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HOW MUCH OF AN INFLATION THREAT IS CHINA?

China's demand for raw materials remains insatiable. Metal prices hit a new high on the final day of 2004, driven up by another sharp rise in import demand from the world's second largest economy. And yesterday's release of the December trade report highlighted the short-term inflation threat posed by China. Import demand is turning up again after a summer lull. However, exports are accelerating even faster, pushing the trade surplus up to new highs. The short-term inflation risks may be self-evident, but the longer-term possibility of renewed deflation in durable goods cannot be overlooked either. China is turning from a net importer of some basic goods to a net exporter. Steel exports have soared. Indeed, the steady deterioration in the trade imbalance between the US and China is setting the stage for a significant political confrontation in 2005. China's refusal to countenance any shift in its currency peg is helping to prolong the country's economic boom, but at a significant cost to some economies in the West, a point highlighted yesterday by ECB Chief Economist Otmar Issing. China's obduracy increases the risks that the Fed will be obliged to tighten policy, triggering a downturn in house prices and the economy in the US, just when the full deflationary impact of China’s overinvestment is coming on tap.

China's Import Boom

Twelve months ago, speculation was rife that China would soon be forced to break the currency peg, or at least agree to a revaluation of the renminbi. But as the year progressed, it became clear that the authorities in Beijing had no intention of caving into Western demands for currency flexibility. The recapitalisation of two leading banks (China Construction Bank and Bank of China) marked a clear declaration of the government's strategy. The banks received US$22.5bn each to facilitate restructurings ahead of public listings. The Industrial & Commercial Bank of China is expected to be the next beneficiary. By refusing to revalue the currency, China's significant competitive advantage has been used to accumulate record foreign exchange reserves. And it is these funds that are being recycled into the banks, effectively underpinning the strategy of export-led growth, exploiting the labour cost advantage vis-a-vis the West. China's state-managed banks will continue to play an important role in driving this strategy. Inevitably, there are risks. Endemic overinvestment implies there is always a risk of too much capacity emerging in some sectors. But for now, these costs are manageable, so long as the peg remains in place, allowing the People’s Bank of China to accumulate reserves that can be used to finance resulting debt write-offs.

Against this backdrop, we should not be surprised the authorities are dragging their feet in relaxing capital controls and honouring their commitments to the WTO agreement. The primary objective of the People's Bank of China (PBoC) is to diffuse the capital inflows. Removing the myriad of restrictions which remain in place will exacerbate the task of keeping the peg, and increase the risks that China's economic boom turns to bust. While asset speculation has been a problem, it could be so much worse if the authorities lost control over the money supply. As the events of 2004 showed, the credit aggregates have proved quite sensitive to administrative guidance. Money supply growth slowed sharply in the summer, but then stabilised soon after the authorities feared they might have hit the brakes too hard. The monetary aggregates quickly rebounded, and the dreaded hard landing has been averted, for now. The contrast with Japan's experience in the early 1990s will not have been lost on the PBoC. Interest rates can be a rather blunt and 'ham-fisted' way of controlling credit growth. Certainly, the Bank of

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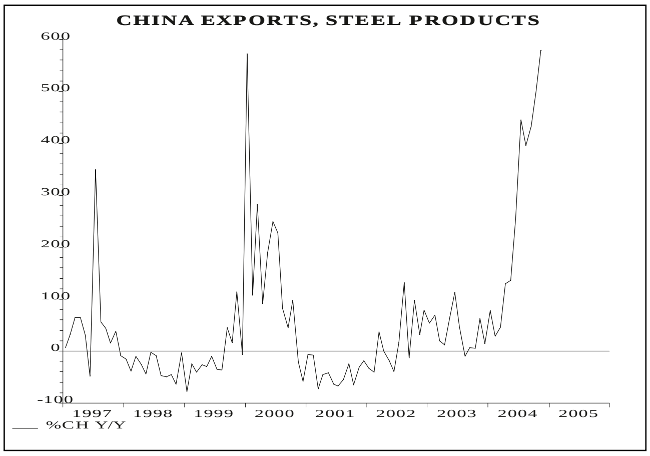
Japan misjudged its rate policy with devastating consequences. For that reason, the PBoC may well believe that it is far too early to contemplate the full liberalisation demanded by the agreement secured in China's accession to the WTO.

All this suggests that China's boom will roll on, unfettered even by the prospect of a rise in interest rates, since the very overinvestment underpinning the country's economic transformation is keeping core inflation in check. To be sure, wage rates are being bid up, and there are reports that organised labour is starting to flex its muscles. But these cost increases have to be put in perspective. It is quite consistent for wage pressures to emerge during the final stages of an overinvestment boom. Both Japan and the US saw a tight labour market towards the end of their respective booms in the late-1980 and 1990s. A growing number of Chinese manufacturers report that margins are being squeezed by higher labour costs and raw material prices. But their ability to raise prices is being hampered by the excessive levels of capacity. Headline inflation has fallen to 2.8%, its lowest level since October 2003.



In this regard, the real threat facing the West from China's emergence as an economic power is all too apparent. In the short run, import demand remains voracious. Yesterday's trade report showed that the US$ value of imports fell in December in seasonally adjusted terms, by 1.5% m/m. But after three successive monthly gains, this modest drop still implies the underlying trend is turning up again. The 3m/3m annualised rate of change has accelerated from a low of -5.3% in September to 49.8%. The December numbers do not provide a complete breakdown at this stage. But the data up until November shows that more than half the rebound in imports since the summer has been concentrated in 'primary goods'. That may not be very helpful for Western economies if it increases the risks of a negative terms of trade shock. At the same time, the trade numbers also show there is little sign of any slowdown in exports, which jumped at an extraordinary 3m/3m annualised rate of 62.6% in December.

Even though Western economies are still effectively being squeezed between the encroachment of low cost Chinese manufacturers and rising commodity prices, the authorities in Beijing seem more than happy with the status quo. This morning's news that China's foreign exchange reserves had climbed to a record US$609.9bn at the end of 2004 underlined the point. The intervention in December was a record US$36.0bn, eclipsing the previous month's high of US$31.4bn. The increase in reserves during 2004 of US$206.6bn exceeded the 2003 rise of US$116.8bn. More than half the increase in 2004 came in the final quarter of the year. The PBoC is working hard to sterilise the heavy inflows that have made the intervention necessary. The central bank set a one-day record yesterday, when it drained US$11.5bn from the money markets through the offer of six-month and one-year bills. The record inflows and soaring trade surpluses will be cited by critics of the currency peg in favour of an early revaluation. But the PBoC has argued these inflows are precisely why there can be no realignment. Any shift in the renminbi will attract more destabilising capital inflows. That may be true in part, but ultimately, the peg is unsustainable, for the very reason that it is driving countries in the West - notably the US - closer towards some form of debt deflation on a 2 - 3 year view. There is no telling when the peg will be broken. The entrenchment of the Chinese authorities suggests that it will not be soon. But the potential ramifications for the West will eventually raise the political pressure to breaking point.