THE U.S. vs CHINA. THE CASE OF THE TWO STUMBLING ECONOMIES.

It is clear that U.S. foreign policy has been blown of course forcing the U.S. to backtrack. However, in the end the conflict between these two super-powers will not be resolved by diplomatic means but by economic muscle, in other words politically.

Are we witnessing the U.S. making political concessions, are we seeing the neo-cons sobering up, and after 300 wars since 1945, are we seeing the State Department abandoning the Wolfowitz Doctrine intended to reshape the world after the collapse of the Soviet Union. Here is a useful summary: *The Wolfowitz Doctrine, named after then U.S. under-secretary of defense Paul Wolfowitz, was leaked to The New York Times in 1992. The crux of the policy underscored American supremacy at all costs in a post-Soviet world and "**stamping out rivals wherever they may emerge**." In addition, U.S. leadership would place defense agreements as the cornerstone of its policy and inadvertently monopolize the global arms trade through treaties. Furthermore, it would prevent allies from developing their defense systems and increase reliance on American-manufactured hardware. Finally, interoperability formed the basis for amalgamating competing factions within NATO.* (my emphasis)

The Whitehouse has backtracked from promising Ukraine a direct path to NATO membership having initially agreed to remove the Member Action Plan threshold to joining. That is now reinstated. The Pentagon knows that the Ukrainian 'offensive' was always going to be a bloody propaganda stunt. They also know that if the U.S. perseveres with their NATO promises, the savaged Ukrainian army will be in no position to stop the Russian marching up to the Polish border.

Both Russia and NATO are desperately seeking to avoid a European war in which NATO intervenes in the Ukraine. Such an escalation would make a World War fought with nuclear weapons inevitable. Both sides know this. For its part Russia has always categorized its offensive as a *Special Military Operation* and not a full scale military invasion. Clearly whatever it called its military operation it structured the opening attack all wrong. It should have gone straight for the Donbass borders to secure them splitting the Ukrainian army into two and trapping half of it within these borders. It should never have gone into Western Ukraine, especially surrounding Kiev, and it should never have destroyed non-military infrastructure in Western Ukraine later. Obviously, it thought its initial show of force together with prodding by the Israelis who had seen Russia in action in Syria, would be sufficient to force Zelensky to the negotiating table in Turkey. It did, but this was never going to succeed. The biggest mistake Putin ever made was to under-estimate the U.S. resolve to block any peace deal, because though he is a hundred times more astute than the average western politician, he did not appreciate the enormity of what the U.S. was seeking to achieve, that is to preserve its hegemony in the face of a rising China.

For its part, the U.S. believed that 7 years of preparation and the promise of unlimited weaponry would be sufficient to bog down and demoralize the Russian army. Had that happened, many economies including China who are trading Russian goods, would have thought twice, making the economic sanctions bullet proof. Thus, as far as the Whitehouse and Whitehall were concerned this was always going to be proxy war, one they believed had the likelihood of leading to regime change in Moscow, hence the deluge of newspaper headlines, continuing to this day, proclaiming an escalating civil war within the corridors of the Kremlin. But in the end the war in Ukraine weakened western imperialism rather than Russia. The clue is within the words. Whenever Zelensky uses the words, *the going is tough*, this is code for an impending

defeat. He used the same terminology towards the end of the battle for Bakhmut and he is using the same words now to describe the current offensive.

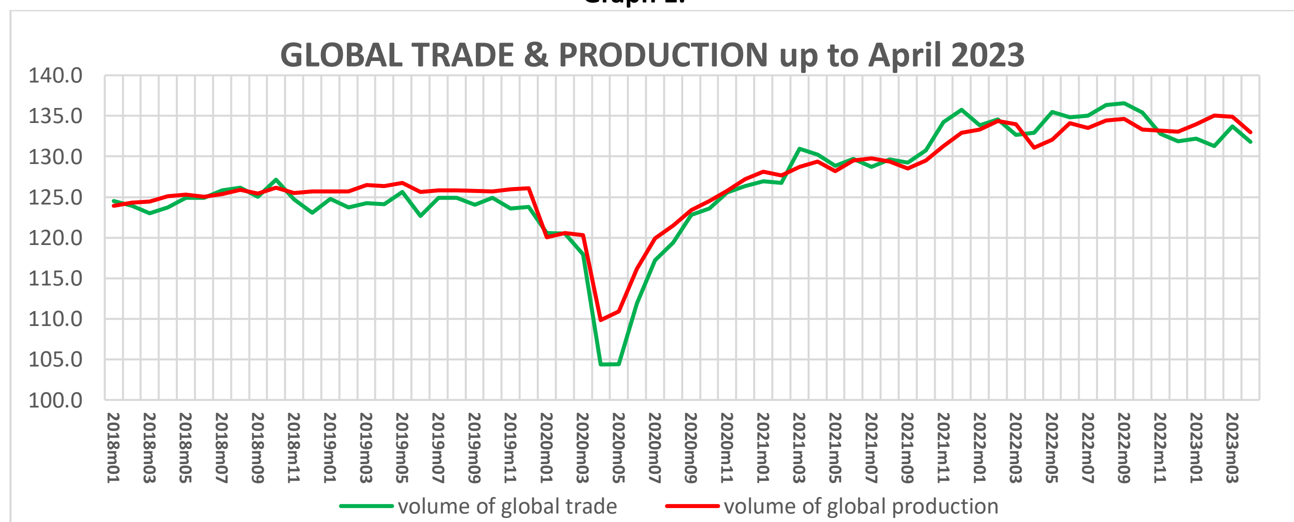
This setback has resonated across the Pacific. Oftentimes it appeared that Biden was unable to remember which way was off the stage following his public appearances, similarly he appeared to forget which way the position on Taiwan went. Following Blinken's recent trip to China, the State Department has updated and reaffirmed its position on Taiwan. "*We oppose any unilateral changes to the status quo from either side; we do not support Taiwan independence; and we expect cross-Strait differences to be resolved by peaceful means,*". As the article from SouthFront goes on to say, if Taiwan is not an independent state, which means the U.S. recognizes Beijing's *One China Policy* then the Taiwanese Strait is off limits to the U.S. Navy. Knowing full well that actions count more than diplomatic words, Beijing refused to entertain Blinken's request to re-establish military backchannels as a means to deconflict any crisis. No doubt Beijing is smarting at the escalating and provocative military encirclement of China by the U.S. military which makes any talk of *military defusing* a nonsense.

Once again Blinken emphasized that the U.S. was seeking to *derisk* not *decouple* its economy from that of China. This is just misdirection, what the U.S. is seeking to do is to behead the Chinese economy by garroting its high tech industries which will soon extend to embargoing jet engines to China's first airliner, the C19. However, in the end it will be economics which takes the helm. The capitalists are at peace only when the profit pie expands fast enough to grow big enough slices. When the pie gets smaller, that is to say when the global economy is becoming constrictive, when losses are replacing profits, then war follows as national capitals seek to preserve their capital by forcing any losses on to competing capitals.

The World Trade Monitor.

The CPB World Trade Monitor was released on Friday. It reveals that the uptick in March as a result of China's reopening was reversed in April. As a result, on an annual basis, quarterly global trade volumes did not grow and fell by 1.4% month on month while industrial production also fell by 1.4%. The falls would have been greater were it not for base effects, given that April 2022 was weak. As it happens, trade volumes have fallen by 5% from their September peak whereas production has fallen marginally. Thus the first quarter of 2023 cannot be classified as an industrial recession despite the sharp fall in global trade.

Graph 1.



Alongside CPB data it is worth examining the S&P flash global PMIs for May. The flash US PMI showed industrial weakness in the USA gathering pace falling from 48.4 in April to 46.3 in May. In China the manufacturing PMI rose to its highest point for five months though at 50.9 it was barely positive. This correlates to the growth in manufacturing as reported by the Chinese Statistical Bureau reported later in this article.

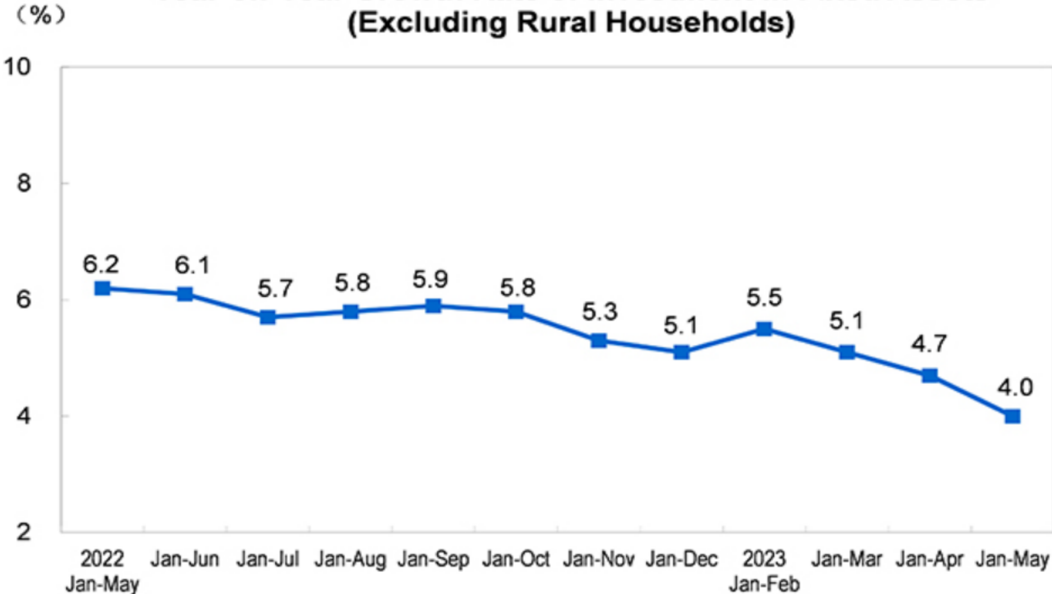
Industrial production also fell in Europe. HCOB Flash Eurozone Manufacturing PMI fell to 43.6 an 8-month low. Globally the manufacturing PMI remained marginally in contraction at 49.6, unchanged for the month. The number of countries in below 50 vastly outnumbered those above 50.

Industrial production in what has become the world's biggest sector, electronics, continued to deteriorate. Electronics sector conditions worsen to greatest extent for nearly three years. The global index fell from 48.2 in April to 47.9 in May. So no revival yet as orders continued to fall despite all those expensive chips destined for use in Cloud Computing and A.I.

Examining the two economies side by side.

In this section I have placed graphs for both China and the USA below each other for comparison purposes. In many ways graphs are self-explanatory. I would have liked to have included the *complex rate of return* for China, but the data on profits is only released next week. However I do not expect an improvement on the recent dismal performance of Chinese profitability. The uptick found in March, given the weakness of the data below, is likely to have been reversed. Things are a little better in the USA. Though the rate of profit in the USA fell in Q1 2023 it still has not returned back to its 2019 level. However, the outlook is for a continuation in the fall in the rate of profit. FactSet has revised down its earnings forecast for Q2 2023 to minus 6.4% from minus 4.8%. Thus in both countries a *crisis of profitability* has emerged. And it is unlikely that generative computing models such as CHATGPT will rise to the rescue in time.

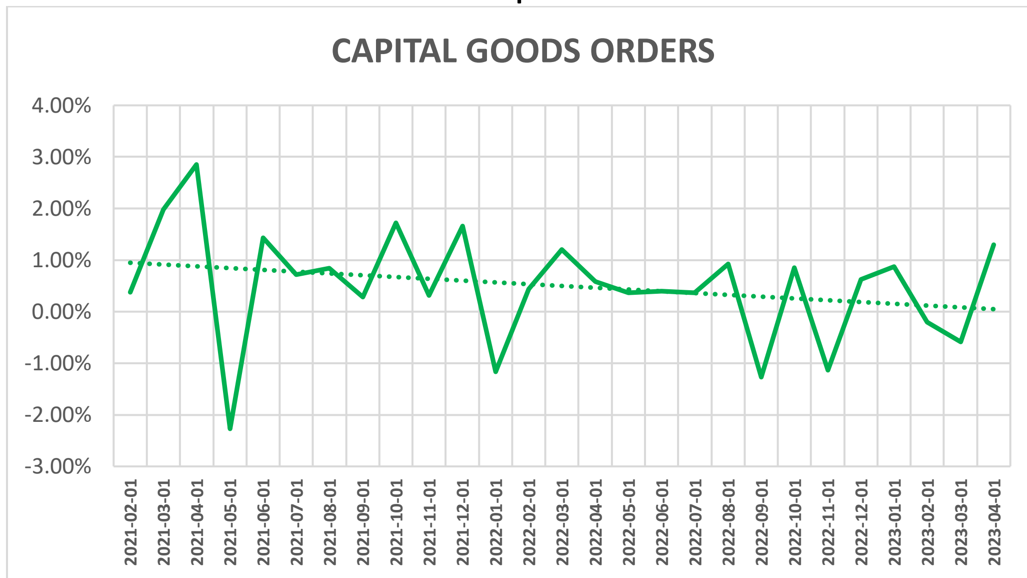
Graph 2.



(Source: National Bureau of Statistics of China)

Of which: State-owned and state holding 8.4% Of which: ***Private investment -0.1*** *Secondary industry, of which manufacturing is the biggest part rose by 8%,* but the tertiary sector in which real estate is found rose by only 2% despite the 7.5% boost from infrastructural spending. Within manufacturing the higher tech element including automobiles at 17.9%, did much better. Indeed, in its commentaries the statistical bureau notes the improvement in high end and high tech products compared to the rest of industry.

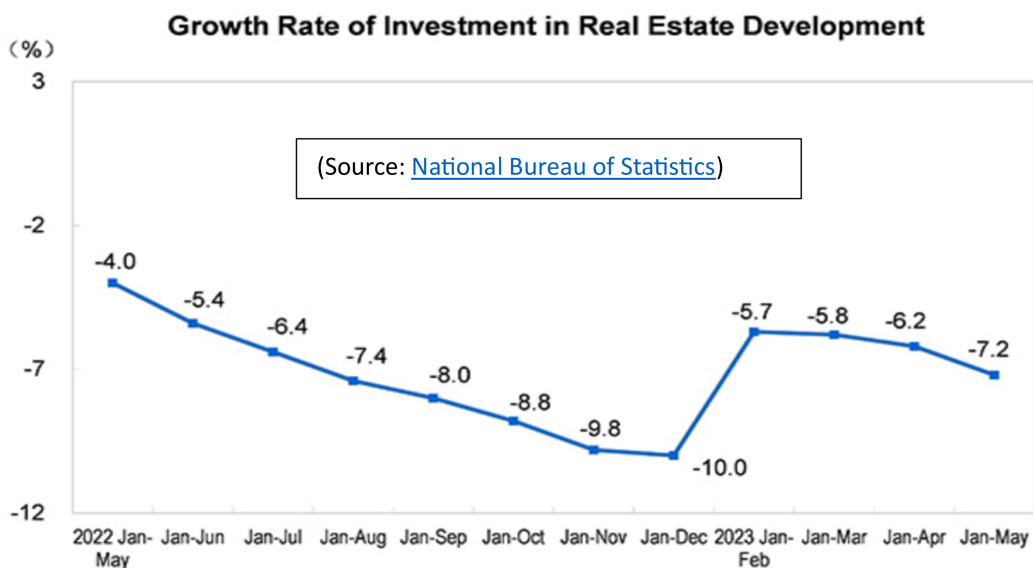
Graph 3.



(Source: FRED Table NEWORDER)

The same weakening trend in investment is found in the USA despite the inducements found in Biden's CHIP and Inflation Reduction Act (!) as well as state subsidies. The monthly growth rate in new orders has been 0.21% yielding an annual growth rate of 2.5% or below that found in China especially when higher US inflation is factored in to yield volume growth. Despite inflation the trend is moving towards 0%.

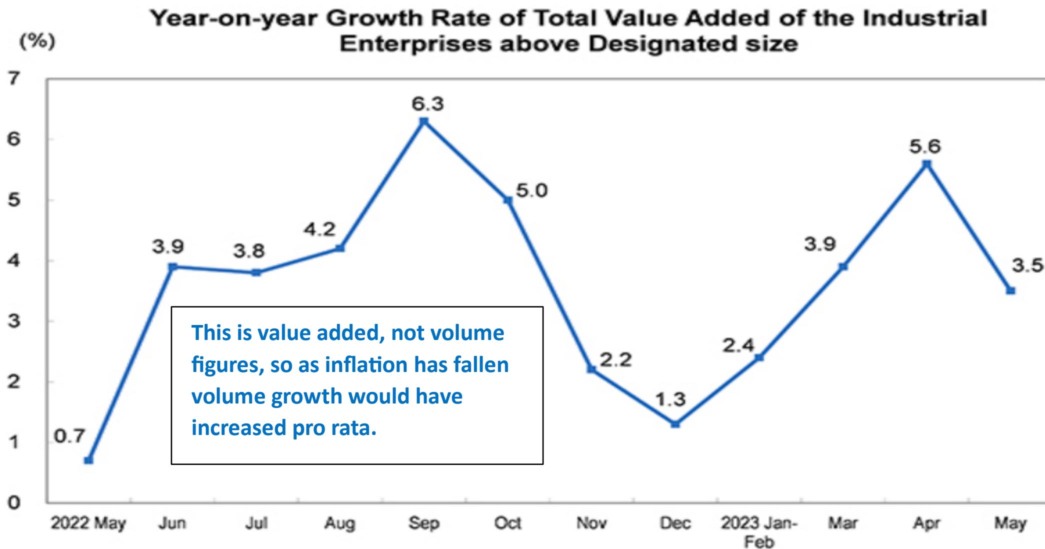
Graph 4.



"From January to May, floor space of commercial buildings sold was 464.4 million square meters, a year-on-year decrease of 0.9 percent, of which the floor space of residential buildings sold increased by 2.3 percent. The sales of commercial buildings was 4,978.7 billion yuan, up 8.4 percent, of which the sales of residential buildings increased by 11.9 percent." Thus, there were significant price rises in this sector amounting to 9.1% for non-residential and 8.6% for non-residential. Given the overall inflation picture as well as the surplus space available for sale, this seems to be excessive. *"At the end of May, the floor space of the commercial buildings for sale was 641.2 million square meters, a year-on-year increase of 15.7 percent. Among them, the floor space of the residential buildings for sale increased by 15.9 percent."*

There is no equivalent monthly data for U.S. residential investment.

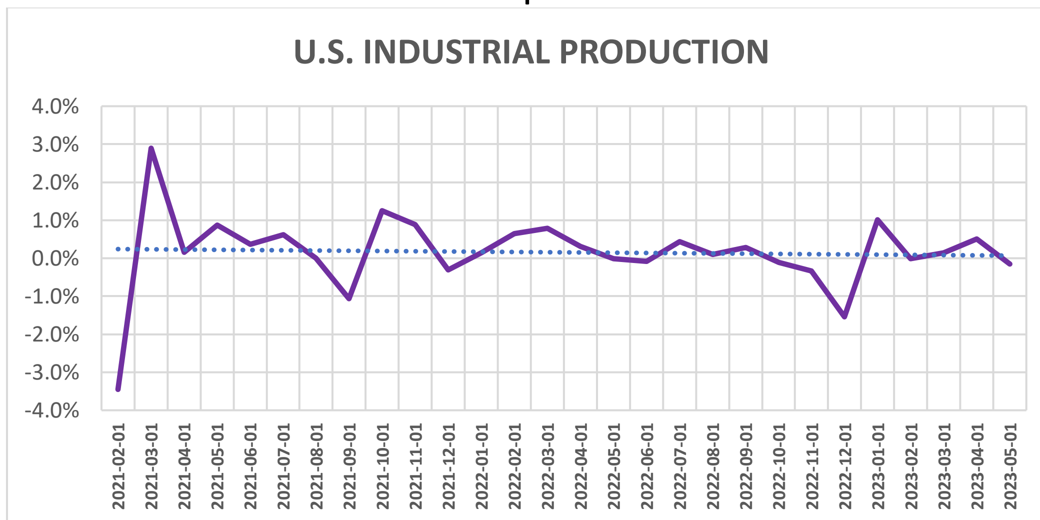
Graph 5.



Source: National Bureau of Statistics of China)

Chinese manufacturing growth for January to May was 4.0% yoy and 4.1% for May on its own.

Graph 6.



(Source: FRED Table INDPRO)

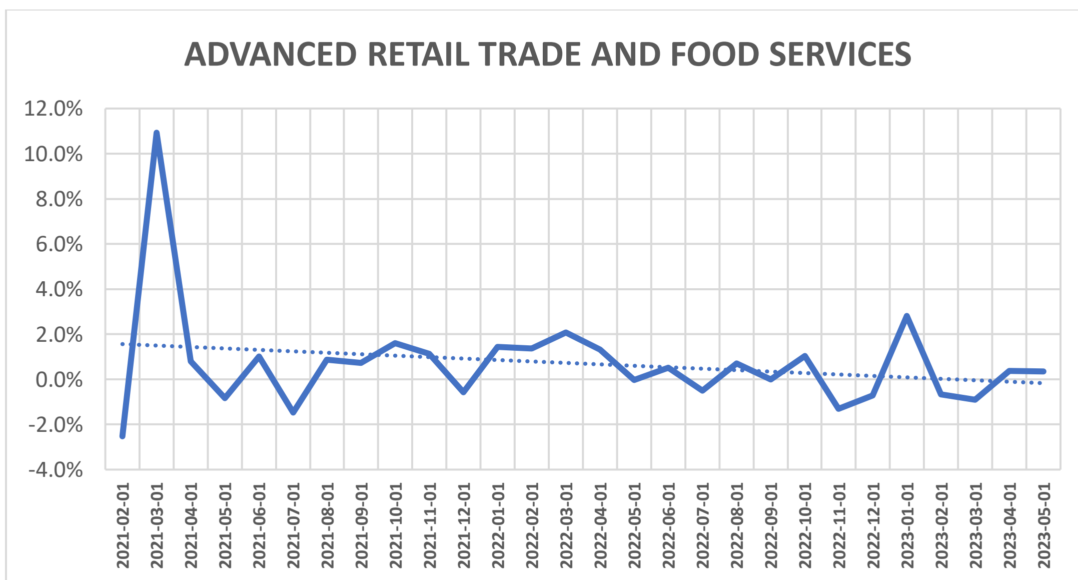
Industrial production within the USA, despite the various Federal and State subsidies to foster reshoring, has had little or no impact on production, certainly no renaissance in the figures.

Graph 7.

(Source: National Bureau of Statistics of China)

The rise in sales, flattered by base effects (lockdowns last year), came in lower than expected despite expanding by 8% month on month. The sales of motor vehicles rose 8.9%, which was positive while building and decoration materials fell 6.6% indicating weakness in the real estate sector.

Graph 8.

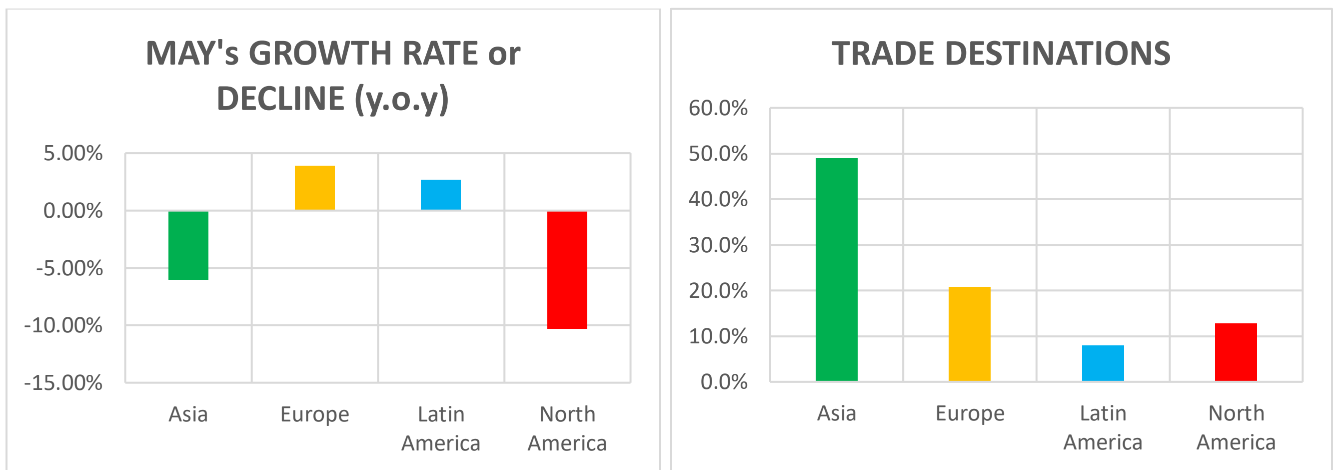


(Source: FRED Table RSAFS)

Despite the unusual spike in U.S. sales in January of all months, nominal retail sales have been flatlining for quite some time despite significant inflation. Year over year growth in May was 1.1% compared to the RPI of 1.1% and the CPI of 4%. In common with China, food services grew much faster than retail although it is much more difficult to measure food services output.

Finally Chinese exports. In the CPB data we saw growing weakness in global trade. This weakness was driven by the weakness in Chinese exports. Total exports were down 7.5% measured in Dollars with imports down 4.5% (Source: General Administration of Customs of China) In the two graphs below there is an analysis of the breakdown in Chinese Trade provided by GACC. We note the decline in trade with both Asia and North America. This is significant because the Chinese government has prioritized Asia to compensate for the fall in exports to the USA.

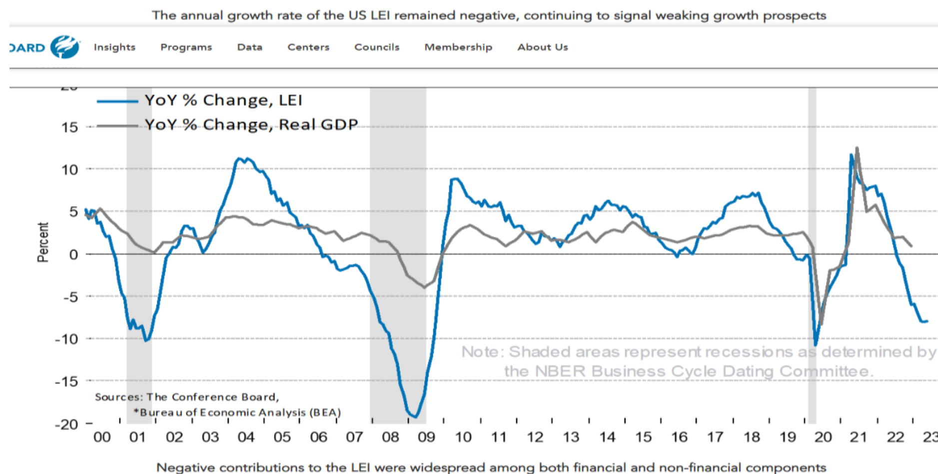
Graph 9A & 9B.



Forward looking indicators.

As there are few indicators for China for May, I will focus on the USA. Below are two graphs prepared by the Conference Board and the Chicago FED. The first comprising leading indicators portends recession, while the latter shows economic activity has stalled.

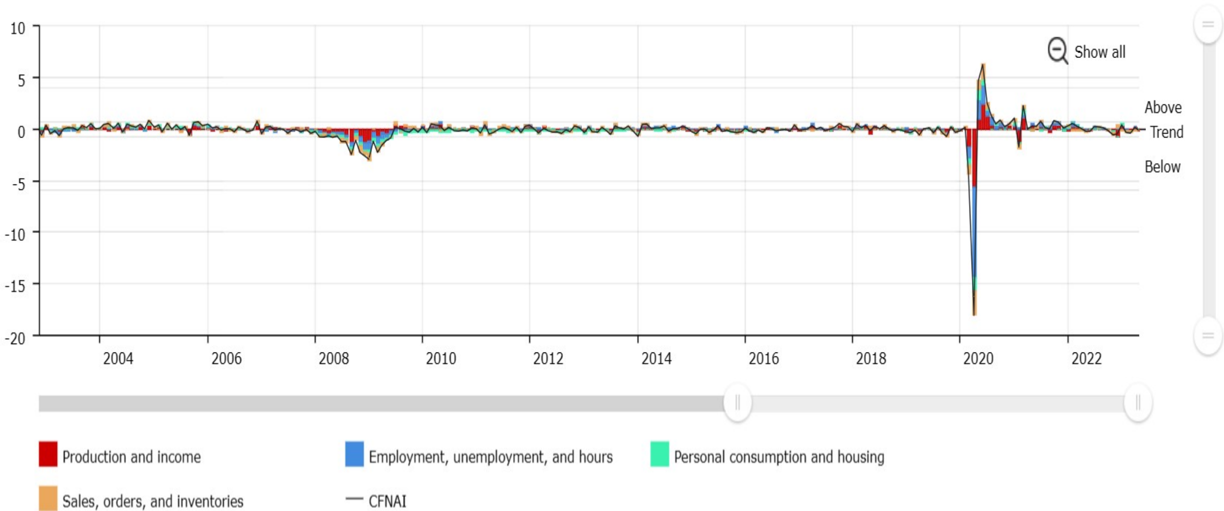
Graph 10.



(Source: Conference Board)

"The Conference Board Leading Economic Index® (LEI) for the U.S. declined by 0.7 percent in May 2023 to 106.7 (2016=100), following a decline of 0.6 percent in April. The LEI is down 4.3 percent over the six-month period between November 2022 and May 2023—a steeper rate of decline than its 3.8 percent contraction over the previous. six months from May to November 2022." To which such falls over what is now an extended period are usually associated with recessions.

Graph 11.



"*The Chicago Fed National Activity Index (CFNAI) was –0.15 in May, down from +0.14 in April."* The index showed that all the advances in April were reversed in May. Therefore in sum, current and leading indicators for U.S. show contraction. This is the pattern seen in most countries.

Summing up.

Superficially things seem to be going in favour of the U.S.A. in its economic war with China. Its share markets are up in the trillions of dollars although the gains are narrowly focused, while Chinese share markets are bearing losses in the hundreds of billions. And whereas the FED it is tightening up on monetary policy to reign in the economy, the PBOC (Peoples Bank of China) is being forced to loosen policy in order to stimulate the economy. And it appears that unlike the U.S.A., China is experiencing an unemployment problem for the first time.

Much of this inversion is due to the investor love affair with anything A.I. However, the first inkling that all is not well with A.I. is being recognised. Firstly, companies such as *OpenAI* are seen to be struggling with monetizing CHAT. Secondly, even the likes of Google and Microsoft are spending far more on 'A.I.' than they are recouping. Thirdly, the owners of the source material on which the generative models are trained such as the media are now demanding payment for the use of their data. Fourthly, the legality of moving the onus of liability away from the producers of these systems and onto the users is being questioned. Fifthly, the difficulty of removing the errors and biases built into learning models at source has belatedly been acknowledged.

In sum, the companies being chased by investors on Wall Street, with the exception of the chip manufacturers themselves, are adding workers not losing workers. The real benefit to capitalism will only come when these systems start culling workers. Thus the companies that will increase their profits are those who adopt and adapt these learning systems to their own needs. The threat to workers does not come from the titillating open source and general CHATGPT programs but from the proprietary systems used by the corporations to replace workers. For example Maersk the shipping giant has produced its own generative system to streamline its shipping functions taking over human functions. This kind of development is yet to be recognised by Wall Street who in many ways are chasing the wrong targets, the providers, making the current Tech Bubble, well yet another bubble. In other words the companies being neglected currently, whose share prices are in decline, that is the majority of companies, will in the end be the winners as they fire whole layers of workers, unless of course this software revolution provokes an actual revolution.

But all this is in the future. With El Nino strengthening by the day, with the US wheat, corn and soyabean wilting on the stalk, with sweat rising and productivity drooping, both economies are stumbling. I have presented a whole series of graphs to show both economies are drifting towards stagnation and beyond. Clearly both are being hurt by the cleaving of the global market into two. In the end the disruption to global supply chains and the subsequent loss of least cost options, economies of scale and standardization is likely to cost capitalism more than the revolution in work practices these generative models potentiate.

The economic conflict between the USA and China with all the collateral fallout could not have come at a worse time for both economies, but that is capitalism for you, they only fight in the bad times aggravating matters. And now they are doing it in the middle of a climate catastrophe with Beijing recording its hottest June day since records began while the Mississippi river in the US will reach low status in the next week or so unless there is heavy rainfall in its catchment area. Like two boxers with glass jaws they face each other with deceptive fists even as the ring and its ropes starts enveloping them.

Brian Green, 23rd June 2023.