



TD Economics

Special Report

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CHINESE ECONOMY: THE SONG REMAINS THE SAME

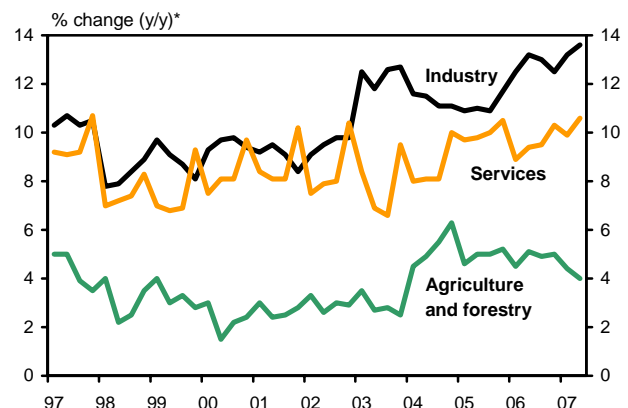
Chinese figures released today showed the economy expanded by 11.9 per cent in the second quarter of 2007 over where it was one year earlier. Year-to-date, the economy has grown by 11.5 per cent. This is an acceleration over the 11.1 per cent pace seen in the first quarter and is not consistent with policymakers' desires to orchestrate a steady cooling in the economy. Heightening this concern were inflation figures which showed a full percentage point increase in consumer inflation, from 3.4 per cent in May to 4.4 per cent in June. While there will be further moves to reign in economic growth and inflation, which will include further appreciation of the renminbi and increases in interest rates, these will not be the primary methods, nor should they be.

One mechanism that will eventually help slow Chinese growth is the reduction in value-added tax (VAT) rebates on many Chinese exports that went into effect July 1. We saw a very sizeable increase in exports out of China in the first half of 2007 and anecdotal evidence suggests producers were trying to frontload as much of their exports as

HIGHLIGHTS

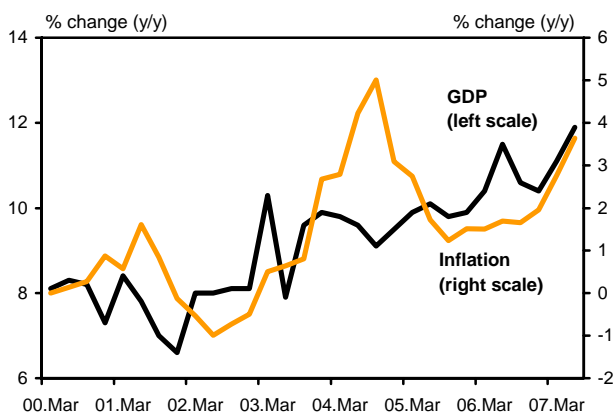
- **Chinese economy & inflation accelerate in Q2**
- **Economy should cool only slightly from here**
- **Currency and interest rates unlikely to play much of a role**

CHINESE GDP



*Cumulative annual change; Source: China National Bureau of Statistics and Haver Analytics.

CHINESE GDP AND INFLATION



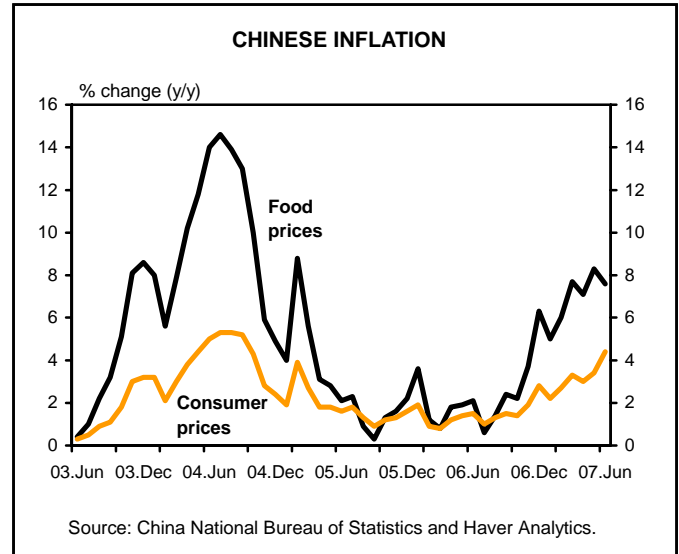
Source: China National Bureau of Statistics and Haver Analytics.

possible so as to avoid these higher costs. As a result, the industrial and services sectors of the Chinese economy picked up steam in the first half of 2007, but the agricultural sector continued to weaken. Coupled with rising inflation, this will be an important political concern with national leaders meeting this fall to discuss planning priorities for the next five years. We do expect to see less strength out of the Chinese economy in the second half of this year. Nevertheless, because of the tremendous start to the year and only limited cooling expected, the Chinese economy will easily beat its 10.7 per cent pace of expansion in 2006, and will very likely exceed the 11.0 per cent mark.

While this growth is stoking inflation, currency and interest rates are unlikely to play an important part in Chinese monetary policy and economic planning, and for good reason. There has been a loud cry, especially in political circles, for substantial appreciation of the Chinese currency, but this would have little impact on slowing Chinese exports – or improving the U.S. trade deficit as some would hope. Over half of Chinese exports are “re-exports,” meaning various parts have been imported into China, assembled, and then re-exported to various destinations around the world for further assembly or final sale. With such a supply chain, any increase in the value of the Chinese currency, meant to make their exports more expensive, will simultaneously decrease the cost of imports into China. Falling production costs would offset at least half of the impact of rising prices on the backend.

Alternatively, as we have argued before (see TD Economics Special Report, *Slowing the Chinese Juggernaut*, http://www.td.com/economics/special/rk0407_china.pdf), Chinese interest rates must be increased as they are still too low. However, they will be increased only gradually over time. To do otherwise would hurt the fledging consumer and domestic demand more than the overheating external and investment sectors, and would put unwanted pressure on the currency. For this reason, changes in traditional monetary policy tools are likely to remain modest.

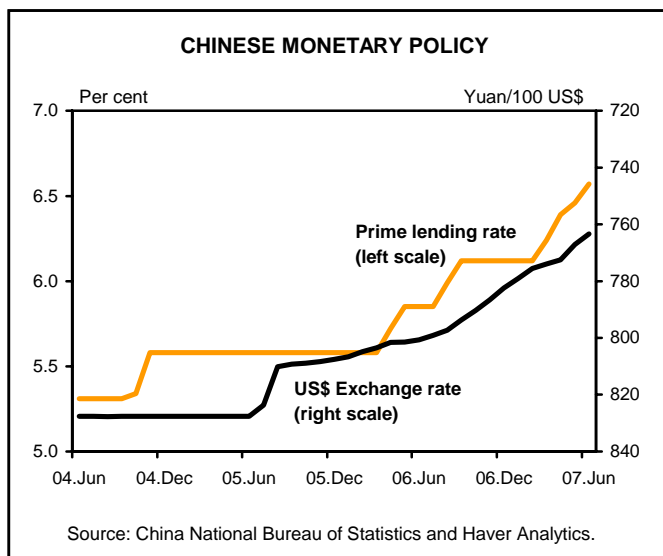
Instead, the most important policy tool for Chinese authorities will remain sectoral targeting. The tax increases which took effect on July 1, 2007, were targeted to spe-



cific industries in China. Those industries which are heavy polluters and those which are heavily dependent on commodities saw larger increases in their tax rates. In terms of long-term goals, the authorities hope to shift production toward higher value-added output and reduce the growing environmental costs of rapid industrialization.

In the near-term, the authorities' principal concern remains reigning in inflation. With the elevated level of commodity prices, authorities hope to limit the price pressures coming from the industrial sector by nudging more production into other sectors. There has also been a lot of concern about rapidly rising food prices in China, as elsewhere. On that account, we saw some easing in the pace of food price growth in June and expect this downtrend to continue through the second half of this year, albeit at a rather muted pace. While inflation is still not near worrying levels, some sign that economic management is finding some traction in controlling the economy would be a welcome development. If trade and investment data for July and onward show no slowdown in reaction to higher taxes, we would expect the authorities to redouble their focus on fiscal and structural policies to guide economic growth lower. But substantial moves in exchange rate policy, while certainly a risk due to external political pressure, are unlikely based on economic fundamentals and Chinese policymakers past actions and statements.

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