



## Is China's Economy Overheating?

*Nicholas R. Lardy reports that China is worried about its economy overheating but is taking a number of actions that could curb the problem and ease inflationary pressures.*

*Edited transcript, recorded December 16, 2010. © Peterson Institute for International Economics.*

Steve Weisman: Is China's economy overheating and in danger of hampering economic growth? This is Steve Weisman at the Peterson Institute for International Economics with the man who can answer that and other questions: Nicholas Lardy, senior fellow at the Institute. Thanks Nick.

Nicholas Lardy: Thank you, Steve.

Steve Weisman: We could start with the news reports that the Chinese are worried about inflation, asset bubbles, and an overheating economy. You've been in China a few times recently. How concerned is the Chinese leadership?

Nicholas Lardy: I do think there is a lot of concern about inflation. It is now running at roughly a two-year high, a little bit more than 5 percent per year, which for many economies wouldn't be particularly alarming. But over the last decade, China has managed to keep inflation to an average of something closer to 2 percent. So by recent historical standards, 5 percent is quite a bit on the high side. They have taken a number of steps to reduce the rate of growth of credit. They've taken some special measures to address food prices, which have been a big component of the increase in inflation. The Chinese leadership has always been highly sensitive to inflation, so I think yes, it is a major concern.

Steve Weisman: Will these steps slow down China's phenomenal economic growth?

Nicholas Lardy: I think that's the challenge. They want to moderate the rate of price inflation, but they don't want to step on the brakes so hard that the economy slows down dramatically. So they're a little bit conflicted. They want the best of both worlds. They want to have high growth and stable prices.

Steve Weisman: Wouldn't we all?

Nicholas Lardy: Yes, wouldn't we all? There's usually a tradeoff, and there will be a tradeoff in China. I think it will take some time before we find out exactly what their priorities are. But they would like to keep price growth moderate, and they would like to keep the economy growing at 9 percent or so. Their official target is a little bit below that, but I think in their heart of hearts, they don't think 9 percent is too high.

Steve Weisman: Normally, inflation would bring a depreciation of Chinese currency effectively. Is that correct?

Nicholas Lardy: No, it works the other way. If you have more price inflation than your trading partners, then in real terms your currency is appreciating because your goods are becoming more expensive relative to those of your trading partner.

Steve Weisman: Are they worried about that and the additional factor of interest rates, which might be going up, leading to an overappreciation of their currency?

Nicholas Lardy: It's hard to know for sure because a lot of the discussion in China, and particularly at the top leadership, is in terms of nominal exchange rates rather than adjusting for relative prices. Certainly throughout, at the height of the crisis, they refroze their currency to the dollar because they didn't want to have any leakage of demand into the global economy. In June of this year they then relaxed that a little bit and they have allowed a little bit of appreciation. And it certainly may well be that they fear that the combination of some nominal appreciation and much higher price inflation could give them more real appreciation than they desire. I don't think they're really at any danger of that right now because the nominal appreciation has really been quite modest, about 2.5 percent since they changed policy in June of this year. And the dollar has actually depreciated a little bit over this period. So in a trade-weighted basis across all their trading partners, there's probably been a modest amount of depreciation rather than appreciation.

Steve Weisman: From the point of view of the United States, and especially the Congress, the US-China currency relationship has created political problems. Do you think this modest amount of appreciation is going to be enough to satisfy critics and President Obama, especially since Mr. Obama will be greeting President Hu in January?

Nicholas Lardy: I think it, to some extent, depends on what happens over the next month. It is roughly a month until President Hu arrives, and I think some [members] of the administration are still hoping that the Chinese will allow their currency to appreciate significantly, vis-à-vis the dollar, over that period. If that does not happen, I certainly think it's going to be a point of discussion. We do know the last time the two presidents met economic issues were at the top of the agenda, and currency was perhaps the most important issue that was discussed.

Steve Weisman: Was that in Seoul?

Nicholas Lardy: Yes, it was on the sidelines of the G-20 meeting in Seoul when they did have a bilateral meeting.

Steve Weisman: What about the ancillary issues on President Obama's agenda with China—I mean: the new military cooperation between the United States and South Korea; the joint naval exercises that China objected to; the talk of a revived military cooperation with Japan; and generally the United States reaching out to China's neighbors?

Nicholas Lardy: Surprisingly I think there's a reluctance to recognize that the bilateral relationship has deteriorated.

Steve Weisman: Reluctance in China?

Nicholas Lardy: In China on the part of Chinese—even Chinese military people. They maintain a policy of wanting to have a good relationship with the United States. Quite frankly it's a problem that they don't want to recognize that some of their own policies have been counterproductive from the point of view of their own national interests.

Steve Weisman: Such as?

Nicholas Lardy: Their refusal to criticize the North Korean sinking of the ship last spring that killed 45 South Korean service people.

Steve Weisman: And then the shelling of the island.

Nicholas Lardy: The shelling of the island. China didn't want to criticize that. They have not been as cooperative as they might have been in terms of putting pressure on their ally in North Korea, even though they recognize it's a pretty unstable situation. So now Defense Secretary Gates will be visiting China, and they're trying to smooth over the frictions on the military side that have arisen in the run-up to President's Hu's visit to the United States. I think there will be an effort to try to ameliorate some of these differences or at a minimum, to paper them over.

Steve Weisman: When you say that the Chinese are in denial or not aware of these consequences, what happens when the subject comes up in your conversation with the Chinese?

Nicholas Lardy: They don't want to recognize that their very, very strong reaction against the Japanese seizure of a fishing boat and its captain [in September] actually cost them dearly in terms of their relationship with the Japanese. They're driving the Japanese into a closer cooperative military relationship with the United States. It's largely a function of the fact that the Japanese were shocked at the strong-arm tactics that the Chinese used.

Steve Weisman: And there was the rare earths episode.

Nicholas Lardy: They cut off exports of their rare earths to Japan shortly after that as a way of retaliating. The fact of the matter is, China played very hardball and I think it has contributed to a deterioration of the relationship with Japan, at least in the short run. But they don't want to admit that they made a mistake. So when this gets discussed, they tend to glide over these details and pretend that the relationship with Japan is unchanged.

Steve Weisman: What about other trade issues besides currency? One hears that American business interests are more aggravated over Chinese policies encouraging "national champions," and some of their procurement policies or other government policies.

Nicholas Lardy: Discussions on these issues concluded [in mid-December] in a forum that is referred to as the JCCT, the Joint Committee on Commerce and Trade, run between China and the United States on a biannual basis. The US side is co-chaired by our Secretary of Commerce, the US Trade Representative, and Secretary of Agriculture. They came out with some very positive statements saying that the Chinese had agreed to do much more to protect intellectual property, and that they were still in the process of modifying their policies.

With respect to what is referred to as indigenous innovation, which is the term they use for their promotion of national champions, it's kind of their industrial policy. The import of beef is one of the issues that perhaps some progress has been made on. So I think we're probably making more progress on those issues than we are on the currency. That's perhaps not surprising because the currency affects all trade, and these disputes affect segments of trade that are very, very important for some firms, but they don't affect everything.

Steve Weisman: What's the level of concern in Europe, where they have their own currency problems with China?

Nicholas Lardy: They have been soft pedaling the issue compared to the United States, but in the last couple of years, they have raised it. It has gotten onto the official agenda for the first time, with quite a lag compared to the United States. They're also concerned about indigenous innovation. European manufacturing in industrial groups did send letters to the Chinese early this year, when the industrial policy was first promulgated, expressing alarm that there were many provisions and that seemed inconsistent with China's WTO obligations, for example. So there is a parallel interest, I think, between Europe and the United States. But quite frankly the Europeans have never been willing to address these issues as forcefully as has the United States.

Steve Weisman: Just coming back to the Chinese economic outlook, do you see any impediments to China continuing its very impressive growth in the next year or two?

Nicholas Lardy: I think they will ultimately be successful in bringing down inflation. It may take a few tenths of a percentage point off the growth rate, but I think they're still going to be in the 9 to 10 percent range. They've been doing a lot of sensible things—withdrawal of the stimulus that was so strong starting in late 2008, monetary policy has been adjusting, credit policy has been adjusting, they're about to launch a new five-year economic program that I think will be pretty important in sustaining the growth at very high rates going forward.

I think we do have to recognize that the last five years were unprecedentedly rapid rates of growth for China. The growth rate wasn't just 10 percent. It averaged about 12 percent over the five-year period. I think looking forward we should expect a growth rate that is several percentage points lower. It will still probably be the fastest growing economy in the world, but I think we should anticipate something in the 9 to 10 percent range rather than in the 11 to 12 percent range—one year it was even 13 percent growth in real terms. So I think the kind of superheated growth of the last five years, we shouldn't anticipate that that will continue.

Steve Weisman: Will we see progress toward more domestic consumption?

Nicholas Lardy: They've certainly put a very high priority on it in the 12-year program recently unveiled. Whether they will actually follow through with the policies that will bring that about, I think we'll have to wait and see. But it's certainly an announced policy objective. I think they have a very good idea how to go about accomplishing it. But there's a lot of resistance in various quarters toward some of these policies and so it will be a struggle to pursue the policies with sufficient strength that you get the rebalancing that's desired.

Steve Weisman: Nicholas Lardy, thank you very much.

Nicholas Lardy: Thank you.

