China Will Not Be Exporting Inflation

When did we arrive at the point where the answer to every question in finance was either "China" or "hedge funds?" The answer is somewhat immaterial, but the answer here is a specific date, May 6, 2003, when the Federal Reserve lowered the federal funds rate to 1.00% and pledged to undertake whatever extraordinary measures were required to forestall deflation.

Some wars are winnable, and for better or worse, the world's central banks were able to win this one by stuffing enough liquidity into financial markets to make the world safe for anyone, hedge funds especially, who wished to leverage their positions and ignite a multi-year boom in risky assets whose consequences became apparent by mid-2007.

And if low interest rates operate by encouraging current consumption at the expense of savings, China became the immediate beneficiary thereof. As China pegged its yuan (CNY) to the dollar, it was part of the dollar bloc. It became quite easy to satisfy the American consumer by building export-oriented plant and equipment in China, the lowest-cost producer in the dollar zone. In addition to direct cost advantages and a currency alleged by headline-grabbing politicians to be manipulated, China enjoyed other advantages such as no health, safety and environmental regulations to speak of and a banking system that is a direct adjunct to the ruling Communist Party.

As an aside, can anyone point to a currency that has not been manipulated over the past thirty-five years? The U.S. engaged in a deliberate policy of dollar devaluation between the September 1985 Plaza Accord and the February 1987 Louvre Agreement in an effort to correct its trade deficit. How well did that policy work? In addition, the U.S. turned a blind eye toward the effects of low interest rates on the dollar in 1992-1993 and again in 2002-2004. Nations who live in glass houses should not throw stones.

We cannot rewind history and see what would have happened if the Federal Reserve had not been so stimulative in 2003, but it certainly would have been different. It may be fair to summarize the situation as the Federal Reserve aimed at the U.S. and hit China.

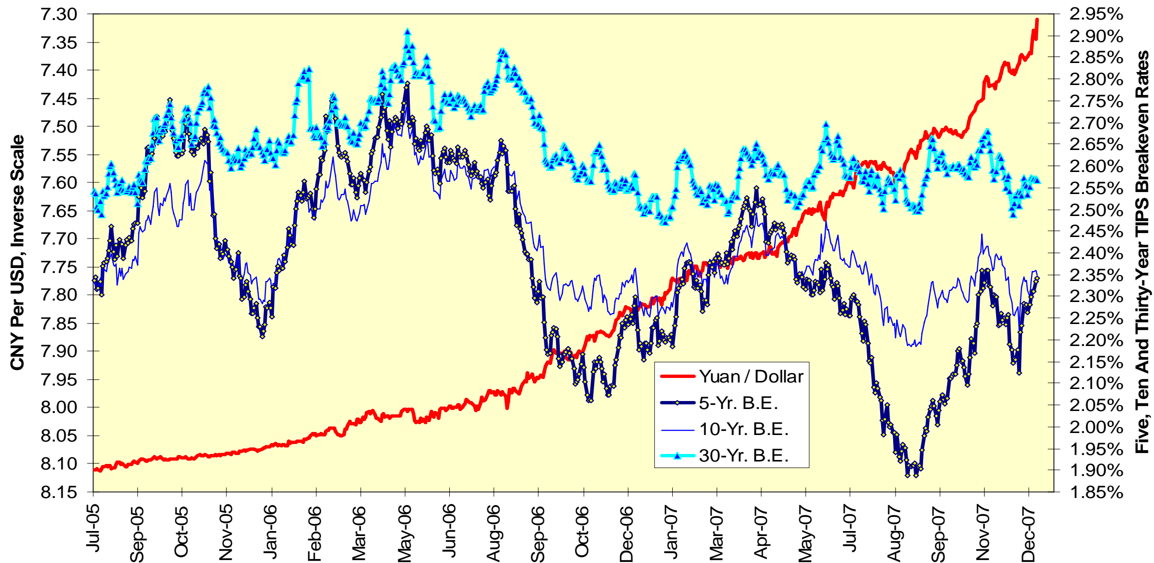
The Rise Of The Yuan

We will leave aside for now whether there is any level of the yuan that could make manufacturing in the U.S. competitive, and focus instead on whether a stronger yuan would result in higher U.S. inflation. While fewer statements are accepted without further examination than a weaker currency leads to higher inflation, both expected and reported, fewer statement have less supporting evidence on their behalf. It may seem logical to assume Chinese exporters would raise prices to offset the diminished value of the dollars they receive, and that these higher prices for Chinese imports would provide a competitive opportunity for U.S. manufacturers to raise prices in response, but we must live in a world of demonstrable facts, not flippant assumptions.

The U.S. and China are in a symbiotic relationship. They need to maintain their breakneck double-digit real growth in GDP to provide employment to their increasingly aged and increasingly male population, the latter a result of three decades of a one-child policy. The U.S. has become addicted to their goods, and both sides are locked in a cycle of capital flows where China must buy vast quantities of U.S. Treasuries and other securities as a form of vendor financing.

Even with this tight relationship, China acceded as all nations with a huge trade surplus eventually do, to allowing a gradual appreciation of the yuan starting in July 2005. The pace was too slow for many American protectionists in Congress, Senators Schumer and Graham (D-NY and R-SC, respectively) and the pace of revaluation, seen in Chart 1, was accelerated in both August 2006, May 2007 and especially in December 2007.

Chart 1: Inflation Expectations Independent Of Yuan



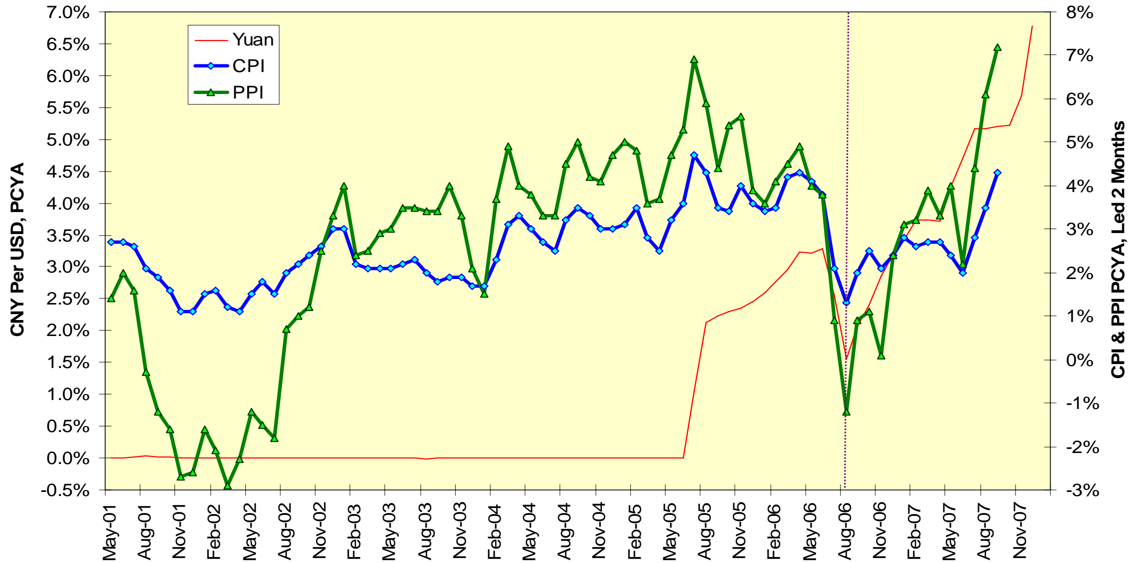
How did inflation expectations respond? If we construct breakeven rates of inflation from the Treasury Inflation Protected Securities (TIPS) market, we can a rise in both five-year and ten-year inflation expectations between November 2006 and April 2007. Those expectations, especially at the five-year horizon, fell sharply into September 2007, but then rose again once the Federal Reserve loosened credit in response to various financial crises. We can conclude from this data sample inflations expectations in the U.S. have moved independently of the yuan.

Reported Inflation

Many observers fail to distinguish between expected inflation, a forward-looking measure, and reported inflation, a backward-looking measure. The monthly Consumer and Producer Price index reports are stale data that should not influence economic decisions being made today. However, we all know this to be a noble sentiment well-expressed; markets build those backward-looking reports into current prices.

How has the revaluation of the yuan affected the CPI and PPI? The answer is quite surprising: Over the small data sample available, the yuan has a two-month leading relationship to both indices' annual rates of change. This has been fairly symmetric; reported inflation fell after a lag as the yuan's year-over-year rise moderated into the summer of 2006, and then rose after a lag afterwards. The August 2006 date, marked with a vertical line in Chart 2, is critical. This is when the Federal Reserve ended its long run of seventeen consecutive rate hikes.

Chart 2: Measured Inflation And Yuan Rise Accelerated After Rate Hikes Stopped

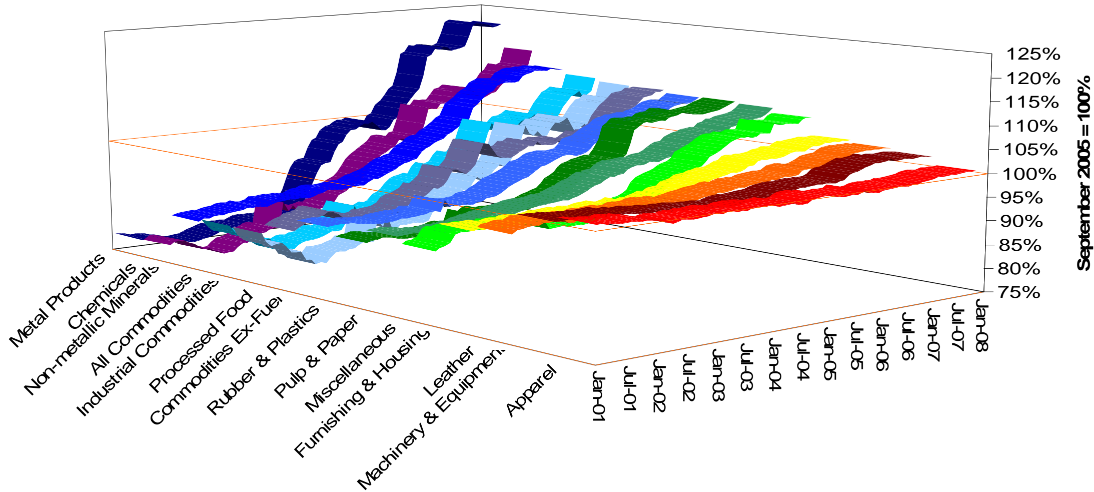


Differential Reported Inflation

The average citizen can function perfectly well without knowing all of the different inflation subindices published every month by the Bureau of Labor Statistics. This is one case where the government actually helps economists and market analysts, a collection of worthies generally not appreciated by society as a whole.

How have various subindices moved since September 2005, a date which incorporates the two-month lag noted above into the July 2005 starting point of the yuan's revaluation? If we index various segments of the PPI to this point, we find the most rapid price acceleration has occurred in metals, minerals, chemicals and commodities ex-fuel. These are bulk commodity and raw material markets wherein China is a key and large-scale buyer.

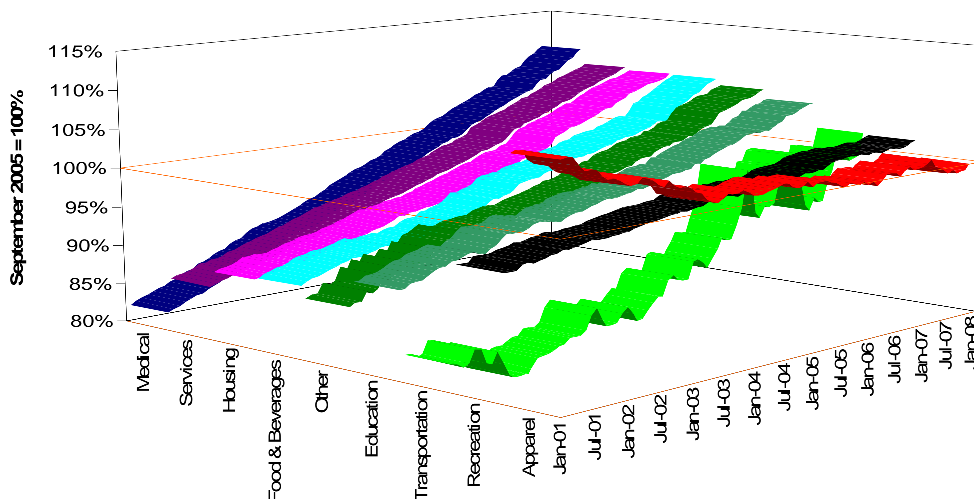
Chart 3: PPI Sub-Indices After Yuan Float Began



The subindices involved finished and manufactured products such as apparel, machinery, leather and furnishings have seen only mild price increases. China's impact on producer prices has not been a function of any level of the yuan so much as its own enormous size and sheer physical demand for materials. While a stronger yuan gives China a stronger economic claim on those materials, it does not translate into higher prices for finished producer goods.

We can repeat the exercise for consumer prices and display the results in the same fashion as above in Chart 4. Here the most rapid prices increases have occurred in sectors without significant import competition, such as medical

expenditures, services and housing. Apparel, which is imported from China rather heavily, has scarcely moved higher in price.



Going Forward

One thing we can conclude with certainty from economic history is low-cost producers do not remain low-cost producers forever. Those of a certain age can recall when the tag "Made in Japan" was synonymous with cheap and shoddy goods. That has not been true for close to forty years, and we can expect China to move up the quality and prices curves the same way.

But just as the world accommodated higher production costs from Japan in the 1980s without a global reacceleration of inflation, so it will with China. Inflation is not a cost-push phenomenon so much as it is a monetary phenomenon. The real danger to the U.S. inflation outlook will not originate across the Pacific or from a stronger yuan so much as from a repeat of the monetary mismanagement of the 1970s.

The U.S. inflation picture appears resilient to a stronger yuan. It has yet to demonstrate such resilience to a monetary policy that appears ready, willing and able to bail out misguided bankers and over-extended homebuyers. Maybe we should pay attention to things at home before we cast our eyes across the Pacific in blame.