Importing Inflation

By The Mogambo Guru

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China's decision to de-peg the yuan and allow for a maximum movement of 0.3% per day may not seem like a very big deal, but as the Mogambo Guru points out, these little bits of movement could add up to big trouble for the U.S. economy…

The big, big, big, BIG, BIGBIGBIG news is, of course, is that China has lowered the peg of the Chinese yuan to the dollar by 2.1%. As David Tribble commented, "From this point forward, the United States Federal Reserve no longer matters. The balance of power has shifted from the West to the East."

He is right, as the new currency regime is a "managed float" of currencies, and the people managing the float are the Chinese, so they run things from now on. It's a scary new world, and I am sure that you are, like I am, in the throes of hysterical paroxysms of fear, characterized by infantile screaming, crying, begging, moaning, and random bursts of gunfire at unseen enemies lurking in menacing, murky shadows.

At the same time, Malaysia also announced it would no longer tie their currency, the Ringgit, to our dollar, either. Apparently this Malaysian currency untying does not surprise Chuck Butler, president of EverBank, and who is a guy that they say knows what in the hell he is talking about when it comes to this kind of currency stuff. Putting all this wisdom and education to work, he noted that the Chinese de-pegging would "lead to other currencies in the region to allow their currencies to gain vs. the dollar."

Floating the Yuan: Two Bits Here, Two Bits There

Aside from the problems of one more large group ganging up on us Americans, there is no more permanent peg at all, although the government will allow a maximum movement of 0.3% per day. 0.3? Like you, at first I said, "A third of a lousy percent? That doesn't sound like much!" But it is! This percentage move is every (pause) freaking (pause) DAY! It is like the little boy who killed his mother and father for twenty-five cents and explained, "You know how it is, judge; two bits here, two bits there, it adds up!" It adds up!

My horror lies in the fact that after a few months of this "two bits here and two bits there," and the dollar could be down by fifty percent! There is a lot of work done through the last few years that suggests that the Chinese yuan is overvalued by around 40%, so overshooting that overvaluation is not inconceivable to me.

If you notice that you are suddenly bathed in a cold chill, then you have passed a milestone in your quest for Total Mogambo Enlightenment (TME), as you understand that a giant disturbance has occurred in the cosmic continuum, and things are not going to be good.

Or perhaps you heard a bell, as Peter Schiff of Euro Pacific Capital suggests when he said, "The old saying ‘no one rings a bell,’ certainly doesn’t apply today, as China rang the ‘mother of all bells.’ So deafening was its sound, that its vibrations will be felt around the world. Nowhere will the amplitude of these waves be more pronounced than in the United States."

Immediately (and this is the part that ought to make your trigger finger twitch involuntarily and your heart slam-dance against your ribcage), oil, precious, precious oil, which is priced in dollars, becomes instantly 2.1% cheaper for the Chinese! The price to us is (big sigh of relief!) unchanged. So far. Note the caveat "so far," which is very meaningful to those of you with sharp eyes.

But the oil exporters have to be looking at this, too, and figuring that getting paid in dollars is really, really, really stupid if they are going to turn around and buy something from the Chinese. If they do intend to buy some Chinese products (and who doesn’t?), then petroleum exporters just lost 2.1% of their buying power! In one day! Remember, these oil production companies are in the business of making profits, currently denominated in dollars, by pumping and selling oil. Then, in the natural course of events (and this is the best part!), they will take some of their new dollars and spend them on a few necessities and some other really neat stuff. But when the wife gets to the store, she finds that the prices of everything are 2.1% higher! And getting higher by 0.3% per freaking day!

Floating the Yuan: The Alternatives Aren’t Promising

But this is not about my life in hell, but rather about that, as Americans, it will just get worse and worse and worse, as Chinese imports will immediately cost 2.1% dollars more, because the dollar is worth 2.1% in buying power, UNLESS (and this is the crucial part) somebody along the way agrees to make less profit, which is bad for the company, or otherwise cuts expenses. Both of these ideas will work, but crap for somebody else, because all of those lost profits or cuts in expenses were somebody else’s income (shareholders or suppliers), and now THEY are suffering a loss of income! There is nothing good about price inflation. Nothing. It is always bad news. Always.

So why have we allowed this? Occam’s Razor mandates that we find the simplest answer. Thus I loudly declare that we, as a nation, are really, really stupid. A lot like me, personally, but without the crippling emotional problems. But perhaps there is something more to this whole thing, something in the line of, ummm, destiny, as Bill Bonner of The Daily Reckoning perhaps suggests when he observes, "An empire has to figure out a way to exhaust or destroy itself in order to make room for the next empire." And that is exactly what we have done. We have destroyed ourselves so that the Chinese empire can assume dominance, continuing the universal cosmic dance of birth, death and renewal.

Out of the corner of my eye I can see Peter Schiff is bored with listening to this metaphysical philosophy, and me and is furtively looking around for a discreet way out. I figure "I’ll teach him!" I spin around, point my finger at him, and say, "So, Mr. Schiff, what are your final conclusions?" Without missing a beat, the guy jumps up, snatches the microphone out of my hand, and, ignoring the audience cheering him on and urging him to use it to beat the hell out of me, says, "In conclusion, July 21, 2005 will be another date likely to live in infamy. This time the aggressor is China not Japan, and the bombs are purely economic. Though there will be no immediate loss of life, and no American retaliation, the financial damages will be devastating. History will remember this date as the beginning of Chinese independence, and the beginning of the end of America's ability to depend on the Chinese."

So I confidently predict, without fear of contradiction that the yuan will continue to gain strength over the long run. It will be, of course, in fits and starts so that the Chinese can "manage" the currency markets so that the local boys will profit from the ups and downs of the currencies, and Wall Street, the Federal Reserve and government will "manage" the stock and bond markets in the United States so that this whole stock/bond/housing idiocy will not implode, and at the same time allow American local boys to make profits from the manipulation. The whole cost will be shifted onto the average American citizens, paid for by suffering a huge, huge, decline in their standard of living, and the wrenching societal dislocations that will result, as the coming years and decades roll by.

And this will be peachy with China, as their strong currency makes imports cheap! Thus, they can import a lot of raw materials to the emerging Chinese consumer, whose average wage is increasing at ten percent a year, and who is a-hungering for the Promised Land of up-scale goods and downright luxuries.

So, and this is the important part for those of you who are whining, "When the hell is he going to get to the damned point?" with a strengthening currency they will import deflation into China, which will offset a lot of the monetary inflation. The downside is for everybody else to gag on, because when the Chinese import deflation, they simultaneously export inflation. So what will we be mainly importing from China? Inflation! Hahahaha!

Regards,

The Mogambo Guru
for The Daily Reckoning

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The Mogambo Sez: Addison Wiggin of the Daily Reckoning has some advice gleaned from technical analysis that is better than anything I could come up with. He writes, "Since the beginning of the Dollar Standard era, every time an ounce of gold could buy less than 10 barrels of oil, an investor would do well to buy gold. Today, an ounce of gold buys only seven barrels of oil. The message from the markets it clear: Buy gold."

And this devaluation of the dollar makes that analysis even more clear and compelling.