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China rate move turns focus on rising prices

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Published: October 20 2010 17:38 | Last updated: October 20 2010 17:38

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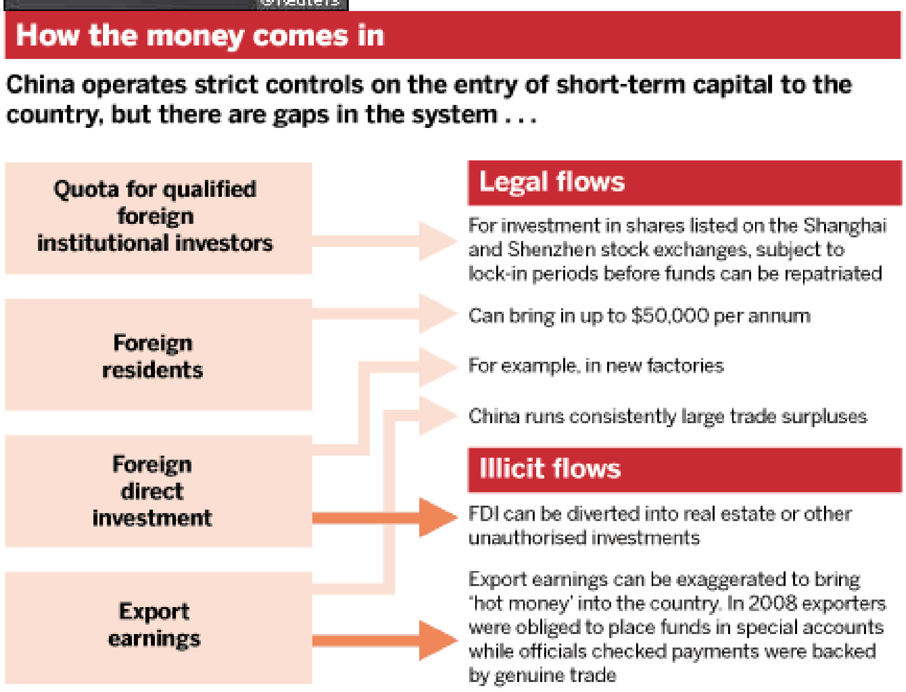

Chinese officials have been complaining for weeks about the impact of loose monetary policy in the US on economies in the developing world.

With a decision on Tuesday to raise interest rates for the first time in almost three years, it is now clear why.

Chinese policymakers have been divided between those concerned about inflation and those worried about weak demand.

The decision to opt for the blunt instrument of higher interest rates suggests the focus is firmly on preventing an asset bubble being fuelled by international liquidity that is already abundant – even before the possible **extension of quantitative easing** in the US.

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"Worries about soaring prices overwhelmed fears about economic growth," Li Daokui, a member of the central bank's monetary policy committee, was quoted as saying by the official Xinhua news agency.

Some analysts believe the rate rise means inflation and third-quarter gross domestic product figures to be published on Thursday will be surprisingly high. The consensus forecast is that economic growth slowed to 9.5 per cent year on year last quarter, down from 10.3 per cent on the second quarter.

However, the most likely backdrop to the rise is what has been happening in the housing market in places such as Chongqing, a city in central China.

Rather than raise rates, China introduced a range of targeted policies in April to try to cool the property sector, which seemed to work for a while.

Yet when the developers of the Jinjiang Licheng project in Chongqing put 500 flats up for sale on October 6, they sold out within the day. At a real estate fair held at the weekend in the city, 10,000 apartments were bought.

“The market does not seem to be affected any more by the government clampdown,” says Wang Yong, at the Chongqing office of **China Index Academy**, a research consultancy.

With real interest rates on deposits at negative levels, the temptation to take money out of the bank and invest in property is powerful.

Yet raising rates sets up two dilemmas for the Chinese authorities. Inflationary pressures are being fuelled by capital inflows but higher rates run the risk of attracting even more capital into the country. Capital inflows will probably increase as a result of higher rates, says Huang Yiping, an economist at Peking University, although the government might try to tighten capital controls at the same time.

That in turn raises difficult issues for managing the currency, which the authorities have allowed to appreciate 2 per cent against the dollar since early September as political pressure from the US and Europe rose.

One instinct would be to halt appreciation in an attempt to deter speculative inflows. Indeed, the currency barely moved in Wednesday’s trading.

However, if investors take the view that this is just delaying inevitable gains in the currency at a later date, it would act as a further incentive to capital inflows.

“Increasing interest rates will lead to more inflows, so the currency will need to appreciate to counter this,” says Eswar Prasad, a former head of the China desk at the International Monetary Fund now at Cornell University in the US.

The broader question is whether this is a modest one-off concession to concerns about bubbles or the start of a new cycle.

Several analysts believe the rate rise could mark a substantial shift in economic policy from a government that was previously obsessed about meeting high growth targets.

The rate rise comes days after a Communist party meeting to approve the next five-year plan, which some analysts took as endorsement of structural reforms to rebalance the economy away from investment and exports.

The communiqué released afterwards pledged to increase the share of national wealth from household income and made no reference to real estate as a main priority.

Higher rates for bank deposits would form part of that process of boosting consumption.

Recent comments by **Yi Gang, deputy central bank governor**, about setting a target for a large reduction in the size of the current account surplus have also encouraged hopes of a renewed push on reforms.

“The tightening is part of a shift in economic policy from growth towards structural reforms and managing the risks of a bubble,” says Isaac Meng, an economist at BNP Paribas in Beijing.

Whether rates continue to rise will be one important barometer of the political support for more reforms.

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