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### **WILL CHINA STUMBLE AS THE U.S. SLOWS CLOSE TO RECESSION?**

Last year, China's economy grew 11.4% year-over-year in the fourth quarter, above the rate seen in 2006 and far exceeding the growth rates of other major economies. However, China is confronted with a number of challenges in the short and long terms that have the potential to diminish growth there. Below, we have the opportunity to drill down a bit and take a closer look at:

- Why has growth in China remained so strong for so long?
- What have been some of the adverse side effects that have flowed from that strong long-lived growth?
- Will growth there remain vibrant over the next couple of years, especially with the U.S. now growing a snail's pace, being close to (or even in) recession?

For years China's stunning growth has been driven principally by two areas— 1) government and private sector investment and 2) exports of goods to the U.S. and the rest of the world (increasingly to Europe and Asia). Moreover, the growth flowing from these two areas has to been to a large extent self-reinforcing. For example, vibrant export growth leads to more factories being built to satisfy foreign demand for Chinese goods. That investment in turn makes the exports producing and transporting sectors more efficient, leading to increased price-competitiveness of Chinese goods on world markets. And, the beat has gone on like this for decades, with exports and public and private investment continuously soaring to new heights in this mutually reinforcing way, helping to propel China's economy to even greater heights.



In addition, in an effort to make China the world's largest manufacturer, governments there have spent enormous sums of money over the years to improve and expand China's transportation and utility infrastructure. Not long ago, railway and other transportation bottlenecks were quite common. Today, such bottlenecks are largely gone, with much of the transportation infrastructure there now world class. In addition, only a decade ago, electricity was in short supply and frequently was of poor quality, causing businesses to incorporate electricity shortfalls into production plans to minimize any disruptive impact on their factories. Today, electricity shortages are very rare and are usually due to something else (such as the recent massive snowstorms) other than lack of baseline generating capacity.

Likewise, the private sector has raised the capacity and quality of its production facilities. Flush with money from vibrant profits and readily available bank credit, Chinese firms have had little difficulty in funding the expansion and improvement of their factories. As a result, China's manufacturers (including multi-nationals) have continued to invest heavily, a process that accelerated with China's accession to the World Trade Organization in 2002.

Moreover, other areas of private investment have also done very well recently. With the number of middle-class households seeing a sharp rise and with incomes and wealth increasing, residential real estate has enjoyed a boom, especially in China's major cities (such as Beijing and Shanghai). Consequently, residential investment has also been an important economic growth driver in recent years.

So, with exports and overall (public and private) investment strong and accelerating, it is not too surprising that China has done quite well recently. Specifically, real investment in fixed assets rose at about a 25% pace last year, helping China post a blistering 11.4% growth rate for the overall economy in 2007. In addition, fixed investment has grown so strongly that it now represents about half of GDP there, a number (or weight) significantly exceeding that seen in most countries.

In contrast, consumer spending, while growing rapidly of late, has actually seen its weight (now near 50%) in GDP decrease a bit in recent years. In contrast, consumption represents about 70% of GDP in the U.S. Hence, what happens to household spending is critical to GDP growth in the U.S.

That is obviously not as much the case in China where investment and exports together dominate the economy. Nonetheless, despite its weight in GDP holding relatively low compared to the U.S., household spending has risen at double-digit rates recently. But, this largely represents the rapid growth of income there, not a fundamental shift towards spending more (or saving less) of each after-tax dollar earned. As a consequence, China still enjoys one of the world's highest saving rates (between 40 and 50%), in sharp contrast to the very low savings rate in the U.S. (with a personal saving rate in low single digits). There are many reasons for the high saving rate in China (a rapidly aging population, the lack of a social safety net, and a cultural bent towards precautionary savings given the political and social tumult of the past), but the fact remains that investment and exports, not household consumption, have been the main drivers behind economic strength in China.

Of course, China's strong growth does not come without problems, some of which could ultimately cut into growth in the future, a future that is already less bright due to China's rapidly aging population.

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 about a 7% year-over-year rate in January, up substantially from the 2–3% rates earlier in the year. But, most of the recent run-up in inflation is due to soaring meat prices (especially pork prices which were up more than 40% year-over-year in January). Moreover, there are increasing worries that increased inflation will be seen in more and more sectors. As a result, the People's Bank of China (PBoC) became more aggressive late last year in combating incipient inflation pressures, raising interest rates and bank reserve requirements more sharply and installing more stringent curbs on bank loan growth.

Second, decades of strong growth have resulted in severe environmental degradation in many parts of China. For instance, Beijing is now frequently covered by dense smog (especially in summer), resulting from the rapid growth of automobile and (coal-fired) power plant emissions. In addition, water pollution is now a major problem there, affecting the safety of agricultural products and the availability of quality water for human and industrial consumption.

Finally, China's rapid growth has resulted in marked income and wealth disparities. With respect to income and wealth, urban coastal areas have prospered, but rural areas (particularly in the interior) have lagged. In addition, skilled workers have done much better than unskilled workers, which there are still many in China. These inequalities have been given greater notice by the Communist central government in Beijing in its promotion of a "harmonious society," but to date with little real effect.

Sadly, little has been done to address any of the problems listed above. Unfortunately, the longer the authorities fail to act, the harder it will be to solve these problems, especially as the economy ages and shows intrinsically slower growth.

But even though China's long-term economic future looks less bright compared to the recent past, can we really expect China's economy to markedly slow over the next couple of years? Will the near-recessionary conditions we are now experiencing in the U.S. make a serious dent in China's rapid economic growth? More likely than not, China will continue to enjoy rapid growth near-term. The reason

for that is a major portion of China's rapid growth is due to robust domestic demand, not foreign demand. As we saw above, much of the strong growth in China is due to vibrant investment demand there. And, with more of China's exports presently going to Europe and Asia, the current U.S. slowdown is likely to have less of an adverse impact now on China's export and GDP growth than it would have in the past. Therefore, while China's economy is not totally immune to a sharp U.S. slowdown, the impact on growth there from such a slowdown is not large. For instance, some estimates indicate that for every one percentage point decline in U.S. growth, China's growth rate will decrease by a half of a percentage point.

In addition, even if the above estimates understate the hit China would take from a U.S. slowdown, China has plenty of policy ammunition to more than offset any growth slowdown emanating from the U.S. With the PBoC tightening policy over the past two years and the government fiscal deficit low (at about 1% of GDP), China's policy makers have ample flexibility to stimulate the economy to maintain growth at a vibrant pace.

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