CHIMERICA

Macro Watch

Third Quarter 2016

http://www.richardduncaneconomics.com

What Is Chimerica?

- Chimerica is a term coined by the historian Niall Ferguson in late 2006 to describe the relationship between China and the United States.
- In an article in The Telegraph in March 2007 Ferguson wrote: “Think of the United States and the People’s Republic not as two countries, but as one: Chimerica. It’s quite a place: just 13% of the world’s land surface, but a quarter of its population and fully a third of its economic output. What’s more, Chimerica has accounted for around 60% of global growth in the past five years.”

What Is Chimerica?

- “Their relationship isn’t necessarily unbalanced; more like symbiotic. East Chimericans are savers; West Chimericans are spenders. East Chimericans do manufactures; West Chimericans do services. East Chimericans export; West Chimericans import. East Chimericans pile up reserves; West Chimericans obligingly run deficits, producing the dollar-denominated bonds that the East Chimericans crave. As in all good marriages, the differences between the two halves of Chimerica are complementary.”

What Is Chimerica?

- “Of course, many economists fret about the global imbalances associated with China’s rise.”
- “Yet there’s another way to see these supposed imbalances: as no more worrying than the doubtless very large imbalances between, say, California and Arizona.”
- Ferguson is a very good historian; not such a good economist. When the global economic crisis erupted in 2008, he came to realize that “these supposed imbalances” were not only unsustainable, but also, that they had played a leading role in bringing about the crisis in the first place.

In This Video

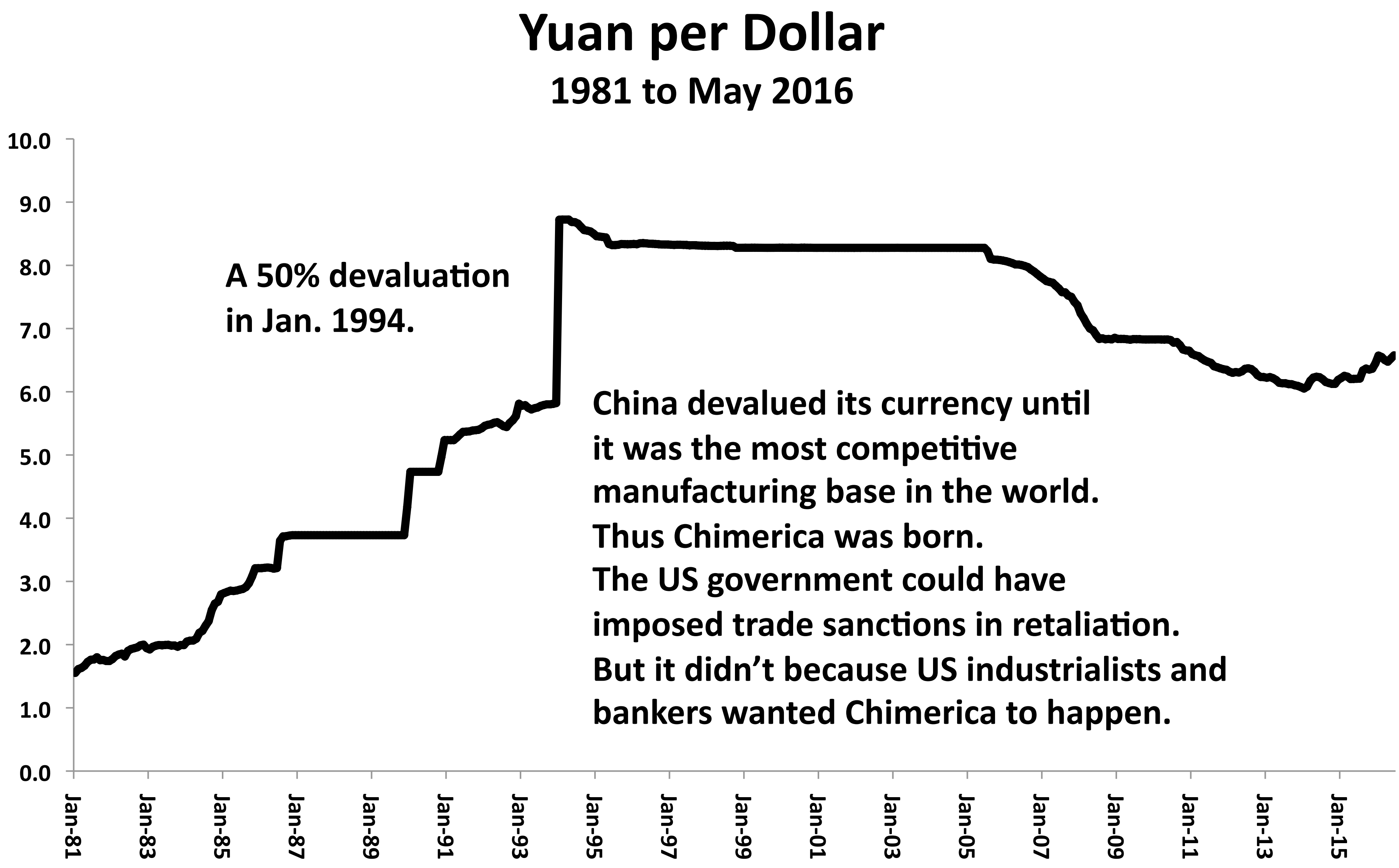
- Even though Ferguson's original ideas regarding Chimerica were flawed, I believe much can be learned by analyzing the evolution of the US – Chinese (Chimerican) economic relationship.
- That's what we are going to do in this video.

How Did Chimerica Emerge?

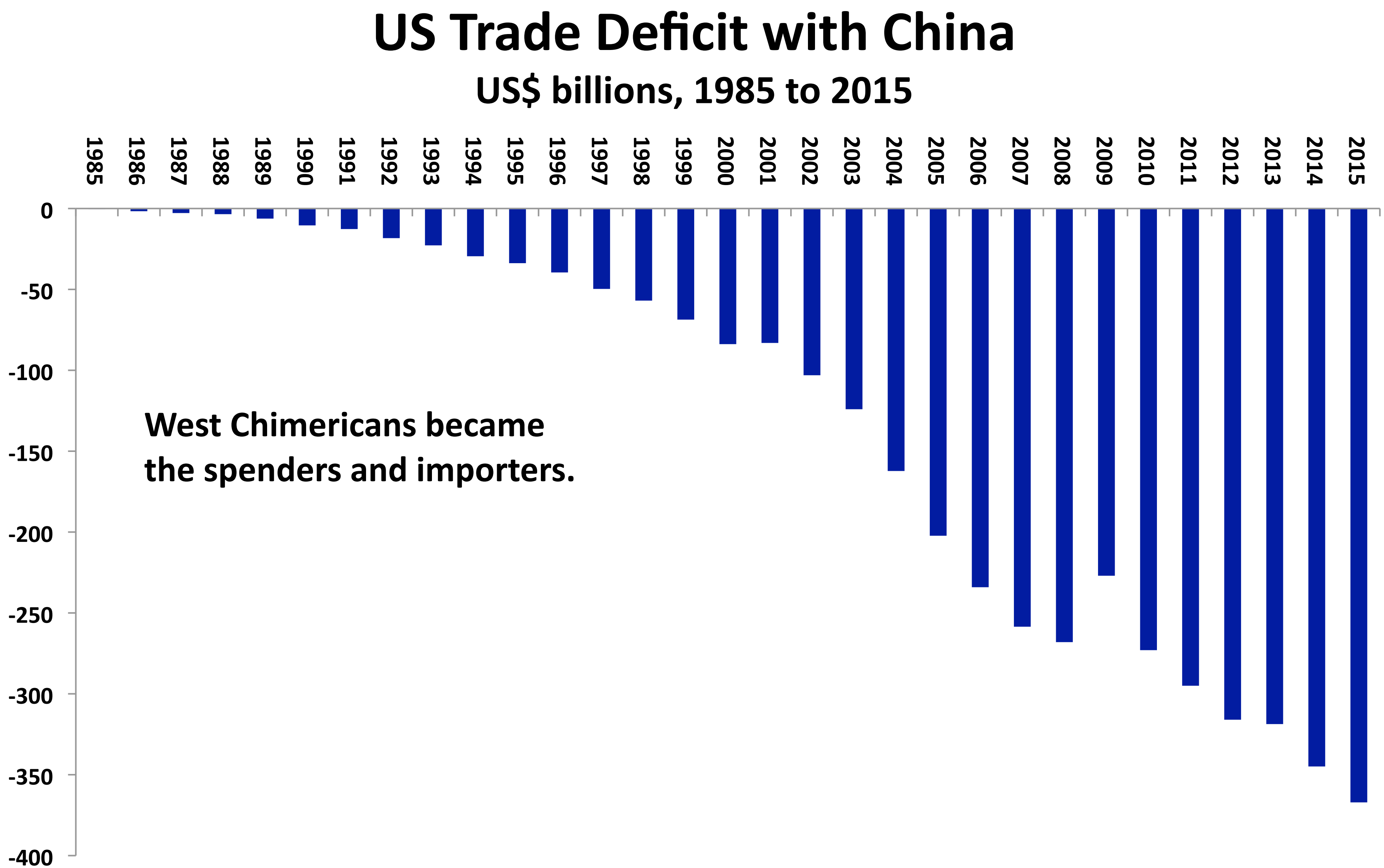
- Following the collapse of the Bretton Woods International Monetary System, Chimerica emerged, in part, naturally, as the result of market forces, political developments and technological advances; and, in part, due to coordinated US-Chinese government policies designed to bring it about and support its growth.
- The breakdown of the Bretton Woods system meant that trade between nations no longer had to balance.
- It also meant countries were free to print their currencies in order manipulate their value to make their exports more competitive.
- The end of the Cold War in 1989 changed the US government's attitude toward China. Consequently, the US became willing to accept Chinese imports.
- Technological advances in communications (the fax machine) and logistics (containerization in shipping) made manufacturing on the other side of the world feasible.

How Did Chimerica Emerge?

- Competitive pressures drove US corporations to relocate their factories to China or face alienation from their rivals who did.
- US businessmen, who sought to drive down their wage expenses and push up their profit margins, put pressure on Congress to allow free trade with China and to ignore China's currency manipulation.
- US Bankers used their influences over (some might say, "their capture of") the US Treasury Department to support Chimerica. And, they also applied pressure on Congress (through large campaign contributions).



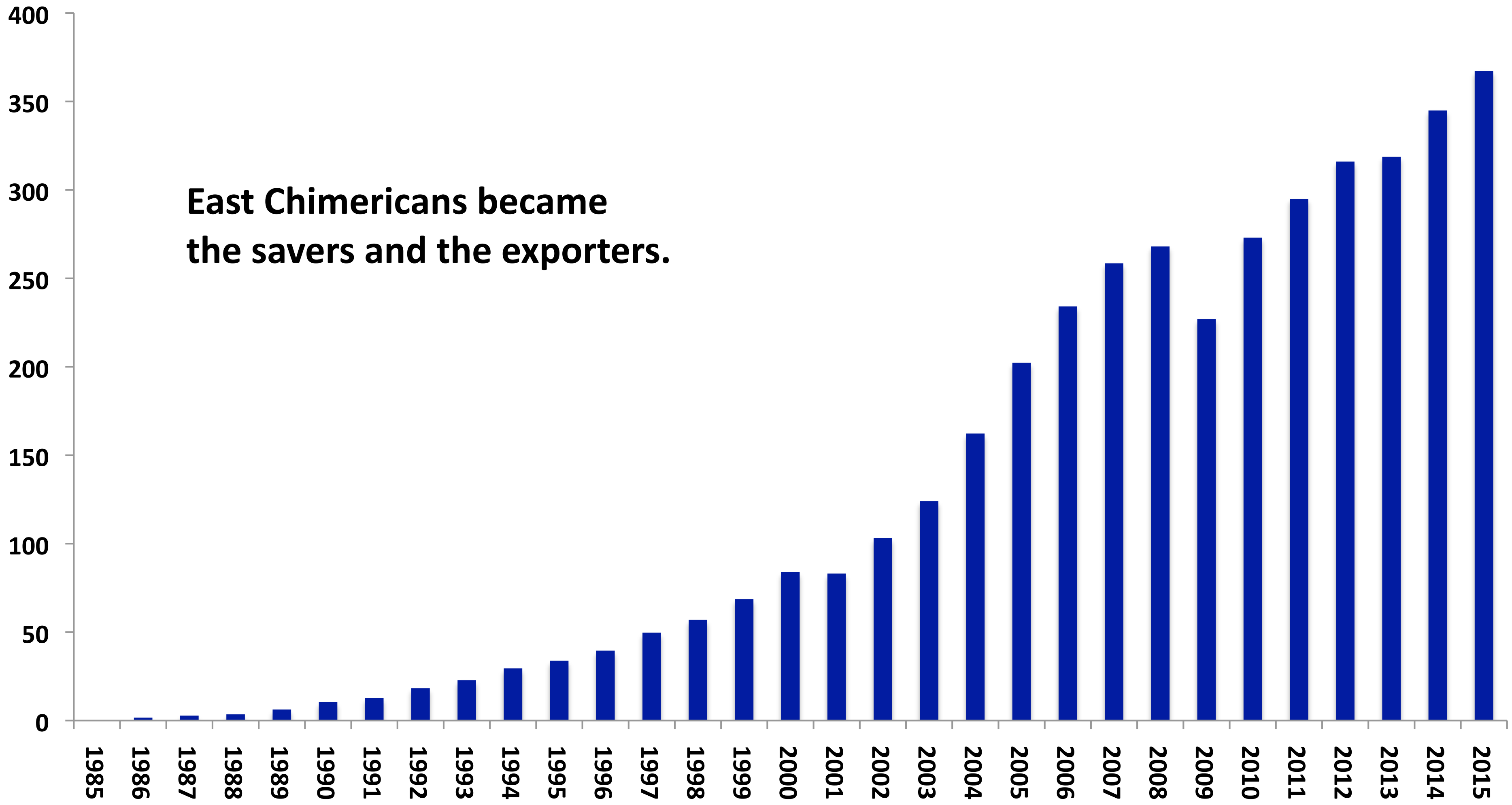
Source: St Louis Fed



Source: US Census Bureau

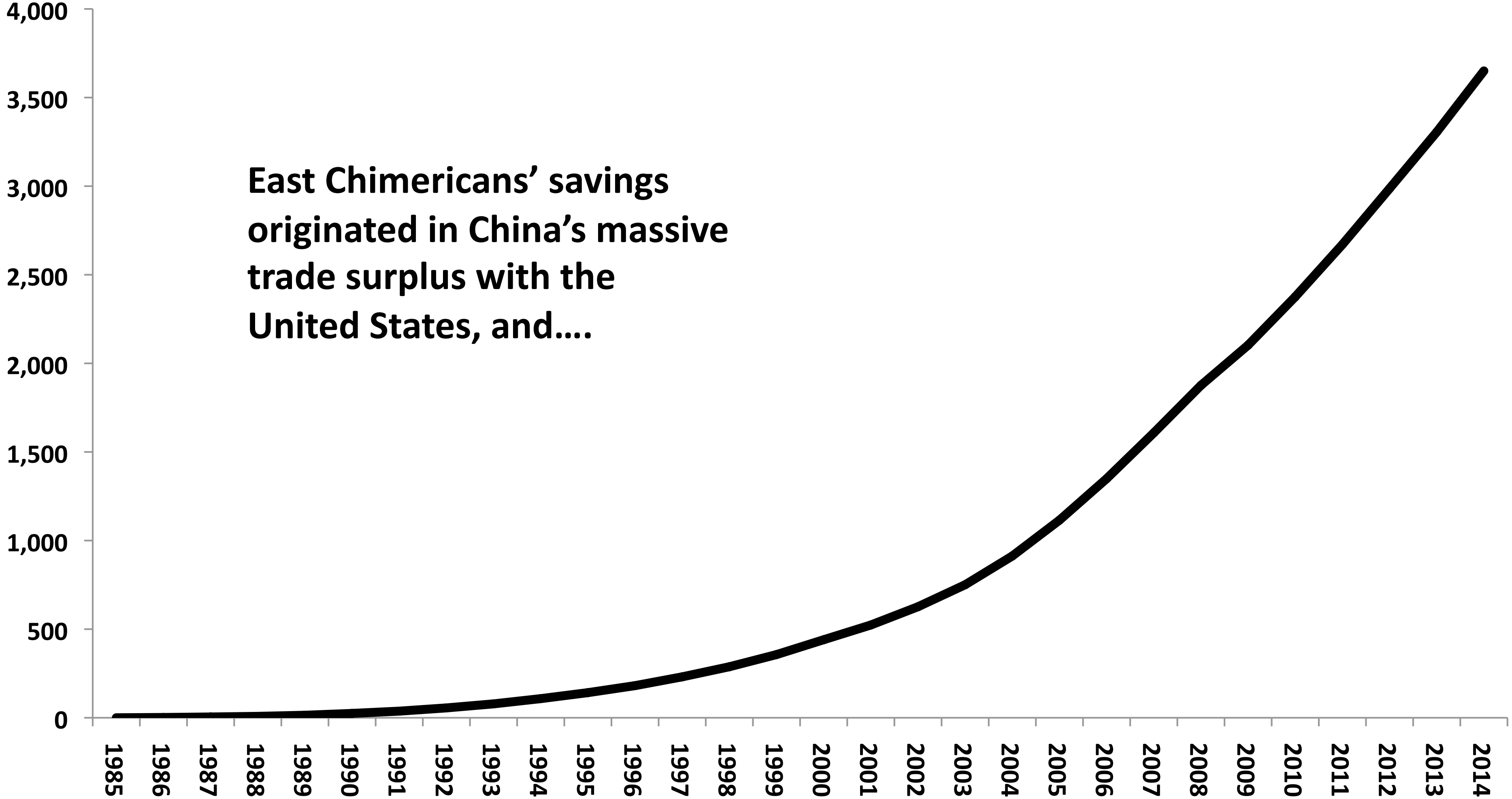
China's Trade Surplus With The US

US$ billions, 1985 to 2015



Source: US Census Bureau

China's Trade Surplus with The US (Cumulative 1985 to 2014), US$ billions

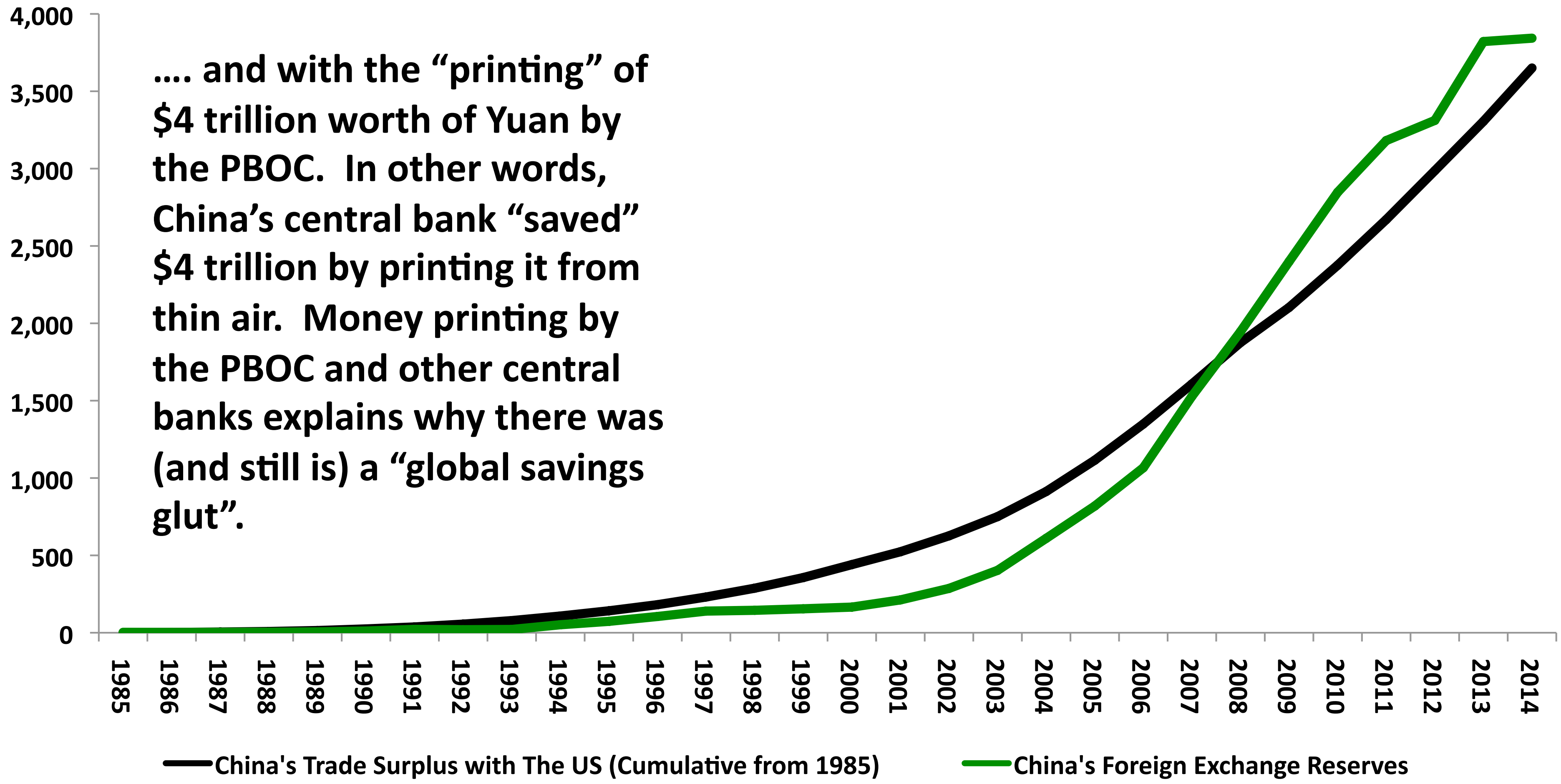


East Chimericans' savings originated in China's massive trade surplus with the United States, and....

Source: US Census Bureau

China's Cumulative Trade Surplus with the US vs. China's Foreign Exchange Reserves

US$ billions, 1985 to 2014



Source: US Census Bureau, CEIC

Bubble Fuel

- China's central bank printed Yuan and used them to buy (mostly) Dollars to hold down the value of the Chinese currency.
- China accumulated (the equivalent of) more than $4 trillion in Foreign Exchange Reserves that way. (I estimate that at least 75% of China's FX Reserves are US Dollars.)
- As China accumulated those Dollars, it invested them in US Dollar-denominated assets like Treasury Bonds, Fannie & Freddie Debt, Corporate Bonds and Stocks.
- Those investments (by China and the other trade surplus countries) pushed down US interest rates, thereby facilitating the growing indebtedness of US households and, so, playing a leading role in blowing the US into an economic bubble.

Thus

- Thus:

  East Chimericans became savers; West Chimericans became spenders. East Chimericans do manufactures; West Chimericans do services. East Chimericans export; West Chimericans import. East Chimericans pile up reserves; West Chimericans obligingly run deficits, producing the dollar-denominated bonds that the East Chimericans crave.
- **That is how Chimerica emerged.**
- **Now, let’s consider Who Benefited?**

Who Benefited In China?

- Just about everyone in China benefited.
- Nearly all Senior Communist Party officials became very wealthy.
- A Chinese billionaire class emerged.
- A large Chinese millionaire class emerged.
- A middle class emerged and grew in size to hundreds of millions.
- Hundreds of millions of the poorest benefited from being able to work in factories or factory-related jobs instead of in farming.
- The only real drawback was the severe environmental degradation.

Who Benefited In The US?

- The US “Capitalist class” benefited. Factories were moved to China to take advantage of the very cheap labor there. As the cost of labor fell, corporate profits rose. The share of profits going to “Capital” rose (and the share going to “Labor” fell).
- Bankers benefited by financing rising US debt levels.
- Those people who owned assets benefited. The lower cost of production in China caused inflation in the US to fall. Disinflation pulled down US interest rates. Falling interest rates pushed up asset prices (stocks and property). So those who owned assets benefited. The wealthiest benefited most.
- Potential home buyers benefited. Lower interest rates made homes more affordable, so more people were able to buy houses, particularly with the assistance of Fannie Mae and Freddie Mac.

Who Benefited In The US

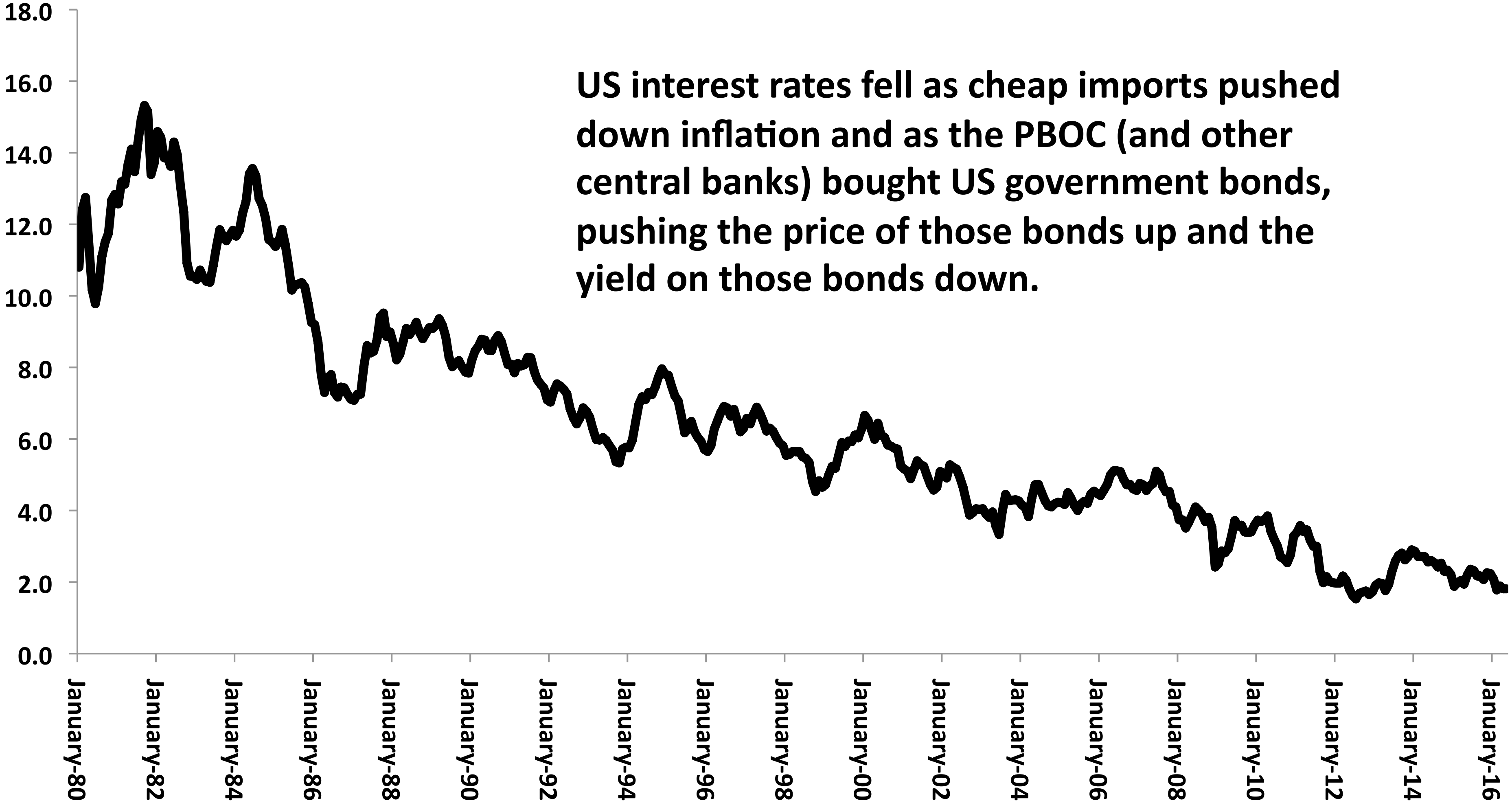
- All US consumers benefited from falling product prices (due to the low cost of manufacturing in China that resulted from the ultra low wage rates there).
- The US Government benefited because it was able to finance its borrowing at very low interest rates (due to disinflation and the PBOC buying of US government bonds).
- The US State Department also benefited. The very large US trade deficits with China bought China's friendship or, at least, China's lack of hostility to most US foreign policy initiatives, such as the first Gulf War and the subsequent US invasions of Afghanistan and Iraq.

Who Lost In The US?

- Blue collar workers lost their high paying factory jobs. Deindustrialization put downward pressure on the wages of the largest part of the population since those who had worked in factories had to find other jobs. Consequently, wages stagnated for decades.
- However, to a large extent, rising asset prices created a Wealth Effect that allowed those who owned assets to keep spending even though their wages were depressed.
- And the Wealth Effect and the spending by the wealthy created more service sector jobs for those who could no longer work in factories. Unfortunately, most service sector jobs paid less than the factory jobs had paid.

10-Year US Government Bond Yield

%, Monthly, 1980 to May 2016

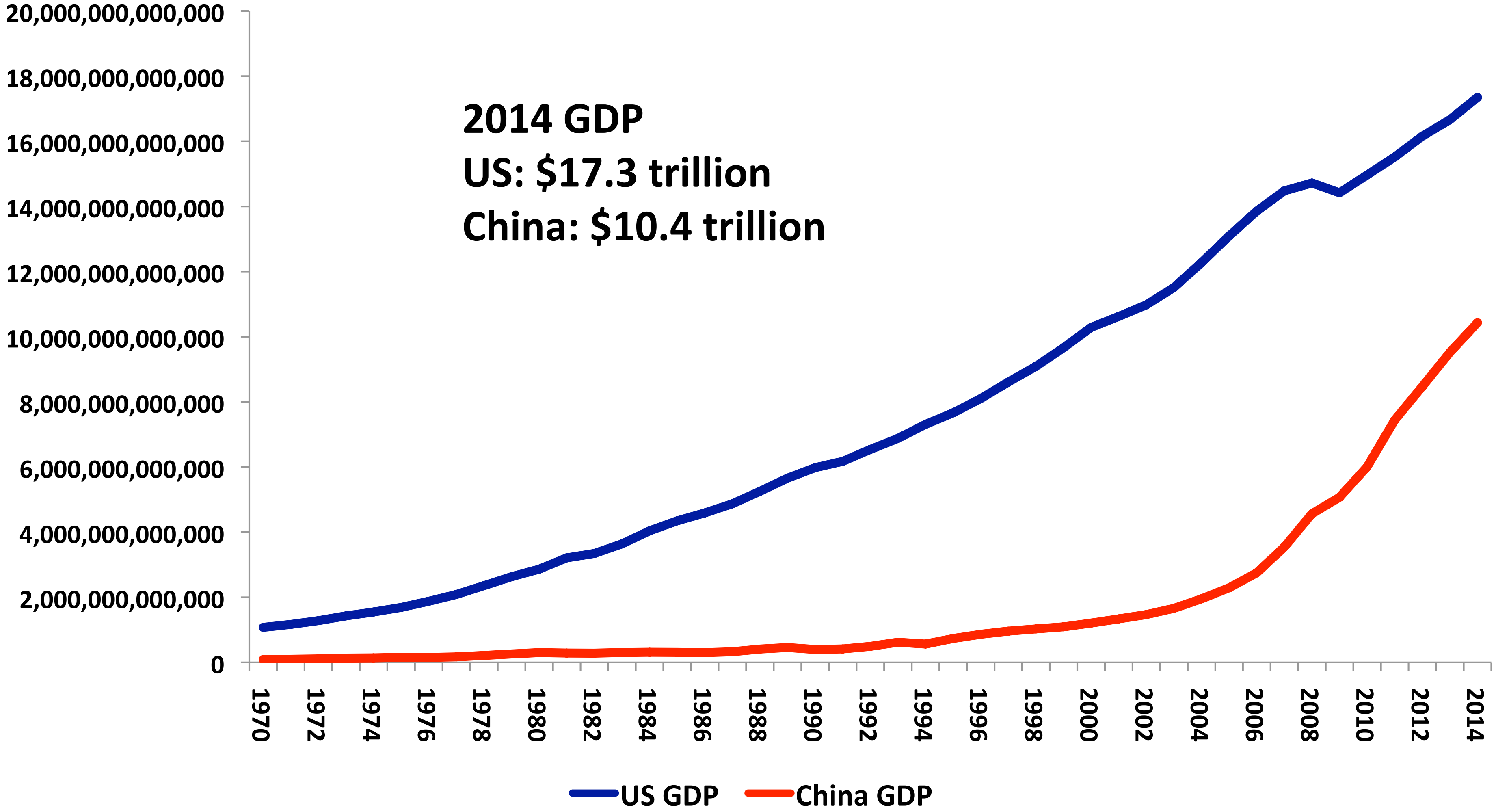


Source: St Louis Fed

So, How Large Is Chimerica?

GDP: US vs. China

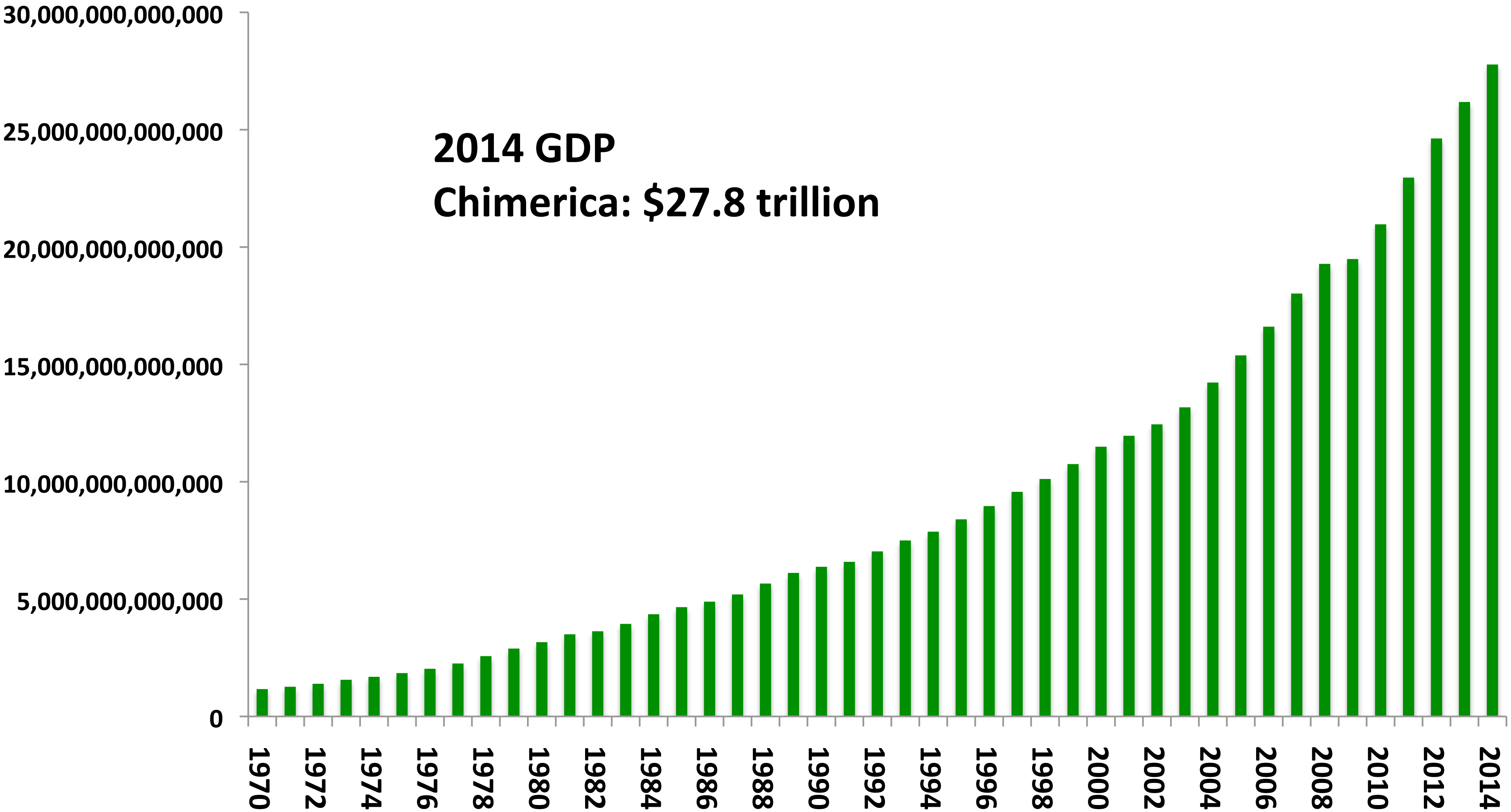
US$, 1970 to 2014



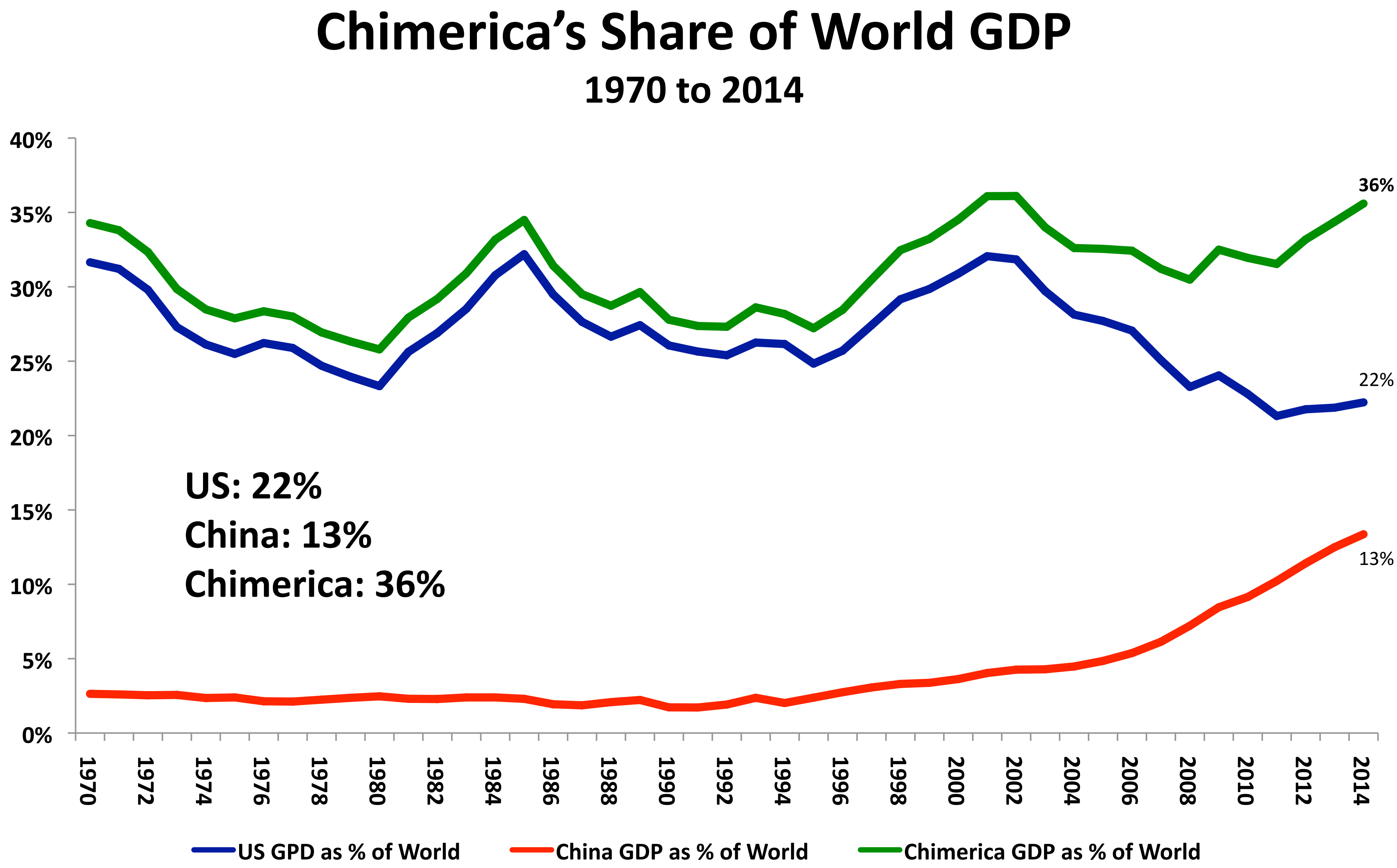
Source: United Nations Statistics Division

Chimerica GDP

Nominal, US$s, 1970 to 2014



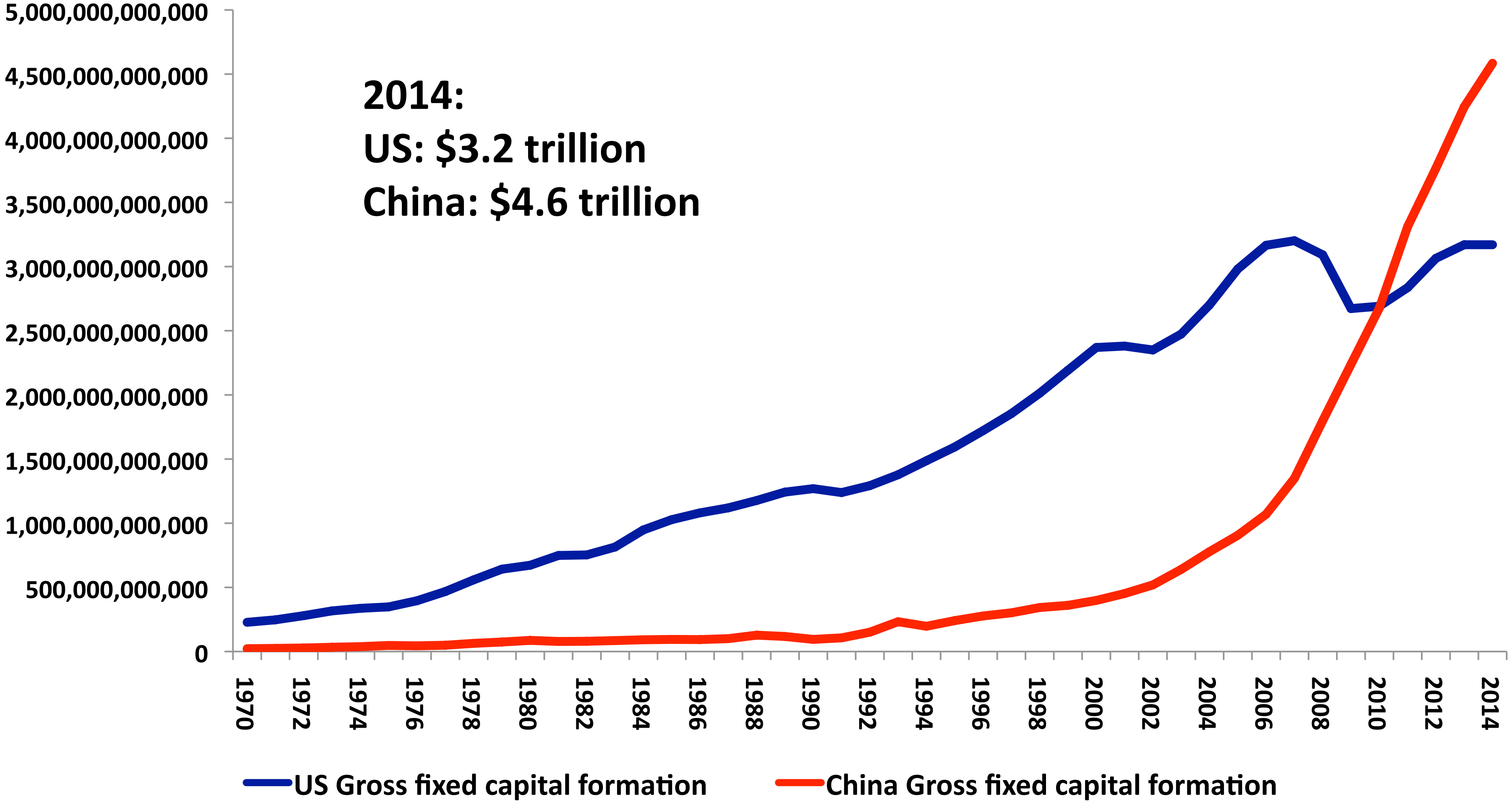
Source: United Nations Statistics Division



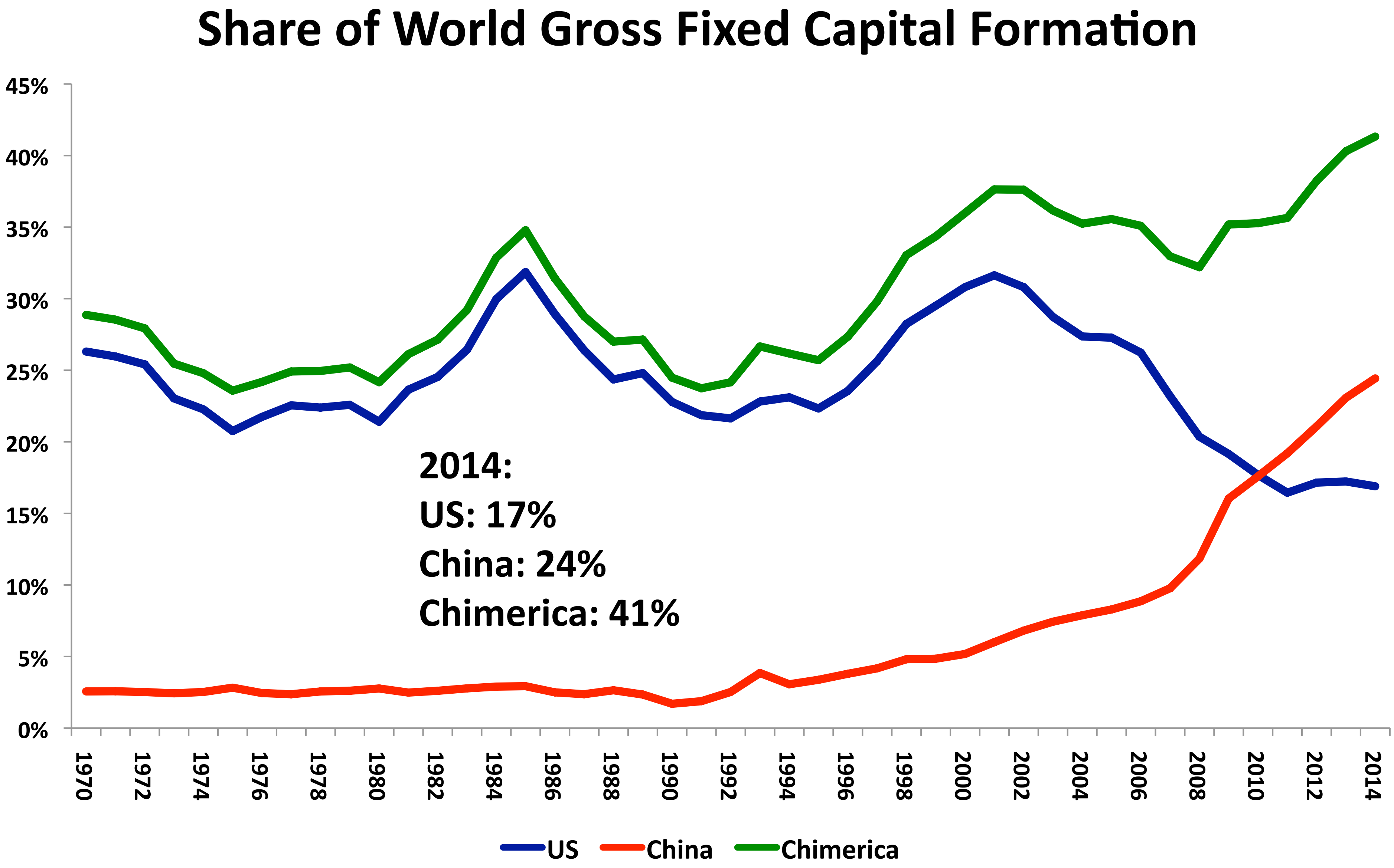
Source: United Nations Statistics Division

Gross Fixed Capital Formation (Investment)

US$s, 1970 to 2014



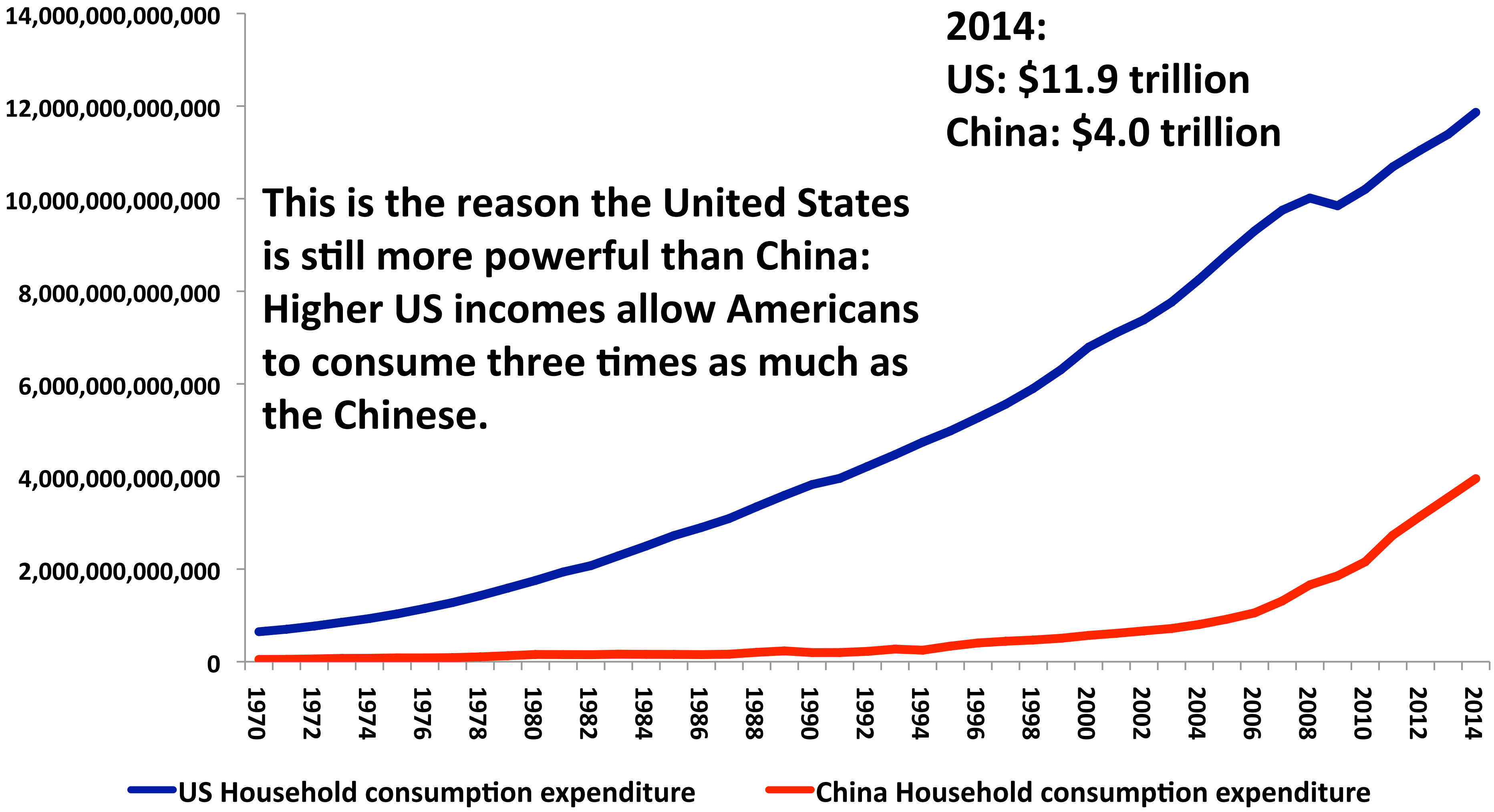
Source: United Nations Statistics Division



Source: United Nations Statistics Division

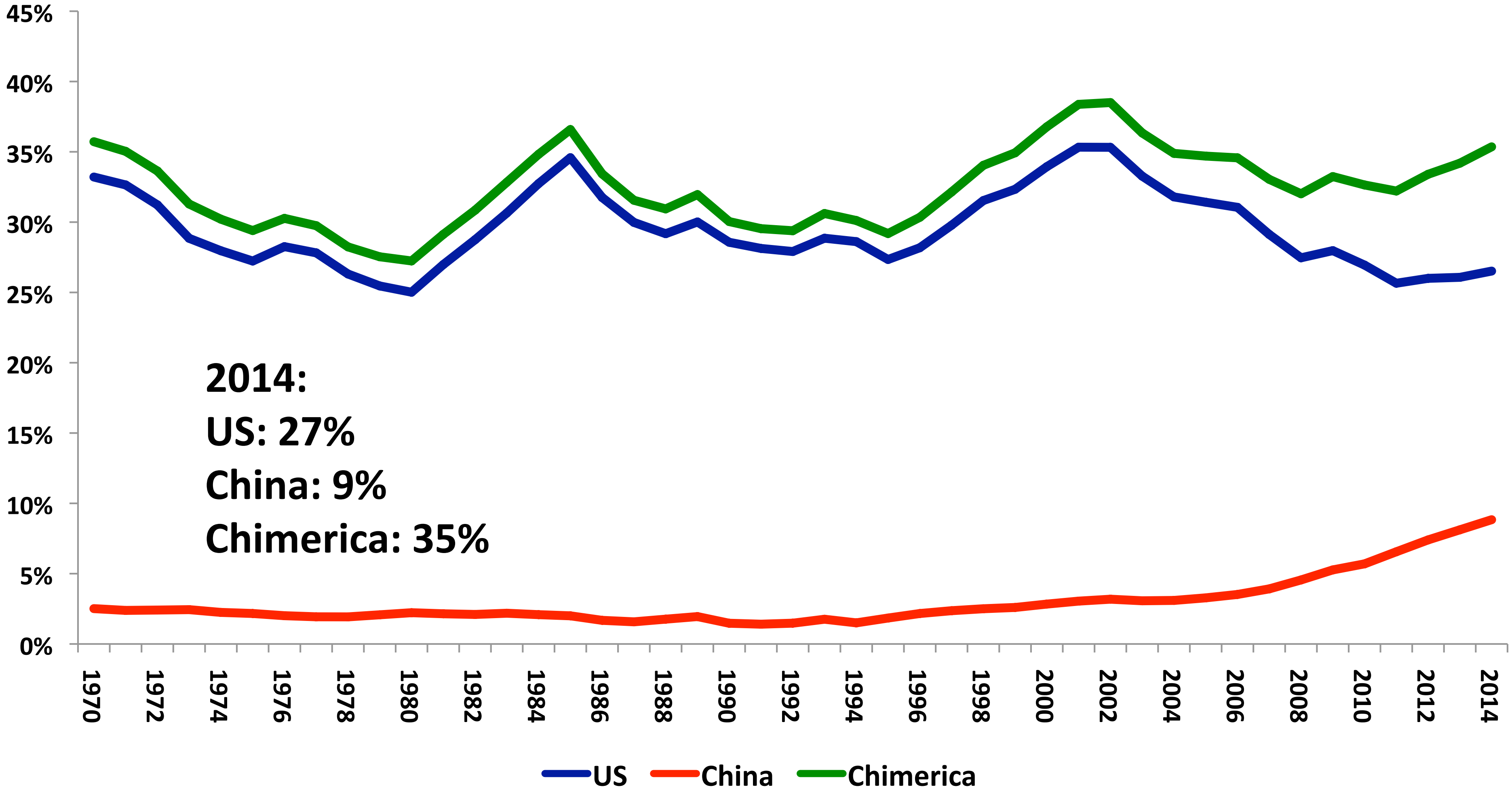
Household Consumption Expenditure US vs. China

US$, 1970 to 2014



Source: United Nations Statistics Division

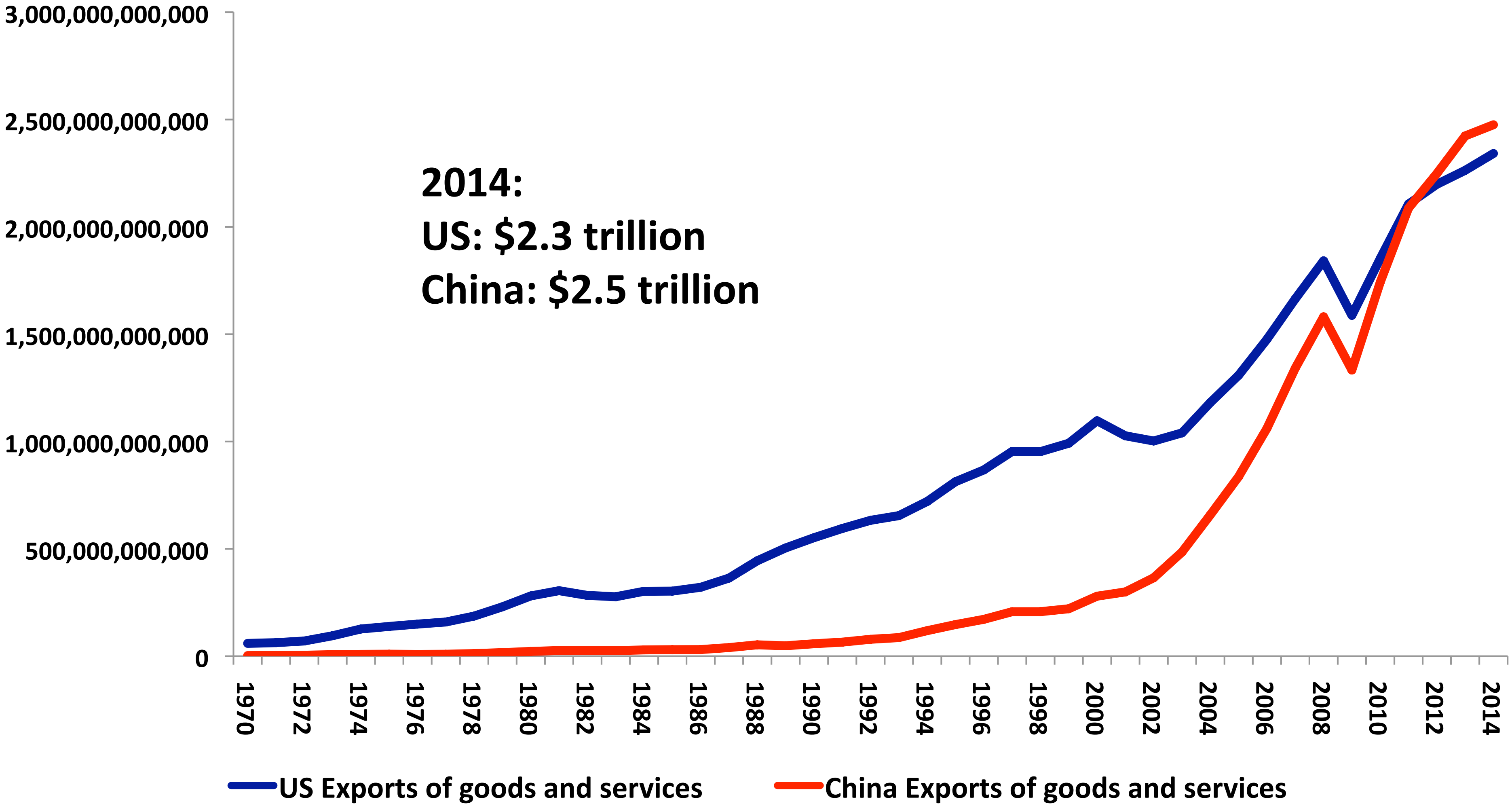
Share of World Household Consumption Expenditure



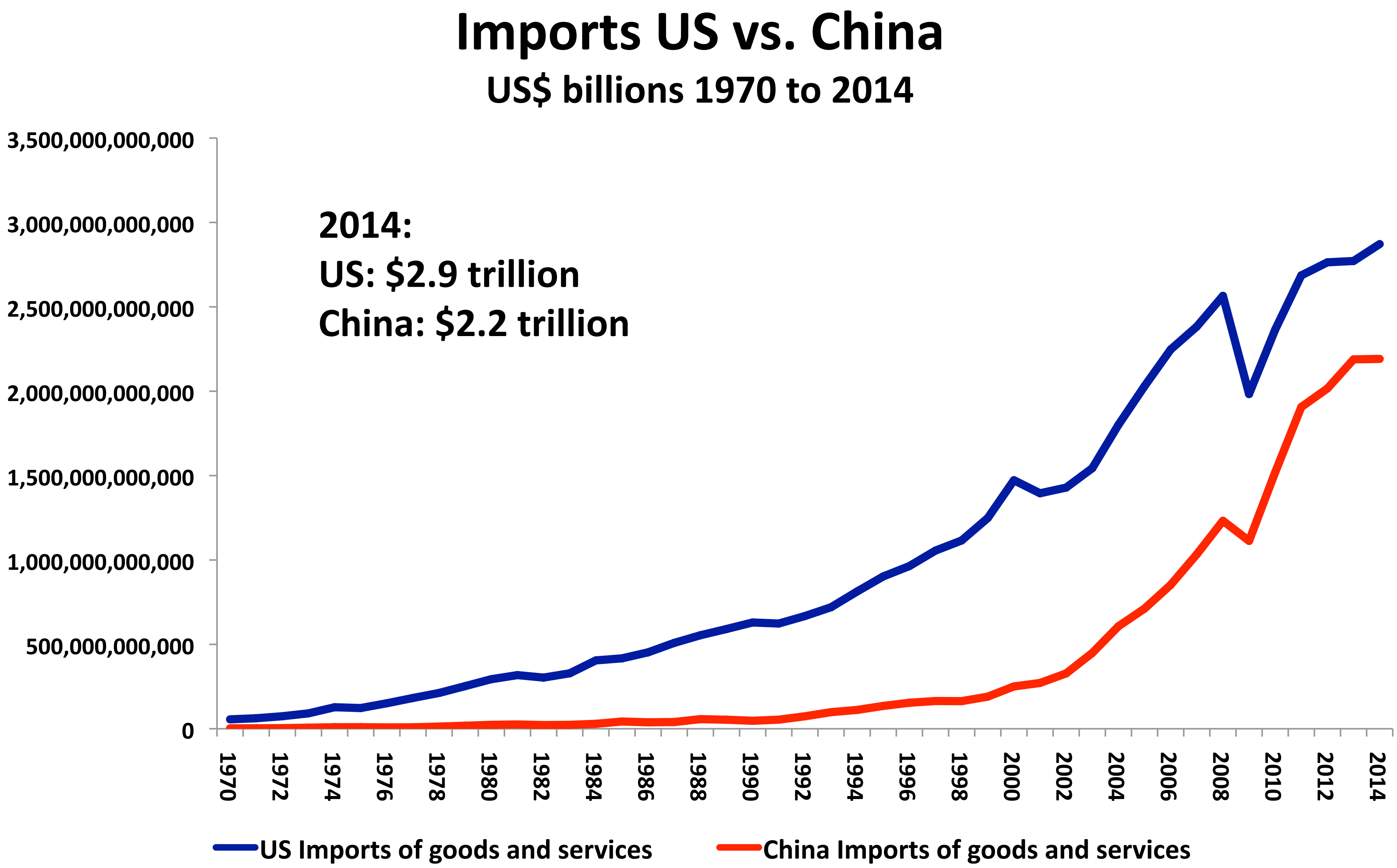
Source: United Nations Statistics Division

Exports US vs. China

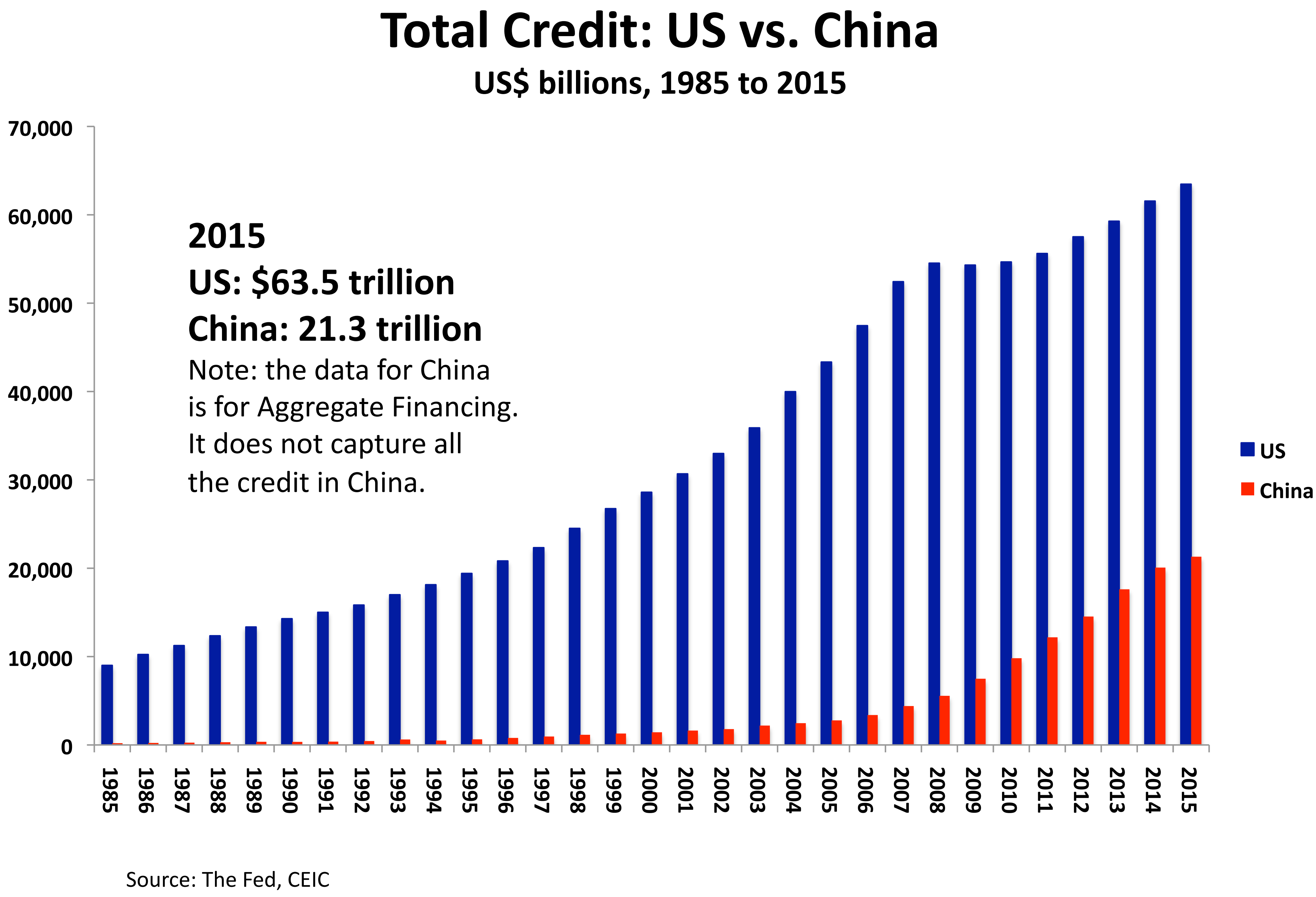
US$ billions, 1970 to 2014



Source: United Nations Statistics Division



Source: United Nations Statistics Division


Total Credit: US vs. China
US$ billions, 1985 to 2015
70,000
60,000
50,000
40,000
30,000
20,000
10,000
0
2015
US: $63.5 trillion
China: 21.3 trillion
Note: the data for China
is for Aggregate Financing.
It does not capture all
the credit in China.
US
China
1985
1986
1987
1988
1989
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1993
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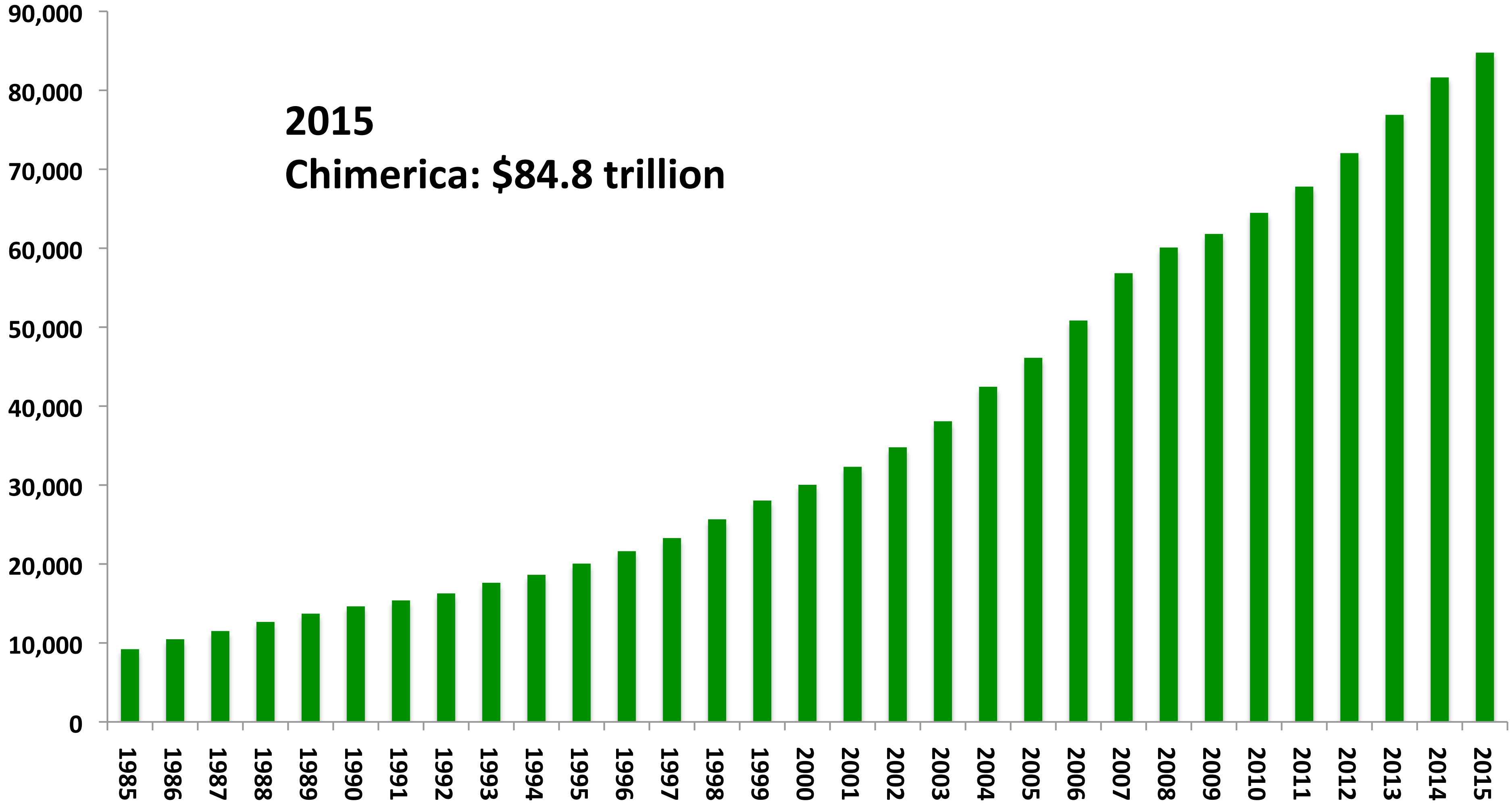
2010
2011
2012
2013
2014
2015
Source: The Fed, CEIC

Chimerica: Total Credit

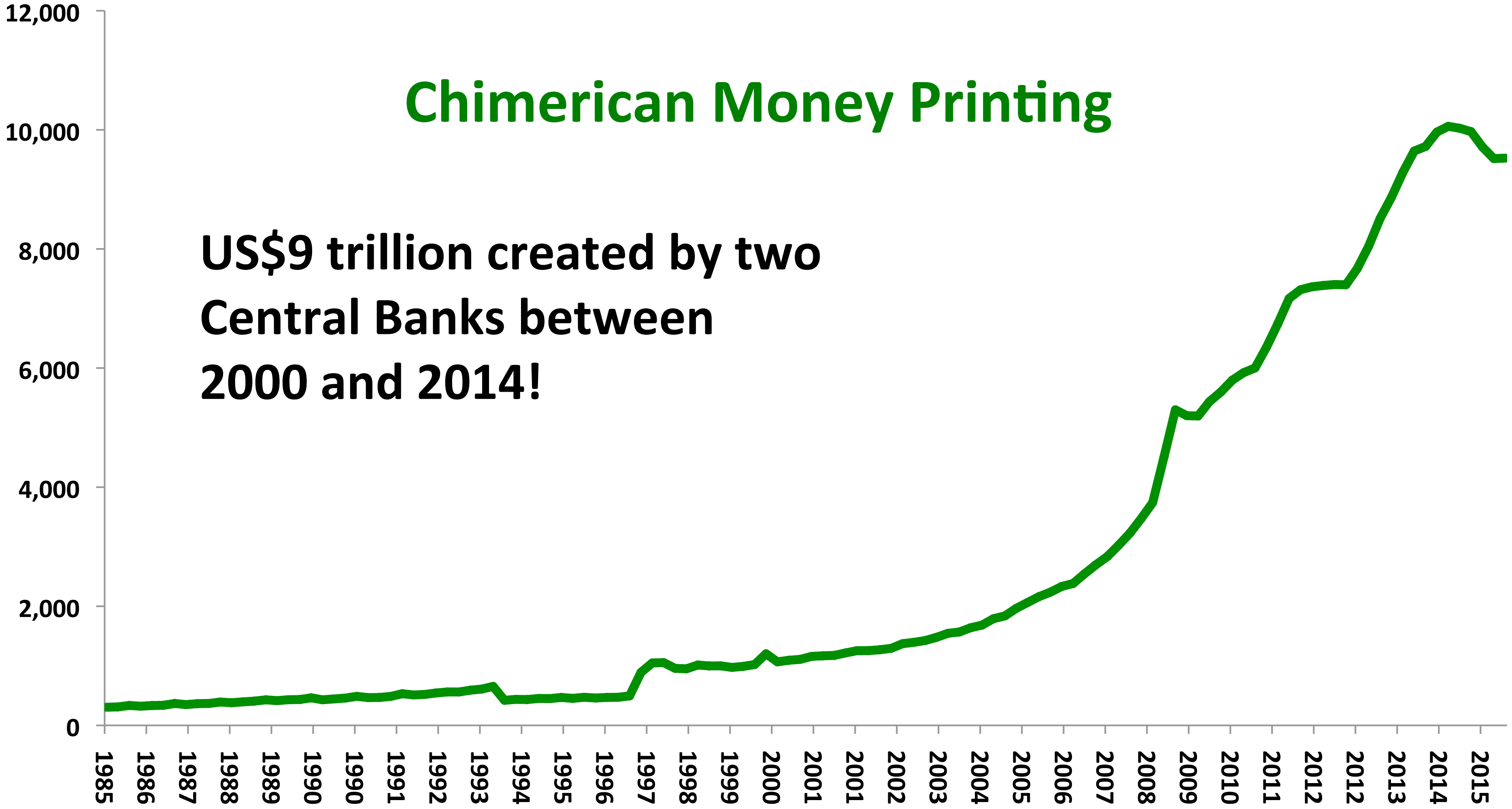
US$ billions, 1985 to 2015



Source: The Fed, CEIC

Total Assets of The Fed & PBOC Combined

US$ billions, 1985 to Q1 2016



Source: The Fed, CEIC

But Then Things Changed

- The capital inflows from China blew the US into a bubble (which was fine as long as it lasted), but then the bubble popped in 2008.
- Now the US households can't take on more and more debt as they used to, so the US is not able to keep up its end of the Chimerican deal by rapidly increasing its imports from China every year. If the US can't buy, then China can't sell.
- The US is verging on deflation, so the downward pressure that the cheap Chinese products put on prices is no longer desirable.
- Also, US interest rates have fallen so low (1.5% on the 10-year government bond), a further drop is considered unhealthy since it could cause another destabilizing asset price bubble. So, the US government is no longer so keen as it used to be to have the PBOC buy US government bonds by printing Yuan and buying Dollars.

But Then Things Changed

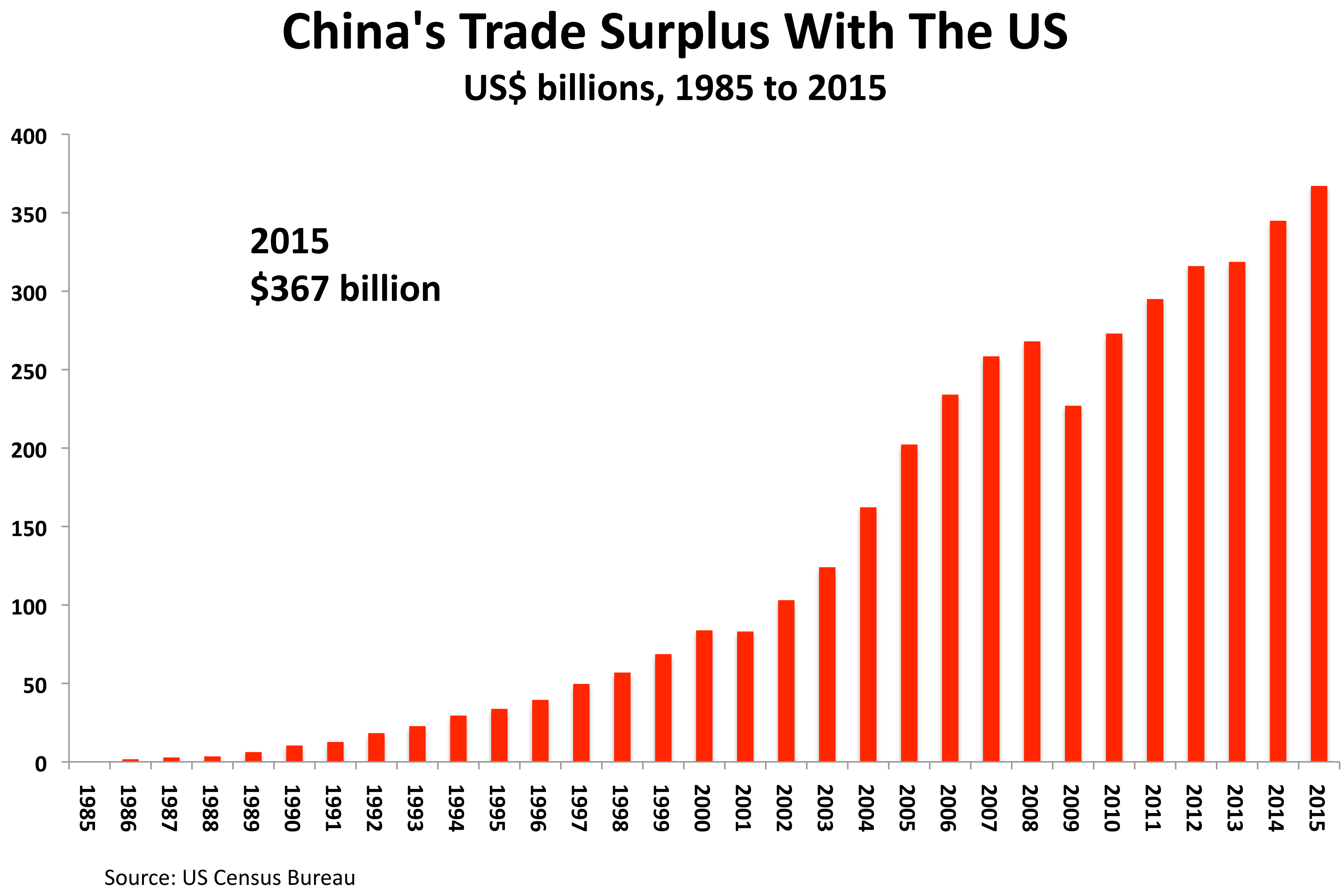
- China’s military power has been growing in line with its economic power. Over time, the US State Department and the US Military have come to see China’s growing military power as a threat that more than outweighs the benefits the US had derived from China’s lack of opposition to US foreign policy initiatives (outside Asia).
- These US military concerns have dampened the United States enthusiasm for Chimerica.
- A political revolution has begun in the US. Those who have been harmed by Chimerica are fighting back by voting for Trump and Sanders. This backlash could be the end of Chimerica.

But Then Things Changed

- China has grown so large that the United States is no longer big enough to meet China's needs – especially since US economic growth is now so weak. This changes how China feels about the US. It doesn't need the US the way it once did.
- Finally, the very aggressive stimulus measures China took to keep its economy growing after the US crisis started have destabilized China's economy. The Chinese bubble is now in danger of popping. China may have to adopt measures that are contrary to US interest (like a large Yuan devaluation or military adventures).

Blurred

- To some extent, China and America reversed roles or, at least, their roles became blurred.
- China ramped up its borrowing to drive Chinese growth. So Chinese credit growth and economic growth became larger than US credit growth and economic growth in absolute terms.
- The Fed joined the PBOC in printing extraordinary amounts of money to finance US government debt.


China's Trade Surplus With The US
US$ billions, 1985 to 2015
400
350
300
250
200
150
100
50
0
2015
$367 billion
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
Source: US Census Bureau

China's Trade Surplus with The US
Annual % Change, 1987 to 2015
80%
70%
60%
50%
40%
30%
20%
10%
0%
-10%
-20%
68%
25%
79%
67%
22%
44%
24%
30%
15%
17%
26%
15%
21%
22%
-1%
24%
20%
31%
25%
16%
10%
4%
-15%
20%
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1987
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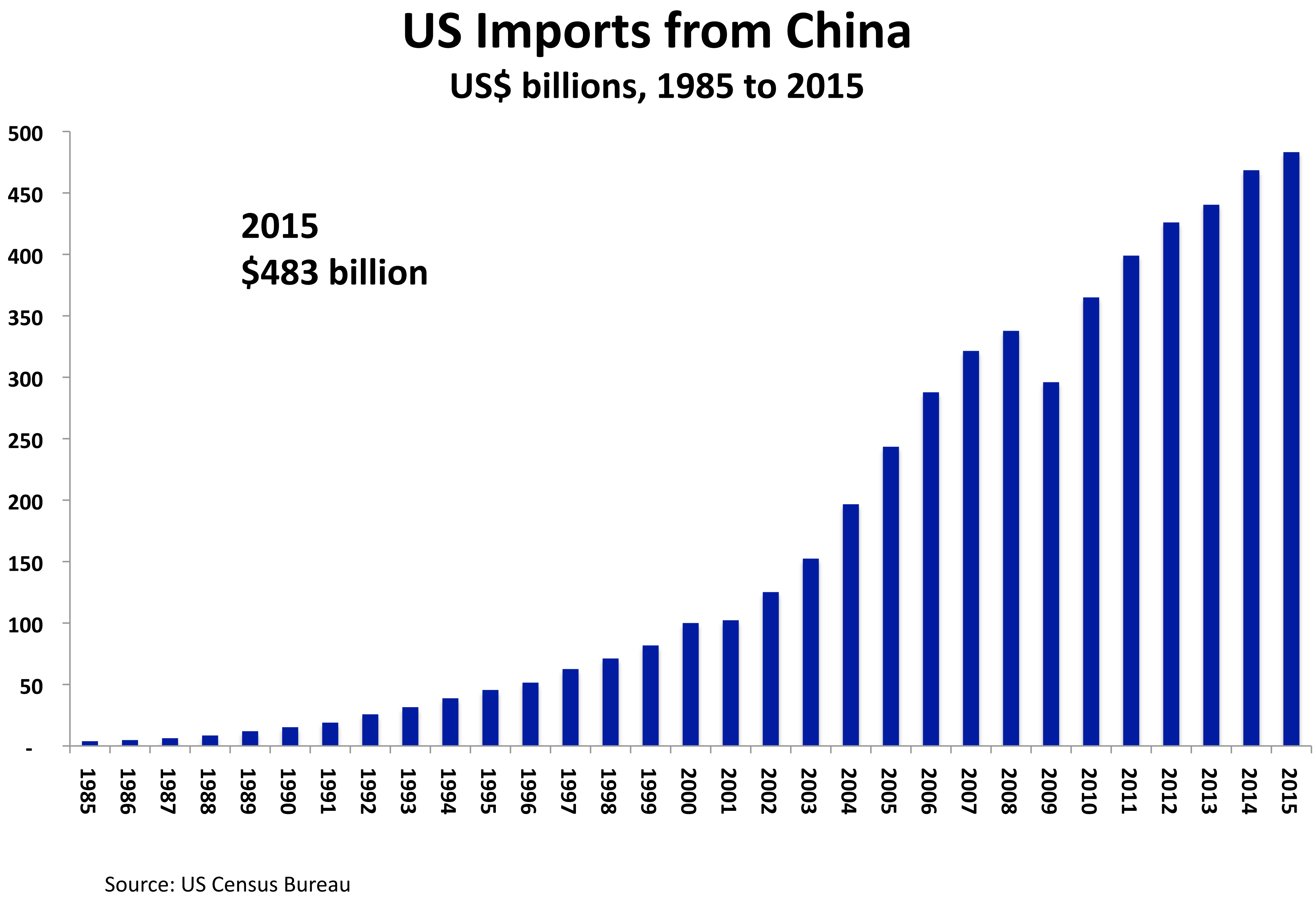
2014
2015
Source: US Census Bureau


US Imports from China
US$ billions, 1985 to 2015
2015
$483 billion
500
450
400
350
300
250
200
150
100
50
-
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
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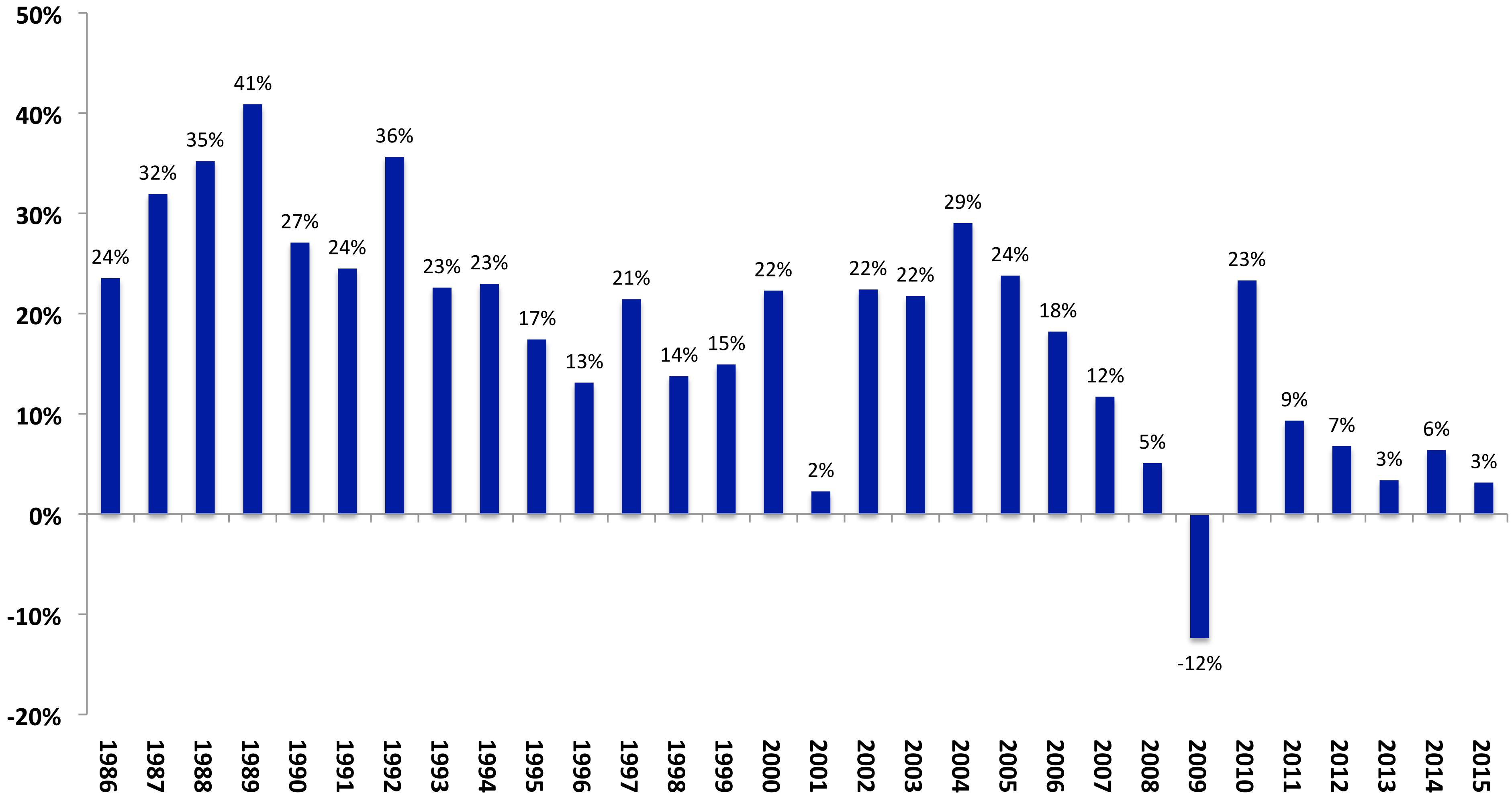
2015
Source: US Census Bureau

US Imports from China

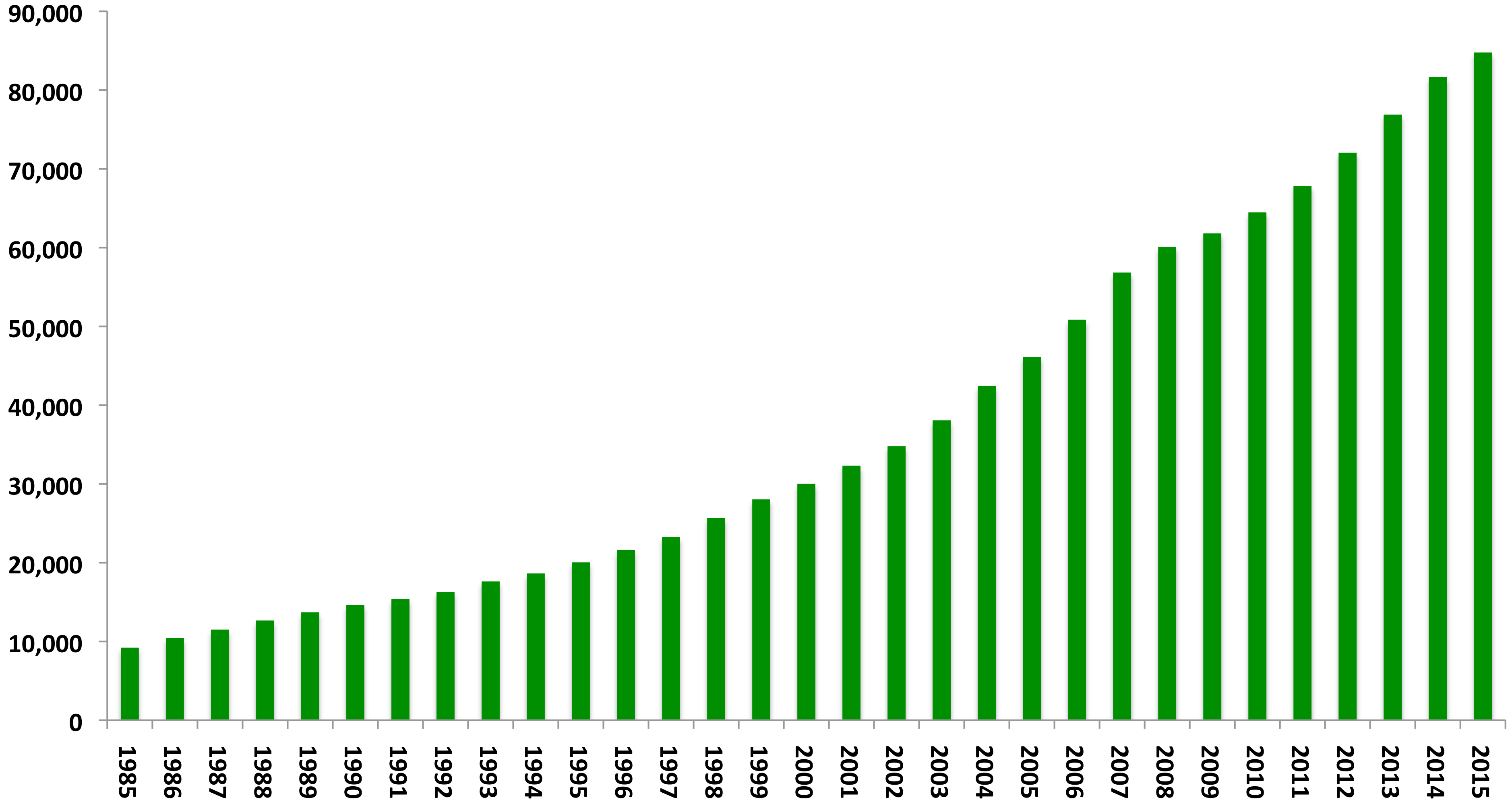
Annual % Change, 1986 to 2015



Source: US Census Bureau

Chimerica: Total Credit

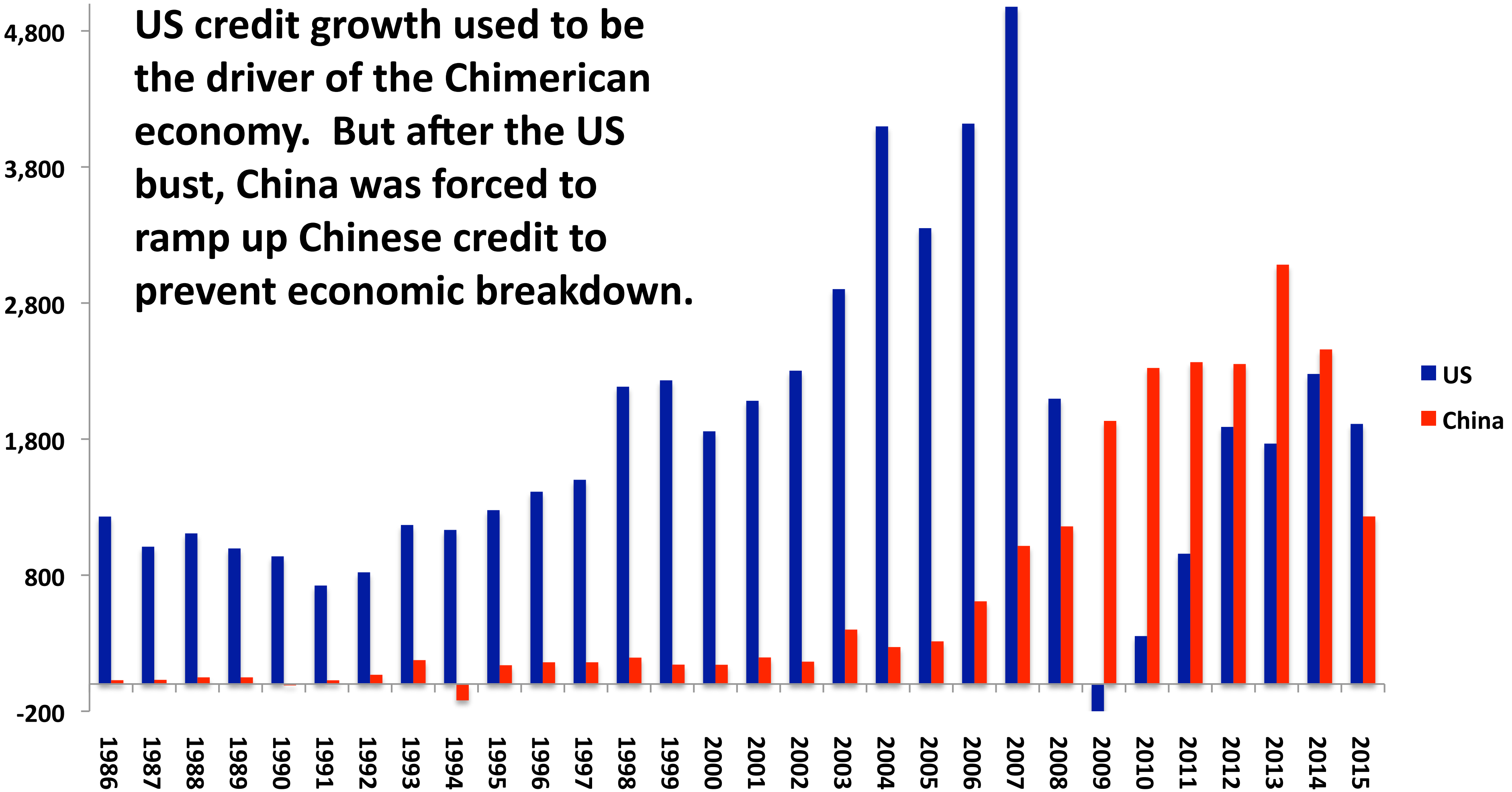
US$ billions, 1985 to 2015



Source: The Fed, CEIC

Credit: US vs. China Annual $ Change

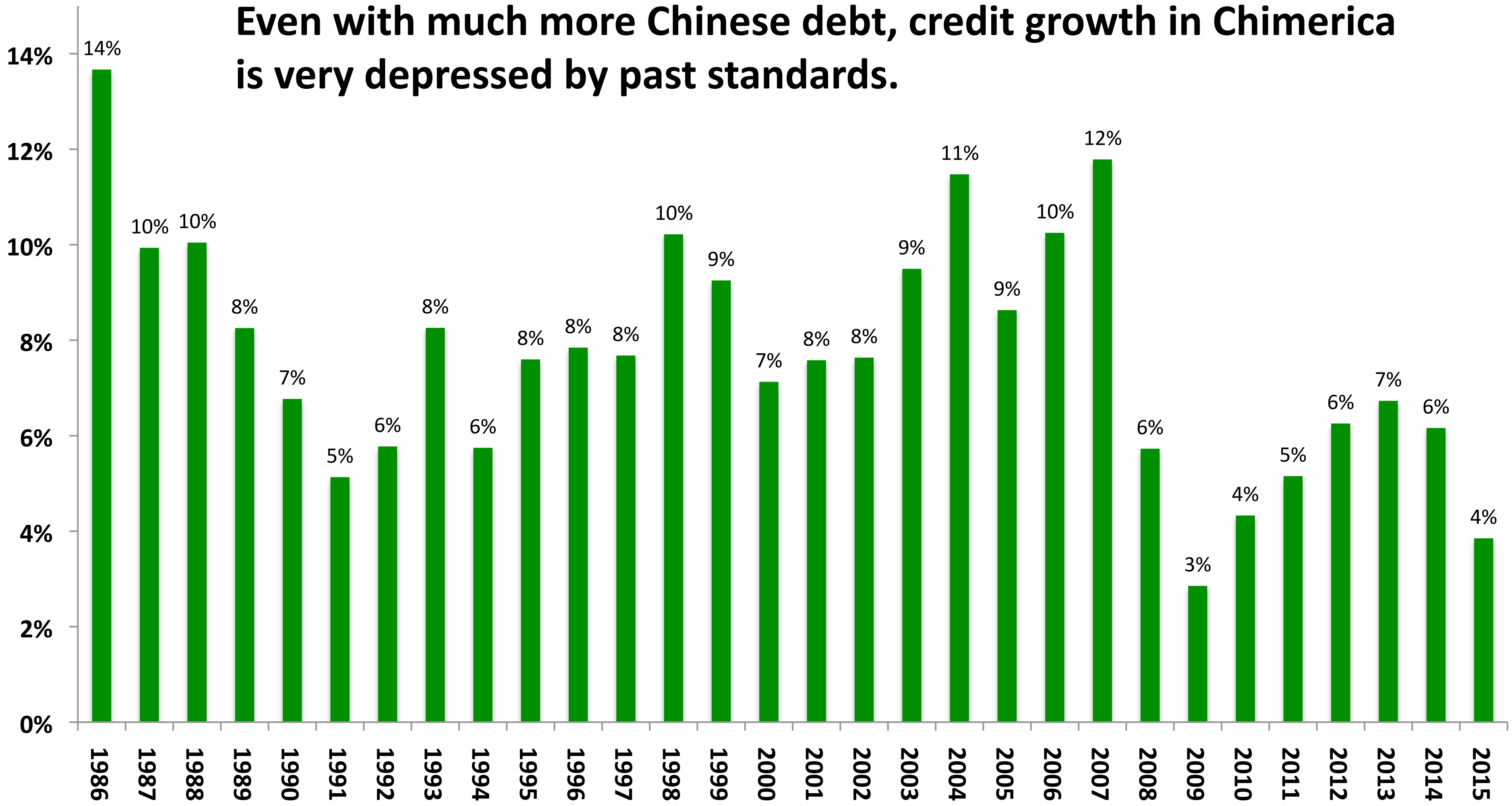
US$ billions, 1986 to 2015



Source: The Fed, CEIC

Chimerica Credit Annual % Change

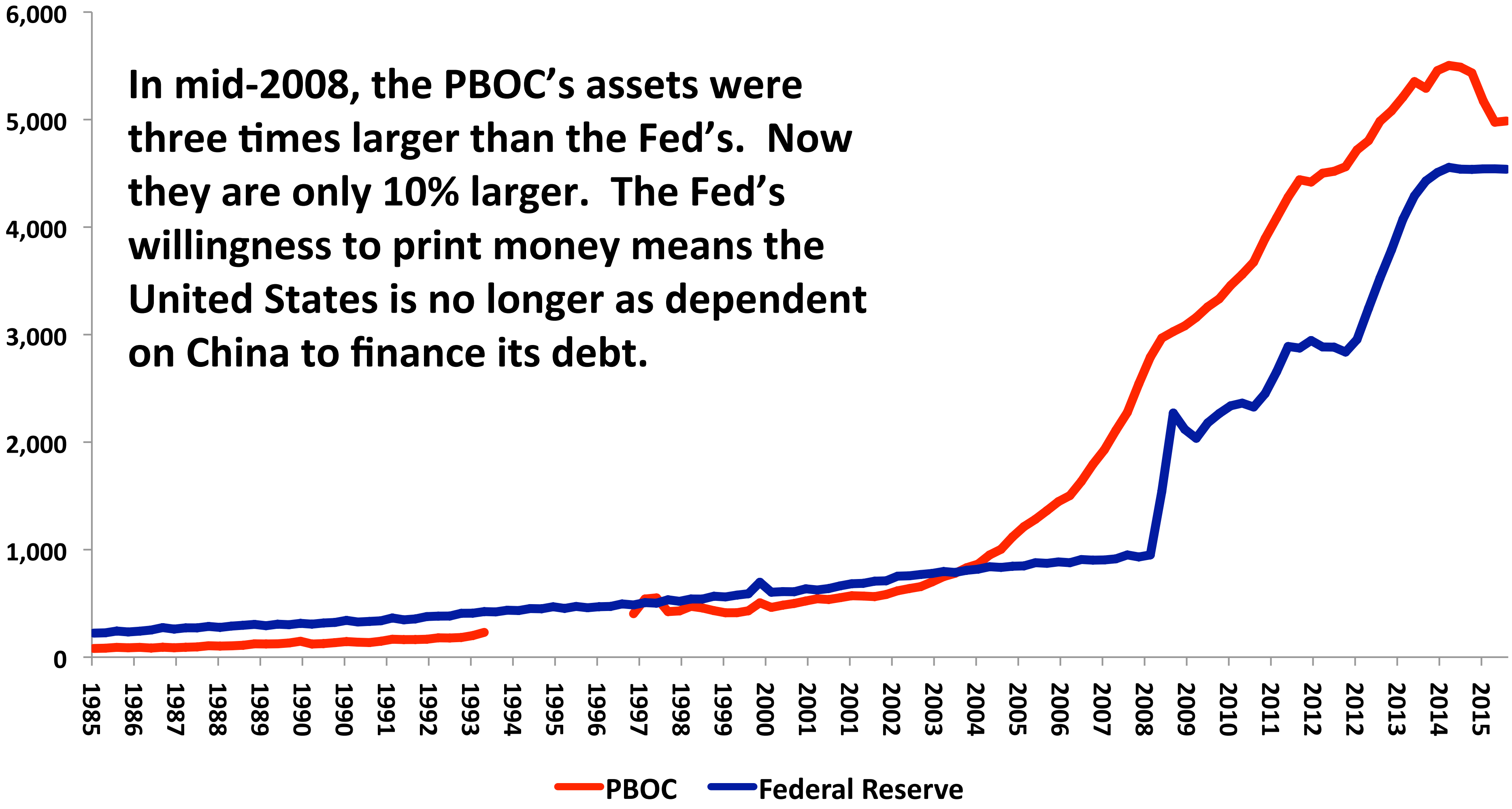
1986 to 2015



Source: The Fed, CEIC

Total Assets of The PBOC and The Fed

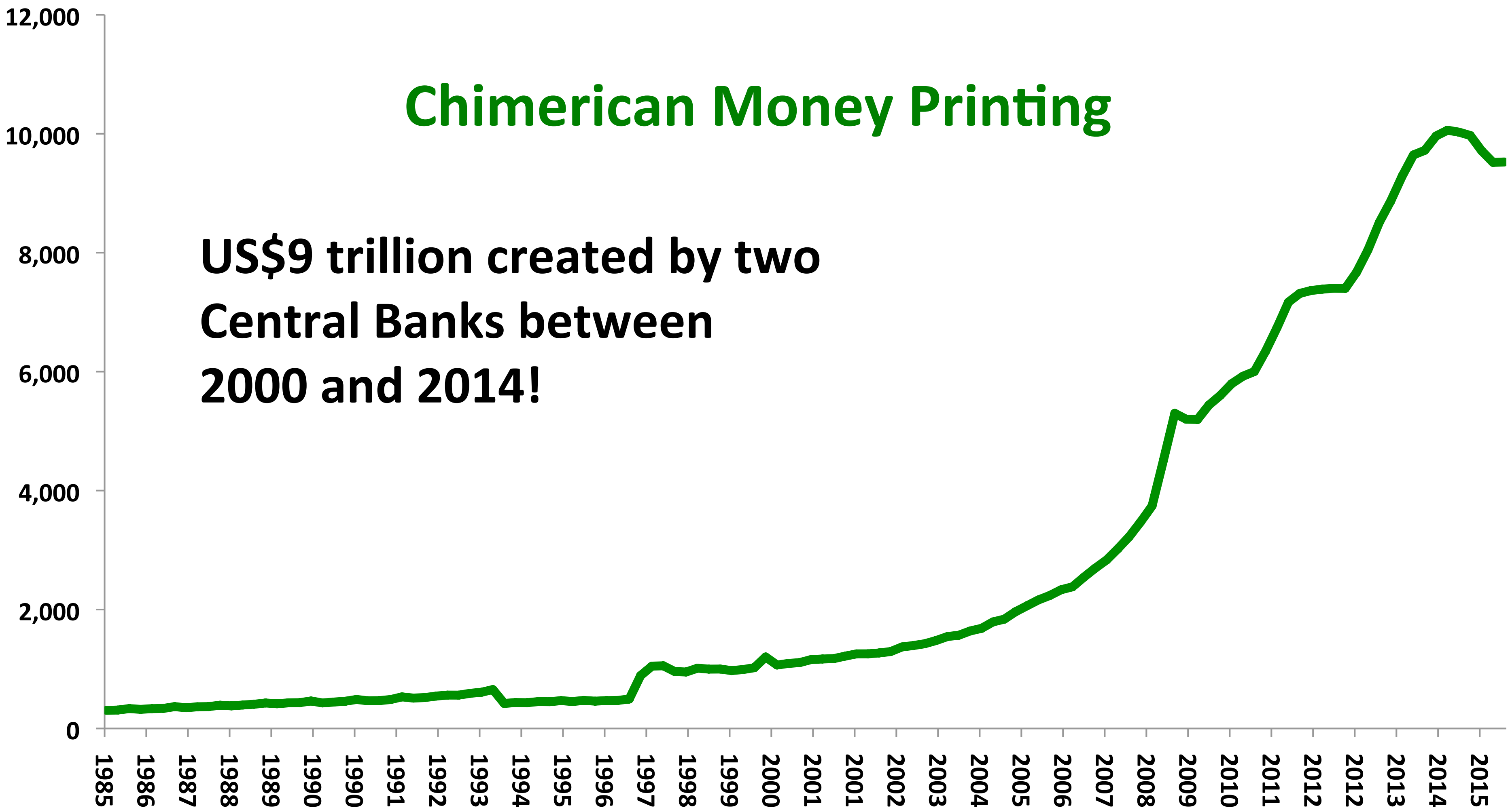
US$ billions, 1985 to Q1 2016



Source: The Fed, CEIC

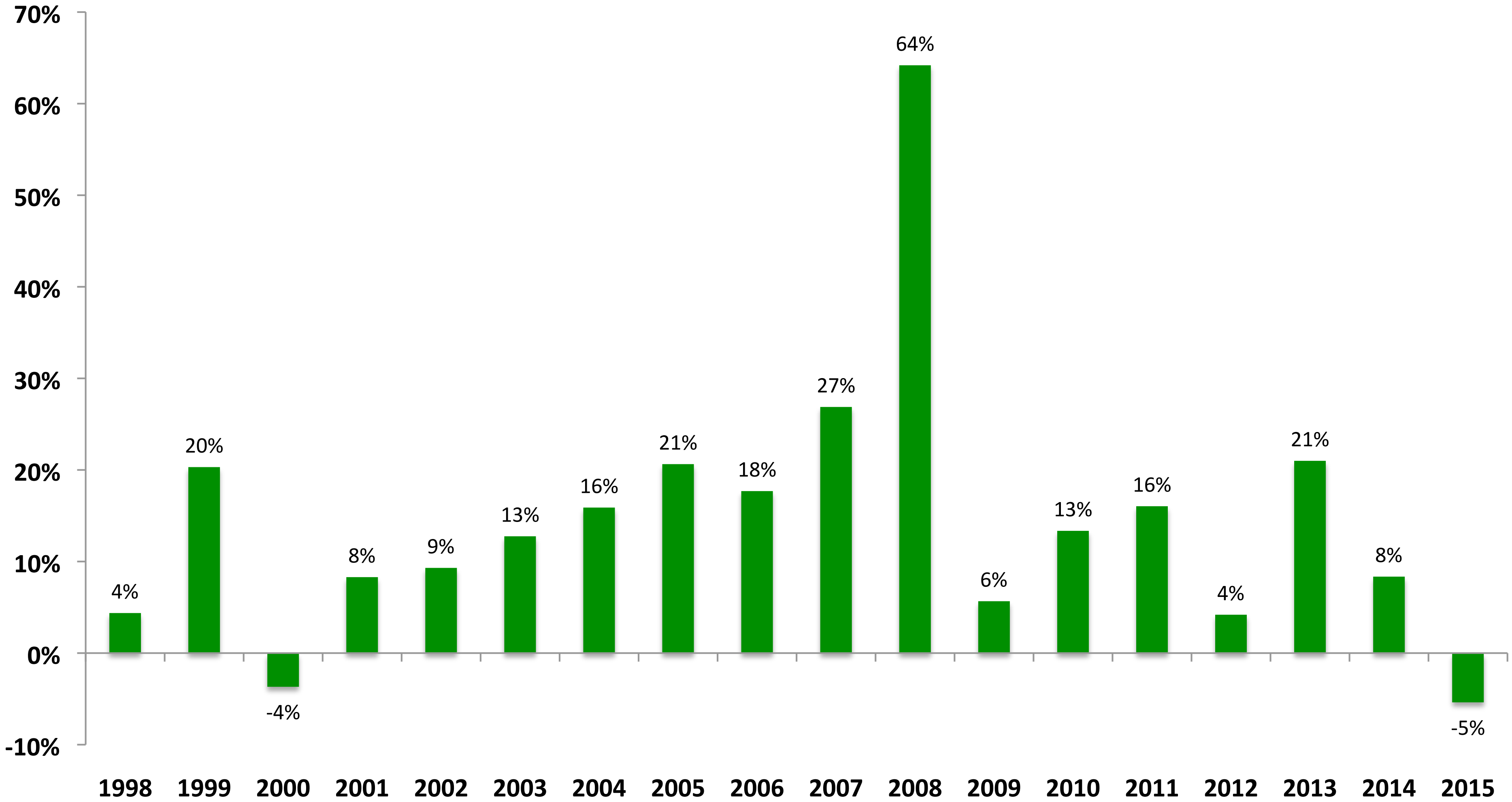
Total Assets of The Fed & PBOC Combined

US$ billions, 1985 to Q1 2016

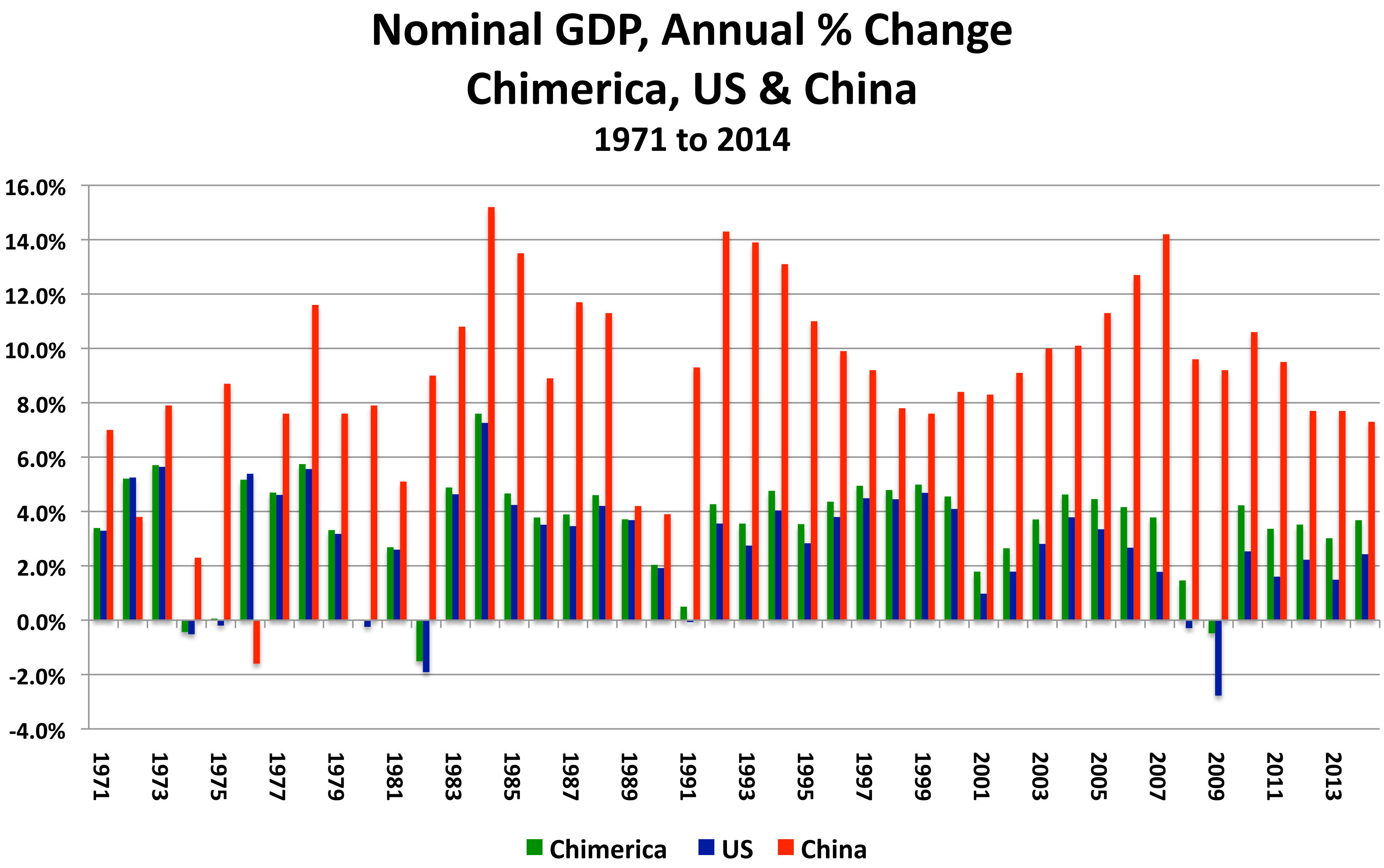


Source: The Fed, CEIC

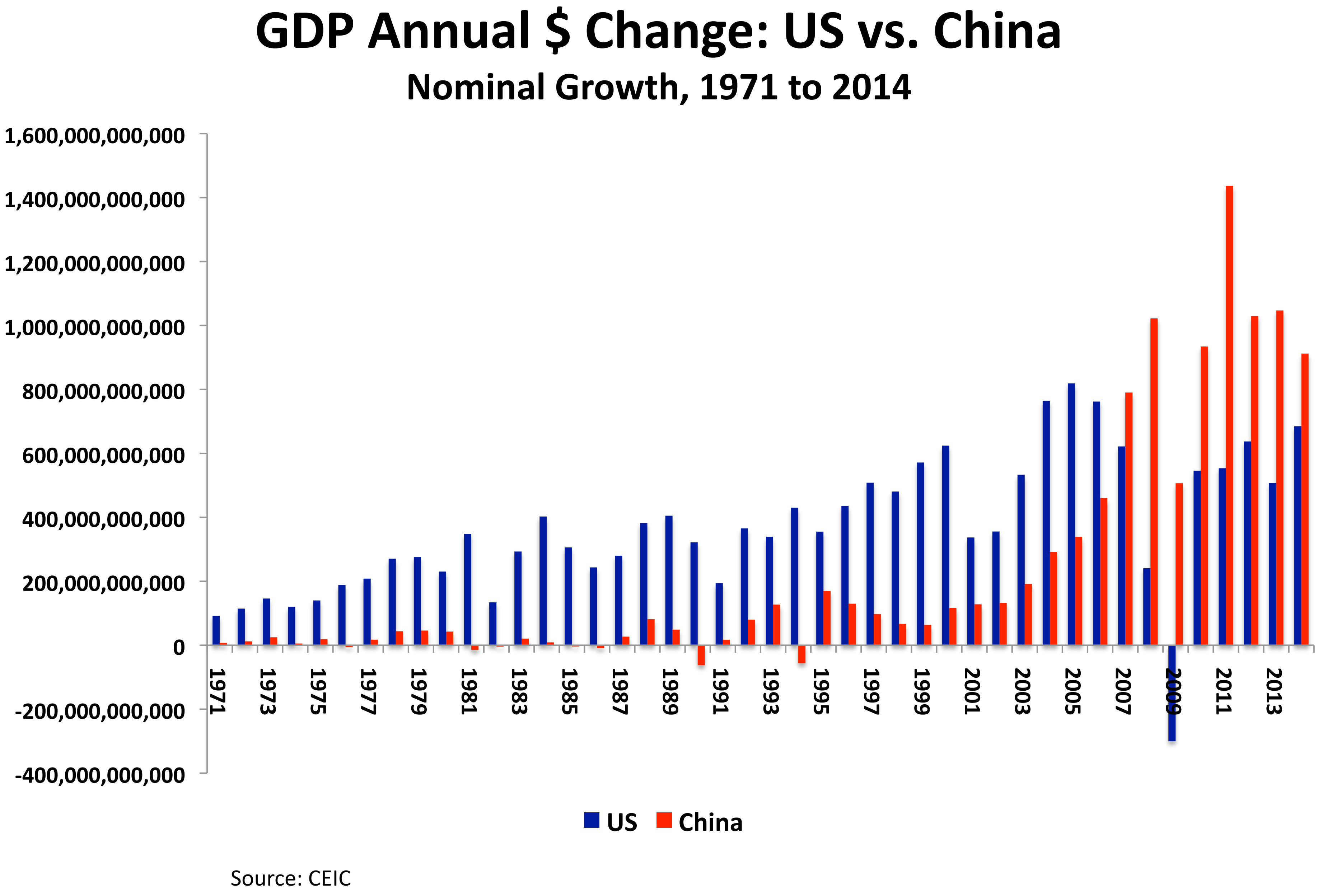
Total Assets of The Fed & PBOC Combined
Annual % Change, 1998 to 2015



Source: The Fed, CEIC



Source: United Nations Statistics Division


GDP Annual $ Change: US vs. China
Nominal Growth, 1971 to 2014
1,600,000,000,000
1,400,000,000,000
1,200,000,000,000
1,000,000,000,000
800,000,000,000
600,000,000,000
400,000,000,000
200,000,000,000
0
-200,000,000,000
-400,000,000,000
1971
1973
1975
1977
1979
1981
1983
1985
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1993
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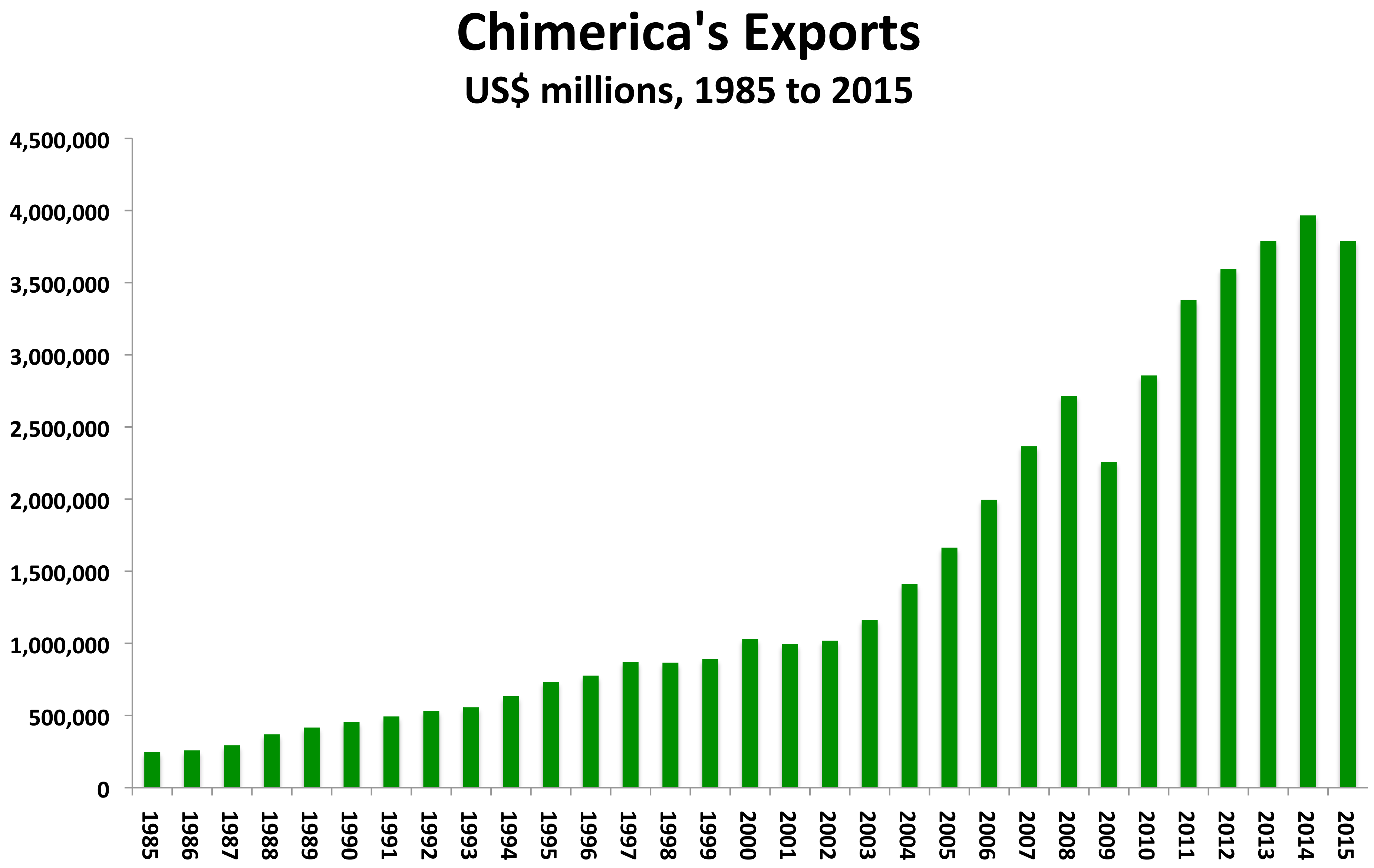
1999
2001
2003
2005
2007
2009
2011
2013
US
China
Source: CEIC



Chimerica's Exports
US$ millions, 1985 to 2015
4,500,000
4,000,000
3,500,000
3,000,000
2,500,000
2,000,000
1,500,000
1,000,000
500,000
0
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
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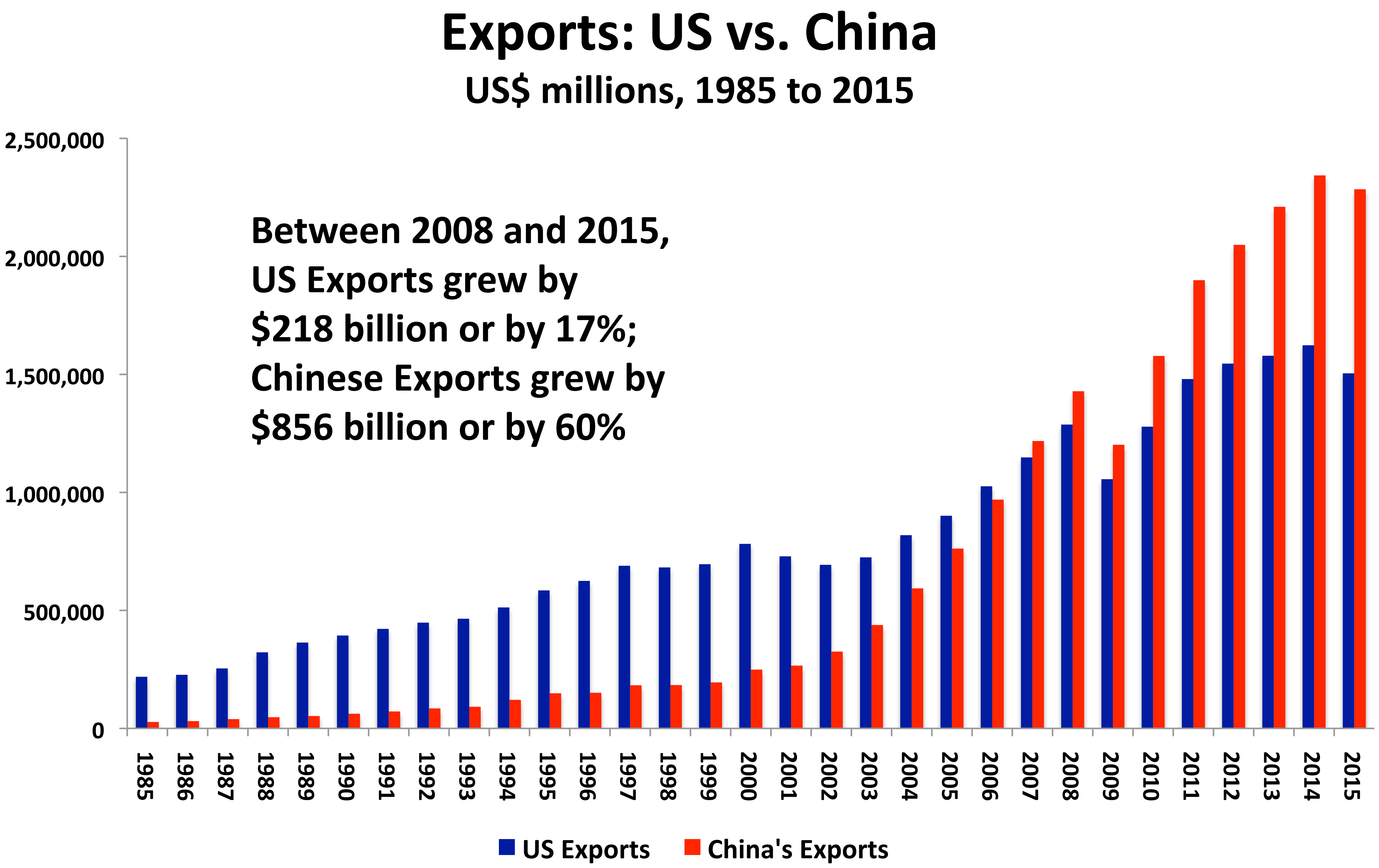
2015

Source: CEIC


Exports: US vs. China
US$ millions, 1985 to 2015
2,500,000
2,000,000
1,500,000
1,000,000
500,000
0
Between 2008 and 2015,
US Exports grew by
$218 billion or by 17%;
Chinese Exports grew by
$856 billion or by 60%
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
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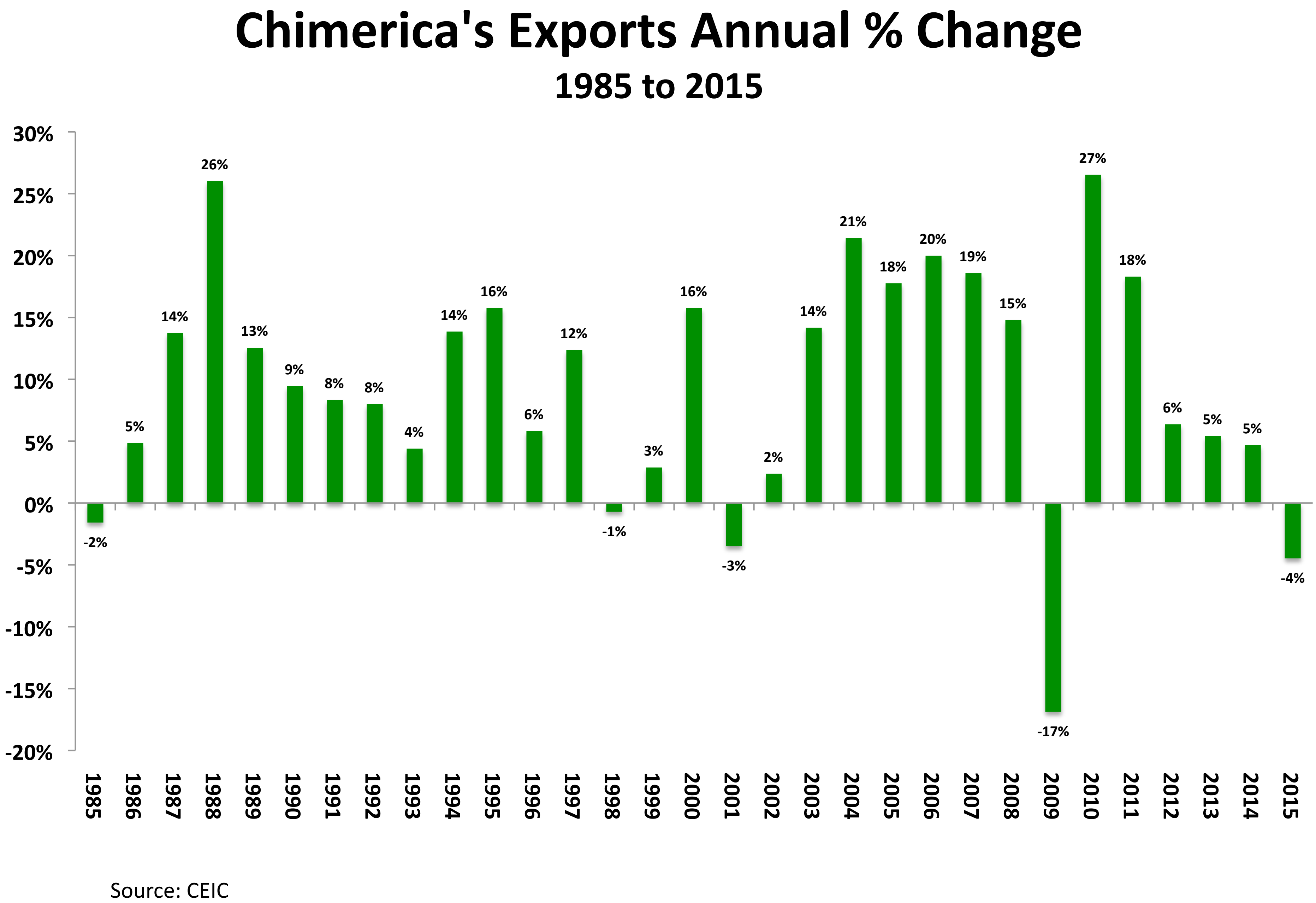
2014
2015
US Exports
China's Exports
Source: CEIC



Chimerica's Exports Annual % Change
1985 to 2015
30%
25%
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
-2%
5%
14%
26%
13%
9%
8%
8%
4%
14%
16%
6%
12%
-1%
3%
16%
-3%
2%
14%
21%
18%
20%
19%
15%
-17%
27%
18%
6%
5%
5%
-4%
1985
1986
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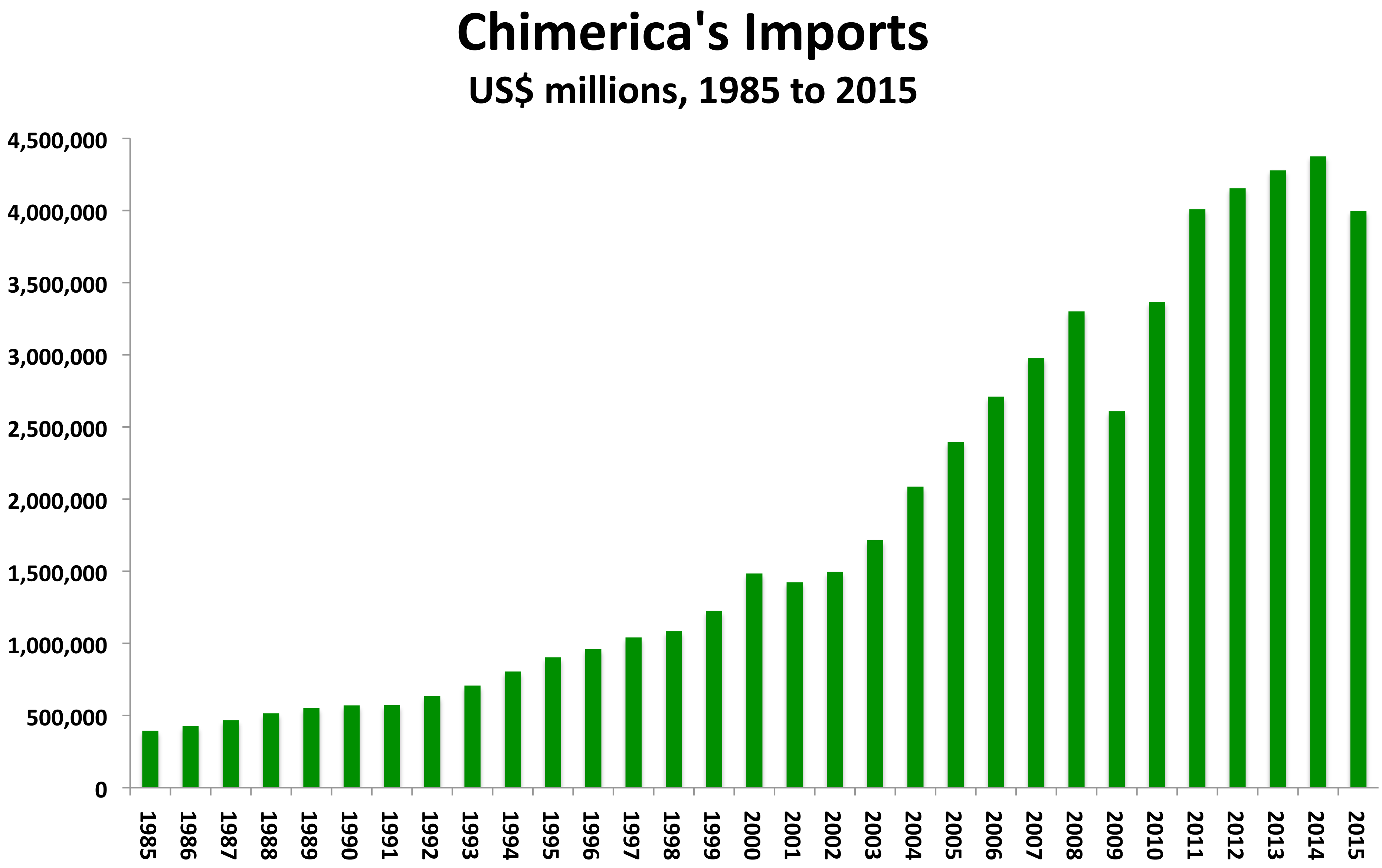
2013
2014
2015
Source: CEIC


Chimerica's Imports
US$ millions, 1985 to 2015
4,500,000
4,000,000
3,500,000
3,000,000
2,500,000
2,000,000
1,500,000
1,000,000
500,000
0
1985
1986
1987
1988
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1999
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2001
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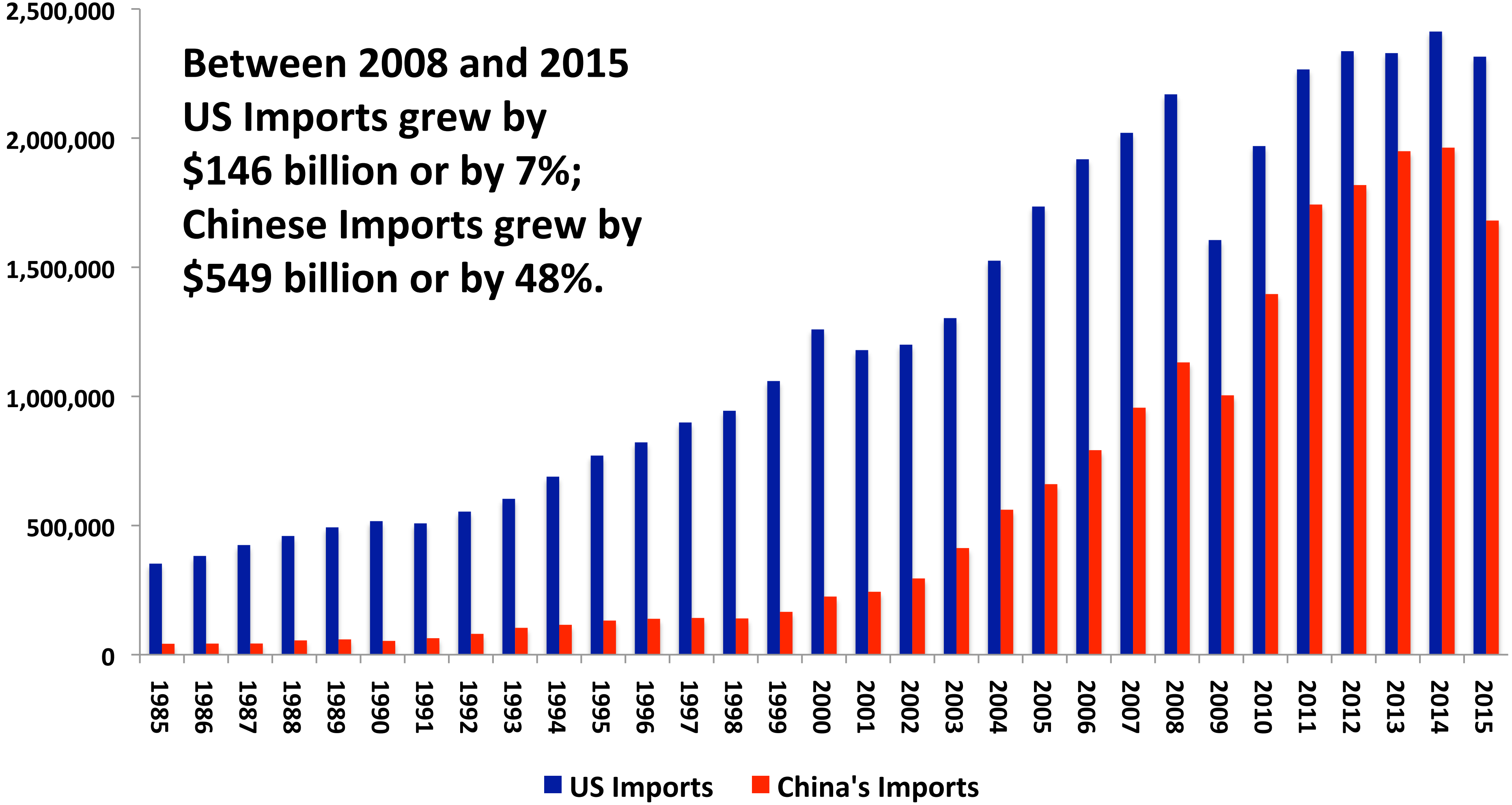
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015

Source: CEIC

Imports: US vs. China

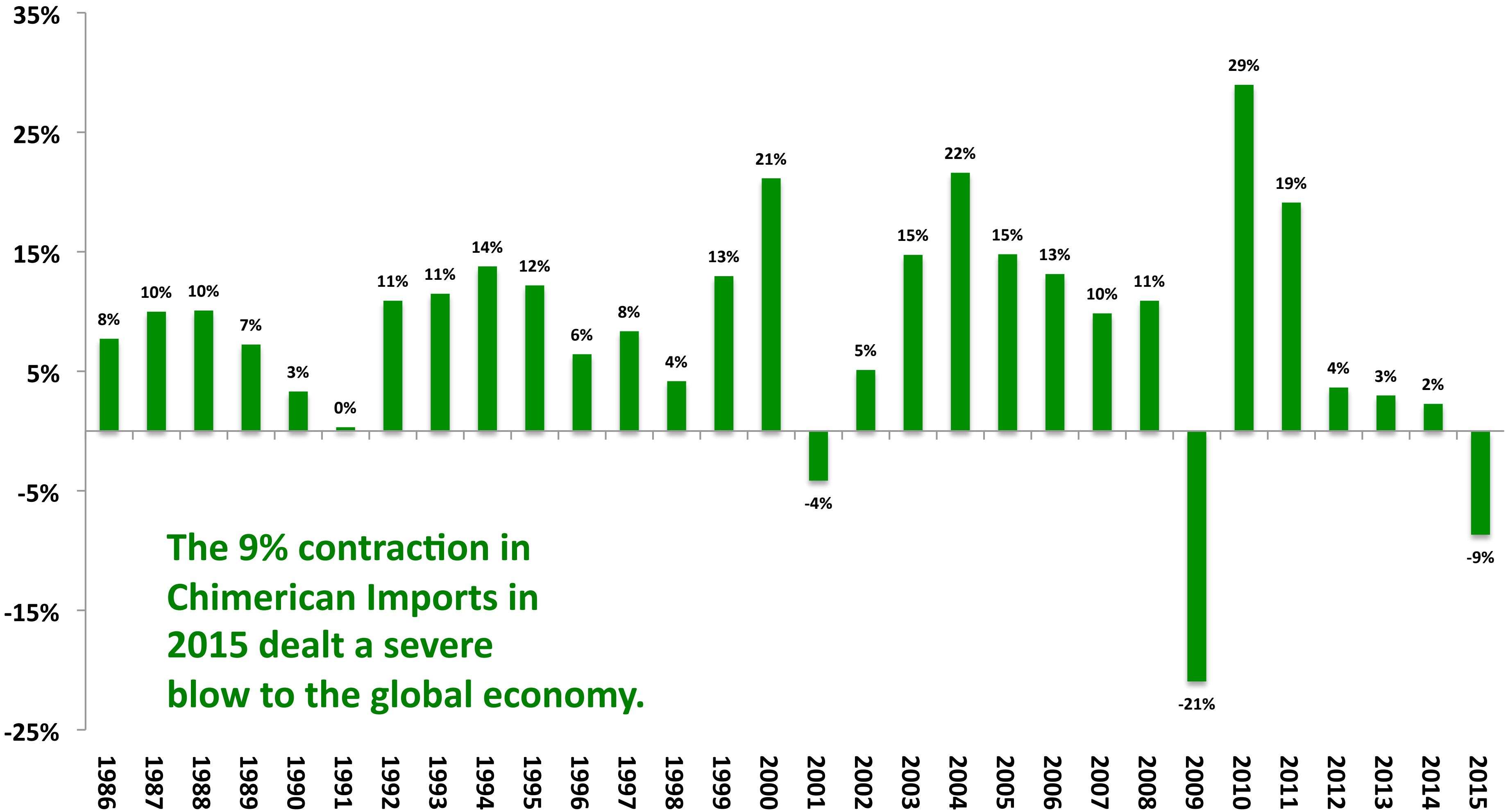
US$ millions, 1985 to 2015



Source: CEIC

Chimerica's Imports Annual % Change

1985 to 2015



Source: CEIC

The End Of The China Boom

- The last few charts show how important growth in China was to Chimerica and the world after 2008.
- China surpassed the US in both credit growth and economic growth (not just in % terms, but in nominal dollar amounts).
- China became the driver of Chimerican economic growth after 2008, but now the China boom is beginning to bust.
- As we saw in the 3rd and 4th videos in this series, China is facing funding constraints and extreme excess capacity across all its industries (relative to domestic and global purchasing power).
- It’s economic model of Export-Led, Investment-Driven growth is in crisis.

From Driver To Drag

- US credit growth is weak and Chinese credit growth is going to weaken. Therefore, there will not be enough credit growth to drive Chimerica.
- Already, Chimerican Imports and Exports have begun to fall (2015).
- China's economy is a very large economic bubble. The chances are high that China's economy will stop growing; and there is a real possibility that China's economy will shrink, perhaps significantly.
- With China now slowing sharply and the US unlikely to rebound, Chimerica is shifting from being the driver of global growth to being a drag on growth and a source of destabilizing deflation.

The Last Card

- Making matters worse, global trade tensions are increasing due to a grassroots backlash against free trade and Globalization.
- Chimerica is in danger of going into severe recession. If that happens, the chances of a Chimerican divorce involving trade tariffs will increase. If the divorce occurs, a global depression will follow.
- Even if a worse case scenario can be avoided, it is difficult to see what will drive global economic growth during the years immediately ahead.
- Large-scale fiscal stimulus is the last card we have to play if a protracted slump – or worse – is to be avoided.