



Daily Note: 10 December 2008

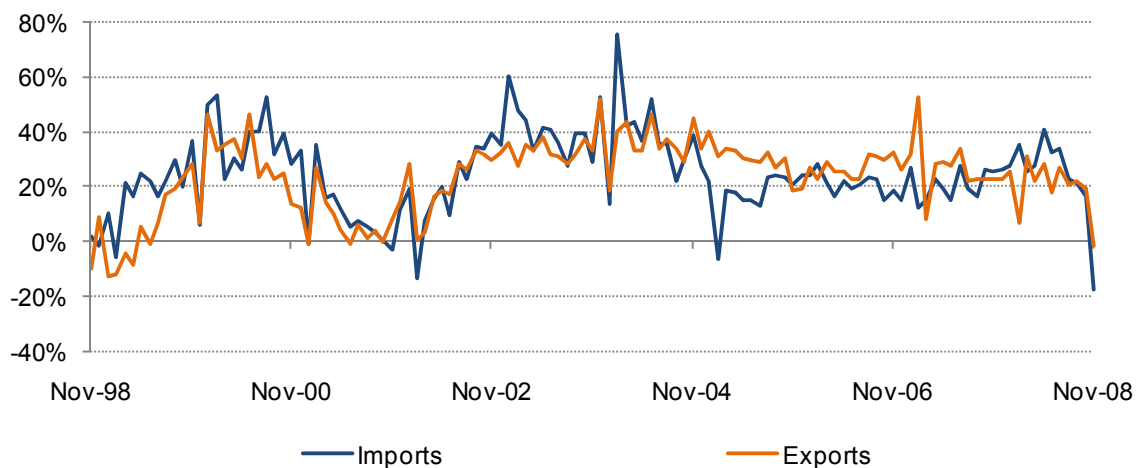
Chinese imports and exports slump: world trade threat

WE SUGGEST: Yuan to weaken further, possibly be devalued

SUMMARY: Chinese imports fell sharply in the year to November. Much was due to lower oil and other commodity prices, but demand is clearly weak. Worse, exports fell fast in yuan terms. This risks triggering further efforts to boost exports, notably through weakening the currency. It won't work – and the consequences for the world economy could be very serious.

Chinese imports fell by 17.7% in the year to November (all data seasonally adjusted by *LSR*). This is unusual. While Chinese imports have fallen before, this has usually been due to the timing of the Lunar New Year. In the past 10 years, the only three falls in imports occurred in the month of February in years when the New Year occurred in February but in the immediately previous year in January. Moreover, in neither case was the fall as large as the one last month. Part of the fall was clearly in oil imports, which fell by 1.8% by volume – but oil prices are also down by 10% (West Texas Intermediate, October 2007 – October 2008), so the total dollar value of oil imports would come down by 11.6% based on oil alone. Oil and oil-based products are slightly less than 15% of Chinese imports, so the combined effect of a lower oil price and a smaller import volume translates into approximately 1.7 percentage points of the total 17.7% fall in imports. Even factoring in other commodity price weakness, the large imports fall confirms other reports (eg, falling energy consumption in the year to October) of a substantial weakness in Chinese demand – although whether in domestic demand or mainly in inputs for future exports, is not yet clear.

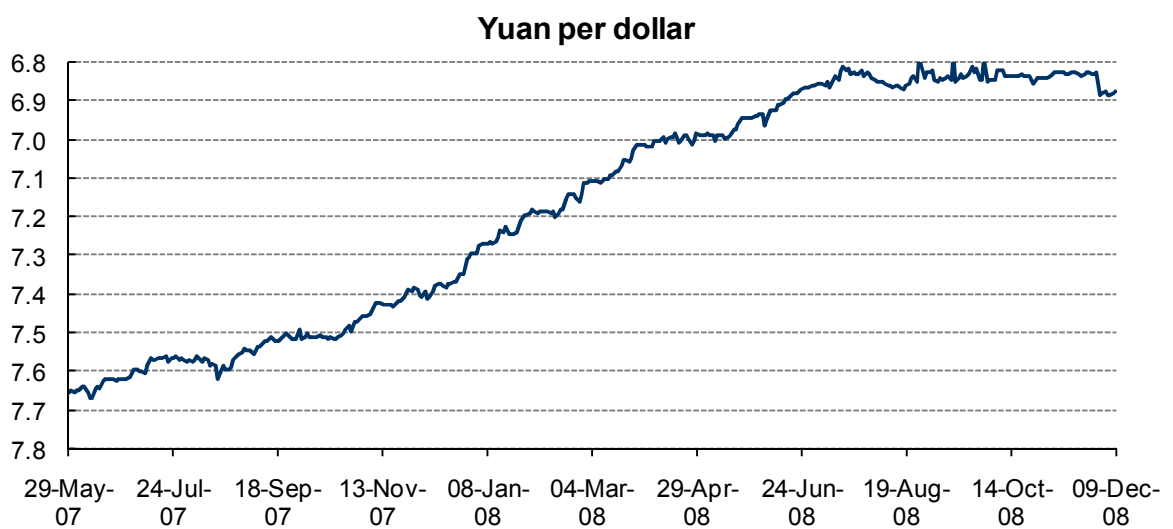
Chinese foreign trade, 12-month change, %



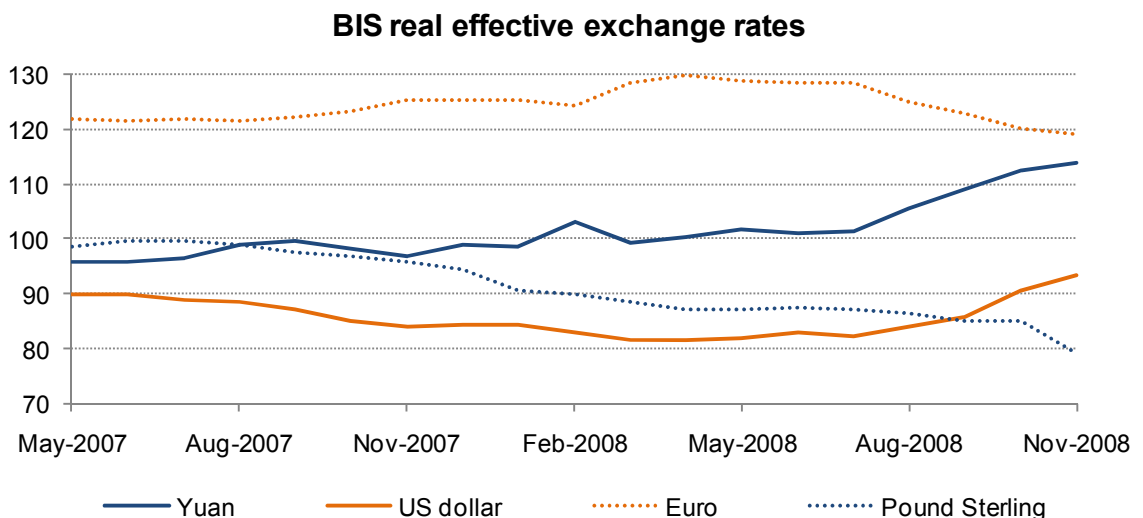
From a global policy perspective, however, it is not Chinese imports that are worrying, but Chinese exports – or, rather, the consequence thereof. Exports also fell, down 1.9% in the year to November. This was the first fall since a brief dip in the year to June 2001

and the largest since the middle of 1999. In yuan terms, exports were down much more, dropping by just under 10%. Weaker Chinese export growth should not be surprising, given that much of the world is in recession, notably the European Union (the target for about 35% of Chinese exports), the US (23%) and Japan (7%). But Chinese growth has for the last ten years (and certainly the last four) been based on exports. As recently as in the year to October, exports grew by 19% and the average over the past year is 20%. Going from a double-digit growth rate to a contraction is certain to set alarm bells ringing.

The instinctive reaction of the Chinese leadership is likely to be that further attempts need to be made to boost exports. There have been various methods introduced during 2008, such as increasing tax rebates for exporters in various sectors. But the key measure has been to stabilise and slightly depreciate (from 6.8 to 6.9) the yuan against the dollar from early July onwards.



The problem with that policy is that it came at a time when the dollar began to strengthen against other currencies, notably the euro and the pound sterling. Since the euro area and the UK together are a more important export market for China than the US, China was hit by a double whammy of a stronger currency and weakness in its main markets.



In recent days, the yuan has actually appreciated again, primarily because the authorities are trying to stop capital outflows. But today's data are likely to mean that the Chinese authorities will revert to a policy of depreciation – there has even been anecdotal mention of the word 'devaluation', ie, a larger, once-off fall.

The problem with such a policy is that it won't work. Chinese exports are not falling because they are too expensive – they are falling because the demand in the rest of the world isn't there. Making them cheaper is unlikely to have much short-term impact. Much more importantly, it will reignite American and European protectionist impulses (which need very little to get going). After all, the combination of rapidly falling imports and a smaller fall in exports means that the Chinese trade surplus widened from \$27.4bn in October to \$34.5bn in November, with the year-to-date surplus widening from \$244.6bn in 2007 to \$257.8bn in 2008. A trade war to stop a doomed Chinese attempt at exporting its way out of trouble could be extremely bad news for the world economy. It risks transforming what is still only a slowdown, if a severe one, into something much more nasty.

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