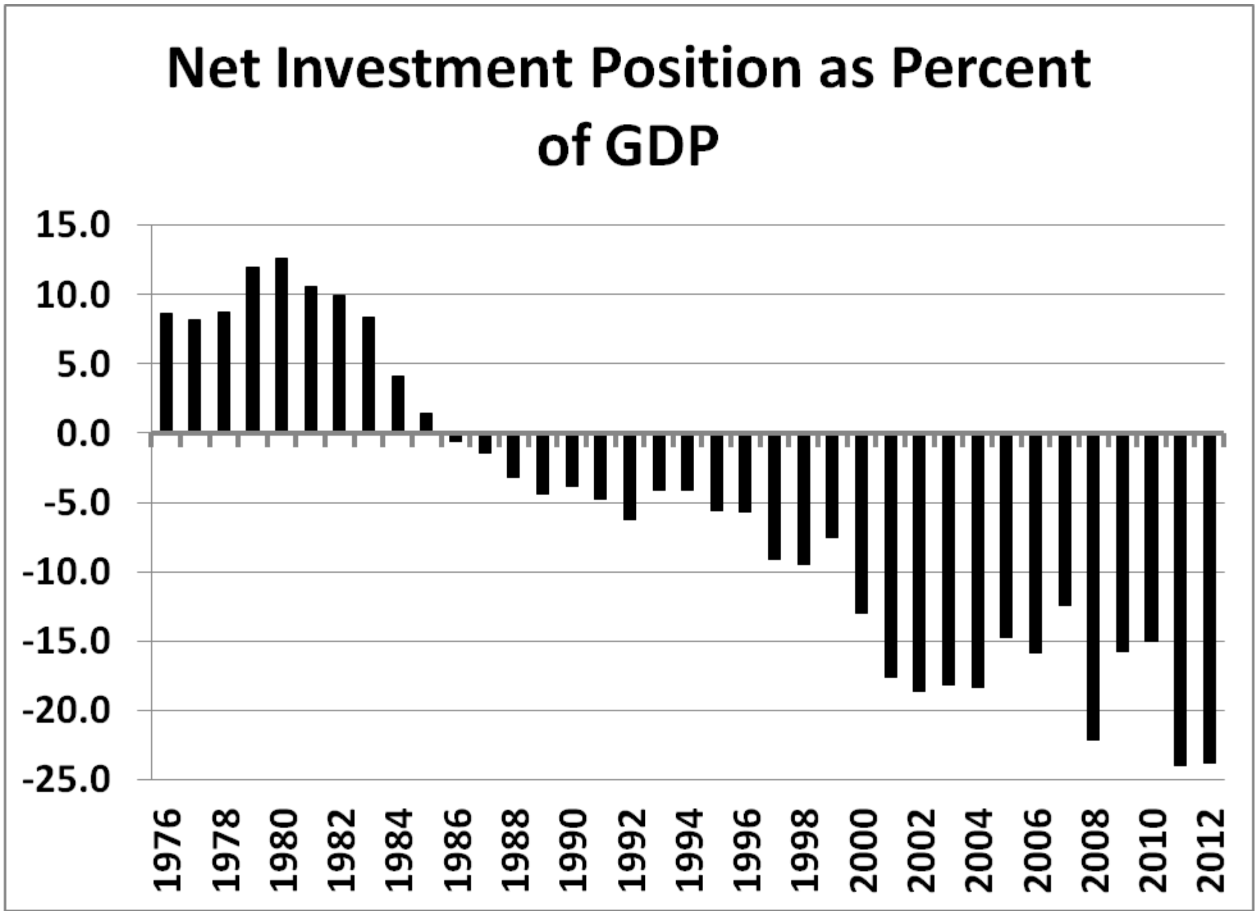
Mitchell's Musings 11-25-13: More Alike on Both Sides of the Pacific Than We Care to Admit?

Daniel J.B. Mitchell

From time to time, we muse about the American "trade deficit. " [We use that inaccurate phrase as shorthand for "net export deficit" which includes service exports and imports as well as goods.] As we have pointed out in the past, and as a recent op ed in the New York Times by Jared Bernstein and Dean Baker emphasizes, the trade deficit doesn't seem to be the deficit Washington wants to worry about. Washington types fret about the federal budget deficit instead.[1] Why is that?



When the U.S. buys more in value abroad than it sells (a negative trade balance), it can only do so by running down its net assets abroad and/or going into debt. In that sense, the U.S. – or any country – is like a household spending more than it earns. When Washington types fret about the federal deficit, they point to what they see as a problem of the government spending more than it takes in. Let's put aside the question of how much a problem the federal deficit actually is. And let's simply note that it is inconsistent to worry about the federal government spending more than its revenue inflow and yet be

[1] www.nytimes.com/2013/11/07/opinion/taking-aim-at-the-wrong-deficit.html.

unconcerned about the nation as a whole doing the same. If your thing is to worry about situations in which inflow < outflow, you should worry about both deficits.

As the chart on the previous page shows, the U.S. became a net debtor to the world in the mid-1980s and the tendency has been to increase the net debt. Each annual trade deficit adds to the debt, although due to exchange rate fluctuations (which affect the dollar valuation of U.S. assets abroad but not the valuation of foreign assets held in the U.S.), the descent into more and more net debt is erratic allthough unmistakable. If there were some U.S. policy in effect aimed at halting or even reversing the trend, it has yet to be apparent.

Now it might be argued that it isn't true that Washington types are unconcerned about the trade deficit. You can point to various politicians who complain about exchange rate manipulation by China, Japan, and other countries that they see as contributing to the U.S. trade deficit. But while we have sequesters and even government shutdowns ostensibly over concens about the federal deficit, what *actua*l actions can you point to on the trade deficit apart from talk? Other than rhetoric, you really can't point to a specific effective policy aimed at the trade deficit that has ever been implemented.

In the 1980s, we complained to Japan - and not much happened. More recently, we have complained to China - and not much happens. From time to time, members of Congress press the President to do something – and not much happens.[2] It's all talk.

It is sometimes said that doing the same thing over and over again and expecting a different result is insanity. But it is unlikely that those making rhetorical complaints do expect a different result. So if they don't expect a different result, it is hard to avoid the conclusion that what they want is to be on record as being against currency manipulation – or maybe just against foreign competition – without really wanting any change in outcomes.

I recently attended a lecture on the outlook for China by my UCLA colleague, Matthew Kahn. Essentially he argues that despite its lack of elections as a channel for the Chinese population to voice complaints over such issues as pollution, food safety, and other ills of China's economy, there are nonetheless incentives within the system for addressing those issues by the powers-that-be there.[3] Economists might argue against the kind of modern mercantilism China is engaged in – exporting goods to accummulate more and more paper claims on the rest of the world, particularly the U.S. – is not a sound policy for China. But from the viewpoint of Chinese rulers, the system is working well enough. If it ain't broke, etc. Moreover, in many respects, China can be seen as emulating Japan, a country that moved

[2] http://touch.latimes.com/#section/1780/article/p2p-77566070/.

[3] You can hear his lecture in two parts. Part 1: https://www.facebook.com/photo.php?v=1436944331192023&l=2017861003521192905 and Part 2: https://www.facebook.com/photo.php?v=1436945526525237&l=9082582019982392093.

from feudalism in the 19th century to a prosperous modern economy while at least since the 1970s practicing mercantalism.[4] Maybe the Japanese could have done it better without practicing mercantilism, but who can be sure?

So let's look at the picture from the American viewpoint. Is there a need to worry about the trade deficit and mounting debt to the world? At the present time, when unemployment is high, improving the trade balance would likely produce a jobs stimulus that exceeds anything done by fiscal policy after the Great Recession. Many of those jobs would be in the distressed manufacturing sector which is disproportionately engaged in trade, both on the export and import-competing side. In the short run, therefore, there would be a macro benefit in terms of job creation.

In the longer term, let's suppose there is a return to something like full employment. Then the effect of the trade deficit is not so much on the total *number* of jobs but on the *kind* of jobs. Good jobs in manufacturing are depressed. Other jobs in sectors such as retail trade are enhanced. There is an exacerbation of income inequality.

Finally, there is a financial risk in hoards of dollars held abroad. The best scenario would be that eventually, even mercantalists become less and less willing to trade real goods for paper claims and, as a result, the dollar gracefully declines in value, exports are stimulated, imports are discouraged, and trade becomes balanced. The worst scenario is a run on the dollar putting at risk big financial institutions that have bet on the idea that the trade deficit and mounting dollar debt can go on forever.

If it turns out that there is a sudden, unexpected fall in the dollar and some big institutions have their assets in dollars and their liabilities in something else, they are in trouble – and so are we, as we learned in 2008. Is that an experiment that you would like to run? Smart policy would be that even if it *might* be broke, it is worth fixing it.

Of course, all of these arguments assume that there are options to do something about the trade deficit and the growing net debt. Usually, to the extent there are suggestions of policies that might address the problem, they are based on some kind of bilateral threats. We threaten to impose tariffs or otherwise limit imports from China if they don't revalue their currency by X percent. Up by twenty percent? Thirty percent? But when such actions are proposed, they are seen as protectionist, China-bashing, and antithetical to other American intersts such as inducing China to be helpful with regard to North Korea, or Iran, or some other foreign policy concern. So a feasible policy needs to be country-neutral, i.e., not aimed at some specific country. It needs to be simply focused on the U.S. trade balance with the rest of the world as a whole.

[4] Lest it be argued that the large reserves built up by Japan are some kind of rainy day fund, note that the rainy day surely arrived with the earthquake-tsunami-nuclear disaster. Yet there was no real drawing on the reserves. Indeed, we had the spectacle of charitable Americans wanting to send monetary aid to Japan when the one thing Japan didn't lack was dollars!

As we have noted in previous musings and in other forums, such a policy *was* suggested back in the 1980s by no less an advocate than financier Warren Buffett in an op ed that appeared in the Washington Post.[5] At the time, the trade deficit villain *de jour* was Japan and what Buffett proposed was a market mechanism of getting to balanced trade without engaging in Japan-bashing or even singling out Japan. You can view his proposal as a variant of what is now termed "cap and trade."

Under the Buffett plan, anyone who exported a dollar's worth of whatever from the U.S. would get a voucher entitling the exporter to import a dollar's worth of whatever from abroad. The exporter could use the voucher directly or sell it in the open market to some importer. A market would develop for such vouchers.

If you do the math, the resulting combination of the market price of the voucher and the prevailing exchange rate is whatever exchange rate would be needed to produce balanced trade. But anyone is free to import whatever from wherever so long as they acquire the required vouchers. No country is singled out. There is no need to do a bilateral deal on exchange rates with anyone or try to guess what exchange rate would do the trick. There are no threats aimed at a particular country. The market does the trick.[6]

So why has some variant of the Buffett plan not been implemented? It's not really complicated to explain the plan. It was published in the Washington Post, so it's hard to argue that it is unknown to Washington types. Possibly, the elites have bought into a simple notion that because things are cheap in China, there is a natural order of things that says they should produce and we should consume (and pay on credit). This approach is a strange version of comparative advantage, i.e., the Chinese are good at producing and we are good at consuming so we naturally do what we are good at.

A more likely explanation is that in our political system, those who have been hurt by the loss of jobs and those who would benefit from balanced trade simply don't have much voice in our system, despite the fact that we have elections (unlike the Chinese). There would be *some* costs in rolling out the Buffett approach and administering it. The costs are not great; we review incoming imports for tariff purposes and have various export controls for national security reasons. But although the costs would not be great, apparently it's not worth dealing with those costs under current political arrangements. There is not much incentive politically for those in charge of making U.S. policy to address the trade issue.

In the end, there is a symmetry on both sides of the Pacific. In China and Japan, even if mercantilism might not be the best approach, it seems to be "working" for now. So there is little pressure internally to change course from their perspectives. In the U.S., borrowing to pay for net imports seems to be working for now and those folks adversely affected in the domestic labor market aren't making trouble.

---

[5] https://docs.google.com/document/d/1SFiISDsdphrQS0Q_x0mREd7kHuIiVbKNSrni1MRBCwE/edit?usp=sharing.

[6] Note that the impact could be phased in gradually. Initially, a voucher might allow $1.20 of imports. Sometime later, vouchers might allow $1.10 of imports. Then they might go to $1.00.

Moreover, there are always stories around that the problem is taking care of itself; production is coming back to the U.S. under the rubric of "in-sourcing." The news media lap up such stories and they are good PR for retailers, as the picture below illustrates. So let someone else in the future deal with the issue.

Maybe we are more alike on both sides of the Pacific than anyone cares to admit.

Los Angeles Daily News

CALIFORNIA

News Sports Business Entertainment Lifestyle Obituaries Opinion

BREAKING NEWS

Port of Los Angeles truck drivers from 3 companies strike

49 MINS AGO

Typhoon Haiyan: Philippine corruption magnifies effects of massive disaster

1 HR AGO

Mideast Peace talks: Palestinians say they're committed to 9 months of negotiations

Home News California

'Made in America' comeback gets help from L.A., Walmart, Martha Stewart