China Drains Obama Stimulus Meant for U.S. Economy: Andy Xie

By Andy Xie - Aug 17, 2010 4:00 PM GMT-0300

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Aug. 18 (Bloomberg) -- Andy Xie, an independent economist, talks about the impact of U.S. stimulus measures on global inflation. Xie talks with Betty Liu on Bloomberg Television's "In the Loop." (Source: Bloomberg)

The global economy is like fried ice cream: If you don't act fast, it turns into a mess.

American pundits, Nobel laureates included, are predicting Japan-style deflation for the U.S. and Europe. They are urging the Federal Reserve to pursue another round of quantitative easing to stop the onset of an Ice Age for Western economies. The Fed didn't oblige at its last meeting, but it threw a bone to the deflation crowd by promising not to pull money out of its previous round of asset purchases to stimulate a recovery.

On the other side of the world, consumer prices are surging. Emerging markets as a whole now have an inflation rate of more than 5 percent. India is registering price increases of more than 13 percent. China's are more than 3 percent. But it surely feels a lot higher for average Chinese.

Much of the "heat" comes from the property market in emerging markets. Million-dollar flats in Mumbai have panoramic views of the city's slums. Hong Kong's real-estate prices have almost reclaimed their 1997 peak, though the economy has barely grown since then in per-capita terms. Overpaid bankers who pay 15 percent income tax in Hong Kong are stretched to buy Beijing or Shanghai properties. Moscow is somehow always near the top of the list of the world's most expensive cities.

The emerging markets are on fire.

Rude Awakening

Deflation prophets in the West are in for a rude awakening. Eastern fire will turn Western ice into a mess, and 2012 looks like it will be the year of melting. The fuel for the fire is coming from deflation-fighting stimulus programs, such as that of U.S. President Barack Obama.

Stimulus is prescribed as a panacea for recession. In today's global economy, it isn't effective in the best of circumstances and is outright wrong for what ails the West now.

Trade and foreign direct investment total half of global gross domestic product. Multinational corporations drive both. They shop around the world for the lowest-cost production centers and ship goods to wherever the demand is. Demand and supply are dislocated. So when a government introduces stimulus, the initial increase in demand doesn't necessarily boost local supply. More importantly, if multinationals decide to invest somewhere else, there wouldn't be an increase in jobs to sustain the growth in demand beyond the stimulus.

Just as water flows down, stimulus affects low-cost economies more, wherever it is initiated. As the West pours money into the global economy through large fiscal deficits or central banks expanding balance sheets, the emerging economies are drowning in excess liquidity. Everything is turning red-hot.

Ideal Scenario

How will this all end? Ideally, before inflation takes hold in the U.S. and Europe, the costs in emerging economies will rise high enough for multinationals to invest and hire in the West again. I wouldn't count on that. The average wage in the developed economies is 10 times that in emerging markets. There are five people in the latter for one in the former.

A more likely scenario is that the West will have to stop stimulus programs when inflation spreads to it from the emerging economies. The most immediate channel is through rising commodity prices. It's a tax on the West to benefit emerging economies that produce raw materials. That's the irony: The stimulus in the West can immediately bring harm to itself. It's also the magic of globalization.

The prices of imported consumer goods will rise with increasing labor costs in emerging economies. China's nominal GDP is growing at about 20 percent per year. The odds are that its labor costs will surge as its worker shortage bites.

Wage Blowout

Lastly, labor in the West will demand wage increases to compensate for current and future inflation. One may argue that high unemployment rates will keep wages in check. Think again. In the 1970s, the U.S. suffered a wage-price surge even with high unemployment because workers saw through the Fed's "growth first and inflation be damned" intention.

In 2012, the Fed will run out of excuses not to raise interest rates. As the excess liquidity in the global economy will be gigantic by then, the tightening will probably trigger a global crisis as asset bubbles burst.

What really ails the West is declining competitiveness. Globalization is pitting the Wangs in China or Gandhis in India against the Smiths in the U.S. or Gonzalezes in Spain.

Multinationals such as General Electric Co. or Siemens AG decide on whom to hire. The Wangs and the Gandhis offer productivity but have little money. So they are willing to accept low wages to accumulate wealth. The Smiths and the Gonzalezes have wealth and won't accept Third World wages. When their governments give them money to spend, their demand just makes the Wangs and the Gandhis richer and themselves poorer with rising national debt.

The West must wait for the Wangs and the Gandhis to become rich enough so that they demand Western wages and spend like the Smiths and Gonzalezes.

It is a long and painful process for the West. And there is no way around it.

(Andy Xie is an independent economist based in Shanghai and was formerly Morgan Stanley's chief economist for the Asia- Pacific region. The opinions expressed are his own.)

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