Introduction

TANSTAFL [There Ain't No Such Thing as a Free Lunch] is the name of the student-run snack bar in the Pierce residential student dorm of the University of Chicago. The name references the fact that the use of the term in economics was popularized by Milton Friedman, the Nobel Prize-winning former University of Chicago professor.

-Wikipedia

A basic principle of economics is that there is no free lunch. Benefits are accompanied by costs. This book is about the costs and benefits of US trade and tax policies. We believe that the policies which have produced and sustained the enormous US trade deficits have many more costs than benefits. Those who think that the Chinese, Japanese, Saudis et al. are giving the United States a free lunch when they sell more than they buy are engaged in short term thinking that ignores huge long term costs.

With the dollar falling steadily, foreclosures rising, and credit tightening, by the fall of 2007 Americans were beginning to realize that the large American trade deficits were indeed a problem. When former Federal Reserve Chairman Alan Greenspan came out with his memoirs, he was peppered with questions about the trade deficit and the future of the dollar. In an interview with German *Stern* magazine, Greenspan said it was "absolutely conceivable that the euro will replace the dollar as reserve currency, or will be traded as an equally important reserve currency."[1] When questioned by Lesley Stahl on the CBS television program *Sixty Minutes* about where his own savings were located, he admitted that he had diversified them so that a large proportion were in currencies other than the dollar.[2]

The future of the dollar was looking grim. The strength of a currency is largely based upon the productivity of the economy that uses it. In the short-run, a country can borrow in order to prop up its currency, but in order for a currency to be strong in the long-run, that country must export about as much, or more, than it imports.

Unfortunately, during the decade from 1996 to 2005, the last ten years of Greenspan's reign at the Federal Reserve, the US trade defi-

cits steadily increased as a percentage of GDP. The financial flows that sustained these deficits did not go to expand the US capital stock — they mostly financed consumption of foreign goods. Japan and China and other Pacific Rim nations stole industry after industry from the United States. America's manufacturing investment declined so much that by 2004 and 2005, net investment in American manufacturing actually went into negative territory, meaning that US manufacturers were not even investing enough to replace wearing out machinery and plants. The US manufacturing workforce declined steadily, so that by 2007 over a fifth of the US manufacturing jobs that would have existed given balanced trade had been lost. Those losing their manufacturing jobs often took less skilled jobs in the service sector, causing median wages to stagnate. In 2007, the United States was in a much weaker position to compete in world markets and the dollar had nowhere to go but down.

The decline of US manufacturing also had profound effects upon the US military, lengthening supply lines as more parts were sourced from abroad and reducing US capability to rapidly develop and deploy new weapons systems. The United States-China Economic and Security Review Commission 2007 report sums up the problem as follows:

> "U.S. defense contractors have merged and moved some manufacturing outside the United States. Sources of defense components are becoming scarcer in the United States, and the supply of American workers skilled in manufacturing these components is diminishing."[3]

While this was happening, most US elected leaders were ignoring the negative effects that our tax system was having upon the trade deficit and upon American savings. They were ignoring the fact that our tax system was subsidizing the foreign savings that were causing the trade deficits. They were ignoring the fact that our tax system was encouraging the consumption of capital. America needed to generate more of its own savings instead of borrowing them from abroad.

But the US government is not the only government that has contributed to the trade deficits. Recently some economists have begun to realize that the trade deficits are largely the result of a new form of

mercantilism, dubbed "monetary mercantilism" by Joshua Aizenman & Jaewoo Lee in 2005, who defined it as "hoarding international reserves in order to improve competitiveness."[4] Under the old form of mercantilism, countries encouraged their exports and discouraged their imports in order to build up their gold hoards. Under the new form, which we call "dollar mercantilism," countries build up their dollar hoards as part of currency manipulations designed to encourage their exports and discourage their imports.

Here's how they do it. The dollar mercantilist governments borrow their own currency and then use it to buy dollars so that they can drive up the price of the dollar compared to their own currency in currency markets. As a result of the higher price of the dollar and the lower price of their own currency, their own products can then outcompete US products in world markets.

Because the dollars purchased by the mercantilist governments are not used to purchase US goods and services, demand for US produced tradables is kept artificially low. This new form of mercantilism intentionally produces trade deficits for the United States while allowing the practicing country to build up its manufacturing capacity at the expense of US industry.

Instead of keeping the purchased dollars in their bank vaults, the mercantilist governments loan them back to us so that they can earn interest on them. In effect, the mercantilist countries are lending us money to buy their goods, and just like a teenager with a new credit card, we are running up our balance with no thought to the future.

Japan gradually invented dollar mercantilism in the years following World War II. Beginning in the late 1990s, China copied the policy that had converted Japan from a weak and backward economy to a world powerhouse. In recent years, more and more countries have been joining the bandwagon, with the United States as their primary target. They have been accumulating dollar assets in order to manipulate currency values and preserve the conditions that produce trade surpluses for them and trade deficits for us.

Although the evidence of manipulation was mounting, as recently as 2007 most economists were still in denial. Free-trade ideology

was still blinding them to the severity of the problem and the fact that the market forces that they expected to correct trade imbalances were being blocked by government policies. They were explaining away the causes of the trade deficits. They were minimizing the costs of the trade deficits. They were minimizing the role of the mercantilist policies, pursued by Japan for a half century and by China for over a decade, that had undermined the productive capacity of the United States and converted the United States from the world's leading creditor to the world's leading debtor. These economists were still equating globalization, the signing of the General Agreements on Tariffs and Trade and the creation of the World Trade Organization, with free trade. These and other agreements had reduced barriers to trade but had not prevented countries from pursuing mercantilist policies to our detriment.

Even though in private Greenspan was protecting himself against a fall in the dollar, his public analysis stumbled with most economists. In his 2007 memoirs, *The Age of Turbulence,* Alan Greenspan took the view that the increased trade deficits were no great problem but were the result of increased international specialization that has been going on since before the industrial revolution, what we now call *globalization*. He wrote, "It is the focus of a worldwide fear that America's external imbalance – the dramatic gap between what a nation imports and what it exports – will precipitate both a collapse of the US dollar's foreign-exchange value and a world financial crisis." He wrote that while the concern is not groundless, "it is easy to exaggerate the likelihood of a dollar collapse."[5]

Nowhere in his book was there any recognition that the trade deficits had depressed US manufacturing investment, making it more and more difficult for the United States to compete in the world market place. Nowhere was there any recognition of the strong role played by governments in creating and sustaining the trade deficits, distorting free market forces.

As advocates of free markets, we generally approve of relying on the free play of market forces to provide the highest level of welfare for Americans. But we discovered that *free trade*, normally benefi-

cial, had become an ideology blinding the United States establishment from seeing key causes of the trade deficits and their disastrous consequences. The trade deficits are sustained by government policies, both US government tax policies and foreign government mercantilist policies, not by the free play of market forces. We have to face it. While trade often benefits all, when it comes to government-driven trade deficits, *there ain't no free trade!*

We must act now! If the correct actions are taken, we may still avoid the worst consequences of our failed economic policies. That task will involve direct action to balance trade, ending our tax subsidies for foreign savings, and changing our tax system to encourage American savings and investment. If we address the trade deficits now, then the United States, together with other advocates of democracy, will continue to dominate the world's economy. If not, then resolutely nondemocratic China will dominate. The world's future is in the balance.