JVB Financial Group, LLC

CRONIN'S CORNER MONTHLY

A Perspective on the International Economy

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by Keith Cronin, JVB Senior Vice President of US Credits and International Sovereign Trading

Without the ancient Egyptians the magnificent Clydesdale horses may not have secured the expansive television exposure that has befallen them. Oktoberfest would be 'fest-less' and the name might simply be slapped as the title to an obscure movie or become an anthem for a middle European rock and roll band. The reason is of course, a la histoire, because it was the ancient Egyptians who invented beer. However, a point that may resonate with the more fastidious palates is that it was actually the Chinese who made the alcohol content of beer more, shall we say, potent. They took a beverage with a four percent alcohol content and, with a modified fermentation process, created an elixir that was comprised of eleven percent alcohol. Impressive (or maybe it's oppressive) - but of course the Chinese are credited with many inventions. From fireworks (as we all know) to acupuncture to the crossbow, their point of origin can all be traced to the Chinese. An immense culture of fascinating dimensions, the Chinese can also be lauded with inventing banknotes. The first recorded use of paper currency came about fifteen hundred years ago, forced into existence by a shortage of copper. Over a thousand years later and the currency of China may again be penning history. This time it's due to a shortage of jobs.

The first quarter of this year heard the resurgent roar of the Chinese economy with an almost twelve percent growth rate billowing from the Asian behemoth. This represents the fastest rate of growth in about three years and now with economic growth no longer a problem for the Chinese, policy will likely have to turn towards tempering such violent growth to quash the dreaded specter of inflation. This furnace of economic activity was stoked not only by a jump in consumption but also by an almost thirty percent jump in exports, and it is these exports that have been the focus of debate across global economic and political forums. China's exports have been the scourge of global imbalances and ballooning deficits. The flood of goods leaving Chinese shores has been significantly aided by pegging the country's currency to that of the US Dollar. The Chinese Renminbi (or Yuan) has effectively been tied to the greenback since the summer of 2008. Many members of the US Congress, along with more than a few economists, argue that the billions of Dollars that Chinese officials spend each year to keep the Renminbi suppressed is giving them an unfair advantage in export markets. This advantage, they opine, is costing the US manufacturing base jobs and weakening the US economy. The pressure then to let the currency appreciate versus the Dollar has been palpable and has almost resulted in an all-out trade war between the two nations. It now seems inevitable that the Chinese will indeed remove the peg and let the currency appreciate (probably as early as the next month or so), but at a very gradual pace. They will not allow their unit to be subjected to a large scale revaluation but rather a slow and steady appreciation versus the Dollar, despite pressure from the US and her other main trading partners. The Obama administration will probably take credit for 'forcing' the Chinese to bow to their demands, but we feel that the Chinese decision to let the currency appreciate has more to do with domestic Chinese policies than an appeasement to demands from Washington. A stronger Renminbi will help the economy from overheating. Exports will be dented and Chinese consumers will be more likely to buy more imports than Chinese manufactured goods, which will restrain the economy and probably help curtail any threats of inflation. There have been vociferous pleas for the Chinese to allow their currency to appreciate rapidly and severely, but such a move would likely imperil the growth of the overall economy, so we expect to see a very gradual climb in the Renminbi versus the greenback as soon as the peg is removed. What we don't expect however is a resultant plethora of jobs being created in the United States as a result of this policy. Economic theory suggests that when a country imports less and exports more, it results in more jobs being created. With the revaluation, the US should import less Chinese goods and make American exports to China more competitive. However, we question the power that this paradigm shift will have upon the real economy. China exports about four times as many goods to the US than it imports and so a gradual appreciation of the Renminbi may not result in a significant reduction of the deficit that the US runs with China. In fact, this appreciation of the currency may have the reverse effect and actually cause job losses within the export sector. Many US exporters rely upon Chinese components to complete their products. A stronger Chinese unit will make such components more expensive for them and may make them less competitive on global export markets with the obvious consequences. Thus, whilst the stronger Chinese currency may ultimately help to mitigate against a ballooning US deficit with China, the impact upon the US labor market remains more opaque. Whilst we feel that a stronger Renminbi will help to reduce many of the global trade imbalances, we are not convinced that it will automatically produce more jobs for the American economy. Besides the deficit debate, the stronger Renminbi, we feel, could result in higher US Treasury yields – at least in the short run – as Chinese officials buy fewer Dollars to allow the Renminbi to appreciate. It is worth noting that Malaysia and Singapore are also going to revalue their currencies, and with the Japanese Yen surely set to benefit from a stronger Renminbi, we could see uniform USD weakness versus a broad basket of Asian currencies. We wonder then, if this dollar weakness comes to pass, if that will put upward pressure on oil again and re-ignite global inflation concerns. Overall, there seems to be no glaring benefit for the American economy as a result of this imminent revaluation and US officials would be wise

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to ensure that it doesn't trip up the American stagger from recession.

We feel that it might serve American business better if the current administration were to seek to create a more bi-lateral trading relationship with the Chinese. As the Chinese economy grows, it continues to expand internally. Therefore, regions that were not economically viable have now become points of interest and will be a target for American exporters. It would serve the US economy better to ensure that American firms looking to expand to these regions within the vast geography of China will not be faced with obstacles to market access. Other helpful policy shifts might be for the Chinese to amend rules that limit foreign ownership or reduce tariffs on American imports. The paragon of concessions, from an American standpoint, would be if the administration could get the Chinese to limit the extent to which they are involved in the country's industries. Whilst such a proposal might actually insult the Chinese administration, even if they were to be more transparent as to the extent of state control within certain industries, this would help US firms compete more effectively within it borders.

As the year progresses, the main trading partners of the Chinese will be looking to reduce and eliminate their imbalances with China, whilst the Chinese themselves will be looking inward. Their focus will be internal and will probably focus sharply on keeping the economy on a sustainable double digit growth path without generating asset bubbles and inflationary rip currents for economic growth. Therefore, it would be advisable for the current administration in the US to look internally themselves to help reduce the unemployment rate rather than relying on Chinese policy to do it for them. •

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