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TRADING & INVESTMENTS, LLC

Weekly Economic Update

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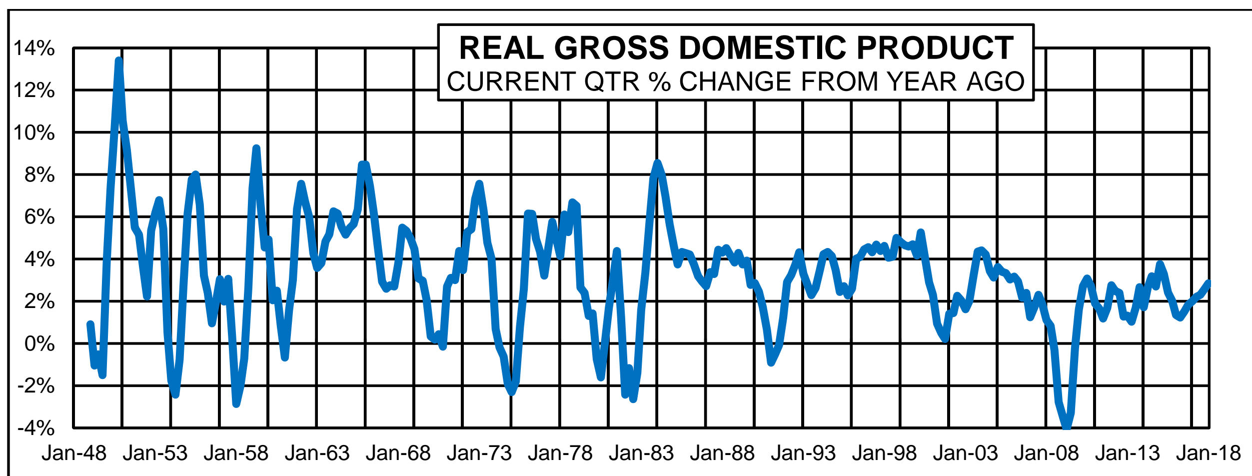
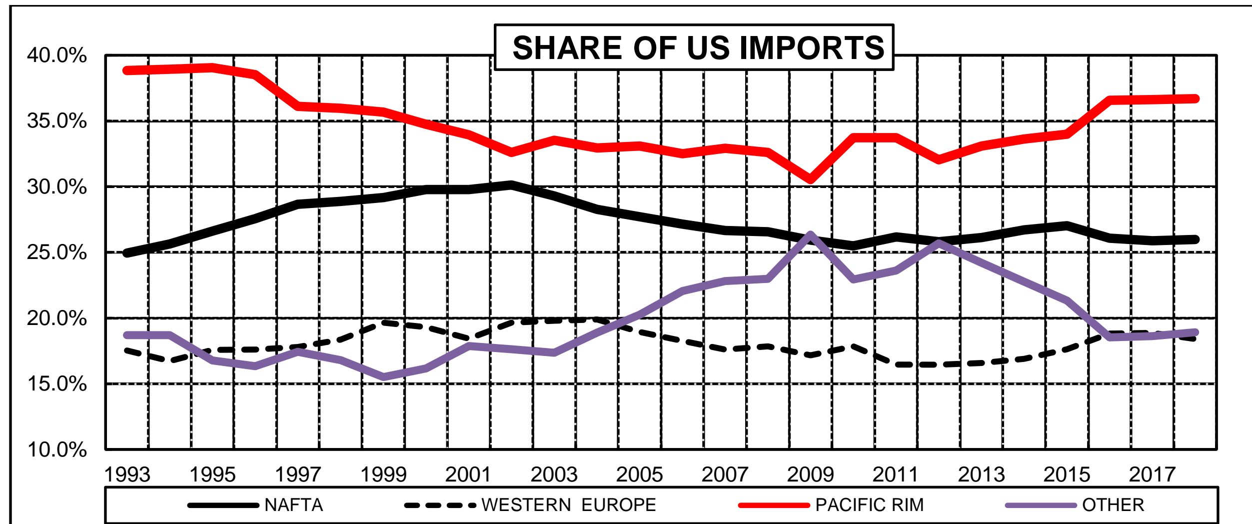
Volume 89, Number 6 **February 8, 2019**

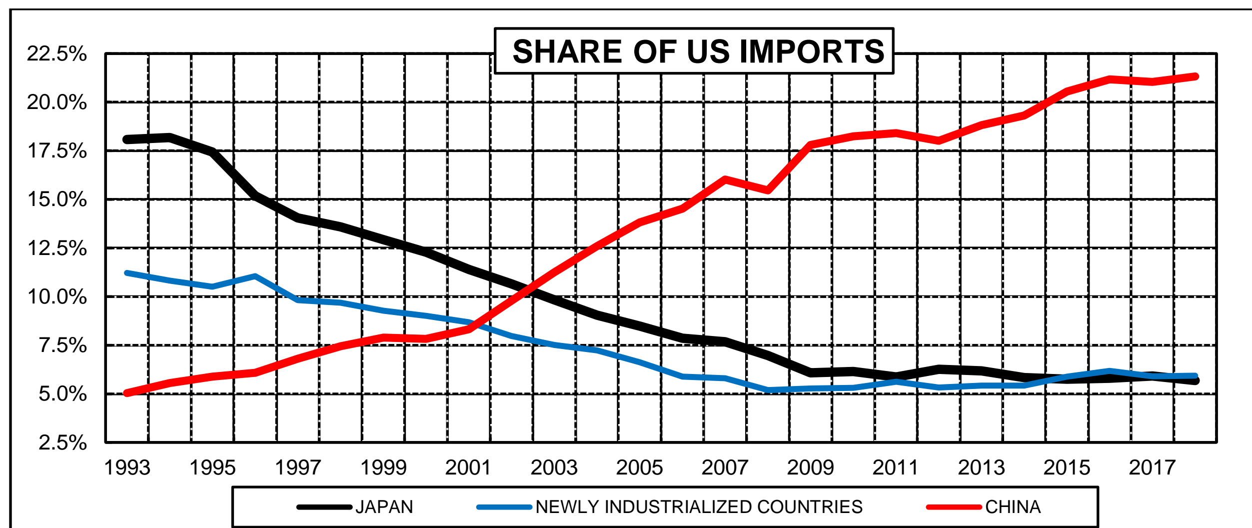
Following up on last week's missive which examined where the next round of cheaper labor might come from (the answer was China, then India, with a little ASEAN in between), we ask a related question of what will happen to the US economy if it does not have access. For us, the history of US growth is much like the development of the City of Boston where we grew up. Back in the early post war period, Boston, like the US, was a manufacturing led economy – mostly footwear and chemicals. Over time, its universities were first regional, then national and ultimately international powerhouses that generated leaders in business, finance, medical care, technology and education. Manufacturing jobs moved south, then overseas. For the US in the early post war period, the economic cycle was a short boom bust pattern, with peaks near 8% and bottoms around -2%. The one longer cycle was in the 1960s as the Government funded the Space Race to fend off the threat to world leadership from the Soviet Union. This led to a cold war, with a proxy fight in Vietnam, and a domestic war on poverty rather than a Thucydides trap (where the rising power physically fights with the current leader).



The US opened up to international trade via a rising trade deficit after 1973, first to OPEC, then Japan, and then the Newly Industrialized Countries led by South Korea and Taiwan. Following the deep double dip recession of 1980-82, the US cycle flattened and lengthened because it had less volatility

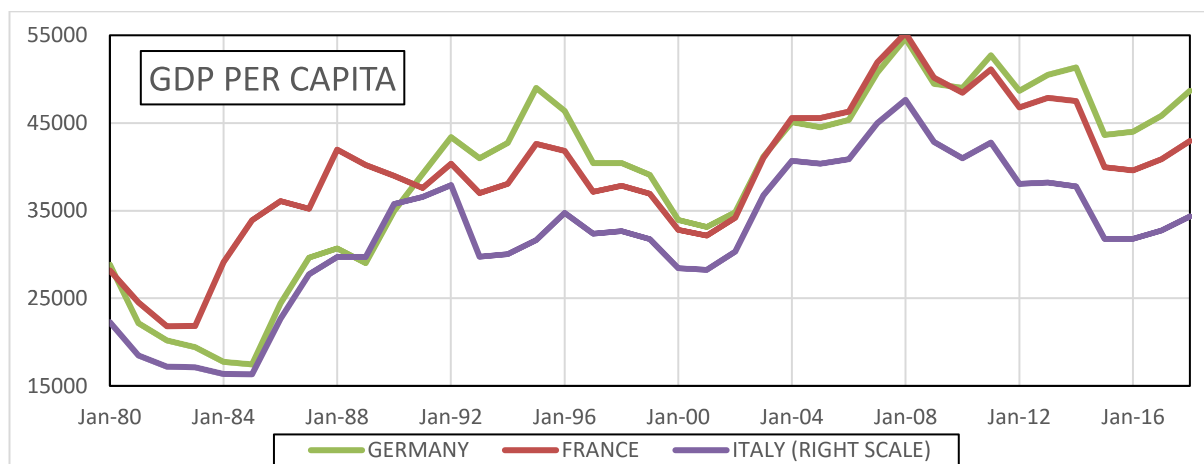
from manufacturing as the factory sector shrank as a share of GDP, with growth between -1 and 5%. After the Lehman crisis it has flattened and likely lengthened again (we will reach the longest cycle on record in five months) – with growth now between 1% and 4%. More manufacturing jobs have gone abroad, and the domestic auto and housing sectors are less important.





As two of our favorite charts point out, US imports come from around the world and in relatively constant shares as the comparative advantages that companies seek remain stable: Canada and Mexico for proximity; Europe for rival technologies; Asia for cheaper labor; and elsewhere for commodities. The hunt for cheaper dominates all markets with share moving to Mexico from Canada, and to Italy and Poland from Germany – but in Asia, where cheaper dominates, shares between Japan, the NICs and China have been stabilizing. Japan and the NICs are now rivals to Europe for technology, and China's domestic drive has lifted labor costs. New labor markets are needed for cheaper – but as we saw last week they may be primarily in China. This will not be a problem for our competitors in Europe, Japan or the NICS. A Sino-US trade war would hand them a cost advantage as they continued to produce in and import from China, while the US had to develop new factory floors elsewhere.

We turn to the Euro Area for a glimpse of what might occur. Before the Berlin Wall fell, it was France that was the leader in Europe. Coming out of the 1982 recession, Germany and Italy – much heavier in capital goods industries – were running about $17,000 in per capita GDP, while France quickly recovered to near $34,000. Given the populations were roughly the same, France's economy was twice as large in 1985 and maintained a 40% advantage through 1988. It was France that promoted the Euro Area as a way to bind Germany to a western looking stance rather than turning east as the Soviet Union dissolved. A scarcity of Deutschmarks and heavy capital investment after unification boosted German incomes (and Italian's briefly), but this settled by the start of the Euro in 2000. Until Lehman, the incomes of Germany, France and Italy moved in lock step (with Italy about 15% behind). However, over the past decade the now larger German population has earned a growing advantage. Bottom line, it appears the French were right and that Germany's better access to cheaper labor both in Eastern Europe and in the Asian markets – rather than maintaining a western looking focus – has given Germany a comparative advantage that a single currency now makes harder to offset.



Over the past 18 years, China has become virtually everyone's largest trading partner – adding Japan just last week. If the US unilaterally sets tariffs that make Chinese exports – including those with substantial supply chains elsewhere – more expensive, it hands the rest of the world a major comparative advantage. US firms will now need to find or develop comparable labor. Last week's missive illustrates that China has few competitors at the $6,000-$10,000 level – though Mexico stands out. While the US could shifts to ASEAN and India options at less than $5,000, there is a reason they are currently so cheap. The market dictates labor value in comparison to other options. Bottom line, regardless of whether US firms pay the tariff or shift to alternatives, they will be paying 10% -- or 25% -- more initially relative their competitors in every other nation. We agree that markets will be good at finding work arounds that avoid some of the tariffs impact – but that is not a game limited exclusively to US firms. Bottom line, what is seen as a policy to enhance US manufacturing's cost competitiveness will only provide and advantage to Europe, Japan, the NICs and other nations that are more closely competitive with the US – as reflected in their current per capita earning power.