Sinology

by Andy Rothman
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- Trump is right to focus on problems U.S. firms face in China, but his proposed remedy—taxes on Chinese imports—will be counterproductive.
- Many American firms and farmers already count on Chinese consumers for a significant share of their revenues, so retaliation by Beijing will be costly.
- Trump taxes will also raise prices for American families for goods like mobile phones and laptops.
- A less confrontational, multilateral approach to pressuring Beijing to improve the operating environment for U.S. firms would be more successful.

Dear President Trump,

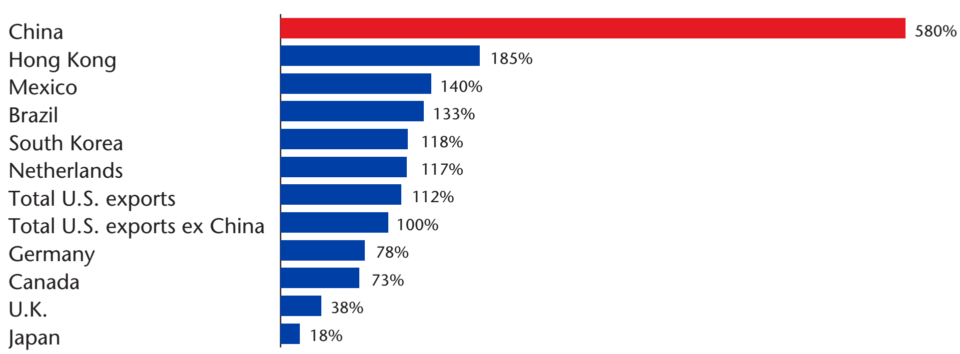
Thank you for the opportunity to comment on your plans to impose new taxes on imports from China, under Section 301 of the Trade Act of 1974. While I support your efforts to focus attention on the problems faced by some American companies in China, I believe your proposed remedy will harm the U.S. economy without pressing Beijing to further open its markets.

It is important to recognize that many American firms and farmers already count on Chinese consumers for a significant share of their revenues, so retaliation by the Chinese government will be costly. I encourage you to reconsider your focus on the size of the U.S. trade deficit with China: the deficit is not a scorecard for trade, and the American economy has prospered over many decades of running a deficit. China is the U.S.' third-largest export market for goods and services, and Beijing's support is critical to reaching constructive solutions to two of our most important strategic challenges—nuclear weapons programs in North Korea and Iran—so I encourage your administration to take a less confrontational, multilateral approach to pressuring Beijing to improve the operating environment for American companies.

Many U.S. Firms are Winning in China

China's 2001 inclusion in the World Trade Organization (WTO) has been a boon to many American companies. During the 16-year period when U.S. exports to China rose by 580%, our exports to the rest of the world were up by only 100%. This has opened up opportunities for many publicly listed American companies. General Motors sells more vehicles in China than it does in the U.S., and China accounts for about 20% of GM's global earnings. Boeing delivers more aircraft in China than in the U.S. China contributes 19% of Apple's revenue. Nike shoe sales in China rose 21% over the last quarter and accounted for about 17% of their global shoe revenue. China contributes roughly 15% of global earnings for firms such as Nvidia, Dolby and Tesla.

Figure 1. **U.S. EXPORT GROWTH TO THE TOP 10 MARKETS SINCE 2001**



Source: CEIC; Data as of December 31, 2017

While some American companies are blocked from the Chinese market, many are very profitable there. The U.S.-China Business Council represents some of those companies, and their latest member survey found that 90% of their China operations were profitable in 2016, up from 83% in 2014. The American Chamber of

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Commerce in China (Beijing) conducted a similar survey of its members, and 68% of companies described their operations in China as profitable or very profitable, and 69% said they plan to increase their investment in China operations.

China is also the largest overseas market for American farmers.

Retaliation by Beijing Would be Costly

There is no doubt that the Chinese government would retaliate against your proposed import taxes. And because so many American workers and shareholders profit from China, that retaliation could be very costly.

About one-third of the U.S. soybean crop is sold to China, which could cut its purchases and buy more from Brazil and Argentina. (It is worth noting that 24 Republican Members of Congress represent districts which account for about 60% of the total U.S. soybean crop.) Beijing could instruct its airlines to buy more Airbus and less Boeing. A trade war may leave Chinese consumers less inclined to buy GM cars, Apple phones and Nike shoes.

Exports to China are also important to job creation at home. You've probably read reports that imports from China led to 2.4 million U.S. job losses. But those jobs were lost over a more than 10-year period, while another study found that U.S. exports to China directly and indirectly supported 1.8 million new jobs in just one year, 2015. China is the single-largest market for Boeing, which reports that the company and its subsidiaries had about 140,000 employees working in 49 states at the end of 2016, and it supported an additional 1.5 million supplier-related jobs across the country.

Higher Prices for American Families

Trade with China has kept prices lower for American consumers. According to a study by Oxford Economics, in 2015 Chinese imports helped the typical U.S. household save up to $850.

For many goods the U.S. imports from China, such as mobile phones, notebook computers and televisions, there are few alternative sources, so your proposed import taxes are likely to result in higher prices for American consumers.

This is likely to have a disproportionately large impact on poorer Americans, as they tend to gain the most from trade. As a recent paper published by the National Bureau of Economic Research explains, poor consumers "spend relatively more on sectors that are more traded, while high-income individuals consume relatively more services, which are among the least traded sectors. Additionally, low-income consumers happen to concentrate spending on sectors with a lower elasticity of substitution across source countries."

China's Economy is No Longer Export-led, so Pressure is Limited

Some of your advisers appear unaware that China's economy is no longer export-driven, meaning that taxes on their shipments will have a very modest impact. Net exports (the value of exports minus the value of imports) account for only 2% of China's GDP. In contrast, domestic consumption accounts for the majority of China's economic growth and more than half of its GDP.

Because the U.S. takes only about 19% of China's exports, your proposed unilateral approach means that your taxes will apply to only a small minority of China's total exports, mitigating the overall impact.

It is also worth noting that much of the impact of your proposed taxes will not be borne by Chinese companies: about two-thirds of the 25 largest exporting companies based in China are foreign owned. Moreover, one-third of the value-added from all Chinese exports actually accrues to other countries, including U.S. partners such as Japan, South Korea, Taiwan and Germany, as well as to American companies.

The iPhone X is one example. According to Reuters, "IHS Markit estimates its components cost a total of $370.25. Of that, $110 goes to Samsung Electronics in South Korea for supplying displays. Another $44.45 goes to Japan's Toshiba Corp. and South Korea's SK Hynix for memory chips. Other suppliers from Taiwan, the United States and Europe also take their portion, while assembly, done by contract manufacturers in China like Foxconn [a Taiwan-headquartered company], represents only an estimated 3 to 6 percent of the manufacturing cost."

While only 3% to 6% of the manufacturing cost of an iPhone X accrues to China, the full cost of the device is included in China's trade surplus with the U.S. Most of the profits, of course, accrue to Apple, which designed the phone, and its shareholders.

The very modest impact on China of your import taxes means that Beijing will feel little pressure to respond by opening further its markets to American firms. It is even possible that Beijing's response will be to delay additional market opening plans, so as to not appear to be caving in to pressure from Washington.

A Multilateral Approach Will Be More Successful

Mr. President, I know that you prefer bilateral negotiations, but in this case a multilateral approach is likely to be more successful.

In a February report to Congress, Kevin Hassett, the chairman of your Council of Economic Advisors, noted that the U.S. is usually on the winning side of WTO cases. "The United States gets better outcomes via formal WTO adjudication than negotiation … the United States has won 85.7% of the cases it has initiated before the WTO since 1995."

Even if you choose not to work within the WTO framework, taking a coordinated approach with our partners in Europe and Japan—which account for 25% of China's exports—would put greater pressure on Beijing while making retaliation against our companies more difficult.

Past negotiations with China haven't led to perfect results, but have opened markets enough that our exports rose by close to 600% since Beijing joined the WTO 16 years ago, while the value of our agricultural shipments jumped by 1,000%.

The Size of Our Trade Deficit is Not Important

Finally, Mr. President, I'd like to take this opportunity to try to persuade you to focus less on the size of our trade deficit with China, and more on the process of opening up their market to our companies. Several years ago, Commerce Secretary Wilbur Ross said, "I think that it's total political nonsense, all the China bashing. The trade deficit we have with the rest of the world is almost equal to the trade deficit we have with China, so what's the big deal about China?"

Most economists agree with Secretary Ross that our deficit with China isn't a big deal. Mr. Hassett, your top economic advisor, last month wrote that the current account balance "reflects the excess of domestic savings over domestic investment" and that "policies that try to affect the trade balance without considering the broader current account balance, or vice versa, will be hard-pressed to succeed in the long run."

Trade is not a zero-sum game, and trade deficits are not a scorecard. Trade deficits are not a threat to economic growth and full employment, and a trade deficit can in fact be seen as reflection of a healthy economy (with strong demand for imports). The U.S. has run a current account deficit every year since 1992, but this has not caused an increase in U.S. unemployment. In fact, the unemployment rate has been relatively low during times when the U.S. current account deficit has been relatively large.

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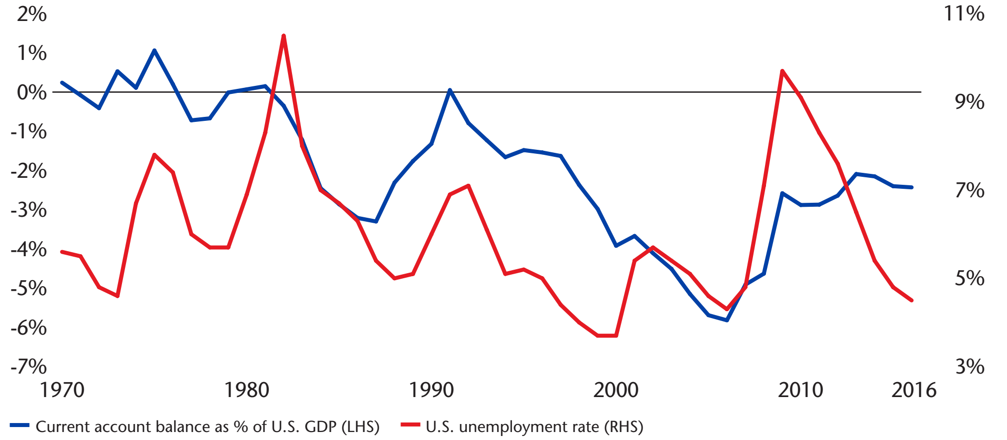
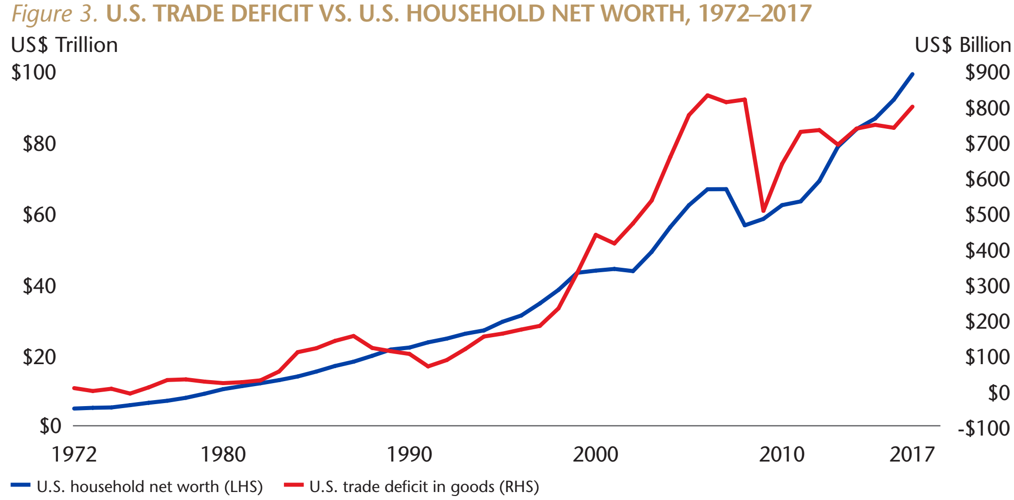
Figure 2. **U.S. UNEMPLOYMENT RATE AND CURRENT ACCOUNT BALANCE AS % OF U.S. GDP**



Source: CEIC

Since 1992, the steady rise in the U.S. trade deficit has also been accompanied by a three-fold rise in U.S. household net wealth.

Figure 3. **U.S. TRADE DEFICIT VS. U.S. HOUSEHOLD NET WORTH, 1972–2017**



Sources: Federal Reserve Bank of St. Louis, U.S. Census Bureau

An Opportunity to Change Course

Mr. President, your openness to comments on your proposed tax on imports from China, as well as your administration's ongoing discussions with Chinese leaders, gives me hope that you are willing to consider changing course to an approach with greater prospects for persuading Beijing to further open its markets, as well as fewer risks to the U.S. economy and equities markets.

In the past, American leadership within the global institutions that the U.S. helped create delivered new opportunities for U.S. companies in China and for U.S. consumers at home. Renewed pressure via the WTO, in coordination with our allies, is the best approach to pressuring Beijing to improve the operating environment for American companies.

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Sources: CEIC and China's National Bureau of Statistics unless otherwise noted.

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