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RE-BALANCING U.S. TRADE AND CAPITAL ACCOUNTS

**An analysis of Warren Buffett's
import certificate plan**

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Since the mid-nineteen seventies, the United States has developed large and growing trade deficits. These deficits have displaced millions of jobs in U.S. manufacturing industries, and millions of other jobs in resource, construction and service industries that provide inputs to manufacturing (Scott 2008). These deficits have been financed by selling trillions of dollars of U.S. assets to foreigners. As Warren Buffett (2003) noted, U.S. net assets are being transferred abroad to pay for these deficits at an “alarming rate,” and at the end of 2008 the U.S. net international investment position was -\$3.5 trillion (Bureau of Economic Analysis 2009).¹ Buffett proposed an innovative plan for eliminating the U.S. trade deficit through the creation of an import certificate program.

Buffett proposed to give import certificates (ICs) to exporters in exchange for each dollar’s worth of goods produced domestically and sold abroad. Exporters could retain those certificates for their own use (to purchase imports), or sell them in a special commodity market for ICs. Surplus certificates would be sold at market value to firms wishing to sell goods in the United States, acting as a type of quota-license for all U.S. imports.

- The ICs would sell at a premium of perhaps 10% to 20% over their face value, given that demand for imports exceeds that for exports by a substantial amount (as reflected in the trade deficit). The IC plan is, in effect, “a tariff by another name” according to Buffett, but one that would also benefit exporters.

Senators Byron Dorgan and Russell Feingold introduced legislation in 2006 to implement the Buffett plan (S. 3899). Their proposal would gradually phase in the Buffett plan, steadily eliminating the U.S. trade deficit.

This report examines Buffett’s proposal in the context of current and expected future trade deficits, and summarizes four research reports which evaluated aspects of the Buffett plan. They are:

- Blecker (2009): *The Trade Deficit Trap: How it got so big, why it persists and what to do about it*
- Garr and Scott (2009): *Restoring the U.S. Trade Balance: How lessons from emissions trading can inform the Buffett proposal*
- Papadimitriou, Hannsgen and Zezza (2008): *The Buffet Plan for Reducing the Trade Deficit*
- Stewart and Drake (2009): *Addressing Balance-of-Payments Difficulties Under WTO Rules*

These reports suggest a number of ways in which the Buffett and Dorgan/Feingold plans might be improved. Key findings include:

- Many developed and developing countries have implemented broad-based restrictions on imports when faced with “balance of payments difficulties.” Stewart and Drake (2009) show that the U.S. trade and payments imbalances meet the standards established by the GATT and

¹ A trade deficit must be financed by an equal and offsetting capital inflow, which is achieved through the sale of net U.S. assets to foreign holders. This is an accounting identity which must always hold true. If the rest of the world is running a trade deficit with the United States, then individuals and/or governments in other countries are accumulating a net stock of dollars, which are usually converted into interest- or income-generating assets. Net purchases of U.S. treasury bills and other government-backed assets by foreign central banks have essentially financed all U.S. trade deficits since 2000. This reflects widespread currency manipulation by many governments, especially China (see Bivens and Scott 2006)

WTO for imposing such restrictions. One of the most important examples of broad-based trade restrictions was the 10% across the board surcharge on U.S. imports imposed by President Nixon in August, 1971. Stewart and Drake (2009) note that “the primary goal of the surcharge was to push trading partners to revalue undervalued currencies and thus remedy the emerging U.S. trade deficit. The U.S. also demanded that major trading partners eliminate certain trade barriers and make additional contributions to common defense projects. “

- The Nixon administration convinced trading partners to revalue their currencies and to remove trade barriers, and it announced the removal of the import surcharge four months later in December, 1971. Passage of the Buffett plan, or similar package of trade remedies, could help persuade trading partners, especially China, to adopt similar policies now.
- Papadimitriou, Hannsgen and Zezza (2008) of the Levy Institute show that implementation of the Buffett plan would stimulate the economy and that its impact on prices would be limited. They estimate that net profits of exporters would rise by an amount equal to 1.2% of GDP and that GDP would rise by a similar amount. The IC system would cause import prices to rise by nine percent, pushing inflation up to slightly more than four percentage points in the short term. The Levy study assumed that the Buffett plan would be implemented immediately, with no phase in as in the Dorgan/Feingold proposal. The authors also expressed concerns that the plan would give rise to retaliation and therefore developed an alternative policy proposal which would reduce these concerns (discussed below). Buffett, on the other hand, claims that retaliation is unlikely.
- Blecker (2009) analyzes the causes of steadily growing U.S. trade deficits and examines claims that the trade deficit is “caused” by growing U.S. budget deficits. He finds that there is no statistically significant relationship between shocks to (changes in) the government budget balance and the U.S. current account balance (the broadest measure of U.S. trade balance). Blecker concludes that the U.S. is caught in a “trade deficit trap” and that no single policy is likely to eliminate U.S. trade deficits. Dollar devaluation, especially against the Chinese renminbi and other currencies that are systematically undervalued against the dollar is a necessary first step. However, other measures are also needed to “rebalance global demand” by encouraging more consumption (and rising wages) in China and other chronic surplus countries. The U.S. also needs to rebuild domestic manufacturing capacity, which has been decimated by structural trade deficits. Such measures would include public investments and other forms of industrial policy (such as a National Investment Bank—Scott 2010).
- Garr and Scott (2009) address concerns that the prices of ICs could become excessively volatile, and review the literature regarding policies designed to address climate change, specifically through cap and trade systems for reducing Green House Gas (GHG) emissions. The paper concludes that several policy instruments can be used to mitigate price volatility. These include banking and borrowing of ICs, direct auctioning by the Commerce Department (discussed below) and the importance of enforcement and transparency in ensuring effective operation of the system.

This report also simulates the likely impacts of Senator Dorgan and Feingold’s (S. 3899) proposal for gradually phasing in the Buffett plan between 2010 and 2020. If their plan is implemented, it would have large benefits for U.S. manufacturing industries and it would support a substantial expansion in exports and import-competing industries as well as employment in these highly productive sectors of the economy. The plan need not severely curtail imports or the supply of imported components. Though concerns have been raised regarding potential volatility of IC prices, these could be addressed through measures such as banking and borrowing of certificates.

Background

The U.S. has had a steadily growing goods and services trade deficit since the mid-1970s, as shown in **Figure A**. This deficit reached a peak of 6.1% of GDP in the fourth quarter of 2005 (deficit figures are shown on the right-hand axis in the figure). The goods and services trade balance is very close to the current account balance, the broadest measure of all U.S. income from trade in goods, services and income flows, as shown by Blecker (2009 Figure A). Goods and services trade are shown here because they provide the most up-to-date trade data available.

U.S. trade and current account deficits are closely related to changes in the real value of the dollar (shown on the left axis in Figure A). Increases in the real value of the dollar make U.S. exports more expensive and less competitive on world markets, while lowering the costs of imports and making them more attractive to domestic consumers. Therefore increases in the value of the dollar usually lead to rapid growth in the trade deficit, with a lag of a few years. Several dollar value/deficit cycles are clearly shown in Figure A. The dollar soared to a peak in the mid-1980s and then fell sharply, leading to a peak in the trade deficit that persisted through mid-1987. The deficit declined sharply in a trend that lagged two to three years behind the fall in the dollar, and trade was roughly balanced during the 1991-92 recession (recessions also tend to lower trade deficits because the demand for imports tends to fall much faster than exports).²

The rise in the dollar from the mid-1990s until 2002 precipitated a much larger and more persistent rise in the trade deficit. Blecker notes that it took almost four years after the dollar's peak in 2002 for trade deficits to begin to shrink, and that current account deficits still exceeded 5% of GDP in the first half of 2008 before the recession of 2007-2009 produced the "greatest trade collapse the world has ever seen (Baldwin and Taglioni 2009)." U.S. trade deficits are widely expected to increase again after the current recession ends.³

U.S. trade deficits have persisted for a variety of reasons. First, although the fall of the dollar since 2002 has made U.S. exports cheaper (and therefore more competitive on world markets) and imports more expensive (thereby boosting the competitiveness of domestic makers of similar products), the dollar has fallen primarily against the currencies of other major, developed economies, especially the euro, Canadian dollar, and Japanese yen. Blecker points out that between February 2002 and March 2008, the dollar fell 32% against these major currencies but fell only 14% against those of "Other Important Trading Partners" (OITP, as defined by the Federal Reserve, a group that includes China, Mexico and a number of other Asian trading partners). While the "major currency" countries are primary markets for U.S. exports, the OITP group is responsible for over half of total U.S. imports and two-thirds of the U.S.

² Trade balances usually lag at least one to two years behind changes in the value of the dollar, due to a phenomenon known as the "J curve," which describes the shape of the trade balance following a change in currency values. For example, when the dollar falls in value, it raises import prices. In the short run, this raises the costs of imports, increasing the trade deficit (or reducing a trade surplus). Over time, production and consumption of competing domestic products rises. Likewise, a decline in the value of the dollar increases the competitiveness of U.S. exports, which begin to grow (slowly at first). Thus a fall in the dollar tends to first worsen and then later improve the trade balance.

³ See also Krugman (2009) and Bertaut, Kamin and Thomas (2009).

trade deficit. Thus, while the fall in the dollar since 2002 helped promote U.S. exports, it did little to discourage imports since the OITP currencies did not fall by nearly as much.

China and other many other OITP countries have actively intervened to artificially suppress the values of their currencies by purchasing hundreds of billions of dollars in U.S. assets and other foreign exchange reserves (Bivens and Scott 2006). China alone added assets worth more than two trillion dollars to its foreign exchange reserves between the first quarter of 2002 and September 2009 (International Monetary Fund 2009 and Chinability 2009).

Several other structural factors contributed to the growth and persistence of U.S. trade deficits. Because the vast majority of traded goods are manufactured products, decades of steadily growing trade deficits have eroded U.S. manufacturing capacity and global market shares which has made it difficult to reduce large trade deficits once they became engrained in the economy, a condition referred to as hysteresis. Blecker (2007) estimated that the capital stock of U.S. manufacturing was 17% lower in 2004 than it would have been if the dollar had remained at its 1995 level, and that annual investment in manufacturing was 61% lower in 2004, but for dollar over-valuation.

Unfair trade practices including currency manipulation, illegal subsidies, import and export restraints, dumping, and repression of labor rights all contribute to making foreign-made goods artificially competitive, thus increasing U.S. imports and reducing U.S. exports.

Over the past decade, one of the most important factors in the growth of U.S. trade deficits was the symbiotic, or co-dependent⁴, relationship that developed between large savings surpluses in China and other trade-surplus countries and growing U.S. trade deficits. Federal Reserve Chairman Ben Bernanke (2005) has referred to this as the saving glut problem. In this view, a shortage of *private* savings in the U.S. (especially on the part of households) led to a shortage of total domestic savings, relative to investment. At the same time, a flood of cheap capital from Central Banks in China and Japan (and later, oil exporting countries) flowed into the U.S., which encouraged an investment boom in housing and other forms of consumer borrowing based on rapidly rising housing prices. In this view, capital inflows were a primary cause of trade and current account deficits, working in part through artificially suppressed currency values and in part by inflating consumer demand for imports of all types, which were financed with borrowed capital. The collapse of the resulting housing bubble in 2007 and 2008 then precipitated the worst recession since the 1930s.

As noted above, Blecker carefully disentangles the effects of changes in private and public savings and concludes that there was no statistically significant relationship between increasing government budget deficits and growing trade deficits. In fact, over the entire post Bretton-Woods era (1973QI to 2008QIII) there were a number of periods in which the trade and government budget deficits moved in opposite directions. The two most recent examples were the late 1990s and in the 2007-09 recession.⁵ During the former, Clinton administration tax and spending policies generated significant budget surpluses while trade deficits were growing sharply. Between 2007 and 2009, spending on bank bailouts and the

⁴ Mann (2005) was one of the first to apply the term co-dependent to the economic relationship between the U.S. and its Asian trading partners.

⁵ [The National Bureau of Economic Research](#) "Business Cycle Dating Committee" has determined that the economy reached a peak in December 2007 and that a recession began in that month. As of this writing the Committee has not yet determined if or when this recession has ended. The Committee relies on a number of indicators in making its determinations including measures of production, employment, real income and other indicators.

American Recovery and Reinvestment Act of 2009 combined with the recession to generate budget deficits far in excess of a trillion dollars, while the trade deficit fell to its lowest levels in more than a decade (Figure A).

Steadily growing U.S. trade deficits over the past three decades have been widely blamed for contributing to the U.S. and global financial crisis of 2007-09 (Baldwin and Taglioni). They have been clearly linked to currency manipulation, unfair trade practices and the accumulation of vast stocks of private and public savings in surplus nations. These trade deficits are widely expected to get “much worse” in the near future (Krugman 2009). Thus, the trade deficit problems addressed by Buffett in 2003 are, if anything, likely to get much worse. The U.S. unemployment rate exceeded 10% in September 2009 (Shierholz 2009), and it is expected to rise for some time in 2010. The economy is in exceedingly weak condition. Meanwhile, asset bubbles are already growing again in China and other Asian economies. If the world is hit with another financial crisis before recovering from the recession of 2007-09, it could result in a generation or more of lost income and unprecedented unemployment (Faux 2009).

For these reasons, it is imperative to consider policy alternatives that can reduce and eliminate structural U.S. trade deficits. If these measures are put in place now, while deficits are off their previous highs, then adjustment costs can be minimized. At the same time, reduction of the U.S. trade deficit can help rebuild U.S. manufacturing, creating jobs throughout the economy and providing a foundation for sustainable growth in the future.

The Buffett plan

Buffet’s (2003) trade policy proposal would radically stimulate essential, goods-producing sectors of the U.S. economy, particularly domestic manufacturing industries. This would be achieved by systematically reducing or eliminating U.S. trade deficits. Buffett proposed to give import certificates (ICs) to exporters in exchange for each dollar’s worth of goods produced domestically and sold abroad. Exporters could retain those certificates for their own use (to purchase imports), or sell them in a special commodity market for ICs. Surplus certificates would be sold at market value to importers, or to foreign exporters wishing to sell goods in the United States, acting as a type of quota-license for firms wishing to sell foreign goods in U.S. markets. The total supply of ICs would constitute a national quota on the total value of imports. The ICs would initially sell at a premium (of approximately 10% to 20% over their face value, according to estimates reviewed here) given that demand for imports substantially exceeds U.S. export sales.

Buffet argues that such a broad-based system is more likely to achieve trade balance than increasing tariffs or setting quotas on specific products. The IC Program manages to leverage elements of both tools by tying imports to the level of U.S. exports. It restricts import levels to those equivalent to U.S. exports (without naming a specific quantity), and it requires the importer to obtain an IC (without naming a specified price). The volume of exports and imports, as well as the value of the IC, are all determined in private markets. The IC is, according to Buffet, “a tariff that retains most free-market virtues neither protecting specific industries nor punishing specific countries nor encouraging trade

wars.” In fact, other developed and developing countries have used broad-based tariffs or quotas to reduce trade deficits on many occasions in the past (Stewart and Drake 2009). Assuming that such a program is implemented successfully, the U.S. trade deficit would be eliminated.

The IC plan responds to the U.S. trade deficit in both the short and long term. First, the profits from selling the ICs would provide the impetus for U.S. industries to expand production and, subsequently, labor demand. This would circulate spending back into the domestic economy. Second, it allows U.S. consumers to be less dependent on foreign imports and to increase consumption of domestically produced substitutes. Finally, it reduces U.S. reliance on foreign capital inflows to finance trade deficits, reducing risks of a sudden dollar collapse and a further jolt to the economy. By stimulating the creation of domestic jobs the plan increases consumer income (and hence private savings) and also tax revenues (reducing government budget deficits).

A version of the Buffett plan introduced as draft legislation by Senators Byron Dorgan and Russell Feingold (S. 3899) in 2006 would gradually eliminate the U.S. trade deficit by steadily shrinking the supply of ICs relative to the volume of U.S. exports. Initially, each dollar’s worth of exports would generate 1.4 ICs, allowing the total volume of imports to exceed exports by 40%. This IC “multiplier” would decrease gradually, by ten percentage points per year (0.1 units) until trade balance was achieved. Note that the actual volume of imports each year would depend on the level of exports. If exports increased 10% or more per year and the IC multiplier fell ten percentage points per year, then imports would grow along with exports, though at a slower rate, until trade balance were achieved after four or five years. Import growth would occur in this scenario because more ICs would be created through the growth of exports than would be lost through the shrinkage of the multiplier (since each dollar’s worth of growth in exports would generate 1.x dollars worth of new import ICs).⁶

The IC Program, as proposed by Buffett, would by definition achieve its objective of eliminating the trade deficit. IC prices, on the other hand, would be indeterminate and subject to market forces which would set the market-clearing IC price as a function of IC demand.

If the U.S. were to adopt and implement the Buffet plan, it would have far-reaching implications for U.S. trade and capital flows. However, simple passage of the agreement by the U.S. Congress would have important political ramifications that could affect similar changes to the economy without ever ‘firing a single trade bullet.’ The balance of power in trade negotiations would shift if such legislation was approved by either the House or the Senate. Examples of similar actions from recent U.S. history illustrate the potential power of the Buffet plan to reduce U.S. trade deficits.

Politics of the Buffett plan

The founders of the General Agreement on Tariffs and Trade (GATT) in 1947 recognized that situations could arise when countries were faced with large, potentially destabilizing imbalances in trade and capital flows. Article XII of the GATT permits countries to restrict “the quantity or value of imports in order to safeguard its external financial position and its balance of payments (Stewart and Drake 2009,

⁶ Note that if the volume of exports fell (for example, during a recession), then the supply of ICs would fall even faster. Blecker (2009) has expressed concern that this process could lead to a destabilizing contraction in trade flows. However, rapid shrinkage of trade deficits is a normal consequence of business cycle downturns, as noted above.

1).” Article XII and the rest of the GATT are now overseen by the World Trade Organization, which was created in 1995 to monitor trade relations and to facilitate dispute resolution between member countries concerning trade complaints.⁷

Article XII has been invoked dozens of times in the past fifty years. Between 1970 and 1974 alone the GATT Balance-of-Payments Committee reviewed Article XII actions by 24 countries. “Developed countries that have applied import restrictions for balance-of-payments reasons include Austria, Australia, Denmark, Finland, France, Greece, Iceland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Sweden, Spain, the United Kingdom, and the United States (Stewart and Drake 2009, 8-9).”

The Nixon import surcharge

One of the most important and relevant Article XII cases was the Nixon Administration decision to impose a 10% import surcharge on August 15, 1971. This policy was implemented in the wake of Nixon’s decision to terminate the Bretton Woods system of fixed exchange rates, and to end the gold standard, under which the United States was committed to exchange dollars for gold at a fixed exchange rate of \$35 per ounce. This system had been in existence since the formation of the GATT in 1947. Nixon’s decision was precipitated by a series of U.S. balances of payments crises which began in the early 1960s.

Under the Bretton Woods System other countries were allowed to periodically adjust their currency values, relative to the dollar, but the U.S. was committed to maintaining the fixed exchange rate, tied to the gold standard. The United States’ major trading partners had engaged in a series of devaluations which reduced U.S. competitiveness and resulted in balance-of-payments difficulties (the U.S. developed a current account deficit in the second quarter of 1971 that persisted until the first quarter of 1973).

The Nixon administration set three specific conditions for removal of the surcharge: a) currency revaluation by key U.S. trading partners to remedy U.S. trade deficits; b) elimination of certain trade restrictions by the European Community and Japan; and c) additional contributions to common defense projects from U.S. Allies (e.g. NATO) (Stewart and Drake 2009 9-11).

The GATT General Council convened a Working Party on the U.S. surcharge. The International Monetary Fund (IMF) was asked to prepare a report on U.S. actions, and it concluded that the surcharge was “within the bounds of what is necessary to stop a serious deterioration in the United States balance of payments position.” The Working Party submitted its report to the General Council on September 16, 1971, and it was accepted. Some members reserved the right to retaliate, but none did. In December 1971, four months after the initial surcharge was imposed, it was removed by the Nixon Administration after an agreement on currency realignment was reached with major U.S. trading partners.

This case illustrates the power of a relatively limited emergency trade restriction, implemented under the terms of GATT Article XII, to increase the leverage of the United States in trade negotiations and to obtain relief from currency manipulation. It also suggests that the Buffett plan or threats of other trade

⁷ Article XII was last revised in 1954 and 1955 (changes effected in 1957), and was the subject of two significant clarifications in 1979 and 1994 that were the result of various working party discussions. These measures have clarified procedures implementing Article XII trade restrictions, and for oversight and dispute resolution regarding these actions. (Stewart and Drake, 2009)

sanctions could also be used to persuade trading partners such as China and Japan to remove legal and illegal non-tariff barriers to U.S. imports.

The Plaza Accord

In 1985, the U.S. was faced with a sizeable current account deficit and a substantially overvalued dollar, as shown in Figure A above. There was concern that growing U.S. trade deficits would become unsustainable, resulting in a dollar crash and “hard landing” (recession) for the domestic economy. The U.S. lost nearly two million manufacturing jobs between 1980 and 1985. This resulted in substantial pressure in Congress for administration action on trade and the dollar. A large number of pieces of “protectionist” trade legislation were proposed, especially during the spring and summer of that year.

The Plaza Accord might never have happened were it not for strong congressional pressure. One of the most important measures proposed in Congress was the Rostenkowski-Gephardt-Bentsen trade act, which would have imposed a 25% import surcharge on countries such as Japan, Brazil, Korea and Taiwan that maintained large trade surpluses with the United States.⁸ The House version, H.R. 3035, was passed twice in the summer and fall of 1985.

On September 22, 1985 the U.S. announced that it had reached a “Plaza Accord” with other members of the G-5 group of finance ministers and central bank officials (representing the United States, Japan, Germany, France and the United Kingdom) in order to head off Congressional threats to impose trade restrictions, and in response to substantial pressure from other members of the G-5 and other leading industrial nations (Funabashi 1989, 15-16).

The dollar reached a peak in early 1985 and had already begun to decline when the Plaza Accord was announced. The accord remained in effect until February 22, 1987 when the Finance Ministers and Central Bank Governors of the G-6 countries announced the “Louvre Accord,” which was designed to stabilize the dollar going forward. The real, trade-weighted value of the U.S. dollar fell 17% between the Plaza and Louvre Accords, and it declined 29% overall between the peak in the first quarter of 1985 and 1991. In that period, the U.S. trade deficit declined from about 3.5% of GDP in 1986 to roughly balanced trade in 1991, as shown in Figure A.

This case illustrates that approval of significant trade restrictions by just one house of Congress can significantly shift the balance of power in the U.S. favor in negotiations about currency manipulation and the need for trading partners to raise the value of their currencies, relative to the dollar. The mere threat that such restrictions might be imposed can sway finance ministry officials and government leaders in other countries, and it can increase their willingness to enter into negotiations to resolve long-standing differences about trade and currency policies. The Plaza Accord was negotiated specifically to head off the threat of tough Congressional action on trade.

A wide array of policy tools are available that could achieve similar results. Among these, the Buffett plan has several advantages, including the fact that it does not discriminate against imports from particular industries or countries and that it would benefit both exporting and import-competing industries. In this way, implementation of the Buffett plan would have effects that are tantamount to

⁸ Bentsen, Lloyd, Dan Rostenkowski and Richard Gephardt *et al.* 1985. Trade Emergency and Export Promotion Act (S. 1449 and H.R. 3035). These measures were introduced in the 99th Congress on July 17 and July 18, 1985, respectively.

dollar depreciation, which would make U.S. exports more competitive on world markets and imports more expensive.

Threats of retaliation?

Several of the papers published in this series expressed concerns that implementation of the Buffett plan could provoke retaliation from trading partners. Papadimitriou et al (2008) assume that “retaliation against the Buffett plan would raise foreign prices of U.S. exports by half as much as dollar prices for U.S. imports.” If this assumption is eliminated, the impact of the Buffett plan on profits and GDP doubles in their model, rising from a stimulus of 1.2% of GDP to 2.4%. Thus, these authors anticipate that the effects of retaliation would be very significant.

Blecker maintains that the allocation of ICs to exporting firms could be interpreted as a GATT-illegal export subsidy, raising the risk that trading partners who file complaints about the Buffett plan would be authorized to impose retaliatory tariffs (Blecker 2009, 27).

Buffett addressed concerns about retaliation and the threat that implementation of his proposal would ignite “another Smoot-Hawley” tariff war. He claims that it would not, for two reasons. First, countries with trade surpluses would not implement their own Buffett plans because ICs would be worthless (since exports exceed imports in those countries). Second, he notes that the world has struggled for decades with “a shifting maze of punitive tariffs, export subsidies, quotas [and] dollar locked currencies (Buffett 2003).” These have been used effectively by countries trying to amass growing trade surpluses, but they have not triggered major trade wars. Indeed the major response of countries like the United States to these barriers has been the negotiation of a series of Free Trade Agreements and negotiations to bring China and other countries into the World Trade Organization, steps that have rapidly *lowered* trade barriers and resulted in steadily growing U.S. trade deficits and job losses (Scott 2006 and 2008b).

If the Buffett plan, or one of its alternatives, was endorsed by one or more houses of Congress, it could achieve its intended goals (trade deficit reduction) through a negotiated revaluation of the Chinese renminbi and other undervalued currencies. There is a significant chance that it would not need to be implemented to achieve this outcome. If the plan never took effect then countries would never have the opportunity to retaliate. There are many steps that would be required to implement the Buffett plan, thus providing opportunities for negotiated solutions to U.S. trade deficits and further limiting the risk of retaliation.

Alternatives to the Buffett plan

Each of the papers in this series evaluated alternatives and ways in which the Buffett plan might be improved. Stewart and Drake (2009, 12) emphasize the importance of implementation details that should be considered in enabling legislation and program design. First, they note that GATT article XII measures are designed to be temporary. Thus it is important to have a built-in phase out for the program. Another alternative would be to include a trigger (minimum trade or current account deficit), below which the program would be phased out.

The 1994 GATT understanding (the most recent interpretation of Article XII procedures) established a preference for “price based mechanisms” (e.g. tariffs). Thus, an explanation of why a price-based measure would be inadequate should accompany implementation of any plan based on the Buffett

proposal. Blecker notes that there is a long history of countries being “disappointed in the use of tariffs for balance of payments purposes” because such measures do nothing to stimulate exports. Thus implementing rules and legislation should explain why export promotion is key to reducing the trade deficit. These rules should also note that, as Buffett points out, an IC is simply a tariff by another name (since its value is determined in the market and it is simply added to the value of imports).

It is also important to note that Article XII focuses on a decline in a country’s monetary reserves which is less relevant for a country like the United States since it has a flexible exchange rate and borrows primarily in its own currency. Stewart and Drake note that the IMF has repeatedly expressed its concerns regarding the unsustainability of U.S. trade deficits, as have many leading government officials and economists (e.g. Bernanke 2005, Krugman 2009). The concerns of the IMF should also be noted in implementing legislation and rules.

Garr and Scott (2009) address concerns that the prices of ICs could be excessively volatile.⁹ The paper draws on the literature regarding policy designed to address climate change, specifically cap-and-trade systems for reducing emissions of Green House Gases (GHGs) and other pollutants. Banking and borrowing of ICs could reduce IC price fluctuations that could result from speculative purchases of the certificates. Implementation of these tools would require having a longer shelf life for the certificates (the Dorgan/Feingold bill proposes a one-year shelf life for certificates, but this could lead to large price swings if trade volumes shift rapidly over time). On the other hand Buffett, in his original proposal, suggested a very short shelf life of six months to limit speculative purchases. Another alternative to limit the impact of speculation would be the creation of a public ceiling, which would require a safety value (e.g. the sale of unlimited ICs at a certain price ceiling) and a price floor, with the government serving as the buyer of last resort. Under the latter system, there is some risk that the government could lose money, though it could also profit if it were able to bank certificates and resell them if prices rose at a later date. The authors note that enforcement, transparency, and effectiveness are also important. If the Buffett system is implemented as proposed, both importers and exporters could try to cheat the system by manipulating export and import prices, thereby influencing the supply and demand for ICs.

Many of these concerns would be eliminated if ICs were not given to exporters. Two main alternatives to exporter allocation were proposed. Papadimitriou et al (2008) propose that the government auction ICs directly to importers and firms wishing to export goods to the United States, and use the proceeds to temporarily reduce payroll (social security) taxes. They estimate that GDP would initially increase by approximately two percent (4.9 % of taxable payroll for earnings up to \$102,000 per year), with the stimulus gradually declining as the trade deficit is eliminated. Employer and employee contributions would decline by about 1 percentage point each, as a share of GDP (thus reducing the employee and employer contributions for social security insurance by roughly a third). This decline would be temporary, and would be phased out as the trade deficit shrank with the value of ICs. The reduction in payroll taxes would provide an incentive for firms to hire more workers and expand production and exports. The reduction in personal payroll taxes would directly raise workers’ income and spending. Both of these actions would increase GDP. Direct auctioning could also reduce IC price volatility, but

⁹ Papadimitriou *et al* (2008, 27) also express concerns about IC price volatility resulting from speculative investments.

speculative purchases could still lead to wide price fluctuations, especially as the supply of ICs is reduced, relative to import demand.¹⁰

An across the board tariff, like the Nixon import surcharge, is another alternative to the Buffett plan. A tariff program is essentially a “certificate program with an unlimited amount of certificates” available at a specific, fixed price (Papadimitriou et al 2008). Blecker (2009) notes that a tariff increase would be easily administered by the Customs Bureau. Like the Buffett plan, it would not discriminate against particular countries or products. However, it would not guarantee a closing of the trade gap.

In the final analysis, and keeping in mind the ultimate goal (elimination of the U.S. trade deficit), serious consideration by Congress of any of the major alternatives discussed here—the Buffett plan with allocations to exporters or direct auctioning of certificates, an across the board tariff, or a Rostenkowski-Gephardt-Bentsen style tariff on imports from countries that maintain large, structural trade surpluses with the United States—could significantly shift the balance of power in U.S. negotiations over currency manipulation and reduction of trade barriers by major trading partners.

Consequences of the Dorgan Feingold Buffett bill

One of the most important benefits of the Buffett plan over the alternatives considered above is that it would provide a strong stimulus to exports. By allocating ICs to exporters, the system would generate a new stream of revenues that would provide both increased cash flows (contributing to corporate savings that could be used to finance investment) and incentives to increase production for exports. This section will examine likely impacts of gradually phasing in the Buffett plan as it would be implemented in the Dorgan/Feingold bill (S. 3899).

This section summarizes results of a simulation of how the Dorgan/Feingold bill would affect trade flows if it were enacted in 2010. The simulation begins with the recognition that the 2008-2009 recession generated “the greatest trade collapse the world has ever seen (Baldwin and Taglioni 2009).” Through September 2009, U.S. exports (year to date) were down 20%, imports declined 28% and the trade deficit fell 50% relative to the same period in 2008 (U.S. Census Bureau 2009). The simulation optimistically assumes that trade flows in 2010 return to their pre-recession levels.

The simulation provides suggestive results designed to illustrate how trade flows could evolve if the Buffett plan were gradually implemented, as proposed in the Dorgan/Feingold plan. It makes a number of simplifying assumptions; it ignores short term dynamics such as J-curve effects and lags in the response of exports to IC prices. Macro-economic impacts, including the plan’s impacts on inflation, domestic and foreign savings, and investment balances, are not considered. Therefore, incorporation of these factors could alter the dynamics of adjustment. Notwithstanding these limitations, implementation of the Dorgan plan would eliminate the trade deficit in a relatively short period of time.

The Dorgan/Feingold plan calls for a very gradual reduction of the trade deficit. It would eliminate the trade deficit in non-oil goods in five years and in all goods in ten years. The bill would initially give exporters 1.4 ICs for every dollar’s worth of goods exported. This “multiplier” would fall by ten percentage points each year, reaching 1.0 in year five for non-oil goods.

¹⁰ Direct auctioning of the certificates could reduce the volatility of IC prices, and it would greatly reduce problems with enforcement and transparency identified by Garr and Scott (2009). Government auctions of ICs would have lower administrative costs and be less susceptible to fraud, according to Papadimitriou *et al* (2008).

The simulation establishes a baseline case with exports and imports growing at their average rates in the 2003-2007 (pre-recession) period, with imports growing 10% per year, exports growing 9%, and nominal GDP increasing 5% per year. The supply of ICs in each year is estimated as a function of the level of exports and the Dorgan/Feingold multiplier. The available number of ICs (after subtracting out oil imports) is estimated for each year and compared with import demand in the base case. The resulting IC “shortfall,” or excess demand for ICs, is shown in Figure B.

The simulation assumes, based on numerous studies, that the price elasticity of demand for imports is approximately one, which says that import prices must rise by one percent to reduce import demand by one percent. The simulation assumes that IC prices would reflect this underlying demand structure so that if import demand in the base case exceeded the supply of ICs by 10% in year N, then IC prices would be approximately 10% (10 cents per dollar of imports). Thus, Figure B provides an approximate estimate of IC prices in each year of the simulation.

In the simulation shown in Figure B, IC prices would climb to a peak of about 18 percent in 2016, and then fall thereafter as the supply of exports expands (see analysis of export flows, below). IC prices fall rapidly after 2016, dipping to 4% in 2020. The system could be rapidly phased out thereafter, as trade balance would be achieved, as shown below.

It is assumed that the IC system is implemented in 2011. Given the large initial IC multiplier in the Dorgan/Feingold plan, the supply of ICs would exceed demand in 2011. Therefore, the model assumes that IC prices would be zero in year one. In reality, if banking and borrowing were allowed, firms that needed imports in the future as well as speculators would create demand for the surplus ICs in 2011, which would be purchased for later use and resale, helping buffer price increases in future years.

The fact that the IC program could be passed in 2010 and implemented in 2011 with no shortfall in IC demand before 2012, creates a substantial window of opportunity for negotiating solutions to the underlying causes of U.S. trade deficits, such as manipulated currencies and trade barriers. In this event the IC system could be terminated before it ever imposed a binding constraint on actual trade flows.

Implications of the Buffett plan for trade flows

The simulation assumes that the rate of growth of exports increases in proportion to the value of ICs.¹¹ Since, based on Figure B, firms can expect that the value of ICs earned from exports will rise rapidly for several years, this will create incentives for firms to rapidly build up capacity to market and produce exports, and to price them very competitively on world markets. As a result, exports would grow rapidly relative to the base case, as shown in Figure C, which shows exports as a share of GDP over time.¹² In the base case, exports reach 12.8% of GDP in 2020. Under the Dorgan/Feingold plan, they reach 18.3%. This jump in exports will provide a substantial stimulus to U.S. GDP growth in this period, which is equal to roughly \$1.3 trillion dollars in 2020, relative to the base case without the plan.

¹¹ Specifically, for each one percent increase in import prices it is assumed that exports increase by one half percentage point. This is a conservative assumption because firms would receive ICs worth substantially more than one dollar’s worth of exports in the first four years under the Dorgan/Feingold bill.

¹² Note that rate of growth of exports increases over time in the base case because exports grow faster than GDP, in nominal terms.

Imports would stabilize as a share of GDP during the years when ICs were most expensive (2013-2016), as shown in Figure D. Thereafter, imports would increase rapidly as exports expanded. Thus, concerns that the Buffett plan could severely limit access to imported components and intermediate products would seem unfounded. Imports would grow, in nominal terms, in every year of the plan, reaching a nadir of 1.1% in 2013, but rising to double digit levels by 2017.

The combination of rapid export growth with suppression of import growth for a few years would rapidly eliminate the trade deficit, as shown in Figure E. Under the Dorgan/Feingold plan, the trade deficit would peak at 4.4% of GDP in 2012. The vast majority of the deficit would be eliminated by 2016 when it would fall to 0.7% of GDP. Thereafter, ICs would be expanded to include net oil imports. The overall goods trade deficit would be eliminated by 2020 under the plan.

The Dorgan/Feingold plan would be trade promoting

Economists frequently express concern that measures like the Buffett plan would ignite “another Smoot-Hawley” tariff war, as Buffett noted above. The underlying concern for most economists is that trade restrictions would reduce the volume of trade, thereby undercutting world growth. This is frequently alleged to have been the result of the Smoot-Hawley tariffs, which were implemented in 1930 at the start of the Great Depression.

In the current downturn, trade has collapsed because of a great recession. Analysis of the simulation results reveals that the Dorgan/Feingold plan would actually be trade promoting in the long run, as shown in Figure F which reports total trade (exports plus imports) as a share of GDP in the base case and in the Dorgan/Feingold simulation. The rapid growth of exports that would result from the gradual implementation of the Buffett plan, combined with the recovery of imports shown in Figure E, would lead to an expansion in total trade. It would also lead to an expansion in investment and capacity of export-producing and import competing firms. If the IC plan went into effect in 2011, total trade in the simulation of the Dorgan/Feingold plan would exceed total trade in the base case by 2017. By 2020, total U.S. trade would exceed trade in the base case by 4% of GDP, or \$1.0 trillion. The growth in trade under this plan would provide a stimulus to domestic and world growth, as production by efficient U.S. export industries expands.

Conclusions

Warren Buffett’s (2003) plan for eliminating the U.S. trade deficit is as timely today as it was when first published six years ago. The United States is struggling to recover from the worst recession since the 1930s and needs to create a new economy based on the growth of sustainable domestic industries that can provide good jobs for millions of U.S. workers. The trade deficit is a lurking time bomb which could explode into another financial crisis, derailing the recovery for perhaps a generation. On the other hand, if the trade deficit were gradually eliminated it would provide a strong, sustainable stimulus to the economy and reduce the risk of future financial crises.

The United States would be entirely justified to implement the Buffett plan under the terms of Article XII of the GATT, which many countries, including the United States, have used to correct fundamental trade imbalances. Doing so is unlikely to result in significant retaliation. If the Buffett plan is passed by one or both houses of Congress it will shift the balance of power in international financial negotiations between

the United States and countries such as China that have been unfairly manipulating their currency and engaging in widespread unfair trade practices for a decade or more. Passage of such a plan, or one of the major alternatives considered here, such as government auction of ICs (with revenues used to reduce payroll taxes) or an across-the-board tariff, would empower the President and Treasury Secretary to get tough in negotiations with their counterparts in the G-20 to work out a global solution to the underlying causes of mounting U.S. trade deficits.

If the Buffett plan is implemented, it would have substantial benefits for U.S. manufacturing industries, and it would support a substantial expansion in exports and employment in these highly productive sectors of the economy. The plan need not severely curtail imports. Though concerns have been raised regarding potential volatility of IC prices, these could be addressed through measures such as banking and borrowing of certificates.

The U.S. can no longer ignore the costs and risks imposed by large and growing trade deficits, and it can no longer afford to tolerate the abusive, beggar-thy-neighbor trade practices of China and other countries that manipulate their currencies for mercantilist gain and hide behind walls of unfair trade barriers. The Buffett plan provides a way of out of our codependent net import- and capital-dependent past and a way forward for the U.S. economy. It is time to seriously consider such bold solutions to our longstanding trade problems.

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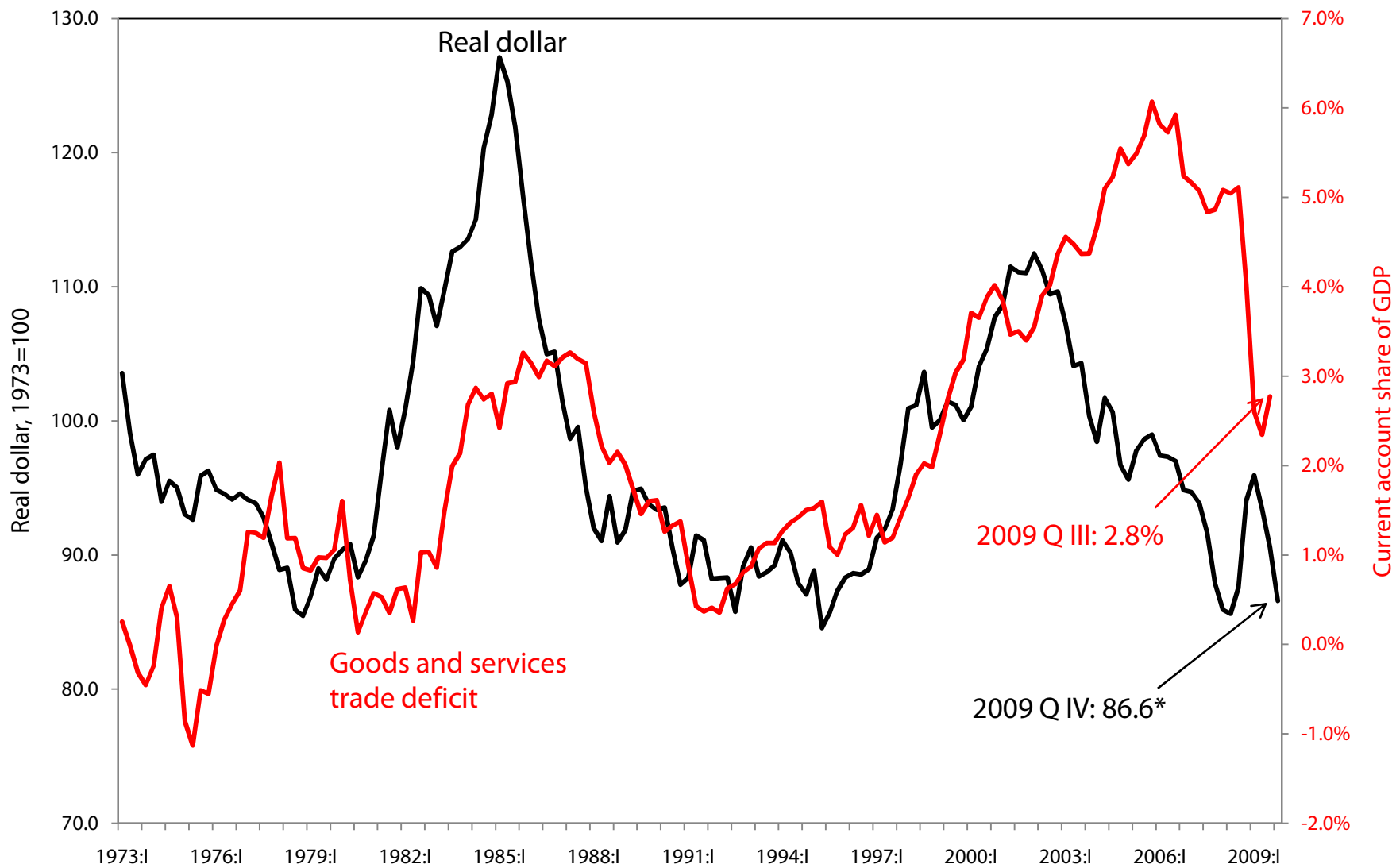
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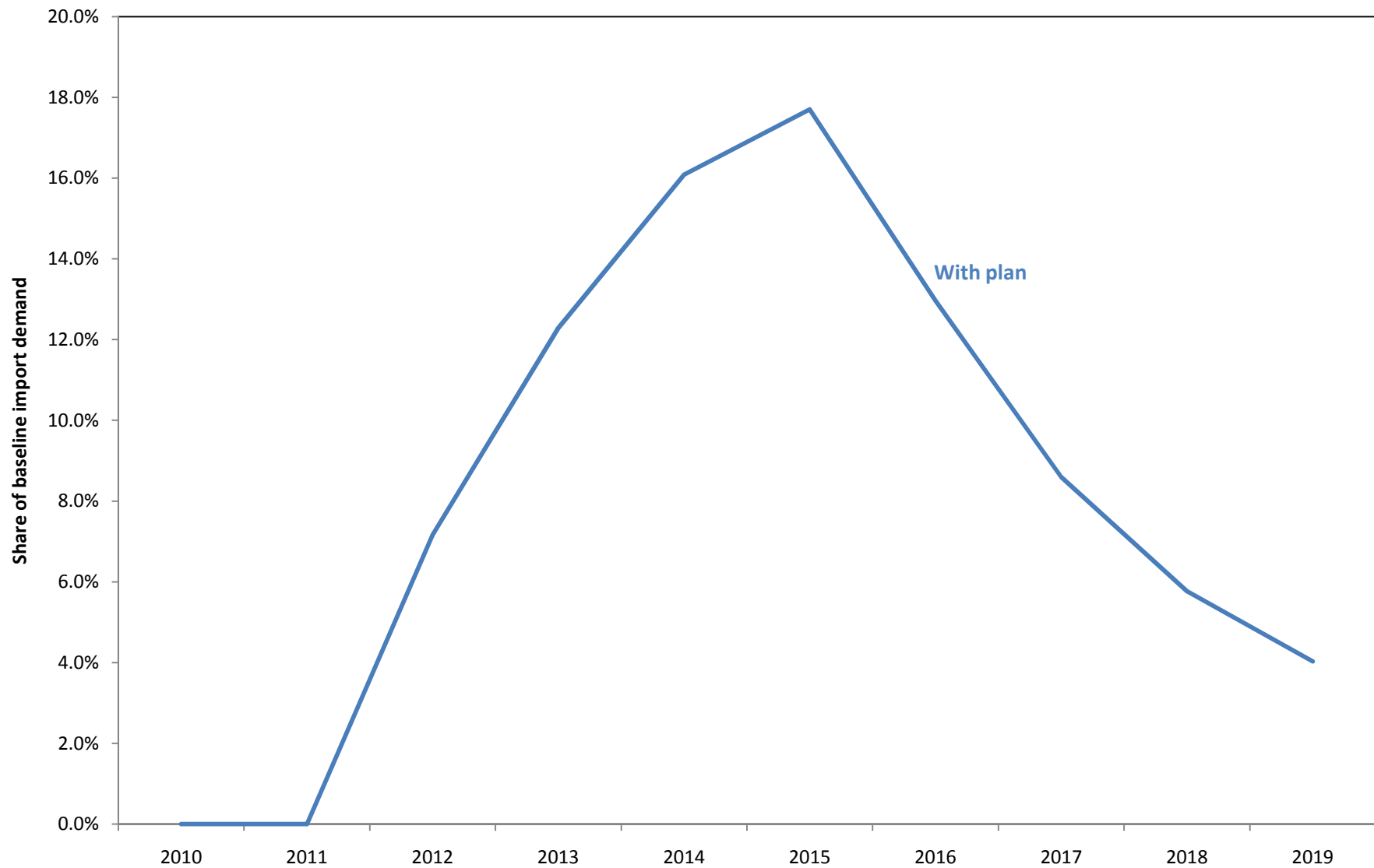
FIGURE A. U.S. goods and services trade deficit and the dollar: 1973 - 2009



*Through Dec 4, 2009.

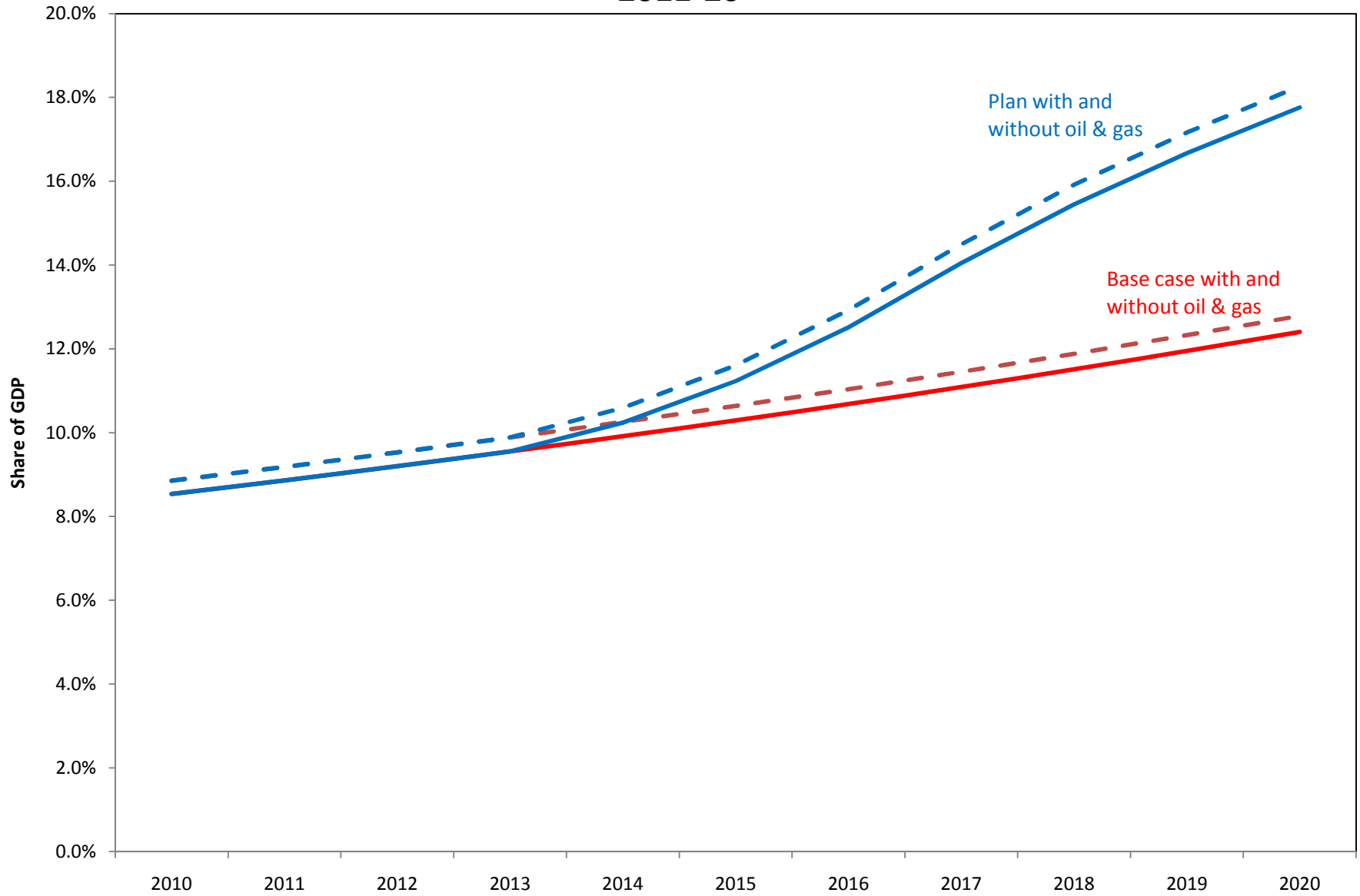
Source: Bureau of Economic Analysis, Federal Reserve, and EPI

FIGURE B. Import Certificate shortfall never exceeds 20% of baseline import demand, 2011-2020



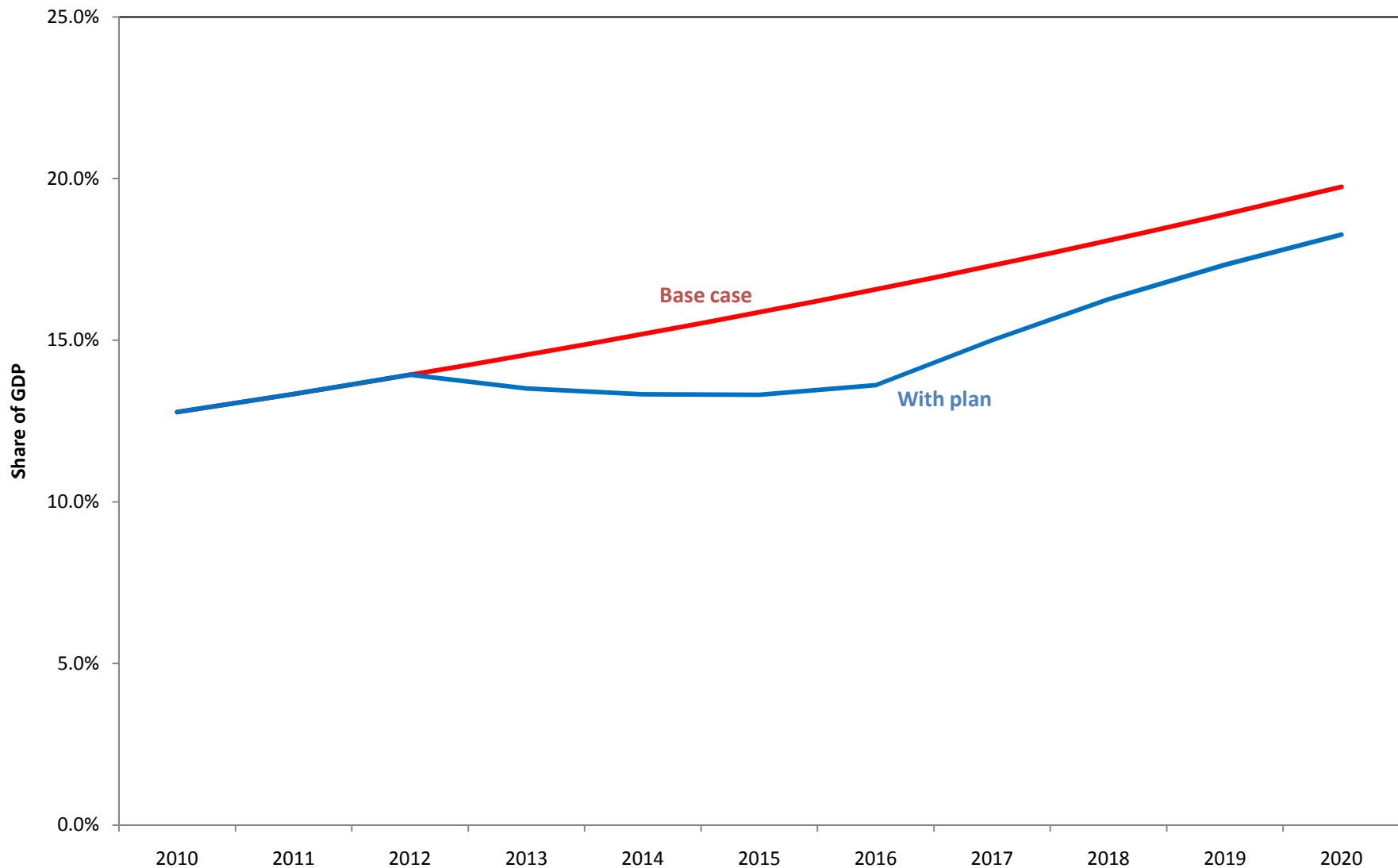
Sources: U.S. International Trade Commission and Economic Policy Institute

FIGURE C. Exports grow much more rapidly under Dorgan/Feingold plan, 2011-20



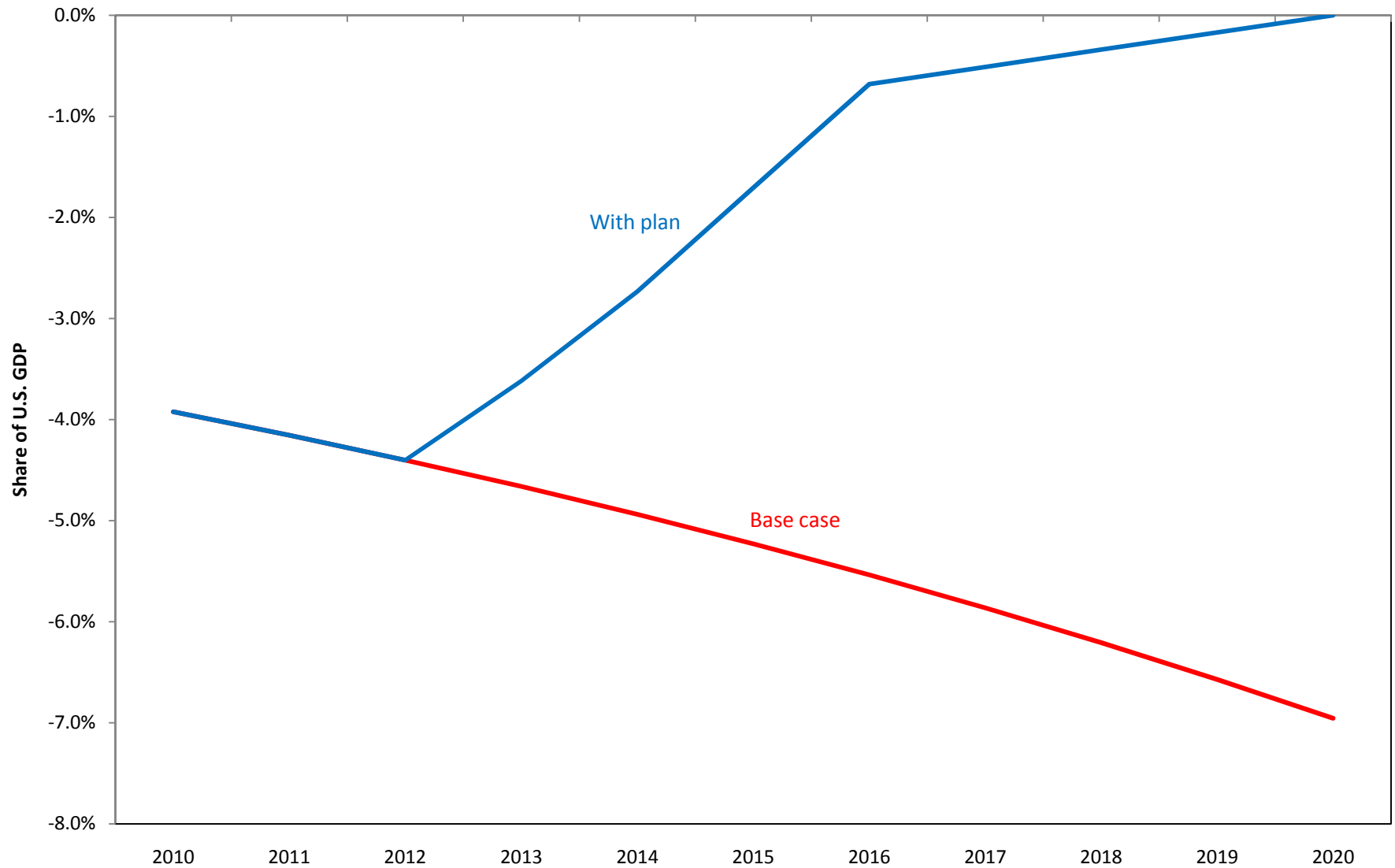
Sources: U.S. International Trade Commission and Economic Policy Institute

FIGURE D. Import growth slows for four years, then returns to trend under Dorgan/Feingold plan, 2011-2020



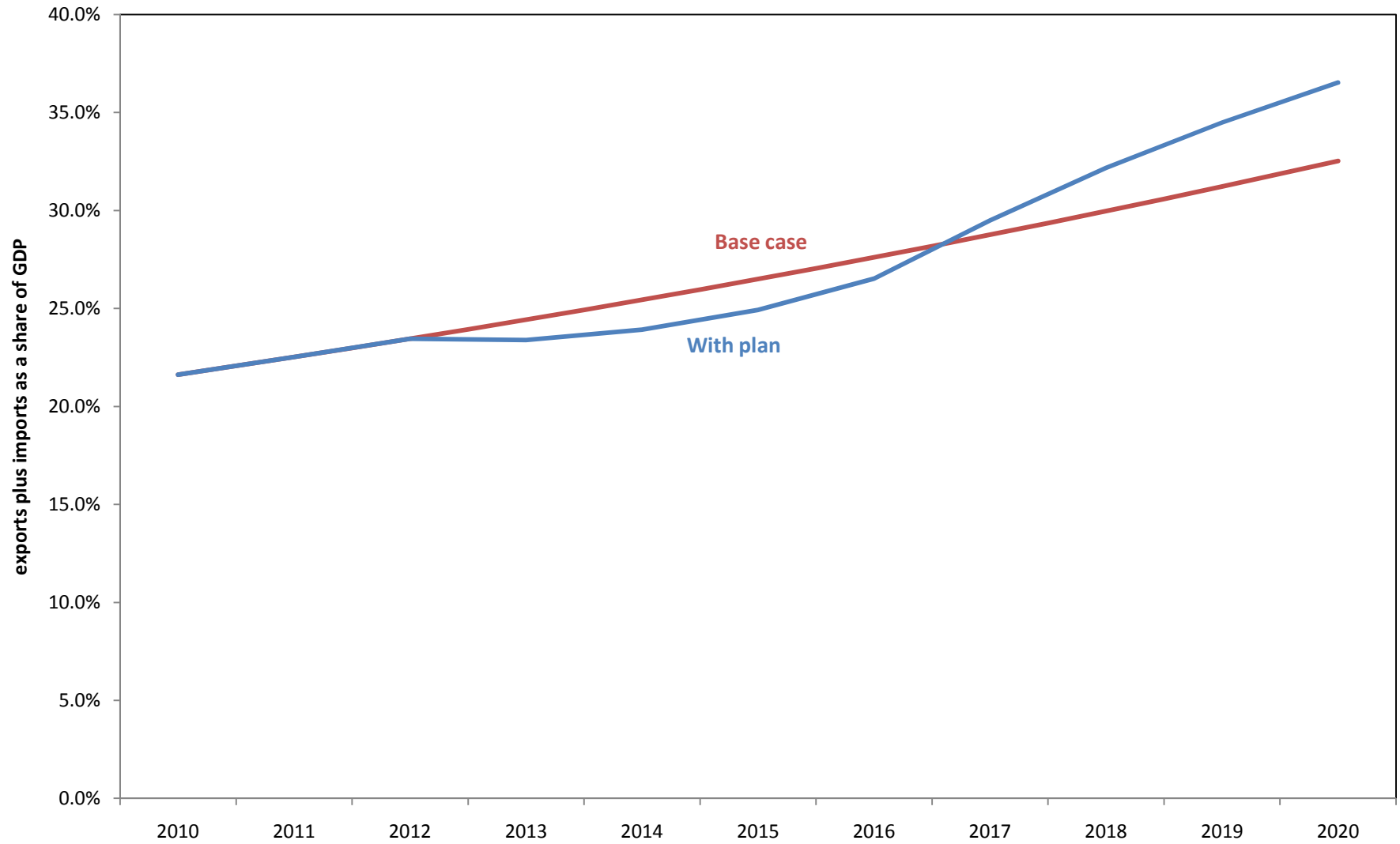
Sources: U.S. International Trade Commission and Economic Policy Institute

FIGURE E. Trade Balance achieved in nine years under Dorgan/Feingold plan



Sources: U.S. International Trade Commission and Economic Policy Institute

FIGURE F. Dorgan/Feingold plan would increase total trade in the long run



Sources: U.S. International Trade Commission and Economic Policy Institute