What monetary policy does China need?

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China's remarkable growth has been financed recently by a rapid expansion of money and bank credit that is producing an unsustainable investment boom.

This renews concerns the country may not be able to avert a replay of the painful boom-and-bust cycle such as the one it endured in the mid-1990s. Monetary policy is usually the first line of defence in such situations. But China's policy has been hamstrung by the tightly managed exchange-rate regime. This regime prevents the central bank - the People's Bank of China (PBC) - from taking appropriate policy decisions to manage domestic demand, because interest-rate hikes could encourage capital inflows and put further pressure on the exchange rate.

There is a vigorous ongoing debate about China's exchange-rate policy. China's rising trade surplus has led some observers to call for a revaluation of the renminbi to correct what they see as an unfair competitive advantage that China maintains in international markets. Others argue that the stable exchange rate fosters macro-economic stability in China. But this debate misses the point. What China really needs is a truly independent monetary policy oriented to domestic objectives. This would enable the PBC to manage domestic demand by allowing interest rates to rise to rein in credit growth and deter reckless investment. An independent monetary policy requires a flexible exchange rate, not a revaluation. But what could replace the stable exchange rate as an anchor for monetary policy and for tying down inflation?

We recommend a low inflation objective. Research and the experiences of many countries show that focusing on price stability is the best way to achieve the broader objectives in the charter of the PBC: macro-economic and financial stability, high employment growth, etc. The low inflation objective need not involve the formalities of an inflation-targetting regime, such as that practiced by the European Central Bank, and is similar in approach to that recommended for the US by US Federal Reserve Chairman Ben Bernanke.

The banking system remains fragile, but we believe a minimal set of financial-sector reforms - essentially making banks' balance sheets strong enough to withstand interest-rate actions - should suffice to implement a low inflation objective. Although full modernisation of the financial sector is a long way off, even in the best of circumstances, the minimal reforms that we recommend could strengthen the banking system sufficiently in the near term to support a more flexible exchange rate anchored by an inflation objective. Indeed, price stability, and the broader macro-economic stability emanating from it, would provide a good foundation for pushing forward with other financial-sector reforms. The framework we suggest has the important benefit of continuity. The PBC would not have to change its operational approach. Only a shift in strategic focus would be needed to anchor monetary policy with a long-run target range for low inflation.

Monitoring of monetary targets would still be important in achieving the inflation objective. Furthermore, it should be easier to adopt the new framework when times are good - like now, when growth is strong and inflation is low.

There is some risk that appreciation of the exchange rate if greater flexibility were allowed could precipitate deflation. What this really highlights, however, is the importance of framing the debate about exchange-rate flexibility in a broader context. Having an independent monetary policy that could counteract boom-and-bust cycles would be the best way for China to deal with such risks.

Contrary to some opinions that it is premature, there are good reasons for China to begin right now to build the institutional foundation for the transition to an independent monetary policy. Indeed, early adoption of a low inflation objective would help secure the financial stability China needs, as it allows greater exchange-rate flexibility.

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