

## China: An Intriguing Puzzle

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The omens for a sustained Chinese foreign trade performance were hardly propitious. In January, Japan's year-on-year exports and imports shrank by a stunning 35% and 22%, respectively. For South Korea, the value of both exports and imports plummeted by 32%. Chinese exports, which were losing momentum but which were only marginally negative in December (compared to December 2007), shrank by 17.5% in January. While this figure grabbed the headlines, the January import performance, at -43%, was the real shocker. The resulting monthly trade surplus was a near-record \$39 billion. At a minimum, this poses the question whether China is, or will imminently, play a vital locomotive role to help stabilize the global economy.

Admittedly, lower energy and commodity prices are lowering its import bill. However, the import weakness was much more broadly based, as reflected in Table 1. The Chinese import and export data, from non-energy and commodity-dominated trade partners, show not only a near-collapse in intra-regional trade with countries considered part of the East-Asian manufacturing complex, but also with Japan, and, to a lesser but still significant degree, with the U.S. and Germany. While it is premature to form a definitive judgment on the basis of a few months, the current situation of sustaining high net savings in China through a disproportionate fall in the country's imports from its major trading partners is disturbing.

**Table 1: Imploding Chinese Trade**

	China January YOY % Change January 2009	
	Imports from	Exports to
<b>South Korea</b>	-47	-29
<b>Hong Kong</b>	-58	-42
<b>Japan</b>	-44	-9
<b>Taiwan</b>	-42	-44
<b>United States</b>	-30	-10
<b>Germany</b>	-16	-11

Source: Bloomberg/Cutoms General Administration (China)

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A rather perverse aspect highlighted by the table is that with the exception of Taiwan, China's export performance is holding up better than its imports from all its major trading partners. It is tempting to ascribe this development variously to: a contraction in Chinese domestic demand at a higher rate than that of its partners; or to a temporary additional dislocation; or that China Inc. is behaving in a surreptitiously protectionist fashion. The fear arises that this will intensify global protectionist pressures, which are already surfacing in many developed countries in the guise of buying locally produced goods in a misguided attempt to protect "local jobs."

Apart from the contraction of global consumption and an all-out global race to reduce inventories, the financial crisis has an additional dimension that adds fuel to this alarming trend. Banks are so preoccupied with protecting capital and satisfying national regulators and domestic constituencies that finance to facilitate international trade flows has all but dried up. The outlook for economic growth is fundamentally leveraged to world trade growth, which typically advances at about twice the rate of the increase in global economic activity.

The outlook for the world economy – if trade does contract at an annual rate in excess of 10% – is, in this context, not one even an alarmist would want to contemplate.

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The paths that are taken by national authorities and central banks in the coming months will therefore be critical. The unfreezing of trade finance and substantial fiscal stimuli to place a safety net under consumption should not be tied, overtly or covertly, to domestic sourcing. As a *quid pro quo*, China needs to step up to the plate and make haste with its \$566 billion stimulus package to boost domestic spending (and, by extension, imports). It is inconceivable, in an inextricably intertwined world, that remedying the global financial system can be synonymous with steadily falling trade.

While this could be a first swallow that does not constitute the arrival of summer, the performance of the Chinese Shanghai Index since late October is, thus far, a remarkably good sign.

After falling by two-thirds in the year to October 2008, it has returned almost 30% since then while the MSCI EAFE Index (for developed international markets) and the MSCI Emerging Market Index are in negative territory. The Chinese market is, admittedly, somewhat insulated due to foreign investor restrictions, but nonetheless it is difficult to reconcile with the notion that China is in dire straits.

A lack of courage and vision by global leaders to defend global trade as they address the tattered financial system, and an insular China, will be detrimental for all markets, including China's. In a world where swallows are a rare sight, we will hang on to this one and hope for the imminent arrival of the flock. ■