

# WEEKLY MARKET MONITOR OCTOBER 8, 2007

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## UPDATE ON CHINA

China's stunning growth continues to be mainly propelled by two areas:

1) investment in both the public and private sectors and 2) exports. Growth in each of these areas reinforces the others. For example, strong export growth induces more investment in factories. More efficient factories and better infrastructure help to grow exports by making China's goods more price-competitive in world markets.

Strong investment has been a familiar feature of the China economic landscape for quite some time. Over the years, governments there have poured huge sums of money into improving and expending China's transportation and utility infrastructure. Importantly, such infrastructure improvements have especially facilitated China's export push into world markets, which has benefited substantially from the transportation improvements (better seaports, roads, airports) and from the availability of reliable electricity.

Private investment has also been vigorous and continues to be so, actually performing stronger more recently than public infrastructure spending. China's manufacturers (including multi-national firms) continue to invest heavily in new factories and equipment. This is especially so since China's accession to the World Trade Organization (WTO) in 2002, which allowed China increased access to world markets. Further, since China's entry into WTO, foreign companies have invested heavily in China, wishing to secure a low-cost manufacturing base in



Asia and a foothold in potentially one of the world's largest markets. And, with that increased access and global growth still good, demand for China's exports has recently risen sharply, causing firms to step up their investments in plant and equipment to satisfy that demand.

Exports have also played an important role in China's success story, especially recently. As mentioned above, China's export momentum got a substantial boost following its accession into the WTO. Entry into WTO couldn't have been timed better. Since 2003, the combination of strong global growth, an undervalued currency, low labor costs, and rising productivity (arising from ever-strong investment) has allowed China's exports to grow rapidly and gobble up increasingly larger shares of global export markets at the expense of developed countries and, importantly, other Asian economies. China's exports, by increasingly gaining world market share, appear fairly resilient to a slowdown in developed markets, such as, the U.S. and Europe. Finally, China's currency (yuan or renminbi) is not likely to appreciate annually much beyond the 5% average since the currency regime "liberalization" of mid-2005. And this is despite an ever increasing level of foreign exchange reserves (now probably near 1.5 trillion in U.S. dollars). Both of these factors will help to keep China's exports strong.

But, what is happening with household spending? Aren't households also spending vigorously? The answer to this is yes, with retail sales currently rising at double-digit rates. However, much of that growth reflects rising incomes in China, not a greater desire to spend more of each yuan earned. As a result, savings rates (that is, savings as a proportion of income) remain high in China, in part due to the greater precautionary savings induced by an earlier dismantling of the public medical and retirement safety nets. In addition, China is rapidly aging, which also engenders greater savings for prospective medical and retirement needs.

Of course, China's strong growth does not come without problems, some of which could ultimately cut into growth in the not too distant future. First, inflation has picked up, in part due to the strong economic growth and a rise in incomes there. The Consumer Price Index came in at a 6.5% year-over-over rate in August, up substantially from the 2-3% rates earlier in the year. While most of the recent run-up in inflation is due to soaring meat prices (especially

those related to pork and chicken), there are increasing worries that inflation is picking up more universally (that is, in areas besides food). The People's Bank of China (PBoC) is concerned about inflation getting out of control and has thus been raising interest rates and bank reserve requirements to slow the economy and curb inflationary pressures. Obviously, those measures have not yet been very successful. The economy has accelerated, not slowed, since the PBoC began hiking interest rates and reserve requirements. Nonetheless, the PBoC will likely continue on its current tightening course.

Second, decades of strong growth without regard for the environmental consequences has now produced severe environmental degradation in many parts of China. Heavy air pollution is all over China, most acutely in developed coastal urban areas. Even Hong Kong, now principally a service economy, suffers from air pollution coming from the neighboring manufacturing-intense mainland province of Guangdong. And, the mighty Yellow River, the historic boundary between north and south China, has now become an environmental nightmare. Rapid industrialization and urbanization have resulted in massive amounts of municipal (primarily sewage) and industrial pollutants being poured into the Yellow River, causing its water, without extensive treatment, to become undrinkable and unusable in some industrial and agricultural processes. Further, so much water is now being extracted from the River for industrial and other uses that little, or none, of that water ever reaches the sea.

Finally and very importantly, China's rapid growth has resulted in marked income and wealth disparities. While the urban coastal areas have prospered, rural areas (particularly in the interior) have lagged way behind. Even in the coastal cities, wealth and income gains have been uneven with skilled workers doing much better than the unskilled. In addition, while China is still largely rural, farmers are increasingly being driven off their farms, farms that their families had tilled for generations, to make room for factories. Hence, it's not surprising that rural revolts against the (mostly provincial) authorities have now risen into the tens of thousands annually, something that has not gone unnoticed in Beijing even though little has been done to solve this problem to date. In fact, little has been done to address any of the problems listed above.

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