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# Energy price increase is good news for China

By Robert Blohm

China's recent wave of domestic energy price increases is very positive both for the nation's economy and for relations with the major net oil-importing industrial economies. The latest, a 10 per cent retail price increase three weeks ago for refined oil products, was the seventh since 2005, and came just three weeks after I predicted such a rise in an article in China Daily.

The domestic price increases make China consume less energy than it would without the price increases. In addition, they pay for alternative forms of energy — both renewable and environmentally friendly, and they make China's economy efficient and stronger by prompting it to produce the same output from less energy, and by enabling Chinese energy companies and investors to earn a profit that gets efficiently reinvested in the economy. They also increase China's national security by making China less dependent on imported oil than it would be without the price increases.

Bringing oil prices inside China closer to the global market price aligns Chinese strategic economic interests closer to those of major net oil-importing industrial economies and distances them from net oil-exporting economies such as Russia, where economic reform risks being postponed amid the euphoria of high oil-and-gas export prices to Europe.

The most effective and fastest solution to high world oil prices is high world oil prices. Following the two oil shocks of the 1970s, the world developed and adopted less-energy-intensive technologies and developed and used cheaper substitutes for expensive forms of energy. The result was a permanent loss of customers for oil producers and a 30-year decline in energy's percentage of GDP that is continuing today.

The most effective way to "globalize" China's domestic energy prices is to "marketize" them by finishing the job, started by China at the end of 2002, of bringing the market economy to the energy sector. The strategic national-defence-related aspects of energy and food do not exempt these two sectors of the economy from the efficiency benefits of market competition and capital allocation determined by the objective laws of supply-and-demand driven pricing.

Will high oil prices cause China's economic growth to slow? No, although it is government policy to slow growth slightly to avoid overheating and inflation. Not unless the high oil prices are inflationary, in other words, not unless they increase too fast the demand for money whose supply is controlled by the central bank and is reflected in how low interest rates are. But China is capable of further massive improvements in efficiency (think of the huge potential for eventual large-scale industrial farming) that can more than make up for the impact of any price increase on inflation.

Price increases can indicate excess demand that can be met by increased productivity (the supply of goods) on the one hand, or by increased money supply or higher interest rates on the other. The more price increases (demand for a good) are met by increased productivity (supply of a good), the less impact the price increase has on money demand reflected in higher interest rates or increased money supply (possible inflation in terms of an excessive money-supply growth rate). Accordingly, companies have two ways to face cost increases — raise prices to customers (and risk inflation) or increase efficiency and productivity.

The more companies can pass through cost increases by raising prices, the greater the risk of inflation. The more companies can offset cost increases by increasing the amount of output per unit of higher-cost input, the less likely inflation is. The United States has avoided the inflationary impact of energy price increases because consumers have been able to resist price increases thanks to the huge productivity gains of the Internet economy and price competition unleashed by deregulation.

China has huge still-untapped productivity improvement potential far more basic than the benefits of the Internet economy. These should enable China to experience non-inflationary domestic price increases, while rising income from the growing economy enables consumers to pay higher prices and still consume and save more.

China needs to allow non-inflationary domestic price increases in order to avoid an appreciation of the RMB, which would slow China's economy. Domestic price increases depreciate the RMB. They neutralize current upward pressure on the RMB's exchange value. Upward pressure on the RMB's exchange value makes its purchasing power stronger than other currencies' due to the comparatively low prices for goods in China. To maintain the policy of a fixed RMB exchange rate, prices inside China must be allowed to increase in a non-inflationary way to achieve "purchasing power parity" with other currencies.

If instead, the RMB appreciates because prices inside China have not been allowed to increase, three economic shocks will occur that will slow China's economy and harm innocent sectors of the economy not directly driven by those prices: (1) China's exports drop dramatically (especially where the profit margins are as slim as 3 per cent); (2) the cost of imported foreign capital equipment used to increase productivity increases dramatically; and (3) China experiences huge financial loss on the massive capital investment abroad that it has made to finance foreign demand for its exports.

By allowing domestic energy prices to rise closer to the global market level, China is moving in the correct direction (towards "marketization" of energy) and deserves support and recognition for its enlightened and informed policy-making.

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