Oct. 1, 2010

UCLA Today | Faculty and Staff News

http://today.ucla.edu/portal/ut/how-to-solve-our-trade-mess-without-172702.aspx

How to solve our trade mess without a confrontation with China

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For years, the U.S. has fretted about its large trade deficit — the excess of goods imports over exports — an imbalance of roughly half a trillion dollars in 2009. The mirror image of that deficit is that America has become the world's largest debtor. You can't buy more than you sell year after year without either running down past assets or borrowing, and the U.S. has done it mainly by borrowing. So we have also fretted about the unsustainability of continued unprecedented international borrowing.

About 45 percent of our trade deficit is with China. So when we fret, China is inevitably the target. From time to time, the U.S. indicates that it would like the Chinese to allow their currency to appreciate against the dollar sufficiently to eliminate the imbalance. Sometimes the Chinese respond — but only a little. Sometimes they bluster. At the moment, Congress is threatening the Chinese with tariffs if they do not fix the exchange rate problem. But the Obama administration fears a confrontation with China at a time when we need that country's cooperation in dealing with North Korea, Iran, and other world problems. It also fears a trade war in which the Chinese impose retaliatory tariffs for any that we might put in place.

So what to do? Surprisingly, Warren Buffett — the famed financier — told us what could be done 23 years ago in an op ed in the Washington Post. It appeared under the title "How to Solve Our Trade Mess Without Ruining Our Economy." His suggestion, written well before China became the prominent economic and political power that it is today, had three virtues. First, it addressed the problem of the trade imbalance. Second, and equally important, it didn't single out any country as the sole target. The third virtue is that after economists instinctively yell protection, they will do the math. And they will then realize that the Buffett plan is the rough equivalent of what would happen if in fact China and other countries that maintain artificially cheap currencies ceased to do so.

What was the solution Buffett proposed? In his own words:

"…The plan I have in mind may at first sound gimmicky. In truth, it retains most free-market virtues. It neither protects specific industries nor punishes specific countries, and it should not engender trade wars. It would increase our exports and might lead to increased overall world trade. And it would balance our books without further devaluations of the dollar.

"We would achieve this balance by issuing what I will call Import Certificates (ICs) to all U.S. exporters in an amount equal to the dollar value of their exports. Our exporters would, in turn, sell the ICs to parties wanting to import goods into the United States. To import $1 billion of goods, for example, an importer would need ICs that were the by-product of $1 billion of exports. The inevitable result: trade balance."

In short, if you export a dollar worth of goods and services to the world (not just China) from the U.S., you get a voucher allowing you to import a dollar's worth of goods and services into the U.S. You can use the voucher to do the importing yourself. Or you can sell it on the open market to an importer. The Buffett plan insures balanced trade since imports cannot exceed exports. You can think of the Buffett plan as a currency version of "cap and trade."

The effective exchange rate under the plan for an exporter from the U.S. is the market exchange rate plus the added value the vouchers associated with those exports would bring. Exports become more profitable. For an importer, the effective exchange rate is the market exchange rate plus the cost of obtaining the required vouchers. Imports become less profitable. The net result for the U.S. is the same as would occur if China and other countries did not manipulate their currency values. Export production would rise in the U.S. and we would import less.

Once the exchange problem is internationalized by the Buffett plan rather than focused on China, all countries that want to trade with the U.S. will have an interest in ending currency manipulation. If the U.S. announced it was about to impose the Buffett plan, the likely result would be an international conference, perhaps under the auspices of the WTO. It would become apparent to all countries that every dollar of exports to the U.S. that a country such as China obtains artificially is one less dollar of exports to the U.S. for them. It would not be the U.S. vs. China. It would be the European Union plus Japan plus the rest of the world demanding appropriate exchange rates.

Are there administrative issues and costs related to the Buffett plan? Of course. Are there risks? Again, of course. But the simple fact is that the U.S. has pursued its on-again-off-again policy of timidly grumbling about exchange rates for decades - first with Japan and now with China — without tangible results. In fact, the ordinary citizens of both Japan and China – although perhaps not their elites — would be better off if their governments had not insisted on mercantilist policies of selling goods to the U.S. in exchange for IOUs. They would be better off exchanging their goods and services for goods and services made in the U.S.A. Our manufacturing sector, which has been disproportionately disadvantaged by the trade imbalance, would be healthier.

Isn't it time for the U.S. to try a different approach to trade and exchange rate policy? Unless someone has a better idea than Buffett's, why not belatedly accept his advice?