As we see it

August 2019

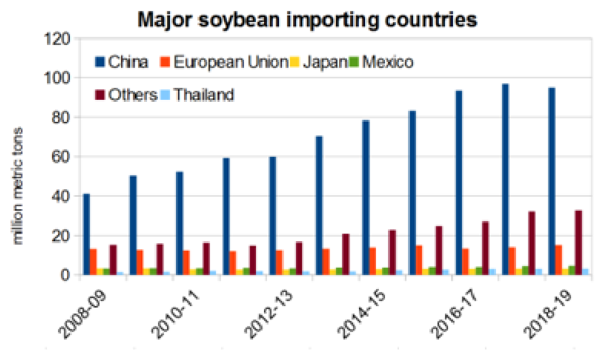
"I am in favor of helping the prosperity of all countries because, when we are all prosperous, the trade with each becomes more valuable to the other"

– William Howard Taft

Financial markets are watching two of the world's largest trade partners—China and the United States—and wondering how bad the result would be if trade negotiations break down. Market fears miss one thing—how intertwined the economies of China and the United States truly are. The trade partners have cooperated well beyond prior generations' imaginations in sectors ranging from food to technology—out of both choice and necessity. Open trade will continue to raise the standard of living in both countries, as each side benefits from the other's competitive advantages.

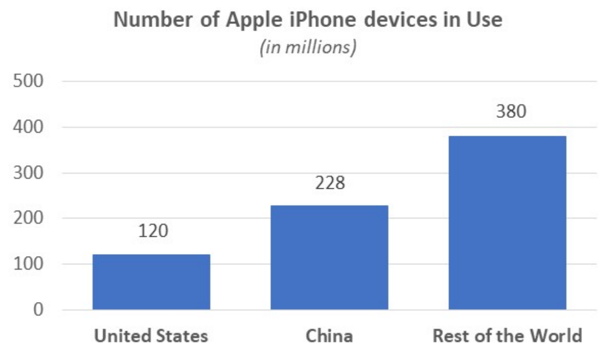
An example of the benefits of trade begin with food. Until the 1990s, China grew most of their own soybeans, which are a key ingredient in cooking oils and a protein feed for livestock. As Chinese incomes rose, demand for animal-based proteins increased. However, the nation's growing consumption needs required greater quantities than could be economically harvested domestically. China's solution was to rely on their comparative advantage in agriculture. Today, China imports the agricultural goods that are land-intensive (soybeans, cotton, and barley) and exports the goods that are labor-intensive (fish, fruits, and vegetables).

In the U.S., China's increasing consumption of soybeans was a welcome development for American farmers. The United States' domestic consumption of soybean oil peaked in the early 2000s. International trade stepped in and brought together natural partners. The soybean crop grown in the cooler climates of the Midwestern states like



Illinois, Iowa, and Minnesota was increasingly shipped to China, which now imports over 80% of the soybeans they consume from the United States, Brazil, and Argentina. Roughly a quarter of the United States' soybean crop is exported to China.

What we see in soybeans can also be seen in smart phones. Trade's benefit to both countries extends beyond basic necessities (food) and into aspirational goods (smart phones). America's largest import category from China is electrical machinery—a segment that covers everything from basic electronics to smart phones. Trade in this relatively new product category is now substantially larger than agricultural trade between the U.S. and China. American technology companies have found a natural home for manufacturing in China's urban markets where skilled labor is abundant, and wages are lower. The net effect is to keep the costs of American innovation down.



However, not all products of American companies manufactured in China are shipped back to the United States. The Chinese are currently the largest users of iPhones in the world (see graph above) with an installed base twice the size of iPhone owners in the United States. As the world's largest market for smart phones, China's technological advancement benefits from cooperation with the United States every bit as much as we do from the Chinese labor market.

At the core, both sides realize they must not only engage, but eventually compromise to prevent undoing progress. The stakes of not negotiating in trade talks are simply too high. From food to innovation, beans to mobile devices, China and the U.S. are more reliant on each other than ever before. Farmers in both countries would have to plant new crops and prices for food staples would rise (or the goods disappear) at stores in both markets. The cutting edge of technology would likely advance at a slower pace and end products would be more costly to all if either side walked away from the table. Trade talks may remain tense for a while, but—for the common good—it is hard not to see both sides agreeing to continue to do what is in their mutual best interest.

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