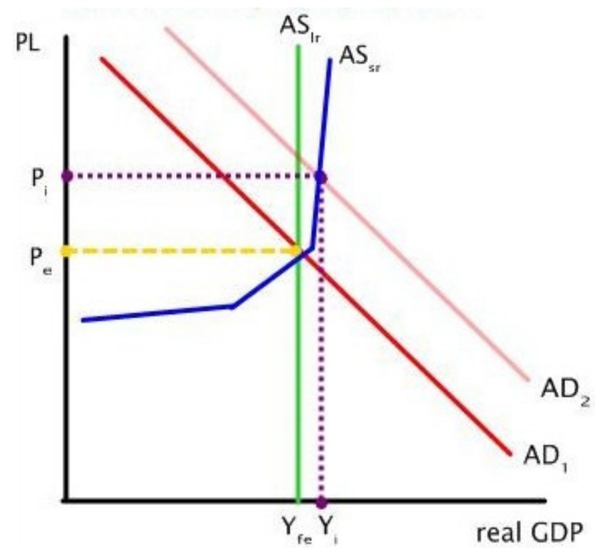
Worksheet 22.2

China's Silver Bullet

Two goals have recently been voiced by the Chinese government: *increased consumer spending and reduced inflation*. These are worthy goals for policy makers to pursue; if accomplished, they will mean increased well-being for the average Chinese household, which will enjoy more goods and services at lower prices.

The problem is, increased consumption usually means rising prices, as can be clearly illustrated in an aggregate demand / aggregate supply diagram. Household spending makes up somewhere around 40% of China's GDP, exports, government spending and investment account for the rest. Whenever one component of total expenditures increase in the economy, all other things equal, the price level will rise.



Only two things could happen to make the Chinese leadership's goal of increased consumer spending and stable prices a reality: either productivity in the economy must increase more rapidly than consumer spending, shifting aggregate supply outward, or another component of aggregate demand must be reduced more rapidly than consumption increases, offsetting the increase in overall expenditures cause by rising consumption.

So what magical combination of fiscal and monetary policy can be employed to both increase consumption and stabilize the price level? The answer may not rest purely in the realm of domestic macroeconomic policy making, but rather in the foreign exchange markets, where a weak RMB has kept domestic consumption low and net exports (thus the price level) high. Allowing the RMB to appreciate should make 'magic' happen and lead to rising domestic consumption and disinflation simultaneously. According to financial expert Peter Schiff: read paragraphs two, three and four from this link.

If China adopts a 'strong yuan' policy, its demand for US dollar-denominated financial assets, including government debt, will decline, reducing demand in the US bond market, which would drive up interest rates in the US. Higher US rates will discourage investment and consumption, exacerbating the slowdown already underway in America. Furthermore, reduced demand for US assets by China will cause demand for the dollar to slide in foreign exchange markets. Since much of Americans' household spending is on imports, inflation will rise in America as not only Chinese goods, but all imports, are now more expensive to Americans.

Questions:

1. How could a stronger RMB simultaneously increase domestic consumption and reduce inflation in China?
2. Why would a stronger RMB lead to higher interest rates in the US?
3. Why would a stronger RMB lead to inflation in the US?
4. Why do you think the Chinese government refuses to let the RMB appreciate against the US dollar?