

From the Desk of...

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China's Cooler Growth, Hotter Money

August 2008: GDP growth slowed to 10.4% year-on-year in Q2, from 10.6% in Q1. The slowdown had been long expected. In fact, it is part of a general downward trend that began in Q3 2007. Industrial output increased 16.3% year-on-year in June, and fixed asset investment 15.3% y/y in real terms, up 0.6 percentage points from May. But in both cases growth has been slowing since the end of 2007.

CPI inflation fell to 7.1% in June, from 7.7% in May, largely as a result of rapid disinflation in food products and possibly slowing domestic demand. Severe inflationary pressures are expected to persist, as domestic energy prices will be forced to eventually rise to roughly international levels.

The trade surplus, at \$99 billion in H1, is down 12% from H1 2007, but still above 2006's level.

Faster RMB appreciation may have been caused by a

possible moderate shift in the exchange rate policy: readjustment of the weights of the RMB's targeted basket of currencies. The change may have been motivated by an effort to protect the economy against excessive imported inflation.

FX reserves reached nearly \$1.809 trillion at the end of June, amid strong debate over whether hot money inflows were responsible for the rapid rise, and even calls for restrictions on foreign access to capital markets. Our quick analysis shows that the blame laid upon hot money is largely unsubstantiated. We expect the government's basic policy stance toward external financial relations, and domestic capital market development, to remain unchanged.

NERI Executive Summary by Prof Fan Gang and Prof He Liping

About Prof. Fan Gang and The Insight Bureau

Dr Fan Gang is one of China's most influential economists, based in Beijing. Trained at the Chinese Academy of Social Science (CASS) and Harvard University, he is the Director of the National Economic Research Institute (NERI) and Chairman of the China Reform Foundation, China's first independent economic think-tank. He is also a professor at several top universities in China, notably Peking University. He is an advisor to numerous Chinese government ministries and is therefore highly sought-after for his insights, focusing on the direction of China's economic policy and its implications for Chinese and international businesses investing in China.

Fan Gang is part of The Insight Bureau's resource network that provides confidential, in-house briefings to senior executives, a service that helps to achieve a better understanding of the world in which businesses operate around the world and therefore ultimately to enable companies to make better business decisions.

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