A study of inflation in China

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China's economy is estimated to have grown, during 1995, at a rate of 10.2%, and inflation dropped below 15%. Despite this, the view is, that China still faces a difficult task of curbing inflation over the long term. There has been a series of debates on inflation among Chinese economists. This article refers to the arguments and analyses presented in this debate, on the future of the Chinese economy.

Since all of the measurements of the economy of China, like other nations, are influenced by the generally accepted, and incompetent standards demanded by international monetary agencies such as the International Monetary Fund (IMF), no estimate of rates of growth, or of inflation, can be accepted at face value. Nonetheless, the discussion of these estimates is extremely significant, as a factor in shaping the policies which China will adopt during the immediate future.

Argument 1

It is necessary to curb inflation to assure long-term stability and coordinated development of the national economy; refuting the argument for "simultaneous growth of economic development and prices."

This argument goes: There has long been a misconception in the theoretical circles of our country, that inflation, despite the multitude of harm it causes, can promote economic growth. In fact, this is a theoretical misapplication of Keynesianism and the Phillips curve. Since the 1970s, due to the appearance of "stagflation" in western countries, the stable direct correlation between economic growth and inflation, or the negative correlation between unemployment and inflation, has been eliminated, while the new theory of "natural rate of growth" appeared. This theory believes that, on the basis of a natural rate of unemployment, the economic growth of various countries has an objective, rational speed called "natural rate of growth." If this speed is surpassed, the rise of prices will be accelerated, while depressing prices will accelerate the drop of economic growth.

The argument proceeds: From a long-range point of view, the average speed of growth does not increase with the appearance of a big rise and big fall in the economy. According to the calculations of a number of experts, if China's economy has a continuous 9-10% rate of growth over 30 years, it will be the biggest in the world. A continuous growth above 10% will naturally accelerate the rise of prices, with the consequent, forced deflation cancelling the increased percentage of the previous super-high-speed growth.

The argument continues: This regular pattern of growth has been proven by the economic development of China. In the 1980s, with an average economic growth of 8.8%, the rise of prices reached its peak in 1989. The annual rise was 19.8%, with a rise of 27.9% in February. When we depressed the rise of prices to 11.4% in September 1989, the growth of industry dropped to 0.9%. In January 1990, when the rise of prices dropped to a level below 10%, the rate of industrial growth was -0.6%, the first negative growth since the start of economic reform. In 1991, economic growth attained an annual rate of 11.9%, with a rise of prices of 2.9%. In 1992, annual economic growth was 13%, with a 6% increase of prices. In 1993, the annual economic growth continued to be 13%, and a similar rate of price increases. In 1994, the annual rate of economic growth rose to 22%. In the coming two years, if the rate of economic growth does not drop to below 8%, it is expected that it will be very difficult to bring the increase of prices below 10%.

The inflation expectation in China was formed in 1987, reached its peak in 1988-89, dropped during the three-year period of rectification and adjustment, and rose again in 1992-93. Due to the stable exchange rate of the renminbi (RMB), in 1994, the inflation expectation weakened somewhat abroad, but it was still high at home. Under the influence of continuous high inflation and high-inflation expectation, an entrepreneur would mistake the rise of his own product's price, for a rise of the whole price level. His decision would not be to expand production, but merely to raise his product's price, so as to neutralize the effect on his costs, of rising prices of other products. Workers would demand wage increases in accordance to the expectation of inflation.

Under such circumstances in China, if wages could not be increased, work efficiency and output would drop. Then, stagflation would appear, with a continuous rise of the overall price level and drop of output in the whole society. It was estimated that for every price rise of one percentage point, stimulated by inflation, the prices of the same year rose 0.3-0.4 percentage points, causing a drop of 0.7-0.8 percentage points of economic growth in the following year. Growth
could be maintained in the following year, at the cost of higher inflation. Inflation cannot bring us anything except stagflation, and even a big economic rise and fall. It can only bring us more random price increases, monopolies, cheating, and profiteering in the present situation. Whether in theory or practice, the policy of inflation cannot stimulate economic growth over a rather long period. It is also impossible to have "simultaneous growth" of the economy and of prices. We should clearly realize that curbing inflation should be a goal of long-term policy, and not only a short-term measure.

**Argument 2**

To reduce the impact of restructuring industry by inflation, is to relieve thirst by drinking poison; refuting the argument that "unemployment is more dangerous than inflation."

This argument goes: In the debate on inflation among economists in the early 1990s, a typical argument was: "Unemployment is more dangerous than inflation." The economic grounds for the argument were that the reform of State-run enterprises cannot be carried out quickly, due to the nonexistence of a social security system. The social grounds for the argument were that unemployment, by concentrating economic pressure on a minority of the population, would result in trouble-making by that minority, while the economic pressure caused by inflation is shared in common by the whole society.

Despite popular discontent among the people, nobody, generally speaking, would "initiate trouble." The meaning behind such an argument is, that China may use inflation policy to reduce the pressure of employment. This is a viewpoint hampering the control of inflation. First, to advocate using the monetary policy of expanding the economic quantum to solve the problems of economic structure, violates the basic axiom of implementing economic policy. The existence of a big potential labor supply in rural areas, may keep economic development at about 10%, at least not below 8%. This is a common acknowledgment of economists both abroad and at home.

However, when the argument that "unemployment is more dangerous than inflation," is used to advocate lessening unemployment by high-speed development, this confuses two kinds of unemployment, with different natures. The above-mentioned job-awaiting population in the urban and rural areas, is a problem of regulating the economic quantum. It may be alleviated, in a certain period and to a certain extent, by the expansion of monetary policy.

However, the "underemployment" under discussion in our country, means the existing special type of unemployment, namely, the 30% redundant personnel among the 150 million staff and workers of State-run enterprises. This is the core problem of China’s economic restructuring, and transformation of industrial structure. If we admit that the nature of State-run enterprises is a problem of economic structure, then we should admit that financial measures should be mainly adopted in economic policy. The attempt to solve the problem of economic structure by the monetary measure of expanding economic quantum, not only violates the basic principle of economics, it is also impracticable, as proven in China. In 1992-93, the economy of our country grew at a super-high speed, with very serious inflation, yet the performance of State-run enterprises did not obviously improve.

Since the macro regulation, our government has subsidized the losing State-run enterprises with a big amount of low-interest loans. The State-run enterprises shared 70% of the low-interest loans provided by the banks, yet produced only 45% of the output value. To subsidize the State-run enterprises by expansive monetary measures for a long period, has become a special source of inflation in our country. It has no economic benefit, as well as no ending. If this continues, then how high must be the speed [of economic expansion] and how high must be inflation, to be able to save the State-run enterprises?

Second, exaggerating the danger of unemployment, while belittling the danger of inflation, is not in conformity with the axiom of policymaking and social control. Under general circumstances, unemployment is certainly more dangerous than inflation, because the unemployed minority bears the entire economic pressure. Inflation is just the reverse. The pressure of inflation is borne by a portion of all social brackets, so it is bearable generally, unless galloping inflation appears.

From the viewpoint of the local government, this is a thing of "very great benefit, yet costless." If serious trouble from the unemployed occurs in a local area, the local government has to shoulder all the responsibilities. While issuance of more money mitigates the unemployment of its local area, the inflation pressure created by such issuance has to be borne by the people of the whole country. This is tantamount to making the people of all China and other areas, pay for the benefit of employment and social stability benefit "of its own locality."

Therefore, the policy of the local government is certainly to assure employment to the best of its ability, disregarding the cost of inflation to be paid. From the viewpoint of the central government, the same "cost-benefit approach," turns out to be an entirely different thing. The "trouble making" of the unemployed in a locality is just a local problem, not necessarily endangering the whole country immediately, while the route of extending "stability and unity loans by the banks" can only aggravate inflation in our country. The "benefit" gained by the central government is short-term stability in different localities, but from the angle of national control, it is not beneficial.

The contradiction has not been solved; rather, it is exacerbated, by turning the crisis of State-run enterprises into the crisis of national banks, which is further turned into the credit crisis of the government. This will finally concentrate on some unexpected incidents, and explode. Then the "social cost" to be paid will be incalculable.
Argument 3

Macro financial stability is necessary for market direction reform; refuting the argument that "inflation is necessary for reform."

This third argument, in favor of inflation, is that the process of reform requires inflation. According to the calculations of the experts concerned, the structural price reform caused prices to rise 3% annually, while the additional issuance of money required to lessen the friction of reform, caused another 3% rise in prices. Lou Ji Wei wrote in 1994 that this 6% rise in prices annually is the "cost of reform."

It is necessary to maintain economic development and to alleviate social friction in the process of gradually progressing reform; hence, it requires the rise of prices, to a certain extent. This is understandable. However, if the rise of prices has been continuously over 10% for several years in China, and will even increase, this will naturally create doubts among the people about such reform. The "reform cost argument" is only suitable for a "once and for all" price reform.

Under a gradually progressing reform, the prices of agricultural products have been raised, without a drop of the prices of industrial products, and the overall price level is naturally raised. Such a price rise is not due to inflation. Inflation means the issuance of money, surpassing the needs of circulation. For structural price adjustment, it is necessary to increase the issuance of money, because the adjustment itself raises the prices. This is also true for monetization of the economy. This kind of increase of money, does not cause the money supply to surpass the need of circulation, hence it is not inflation.

Only the policy of pursuing super-high-speed economic growth, by subsidizing budgetary deficits through bank overdrafts or by engaging in credit inflation, can lead to inflation. Only a small portion of the appearance of continuous overall price rises in the process of price reform, is due to the price reform itself, while a major portion is due to demand inflation and monopoly. As the cause cannot be distinguished in the monetary issuance, somebody uses it as a defense for inflation, in the name of the "needs of reform" and "economic axioms."

Actually, the price reform in China has long passed the stage of "price adjustment promoting rise in overall price level," and has entered the stage of "inflation leading to restoration of price ratio." When the prices of agricultural products and basic products were adjusted upward for the formation of a rational price structure, a continuous total demand inflation appeared, resulting in a faster rise of the prices of processed industrial products, as well as the re-enlargement of the "scissors" differential between agriculture and industry. Then, it becomes necessary to raise the prices of agricultural products and basic products again.

Can we call such a "rotating increase of prices," price reform? Inflation not only can promote no reform, but will instead undermine the stable economic and social environment. The inflation in 1988 caused social unrest. Whenever the rise of prices was too high, the central government demanded that local governments temporarily stop promulgation of new price reform measures.

At the end of 1993, the price of grain rose, accompanying the galloping rise in price of steel futures from RMB 3,000 to RMB 4,000 per ton, resulting in a rise of 20% in retail prices. The central government was forced to make stability the priority, and slow down the pace of reform. In the latter half of 1994, the continuous, unexpected rise of prices forced the central government to make controlling inflation the core economic task. The higher the rise of prices, the more the administrative measures have become a regular pattern. In many places this year, the use of grain and edible oil coupons reappeared, while the State monopolized the dealing in products, as well as fixing their prices. The appearance of galloping inflation led to total economic control, forcing the market economy to retrogress to a planned economy. This happened in a number of countries.

Another harm inflation does to market-guided reform, is damaging market signals and promoting economic instability. Since price mechanism is the basis for regulating the relation between supply and demand in a market economy, how can we imagine that a confused and uncertain price system can effectively allocate resources?

Inflation is directly related to economic uncertainty. It is impossible to have a "stable inflation"—the illusion cherished by some people—by hooking prices, wages, rates of interest, and rates of exchange, to the practice of legalized and open inflation, so as to make it up to the suffering social strata and to stabilize the psychology of the residents. As soon as galloping inflation appears, it is certainly unstable and will surely bring along confusing market signals, making it impossible for government policy to be stable, also.

Since 1993, speculative capital to the amount of RMB 300 billion has appeared in China. In conjunction with confusing price signals and confusing psychological expectations, this has greatly aggravated the economic instability in China. In today's economic reform in China, inflation has reached the "stage of serious inflation," with three consecutive years of two-digit inflation rates. The seriousness of the result, is not whether it is bearable by the population, but the possibility of forcing the government to practice the "hook-up policy" after the inflation rate reaches 20%, which in turn will have inflation running wild, and quickly lead to galloping inflation.

In short, in order to carry out well the reform of the market economy, we should pay close attention to macro-economic stability, as well as prevent the appearance of galloping inflation in China. A real market economy is an economy with supply greater than demand, but not an economy with galloping inflation.

Argument 4

The "population's ability to bear it," is basically "the
The increase of prices and wages in urban areas, which was originally intended to absorb and subsidize the previous rotation of price rises, instead hurt agriculture, causing a more serious rise of prices in the next rotation. Agricultural prices always logically lagged behind; there was a subsidized rise of prices after agriculture suffered the blow. Agriculture suffered blow after blow, in the series of inflation cycles over a long period.

Agriculture cannot stand the fluctuations of market economy, let alone the blow of serious inflation, especially under the conditions of the initial stage of market economy and the dispersed blind production of countless small peasants in China. Therefore, the "bearability of prices to the population" cannot be measured by a standard such as a 10% or 20% rise of prices, because, with the practice of indexation, while even the blow of inflation is bearable to the wage-earning residents of urban areas, it is nonetheless unbearable to the peasants. This will shake social stability. The existence of a vast rural area with its massive population, is the basic reason why China cannot depend upon foreign trade for its national survival, and cannot depend upon foreign loans and inflation for its take-off. It is also a self-regulator for policy errors, and has prevented previous successive strategic mistakes from lasting long.

**Argument 5**

Behind inflation and the price monopoly is the scramble for recourse by the diversified interest groups; the nature of inflation is comprehensive social crisis.

In China, the effective control of issuance of money cannot entirely depend upon the central bank. The credit program target is often surpassed. The local government can actually force the bank to increase the loan, or divert it for other purposes, thus forming a "backward pressure mechanism" on the central bank. Therefore, in order to control inflation, it is necessary, first of all, that the central bank should have independent power of issuance, many of the specialized banks should be commercialized, and the structural reform of the enterprises should be carried out.

The other reason for not being able to control the issuance of money, is the wide existence of price monopolies. In the
The economy is characterized by a broad existence of monopolies and sudden huge profits. In the event of currency deflation, the monopoly section of the economy would reduce production and raise prices to seek a high profit, while the non-monopoly section of the economy would shrink with the economic contraction.

The third reason is investment inflation, which is hard to check. Both demand inflation and price monopoly in China reflect a common nature, as the various interest groups scramble for resources in an unfair way, thus creating a comprehensive social crisis. There are, principally, five kinds of “interest groups,” as follows:

1. The central government, which has decentralized a considerable part of economic power after the reform.
2. The local governments, which have gained considerable power and become the biggest beneficiaries since the reform. The local governments’ increase in power has brought prosperity to local economies, with the appearance, on the other hand, of duplicate construction and investment inflation. Local blockades are thus hampering the formation of a unified national market and thorough implementation of the industrial policy of the central government. Each local government scrambles for resources with investment inflation, as a means to strive hard for high-speed and high-income development of its locality. At the same time, this is transferring inflation to other localities.
3. The economic departments in charge under the central government. After the practice of the contract responsibility system of industries, many of the departments have their own economic interests and established a large number of companies. In the resistance to purchasing property rights by foreign capital, in seeking State protection in terms of departmental tariffs and non-tariffs, in “seeking rent,” and monopoly business, this is a force capable of influencing policymaking of the central government. Meanwhile, the appearance of monopoly prices also pushed up domestic inflation.
4. The State enterprises.
5. Individuals, who play a stronger economic role. The savings rate of the population has been maintained above 40%, with a continuous increase of savings over consecutive years. This is the key to ensuring high accumulation.

In the process of rapid economic prosperity, the various interest groups have undergone considerable diversification. The lack of standardization in behavior, produced the social problems of corruption, monopolies, cheating, sudden huge profits, and damage of resources, accompanied with the drop in ability to maintain social control. Meanwhile, each interest group adopted various unfair practices in pursuing its interests. Besides seeking special protection and privileges from the government, one of the unfair practices is to scramble for resources by gaining sudden huge profits through raising prices or by investment inflation. Therefore, the real nature of worsening inflation in China is lack of an integrated mechanism for effective, open, and legalized regulation of the interests of various interest groups.