

## **China's inflation harder to control than web**

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Suddenly, the new China is looking a lot like the old China.

The most obvious sign is the security clampdown before the Olympics' opening ceremony on August 8. The Beijing Games were meant to showcase the new China, yet the International Olympic Committee finds itself pressuring officials to allow journalists to view Web sites previously barred in the nation's capital.

The most important reminder that China isn't evolving as hoped concerns economic policy.

The yuan last week had its biggest weekly loss since China scrapped its dollar peg in 2005. On July 25, the Politburo, the Communist Party's top decision-making body, left little doubt that the currency gains of recent years are over for now. It said China will focus on ``steady" growth after the economy expanded at the slowest pace since 2005 in the second quarter.

The politics of such a shift are clear enough; the economics of it are less persuasive.

Part of China's rationale is reducing so-called hot-money flows. As the yuan appreciates, it can attract capital inflows that pump up the money supply. That has increased risks for Asia's second-largest economy.

If China expects to control things, it will have to make its monetary policy consistent with exchange-rate policy. That means lower domestic interest rates, which could cause new problems.

### **Dangerous Dynamic**

"Ending appreciation, cutting rates and relaxing lending curbs would certainly support growth," says Council on Foreign Relations economist Brad Setser in New York. "It also would risk pushing Chinese inflation up to the levels seen in the Gulf."

Gulf states, including Saudi Arabia and the United Arab Emirates, are under pressure to revalue currencies or drop their pegs to the US dollar. Inflation is running at more than 10 percent in five of the six Gulf Cooperation Council states as oil-fueled growth creates shortages of real estate and services, while the weaker dollar and surging global food prices increase import costs.

It's a dangerous dynamic even for governments awash in petrodollars. While they can afford to help low-income families, the risk of losing economic control has to be considered. If you are China, home to the biggest population and run by a single party obsessed with keeping things that way, imported inflation is a bigger problem.

Setser is among a sizeable group of economists who would prefer to see the yuan strengthen further. It would keep China from importing some inflation and increase the international purchasing power of many of the nation's 1.3 billion people. China also is enjoying the fastest growth among major economies and the largest current-account surplus of all major oil- importing nations.

Considering the bewildering number of risks facing Chinese officials - a global credit crunch, social instability, the widening gap between rich and poor, worsening environmental conditions - the focus on currency policy is predictable.

There are many risks to this approach. One is how global growth is slowing and imperiling China's outlook. Realistically, Setser says, China can't rely as heavily on exports for growth in the future as it has in the past.

"It has the policy tools available to shift the basis of its growth," he says. "The political will to do so, though, seems lacking - at least for now."

## Growth Obstacles

JPMorgan Chase is advising investors to close three- month bets on a stronger yuan, an investment it first recommended in May. Increasing growth impediments are expected to slow yuan appreciation this year, says Claudio Piron, a Singapore-based currency strategist at the bank.

China has been more willing to tolerate a stronger yuan than many investors expected just a year ago. The Chinese currency, after all, is the best performer among the 10 most-active Asian currencies, excluding the yen, over the past year.

Yet a few stubborn facts are worth considering. One is how daunting China's balancing act really is. The People's Bank of China says controlling inflation is taking a "prominent position" in decisions. With inflation advancing at a 7.1% rate in June, a stronger yuan would help.

The other side of China's balancing act is economic growth, something that would be aided by a weaker yuan. The key is deciding which is the greater risk. China appears to be siding with US Federal Reserve Chairman Ben Bernanke, whose policies are putting recession risks ahead of the inflation threat.

## Internet Is Easier

China will find that controlling the Internet is easier than taming price pressures. Officials in Beijing have compliant executives at Google and Yahoo helping them censor cyberspace. Even after employing all of the conventional tools of economic policy, cooling inflation is easier said than done.

The second fact is the nature of China's economy. The country has yet to develop a private sector that can jumpstart a viable domestic economy. The longer that China subsidizes its companies with a weaker currency, the longer it will take for them to become globally competitive.

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Governments sitting atop massive oil reserves often put off diversifying economies. Gulf states may feel they have that luxury; China doesn't. Halting the yuan's gains may not be in China's best interest.

**Source:** William Pesek