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China has emerged as the country least affected by the worldwide financial collapse. While many developed countries faced harsh recession in 2009, China grew by a robust 8.7% — and by an astonishing 10.7% in the last quarter alone.

When the crisis began, the government mobilized a huge volume of resources to stimulate the economy, the bulk of it in lending by state-owned banks. As a result, new loans more than doubled last year. This year the momentum is still powerful. As developed countries begin to recover, Chinese exports will again grow, and China’s heavy investment in infrastructure will continue. Yet one factor could disrupt the recovery: high inflation.

China’s stimulus measures lead to a huge credit expansion and acceleration of inflation.

Source: China’s national Bureau of Statistics.
Over the past two decades China has achieved an enviable combination of rapid economic expansion and only modest inflation. However, the significant increase in money supply last year could fuel inflation while the recovery in the economy is still consolidating. Changes in the structure of the labor market could also cause wages to zoom up. Because an inflation take-off could seriously slow growth, that risk has been intensely debated among top government officials.

The signs of the dragon
Although the Consumer Price Index (CPI) showed deflation for most of 2009, the 12-month inflation rate increased by 0.5% in November, 1.9% in December, 1.5% in January, and 2.7% in February. Rising food prices were the main cause; they rose 5.3% in December, 3.7% in January, and 6.2% in February. After falling 2.1% in November, the 12-month Producer Price Index (PPI) inflation also rose, to 1.7% in December, 4.3% in January, and then 5.4% in February.

Seasonal factors explain some of the recent pickup in inflation, especially heavy snows that damaged crops and hampered transport, pushing up food prices. But keep in mind that last year’s stimulus measures led to a 30% expansion in the volume of credit in the economy. Chinese banks issued US$1.4 trillion (RMB 9.6 trillion) in new loans in 2009, almost double the total of 2008 and equivalent to more than 25% of GDP. In January 2010 alone, loans reached RMB 1.3 trillion. “The faster than expected CPI acceleration, combined with the banks’ rush lending in the beginning of the year, is likely to reinforce inflation expectations,” said Qu Hongbin, an economist at HSBC bank. He thought Beijing will have to tighten credit through higher reserve requirements, open market operations, and guidance on how much banks should lend. He added that Beijing is expected to cut back on new infrastructure projects, another effective instrument of macroeconomic tightening.

The recent numbers have fuelled the debate among economists and policymakers about how to deal with inflation risk. Officially, Beijing has been downplaying the threat. In early February People’s Bank of China Governor Zhou Xiaochuan said that inflation was “relatively low,” but acknowledged that it should be watched “closely.” Despite such low-key official statements, however, “the problem of inflation and the pressure created by asset bubbles is causing great concern among government officials,” Fan Gang, an advisor to the Chinese central bank and director of the National Institute of Economic Research of China, said in a recent interview. “I believe that the asset price bubble is the main concern for the country and an issue that we must resolve” — a reference to the current...
frenzied speculation in property markets, especially in larger cities.

The huge recent expansion in credit has raised red flags, particularly because the economy had already been growing fast for many years. “The scale of credit last year was unusually large,” said Zhang Weiying, professor of economics at the University of Beijing, who pointed out that excessive expansion of credit combined with low interest rates had triggered financial crises in other parts of the world, causing inflation and a surge in bad debts.

For a few months the Chinese could manage a temporary surge in inflation through monetary tightening and a dip in economic activity. The problem, however, is that structural changes in the labor market could produce longer-term inflationary pressures. Before the global crisis wages were already beginning to rise rapidly. That phenomenon is now recurring as the economy recovers. “This is not just a short-term issue — the Chinese government should seriously worry about it,” said economist Arthur Kroeber, editor of the China Economic Quarterly.

**Wage inflation**

The number of new workers aged 15 to 20 years coming into the labor market peaked in 2005, when 125 million Chinese from that age group sought work. But China’s one-child policy, initiated in the early 1980s, means that the number of new workers is now declining. That is pushing up the value of wages. Data from investment bank UBS shows that at the beginning of the 1990s salaries of internal migrants were increasing annually at about 3% a year. Since 2004, that pace has more than doubled, with salaries at the lower end increasing by 10% to 15% each year.

Moreover, a new labor law introduced early in 2008 extended the rights and benefits already granted to most urban workers to more than 100 million migrant workers, which will further elevate labor costs. During the global economic crisis about 20 million people in China lost their jobs — many without the means to return to their home provinces until they received help from local governments — so wage pressures were contained. Now the labor market is again tightening.

The rebound in exports means that “wage pressures are expected to rebound again, potentially boosting domestic demand and adding to pressure on prices,” said economist Liu Ligang at ANZ Bank. A recent survey by ANZ shows demand increasing for workers in cities around the country and in most major sectors. For example, Jiangsu province (one of the richest in the country, close to Shanghai) recently raised the local minimum wage by 13% in an attempt to attract migrant workers. Liu said, “We expect other provinces,
especially those in the coastal areas, to follow suit soon.”

But not everyone believes that a future of higher inflation is inevitable. Despite pressure from rising wages, China also has significant excess capacity that could dampen the pressures. Excess capacity has been one of the main reasons why inflation was only moderate for most of the last decade. With high rates of domestic savings and state-led investment, China’s economy has been flooded with bank credit. Last year, total fixed asset investment was equivalent to 47% of GDP — far beyond the 20% invested by most developed economies.

“The government knows very well that the economy is suffering from overcapacity,” said Yu Yongding, economist and former member of the central bank monetary policy committee, who has warned about the side effects of high investment. (Investment has been growing rapidly since 2001, when it was equivalent to 25% of GDP.) “Excess capacity will become more serious in the future,” Yu said in a recent lecture. Moreover, the stimulus package has also undermined the efficiency of these investments, he said, although the government has taken measures to direct new loans to infrastructure projects rather than manufacturing plants. Professor Yu calculates that the incremental capital-output ratio has reached more than 6 in China, compared to a ratio between 1991 and 2003 of 4.1 (and to 3 in Japan in the 1960s). He predicts that this reduced efficiency “will have significant negative consequences for China’s long-term growth.”

However, economists Hong Qiao and Yu Song at Goldman Sachs argue that overcapacity in the economy has been exaggerated. If so, inflation risk could be greater than many think. They point to surges in demand for electricity, coal, transport, and metals as indications that higher inflation is a real risk. Even taking into account expected tightening measures, Goldman Sachs recently increased its forecast CPI for 2010 from 2.4% to 3.5% and predicts PPI of 5.5% for the year.

**Yuan appreciation**

Because high prices have provoked social tensions in the past, the Chinese authorities are usually very wary of a pickup in inflation. Many believe that high inflation was an underlying cause of the Tiananmen Square protests in 1989. Therefore, if inflation actually does head upward, there will be huge political pressure to adopt measures to control prices. The most likely response would be considerable economic tightening, including a rise in interest rates and restricting new lending by commercial banks. If the causes of inflation should be short-term, a result of the monetary excesses of
2009, the consequence would simply be a temporary dip in growth. However, if an inflation outbreak is due to structural changes in the labor market, interest rates might have to stay higher, raising the cost of capital and reducing long-term economic growth potential.

Another possibility if prices rise is that the government could decide to let the nominal exchange rate appreciate to dampen inflationary pressures. Zhang Bin and Zhang Shugang, at the Chinese Academy of Social Sciences of China, a state-run think tank, recently proposed an appreciation of about 10% to contain inflation.

Some economists believe, however, that higher inflation could bring benefits — as long as it can be kept under control. For years Beijing’s plan has been to try to stimulate domestic demand, especially consumption, so that it can replace exports as the primary driver of growth and reduce the economy’s exposure to shifts in international markets. Because Chinese consumers have US$2 trillion in bank deposits that earn minimal returns because real interest rates are close to zero, a sustained rise in interest rates would increase the resources available for consumption. A stronger currency might also increase Chinese purchasing power, which would again encourage consumption.

Moreover, inflation might be seen as reflecting rising labor productivity. Inflation derived from increased productivity “should be viewed positively, not negatively,” Arthur Kroeber told us. “If the authorities tolerate a higher rate of inflation, it will actually help the transition from an investment-driven economy to a consumption-driven economy, because the costs of capital and relative returns on labor will rise.” The experiences of Japan and South Korea suggest that GDP growth of 8% per year can be sustained for at least a decade with annual inflation of about 5%.

If China is to consider accepting a higher level of inflation, however, it will need to make some adjustments in how it manages its economic policy. Previously Beijing has focused on achieving targets for economic growth. In 2009, for instance, the state did everything it could to generate a growth rate of at least 8%. However, if inflation were higher the government would need more instruments to contain inflationary expectations so that price increases did not run out of control. One way would be to introduce a system of inflation targets, which would help reduce the risk of inflation spikes. However, this would imply that Chinese growth rates could become less predictable.
Anxiety about bursting the bubble

Dramatic price increases in the Chinese property market last year have set off alarms in Beijing about the risk of a speculative bubble in the big cities.

Prices of new apartments in 2009 rose by 68% in Beijing and 66% in Shanghai, according to the property group Knight Frank. In Shenzhen, a major city in southern China, prices rose by 51%. The ratio of house prices to average salaries suggests that China is now one of the most expensive places in the world to live. Policy-makers are worried about both the potential for social discontent about high property values and about the risks to the banking system of an abrupt correction in the market.

Many Chinese see buying a house as one of the most attractive ways of investing their money (along with equities), because they have few other options. Low domestic real interest rates reduce the returns on bank deposits, and tight government controls on flows of capital leaving the country makes it impossible to invest large sums elsewhere. Thus, the high rates of domestic savings and the trillions of Chinese yuan that have been injected into the economy as part of the stimulus package add up to excessive liquidity and repressed demand for investment alternatives.

The speculation has been particularly intense in the market for plots of land. Research by Standard Chartered found that the average price rose from Rmb933 per square meter early in 2009 to Rmb1,923 at year-end — an increase of 106%. The numbers cover land sold for residential, commercial, and industrial use. Although the national average was similar in 2007, the recent price increases in large cities like Beijing and Shanghai have been without precedent.

Stephen Green, chief economist at Standard Chartered in China, says there is little doubt that a bubble is building in many parts of the country: "In at least seven cities, the price of land tripled in 2009, which clearly shows that there is a bubble. If nothing is done, land prices will gradually be transformed into higher prices for residential apartments."

In a recent interview with the magazine China Business, Zhang Xin, president of SOHO China, one of the biggest property companies, warned about the consequences of overheating in the market. She said that the huge volume of funds the government has injected into the economy is the principal cause of surging prices. In particular, she noted that state-owned companies have been inundated with credit, adding that "State-owned businesses can be irrational because their executives are only in charge of the companies for a short period of time, and frequently their decisions are very much focused on the short-term... with the objective of maximizing results... As a result, if a plot of land is bought for a much higher price it does not matter, because the project will only be completed at some stage in the future when that person has left, which is why we are worried about the market." She said that if SOHO is bidding for a plot of land against state-owned companies, there is little chance that the company will win.

The government has already tried to slow the market down. The central bank has introduced tougher rules for getting a mortgage, requiring a 40% down payment on any second home. In some regions loans to developers are being reduced, and developers face higher penalties for sitting on large plots of unused land.

But the main worry for the government is that if its measures are too tough, the market could collapse. "The central bank is trying to slowly take the air out of the market in the most delicate manner possible, rather than bursting it," says Stephen Green.