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MANAGING FOREIGN TRADE

Feb. 2, 2009 PM by W. Raymond Mills

INTRODUCTION

It is ironic that the man-on-the-street in any town in Ohio has a better understanding of the harm done to the U.S. economy by the trade deficit than do the experts who study the problem. The ordinary citizen knows that goods manufactured overseas and sold in the U.S. reduce output among U.S. manufacturing firms. The ordinary citizen knows that unbalanced trade – more imports than exports – means that foreign producers are, on net (using Greenspanese) displacing and replacing U.S. firms and U.S. manufacturing jobs.

The U.S. desperately needs action, not talk, by the Federal government to reduce the size of the U.S. trade deficit.

The most effective way to reduce the size of the U.S. trade deficit is for the Congress to pass a law which restricts the volume of imports accepted in the U.S. This solution has been viewed as "off the table", not to be considered or discussed, because of some myths, false beliefs, widely shared among American Economists.

Most American Economists believe:

1. The only alternative to free trade is restraint of imports or subsidies of exports which vary in severity by individual products, such as steel, sugar, pants, etc.(classical protectionism).
2. The level of savings controls the size of the trade deficit, therefore, increased savings is the only way to reduce the size of the trade deficit.
3. All the possible reasonable objections to free trade have been discussed and discredited by previous generations of economists.

Rather than spend time in the tedious task of listing all these myths and explain why they are wrong, a better alternative is simply to state the correct propositions that should be substituted for current conventional wisdom. The following propositions are introduced in context and defended in the following 7 chapters of this essay. These next 7 chapters would provide a good beginning for a new textbook, explaining to graduate students how to understand international trade.

PART ONE - TRADE AND GROSS DOMESTIC PRODUCT

1. The goods and services created by a domestic economy determine the wealth of nations.
2. The value of wealth created by the activity of the domestic economy is measured each year by Gross Domestic Product.
3. Trade increases Gross Domestic Product of a nation when Exports are equal to or larger than imports.
4. Equal Trade is proposed as the ideal policy goal for each nation because that allows each nation to use trade to increase its GDP.

5. Imports add to Consumption or Investment resulting in an increase in measured GDP. Exports must match imports for measured GDP to equal actual GDP. If imports are in excess of exports, that excess must be subtracted from the sum of consumption and investment to get a correct estimate of the size of domestic production.
6. An excess of exports over imports results in an increase of GDP over what is achieved with equal trade.
7. Every dollar of increase in GDP achieved by an excess of exports over imports in one nation must be matched by an excess of imports over exports in another nation.
8. Every dollar of imports in excess of exports requires a dollar of financial assets to be transferred from the deficit nation to the surplus nation.
9. A trade deficit may require that the deficit be paid back by future generations, if the surplus nation trades the dollars gained in trade for U.S. debt instruments. However, if the surplus nation trades the dollars gained in trade for U.S. equities or real estate or other physical object existing in the U.S., then the wealth created in the U.S. by past generations pays for the trade deficit. An inter-generational transfer is backward in the last instance and forward in the first.
10. Since a trade deficit reduces GDP below what could be achieved with equal trade, every trade deficit nations should take unilateral steps to move toward equal trade.
11. Free trade fails as a policy goal because of the financial and productivity gains each nation can achieve by violating the prescription to open borders to all imports. Because free trade is an impossible to achieve goal and The World Trade Organization is founded on support for free trade, WTO activities are dominated by hypocrisy.
12. The manufacturing sector is the foundation on which a continuous supply of goods is sold in the international market resulting in sustaining the size of exports.
13. A sudden addition of wealth in a nation in the non-manufacturing sector of the economy, such as discovery of Gold or Oil or value increases in the stock market not matched by growth of production of manufactured goods, results in a decrease in the relative and sometimes in the actual size of the manufacturing sector of the economy.
14. An increase in wealth is a necessary condition for creating a trade deficit. It is not a sufficient condition. Open borders are also required for an increase in wealth to create a trade deficit.
15. When the U.S. possessed a manufacturing sector more effective than any other nation, during the Cold War, the U.S. could afford to advocate Free Trade. When the manufacturing sector dominance disappeared, the U.S. should have rejected Free Trade and embraced instead Equal Trade.
16. Japan, China and Germany have made extensive use of governmental resources to insure that their economy produces an excess of exports over imports. These nations have a right to act in their own self interest in assigning governmental resources as they see fit.
17. The U.S. must make extensive use of governmental resources to reduce the size of the trade deficit so as to insure that trade increases the growth of the domestic economy.
18. If membership in the World Trade Organization interferes with this proposed action, the U.S. should withdraw from the World Trade Organization

Please read these 7 chapters if you are inclined to ignore or dismiss any attempt to use legislative action to reduce the size of the U.S. trade deficit (we will focus on the trade deficit in goods. The deficit in goods is the reason we have negative trade balance in goods and services combined).

Part two of this document will set forth the contents of the law that should be passed to restrict imports and will provide justification and defense of that position. Part three of this paper will provide additional justification for the perspective and the solution proposed.

PART ONE : FOREIGN TRADE AND GROSS DOMESTIC PRODUCT

DOES TRADE CREATE WEALTH FOR A NATION? - #1

Adam Smith answered the above question with a resounding “Yes” without any qualifications or conditions. My answer is more nuanced. Trade does create wealth for most nations participating. But the benefits from trade vary greatly between nations. Nations with a large trade deficit, like the U.S., may experience some addition to national wealth via trade, but their gain is tiny compared to the large gains made by nations that have a large trade surplus. Can this be changed by U.S. action? Should a nation like the U.S. manage their trade with the aim of changing conditions so that the U.S. gain from trade is larger? My answer is a resounding “Yes”.

Adam Smith was unable to take advantage of the additional knowledge of trade made possible by the invention of a means for measuring Gross Domestic Product in each nation. The National Accounts were invented in the U.S. in the decade of the 1930’s. Of course he could not use this resource. Likely he would have used these numbers, had they been available. The National Accounts were created using one of Adam Smiths’ insights. He argued that the total wealth created by a country is a function of the value of the goods and services created and sold by the businesses domiciled in the nation. Smith preferred to say “created by labor”. Now we see labor as only one of the important inputs used by businesses to create goods and services. Gross Domestic Product measures the total value of the goods and services created by the economic activities in a nation during a given time period (One Quarter. One Year).

The following discussion is as clear and as simple as I can make it but some people find it impossible to tolerate formulae. To those I say, stick with it, the gain in insight is worth the trouble. By understanding how Gross Domestic Product is measured, we can see clearly how trade increases the wealth in a nation.

Gross Domestic Product = Consumption (both public and private) + Investment (both public and private) + Trade Balance (exports minus imports). The above version of this formula is different from the one most commonly used. The public component of both Consumption and Investment is usually separated out, added together and labeled “Government”. The version I use is simpler. It focuses attention on Consumption and Investment (congruent with my needs).

Consumption and Investment are not production, they are expenditures. They measure the value of goods and services when they are sold. How do we get from measurement of expenditures to estimates of the value of domestic production? Simple. If trade did not exist (no imports or exports), expenditures and production would be equal. We get the statistical equivalent of no trade when exports and imports are equal. When unbalanced (unequal) trade exists, we must add the value of the exports and subtract the value of the imports to get the value of the domestic expenditures that are equal to the value of domestic production. It is the size of domestic production that we seek.

This formula correctly estimates the value of domestic production, even when unbalanced trade exists. We need to know more about how the formula works.

When imports come into a country they are used – they go somewhere – and the only place they can go in this accounting system is Consumption or Investment. Consumption and investment are added together to get Gross Domestic Product. Thus, as the size of imports increase, the size of Gross Domestic Product, as measured, increases.

A numeric example will illustrate the point. Suppose we have the following distribution of components of GDP (first formula below) and 100 units of both imports and exports are added to the economy. What happens to GDP? GDP = C + I + EX - IM
13,000 = 9,000 + 4.000 + 1.000 - 1.000 (original condition). Add 100 units to both imports and exports produces 13,100 = 9,070 + 4,030 + 1,100 - 1,100 (assuming a 70-30 split of imports going to consumption, investment).

If exports are as large as imports, the larger measured GDP, including imports, properly measures the actual production in the U.S. That is because the exports that match the imports require additional production in the U.S. to create the goods and services sold overseas. Imports create a larger measured GDP. Exports create a larger real GDP. Thus the real and measured are the same, when exports and imports are in balance. When imports are in excess of exports, the size of this excess is subtracted from Gross Domestic Product. This subtraction prevents measured GDP from exceeding actual GDP.

When exports and imports are equal, a large increase in imports means a large increase in exports and both changes together results in a large increase in Gross Domestic Product.. Adam Smith knew that it was not necessary to create a trade surplus in order to benefit from trade. He just did not have the tools to demonstrate that reality so clearly.

Our formula clearly shows that exports add to domestic production and imports subtract from domestic production. Domestic production is obviously less when goods are made overseas as compared to when goods are made in the U.S. Free traders assert that the production lost to imports is made up for by additional domestic production of some other product. If that were in fact the reality, there would be no trade deficit. The large trade deficit shows a net reduction in domestic production (and domestic employment) compared to what would happen if exports and imports were equal. This is the vital reality which provides the foundation on which this document is built. Adam Smith was 100% wrong and any current economists are 100% wrong when they argued that a trade deficit is unimportant and should be ignored.

The above discussion can be made concrete by examining the data shown in Table 1.

Table 1. Exports and Imports as a share of Gross Domestic Product for four nations, 2006. (Goods only)(In billions of Current U.S. dollars)

Nation	Gross Domestic Product	Exports	Imports	Trade Balance	Percent of GDP		
					Equal Trade	Trade Balance	Total
China	2,644	969	791	+ 177	+ 30%	+ 7%	+ 37%
Japan	4,366	647	579	+ 68	+ 13%	+ 2%	+ 15%
Germany	2,916	1,108	907	+ 201	+ 31%	+ 7%	+ 38%
U. S.	13, 195	1,037	1,918	- 881	+ 8%	- 6.7%	+ 1%

Source: IMF for GDP: WTO for all others, Statistics, Annual Reports 2008, Appendix tables A6 and A7
Note: a) Exports and Imports for each nation are the total trade with the world.
b) % for equal trade is calculated, for China, by dividing 791 by 2664 = .297. For the U.S. the calculation is 1,037 divided by 13195 = .079.

The smaller number of the two (exports and imports) measures the amount of trade in each nation that can be said to be equal trade. Equal trade adds to GDP in each case, just as the above discussion indicated. But in the case of China and Germany, equal trade contributed 30% of the Gross Domestic Product created in the country. For the U.S., equal trade contributes only 8% to the Gross Domestic Product created in the country. This calculation shows that all nations, even the U.S., could gain significant benefits from trade, if exports and imports are equal.

The trade balance shows further disparity. In the U.S. the trade deficit takes away most of the gain made from equal trade. For the other 3 nations, the trade surplus adds to the gains they get from equal trade. The size of the extra gain from trade experienced by a trade surplus nation is balanced by the harm that a trade deficit does to some other national economy. Surplus and deficit are like the two ends of a see-saw. When surplus increases the wealth in one nation some other nation must experience a decline in wealth via a trade deficit. The benefits gained by all the surplus nations are equal in size to the harm done to all deficit nations. The U.S. is unwilling to recognize the harm that the trade deficit has done to the nation. The most important harm is the reduction in Gross Domestic Product created by a trade deficit. Some other consequences of importance that accompany a trade deficit will be identified below.

This discussion leads to both a moral and practical question. Does the U.S. Congress and the President have a moral obligation to the citizens of the U.S. to manage trade so that the difference in gain from trade between the U.S. and its trading partners is reduced? How about the U.S. obligations to other nations – do we have a moral obligation to move international trade closer to a balance so that international trade will become sustainable?

EQUAL TRADE VERSUS FREE TRADE - **#2**

Equal trade is presented here as a new idea, a proposed ideal, hopefully to be adopted by all nations. (Balanced trade is widely advocated for the world as a whole. This proposal urges each individual nation to adopt equal trade as a goal. I assume this idea has been discussed before, I just do not know where). Free trade is an old idea (1776), also presented as an ideal to be adopted by all nations.

The first difference between the two ideals is that the utility of equal trade, for any nation that adopts this ideal, is not dependent upon how many other nations adopt the same ideal. If the U.S. is the only nation to embrace equal trade, the gains for the U.S. will remain. Moving from a goods trade deficit of 881 billion to a much smaller number will benefit the U.S., regardless of what other nations do. That world trade will become sustainable is a side benefit enjoyed by all nations.

The utility of free trade ideal, for any adopter nation that is not the leading manufacturing nation in the world, is totally dependent upon what other nations do. If all nations open their doors fully to imports, with no restrictions, this would maximize the ability of each participating nation to specialize in producing those goods in which they have a comparative advantage. This extreme degree of specialization would maximize total world production and each nation would maximize their GDP by using their own resources to maximum advantage. This is the vision which has entranced economists for years.

The reality is that all nations restrict imports, with the possible exception of Hong Kong. Because exports add to GDP and imports detract from GDP, each nation that restricts imports gains an advantage over other nations who do not restrict imports. Subsidizing exports also increases the likelihood of creating a trade surplus. The incentives available to each nation, to move their nation towards a trade surplus, work against every nation following the free trade ideal.

The World Trade Organization has become a place where nations squabble with each other over who is deviating the most from the free trade ideal. The vision of every nation opening its door to imports without restrictions cannot become a reality. It has not happened and it will not happen, given the gains in GDP every nation can achieve by creating a trade surplus.

Trade had become an arena where nations compete with each other for selling exports to the world. The most successful nations in this competition are those who use their government to encourage exports and discourage imports. Those nations who guide their action by the free trade prescription fall behind in this competition (unless they have the strongest most effective manufacturing sector in the world). Great Britain and the U.S. are the only nations who really believe the free trade doctrine. They are the nations now suffering the most from a trade deficit. Most of the rest of the world regard Free Trade as a doctrine to which lip service is given while action is guided by national goals.

The proper trade policy for each nation is to seek to manage its trade so as to gain as much as possible from trade. This would encourage each nation that has a trade deficit to adopt the goal of equal trade.

The U.S. should withdraw from the World Trade Organization if that organization will not shift to the goal of equal trade.

Comparative Advantage shows that each nation will gain from trade, regardless of its productive efficiency, if it concentrates its productive resources on that product for which it has a comparative advantage AND THE PRODUCTS CREATED BY EACH NATION CAN BE SOLD ON THE INTERNATIONAL MARKET. The last requirement is not listed in the usual discussion of Comparative Advantage. Comparative Advantage demonstrates the ability of two nations to maximize joint production of goods when both nations specialize properly. But the production of goods is only part of the process. The products created must be sold or swapped for the greater production to benefit both parties. If one nation refuses to swap (or exchange via cash) the extra wealth each nation expects to gain disappears. The existence of equal trade is a logical requirement for the increased production possibilities, made possible because of comparative advantage, to benefit both parties to the exchange.

The heavy use of models by the economics profession provides another reason to use equal trade as an ideal. Modeling is made easier by assuming equal trade. Simple trade models assume both equal trade and no unemployment. If the economics profession would switch to equal trade as an ideal that would make their models more congruent with the ideals they profess.

This material argues that the U.S. government should abandon the attempt to support free trade and instead embrace equal trade as the goal

SAVINGS - **#3**

National Savings is defined as that part of national production that is not consumed in the time interval (a year or a quarter of a year). It is left over, during this time period. In the year 2006, Gross Domestic Product was 13, 399 billion and Consumption was 11,416 billion (both public and private) resulting in a Savings of 1,983 billion. This is money that can be used in a subsequent time period or it can be stored. (The above description of National Savings is conventional wisdom, used by economists for years, but it is an example of careless labeling. It will be accepted as valid temporarily, for the purpose of understanding the causation issue. See the end of this discussion for a correct interpretation of what is left over after Consumption is subtracted from Gross Domestic Product).

The equation we are working with is GDP = Consumption + Investment + Trade Balance. When we move consumption over to the left side of the equation we have GDP – Consumption = Investment + Trade Balance. By definition, the two sides of an equation are equal. Therefore, Savings is also equal to Investment + Trade Balance. The numbers for the year 2006 are 1,983 = 2,752 – 769 (these numbers are taken from the National Accounts provided by the U.S. Bureau of Economic Analysis. They differ slightly from the numbers taken from IMF and WTO. Also they refer to total imports and exports, not just goods).

Some people (who are misguided) think that the level of Savings (1,983) controls or determines the level of Investment minus the Trade Deficit (2,752 – 769). This is the direction of causation controversy. How we decide the direction of causation in this equation is important. For if Savings controls the level of the other two variables, and investment is controlled by the expenditures business firms make on equipment, building and software, it would follow that the level of the trade deficit is controlled by the level of Savings. That would mean that the U.S. must increase Savings in order to reduce the trade deficit. Free trade advocates prefer this answer to the direction of causation question because it means that the trade deficit cannot be reduced by restricting imports or subsidizing exports. If Savings in the controlling variable, the U.S. can't do anything about the size of the trade deficit because the level of national savings is so very difficult to change.

If, on the other hand, the trade balance is controlled by the size of imports and exports, then the U.S. can change the level of the trade balance by restricting imports or subsidizing exports.

The trade balance and investment are both calculated from numbers collected from businesses and Customs Agents. Savings, on the other hand, is derived from other numbers found in the equation. Numbers created by manipulating other numbers in an equation are called endogenous – dependent for their size on other numbers in the same equation. It seems reasonable to assume that the numbers used to determine the size of savings are in fact controlling the size of savings. How the numbers are created tells us which numbers are controlling.

The conclusion is that the size of Savings depends upon the size of the Trade Balance and Investments and not the other way around. It is also true to say that the size of savings depends upon how wide the gap between Consumption and Gross Domestic Product. GDP can only be larger than consumption when the combination of investment and the trade balance force GDP to be larger than Consumption. A nation like China has a large level of national savings because both investment and the trade surplus are large relative to consumption. The Chinese government wants to use funds received from the trade surplus to increase investment. In addition, the low level of wages in China suppresses consumption.

Compounding one error with another, some writers assume that the level of investment in a given time period is controlled by the level of savings in that same time period. The level of investments at any time period is controlled by investor's decisions as to the likelihood of a good return on the investment. The money to pay for the investment in a given time period is assembled independently of the savings in that time period. After all, Savings, by definition, are not spent during the time period Savings is recorded. There can be no connection between the level of Savings in time period X and the level of spending for investments in time period X.

A further extension of this silly logic is to say that when savings is less than investment in a given equation, a trade deficit is necessary to provide the funds needed to fund investment. This is doubly silly: 1) Investment is not funded from funds created in the time interval of the investment and 2) A trade deficit does not increase the net financial position of the nation experiencing the trade deficit. Just the opposite. A trade deficit creates a net flow of financial funds from the deficit nation to the surplus nation.

An increase in financial assets in the trade surplus nation is created when financial assets flow from the deficit nation to the surplus nation in payment for goods and services. The trade deficit nation gets more goods (worth 881 billion to the U.S. in 2006); the trade surplus nations get more financial assets (881 billion dollars distributed among many nations).

The trade surplus nations prefer to exchange these dollars for other financial instruments, such as U.S. Treasury certificates, stocks or bonds or ownership of real estate or companies. This flow of funds back to the U.S. is mistakenly seen as increasing net financial assets in the U.S. only if the observer ignores the ownership certificates that flow in the other direction. Accounting conventions requires that a flow of funds across international borders is always matched by a flow of something else of equal value back in the other direction. When financial instruments are exchanged for financial instruments between nations there is no change in the net financial position of either nation.

It is simply wrong to assert that a trade deficit provides funds to the trade deficit nation that can be used for any purpose, especially not to fund investment during the period the trade deficit is experienced. This issue has tangled the thinking of many economists.

“Oh what a tangled web we weave, when first we practice to deceive”.

The material covered in this post clears the way for the U.S. government to manipulate factors that influence the level of imports or exports without fear that savings or some other financial entity are controlling the level of imports and exports.

Note: The conventional wisdom as to what is left over after Consumption is subtracted from Gross Domestic Product is wrong. Subtracting Consumption from Gross Domestic Product allows us to separate current production into that part that serves the needs of the present versus that part of current production that serves the needs of the future. Investment is money spent today to increase future production ability and capacity. The trade balance shows deviation of current production from what is required to balance exports and imports. A positive deviation creates production knowledge and tools in the present that lay the foundation for future growth in domestic production. A negative deviation reduces the knowledge and tools existing in the present that can be used as a foundation for future growth in domestic production (compared to what is achieved with equal trade). The flow of money out to support a trade deficit and the flow of money in because of a trade surplus also impact the ability of an economy to produce in the future.

Everything in the formula for Gross Domestic Product is a form of production. No room is left for surplus money that is not used in production.

On the other hand, domestic production does create additional wealth in the nation. Our problem is that economists, thus far, have not devised a satisfactory way to measure it. We know how much Net Wealth is added to households during each quarter (Federal Reserve Board data). We do not know how to separate this total gain into that part that is created by domestic production. . . . Table 5.1 in the National Accounts provides estimates of Gross Savings. This number is dominated by an accounting concept (Consumption of Fixed Capital) which is an estimate of depreciation of fixed capital. How that results in more stored wealth is not clear to me. Gross Savings in 2006 amounted to 2, 174 billion, a number which is 10% different from Savings as calculated above from GDP numbers. One of the components of a proper measure of National Savings will probably be Net Operating Surplus of Non-financial Corporations (discussed in the May 2009 issue of Survey of Current Business). In 2006, that number was 1,938 billion.

Summary thus far: 1. A trade deficit reduces the growth of an economy and its financial assets, compared to what would be achieved with equal trade. 2. The larger the trade total for each nation engaged in equal trade, the larger the contribution of trade to the growth of that nation’ economy. 3. The Free Trade ideal is torpedoed by the advantages nations gain from a trade surplus. 4. Expansion of National Savings (as conventionally defined) is not needed to reduce the trade deficit because the size of the trade balance (and investment) controls the size of savings. The trade balance also shows the contribution of current production to creating the knowledge and tools and money needed to expand future production.

TRADE AND MANUFACTURING - #4

Adam Smith saw the growth and spread of trade throughout the world as closely linked to the growth and spread of the industrial revolution throughout the world. Smith was very impressed by the increase in productivity in a factory that specialized in one particular product. But the size of the factory and the degree of specialization that could be achieved was limited by the size of the market that could be served. Smith recognized that free trade would expand the size of the market, thereby allowing for increased specialization which would create more goods and services for the entire world.

The expansion of productivity during the 19th Century demonstrated the validity of his insight. Cotton producers and brokers in the U.S. south grew wealthy by producing cotton and shipping bales of cotton to England for processing. The wealth created by planting seeds and tending land in the south was large but the size of this wealth creation was not as large as the wealth created in England where the raw material was converted into shirts and pants. The value added by manufacturing exceeded the value added by farming. Some claim that the trade surplus in England during this period (first 3/4ths of the 19th Century) averaged around 5% of their Gross Domestic Product each year. The wealth of England in its Golden Age was created by a combination of expanded manufacturing production and expanded trade.

England prospered from free trade during the era when it had the most productive manufacturing system in the world. England ceased prospering from free trade when it lost that dominance. Economists have noted the tendency of nations with large trade surpluses to favor free trade. England's problem is that it did not change its approach to trade when it lost its dominant position in manufacturing.

The primary reality about trade in Adam Smith's world (near the beginning of the industrial revolution) was the fact that industrialists and brokers in England and France were persuading their respective legislators to impose import duties on the specific product the domestic producers and brokers had for sale, so as to benefit themselves, regardless of the effect on the nation as a whole. One of the most important arguments used by domestic manufacturers was that English import duties were necessary because of other nations were restricting imports of English goods. Long lasting competition and hostility between England and France made such arguments irresistible to English legislators. Adam Smith cut through this Gregorian knot by proposing that England open its door to all imports, regardless of what other nations were doing. Smith had a good reason for supporting free trade, given his view that the excuse used by protectionists (we are seeking equal trade) must be eliminated – and the fact that he was a resident of the dominant manufacturing nation. But he left a legacy of overconfidence about the widespread utility of free trade that has haunted both Great Britain and the U.S. to this day.

The U.S. is suffering today because U.S. economists have not had the good sense to see the limitations of free trade for a nation that has a trade deficit.

Some would argue that manufacturing activities are no longer necessary in the U.S. We have become a service oriented economy. Let other nations do the manufacturing for us. Here are two answers to that point:

1. We need to sell something to the rest of the world to pay for our imports. The U.S. share of world services is not growing fast enough to make up for the loss of manufacturing. The total U.S .trade deficit of 696 billion dollars in 2008 consists of a loss of 840 billion in goods and a gain of 144 billion in services.
2. Service activities do not provide employment benefits comparable to manufacturing. Not only is manufacturing pay higher than service activities (generally, except for Finance and Insurance). We also find that manufacturing requires employment in other industries to produce the intermediate inputs needed by manufacturing industries. Also, manufacturing payrolls support many service activities. Mayors and other local officials fight with outrageous subsidies to try to entice manufacturing plants to locate in their district because of the spill-over benefits to the local area.

Thirty-two percent of all the intermediate inputs used by all U.S. domestic industries in 2006 were purchased by U.S. domestic manufacturing industries. The share provided by Finance and Insurance was 8.5%. As recently as 1998, manufacturing purchased 38% of all intermediate inputs. Some other industries stepped forward to fill the gap but not finance and insurance. They purchased 7% of all intermediate inputs in 1998, for a gain of 1.5 percentage points compared with a loss of 6 percentage points from manufacturing.

Finance and insurance were able to create enough profits in 2006 to replace the profits no longer provided by manufacturing firms. But these profits supported a very small number of employees. The spill-over from these profits to other jobs were not sufficient to sustain U.S. employment. Now we learn that a considerable part of these profits were fictitious.

Manufacturing employment in the U.S. continues to decline for four reasons: 1. The recession, 2. Trade deficit; 3. Automation, 4. The shift to purchasing services rather than goods. The last factor is becoming less important because it is changing very slowly.. Of the four, only the trade deficit lends itself to immediate correction by action of the U.S. Congress and the President.

Manufactured goods are the main item exchanged among developed nations. Continuing participation in global trade requires a viable manufacturing sector.

CAUSES AND CONSEQUENCES - #5

The main, simple theme of this document, thus far, is that the U.S. has a bad habit of spending too much money on imports and it has to stop.

In this section, I am going to attempt an explanation of the primary reason why that happened and what it has done to the U.S. economy.

The main reality is that the U.S. is a big rich country and we have been able to create increased wealth, or at least the illusion of wealth, for the last three decades, despite our continuing trade deficit. Wealth enabled us to purchase imports in excess of our exports. This country made no attempt to restrain the total of imports, due to the belief in free trade.

During the period from 1994 – 1997, the wealth created by the domestic economy was not illusory. The U.S. manufacturing sector added employees during this four year period. Manufacturing accounted for 30% of all profits earned by domestic corporations during that period. This time of good wealth creation was succeeded by speculation on the stock market by individuals and firms trying to capture more of the new wealth. Redistribution of existing wealth does not create new wealth, despite appearances.

After 1997, the financial sector became the main source of wealth accumulation (if partly temporary and/or fictitious). The stock market became the place to get rich. Foreign capital poured in. Folks whose investments told them they had increased wealth went on a buying spree, including imports.

The bursting of the tech stock bubble decreased perceived wealth but imports did not decline as much as wealth. The Federal Reserve Board dropped the Federal Funds rate from 6% to 2% in the 12 months of 2001. This was the first recession in recent history when consumer credit did not decline. Consumers supported the U.S. economy - and imports. Consumers were searching for bargains and they found them in imports. Profits earned by domestic manufacturing corporations took a beating, declining from 30% of corporate profits in 1997 to 8% in 2002.

The domestic manufacturing sector never really recovered from the recession of 2001 and 2002. As the economy recovered in 2003 and 2004, manufacturing profits recovered partly, to a level of 20% of corporate profits during 2006-2008

The financial sector, meanwhile, was going great guns after 2004, piling up profits by the bushel. Again, foreigners were happy to buy the "instruments" the financial sector had for sale. The housing sector became the new means of getting "rich".

The recent financial collapse shows that wealth accumulation based on speculation is not reliable.

Economists have recognized that a sudden increase in wealth in a country is likely to reduce the domestic manufacturing sector. The new source of wealth attracts resources away from manufacturing. This happens because: a) Increased wealth causes the currency to appreciate, making imports cheaper and exports more expensive: b) Increase wealth attracts domestic resources to the new source of wealth, drying up investment in manufacturing. Adam Smith gives us the example of the importation of Gold from South America. With this new wealth, the Spanish hired others to do the work in their country that needed doing. This caused an atrophy of ability on the part of Spaniards. When the value of gold declined, due to its lack of scarcity, Span became a second rate country because they had lost the capacity to build businesses and goods themselves.

This is called the Dutch Disease because the phenomenon was described when the Netherlands experienced an oil boom in the decade of the sixties. The website Wikipedia lists 22 different examples of the Dutch Disease known to economic historians. One of their examples is the wealth generated by Cotton in the South made unnecessary participation in the ongoing industrial revolution being experienced in the North.

The problem is that the new found wealth source may be temporary. Natural resources become depleted; finance booms become overheated and lead to a collapse of the wealth creation.

The U.S. is currently faced with the very practical question of what to do to revive the U.S. economy after two closely related financial booms and busts.

One option is to try to retrieve the financial sector since it was the most recent source of wealth creation. The other option is to try to revive the manufacturing sector, since it is the source of stable growth, not subject to booms and busts.

The Congress and the President have been led down the path of trying to retrieve the financial sector. A better option exists.

The whole point of this discussion is to encourage governmental focus on revival of the manufacturing sector. This will mean ceasing to pump money into the financial sector. Instead, reform trade policy so that balanced trade (and manufacturing) are supported by aggressive Federal government action.

(Other "stories" of what happened could be created. Go to the internet, IMF, and retrieve the document "Global Imbalances : In Midstream?", December 22, 2009. It contains a treasure trove of charts which portray current account balances by countries and groups of countries as well as currency value change, investment and currency flows. My account is consistent with those data but the authors arrive at a different conclusion).

HISTORY - #6

Immediately after WW II, the U.S. became preoccupied with the struggle to prevent the Soviet Union from extending communism all over the world. Sound economic growth in nations-at-risk was an effective antidote to the Communist push for control. Increased trade supported economic growth in nations-at-risk and bound other nations into the U.S. orbit. World trade moved rapidly towards the ideal of free trade as the U.S. encouraged other nations to join us in reducing tariff barriers. Free trade was a useful objective for the U.S. during the Cold War.

The U.S. economy thrived in the early part of this period but after 1983 a string of trade deficits reduced the U.S. net foreign wealth to zero by 1987. Exports of goods from the U.S. stood at 237 billion in 1981. Goods exports in the subsequent 5 years were less than 237 billion. This sudden halt in goods exports growth (which had existed for 20 years prior to 1981) was due to the rapid growth in the value of the U.S. dollar. The real, trade weighted value of the dollar began to decline in the spring of 1985. Its descent was hastened by intervention of 5 major nations in the world currency market to push down the value of the dollar. This ploy worked. The U.S. goods trade deficit declined from a level of 152 billion in 1987 to 31 billion in 1991.

After 1991, the U.S. goods trade deficit grew, but slowly. The growth was especially slow during the four years of 1994 – 1997 (from 98 billion to 108 billion).

After 1997, imports into the U.S. exploded, going from 1 trillion in 1997 to 2.3 trillion 10 years later. This change began after 1997 with the increase in values in the stock market increasing both buying in the U.S. and increasing the value of the dollar. By 2000, the well oiled import pattern had developed a momentum of its own. The slow decline in the value of the dollar after the spring of 2002 did little or nothing to slow down the growth in imports (1.4 trillion in 2002 to 2.3 trillion in 2007).

The U.S. Congress grew concerned with the growth of the trade deficit after 1997. In October, 1998, the U.S. Congress established The U.S. Trade Deficit Review Commission with the aim of understanding the trade deficit and providing the Congress with recommendations of what, if anything, to do about it. The Republican members of the Commission decided that nothing should be done to reduce the trade deficit because it was an inevitable product of a rapidly growing economy. This conclusion is unreasonable, as Spock would say. Rapid growth is a necessary but not sufficient condition. Open borders must be combined with rapid growth to produce a large trade deficit. By restricting imports, Japan has shown that rapid growth can be combined with a trade surplus – the opposite of a trade deficit. The Democrat members of the Commission did not seize upon this logical non-sequitur. Instead, they focused on mitigating the harm done to worker by the closing of domestic firms due to the trade deficit.

The Commission recited the facts but they drew the wrong inference from the facts because they took for granted continued open borders in the U.S. A good opportunity to reorient U.S. trade policy was missed..

The U.S. Chamber of Commerce has lobbied hard for Most Favored Trade Status for China and for other trade deals. Their behavior is understandable if one begins with the assumption that the open borders policy cannot be changed. In that case, domestic manufacturers must try to locate production facilities overseas, to compete with the flood of imports coming from producers domiciled overseas. Apparently, the Chamber expected that support for free trade status in the U.S. Congress would result in U.S. firms being allowed to set up shop in China. That was a vain hope. China thwarted U.S. firms that wanted to exploit their cheap labor. Data on the location of value added by U.S. multinational corporations gives the details.

Multinational corporations with the parent company in the U.S. generated 3, 706 billion of value added from all over the world in 2007 (including the U.S.). Foreign affiliates contributed 1,117 billion, 30% of the total. China contributed only 22 billion of value added to U.S. majority owned foreign affiliates of U.S. parent. Twenty-two divided by 3,706 equals .0056, less than 1%.of the value added by all U.S. multinational firms surveyed (Survey of Current Business, August, 2009, p. 72). Multinational firms headquartered in the U.S. have been able to locate production facilities all over the world, except in China.. Our national leaders in the Chamber of Commerce are naïve and harmed the nation as a whole by their desperate grab for some Chinese goodies that were beyond their reach. China has played our leaders for suckers.

The Japanese experience shows the important role that government can play in structuring a domestic economy to enable it to compete in global trade.
"In February 1985, one U.S. dollar traded on international markets for 260 Japanese yen; in January 1988, a dollar was worth only 123 yen (this is consistent with the above discussion of change in the value of the dollar after 1985). This change had effects that reached far beyond financial markets" (Krugman and Obstfeld, *International Economics,* 1993, page 6). Wage rates in Japan rose to be equal to those paid in the United States. The Japanese economy was able to absorb this change because of the strength of their manufacturing sector. Japan still had a positive trade balance with the U.S. in the years after 1988. In 1990. the combination of Investment + Trade Balance in Japan was 33.5% of Japanese GDP, whereas the comparable U.S. number was 12.7% of GDP (Krugman and Obstfeld, pages 315-316). Two countries with entirely different economic structures – one oriented to create a better future, one oriented to serving current consumers.

After 2005, the slowly declining value of the dollar gradually reduced the U.S. trade deficit. As reported previously, the share of U.S. goods imports that could not be matched with U.S. goods exports (goods trade deficit) was 47% in 2005, 42% in 2007 and 34% in the first 9 months of 2009 (the financial meltdown in late 2008 combined with change in currency value to create the low numbers for 2009).

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HOW DID THREE NATIONS CREATE A TRADE SURPLUS? - **#7**

Each of the three nations (Japan, China and Germany) used a different route to position their nation to achieve a trade surplus. Germany is in some ways the most interesting example because they are a high income nation like the U.S. that has managed to find a way to prosper in a world of low cost manufacturing production growing in Asia.

Germany does not try to compete with China. Instead, Germany competes with Japan, the U.S. and other developed countries in supplying machine tools to the Asian countries to be used to produce low cost manufacturing goods. They have developed a niche in the ability to service the need of Asian nations for capital goods to increase industrialization in formerly undeveloped nations. They also compete in supplying all kinds of precision manufacturing products to both developed and undeveloped nations. Their educational system is designed to support this kind of an economy. The cooperation between union and management is based on the desire of all citizens to enhance the economic development of Germany. Their taxation system is perhaps their most important weapon in the competition to supply exports to the world. They charge a tax of 19% of the Value Added to each product sold in their economy. Though careful bookkeeping, the government knows and each individual firm knows who paid what taxes up front. The contribution of each business to the tax paid on value of the sold product is rebated to each firm, IF THE PRODUCT IS SOLD OVERSEAS. This creates the ability to sell products overseas for 19% less than must be charged in Germany. There was considerable public opposition to this tax as first proposed but the opposition was overcome by the desire of decision makers in Germany to support exports.

Japan established an explicit “industrial policy” after WW II to use resources available to the Japanese government to support the growth of steel making and other heavy industries so as to enable Japanese manufacturing firms to earn the money that will pay for the imports Japan needed in order to become a successful industrialized nation. This was an explicit rejection of the U.S. policy of Free Trade. The U.S. ignored this because seeing Japan grow into a strong ally in Asia was more important than insisting that Japan do everything our way. Currently, Japan has no need for an industrial policy. Their firms are strong enough to compete in the global market without support of the government. But they retain restrictions on import of food in deference to Japanese farmers, who might be called upon to provide food for the population, if another WW III were to develop.

The current Chinese government came into power with an explicit promise to take power away from landlords and the warlords. The current Chinese government controls everything of importance in China, including the rush to industrialization, with the view that outsiders must be prevented from gaining advantage from Chinese resources. The Chinese view of the role of the central government is that trade must be managed so as to increase the long term power and wealth of China and the current Chinese government.

In all three nations, the national governments were the major actors managing trade to create the conditions which led to large exports.

PART TWO - THE SOLUTION

NEXT STEPS FOR THE U.S. **- #8**

The U.S. can learn from these other nations but we must not imitate them blindly.

1. The U.S. government does not possess the financial resources to compete with Germany or China in subsidizing exports.
2. The U.S. prefers to rely upon private enterprise to create the goods and services produced by the nation. We do not want the Federal government to pick winners and losers among private firms.

What we must learn from other nations is that the national government has an important role to play in creating the conditions under which foreign trade will benefit the nation.

The great natural advantage possessed by the U.S. is the attractiveness of its domestic market. The U.S. has the wealth to purchase whatever is for sale. No other nation has a domestic market near as attractive as the U.S. That market has attracted other nations to adjust their production to what will sell in the U.S. Of course, the historic desire of the U.S. leadership to open their country to foreign trade encouraged selling in the U.S.

The U.S. needs to use its ability to limit access to the U.S. market so that other nations will be willing to adjust their trade with the U.S. to a level that can be supported by U.S. exports.

While equal trade is a good conceptual, clean-cut goal, the U.S. should not aim for equal trade with all nations in goods (table 1 is limited to goods or merchandise trade). The U.S. has been able to sustain a surplus in services for years.

A good practical goal for the U.S. is to seek to reduce the U.S. goods trade deficit to 23% of U.S. goods imports. That is the level achieved in the U.S. in the period 1994 – 1997. In that four year period, the combination of a low trade deficit and low value of the dollar enabled the U.S. to increase employment in the manufacturing sector of the economy. The manufacturing sector was also able to provide 30% of the corporate profits earned by all domestic industries during those years. These numbers may not be achievable in the short run but they provide a good target.

The recent history of the size of the U.S. goods trade deficit relative to goods imports provides hope that the 23% goal is achievable. The goods trade deficit as a share of goods imports has been declining recently (without U.S. government interventions) due to reductions in the value of the dollar and the financial crisis that hit in 2008. The goods trade deficit as a share of goods imports were: 47% in 2005; 42% in 2007 and 34% in the first 9 months of 2009. Currently, the U.S. is only 11 percentage points from the goal of 23% of imports not paid for with exports. (The expectation is that the U.S. trade deficit will increase, gradually, after 2009, when the U.S. consumer ceases reducing consumer debt, if the Federal government makes no attempt to use its powers to reduce the trade deficit).

AVOIDING OBVIOUS PITFALLS - **#9**

The next background issue to be discussed is what NOT to do when constructing a proposal or a program for reducing the size of the U.S. trade deficit.

This discussion should be preceded with the information that experts in this field think that there is no way a U.S. action can reduce our goods trade deficit.

1. They think that anything the U.S. does will be met with instant retaliation by our trading partners.
2. They also think that the U.S. public will never support what I will propose because of the fear that the change will reduce some of the benefits they now enjoy, such as cheap and good quality goods made overseas.
3. The financial gains current trading practices provide to some U.S. businesses are seen as a barrier..
4. They are certain that any alternative to free trade will be intellectually indefensible..
5. Finally, opposition to increased government interference in the private sector will prevent strong action by the Congress and the President.

In order to answer the nay-Sayers, the proposed solution must be carefully constructed. Below is a list of options to avoid.

1. Reject secrecy and duplicity.

Nations tend to seek some advantage for themselves from international trade. Many nations think that they must disguise their motives and their actions from their trading partners. Informal barriers to imports have become at least, perhaps more important, than formal barriers.

The U.S. is not comfortable with this practice of duplicity and secrecy. The solution proposed herein will be explicit with our motives clearly identified. Tariffs are the most explicit and above-board way to reduce imports and tariffs will be used in this proposed solution.

2. Reject discrimination by product.

In the past, explicit trade barriers, such as tariffs or subsidies, have discriminated by individual product – steel, textiles, etc... That practice grew out of the wishes of domestic industrialists and traders. Individuals and firms sought to protect their own interests by urging the legislature to pass laws that restricted imports of the particular product they had to sell.

The U.S. has no interest in protecting specific domestic producers from foreign competition. What we want is imports balanced with our exports – to reduce our large trade deficit. It is the total of imports relative to the total of exports that is the issue. So, we must deal with all imports.

3. Reject the "Big Bang" approach.

It would be a mistake to assume that the transition from current practice to a more balanced trading system can be accomplished overnight. Time is required to unwind existing trading relationships and establish new production locations consistent with the proposed new system.

This proposal is that restrictions on imports into the U.S. will be implemented gradually. This can be accomplished by establishing a schedule of tariff rates increases over time.

It would also be a mistake to assume that the new system will be perfect as initially established. The Congress will retain the authority to modify the law as experience accumulates.

4. Reject treating all trading partners alike.

Some of our trading partners already have a near equal trading relationship with the U.S. Since our aim is to achieve near equal trading relationships with all our trading partners, it makes sense to exclude many nations from the import restrictions.

Limiting import restrictions to those nations who have the largest trade surplus with the U.S. will simplify administration and it will insure that the U.S. has a number of nations with which it can trade, if those nations who become subject to the restraints try to retaliate in some fashion.

5. Reject ignoring potential problems.

We expect our trading partners that are subject to new restrictions on imports into the U.S. will try to find ways to avoid the restrictions. They may try:

a. Smuggling
b. Limiting sales to the U.S. of any goods or products that are essential for U.S. survival.
c. Refusing to accept some or all exports from the U.S.
d. Stop buying U.S. Treasury bonds.

The solution proposed must be designed to support a ready response to likely retaliation efforts.

One of the dangers to be avoided is inflation. If our trading partners who are subject to additional tariffs are able to increase the price of their products in the U.S., the U.S. will have a problem with inflation.

6. Reject the assumption of a bumbling and powerless Federal government.

Ability to establish the conditions under which legal imports will be accepted in the country has long been recognized as the right of every sovereign nation. The Federal government can act reasonably and responsibly to reduce the size of the U.S. trade deficit if a proposed solution is thoroughly debated in the country and a consensus developed before the Congress is requested to act.

HOW TO BALANCE EXPORTS AND IMPORTS - #10

What law should Congress examine and debate with the aim of moving the U.S. closer to the goal of imports equal to exports with every trading partner?

1. Assure Competition among Domestic Producers.

Previous efforts to control the volume of imports into a nation have failed because they imposed separate tariffs on each product imported. This approach fails because it grants one firm or industry an advantage over other domestic producers and by this process reduces the ability of market competition to determine what is bought and sold ands thus firm success or failure. The tariffs imposed on each product are also irrational. They depend solely upon the political power of the various congressmen, each defending the interests of his constituents.

If tariffs on all imports are equal, the import products that will be able to be sold in the U.S. are those that are the most effective competitors for the consumer dollar. Goods will be available in the U.S. from all over the world – from the countries whose products can overcome tariffs; also from other countries whose imports are not subject to tariffs. Domestic producers will be more competitive because increased tariffs will offset the advantages currently enjoyed by some products from those countries with which the U.S. has a very large trade deficit.

2. Gradual Implementation.

The proposed legislation will establish a schedule of tariff increases in 4 month intervals. When the tariff rate reaches 40% (if it does) all scheduled increases will cease. A second recommendation is that tariff rate increases cease when the percent of goods imports not covered by exports declines to 23% (if it does).

The tariff rate will begin at 10% of the value of the goods and will increase by 5 percentage points each 4 months. The new rate of 10% will begin 4 months after the legislation is signed into law.

If this proposal ever comes to the Congress for debate, the discussion will extend over a period of months, perhaps years before a law is enacted. Business firms will have plenty of time to adjust production to the new law.

3. Tariffs for only five countries.

Limiting the tariffs to only 5 countries will mean that most of the nations of the world will escape coverage. Some nations will be able to increase imports to the U.S. as a consequence of this change. Limiting coverage to 5 countries will ease the administrative burden.

The five countries will be chosen on the basis of which countries contributed most to the U.S. trade deficit in the period 2004 to 2006, when our trade

deficit problem was most severe. It happens that the sixth country is significantly below these 5 in share of U.S. trade deficit created.

The five countries, in order, are China, Japan, Canada, Mexico and Germany.

Three of these countries are export oriented. That means they have arranged their laws and practices internally so as to produce a trade surplus with their trading partners.

Canada and Mexico are different. They have a large trade surplus with the U.S. because they border the U.S. Their government does not need to manage trade to achieve a trade surplus with the U.S. The private firms do it for them (most of these private firms are partly owned by U.S. interests).

Regardless of the reason for the trade surplus with the U.S., it is in the interests and power of the U.S. to use tariffs to discriminate against countries that create most of the U.S. trade deficit. In the measured period, these five countries were responsible for 61% of the U.S. trade deficit in goods Their dominance only increased as the U.S. trade deficit declined in relative size in the first 9 months of 2009. During 2009, these five countries generated 73% of the U.S. goods trade deficit. (Services are ignored because the U.S. traditionally has a surplus in services).

The new law must include a requirement that every item (good) imported into the U.S. will be labeled as to its country of origin – not the country from which it was shipped. The origin country will be the last country to add more than 25% to the value to the product (excluding shipping).

4. Limiting tariffs to manufactured goods.

Increased employment and production in manufacturing in the U.S. is the benefit sought from this proposal. Other issues, such as oil imports, should be handled in another conceptual framework. Manufacturing goods are the main item exported from the U.S., accounting for 69% of all goods exported in 2006 (Census Bureau, Foreign Trade, Data, Produce Trade, End Use, Exports, SIC Code 6,7 and 8).

All manufacturing goods imported from all five nations will be assessed the same tariff.

5. Estimating Outcome

We can expect implementation of this proposal to reduce imports from the five nations, to increase the cost of the imports they sell in the U.S., to increase imports from other nations and to increase output in the U.S. We do not have a good way of estimating how much of each.

In the absence of a good basis for estimating, I will provide one calculation based on stated assumptions, without any expectation that this estimate will

be accurate. Readers are welcome to substitute better assumptions and arrive at different conclusions.

Assume that the process continues until the tariff is 40% and that all the imports not received from these 5 nations, due to the tariff, are replaced either by domestic production or by imports from other nations. In addition, we will assume that we will split the difference between each of two options.

Using the numbers from 2006 as an example, we will assume that those goods from the 5 nations that do sell in the U.S. will have an additional cost of 20% (half of 40% tariff). That the goods imports normally received from the 5 nations (1,084 billion) will be cut in half (to 542 billion) and that the 542 billion not sent from the 5 nations will be replaced by 271 billion of domestic production and 271 billion of imports from other nations. Total imports into the U.S. will be 1,683 billion (1,954 total in 2006 minus 271). The trade deficit will be 667 billiom(1,016 exports minus 1,683 imports). The ratio of the trade deficit to imports will be .40. This ratio is 7 percentage points less that the actual ratio of .47 in 2006.

The price of the 542 billion of goods imports from the five nations and sold in the U.S. will increase by 20% (542 times .2 = 108 billion). This amount is .008 of the 14,158 billion spent in the U.S. in 2006 on Consumption and Investment. If the price increases in equal increments in the 7 quarters needed to get to a rate of 40%, the price increase each quarter will be .0011 per quarter or 4 tenths of one percent each year.

This seems like a puny result from a big change in approach to trade. I cannot support the proposition that the above calculations are reasonable. Whatever the results, a change in U.S. law will send a message that the U.S. no longer accepts a large trade deficit and that we are willing to change U.S. import laws in order to move toward equal trade.

If this proposed law is enacted and implemented, it will supersede and make void all current U.S. treaties and trade agreements with other nations that are contrary to the new law*, including membership in the World Trade Organization*

PART THREE - DISCUSSION AND JUSTIFICATION

PREPARATIONS FOR DEFENSE - **#11**

None of the five nations are expected to be pleased with the proposed law. How they will react is not known. The U.S. must be prepared to live with whatever actions other nations take

a. Smuggling.
Smuggling will be attempted by individuals and groups other than national governments. As the tariff increases, the potential gains from smuggling increases. The inability of the U.S. to prevent drugs from entering the U.S. is an indication that smuggling could become a serious issue.

Drug smuggling is aided by the small size – large value characteristic of drugs. Some imports are similar to drugs, but most are larger and less valuable per weight.

The U.S. must be prepared to spend more money on interdiction, as the size of the tariff increases. Fortunately, the tariffs collected by this law will greatly exceed any sum that can usefully be used against smugglers.

b. Refuse to send scarce and necessary imports to the U.S.
If the law is passed, the agency of the U.S. government must be assigned the duty to stockpile material essential to the survival of the U.S. and to establish relationships with exporter nations other than these 5 to ensure a continuous supply of essential imports.

c. Refuse to send any imports to the U.S.
This would be an outcome to be hoped for. This would leave a big hole for U.S. producers and producers in other nations to fill. The expansion of production facilities around the world that exists at the present says that the hole would be easily filled.

d. Refuse to accept any exports from the U.S.
This would be a more serious matter. The U.S. must prepare to survive if this option is embraced.

In 2008, 32% of U.S. exports went to our neighbors on the north and south – Canada and Mexico. The response of the governments of these two countries is crucial to the success of this proposal. If they can be persuaded to continue to accept exports from the U.S., without any added restrictions, other nations will not be able to use this threat to force Congress to retreat. In 2008, 54% of U.S. exports went to countries other than the five who will be discriminated against. If we can continue to export to all these countries and to Canada and Mexico, 86% of U.S. exports will continue

In 2008, 5.5% of our exports went to China and 5.2% went to Japan. Together, they account for around 11% of our exports, 24% of our imports and 45% of our trade deficit. These two countries have been the major beneficiaries of the current trading system. How they will respond to this initiative is impossible to predict. Whatever they do, the U.S. must be prepared to live with the consequences and/or to counter with whatever response seems appropriate.

e. Stop buying U.S. Treasury bonds.

If China stopped buying U.S. Treasury bonds, the interest paid by the U.S. to sell the bonds is likely to increase. The consequences of this increase are not as easy to predict as many commentators assume. How much the interest level will increase is not known. New buyers will move in as the interest rate goes up. The Net Worth of U.S. resident is clearly large enough to buy all the bonds the Treasury wishes to sell. Higher interest rates on Treasury bonds may or may not lead to higher interest rates on corporate bonds. Higher interest rate on corporate bonds will set a higher standard for expected return on investment, unless banks fill in the gap and reclaim their role as the providers of funds for investment. Higher interest rates paid on Treasuries and corporate bonds will lead to greater income for those retired citizens living on fixed income securities.

The Federal Reserve Board and the Treasury Department have demonstrated an amazing capacity to deal with liquidity problems in the banking industry. Whatever the consequences of less Treasury purchases by China, the U.S. government will take whatever actions are necessary to prevent higher Treasury interest rates from derailing the U.S. economy.

f. Possible inflation in the U.S.

The new law should contain a provision providing the U.S. Federal Reserve Board with the power to delay indefinitely any scheduled increase in tariff rates when that Board believes that an increase in the rate at this time would lead to an unacceptable level of inflation in the U.S. This stay will be removed only when the Board believes that the inflation threat no longer exists.

g. World public opinion.

This proposal is different from the usual protectionist action in that it is based on a good motive – to restore the world trading system to a more sustainable exchange with fewer deficits and less surpluses. It will not punish any nation in that equal trade will continue to allow export oriented nations to continue to increase the size of their domestic economy by engaging in trade.

Balanced trade is widely advocated. Which nation will oppose moving the world trading system toward balance?

THE FUTURE - **#12**

Will this proposal die quickly or will it gain traction? No one knows. At the moment it has no well regarded sponsors or defenders. It does need to be tested by argumentation and public debate.

If it does gain traction and become the law of the land, the law will be modified as experience accumulates. Events as they unfold after the law is passed and the will of the Congress will determine when and how the proposed law will be modified. Congress will be able to change this law any time it wishes. Mexico and Canada may be removed from the proscribed list rather quickly, if a significant proportion of U.S. plants now operating in those two countries return to the U.S. Other countries can be added to the list, if their trade surplus with the U.S. becomes a problem.

Change in the law must be carefully considered. For the law to achieve its purpose (increasing the number of good jobs in the U.S.) the restrictions must not be reduced. Firms must believe that these restrictions will stay in place for the foreseeable future – or until the targeted nations change their behavior.

Congress may wish to reconsider the criteria for choice of a nation to be subject to the tariff, after a few years. The criterion used herein is sheer size of the trade surplus a nation has with the U.S. An alternative criterion is the share of imports not matched with exports from the U.S. (percent of imports from each nation classified as U.S. trade deficit). This criterion abstracts from the size of the nation and focuses on the ability of the nation to accept exports from the U.S. relative to the imports they sell to the U.S. The U.S. will have plenty of time to examine this issue. Some formula combining the two criteria may be devised.

This law is intended not only to decrease the U.S. trade deficit with 5 countries; it is intended to send a message to all nations. Access to the U.S. market can no longer be created by treaty or agreement with administrative authorities. Access to the U.S. market will depend upon the behavior of our trading partners. No nation should expect to duplicate the recent experiences of Japan, China or Germany.

If the proposed law is passed, every national trading partner should aim to avoid excessive surplus with the U.S. so as to avoid the tariffs.

The smaller the U.S. trade deficit, the more stable the world trading system and the better the contribution of trade to the size of the U.S. economy.

THE UNITED STATES CAN MOVE TOWARD EQUAL TRADE - **#13**

From one perspective, reforming foreign trade should be easier than some other pressing problems (such as health care, federal debt or the financial sector) because reforming foreign trade disturbs fewer domestic pocket book interests.

There are however, intellectual issues blocking reform of foreign trade. Generations of economists have been taught, and continue to believe, that classical protectionism (discrimination by individual products) is the only alternative to free trade. Thus they support free trade because of the lack of a viable alternative.

This proposal for reducing the size of the U.S. trade deficit is the previously unavailable good alternative.

Because of their traditions, economists are expected to greet this invasion of their turf with suspicion and initial hostility, but they are rational people and this is a rational proposal, which should ultimately pass muster.

Equal trade is proposed as a goal to be substituted for the current goal of free trade. A new tariff regime is proposed, beginning at 10% of the value of the imported product, to begin 4 months after the law is passed and increasing by 5 percentage points each 4 months thereafter until a set goal is reached. These tariffs will apply only to goods manufactured in the countries of China, Japan, Canada, Mexico and Germany.

The U.S. created this unbalanced world trading situation by accepting more imports than our exports. It is up to the U.S. to correct the situation. The responsibility of the U.S. to correct its own problem was stated to Obama by the premier of China in their recent discussion of unbalanced trade. Here is your response to China, Mr. President.

This proposal has a rationale – equal trade promises a more stable and longer lasting global trading system and it guarantees that all participating nations will benefit from trade. Those countries that can reduce their trade deficit most will benefit the most but all will benefit from equal trade. Equal trade will insure that current trade surplus countries will continue to benefit from participation in trade.

Care has been taken to alleviate the most likely fears and potential objections.

1. The adjustment proposed is radical conceptually (quite different from present practice) but the change proposed is marginal. Imports will continue to arrive in the U.S. as before – hopefully, at a gradually decreasing rate.

2. The U.S. government will set the conditions under which imports enter the U.S. Private sector competition will determine what goods are sold.
3. Consumers who might fear price increases will be reassured by the role assigned to the Federal Reserve Board – to delay tariff increases when inflation threatens. Also, a continued supply of imports into the U.S. will be assured because most trading partners will face no increase in tariffs. Competition between importers and U.S. producers will persist and will hold down price increases
4. Possible retaliation by affected nations has been discouraged by excluding most nations from the tariffs, by recognizing that Mexico and Canada are essential allies, by beginning slowly, allowing the affected nations time to adjust and by providing a sensible rationale for the proposed change.
5. Firms with sunk investments in any of the 5 countries will be given months, perhaps years, to adjust their production locations to the new realities. If the time between tariff increases is too short (now 4 months), the time can be extended. A balance will be sought between concern for sunk investments and desire to get the benefits of better trade as soon as possible.
6. Elimination of tariffs applied separately to each individual product has removed a major objection to tariffs – namely, the argument that the use of tariffs will open the door to Congressional log-rolling to benefit their district.
7. Economists can continue to recognize and assert that free trade is an ideal that would maximize trade benefits to the world, if it could be implemented. However, they will be asked to agree that the ideal has proved to be a failure as a guide to any nation's trade policy in the real world of competition among nations. Without 100% compliance among all trading partners or manufacturing dominance, adherence to the free trade ideal prevents a nation from gaining significant benefits from foreign trade. This proposal claims to be based on current realities. Economists will be asked to evaluate this proposal solely in terms of its likely consequences.
8. The five trading partners selected for imposition of tariffs were chosen by statistical analysis. Our deficit creating trading partners have been treated with respect. They have earned respect. They have succeeded in a competitive environment by taking advantage of the opportunities presented to them, as each leader of a nation should do. The hope is that they will recognize that world trade will become sustainable by reducing the size of trade deficits. And that reduction of trade deficits depends upon reduction of trade surpluses.

The fact that the size of the goods trade deficit relative to goods imports has decreased by 13 percentage points in the last 4 years argues that achievement of an additional improvement of 11 percentage points is possible.

. ME AND MY TEXTBOOK - #14

More than a decade ago, I acquired the 1994 version of the classic textbook on trade titled "*International Economics"* by Paul Krugman and Maurice Obstfeld. This book provided the basis for understanding both international trade and what was taught to undergraduates about international trade. I wanted to learn what the economics profession has to say about the U.S. trade deficit.

I was encouraged to encounter, on page 2, a chart showing the spread between imports and exports that developed in the U.S. after 1983. And this sentence: "Since 1980, the gap between imports and exports has been one of the most heated issues of U.S. economic controversy".

This sentence was all this textbook had to say about the U.S. trade deficit. Trade deficit is listed in the Index but only one page is referenced, the page which includes this sentence. What kind of a textbook is this, that refers to an issue as "one of the most heated" economic controversies then has no more to say on the subject? There are glancing references to this issue but not enough prolonged discussion to qualify for a page reference in the Index.

I found myself at odds with this book throughout. For me, the central question is a normative one – what should governments do about foreign trade? Should they try to increase the volume of world trade? Should they concentrate on managing trade so as to get the most benefit for their country from world trade? Or should they take no stand on world trade as it affects their nation – be a bystander, ignore what trade is doing to their country and their economy? This is the practical question I thought should be central to the textbook.

Apparently, the economic profession does not focus instruction of students on heated controversies or on practical guidance for governments but instead provides instruction in models, ways of looking at trade, that provide the tools students need to be able to think like an economists.

But I had no interest in a career as an economists. I wanted to know what should be done about an obvious serious pressing problem.

The central question for me, trying to use the ideas in the textbook, was what do the models provided tell me about the U.S. trade deficit? The answer is very little. None of the models assume that trade will be unbalanced. They all assume equal trade.

The instruction focused on two abstractions – supply and demand curves. The instruction showed the various use and conclusions that can be drawn from supply and demand curves. But the connection between reality and these graphs remained uncertain. There must not be a simple way to know exactly how supply and demand curves should look to represent different conditions in the real world.

I learn, from another source that: "Demand and supply relations in a market can be statistically estimated from price, quantity, and other data with sufficient information in the model. This can be done with *simultaneous-equation methods of estimation* in econometrics. Such methods allow solving for the model-relevant "structural coefficients," the estimated algebraic counterparts of the theory". But this text did not solve the problem of how to translate the knowledge gained form econometric models to tell us what the slope of these curves should be in specific situations.

My skepticism about theusefullness of these models was reinforced when the discussion turned to the important issue of the gains from trade experineced by nations. This book said that the welfare effect of trade on a nation depends upon the price of exports divided by the price of imports. I could not get a clear answer as to whether this is unit price that is being measured or price times quantity. I inferred that this is unit price, not price multiplied by the number of units. If this inference is correct, this is a mistake. The welfare effects of trade are the total costs of exports minus the total cost of imports, our familiar trade balance which is a trade deficit when the balance is negative. Price per unit is of minor importance. If terms of trade gains are unimportant, the welfare gains argument based on unit price is undermined.

This focus on unit price enables the authors to show that the declines in price for the U.S. between 1967 and 1991 have been negligible; therefore the U.S. has not suffered from recent trade. The conclusion does not follow from the data.

The model developed in Chapter 5, The Standard Trading Model was a disappointment because it did not deal with a world in which trade deficit and trade surplus are important. Instead, it talked as if the gap between imports and exports can be ignored when discussing the welfare effect of trade.

The lines drawn on a chart to represent change in price due to change in supply and demand are purely hypothetical. No evidence is presented that the lines as drawn represent reality. A chart of this type shows that a tariff is undesirable because it raises the price in the country imposing the tariff producing distortion in both production and consumption. Distortion from what? How do we know that the existing price does not itself produce distortions from a perfect free trade environment? A *reductio-ad-absurdum* argument would say that this chart shows that anything less than perfection (free trade as idealized – all countries opening their borders to all imports) is less than perfect. Deviation from an idealized state that cannot be realized (for reasons discussed in Chapter 2) is irrelevant to me.

My version of a proper cost-benefit analysis of trade would begin with the consumer faced with a choice between two objects – say cars, for example. The foreign made car costs 10% more than the domestic product but the consumer would be willing to pay 20% more for the foreign made car – he thinks it is that much better than the domestic car. The domestic consumer gets a 10% gain in consumer surplus by purchasing the foreign car. The domestic produced car that is not sold reduces domestic GDP by the sale price of the domestic car. Whatever number is assigned to the consumer surplus, it cannot be

but a fraction of the total cost of the domestic car. If the loss of domestic production, in dollars, can be compared with the consumer surplus, in dollars, it is clear that the U.S. economy loses more than the consumer gains when the foreign car is sold in the U.S.

This does not justify raising tariff on foreign automobiles. Tariffs on individual products are counter productive. It does show that the textbook cost-benefit analysis, which ignores the effect of consumer choice on domestic production, is short sighted.

The only alternative to free trade, in this text, is protectionism. "If the gains from trade is the most important theoretical concept in international economics, the seemingly eternal battle between free trade and protection is its most important policy theme". Protectionism is not defined in this book, so far as I can tell. The subsequent discussion is all about protectionism as it has existed historical – tariffs or restraint on imports imposed on each good separately. Protectionism means discrimination by product, if we limit the definition to what is discussed in this text.

This limitation ignores the possibility of discrimination by some other category. Warren Buffett proposed use of import certificates to restrain imports into the U.S. The value of the import certificates would be limited to the value of exports from the U.S. It is clear that this proposal is not protectionism as discussed in this text because it does not discriminate by product.

My proposal in this text – to impose tariffs by country rather than product – is another option that does not rely upon discrimination by product.

The authors are not interested in discussing alternatives to free trade. They want to use the failure of classical protectionism to bolster the case for free trade. Their ploy will not sell. Other alternatives to free trade can be imagined that are not classical protectionism.

My textbook did not take the trade deficit seriously, contrary to the statement in the introduction. The trade deficit is not discussed in the initial section which focuses on exports and imports. The trade deficit issue is deferred to the financial section and is discussed in terms of the Current Account balance. That placement of the issue avoids the confrontation with the issues raised in this document. Not all issues can be avoided. The last two sentences in the Balance of Payments chapter are as follows: "Unfortunately for the United States, most of its foreign borrowing over the 1980s financed government budget deficits rather than investment, as we saw in the last Case Study. Future generations of U.S. citizens therefore will face a real burden in repaying the resulting foreign debt".

This statement should (in my mind) have been followed with a recognition that trade deficits are dangerous for the U.S. in the current circumstance and should be avoided. Instead, we find a discussion of what nations tend to do rather than what they should do. That neutralizes the issue. Perhaps I expect too much from a textbook.

The flow of funds from the U.S. to other nations does result in resources owned by foreigners which have been used to acquire much U.S. Treasury debt. The funds were made available by a trade deficit. But they could not have been used to purchase Treasury debt had the U.S. government been continuously living with a balanced budget. Trade provided the means. U.S. Treasury provided the opportunity. Freedom to use the acquired dollars as they see fit allowed foreign nations to stockpile U.S. financial assets in their Reserve Funds. These assets allowed China to pay for a large stimulus package that built need infrastructure. It also allows China to control the exchange value of their currency, insuring continued trade surplus for China.

The hidden harm that a trade deficit does to an industrialized nation is elimination of some of the productive capacity in the manufacturing sector. This harm is more important than the financial bind. If the U.S. possesses productive capacity to enable it to sell products in the international market, the financial loss can be replaced. Without a growing ability to export, the U.S. economy will have great difficulty repaying debts. This textbook ignored this reality.

In summary, my textbook focuses on models which are idealized versions of reality. The discussion that follows the presentation confronts the question of the utility of the models by showing how and when they are applicable to real world situations, sometimes. But this discussion is missing when the all important issue of the welfare effect of trade are discussed or when cost-benefit is discussed. Even when the utility question is admitted, the discussion is uneven – sometimes convincing, often not. This textbook failed my test. It did not provide a clear understanding of why the U.S. has a trade deficit, what are the consequences of a trade deficit and what could be done to move toward a more desirable state of affairs.

I hope more modern textbooks will avoid some of these problems. The data for this version ended around 1991 – the year when the U.S. trade deficit in goods hit bottom. The 1991 data did not show that the trade deficit was a problem, at that time. Timing is a mitigating factor. Whatever the reason, this textbook did not deal adequately with the U.S. trade deficit.

My preference would be to have a textbook begin as this essay began – with a discussion of Gross Domestic Product and the role that trade plays in creating Gross Domestic Product. Trade is a macroeconomic level event. The discussion should concentrate on nations productive output first so as to understand what trade does to expand domestic production.

ME AND ADAM SMITH - #15

Adam Smith established the importance of markets in creating wealth in a nation, in motivating entrepreneurs, in allocating use of scarce resources, in assisting the development of specialization of productive activities.

Because trade expands the size of the market that can be served by one firm or one factory, trade increases wealth by increasing specialization. Specialization is one way to increase productivity per man hour.

Everything Smith says about trade and markets is accurate, so long as the trade is within one nation. Internal trade played a major role in assisting the growth of the U.S. economy in our "Golden Era" from 1876 to 1919. Internal improvements created railroads and highways to bring farm produce to market, to transport new machinery to the farms. Productivity exploded in the U.S. due to new inventions, the use of machinery on farms, immigration of foreign labor, the movement of the labor force from agriculture to industry and the high quality of the unexploited raw materials in the U.S. So long as the trade and specialization occurs within one country, all the productivity gains of the entire system stays within one country. When we have foreign trade, each nation gains in terms of what part of the system they supply and the productivity per man hour created in that country. Supplying raw materials for manufacturing in another country is always less productive per man hour than the manufacturing process which transforms raw materials into a more valuable product.

Smith said one good thing about foreign trade – that is was not necessary to achieve a trade surplus in order to benefit from trade (a proposition supported by Table One in Chapter One of this essay). But he made a mistake when the he provided arguments to support the proposition that a trade deficit is harmless and should be ignored. These arguments are unpersuasive. Their quality is shown by the fact that they are not repeated by modern defenders of Free Trade.

The first 2 chapters of this essay provides evidence that a trade deficit reduces both the financial assets in a nation and the size of Gross Domestic Product below what would be achieved with equal trade.

The logical next step after showing that equal trade will allow a nation to profit from trade and to expand their Gross Domestic Product via trade, is to argue that equal trade is the desirable trade policy goal for each nation because it prevents the beggar-thy-neighbor strategy.. Smith rejected that option. I think I know why. He was consumed by the loss of productivity in both England and France because both nations were quick to impose import restrictions on whatever product an influential factory owner or broker argued was being discriminated against by the other nation. He believed that the goal of equal trade would not eliminate this tit-for-tat action, given the history of conflict between France and England. The audacious goal of every nation opening its door to imports from everywhere cut off all possibilities of using legislation to restrict imports of any products.

Besides which, free trade, if enacted by all nations, would elevate the productivity level of each nation that participated in the trading system. He ignored the fact that free trade opens the possibility of trade surpluses and trade deficits – I think because he knew that England was in a position to create trade surpluses.

Smith railed against "Mercantilism". The part of his argument that was correct was that a trade surplus is not necessary to benefit from trade and that piling up wealth in a nation due to a trade surplus is not needed to benefit from trade. He was wrong in so far as he implied that a trade surplus would not benefit a nation (I am not sure he went this far. If he did, he was wrong).

Smith used a logical fallacy to sell his vision of Free Trade. "All commerce that is carried on betwixt two countries must necessarily be advantageous to both" and therefore "all duties, customs, and excise [on imports] should be abolished, and free commerce and liberty of exchange should be allowed with all nations". Another famous quote is "What is prudence in the conduct of every family can scare be folly in that of a great nation".

What is true for an individual member of a nation is not necessarily true for the nation as a whole. To assume to the contrary, as Smith does, is called the Fallacy of Composition. Many instances exist where an action will benefit one member of a group but will harm the group as a whole. Running for the exit in a crowded theater when a fire breaks out is an off cited example. I used the example of an individual in the U.S. purchasing a foreign car because this purchase increases his consumer surplus but it has the effect of reducing the Gross Domestic Product of the U.S. by the size of the value of the non-sold U.S. competitor car.

Foreign trade is normally carried on between private firms and individuals living in different nations. It is correct to assume that trade would not exist unless both parties to the trade expected to benefit from the transaction. But individual benefits do not always translate into group benefits. These individual transactions have implications for the wealth and size of the Gross Domestic Product of each nation. A trade deficit is not a characteristic of an individual trade. A trade deficit is a characteristic of a group of trades summarized. Trade deficits should be examined in terms of their impact on the nation as a whole.

The present consumer is reduced to a non-factor or a secondary factor in this discussion. However, correcting a trade deficit has long term benefits for future consumers. This perspective says that the well being of future consumers (since they are more numerous) takes precedence over the preferences of current consumers. The marginal impact on current consumers is less corrosive than the long-terms enfeebling of the U.S. manufacturing sector.

To repeat a previous point, Free Trade served England well when it was the dominant manufacturing nation. Free Trade served the U.S. well when the U.S. was the dominant manufacturing nation and trade was a useful weapon against communist expansion.

CASTING A WIDER LOOP - #16

At the end of the year 2009, the U.S. was in the process of deciding what political philosophy will succeed the assumptions of the Reagan Era. Reagan was elected on a promise to roll back taxes, to increase military spending, to balance the budget and reduce excessive activism at home of the Democratic Party. His one-liners were effective – "I'm from the government and I am here to help you" and "If they don't have it they won't spend it". After in office, his actions showed that he was willing to use the power of the Federal government overseas but not at home. He succeeded in reducing taxes and increasing military spending. He failed to balance the budget or to reduce the size of the federal government. The details of the struggle and failure to reduce the size of government is described in the tell-all book by David Stockman, the man in his first administration charged with reigning in excessive governmental actions. The title of the Stockman book summarizes the contents: "The Triumph of Politics".

Other failures of his policy occurred long after he left office. The collapse of the U.S. financial system in 2008 showed that governmental regulation of the financial system is necessary. The inability of the U.S. military to conquer and control Vietnam and Iraq made the point that the U.S. military cannot impose its will on foreign nations.

What to do next? Despite setbacks, the fundamental assumptions of the Reagan era remain in the minds of many, even after deficiencies are exposed. The U.S. is still attempting to gain military control of Afghanistan. There has been no official rejection of the long standing policy of creating and maintain a military establishment strong enough to protect foreign allies from invasion by other nations. The Bush policy of trying to eliminate breeding grounds for terrorists cells in other nations has not been rejected.

Obama was elected on a program of not continuing with the status quo. He has not fulfill his promise, up to now.. Obama and his administration appear destined to provide this country with Reagan-Lite (modify the status quo slightly).

When Obama runs for a second term, he will have the opportunity to run on a platform of rejection of the Reagan consensus, if he has the nerve to do so. Only by campaigning for a specific proposal will he be able to lead the country to a strong new beginning.

1. Should the U.S. continue to maintain a protective military umbrella to protect the sovereign of national allies? Obama should say No – and explain and defend his decision.
2. Should the U.S. budget be dominated by military spending? Obama should say NO – and explain and defend his decision.
3. Should the U.S. government guarantee all contracts entered into by all financial institutions in the U.S.? Obama should say no. And he should task his subordinates to develop, within the next year, a way to isolate regulated financial firms from non-regulated financial firms. Those financial institutions that provide safe storage of financial assets

and who fund expenditures of non-financial firms and citizen deserve Federal protection and regulation. Those financial firms who wish to engage in gambling should be allowed to do their thing – but with someone's money who wants to gamble. New, tough regulations are required for financial institutions who wish to be supported by U.S. taxpayers. Gambling oriented financial institutions should be allowed to exist outside the governmental system.

4. Should the Federal Government adopt some form of Single-Payer health care system, modeled after the best procedures developed in foreign countries, that is most in accord with the U.S. citizens preference to allow wealth to ration access to scarce resources? Obama should say Yes – and provide an explanation of the merits of the single payer system and the modification needed for the U.S. which creates a two-tier system – one for those who can afford to and wish to pay extra for extra care – and another for those who must be satisfied with the system that can be supported from taxes. This single payer system will not provide governmental support for health care insurance. The legal system must be overhauled to recognize that doctors are human rather than omniscient.

Before he runs for a second terms, Obama must provide a demonstration for the public of the ability of his administration to take charge of some domestic problem and to provide an effective solution. The shortage of good jobs in the manufacturing industries is the problem he should tackle. The solution to that problem is to change U.S trade policy – to abandon the goal of free trade and embrace the goal of equal trade. The intellectual rationale for such a shift is provided in this document. The new law that will implement this new policy is described in this document (Chapter 10)..

CONCLUSIONS - **#17**

This paper advocates that a 50 year old tradition be reversed. I do not take this position lightly or without research. I hope this conclusion will be critiqued and evaluated by others.

For 50 years, the U.S. has led the other nations of the world on a quest to reduce barriers to trade. That tradition should be reversed. Today's world requires that nations experiencing a persistent trade deficit should take steps to reduce the volume of imports into their country.

A new perspective for viewing international trade, focusing upon the effect of trade on Gross Domestic Product, leads to the conclusion that all nations should seek equal trade rather than free trade. The main findings from the focus on GDP is presented below.

Table One, page 6 of this document, showed that the U.S. goods trade deficit in 2006 reduced Gross Domestic Product for the nation by 6.7% from the level of GDP that would have existed if exports and imports had been equal. The size of the goods trade deficit for the year 2006 is listed as 861 billion (6.4% of GDP) in the latest GDP figures reported by BEA (U.S. Bureau of Economic Analysis). Table 1.10 in the GDP series shows that the income earned by creating GDP [Gross Domestic Income] in 2006 went to two main recipients: [Compensation of employees] and [Net operating surplus]. Six point four percent of each of these detailed numbers is 478 billion for compensation of employees and 227 billion for Net operation surplus. The inference is that the 6.4% deviation from equal trade cost the U.S. economy a total of 705 billion not paid in either compensation or profits. These numbers are accurate but the zero percent goods trade deficit is considered to be unattainable and unnecessary. Cutting the goods trade deficit in half is a reasonable goal. Half of 705 billion is 352 billion in additional compensation and profit available to U.S. citizens and business firms if the U.S. trade deficit had been half of its actual level in 2006.

This discussion assumes that expenditures by consumers and business firms would have been the same without the trade deficit. This assumes that people make choices among the products available to them and that removal of the most desirable products does not reduce consumption of the most desirable products still available.

I consider these numbers as irrefutable evidence that the goods trade deficit in 2006 created a measurable reduction in employee compensation and profits compared to what would have existed if the goods trade deficit had been half its real level. In addition, the actual goods trade deficit of 861 billion required 861 billion of dollars or other financial asset to be sent overseas. These are measurable consequences. A very important immeasurable consequence is the loss of the knowledge, skills, tools, building, and organization expertise when fewer goods are produced in the

U.S. Each additional increment of a trade deficit reduces the capacity of the U.S. to compete in future trade contests with other nations.

On the other side of the ledger, each dollar of the 1.9 trillion dollars of imports purchased in the U.S. in 2006 provides some degree of consumer surplus to the purchaser (consumer surplus is the difference between what a purchaser would be willing to pay for an item minus the amount actually paid)(this number is imagined, a guess). If the consumer surplus amount to 10% of the purchase price, on average, the consumer surplus due to 1.9 trillion of imports would have been 190 billion in 2006 – a number that is close to the 325 billion gains if the goods trade deficit is cut in half. No one knows the proper estimate of the size of the consumer surplus.

I am willing to assume that the consumer surplus eliminated by reducing the trade deficit in half may be somewhere close to the gain of Gross Domestic Product. In that case, the welfare of current consumers is pitted against the welfare of future citizens of the U.S. My judgment is that all rational minded citizens who are concerned for the future of the U.S. economy would vote in favor of reducing the U.S. trade deficit. The loss to current consumers, spread over all consumers and all imported products, can easily be absorbed by current consumers, but the loss of wealth and jobs and future production capacity more than outweighs the gain experienced by current consumers.

In addition, consumer surplus is a theoretical number, not a real one. It represents the feeling of satisfaction one has when a purchase is a bargain. Since it is subjective, it is possible that consumer surplus accompanies every purchase. The purchase would not have been made absence a feeling of satisfaction. The feeling is real but it may not be controlled by anything in the external environment. It is not clear that the consumer surplus for the purchases in the U.S. will be any less after 542 billion of products formerly supplied by the 5 surplus nations is instead supplied half by other importers and half by domestic production in the U.S. The consumer decides what he is willing to purchase and how much more he would be willing to pay when contemplating the options before him. The subjective judgment that a bargain is purchased may be the same in any external reality. In short, I would hope that no one will decide against reducing the trade deficit for fear that some subjective satisfaction that <u>may</u> be lost is equal to the easily quantified harm a trade deficit does to a nation's economy.

Preliminary data for the year 2009 from the Bureau of Economic analysis reports a goods trade deficit of 535 billion, 3.8% of GDP (59% of the 2006 number) and a ratio of the trade deficit to imports, for goods, of 40% (compared with 46% experienced in 2006). Forty percent is still 17 percentage points above the 23% goal suggested previously in this paper. The change for 2009 is almost all due to a reduction in imports, which I advocate. However, in this case, the reduction in imports is due to the recession which has produced a loss of confidence in the future on the part of both private consumers and business firms in the U.S.

My proposal is for a federal law aimed at forcing down imports, regardless of consumer and business confidence. I want a law today that will prevent a resumption of a large trade deficit as has happened every time in the past when the U.S. recovers from a recession.

The solution proposed, in Chapter 10, is valuable because:

1. It focuses directly on the size of the trade deficit. The most efficient way to reduce the trade deficit is to act against the nations that are creating the problem.
2. By excluding all nations except 5, continued trade with the rest of the world is assured.
3. By including China in with 4 other nations, we are not directly attacking China alone – a necessary condition, in my opinion.
4. The change each year will be small, thus easily accommodated, but the ultimate result will be very helpful to the growth of the U.S. economy.
5. Acceptance by the Congress is helped by the specificity of the proposal. There is no need to negotiate about the details. No interest group, no part of the nation, can gain by modifying the timing, the size of the tariff, or other details.
6. It is a data based proposal. Good neighbors, like Canada and Mexico, are treated the same as the other 3 countries.
7. Competition among producers is preserved, as is consumer sovereignty. This solution respects American traditions and preferences
8. The government is not forced to pick winners and losers among domestic producers.
9. This proposal does not cost the government. Instead, it adds revenue to the Federal coffers.
10. Likely objections to this proposal have been anticipated and countered in the discussion in the previous pages.

THE END