Global Monetary Viewpoint

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LESSONS FROM SHARED MONETARY INFLATION IN CHINA AND US

No combustion point yet reached for sustained high CPI inflation

The basics of mortgage credit booms

US monetary inflation shelters the Communist elites in Beijing

Secretary Yellen's disastrous sentimental attachment to 2 per cent

Executive Summary

Virulent monetary inflation in the US and China are twinned in several vital respects

In both countries, there is no combustion as yet into sustained high consumer price inflation. Strong asset inflation has epicentres in digitalization and residential real estate. Mortgage credit booms have not spilt over into demand across many goods and services markets, outstripping supply.

The asset inflation process in both countries would be vulnerable to surprise economic slowdowns into 2022. Other factors could turn asset inflation into asset deflation, some of which have their likely base in Chinese developments.

Monetary inflation in the US has in many respects suited Beijing. In particular, it means that rampant government expenditures and interventions have not brought about a decline of the yuan, threatening higher consumer price inflation. And a robust domestic demand has continued within China for risky and low yielding debts whose issuance has bulged as a consequence of government policies.

Some notable similarities exist between the US and Chinese monetary inflations. Both are virulent, and yet they have not undergone combustion into sustained high CPI inflation and are unlikely to do so in this already long monetary cycle. Both feature virulent asset inflations. The epicentres for both are big tech "monopoly capital" (including social media, internet, online distribution, smartphone giants) and residential real estate. Financial engineering has boomed in both. Bulges in credit growth have not translated into overall demand across goods and services markets running on a sustained basis ahead of supply, even though they have ignited a boom in some economic sectors. Governments in both countries are amassing enormous monetary taxation in the form of monetary repression tax.

The failure of high CPI inflation to take off in China reflects the coincidence of the US pursuing a virulent monetary inflation policy. In consequence, the Chinese currency has not fallen sharply and indeed has been rising of late. Combustion of monetary inflation into sustained high-CPI inflation requires some combination of currency collapse and credit boom, which drives overall demand in goods and services markets on a sustained basis ahead of supply. The strength of the Chinese currency means that one of these two conditions is not satisfied. We see below how the second also remains unsatisfied.

How US monetary inflation suits Beijing

Hence crucially, the global monetary inflation environment established by the US, by inhibiting any collapse of the Chinese currency despite Beijing's vast control of the economy, including policies of monetary and financial repression in the pursuance of state objectives, has protected the communist regime. If Chinese citizens had been able to escape the impact of those policies by various forms of capital flight into superior monies and assets, still possible despite exchange restrictions, a weak currency and high inflation would have undermined seriously its ability to sustain power.

Instead, with nominal interest rates in China significantly positive, the appetite domestically in the People's Republic for domestic debt, whether government-backed or high-yield, remains robust. Again, this is a crucial point of support for

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the regime. For example, 10-year China government bond yields are circa 3.2 per cent compared to 1.5 per cent in the US, and short-term rates at about 2 per cent compared to zero.

No matter that foreign demand, at least from the US for China, debt is somewhat restrained. The fact that yields are so low in the US means that the Chinese stay at home and buy masses of their risky debt rather than pursue all the available winding paths through domestic regulations. If the US were pursuing sounder monetary policies, the asset inflation in China would have gone along with the yuan's sharp depreciation, which in turn would have fed consumer price inflation.

Why China's credit bulge does not translate into high CPI inflation

Even so, shouldn't the rapid expansion of credit in China cited in IMF and World Bank reports, amongst others, be an underlying cause of concern? Could we not imagine that against the background of secularly declining economic growth rates, that virulent monetary inflation in China would undergo combustion into high goods and services inflation?

It is evident that over this monetary cycle (in China starting in 2014), rapid credit growth has not spilt over into demand, persistently outstripping supply across many goods and services markets. Several factors could explain this.

Supply might have been very elastic, including the albeit shrinking supply of migrant labour from the countryside. Much of the credit growth has undoubtedly been related to financial engineering (a substitute for equity) rather than spending, including notably for SOEs (state-owned enterprises). Note that access to private credit remains a high cost for the private sector in China, if possible at all.

In the personal sector, much of the debt increase has been presumably matching a vast rise in the price of urban land, especially in prime centres. The original landowners have amassed wealth that did not exist in this asset class in China barely a quarter-century ago. The same households which run up debt against their real estate holdings may correspondingly be accumulating financial assets out of current earnings – hoping to balance the obligations on the one hand with a cushion of savings on the other hand. Those with higher risk tolerance and greed for yield will be accumulating junk bonds and technology stocks, perhaps even convincing themselves that the underlying risks are pretty low given their conviction in the truth of current speculative narratives.

As elsewhere, but perhaps more so in China, the forces of digitalisation and globalisation, coupled with domestic market-de-control as the state sector recedes in retail areas, means strong non-monetary disinflationary forces at work in the retail space.

Yes, there have been spikes in China CPI inflation over the past two decades, but this is primarily related to specific or broad commodity market acute shortages, which is greatly exacerbated by tremendous speculation. Households in China may well not believe the official statistics and realise that their real spending power is growing much more slowly than these would suggest. Moreover, households may think that actual, plus future burdens of taxation, including financial and monetary repression, are high. This all matters when they plan for their old age. There is, therefore, no spring to consumer spending likely to come from credit, whatever misleading statistics on credit swollen by mortgage transactions might say.

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As in the US, some prices have been soaring in China. The economic spasm of the pandemic has been followed by rapid catch-up amongst considerable dislocation in some areas due to supply disruptions. And in the case of China, soaring commodity prices driven in part by ramped-up state industry spending and construction, with massive speculation positions built on the back of that, have contributed directly to the inflation statistics.

Chinese and US slowdowns in Winter 21/22 – implications for asset inflation

Yes, there is much that is transitory here. State spending will be rolled back over the next year and beyond to well below its pandemic stimulus spurge level. The Chinese authorities will use direct controls to rein back overall demand to lower the perceived risks of a sustained inflation break-out which could be perilous to the Communist Party. There will probably be no raising of interest rates as this would send the currency higher against the dollar, not an official desired outcome.

Turning to the path of asset inflation in China, it is probable that a broad economic slowdown ahead, coupled with a downturn in the US which could well emerge by this coming Winter, would cool commodity markets. And who knows, in other bottleneck areas, for example, chips, relief could come from receding manias of this asset inflation, including bitcoin, whose miners now account for 10 per cent or more of new chip consumption. It is plausible that there will be more direct action ahead to cool the residential real estate market.

Bubble-bursting events are always unpredictable, but none would come as a black swan event in China. There has already been some cooling of Big Tech equities in line with Beijing' anti-trust policy', which has more to do with confronting rivals to communist party power than any spirit of free-market capitalism. And of course, there remains a scenario where asset inflation in China goes into reverse, led by the process of global asset deflation. Specifically, if high yield credit markets across Europe, North America, and many emerging markets plunge for whatever reason, indeed, Chinese credit and, more broadly, asset markets would catch a cold.

The chain of asset deflation chain could also run in the opposite direction, starting in China, which becomes the catalyst to asset deflation globally.

Hong Kong, Wuhan, and US crony capitalist party-goers

In that scenario of asset deflation, we must consider possible short-circuiting in Hong Kong – the epicentre of global asset inflation where US and Chinese monetary inflation meet. No one knows the actual direct and indirect exposures of US, European and Japanese financial institutions to Chinese credit via the intermediation of Hong Kong. We know the gigantesque real estate and equity valuations in Hong Kong, based on this continuation to thrive on the confluence of inflations there, heightened by the fixed peg of the HK dollar to the US dollar.

Of course, there is considerable smugness that Hong Kong can continue to thrive in its role as an asset inflation epicentre. No doubt that has been the calculation for example of HSBC top management in deciding to support Beijing's enacting its HK security law and since then promoting to its helm the mouthpiece of that support. Yes, there is much chatter about how the Biden Administration's decision to delve into the possible Wuhan laboratory origins of Covid 19 could result in the bursting of the Chinese asset inflation.

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Cynicism abounds. All the cronies around the Administration who are gaining much from the status quo of communist party control in China may be using this strong talk from Washington as a catalyst to winning concessions to market access. Beijing is a past master at sweetening life for its friends on Wall Street. They would love to join the asset inflation party in China in the role of fee earner and elsewhere at difficult moments and counting on them in return to dissuade the US Administration from taking a punitive course concerning China. The cynic would say that these cronies welcome the paper tiger threats from Washington as the catalyst to concessions from Beijing.

How long does the partying continue? There is an undercurrent of concern that rising inflation in the US could trigger a sooner-than-expected tapering of QE, which could be the catalyst to asset price deflation, spreading instantaneously to China. Secretary Yellen's comment at the weekend about how higher US interest rates would be a sign of US economic strength or something to that effect was seen as ominous in this connection. That is likely all false alarmism.

Secretary Yellen's fondness for a failed monetary regime

No doubt Secretary Yellen yearns for a future when inflation in the US ticks along at 2 per cent per annum, the economy is at full employment and real interest rates back to 3 per cent. That is the vision of the future she likely had when she was the chief advocate in the Greenspan Fed (back in 1997) of putting the US on the 2 per cent inflation standard.

Professor Yellen would be the last person to recognise, let alone admit, that her policy course was the origin of the first great asset inflation of the past quarter-century (1996-2007), including its disastrous end. And subsequent perseverance with the standard has meant a decade of low economic growth coupled with resurgent asset inflation. Beyond the quarter-century of turmoil, she still apparently believes in the stability and prosperity of her 2 per cent standard.

She will undoubtedly be instrumental in the search committee for a successor to Chief Powell in finding a suitable replacement candidate who shares her views and commitment. And there is the overriding political objective of victory in the mid-term elections. This tolerance of inflation on the US side contrasts with a Communist Party in China, which could be alarmed at the consequences for its continued command by the present high CPI numbers even though on a balance of risks, they may be transitory. This combination suggests that we should keep our sights on Chinese developments in thinking about how global asset inflation could reverse.

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