CATALPA CAPITAL ADVISORS LLC

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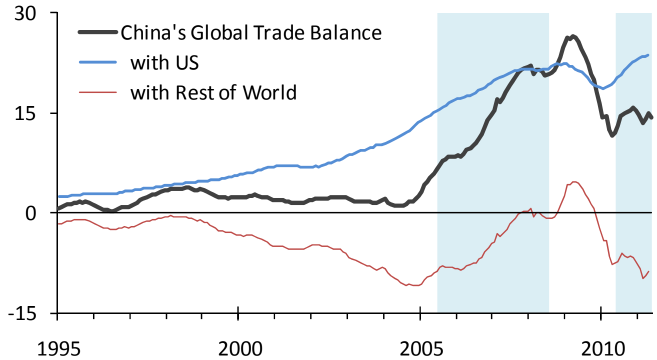
CHINA'S TRADE ~~SURPLUS~~ DEFICIT

US$ Billions, 12M moving average. Shading denotes periods of yuan revaluation.



Source: Bloomberg, Catalpa Capital Advisors | catalpacapital.com

After hitting record highs in 2009, China's global trade balance is well below where it used to be and ticked up only modestly in the latest data. However, the headline number can be misleading: the trade surplus with the US continues to hit new highs while China is running massive trade deficits with the rest of the world.

Without the US, China is running a trade deficit with the rest of the world.

Mark Twain often said that there are "lies, damned lies, and statistics." In a highly-developed country like the United States, economic data is revised regularly and sometimes by wide margins, even with the best of intentions. In a still-developing country like China, interpreting the data can be more art than science. As Li Keqiang, the vice premier and heir-apparent to Wen Jiabao, laconically remarked to the US ambassador a few years ago, most of the statistics in China are "for reference only."

With due caveats in mind, the world's second largest economy reported net exports of $14.4 billion worth of goods in May 2011 on a 12-month moving average (the thick black line in the chart), about where it was a year ago. While China's Ministry of Commerce breaks out individual countries, trade with Hong Kong is deemed to be domestic and is excluded from the export data, even though many of the goods are subsequently shipped to other countries. As an alternative, the US includes Hong Kong in its data, which currently shows that China's trade surplus with the US is running at a record $23.7 billion (the blue line). When all the math is done, without the US, China is running a trade deficit with the rest of the world (the red line).

Although China's policymakers argue that the trade surplus with the US is unaffected by the value of their currency, they suspended yuan revaluation when the surplus with the US contracted. Between 1995 and 2005, a period when the yuan was firmly pegged to the dollar, the overall trade balance was relatively flat, as rising imports from the rest of the world were offset by booming exports to the US. For the next few years, the export boom to the US continued unabated while non-US imports slowed and the yuan was strengthened (the shaded area in the chart). In late 2008, when the trade surplus with the US began to contract, yuan revaluation was suspended until 2010, by which time exports to the US were rising once again.

The renewed strengthening of the yuan against the dollar, however, has lagged the global surge in commodity prices. Because China is paying more for its commodity imports, the deficit with its non-US trade partners continues to grow. China has been buying US Treasuries for many years to finance its trade surplus with the US. China may need to continue doing so for some time to come to offset its trade deficit with the world ex-US and keep its overall trade balance stable.

Catalpa Capital Advisors LLC | 230 Park Ave Ste 863 | New York, NY 10169 | Tel: 212.231.8701 | info@catalpacapital.com | www.catalpacapital.com