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Looking to the East

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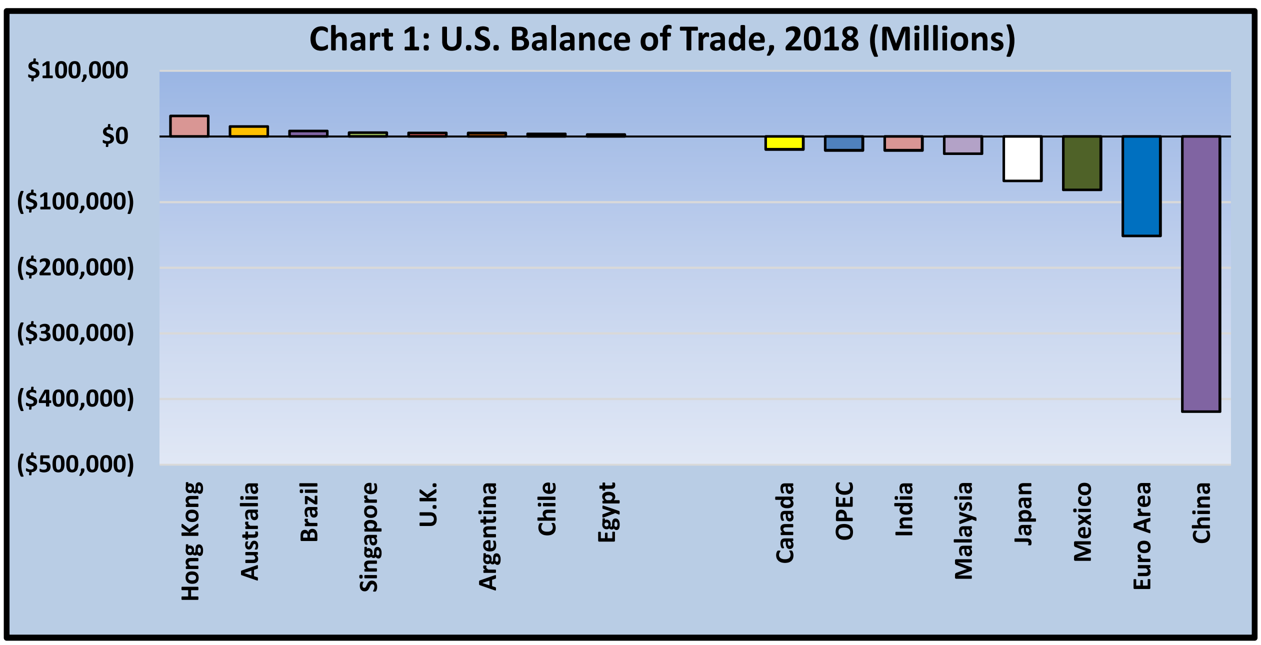
When the sun comes up on a sleepy little town down around San Antone …
The people of the town are strange and they're proud of where they came …
And though it's a part of the Lone Star State, people don't seem to care
They just keep on looking to the East
Well, you're talking 'bout China Grove

In 1973, the Doobie Brothers scored a big hit singing about immigrants from China struggling in their new land.[1] Today, their children (and grandchildren) have assimilated and spread across Texas and the rest of this country, but they are still "looking to the East." What's different is *why*. Those children of China Grove are discovering that their adult livelihoods are being challenged by jousting between Washington and Beijing. Indeed, the fallout from this trade war could directly affect nearly every American.

The political genesis of this conflict lies in America's trade deficit with China, which topped $400 billion last year (Chart 1). That's larger than our deficit with the entire Eurozone, Mexico, and Japan combined. While a bilateral trade deficit *per se* isn't a matter of concern when trade rules are fair, the problem with our China trade deficit is precisely that the rules are unfair.



Source: U.S. Census Bureau

[1] China Grove is a real city and it really is just outside San Antonio, but the real China Grove was never a destination for Chinese immigrants; of the city's approximately 1,200 residents, fewer than 1% identify as Asian.

Back when the Doobies were singing about the immigrant residents of that San Antonio suburb, American companies were just beginning to contemplate selling their wares to a potentially immense untapped market. As China's economy grew larger and wealthier, the American appetite grew ever more voracious. We – American companies and the federal government – agreed to trade rules that we wouldn't accept from other countries, a situation made worse when we allowed China to enter the World Trade Organization in late 2001 without requiring adherence to more equitable rules. As a result, China still engages in unfair practices regarding intellectual property, coerced technology transfer, equity joint ventures, capital flows, and others.

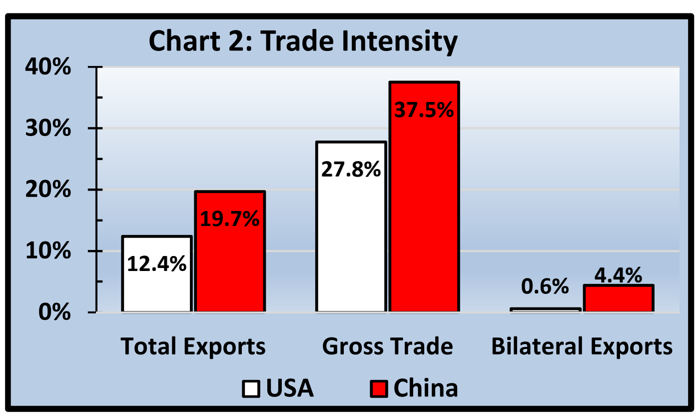
Today, the Trump administration also believes that China cheats on many of its existing agreements, exacerbating its unfair trade advantage. The administration is trying to force China to change its behavior to open its vast domestic market to fair foreign competition. Most economists generally support this objective, but they also mostly condemn the choice of a tariff campaign as the means to that end. Yet despite the risks, there is also still merit to this strategy.

Both sides have huge incentives to reach an agreement. For the United States, our current $120 billion of exports to China is a tiny drop in that country's $12 trillion economy; China is still a mostly untapped market, one that would be vastly more profitable to our private industry with fair trade rules. For China, exports to the United States are one of the country's most important sources of economic growth, so access to this market is critically important. That's why the Trump administration chose to use tariffs as a cudgel in its negotiations.

A wide consensus of economists argue that tariffs are inherently bad for economic growth; they are nothing but a tax on consumption that raises prices and reduces demand. This is true, but the effects are not the same on both sides of the Pacific Ocean; the direct pain of paying higher import tariffs falls disproportionately on us.

Here's the arithmetic for the U.S.: A 25% tariff on all $540 billion of Chinese imports to the U.S. would drain our economy of $135 billion, representing a 0.7% direct hit to our GDP – enough to be noticed and to slow our growth, but not enough to throw the economy into recession. Even if tariffs lead to lower consumer confidence and a larger drag on the economy, we can withstand them. Across the Pacific, it's a different story: China's new 15% tariff, even if applied to all $120 billion of imports from the U.S., would barely be noticed, denting GDP by less than 0.2%.

The value of tariffs as a negotiating tool is on the opposite side of the ledger – exports. China relies on exports much more than we do, as shown in Chart 2. Only about 12% of American output is for export globally, compared with 20% of Chinese output. Combining exports and imports, China derives more than a third of its economic activity from global trade, compared with only about one quarter for the United States.



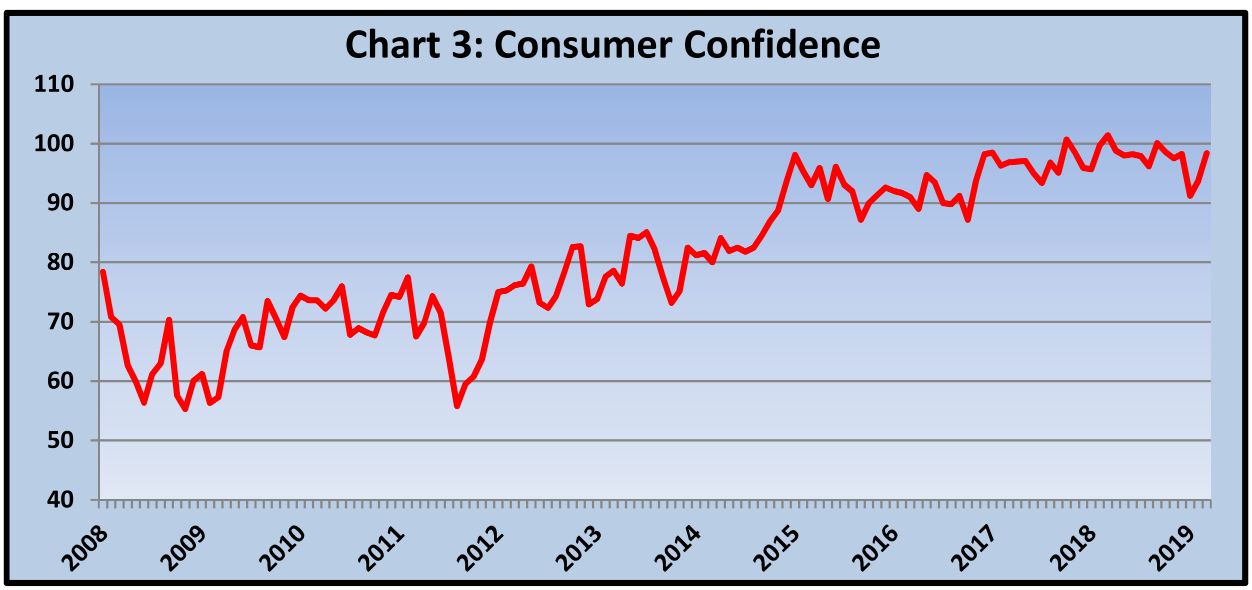
Sources: U.S. Bureau of Economic Analysis, CIA, World Bank

Despite the perception that the United States is a globalized economy, we are also a relatively closed market: There isn't much that we can't make or find here at home. Thanks to our size and economic diversity, we depend less on trade than most other developed nations, and a lot less than China does.

This difference is sharply illuminated in the third pair of columns in Chart 2, showing the proportion of each nation's economy that comes from exports to the other. While our exports to China are only 0.6% of our own economic output, China's exports to the U.S. drive almost 5% of its total economy. Put another way, we can live without shipping *anything* to China, but China's growth is heavily reliant on its access to the U.S. market. That's why our tariffs matter so much to China: They can choke off one of China's most important sources of demand.

It's unclear at this point whether China will respond to the American tariff offensive by changing its trade rules or practices; the newspaper headlines seem to change almost every day. The ongoing tension has the stock market on edge, as investors seek clarity about the outlook for tariffs, trade rules, and their impact on future earnings prospects. For most of this year, the pendulum has swung toward a more sanguine view that China's leaders will amend their trade rules and the U.S. will drop its tariff regime. That may be the most rational outcome for all sides, but it's by no means certain that events will unfold so beneficially.

Back in China Grove, Texas, the residents are "still looking to the East," wondering how China will respond. For them and for consumers nationwide, the impact of the current tariff regime is being felt mostly in the form of higher prices for consumer goods imported from China: electronics, home appliances, apparel, and more. The potential benefits of equitable trade practices are both distant and indirect. This mismatch – palpable pain now against theoretical benefits in the future – accounts for the nervous concern that has begun to seep into consumer attitudes (Chart 3).



Source: University of Michigan

In the industrial centers of this country – from San Antonio to Dallas, Silicon Valley to Boston – the mood is also anxious as corporate executives, too, look to the East. The boardroom concern isn't the impact of higher import prices, since most industrial commodity prices have been stable; instead, the worry in these places is that a breakdown in trade talks could close off their fastest growing markets.

The stakes are high for everyone. A misstep on either side could trigger a long-term tariff war without changing China's trade practices; we would suffer both higher prices and inferior access to China's domestic market, while China's economy would be unable to offset the sudden falloff of American demand for its products. That would be a colossal loss for both countries, and for the many other nations participating in the complex supply chains of a truly global economy. Markets on both sides of the Pacific are likely to remain jittery while this process unfolds, but the measured and careful actions by both governments up to now suggest that a mutually beneficial agreement is still the most likely outcome.