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Domestic Trade

GDP maintained strong growth and consumption played a greater role in driving economic growth. In 2007, China's real GDP reached 11.4% yoy, up from 11.1% yoy in 2006. Note that consumption, for the first time in the past seven years, contributed more to the GDP growth than investment. The nominal growth of retail sales accelerated to 16.8% yoy in 2007. State Information Center predicted that retail sales growth would maintain at a level of 15.5%-15.8% yoy.

CPI growth hit new high in November since 1996. CPI was up by 4.8% yoy in 2007. Since August 2007, CPI growth has accelerated and stayed above 6% yoy. Price hikes of the food category was the main cause of the soaring CPI. We expect that CPI will continue to stay at high level in 2008.

Curbing overheating and inflation will be the most important task of 2008 – monetary policy shifted from prudent to tight. In 2008, we expect to see more interest rate hikes, but probably not as frequent as in 2007. RRR will be raised for a few more times and credit rationing will be used more frequently.

Foreign Trade

Trade surplus hit new high, but showed a decelerating growth. The annual trade surplus ballooned to US\$262.2 billion, up by 47.7% yoy from 2006. In 4Q07, the yoy trade surplus growth stepped down to a record low of 12.5%. China's export growth has moderated while import growth has accelerated.

Foreign exchange reserve ballooned and China remained the world's largest holder. In 2007, China's foreign exchange reserve reached US\$1.53 trillion, way ahead of Japan (US\$973.4 billion). The accumulation in 2007 was stunning—US\$461.9 billion relative to US\$247.5 billion in 2006, with foreign exchange reserve grew by 40.3% yoy.

RMB appreciation speeded up in 4Q07. RMB advanced 6.7% versus USD in 2007, compared with 3.3% in 2006. The government has hinted that RMB may appreciate at a faster pace in 2008 while the annual appreciation rate will probably be kept below 10%.

Fear of US recession is growing. The country is faced with still-slumping housing market, an escalating credit crunch and spiraling inflationary pressures. The recently released economic data was worse than expected. China's exports to the US may drop as a result.

Freda Tong, Timothy Cheung
Tel: (852) 2635 5593
fredatong@lf1937.com
timothycheung@lf1937.com

Li & Fung Research Centre
13/F, LiFung Centre,
2 On Ping Street, Shatin, Hong Kong
Tel : (852) 2635 5563
Fax : (852) 2635 1598
E-mail: lfdc@lf1937.com
<http://www.lifunggroup.com/>

Part one: Domestic trade

I. Recent developments

1. Retail sales posted strong and steady growth

In 2007, the nominal growth of China's retail sales of consumer goods accelerated to 16.8% yoy, up from 13.7% yoy in 2006. Overall, in 2007, total retail sales amounted to 8,921.0 billion yuan. Note that inflation was high in 2007. The real retail sales growth was estimated to be only around 12% in 2007, similar to that of 2006. Retail sales registered a strong and steady growth.

Retail sales was still mainly urban-driven. In 2007, urban retail sales reached 6,041.1 billion yuan, up by 17.2% yoy and 2.9 ppt higher than that of 2006. Rural retail sales, though still lagged behind, showed a faster pace of growth—rural retail sales totaled 2,879.9 billion in 2007, up by 15.8% yoy and 3.2 ppt higher than that of 2006.

High-income growth of both urban and rural households was one of the main drivers of retail sales. Besides, consumer confidence on future economic growth and expectation of higher inflation in 2008 has driven people to save less and increase their present spending.

2. GDP maintained strong growth and consumption played a greater role in driving economic growth

In 2007, China's GDP amounted to 24.7 trillion yuan, with real GDP growth reaching 11.4% yoy, up from 11.1% yoy in 2006. This marked a fifth year of double-digit growth. Affected by the tightening policies, GDP growth moderated from the peak of 11.9% yoy in 2Q07 to 11.5% yoy in 3Q07 and 11.2% yoy in 4Q07.

According to the National Bureau of Statistics (NBS), the GDP growth of 11.4% yoy was driven by consumption (4.4%), investment (4.3%) and net export (2.7%). It is noteworthy that consumption, for the first time in the past seven years, contributed more to the GDP growth than investment. Given the acceleration of household income growth, the government policies to boost consumption and the Olympic effect, consumption is expected to play a bigger role in driving the country's economic growth.

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

In 2007, the per capita disposable income of urban households reached 13,786 yuan, up by 12.2% yoy in real terms, and 1.8 ppt. higher than that of 2006. The per capita net income of rural households was 4,140 yuan in 2007, grew by 9.5% in real terms, 2.1 ppt higher than that of 2006. At end-2007, the balance of savings deposits of households amounted to 17,253.4 billion yuan, an increase of 1,096.7 billion throughout the year.

Besides income, employment in urban area also improved: the registered urban unemployment rate by the end of 2007 was 4.0%, 0.1 ppt lower than that of 2006. The high GDP growth, together with the improved employment situation, continued to drive up income growth in both rural and urban areas which, in turn, was conducive to domestic trade.

The trend of rural income growth remains to be seen this year. The downside risk would be the government's determination to curb the growth of food prices. On the upside, the government will increase investment in rural areas, launch several policies to support agricultural development and narrow the income gap between rural and urban residents.

4. Mounting consumer price pressures – CPI growth hit new high in November since 1996

The national consumer price index (CPI) was up by 4.8% yoy in 2007, the highest since 1996. Since last August, CPI growth has accelerated and stayed above 6% yoy for the rest of the year. CPI growth stroke its 11-years' high in November (6.9% yoy) and then moderated a bit to 6.5% yoy in December (see Exhibit 1). The inflationary pressure was higher in rural area (5.4% yoy) than that in cities (4.5% yoy).

Price hikes of the food category (12.3% yoy in 2007), which weighs 33.2% in the CPI accounting, contributed 4 ppt to the overall price rise and was the main cause of the soaring CPI. For example, price of meat and poultry surged by 31.7% yoy last year.

The rising food price has grasped huge attention and created alarm among many Chinese people. A recent survey of 2,538 people in 29 Chinese provinces showed that 92% of the respondents indicated that they have been affected by the rising food prices to some extent.

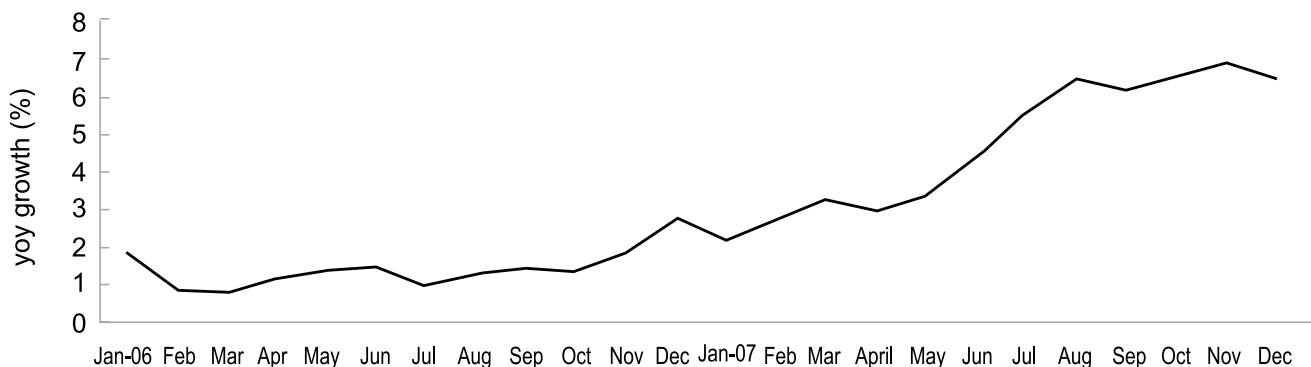
The Chinese government is much concerned about the rising prices, which would directly affect people's livelihood and thus potentially harm social stability. Premier Wan has said that policies would be issued to ensure sufficient supply and stabilize prices of food. These measures include: supporting the production of pork, oil and dairy products to increase the supply; importing foreign products; improving transportation, coordination and storage of materials to speed up the delivery; cracking down on activities that artificially raise prices above the actual market value.

Yet on the other hand, under the pressure of international oil price hikes and the fuel shortage in China, the government was forced to raise the local prices of gasoline, diesel oil and aviation kerosene by 8-10% in early November 2007. By reducing the gap between the soaring global crude prices and domestic fuel prices, the government wanted to encourage loss-making refiners to step up production. This was the first increase in 17 months. The increase would drive up transport fees and would have ripple effects on the prices of other products.

One noteworthy point is that to temporarily control the price of daily necessities, the government has started to intervene the market by capping the prices of products including grain, meat, milk, edible oil, eggs, liquefied petroleum gas. Starting from 16 January 2008, major producers, retailers and wholesalers of daily necessities have to obtain approval from the central and provincial governments 10 working days prior to raising their prices. It is the first time in 15 years that the central government has used administrative measures to intervene the pricing of basic necessities. Moreover, the National Development and Reform Commission (NDRC) stated that the price of gasoline, natural gas, electricity, water, heating and urban public transport fees, scenic spot ticket charges, and school tuition would remain frozen in the near future.

In fact, inflation is likely to be a global trend due to rising international oil and food prices. In December 2007, Eurozone also recorded an inflation of 3.1% yoy.

Exhibit 1: China's monthly consumer price indices, Jan 2006–Dec 2007



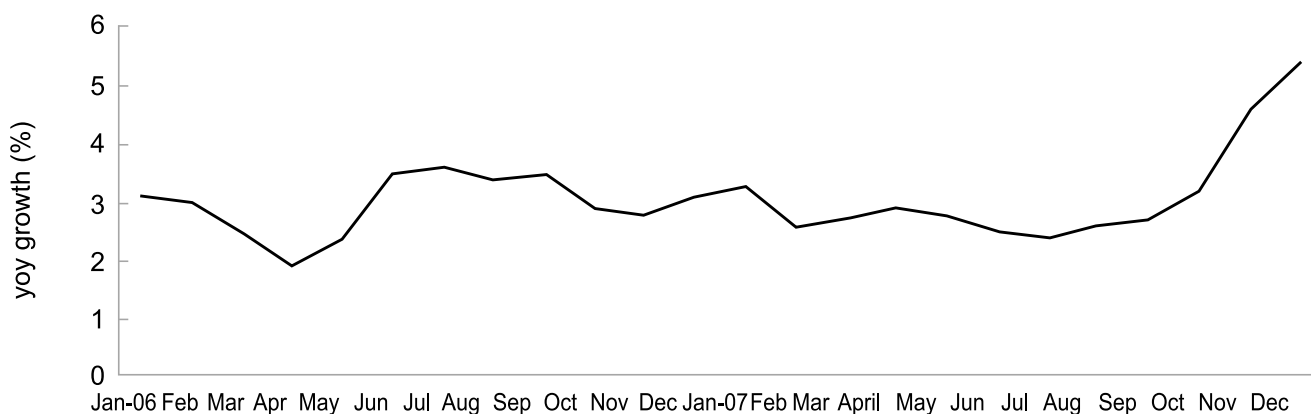
Source: National Bureau of Statistic, PRC

5. Growth of ex-factory prices speeded up in 4Q07

The producer price index (PPI), which measures the price of industrial products when they are sold for the first time after production, grew by 3.1% yoy in 2007, up from 3% yoy in 2006. In the first three quarter of 2007, PPI growth remained moderate at 2.7%. However, growth of PPI started to climb in 4Q07—3.2% yoy in October, 4.6% yoy in November and 5.4% yoy in December (see Exhibit 2).

Resources prices were rising as well. The index of purchasing prices of raw materials, fuels and power, which measures the price of production inputs purchased by industrial enterprises, grew by 4.4% yoy.

Exhibit 2: China's monthly producer price indices, Jan 2006-Dec 2007



Source: National Bureau of Statistic, PRC

6. Industrial production slowed down slightly in 4Q07

Overall, industrial production rose by 18.5% yoy in 2007, 1.9 ppt higher than that in 2006. The growth of industrial production moderated in 4Q07 (17.9% yoy in October, 17.3% yoy in November and 17.4% yoy in December), compared with 18.5% yoy in 1-3Q07.

Although China's industrial production was still bolstered by expanding domestic demand and expenditure, it showed signs of cooling down due to a slower export growth. Many firms are believed to avoid a quick build-up of inventories and hence, scaled down production.

The oil price hike, increase in production costs and interest rate and the government's tightening monetary policies to discourage bank lending are likely to have negative impacts on industrial activities as well, especially for the small and medium-sized enterprises.

II. Highlights

1. Tightening measures in response to the overheating signs and inflationary pressure continued

In response to the overheating economy and inflationary pressure, the government continued to implement a number of tightening measures in 4Q07.

In October 2007, the bank's reserve requirement ratio (RRR) was raised by 50 bps to 13%. In mid-November, the RRR was further raised by 50 bps to reach 13.5%. On 8 December, China's central bank, the People's Bank of China (PBOC), announced to raise the RRR for the tenth time in 2007 by 100 bps to 14.5%, the highest RRR since 1987. In late December, the PBOC raised the one-year deposit interest rate by 27 bps to 4.14 % and one-year lending rate by 18 bps to 7.47 %. This was the sixth time for China to raise the benchmark interest rates in 2007. On 16 Jan 2008, the RRR was again raised to 15% by 50 bps.

Comparing to 2006, the PBOC put more efforts on cooling down the economy in 2007. One-year deposit rate was raised to 4.14% from 2.52% by 162 bps. One-year lending rate increased to 7.47% from 6.12% by 135 bps. The RRR was raised from 9% to 14.5% by 5.5 ppt.

Affected by the tightening measures, growth of yuan lending by Chinese banks slowed in November 2007. New yuan loans in November 2007 amounted to 87.4 billion yuan, compared with 136.1 billion yuan in October 2007, and 283.5 billion yuan in September 2007, marking a continual downward trend.

Nonetheless, the problems of overheating, inflation, excess liquidity, etc. have yet to be resolved. The government has identified cooling the overheating economy and controlling inflation as the most important task of 2008. The Central Economic Working Conference, held during 3–5 December 2007, announced to shift the country's monetary policy from "prudent", an approach that China has followed for the last ten years, to "tight". More coordinated macro-control policies, probably in heavier dosage, are expected to come in 2008. Detailed discussion on the future tightening measures can be found in the "Outlook" section.

2. Property market showed signs of cooling down in terms of transaction volume

Investment in real estate development was massive in 2007, with growth rate accelerating to 30.2% in 2007 from 23% yoy in 2006 and surpassing the FAI growth by 5.4 ppt in 2007 (in 2006, it was lower than the FAI growth by 0.9 ppt).

Property price maintained high growth in 4Q07. According to the NBS and the NDRC, housing prices in 70 major Chinese cities surveyed was, on average, up by 9.5% yoy in October, 10.5% yoy in November, and 10.5% yoy in December 2007.

Two cities recorded over 10% growth of property prices in 4Q07: Shenzhen (19.5% yoy in October, 18.6% yoy in November, 16.4% yoy in December) and Beijing (15.1% yoy in October, 14.9% yoy in November, 15.0% yoy in December). In Shanghai, property prices grew by 7.9% yoy in October, 8.8% yoy in November, and 9.3% yoy in December. Price of new residential buildings in the 70 cities surveyed was, on average, up by 10.6% yoy in October, 12.2% yoy in November, and 11.4% yoy in December 2007.

If looking at the growth rate of real estate investment and property price only, one may think that China's property market was "red-hot" throughout the year. However, we noted that the transaction volume of property have plummeted in 4Q07, showing signs of cooling down.

According to DTZ, a global real-estate advisor, monthly transaction volume of property plunged in Shenzhen — in November 2007, the volume fell 81% from a peak high of 8.6 million square feet in January 2007. Statistics showed that the trade volume of second-hand houses in Beijing dropped 15% yoy in December 2007. Local media reported that apartment sales in Beijing, Shenzhen and Nanjing fell by 20%, 38% and 52% respectively in the first week of 2008 compared with the previous week.

China Vanke Co, the country's largest publicly traded real estate developer, announced a 25.4 % drop in sales in October 2007 from the previous month. In November 2007, the value of property sold by Vanke was 4.23 billion yuan, 18% less than the previous month. Wang Shi, chairman of Vanke Co Ltd, said in mid-December that the property market had reached a turning point. To boost sales, Vanke has cut its property prices by 15% to 30 % in major cities like Shanghai, Shenzhen and Guangzhou.

Many property agencies have been deeply affected. Shenzhen-based Chuanghui Real Estate Agency, China's largest property agency, has closed 1,000 outlets since November 2007 while Beijing's Golden Keys Agency closed 50 branches in January 2008.

Developers have become cautious about land acquisitions. Two Guangzhou residential sites were sold in late November 2007 at prices which were 78% and 55% lower than the price of the land in the same area which was sold in September 2007. In December 2007, a sale of 32 parcels of land in Shanghai received only four tender applications. A month ago, there were 10 developers competing for one parcel of land.

Although the statistics show that property prices were on the rise in 2007, the sharp decline in transaction volume represented that the soaring properties price did not truly reflect the changing market sentiment. Many property owners were reluctant to lower the property price but the fact was that many investors were holding back due to the high prices and market uncertainties.

In 2007, the government has implemented and put forward many measures that help cool down the real estate market. The tightening policies such as raising interest rate and RRR, and imposing loan quota have discouraged investment in real estate.

On the other hand, property developers are no longer allowed to hoard lands for more than two years. This measure will help raise land use efficiency and thus, ease land shortages in China. On 7 January 2008, the State Council issued a notice that developers would be charged a fee amounted to 20% of the land transaction price if they hoard land plots and leave them idle for more than one year but less than two years after acquiring them. The government will reclaim land plots left aside for more than two years. This implies that more apartments will be built in the coming two years. The supply of land and apartments is expected to increase, which lower the market expectation of future property prices.

The central bank announced a broader definition of "second apartment". More people now have to pay higher interest rate and down payment. In September 2007, the central bank raised the interest rate on mortgage for second apartment buyers to 1.1 times the benchmark one-year lending rate; and the mortgage down payment for the second apartment was raised to 40%. However, there were a lot of controversies over the definition of second apartment. Thus, on 12 December 2007, the central bank clarified that second apartment refers to the property owned by the mortgage applicant's entire family, instead of the applicant alone. Therefore, more people will fall into the category of second apartment buyers.

The construction of low-rent apartments will be speeded up and may exert downward pressure on property price. Ensuring the housing supply for low and middle-income families tops the government priority. In 2007, more than 7.7 billion yuan was allocated to fund the nationwide low-rent housing program. This will improve the living condition of 681,000 low-income urban families in 2008.

By and large, the market has been filled with the wait-and-see sentiment because of the climbing prices and the central government's new macro-control policies. The investment sentiment is also overshadowed by the prolonged US subprime crisis. In 2008, we will see a continuous market correction in the property market. The growth of real estate investment will decelerate gradually. In 1H08, property prices growth will decelerate or even remain unchanged. Transaction volume of properties will contract further.

III. Outlook

1. **Curbing overheating and inflation will be the most important task of 2008 – monetary policy shifted from prudent to tight**

In 2007, fixed asset investment (FAI) growth reached 24.8% yoy, 0.9 ppt higher than that in 2006. CPI grew by 4.8% yoy. There were signs of overheating and soaring inflation. As mentioned previously, in 2008, controlling overheating and inflationary pressure will be the most important task of the government and the country's monetary policy will be shifted from "prudent" to "tight", as announced in the Central Economic Working Conference held in December 2007. The central bank is likely to take the following measures:

(1) We will continue to see interest rate hikes, but probably not as frequent as in 2007

In 2008, if RMB does not appreciate at a faster pace and the US continues to reduce its interest rate, there will be little room for China to increase its interest rate. If the PBOC raises interest rate to a higher level, large volume of foreign capital inflow will be induced and this will exacerbate the excess liquidity problem in China. Therefore, we expect that the PBOC will not raise interest rate as frequent as it did in 2H07.

(2) We will see a few more times of RRR adjustments, pushing it towards 18.5%

The current RRR is 15%, which is the highest in 20 years. However, it is expected that it will be further raised to 17.5%-18.5% in 2008. The move is to solve the problem of excess liquidity. Since the beginning of 2008, the PBOC has already raised RRR by 50 bps.

(3) Credit rationing will be used more frequently

Loan quota will be imposed on banks, possibly in quarterly basis. This kind of measure was rarely taken in the past few years. The central bank has ordered the country's financial institutions to offer no more than 3.63 trillion yuan new loans in 2008. The target loan growth in 2008 is 12%, down from 15% in 2007.

However, the US economic indicators announced after the Central Economic Working Conference were worse than expected and this signaled a higher risk of global economic slowdown. The latest speech of President Hu Jintao on 29 January 2008 hinted that the government might relax the tight monetary policies. He said that China should have a clear understanding of global economic trend and its influence on the Chinese economy. The government will design the macroeconomic policies well and keep the right "pace and degree" in controlling the economy, so as to prolong the steady and relatively fast economic growth.

On the other hand, the snowstorm has badly hit the Chinese economy. Though the impacts are believed to be short-term, it is highly likely that the Chinese government will ease its tight monetary policies in 1Q08 to enable a quick recovery of the economy.

2. FAI growth is likely to moderate as a result of the tightening measures

FAI, after a strong growth in 2007, is likely to moderate in 2008 as the government is adamant to prevent overheating. The tight monetary policies will discourage investments. Investment projects and land use will be subject to more rigorous control by the government.

However, the following factors may drive the FAI growth. First, some enterprises generated huge profit in 2007 and they are likely to make reinvestment. Second, the property developers have to make investment in their idle lands within 2 years or else they will be subject to penalty. Third, the government will increase investment in infrastructure to develop rural area as well as constructing low rent apartments; the continued foreign capital inflow may push up FAI.

State Information Center forecasted that the nominal FAI growth in 2008 would moderate to 22.5% yoy, down from 24.8% in 2007.

3. Retail sales will maintain a strong growth momentum

Retail sales witnessed a strong and steady growth in 2007. We expect that it will maintain a strong growth momentum in 2008. State Information Center estimated that the nominal retail sales growth in 2008 would maintain at a level of 15.5%-15.8% yoy, a bit lower than 16.8% yoy in 2007.

We believe that consumption will play a much bigger role in China as the economy grows. According to Chinese Academy of Social Sciences (CASS), consumption contributed only about 36% to China's GDP in 1-3Q07, a very low level compared to an average of 70% across the world.

In the 17th National Party Congress, the government announced to make domestic consumption an important growth driver of the economy and reduce the reliance on export and investment. Several policies have been announced to boost people's current and expected disposable income.

The government will further raise the country's monthly individual income tax threshold from 1,600 yuan to 2,000 yuan, effective from 1 March 2008. The move is to relieve the economic burden of medium- and low-income earners amid the soaring inflation. Consequently, 70 % of income earners in China would be free from paying income tax while the current threshold of 1,600 yuan only makes 50 % of income earners free from paying the tax.

Low-income families will receive more stipends as an offset of price rises for basic living necessities. Fiscal expenditures in social security, medicare, sanitation, education and household benefits will be increased. Several policies to be taken include: developing the pension and medical insurance systems; supplying cheap housing for low-income families; establishing a mechanism to ensure "normal pay rises" and guarantee the payment for company employees. In the countryside, the cooperative medical insurance, which funds farmers' medical expenses, will continue to expand. Currently, the system covers 85 % of the country's rural residents.

China's newly adopted labor contract law, effective from 1 January 2008, would better protect the labor and hence, raise their expected income. First, the new law demands compensation upon termination and imposes higher penalties. Second, employers will find it more difficult to terminate employees, especially those of long serving workers.

The continual improvement in employment and income of both urban and rural households will help boost people's consumption. In addition, it is estimated that the coming 2008 Olympic Games will attract 500,000 foreign tourists to China and thus, this would stimulate industries including tourism, retailing, advertising, etc.

On the downside, the tightening measures such as stricter control of bank lending and the increasing borrowing costs may dampen the consumption sentiment.

4. Price pressure continues to be major concern

CPI surged to 4.8% yoy in 2007, up from 1.5% yoy in 2006. This aroused serious concerns in the government. The government has implemented many measures to tackle the continuous inflation. Yet, we expect that CPI will still stay at high level in 2008.

The fundamental problems leading to food shortage have yet to be resolved. Arable land in China has been greatly reduced in recent years while domestic demand for food have been increasing rapidly due to improved income of Chinese people. The grain production in China is unlikely to have huge expansion after the harvest in the past four years. On the other hand, although the production of pig has rebounded, it still takes relatively long time to restore to previous level. The supply of pork will still be tight.

The recent snowstorm in China further aggravates the inflationary pressure. Starting from mid January, the heavy snow in China's southern, central and eastern areas, has affected 80 million people; forced hundreds of thousands to relocate; led to power cuts, collapsed buildings, damaged crops; and left thousands of head of livestock dead. The already tightened food supply was further stretched by the disrupted transportation. Economist from the Asian Development Bank believed that the snowstorm would push up the short-term inflation rate to 6.5% yoy in 1Q08. However, the impact of the snowstorm on the whole year's grain production remains uncertain as it depends on how long the storms would last and whether the storms would head to the north. As China is in general short of water, the snowstorm may provide a new source of water and help improve grain production.

The rising production costs in China also add to the inflationary pressure. China is poised to further reform the pricing mechanism of resources in 2008 after the pressure of food price hikes has been alleviated. The move will raise the prices of resource such as gasoline and diesel, bringing them roughly in line with the international market price.

5. GDP growth will slow down

In 2008, we expect that GDP growth will moderate. Both State Information Center and CASS estimated that the GDP growth would drop to 10.8% yoy in 2008 while the Bloomberg's median estimate is 11.0% yoy. World Bank's estimation is less optimistic. It estimates China's GDP growth to be 9.6% yoy because of the adverse impacts of the potential slowdown of the global economy.

In 2008, China's export growth will moderate with the global economic slowdown and government's policies to discourage exports. Investment will continue to register strong growth but the growth is expected to decelerate. Domestic consumption will play a bigger role in driving the economic growth.

Note that though the recent snowstorm has caused economic losses of about US\$7.5 billion, the adverse impacts on the economy is likely to be only short-term and the impact will dissipate over the year.

6. The January manufacturing PMI fell to 53%

The January PMI dropped to 53.0%, down from 55.3% in December 2007. Except stocks of finished goods, all sub-indices recorded lower readings compared with the previous month. Output index fell to 56.1% in January. New orders also showed weaker growth momentum. The new exports order index, for the first time since the PMI was launched in January 2005, recorded PMI below 50%, indicating a moderating export growth. The input prices index remained high at 67.7%, indicating continuous upward cost pressures for manufacturers (see Exhibit 3).

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.

Exhibit 3: China manufacturing PMI at a glance – January 2008

Index	S. Adj Index	Index Compared with the Previous Month	Direction
PMI	53.0	Lower	Expanding
Output	56.1	Lower	Expanding
New Orders	55.2	Lower	Expanding
New Export Orders	49.0	Lower	Contracting
Backlogs of Orders	48.6	Lower	Contracting
Stocks of Finished Goods	48.4	Higher	Contracting
Purchases of Inputs	56.9	Lower	Expanding
Imports	51.3	Lower	Expanding
Input Prices	67.7	Lower	Expanding
Stocks of Major Inputs	49.2	Lower	Contracting
Employment	49.7	Lower	Contracting
Suppliers' Delivery Time	49.7	Lower	Slackening

Source: Li & Fung Research Centre

7. Entrepreneurs' confidence still maintained at high level

Though the national Entrepreneur Confidence Index (ECI) in 4Q07 dropped from 143.0 in 3Q07 to 139.6, it was still 4.3 higher than that in 4Q06. Entrepreneurs were more optimistic in 2007 than in 2006, indicating by the fact that all quarterly indices in 2007 are higher than that in 2006 (see Exhibit 4).

Exhibit 4: Entrepreneur Confidence Index in 4Q07

Entrepreneur Confidence Index (ECI)	4Q07	3Q07	Compared with the previous quarter
National	139.6	143.0	Lower
By sector			
Manufacturing	136.2	140.5	Lower
Construction	138.5	142.1	Lower
Transportation, storage & post service	137.2	142.2	Lower
Wholesale & retail	146.6	145.2	Higher
Social services	138.7	141.0	Lower
Information transmission, computer service and software	155.4	158.4	Lower
Hotel & catering	134.0	136.0	Lower
Property	137.9	146.6	Lower
Electricity, gas & water	141.7	144.2	Lower

Source: National Bureau of Statistic, PRC

Part two: Foreign trade

I. Recent developments

1. Trade surplus hit new high, but showed a decelerating growth

China's total imports and exports, for the first time, exceeded US\$2 trillion in 2007. The annual trade surplus ballooned to US\$262.2 billion, up by 47.7% yoy from 2006. The growth rate was impressive but compared with that of 2006, the growth showed a downward trend—the 2007 trade surplus growth dropped by 27.2ppt from 74.2% yoy in 2006. In fact, the growth has been moderating since mid-2007. The surplus for December shrank to US\$22.7 billion, below November's US\$26.4 billion and the forecasts of US\$24.5 billion. In 4Q07, the yoy trade surplus growth stepped down to a record low of 12.5% from 98.6% in 1Q07, 75.1% in 2Q07 and 51.1% in 3Q07 (see Exhibit 5 & 6).

The downward trend of trade surplus growth stemmed from the decelerating export growth and the accelerating import growth. Export growth has slowed – 25.7% in 2007 relative to 27.2% in 2006 – while import growth speeded up – to 20.8% in 2007 relative to 20% in 2006. In 4Q07, the monthly import growth has exceeded 25% yoy, outpacing the export growth, for three months in a row.

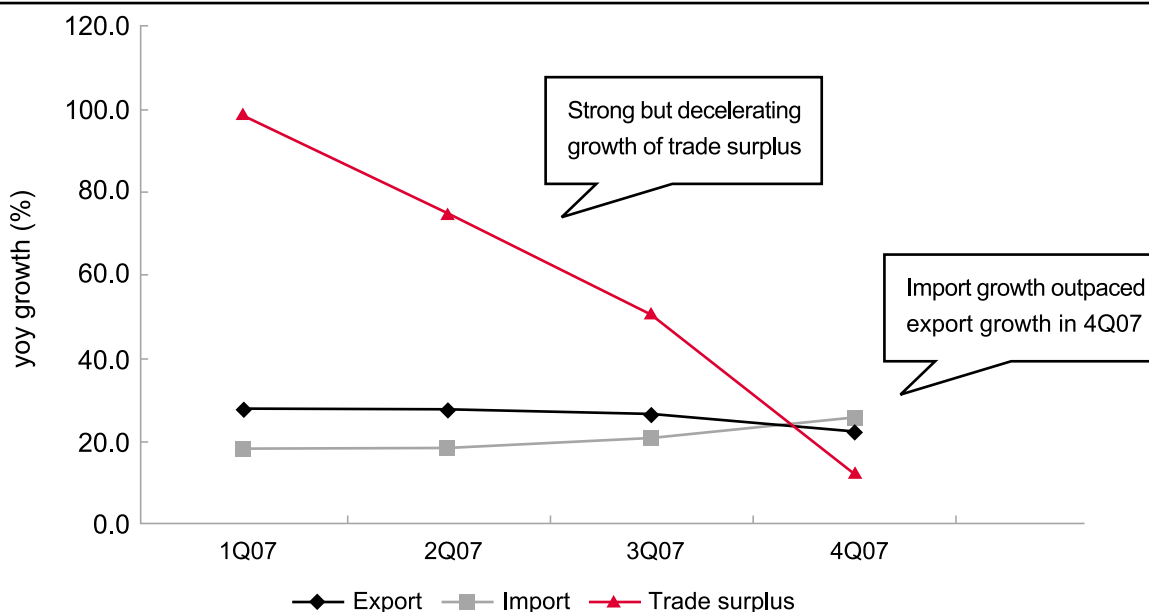
The decelerating export growth indicated that the government's efforts to curb export, especially the resource- and energy-intensive and highly polluting products, has started to take effect. The US slowdown and the faster appreciation of Renminbi (RMB) against US dollar in 2007 have also contributed to the relatively weak exports from China—the yoy growth of China's exports to the US has weakened from 24.9% in 2006 to 14.4% in 2007.

On the other hand, the strong import growth could be attributed to the surging international oil and commodity prices, rising demand from China as well as the reduction of import tariff on products such as automobiles, coal, primary aluminum, audio and video products.

Exhibit 5: Foreign trade of China, 2007 monthly figures

Period	Trade balance		Export		Import	
	Value (USD billion)	yoy growth (%)	Value (USD billion)	yoy growth (%)	Value (USD billion)	yoy growth (%)
Jan	15.9	64.5	86.6	32.9	70.7	27.4
Feb	23.7	836.7	82.0	51.6	58.3	13.1
Mar	6.8	-39.3	83.4	6.9	76.7	14.6
Apr	16.7	60.7	97.4	26.8	80.7	21.5
May	22.4	73.3	94.1	28.7	71.6	19.1
Jun	26.9	87.2	103.4	27.2	76.5	14.3
Jul	24.4	67.6	107.7	34.2	83.4	26.8
Aug	25.1	33.9	111.4	22.8	86.2	19.9
Sep	24.0	56.3	112.3	22.6	88.3	15.8
Oct	27.2	13.8	107.7	22.2	80.5	25.3
Nov	26.4	15.5	117.7	22.8	91.2	25.1
Dec	22.7	7.8	114.4	21.7	91.7	25.7
FY 2007	262.2	47.7	1,218.0	25.7	955.8	20.8

Source: China Customs

Exhibit 6: Growth rate of foreign trade, 2007 quarterly figures

Source: China Customs

2. General trade plays a more important role

Note that both export and import under general trade grew much faster than that of processing trade¹ in 2007. Under general trade², export grew by 29.4% yoy to US\$538.6 billion, 2.7 ppt. lower than 2006, while import increased significantly by 28.7% yoy to US\$428.7 billion, 9.6 ppt. higher than the yoy growth of 2006 (see Exhibit 7).

Under processing trade, export grew by 21.0% yoy to US\$617.7 billion, 1.5 ppt. lower than the yoy growth of 2006; import increased by 14.6% yoy to US\$368.4 billion, 2.7 ppt. lower than the previous year.

Processing trade has been losing weight in the total foreign trade – in 2007, processing trade accounted for only 45.4% of the total trade value, compared with 47.2% in 2006. By contrast, general trade is playing a more important role—its share in China's total trade value rose to 44.5% in 2007 from 42.6% in 2006.

This trend reflects the impact of the government policies to limit processing trade since September 2006. Over the past year, the government has reduced and removed value-added tax (VAT) rebates for over 2,000 types of products, banned processing trade enterprises from dealing in 1,729 product categories and launched the Restricted List for Processing Trade, a regional discriminatory policy which requires processing enterprises dealing in the restricted product categories in the Eastern region to pay guarantee fund while registering their processing trade contracts with the authorities. These policies have greatly discouraged the export of products that are energy- and resource-intensive, highly polluting, labor-intensive, low value-added and susceptible to trade frictions.

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.

Exhibit 7: Foreign trade of China in 2007

Item	Value (USD billion)	yoy growth (%)
Total of Imports and Exports	2,173.8	23.5
Exports	1,218.0	25.7
Of which:		
General Trade	538.6	29.4
Processing Trade	617.7	21.0
Imports	955.8	20.8
Of which:		
General Trade	428.7	28.7
Processing Trade	368.4	14.6

Source: China Customs

3. Foreign exchange reserve ballooned and China remained the world's largest holder

In 2007, China remained the world's largest holder of foreign exchange reserve, having a total accumulation of US\$1.53 trillion, way ahead of Japan (US\$973.4 billion). The accumulation in 2007 was stunning—US\$461.9 billion relative to US\$247.5 billion in 2006, with foreign exchange reserve grew by 40.3% yoy. However, looking closer at the figures, we noted a decelerating accumulation throughout the year (see Exhibit 8)

Exhibit 8: Accumulation of foreign exchange reserve by quarter, 2007

Period	Accumulation (USD billion)
1Q07	135.7
2Q07	130.6
3Q07	101.0
4Q07	94.6
FY07	461.9

Source: State Administration of Foreign Exchange

Both China's soaring trade surplus and foreign capital inflow contributed to the foreign exchange reserve boom. The trade surplus grew by US\$262.2 billion last year, contributing to half of the foreign exchange reserve accumulation in 2007. However, as discussed previously, the trade surplus growth is decelerating. The State Information Center predicted that trade surplus growth would down from 47.7% to 26.6% in 2008. Therefore, it is highly possible that foreign exchange reserve growth would decelerate unless there was a big jump of foreign capital inflow.

Capital inflow was another major source of China's foreign exchange. Foreign funds were attracted by the good economic and business prospects and inflating asset prices in China. The anticipation of continued RMB appreciation also boosted the expected returns of foreign investment. The foreign exchange reserve ballooned because the central bank tried to slow down the RMB appreciation, against the huge current account and capital account surplus, by buying in foreign

exchange and selling the domestic currency in the market. Meanwhile, slower appreciation would lead to more prolonged fund influx, further aggravating the problem. However, the possible US economic recession may curb investors' optimism on Chinese economy and thus capital inflow may slow down in 2008. .

The huge foreign exchange reserve has led to excess liquidity and exerted pressure on RMB appreciation. Thus, China's Sovereign Fund – China Investment Corporation (CIC) – was launched last September to manage and mitigate the risk of China's huge foreign exchange reserve. It aims to enhance the utilization and investment returns by actively exploring channels and means for using and investing the foreign exchange reserve. The startup capital of CIC was US\$ 200 billion. Of which, US\$ 66.7 billion would be used to invest in the global financial market. It invested US\$ 3 billion in the Blackstone Group last May and further acquired 9.9% of Morgan Stanley shares with US\$5 billion last December.

4. EU surpassed US to become China's largest trading partner

The European Union (EU) surpassed the US to become China's biggest trading partner in 2007. Note that the difference between China's exports to the EU and the US has widened from US\$0.6 billion in 1H07 to US\$11.8 billion in 2H07. In 2007, Sino-EU trade reached US\$356.2 billion, up by 27% yoy. China's trade surplus against the EU totaled US\$134.2 billion. Appreciation of Euro against RMB was believed to be one of the major factors driving China's exports growth to the EU.

The US was China's second largest trading partner in 2007. Sino-US trade reached US\$302.1, up by 15% yoy. China continued to record large trade surplus – US\$163.3 billion in 2007, grew by 13.2% yoy. Faster RMB appreciation against the US dollar and the slowdown of the US economy had led to the downward trend of China's exports growth to the US. China's export growth to the US dropped from 20.4% yoy in 1Q07 to 15.6% yoy in 2Q07 and further dipped to 12.5% yoy in 3Q07 and 10.8% yoy in 4Q07.

Japan was the third largest trading partner of China. Sino-Japan trade hit US\$236.1 billion in 2007, increased by 13.9% yoy.

Apart from the big three, China's foreign trade between ASEAN (Association of South East Asian Nations), Korea, Hong Kong and Taiwan also registered double-digit growth.

Exhibit 9: Major export destinations, Jan-Dec 2007

Country/Region	Export value (USD billion)	yoy growth (%)
EU	245.2	29.2
Germany	48.7	20.8
Holland	41.4	34.2
UK	31.7	31.0
US	232.7	14.4
Hong Kong	184.4	18.7
Japan	102.1	11.4
Korea	56.1	26.1
Singapore	29.6	27.8
Taiwan	23.5	13.1

Source: China Customs

Exhibit 10: Major import origins, Jan-Dec 2007

Country/Region	Import value (USD billion)	yoy growth (%)
Japan	134.0	15.8
EU	111.0	22.4
Germany	45.4	19.8
Korea	103.8	15.6
Taiwan	101.0	16.0
US	69.4	17.2
Malaysia	28.7	21.8
Australia	25.9	33.8
Russia	19.7	12.1
Singapore	17.5	-1.1

Source: China Customs

Exhibit 11: Exports by category

Volume	Jan-Dec 2007	Jan-Dec 2006	yoy growth (%)
	million tons	million tons	
Coal	53.2	63.3	-16.0
Crude oil	3.9	6.3	-38.7
Refined oil	15.5	12.4	25.6
Steel	62.7	43.0	45.8
Value	USD billion	USD billion	yoy growth (%)
	Textile materials & products	56.1	
Garments & clothing accessories	115.1	95.2	20.9
Footwear	25.3	21.8	16.0
Toys	8.5	7.1	20.3

Source: China Customs

Exhibit 12: Imports by category

Volume	Jan-Dec 2007	Jan-Dec 2006	yoy growth (%)
	million tons	million tons	
Cereal & cereal flour	1.6	3.6	-56.6
Soybean	30.8	28.2	9.2
Iron ore	383.1	326.3	17.4
Crude oil	163.2	145.2	12.4
Refined oil	33.8	36.4	-7.1
Steel	16.9	18.5	-8.8
Synthetic yarn (1,000 tons)	510.0	620.0	-18.4
Vehicles and related parts (1,000 units)	313.0	227.0	37.9

Source: China Customs

II. Highlights

1. The launch of the *New Catalogue for Guiding Foreign Investment in Industries (2007 revision)*

One of the major policies adopted by the Chinese government to guide foreign investment is the *Catalogue for Guiding Foreign Investment in Industries*³. To reflect China's latest policy direction, the NDRC and the MOFCOM jointly revised the *Catalogue* and released the latest *Catalogue for Guiding Foreign Investment in Industry (2007 Revision)* on 30 October 2007. The New Catalogue has come into effect on 1 December 2007, replacing the 2004 version. The New Catalogue will drive foreign enterprises to appropriately adjust their investment strategies in China.

One significant amendment in the new catalogue is that China has adjusted its long-adopted export-oriented policy. Foreign trade policy that puts lop-sided emphasis on exports would no longer be implemented.

Other major amendments introduced in the new catalogue are highlighted as follows:

(1) Encourage industrial upgrade, resources conservation and environmental protection

To encourage industrial upgrade and technology transfer, foreign companies are encouraged to invest in the high-tech, equipment manufacturing and new materials production industries. Foreign companies are no longer encouraged to invest in traditional manufacturing industries in which domestic enterprises have already mastered the necessary technologies and have strong production capacity.

Another major objective of the new catalogue is to promote resources conservation and environmental protection. Thus, foreign companies are no longer encouraged to invest in projects involving important mineral resources that are rare in China or non-renewable. Foreign investment in high energy- and resource- consumption, and high pollution projects will be restricted or prohibited. Meanwhile, the government encourages foreign investment in the development of clean production, renewable energy, ecological environment protection and comprehensive utilization of resources.

(2) Further liberalize the service sector

"Service outsourcing", "modern logistics" and some other service industries have been added to the encouraged category. On the other hand, some service industries have been removed from the restricted and prohibited categories.

2. Acceleration of RMB appreciation in 4Q07

RMB advanced 6.7% versus USD in 2007, compared with 3.3% in 2006. The appreciation accelerated in the last two months of 2007. RMB/USD rate rose from 7.4745 on October 29 to 7.2418 on December 28, up by 2.1%.

Note that though RMB appreciated against the US dollar in 2007, it in fact depreciated against the Euro. Officials of both the US and the EU share the same view that RMB is still undervalued and is not reflecting China's economic fundamentals, thus has led to the yawning trade surplus against the two economic entities. They urged the Chinese government to appreciate RMB more rapidly.

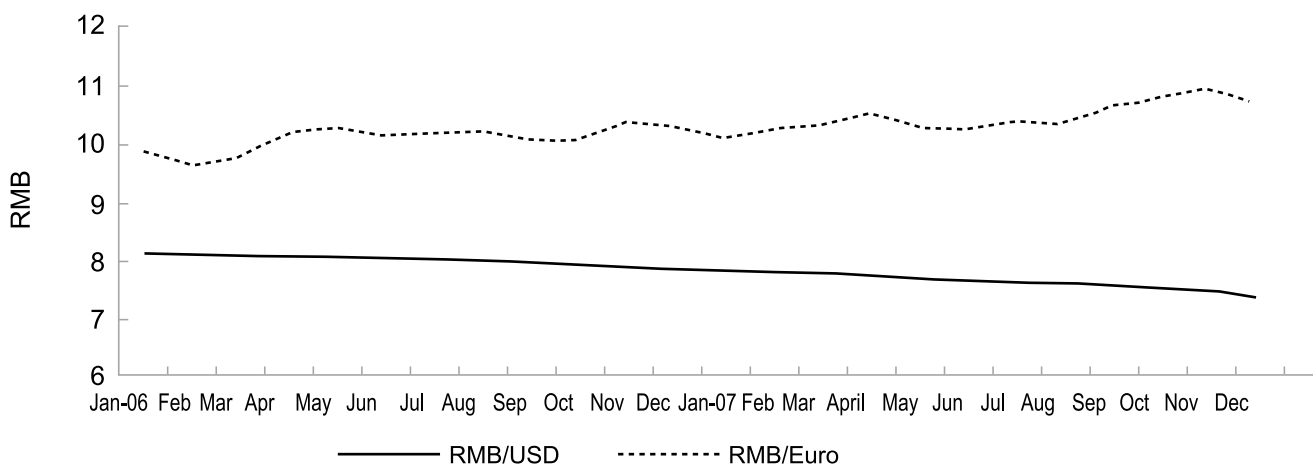
³ The Catalogue classifies industries into three categories, namely encouraged, restricted and prohibited. The "encouraged" industries will be given automatic approval and will only need to be registered with the State Council. Projects categorized as "restricted" must undergo more rigorous scrutiny. Industries not specified in the Catalogue are regarded as permitted.

In response, in December 2007, the Minister of the MOFCOM Chen Deming said that the currency's advance in 2007 "fit China's economic needs". RMB would continue to appreciate, but should not have "excessively rapid" adjustment. He believed big swings in US dollar and RMB could mean disaster not only for China and the US, but also for the entire world.

The PBOC vowed to make RMB more market-driven. The governor of PBOC Zhou Xiaochuan suggested that China may make its exchange rate more flexible and, if necessary, consider widening the yuan's trading band. This probably hints that the government is willing to let RMB to appreciate faster. Some analysts predicted that the daily spot-trading band would be widened to 0.8% from the current 0.5%. According to the director of the International Economic Research Institute under the NDRC, Zhang Yansheng, the pace of appreciation of RMB is set for a significant pick-up in 2008, but the appreciate rate will be kept under 10%.

China must choose between speed and stability in its exchange rate appreciation. Slower appreciation will lead to prolonged appreciation expectation and thus continuous influx of foreign direct investment (FDI) and hot money, which will then exacerbate the domestic excess liquidity problem. Quickening the pace of RMB appreciation would be disruptive to the real sector and domestic enterprises, but it will help strengthen monetary policy as an effective economic tool, as well as lower the imported inflation.

Exhibit 13: Exchange rate: RMB/USD and RMB/Euro, Jan 2006-Dec 2007



Source: State Administration of Foreign Exchange

3. Sino-US Strategic Economic Dialogue

The third Sino-US Strategic Economic Dialogue was held on 12-13 December 2007. The Chinese Vice Premier Wu Yi and the US Treasury Secretary Henry Paulson co-chaired the meeting. 31 agreements were reached, covering aspects like financial services, food safety, product quality, environment and energy, and China's market economy status. However, note that such talk never meant to produce real changes of major policies such as the pace of RMB appreciation.

Some of the major agreements reached include:

(1) Re-allowing foreign participation in China's securities firms

China Securities Regulatory Commission (CSRC) said it would start accepting applications for Sino-foreign joint ventures in the securities business for the first time in two years, yet regulations detailing the form of new foreign-invested brokerages have yet to be released. It is highly likely that a 33.3% ownership cap for foreign firms will remain in place for the near term. China also agrees to allow qualified foreign-invested companies, including banks, to issue RMB denominated stocks; qualified listed companies to issue RMB denominated corporate bonds; and qualified incorporated foreign banks to issue RMB denominated financial bonds. This will help shore up the quality of the China's capital markets and boost the nascent corporate bond market. Funds offered by the Chinese banks under the Qualified Domestic Institutional Investor (QDII) scheme will also be permitted to invest in US stocks. It is a move by China to loosen the nation's capital account and drain excess liquidity from the domestic economy.

(2) Establishing an information-sharing mechanism on food and product safety

Both parties agree to enhance the infrastructure of laws, policies, programs and incentives that allow for effective government oversight of exports of food, drugs, medical products, and consumer goods. Also, the first-ever Sino-US agreement on drug and medical equipment safety was signed. For product safety, the US Food and Drug Administration (FDA) is entitled to launch a joint probe with its Chinese counterpart, the State Food and Drug Administration (SFDA) against a registered firm if its products are found unsafe.

(3) Energy and environment cooperation

Both sides would set up a working group to outline a 10-year blueprint for energy and environment cooperation. Extensive cooperation focusing on technological innovation, adoption of clean technology and sustainable natural resources will be conducted over a 10-year period. The move aims to raise energy efficiency and fight climate change.

4. A joint surveillance system to monitor the trade flow of textile between China and the EU is now in place

The quota restriction imposed on China's textile exports to the EU came to an end at the end of 2007. From 1 January 2008 onwards, China and the EU monitor Chinese exports of T-shirts, pullovers, men's trousers, blouses, dresses, bras, bed linens and flax yarn through a joint surveillance system until the end of 2008. Under this system, these eight categories will be tracked on the Chinese side through export licenses and will be monitor when they enter the EU, which is watching for signs of surge in textile goods from China. The MOFCOM and the General Customs Administration have jointly issued a circular stipulating that only qualified textile makers could apply to local MOFCOM branches for export licenses. A qualified exporter should have a minimum registered capital of 500,000 yuan, at least two years of export operation experience and no violation of intellectual property or environmental protection laws. Exporters' quality assessment, license application and approval system can help accelerate industry consolidation and reduce the often-vicious competition among domestic enterprises.

Industry watchers suggested that if the bilateral monitoring system functioned smoothly, it would serve as a good example for dealing with the Sino-US textile quota system, which is set to expire by the end of 2008.

5. Export of crude oil and coal continued to sink while import of crude oil hit record high

There was a soaring local demand for crude oil. In 2007, China's crude oil import hit a record high of 163.2 million tons, up by 12.4 yoy while export of crude oil dropped 38.7% yoy to 3.9 million tons. The Ministry of Commerce (MOFCOM) estimated that the country's crude oil output for 2007 would stand at 187 million tons, up by 1.7yoy. The output growth, however, would fail to keep pace with the demand growth, which was estimated to be 6%. It is believe that the import of crude oil would maintain a strong growth momentum in coming year.

In 2007, export volume of coal declined by 16% yoy to 53.2 million tons. The decline of coal exports was attributable to the policy direction of protecting domestic energy resources, as well as discouraging energy-intensive processing industries that seriously pollute the environment. The government has scrapped tax rebates and levied export duties on coal, in order to discourage exports. The coal mining industry has also been streamlined—thousands of small-scale mines have been closed down since 2006. At the same time, the government has also suspended the approvals of coal mine projects which fail to meet the standard requirements.

6. Export growth of steel slowed down

In 2007, export volume of steel grew by 45.8% yoy to hit 62.7 million tons. Growth remained strong yet decelerated, compared with 109.6% in 2006, 97.9% in 1H07 and 73.3% yoy in 1-3Q07. The deceleration in export growth showed that the government policies to limit steel exports since 2006 has started to take effect. Effective from 1 January 2008, the export tax on semi-finished steel products have been raised to 25 %, and that on some stainless steel, welded pipes and other steel products such as steel tubes, etc, to 15 %. Existing tariffs on the exports of carbon steel billets and pig iron have also been raised. Another reason for the decelerating export growth was that the shortages of steel in the international market, which had existed in 2006 and 1H07, alleviated much in the second half of 2007. Other reasons included trade disputes and foreign pressures to limit China's steel exports. Given these factors, we expect to see a gradual slowdown in China's steel export growth in early-2008.

7. Import of vehicles sustained high growth

Import of vehicles reached 312,979 units and sustained a high growth rate of 37.9% yoy in 2007, though fell slightly from 40.7% yoy growth in 2006. The strong growth was attributable to the reduction of tariffs to 25% from 1 July 2006 onwards and the growing domestic demand in China. Note that China has overtaken Japan to become the world's second largest car market second only to the US since 2006.

8. The importance of foreign-invested enterprises in China's foreign trade fell, but still accounted for more than half of China's foreign trade

According to the China Customs statistics, in 2007, foreign-invested enterprises (FIEs) accounted for 57.7% of the national total of exports and imports. The proportion dropped by 1.1 ppt. compared with the 2006 proportion.

Exports by FIEs totaled US\$695.5 billion, up by 23.4% yoy, 2.3 ppt. lower than the national growth rate (25.7% yoy) in the same period. FIEs accounted for 57.1% of the total exports, 1.1 ppt. lower than the proportion in 2006.

Imports by FIEs recorded US\$559.4 billion, up by 18.4% yoy, 2.4 ppt. lower than the national growth rate (20.8% yoy), accounting for 58.5% of the total imports, 1.2 ppt. lower than the 2006 proportion.

In its latest bid to curb the expansion of exports, the Chinese government discouraged foreign investment in export-oriented industries. Meanwhile, the domestic enterprises are fast developing and gaining strength. The trend of diminishing FIE importance in China's foreign trade is set to continue.

9. Guangdong, Jiangsu and Shanghai accounted for 58.3 % of China's foreign trade

In 2007, the top three provinces/municipalities, ranked in terms of foreign trade values, jointly accounted for 58.3% of China's total foreign trade. Of which, the total value of exports and imports of Guangdong Province was US\$ 634.1 billion, up 20.3% yoy, accounting for 29.2% of China's total foreign trade. Total value of exports and imports of Jiangsu Province was US\$ 349.6 billion, up 23.1% yoy, 16.1% of the national total. Total value of exports and imports of Shanghai was US\$ 282.9 billion, up 24.3% yoy, 13% of the national total.

III. Outlook

1. Fear of US recession is growing

There is fear that recession is looming in the US. The country is faced with still-slumping housing market, an escalating credit crunch and spiraling inflationary pressures. An advance estimates released by the Bureau of Economic Analysis suggested that the US GDP grew at a slower-than-expected 0.6% in 4Q07 and gained only 2.2% for 2007 - the slowest full-year growth rate since 1.6% in 2002. While analysts had expected a decline from 3Q's 4.9% rate, the advance estimate did not meet expectations of a 1.2% growth rate in 4Q07.

The US economy continues to be haunted by the subprime mortgage crisis. The housing slump is deeper and more prolonged than central bankers had expected. The housing sector fell so precipitously that it took 1.2 ppt out of the GDP growth in 4Q07 and 1 ppt for the year 2007. The US is experiencing its worst housing recession in more than 15 years.

The subprime crisis also threatened the US financial system and led to financial turmoil in the US. In early January, the fifth-largest US securities firms Bear Stearns reported a fourth-quarter loss of US\$854 million. In mid-January, Citigroup, the largest US bank, reported the biggest loss in its company history. The loss in the 4Q07 reached US\$9.83 billion after writing down the value of subprime-mortgage investments by \$18 billion. Merrill Lynch, the world's biggest brokerage, also reported a US\$9.83 billion loss in 4Q07.

The prolonged housing woes, combined with the tightening of lending standards, have harmed consumer spending and the US economy as a whole. Retail sales fell 0.4% in December 2007. The US Federal Reserve (the Fed) described that the holiday sales in December 2007 were "disappointing", indicating subdued holiday spending. The US industrial production fell 1% yoy in 4Q07, suggesting a slowdown in the manufacturing sector. The falling property prices and rising petrol prices were crimping disposable incomes.

In 2007, the US's unemployment rate shot up in December to 5%, from 4.7% in November. The magnitude of that increase — something not seen since right after the September 2001 terror attacks — sent off alarm bells. In January 2008, the unemployment rate moderated a bit to 4.9%. However, the total payrolls fell by 17,000 in January 2008 – the first decline since August 2003 when the labor market was still struggling to recover from the 2001 recession. In 2007, the economy added an average of just 95,000 jobs a month, versus an earlier estimate of 111,000 a month for the year. Job losses were widespread. Manufacturers, construction firms, a variety of professional and business services, and even the government cut jobs in January 2008.

Wage growth also slowed, indicating employers are tightening their belts. Over 2007, wages went up by 3.7% yoy, though, with high energy and food prices, employees have to squeeze spending. Taken together, the figures suggested that employers have grown cautious as they try to cope with fallout from housing and credit problems and rising worry about the ailing economy. Many of the investors have postponed their investment in the US until they see a clear picture of the US economic development. The slower employment and wage growth will also harm consumer confidence and spending power.

To restore investors' confidence, and to avoid a marked slowdown of the US economy, the Fed has reduced its benchmark rate from 5.25% to the current 3% since September 2007. The amount and frequencies of adjusting interest rates were out of most investors' expectation – as this has been the most aggressive monetary policy easing since the economy emerged from its last recession in 2001. According to what the Fed has said, the Fed could make further “timely” interventions as there are still “downside risks” to growth. This series of actions somehow suggests that the subprime debt problem has been much more serious than the market had imagined.

The interest rate cut could make the US's economic downturn less painful, but it might also lead to considerable inflation and another asset bubble in the future, and put US dollar under depreciation pressure.

That would pose a problem to the Chinese government—if the RMB does not quicken its appreciation against the US dollar, it would be depreciating against other currencies. Chinese exports would become cheaper and more competitive for those countries, and that is against the government direction to narrow the trade surplus. Besides, that would lead to imported inflation in China.

It is also noteworthy that, interest rate hikes in China, combined with interest rate cut in the US, will induce more funds flowing into China. This would put RMB under great pressures to appreciate and, if RMB is not to appreciate faster, would necessitate more sterilization by the central bank in order not to create extra liquidity.

On the other hand, China's exports will be dampened if US consumption weakens. China's exports growth to other countries may slow as well if the US slowdown spills over to the global economy. Therefore, we predict that China's exports will drop in 2008 and China's trade surplus will fall accordingly, which will result in slowdown in China's economic growth and industrial activities.

2. The Eurozone economy shows signs of moderation, but remains robust

The Eurozone economy has been growing steadily: in 3Q07, GDP grew by 0.8% compared with the previous quarter, and 2.7% yoy. Household final consumption expenditure increased by 0.5% qoq. Investment grew by 1.2% qoq. Exports and imports rose by 2.2% qoq and 2.6% qoq respectively. The Eurozone unemployment rate was kept at its record low of 7.2% in December 2007. Yet, in November 2007, the volume of retail trade fell by 0.5% compared with the previous month as rising food and energy continued to hit the consumer's wallet.

Although the growth figure shows that the Eurozone economies are still in good shape, Eurozone inflation reached an unexpectedly high level: annual inflation rate in 2007 hit 3.1% and January 2008 inflation is expected to be 3.2%. In December 2007, the lowest annual rates were observed in the Netherlands (1.6%) and Finland (1.9%). The main components with the highest annual rates in December 2007 were education (9.4%), transport (5.6%) and food (4.8%).

The president of the European Central Bank (ECB), Jean-Claude Trichet, predicted that Europe was likely to face a longer period of high inflation than previously expected. Therefore, the ECB decided to keep the key policy rate at 4% after its 10 January 2007 meeting despite the US central bank has aggressively cut the interest rate since September 2007. This move can keep Euro as a strong currency.

High interest rates, in tandem with faltering confidence and stringent lending standards, will result in some cooling of the EU housing market and in turn consumer spending. Yet the impact should be less pronounced than in the US. The continued appreciation of the Euro would harm the manufacturing and service industries. Surging oil prices, rising inflation, relatively high interest rate, higher labor cost, continual labor unions activities, and the spillover of the US slowdown and the subprime crisis would also weaken the growth momentum of the Eurozone economy.

On the upside, it is possible that consumer spending could kick in more than anticipated, as purchasing power is supported by rising employment and higher wage growth. The Eurozone expansion could also surprise on the upside if the Euro turns out to be softer than expected and global economic activities stronger than expected.

By and large, in 2008, we believe that the economic growth of Eurozone, though will slowdown somewhat, should remain relatively robust with its strong fundamentals. The European Union (EU) Economic and Monetary Affairs Commissioner Joaquin Almunia forecasted that economic growth might drop below 2 % in 2008 for the first time in three years. World Bank forecasted the Eurozone economy would grow by 2.1% in 2008 amid the global modest growth.

Though the downturn of the US economy may hit the Eurozone economy and lower its import demand, the impact is believed to be moderate. Chinese products will continue to be competitive in the Eurozone market, especially since the RMB has already fallen by more than 5% against the Euro over the last two years. The EU could give China some buffer to softer demand from the US.

However, with China's soaring trade surplus against the EU, the EU is expected to be tougher on trade issues with China. The pre-registration process of the EU's new chemical policy, REACH (Registration, Evaluation and Authorization of Chemicals), will take effect from June 2008. Manufacturers will be required to provide detailed information on substances used in their products. This could be a hit to China manufacturers considering the number of recalls of Chinese products in 2007.

Another important regulatory change is the implementation of the one-year surveillance system on China's textile exports to the EU, effective from 1 January 2008. Under this system, China's textile exports to the EU will be tracked on the Chinese side through export licenses and will be monitored when they enter the EU. The worst case is that this new system will become one of the EU's measures to curb textile imports from China.

3. China's export growth will moderate while import growth will accelerate

State Information Center under the Chinese government estimated that China's export growth would decrease to 19% yoy while imports growth would be kept at 18% yoy in 2008. Thus, the trade surplus would reach US\$ 332 billion, up by 26.6% yoy in 2008, down from 48.1% in 2007.

Negative factors affecting China's export growth include: speeding up of RMB appreciation; a US-led global slowdown; rising overseas protectionism; impacts of China's policies on processing trade; and increasing export prices driven by rising labor cost, raw material costs and other production costs.

On the contrary, import growth is likely to continue its upward trend, boosted by factors such as: government policies to promote imports and narrow trade surplus; the emerging middle class in China; increasing household income; accelerating rate of urbanization; and the influx of foreign brands in China. The increase in import, coupled with decelerating export growth, would result in slowdown in the growth of, or even decline in, the trade surplus in 2008.

Meanwhile, we have seen general trade keeps catching up with the processing trade. We also witnessed a significant upgrade in China's export structure. Export of low-value added products have been dropping while export of high-tech products and services are growing. This is in line with the government policy direction of industrial upgrading.



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