CHINA AND HORSERACES

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By Rob Rikoon

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The U.S. has a symbiotic relationship with China. We need China to finance our debts and they need us to buy large amounts of their manufactured goods. We now owe roughly $17.8 trillion to our creditors and at some point in the not too distant future, we will need to pay a reasonable rate of interest in order to continue to attract the money necessary to service that debt.

If the average interest rate our government has to pay goes up to 5%, which is well below the average borrowing cost since 1980, our nation's total interest payments going out the door each year would equal the total gross receipts the IRS collects from all income taxes. Some economists believe that once interest payments on government debt go above 30% of tax revenue, either the local currency breaks down, interest rates rise to a level that crushes business activity or there is some kind of a default where repayment to creditors does not take place.

In the past, the U.S. was content to be a net importer from other countries because of the political influence it fostered. In Europe, after WWII, we strengthened our political alliances with nations with whom we traded at a deficit so that they would have a real incentive to remain in the fold of the U.S.'s military and markets' network.

China does not fit into our traditional strategy. Because of its extremely large size and the dominant role the government plays there, the Chinese government can essentially force a billion workers to save large portions of their income by funneling all domestic transactions through state-owned banks. This is how China has financed a terrific rate of expansion over the last decade, about 10% annually. In the US, 4% is seen as outstanding growth!

Chinese leaders have long discouraged their citizens to consume. The consumer base in China is about the same size as in France, who has roughly 1/20th of China's population. Therefore, China must export their manufactured goods in order to keep its factories churning, which in turn keeps its citizens employed. This kind of strategy works when there is an endless demand for exported goods, but as the recent global recession has shown, the U.S. no longer serves as an unlimited export market for Chinese companies. The Chinese system will, sooner rather than later, exhibit classic signs of instability. The best indicator of this is that the Chinese residential and commercial property market is greatly over inflated with prices pumped up sky high.

China therefore faces some hard choices. Since the Chinese export 36% of their gross national output, they can't afford to lose the USA as their biggest customer. They also cannot afford to let their currency appreciate as this would let their competitors in

Vietnam and other emerging Asian countries operate at an advantage. If rising U.S. protectionism takes the form of Congress trying to limit US market access for Chinese companies, then China will have to figure out how to keep its large population employed which is no small matter.

We are likely to see Chinese domestic consumption increase somewhat in areas like automobiles and consumer electronics. Watch for continued and successful efforts on the part of Chinese companies to garner control of much of the world's remaining natural resources. They face unique problems generated by their own success stories, which are, in many ways, the reverse images of our society. We are encouraged to spend and consume and the goal, at least as portrayed in our media, is to work as little as possible. The Chinese obsess about saving for the future, getting ahead by working harder and longer, and about obtaining a practical or technical education. This is the makings of a good horse race!

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