<u>CHINA AT A CROSSROADS: ECONOMIC AND POLITICAL DANGER SIGNS</u>
(c) Leo Haviland, 646-295-8385 August 5, 2018

"Our million hearts beat as one,
Brave the enemy's fire, March on!" "March of the Volunteers", China's national anthem

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OVERVIEW AND CONCLUSION

Although China's era of miraculous economic growth has marched into history, the nation nevertheless achieved enviable real GDP increases in recent years. Benchmark predictions by numerous economic wizards regarding China's economy remain rather sunny, especially in comparison with those for most other countries. In fact, most observers are fairly complacent about China's current situation and future prospects. Faith in adequate global growth intertwines with belief that China's expansion will continue to be substantial.

As the world has become more globalized and intertwined, China's substantial economic expansion not only has boosted China's international economic (financial, commercial, business) and political presence and power. It also has helped to ensure domestic political stability and protected the central role and authority of the Communist Party. The country's leadership and other elites obviously desire and battle to protect such impressive accomplishments.

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However, China has a significant debt problem, and one that probably will worsen. Most China watchers nevertheless ignore or downplay this, with analysis and concerns banished to obscure articles, back pages, and fine print. China's strong economy in the past five years probably derived substantially from a substantial expansion of its overall national debt. Will China's government (and other areas of the economy) need to borrow more and more and go greater in debt in order to sustain "appropriate" GDP growth? Probably.

Yet the Chinese debt explosion, with totals at or moving toward high levels relative to GDP (particularly in the government and corporate sectors), endangers prospects for continued robust Chinese economic growth. Creditor (lending) confidence probably is not unlimited, especially in regard to segments of China's corporate, banking, and local government arenas.

Moreover, very elevated debt is not just a Chinese phenomenon, but a worldwide one. The International Monetary Fund's "Fiscal Monitor" (April 2018; Chapter 1) stated: "Global debt [public and nonfinancial private debt] is at historic highs, reaching the record peak of US$164trillion in 2016, equivalent to 225 percent of global GDP [current levels probably are higher]. The world is now 12 percent of GDP deeper in debt than the previous peak in 2009, with China as a driving force." See also the Institute of International Finance's perspective on the expanding global debt as a percentage of world GDP trend (July 2018). Public debt has played an important part in the leap in global indebtedness. China obviously is not an island isolated from other nations. So if international economic conditions weaken, perhaps partly encouraged by prior or prospective interest rate increases, it probably will become somewhat harder for many entities, both public and private, to raise cash.

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China's glorious economic growth, and the related boom in its exports, has interconnected with increasing openness in international trade. Enthusiastic challenges to the free trade (globalization;

multilateral) order and ideology, especially by the current American leadership (President Trump; "Make America Great Again!"), has raised concerns about trade wars and currency conflicts. The American Administration's noisy criticism of China's allegedly colossal (and supposedly unfair) trade surplus (at least in relation to the United States) and its willingness to impose tariffs on Chinese products has encouraged a rapid noteworthy depreciation in the Chinese renminbi relative to the US dollar in recent months.

Currency depreciation, not merely the running of large government deficits or tolerating (encouraging) jumps in corporate and household borrowing (and spending), is another strategy aimed at creating or sustaining adequate economic growth. Perhaps China's currency depreciation relative to the US is to some extent a competitive plan designed to maintain its economic growth rate by ensuring continued substantial entry of its exports into the American marketplace. And the dollar/renminbi cross rate fascinates most marketplace observers in an environment excited by trade and currency war talk.

America of course is an important commercial counterparty for China. But it does not come close to capturing a majority of China's overseas economic transactions. A review of China's currency patterns and levels from a broad real effective exchange rate ("EER") vantage point therefore offers superior enlightenment regarding the overall Chinese currency situation, and thereby its overall economic one.

The high level in China's EER likely has tended to reduce exports and thus GDP growth to some extent from what they (all else equal) otherwise would have been. This consequently has tended to encourage China's debt expansion as a means of achieving "sufficient" (official targets for) economic growth. Even allowing for the recent renminbi depreciation versus the US dollar, China's EER remains rather lofty from the historical perspective. From China's policy standpoint, its EER probably should depreciate even more than it has since its 2015 pinnacles in order to achieve desired economic growth and to handle its growing debt troubles.

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Not only do China's debt predicament and the renminbi's feebleness relative to the US dollar (and the need for the renminbi to slump further on an EER basis) warn of underlying weakness in and the probability of slower growth than generally forecast for the Chinese economy. The sharp fall in calendar 2018 in the Shanghai Composite Index (and other emerging stock marketplaces) and declines in key commodity benchmarks also signal subsiding (slowing) Chinese GDP growth. The gradual rise in US interest rates (ongoing Federal Reserve tightening; underline climbs in the Federal Funds rate and the 10 year US Treasury note), given the links across global marketplaces, also probably is starting to curtail economic growth around the globe. In any case, given China's major role in the international economy, a slowdown in its output relative to levels anticipated (hoped for) by economic pundits and financial pilgrims likely will injure expansion elsewhere.

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China's leadership probably is more fearful of inadequate economic growth than it publicly confesses. Why else has the country in the past few years further centralized political leadership and emphasized Communist Party control, embarked in well-publicized anti-corruption drives, and engaged in assorted territorial squabbles with its Asian neighbors? Such political programs suggest that real economic growth not only has slowed down (and perhaps to lower levels than official statistics indicate), but also probably eventually will ebb further than many high priests predict. A sharp deterioration in China's GDP levels and prospects probably entails heightened internal political risks.

GROWTH STORIES, TRENDS, AND FORECASTS

According to the International Monetary Fund, China's real GDP grew 7.6 percent in 1999. It thereafter steadily advanced (benefiting from ongoing industrialization, opening up to the world, and other factors), reaching heavenly levels of 12.7 percent in 2006 and 14.2 percent in 2007. Despite the dreadful global economic disaster of 2007-09, assisted by generous Chinese government stimulus, the nation's GDP remained awe-inspiring for several more years. It was 9.6pc in 2008, 9.2pc in 2009, 10.6pc in 2010, and 9.5pc in 2011.

However, the rate of real GDP growth gradually has eroded from such fantastic heights. The IMF said it was 6.7pc in 2016 and 6.9pc in 2017. This weathervane predicts output will expand 6.6pc in 2018 and 6.4 pc in 2019, 6.3 pc in 2020, shrinking to 5.5pc in 2023. See the IMF's "World Economic Outlook Update" (Table 1; 7/16/18) as well as its Article IV Consultation with China (July 2018, Figure 6), and World Economic Outlook Database (April 2018). Thus the recent and predicted GDP growth level is no longer miraculous and its pattern is on a downward trajectory.

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The IMF headlines a generally optimistic view for the near-term overall global environment. This oracle heralds, in its 7/16/18 "World Economic Outlook Update" (Table 1), that world real GDP should rise 3.9 percent in 2018 and 2019, an increase from 2017's 3.7pc (2016 was 3.2pc).

However, the IMF murmurs: "risks to the outlook are mounting"; "balance of risks has shifted further to the downside, including in the short term"; "the potential for disappointments has increased". Higher yields in the United States, tighter global financial conditions, escalating trade tensions/protectionism, and further US dollar appreciation confront the global scene.

In today's interlinked worldwide economy, how can China possibly remain immune from such risks?

RHETORICAL TALES

Gospels trumpeted by international high priests as well as Chinese authorities fight to promote a vision of strong (or at least adequate/sufficient) Chinese economic growth.

For example, in recent years, entrancing sermons from the IMF and other gurus have heralded that China is transitioning (transforming; via a complex navigation) to a new normal, with slower yet safer and more sustainable (more balanced) growth rate. The growth model is moving from investment to consumption, from exports to domestic demand, and from manufacturing to services. This is one of the most impressive economic transitions in economic history. The country indeed is shifting to a more market-based financial system. A new era beckons. The nation has made some progress in reining in vulnerabilities. China is dedicated to a comprehensive reform program.

In its recent positive spin on China, the IMF declares: "The Chinese economy is performing well and reforms are making good progress. In particular financial sector derisking has advanced further. Credit growth has slowed. Overcapacity reduction has progressed….opening up has continued." "China's economy has got very strong fundamentals…There is undoubtedly a rosy picture to the long term growth fundamentals." "We welcome the government's increased focus on switching from high speed to high quality growth." ("Transcript of the Press Briefing on the Annual Review ["2018 Article IV Consultation"] of the Chinese Economy" (7/27/18).

Underline China's President Xi's uplifting message. He solemnly proclaims from his pulpit that China can win the battle against various economic risks and challenges. It needs to maintain confidence. The Chinese economy has resilience and room to maneuver (see the Reuters website, citing China's state radio; 7/31/18). China's end July 2018 Politburo (Communist Party leadership council) meeting warned of economic tests, spoke of facing new issues and challenges, and stated that the external environment clearly has changed. However, these guardians declared that the Chinese economy is sound and promised to keep growth steady (NYTimes, 8/1/18, pA1, citing Xinhua, China's state-run news agency).

CHINA: THE DEBT DRAMA

"Seek truth from facts." Mao Zedong and Deng Xiaoping

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Much about China's economy and statistics remain murky and questionable and thus subject to considerable interpretation and debate. The debt sector is no exception. In any case, what probably has happened on China's debt stage over the past several years? What are prospects for the future? China's overall debt as a percentage of GDP probably has ballooned. Overall government debt as a percentage of GDP not only has expanded but also will continue to do so. Past, current, and future government debt levels and growth probably have been and will remain more substantial than China's leaders admit and the nation's official statistics reveal. Corporate debt has spiked. And the household debt elevation, though not mountainous, has risen.

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Let's focus first on the general government debt situation. General government debt includes both central government and local government debt. The extent to which the central government must (or would) back up local government obligations (particularly if times became difficult) is unclear.

According to the International Monetary Fund's "2018 Article IV Consultation" with China (Press Release 7/26/18; Staff Report finished 6/28/18; see Table 5), China's "official" fiscal deficit (the viewpoint embraced by China) in calendar 2017 was 2.9 percent.

Significantly, the IMF disagrees with China regarding what must be included in China's general government debt in order to generate a reasonable estimate of and assessment regarding that country's budget deficits and debt levels. The bottom line: IMF does not adopt China's view on what constitutes government debt (scan the Consultation, and particularly Tables 5 and 6). According to the IMF's own guideline (it labels this the "Fund definition") in the Consultation, 2017's general government overall balance was -3.9 percent; this deficit is about the same as what it reported in its April 2017 "Fiscal Monitor" (see Table A9). Deficits for China in years prior to 2016 in the Fiscal Monitor match those in the Article IV Consultation. The deficit in the Consultation for 2018 is 4.1 percent, with that total persisting out through 2023.

The IMF's deficit estimate height exceeds China's official elevation by about 1.4 percentage points over each of the years from 2018 through 2023. Maybe this 1.4 percent difference between China's official view and that of the IMF's "Fund definition" indicator should not make marketplace clairvoyants very nervous (at least for now). And assuming China's growth remains strong, and if its overall government debt as a percentage of GDP (really and truly) is and manages to remain modest, then a relatively high (around four percent) budget deficit for “the” general government over the next several years may not inspire substantial fear about China’s economy.

However, to more accurately capture China’s actual deficit situation and debt levels, the IMF in its Article IV Consultation discusses and employs a concept of “augmented” net lending/borrowing and debt. The augmented category includes additional infrastructure spending financed by local government financing vehicle debt as well as spending of special construction (SCF) and government guided funds (GGF). This augmented perspective spikes the general government fiscal deficit to 10.8 percent in 2017, 10.7pc in 2018, and 10.9pc in 2019. It slips only slightly thereafter, reaching 10.3pc in 2023. These obviously are celestial budget deficit levels.

Head back to the fine print of the Article IV Consultation (especially Table 5) and the most recent Fiscal Monitor (April 2018; Table A15). According to the competing “official”, “Fund definition” (implicit in the Fiscal Monitor), and augmented approaches, what are China’s government debt levels as a percentage of GDP?

According to the “official” estimate, general budgetary debt (central government debt plus “explicit local government debt”) as a percentage of GDP was 16.0pc in 2013. It rose to 36.9pc in 2017, with 2018’s at 38.1pc, growing to 43.2pc in 2023. This rather rosy vista suggesting only modest debt surely pleases Chinese officialdom.

The IMF’s April 2018 Fiscal Monitor indicated the rising trend for China’s general government gross debt (Table A15) China’s general government debt averaged 34.0 pc of nominal GDP from 2009-12 and was 37.0pc in 2013. However, the debt motored up to 44.3pc in 2016 and 47.8pc in 2017. The Fiscal Monitor forecasted it will reach 51.2pc of nominal GDP in 2018, ascending to 54.4pc in 2019 and 65.5pc in 2023.

The Fiscal Monitor debt as a percentage of GDP levels for China apparently are updated via the Consultation’s augmented category, but excluding “possible to be recognized” (see line 16 of Table 5). The statistics in the Fiscal Monitor (Table A15) and the Consultation (line 16) are close. According to the Consultation, China’s debt as a percentage of GDP was 37.0 percent in 2013, climbing to 44.2pc in 2016 and 46.9pc in 2017, with 2018’s expected at 50.3pc and 53.4pc in 2019. These extend moderately above the “official” viewpoint of China’s statistical sorcerers. This augmented debt (from line 16) stretches up significantly to reach 63.5pc in 2023, about twenty percent more than the official level.

Even though this 63.5 percent height by itself probably is not a scary number, its level and the trend to which it belongs should inspire substantial anxiety among international and national economic and political authorities as well as marketplace players. The IMF’s Fiscal Monitor (Chapter 1, footnote 15) states: “The IMF’s Debt Sustainability Analysis for Market Access Countries identifies the critical debt thresholds—beyond which debt sustainability is put at high risk—as 85 percent of GDP for advanced economies [such as the United States] and 70 percent of emerging market economies [such as China].” In any case, the 63.5pc level (and perhaps even the 50.3pc level of 2018) arguably seems rather dangerous when interpreted in combination with China’s corporate and household debt levels and trends.

Yet let’s dig deeper. The augmented debt which includes the “possible to be recognized” paints a different and even more ominous picture. This includes local government financing vehicle

(LGFV) debt likely/possible to be recognized as well as additional debt tied to SCFs and GGFs. According to this measure, China's general government debt as a percent of GDP significantly exceeds that derived from other methods. If it "is" the "real" Chinese government debt, levels for 2018 and thereafter increasing should look troubling to global economic guardians and marketplaces. It was 48.1pc of GDP in 2013 and 67.5pc in 2017. It will reach 72.4pc in 2018 and 77.1pc in 2019, which are dangerous levels (recall the 70pc critical debt threshold for emerging market economies). Moreover, this China debt indicator climbs to a monumental and frightening 91.6pc of GDP in 2023. Though this forecast 2023 height does not approach Japan's general government debt of around 236 percent as a percent of GDP in 2017; Fiscal Monitor. Table A7), it rivals the 2017 level of nearly 108pc for the United States.

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The Article IV Consultation suggests but does not conclusively prove the wisdom of adopting the augmented approach for China. Arguments related to it are esoteric, particularly given the somewhat opaque Chinese economic scene (including government relationships within it, as well as the relationship between local governments and business ventures). Admittedly the IMF does not emphasize this augmented approach and its implications in its other economic wordplay. And central banks and finance ministries seldom (if ever) speak about it. In general, the mainstream financial press seems blissfully unconcerned by notions of augmented debt.

China's economic wizards (perhaps not surprisingly) dispute the merit of the augmented method and its conclusions. After all, China does not want the world in general, key financial marketplaces in particular, and its own general public to worry about the nation's current and future economic strength and the quality of its economic and political leadership.

Yet suppose the augmented viewpoint (or a significant portion of it) is a guide superior to that of the traditional (basic Fund definition) underlying the statistics for the Fiscal Monitor/Consultation. Then the international scene should be considerably more fearful about China's near-term and especially its long-term economic prospects than it currently is.

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According to the IMF's Article IV Consultation (Table 6), China's total non-financial sector debt was 207pc of GDP in 2014 and almost 253pc in 2017. The 253 percent statistic (or those akin or related to it) and the overall rising debt trend succeed in worrying some marketplace sheriffs and players and manage to capture occasional (although rather brief) media attention.

The central and local government debt within this outline includes the "official" level (2017's adds up to 36.9pc of GDP, for example), but also incorporates local government financing vehicles (LGFVs; 24.2pc in 2017) and government funds (government guided and special construction; 6.5pc in 2017). This adds up to 67.6 percent, which is the (broad) augmented total.

Chinese household debt rose from 35 percent of GDP in 2014 to 49pc in 2017. The 2017 height is not high by advanced nation standards, but the ascent over that relatively brief span is noteworthy.

China's overall corporate debt levels and trends themselves agitate some Wall Street, central bank, and finance ministry insiders. According to Table 6, corporate debt (excluding LGFVs) rose from 120 percent of GDP in 2014 to 136pc of GDP in 2017. (Corporate debt including LGFVs rose from 133pc in 2014 to 161pc in 2017).

And what will happen to marketplace confidence in China's economy (and the other parts of the global economic and political landscape entangled directly or indirectly with it) if China's total non-financial debt percentage climbs significantly further from 2017's 253 percent (67.6pc augmented government plus 49pc household plus 136pc corporate)?

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The IMF's late July 2018 Press Briefing for its Article IV Consultation prays that "shifting from excessive debt finance investment to consumption will sustain growth". Yet the Briefing notes: "The credit growth has slowed in 2017 but it remains too fast. Slowing it further will require less public investment, tighter constraints on state-owned enterprises and curbing the rapid growth in household debt." "China needs to continue to reduce its debt levels and to reduce credit growth and on the whole fiscal policy should be somewhat contractionary to reduce debt." Mortgage debt/property marketplace growth is still rapid, at 20pc year-on-year; "local government borrowing is still quite substantial".

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Since the Article IV Consultation Table 6 summary only deals with China's "non-financial sector debt", the nation's financial sector debt therefore presumably adds weight to an already apparently significant burden.

In late 2017, the International Monetary Fund's "Financial Sector Stability Assessment" (12/6/17) said China's financial assets were nearly 470 percent of GDP. So shouldn't we wonder how much of corporate bank loans are potentially at risk?

The IMF stated that risky lending has moved away from banks toward "the less-well-supervised part of the financial system". Let's not forget the notorious shadow banking universe. In any case, this Stability Assessment warns of "moral hazard and excessive risk-taking". "The system's complexity has sown financial stability risks." And significantly in relation to China's economic growth story (including the demise of its growth miracle): "In recent years, the amount of credit needed to generate additional GDP growth has risen (known as "credit intensity") so that the financial sector has grown rapidly despite a slowing economy…As a result, the outstanding stock of corporate debt is large and risky."

The IMF's "Global Financial Stability Report' (April 2018) emphasized: "The large-scale and opaque interconnections of the Chinese financial system continue to pose stability risks (Figure 1.18). China's RMB trillion (300 percent of GDP) banking system is tightly linked to the shadow banking sector through its exposure to off-balance sheet investment vehicles…These little-regulated vehicles have played a critical role in facilitating China's historic credit boom and have helped create a complex web of exposure between financial institutions)."

Recent actions by China's central bank point to concerns of China's economic and political leaders about economic growth and financial stability. The central bank recently injected $74 billion into its financial system via its Medium-term Lending Facility (its largest ever by this mechanism). This followed its cutting of bank reserve requirements in late June. The central bank's party secretary and head banking regulator urged banks to boost lending to small and medium-sized enterprises (Financial Times, 7/24/18, p1).

The Financial Times asserts (7/31/18, p7) that reliance by China's regional banks on unstable, short-term funding, exposure to the slowing industrial economy, and complex accounting ("financial engineering and creative accounting") to evade capital adequacy rules has placed some of China's regional lenders "in a precarious place". The FT claims analysts generally do not expect problems at small banks to become a systemic crisis. But: “Recognizing shadow loan defaults would wipe out capital in some Chinese banks”.

Real estate has played a key role in the China growth story. Financial Times research shows Chinese home sales fell in July 2018 to a five month low (7/31/18, p3).

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China perhaps will manage to postpone its debt difficulties for quite some time. National debt (or sectors within it, whether government, corporate, or household) can go on rising as a percentage share of GDP for several years before a severe problem (challenge of meeting obligations; the emergence of a crisis of confidence) appears in practice. And most financial audiences remain confident about China’s economic (and debt) prospects.

Japan and China of course differ in many respects. Yet Japan for several years has had a towering central government debt (236 percent of GDP in 2017), and it has magically managed to keep kicking the can down the road on the issue.

What about the United States? The IMF’s Fiscal Monitor (April 2018) shows the rising trend of US government debt is on a rising trend. It was 87.0 percent of GDP in 2009 (compare the much lower levels prior to the economic crisis), but 107.8pc in 2017, 108.0pc in 2018, and 116.9pc in 2023. Compare these percentages with those for China’s augmented debt.

Suppose one focuses only on the US federal arena. The federal government has a substantial debt burden now. This problem likely will worsen in future years due not only to the cost of meeting underlying long-run challenges (such as a substantial aging population), but also due to the recent legislative enactment of the so-called tax “reform” scheme.

According to the Congressional Budget Office, at the end of fiscal year 2017, debt held by the public was 76.5 percent of GDP. This is a rather high number and much above that preceding the global financial crisis of 2007-09. The estimated guideline percentage blossoms to 87.9pc in 2023 and attains a formidable 96.2pc in 2028, and that amount is far greater than the debt in any year since just after World War II. As more time passes, the federal debt percentage relative to GDP is forecast to soar well beyond World War II’s debt pinnacle (“The Budget and Economic Outlook”: 2018 to 2028”, Summary Table Two; “The 2018 Long-Term Budget Outlook”, 6/26/18). Nevertheless, no debt crisis has erupted (yet) for America due to concerns about this ominous federal debt situation and projections for it (or about levels and trends for the overall American debt, which includes state/local governments, corporations, and households).

China’s foreign exchange reserves held or controlled by the government are substantial, at just over three trillion dollars as of mid-2018. Many with abiding devotion to the view that China’s illustrious growth story will continue believe the government can employ these assets to bolster the country’s economic expansion.

China’s gross national savings as a percent of GDP are high. This savings pool perhaps gives the country room to deal with any substantial debt difficulties. Gross national savings were 36.0 percent of GDP in 2000, rising to 52.3pc in 2008. The rate remains hefty at 45.4pc in 2018. The IMF estimates only modest dips in subsequent years, with 2023 an estimated 42.2pc (IMF database).

Some other measures of China's economy in addition to the widely-watched GDP figure suggest current economic strength. For example, Chinese electricity output is up a cumulative 8.3 percent in 2018 through June 2018 year-on-year (National Bureau of Statistics of China).

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However, marketplace watchers should not be complacent about the debt problem facing China (and many other nations). Prior to and during the early stages of the 2007-09 global economic disaster, most clairvoyants discerned no significant difficulties lurking in the US real estate marketplace. But as the extraordinary Goldilocks Era ended, monstrous problems in the allegedly sound US real estate sector sprang into view and worsened; so eventually did debt/credit/leverage troubles in other domains around the world. The global economic disaster of 2007-09 surprised most prophets.

TRADE AND CURRENCY WARS

In the movie "Trading Places" (John Landis, director), the actor Eddie Murphy as "Winthorpe" strides onto the commodities trading floor and advises: "Never show any signs of weakness. Always go for the throat…Nothing you have ever experienced can prepare you for the unbridled carnage you're about to witness. The Super Bowl, the World Series, they don't know what pressure is. In this building it's either kill or be killed. You make no friends in the pits, and you take no prisoners."

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Fears about substantial trade (tariff) wars, significantly inspired by President Trump's oratory (fair trade; Make America Great Again!) and his related threatened and actual policies, have increased in recent months. Despite the interconnected global economy, the President's trade orientation is primarily bilateral rather than multilateral. Current and prospective trade battles have generated concerns about their consequences for global economic growth. Trump has quarreled with various regions on the trade front, including Mexico and Canada (NAFTA), the European Union, the Pacific in general (withdrew from the proposed Trans-Pacific Partnership agreement), and especially China. Will he impose tariffs on all of America's roughly $500 billion in imports from China?

Currency trends at times can reflect, perhaps substantially, trade wars. The recent quarrels between America and China appear via movements in the US dollar/renminbi cross rate.

The renminbi's major high against the dollar occurred 1/14/14 at 6.039. A ten percent decline from the renminbi's January 2014 major top against the dollar is 6.643, with fifteen percent 6.945; a twenty percent crash equals 7.247.

Amidst various twists and turns, the renminbi tumbled to 6.596 on 1/8/16. However, it slumped even further to attain a very significant trough at 6.965 on 12/16/16, midway between Trump's stunning 11/8/16 election victory and his 1/20/17 inauguration. Although the renminbi rallied to 6.243 on 3/27/18, as the US/China trade turmoil has grown, it nosedived to 6.897 on 8/3/18. This meltdown is about 14.2 percent beneath January 2014's peak and a sharp 10.5pc fall from late March 2018's interim top.

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Although the majority of currency visionaries (and leading politicians) concentrate on the Chinese renminbi cross rate against the United States dollar, China's broad real effective exchange rate also is a crucial indicator ("EER"; Bank for International Settlements, 2010=100, data back to January 1994, monthly average; CPI based). The US is a very important trading partner for China, but it nevertheless represents only 17.8pc of China's broad EER index.

China's broad real EER began a major advance after June 2011's 99.6. Recall that the last amazing (as opposed to great or good) growth year for China's real GDP was 2011's 9.5 percent. China's EER attained a major high in July/November 2015 around 131.1 (February 2016 130.9), soaring 31.6pc from its June 2011 level. Although China's EER fell about 9.6 to May 2017's 118.5, it rallied to 127.6 in February 2018 and stood at 126.4 in June 2018 (7/19/18 is the most recent release).

Much of Trump's belligerent campaign for fair trade centers on goods (such as manufactured items and agricultural products). However, concentrating on that dimension alone, though exciting for advocates of a given political agenda, is narrow-minded.

The current account yardstick includes important aspects of international commerce such as the service balance (as well as the income balance and current transfers), not only the trade balance. Thus the current account measure is much broader and a better guide for a nation's "overall situation" than measures focusing on "trade" guideposts based upon on goods. For example, China had a trade surplus of four percent of GDP in 2017. Yet that year it ran a services deficit of 2.2pc of GDP; its income deficit was .3pc of GDP, with the deficit for current transfers at .1pc. Thus China's 2017 current account balance was merely 1.4pc of GDP.

China's current account balance as a percentage of GDP was only 1.7 percent in 2000 and 3.5pc in 2004. Though the surplus skyrocketed to 9.9pc in 2007 (8.4pc in 2006; 9.1pc in 2008), it thereafter plummeted. From 2011 through 2017, China's current account surplus averaged about two percent. In 2015, it was 2.7pc, but in 2016 it was 1.8pc. The IMF's expected current account surplus for 2018 drops from 2017's 1.4pc to under one percent (.9pc; 2019 current account surplus forecast is .8pc, with 2023's only .4pc). See the IMF database and the recently-released Article IV Consultation (Table 2).

Thus analysis from the current account perspective shows that China has made far more progress in relation to its international commerce balance than the creed preached by President Trump and his acolytes suggests.

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Keep in mind the appreciation of the China EER from mid-year 2011 to its 2015 pinnacles, as well as its relatively still-high level from early 2016 through June 2018. The strong China EER probably contributed to (assisted in) an ongoing (sustained) reduction in the nation's current account surplus. Also in this context, recall the gradual decline in China's real GDP rate from 2011's 9.5 percent. Given the importance of exports to China's incredible growth story, the rise in China's EER probably encouraged the slowing real Chinese GDP growth rate during 2012 and thereafter. Also remember the rise in China's debt (and particularly in its general government and corporate debt) in recent years, and particularly since 2013. Thus China's overall (national) willingness to incur greater debt obligations (burdens) probably in part reflects its declining success in international trade (as shown by its falling current account surplus); China's debt increase pattern partly represents the country's determined effort to overcome the GDP consequences of its elevated EER.

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The IMF's Article IV Consultation Press Briefing claims that the renminbi on a trade-weighted basis is "fairly valued". The Consultation itself saw the renminbi as "broadly in line with fundamentals" (Executive Board; see also Appendix 1).

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Based upon daily closes, the renminbi probably depreciated roughly 3.8 percent against the US dollar from June (monthly average around 6.470) to July (average 6.717). The BIS will not release EER data for July 2018 until mid-August. Also, July and early 2018 renminbi weakness apparently primarily related to the dollar. Anyway, suppose China's EER fell 3.8pc in July from June 2018's 126.4; its July 2018 EER will be around 121.6. May 2017's 118.5 level represents important support for the China EER.

China probably is willing to engage in competitive devaluation (currency wars) to sustain growth at desirable levels, but so are other nations. Most countries do not want their currency to be "too strong". How easy will it be for China to devalue its EER substantially relative to its (probable) July 2018 level? Look at Japan's EER; its June 2018 EER of 74.9 stands not much higher than June 2015's important bottom at 67.9. Japan's EER was 106.8 in January 2009 (during the dismal global economic crisis) and 102.5 in July 2012.

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China is unlikely in practice to retreat substantially in its trade dispute with America. Not only does it need to maintain substantial exports (and probably at least a modest global current account surplus) to maintain adequate real GDP expansion. China's population generally will remain relatively peaceful, and less inclined to aggressively question (or attack) the current authoritarian political structure and related political and economic elites, if national output remains sufficient (and if political generals appear resolute). Keep in mind China's significant income inequality, as well as the divide between urban and rural prosperity.

According to a Bloomberg News article (website, 8/2/18), the Chinese Ministry of Commerce declares that "China has made full preparation for the U.S. threats to escalate the trade war, and will have to retaliate to defend national pride and the people's interests." "China Refuses to Blink, Piling $60 Billion on Tariff Threats", warning it will tax an additional $60bb per year worth of imports from America if the Trump Administration imposes its own new levies on Chinese goods (NYTimes, 8/4/18, ppB1, 6). On the currency front, China's central bank acted on 8/3/18 to halt the renminbi's slide by imposing a 20 percent reserve requirement on banks that sell dollars to clients using currency forwards (Financial Times, 8/4-5/18, p11). The banks probably will pass the cost of the requirement on to their clients, thus increasing the cost of speculating on renminbi weakness.

In its conflict with the US Administration, in addition to tactics directly related to trade (or other aspects of the current account balance) or the regulation of foreign investment within China, how else might China respond? The US Treasury's "Major Foreign Holders of Treasury Securities" (Treasury International Capital Report; 7/17/18) statistics reveal Mainland China held just under $1.2 trillion in UST (about 19.0 percent of total foreign holdings) at end May 2018 (the most recent month available), about unchanged from August 2017's slightly higher $1.2 trillion. America's federal budget deficit likely will keep widening over the next several years. Looking forward, China might elect to keep its UST stockpile unchanged, making it more difficult for America to finance its deficit.

Or, suppose China decided to be even more combative and became a significant net seller of its US Treasury holdings (even if that risked a sharp rise in US government and related interest rates). The possibility of such substantial Chinese net selling is not fanciful. Note recent net UST selling by Russia. Perhaps in response to US sanctions and other political debates with the US, Russia arguably responded by selling about $100 billion in UST between November 2017 and May 2018, reducing its total holdings to a mere $15 billion.

China might choose to reduce its exports of rare earths, which are important for many modern products. In 2010, it stopped exports for two months to Japan over a territorial dispute. (NYTimes, 7/12/18, pA1, 10).

STOCK AND COMMODITY BATTLEFIELDS

China is not the only emerging marketplace nation challenged by the rising trend of United States interest rates and the rally in the US dollar. The Financial Times headlines "Rising debt leave EMs at epicenter of worries as conditions tighten" (7/14-15/18, p13).

The US 10 year Treasury note yield has climbed from its key low at 2.01pc on 9/8/17 (major bottom 1.32pc on 7/6/16). Its yield rose to about 3.13 percent on 5/18/18. It has hovered around 3.00pc recently. The broad real-trade weighted dollar (Federal Reserve, H.10; monthly average; March 1973=100) ascended from its January 2018 interim low at 94.6 to 99.9 in July 2018. The trade-weighted dollar thus has moved above the critical level of 96.6 (March 2009's pinnacle during the 2007-09 global economic disaster), though it remains somewhat distant from its major summit of December 2016 (103.2)/January 2017 (103.1); recall also January 2016's 101.1 crest.

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To some extent, the renewed weakness in the Chinese stock marketplace during calendar 2018 probably reveals increasing fears about China's growing overall debt and a slowdown in Chinese growth.

Trends in the Chinese stock marketplace do not always parallel the China GDP growth story. However, the significant decline in the Shanghai Composite Index since its first quarter 2018 high suggests that clairvoyants should be skeptical regarding prospects for renewed remarkable Chinese economic growth. The Shanghai Composite's twenty-five percent fall in recent months is not an illusion or of minor importance; it warns that Chinese GDP growth for at least the next couple of years may not meet the IMF's (and China's) baseline predictions. The similar bear move in emerging stock marketplaces in general (Morgan Stanley's MSCI Emerging Stock Markets Index: "MXEF") since early 2018 confirms the Shanghai Composite decline and hints at the potential for a disturbing Chinese (and global) GDP slowdown.

In addition, the price trend for commodities in general has been bearish since around mid to late spring 2018. The broad S&P Goldman Sachs Commodity Index ("GSCI"), although it is heavily petroleum-weighted, is a widely-watched benchmark for commodities Base metals are an important variable for estimating the strength of and trends for the Chinese economy. The London Metal Exchange Index (LMEX) includes six primary non-ferrous metals such as aluminum, copper, lead, and zinc.

	Broad GSCI	**Emerging Market Stocks MXEF**	**China Shanghai Composite Index**
Peak 2018	498	1279	3587

	(5/22/18)	(1/29/18)	(1/29/18)
Recent Low	448 (7/18/18)	1039 (6/28/18)	2691 (7/6/18)
Percent Fall	10.0pc	18.8pc	25.0pc

The LMEX recent tops were at 3494 on 4/18/18 and 3500 on 6/7/18. It fell 16.2 percent to 2934 on 7/19/18. The Shanghai Composite's July 2018 low neighbors its critical first quarter 2016 bottom (1/27/16 at 2638 and 2/29/16 at 2639).

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The S+P 500's trend in recent months has diverged from those of the Shanghai Composite Index and MXEF. The S+P 500 now floats just beneath its first quarter 2018 pinnacle, whereas the Shanghai Composite and MXEF remain well beneath their 1Q18 tops. However, despite this divergence, recall that S+P 500 and emerging stock marketplace trends in recent years often have been rather close from the overall trend direction and timing perspective. The S+P 500's high to date occurred on 1/26/18 at 2873, very near in time to summits in the MXEF and Shanghai Composite.

THE CHINESE POLITICAL STAGE

Politics and economics entangle in both advanced and emerging/developing nations. What does China's political situation suggest about its economic prospects, and thus world growth? Various political signs point to the Chinese leadership's alarm regarding its economic growth (and political and social stability). If China's economy is growing adequately (and if the probable prospects for its future genuinely are good), why has the country's leadership been engaging in foreign quarrels and attempting to exert greater political control over its domestic situation?

China's political elite (notably its Communist party chiefs) seeks to ensure its own power and go maintain overall national political, economic, and social stability. Insufficient GDP growth and related widespread popular unrest (or anger) regarding income levels, economic inequality, and potential opportunities probably endangers these goals.

What do the political rhetoric and actions over the past few years (including recently) by China's leaders reflect? Quite significantly, they portray increasing concern about their nation's current and prospective economic situation, particularly its growth level and outlook.

To deflect and dilute growing popular concern about a weakening economic situation (slowdown; feebler growth than desired), and to maintain their political power and influence, China's political leaders have acted vigorously on both the external and internal fronts.

In the foreign sphere, China often has quarreled with other nations. On the internal landscape, efforts to control political (and other social) communication and activities have increased. These policies from China's guiding authorities tend to confirm the trends of slowing Chinese (and global) growth.

Why does China engage in these external political fights? China probably is not only concerned about land and related mineral rights. Hostility to the opposing nations and related political power relationship issues are probably not the only explanation.

China's headline-grabbing overseas disputes distract attention from internal economic (and political) problems. Note China's territorial quarrels with Japan over some tiny islands (the Daioyu) controlled by Japan. China has had similar feuds with Vietnam and the Philippines (South China Sea). Note a brief flare-up with India over the disputed India-China border.

If China's economy was booming and likely to remain strong going forward, why have the country's political leaders engaged in for quite some time in noisy campaigns against official corruption? Moreover, note the centralization of power around President Xi (including the February 2018 abolition by the Communist Party of constitutional limits on presidential terms). Also, in recent years there has been tighter Party control over the media.

Don't overlook China's effort to promote its values relative to Western ideals. If all was well with China in its political (and economic) arenas, why attack alternative viewpoints?

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For further related marketplace analysis of stock, interest rate, currency, and commodity fields, see "Shakin' All Over: Marketplace Convergence and Divergence" (6/18/18) and other essays.

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