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Economic Outlook

China and the United States

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A new truth of geopolitics has emerged during 2009. It is that the complex and rapidly evolving Sino-American relationship has become the most important bilateral relationship either country has. To this observation, made recently by William C. McCahill Jr. in the November 13 special issue of *The China Report*, must be added another claim: the course of the Sino-American relationship in both the economic and the political spheres will play a growing role in determining the levels of global economic and geopolitical stability. Trips like President Barack Obama's three-day visit to Shanghai and Beijing November 15–17 will probably be made with increasing frequency in coming years.

Major economic issues facing China and the United States include trade disputes, the disposition of China's $2.5 trillion in foreign exchange reserves, currency policy, each country's role in the G20, and climate change. Geopolitical issues include China's expanding strategic presence in Asia; nuclear nonproliferation; and China's ties to Iran, Afghanistan, and North Korea, just to mention the most potentially troublesome issues for Sino-American harmony. As noted by McCahill in *The China Report*, China's large commercial presence in Iran, its dependence on Iranian oil, and its historical ties to the Iranian nuclear establishment are all factors that make the volatile situation in the Middle East and U.S. involvement there a source of serious potential problems for the Sino-American relationship. It is not pleasant to contemplate the rapid escalation of Sino-American tensions that would accompany, say, an Israeli attack on Iran's nuclear facilities.

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Toward Currency Adjustment

Despite those sources of possible tension, in a postbubble world, a clear opportunity has emerged for Sino-American economic coordination. At a time when inflation pressures are beginning to appear in China while the U.S. economic recovery is showing signs of weakness, a change toward more dollar-renminbi currency flexibility would serve the interests of both China and the United States.

There are hopeful signs that China may be moving in that direction. The monetary report of the People's Bank of China (PBOC) for the third quarter of this year said the bank aims to "improve the exchange rate pricing mechanism in a proactive, controlled, and gradual manner with reference to international capital flows and major currency moves." The commitment in previous reports "to keep the exchange rate basically stable at a reasonable and balanced level" has been considerably softened.

A move toward greater exchange-rate flexibility that is tied to China's own internal interest in containing rising inflation pressures is far more credible than expectations of more renminbi appreciation in the face of U.S. pressure.

China's Inflation Threat

Despite the persistence of modest year-over-year headline deflation, China is quickly moving toward a resurgence of inflation that will force a sharp tightening of monetary policy sooner than markets expect. The tip of China's inflation iceberg popped clearly into view November 9 when, after September's commercial hiatus during the Golden Week holiday, October pork prices were reported to be up sharply from August levels, rising at an 18 percent annual rate. This is an especially troublesome development because pork and food prices are responsible for most of the volatility in China's inflation rate. The increase reflected sharply higher feed costs for pork producers, which were caused in turn by the 13 percent drought-induced drop from a year earlier in China's September–October corn harvest.

The jump in food prices presents some difficult but necessary choices for China's important Central Economic Work Conference early in December. A year after the acute phase of the financial crisis and subsequent extraordinary accommodation by central banks and governments, the country's policymakers are facing critical decisions. They either have to signal a preemptive exit from highly accommodative policies, thereby risking a return to weakness in the real economy or even a sharp sell-off in financial assets, or opt for a reactive stance of awaiting clearer signals of economic recovery before exiting an accommodative stance.

While the choice between a preemptive and a reactive stance is still a very difficult one for U.S. policymakers, and perhaps even for European and Japanese central banks and treasuries, China may soon need to withdraw some of the extraordinary stimulus applied after last fall's financial panic. China reacted most aggressively and most rapidly to the negative shocks to financial markets and economic activity following the September 2008 collapse of Lehman Brothers. By November 2008, the Chinese had announced a massive fiscal stimulus claimed to equal 14 percent of Chinese GDP, applied over a period of about two years, and substantially front-loaded. For perspective, consider that 14 percent of GDP would equal a $2 trillion stimulus in the United States, or about triple the size of the U.S. stimulus plan announced in 2009. Beyond that, China's centrally planned policy apparatus can and has implemented stimulus considerably more rapidly than governments in market economies.

China's sudden shift away from what had been a contractionary stance in the face of signs of overheating through the middle of the third quarter of 2008 produced a rapid reacceleration of growth from a low of 6.1 percent year-over-year in the first quarter of 2009 to almost 9 percent year-over-year growth in the third quarter of 2009. Of course, quarter-over-quarter growth rates rose even more sharply. It took China less than six months to move its year-over-year growth rate close to its long-run trend level. By the same yardstick, growth in the United States and other G7 countries continued to lag during the first half of 2009. The U.S. economy was still contracting at a 2.3 percent year-over-year pace in the third quarter. During 2009, China's contribution to world growth has gone from 15 percent of the total to nearly 20 percent, underscoring China's extraordinarily early and rapid acceleration of growth during the first three quarters of 2009.

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China also provided powerful augmentation for its growth resurgence by engineering a sharp acceleration of money and credit growth. During the first nine months of 2009, loan growth accelerated from a 15 percent year-over-year rate to a 34 percent rate, while money growth accelerated at about the same pace. Here again, the success at engineering an easing of money and credit conditions in China is striking compared to efforts in the United States, where rapid increases in the monetary base have not translated into any acceleration of money growth and where credit growth is still largely absent.

China's central bank is increasing the flow of liquidity to China's state-controlled banks, which, in turn, are rapidly increasing their loans. Part of the acceleration in Chinese money growth may be a reaction to some inventory accumulation in the retail sector and some delays at the provincial level in distributing the rapid increase in government funds available for infrastructure projects. Whatever the reason, the large surge in China's money and credit growth during 2009 to twice the normal rates over the past decade is fueling asset bubbles in real estate and equities. Stock prices on the Shanghai Index have risen between 75 percent and 100 percent so far in 2009, while property prices in most Chinese cities are rising rapidly. In Shanghai, the September rise of property prices relative to a year earlier was nearly 50 percent.

Most Chinese policymakers have signaled that they intend to continue the loose monetary and fiscal measures until they see a rise in inflation. Fan Gang of the PBOC monetary policy committee publicly stated as much on November 6. While China's year-over-year inflation rate is still slightly negative, sequential inflation has been rising month-over-month at about a 0.3 percent rate, suggesting an annualized inflation rate of close to 4 percent. The transition from negative month-over-month inflation early in 2009 to the recent 4 percent positive annualized rate is not surprising in view of the massive stimulus being applied by China's fiscal and monetary authorities.

The sharp jump in pork prices along with a drought-driven corn shortage means China is risking a sudden acceleration of inflation that could require a sharp withdrawal of stimulus and a bursting of the real estate and stock market bubbles that have already developed. Most Chinese price increases during the last two bursts of inflation, in 2004–2005 and 2007–2008, were tied to sudden jumps in food prices. Food prices as a whole are shaped significantly by the volatile price of pork. If pork and other meat prices continue to spike upward in 2010, overall Chinese inflation could reach double digits rapidly, forcing a prompt withdrawal of the extra stimulus already in place. Waiting until year-over-year inflation reaches 4 or 5 percent will virtually assure a sharper run-up in inflation, since once the trend rate of inflation is established at that level (given the sizeable stimulus already in place in China), momentum will quickly carry prices higher.

While many are looking to the U.S. Federal Reserve as the central bank needing to choose between preemptive and reactive policies in response to a stabilization in asset markets and economic activity, the key institution to watch may be China's central bank—the PBOC. China's financial system was not as fundamentally damaged by the Lehman Brothers crisis as the U.S. financial system was. Unlike U.S. banks, China's banks are still functioning and actively making loans in an environment where government spending has increased at a pace three times the rate of increase in the United States.

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Add to this scenario a Chinese central bank that is not independent, but rather essentially under the control of the government, and the potential for a reflationary overshoot that requires an abrupt reversal of policy is clearly in place. If China's current sequential inflation rate of about 4 percent accelerates to double digits, the Chinese will quickly face the need for a rapid reversal of current expansionary policies.

Given this background, allowing the renminbi to appreciate would be a constructive way to preempt the rising inflationary pressure in China. The alternative will be a rapid reversal of accommodative monetary and fiscal policies that could create a globally disruptive collapse in China's property and asset markets.

A Sustainable Chinese Ascent

The sharp contrast between China's huge fiscal stimulus and money growth, which have boosted GDP growth to 9 percent, and the tepid U.S. recovery suggests that the need for rebalancing measures persists. A preemptive step to allow the renminbi to strengthen against the dollar and numerous other currencies in Asia and Europe would help prevent a resurgence of Chinese inflation and thus would constitute a major contribution to stability in China, the United States, and the global economy.

That contribution would be a fitting way to underscore China's incipient emergence, both as the world's second-largest economy and as part of the world's most important bilateral relationship. Better to have a sustainable ascent in China's global geopolitical prominence than an unsustainable bubble in China's prices for assets and goods.