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Where Chinese And Americans Agree: An Irrational Fear Of The Fed

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By: **ROBERT MCTEER**

If Ben Bernanke's policies haven't created significant money supply growth in the U.S., how can they be sparking inflation in China?

I recently visited China—Shanghai and Hangzhou—for a too-brief five days. I spoke to investor groups about the U.S. economy and its parallels to and interrelationships with China and answered tons of questions from investors and the press about—guess what?—QE2. Why was the Federal Reserve printing so much money, exporting inflation to China and other countries, and putting strains on exchange-rate relationships? When will QE2 end and will it be replaced by QE3? These are, of course, the same questions I get from U.S. audiences, and my answers were met with about the same degree of skepticism.

I read recently in *The Economist* that the Chinese are skeptical of official government pronouncements. It cited a Chinese saying, according to which, "you can't believe anything until it's been officially denied." On the contrary, in this case, their and repetitious questions suggested that they had bought the official pronouncements hook, line, and sinker.

For the past two months, consumer prices in China have increased year over year 4.9 percent, with food and property prices rising at double-digit rates. The People's Bank of China, their central bank, is carrying out an aggressive anti-inflation campaign using jawboning, moral suasion and several significant increases in bank reserve requirements. That's on the one hand. On the other hand, the PBOC is conducting aggressive open market purchases of dollars to hold down their yuan, which is naturally increasing their domestic money supply and offsetting their tightening measures.

Allowing the undervalued yuan—China has the world's cheapest Big Macs—to appreciate has long been an action that would help achieve their new goals of saving less domestically and replacing some of their export growth with domestic consumption. Now it would have the additional advantage of removing price pressures through lower import prices and freeing the central bank to pursue anti-inflationary monetary policies. Yet, even discussion of that obvious remedy is off the table officially. The Chinese recently hosted a high-level conference on exchange rates and prohibited a discussion of the yuan.

I pointed out that their inflation rate was twice ours; so it seemed odd to think they were importing inflation from us. Their decision to engage in yuan-creating open market purchases of

dollars was their decision, not ours. I asked whether they didn't think that years of ten percent growth might have something to do with Chinese inflation.

I also explained that the idea that the Federal Reserve had created an explosive growth in the U.S. money supply was a myth. I cited the recent statistics that our M2 growth was only at a 4.7 percent rate in the past three months; a 5.3 percent rate in the past six months; and a 4.1 percent rate over the past year. Those growth rates would hardly be excessive for a full-employment economy, much less an economy with 8.8 percent unemployment.

I explained that Federal Reserve open market purchases of assets normally would create a multiple expansion of money, but that this transmission mechanism was being blocked by the banks' desire to hold onto more reserves than are required by regulation, i.e. excess reserves. Large amounts of bank reserves have been created, but they haven't yet been translated into multiple amounts of deposit money.

It's true that bank reserves plus currency constitute the "monetary base," and that the monetary base is usually called one of the monetary aggregates, along with M1, M2, etc. However, the M's are measures of money while the monetary base is a measure of potential money, not actual money. Yet many people treat the monetary base as a measure of the money supply. Some cite the velocity of the monetary base that existed in the past and assume it is still relevant, but the You Tube rocket of the base rising into the stratosphere is matched by an offsetting plunge of its velocity reaching all the way to China.

When I returned home from my China adventure, highlighted by a bullet train ride between Shanghai and Hangzhou, I met with similar skepticism. The whole world seems to believe that 4 percent money growth is about to ignite hyperinflation. Of course, they have believed that for a couple of years now. The fact that it hasn't happened yet apparently only makes it more likely to happen now.

After I returned home, I received an email from a Chinese investor who took an interest in my comment, regarding excess reserves, that you could lead a horse to water but you can't make him drink. He suggested heating the barn or making the horse run more. I told him my preference was to spike the water with punch.