Beijing's Olympian task is to curb inflation

By Stephen Roach

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Too much is being made of the economic impact of the Beijing Olympics on China and the rest of Asia. China was slowing before the onset of the XXIX Olympiad and is likely to continue to slow in the year ahead. Elsewhere in Asia, a similar outcome appears to be in the offing.

Significantly, most of the Olympics-related construction activity in Beijing – some $42bn (€29bn, £23.6bn), according to the official Chinese tally – was completed more than a year ago. That means any post-Olympics construction payback should have occurred quite some time ago rather than in the aftermath of the summer games. Yes, there were plant closings in Beijing and the neighbouring city of Tianjin for a few weeks before and during the Olympics. But these two metropolitan areas collectively account for less than 6 per cent of total Chinese output – hardly enough to make much of a dent in the Chinese production juggernaut.

At work, instead, are powerful repercussions of an external shock that has nothing to do with the Olympics: post-bubble adjustments bearing down on the US consumer, along with collateral damage now starting to show up in Europe and Japan. Developing Asia is the most export-intensive region of the world, with a record of more than 45 per cent of its pan-regional output now going to foreign markets. China's export share is close to 40 per cent. As the industrial world slows, China and the rest of export-dependent developing Asia will feel the effects of a shortfall in external demand with a lag. Any gyrations traceable to the Olympics are likely to be overwhelmed by these much broader, more powerful macro forces bearing down on the region.

Policymakers in China are very much aware of the mounting downside risks to economic growth. Bank lending quotas, which have been the centrepiece of recent tightening initiatives, have now been relaxed. The pace of currency appreciation has also slowed – a sharp departure from the accelerated rate of revaluation that had been evident in late 2007 and early 2008. And policy interest rates have been left unchanged in a rising inflationary climate – keeping real short-term interest rates close to zero, a highly stimulative position for any country's monetary policy. In short, China's pro-growth policy bias is once again coming though loud and clear, reflecting a shift in its policy stance that seems traceable to events far bigger than the Olympics.

In this context, inflation remains the biggest riddle for China. The recent pro-growth policy initiatives suggest that Chinese authorities are attempting to put a floor on the gross domestic product growth shortfall of somewhere in the 8 to 9 per cent range. Perhaps the biggest macro question for China over the next year is whether such a slowing – from the torrid growth pace of nearly 12 per cent in 2006-07 – is sufficient to stem the recent build-up of inflationary pressures.

There is good reason to believe that inflation risks will remain China's most daunting macro challenge over the next few years. Particularly worrying is a growing inclination of Chinese officialdom to dismiss the build-up of inflationary pressures as "structural" – traceable to special forces that are argued to be beyond the control of domestic monetary policy. Three such developments are cited most frequently: recent labour reforms that have boosted minimum wages, an outbreak of "imported" commodity inflation, and international price equalisation that is presumed to bring the quotes of Chinese products up to world standards.

This structural excuse for China's inflation problem is painfully reminiscent of an equally erroneous dismissal of US inflation risks in the 1970s. Back then, three structural forces were also cited as being beyond the purview of the US Federal Reserve, namely wage indexation to CPI shocks that created a wage-price spiral, imported inflation due to the worldwide commodity boom of the early 1970s, and mandated increases in production expenses traceable to regulatory initiatives in pollution abatement and worker safety.

The most important lesson of the 1970s is that the Fed proved to be dead wrong in dismissing inflation risks as structural. While inflation eased off in the middle of the decade as the US went through a deep recession, it roared back with a vengeance as the economy recovered in the latter half of the 1970s, hitting a high of 13 per cent by the end of 1979. It took a new, courageous Fed chairman, Paul Volcker, to put the structuralist inflation argument to rest by driving up the federal funds rate to extraordinary levels and putting the economy through a wrenching hard landing.

That is an outcome that China – and an increasingly China-centric developing Asia, long fixated on social stability and poverty reduction – simply cannot risk. A hard landing could prove devastating to regional development imperatives. Yet to the extent that China and other Asian countries dismiss mounting inflation risks as structural and fail to heed the most salient lesson of the 1970s, the risk of an eventual hard landing will only grow.

That poses a serious question for the rest of Asia as well as for the broader global economy: can a build-up of inflationary pressures be contained to China? In the near term the downside of the global business cycle may limit the spread of inflation. But over the medium term that could change. The cross-border linkages of globalisation may make containment of Chinese inflation exceedingly difficult.

Temporary growth risks should not be the dominant concern in post-Olympics China. Stagflation may well be the greatest risk: an externally induced growth shortfall coupled with a significant deterioration of underlying inflation risks. Chinese officials are fixated on the growth side of the stagflationary equation, but they ignore the inflation piece of the outcome. That remains the greatest worry in the aftermath of an otherwise spectacular Olympics.

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