The *Inflation* Threat

Unlikely for the developed world, but highly probable for China.

BY CHI LO

U.S. Treasury yields have risen decisively from their lows in December 2008. Many market players argue that the U.S. bond sell-off, which has led to the rise in yields, was a result of an inflation scare. This premise for the rise in yields is wrong, as the inflation threat will likely remain very small through 2010, if not longer, in the developed world. But the inflation threat is more real for China because it does not have the financial impairment that the developed world has. While interest rates may remain low for a long period in the United States, as Fed Chairman Ben Bernanke recently pledged, in China the risk of a monetary policy shift there is on the upside in 2010.

INFLATION SCARE OVERPLAYED IN THE DEVELOPED WORLD

Many analysts attribute the rise in long U.S. Treasury yields since December 2008 to worries about a soaring fiscal deficit, which will lead to a massive government bond supply and a fiscal crisis, and the Fed's quantitative easing, which will lead to runaway inflation later. There is no doubt about the fear of massive public sector borrowing leading to a surging government bond supply in the coming years. But the worry about a soaring fiscal deficit causing a debt crisis and another round of financial chaos is not necessarily justified.

In general, a government debt crisis is rooted in excessive fiscal spending. But the economic impact can be either inflationary or deflationary. If the spending is debt-financed, it is deflationary because public borrowing competes with private credit demand, driving up bond yields and the exchange rate, and thus damaging the economy. If the spending is financed by central bank monetization, as is the case currently in the developed world, it is inflationary. Money printing boosts demand, forcing the exchange rate to depreciate, and finally pushing up bond yields.

Thus, many market players attribute the recent rise in long Treasury bond yields to the Federal Reserve's quantitative easing effort. Back in June, the market was even

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pricing in a Fed rate hike later this year. While this rate hike expectation has faded, it will return. This expectation is myopic. Disinflation with periodic deflation is a more likely outcome than soaring inflation in the developed world in the coming year, if not longer. The output gap opened up by the subprime crisis is large and will take a few years to close. This is deflationary, not inflationary.

It is also not obvious whether U.S. government spending at this stage is excessive and would lead to robust aggregate demand boosting inflation. In this post-subprime crisis adjustment period, copious fiscal spending is only partially offsetting the contraction in the private sector. Indeed, the U.S. economy is still suffering the typical symptoms of impaired demand—contracting GDP, falling prices, rising unemployment, and inventory liquidation. The U.S. corporate and financial sectors are in a serious cost-cutting mode and the consumer sector is in a serious saving mode. All these are hardly inflationary.

As and when the world economy starts to grow again and if the Fed and other global authorities fail to exit quantitative easing and rein in fiscal spending in time, there will be a serious inflation problem. But there is still a long way to go before the global economy reaches that point. Further, global authorities are already considering exit strategies, including sharp tax hikes and scaling back on quantitative easing, from their expansionary policies. Given the long and painful post-bubble adjustment process, such a scenario actually raises the risk of premature tightening crashing the economic "green shoots," but not the risk of inflation.

There is no doubt about the fear of massive public sector borrowing leading to surging government bond supply in the coming years.

What about energy prices, which are a key component in the inflation scare? The nature of the energy price increase in the recent decade is different from that of the 1970s. Back then, high and rising energy prices were caused by supply shocks resulted from geopolitical events. But rising energy prices in the past decade were largely due to demand shocks resulting from surging demand from the emerging markets, especially China and Asia, on the back of a muted energy supply response. Hence, large output gaps and low capacity utilization will help keep inflation at bay at least through 2010.

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WHAT ABOUT MONETIZATION?

Many analysts fret over too much monetization causing inflation soon. This fear may be exaggerated. Recently, the Fed has not gone as aggressively into quantitative easing as many have thought. U.S. M2 growth has eased since early 2009, and the Fed's balance sheet has remained below its peak in December 2008 despite expansion again in March 2009 (see figure). Meanwhile, the U.S. government has been issuing massive amounts of bonds, redirecting liquidity and spending from the private sector to the public sector. The net impact on inflation is neutral, as public sector borrowing and hence spending is just offsetting the private sector contraction. Finally, there is no sign that the U.S. money multiplier has been repaired, so the link between monetization and inflation remains severed.

In a nutshell, there is no convincing evidence suggesting that the developed world central banks have moved ahead of the deflation curve. This is reflected by the fact that CPI, property prices, and household income growth in most of the developed world are still falling on the back of shrinking bank credit. With all these deflationary forces dominating, inflation is unlikely to emerge in any significant way in the developed world for the next year, even though the economic policy may remain expansionary.

CHINA'S INFLATION SCARE IS MORE REAL

China does not have a financial crisis, its consumer sector is under-leveraged and, hence, does not need to contract. Indeed, real retail sales (a proxy to consumption) have been growing at a steady rate of around 14 percent a year,

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with rural consumption rising faster than urban consumption since November 2008. This is an important sign of demand growth momentum because the marginal propensity to consume in the poor rural areas is much higher than the marginal propensity to consume in the rich urban areas. In a nutshell, Beijing's stimulus measures have been effective in counteracting the negative external subprime shock.

I have long argued that China has an inherent deflation problem due to excess capacity, interrupted by cyclical inflation flare-ups. China's core inflation (CPI excluding food and energy) has been stuck at very low levels, averaging less than 2 percent since 1998 (see figure). In the coming year, however, the cyclical inflation threat is more real in China than in the developed world due to the absence of financial and demand impairment in China.

Indeed, when China's Purchasing Managers Index data for June were released, some analysts were quick to warn about a return of inflation on the back of a 4.7 percentage point jump (to 57.8) in the input price index component in the PMI. The worry is that the rising input costs can be passed onto the domestic sector more easily in China than in the developed world. Further, more government projects and property development and capital expenditure (boosted by strong bank lending) will push up raw material and input costs further.

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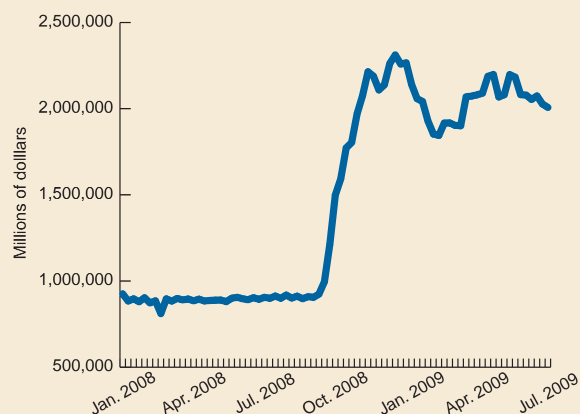
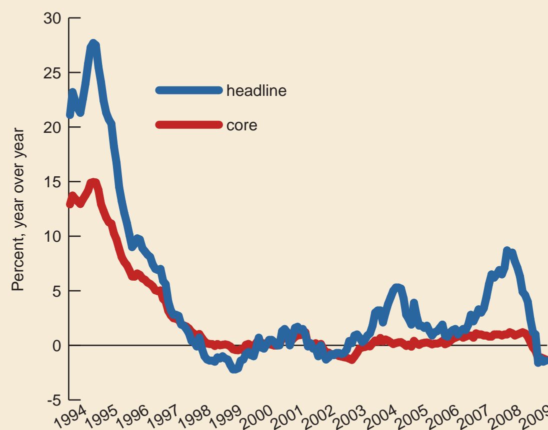
Federal Reserve Total Assets



Source: CEIC

China's Inherent Deflation Problem



Sources: CEIC, PAAMC (HK)

In the short term, Chinese authorities will likely keep interest rates—and thus the short end of the yield curve—low as insurance to support GDP growth. But the market will continue to discount an improving economy, pushing up long yields and causing the Chinese yield curve to steepen. There is a risk of policy tightening in the second half of 2010 if the global environment improves more solidly and domestic inflationary expectations turn up from the current depressed level. Overall, bond yields are expected to be higher in 2010. ◆