Worksheet 14.3

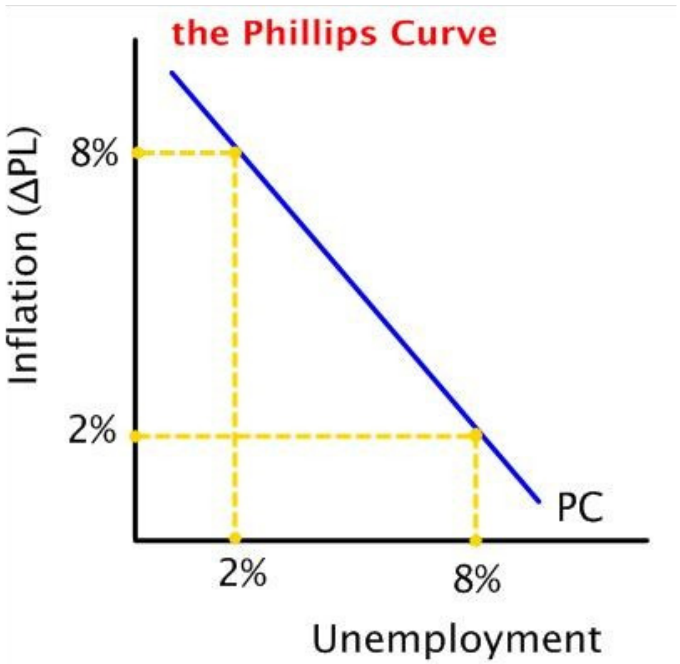
Politics, Priorities and the Phillips Curve

Inflation, with its erosive effects on wealth and income, has plagued China at increasing rates since mid-2007. In February it reached an annualized rate of 8.7%, threatening to undermine China's GDP growth rate, which has been predicted in the 8% range for this year.

China's inflation is caused by a combination of demand and supply-side factors. On the demand-side, a growing middle class has driven consumer spending to record levels recently, surpassing investment as the largest component of China's GDP in 2007. Of course, as always, high inflation (thus low real interest rates), optimism about rising consumption in the future, and a comparative advantage in labor-intensive manufacturing (albeit a diminishing one as wages continue to rise) all combine to keep investment extremely high. Furthermore, cheap exports have helped keep demand for China's output from abroad strong. The combination of increasing consumption, strong investment, and its trade surplus have resulted in demand-pull inflation.

On the supply-side, China has encountered additional inflationary pressures of late. Rising energy prices (mostly due to coal and oil shortages) combined with record rises in food prices (24% increase in the last year), have driven costs to firms up, shifting the aggregate supply curve leftward, further fueling inflation.

Knowing the damaging effects inflation has on income and wealth, it might be assumed that Beijing would place the utmost emphasis on taming the country's rising prices. This, however, is not at the top of the government's macroeconomic goals, according to premier Wen Jiabao: read paragraphs seven and eight from this link.



The tradeoff between inflation and unemployment to which Mr. Wen refers is an example of the challenges faced by macroeconomic policymakers everywhere. This trade-off is illustrated in the Phillips Curve model, which shows that in the short-run, there exists an inverse relationship between the price level and the unemployment rate.

In his words in the link above, Mr. Wen demonstrates Beijing's preference in the trade-off between inflation and unemployment: he'll take inflation. Here's why.

In case you haven't heard, China is not a democracy. Nor is it a 'free' country. According to former US Federal Reserve Bank chairman Alan Greenspan in his book 'The Age of Turbulence' democracy and freedom of speech act as 'safety valves' in Western countries; in other words, in times of economic or political unrest, the right to gather in the streets, the right to vent frustrations through a free press and the opportunity to advocate political and economic change through the various media, all combine to prevent violent and revolutionary uprisings when times get tough economically.

Take the US for example. Times are certainly tough right now. US unemployment is at its highest level since the Great Depression, and amid expectations of a 'double dip' recession, inflation is near zero percent, and deflation is looming. The bursting of the housing bubble in 2008 represented one of the most massive losses of wealth in recent history. A weak dollar has meant that even cheap imports don't seem so cheap anymore. When we consider the political turmoil, debate over the federal budget deficit and the national debt, and a highly partisan climate in the nation's capital, and by some measures the country would appear ripe for revolution.

However, a revolution is about the least likely thing to occur in America, because it enjoys the 'safety valve' of democracy. Rather than *overthrowing* their government, Americans have the right to go to the pole and vote for a new one.

Now let's look at China. The picture's not quite so gloomy for the Chinese right now. Yes, inflation is high, but unlike America, China is still growing at a very healthy pace, unemployment is probably still below its natural level, the real estate markets in China's cities are still booming, meaning the middle class residents there are experiencing leaps and bounds in terms of personal wealth. Demand for its exports remains strong, and ever more poor Chinese are finding jobs in high paying factories across the country. Investments in capital, infrastructure and education point towards a bright future of continued growth.

China's 8.4% inflation, in other countries, would really be something to worry about. But China's leaders don't seem to concerned about bringing down inflation, rather have decided to maintain a growth policy that guarantees low unemployment. In short, China has chosen to remain in the upper left region of its Phillips Curve, accepting high inflation in order to maintain low unemployment.

It appears that Beijing's greatest fear is a population out of work. Without the 'safety valve' of democracy through which economic frustrations and hardships can be channeled, were the country to experience a slowdown in growth and an increase in unemployment, it is not unlikely that frustrated Chinese citizens would turn revolutionary and demand major changes to how China is run, threatening the Communist Party's power.

This one passage spoken by Wen Jiabao, China's premier, tells a vivid story about the reality of Communist dictatorship in China. Sound economic policy may go on the back burner in times of political uncertainty.

Questions:

1. Why will maintaining low unemployment and rapid economic growth in China likely mean continued high rates of inflation?
2. Why can't the Chinese government enact policies to bring down inflation while keeping unemployment low?
3. If the government decided to tackle inflation instead of focusing on employment, what political risk is it taking?