

Chronic U.S. Trade Deficit and Free Trade

draft

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Abstract

The paper suggests that the current international monetary arrangement (known as the New Bretton Woods, or Bretton Woods II) that creates a persistent international trade imbalance qualifies as an exception to free trade, along with infant industry and national security. The U.S., which has had a half-century long and massive trade deficit because the USD is kept overvalued by countries pursuing export-led growth policies. But the models used to illustrate the goodness of free trade as a policy (such as the Ricardian model or the Heckscher-Ohlin model) presume the balance of trade. The models cannot vouch for the goodness of free trade in an international monetary arrangement that implies a structural trade imbalance. The paper examines different monetary arrangements—the gold standard, the gold exchange standard, the Bretton Woods System and the current New Bretton Woods System—and argues that free trade is not compatible with a monetary order which produces trade imbalance. Trade imbalance distorts economic incentives and the long run consequence is negative not only in economic terms, but also in political and national security terms. The paper ends some thoughts on how to address trade imbalance under the New Bretton Woods System.

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I. Introduction

The U.S. trade imbalance is nearly a half-century long. Since the mid-1980s the current account deficit has been not only persistent, but also grew ever bigger. Since the year 2000, the current account deficit has gotten worse, averaging \$500 billion a year, for two decades. (Figure 1) As a result, the U.S. net international investment position has deteriorated from negative \$2.5 trillion in 2005 to more than negative \$10 trillion at the end of 2018. The deteriorating U.S. trade balance and the unfavorable shift of the U.S. international investment positions are necessary consequences of the current international monetary arrangement, known as the New Bretton Woods. (NBW, hereafter.)

Concerns have waxed and waned for the prospect for the downfall of the USD as the international reserve currency, the end of the “exorbitant privilege” and a hard-landing of the U.S. economy with a massive inflation combined with recession. Yet, the predicted adverse consequences have not materialized. The NBW lives on and the U.S. economy has done rather well, relative to other rich countries. Numerous uneventful passing of the predicted downfall of the USD has made economists and policy makers complacent with the NBW and the serious international trade imbalance it implies.

The generally accepted view among economists is that free trade under the NBW is good because it is advantageous for the U.S. and others.¹ They often note the following: the NBW is sustained by foreign countries (especially Asian countries) by accumulating the USD denominated assets, that foreigners are willing to give up real goods in exchange for American IOUs (which cost nothing to produce); that the chronic current account deficits reflect the strength of the U.S. economy as it is driven by the inflow of foreign capital in search for safety; that the massive inflow of capital is good for the U.S. because it keeps inflation low and let Americans enjoy a higher standard of living than otherwise possible; that the chronic current account deficit reflects the role of the U.S. as the world’ banker, taking deposits (paying low interest rates) and investing overseas (earning higher rates of return); that a financial crisis (or a hard-landing) from a rapid devaluation of the USD is not likely because all US debts are denominated in the USD (which Americans can print at will if needed); that the U.S. net investment position will not suffer even if the USD does depreciate because then the value of the U.S. assets abroad would correspondingly increase; that when countries that currently support the NBW (China and others) stop lending money after they attain a level of economic maturity, other countries (such as India) may step in to pursue export-led growth policies, enabling the U.S. run more trade deficits without facing the day reckoning; and so on.

I am not persuaded by these comforting explanations based on a partial and short-term considerations. The chronic U.S. trade deficit is a symptom of a structural trade imbalance engendered by the NBW in which the USD, a fiat currency, is the international reserve currency in the post-Bretton Woods era.

¹ The U.S. Trade Deficit Review Commission (2000), Coughlin, Pakko, and Poole (2006), and Reinhold and Yi (2018)

The emergence of the NBW has been gladly accepted by the U.S. and diligently promoted by countries pursuing export-led growth policies, to keep their currencies under-valued. The reserve-accumulating countries (countries with chronic trade surplus) have been perfectly willing to sacrifice the purchasing power a little now in exchange for a higher growth rate and a higher standard of living later. Americans have been delighted in the continuation of the USD as the international reserve currency in the post-Bretton Woods era. Americans have been quite willing to trade her IOUs for real goods, consume more without cutting back on investment, and debt finance chronic government budget deficit.²

Yet, the NBW lets Americans enjoy the “exorbitant privilege”, increasingly underwritten by countries that sustain the NBW in pursuing mercantilist policies. Is free trade a sound trade policy under the NBW? In the short run, it appears that everyone gains—for the U.S. living beyond means and for the mercantilist countries high growth rates. But can the massive international trade imbalance continue? For how much longer the U.S. finance trade deficits by borrowing before creditor nations begin to question the ability (or willingness) of the U.S. to honor its obligations? The cumulative effects of massive trade deficits will eventually show up: (1) at some point the sustainability of mounting external debt will become apparent, (2) creditor nations will exert increasing influence on the U.S. policies, (3) the cumulative distortions in the U.S. economy will manifest themselves as the conflict between Wall Street and Main Street, and (4) national security concerns from the rise of challengers to the balance of power in international politics.

Given these, is free trade a sound trade policy for the U.S. under the NBW? Can the NBW be added to the list of exceptions to free trade, along with national security and infant industry argument?³ To make a case that the NBW would qualify as an exception to free trade, I will first argue that free trade doctrine rests on the presumption of balanced trade and that the NBW makes balanced international trade impossible.

II. Trade with No Money

All models of trade that support free trade, whether personal exchange or international trade, presume trade balance. The presumption is implicit in the trade models because they portray the one-period barter. In the models, there is no money. (If there is money, it is only notional money, as a unit of account.) In the world of one-period barter, what one buys must be paid for by what one sells. The value of exports must be equal to the value of imports. Prevalent trade models, portraying barter exchanges, are not equipped to examine the issues of trade imbalance, let alone the chronic trade imbalance, financed by IOUs.

The most widely used models of international trade are the Ricardian model (focusing on the differences in technology/productivity) and the Heckscher-Ohlin model (focusing on the differences in resource endowments). They are designed to show, among other things, gains from specialization and trade, relative to autarky. It is the difference in the relative prices in autarky that determines the direction of specialization and trade. The price of traded goods are bound by their respective prices in autarky. Since all the parties can get more through specialization and trade than they can on their own, all gain. Hence, the argument for free trade.

As countries specialize and trade, each country faces a shrinkage of the import-competing sector and an expansion of the exporting sector of the economy. Resources (including the labor)

² The cumulative U.S. federal government budget deficits between 2002 and 2018 is about \$11 trillion.

³ I will set aside the issue of what can be done about the international monetary system for another paper.

rendered redundant in the import-competing sector are to be redeployed in the expanding export sector, or in the non-traded goods sector. The redeployment of resources may not be instantaneous, but with flexible prices and wages and mobility of resources and labor, there wouldn't be a question of unemployment or under-employment of resources.

If the model is extended to multiple countries, it is not necessary that trade between any two countries should be bilaterally balanced. But the overall trade of each country must be balanced. In a one-period world, it is clear that no country should have an overall trade deficit or surplus. The balance of overall trade is crucial to argue for free trade because only then the resources released from the import-competing sectors can be reallocated in the export sector, to pay for imports.

The models of trade can be thought of as dealing with multi-period if it is assumed that the same repeats itself over time. Imagine a two-period trade model, with two countries England and France, and two goods X and Y. England exports X to France and imports Y. If trade is balanced in the first period, the value of exports must equal to the value of imports. The same will be necessarily true in the second period. International trade would be balanced in each period. But this story introduces nothing new to the story of one-period world.

However, if inter-temporal trade is possible, trade need not balance every period. But trade must balance over time. Imagine a two-period world with two countries, England and France and two goods, X and Y. Suppose that England runs a trade deficit in the first period. England consumes more than what is produced. Let's further suppose that the deficit is paid for by IOUs.⁴ England then must run a trade surplus in the second period, to pay back the debt to France. Paying back the debt would be easier if the trade deficit in the first period funded productive investments.⁵

In the multi-period world, England may carry over the debt from the trade deficit in the first period to the next and roll over into the future, or have trade deficits in multiple periods, before debts must be repaid by running surpluses and the overall trade balance is restored.

If England has a chronic trade deficit (and external debt accumulates), France (the creditor) may become concerned about England's ability to repay. The cumulative debt obligation relative to the national income may become unmanageable. Compounding interest will make the day of reckoning come sooner. At some point France may insist that England either pay a higher interest or settle the debt by transferring assets. If England repudiates the debt, or declares bankruptcy, the French may forcefully seize English assets by invasion.

The morale of the story is that in the world of barter, as portrayed in the popular international trade models, free trade is beneficial to all. It is because the barter exchange does not permit persistent trade imbalance. Temporary aberrations from balanced trade are possible in a multi-period world, but they must be balanced over time.

Does the lesson of the goodness of free trade carry over to the world of money? In what follows, we will examine the goodness of free trade in different types of money for international

⁴ This can happen for a variety of reasons, such as the need for consumption smoothing (say, a fall in output due to a drought or a natural disaster), or for greater investment than current savings would allow, or to meet an unusually large resource demand to wage a war, etc.

⁵ The situation for France is exactly the mirror image of England; a trade surplus of the matching amount in the first period and a deficit in the second period.

trade: commodity (gold), gold exchange, the Bretton Woods System and the New Bretton Woods System.

III. Trade under the Gold Standard

The requirement of balanced trade carries over to the world of commodity money, the most outstanding example of which is the gold standard. One central feature of the gold standard is the fixed exchange rate among circulating currencies of different countries.

Historically, there have been variations of the gold standard: (1) literal circulation of gold coins; (2) the circulating currency redeemable in gold coins on demand at a fixed price, backed by 100% reserve; (3) the circulating currency redeemable in gold coins/bullion on demand at a fixed price, backed by less than 100% reserve; and (4) the gold exchange standard where the circulating currency is redeemable in gold bullion at a fixed price, only by foreign central banks to settle trade balance. Over time, given the inconvenience of carrying the weighty and soft metal, (1) was replaced (2), and (2) soon by (3). (3) eventually gave way to (4) as vagaries of fortunes of different economies invited creative monetary responses.

(1) Gold coins: Let's suppose that gold coins are used as money, where the worth of a coin is determined by its weight, given purity. If England uses gold coins as money, she has the pure gold standard. Every purchase is made by gold coins. In international trade, there is no question of exchange rate. Gold is gold. If England runs a trade deficit, the deficit must be settled by shipping out gold to France, which runs a trade surplus. The settlement of deficit by gold leaves less money in England and more money in France. Price of goods in terms of gold coins will decrease in England and increase in France. Drop in prices in England and rise in France should restoring the trade balance. Use of gold coins as money tends to keep trade balanced. Free trade would be a sound trade policy.

If the English King wants to amass gold, for whatever reason, he would adopt mercantilist policies (encourage exports and discourage imports) and tax. This is the context in which classical economists rightly advocated free trade for general prosperity.

(2) The 100% reserve gold standard: As carrying the soft and weighty metal pieces is inconvenient, gold coins tend to be replaced by circulating media. If a country issues paper money redeemable in gold coins/bullion at a fixed rate, the country has the gold standard. The implication for free trade of this type of money is identical to that of the use of gold coins.

Assume that the country has 100% gold reserve for paper money. Further assume that France sets 1 Franc = 0.2 oz of fine gold, and England sets 1 Pound = 0.5 oz of fine gold. Therefore, the pegged exchange rate is 2.5 Francs per Pound. If transaction costs are negligible, a deviation of the market exchange rate from the pegged exchange rate presents an opportunity for arbitrage profit. Suppose that English imported more than exported, the market exchange moves to 2.4 Francs. An arbitrageur will buy, for example, £1 million for F 2.4 million. Redeem the Pound into 0.5 million oz of gold in England. Ship the gold to France and convert it into F 2.5 million. That is a profit of F 100,000, or 4.1% return. Arbitraging would continue until the market exchange rate coincides with the pegged exchange rate. Given the possibility of arbitrage, the exchange rate between the Pound and the Franc under the gold standard will be kept within a narrow band.

With the full gold standard, international trade will automatically balance, as argued by David Hume. If England runs a trade deficit, the Pound will depreciate, causing the outflow of gold. Money supply in England falls, as paper money is redeemed for gold, and the money supply in France will rise, as increased gold is turned into more Francs. A fall in money supply

would depress prices in England and cause an inflation in France. The changes in prices in England and France will reverse the trade flow, until the trade balance is restored.

(3) A less than 100% reserve gold standard: The 100% gold reserve creates too much of a temptation for government to resist the opportunity to create additional circulating currency. Just as profit-seeking banks hold fractional reserve, government pledging the redeemability of circulating currency into gold at a fixed rate may also safely maintain a fraction of gold bullion as reserve. Historically, the gold reserve ratio was 10-40% for the U.S. and 10-60% for the U.K.

If all countries maintain a constant gold reserve ratio, the effect on trade balance may not be materially different from the 100% gold reserve, as a gold flow will directly influence money supply and prices. The implication for free trade would be indistinguishable from that of the 100% reserve gold standard discussed above.

However, if countries keep variable reserve ratios, the link between gold flow and money supply is loosened. A deficit country can, in an attempt to avert recession, counter the effect of gold outflow by increasing paper money (lowering the gold reserve ratio) and a surplus country can, in an attempt to prevent inflation or to continue trade surplus, counter the effect of gold inflow (increasing the gold reserve ratio). Sterilization undermines the price-specie flow mechanism and international trade imbalance may persist for a longer period.

The fixed exchange rates at which international trade imbalance is sustained, cannot last too long, however. If England sterilizes the loss of gold from trade deficits, she will keep on having trade deficit and her gold stock will continue to decrease. If France sterilizes the inflow of gold from trade surplus, her trade surplus will continue, and her gold stock will increase. Continued sterilization will eventually create an unsustainable situation. In the face of decreasing gold reserve ratio, England will eventually have to adjust downward the redemption rate of gold, effectively devaluing the Pound.⁶ A big enough devaluation will rebalance trade.

Thus, even under a less than 100% reserve gold standard, international trade tends to be balanced through price-specie mechanism, through periodic adjustments of exchange rates, if countries sterilize the effects of gold flows. All things considered, free trade under the gold standard would be a sound trade policy to promote wealth of nations.

(4) Gold Exchange Standard: WWI brought a great stress to the gold standard. To finance the war, belligerents suspended the redeemability of the currency and resorted to printing money (or debt finance), causing high inflation in European countries. The U.S. Federal Reserve sterilized massive inflow of gold from Europe. At the conclusion of WWI battered European countries tried to return to the gold standard. The redemption rates had to be reset to reflect inflation during the war. To protect the banking interest, however, U.K. returned to the gold standard at the pre-war redemption rate. It amounted to over-valuing the Pound and gold flew out of England rapidly. U.S. and France sterilized the gold inflow and continue to run trade surpluses. Their counterparts saw shrinking money supply and depressed economy. Some countries suspended gold standard to stimulate the economy with easy money, competitive devaluation, and beggar-thy-neighbor policies. Free trade as a policy became impractical. The collapse of asset bubbles and increasing trade barriers drove Western nations, one by one, into a severe recession. The gold exchange standard was a tenuous attempt to hold on to the gold

⁶ If the gold reserve ratio fall below a certain level, the Pound would be under speculative attacks, in anticipation of devaluation of the Pound. Speculators would short the Pound and the Bank of England would be driven to suspend redeemability, or devalue.

standard, but policy makers of too many countries began to think the gold standard became more burdensome than worth keeping.⁷

IV. Trade under the Bretton Woods System

Toward the end of WWII, leaders of allied nations (sans Soviet Union) felt a need for a stable international monetary system, to avoid the problems caused by the monetary chaos in the inter-war period, (competitive devaluations, protectionism, beggar-thy-neighbor policies, the worldwide recession, and the war). Their delegates met in Bretton Woods in 1944. Thus, emerged the Bretton Woods System (BWS hereafter), largely based on the American proposal.

The BWS was a variation of the gold exchange standard in which the USD, then the only currency still backed by gold, was to be the anchor for other currencies and the international reserve currency to settle trade balance among nations.⁸ All countries were to maintain a fixed exchange rate. IMF was to discourage competitive devaluation and assist countries facing a temporary trade imbalance with a short-term loan. Subsequently, the BWS, along with the GATT, provided the basis for an unprecedented expansion of international trade in the post-WWII era.

The BWS tried to retain a feature of the gold standard, the fixed exchange rate. But one feature the BWS could not share with the gold standard was capital mobility. The reason is that discretionary macroeconomic policy became the orthodoxy in the post-WWII era. According to the “impossible trinity of international finance”, a country that desires fixed exchange rate and discretionary monetary policy must give up on capital mobility. So, European countries and Japan adopted capital control.⁹

The BWS was initially welcomed by all parties. After the destructions of WWII, European countries and Japan could fix their exchange rates under-valued to generate trade surplus, to pay back the debt to the U.S. and to accumulate the USD as reserve. U.S. was pleased to supply the USD as the reserve currency, enjoying seigniorage.

As Robert Triffin pointed out, however, the BWS had a built-in dilemma. The U.S. must run trade deficit to supply the world with the USD to meet the demand of expanding trade; but the persistent trade deficits may weaken the confidence in the redeemability of the USD. The difficulty manifested itself in recurrent financial crises that called for periodic adjustments in the fixed exchange rates and steady gold outflow.¹⁰ The difficulty became more pronounced as some LDCs (such as the Four Asian Tigers) followed European countries and Japan in pursuing export-led growth policies and began to accumulate the USD from the mid-1960s.

Indeed, European countries (especially France) began to grumble about the “exorbitant privilege” of the U.S. Some countries began to demand gold for the USD, when the official redemption rate was less than the market price of gold, especially in the aftermath of the U.S. inflation in the Vietnam War era. Through the 1950s and 1960s the USD gold reserve ratio

⁷ J.M. Keynes was a foremost critic of the gold standard.

⁸ Though not encouraged, central banks could redeem the USD for gold at a fixed rate.

⁹ The gold standard which fixes the exchange rate calls for capital mobility, implying that countries give up on discretionary monetary policy. In the gold standard, there is no monetary policy.

¹⁰ M. Friedman (1953) and G. Johnson (1969) argued against fixed exchange rates that produced periodic financial crises, given the inflexibility of domestic prices and the new orthodoxy of independent national monetary policy.

declined from 67% to 22%. Realizing the difficulty of defending the convertibility of the USD, President Nixon closed the gold window in 1971, pulling the plug on the BWS. The last vestige of the gold exchange standard disappeared. The USD became a fiat currency. The world entered a new era of all fiat currencies.

V. Trade under All Fiat Currencies

The world did not immediately descend into a monetary chaos. The USD was not dumped by foreign countries. As if by custom, the USD remained as the currency of international trade and the reserve currency for central banks. The dominance of the USD as the international trade currency has continued even after the Euro managed to carve out a significant share of international trade settlements since 1995. The continued dominance of the USD as the international trade currency since the “Nixon shock” is referred to as the New Bretton Woods (NBW), or Bretton Woods II.

The NBW has succeeded the BWS, without any explicit agreement or formal ratifications by parties involved. The NBW continued, even as European countries, long been jealous of American “exorbitant privilege”, launched the Euro to capture their own seigniorage. Japan steadfastly maintained the export-oriented economy for which the continuation of the NBW has been crucial. Asian Tigers that had begun to thrive under the BWS had a good reason to sustain the NBW. Other late developing countries hitched on to the NBW to pursue an export-led growth policy, the most significant of which China. Despite concerns about the persistent trade deficit, the U.S. has enjoyed riding along the NBW, for a higher level of consumption than otherwise possible.

International trade balance is possible, in principle, even in the world of all fiat currencies, if capital is mobile and exchanges are flexible. But wide and frequent fluctuations in the market-determined exchange rate are difficult to live with. Many countries therefore try to maintain a fixed exchange rate within an acceptable band. Varying degree of frequency with which the central bank is willing to adjust the exchange rate are called pegged, or managed float, or float.

The practice of fixed or semi-fixed exchange rate, combined with financial market liberalization, creates, at times, profitable opportunities for speculative attacks on currencies. When speculators believe that a currency is over-valued at an indefensible level, given the underlying economic conditions (such as trade imbalance or interest rate differentials), they short the currency. The central bank whose currency come under speculative attacks ends up surrendering, after exhausting the USD reserve, and letting the currency depreciate, often drastically. Speculators then would cover the short and realize profits.

Each episode of financial crises has made the central banks to crave for an ample reserve in the USD, (or else introduce capital control), to ward off currency speculators. To accumulate the USD, a country must run a trade surplus. To persistently run trade surplus, surplus earnings must be sterilized. Otherwise, the net USD inflow would lead to an increase in the domestic money supply and higher prices, restoring trade balance. From around the mid-1970s the success of the export-led growth policies of the Japan, Germany, and Asian Tigers became widely known. Many other countries began to imitate the successful strategy for export-led economic development. In the late 1970s, Mainland China began to pursue the same strategy.

The early 1980s was a difficult time for the U.S. economy. Between 1980 and 1985 the USD appreciated nearly 50% against the major currencies.¹¹ A major split in interest between the finance industry and the manufacturing industry appeared. The former welcomed the opportunity to buy foreign assets cheaply; the latter was rendered uncompetitive against foreign competition, resulting in business closures on a massive scale. (The unemployment rate reached above 10% in the early 1980s.)

Under the pressure of increasing demand for protectionism, the Reagan administration tried to bring about a devaluation of the USD through coordinated interventions by the major trading partners (England, Germany, France, and Japan) in the Plaza Accord of 1985.¹² The coordinated effort succeeded in devaluing the USD and narrowed the U.S. trade deficit considerably, but the respite was temporary. The U.S. industrial health was not fully restored.¹³

The problem of chronic U.S. trade deficit has become worse since Mainland China began to adopt the proven method of industrial development of Japan, Korea, Taiwan, Singapore, etc. The problem of trade imbalance has become an order of magnitude worse since the Chinese accession to the WTO in 2001. There are two reasons for this: the extent of the under-valuation of RMB and her size.

(1) Mainland China has pursued an export-led growth policy by under-valuating the RMB. China has a strict capital control and chooses the exchange rate. China sterilizes the inflow of the USD by selling government bonds, or by raising the bank reservation ratio.¹⁴ In March 1981, the exchange of the RMB per USD was 1.61. In January 1987, it became 3.73. (Figure 2) In March 1994, it became 8.72. From July 1995 to March 2005, it was kept at 8.27-8.30. That is over 500% devaluation in about 15 years. In August 2008, the RMB was revalued to 6.8. Since then the exchange rate ranged between 6.3-6.8. That is still about 400% devaluation compare to the initial exchange rate. Moreover, China maintains high protective barriers in tariffs, non-tariff barriers, and arbitrary government interferences in business. No wonder China has run a huge current account surplus year after year.¹⁵ No wonder the U.S. a huge current account deficit year after year¹⁶.

(2) Of course, China is not the only country that has under-value the currency and pursue an export-led growth policy. Other countries (Germany, Japan, Korea, Taiwan, etc.) have chronic

¹¹ The main reasons were Volker's attempt to reduce inflation and the ballooning budget deficits from spending increase and cut in taxes in the Reagan Era.

¹² In 1981 Japan agreed to a "voluntary export restraint" on automobile, demanded by the Reagan Administration. In compliance with the Plaza Accord, Japan revalued the Yen against the USD up to 50%, causing recession in Japan. Japan then countered the impact by an expansionary monetary policy, leading to the real estate bubble in the late 1980s and eventually to the "lost decade" in the 1990s.

¹³ The reason has to do with the fact that through the recession, many U.S. businesses either relocated their productions overseas, or outsourced a good part of their operations; also, many foreign producers managed to enhance their productive capacities. This was an instance of hysteresis in economics.

¹⁴ Chinese cash required reserve ratio ranged from 5% to 21%.

¹⁵ The Chinese current account surplus in 2017 was 3.4% of GDP. In 2007 it was over 11% of GDP.

¹⁶ The U.S. current account deficit in 2017 was 4.4% of GDP. In 2006 it was over 6% of GDP.

overall trade surplus. But China is by far the largest among them. Its GDP is the second largest in the world, next to the U.S.¹⁷ It has the largest population size and a very large market it protects. In 2018, 67% of the \$621 billion U.S. trade deficit was with China. The size makes a qualitative difference.¹⁸ As a major creditor, Chinese can exert much influence on U.S. policies. The growing wealth of China has enabled her to entertain global hegemonic ambitions, in projecting herself economically and diplomatically and in challenging the U.S. militarily in Southeast Asia and beyond. International relations are becoming increasingly strained as smaller countries are forced to take a side.

The NBW has produced a serious international trade imbalance, through the over-valuation of the USD. The U.S. does not choose the exchange rate; it is decided by other countries that choose to accumulate the USD, beyond the level needed to settle international trade. In the NBW, the U.S. has been entrusted to perform the role of world's engine of economic development, in exchange for seigniorage and the privilege of the liberal use of IOUs, funding the seeming prosperity—low inflation, low unemployment rate, and decent growth rates.

But the NBW has brought profound changes in the U.S. economy. Consumers delight in bargain-priced imports. Most goods that Americans buy nowadays are made overseas.¹⁹ With the perpetually over-valued USD, the U.S. import-competing sectors continually shrink (and erstwhile export sectors become import-competing sectors), without comparable expansion of the export sector. The rapid decline in manufacturing jobs are increasingly replaced by jobs in government, education, health care, and distributing/servicing imports. The outcome is negative in terms of government finance (requiring more and more transfer to compensate the losers), political peace (because of increasing inequality), international balance of power (from the relative diminution of the U.S. economy which depends on the continued credit from potential foreign adversaries), and the eventual reckoning of the books, (potentially accompanying a drastic depreciation of the USD, high inflation, and a drastically lower standard of living.)²⁰

VI. Summary and Concluding Thoughts

The goodness of free trade rests on trade balance. That is the assumption of international trade theories, or models. The requirement of trade balance is often overlooked because international trade models portray barter in which trade is balanced. The idea of the goodness of free trade carries over to the pure gold standard, in which trade is balanced. But the requirement of trade balance is less strictly maintained with the gold exchange standard, with the possibility of under-

¹⁷ In 2018, the American GDP was \$20.5 trillion and the Chinese GDP, \$13.5 trillion. But if the RMB is 50% under-valued, the GDP of the two would be about the same.

¹⁸ Imagine a lapdog. One can easily tolerate it sitting on one's lap. But would one tolerate a donkey or an elephant on one's lap? That would be intolerable.

¹⁹ Since 2014, the merchandise account deficit has been over \$1 trillion dollars. In 2006, the merchandise account deficit was over \$1.6 trillion.

²⁰ One positive outcome of the NBW where the U.S. has played the role of the world's economic development has been lifting billions of people out of abject poverty, (in addition to expanding the rank of the middle class and creating scores of billionaires around the world.)

valuation of the currency through sterilization. The requirement of trade balance is met only through periodic adjustment of exchange rates.

Under the stress of trade imbalance after WWI, the gold exchange standard disintegrated through competitive devaluation and protectionism. After WWII the BWS was arranged to bring about a stable international monetary order, with the USD as the anchor currency. It was a variant of the gold exchange standard, based on the preponderance of the U.S. economy. But it faced the Triffin Dilemma. The BWS entailed a persistent trade imbalance, frequent exchange adjustments, and steady outflow of gold from the U.S., leading to the Nixon Shock of 1971. Even after the formal demise of the BWS, the USD, now a fiat currency, has remained as the reserve currency and international trade imbalance persists. If anything, over time, the international trade imbalance has become an order of magnitude worse with the Chinese accession to the WTO. Can the trade imbalance continue? Even Chinese officials have begun to wonder publicly whether the NBW needs a reform.²¹

Should economists maintain the idea of the goodness of free trade in the face of persistent and an unsustainable trade imbalance under the NBW? Can the NBW be regarded as an exception to free trade, along with infant industry and national security? I think the case for the latter deserves a consideration.

If the NBW is viewed as incompatible with free trade, what can be done? What could the U.S. have done in 1971 when it declared moratorium on the BWS? What can the U.S. possibly do now to extricate itself from the NBW? These are big ifs, especially considering that there are conflicting interests in reforming any system. Consider the following possibilities:

(1) In 1971, the U.S. could have proposed to reconsidered Keynes' 1944 proposal, the Bancor, as a means of international trade settlements. The Bancor is a fiat currency issued by the world central bank and managed by an international clearing union to make sure that international trade is balanced. Trade surplus countries would face penalty and trade deficit countries would be forced to devalue. The scheme raises a host of issues regarding the independence and faithfulness to the mission of such an international organization, as well as its ability to enforce rules on sovereign nations. But at least the Keynes' proposal recognizes the central importance of trade balance and is not subject to Triffin Dilemma.

(2) In 1971, the U.S. could have proposed to reform IMF so that the SDR can play a role similar to that of the Bancor. This would have involved a complete overhaul of the IMF and expanding its mission to become the world central bank for international trade settlement.

(3) In recent years, Warren Coats, a former IMF official, has proposed the "real SDR" (RSDR) as a means of international trade settlements. In this scheme, IMF (or a similar organization) can act as the central bank of the world for international trade settlements and clearing house. Where the SDR is currently a composite of contributing currencies, the RSDR is to be a composite of several commodities, whose prices are determined in the market. The proposed central bank can operate without accumulating reserve-commodities at great costs; it

²¹ Zhou (2009). Chinese holding of foreign exchange reserve peaked at almost \$4 trillion in early 2014. More recently, the reserve holding is down to a little above \$3 trillion. (Figure 3) The difference can be accounted for by increasing import of gold and acquisition of real assets abroad (farms and mines in Africa, Australia, Latin America, and elsewhere.) This can be seen as an attempt to diversify Chinese reserve holding.

could operate like a currency board. The RSDR's main goal of to maintain international trade balance, by enforcing rules similar to that of the Bancor.

These are interesting ideas, but all of them require international cooperation. Would there be enough interest in reforming the NBW? Would countries that currently benefit from the status quo agree? Will there be enough interest in the U.S.? And what is to be done with the existing reserves (and IOUs) that foreign central banks hold? If the creditors are made whole, the transition costs (of paying off the past profligacy in gulp) would be enormous for the U.S. If the debt is to be paid off over time, the U.S. will have to run trade surplus for a long time. Would others agree to it? Even if there were enough interest in reforming the international monetary order, it may take years to reach a workable agreement. Is there anything the U.S. can do unilaterally to end the NBW?

(4) The NBW is maintained by the countries that accumulate excess reserves in the USD, apparently because they benefit from doing so. One possible solution, therefore, is to have the surplus countries pay for the benefit they derive from trade surplus, or at least a good part of it. That would reduce the surplus countries' incentive to hold the USD reserve, reduce the extent of the over-valuation of the USD, and decrease trade deficits. Also, using the proceed to narrow the budget deficit and government would have to borrows less. This may not provide a complete solution, but it should have the effect of making the USD less attractive to accumulate and induce other countries to consider reforming the international monetary order more seriously.

But how? Selective tariffs and trade barriers would bring too much complications in international relations and enforcements. One possibility is a value-added tax.²² It a consumption tax that taxes all imports and exempt all exports from taxation, (by rebating value added taxes upon export). Most other countries around the world already have the value-added tax. There shouldn't be any international complain about it as being unfair. A value added tax as a tax on imports may not only reduce deficit (by countering the undervaluation of currencies by mercantilist countries), but also generate revenue to reduce government deficit. Tax rates can be calibrated over time to achieve a trade balance.

It may be worthwhile to explore other ways to make the accumulation of the USD as reserves by foreign central banks less attractive. Free trade would make sense only when trade is balanced, or when people pay for what they buy, not when they can go on buying things using credit cards, till the day of bankruptcy.

End

²² Among European countries the VAT ranges 18-27%. The Republic Party proposed Destination-Based Cash Flow Tax (or Border-Adjustment Tax) is related to the value-added tax.

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Figure 1

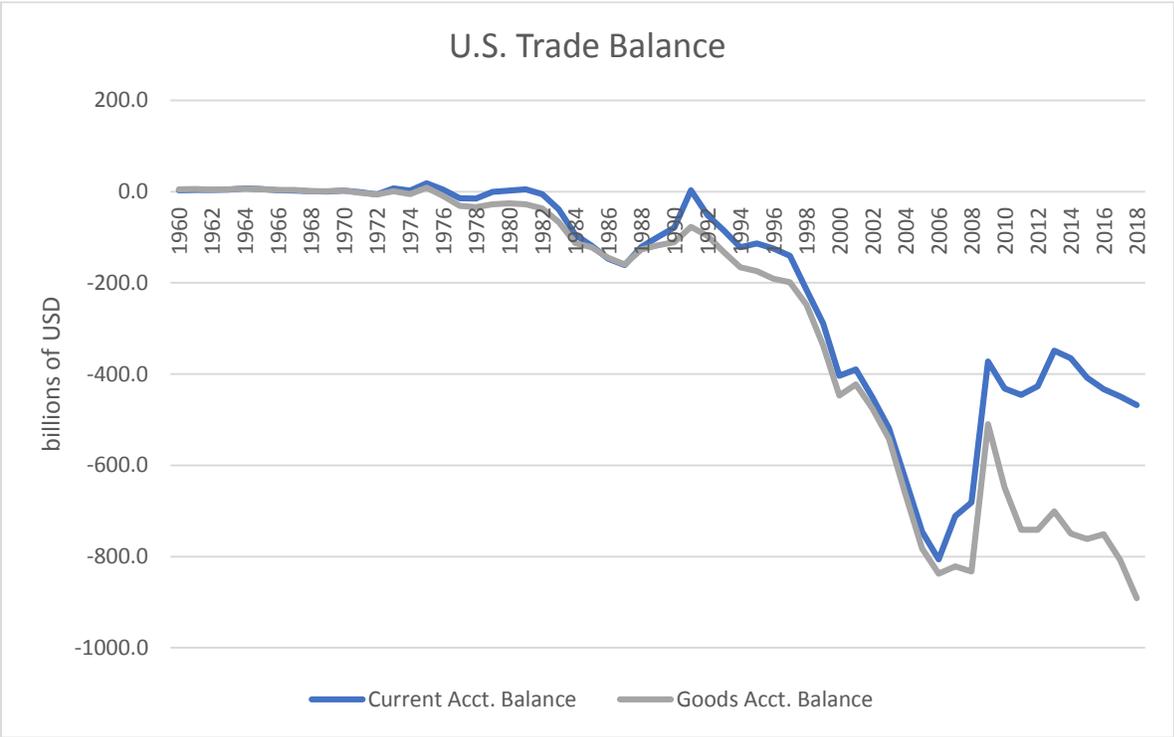


Figure 2

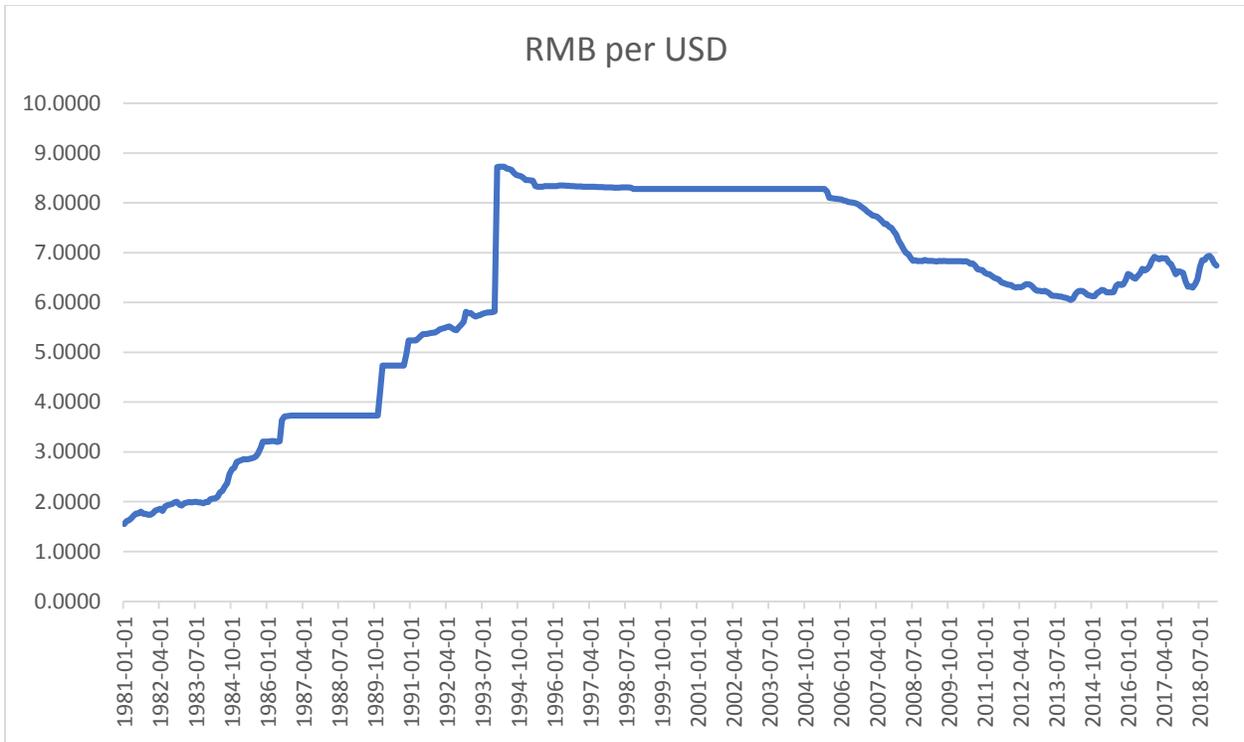


Figure 3

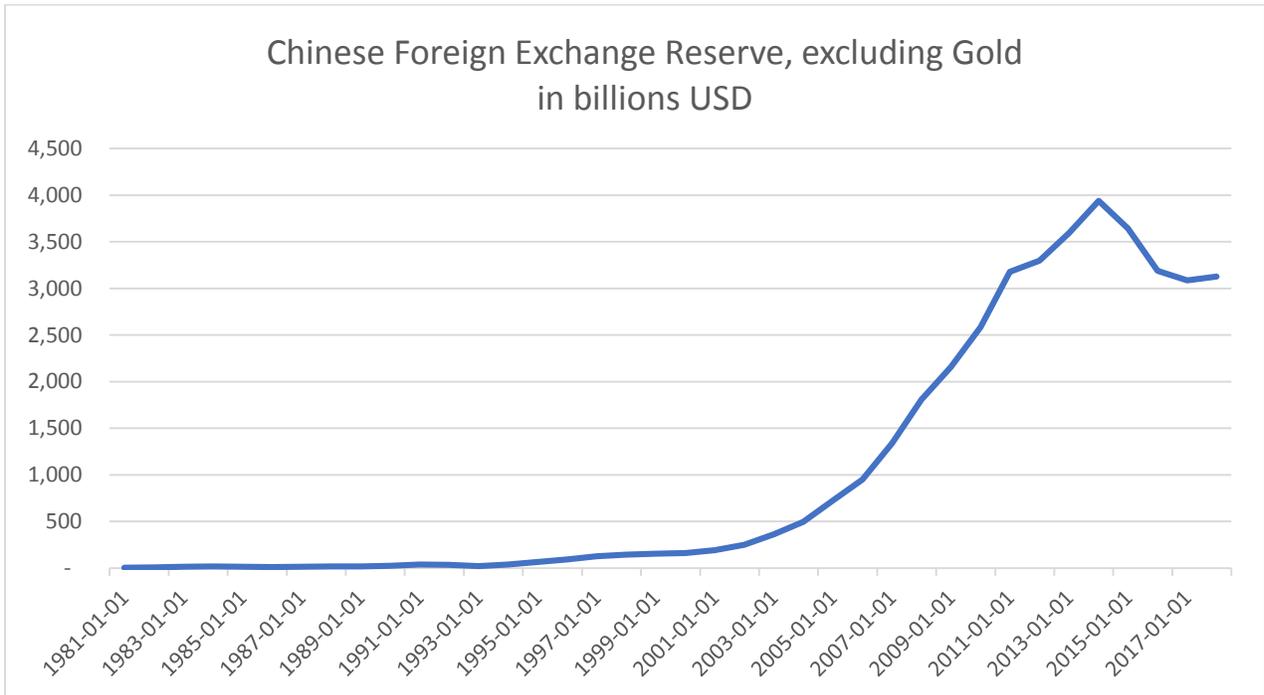
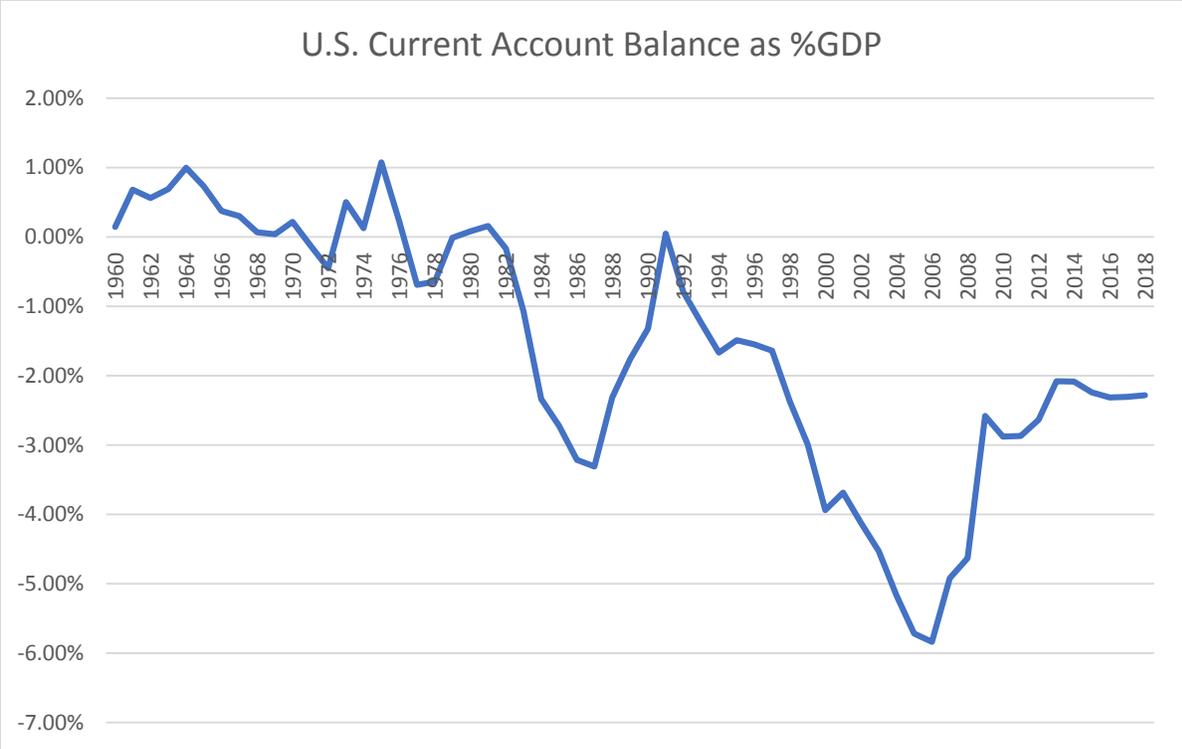


Figure 4



Trade w/ different exchange rates

