Is China's Economy Overheating?

Nicholas R. Lardy says China is concerned but is not "slamming on the brakes" or showing any signs of planning increases in interest rates or the value of its currency.

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Steve Weisman: Is China's economy overheating? This is Steve Weisman at the Peterson Institute for International Economics with Nicholas Lardy, senior fellow at the Institute, to bring us up to date on some recent developments in China's economy. Thanks for joining us, Nick.

Nicholas Lardy: I think the short answer is there are certainly signs of overheating. Inflation is still low, property prices had begun to come up over the last few months, and the central bank and the financial authorities are beginning to take steps to cool things off a little bit, but they're not slamming on the brakes.

Steve Weisman: What is China's projected growth this year and what would be a sign of overheating in that economy?

Nicholas Lardy: They'll probably grow north of 9 percent this year. Overheating would be reflected in a significant rise in inflation, particularly consumer prices. China had a very rapid growth of credit last year, and many people anticipate that this will feed through to higher prices with a delay. But they had deflation from most of last year. Prices were falling because growth, although very impressive compared to the rest of the world, was far below China's usual pace. So there were some deflationary pressures in the economy. They're coming into this year with the deflation ending and they're heading into positive territory. They won't get really too excited about inflation until they're convinced it's going to go to 3 percent or more.

Steve Weisman: What are the signals that the Chinese leadership is concerned about it?

Nicholas Lardy: The main thing they're concerned about at the moment is that lending growth in January was extremely high, almost as high as it was in the beginning of last year when they had unprecedented growth of credit. So they're very concerned that to avoid inflation three or four or five months from now, they've got to bring credit growth under control.

Steve Weisman: What have they done to do that?

Nicholas Lardy: They've raised the amount of money that banks have to put on deposit at the central bank, the so-called required reserve ratio that reduces their liquidity, slows down their ability to lend. And they've introduced a lot of new regulations. They've formally reintroduced credit quotas that basically tell each bank individually how much they'll be allowed to lend over the course of 2010. And they're trying to smooth that out a little bit. They say you can't lend more than 30 percent of your quota in any given calendar quarter. So instead of all the loans being front-end loaded at the early part of the year, they're trying to smooth it out over the course of a 12-month period.

Steve Weisman: Are these steps likely to have any effect?

Nicholas Lardy: I think they will. It may not be evident in the February data when we get it, but I do think the central bank has a lot of ways to penalize banks if they don't follow the guidance that they're getting, and the banks know that. So I think they will ultimately be successful in controlling credit along the lines they've talked about.

Steve Weisman: Here's a purposely dumb question: Why don't they raise interest rates?

Nicholas Lardy: They are very worried about attracting more capital from abroad. They had to intervene in the currency markets in excess of $400 billion last year in order to prevent the currency from appreciating as a result of these inflows and their trade surplus. So, until the United States raises rates and we see some other central banks raising short-term rates above zero, they're going to be relatively constrained in the use of the interest rate policy instrument. Although I do think it's not unlikely by the second half of this year they'll have to raise rates.

Steve Weisman: So the answer is that they still don't want to allow the renminbi to appreciate in relation to other currencies, which of course is what much of the rest of the world is still asking China to do. Where do we stand on that?

Nicholas Lardy: It's really a standoff right now. China has maintained this fixed peg to the dollar now for well over a year. And their view is they've had this tremendous headwind from the international economy, the shrinkage of their exports last year by 15 percent dragged down their growth quite substantially, and they don't want to resume appreciation until they think that their exports are going to do better than they did last year. And that of course depends on having a sustained recovery in the United States and it also depends very importantly on a European recovery, which is very difficult to see so far. And Europe as a whole is a bigger export market for China than the United States. It's their biggest export market, Europe collectively. So if they think Europe is going to continue to be relatively weak, either no recovery or extremely weak recovery, I think they're going to be very reluctant to allow their currency to appreciate. The external sector, as I said, subtracted from growth last year. They hope that won't be the case this year. And until they have some confidence in that, I think they'll be very reluctant to move very significantly on the currency.

Steve Weisman: What's your sense of the administration moving toward a more confrontational policy on this, including the labeling of China as a currency manipulator in April or May? The United States is supposedly considering other steps that China might not appreciate—arms sales to Taiwan, etc.

Nicholas Lardy: I think the only thing that we can say with confidence is that there is a considerable debate within the US government about how to respond to China. I think there's a consensus that China has become more robust, more muscular in its dealings with the United States. They've responded much more aggressively on a number of issues. And the question that's being debated is: How should we respond? Should we continue along the lines of the first year of the Obama administration, holding out the hope of a strong, cooperative, productive relationship? Or do we also need to look for alternatives? And one of them might be to cite China as a currency manipulator. I don't think that decision will be made until just before the report is issued, as I say, because it's being debated within the US government.

Steve Weisman: Thanks, Nick. Let's be sure and talk about this as it heads toward another turning point in April or May.

Nicholas Lardy: Good.