## The Trade Deficit Is China's Problem

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**The Trump administration views the U.S.-China trade relationship upside down: It's not Americans who suffer from Chinese surplus.**

Brian Snyder / Reuters

The Trump administration last week escalated its trade war upon China. China will retaliate. As in any war, there will be casualties. As Catherine Rampell reported in *The Washington Post* last week, the price of dishwashers has risen 17 percent since the January 2018 round of tariff increases. Soon, Chinese consumers will pay more for food.

Can this mutual self-harm possibly lead to good? Almost certainly not—because the Trump administration, like most of us, is viewing the problem upside down.

They focus on one aspect of the United States-China relationship, the balance of trade. That shows a huge surplus for China, $366 billion in 2017. To simplify the story a lot, that $366 billion imbalance translates into an incremental increase in U.S. indebtedness to China, which tallied $1.17 trillion at the end of 2017.

These figures are usually described as a huge vulnerability for the United States. They are also often told as a morality tale of American self-indulgence or (alternatively) American naivety. Either because Americans do not work hard enough or because they have been sold out by globalist elites, America is losing and China is winning.

Or so the story goes.

Here’s another way to think about it. In about 1890, the U.K.-U.S. relationship looked a lot like the U.S.-China relationship today. In 1890, Britain held the world’s largest pool of investible wealth, as the United States does today. In 1890, the U.S. economy was growing much faster than the U.K. economy, much as China’s economy grows faster than America’s today.

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Now comes the difference. In 1890, investment capital flowed *from* Britain (the more mature economy) *to* the United States—and on a huge scale. In those days, Britain invested something like 6–8 percent of its national income overseas, with the U.S. as the single largest destination.

Instead of attracting capital, however, China is repelling it. Even accepting the claim that official statistics may undercount U.S. investment, the most rah-rah private consulting firms estimate the total U.S. investment in China since 1990 at about$250 billion—not much more than double the U.S. investment over the same period in tiny Belgium.

China attracts less capital than either the United Kingdom or the United States, two mature developed economies that theoretically should offer fewer opportunities than China. More ominously still: By far the largest source of nominally foreign investment in China—69 percent of all received—is Hong Kong. That money looks more like laundered and recycled domestic Chinese money than true foreign investment.

China's trade surplus is the flipside of its failure to attract foreign direct investment. It's an axiom of national accounting that the current account (the trade balance plus earnings on overseas investment) must precisely equal the capital account (net foreign investment in a country).

The story that China's trade surplus produces China capital surplus could be flipped, to be told as China's capital surplus produces China trade surplus. And while the word "surplus" sounds like a good thing either way, for a country like China, a capital surplus is actually a very bad thing.

China's foreign investment is working out exactly as economic theory would predict: It is yielding much lower returns than it would if it were invested in productive enterprise at home. A 2008 World Bank study found that the average return on multinational corporations' investments in China was 22 percent. American multinationals earned even more, an average of 33 percent. China earns less than 3 percent on its immense holdings of U.S. Treasury.

Congratulations to those successful multinationals operating in China. But notice something: When people are earning 22 and 33 percent on their investment, that implies it takes a very, very glittering incentive to induce them to do something. A 10 percent return would be considered very handsome opportunity in Europe, Japan, or North America—but does not suffice to overcome foreign reluctance to invest in China.

That foreign reluctance is nothing near as ominous as the verdict the Chinese themselves are rendering on their country's future.

In 1890, when the U.S. was fast industrializing, it was not the dream of every candy maker in Cleveland or every furniture maker in Buffalo to gain a French passport for his children and a second home in Germany for himself. The 19th-century American business class not only earned its profits in the U.S., but it saw its future and its security here as well. When Chinese business leaders invest tens of millions of dollars in second homes in Vancouver or send their granddaughters to Los Angeles to give birth to U.S. citizens, what are they saying about their expectations about China?

In 2007, Kellee Tsai (then a political scientist at Johns Hopkins) published an eyebrow-raising study of Chinese businesspeople's fears of the future, *Capitalism Without Democracy*. She looked at entrepreneurs a rung or two below the ruling oligarchy, people with some money but no political power. Their overwhelming wish was to see their children emigrate to a democratic country: Canada, Australia, the United States. Their overwhelming fear: the democratization of their own country, which they worried would mean their poorer fellow citizens seizing the opportunity to plunder them.

The fears we express for the American side in the U.S.-China equation may be deeply misplaced. The fears should attach to China.

When the United States was growing fast, in the 1890s, it imported goods on a massive scale from the United Kingdom: locomotives, engineering equipment, and other high-technology items; high-quality consumer goods like Sheffield cutlery and Staffordshire ceramics; and hot-weather commodities grown within the British empire and reexported from London to the U.S., including rubber, chocolate, and palm oil. Those imports enabled a higher standard of living inside the United States. They were paid for by U.S. food exports—but even more, by selling the British an opportunity to participate in future U.S. growth, which is what a capital account most fundamentally represents.

Because China cannot or will not attract foreign capital, it must run a huge trade surplus. That means fewer food imports (and thus a lower standard of living for its people). That means China must finance its future development out of its own savings (which means its people must consume much less of the proceeds of their own development). And very visibly, those who have accumulated savings are redeploying them elsewhere. They accept radically lower returns on their investments in order to gain from Canada or Australia or the United States the security of property that their own government cannot provide.

If this is winning, it’s no wonder that so many Chinese every year seek to emigrate to the countries on the “losing” side. What is a wonder is that so many in the Trump administration want to emulate on this side of the Pacific the Chinese model of economic development that terrifies so many of those who must live under it.