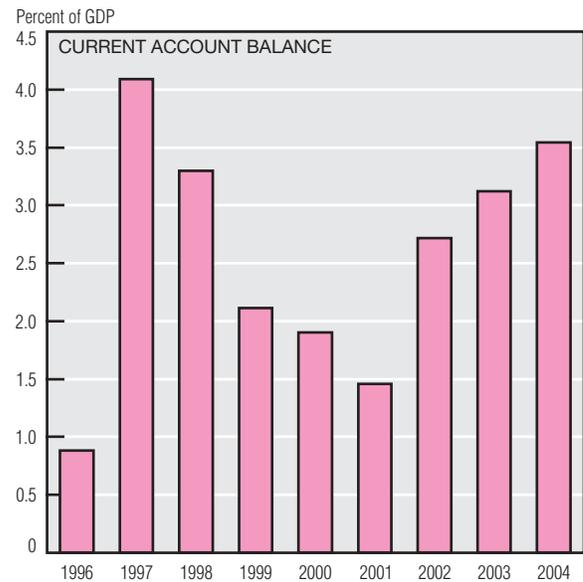
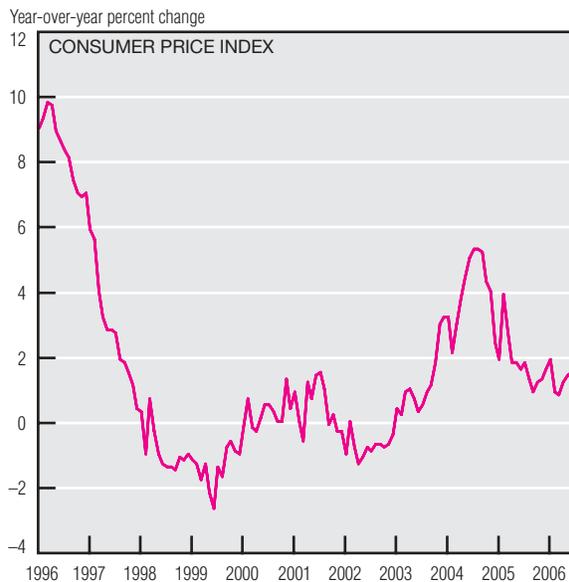
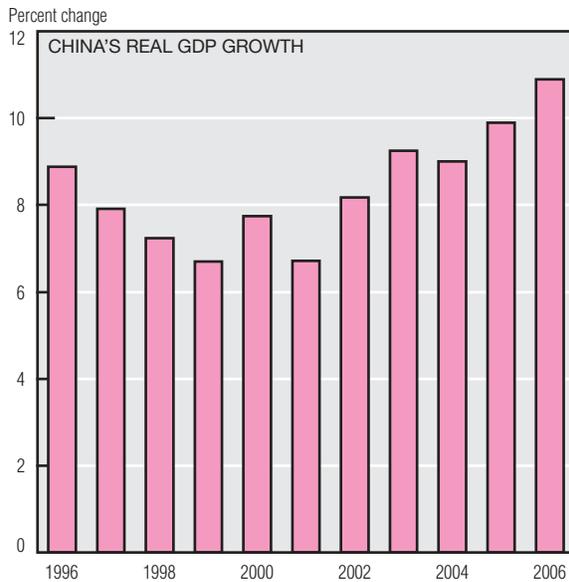


China and the Inflation Threat



SOURCES: International Monetary Fund, *International Financial Statistics*, July 2006; People's Bank of China; and National Bureau of Statistics of China.

There's smoke...China's GDP advanced 11.3% on a year-over-year basis in 2006:IIQ, mostly thanks to vigorous exports and very strong investment spending. China's trade surplus reached a record \$174 billion (annual rate) in May, and investment spending this year is advancing at a 30% clip. The strong second-quarter showing brought economic growth to 10.9% for the first half of the year. Economists, who earlier projected that the country's real economic

growth would advance only modestly more than 9%, are ramping up their forecasts for this year to roughly 10½%. Rapid money growth is accommodating this brisk expansion. The standard broad measure of money, M2, is reportedly exceeding its 2005 growth rate this year and significantly overshooting the 16% target set by the People's Bank of China.

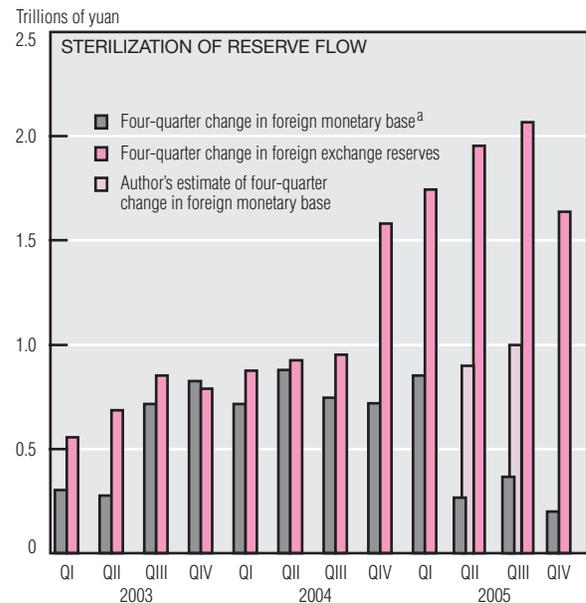
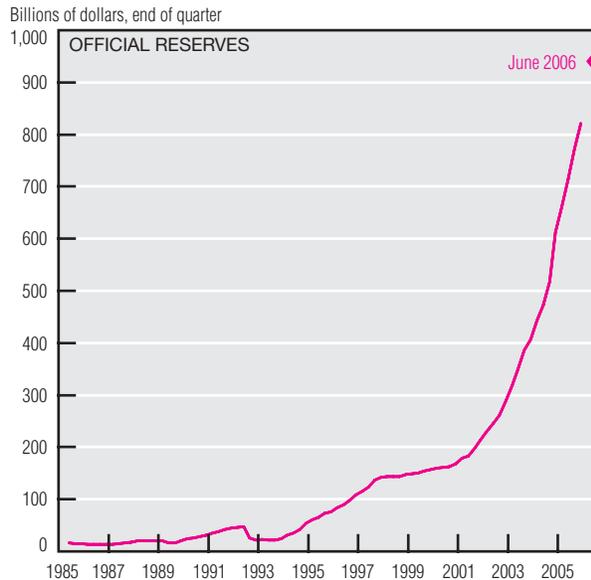
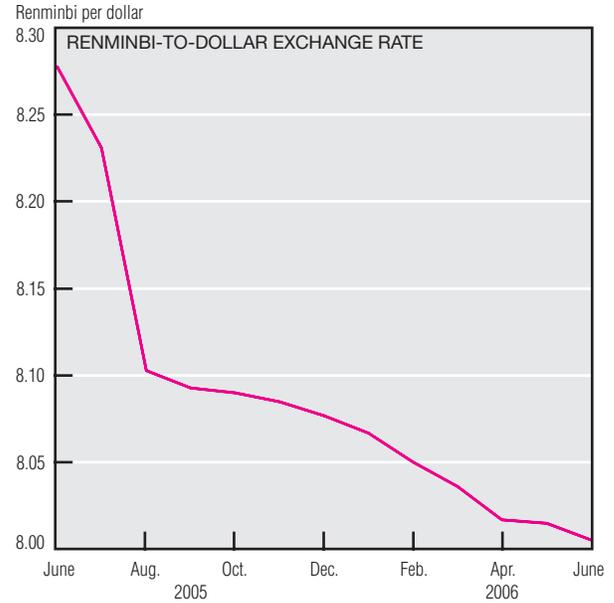
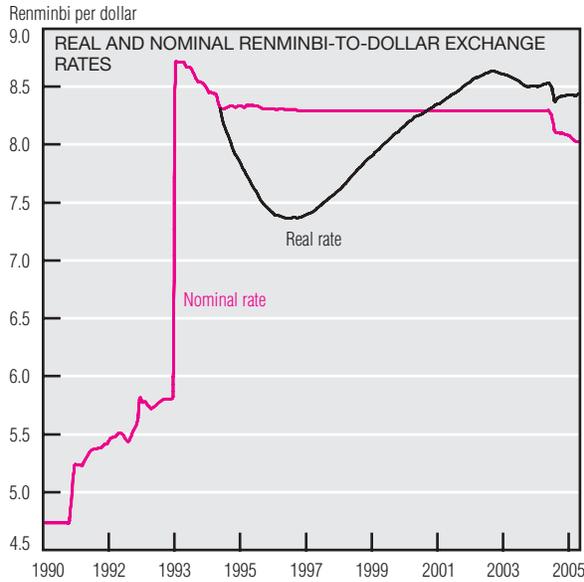
But no fire! Although the economy is heating up, strong growth and rapid money expansion have not yet

ignited an inflationary flame. Chinese consumer prices rose just 1.5% on a year-over-year basis in June. Producer prices have shown somewhat more spark, rising 3.5% for the year ending in June, but producer prices do not seem to forecast inflation at the consumer level.

China's central government has been trying to prevent the economy from overheating. They have relied partly on selective credit controls designed to restrict certain types

(continued on next page)

China and the Inflation Threat (cont.)



a. The four-quarter change in the foreign monetary base for 2005:IIQ–2005:IVQ seems to be based on incomplete information; the author's estimates for that period are also shown.

SOURCES: International Monetary Fund, *International Financial Statistics*, July 2006; and People's Bank of China.

of investment, notably in the steel, aluminum, and cement industries. Local officials, who focus on employment and local development, have been less than fully cooperative. The People's Bank also raised reserve requirements in June and July, and increased its one-year benchmark lending rate in April for the first time since October 2004. Damping down economic activity through the banking sector may prove difficult

because the country's banks are weak, and firms rely heavily on retained earnings to finance investment.

But China's most powerful weapon in the fight against inflation is rarely mentioned. The country manages its exchange rate closely, imposes tight restrictions on financial outflows, and requires firms to remit much of their foreign exchange earnings. As a result, the People's Bank accumulates huge reserve holdings and pays

out Chinese renminbi in the process. All else being constant, China's monetary base should keep pace with its very rapid accumulation of foreign exchange reserves. Its central bank, however, offsets at least half the impact of its foreign exchange interventions by selling special bonds to the market. How long can it keep this up? To conduct an independent monetary policy, China needs a flexible exchange rate.