TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

INTELLECTUAL AMMO

China and Inflation

Wednesday, February 18, 2004

Donald Luskin

Our inflationary fears are not reduced by the several popular China theories.

The influence of **China** on the **US** economy is often cited as a "this time it's different" rationale for why we are wrong in our analysis that rising gold, commodity and forex prices presage a new cycle of inflation over the next several years. On the one hand, it is said that China is "exporting deflation" by flooding the US market with inexpensive goods, and destroying US manufacturing jobs. At the same time, it is said that China is confounding the inflation signals by driving up raw materials prices.

We find little substance to any of these theories.

The claim that cheap Chinese goods are affecting American consumer prices overall in any significant way is demonstrably untrue on empirical grounds. An International Finance Discussion Paper released last month by researchers at the **Board of Governors of the Federal Reserve System** reported:

> "...a statistically significant effect of U.S. imports from China on U.S. import prices, but given the size of this effect and the relatively low share of imports in U.S. GDP, the ultimate impact on the U.S. consumer prices has likely been quite small. Moreover, imports from China had little apparent effect on U.S. producer prices. ...we estimate that since 1993, Chinese exports lowered annual import inflation in a large set of economies by 1/4 percentage point or less on average..."

Even if such empirical evidence did not refute the belief that cheap Chinese goods exert a deflationary effect on US prices, we would reject the theory on the grounds of irrelevance. An exogenous supply shock such as the arrival on the scene of a new lower-cost producer has nothing to do with inflation. Why? Because inflation (or in this case, deflation) is not simply the measurement of price changes without regard to *why* prices have changed. An increase in the price of orange juice following a freeze is not inflation, it is scarcity. A decrease in the price of silicon transistors thanks to Moore's Law is not deflation, it is productivity. No, as **Milton Friedman** correctly said, inflation is "always and everywhere a *monetary* phenomenon." That means that inflation and deflation result from imbalances in the supply and demand for money, which can only occur due to policy errors by the central bank.

Consider this stylized example. Suppose our economy consisted of transactions in only two domestically produced consumption goods valued at $50 each, so the CPI is at 100 (the sum of the prices of the two goods). Then China offers one of the two goods at $25, and all transactions in it gradually switch to the Chinese version (and let's say there are no other changes in the economy as a result). The Consumer Price Index would, over the period of the change to Chinese sourcing, show a drop of 25% -- from 100 to 75.

Surely anyone who worries about China "exporting deflation" would agree that this example portrays a clear case of it. Presumably, then, they would argue that the Fed should inject money

into the economy in order to reverse the deflation. If such Fed action were perfect, and if it affected both goods proportionately, then the price of the American-made good would rise 33% from $50 to $67.77 and the Chinese-made good would rise 33% from $25 to $33.33 (still cheaper than its original $50) -- and the CPI would thus be restored to 100.

In our view, though, the CPI drop from 100 to 75 in the example does *not* constitute deflation, because it was the result of an exogenous supply shock, not monetary policy. But the CPI's rise back to 100 as the result of deliberate monetary policy *does* constitute *in*flation -- and it robs the American consumer of what amounts to a gift.

So now let's connect this example to today's inflation situation. *Even if* cheap Chinese goods constituted a significant supply shock (which, apparently, they do not), we would not let that fact ease our inflation fears when we see steep price rises in goods *not* subject to shocks, such as gold.

Some have claimed, however, that the price of gold and other basic commodities has been driven up by China's enormous appetite for raw materials. This, it is said, distorts and invalidates these forward-looking market-based indicators of inflation. To a point, we agree, at least as far as industrial commodities are concerned. Indeed, our **Model Position long basic materials stocks** is premised on the convergence of both demand-driven *and* inflationary forces. But gold has little industrial use, and the amount of it traded is tiny in relation to the world's stock of it. Abstracting from transient safe-harbor demand effects (such as a year ago, just before the invasion of **Iraq**), we believe that the dollar price of gold is affected by very little other than its valuation as a monetary substitute. There have been situations in which gold and other commodities diverge, as in the mid-1990s when commodities soared to all-time highs while gold remained stable in a narrow range just below 400. In that instance, gold proved to be the more accurate inflation predictor. Today, with both gold and commodities moving in the same direction, there is no issue.

Finally, it is claimed that the destruction of US manufacturing jobs due to competition from China exerts a deflationary influence. First, it is probable that US job losses due to China have been vastly exaggerated by politicians and the media. According to the Economic Report of the President,

> "The data on...job losses in manufacturing indicate that China is not a primary factor in these declines... With the exception of apparel, the largest job losses have occurred in export-intensive industries for the United States, and job losses in U.S. manufacturing have been mainly in industries in which imports from China are small. For example, the computer and electronic equipment industry accounts for 15 percent of all manufacturing job losses since January 2000, but imports from China were only 8 percent of U.S. output in 2002."

Even if Chinese manufacturing competition were destroying a large number of US jobs, this would not necessarily lead to a deflationary effect. Yes, there may be a *recessionary* effect -- but recession and deflation are not the same thing, as we learned in the stagflation epoch of 1970s. Again, inflation (and deflation) are "always and everywhere a *monetary* phenomenon." TM