

The U.S. and China

An evolving economic relationship

The government of China is keeping a close eye on the impact the global recession is having on the U.S. economy. Recently, Chinese Premier Wen Jiabao made headlines when he publicly expressed concern about his country's holdings of U.S. government debt. Shortly afterward, the head of the Chinese central bank proposed replacing the U.S. dollar with a new global currency controlled by the International Monetary Fund.

Since the 1970s, the communist nation of 1.3 billion people has pushed away from Soviet-style central economic planning and watched its GDP grow by more than 10 percent annually and per capita income soar more than 8 percent. It is now the world's third largest economy, behind only the United States and Japan. And with many Western countries experiencing economic difficulties, China has been increasingly assertive about the global response to the financial crisis.

Outlook recently sat down with China expert Barry Naughton for some insight on China and the country's response to the U.S. recession and global economic downturn. Naughton, who specializes in the Chinese economy, is the So Kwanlok Chair of Chinese International Affairs at the Graduate School of International Relations and Pacific Studies at the University of California, San Diego.

OUTLOOK: China has one of the fastest growing economies in the world. How has it been impacted by the economic downturn and what are the implications for the U.S. economy?

Barry Naughton: China is heavily dependent on exports, so it's going to get hit by the worldwide turndown in export demand. What many people don't realize is that China also has its own domestic issues. China is also experiencing the painful bursting of an economic bubble, but in their case the bubble was caused by the creation of excessive industrial capacity. They built too many steel mills, aluminum production facilities and cement plants during the last five years. As a result, they're going through a correction that is triggered by and coincides with this global economic crisis.

Unfortunately, this means their downturn is synchronized with our downturn. In the short run, China is going to demand fewer commodities and fewer high-technology machinery items that the U.S. produces and provides to China.

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About this interview

Barry Naughton is the So Kwanlok Chair of Chinese International Affairs at the University of California, San Diego. Naughton has published extensively on the Chinese economy, with a focus on economic transition, industry and technology, foreign trade and Chinese political economy. Naughton publishes a quarterly analysis of China's economic policy-making on the website of the Hoover Institution.



Barry Naughton
So Kwanlok Chair of Chinese International Affairs
University of California, San Diego

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OUTLOOK: How severe do you think the impact will be there?

BN: They can limit the overall impact through government stimulus programs, but they're still going to get hit by the export slowdown. Although everyone could see it coming, the really dramatic export reduction didn't hit China until February of this year. China is still a relatively low-end producer; the things people keep buying in a downturn are the things that come from China. Also, China is at the end of all these production chains. So when a computer company decides that demand for computers is down, the first thing they do is cut orders for processors and screens and high-tech components that actually aren't manufactured in China. They come from Japan or Korea or Taiwan and are then assembled in China. So Chinese imports so far have dropped faster than their exports.

OUTLOOK: China has offered its own economic stimulus package. What does it do, how does it compare to the U.S. version and how much does it cost?

BN: Their approach in many ways is like ours. The first thing they did was crank up domestic infrastructure spending – new highways, railroads and airports. That makes sense because they can do it fast; they've got projects queued up. Additionally, because they have this excess industrial capacity, they can keep demand for things like steel and cement from falling too fast and too suddenly. They have also adjusted the structure of their stimulus package so that it includes more money for housing and health and human services.

Regarding cost, they announced it as a 4-trillion Yuan stimulus package, about \$586 billion. The central government is going to fund about a third of it, with the rest funded by local governments and banks. Once the central government gave local governments the go-ahead, they responded very enthusiastically with a huge list of projects. We are looking at a total stimulus package that is about 4 percent of the Chinese GDP. It's clearly the second biggest stimulus package in the world after the U.S.

CHINA BY THE NUMBERS

Source: CIA World Factbook

Population	1.3 billion
Life Expectancy	73.5 years
Pop. Below Poverty Line	8%
Inflation Rate	6%
Foreign Reserves	\$2 trillion
Central Bank Discount Rate	3.06%
Commercial Prime Rate	5.58%
Labor Force	807.7 million
Unemployment	4-9% (urban)
Airports	467
Pipelines	
Gas	28,132 km
Oil	20,204 km
Other	9,746 km
Railways	75,438 km
Roadways	1,930,544 km
Merchant Marine Fleet	1,826 vessels

OUTLOOK: Can the Chinese stimulus package help lead the world out of this economic downturn?

BN: China, with this big stimulus package, will end up being a net positive. It will be a bright spot that will help us to recover, but it is a long way from being big enough to be the engine that pulls the world economy out of recession.

OUTLOOK: The U.S. downturn has exposed weakness in the U.S. banking system, regulatory structure and the housing sector. What unforeseen weakness has the economic downturn exposed in the Chinese economy?

BN: In the short-run, if anything, it has highlighted their strengths. Their banking system is not very sophisticated – but it’s not broken. They had already gone through a painful period of writing off a high level of bad debt in the early 2000s, so their bank balance sheets look pretty good right now. They’ve been able to turn to the banking system quickly and without too many worries to go generate a great deal of funding for stimulus-related expenditures. In that sense, they have an advantage over the United States.

That is backed up by a huge foreign exchange reserve, just shy of \$2 trillion, which is security more than anything. They can bust their budgets this year and next year without having the world worry about whether they are really credit-worthy.

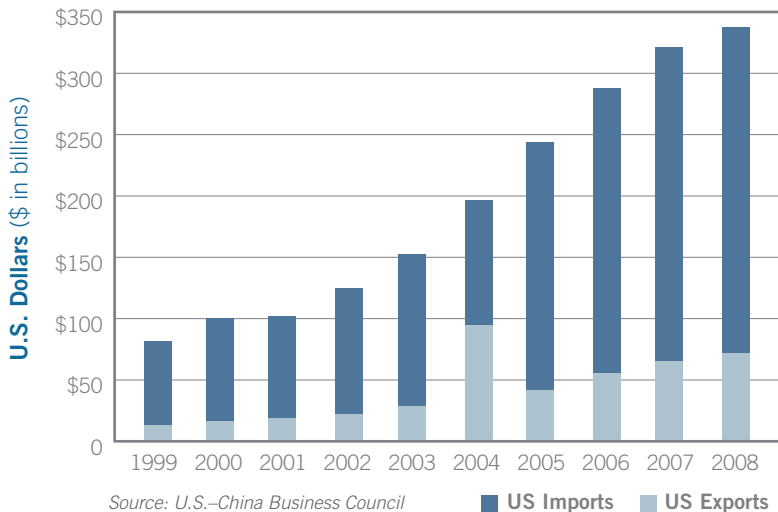
OUTLOOK: At least \$1 trillion of that reserve is held in U.S. Treasury bonds. What’s your take on the Premier Wen Jiabao’s concern about the safety and security of U.S. Treasury bonds?

BN: I think his economic advisors are telling him they are locked into U.S. Treasury bonds and there are no alternative investments. They are watching the U.S. crank up its stimulus package and run up big deficits. It’s clear that, sometime down the road, interest rates on U.S. Treasury bonds are going to go up and the value of the U.S. dollar is probably going to go down. When you put those two things together, it means China is going to take a huge hit on everything it has invested in U.S. government paper. Really, they are begging the U.S. to run a more conservative financial policy in the hopes that it will avoid both a rise in interest rates and a crash in the U.S. dollar.

OUTLOOK: What’s driving China’s call for a new global currency to replace the U.S. dollar?

BN: The U.S. currency is used by the world, but the U.S. Federal Reserve only uses monetary policy for domestic purposes. It means nobody is targeting monetary policy for world needs. The problem is systemic, and we would have been better off following John Maynard Keynes’ proposals in 1945 for a multi-commodity based world money. The objective of a world

U.S.–CHINA TRADE



money is clearly something for the distant future and to say “it may take a long time” is a tremendous understatement.

Instead, this looks like an effort by China to jump-start IMF reform. The IMF needs more money, China has it but is unwilling to give more unless it gets a bigger quota and vote on the IMF board. My understanding is that the biggest obstacle there has been the Europeans, who want to defend their large percentage quota and thus voice in governance. By adding some elements to the bargaining mix, perhaps China hopes to get the IMF discussion moving.

OUTLOOK: Does China stand to benefit at all from the global recession?

BN: There are people in China who have money and are starting to wonder whether there are some good investments in the U.S., absolutely. But a busload of Chinese real estate investors looking for deals is pretty trivial in the grand scheme of things.

The place where I’d look for China to make a real impact is in the acquisition of natural resources. China recently agreed to put \$18 billion into Rio Tinto, an Anglo-Australian iron ore, coal and bauxite producer. That’s definitely going to be a good deal for China if and when global resources markets recover. There was a two-week period in February where they made a series of very large deals in quick succession with Australia, Brazil and Russia. If those deals pan out, then China, absolutely, will have benefited.

Over the last year, China has avoided a lot of the financial damage because they’ve been in very liquid investments. Even those U.S. Treasury bonds they like to complain about have actually been a fabulous investment over the last year. In fact, they’ve been the only really positive investment return available in the world. So if now there were a way to move out of U.S. Treasury bonds just at the time the U.S. economy turns the corner, then that would be a huge investment coup for China, especially if they bought into the natural resources they need. But realistically, their holdings are so big

CHINA GENERAL ECONOMIC INDICATORS

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
GDP (\$ in billions)	8,967.70	9,921.50	10,965.50	12,033.30	13,582.30	15,987.80	18,321.70	21,192.40	25,730.60	30,067.00
GDP (% growth)	8%	11%	11%	10%	13%	18%	15%	16%	21%	17%
Foreign Exchange Reserves (\$ in billions)	154.70	165.60	212.50	286.40	403.30	609.90	818.80	1,066.30	1,528.20	1,946.00

Source: U.S.–China Business Council

CHINA'S TOP EXPORTS	
Commodity	Volume (\$ in billions)
Electric Equipment	342
Power Generation Equipment	268.6
Apparel	113
Iron & Steel	101.8
Optics & Medical	43.4
Furniture	42.8
Chemicals	42.4
Vehicles	39.3
Toys & Games	32.7
Mineral Fuel & Oil	31.6

Source: U.S.–China Business Council

CHINA'S TOP IMPORTS	
Commodity	Volume (\$ in billions)
Electric Equipment	80.3
Power Generation Equipment	65.1
Toys & Games	27.2
Apparel	24
Furniture	19.4
Iron & Steel	14.8
Footwear	14.5
Plastics	8.9

Source: U.S.–China Business Council

that we cannot really expect to see them nimbly moving a large amount at just the right time.

OUTLOOK: Will any of this global economic turmoil cause China to reverse course or change any of its market-oriented economic reforms?

BN: There is always a danger of a protectionist response. So far, China has avoided erecting new barriers to trade and investment. But as we go through this crisis, governments everywhere are moving to prop up their domestic producers. China is pumping money into their state companies and also beginning to provide subsidies to their farmers. Obviously this puts our exporters and investors at a comparative disadvantage.

In terms of really rethinking the direction of their economic reform, we really don't seem to be seeing much of that at all. They've actually done a couple of things with their financial system that are bolder than we expected. For instance, they see that small firms need credit and are an important part of keeping employment growing. As a result, they have become much more open to lending to small firms, all of which are private. They also have moved more rapidly on the corporate bond markets.

In some ways, they are certainly feeling a little smug. They feel like all the people who have been dispensing advice aren't that great after all. That's particularly true given that the standard dialogue between the Chinese and the Americans, the World Bank and the International Monetary Fund has always been that the outside people push them to open up their economy faster than they are comfortable. Now it seems that they were right to be more cautious.

OUTLOOK: What should China and the United States be doing together over the next year to help each other through the current economic conditions?

BN: China has really large trade surpluses with the U.S. and globally, and they are keeping their currency stable. There is a body of opinion in the U.S. that says this is terrible, that because they have a big surplus their currency should appreciate. But in my view, the most important thing for the U.S. is to accept that the stability of China's currency is positive in this environment. We also need to recognize that the Chinese stimulus package is big enough that it counts as being a net contributor to turning the corner with the recession. Lastly, we need to try to work together to keep protectionist measures from increasing. If we can keep on this track, then basically China is doing what we would want them to do.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 04/30/09. They are intended to provide rate or cost indications only and are for notional amounts in excess of \$5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Forecasts courtesy of Insight Economics, LLC

US Treasury Securities

2008	GDP	CPI	Fed Funds	2-year	10-year
Q4	-6.30%	-8.30%	0.51%	1.20%	3.30%
2009	GDP	CPI	Fed Funds	2-year	10-year
Q1	-6.10%	-2.40%	0.18%	0.90%	2.70%
Q2	-2.50%	2.30%	0.20%	0.90%	3.00%
Q3	-3.50%	1.80%	0.20%	0.90%	2.90%
Q4	-1.00%	2.30%	0.20%	1.00%	2.80%

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	1.02%	1.88%	1.93%	2.55%	2.90%	3.20%
0.25	2.07%	1.97%	2.10%	2.68%	3.00%	3.28%
0.50	2.04%	1.73%	2.19%	2.76%	3.07%	3.33%
0.75	2.29%	1.46%	2.30%	2.85%	3.13%	3.39%
1.00	1.40%	1.08%	2.40%	2.93%	3.19%	3.44%
1.50	0.96%	1.72%	2.78%	3.19%	3.39%	3.59%
2.00	2.38%	2.80%	3.28%	3.52%	3.63%	3.78%
2.50	2.91%	3.11%	3.50%	3.66%	3.75%	3.87%
3.00	3.06%	3.33%	3.65%	3.75%	3.83%	3.94%
4.00	3.49%	3.71%	3.84%	3.88%	3.97%	4.04%
5.00	3.70%	3.87%	3.91%	3.96%	4.04%	4.10%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	10	10	12	6
90	20	21	29	14
180	24	32	51	23
365	57	55	98	42

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

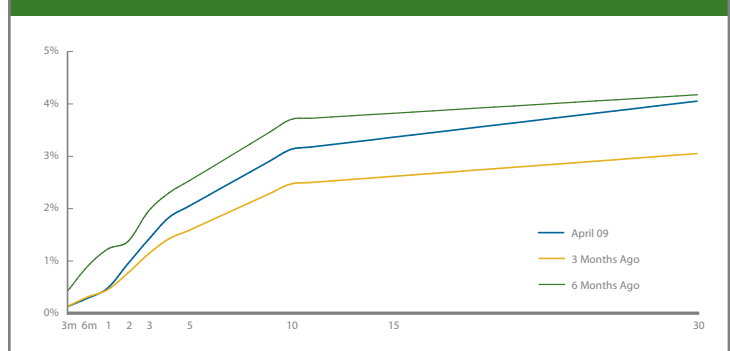
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE





A New “Outlook”

This month CoBank is pleased to introduce a new and improved Outlook publication for our customers. Outlook has been completely redesigned for electronic distribution. Each month, Outlook will continue to provide valuable data on interest rates and economic indicators, along with commentary from leading economics experts around the world. If you or others at your organization would like to be added to our distribution list, please contact your CoBank relationship manager.

About CoBank

CoBank is a \$63 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation’s rural economy. Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore. For more information about CoBank, visit the bank’s web site at www.cobank.com.

This economic commentary is for general information only and does not necessarily reflect the opinion of CoBank. The information was obtained from sources that CoBank believes to be reliable but is not intended to provide specific advice.

CoBank Shareholders Approve Voting Rights Proposal

In March, CoBank Class E shareholders approved an amendment to the bank’s bylaws that extends voting rights to qualified, directly eligible, non-cooperative borrowers.

The measure was approved by 86 percent of ballots cast on an equity-weighted basis and 83 percent on a one-stockholder-one-vote basis. The proposal expands CoBank’s pool of voting customer-owners by approximately 30 percent.

“We are pleased that our Class E shareholders supported this proposal,” said Everett Dobrinski, chairman of the CoBank board of directors.

“Our board believes the amendment creates a stronger and more equitable governance structure that recognizes the contributions of our eligible, non-cooperative borrowers. We believe this best serves the long-term interest of CoBank and its stockholders.”

Previously, voting rights at CoBank were limited by federal law to entities organized on a cooperative basis. The 2008 Farm Bill, however, included provisions specifically allowing CoBank to extend voting rights to its base of directly eligible borrowers that are not cooperatives.

The CoBank board of directors approved the proposed bylaw change in December, and the measure was submitted to Class E shareholders in early January. The Class E shareholder group primarily is comprised of directly-eligible borrowers organized as cooperatives.

As a result of the election, all existing common equity was converted into one new class of common equity for the bank as of April 1, 2009.

CoBank Products and Services

- Tailored loan programs with short-, intermediate- and long-term maturities
- Cash management services
- Leasing through Farm Credit Leasing
- International banking services
- Loan participations and syndications
- Letters of credit
- Interest rate risk management services
- CoLink® online financial solutions
- Equity partnerships
- Private placements
- Tax-exempt bonds