TD Bank Financial Group

TD Economics

Special Report

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SLOWING THE CHINESE JUGGERNAUT

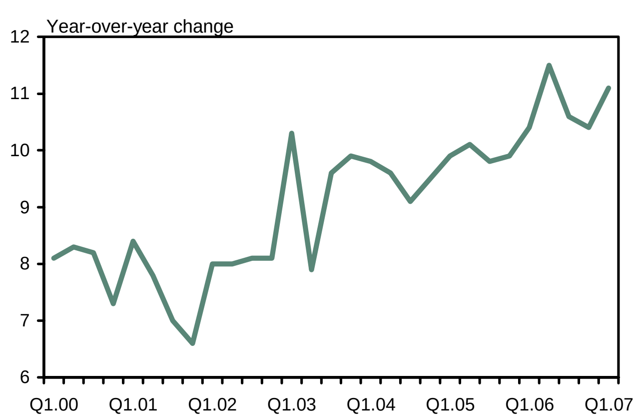
Chinese data released this morning showed the economy expanded at a blistering 11.1% annualized pace in the first quarter of 2007, up from 10.4% in the fourth quarter of 2006 and breaking with the slight cooling trend that we had been seeing. Export and investment growth appears to have surged in the first three months of this year (though an official breakdown of the real GDP figures are not available). Also today, it was reported Chinese CPI inflation increased to 3.3% in March from 2.7% in February, and that industrial production and urban fixed investment also accelerated.

All this points to the difficulties in managing an economy as large as China with the blunt instruments available to authorities. But, there are also significant tax policy changes underway, which were announced in February, that suggest these first quarter figures may be more of an anomaly. Past Chinese polices allowed many export-oriented firms in China to operate tax-free until they became profitable, and even continue to pay little to no taxes for 3-5 years after they became profitable depending on their strategic importance and level of R&D investment. Having attracted large numbers of firms, Chinese policymakers feel these policies have served their purpose and they announced earlier this year that these advantages will now be phased out. As a result, trade data released earlier in the year suggested exporters were pushing sales forward to take advantage of these implicit subsidies before they disappear. This would suggest that the first quarter GDP number may have more noise in it than usual and the pace of economic growth may resume its cooling trend before long.

HIGHLIGHTS

- **Chinese economy grows by unexpectedly strong pace in the first quarter**
- **Changing corporate tax structure may explain some of this**

CHINESE GDP GROWTH



Source: China National Bureau of Statistics and Haver Analytics

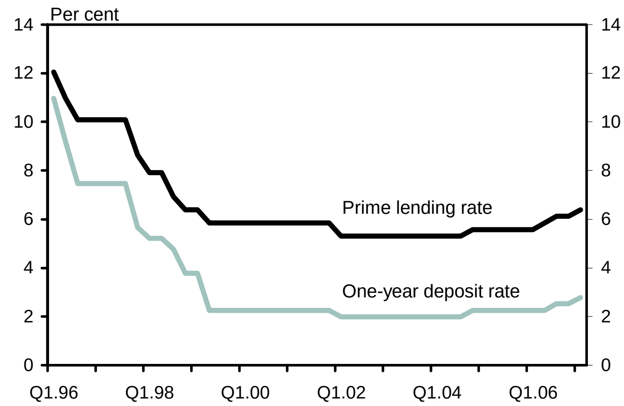
So today's data can certainly be used to justify the increases in interest rates and bank reserve requirements that were viewed as being inevitable this year. The levels of banks' reserves continue to be higher than the official reserve requirement though, so this constraint has yet to bite. The Bank of China has raised the one-year lending rate three times by 27bps increments (the odd number because the number 5 is unlucky) in the last year to 6.39%, but have increased the deposit rate only twice to 2.79%, as the authorities want to reign in borrowing, while spurring consumers to spend. But once again, these rates have little bite. In an economy growing by 11.1%, an interest rate slightly above 6% (and only slightly above 3% after-inflation) is miles away from neutral. **Monetary policy, therefore, has little choice but continue to tighten.**

However, higher interest rates will put pressure on the Chinese currency to rise, something authorities would like to avoid. There is certainly a non-negligible risk that we might see further and faster appreciation of the Chinese renminbi - or even a one-off revaluation, as seen in 2005. However, this should not be taken too far. The Chinese Premier and central bank Governor have both signaled this year a greater willingness to tighten monetary policy to manage the economy. They have not, though, sent any clear signs they see the value of the exchange rate as an issue, per se, but rather seem to believe they can relieve the inflationary pressures on their economy emanating from the undervalued exchange rate by revising the tax code instead.

Firms in China have used a process called "round-tripping" to report their profits abroad and then bring the capital back into China as FDI in order to receive the favourable tax treatment. Some estimates place this figure as high as half of all inward investment into China. This has put some pressure on the renminbi to appreciate and has fueled the accumulation of international reserves by China. Authorities hope that when they get rid of the tax incentives, they will reduce inward FDI and relieve some of the pressures. In fact, in response to today's data, the Chinese Premier spoke of increasing Chinese investment abroad, which is an equal and opposite way to relieve stress on the exchange rate**. So, China, at least at this point, seems to prefer to relieve the upward pressure on the currency by changing fiscal policy and investment incentives, not through any radical change in exchange rate policy.**

We know Chinese reserves increased by nearly 10% in the first quarter of 2007, and some of this could be explained by firms bringing their capital back home before the tax advantages disappear. The rest of the increased pace of reserve accumulation seems to have been driven by the big increase in exports that may have resulted from the tax changes, as well as reports that the Chinese central bank was unwinding some currency swaps it had with local banks. This last factor is part of plans to reinvest the money at higher yields, but also a sign that the increased pace of economic growth and trade may have taken the authorities off guard. Under the assumption Chinese trade and the economy were cooling, there should have been less pressure on the exchange rate to appreciate and the authorities might have seen this as a good time to bring these dollars back onto their balance sheet during this period of reduced stress.

CHINESE OFFICIAL INTEREST RATES



Source: China National Bureau of Statistics and Haver Analytics

All in all, the continuing story of the Chinese economy is how to rebalance the economy away from exports and investment and toward domestic consumer spending. Today's data probably helps on the public relations front in justifying to domestic Chinese skeptics why reforms need to accelerate. The unexpected increase in the pace of GDP growth, though, could very well have been driven by a one-off blip and be the result of the ongoing reforms. These certainly highlight the difficulties in managing an economy as large as China by writ, and the inherent dangers in transitioning from a centrally-directed to market-based economy. But at the very least, they might be some reason to hope that reforms are having a meaningful effect.

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