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By David Cohen

A Plateau for China's Growth?

Second-quarter GDP is expected to "moderate" to 9%, which may give Beijing the room it needs to resist calls for currency appreciation

How do you say "Goldilocks" in Mandarin? China's second-quarter gross domestic product report, expected this week, is forecast to show 9% year-over-year growth, a rate not usually associated with a not-too-hot and not-too-cold economy. But it does show that the Chinese economic juggernaut is beginning to pull back from a 9.4% year-over-year growth in the first quarter, and 9.5% annual growth in 2003-04. And it may also enable Beijing to resist the pressure of allowing its currency, the yuan, to appreciate against the U.S. dollar.

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"Cooling" is a relative term when talking about the pace of China's growth. Its second-quarter GDP will still reflect continued broad-based momentum in consumption, investment, and booming exports. Data through May showed cumulative retail sales of consumer goods growing at a 13.2% year-over-year rate, and fixed-asset investment at 26.4%, while exports continued at a robust 32.7% year-over-year pace during the first half. A mild slowing of year-over-year GDP growth to the 8% to 9% range during the second half would leave annual growth near 9% for 2005, after 9.5% growth in 2004 and 2003.

Still, recent reports indicate that some deceleration is under way. The CLSA purchasing managers' index slipped to 51 in June -- still indicative of economic expansion, but at its lowest level since the survey began in April, 2004. Foreign direct investment actually utilized during the first five months of 2005 slipped by 0.8% from the year-earlier period.

NO TIGHTER. On another closely watched front, China's consumer price index is projected to narrow to 1.6% in June from a year earlier -- a 21-month low. It comes amid reports of deceleration -- including slowing growth in property values.

Not coincidentally, the official media have been filled recently with statements from government officials downplaying the near-term need for new tightening-control measures. One report quoted an unidentified central bank official as saying that falling inflation meant monetary policy would probably be relaxed in the second half.

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China's central bank has repeatedly said it will keep monetary policy stable -- after hiking interest rates by 27 basis points in October, 2004, for the first time since 1995. That tightening came as part of a larger government effort (including administrative controls) to curb investment and loan growth in order to avoid economic overheating in particular sectors.

WINNING FORMULA. How might these factors play out in terms of the contentious issue of the dollar-yuan exchange rate? China has pegged its currency at 8.28 yuan to the dollar since 1994, an arrangement that has raised charges of currency manipulation in the U.S., especially from the beleaguered manufacturing sector.

China has repeatedly pledged a "gradual move toward exchange rate flexibility," while refusing to give a timetable. With growth seen moderating to a more sustainable pace amid slower inflation, it's more difficult to argue for the immediate need for currency appreciation as a means to cool off an overheated economy. It could be a case of "if it ain't broke, don't fix it," since Beijing may not be in a hurry to discontinue an arrangement that has allowed China to achieve impressive growth with limited inflation.

And currency flexibility has a fundamental appeal over the long term. China's foreign-exchange reserves soared an additional $51.9 billion in the second quarter, to $711 billion, as authorities intervened in currency markets to maintain the dollar-yuan peg. Though China's efforts to counterbalance the swelling forex reserves by buying U.S. government debt can limit the inflationary consequences of reserve accumulation, it can potentially strain Beijing's capacity for monetary control. This is the argument Federal Reserve Chairman Alan Greenspan has made for China allowing the yuan to appreciate, warning that otherwise, China risked triggering general pressure on inflation.

JOURNEY TO THE WEST. Another, perhaps crucial reason for Beijing to adopt currency flexibility is as a bargaining chip in the realm of international relations. Trading partners, notably the U.S., would welcome the yuan's appreciation and presumably would be willing to make some concessions of their own. This may be a desirable outcome for Beijing amid threats to impose protectionist trade barriers, which could potentially harm the Chinese economy.

There's heightened speculation that China will find it convenient to move toward allowing its currency to appreciate ahead of the planned visit to Washington by President Hu Jintao in September, perhaps implementing a scheme whereby the yuan would be pegged to a basket of currencies.

Without such a move, the trip threatens to be overshadowed by controversy. Indeed, increasing noise is already coming from the U.S. Congress on the issue. Still, according to press reports, the co-sponsors of the Schumer-Graham bill (which would impose a tariff on Chinese imports) indicated that they had agreed to delay a vote on the legislation after Treasury Secretary John Snow and Greenspan argued that passage would only make it politically more difficult for China to act.

POSITIVE DEVELOPMENT. True to form, China so far has refused to give a timetable and ultimately can set its own pace. And currency appreciation wouldn't be all painful, since it would help to contain the higher oil import bill faced by China (see BW Online, 7/19/05, **"China's Shrunken Thirst for Oil"**).

Though a 10% appreciation in the yuan vs. the greenback would hardly put a dent in the massive U.S. current-account deficit, it would be a welcome step toward correcting one of the fundamental imbalances in the world economy today. A potential August move by Beijing represents a credible -- and welcome -- scenario.

Singapore-based Cohen is director of Asian economic forecasting for **Action Economics**
Edited by Beth Belton

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