

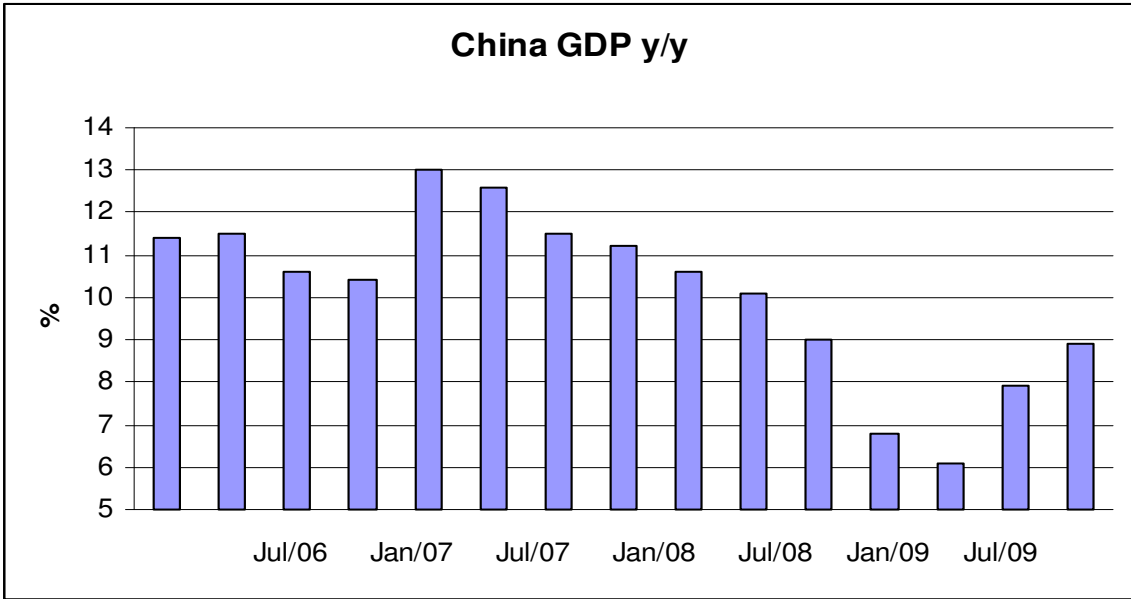
Will China begin to withdraw stimulus?

Last week China reported that the economy expanded at its fastest pace in a year with Q3 GDP at 8.9%. China reported a sharp rise in September industrial output and retail sales as well. Industrial output rose 13.9% and retail sales rose 16%. The rapid rise in China's growth reflects the impact of record fiscal and monetary stimulus implemented by the Chinese government and central bank to boost growth. China announced a \$585 bln stimulus package in April and the central bank expanded bank lending by over \$1.27 trln in the first nine months of 2009. The strength of China's recovery has sparked concern that China's economy may be overheating. A debate is emerging over whether China will begin to withdraw fiscal and monetary stimulus to avoid overheating of the economy and the creation of an asset bubble in China.

China has lead the global recovery and it will be key for the Chinese and global economy that China withdraws stimulus without triggering a significant slowdown in growth. The government and central banks of the major industrialized nations closely coordinated the expansion of fiscal and monetary policies which helped to set the stage for the global recovery but there appears to be no similar coordination for an exit strategy from stimulus. This lack of coordinated exit strategy is a major risk to the global recovery should some nations like China begin to exit too soon. Last week China's PM Wen warned that if China removes fiscal and monetary stimulus too soon previous efforts to boost growth will be wasted and the recovery could be dealt a setback. At some point China will have to reduce fiscal and monetary stimulus. The major fear is the global economy may slip back into recession when stimulus measures are removed.

Chinese interest rates were higher Monday as speculation grows that China is preparing to shift to a tightening of fiscal and monetary policy. Monday, China's Vice Premier Li said that China's economy is growing firmly. He also said that China will stick to active fiscal policy and maintain loose monetary policy. His comments helped to fuel Monday's early equity market rally and weaker USD as China is not yet ready to pull the plug. US equities reversed early gains pressured by report of seven more US bank failures and a downgrade of several major US banks. Continued US bank troubles may add to USD reserve diversification speculation and delay US exit strategy from stimulus. A researcher at China central bank recommends that China increase its reserve holdings of EUR and JPY. The Chinese government tried to cool USD reserve diversification issuing a statement that reserve diversification is a long term goal and should not contribute to short term volatility.

Massive fiscal and monetary stimulus have stabilized the global economy and set the stage for a rebound in growth into the end of 2009 and in 2010. Once the stimulus fades it is unclear if the recovery can be sustained. Growth in China will be key to the sustainability of the recovery. China is expected to begin to hike rates in Q1 2010 and reduce its loan target for 2010. A drop in China's loan growth sent global equities tumbling in July. There are a number of articles in the weekend press warning that the current global equity market rally appears to be tiring. The timing of when and how China withdraws stimulus will be a key driver for the global markets and whether optimism about the global recovery is sustained. When stimulus is removed, slow global growth may be the best that can be expected.



By Michael J. Malpede,

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