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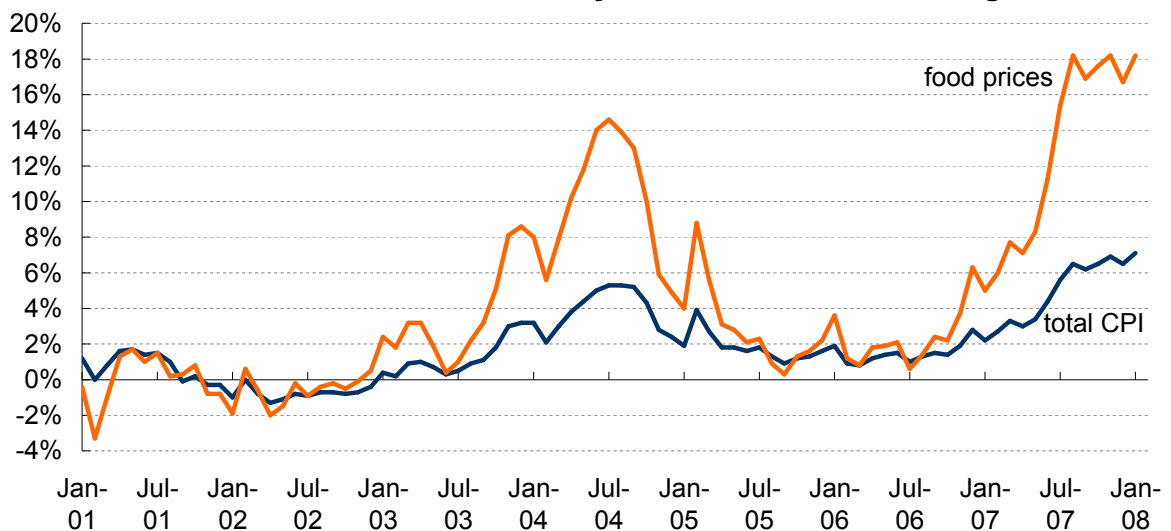
## Chinese inflation forces further yuan gains

**WE SUGGEST: PBoC may not like one-way street – too bad**

**SUMMARY: China's CPI inflation accelerated to 7.1% in January and could easily reach 10% later this year, driven by severe overheating of the economy. The alternative to accepting this or hammering domestic demand directly – risking riots during the Olympics – is a rapid rise in the yuan. Rather than offering obvious profits to speculators, Beijing should revalue by (say) 10% now – or better still float.**

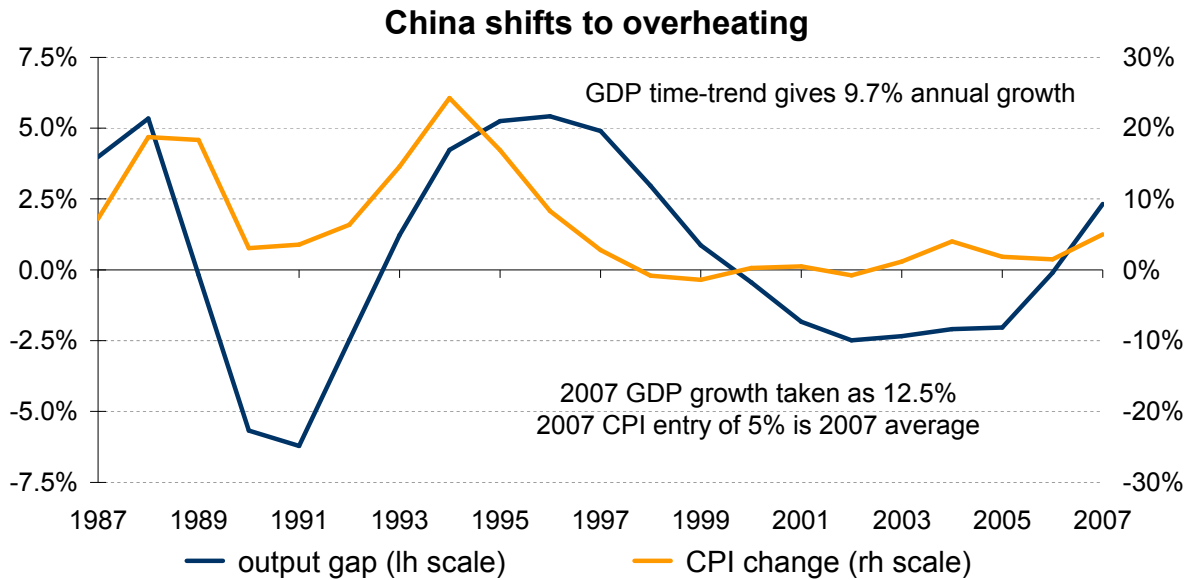
China's overheated economy saw inflation hit a new high (since the Asian crisis of ten years ago) of 7.1% for January. Its acceleration was triggered early last year by pig disease driving up meat prices. While that eased off in the autumn, levelling inflation off for a bit, the rate could be aggravated from February onward by the bad weather effects.

### China's CPI takes off, led by food, 12-month % change

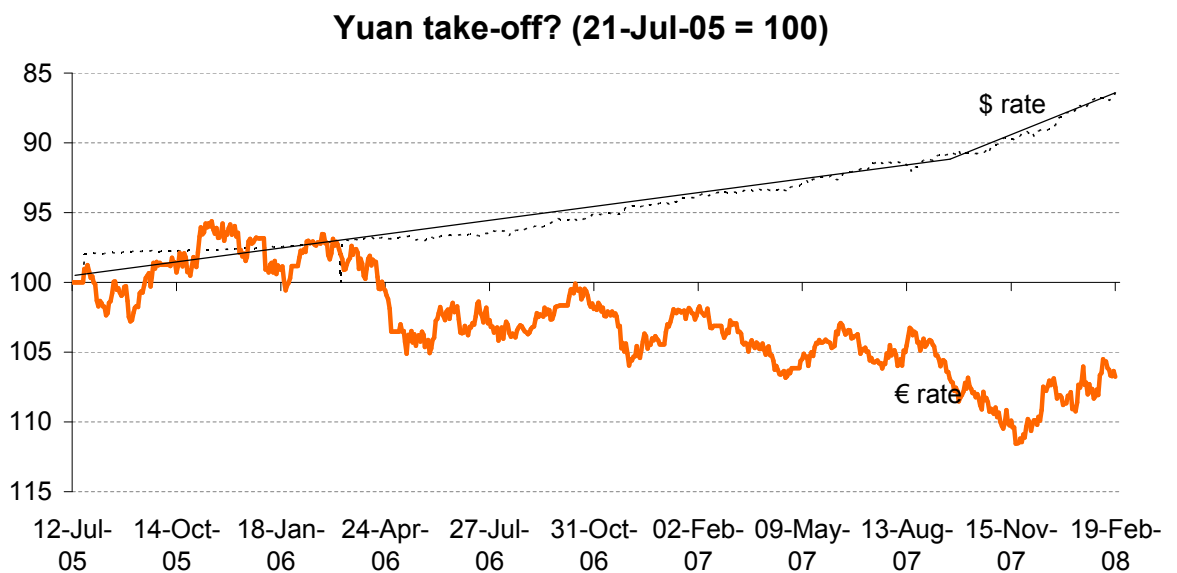


Food prices are 37% of the CPI. The 18% food price inflation of the past year therefore translates into 6.7% on the total CPI, accounting for the bulk of the 7.1% actual number. A very foolish acolyte of the US Federal Reserve System might therefore declare these price gains to be “non-core” – and some such commentators support such language by reference to the pig disease. It may be that Americans neither eat nor drink nor drive, rendering food and energy non-core items, though I and most others who have lived in the US have observed otherwise. In China, their very weight in the CPI proves that food is the core item of expenditure – as is quite normal in relatively poor countries: China's income per head in

purchasing power parity is about one eighth of America's. The acceleration of prices is chiefly driven by excess demand – overheating.



The past two years' nominal GDP, adjusted for inflation gives real growth of about 12% for 2006 and 12½% for 2007. The 2007 Q4 growth for nominal GDP was 17% from 2006 Q4. While the CPI for that quarter averaged 6½% up, the overall price level only rose some 4%, as consumer spending is little over half GDP. Real growth was close to 13%, and that of domestic demand was slightly more than GDP, for the first time since early 2004. As a result, the level of GDP, below potential for the whole decade from 2000 to 2005, has shifted to overheating of about 2½% in 2007, more of course by end-year. Inflation can only be expected to accelerate from 7%. The emphasis on food prices simply reflects the fact that people who have historically mostly been hungry will tend to spend gains in income on eating better!



The chart above shows the forced Beijing response. Mister Paulson may be the subject of polite indifference, but the alternative to letting the yuan rise a lot is either accelerating inflation – current overheating already means 10% on the CPI will be hard to avoid later this year – or hammering domestic demand unnecessarily: just the way to provoke riots in the middle of the Olympic Games. Hardly the “stability” that the yuan-dollar peg is supposed to ensure. The chart above has some tendentious trend-lines put in by the under-signed to show how the dollar rate has accelerated its appreciation since October. Even the euro rate is now showing signs of an up-trend, not a minor fluctuation.

Beijing policy-makers do not want to have their hand forced by bullish speculators. They would be well advised to make a pre-emptive revaluation of 10% or so soon. Or better still float the rate and let the punters reckon with a two-way risk: if capital exports were freed up too, the rate might go down!

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