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“THE END OF AN ERA? INFLATION RETURNS TO CHINA”

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ALBERT KEIDEL: Good morning and welcome to the Carnegie Endowment. I'm Albert Keidel, senior associate here in the China program. On behalf of Jessica Mathews, our president, I'm going to extend a warm welcome to you on a chilly morning. We have a program today that involves this policy brief, which I think has circulated now for quite some time and actually came out in Chinese at the very end of August.

And we have an excellent panel. Their bios are on your handout and I think they’re familiar to you. I just want to personally thank Pieter Bottelier and Nicholas Lardy, Pieter of the Johns Hopkins University School of International Studies and Nick of the Peterson Institute for International Economics for kindly agreeing to prepare comment on this. It’s a topic that there may be some varying views on and we look forward to your views.

I also want to thank the Ford Foundation, which generously sponsored research in the historical trends of the Chinese economy on which many of the concerns about repeating historical inflationary crises are based. I’m now going to turn it over to Professor Bottelier, who is going to be the moderator. And we can get started. I don’t know, Pieter, if you want to say anything or shall I just start.

PIETER BOTTELIER: Bert, I think you just about preempted what I could possibly say by way of introduction. I will now reassign you back to the podium to make the first presentation and then I will ask Dr. Lardy to give some comments and I will then make some comments myself. And then, the discussion with the audience will start.

MR. KEIDEL: Thank you, Pieter. Well, the concern in this policy brief is about the risk of inflationary crisis. And overheating, therefore, is the topic that is underlying this concern. This is a record of inflationary crises in the past and where we are right now. And it’s the first slide on your handout.

As you can see, the scale of inflation by the ordinary measures is pretty insignificant so far. And I think everybody agrees that we are not in an inflationary crisis. We’ve seen an uptake and the numbers for 2007 here only reflect the first half year although I have updated that because today in Beijing, the statistical bureau released its third quarter numbers. And I have a table that follows, that incorporates that in it. But I didn’t have time to change this graph; it’s up slightly more, that round blue line which is the national CPI. The national CPI hasn’t changed, but the GDP inflation has changed just a bit.

And my thinking on this involves a number of linkages. I’ve only got four slides so you can stare at that for a long time; it’s not going to change very much. (Laughter.) The first is that this is not a crisis right now. The price increases that we’ve seen are mostly food; and this has been well-documented and most recently by the vice chairman of the planning commission, the NDRC, Zhang Xiaoqiang (sp), had a press conference during the Party Congress last week in which he made this point pointedly. It’s mostly food and it seems as if the CPI leveled off, not coming down, just a bit in September after August. So maybe everything is fine. My point is, and I’ll be repeating it, I think, is that it’s the risk of an inflationary crisis that we have to worry about. And therefore, shouldn’t the Chinese government be taking some preemptive steps to make sure that it doesn’t happen the way it has happened in the past.
It is mostly food, but if you looked at food prices in August, they didn’t—they were scheduled also to have a monthly statistical indicator released today—it was supposed to be yesterday, the 24th—they didn’t do that. They just had the quarterly summary numbers. So we really don’t know what happened to food prices on average. But they were up in the high double, you know, by August, 18 percent, with, as you read in the policy brief, some really very high numbers for meat and eggs and oil.

Now, these are staples. They are a smaller share in the household consumption basket than they were, say, fifteen years ago, but they’re still a significant component of the consumption basket for lower income workers, in particular, the migrant workers who are in a lot of the factories in coastal industrial China. So it’s food. We don’t know whether it got a little better in September or not, but it’s still quite high. And even if, in a year or so, if it slows down—this is year-on-year data, don’t forget. This is saying this is how high it was compared to a year ago. So even if there’s no change now, it will stay at that level for quite a few months. But the question is, will other prices in the economy, that are based on labor costs then also have to go up.

There’s an old Chinese saying that says, when grain prices rise, everything else rises. Whether that’s the case now or not, we’ll have to see. The scenario continues, though, that other prices could also be pulled up through a demand pull. And this happens because with CPI inflation, even at this lower level of 6.2, 6.4 percent, it’s well above consumer deposit rates in the bank. So you’ve got negative return on your money in banks. This time around, as opposed to 15 years ago, we have a stock market phenomenon. That didn’t really operate 15 years ago. But now, cash is coming out of the banks and going into stock market purchases; so there’s a bit of a buffer there.

And you might say, well, then that will cushion the economy and it won’t have the demand pull of this cash coming out of the banks that we’ve seen in the past. But nevertheless, that is the worry. And in the past, they’ve always delayed raising deposit rates until it was too late. That’s just been their pattern. And you can blame it on the year-on-year data, that they don’t see the problem until it has become more serious. But what interests me, of course, is that the way to keep the money in the banks and what they’ve done in the past is to not raise, announce nominal interest rates, but indexed deposit rates to inflation. Which is, make a little announcement saying, by the way, if you keep your money in three-year bank deposits, when you withdraw it, will have a table. And you will earn the CPI rate of inflation.

And that meant—my driver in Beijing said, yeah, it’s a lot of money. He didn’t realize of course that he was getting zero real rate of return on his money. But compared to what they would get with the negative interest rates, it was quite a bit. And it really worked. You can see in this report, the one funded by the Ford Foundation, there is extensive documentation in tables and description of those processes, both in 1988, ’89, which is the first really high inflationary surge here that you see and in 1992, ’93.

Interestingly, in the third quarter of this year, the growth of cash and circulation, M-0 has actually slowed dramatically. It’s down to just over 8 percent. I’m interested whether Nick or Pieter can explain that. I don’t have a chart on that. It’s just a single number after
being the M-2 is still growing, the whole money supply at 15, 16 percent, but M-0 for some reason, year-on-year dropped its growth rate dramatically.

Continuing on the scenario of a crisis that could emerge, if there is higher inflation, holed out by this demand that is reflecting cash leaving the banks, then we will be repeating what has happened in the past. And you'll have inflation that will go into the teens if not into the 20 percent range. And the government will be forced, politically, to take action. And that action to slow the economy will mean raising interest rates, doing administrative cutbacks on investments. Mainly that affects incomes and jobs. And the effect of those steps in the past has been to generate social unrest.

I was at Tiananmen the May of 1989, and so much of the talk and the demands of the students – written seven demands; there were two versions of them – were about inflation and who was responsible for inflation and they needed to be punished. And their standards of living had been hurt. And then you saw that the last few demands were demands for access to the media, access to assembly to make these points. But it was very clear to me, talking to students and citizens in that square, that it wasn't just a pure – besides, they said, you know, the peasants don't need to vote, so we can keep our subsidies in the city, but it was clearly that inflation was a major force there.

In the 1990s, the effort to combat inflation was coupled with efforts to cut costs in state-owned enterprises. And therefore, you saw significant layoffs, a lot of hardship. And you also saw an effort to bring grain prices down by forcing farmers indirectly to plant more grain. And that cycle meant that consumption in rural areas decline, absolutely, for three years, in '97, '98, '99. It forced local governments to go to extraordinary measures to raise revenues through fees and extra taxes. And the explosion in social unrest in the late 1990s is heavily linked to those rural fees that were brought on by what was, in effect, a concerted effort across the board to control inflation in China.

So that's the worry, that if they don't take easy steps they could take now to preempt what could be an inflationary crisis, the consequences could be unsettling and disturbing in a year when the National People's Congress is going to meet next year and then you have the Olympics with the media from all around the world coming to document the kind of society that China has developed. It would just be a shame; the stakes are just too high to allow an inflationary crisis to emerge from what now looks to me like historically, the same preconditions that we've seen in the past.

Now, the food-price issue is what's behind the CPI increase. And here you see the monthly CPI numbers. In the period since the end of 2000, which is really the last – this whole period has been a boom growth period for China in terms of GDP and outward expansion. There was a surge of inflation in 2004. The reasons for that are pretty well-known: One is the SARS epidemic of 2003, generated a lot of investment in the effort to try to keep the country's economy going that turned out not to be necessary. And therefore, there was excess demand and they had to mop that up.

At the same time, the output of grain and land planted to grain had dropped so much because of the relaxation in these controls from the 1990s that grain prices started to rise. And they began to lift grain prices a lot. And there was a burst of inflation linked to
those food prices. This is exactly what happened in 1985, '86, '87, leading up to the '88 inflation. And grain prices also were critical in 1992, '93 because they eliminated grain coupons on that time and raised urban grain prices to a more market-based level.

So in each of the two previous major inflationary surges, we saw grain prices play a precursor role. And in 1987, they even led to a pork price-rise crisis because grain was a major feedstock for hogs. And with the price of hogs too low, farmers began to slaughter their sows. And they had to raise the price of pork dramatically along with other food prices in '88. Li Peng did it when he came in as the new premier. And that fed, in part, the inflation of '88, which was the precursor, I would say, to some of the unrest at Tiananmen.

So the grain price increase, this precursor here, fits an historical pattern. I also want to mention that even though we are saying that it's food prices that are only what are going up and that Guo Boxiong (?) and others have said, these can be controlled, but we have to be vigilant. But it's food. So with a better grain harvest this year, things should be fine.

Other statistics indicate that it may not just be grain. I have some serious questions about the degree to which the CPI, the Consumer Price Index, really reflects inflationary trends economy-wide. And the economy-wide estimates of inflation – you can see the CPI here in column number one on the far left. And I’ve inserted the September number that just was announced last week by Guo Boxiong, the deputy commissioner of the Planning Commission.

And I’ve also included the January through September number that was announced today in Beijing. GDP inflation measures, and this looks like the CPI should not be under the GDP column. But the second column is the official GDP output measure of inflation. And you can see that it took a surge in '04 and then came back down. But in the third quarter – again, this is based on the data released today – it’s back up over 5 percent. So we’re seeing an economy-wide GDP level of inflation now that’s over the Chinese's own warning level of 5 percent. So it’s not just food. Or if it’s just food, food has become so important that it’s raised the overall inflation level now up to the 5 percent level.

Another way to measure GDP is the expenditure method. Spending: C plus G plus I plus E, consumption plus government spending plus investment plus net exports. All of you who took principles of economics have happily forgotten that, but that is, in many ways, an international standard and it gives us an interesting result. On the far right-hand column, the nominal growth of that measure of GDP has been over 17 percent for three years; that’s really high.

Now, you have to say either inflation was quite high, and according to the official, for the first time, the last couple of years, the Chinese released data that allow us to calculate official GDP inflation by the expenditure method. And that's in column number three. That inflationary measure, by the Chinese calculation, has been 6 percent or above in the last three years. If you take an average of the investment-price deflator and the consumption-price deflator, which are the bulk of the inflation – you get a much lower informal deflator, which is column four. And if that's the case then real GDP growth was over 15 percent. Otherwise, it was only 11 percent with a high 6 percent inflation.
So when we try to say, well, how serious is this really? Isn’t it just some food blips, the core inflation isn’t very much? I have to say, yes, of course that’s technically true, but how accurate is the CPI in reflecting these other broader inflationary trends in the economy? How much can they be trusted? They’ve been manipulated in the past. And what are these other measures telling us?

Now, there are steps that they can take. And there’s a concern that, well, if they raise interest rates, won’t this just encourage the carriage (?) trade? Won’t it encourage outsiders to bring their money into China to invest it? And yes, that’s an issue. And it would be more of an issue if China had an open, short-term capital account, which it does not. China has a managed capital account that has a lot of leakage in it. So the situation is very different from what it would be if anyone could come into China and invest right away. You might have a huge surge.

The other point is, China doesn’t have an independent central bank, and so it has been quite successful under the direction of both the politburo and the state council in pulling that money back out of the economy. And so, they have been able to manage the inflows so far.

And this leads me to one of the important generalizations in the policy brief, also based on findings in this Ford Foundation funded study which, by the way, was done in collaboration with the Planning Commission of China, the NDRC. We spent a lot of time both in China and in rural China documenting the impact of various cyclical trends on the rural economy. But what came out of it was that China’s macroeconomic fluctuations and trends are heavily, almost overwhelmingly determined by domestic factors. China does not have export-led growth in the sense that other Asian economies do. If you try to see what influences China’s growth surges and growth slowdowns, and you look at the data on exports and net exports, either one, you don’t see any meaningful correlation; and usually, there’s no correlation at all.

And so this is emphasized by the finding in this or the analysis in this policy brief that China’s inflation also at this point is domestically generated. It’s this cyclical process where grain prices have gone up, now we’re getting food prices. Deposit rates are negative and therefore, money can start coming out of the banks. It may initially go into the stock market, but it could start going into the goods and services market and may already have if these other broader measures of inflation are accurate. And in that case, we are looking at what is almost a repeat of steps leading to inflationary crises in the past. And in my view, it’s worth it for the Chinese government to take a few preemptive steps to keep that from happening.

And the more general lesson for the United States and its analysts and policymakers is to realize that what China faces in terms of the challenges to its domestic economy are domestic phenomena. And therefore, trade balances and exchange-rate issues are really not at the top of their list or near the top of their list at all on issues they’re really worried about. And therefore, our analysis, A, of what could happen in the Chinese economy, we need to focus much more on the purely domestic dimensions of their trends and cycles. And we also need to understand why the Chinese may not be responding so quickly to our concerns
about international balance of payments and pricing. That’s a quick introduction to the policy brief and we look forward to your questions after the commentary.

MR. BOTTELIER: Thank you. Thank you, Bert. Nick, would you like to speak from where you sit or – it may be easier to do that. For those of who don’t know Nick Lardy, and I don’t think that will be many, Nick has been at the top of national and international analytical capability and experience on China’s economy. He has been an icon in this rather, for many of you, an esoteric field of China’s economy analysis. So Nick, the floor is yours.

NICK LARDY: Thank you, Pieter. This paper by Bert really has two parts; they are loosely linked, but really not very closely linked at all. The first is the challenge of inflation, on which Bert spent most of his time. And the paper is very good in taking us through the previous inflationary episodes over the last couple of decades and raising the question of whether or not we are entering or have entered a third episode, how real is the threat of generalized inflation now, and what is the appropriate policy response.

The second part of the paper is the one he touched on at the end of his remarks. And it really addresses the question of whether or not China’s economic growth in the reform period has been export-led; has a misdiagnosis led to inappropriate U.S. policy towards China? So the recommendations from the first part of the paper are primarily for Chinese authorities. The recommendations in the second part of the paper are primarily directed towards the United States. So that’s just a brief summary of what’s in the paper that you can all read in detail later.

Let me start out by talking about the inflation part of the paper, and I’m going to focus my remarks really a bit on the comparison of the current situation with the previous inflationary episode of roughly 1993, ’96. And the question I want to raise is really how strong are the parallels. Bert, in the paper and his verbal remarks, made a very strong case that in certain critical respects this looks like a replay of earlier episodes. But I have a somewhat different interpretation. It seems to me, the inflation that we saw in 1993, ’94, when the CPI reached a peak of almost 25 percent was partly, if not largely, driven by sharply rising investment. Between ’91 and ’93, the share of resources devoted to investment went from about 35 percent, which by international standards is not low, to 43 percent, which is extraordinarily high. And if you just look at the Chinese data on producer-goods prices, inflation actually peaked in 1993; in other words, a year before consumer price, before consumer prices peaked.

CPI inflation was very low; we saw the diagram. I don’t have any diagrams for you, but I think the factual background has been laid out by Bert. CPI inflation was very low, about 3 percent, in 1990 and ’91 and then as I said to 24 percent in 1994. And it didn’t get back to 3 percent until 1997. But in response to the sharply higher rate of investment, if you look at the Chinese data on producer-goods prices, inflation actually peaked in 1993; in other words, a year before consumer price, before consumer prices peaked. So at least looking crudely at these annual data, it looks to me like the inflationary spike in the mid 1990s was stimulated by sharply rising investment demand that raised the price of investment goods very, very sharply and then fed into consumer prices more broadly, including food, with a lag of about a year. Maybe if you looked at the monthly data, you’d get a more sophisticated
analysis. This is kind of just back-of-the-envelope, but it looks to me like we go from investment to producer-goods prices to CPI-type prices; that’s the direction of causation.

Now, the origins of the inflation that we’re running into now look quite different from the episode that I just described, at least in broad-brush terms. The beginning of the story does have certain similarities; we did have a big increase in capital formation between 2001 and 2004; it went from 36.5 percent up to about 43.2 percent, so very close to the rise that we saw in 1991, ’93, although it was spread out over more years or at least three years instead of two. But what we’ve seen since then is that in the investment share has stabilized over the last couple of years. The investment share of GDP is very, very close, just slightly below the peak of 2004. So within the last couple of years and maybe this year as well – the data we don’t have yet – capital formation seems to be growing at about the rate of underlying economies. So its share has stabilized.

Even though there was a big increase in investment this time, the CPI remained very well-behaved; it went from slight deflation in ’98 to 2002 to very modest inflation of 4 percent in ’04. The year investment peaked 2 percent, then went down to 2 percent in ’05 and 1.5 percent in 2006; so that in this cycle, the investment, the sharp increase in investment did not seem to stimulate the kind of inflation we saw in the last cycle. In this cycle, if it does turn out to be a cycle, the rise in the CPI started in mid-year, this year. If you look at the monthly data, you can’t even see it very much in January and February, but by May, June it’s very pronounced. And as Bert said, it’s primarily in food.

Now, let’s turn to the policy challenge. What is the policy challenge? Bert says food price increases will be difficult to roll back and that it will lead to wage increases and then to more general inflation. Maybe that will turn out to be the case; I would bet against it at this moment. It seems to me, the food price increase seems to be entirely supply-side or at least largely supply-side in origin. And this is not mentioned in the paper, at least as I read it. We have this infectious swine virus, an unusually deadly form of infection, which is usually called blue ear disease, blue-eared pig disease, that has devastated pig stocks and caused a sharp decline in pork production. So this is not farmers slaughtering their pigs because they can’t make any money at it; this is the pigs dying off because of the disease. So it seems to be much more explicitly supply related than demand related, as in the earlier episodes.

Now, the real question I think is, will this shrink in supply be short-run? The NDRC is already reporting that pork prices are beginning to fall from their peak levels of early August; the government has taken a number of steps to try to – they say they have a vaccine. I guess internationally that’s been questioned. I’m not an expert on these kinds of diseases so I don’t have any comment. But the voracity of the Chinese claims that they have a disease and they’re offering incentives for farmers to rebuild their pig stocks, et cetera, et cetera. But anyways, prices of pork are now beginning to come down.

So there is a possibility that what we will see when we look back at this six months from now that we had a four to six, maybe eight-month spike in pork prices and some other closely related products and that it may not lead to general wage inflation or higher rate of wage inflation as the paper postulates.
Bert puts a lot of emphasis on the rising price of grain as the major cause of the rise in pork prices. It is true; feed is about two-thirds to three-quarters of the cost of raising pigs. And if the price of pigs has gone up 90 percent, that means the price of feed must have gone up. If feed is the whole explanation, then that means the prices of feed must have gone up by about 100 or 120, 130 percent. I don’t think it’s gone up anywhere near that much. Bert probably has the data. I don’t have any data on feed prices, but it seems to me that the feed story is not, the feed-price story is not really demonstrated or proven in the paper.

Now, let me go to the main policy recommendation. Bert argues that China should eliminate all controls on cultivated area and let farmers to have complete freedom to decide what kinds of crops and other agricultural products to grow. And that this needs to be combined with a policy of liberalizing imports of fine grains, i.e., wheat and rice and – that’s the recommendation. So liberalization on cropping patterns and liberalization of imports of grain to go with it. I certainly, whole-heartedly, agree with the recommendation. And I would say – but the real rationale for this approach is that the long-term efficiency gains that could be realized from that – I mean, we’ve already got, they’ve already moved in this direction and they’ve got a lot of gains from it over the last couple of decades beginning in the late 1970s, but not only the efficiency gains, but obviously the potential for a much more rapid growth of farm income.

It seems to me there’s an – if you’re looking for economic arguments to adopt these policies, they are very powerful; they’ve been around for a long time. The Chinese government, for a number of reasons, hasn’t bought on – (chuckles) – to this argument, which has been made over the years repeatedly. I’m not persuaded that this short-term anti-inflationary rationale adds much to the story because the corollary would be, well, if you liberalized and you got a big short-term payoff, inflation went away, then you should reimpose the controls after inflation is back down. So it seems to be the long-term argument for moving in this policy direction that Bert talks about is overwhelming; I don’t think the short-term anti-inflationary rationale adds too much to the argument.

The paper also argues for financial reform and that keeping deposit rates above the rate of inflation so that the value of household savings is not eroded over time in real terms and banks don’t suffer from disintermediation and you have more potential or more prospect of avoiding the creation of bubbles in property and in equity prices. In the first three quarters of this year, household deposits in the banking system rose only 762 billion RNB. That’s almost one trillion less than they rose in the same nine-month period of 2006. One trillion is a big number. You know, it’s about 5 percent of last year’s GDP.

So people are voting as inflation rises, the amount of money going into the banking system is declining compared to past trends. And the incremental savings are not going into bank deposits, but are going into the equity market and property. Everybody reads the newspaper; compared to two years ago, the prices of equity are about seven times where they were. So there’s been this staggeringly large run-up in equity prices which has actually accelerated this year as savers have taken their money, increasingly allocating it for equity rather than for bank deposits.

Lots of countries have moderately negative deposit rates from time to time. China is exceptional in that in the current environment, the negative rate on deposits is massive. If you take inflation as it was in August of 6.5 percent, the deposit rate for demand deposits –
that is money that you can take out of the bank anytime you'd like – is currently 91 basis points. So if you keep your money in a demand deposit and according to the Chinese, half of all savings in the banks are in demand deposits, you are earning a negative 5.7 percent on your money in August of this year, you know, maybe 5.5 percent negative last month.

This is a very high negative rate of inflation. And I think it’s creating problems in not so much in the goods market, but in the asset markets, the property market and the equity market. And as Bert points out, this is fundamentally different from the earlier inflationary episodes. In the earlier inflationary episodes, it was a – for household savers, it was a matter of you keep your money in the bank or you go into goods because there were no equities to buy and house privatization was barely getting under way back in the mid ’90s in the last inflationary episode. So in this environment, everyone doesn’t rush to the store and buy vegetable oil, which is what they did in the last 1980s. They open a brokerage account and buy some stocks.

Now, so we may see less CPI inflation in this environment than we saw in the last two inflationary episodes. But it doesn’t mean the risks aren’t very substantial. It seems to me there’s a huge accumulation of risks because of the surge in stock prices, maybe property prices as well. I think the real question, the one that Bert alluded to, but didn’t answer, and I don’t have an answer, is why did the authorities delay so long on raising interest rates. My interpretation is – there’s a big debate in these episodes between the People’s Bank and other players in the system. Yi Gong, the assistant governor, said three weeks ago – he didn’t say we’re desperate, but the body language was basically, we desperately need to raise deposit rates so that they are not negative, so that they’re not in negative territory.

But PBOC does not have the authority to set interest rates on its own; it’s got to persuade others: the NDRC and maybe the state council or maybe even the standing committee of the politburo who knows; it’s a black box. But I certainly think the evidence is that PBOC would like to move faster and other players have not been persuaded of the urgency of the situation; so you get a big delay. And it’s not until you have much bigger disintermediation than we’ve seen so far that the legal dynamic changes and they start raising rates.

Now, let me conclude quickly with – so I’m a little bit skeptical we’re going to see a repeat of what we saw last time around. But I think there are some risks there. And they stem from the financial sector and I certainly agree on the policy recommendations on raising real deposit rates, particularly on the short term and demand deposits. And I certainly agree with the recommendation and liberalization of, in the agricultural sector and on trade and grains.

On the question of export-driven growth, let me just be very brief. I am in complete agreement with Bert that China’s growth since 1978 has not been export-led until the last three years. And I think even if you look at his diagram, his argument falls apart for 2005 and 2006 and 2007. And the reason is, this is the – we are now in a period in which net exports are contributing between a fifth and a quarter of economic growth. That is about 2.5 percentage points of GDP growth in the last three years, including this year, is generated by the increase in China’s trade surplus for goods and services.
The only other periods, if you go back – he doesn’t have ’07 on here yet, but it’s going to be up like this – the only other periods where you see big, red bars on the top, that is where there is a big positive contribution of net exports, is when GDP growth is slowing down. And the mechanism in the past has been very straightforward; that is, when GDP growth slows down, the demand for imports slows down; the demand for exports is much more a function of what’s going on in the global economy. And so, you have slowing import growth with continuing export growth and you get a big increase in the trade surplus. For example, in some of the earlier periods, ’97, ’98, but it’s period when growth is going way below trend.

This last three years, including ’07, is unique. And that is, we have a large positive, contribution to GDP growth by net exports. The average from 1978 to 2004, through 2004, net exports contributed – this is according to official Chinese data, not my calculation – 6.5 percent of total economic growth, on average. That is, more than 90 percent of all growth is being contributed by domestic demand, either investment or consumption.

The last three years, including this year, the contribution of net exports is more in the neighborhood of 20 to 25 percent, more than three times the long-term average. And it’s occurring in a period in which economic growth is extremely rapid. So I think there is something different going on in 2005, 6, and 7 from the earlier period. I do think China can now be described as having export-led growth even though I would agree that, in general, that has not been an accurate characterization of the growth process in, let’s say, the first twenty years of – or whatever, ’78 to 2003, 24, or 4, that is, the first 25 years of the economic reform process.

You can see it in the external accounts; the current account surplus has gone from 3.6 percent of GDP in 2004 to 7.2 percent in ’05, 9.5 percent last year, the largest current account surplus in dollar terms of any country in the world. And this year, it's going to be 12 percent of GDP, just to put that number in context. If anybody remembers, the mid ’80s, when we were concerned about Japan’s large surplus, it was 4 percent of GDP. So China’s surplus, as a percentage of its output today, is three times the peak ever experienced in Japan.

China is in totally uncharted territory, in my judgment. No country other than a resource exporter like, you know, Saudi Arabia or one of those guys, has ever had a current account surplus this big. Obviously, you can find big surpluses in Singapore and some small countries, but not in a big country that’s one of the top economies of the world. And they’ve done almost nothing on the exchange rate; there’s been a little bit of appreciation vis-à-vis the dollar, but on trade-weighted real basis, according to recent calculations. Again, I don’t do them; it’s JP Morgan and Citibank and so forth. There’s been virtually no appreciation of the currency since they’ve announced a supposed change in policy in July of 2005.

So the conclusion I draw here is quite different from Bert’s. I do think a significant exchange-rate appreciation is needed; it’s not – by itself, it will not be sufficient to deal with the problems I’ve just described. But it’s one of several components that are badly needed to begin the process of rebalancing economic growth in China. They need to reduce the
contribution of investment and net exports to growth. They need to raise the contribution of private and government consumption.

And they’ve talked about this now for three or four years. The problem is not just that the authorities have not allowed the exchange rate to appreciate on a real basis, but they’ve also not undertaken the kinds of policies, both in the fiscal side and the financial side, that would contribute to rebalancing. So I think this economy is becoming more imbalanced. It’s current account surplus is going to be even more gigantic in 2008 because there’s nothing in the pipeline that is going to mitigate the trends that we’ve seen evolving over the last few years.

So in summary, I agree with the policy recommendations on the first part, but for somewhat different reasons than Bert puts forth. And I disagree with the second part.

MR. BOTTELIER: Thank you, Nick. It’s a little difficult for me to, I think, add significant additional perspective on the question because I find myself in substantial agreement with almost all of the comments that Nick had made. The focus of this seminar is on the inflation risk in China, but allow me to start with some comments where Nick left off, namely, the exploding external surplus in China.

This is indeed a new situation. This started roughly in the third or fourth quarter of 2004 and I agree with Nick that the current account surplus, China’s current account surplus, is now, for a large economy, out of balance. And we haven’t seen the end of it. I would not be surprised – I would expect it to be of the order of $400 billion this year. But this is not the end of it. We could see a current account surplus of $1 trillion in the next few years on current expectations.

This has indeed created a whole new situation and I think puts me in firm alliance now with the experts at the Peterson Institute and their perspective on the exchange-rate issue. Leaving that aside, we can come back to that in the Q&A.

The paper is focused on the inflation risk; that’s the main seam of the paper. That’s where I’ll focus my comments on. I think in his oral presentation, Bert stressed more the inflation risk than the looming crisis, which is the title of his paper. And I would agree with that, I think, subtle shift in emphasis. Like Nick, I agree with the main recommendations that Bert is making on the policy side with regard to the need to quickly raise deposit rates to at least neutral, preferably positive, real levels. And I also agree with the recommendations to accelerate the liberalization of fine grain imports; I think they’ve been too slow on that.

Though agreeing with those recommendations, I am not necessarily in agreement with the analysis that underlies your conclusions. You draw or you suggest very strongly that there are strong parallels between the current monetary situation in China and that which we observed in the late 80s and in the early 90s, ’93, ’96. I don’t see there is really reason to draw these parallels. While I agree more generally that the risk of inflation in China has to be taken very seriously because of the tremendous monetary overhang, and I’ll talk about that later.
I don’t see too many parallels between the current situation and the earlier episodes. But should I be wrong and should inflation take hold, as indeed, you are not the only one who feels that that may be the case. Should inflation take off, we all have to worry about it. Inflation is an extremely dangerous thing in China. And the Chinese see it as a very dangerous thing. Many of the older leaders remember that the nationalist government might never have lost the civil war between say ’46 and ’49 or ’48 if it hadn’t been for the hyperinflation at that time that mightily helped the Communist revolution in the civil war. And furthermore, the Tiananmen disaster, which by all accounts is perhaps still the most traumatic event that has happened in China’s history – certainly since the market reforms of Deng Xiao Ping in the late ’70s, which has not been digested yet, might not have occurred had it not been for the high inflation at that time.

So I think Bert is entirely right to take this inflation risk very, very seriously, but how serious is that risk? Let me given you a number of reasons why I believe that the CPI inflation risk might be discounted, but two (?) inflation risks plus the asset price inflation – which I believe is the most serious risk – and the CPI inflation. The current CPI inflation, as I think you also pointed out, is not the generalized demand-driven inflation that China experienced in the ’80s and early ’90s.

It’s essentially due to supply factors, supply disruptions, mainly in the food sector, at least so far. And furthermore, within the food sector, we can point to just a limited number of items that are chiefly responsible for the recent spiking in the CPI inflation. Pork has been mentioned, eggs, noodles, cooking oil, and things like that. Grain price inflation in fact, after 2004, has come down.

Other major price indices, including the production-based GDP deflator, as I will show in some slides if there is time later on, are actually pointing down, not up, suggesting that it is more likely that we will see a moderation of CPI inflation in China by the end of this year or early next year.

Furthermore, I’d like to draw your attention to one of the calculations that Bert made in his own paper on page five, where he compares the CPI inflation, that’s the left-hand column, with his own personal estimate of the informal GDP deflator, based one expenditure accounts. Well, you see remarkable parallels between the inflation index and the informal spending-based GDP deflator which to me – because I believe in these numbers – would suggest that the problem next to it is of lesser value and does not really suggest that GDP deflation on a production basis is a harbinger of a major new inflationary wave in China; I think by this column, Bert in fact undermines his own argument.

There are further arguments why I am not overly excited about the current CPI inflation. One is that the indicator for consumer price inflation in the high-income, high-density, urban, east-coast area is actually lower than in interior China. If the inflation had been demanded-driven, as is almost suggested, then the reverse would have been the case. We see higher inflation in the interior than on the coast at the moment.

A further argument is that the room for productivity growth in China is much higher today than it was in the early ’90s or the late ’80s. If there is a risk of demand-driven inflation in China, supply capacity of the Chinese economy is now so much greater and so
much more flexible than it was 15 or 20 years ago that there is a margin of comfort there that lies in the supply capacity of the economy, which we did not have in the past.

Let me then focus on some arguments that might lend support to your cycle, to your argument that CPI inflation in fact is more serious than Nick and I make it out to be. It is indeed remarkable that China’s CPI inflation now, today, is the highest amongst all the major economies in the world. Even up from, you know, on a year-on-year basis of 2.2 percent in January to 6.5 percent in August, now we’ve seen a slight decline in September to 6.2. But still, this is serious.

China’s not the only course, of course, where inflation is coming up again. We see the same problems in Hong Kong and the same in Taiwan. Taiwan also is experiencing higher rates of inflation.

The second reason why I’m not entirely sure that we can relax is that China’s central bank, in its effort to reduce bank liquidity through open market operations and raising the required reserve ratio, which they’ve done repeatedly in the last year or so, have not had the effect of significantly reducing the rate of bank lending. This is surprising. If you look at the narrow concept of liquidity in China, that’s the amount of loanable funds in the banking system, that’s the kind of liquidity that is really the target of the central bank monetary policies. Those monetary policies have not been as effective as we might have expected on the basis of the official statistics. China’s bank-lending rate has not decreased a lot.

That leads me to suggest that there may be something wrong with that monetary policy. We think that this massive issue of central bank bills has been effective in sterilizing domestic liquidity. I’m beginning to doubt how effective that has been. This bills, which are now in total volume much larger than ministry of finance bonds circulating in the interbank market, those bills may in fact be much more liquid than they were intended to be. And that may be the factor that is undercutting, in fact, the central bank’s effort to sterilize excessive domestic liquidity.

Let me then focus on the other kind of liquidity that is the existing pool of money in the Chinese economy that is not necessarily subject to direct central bank intervention. Central bank intervention is focused on that much narrower concept of liquidity in the banking system. I’m talking about the other side of the balance sheet and that is M-2 essentially, all money in circulation plus all deposits, that’s M-2. China has an exceedingly high M-2 GDP ratio.

When I was in China in the early ’90s and it was 70 or 80 percent, we began to worry that it might at one point be 100 percent, which would be an unusually high ratio for M-2 GDP. At the moment, the M-2 GDP ratio in China is of the order of 170 percent, one of the highest in the world. Most of that is deposits. And what were seeing, which Nick pointed out also, that within the composition of deposits – and I have a slide on that; I’ll show you that – you see a marked change from time deposits to demand deposits. And of course the rate at which total deposits is increasing is slowing down significantly, which all suggests that there is a potential liquidity boom in China that could unravel – that could, if unleashed, could significantly worsen the inflationary situation by creating links between the asset price inflation and the CPI inflation which have so far been largely separate.
But we cannot assume that they will remain separate. So I indeed agree with Nick that there is a risk of inflation, but I have a slightly different perspective on what is really on the line in those risks. I believe the internal liquidity boom is a potentially dangerous factor, particularly if it stimulates inflation, the expectations, and one’s expectations take over; all bets are off. I hope they can keep it under control, but we cannot be totally confident they will.

Still, I think on balance, since Nick’s – Bert’s paper is focused on the CPI inflation, I would have taken a slightly different tactic. I would be more relaxed about CPI inflation, but would have drawn more attention to the potential of the unleashing of the liquidity boom. Let me conclude with this one comment; China is not the only country in East Asia with such an exceptionally high M-2 GDP ratio. For the fun of it, I looked at the Taiwan ratio, which is even higher than mainland China’s. Japan’s is also very high. Well, nobody is worried about inflation in Japan, right? But Taiwan now is beginning to have a creeping, upward creeping inflation. So I’m not sure entirely even how to deal with this exceptionally high M-2 GDP ratio.

If China were the only country with that ratio, I would perhaps be more worried than I am not, given the fact that Taiwan and Japan have almost equally high ratios, Taiwan even higher. So let me conclude my comments with that. I could just, if you allow me, just show a few slides to underline – (pause) – this slide, there are only a few of them, is simply to show that the CPI inflation, worrying as it is at 6.5 percent, is indeed a food-price driven phenomenon and it’s not generalized price inflation in China. Many other indicators, as you can see, are stable or on the way down. There is no guarantee it will remain like that because if inflationary expectations may take over.

And within food, as this slide shows, it’s not grain that is the most important factor; grain is in fact fairly stable; it went up in 2004 a lot. But there are really only a few items; it’s eggs; it’s pork, which is not shown separately, and some cooking oil. So it’s a very narrowly supply-driven CPI inflation problem, at this point. These are some other price indicators for services which indicate that the inflation, indeed, at this point is not generalized. Many of the important service price indicators are actually on the way down again reaffirming my argument and I think Nick’s argument that we have a situation today that is very different from the one in the early ’90s or late ’80s.

This is yet another series of price indicators that show the same story. There is no indication that the GDP deflator, the corporate good deflator, the price index, raw material price index or the producer price index are all pointing up. In fact, they are stable or point down. This is what I was talking about earlier. This shows you the change in composition in the total deposits between the less liquid time deposits and the much more liquid demand deposits which, as Nick pointed out, now attract a negative rate of interest of maybe 5, 5.5 percent. It is indeed remarkable that, in spite of that, total deposits have continued to increase in China. I would not have been surprised if total deposits had gone down.

But what I am drawing the attention to is that there is indeed an accelerating shift from time deposits to demand deposits. That is dangerous because the demand deposits will be translated into share purchases the next day. And once people get fed up with shares,
they’ll have to buy something else and that could be consumer goods and then you have generalized CPI inflation. So I’m not suggesting that there is no risk; there is a risk.

This is the last point that I made earlier, this unusually high M-2 GDP ratio for China, which I estimate now at close to 170 percent in 2007, is not unique; look at Taiwan; it’s even higher. Taiwan inflation is well below 5 percent at the moment. And Japan, of course, is still struggling with deflation in significant categories, price categories. It’s very peculiar that these major East Asian economies all have this syndrome of exceptionally high M-2 GDP ratio. If you compare it with some of the major Western economies, they are all well below 80 percent. The U.S. is maybe below 50 percent. I’m just drawing your attention to that because I myself am puzzled by the meaning of the M-2 ratio. And I’m at a loss to interpret precisely what it means. That’s the end of my slides, so thank you very much.

So we shall, and I shall remain here so that I can –

MR. KEIDEL: Can I just do comments in reply to you all first?

MR. BOTTELIER: Yes, thank you for being the corrective moderator. I think the best way to procedure since we have – how much time – about an hour is to give Bert a chance to respond to Nick’s comments, my comments, and then open the floor for questions. Would you like to be here or –

MR. KEIDEL: Well, I just want to thank both of you whole-heartedly for the time and thought you’ve given to these very useful and helpful comments. I just have a few clarifications to make about some areas where I think we agree and then to maybe adjust a little bit what might be seen as the difference between us.

I think the paper – and I didn’t in my oral remarks – the paper clearly addresses the issue that when inflation goes up, the real rate of investment cost, in terms of loan rates, goes way down, and that that has been a consistent pattern in previous inflationary crises. And we’re seeing it again now; the cost to an enterprise of making a loan and investing it has dropped because inflation is so high so that the risk that you won’t be able to repay your loan is actually much lower. And I would therefore say, and I do in the policy brief, remark directly on the significance of an investment surge as a contributor to inflation and overheating.

I wanted to just go back to Pieter’s comparison of these two deflators for GDP because I think it’s a very interesting – if we look at this set of numbers and I don’t – here we go; I’m getting a cursor. He’s saying this is my informal one. And the reason it looks so much like the CPI is that it’s a weighted average of the CPI and the investment deflator, which is what you might expect to be operational. But I would draw your attention to nominal growth here. In the last three years, it’s been over 17 percent so of course, that means that if you take out this kind of inflation – at this level, you can subtract the formal inflation from the nominal growth to get the real growth and not be too far off the answer – you’re in an area where this is 16 percent growth and this is 15.5 percent real growth. That’s quite high. Now, that might be considered to be overheating. Or the Chinese have published the contributions to growth in real terms of the various components of
expenditure account. If you add them up, you get a real growth rate that’s not too surprising; it’s very similar to the official growth rate.

If you use that official expenditure-account growth rate, you get what I have called in column three, the official expenditure growth rate of 6 percent. So I say in the paper, you take your pick; either you’ve got GDP growing at 16 or 15.5 percent – and ask yourself is that an inflationary risk – or you have lower growth, but still 11 percent, and a higher inflation rate on 6 percent that has lasted for three years. Either way, I would say it’s quite noteworthy and would be cause for concern.

The idea that in the last two or three years, China’s growth has become export-driven I think is very attractive given the growing share of the export surge in China’s GDP growth. I would just quibble a little bit that is in export-led when, in fact, you’ve got an enormously rapid growth in domestic consumption and investment that account for much more than half of the growth.

I would suggest that perhaps this export surge is a headache; it’s an unwanted dollop of extra growth that they really don’t need because of the monetary headaches that it might bring and that. Therefore, I would just quibble with the notion that China’s growth in the last few years has been export-led. Exports have become a larger component in explaining where the growth has come from, but it’s by far the most important dimension of China’s growth in the last two and a half years and in this year also have been clearly domestic.

And this isn’t the venue to go into the exchange rate issue. Just for the record, there are a lot of other things that have changed in regard to China’s balance of payments than what might have or have not changed in terms of this exchange rate and in particular, the asymmetrical impact, potentially – I don’t think we know, of China’s accession to the WTO is still playing itself out, one would argue. And I think Nick has some good arguments why that may not be the case that you can point to the fact that it’s played itself out fully. I just think that it may be too early to hang all of our arguments about where this current account surplus comes from. And I focus on, less on current account than on surplus in goods and services because some of the current account is actually capital leakage coming in.

I think that the stock market price is interesting; you could say that it’s a buffer in there for we may not see inflation because this cash – and I think Pieter’s point is very interesting, the M1 now may be taking the place of M-0 operationally within the economy, so that the economy is much more able to make payments and receive payments in ways that don’t involve actual transitions of cash, but that could affect price rises and demand that would affect inflation. So, I think that’s something that we all need to look more closely at and I intend to go upstairs and do some numbers on that and try to see whether that’s really made a big difference or not.

But is that money, then, going into – right for Temple – right into bank account, into accounts at your brokerage house so that it doesn’t ever turn into cash? How is the system treating brokerage accounts? Has it changed and is it really well handled very well? Not so clear to me because I’m not an expert on that, but what’s interesting to me is that the buffer of the stock exchange could lay official government policy changes to forestall an inflationary crisis. They could say, well, you know, and they have said – Greenspan says,
Greenspan wasn't worried about the bubble too much, just called it exuberance, why should we be worried and besides, anybody playing the stock market is rich, so it’s not really going to affect what happens in the society.

To me it would be, if that – if the money going in to the stock market allows the underlying conditions to continue for a longer period of time before they take action, or before they’re forced to take action, it could increase the virulence of the inflation when and if – and I appreciate Pieter’s commenting that the title here, which by the way these titles are heavily laden with Carnegie editorial architecture – (chuckles) – to move it along – the idea for me has clearly always been it’s risk, risk, risk, and why take a chance?

And this idea that demand is driven more highly in the interior, Pieter, that’s interesting; my research assistant Yan Jiang (sp) pointed that out to me also. My point is that the domestic-driven nature of this inflation is not a monetary phenomenon in the sense that we’ve seen it so far. What’s pushing prices up well over deposit rates is a cost-push; some of it’s the disease in the porks, but I think it’s the grain issue also in terms of feed and I don’t think 100 percent of pork, of pig feed is grain so how you make that calculation backwards to the influence that it has, particularly if profits get squeezed and we’re seeing then a surge in prices, but it’s – the risk I’m talking about is what would happen if the monetary influences became operational in the inflation, that’s the risk, that you get this overhang suddenly expressing itself in prices rather than in, say, the stock market.

But what’s making that a risk is this cost-push that’s coming from the agricultural areas in the interior that’s pushing CPI inflation up above deposit rates for demand deposits which is, as Nick says, essentially just 1 percent. So, I think we may agree more than it seems in the distinction about the causal processes here.

And I – let me just make sure that I – the grain policy issue that Nick has raised as being a long-term policy, of course that’s a long-term policy and I think we all agree. My point is that that cycle that’s brought about by that long-term trouble. By not importing grain, you cyclically go through a process where you have to encourage grain planting, it happens too much, you get some good weather, the grain price drops, farmers have terrible consumption; all of this is either – is spelled out in the policy brief and also in this report and I think what would be for most of you mind-numbing excess. But the cycles in it, then they have to relax grain planting, farmers get out of grain planting in a jiffy, and eventually you have supply problems on grain supply that then feed their way through.

So to me, that process and the policy recommendation therefore is to avoid or remove the underlying condition that makes this kind of inflationary risk repetitive and cyclical. And I agree that doing something about it right now won’t affect the short-term price risk. But I’m just pointing out that in the long-term, if we want to keep this from happening in the future, that’s the major variable that we need to address. And that’s about it.

MR. BOTTELIER: Thank you very – I’m impressed that on a difficult, technical subject like this, I see so many people still wide awake – (chuckles). Now is the chance to broaden the discussion and I believe there is a microphone. This gentleman in the front is Mr. Paal – would you introduce yourself?
Q: I'm Doug Paal, I'm here in my personal capacity. I wanted to push three distinguished three economists to make a kind of political call. There are a number of analysts here in town, some next door, who have been saying that the excesses you've been describing are partly a result of preparation for the party congress. To get along, people are going along with a lot of things that nobody wants to turn off the party to take away the punch from the stock market run-up. Nobody wants to cut off the lending in the provinces that are important to the provincial power structures. And you've cited all of these in a different fashion, but all pointing to the same outcomes.

Is there anything, therefore, in this latest party congress that suggests to you that there are decision that will follow now that couldn't be made before based on personality, experience levels, for whatever you can identify in the new arrangement of Chinese leadership? Thanks.

MR. BOTTELIER: Thanks – (chuckles).

MR. KEIDEL: I can say something about this. We had an event here yesterday with Ambassador Stapleton Roy and Michael Swain and myself and one of the things I said was I was delighted to see the party congress announce so early because in the first place it meant that they had their act together, that there wasn't a huge rancorous fight over who would get what position. And secondly because the earlier the party congress, the better the chance that they might then do something to preempt inflation once they get the personnel decisions made about who's going to be on the standing committee in the politburo. And so, I'm hopeful that we'll do that.

The background from the party congress to this is this definition of scientific development, which was now enshrined in the constitution and the first component in what is scientific about it is to put a lot more emphasis on the science of macroeconomic policymaking. For a lot of other reasons, I think it's quite a significant – you know, miniscule shift it looks like – but with major implications. But that – the only question I have is whether they can afford to do something now or whether they think that have to wait until the national people's congress in March to line up the whole state council and the positions and the planning commission and the central bank and whatever might change in that regard. If they think they've got all that nailed down, and you had, you know, Li Keqiang was commented on in many of the write-ups, not in the official documents, as the executive premier to be, and Xi Jinping is going to be maybe in two years named the vice commissioner of the military commission and will be, since he's the secretary at head now for the politburo and the standing committee in the politburo, that he's clearly the anointed one to be party secretary.

If that's all so strongly entrenched, now they don't need to worry about March and the NPC and where the government positions are going to be done, then I might expect them to move a little more quickly if they're skittish about not wanting to look like they don't have – they're worried about strengthening the opposition to some of the appointments they want to make, they may hold off again, which I think would be a mistake, but that's a good question.
MR. BOTTELIER: Allow me just one or two supplementary comments, prefacing it by an exclamation, and that is I miss Zhu Rongji – (chuckles). What we are seeing is an able government, technically very competent, but politically much less adventurous or courageous or decisive. We have much more decision making by committee than we had in the '90s. Now, that may be more democratic but China’s economy, I think, is now suffering from an excess of gradualism. The enormous external imbalance that has developed in the last few years would not have happened if Zhu Rongji had still been in charge. They would have raised – they would have appreciated the exchange rate must faster and they would have ensured that deposit rates would not become so wildly negative as they are at the present time.

Whether we now can look forward to a sort of more aggressive economic policy stance now that the party congress is behind us, I’m not confident at all. I think we are suffering from an excess of gradualism.

MR. LARDY: I think I agree pretty much with Pieter. I think there’s been a very large disconnect between the articulated objectives of the current administration in China, Hu Jintao and company, and what they’ve actually done in policy terms and it’s very difficult to explain. Hu Jintao stands up at the NPC and says we must reduce our excessively large trade surplus, and they’ve done almost nothing. They’ve adopted almost no policies that will have a perceptible effect on it. So, in 2004, the central committee said we need to rebalance economic growth. Again, they’ve done, three years later, they’ve done almost nothing to accomplish that objective.

So, they say they want to have more environmentally favorable growth; again, complete disconnect. They’re not doing what they need to do if they really want to have – achieve that objective. So, I think just, you know, they say they want less income inequality and you look at the policies they’re adopting; they’re exacerbating income inequality. So, I’m not optimistic that this will change as a result of a party congress.

Q: Dan Newman with Inside U.S. Trade, the – one of the major drivers in current U.S. policy toward China is in the strategic economic dialogue in the JCCT is to move China away from this what they identify as export-led growth and what Secretary Paulson has identified mainly as by increasing market access and increasing domestic consumption. One of the major U.S. industries that’s recently been screaming about market access and the shutoff of their market access is the pork industry, the U.S. pork exports to China were recently cut off, they say politically because of U.S. concerns that were raised about food safety; China says because of a food additive that 24 of the 25 major pork exporters use, which they find questionably allowable.

Would – if the U.S. government were successful in increasing this market access for pork and for some of the other agricultural industries that want to get into China, would the government essentially be then unwittingly solving both of the problems that you have identified today from the IIE perspective regarding balancing the trade surplus and addressing the inflation risks?

MR. KEIDEL: Yeah, I just think that pork is the next stage and importing pork as opposed to importing grain, it would certainly help alleviate the problem. I would say that
the problem with importing pork from the Chinese side may be that it might really hit farmer incomes more because that’s where they can make more money and if you introduce world price, particularly with a nominal appreciated currency, it may have a damaging effect on rural incomes and I think that’s one of the concerns that they have. It also may be that they’re not ready to make a major shift that would favor the U.S. in terms of trade unless the U.S. gives them something else, say in dual-use technologies or something like that. So, that’s a very complicated, murky world but in principle, I think you could help control this inflation in the rise of pork prices by certainly allowing good quality pork to come in and I think that’s what they might do. I think they, as I said, they’re concerned about incomes in rural areas.

MR. LARDY: Yeah, but I would just quickly add, it will have zero effect on the kind of global, you know, China’s gigantic current account and goods and services surplus.

MR. BOTTELIER: One supplementary comment, I agree with your comment that it would be in China’s interest to liberalize a number of imports, including pork, and I’m not an expert on this health reason stuff as cited by the Chinese for taking it easy on that. Incidentally, they’re also still banning U.S. beef imports, you know, for alleged health reasons. One comment on the consumption growth, there’s a lot of misunderstanding on that. People think that because the consumption GDP ratio in China is so low, particularly household consumption is well below 40 percent now, that that would be an indication of slow consumption growth in China; nothing could be further from the truth. China’s consumption is growing three times as fast as in the U.S.; it’s probably the fastest consumption growth in the world in absolute terms. But the point it its share in GDP is declining because GDP growth is even higher than that.

What is underlying this lagging consumption growth even though the absolute rate is very high, that I think is probably the main factor is relatively slow official employment growth. The share of wages in GDP in China is now one of the lowest in the world. The share of profits in GDP has increased enormously in China, which is one of the main factors explaining and driving this investment boom; it’s all self and ends (?), not bank credit finance.

Now, there may be a problem here, a statistical measurement problem because what the official employment statistics tell us is that employment growth is very low, between 1 and 2 percent, and that would then explain the declining wage GDP ratio and the declining consumption GDP ratio. But is that the truth? Many people are arguing that most of the employment growth in China’s booming informal sectors on the east coast is not measured at all, that in fact employment growth is much faster than the official statistics indicate, which might also indicate that total wage income is much higher. And if that is true, total GDP growth might be higher. That’s a link to a comment that you made earlier, that if you take the GDP deflator on an expenditure basis seriously, as I’m inclined to do, then by implication, your GDP growth is so much higher and I would not be surprised if that really is the real story, that China’s GDP growth is running 2 or 3 percent higher than what the statistics indicate.

Yes, sir?
Q: Thank you, Keith Krulak, Department of State, I have three questions, they’re somewhat related. The first one is the actual statistics themselves; we’ve talked a lot about statistics, various types of statistics. I mean, can we trust the statistics? You’ve just indicated one important statistic, GDP, could be totally off because of certain measurement issues. I mean, that’s, I guess, a primary concern is how reliable are these? What are the risks upside and downside if these are mis-measured?

Second thing, grain prices in world markets, I believe, have gone up recently. Has that factored into grain price increases in China, or more broadly, do world commodity prices have an impact on prices in China, and to what extent? And the third point is, if China is experiencing inflation or will experience a greater amount of inflation, what does that mean for the rest of the world in terms of pricing?

MR. BOTTELIER: Thank you, three very excellent questions. Nick, you might wish to take at least one of those three.

MR. LARDY: Well, I mean we could spend all day on that and Bert’s just been at a conference talking about this in China. The only safe thing to say about Chinese statistics is that some of them are reasonably good and some of them are useless and I would put in the reasonably good category most of the monetary data. I think when they tell us M-0 is this amount, it’s not that hard to measure, you know, when they say loans have gone up by this amount, I think those numbers are likely to be extremely accurate. At the other end of the spectrum I would put data on the labor force, particularly this has been a problematic era for more than a decade, and some of the price data, I think, are somewhat questionable.

In terms of China’s influence on, you know, rising inflation in China in terms of its influence on global prices. At least at the moment there’s no risk. I mean, prices of goods imported into the United States from China today are the same as they were in 2–5 when the currency started to appreciate nominally vis-à-vis the dollar. So we have 10 percent appreciation vis-à-vis the dollar and the prices of Chinese goods coming to the U.S. are unchanged and that suggest a very high rate of productivity growth that allows exporters and producers to absorb the increase in the value of the RMB vis-à-vis the dollar. And there is no price inflation for the goods that we’re importing from China, you know, IT hardware, consumer electronics, those kinds of things are not going up in price; I think they’re going down in price in China by about 5 percent per year.

MR. KEIDEL: Those are great questions, Keith. I think the stats, I always like to say, it’s important to know what you want to use them for. GDP is clearly full of problems and one of the paper I presented for the statistical bureau and reviewed critically was how they do quarterly GDP and really, saying it’s gone downhill in the last ten years. I think, survey data are better than administratively reported data, so that should point to better household information so when you try to measure different – and migration affects the denominator in per capita measures, so you need – these are all sort of things to be careful of. Prices are supposed to be calculated by surveys, but of course they also still use book prices and then, initially produce things in book price form of statistics and then you have to do your calculations. That’s why these GDP deflators are so quirky.
And in the household, they – the household surveys there are two of them, urban and rural, and they miss the migrants in large part, so it really depends on what question you want to answer. And so, I also – they’re also subject to political pressure, I think, I know from the ’90s, the inflation numbers from direct contact with the statistical bureau people, were clearly fiddled with to try to meet certain political needs. And I’m not surprised if that’s not the case now. So, I – I share your doubts but I’ve also worked with data from India, and from Kenya, and they’re so much horrifically less transparent and worse that you have to work with what you have. And in the broad perspective of things we have a good picture of what’s happening in China that’s not happening in a lot of other countries, so I share your concern.

I’d just point out that inflation and its impact on the rest of the world should have, if it gets very strong, should have the same effect as the real appreciation of the currency. So, it’s interesting, reporters call to say, my editor’s really worried about what inflation might mean. And I say, well just tell him it means that they’ll effectively be appreciating their currency a lot, and if that’s supposed to be a good thing, okay, then go ahead with it. And the rise in grain prices in the world, and some of the largest rice exporters are Thailand and Vietnam; China has different regions, some are surplus, some are in deficit and so, officially is net. And also, grain covers potatoes and soy and a whole bunch of other things that – if you don’t find grains, wheat and rice, there’s very little net trade, but that doesn’t mean there aren’t inflows and outflows because south China is a pretty porous region of the country, so I wouldn’t be surprised if that has had an effect, that there’s some effect of this international fine grain price increase on fine grain prices within China.

MR. BOTTELIER: Allow me one supplementary comment, I agree with everything you say on the statistics and also on the links between domestic and international grain prices. If we don’t see a significant increase in China’s export prices, as Nick stated, it seems to be incidentally somewhat in alliance with the DEA statistics which claim that China’s export prices have turned up to the United States, but –

MR. LARDY: That’s only in the last six months, I was saying if you take the full period from June before they changed the exchange rate to the end of the September, Chinese prices are up 0.2 percent.

MR. BOTTELIER: Okay, over a two-year period, correct.

MR. LARDY: Two years and a couple months.

MR. BOTTELIER: That’s great, but the question – if I may, just draw your attention to a phenomenon or to a factor that may explain all that. How do we explain that China, with domestic wage increases in real terms now, according to many sources, running at around 10, maybe even 15 percent per annum on the coastal zone, land prices rising, utility prices rising, how do we explain that there isn’t more inflation in China, certainly not export inflation?

Well, the only underlying factor that explains all that is continuing very high productivity growth in China. It’s a factor that is very hard to put your arms around because it is so hard to measure, but people have made very serious productivity analysis, either at
the firm level or secretary level or nationally, all come to the conclusion that productivity growth in China continues exceptionally high, at the national level at least three times the productivity growth in the United States. Well, if you have that kind of productivity growth, you can accommodate a lot of cost increases without inflation, and I think that’s probably the single most important factor.

MR. KEIDEL: I would agree, and that’s in both – that’s a lot in here, what that means, and it comes in labor-saving techniques. There’s a lot of labor-saving techniques they can introduce.

MR. BOTTELIER: On that point, if I may for those of you who are interested in that point, I’ve been somewhat associated with a very long, profound analysis by experts who work for the conference board who have access to the original Chinese national bureau of statistic database on 20,000 firms, where they’ve done firm-level productivity measurements between ’95 and 2003. Their conclusion is that labor productivity, which is the broadest concept of productivity, per annum in the manufacturing sector was 20.4 percent; this is unbelievable, this is totally astonishing. This explains so much of what has happened in China since the mid ’90s.

Initially, much of that productivity, phenomenal productivity increase, was of course driven by the massive layoffs in the state sector which became possible from ’95 onward. From the late ’90s, my guess is, the productivity growth continued strong, not so much because of continuing layoffs, but because of massive technological upgrading in China’s manufacturing sector. Many of China’s manufacturing sectors are now state of the art; they can compete, you know, with the best technology available in the United States and Europe and Japan, you’ll find that in China. That has driven further productivity growth.

What we have also seen is that China’s infrastructure has improved significantly, partly as a result of government supplementary investments in infrastructure, but the – the effect of that is that logistics costs for enterprises have declined in China; in most countries they increase. In China, because of the enormous improvements in infrastructure, telecommunications, roads, ports, what have you, have declined – allowed enterprises to reduce their logistics costs. All these factors have combined to sustain a very high level of productivity growth, which is one of my reasons to say that we do not really have to fear too much about demand-driven inflation in China at this point because the supply capacity of the economy is colossal, more than anywhere in the world at the moment.

Q: I’m Catherine Gelb with the U.S.-China Business Council. I wanted to get back to the interest rate question, I mean – I mean, Nick pointed out that there seems some sort of disconnect between well, what the data are saying and what the government’s been willing to do. I mean, can you guys explain a little bit more about, on the other side, why they’re not raising interest rates as quickly as it seems that they should? Or maybe they’re not as concerned about it as you are?

MR. LARDY: Well, I can offer some hypotheses; I don’t know how strongly I want to support any of them. But certainly, one is the concern about bank profitability, number – you know, they’ve poured hundred of billions of equivalent, U.S. dollar equivalent, into recapitalizing the banks and one of the ways they’ve tried to reduce that cost or make it
smaller than it would otherwise be is to create an interest rate structure that has very high 
spreads between lending rates and deposit rates, so that banks can be profitable and build up 
their capital in part through retained earnings rather than handouts from the ministry of 
finance or foreign exchange reserves or some other source. And so, that’s a constraint on 
policy

Now, then the question becomes, well, they wouldn’t just raise deposit rates because 
the lending rates are also too low; why don’t they just raise the whole structure? Then you 
get into a second hypothesis which is that they are fearful of doing so for fear that they will 
attract more foreign capital inflows. Again, the idea here is that you don’t have much 
monetary policy independence if you have a fixed, highly undervalued exchange rate because 
market participants anticipate there will be some appreciation and the policy of the 
government has been to try to keep deposit rates so low, so people can’t bring their money 
into China and earn a high rate of interest plus whatever the expected appreciation is. So, 
they’re trying to keep the deposit rates below international rates or U.S. rates or some 
benchmark.

Now, again that’s debated; some people say that’s not really a factor, they have these 
capital controls and then they leak a little bit, but they don’t leak that much. But the central 
bank and other people in China from time to time suggest they don’t really want to test that 
by raising up their interest rate structure. So, I think those are two factors. The idea that 
you get a subsidy to the bank – and this is, this is basically, the first argument it’s basically a 
very high degree of financial repression in the financial system and – or put it another way, 
it’s a very large, implicit tax on depositors, particularly households.

And I have a diagram which I didn’t bring, but I’ve used in other context, which 
shows if you compare the mid ’90s with – you know, roughly ’93, ’94 with 2003 – household 
deposits in the banking system as a share of GDP went from about 40, 45 percent up to 
about 70 percent as part of this ratio that Pieter was talking about earlier; I’m just looking at 
the household side. In the mid ’90s, in part because the indexing system was in effect, that 
Bert was mentioning, was in effect for part of that time, the earnings on these deposits were 
equal to about 5 or 6 percent of GDP. Flash forward 10 years, household deposits in the 
banking system are 70 percent of GDP, and interest earnings are 2.2 percent of GDP; in 
other words, that stylized facts are roughly, that they’ve double their stock of financial assets 
in the banking system, and the interest that they’re getting has been cut in two-thirds.

So, this surprised me because I tend to be very supportive of the kind of financial 
reforms that have gone on in the last five or six years, I think the banking system has made a 
lot of progress; we know it was a highly repressed system back in the ’90s, so I thought well, 
the degree of financial repression must be going down. But at least on this metric, which is 
basically a household perspective, the system is more repressive than it was a decade ago and 
my last data points, since these come from a data series that has a long timeline, is 2003. But 
if you look at what’s happened to real interest rates since 2003, particularly this year, the – 
you know, they’re highly negative, more negative than any other time over this period.

So, households are taking it in the form of highly repressed interest rates and so 
they’re looking for other assets and I think Pieter is absolutely right. The risk is they will 
move increasingly in this direction and you have household deposits that are equal to 70
percent of GDP, half of which are now in – I think this data was a little out of date, at least according to what I’ve read – so it can be moved over night into other asset categories. It can be moved into goods, which Bert has talked about, it can be moved into the stock market, it can go into property, et cetera. So, those would be two hypotheses about what’s going on.

MR. KEIDEL: I would just support Nick’s hypotheses, I think particularly the second one, that there is official political concern about raising lending rates. And as Pieter pointed out, actually most investment funding doesn’t come from bank loans, it comes from retained earnings and individual equity contributions, which you could argue because they price themselves at the opportunity cost of what else they might do with their money is actually pretty market based. But the loans, I would second the notion that China has a repressed financial system.

I would just point out that they’ve used this to finance infrastructure and so that you get, and that includes pillar industry expansion so that you have the planning commission, the NDRC, with a whole program that’s budgeted out to expand a whole series of things that are classified as what they call public investments and they’re really concerned about keeping the costs down going forward of those investments. And therefore, they want to be able to milk the bank deposit system the way Japan has done, and in particular in Japan’s case the postal savings and other kinds of asset sources, and their attitude in my thinking, how they think about it is, look, if you’re a Chinese person and you don’t want to take any risk, you want to be a completely passive investor, you don’t deserve anything. You don’t deserve squat because you could walk out the door and invest in your brother’s restaurant and make a lot of money, so we’re going to thank you very much, take your money, and put it into infrastructure and other public investments that are going to grow this economy.

But to do that, you want to keep the cost down and they’ve got their budgets and so forth and the way to do that is to resist politically, as Nick has said, the state council and the politburo level, increases in interest rates because they would translate into increases in loan costs for a lot of these public projects and there’s this philosophy and what the bottom line would be, while a repressed financial system may be an important part of a successful financial system for a country going through this phase of development, which is not the evaluation you would get from a bank of international settlements or an IMF or some other evaluation of how a financial system should function with much more of a fiduciary concern or much more of a free choice for your depositors’ concern. But as a nation, the leaders of the nation may decide that, if we’ve got these passive investors, they don’t deserve a thing.

MR. LARDY: Well, this is a continuation of an argument we’ve had in the past, so I’m deeply skeptical of the idea that a highly repressed financial system has a net positive contribution to anything except income inequality. This is a regime that claims to be very concerned about income inequality. Now, look at either the Forbes new list or the – what is it? The Shanghai Indigenous Organization, Huanren (ph) or something, I don’t – they all have these lists of how many billionaires there are in China, this is a rather large number for a country that has a per capita income of $2,000, almost as many as the U.S., and you look at what sectors are they in? The vast majority are in property.
Well, what’s property? It’s highly leveraged; they put in almost none of their money. The construction companies and the real estate developers have gotten rich. They borrow money at a zero real interest rate from the banks that finances 90 percent of their activities, and you’re basically transferring income from households in general who are saving because there’s no pension system and there’s no healthcare and there’s no anything else. And you’re handing it over to people that are, you know, have become billionaires; they would not be billionaires if they had to borrow at a market interest rate.

So, maybe a little infrastructure gets financed this way, but there are lots of other negative things going on and I think for a regime that claims it’s concerned about rising income inequality, ought to start looking at what their interest rate policy is and who’s borrowing the money. It’s not – it is true in the manufacturing sector; most investment is finance from retained earnings and depreciation funds. But in the real estate sector, borrowed money is extremely important.

They’re trying to reform this by saying that developers have to put at least 20 percent of their own money into these projects before the bank can lend, but that has not been – whether or not the banks are enforcing these new regulations or not, I’m not sure, but anyway, these regulations did not exist in the past when these massive fortunes were created. You know, Rolls Royces selling more cars in China than anywhere else, they have more dealerships – you know, they’re opening new dealerships, I mean every indicator of extreme of income inequality is visible in China and this is not an accident; it is a function of government policy.

Q: Thank you, Harvey Feldman, Heritage Foundation, this has been a marvelous learning experience for an economic illiterate like me. But I have further question which will probably demonstrate the extent of my economic illiteracy. Pieter, you have – I want to go back to your point about the financing of, no, of the productivity growth and my question is, how is it financed? Now, you’ve said that what is happening is the creation of something approximating state of the art manufacturing techniques in these export industries, perhaps some of the domestic industries as well. At the same time, we’ve just been told repeatedly by both Bert and by Nick, that companies finance by retained earnings, not by borrowing.

MR. LARDY: The manufacturing companies –

Q: Manufacturing companies, that’s what I mean. Manufacturing companies finance their acquisition of these state of the art manufacturing devices by retained earnings and not by loans. Surely, this would result in, I would think, a price appreciation, which we do not see as Nick has pointed out. I expect, or I guess, Pieter, that your argument is that productivity growth is so high as to absorb these costs as well and that’s why we don’t see price growth. Is this the case? How are these manufacturing innovations financed?

MR. BOTTELIER: I don’t think there is much of a problem with your illiteracy in economics, these are very, very good questions. Let me have a stab at them.

What has been observed, particularly in the manufacturing sector, but also in the economy as a whole, is tremendously high productivity growth since the mid ’90s. What we are seeing since the turn of the century, since around ’99, 2000, is a very sharply increased
profitability of enterprises in China. We all hear about these cutthroat competitions, low margins, forget about it; China manufacturing sector is very profitable, local as well as foreign companies. It’s – every profitability is now at or above American levels or European levels.

That is the main factor, the upswing – excuse me – the upswing in corporate profitability is the main factor that explains the increase in the investment rate. It’s not bank credit, it’s self-raised, what the Chinese call, self-raised funds. Most of that is internal retained cash flow; nobody pays dividends, everybody expands, expands, expands in order to increase or at least preserve market share. And that is, more than anything, explained by – is very sharply increased in returns on capital, particularly in the manufacturing sector.

The self-raised funds, which is – accounts for more than 60 percent of corporate investment in China, includes principally, as I mentioned, retained profits, but there are other factors as well. Don’t forget that since the late ’90s, China has privatized all, almost all urban housing, a massive amount of wealth transfer to the new owners of those houses, but also significant relief on the cash flow of the corporations that own those houses. They no longer have to build new houses; it’s all privatized now. Where did the additional cash flow go to get them to investment? That’s another part of the explanation of the puzzle.

Where do the proceeds of privatization go in China? If you privatize a company in the UK, the minister of finance gets the money in the budget; no such thing in China. All that money goes back the very enterprises that are being privatized or their holding companies that may decide to allocate it to somebody else in the group. These are all accelerating factors that explain this tremendously high corporate investment level, which underlies, I think, one of the factors that is driving productivity of course, and the state of that art technology that you find now in sector after sector.

With an eye on the time, what I would like to suggest, since several of you have raised hands, that we take three question and we will try to remember what they were and then respond to them.

Q: Ben Cushman, here on my own behalf, we’ve alluded today to the – or you’ve alluded to the struggle within the Chinese government of using monetary tools to stem inflation or administrative measures, I guess administrative measures primarily being controlled by the NDRC. So, I’m just curious, and for example there’s been some sort of anti-collusion campaigns, I think one that comes to mind is against manufacturers of fong bien mien, the instant noodles, from raising their prices, and then also a decree that local governments couldn’t increase administered prices, I think, for the rest of the year. I’m curious, you know, how much of the CPI is administered prices? And you know, if we see, you know, so – for example, maybe the food prices increases, maybe pork prices are one of the only prices that actually could move in the consumer basket? So, my question, I guess, is how effective are these price controls and are they sort of keeping CPI inflation from jumping more than it otherwise would?

MR. BOTTELIER: Thank you. You glass – anybody else? Sheldon, yeah?
Q: Sheldon Ray, UBS, my memory serves me correctly, it’s questionable, the Hang Seng index in Hong Kong went up 120 percent, I think in ’93 which correlates with your Chinese CPI going off the charts. And as you mention, it’s a totally different world today with the stock market situation. But, it seems to me that the stars are aligned with Chinese insurance companies being allowed to invest outside the mainland, the public on the verge of that. Funds could come out of the mainland and drive Hong Kong to insane levels, to unsustainable levels, and even cause unbelievable pressure on the maintenance of the Hong Kong peg to the dollar. Any comments on that would be appreciated.

MR. BOTTELIER: If there are no other takers, I think we’ll try to deal with these questions, both relate to price factors. In the case of Ben Cushman’s question, more on what is the – how much is the CPI still reflecting today administered prices. Let’s take that one first. Nick, would you like to comment on that?

MR. LARDY: I defer to Bert, I don’t – the only thing I can think of in the CPI that’s administered are utility prices and pharmaceuticals. I think the weight, well I suppose education would be another one, but it seems to me that’s fairly small share of the total CPI. But I defer to those with greater knowledge.

MR. KEIDEL: No, I’m not but – I think it depends on what you mean by administered. They no longer have pai xia (sp), list prices or anything like that, but the activity of the price bureau which is directly under the control of the planning commission of NDRC, has really been gassed up in the last nine months with lots of directives going out to make sure that prices don’t rise too fast.

And so when you get also regulations about anti-collusion, then you can go after somebody whose price has gone up and say you’re colluding. I mean the evidence, or what the reason was, is something else. So, there’s clearly been an administrative effort to keep prices from rising. And as we know, also to not even use the word inflation, and Xiu Zhoujin (sp) actually mentioned that in his press conference, he said, you know there’s a different price rises and inflation. Well, that’s true in Chinese, Chinese is tenghua pengxia (ph) which means going through monetary phenomenon getting a price rise, so it’s kind of like, they used to say, we don’t have deflation because our money supply is increasing when the prices were falling. So, they have a very literal translation or almost a mistranslation of inflation meaning almost going back to the 17th century when you had more gold, all the prices went up.

But price rises as – that term, therefore, has been forbidden to be used in local settings. But I think more than that, we’re seeing a lot of efforts to subsidize, which is the other side of price controls, subsidize certain production processes like pork or pork transport, things of that kind. So, there’s all of these ad hoc methods and so I share the concern that the CPI may not really be reflecting price pressures that exist even if they’re not expressed in the prices that people have to pay.

MR. BOTTELIER: Would you like to comment on the second question, either you or?
MR. KEIDEL: Yeah, well I think Sheldon had a guest the other day, KC Kwok, chief economist for the Hong Kong government, who answered this question in his way with all of the investors given permission through qualified domestic investor, you know, funds, to go to Hong Kong and invest. Isn’t this going to -- bottom line, your question is, isn’t this going to un-peg the link between the Hong Kong dollar and the RMB at some point, because that would mean un-peg the Hong Kong dollar from the U.S. dollar unless there’s some dramatic change in the RMB dollar rate. And my understanding is that the Hong Kong folks are just ready to let that money go into their system and work its way through the monetary – the currency board system that they have. But he also made the good point that these really represent rapid increases in real assets whose values are being expressed in our stock exchange.

And so therefore, the degree to which, you know, that might affect the exchange rate and so forth is limited in that regard. The money going, how money Hong Kong dollars are you going to buy, but then what are you going to do with that money? It could be inflationary, but then if it’s inflationary, if that money stays in Hong Kong, but if it doesn’t – if it’s just somebody else bringing dollars in, fine, some shares of an insurance company, a mainland insurance company, and then that money leaves Hong Kong – (off mike) – or that it will pour out again – (off mike) – ah, well then you have to say, what happens when there’s an IPO.

Oh, I see, you’re saying that it’s going to be locked up in brokerage accounts in Hong Kong. My -- I think we can expect that the Hong Kong system will just let that ride. I mean, he was asked, do you see any process or possibility of change or merging between RMB and the -- RMB and the Hong Kong dollar or the U.S. dollar. And he said, well clearly everything’s going to, in 40 years once one country, two systems, we’re going to see some adjustments, but until then we don’t expect anything. And I think, well he’s obviously going to say that anyway to support stability, but I think that the currency board system can probably take it.

MR. BOTTELER: We’re almost out of time, allow me just to make one or two comments on this intriguing question that you put here. What we have seen is an accelerated opening of – or intended opening of China’s capital account since the announcement of 20 August that Chinese households would be permitted to invest, in limited amounts, on the Hong Kong stock exchange, the Hang Seng has risen by well over 30 percent as you know, that’s your point. Not a penny has actually moved, so this is on the mere expectation that this will happen and it’s explainable by the difference between the domestic A price and actually the Hong Kong H share price index.

My observation is this, we may be seeing the beginning of an accelerated opening of China’s capital account. That would have major implications for China, but also for the rest of Asia and the world because once money is in Hong Kong, it can be anywhere. I mean, the households that may invest in Hong Kong could sell the next day and then ship the money to New York. There is a wall of liquidity sitting there in China that may actually begin to spill over on the international capital markets and have implications for asset prices, not just in Hong Kong, but in many other markets as well.
Well, that’s separate measure, that was just a few days ago that they were allowed to invest up to 50 percent of their accumulated funds in non-Chinese foreign assets. What I’m suggesting is that we may be seeing an accelerated opening of the capital account and it is not just Hong Kong because Hong Kong is part of the global economy, so watch what’s happening here. They may, in fact, trying to accelerate, which seems to conflict my earlier complaints about an excess of gradualism, that may in fact be trying to accelerate now the outflow of capital to reduce domestic liquidity pressures, but the effects will be felt around the world.

MR. LARDY: But, Pieter, do you think that if it gets out of hand or there’s a crisis, that they won’t pull back somehow or adjust the policy or sort of correct it, I mean isn’t that the pattern over the years?

MR. BOTTELIER: There’s always a big difference between Chinese announcements and the implementation. I mean, there hasn’t been an announcement on how it would actually be done.

MR. LARDY: Isn’t this telling us something? Normally, you have a big announcement in principle, and in a few weeks, not many weeks, you get the implementation rules? This was announced two months ago and as you just said, not a dime has moved. I think they’re having second thoughts about the whole process and we’ll have to wait and see.

MR. KEIDEL: Well, thank you all for staying so long and providing us so many stimulating questions. We’ve reached the end of the hour and we look forward to seeing you again and if you have any further issues you’d like to raise with us.

(END)