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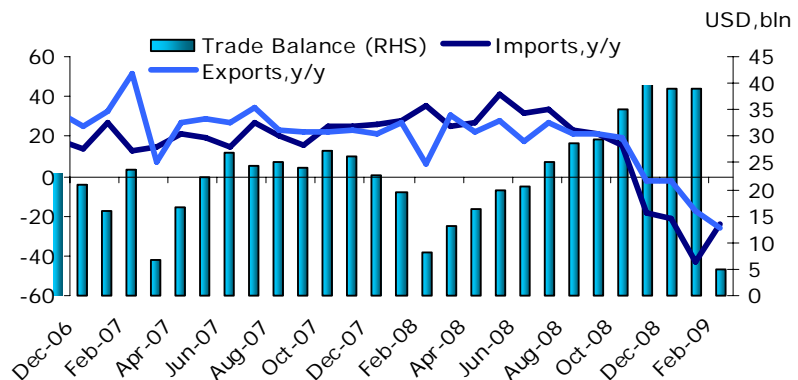
Yesterday's Chinese trade data were interesting on a number of fronts. First, they confirmed an environment of extremely weak foreign demand. Second, and relatedly, they underscored our *2009: Year of the Bootstrap* theme—that growth in Asia will have to come largely from domestic sources. Finally, they suggest something that we have not seen for some time: China may be selling down its reserves in order to keep USD-CNY stable.

This article takes a look at the last of these issues. With the sharp decline in the monthly trade surplus from \$40 billion to under \$5 billion, and assuming that the pace of unidentified or "hot money" outflows we saw in late 2008 has continued, the implication is that China currently has a balance of payments (cash) deficit. Therefore, in order to maintain a stable USD-CNY, the Chinese authorities must be selling down reserves to keep the Yuan from depreciating against the US dollar. This revealed preference for currency stability accords with repeated official announcements and casts doubt on the "currency manipulation" charge¹ often hurled at China. As such, we retain our call for a stable USD-CNY in 2009.

Trade surplus all but evaporates

Export data for February surprised on the downside. Shipments fell by a record 25.7% (y/y), down from January's 17.5% decline and well below the consensus forecast of -1%. This is fully consistent with the notion of deteriorating external demand as the advanced economies continue to weaken. Export growth declined sharply to both the United States (-23.9%) and the European Union (-30.2%) last month, China's two largest export markets.

China-Foreign Trade



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¹ The US and other governments have repeatedly accused China of artificially weakening the Yuan in order to gain an unfair competitive advantage for its exports.

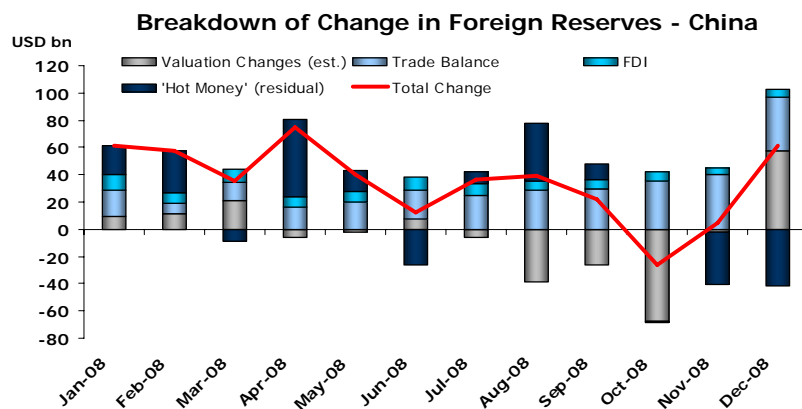
In contrast, import growth improved somewhat, but still remains very weak. Import growth fell by “only” 24.1% (y/y) in February, better than January’s 43.1% decline. Import prices are falling sharply, down by 11.1% (y/y) in January (February figures have not been released) suggesting that real import growth is declining at about one-half the pace of the nominal rate.

As a result, the trade surplus narrowed substantially in February. The monthly surplus had averaged \$40 billion in recent months and \$25 billion over the past year. Indeed, the February print is the lowest monthly trade surplus in two years. While there appears to be some element of seasonal weakness in the trade balance in the first quarter of every year, we need to see recent trade developments in light of the rest of the external accounts. Indeed, at the current juncture the much lower trade surplus implies some interesting balance of payments math.

Some Interesting Balance of Payments Math

A weaker trade surplus has clear implications for China’s balance of payments. As a quick review, China has been running a sizeable current account surplus in recent years, on the order of 10% of GDP. This, combined with the authorities’ preference for the Yuan to remain “basically stable” has led to a large and sustained accumulation of foreign reserves, which are now close to \$2 trillion. The main contributor to this high current account balance has been the high trade surplus. Thus, an abrupt change in the trade balance will have a significant effect on the current account and, by implication, the overall balance of payments and the rate of reserve accumulation. The capital account, including so-called “hot money” flows, also matters as we explain below.

In contrast to recent years, in the fourth quarter of 2008 China’s overall balance of payments was broadly balanced. This means that the change in reserves, net of estimated currency valuation effects,² was close to zero. In terms of the numbers in Q4 2008, the ongoing large trade surplus of \$40 billion was largely offset by a rise in unidentified or so-called “hot money” outflows to roughly the same amount. As far as currency policy is concerned, intervention in this environment with the objective of keeping the bilateral USD-CNY exchange rate stable would have been minimal.



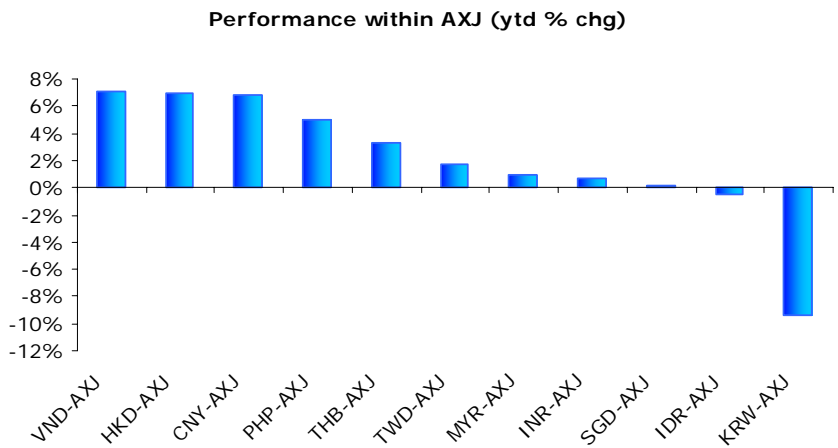
² The currency composition of Chinese reserves is not publicly available.

The latest trade data suggest that the overall balance of payments may now be in deficit. The lack of reserve data for 2009 to date (these are released quarterly and will not be published until April) clouds the picture. Nonetheless, if (i) hot money flows have not changed much in recent months and (ii) other key elements of the balance of payments (e.g., interest income and FDI flows) have remained broadly unchanged, then the overall balance of payments slipped into deficit in February.

If the balance of payments has slipped into deficit, then China must be selling down its reserves in order to keep USD-CNY stable. The math is simple: given the balance of payments deficit, the flow of foreign currency out of China must be larger than the flow into China. (These flows are overwhelmingly denominated in US dollars.) In the absence of official intervention, the currency would therefore weaken. However, the Yuan has been stable against the US dollar since mid-2008 implying that the Chinese authorities must now be selling down official reserves to prop up the currency. In our view this response speaks volumes about Chinese exchange rate policy.

Currency manipulation? Not...

An overall balance of payments deficit should be a “currency manipulator’s” dream. A deficit means that the currency will weaken naturally through market forces, with no intervention required. Exports will therefore rise and the export-dependent growth path can be restored. Since the Chinese authorities are, in the eyes of some, inveterate currency manipulators, then we should have seen the Yuan weaken along with the decline in the trade surplus in February, aided by capital outflows. The opportunity should have been too tempting to resist. So what happened?

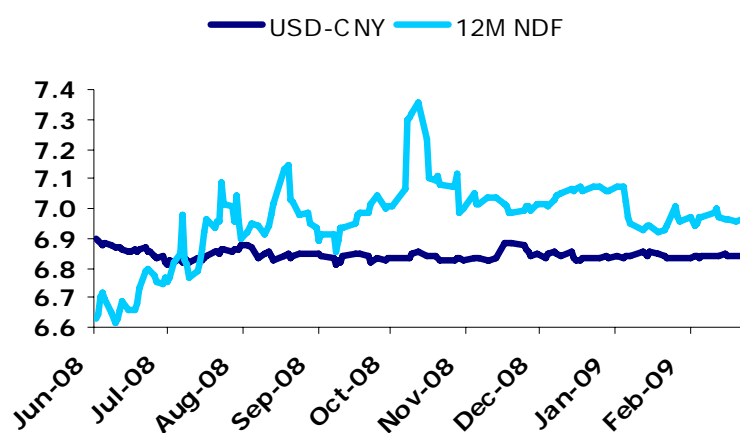


USD-CNY has continued to be held stable. The difference now is that, assuming the analysis above is correct, the authorities must be intervening the other way—that is, by selling down reserves. This is an example of what economists call “revealed preference.” We are not able to observe preferences directly, but through the currency policy actions of the authorities over different states of the world in recent quarters (i.e., shifts in the overall balance of payments), we can infer what their preferences are, and don’t need to speculate about the validity of commentary reported in the media.

The Yuan continues to out-perform within AXJ. As the chart below shows, the currency is among the strongest performers in the region, up 6.9% year-to-date within AXJ. Aside from the Hong Kong dollar (which is pegged to the US dollar), the Yuan was also the strongest performing currency in AXJ. The Yuan has also gained 8.3% against the euro so far this year.

Notwithstanding the above, the non-deliverable forward market still anticipates only a small depreciation. Despite the much worse than expected performance of Chinese exports in February, NDFs are still priced for a modest 1.9% devaluation in twelve months time. Our interpretation of this lack of response in the NDF market is that the Chinese authorities' asserted commitment to a stable currency remains credible.

NDFs still anticipate a small devaluation



Our Call for a Stable USD-CNY in 2009 Remains Unchanged

Recent developments underscore our call for a stable USD-CNY in 2009. Our reasoning is the following:

- Given the substantial uncertainties in the current environment, the Chinese authorities have a strong preference for USD-CNY stability, which they continue to demonstrate. Similar behaviour was seen in the Asian crisis 11 years ago.
- The case for a weaker CNY is not compelling. With the advanced economies in recession it is not clear how exports would respond to a weaker currency. In contrast, the political costs to the Chinese authorities if they allow the Yuan to weaken are likely to be substantial.
- China is not an export dependent economy. While the export-to-GDP ratio is large for a continental sized economy, the contribution to growth of net exports is modest, although it has risen in recent years. Investment remains the key driver of growth and it is here where the authorities have appropriately focussed their stimulus plan, which seems to be gaining traction.

- That being said, the export sector is relatively labour intensive, and job losses in some industries and provinces have been relatively large. However, we see these costs as manageable, as the recent budget makes boosting consumer spending a priority and provides support for low-income urban residents.
- Although growth has slowed markedly in China, in relative terms China offers some of the best fundamentals in the world. Indeed, one of the few equity markets not in the red this year belongs to China—the Shanghai composite is up 16% year-to-date.³
- The Chinese authorities are likely to be quite comfortable with the opportunity to trim their USD exposure. Quite recently, PBOC Governor Zhou called for raising the status of the IMF's SDR as a means of avoiding excess concentration of FX reserves in a single currency. Moreover, the timing for selling US Treasuries has never been better.

There are two sources of risk to our call. First, if the slowdown in China is longer than currently envisaged, then the authorities will keep USD-CNY stable for longer than we envision. USD-CNY will resume its downward path only once the recovery is secure and risk appetite begins to be rebuilt. Second, if hot money outflows pick up substantially, then in our view there is a case for the CNY to weaken as the authorities would be hard pressed to justify allowing agents to exit the Yuan at a favourable exchange rate.

³ The rally in Shanghai and Shenzhen equity markets, along with the movement in USD-HKD off of the floor of the USD-HKD trading band, may indicate that hot money outflows from the Mainland have ebbed in Q1.

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