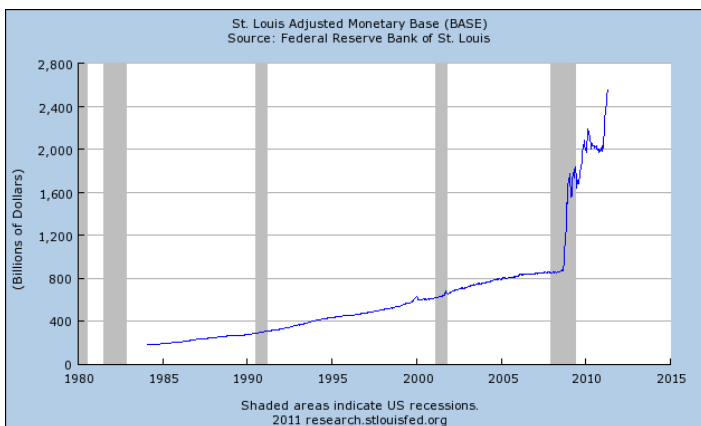


Feeling at little QEasy? May 2011

2011 has so far witnessed an increasing number of headlines regarding the attempts by the Chinese authorities to curb the price levels of many consumer items. Indeed, the annual "Blue Book of China's Society", compiled by the Chinese Academy of Social Sciences, recently indicated that inflation is the top concern among Chinese citizens. The Financial Times reported in early May 2011 that the Chinese Government is set to fine Dutch consumer products company Unilever AUD300,000 for "suggesting it might raise detergent and soap prices"; and, that Unilever had "acted to intensify inflationary expectations among consumers and seriously distort market order"¹. The actions of the Chinese follow a well trodden path that traces back to the ancient Roman Emperor Diocletian, Revolutionary France of the late 1700s, George Washington's America, Weimar's Germany and Stalin's Russia, to name but a few such episodes.

These types of occurrences are more often than not linked to wars funded through the printing press rather than taxation. America's misadventures in Iraq and Afghanistan in the past decade and then nationalisation of much of its banking sector in 2008/2009, have led its central bank down the path of debt monetisation. This has been expressed as "quantitative easing" in central banker parlance. The chart below shows the dramatic expansion of the monetary base engineered by the US Federal Reserve since 2008 and represents the very definition of inflation, according to the Austrian school².



Source: www.mises.org

By adhering to a policy of fixing exchange rates to the US dollar, the Chinese Central Bank (PBOC) has also adopted the monetary stance of the US Federal Reserve, inclusive of all the consequences of this stance. As night

follows day, inflation is now beginning to make its way through the system, expressed through both asset inflation and the price of final goods and services. Using real estate as a measure, the value of Chinese real estate is set to exceed 350% of China's GDP in 2011. This level was last seen in Japan in the late 1980s and roughly the same level as in Ireland prior to its dramatic real estate collapse in 2008³. Meanwhile, consumer price inflation is heading through 5%, in spite of the authorities taking the drastic step earlier this year of lowering the weighting of food items in its CPI calculations. Policies to control inflation through direct attacks on the workings of the free market have historically ended badly, often exaggerating the effects they were originally designed to circumvent. By suggesting Unilever's actions to increase the price of items, such as shampoo and washing detergent, somehow distorts the market, indicates that the Chinese authorities have a rather 'distorted' view of how markets work.

Early America's experience with paper money ended in disaster in July 1775, when Congress issued USD2 million in bills of credit, known as "Continental", to fund its war with the British. With a fixed supply of commodities and what was then a very simple economic structure, commodity prices rose by 480% over the ensuing two and a half years. In other words, the newly issued Continentals declined in value by 99.8%. In the midst of this rampant inflation, the General Assembly of Connecticut felt compelled to pass a series of regulations providing maximum prices for many basic goods; and, in 1777 the legislature of Pennsylvania attempted to limit prices for those commodities most needed by the army in an attempt to reduce war expenditures. Rather than improve the lot of Washington's army, most farmers ended up holding back supply of critical commodities knowing they were receiving below fair market prices. In an almost treasonous act, some farmers with large families to support sold their produce to the British who were prepared to pay in gold.

Following the near starvation of Washington's army in the winter of 1777/1778, the Continental Congress passed the following resolution in June 1778:

"Whereas... it hath been found by experience that limitations upon the prices of commodities are not only ineffectual for the purposes proposed, but likewise productive of very evil consequences to the great detriment of the public service and grievous oppression of individuals... resolved, that it be recommended to the several states to repeal or suspend all laws or resolutions within the said states

¹ Financial Times, May 7th 2011, p1.

² Economic Freedom and Interventionism: An Anthology of Articles and Essays by Ludwig von Mises (Irvington-on-Hudson, New York: The Foundation for Economic Education, 1990), Chapter 20: Inflation: An Unworkable Fiscal Policy.

³ Chancellor, Edward. "Entranced by China's bubbling economy", Financial Times: February 6th 2011, Last Word.

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respectively limiting, regulating or restraining the Price of any Article, Manufacture or Commodity"⁴.

The Law of the Maximum was passed in revolutionary France in 1793 in an attempt to head off the rampant inflation that resulted from the ill conceived policies of its Government. As Andrew Dixon White chronicles in "Fiat Money Inflation in France"⁵, the revolutionary government of the new French Republic tried almost every experiment in wage and price controls which had been attempted before or since. White notes that the seduction of issuing paper money in times of hardship when all other avenues seem lost or involve too many difficult choices:

"It was urged, then, that the issue of four hundred millions of paper... would give the treasury something to pay out immediately, and relieve the national necessities; that, having been put into circulation, this paper money would stimulate business; that it would give to all capitalists, large or small, the means for buying from the nation the ecclesiastical real estate, and that from the proceeds of this real estate the nation would pay its debts and also obtain new funds for new necessities:

never was theory more seductive both to financiers and statesmen."⁶

The first law of the Maximum provided that the price of grain and flour in each district of France should remain at the level of January to May 1793. In addition to this, farmers were required to accept payment at the face value of badly depreciated *assignats* (the paper currency of the day). A second plan in September 1793 called for a uniform price for a long list of goods to be set for the entire country, with allowances made for the cost of transportation. Quickly discarded, another new plan was adopted later the same month, which partially acknowledged market forces by setting uniform prices for all goods at the local rates of 1790 plus one third. By the following month, this plan too had failed and was replaced by a plan to base prices on those of 1790 plus one third plus a rate per league for transportation plus 5% for the wholesaler and 10% for the retailer. Local governments were also given authority to compel local farmers to bring product to market.

A large black market grew across the country, with items such as butter, eggs and meat sold door to door, mainly to the rich, at prices reflecting their true monetary worth. Much like the experience in Washington's America, price controls produced effects opposite to those originally envisaged.

It remains to be seen what lengths the Chinese government will go to in its attempts to circumvent market forces in 2011. However, a cursory walk through the history of these policies reveals their ineffectiveness in dealing with the underlying problem. With its roots as an authoritarian central planner, the modern Chinese Communist Party's urge to control is clearly not easily forsaken.

4 Journal of the Continental Congress (NY, 1908) Vol. 21 p 569.

5 White, Andrew Dixon. "Fiat Money Inflation in France", 1912.

6 Ibid p. 5