CHINA BITES BACK.

China US relations continue to deteriorate due to the escalating pressures the US is imposing on China. What is of interest is that for the first time Xi and his Foreign Minister declared this pressure and encirclement to be intolerable and for the US to step back. This article investigates this deteriorating relationship and the balance of forces.

"Western countries, led by the US, are implementing all-round containment, encirclement and suppression against us." These remarks were made by Xi and Qin Gang in and around the National People's Congress (NPC). For the first time Xi named the US as the chief instigator of this aggression towards China. His words were echoed and elaborated by his foreign minister Qin Gang who previously was considered a moderate having been China's ambassador to Washington. *"If the US doesn't hit the brakes and continues to barrel down the wrong track, no amount of guardrails can prevent the carriage from derailing and crashing, and there will surely be conflict and confrontation,"*

The most significant element of Qin Gang's remark is that he draws out the consequences of Washington's foreign and military policy towards China, that it will inevitably end in conflict. And the manner in which the remark was presented suggests there is a hidden element at play "*and we are ready for you*". The NPC rubber stamped a 7.2% rise in defence spending which is 50% higher than the expected growth rate for GDP of around 5%. In addition, of the 2,977 deputies who are attending China's legislative session, 281 are from the armed forces, the highest number who have attended the Two Sessions up to now.

So what was the US State Department response. It was the equivalent of: 'Me, you gotta be kidding me' or the equivalent of blaming the blowing up of the Nord Stream 2 pipeline on Russian and Ukrainian dissidents when it was caught out by investigative reporter Seymour Hersh's revelations. *"We have made it clear we do not seek to contain China or have a new Cold War," the U.S. State Department spokesperson said. The spokesperson pointed to Secretary of State Antony Blinken's comments last year that said the U.S. doesn't seek to stop China from growing its economy or "advancing the interests of its people." "He also said we do not want to sever China's economy from ours, though China is pursuing asymmetric decoupling," the spokesperson said."* There is only one thing worse than a bully, a dishonest bully who refuses to fez up. Could anything be further from the truth. They treat us for fools, or they simply don't care what we think. Arrogance mixed with contempt is a toxic brew.

Although China's military expenditure is about a third of the US defence budget a greater proportion of the Chinese Budget is spend on arms and soldiers rather than on benefits and pensions. Thus the figure of 1:3 is misleading regarding actual military assets and their respective accumulations. In addition, both expenditures are measured in Dollars which tends to understate the volume of military procurement in China, because when Chinese industrial production is measured in Yuan, it is cheaper.

The question as always has to do with the quality of weapons, or more precisely the improvement in Chinese military technology. To answer this question it is useful to consider the 2022 Pentagon's Annual Report to Congress on China's intentions and capabilities which was published on the 29th November.

While the Pentagon recognises the current 2021 doctrine to be active defence, "*the PRC's stated defense policy aims remained oriented toward safeguarding its sovereignty, security, and development interests, while emphasizing a greater global role for itself. The PRC's military strategy remains based on the concept* *of "active defense (积极防御)",* it is the future that concerns the Pentagon which is why it highlights 2027 and 2049 over and over again. 2027 is the date set by the CCP to achieve overall military supremacy in the Indo-Pacific region forcing Taiwan to the negotiating table. This seems achievable given that in 2021, despite Covid, the People's Liberation Army (PLA), PLAN (Navy) and PLAAF (Air Force) achieved their 2020 modernisation goals according to this Pentagon Report. 2049 is the date China has set to achieve global military and economic superiority although that should occur much earlier on present trends with 2035 as the likely target date.

The Report also highlights the CCP's Military-Civil Fusion Development Strategy as it has done in previous Reports. "*The PRC pursues its Military-Civil Fusion (MCF) Development Strategy as a nationwide endeavor that seeks to meld its economic and social development strategies with its security strategies to build an integrated national strategic system and capabilities in support of China's national rejuvenation goals. The Party's leaders view MCF as a critical element of their strategy for the PRC to become a "great modern socialist country" which includes becoming a world leader in science and technology (S&T) and developing a "world-class" military."*

So does the report conclude that China is becoming a world-class military. This is probably the most important strategic question in the world today. The chief prong of US imperial policy towards China is not military containment but technological containment. If the US cannot arrest China's technological progress then war will ensue which the Pentagon has prepared for, because the loss of its technological lead will end the US's hegemonic hold on the world economy and the major source of its super profits.

In its 2021 report the Pentagon placed the emphasis on how rapidly the Chinese military was improving its technological prowess. This report is more mixed. In terms of Chinese ground forces the Report is quite negative. It refers to the PLA being saddled with outdated tanks mainly the Type 96 tank with only 4,000 of the world class Type 99 tanks available and which are probably equal to the Abrams tanks which numbers 10,000. However the Pentagon acknowledges that China can produce ground force weapons at or near world class standards. Thus it is a numbers game and no one should doubt the capacity of Chinese industry to ramp up production.

Currently China has 12,954 artillery pieces vs the US's 7,107, while the US has 47,399 armoured vehicles including tanks compared to China with 19,880.

The Pentagon is more respectful of the Chinese Navy. "*The PLAN's overall battle force is expected to grow to 400 ships by 2025 and 440 ships by 2030. Much of this growth will be in major surface combatants."* The report recognises that the quality of these ships and their missiles are world class and that China, being the world's largest ship builder has the capacity to accelerate ship production. In addition the Chinese fleet is more modern than the US surface fleet but it lags far behind the US under-water fleet of submarines. The growth and quality of the Chinese navy shows this arm of the military has been the priority area for the CCP because of Taiwan and US encirclement.

The Report also acknowledges the strides made by the air force. However the PLAAF still lags half to one generation behind the USAF as it is still not a fully formed 4th generation air force. *"The PLAAF is rapidly catching up to Western air forces. The PLAAF continues to modernize with the delivery of domestically built aircraft and a wide range of UASs. This trend is gradually eroding longstanding and significant U.S. military technical advantages vis-à-vis the PRC in the air domain." "The PLAAF and PLAN Aviation continue to field greater numbers of fourth generation aircraft (now more than 800 of 1,800 total fighters, not including* *trainers) and probably will become a majority fourth-generation force within the next several years. For fifth-generation fighters, the PLAAF has operationally fielded its new J-20 fifth-generation stealth fighter. Development continues on the smaller FC-31/J-31 for export or as a future naval fighter for the PLAN's next class of aircraft carriers. China continues their comprehensive UAS modernization efforts, highlighted by the routine appearance of ever more sophisticated UASs across theatre and echelon levels." "The last three years have seen several key milestones. China's decades-long efforts to improve domestic aircraft engine production are starting to produce results with the J-10 and J-20 fighters switching to domestically produced WS-10 engines by the end of 2021."* Thus not only does China's air force's capabilities lag behind the USA in general, the latter has a much bigger air force with 12,930 planes including 4741 helicopters versus China's 4,630 planes including 1355 helicopters.

Interestingly enough there is no analysis of the more powerful WS-15 engine which is comparable to the best in the west in terms of thrust to weight ratios. *The Asia Times* *reports that J20 planes are now using the modern ws-15 engines with performances to rival 5th generation US planes.* What has been holding back the production of the J20 and J31 has been engine availability, if this has been sorted then the current estimated annual production rate of 40 J20 planes vs 80 F35 planes for the USAF will be ramped up as only the Chinese are able to do.

The Report is also complimentary about Chinese advances in electronics, both in terms of observation, communications, and electronic warfare.

In one area China leads, non-nuclear missiles, especially hypersonic missiles. "*Most of China's missile systems, including its ballistic and cruise missile systems, are comparable in quality to systems of other international top-tier producers*." This was once again a priority area given the encirclement by the USA reaching as far back as to Guam and Australia. Given the disparity between the militaries of China and the USA, the emphasis on missiles to level the differences was logical.

Another factor we have to take into account is the war in the Ukraine. US military policy in the Ukraine is in a shambles. Despite emptying NATO's arsenals of crucial equipment, Russia is winning. Instead of weakening Russia it is the USA and NATO who have been weakened. Xi knows this which is why he is expressing more and warmer support for Putin and most probably secretly supplying him with weaponry despite Washington's dire warnings.

In summation, the USA has a quantitative and qualitative lead over China but this is rapidly narrowing. In the end the size of each country's industrial base will be decisive and China's is three times bigger. To close the gap with the USA by 2027, China will have to outproduce the USA in terms of air and land assets by at least 50% p.a. which means trebling the production rate for its J20 and J31 fighters as well as its Type 99 tank.

Australian Strategy Policy Institute (ASPI).

To answer the question about who is winning the technological race, we could turn to ASPI's newly released Policy Brief No. 69 2023. However, we need to bear in mind that the funding for this report is murky. Less than half of ASPI's funding now comes from the Australian government, with much of the remainder coming from the arms industry. It is also mentored by the likes of Eric Schmidt, ex-Google boss who also helped prepare the Special Competitive Studies Project which met last year and which pitched China's lead in 5G as a *wake-up-Sputnik* moment. As with everything capitalist, there is an economic incentive to enhance the Chinese threat to extract more funds from governments for the private sector. That it has had some success can be seen with the passing of the Chips Act and the Build Back Better Act in the USA by the Biden Administration.

Nevertheless, if the 'hawkish' report is even 75% correct it shows China starting to dominate key areas of technological innovation and production. This is what the report had to say in its introduction: "*Western democracies are losing the global technological competition, including the race for scientific and research breakthroughs, and the ability to retain global talent—crucial ingredients that underpin the development and control of the world's most important technologies, including those that don't yet exist. Our research reveals that China has built the foundations to position itself as the world's leading science and technology superpower, by establishing a sometimes stunning lead in high-impact research across the majority of critical and emerging technology domains. China's global lead extends to 37 out of 44 technologies that ASPI is now tracking," "The Critical Technology Tracker shows that, for some technologies, all of the world's top 10 leading research institutions are based in China and are collectively generating nine times more high-impact research papers than the second-ranked country (most often the US)."* The bias can be seen in the following statement: "*A key area in which China excels is defence- and space-related technologies."* In space maybe in defence not yet. Clearly this is a nod to its military backers.

The methodology behind the report seems sound. *The top 10% most highly cited research publications from the past five years on each of the 44 technologies were analysed.* In addition, it claims China produces five times more high impact research papers than does the USA. If the conclusions of this report are close to the mark then indeed the technological gap between the USA and China is narrower than previously thought with an additional rider, China has a lead in key emerging technologies. This brings the prospect of war closer because on the basis of this report, time is on the side of China, while the US is running out of time.

In addition China is beginning to weaken US alliances around the world. The Chinese brokered reproachment between Saudi Arabia and Iran is a strategic setback for the West in the Gulf Region. And not only in this region, but in Latin America and Africa, China is also making diplomatic headway. The global political architecture is beginning to shift.

In terms of the Chinese economy, it is still too early to assess what is happening there. For this, March's data which will be released in April, is needed. However the omens are not looking good. Empty shipping containers are piling up in Chinese ports whereas during the pandemic it was the other way around, Chinese ports were short of containers. In addition, oil prices and copper prices continue to languish despite China aiming for 5% GDP growth this year.

THE USA.

This week was dominated by one event, the failure of the largest bank since Lehman Brothers in 2008. Wall Street tried to minimize the fall out from the collapse of SVB Bank based in silicon valley. It was often described as a purely Tech Bank. The only thing which was unique about the bank was its greater exposure to volatile assets. See Michael Roberts blog for more details. But many more regional banks are at risk. The KBW Regional Bank Index, a barometer of the health of these banks fell 14% over the week as the graph below shows, and bank shares dropped 4% on Friday on Wall Street. This 14% fall was the steepest fall since the Lehman days in 2008. One of the reasons for the drain of liquidity from these banks is that when an investor can get +4.5% buying up short term treasuries why keep any money in the bank.

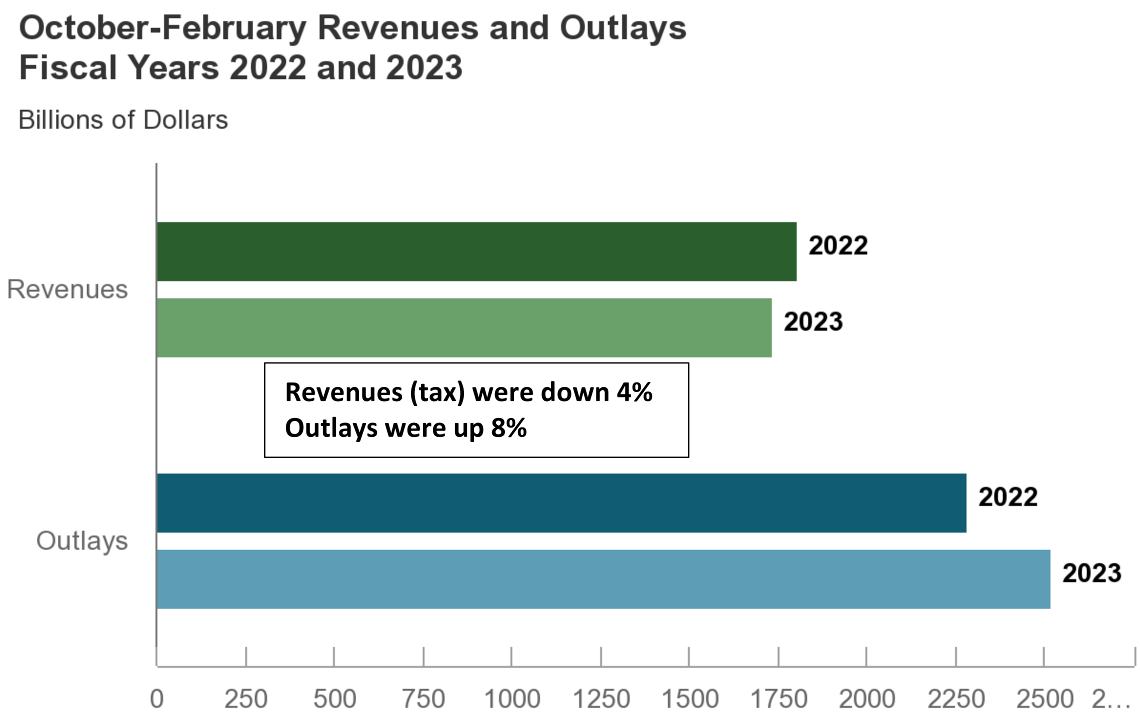
Its not only interest rates which are hurting, its also the outlook for profits. Interest rates are always relative to prices and profits. And it is the fall in profits which is complicating interest rates. We will know more at the end of the month about the financial health of corporations when the BEA releases profits for Q4 2022, but its looking grim. Impatient for these figures I have prepared a table below which covers more than three quarters of the Tech Industry. It shows that nominal revenue fell 5.1% and operating income 22.35%, or in real terms using the implicit price deflator for final sales of 6.8%, the real fall was 11.9% for revenue and 29.2% for operating income. Hence the mass sackings and financial tremors in silicon valley. (Total income in the table is about a fifth of all non-financial corporate income.) (All data in $ millions and sourced from corporate investor relations websites.)

Corporation	Revenue Q4 2021	Revenue Q4 2022	difference	Income Q4 2021	Income Q4 2022	difference	Profit Margin	Profit Margin
Apple	123,945	117,154	-6,791	54,243	50,332	-3,911	0.44	0.43
Alphabet	75,325	76,048	723	20,642	13,624	-7,018	0.27	0.18
Microsoft	51,728	52,747	1,019	22,247	20,399	-1,848	0.43	0.39
Meta	33,671	32,165	-1,506	12,585	6,399	-6,186	0.37	0.20
Dell	27,992	25,039	-2,953	1,609	1,189	-420	0.06	0.05
Intel	20,528	14,042	-6,486	4,989	-1,132	-6,121	0.24	-0.08
Qualcom	10,705	9,463	-1,242	3,864	2,465	-1,399	0.36	0.26
Hewlett Packard	7,871	7,809	-62	-339	591	930	-0.04	0.08
Broadcom	7,706	8,915	1,209	5,049	5,926	877	0.66	0.66
Nividia	7,643	6,051	-1,592	1,257	601	-656	0.16	0.10
AMD	4,826	5,599	773	1,207	-149	-1,356	0.25	-0.03
Micron	6,643	4,085	-2,558	1,662	-65	-1,727	0.25	-0.02
Totals	**378,583**	**359,117**	**-19,466**	**129,015**	**100,180**	**-28,835**	**0.34**	**0.28**
Change over year			**-5.1%**			**-22.35%**		**-17.6%**

FactSet has a higher fall for profits in the information sector estimating the fall per share to be above 24% for S&P 500 companies.

This week important data came out regarding the health of the US economy. The first was the Congressional Budget Office's (CBO) monthly report covering taxes and expenditure by the Federal Government. The second was the employment release for February which against surprised on the upside.

The graph below is taken from the CBO report. I think they included this graph in the context of the budget ceiling debate to jolt the senators awake by showing them in simple terms what is going on in the realm of governmental finances. A 12% gap between taxes and spending should set alarm bells jangling anywhere. This graph showing falling taxes, unless it is the victim of epic tax dodging, is of an economy that is definitely not expanding. The tax take fell 4% or by over 10% in real terms. Were it not for COVID delayed withholding taxes amounting to £180 billion being paid this financial year, instead of the previous financial year when they were due, the fall in the tax take would have been even bigger.



It is also worth pointing out that interest rates are exacerbating the deficit. Not only are interest payments surging on government debt, equal now to all the Dollars spent on Medicaid but the net income of FED banks is also falling as a result. "*Remittances from the Federal Reserve decreased from $48 billion to less than $1 billion. Higher short-term interest rates raised the central bank's interest expenses above its income, eliminating the profits of most Federal Reserve banks, while interest paid rose $240 billion on par with Medicaid*." This will depress non-financial corporate earnings when they are released on the 30th.

The release of both the ADP employment and pay data as well as that from the Bureau of Labour Statistics (BLS) on Friday allows for a comparison with the tax data provided by the CBO. According to the BLS the aggregate hours worked, rose by 2.0% YOY in February while pay rose by 4.6%. That yields a figure of 6.7% not too distinct from the CBO increase in payroll and withheld taxes of 6.4%. If we take payrolls instead of hours then the figure rises to 8.6% or 8.1% when adjusted for the proportionate increase in part time work, and if we take ADP's estimate then we get 10%. 8.1% compared to 6.4% implies an inflation in payrolls of 2 million.

Turning to pay. The ADP estimate of 7.2% is derived from its own records as it manages 25% of corporate payrolls. These larger corporation would tend to have higher paid workers. The only way to reconcile the ADP increase of 7.2% with the BLS figure of 4.6% is to assume that many of the new jobs created over the year are lower paid thus dragging down the average pay.

Furthermore the disarray between the ADP estimate for job creation by sector in February and that of the BLS is startling.

Sector	ADP	BLS	difference
Mining	25000	0	25000
Construction	-16000	24000	40000
Manufacturing	43000	-4000	47000
Financial Services	62000	-1000	63000
Leisure Hospitality	83000	105000	22000
Education Health Care	35000	74000	39000
Information	9000	-25000	34000
	241000	**173000**	**270000**

The final point I would like to make is that the various Bills passed in Congress to support the manufacturing of chips and electric vehicles within the USA is having an effect. Orders for capital goods from US manufacturers are up. Industrial Robot imports into the USA are up by 24% in 2022. The CEO of Bechtel, a major builder of industrial structures such as factories complains the scale of building work is expanding faster than the supply of craft men and women - plumbers, electricians, carpenters, tool makers and so on. Of course as far as chips go it is likely to end up as a car crash. There is a global glut of chips at a time when capacity is surging, and given that the US will be the highest cost producer, all this new capacity is likely to be loss making which is why TSMC had to be bullied to invest in the USA. At least the money is not being wasted on armaments.

By the day, it is becoming clearer that the US disruption of global supply chains is raising cost prices at a time when profit margins are being squeezed. Well done Trump and Biden for damaging the prospects for capital and making our job easier. It shows once again that in pursuit of a sectional interest of capital, in this case the US and the EU, the general interest of their class is harmed.

Conclusion.

Both economies are beset by problems. Over the next few months the financial crisis in the USA is likely to do more damage to productive assets than 1000 conventional Chinese cruise missiles could ever accomplish. To secure its hegemony the US is embarking on an economic scorched policy to contain China's technological advancement. Should China overcome this containment it will be game over for the USA. We continue to be in this dangerous window. Of one thing we should be clear - the US has everything to gain from war, while the Chinese have everything to lose from war.

Brian Green, 11th March 2023.