Another Cycle of Macroeconomic Crackdown

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During the summer of 2006, Chinese leaders focused economic policy on the danger of overheating. As in the previous round of economic contraction, in 2004, policy involved a potent combination of monetary and administrative measures. However, unlike 2004, policy instruments this time have been well coordinated across financial, macroeconomic, and administrative measures, even including a slight acceleration in the rate of appreciation of the RMB exchange rate. The result is an economic policy package that is stable and consistent, but that may not be bold and flexible enough to meet the needs of the extremely dynamic Chinese economy. The recent visit to China by Hank Paulson, secretary of the U.S. Treasury, should be interpreted as an effort to nudge China out of this extreme policy stability. Paulson's meeting with President Hu Jintao injected some flexibility into the balance of forces that determine Chinese economic policy, but probably not enough to result in a major change at this time.

Prologue: The Paulson Visit

On 20 September 2006, newly appointed U.S. treasury secretary Hank Paulson, visiting China, announced the beginning of an institutionalized, long-term strategic dialogue between China and the United States. The dialogue is to "involve cabinet-level officials on both sides across the entire span of economic and foreign policymaking, feeding into a single process headed by Paulson on the U.S. side and vice-premier Wu Yi for China."[1] This is an important initiative that clearly represents an effort to change the opinion climate in both Washington and Beijing. In Washington, Paulson's initiative had the effect of pushing back protectionist efforts in the Senate, and in Beijing the initiative was immediately accorded a warm welcome. Indeed, Paulson was rewarded with nearly hour-long meetings with both Premier Wen Jiabao and First Secretary Hu Jintao.

By Paulson's own account, the meeting with Hu involved an "enthusiastic exchange of ideas," and was "substantive, unscripted, and spontaneous."[2] Paulson's talk with Hu broke with precedent in several respects. First, in protocol terms, a visiting cabinet minister would not normally have a formal meeting with Hu, the head of state, and previous visiting treasury secretaries have not enjoyed this treatment. Second and more important, although Hu Jintao presides over the Standing Committee of the Politburo, which ratifies key economic decisions and sets parameters for economic decision making, Hu does not generally play a significant direct role in economic policy himself. Indeed, Hu Jintao does not visibly intervene in economic policy at all, although

he must at least acquiesce in any important policy. Instead, the day-to-day decision-making process takes place primarily within the specialized functional bureaucracies of the State Council. The most important of these functional bureaucracies in economic policymaking are the financial specialists under the umbrella of the People's Bank of China, and the industrial and sectoral specialists under the umbrella of the National Development and Reform Commission. The technocrats in those bureaucracies are overseen by Premier Wen Jiabao, who herds the various bureaucracies into a position of public consensus, but rarely overrules a specific bureaucracy on issues within its sphere of competence. In fact, this pattern has been very much in evidence during the recent shift in macroeconomic policy, as discussed below.

Paulson's visit should be seen as part of an effort to inject new elements into this decision-making process. In the remainder of this short essay, I will look at the recent pattern of Chinese economic decision making, and argue that some disruption to the existing pattern would be highly welcome. Paulson recognizes that an elaborate minuet of exaggerated mutual respect can be helpful in clearing away some of the underbrush in the U.S.-China relationship, and in particular soothing some of the hurt feelings remaining from the way the United States bungled the Hu Jintao visit to Washington in April of this year. This calculation is surely right, although whether it is based on an accurate understanding of the specifics of Chinese economic decision making is not clear. A U.S. briefing on the new dialogue claimed that Wu Yi "has been given full decision-making authority across all aspects of the Chinese economy."[3] This statement is inaccurate, and, if made in good faith, would betray a significant misunderstanding of the Chinese decision-making process. Nonetheless, Wu Yi was quick to return the compliment to Secretary Paulson. "Among the senior officials of all governments," she gushed, "there must only be a handful who understand China as you do."[4] In fact, as explained below, the creation of this mutual admiration society may indeed contribute to improved policymaking in both the United States and China.

Renewed Nervousness, Policy Falls in Place

Throughout 2006, policymaking has stayed on message, with a steady ratcheting-up of concern about economic overheating. The intensity with which macroeconomic austerity measures have been applied increased steadily through August. As data accumulated on growth of bank lending, growth of investment, GDP growth, and a steadily expanding export surplus, Chinese policymakers across the spectrum gradually became convinced of the need to step up measures to cool the overheated economy. This consensus was important because it was achieved *without* significant inflation or shortages in electricity such as those that triggered an earlier round of contraction. Thus, policymakers have had to grapple with the dangers of overheating without having the traditional red flags of accelerating inflation or shortages to galvanize them into action. Instead, the alarming May data on the growth of fixed investment, money supply, and bank credit—all at new peaks—set off alarm bells. Urban fixed investment grew 31.9 percent over the year previous, stirring real concern as the data were released. Reflecting the newfound consensus, the Macroeconomic Research Institute of the National Development and

Reform Commission (NDRC) in early July weighed in with an influential report that fully supported the need for macroeconomic adjustment, including interest rate increases.[5] Both main centers of China's economic policy—the People's Bank of China (PBC, the central bank) and the NDRC—took steps from April through August to reduce investment demand.

PBC Moves

The first milestone of PBC action came on 28 April 2006, when it raised loan interest rates by 0.27 percentage points.[6] This was the first increase in interest rates since October 2004. (As interest rates take effect with very significant lags, it was not surprising that the economy was still gathering momentum in May). On 5 July, the PBC raised the reserve ratio on bank deposits by 0.5 percentage points, a move that reduced bank lending by lowering the "money multiplier" (because it requires commercial banks to place a higher percentage of funds with the central bank).[7] Less than three weeks later, the PBC announced a further increase in the reserve ratio of 0.5 percentage points, effective on 15 August. Then, on 18 August, the PBC raised loan and deposit rates by another 0.27 percentage points. This last move was a clear surprise, exceeding what most observers expected. Coming so soon after the other measures, without a pause to judge their impact, this second hike seemed to signal a new activism at the PBC.[8] A significant shift in the stance of orthodox monetary policy instruments occurred over the summer.

But even more striking has been the extent to which complementary measures have been put into place at the same time. First, the PBC itself initiated compulsory sales of short-term notes to the commercial banks on two occasions, on 17 May and 13 June. These allocations quickly soaked up liquidity at the banks, and were issued in substantial amounts (100 billion RMB in June alone), soaking up about a quarter of the liquidity created by increased foreign exchange reserves. Second, by using these targeted instruments, the PBC was clearly announcing its willingness to exert much greater direct influence over commercial bank lending decisions. Since the targets of the compulsory sales are specifically designated by the PBC, the PBC has much greater influence when it urges "restraint" on the commercial banks and tries to jawbone them to control lending to certain overheated sectors. In other words, the ability of the PBC to exercise Japan-style "window guidance" over the banks has been enhanced.[9] The PBC has clearly embraced a more diverse bundle of "composite" (*zuhe*) policies.

NDRC Moves

At the same time, the other most important economic player, the NDRC, has also participated in this macroeconomic policy shift. NDRC is, of course, always engaged in multiple ongoing programs of "structural adjustment" and sectoral upgrading, which can be adapted into macroeconomic control policies when the need arises. On 12 March, the State Council issued a general circular on the need to accelerate restructuring of sectors with excess capacity.[10] The NDRC then followed up with a series of measures for different sectors, of steadily increasing urgency and countersigned by an increasing

number of other bureaucratic agencies. By late April, the time of the first PBC interest rate increase, the NDRC had shifted to a clearly contractionary stance. A full panoply of measures to control investment was rolled out on 13 June 2006, when the NDRC, jointly with the Ministry of Land and Resources and the China Bank Regulatory Commission, issued the directive, "Opinions on Strengthening the Adjustment of Fixed Investment and Rigorously Controlling the Start of New Investment Projects."[11] This opinion signals the clear initiation of a new phase of policymaking. Finally, on 1 August, the NDRC Investment Bureau promulgated its "Guiding opinions on rectifying new investment projects," jointly with the Ministry of Land and Resources, the State Environment Protection Bureau, the State Safety Administration, and the Bank Regulatory Commission. This regulation has an extremely clear set of criteria for new project approval, and its official page on the NDRC website also has an extensive and convenient set of links to all the NDRC and State Council regulations that form the basis for its authority.[12] NDRC argues that PBC monetary policy is correct, but that the need for stability and moderation in monetary policy makes NDRC measures essential as well.[13]

State Council Moves

In the midst of the August flurry of policymaking, two days before the PBC's second interest rate hike, the State Council waded directly into the act of macroeconomic contraction. At the 16 August meeting of the State Council, the government of Inner Mongolia was rebuked by name for failing to implement macroeconomic policies, and the Autonomous Region chairman was instructed to write a self-criticism. This type of naked political muscle is extremely unusual, and did not appear in 2004, even though the policies at that time were also contested by local governments.[14] It was also about this time that the center dispatched a team to Shanghai to investigate diversion of Shanghai pension funds into various speculative schemes, especially real estate deals.[15] By the end of September, this investigation had ensnared Chen Liangyu, first party secretary of Shanghai and a prominent member of Jiang Zemin's "Shanghai faction." The long-run political consequences of this move are yet to be determined.

Thus, by August, an entire array of measures was in place, coordinated among all the authoritative economic management agencies, and with obvious political backup. Not surprisingly, all these coordinated measures had a rapid, short-run effect. In August, fixed investment was up only 21.5 percent over the year previous period, dropping 10 percentage points from the alarming May numbers. However, a sustained shift in investment and macroeconomic conditions will require steady application and further intensification..

Policy Coordination

The measures taken so far have been far better coordinated than the rather similar measures taken in 2004. During 2004, administrative controls under the purview of the NDRC were adopted abruptly and to an extreme degree, and without the agreement of the

PBC. There was a period when the two power centers of economic policy—NDRC and PBC—were utterly at loggerheads, arguing over policy measures on a daily basis in front of Premier Wen Jiabao. It remains true that there are two important power centers, and that those two groups see the economy in quite different terms. The PBC advocates stronger reliance on financial and monetary policies, although it is willing to countenance some unorthodox measures that are suited to China's less developed financial markets. The PBC is unenthusiastic about excessive reliance on administrative means to control investment. The NDRC, on the other hand, strongly favors the use of administrative measures, because this accords with its broader agenda of implementing sector-specific industrial policy. Any time government policy shifts toward administrative measures, bureaus and bureaucrats within NDRC gain power and influence.

However, the opposition between PBC and NDRC is much less extreme today. On the one hand, NDRC has come to accept a stronger role for the PBC in overall macroeconomic policy. The 2004 application of administrative measures to cool the economy was not particularly successful, and in the end, PBC macroeconomic policy was more responsible for cooling the economy slightly in 2005 than NDRC administrative measures. NDRC officials, obviously, still defend their 2004 intervention in the economy, and still support administrative interventions today. However, the head of NDRC, Ma Kai, and the author of the NDRC's macroeconomic analysis cited above, Wang Xiaoguang, have led the NDRC to take a more positive view, accepting the PBC's lead role in macroeconomic policy.

On the other side, the PBC has come to accept that direct administrative action is necessary at this stage in economic policymaking. Thus, while PBC monetary policy has led the macroeconomic initiative, there has also been a lot of jawboning and stepped-up oversight. In part, this is because of the specific economic dilemmas in which PBC finds itself, and in particular the tension between domestic monetary policy and exchange rate policy, which are discussed below. In part, though, it is due to an increased recognition of China's need for improved regulation. Administrative interventions in the economy are a poor substitute for an effective macroeconomic policy, but they may be an acceptable temporary substitute for an effective regulatory regime. NDRC now has its proclamations countersigned by a series of regulatory agencies, which makes its rulings sound more objective and authoritative. The practice also represents an attempt to strengthen the regulatory side of the Chinese state, particularly insofar as it concerns land use and environmental procedures. Indeed, even the China Bank Regulatory Commission comes in as an overseer of procedures for investment loans. The new regulations represent an effort to slow down the investment process, but also to prevent arbitrary and impulsive investment decisions, especially those on the part of local governments. Distortions in the land appropriation and approval process are a particularly important means of local government corruption, and an especially potent source of popular discontent. Making it somewhat harder for governments to run roughshod over local population land rights will slow investment and reduce opportunities for corruption. Thus, there is much more common ground between the two power centers than there was earlier.

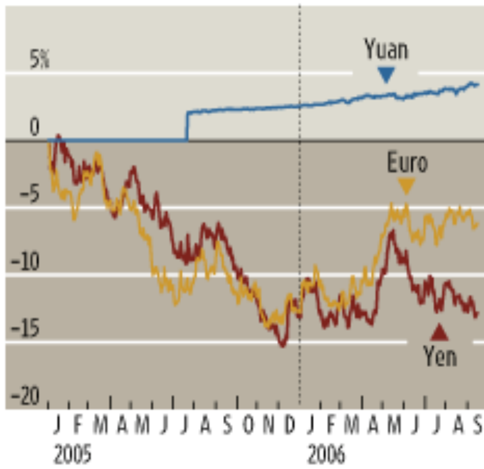
Today, overall macroeconomic policy measures are reasonably well coordinated and consistent. Fiscal policy has become substantially less stimulative over the past three years. Overall fiscal deficits shrank from 2.6 percent of GDP in 2002 to 1.1 percent in 2005, and will probably drop below 1 percent this year.[16] The RMB exchange rate still

contributes to expansionary pressures, but even here, a modest appreciation of the RMB has taken place. Thus, all the main policy settings have been adjusted recently in a way that ought to gradually reduce aggregate demand and cool the economy. Some short-run moderation is therefore quite likely. However, precisely because so many steps have been taken at once, it will be difficult to determine the effectiveness of any one measure. Moreover, the full package has some of the quality of an overall political compromise, carefully balancing bureaucratic divisions and the interests they represent. That suggests a certain rigid adherence to policy that may inhibit its ability to respond to rapidly changing conditions. However, before discussing overall policy, we must examine the policy we have heretofore set aside, namely the RMB exchange rate.

The RMB Exchange Rate

The RMB exchange rate is a crucial part of the overall macroeconomic policy mix. (Of course, it is also the policy that is of the greatest interest to U.S. politicians and government officials such as Treasury Secretary Paulson). In any economy, the exchange rate is a crucial economic variable, the most important single price in the economy. When the home currency (the RMB) appreciates, or gains in value, that tends to cool off the economy. This is because appreciation erodes the competitiveness of exports, and makes imports less expensive. Both of these effects increase domestic supply of goods relative to domestic demand, and thus ease the demand/supply imbalance that lies at the heart of economic overheating. Clearly, if the only objective of Chinese policymakers were to cool off the economy, RMB appreciation would be a very desirable and very powerful tool to do just that. However, Chinese policymakers are extremely reluctant to let the RMB appreciate rapidly, for a variety of reasons. Instead, policy since the initial RMB revaluation in July 2005 has been extremely cautious and consistent.

It is worth taking a minute to see what Chinese exchange rate policy has actually been over the past year plus. China revalued its currency by 2.1 percent in July 2005. At that time, in theory, the RMB was de-linked from the U.S. dollar and linked to a basket of currencies, but permitted to fluctuate slightly in value on a daily basis. But actually this description “in theory” is nonsense. In reality, the RMB’s value is still more closely tied to the U.S. dollar than any other currency, but is allowed to creep up steadily. The daily value of the RMB fluctuates slightly, based on who-knows-what calculation of the central bank, but the medium-term trends are very steady. The RMB is tied to the dollar, with a steady appreciation (nearly) every month. The RMB, in other words, is in a de facto “crawling peg” against the dollar. (Note that the pattern of exchange rate fluctuations over the past year is utterly unlike what it would have been if the RMB were actually pegged to a basket of international currencies: shortly after the initial RMB revaluation, the euro and yen both declined against the dollar. If the RMB were tied to a basket of currencies, it would also have depreciated against the dollar, but it did not. See figure on the following page.)



Source: Michael Phillips, "U.S., Allies Seek Currency Crackdown," *Wall Street Journal,* 16 September, page A2, at http://online.wsj.com/article/SB115836590833265124.html?mod=todays_us_page_one.

The appreciation of the RMB against the dollar has been slow, but it has gradually accelerated. Arguably, this slow acceleration is in line with the shifts in Chinese macroeconomic policy described above. Through the end of 2005, the value of the RMB in dollar terms increased by only 0.1 percent per month on average; since March 2006, the RMB's value has been increasing about 0.2 percent per month. There are some indications that the RMB has been appreciating slightly more rapidly in September, but it is still too early to tell if the overall pace of appreciation has increased. As of 22 September 2006 the value of the RMB has increased 4.4 percent compared to its pre–July 2005 value.

Even without the shift in macroeconomic policy (and without any influence of U.S. policymakers), the growing Chinese trade surplus could have been expected to lead to somewhat faster RMB appreciation. Chinese export surpluses have been growing rapidly. In the past, China typically had balanced trade or at most ran a modest overall trade surplus. This changed in 2005 when China's global merchandise trade surplus surpassed U.S. $100 billion for the first time. According to the State Administration of Foreign Exchange, China's overall current account surplus in the first half of 2006 was a whopping $91.6 billion, almost 7 percent of GDP. Although some of the surplus is due to unrequited transfers of nearly $15 billion that have more in common with capital inflows than with the trade surplus, the reality is that China's overall trade surplus is now big and growing fast.[17]

The expanding surplus should encourage more-rapid appreciation. In the first place, the surplus increases external pressure on China. The widening surplus takes away China's strongest argument *against* appreciation, which has always been simply that China's overall trade was close to balance. The pressures for RMB appreciation have come primarily from capital inflows and not from a fundamental disequilibrium of the current account. Obviously, this argument is not as persuasive as it used to be. At the same time, the continued robust growth of Chinese exports means that China has more leeway to let its currency appreciate without throttling those many exporters who are exposed to a hypercompetitive environment (clothing exporters, for example). In other words, the robust growth of exports shows that the dire fears of exporters—and of the Ministry of Commerce, which represents the exporters' interests—are not likely to be realized. Thus, both trade and macroeconomic factors lead us to expect more-rapid adjustment of the exchange rate, yet thus far appreciation, while accelerating, has remained modest. What then is the relationship between exchange rate policy and overall macroeconomic policy?

The Conflict Between Monetary and Exchange Rate Policy

The single most important source of macroeconomic imbalance in China is the presence of continuing large capital inflows. Capital inflows swell China's official foreign exchange reserves, which will surpass $1 trillion sometime around the end of September, an uncomfortably large headline number that will tend to aggravate political pressures from the United States. More importantly for China, the buildup of official reserves causes a parallel increase in the Chinese domestic money supply, as the PBC issues domestic currency to pay for U.S. dollar–denominated foreign exchange reserves. Although the PBC tries to "sterilize" this domestic money creation as much as possible, capital inflows and the growing trade surplus still contribute substantially to overly rapid growth of domestic money, bank lending, and fixed investment.

Most of the capital inflows to China are attracted by real investment opportunities in the first place, and especially investment in real estate. The PBC is very concerned about adopting a policy that will also encourage people to park idle money in Chinese RMB-denominated bank accounts. If the interest rate on Chinese bank deposits plus the expected rate of RMB appreciation is greater than the interest rate on U.S. dollar–denominated bank deposits (in the U.S., Hong Kong, or China), then even ordinary households and businesses will have an interest in keeping their saving in RMB-denominated bank accounts. Capital will be channeled into China not only by investors and speculators, who need to find fairly sophisticated, and sometimes risky, assets, but also by ordinary people looking for a safe place to put their money and earn the best return possible. So far, the PBC has kept the sum of the one-year bank deposit rate and the rate of RMB appreciation below the U.S. dollar term deposit interest rate. As the U.S. Federal Reserve Board has raised U.S. interest rates, this has given the PBC greater leeway to raise *either* domestic interest rates *or* the speed of RMB appreciation. When interest rates on loans were first raised this year, deposit rates were not increased at all.[18] The second interest rate hike, though, affected both loans and deposits, and pushed the one-year deposit rate in China to 2.52 percent. Between March and September the RMB appreciated at a speed equal to a 2.4 percent annual rate. Compounded together, these create a return of exactly 5 percent per year, which is about what one could expect to earn in a one-year certificate of deposit in the U.S. or Hong Kong if one searched out a relatively good rate. Thus Chinese policymakers are up against the de facto constraint on interest plus appreciation.

Of course, there is no reason why policymakers are forced to abide by this constraint. There is nothing to prevent the adoption of a completely different policy, in which the RMB would be suddenly and discontinuously revalued by, say, 15 percent at one step. This would completely change the saving and investment calculation: it would eliminate the forward-looking expectation that depositors in Chinese savings accounts would earn from future appreciation, expose investors to the negative interest rate differential, and even subject them to the risk of possible RMB devaluation in the future.

Of course, such a policy would incur other costs and risks in other dimensions, but it ought to at least sharply reduce capital inflows. For that reason, the top policymakers have not been willing to countenance a drastic shift in policymaking approach. However, *if* policymakers stay committed to a policy of gradualism and minimum disruption, then they must accept this limitation on the combined interest rate and speed of RMB appreciation. Thus far, the Politburo has not given the PBC permission to break out of the policy of gradualism and stability. Therefore, no matter what the PBC thinks—and there is evidence that some PBC officials would be receptive to more dramatic policies—the PBC is limited to providing advice and making policy within the constraints set by the top political leadership.[19]

Role of Interest Rates

The foregoing considerations are fundamental to understanding the role of interest rate policy in China. Is China ready to move toward a more orthodox, but also more professional, type of macroeconomic management in which central bank interest rate policy is the main macroeconomic instrument? Some economists think that interest rates simply won't be very effective in curbing investment demand in China.[20] Even the *Wall Street Journal* thinks that interest rates don't matter in an environment where local governments are powerful, and flush with cash.[21] The high level of retained earnings in state-owned enterprises is also adduced in support of the idea that investment demand will be relatively unresponsive to changes in interest rates. And of course, China does indeed lack the comprehensive web of diverse financial instruments—bonds, stocks, bank deposits, and derivatives—that give financial markets in developed countries their stable responsiveness to interest rates.

However, it is just as common to hear economists in China argue that interest rate increases cannot be used more aggressively precisely because they have *too much* impact on macroeconomic developments. For example, Chinese economists sometimes argue that larger interest rate increases today would smother the nascent recovery in the Chinese stock market. Indeed, the discussion about the conflict between exchange rate and monetary policy in the previous section illustrates the argument that interest rate increases cannot be too large precisely because they have a big impact. Since China's capital account is actually quite open, interest rate differentials with the United States drive large (and potentially unstable) capital flows. Therefore, interest rate policy *cannot be used given the constraints on exchange rate policy*, because higher interest rates would simply attract more capital inflows, increasing liquidity rather than reducing it. Therefore, the PBC is constrained to modest increases in interest, combined with many other measures designed to cool the economy.

This set of economic and political conditions thus determines the policy outcomes we see today. As the economy overheats, the PBC has been unable to raise interest rates in a timely fashion to "lean against the wind" and keep the economy from overheating. The interest rate hikes in April and August only partly changed this scenario. The PBC is

still unable to adopt a fully active interest rate policy, as it would no doubt prefer to do, because of a combined political and economic constraint: the political commitment to a stable exchange rate and the economic fact of an open capital account make it impossible for the PBC to run an autonomous interest rate policy.[22] Given these constraints, the need to cool the economy requires an extensive panoply of complementary measures: increases in reserve rates, compulsory sales of government notes, and administrative crackdowns on investment by government agencies. That is exactly what we see today.

Conclusion

China's crackdown on investment in the summer of 2006 looks a lot like the earlier crackdown in the spring of 2004. It's not that nothing has been learned. In fact, quite a lot has been learned. PBC policy and NDRC policy are much better coordinated, and fiscal policy and exchange rate policy are more in line with the overall direction of macroeconomic policy than before. But in both 2004 and 2006, policymakers have lost an opportunity to use monetary policy in an active and effective way to re-equilibrate the economy, thus losing an opportunity to strengthen monetary policy institutions and improve the responsiveness of the economy. Instead, the government in both episodes has resorted to multiple administrative interventions to provide the muscle that monetary policy lacks. The cost is the imposition of new distortions on the economy, and new distortions on decision making. Finally, the fact that such policies have been adopted a second time shows rather clearly that their adoption the first time was not terribly effective. China's economy would benefit greatly from an economic configuration in which money was more expensive, and access to investment funds was more competitive. This would help drive China's upgrading and produce a higher quality growth.

However, to move to this new equilibrium would require breaking out of the current configuration of exchange rate policy. There are calls in China to do just that. For example, Hu Shuli, the editor of the influential journal *Caijing*, calls for a shift to a more active interest rate policy. She argues:

> So the cost of money must be raised. And to do that, further interest rate and exchange rate adjustments are needed. Such adjustments are inevitable. . . . The key is to pick the right time to make a move. Why not now?[23]

The views of *Caijing* often reflect the viewpoint of economists in financial institutions, and especially those in the PBC.

Is such a change likely to happen now? Probably not. Current policy seems to be locked in a holding pattern, a kind of hyper-stability of policy. Of course, there are few crises or really evident problems that force a dramatic and risky shift in policy. Indeed, China even has low inflation, so not all economists share a sense of alarm at economic overheating. While the economic organs have achieved consensus on the need to cool overheated investment, this consensus surely does not extend to a sense of crisis about the economy as a whole. Thus, economic decision making remains caught up in the balance of forces between the financial bureaucrats and the industrial bureaucrats,

between the PBC and the NDRC. These specialists have learned to work with each other, and within the parameters set by the Communist Party Politburo. Therefore, there are so far few forces to move Chinese policymaking off dead center. Undoubtedly, Treasury Secretary Paulson hopes that by involving Wu Yi and Hu Jintao directly in the policymaking process, he may be able to change the terms of the discussion.

Notes

[1] Krishna Guha and Richard McGregor, "Dialogue with Beijing will lock in economic liberalisation, says U.S.," *Financial Times*, 21 September 2006, p. 3.
[2] Krishna Guha, "Paulson China talks 'exceed expectations'," *Financial Times* online, 22 September 2006, at http://www.ft.com/cms/s/82c51d3c-4a05-11db-8738-0000779e2340.html
[3] Krishna Guha and Richard McGregor, "Dialogue with Beijing will lock in economic liberalisation, says U.S.," *Financial Times*, September 21, 2006, p. 3.
[4] Michael Phillips and Andrew Browne, "Paulson Prods Beijing on Currency," *Wall Street Journal*, 22 September 2006, p. A2.
[5]NDRC Macroeconomic Research Institute Economic Conditions Team [Guojia Fagaiwei Hongguan Jingji yanjiuyuan Jingji Xinshi Ketizu], "NDRC: Appropriately increase the strength of adjustment; restrain the excessively rapid growth of investment," *Zhongguo Zhengzhuanbao* [*China Securities Daily*], 4 July 2006, at http://www.cs.com.cn/xwzx/200607/t20060704_953157.htm.
[6] Qian Chunxuan, "Xinwen beijing: Jinnian Zhongguo Renmin Yinhang chutai de huobi zhengce" [News background: monetary policies implemented this year by the PBC], 18 August 2006, at http://finance.sina.com.cn/g/20060818/19002836132.shtml
[7] The rural credit cooperatives were exempted from this increase.
[8] Liu Xiaowu, "Huilu zhengce rangwei lilu zhengce; tiaokong kaqi 'lilu shidai'? [Exchange rate policy gives way to interest rate policy; is macro adjustment beginning the 'age of interest rates'?" *Zhongguo Jingyingbao*, 27 August 2006, at http://www.china.com.cn/finance/txt/2006-08/27/content_7108724.htm; Liu Yuhui, "Jiaxi xiaoguo shixian mianlin de nanti [Interest rate increases face problems in becoming effective]," *Xinjingbao*, 22 August 2006, at http://comment.thebeijingnews.com/0736/2006/08-22/021@003219.htm.
[9] NDRC Macroeconomic Research Institute, 4 July 2006, *op. cit.*
[10]State Council, "Guowuyuan guanyu jiakuai tuijin channeng guosheng hangye jiegou tiaozheng de tongzhi" [State Council Notification on accelerating the structural adjustment of sectors with excess capacity], 12 March 2006, State Council [2006], No. 11, at http://tzs.ndrc.gov.cn/xkxmql/xkxmyj/t20060321_78937.htm.
[11]NDRC, Ministry of Land and Resources; and China Bank Regulatory Commission, "Guanyu jiaqiang guding zichan touzi tiaokong, congyan kongzhi xinkaicong xiangmu de yijian" [Opinion on Strengthening the Adjustment of Fixed Investment and Rigorously Controlling the Start of New Investment Projects], 13 June 2006, also known as State Council Office [2006], No. 44. At http://tzs.ndrc.gov.cn/xkxmql/xkxmyj/t20060620_78913.htm.
[12] NDRC Investment Bureau, "Xin kaigong xiangmu qingli gongzuo zhidao yijian" [Guiding opinions on rectifying new investment projects], 1 August 2006, at http://tzs.ndrc.gov.cn/xkxmql/default.htm.
[13] Li Yang, "Fagaiwei hongguan jingjiyanjiuyuan baogao: Ru touzi reng guori jiang huizai jiaxi [NDRD Macroeconomic Research Institute Report: If investment is still overheated, another interest rate hike might be necessary]" *Guoji Jinrongbao* [*International Finance News*]. 30 August 2006, at http://finance.ce.cn/macro/gdxw/200608/30/t20060830_8344305.shtml; Liu Yuhui, *op. cit.*
[14] Zheng Weiqiang, "Guonei hongguan tiaokong jinru disan jieduan [PRC macroeconomic recontrol enters its third phase]" 23 August 2006. Appeared originally on http://zhengweiqiang.chinavalue.net/showarticle.aspx?id=41618&categoryID=3.
[15] Richard McGregor, "Beijing probes Shanghai pension scandal," *Financial Times*, 27 August 2006.
[16] Fiscal deficits have here been normalized by the higher, revised Chinese GDP data in use since this year.

[17] State Administration of Foreign Exchange, *2006 nian shangbannian Zhongguo Guoji shouzhi baogao* [*2006 First Half Report on International Balance of Payments*], 6 October 2006, at www.safe.gov.cn/model_safe/tjsj/pic/20061006171402830.pdf.

[18] Conveniently, this increased the "spread" between lending and deposit rates, thus making the banking sector more profitable.

[19] Xia Bin (head, Finance Research Institute of the Development Research Center). "Zhongguo bucunzai Meiguoshi de jiaxi zhouqi" [There is no U.S.-style pattern of progressive rate increases in China], 25 August 2006 Reuters dispatch, at http://cn.today.reuters.com/investing/FinanceArticle.aspx?type=macroEconomic&storyID=2006-08-25T094728Z_01_CN6083593_RTRIDST_0_ZHAESRNS760.XML.

[20] A very useful survey of those opinions, with excerpts, is Daniel Rosen, "Survey Question: Why Is the PBOC Taking Such a Passive Stance?" *China Strategic Advisory*, August 2006.

[21] Browne, Andrew, "Booming Municipalities Defy China's Effort to Cool Economy," *Wall Street Journal*, 15 September 2006, pp. A1, A6.

[22] This is, of course, a standard result that appears in all international macroeconomic textbooks. However, it is not always recognized that this applies to China as well, because not everybody recognizes the de facto openness of China's capital account.

[23] Hu Shuli, "Sea-change needed in macroeconomic adjustment," *Caijing*, 4 September 2006. Quotation is from summary English version at http://caijing.hexun.com/english/detail.aspx?issue=167&sl=2483&id=1822414; full Chinese article is at http://caijing.hexun.com/text.aspx?lm=2551&id=1810588.