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Tobacco and Products

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Report Highlights:

Tobacco production fell during 2001 and is forecast to fall further during 2002 as production control efforts begin to have an impact. Imports of both leaf tobacco and cigarettes increased, with further gains forecast for 2002. Imports of leaf tobacco from the U.S. may begin as early as 2002, but only trial shipments are expected during the initial period.

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Tobacco Situation and Outlook

China's tobacco industry is undergoing restructuring in preparation for increased competition from imports. Production of tobacco leaf is being reduced and concentrated in specific geographic areas, and production of low quality leaf is being phased out. Likewise, small scale and low quality cigarette production is being phased out in order to improve the efficiency of the industry. Imports of tobacco leaf may increase as tariffs are being gradually reduced. Increases in imports are likely to be greater for cigarettes, however, as leaf continues to face an awkward and opaque import quota system, whereas restraints on retail sales of imported cigarettes are being removed.

Government efforts to reduce tobacco production appear to be paying off after several years of mixed success. Production fell by 7.9% in 2001 and is forecast to fall another 1% in 2002. One important element in this success appears to be the government's willingness to reduce overall procurement prices for tobacco. In recent years procurement prices for high grade tobacco were increased significantly, while prices for other grades remained stable or increased by less than 1%. At a time when support prices for other commodities were falling, this provided a significant incentive to farmers to plant tobacco, despite the government's intention to reduce tobacco production. In 2001, however, prices for high grade tobacco increased only slightly, while all other grades fell. Prices for the lowest grades of tobacco dropped by as much as 47%, providing a significant disincentive to producers. The government also appears to be enforcing provincial production quotas more aggressively, punishing local cadres who exceed their procurement quota. At the same time, the government is investing in improved production technology to increase the efficiency of tobacco producers.

Cigarette production increased by 2.2%, while revenues increased by 12.7%. Under pressure from the government and consumer demand, production is shifting into higher quality cigarettes. A recent change in tax structures will effectively increase taxes on the lowest grades of cigarettes, and is likely to drive some of the more inefficient factories out of business. Counterfeiting and illegal (over quota) production of cigarettes continue to be significant problems.

Imports of leaf tobacco jumped by nearly 50% in 2001. The vast majority of imported tobacco comes from Brazil and Zimbabwe, reflecting the extreme price sensitivity of Chinese cigarette producers. During that time, tariffs fell from 40% to 34%. Tariffs on leaf imports are scheduled to fall to 10% by 2004. Leaf exports also increased by 23%, likely reflecting lower prices. Cigarette imports dropped during 2001, likely reflecting lower domestic prices, domestic tastes that still favor Virginia style cigarettes, and continued restrictions on retail sales of imported cigarettes. The latter restrictions were removed at the start of 2002, and increased cigarette imports are forecast.

Although China has removed its ban on imports of U.S. leaf tobacco, Post does not forecast a sudden surge in imports. China continues to maintain a complex and opaque system of import quotas for leaf tobacco which are likely to delay imports. According to the State Tobacco Monopoly Administration (STMA), the first samples of U.S. tobacco will soon be distributed to cigarette manufacturers for testing. Once the manufacturers have completed their testing, they may request quotas, at which point the rather long and complicated import process can begin. Due to the length of time involved, Post does not expect much beyond trial shipments for 2002, although STMA officials have stated that imports could range from 0 to 200 MT, depending on how quickly the cigarette companies make their requests.

Statistical Tables

Table 1. Unmanufactured Tobacco: Production, Supply and Distribution

PSD Table						
Country:	China, Peoples Republic of					
Commodity:	Tobacco, Unmfg.					
		2000		2001		2002
	Old	New	Old	New	Old	New
Market Year Begin		01/2000		01/2001		01/2002
Area Planted	1437200	1437200	1425794	1339600		1330408
Beginning Stocks	3340032	3354861	2941020	2891996	2541432	2204599
Farm Sales Weight Prod	2543173	2552000	2587685	2349627		2328978
Dry Weight Production	2161697	2169200	2199532	1997183		1979632
U.S. Leaf Imports	0	0	300	0		60
Other Foreign Imports	37831	37831	39397	56686		59580
TOTAL Imports	37831	37831	39697	56686	0	59640
TOTAL SUPPLY	5539560	5561892	5180249	4945865	2541432	4243871
Exports	113594	113005	115080	139917		118930
Dom. Leaf Consumption	2447115	2519060	2484040	2544663		2573674
U.S. Leaf Dom. Consum.	0	0	300	0		60
Other Foreign Consump.	37831	37831	39397	56686		59580
TOTAL Dom. Consumption	2484946	2556891	2523737	2601349	0	2633314
TOTAL Disappearance	2598540	2669896	2638817	2741266	0	2752244
Ending Stocks	2941020	2891996	2541432	2204599		1491627
TOTAL DISTRIBUTION	5539560	5561892	5180249	4945865	0	4243871

Table 2. Flue-Cured Tobacco: Production, Supply and Distribution

Production Table						
Country:						
Commodity:	Flue Cured					
		2000		2001		2002
	Old	New	Old	New	Old	New
Market Year Begin						
Area Planted	1269200	1269200	1259127	1180600	0	1173263
Beginning Stocks	3058950	3068515	2600479	2610044	2132950	1928510
Farm Sales Weight Prod	2238000	2238000	2269643	2045250	0	2030812
Dry Weight Production	1902300	1902300	1929196	1738463	0	1726190
U.S. Leaf Imports	0	0	200	0	0	40
Other Foreign Imports	36740	36740	38377	55948	0	58705
TOTAL Imports	36740	36740	38577	55948	0	58745
TOTAL SUPPLY	4997990	5007555	4568252	4404455	2132950	3713445
Exports	108611	108611	110783	134055	0	113947
Dom. Leaf Consumption	2252160	2252160	2285942	2285942	0	2320232
U.S. Leaf Dom. Consum.	0	0	200	0	0	40
Other Foreign Consump.	36740	36740	38377	55948	0	58705
TOTAL Dom. Consumption	2288900	2288900	2324519	2341890	0	2378977
TOTAL Disappearance	2397511	2397511	2435302	2475945	0	2492924
Ending Stocks	2600479	2610044	2132950	1928510	0	1220521
TOTAL DISTRIBUTION	4997990	5007555	4568252	4404455	0	3713445

Table 3. Burley Tobacco: Production, Supply and Distribution

Production Table						
Country:						
Commodity:	Burley					
		2000		2001		2002
	Old	New	Old	New	Old	New
Market Year Begin						
Area Planted	132068	58000	131020	56187		58434
Beginning Stocks	178465	178917	247457	177023	88549	174091
Farm Sales Weight Prod	247077	126000	250018	99428		104400
Dry Weight Production	210015	107100	212516	84514		88740
U.S. Leaf Imports	0	0	100	0		20
Other Foreign Imports	858	545	770	369		460
TOTAL Imports	858	545	870	369	0	480
TOTAL SUPPLY	389338	286562	460843	261906	88549	263311
Exports	4536	1894	3855	2932		2491
Dom. Leaf Consumption	136487	107100	138534	84514		88740
U.S. Leaf Dom. Consum.	0	0	100	0		20
Other Foreign Consump.	858	545	770	369		460
TOTAL Dom. Consumption	137345	107645	139404	84883	0	89220
TOTAL Disappearance	141881	109539	143259	87815	0	91711
Ending Stocks	247457	177023	317584	174091		171600
TOTAL DISTRIBUTION	389338	286562	460843	261906	0	263311

Table 4. Oriental Tobacco: Production, Supply and Distribution

Production Table						
Country:						
Commodity:	Oriental					
		2000		2001		2002
	Old	New	Old	New	Old	New
Market Year Begin						
Area Planted	10481	12000	10397	10373		10581
Beginning Stocks	6724	6600	555	5100	2115	3341
Farm Sales Weight Prod	10481	23000	19841	24620		25112
Dry Weight Production	8909	19550	16865	20927		21346
U.S. Leaf Imports	0	0	0	0		0
Other Foreign Imports	68	327	82	221		265
TOTAL Imports	68	327	82	221	0	265
TOTAL SUPPLY	15701	26477	17502	26248	2115	24952
Exports	360	1500	367	1759		1495
Dom. Leaf Consumption	14718	19550	14938	20927		21346
U.S. Leaf Dom. Consum.	0	0	0	0		0
Other Foreign Consump.	68	327	82	221		265
TOTAL Dom. Consumption	14786	19877	15020	21148	0	21611
TOTAL Disappearance	15146	21377	15387	22907	0	23106
Ending Stocks	555	5100	2115	3341		1846
TOTAL DISTRIBUTION	15701	26477	17502	26248	0	24952

Table 5. Dark Air and Sun Cured Tobacco: Production, Supply and Distribution

Production Table						
Country:						
Commodity:	Dark Air & Sun Cured					
		2000		2001		2002
	Old	New	Old	New	Old	New
Market Year Begin						
Area Planted	25451	98000	25250	92440		88130
Beginning Stocks	95893	100830	92529	99830	88785	98657
Farm Sales Weight Prod	47616	165000	48182	180329		168654
Dry Weight Production	40473	140250	40955	153279		143356
U.S. Leaf Imports	0	0	0	0		0
Other Foreign Imports	165	218	168	148		150
TOTAL Imports	165	218	168	148	0	150
TOTAL SUPPLY	136531	241298	133652	253257	88785	242163
Exports	87	1000	74	1173		997
Dom. Leaf Consumption	43750	140250	44625	153279		143356
U.S. Leaf Dom. Consum.	0	0	0	0		0
Other Foreign Consump.	165	218	168	148		150
TOTAL Dom. Consumption	43915	140468	44793	153427	0	143506
TOTAL Disappearance	44002	141468	44867	154600	0	144503
Ending Stocks	92529	99830	88785	98657		97660
TOTAL DISTRIBUTION	136531	241298	133652	253257	0	242163

Table 6. Cigarettes: Production, Supply and Distribution

PSD Table						
Country:	China, Peoples Republic of					
Commodity:	Tobacco, Mfg., Cigarettes					
		2000		2001		2002
	Old	New	Old	New	Old	New
Market Year Begin		01/2000		01/2001		01/2002
Filter Production	1664530	1664530	1654670	1677186		1688991
Non-Filter Production	33970	33970	30330	23814		20514
TOTAL Production	1698500	1698500	1685000	1701000	0	1709505
Imports	2088	2089	2129	1787		1877
TOTAL SUPPLY	1700588	1700589	1687129	1702787	0	1711382
Exports	12811	12811	13003	13815		14091
Domestic Consumption	1687777	1687778	1674126	1688972		1697291
TOTAL DISTRIBUTION	1700588	1700589	1687129	1702787	0	1711382

Table 7. Tobacco Production by Province

Table 7. Tobacco Production by Province			
China's Leaf Tobacco Production Area By Province			
	(1,000 HA)		
	2000	2001	2002
Province	Revised	Prelim	Forecast
Yunnan	340	336	341
Guizhou	214	202	202
Henan	166	174	171
Hunan	89	86	86
Sichuan	82	70	72
Hubei	75	63	61
Heilongjiang	49	46	44
Shandong	63	47	46
Chongqing	71	55	56
Shaanxi	52	42	41
Fujian	55	59	59
Others	182	158	151
TOTAL HA	1437	1340	1330
China's Leaf Tobacco Production Volume By Province			
	(1,000 MT)		
	2000	2001	2002
Province	Revised	Prelim	Forecast
Yunnan	656	615	615
Guizhou	338	289	283
Henan	276	320	320
Hunan	168	163	168
Hubei	138	123	119
Sichuan	156	122	116
Shandong	117	84	83
Heilongjiang	96	84	86
Chongqing	104	80	78
Shaanxi	77	65	66
Fujian	94	101	96
Others	334	303	300

TOTAL MT	2552	2350	2329
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Table 8. Tobacco Production by Type: Revised Series

China's Tobacco Production By Tobacco Type (2000-2002)					
	Area (1,000HA)				
	1998	1999	2000	2001*	2002**
Flue Cured	1200	1150	1269	1181	1173
Burley	54	50	58	56	58
Oriental	14	12	12	10	11
Dark Air & Sun Cured	93	88	98	92	88
TOTAL	1361	1300	1437	1340	1330
	Production (1,000MT FSW)				
	1998	1999	2000	2001*	2002**
Flue Cured	2088	2185	2238	2045	2031
Burley	96	114	126	99	104
Oriental	23	22	23	25	25
Dark Air & Sun Cured	157	148	165	180	169
TOTAL	2364	2469	2552	2350	2329
All figures are post estimates based on SSB, STMA and industry figures.					
* Estimate **Forecast					

Table 9. Procurement Prices for Flue Cured Tobacco

Table 9. Procurement Prices for Flue Cured Tobacco (2001)					
US\$/MT					
	Region 1	Region 2	Region 3	Region 4	Region 5
Class A	1665	1606	1489	1371	1292
C1F	2210	2133	1976	1819	1716
C2F	1940	1872	1735	1598	1506
C3F	1670	1614	1494	1373	1296
C1L	2024	1952	1807	1663	1566
C2L	1752	1687	1566	1446	1359
B1F	1711	1651	1530	1410	1325
B2F	1414	1364	1265	1166	1099
B1L	1369	1320	1224	1128	1060
B1R	1414	1364	1265	1166	1099
H1F	1477	1422	1320	1217	1147
X1F	1335	1287	1193	1099	1036
Class B	1179	1137	1054	971	915
C3L	1429	1378	1277	1176	1108
X2F	1024	988	916	843	795
X3F	754	728	675	622	586
X1L	1267	1222	1133	1043	983
X2L	971	935	867	800	754
B3F	836	805	747	689	651
B4F	482	467	434	400	376
B2L	863	831	771	711	670
B3L	434	417	386	354	337
B2R	1173	1133	1048	964	911
B3R	687	663	614	566	530
H2F	1234	1190	1104	1017	959
X2V	776	747	694	639	602
C3V	1212	1171	1084	998	940
B2V	940	911	843	776	733
B3V	675	651	602	554	523
S1	566	547	506	465	439

Class C	315	305	282	259	245
B4L	270	260	241	222	210
X3L	619	598	554	511	482
X4L	296	289	265	241	231
X4F	323	313	289	265	251
S2	405	390	361	333	313
CX1K	390	376	349	323	304
CX2K	214	207	193	178	169
B1K	323	313	289	265	251
B2K	161	157	145	133	125
GY1	149	145	133	120	116
Class D	71	70	64	58	57
B3K	89	87	80	72	72
GY2	53	53	48	43	41

Table 10. Cigarette Prices

Table 10. Factory Price for Cigarettes (2001)				
Class	Price in RMB	Price in USD	Share of production for Quarter 4, 2001	Share of sales for Quarter 4, 2001
Class A	Greater than RMB 7,553/50,000 pcs.	\$903.61/50,000 pcs.	13.4	21.0
Class B	RMB 2,522 - 7,553/50,000 pcs.	\$301.20 - 903.61/50,000 pcs.	21	21.8
Class C	RMB 1,220 - 2,522/50,000 pcs.	\$150.60 - 301.20/50,000 pcs.	30.2	32.1
Class D/E	Less than RMB 1,220/50,000 pcs.	Less than \$ 150.60 50,000 pcs.	33.3 for D	23.0 for D
			2.1 for E	2.1 for E

Production

Tobacco

Tobacco planted area fell by roughly 6.8% in MY 01, with a corresponding drop of almost 8% in production. All major producing provinces reported a drop in planted area, with the sharpest reductions occurring in Shandong, Chongqing and Shaanxi. The only exception was Fujian, with an 8% increase. The smallest reduction, 1% was recorded in the largest producing province, Yunnan. This will have the effect of further strengthening Yunnan's position as China's dominant tobacco producer. For MY 01, Yunnan produced 615 TMT of tobacco, accounting for roughly 26% of the national total and almost double that of the next largest producer, Henan. Reductions in area were also relatively small in the other top four producing provinces, Henan, Hunan and Guizhou. Average yields fell slightly during MY 01. The largest drop, 23%, occurred in Heilongjiang province, where drought damaged the crop. The largest gain took place in Henan, where a gain in yields of almost 11% more than offset declining area to make Henan the only province other than Fujian to increase production. Concentration of tobacco production in certain areas is becoming a self-reinforcing trend, as increased concentration is producing greater production efficiency and investment in technology and infrastructure in those areas, while little or no investment is taking place in low production areas.

Officials attribute the reduction in planted area to government policies aimed at reducing China's production of tobacco, first implemented in MY 97. These policies have been notably unsuccessful at controlling production, which has increased every year since then, until MY 01. The renewed effectiveness of control policies appears to be rooted in a decline in local obstructionism and a change in the government's approach to procurement pricing. The centerpiece of the tobacco control policy has been a system of quotas distributed to provinces by the central government. These are enforced through limits on the amount of tobacco that local governments are allowed to procure at the government-set price. Local governments, however, have been unwilling to carry out reductions, often ignoring quota limits and even encouraging increased production. This is because tobacco is a key source of cash income for local farmers, and tobacco taxes constitute one of the largest sources of local tax revenues. Domestic sources report that the government has begun to punish cadres whose tobacco procurement exceeds guidelines. While this may not have eliminated over-quota procurement entirely, it does appear to have eliminated the more flagrant violations. Contributing to the success of the quota system is the continued movement of the cigarette factories to forward contracting for tobacco procurement. Since cigarette manufacturers are limited by production quotas, they are limited in the amount of tobacco they can sign contracts for. While guaranteed sales provides strong incentives for in-quota leaf production, sales of over quota (and thus non-contracted) production face a more uncertain market.

A second factor contributing to the decline in production appears to be a change in procurement pricing policy. Prices for Class A tobacco remained flat or increased by less than 1%, while prices for lower classes fell sharply. Procurement prices for the lowest class (Class D) were reduced by between 42% and 47%, depending on the region. Reflecting this change, production of low-quality leaf dropped. Favoring production of high quality tobacco is nothing new, however in the past the government has done this by increasing prices for high quality leaf, rather than reducing prices for low quality leaf. The reductions in price for lower quality tobacco in MY 00 very likely contributed to the reduction in planted area, and seems to signal a willingness to take more painful measures to rationalize production. Price reductions for tobacco are politically sensitive. In addition to being the most important source of tax income in many areas, tobacco is a key cash crop for some of China's poorest regions, many of which have large minority populations and are located in sensitive border areas.

Although the central government is attempting to limit tobacco production, it is also undertaking efforts to make domestic tobacco producers more competitive. The primary objective appears to be to concentrate tobacco production in a limited area and improve the quality and technology component of those production areas to make them more competitive. Investments include development and distribution of improved seed types, construction of standardized curing facilities and education for farmers in proper use of fertilizers. A more recent development is for support of burley tobacco production in Hebei, Sichuan and Chongqing. STMA is also investing in marketing infrastructure, and has plans to develop internet connections between provincial offices, tobacco procurement stations and major tobacco processors.

A note on production statistics. This year's annual report includes yet another revision to non-flue cured tobacco production. These revisions reflect the general problems with agricultural statistics in China. While statistics on flue-cured tobacco, which constitutes over 87% of production, are consistent, there is wide variation in estimates for other types, most notably dark air and sun cured tobacco, and burley tobacco. The primary official sources for tobacco statistics are the National Statistical Bureau and the STMA. While NSB's statistics are generally regarded as more accurate overall, they do not provide any breakdown for non-flue cured tobacco. Thus any breakdown of types using these statistics is made using a simple percentage estimate based on a 'best guess.' STMA provides estimates for production of other types, but many sources claim that these are inaccurate as STMA does not have authority over non-flue cured tobacco production and marketing. The differences in the two methods may be related to differences in how they classify tobacco types. The total of non-flue cured tobacco production appears to be consistent between the two sources—the difference is primarily over the division between burley and dark air and sun cured. Post has chosen to switch back to the STMA estimates this year as this is the only source for which a time series is available. A revised 5-year time series is included in table 8.

Cigarettes and Cigars

Total cigarette production increased by 2.2% in MY 01, reaching a total of 1.36 trillion pieces. Filter cigarettes accounted for 96.8% of the total. The balance between filter and non-filter cigarettes continues to shift, as production of non-filtered cigarettes fell by over 70%, while filtered production increased by 2.5%. Total revenues from cigarette sales amounted to \$18 billion in 2001, an increase of 12.7% over 2000. As with leaf, the Chinese government is making efforts to improve the quality of cigarette production. As a part of this effort, China implemented new taxation regulations for cigarettes beginning June 1, 2001. The new system utilizes a compound tax with a fixed component and a price-based component. The fixed component amounts to \$18.1/case. The price-based component charges 45% for cigarettes with a unit price, excluding VAT, in excess of \$6/carton, and for all imported cigarettes. Cigarettes with a unit price under \$6/carton will be charged at a rate of 30%. By creating a minimum tax, this scheme will effectively increase taxes on class 4 and class 5 cigarettes, the lowest grades. The government is hopeful that this will lead to further consolidation and the elimination of the least efficient and lowest quality manufacturers.

Illegal production of cigarettes continues to be a problem, although it appears that increased reliance on forward contracting as well as more aggressive enforcement of tobacco production quotas has reduced the problem somewhat. Counterfeiting, however, remains a serious problem. Industry sources estimate that over 2 million cases of counterfeit cigarettes were sold in 2001—in the range of 6% of total production. Since counterfeits are difficult to track, the actual number could be significantly higher. Counterfeiting activity appears to be moving from South China to North China. Authorities cite local authorities as an important obstacle to anti-counterfeiting efforts. Local officials continue to see production, even illegal production, as a source of economic growth. Thus it is common for local officials to turn a blind

eye or even provide protection to illegal manufacturers. The regional shift in counterfeiting activity may be related to more aggressive enforcement of tobacco controls in the main producing regions in the south. Since tobacco is a less important crop in North China, regulation tends to be looser.

Consumption

NSB statistics indicate a slight increase in cigarette consumption for both urban and rural households in 2001. Urban annual per capita consumption increased from 536 pieces in 2000 to 544 pieces in 2001, an increase of 3.2%. Rural per capita consumption increased from 461 pieces to 477 pieces, for a gain of 3.39%. This is in contrast to a significant drop in consumption the previous year. Chinese industry officials expect growth to be fastest for high and middle-grade cigarettes, and for blended cigarettes. Consumption of blended cigarettes remains relatively low, and is concentrated in urban areas. Tobacco officials cite health concerns as a reason for growing sales of high-quality cigarettes.

The fastest consumption growth appears to be among young people and women. A recent survey by the Ministry of Sanitation found that roughly 34% of all the people surveyed over the age of 15 were smokers. Of these, 61% are male. The same survey found that the average age of smokers is declining. The Chinese government estimates that there are roughly 50 million underage smokers in China. At the same time, surveys indicate that consumers are becoming more health conscious—one statistic cited by government sources claims that nearly half of China's smokers want to give up smoking.

Stocks

Leaf tobacco stocks declined more quickly than expected in MY 01. This is the result of a combination of factors, including the decline in leaf tobacco production and an unexpected increase in cigarette production. At the same time, increased production of high quality tobacco appears to be helping to resolve the long-term imbalance in the production mix, preventing further accumulation of leaf stocks. Over the past few years production of low grade tobacco has exceeded demand, resulting in the accumulation of large stocks of low quality tobacco. Official data on cigarette stocks is not available. However, industry sources estimate that total cigarette stocks grew by 2.6%, as compared to a reported growth of 13.3% the previous year. Stocks tend to consist of low grade cigarettes, and the slowdown in growth likely reflects declining production of low-end cigarettes.

Trade

Tobacco

Total imports of leaf tobacco in 2001 jumped to 56.7 TMT as compared to 37.8 TMT in 2000 and 10 TMT the year before. Nearly the entire quantity (98.7%) was composed of flue cured tobacco. The vast majority of the imported tobacco came from Brazil and Zimbabwe. This reflects a reduction in tariffs from 40% to 34%. Further cuts agreed to as part of China's WTO accession agreement are scheduled to bring tariffs down to 22% in 2002, eventually reaching a final rate of 10% by 2004. Although tobacco is imported primarily to improve the overall quality of cigarettes, Chinese manufacturers remain extremely price sensitive. Imports are forecast to increase only slightly in 2002. The arcane system for assigning import quotas for leaf, production quota limits on cigarette manufacturing and increased

domestic production of high quality tobacco are all factors that may limit tobacco imports. China also increased its exports of tobacco in 2001, reaching a total volume of 140 TMT, an increase of 23% over the previous year. Increased export volume likely reflects the falling unit price of Chinese tobacco: export values increased by a mere 1.3%. According to China Customs, China exported some 3.6 TMT of tobacco to the U.S. in 2001, as compared to 2.9 TMT in 2000. Exports are generally of lower grade tobacco, as China continues to suffer from an imbalance in production. Exports are forecast to decline in 2002 as reduced production of low quality tobacco reduces the exportable surplus.

Although China removed its ban on imports of U.S. tobacco (due to concerns over tobacco blue mold), no shipments were recorded in 2001. This is due primarily to the rather arcane system of procedures governing China's tobacco import quotas. Under the current system, all companies wishing to import tobacco must submit their requests at the beginning of the year, after which the Chinese government allocates quotas. Since the suspension on imports of U.S. leaf was not lifted until mid-year, 2002 will be the first year in which any imports may take place. STMA has stated that it will move quickly to issue quotas once they are requested, but Post does not expect a sudden jump in imports. Industry sources report that there is a great deal of interest from some companies, however STMA claims that Chinese manufacturers will require a considerable amount of time to develop appropriate blends. According to STMA, imports of U.S. tobacco are extremely difficult to forecast, and could range anywhere from 20 MT to 200 MT. It should be noted that a total of only six small samples were taken for distribution to cigarette companies, and these have yet to arrive in China. Thus, Post has taken a cautious approach, forecasting only trial shipments for 2002. There is also some debate over what type of tobacco is likely to be imported. STMA officials have stated that burley tobacco is most likely to benefit, as China produces very little burley of its own for blending. Industry sources, however, believe that there is a great deal of interest in importing U.S. flue-cured tobacco. Long term prospects for leaf imports may depend on the ability of domestic cigarette manufacturers to compete with imported cigarettes as tariffs go down.

Cigarettes

Total cigarette exports for 2001 amounted to 13.8 billion pieces, an increase of 7.8% over 2000. The total value of exports actually fell, however, dropping from \$198 million in 2000 to \$175 million in 2001. The unit value of exports fell from \$15.48 per 1,000 pieces to \$12.68. Exports to the United States doubled, making the U.S. the second largest destination for Chinese cigarette exports, behind Hong Kong and ahead of Myanmar. It appears likely that most of these cigarettes are re-exported to other destinations, particularly Mexico and Central America. The unit value of Chinese cigarettes exported to the U.S. is roughly \$5.24/1,000 pieces, as compared to an average unit value of \$24.98/1,000 for Canada. In addition, China Customs data indicates no significant exports of Chinese cigarettes directly to Mexico, while U.S. re-export data shows re-exports of cigarettes from the U.S. to Mexico at over \$4 million.

Cigarette imports fell almost 17% in 2001, due in part to the combination of falling domestic cigarette prices and continued restrictions on the sale of imported cigarettes. This situation is likely to change in coming years. Prior to 2002, sales of imported cigarettes were limited to tourist hotels and similar venues. However, beginning in 2002 restrictions on the retail sales of imported cigarettes have been removed. Likewise, tariffs on cigarettes are scheduled to fall. Tariffs have already come down from 150% in 1997 to 65% in 2001. For 2002 cigarette tariffs have been set at 35% and will fall to 25% in 2004. The United Kingdom is by far the largest exporter of cigarettes to China, with a market share of 52% in 2001. The U.S. ranked second with a total export volume of 243 million pieces for a market share of 13.6%.

Increased imports are likely to cause the greatest harm to smugglers and counterfeiters. Smuggling continues to be a significant problem for Chinese authorities, who report that seizures of illegally imported cigarettes increased by 34.8% in 2001, reaching a total of 4.7 million pieces. These seizures likely only represent the tip of the iceberg. In past years, smuggling is believed to have been equal to if not greater than legal imports. The government began an aggressive anti-smuggling campaign in the mid 1990's including the highly publicized executions of several major smugglers. The campaign appears to have peaked in 2000, and illegal imports are reported to be on the rise again. Smuggling is largely a byproduct of restrictive import policies and high tariffs. As these policies are moderated, smugglers are likely to find their profit margins falling.

Tariffs and Non-Tariff Barriers

As noted previously, tariffs on both tobacco leaf and cigarettes are falling quickly. Changes in the restrictions on retail sales of cigarettes this year have also eliminated a major non-tariff barrier for cigarettes. Signature of a protocol for the import of U.S. tobacco last year eliminated a longstanding non-tariff barrier for U.S. tobacco leaf. This leaves the VAT and the tobacco import quota procedures as the most important barriers remaining to trade. A VAT of 17% is charged on the full value of all imported tobacco. China also levies a VAT on domestic tobacco. However, domestic farmers are provided a discount on the VAT, based on the assumption that they have already paid VAT on agricultural inputs such as fertilizer and seed. The methods used to calculate the reductions are subject to debate, as is the question of how often domestic agricultural products pay the VAT in the first place.

The second major barrier to trade is China's rather arcane system for allocating import quotas for leaf tobacco. Under the current system, the STMA holds annual tobacco fairs for different types of tobacco. At each meeting, buyers are given the opportunity to sample and price different types of tobacco. They then present a request for import quota for the next year to STMA. STMA then makes a determination of how much quota should be issued, based on their perception of the industry's needs and the overall health of the domestic tobacco industry. This process is somewhat opaque, and leaves considerable room for regulatory mischief. Once the quotas have been issued, cigarette companies must conduct a buying mission to the source country to price and select tobacco. The buying mission is also accompanied by quarantine officials, who inspect and clear the tobacco. Once the buying decision is made, a second mission will arrive to supervise packing and ensure that the tobacco shipped meets the terms of the contract. The lead time for this process is quite long.

According to STMA officials, a tobacco fair will not be required for U.S. leaf, as samples will be passed directly on to Chinese cigarette companies. These same officials have provided assurances that, once cigarette companies make their requests for import quotas, STMA will try to expedite their requests. However, they do not expect the requests to be ready soon, as the samples have yet to be distributed. They have also stated that Chinese companies are not accustomed to working with U.S. tobacco, and may require a considerable length of time to develop their blends. Once the companies have made their requests, the buyers' mission and the mission to supervise the packing will still have to be conducted. STMA has stated that it intends to reform the import procedures, but the exact nature and timing of the reforms remains unknown.

Marketing

In the past, STMA has maintained a monopoly on the distribution of cigarettes. This monopoly appears to have long since broken down at the retail level. Anecdotal evidence indicates that STMA's tobacco monopoly stores account for a mere fraction of retail sales as small shops routinely sell cigarettes. Recent revisions of the retail regulations on tobacco are a mere recognition of this fact, though they may make it easier to market imported cigarettes, and possibly undercut counterfeiters.