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Domestic Trade

Retail sales of consumer goods reached 13,081.1 billion yuan in 1-3Q11, up nominally by 17.0% yoy. Among commodities, sales of 'gold, silver, and jewelry' registered the strongest growth of 47.8% yoy in 1-3Q11, followed by 'petroleum and related products' (39.3% yoy). The growth of sales of 'automobiles' declined to 16.0% yoy in 1-3Q11. The consumer confidence index was on a downward trend in 3Q11.

China's CPI growth moderated on a year-on-year basis in August and September. On a month-on-month basis, the CPI gained 0.3% and 0.5% in August and September respectively, indicating that consumer prices in China have continued to increase.

The number of wealthy individuals in China has grown rapidly, according to the GroupM Knowledge - Hurun Wealth Report 2011. China's wealthy individuals were concentrated in Beijing, Guangdong, Shanghai, and Zhejiang. The rapid rise in the number of wealthy individuals bodes well for China's luxury market.

The rural subsidies scheme for home appliance purchases in Shandong, Henan, Sichuan and Qingdao will come to an end on 30 November 2011. We believe the subsidies scheme adopted in other provinces will be ended in late 2012 and early 2013. The withdrawal of the scheme will adversely affect the sales of home appliances in the short term, but we are still optimistic about the medium to long term outlook for the home appliance market in rural areas.

Foreign Trade

Both China's exports and imports showed decelerating growth. Overall, in 1-3Q11, China's exports amounted to US\$ 1,392.3 billion, up by 22.7% yoy; Imports totaled US\$ 1,285.2 billion, up by 26.7% yoy. China recorded a quarterly trade surplus of US\$ 63.8 billion in 3Q11, the highest in four quarters.

China's trade with its major trading partners showed robust growth. In 1-3Q11, Sino-EU trade amounted to US\$ 422.5 billion, up by 20.9% yoy; Sino-US trade rose by 17.0% yoy to hit US\$ 325.9 billion; Sino-ASEAN trade increased by 26.4% yoy to reach US\$ 267.1 billion; Sino-Japan trade grew by 18.2% yoy to US\$ 253.5 billion.

RMB appreciated by 1.8% against the US dollar in 3Q11. We forecast that the nominal RMB/USD exchange rate will appreciate by 5.1-6.8% overall in FY11 to reach 6.2-6.3 at end-2011.

The free trade agreement signed by China and Costa Rica has been implemented recently. According to the agreement, more than 60% of tariff items traded between China and Costa Rica have become tariff-free since 1 August 2011. The arrangement is expected to boost Sino-Costa Rica trade.

Chinese exporters face rising risk of trade protectionism. On 5 September, the WTO rejected China's appeal against the WTO ruling that backed the US government's imposition of punitive tariffs on Chinese tires in September 2009. The WTO ruling may encourage foreign governments to impose more product-specific safeguard measures targeted at Chinese exporters.

European leaders agreed on a comprehensive set of measures on 27 October to address the tensions in the financial markets and to restore confidence. The move will help stem the contagion from the debt crisis in the short term. However, the measures are not enough to solve the structural problems underlying the debt crisis.

Helen Chin, Timothy Cheung
Tel: (852) 2300 2471

helenchin@lf1937.com

timothycheung@lf1937.com

Li & Fung Research Centre

11/F, LiFung Tower,
868 Cheung Sha Wan Road,
Hong Kong

Tel : (852) 2300 2470

Fax : (852) 2635 1598

E-mail: lfdc@lf1937.com

<http://www.lifunggroup.com/>

Part One: Domestic Trade

I. Recent Development

1. China's economic growth moderated but was still strong

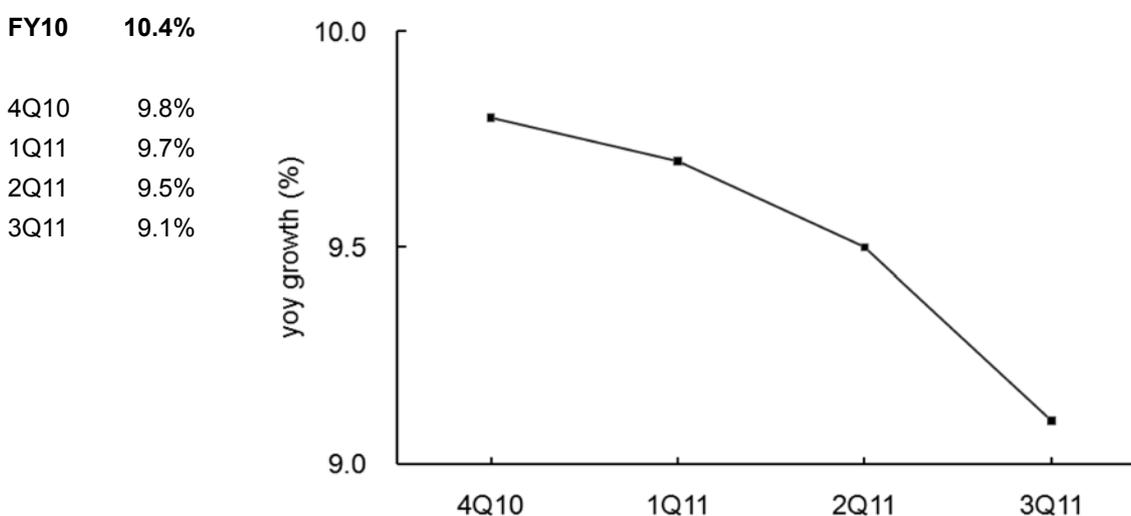
China's real GDP rose by 9.1% yoy in 3Q11, compared to the growth of 9.5% yoy in 2Q11. On a seasonally-adjusted basis, the real GDP growth edged down from 2.4% qoq in 2Q11 to 2.3% qoq in 3Q11. Overall, in 1-3Q11, China's nominal GDP amounted to 32.1 trillion yuan, up by 9.4% yoy in real terms. (See exhibit 1)

Among different industries, the contribution of the secondary industry to China's nominal GDP was 48.3% in 1-3Q11, up from 46.9% in 2010; the contribution of the tertiary industry declined from 43.1% in 2010 to 42.3% in 1-3Q11; and the contribution of the primary industry was 7.7% in 1-3Q11, down from 10.1% in 2010.

The dataset released by the National Bureau of Statistics (NBS) indicated that the Chinese economic growth moderated, but was still strong in 3Q11. However, in recent months, there have been numerous reports about the serious slowdown in economic activities in Wenzhou, one of the prime manufacturing bases in China, caused mainly by the tight credit conditions and the slowing export demand. A spokesman of the Zheshang Research Association said in late August that 30% of the 360,000 small- and medium-sized enterprises (SMEs) in Wenzhou had partially suspended or even shut down their operations. Besides, many business owners in Wenzhou fled and left massive amounts of unpaid loans behind, according to the local media. Due to limited media coverage, we are uncertain whether the economic situations in other areas in China are similar to Wenzhou, and we will continue to monitor the latest developments.

Looking ahead, the Chinese economic growth is expected to further decline in coming quarters, due to the slowing foreign and domestic demand. We predict that the GDP growth will go down from 9.1% yoy in 3Q11 to around 8.5% yoy in 4Q11. (More discussion about the economic outlook in China can be found in the *Outlook* section.)

Exhibit 1: China's real GDP growth, 4Q10 - 3Q11

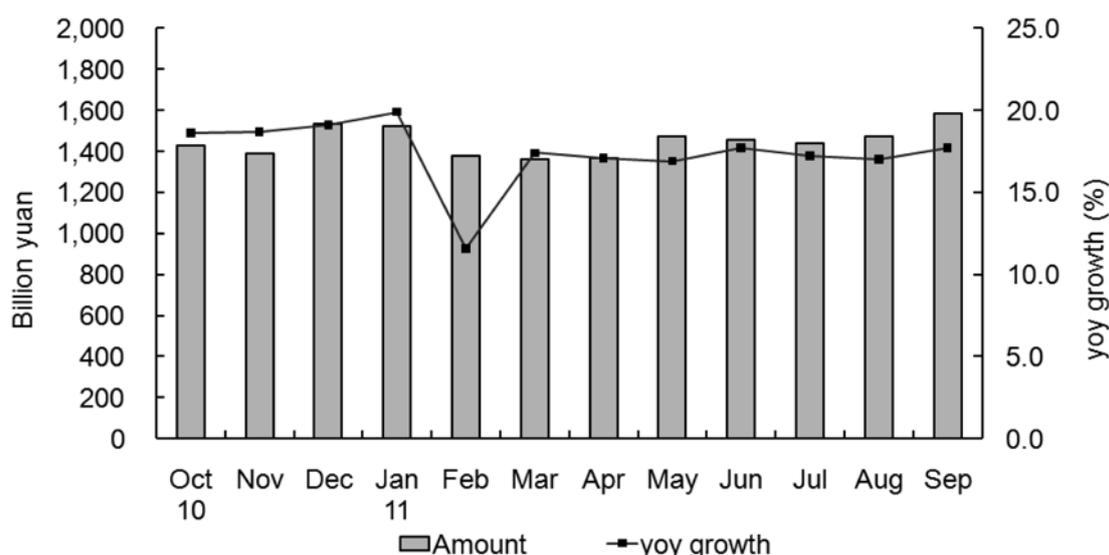


Source: National Bureau of Statistics, PRC

2. Retail sales of consumer goods witnessed steady growth in the first three quarters of the year

According to the NBS, the total retail sales of consumer goods grew nominally by 17.0% yoy to reach 13,081.1 billion yuan in 1-3Q11. By month, the retail sales grew nominally by 17.2% yoy, 17.0% yoy and 17.7% yoy in July, August and September respectively. (See exhibit 2)

Exhibit 2: China's total retail sales of consumer goods, Oct 2010 - Sep 2011



Source: National Bureau of Statistics, PRC

From April 2011 onwards, the NBS released the month-on-month (mom) growth figures of the total retail sales. On a seasonally-adjusted basis, the mom growth of the retail sales stayed stable throughout February to September, ranging from 1.30% to 1.36%. (See exhibit 3)

Exhibit 3: China's total retail sales of consumer goods, Apr - Sep 2011

mom growth (%), seasonally adjusted

	Apr	May	Jun	Jul	Aug	Sep
Total retail sales	1.32	1.33	1.36	1.31	1.30	1.35

Source: National Bureau of Statistics, PRC

In 1-3Q11, the urban retail sales totaled 11,326.5 billion yuan, up nominally by 17.1% yoy, while the rural retail sales amounted to 1,754.6 billion yuan, up by 16.4% yoy.

By mode of sales, the retail sales of commodities reached 11,607.4 billion yuan, up nominally by 17.0% yoy in 1-3Q11; the catering industry posted sales growth of 16.5% yoy in nominal terms to reach 1,473.7 billion yuan.¹ (See exhibit 4)

¹ Since January 2010, the NBS has adopted new categories for the total retail sales of consumer goods. "Retail sales of commodities" and "retail sales of the catering industry" replaced the previous categories of "retail sales in the wholesale and retail industries" and "retail sales in the accommodation and catering industries".

The retail sales of commodities of enterprises above designated size² grew by 24.3% yoy to reach 5,560.7 billion yuan in 1-3Q11. Among commodities, sales of “gold, silver, and jewelry” registered the strongest growth of 47.8% yoy in 1-3Q11, followed by “petroleum and related products” (39.3% yoy). Meanwhile, the growth of sales of “automobiles” declined to 16.0% yoy in 1-3Q11, 18.9 ppt. lower than that of the same period last year. The slowdown in growth was caused mainly by the withdrawal of the government subsidies on car purchases and the government measures to limit the new car registrations in some cities. Housing-related items saw slower sales growth as well, which was attributable to the government’s efforts to cool down the housing market. For example, growth of sales of “furniture” was 31.4% yoy, 7 ppt lower than that in 1-3Q10. Exhibit 5 demonstrates the nominal growth of China’s retail sales of enterprises above designated size by commodity.

Exhibit 4: China’s total retail sales, 2010 - 1-3Q11

<i>yoy growth (%)</i>	FY10	1Q11	1H11	1-3Q11
Total retail sales	18.4	16.3	16.8	17.0
- Commodities	18.5	16.5	16.9	17.0
<i>of which: enterprises above designated size</i>	29.9	23.0	24.2	24.3
- Catering	18.0	15.3	16.2	16.5

Source: National Bureau of Statistics, PRC

Exhibit 5: China’s retail sales of enterprises above designated size by commodity, 2010 - 1-3Q11

<i>yoy growth (%)</i>	FY10	1Q11	1H11	1-3Q11
Clothing, shoes, hats and textiles	24.5	22.3	23.9	24.8
Cosmetics	16.0	17.8	20.0	19.5
Stationeries and offices accessories	23.4	20.2	21.8	24.5
Goods for daily use	24.9	22.7	24.5	24.7
Home appliances and video equipments	26.9	20.5	21.5	20.5
Furniture	37.5	24.5	30.0	31.4
Grain, oil, food, beverages, tobacco, and liquor	23.7	23.1	24.7	25.2
Gold, silver, and jewelry	45.8	51.8	49.6	47.8
Telecommunication equipments	19.2	22.8	27.0	27.8
Automobiles	34.5	14.2	15.0	16.0
Petroleum and related products	34.5	37.6	39.2	39.3
Building and decoration materials	31.6	25.5	28.3	29.8
Sports and entertainment products	18.5	19.0	15.8	13.0
Chinese and western medicine	23.4	21.0	19.6	20.2

Source: National Bureau of Statistics, PRC

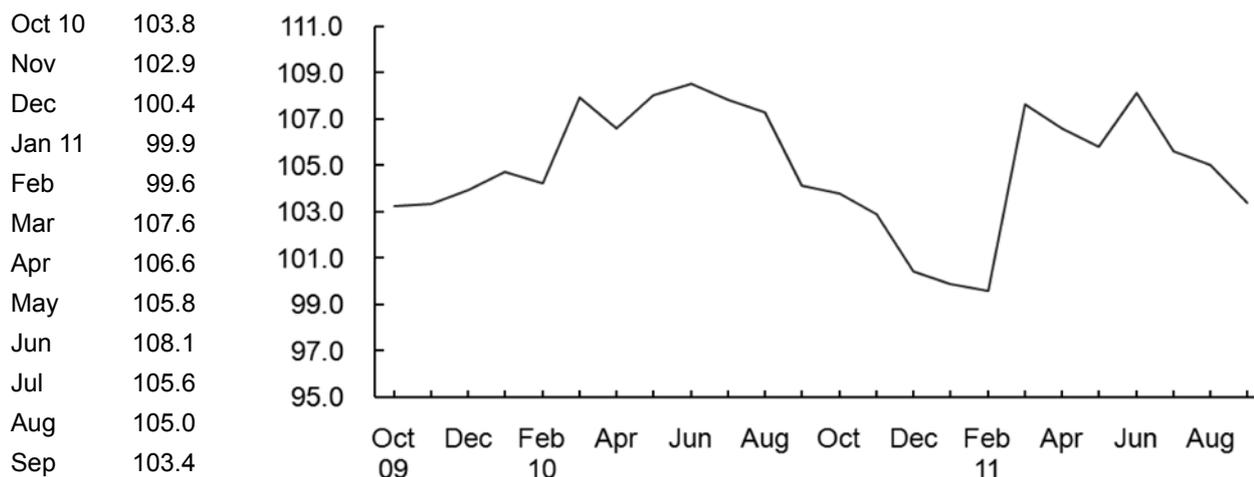
On the other hand, according to the Ministry of Commerce (MOFCOM), the retail sales during the “Golden Week” (1-7 October) this year were robust. Retail sales of surveyed retailers and restaurants amounted to 696.2 billion yuan, up by 17.5% compared with the last Golden Week holiday.

² Enterprises above designated size refer to enterprises with annual sales of 5 million yuan or above and with an employment of or over 60.

3. Consumers were less optimistic in the third quarter of 2011

The consumer confidence index³ was on a downward trend in 3Q11, declining from 105.6 in July to 105.0 in August and further to 103.4 in September. The decline in consumer confidence was probably due to escalating inflationary pressure in the past months and renewed concerns about the economy. (See exhibit 6)

Exhibit 6: China's consumer confidence index, Oct 2009 - Sep 2011



Source: National Bureau of Statistics, PRC

4. Per capita cash expenditure on consumption of rural households grew strongly in 1-3Q11

In 1-3Q11, both urban and rural household income recorded double-digit growth, boding well for domestic consumption. The nominal growth rate of the per capita cash income of rural households accelerated to 20.7% yoy in 1-3Q11, up from 13.1% yoy in 2010. In 1-3Q11, the per capita cash income of rural households reached 5,875 yuan. In comparison, the per capita disposable income of urban households, which amounted to 16,301 yuan in 1-3Q11, grew at a slower pace. The nominal growth rate was 13.7% yoy in 1-3Q11, higher than that in 2010 (11.3% yoy).

Nevertheless, the real income growth of Chinese households was eroded by inflation. In comparison to the nominal growth rates, the real growth rates of both urban and rural household income were much lower in 1-3Q11, registering only 7.8% yoy and 13.6% yoy respectively.

The per capita consumption expenditure of urban households registered growth of 12.6% yoy in nominal terms in 1-3Q11, compared to the growth of 9.8% yoy in 2010. It is noteworthy that the nominal growth rate of the per capita cash expenditure on consumption of rural households was much higher in 1-3Q11, registering 23.0% yoy.

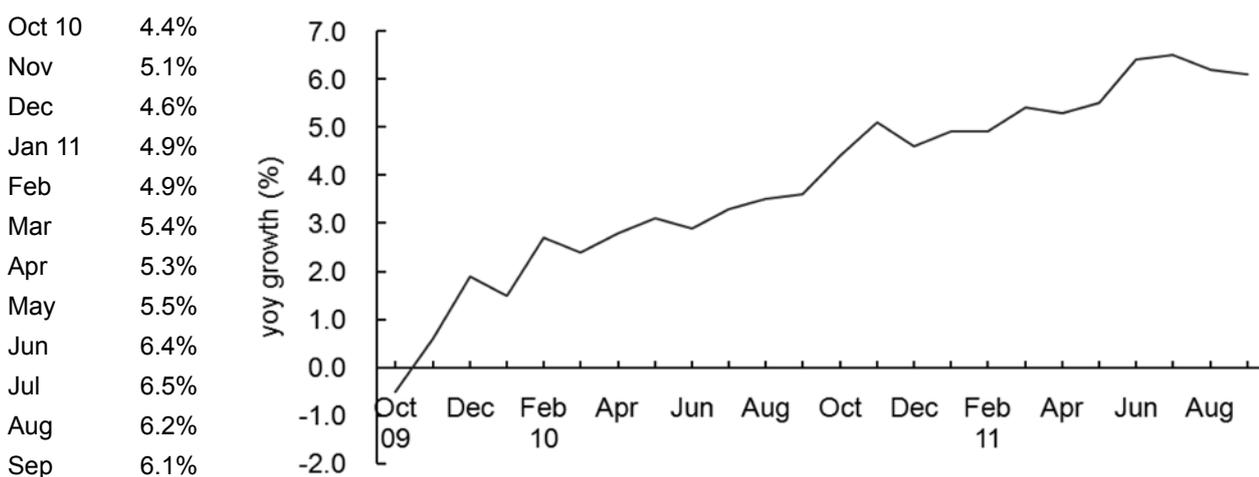
³ A reading above 100 indicates that consumers tend to be optimistic; a reading below 100 indicates that consumers tend to be pessimistic.

5. China's CPI growth moderated on a year-on-year basis

Driven mainly by mounting food prices, the yoy growth rate of China's consumer price index (CPI)⁴ stayed high at 6.4% yoy in June and 6.5% yoy in July, the highest in thirty seven months. Afterwards, it moderated to 6.2% yoy in August and 6.1% yoy in September. (See exhibits 7 & 8) The decline in the CPI growth was due to the higher comparison base in the same period of the previous year. On a month-on-month (mom) basis, the CPI gained 0.3% and 0.5% in August and September respectively, indicating that the consumer prices in China have further increased. In September, the price index of food rose by 1.1% mom, while that of non-food was up by 0.2% mom.

Looking ahead, we expect that China's consumer prices will continue to rise in the near term. Supported by strong domestic demand, food prices are likely to stay elevated. At the same time, non-food prices are also set to trend upward, influenced by factors such as the pass-through of higher labour costs, greater inflationary expectations, etc. Nevertheless, the yoy growth of the CPI may further moderate in the following months, given the higher comparison base in 4Q10.

Exhibit 7: China's CPI growth, Oct 2009 - Sep 2011



Source: National Bureau of Statistics, PRC

Exhibit 8: China's CPI growth by commodity, Apr - Sep 2011

yoy growth (%)	Apr	May	Jun	Jul	Aug	Sep
Food	11.5	11.7	14.4	14.8	13.4	13.4
Tobacco & liquor	2.4	2.6	2.7	2.8	2.9	3.4
Clothing	1.4	1.8	2.1	2.2	2.9	3.2
Household services, maintenance and renovation	2.1	2.5	2.5	2.7	2.8	3.0
Medical healthcare & personal care	3.2	3.2	3.4	3.6	4.1	4.1
Transportation and communication	0.5	0.7	0.9	0.9	1.0	1.0
Recreational, educational products & services	0.5	0.6	0.6	0.5	0.4	0.0
Housing	6.1	6.1	6.2	5.9	5.5	5.1

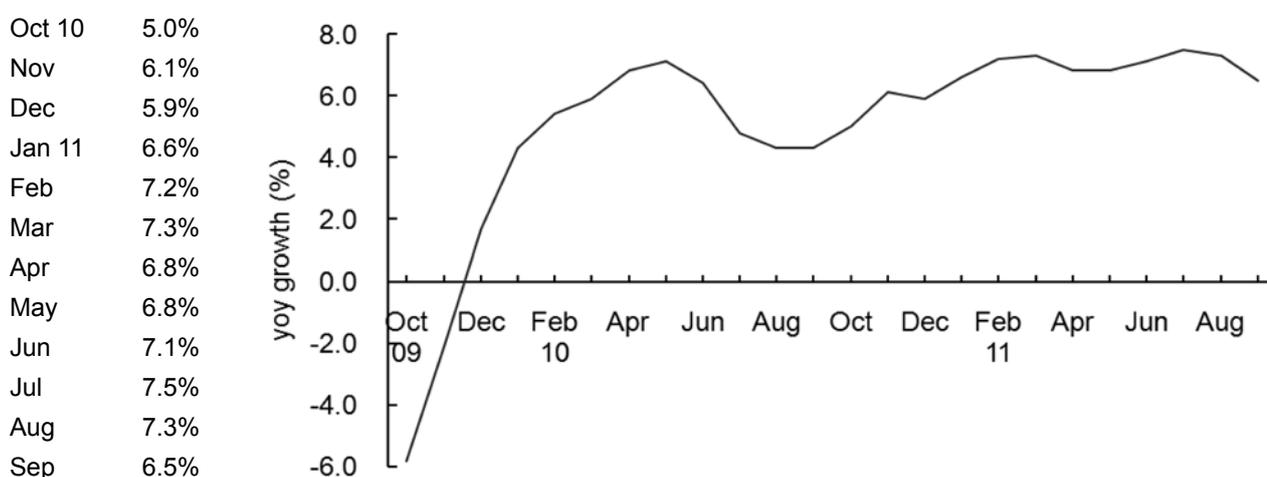
Source: National Bureau of Statistics, PRC

4 The CPI, compiled by the National Bureau of Statistics of China, measures the price of a basket of goods and services that a typical household purchases.

After going up from 7.1% yoy in June to 7.5% yoy in July, the growth rate of China's producer price index of industrial products (PPI)⁵ edged down to 7.3% yoy in August, and further dropped to 6.5% yoy in September, the lowest in nine months. (See exhibit 9)

Looking ahead, the PPI growth is expected to slow further in coming months, as manufacturers will find it more difficult to raise prices of their products, amid the weakening domestic demand and foreign demand. On the other hand, the decline in global commodity prices will ease cost pressure on manufacturers. However, labour-intensive manufacturers in China will continue to suffer badly from rising labour costs in the foreseeable future. According to the 12th Five-year Plan, the minimum wage is targeted to increase by 13% per annum in 2011-2015. We expect that local governments in a number of provinces will raise minimum wage levels in their jurisdictions in 2012, although many of them already did so in 1-3Q11.

Exhibit 9: China's PPI growth, Oct 2009 - Sep 2011



Source: National Bureau of Statistics, PRC

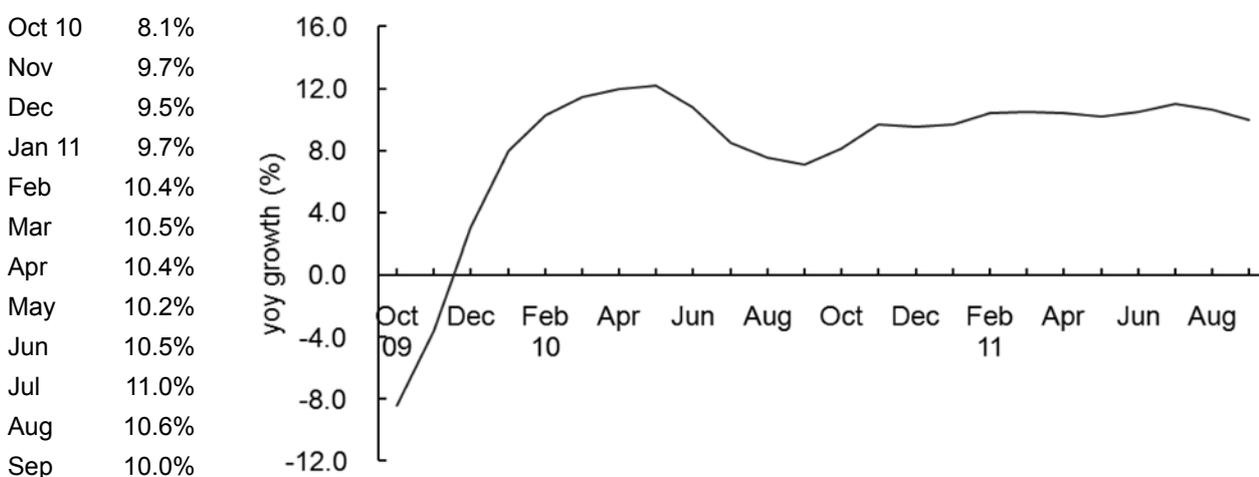
The yoy growth rate of the purchaser price index of industrial products⁶ rose to the recent peak of 11.0% yoy in July, before moderating to 10.6% yoy in August and 10.0% yoy in September. (See exhibits 10 & 11) On a month-on-month basis, the purchaser price index gained 0.1% in September, showing that upstream prices had risen from the previous month. The rise in the price index raises concerns about the problems of production cost pressure and squeezed producers' margins.

Looking ahead, we believe that global commodity prices will further decline in the near term, amid the slowing growth of the global economy. This, in turn, will put downward pressure on the prices of production inputs.

5 The PPI, compiled by the National Bureau of Statistics of China, measures the prices of industrial products when they are sold for the first time after production.

6 The purchasing price index of raw material, fuel and power was renamed the purchaser price index of industrial products, effective from January 2011. The price index, compiled by the National Bureau of Statistics of China, measures the prices of production inputs such as raw materials, fuels and power purchased by industrial enterprises.

Exhibit 10: The purchaser price index of industrial products, Oct 2009 - Sep 2011 (% yoy growth)



Source: National Bureau of Statistics, PRC

Exhibit 11: The purchaser price index of industrial products by selected commodity, Apr - Sep 2011

yoy growth (%)	Apr	May	Jun	Jul	Aug	Sep
Fuel & power	11.6	11.7	12.0	12.6	12.7	12.3
Ferrous metals	10.9	9.4	8.9	10.2	9.9	8.8
Non-ferrous metals	13.2	14.5	17.2	18.9	16.8	14.7
Raw materials for the chemical industry	11.7	11.6	12.5	13.3	13.4	12.7

Source: National Bureau of Statistics, PRC

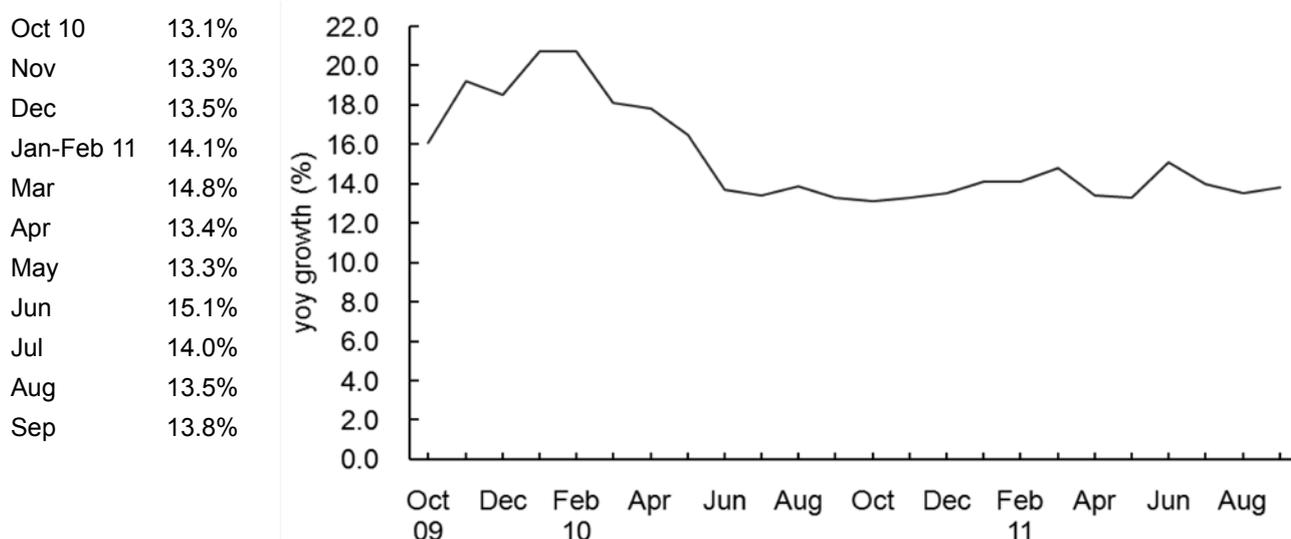
6. Growth of industrial production has stayed relatively stable

The growth of the value-added of industrial output (VAIO) in China stayed relatively stable at 14.0% yoy, 13.5% yoy and 13.8% yoy in July, August and September respectively, compared to 14.3% yoy in 1H11.⁷ (See exhibit 12)

Among different industries, the industrial output of heavy industry rose by 14.6% yoy; while that of light industry increased by 13.1% yoy in 1-3Q11.

Looking ahead, we expect that industrial activities in China will continue to be supported by the robust consumption demand and the local governments' efforts to build public housing. Downside risks, however, include the liquidity crunch problem facing the Chinese enterprises if the monetary and credit tightening continues, spiraling labour cost, escalated measures to curb inflation and real estate speculation, as well as worse-than-expected situations in the EU and the US.

⁷ The National Bureau of Statistics has changed the method of compiling the value added of industrial output (VAIO), effective from January 2011. The statistical threshold for industrial enterprises has been raised to cover those with annual revenue of 20 million yuan or above, up from the previous threshold of 5 million yuan or above. According to the bureau, the adjustment would have limited impact on the growth figures.

Exhibit 12: China's industrial production growth, Oct 2009 - Sep 2011

Source: National Bureau of Statistics, PRC

7. Fixed asset investment recorded rapid growth in 1-3Q11

China's nominal fixed asset investment (FAI) (excluding rural households) recorded rapid growth of 24.9% yoy in 1-3Q11, reaching 21.2 trillion yuan.⁸ (See exhibit 13)

Among different industries, FAI (excluding rural households) in the tertiary industry totaled 11.4 trillion yuan in 1-3Q11; that in the secondary industry was 9.3 trillion yuan; and that in the primary industry was 495.7 billion yuan. FAI (excluding rural households) in the tertiary industry recorded a growth of 23.4% yoy in 1-3Q11, lower than that in the secondary industry (26.9% yoy). Although the Chinese government has implemented a series of property tightening measures since early 2010, growth of FAI (excluding rural households) in real estate development stayed robust at 32.0% yoy in 1-3Q11, softening from 32.9% yoy in 1H11.

Looking ahead, we do not expect FAI growth to record a sharp decline in the near term, supported by the government's efforts to build public housing. The government plans to start the construction of 10 million units of public housing in 2012, implying that it will continue to make massive investments in public housing in the near future. Also noteworthy is that the growth of the planned FAI in newly started projects rose from -12.7% yoy in 1Q11 to 23.4% yoy in 1-3Q11, suggesting that investment demand will accelerate soon.

Exhibit 13: China's FAI (excluding rural households), Apr - Sep 2011

ytd yoy growth (%)	Apr	May	Jun	Jul	Aug	Sep
FAI (excluding rural households)	25.4	25.8	25.6	25.4	25.0	24.9

Source: National Bureau of Statistics, PRC

⁸ The National Bureau of Statistics has expanded the coverage of the monthly statistics on FAI from the urban areas to rural enterprises and institutions, effective from 2011. Thus, "FAI (excluding rural households)", the new indicator, has been released by the bureau since March 2011 to replace "urban FAI", the old indicator. Besides, a new statistical criterion has been adopted. The statistical threshold for the size of investment project has been adjusted upward from 500,000 yuan to 5 million yuan. According to the bureau, the adjustment would have limited impact on the growth figures.

II. Highlights

1. The fast growth of consumer loans in China is set to continue

The fast growth of consumer loans in China is set to continue in coming future. In its latest report, the Boston Consulting Group (BCG) projects that the total amount of consumer loans will grow at a compound annual growth rate (CAGR) of 24% between 2010 and 2015, due largely to the strong growth of the economy and household income, the intensified government efforts to boost consumption, as well as the low penetration rate of consumer finance.⁹ In 2015, the total amount of consumer loans is projected to reach 21 trillion yuan, compared to 7 trillion yuan in 2010.

Among the major types of consumer loans, mortgage is projected to account for the largest share (75%) of the total amount of consumer loans in 2015. However, the CAGR of mortgage is projected to slow to 21% between 2010 and 2015, compared to the CAGR of 27% between 2005 and 2010.

The short term loans for personal consumption of durable goods or services such as education, healthcare, house renovation, which are collectively called “consumer finance” by the BCG, are projected to register the highest CAGR of 45% between 2010 and 2015, after rising at a CAGR of 141% between 2005 and 2010.

According to a survey recently conducted by the BCG, 8% of the respondents indicated that they planned to apply for “consumer finance” in the next year, while only 2% of the respondents were users then. On the other hand, it is expected that local banks and consumer finance companies will strengthen their efforts to offer this type of loans to their customers. In our view, the rapid development of consumer finance, together with increasing household income, will continue to boost the growth of household expenditures on durable goods and services such as education, healthcare, home renovation, etc.

2. Urban disposable income recorded robust growth in 1H11

In 1H11, the per capita disposable income of urban households in most provinces/municipalities in China recorded double-digit growth. The exceptions were Guangxi, Tibet and Qinghai. Among provinces/municipalities in the country, Tibet registered the slowest growth of 8.6% yoy, whilst Hainan recorded the highest growth of 19.4% yoy in 1H11. (See exhibit 14)

In 1H11, urban households in the eastern provinces, in general, still earned much more income than those in the central and the western provinces. Nine of the top ten provinces in terms of the per capita disposable income of urban households were the eastern provinces.

Given the strong job market and the government determination to boost income of the low-income households, we predict that the per capita disposable income of urban households in most provinces will maintain double-digit growth for the rest of the year, and thus urban retail sales are set to show strong growth in the coming months.

⁹ <http://www.bcg.com.cn/en/newsandpublications/publications/reports/report20110831001.html>

Exhibit 14: Provinces/municipalities ranked in terms of per capita disposable income of urban households, 1H11

Rank	Province/ municipality	Per capita disposable income of urban households	
		amount (yuan)	yoy growth
1	Shanghai	18,381.9	12.4%
2	Zhejiang	16,834.6	12.8%
3	Beijing	16,236.3	10.1%
4	Guangdong	13,903.4	11.9%
5	Jiangsu	13,741.1	13.8%
6	Fujian	12,980.1	12.9%
7	Tianjin	12,860.6	13.6%
8	Shandong	11,098.0	13.3%
9	Chongqing	10,382.7	14.3%
10	Liaoning	10,037.5	15.4%
11	Inner Mongolia	10,035.2	13.9%
12	Hunan	9,512.5	12.7%
13	Hainan	9,512.0	19.4%
14	Hubei	9,485.3	13.6%
15	Guangxi	9,484.0	8.8%
16	Sichuan	9,387.9	14.9%
17	Anhui	9,356.1	18.2%
18	Shaanxi	9,345.9	15.6%
19	Yunnan	9,137.4	13.5%
20	Hebei	9,104.3	11.3%
21	Henan	9,009.8	11.5%
22	Jilin	8,759.8	15.2%
23	Shanxi	8,653.3	14.6%
24	Jiangxi	8,536.2	12.1%
25	Guizhou	8,284.9	14.2%
26	Ningxia	8,084.6	12.4%
27	Tibet	7,895.2	8.6%
28	Xinjiang	7,654.2	15.9%
29	Heilongjiang	7,531.2	11.6%
30	Gansu	7,329.5	13.7%
31	Qinghai	7,032.4	8.7%

Source: National Bureau of Statistics, PRC

3. The number of wealthy individuals in China has grown rapidly

According to the GroupM Knowledge - Hurun Wealth Report 2011, China had 960,000 individuals with personal wealth¹⁰ of more than 10 million yuan in 2010, up strongly by 9.7% from the previous year.¹¹

¹⁰ The GroupM Knowledge - Hurun Wealth Report takes into account all private wealth, including privately-held businesses, private residences and investable assets.

¹¹ <http://img.hurun.net/hmec/2011-08-23/201108231121093254.pdf>

China's wealthy individuals were concentrated in Beijing, Guangdong, Shanghai, and Zhejiang. According to the report, 60.9% of the individuals with personal wealth of more than 10 million yuan in China lived in the abovementioned provinces/ municipalities in 2010.

The rapid rise in the number of wealthy individuals bodes well for China's luxury market. Bain & Company forecasted in mid-October that the sales of luxury goods in China would increase considerably by 35% in 2011.¹²

4. The rural subsidies scheme for home appliance purchases in Shandong, Henan, Sichuan and Qingdao will soon come to an end

To boost rural consumption, the Chinese government launched the rural subsidies scheme for home appliance purchases in Shandong, Henan, Sichuan and Qingdao on 1 December 2007, and extended the scheme to cover other provinces in China in late 2008 and in early 2009.

According to an announcement by the government on 8 September 2011, the scheme carried out in Shandong, Henan, Sichuan and Qingdao would be ended, as scheduled, on 30 November 2011. The move hinted that the scheme adopted in other provinces would be ended in late 2012 and in early 2013.

In our view, the implementation of the scheme has been effective at boosting the sales of home appliances in the rural areas. As of September 2011, the sales of home appliances under the rural subsidies scheme for home appliance purchases amounted to 429.9 billion yuan, with around 189 million units of subsidized home appliances being sold. Therefore, it is expected that the withdrawal of the scheme will adversely affect the sales of home appliances.

That said, we are still optimistic about the medium to long term outlook for the home appliance market in rural areas, as the penetration rates of various types of home appliances remain low. According to the NBS, among every 100 rural households, 45.2 owned refrigerators, 16.0 owned air-conditioners and 57.3 owned washing machines in 2010. Besides, we expect rural household income to maintain strong growth, as a result of the government efforts to foster the development of the rural areas through accelerating infrastructure investment and implementing favorable policies to support the agricultural industry.

5. The credit conditions in China have remained tight

The credit conditions in China have remained tight in the recent months. Compared to 2Q11, the yoy growth rates of both money supply and RMB loans moderated in 3Q11. As of end-September, the broad money supply (M2) rose by 13.0% yoy, lower than the 15.9% yoy growth registered as of end-June. The amount of total outstanding RMB loans increased by 15.9% yoy as of end-September, compared to the 16.9% yoy growth as of end-June. The total amount of the new RMB loans was 5.7 trillion yuan in 1-3Q11, lower than that in 1-3Q10 (6.3 trillion yuan). (See exhibit 15)

In late August, China's central bank issued a notice that banks' reserve requirement would be extended to cover margin deposits. The new reserve requirement rule, which has phased in since 5 September 2011, would cause banks to increase required deposits with the central bank, and in turn would tighten the credit conditions.

¹² <http://www.bain.com/about/press/press-releases/worldwide-luxury-goods-market-poised-to-surge-ten-percent-in-2011.aspx>

Amid the tight credit conditions, many private enterprises, especially the small- and medium-sized enterprises (SMEs), have found it difficult to get bank loans in recent months. Some of them have been forced to obtain loans from underground lenders with sky-high interest rates (as high as an annualized 60%).

On 12 October, the State Council announced to increase credit support to small and micro-sized enterprises, hinting that the government would start to adjust the lending structure. However, in our view, the government statement should not be viewed as a sign that the government will take action to ease the overall credit conditions in China. It is too early to speculate that the central bank will soon loosen the loan quotas, reduce interest rates or lower banks' reserve requirement ratio (RRR). In fact, as the inflationary pressure is still intense, we do not expect major changes in China's overall monetary policy in the near term (despite comments by Premier Wen Jiabao that China must 'fine-tune' policy at an appropriate time), and the overall credit conditions are set to remain relatively tight.

Exhibit 15: Broad money supply (M2) and RMB loans

As of	Broad money supply (M2)		Total outstanding RMB loans	
	Amount (trillion yuan)	yoy growth	Amount (trillion yuan)	yoy growth
End-Oct 10	70.0	19.3%	46.9	19.3%
End-Nov	71.0	19.5%	47.4	19.8%
End-Dec	72.6	19.7%	47.9	19.9%
End-Jan 11	73.6	17.2%	48.4	18.5%
End-Feb	73.6	15.7%	48.9	17.7%
End-Mar	75.8	16.6%	49.5	17.9%
End-Apr	75.7	15.3%	50.2	15.8%
End-May	76.3	15.1%	50.8	17.1%
End-Jun	78.1	15.9%	51.4	16.9%
End-Jul	77.3	14.7%	51.9	16.6%
End-Aug	78.1	13.5%	52.4	16.4%
End-Sep	78.7	13.0%	52.9	15.9%

New RMB loans (trillion yuan)	
FY09	9.59
FY10	7.95
Oct 10	0.59
Nov	0.56
Dec	0.48
Jan 11	1.04
Feb	0.54
Mar	0.68
Apr	0.74
May	0.55
Jun	0.63
Jul	0.49
Aug	0.55
Sep	0.47

Source: People's Bank of China

Exhibit 16: Adjustments in one-year benchmark deposit and lending rates, Jan 2010 - Oct 2011

Effective date	Adjustment	One-year benchmark deposit rate after the adjustment	One-year benchmark lending rate after the adjustment
20 Oct 10	+25 bps	2.50%	5.56%
26 Dec	+25 bps	2.75%	5.81%
9 Feb 11	+25 bps	3.00%	6.06%
6 Apr	+25 bps	3.25%	6.31%
7 Jul	+25 bps	3.50%	6.56%

Source: People's Bank of China

Exhibit 17: Reserve requirement ratio (RRR) adjustments, Jan 2010 - Oct 2011

Effective date	Adjustment	RRR for the major banks after the adjustment*
18 Jan 10	+50 bps	16.0%
25 Feb	+50 bps	16.5%
10 May	+50 bps	17.0%
16 Nov	+50 bps	17.5%
29 Nov	+50 bps	18.0%
20 Dec	+50 bps	18.5%
20 Jan 11	+50 bps	19.0%
24 Feb	+50 bps	19.5%
25 Mar	+50 bps	20.0%
21 Apr	+50 bps	20.5%
18 May	+50 bps	21.0%
20 Jun	+50 bps	21.5%

* The major banks include Bank of China, Industrial and Commercial Bank of China, Agricultural Bank of China, China Construction Bank, Bank of Communications, and Postal Savings Bank

Source: People's Bank of China

III. Outlook

1. The Chinese economic growth is expected to slow further

The Chinese economic growth is expected to decelerate further in the coming quarters, due to the slowing foreign and domestic demand. We think China's export growth will go down from 20.6% yoy in 3Q11 to around 15%-20% yoy in 4Q11 and 10%-15% yoy in 1Q12, amid the weakening global economy. Export orders in the coming months may fall drastically if the financial turmoil and economic slowdown in the EU and the US deteriorate rapidly, although China's exports will continue to be cushioned by orders from emerging markets.

Also noteworthy is that the recent decline in property sales in a number of cities is expected to trigger a moderation in demand for housing-related items such as home appliances, furniture, kitchen products, bathroom products,

household textile products, etc. The investment demand of private property developers will also be greatly discouraged, which will in turn reduce the demand for construction materials and lead to a slowdown of industrial and construction activities.

Besides, as mentioned above, China's central bank is unlikely to relax its monetary policy in the near term, as the inflationary pressure is still intense. The tight credit conditions will continue to constrain the domestic demand in China.

On the other hand, economic activities will be supported by the government's efforts to build public housing and to help the small enterprises. On 12 October, the State Council announced to introduce a series of measures to support small and micro-sized enterprises.¹³ The key takeaways are:

- To increase credit support to small and micro-sized enterprises.
- To expand financing channels for small and micro-sized enterprises.
- To halt the collection of unreasonable bank charges.
- To support the development of small financial institutions.
- To differentiate regulatory rules and to offer tax cuts to encourage financial institutions to make loans to small and micro-sized enterprises.
- To increase the minimum thresholds for the value-added-tax (VAT) and the business tax on small and micro-sized enterprises.
- To extend the tax breaks for low-profit enterprises to 2015.
- To increase funding to support small and micro-sized enterprises.

Overall, we predict that China's economic growth will decline from 9.1% yoy in 3Q11 to around 8.5% yoy in 4Q11. We also maintain that the probability of an economic hard landing is low, as the central government is able to introduce fiscal stimulus to boost the domestic demand if necessary, given its healthy fiscal position.

2. China's Entrepreneur Confidence Index dropped to 129.4 in 3Q11, the lowest since 1Q10

Chinese entrepreneurs, in general, were less optimistic about the prospects of their respective industries in 3Q11, as China's Entrepreneur Confidence Index (ECI) dropped from 132.4 in 2Q11 to 129.4 in 3Q11, the lowest since 1Q10.¹⁴ In our view, the decline in the ECI was mainly associated with the slowing domestic demand and foreign demand, as well as the mounting cost pressure. (See exhibit 18)

The ECIs of the property sector and the construction sector posted relatively sharp qoq decline in 3Q11, down by 7.6 points and 7.2 points respectively from the previous quarter. On the other hand, the hotel & catering sectors registered the biggest qoq gain, the ECI of which rose by 4.2 points from the previous quarter.

In 3Q11, the ECIs in the eastern and the western regions declined to 127.4 and 129.6, down by 5.0 points and 3.2 points respectively from the previous quarter, while the ECI in the central region edged up by 0.3 points from the previous sector to 132.4. (See exhibit 19)

¹³ http://big5.gov.cn/gate/big5/www.gov.cn/ldhd/2011-10/12/content_1967589.htm

¹⁴ China's Entrepreneur Confidence Index (ECI) ranges from 0 to 200. A reading above 100 indicates an expectation of improving economic situation; a reading below 100 indicates an expectation of worsening economic situation.

Exhibit 18: Entrepreneur Confidence Index

4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11
127.7	135.5	133.0	135.9	137.0	137.4	132.4	129.4

Source: National Bureau of Statistics, PRC

Exhibit 19: Entrepreneur Confidence Index, by sector

	2Q11	3Q11	Compared with the previous quarter
National	132.4	129.4	Lower
By sector			
Secondary industry	128.9	125.8	Lower
- Mining	154.7	156.3	Higher
- Manufacturing	127.2	123.9	Lower
- Electricity, gas & water	129.0	126.1	Lower
Construction	139.0	131.8	Lower
Transportation, storage & post service	128.5	128.9	Almost the same
Wholesale & retail	144.2	143.0	Lower
Property	107.5	99.9	Lower
Social services	139.5	138.1	Lower
Information transmission, computer service and software	163.5	159.8	Lower
Hotel & catering	135.3	139.5	Higher
By region			
Eastern region	132.4	127.4	Lower
Central region	132.1	132.4	Almost the same
Western region	132.8	129.6	Lower

Source: National Bureau of Statistics, PRC

3. The PMI has improved slightly

After going down from 50.9 in June to a twenty-nine-month low of 50.7 in July, China's manufacturing PMI edged up to 50.9 in August and then improved to 51.2 in September. The index readings indicate that the manufacturing sector in China has expanded in a steady manner in recent months. (See exhibit 20)

The new orders index improved slightly from 50.8 in June to 51.1 in July and in August, and further edged up to 51.3 in September. On the other hand, the new export orders index has fluctuated much in recent months. After decreasing from 50.4 in July to 48.3 in August, the index rebounded to 50.9 in September. Corresponding to the modest improvement in demand, the output index rose slightly from 52.1 in July to 52.3 in August, and further edged up to 52.7 in September.

Input prices stayed elevated, albeit rising at a relatively slow pace in recent months. The input prices index stayed within the range of 56.3-57.2 throughout June to September, compared to 60.3 in May. The purchases of inputs index fluctuated within the range of 51.2-52.0 throughout June to September.

Inventories have been shrinking. The stocks of major inputs index has remained below the 50-mark, although it rose all the way from 47.6 in July to 49.0 in September. Meanwhile, the stocks of finished goods index recorded readings of 49.2, 48.9 and 49.9 in July, August and September respectively. Manufacturers' destocking activities would constrain the growth of industrial output and might trigger the deceleration in purchases in the coming months.

Looking forward, we expect the headline PMI to fluctuate between 50-52 in 4Q11. Though a hard landing is unlikely, we forecast a soft landing of growth to around 8.5% in 4Q11. Industrial activities will continue to be supported by local governments' accelerated efforts to build public housing and robust consumption demand. Downside risks, however, include the liquidity crunch problem facing Chinese enterprises if the monetary and credit tightening continues, spiraling labour cost, escalated measures to curb inflation and real estate speculation, as well as worse-than-expected situations in the EU and the US.

Exhibit 20: China's manufacturing PMI at a glance, September 2011

Index	S. Adj Index	Index Compared with the Previous Month	Direction
PMI	51.2	Higher	Expanding
Output	52.7	Higher	Expanding
New Orders	51.3	Higher	Expanding
New Export Orders	50.9	Higher	Expanding
Backlogs of Orders	48.9	Higher	Contracting
Stocks of Finished Goods	49.9	Higher	Contracting
Purchases of Inputs	51.5	Higher	Expanding
Imports	50.1	Higher	Expanding
Input Prices	56.6	Lower	Expanding
Stocks of Major Inputs	49.0	Higher	Contracting
Employment	51.0	Higher	Expanding
Suppliers' Delivery Time	49.5	Lower	Slackening

Source: Li & Fung Research Centre

Part Two: Foreign Trade

I. Recent development

1. The growth rates of both China's exports and imports decelerated in September

China's export growth rose from the recent low of 17.9% yoy in June to 20.4% yoy in July and 24.5% yoy in August, but then decelerated to 17.1% yoy in September. Overall, China's exports amounted to US\$ 1,392.3 billion in 1-3Q11, up by 22.7% yoy. We believe that the recent slowdown in export growth was attributable to the weakening export demand. Besides, according to the local media, many manufacturers have not accepted production orders to their full capacities in recent months, as they found it difficult to fund their production activities. In addition, manufacturers in some provinces such as Guangdong, Guangxi, Guizhou, etc. have even faced power cuts. (See exhibits 21, 22 and 23)

In 3Q11, China's export growth to the US further moderated, while export growth to the European Union (EU) and Japan increased from the previous quarter. China's export growth to the EU, the US and Japan were 17.4% yoy, 14.7% yoy and 24.6% yoy respectively in 1-3Q11, compared to 16.9% yoy, 16.9% yoy and 23.7% yoy respectively in 1H11.

China's import growth declined to 20.9% yoy in September, after picking up from 19.3% yoy in June to 22.9% yoy in July and 30.2% yoy in August. China's import growth in 3Q11 accelerated to 24.6% yoy, after decelerating from 32.6% yoy in 1Q11 to 23.1% yoy in 2Q11. Overall, China's imports amounted to US\$ 1,285.2 billion in 1-3Q11, up by 26.7% yoy.

China's trade balance rose from US\$ 46.8 billion in 2Q11 to US\$ 63.8 billion in 3Q11, the highest in four quarters. Against this backdrop, Chinese exporters face rising risk of trade protectionism. In mid-October, the US Senate passed a currency bill that allows the US government to impose retaliatory tariffs on imported goods, if the currency of the exporting country is determined to be undervalued. In fact, quite a few politicians in the US believe that the RMB is still undervalued. Therefore, if the bill is further passed by the US House of Representatives and is signed by the US president, trade tensions between China and the US are likely to increase.

Exhibit 21: China's quarterly foreign trade data, 4Q10 - 3Q11

USD billion (yoy growth)

	Exports	Imports	Trade Balance	
FY10	1,577.9 (31.3%)	1,394.8 (38.7%)	183.1	(-6.4%)
4Q10	443.4 (24.9%)	380.7 (29.7%)	62.7	(1.9%)
1Q11	399.6 (26.5%)	400.7 (32.6%)	-1.0	(-107.3%)
2Q11	474.9 (22.1%)	428.1 (23.1%)	46.8	(14.1%)
3Q11	518.1 (20.6%)	454.4 (24.6%)	63.8	(-1.7%)

Source: China Customs

Exhibit 22: China's monthly foreign trade data, Oct 2010 - Sep 2011

USD billion (yoy growth)

	Exports	Imports	Trade Balance
Oct 10	136.0 (22.9%)	108.8 (25.3%)	27.2 (14.1%)
Nov	153.3 (34.9%)	130.4 (37.7%)	22.9 (20.7%)
Dec	154.2 (17.9%)	141.1 (25.6%)	13.1 (-28.9%)
Jan 11	150.7 (37.7%)	144.3 (51.0%)	6.4 (-54.1%)
Feb	96.7 (2.4%)	104.0 (19.4%)	-7.3 (-199.7%)
Mar	152.2 (35.8%)	152.1 (27.3%)	0.1 (-101.9%)
Apr	155.7 (29.9%)	144.3 (21.8%)	11.4 (704.5%)
May	157.2 (19.4%)	144.1 (28.4%)	13.1 (-32.6%)
Jun	162.0 (17.9%)	139.7 (19.3%)	22.3 (10.5%)
Jul	175.1 (20.4%)	143.6 (22.9%)	31.5 (10.3%)
Aug	173.3 (24.5%)	155.6 (30.2%)	17.8 (-10.2%)
Sep	169.7 (17.1%)	155.2 (20.9%)	14.5 (-12.4%)

Source: China Customs

Exhibit 23: Growth rates of exports and imports, Oct 2009 - Sep 2011



Source: China Customs

Exhibit 24: Exports by category, 2010 & 1-3Q11

<i>yoy growth (%) of export value, calculated in US\$</i>	2010	1-3Q11
Textile materials & products	28.4	25.9
Garments & clothing accessories	20.9	23.3
Footwear	27.1	19.6
Toys	29.4	8.9
Coal	-5.2	30.1
Crude oil	-23.4	36.8
Refined oil	35.9	17.3
Steel	65.3	37.4
Mechanical & electrical products	30.9	18.2

Source: China Customs

Exhibit 25: Imports by category, 2010 & 1-3Q11

<i>yoy growth (%) of import value, calculated in US\$</i>	2010	1-3Q11
Cereal & cereal flour	70.1	6.1
Soybean	33.5	22.7
Iron ore	58.4	50.3
Crude oil	51.4	43.2
Refined oil	31.3	52.4
Steel	3.3	11.0
Synthetic yarn	24.4	13.9
Vehicles and related parts	99.1	39.1

Source: China Customs

Exhibit 26: Foreign trade of China (general & processing trade), 2010 - 3Q11

Item	yoy growth (%)			Share (%)		
	FY10	2Q11	3Q11	FY10	2Q11	3Q11
Exports	31.3	22.1	20.6	100.0	100.0	100.0
Of which:						
General Trade	36.0	29.3	29.1	45.7	49.0	49.3
Processing Trade	26.1	13.9	11.7	46.9	43.4	42.9
Imports	38.7	23.2	24.6	100.0	100.0	100.0
Of which:						
General Trade	43.7	28.8	34.4	55.1	57.1	58.3
Processing Trade	29.5	11.6	10.7	29.9	27.7	27.0
Total of Imports and Exports	34.7	22.5	22.5	100.0	100.0	100.0
Of which:						
General Trade	39.9	29.1	31.7	50.1	52.8	53.5
Processing Trade	27.3	13.0	11.3	38.9	35.9	35.5

Source: China Customs

2. General trade continued to grow faster than processing trade

The trade value under general trade¹⁵ grew faster than that under processing trade¹⁶ in 3Q11, as both exports and imports under general trade showed strong growth. In 3Q11, China's exports under general trade grew rapidly by 29.1% yoy, while imports under general trade also soared by 34.4% yoy. (See exhibit 26)

Compared to the previous quarter, growth of exports and imports under processing trade softened in 3Q11. Exports and imports under processing trade increased by 11.7% yoy and 10.7% yoy respectively in 3Q11, compared to the growth rates of 13.9% yoy and 11.6% yoy respectively in 2Q11.

The share of processing trade in China's total trade declined from 35.9% in 2Q11 to 35.5% in 3Q11. Nevertheless, processing trade still plays an important role in China's foreign trade, especially as processing trade recorded a large trade surplus of US\$ 99.7 billion in 3Q11. In contrast, general trade recorded a trade deficit of US\$ 9.6 billion over the same period.

3. China's export growth to the EU and Japan showed slight improvement in 3Q11

Same as in 2010, the European Union (EU) was China's biggest trading partner in 1-3Q11, accounting for 15.8% of China's total foreign trade. Sino-EU trade amounted to US\$ 422.5 billion in 1-3Q11, increasing by 20.9% yoy. China's export growth to the EU improved a bit to 17.4% yoy in 1-3Q11, compared to 16.9% yoy in 1H11.

The US was China's second largest trading partner in 1-3Q11. Sino-US trade rose by 17.0% yoy to US\$ 325.9 billion in 1-3Q11, accounting for 12.2% of China's total foreign trade. China's export growth to the US declined from 16.9% yoy in 1H11 to 14.7% yoy in 1-3Q11, implying that the export demand from the US further moderated in 3Q11.

China's trade with the Association of South East Asian Nations (ASEAN) increased by 26.4% yoy to reach US\$ 267.1 billion in 1-3Q11, accounting for 10.0% of China's total foreign trade. It is noteworthy that ASEAN has overtaken Japan to become China's third largest trading partner since 1H11, helped by the strong growth of Sino-ASEAN trade. In fact, trade cooperation between China and the member countries of ASEAN have been enhanced by the ASEAN-China Free Trade Area (ACFTA) agreement effective since 1 January 2010.

Japan was the fourth largest trading partner of China in 1-3Q11. Sino-Japan trade grew by 18.2% yoy to reach US\$ 253.5 billion in 1-3Q11, accounting for 9.5% of China's total foreign trade. China's export growth to Japan improved slightly to 24.6% yoy in 1-3Q11, after declining from 28.1% yoy in 1Q11 to 23.7% yoy in 1H11. On the other hand, the growth of China's imports from Japan continued its downward trend, slowing from 15.8% yoy in 1H11 to 13.9% yoy in 1-3Q11. (See exhibits 27 & 28)

¹⁵ 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: import and export using loans or aids; the import 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 import 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.

¹⁶ 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.

4. China's imports from the BRIC economies showed stronger growth in 3Q11

China's exports to some major emerging economies have become an increasingly important driver of China's export growth. For example, the growth rates of China's exports to Brazil and Russia were 35.5% yoy and 35.8% yoy respectively in 1-3Q11, much higher than China's total export growth of 22.7% yoy in 1-3Q11. The other three members of the BRICs, namely, Brazil, Russia and India, jointly accounted for 6.4% of China's total exports in 1-3Q11. On the other hand, together they accounted for 6.6% of China's total imports in 1-3Q11, up from 6.1% in 2010. China's imports from the BRIC economies also showed stronger growth in 3Q11, compared to 1H11. The growth rates of China's imports from Brazil, Russia and India reached 38.3% yoy, 52.5% yoy and 8.9% yoy respectively in 1-3Q11, up from 37.4% yoy, 34.2% and 5.9% yoy respectively in 1H11. (See exhibits 27 & 28)

Exhibit 27: China's trading partners, 1-3Q11

Country /Region	Trade value (USD billion)	Share of total trade (%)	Export value (USD billion)	Import value (USD billion)	yoy growth (%)		
					Total trade	Exports	Imports
EU	422.5	15.8	265.3	157.2	20.9	17.4	27.5
US	325.9	12.2	235.7	90.3	17.0	14.7	23.6
ASEAN	267.1	10.0	124.1	143.0	26.4	24.7	27.9
Japan	253.5	9.5	107.7	145.7	18.2	24.6	13.9
Brazil	62.4	2.3	24.1	38.3	37.2	35.5	38.3
Russia	57.9	2.2	28.5	29.5	43.8	35.8	52.5
India	54.5	2.0	37.2	17.3	20.0	26.0	8.9

Source: China Customs

Exhibit 28: China's trading partners, comparing the growth rates of 2010 & 1-3Q11

Country/Region	yoy growth (%)							
	Total trade		Exports		Imports			
	2010	1-3Q11	2010	1-3Q11	2010	1-3Q11		
EU	31.8	20.9	31.8	17.4	31.9	27.5		
US	29.2	17.0	28.3	14.7	31.7	23.6		
ASEAN	37.5	26.4	30.1	24.7	44.8	27.9		
Japan	30.2	18.2	23.7	24.6	35.0	13.9		
Brazil	47.5	37.2	73.3	35.5	34.7	38.3		
Russia	43.1	43.8	69.0	35.8	21.7	52.5		
India	42.4	20.0	38.0	26.0	51.8	8.9		

Source: China Customs

5. The top seven provinces/municipalities in terms of foreign trade value jointly accounted for 82.0% of China's total foreign trade in the first eight months of 2011

The top seven provinces/municipalities in terms of foreign trade value – Guangdong, Jiangsu, Shanghai, Beijing, Zhejiang, Shandong and Fujian – jointly accounted for 82.0% of China's total foreign trade in January to August 2011, down slightly from 82.4% in 1H11. (See exhibit 29)

Among the abovementioned provinces, Guangdong, Jiangsu, Zhejiang and Shandong showed slower export growth in January to August 2011, compared to 1H11. In particular, Guangdong, the biggest contributor to China's exports, witnessed relatively sharp decline in export growth. The growth rate of exports from Guangdong fell from 28.2% yoy in 1H11 to 24.0% yoy in January to August. Meanwhile, the growth rates of exports from Jiangsu, Zhejiang and Shandong edged down to 20.0% yoy, 22.2% yoy and 26.1% yoy respectively in January to August, compared to 20.4% yoy, 22.3% yoy and 26.8% yoy respectively in 1H11.

Exhibit 29: The top seven provinces/municipalities in terms of foreign trade value, Jan - Aug 2011

Provinces /municipalities	Total trade		Exports	
	Amount (USD billion)	yoy growth (%)	Amount (USD billion)	yoy growth (%)
Guangdong	594.3	22.4	344.9	24.0
Jiangsu	353.1	19.4	204.2	20.0
Shanghai	286.4	21.5	136.8	18.5
Beijing	251.0	28.7	37.4	4.1
Zhejiang	202.5	23.8	142.0	22.2
Shandong	152.8	28.6	82.2	26.1
Fujian	88.0	27.3	56.9	24.5

Source: China Customs

6. FDI in China grew by 16.6% yoy in 1-3Q11

In 1-3Q11, China's FDI totaled US\$ 86.7 billion, up by 16.6% yoy. (See exhibit 30) Of which, FDI in the service sector recorded relatively stronger growth of 20.1% yoy. In 1-3Q11, FDI in the service sector amounted to US\$ 40.2 billion, accounting for 46.4% of China's total FDI. On the other hand, FDI in the manufacturing sector rose by 13.0% yoy in 1-3Q11. FDI in the manufacturing sector accounted for 46.1% of China's total FDI in 1-3Q11, down slightly from 46.9% in FY10.

Among regions, the eastern region was the largest recipient of FDI, attracting US\$ 74.4 billion in 1-3Q11, while the central and the western regions attracted US\$ 6.0 billion and US\$ 6.3 billion respectively over the same period. It is noteworthy that the growth of FDI in the western region decelerated to 11.9% yoy in 1-3Q11, down from 35.2% yoy in 1H11.

In 1-3Q11, FDI from the US declined by 9.9% yoy to US\$ 1.9 billion, while FDI from the EU dropped slightly by 1.8% yoy to US\$ 4.2 billion. By contrast, FDI from the selected ten countries/regions in Asia (i.e. Japan, the Philippines, Thailand, Malaysia, Singapore, Indonesia, South Korea, Hong Kong, Macau and Taiwan) increased strongly by 23.7% yoy to US\$ 65.3 billion in 1-3Q11.

Looking ahead, we believe that China will continue to receive large amount of FDI, given the huge potential of the service sector in China. On the other hand, we expect more and more foreign enterprises to make investment in RMB instead of foreign currency in the future, as the government has recently taken a big step to improve the transparency of the related procedures. On 14 October, the Ministry of Commerce promulgated "the Notice on Cross-border RMB Foreign Direct Investment"¹⁷ and the People's Bank of China promulgated "the Rules of RMB Foreign Direct Investment Settlement"¹⁸. Such moves would benefit foreign enterprises, which can take advantage of making investment in RMB to reduce their currency risk exposure.

17 http://big5.gov.cn/gate/big5/www.gov.cn/gzdt/2011-10/14/content_1969510.htm

18 http://www.pbc.gov.cn/publish/huobizhengceersi/3131/2011/20111014085818532376755/20111014085818532376755_.html

Exhibit 30: China's foreign direct investment (FDI), Oct 2010 - Sep 2011

	Amount (US\$ billion)	yoy growth
FY10	105.7	17.4%
1-3Q11	86.7	16.6%
Oct 10	7.7	7.9%
Nov	9.7	38.6%
Dec	14.0	15.6%
Jan 11	10.0	23.4%
Feb	7.8	32.2%
Mar	12.5	32.9%
Apr	8.5	15.2%
May	9.2	13.4%
Jun	12.9	2.8%
Jul	8.3	20.2%
Aug	8.4	11.1%
Sep	9.0	7.9%

Source: Ministry of Commerce, PRC

7. The accumulation of the foreign exchange reserves declined sharply to US\$ 4.2 billion in 3Q11

As of 30 September 2011, China's foreign exchange reserves amounted to US\$ 3.2 trillion. The accumulation of the foreign exchange reserves declined sharply from US\$ 152.8 billion in 2Q11 to US\$ 4.2 billion in 3Q11.

Considering that China recorded a trade surplus of US\$ 63.8 billion and FDI totaled US\$ 25.7 billion in 3Q11, we believe that the sharp decline in the foreign exchange accumulation in the quarter was mainly attributable to the foreign capital outflows, as well as the drop in value of non-US\$-denominated assets held by the Chinese government due largely to the appreciation of the US dollar. In 3Q11, the US dollar appreciated against the currencies of a number of countries. For example, the nominal USD/Euro exchange rate was 1.3424 on 30 September 2011, up from 1.4521 on 30 June 2011. (See exhibit 31)

Looking ahead, the strength of the US dollar and the prospect of the Chinese economy will continue to significantly affect the foreign exchange reserves in coming quarters.

Exhibit 31: Foreign exchange reserves by quarter, 4Q10 - 3Q11

USD billion

	Accumulation	End of the quarter
FY10	448.1	2,847.3
4Q10	199.0	2,847.3
1Q11	197.4	3,044.7
2Q11	152.8	3,197.5
3Q11	4.2	3,201.7

Source: State Administration of Foreign Exchange, PRC

II. Highlights

1. The RMB appreciation against the US dollar continued in 3Q11

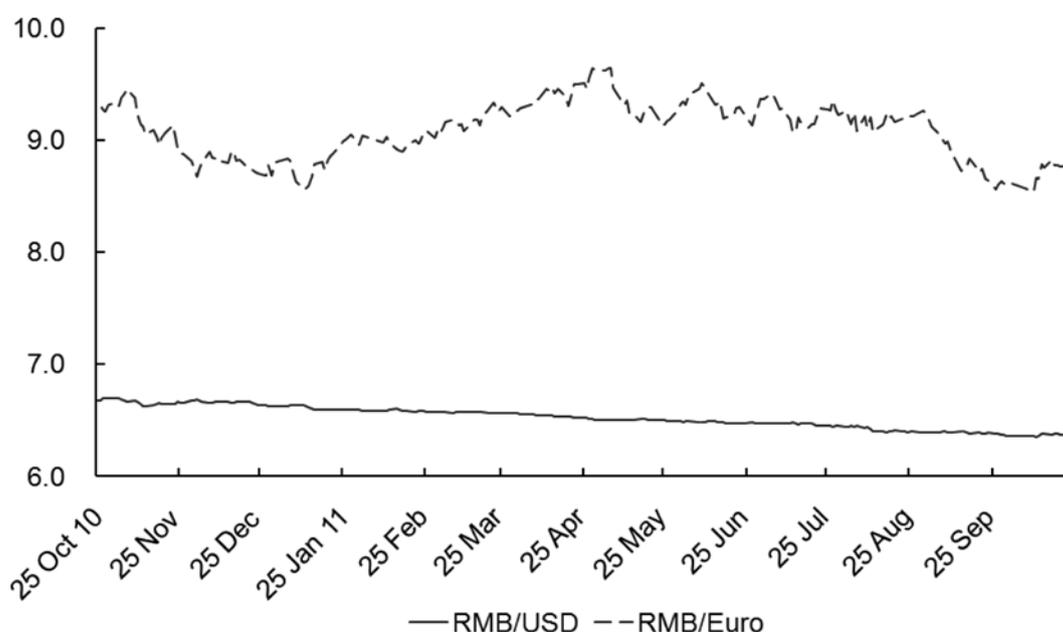
On 30 September 2011, the nominal RMB/USD exchange rate was 6.3549, implying that the RMB appreciated by 1.8% against the US dollar in 3Q11, compared to the 2.3% appreciation in 1H11.¹⁹ Afterwards, in the first few weeks of October, the nominal RMB/USD exchange rate fluctuated within the range of 6.3483-6.3762.

On the other hand, the RMB appreciated against the Euro in early May to early October. The nominal RMB/Euro exchange rate advanced from 9.6413 on 5 May to the recent peak of 8.5345 on 10 October, before declining to 8.8015 on 24 October. (See exhibit 32)

According to the Bank for International Settlements, the real effective exchange rate (REER) of the RMB picked up from 117.24 in June to 125.01 in September, implying that the RMB appreciated by 6.6% in real terms against its trading partners in 3Q11.²⁰ (See exhibit 33)

In mid-October, the US Senate passed a currency bill that allows the government to impose retaliatory tariffs on imported goods, if the currency of the exporting country is determined to be undervalued. If the bill is further passed by the US House of Representatives and is signed by the US president, pressure for RMB appreciation will further intensify. Against this backdrop, the RMB appreciation against the US dollar is likely to continue in the near term. It is forecast that the nominal RMB/USD exchange rate will appreciate by 5.1-6.8% overall in FY11 to reach 6.2-6.3 at end-2011.

Exhibit 32: RMB/USD and RMB/Euro, Oct 2010 - Oct 2011

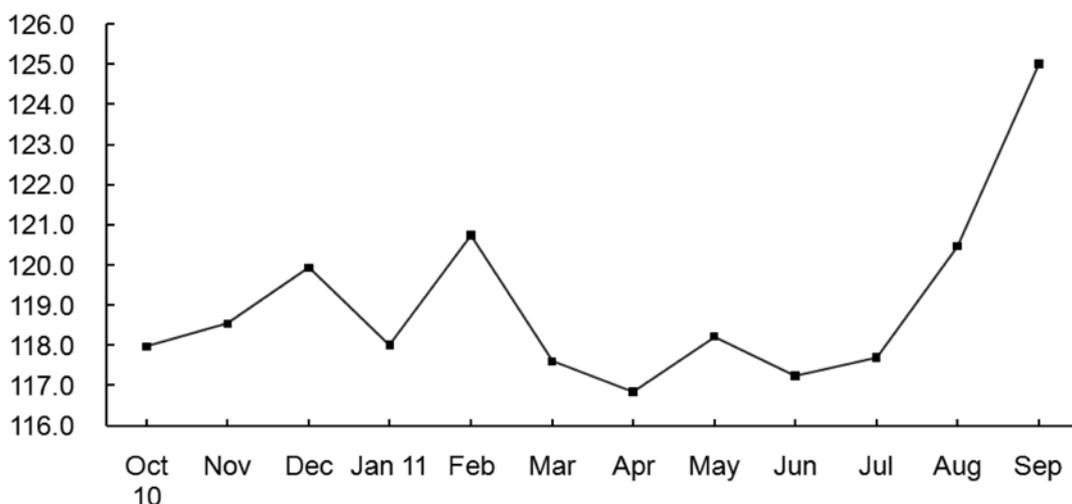


Source: State Administration of Foreign Exchange

¹⁹ After the People's Bank of China (PBOC), China's central bank, announced to "proceed further" with the reform of the RMB exchange rate regime on 19 June 2010, the RMB has started to appreciate against the US dollar.

²⁰ The Bank for International Settlements (BIS) calculates effective exchange rate (EER) indices for a total of 58 economies (including individual euro area countries and, separately, the euro area as an entity). Nominal EERs are calculated as geometric weighted averages of bilateral exchange rates. Real EERs are the same weighted averages of bilateral exchange rates adjusted by relative consumer prices. The weighting pattern is time-varying, and the most recent weights are based on trade in 2005-07.

Exhibit 33: RMB REER, Oct 2010 - Sep 2011



Source: Bank for International Settlements

2. The free trade agreement signed by China and Costa Rica has been implemented recently

The free trade agreement (FTA) signed by China and Costa Rica has been implemented recently. According to the agreement, more than 60% of tariff items traded between China and Costa Rica have become tariff-free since 1 August 2011. The arrangement is expected to boost Sino-Costa Rica trade. Nevertheless, the impacts on China's overall exports and imports are likely to be minimal, as Sino-Costa Rica trade only accounts for a very small share (0.04% in 2010) of China's total foreign trade.

So far, China has signed FTAs with the Association of South East Asian Nations (ASEAN) and countries such as New Zealand, Pakistan, Chile, Peru, Costa Rica, etc. Of which, the implementation of the ASEAN-China Free Trade Area (ACFTA) agreement has drawn huge attention, as ASEAN is one of China's major trading partners. Indeed, the Sino-ASEAN trade has been greatly boosted by the ACFTA agreement effective since 1 January 2010. China's trade with ASEAN increased sharply by 37.5% yoy in 2010, compared to the negative growth of -7.9% yoy in 2009.

To lower trade barriers, the Chinese government is expected to sign FTAs with many other countries in coming future. According to the Ministry of Commerce, the government is now in negotiations with countries such as Australia, Iceland, Norway, Switzerland, etc.

3. Chinese exporters face rising risk of trade protectionism

On 5 September, the World Trade Organization (WTO) rejected China's appeal against the WTO ruling that backed the US government's imposition of punitive tariffs on Chinese tires in September 2009.

The WTO ruling could be bad news for Chinese exporters, as the measure was imposed as a product-specific safeguard, which enables government to protect domestic producers of a specific product against a sharp increase in imports. Given that various types of made-in-China products have become more popular in different countries in recent years, the WTO ruling may encourage foreign governments to impose more product-specific safeguard measures targeted at Chinese exporters.

Indeed, we have become more concerned that Chinese exporters will face rising risk of trade protectionism in coming future, especially as the unemployment rates in the developed countries are likely to trend upward again amid the economic slowdown. In 2008 to 2009, the unemployment rates in a number of developed countries such as the US, the UK, France, etc. shot up, as the global financial crisis and the economic slowdown dealt a hard blow to their labour markets. Governments in those countries were thus under huge political pressure to save jobs through protecting domestic industries from import competition. At that time, trade protectionism was on the rise around the globe. According to a World Bank study, as many as 47 trade-restricting measures were implemented within five months after the outbreak of the financial crisis in October 2008.

Recent signs indicate that politicians in the US have put intense pressure on the government to limit imports from other countries. In mid-October, the US Senate passed a currency bill that allows the US government to impose retaliatory tariffs on imported goods, if the currency of the exporting country is determined to be undervalued. In fact, quite a few politicians in the US believe that the RMB is still undervalued. If the bill is further passed by the US House of Representatives and is signed by the US president, trade tensions between China and the US are likely to increase.

III. Outlook

1. The recent indicators paint a mixed picture of the US recovery

Of particular concern to China's foreign trade outlook is the US economy. The recent indicators paint a mixed picture of the US recovery.

Amid the deepening of the European debt crisis, the US real GDP rose at an annual rate of 2.5% in 3Q11, up from 1.3% in 2Q11. The US GDP growth in 3Q11 was much higher than market expectation. (A consensus of economists surveyed by Bloomberg News in mid-October estimated that the US economy would grow at an annual rate of 1.8% in 3Q11.) The acceleration in the US economic growth in the third quarter was mainly associated with the stronger growth of personal consumption expenditures and nonresidential fixed investment, as well as the slower decline in state and local government spending.

On the production side, the growth of the industrial output dropped from 1.1% mom in July to 0.0% mom in August, and then edged up to 0.2% mom in September. (See exhibit 35) According to the Institute for Supply Management, the manufacturing PMI dropped sharply from 60.4 in April to the recent low of 50.6 in August, before rebounding a bit to 51.6 in September. The decline in the PMI indicated the weaker growth momentum in the manufacturing sector. According to the US Department of Commerce, new orders for manufactured durable goods decreased by 0.2% mom in August on a seasonally-adjusted basis, posting negative mom growth in two of the last three months.

The US non-manufacturing sector has also expanded at a slow pace. According to the Institute for Supply Management, the non-manufacturing index (NMI) went down from 53.3 in August to 53.0 in September, the third lowest in twelve months.

The good news is that the US retail sales grew rapidly by 1.1% mom in September, after recording modest growth of 0.0-0.4% mom throughout April to August, according to the US Department of Commerce. However, the strong growth of the retail sales may be unsustainable. Caused mainly by the renewed concerns about the outlook for the economy, the Reuters/ University of Michigan index of consumer sentiment slumped from 71.5 in June to 55.7 in August, the lowest since November 2008, and then stayed low at 59.4 in September, showing a rapid loss of confidence among the US consumers. (See exhibit 36)

The unemployment problem in the country is still serious. In September, the US unemployment rate stayed high at 9.1%, despite the fact that the non-farm payroll employment continued to rise in recent months, increasing by 57,000 and 103,000 respectively in August and September. (See exhibit 37)

Looking ahead, we expect the US economic growth to slow further in the near term, affected by the poor housing market, as well as weak consumer sentiment. In its latest report released in September, the International Monetary Fund (IMF) heavily revised its earlier forecasts about the economic growth of the country. The institution predicted that the US economy would grow by 1.5% and 1.8% in 2011 and 2012 respectively, down 1.0 ppt and 0.9 ppt respectively from its previous projections made in June.²¹

Exhibit 34: US national accounts, 2009 - 2Q11

annual growth (%)

	2009	2010	4Q10	1Q11	2Q11	3Q11
GDP	-3.5	3.0	2.3	0.4	1.3	2.5

Source: US Department of Commerce

Exhibit 35: US industrial output growth, Apr - Sep 2011

mom growth (%), seasonally adjusted

	Apr	May	Jun	Jul	Aug	Sep
Industrial output	-0.4	0.3	0.0	1.1	0.0	0.2

Source: US Federal Reserves

Exhibit 36: US consumer market, Apr - Sep 2011

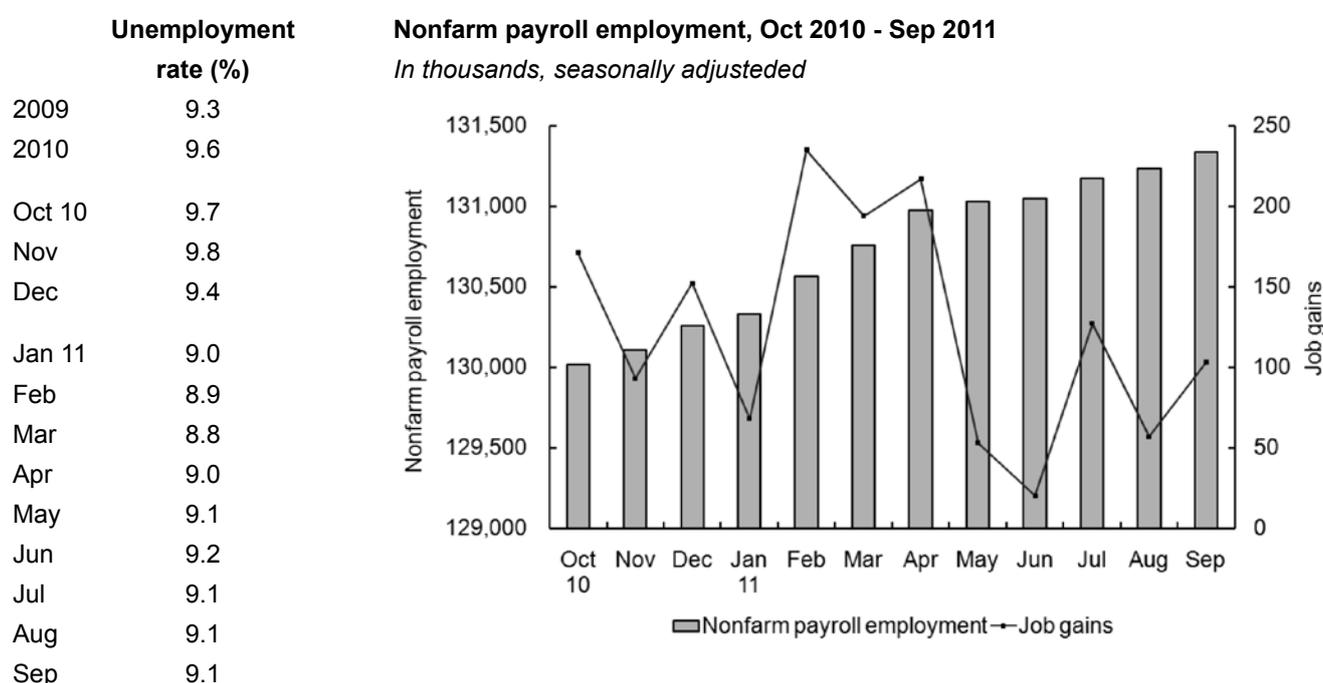
	Apr	May	Jun	Jul	Aug	Sep
Retail and food services sales <i>(mom growth %, seasonally adjusted)</i>	0.2	0.0	0.2	0.4	0.3	1.1
Reuters/University of Michigan index of consumer sentiment	69.8	74.3	71.5	63.7	55.7	59.4
CPI <i>(yoy growth %)</i>	3.2	3.6	3.6	3.6	3.8	-

Source: US Department of Commerce, Reuters/University of Michigan Surveys of Consumers, US Department of Labor

21 IMF, *World Economic Outlook Update*, September 2011



Exhibit 37: US employment situation



yearly figures: annual average; monthly figures: seasonally adjusted
Source: US Department of Labor

2. The Eurozone GDP growth slowed in 2Q11

The real GDP growth in the Eurozone²² declined from 0.8% qoq in 1Q11 to 0.2% qoq in 2Q11, due largely to the growth deceleration in investment and exports. (See exhibit 38) In 2Q11, the growth rate of investment was 0.2% qoq, down sharply from 1.8% qoq in 1Q11. The growth rates of exports and imports went down to 1.0% qoq and 0.5% qoq in 2Q11, compared to 2.0% qoq and 1.5% qoq respectively in 1Q11. Government final consumption expenditure dropped by 0.2% qoq in 2Q11, after increasing by 0.4% qoq in 1Q11. In 2Q11, household final consumption expenditure fell by 0.2% qoq, compared to the growth of 0.2% qoq in 1Q11.

The economies of China’s major export destinations in the region showed weak growth or even zero growth in 2Q11. The real GDP in Germany, France, Italy and Netherlands grew by 0.1% qoq, 0.0% qoq, 0.3% qoq, and 0.1% qoq respectively in the quarter.²³

The latest indicator suggested that consumption in the Eurozone was still sluggish. The volume of retail trade in the region registered negative growth of -0.3% mom in August. (See exhibit 39) The weak consumption demand could be attributed to the poor labour market, given that the unemployment rate in the region stayed high at 10.0% in August. (See exhibit 40)

The Eurozone manufacturing PMI fell from 50.4 in July to 49.0 in August and 48.5 in September, and the Eurozone services PMI declined from 51.5 in August to 48.8 in September. Both indices dropped below the critical level of 50 in recent months, indicating the contraction in both the manufacturing sector and the service sector in the region.

²² Estonia has become the 17th member of the Eurozone since 1 January 2011. And the other member countries include Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovenia, Spain and Slovakia.
²³ China’s exports to these four countries accounted for 11.2% of China’s total exports in FY10.

Looking ahead, it is widely expected that the economic situation in the region will deteriorate further in coming future. The IMF predicted in late September that the Eurozone GDP growth would slow to 1.6% and 1.1% in 2011 and 2012 respectively, down from 1.8% in 2010.

In recent months, the European debt crisis has deepened, with rising concerns that Greece would default. On 27 October, European leaders agreed on a comprehensive set of measures to address the tensions in the financial markets and to restore confidence. The key takeaways are:

- The public debt of Greece should be reduced to 120% of GDP by 2020. Private creditors agreed to reduce the face value of the Greek debt held by them by 50%. Eurozone member states will contribute to the private sector involvement (PSI) package with up to 30 billion euros.
- To enlarge the lending capacity of the European Financial Stability Facility (EFSF), the region's bailout fund, to 1 trillion euros from 440 billion euros.
- To require banks in the region to bring the level of their highest quality capital to 9% by June 2012.

At this stage, the move will help stem the contagion from the debt crisis in the short term. However, in our view, the measures are not enough to solve the structural problems underlying the debt crisis. Governments in the region should join hands to introduce structural reforms, in a bid to strengthen the financial system, reduce sovereign debt levels, restore confidence and bolster growth prospects.

Exhibit 38: Eurozone GDP growth, 2009 - 2Q11*

	2009	2010	3Q10	4Q10	1Q11	2Q11
GDP (<i>qoq growth %</i>)			0.4	0.3	0.8	0.2
GDP (<i>yoy growth %</i>)	-4.3	1.8	2.0	2.0	2.4	1.6

* The figures in 2009 and 2010 do not reflect Estonia's membership of the Eurozone, which has begun on 1 January 2011.

Source: Eurostat

Exhibit 39: Eurozone consumer market, Mar - Aug 2011

	Mar	Apr	May	Jun	Jul	Aug
Volume of retail trade (<i>mom growth %, seasonally adjusted</i>)	-0.8	0.8	-1.2	0.6	0.2	-0.3
Annual inflation (%)	2.7	2.8	2.7	2.7	2.5	2.5

Source: Eurostat

Exhibit 40: Eurozone labor market, Mar - Aug 2011

	Mar	Apr	May	Jun	Jul	Aug
Unemployment rate (%)	9.9	9.9	10.0	10.0	10.0	10.0

Source: Eurostat

Exhibit 41: Eurozone economic sentiment indicator, Apr - Sep 2011

<i>seasonally adjusted</i>	Apr	May	Jun	Jul	Aug	Sep
Economic sentiment indicator	106.1	105.5	105.4	103.0	98.4	95.0

Source: Eurostat

3. China's export growth is set to slow further

In its latest report, the International Monetary Fund (IMF) projects that the real GDP growth of the advanced economies will decline from 3.1% in 2010 to 1.6% in 2011, and will then edge up to 1.9% in 2012. Meanwhile, it is projected that the real GDP growth of the emerging and developing economies will moderate from 7.3% in 2010 to 6.4% in 2011 and 6.1% in 2012, due to slowing foreign demand, monetary tightening and capacity constraints.²⁴

Merchandise exports from the emerging and developing economies are projected to register single digit growth in 2011 and 2012, amid the slowing growth of merchandise imports from both the advanced economies and the emerging and developing economies. It is projected that the growth of volume of merchandise exports from the emerging and developing economies will moderate from 13.5% in 2010 to 9.6% in 2011 and 7.6% in 2012. Comparatively, the growth of volume of merchandise exports from the advanced economies will post sharper drop, falling from 14.4% in 2010 to 7.1% in 2011 and 5.2% in 2012. (See exhibit 42)

Looking ahead, we think China's export growth will also slow down, moderating to around 15%-20% in 4Q11 and 10%-15% in 1Q12. Export orders in the coming months may fall drastically if the financial turmoil and economic slowdown in the EU and the US deteriorate rapidly, although China's exports will continue to be cushioned by orders from the emerging markets.

Exhibit 42: Latest forecasts by the IMF

<i>yoy growth (%)</i>	FY07	FY08	FY09	FY10	FY11 (projected)	FY12 (projected)
Real GDP						
Advanced economies	2.8	0.1	-3.7	3.1	1.6	1.9
Emerging and developing economies	8.9	6.0	2.8	7.3	6.4	6.1
<i>yoy growth (%) of volume</i>						
Trade in goods						
Exports						
Advanced economies	6.4	1.9	-14.0	14.4	7.1	5.2
Emerging and developing economies	9.4	4.7	-8.0	13.5	9.6	7.6
Imports						
Advanced economies	5.3	0.4	-13.6	13.5	6.9	4.0
Emerging and developing economies	13.3	8.4	-9.5	15.3	12.4	8.0

Source: IMF, *World Economic Outlook*, September 2011

²⁴ IMF, *World Economic Outlook*, September 2011



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