Purchasing power of money

Inflation and the internal purchasing power of money:

On the surface there appears to be no inflation in the US. 1.1% YOY inflation is neither too high nor too low. However, given the state of growth in the economy, central bank policy, fiscal strength or lack thereof, the risk of deflation has become a topic of concern. In macroeconomics the debate between inflation and deflation is one of the most important for the future health of the economy.

In the inflation camp are those who point out that the rate of monetary expansion will inexorably lead to inflation both from the fact that inflation has historically been a monetary phenomenon, and from the fact that debasement of currency must lead to a repricing of goods and services. Already natural resource prices have recovered as developed country currencies have weakened which will lead to at best margin squeezes for corporates or outright retail price inflation facing consumers.

In the deflation camp are those who recall the vain efforts of the Japanese for the last 2 decades to revive their economy from a deflationary slumber. They fear that the economy will slip into a second recession, a fear that is quite real when one considers the risk that bank disclosures have been less than crystal clear, that debt refinancings loom in the next 2 to 3 years, that sovereign balance sheets look like junk and unemployment remains persistently high.

The truth is somewhere in between. Inflation is subtler than the rate of change of the CPI. A closer inspection of the constituents of CPI is illuminating. 25% of the index is an item called owners' equivalent rent. This is an item that represents no cash flow and therefore has no income effect on consumers. Housing as represented by actual rental is a normal good. Substitution effects are always negative delta. As price rises demand falls. Income effects are complicated. In the case of rented housing, a fall in rent has a positive income effect so that more is demanded. With owner occupied housing, however, the income effect is negative (via home equity credit, psychological effects etc), since the nominal value of an asset has fallen. Note that the owner’s welfare or utility is invariant to changes in the value of the principal residence. A more relevant measure is the cost of financing the asset, thus mortgage costs ex capital repayment. With CPI growing at 1.10% YOY and if we assume that housing prices relapse into a 5% decline over the next year, then inflation in all other items would have to be running at over 3%. It is entirely possible that inflation is already underway but is being under-detected by the CPI methodology.

With higher inflation the term structure of interest rates may need to steepen.

FX and the external purchasing power of money:

Trade and current account imbalances have threatened a so called currency war. The US would like to see a stronger RMB. The Chinese would like to see less quantitative easing in the US. The Chinese have amassed a huge inventory of US assets which would be devalued if the RMB was allowed to appreciate. More importantly the Chinese export economy would suffer and more subtly, Chinese SMEs do not have to sophistication to manage FX exposure and are likely to face significant problems managing large fluctuations in the RMB exchange rate. A weaker USD will be inflationary in the very short term as prices are slow to adjust. In the longer term, the nature of imports and exports will change and the story is less clear. Given the volume of oil imported by the US, a weaker USD is likely to be inflationary.

Behind the trade imbalances lie a feedback loop that needs watching. If the US indeed manages to reverse its trade deficit with China, the need for China to recycle USD will be greatly diminished to the extent that the PBOC may not support Treasury auctions, which would require the Fed to plug the gap lest there is a failed auction or yields head significantly higher. This would represent unplanned printing of money which would further weaken the USD. Normally, in an open economy, a trade surplus exerts supporting pressure for a currency. Here, it might not. The eroded external purchasing power of the USD could require higher interest rates to compensate holders of USD.