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Special Commentary

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How Exposed Is the U.S. Economy to China?

Executive Summary

The recent devaluation of the Chinese yuan rekindles memories of the currency collapses and financial crises that swept through Asia in 1997-1998. If China were to experience a similar episode today, what economic and financial fallout would the United States experience? Exactly how exposed is the U.S. economy to China?

The direct economic and financial exposure of the United States to China is rather limited. China accounts for only 7 percent of total American exports, which represents less than 1 percent of U.S. GDP, and American multinational enterprises (MNEs) derive only 2 percent of their net income from China. American banking exposure to China represents less than 1 percent of banking system assets. Even when indirect effects, which operate through the exposure of other countries to China, are considered, it appears that total American exposure to China is rather limited.

Moreover, stability is the hallmark of Chinese economic policy, and the central bank has ample resources to maintain an orderly pace of currency adjustment. In short, we believe that the economic and financial fallout on the U.S. economy from the downward adjustment in the value of the Chinese currency will be limited.

China circa 2015 and Memories of Asia circa 1997

Financial markets have been in a bit of turmoil since August 11, when China began a process of devaluing the renminbi (a.k.a., the yuan). Other Asian currencies have weakened in tandem with the renminbi, and memories of 1997-1998, when the devaluation of the Thai baht eventually culminated in a series of financial crises that swept through the developing world, come floating to mind. By autumn 1998, capital markets in the United States were starting to seize up. The S&P 500 index fell nearly 20 percent in mid-1998 before rebounding.

There are many similarities, as well as many differences, between China circa 2015 and Asia circa 1997. Our objective in this report is not to compare and contrast the two episodes. Rather, we aim to examine the economic and financial linkages between China and the United States in an attempt to analyze the potential fallout on the U.S. economy. Will the devaluation of the Chinese yuan delay, if not postpone indefinitely, the Fed's long-awaited tightening cycle? Could financial turmoil in China bring the U.S. economy to its knees?

As we wrote in a previous report, we think that "Chinese authorities would take steps to stabilize the exchange rate well before a generalized rout occurred" and that "volatility related to" the "devaluation of yuan will soon start to subside."¹ What if we are wrong, however? What happens if Chinese authorities allow the yuan to depreciate significantly further and financial markets remain unsettled? How exposed is the American economy to China?

¹ See "Will Yuan Devaluation Destabilize the Global Economy?" (August 11, 2015), which is posted on our website.



China accounts for only 7 percent of total American exports.

Yuan devaluation should have little overall effect on U.S. CPI inflation.

Direct U.S. Economic Exposure to China Is Rather Limited

The economic relationship between the United States and China begins with the trade ties between the two countries. As shown in Figure 1, American exports to China totaled nearly \$125 billion last year, making China the third-largest destination for U.S. exports. That said, exports to China accounted for only 7 percent of total American exports and less than 1 percent of U.S. GDP last year. Although yuan devaluation vis-à-vis the U.S. dollar could negatively affect American exports somewhat, it is unlikely to have a measureable effect on U.S. GDP growth, everything else equal.

The United States imported nearly \$470 billion worth of goods from China in 2014, the majority of which were imports of consumer goods. The value of these imports was equivalent to about 12 percent of all the goods consumed in the country last year.² Yuan depreciation could improve the price competitiveness of Chinese goods and eventually boost the value of American imports from China. The American bilateral trade deficit with China, which already is the largest bilateral deficit that the country incurs, would presumably widen further.

Speaking of Chinese imports, Figure 2 shows that the price of American imports from China were down 1.2 percent on a year-ago basis in July. The devaluation of the renminbi should exert some further downward pressure on Chinese import prices in coming months. Given the high correlation between year-over-year changes in Chinese import prices and total import prices in recent years, a drop in the former should lead to some further decline in the latter. However, the correlation between import price inflation and core CPI inflation is rather low.³ Services account for 62 percent of the consumer price index, and the United States imports relatively few services from the rest of the world, let alone from China. In other words, yuan devaluation should have little overall effect on U.S. CPI inflation.

Figure 1

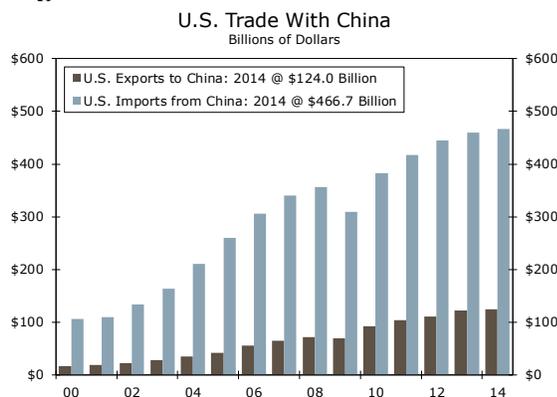
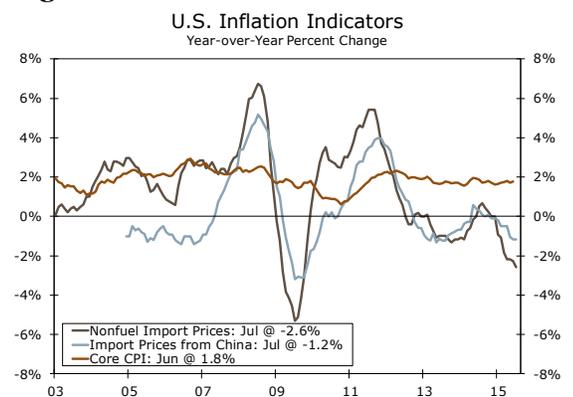


Figure 2



Source: IHS Global Insight, U.S. Department of Labor and Wells Fargo Securities, LLC

A second way in which the United States could be economically exposed to China is via the operations of American MNEs doing business in China. In 2012, the \$330 billion worth of revenue that American MNEs generated in China produced \$25 billion worth of net income. However, these totals represent only 5 percent of sales and 2 percent of net income that these MNEs produced via their foreign affiliates. In sum, American economic exposure to China is rather limited when viewed through the prisms of trade flows and MNE operations.

² Consumption expenditures in the United States totaled \$11.9 trillion last year. Americans consumed \$3.9 trillion worth of goods and \$7.9 trillion worth of services.

³ Because the United States imports very little energy from China, we plot year-over-year changes in non-fuel import prices and the core CPI in Figure 2. The correlation coefficient between year-over-year changes in Chinese import prices and total non-fuel import prices since 2005 is 0.74. The correlation coefficient between non-fuel import price inflation and core CPI inflation is only 0.23.

Manageable Direct U.S. Financial Exposure to China

There are also financial linkages between the United States and China. As shown in Figure 3, American bank exposure to China has shot up from only \$5 billion ten years ago to nearly \$100 billion today. In the unlikely event that a deep recession in China takes hold, American banks could suffer some losses. In addition, yuan depreciation would raise the cost of servicing any dollar-denominated obligations that Chinese businesses may owe to U.S. banks. That said, exposure to China represents less than 1 percent of the \$15 trillion worth of assets held by the American banking system. Any losses by American banks associated with economic weakness in China should be easily manageable.

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Not only do American companies have economic exposure to China from exports and overseas operations, but they also have financial exposure via the capital they have invested in the country. Over the past decade, the stock of American foreign direct investment (FDI) has trebled from about \$20 billion to more than \$65 billion today (Figure 4). However, the value of American FDI in China pales when placed in the context of the \$6 trillion worth of directly invested capital that Americans hold in all foreign economies.

Figure 3

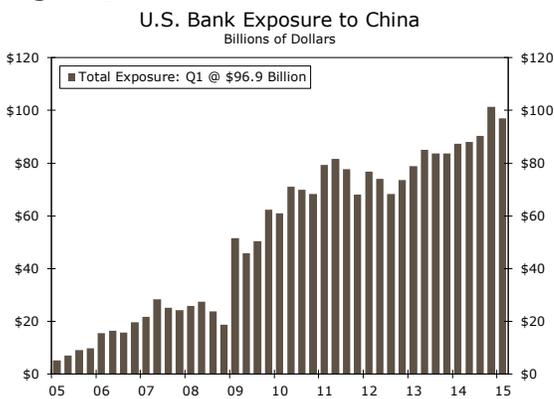
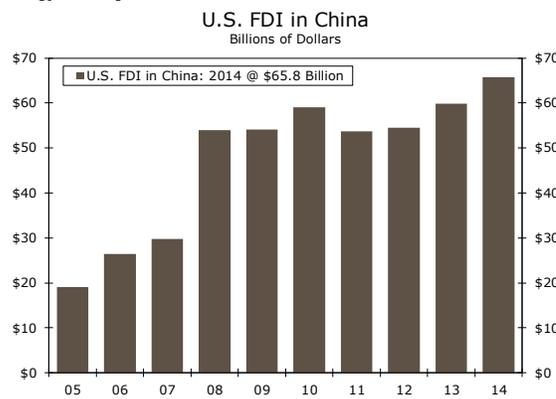


Figure 4



Source: Bank for International Settlements, U.S. Department of Commerce and Wells Fargo Securities, LLC

Global Economic & Financial Exposure: Less than Meets the Eye

The takeaway from the first part of this report is that the direct economic and financial exposure of the United States to China is rather limited. However, China is the second largest economy in the world, and economic weakness in China could negatively impact other countries thereby spilling back to the United States. Not only does the United States have direct economic and financial exposure to China, but it has indirect exposure as well. We really need to put China into a global context.

Let's start with trade. China's imports are some other country's exports and China accounts for more than 10 percent of global imports, making it more or less equivalent to the United States, which takes in 12 percent of global imports. Although China accounts for only 7 percent of American exports, some countries have significant trade exposure to China. For example, Japan sends nearly 20 percent of its exports to China, which is equivalent to about 3 percent of Japanese GDP. China accounts for roughly one-quarter of Korean and Taiwanese exports, equivalent to 10 percent and 15 percent of each respective country's GDP. A "hard landing" in China could weaken these Asian economies, which could have negative spillover effects for the American economy.

However, as we discussed in more detail in a report two years ago, the trade numbers discussed in the previous paragraph overstate the effect that the Chinese economy actually has on these other

China has only about one-half the weight on global economic activity as the United States.

countries.⁴ China is the “factory of the world” and many of its imports are reassembled into finished goods which are subsequently exported by China. What matters more for countries that are supplying intermediate inputs to China is not the state of the Chinese economy per se, but rather the state of demand in the countries that ultimately import the final products.

The best way to measure China’s “true” effect on the global economy is via the contribution that its final domestic demand (i.e., final spending by Chinese consumers, businesses and the government) makes to value added in other countries. As shown in Figure 5, Chinese final domestic demand (FDD) accounts for a bit more than 1 percent of global value added.⁵ China’s “pull” on the rest of the world clearly has increased over the past two decades. However, it still has only about one-half the weight on global economic activity as the United States. A sharp economic slowdown in China obviously would have global ramifications, but it would not be as meaningful to the global economy as a similar-sized slowdown in the United States.

Figure 5

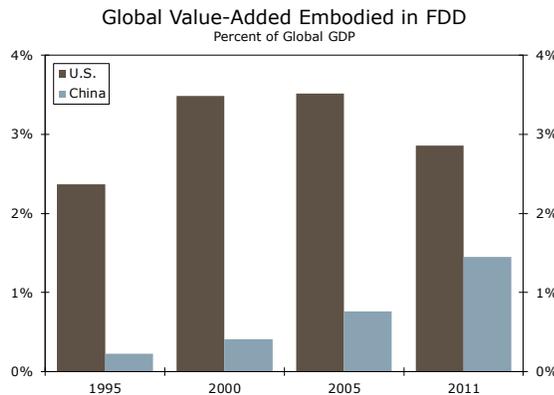
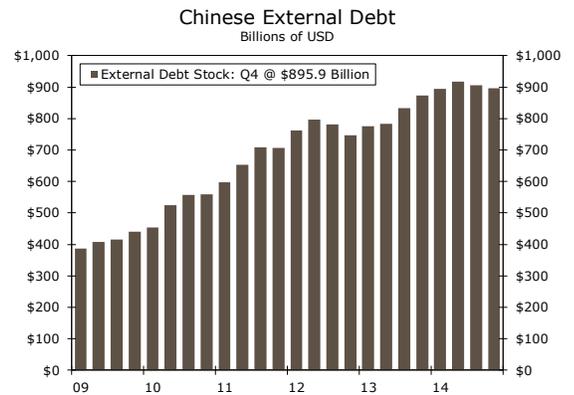


Figure 6



Source: Organisation for Economic Cooperation and Development, the World Bank and Wells Fargo Securities, LLC

There are also global financial ties to China to consider. As noted above, American banks have about \$100 billion on the hook to China at present. However, the United States is not the only foreign country from which Chinese businesses, households and the government borrows. Therefore, we need to look at China’s gross external debt, which measures the amount that these Chinese sectors have borrowed from foreigners. Figure 6 shows that Chinese external debt has more than doubled over the past five years to \$900 billion today. External debt of close to \$1 trillion is certainly an eye-opening number. However, this number needs to be put into context.

An external debt crisis in China does not appear to be in the cards anytime soon.

China’s external debt is equivalent to only 9 percent of Chinese GDP and the amortization and interest payments associated with this debt represent less than 2 percent of the value of China’s exports. These ratios are not worrying at all. Secondly, one needs to also consider the asset side of China’s balance sheet when looking at external debt, which shows up on the liability side. China owns more than \$6 trillion worth of foreign assets, including its foreign exchange (FX) reserves, which currently total nearly \$3.7 trillion. The country’s foreign assets exceed its foreign liabilities by roughly \$1.8 trillion.⁶ In short, an external debt crisis in China does not appear to be in the cards anytime soon.

From the perspective of foreign economies, China’s external debt is not particularly troubling either. Arguably, the United Kingdom would have the most to lose. On a consolidated ultimate-risk basis, British banks have about \$200 billion of exposure to China, which represents nearly

⁴ See “How Much Does Slower Chinese Growth Matter?” (July 10, 2013), which is available upon request.

⁵ Chinese final domestic demand accounts for less than 1 percent of value added in the United States.

⁶ In the United States, foreign liabilities exceed foreign assets by nearly \$7 trillion.

4 percent of their total assets. Japanese banks have \$76 billion on the hook to China, but that amount represents only 1 percent of their total assets. Indeed, the \$900 billion worth of Chinese external debt is equivalent to less than 1 percent of total banking system assets worldwide. In the very unlikely event that China should default on a good proportion of its external debt, the global banking system would likely be able to deal with the fallout.

Conclusion

The direct economic and financial linkages between the United States and China appear to be rather limited. China accounts for only 7 percent of American exports, which represents less than 1 percent of U.S. GDP, and CPI inflation in the United States is not highly correlated with changes in the prices of imports from China. The direct financial exposure of the United States to China is also not very extensive. Even when indirect effects are considered, the United States simply does not seem to have significant economic and financial exposure to China.

Of course, the effects on the U.S. economy could be magnified if the Chinese economy and financial system were to become very destabilized by the depreciation of the yuan that now appears to be underway. As we wrote in the recent report that we referenced earlier, “stability is the hallmark of Chinese economic policy,” and we simply do not believe that Chinese authorities would allow a destabilizing move in the yuan to take place. A series of sharp currency depreciations and financial crises swept through Asia in 1997-1998 when those countries, which had maintained fixed exchange rates versus the dollar, ran out of FX reserves and had to let their currencies float.

The People’s Bank of China has nearly \$3.7 trillion worth of FX reserves, giving it essentially an unlimited ability to maintain an orderly adjustment in the currency. The yuan very well could depreciate further in coming weeks and months. We just do not think the adjustment will occur in a disorderly fashion. In sum, we believe that the economic and financial fallout on the U.S. economy from the downward adjustment in the value of the Chinese currency will be limited.

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