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Crouching Stimulus, Hidden Inflation: The Number One Concern Facing China in 2010?

by: Patrick Chovanec

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I know I promised to follow up with more comments on China's real estate market, but I'd like to take a few moments today to offer some thoughts on a closely related but much broader issue: inflation. When I spoke at the American Chamber of Commerce in China a month ago, my fellow panelist Arthur Kroeber, head of the research firm Dragonomics, identified the prospect of inflation as the number one concern facing China's economy in 2010. In subsequent weeks, blogs and news reports have been buzzing at hints that inflation might be on the rise in China, but the signs are uncertain, and there is much disagreement over its nature and whether it will actually materialize.

The most common reason given for expecting inflation to rear its head is China's extraordinary growth momentum heading into the new year. Most analysts expect China's 4th Quarter GDP growth rate to well exceed 10% (annualized), and maybe even top 11%, when official figures are released next Thursday. Such go-go growth rates suggest that China's economy may be in danger of "overheating" — that surging demand for resources is outstripping supply, which most economists see as a trigger for inflation (Monetarists, who believe inflation — a general rise in prices — is always and everywhere the result of an increase in the money supply, disagree).

Others argue that inflationary pressure in China is a direct and unavoidable consequence of its chronic trade surplus, supported by an undervalued Renminbi. Paul Krugman, an outspoken advocate of pushing China to strengthen its currency, offered this explanation on his blog:

> Consider the real exchange rate, defined as RX = EP*/P, where E is the exchange rate measured as the domestic currency price of foreign currency (so an appreciation of the renminbi is a fall in E), P* is the foreign price level, and P the domestic price level. Basic international macro says that there is a "natural" level of the real exchange rate, determined by trade competitiveness and international capital flows. And the economy "wants" to get to that real exchange rate.
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> If you have a floating exchange rate, you get there via a rise or fall in E. But if you have a pegged rate, there's pressure on prices instead. By deliberately keeping E higher than it would be under floating, China is creating pressures for P to rise; the inflationary pressures are directly related to the exchange rate policy.

Indeed, regardless of the explanation, there are signs that inflation is picking up. China's official Purchasing Managers Index (PMI, its version of PPI) hit 56.6 in December, up from 55.2 the previous month (any score above 50 indicates rising prices for inputs). HSBC's own PMI estimate for December came in at 56.1, the highest level since it began the survey in April 2004. Consumer prices rose at an annualized 0.6% in November after a nine-month period of deflation, and Chinese investment bank CICC expects the rate to rise to 1.6% in December.

Still, this so-far modest rise in consumer prices, after such a long stretch of deflation, is perplexing many who think inflation should already be much higher – prompting U.C. Berkeley economist Bradford DeLong to ask "Where is my Chinese consumer price inflation?" Some observers are confident inflation is already raging, even if consumers haven't quite felt it yet. They point to skyrocketing stock market and real estate prices as examples of asset inflation that could eventually spill over into the rest of the economy. *Century Weekly*, where star editor Hu Shuli has just taken over, after leaving *Caijing*, says "tepid CPI numbers barely conceal the reality of ferociously rising inflation."

Hu has her finger on something here that I'd like to explore. It's hard to argue with the formula Krugman presents, but he's awfully vague on the actual chain of cause and effect. Economic identities that appear simple and irrefutable on paper can work themselves out in many different ways in reality, with very different consequences.

So let's look at DeLong's description of how Krugman's formula plays out in real life:

> Every month the People's Bank of China pays 200 billion renminbi to China's exporters to buy up the dollar-denominated assets they have accumulated and so prevent those assets from generating upward pressure on the value of the renminbi. It gets those 200 billion renminbi by borrowing them from the good burghers of Shanghai. By now the central bank owes the good burghers of Shanghai some 16 trillion renminbi. To them, this wealth is nearly as good as cash. It has been piling up for years–and because it is nearly as good as cash, the good burghers of Shanghai should be spending it.
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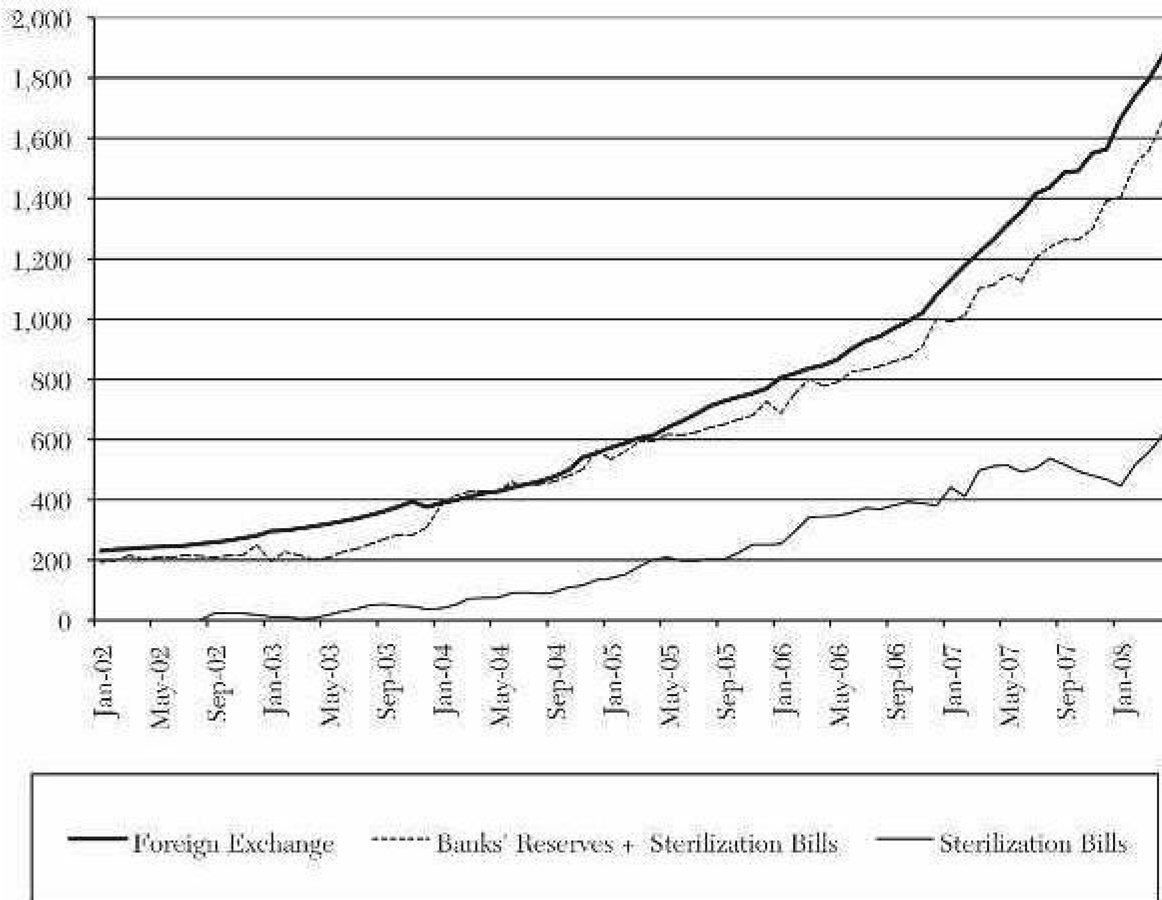
> They should be spending it. But the goods that are the counterparts of this financial wealth have been shipped via container to Long Beach. So demand in China should be massively outrunning supply, and China should be seeing strong and rising inflation.

DeLong's description is partly right — it's a little bit more complicated than that. It's true that when the PBOC buys dollars, at a fixed exchange rate, to accumulate as reserves, it issues RMB. Ordinarily that would mean the supply of RMB in circulation would increase, and if the economy remains the same size, each unit of RMB would buy a little bit less. That's classic monetary price inflation, as the Monetarists themselves would describe it.

The thing is, China knows that's what will happen and wants to prevent it. So the PBOC does two things to reduce the amount of RMB in circulation and cancel out the increase in the domestic money supply from its purchase of dollars. First, it raises the reserve requirement of Chinese banks, and second, it issues bonds — so-called "sterilization bonds" — mainly to the banks in order to soak up even more RMB. Josh Greenwood, Chief Economist at INVESCO, wrote an excellent paper for the Cato Institute that lays out this process in detail, for those who are interested. But more to our immediate point, he demonstrates how together the increases in reserve requirements and total bonds issued almost exactly track China's accumulation of reserves. The PBOC is entirely canceling out the inflationary increase in China's domestic money supply.



I supposed this is what DeLong means when he refers to the PBOC borrowing from the "good burghers of Shanghai." This money that's been lent, he says, is "nearly as good as cash." But it's *not* cash — and it's certainly not readily available for spending to fuel demand. The funds — in the form of mandatory deposits and long-term bonds — are basically being requisitioned from China's banks, which in turn are drawing on the savings of Chinese citizens. They do this in part by selling government bonds, in turn, to the public, and in part by investing their deposits. In principle these are demand deposits, but in practice, for a variety of reasons — cultural predilection to save, lack of health insurance and other provisions for potential calamity — these funds are locked up in long-term savings. And the government has a lot of leeway in tapping this large pool of savings, because (1) it owns the banks, (2) it sets interest rates, and (3) it severely restricts the range of other investment alternatives. The effect of this borrowing is to tamp down consumer demand, not unleash it.

But as Greenwood notes, "monetary sterilization," as the process is known, is not the perfect antidote to inflation it appears to be. Maintaining a below-market rate for the RMB, which is the whole point of the exercise, fuels the growth of the export sector. The excess profits and input demand generated by exports will ultimately, he argues, boil over into inflation. So either you get monetary inflation, by expanding the money supply, or you get "overheating" from over-incentivized exports, but one way or another you eventually get inflation.

The key word, though, is *eventually*. Inflation works its way through the system differently in the two scenarios. In fact, inflationary "overheating" from a turbo-charged export sector was precisely China's main worry in the months just preceding the global financial crisis. But given the massive drop-off in exports (nearly 20%) and resulting overcapacity this past year, it's hard to see — in the face of ongoing monetary sterilization of China's trade surpluses – how the export sector would have continued playing this role. True, China's exports, year-on-year, were 17.7% higher this December than last, which has been interpreted as a "surge." It was a surge (55.9%) relative to November, but as CNN notes, "the year-on-year comparisons were inflated by the low base of the previous year's figures, which were depressed by the economic crisis." By December 2008, exports were already taking a beating, so topping that performance might be a sign of recovery, but not quite inflationary "overheating."

No, exports are *not* what is driving China's 8%+ GDP growth, or any consequent inflation – in fact, for most of the year,

exports were dragging GDP down. My guess — and I don't think I'm alone here — is that without the stimulus, China would pretty much be treading water on GDP. And by "stimulus," I don't just mean the RMB 4 trillion package in government spending announced in late 2008. I mean the more than RMB 10 trillion (USD $1.4 trillion) lending boom led by Chinese banks, of which only 2 trillion went to fund the "official" stimulus. Even China's National Bureau of Statistics says that this lending boom dramatically expanded the money supply, in a manner that was not cancelled by any sterilization:

> By the end of September, the supply of broad money (M_2) was 58.5 trillion yuan, a year-on-year growth of 29.3 percent, which was 11.5 percentage points higher than that at the end of last year; that of the narrow money (M_1) was 20.2 trillion yuan, a rise of 29.5 percent, or 20.5 percentage points higher; the cash in circulation (M_0) was 3,678.8 billion yuan, up by 16.0 percent, or 3.3 percentage points higher.

Where did this money go? As I've noted before, China's lending boom evolved over the course of the year. In Q1, it mainly went out in the form of short-term operating capital loans to prop up struggling businesses. But evidence suggests those recipients weren't dumb. Rather than use those funds to manufacture goods they couldn't sell, it appears many borrowers stashed the money in stocks and real estate — which helps account for the astonishing resilience of those markets in the face of last year's slowdown.

By Q2, the picture began to shift, with much of the new lending going into longer term loans, which I interpret as construction and infrastructure projects. By Q3, the pattern continued shifting, with money going mainly into long-term consumer loans, which I take to be mortgages. Q4 saw a moderation in lending, but with a continued emphasis on funding construction and mortgages. There's also plenty of evidence to suggest that a big chunk of business loans to large State-Owned Enterprises (SOEs) made its way into investment in land and real estate development.

I think it's reasonable to say that — besides a big boom in automobile purchases this year — the big growth story in China this past year was construction and real estate. The government itself, until it began to grow worried a month ago about the prospect of a property bubble, talked up these two related sectors as "key drivers" of growth. So the picture that emerges is as follows:

- An ongoing expansion of the RMB money supply to buy dollars (to sustain the US$ peg and support chronic trade surplus, the direct, immediate effects of which are *entirely cancelled* by "monetary sterilization."
- An overstimulation export sector which, in principle, can transmit inflationary pressure to the economy, but is unlikely to have actually done so while reeling from the effects of the global slowdown for the past 14 months.
- A massive expansion of the money supply from an unprecedented burst of bank lending that was channeled mainly into *construction and real estate*, and to a lesser extent the stock market, accounts for a large part of China's GDP growth over the past year, and was *not* counteracted by sterilization.

If it's the flow of easy money into certain sectors that's generating all or most of the GDP growth in China, it would not be surprising to find inflationary pressure — whether generated by monetary expansion or "overheating" (or perhaps both, as two faces of the same coin) — initially concentrated in those same "pockets." You would expect to see asset inflation in real estate (as well as possibly the stock market), and producer price inflation driven by key construction inputs such as steel and cement. Only later would those price pressures potentially reach their way into the rest of the economy and affect consumer prices. That looks strikingly like what we're seeing in the Chinese economy right now — you could call it "Crouching Stimulus, Hidden Inflation."

Of course, as overseas demand picks up, China's export sector could come back online as a source of inflationary pressure, as Krugman predicts. But as long as China sterilizes the RMB it issues for dollars, negating the direct monetary effect of the imbalance in payments, its *structural* overcapacity in exports — sustained, in large part, by the stimulus — will continue to blunt that pressure for some time to come.

That's not to say China should be unconcerned. My worry is that if the expansion in construction and real estate (as well as the flow of money into the stock market), which is generating both the growth and the inflation, proves unsustainable, China could be looking at *stagflation*. If you dramatically expand the money supply, and that money goes into unproductive activities that do not produce real wealth, you get the worst of both worlds — inflation without growth.

One last topic I need to mention, before wrapping up, is the subject of "hot money." Hot money refers to foreign capital flowing into China in unrecorded ways, presumably to speculate on stocks, real estate, or the future appreciation of the

RMB. The Chinese government likes to point the finger at "hot money" from abroad as a major cause of market instability. Many of its periodic policies aimed at bringing frothy real estate markets under control are targeted at hot money. The government isn't the only one taking the line that hot money plays a key role. Logan Wright, a Beijing-based analyst with Medley Global Advisors, told the *Wall Street Journal* the other day that "As long as money comes in, it's my belief that it will be increasingly difficult for the central government to control the domestic money supply and inflationary pressures."

I don't agree. First of all, the way people arrive at estimate of "hot money" flowing into China is to take the net increase in China's foreign reserves, subtract the trade surplus and known Foreign Direct Investment (FDI) into China, and whatever is left, the unrecorded difference, is assumed to be hot money. But if you look at Greenwood's chart, above, it's clear that the PBOC is sterilizing the monetary effect all of China's *entire* purchase of reserve currency, whether the inflow of that currency is hot or not. Authorities may not know where hot money comes from, but it still gets factored into the monetary balance. It's not some kind of curveball being thrown at China's money supply.

It's true, of course, that even if the purely monetary effect of hot money is negated, neutralizing its effect on the value of the RMB could contribute to "overheating" and therefore inflation. But relative to the other factors we've been looking at, it's far from being the dominant factor. Morgan Stanley estimates US$ 26 billion in hot money inflows in Q3. Wright estimates US$ 30-40 billion came in during Q4. Annualized, that works out to something like US$ 120 billion. Compared to China's net trade surplus in 2009, US$ 196 billion, that looks pretty sizeable — although it's worth remembering that trade surplus was down 34% from 2008. But compared to the US$ 1.4 trillion boom in stimulus lending, which actually did blow out the money supply, hot money was a bit player.

I don't mean to completely dismiss the destabilizing impact of hot speculative money into China, but whether you're looking at the prospect of a real estate bubble or more general inflation, "hot money" is not the one throwing this party. It's a guest arriving at a party that's already well underway.