China’s economy will overheat unless the central bank regains control of the money supply

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"HOW high are Chinese interest rates?" your correspondent enquired. Unsure of the answer, and a bit embarrassed, the man flipped through a fat statistical report. This was surprising in one way, since the man in question was a senior official of the People's Bank of China, the country's central bank. But it was, perhaps, less surprising in another way, for interest rates play little role in an economy in which credit is allocated with scant regard to its price. And this anecdote demonstrates how hard it will be to cool China's red-hot economy by the means traditional in capitalist economies: charging more for borrowing money.

If China’s economy is overheating, that will be hugely important for economic prospects worldwide, because the country has accounted for a quarter of global GDP growth (measured at purchasing power parity) over the past five years. The People’s Bank is desperate to slow growth in the money supply and in bank lending. To bring down the latter, on April 11th it announced that it was raising banks’ reserve requirements (the deposits they have to hold at the central bank) from 7% to 7.5%—the third increase in eight months.

Official statistics released a few days later explain the central bank’s concern. Real GDP growth continued at a breakneck pace of 9.7% in the year to the first quarter of 2004, and consumer-price inflation rose to 3% in the 12 months to March, up from 0.9% a year ago.

Besides increasing banks’ reserve requirements, the central bank and the government have also instructed banks to curb new lending to sectors which officials believe are growing too fast—namely steel, cars, cement, aluminium and property. In late March, the People’s Bank also raised the interest rate it charges banks. But the rates at which consumers or firms borrow from banks—the key interest rates in free-market economies—have remained fixed for more than two years.

The government line is that the economy is overheating only in this handful of sectors. Yet the figures suggest that it is an economy-wide problem. Bank lending rose by 21% in the year to March. And although the rates of increase in the money supply and bank credit started to slow from the middle of last year, they picked up again in March.

As always, analysis of China’s economy is clouded by dreadful statistics. Widely quoted figures show investment 50% higher than a year ago in the first quarter of this year. These figures almost certainly overstate the true pace of growth, and yet more reliable numbers suggest that investment is growing at the still-rapid rate of about 30%.

While that is unsustainable, some perspective is in order. The situation is nowhere near as severe as in 1993-94, when investment grew at an annual rate of over 60%, GDP growth peaked at over 15%, and inflation hit 28%. Nor is China’s condition now as fragile as East Asia’s economies were in the late 1990s, before the region’s economic crisis. Then, excess demand resulted in higher inflation, huge current-account deficits and rampant asset-price inflation. China’s inflation is still quite low and it has a current-account surplus, if a shrinking one. Although there may be a bubble in luxury housing, especially in Shanghai, house prices nationwide rose by only 4% on average last year. China’s stockmarket has been one of the world’s worst performers over the past year.

Although China may not be seriously overheating yet, there are signs that it could so soon. The main risk of excessive growth is not a surge in inflation, but the inability of China’s financial system to allocate capital efficiently. Excessive borrowing is likely to lead to another wave of bad debts. On some estimates, these already amount to 40-50% of all bank loans.

In a developed economy, the obvious solution would be to raise interest rates. But it is a truism of economics that a country cannot control both its exchange rate and its interest rate simultaneously. While the yuan remains pegged to the dollar, the People’s Bank can do little about monetary conditions. Huge inflows of capital put upward pressure on the yuan. To hold it down, the central bank must buy foreign currency, which injects new liquidity into the banking system. As a result, banks have excess reserves, undermining the impact of a rise in reserve requirements.

The central bank has tried to mop up the extra liquidity by selling bonds. But such “sterilisation” is getting harder. The central bank has had difficulty selling its bonds in recent months because it needs to sell so many. China’s foreign-exchange reserves climbed by 39% in the year to March, to $440 billion, second only to Japan’s. Unless investors are offered higher interest rates, they will be reluctant to buy more bonds. But higher interest rates would attract yet more capital inflows.

Chinese puzzle


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Though economists hotly debate the question of whether the yuan is undervalued, China needs to adjust its currency, not because it may be too cheap, but to regain control of monetary policy. In the medium term China needs to allow its exchange rate to float. That cannot happen, however, until the banking system is in better shape.

Many foreign economists argue that in the meantime the government should revalue the yuan's peg, widen its trading band or shift from a dollar peg to a basket of currencies. But a modest 5% revaluation of the yuan or a widening in the band within which it is allowed to trade could prove counter-productive. Recent strong capital inflows are driven by higher interest rates in China than in America and by an expected appreciation of the yuan. A small revaluation might thus attract still more capital in expectation of another rise. Any revaluation would need to be large enough—15-20% say—to dash such hopes. Since a rise of this magnitude would be unacceptable to the government, any move is unlikely this year.

Instead, the government may be considering tougher enforcement of capital controls, such as cracking down on the illegal ways in which banks conspire with their customers to dodge restrictions on bringing in speculative capital. The China Economic Quarterly, an independent newsletter, points to a report published on the website of the State Administration of Foreign Exchange, which details such illegal techniques. This was, it thinks, intended as a warning shot to banks.

Tighter capital controls could allow the People's Bank to raise interest rates. But it is unlikely to be allowed to do so by the government unless inflation goes above 5%. On the other hand, if capital inflows continue to accelerate, the China Economic Quarterly predicts that inflation could be double that by the end of the year. And then the question would not be whether China is growing too quickly, but how fast it will slow down.

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