A Crisis with Chinese Characteristics

There is no doubt that the advanced industrialized countries are deep in an economic downturn. Given that consensus expectations continue to overshoot the actual data, it appears that many still do not fully appreciate the magnitude. The fact that policy makers continue to cut growth forecasts implies they too have not appreciated the depth of the downturn.

There is hope in many quarters that the Chinese economy, which after passing Germany last year is the world's third largest, will remain relatively insulated. This optimism is based on structural factors, such as where China is in the industrialization process, *the command features of its capitalist economy with Chinese characteristics,* and the vast resources it can bring to bear. Late last year, China announced a CNY4 trillion fiscal package and on January 11th Premier Wen Jiabao promised it would be increased.

The prolific historian Niall Ferguson captured this sense when he wrote in September 2008 that "By contrast [to the US] China's planned economy seems unlikely to be significantly affected by the slowdown because net exports are no longer the key driver of China's growth. The only true constraint on China's planned economy, as I have said, is environmental."

Optimism Shattered

This seems too Pollyannaish by half. The Chinese economy is slowing down considerably. While many economists question the accuracy of official data, even the government's estimate shows a distinct slowdown in Q4 08 to a 6.8% pace year-over-year, the slowest in seven years, after a 9% pace was recorded in Q3 08 and about a 10.3% pace in H1 08.

These figures might actually exaggerate economic activity. In order to triangulate Chinese growth, many economists also look at China's energy consumption. In November, the most recent data available, electricity generation in China was 15% below year ago levels. By comparison in Nov 07, it was 15% above the prior year's levels, which were 20% above those of 2005.

The press warns that Chinese power producers face a $10 bln loss for last year due to the collapsing demand for electricity. Roughly 80% of China's power production is driven by coal, and with electricity demand evaporating, the power producers are drowning in piles of coal for which they paid top dollar. Some estimates suggest that coal-fired power output fell by a fifth between July and November.

Not only does Q4 GDP actually appear weaker than the government's estimate, it seems likely that further weakness will be seen in the current quarter. Foreign demand is contracting and there is concern that domestic demand, which already is slowing, weakens further. Canada's National Post cited officials in the Guangdong province warning that 20% of its factories may close in the next three months costing China 2.7 million jobs on top of the more than 6.5 million jobs lost in 2008.

Bearish Widening

In the debt market, a distinction is made between a bearish steepening of the yield curve, which is when the long-end sells off more than the short-end, and a bullish steepening, which is when the short-end rallies more than the long-end. A parallel situation is taking place in terms of China's trade balance. Its trade surplus remains near record levels ($39 billion in December, down from the record of $40.1 billion in November). However, these figures are not being generated by strong exports, as was the case previously. Rather Chinese exports have fallen on a year-over-year basis for the past two months. Meanwhile imports are falling significantly faster; plummeting 21.3% year-over-year in December after a 17.9% drop in November.

The rise of intra-Asian trade was embraced by policy makers and pundits as an alternative to the heavy reliance on the US markets, and was the apparent basis for some degree of de-coupling. However, the increased reliance on intra-Asian trade seems to be amplifying the economic downturn.

Marc Chandler 212-493-8800
Win Thin 212 493-8361
Meg Browne 212-493-8744
Audrey Childe-Freeman 44 207 614 8791

Consider that the same day China released its GDP figures, Japan reported that their exports to China fell by more than a third in December, indicating that the once famous export machine has stalled. Moreover, later that day South Korea reported that its economy contracted by 5.6% in Q4 08, more than double what economists had predicted. Despite the won being the worst performing Asian currency in 2008, Q4 Korean exports of goods fell by an eighth from the previous quarter, which is the biggest decline since the late 1970s. Singapore's economy collapsed by nearly 17% at an annualized pace in Q4 08.

Manipulation

In his confirmation hearings, Timothy Geithner was unequivocal: President Obama believes China is manipulating its currency. This seemed precisely what many of the Senators wanted to hear. In its semiannual assessment, the US Treasury has not cited any country for currency manipulation since China in 1994. While Senator Graham said that while Geithner's judgment was "music to his ears", we should refrain from jumping to conclusions.

Talk, while tough, is cheap. And, although likely to be all but ignored by the media and pundit class, Geithner also was clear that the Obama Administration was reserving tactical flexibility: "The new economic team will forge an integrated strategy on how best to achieve currency realignment in the current environment."

Being cited as a currency manipulator is a rather toothless policy in many respects. Even though it has not been deployed for years, this charge has developed a bit of a stigma which is more perceptual than actual. The 1988 law simply requires that the US engages the accused party in official talks to redress the situation.

At the same time, China joining the WTO in 2001 would seem to limit the kind of retaliation the US can legally pursue. While some US companies might seek compensation if China is cited as currency manipulator, there will be a number of US corporations that can be counted on to lobby against such a claim, like Caterpillar, Cargill and Ford. Talking tough on China may provide another tactical advantage, possibly helping Obama win over much needed votes if he, as has been signaled, would like to have the pending free-trade agreements approved.

No Coalition of the Willing Here, Sir

The US may find very little international enthusiasm for labeling China a currency market manipulator. If doing so is an effort to boost exports, than lately it has worked very well. However, such a claim will ring hollow to many as the Chinese currency has appreciated markedly against most of the world's currencies ever since breaking the peg with the dollar in July of 2005. The South Korean won has declined by nearly 37.5% against the yuan, the Indonesian rupiah has fallen more than 26%, the Indian rupee by 25%, the Taiwanese dollar by more than 20%, and the Malaysian ringgit by 12%. This trend is not limited to the Asian neighborhood; the Brazilian real has fallen by 13.5% against the yuan, the Australian dollar by 27%, and the Mexican peso by almost 35%. In Europe the euro has declined by 9% against the yuan and the British pound by nearly 33%.

Moreover, the majority of the yuan's appreciation vis a vis these currencies has taken placed since the crisis began, arguably at the start of H2 07. Notably the yuan has gained about 15.5% against the dollar since it broke the peg and almost 10% since July 2007. This does not appear to be lost on these countries. Even if the US Congress insists on considering a narrow bilateral rate, citing China as a currency market manipulator risks raising international fears of US protectionism. With unemployment increasing, this is something that is perceived to be not far from the political surface.

The Japanese yen is the main exception. It has risen by about 5% against the yuan since July 2005 and a whopping 23% since July 2007. Japan may be sympathetic to the US desire for the yuan to appreciate, but the source of the yen's strength is obviously far beyond Chinese currency manipulation and widely recognized to be so.

What is China Going to Do

China has the wherewithal and will to do whatever it takes in order to prevent an even more dramatic economic downturn. Since September, the benchmark one-year lending rate has been cut 216 basis points to 5.31%, and additional cuts are expected as early as next month.

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There is plenty of scope for fiscal stimulus as well. China's budget deficit last year was about 180 billon yuan, which is less than 1% of GDP. Debt levels are also modest by international standards. It has already announced a 4 trillion yuan stimulus package, largely consisting of previously announced or intended programs. Additional spending programs and tax cuts are likely. The Ministry of Finance's Research Institute for Fiscal Science projects China's budget deficit to be 3% of GDP this year.

However, China continues to invest at an incredible pace. Fixed investment in urban areas rose 26.1% last year after a 25.8% gain in 2007. This is in contrast to the US, where investment was exceptionally poor during the recent expansion phase; with companies borrowings mainly going to share repurchase schemes.

China's problem appears just the opposite, investing too much and being terribly inefficient. It has reached the point of diminishing returns, with growth slowing to 9% in 2008, down from the 13% in 2007, despite an increase in plant and equipment. The excess investment lead to excess production which has resulted in a notoriously severe oversupply of manufactured goods.

Although it may be hard to discern from press reports and the rhetoric of many in Congress, in recent years the US Treasury has pursued a wider range of issues with China than the bilateral currency rate. Among other matters, the US has encouraged China, through a commitment to a stronger social safety net, including health care and unemployment compensation, to boost domestic consumption and to raise labor costs.

As Geithner was talking tough about currency manipulation, China was earmarking 850 billion yuan over the next three years to reform its health care system. Currently the Chinese government accounts for about 42% of the country's health care expenditures, which, when compared to figures of 49% in the US and 87% in the UK, puts China in the lowest quartile of countries according to the World Health Organization. The cost of the program is reported to be approximately equal to the country's total health care expenditures in 2005

Deal or No Deal?

There is a strong case to be made that far from manipulating its currency for narrow trade purposes; China has allowed the yuan to appreciate distinctly against most of its trading partners. US interests lie in an economically strong China. US and indeed the world's problems would be aggravated by upsetting the proverbial apple cart and risking recriminating trade war, beggar thy neighbor currency policies, and a sharper slowdown in the Chinese economy.

On balance, given the track record of the main players, despite Geithner's acknowledgement (just shy of a revelation given some of the rhetoric during the campaign) about the President's claim that China is manipulating its currency, the Obama Administration may very well conclude that in the current economic environment, it makes little sense to push the point aggressively and officially cite China. And Geithner will be able to point to the fiscal package and programs like the health care reform as desirable measures that China is implementing that, over time, will lead to a stronger yuan.

Lastly, many US policy makers share a conceit that they know where the yuan would move if it were to float, so sure it would rise that they have ceased to question that assumption. It is possible that if allowed to float, the yuan might actually sink, with hot money reverses and global companies finding it easier to repatriate profits and domestic savers diversifying overseas. As the crisis has underscored, policy action often has unintended consequences and the Obama Administration and Congress should be careful what they wish for.

Marc Chandler
Global Head of Currency Strategy