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Rely on market measures

A new administrative drive to tame run-away investment growth is under way. It is a necessary move to suppress the investment binge: investment, which surged by an annualized rate of 30 per cent during the year's first half, has been the leading force pushing the economy ever closer to overheating during the past three years.

However, policy-makers should be well aware that they cannot expect to always rely on such campaigns to manage the economy.

In addition to measures making local officials more willing to follow the central government's policies, more effort should be made to form an environment in which enterprises are responsive to market-oriented measures, such as changes to interest and currency exchange rates. This demands that the nation pushes ahead with its unfinished agenda of reforms in the banking sector, State-owned enterprises and the pricing system for products such as oil and electricity.

Earlier this week, the National Development and Reform Commission (NDRC), joined by four other ministries and government agencies, issued an urgent policy directive to local governments demanding they review large projects launched this year. Projects that are not in line with the policies and rules should be halted and are only to proceed after being modified according to government requirements.

Newly launched projects, of course, bear the brunt of this initiative but the real goal is deterring new violations.

The move is reminiscent of a similar crackdown in 2004 over disobedient investors.

However, two years on, the benefits of that drive are difficult to see.

The spectre of overcapacity is looming again in such sectors as aluminium, explicitly named in 2004 as an area subject to strict control. Credit growth has rocketed. Environmental standards continue to be disregarded and the illegal seizure of farmland for industrial use is rampant in some provinces.

It is no surprise that administrative measures are not efficient. As one NDRC official puts it, no matter how forceful the administrative measures are, enterprises will still furtively launch new projects as long as there are profits to make.

On the other hand, if the administrative measures are too harsh, they could hurt economic vitality, which may not be easily recovered.

The long-term solution to that dilemma lies in market-oriented instruments.

During the past two years, the central bank's manoeuvres to slow down loan growth — which included slight increases in interest rates and in the proportion of commercial banks' funds required to be put on reserve — have achieved insignificant results.

Bolder interest rate hikes were precluded due to a fear of an influx of more hot money. A currency with a more flexible exchange rate was not in policy-makers' toolbox either, especially given the continued inability of banks, firms and capital markets to cope with more radical changes to the renminbi's value.

Policy-makers should have a sense of urgency in deepening reforms. Otherwise, they will continue to face the daunting challenge of managing the economy with non-market-based measures.

Higher interest rates not the only option

By Robert Blohm

Many economists and financial market players wrongly blame the relatively fixed RMB exchange rate for China's "runaway" economic growth and for attracting "hot money" in anticipation of what they think is inevitable RMB appreciation. That's because they think the only way for China to control economic growth is by tightening credit, reflected in higher interest rates. They assume higher interest rates mean greater foreign-exchange demand for RMB for investment and thus the impossibility of a fixed RMB. This view was expressed recently by Nicholas Lardy, senior fellow at Washington's Institute for International Economics and a leading US expert on China's economy, in an appearance on CCTV9's Dialogue programme just over a month ago. This thinking may stem from three misconceptions.

The first may be the danger of identifying the real economy with the financial or monetary economy, or of looking at monetary policy as the be-all and end-all anchor of all economic policy. Money and credit are a commodity like others, not a proxy for the entire economy which uses money as a medium for valuation and exchange. Interest rates are the price for credit but it's the level of all prices (reflecting their rate of change), not just of credit, that drives the economy.

Rising price levels in China reduce foreign-exchange demand for RMB for investment because they lower the "purchasing power" of the RMB in terms of the amount of goods one unit of the currency can buy. Higher interest rates are the exception but higher goods prices neutralize the ability of interest rates to cause appreciation of the RMB. Think of the negative effect of higher prices on the ability to export, resulting in less foreign demand for RMB.

A second reason for the erroneous thinking relates to China's economic rise's still being in its early stages. In this period, the contribution to economic growth by construction of infrastructure and buildings is disproportionately high compared to the contribution made by the use of those facilities. This attracts real-estate investment fed by credit availability, and that is investment which seeks to profit from price appreciation, not from income from use. So, higher real-estate prices, like high interest rates and the price of other investments, wind up serving to appreciate the RMB rather than acting as goods prices.

But there are a lot of other prices driving China's economy, and their rise has the effect of depreciating the RMB. Furthermore a price rise by a company makes it more profitable and this serves to attract market investment away from real estate into other sectors of the economy where it is not financed by the mortgage credit that would otherwise be made more available by ever higher real-estate prices, or away from other "fixed-asset" over-investment that has been driven by artificially-low input prices.

Foremost among those prices are the prices of energy, the economy's most important single input. If any industrial policy needs to be consistent with the rest of economic policy, it's energy policy. But few economists understand energy because of its nature as a bulk-market commodity and many get distracted by its nature as an essential commodity. Economists typically understand best the retail markets they deal with in their everyday lives.

China has recognized the need to bring energy into the competitive market economy by being the only Asian country besides Japan and the Philippines not to cancel the marketization of at least the supply side of the electricity sector after the US's abysmally-designed California electricity market collapsed in 2001. China broke State-owned oil, gas and petrochemical exploration, production and marketing into four competing companies. Just over a month ago the National Development and Reform Commission continued its policy of letting energy prices rise to a level more consistent with energy markets, as I have supported in previous China Daily articles.

In particular, NDRC allowed an approximate 7 per cent rise in the still-regulated electricity price to consumers to cover 70 per cent of the cost increase experienced by the electricity suppliers. This came a month after the 7th in a recent series of refined oil-product price increases.

Higher prices alone automatically solve much of the energy conservation and energy efficiency issues China faces. Just this week NDRC's latest 1st-half-year statistics show that low administratively-set prices have caused the nation's energy efficiency to continue declining, especially in energy-intensive industries (except for construction and steel where higher world steel prices have reduced demand growth).

Hopefully the NDRC will next move toward "demand-side management" or market-price-driven reduction in electricity, gasoline and natural gas demand growth that enables producers to recover 100 per cent of their costs. NDRC can do this by marketizing retail gasoline pricing and the demand side of electricity, and by marketizing natural gas distribution and encouraging the building and opening of an intercity natural gas pipeline grid that is operated independently of production just like the electricity grid. An intercity gas grid is needed to support a market for natural gas trading. It would also deliver clean energy to all China's cities, including the gas from coastal Liquified Natural Gas terminals, and the gas from coal mines, whose extraction makes the mines safer and more profitable.

The third reason for ignoring prices and blaming the fixed RMB for contradicting tighter monetary policy is the common misidentification of inflation with price increases and ignoring that price increases are in fact non-inflationary, especially when they prompt productivity or efficiency improvements which raise both incomes and the supply of goods. Price increases are actually counter-inflationary: they increase the demand for money, not the money supply whose increase is defined as inflation.

It is what the People's Bank does or does not do in response to increased money demand that is inflationary or not: It can expand credit or let interest rates rise. And that is a very complicated judgment, informed by the fact that any upward-biased effect on the RMB is neutralized by the higher goods prices. If prices ever began increasing in anticipation of an inflationary monetary policy, we would enter the bottomless pit of hyperinflation, which China's sound monetary policy is nowhere near.

Accordingly, higher prices, not just of credit, can have the effect of controlling economic growth. Allowing prices to adjust, ideally through market mechanisms, precisely makes the policy of a fixed RMB exchange rate consistent with any credit-tightening. The temptation, in a system of regulated prices, may be to attempt to use a single blunt instrument, like credit-policy through the People's Bank, to achieve an objective that is very complicated to co-ordinate. Moreover, compared to markets, government regulation of prices or supply carries the added burden of secrecy and a temptation of corruption, suggested by the modest gas-pump queues seen on the eve of a gas price increase, or by the rise in the stock-market price of energy producers when a price-increase is announced.

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