WALSKY INVESTMENT MANAGEMENT

"Made in China"

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In our Fall 2016 newsletter, we pointed out that U.S. consumption has grown an average of 5.6% annually for the past 20 years, while the overall economy (as measured by the Gross Domestic Product) has grown less than 2% annually. Some readers asked if these figures prove that the U.S. trade deficit (especially with China) is hurting the economy. Perhaps. However, China's trade surplus was mainly the result of Chinese currency manipulation that may end up causing their economy to unravel and lead to a resurgence of U.S. economic growth.

It is easy to understand why most Americans do not view trade with China favorably. For over 30 years, it has been a lopsided affair. Since 1986, the U.S. trade deficit with China has grown an astounding 22,056%, leading many Americans to question the U.S. policy of supporting "free trade" agreements. For investors, the outcome of this debate is critical. Will the U.S. become protectionist? Will free-market influences prevail? Or, will the Chinese economy collapse as a result of decades of government manipulation of its currency to encourage exports?

In the 1950's, most Americans favored free trade as a way to help thaw cold war relations, but as

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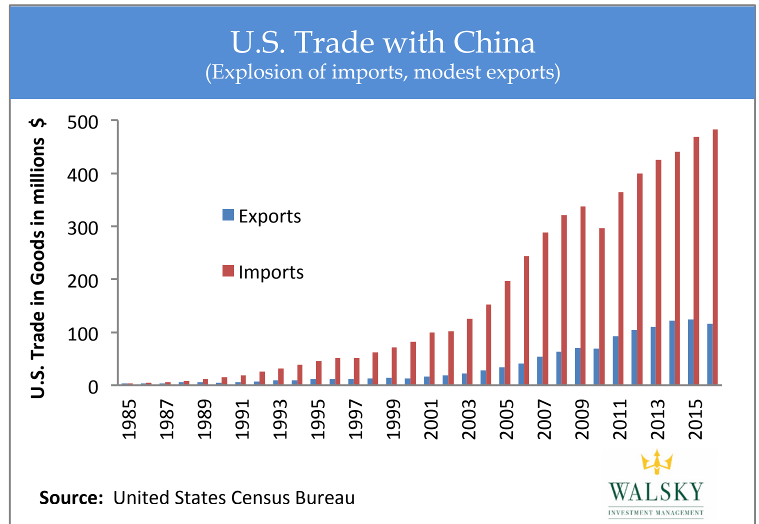

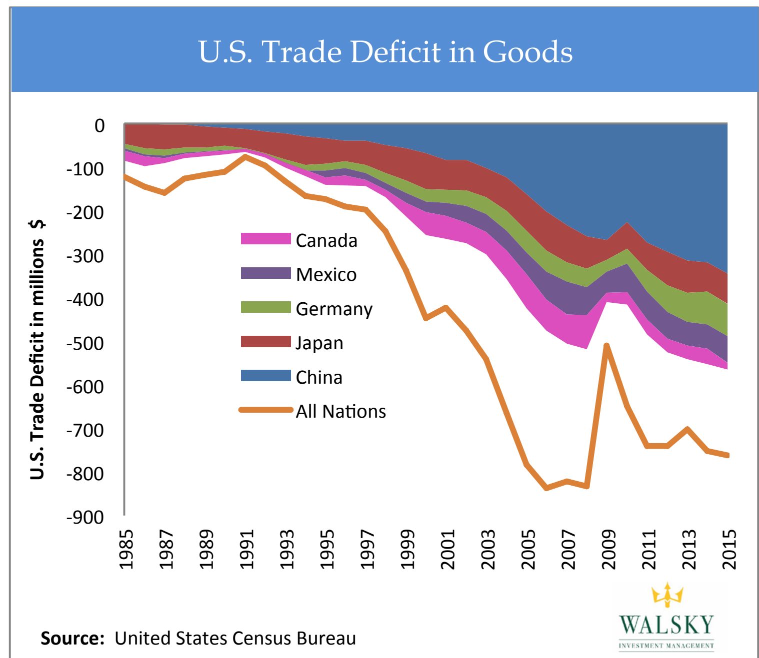

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trade deficits grew in the 1990's, many began to view international trade as a threat to their jobs. Today, 65% of Americans favor greater restrictions on imported goods, according to a recent Bloomberg poll. The changing view on international trade coincides with the growth in Chinese imports. A closer look reveals how China has played an integral role in the growing U.S. trade deficit, and why it is a unique problem.

The chart on the prior page shows how trade with China has resulted in the growth of the overall U.S. trade deficit in goods. In 1985, China comprised less than 1% of the deficit. In 2015, China accounted for 49% of the entire U.S. trade deficit. The next four largest trading partners (Japan, Germany, Mexico and Canada) made up 25% of the trade deficit. In all, these five nations made up 75% of the entire U.S. trade deficit in goods. There are several important elements that this data does not point out, however. First, only imported and exported goods are reflected, not services. While the U.S. has a growing deficit for goods, we are exporting more services than we import, with a trade surplus of $262 billion for services in 2015. Second, the chart does not identify nations with whom we have a trade surplus for goods. Third, it is difficult to see that with some nations, such as Canada, our trade deficit has been declining. However, what is apparent is that over the past 30 years, U.S. trade with China has been greatly imbalanced. It is this imbalance that has hurt U.S.-based manufacturers the most.

The modern history of America's trade with China began during the cold war. For more than 20 years after World War II, the two countries viewed each other as adversaries and had virtually no trade. The relationship began to change when President Nixon visited China in 1972. As diplomatic relations improved, U.S. companies began to explore how they could get into the Chinese market, leading to an initial growth (albeit small) in trade with China. A setback occurred in 1989 when Congress and President George H.W. Bush imposed a series of tough trade sanctions due to the Chinese government's actions during the Tiananmen Square protests. Trade between the nations remained tepid until 1993, when President Clinton decoupled China's human rights abuses from trade with the U.S. and renewed their most-favored-nation status, opening the U.S. market to a sea of Chinese products. According to Amnesty International, China remains an authoritarian state with a poor human rights record.

In theory, free trade between two countries results in them having neither a long-term trade surplus nor a long-term deficit. To counterbalance trade surpluses, the currencies of both nations would float freely, increasing or decreasing in value as the demand for each other's products and services shifts. For example, as Americans would demand more products from China than China from the U.S., there would be an increased demand for Chinese yuan vs. the U.S. dollar. This would cause the value of the yuan to increase relative to the dollar, thus making Chinese products more expensive for Americans. However, this has not occurred.

As is often reported, China has long prevented its currency (the yuan) from floating in the free market and pursued a policy of keeping the value of the yuan low in relation to the U.S. dollar. They did this to encourage exports and support robust economic growth at home. To prevent the yuan from increasing in value, the Chinese government offset the increased demand from Americans for the yuan by increasing China's demand for the dollar. Since the Chinese are importing fewer products from the U.S. than they are exporting and can't drive up the value of the dollar that way, the Chinese government purchased U.S. Treasury notes to offset America's demand for the yuan. Today, China holds $1.4 trillion of U.S. debt. These actions have caused robust economic growth in China and kept U.S. interest rates low.

However, implementing such a policy seldom ends well. The growth that China encouraged through currency manipulation has led to overbuilding and inflated real estate prices there. It has also caused U.S. economic growth (as measured by the GDP) to languish. The result is many economists fearing that the Chinese economy is a bubble about to burst. Ironically, the only way to prevent that from happening is to allow the yuan to increase in value relative to the dollar in an effort to slow down the overheated Chinese economy. This would cause a decline in imports of Chinese goods, which would in turn reduce the trade deficit and lead to greater economic growth in the U.S. For China, the choice is a "catch-22" that either way will result in the U.S. economy gaining steam after decades of disinflation.