

## China's Looming Crisis— Inflation Returns

ALBERT KEIDEL

Senior Associate, Carnegie Endowment for International Peace

China's longest-running economic boom since reforms began may finally be coming to an end—possibly a difficult one. As Americans focus on criticisms of Chinese commercial practices, China's economy surges on. It grew an astounding 12 percent in the second quarter of this year. But as this surge has accelerated, inflation has begun to stalk the land. This spring and summer, food prices jumped dramatically, and China is now careening on the brink of dangerous overheating.

China's economy today looks much as it did before the inflationary catastrophes of 1988–1989 and 1993–1996. And as in the past, China today faces more than inflation. If inflation gets out of control, draconian steps to suppress it could cause hardship and social unrest. The consequences would hurt not just growth but also China's commercial and political relations with the United States.

China has the domestic policy tools to limit inflation to moderate levels, but if history is any guide, policy adjustments will be too little and too late. If inflation gets out of hand, strong decisions like those in the past will eventually restore social equilibrium and rapid growth. But the costs—in delayed progress, public dissatisfaction, and international criticism—could be high.

The next fifteen months will be especially crucial for China. Foreign criticism has already been severe, thanks to imbroglios over food and toy safety, dollar-holding scares, and Olympics-related activism. U.S. political players are all sharpening their anti-China claws for the 2008 elections. Brutal suppression of inflation-related domestic dissent would harden already negative U.S. attitudes governing commerce, sanctions, strategic contingencies, and military spending.

Such heightened international sensitivity comes just when China's domestic developments may afford the top leadership little room for maneuver in a crisis. Political balancing over leadership consolidation at both the five-year Communist Party Congress this fall and five-year People's Congress in March might force President Hu Jintao to prove that economic reforms do not jeopardize the party's rule. If unrest threatens the Olympics, vicious reprisals could swiftly fill the global media. Beijing should avoid all these difficulties by heading off serious inflation now.

To see why quick action is essential, it is important that both China and the United States appreciate the domestic, structural origins of this inflationary overheating. China's long-term restrictions on the importa-

### SUMMARY

Surging food prices in China indicate a serious risk of inflationary overheating. Past steps to control inflation caused social protest and deadly unrest. China faces the same risk now. China could avoid severe inflation by learning from its past failures and quickly raising interest rates—but politics make this unlikely. “Cooling off” policies in the future will thus be harsher than necessary. Beyond short-term fixes, China should increase imports of fine grains, with long-term U.S. supply assurances, both to stabilize prices and to promote lucrative farm diversification.

U.S. intelligence analysis of this overheating risk should refute the conventional wisdom that China's growth is export-led—it is clearly domestically driven. Policy makers need to realize that China's rapid economic rise is homegrown and sustainable. The United States should quietly remind China that harsh handling of inflation-related unrest could seriously damage U.S.-China relations—especially in a U.S. election year.



**Albert Keidel** is a senior associate at the Carnegie Endowment for International Peace in Washington, D.C. Until August 2004, he was deputy director and acting director of the Office of East Asian Nations in the U.S. Treasury Department, where he supervised its China desk and was its principal specialist on China exchange rate issues. Through the end of 2000, he served as senior economist in the World Bank's Beijing office. Since the latter 1980s he has taught graduate courses on China's economy variously at the School of Advanced International Studies (the Johns Hopkins University), the George Washington University, and Georgetown University. Keidel's recent writings include "Congress Pimps for Wall Street" (*Washington Post*), *China's Economic Fluctuations and Their Implications for Its Rural Economy*, and *Assessing China's Economic Rise: Strengths, Weaknesses and Implications*. Keidel's Ph.D. in Economics is from Harvard University. He speaks and reads Mandarin Chinese. The author is grateful to the Ford Foundation for its generous financial support of this Policy Brief and for research supporting its analysis. The analysis and conclusions in this brief are the author's.

tion of wheat and rice have forced a domestic pattern that for more than twenty years has oscillated between low and high food price inflation. These import restrictions, originally maintained for "security" reasons, seem to have more to do with an age-old Chinese practice of treating rural areas as an inexhaustible resource—a means for saving on foreign exchange rather than a reason for spending it. But in today's market-based China, open to the world, this attitude is a debilitating anachronism.

Since crop liberalization began more than twenty years ago, China's farmers have wanted to switch land out of low-profit grain production. But whenever they switched, supply problems eventually appeared, and food prices rose too fast. Following each such price rise, rather than increasing imports, the government instituted some version of an administrative "responsibility system" with subsidies and other inducements to "encourage" grain planting. Low if not negative profits hurt farmers' income and consumption, but inflation eventually subsided as food prices stabilized and nonfood prices rose to compensate. As planting inducements weakened, farmers started switching land out of grain, and the cycle began again.

China's gathering inflationary storm today is thus not powered by international factors—like trade surpluses or increased foreign reserves. It is a domestic storm, blowing in from the country's grain-growing central regions. Indeed, the structure of this overheating risk illustrates a more general characteristic of China's recent economic performance. Contrary to popular views, a range of statistics and analyses confirms that China's growth is domestically driven—not export-led. It is thus not surprising that domestic forces also drive suddenly looming problems. Both China and the United States need to take this into account.

### The Overheating Risk

Many analysts have denied that China faces a serious inflation risk. The official consumer price index (CPI) only climbed above 5 per-

cent in July—and barely over 6 percent in rural areas. But more detailed price data show startling trends—overall food prices in July were up 15 percent. Pork, which makes up more than 90 percent of the meat China eats, saw a 90 percent price rise in July. Cooking oil and egg prices were up 30 percent. In addition, midyear soybean oil prices were up 43 percent, and instant noodle producers in China raised their prices 20 percent because palm oil prices had climbed 90 percent. These are all explosive price increases in key consumer categories.

It is true that most price increases have been confined to food. If the government could contain them, there would be little risk of overheating. But rolling back such large food price increases will be difficult. Even if they level off, they imply the need for higher wages for a large segment of the industrial labor force. Unless there are significant layoffs, productivity will not grow fast enough to match such wage costs. Higher inflation will then follow.

More general inflation is already evident in its broadest measure, gross domestic product (GDP) inflation—that is, the price of everything China produces. This GDP inflation has been in a danger zone between 6 and 7 percent for the past three years (see box 1). Somehow, price rises from the anti-SARS investment boom and recent grain price increases did not show up in the CPI. Such high GDP inflation mirrors similar trends before the inflationary crises of 1988–1989 and 1993–1996.

Nominal GDP growth, which includes inflation, ranged between 17 and 18 percent in 2004–2006 (see table 1, column 5). This trend alone confirms the overheating risk. If inflation is as low as the CPI suggests, real growth—corrected for inflation—must have been over 16 percent for the last three years (see box 1). That would be even faster than growth before the worst inflationary crises of the past. If, however, real growth is closer to the official rate of 11 percent, then inflation must be in the 6 percent range. Either way, the overheating risk is clear.

Recent price trends have troubled the Chinese government. In July, Beijing formed a high-level task force to monitor inflation. But the suggested corrective measures for the task force to consider are not impressive. They include administrative restrictions on price increases and subsidies for hog farmers and pork transport. Such steps might keep symptoms from worsening for a while, but they cannot eliminate them. More recently, to control public expectations, Beijing has instructed local provincial and urban statistical bureaus in a subtle form of denial—they are not to use the word “inflation” to describe what is happening.

What is indeed happening? The cyclical trend of food output shifts and price hikes has been a consistent component of China’s major economic fluctuations for nearly 30 years. Higher feed grain costs are a big part of the pork price problem. China’s grain prices shot up in 2004 because of planting and output declines in 2000–2003. A new “responsibility system” in 2004 restored a portion of the lost planted area and output. Grain prices are unlikely to come down soon, however, because other input costs, such as those for petroleum-based fertilizers, have subsequently risen.

Recent trends look much like the “hog crisis” of 1987, when high feed prices and controlled low pig prices prompted farmers to slaughter their sows rather than operate at a loss. Higher pig prices eventually solved that problem but also underpinned high inflation in 1988–1989. Inflation figured heavily in citizen complaints during the 1989 Tiananmen Square demonstrations.

## Beijing needs dramatic action now to avoid repeating inflation-driven panics of the past.

### A Weak Response— Past and Present

Beijing’s weak response to the current inflation risks is reminiscent of China’s poor record in earlier decades. China’s three bouts of overheating—in 1985, 1988–1989, and 1993–1996—offer a key lesson for today. Beijing needs to increase interest rates dramatically, both for deposits and loans. But such quick action is unlikely. Adjustments to China’s government-administered interest rates are tied up by political disputes between competing interest groups, like the recent dispute between

## BOX 1 Price Measures and Growth

The most frequently cited measure of inflation in China is the consumer price index, but in recent years the CPI has shown quite low inflation (see table 1, column 1). A more robust measure is GDP inflation, called the GDP deflator, but there are three different methods for calculating it. The most widely used compares two official measures for GDP *output* growth—nominal growth with inflation effects, and real growth without inflation (table 1, column 2). The best measure, however, follows international best practices. It makes the same nominal-versus-real comparison for GDP *spending* growth (table 1, column 3). Real spending growth data are only recently available as the sum of real growth contributions from consumption, investment, and net exports. A third, informal, method uses CPI and investment price data to clean inflation effects out of nominal GDP spending statistics (table 1, column 4). Because consumption and investment completely dominate GDP demand, this should be a good measure, but the results are lower than from other methods. Subtracting inflation from GDP nominal growth gives a rough approximation of real growth. Hence, as explained in the text, the high nominal GDP growth rates in recent years by themselves suggest overheating. If GDP inflation is low, growth is exceedingly high. If growth is less worrisome, GDP inflation must be high.

Beijing and Shanghai's former Communist Party leadership over the pace of investment. Compromise jockeying before upcoming party and government congresses will also make bold economic steps more difficult.

The danger of delay, as in the past, stems from bank interest rates that are lower than inflation. Both citizen and corporate bank deposits are now losing purchasing power. Even after adjustments in July and August, government-set deposit rates were still less than

### Past procrastination fueled the deadly Tiananmen demonstrations and violent unrest in the 1990s.

1 percent for demand deposits, barely over 3 percent for one-year deposits, and less than 5 percent for three-year deposits. With CPI inflation in July at well over 5 percent, these deposits are all losing value.

Value-losing deposit rates early in both the 1988–1989 and 1993–1996 inflation bouts sparked heavy bank withdrawals and accelerated consumer spending—pushing inflation pressures to the crisis point. In 1988, as inflation rose far above deposit rates, cash rushed out of the banks and into a panic buying spree that stripped many stores bare of their goods. The resulting inflation took two years to tame. Harsh corrective steps caused severe declines in GDP growth, fueled deadly urban civil unrest at Tiananmen and throughout the country, and caused long-lasting damage to what had been China's improving international reputation.

The same sequence erupted at the outset of the 1993–1996 inflationary period. Early, moderate inflation—again triggered by higher food prices—rose far above bank deposit and lending rates. Chinese citizens quickly began withdrawing cash and spending it, and corporations pounced on bank loans that were cheaper than inflation to splurge on investment projects. These reactions pushed inflation over 20 percent.

Taming this round of inflation took until 1997 and required harsh, painful measures.

The government fired the central bank's governor, outlawed all independent bank branch lending, and introduced significantly higher bank lending rates. Soon, enterprise failures triggered layoffs and benefit reductions that completely altered the previously comfortable lifestyles of registered urban residents. Serious unrest, as at Tiananmen in 1989, was avoided thanks to a new urban social safety net. Nevertheless, strikes, sit-ins, and street demonstrations were widespread throughout traditional industrial areas.

Rural China bore the highest inflation-fighting costs. Steps taken to lower food prices hurt rural incomes, and household consumption actually declined from 1997 to 1999. Rural social unrest exploded, especially against fee and tax burdens imposed by cash-strapped local governments. Significant rural recovery began only after grain prices increased sharply in 2004.

One key step for ultimately taming inflation in both the 1988–1989 and 1993–1996 periods was an indexing policy. Banks had to promise that no matter how high the inflation rate rose, certain deposits would always pay out interest rates to match it. To ordinary Chinese citizens, this policy meant large take-home increases in interest earnings and was very popular. Cash quickly returned to the banks, but the damage was already done.

The ultimate conclusion is that these and other policies came too late. Had they been implemented earlier, the worst of the panic buying and inflationary damage—including subsequent tragic social conflict—might have been avoided. This is the key lesson for today. Without quick steps to dramatically raise effective deposit rates or index them to future inflation, moderate overall price rises could lead to an inflation crisis.

As an alternative and to buy time, Beijing will increase subsidies for meat and other foods. Such subsidies might stave off discontent for some months and maybe even for a year, but they will not reverse the cost pressures that are pushing up prices and wages. Higher food prices in the past have created

pressures to raise urban incomes—especially for lower-income workers and migrants. Higher wages that outpace productivity increases will in turn push up prices and trigger layoffs. In such a setting, the Olympic Games may provide a tempting environment for seemingly spontaneous urban demonstrations claiming that democracy would solve all these problems.

On a deeper level, instead of significantly increasing imports of “fine” grains—that is, wheat and rice—China has always controlled prices by “encouraging” farmers to plant these low-profit grains. The resulting hardship in rural areas has lasted many years. Hence, even if China does act quickly, more fundamental steps are called for. The critical strategic choice—one that can contain future food price inflation and reward farmer productivity—is to enable lucrative farm diversification by expanding fine grain imports. Ironically, the solution to what is fundamentally a domestic problem involves greater openness to global markets—in this case for wheat and rice.

**The Right Focus Is Domestic**

For all the difficulties it is bringing China, the current inflationary outbreak serves a valuable purpose for American policy makers. It drives home the point that China’s growth and inflation are essentially domestically driven—not export-led. This perspective should guide re-

assessment across a wide policy spectrum—commercial, diplomatic, and military.

What is the evidence that China’s growth is domestically driven? A detailed review of the nine cyclical phases of China’s economy since reforms began in 1978 shows that, except for possibly 1987 (when, however, China still had a trade deficit), no shift in GDP growth has been heavily influenced by the trade surplus or deficit. If anything, trade stimuli have moved in the opposite direction (see figure 1). Changes in domestic investment policy, pricing policy, and financial policies have been responsible for all major shifts in growth and inflation. Even in the middle of the current expansion, as export growth and China’s trade surplus have recently surged, contributions to GDP growth from trade have been significantly less than those from domestic counterparts.

Other indicators also undermine export-led hypotheses. China’s interior provinces—with two-thirds of its total population—are much less integrated into global trade and investment activity than coastal regions. But they all reported GDP growth rates between 11 and 14 percent in 2006.

Furthermore, though many Asian and European economies are linked to trends in the United States, China is not. During the U.S. boom of the late 1990s, which pulled many countries out of financial crises, China suffered a growth slump due to weak domestic

**TABLE 1 Inflation Measures and GDP Growth (annual percent)**

YEAR or PERIOD	1	2	3	4	5
	CPI	GDP Inflation Measure			GDP <sup>a</sup> Nominal Growth
		Official Output	Spending		
			Official	Informal	
2003	1.5	2.6	3.0	1.5	13.3
2004	4.0	6.9	6.7	4.4	17.5
2005	1.5	3.9	6.5	1.6	17.7
2006	1.5	3.7	6.0	1.5	17.1
January–June 2007	3.2	4.3			
July 2007	5.6				

<sup>a</sup> This is GDP spending (or expenditure). “Nominal” means that it includes price effects.

Sources: China National Bureau of Statistics, various publications and web pages, along with the author’s calculations.

investment and rural consumption. Conversely, the 2001–2002 U.S. slowdown and recession hurt growth in Asia and Europe. But in China, starting in 2001, domestic investment propelled growth into a new expansionary phase.

This conclusion flies in the face of popular notions that China's growth is export-led. Of course, exports are important. China uses them to finance its imports of equipment and raw material, including energy. But it does not rely on exports to power demand for output. Exports are just one of many components in its overall successful development program. In fact, recent trade surpluses and related inflows of foreign exchange are an unwelcome complication—they are not necessary to sustain GDP growth in the high single-digit range.

Both Chinese and U.S. policies need to reflect the domestic-led nature of China's development. Inflation, too, is homegrown.

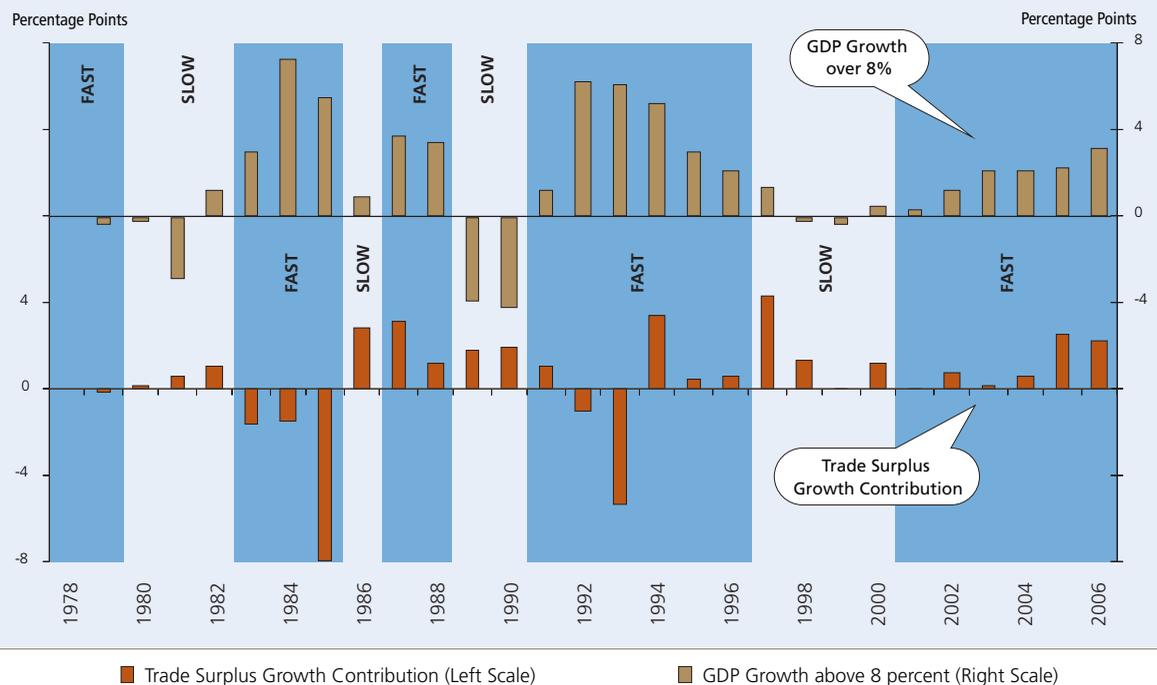
Some Chinese officials worry that raising domestic interest rates will attract unwanted speculative foreign capital. This should be a secondary if not third-order concern. China's short-term capital account is still heavily, albeit imperfectly, regulated. The scale of speculative

inflows is manageable. The central bank has ample resources to pull foreign cash inflows back out of the economy by selling either treasury bills or its own bonds. Priority should go to controlling domestic inflation with higher interest rates.

Some say that a strong currency revaluation reducing import costs would help control inflation. But China's cost-push price-rise pressures have domestic roots, and the exchange rate link to inflation could work the other way. General inflation in China would make its goods more expensive abroad, just as a currency revaluation would. If inflation were strong enough, China's trade surplus would move in the direction of a deficit—as it has in the past. Under such conditions, markets might pressure China to devalue, not revalue, its currency.

On the other side of the Pacific Ocean, U.S. policy making would be well served if government analysts emphasized that China's economic emergence is long term and deeply rooted in its well-run domestic economic program. It is not fragile or dependent on U.S. import "largess," as many believe. Whatever happens to the global economy, China's ex-

**FIGURE 1** China's Trade Surplus Does Not Explain Trends in Its GDP Growth



*Note:* GDP growth in the top series is the number of percentage points it was above 8 percent, a reasonable but unofficial growth target. The trade surplus series shows its percentage-point contribution to GDP growth, so that, for example, in 2003 GDP growth was 10 percent (2 percentage points above 8 percent), and the trade surplus contribution was close to zero (0.1 percentage point), meaning that virtually all growth was from domestic demand.

*Source:* China National Bureau of Statistics, 2007 *Statistical Abstract* (in Chinese). For a detailed description of the "Fast" and "Slow" periods, which reflect inflation and investment cycles as well as GDP growth, see Albert Keidel, *China's Economic Fluctuations and Their Implications for Its Rural Economy* (Washington, D.C.: Carnegie Endowment for International Peace, 2007).

pansion will likely continue at a high rate for many decades—it might even benefit from a global slowdown that made energy, technology, and critical materials less costly. This prospect offers strategic opportunities and challenges requiring careful policy planning.

The popular misperception that China's growth is export-led also strengthens the claims by U.S. special interests that China is causing their commercial and financial difficulties. When U.S. and Chinese officials talk, this misunderstanding impedes useful communication. A more accurate U.S. assessment of the sources of Chinese growth might rescue America from squandering its diplomatic leverage on misdirected talking points. A sharper assessment would also help shape more effective complaints and countermeasures targeting the many Chinese commercial practices that do deserve discipline.

Finally, U.S. policy makers should carefully prepare their response to possible unrest stemming from an inflationary crisis. If U.S. policies accounted for the domestic origins of both China's success and its difficulties, they might better anticipate China's impending social and political challenges. Instead of criticizing China's political system for causing inflation-related dissent, U.S. politicians and diplomats could focus on ways to help China alleviate such social tensions.

U.S. policy makers should be especially careful to avoid vague calls for democracy as a cure-all for the social instability that an inflationary crisis might generate. Inflation often makes possible reforms in favor of market-based prices. But these undercut the remnants of Maoist-era subsidies for privileged urban citizens. In a crisis, some will likely go to the streets, misguidedly blaming corruption or authoritarianism. U.S. policies must be careful to discern which "prodemocracy" demonstrations are constructively legitimate and worthy of encouragement. Some high-sounding movements may merely camouflage defense of outdated and dysfunctional subsidies.

## Conclusions

China needs to raise deposit rates dramatically, so returns can match current inflation. It needs to relax restrictions on the import of fine grains—wheat and rice—to encourage permanent farm diversification.

The United States needs to find ways to reassure China that importing more wheat and rice would not jeopardize its national security. Analyses of China's development progress—for example, in Treasury's reports to Congress—should emphasize the domestic sources of China's economic success and stress that China's growth is not export-led.

### **America must reassess its commercial, diplomatic, and military strategies to reflect China's domestic-led economic success.**

By acknowledging priority for China's domestic challenges, U.S. participants in the year-old Treasury-led dialogue with China's cabinet will be in a better position to insist on Chinese relief in the many cases where America has legitimate complaints. ■

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## RESOURCES

Visit [www.CarnegieEndowment.org/pubs](http://www.CarnegieEndowment.org/pubs) for these and other publications.

**China's Economic Fluctuations and Their Implications for Its Rural Economy**, Albert Keidel (Carnegie Endowment for International Peace, 2006)  
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1779 Massachusetts Avenue, NW  
Washington, DC 20036

