The United States of America was founded on a trade dispute. Late on the evening of November 29, 1773, a band of Bostonian patriots, angry at tariffs imposed on tea imported to the colonies by the East India Company, dumped 342 chests of tea into the Boston Harbor, thereby setting into motion a string of events that ran from Lexington and Concord all the way to Yorktown and Independence Hall. The Revolutionary War was fought over both political and economic independence. America has always been a trading nation.

Two hundred and forty-six years later, the nation is once again engaged in a war over trade, although this time the conflict is waged with tweets and tariffs instead of militiamen and muskets. In the pages that follow, we explore the evolving role of international trade in the U.S. economy, the current state of disputes with China, what risks this conflict poses and how it might be resolved.
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TRADE AND THE U.S. ECONOMY

Despite the attention that trade currently attracts in the media, it is a relatively small part of the U.S. economy. Personal consumption is by far the biggest engine of economic activity, accounting for 68% of total gross domestic product (GDP) as of the second quarter of 2019. As the nearby graph illustrates, consumption has long been the largest contributor to the economy and has even risen slightly over time. Contribution from business spending has hovered around 20% of GDP, rising and falling slightly in importance as business cycles either encourage spending (during expansions) or impede it (during recessions). Similarly, government spending has historically been about 20% of the economy as well and usually moves conversely to business spending, as governments use fiscal stimulus to address periods of economic weakness.

Just as government and business spending tend to move in opposite directions, note that personal consumption and net exports are inversely correlated as well. This makes sense. If a nation consumes more than it produces, it has no option but to import more than it exports. As Americans have consumed more and more over time, and therefore become a bigger and bigger part of GDP, an increasing share of this consumption is manufactured abroad.

From the end of World War II through the early 1970s, the United States ran a trade surplus, which contributed to GDP. Since then, however, the U.S. has imported more than it has exported, resulting in a trade deficit and a drag on GDP. The math is simple: When we consume goods and services created abroad, this creation is another country’s GDP, not ours. In the most recent quarter (second quarter 2019), the United States exported $2.5 trillion of goods and services and imported $3.2 trillion (at an annualized pace). The difference of $700 billion is equivalent to -3.1% of GDP.
These figures on their own do not represent a failure of policy or practice. A perfect balance of trade with any other country is no more than a theoretical aspiration. Indeed, the United States has historically run a trade surplus with the Netherlands, Singapore, Australia, the United Kingdom, Argentina, Chile and others. As the nearby pie graph shows, the U.S. exports to just about every country in the world. Our largest export market, Canada, accounts for only 10% of total exports, followed by Mexico, China, Japan and the United Kingdom. The rest of the world comprises the other 69% of U.S. exports, demonstrating how diversified our export markets are.

Imports are a bit more concentrated, with China representing 17% of total U.S. imports. Mexico, Canada, Japan and Germany round out the top five, with the rest of the world accounting for the balance of 53%.

Although U.S. trade is a relatively small part of the overall economy, and reasonably well diversified around the world, it is more important for some sectors than others. One-third of U.S. exports are services, and most of this is spending on travel and tourism, intellectual property licenses and business services. Industrial goods – including energy – make up about 22% of U.S. exports. Capital goods exports are broadly diversified and account for 23% of exports. The automotive sector relies heavily on trade: 6% of total U.S. exports are vehicles, parts and engines.

The automotive sector is even more meaningful on the import side, accounting for 12% of total imports to the U.S. Other broad import categories are fairly well balanced, with services, industrial products, capital goods and consumer goods each comprising around 20% of total imports.

Just as the U.S. runs surpluses with some trading partners, so, too, does the U.S. run surpluses in some economic sectors. Services is the clearest example of this, where the U.S. exported $827 billion of services in 2018 and imported $567 billion, for a positive trade balance of $260 billion.

These are small figures relative to overall economic activity but loom large in some critical industries that rely heavily on good trading relationships. These figures furthermore do not take into account the secondary implications of tightly networked supply chains. An entirely domestic company that sells to U.S. corporate customers who are in turn reliant on exports may have unanticipated and indirect exposure to international demand. Similarly, a domestic company that relies on parts and services from abroad is also exposed to trade risk.

Finally, consumers depend on trade as well, whether they realize it or not. The four largest U.S. importers of goods by volume are all retail companies selling directly to consumers: Walmart, Target, Home Depot and Lowe’s. In its annual ranking for 2018, The Journal of Commerce reports that these four companies alone imported almost 2.3 million cargo containers last year. The goods you buy at these four retailers (and most others as well) likely sailed across an ocean to reach you and are subject to the global trading environment.

**THE BENEFITS OF TRADE**

Trade is good. From a theoretical standpoint, economists argue that free trade allows for a more efficient allocation of financial,
natural and human resources. The law of comparative advantage, formulated by David Ricardo in 1817, explains why trade between two countries is beneficial even in the extreme case that country A is better than country B at manufacturing everything. In essence, if country A reallocates resources to the production of those things it is really good at, and imports from country B those things that it is only marginally good at, standards of living and economic activity increase in both countries. A more efficient allocation of resources is economic magic.

The world is, of course, not this simple. In many cases, goods and services are only found in certain areas. Tourism is the most obvious example. If you want to see the Coliseum, you have to go to Rome and support the Italian economy. Closer to home, your kitchen would be culinarily poorer without Brazilian coffee, Italian olive oil, French wine, Japanese steak knives and Mexican avocados. Many goods and services simply do not have domestic equivalents. Trade improves life.

Trade offers political benefits as well. Countries with trading ties rarely go to war with each other. President Richard Nixon understood this dynamic, and, despite his intense hostility toward communism, traveled to China in February 1972 to establish a commercial relationship between China and the United States. It is hard to imagine this today, but at the time China was largely closed to Western commerce and tourism. Nixon’s historic visit ended an isolation that stretched back to the communist takeover of China in 1949 and laid the groundwork for the economic reforms of Deng Xiaoping just a few years later. At the same time, Nixon’s economic overtures drove a political wedge between China and the Soviet Union.

Nixon was the first U.S. president to go to China, but he wasn’t the last. Every president since (with the curious exception of Jimmy Carter) has made at least one formal state visit to China. Economic ties cement political ties.

TRADE FRICCTIONS

If trade is good, what are the sources of the current dispute, and why has it arisen now? Both questions share a common and obvious answer. As a presidential candidate, Donald Trump committed to “negotiate fair trade deals that create American jobs, increase American wages and reduce America’s trade deficit.” Once elected, President Trump carried through on this commitment within hours of his inauguration, walking away from the Trans-Pacific Partnership (TPP) and insisting on a reset with the European Union on the Transatlantic Trade and Investment Partnership (TTIP). President Trump then turned his attention to a renegotiation of the North American Free Trade Agreement (NAFTA), resulting in the United States-Mexico-Canada Agreement of 2018 (signed, but not yet ratified by the legislatures of the three countries).

It is one thing to walk away from unsigned treaties and tweak existing ones. It is another thing altogether to completely restructure the basis of trade with a major economic power. Having dealt with Asia, Europe and our neighbors to the south and north, in 2018 President Trump turned his attention to the single largest exporter into the United States and the source of the single largest bilateral deficit – China. In the 12 months ending May 2019 (the most recent monthly data), the United States exported $110 billion of goods and services to China and imported $514 billion from China. The difference of $404 billion represents the trade deficit with China that the White House would like to see narrow.

In the 12 months ending May 2019 (the most recent monthly data), the United States exported $110 billion of goods and services to China and imported $514 billion from China. The difference of $404 billion represents the trade deficit with China that the White House would like to see narrow.
The nearby graph of U.S.-China trade argues that escalating tariffs are affecting both imports and exports but to a varying degree. (Our data is based on a trailing 12-month calculation to adjust for seasonal variability.) On this annualized basis, U.S. exports to China are down about 17% from March 2018, when President Trump first threatened to impose tariffs. Imports from China, although down over the past few months, are right about where they were when tariffs were first imposed. In other words, U.S. demand for Chinese goods and services is unchanged from the beginning of the trade dispute, and the U.S. trade deficit with China has therefore widened over this period.

Personal consumption growth in the U.S. remains healthy, implying that other exporters have stepped into the gap to meet this rising demand. A quick glance at bilateral trade with other countries bears out this conjecture. Imports from Mexico and Canada to the U.S. have risen nicely over the past year and a half, but the real beneficiaries are other Asian economies. U.S. imports from Vietnam are up 13% since early 2018, imports from Cambodia have risen 21%, and Myanmar has enjoyed a 35% bump in exports to the United States.

This is impressive in percentage terms, but the size of these smaller Asian markets—even if combined—pales in comparison to China. This data argues that the real winners of the U.S.-China trade war, so far, are those markets that are benefiting from shifting trade patterns.

On August 1, President Trump, unhappy with the pace of negotiations, threatened to levy a 10% tariff on a further $300 billion of Chinese imports as of September 1, in addition to the $250 billion of Chinese imports already subject to a 25% tariff. This imposes tariffs of 10% or 25% on essentially all Chinese exports to the United States.

A final broad issue is better protection of intellectual property. China has long been accused of pilfering U.S. technology by insisting on joint ventures in critical sectors, obtaining sensitive technology from JV partners, and then using that technology elsewhere. Here, too, China has made gradual progress. In December 2018, China issued a list of 38 specific punishments for Chinese companies that steal proprietary technology from business partners, including restricted access to financing. As part of that announcement, China explicitly acknowledged U.S. concerns for the first time: “The release of the memo, one of the most detailed documents on intellectual protection issued by China, signals a further step by China to strengthen IPR protection and shows China’s sincerity in addressing American expectations so far.

On a related topic, President Trump is demanding that China open its markets more fully to American exports, particularly in the areas of financial services and automotives. There are 1.4 billion people in China with a GDP per capita of $15,000. This represents a growing demand for things like automobiles, savings accounts and insurance policies that the United States wants to help meet. China is making progress on these fronts, albeit at a measured pace. Earlier this year, Premier Li Keqiang promised that China is “quickening the full opening of market access for foreign investors in banking, securities and insurance sectors,” but the “quickness” of this reform falls short of American expectations so far.
concern over the issue.” To make the point even clearer, the Chinese memorandum continues, “It could be useful as part of the U.S.-China trade discussions, but this is not a direct reaction to pressure from the U.S.”

The good news is that the direction of reform in China is consistent with U.S. demands. The bad news is that change moves slowly in a 4,000-year-old nation. Committing to reform is one thing. Implementing and monitoring it is another.

The pace of change (or lack thereof) is a driving force in trade negotiations, due in no small part to the U.S. election cycle. Economically, the United States holds the stronger hand in negotiations. Trade is a large part of the Chinese economy, so the U.S. can theoretically exert more economic pain on China than China can on the U.S. through the imposition of tariffs. Politically, however, the advantages are reversed. Whereas the American president has to face an election every four years and is term limited from more than eight years in office, Chinese President Xi Jinping faces no such constraint on his leadership. China can wait out the current U.S. administration – even at the cost of short-term economic pain – and hope for a more malleable successor.

Domestically, prolonged trade friction is a double-edged sword. On one hand, addressing the imbalance of trade with China is as close to a bipartisan issue as can be found in Washington these days, and President Trump’s supporters generally applaud his approach to China. And, with other sectors of the economy doing well, the United States can afford some pain in export markets as China retaliates with tariffs of its own. The domestic unemployment rate is low, wages are rising, inflation is subdued and financial markets are near all-time highs.

On the other hand, the uncertainty of prolonged trade disruption does pose a risk to the broader economy, which informed the Federal Reserve’s decision in late July to lower interest rates by 25 basis points and accelerate the end of balance sheet adjustments. In the absence of the risks to the global economy posed by trade disputes, there is simply no rationale for the Federal Reserve to ease monetary policy. Traders have concluded that there is more to come. In the wake of the Fed’s action in late July, futures markets placed the probability of another interest rate cut in September at more than 90%.

WHAT NEXT?

The politics on both sides of the negotiating table imply that this conflict can be resolved. President Trump wants a victory headed into the 2020 election, as would any candidate for re-election, and China knows that it has enjoyed the benefit of outdated trade agreements for far too long. We are encouraged by the steps that China has taken to address U.S. concerns, while recognizing that the pace of progress falls short of U.S. demands. Our optimism, however, is tempered by the recognition that mistakes happen in tense situations. We see three scenarios in which the present trade environment might deteriorate to the detriment of the U.S. economy.

First, current tensions could both escalate and broaden, and arguably we are already experiencing this. Within hours of President Trump’s August 1 announcement that the U.S. would levy tariffs on all Chinese exports as of September, China promised to retaliate without offering any specifics. The imbalance of trade makes it hard for China to match U.S. tariffs proportionately, as the country’s $514 billion of annualized exports to the U.S. is far larger than our $110 billion of exports to it. This might prompt China to apply pressure to specific U.S. industries or companies in addition to broader tariffs. Technology companies are particularly wary of this risk. The U.S. has already engaged in targeted trade measures by placing severe trading restrictions on Huawei, a leading Chinese technology exporter. If the U.S. follows through and imposes tariffs on all Chinese exports, the risk of more targeted measures will increase. China could, for example, restrict the export of vital materials such as rare earth minerals, critical elements for technology manufacturing that are only found in China.

This possibility raises a second category of risks, namely that U.S. companies might rein in investment and spending in response to heightened uncertainty about trade. Not only does this pose a threat to the 17.6% of the American economy that is the business sector, but it potentially has implications for hiring and employment as well. There is some evidence that business sentiment has already shifted in response to trade uncertainty. As shown in the nearby graph, the Institute for Supply Management’s Purchasing Managers’ Index (PMI) declined to 51.2 in July, the weakest level since August 2016. Readings below 50 are historically associated with a downtown in economic activity.

![U.S. Manufacturing Sentiment](chart)

**U.S. Manufacturing Sentiment**

The U.S. second-quarter GDP report confirmed this slowdown in corporate activity, as business spending subtracted 1.0% of economic growth during the quarter. Fortunately, personal consumption was strong enough to drive overall GDP higher, but it is meaningful that business spending was negative for just the second time in the past three years and was the biggest drag on a quarterly GDP report since the recession of 2008-2009. One quarter does not a trend make, but this apparent deceleration in business sentiment and spending warrants consideration.

Finally, if tariffs become part of the permanent trade relationship between the U.S. and China, it could lead to higher inflation. This is not yet the case, at least at the broad level. The Consumer Price Index (CPI) was up a mere 1.6% in June, and up only 2.1% if the more volatile elements of food and energy are excluded. Average hourly earnings have grown faster than 3% for the past year, thereby outpacing inflation and allowing real incomes and living standards to expand. This may change, however, as tariffs broaden to cover more consumer goods and if companies choose to pass on higher tariffs to their end customers.

If the White House carries through on its threats, tariffs will for the first time be imposed on Chinese exports of toys, clothing, shoes and consumer electronics. To the degree that companies choose to pass these higher costs through to customers, consumer inflation might begin to rise more rapidly. Subdued inflation allows the Federal Reserve to pre-emptively lower interest rates, as it did in late July. If inflation accelerates, however, the Fed would lose that leeway and might even find itself needing to raise interest rates to contain inflation even as economic conditions worsened.

None of these scenarios is a forecast. We still believe that both sides want to come to a resolution, notwithstanding the rhetorical fireworks that accompany trade negotiations. At the same time, the path to resolution is not entirely clear.

CONCLUSIONS

The U.S. economy is in great shape. Unemployment is at a 50-year low, wages are rising at the fastest pace in 10 years (but not fast enough to spark inflation), interest rates are low and dropping, and the stock market and housing prices are at all-time highs. All of this translates into robust consumer confidence, and robust consumer confidence translates into personal spending and GDP growth. In June 2019, the U.S. economy set a record for the length of an expansion.

And this record is likely to extend unless an escalating trade war upends this fortunate convergence of economic tailwinds. The fact that companies and individuals have taken the trade dispute in stride for the past few years is a testament to underlying fundamental strength, but we should not take that for granted.