



Investment Strategy Group

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Investment Strategy Bulletin

Yuan appreciation: a blunt policy tool?

Ironically, the USD1.4 trillion in new bank lending last year that gave a boost to global growth by adding to already excessive productive capacity and exacerbating *disinflationary* pressures in the developed economies has now had the inevitable consequence of worsening domestic *inflationary* pressures in the supply constrained Chinese economy.

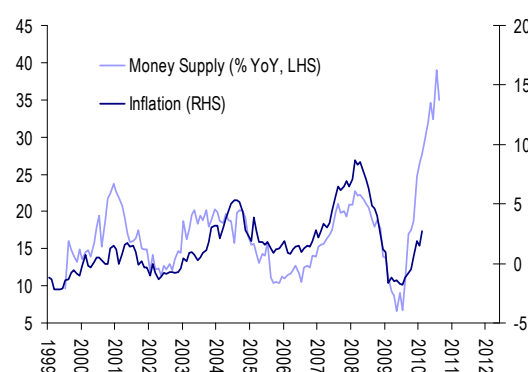
Despite immense excess capacity levels, which result in a very elastic global supply curve for goods, the domestic supply curve remains comparatively inelastic and gives rise to the paradox of an inflating economy exporting disinflation to its trade partners.

The upper chart shows the relationship between Chinese money growth, currently 35% annually, and domestic price inflation 6 months later: the rapid surge in monetary growth arising from the expansion of bank balance sheets in 2009 promises a marked increase in consumer inflation through the second half of this year. *The lag from money supply to inflation is comparatively short.*

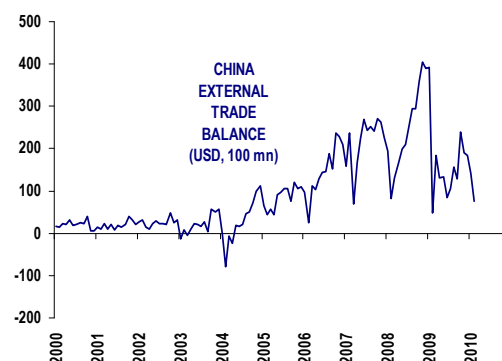
It has been suggested that a Yuan appreciation could be part of the policy response to dampen the impending inflationary pressures. Unfortunately, we are not so convinced that this path can have an appreciable impact on inflation in the desired time space. Some research at the BIS (Bank for International Settlements) in March 2007 looked at the pass-through from exchange rate changes to consumer prices: it found that a 1% change in the exchange rate changes consumer prices by 0.08% after 4 quarters and a cumulative 0.77% after 8 quarters in China. This compares with an effect of 0.01% / 0.02% in the US and 0.07% / 0.13% in the Euro area.

Whilst the lag from money growth to inflation is *short*, the lag from the exchange rate to inflation is *long*: this suggests that the exchange rate is a comparatively blunt tool to manage worsening near term inflationary pressures. Moreover, with an appreciation of just 2% to 5% implied in the forward curve / anticipated by analysts, the full consequence would be far from sufficient to contain inflation. Whilst research shows that traditional monetary policy transmission (from official rates through to credit demand) is less effective in China, we believe that it will take a combination of higher short rates, above and beyond the 115bp currently discounted in the market, and meaningful increases in reserves requirements to dampen credit creation and monetary growth. As well as being a blunt tool, with long effective lags, the detrimental impact on export demand, at a time when the trade surplus in China is shrinking rapidly (see lower chart), will want to be avoided by policymakers.

**Chinese Money Supply Growth (advanced 6 months)
versus Chinese Consumer Price Inflation**
Year on year % change



Chinese Trade Balance
Hundreds of millions, USD



Source: Datastream, Bloomberg, LO calculation

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