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How to Fight Inflation in China

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Inflation in China exceeded five percent in November (2010) for the first time since early summer in 2008. China's central bank (PBC) raised interest rates twice and took other steps to restrain inflation. In early January Prime Minister Wen Jiabao vowed to bring price increases under control.

Chinese economic policy-makers face a dilemma: they want to reduce pressures in the economy to reduce inflation, but do not want to cut employment, especially in export industries. Yet the major source of inflation is the large export surplus. It operates through two channels. First, exports are a significant and increasing source of aggregate demand in the economy. Second, the export surplus combined with a fixed exchange rate increases the money supply and domestic credit in the economy. Export earnings (net of imported inputs) in foreign currency are converted into rmb at the PBC, thus increasing the rmb in circulation. The PBC has "sterilized" some of the resulting credit, for example by raising the reserves that banks must hold against their deposits, but the export surplus, augmented by net inflows of capital, is so large that the money supply has nonetheless increased sharply [get data].

Engineers would not think of designing bridges or dams that defy the laws of physics. Yet Chinese policy-makers (many of whom are engineers by training) seem to want to frame economic policy in a way that violates the laws of economics, one of which is that a large export surplus (not matched by net capital outflow) will necessarily be inflationary if the exchange rate is fixed. A country cannot over time simultaneously run a balance of payments surplus, fix the exchange rate of its currency to foreign currency, and keep inflation under control.

What to do? There are three possibilities. First, permit large capital outflows from Chinese firms and households. Second, appreciate the currency, i.e. change the exchange rate to offer fewer units of rmb per dollar. Third, permit inflation to occur, particularly wage inflation, to appreciate the currency indirectly rather than directly.

The first course is not a short-term solution. Capital outflows could be liberalized quickly, but it would take time for the public to respond on the required scale, especially so long as currency appreciation remains a serious possibility. Nonetheless, for a variety of reasons the Chinese government should liberalize much further than it has done already.

Currency appreciation is the obvious solution under the current circumstances of large external surplus combined with excessive aggregate demand on the economy. Chinese officials emphasize the vulnerability of export industries on grounds that their profit margins are thin. But the main reason that they are thin involves vigorous competition among export firms within China. Currency appreciation would affect all of them. Of course, some firms would find it unattractive to export and would drop out;

that would contribute to reducing pressure on the economy, but there would be no wholesale devastation of the export industries.

The third alternative, tolerating some inflation, is a functional alternative to currency appreciation, especially wage inflation in the export sectors, which in time would spill over into domestic inflation, contrary to the stated objective of the Government.

Currency appreciation seems the most attractive solution, as it would simultaneously relieve the inflationary monetary pressure and at the same time put direct downward pressure on rmb prices of goods that are imported or in close competition with imports.

The Chinese government is said to resist currency appreciation on grounds that it is being pressed by some foreigners, most vocally Americans but including also Europeans and now Brazilians and some Asians. This is silly. It is like a petulant teenager insisting on smoking because his parents told him it is bad for him. Chinese officials should analyze their situation objectively and dispassionately and take appropriate action even if some foreigners are also advising it. Foreigners are unlikely always to be wrong.

Chinese need to become less sensitive to critical comments by foreigners. They do not typically imply anti-Chinese sentiment, although they are too often interpreted so in China. Rather, they are the price of China's great economic success. As China has grown from a negligible to a major part of the world economy, its behavior affects many people around the world and that naturally attracts their interest and attention. They do not always like what they see, particularly if they believe their interests are being adversely affected. They will understandably make critical comments and suggestions for change. China is not the first country to experience this phenomenon. In the past half century Japan also grew from a small to a large economy; it too attracted much more attention; and in Japan's case too, foreigners did not always like what they discovered, and complained about it. As noted above, such attention, including critical attention, is the price of economic success.