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CHINA'S ECONOMY CONTINUES TO ROAR ALONG, BUT INFLATION REMAINS LOW

China's economy continues to roar along, and will post somewhat slower, but still robust, growth in 2007.

In the following, we will explore:

- The reasons for this robust growth path, including why investment will continue to be strong this year and why exports will still be a major growth driver
- Why robust export growth in China is important to the U.S., both for our economy and for U.S. investors
- Why inflation will remain low in China, despite economic growth remaining so strong
- What China's rapidly aging population means to economic growth and inflation in the not-too-distant future

Investment growth remains strong in China, and will continue to be the major growth driver there this year. This is despite supposedly more stringent administrative measures (tighter land use and environment permitting, higher taxes on residential property purchases) and heightened monetary restraint (higher interest rates and reserve requirements) to rein in the rapid pace of investment. The reasons for stronger-than-expected growth include a rebound in



foreign direct investment (FDI), administrative slippage at the provincial/local level in enforcing heightened controls mandated by the central government, strong corporate profits growth, and still-rapid bank lending despite higher borrowing costs. Provincial governments' support of robust construction activity is probably fostered by strong financial and political incentives in those provinces for promoting and building out private capacity and public infrastructure. Also, with investment continuing to be strong, we expect further government efforts to curtail investment growth. Such efforts include additional administrative restraints on investment and further measures to cut loan growth (e.g., interest rate hikes, reserve requirement increases, and greater regulatory scrutiny of bank lending practices).

In addition, China's exports will continue to do well this year. This means that its trade surplus with the U.S. will likely grow again this year. However, while still growing smartly, export growth will be a bit less this year, due to an expected slowing in developed economies, which, of course, are China's major customers. Nonetheless, with a still much undervalued real effective exchange rate and a continued build out of industrial capacity, China remains highly competitive in world markets, continuing to take world market share from both developed and developing economies.

Moreover, China is rapidly moving up the value added chain, in both the exports and domestic goods it produces. Not too long ago, China's exports were mainly labor-intensive goods, such as apparel and textiles. Today, China produces many more technologically advanced goods, including computers, consumer electronics, semiconductors, and autos. Soon, many of the high-tech components that China imports will not only be produced, but also designed, in China.

And, the rampant infrastructure investment of recent years has facilitated both the production and transport of exported products. Electricity capacity has been built up to such an extent that black-outs and brown-outs are now very rare, a situation radically different from the not-too-distant past. Also, new highways, railways, ports, and air transport facilities have resulted in a better coordination of supplies with manufacturing and in improved, timelier, transportation of both supplies and finished goods.

Furthermore, exchange rate policy has and will continue to be very supportive of robust export growth. Since introducing a slightly more flexible exchange rate regime in mid-2005, China's currency, the renminbi (RMB), has risen to 7.7 per each USD today, versus 8.2 in mid-2005, only about a 6.5% appreciation over a 1.5 year period, not much. Moreover, RMB appreciation this year will likely be only 4–5%, again not much. These modest amounts of RMB appreciation have done little to erode China's price competitiveness in world markets.

So, in short, China is now a greater export powerhouse than ever before. This is especially true with respect to the United States. China's burgeoning trade surplus with the U.S. will continue to grow. At this juncture, this has not been a problem for the U.S., since much of that surplus is financed by China recycling funds back into U.S. financial markets, helping to keep interest rates (particularly bond yields) low. The risk, however, is that China may want to lighten up on new U.S. investments, investing its trade surplus proceeds elsewhere in the world. Discussions along those lines have already occurred regarding how foreign exchange reserves will be invested by the new Chinese government agency [State Administration of Foreign Exchange] charged with managing China's "excess" foreign exchange reserves (in excess of those required by the central bank). If that were to occur, it could cause U.S. interest rates to rise, perhaps dramatically, and put further downward pressure on the dollar exchange rate. So what happens in China, particularly with respect to exports, could have very important implications for U.S. investors and for our economy.

Meanwhile, don't look for consumer demand in China to reverse the rising trade surplus there. While consumer spending has been quite solid (retail sales rising at double-digit rates last year), saving rates still remain at very high levels. The rapid growth of consumer incomes (most in urban areas) is supporting fairly solid gains in household spending, but not enough in the form of imports to substantially dent the trade surplus.

But even with its rapidly growing economy, there is little risk of a sustained rise in inflation in China. There are a number of reasons for this, but the most important is that productivity adjusted labor cost gains remain quite low. This is because the huge investments that China has made

have resulted in productivity there rising at a rapid clip. In addition, China's pushing out of huge supplies of goods onto global markets tends to have a depressing effect on inflation globally. So for *now*, China is in a "sweet spot," enjoying rapid economic growth and very low inflation.

But how long will this "sweet spot" continue? China faces major challenges over the next decade, the most important being the rapid aging of its population. Due to the one child rule instituted in the early 1980s, China will see the ranks of the elderly climb rapidly in about five years. This will put large pension and health care cost burdens on the government, something it is not experiencing today. In addition, labor force growth will diminish markedly as the economy ages, where retiring older workers are replaced by fewer younger workers. Without a large ramp-up in productivity, this means that China's potential and actual economic growth rate will likely be substantially less than it is today. Whether this slower potential growth rate results in higher inflation will depend critically on future macroeconomic policy. Certainly, with potential output growing much less rapidly compared to today, macroeconomic policy will have to shift its stance away from today's policies that promote rapid growth toward policies promoting more moderate growth. Otherwise, China could end up with more inflation than it has experienced in recent years.

To summarize, China's economy will continue to be strong this year, again driven by robust investment and export activity. And how China chooses to invest the proceeds from its rising trade surplus could have profound implications for the global economy and financial markets around the globe, particularly those in the U.S. Nonetheless, inflation will remain quite low. However, looking out a bit, China faces major challenges, including slower growth, many deriving from the rapid aging of its population.

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