China Anxiously Faces a Future of Rising Prices

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Inflationary pressures have been building in China for the last year, and they erupted into the open beginning in July. Policymakers have responded strongly, and the issue has taken center stage. After recounting current events, we examine the economic background and implications of the recent changes, and then look at some of the political implications. The emergence of inflation heightens the economic and political dilemmas facing China's leaders in the run-up to the 17th Party Congress.

Inflation fears surged to the top of the policy agenda in China during the summer. Policymakers had been grappling with the implications of surging prices of pork and several other key farm products for several months, amid widespread public grumbling about rising food prices. Early in August it was announced that consumer price inflation had surged to 5.6 percent in July on the back of these food price increases. A clear shift in public mood was discernible, with worries about housing prices, health care, and inflation topping lists of concerns. Many commentators announced that inflation had returned, and predicted that the August increase in the consumer price index (CPI) figure would exceed 6 percent. In fact, the actual number came in at 6.5 percent, the highest in more than 10 years, and it set alarm bells ringing.

Policymakers had already been steadily ratcheting up the attention they were giving to the overheated economy through the course of the year. The People's Bank of China (PBC), in particular, had been deploying all of the policy instruments at its disposal. Interest rates were increased on 15 September for the *fifth* time this year.[1] Not content to increase the price of credit in the economy, the PBC has also moved aggressively to reduce the supply of credit available. *Seven* times this year, the PBC has raised the reserve ratio requirement for banks, most recently on 6 September, by 50 basis points to a near-historic high. The reserve ratio is now 12.5 percent, meaning banks have to keep more than twice as large a proportion of their deposits in reserve at the central bank as they did between 1999 and 2003, when reserve rates were at 6 percent.[2] Another measure that reduces the supply of credit is the issuance of central bank notes, which soak up bank funds that could otherwise be used to make loans. The PBC has issued such notes *five* times in 2007, most recently on 7 September. Finally, the PBC began selling a tranche of 300 billion RMB worth of special Treasury bonds in mid-September, in a move that will tie up funds for longer periods.[3] The fact that the PBC is simultaneously taking multiple, mutually reinforcing actions shows how seriously they view the challenge of reducing liquidity and restraining China's macroeconomy.

The other wing of the economic policy team, represented by the National Development and Reform Commission (NDRC), has typically been less hawkish on inflation, but they also jumped into the fight. NDRC head Ma Kai, in his late-August report to the 29th Session of the National People's Congress, acknowledged the emergence of inflationary pressures in the economy. Overly rapid growth of investment, overly rapid growth of money and credit, and overly large trade surplus were all identified as problems.[4] In fact, from late July, the NDRC had launched a very traditional type of activity, sending "price-inspection" teams to various localities, and reminding everyone of the need to adhere to regulated prices. The focus of course was on price and supply of agricultural goods.[5] On 2 September, the NDRC led five ministries in promulgating a measure on market supply and price control, instructing that no government-controlled prices were to be increased during the rest of the year. If rigorously implemented, this would imply that prices for gasoline, electricity and most services would be frozen until year end. Couched as a directive on ensuring an abundant and orderly supply of goods for this year's (early) Mid-Autumn Festival and October 1st Holiday, the measure explicitly mentioned this would also create smooth conditions for the opening of the 17th Party Congress in mid-February.[6] Moreover, the NDRC led market supply and price-inspection teams to 26 provinces, focusing on the supply of pork and other key agricultural products.[7] The economic policy technocrats in the Chinese government have clearly been forced to focus on the very real threat of inflation.

Top Leaders Respond to Popular Pressures

Popular concerns about inflation are clearly spreading. Moreover, there are more institutionalized channels than before through which popular discontent can be communicated to Party leaders. Although these channels are still subject to tight limits, they serve as fora to bring popular concerns before top leaders. For example, the 29th meeting of the NPC Standing Committee, referred to above, heard a report on the implementation of the annual economic plan during the first half of 2007. This pattern of regular reporting and discussion exemplifies the increased examination of policy in semi-open conditions. The Committee then broke out into small groups to discuss various aspects of Ma Kai's report, and government performance in restraining economic overheating came in for some pointed criticism.[8] Everywhere, city people are concerned with the rising price of food, and the soaring cost of housing. These popular pressures have clearly captured the attention of the top leadership. Concerns about macroeconomic imbalance—along with the turbulence affecting U.S. financial markets—led the Chinese Communist Party Politburo to focus on financial stability and reform in its 43rd collective study session, held on 28 August. Two outside experts came in and lectured the Politburo on international financial markets and domestic financial reform.[9]

Surprisingly, Hu Jintao also used this occasion to weigh in personally on financial issues. This is unusual. Hu usually leaves pronouncements on economic issues to Premier Wen Jiabao, and Hu's speech led to some speculation that he might be opening up a bit of daylight between himself and Wen on economic policy.[10] This seems unlikely, however. From what is publicly available, the speech was couched in generalities, and without much specific content. Hu stressed the growing importance of finance, the need for continued improved regulation, and also the need to continue reform. Hu may have found it necessary to put some additional muscle behind the processes of financial reform and regulation. Alternatively, he may simply have felt that the top leader must be seen to be making authoritative pronouncements on the most important economic and financial issues of the day.[11] Why does a single monthly inflation figure seem to have so much importance in China today? In the following sections, we examine the economic background and political consequences of China's recent CPI figures.

Economic Background

The August inflation rate of 6.5 percent was the highest China has experienced since 1996. For more than 10 years, China has experienced a remarkable period of relative price stability, with periods of extremely mild inflation alternating with two stretches of modest deflation. This recent record of price stability is all the more remarkable since it has accompanied extremely rapid growth since 2001. Most economies find it difficult to combine rapid growth with price stability, and it is more common for moderate or rapid inflation to accompany periods of hyper-growth. Moreover, it is important to remember that over the reform period as a whole (since 1978), China has consistently sustained high investment and rapid growth, but usually in the context of a strongly cyclical pattern. Five major boom-and-bust cycles have been evident since 1978. Each growth cycle was brought to an end by high inflation or serious economic imbalances. The most recent post-2002 boom has been remarkable so far precisely because extraordinarily rapid growth has not produced any of the pathologies that brought the earlier boom phases to an end. To be sure, in 2004, it seemed as if rapid growth would be quickly brought down to earth by the emergence of shortages of electricity and other key inputs, and by inflation that by year end had surged above 5 percent. But in fact electricity shortfalls were promptly overcome as a swarm of new power plants came on line. The rate of inflation, meanwhile, dropped back down promptly after food-price increases (the biggest part of the surge) quickly stabilized as higher prices prompted an increase in supply. China's economy is on its fifth consecutive years of over 10 per cent growth, without, until now, having experienced any significant inflation or crippling supply bottlenecks.

This benevolent reality is now changing. The remarkable performance of the past five years can basically be traced to three fundamental factors. First, most importantly, productivity has surged. China's economy has reaped the benefits of the growth of markets, expansion of the private sector, experience with the world economy, implementation of WTO-based openness, and release of resources from the state sector, following that sector's downsizing in the late 1990s. Soaring productivity has pushed costs and prices down for a whole range of products. One simple piece of evidence is the explosion of exports produced by private firms, which has increased from virtually zero in 2000, to one-fifth of China's total exports, $108 billion, in the first half of 2007.[12] Second, planners and government officials have successfully poured money into the key infrastructure sectors, increasing infrastructure services rapidly enough to support growth and prevent bottlenecks emerging. Investment has soared, but production of investment goods (steel, cement, and machinery) has exploded as well, creating a medium-term virtuous cycle of increasing infrastructure services and producers' goods. Third and finally, macroeconomic adjustment policy has been "just good enough." It is emphatically *not* the case that macroeconomic policy has rebalanced the economy, lowered the economic growth rate, or lowered the super-high investment rate. But repeated actions both by the central bank and the NDRC have managed, just barely, to steer the Chinese economy away from the worst macroeconomic pitfalls. In effect, the PBC and NDRC have tapped on the brakes enough times to prevent the economy from speeding completely out of control. Put together, soaring productivity, improved infrastructure, and occasional brake-tapping have kept the economy on a rapid growth path without inflation. Until now.

A New Long-Term Reality

The fundamental cause of inflationary pressures in China is the continued massive growth of liquidity caused by the accumulation of foreign exchange reserves. Each increase in foreign exchange reserves translates into an increase of domestic money supply (since the monetary authorities have to pay out in renminbi for their increased stock of dollars, euros, and yen). The increased productivity that moderates cost-side pressures also in a sense creates imbalance in the market for foreign exchange. First, by increasing the competitiveness of China's exporters it leads to expanding trade surpluses. Second, by increasing the attractiveness of investment in China it leads to capital inflows. The renminbi has now appreciated by 10 percent against the dollar since the fixed exchange rate was broken, but this is nowhere near enough to rebalance the economy, especially given the dramatic depreciation of the dollar against virtually every other currency over the last two years. As a result, the PBC has to struggle mightily to sop up the excess liquidity created—just as we have seen the bank doing throughout 2007—and even with the bank deploying all its tools, it still seems to be fighting a losing battle.

Admittedly, based only on the CPI figures themselves, this is by no means certain. Adjustment in relative prices can cause a short-term jump in the CPI without necessarily signaling the beginning of inflation. Moreover, the basic situation of rapidly accumulating foreign exchange reserves has been in place since 2002 without yet producing serious inflation, as we have seen. In fact, the most recent eruption of inflation also has some of the characteristics of a short-term price correction, rather than the beginning of inflationary acceleration. By far the most important component of CPI inflation in July and August was the increase in the price of pork. Clearly, pork prices were in no way typical of the broader economy, since pork supply had been severely reduced by an outbreak of "blue ear" pig disease, and prices had soared more than 70 percent through July. A similar spike in the CPI was recorded in 2004, and in that case a simple increase in food prices did lead to a sustained rise in inflation. Indeed, the NDRC, the government body traditionally least concerned about inflation, continues to deny that China has entered a sustained period of inflationary pressures, even as it takes drastic measures to enforce control of state-managed prices.[13]

Despite these reasons for caution in our judgment, overall it appears that China is entering a period of sustained inflationary pressures. The first piece of evidence is simply that there is a widespread shift in public opinion away from the expectation of continued price stability. Average citizens, as well as households with money to invest, see some key prices increasing and begin to consider their options for dealing with an inflationary environment. As we will discuss below, shifts in expectations are very important: If everybody expects inflation, there will be inflation. In addition, the range of product markets showing rising prices is increasing steadily. During the early part of the decade, prices of manufactured goods and export commodities declined significantly. This is no longer the case: Unit costs of exports are now rising, and a majority of industrial sectors now show rising prices. Finally, asset markets all show evidence of investors factoring in inflationary expectations: Housing prices are once again surging (especially in Beijing), and the stock market is hitting new highs weekly. These signs—perhaps evidence of bubbles being formed—reflect shifts in wealth-holding partially driven by shifts in inflationary expectations.

The traditional macroeconomic indicators—growth of money and credit, trade surplus, speed of investment growth (the things that the NDRC monitors)—have long been seen as reflecting structural imbalances that must eventually create inflationary pressures. Today, they are increasingly seen as driving a reality of actually spreading inflation. From a situation over the past few years where some indicators were flashing red and some shining amber, today virtually all the indicators show red.

Even more compelling, underlying cost conditions strongly support the emergence of open inflation. For years, abundant flows of labor from the countryside kept wages low in China's informal sector. Wages in the export-oriented factories of Guangdong and Jiangsu stayed fairly constant through about 2005, even after signs of obvious labor surplus dried up. These wages are very poorly monitored by the Chinese statistical system, but indicators are that wages have been increasing rapidly since late 2005. Moreover, future expectations of wage increases are strong. Although there is still plenty of excess available labor in China's vast countryside, the supply of young, able-bodied workers in accessible areas is no longer in surplus of China's needs. An important study of over 2,750 villages in 20 provinces in 2006 found that in 75 percent of villages surveyed, all the young, able-bodied workers had already left.[14] The reservoir of accessible surplus labor is being sopped up. Increased labor costs of course drive up all other costs, and this is supported by other long-range structural changes. Land prices are moving up, and energy and raw material prices show no sign of easing off. In the short term, increased interest rates also add to costs. So the prospects for long-term inflationary pressures are strong.

The growth of inflationary expectations creates a new set of pressures on policymakers. If people begin to expect inflation, they start to build future price increases into their actions. Businesses start to believe they can push up prices; workers seek higher nominal wages to offset consumer prices increases. Moreover, increased expected inflation means that the expected real interest rate is lower for any given nominal interest rate. Lower real interest rates encourage households and businesses to take money out of bank accounts and purchase expensive durables, or put money into real estate and stocks. Nominal interest rates, after the 15 September hike, are 7.29 percent for one-year loans and 3.87 percent for one-year deposits. That means that real deposit interest rates are already significantly negative, and real loan rates close to zero. Low real interest rates in turn feed assets bubbles and leads to future economic instability.[15] Moreover, it is known that the PBC views negative real interest rates for deposits as a strongly negative phenomenon, so the bank will take steps to prevent expectations of low real interest rates from becoming entrenched in the population.

Increased Contradictions

Macroeconomic policymakers now face increased pressure to change their overall approach to policy. By definition, increasing inflationary pressures mean that the past policy setting has failed in at least one of its key objectives. But perhaps more importantly, the fundamental contradiction of Chinese economic policy is now intensified. Chinese interest rates are going up, and they will have to go up further to restrain inflationary expectations. But U.S. interest rates were cut on 18 September, and many analysts anticipate further cuts. That means that Chinese interest rates plus the expected gradual appreciation of the renminbi are now much higher than U.S. interest rates. Incentives have been strengthened for savers to move funds into Chinese assets—even safe assets like bank accounts—because the return in dollar terms will be much higher than that from safe U.S. assets. (Even though the purchasing power of the money in Chinese deposits might be eroded by inflation, they can still be swapped for more dollars after the future anticipated appreciation of the renminbi). This will increase capital inflows to China, increasing accumulation of foreign exchange reserves, and putting even more pressure on the exchange rate. Indeed, in a sense, inflation is the automatic correction process for the external imbalances, since it will eventually erode Chinese competitive superiority.[16] However, there is virtually no chance that China will chance its exchange rate policy ahead of the 17th Party Congress. China faces important choices about the makeup of its top economic team after the Congress, and such a momentous policy shift could hardly be made in isolation from a decision about personnel. More importantly, China's leaders seem to have firmly decided to keep a lid on virtually all important policy and discussion matters in the run-up to the Congress. The current macroeconomic situation intensifies that orientation.

Seeking Firmer Central Control

These macroeconomic considerations play into the political calculations of China's leaders. In the first place, it leads them to see storm clouds on the horizon and this, understandably, makes them nervous. Even though the economy has performed majestically over the past five years, China's leaders are very much aware that their efforts to control the macroeconomy have not been very successful. Now it appears that they will have even more challenging problems, and will have to strengthen their policies and instruments of control. Strengthening control and raising interest rates might trigger a broader economic correction. The stock market—and arguably the housing market as well—may be due for a significant correction. Worries are stoked not only by the emergence of inflationary threats, but also by fears of a post-Olympics downturn in markets after mid-2008. In all such scenarios, the dependence of the economy in recent years on dramatic investment growth means that the economy is extremely vulnerable to a downturn in investment, which is the part of the economy most sensitive to expectations about future economic conditions.

These fears lead China's leadership to increase their efforts at political and information control. Indeed, there seems to be an unusually broad clamp-down on expression in the weeks leading up to the 17th Party Congress. Websites are being monitored, newspapers are not producing much political news, and there are few interesting rumors about upcoming personnel changes. The system is locked up tight. Yet China faces important choices about economic leadership. Over the last five-year period, the top economic portfolio in the Politburo Standing Committee was held by Huang Ju, who died of cancer last year. The vice-premier in charge of the economy, Zeng Peiyan, has reached retirement age and will step down. That leaves Zhou Xiaochuan, the head of the People's Bank of China, as the most experienced economic official, and the logical candidate to replace Zeng Peiyan as vice-premier in charge of the economy. Indeed, there are rumors that Zhou had been selected, and then de-selected, for this position.[17] These rumors are not reliable, but they do reflect an important truth. Zhou has superb economic and academic credentials, and enormous international credibility, but he has domestic political liabilities. As the head of the central bank, he has the unenviable task of constantly trying to damp down the economy. As chief regulator of the stock exchange, he presided over an enormous downturn in the market. His family had long-standing ties to Jiang Zemin that lead some to see him as a Jiang protégé. So although Zhou is the most qualified candidate, he might not in fact end up in the top policymaking position.

Silence likewise surrounds the sudden and completely unexpected firing of the minister of finance, Jin Renqing. The acceptance of Jin's "resignation" was another piece of business accomplished at the 29th NPC Standing Committee meeting. Since it would have been perfectly normal for Jin to be replaced next spring by the new NPC, and since Jin had just met with Dominique Strauss-Kahn, the presumptive incoming head of the IMF, the previous week, the personnel change was clearly *not* business as usual. A spate of rumors erupted. Jin was said to have refused his new job, a nominal "transfer" to vice-head of the Development Research Center, an obvious slap in the face, despite—or perhaps because of—the fact that he was carefully described as "retaining his ministerial rank" (in a vice-ministerial job). Inevitably, given recent scandals and the vast amounts of money being rechanneled through the Ministry of Finance, Jin was said to have been corrupt. However, no confirmation of any of these rumors has emerged, and the Chinese press has been instructed not to dig, and to publish only fully vetted official accounts.[18] It is true, of course, that Jin Renqing was not one of the most important members of the core policymaking team. Indeed, Jin Renqing had been a rather lackluster minister, a figure of compromise rather than a dynamic leader. Nevertheless, it is peculiar for the Finance Minister to be fired right in the middle of this period of intensified economic uncertainty, and the top leadership must have had their hands forced by some external event. No information has leaked out about what precisely that was.

The new minister, Xie Xuren, has a clear profile as a finance technocrat. A 60-year-old Ningbo native, Xie began working for the Ministry in Beijing in 1990. He participated in crafting the landmark fiscal reform of 1994, though not as a primary architect. He was moved to head the Agricultural Development Bank (one of China's policy banks) in 1998, and then to a vice-head of the Economics and Trade Commission and a seat on the Monetary Policy Committee. In 2003, he took over the National Tax Administration, serving until last month.[19] Xie is thus well qualified to be finance minister, and he has a reputation as a diligent worker with an understated personality. If China launches significant tax reforms next year, Xie would be an appropriate person to lead the Ministry.

Thus, as the 17th Party Congress approaches, we see the central leadership tightening control in the midst of a difficult macroeconomic situation. The attempts to extend control are not just in the macroeconomy, of course. The macroeconomic issues themselves spill over into housing and land issues, which have been extensively covered in previous issues of *CLM*. The central government is also in the midst of an ambitious effort to impose new requirements on local officials to induce them to conserve energy. The central government has also now promulgated formal documents that obligate state-owned enterprises to turn over dividend payments to the government, experimentally in 2007 and across the board in 2008. All these issues push the central government in the direction of stronger and more authoritative control. At the 17th Party Congress, these policy issues will be in the background, even as the crucial personnel issues are pushed to the foreground.

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