Emerging Advisors Group

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April 23, 2012

What Is It About Chinese Inflation That Makes Perfectly Rational People ....

"How long does getting thin take?" asked Pooh, anxiously.

– *A. A. Milne*

SUMMARY AND INVESTMENT IMPLICATIONS

Yep, Chinese inflation has been rising over the past few years. But this is still an economy with below-average trend price growth – and, despite endless conspiracy theories, no macro evidence whatsoever that the authorities are manipulating or lying about the data.

I.e., we find it very hard to take the idea of a looming mainland "inflation threat" seriously. You're better off worrying about Chinese growth.

... completely lose their bearings?

It's been hard to have a conversation on China over the past few years without getting into a lengthy discussion on inflation. Why? For two reasons.

First, after a long period of near-zero price growth in the late 1990s and the early 2000s, it's clear that China now actually *has* some inflation. And this, well, has a tendency to freak out hard-core China watchers who haven't had to think about things like rising prices for a long time: how on earth will the authorities manage the economy now that they have to face burgeoning inflation pressures as well?

And second, whenever prices do start to rise there is an inevitable chorus of conspiracy junkies who claim that inflation is not only picking up ... it's really exploding into the strong double-digit levels, but just not showing up in the official numbers because the government is cynically manipulating its CPI statistics.

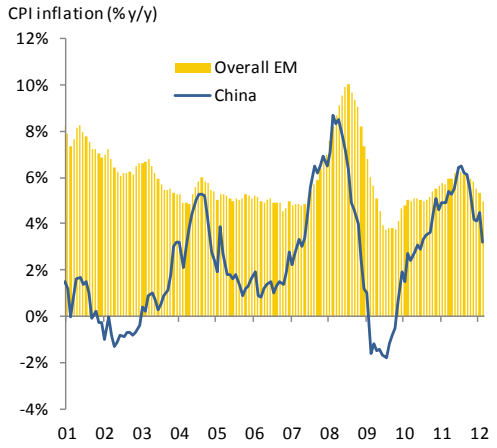
Should you start getting hyper-concerned about inflation in China?

Er, no. The prosaic truth is that (i) there's nothing very remarkable about Chinese inflation, which is still below the EM average, and (ii) there's no macro evidence whatsoever to support the idea that "true" inflation is spinning out of control.

Pretty dull

Let's start with the official headline numbers; Chart 1 below shows the pace of Chinese CPI inflation compared to the EM-wide average.

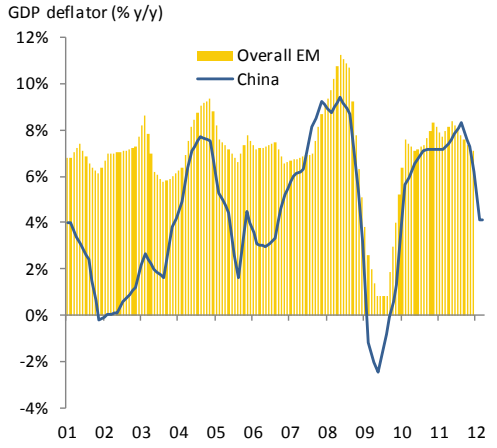
Chart 1. Where China fits in – CPI inflation



As you can see, China is no longer completely out of synch with the rest of the world, as it was in the early 2000s when inflation was essentially zero – but mainland CPI inflation has still been running a percentage point or so below the EM average over the past few years, and is running a percentage point or so below today.

I.e., there's certainly no drama in the data here. China still has a very comfortable level of price growth by EM standards.

Chart 2. Where China fits in – GDP deflator



Now, the immediate response from China specialists is that underlying GDP deflator inflation is a good bit higher than the CPI version, by 1.5pp to 2pp on average over the past half-decade, a sign that we're missing higher inflationary pressures.

The trouble, of course, is that this kind of deflator/CPI gap is pretty much the norm for most other countries in the emerging world as well. If we compare inflation levels according to GDP deflators instead of CPI, China still sits at or below the EM average (Chart 2 above).

Once again, there's nothing very special or onerous about Chinese inflation today.

Are they lying?

Ah ... but these are just the official data. Are the authorities covering up something much more sinister by mis-reporting the CPI numbers?

Not according to any of the macro data we have. And there are basically four ways to tell.

1. Use GDP deflators. The first is to compare CPI data with GDP deflators, which we just did above. Again, implied deflator inflation is faster than CPI inflation in China – but the same is true for most EM countries, and there's nothing unusual in in Chinese numbers.

2. Use bottom-up prices. Second, we can try directly measuring bottom-up prices in the economy and then compare our results with those in other emerging markets as well.

Such an exercise is far beyond our individual capacity, unfortunately – but as luck would have it, *The Economist* magazine provides something that very much fits the bill in its well-known Big Mac Index. We can't think of a product more aggressively standardized across time and across markets than the McDonald's Big Mac; it also happens to be a fortuitous mix of domestic food, materials, wages and rents, i.e., an almost ideal proxy for a local economy-wide price basket. And *The Economist* has been collecting local price points in dozens of countries for more than two decades now.

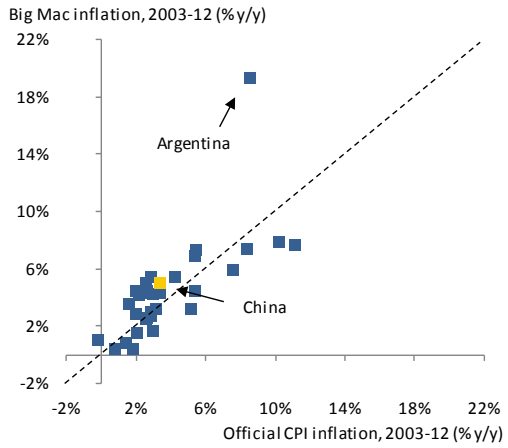
How do the numbers look for China? Well, nearly ten years ago in early 2003, the average price of Big Mac in five major Chinese cities was RMB9.90, and as of the last update in January 2012 the price was RMB15.40. This corresponds to an annual inflation rate of 5% over the last nine years. By contrast, the officially reported inflation rate was 3.4% – or a difference of around 1.6 percentage points.

Is this a lot? The short answer is "no".

Chart 3 below shows the corresponding Big Mac/CPI differentials for major EM and developed countries. The square at the top of the chart is for Argentina, a country that clearly *is* lying about its inflation numbers in a big way, and of course the extent of the discrepancy is immediately evident.

By contrast, China falls pretty much in the middle of the pack – right next, in fact, to the US, Sweden, Singapore, Malaysia and other middle- and high-income countries that don't usually raise investor suspicions of pervasive statistical inflation misreporting.

Chart 3. Big Mac vs. official inflation



I.e., according to the Big Mac index China official price statistics are, well, probably as accurate as anyone else's.

3. Use monetary data. But how can this be, when China has been printing money so egregiously faster than anyone else?

Ah. The answer is that China *hasn't* actually been printing a lot of money, a fact that most investors invariably miss.

What matters for inflation over the long run is the trend growth rate of broad money in excess of underlying real GDP growth, and Chart 4 shows the figures for China and EM over the past decade:

Chart 4. China vs. EM "excess" money growth

As you can see, China did have a monetary "blow-out" relative to growth ... for around 12 months in calendar 2009. But on average, China GDP-adjusted broad money growth has been far less than in the rest of EM – and, crucially, it has been running at *less* than the EM average over the past two years as well.

4. What about wages? But aren't wages exploding in China?

Um, no. *Migrant* wages are exploding in China, but this is more of a sectoral than a nationwide issue. Chart 5 shows the pace of average nominal earnings growth for urban households and rural migrants respectively; as it turns out, migrant wage inflation is now at least 15pp higher than it was at the beginning of the 2000s – but according to the same surveys, urban income growth is pretty much the same.

We can't guarantee the veracity of these survey data, but you get the point: there's a lot more wage pressure coming through the 120-million migrant labor pool than there is in the 400-million strong urban resident labor force. And the key point here is that migrants are heavily concentrated in a few sectors in the economy such as light export manufacturing and construction, which in turn explains why there has been a much stronger trend increase in US dollar Chinese export price inflation than in overall Chinese CPI (Chart 6).

Chart 5. It's about migrants

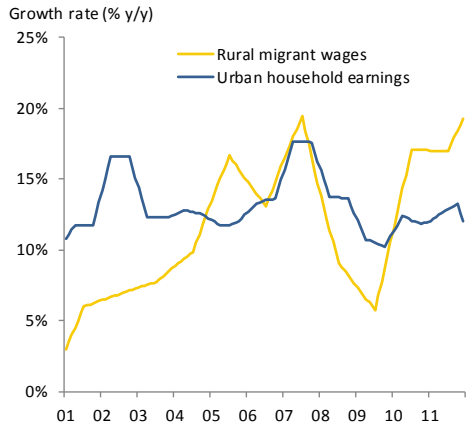
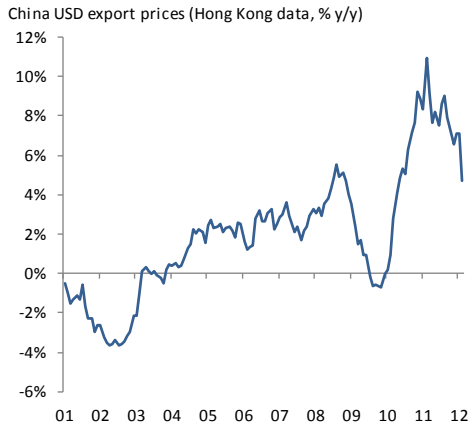


Chart 6. The export price boom



Nothing to see here, folks

The bottom line is that, yes, Chinese inflation has been rising on trend over the last six years of so. But no, there's really nothing to see here by emerging market standards.