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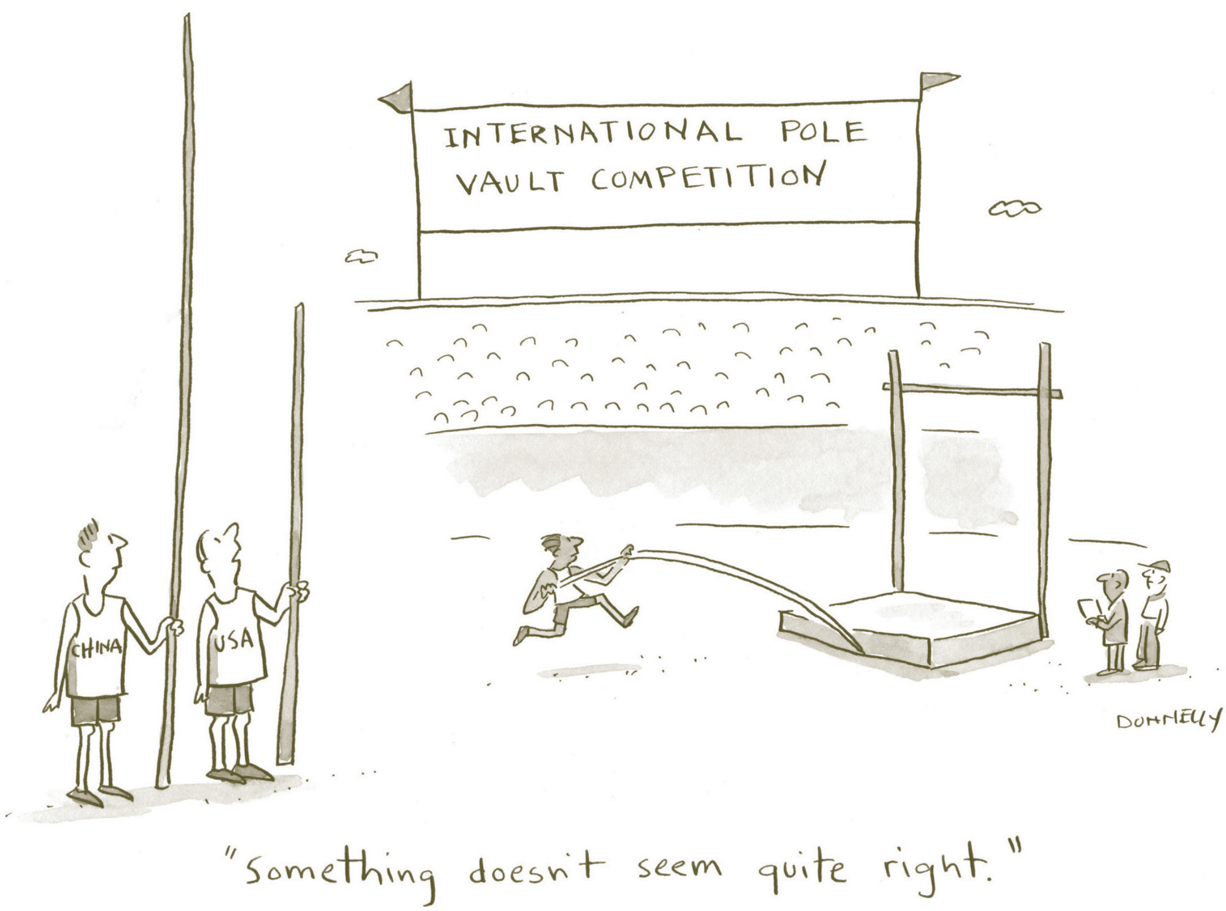
THE DISPARITY IN CHINA-U.S. TRADE

In March, a tit-for-tat pattern of trade tariffs began between the U.S. and China, the world's two biggest economies. The U.S. rolled out plans to implement tariffs on steel and aluminum imports and, later, announced an additional $50 billion in tariffs on Chinese imports—both purportedly in response to unfair trade practices and the theft of U.S. intellectual property by China.[1] China retaliated with tariffs of its own, aimed at everything from pork and soybeans to chemicals and automobiles. In June, tensions continued to escalate as President Trump announced an effective date for the aforementioned tariffs and began identifying hundreds of billions of dollars more to potentially levy in the future. The rest of the world is waiting to see if these threats will create a trade war and hinder the decades-long drive toward globalization. »



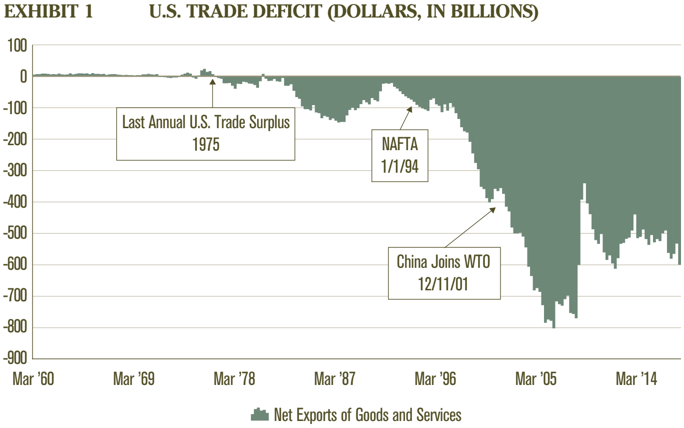
Even so, the tariffs have been small relative to the roughly $16 trillion worth of goods that change hands around the globe every year—almost $4 trillion of which is to and from the U.S. alone.[2] But they've been significant enough to make investors nervous and to spur a volley of articles about "the coming trade war."

While a trade war between the U.S. and China could be a costly and consuming affair, one need only look briefly at the history of U.S. trade to see that a trade *negotiation* is long overdue. Over the past few decades, a $375 billion trade deficit has built up between the U.S. and China. Using history as a guide, this article offers insight into how that deficit has developed and explains how trade agreements or protectionist actions, such as the tariffs currently being levied, affect the domestic and global economy.

A Brief History of the U.S. Trade Deficit

In the second quarter of 1975, the U.S. trade surplus peaked at $21.6 billion. That was the last trade surplus the U.S. would see in the 20th century. By the second quarter of 1976, the U.S. had begun its long, steep slide into the trade deficit we are experiencing today. In the late 1970s, both Europe and Japan began to compete effectively with the U.S. in a range of industries, and imports of oil greatly increased as OPEC rose to international prominence. The trade deficit continued to widen, as shown in Exhibit 1, until 2005 when it peaked at just over $800 billion. Since then it has scaled back, but still stands at a towering $600 billion.

EXHIBIT 1 U.S. TRADE DEFICIT (DOLLARS, IN BILLIONS)



Source: FactSet (U.S. Bureau of Economic Analysis). Data reflects seasonally adjusted annualized rate as of 3/31/18.

Two events in recent history can be pointed to as sources for this massive trade deficit: the enactment of the North American Free Trade Agreement (NAFTA) in 1994 and China joining the World Trade Organization (WTO) in 2001.

Part One: NAFTA Is Established

The goals of NAFTA were to boost the international competitiveness of North American exports, to better incorporate Mexico in the North American economy, and to reduce illegal immigration flowing from Mexico into the U.S. Over the past couple of decades, some of these goals have been achieved. The trade agreement lowered the costs of goods manufactured in the U.S.—a boon to consumers and an advantage for the U.S. and Canada on the global trading stage. However, those cost-cutting measures had ramifications for the U.S. job market. Companies moved many lower-skilled jobs from the U.S. to Mexico, where labor is significantly cheaper. In turn, this created other well-paying U.S. jobs in fields like logistics.

Ultimately, various competing factors make it difficult to calculate NAFTA's net effect on the gross U.S. domestic product. As we will discuss further, China joining the WTO in 2001 changed the manufacturing landscape, making it even more difficult to isolate the benefits of NAFTA.

From the campaign trail, President Trump was vocal about his opposition of NAFTA. In mid-2017, his administration triggered talks aimed at modernizing the agreement. While all parties have expressed a willingness to renegotiate, the clamorous political environment has threatened to derail the ongoing talks.[3]

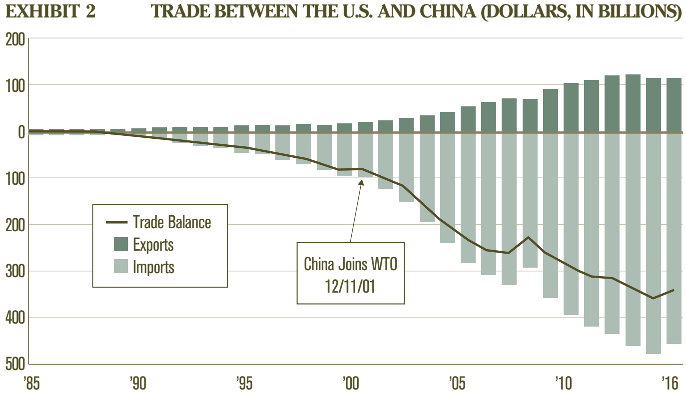
Part Two: China Joins the WTO

After NAFTA, the next significant increase in the U.S. trade deficit occurred when China joined the WTO in 2001. Prior to this, China's murky history of questionable data and predatory trade tactics led many countries to avoid entering into trade agreements with it. Because the WTO acts as an international watchdog, regulating trade between nations and resolving trade disagreements between its 164 members, China's affiliation sent a signal to the rest of » the world that the country was now compelled to play by the global trade rules. This notion, as well as the decreased barriers to trade with other member companies, opened up many new trade opportunities for China.

In reality, though, China has not demonstrated a willingness to change its ways and be a team player in the world trade arena. Instead, it has allegedly forced companies to transfer technologies to Chinese firms, restricted companies' access to Chinese markets, and stolen technology patents. And yet, complaints within the WTO against China are rare, potentially due to a fear of retaliation. This could also be a reflection of how difficult it is for outsiders to monitor and trust data coming out of the country—and therefore review and enforce China's WTO obligations—given its authoritarian system.[4]

The U.S. has borne the brunt of many of China's questionable tactics, and the U.S. trade deficit has increased accordingly. Before 2001, trade with China made up less than 25% of the U.S. trade deficit. Now, it accounts for two-thirds of it.[5] As shown in Exhibit 2, the U.S. trade deficit with China currently stands at nearly $400 billion.

EXHIBIT 2 TRADE BETWEEN THE U.S. AND CHINA (DOLLARS, IN BILLIONS)



Source: The Economist, "Averting a Chinese-American Trade War" (U.S. Census Bureau). Data as of 12/31/17.

The Trump administration is hoping the proposed tariffs and other trade pressures will help to reduce our trade deficit with China. However, economists are estimating that the recently proposed U.S. tariffs will have a minimal effect on Chinese GDP growth. This is primarily due to the fact that China's dependence on the U.S. has declined significantly over the last few decades, as China's economy has become less reliant on exports. Exports accounted for only 19% of Chinese GDP growth last year, down from 35% in 2007. Relatedly, contributions to GDP from Chinese household consumption have steadily increased over the past five years. As China has taken its place on the global stage, it has focused on becoming an independent producer and consumer.[6]

Bottom Line

If the Trump administration is able to negotiate better trade agreements with China, it will be a boon for the economy and a big step toward correcting the U.S.'s ballooning trade deficit. But given China's current leverage, negotiations will be far from easy. And should talks devolve into a trade war, it will likely cause chaos in the markets. Uncertainty around trade policy was the root of much of the market volatility that occurred in the first half of 2018. Regardless of how the situation evolves, we will continue to monitor it closely to ensure our clients' portfolios are properly protected. ■

Flash Update: Throughout the second quarter, trade tensions intensified, further increasing the potential for a trade war. However, stocks largely continued their upward trend—perhaps signaling that investors have grown accustomed to the unpredictable trade headlines, or even that they view the renewed focus on trade as a positive. ■

1 *Bob Davis, "U.S. to Apply Tariffs on Chinese Imports, Restrict Trade Deals," Wall Street Journal, March 22, 2018.*

2 *Avi Salzman and Daren Fonda, "The World on Edge: How Trade Tensions Threaten the Economy, Companies, and Investors," Barron's, April 16, 2018.*

3 *Carl R. Tannenbaum, Ryan James Boyle, and Vaibhav Tandon, "A NAFTA Retrospective," Northern Trust Weekly Economic Commentary, April 27, 2018. https://www.northerntrust.com/insights-research/detail?c=6d19fe23b0113c4d1c3696ad9eb2a7bf.*

4 *Greg Ip, "China Started the Trade War, Not Trump," Wall Street Journal, March 23, 2018.*

5 *"Averting a Chinese-American Trade War," Economist, March 30, 2017.*

6 *Liyan Qi, Chun Han Wong, and Dominique Fong, "China's Shift Away from Exports Provides Cushion Against Tariffs," Wall Street Journal, March 23, 2018.*