

April 7, 2008

Increasing Difficulty in China's Economic Management

Hidetaro Muroi
Senior Economist

China's economic management is becoming increasingly difficult. It was decided that the emphasis in its 2008 economic policy would be to curb inflation. However, since it is feared that a sharp increase in interest rates will increase the inflow of speculative funds, the government is taking a cautious stance. In addition to deciding on the margin of interest rate increase, the authorities face many tasks, including the management of the yuan's exchange rate and the strengthening of surveillance on capital inflows and outflows.

Last year, China's consumer prices rose by 4.8 percent, surpassing the government target of 3 percent or less. In January of this year, consumer prices rose by 7.1 percent, the largest increase in 11 years. Last year, food prices rose conspicuously, with the prices of meat and eggs rising by 31.7 percent and 21.8 percent, respectively. The People's Bank of China, China's central bank, raised the reserve requirement in December and then again in January, with the result that it reached 15 percent. In December, the reference rates for both lending and deposits were also raised. Meanwhile, the government put into operation a number of administrative measures and since the start of this year has made it mandatory to apply for price increases for rice, pork, eggs and other items.

The government has clearly tightened its monetary policy, having been forced to take measures against the bubble in stock and real estate prices, which soared due to excess liquidity. In July 2005, China revalued the yuan against the dollar by 2 percent and adopted a managed floating rate system. Nevertheless, it has continued to make dollar-purchasing interventions to keep the yuan from rising sharply. The excess liquidity resulting from this operation has dramatically raised the prices of stocks and real estate.

Due to the monetary tightening and partly because of the psychological effects of the subprime loan (home loans to less credit-worthy borrowers) problem in the United States, share prices have declined by just over 20 percent from their peak levels. With respect to real estate, the government has increased the mandatory down payments on second purchases of condominiums and also imposed a surcharge on idle land. In Shenzhen in Guangdong Province, for example, the prices of some properties have already begun to fall.

Nevertheless, as liquidity continues to increase due to its intervention in the foreign exchange market, the government is on the horns of a dilemma involving the choice between excess liquidity and anti-inflationary measures. Inflation has depressed the real interest rate on one-year time deposits to minus 2 percent, and this is prompting the people to withdraw their deposits and invest in stocks. Dr. Yu Yong Ding, Director of the Institute of World Economics and Politics at the Chinese Academy of Social Sciences (CASS), who served as a member of the monetary policy committee of the People's Bank of China (which

corresponds to the policy board of the Bank of Japan) for two years from 2004, argues that interest rates should be raised to resolve the negative-interest rate situation in real terms.

Inflows of Speculative Funds Feared

The government, however, is limiting interest rate increases to small ones. The authorities fear that if interest rates were increased sharply while the United States is cutting its interest rates because of the subprime loan problem, there would be a reversal of the relationship between the Chinese and U.S. interest rates, which in turn would add momentum to the inflow of speculative funds to China.

China's excess liquidity stems from its pattern of export-led economic growth. As China has promoted the expansion of exports through the introduction of foreign direct investment, the surplus situation in its trade balance has persisted and pushed up its foreign exchange reserve. The curb, through market intervention, on the increase in the yuan's exchange value in order to protect China's exporting companies, has caused the excess liquidity to swell further.

Inbound foreign direct investment remains at a high level. In 2007, it increased by 13.6 percent above the level of the previous year to 74.7 billion dollars (on an execution basis). While direct investments from Japan and some other countries have declined, investments from tax havens, such as Hong Kong and the British Virgin Islands, have increased sharply. The latter are thought to be roundabout investments from inside China or investments of Taiwanese or overseas Chinese capital. A rush of such investments appears to be taking place because of expected changes in the preferential tax treatment of foreign capital companies, which, in the future, will be treated in the same manner as domestic companies. Overseas funds also appear to be directed at Chinese stocks and real estate.

Many Loopholes in Capital Regulations

Since 2004, China's foreign exchange reserve has been increasing by more than 200 billion dollars annually. An examination of China's balance of payments shows that in 2004, surpluses in the capital and financial balance, securities investment, "other investments" and errors and omissions were more conspicuous than its trade surplus (Table). However, in 2005, securities investment, "other investments" and errors and omissions shifted to deficits. These balances fluctuated widely. According to Dr. Yu Yong Ding, this is attributable to the many "loopholes" existing in the

Table China's International Balance of Payments

(In 100 millions of dollars)

	2004	2005	2006
Current account balance	686.59	1608.18	2498.65
Trade balance	589.82	1341.89	2177.46
Services balance	-96.98	-93.91	-88.33
Capital and financial balance	1106.59	629.63	100.36
Outbound direct investment	-18.05	-113.05	-178.29
Inbound direct investment	549.36	791.26	780.94
Securities investment	196.89	-49.32	-675.57
Other investments	379.07	-40.261	33.09
Errors and omissions	270.45	-167.66	-128.77
Increase in foreign exchange reserve	2067	2089	2475

Source: People's Bank of China

supposedly-rigorous regulations on capital transactions. He argues that surveillance on capital inflows and outflows should be tightened.

The authorities, meanwhile, are by no means standing still. They are working to accelerate the pace of the yuan's appreciation and the dollar's depreciation. The yuan rose 6.4 percent against the dollar last year, and since the beginning of this year (i.e. within approximately one month), it has risen by a further 1.4 percent. In order to curb the trade balance, the government reviewed its export incentives. Specifically, it banned some processing trade, made it mandatory to obtain export licenses and reduced the rate of refunds on value added tax. Thanks to these measures, the rate of increase in China's trade balance as compared with a year earlier, which, through last September, had been as much as 50-60 percent, declined to 10 percent in October and 8 percent in December.

Nevertheless, there still remain major problems. With respect to raising interest rates, the problem is that the People's Bank of China does not have the power to determine monetary policy independently. Dr. Fan Gang, the economist who has replaced Dr. Yu Yong Ding as a member of the monetary policy committee, admits that the decision to raise interest rates tends to be delayed due to strong resistance from business.

With respect to the exchange rate of the yuan, although China stated that it would use a "currency basket as a reference" when it adopted the managed floating rate system, in reality, the yuan is under a crawling peg with the dollar (the yuan is linked to the dollar within a certain band). As a result, the expectation of further appreciation of the yuan vis-à-vis the dollar has been causing an inflow of speculative funds. If China's floating rate system is really using a currency basket as a reference, the yuan should be able to rise or decline against the dollar, preventing the inflow of speculative funds. The reason that it is not working properly is thought to be technical.

Although securing independence for the People's Bank of China is not a simple matter, improvement in the foreign exchange rate mechanism of the yuan, and strengthening controls on capital inflows and outflows are two measures, which should be implemented without delay.

Hidetaro Muroi

Senior economist in the Asian Research Department, JCER, specializing in the Chinese economy.

For inquiries regarding this paper, please contact at 81-3-3639-2823 (phone).

Copyright © 2008 JCER

※ Copying of this report is prohibited. Please contact us for further details.

Japan Center for Economic Research (JCER)

Nikkei Kayabacho Bldg. 2-6-1 Nihombashi Kayabacho, Chuo-ku, Tokyo 103-0025, Japan

Phone:81-3-3639-2801 / FAX:81-3-3639-2839 / E-mail:jcernet@jcer.or.jp