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China's Negative Economic Outlook

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Certain recent developments in conjunction with prevailing global economic trends appear sufficiently serious to warrant a current economic assessment of the People's Republic of China [PRC] and a review of China's sovereign credit risk.

U.S. ECONOMIC TRENDS

The U.S. economy is experiencing a significant contraction as U.S. consumer spending continues to decline. Housing prices have plummeted as the rate of both residential and commercial mortgage delinquencies continues to increase. At the end of the first quarter of this year, nearly nine million borrowers held mortgages exceeding the value of their homes, and this number is expected to increase significantly. The U.S. economy shed 80,000 jobs in March according to the U.S. Department of Labor, the largest loss in five years. Average U.S. household debt is 85% higher than in 2001, and continues to increase as consumers take on greater levels of debt in response to rising commodity prices, particularly food and energy costs. Delinquency and default rates for credit card debt, automobile loans and student loans continue to rise rapidly, as delinquencies have increased from less than \$300 billion in 2005, to \$715 billion in 2008; representing an increase of nearly 150% within 36 months. The present economic stress will likely be compounded by an expected record number of bank failures. U.S. consumer spending is predicted to continue to decline as consumers experience increasing commodity price inflation and credit contraction.

In a report dated May 19th, Oppenheimer analyst Meredith Whitney The real harrowing days of the credit crisis are still ahead of

us and will prove more widespread in effect than anything yet seen. Just as strained liquidity pushed so many small and mid-

sized specialty finance companies to the brink, we believe it

will do the same to the U.S. consumer. We believe losses will

only accelerate further and far worse than the most draconian estimates. Ms. Whitney also estimates about \$2 trillion of credit card lines will be removed by 2010, cutting the credit available to U.S. consumers by

nearly half. CHINA'S ECONOMY DEPENDENT ON U.S. CONSUMER SPENDING

The significance of the negative short- and mid-term U.S. economic

anticipated to produce severe structural pressures on China's export-

outlook is especially troubling to China's export sector, which is the primary hard currency earnings producer for the Chinese government. As U.S. consumer spending continues to retreat, the economic effect is

driven domestic economy due to significantly decreasing external

PERVASIVE INFLATION IN CHINA'S DOMESTIC MARKET China's economy continues to experience pervasive inflation which is particularly manifest in such consumer sensitive sectors as energy (e.g., petroleum prices which have more than doubled over the past twelve months) and food staples (e.g., the price of food, which increased 23% just during the month of February). Chinese consumers have benefitted from the state control of energy prices, which has also resulted in the loss of over 50% of the value of Sinopec shares within the last six months as the government continues it attempt to control fuel costs for consumers. Such trends are unsustainable for a country with a population in excess of 1.3 billion and which imports approximately 78% of its petroleum. Data published by the U.S. Energy Information

majority of the total global increase in demand. With increasing demand and relatively flat domestic production since 1986, China's reliance on petroleum imports is expected to continue, subjecting the government to additional economic stress. In its semi-annual Economic Outlook published this month, the Parisbased Organisation for Economic Co-operation and Development [OECD] pressures manifest in China's domestic market. China's consumer price index was officially reported at 7.7% in May and 8.5% during April, and

Administration indicates that China's increase in oil demand represents a

remains above its January level of 7.1%. Taking into account China's industrial consumption of commodities and that China produces very few commodities domestically and is therefore reliant on global sourcing at prevailing prices to procure raw materials for its manufacturing industry, the OECD expects wage and price inflation to erode China's export competitiveness. The OECD report states:

Coupled with ongoing weakness in external demand, exports and the pace of market share gains are projected to slow

markedly. Such an outcome raises the risk of political instability resulting from increases in urban unemployment and other factors as discussed in this

ACTION

The following trends and events are identified as material to an assessment of China's near- and mid-term economic outlook: 1. The extent of dependency of the Chinese government on hard

largely by U.S. consumer spending. 2. The depth of the retreat in U.S. consumer spending and the high probability of a prolonged contraction of the U.S. economy.

currency earnings derived from manufactured exports supported

- 3. The fundamental dynamics responsible for China's domestic wage and price inflation and the increased risk of political instability attributable
- to the rising cost of imported consumer and industrial commodities, reduced demand for export products, and a significant increase in urban unemployment. 4. The rate of increase of China's petroleum consumption and the dependency of China's export manufacturing sector on petroleum
- 5. China's ability to maintain the global competitiveness of Chinese manufactured goods in the face of rapidly increasing transportation
- on debt financing, particularly short-term debt, to sustain economic 7. Repudiation by the Government of China of \$260 billion of its sovereign debt and the pending reclassification of the Chinese

6. Government debt statistics evidencing an unsustainable overreliance

government's sovereign credit rating into 'Selective Default'. Upon an evaluation of the foregoing, Sovereign Advisers issues a Negative Outlook for the domestic economic prospects of the People's Republic of China and a Negative Outlook for the safety and

performance of government bonds issued by the People's Republic of

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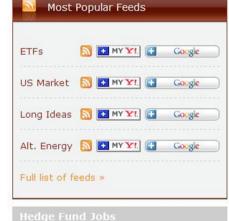
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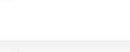
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