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CHINA, ITS CURRENCY & THE GLOBAL ECONOMY

Which move will it make to address pressing issues?

Provided by Frank DeMaio*

Right now, there are dozens of investment products devoted explicitly to investing in China's impressive emerging market. Even with the risk of asset bubbles, the promise of China is simply too tantalizing to ignore for many.

The question is whether its economy can maintain its powerful momentum in 2012. If not, the impact on global investors could be significant.

Is China headed for a soft landing... or a hard one? Recent data out of the PRC has given economists pause. China's official manufacturing index fell to 49.0 last November, indicating sector contraction; since then, it has barely crept above 50 (51.0 in February, 50.5 in January). Its red-hot GDP cooled slightly to 8.9% in Q4 2011 following a series of interest rate hikes by the People's Bank of China to try and rein in inflation. Still, consumer prices are on the rise in China - the inflation rate rose 0.4% in January to 4.5%.¹

Other troubling signs emerged in January: a 23.8% monthly drop in auto sales, a fifth consecutive monthly dip in property prices, a third straight monthly decrease in foreign direct investment, and month-over-month declines in exports and imports.²

While China has one of the best debt-to-GDP ratios in the world - 16.3% at the end of 2011 - that ratio may reflect the "official story" rather than the reality of its "hidden liabilities".³

What if the yuan appreciates? Until recently, this was the trend. The People's Bank of China elected to loosen the yuan from the dollar about two years ago, and the currency now "floats" within a narrow band. In February the yuan reached an all-time high versus the U.S. dollar (6.3287). The PBC projects about 3% appreciation for the currency in 2012.⁴

An even stronger yuan would alter the exchange rate between China and the U.S. and theoretically lessen American consumer demand for Chinese imports. If the yuan continues to appreciate against the dollar, there may be three macroeconomic

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effects. One, American firms would have to pay more for Chinese goods they buy. Two, American companies might try to source out new suppliers and cheaper factories in nations like India, Thailand and the Philippines - or they might even direct some dollars back into our own manufacturing sector. None of this can be done overnight, so in this scenario our trade balance with China could worsen before showing any long-run improvement.

A fast-appreciating yuan would mean more purchasing power for the rising Chinese middle class, less emphasis on exports in China's economy, and some deflation - and a little price deflation might be welcomed by China's citizenry. However, a gradually appreciating yuan (on the level of 2-3% annually) might amount to the best-case scenario for the global economy and investors.

What if the yuan depreciates? China is poised for political change in late 2012 - a Communist Party congress will occur and Vice President Xi Jinping is in line to become the nation's new leader. Will the new administration elect to reverse any yuan appreciation? ²

For some time, China has bought dollars in the forex markets to keep the yuan undervalued, and that has served as a tonic to its export-driven economy. A weak yuan policy (and low labor costs) also helped to encourage direct foreign investment in China. Weakening the yuan again would drive up the cost of imports for the Chinese consumer, and China would be prompted to boost exports anew - implying more economic growth, less unemployment and renewed price advantage in global markets - in other words, an antidote to a slowdown.⁴

The cloudy near-term future of the yuan makes investing in China something of a wild card. While some economists think a stronger yuan would be good for the world economy in the long run, the fear of a hard landing (and its impact not only on the Chinese economy but the world economy) may prompt the nation's leaders to move in a different direction.

Chinese government researchers have told Reuters that the PRC has set a target of 7.5% growth for 2012; the PRC usually sets GDP targets it can comfortably meet, so results might exceed projections. Even so, growth might not approach the 9.2% GDP China saw in 2011. In February, Standard & Poor's gave China a 10% chance of a hard landing in 2012 (5% GDP) and a 25% chance of a "medium landing" (7% GDP).^{2,5}

Which way in? If you are thinking about investing in China, keep in mind that its economy has a relatively high inflation rate. This may encourage Chinese companies to overstate or overestimate factors like sales growth, operating margins, debt-to-asset ratios and fixed asset turnover. So while an individual investor may at first be enticed by a large-cap international Chinese company, he or she may opt for a more diversified investment after further consideration. A discussion with an investment professional can help the small investor decide whether an entry into China makes sense for their portfolio.

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