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America's Growing Trade Deficit Is Selling the Nation Out From Under Us.

Here's a Way to Fix the Problem—And We Need to Do It Now.

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I'm about to deliver a warning regarding the U.S. trade deficit and also suggest a remedy for the problem. But first I need to mention two reasons you might want to be skeptical about what I say. To begin, my forecasting record with respect to macroeconomics is far from inspiring. For example, over the past two decades I was excessively fearful of inflation. More to the point at hand, I started way back in 1987 to publicly worry about our mounting trade deficits—and, as you know, we've not only survived but also thrived. So on the trade front, score at least one "wolf" for me. Nevertheless, I am crying wolf again and this time backing it with Berkshire Hathaway's money. Through the spring of 2002, I had lived nearly 72 years without purchasing a foreign currency. Since then Berkshire has made significant investments in—and today holds—several currencies. I won't give you particulars; in fact, it is largely irrelevant which currencies they are. What does matter is the underlying point: To hold other currencies is to believe that the dollar will decline.

Both as an American and as an investor, I actually hope these commitments prove to be a mistake. Any profits Berkshire might make from currency trading would pale against the losses the company and our shareholders, in other aspects of their lives, would incur from a plunging dollar.

But as head of Berkshire Hathaway, I am in charge of investing its money in ways that make sense. And my reason for finally putting my money where my mouth has been so long is that our trade deficit has greatly worsened, to the point that our country's "net worth," so to speak, is now being transferred abroad at an alarming rate.

A perpetuation of this transfer will lead to major trouble. To understand why, take a wildly fanciful trip with me to two isolated, side-by-side islands of equal size, Squanderville and Thriftville. Land is the only capital asset on these islands, and their communities are primitive, needing only food and producing only food. Working eight hours a day, in fact, each inhabitant can produce enough food to sustain himself or herself. And for a long time that's how things go along. On each island everybody works the prescribed eight hours a day, which means that each society is self-sufficient.

Eventually, though, the industrious citizens of Thriftville decide to do some serious saving and investing, and they start to work 16 hours a day. In this mode they continue to live off the food they produce in eight hours of work but begin exporting an equal amount to their one and only trading outlet, Squanderville.

The citizens of Squanderville are ecstatic about this turn of events, since they can now live their lives free from toil but eat as well as ever. Oh, yes, there's a quid pro quo—but to the Squanders, it seems harmless: All that the Thrifts want in exchange for their food is Squanderbonds (which are denominated, naturally, in Squanderbucks).

Over time Thriftville accumulates an enormous amount of these bonds, which at their core represent claim checks on the future output of Squanderville. A few pundits in Squanderville smell trouble coming. They foresee that for the Squanders both to eat and to pay off—or simply service—the debt they're piling up will eventually require them to work more than eight hours a day. But the residents of Squanderville are in no mood to listen to such doomsaying.

Meanwhile, the citizens of Thriftville begin to get nervous. Just how good, they ask, are the IOUs of a shiftless island? So the Thrifts change strategy: Though they continue to hold some bonds, they sell most of them to Squanderville residents for Squanderbucks and use the proceeds to buy Squanderville land. And eventually the Thrifts own all of Squanderville.

At that point, the Squanders are forced to deal with an ugly equation: They must now not only return to working eight hours a day in order to eat—they have nothing left to trade—but must also work additional hours to service their debt and pay Thriftville rent on the land so imprudently sold. In effect, Squanderville has been colonized by purchase rather than conquest.

It can be argued, of course, that the present value of the future production that Squanderville must forever ship to Thriftville only equates to the production Thriftville initially gave up and that therefore both have received a fair deal. But since one generation of Squanders gets the free ride and future generations pay in perpetuity for it, there are—in economist talk—some pretty dramatic "intergenerational inequities."

Let's think of it in terms of a family: Imagine that I, Warren Buffett, can get the suppliers of all that I consume in my lifetime to take Buffett family IOUs that are payable, in goods and services and with interest added, by my descendants. This scenario may be viewed as effecting an even trade between the Buffett family unit and its creditors. But the generations of Buffetts following me are not likely to applaud the deal (and, heaven forbid, may even attempt to welsh on it).

Think again about those islands: Sooner or later the Squanderville government, facing ever greater payments to service debt, would decide to embrace highly inflationary policies—that is, issue more Squanderbucks to dilute the value of each. After all, the government would reason, those irritating Squanderbonds are simply claims on specific numbers of Squanderbucks, not on bucks of specific value. In short, making Squanderbucks less valuable would ease the island's fiscal pain.

That prospect is why I, were I a resident of Thriftville, would opt for direct ownership of Squanderville land rather than bonds of the island's government. Most governments find it much harder morally to seize foreign-owned property than they do to dilute the purchasing power of claim checks foreigners hold. Theft by stealth is preferred to theft by force.

So what does all this island hopping have to do with the U.S.? Simply put, after World War II and up until the early 1970s we operated in the industrious Thriftville style,

regularly selling more abroad than we purchased. We concurrently invested our surplus abroad, with the result that our net investment—that is, our holdings of foreign assets less foreign holdings of U.S. assets—increased (under methodology, since revised, that the government was then using) from $37 billion in 1950 to $68 billion in 1970. In those days, to sum up, our country's "net worth," viewed in totality, consisted of all the wealth within our borders plus a modest portion of the wealth in the rest of the world.

Additionally, because the U.S. was in a net ownership position with respect to the rest of the world, we realized net investment income that, piled on top of our trade surplus, became a second source of investable funds. Our fiscal situation was thus similar to that of an individual who was both saving some of his salary and reinvesting the dividends from his existing nest egg.

In the late 1970s the trade situation reversed, producing deficits that initially ran about 1% of GDP. That was hardly serious, particularly because net investment income remained positive. Indeed, with the power of compound interest working for us, our net ownership balance hit its high in 1980 at $360 billion.

Since then, however, it's been all downhill, with the pace of decline rapidly accelerating in the past five years. Our annual trade deficit now exceeds 4% of GDP. Equally ominous, the rest of the world owns a staggering $2.5 trillion more of the U.S. than we own of other countries. Some of this $2.5 trillion is invested in claim checks—U.S. bonds, both governmental and private—and some in such assets as property and equity securities.

In effect, our country has been behaving like an extraordinarily rich family that possesses an immense farm. In order to consume 4% more than we produce—that's the trade deficit—we have, day by day, been both selling pieces of the farm and increasing the mortgage on what we still own.

To put the $2.5 trillion of net foreign ownership in perspective, contrast it with the $12 trillion value of publicly owned U.S. stocks or the equal amount of U.S. residential real estate or what I would estimate as a grand total of $50 trillion in national wealth. Those comparisons show that what's already been transferred abroad is meaningful—in the area, for example, of 5% of our national wealth.

More important, however, is that foreign ownership of our assets will grow at about $500 billion per year at the present trade-deficit level, which means that the deficit will be adding about one percentage point annually to foreigners' net ownership of our national wealth. As that ownership grows, so will the annual net investment income flowing out of this country. That will leave us paying ever-increasing dividends and interest to the world rather than being a net receiver of them, as in the past. We have entered the world of negative compounding—goodbye pleasure, hello pain.

We were taught in Economics 101 that countries could not for long sustain large, ever-growing trade deficits. At a point, so it was claimed, the spree of the consumption-happy nation would be braked by currency-rate adjustments and by the unwillingness of creditor countries to accept an endless flow of IOUs from the big spenders. And that's the way it has indeed worked for the rest of the world, as we can see by the abrupt shutoffs of credit that many profligate nations have suffered in recent decades.

The U.S., however, enjoys special status. In effect, we can behave today as we wish because our past financial behavior was so exemplary—and because we are so rich. Neither our capacity nor our intention to pay is questioned, and we continue to have a mountain of desirable assets to trade for consumables. In other words, our national credit card allows us to charge truly breathtaking amounts. But that card's credit line is not limitless.

The time to halt this trading of assets for consumables is now, and I have a plan to suggest for getting it done. My remedy may sound gimmicky, and in truth it is a tariff called by another name. But this is a tariff that retains most free-market virtues, neither protecting specific industries nor punishing specific countries nor encouraging trade wars. This plan would increase our exports and might well lead to increased overall world trade. And it would balance our books without there being a significant decline in the value of the dollar, which I believe is otherwise almost certain to occur.

We would achieve this balance by issuing what I will call Import Certificates (ICs) to all U.S. exporters in an amount equal to the dollar value of their exports. Each exporter would, in turn, sell the ICs to parties—either exporters abroad or importers here—wanting to get goods into the U.S. To import $1 million of goods, for example, an importer would need ICs that were the byproduct of $1 million of exports. The inevitable result: trade balance.

Because our exports total about $80 billion a month, ICs would be issued in huge, equivalent quantities—that is, 80 billion certificates a month—and would surely trade in an exceptionally liquid market. Competition would then determine who among those parties wanting to sell to us would buy the certificates and how much they would pay. (I visualize that the certificates would be issued with a short life, possibly of six months, so that speculators would be discouraged from accumulating them.)

For illustrative purposes, let's postulate that each IC would sell for 10 cents—that is, 10 cents per dollar of exports behind them. Other things being equal, this amount would mean a U.S. producer could realize 10% more by selling his goods in the export market than by selling them domestically, with the extra 10% coming from his sales of ICs.

In my opinion, many exporters would view this as a reduction in cost, one that would let them cut the prices of their products in international markets. Commodity-type products would particularly encourage this kind of behavior. If aluminum, for example, was selling for 66 cents per pound domestically and ICs were worth 10%, domestic aluminum producers could sell for about 60 cents per pound (plus transportation costs) in foreign markets and still earn normal margins. In this scenario, the output of the U.S. would become significantly more competitive and exports would expand. Along the way, the number of jobs would grow.

Foreigners selling to us, of course, would face tougher economics. But that's a problem they're up against no matter what trade "solution" is adopted—and make no mistake, a solution must come. (As Herb Stein said, "If something cannot go on forever, it will stop.") In one way the IC approach would give countries selling to us great flexibility, since the plan does not penalize any specific industry or product. In the end, the free market would determine what would be sold in the U.S. and who would sell it. The ICs would determine only the aggregate dollar volume of what was sold.

To see what would happen to imports, let's look at a car now entering the U.S. at a cost to the importer of $20,000. Under the new plan and the assumption that ICs sell for 10%, the importer's cost would rise to $22,000. If demand for the car was exceptionally strong, the importer might manage to pass all of this on to the American consumer. In the usual case, however, competitive forces would take hold, requiring the foreign manufacturer to absorb some, if not all, of the $2,000 IC cost.

There is no free lunch in the IC plan: It would have certain serious negative consequences for U.S. citizens. Prices of most imported products would increase, and so would the prices of certain competitive products manufactured domestically. The cost of the ICs, either in whole or in part, would therefore typically act as a tax on consumers.

That is a serious drawback. But there would be drawbacks also to the dollar continuing to lose value or to our increasing tariffs on specific products or instituting quotas on them—courses of action that in my opinion offer a smaller chance of success. Above all, the pain of higher prices on goods imported today dims beside the pain we will eventually suffer if we drift along and trade away ever larger portions of our country's net worth.

I believe that ICs would produce, rather promptly, a U.S. trade equilibrium well above present export levels but below present import levels. The certificates would moderately aid all our industries in world competition, even as the free market determined which of them ultimately met the test of "comparative advantage."

This plan would not be copied by nations that are net exporters, because their ICs would be valueless. Would major exporting countries retaliate in other ways? Would this start another Smoot-Hawley tariff war? Hardly. At the time of Smoot-Hawley we ran an unreasonable trade surplus that we wished to maintain. We now run a damaging deficit that the whole world knows we must correct.

For decades the world has struggled with a shifting maze of punitive tariffs, export subsidies, quotas, dollar-locked currencies, and the like. Many of these import-inhibiting and export-encouraging devices have long been employed by major exporting countries trying to amass ever larger surpluses—yet significant trade wars have not erupted. Surely one will not be precipitated by a proposal that simply aims at balancing the books of the world's largest trade debtor. Major exporting countries have behaved quite rationally in the past and they will continue to do so—though, as always, it may be in their interest to attempt to convince us that they will behave otherwise.

The likely outcome of an IC plan is that the exporting nations—after some initial posturing—will turn their ingenuity to encouraging imports from us. Take the position of China, which today sells us about $140 billion of goods and services annually while purchasing only $25 billion. Were ICs to exist, one course for China would be simply to fill the gap by buying 115 billion certificates annually. But it could alternatively reduce its need for ICs by cutting its exports to the U.S. or by increasing its purchases from us. This last choice would probably be the most palatable for China, and we should wish it to be so.

If our exports were to increase and the supply of ICs were therefore to be enlarged, their market price would be driven down. Indeed, if our exports expanded sufficiently, ICs would be rendered valueless and the entire plan made moot. Presented with the power to

make this happen, important exporting countries might quickly eliminate the mechanisms they now use to inhibit exports from us.

Were we to install an IC plan, we might opt for some transition years in which we deliberately ran a relatively small deficit, a step that would enable the world to adjust as we gradually got where we need to be. Carrying this plan out, our government could either auction "bonus" ICs every month or simply give them, say, to less-developed countries needing to increase their exports. The latter course would deliver a form of foreign aid likely to be particularly effective and appreciated.

I will close by reminding you again that I cried wolf once before. In general, the batting average of doomsayers in the U.S. is terrible. Our country has consistently made fools of those who were skeptical about either our economic potential or our resiliency. Many pessimistic seers simply underestimated the dynamism that has allowed us to overcome problems that once seemed ominous. We still have a truly remarkable country and economy.

But I believe that in the trade deficit we also have a problem that is going to test all of our abilities to find a solution. A gently declining dollar will not provide the answer. True, it would reduce our trade deficit to a degree, but not by enough to halt the outflow of our country's net worth and the resulting growth in our investment-income deficit.

Perhaps there are other solutions that make more sense than mine. However, wishful thinking—and its usual companion, thumb sucking—is not among them. From what I now see, action to halt the rapid outflow of our national wealth is called for, and ICs seem the least painful and most certain way to get the job done. Just keep remembering that this is not a small problem: For example, at the rate at which the rest of the world is now making net investments in the U.S., it could annually buy and sock away nearly 4% of our publicly traded stocks.

In evaluating business options at Berkshire, my partner, Charles Munger, suggests that we pay close attention to his jocular wish: "All I want to know is where I'm going to die, so I'll never go there." Framers of our trade policy should heed this caution—and steer clear of Squanderville.

FORTUNE editor at large Carol Loomis, who is a Berkshire Hathaway shareholder, worked with Warren Buffett on this article.