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Want To Know How Equity Markets Will Perform The Next 2 Years? Tell Me What President Trump Will Decide About China's Growing Technological Prowess

Martin Lowy

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The consensus seems to be that technological innovation in Europe beginning around 1800 was the primary cause of the Great Divergence between the economies of Europe and China, then that is not lost on today's Chinese leaders, and they will not, under almost any circumstances, permit China to fall behind technologically.

Before 1800, China and the West basically had similar economic outcomes. Sometimes one led, sometimes the other. But progress in both societies was slow. Beginning in about 1800, economic growth in the West took off while Chinese economic growth remained slow. As a consequence, the standard of living in China did not keep up and the West became militarily dominant. Gunboat diplomacy reduced China to a comparative vassal. I wrote about that at greater length in an article published in June called "It's Bolton's World Now" here.

Here is a recent summary of the proposition that I think is accepted by the Chinese leaders:

[T]he real difference after 1800 is that Europe was able to sustain and accelerate technological innovations, unlike China.

Yongseok Shin, "Finance and Economic Development in the Very Long Run: A Review Essay", *Journal of Economic Literature 2018*, 56(4), 1577–1586 here, summarizing works by Joel Mokyr, a professor at Northwestern.

The Great Divergence led to China being dominated by the West, both economically and militarily for about two centuries. The scars are still evident.

This of course has implications for the possible paths of negotiation toward a reduction of trade war postures between the U.S. and China. To me, it sets a boundary on what China may accede to. That is, various "opening" steps that will liberalize access to the Chinese market are quite possible—indeed probable—in part because they are steps that many policy makers in China have been advocating for a long time on the ground that they will be good for the Chinese economy. But to think that China will reduce its drive to achieve technological parity or better would be a mistake. That will not happen because the Chinese leadership will not give up what it sees as China's destiny. As I said in June, you would not give that up, either.

The question, therefore, is whether the Trump administration is willing to make a trade deal. A trade deal is quite possible, to the benefit of all parties. Or will the administration stick to its

stated goal of stopping Chinese technological progress—and therefore industrial, knowledge business and military parity—as a price for a trade deal? If the latter, we are in for a dark period of Sino-American relations and for world trade—and that dark period likely will reflect badly on global business and prosperity.

I do not have an answer to what the Trump administration will do. But one's view of the equity markets of the world over the next two years should depend on one's guess as to what the Trump administration will settle for by way of Chinese capitulation. My own guess is that the President himself does not know that answer today. I guess that he has advisers on both sides of the issue and he will let his "gut" be his guide, as he has said it is so often. Whenever that part of his anatomy decides to speak on the subject, he will know the answer and he will tweet it to us.

It's a heckova way to run a railroad. But if you are an investor today, I think that is realism. Trade peace and we have a good chance to ride out the next economic downturn and return to a good equity market. No trade peace and the dislocations and inefficiencies caused by tariffs are likely to cause profits to sag and stocks to stagnate or worse.

Historical precedent

The historical precedents for dire consequences for the U.S. stock market are clear. The most prominent is the Smoot-Hawley tariff law enacted in 1930. That law is commonly credited with causing the depth of the Depression by causing international trade to diminish significantly. Recent work by the Cato Institute has broadened the possible impact of Smoot-Hawley by attributing the stock market crash of 1929 itself to that law even though it had not been enacted at the time of the crash. An article by Alan Reynolds of Cato is very much to the point of why and how the U.S. stock market today might well react to events that will take place months or even years from now:

Many scholars have long agreed that the Smoot-Hawley tariff had disastrous economic effects, but most of them have felt that it could not have caused the stock market collapse of October 1929, since the tariff was not signed into law until the following June. Today we know that market participants do not wait for a major law to pass, but instead try to anticipate whether or not it will pass and what its effects will be.

It may be hard to realize how international trade could have so much impact on the domestic economy. For years, in explaining income movements in the Thirties, attention has instead been focused on federal spending and deficits. Yet on the face of it, trade was far more important: exports fell from $7 billion in 1929 to $2.5 billion in 1932; federal spending was only $2.6 billion in 1929 and $3.2 billion in 1932. In 1929, exports accounted for nearly seven percent of our national production, and a much larger share of the production of goods (as opposed to services). Trade also accounted for 15 to 17 percent of farm income in 1926-29, and farm exports were slashed to a third of their 1929 level by 1933.

These are merely excerpts from a most persuasive article on how Smoot-Hawley caused the stock market crash of 1929 because investors are forward-looking.

The libertarian Cato Institute might be expected to oppose tariffs and might exaggerate their evils. But there are articles by economists of every political stripe warning of the Smoot-Hawley-like evils of the current trade war. And every day, the mainstream press attributes the ups and downs of the market to the temperature of the dialogue between the U.S. and China.

Thus the market is very sensitive to the connection between trade war and equity values, as is the administration. The question is whether the administration will risk the market's reaction to what it sees as acts to further the legitimate medium-term goals of the U.S.