Mitchell's Musings 9-24-12: Forget it, Jake; it's Chinatown

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The quote in the title of today's musing comes from the movie "Chinatown." It occurs at the very end of the film after a web of corruption, incest, and murder has been revealed.[1] The film has nothing to do with China and not much to do with Chinatown, either. But the quote is meant to suggest that there is no point in getting upset about what has happened because it would be futile to do so. Nothing can be done, so just forget about it.

Despite its lack of any connection with China, I am nonetheless reminded of the quote – with its message of total futility - when it comes to trade policy with China. I was further reminded of it on September 20 when I happened to hear a public radio program about whether the U.S. will "get tough" with China, as both presidential candidates seem to be promising.[2] And, of course, there have been recent headlines, as shown at right, regarding a current trade dispute between the U.S. and China that has been sent to the World Trade Organization.

Despite the futility of suggesting a solution - one not original to this author - to our China/trade problem and to other related trade problems, let me first rehash what went on in the September 20 broadcast. I don't mean to single out that program as uniquely missing a key point; missing the key point seems to be an ingrained feature of the debate. But the broadcast was a good example of our inability to address an important trade problem, even in an era when seemingly job creation (and job destruction) is especially important.

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[1] The film is ostensibly based on the construction of the Owens Valley Aqueduct, an early 20th century engineering project of great magnitude, and one that permitted the development of modern Los Angeles. But the film is fiction, even though many viewers seem to believe it is a quasi-documentary. As such, it has affected actual California water policy debates. It is now impossible to discuss state water policy without someone bringing up "Chinatown." The story is reset in the film in the 1930s, probably because it was easier to find neighborhoods in Los Angeles that looked like the 1930s than to recreate an earlier horse-and-buggy city. On the Aqueduct itself, see http://www.youtube.com/watch?v=QesBtxLwvWY. The famous movie quote can be seen at http://www.youtube.com/watch?v=9cWnubJ9CEw.

[2] You can hear the program – *To the Point* - at http://www.kcrw.com/media-player/mediaPlayer2.html?type=audio&id=tp120920can_a_us_president_s [It starts at the 7:30 minute mark.]

If you listen to the broadcast you will hear China experts tell you that a) in every presidential election there are promises by candidates to do something about jobs lost to China, b) that the candidates really don't mean what they say because going beyond symbolic gestures would cause a trade war with China, and c) that even beyond the potential negative economic effects of such a trade war, it would harm American political relations with China which we need to keep in reasonably good shape to deal with Iran, North Korea, etc. (The experts don't consider the possibility that China likes to keep the pot simmering with Iran and North Korea so that the U.S. won't be tempted to make more than symbolic moves on trade.)

The experts suggest that China does indeed manipulate its exchange rate, i.e., keep its currency below what a freely-floating rate relative to the U.S. dollar would be in order to stimulate Chinese exports and restrict imports. But China is slowly raising the rate, we are told, although it may be a very long time before its currency is allowed to appreciate to an appropriate rate. In theory, we could impose tariffs on Chinese goods in retaliation for that manipulation as some in Congress advocate. But we won't do anything so provocative, the experts say, because a provocative action would start a trade war.

Expert opinion is that China is keeping its exchange rate artificially low because its rulers see two major benefits. First, it creates jobs which keep China's population content (or at least content enough) so that they won't rebel against the current regime. Second, in a variation of what trade textbooks call the "infant industry" theory, China's rulers are said to want to foster new industries which need protection at first, but in the future will be viable and capable of dealing with world competition. The current currency manipulation is to protect the infants until they grow up. Because of these benefits, it is argued, the Chinese would respond to any serious U.S. pressures with a trade war which the U.S. wants to avoid. (The experts tend not to consider the possibility that the rulers of China - through ownership profits and other connections - themselves benefit from the current system. It is, after all, a system in which the workers of a poor nation make consumer goods for a rich country – the U.S. – in exchange for dollars which pile up in huge amounts in the hands of the Chinese central bank and which thus provide those workers with no immediate benefits.)

Let's put aside the motives which drive Chinese currency manipulation. Let's assume instead that whether their reasons are good or bad, China's rulers would start a trade war if pushed by serious U.S. sanctions such as tariffs. Let's put aside the various reasons given for why the U.S. doesn't want a trade war and whether they are valid. Let's assume instead that the U.S. doesn't want a trade war with China, whether for good or bad reasons. Then the whole matter boils down to a simple premise: The U.S. can do very little because it doesn't want a trade war with China. *Note, therefore, that if it were possible to do something effective that would not provoke a trade war, the entire framework of the current discussion – and of the broadcast cited earlier – falls apart*.

So let's reframe the discussion and then point to an alternative trade policy that avoids singling out China for special sanctions. The U.S. has a trade imbalance problem with the world, not just with China. China may be the current target as the villain but the trade imbalance problem goes back earlier. At one time, the target villain was Japan. Indeed, Japan's trade policy with the U.S. has not changed all that much since it was the villain of choice. It's just that China has become a much bigger target to the point that Japan has been eclipsed.[3]

The U.S. trade imbalance (exports minus imports) in the national income accounts in 2011 was a little under 4% of GDP.[4] Four percent may not sound like much but adding another 4% to GDP through balanced trade would be a major achievement in terms of jobs – particularly in manufacturing, a sector on which both presidential candidates have been focusing. Because we have been running deficits in trade for decades, the U.S. is by far the world's largest debtor. If you continually buy from the world more than you sell to the world, you can either run down your assets and/or take on debt to pay for the imbalance. The U.S. net debt to the world (assets minus liabilities) at the end of 2011 was about $4 trillion.[5]

Where is the U.S. trade imbalance located? In fact, it is located just about everywhere. Look at recent data. We have a negative trade balance with Europe, including with just the EU and with just the euro-zone. We have a negative balance with Canada and with the rest of the Western Hemisphere. We have a negative balance with the Middle East and with Africa. So it's not just Asia and not just China and Japan.[6]

This simple fact suggests that a policy solution to the U.S. trade problem has to be an all-country policy, not just a China policy. And if it is an all-country policy, it doesn't require singling out China and it does not require China bashing. If there is no singling out of China and no China bashing, the policy need not provoke a trade war with China. Indeed, there would be no point in going for advice to China experts – who will always say there is no solution because a solution would involve a trade war with China. Since the policy would not be China-centric, why would we talk only to folks who have expertise in that one country?

Now I haven't said what this seemingly-magic policy solution for the U.S. would be, although if you have read the Mitchell's musings since they began you would know I am referring to the (Warren) Buffett proposal. Assuming you are not such a loyal reader, let me keep you in suspense just a little bit longer while I present additional information. If we closed the 4% of GDP gap in the net export balance, we could roughly expect about half the resulting increase in economic activity (more exports; fewer imports) to be in manufacturing. Only about a tenth of American workers are employed in manufacturing. So if jobs rose by something like 4% (in proportion to GDP) and if half of those went into

[3] You could see how much Japan has been forgotten as the villain after the earthquake/tsunami/nuclear disaster in Japan. American charities began raising dollars to send to the Japan as some kind of aid. But Japan has a trillion dollars in reserve from its trade surplus. The last thing it needed was dollars.

[4] http://www.bea.gov/scb/pdf/2012/09%20September/D%20pages/0912dpg_a.pdf. (Page D-12)

[5] http://www.bea.gov/scb/pdf/2012/09%20September/D%20pages/0912dpg_g.pdf.

[6] http://www.bea.gov/scb/pdf/2012/09%20September/D%20pages/0912dpg_f.pdf. (Pages D-68 - D-70)

manufacturing, we would be talking about an increase in manufacturing employment by something like a fifth. That's a lot! I could be off by a significant magnitude and yet the result would still be big.[7]

OK. So what was the Buffett plan? Warren Buffett – the famed financier/business executive – made his proposal in an op ed in the *Washington Post* back in 1987 at a time when Japan – as noted earlier – was the trade villain and China was just emerging on the international economic scene.[8] Buffett did not want to have a trade war with Japan or even to engage in Japan bashing. His solution was what might now be called a cap-and-trade plan for international commerce. It was a market-based solution which did not involve filing complaints with some international organization about a particular country or a particular product or a particular trade practice.

Basically, under the Buffett proposal, anyone who exported a dollar of anything from the U.S. would get a certificate allowing that exporter, or anyone or any entity who bought the certificate, to import one dollar's worth of goods and services. You would have to have sufficient certificates to import whatever good or service you wanted to bring in. Since the total value of the certificates would equal U.S. export value, the value of imports would automatically equal the value of exports. There would be a market for the certificates so anyone would be free to import anything in any quantity as long as sufficient certificates were obtained. For economists who want instinctively to scream out that the Buffett plan is some kind of disguised tariff or a tariff-and-subsidy plan, my advice is to do the math first. You will find it is equivalent to setting the exchange rate at a price at which the value of exports = the value of imports.

The Buffett plan could be phased in over time. For example, initially, an exporter of one dollar could receive an import certificate allowing $1.20. At some point, the certificates being issued would drop in value to $1.10 and still later to $1.00. A key point is that in describing the plan, I never had to say "China" or "Japan" or name any other country. No country is singled out.

The Buffett plan, by halting the U.S. tendency to buy more abroad than it sells, would stop the rise in net U.S. debt to the world. Since the U.S. import market would be constrained to the value of U.S. exports, all countries that trade with the U.S. and that want to sell in its domestic market would have an interest in seeing that their competitors – including China – play fair and don't manipulate their currency. To the extent that there would be pressure on China, it would come from everyone, not just the U.S. If China "unfairly" exported a dollar to the U.S., it would have taken that dollar of exports from someone else. The collectivity of the someone elses – all other countries - would do the pressuring, not the U.S.

Of course, there are administrative complications in administering the Buffett plan. Exporters might try to claim a greater value than they were actually exporting (particularly since many export transactions are internal, i.e., between different international units of a single firm). Similarly, there would be a

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[7] Roughly half of U.S. trade in goods and services involves manufactures.

[8] Warren E. Buffett, "How to Solve Our Trade Mess Without Ruining Our Economy," *Washington Post*, May 3, 1987, p. B1. Available at: https://docs.google.com/file/d/0BzVLYPK7QI_4NmYyOGQzYzQtMWU1MC00MDEwLWI0ZGUtMzYxYmM2OTY5NjMz/edit

temptation to undervalue imports. However, we already have customs agents who are supposed to police such matters, at least on imports.[9] My guess, moreover, is that simply announcing the Buffett plan might well obviate any need to administer it. Such an announcement might well trigger an international conference on exchange rates in which all players, not just the U.S., would be able to say to the currency manipulators that one way or another, the manipulation game was over and they might as well simply allow their currencies to float freely.

Now I said at the outset of this musing that I was reminded of the futility quotation from the final scene of the movie “Chinatown.” The Buffett plan created a brief stir when it appeared in the *Washington Post* in 1987; then it was quickly forgotten. Maybe it was forgotten because the suggestion came from outside the Beltway. Maybe only economists are supposed to suggest economic policy. Maybe bashing the trade villain *de jour* is more attractive to politicos than solving the underlying trade problem. Whatever the reason, the discussion on trade relapsed back to interviewing experts who would say that nothing could really be done because anything that might be done would lead to a trade war with (then) Japan and (now) China. The years have advanced but the conversation remains stuck where it was in 1987. How sad. But should we really just “forget it” and go on indefinitely repeating the past?

[9] Service trade, such as tourism, would pose problems. Like all systems, some costs and imperfections are inevitable.