America and China's codependency trap

Stephen Roach | Yale University | 05 September 2017

Seemingly at odds with the world, US President Donald Trump has once again raised the possibility of a trade conflict with China. On 14 August, he instructed the US Trade Representative to commence investigating Chinese infringement of intellectual property rights. By framing this effort under Section 301 of the US Trade Act of 1974, the Trump administration could impose high and widespread tariffs on Chinese imports.

This is hardly an inconsequential development. While there may well be merit to the allegations, as documented in the latest "USTR Report to Congress on China's WTO Compliance", punitive action would have serious consequences for US businesses and consumers. Like it or not, that is an inevitable result of the deeply entrenched codependent relationship between the world's two largest economies.

In a codependent human relationship, when one party alters the terms of engagement, the other feels scorned and invariably responds in kind. The same can be expected of economies and their leaders. That means in a trade conflict, it is important to think about reciprocity – specifically, China's response to an American action. In fact, that was precisely the point made by China's Ministry of Commerce in its official response to Trump's gambit. China, the ministry vowed, would "take all appropriate measures to resolutely safeguard its legitimate rights".

Caught up in the bluster of the US accusations being leveled at China, little attention is being paid to the potential consequences of Chinese retaliation. Three economic consequences stand out.

First, imposing tariffs on imports of Chinese goods and services would be the functional equivalent of a tax hike on American consumers. Chinese producers' unit labor costs are less than one fifth those of America's other major foreign suppliers. By diverting US demand away from Chinese trade, the costs of imported goods would undoubtedly rise sharply. The possibility of higher import prices and potential spillover effects on underlying inflation would hit middle-class US workers – who have faced more than three decades of real wage stagnation – especially hard.

Second, trade actions against China could lead to higher US interest rates. Foreigners currently own about 30% of all US Treasury securities, with the latest official data putting Chinese ownership at US$1.15 trillion in June 2017 – fully 19% of total foreign holdings and slightly higher than Japan's $1.09 trillion.

In the event of new US tariffs, it seems reasonable to expect China to respond by reducing such purchases, reinforcing a strategy of asset diversification away from US dollar-based assets that has been under way for the past three years. In an era of still-large US budget deficits – likely to go even higher in the aftermath of Trump administration tax cuts and spending initiatives – the lack of demand for Treasuries by the largest foreign owner could well put upward pressure on borrowing costs.

Third, with growth in US domestic demand still depressed, American companies need to rely more on external demand. Yet the Trump administration seems all but oblivious to this component of the growth calculus. It is threatening trade sanctions not only against China – America's third-largest and fastest-growing major export market – but also against NAFTA partners Canada and Mexico (America's largest and second-largest export markets, respectively). As the reactive pathology of codependency would suggest, none of these countries can be expected to acquiesce to such measures without curtailing US access to their markets – a counter-response that could severely undermine the manufacturing revival that seems so central to the Trump presidency's promise to "Make America Great Again".

In the end, China's economic leverage over America is largely the result of low US domestic saving. In the first quarter of 2017, the so-called net national saving rate – the combined depreciation-adjusted saving of businesses, households, and the government sector – stood at just 1.9% of national income, well below the longer-term average of 6.3% that prevailed over the final three decades of the twentieth century. Lacking in saving and wanting to consume and grow, the US must import surplus saving from abroad to close the gap, forcing it to run massive current-account and trade deficits with countries like China to attract the foreign capital.

It is sheer political chicanery to single out China, America's NAFTA partners, or even Germany as the culprit in a saving-short US economy. Fostering policies that encourage an economy to squander its saving and live beyond its means makes trade deficits a given – as are the seemingly unfair trading practices that may come with this Faustian bargain for foreign capital.

The US ran trade deficits with 101 countries in 2016 – a multilateral external imbalance rooted in America's chronic domestic saving problem. The fix for this problem cannot be made in China. Ironically, with the Trump administration's policies likely to lead to larger budget deficits that put national saving under additional downward pressure, the need for Chinese and other foreign capital will actually intensify and the codependency trap will only close more tightly.

America does not hold the trump card in its economic relationship with China. The Trump administration can certainly put pressure on China, and, on one level, there may well be good reason to do so. But deep questions concerning the consequences of such pressure have been all but ignored. Getting tough on China while ignoring those consequences could be a blunder of epic proportions.

Stephen S. Roach, PhD, former Chairman of Morgan Stanley Asia and the firm's chief economist, is a senior fellow at Yale University's Jackson Institute of Global Affairs and a senior lecturer at Yale's School of Management.