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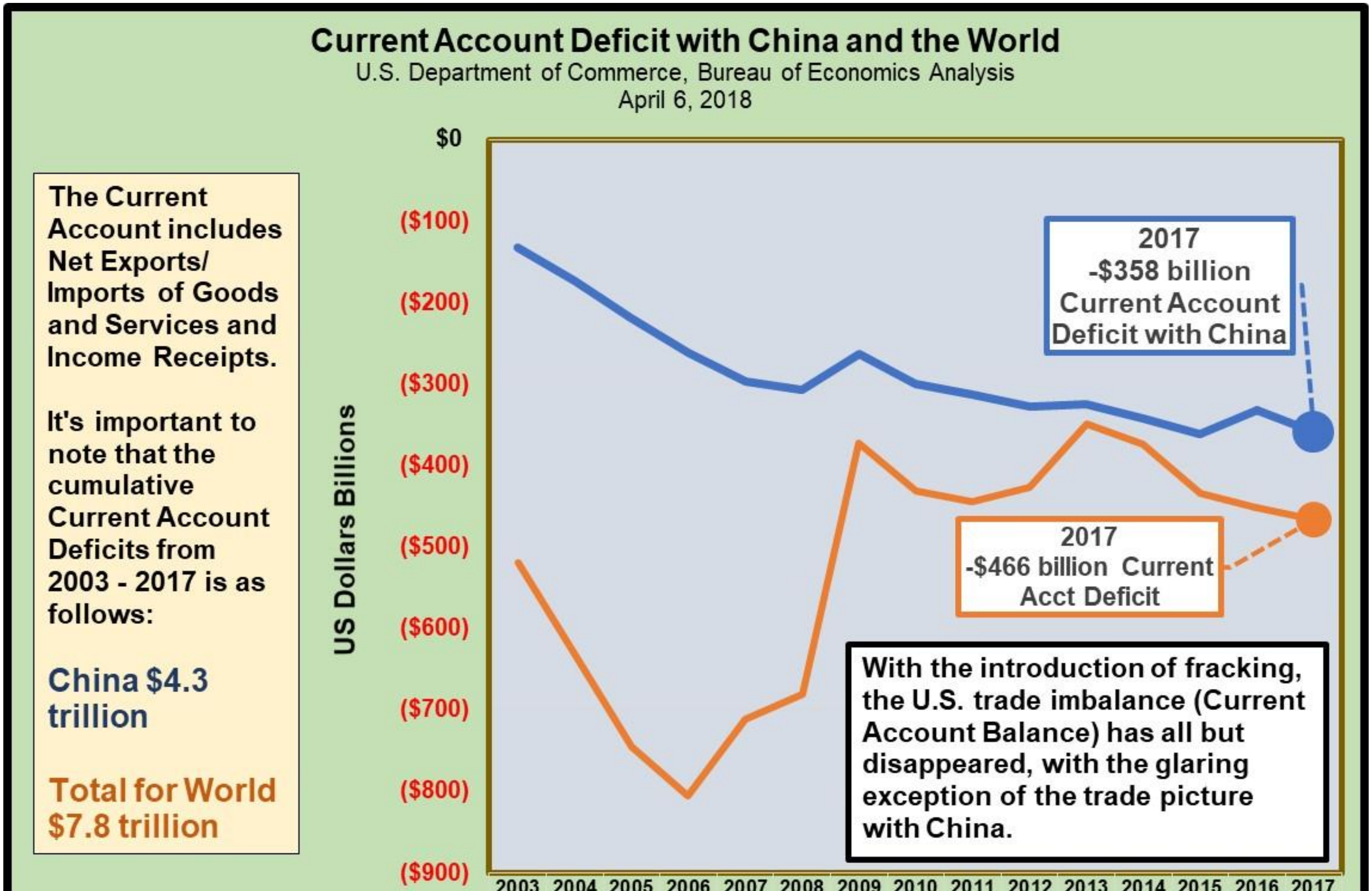
China and the US: Trade Deficit (Current Account Deficit) or the Balance of Payments and the Law of Two Prices

In 2017, the overall US Current Account Deficit (the tally of Goods and Services plus Income Receipts) came to $466 billion; 77% of that, at $358 billion, was attributed to trade (Current Account Deficit) with China.



	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Current Acct Deficit with China	(132)	(173)	(220)	(262)	(296)	(307)	(263)	(300)	(313)	(328)	(325)	(343)	(362)	(333)	(358)
Current Acct Deficit with World (including China)	(519)	(632)	(745)	(806)	(711)	(681)	(373)	(431)	(445)	(426)	(350)	(374)	(435)	(452)	(466)

Trade Picture with China

When the Chinese import goods from the U.S. it depresses their economy, but stimulates the American economy because it drives up what is referred to as the Net Exports section of the total demand for U.S. goods and services. When the Chinese export goods to the U.S. the opposite of course occurs. In that case, the Americans buy the goods and services, depressing the U.S. economy and stimulating the Chinese economy. Simply put, the U.S. Net Exports (Exports minus Imports) are driven down. If imports exceed exports, we would see – as has been the case for the U.S. since 1981, negative Net Exports, or a Current Account deficit. The end result has been a net stimulus to the Chinese economy while there is a net depressive force on the U.S. economy.

Tiananmen Square: April – June 1989

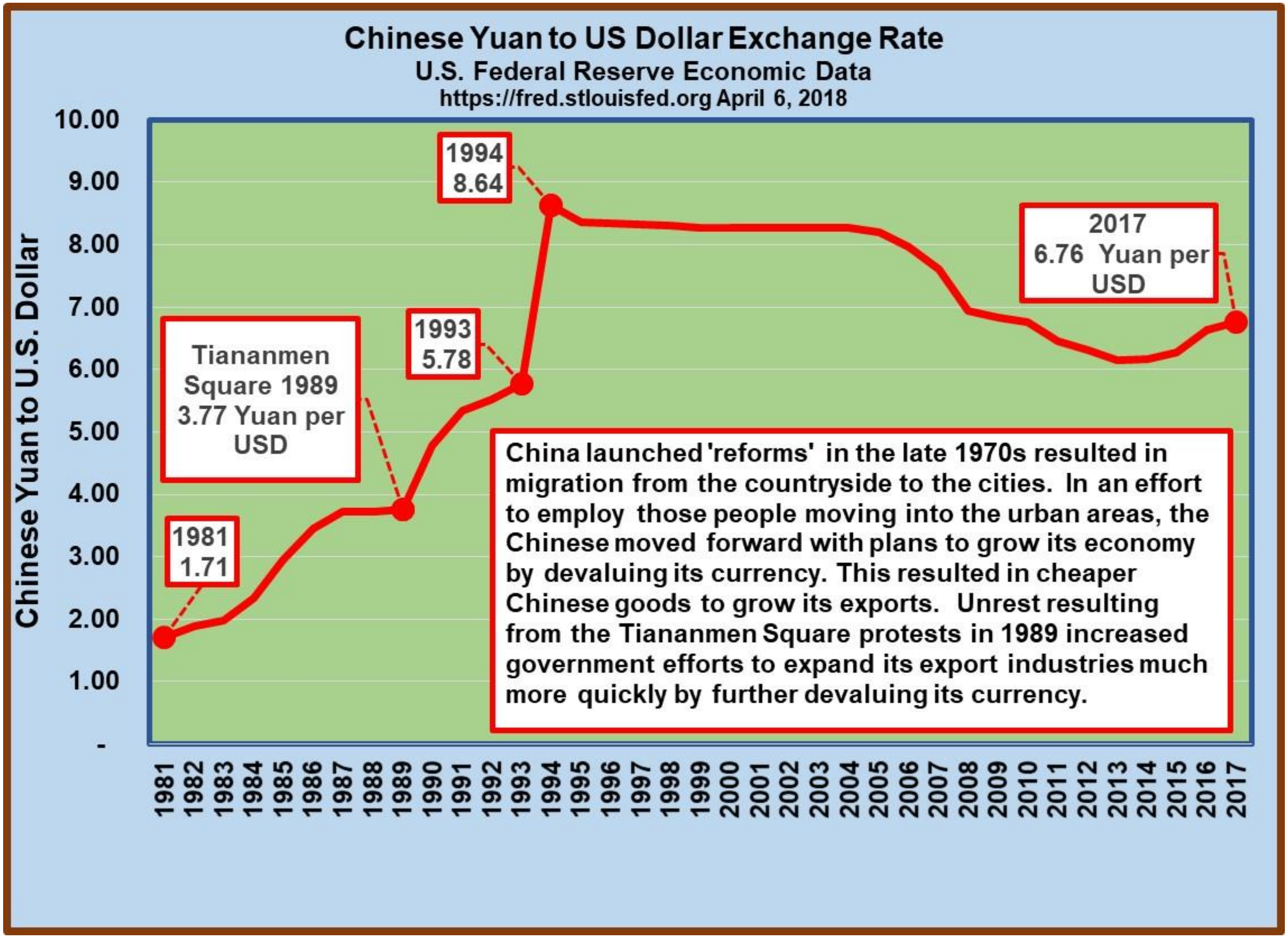
Going back more than 30 years ago, leading up to the protests in Tiananmen Square, there was significant unrest in China owing to issues relating to demands for free speech and other democratic reforms. To counter those efforts, driven at least in part by increasing migration into the urban areas from the countryside, the Chinese government capitalized on the opportunity to ease that unrest by devaluing its currency. The aim was to put more people to work and keep them busy and thus discouraging the protesting in the streets.

One way to accomplish this goal, which served to enhance the U.S. standard of living, at the expense of their own standard of living, was to pursue exports on a net basis. Again, this means that the Chinese would export more goods and services to the U.S. than they imported. This begs the question: how did the Chinese go about making this export driven relationship possible?

Devaluation of the Chinese Yuan: 2.0 Yuan per US Dollar in 1982; 8.6 Yuan per US Dollar in 1994

In all international transaction, wherever they might occur, there are two prices determined in the market, not one. Looking at the Chinese scenario, the first price is the price of Chinese domestic goods and services in China in Yuan (Chinese currency is called the Yuan or Renminbi). The second price, the Yuan price itself, is dictated by the foreign exchange market. The goal was to drive down the price of the Yuan in the foreign exchange market to make Chinese exports less expensive. The Chinese government, by taking an active role in decreasing the value of its currency, devalued the Yuan relative to other currencies – the U.S. dollar among them. They accomplished this task by selling Yuan (adding to the supply) in the foreign exchange markets and buying other currencies. This serves to drive the price of the Yuan down relative to other currencies. The result of course is that the Yuan is cheaper and the goods and services are also less expensive for foreign buyers – U.S. imports in this case. When the Chinese devalue their currency, the price of goods and services denominated in Yuan does not change in China, but the price of those same goods and services are lower and thus more attractive to foreigners – as certainly has been the case for U.S. consumer.

Beginning in the early 1980s, the Chinese have actively been depressing the value of their currency. In 1981, the price of the Yuan was 1.71 Yuan per US dollar. In 1989, when the protests in Tiananmen Square occurred, the price of the Yuan had risen to 3.7 Yuan per US dollar. By 1994, the price of the Yuan had fallen to nearly 9 Yuan per US dollar.


Chinese Yuan to US Dollar Exchange Rate
U.S. Federal Reserve Economic Data
https://fred.stlouisfed.org April 6, 2018
Chinese Yuan to U.S. Dollar
10.00
9.00
8.00
7.00
6.00
5.00
4.00
3.00
2.00
1.00
-
1994 8.64
1993 5.78
Tiananmen Square 1989 3.77 Yuan per USD
1981 1.71
2017 6.76 Yuan per USD
China launched 'reforms' in the late 1970s resulted in migration from the countryside to the cities. In an effort to employ those people moving into the urban areas, the Chinese moved forward with plans to grow its economy by devaluing its currency. This resulted in cheaper Chinese goods to grow its exports. Unrest resulting from the Tiananmen Square protests in 1989 increased government efforts to expand its export industries much more quickly by further devaluing its currency.
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Putting the Chinese Miracle into Perspective – starting in the run up to Tiananmen Square in 1989

Looking back to the early 1980s the Chinese, in effect, began dumping or selling large portions of their currency to drive down the price of Yuan; making the currency and thus the goods denominated or produced in the Chinese domestic environment less expensive for the U.S. consumer in this case. So again, while the price of domestically produced goods and services in China were unaffected, the price for those same goods and services fell dramatically for foreign markets, including the U.S of course.

To illustrate this further, let's assume the price of a television in the U.S. and China were roughly the same in 1982, when the price of the Yuan was around 2 Yuan per US dollar. Fast-forwarding a dozen years to 1994, the price of the Yuan had been driven down to around 8 Yuan per US dollar. This effectively reduced the price of the Yuan by 75%. In our example, identical televisions were produced and sold for $500 in 1982 in both the U.S. and China with the price of the Yuan at 2 Yuan (CY) per U.S. dollar (USD) ($0.50 per Yuan) so the Yuan price for the television would have been 1,000 CY. Holding all else constant over the next 12 years, the price of the Yuan went from 2 CY per 1 USD to 8 CY per 1 USD ($0.125 per Yuan). While the price of the domestically produced television in the U.S. remained at $500, the price of the imported Chinese television, due to the devaluation of the Chinese Yuan, was 75% less – or $125. This is what brought about the Chinese Miracle, not at all dissimilar to the Japanese and German miracles which predated it.

To reiterate the main thrust of this article, there are two prices under consideration: first, is the domestic price of the goods or services for the domestic market in the exporting country (China); and second, is the price of the foreign exchange associated with those goods and services in the importing country (United States). China made a deliberate and quite successful effort to bolster its export economy, creating millions of jobs in the process. Again, just doing a quick and very rough estimation, with the 2017 Current Account Deficit (trade deficit plus income receipts) with China at $358 billion, this would equate to around a 7 million job shortfall in the U.S. based on $50,000 per year income per individual.

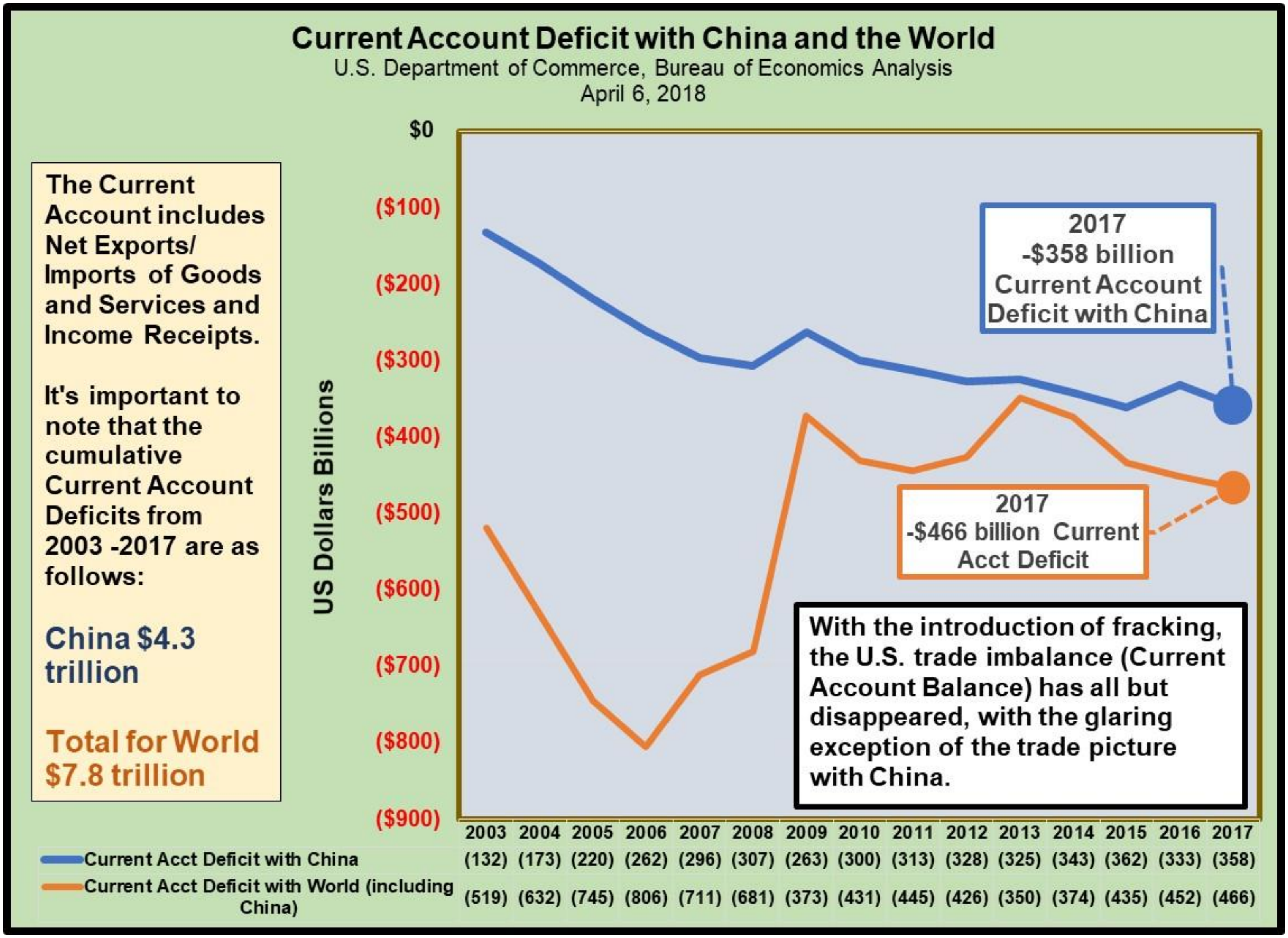
As an aside, some might argue that we could not absorb those jobs, given the current 4.1 percent U3 unemployment rate. In previous articles, we have pointed to the fact that the U.S. is currently well below its pre-recession labor force participation rate {[labor force (employed + unemployed)] / Civilian Noninstitutional Population} of 66%. The difference between the current labor force participation rate and the previous rate equates to roughly 7 million workers.

Employment Expansion - here come the jobs 13 March 2018

“Let's be clear, a 4.1% U3 Unemployment Rate is quite low and would have indicated an economy at full employment historically. The situation we are encountering is that low Labor Force Participation is actually pointing to a large number of people - on the order of 7.7 million, are on the sidelines outside of the labor force. The term discouraged worker comes to mind describing a situation where individuals who would normally be considered unemployed have left the workforce entirely and no longer attached to the labor force due to the fact that they have given up any hope of finding employment.”

Is the Yuan really undervalued relative to the Dollar?

While that initial move by the Chinese government to alter the trade balance (Current Account Balance) was more than 35 years ago, is the Yuan still undervalued? There is no doubt that the Chinese government is very actively involved in its efforts to ‘peg’ Yuan/Dollar exchange rate at a lower level than would otherwise be dictated through the market clearing process if left alone. The Yuan price of the US dollar remains above 6 CY per 1 USD, or around $0.16 per CY. In a normal, freely floating environment, the exchange rate would fluctuate to address imbalances. This clearly has not been the case with the Current Account (Trade Balance) between the U.S. and China. While the Current Account Deficit with China for 2017 was at $358 billion, the cumulative deficits with China, going back to 2003 amounted to $4.3 trillion or $4,315 billion. This clearly points to active involvement in foreign exchange markets to prop up the dollar, while serving to reinforce and maintain a weaker Yuan.



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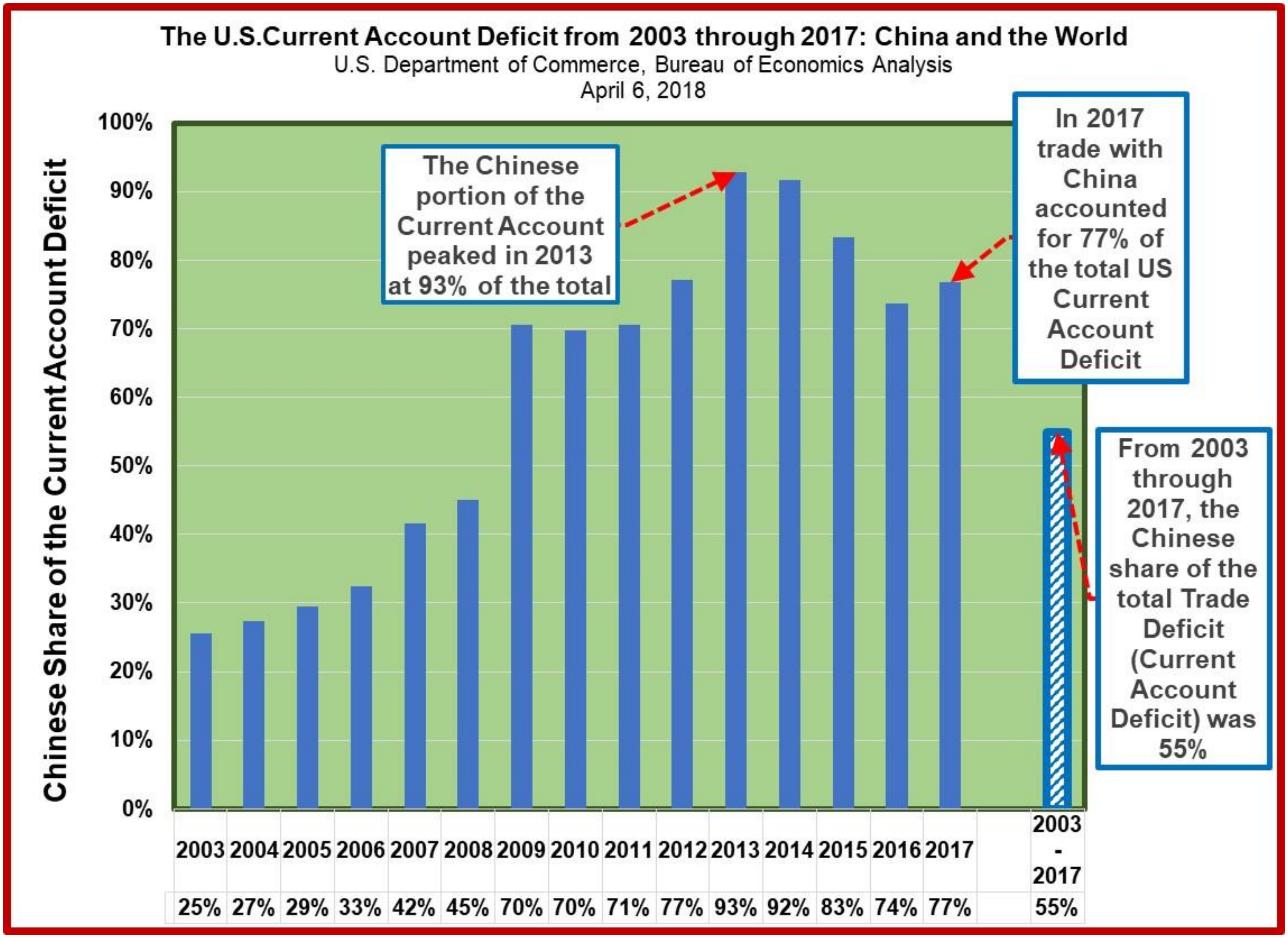
While there is no doubt that other nations have done the same in terms of intervention in the foreign exchange markets, China, accounts for the lion share of the overall Current Account Deficit with the U.S. in recent years and over the last 30 years or so.

This is clearly not free and fair trade.


The U.S.Current Account Deficit from 2003 through 2017: China and the World
U.S. Department of Commerce, Bureau of Economics Analysis
April 6, 2018
Chinese Share of the Current Account Deficit
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
The Chinese portion of the Current Account peaked in 2013 at 93% of the total
In 2017 trade with China accounted for 77% of the total US Current Account Deficit
From 2003 through 2017, the Chinese share of the total Trade Deficit (Current Account Deficit) was 55%
2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2003 - 2017
25% 27% 29% 33% 42% 45% 70% 70% 71% 77% 93% 92% 83% 74% 77% 55%

Unfair Trade?

As we have noted, the current and previous relationship between the U.S. and China is clearly not representative of a fair-trade environment between the partners. Keep in mind that China was admitted to the World Trade Organization and received most favored nation trading status (from the U.S.) with the intention to promote more free and fair trade between the nations. Again, you need only to point to what has transpired in terms of the continued and worsening of the Current Account Deficit between the U.S. and China ($358 billion in 2017 and $4.3 trillion in cumulative deficits from 2003-2017) and the relatively unchanged foreign exchange rate between the Chinese Yuan and the U.S. Dollar over the last couple of decades or more (1981 1.7CY per USD; 1994 8.6CY per USD; 2018 6.3CY per USD).

The Impact of the Trade Imbalance in the Balance of Payments between the U.S. and China

This trading relationship is referred to as the balance of payments between nations reflects the impact of that trade (e.g., exchange of goods and services) on real economic growth within those countries. Again, if we were to accumulate those trade deficits between 2003 and 2017 (data from previous years is a bit more difficult to dig out) the U.S. effectively lost $4.3 trillion dollars in production or a reduction in Gross Domestic Product (GDP) of that same amount. This is not to say that there is no benefit for U.S. consumers, nor harm to Chinese consumers since in the former case, American buyers benefit from lower prices while also reinforcing domestic competition; likewise, in the case of the latter, Chinese consumers are essentially denied access to a portion of their own production (goods and services are exported) and domestic prices tend to be higher.

Who has the most to lose in terms of a de facto trade war if the U.S. imposes tariffs on Chinese Goods and Services?

Recent political tension arising from the U.S., points to a series of tariffs (or at least the threat of tariffs) being directed at the Chinese in a list imports ranging from steel and aluminum to a variety of other goods. This is causing fears of a Smoot Hawley Tariff type disaster which crippled international trade in the Great Depression. This has to be taken in the proper context, however. While it is clear that if the U.S. imposes tariffs on Chinese imports, China will likely respond with tariffs on such things as agricultural products. Keep in mind that while those tariffs directed at U.S. imports will certainly impact American farmers and other producers, China, with its $358 billion in net exports (exports minus imports) certainly has much more to lose.

How does the exchange rate enter into the equation?

While the U.S. can look at and address this relationship from the perspective of the imposition of trade restrictions in the form of tariffs, etc., this can also be addressed from the foreign exchange side of the equation (the other price consideration). By simply entering into the foreign exchange markets and buying Yuan (and/or selling Dollars) the U.S. could rebalance the playing field, weakening the dollar and strengthening the Yuan. If the preceding actions are referred to as a war, keep in mind that the Chinese have been waging and taking advantage of this one-sided arrangement for the last 25 years and more. The bottom line is that Chinese have significantly more to lose in waging a trade war, namely a huge trade surplus. Frankly, the preferred or perhaps cleaner approach to addressing the imbalance would be to get involved in the foreign exchange markets – again, with the U.S buying Yuan (and/or selling Dollars).

The current state of affairs and where is it going from here.

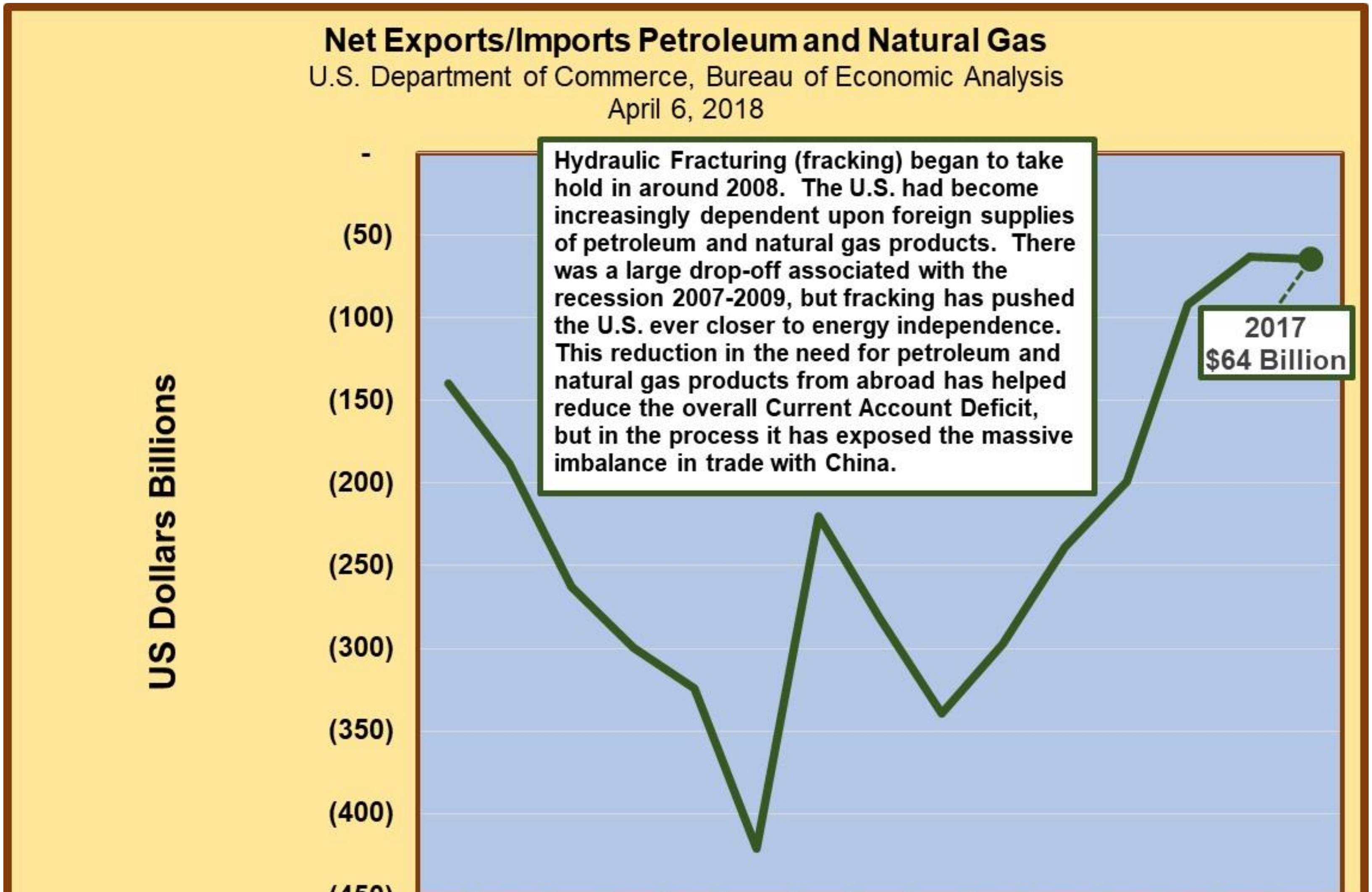
At the moment, most media outlets and pundits are decrying the current administration's proposals involving tariffs because of fears of reprisals and descending into a situation reminiscent of the Smoot Hawley Tariff during the Great Depression. There have been numerous instances before and since the imposition of the Smoot Hawley Tariffs and as a rule have not fared all that well.

The way a tariff works is quite simple. For every dollar imposed, that dollar is tacked on to the price of the imported good or service in question. The imposition of a tariff on Chinese goods would effectively increase the price of Chinese exports and American imports. The Chinese of course could respond in a reciprocal fashion with respect to the same goods and services, and or some other targeted items.

Again, the preferred way to address the imbalances would be by taking the foreign exchange route: buying Yuan and/or selling Dollars. Keep in mind that the other option would be to impose tariffs, i.e., taxes on (domestic) consumers. By taking the former approach, we would be addressing the original causation of the current problem: the Chinese devaluation of their currency – lo on 35+ years ago; when the price of the Yuan was changed from around $0.50 to $0.125 per Yuan (the 2018 level is in $0.16 per Yuan range). The impact related to this massive reduction in the price of the Yuan must not be understated. The price of the Yuan dropped by 75% and was reflected in a significant drop in the price of Chinese exports and the price of U.S. imports.

Fracking – the impact on current account imbalances

One of the under-reported stories over the last ten or so years is the impact that increased production of crude oil and natural gas has had on the overall trade imbalance. While the peak level of imported oil and natural gas was reached in 2008 (remember when the price of crude oil rose to more than $145 per barrel) at $421 billion, as late as 2011, the number was at $339 billion. In 2017, the deficit on petroleum and natural gas had fallen to $64 billion. Without the increases in domestic production brought about by hydraulic fracturing (fracking), the deficits would still likely be in the $700 to $800 billion ranges seen from 2005 – 2008. As it stands now, if the U.S. continues on the same trajectory, energy independence on a net export basis is likely going to become a reality in a few short years.



	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Net Exports/Imports Petroleum and Natural Gas	(140)	(188)	(263)	(299)	(325)	(421)	(220)	(282)	(339)	(297)	(239)	(199)	(92)	(63)	(64)

Last words

While we would prefer going the foreign exchange route to correct the trade imbalance, the trade restrictions in the form tariffs will have the same results. Again, to put this into perspective, imported goods have a depressing effect on the domestic economy because the goods and services are not being produced at home, nor is the related income going to the households. In looking at the $358 billion current account deficit related to China in 2017, this roughly equates to around 7 million jobs with salaries or wages in the $50,000 per year range. While we have experienced decades of job losses to China, the current aim is to reverse this process and bring those jobs back home.

This brings us back around to our initial lead in for the article: in all international transactions, there are two prices under consideration: the first price is the price of (Chinese) domestic goods and services in the home country (China) in terms of the Yuan. The second price, the Yuan price itself, is dictated by the foreign exchange market. To affect the exchange rate, to drive down the value of the dollar for example, would entail selling dollars and/or buying other currencies (Chinese Yuan). This relationship between the two prices is nearly always overlooked in most analysis where trade and international finance are seen as standalone considerations.

The added benefit to the Chinese with regard to running these enormous trade deficits is that they are accepting our growing indebtedness to them. This enables the Chinese to purchase increasing amounts of our US Treasury debt for example, or any other investments in the U.S. There has been some pushback in the way of blocking the purchase of some American firms (Maytag, etc.), but the pressure continues as evidenced by the increasing Chinese involvement in the domestic American economy.

On a last note, there have also been concerns raised regarding the ‘theft’ of intellectual property. The cost associated with that theft, is estimated to be well into the trillions of dollars whether we’re talking about corporate espionage, or plans related to advanced military equipment – from jet fighters to aircraft carriers.

We are at a very important crossroads regarding these trade relations with China. While there are different ways to address these complex issues, in a political sense, this is one ‘can’ that won’t be kicked any further down the road. Politicians have pointed to this trade imbalance problem for many years, but none have followed through. Let’s see what happens this time around.

Keep in mind that yes, this is a problem that has not only been ignored for well over 30 years, but it was actually rewarded in years past in terms of admittance to the World Trade Organization and the being further rewarded with ‘most favored nation status’.