

China's stealth problems

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Inflation is creeping into China's economy

China's new stealth fighter, test-flown for the first time Tuesday, apparently is so effective not even China's President knew it was in the air.

The first he heard of the flight was when the visiting U.S. Secretary of Defense asked whether it had been intended as a message for him. Not at all, said the President, meaning not from him, at least, since he hadn't known about it. The New York Times surmised the message was from the People's Liberation Army, which doesn't much like the Secretary, especially after his remark two years ago that China wouldn't have stealth technology until 2020. It also doesn't seem to like the President that much, partly because he seems increasingly willing to work with the Secretary and his boss, Barack Obama.

The Secretary concealed his sources in China under the cover of Chinese bloggers, whose posted pictures of the plane's first flight, atypically, weren't jammed by Chinese censors. (If bloggers can track it, how stealthy can it be?)

China's acquiring yet another accoutrement of superpowerdom does at least mean we can send less development assistance. As *The Economist's* cover put it after China's first manned spaceflight in 2003: "So, no need for any more aid, then?" Maybe we can even apply for some from them.

If you're Taiwan, or Taiwan's ally, as the Americans are, a Chinese stealth fighter is ominous, even if China already has enough unstealthy aircraft to clobber the island non-state if it really wanted to. Noisily delivered bombs hurt as much as quiet ones.

In other ways, though, the news from China is reassuring. First, there's Chinese growth. The World Bank reported Wednesday that developing countries as a whole not only have their output back to where it was before the crash, but have reached where they would have been had the crash not occurred at all. In the seminar room, economists often speculate about the true cost of perturbations that don't actually reduce overall output but merely redistribute it through time. The studies suggest deviating from the steady growth most people presumably prefer does cost something, but usually not very much. We can now ask people in the developing countries how much it all hurt them after the fact.

In richer countries, recovery is taking longer, though last year Germany posted its best economic performance since unification, while even in the U.S. things are looking up.

This week, The Wall Street Journal's editorial board was praising, of all things, the 23% rise in individual income taxes in the final three months of 2010, not because the board has suddenly gone over to the dark side on taxes, but because revenue growth is sure evidence economic growth is being firmly re-established.

Further evidence of China's migration to normality is that the Bank of China is opening currency trading desks in the U.S. so Americans and others can buy yuan, even if for the time being the amount they can buy will still be controlled.

Finally, as good capitalist macroeconomic theory would predict, China's inflation rate is accelerating, hitting 5.1% on a year-on-year basis in November, and maybe twice that in reality. (Like everything else in China, it seems, the country's consumer price index, which is unreliably antiquated and incomplete, is currently being modernized.) Theory says that if you suppress your currency's value by buying dollars or other foreign currencies every time it wants to rise, your resulting international surpluses eventually heat up your economy. Under China's very controlled float, the yuan did rise 3% against the U.S. dollar last year, though that evidently wasn't enough to cool things down.

China's economy has seemed magical for so long now it's almost reassuring to see signs of the same afflictions, such as inflation, that visit the rest of us. Inflation is a kind of stealth killer of economies, not to be wished on anyone. Moreover, if Chinese monetary policy can't engineer a soft landing but instead causes the economy to lurch into inactivity, that helps no one and may cause dangerous mayhem within China.

But if for a time Chinese wages and prices rise more quickly than Canadian or U.S. prices do, that will raise the delivered price of Chinese goods even if the yuan doesn't move at all against either country's dollar. The "real exchange rate" will be higher, even if the nominal one isn't.

It's not clear that exchange-rate movements will fix the "imbalances" in the world economy — the Americans' chronic indebtedness, China's massive surpluses — that so worry so many policy analysts. It's not even clear these imbalances really are such a problem: China has lots of willing savers and the United States still offers abundant investment opportunities, and will offer more as its recovery gathers steam.

Still, a rise in the real exchange rate would very likely reduce economic tensions between the two countries and that, in turn, would undermine many unsound policy ideas for dealing with the challenges each presents to each other — the U.S. export-import bank offering cut-rate loans on exports to Pakistan so as to match similar loans from China, for instance, or any of 100 different proposals in Congress or within the Communist party apparatus for blocking imports from the other guy.

Avoiding such a showdown would be a good thing for the world, Canada included, whatever the People's Liberation Army might think.

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