Cales Investments, Inc.

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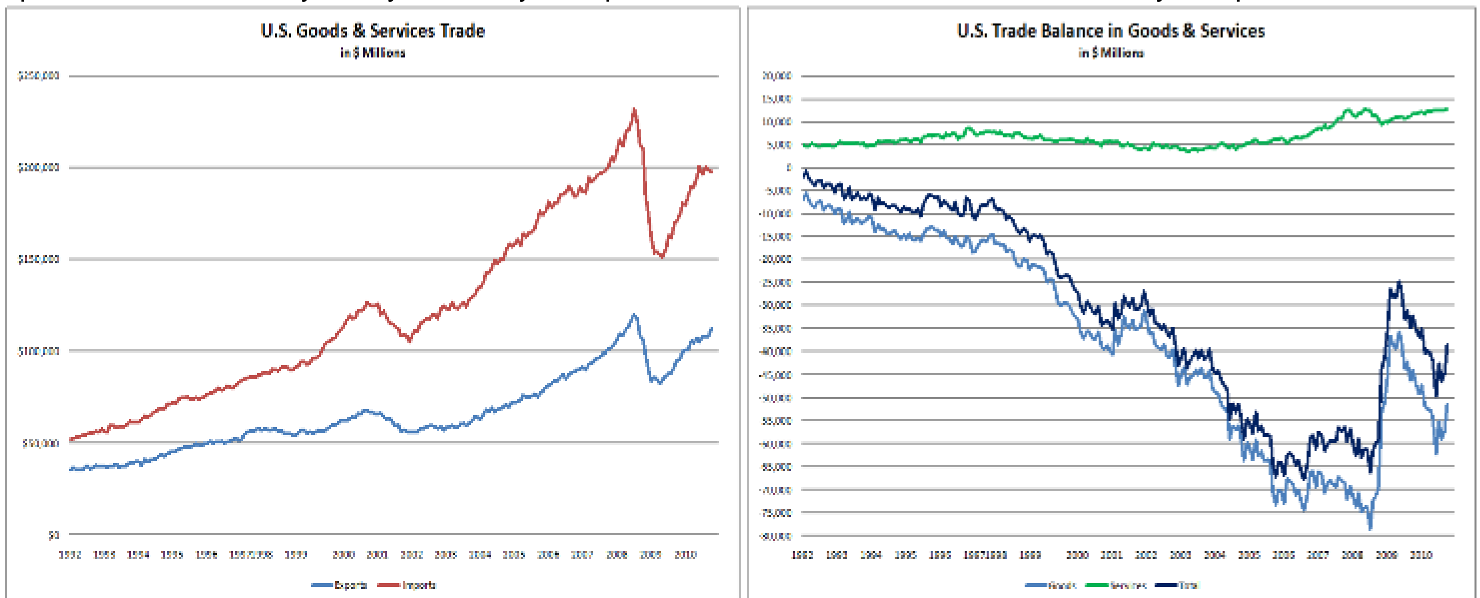
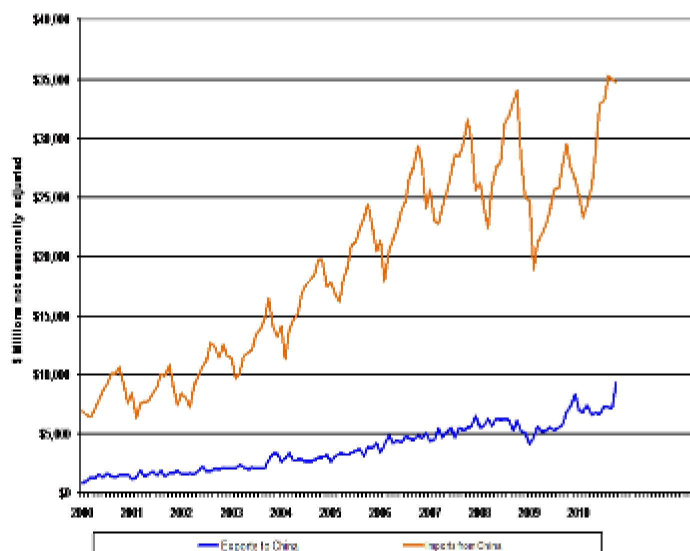
Chinese Currency Problem

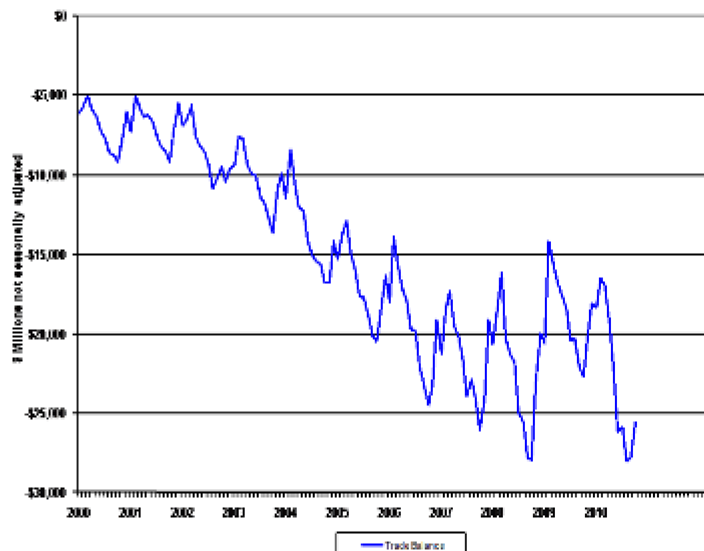
The trade deficit narrowed to $38.7 billion in October from a gap of $44.6 billion in the prior month. The 3.2% increase in exports of goods and services and a 0.5% decline in imports of goods and services brought about a narrowing of the trade gap. Overall, this reading is a big plus for real GDP growth to be expected in the fourth quarter. US exports rose to a new recovery high in October increasing by $4.9 billion over September. Imports declined by $0.9 billion. Trade in services was mostly unchanged, but nearly every category of goods showed improvement. The trade balance figures tend to jump around a bit, so it's dangerous to extrapolate anything from just one month's reading, but the balance appears to have broken away from its downward trend. Exports of goods increased by 4.2% for the month of October to $112.31 billion. Relative to a year ago, goods exports are up 17.9%. Now before you say "currency manipulation", let us first consider the trends of years past:



The first chart above shows us the monthly raw amounts of exports leaving the country and imports coming to our shores. The second chart shows us the difference between imports and exports by category. The trade balance for services is positive, meaning the US consistently exports more services (or collects more for these services) than we import. The goods part is the problematic aspect. Here things are out of whack and many people blame the Chinese and their "unfair currency manipulation" for it. However, other factors play a much bigger role. Imports of petroleum and petroleum products for example cost the U.S. about $350 billion per year or around $30 billion per month. In other words, 75% of our trade deficit is caused by oil imports, not by Chinese currency manipulators. While China's valuation of the yuan may unfairly provide a trade advantage to China, a lower yuan keeps consumer prices lower in the U.S. for goods that we import from China. Punishing companies that have production facilities in China (some of them are subsidiaries of U.S. companies by the way) through trade sanctions or by forcing China to revalue the yuan more aggressively than it has already done so far might not shift production to the U.S.; it might simply shift those manufacturing facilities to other low-cost nations. The other question we must ask ourselves is, what products do we manufacture in this country that would compete directly with Chinese manufactured goods? Whatever we import from China has moved over the last 50 years from the U.S. to Japan, then Korea and then finally China for a reason. Chinese imports are generally low tech and involve a lot of cheap manual labor. In 2009, China was our largest supplier of goods imports (other than petroleum) according to the Office of the United States Trade Representative. We imported $296.4 billion that year, which was 19% of overall U.S. imports. We imported electronics ($72.9 billion), machinery ($62.4 billion), toys and sporting goods ($23.2 billion), furniture ($16.0 billion) and footwear ($13.3 billion). All of these goods rely on

plants and equipment and established distribution channels. The whole infrastructure is costly to move around. Nobody in their right mind would scrap factories and relationships and move a shoe factory from China back to the US, not even if the Chinese currency had appreciated by 20% overnight. If they would move their production at all, they would probably move it to Vietnam. In 2009 China imported $69.8 billion from the U.S. and thus constituted our **third-largest export market** for that year. Agricultural products were the largest category, at $13.1 billion (soybeans constituted $9.3 billion of that). Virtually tied with soybeans were electrical machinery, at $9.5 billion, machinery ($8.4 billion), aircraft ($5.3 billion) and plastics ($4.4 billion). Revaluing the yuan isn't going to make China need more food or aircraft, though some other export categories may rise. Increased exports to China will likely result more from China's move to develop a consumer-demand-driven society over time, and less from currency exchange rates.





The time, where China is importing more and more consumer products (from the US and Europe) may have already arrived. The first chart above shows us the amount of imports coming from and the amount of exports going to China. You can see that the imports (yellow) have recently reached a new all-time high. Exports to China however have increased even more dramatically on a percentage basis. One month does not a trend make but the blue line sure looks like it wants to accelerate. The second chart shows us the difference between the two lines of the first chart (imports minus exports). October's acceleration in exports and the stalling out of imports improved the trade deficit. A stronger yuan may not, in fact, be in the best interest of U.S. consumers, nor might it actually help U.S. exporters. That hasn't stopped U.S. policymakers from demanding that China revalue its currency. The U.S did the same with Japan in the mid-1980s in the Plaza Accord, when, at that time, Japan was accused of having an unfair trade advantage because of the value of the yen. As David Rosenberg of Gluskin Sheff pointed out in a research note to clients last month, "Since 1985, dollar-yen has sunk nearly 70% and yet the U.S. has the same bilateral deficit with Japan today as it had then." Perhaps it really isn't the currency that creates the trade-deficit issue. We need to watch China for many reasons -- currency manipulation, however, is not one of them. The yuan peg to the dollar benefited China as long as the dollar weakened. Now that the dollar strengthens, Chinese exports may suffer. Their paper thin profit margins will compress further and pretty soon once profitable industries may no longer be able to justify their existence in that particular part of Asia. The lack of profitability may be subsidized for a while but eventually, loans need to be paid back and industries need to turn profits. So far, cheap credit and benevolent (reckless) central planners allowed for the dramatic expansion of the Chinese economy that emphasized expansion over profits. This is dangerous in an economy where 50% of all economic activity is based on construction and real estate. Headlines coming out of China will become more somber next year and Chinese growth assumptions look questionable to me. Stay away!.

Hermann Vohs

"It is better to keep your mouth closed and let people think you are a fool than to open it and remove all doubt."
-- Mark Twain

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