

# THE ORIENTAL ECONOMIST

ALERT

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## ECONOMIC FALLOUT IF TRUMP HITS CHINA, MEXICO ON TRADE TRADE WAR BLOWBACK, PART 1

### Key points:

- **Trump trade war with China, Mexico would cause economic slump, loss of jobs**
- **Would not “bring back jobs” since growth in imports from China mostly replaced imports from elsewhere in Asia**
- **Cannot bring back jobs that were never in US (auto shift to Mexico is a different story)**
- **Tariffs would be a tax hike equal to 1.5% of GDP**
- **Unless countered by some tax cut, it means cut in GDP, perhaps enough to cause recession; size of the impact depends on multiplier effects and other factors**
- **Firms now sourcing from China will move to other countries, but complex supply chains cannot be rejiggered in just a few months**
- **More than half of imports from China, and over three-quarters from Mexico are capital goods and intermediate goods that firms need for their own US-based production; hence, the price hike would not only disrupt the production of these firms, but make them less competitive in global and domestic markets vs. other foreign competitors**
- **Other consequences—the hit to American exports and financial market turmoil—will be discussed in part 2**

### Overview

What would be the economic fallout from a President Donald Trump carrying out his threats to impose a 45% across-the-board tariff on imports from China, and slap a tariff of 35% on imports from the Mexican operations of Ford, Carrier, and perhaps other American importing

products from their Mexican affiliates? Would the negative impact be big enough and sufficiently clear as to great lots of political pressure on Trump to retreat?

We should start off by saying that the positive impact Trump promises—a return of jobs to the US—isn't going to happen. At least not in the case of China. That's because it was not American jobs that moved to China when its exports increased. Most of the increase in China's exports to the US in the last 15 years simply replaced exports from other countries in Asia, from Japan to Korea to Thailand. So, a decline in US imports from China might increase jobs in Vietnam or Malaysia, but not in Flint or Dubuque.

As for the negative effects, we'd classify them under the following categories:

- 1) **Price shock/tax hike.** The “first order effect” of a 45% tax of all imports from China would be equivalent to a tax hike of 1.2% of GDP. There would likely be some job losses.
- 2) **Trade War.** China and Mexico would likely retaliate against US, causing a drop in US exports to China and Mexico. China might even hinder the export of certain critical items to the US, just as it hindered shipments of “rare earths” to Japan during the 2012 dust-up over the Senkakus issue. This, too, could lead to some job losses
- 3) **Financial Market turmoil.** The stock market and currency markets would react—possibly in a bigger way than they did over fears a China slowdown during the second half of 2015.
- 4) **Impact on East Asia.** The countries of East Asia would likely be hurt even more so than the US. Exports from Japan and the rest of East Asia depend more on China's own exports to the US than on China's internal growth.

### **China Didn't Take US Jobs; So Tariffs On China Are Not “Bringing Them Back”**

Donald Trump promises that harsh trade tactics will bring jobs back to the US, as in a recent interview with CNBC:

“I'm going to bring jobs back from China. I'm going to bring jobs back from Mexico and from Japan, where they're all—every country throughout the world—now Vietnam, that's the new one. They are taking our jobs. They are taking our wealth.”

His logic seems like common sense to many voters. In 2015, the US imported \$482 billion worth of goods from China in 2015, but exported just \$116 billion, leading to a bilateral trade deficit equal to 2% of US GDP. Trump can point to American economists who claim that this deficit has cost America millions of factory jobs.<sup>1</sup>

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<sup>1</sup> A recent paper getting a lot of press play— *The China Syndrome: Local Labor Market Effects of Import Competition in the United States*—claims imports from China cause a loss of 1.53 million

The problem is that this argument flies in the face of a simple reality. The big rise in imports from China over the past 15 years did not replace products previously made in the *US*; rather, it mostly replaced products previously imported from *elsewhere in Asia*. This is documented in a December 2015 report from the Congressional Research Service entitled, *China-US Trade Issues*:

In 1990, 47% of the value of US manufactured imports came from Pacific Rim [i.e. East Asian] countries (including China); this figure *declined* to 46% in 2013. Over this period, the share of total US manufactured imports that came from China increased rose from 3.6% to 26% (*emphasis added*; see *Figure 1*).

In short, the growth in manufactured imports from China didn't *add* substantially to America's overall imports of factory goods; it mostly *replaced* imports that had previously come directly from other countries.<sup>2</sup> Moreover, to a large degree, products like semiconductors, which previously came directly from Japan, now come to the US inside a computer assembled in China. US trade law requires that it be labeled "Made in China," even though if the value of the Made-in-Japan components is greater than the value of the work done in China. There is the famous case of the iPod which is labeled "Assembled in China," but only 4% of its value consists of Chinese inputs, mostly assembly labor.

The CRS report continues:

In 2000, Japan was the largest foreign supplier of US computer equipment (with a 20% share of total US imports), while China ranked fourth (with a 12% share). By 2014, the value of [Japan's] shipments dropped by 73% from 2000 levels, and its share of US computer imports declined to 3.4%. China was by far the largest foreign supplier...with a 64% share...While US imports of computer equipment from China from 2000 to 2014 rose by 725.1%, the total value of US computer imports worldwide rose by only 52.4% [*emphasis added*].

Moreover, while computers are the largest single item in China's exports to the US, 99% of those exports are made by foreign-owned firms who choose to locate their assembly in China rather than other foreign countries. If tariffs imposed by Trump made Chinese costs prohibitive, then, over time, they'd move their assembly to some other countries, perhaps Thailand, or Vietnam or Mexico. How can Trump "bring back" those low-skill assembly or textile jobs to the US when they haven't been in the US for decades, and left the US ages

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US factory jobs between 1990 and 2007. The authors state: "We more conservatively estimate that Chinese import competition explains...21% of the decline [in manufacturing jobs during 1990-2007]."

<sup>2</sup> Certainly, America's *global* imports of manufactured goods rose as a share of US GDP, just as they did in most countries, as they all became far more interdependent. But, as we can see in *Figure 1*, the growth in imports from China mostly reflected this trend; it didn't cause it.

before China became the world's factory? Is Trump going to respond by imposing tariffs on Thailand and Vietnam?

The situation may be very different regarding Mexico, particularly in the automotive industry, where many jobs were clearly shifted from the US to Mexico.

### **“How Comes Everything I Buy Is Made in China?”**

Recently, a friend asked me: “How Comes Everything I Buy Is Made in China?” It's easy to understand this perception. An American who walks into the local Walmart will find that about 70% of the goods on the shelves carry the “Made in China” label. In 2010, 36% of the clothing and shoes bought by American were labeled “Made in China.”

But the shoes, shirts, toys, hammers, cellphones, and patio chairs that one buys at Walmart comprise only a small share of the overall consumer dollar. A few years back, the Federal Reserve Bank of San Francisco found that goods carrying the “Made in China” label account for just 2.7% of all consumer spending on goods and services. One reason that it's so small is that the Chinese supply is limited to just a few items that, in total, account for just about 8% of total US consumer spending. For example, goods labeled “Made in China” account for 20% of all consumer spending in the “furniture and household equipment” category and 36% of all spending in the “clothing and shoes” category. On the other hand, Chinese-made goods have little presence in services, which takes up two-thirds of the US consumer dollar, or in food, energy, autos, and so forth (see *Figure 2*).

Even though “Made in China” goods account for 2.7% of US consumer spending, the actual Chinese content is just 1%. The other 1.7% consists of inputs from other countries that are just assembled in China, e.g. the Japanese chips and American glass assembled into an iPhone by a Taiwanese-owned firm operating in China. The Chinese share is higher in lower tech goods. In textile, apparel and footwear, it's more like 75%. In electrical and optical machinery, it's 46%. In some items, like a cellphone, it can be as low as a few percent.

Moreover, the San Francisco Fed found the same trend as the Congressional Research Service did: most of the rise in US imports of consumer goods from China came, not at the expense of American producers, but of producers in other countries.

The total import content of US consumer spending on imports from all countries was relatively stable in the 12-14% range during 2000-2010 (of which about half consisted of the crude petroleum imports embedded in gasoline and other consumer products). On the other hand, the Chinese content of US consumer spending doubled from 0.9% in 2000 to 1.9% in 2010 (see *Figure 3*). The Fed concludes:

The fact that the overall import content of U.S. consumer goods has remained relatively constant while the Chinese share has doubled indicates that Chinese gains have come, in

large part, at the expense of other exporting nations.

### **Why Some Tasks Are Done In China: iPhone, Corning Glass, and China**

Some tasks are done in China because that happens to be the best—not just the cheapest—placed to do them. Take, for example, the glass screen in an iPhone. Steve Jobs insisted on glass because he found that plastic screens were too easily scratched. Apple hired America's Corning Inc. to make the big panes of specialty glass, but those panes had to be cut—with immense precision in cutting and grinding—to fit them into the iPhone, and at a cost that would keep the iPhone affordable. According to the *New York Times*, Corning could not do that part of the job, but a company in China could. It's not clear that a company elsewhere in Asia that could match the Chinese price could also match the quality.

Those glass-cutting jobs are not “coming back” to the US because they were never in the US in the first place. A 45% tariff on an Apple iPhone would raise the price so much that fewer of Trump's working class supporters could afford them.

### **Supply Shock: Trump Would Impose Big Tax Hike During Lackluster Recovery**

The most immediate impact of Trump's tariffs against China and Mexico would be a big tax hike equal to perhaps 1.5% of US GDP. Doing this in the midst of a lackluster recovery would be, as the GOP is fond of saying, “a job-killer.” A tariff is a tax paid by those importing goods from China and Mexico. It goes from the pockets of US firms and consumers straight into the vaults of the federal government.

US imports from China in 2015 amounted to 2.7% of US GDP. A 45% tariff would equal 1.2% of GDP.

Total manufactured imports from Mexico equal 1.6% of GDP. Trump has talked of levying a 35% tariff on products produced by Ford and Carrier (air conditioners) in Mexico on the grounds that they have shifted production from the US to Mexico. 56% of the manufactured goods imported from Mexico are made by US firms importing them from their affiliates there. If Trump applied the same principal to all of these firms, that would mean a tax hike on Mexican imports equal to another 0.3% of US GDP.

So, that's a total of 1.5% of GDP, even if Trump includes no other countries in his tariff plans. Unless Trump returned that money to US firms and consumers via some other tax cut, that would remove 1.5% of purchasing power from the US economy. That's the kind of hit that could cause a mini-recession, such as the 1.4% peak-to-trough decline in US GDP seen in the 1990 recession. Trump may remember that “It's the economy, stupid,” led voters to evict President George H.W. Bush from the White House in 1992.

The size of the hit to GDP depends not only on the direct “multiplier effects” of such a tax hike, but also on what economic uncertainty does to business investment.

Naturally, much of the assembly-fabrication done in China will *eventually* shift to other countries. But these are very complicated supply chains, sometimes involving as many as two dozen countries for a single product. One does not rejigger such supply chains in just a few months. Think of all the physical and human infrastructure required: airports, roads, transport equipment, communications, electricity, workers, managers, and even the acreage of available industrial land. As in the iPhone glass screen example cited above, these supply chains are quite complex and not always easy to shift, particularly in high-tech industries.

### **Hitting US Firms Who Trade With China, Mexico**

The tariff hikes would cause a big disruption beyond the macroeconomic ripples effects of the big tax hike. That’s because it would disrupt the operations of all the firms involved in US trade with China and Mexico.

In the case of China, 80% of all the manufactured goods that the US exports to China are made by US firm to their subsidiaries, affiliates, joint venture partners, or related firms in China. 77% of all the manufactured goods the US imports from China come from related firms. In the case of Mexico, the comparable numbers are 70% for US exports and 56% for US imports (see *Figure 4*).

When most people think of imports from China, they think of shoes, clothes, consumer electronics products, and so forth. But the majority of the products the US imports from China, Mexico, indeed globally, are capital and intermediate goods that US firms need to run their own production processes in the US.<sup>3</sup> A disruption in supply from China and Mexico—or a very sudden hike in prices—would disrupt these firms’ production within the US. It would also make their products less competitive.

For example, if US automakers (be they part of the Detroit Three or foreign “transplant” factories) were forced to pay more for steel, they would be less competitive vis-à-vis imports from Japan, Korea, and Europe. Does America’s national interest lie in protecting the American steelmakers and steelworkers selling to US-based automakers? Or, does it lie in keeping American-based auto plants competitive by giving them access to the least expensive supplies? The same goes for US firms importing semiconductors and other parts for their computers and other electrical and electronic products.

In the case of China, almost half (46%) of all the manufactured products imported by the US from China consist of capital goods and intermediate goods. Another fifth (19%) are dual-use

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<sup>3</sup> Capital goods are primarily the machinery needed to run production processes; intermediate goods would be the parts and materials used in production, e.g. steel or fabricated metal parts.

goods, almost entirely cell phones and computers that can be bought by either companies or consumers. Just a third (35%) are pure consumer goods, like the shoes, socks, T-shirts and cellphones, or patio chairs one might pick up at the local Walmart. In the case of Mexico, almost 70% of all the manufactured products imported by the US consist of capital goods and intermediate goods. Another 16% are dual-use goods, almost entirely cell phones and automobiles that can be bought by either companies or consumers. As we can see in *Figure 5*, the pattern with China and Mexico resembles that of US imports globally.

The bottom line is that it's impossible to hit imports from China and Mexico without doing a lot of damage to US firms using those imports, and the people working at those firms.

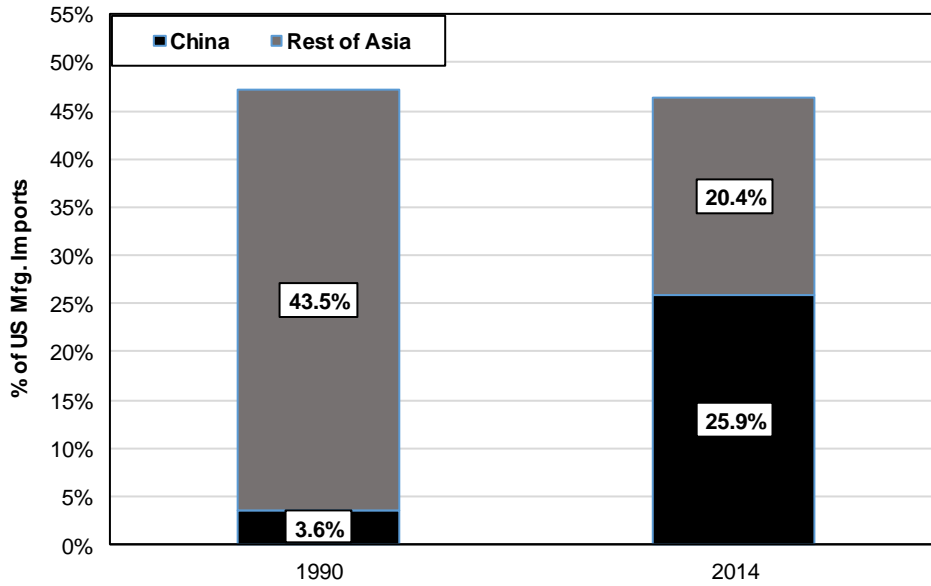
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**Figure 1: US Mfg. Imports Just Shift from Elsewhere In Asia To China**



Source: Congressional Research Service

**Figure 2: Import Content of US Consumer Spending**

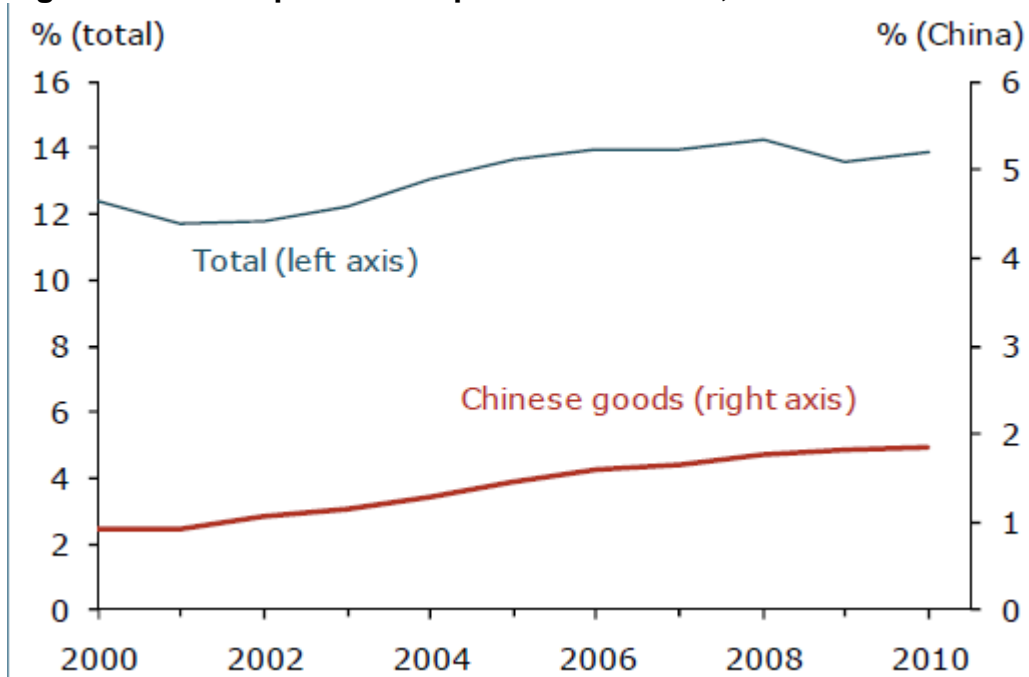
	% of US consumer spending	Share		Import Content	
		"Made in US"	"Made in China"	Total	Chinese inputs
<b>Total</b>	<b>100.0%</b>	<b>88.5%</b>	<b>2.7%</b>	<b>13.9%</b>	<b>1.0%</b>
<b>Durables</b>	<b>9.9%</b>	<b>66.6%</b>	<b>12.0%</b>	<b>26.3%</b>	<b>7.3%</b>
Motor vehicles	3.4%	74.9%	1.2%	27.4%	1.9%
<b>Furniture/equipment</b>	<b>4.7%</b>	<b>59.6%</b>	<b>20.0%</b>	<b>27.8%</b>	<b>11.6%</b>
Other durables	1.8%	69.0%	11.8%	20.5%	6.2%
<b>Nondurables</b>	<b>23.2%</b>	<b>76.2%</b>	<b>6.4%</b>	<b>22.1%</b>	<b>3.3%</b>
Food	8.0%	90.8%	0.4%	13.9%	1.1%
<b>Clothing/shoes</b>	<b>3.4%</b>	<b>24.9%</b>	<b>35.6%</b>	<b>33.6%</b>	<b>14.7%</b>
Gasoline/fuel oil/etc.	3.6%	88.4%	0.1%	34.1%	0.5%
Other nondurables	8.4%	77.7%	3.1%	20.1%	2.0%
<b>Services</b>	<b>66.9%</b>	<b>96.0%</b>	<b>0.0%</b>	<b>9.2%</b>	<b>0.6%</b>
Housing	16.6%	100.0%	0.0%	2.5%	0.4%
Household operations	7.2%	99.7%	0.0%	10.6%	0.6%
Transportation	1.6%	90.4%	0.0%	20.8%	0.4%
Medical care	18.4%	99.3%	0.0%	6.0%	0.6%
Recreation	8.2%	99.6%	0.0%	6.6%	0.8%
Other services	14.9%	84.3%	0.0%	20.2%	0.5%

Source: Federal Reserve San Francisco

Note: "Made in China" is in quotes because of the quirks of US trade law; see text for explanation

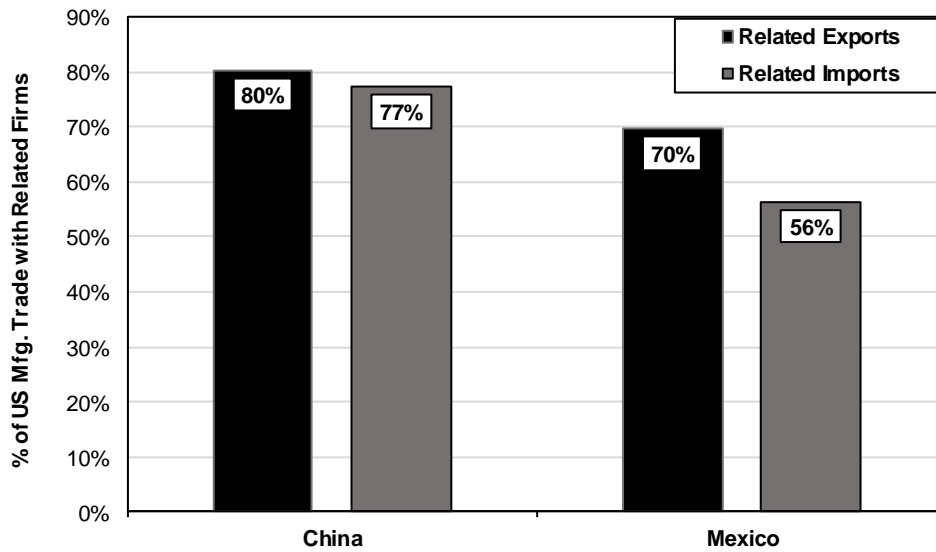


**Figure 3: Total Imports vs. Imports From China, % of US Consumer Spending**



Source: San Francisco Federal Reserve

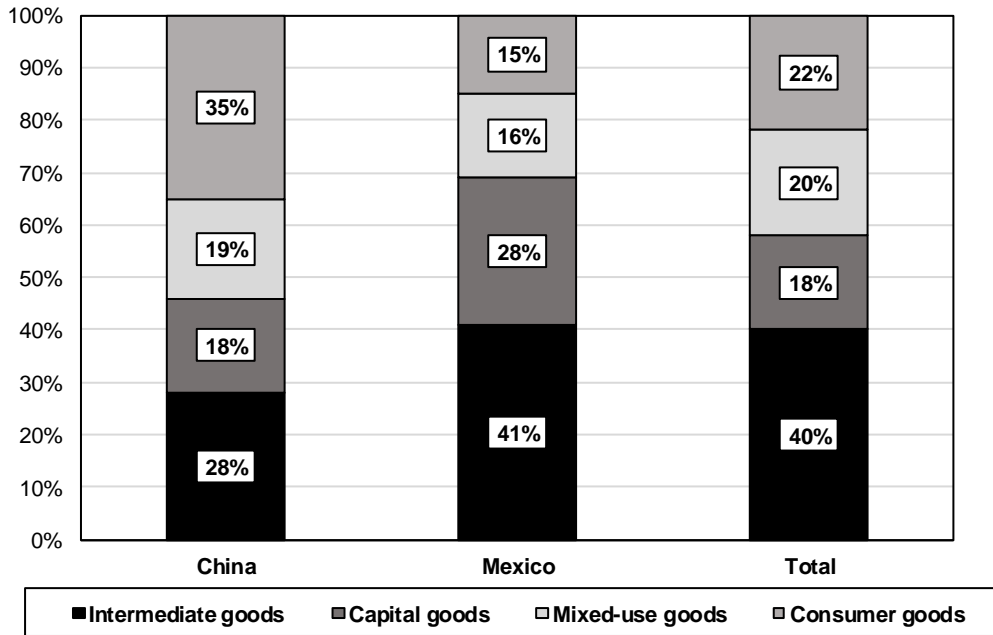
**Figure 4: US Firms Export To, Import From, Their Affiliates in China, Mexico**



Source: Commerce Department

Note: The share of US manufactured exports to, and imports from, firms' subsidiaries, joint venture partners, and other related parties

**Figure 5: China, Mexico Provide Capital/Intermediate Goods Used In US Production**



**Source:** Commerce Dept.

**Note:** Mixed-use manufactured goods (e.g. can be either consumer good or capital good) include phones and computers in the case of China and phones and vehicles in the case of Mexico)