4. How to Balance Trade

A frog sits in a pot. Gradually the water gets warmer. Unknown to the frog, somebody has been turning on the heat. At first the frog swims around; the warmer water is pleasant. But then the water gets hot. The frog needs to do something soon or it will be too late. Although the frog's limbs have registered the fact that there is a problem, the frog's brain does not yet know that he is in trouble. Will he hop out of the pot while he is still able to do so?

Those involved in American manufacturing industries are feeling the heat, but Washington has not come up with an effective response. In this chapter we will discuss just what we would do to end the trade deficit.

We did not get into the present stew overnight, and getting out without getting burned will be difficult. Our moves need to be planned out as if we were in the middle of a tricky chess game. The key to success is that the trade deficit must be brought down gradually. The trick is to avoid extremes. Should the trade deficit persist for too long, we could lose most of our remaining manufacturing. If it ends too abruptly, the United States economy could be thrust into a high-inflation and high-interest-rate hard landing.

If we are not careful, the Chinese government could manipulate the level of savings that it is sending to the United States in order to force the United States into passivity. First they could suddenly jerk out dollar reserves. Then they could "rescue" the US economy by resuming their dollar purchases. In other words, they might "jerk-on-our-chain" by not letting us do things gradually.

The Chinese government has already been indirectly threatening to dump dollars should we enact tariffs.[1] Given the likelihood that most of China's more than $1 trillion of dollar reserves are being held in foreign banks outside of the United States, it would be very difficult for us to respond by freezing Chinese funds should they engage in such economic warfare.

We need to take the necessary steps in the proper order. The first step should be to eliminate the private-foreign-savings tax loop-

hole and the provisions in our tax treaties that prevent or limit taxation of interest at the source. This would not only reduce the flow of private foreign savings and help the comeback of domestic savings and American exports, but it would also encourage the Chinese government to put its dollar reserves in American accounts where the United States could freeze their assets should they try to jerk them out.

The second step should be to enact Import Certificates or some other form of import limitation tied to exports that would bring trade into equality over a period of years. Import Certificates would solve the trade deficit steadily while producing a boom in American manufacturing investment.

The third step should be to take measures to prevent future dollar mercantilism. We could do so by taxing dollar reserves and by buying foreign currency reserves.

Step 1: Restore the Withholding Tax

As we discussed in Chapter 2, in 1984 the United States enacted one of the most foolish tax loopholes of all time, the private-foreign-savings tax loophole. Other tax loopholes have simply led to tax avoidance strategies, but this tax loophole invited the private foreign financial investment that is wrecking the manufacturing sector of our economy. Before 1984, private foreign savers from many countries paid a 30% withholding tax on any interest earned in the United States. Since enactment of the loophole, they have paid nothing.

As a first step, the United States should begin requiring that banks report all interest payments to the IRS, including payments to those that are at present tax free. The IRS almost changed the rules to do this in 2001 and 2002. Congress should pass a law requiring the changed policy. Simply recording interest income (and passing that information along to tax authorities abroad) would end massive tax fraud by foreigners who earn interest in the US, but fail to report that income on their taxes.

The next step would be to restore the withholding tax. If we delete §871(h,i,k) and §881(c,d,e) from the Internal Revenue Service code and either terminate or renegotiate our tax treaties with foreign governments, private foreigners would soon pay a 30% withholding

tax on any interest earned in the United States on their financial investments. Almost all of these treaties include a provision that they can be terminated unilaterally by either country. As a result, they are very easy to renegotiate. When we renegotiate these treaties, they should be restructured to eliminate all limitations on our taxation of interest paid by Americans to nonresident foreigners.

We should also consider simply terminating all of these treaties and *not* renegotiating them. There is only one equitable and efficient way to achieve neutrality in where investment takes place. American residents, including corporations, should be taxed on their income wherever earned and given a tax credit for income taxes paid to the country from which the income originated. Foreign residents, businesses and governments, should be subject to the same rules and rates on income earned in the United States. This would end the discriminatory treatment enjoyed by special interest groups, especially the avoidance of taxes made possible by tax treaties.

If countries want to unilaterally give their citizens tax credit for foreign taxes on interest earned abroad, they can; traditionally, the United States and the United Kingdom unilaterally gave their citizens a tax credit on such taxes.[2] If countries want to seek foreign capital by unilaterally eliminating interest taxation at the source, let them. Several European countries did so in order to attract foreign private loans to help with rebuilding following World War II.

At present the inflow of foreign financial capital is damaging to the US economy. We should not give any incentives for foreigners to send their financial capital here! It may at first seem counterintuitive, but the financial inflows sustain the trade deficit and thereby discourage investment in productive enterprises producing tradable goods and services. Instead, of financing investment they merely finance consumption, while diminishing the long term prospects for the US economy.

Given the $4 trillion of private foreign capital earning interest in the United States in 2006 and estimating a 5% interest rate, elimination of this tax loophole and the relevant tax treaty provisions could increase United States annual income tax collections by as much as

$60 billion,[3] though the total would likely be offset by increased tax credits to Americans earning interest abroad since foreign governments would likely respond by raising their taxes on interest paid to Americans.

But more importantly, eliminating this loophole would discourage the inflow of foreign savings and raise American interest rates which would encourage American domestic savings. Eliminating this loophole would also lower the exchange rate of the dollar, making American exports more competitive in world markets and when competing with foreign imports in American markets.

Eliminating this tax loophole would also improve American national security. Before 1984, most foreign governments would put their dollar reserves directly into US assets where they would be tax free under the long-standing foreign government tax loophole. In those days, they would take a huge interest cut were they to put them into the dollar-denominated accounts of foreign banks.

However, since the passage of the private-foreign-savings tax loophole, many foreign governments have changed the location of their dollar reserves. Although the Japanese government continues to put most of their reserves directly into America,[4] those who are less friendly to the United States, including the Chinese government, avoid the possible freezing of their funds (as President Jimmy Carter did to Iranian funds in 1979) by putting their money into the dollar denominated accounts of foreign banks which in turn can put the money tax free into US assets under the foreign bank's name.

Figure 18 shows the current situation, assuming a 5% US interest rate. At this interest rate, foreign governments can earn just under 5% interest by putting their reserves into a foreign bank that in turn puts them into US assets, or they can earn 5% interest by putting their reserves directly into US assets. If they keep their dollars in foreign banks, they would be less likely to have their funds frozen should they come into conflict (economically or militarily) with the United States.

If we were to close the foreign-private-savings tax loophole and end the interest provisions of our tax treaties, the Chinese government would likely put a much higher proportion of their dollar reserves

directly into US assets in order to earn about 5%, not 3.4% interest. Once invested in American assets, their funds could be frozen were they to suddenly start jerking our chain by pulling out their dollar reserves or were they to attack Taiwan.

Step 2: Impose Import Certificates on Mercantilists

By the end of 2006, foreign governments had already accumulated about $3,200 billion in dollar reserves (about 24% of our GDP) with the dollar-mercantilist Chinese and Japanese governments having accumulated the majority. Unless we do something, these countries will keep accumulating and lending us more and more dollars while taking away what remains of our manufacturing industries.

In the fall of 2003, Warren Buffett in *Fortune*[5] and one of us in the Pittsburgh *Tribune-Review*[6] both looked at the problem and discovered that the United States, on its own without even needing to consult with any other countries, could eliminate the trade deficits. All we would have to do is tie other countries' exports to the United States to the exports that they accept from us.

Buffett's plan was endorsed by Senator Byron Dorgan in his 2006 book, *Take This Job and Ship It.* Dorgan wrote, "The plan that I believe we should employ to tackle these dangerous trade deficits and stop the wholesale export of American jobs is one offered by Warren Buffett."[7]

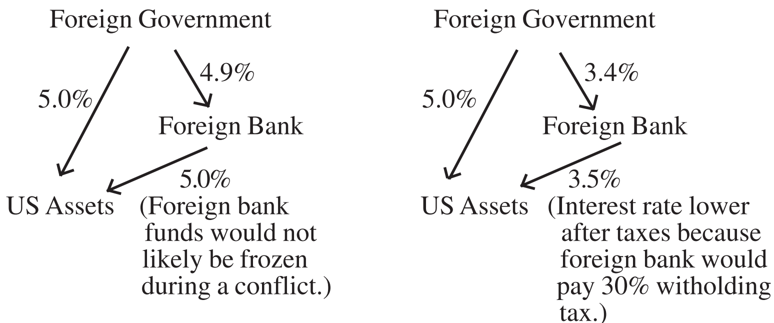

Figure 18. Where Foreign Governments Put Dollar Reserves
Closing the loophole would encourage foreign governments to put dollar reserves directly into assets that US government could easily freeze.

Buffett's plan and our plan differ regarding how the Import Certificates would be issued. Buffett's plan would issue the marketable Import Certificates (ICs) directly to US exporters in proportion to their exports and then allow the exporters to sell the ICs to importers. Our plan would just have the US Treasury Department auction the marketable ICs directly to importers.

The Buffett Plan

In September 2006, Senators Byron Dorgan and Russ Feingold fleshed out the Buffett plan in bill form (Senate Bill 3899), which they named the *Balanced Trade Restoration Act of 2006*.[8] Their bill would have the Department of Commerce issue Import Certificates (which they called "Balanced Trade Certificates") directly to exporters.

Each $1 of exports (based upon the appraised value declared on the shipper's export declaration) would earn the exporter a $1 Balanced Trade Certificate which the exporter could then freely market to importers of goods to the United States. The value of imports allowed by a Balanced Trade Certificate would change over time. During the first year of the program, a $1 certificate would allow up to $1.40 of imports, during the second year, $1.30 of imports, the third year $1.20, and so on until by the fifth year $1 of exports would allow $1 of imports. The exporters would freely market the Balanced Trade Certificates to those who wished to import goods into the United States and the Department of Commerce would require that the certificates be submitted with imports.

Dorgan and Feingold's bill exempted oil and gas imports from the Balanced Trade Certificate requirement during the first five years and then phased them in thereafter. There is no economic reason, however, to exclude energy imports during the first five years of the Balanced Trade Certificate plan. America's exports should pay for all of our imports, including energy imports. The Balanced Trade Certificates would give Americans more incentive to conserve energy and increase their own energy production.

In the findings portion of their bill proposal, Dorgan and Feingold claimed that the plan would not violate WTO Rules:

> (4) Article XII of the General Agreement on Tariff and Trade (GATT 1994), annexed to the Agreement Establishing the World Trade Organization entered into on April 15, 1994, permits any member country to restrict the quantity or value of imports in order to safeguard the external financial position and the balance of payments of the member country.
>
> (5) In accordance with Article XII of the GATT 1994, the United States should take steps to restore balance to its merchandise trade, and safeguard its external financial position and its balance of payments.

The Richman Plan

Our plan differs from Buffett's plan in that we would have the Department of Treasury auction the Import Certificates, rather than have the Import Certificates issued directly to exporters. Also, the certificates would just be targeted to individual dollar mercantilist countries, as evidenced by their excessive amounts of dollar reserves. Here's how one of us described our plan in the original article:

> Is there any way to balance our trade? Let's take a clue from the fact that barter is always beneficial to both parties. Instead of "Free Trade" as the slogan, how about the slogan, "Free and Balanced Trade"? We could announce to countries with whom we have large chronic deficits that their exports to us in the future will be limited to, say, 110% of what we bought from them last year. If you want to trade with us, you'll have to buy from us. Let's barter!

We would announce to all the countries that have been accumulating dollar reserves in order to run a trade deficit with the United States, that effective the following year their deficit on goods and services would have to be reduced twenty percent. They may respond to this challenge by planning to increase their imports from us, reduce their exports to us, or some combination of both. Failure to meet this annual goal would result in our imposition of a requirement that all imports from the offending country would require an Import Certificate (IC) purchased from the US Treasury Department or other designated agency of the federal government. (The US Treasury Department has experience in auctioning off its own obligations; much the same process would be involved in auctioning off import certificates.)

Prospective importers from countries that fail to reduce their defi-

cits in timely fashion would have to apply for an IC and follow the Treasury's instructions. Over a period of five years, the US Treasury Department would steadily reduce the amount of available import certificates so that the targeted country's trade exports to the United States would be no higher than 5% above their imports from the United States. The Treasury would publish the amount of ICs issued and available and the date of each auction. Each certificate would have to be utilized within a specified period.

We recommend that the proceeds from selling the Import Certificates be placed in an off-budget fund that the US Treasury would use to buy foreign currencies and foreign financial assets, putting money into the hands of foreign consumers, especially the consumers of the dollar mercantilist nations. These currency reserves could also be sold by the US Treasury whenever the dollar is declining too rapidly in foreign exchange markets.

Clearly the dollar mercantilist countries would be directly affected by our plan. In 2006 China had already accumulated $1,066 billion in currency reserves, preponderantly dollars, and was exporting 4.5 times more goods and services to the United States than it was importing. That year Japan had already accumulated $884 billion in currency reserves, preponderantly dollars, and was exporting 1.7 times more goods and services to the United States than it was importing.

Comparison Between the Plans

There are many differences between the two plans. Buffett's plan (as put into bill form by Senators Dorgan and Feingold) would involve our trade with all countries of the world, while our plan would only affect our trade with the dollar mercantilist countries. Buffett's plan would distribute the certificates to US exporters with no change in US government revenue, while our plan would have the US government gain revenue by auctioning the import certificates directly to importers. Buffett's plan would clearly and definitely balance trade over a period of 10 years. Our plan would balance our trade with the dollar mercantilist countries, but would not completely balance trade. The biggest difference, however, would be the effect of the plans on the international trading system.

Buffett's plan runs contrary to the spirit of World Trade Organization rules, since it subsidizes US exports. The current system of international regulations was designed to gradually reduce government interference with free trade. Even so, other countries have taken advantage of loopholes in the international regulations to directly subsidize their exports. The dollar mercantilist nations have been the most egregious, selling their currencies and buying dollars in order to make their exports cheaper and US exports more expensive in world markets. The European nations rebate value-added taxes to their exporters and charge them on American imports so that their goods actually sell for less in the United States than they do in Europe. Even though the rules are not fair, they have been improving and many would be hesitant to reverse them. Buffett's plan would enshrine the principle that countries have a right to subsidize their exports if that is necessary in order to balanced trade and so would weaken the system of regulations that has governed trade in recent years.

Our plan has the advantage that it is much more modest. It could more clearly be instituted without violating World Trade Organization rules since it would only impose import certificates upon countries having a large trade surplus with us. Article 12 of the Uruguay Round GATT agreement specifically lets countries running a threatening overall trade deficit restrict imports from any country with whom they are running a trade deficit.[9] Our plan would simply enforce the International Monetary Fund agreement that countries should not manipulate their currency values. The result would be a more balanced playing field under the current rules of international trade.

Our plan would directly force the dollar mercantilist governments to change their policies. Instead of discouraging their people's consumption of American goods and services, the dollar mercantilist governments would have to encourage their people to import more goods from the United States should they want to export goods and services to the United States. Our plan leaves the current system of international regulations intact. It would just end dollar mercantilism, the export-subsidy loophole unnecessarily permitted by the United States under the current system.

But is the current system of international regulations really worth preserving? It may be that decades from now people will look back with wonder at the foolishness of 20th century nations putting their faith in a system of rules. No system is ever perfect. Governments will always find loopholes to exploit.

The Buffett plan has within it the seeds of a different, but perhaps better international system, one based upon the fact that balanced trade, like barter, always benefits the parties involved. Under the new system, any country experiencing a trade deficit could decide to impose a system of import certificates in order to bring that trade back into balance. The new system would put an end to mercantilism. Any country that tried to subsidize one particular export-competing industry would be hurting its import-competing industries. There would no longer be a need for the World Trade Organization, nor for the GATT treaties, nor for any other of the forms and bureaucracies of the current regulatory-based trade system.

The new system could easily retain the dollar standard using the dollars that are already abroad. By the end of 2006, we estimate that foreign governments already had $3.2 trillion dollars in reserves. Unless the United States were to begin to run trade surpluses, these dollars would remain abroad where they could be used as the medium for international transactions.

Under the new system, countries that were running trade deficits would need to decide whether or not they wanted to impose import certificates in order to balance their trade. Not all countries would decide to do so. Developing or recovering countries might want to attract the financial capital that accompanies trade deficits.

No longer would it be possible for one country to deindustrialize and economically destroy its trading partners without its trading partners' consent. With balanced trade the rule, not the exception, no longer would the world economy be characterized by massive movements in the prices of currencies that would cause intense recessions and depressions. The mercantilist era of economic warfare would end. The era of economic instability caused by currency collapses would end. An era of international economic stability would begin.

Advantages of Import Certificates

Some people mistakenly think that export-linked ICs would be no different in their effects from across-the-board tariffs. But this is not true. ICs guarantee that the trade deficit is eliminated, while tariffs invite counter-tariffs.

Furthermore, ICs linked to exports change the psychology of the situation both among US manufacturers and also among foreign governments. Manufacturers, knowing that the trade deficits would move toward parity, would increase their investment in US production. Foreign governments, knowing that they would need to import more in order to export more, would increase their imports. ICs are the only way to solve the problem assuredly and consistently over a preset period of time.

Each year of ICs, our manufacturing industries would come roaring back, as would our level of manufacturing investment. The risk of a hard landing would diminish: our economy would gain the strength needed to withstand sudden pullouts of foreign financial funds. Gradual pullouts of foreign financial investment would probably be matched by increases in foreign fixed investment as foreign companies would rush to build and expand factories in the United States.

Objections to Import Certificates

When the Buffett plan was introduced as a bill in September 2006, Sherman Katz[10] of the Carnegie Endowment for International Peace and Sallie James[11] of the Cato Institute focused upon four overall criticisms:

1. *The plan would raise consumer prices paid by Americans*. This is true. At present the prices of imports into the United States are being subsidized by the dollar mercantilist countries in order to steal the market share of our industries. The result has been the deindustrialization of the United States. This plan would end those subsidized prices and that deindustrialization.
2. *The plan would raise US interest rates and thereby reduce investment in the United States*. Although interest rates would indeed go up, investment in those sectors of our

economy that export or compete with imports would surge. The loans being forced upon us by the mercantilist countries have indeed lowered interest rates, causing us to mortgage our future in order to buy consumer goods.

3. *The plan would anger our trading partners.* The Richman plan would only apply to those countries running large export surpluses with us, not our other trading partners. The Buffett plan could be adjusted to exempt some of our trading partners. If we wish to exclude the North American countries (Mexico and Canada), we could, perhaps, persuade them to adopt the same ICs themselves. Then North America would continue to be a free-trade zone, but all imports into North American countries would have to be accompanied by ICs.
4. *The plan would intrude government into business activity*. Not all business activity would be affected. The Buffett plan would affect exporters by giving them a bonus. The Richman plan would *not* involve exporters. Both plans would indeed place additional costs upon importers.

In general, the objections to Import Certificates come from those who do not recognize the unsustainable and dangerous nature of the current situation. They reason that lower prices paid by consumers are good, without realizing that the lower prices won't last but that the industries lost as a result of them may never return. They reason that lower interest rates mean higher investment, but don't realize that the dollar mercantilism that causes the lower interest rates also takes away investment opportunities for American manufacturing. Import Certificates, whether the Buffett plan or the Richman plan, may be the only way to solve the trade deficit problem without precipitating a crash in the value of the US dollar.

Governments should not be allowed to subsidize their exports and limit their imports by accumulating dollar reserves or reserves of any other currency. If they wish to protect themselves from a sudden fall in the value of their own currency, let them purchase SDRs (Special Drawing Rights) from the International Monetary Fund. The International Monetary Fund could, in turn, lend out those reserves to

underdeveloped countries that want infrastructure investment.

Step 3: Tax Foreign Dollar Reserves

The U.S. income tax system provides a special tax break that exempts foreign governments from paying any U.S. taxes on dividends, interest, or any other income earned from their U.S. investments. Other governments have the same policy. It is a sort of gentleman's agreement among governments. *We won't tax you if you won't tax us.* This gentlemen's agreement is very one-sided inasmuch as the U.S. government has virtually no investments abroad while foreign governments, especially those practicing dollar mercantilism, have huge investments in the United States.

The United States should tax dollar mercantilism by placing the highest rate of tax possible on foreign government investments. If it were possible, we would tax foreign government investments at a 100% rate so that they would earn no interest or dividends whatsoever. We would also make it completely illegal for foreign governments to buy stock in US corporations, as they are currently doing through their Sovereign Wealth Funds. US capitalism should not be for sale!

It is not possible, however, to tax foreign government savings at a higher rate than private foreign savings are taxed. If we tried to do so, foreign governments could simply put their reserves into the eurodollar accounts of foreign banks and earn interest thereby when the foreign banks, in turn, put their dollars into US assets. Also, until the United States is well on its way to recovery from the trade deficits, it could be useful to encourage foreign governments to directly place funds into US assets where they could be frozen (see Figure 18).

Unfortunately, taxing foreign investments would not much discourage dollar mercantilism; the mercantilist governments put their money into dollar reserves in order to manipulate currencies, not in order to earn interest income. But doing so would earn plenty of revenue. In 2006, taxing foreign government income at a 30% tax rate would have earned about $45 billion in tax revenue from the interest paid to the $3.2 trillion of foreign government reserves. So long as dollar mercantilism continues, the amount of potential revenue from this mea-

sure will climb steadily. If other countries retaliate by taxing the income earned by the paltry $41 billion of US foreign currency reserves (at the end of 2006), the tax paid out by the US government would be negligible.

Step 4: Build Up US Foreign Currency Reserves

Just as the dollar mercantilist countries buy our currency, our government should buy their currencies. This could be done by the Federal Reserve without requiring any new laws from Congress. Since 1962, the Federal Reserve has had the power to buy foreign currencies under its own account without being subject to any control by the US Treasury. The Federal Reserve could use that power to buy foreign currencies and bonds to match the buildups of dollar reserves by foreign central banks. (China does not permit foreign purchase of their government bonds, so the Federal Reserve would have to find other indirect ways to lend money to Chinese residents.[12])

Whenever the Federal Reserve responds in kind with reciprocal actions to the monetary mercantilist policies of foreign central banks, the effects would be exactly the same as if each central bank were minding its own business. (See the technical appendix at the end of this chapter for the mechanism behind this assertion.) By buying foreign treasury notes, the Federal Reserve would be gradually boosting available credit within the economies of our trading partners and increasingly the value of their currencies relative to the dollar so that they would increase their consumption of our exports.

This method would have to be practiced very gradually. The Federal Reserve would be borrowing by selling US Treasury Notes, using the dollars obtained to purchase foreign currencies, and then using those foreign currencies to purchase foreign financial assets. Such borrowing from Americans would likely boost American interest rates.

The Federal Reserve would want to be careful *not* to raise interest rates so high as to choke off investment, although somewhat higher interest rates could encourage personal savings. The Federal Reserve currently does an excellent job of balancing the growth in money supply so that it is neither inflationary nor deflationary. Intelligent leadership could eventually work out a balancing act that includes keeping

mercantilists from artificially boosting the dollar as well.

Such Federal Reserve action would build up stores of foreign currencies that the Federal Reserve could use to slow the fall of the dollar should there be a sudden run on the dollar, and thus prevent a "hard landing."

Once our trade is in balance, the Federal Reserve should be given the job of keeping it in balance by immediately matching any foreign government buildup of dollar reserves with our own build up of reserves in their currency. In the future, Presidents should only appoint Federal Reserve chairmen who understand that the Federal Reserve's responsibility is not only to maintain a steadily increasing money supply, but also to prevent attacks upon the competitiveness of our economy by foreign central banks.

Changes Need to Be Gradual

The trade deficits were not built in a day and cannot be eliminated in a day. The gradual increase in foreign savings coming into the United States over the past three decades has not only produced huge trade deficits, but has also caused a decline in our manufacturing investment and in our domestic savings rates. The countries exporting to us have come to rely upon American markets to demand the goods that they produce and US consumers have come to rely on inexpensive imports combined with low interest rates.

It will take time to reverse those trends. In order to export and compete more effectively with imports, we will need more manufacturing investment. In order to finance domestic investment, we will need more domestic savings. Countries relying upon the US consumer will have to cut their taxes, expand their money supply, or otherwise make credit more readily available to their own citizens.

Any movement to reduce the trade deficits will necessarily reduce the other side of the coin, the foreign savings flowing into the United States. We will need additional domestic savings in order to counteract the loss of foreign savings. In the next chapters, we will discuss ways that the United States could improve its tax code in order to facilitate the needed bounce-back of domestic savings.

Technical Appendix: Reciprocal Buying of Reserves

Whenever the Federal Reserve responds in kind with reciprocal actions to the monetary mercantilist policies of foreign central banks, the effects would be exactly the same as if each central bank were minding its own economy. We'll explain the economics involved with three examples. In these examples we'll assume that there are only two countries in the world with trade between them. We will call these countries US and Japan and we will call their currencies the dollar and the yen. We'll also assume that, in each country, the central bank is expanding the monetary base to meet the needs of its growing economy. For simplicity of discussion, we'll also assume that at the beginning the exchange rate is such that 1 dollar trades for 1 yen.

Example #1 – Japan and US each buy own bonds.

This is the normal situation. In this example the central bank of Japan buys 1 million yen of Japanese bonds and the central bank of the US (i.e. the Fed) buys 1 million dollars of US bonds. There would be no reason to suppose that these actions would affect either the exchange rate or the balance of trade. The effects would be expansion of aggregate demand in both countries just as described in any macroeconomics textbook:

1. *Monetary Base*. Both monetary bases would expand.
2. *Interest Rates*. There would be a reduction in both the Japanese and US interest rates because the Japanese central bank bid up the price of the Japanese bonds and the US central bank bid up the price of the US bonds.
3. *Credit Expansion*. Banks in both Japan and US would have new excess reserves that they would want to lend out.
4. *Aggregate Demand*. Consumers and investors in both countries would have more money that they could borrow and spend. They would spend some on products of their own country and some on products of the other country. The consumption and investment components of aggregate demand would rise in both countries with little expected change in net exports.

Example #2 – Japan and US both buy US bonds.

In this example, the Japanese central bank uses its 1 million yen to buy 1 million dollars and then uses the 1 million dollars to buy US bonds; the US central bank also uses its 1 million dollars to buy US bonds. These actions would give the US a lower interest rate, a higher dollar, and a negative trade balance:

1. *Monetary Base*. Both monetary bases would expand. The Japanese monetary base would expand by 1 million yen because the Japanese Central Bank created 1 million of new yen which it used to buy the 1 million dollars.
2. *Exchange Rate*. The US dollar would appreciate vis-à-vis the yen because the purchase of 1 million dollars by the Japanese central bank would increase demand for the dollar. This would increase the relative price of US products and decrease the relative price of Japanese products.
3. *Interest Rates*. There would be a double reduction in the US interest rate because both the US central bank and the Japanese Central bank were bidding up the price of the US bonds. There would be no expected change in the Japanese interest rate.
4. *Credit Expansion*. US banks would have new excess reserves that they would want to lend out.
5. *Aggregate Demand*. The consumption component of US aggregate demand would rise while the trade surplus component would fall. US consumers and investors would have more money that they could borrow and spend. Investment in the US could go either way. Falling interest rates would make fixed investment less expensive but the rising dollar would make investment opportunities less attractive. The trade surplus component of aggregate demand in Japan would increase.
6. *Balance of Trade*. US exports to Japan would decrease and Japanese exports to the US would increase. The only counterforce that could prevent this from happening would be a possible flow of private savings from the US to Japan. The reduced interest rate in the US would encourage a flow of private savings to Japan, but the appreciating dollar versus the yen would encourage a flow of

private savings from Japan to the US.

Example #3 – Japan and US each buy other country's bonds.

This is what the Fed could do whenever a foreign country buys dollars to increase its dollar reserves and trade surplus. In this example the Japanese central bank uses its 1 million yen to buy 1 million dollars and uses those dollars to buy US bonds; the Fed reciprocates and uses its 1 million dollars to buy 1 million yen and then uses those yen to buy Japanese bonds. The effects would be the same as in the normal situation of Example #1 where each country buys its own bonds:

1. *Monetary Base*. Both monetary bases would expand.
2. *Interest Rates*. There would be a reduction in both the US and Japanese interest rates because the Japanese central bank bid up the price of the US bonds that it bought and the US central bank bid up the price of the Japanese bonds that it bought.
3. *Everything Else*. Aggregate demand, exchange rate, and trade balance would be exactly the same as in Example #1.

It is clear from Example #3 that there are absolutely no negative economic effects if the Fed matches a foreign build-up of US dollar reserves with a reciprocal build-up of US reserves in the foreign currency. The effects would be exactly the same as when each bank buys its own country's bonds: No increased trade deficit. Mutual increases in consumption and investment in both countries. Mutual increases in the purchases of each other's exports. Whenever the Fed responds in kind with reciprocal actions to the trade-war attacks of foreign central banks, the effects would be exactly the same as if each central bank were minding its own economy.