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Domestic macroeconomic sources of the USA–China trade conflict

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Abstract

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Purpose – Trade relations between China and the USA have been marked by conflict, especially since China's membership in the World Trade Organization (WTO). These conflicts have been analyzed from a variety of perspectives, including the loss of jobs in the USA due to Chinese imports, competition in high technology sectors and the balance of trade. Conceptual frameworks have employed models of domestic differences as well as models of international power distribution. Among domestic differences examined are the existence of state-owned enterprises in China compared to the domination of the USA economy by private firms, the large role of the Communist Party in China and the influence of labor and environmental and labor groups in the USA. Power distribution theories focus on the systemic effects of the distribution of power on trade openness and on the pattern of intra-bloc versus between-bloc trade. This paper aims to examine the role of macroeconomic policy factors in China and the USA, in particular, the role of national patterns of savings, investment and consumption (both private and government). The paper concludes that insofar as the balance of trade is an important component of the trade conflict, domestic macroeconomic factors continue to be important. The resolution of the conflict will have to take into account the respective macroeconomic policies of China and the USA.

Design/methodology/approach – The design is an analytic case study of US–China trade relations with a particular focus on the balance of trade. The conceptual framework employed involves an analysis of macroeconomic policy categories, especially the overall pattern of savings (household, firm and government), investment and consumption. Process tracing over time since China's membership in the WTO is carried out with an eye toward the relationship between the balance of trade and macroeconomic policy.

Findings – The main findings are that there is a strong relation between the respective macroeconomic policies of the USA and China and their trade relations. The domestic political economy of the USA encourages consumption and a low rate of savings. The opposite is true of China where household income is low by design and national savings are high. China depends on the USA to consume what is not consumed domestically. The USA depends on Chinese imports for additional consumption encouraged by its low rate of savings. The two economies are locked in a mutual dependence.

Research limitations/implications – Key research implications are that there should be more focus on domestic macroeconomic policies since these are the root causes of the trade imbalance. This is not to say that trade frictions centering on jobs, subsidies and competition in high technology are unimportant. However, without the resolution of differences in the management of macroeconomic policies, trade conflicts between the USA and China will continue.

Practical implications – Practical implications are huge, in some ways much more important than the academic implications. Macroeconomic policy differences in savings, investment, government spending, taxation and infrastructure are important. Furthermore, there are available tools in both China and the USA to manage the macroeconomy, particularly, monetary and fiscal policy.

Social implications – One implication of this paper is that satisfaction or dissatisfaction of workers is dependent on income distribution which in turn affects trade. Treatment of people in different socioeconomic categories, such as the elderly, the young, and those at working age are a function of macroeconomic policies.

Originality/value – Many people have written about macroeconomics. It is a conventional subfield of economics. The originality of this paper lies in its advocacy of a shift of focus and attention and in the argument that traditional macroeconomics is related to trade. Despite its importance, macroeconomics has not been the center of attention for most political scientists, though economists have made it more central.

Keywords Investments, Macroeconomics, Consumption, Savings, Imbalances, Trade deficits

Paper type Research paper



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At the theoretical level, this article is about macroeconomic imbalances within capitalist economies and the implications of these imbalances for the balance of trade. The traditional macroeconomic categories are savings (households, firms and government), investment (firms and governments) and consumption (again households, firms and government). The way toward a positive balance of trade is to increase savings by reducing private consumption and/or to decrease government expenditures in relation to revenues.

These categories refer us to the simple analytics of trade accounting but behind these categories lie the dynamics of household savings and consumption and the amounts of national savings for investment, infrastructure and growth. If national income is distributed unequally among these categories, e.g. if households have too little or too much, or if firms have too little or too much, we can see crises of consumption or investment with predictable consequences for trade policies. Despite the importance of these imbalances for trade, they are often pushed into the background in favor of a focus on tariffs, regulatory playing fields, property rights, theft and subsidies. Indeed, in the US–China trade conflict during the USA presidential election campaigns of 2016 and 2020, savings, investment and consumption barely made an appearance.

While the macroeconomic picture is clear to economists, it does not get the recognition it deserves in the press. Part of this is due to the fact that economic theory has been preoccupied with the notion of a self-equilibrating economy and has missed endogenous imbalances. Marx was a departure from this model (indeed he saw capitalism collapsing under the weight of its own dynamics of accumulation) but the problem for Marx never developed a rigorous model of the crises of capitalism, aside from some broad observations about periodic crises of underconsumption and over/underinvestment. More importantly, he analyzed each country as a closed economy which ruled out trade and capital flows as central components of crises.

It was not until Keynes that we got a satisfactory treatment of the oscillations of capitalism with implications for trade. Keynes' work showed that disequilibrium was a systematic feature of the economy—not an aberration. Departures from equilibrium in terms of overinvestment, underinvestment, too much and too little consumption, periods of under-savings followed by over-savings, manias and crashes were normal features of capitalism. Keynes *General Theory of Employment, Interest, and Money* (1936) was his attempt to understand the oscillations of the capitalist economy and to devise policies to deal with them.

While US–China trade became an acute political issue in 2016, conflict had been brewing for a number of years. China is a huge country, with a large labor supply, and a comparative advantage in labor-intensive manufacturing. In this sense, China was a sleeping giant years before its economic takeoff. In any trade model based on relative factor abundance, as outlined in the [Stolper-Samuelson theory \(1941\)](#), the huge relative labor supply implied that China would export goods intensive in labor inputs. However, what this meant for workers in importing countries did not become clear until several years after China's entry into the World Trade Organization (WTO) in 2001.

Deng's reforms, dating from 1978 but accelerating in the following years, involved foreign investments, privatization of state-owned enterprises and the decrease of protectionist measures. Not all these reforms took place at the same time, but they coalesced in the 1990s and spurred manufacturing production and exports. This period of reform was followed by membership in the WTO in 2001 and a successful campaign for permanent most favored nation (MFN) status. Prior to this, MFN status was granted on a yearly basis. Yet decisions about corporate investment require long time horizons. In this sense, the interests of China and US corporations were the same. Indeed, the lobbying leading up to the vote in the US Congress pitted corporations against a coalition of labor unions and environmental interests.

China's rapid economic development comes with an even more impressive acceleration of its exports. It is the second-largest economy in the world, at current exchange rates and the

number one exporter. It should not be a surprise that China's ascendance has created conflicts with other established powers.

Three explanations for the US–China trade conflict

How do we explain the US–China trade conflict and especially its hardening in the period leading up to and continuing after the US presidential election of 2016? After all, the USA and China have been trade partners for a long time, and while there have been frictions, they have been managed and trade has continued to the benefit of both countries. Both the Republican and the Democratic parties have been in favor of free trade and the US–China Relations Act of 2000 was a bipartisan achievement of the US Congress. Engagement with China has cut across several Bush administrations (1989–1993 and 2001–2009), two Clinton administrations (1993–2001) and two Obama administrations (2009–2017). During these periods of free trade, huge benefits have accrued to US consumers and US exporters of goods and services have profited handsomely by access to China's market. At the same time, China has profited through access to US technology. Yet, despite gains to corporations and consumers, there are growing conflicts, at times intense, between the USA and China. Why?

Three explanations will be considered here. The first emphasizes domestic differences between China and the USA, differences in the nature of the economy and their respective political systems, with a focus on how these differences play out at the bilateral level. A second explanation is systemic and has to do with the shift from bipolarity to multipolarity. A third explanation, the one on which I will focus in this article, has to do with the different macro-economic policies of the USA and China, differences that create frictions that are likely to cause serious long-term problems. These explanations draw on different theoretical wellsprings and are based on factors which are sometimes relatively fixed (domestic structures which drive policy making in the first explanation; the distribution of power in the second explanation). The third explanation, based on policies that are manipulable in the short to medium term (savings, investment, consumption) provides the greatest opportunity for change.

(1) Domestic Differences. Relations between China and the USA today are marked by important differences in domestic structures. China is in part [1] a state capitalist country where economic policies are not dictated by market forces and the role of the Communist Party is considerable. The role of state-owned enterprises has diminished but the influence of the Communist Party is still important. Nicholas Lardy followed the publication of his *Markets Over Mao* (2014), touting the accomplishments of market reforms and the decrease in state-owned enterprises, with *The State Strikes Back* (2019) showing the resurgence of the Communist Party and the limits of economic reform. The USA comes closer to the liberal ideal of the market, this despite the fact that there is also a large role for protectionist lobbying in the USA. Finally, China's departure from the ideal of a liberal democracy creates difficulties for their membership in the WTO where the rules reflect characteristics of liberal market societies. Questions related to subsidies, state aid to industries, protection and anti-competitive behavior are all based on models of liberal market economies.

Distribution of power: hegemony, bipolarity, multipolarity and trade

A second explanation for trade conflicts rests on the distribution of power in the international system. Two such power distributions are bipolarity and multipolarity. Bipolarity creates incentives to capture the gains from trade within power blocs and simultaneously discourages across-bloc exchanges (Gowa, 1989). Multipolarity, in which time horizons for friends and foes are shorter, creates less clear geopolitical trade divisions. Exit opportunities

are greater in multipolar systems since the pattern of alliances is not as dependent on the overall distribution of power as compared to bipolarity (Gowa, 1989). States which are less certain about what the future holds will be less likely to tie their economic fortunes to Allies on whose support they cannot rely.

We concentrate on the systemic implications of bipolarity and multipolarity. In terms of the major economic players in the global economy, the USA and China stand out, the USA as the largest economy and China as the largest exporter. What does international relations theory tell us about bipolarity and trade? In “Bipolarity, Multipolarity and Free Trade,” Joanne Gowa (1989) argues forcefully that international structure shapes the degree and type of trade among states. Multipolar systems, with their shifting coalitions and lack of fixed membership structures, discourage trade blocs. Fear that one’s friends today are one’s enemies tomorrow works against complex divisions of labor which create vulnerabilities. Bipolar structures work in the opposite fashion. Countries that are in the same bloc are encouraged to trade with one another and discouraged from trade across blocs. Members of a bloc will not only experience directly the gains from trade but will also benefit from the positive security externalities [2] of exchange.

There are differences between the current bipolar system and the bipolar system of the Cold War. One important difference is that while Waltz could credibly claim that the Soviet–US bipolar world had an absence of peripheries, i.e. countries that were not clearly in one bloc or another, the same cannot be said about US–China relations today. During the Cold War, most states in Europe were either members of one of the two blocs or were neutrals with understood rules of the road. No country changed sides, i.e. shifted membership from one bloc to another. Sweden, Austria, Switzerland and Finland were neutrals in terms of the geopolitics of the US–Soviet Cold War rivalry. Both membership and non-membership in the major blocs were stable [3] The situation is very different in Asia today. As Mearsheimer puts it, “In Asia, there is no clear dividing line like the Iron Curtain to anchor stability. Instead, there are a handful of potential conflicts that would be limited and would involve conventional arms, which makes war thinkable” (Mearsheimer, 2021, p. 57).

Economic relations among countries in Asia also differ sharply from the relatively closed economic exchanges across power blocs in the US–SU Cold War. The EU and the larger Organization for Economic Cooperation and Development (OECD) within which it was comfortably nested, defined the capitalist world economy. The Council of Mutual Economic Assistance (CMEA) and several other countries like North Korea, Cuba and China defined the socialist world economy. Each was relatively self-contained. Interdependence creates problems and opportunities that independence avoids, for good or for ill. What cannot be solved by comity is addressed by distance. In economic terms, distancing does not characterize relations among the major players today. There are strong and multifaceted political and trade relations between the USA and China, China and Japan, China and Korea and China and Taiwan. The multipolar international system makes for complicated trade relations with no clear dividing line between within-bloc and across-bloc trade patterns that characterized the Cold War period.

In contrast to bipolarity, where inter-bloc economic relations are thin, today’s geometry of power sees huge volumes of trade between China and others. As Lardy points out (2019), China is “deeply integrated in global value chains and is a top ten export market for over 100 countries accounting for about 80% of world GDP” (Lardy, 2019, p. 9, based on IMF data). China is the top trade partner for Japan, South Korea, Vietnam and Taiwan, countries that do not form a united bloc. Conflicts among these countries cannot easily be resolved by distancing, since interdependence is a fact of life, nor by within-area balancing, since no conceivable coalition of countries can provide an effective counterweight to China.

(3) Macroeconomic Imbalances. In this section, I examine domestic imbalances within the USA and China that are transmitted to imbalances of trade.

I proceed as follows. First, I provide an overview of national accounting as it relates to international trade. Second, I provide an overview of China and the USA from the standpoint of this accounting scheme and analyze their interactions as an outgrowth of their domestic macroeconomic policies. Given their domestic policies with regard to savings, investment and consumption, a trade conflict was all but inevitable. Third, I briefly address the way the imbalance problem could be resolved.

National and trade accounting

To understand the macroeconomic imbalance argument, we need to review the basic macroeconomic categories and understand the relationships among them. The categories include domestic production (gross domestic product), consumption, savings (the difference between total product and consumption), investment (the total amount of savings that is set aside to improve the capital stock), exports (amount of national product sold to other countries) and imports (consumption imported from other countries). These categories are logically related so that movement in one part implies movement somewhere else in the system. Indeed, the basic claim is that any increase in domestic savings that is not offset by domestic investment will result in the export of those savings abroad.

Let us look more carefully at this argument. Savings are composed of personal savings, business (firm) savings and government savings (tax receipts in excess of expenditures) and are the difference between gross national product and consumption. Savings reflect the fact that consumption may be less than total national production. Ideally, savings may be plowed into new investments to improve the quality of the stock of physical (non-financial) capital, but if consumption is already low and prospects for improvement weak, the tendency will be to search for markets abroad. Imports and exports provide the remaining categories needed to understand the argument. Imports are that portion of consumption not produced domestically but purchased from abroad. Exports are that portion of production not consumed domestically and sold abroad.

How do these categories connect to international trade? The basic argument is one of underconsumption, most famously associated with John Hobson's *Imperialism, a Study* (2001). If savings are "too large," meaning of such a scale that they cannot be absorbed by either additional consumption (including government consumption) or by domestic investment, then they will be exported abroad. Notice that if savings are "too high," it is likely that domestic investment opportunities are likely to be "too low" for the same reason, namely, that the purchasing power of households is weak. This weak purchasing power may have multiple causes, including low wages, high taxes on consumption, a weak safety net for old age and an undervalued exchange rate (implying higher prices for imports on which low earners disproportionately rely). Poor prospects for consumption are bad not only for the consumer but also for prospective investors since they will have weak prospects for sale in the domestic market.

The above relies on a savings glut to create pressures for the export of capital. But how are capital exports and trade-related? As Pettis (2013, p. 6) points out, the export of capital requires foreign exchange and this, in turn, "requires an increase in net exports" (2013, p. 6). Two problems are solved simultaneously. Both the export of capital and the export of unsold goods are served by the initial export of capital. The fact that these two phenomena occur together, with capital outflows often preceding the outflow of goods and services, demonstrates the affinity of trade and capital flows. When China had a trade surplus with the USA, it meant that there was a net inflow of capital from China to the USA (as a claim on US assets). When Germany had trade surpluses with Portugal, Spain and Greece, it meant that there were capital outflows from Germany to the Eurozone's periphery (Wolff, 2011/05, pp. 1–3; Purroy, 2019, ch. 8). Whether we are talking about Germany's surpluses in the Eurozone or China's bilateral surplus

with the USA, the message is the same. These imbalances are not primarily the result of currency manipulation (Germany has the same currency as others in the Eurozone), unfair trade practices, or even underlying comparative advantages. They are the result of domestic macroeconomic policies related to savings and investment which have external implications for trade balances. In the following section, I turn to the specifics of the USA and China to see these abstract categories at play in a concrete trade dispute.

Macroeconomics of China–US trade conflict

China's rapid rise from 1980 to 2019 established it as the number one exporter and second largest economy in the world, behind the USA. China had a phenomenal growth rate of over 8% for this 39-year period. While some of this growth was due to "catch-up dynamics" (the advantage of being able to borrow technology from the front-runners), China went beyond and developed new technologies, e.g. Alibaba and Huawei ([Acemoglu, 2022](#)), in addition to pioneering research in artificial intelligence and electric vehicles. While the benefits of China's rise were widespread, there were and continue to be predictable economic and geopolitical conflicts with other countries.

China's conflicts with the USA are not really about market share or even competitiveness. China and the USA have very different factor profiles and economic niches which lead them to produce different goods for different markets. China has a relative abundance of unskilled labor while the USA has an abundance of human and physical capital as well as less sharply defined advantage in some raw materials and agricultural goods. The conflicts are not so much over competitiveness in third-country markets as in overall bilateral trade volume. The USA has accused China of currency manipulation, coerced technology transfers and unfair trading practices ([Hopewell, 2020](#); [Mavroidis and Sapir, 2021](#)). Some of these conflicts were concentrated in specific economic sectors such as agricultural subsidies, fisheries and export credits but the most salient conflicts were not sectoral at all. Rather they applied to the entire economy. The discontent, like the problem itself, is best described in macroeconomic policy terms.

Some of the conflicts may be due to misunderstandings but even here the misunderstandings tend to support the biases of each country. The US argument about the harmful effects of currency depreciation fails to notice that China's currency has been appreciating since 2005 ([Lardy, 2019](#), pp. 38–39), an appreciation that has not corrected the trade deficit of the USA. If appreciation of the renminbi does not correct the trade balance, it suggests the problem lies elsewhere. If the problem is US savings are low, we expect to see US trade deficits spread widely over many countries, which is in fact what we see and we do not expect to see the trade balance corrected by changing currency values. The USA has a negative balance of trade with over 100 countries ([Roach, 2014](#), p. 126). Focusing on one country and its alleged currency manipulation will not solve the problem. Roach argues that "There can be no bilateral fix for multilateral problems of a savings short economy" ([Roach, 2014](#), p. 144).

A second misunderstanding stems from the fact that in a world characterized by complex supply chains and part-processing operations, it is difficult to attribute the price of a good to specific countries. The Ricardian model of trade is based on two countries and two products. Yet in today's highly differentiated global economy, a single product is likely to be the result of part-processing operations in many different countries. The Apple phone is designed in Cupertino, Ca., uses inputs from Taiwan and is manufactured and assembled in China. It may be delivered to the doorstep of an American consumer by a Fed-Ex driver but its production and assembly cross many nations. Trade accounting is out of step with rapid developments in global production. Research on the I-pod shows that China receives total credit for the exports of the I-pod even though they contribute 3% of value added ([Roach, 2014](#), p. 138).

Misunderstandings aside, there are serious problems in US–China trade relations but these problems lie less in the state-to-state bilateral trade relationship and more in the

respective domestic macroeconomic policies of the two countries. The basic problem in a nutshell is that the USA consumes too much and saves too little while China saves too much and spends too little. China needs the consumption power of the USA and the USA needs the excess savings of China. This is changing (Lardy, 2019, pp. 28–41) but this relationship has been the core of the US-China trade problem.

Domestic imbalances lead to international imbalances. First, I will discuss the reasons for China's domestic imbalances, particularly their high rate of savings. After that, I will discuss imbalances in the US economy. Finally, I'll turn to the way these two "domestic" macroeconomic distortions play out at the international level.

China's domestic imbalances

China has a model of development that depends on high rates of investment, especially in developing the forces of production in manufacturing. True, most development in its early stages is unequal development, in the sense that some sectors of society are inevitably squeezed in favor of others. Indeed, advocates of unbalanced growth (Hirschman, 1958) explicitly argue for concentrating on strategic sectors. The argument is that a less developed country is by definition capital-poor and thus incapable of investing for growth along a broad and diversified front. Instead, a focus on "strategic imbalances" is advocated so that growth in high priority sectors spills over into linked sectors.

In China, from 1980 until recently, the household sector (consumer) was squeezed, the investment sector (both government and private) expanded and the rate of savings, essential to investment, also remained high. The results were high savings and rapid growth from 1980 to 2019, artificially low household consumption and high debt accumulation. Klein and Pettis report that household consumption in China was less than 40% of the national product as late as 2018, "a lower ratio than in any other country in the world" (Klein and Pettis, 2020, p. 111).

There was of course a rationale for the unbalanced growth model. It was not an accident of poor planning. By 1978, When Deng Xiaoping initiated his reforms, China was not even three decades beyond the Communists coming to power in 1949, and it was less than a half-decade removed from the Cultural Revolution (1966–1976). China's basic infrastructure, logistics and manufacturing capacity were very weak, and in no position for a rapid takeoff unless government action was taken. In a way, this is the problem of the original accumulation of capital, how to provide the original stock of capital to spur economic growth when there is little surplus in the first place. Logically, the existence of a stock of capital precedes the development of the productive forces.

So an economic model was put into operation that stressed squeezing the household, encouraging savings and investment and building basic industrial capacity. The result was high growth overall for the economy but an excess of production over consumption. The households that were squeezed to the end of higher investments and growth, did not have disposable income to buy and consume the surplus. To productively utilize the surplus, China had to either invest or export. Investing was not an attractive option because of declining returns for both infrastructure and manufacturing investment. In any case, the problem was how to consume what was produced—not how to produce more. Exporting the excess production was the only real option. The title of Pettis's article "How China Trapped Itself" (2022) captures the iron network of constraints that China created for itself.

To understand China it may be helpful to compare its position with Germany's in the Eurozone. China and Germany are in similar structural positions with regard to their partners (the USA for China and the Eurozone's periphery for Germany) but there are important differences. Both are net exporters of capital and both are in a position of surplus on the trade account. However, the USA, as the world's largest economy and demander of last resort, is in a stronger position to resist China than the Eurozone's periphery to resist Germany. Despite

the US's strength, Germany has exerted greater control over the Eurozone's periphery than the USA has over China. The irony is that Germany's power was used to impose austerity on Greece, Portugal and Spain, thus destroying the very consumption power on which German exports depended.

To summarize, China's levels of savings and investment have been high, as high as 40–50% per year. But why? Stephen Roach, in *Unbalanced* (2014, pp. 133–134), offers a number of reasons: China's mercantilist model, the lack of an adequate social safety net, especially for retirees, and the financial repression of Chinese households.

China's mercantilist model has relied on high levels of domestic savings, a managed exchange rate, cheap production platforms to assure competitiveness in global markets against potentially even cheaper producers elsewhere and most of all for our purposes, access to foreign demand, particularly the voracious demand of the US consumer (Roach, 2014, p. 133). As many have pointed out, China's trade surpluses have led to the buildup of foreign exchange reserves and large investments in dollar-denominated assets (Roach, 2014, p. 133). This has simultaneously eased the savings shortfall in the USA and provided the capital that the USA needed to purchase Chinese goods. Indeed, the export of capital and the export of goods are linked, perhaps counter-intuitively. It is exactly the same situation in the Eurozone with German capital exports to Europe's periphery preceding German exports of goods to Portugal, Spain, Greece and Italy (Purroy, 2019, pp. 154–155). In both cases, Germany and the Eurozone countries and the USA and China, the unbalanced relationship depends on liquidity from enabling partners (Purroy, 2019, pp. 154–155; Caporaso and Kim, 2016, pp. 26–30).

A second reason for high savings has to do with China's weak social safety net, especially for the increasingly aged population and rural households. Earlier (pre-1980) welfare programs were based on "cradle to grave" commitment by the state. When economic growth became a policy priority and as population aged and fewer younger workers were in the work force, resources were shifted to investments in infrastructure and economic growth. This stimulated families to save more for old age. Given the lack of state commitment to funding social security and medical insurance for the aged, at least until the Twelfth Five-Year Plan (2011–2015), savings for retirement became a necessity.

A third reason for the low purchasing power of households has been financial repression. Financial repression occurs when governments use private resources for government purposes. One way in which this has taken place has been for the Chinese government to pay low or negative real interest rates on private holdings and to use the money to liquidate state-owned debt. If banks are state-owned and the external capital account, including foreign stocks, is all but closed, there are few alternatives to keeping one's assets in the state-owned banks.

Lardy (2019) argues that financial repression affects consumption through two channels. The first and most obvious channel is the lower real income of households, in comparison to the baseline of income generated by investments in a more liberal environment. If real interest rates on household deposits had been the same in 2008 as in 2002 (when real rates were higher), there would have been an additional RM 690 billion of interest on savings deposits, the equivalent of 5.3% of GDP in the first half of 2008 (Lardy, 2019, p. 35). The second channel is also straightforward. Knowing that their money was worth less, Chinese households responded rationally by saving more. Ironically, financial repression both reduced real household income and increased household savings at the same time (Lardy, 2019, p. 36).

By the end of the first decade of the 21st century, China's growth had started to slow. Overinvestment in infrastructure played a role, as did the resurgence of state-owned enterprises, which Lardy discusses at length in *The State Strikes Back* (2019). But a central factor in the slowdown from our perspective was the domestic imbalance between savings, investment and consumption and the ways in which these imbalances ran up against their natural limits. Next, we explore the situation in the USA.

US domestic imbalances

Macroeconomic imbalances in the USA are important in our understanding of US–China trade relations. While the US–China trade conflict stands out because of the size of the deficits, trade deficits are not new to the USA. The USA has been a deficit country since the 1970s. The deficit was \$480 billion in 2019, down from a historic peak of \$816 billion in 2006. The USA has had to borrow to make up the difference. As Pettis (2013, 162–163) puts it, “the larger a country’s current account deficit as a share of GDP, the more ‘help’ that country’s government gets from foreign investors to buy its bonds.”

While it is true that the USA and China are very different, it is also true that their differences are complementary. One squeezes consumption while the other encourages it with a variety of easy credit vehicles. One has a very high rate of savings and investment; the other’s saving rate is very low; one relies on deficits and importing the savings of other countries to capitalize on its economy while the other is the source of those funds. This has led some scholars to label the US–China partnership as “unbalanced but codependent” (Roach, 2014).

Some data will help to make this clear. In the USA, the spendthrift US consumer is associated with low household savings. From June 2009 to Feb 2020, the rate of savings averaged 7.3% (Federal Reserve Economic Data, accessed 10/03/2023). The rate of savings in China has been in the mid-forties on average since 1952 (ceicdata.com/eng accessed 10/03/2023). It is easy to understand the low savings figures in the USA. Household savings are low, government consumption is nearly always negative (expenditures are greater than revenue) and while private investment is positive, it relies heavily on foreign capital inflows. This imbalance in domestic savings creates a huge demand for China’s goods by US consumers and a much smaller demand for US goods by the Chinese consumers.

The domestic profiles of the USA and Chinese economy have international implications. At the international level, China’s domestic savings are the source of financial flows into the USA. They are the complement of China’s export surplus of goods and services. From the US standpoint, the influx of foreign capital is offset by a deficit in the current account. One can look at this in two ways: either exogenous changes in trade drive changes in capital flows or exogenous changes in the capital account are primary and the trade account accommodates these changes. Most analysts assume that changes in the flows of goods and services in the real economy are primary, with autonomous traders carrying out their respective import and export activities, and financial flows making the necessary adjustments. However, Richard Cooper argues the opposite, saying that “in economic terms it is more nearly correct to say that net capital inflows *cause* the current account deficit” (2001, p. 217). Which way we view the causal direction does matter, in the sense that if trade is the big mover, we are likely to view a deficit as negative, while the financial adjustments are likely to be seen as mere bookkeeping. But if it is the other way around, we can visualize the situation as one in which the USA is an attractive destination for capital because there are profitable investment opportunities (stocks, Treasuries, real estate). The resulting capital inflows push the value of the dollar upward and make US goods more expensive, foreign goods cheaper, worsening the trade balance. The general point is that the domestic macroeconomic policies of the USA and China have an agreeable fit at the bilateral level.

Summary and discussion

The first conclusion of this article is that the US–China trade imbalance is driven mostly by the domestic macroeconomic policies of these two countries. China’s high-growth economy is powered by high savings and investment and low consumption, especially at the household level. The US economy is powered by consumption, both government consumption and household consumption, with the legendary “resilient American consumer” carrying the US

economy through sluggish times while business investment is supported by reliable capital inflows into the US Treasury (FRED, Federal Reserve Economic Data, August 8, 2021, accessed 10/03/2023). These trade dynamics are all but assured by the domestic macroeconomic policies of China and the USA.

Does this mean that a host of other issues—subsidies, coerced technology transfer, intellectual property rights and tariffs, highlighted in the media, are irrelevant? Not at all. Yet, my conclusion is that it is the macroeconomic factors discussed here that are the root cause of the problem and that fixing problems associated with exchange rates, tariffs and technology transfer will not solve the trade imbalance.

A second conclusion, a main point running throughout the paper, is that both China and the USA sometimes fashion policies that might be fitting for a bilateral world but that do not work in a multilateral world. The international trade system is multilateral not only in terms of numbers of participants (164 members of the WTO) but also in terms of its deep organizing principles such as most favored nation and generalized reciprocity. Trade also demonstrates that the transnational system is non-state-centric in some non-obvious ways, one of which is exemplified in our complex international division of labor. How exactly do we calculate bilateral trade figures in a world where nested inside countries we have entities (subsidiaries of firms, banks, lawyers and entrepreneurs) that are often legally or for fiscal reasons parts of other nation states? One of the prime functions of the modern nation-state is to fend off (to extrude) external authority structures, i.e. to consolidate authoritative rule for indigenous political institutions. However, no such parallel claim is made to keep out external economic and financial structures. These abstract concerns become real in the case of US–China trade relations. While the situation is complex, China’s exports to the USA far exceed gravity model expectations and this excess is almost certainly due to the large share of foreign value added to Chinese exports as a result of inputs from S. Korea, Taiwan and other countries in the Asian supply chain (Thorbecke, 2015, pp. 2–3). One reason that the US trade deficit with China continued to increase after 2005 (when renminbi revaluation started to take place) is that exchange rates in supply chain countries did not appreciate until well after the 2005 date (Thorbecke, 2015, pp. 1–4). In short, there are many countries and firms implicated in the China–US trade relationship. It is not really a bilateral relationship at all but trade accounting forces the flow of goods and services among countries into the bilateral balance.

A third conclusion is that US–China trade is surprisingly robust in the sense that both the volume of trade and the deficit have persisted. In part, this is because the structure of comparative advantages is based on large differences of comparative costs. The USA is a capital-rich country in relation to China and China has huge advantages in the supply of labor-intensive goods. So, following the [Stolper-Samuelson theorem](#) (1941), we expect the USA to import labor-intensive goods into the USA and for China to import capital-intensive goods. Of course, many countries produce labor-intensive goods and capital-intensive goods so shifts in trade partners are possible. However, the opportunity costs of changing partners are likely to be high for the simple reason that China produces what the US imports more cheaply than others. China is the number one trade partner of the USA from the standpoint of imports and the next countries are Mexico, Canada and Japan and Germany. Clearly, costs of production are higher in these countries so the “switching costs” would be correspondingly high, a point that has been recognized by retail stores (Costco, Walmart, Target) in the USA.

Solutions: addressing the imbalances

In *Unbalanced*, Roach argues that “the heart of the matter is that the US multilateral trade imbalance is not made in China. It is made at home by a nation seemingly incapable of savings.” (2014, p. 126) If this is true, it implies that policy changes are required at the domestic

level in the USA. Most directly, the USA should devise policies to increase domestic savings. There are many ways to do this, including creating savings vehicles with attractive interest rates and heavy withdrawal penalties. Individual retirement accounts are one vehicle that has proven to increase net savings (Venti and Wise, 1990). Also, one could follow the German model and impose high consumption taxes on consumers. The German rate is 19% and has yielded high savings for the German economy. But the problem with a consumption tax in the US context is that the burden would fall disproportionately on workers, who already spend nearly all their income. A high consumption tax across US states would probably not generate savings as much as it would simply lower the real income of the worker.

One innovative and in some ways radical idea comes from Stansbury and Summers (2020; see also Ahlquist, 2017). They advance an explanation for the US economy that centers on a “declining worker power hypothesis.” The argument is that part of the reason US savings are so low is that workers have been receiving a declining share of total national income. Since the marginal propensity to consume is higher among workers than among higher earners, this lowers the national savings rate. Owners of capital have acquired additional options that laborers have not enjoyed, and this has resulted in the redistribution of rents in the form of salaries, dividends and stock options from labor to capital. Notice that there are benefits to capital from two separate sources, first from globalization itself and second from the decline in the organizational power of workers (2020, pp. 3–4). The redistribution of rents from capital to labor holds for both trade-exposed and non-trade-exposed sectors. Savings are low in the US economy in part because workers and unions are weak. This is a tantalizing proposition for which there is considerable evidence. Yet acting on this knowledge would require radical changes in the US economy.

A final way to correct the macroeconomic picture is to monitor and control the creation of asset bubbles, most prominently in stock markets, housing and real estate, both in the USA and China. This is a problem that the European Union has taken on frontally with surveillance of credit bubbles and bubbles in real estate and tourism. Bubbles, associated always with the expansive phase of the economic cycle, are important because they fuel spending and debt in unsustainable ways (Kindleberger and Aliber, 2005). Roach (2014, pp. 129–132) worries that the US consumers are using equity in homes as a source of cash to fuel personal consumption. In a rising housing market, there is a great temptation to use home equity as a flexible bank account from which to take loans. When this happens on a broad scale, a country becomes reliant on speculative assets rather than income from labor. Instituting laws to control using assets to fund consumption would go some way toward increasing savings, or at least not increasing debt.

There are also changes that China can make. As Acemoglu argues (2022), China’s rapid growth was built on a quartet of huge investments, technology transfers from the West, export-oriented production and financial and wage repression. Some of these phenomena are linked so that changing one implies alterations among the others.

It is sometimes argued that China’s savings rate is too high but it is not that simple. Households save because they are fearful of their future and heavily reliant on children. Children are fewer than desired partly as a result of past government policy. Related, the consumption patterns of the aging population will be hard to change because of a weak safety net and small number of children. Shifting income to the household sector, as necessary as it is, will aggravate conflicts with government, both central and local, as well as private investors.

Most analysts (see Wolf, 2016; Feldstein, 2008; Pettis, 2013; Roach, 2014) agree with this broad assessment and if such changes are made (investments decline, households acquire more income and spend more, overall savings decline), then the imbalances in trade will diminish also. As pointed out, Lardy (2019) demonstrates that these changes are already in motion.

Most importantly, disposable household income as a share of a gross domestic product has increased to 61% since 2008; the share of national income that goes to labor has increased consistently from a low point at the beginning of the financial crisis; and net exports (exports minus imports) have declined. All of these indicators are moving in the right direction and while the USA still has a trade deficit with China, it is substantially lower compared to earlier periods (Lardy, 2019, pp. 28–32). In sum, the trade deficit is responsive to changes in macroeconomic categories, especially household income and the share of income going to labor.

Notes

1. Lardy (2019, p. 2) tells us that by 2012 almost half of all investments were undertaken by private firms.
2. Security externalities refer to the way that trade creates either positive or negative outcomes for security. If A and B trade with one another, and if both expand their wealth because of trade, and if wealth is a source of power, then there are positive security externalities to the trade relationship.
3. It is true that the UK, Ireland, Denmark, Greece, Spain and Portugal became members of the EU before the end of the Cold War but most of these countries were de facto members of the Western coalition before their formal membership in the EU. The case of the Republic of Ireland is complicated and cannot be explored here.

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