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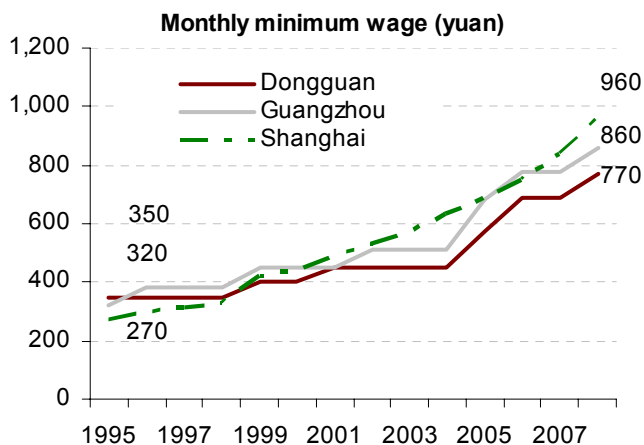
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China: The beginning of the end of an era Troubled export sector

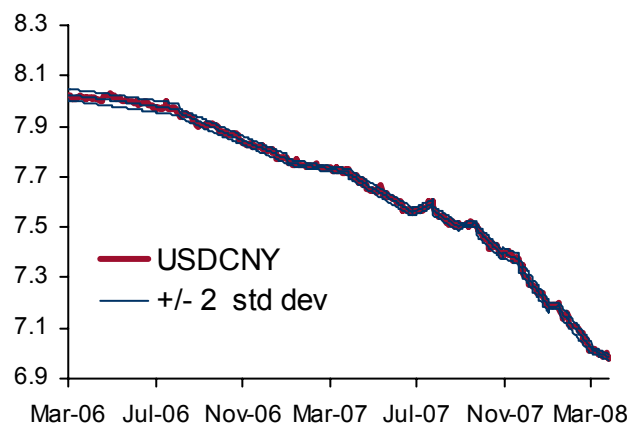
- The introduction of the new labor law may prove to be the straw that broke the camel’s back, bearing in mind that Chinese exports are already suffering from surging wage costs, currency appreciation, high material/energy prices, and reduced tax rebates.
- The mighty Chinese export sector will likely hit a period of hard times, beyond the US recession, though the Yangtze River Delta may do better than the Pearl River Delta. We predict that one-third of export-oriented manufacturers in Guangdong, which produce 30% of China’s exports, will be closed in three years.
- Rising wage rates and improved labor rights are generally bad for capitalists and the export sector, but tend to be positive for workers and domestic consumption. We see the economy leaning towards the domestic sector over the next decade, perhaps with slightly slower but better quality growth.
- China’s private consumption is seemingly on the rise, led by service consumption and rural consumption. The “one-child generation” is emerging as an influential new force that may redefine Chinese consumer behavior. Our projections show China leapfrogging the US as the world’s largest consumer market before 2020.

Exhibit 1: Minimum monthly wage rates are surging ...



Source: Provincial bureaus of Human Resources and social security, Credit Suisse

Exhibit 2: ... while RMB appreciation is accelerating



Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

The beginning of the end of an era

We think the end of an era in terms of China's mighty export industry has just begun. Current conditions will likely go beyond the cyclical slowdown caused by the US recession, in our view. After years of currency appreciation, wage increases, and material cost surges, we think the Chinese export sector has started to crack. The introduction of the Labor Contract Law this year is probably the straw that broke the camel's back.

The factory closure in Guangdong province is much more severe than our already pessimistic assessment. We have made three trips to various parts of Guangdong, which produces 30% of China's exports. Company management teams in Guangdong have indicated that the market has grossly underestimated the severity of the issue. On one car ride in the streets of Dongguan, the largest manufacturing and export hub of Guangdong, we found five factories in the throes of closing down with workers lining up for severance pay.

We predict that about one-third of export-oriented manufacturers in Guangdong province will be closed within three years. In our view, China's entire export industry face difficult times ahead. Some may survive by climbing up the product value chain, improving efficiency, or relocating their factories, but this process is likely to be painful.

The transformation facing China's export industry has major implications for China and the rest of the world. It affects China's growth model, inflation, and income distribution on the domestic front. It will also affect margins of many listed foreign companies using China as a production base, as well as the wallets of consumers worldwide.

The Labor Contract Law shock

China has introduced a new labor law, effective 1 January 2008, and we think that the world has grossly underestimated its impact. The new law requires (1) extra pay for working beyond the normal working hours; (2) contributions to social and pension funds; and (3) severance pay packages upon employment termination. This raises China's labor rights to international standards, but is an immense shock to the manufacturing industry, which takes an over 80-hour week for its workers for granted. Many other countries have lower wages than China. But what anchored China's status as the world's factory was its extremely pro-capitalist standard in terms of workers' rights, in our view. But that standard has gone overnight, and to our surprise, not many economists are talking about it.

Exhibit 3: Key amendments to China's labor law: Labor Contract Law (2008) vs. Labor Law (1994)

Overtime work must be compensated

1) Over 40 hours/week:

wage x1.5 on weekdays, x2 on weekends, x3 on public holidays

2) Maximum overtime on weekdays

3 hours/day or 36 hours/month overtime work on weekdays

Worker can only be dismissed when contract expires or for causes defined in the law

Severance pay at the rate of one month's salary per year of service is required

Written contract is compulsory

Wage x2 for each month working without a written contract

Contract becomes open-ended, if it has not been concluded in the first 12 months

Compulsory enrolment in social security program

Rate at 13-15% of wages on average, set by local government

Permanent contract is required, if a worker has

1) Ten years of continuous employment with the firm; or

2) Worked under two fixed-term contracts previously

Source: Ministry of Human Resources and social security, Credit Suisse

We estimate that the new labor law adds about 15-20% extra in terms of operational costs to the labor-intensive manufacturing sector. For non-labor intensive companies, the extra costs could be 2-7%. Besides the overtime payments, social benefits and pension fund contributions have become compulsory. On top of that, factories will face greater difficulties when hiring temporary workers. Many factories in Guangdong hire workers when they receive new orders and terminate the workers as soon as the orders are completed. The new law introduces protection for these temporary workers and requires employers to recognize them as permanent employees if they are hired on a temporary basis for an extended period.

More importantly, we expect a surge in labor disputes and lawsuits, as the government has started to lean towards support for the workers. We think this will inevitably distract management attention. The potential damage to China's reputation as the top recipient of FDI could be huge. For more details about the new Labor Contract Law, see the Appendix of this report.

Exhibit 4: Average monthly wage rate in manufacturing sector

(USD)	IN*	ID	VN	TH	CH	MA	HK	TA	SG	KR
2004	78	94	98	153	141	446	1209	1217	1982	2000
2005	83	94	110	162	160	461	998	1297	2100	2402
2006	85	107	124	179	188	488	1238	1301	2276	2724
2007	104	119	139	203	234	542	1295	1311	2498	2980
% change (2004-07)	33.3	26.6	41.8	32.7	66.0	21.5	7.1	7.7	26.0	49.0

Note: 2007 data for ID is as June 2007; IN is as of October 2007; CN and VN are based on growth rates of national average wages in 2007.
 *IN wage data reflect those in cotton textile mills.
 Source: Credit Suisse, CEIC

According to a survey conducted by the Federation of Hong Kong Industries, Hong Kong's factory owners in Guangdong ranked the labor law as the top concern of their operations, and more worrying than RMB appreciation and reduced VAT tax rebates. Almost half of all respondents suggested that the law would raise their labor costs by at least 20%. Around 30% of respondents are having labor disputes with their workers since the enforcement of the law three months ago. The same survey suggested that 10-20% of their businesses in the Pearl River Delta, the area in which the export-oriented factories in Guangdong are concentrated, had been forced to close down over the past 12 months, with another 10-20% to be closed down in the coming one or two years. In our view, the operational stress among FDI manufacturers is considerable.

Exhibit 5: Estimated impact on costs

(% of total respondents)

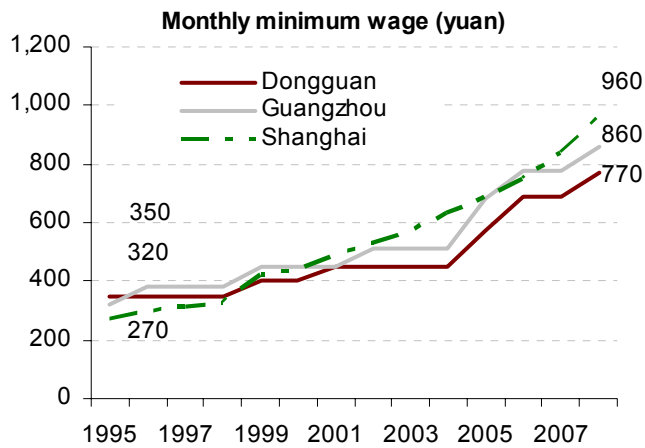
	RMB appreciation	Inflation	Enforcement of Labor Contract Law
Rise in cost above 10%	0	40.7	51.2
			(average cost rise around 21.8%)
Rise in cost 5-10%	84	34.6	28.4
Rise in cost 1-5%	13.6	23.5	16.7
No obvious impact	1.9	1.2	2.5
No comment	0.5	0	1.2

Source: Federation of Hong Kong Industries

Cost hikes

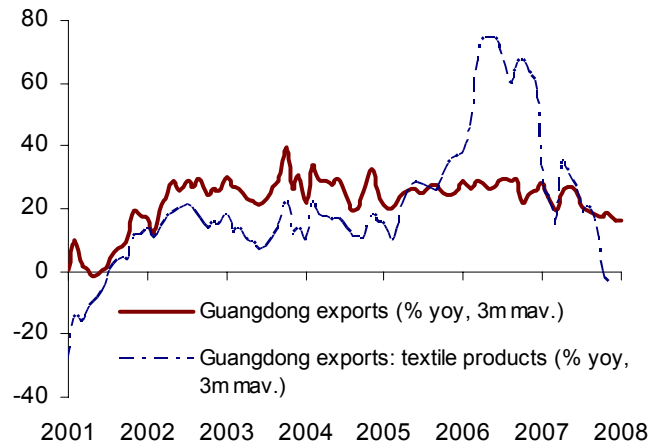
Besides the Labor Contract Law, surging production costs are also biting deeply into producers' margins. Migrant workers' wages almost doubled over the past three years. The RMB exchange rate appreciated by 13% against the USD during the same period. At the same time, global raw material prices surged, as did energy prices. While domestic diesel prices increased to a lesser extent due to government-imposed price controls, many gas stations opted to stop selling diesel all together.

Exhibit 6: Minimum wage rates are surging



Source: Provincial bureaus of Human Resources and social security, Credit Suisse

Exhibit 7: Export growth of traditional manufactured goods has been sluggish



Source: CEIC, Credit Suisse

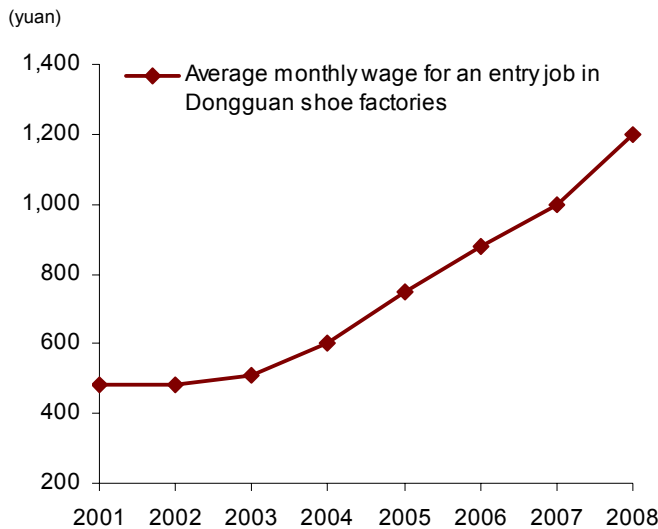
Meanwhile, policy measures that favored the FDI and export sectors have been taken away. VAT tax rebates for exports were lowered three times in 2007. Corporate tax rates for FDIs have been raised from 15% to 25% starting this year. Moreover, local governments are launching more restrictive environmental protection measures.

We expect about one-third of export-oriented manufacturing factories to close down in Guangdong. Among them, one-third are to be relocated to inland areas, one-third will likely leave China, and the remaining one-third will opt to close down forever.

The rising cost stress to companies in the Pearl River Delta (PRD) is significantly larger than their counterparts in the Yangtze River Delta (YRD). The PRD manufacturing zone was largely built in the 1990s, with a heavy focus on low-end consumer products, e.g., shoes, textile, toys. Factories there tend to pay salaries lower than the national average on thinner profit margins. Guangdong's provincial government aggressively enforced labor laws and environmental protection. Based on our conversations with the management teams at various factories, we believe we had underestimated the cost stress and possible factory closures, as have the government and the market. However, we note that larger companies are faring better in this environment than smaller ones.

The YRD manufacturing company performance is better. The YRD boomed in the early 2000s highlighted by the jump in China's electronics production capacity. Factories in the YRD tend to pay higher salaries and offer workers a better working environment in the first place. So while costs are increasing, we do not foresee a large wave of imminent closures. Still, we expect a surge in labor dispute cases.

Exhibit 8: Wages in low-end manufacturing sector are surging



Source: Dongguan Shoe Making Association, Credit Suisse

Exhibit 9: Higher wages in the services sector, shifting workers away from manufacturing sector

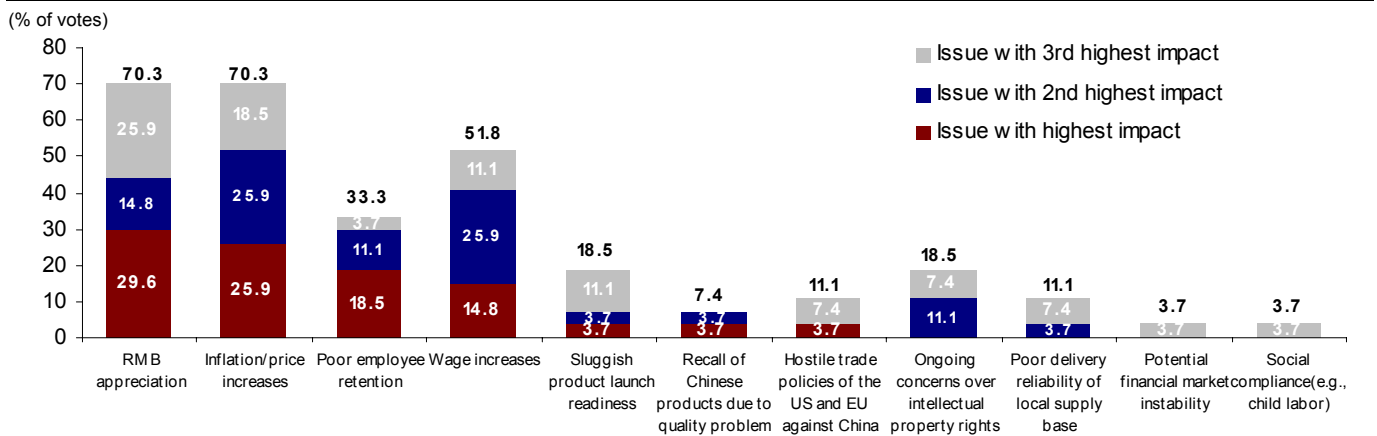
Average monthly wage for female migrant workers (unskilled, but with one-year experience)

Manufacturing	Shoe factory in Dongguan, Guangdong	Toy factory in Foshan, Guangdong	Textile factory in Ningbo, Zhejiang	Electronics factory in Suzhou, Jiangsu
Monthly wage (yuan)	1100	1200	1600	1700
Services	Nanny in Chongqing	Supermarket clerk in Tianjin	Restaurant waitress in Shanghai	Foot masseur in Shenzhen, Guangdong
Monthly wage (yuan)	1800	1900	2200	2500

Source: Various local labor market authorities, Credit Suisse

At the recent China Export and Import Fair (the Canton Fair), two interesting trends emerged: (1) Signed export contracts rose by a mere 6% yoy, and the US slipped to third position by order volume, behind the EU and the Middle East. This probably reflects the cyclical development in the global economy. (2) Most exporters raised prices, in sharp contrast to the usual practice of Chinese exporters, who tend to absorb higher costs by squeezing margins. This is consistent with a survey published by Global Sources, which indicates that 80% of greater China suppliers plan to raise export prices in the next six months. This is likely to add inflationary pressure to end users worldwide, but is probably not enough to reverse what we see as a climate change in the Chinese export sector.

Exhibit 10: Top concerns of companies that believe China is losing manufacturing competitiveness, 2007



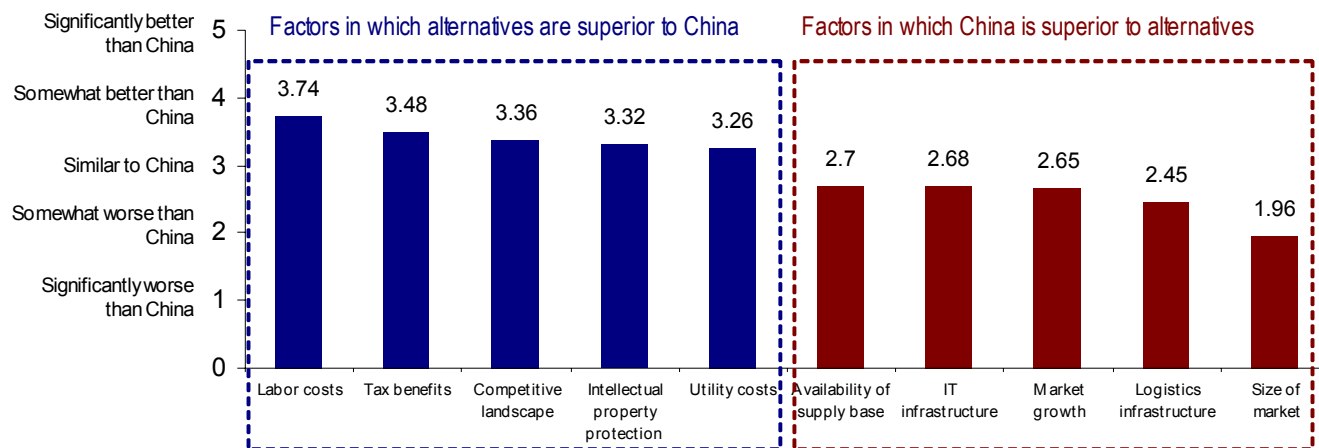
Note: Survey conducted in December 2007. Source: Booz Allen Hamilton

In a survey conducted by consulting company Booz Allen Hamilton, 54% of multinational corporations (mainly located in the Shanghai area) believe that China is losing its competitiveness to other low-cost countries, due to currency appreciation and rising wage costs. The survey was conducted in December 2007, so the new labor law has not been featured. Almost 20% of the multinationals indicated that they have clear plans to move part of their operations away to other countries (63% said they would move to Vietnam and 37% to India).

Still, 83% of manufacturers said that they would at least maintain part or all of the operation in China. Among these manufacturers, 78% have decided to stay because of China's vast domestic market, while 39% pointed to China's supply chain and infrastructure facilities.

Exhibit 11: Comparison of China with respondents' most favorable candidates for foreign relocation, 2007

(Average score of top five and bottom five parameters)



Note: Survey conducted in December 2007.
Source: Booz Allen Hamilton

Why did Beijing introduce all these measures, apparently harming the export industry? The current regime of President Hu Jintao and Premier Wen Jiabao has tried to improve the distribution of the benefits of growth since they took over from the Jiang Zemin-Zhu Rongji regime, which focused more on growth per se. It took the Hu-Wen regime a few years to wrestle with the local governments, which are traditionally aligned with foreign capital and the export sector. Local government resistance started to weaken after the Hu-Wen regime cracked down on the Shanghai government in 2006. That led to a series of changes in VAT tax rebates, tax notification, and the new labor law – all have been delayed numerous times. Coincidentally, the RMB has also started to accelerate in its appreciation. While we think the intention of these policies is good from the point of view of labor rights and the distribution of the fruits of growth, the timing could not be worse, just as the global cycle hits a downturn and too many policies come into effect simultaneously.

Will growth fall sharply? Probably not

A rise in labor benefits is not all negative. It may hurt capitalists and exporters, but generally benefits workers and domestic consumption. To some extent, this is a zero sum game, to relocate the benefit of growth to workers/consumers, at the cost of capitalists. In the medium term, the transition promotes a structural change in the Chinese economy, with less emphasis on exports and more emphasis on consumption. The rise in consumption and the decline in exports are healthy for China's growth in general, although trend growth may become a little slower.

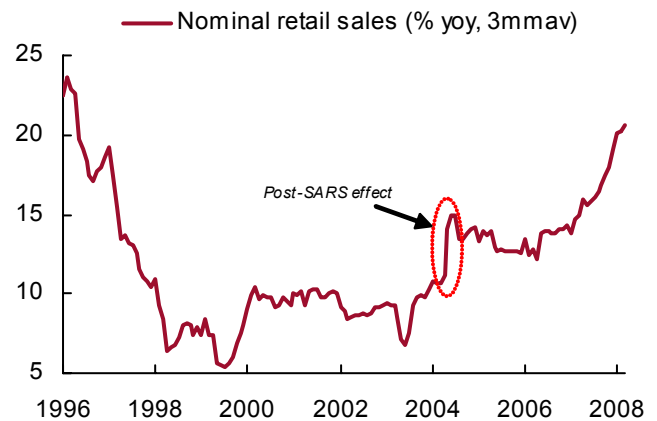
The moderation in exports will inevitably affect China's growth prospects, but we do not foresee a sharp fall in GDP growth at this stage in our central case scenario. We estimate about 3-5 million jobs (mainly migrant workers in Guangdong) will be affected this year due to a slowdown in exports, partially due to the structural issues discussed earlier and partially due to the global slowdown. We expect the current account surplus to shrink as well. However, in our view, this will all boil down to a crucial question – whether Chinese migrant workers can still expect positive income growth, in both nominal and real terms.

Exhibit 12: China exports are moderating ...



Source: CEIC, Credit Suisse

Exhibit 13: ... while consumption is picking up

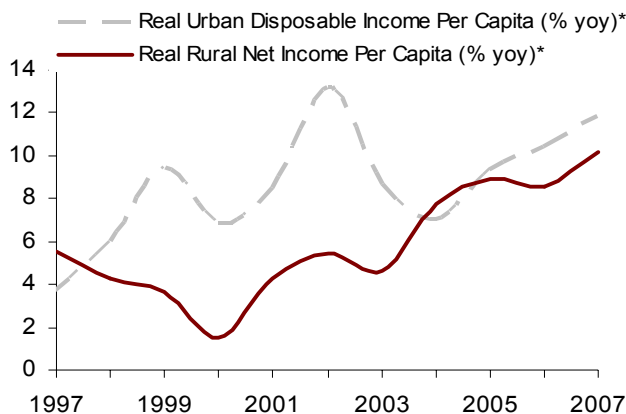


*Real data are deflated by retail price index.
Source: CEIC, Credit Suisse

We expect continued strong wage growth in China despite the trouble in the export sector. As the booming domestic services sector bids away workers, the labor market has tightened recently. This is especially visible in the migrant labor market for which we expect a 15% salary increase in 2008. Without the structural change in the export sector (along with the US slowdown), migrant workers' wage rates could have ballooned by 30-40%, in our view. Higher wages and a new source of consumption do add to aggregate demand.

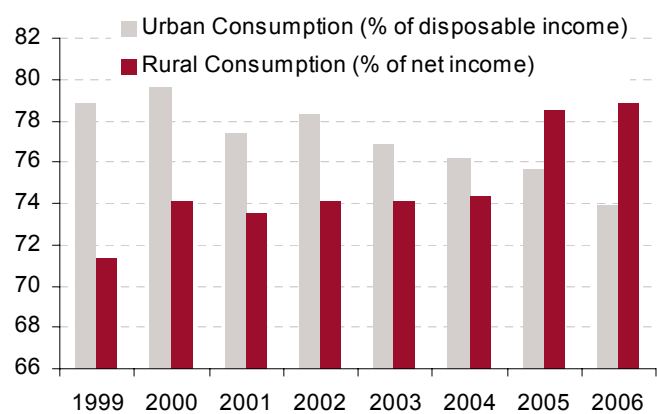
Individual income growth is accelerating in China anecdotally, though data collection and accuracy are always a problem. The National Statistics Bureau reported 17.2% income growth for the urban population and 15.4% for the rural population in 2007, both accelerated from previous data points, though some economists argued that actual income growth was even faster due to income expansion in the gray economy. In our own consumer survey (see next section), respondents reported the fastest household income growth in 2007 over our four-year survey period.

Exhibit 14: Strong income growth in both urban and rural areas



*Real data are deflated by CPI
Source: NBS, Credit Suisse

Exhibit 15: Consumption is booming especially in rural areas



Source: NBS, Credit Suisse

Lowered tax rates also help. The agricultural tax has been abolished, raising disposable income in the rural sector. In the urban sector, the tax exemption level was raised from RMB800 to RMB1,600 per month in 2005, and was increased further to RMB2,000 in March 2008, leaving about half the population outside of the personal tax net. We expect the tax exemption level to rise further next year.

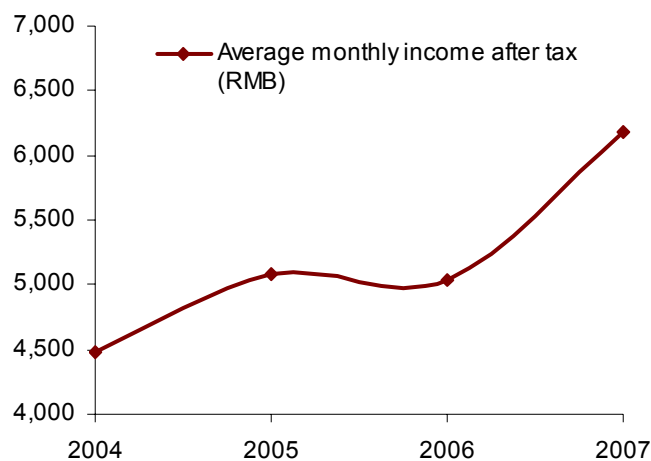
Mortgage payments remain a big liability for Chinese consumers, but people are getting used to the debt burden and feel more comfortable with spending now. Many Chinese bought apartments during the housing boom in the mid-2000s. Most were first-time homeowners. Their concerns about a large liability, on top of heavy spending needs for renovation, slowed down spending in non-housing areas. We think the psychological shock may be over now. So spending in the non-housing sector is likely to rise.

The last major contributor to rising consumption is the revival of inflation. Persistent high inflation has changed peoples' expectations about future prices, in our opinion. Currently, the six-month time deposit rate stands at 3.78%, while inflation exceeds 8% yoy. Negative real interest rates are likely to give consumers the incentive to save less and spend more – a trend repeatedly echoed in the *2007 China Consumer Survey* published by Credit Suisse.

Interesting change among consumers

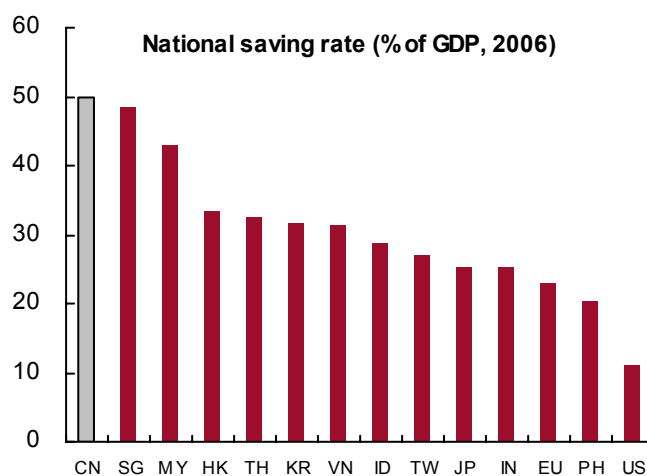
The China Consumer Survey published by Credit Suisse shows that income growth is surprisingly strong after a year of stagnation in 2006. The mean average monthly after-tax household income is RMB6,180, significantly higher than the approximate RMB5,000 income for both 2005 and 2006. It is interesting to note that the younger age group, ages 20-29, commands the highest monthly income. This is not a surprise in China, as the younger generation is more likely to be associated with the private sector and the services industry. This is particularly relevant to our view that the post-1980's generation is starting to exert influence over China's consumption patterns and profile.

Exhibit 16: Average monthly household income after tax



Source: Credit Suisse

Exhibit 17: A global comparison of national savings rates



Source: CEIC, Credit Suisse

In terms of household income distribution, improvement is visible. 15.2% of the surveyed households earn after-tax monthly income between RMB1,000-2,000, down from 18.2% in 2006 and 19.4% in 2005. Meanwhile, 10.7% of households make more than RMB10,000 per month, up from 6.3% in 2006 and 7.1% in 2005. The median household income reached RMB4,790, against RMB4,200 in 2006 and RMB3,940 in 2005.

Exhibit 18: After-tax monthly household income distribution (% of total households)

	RMB 1000- 2000*	RMB 2000- 3000	RMB 3000- 4000	RMB 4000- 5000	RMB 5000- 6000	RMB 6000- 7000	RMB 7000- 8000	RMB 8000- 9000	RMB 9000- 10000	RMB 10000 +
2004	24.7	21.0	16.2	12.0	8.9	4.4	3.2	1.5	2.0	6.1
2005	22.2	20.5	16.5	11.0	9.8	3.8	3.6	2.2	2.3	8.1
2006	20.3	17.3	17.7	13.3	10.3	4.4	4.6	1.7	3.3	7.1
2007	17.5	15.6	12.9	13.6	11.7	4.9	5.7	2.4	3.4	12.3

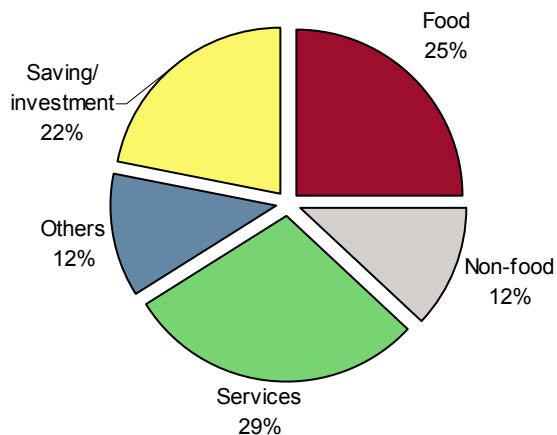
Note: invalid respondents are excluded. *RMB1500 - 2000 for Tier 1 city
Source: Credit Suisse

In terms of income growth, respondents with a college degree or above had the best performance,, reporting more than a 30% increase in personal income in the last three years. Other education groups had income increases of slightly below 12%. Those working in government or semi-government operations saw 34% income growth; the self-employed had a 20% increase, and those working for private companies reported a 17% gain. The 20-29 age group reported 29% income growth while the group between 50-59 saw only a 9.6% income increase.

Changes in spending habits

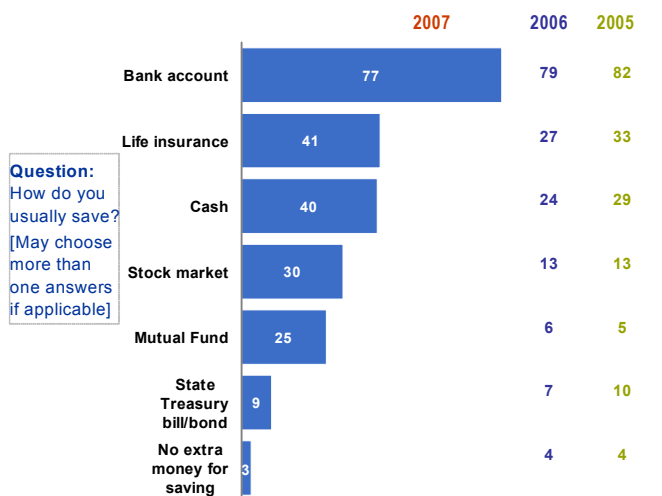
The change in household spending is interesting. Spending on food has been rising as a result of surging prices, with urban Chinese spending 25% of their disposable income on food. Families now put aside 22% of their disposable income for saving or investment use, down from 25% a year ago. The survey suggests that 29% of disposable income is used for service consumption, down from 31% a year ago, though the “others” category saw a jump from 9% to 12%.

Exhibit 19: Household expenditure breakdown in 2007



Source: Credit Suisse

Exhibit 20: Changes in household saving patterns



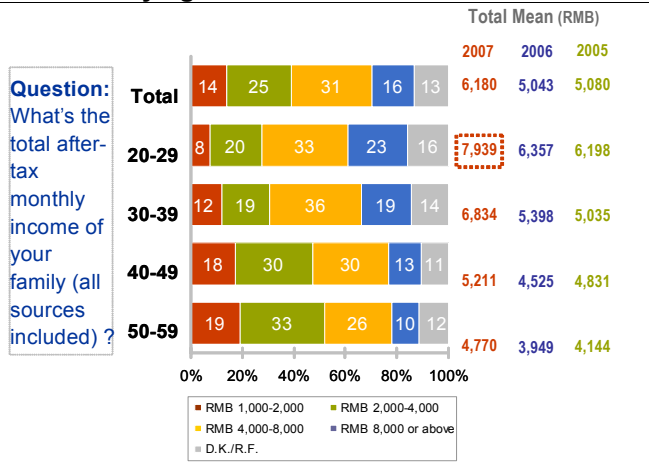
Source: Credit Suisse

77% of respondents in 2007 said they put some of their wealth into bank accounts, down from 82% in 2005. 30% and 25% of those surveyed said that they put money into the stock market or mutual funds, respectively, up from 13% and 5% two years ago. Average mortgage or rent payments reached RMB2,023 in the 2007 survey, compared to RMB1,613 for 2006 and RMB1,596 for 2005. This roughly translates into 33% of disposable income, on average.

Another major change comes from demographics as those born after 1980 (the so-called post-80's generation) become an increasingly important spending force. The post-80's generation consists of predominantly “one child” raised in an overly protective

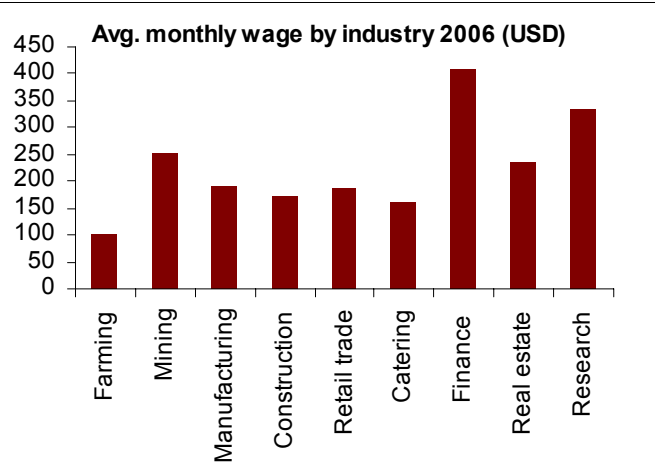
environment. This is the youngest group of consumers, receiving monthly income of RMB 7,939, the highest pay among all age groups (please see Exhibit 21). This group tends to be more willing to save less and spend more. It also seems to be most adaptive to the borrowing culture, and banks are pleased to lend to these consumers. The “one-child generation” will redefine consumer behavior and trends in China over the next decades, in our opinion.

Exhibit 21: Average monthly household income after tax – by age



Source: Credit Suisse

Exhibit 22: Average monthly wage – by industry



Source: NBS, Credit Suisse

Structural factors

Our optimism about Chinese private consumption goes beyond the next few years. This is based on the following factors: First, we expect wage growth to accelerate. The Chinese labor market is tightening now after decades of a virtually unlimited supply of migrant workers. This may not be favorable for corporate costs and export competitiveness, but it should provide consumers a better share of the wealth created from rapid economic expansion. We project 15% nominal income growth over the next decade.

This is in conjunction with a shift in the inflation outlook. In our view, the era of disinflation/deflation that prevailed over the past decade has ended. We anticipate continued rises in wages and rents. That should lead to a structural rise in services inflation. Rising food and energy prices add further price pressure. We look for trend inflation in China between 4-5% over the next decade, as against 1.1% in the past decade. Higher (but non-hyper) inflation tends to encourage consumption.

Exhibit 23: China’s growth in the past 20 years

	1990-94	1995-99	2000-04	2005-09F
Real GDP (% yoy)	10.9	9.1	9.2	10.6
Real retail sales (% yoy)	8.7	9.5	10.2	15.1
CPI (% , year - average)	10.3	5.2	1.1	4.0

Source: NBS, Credit Suisse estimates

The younger generation of Chinese consumers is showing more willingness to spend and borrow, as indicated in our survey. This demographic change is likely to lead to a decline in the savings rate in the long run. Meanwhile, Chinese banks, most of which have just completed reforms and recapitalisation, are expanding their consumer lending businesses. Financial products at this stage are limited (mainly to credit cards and auto loans) and penetration is still low, but rapid growth in consumer finance is set to take place judging from the experience of other emerging markets with annual income levels of about US\$8,000-10,000.

We also expect acceleration in RMB appreciation as China's income growth and productivity growth significantly outpace the rest of the world. Credit Suisse projects 10% RMB appreciation against the USD this year, 12% appreciation in 2009, and 8-10% appreciation yearly for the subsequent three to four year period. This should help ease domestic inflationary pressure and give domestic consumers greater purchasing power for imported goods. Strong currency appreciation typically boosts domestic consumption.

The lack of a social safety net will likely continue to be a drag on China, but the magnitude of the discomfort may ease, in our view. Failed reforms and surging costs in the health-care and education systems over the past decade have been largely responsible for China's persistently high savings rate. The under-funded and ineffective state-managed pension and unemployment scheme further undermine consumer confidence. While the government attempts to establish a social safety net that covers both urban and rural areas by 2020, we believe that Chinese consumers will have to depend on their own savings and family support to meet the bulk of their health-care and retirement costs. This means that China's savings rate may remain high by global standards, but consumers are still likely to increase their propensity to spend as they become less concerned. Some anecdotal evidence recently seems to be suggesting this is an accurate assumption.

Long-term projections

With the economy moving away from exports with more weight on private consumption, we expect the trend growth in China to be lowered gradually. Structurally, private consumption is likely to make a greater contribution to GDP. The current account surplus as a percent of GDP likely shrinks first, followed by a lower weighting for investment. This is consistent with the trend of Chinese currency appreciation as well as the rising wage rates. While domestic and global cycles could influence the process of this structural transformation, we believe the long-term trend will play out over the next decade or so. The Beijing Olympics could be referred to as a historical event for the escalation of domestic demand, similar to the pattern in the Tokyo Olympics and Seoul Olympics years ago.

We project China's trend GDP growth should moderate from 10% now, to 7.5% in 2011-20. While the growth rate is trending down, quality of growth probably will improve, as the domestic population benefits more from the fruits of economic development. Currently, China's growth model is built on an unlimited labor supply, cheap capital (subsidized by high savings ratio, low interest rates and state banks' policy supporting lending) as well as utilizing widespread natural resources. This is likely to change. Besides the new labor laws, the Chinese demographics are projected to transition in about five years' time, thanks to the "one child policy". Thirty-five years ago, for every one hundred people, representing new labor worldwide, thirty came from Chinese. Today, the number declines to thirteen and is projected to be only three in thirty-five years. Furthermore, the ongoing banking reforms should better discipline banks' lending practices, in our opinion, which should result in a curtailment of excess investment.

Exhibit 24: Summary of long-term macroeconomic forecasts

(% yoy)	Forecast						
	2001-2005	2006	2007E	2008 - 09	2010 - 14	2015 - 19	2020 onwards
Real GDP growth	9.6	11.6	11.9	10.0	8.5	7.0	4.0
Real private consumption growth	7.8	10.9	10.9	11.0	9.4	7.5	5.0
CPI (ya)	1.4	1.5	4.8	7.1	5.0	5.0	3.0
Export growth	25.5	27.2	25.7	10.4	7.5	6.0	4.0
RMB appreciation against USD (ya)	0.0	2.8	4.7	11.0	7.0	0.0	0.0

Source: NBS, CEIC, Credit Suisse estimates

China's private consumption is expected to reach \$17tn by 2020, replacing the US as the world's largest consumer market. This should not come as a surprise, given the trends in population size, pace of economic and income growth and exchange rate movement. In fact, China is likely to produce more incremental consumption than any other countries in the world in 2008. Of course, this is achieved in light of negative US incremental consumption. Still, it is a testament of the rising importance of the Chinese economy worldwide.

Exhibit 25: China's private consumption is expected to count for 21% of global consumption in 2020

(% share of global consumption)

	2006	2007E	2008F	2009F	2010F	2015F	2020F
US	31.1	30.2	29.3	28.3	27.4	23.5	20.8
Japan	8.4	8.2	7.9	7.7	7.4	6.5	5.8
Germany	5.8	5.6	5.5	5.3	5.1	4.3	3.8
UK	5.1	5.0	4.9	4.8	4.6	4.0	3.7
China	4.7	5.3	6.4	8.0	9.3	16.4	21.1
France	4.3	4.2	4.1	3.9	3.8	3.2	2.9
Italy	3.7	3.6	3.4	3.3	3.2	2.7	2.3
Spain	2.4	2.4	2.3	2.2	2.2	1.9	1.8
Canada	2.4	2.3	2.3	2.2	2.1	1.9	1.7
Mexico	1.9	1.9	1.8	1.8	1.8	1.7	1.6

Source: CEIC, DataStream, IMF, Credit Suisse estimates.

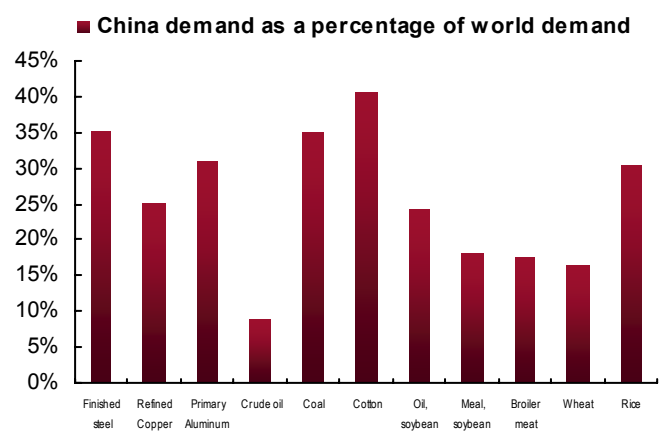
China accounts for 8.8% of world exports, dominating consumer goods such as textile and electronics. Its imports represent 6.9% of world imports – the largest importer for iron ore, copper, soybeans and the second largest for crude oil in the world. Its exports have been growing at an average pace of 30% per year, vs the world average of 16%, over the past five years. This is likely to moderate as part of its export competitiveness erodes. Nevertheless, we still project 6.4% average export growth between 2011-2020, above the world average, and foresee Chinese exporters climbing the product value chain. We believe Chinese import growth will remain robust amid the continued housing and infrastructure boom, though momentum may start to moderate in the second half of the next decade.

Exhibit 26: China exports are moderating ...



Source: NBS, Credit Suisse estimates.

Exhibit 27: ...however, demand for commodities would remain strong



Source: Credit Suisse

A crucial assumption we have made in our long-term projection is a continuously rapid currency appreciation. We assume 10% RMB appreciation against the USD this year, 12% appreciation in 2009, and 8-10% appreciation yearly until 2013. Pressured by excess domestic liquidity and rising inflation, it is our view that Beijing will tolerate a continued and relatively fast appreciation (and we do not rule out one-off revaluation either). A different attitude towards low end exports has made the appreciation decision easier. We believe that a near-complete currency convertibility will arrive sooner rather than later, and so will liberalization of the capital account.

Implications to take away

The Chinese economy is shifting away from the export sector towards the domestic sector, particularly for consumption. The volume growth and pricing power should reflect such a structural change.

Trend growth is likely to moderate somewhat, but quality of growth probably will improve. The current account surplus is expected to shrink significantly in the medium term. This might also signify less cheap money re-cycling back to US treasuries.

Various export-oriented companies have a large production base in China, especially in Guangdong. This applies not only to the Chinese exporters, but also to Taiwanese, Korean and Japanese companies.

We note extra caution is needed regarding the property market within the Guangdong province. Factory closures should have a negative impact on purchasing power.

Beijing likely can take a somewhat more aggressive approach in RMB appreciation, as export sector importance is downgraded as the lower end exports are diminishing anyway.

China's role as a source of global disinflation has ended, likely permanently, in our view. We see China raising export prices more aggressively, as companies must now decide between price hikes or business termination. Domestic inflation may also be on the rise in both the manufacturing and service sectors.

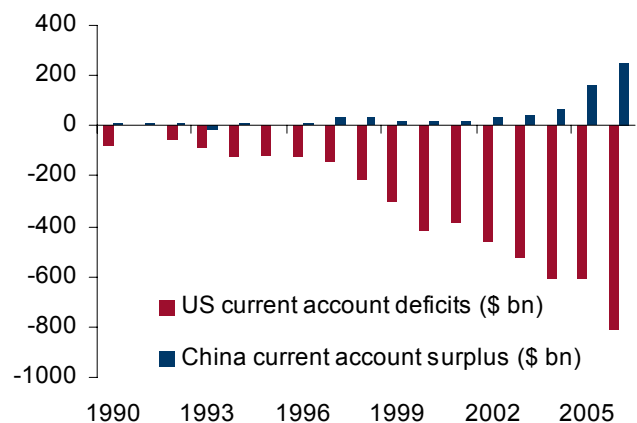
Vietnam and India appear to be the major beneficiaries of the loss of competitiveness in China's export sector, though both countries are facing similar overheating problems as well.

Exhibit 28: China now exports inflation



Source: US Bureau of Labor Statistics, Credit Suisse

Exhibit 29: Its current account surplus may narrow



Source: CEIC, Credit Suisse

Appendix

Exhibit 30: Major amendments to China's labor law: Labor Contract Law (2008) vs. Labor Law(1994)

A written employment contract is compulsory with detailed terms included

- 1) Wage x2 for each month working without a written contract
contract becomes open-ended, if it has not been concluded in the first 12 months
- 2) Clear terms specified on compensation, working hours, rest, leave, social benefits, work safety and training, etc.
- 3) If no lawful contract concluded or the employer breach the terms:
Workers can sue the employer, and significant penalties and compensation can be imposed

Overtime work must be compensated:

- 1) Over 40 hours/week:
wage x1.5 on weekdays, x2 on weekends, x3 on public holidays
- 2) Maximum over-time on weekdays
3 hours/day or 36 hours/month overtime work on weekdays
- 3) Workers are entitled to trace back and request historical overtime work compensation

Worker can only be dismissed when contract expires or for legal causes

Severance pay at the rate of one month's salary per year of service is required.

Compulsory enrolment in social security program

Rate set by local government, average 13-15% of wage

The use of probationary period is tightened with wage floors set for the period:

- 1) The probationary period may not exceed
 - a) one month, if the contract length is between three months and one year;
 - b) two months, if the contract length is one year to three years;
 - c) six months, if the contract length is longer than three years or open-ended.
- 2) Only one probationary period allowed with a single worker
- 3) Wage during the probationary period cannot be less than 80% of contract wage or lower than the local minimum wage rate

The use of business confidentiality agreements is restricted to senior management and employees with access to sensitive information

A worker can only be charged for terminating the contract if he/she has participated in training courses paid for by the employer and has signed a related agreement

Source: Ministry of Human Resources and social security, Credit Suisse

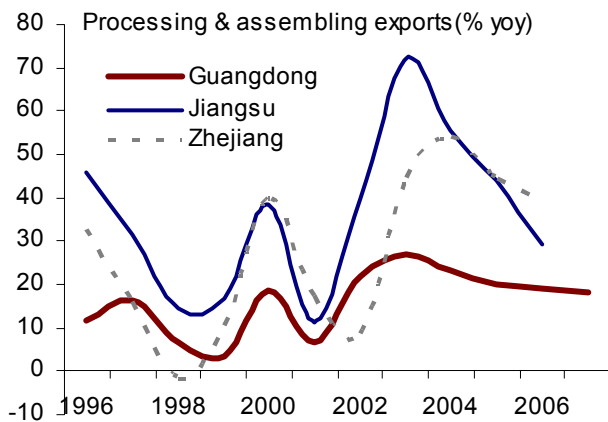
Exhibit 31: Summary of adjustments to VAT rebate rates, effective from Jul 2007

In total, 2831 products (37% of China's custom-registered traded goods) were affected, and on average, VAT rebate rates decreased by 2pp.

Cancellation of VAT rebates (533 products)	Previous rate	New rebate rate
Cement	13%	
Fertilizers	5-13%	
Leather	8%	
Non-ferrous metal products (excluding aluminum)	13%	
Pollusive chemical products	13%	
Salt and mineral products	11-13%	
Reduction in VAT rebates (2268 products)		
Chemical products	5-11%	5-9%
Clocks and watches	13%	11%
Clothing and accessories	13%	11%
Furniture	11-13%	9-11%
Leather products	13%	5%
Luggage and travel articles	13%	11%
Paper products	13%	5%
Plastic and rubber products	11-13%	5%
Steel products	13%	5%
Stone, clay and precious products	8-13%	5%
Textiles	11%	5%
Toys	13%	11%
Wooden products	11-13%	0-5%

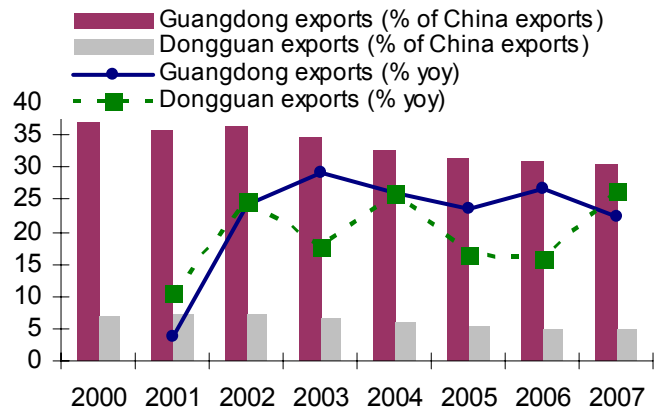
Note: There were another two cancellations of/reduction in VAT rebate rates in smaller scales in 2007. One was mainly targeting against oil and machinery product exports, effective from Apr 2007, and one was effective from Jan 2008, affecting steel product exports.
Source: Ministry of Commerce, Credit Suisse

Exhibit 32: Trend of weaker processing trade growth has started to show



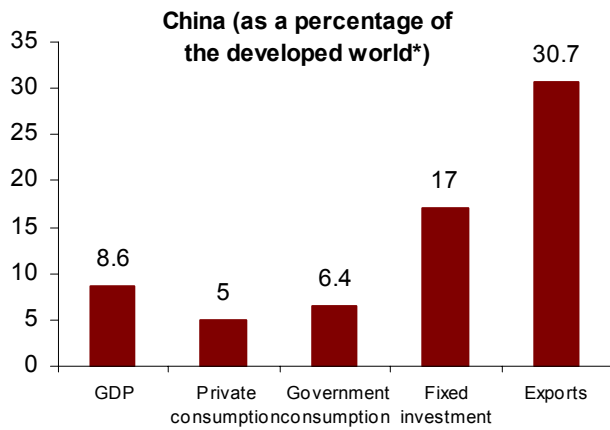
Source: CEIC, Credit Suisse

Exhibit 33: Guangdong exports currently count for 30% of China's exports



Source: CEIC, Credit Suisse

Exhibit 34: Disproportionately large share on investment and exports globally



* using the US, Japan and 27 European countries as a proxy for the developed world
Source: CEIC, Credit Suisse estimates

Exhibit 35: Greater contribution to the global growth



Source: IMF, Credit Suisse estimates

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