
China's Economic Growth with Price Stability: What Role for the Central Bank?

By Thomas M. Hoenig

I am honored to have the opportunity to address such a prestigious group on the matters of economic growth, price stability, and the role of central banks, particularly as they relate to the role of the People's Bank in China. I am especially pleased to be here since it was only two years ago that I visited the People's Republic of China, and I have developed a keen interest in the economic reform process in this critically important nation.

As I think about recent and prospective economic developments in China, I am not overstating matters when I say that the People's Bank is critical to the success of Chinese economic reforms. Since the reform process began in 1978, the Chinese economy has grown at an average annual rate of almost 9 percent. This is an enviable growth rate, and in my view its continuation relies importantly on an ongoing commitment by the People's Bank to maintain financial stability.

Despite dissimilar political and social systems, the emerging market economy in China and the more highly developed market economy in the United States must, by definition, ultimately func-

tion in similar fashions. In this context, the Federal Reserve System's experience in working within a rapidly changing, geographically diverse economy—its experience in balancing the pursuit of ambitious growth objectives against the dangers of inflation—may provide useful guidance to the People's Bank of China as it must now also confront these challenges in a more market-oriented environment.

As with central banks in most industrialized countries, a fundamental objective for the People's Bank is to have monetary and regulatory policies that contribute to financial stability and promote strong, consistent economic growth. Without stable, consistent growth, the market reform process in China cannot achieve its potential in improving the standard of living for the Chinese people.

I realize this is a rather broad statement, so let me cite more specifically four principles that I believe are critical to a central bank's long-run success.

The first principle I would list is not the most obvious, but it is critically important. It does not focus on any one policy tool but rather on the fact that in fast-changing financial markets, a central bank's varied functions are importantly interrelated and must be carefully managed and coordinated in pursuing financial stability. For example,

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the Federal Reserve, like the People's Bank, not only conducts monetary policy but has a significant role within the payments system and is involved in supervising commercial banks. The Federal Reserve, moreover, is a participant in some of the world's most important securities markets and is keenly aware of and, to a degree, involved in foreign exchange markets. The coordination of its involvement in these activities is important to the efficient functioning of a sophisticated economic and monetary system.

Often, these multiple functions are thought of in isolation, as if they had separate and distinct purposes. When inflation is held in check, when financial markets are operating smoothly, and when financial institutions are in sound condition, the various functions seldom seem to touch one another. But in times of crises their ties to one another become critical and all too apparent. Only when one or another function is out of balance do we realize how critically important that one is to the others.

A dramatic example of the significance of the linkages among central bank functions is the U.S. stock market crash in October of 1987. Concern about U.S. inflation and uncertainty about global macroeconomic policies contributed to the erosion of confidence that started the initial wave of selling of shares in the stock market. Computerized sell programs so increased the volume of sales that funds could not be transferred rapidly enough through the payments system to clear the transactions. Because of the resulting confusion and uncertainty, commercial banks were reluctant to serve their traditional role of providing liquidity to securities firms. In short, instability in the equity market contributed to instability in the credit market and the payments system, threatening a "melt-down" of the U.S. and international financial systems.

In these circumstances, Federal Reserve officials, in conjunction with other central bankers, suddenly found themselves needing to marshal the varied resources at their command. Officials

worked to ensure that problems with clearing transactions did not lead to gridlock in the payments system. Our operation of Fedwire, the principal electronic funds transfer system in the United States, enabled us to assist securities-clearing firms swamped by an unprecedented volume of transactions.

Other Federal Reserve personnel were reminding commercial banks of their need to provide credit to securities and other firms critical to clearing financial transactions; in return, the Federal Reserve assured the banks that it stood ready to meet their liquidity needs through the discount window and open market operations. Before U.S. markets opened the next day, Chairman Greenspan of the Federal Reserve issued a statement reassuring all financial market participants and the American people as a whole that the Federal Reserve would provide liquidity as necessary to protect the safety of the financial system. Employees from virtually all functional and geographical areas in the Federal Reserve played important roles in averting a financial collapse that would have led to untold consequences for the U.S. and world economies.

What would have happened if our central bank at this critical juncture did not understand how the various pieces fit together—the payments system, securities markets, the banking system, foreign exchange markets, and macroeconomic policies? We will, of course, never know the answer to that question; nor should we want to know. My point is that during such episodes of financial crisis, the broad scope of a central bank's responsibilities serves a country well. Only in such instances do we fully appreciate the intricate linkages between the various functions performed by most central banks, and how such linkages make price stability and stability of the financial system merely different hues in the mosaic of overall financial stability.

A second principle that I believe must guide a central bank's actions is that financial stability is served best through aggregate price stability, which thus should be the focus of monetary policy.

China's own history has shown that rapid inflation or deflation leads to unnecessary social friction—between borrowers and lenders, between workers and retirees, and between landlords and renters. Price stability best minimizes these inherent frictions and enhances a country's overall standard of living in the long run.

Prices play a critical allocational role in a market economy, and they play that role best, and contribute to economic growth best, in an environment of aggregate price stability. Markets function most efficiently when prices set in those markets give proper signals to consumers and producers. When prices accurately reflect consumer preferences, resource scarcity, and existing technology, then resources will be allocated to their most desired and efficient uses. And such efficiency is essential if the economy is to achieve its maximum growth potential.

Price stability, however, is sometimes sacrificed to calls for immediate, faster growth. The Federal Reserve and other central banks may be urged by well-meaning members of the press, of academe, and of the government to adopt policies that more quickly boost the economy. After all, it is argued, if a little liquidity is good, furnishing more liquidity is better, providing the means for banks and other financial institutions to increase lending. Greater availability of credit, in turn, would enable individuals and businesses to raise their spending on goods and services, thereby raising output and employment.

The problem with this line of reasoning is that it is shortsighted. The temporary spurt of economic growth will soon be cut short by accelerating inflation and uncertainty. As this pattern emerges, the central bank finds itself needing tighter monetary policy to prevent a further spiral toward rapid inflation and financial instability.

Such erratic stop-and-go policies impair rather than enhance long-run economic growth. They create distortions that lead to a misallocation of resources, a change in investment and consumption patterns, and a consequent reduction in

the long-run output potential of an economy. For this reason, policy actions that seem to provide short-run benefits are often incompatible with sustaining the maximum rate of economic growth.

Unfortunately, the world economies periodically must relearn this lesson through bitter experience. For example, inflationary forces unleashed in the United States during the late 1960s were allowed to ratchet up throughout the 1970s. By 1979, inflation had become so ingrained in the U.S. economy that domestic and international financial markets were in turmoil as investors throughout the world lost confidence in the soundness of the U.S. dollar. Not surprisingly, U.S. economic growth was also poor through much of the 1970s.

The Federal Reserve came to realize that monetary policy actions in the 1970s—although well-intentioned—were economically destabilizing. Regrettably, this realization came too late to prevent the painful adjustments necessary to restore confidence in U.S. monetary policy. These adjustments required a period of tight money and disinflation in the early 1980s. This led to the worst recession in the postwar period and to severe strains on financial institutions, indebted farmers, and others who had bet on continued inflation. Banks throughout the industrial world relearned the harsh lesson that real estate values can decline precipitously if a speculative, inflationary runup in prices is allowed to occur. And central bankers throughout the world were reminded anew that inflation, once unleashed, has prolonged and severe consequences, especially for financial institutions.

As for us in the United States, only when inflation began to be brought under control, at the cost of a severe recession, was the groundwork set for one of the longer U.S. expansions. And only through this painful process of recession and recovery was a consensus reestablished among central bankers worldwide that monetary policy oriented toward stable prices is the best way to ensure sustainable economic growth.

The third principle I offer for consideration concerns the central bank's need for independence. A degree of independence from other government functions is important to a central bank's ability to achieve long-run price and financial stability. Independence is particularly important if monetary policy is not to become subservient to the government's fiscal policy. Fiscal authorities have long recognized the short-term expediency of having central banks finance government spending. Yet experience in both the United States and elsewhere clearly indicates that both monetary and fiscal policies will be improved in the long run by granting the central bank a degree of independence from other government functions.

The need for an independent monetary authority is borne out by evidence from many countries. The German Bundesbank, the Swiss National Bank, and the Central Bank of Chile are generally considered to be among the most independent central banks in the world. Not coincidentally, each has an enviable record in keeping inflation under control. Indeed, empirical studies consistently find a strong negative correlation between a nation's average inflation rate and the degree of independence enjoyed by its central bank.

The most recent confirmation of this relationship comes, I regret to say, from the extremely high inflation rates in some of the emerging market-oriented economies in Eastern Europe and the former Soviet Union. As losses from state-owned enterprises swell the budget deficits in those countries, the central banks have been forced to monetize government debt—that is, government debt is converted into legal tender. Especially in Russia, the resulting inflation threatens to undermine the entire reform effort. It would be tragic indeed if the Russian people's first impression of a market economy is a debauched currency resulting from the central bank being subservient to the government's financing needs.

The founders of the Federal Reserve took steps designed to assure it at least a degree of

autonomy. Members of the Board of Governors are appointed to relatively long terms, intended to insulate them from the vicissitudes of politics. Moreover, the important monetary policy role assigned to Reserve Bank presidents and directors, none of whom are political appointees, provides further safeguards against those policies that can result when political leaders are pressed to produce quick results and are allowed to enlist the aid of the central bank in doing so. The founders of the Federal Reserve System clearly thought it prudent to have a monetary authority that is independent enough to take a longer run view of the national interest.

The final principle I offer for consideration is that, in a market economy, monetary policy necessarily evolves to become national in scope, while recognizing and allowing for regional differences. Monetary policy cannot alleviate regional imbalances in an economy that has a modern, efficient financial system. In such an economy, through price signals, financial resources flow inevitably to industries and regions where they can most productively be employed. A central bank's attempts to allocate credit to specific regions or uses are at best futile and, at worst, counterproductive. This is true for the United States today and will increasingly apply within the People's Republic as it evolves to a more fully integrated market economy.

Countries as large as the United States and China do, of course, have diverse economic conditions among regions. The district I serve, for example, experienced a serious recession in the mid-1980s as energy prices collapsed and agriculture went through wrenching changes. This occurred while other regions experienced rapid and sustained growth. In this instance, we realized that any attempt on our part to lend at rates lower in our region than in the others was bound to prove futile. These funds inevitably would have flowed to regions where the economy and loan demand were stronger. Through hundreds of channels, efforts by our Reserve Bank to provide credit on

preferential terms would be frustrated by private financial markets.

In an economy with less highly integrated and developed financial markets, there can be impediments to the flow of funds among regions, as I suspect is still somewhat the case in the People's Republic. In the early part of this century, U.S. financial markets also were more segmented and there was some constructive role for the Federal Reserve to target credit toward specific regions. On occasion loan rates among the regions differed substantially. U.S. markets obviously are now far more efficient, and region-specific monetary policy has long ceased. In a modern market economy, a single national monetary policy must necessarily be pursued.

Having said this, I hasten to add that the Federal Reserve still recognizes that economic activity differs among regions and that there is a need for regional input into national monetary policy. The presidents and boards of directors of each regional Reserve Bank bring unique information into the policymaking process by providing expertise on regional economic conditions. In deliberations establishing the Federal Reserve's discount rate, Chairman Greenspan and his colleagues on the Board of Governors give considerable weight to incoming information from these various regions. In addition, input from the 12 presidents brings a breadth of experience to monetary policy deliberations that would not be possible if all policymakers were located in the nation's capital.

As president of a regional Federal Reserve Bank, I am of course always particularly sensitive to the economy and industries in my district. I feel it is my responsibility to inform my colleagues on the Federal Open Market Committee how economic developments in my district fit into the national outlook. But it is also my responsibility to discern what monetary policy actions are appropriate for the national economy, not just for some particular region or industry.

Let me conclude by addressing briefly how I see some of these principles applying more specifi-

cally to China's People's Bank, as the country moves increasingly toward a market-based economy.

First and foremost, the People's Bank should continue to focus on price stability. As an increasing number of prices in the Chinese economy are influenced by market forces, it will be particularly important to avoid inflation. The People's Bank has demonstrated by its actions in recent years an obvious understanding of this most basic principle. As in every country, however, the efforts to control inflation will continue to exact some short-run costs.

The economic slowdown from rates exceeding 11 percent, which followed the more restrictive monetary and credit conditions implemented in 1988, may have seemed to some a regrettable interruption in the remarkable Chinese economic reform program. But it was correctly realized that inflation could not be allowed to continue accelerating as it had in 1987-88 at rates above 18 percent. Again, earlier this year it was deemed necessary to tighten credit to prevent another overheating of the Chinese economy. In each instance, the People's Bank rightly decided, I believe, that a sound currency is indispensable if the Chinese economy is to continue reaping the benefits of economic reform.

Looking ahead, as China's financial economy continues its rapid development, the People's Bank will need to develop more efficient tools for influencing monetary and credit conditions. I heartily endorse the recommendation of the recent World Bank study that the People's Bank redouble its efforts to develop indirect monetary policy levers. As markets develop, expand, and become more efficient, regions within the People's Republic will become increasingly linked. Such an evolution within the economy will require that, to the greatest extent possible, monetary policy be allowed to work through its effect on prices and yields in financial markets, replacing quantitative controls now frequently used. Also, as this evolution occurs, the extent to which the People's Bank can—or should try to—influence the regional allocation of

credit in China will inevitably diminish just as it has in the United States.

As it is currently structured, the People's Bank will play a critical role in ensuring that the nascent financial markets are both safe and efficient. Instability in financial markets will on occasion disrupt the real economy in China, just as it threatened to do in the United States and other industrial countries in 1987. To minimize this possibility, the People's Bank will need to understand these markets and devote particular attention to developing laws and regulations that balance the need for open and efficient financial markets with the need for the safety and soundness of the financial system.

Finally, the People's Bank should, to some

reasonable degree, be independent in conducting monetary policy. The need for such independence is amply demonstrated by recent experience. The restrictive policy actions leading up to the Chinese recession caused increased losses by state-owned enterprises. Financing these losses, as I understand, contributed to overshooting the credit expansion plan in both 1990 and 1991. This rapid credit growth may be complicating ongoing efforts by the People's Bank to avoid another bout of accelerating inflation. Progress in achieving a more complete separation of fiscal and monetary policies is thus essential if the People's Bank is to fulfill its responsibility for long-run price stability and, most important, for long-run growth and an improved standard of living.