Mitchell's Musings 4-27-15: A Problem with a Solution

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American's tend to believe that all problems have solutions – if only folks would just get together and work things out. Thus, they are annoyed when ideological differences cause gridlock in Congress. Americans tend to think simplistically about the Middle East. Why can't the people there just sit down and settle their conflicts? But there is one problem which seems to escape the notion that all-problems-have-solutions and that is exchange rates. There are calls from time to time for someone to do something about exchange rate manipulation but the calls include no real solutions for the U.S. Someone should do something – but what?[1]

As we have pointed out many times in prior musings, the U.S. has become the world's champion debtor as the result of continuous net export deficits. The effect of such deficits falls disproportionately on U.S. manufacturing which was once the provider of those good jobs that politicians, policy wonks, and just about everyone else pine for when such topics as income inequality are raised. So if you want to do something for manufacturing, before you start proposing such remedies as more community college, you would want to focus on the trade side.

First, let's put the issue of manufacturing in perspective. Manufacturing as a proportion of total economic activity has been in decline since the end of World War II. Although we keep changing the measurement of that sector via changes in industrial classification systems, manufacturing in relative terms compared to overall GDP is about one third of what it was at that time.[2]

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Manufacturing as Percent of GDP

1950 31%	1960 29%	1970 25%
1980 23%	1990 18%	2000 15%
2010 11%	2014 11%	

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Given its rate of shrinkage, it is unlikely that any "remedy" – trade deals, community colleges – would restore manufacturing to its 1950s' importance. On the other hand, since the sector is only 11% of total economic activity, even a modest trade-related boost could have a notable impact on the manufacturing sector.

Exchange rates can change the relative costs of production between countries. The Federal Reserve has an index of the U.S. dollar exchange rate compared to a large array of other countries' currencies, all

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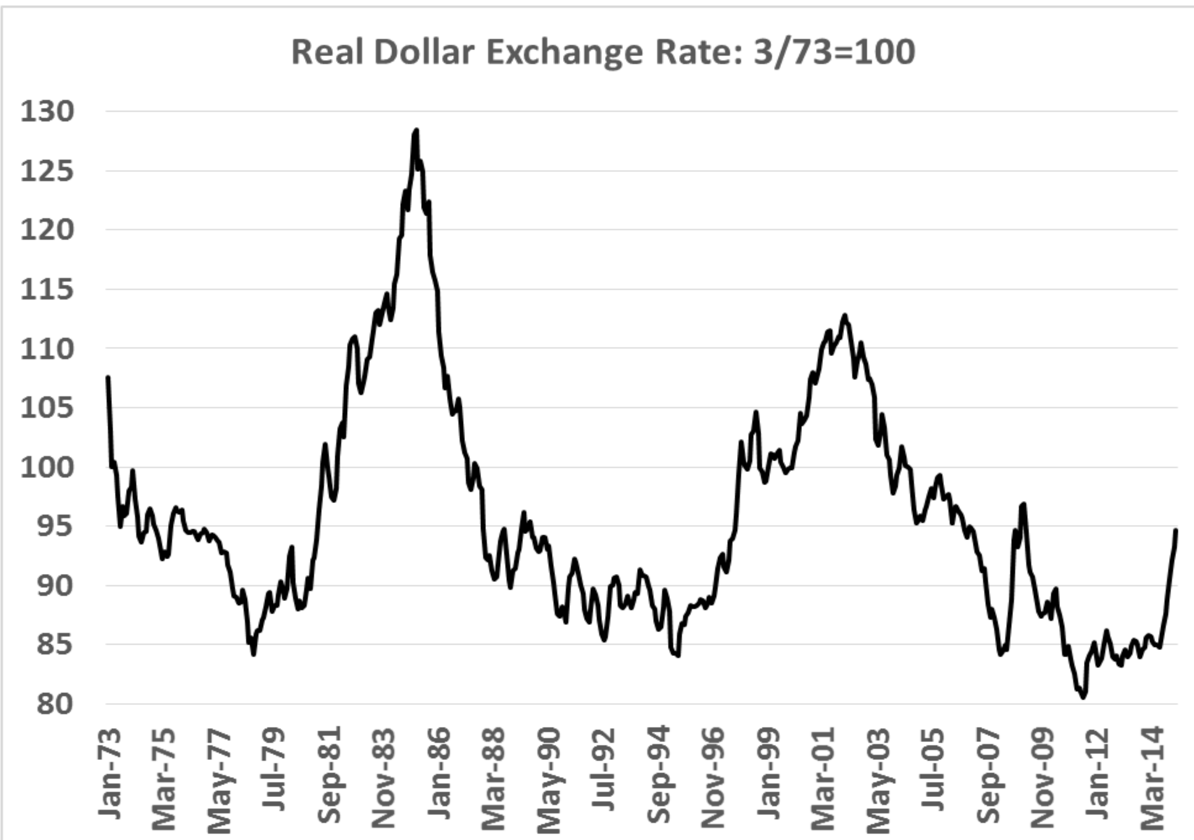
[1]For examples, see http://www.latimes.com/opinion/op-ed/la-oe-0408-baker-currency-20150408-story.html, http://www.cepr.net/index.php/blogs/beat-the-press/the-end-of-china-bashing-toward-a-serious-discussion-of-the-trade-deficit, http://www.iie.com/publications/pb/pb12-19.pdf,

[2]The chart uses the SIC code for 1972 through 1980, the SIC code for 1987 for 1990 and 2000 and the NAICS 2002 for 2010 and 2014. The two SICs showed no appreciable difference in 1987. NAICS measurement showed a slightly smaller manufacturing sector in 2000 compared with SIC.

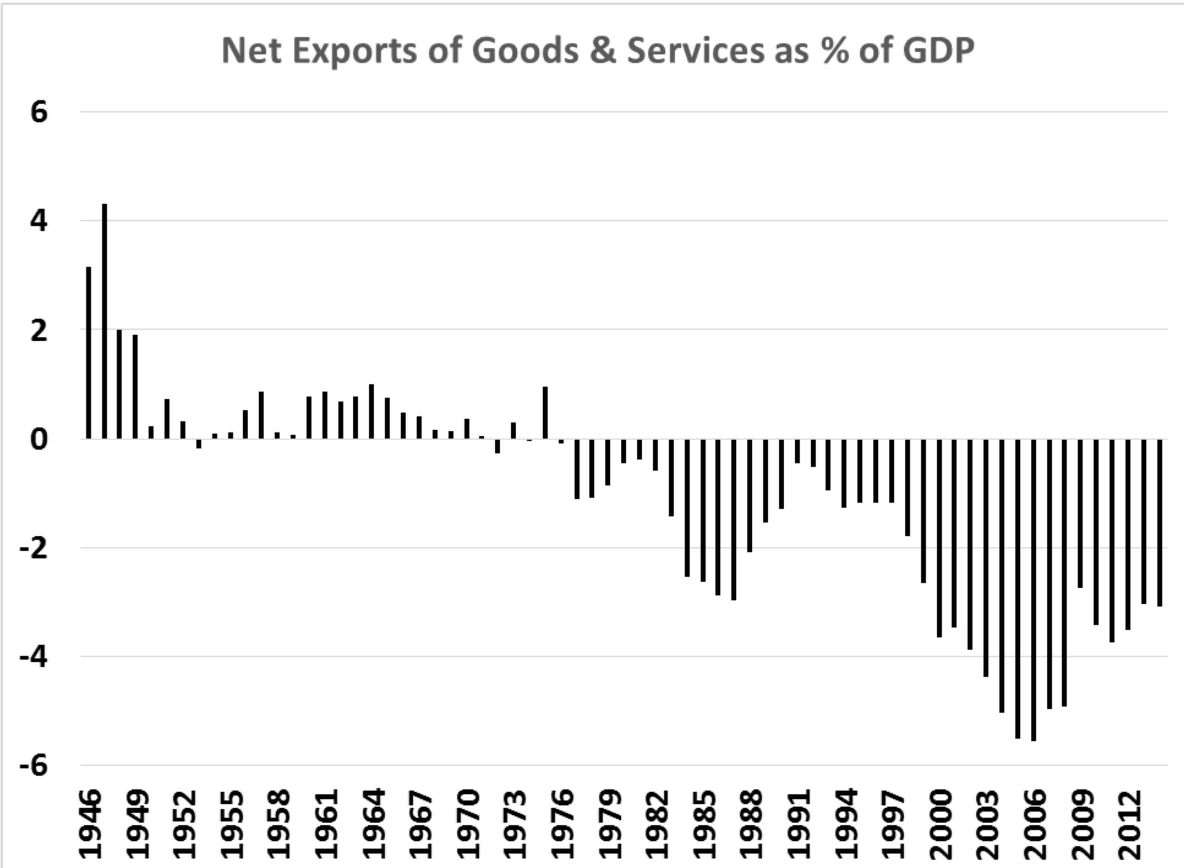
adjusted for inflation. Attempts by the U.S. to retain a fixed exchange rate system relative to other currencies ended in the early 1970s. Since that time, the dollar has been subjected to substantial swings in value. It's hard to look at the chart below and interpret these swings as having some "fundamental" causes. How much can "fundamentals" change in the course of a few years? In fact, the history suggests both speculative volatility (a characteristic of other financial markets) and opportunities for countries to set their exchange rates at arbitrary levels (including arbitrarily low levels).

Although countries are not supposed to "manipulate" their exchange rates, it is hard to define that concept in practical terms. Given the kind of volatility exhibited in exchange markets, surely countries have the right to intervene in currency markets to try to smooth out the swings. And if they hold their exchange rates at levels that generate net export surpluses (so that official reserves accumulate), who is to say what the appropriate reserve levels should be? In short, unlike negotiations over tariffs and other trade barriers, no one has come up with a workable way of regulating exchange rate manipulation.



However, because exchange rate manipulation cannot be regulated easily through international negotiations and trade treaties, that doesn't mean there are no solutions. It just means that the solution won't be found in trade treaties and negotiations. We have noted in prior musings that a solution was suggested many years ago and was ignored at that time and after. Below we will (again) repeat it for the record. But let's first go back to U.S. manufacturing and the net export deficit.

The chart below shows the U.S. net export surplus or deficit from the end of World War II through 2014. Immediately after the War, the U.S. had large surpluses reflecting both foreign aid to war-damaged countries and attempts by various countries to hold their currency values relative to the dollar at unsustainably high levels. But by the 1950s and until the end of fixed exchange rates in the early 1970s, the U.S. ran modest trade surpluses – typically in the range of 0-1% of GDP.[3] But once the fixed exchange regime ended, the U.S. ran chronic deficits. These deficits fluctuated in amount but at times ran over 5% of GDP. At present, they seem to have stabilized at around 3% of GDP.



Suppose the dollar were now to be maintained at an exchange rate consistent with a zero deficit. While that wouldn't begin to pay back the U.S. debt to the world, it would stop adding to the debt. Trade treaties, for reasons already explained, are unlikely to produce such a result. Negotiations with particular countries – China and Japan would be prime candidates – would also be unlikely to produce changes in behavior and would lead to charges of China-bashing or Japan-bashing. The U.S. shrinks from such charges officially because it wants cooperation from these countries in other matters of foreign policy. Politicians don't necessarily shrink from such bashing – indeed they may be attracted to it around election time – but, as noted, their bashing doesn't come with solutions.

[3]The ongoing "balance of payments problem" of the U.S. before the end of fixed exchange rates had to do with the financial side of the accounts. Low interest rates in the U.S. (maintained for domestic reasons) encouraged borrowing in the U.S. by foreigners and U.S. direct investment abroad. In effect, that accumulation of claims on the world by the U.S. was financed by increased dollar reserves held by foreign central banks under the fixed exchange rate system that had been established by the 1944 Bretton Woods agreement.

If the exchange rate were reset so that net exports were zero ("balanced" trade), perhaps half of the increased activity (more U.S. exports; more U.S.-made import substitutes) would be in manufacturing. At present, that would be about 1.5% of GDP (half of 3%). With manufacturing at about a tenth of total activity, the employment gains in that sector would be about 15%. No trade treaty or negotiation is likely to produce such an effect. Similarly, long term remedies such as more technical training in community college seem unlikely to produce that impact.

But wait! What could bring about such an exchange rate effect and do it without singling out any particular country for bashing. As we have noted many times, back in 1987 (when Japan was seen as THE trade villain), financier Warren Buffett wrote an op ed in the Washington Post outlining a specific plan.[4] It was basically a cap-and-trade plan for trade similar to the plans more commonly applied to air pollutants. Under the Buffet plan, U.S. exporters would receive a $1 voucher for each $1 of their exports of goods and services. The voucher would be a license to import $1 of goods and services. The voucher could be exercised directly by the exporter or sold in an open market to some importer. By definition under the system, value of exports = value of imports. The market cost of the voucher plus the prevailing exchange rate would be the equivalent of the exchnage consistent with net exports = zero.

The Buffett cap-and-trade exchange rate plan singles out no country or countries. There is no bashing. There is no negotiating with any particular country about its exchange rate relative to the U.S. dollar. It is not protectionist. It simply achieves the result of the exchange rate consistent with net exports = zero. Under the Buffett plan, U.S. debt to the world stops rising.[5]

Would there be administrative problems? Any system has costs. There would need to be verification of export value in issuing vouchers and verification of import value when they were exercised. We do have customs inspectors in place but there would need to be more of them to implement the system. Perhaps one might oppose the Buffett plan on the basis of administrative cost but to do so, one would have first to recognize and evaluation the possibility of the plan.

How can those commentators who lament exchange rate manipulation without even mentioning the Buffett plan be interpreted? Do they just want to pose a problem without offering any solution? Are they unaware of a plan that would provide a solution to the problem they pose even though the plan was published in a prominent daily newspaper and written by a well-known financier? You can chose between those two answers. I can't think of any others.

[4]https://drive.google.com/file/d/0BzVLYPK7QI_4NmYyOGQzYzQtMWU1MC00MDEwLWI0ZGUtMzYxYmM2OTY5NjMz/view?usp=sharing. Warren E. Buffett, "How to Solve Our Trade Mess Without Ruining Our Economy," May 3, 1987, page B1.

[5]The voucher entitlement could be set so that the U.S. ran a surplus and began paying off its debt. For example, each $1 of exports could produce an entitlement equal to, say, 90 cents worth of imports.