The Ant And The Grasshoppers

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In the last few days, Chinese policymakers have stepped up the campaign to rein in their domestic tech giants, slapping Alibaba with fines of US$2.75bn and forcing the restructuring of Alibaba spin-off Ant Financial. Their action is in stark contrast to the inaction of regulators in western countries, where the reign of the tech barons has scarcely been challenged. But this is hardly the only contrast between China and the west. Just consider what else we have seen in recent months:

- The US and eurozone have embarked on a new budget and monetary experiment to stimulate final demand. In the words of Jacques Rueff, they are "subsidizing expenditures that give no returns with money that does not exist." Meanwhile, the Chinese authorities are acting to curb government spending and are constraining money supply growth.

As the US ramps up its public spending, Beijing is targeting its slowest state spending growth ever

- The US government is launching massive investment programs at a time when there is little industrial spare capacity. Much the same is happening in Europe. Again, China is trying to rein in government spending.
- The US has gone pedal to the metal on monetary policy, encouraging a property and construction boom, even as the sector suffers shortages of workers and raw materials. China is trying to slow construction activity.

It seems that every time a western government decides to spend yet more money or to launch another state investment program, the Chinese authorities immediately make it known they will move in the opposite direction. Why?

The rate of relative excess money growth points towards exchange rate moves

The chart overleaf may begin to give an inkling of the explanation. The red line shows the ratio of Chinese excess money growth to US excess money growth. What is excess money? Simply local M2 divided by nominal GDP. The idea is that over the long term, money supply should grow at roughly the same rate as nominal GDP. As a result, the ratio between the growth of excess money in two economies should indicate which way the exchange rate is heading—with the country showing the faster increase in excess money supply having the weaker currency.

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US NY Fed consumer inflation expectations rose to 3.2% in Mar, from 3.1% in Feb	N/A	More signs of rising inflation; all eyes on US CPI Tuesday; expect a big jump
Eurozone retail sales rose 3.0% MoM in Feb, from -5.2% in Jan	Above 1.7% expected; YoY, sales fell -2.9%, from -5.2%	Non-essential shops still closed in several countries; reopening will drive a strong rebound
China total social financing increased 12.3% YoY in Mar, from 13.3% YoY in Feb	Below 12.5% YoY expected	TSF growth is likely to decline further as policies are getting back to normal
Indian CPI rose 5.5% YoY in Mar, from 5.0% in Feb	Above 5.4% expected; core CPI rose 6.1% YoY, from 6.0%	Broad-based price pressures limit room for RBI to pursue further stimulus

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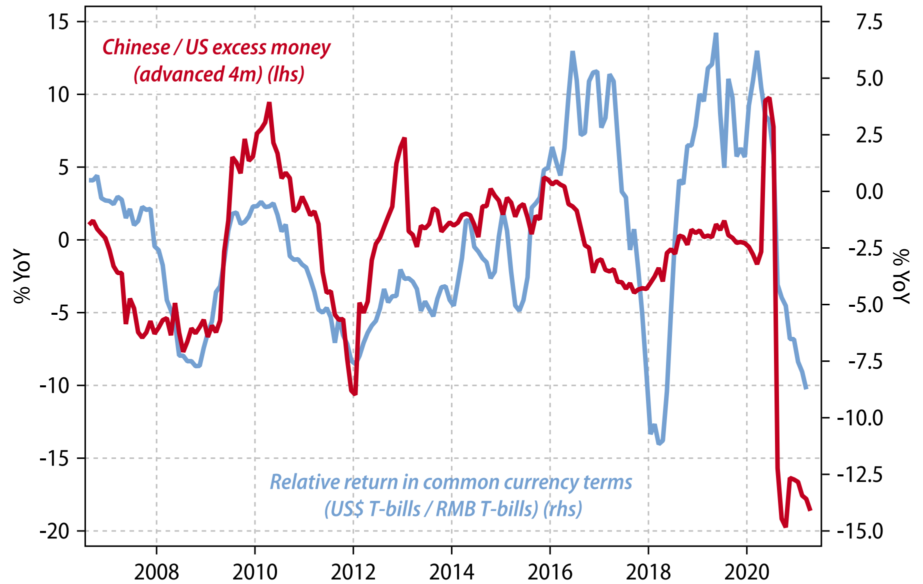
Excess money growth is inversely correlated with currency returns



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The relative returns on the US dollar versus the renminbi are set to collapse

The blue line shows the year-on-year change of relative money market returns in common currency terms. If the past correlation between the two series is anything to go by, the relative returns on the US dollar are about to collapse even further. In other words, the renminbi is set to surge against the US dollar.

China is building an Asian monetary zone

Now, if you accept my view that China is trying to establish an Asian monetary zone based on the renminbi, it follows the renminbi's appreciation will have widespread implications, much like the rise of the deutschemark in the 1970s.

- As the other currencies of emerging Asia's renminbi bloc track the renminbi higher, one result will be an enormous effective devaluation of the Hong Kong dollar. This will boost Hong Kong's competitiveness against other major financial centers. But if I were a Hong Kong resident, I would quickly convert my cash holdings into renminbi. Over time, this points towards the disappearance of the Hong Kong dollar as a currency.
- As the US dollar depreciates, there will be a sharp rise in the US dollar prices of many commodities. I would buy commodities in the futures markets today, settling once the dollar decline has happened.

Buy Asian currencies now, before they rise

- Conversely, if I have to buy Asian products in local currencies, I would buy Asian currencies today to settle with producers later.
- The Japanese, knowing the yen will ultimately follow the renminbi higher, will put downward pressure on the yen so it revalues from a lower base.
- I would park my cash in 10-year Chinese government bonds, as over time I would expect their yield to fall below the yield on US treasuries. It's what happened in Europe in the 1970s, when bund yields fell from 200bp over treasuries to more than -200bp below.

This move will be as inflationary for the rest of the world as the 1998 Asian crisis was deflationary. As Karl Otto Pohl, Bundesbank boss in the 1980s, put it: "Inflation is like toothpaste. Once it's out of the tube, you can't put it back."