China Syndrome

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Max Wolff
Senior Economist
The Beryl Consulting Group LLC

Over the last 3 and 6 month periods, Chinese indexes have led a global rally. China has outdone emerging markets broadly and has left US indexes well behind. FXI has outperformed EEM and the S&P 500. This does not fit standard macroeconomic patterns, theory or intuition. Leveraged industrial exporters and credit providers do not walk through the blazing destructive fires of the present global economy without getting burned. For 20 years, China has accelerated into the most rapid and sweeping large country industrial revolution we have ever seen. The changes are real. We are seeing a transfer of industrial production from many locations. Transnational firms from the US, Euro zone and Asia have come for the infrastructure, wage rates, environmental policy, workers and market. They have also come for the bubble. It is very difficult to separate the bubble from the real economic revolution. Both are clearly present. For the last 4 months it has been the bubble that has been the dominant element in China perception and investment. The China centric emerging market bubble has led us up since February 2009.

For many years, the US and China have shared a transnational economy. Chinese lending and export are inextricably interwoven with US import and borrowing. China is now the world's second largest exporter and is responsible for 9% of world trade. China is the largest source of manufactured imports for the US and the EU. The World Bank *Global Economic Prospects* 2009 joins OECD and other global institutions in forecasting a 6% decline in world trade with particularly sharp declines in the US, EU and manufactured goods trades.

China will be seriously and structurally influenced alongside her major trading partners. China's growth rate fell to a reported 6.1% in 1Q2009, its slowest growth rate in 20 years. China's imports, exports and GDP growth have been falling for 6 months. April and March 2009 exports were down double digits. A 22.6% decline in April 2009 marks a larger fall than March 2009 17% decline. Chinese firms are growth plays with thin profit margins and huge export markets. These markets require huge import growth and intense free trade policy from importers. Export driven Chinese growth and lending were part of the same debt consumption system that has been imploding since Spring 2007. This is not discussed, it never is in bubbles. It is demonstrably true.

The IMF April 2009 Global Financial Stability Report details China as the world's largest exporter of capital in 2008 with 24.2%. The same report details the US as the world's largest importer of capital, 43.0%. According to US Census Bureau Foreign Trade Statistics for January and February of 2009, the US ran a cumulative trade deficit of approximately $35billion with China- our largest deficit trading partner. In January and February of 2008 The US ran a cumulative trade deficit of $39billion with China, also our largest deficit trading partner across the first two months of last year. During 2008-2009, our trade deficit with China declined by 10% for January and February. In March 2009, US imports from China declined by $1.4 billion from March 2008. The Ministry of Commerce for The People's Republic of China reports the US as the largest trade surplus partner for all months with reported data for 2008. US exports to China were $71.5billion in 2008 and US imports were $338billion. This produced a deficit of $266billion. We are on pace for a China trade deficit tens of billions less this year, on the order of $205-$225 billion. Markets are now betting that we will import much less and China will lead us back to growth through government stimulus, increased domestic consumer spending and lending?

If any nation could pull of a deft transition from export industrialization to domestic consumption, it would be China. Success will require years, good luck, lower profits and lower growth. To move from global production with transnational partners to domestic production is a sea change in an economy. This means changing what, where, how and at what wages you produce. For China, such a radical transition means much higher wages, different products, marketing and sales. The Chinese economy produces world and export commodities, with imported basic commodities, and compulsively invests to grow capacity. This will not return revenue growth for the next few years. Recent growth is dependent on huge trade surpluses and lending vast sums to sustain unsustainable, imbalanced exports. This will be increasingly difficult as political pressures mount in China and her export markets. Selling at home means different production methods, wage structures and lower profits. Even if this works, the equity bounce in China has come several years too early.

China's economic relations with the EU are similar to those with the US. In 2008, the EU exported approximately $104 billion in goods to China and imported $330 billion in goods from China. In 2008, the EU was China's largest trading partner. There is massive and rising concern in the Euro-zone about the size of the deficit and market access for European firms. The Euro area is deep into a serious recession. Likewise, South Korea, Japan, Russia and all of China's major trade partners are in deep structural recession. Approximately 45% of China's exports go to the US and EU. Exports to the US and EU comprise over 15% of Chinese 2008 GDP at official GDP and exchange rate. A third of Chinese GDP is derived from exports. All major trading partners are presently contracting. That is why we hear so much about their stimulus plan and domestic demand. We are expecting to see a 20 year growth bonanza based on one economic model seamlessly transition to a different national economic model in 6 months with no business cycle point below 6% annual growth. Like American home prices, Chinese growth is always positive.

None of this is to doubt the power and transformation of China. She has arrived as a global power and will continue to do so over decades to come. China has not triumphed over the business cycle. No one ever has and no one ever will. As her imports fall, her energy consumption and generation declines and her shipping tonnage falls, China is struggling. Middle Kingdom investments are a growth play in a global economy without growth. China has arrived and will suffer as the rest of the global economy suffers. Ironically, it is the weakness that shows that China has arrived. The recent meteoric rise of her shares and indexes is simply the latest in a long string of bubbles. As emerging markets and China have led up lately, it seems increasingly likely they will lead the way down.