ASK: NUS ECONOMISTS

Different tools to manage the economy

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Although they are both large economies, the United States puts a lot of emphasis on interest rates while China targets the exchange rate in managing the economy and reining in inflation. What is the difference and why?

ECONOMIC growth and controlling inflation are two of the most important targets of monetary policy. The first aims to create jobs and the latter to control prices.

There are different ways to achieve these goals. The US uses the interest rate while China focuses on its exchange rate.

A country may aim to target an interest rate for its currency. It cannot do so directly, but only indirectly, by buying or selling funds in the market. For example, the Federal Reserve – the US central bank – regularly buys or sells short-term government bonds on the open market. This injects or withdraws money from circulation, affecting the short-term interest rate and, thereby, the other rates.

Interest rate targeting is based on the idea that the private sector, and not the government, is best at allocating funds for spending.

In a recession, the Fed aims for a lower rate. This makes it cheaper for private sector companies to raise or borrow money for their expenditure. This raises aggregate demand. But in times of inflation, the central bank works towards a higher interest rate to cool down the demand.

There are, however, circumstances where interest rate targeting may not work. For instance, in the current zero-rate environment, the Fed cannot push the interest rate down any further.

But in normal times, interest rate targeting is effective in curbing inflation or unemployment.

If inflation and recession occur at the same time, as they did in the 1970s, the Fed has to make a judgment call as to which is more important to tackle.

The ultimate aims of China’s efforts – increasing growth and reining in inflation – are not that dissimilar to those of the US.

But the institutions that can support its market are still underdeveloped in China and its average living standard is still a fraction of that of advanced economies.

To catch up, its priority is fast growth. So it uses its exchange rate to drive up its manufacturing exports as the best strategy for now, even though this may lead to unbalanced growth.

Such a strategy has many advantages for an emerging economy. First, it feeds on the large global consumption market rather than the smaller domestic market. Secondly, it attracts foreign investment and technology, and the global market network of multinational corporations.

Competing in global markets also subjects companies to stringent market discipline, thus improving domestic production efficiency.

Over the past few decades, this strategy has taken Japan, South Korea, Taiwan, Hong Kong and Singapore from poverty to First World standards of living.

The strategy, together with other state-directed investment policies, has also produced spectacular results for China. It is now the second-largest economy in the world. It manufactures a large array of goods at low prices. The strategy has also lifted the national income of its trading partners that produce commodities and resources, and it has amassed nearly US$3 trillion ($3.6 trillion) of foreign reserves that can help its own domestic development and be lent to debt-ridden advanced economies.

But these achievements come with several problems: unbalanced growth between the manufacturing and service sectors, income inequality between the coastal urban and rural areas and, on the global stage, huge trade imbalances between China and the US. These are acute problems that raise domestic and international political tension, and have been acknowledged as urgent challenges to be tackled in China’s latest five-year plan.

Another serious consequence of the strategy is inflation. Keeping the exchange rate low requires the constant purchase of foreign exchange using newly created money, leading to loss of control of its money supply and fueling housing bubbles and inflation, problems that further increase social tension.

Several measures have been put in place to soak up the money supply. These include foreign capital control, purchase of foreign assets, raising the amount that commercial banks must hold in reserve, and sales of government bonds.

But such policies are costly and only partially effective in taming inflation and asset bubbles. China may have to allow its exchange rate to move upwards sooner rather than later to deal with inflation.

In the long term, when China approaches advanced economy status and has developed market-supporting institutions, including finance markets, it will not need to pursue the unbalanced growth path it is on now. Instead, it is likely to engage in interest rate targeting and allow its currency to float as the advanced economies of the US and Japan do now.

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