

Flash Comment

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China: Time to step on the brakes

Chinese GDP surged by a stunning 11.3% y/y in Q2 - the fastest pace of GDP growth in the Chinese economy since the mid-1990s. Buoyant expansion in investment is still the main growth driver, and fixed asset investment spurred by 31.3% y/y in June.

The strong growth in the overall economy - and especially the very strong growth in investment - has obviously added to worries that the Chinese economy is overheating. As such, it is also becoming increasingly likely that the Chinese authorities will take further measures to dampen the strong expansion in demand. This outlook is underlined by the fact that investment growth is, to a large extent, financed by cheap credits, which in turn spur high money and credit growth, and that China's underdeveloped financial system entails a clear risk that a large part of the new investments could be of questionable quality.

We would therefore expect the Chinese authorities to implement new macro and credit controls to dampen demand sooner rather than later. The authorities have a number of instruments at their disposal for this purpose. Given the underdeveloped state of the Chinese financial system, we would expect the authorities to rely much on administrative measures - such as raising reserve requirement for banks and regulating investments. Furthermore, it is obvious that the People's Bank of China (PBoC) will deliver more rate hikes.

It is becoming increasingly clear that the PBoC is unable to sufficiently sterilize the huge capital inflows into the Chinese economy, and this is causing rapid money and credit growth. Combined with China's high economic growth, this obviously provides a strong economic rationale for allowing the renminbi to appreciate at a faster pace than it has done over the past year. We find it likely that the Chinese authorities will eventually move in this direction, but as always, steps taken will be small and gradual.

While we expect the Chinese authorities to implement further tightening measures, we believe that the measures are likely to be fairly limited and that they will only reduce growth a little. Furthermore, as we have argued before, the instruments available to the authorities are rather ineffective (see our *Flash Comment "China: Can China slow its economy?"* of June 19, 2007). Hence, even though growth should slow down in the second half of this year, the Chinese economy is likely to keep growing at a strong - or rather too strong - rate.

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