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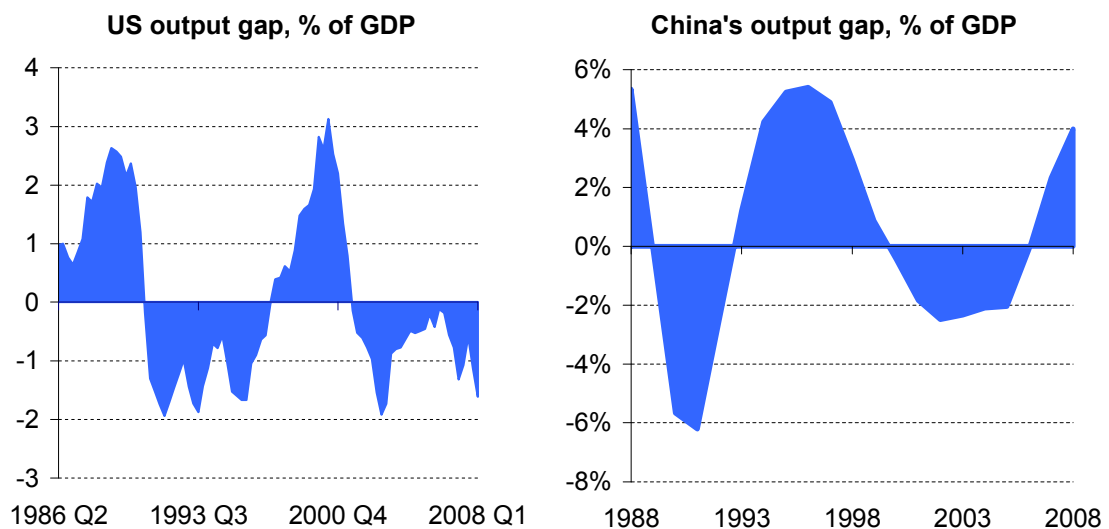
Daily Note: 11 June 2008

China's tightening helps the Fed

WE SUGGEST: A yuan revaluation likely

SUMMARY: The faster China acts to cool its overheating economy, the easier it will become for the Fed to steer the US economy away from the abyss. Our global output gap shows the world is operating above its capacity, but the excess demand is coming from the developing countries – China in particular. There is little the US can do about cost-push inflation unless it hammers its domestic economy to the ground.

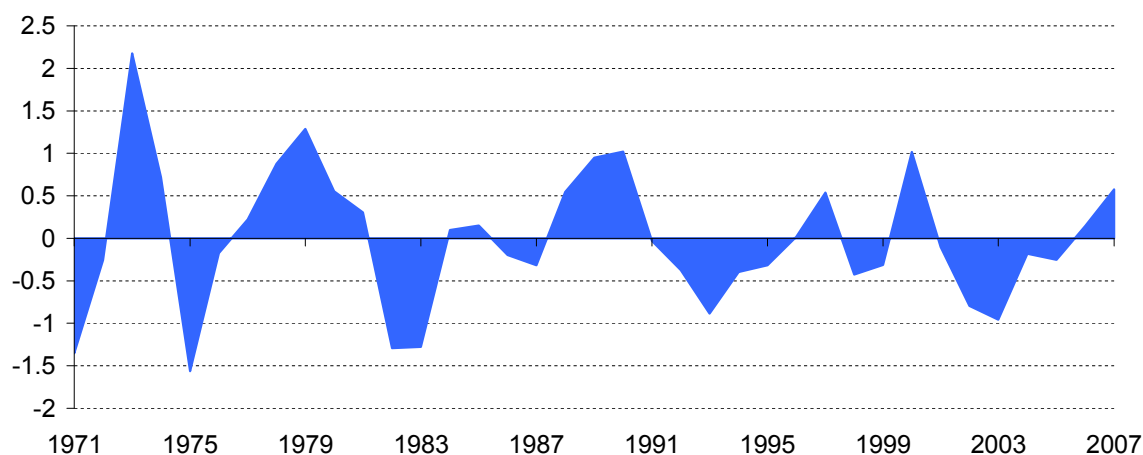
The world economy is overheating. But like a pantomime horse, the developed and the developing countries are moving in opposite directions. The two protagonists of the global story are China and the US – the excess saver and the excess borrower. During the Goldilocks years, this panto horse managed a jolly gallop forward, but this is no longer possible. The US has exhausted its ability to borrow and spend, output growth has slowed below its trend and there is already significant slack in the economy. China, on the other hand, began to overheat in 2006. Since then its output gap, the difference between actual and potential output, has been positive and widening as the economy powers ahead. Unsurprisingly, consumer price inflation has accelerated. For the US, inflationary pressures are cost-push – faster energy and food price inflation – the result of the overheating in China and other developing economies.



With China and the rest of the developing world now a sizable chunk of the global economy, especially in terms of incremental demand it is crucial to see where the global

economy is relative to its trend overall. We have estimated a rough and ready global output gap, which confirmed our suspicion that the overheating in the developing economies is more than outweighing the below-trend performance of the developed countries.

Global output gap, % of GDP



China cannot afford to let inflation run wild. Politically, Beijing associates spikes in inflation with social unrest, especially when it comes to food price inflation. It is in China's utmost interest to cool its economy. The authorities are increasingly taking the inflation threat seriously. The People's Bank of China announced a hike in the required reserves ratio last weekend in two staggered steps to reach 17.5% at the end of June, an increase of 1000bps since the authorities started tightening in mid-2006. This amount of tightening may appear super aggressive, but China's problem was not a runaway credit boom. It is only with this recent hike that conditions are beginning to get tougher for banks. Bank deposits were some Rmb13.5trn. higher than bank loans in April, with required reserves reaching Rmb7.3trn. Further hikes in the required reserves ratio are to be expected and they will be biting. As it is usually the case, Chinese monetary policy tends to respond too late. Hence, China will have to step too hard on the brakes and the economic slowdown is likely to overshoot on the downside. But the sooner China acts to cool its economy the easier it will be for the rest of the world, the US in particular, to rebalance.

The US's problem is stagflation. Output is below trend and output growth is set to stay below-trend, widening the negative output gap, at least until the end of next year. But inflation is on the rise at the same time. These conditions are reminiscent of the oil shocks of the 1970s. But the big difference is that with the US economy already operating below potential the cost-push inflationary pressures are external and unlikely to translate into higher nominal wage growth. The gloomy outlook for US consumer spending has already dampened business sentiment, leaving firms unlikely to succumb to higher wage demands. So no luck for the debt-ridden US consumer to see its debt to income ratio improve quickly. Instead it faces falling real incomes on top of falling net wealth as housing and equity markets correct.

Stagflation is making the job of the Fed extremely difficult, especially because, ultimately, it is Beijing that calls the shots. Moreover, even if Beijing is successful in cooling its economy, this is most likely also going to involve further appreciation of the yuan vis-à-vis

the dollar. It would not be a surprise if there is a one-off revaluation of the yuan after the Olympics. Hence, the US inflation problem could persist. The Fed made a mistake to slash policy rates in the face of accelerating cost-push inflation, risking its credibility. It is now signalling that its risk bias has shifted towards inflation. For the sake of the domestic economy it is too early for the Fed to be hiking policy rates. But if China does not act fast to curb its overheating, the Fed may have to hammer its domestic demand to the ground and risk not only a prolonged but also a severe correction in the US economy.

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