

Delayed calls: the paradox of demand side deflation versus supply side inflation

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US-China efforts to sustain demand and ward off deflation

Economic long waves are very complicated phenomena, involving both demand side and supply side factors, cyclical and structural dynamics, and, above all in this new era of powerful central banking (especially the practices of the US Fed) and treasury operations, the often unpredictable interactions between reality and policies.

From the demand side, western capitalism is a very tired economy, quite ripe for drastic adjustments. Hence deflation in Japan, and the recent threat of it in the US. But after the largest financial bubble in modern history, for which its policies had been partly responsible, the US Fed under the command of Alan Greenspan decided not to let the downwave take its full course. A series of cuts brought the Fed funds target rate down to a 45-year low. On top of that was Bush's tax reduction programme. The result? A continued ballooning of the unholy debt trinity in the US: private debt, public debt (fuelled by budget deficits), and foreign debt (nurtured by current account deficits).

Such strong demand side boosters have been able to sustain the US economy, but the lacklustre growth in employment contrasts sharply with the ever-rising debt mountain; and the tip of the liability iceberg shifts from the stock market to the housing market, with refinancing and leveraging assisted tremendously by the artificially low interest rates.

Add to the picture China, which by the latest count consumed 1/3 of the world's steel and 40%-50% of its cement while producing only 5% of global GDP on the back of the huge amount of non-performing loans (NPLs) in the country's state-owned commercial banking system, and one should not be surprised by the return of inflation, the underlying threat of debt deflation, à la Irving Fisher, notwithstanding. In other words, Alan Greenspan, George W. Bush and the CCP Politburo (with help from local governments) have been pumping up demand to keep their debt-driven economies from possibly unsettling downward spirals.

Structural and long-cycle supply factors

The fact that inflation is coming back so quickly, at least in the upstream sectors, has caught many by surprise. Geopolitical tensions over oil and terrorism were just trigger points. Analysts watching the chronic bear markets in energy, metals and other renewable or non-renewable resources in the past two decades have been warning about a structural gap between long-term demands and supplies for quite some time. Comments by [Michael Meacher](#), [Lester Brown](#), [Sonia Kolesnikov-Jessop](#), and [Paul Krugman](#) were just the recent examples.

The worldwide taming of inflation after Paul Volcker's Herculean hikes of US interest rates (even more dramatic than Greenspan's downward chops) led to a prolonged period of complacency. Under-investments were prevalent in many exploratory, extraction and generation sectors. Efficiency promoting "demand side management" resulted in lower unit consumption, while environmental awareness rightly curbed marginal profit-seeking ventures that failed to take fully into account social cost.

In any case, the net consequence is that supply constraints become increasingly a potential drag to the world economy in the longer run----meaning if and after the nearly unavoidable debt deflation cleans up the mess and a new, sustainable upwave is viable again. Then the dominant theme of the 21st century might well be the "fight for resources" (as I said in [a recent Chinese piece](#)), equal to, if not more important than Huntington's "clash of civilizations".

Policy intervention: the twists and turns of history

But of course, the governments are not going to sit there and wait for history to unfold "naturally": indeed many of the cumulative problems have been caused, and alleviated (albeit only temporarily), by governments, particularly powerful authorities who don't quite know their own limits. The US is the paramount example, economically as well as politically.

The Chinese government has been much more humble: but it also has its blind spot. The fact that it has become the almost sole favourite destination for international capital has given it tremendous leverage as it expands its trade with the rest of the world rapidly. In 2003, contracted direct foreign investments in the country rose to

US\$115 billion, surpassing the amazing record of 1993 blown up by the “Deng whirlwind”, and China’s forex reserves reached US\$403 billion by the year end. Ironically, China decided to use part of the reserves (US\$45 billion) to inject capital into two of its largest banks (the Construction Bank and the Bank of China), a move that raised the eyebrows of economists, but not many reporters. Further employment of reserves for the enlargement of the capital base of the other two banks is in the pipeline.

In a nutshell, capital inflow is helping to power China’s low-efficiency high growth and to prevent a meltdown in its financial system, directly and indirectly. Prolonged growth might solve the difficulties over time, as the NPL problems seem to be improving (and improving rather spectacularly in the last quarter of 2003), according to official statistics. And it will also continue to help the rest of world by keeping up demands, as the country sucks in more and more imports for final consumption and processing work (that turns out relatively cheap products for exports).

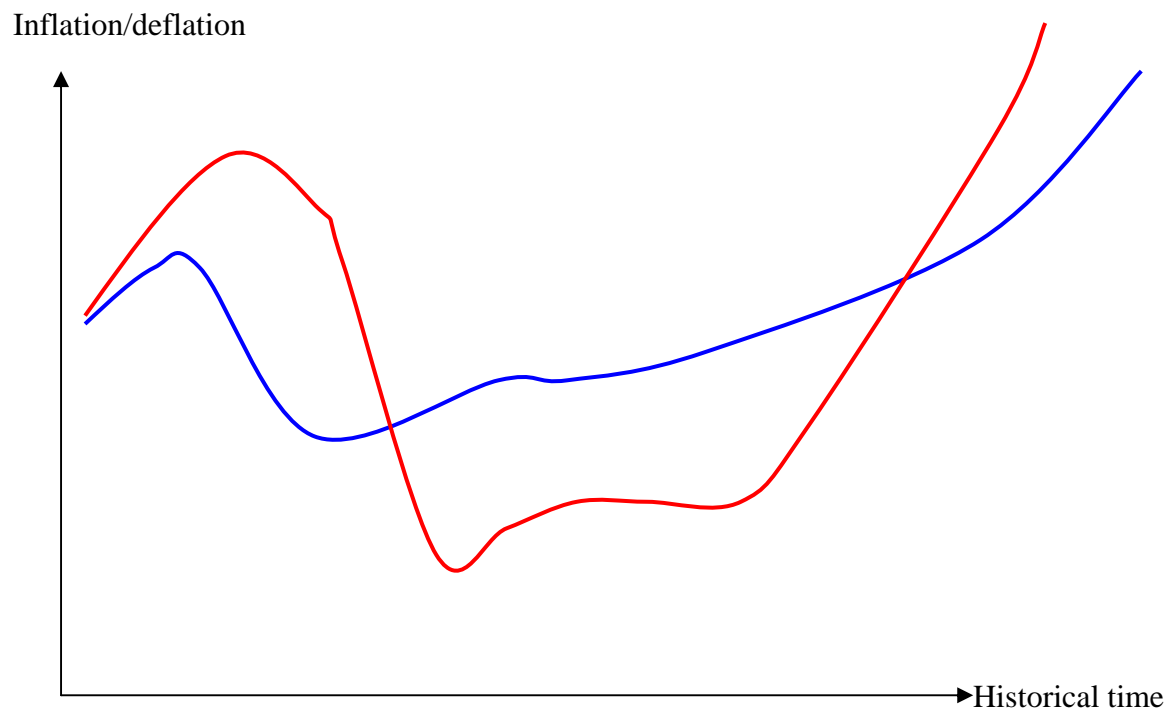
However, there is a risk that things might go wrong. If foreign capital and global demand dry up or even decline, China has little choice but to confront directly the unpalatable consequences, especially the NPLs. The contradictions would show up in either budget deficits and/or trade deficits, both of which are not big problems at the moment. To contain them, taxes may have to go up, or the Renminbi needs to be devalued (I know this latter one is presently a contrarian view)!

How history might unfold

Given the historical trends and various possible policy reactions, future developments are far from certain.

The longer the authorities try to avoid the reckoning, the more precarious would the debt bubble become, and the consequent financial and real-economy adjustments would be more painful. Afterwards, though, the supply constraint might turn out to be more restrictive as severe debt deflation could create worse cyclical and structural disincentives for long-term investments in resources. Unfortunately, election year politics in the US is increasing the probability of such an outcome.

My rough guess about the future is depicted as follows:



The red line represents the “procrastination” scenario, while the blue line that of “biting the bullet”. Of course, in the spirit of “rational expectations” and “irrational exuberance”, any combination of these two scenarios could emerge. And the so-called deflation might mainly be a significant loss of value for the US dollar (some would argue that is the only correct definition, rather than a fall in US CPI); and for a while stagflation could occur in the US and other parts of the world.

China’s growth should still be positive, perhaps even enviable by world standards, despite a possible implosion in debts. But achievement of developmental goals would be delayed and some heavy social costs might be involved.

One should indeed fasten one’s seat belt, if that hasn’t already been done.