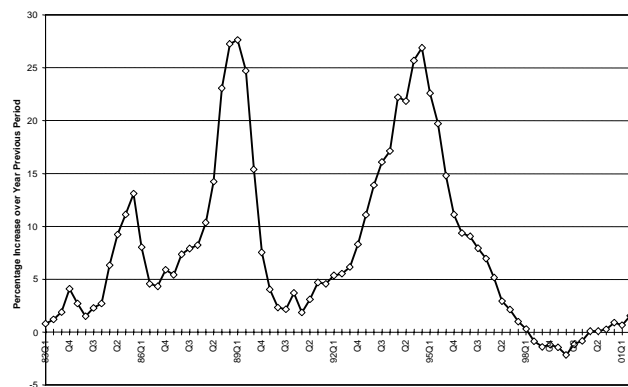


Macroeconomic Fluctuation

- Inflation has been the main concern
 - Historical memory: inflation in late 1940s responsible for the quick defeat of the Nationalist government
 - Inflation: three episodes
 - 1985-86
 - 1988-89
 - 1993-94
- Deflation became a concern
 - 1998-2001: not experienced, caught by surprise
- Overheating and inflation concerns in 2004
- First quarter of 2007
 - GDP growth 11.1%
 - inflation (CPI) 2.7%

Macroeconomic Fluctuation



Inflation and Money

- The quantity equation of money

$$vM = PQ$$

P: price level

Q: real output

M: money supply

v: velocity of money

- Growth of money supply and inflation

$$\begin{array}{ccccccc} -6\% & + & 16\% & = & 2\% & + & 8\% \\ \text{velocity} & & \text{M2} & & \text{Inflation} & & \text{GDP growth} \end{array}$$

What's Special about China

- Government policies
 - Direct control over the growth of bank credit
 - State enterprises' weak responses to interest rates
 - Soft budget constraints
 - No consumer credits
- Structural Changes
 - Demand for money increase
 - Economy is more monetized
 - Velocity of money declines over time
- The link between money growth and inflation is not as tight as in other countries

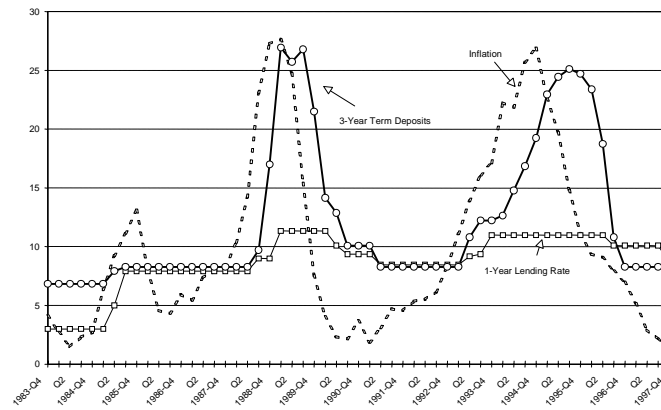
What's Special about China

- Political-economic business cycles
 - Inflation 1985-86: followed by reform push in 1984
 - Inflation 1988-89: followed by reform push in 1988
 - Inflation 1993-94: followed by reform push in 1992
- Why?
 - Reform leads to more decentralization
 - Relaxed supervision
 - More local investment
 - More credit supplied
 - Inflation

Anti-Inflation Policies

- Traditional methods for “tightening up”
 - Dramatically cutting back bank credit
 - Directly reduce the number of investment projects by administrative methods
- Monetary policy in a market economy
 - Do not dictate investment or bank credit
 - Use indirect means
 - Interest rate policy
 - Bank reserve requirements

Inflation and Deposit/Lending Rates



Expansionary Policies in 1998-2002

- Soft landing in 1996
- Asian financial crisis in 1997
- Keynesian expansionary fiscal policy since 1998

$$Y = C + I + G + (X - M)$$

- Deficit spending
- Infrastructure investment
- Income policy
- Export tax rebate

The Chinese Currency Controversy

- Costs and benefits of fixed exchange rate regime
 - A stabilizing force during Asian financial crisis
 - If the exchange rate is consistently over valued: currency crisis (and financial crisis in general) may occur
 - If the exchange rate is consistently under valued: trade protection from other countries may lead to trade war

The Chinese Currency Controversy

- Pressures on yuan appreciation: usual arguments
 - China's trade surplus
 - Foreign direct investment inflow
 - Foreign "hot money" inflow
 - Weak US dollar and low US interest rates

The Chinese Currency Controversy

- Forces for yuan appreciation: China's domestic macroeconomic policy
 - Loss of independent monetary policy under the fixed exchange rate regime
 - The central bank keeps buying foreign currency in order to keep the prevailing exchange rate
 - Fast increase in official foreign reserves and domestic money supply
 - Sterilization to reduce inflationary pressure
 - Selling government bonds
 - Selling central bank bills

The Chinese Currency Controversy

- Forces for yuan depreciation
 - Weak agriculture sector
 - Capital flight

The Chinese Currency Controversy

- The regime change on July 21, 2005
 - One time appreciation of Yuan for about 2%, from 8.27 to 8.08
 - Move from pegging to US dollar to pegging to a basket of foreign currencies (unannounced)
- What happened since
 - Some movement on dollar-yuan exchange rate: from 8.27 to 8.72