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China – The 21st Century Economic Hegemon?

Much has been written about China, some of it in a number of these letters. The effects of China's steel industry on world prices for production inputs and on trade in steel products have been very sizable. No wonder, then, that many view China as a behemoth whose every move has serious repercussions for American producers and users alike. Of course, steel is not the only sector where China has become critical to the world's markets. Reinforcing the impression of China's economic clout are the enormous reserves of foreign currencies held by the Chinese, principally in U.S. dollar obligations.

Notwithstanding that evidence, recent observations by MIT economist Lester Thurow throw some new light on claims that China will be the world's economic hegemon in the 21st Century. Thurow notes that China's claimed 10 to 11% growth rate is implausible:

- China admits that the 70% of its economy based in rural areas is not growing at all; therefore, achieving a 10% overall growth rate would mean that the cities are growing at a 33% rate. There is no evidence for that kind of urban economic growth.
- Hong Kong had decline in its gross domestic product in 2001; China claimed that the adjacent Guangdong province had growth of 10% in GDP for the same year. Very unlikely.
- Electricity consumption is a good indicator of economic growth, and it normally outstrips increases in GDP. The world's 12 fastest growing economies increased their GDP only 45% of their increased consumption of electricity over the last 10 years. Since China's use of electricity has been increasing at 10%, it is unlikely that their GDP has been growing more than 4.5 to 6% per year.

Looking at China's claim that it will become the world's largest economy well before this century is over, Thurow has a good deal of skepticism. Positing inflation adjusted growth rates of 3% for the U.S. (its average for the last 15 years) and 4% for China (which would be the highest in history over a 100 year period), per capita GDP in 2100 would be about \$45,000 in China and \$650,000 in the U.S. These are admittedly ballpark figures, but they show how unlikely it is that China will outstrip the U.S.

Thurow does not discuss the future of a very important part of China's economy – its export trade. We have talked about the vast increases in their exports of steel and steel containing products, but it is unlikely that those growth rates can be maintained, if only because importing countries are unlikely to permit their steel industries to fail under onslaughts from Chinese imports. The same can be said for other industry sectors where the Chinese have focused their efforts. Even the U.S., which has resisted effective action, may join other countries that have imposed limits on unfairly traded Chinese imports.

The Chinese are also under a good deal of pressure to revalue their currency, and there are some signs that those efforts will, over time, result in significant changes. Thus, Chinese exports are not likely indefinitely to enjoy the pricing advantages they now have. Finally, we are seeing mounting troubles for Chinese producers, particularly with the safety of their products. We may be close to widespread consumer rejection of the "Made in China" label, as, almost weekly, additional products are called into question.

In the 1970s and 1980s, America had a fixation on the economic successes of Japan. We were in awe of Japanese manufacturing techniques that seemed to produce an endless stream of high quality, low cost products, and some foresaw the demise of America's economic leadership. Over time, we became aware that the Japanese economy had serious problems, like a calcified service sector and a vastly overvalued real estate base.

Like the Japan of that period, today's China has undeniable economic power and remarkable growth. But those facts should not tempt us into thinking that they will wrest world economic leadership from the U.S. or the EU for many, many years to come.

Turning to some specifics:

- Scrap and Iron Ore. Scrap prices have remained steady for three months now. Both #1 dealer bundles and #1 busheling (Chicago) stayed at \$298 per mt in August. The spot price for Brazilian pig iron (cif New Orleans) has also been very steady, returning to the \$375 per mt (from \$360) that had prevailed in March through June, 2007.

- Natural Gas. The Nymex contract price declined again this month, to \$6.10 per mcf – two dollars less than in June.
- Exchange Rates. Despite the concerns about credit here in the U.S., the dollar has actually strengthened from last month. At this writing, the euro is worth \$1.35, down three cents, the pound is at \$1.99, down five cents, and the Canadian dollar is at 94¢, down two cents.

We continue to welcome your thoughts and suggestions. We are posting this letter (and all the previous ones) on our website www.coreysteel.com and on the international site www.steelonthenet.com. Incidentally, we have entirely redesigned our website and invite you to look it over and give us your reaction.