shifting to balanced development would encourage domestic consumption**

According to a report released by the Department of Fixed Assets Investments (DFAI) under the NDRC in early May, the central government's investment expenditure this year will focus on building a harmonious society; readjusting and optimizing structures; improving rural production and living conditions, increasing inputs in basic education, public health work and other social undertakings, and promoting the development of the Western China. The aim is to tackle the imbalance between urban and rural areas, among different regions, and between economic and social development, under the guidance of the "scientific development" principle.

In the report, it mentioned six major investment orientations of the central government in 2007:

- (1) Adjusting and optimizing production mix, directly improving rural production and living conditions
- (2) Spurring a coordinated growth of the socio-economy
- (3) Energy-saving, environmental protection and ecological development
- (4) Accelerating major infrastructure projects
- (5) Protecting the life and property, and vital interests of the general public
- (6) Independent innovation and industrial upgrading

The above policy directions to boost coordinated and harmonious development would help to motivate domestic consumption, especially in the rural and under-developed regions. It could be seen that the central government would like to restructure the economy industrial upgrading and innovations. Further interest rate hike will hurt domestic consumption and most importantly, put RMB under great pressures to appreciate. To avoid curbing domestic consumption, while solving the excess liquidity problem, economic restructuring is the only path in the medium and long run. As the government is putting more efforts and investment in expanding the service-oriented, high-tech and high value-added industries, we could expect a robust growth across these sectors in terms of domestic consumption.

## **3. Accelerating expansion of the service sector**

In 1Q07, the proportion of the value-added by tertiary industry in GDP increased to 41.9%, up from a weight of 39.5% in FY2006. The service sector is playing a more important role in the economy. This also meets the goal of the party leadership to restructure the economy towards the more environmental-friendly tertiary industries, at the expense of the energy-intensive and highly polluting secondary industries.

It is expected that the service sector will continue to outperform the national GDP growth rate, and become the dominant driver in the national economy, especially in the urban areas. In general, the sector captures around 70% of the GDP in developed countries. This is in line with China's future policy needs. Moreover, accelerating urbanization, continuous income growth and 2008 Beijing Olympics will also stimulate the demand for services in China. An expanding service sector and ballooning service consumption is thus anticipated soon.

#### 4. The May PMI moderates but still kept strong growth; the April PMI points to buoyant growth after a slowdown in 2H06

The rebound of PMI after January suggested that China's manufacturing sector was gathering momentum to grow faster. The PMI surged to 58.6% in April, up from 56.1% in March. It was the highest record ever since the launch of PMI in January 2005. For the second month in a row, PMI marked a rise of more than 2.5 pts. Except imports, stock of major inputs and backlogs of orders, all sub-indexes recorded higher readings than the previous month. Output, new orders, input price, purchase of inputs and new export orders entered the above-60% territory. Among them, the former 4 sub-indices reached their record levels since January 2005. Overall, the PMI and its sub-indices in April indicated an infrastructure-led reacceleration, buoyant manufacturing sector, rising domestic & foreign orders and increasing procurement activities. Input prices in April jumped to 64.9%, up from 58.3% in March, underlining higher production costs and a regaining of pricing power by upstream industries.

In May, the PMI dipped to 55.7%, down from the record high in April. Except input prices, all sub-indexes recorded lower readings than the previous month. Nonetheless, output, new orders and new export orders indices remained at high levels, indicating a still buoyant manufacturing sector. Despite the government's recent tightening measures in cooling down the economy, output and new orders index remained at the above-60% territory for the third month in a row. Upward pressures on input prices persisted in May. The PMI has stayed above 50% for the 29<sup>th</sup> consecutive month since its launch in January 2005.

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 are highly optimistic

The 1Q07 ECI indicates that most entrepreneurs are highly optimistic about the overall operation. The Entrepreneur Confidence Index (ECI) in 1Q07 rose to 142.0, 6.7 pts higher than that in 4Q06.

**Exhibit 3: Entrepreneur Confidence Index in 1Q07**

Entrepreneur Confidence Index (ECI)	1Q07	4Q06	Compared with the previous quarter
National By sector	142.0	135.3	Higher
Manufacturing	141.5	133.1	Higher
Construction	139.6	131.2	Higher
Transportation, storage & post service	137.2	129.8	Higher
Wholesale & retail	143.4	136.1	Higher
Social services	135.0	130.6	Higher
Information transmission, computer service and software	157.9	156.2	Higher
Hotel & catering	131.7	134.6	Lower
Property	137.3	133.3	Higher
Electricity, gas & water	140.7	141.1	Lower

Source: National Bureau of Statistic, PRC

## Part Two: Foreign Trade

### I. Recent developments

Exhibit 4: Foreign Trade of China in Jan - Mar 2007

Item	Value (USD billion)	yoy growth (%)
<b>Total of Imports and Exports</b>	457.7	23.3
<b>Exports</b>	252.1	27.8
Of which:		
General Trade	108.1	31.9
Processing Trade	133.0	24.0
<b>Imports</b>	205.7	18.2
Of which:		
General Trade	91.6	22.5
Processing Trade	78.6	10.9

Source: Chinese Customs

#### 1. Trade surplus continued to grow strong but showed downward trend

Contrary to earlier predictions that the growth of trade surplus would obviously slow down due to earlier export tax rebate policy since September 2006, China's trade surplus almost doubled in the first quarter over the same period last year – The quarterly surplus widened to USD 46.4 billion from USD 23.3 billion in 1Q06. Along the first four months of the year, there were dramatic ups-and-downs in the monthly records of trade surplus. In January, the trade surplus jumped 67% yoy to USD 15.9 billion. Even more surprising was the higher-than-expected increase in February that the trade surplus skyrocketed to USD 23.7 billion, almost tenfold from a year earlier. However, in March, the surplus plunged to USD 6.87 billion (-38% yoy), just about 29% of that recorded in February, much lower than many had estimated. The April surplus hit USD 16.88 billion, up 63% yoy. It brought the trade gap for the first four months to USD 63.3 billion, an increase of 88% yoy. The widening trade surplus stems from the fact that export growth continued to outpace import growth in the first four months of the year.

Despite the ballooning trade surplus in the first quarter (USD 46.4 billion) compared with 1Q06, it showed a moderate downward trend over 3Q06 (USD 48.7 billion) and 4Q06 (USD 67.7 billion). The trade surplus in March even went down to USD 6.8 billion, breaking the line below USD 10 billion for the first time since March 2006. The extraordinary increase in export in the first two months (33.0 % yoy in Jan; 51.7% yoy in Feb) of the year and the sharper-than-expected slowdown of yoy growth in March export was possibly a result of Chinese exporters' rushing to export their goods in January and February out of concerns over further reductions in export tax rebate.

The government has identified "promoting imports" as the key way to narrow the huge trade surplus, we expect to see import growth to accelerating for the rest of the year. From 1 April onward, Chinese firms would see formerly crucial import license lifted for imports in 338 categories. Moreover, in the Canton Fair (China Import and Export Fair), China's largest trade event held in April every year, the "imports section" was added in for the first time this year. In the past, the Canton Fair only focused on export. The government has also encouraged domestic companies to import state-of-the-art equipment and technologies. On the other hand, the government would continue to curb exports through discouraging low-end processing trade and upgrading the export structure. Since 20 May, China has applied export license management to 83 steel products to rein in the expanding steel exports and trade surplus. The above policy measures to encourage imports, while discourage exports (in particular, the low-end export processing trade) is likely to result in a decrease in trade surplus for the rest of the year.

**Exhibit 5: Foreign Trade of China, Jan - Apr 2007 monthly figures**

<b>Exports</b>	<b>Value (USD billion)</b>	<b>yoy growth (%)</b>
January	86.6	33.0
February	82.1	51.7
March	83.4	6.9
April	97.5	26.8
<b>Imports</b>	<b>Value (USD billion)</b>	<b>yoy growth (%)</b>
January	70.7	27.5
February	58.4	13.1
March	76.6	14.5
April	80.6	21.3

Source: Chinese Custom

## 2. Growth of processing trade<sup>1</sup> in export increased mildly; Import decelerated.

In the first quarter, exports under processing trade grew by 24.0% yoy to USD 133 billion, 1.5 pts faster than the yoy growth of 2006; imports increased by 10.9% yoy to USD 78.6 billion, 6.4 pts slower than the growth of last year. Under general trade<sup>2</sup>, export rose by 31.9% to USD 108.1 billion, 0.2 ppt lower than the 2006 yoy growth, while imports increased by 22.5% yoy to USD 91.6 billion, 3.4 pts higher than the 2006 yoy growth.

The accelerating growth of import under the general trade versus the decelerating import under the processing trade indicated the slowdown in importing raw materials and components for the purpose of re-exporting the finished-goods. Instead, import under general trade would still continue to grow and play a more important role in reducing the trade surplus, given the support of government policies.

The government aims to cut processing trade to narrow down the surplus. In addition to further reduction of export tax rebate on certain products highly involved in processing nature (for example, steel), the government tried to ban processing trade in more categories of chemical and resource products. A new policy took effect on 26 April, as the latest move to restrict the export of resource-intensive products and to balance trade. *The 2007 Prohibited List for Processing Trade*, which includes 186 new categories, bans processing trade enterprises from dealing in 990 products. On 12 April, the MOFCOM issued the *Circular on Issues concerning the Strengthening of Processing Trade Management*, calling on processing trade enterprises to optimize their structure, improve efficiency and make proprietary innovations. The circular is aimed at forbidding processing trade enterprises from engaging in the processing of high energy consumption, high pollution and low value-added products, thereby pushing forward the transformation and upgrading of the enterprises.

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 and crude oil declined, but export growth of steel accelerated in the first quarter

In the first quarter, export volume of coal declined by 31.9% yoy to 11.4 million tons, 15.5 pts lower than the same period last year and 20.2 pts yoy lower than the average growth of 2006. For the first time ever, imports of coal surpassed exports of coal in 1Q07. The decline of exports was partly due to the concern over protection of domestic energy resources and the avoidance of excessive energy-intensive processing that seriously pollute the environment. The government has scrapped tax rebates and levied export duties on coal, in order to discourage coal exports. In line with the government policies, China has streamlined its coal mining industry by closing thousands of small-scale mines since last year. Moreover, suspending the approval of coal mine projects which fail to meet the standard requirements has led to a sharp decline in the fixed asset investment in the industry. The downward trend of coal export is likely to continue into the rest of the year.

On the other hand, export of refined oil increased by 19.8% yoy in 1Q07. However, the country recorded an astonishing 70.3% yoy slump in crude oil exports in 1Q07. Crude exports in March were only 0.2 million tons, down 83.2% yoy. February export of Crude oil were even zero while January's export stood at 0.3 million tons. The soaring local demand for the fuel was the root cause of the decrease in crude oil exports. The crude oil exports are likely to fall for the rest of the year, especially with policies such as the temporary tariffs on the exports of crude and refined oil products.

In the first three months of 2007, export volume of steel soared 118.4% yoy to hit 14.1 million tons, 93.7 pts higher than the growth rate of the same period a year earlier. According to China Iron and Steel Association (CISA), China produced 114.7 million tons of crude steel and consumed 102.6 million tons of crude steel in 1Q07. In March, a monthly record of 40.16 million tons of steel was produced. The excess supply was therefore diverted to exports and caused the jump in export volume in the first quarter. The sudden surge in steel exports also indicated that some steel producers had rushed to export the products before the expected cut in the export tax rebate in the second quarter.

However, the continuous growth of steel export might not sustain. The ministry of finance announced in early April that it would reduce tax rebates on exports of selected high-end steel products such as stainless plate and cold-rolled steel sheet to 5% and completely remove the tax rebate on 83 steel products including hot-rolled steel sheet and section steel from 15 April and afterward. On 20 May, the government started to apply export license management to 83 steel products as an effort to rein in the expanding steel exports. In addition, despite the rapidly increasing demand for steel in the international market at the moment, it is expected that shortage of steel will alleviate in the second half of 2007. It is forecast that the world's market demand for steel products would grow significantly slower this year than in 2006. Given the pressures to limit China's steel export in the overseas market and the stricter macro-control to cut FAI and production capacity, there should be a gradual slowdown in China's steel exports for the rest of this year. Thus the focus of China's steel export should be shifted from quantity growth to the optimization of export product mix. Moreover, a decline of domestic steel price would happen in China in 2H07 if exports of steel were limited because of problems such as overcapacity and trade disputes.

### 2. Export growth of textiles, garments and clothing accessories, and footwear decelerated in the first quarter

Export value of textiles grew by 9.8% yoy to USD 11.1 billion, 10.7 pts lower than the growth of the first three months last year. The low-value-added textiles from China often spark trade disputes. The Chinese textile industry also worried that the government would cut the export tax rebates on textiles in the second quarter in order to help balance the country's trade surplus and force the industry to upgrade its export structure.

While China National Textile Industry Council lobbied to maintain the original rebate on textile products, it suggested that export tax rebates on garments could fall from 13% to 11%, instead of 13% to 9%. In the first quarter, export values of garments & clothing accessories rose by 17.6% yoy to 20.2 million tones, 5.4 pts lower than the yoy growth of 1Q06. It was estimated that the growth in garment exports would fall to as low as 10% if the tax rebate rates were cut by 2%; It would also take USD 1.6 billion from the revenues of garment exporters, if the growth rate of garment exports is around 15%.

In 1Q07, footwear exports grew by 16.7% yoy to USD 5.7 billion, 2.3 pts lower than the yoy growth rate in 1Q06. Toys exports rose by 23.9% yoy to USD 1.4 billion, 16.4 pts higher than the growth in the same period last year.

**Exhibit 6: Exports by category**

<b>Exports</b>	<b>Jan-Mar 2007</b>	<b>Jan-Mar 2006</b>	
<b>Volume</b>	million tones	million tones	yoy growth (%)
Coal	11.4	16.8	-31.9
Crude oil	0.5	1.7	-70.3
Refined oil	3.8	3.2	19.8
Steel	14.1	6.5	118.4
<b>Value</b>	USD billion	USD billion	yoy growth (%)
Textile materials & products	11.1	10.1	9.8
Garments & clothing accessories	20.2	17.2	17.6
Footwear	5.7	4.9	16.7
Toys	1.4	1.2	23.9

Source: Chinese Customs

### 3. Imports of steel dropped; Oil and vehicles' import decelerated;

Import volume of steel dropped by 7.4% yoy to 4.3 million tons in the first three months of 2007, already 15.3 pts and 20.9 pts higher than the growth rates in 1Q06 and FY06. The reduction rate decelerated. The decline was possibly due to the fact that the domestic steel industry has gradually upgraded the technology and improved the product quality, thereby reducing China's reliance on importing quality steel from overseas.

In the first quarter, imports of vehicles and related parts grew by 16.6% yoy to 58,800 units, 24.1 pts slower than the average growth of last year. The vehicle and auto industry had been viewed as one of the hardest-hit sectors by the massive vehicle imports with China's tariff cuts and the removal of quotas after the WTO accession. However, overseas-made vehicles failed to flood into China, as the Chinese government cut auto import tariffs in a gradual manner and granted most of its import quota to spare parts to prevent an over-domination of overseas-made vehicles. Besides, the government also encouraged foreign auto giants to team up with Chinese partners to speed up local production in a bid to curb massive vehicle imports. However, given the lower tariffs and low proportion of imported cars in the domestic market, there is still huge room for growth in imported cars, especially automobiles with famous brands.

Contrary to negative growth in crude oil exports, crude oil imports in the first quarter grew by 6.8% yoy to 39.7 million tons, 68 pts lower than the yoy growth in 1Q06. Oil prices have been fluctuating at a fairly high level due to the instability in the Middle East, as well as the difficulty in estimating the US oil reserves. However, high global energy prices will motivate energy conservation and utilization efficiency. The growth of oil imports may decelerate to around 10% yoy in 2007, compared with the 14.5% yoy growth in 2006, given the government's determination to increase energy conservation that brings down fuel consumption.

In a release on 4th May, PetroChina, the nation's biggest oil producer, claimed that it had made a world-scale discovery of a huge offshore field in Bohai Bay with proven reserves equivalent to about 10% of the country's oil and gas reserves. The finding of 405.07 million tons of oil equivalent, believed to be one of the biggest oil discoveries in China in the past 30 years, will help to ease China's strong demand for imported crude oil in the coming years.

In the same period, China imported 8.0 million tones of refined oil, down by 2.2% yoy, 3.6 pts lower than the yoy growth rate of 1Q06. In late April, China announced that it would maintain a strategic oil reserve amounting to the equivalent of 30 days of imports by the year 2010. As the current oil prices in the international market is still at a high level, China would be prudent in building up its strategic oil reserve and try not to induce sharp fluctuations in oil prices. China has decided to establish four strategic oil reserve bases: in Dalian, Qingdao, Ningbo and Zhoushan. Last but not least, on 10 April, the NRDC released the 11th Five-Year Plan for Energy Development, calling domestic enterprises to develop commercial reserves to reduce the adverse impact of rising oil prices on them in times of supply cuts.

#### Exhibit 7: Imports by category

Imports Volume	Jan-Mar 2007	Jan-Mar 2006	yoy growth (%)
	million tones	million tones	
Cereal & cereal flour	0.54	1.1	-51.0
Soybean	5.7	5.4	5.7
Iron ore	100.2	81.2	23.4
Crude oil	39.7	37.1	6.8
Refined oil	8.0	8.2	-2.2
Steel	4.3	4.6	-7.4
Synthetic yarn (1000 tons)	150.0	170.0	-7.2
Vehicles and related parts (1000 units)	58.8	50.4	16.6

Source: Chinese Customs

#### 4. The EU surpassed the US to be the biggest importer of Chinese goods in 1Q07

In 1Q07, the EU continued to be the biggest trading partner of China. Particularly noteworthy is that, in 2006, the US was still the biggest importer of Chinese goods; In 1Q07, however, the EU surpassed the US to be the no. 1 destination of Chinese goods, registering USD 51.5 billion in the amount of imports from China. The growth of Chinese exports to EU was 34.5% yoy, 13.7 pts higher than the yoy growth in 1Q06. Such a growth rate was also much higher than that of China's export to the US in 1Q07 (20.4% yoy). Note that China and the EU is experiencing robust trade relations: The Sino-EU trade volume in 1Q07 topped USD 75.4 billion in 1Q07, up 32% yoy. Despite trade frictions, it is expected that the EU will continue to import competitively priced inputs from China to lower the cost for European processing industries. On the other hand, China's growing number of middle-class consumers will increasingly become the target market for European businessmen.

Trade surplus with the US was USD 34.7 billion in 1Q07, up 21.3% yoy. China's trade surplus with the US amounted over USD \$144 billion in 2006, which aroused the discontent among pressure groups in the US. In the first quarter, trade disputes between China and the US has increased markedly.

In early May, a Chinese business delegation made a 24-state US tour to sign deals with US enterprises in a move to narrow the trade gap between the two countries and as a preparation for the Sino-US Strategic Economic Dialogue later in the same month. The Chinese delegation, headed by the Vice-Minister of the Ministry of Commerce Ma Xiuhong, has signed USD 32.6 billion worth of deals so far, mainly for US high-tech and IT products, revealing the trend that China would like to expand imports, especially electronic and high-tech items.

On 30 March, the US Department of Commerce announced that a preliminary decision has been made to apply the anti-subsidy law on some China imports. It would set a preliminary duty of 10.9% to 20.35% on the coated paper imported from China. The Commerce Department said that Chinese paper producers benefited from government grants, tax incentives, debt forgiveness and other unfair subsidies. It is worrying that the countervailing duty could be followed by similar action on Chinese steel, textiles and other products, especially because many US politicians and manufacturing think that cheap imports from China are harming the US industries.

Since 2006, China has replaced the US as Japan's biggest trading partner. Led by strong sales of electronic components to China, Japan continued to be the major exporter to China. In 1Q07, China's import origins from Japan valued at USD 29.7 billion, up 18.7% yoy. The growth rate was 5.1 ppts faster than the yoy growth in 1Q06.

**Exhibit 8: Major Export Destinations, Jan – Mar 2007**

Country/Region	Export value (USD billion)	year-on-year growth (%)
EU	51.5	34.5
Germany	10.4	15.9
Holland	9.1	38.9
UK	6.7	37.7
US	50.7	20.4
Hong Kong	38.8	26.4
Japan	23.3	11.0
Korea	12.1	29.0
Singapore	6.0	18.4
Taiwan	5.0	16.3

Source: Chinese Customs

**Exhibit 9: Major Import Origins, Jan – Mar 2007**

Country/Region	Import value (USD billion)	year-on-year growth (%)
Japan	29.7	18.7
EU	23.9	22.1
Germany	9.5	19.3
Korea	23.1	16.4
Taiwan	20.9	7.7
US	16.0	19.1
Malaysia	6.3	25.7
Australia	5.8	36.1
Russia	4.6	13.2
Singapore	4.2	-1.2

Source: Chinese Customs

**5. Foreign Direct Investment (FDI) rose, reversing last year's trend**

In the first quarter, China received USD 15.9 billion of utilized FDI, marking a growth of 11.6% yoy, after continuous monthly drops last year. The growth rate was 5.2 ppts higher than that of 1Q06. The number of newly established enterprises with FDI in the first three months was 9,497, up by 4.4% yoy. The upward trend was partly due to the more visible government policy direction towards FDI, especially after the passing of the law for unification of the tax rates for

foreign and domestic enterprises, as well as the government's determination in boosting FDI in service and high value-added sectors. It is believed that some foreign investors had been holding their investment in China last year before the picture was clear. With a number of favourable factors such as the strong economic expansion, growing consumer market and the 2008 Beijing Olympics, the FDI growth is likely to reach 10% this year, compared with the 4.5% growth in 2006.

During the National People's Congress in March, the government raised the corporate tax paid by foreign enterprises to 25% from 15% and lowered the rate from around 35% to 25% for domestic enterprises, in order to create a fair competition environment for both. However, the unification of corporate tax income was unlikely to have a great impact on FDI as China is such a big market with rapid urbanization and rising middle class that is accumulating wealth in an accelerating rate, not to mention there is 5-years transitional period for the foreign enterprises. It was also noteworthy that China was restructuring its economy through better utilizing the foreign investment. China was promoting FDI in high value-added manufacturing sectors while suspending approvals for foreign investments in high-pollution and low-efficiency ventures. It also encouraged FDI in service sectors such as railway, telecommunication, banking and finance that had previously excluded foreign investors. As government policy is paying more attention to the quality, rather than quantity, of the foreign investment, we expect to see FDI growing only steadily in the years to come, with the growth tilting towards the tertiary sector and the high-tech industries.

Geographically, foreign investors are being motivated to invest in the Western regions. Furthermore, they are encouraged to invest in seven industries: energy and chemicals; finance; mining; production of agricultural by-products, including dairy and sugar; manufacturing; high-tech; and tourism.

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**Exhibit 10: Major Sources of Utilized FDI in China, Jan-Mar 2007**


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Country/ Region	Utilized FDI			
	Utilized FDI (USD million)	yoy growth (%)	Proportion of Total Utilized FDI (%)	yoy Change in Proportion (ppt)
<b>Total</b>	15,892	11.56	100	–
<b>Total of 10 Asian countries/regions<sup>3</sup></b>	8,429	7.84	53.04	-1.83
Of which				
Hong Kong	4,958	18.87	31.20	1.92
Japan	1,116	-9.43	7.02	-1.63
Korea	909	-24.96	5.72	-2.78
Taiwan	352	-22.61	2.22	-0.98
Singapore	758	85.01	4.77	1.9
<b>EU</b>	952	-39.6	5.99	-5.08
Of which				
Germany	195	-74.92	1.23	-4.22
Holland	199	-0.81	1.25	-0.16
<b>US</b>	692	13.07	4.35	0.06
<b>Virgin Islands</b>	3,584	57.22	22.56	6.55
<b>Cayman Islands</b>	549	-6.09	3.45	-0.65
<b>Samoan</b>	442	29.32	2.78	0.38

Source: Ministry of Commerce, PRC

<sup>3</sup> 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

Despite the obvious slowdown in the US economy in 1Q07, the world economy was doing fairly well. This shows that the US is becoming a much less important driver of the world economic growth.

The housing slump in the US has not much real impact abroad. A pullback in the American demand might hurt growth of major economies such as China, Japan and Germany, which have been running huge trade surplus with the US. However, strong demand in other industrial nations has helped to offset the negative effect. While many developing countries are becoming less dependent on the US market as their export destination, they are in a better position to 'decouple' from the US economy and still sustain a strong growth if the US slowdown is only moderate. The world trade imbalance also improved due to the falling US dollar – the US currency has fallen 27% in the past five years.

The global economy as a whole is in the midst of its strongest period in more than a quarter century, as two big industrial powers – Germany and Japan, have rebounded to lead the economy in their region. Besides, China has continued to register above-10% growths and contributed to the world economy with its low cost, cheap labor and inputs. The latest China's manufacturing PMI shows that China's new export orders stayed high, indicating that overseas demand for Chinese products has remained strong. However, global trade imbalance, financial market instability, trade frictions and protectionism, pressures to raise world interest rates and fluctuations in oil prices are downside risks that would hinder the global economic growth, which in turn, would affect China's foreign trade adversely. Among all the factors, we should pay special attention to the possibility of spillover of financial risks from one region to the rest of the world, as there is an increase in stock-market volatility and the potential unraveling of the yen carry trade.

#### 2. The slowing US economy

Of particular concern to China's foreign trade outlook is the slowing US economy in the first quarter. US economy did not extend the growth momentum of the last quarter in 2006. The continuing theme of weak economic growth in the US due to a slumping housing market and rising consumer prices along with falling consumer confidence were all confirmed in the latest batch of reports - first quarter GDP growth, March home sales, and the latest measures of the mood of consumers all fell.

The US GDP increased at 1.3% annual rate in 1Q07, the weakest since the first quarter of 2003, mainly caused by the slump in home construction. Sales of existing homes fell 8.4 % in March to a seasonally adjusted annualized rate of 6.120 million, far below expectations. The Conference Board's Consumer Confidence Index fell to 104.0 in April following an upwardly revised reading of 108.2 in March. This is the lowest level since August 2006, the peak of the last summer's gasoline price surge. One-year inflation expectations rose, climbing from 4.9% to 5.2%. Inflation surged to the highest since 1991 caused by the jump in fuel prices. Core consumer prices  $\Delta$  which exclude food and energy – increased at a more moderate 2.2% annual pace, up from 1.8% in the fourth quarter of last year, above the Fed's 2.0% benchmark.

However, the other sets of US economic figures, mainly production and supply side factors, illustrated the reversing trend. In fact, US recorded a sharp increase (3.1% yoy, the biggest in 12 months) in manufacturing orders in March that may put an end to the deceleration of American manufacturing industry growth in one year. Moreover, core prices in the 12 months ended in April were up by 2.3%, the smallest gain in a year. The Institute for Supply Management's index (ISM index) of non-manufacturing businesses climbed to 63.0 in April from 60.5 in March. Growth in orders was the strongest in two years and an index of inventories rose to the highest level since the survey began nine years ago. As the services sector is the heart of the US economy where most of the new jobs are created, the economy in fact seemed gathering momentum again, despite the slowdown trend predicted earlier by the Federal Reserve.

The second half of the year would be crucial to determine if the US economy could manage a soft landing. A few more months of lower core consumer prices would give FED more latitude to reinvigorate the economy through monetary policies. The US domestic consumption seems not optimistic if there exists no room in lowering the interest rate, due to inflationary pressures in the coming months. More likely, it is beginning to see the impact of housing weakness on the overall US economy – weakness in personal consumption due to the waning real estate “wealth effect”. With consumption playing an ever-greater role in economic growth, to what extent consumption would slowdown as the housing market weakens continues to be the all important question. Alan Greenspan, the former Fed Chairman and the Fed economist James Kennedy, recently published an article estimating that home equity had served as a growing source of funds for American consumers from the early 1990s to 2005, when it financed close to 4% of total personal-consumption expenditures. In the latter part of 2006, however, it appeared to finance less consumer spending as the housing market began to slump. Despite the fact that no predictions were made in the paper, some economists further suggested that the wealth the nation’s consumers had extracted from their homes in recent years had a pronounced impact on their spending.

Therefore, given the continuous drop in the housing figures in the US, it is estimated that China’s export growth will be adversely affected due to a decrease in the willingness to consume among US consumers. However, if the US service sector continues to expand, the jobs created will drive consumers to spend more, offsetting some of the slack from a cooling housing market and higher energy cost.

### **3. Strong growth in the Eurozone**

The Eurozone economy rose by 2.6% yoy in 2006, the fastest in the six years. The growth momentum sustained in 2007 – the Eurozone grew at 3.1% yoy in 1Q07. The Eurozone economic expansion is likely to outpace the US growth this year, for the first time since 2001. The latest IMF estimates are that, in 2007, the euro region would grow by 2.3% yoy, surpassing the US growth predicted at 2.2% yoy. We now forecast a steady growth in the Eurozone this year, with growth staying at around 2.6%. The consumer spending outlook also seems optimistic.

As EU has replaced US as the biggest importer of China in the first quarter of 2007, the good prospect in its domestic consumption should benefit China’s exports significantly.

Downside risks of the Eurozone economy include rising inflation and interest rates, caused by the accelerating money supply growth; as well as higher labour cost, as requested by labour unions across Europe.

### **4. Looking ahead, China’s export is unlikely to pose stronger growth; but import growth is likely to accelerate**

Despite the strong export growth in the first quarter, it is likely that the growth would slowdown for the rest of the year, due to the following factors: the trade conflicts especially those with the US; the worldwide rise in protectionist sentiments; ban on processing trade; government policies in shifting from exporting low-ended processing goods to high-end as well as environmental-friendly and energy-saving goods; further reduction in export tax rebates as an effort to upgrade the export structure; the obvious slowdown in the US economy; the shifting in growth focuses of the Chinese economy from “investment-led” and “export-led” to “consumption-driven”; RMB appreciation.

On the contrary, import growth is likely to accelerate, given the government’s policy in promoting imports to curb the widening trade surplus. Moreover, the strong import growth are supported by factors such as the emerging middle class in China, accelerating rate of urbanization, increasing household income, robust domestic consumption, as well as the FDI rebound in China due to clearer policy direction after settling down the unification of corporate income taxes.

The increase in import, coupled with deceleration of export, would result in a slowdown in the growth of, or even a decline in, the trade surplus. Though the issue of huge trade surplus would be lingering for a while, an upgrading of the export structure, currently formulated in the country's strategic development, would help to solve the problem in the medium and long run. The "real", non-processing trade surplus is catching up with processing trade surplus, thanks to those capital-intensive exports. The upgrading of industrial and export structure is going to alter the current unsustainable trend, i.e., "trade surplus remains in China, while profits are captured by the US and Europe", a well-known comment by Bo Xilai.



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