

## China: Accelerating Inflation and Trade Deficit Potential

A dwarf crocodile article<sup>1</sup> to end the year. Unless mayhem erupts between now and yearend, we will return to grace your inboxes once more in 2010.

A dwarf crocodile article to end the year

The two most important variables to monitor in the coming months will be developed world credit growth (or continued contraction) and the Chinese inflation numbers. We discussed the former in detail a couple of weeks back in *Liquidity Update*<sup>2</sup> and concluded that deflation and dysfunctional money multipliers continued to reign in the West. We remain open to changing our opinion should broad money and credit contractions start to reverse themselves but as yet, we struggle to see the evidence. In fact, quite the contrary.

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As for Chinese inflation, as far as we can ascertain, most commentators remain blissfully comfortable that headline CPI in the PRC is going to gradually rise towards 3% and nothing much more. Regular readers will know though that our quaint belief in monetarist dogma has lent us to conclude that Beijing is going to find itself facing a serious inflation surge within the next six months.<sup>3</sup> And arguably, as we will show, this has already begun.

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Our view at the end of last year was that China had more than enough bullets to fire to save itself (if not quite the whole world) and hence China-related risk assets were to be bought, if only for a trade. (We of course were far too premature in recommending profit taking but that is another story.) However, as the year progressed we became increasingly concerned that although conditions probably warranted scaling back some of the monetary insurance policy put in place, there was very little chance that the technocrats would be given the leeway to do so. Hence our view that as economic activity and confidence picked up, so the massive velocity overhang created would start to reverse itself and inflation would surely follow in short order.

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<sup>1</sup> Short and snappy if you really have to ask.

<sup>2</sup> November 23<sup>rd</sup> 2009.

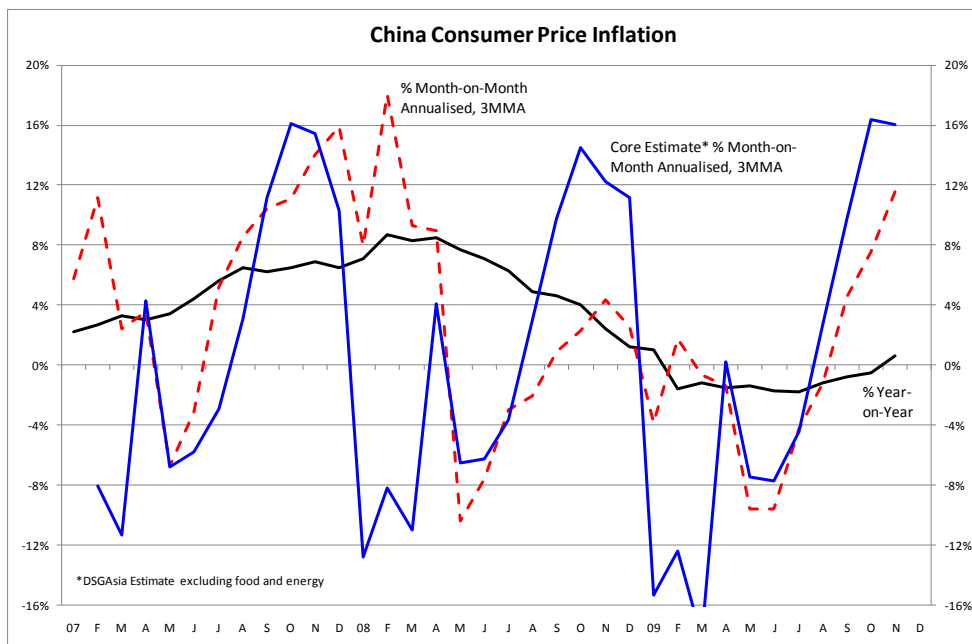
<sup>3</sup> See: “Pre-empting Pre-emption”, November 9<sup>th</sup> 2009.



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The chart below shows this is indeed occurring. A fixation on year-on-year numbers – headline CPI turned positive again (0.6% YoY) only last month – disguises the fact that month-to-month inflation is already rising at double digit annualised rates of growth. And to those who argue that this is merely a reflection of food and energy base effects,<sup>4</sup> we would say, in suitably seasonal vogue: “oh no it isn’t!” Inflation appears to be pretty broadly based as one might expect in an economy that has seen 30% broad money growth in the context of a 7-8% expansion in nominal GDP. For sure there is massive oversupply in items such as steel and DVD players and hence tradable goods inflation is likely to remain tame in China as it should elsewhere. However, such goods have minimal weight in what is admittedly a deeply flawed consumer price index basket and set against this, services are even more under-represented.

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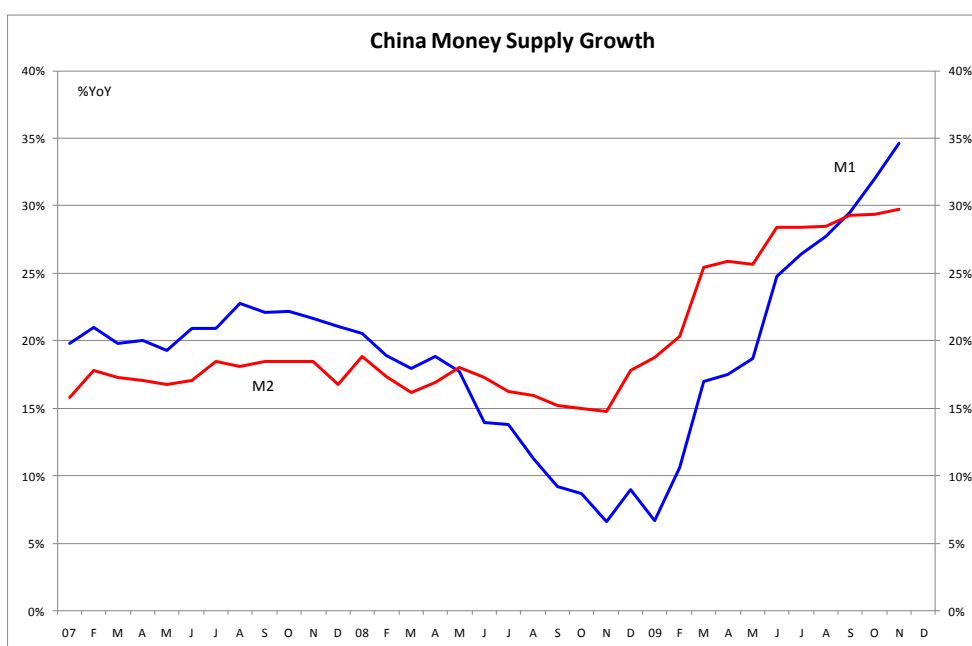


<sup>4</sup> As an aside, we have always argued that in poor countries, *food is the core* and as such helps drive overall inflation expectations. See, for example: “Cut to the Core”, November 11<sup>th</sup> 2007.

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The money numbers (not to mention asset market trends) also suggest that the desire to hold money and therefore inflationary expectations are on the rise. As the next chart below shows, narrow money growth has accelerated through that of its broader counterpart and as real deposit rates move into negative territory (nominal 1-year deposit rates are around 2.25%; 3-month rates are 1.7%) so we would expect this divergence to widen further. Moreover, although talk is for new loan growth to be lower than this year's target of RMB10 trillion and nearer RMB7-8 trillion, this would still represent an additional 18-20% to an already amply oversupplied stock.

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What does this all mean? While headline year-on-year numbers remain in low single digits probably not much, at least in terms of pre-emptive policy action. For sure the PBoC and CBRC will try to talk things down and roll out a variety of prudential measures to try to keep expectations in check. However, by the middle of the year, we believe that the State Council will have to give them the green light to respond more robustly. At that juncture, especially if lag effects of fiscal and monetary stimulus are starting to fade, another global crash in risk assets beckons. Play for the short term by all means but remain liquid for when things turn, they are likely to turn nastily.

If China reverses course and tightens, another global crash in risk assets beckons



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The second part of our title was a bit of a bait and switch for in truth, we find it very hard to see how China can produce a consistent and meaningful trade deficit unless the world is an extremely screwy place. As the first table below shows, the surplus has narrowed significantly this year to around 4% of GDP from 7% in 2008. The current account surplus has shrunk from 10% of GDP in 2008 to 6% in H12009. Analysts of course love to extrapolate and this year has been exceptional in seeing a huge recession in the developed world in the context of only a short and ultimately not particularly deep slowdown in China. The export and import volume numbers – i.e. excluding commodity price swing distortions – reflect this stark divergence.

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### China Trade Performance

	Exports % YoY	Imports % YoY	Trade Balance USD bn
<b>Values</b>			
<b>2008</b>	18%	20%	297
<b>2009 (to Nov)</b>	-19%	-16%	180
<b>Volumes</b>			
<b>2008</b>	9%	4%	
<b>2009 (to Oct)</b>	-15%	-3%	

### China 2010 Trade Balance Sensitivity Matrix (USD billion)

%YoY Exports		Imports						
	0%	5%	10%	15%	20%	25%	30%	
0%	199	258	317	377	436	495	555	
5%	149	209	268	327	387	446	505	
10%	100	159	219	278	337	397	456	
15%	51	110	169	229	288	347	406	
20%	1	61	120	179	238	298	357	
25%	-48	11	70	130	189	248	308	
30%	-98	-38	21	80	140	199	258	

Nevertheless, it is hard to see how a repeat of such divergence would be consistent with continued elevation of commodity prices and as the lower table shows, of the forty-nine permutations of export and import growth we calculate above, only three produce a trade deficit. And one surely has to ask what sort of world it is likely to be for risk assets if China is importing at a 30% annualised growth rate in the context of zero export expansion. In

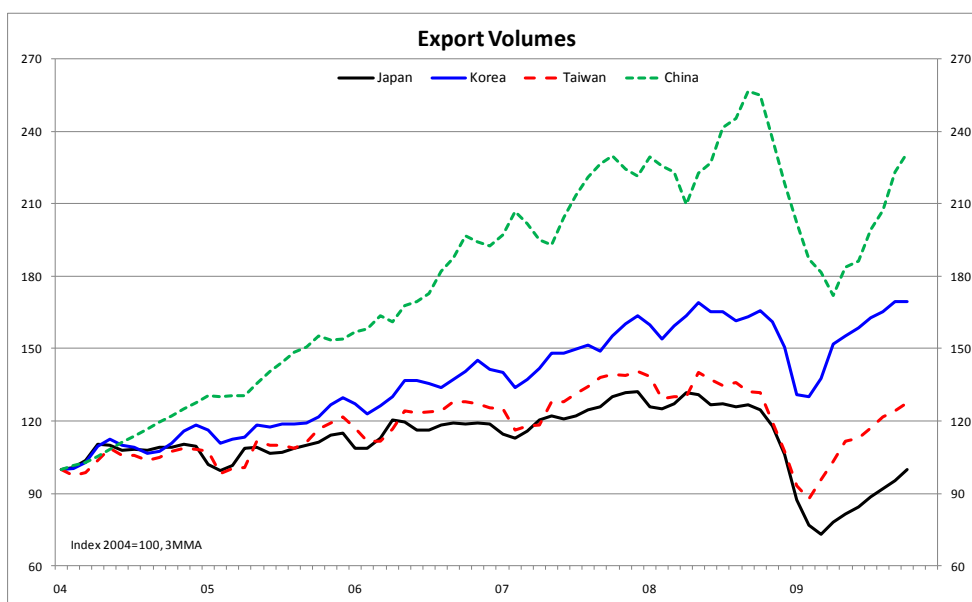


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fact, at least half of the other permutations imply a higher trade surplus for 2010.

Chinese exports disappointingly contracted -1.2% YoY in November, a month where other countries such as Korea saw a return to positive annual growth. Nevertheless, as the next chart shows, China had an exceptional market-share gain blow-off in late 2008 meaning its comparisons are tougher than in other places. And as the year-on-years turn positive in the next couple of months, so the external pressure for China to budge on the RMB (not to mention domestic inflation imperatives) will surely grow.

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Whatever Beijing might like to argue, it *has* been incorrigibly Mercantilist in recent years and as a result the realisation has finally dawned in many other Asian capitals that currency moves independent of Beijing will merely lead to hollowing out; witness, for example, ASEAN's swing to significant bilateral deficit with China after years of running huge surpluses. One should also note that the numbers look even uglier if one looks at non-commodity trade.

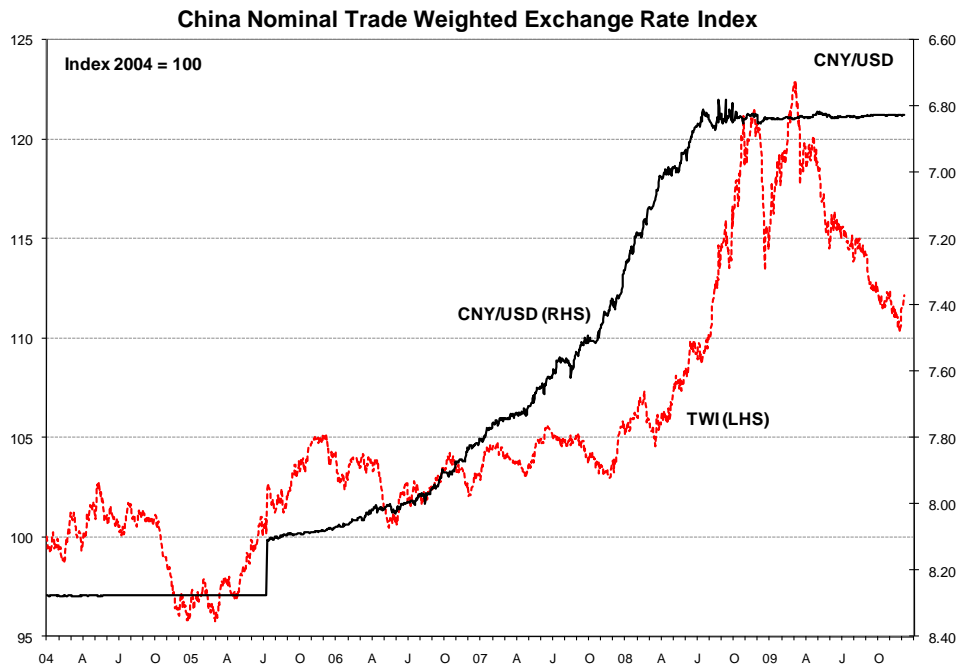
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While the rest of region is of course far too polite/scared to criticise China openly, the bitching behind closed doors has been steadily growing.<sup>5</sup> We

<sup>5</sup> In a similar vein, it is politically correct to blame lax US monetary policy for risking bubbles across the region. Yet nobody is willing to say that Chinese incontinence and the tendency of its citizens to misappropriate massive amounts of state-mandated loans and

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therefore believe that as export growth turns positive that Beijing will conclude it is good politics to re-start RMB appreciation. We would not be surprised to see a relatively rapid 3% or so move within three months, followed by a sell-off to flush out specs, and then a return to the interrupted TWI appreciation seen in the first half of 2008. It is not going to be a make-your-year trade but get the timing right and it could certainly be better than a slap round the face with a wet kipper.



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shovel them overseas in stark violation of the country's capital controls edict. The new HKMA chief is as guilty as any in this context.



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