China in Zugzwang: Part 2

Note: Zugzwang is a condition in which a chess player has a solid position; but, once he or she makes the next move, the consequence is a lost position. Part 1 of this article was published in the March 2017 issue.

Mercantilism works. It was highly successful for the British in the 1800s, the U.S. in the early 1900s, the Japanese after World War II until the 1985 Plaza Accord, discussed later, and China since the 1990s.

Mercantilism and protectionism are joined at the hip. Currently, the world seems to be drifting, perhaps rapidly because of the heavy tide, toward protectionism. One reason is slow global growth, which means that job creation is not sizable to begin with. The second reason, to make matters even worse, is that machines are now replacing workers the world over to an alarming extent. An economy may need to grow 2–3% on a GDP basis just to sustain manufacturing employment in the country. Since 1995, manufacturing employment in the United States is down to 12 million from 15 million; yet, current dollar GDP is up 2.5 times.

WSD sees strong parallels between the Japanese currency and trade balance situation in the mid-1980s and the current Chinese situation. In 1985 and earlier years, Japan was enjoying a massive trade surplus in manufactured goods with the United States and other developed countries. And, because it was pegged — some say manipulated — the Japanese yen had been fairly flat versus the U.S. dollar for more than a decade, which angered the policymakers in the advanced world because their countries were suffering an ever-widening trade deficit with Japan. The advanced countries’ solution, which was unfavorable for the Japanese, was worked out in the “Plaza Accord.” During a meeting at the Plaza Hotel in New York on 22 September 1985, the governments of France, West Germany, the United States and the United Kingdom threatened the Japanese

Authors

Peter Marcus (left)
managing partner,
World Steel Dynamics pmarcus@worldsteeldynamics.com
+1.201.503.0902

John Villa (right)
research strategist,
World Steel Dynamics jvilla@worldsteeldynamics.com
+1.201.503.0911

Figure 1

with sanctions unless they agreed to strengthen their currency. The Japanese acquiesced and, within six months, their currency had strengthened substantially. By 1990, Japan’s GDP growth had fallen back to about 2% per annum from 4% per annum, or more, for the most of the prior 20 years. The Japanese “party” was over.

Regarding the Chinese situation at present, Chinese exports to the U.S. in 2016 were about US$450 billion, with the U.S.'s exports to China at about US$120 billion. Hence, if President Trump is successful in imposing import controls/tariffs on selected Chinese good, he holds the trump card because the massive net trade balances in China’s favor.

Here are some challenges Chinese economic policymakers are facing at the present time:

1. A possible further sizable deterioration in the value of the RMB versus the U.S. dollar because its exports of manufacturing goods are lagging. It is perceived that Chinese manufacturers have lost much of their international competitive advantage because of: (a) sharply rising labor costs; and (b) the advance of technology that permits new factories to be built around the world requiring very few man-hours to make the product. Chinese workers’ wages rose 10–15% per year from 2000 to 2015 — although, the direct take-home wage increase in 2016 may drop to only about 5%.

2. A major flight of capital from China, with the net amount at US$300 billion in 2016 when considering the country’s currency reserves. The net capital outflow might rise to US$50 billion monthly, especially now that interest rates are rising in the United States and USA treasury securities are considered by many to be the best “safe haven.” China’s current currency reserves in December 2016 were about US$3.0 trillion versus US$3.3 trillion 12 months earlier.

3. The sizable rise in workers’ “social benefits” in the years ahead. While the pace of direct wage increases is slowing, the cost for Chinese worker health care and retirement benefits is surging. Social costs may now amount to about 25–30% of a worker’s annual employment cost. Even granted that the direct wage increases slow to 5% per annum from 2016 to 2025, the non-wage social benefits may rise by 15% per annum. Hence, by 2025 social benefits may rise to 51% of the workers’ total compensation — with the combined pace of wage and social benefit increases at 8.9% per annum in the next decade.

4. The Chinese have become an “international scapegoat.” Almost no matter what the problem (this is an exaggeration), the Chinese are now being blamed for it. Chinese bashing helps non-Chinese CEOs the world over to divert attention from real problems; and, it aids politicians searching for votes.

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