



## Is Inflation a Chinese Export?

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By Jim Trippon

While the world watches the Olympic drama play out this August in Beijing, the financial community will also be watching another unfolding economic drama—one with much wider global implications. The world's fastest-growing major economy is starting to feel some serious growing pains, and we are beginning to feel China's pain as well.

Alarm bells went off in February when inflation in China hit a 12-year high of 8.7 percent. Premier Wen Jiabao promptly declared fighting inflation to be the nation's top priority for the year. The Chinese government slapped a freeze on fuel and utility prices as it struggled to meet its goal of keeping inflation below 4.8 percent for 2008.

Always uneasy about the specter of popular unrest, Beijing is taking the prospect of runaway inflation seriously. Major macroeconomic changes are underway, and as we all now know, what happens in China no longer stays in China. The effects of economic changes in China will be felt worldwide.

The effects of China's economic rise are already apparent to every American. High prices at the fuel pump and the grocery store have become a staple of the U.S. news media, and commentators waste no time in pointing the finger at China and other emerging economies for causing America's troubles. Certainly the shrinking dollar is an important factor in skyrocketing fuel prices, but prices at the pump have risen far more than the dollar has fallen.

### **HOW CHINA EXPORTS OIL INFLATION**

China's insatiable thirst for oil has tipped the global petroleum supply balance, contributing to inflation at the consumer level in the United States and the rest of the world. Because Beijing slapped a ceiling on refined fuel prices in China, that aspect of China's inflationary problem is effectively being exported globally.

Oil consumption in China soared to a record high during the first quarter of 2008 as demand soared in an artificially created low-price environment. The China Petroleum and Chemical Industry Association (CPCIA) reports that China's consumption of oil products composed of gasoline, diesel and kerosene rose by 16.5 percent year-over-year to 52 million metric tons during the first three months of 2008. That's a whopping jump in consumption at a time of record-setting world prices for crude oil.

Part of the blame for China's thirst for energy goes to China's consumers who are buying cars and driving over China's expanding highway network with a degree of enthusiasm rarely seen outside of the United States. With auto production setting new records every month, it is small wonder that commodities such as copper, steel and, of course, oil are jumping in price relentlessly.

The surge in auto production and consumption is also happening in a number of other emerging economies, such as India. But China is truly the proverbial thousand-pound gorilla in the global commodity inflation situation.

China ordered national oil companies to stock up on fuel supplies in advance of the Olympics in order to prevent embarrassing supply shortages during the Beijing games. For the first time in history, China became a net importer of gasoline. As giant Chinese oil companies such as Sinopec and PetroChina complained of heavy losses in their refining operations, the government handed out massive subsidies to keep the oil flowing at a price that is technically below cost.

The Chinese government has also given oil refiners huge rebates on imported crude and fuel supplies rather than risk social unrest by increasing domestic pump prices before the all-important Olympic spectacle. China has also added to the pressure on international supplies by starting to fill the tanks of a national oil reserve similar to America's Strategic Petroleum Reserve. This is a project that will continue for years to come, putting continuing pressure on global petroleum supplies.

### **PAYING THE FOOD BILL**

The cost of food is currently at the heart of China's inflationary concerns. Analyzing the 8.3 percent spike in the Consumer Price Index (CPI) during March, the National Bureau of Statistics determined that most of the price increases came from a 21-percent jump in food costs, most significantly in pork, vegetables and grains.

Since last year, Chinese authorities have been doing everything they can to boost food production with only mixed results. In an effort to increase grain production, China has raised minimum purchase prices for rice and wheat several times. Command economy measures may alleviate supply shortages eventually, but the immediate effect is even more inflation. During my recent visit to China, the most common inflation-related complaint I encountered was concern about the soaring cost of food.

China's growing demand for foods with higher protein content and the government's earnest attempts to control the problem have certainly contributed to a global food-price bulge. Just as China sent inflationary ripples abroad by discontinuing shipments of gasoline to East Asia, China's grain exports are being sharply restricted while internal consumption is increasing.

The rising value of the Chinese yuan has coincidentally increased China's competitiveness in the global market for agricultural goods. Until 2005, the yuan was firmly pegged to the U.S. dollar, but that year Beijing started to loosen its policies on exchange rates, and the yuan began a slow and controlled increase in value. As the dollar began to fall precipitously during 2008, the yuan was allowed to appreciate much more quickly in order to maintain China's purchasing power for essential commodities on the world market. In many ways China's macroeconomic expansion is transforming worldwide commodity markets permanently.

### **TOO MUCH MONEY**

One of the biggest unseen drivers of inflation is China's growing mountain of foreign currency. As dollars and euros pour in, China must issue large volumes of yuan to soak up foreign currencies. In the process of buying up foreign currencies, the Bank of China unleashes a flood of yuan, creating a demand-driven inflationary push. In short, too many yuan are chasing too few goods.

The one thing that Chinese authorities will admit freely is that managing the inflation problem is an extremely complex challenge.

China increased interest rates six times during 2007 as part of a massive effort to curb excess liquidity using monetary tools. But while China was hiking rates, the United States Federal Reserve lowered American interest rates an equal number of times. Of course, U.S. authorities had little choice but to cut interest rates as they struggled to alleviate a liquidity crisis and stimulate the economy despite the risk of generating inflation in America.

The immediate result has been a major interest-rate gap between the United States and China, and that's bad news for Beijing's anti-inflation fight. Although increased interest rates and bank reserve ratios were intended to dry up excess liquidity, one side effect has been an inflow of hot money due to arbitrage on the increasing yuan and the gap in interest rates. The broadest measure of money supply, M2, rose more than 15 percent every month during the first quarter in a year-over-year comparison. As the money supply ballooned, assets of Chinese banks topped \$7.5 trillion.

There are few signs that China's surging inflow of foreign reserves will be staunched easily. Foreign direct investment in China continues to accelerate. The Ministry of Commerce reports that FDI jumped by more than 75 percent during the opening months of 2008, with monthly inflows near \$7 billion. An astonishing 4,327 new foreign-funded enterprises were established during the first two months of the year.

### **CHINA DRIVES ITS OWN GROWTH CURVE**

Many China watchers remember the gloomy predictions that a U.S. recession or downturn would crush the long-running Chinese growth curve. To be sure, some easing was to be expected after last year's blazing 11.9 percent growth rate. But there has been no sign at all of the U.S.-driven collapse that seemed inevitable to some pundits just a few months ago. Instead, China came roaring into the New Year with an enviable 10.8 percent growth rate during the first quarter.

What's driving China's growth in the face of a slump among Western economies? The U.S.-led recession has indeed caused a slight easing in the growth rate of exports. But China's own consumers appear to be filling the gap. Retail sales growth in the first quarter accelerated to 20.6 percent, suggesting that domestic demand may be more than strong enough to offset a decline in exports.

But the boom in domestic consumption is also an important driver of inflation. Beijing has no intention of clamping down on consumption. Quite the opposite. The Chinese government's primary interest is in continuing the nation's rapid economic expansion. Well aware of the danger of being too dependent on exports for its economic health, Beijing is increasingly eager to encourage domestic consumption of Chinese-made products.

Although booming consumption may be another driver of inflation, there is no sign that the retail boom will end any time soon. Total retail sales of consumer goods have now topped the 10 trillion yuan mark—almost \$1.5 trillion. Income growth in both urban and rural areas is expected to outpace inflation, which means more consumer demand. The Chinese Academy of Social Sciences predicts that per capita disposable income will jump by 11.1 percent in urban areas this year and 7.3 percent in rural districts.

China hopes to ratchet the inflation rate down to 4.4 percent by the end of the year, but that would be quite an achievement considering the many economic pressures with which Beijing is grappling. Even the most optimistic analysts predict that China's inflation rate will not drop below 6.5 percent by the end of the year.

After the Olympics, Chinese authorities will wrestle with the problem of lifting the ceiling on retail fuel and electricity prices. Ending the price freeze would create new inflationary pressures at the very moment the government hoped to force down the Consumer Price Index. But allowing the freeze to stand will exacerbate the distortions that are rippling through the economy. In addition to the multibillion-dollar losses being absorbed by oil refiners, periodic fuel shortages are developing, and gasoline smuggling is rapidly increasing because of artificially low fuel prices on China's mainland.

The World Bank does not share China's optimism about managing inflation. The development bank predicts that the economic growth of East Asia will continue to be affected by high inflation, driven by increasing prices for grains and energy. The growth of East Asian economies is expected to slow to an average of 8.6 percent due to inflationary strains according to the World Bank.

For the rest of the world, China's expansion and the growth of its consumer class means increasing global competition for shrinking food and energy resources. Unless those demands are met with room to spare, an ongoing commodity price squeeze is inevitable. That means consumers in the West will be feeling the effects of Chinese inflationary pressures for many years to come.

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## **FOLLOWING THE TORCH**

The ruckus that has followed the Olympic torch across several continents could be just the beginning of a global spectacle and quite possibly a multimillion-dollar fiasco.

For the Chinese government and the Chinese people the Beijing Games are all about prestige. On Aug. 8 at 8 p.m., the biggest coming out party in history will begin with a ceremony that will be heard and seen around the world. But the Chinese people won't be the only ones banking on a big payoff from the Olympic Games.

Never before have so many advertisers and commercial sponsors bought into the Olympic spectacle for so much money. More than 50 Chinese and foreign companies have signed on for one of the many high-profile, high-priced deals offered by the Beijing Olympic Organizing Committee. For them the games are all about marketing.

Some of the world's biggest multinational companies have made major Olympic investments through partnership, sponsorship and supplier deals. The highest level of commitment is called partnership, and the cost of the exposure that comes along with being an Olympic partner runs as high as \$200 million.

Companies such as Adidas are once again looking for positive worldwide exposure through an association with the iconic Olympic rings. But what's new this time is an unprecedented opportunity to reach as many as 400 million increasingly wealthy Chinese consumers. They will receive a marketing message like they have never seen before; one that is uniquely intertwined with their national pride.

### **Games of Politics**

Neither the corporate partners nor the Chinese people nor the Chinese government want to see anything like the circus that has followed the Olympic flame. The possibility of a public relations fiasco similar to the disruption of the Olympic torch display in Paris is a possibility but not a likelihood. The Chinese security apparatus is hard at work making sure that doesn't happen.

Unfortunately, the Chinese solution is part of the problem. The arrest of dissidents months ahead of the games is one of the issues that have inflamed human rights activists globally. Still, it's not likely that much organized dissent will take place in Beijing during the games, but the Chinese are taking no chances.

In case anyone has slipped through the net, international broadcasters are being carefully controlled. Reversing an earlier decision, Beijing authorities have now refused foreign broadcasters permission to set up live camera positions in Tiananmen Square, just in case any spontaneous outbursts reach world audiences.

As tight as Beijing's grip is, the threat of a public relations black eye is not entirely within the government's control. Already several European leaders have announced that they will not attend the opening ceremonies in protest against China's actions in Tibet and Sudan and against human rights activists on its own turf.

In the U.S., President Bush has firmly resisted pressure from both presidential candidates to boycott the opening ceremonies of the Beijing Olympics. I think the candidates are entirely wrong in calling for a boycott. They have adopted a strategy that will have no practical effect other than to embarrass and inflame official and public sentiment in China at an extremely sensitive time.

China has a distinct mindset that McCain and Obama have seriously misjudged. Maintaining "face" is crucial to the Chinese people at the street level and at the highest levels of government in Beijing. Hosting the Olympic Games is China's clear signal that its nation is reaching out to the world and is eager to be seen as an important and respected global power. Rebuffing this gesture demonstrates poor leadership. America should embrace and encourage China's peaceful emergence.

The essence of presidential leadership is to set policies that will benefit the United States and the world. Instead, our presidential candidates have chosen to focus on empty political posturing—a choice that will not benefit Americans and will not improve the human rights situation in China whatsoever.

Boycotting any portion of the Olympic Games will be seen as a slap in the face by almost all Chinese people. Humiliating China will do nothing to support human rights or to build a constructive future with the world's next great power. The inflammatory path favored by radical protesters could set the stage for a new Cold War with a nation that holds almost \$1 trillion worth of American debt. This is a time for leadership and diplomacy. At a time of deepening recession, America simply cannot afford to pick a fight by boycotting the games and humiliating its biggest creditor.

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