

DAILY GLOBAL
COMMENTARY

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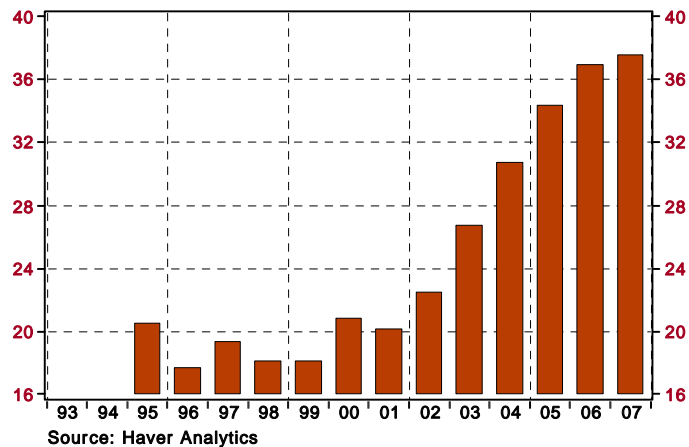
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Major Destinations of China's Exports

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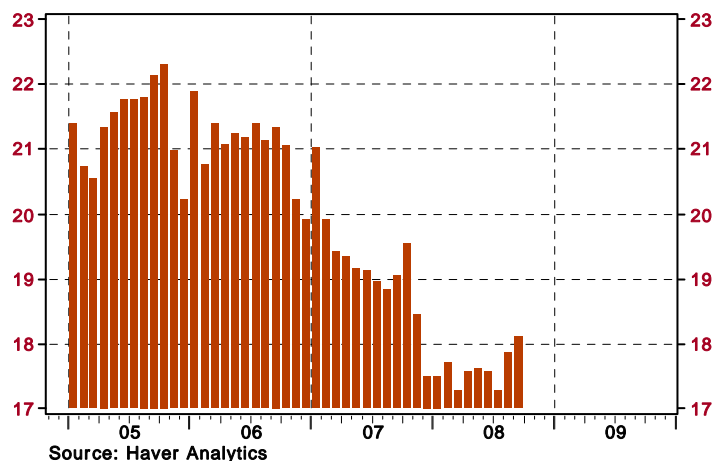
China announced a large fiscal stimulus package (see James Pressler's analysis below) to prevent a serious downturn in economic activity. The share of exports of goods in China's GDP has grown from 20% to 37.5% in a short span of six years (see chart 1). A likely global economic recession in the near term was an important reason for China to consider fiscal measures to keep the economic engine running.

Chart 1
China: Exports of Goods as a percent of GDP



Approximately 17.5% of total exports of China in the first nine months of 2008 went to the U.S., with the recent weakness in economic activity in the U.S. bringing down this share from 21% two years ago (see chart 2). Exports to Asia & the Middle East and the European Union made up about 47% and 24%, respectively, of total exports of China in 2007.

Chart 2
Exports of China to U.S. - Share of Total Exports



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China: Is Beijing's \$586 Billion "New Deal" Stimulus Plan Really "New" Or Even A "Deal"?


For a change, the latest news to rock global markets actually triggered a rally in Japan, Hong Kong and other regional markets. Yesterday, Beijing announced a 4 trillion yuan (\$586 billion, or about 16% of GDP) fiscal stimulus package to be implemented between now and end-2010 to shore up its ailing economy. Regional markets rose in hopes that renewed Chinese import consumption would keep exporters throughout Asia and the industrialized world busy, and commodity prices went higher in anticipation of a recovery in demand. This package has been coined by some as a "New Deal" for China. We decided to pick through the details and see how much of it is "new", how much is a good "deal", and to see if there could be any downsides that have so far been overlooked.

The actual economic activities cited by this package center around the further development of infrastructure – rail and highway connections, housing construction and earthquake recovery support – mostly in the western provinces. Considering how underdeveloped that part of the country is relative to wealthier eastern coastal regions, such investment seems a worthy cause and very much in line with the government's long-term plan to spread development to areas that have so far been left out. However, lost within the blurry figures is how much of this "new spending" is actually a repackaging of programs already queued up for implementation, with their costs now announced as "stimulus". Details are sketchy, but there seems to be a suspicious amount of overlap between previously announced projects and new, stimulative projects. In short, not all of this program is "new".

Other measures are indeed new and stimulative, in the form of VAT revisions and other tax cuts to promote further business spending, offering an estimated 123 billion yuan in savings. This package also lifts unofficial bank lending caps, but it is hard to say how effective this move will be. These informal upper limits on bank credit growth received only a nominal acknowledgement when growth was strong and thus did little to contain credit expansion. Therefore, as demand for loans decelerates, the lifting of such caps only offers room for growth that the market is not asking for.

There is, perhaps, a "deal" within this package, regardless of how much spending is actually "new". The market rallies throughout Asia were not based solely on hopes that those countries would benefit from China's extra economic activity. There is also a growing feeling that China will be able to avoid an economic hard landing and a prolonged period of weak growth. If this fiscal package shores up the waning confidence of foreign investors, it could keep investment flowing into the country and prevent growth from taking a precipitous dive – a nice way to maintain the virtuous cycle of investment, development and growth.

There is one lingering concern we have about today's announcement, however, and it is the same concern we have about any country's stimulus package – where is the money to pay for this? The national government has said it is paying for one-quarter of the bill, with an unspecified amount covered by local governments, and "social investments" covering the balance. The ambiguity of that last source is disconcerting, as it could be as much as 3 trillion yuan – a sum that would not go unnoticed by whatever sources have to pay it out. There is speculation that the "social investments" that will provide the cash may be US Treasuries, of which Beijing holds a substantial amount. If the government flat-out said that it would unload however-many-billion in



US Treasuries onto the market, those words would crush prices and punish the dollar, so some suggest that Beijing's verbal hedging is its way of maintaining market stability as it starts reducing its net Treasury holdings. This is not the consensus opinion right now, but until Beijing clarifies where it is summoning this extra funding, it remains an unsettling option.

We feel that in the near-term, the biggest impact this package will have is as a boost to confidence – both in the outlook for China and for its major trading partners. Given the vagaries of how much real spending was in yesterday's announcement, we are hesitant to significantly modify China's growth forecasts upward or downplay the many risks facing the country's struggling export economy and encumbered financial system. However, we do feel that the uncertainties regarding how China will pay this bill will haunt global markets. If Beijing simply issues 4 trillion in debt to cover its tab, then the long-term impact would be a manageable domestic issue. However, if it considers liquidating any of its many US-backed assets or no longer buying as much of our debt, this New Deal would be a bad deal for the US.

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