



USDA Foreign Agricultural Service

GAIN Report

Global Agriculture Information Network

Template Version 2.09

Required Report - public distribution

Date: 10/20/2005

GAIN Report Number: CH5075

China, Peoples Republic of

Dairy and Products

Annual Report

2005

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Report Highlights:

China's dairy industry for 2006 is forecast to continue expanding, but the pace of growth will slow due to higher production costs and slowed dairy product consumption. Cow milk production for 2006 is forecast to increase 20 percent to 33.8 MMT, while non-fat dry production is forecast to decrease 8 percent to 55,000 MT. A new policy effective on October 15 requiring only pure raw milk be used for pasteurized milk may result in reduced imports of milk powder. China's whey imports are forecast to continue increasing in 2006 due to strong domestic demand and limited domestic production. The U.S. will remain the largest whey supplier to China.

Includes PSD Changes: Yes
Includes Trade Matrix: Yes
Annual Report
Beijing [CH1]
[CH]

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Executive Summary

China's dairy industry continues to develop as post forecast in the previous annual report CH4050, although the pace of growth will slow during 2006. Total raw milk production for 2006 is forecast to increase 20 percent to 34.94 MMT and cow milk production for 2006 is forecast to increase 20.71 percent to 33.8 MMT. The pace of grow is forecast to decrease 2.88 percent for total milk and 3.15 percent for cow milk respectively due to higher production cost and smaller pace of increase in consumption

The national standard "The General Rule on Labeling of Pre-Packed Foods - GB7718-2004", became effective on October 1, 2005. The regulation requires that pre-packed food labels state the truth and forbids usage of strange, unclear or confusing words. The State Council recently issued a new policy requiring that all fluid milk products containing reconstituted milk (from milk powder) must state "reconstituted" and indicate percentages of milk. Plants intending to use reconstituted milk for processing fluid products must register the product with local Quality Supervision Administration and provide detailed information about milk powder suppliers and plants' marketing areas.

As a result of this new requirement, milk powder imports are forecast to decrease because most imported milk powder is reconstituted for fluid products. As a third largest supplier to China, U.S. companies may also be impacted. This looks like a non-tariff barrier to protect domestic raw milk production.

China's non-fat dry milk production during 2006 is forecast to decrease 8.3 percent to 55,000 MT due to decreased demand and an increase in supplies of fluid milk and milk powder. Whole-fat milk powder production for 2006 is forecast to increase 8.9 percent to 1 MMT.

China's whey imports increased from 67,124 MT in 2003 to 186,780 MT in 2005, despite international prices increasing 17.6 percent from January to August in 2005. This trend will continue into 2006 as China's livestock and feed industry continues to expand and modernize. China's fluid milk imports are insignificant and forecast at only 5,000 MT in 2006. Non-fat dry product imports for 2006 are forecast to decrease 5.4 percent to 52,000 MT due to a sharp increase of international prices and reduced domestic demand. Conversely, whole-fat milk powder imports will decrease 10.4 percent due to domestic production increases and higher international prices.

China's dairy exports markets are East and Southeast Asia. Fluid milk exports for 2006 are forecast stable at 31,000 MT. Hong Kong and Macaw account for 97 percent of China's total fluid milk exports due to geographical proximity. Exports of non-fat dry products for 2006 are forecast to decrease about 7 percent due to domestic production decreases. Whole-fat milk powder exports for 2006 are forecast to increase 17.2 percent to 34,000 MT due to Taiwan, Myanmar and Japan demand increases. Although export volume to Hong Kong may decrease about 8 percent, export value is expected to increase slightly.

Production

Cow milk production for 2006 forecast at 33.8 MMT, a 20 percent increase from the estimated 28 MMT in 2005

China's total raw milk production for 2006 is forecast to increase 20 percent from last year to 34.9 MMT. Other milk (goat and buffalo) production for 2006 is forecast to increase 2.7 percent to 1.1 MMT. The pace of increase in raw milk production for both 2005 and 2006 is forecast below that of 2003 (32 percent) and 2004 (28.1 percent) because of higher production costs and a slower pace of dairy consumption growth.

The preliminary data of the National Statistics Bureau indicates that in the first half of 2005 China's cow inventory increased 24.5 percent to 11.5 million head, total milk production increased 22.9 percent to 12.8 MMT and cow milk production increased 24.3 percent to 12.3 MMT respectively over the same period of 2004. Post estimated the year-on-year pace of growth for total milk and cow milk production in 2005 at 22.9 percent and 23.8 percent respectively, almost at the same pace of the half-year level. The top five producing provinces, Inner Mongolia, Heilongjiang, Hebei, Shandong and Xinjiang have remained the same as previously stated in last year's annual report CH4050.

The newly announced official numbers for total milk and cow milk production for 2004 are very close to post's estimation in the previous report CH4050. Post revised upwards the total milk and cow milk production numbers for 2004 in this fluid PS&D table from 23.1 MMT to 23.6 MMT and from 22.0 to 22.6 MMT respectively based on official data from the National Statistics Bureau (NSB).

China's increases in dairy cow inventory will slow during 2006, despite the 11th Five-Year-Plan (2006-2010). Limited feed resources will constrain cow herd expansion. The change of heifer proportion supports this. The heifer ratio dropped from 50 percent in 2002 to estimated 37 percent in 2006. Farmers keep their old cows even after 8 or 9 years. Although China imported 132,446 head of breeding cows in 2004, not more than 30 percent could be used for breeding due to quality problems according to well-known Chinese experts. The Government tightened breeding cow imports. This factor, combined with the need for genetic improvement and China's resumption of frozen bovine semen and embryo imports from the U.S., will provide a trade opportunity for the U.S. industry.

A new factor is that both raw and processed sectors are experiencing smaller profit margins due to higher production costs, fierce competition and price wars between UHT milk and pasteurized milk. The China Dairy Industry Association (CDIA for processed) stated that the sales profits of processed products were 6.8 percent in 2002, 6.1 percent in 2003 and 5.4 percent in 2004 respectively. Heavy investment the last couple of years resulted in a considerable increase of processing capacity. However, raw milk production lags behind due to limited feed resources and genetic improvement.

Large imports of milk powder, following tariff reductions after China joined the WTO, have made it possible for processing plants to reconstitute better quality milk powder into fluid milk. According to China Dairy Association (CDA for raw milk), the current C.I.F. price of imported milk powder is \$1,734-1,858. One ton of milk powder can reconstitute 8 tons of fluid milk, while domestic procurement price for 8 tons of raw milk is over \$2,478. To reduce costs, some processing plants lowered procurement prices for raw milk, some even refused to collect milk from farmers leading to several cases of farmers pouring out raw milk.

Although production cost has been increasing, market prices of processed products changed little due to price wars because several cases of dairy product quality problems have shaken

consumers' confidence, and processors are struggling to maintain sales through reduced prices.

The price range of a maturing young cow in Heilongjiang province dropped from \$1,982-2,230 to \$1,487-1,735. The price of an adult cow in Hebei Province is around \$1,239. Heifer prices also decreased considerably. Even so, farmers are reluctant to buy. Average earnings from a high quality cow are \$248-372, smaller than the comparable period of 2004. Post forecasts that China will focus on raising yield production instead of increasing cow herd size in the next couple of years.

New policy on pasteurized and UHT milk production, labeling and identification standard may change production pattern and impact trade

A national standard "The General Rule on Labeling of Pre-Packed Foods - GB7718-2004", became effective on October 1, 2005, requiring that pre-packed food labels should state the truth and not use strange, unclear or confusing words. According to "The Guideline of Implementing GB18-2004" published by China National Standardization Committee, dairy plants should not use the words "fresh milk" in labeling for pasteurized or UHT milk. They can only use "pasteurized milk" or "pure milk". This new requirement resulted in strong opposition from pasteurizing milk plants that use pure raw milk material because "pasteurized" is a translation from English to Chinese. This term does not convey an image of freshness for consumers.

On September 18, 2005, the State Council issued the "Notice of Strengthening Management on Fluid Milk Production and Marketing" requiring that only raw milk is allowed for pasteurized milk and strongly recommending raw milk for UHT milk. From October 15, 2005, producers should state clearly on labels "reconstituted milk" and the percentage used in the ingredients list. It requires that plants intending to use reconstituted milk for fluid products should register prior production with local quality supervision agency including the information on 1) imported or domestically procured milk powder quantity, quality, place and name of milk powder plant; 2) beginning date and length of production; 3) quantity of fluid products with reconstituted milk and the percentage of each batch of finished products and 4) marketing areas of fluid products with constituted milk. Any change should be notified to the agency 15 days in advance. Without registration, the Administration of Industry and Commerce will not issue production license.

On September 30, 2005, the Ministry of Agriculture (MOA) announced the "Identification of Reconstituted Milk in Pasteurized and UHT Milk to serve as an industry test standard since there is no national standard.

The notice will likely keep some consumers away from reconstituted milk because urban, wealthier Chinese pay more attention to health and they prefer fresh products. This will force producers to adjust product patterns to develop more value-added products such as flavored yogurt, infant formula milk powder, adult functional milk powder or more varieties of flavored UHT milk.

The new notice could lead to a decrease in milk powder imports because most imported milk powder is reconstituted for fluid products, especially after import tariffs for milk powder dropped this year. The raw milk industry indicates that China imported 121,488 MT of milk powder in 2004. If this powder is reconstituted (multiply by 8), the volume would equal the same quantity of raw milk produced by 242,976 head of cows for an entire year, thus affecting the livelihood of many dairy farmers. The U.S. is the third-largest milk powder supplier to China's market with sales of \$9 million in 2004 and an estimated \$13 million for 2005.

Fluid use consumption in 2006 forecast to increase 21 percent to 15 MMT, and factory use consumption forecast to increase 18 percent to 19 MMT

Although China's fluid use and factory use of raw milk are forecast to increase 21.5 percent and 18.8 percent respectively in 2006, the pace of increase in fluid use is forecast to drop 5 percent from an estimated 13 MMT in 2005, and factory use is forecast to drop 1.7 percent from the estimated 16.1 MMT in 2005 due to a slower pace of increase in raw milk supplies. The slower pace of consumption also impacts demand. Well-publicized cases of dairy quality problems--including well-known domestic and foreign brands--have shaken consumers' confidence, according to media reports. Product similarity results in inadequate consumer demand. Marketing promotion in small cities, towns and in rural areas is slow. The small pace of increase in urban consumer expenditures on dairy products (30.5 percent in 2002, 19.0 percent in 2003 and 6.1 percent in 2004) reflects this, though China's GDP growth was 9.5 percent, urban and rural incomes were 9.5 percent and 12.5 percent respectively in the first half of 2005.

Raw milk consumption for processing fluid products is centered in Inner Mongolia, Hebei, Shandong, Shanghai, Heilongjiang, Shanxi, Zhejiang Jiangsu, Liaoning and Beijing. This will continue into 2006.

Nonfat dry milk consumption for 2006 forecast to decrease 7 percent to 105,000 MT, while whole-fat milk powder to increase 7 percent to 1 MMT

The decrease in nonfat dry milk consumption appears due to lower imports as the result of higher international prices (e.g., the unit price was 17.6 percent higher) and in part due to available domestic substitution of other milk. Whole-fat milk powder increases drove decreases in non-fat. More raw milk going to fluid products has also had an effect because non-fat product prices are not much higher. This situation will lead to continued domestic decreases in non-fat milk production in 2006. In turn, reduced whey production will drive upwards imports of U.S. whey in 2006.

Trade**U.S. dairy products the only one among six top suppliers to increase sales during 2005**

In terms of total volume and value, the U.S. is the second largest dairy supplier to China's market. The position has remained for several years. China Customs data (WTA) shows that China's total dairy imports from January to August in 2005 decreased 14 percent in volume to 218,102 MT and 8.6 percent in value to \$308 million over the same period of 2004. However, only the U.S. is gaining among the top six suppliers. The U.S. export volume increased 41.2 percent to 59,013 MT, and the value increased 65.6 percent to \$41.4 million in the first 8 months of 2005. Strong U.S. exports appear likely to continue into 2006 because of the devalued U.S. dollar, EU countries' quota production constraints and reduced government subsidies in dairy, as well as dry weather in Australia and New Zealand, will continue to favor imports of U.S. products.

Although China's fluid imports are forecast to increase 25 percent from 4,000 MT to 5,000 tons, the import quantity is very small due to large domestic production and constraints in storage and transportation. This pattern will not change in the next few years.

U.S. the largest whey supplier to China

China's whey imports have increased from 67,124 MT in 2003 to an estimated 186,780 MT in 2005, though international prices increased 17.6 percent from January to August in 2005 over that of 2004. Whey imports account for over 50 percent of China's total dairy imports in volume, and over 30 percent in value. This trend will continue into 2006 as China livestock and feed industry continue expanding.

The U.S. is the largest whey supplier to China. U.S. whey exports reached 54,501 MT (up 44.4%) and \$31.5 million (up 84.7%) from January to August 2005, accounting for 43.8 percent in volume and 31.7 percent in value of China's total whey imports. Limited domestic substitution explains why whey imports are increasing and the tariff is the lowest among all dairy products. China's strong livestock and feed development, combined with limited domestic production and substitution, will continue drive imports in 2006.

U.S. genetics trade opportunities

China announced approval of 52 U.S. facilities to export frozen bovine semen and embryos during the 16th meeting of the U.S.-China Joint Commission of Commerce and Trade (JCCT) held in Beijing on July 11, 2005. Earlier this year, the Chinese quarantine authorities, AQSIQ, audited and registered all of them. Prior to China's BSE-related trade suspension on U.S. cattle, beef and products, U.S. exports of semen and embryos exceeded \$1 million. Further, China changed its policy to tighten control of breeding cow imports against misuse of tariff-free breeding cows for commercial purpose.

The above-mentioned new labeling policies are forecast to intensify the search for raw milk supplies in the foreseeable future. Combined with China's critical shortage of genetic stocks to improve dairy industry, frozen bovine semen and embryos imports will also increase steadily. Opportunities lie ahead in advantageous dairy production areas like Inner Mongolia, Heilongjiang, Hebei, Shandong, Henan and large cities like Beijing and Shanghai. The top ten Chinese dairy companies produced 49.5 percent of the total dairy products with 56.8 percent of the total value in 2004. Most companies have international shareholders or are joint ventures.

However, if U.S. companies want to invest in China's frozen bovine semen and embryo industry, they need to consider the challenge of gaining a larger part of shareholding because of regulations on state-owned industries with special government permits. Without a larger share, protection of property may not be guaranteed.

Fluid milk exports for 2006 forecast stable at 31,000 MT, while whole fat dry milk powder exports will increase 17.2 percent to 34,000 MT.

Hong Kong and Macau are China's traditional export markets accounting for over 90 percent of China's total fluid milk exports. This will not change in 2006 due to geographic convenience for fluid milk.

China's exports of whole-fat milk powder for 2006 are forecast at 34,000 MT, a 17.2 increase from the estimated 29,000 MT in 2005 due to Taiwan, Malaysia and Japan demand increases. Hong Kong is the largest export market accounting for almost half of China's total exports. Although export volume to Hong Kong in 2005 may decrease about 7 percent due to lower demand in Hong Kong, export value will remain steady. Taiwan, Malaysia and Japan account for another 30 percent of China's total exports of whole-fat milk powder.

PS&D Tables

PSD Table

0.024971 0.085163

Country

China, Peoples
Republic of

Commodity

Dairy, Milk,
Fluid

(1000 HEAD)(1000 MT)

Market Year Begin	2004	Revised	2005	Estimate	2006	Forecast	UOM
	USDA Official [Old]	Post Estimate[New]	USDA Official [Old]	Post Estimate[New]	USDA Official [Old]	Post Estimate[New]	MM/YYYY
		01-2004		01-2005		01-2006	
Cows In Milk	5466	5466	5600	6900	0	8350	(1000 HEAD)
Cows Milk Production	22052	22606	23700	28000	0	33800	(1000 MT)
Other Milk Production	1055	1078	1090	1110	0	1140	(1000 MT)
TOTAL Production	23107	23684	24790	29110	0	34940	(1000 MT)
Intra EC Imports	0	0	0	0	0	0	(1000 MT)
Total Imports	3	3	3	4	0	5	(1000 MT)
TOTAL Imports	3	3	3	4	0	5	(1000 MT)
TOTAL SUPPLY	23110	23687	24793	29114	0	34945	(1000 MT)
Intra EC Exports	0	0	0	0	0	0	(1000 MT)
Total Exports	37	31	50	31	0	31	(1000 MT)
TOTAL Exports	37	31	50	31	0	31	(1000 MT)
Fluid Use Dom. Consum.	10315	10315	11606	13000	0	15800	(1000 MT)
Factory Use Consum.	12758	13341	13137	16083	0	19114	(1000 MT)
Feed Use Dom. Consum.	0	0	0	0	0	0	(1000 MT)
TOTAL Dom. Consumption	23073	23656	24743	29083	0	34914	(1000 MT)
TOTAL DISTRIBUTION	23110	23687	24793	29114	0	34945	(1000 MT)
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0	(1000 MT)
Calendar Yr. Exp. to U.S.	0	0	0	0	0	0	(1000 MT)

PSD Table**Country****China, Peoples
Republic of****Commodity****Dairy, Milk, Nonfat
Dry**(1000
MT)

Market Year Begin	2004	Revised	2005	Estimate	2006	Forecast	UOM
	USDA Official [Old]	Post Estimate[New]	USDA Official [Old]	Post Estimate[New]	USDA Official [Old]	Post Estimate[New]	
	01-2004		01-2005			01-2006	MM/YYYY
Beginning Stocks	0	0	0	0	0	0	0 (1000 MT)
Production	71	68	70	60	0	55	55 (1000 MT)
Intra EC Imports	0	0	0	0	0	0	0 (1000 MT)
Total Imports	69	61	88	55	0	52	52 (1000 MT)
TOTAL Imports	69	61	88	55	0	52	52 (1000 MT)
TOTAL SUPPLY	140	129	158	115	0	107	107 (1000 MT)
Intra EC Exports	2	2	3	2	0	2	2 (1000 MT)
Total Exports	0	0	0	0	0	0	0 (1000 MT)
TOTAL Exports	2	2	3	2	0	2	2 (1000 MT)
Human Dom. Consumption	138	127	155	113	0	105	105 (1000 MT)
Other Use, Losses	0	0	0	0	0	0	0 (1000 MT)
Total Dom. Consumption	138	127	155	113	0	105	105 (1000 MT)
TOTAL Use	140	129	158	115	0	107	107 (1000 MT)
Ending Stocks	0	0	0	0	0	0	0 (1000 MT)
TOTAL DISTRIBUTION	140	129	158	115	0	107	107 (1000 MT)
Calendar Yr. Imp. from U.S.	6	5	10	7	0	7	7 (1000 MT)
Calendar Yr. Exp. to U.S.	0	0	0	0	0	0	0 (1000 MT)

PSD Table**Country****China, Peoples
Republic of****Commodity****Dairy, Dry Whole
Milk Powder**(1000
MT)

Market Year Begin	2004	Revised	2005	Estimate	2006	Forecast	UOM
	USDA Official [Old]	Post Estimate[New]	USDA Official [Old]	Post Estimate[New]	USDA Official [Old]	Post Estimate[New]	
		01-2004		01-2005		01-2006	MM/YYYY
Beginning Stocks	0	0	0	0	0	0	0 (1000 MT)
Production	760	832	780	918	0	1000	(1000 MT)
Intra EC Imports	0	0	0	0	0	0	0 (1000 MT)
Total Imports	113	91	145	67	0	60	(1000 MT)
TOTAL Imports	113	91	145	67	0	60	(1000 MT)
TOTAL SUPPLY	873	923	925	985	0	1060	(1000 MT)
Intra EC Exports	0	0	0	0	0	0	0 (1000 MT)
Total Exports	24	25	29	29	0	34	(1000 MT)
TOTAL Exports	24	25	29	29	0	34	(1000 MT)
Human Dom. Consumption	849	898	896	956	0	1026	(1000 MT)
Other Use, Losses	0	0	0	0	0	0	0 (1000 MT)
Total Dom. Consumption	849	898	896	956	0	1026	(1000 MT)
TOTAL Use	873	923	925	985	0	1060	(1000 MT)
Ending Stocks	0	0	0	0	0	0	0 (1000 MT)
TOTAL DISTRIBUTION	873	923	925	985	0	1060	(1000 MT)
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0	0 (1000 MT)
Calendar Yr. Exp. to U.S.	0	0	0	0	0	0	0 (1000 MT)

Dairy Tariff Table, Effective on January 1, 2005

Tariffs on Dairy Products, Effective January 1, 2005

		MFN	General	V.A.T	Effective Rate (MFN & VAT) 1/
Fluid Milk	0401.1000	15.0%	40.0%	17.0%	34.89%
	0401.2000	15.0%	40.0%	17.0%	34.89%
	0401.3000	15.0%	40.0%	17.0%	34.89%
Powdered Milk	0402.1000	10.0%	40.0%	17.0%	29.89%
	0402.2100	10.0%	40.0%	17.0%	29.89%
	0402.2900	10.0%	40.0%	17.0%	29.89%
	0402.9100	10.0%	90.0%	17.0%	29.89%
Yogurt	0402.9900	10.0%	90.0%	17.0%	29.89%
	0403.1000	10.0%	90.0%	17.0%	29.89%
Whey	0403.9000	20.0%	90.0%	17.0%	39.89%
	0404.1000	6.0%	30.0%	17.0%	25.89%
Butter & Dairy Spreads	0404.9000	20.0%	90.0%	17.0%	39.89%
	0405.1000	10.0%	90.0%	17.0%	29.89%
	0405.2000	10.0%	90.0%	17.0%	29.89%
Cheese	0405.9000	10.0%	90.0%	17.0%	29.89%
	0406.1000	12.0%	90.0%	17.0%	31.89%
	0406.2000	12.0%	90.0%	17.0%	31.89%
	0406.3000	12.0%	90.0%	17.0%	31.89%
	0404.4000	15.0%	90.0%	17.0%	34.89%
	0404.9000	12.0%	90.0%	17.0%	31.89%

Source: China Customs