

Flash Economics

10 August 2018 - 889

Donald Trump should realise that the prior relationship between China and the United States was favourable to both countries

President Trump wants to impose massive taxes on US imports from China, with the stated objective of eliminating the US external deficit with China.

But he should realise that the prior equilibrium between China and the United States was favourable to both countries:

- China had a large external surplus with the United States, and lent to the United States by accumulating foreign exchange reserves;
- There was therefore increased production in China and increased consumption in the United States, and the increased US consumption was financed by China on very favourable terms for the United States.

The transition to a new equilibrium without a US external deficit with China and without Chinese lending to the United States will therefore reduce US consumption (as Chinese products become more expensive in the United States) and Chinese production, and will therefore be unfavourable to both countries.

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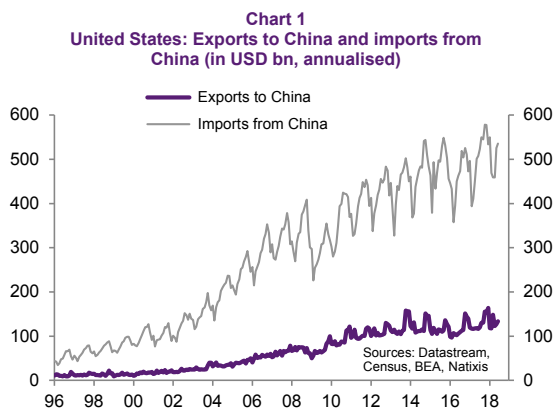
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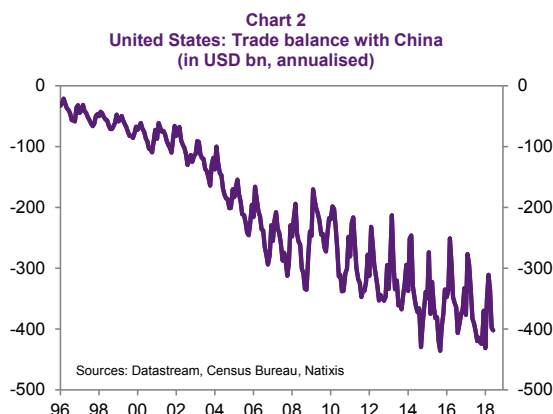
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Donald Trump's objective

President Trump has announced **massive taxes on US imports from China (Chart 1)**, to which China will respond with equivalent retaliatory measures.



Trump's stated objective is to **eliminate the US external deficit with China (Chart 2)**, in the idea that this elimination would boost production in the United States.



But it should be realised that **the prior equilibrium between China and the United States was favourable to both countries.**

The prior equilibrium between China and the United States was favourable to both countries.

In the prior equilibrium:

- **China had a large external surplus with the United States (Chart 2);**
- **China accumulated foreign exchange reserves** due to its external surpluses (**Charts 3A and B**), and **a large proportion of the foreign exchange reserves accumulated by China was lent to the United States**, since a large proportion of the purchases of US bonds by central banks (other than the Federal Reserve) is due to China, as shown in **Chart 4**.

Chart 3A
China: Trade balance (USD bn, annualised)

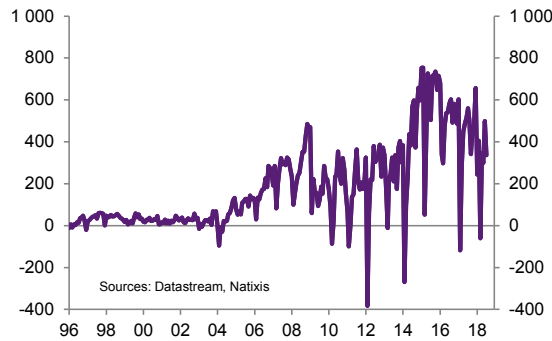


Chart 3B
China: Foreign exchange reserves (USD bn)

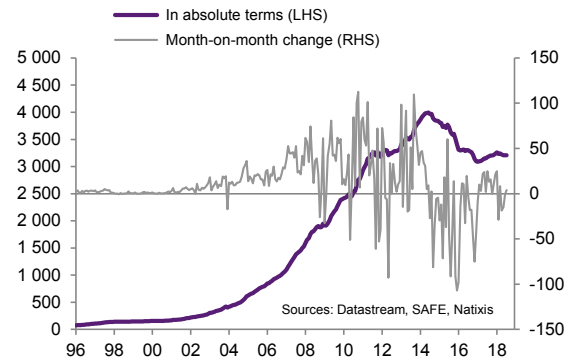
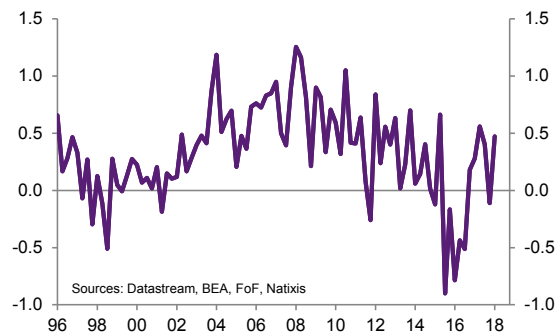


Chart 4
United States: Purchases of US bonds by foreign central banks (as % of nominal GDP)



It is therefore clear that this **equilibrium is favourable to the United States and to China:**

- **The United States can consume more** (have a very low savings rate, **Chart 5**), since the **resulting external deficit (Chart 6) is financed without any problem by foreign central banks**, and especially by China;
- **China can produce more** by exporting to the United States (**Chart 1** above).

Chart 5
National investment and savings rates (as % of nominal GDP)

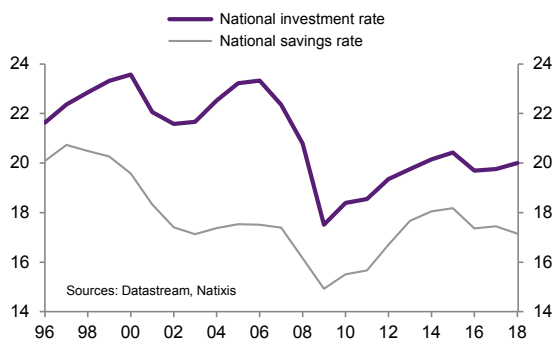
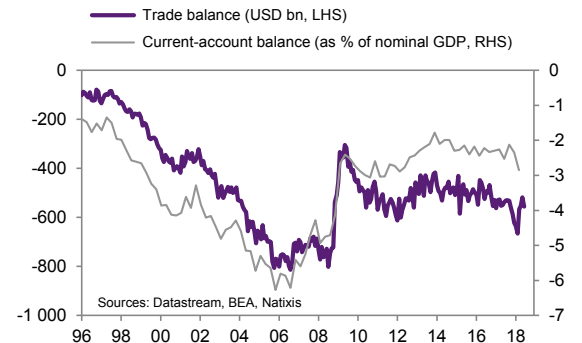


Chart 6
United States: Trade balance and current-account balance



Conclusion: The transition to the new equilibrium wanted by Trump will be unfavourable to both the United States and China

Since the former equilibrium (Chinese external surplus with the United States, Chinese lending to the United States financing the US external deficit) was favourable to both the United States and China, **the transition to the new equilibrium** (tariffs and reduction in China's external surplus with the United States) **will be unfavourable to both countries.**

In the **United States**, tariffs will reduce real household income and household consumption. In **China**, the fall in household demand in the United States will reduce exports and production.

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