

Free Trade Failures – Understanding Root Cause Failure Modes

Here we Provide Excerpts from our book, The Truth of the Modern Recession that provide insight into a number root cause issues to our free trade problems.

A historic overview of the trade deficit is depicted in Figure 9.1. Here we note the incredible growth of the deficit in this 14 year period.

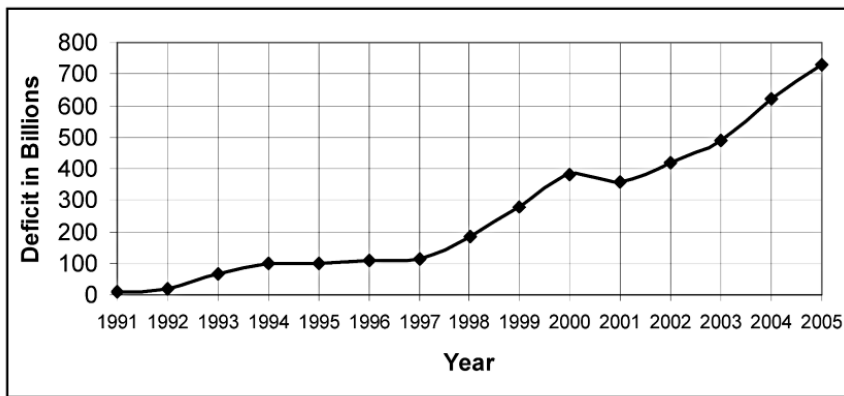


Figure 9.1 Trade deficit in goods and services from 1991 to 2005 US Census Bureau Foreign Trade Division (www.census.gov/foreign-trade/statistics/historical/gands.txt)

The current trade deficit is provided in Table 9.2

Table 9.2 Year to Date & Projected 2009 U.S. Trade Deficit Information¹

U.S. Top 15 Trading Countries	Exports (Year-to-Date)	Imports (Year-to-Date)	Trade Deficit	Projected 2009 Deficit	Percent of Total Trade
In Billions of Dollars					
China	30.4	133.4	103	167	13.5%
Mexico	58.6	79.8	21.2	34	11.4%
Japan	24.8	42.7	17.9	29	5.6%
Germany	21.2	32.7	11.5	19	4.4%
Ireland	4.2	14.8	10.6	17	1.6%
Canada	96.2	104.7	8.5	14	16.6%
Venezuela	5	12.1	7.1	12	1.4%
Korea, South	12.6	19.2	6.6	11	2.6%
Italy	6.1	12.7	6.6	11	1.5%

¹ www.census.gov/foreign-trade/statistics/highlights/toppartners.html

By Alec Feinberg
Based On Chapter 9, From the book
The Truth of the Modern Recession - Root Causes and Reliable Solutions

ModernRecession.com

Taiwan	7.6	13.3	5.7	9	1.7%
France	13.9	16.7	2.8	5	2.5%
India	7.5	10.1	2.6	4	1.5%
United Kingdom	22.8	21.7	-1.1	-2	3.7%
Brazil	11.9	9.5	-2.4	-4	1.8%
Netherlands	16.4	7.7	-8.7	-14	2.0%
Total, All Countries	498.2	715.1	216.9	352	100%
Total, Top 15 Countries	339	531.2	192.2	312	72%

Table 9.2 indicates that our biggest deficit exists with China, followed by Mexico, and Japan. Warren Buffett has been quoted as saying,

Remark 9.7: "The U.S trade deficit is a bigger threat to the domestic economy than either the federal budget deficit or consumer debt and could lead to political turmoil... Right now, the rest of the world owns \$3 trillion more of us than we own of them."²

Currently many companies are now recognizing that job outsourcing has gone too far, but still are unable to resolve their apparent need.

Remark 9.7-A: July 2009, "Jeffery Immelt, the CEO of General Electric, recently said that 'the United States needs to invest in American manufacturing in order to get out of our current economic crisis. Some [companies had gone overboard with outsourcing](#) in the past and now it was time to bring that work back into the United States to create a strong economy.... GE plans to lead this effort.' The author of the article goes on to saying that at the same time GE was actually shipping more jobs overseas by cancelling U.S. orders to instead buying these parts from China."³

9.3: Free Trade Deficit, the National Debt, and U.S. Currency

Free trade deficit means foreigners increasingly own U.S. dollars. For example, when the U.S. spends \$10 on imports from China and China only ends up spending \$5 on imports from the U.S., China has a \$5 U.S. gain. China's currency is the yuan (about 6.8 yuan equals 1 U.S. dollar as of September 2009). Therefore it has two choices: sell the dollar for the yuan, which could decrease the value of the dollar, or purchase securities such as U.S. stocks or treasury bonds. Since treasury bonds are, in essence, loans to the U.S. government, the trade deficit and the trading partners of the U.S. fund some of the national debt. The vast majority of the national debt is held by Americans. However, foreigners own about \$3 trillion of our \$11 trillion-plus debt.

² http://en.wikipedia.org/wiki/Trade_deficit#Warren_Buffett_on_trade_deficits (January 20, 2006)

³ www.huffingtonpost.com/mike-elk/ge-promotes-manufacturing_b_241944.html, Author Mike Elk, huffington post on line.

By Alec Feinberg
Based On Chapter 9, From the book
The Truth of the Modern Recession - Root Causes and Reliable Solutions

ModernRecession.com

In 2009, they have been happy to hold onto U.S. securities. The concern is that at some point, foreigners may want to reduce their holdings. If this occurs rapidly, it could send the value of the dollar, U.S. stocks, and bond prices plunging, since the government will have to print money to pay back the foreign countries. This poses a risk. The current foreign holdings of the U.S. debt are listed in Table 9.3. We see there is strong correlation to the trade deficit. That is, China, Japan, and oil exporters are the largest holders of our debt and proportionately the largest countries that we have a trade deficit with. It is also a cause for concern that, because China and oil exporters hold so much of our debt, many consider their interests unfriendly.

Remark 9.11: In February 2009—an article entitled “Did 2008’s \$677 Billion Trade Deficit Cause The Recession?” was posted by the economist Peter Morici, who noted that the Chinese government holds about \$2 trillion in U.S. and other securities and he worries if we add that to the holdings of Middle East sovereigns and royal families, that the potential purchases of U.S. businesses by foreigners unfriendly to the U.S. is alarming. Mr. Morici also believes the trade deficit is a root cause to the recession.⁴

To put this matter in perspective, Table 9.3 provides information on U.S. debt owed to foreigners.

⁴ <http://seekingalpha.com/article/120195-did-2008-s-677-billion-trade-deficit-cause-the-recession>

ModernRecession.com

Table 9.3 U.S. Debt Owned by Foreigners and Related Trade Deficit⁵

Nation	January 2009 ⁶ Foreign-Owned U.S. Treasuries in Billions of Dollars	Treasuries Owned in Percentage	August 2009 U.S. Trade Deficit in Billions ⁷ (12-month Multiplier)
China	739.6	24.07%	167
Japan	634.8	20.66%	29
Oil exporters	186.3	6.06%	386
Caribbean banks	176.6	5.75%	NA
Brazil	133.5	4.35%	
United Kingdom	124.2	4.04%	
Russia	119.6	3.89%	1.3 (15.6)
Luxembourg	87.2	2.84%	
Taiwan	73.3	2.39%	9
Hong Kong	71.7	2.33%	
Switzerland	62.1	2.02%	
Germany	56.4	1.84%	19
Republic of Ireland	50	1.63%	17
Singapore	38.3	1.25%	
Thailand	37.2	1.21%	
Mexico	34.9	1.14%	34
India	32.5	1.06%	
Turkey	31.3	1.02%	
Korea	31.3	1.02%	11
All other	351.4	11.43%	
Grand Total	3072.2	100%	

9.4: Root Cause Discussion

In this section we provide information on the root causes.

9.4.1: Root Cause—High- Versus Low-Wage Economies

We will start with the root cause of high-wage versus low-wage economies in Table 9.1, since its rating is 10. This root cause implies that whenever a low-wage country trades with a high-wage country it will create big losers and winners. One macroeconomic book explained this concept as follows:

Remark 9.12: “Trade between high-wage countries tends to be a modest win for all, or almost all, concerned....By contrast, trade between countries at very different levels of economic development tends to create large classes of losers as well as winners....And the biggest growth of imports has come from countries with very low wages....South Korea, Taiwan, Hong Kong and Singapore paid wages of 25 percent of U.S. levels in 1990. Since then however, the sources of

⁵ http://en.wikipedia.org/wiki/United_States_public_debt

⁶ http://en.wikipedia.org/wiki/United_States_public_debt

⁷ www.census.gov/foreign-trade/top/dst/current/deficit.html

By Alec Feinberg
Based On Chapter 9, From the book
The Truth of the Modern Recession - Root Causes and Reliable Solutions

ModernRecession.com

our imports have shifted to Mexico, where wages are 11 percent of the U.S. level, and China, where they're only 3 or 4 percent....⁸"

A simple theory will be provided that we will call "the law of financial free trade equilibrium."

Remark 9.13: Law of Financial Free Trade Equilibrium—Consider two containers separated by a wall, one having a high concentration of air, and one with very little air. Once the wall is removed, due to the pressure and concentration difference, after a period of time both containers will have the same amount of air, thus reaching equilibrium. In a similar manner, if two economies have free cash flow, such as China (considered a developing country) and the U.S., the currencies will flow towards financial equilibrium (from richer country to poorer). The imbalanced monetary pressure causing excess deficit is due mainly to three key reasons: cost of wages, each country's GDP, and the value of the country's currency.

In our analogy, we might consider the point where the free trade "concentration wall" was officially removed between the U.S. and China to have occurred when President Clinton signed a bill extending permanent, normal trade status to China on October 10, 2000. This bill clearly undercut American and Mexican factory workers. In terms of free trade, this was a severe final attack on American factory workers. As Remark 9.12 notes, wages in China were almost a quarter of that for the Mexican worker. Since that point in time, in accordance with Remark 9.13, the high concentration of cash has flowed to the low concentration, as noted by our enormous imbalance with the trade deficit projected at \$167 billion in 2009 (Table 9.2). This is now magnified by the fact that, as we stated earlier, in roughly nine short years, the U.S. has ended up owing China over \$800 billion through China's purchase of U.S. treasuries.

It is important to realize the relationship between GDP (Gross Domestic Product) and the population size:

Remark 9.14: "In order for Americans to maintain their standard of living, GDP needs to grow at least as fast as the population!"⁹

Here, GDP is a measure of the size of our economy from everyone's total income. To put this a bit more in perspective, Tables 9.4 and 9.5 provide statistics of the population growth and GDP information from 2000 to 2008 for China and the U.S.

Table 9.4 China's Overall Population and GDP Growth from 2000 to 2008¹⁰

⁸ *Principles of Macroeconomics*, N. Gregory Mankiw, 5th edition, 2009 South-Western Cengage Learning, PP 192-193.

⁹ <http://truecostblog.com/2008/01/25/gdp-doesnt-matter-gdp-per-capita-does/>

¹⁰ CIA World Factbook—as of January 1, 2009, www.indexmundi.com/g/g.aspx?v=67&c=ch&l=en

By Alec Feinberg
Based On Chapter 9, From the book
The Truth of the Modern Recession - Root Causes and Reliable Solutions

ModernRecession.com

Year	China Population (Billions)	China Pop Growth Since 2000	GDP per Capita China in U.S. dollars	China GDP Growth in %	Billions GDP China
2000	1.26183	0.00%	\$3,800	7%	4800
2001	1.27311	0.90%	\$3600	8%	4500
2002	1.28430	1.78%	\$4600	8%	6000
2003	1.28698	2.00%	\$4400	8%	5700
2004	1.29885	2.94%	\$5000	9.1%	6449
2005	1.30631	3.53%	\$5600	9.1%	7262
2006	1.31397	4.13%	\$6800	10.2%	8883
2007	1.32185	4.76%	\$7700	10.7%	10170
2008	1.33004	5.41%	\$5300	11.4%	7800

Table 9.5 U.S. Overall Population and GDP Growth from 2000 to 2008¹¹

Year	U.S. Pop (Billions)	U.S. Pop Growth Since 2000	U.S. GDP Per Capita in dollars	U.S. GDP in Billions	U.S. GDP Growth in %
2000	0.2756	0.0%	\$33900	9255	4.1%
2001	0.2781	0.9%	\$36200	9963	5%
2002	0.2806	1.8%	\$36300	10082	0.3%
2003	0.2903	5.4%	\$37600	10400	2.45%
2004	0.2930	6.3%	\$37800	10990	3.1%
2005	0.2957	7.3%	\$40100	11750	4.4%
2006	0.2984	8.3%	\$41600	12310	3.2%
2007	0.3011	9.3%	\$44000	13130	3.2%
2008	0.3038	10.3%	\$46,000	13860	2.2%

From Tables 9.4 and 9.5, our population consisted of about 304 million, while China's population consisted of 1,330 million in 2008. China, in 2008, had over four times as many consumers.

Noting this, we see that China's GDP skyrocketed in this timeframe from 7 to 11.4% since the Free Trade Bill was passed between the U.S. and China. In comparison, the U.S. GDP growth rate ended down from 4.1% to 2.2% according to the source CIA World Factbook (Tables 9.4 and 9.5). One should also note that this is an inversion with our population growth compared to China. That is, China's population grew by 5.4% and their GDP by 4.4% since 2000. In contrast, the U.S. GDP growth rate contracted -1.9% while its population grew 10.3% since 2000. The World CIA Factbook defines the GDP growth on an annual basis adjusted for inflation and expressed as a percent. (The reader might note that the U.S. GDP and GDP per capita did increase from 2000 to 2008.

¹¹CIA World Factbook—as of January 1, 2009, www.indexmundi.com/g/g.aspx?v=67&c=ch&l=en

By Alec Feinberg
Based On Chapter 9, From the book
The Truth of the Modern Recession - Root Causes and Reliable Solutions

ModernRecession.com

Therefore, statistics in this regard must be reviewed from this source on the GDP growth rate.) However, it is clear that China's GDP is growing faster than the U.S., while America's population appears to be growing faster than China.

It is also important to realize that cash flow is impacted by the average income per person (this is GDP per capita). By comparison, it was \$46,000 for the U.S. citizens compared to \$5,300 for Chinese citizens in 2008.

Remark 9.15: "While GDP measures the size of the total economy, it's GDP per capita, the slice of GDP that an "average" American has, that really matters. While GDP per capita doesn't take into account income inequality and other measures...."¹²

So although China has four times as many consumers, we had on average a factor of 8.7 times higher incomes in 2008. This fact helps us to understand some of the trade imbalance. This is really the root-cause issue; we are a high-income wage earning country trading with a low-income country. Logically, the cash flow is eventually going to get distributed. Financially, it means that the U.S. is giving up quite a bit in the name of free trade and will continue to do so until the playing field is leveled. Since China is our largest trading partner, this fact implies that the U.S. must either reduce its population, grow its GDP at a faster rate, reduce the cost of living and wage earnings, or continue to face the economic crisis that is now occurring.

On the positive side, since China's GDP is growing faster than that of the U.S., eventually the trade deficiency should come down as the value of their currency strengthens compared to the U.S. This is related to the theory of free trade, where eventually the U.S. currency will weaken; exports should then increase to bring back the trade imbalances.

Remark 9.16: "As the yuan appreciates, the relative prices of Chinese-produced goods to American businesses and consumers will rise, reducing U.S. demand for Chinese imports. Simultaneously, the relative prices of U.S. products to Chinese purchasers will decrease, allowing U.S. exports to rise. At least, that is the theory."¹³

This, in theory, is how free trade should work. However, eventually when China has some measure of financial equilibrium with the U.S., the U.S. GDP per capita, according to our law of financial free trade equilibrium, must be significantly reduced simply due to the combined effect of our two populations.

So it would appear the assumption is somewhat flawed. There are also other problems with conducting free trade fairly as we have noted in the FMEA table. This has

¹² <http://truecostblog.com/2008/01/25/gdp-doesnt-matter-gdp-per-capita-does/>

¹³ www.freetrade.org/node/83

*By Alec Feinberg
Based On Chapter 9, From the book
The Truth of the Modern Recession - Root Causes and Reliable Solutions*

ModernRecession.com

occurred with both China and Japan. Both countries have come under scrutiny for some time. This brings us to our next root cause of currency manipulation.

Much More Information Is Available in Chapter 9 in this Book