

July 19, 2007

## CHINA'S REAL GDP UP BY 11.9% IN THE SECOND QUARTER

### Is the Chinese economy robust or overheating?

#### Introduction

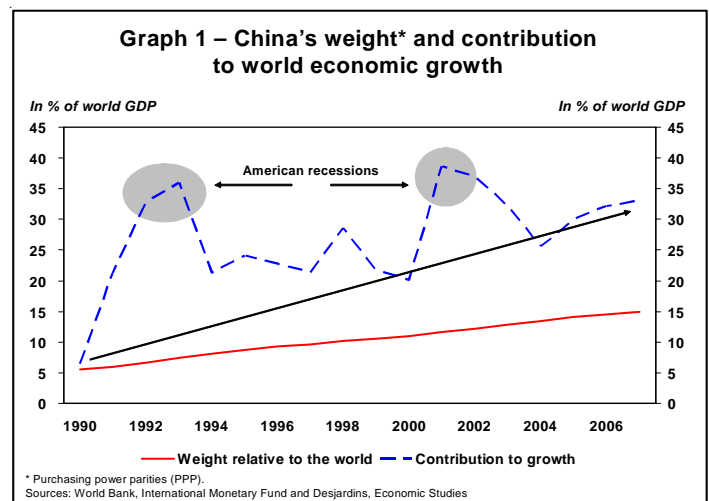
Signs of overheating in the Chinese economy seem increasingly evident. In the second quarter of this year, real GDP soared by 11.9%, at an annual rate, extending the period of above-trend growth<sup>1</sup> to 11 quarters. The last time the economy expanded at such a sustained pace, inflation accelerated sharply. The government was forced to tighten its policies aggressively, and it took several years for the economy to emerge from a renewed period of weakness. In these conditions, it is not surprising to see fears of overheating coming to the fore once again, especially since the current boom is accompanied by 1) inflationary pressures and 2) serious speculation on several classes of assets. Should we expect the Chinese economy to make a forced landing, or are things different this time?

In this *Economic Viewpoint*, we show that the risks of the Chinese economy derailing are, all things considered, low<sup>2</sup>. Investment is still the predominant source of growth, but it is gains from the foreign trade sector that made the biggest contribution to quickening the pace at the beginning of 2007. At the same time, the inflationary pressures (as in 2004) mainly reflect higher food prices (especially the price of grains and, more recently, pork). Corporate profits are high and production prices are under control. Consequently, the overall inflation situation is sound. Stock market speculation is worrisome, but there is no reason to believe that a strong correction would have severe repercussions on the Chinese economy. The size of the stock market is relatively small compared to the economy, and there is little evidence that the current frenzy reflects growth in credit.

#### China: a major player

In recent years, the impact of China's industrialization on the world economy has been phenomenal. With ever-increasing weight relative to the world as a whole (the country's economic weight has tripled since 1990) and accelerated economic growth since the end of the 1990s, China's contribution has skyrocketed from 6% in 1990 to over 30% in 2006<sup>3</sup> (Graph 1).

At the rate things are going, there is every reason to suppose that China will continue to be the main driver of the world's economy in the years to come (Graph 2 on the next page). Given the growth achieved in the first half, projections for 2007 have been revised upwards to near 11.0%, and economic prospects remain favourable. That being said, many analysts consider that, despite numerous restrictive measures that have been adopted in order to slow down



<sup>1</sup> The quarterly series on the non-cumulative annual variation in real GDP starts in 1994. Average real GDP growth over the period is 9.1%.

<sup>2</sup> A similar conclusion was drawn two and a half years ago. See the *Economic Viewpoint* "The phenomenal growth of the Chinese economy: Boom or overheating?", dated February 10, 2005.

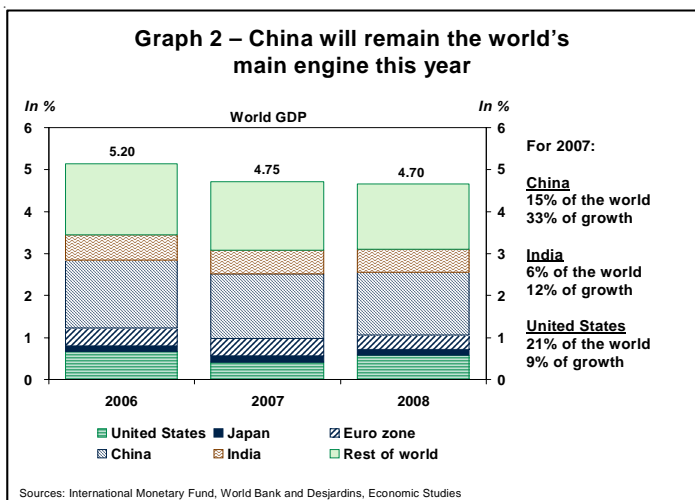
<sup>3</sup> Here we must exclude periods of recession in the United States, during which China's unprecedented contribution to the growth of the world economy is really a reflection of the American economic slump (which made a neutral, or even a negative contribution from the United States) rather than stronger-than-normal economic growth in China.

**François Dupuis**  
Vice-President and Chief Economist

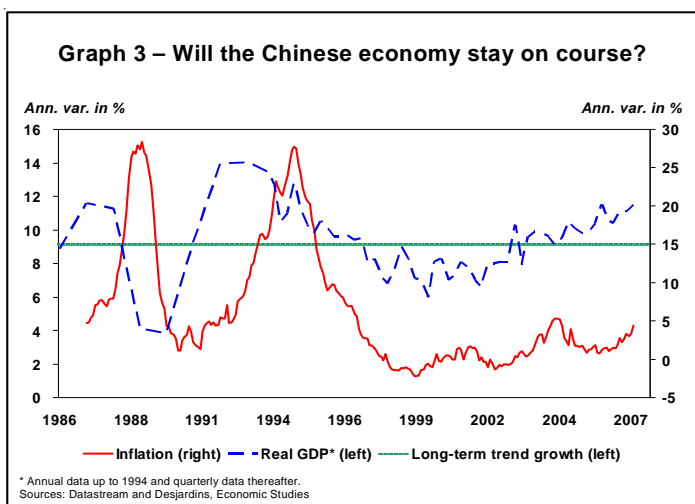
Phone: 514 281-2336 or 1 866 866-7000, ext. 2336

**Martin Lefebvre**  
Economist

E-mail: desjardins.economics@desjardins.com



investment (see box on page 3 for a list of the most recent government measures), China seems to be unable to rebalance growth<sup>4</sup>, and risks of overheating are omnipresent (Graph 3). Given China's growing importance, be it for imports of raw materials or manufacturing at lower cost, an economic collapse would have disastrous consequences for the country as well as the rest of the world.

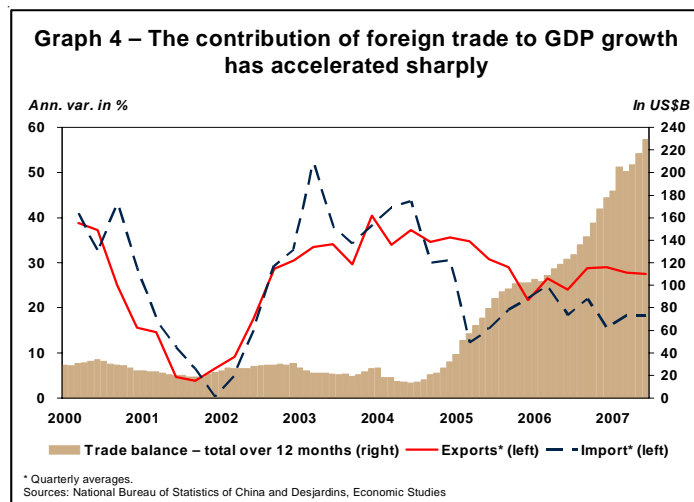


### Can growth continue at this pace?

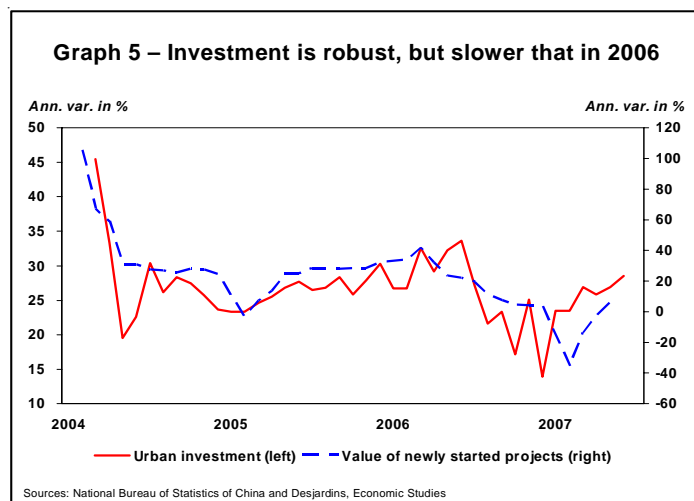
National accounts data are not broken down by component, so it is hard to know with any certainty what their contribution to real GDP growth is. That being said, recent trends in capital investment and net exports suggest that the faster economic growth in the first quarter was based primarily on a stronger-than-expected contribution by gross investments and foreign trade.

<sup>4</sup> The Chinese government's five-year plan aims, among other things, to rebalance economic growth from investment spending towards consumer spending.

Net exports (exports less imports) have literally exploded since the beginning of 2006, pushing China's annual trade surplus to over US\$230B in June (Graph 4). However, it seems that a large portion of recent gains have been triggered by anticipation of the elimination of discounts on the export tax that Beijing applies to nearly 3,000 products. Once the discounts are reduced on July 1, 2007, things will probably fall back into place gradually over the second half of the year.



Thus, the key lies in control over investment spending. Clearly a factor in the slowdown in economic growth that occurred in the second half of 2006, capital investment accelerated during the first six months of this year, contributing to a return to faster growth. That being said, the annual rate of investment spending is still below the levels reached a year ago, and the trend is still heading downwards (Graph 5).



Nevertheless, we should not expect net investment to slow down in the next few months. For one thing, the number and value of newly started projects jumped in April and in May, clearly showing that investment will still be the order of the day between now and the end of the year. For another, the

### Administrative measures put forward by the government

Accelerated economic growth, excessive investment, a higher trade surplus, a fast increase in the money supply and climbing inflation have pushed the Chinese government to introduce a host of administrative measures since the beginning of the year in an effort to ensure stable and sustainable economic growth. These government measures have been taken on several fronts.

#### Monetary policy:

On the monetary policy front, the People's Bank of China (PBoC) has raised its interest rates twice (Graph A) and the mandatory reserve ratio five times (Graph B), since the beginning of the year.

#### Stock market:

On May 18 of this year, with the goal of increasing the opportunity cost of investing in the stock market, interest rates on deposits were raised more sharply than those on loans, with the rates for longer-term deposits\* recording the steepest increases (Graph A).

On May 29, the Department of Finance announced that it was tripling the tax on stock market transactions from 0.1% to 0.3%.

#### Exchange rate:

On May 19, the Bank decided to expand the fluctuation bands of the RMB against the U.S. dollar from 0.3% to 0.5%. Consequently, the daily exchange rate of the RMB against the American dollar can now float by  $\pm 5\%$  around the central parity published that day by the China Foreign Exchange Trading System. The regulations governing currencies other than the U.S. dollar, decided in September 2005, remain in effect.

#### Corporations:

The State Council announced that it was introducing a program requiring stateowned companies that made profits to pay dividends to the government. The program will initially apply to 158 companies. The dividends will be used to boost China's overall industrial development, advance high-technology industries and supplement the social security system (mainly health and education).

#### Trade:

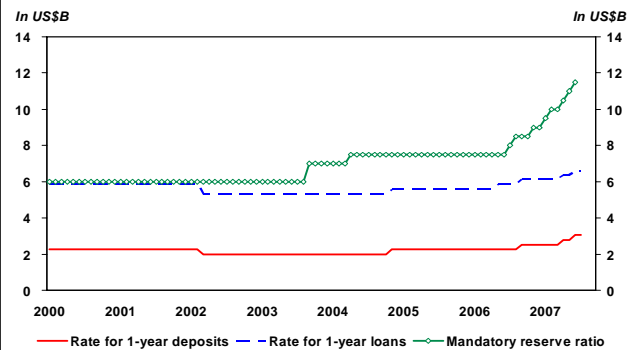
To limit the increase in the trade surplus and to alleviate international political pressures, the Chinese government

Graph A – Interest rate hike by the PBoC in 2007

In %	March 17, 2007		May 18, 2007	
	Level	Variation	Level	Variation
<b>Deposit rate</b>				
3-month	1.98	+0.18	2.07	+0.09
6-month	2.43	+0.18	2.61	+0.18
1-year	2.79	+0.27	3.06	+0.27
2-year	3.33	+0.27	3.69	+0.36
3-year	3.96	+0.27	4.41	+0.45
5-year	4.41	+0.27	4.95	+0.54
<b>Loan rate</b>				
6-month	5.67	+0.09	5.85	+0.18
6-month to 1-year	6.39	+0.27	6.57	+0.18
1- to 3-year	6.57	+0.27	6.75	+0.18
3- to 5-year	6.75	+0.27	6.93	+0.18
5-year and +	7.11	+0.27	7.20	+0.09

Sources: People's Bank of China and Desjardins, Economic Studies

Graph B – Monetary policy has been tightened further in 2007



Sources: Datastream, Statistics Canada and Desjardins, Economic Studies

has adjusted the trade rules governing certain goods three times since the beginning of the year. On March 28, 2007, the government relaxed the rules for 338 import products.

In April (effective June 1), the government imposed or lifted tariffs on 142 categories of goods, including steel and nonferrous metals.

On June 19 (effective July 1), the Department of Finance decided to abolish (or to reduce) discounts on export taxes on over 2,800 products, representing 37% of all of China's export goods. The export tax discounts on 553 highly resource- and energy-intensive products, such as fertilizers, cement and nonferrous metals, will be eliminated. The export tax discounts on 2,268 products likely to generate international friction will be reduced, from between 8% and 17% to between 5% and 11%.

\* In recent quarters, interest rates on loans have been raised faster than those on deposits in an effort to stimulate consumer spending. However, the intended effect has not materialized: spending has not increased as planned; instead, households have been contributing to the effervescence of the stock market.

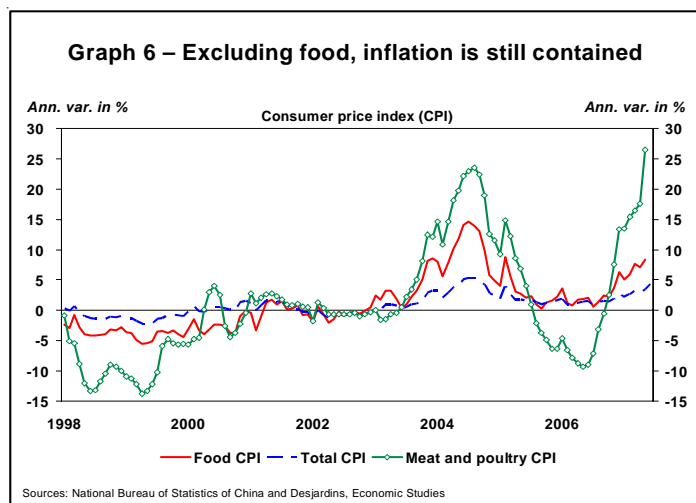
new administrative measure requiring state-owned companies to pay dividends may cool investment<sup>5</sup>, but corporate profits are still high, which should limit any correctional movement. Consequently, we should expect further government measures to be undertaken in the near future.

But not everything is about investment. According to the National Bureau of Statistics, the government's efforts to stimulate consumption could start to bear fruit. Retail sales were up 15.4%, at annual rate, in the first half of the year, marking the strongest growth since 1997. Now, with household's disposable income rising, consumer spending will probably continue to support economic growth in quarters to come.

### Inflation is not a threat just now

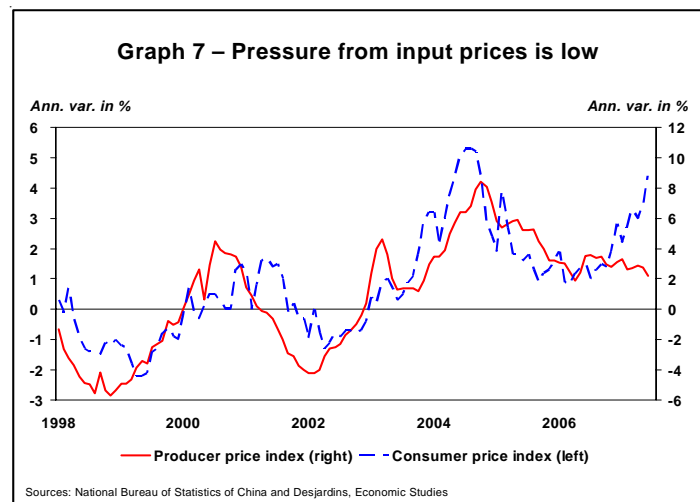
Another sign of overheating to watch out for is inflation. In recent years, China has been a major source of deflation by exporting lower-cost manufactured goods. However, with wages and the price of raw materials heading up, and with the ongoing appreciation of the yuan vis-à-vis the U.S. dollar, many analysts are starting to fear that the elastic has been stretched as far as it will go. For the time being, however, we believe that inflation is not really a threat.

Certainly, inflation has clearly accelerated since the beginning of 2006; it reached 4.4% in June, its highest level in nearly three years. However, this mainly reflects higher food prices, in particular, a sharp increase in the prices of meat and poultry (Graph 6). Due to higher grain prices (the growing popularity of ethanol production has inflated the price of corn intended for consumption), pork prices are particularly hard hit. That being said, if food is excluded, inflation is still very low (1.0% in May), which suggests that inflationary pressures are contained.

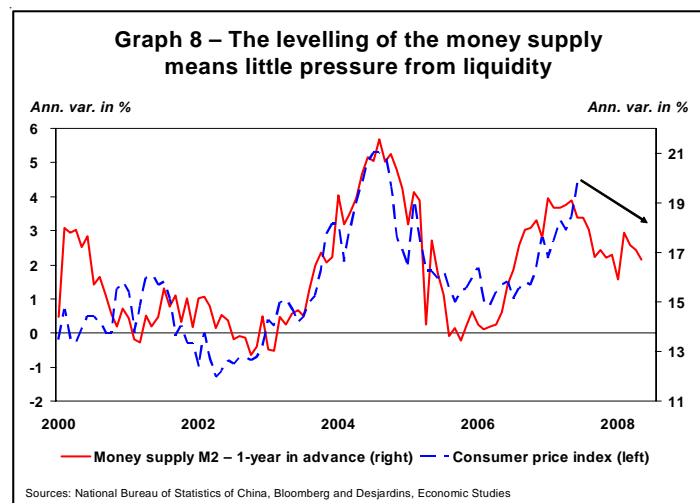


<sup>5</sup> State-owned companies represented 43.3% of total investment in May 2007.

Moreover, thanks to slower growth in commodity prices since the end of 2006, pressures from businesses are subsiding. The annual variation in the producer price index decelerated to 2.2% in June, which represents a much weaker increase than the peak of 8.4% that was reached in 2004 (Graph 7). Wage increases still bear watching, but the overinvestment of recent years suggests that businesses will not be able to pass their costs onto consumers.



At the same time, growth in the money supply has hit a ceiling due to tighter credit in the past year or so, which leads us to believe that inflationary risks associated with increased liquidity are limited (Graph 8). However, we still think that the high accumulations of foreign currency reserves represent a significant risk. The government's sterilization policy<sup>6</sup>, which consists in absorbing the yuans put into circulation by means of an equivalent bond issue, has kept some control

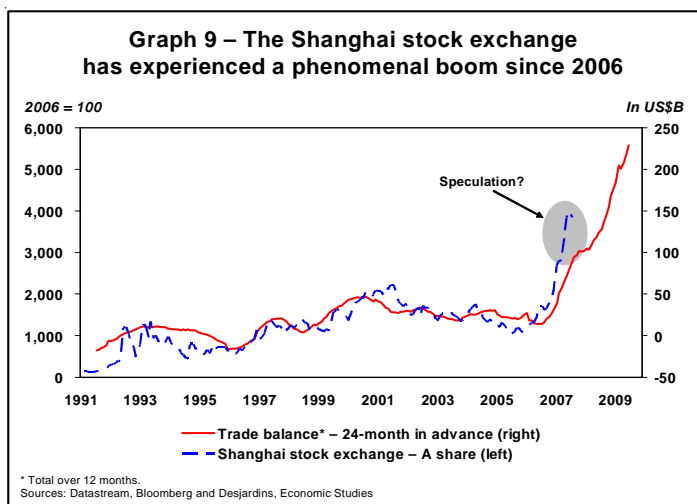


<sup>6</sup> At the end of May, the Department of Finance authorized a special bond issue of 1.55 billion yuans in exchange for US\$200B of the People's Bank of China's foreign currency reserves. For more details on the mechanics of "sterilization", see the *Economic Viewpoint* "Is it time for a re-evaluation of China's currency?", dated May 19, 2005.

over the pressures exerted on the money supply and on liquidity. But at the rate at which China is accumulating currencies, it will be more difficult to control the money supply in the long term<sup>7</sup>.

**The stock market correction could be more severe**

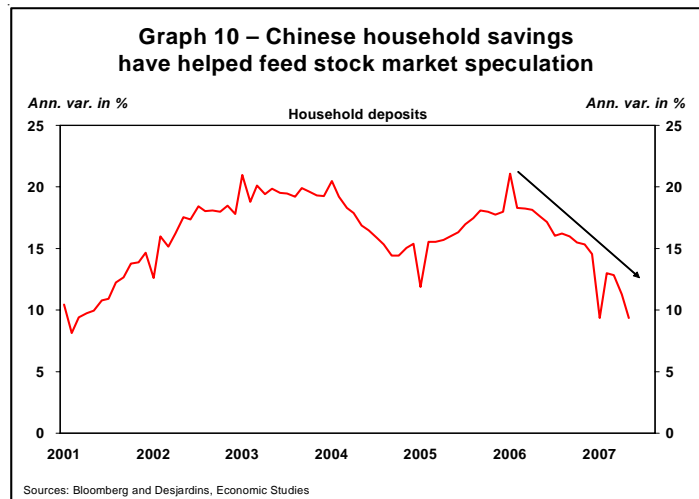
Meanwhile, many classes of assets are appreciating to a disconcerting degree. In particular, the benefits of a weak yuan on the export sector have resulted in higher stock prices, but these are looking more and more like a speculative bubble. Stimulated by the opening of nearly 300,000 new accounts per day over the past several months, the stock market continues to defy gravity despite a price/earnings ratio of close to 45. The Shanghai index has gained nearly 45% since the beginning of the year and has nearly quadrupled in the past two years (Graph 9). Recently, actions by the government, which has tripled the tax on stock market transactions and which intends to require state-owned companies to pay dividends, seem to have cooled the ardour of speculators, but a more severe correction is foreseeable, exacerbating fears that the Chinese economy may collapse.



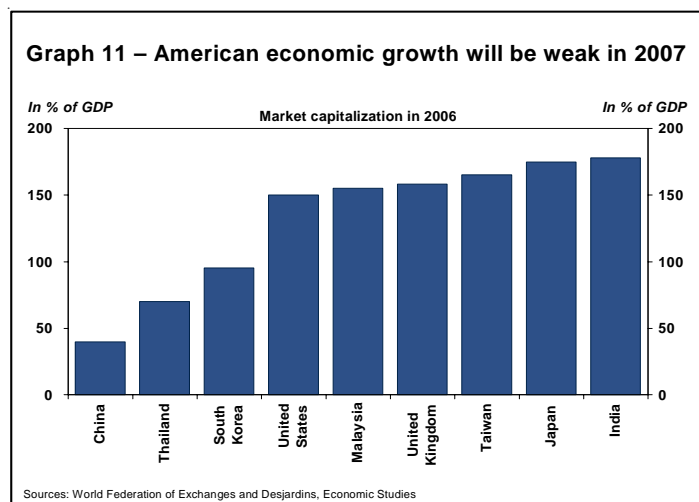
In our view, although stock market speculation does give cause for concern, there is no reason to think that a major correction would have serious repercussions for the Chinese economy, let alone the world economy. First of all, there is no historical link between China's economic growth and its stock market trends. This is partly explained by the low participation in the stock market by households. Certainly, the 100 million retail accounts tallied at the end of May seem astronomical, but this actually represents less than 8% of the total population, and less than 15% of the total assets of Chinese households. Consequently, a major correction in the stock market would affect only a small portion of the population. The banks are not at risk either, since household investments are more often than not financed from their

<sup>7</sup> The contribution of reserves to the increase in the money supply has risen from less than 1% in 2000 to an average of nearly 9% since 2005.

savings (Graph 10). The same holds true for the general health of businesses, which do not rely heavily on equity to raise funds<sup>8</sup>.



Finally, we need to put things into perspective. Compared to the world's large stock exchanges, China's market capitalization is relatively low, with few private enterprises listed. The Shanghai and Shenzhen stock markets put together represent approximately 40% of China's GDP (less than 20% if we take into account that a large proportion of non-floating shares are held by the government). This is far less than the market capitalization of the United States, the United Kingdom or Japan, all of which stand at over 150% of GDP (Graph 11). Certainly, due to market globalization, an abrupt plunge of the Chinese stock market could affect investors' perceptions. However, the limited access that foreigners have to the Chinese stock market suggests that international investors will, to a large extent, remain immune.



<sup>8</sup> Approximately 60% of businesses' funds are raised internally.

## Further administrative measures will be needed

[...] In the first half of 2007, the central government adopted a series of macro-control policies aiming at the outstanding contradictions and problems existing in economic performance, resulting in a steady and fast economic growth, featured as: rapid economic growth, improved efficiency, harmonized structure and more substantial benefits to the masses. [...]

National Bureau of Statistics of China  
Li Xiaochao, spokesman  
July 19, 2007

Although the risks of overheating are increasingly evident, we remain confident that the Chinese government will be able to orchestrate a soft landing for its economy. However, further administrative measures will have to be adopted in order to rebalance economic growth, from investment towards consumption.

With inflation above the maximum comfort level of 3%, interest rates will probably be raised gradually between now and the end of the year. But the issue of cash flows not listed in the balance of payments, commonly referred to as “hot money”, reduces the effectiveness of monetary policy, so the rate hikes will have to be accompanied by other government measures. The increase in the banks’ mandatory reserve ratios has imposed some control over the increase in credit and, consequently, we expect that these measures will be maintained, or even reinforced, in the near term.

At 0.3%, we think that the tax on stock market transactions will have little effect on stock prices in the long term, but it should help bring back a dose of reason to the markets in the short term. It would be surprising if the government were to raise the tax any further, given that excessively high taxation rates on purchases<sup>9</sup> have caused many market tumbles since 1990.

In our opinion, the concept of requiring state-owned companies to pay dividends to the government is the most promising initiative. First of all, without resorting to the financial system<sup>10</sup>, allocation of capital is inefficient and, in many cases, leads to problems of overinvestment. Secondly, the dividends paid will benefit the population and thereby enable the government to partially alleviate social discontent.

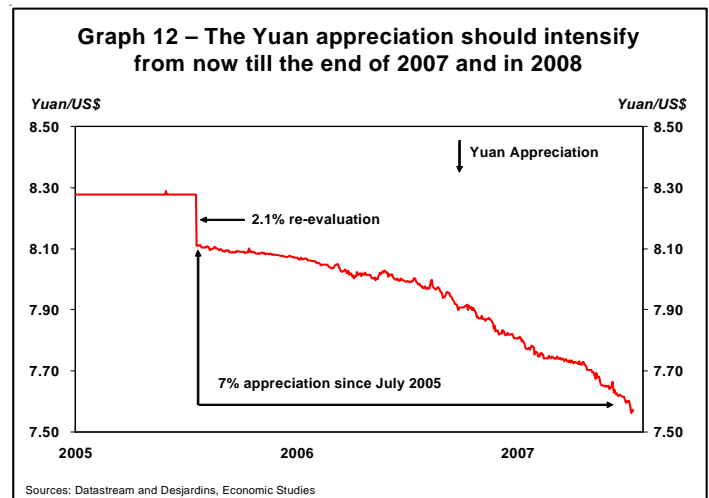
<sup>9</sup> In November 1990, China imposed a tax on stock purchases on the Shenzhen stock market. At 0.6%, the tax drove stock prices down, forcing the government to cut the tax in half, to 0.3% in October 1991. In May 1997, the tax was raised again to 0.5%, but softness in the stock markets obliged the government to readjust and gradually reduce the tax on transactions, first to 0.4% in June 1998, then to 0.3% one year later, and then to 0.2% in 2001.

<sup>10</sup> Investments are funded from corporate profits.

The near non-existence of a social safety net accounts to a large extent for the high rate of saving among the Chinese. An influx of cash into state coffers will enable the government to increase spending on education and healthcare, which could reassure households and encourage them to spend.

## The simplest solution would be to let the yuan float

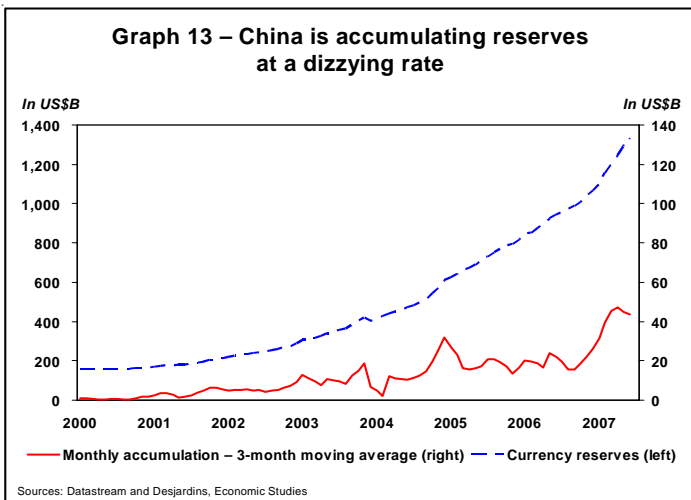
However, the whole issue of overinvestment, inflation and speculation in the stock and real estate markets is linked to the influx of capital and the increase in liquidity; therefore, a stronger re-evaluation of the yuan strikes us as a necessary step (Graph 12). Certainly, the export tax (the third one since the beginning of the year) should help appease international political pressures. But the government will probably accelerate its reforms to allow the yuan to reflect the fundamental variables of the market. The problem is that China’s controlled exchange rate makes monetary policy ineffective. The higher interest rates go, the more China will attract capital, and the more reserves it will have to accumulate. This will only add more pressure to the money supply and, finally, run counter to the original objective of price stability.



## Conclusion

Signs of overheating are evident on several fronts. The weakness of the yuan certainly has a lot to do with overinvestment in many export sectors. Massive inflows of reserves are continuing to exert pressure on liquidity and represent a real danger for inflation stability (Graph 13 on the next page). For now, though, consumer price inflation is mainly reflecting higher food prices, and the overall situation remains sound. Indeed, the government seems more likely than ever to manage to orchestrate a soft landing. There have been a flurry of administrative measures since the beginning of the year, and China should begin reaping the rewards in the second half of 2007 and next year.

Clearly, it is not easy for the government to maintain certain equilibrium in between unprecedented economic



development in urban areas and rising social tensions from rural. Although the task seems colossal, China was able to limit hazards for the time being. However, much remains to be done and, therefore, China will continue to be a puzzle for the rest of the world for some time to come.

[...] The system and structural problems existed in economic performance are still outstanding, in particular, the unbalance balance of payments, the high price rise for food and the high pressure on energy consumption and pollutant emission reduction. In the future, we will adhere to the scientific approach to development to guide the economic and social development. We will further enhance and improve the macro-control, and put into practice various policies set by the central government. Efforts will also be made to adjust the structure, change the pattern of economic growth, deepen reform which will lead to the realization of a sound and rapid growth of the national economy. [...]

National Bureau of Statistics of China  
 Li Xiaochao, spokesman  
 July 19, 2007

**Martin Lefebvre**  
 Economist  
 514-281-2317  
 martin.lefebvre@desjardins.com