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Why Fixing Trade Deficits Is Essential

Trade and budget deficits will eventually catch up with us, and the effect on the dollar won't be pretty.

By
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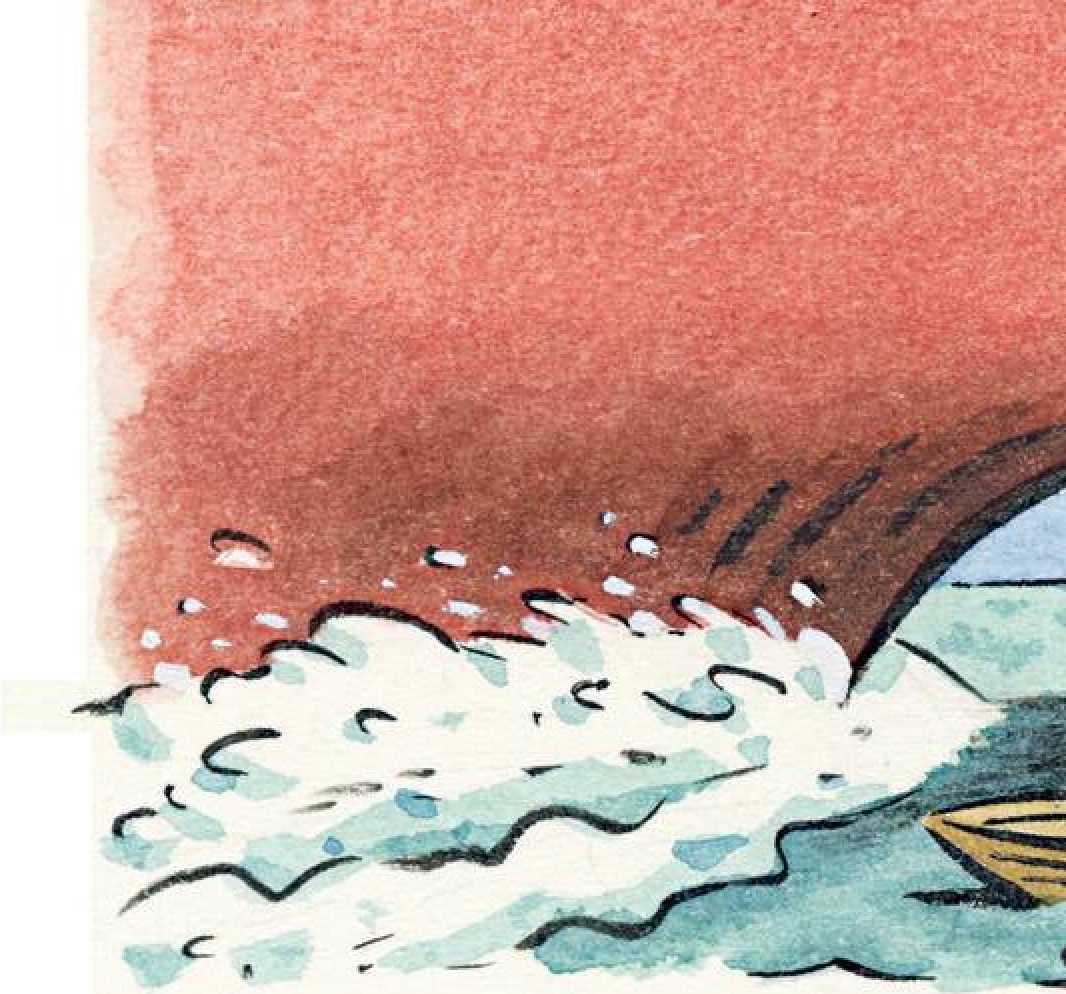
IMPORT

In 1965, when we imported less, manufacturing employed 24% of the U.S. workforce. By 2015, substantial portions of our manufacturing base had moved overseas, and domestic manufacturing had shrunk to just 9% of employment.

The U.S. has now run a trade deficit for 40 years, and at present levels our annual current-account deficit of $400 billion to $500 billion will aggregate additional deficits of $4 trillion to $5 trillion in only 10 years. However, despite the largest cumulative current-account deficit in world history and a plunge in manufacturing as a share of our economy, the U.S. seemingly persevered without a definitive penalty.

So, do trade and balance-of-payments deficits really matter?

Not according to U.S. Sen. Ron Johnson, Congressman Ron Beyer, and many other U.S. politicians. However, history will attest that no country has incurred perennial trade deficits, imported and borrowed more than it exported or lent, and seen its currency live to tell about it.

Much of the demand for U.S. dollars is derived from its reserve-currency status, since the U.S. dollar is commonly held as a means of exchange and lending between independent third parties and not as much for claims on actual U.S. production. Therefore, Americans get the benefit of a higher value for their dollar, and this results in an ability to borrow capital and buy foreign products at lower prices, thus incurring trade deficits. Because reserve-currency status can prevail only alongside confidence in our dollar, the longer U.S. trade deficits go on, the greater the crisis when they cease, voluntarily or involuntarily. Consequences of imprudence often occur when least expected. The 2008 housing crisis is a case in point.

The approaching danger is that in one year or five, we will experience one $40 billion monthly current-account deficit too many, resulting in a decline in the dollar that extends in greater duration and magnitude than the economic climate might dictate. Economists will be mystified, but we will be catching up and paying penance for long decades of trade and budget deficits. On that day, nothing will save the dollar, not the corporate profits offshore, not more Japanese purchases of U.S. Treasuries, not presidential jawboning. Nothing.

At the outset, the degree of upward pricing in imports will overwhelm even the best of optimists. The Toyota, once closely priced to the Chevy, will double, and the U.S. consumer will rapidly devour all outstanding inventories of Chevys. However, enhanced foreign purchasing power will then bid up for domestic U.S. production, and the U.S. buyer will be priced out. Foreign investors will also buy up U.S. farmland, mines, and other industries on the cheap. Understandably, it is hard to imagine such a scenario in today’s disinflationary economy. Nevertheless, unable to afford imported goods, Americans will seek to buy shoes, only to find they aren’t made in America. They will search for televisions, only to find they aren’t made in America. They will ruefully realize that the same applies to Rawlings baseballs, Gerber baby food, Etch A Sketches, Converse sneakers, stainless-steel rebar, Mattel toys, minivans, vending machines, Levi jeans, Radio Flyer wagons, cellphones, railroad turnouts, Dell computers, canned sardines, knives, forks, spoons, and lightbulbs.

Americans will wistfully wonder where their manufacturing base went and how they lost more than 63,000 factories just since the year 2000.

The U.S. urgently needs a plan that will mitigate future long-term trade and budget deficits, an overall blueprint where everyone is better off, including our trading partners. Therefore, I propose that when the U.S. runs a trade deficit with any country for five years, an automatic import limit comes into play in the sixth year, mandating a reduction in the trade deficit with that specific country by 20%. A 10% increase in U.S. exports and a 10% decrease in imports relative to that country would fit the bill, but either way, an additional 20% annually mandated reduction in the trade deficit would continue for four more years until trade is balanced. Then, the law would go into hibernation for five years, allowing free trade with that country to resume. No tariffs, just a country-specific trade-deficit limit to act as a current-account safety mechanism to reduce the dangers of de-industrialization.

This gradualist method would also ensure that our trading partners' interests would be aligned with ours, providing them with a strong incentive to buy more U.S. products. As a result, they would bring to bear innovative solutions on how to import more of our products so that they could

export more of theirs. Ultimately, this would be a much firmer foundation for world trade.
However, modifications in our trade policy aren't the only changes required for the U.S. economy to improve. We need a return to fundamentals that mandate significant reductions in corporate and personal income taxes, as well as government spending and entitlements. A flat tax of 22% at the federal level with a maximum combined state and local income tax of 4% would revive U.S. fortunes better than any single factor. It is no coincidence that Hong Kong, with a maximum 16% income-tax rate, has over the long term been one of the world's best-performing economies. These fundamental changes would result in greater prosperity by increasing aggregate savings, investment, and demand.

If we fail to mitigate our long-term trade deficits alongside our cumulative budget deficits, we will eventually destroy many of our remaining industries, as well as our military. Forty years of trade deficits might lead one to agree with what we are told; that trade deficits, like budget deficits, don't really matter. However, as international economist Rudiger Dornbusch warned, "In economics, things take longer to happen than you think they will, and then they happen much faster than you thought they could."

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