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US Economic and Investment Perspectives

China Has Altered Global Pricing Patterns

China's entry into the global business cycle has greatly altered pricing patterns. Since the start of the current business cycle in November 2001, commodity prices have risen at a record pace, while product prices at the producer and consumer levels have never grown more slowly. The main reason for this sharp divergence is China, where raw materials account for the vast majority of imports and finished goods make up the lion's share of exports.

Given China's significant impact on commodity and product prices, it follows that a higher general product price inflation trend in the US will either require more inflation in countries like China (which supply America with a lot of goods) or a further decline in the value of the dollar. Import prices are indeed beginning to rise, according to the Bureau of Labor Statistics, and this has allowed US firms to raise product prices as well. This—along with gains in productivity—has helped them to offset commodity price increases. But margin pressure remains a key risk in 2005.

Price Patterns

Ordinarily, strong global growth lifts demand for materials and prices and, over time, the higher cost works its way up the supply chain, leading to higher product prices at the producer and retail level. However, the current price divergence is at odds with this historical pattern.

Since the start of the business cycle, commodity prices have risen 70%. This is roughly double the next largest increase, which occurred in the late 1970s, and dwarfs the advances witnessed in the business cycles of the 1980s and 1990s (**Display 1**).

Admittedly, commodity prices in the current cycle have reflected a very large increase in energy prices, with crude oil prices racing to a record high of $55 a barrel. Prices for petroleum products overall have increased almost 200% since the end of 2001. Industrial-materials prices have also risen exceptionally, increasing 80% since the start of the recovery. Moreover, prices for steel, iron ore, copper and aluminum have continued to rise in the early months of 2005.

At the same time, product prices are rising at the slowest rate in 30 years. Finished-goods prices at the producer level, excluding food and energy, have increased only 3.5% since the start of the current business cycle, compared to an average increase of 10% in the three previous cycles since 1975. The trend in core consumer-goods prices is even weaker. Cumulatively, they have actually declined 3.5% since the end of 2001 (**Display 2**). This is the first time in the postwar era that core consumer-goods prices have fallen during the initial three years of a new business cycle. In fact, in the three prior cycles, they rose about 12% on average during the first three years of expansion.

Productivity and Globalization

The role of productivity, particularly in manufacturing, should not be overlooked in analyzing the unusual gap between the prices of commodities and finished goods. The cumulative gain in productivity in the current cycle is about twice the annual average of the past three cycles. This has helped firms absorb some of the surge in commodity prices, thereby avoiding the large margin contraction of past cycles.

Impressive productivity gains would normally suggest a slower rise in goods prices but certainly not the decline witnessed at the consumer level since the start of the year. Something absent in prior cycles is clearly influencing prices.

That factor appears to be foreign producers, particularly those in China, and the increasingly important role they have assumed in the global economy. As we noted in our February 4 commentary, the increased presence of foreign producers in the global marketplace has resulted in US firms losing their role as primary price setters. Accordingly, US product-price inflation is increasingly linked to product-price inflation elsewhere. Put another way, the factors that have traditionally determined US product-price inflation—domestic manufacturing activity, domestic capacity utilization and commodity prices—have lost their importance as predictors.

Much of this is the result of China's emergence as a major importer and exporter. China is unlike any other country in the world. Not only is it growing fast—GDP was up 9.4% last year and is expected to grow 8% to 9% this year, more than double the global average—but it also imports huge amounts of raw materials to support an ever-growing production pipeline. According to official Chinese statistics, raw materials account for roughly 75% of overall imports, while finished goods account for roughly 70% of total exports. As **Displays 3** illustrates, China's raw-material imports have tripled since 2001, while exports of finished consumer goods have increased almost three-and-a-half-fold.

Current price patterns are unlikely to change any time soon, especially as there is little product-price inflation in most countries that supply the US with finished goods. This could change when China removes its currency peg with the dollar—as we expect it to do in the second half of 2005. This will likely lead to more import and product price inflation in the US.

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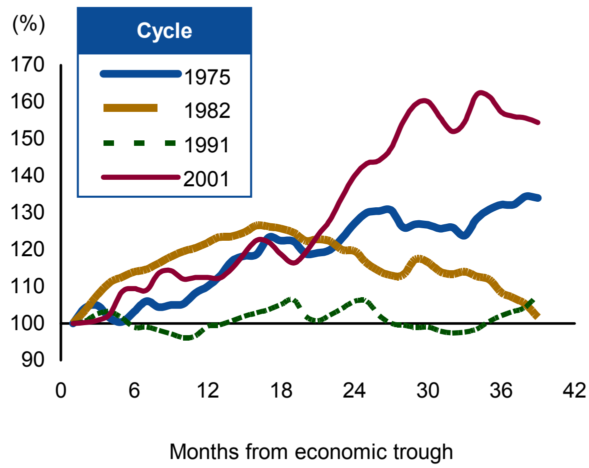
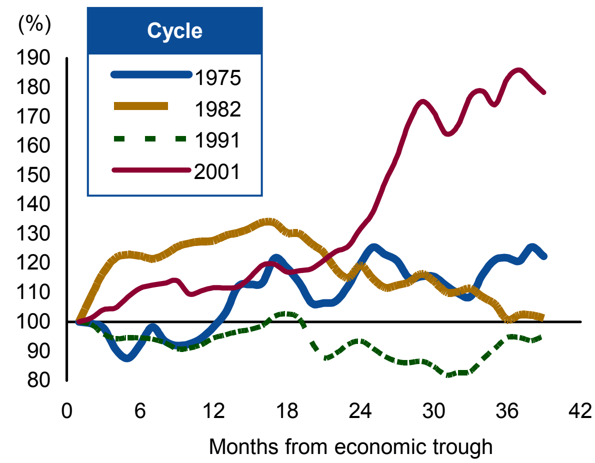
Display 1: Global Commodity Price Cycle Is Strongest on Record
Cumulative Percent Changes in Commodity Prices During Business Cycles

Journal of Commerce Industrial Price Index*



Journal of Commerce Price Index: Metals

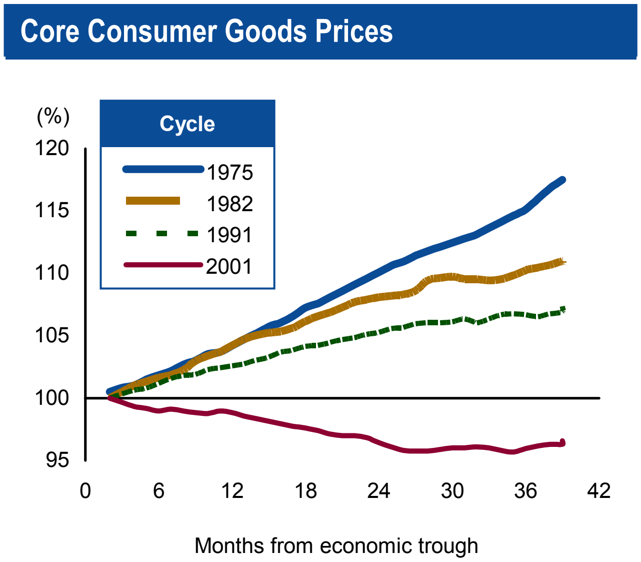


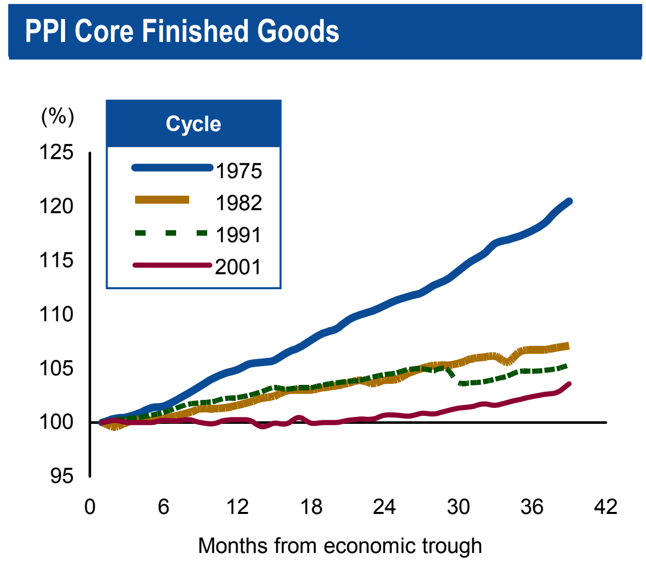
**The Journal of Commerce industrial price index includes prices of textiles, metals, petroleum products and miscellaneous products such as hides and flooring.*
Source: Economic Cycle Research Institute, Haver Analytics and Alliance Capital Fixed Income, March 4, 2005

Thanks to exceptionally strong price gains in petroleum products and industrial metals, the cumulative increase in global commodity prices is the largest on record and twice as large as that of the 1975 cycle—the next largest increase on record.

Display 2: US Product Price Cycle Is Weakest on Recod

Cumulative Percent Changes in Product Prices During Business Cycles





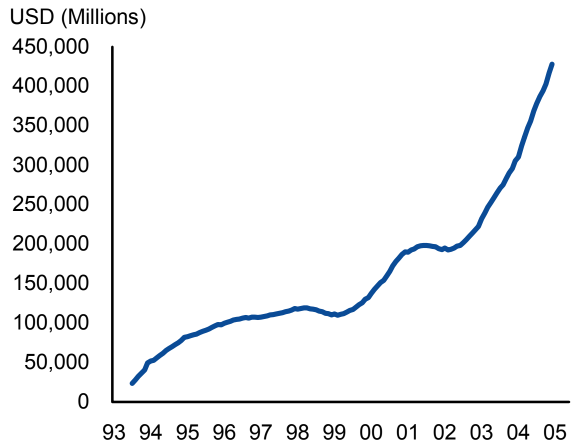
Source: Bureau of Labor Statistics, Haver Analytics and Alliance Capital Fixed Income, March 4, 2005

Since the start of the business cycle, the cumulative change in the price of US core consumer goods has been -3.5%, while prices for core finished producer goods have increased just 3.5%, making the current product price cycle the weakest on record. The relative weakness in product prices is linked to China's entry into the global business cycle.

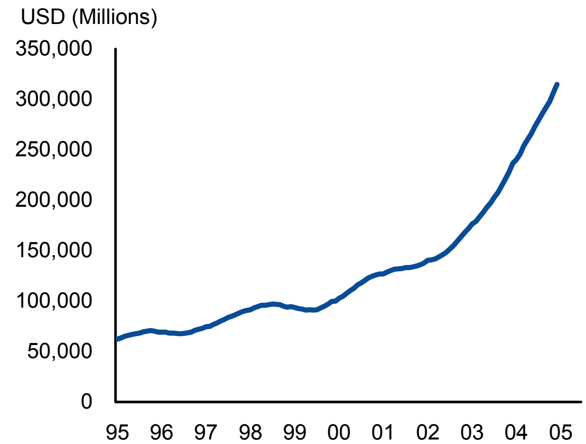
Display 3: China Imports Massive Amounts of Raw Materials But Exports Mainly Finished Goods

China: Imports and Exports (12-month moving average)

Raw-Material Imports



Exports of Finished Consumer Goods



Source: China General Administration of Customs Statistics, CEIC data and Alliance Capital Fixed Income, March 4, 2005

China's economy is unique. Not only is it growing more than twice as fast as the global average, but it imports mostly raw materials while exporting mostly finished goods.