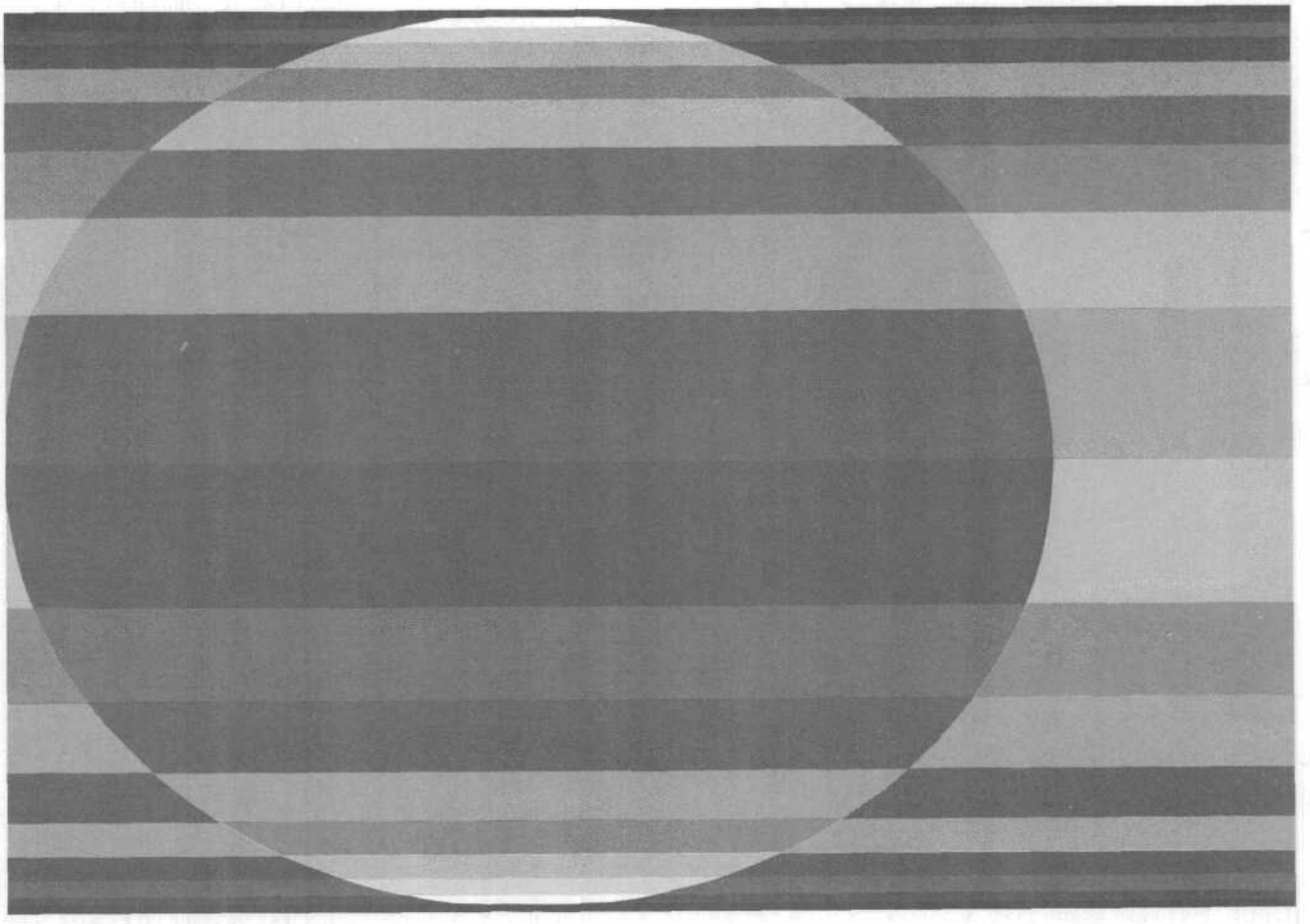
BACKGROUND PAPER

The U.S. Balance of International Payments and the U.S. Economy

February 1978



Congress of the United States
Congressional Budget Office
Washington, D.C.

THE U.S. BALANCE OF INTERNATIONAL PAYMENTS AND THE U.S. ECONOMY

The Congress of the United States
Congressional Budget Office

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PREFACE

The recent deterioration in the U.S. balance of international payments has been a cause of concern both in the United States and abroad. Considerable debate has arisen over the causes and consequences of U.S. merchandise trade and current account deficits and over the appropriate federal policies for dealing with these deficits.

This paper was prepared at the request of Representative Charles A. Vanik, Chairman of the Subcommittee on Trade of the House Ways and Means Committee. It describes the recent history of U.S. international payments balances and examines the causes for their rapid deterioration in 1977. It also presents the major policy alternatives available to the federal government for dealing with the problems posed by deficits in international payments. Testimony based on this paper was presented by the Congressional Budget Office on November 4, 1977 before the Subcommittee on Trade of the Ways and Means Committee. In keeping with CBO's mandate to provide nonpartisan and objective analysis, the paper offers no recommendations.

This paper was prepared by Rosemary Minyard and C.R. Neu of the National Security and International Affairs Division of the Congressional Budget Office and by Joan Schneider of the Fiscal Analysis Division of CBO, under the general supervision of John E. Koehler. The authors wish to acknowledge the assistance of Peggy Weeks, Thyra Riley, and Richard Morgenstern. The manuscript was edited by Robert Faherty and typed for publication by Nancy Swope.

Alice M. Rivlin
Director

February 1978

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SUMMARY

A great deal of attention has been focused on the large balance-of-payments deficits that the United States has experienced since the beginning of 1977. These deficits have aroused concern in the United States because they are seen as aggravating unemployment--especially in export-oriented industries--and retarding the recovery of the U.S. economy from recession. The deficits have also created concern abroad, where they are seen by some as a threat to the stability of the international monetary system or as a potential provocation for the United States to adopt more restrictive trade policies.

Attention has been directed primarily at the U.S. balance of merchandise trade. The merchandise trade deficit for 1977 is expected to be $30 billion, a marked increase over the trade deficit for 1976 which was $9.2 billion.

Nontangible services make up an important additional part of U.S. imports and exports. The largest components of the flows of services are international payments of fees and royalties and interest payments on international loans. Also included are such items as travel services and private services provided by individuals or businesses to clients in foreign countries. While the United States is a net importer of merchandise, it is a net exporter of services to the rest of the world. On the basis of figures for the first half of the year, the United States is expected to have a surplus of about $17 billion on services in 1977. This is up from about $13 billion in 1976.

Foreign trade in both merchandise and services is combined with net unilateral transfers to foreigners to form the current account balance. (These transfers--mostly government grants and pensions--are fairly stable and are running at a rate of about $5 billion a year.) Because the surplus for services partially offsets the merchandise trade deficit, the expected U.S. current account deficit will be smaller than the trade deficit, but it will still be very large by past standards. It is expected to be in the neighborhood of $17 billion, as compared with a deficit in 1976 of only $1.3 billion. The table that follows summarizes the components of the expected current account balance for 1977 and the actual balance for 1976.

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U.S. CURRENT ACCOUNT POSITION: IN BILLIONS OF DOLLARS

	1976 (Actual Figures)	1977 (Projected from Half-Year Figures)
Merchandise	-9.2	-29.9
Services	13.0	17.2
Net Transfers	-5.0	-4.8
Current Account a/	-1.3	-17.6

a/ Detail may not add to totals due to rounding.

To understand how these large deficits have arisen, it is necessary to look more closely at what has been happening to U.S. merchandise trade.

U.S. Merchandise Trade

Since the second quarter of 1975, U.S. merchandise imports have risen rapidly and steadily as the U.S. economy has recovered from recession. Although the growth of imports has been rapid (about 30 percent a year), this growth does not appear to be unusually rapid for such a period of recovery.

Oil imports account for a large share of total U.S. merchandise imports, and they too have grown rapidly during this recovery period and have contributed to the growing U.S. trade deficits. In fact, since the middle of 1975, oil imports have grown somewhat faster than have other merchandise imports. Oil imports alone, however, do not account for the entire recent deterioration in the U.S. trade balance. Nonetheless, large payments for foreign oil are expected to reach $45 billion in 1977, and an effective program to reduce oil imports could improve the trade balance markedly.

U.S. exports have also been growing since the second quarter of 1975, but not as rapidly or as steadily as imports. During the last quarter of 1976 and the first quarter of 1977, the level of U.S. exports did not grow at all, and large trade deficits arose

as a result. Growth in exports has resumed, but exports now lag far behind imports and large deficits continue. This slow growth in exports has not been concentrated in a few industries. Slow growth has characterized all categories of U.S. exports, and it is this unusually slow growth of exports coupled with normal growth of imports that has produced the large U.S. trade deficit in 1977. Figure 1 in Chapter II shows U.S. merchandise imports and exports for recent years.

The Reasons for Slow U.S. Export Growth

Aside from actions of foreign governments to bar U.S. products from foreign markets, there are two possible explanations for the disappointing performance of U.S. merchandise exports. The first is that foreign demand for U.S. products has been weak because recovery from recession has not been as rapid abroad as it has been in the United States. The second is that U.S. exports may be growing slowly because U.S. products are not as competitive in world markets as they once were.

Available evidence suggests that the first of these explanations is the more accurate. The major customers for U.S. exports are the other industrial countries. Unfortunately, most of these countries have not grown as rapidly as the United States has since the middle of 1975. Particularly in late 1976 and early 1977, recovery has faltered in several of these countries. This slow economic growth has reduced demand in these countries for U.S. exports.

Econometric simulations performed by the Congressional Budget Office indicate that, if the other industrial countries had recovered from recession at the same rate as did the United States, U.S. net exports of goods and services would have been $13 billion larger (at an annual rate) by the middle of 1977 than they in fact were. This increase in net exports would have eliminated most of the expected $17 billion current account deficit. As a result of this increased demand for U.S. products, the gross national product would have been some $36 billion higher (again at an annual rate) than it was, and the unemployment rate would have been about one-half of one percentage point lower than current levels.

There seems to be little evidence that U.S. products are losing their competitive position in world markets. The share of total world exports of manufactured goods that is held by U.S.

products has not declined noticeably in the past year. Neither has the price of U.S.-produced goods risen dramatically relative to the price of foreign products. Figure 3 in Chapter III shows indexes of relative costs of U.S. goods based both on wholesale prices and on unit labor costs after adjusting for changes in exchange rates. Both indexes show similar movements. The competitive position of the United States improved dramatically from 1971 to 1973 as a result of major devaluations of the dollar. From 1973 through 1975, both measures showed erratic movements, as U.S. competitiveness declined somewhat. Since the beginning of 1976, however, both indexes have shown a very slow loss of competitiveness for U.S. goods. By either measure, U.S. goods are more competitive today than they were in 1970.

It would seem, then, that trade and current account deficits have risen mostly because of increased oil imports into the United States and because of relatively slow growth in other industrial economies. A part of these deficits may be the result of some deterioration in overall U.S. competitiveness, but the evidence for this is weak.

The Value of the Dollar

In a system of floating exchange rates, large U.S. current account deficits might be expected to lead to a decline in the value of the dollar. This would make U.S. products cheaper relative to foreign goods and could eventually lead to an improvement in the U.S. current account position. Over the last year, the dollar has fallen relative to some currencies--for example, the German mark and the Japanese yen. It has risen, however, with respect to other currencies, such as the Swedish krona and the Canadian dollar. The effective value of the dollar--that is, its value relative to the average value of the currencies of the United States' trading partners--held relatively steady throughout most of 1977. Only at the end of 1977 did the effective value of the dollar decline, losing 5.4 percent in the last three months of the year. Figure 4 in Chapter IV shows the effective value of some major currencies during the last few years.

One reason that the dollar has not fallen further is that foreigners seem to be willing to hold dollars or dollar-denominated assets. Many of these dollars paid out to foreigners for imports to the United States are returning to the United States as foreigners buy assets in this country. In 1977, these capital flows were sufficiently large to make the United States

a net importer of capital, a reversal of its traditional role in international finance. In the first half of 1977, net capital flows into the United States amounted to somewhat more than $4 billion. By comparison, in 1976, there was a net capital outflow of $8.4 billion.

For the most part, the flow of foreign capital into the United States has taken the form of deposits in U.S. banks and purchases of U.S. Treasury securities--not direct investment. Fears that foreign holdings of U.S. government securities may pose a potential threat to U.S. government financial operations appear to be unfounded. Only about 3 percent of U.S. federal debt is held by foreigners outside of the industrial countries of Western Europe.

A decline in the value of the dollar would prove a mixed blessing to the U.S. economy. In the long run, perhaps after a year or so, U.S. exports could be expected to increase and imports to decrease. In the short run, however, a declining dollar would add to inflationary pressures by increasing the price of imports.

Prospects and Policies

The prospects for improvement in the U.S. trade and current account balances in the near future appear dim. Most forecasts predict continued slow growth in the other industrial countries for at least the next year, and even a highly effective energy program cannot be expected to reduce U.S. oil imports quickly. It would seem that the United States must reconcile itself to continuing trade and current account deficits for the immediate future.

The present deficits do not appear to be a reflection of any fundamental weakness in the U.S. economy. On the contrary, they are to a large extent a reflection of the relative success of the United States at recovering from recession. Associated with these deficits, however, are some serious problems. Slow export growth contributes to unemployment--particularly in export-oriented industries--and slows the growth rate of the U.S. economy. Increased competition from imports produces temporary dislocation of U.S. workers as U.S. industries adapt to a changing competitive environment. Simply reducing U.S. deficits will not necessarily alleviate these problems. Much will depend on the particular policies employed.

Some policies might do more harm than good. Restrictive trade policies might reduce deficits in the short run, but they could lead to the adoption of retaliatory policies by other nations and could ultimately result in even slower growth for U.S. exports. Attempts by the United States to reduce the value of the dollar are unlikely to be successful. Even if they were, they would have mixed results. In the long run, U.S. products would become more competitive relative to foreign goods. In the short run, however, currency market intervention could disrupt domestic monetary policy and add to inflationary pressures by increasing the cost of imports.

Among policies that might prove helpful would be more expansionary fiscal and monetary policies that would offset weak foreign demand for U.S. goods. An effective program to reduce imports of oil could, in time, reduce trade imbalances caused by U.S. dependence on imported oil. Continued efforts to encourage other industrial nations to adopt more expansionary policies might prove fruitful; in any event, it seems that such efforts can do little harm. Finally, expanded programs to aid workers and industries suffering from loss of export markets or severe import competition could smooth the adjustment to new patterns of trade.

CHAPTER I. INTRODUCTION

The U.S. balance of international payments has been the focus of much attention in recent months. Since the beginning of 1977, U.S. imports have far exceeded exports, giving rise to large merchandise trade and current account deficits that are without precedent in U.S. history. These deficits have caused concern in the United States because they are seen as contributing to unemployment, retarding the U.S. recovery from the recession of 1974 and 1975, and threatening the value of the dollar. Recent deficits have also been seen as a reflection of more fundamental problems in the U.S. economy. Some see them as an indication that U.S. goods are no longer competitive in world markets. Others claim that U.S. goods are as competitive as ever but that U.S. producers have been victimized by predatory trade policies adopted by foreign governments. Still others claim that the deficits are the direct result of the United States' failure to reduce its dependence on foreign oil. Finally, some have argued that the present deficits are the natural result of an economic recovery in the United States that has been more rapid and more complete than the recovery in the nations that are the principal customers for U.S. exports.

The recent U.S. deficits have also aroused concern abroad. The high level of U.S. imports has been a blessing to many countries because it has increased the demand for their products and has stimulated their economies. Nevertheless, some of these countries have called for the United States to take steps to reduce its deficits. Presumably, these nations would prefer that the United States undertake moderate programs to slow the growth of U.S. imports rather than adopt restrictive trade policies that would limit foreign access to U.S. markets far into the future.

Another cause for concern among foreigners is that U.S. deficits may threaten the stability of world monetary arrangements. International financial markets are only now beginning to settle down after the period of wide fluctuations that followed the change from a fixed to a floating exchange rate regime in 1973. It is feared that a sudden outpouring of dollars because of a large U.S. current account deficit might introduce a new element of uncertainty and instability into the international financial situation.

There is not a simple, direct relation between trade and current account deficits and the performance of the U.S. economy. The effects of these deficits can vary depending upon what set of economic conditions gives rise to them. If, for example, deficits arise because foreign products displace domestic products in U.S. markets or because demand for U.S. exports abroad is weak, the expected result would be increased unemployment in some U.S. industries and slower overall economic growth in the United States. If, on the other hand, large deficits arise because of increased imports of goods that do not compete directly with U.S. goods (for example, oil, some raw materials, coffee, or tea), then there would not necessarily be any reduction in U.S. employment or economic growth. In fact, it seems quite likely that increased imports of oil and raw materials are required (at least in the short run) to sustain economic growth.

The effect of current account deficits on the value of the dollar will depend on the preferences and actions of holders of dollars. As long as individuals, businesses, and governments are willing to increase their holdings of dollars for one reason or another, the value of the dollar need not fall. But even a current account surplus would not maintain the dollar's value if these asset holders chose to exchange their dollars for other currencies.

The problems associated with trade and current account deficits cannot necessarily be eliminated simply by eliminating the deficits. Unemployment resulting from slow growth of exports will not be eliminated simply by reducing imports, even though this may reduce the trade deficit. Similarly, a program to encourage U.S. exports will not provide relief for industries facing increased competition from foreign producers.

Thus, to understand the significance of recent U.S. trade and current account deficits and to formulate policies for dealing with these deficits, it is necessary to consider their causes and their possible consequences. This paper describes the recent changes in the U.S. balance-of-payments position and discusses the possible causes for the present situation. It also discusses the prospects for the immediate future and outlines the alternative policy measures that are available to the United States for dealing with the present large deficits. Throughout the paper, the emphasis will be on the effects of international payments on the U.S. economy. The possible effects on international monetary arrangements of large imbalances in U.S. payments, while of great importance, remain beyond the scope of this paper.

CHAPTER II. THE CURRENT SITUATION

TRADE, SERVICES, AND CURRENT ACCOUNT BALANCES

Recent attention has focused primarily on the U.S. merchandise trade balance. In the first half of 1977, U.S. imports of merchandise exceeded exports of merchandise by about $15 billion on a seasonally adjusted basis. 1/ The U.S. merchandise trade balance--the difference between total merchandise imports and total merchandise exports--will be in deficit by some $30 billion for the entire year. 2/ This is a sharp increase from 1976, when the U.S. trade deficit was only $9.2 billion. In 1975, the United States had a trade surplus of $9.0 billion.

Partially offsetting the large trade deficit in the first half of 1977 was a surplus on the balance of service transactions. Included in this balance are such things as international payments of fees and royalties, interest payments on international loans, income from foreign investments, travel and

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1/ Because imports and exports of some products fluctuate in regular seasonal patterns, trade figures for only a part of a year can sometimes be misleading. For some purposes, it is useful to adjust trade data to eliminate these seasonal variations. Such "seasonally adjusted" figures provide a better measure of the underlying trends in trade than do unadjusted figures that reflect both underlying trends and seasonal variations.

2/ U.S. trade balances are calculated by a number of methods, and the balances derived by one method differ somewhat from those derived by other methods. Generally, the differences involve the valuation of imports and exports (for instance, whether shipping charges are included), the treatment of transactions involving U.S. territories like the Virgin Islands, and the treatment of military assistance. The figures given here are balance-of-payments basis figures as reported by the Bureau of Economic Analysis of the Department of Commerce. Unless otherwise noted, all figures in this paper will be balance-of-payments basis.

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transportation services, and other services provided by individuals and businesses for foreign clients. 3/ In the first half of 1977, the U.S. services balance was in surplus by about $17 billion on an annual basis. This represents a marked increase over 1976, when the services balance was in surplus by $13 billion. By far the largest components of the flow of payments to the United States for services are income from foreign loans and investments and payments of fees and royalties. Thus, the large and growing surpluses in the U.S. services balance are primarily a reflection of this country's position as a net creditor to the rest of the world and the developer of production methods now used widely in other countries.

Unilateral transfers--mostly government grants to foreign countries and pension payments to foreigners--have in the past accounted for a further net outflow of about $5 billion a year from the United States. In 1977, net transfers were at about this same level.

A summary of these international nonfinancial transactions is obtained by combining the three payments measures--trade balance, services balance, and net unilateral transfers--into one measure, the current account balance. A deficit on current account indicates that a country has paid out more for goods, services, and transfers to foreigners than it has received from foreigners for these same purposes. In order to make up the difference, a country in deficit must either reduce its holdings of foreign currencies, using them to meet its obligations abroad, or borrow foreign currencies from abroad to meet these obligations. The foreign currencies can be borrowed either directly, through loans from foreigners, or indirectly, through foreign investment or foreign-held deposits in domestic banks.

Adding together the expected U.S. deficits for merchandise trade and net transfers and subtracting the offsetting surplus for services gives an expected U.S. current account deficit of between $17 billion and $18 billion for 1977. This is sharply higher than the 1976 current account deficit, which was only $1.3 billion. Table 1 provides a summary of the components of the U.S. current account balance in recent years.

3/ U.S. sales of military arms to foreign countries are classified as service rather than merchandise transactions in balance-of-payments accounts.

TABLE 1. U.S. MERCHANDISE TRADE, SERVICES, AND CURRENT ACCOUNT BALANCES, 1973-1977: IN BILLIONS OF CURRENT DOLLARS

	1973	1974	1975	1976	1977 a/
Merchandise Trade					
Merchandise exports	71.4	98.3	107.1	114.7	119.9
Merchandise imports	70.5	103.7	98.0	123.9	149.8
Trade Balance	0.9	-5.4	9.0	-9.2	-29.9
Services					
Military transactions, net	-2.3	-2.1	-0.9	0.4	2.0
Investment income, net	4.8	8.7	6.0	9.8	13.3
Travel and transportation, net	-3.1	-3.1	-3.0	-2.1	-3.4
Other services, net	3.2	4.0	4.6	4.9	5.3
Services Balance	2.6	7.5	6.7	13.0	17.2
Unilateral Transfers, Net	-3.9	-7.2 b/	-4.6	-5.0	-4.8
Current Account Balance c/	-0.4	-5.0	11.6	-1.3	-17.5

NOTE: Figures are balance-of-payments basis.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis.

a/ Annual rates predicted on the basis of data for the first half of the year.

b/ Unusually high because of extraordinary transaction with India.

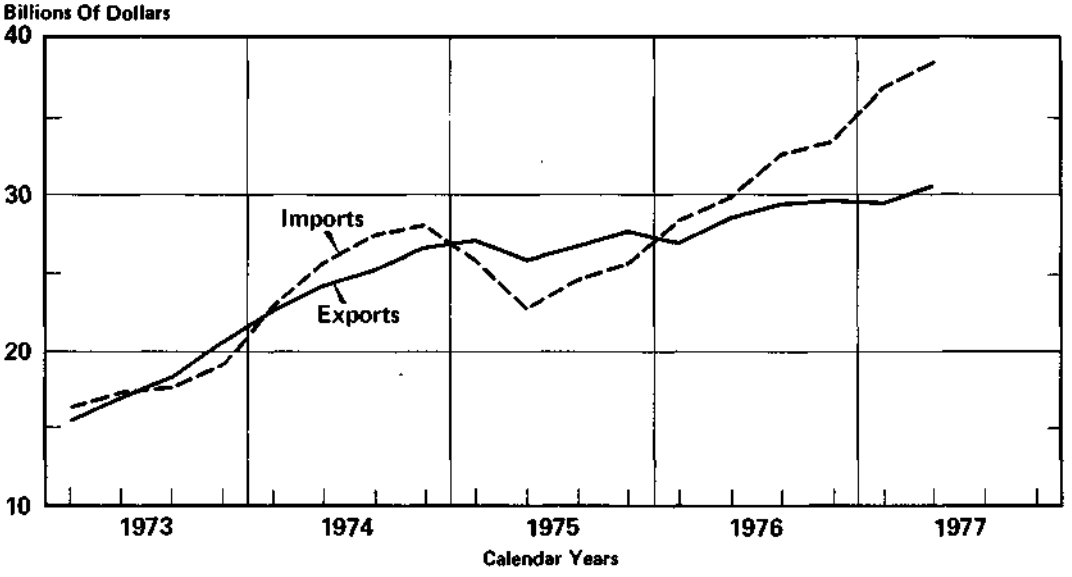
c/ Sum of trade balance, services balance, and net unilateral transfers. Detail may not add to total because of rounding.

THE U.S. MERCHANDISE TRADE BALANCE

The figures presented above make clear that it is the deteriorating merchandise trade balance that is responsible for the growing U.S. current account deficits. Thus, the explanation of the present current account deficit must be sought in the behavior of U.S. merchandise trade during the first half of 1977.

The behavior of U.S. merchandise imports and exports during the last few years is shown in Figure 1. Following weakened consumer demand and slowed growth of industrial production in the United States in late 1974, U.S. merchandise imports declined

Figure 1.
U.S. Merchandise Trade by Quarters, 1973-1977
(Balance-of-Payments Basis, Seasonally Adjusted)

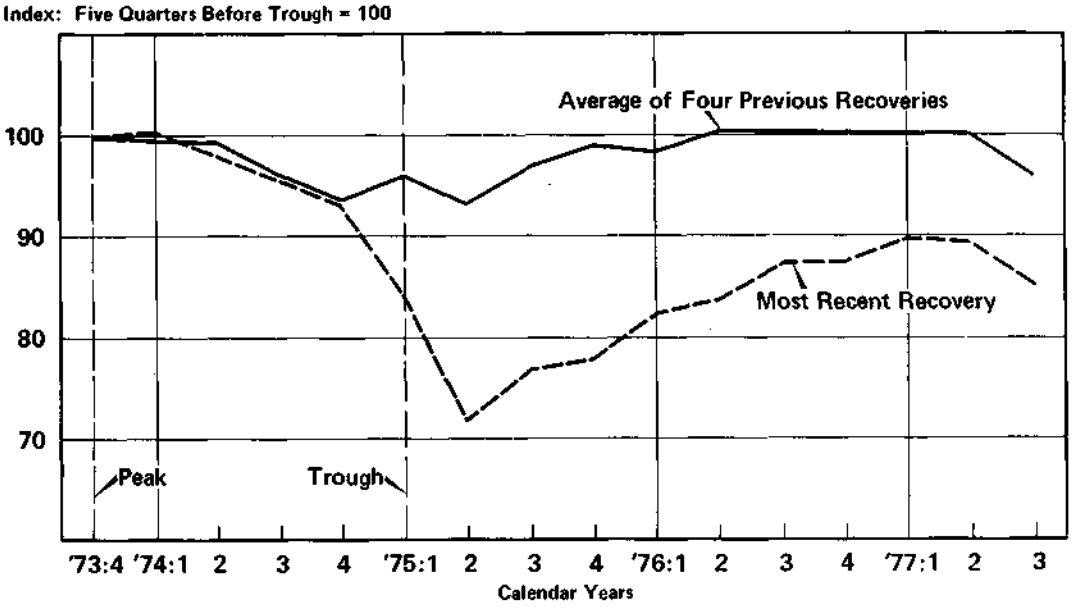


SOURCE: U. S. Department of Commerce, Bureau of Economic Research

sharply, falling by about 20 percent in the first half of 1975. As the economy began to recover in the last half of 1975, so did the demand for imports. Since the second quarter of 1975, U.S. merchandise imports have grown steadily and rapidly--at a rate of about 30 percent a year.

On the basis of past experience, the import growth rates that have occurred during the past two years are not unusual for a period of economic recovery. Figure 2 shows the ratio of merchandise imports to gross national product (GNP) during the recession of 1974-1975 and the recovery period that followed. Also shown is the average value of this same ratio for the four most recent previous periods of recession and recovery. What is unusual about the 1974-1975 recession is how sharply merchandise imports fell as a fraction of GNP. At the beginning of the 1975 recovery period, imports as a fraction of GNP recovered more rapidly than in previous recoveries, but in the later stages, import growth has been similar to historical patterns. Merchandise imports have not, however, regained the level relative to GNP that they held before the recession. In this respect, the recovery of merchandise imports in 1976 and 1977 was slower and less complete than recovery after earlier recessions.

Figure 2.
Imports as a Share of GNP: Most Recent Recession and Average of Four Previous Recessions



Much of the increase in the value of U.S. merchandise imports has been accounted for by the increased value of oil imports. Total oil imports are expected to be $45 billion for 1977, up from only $8.3 billion in 1973. In 1974 and 1975, most of the increase in oil imports came about as the result of oil price increases imposed by the Organization of Petroleum Exporting Countries (OPEC); during these years, the volume of oil imported by the United States declined. Since the beginning of economic recovery in 1975, however, increases in the value of oil imports have been attributable primarily to an increased volume of oil imports. Table 2 summarizes the growth of U.S. petroleum imports since 1973.

Not only do oil imports account for a large share of all U.S. merchandise imports (about 30 percent in 1977), but they have been growing at a faster rate than have other merchandise imports. From 1975 to 1977, the value of oil imports to the United States increased by 69 percent, while imports of all other types of merchandise increased by only 46 percent. About half of the increase in the U.S. trade deficit from 1976 to 1977 can be attributed to increased oil imports. It is important, however, not to let the

TABLE 2. VOLUME AND VALUE OF U.S. IMPORTS OF PETROLEUM AND SELECTED PETROLEUM PRODUCTS, 1973-1977

	Volume (Millions of Barrels)	Percent Change	Value (f.a.s.) a/ (Billions of Dollars)	Percent Change
1973	2,494		8.3	
1974	2,409	-3.4	26.4	217.8
1975	2,369	-1.7	27.0	2.6
1976	2,851	20.3	34.6	28.0
1977 b/	3,448	20.9	45.6	31.8

a/ Free alongside ship.

b/ Annual rate based on January-September 1977 figures.

rapid growth of oil imports obscure the fact that other merchandise imports have grown rapidly also. Indeed, since 1975, increased oil imports have accounted for only 36 percent of the total increase in U.S. merchandise imports.

Because the recession of 1974 and 1975 was felt in almost all industrialized countries, demand for imports was reduced in almost all nations. As a result, U.S. merchandise exports declined, although they did not decline as sharply as did imports. In the second half of 1975, U.S. merchandise exports began to grow again but not as rapidly or as steadily as imports did. During the last quarter of 1976 and the first quarter of 1977, U.S. merchandise exports did not grow at all and the trade deficits increased rapidly. Export growth has since resumed, but now exports lag far behind imports and large trade deficits persist.

The slow growth of U.S. merchandise exports during this recovery has not been restricted to one or two sectors. Instead, it has been widely distributed across all kinds of exports. Table 3 shows the shares of total U.S. merchandise exports by major end-use categories in recent years. The fact that these shares have remained quite stable indicates that all categories of exports have experienced similar slow growth.

TABLE 3. SHARES OF TOTAL U.S. MERCHANDISE EXPORTS BY MAJOR END-USE CATEGORIES, 1974-1977: PERCENT OF TOTAL

End-Use Categories	1974	1975	1976	1977 a/
Capital Goods (except automotive)	33	31	34	32
Industrial Supplies and Materials	29	31	28	29
Foods, Feeds, and Beverages	18	19	17	17
Automotive Vehicles, Parts, and Engines	10	9	11	11
Consumer Goods (nonfood, except automotive)	6	6	7	7
All Other	4	4	3	3
Total b/	100	100	100	100

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

a/ Estimated.

b/ Details may not add to totals because of rounding.

Some traditional U.S. trade surpluses deteriorated in 1977. The U.S. surplus on agricultural products was some $1.3 billion less in 1977 (on the basis of data for the first nine months of the year) than the $12.2 billion surplus registered in 1976. This was because of good harvests in most parts of the world and relatively low prices for some products (most notably grains) that the United States exports. Also, the prices of some U.S. agricultural imports such as coffee rose sharply in 1977. These changes in agricultural trade were attributable primarily to natural conditions and are not usually seen as a cause for long-term concern. In the short run, however, low grain prices can reduce farm revenues, and rising costs of imported agricultural products can raise consumer prices.

More disturbing to some has been a marked decline in the traditional U.S. surplus for trade in manufactured goods. 4/ In 1976, the United States had a surplus for manufactured goods of $12.7 billion. In 1977, this shrank to only $4.1 billion (on the basis of figures for the first nine months), and in each quarter of 1977, the surplus in manufactured goods declined from the previous quarter. 5/ This decline has caused some concern over whether U.S. manufactured products are still competitive in world markets.

In summary, then, the U.S. merchandise trade balance deteriorated during 1977 because imports grew at a much faster rate than did exports. Increased petroleum imports were a major factor in the growth of imports, but other merchandise imports grew rapidly also, and the overall rate of import growth does not appear to be unusually high for a period of economic recovery. The disappointing performance of U.S. exports, however, requires more explanation.

4/ The manufactured goods classification includes chemicals, machinery, basic manufactured goods, transport equipment, and miscellaneous manufactured goods. The term "capital goods" refers to machinery and heavy transportation equipment (civilian aircraft and railroad locomotives, but not automotive products). The term "industrial supplies and materials" refers to chemicals, steel, paper, fibers, nonferrous metals, and related products.

5/ These data are census basis, rather than balance-of-payments basis. The major difference between these two bases is the exclusion from census data of imports and exports of the Virgin Islands and of imports and exports of nonmonetary gold. In the case of manufactured goods, neither of these exclusions will be very significant, and census basis figures and balance-of-payments basis figures should be quite similar.

CHAPTER III. THE REASONS FOR SLOW U.S. EXPORT GROWTH

Aside from actions by foreign governments to bar U.S. products from their domestic markets, there are two possible explanations for the disappointing performance of U.S. merchandise exports. The first is that foreign demand for U.S. products has been weak because recovery from recession has not been as rapid in other countries as it has been in the United States. The second is that U.S. exports may be growing slowly because U.S. products are not as competitive in world markets as they once were. This chapter discusses the evidence for each of these two hypotheses.

SLOW ECONOMIC GROWTH ABROAD

The other industrial nations are the primary customers for U.S. exports. In 1976, nearly 60 percent of U.S. merchandise exports went to Japan, Canada, and the industrialized countries of Western Europe. Since recovery from worldwide recession began in the second half of 1975, however, these countries, with the exception of Japan, have been growing at slower rates than has the United States. At the end of 1976 and the beginning of 1977, the growth of industrial output in some of these countries faltered noticeably. Table 4 shows the rates of growth in industrial production during the past two years for the major industrial countries.

This relatively slow growth in other industrial countries has reduced demand in these countries for foreign products and has contributed to the slow growth of U.S. exports. Because the U.S. economy has grown relatively rapidly, U.S. demand for foreign products has grown rapidly, and the result has been an increased trade deficit for the United States.

Just the reverse of this phenomenon occurred in 1974 and 1975. The recession began earlier in the United States than it did in most of the other industrial countries, and the decline in industrial output was sharper in the United States than in other countries (again, with the exception of Japan). This had the effect of reducing U.S. demand for imported goods sharply, while similar demand in other industrial countries remained relatively strong. The result was a merchandise trade surplus in 1975. It

TABLE 4. GROWTH RATES OF INDUSTRIAL PRODUCTION IN SELECTED COUNTRIES, 1975:II - 1977:II: ANNUAL RATES BY QUARTERS

Quarter	United States	Canada	Japan	Western Europe
1975:II	3.7	-2.1	12.5	-11.2
1975:III	23.8	0.3	9.3	-1.0
1975:IV	9.9	5.3	2.6	17.1
1976:I	13.3	11.5	25.3	12.1
1976:II	6.9	7.5	20.0	9.7
1976:III	4.6	-1.5	6.5	1.8
1976:IV	2.2	2.9	7.8	8.5
1977:I	6.3	8.7	2.1	9.3
1977:II	10.5	1.3	3.4	-8.5

might be contended that current U.S. deficits and their causes are merely the mirror image of the earlier surpluses and their causes. It remains the case, however, that the perceived problems beginning in late 1976 were coincident with the relative slowdown of foreign economies.

About one-quarter of U.S. merchandise exports goes to developing countries, and these countries also reduced their imports in 1977. Throughout the recession of 1975, the developing countries as a group continued to grow, but this growth required many of them to borrow heavily to finance the imports needed to sustain economic growth. By 1977, the foreign debts of some developing countries had reached a level at which further borrowing became difficult. To maintain their creditworthiness and their access to international financial markets, some of these countries were forced to restrict their imports sharply. Among the countries that reduced imports most dramatically were Mexico and Brazil, which are both important markets for U.S. exports. Between the first half of 1976 and the first half of 1977, Mexico and Brazil reduced their total imports by 24 and 15 percent, respectively. 1/

1/ Testimony of Anthony M. Solomon, Undersecretary for Monetary Affairs, U.S. Treasury, before the Subcommittee on International Economics, Joint Economic Committee, October 11, 1977 (processed).

On the basis of data for the first half of 1977, U.S. exports to these two countries alone will be $1.2 billion less in 1977 than they were in 1976.

To measure the impact of slow growth abroad on U.S. trade and current account deficits, econometric simulations were made to estimate what the U.S. trade position would have been if other industrial countries had recovered from recession at the same pace as the United States. 2/ For the purposes of this simulation, industrial production indexes for Canada and Western Europe were adjusted so that their growth equaled that of the U.S. index in each quarter during a period running from the second quarter of 1975 to the second quarter of 1977. This had the effect of equalizing the timing as well as the magnitude of growth in the United States, Canada, and Western Europe. Since Japan's growth over this period was greater than U.S. growth, no adjustment was made in the index of Japanese industrial production. The differences between the actual and simulated behavior of some important trade and macroeconomic variables are shown in Table 5.

Simulated net exports of goods and services are $13.1 billion higher (on an annual basis) than were actual net exports during the second quarter of 1977. 3/ This means that by the second quarter of 1977, the United States would have had a small net surplus of goods and services exports over imports. Total exports of goods and services in the second quarter of 1977 would have been 10.8 percent higher than actual, while total imports of goods and services would have been 3.2 percent higher.

Among the census end-use categories of merchandise goods, net exports of capital goods (excluding automotive products) would have gained significantly from more rapid recovery elsewhere. Net exports of industrial supplies and materials would have increased somewhat less. This is important because U.S. export performance depends heavily on exports of capital goods and of industrial supplies and materials. Table 5 also shows that net exports of consumer goods would have increased as rising

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2/ A model of the U.S. economy developed by Data Resources, Incorporated was used for this simulation.

3/ Measured by the National Income and Product Accounts (NIPA), the accounts used to measure the economy's current output or GNP and its components.

TABLE 5. DIFFERENCES BETWEEN SIMULATED AND HISTORICAL VALUES OF SELECTED MEASURES OF U.S. ECONOMIC PERFORMANCE, 1975:II - 1977:II: IN BILLIONS OF DOLLARS, UNLESS OTHERWISE SPECIFIED

Selected Measures	1975:II	1975:III	1975:IV	1976:I	1976:II	1976:III	1976:IV	1977:I	1977:II
				MACROECONOMIC VARIABLES					
GNP	0.3	2.6	8.6	16.1	21.7	25.1	28.8	32.1	36.5
Real GNP (billions of 1972 dollars)	0.2	1.8	5.6	10.1	13.0	14.2	15.9	17.2	18.7
Implicit Price Deflator (Index: 1972 = 1.0)	0.0	0.0	0.001	0.002	0.003	0.005	0.005	0.006	0.008
Rate of Unemployment (percent)	0.0	0.0	-0.1	-0.2	-0.3	-0.4	-0.5	-0.5	-0.5
Net Exports of Goods and Services a/	0.3	2.2	5.7	7.9	9.9	11.1	12.0	12.0	13.1
Exports of goods and services a/	0.3	2.5	6.6	9.8	12.8	15.0	16.7	17.4	18.9
Imports of goods and services a/	0.0	0.3	0.9	1.8	2.9	3.8	4.7	5.4	5.9
				TRADE FLOWS MEASURED BY CENSUS END-USE CATEGORIES					
Industrial Supplies and Materials									
Exports	0.0	0.44	1.26	1.44	1.83	2.10	2.55	2.67	3.03
Imports	0.0	0.06	0.26	0.67	1.18	1.67	2.02	2.42	2.76
Capital Goods, Except Automotive									
Exports	0.02	0.31	1.17	2.15	3.17	3.83	4.25	4.41	4.75
Imports	0.0	0.05	0.20	0.30	0.41	0.54	0.66	0.74	0.83
Consumer Goods, Except Automotive									
Exports	0.07	0.28	0.45	0.53	0.60	0.67	0.72	0.78	0.84
Imports	0.00	0.02	0.09	0.22	0.32	0.38	0.36	0.38	0.42

NOTE: Simulated values assume faster growth of industrial production in Canada and Western Europe. All figures are yearly rates. Data do not include imports and exports of the U.S. Virgin Islands.

a/ Measured by the National Income and Product Accounts.

income levels abroad allowed consumers there to buy more goods from the United States. Imports of consumer goods into the United States have been strong to date and would not have increased by as much as U.S. exports of consumer goods. Thus, the simulation shows an improved net balance for consumer goods.

Increased demand for U.S. exports would have acted as a stimulus to the overall economy. The simulated level of U.S. GNP for the second quarter of 1977 is higher (again on a yearly basis) than the actual level by $36.5 billion, an increase of about 2 percent. A higher level of GNP would have created more jobs in the United States, and the unemployment rate would have fallen by about one-half of one percentage point. The simulation also indicates that increased demand for U.S. exports would have led to only a small increase in prices--less than 1 percent. This is because the industries experiencing the largest increases in demand--capital goods industries--now have excess productive capacity, and output could be expanded relatively easily. 4/

In summary, these simulations indicate that a large part of the recent deterioration in the U.S. balance of goods and services can be explained by the relatively slow rate of recovery in other industrial countries. If economic growth in these countries continues at rates lower than in the United States, the prospect is for continued U.S. trade deficits.

4/ Different hypothetical scenarios could have been chosen as the basis for this simulation. It might be argued that it is unrealistic to expect the other industrial countries to have recovered from recession at the same rate as the United States because, with the exception of Japan, none of these countries experienced a reduction in industrial output as great as the United States did in late 1974 and early 1975. If, instead of assuming growth rates equal to those experienced in the United States, it is assumed that the depth and timing of and the recovery from recession were the same in all other industrial countries as they were in the United States, a somewhat different picture emerges. In this hypothetical case, the increase in net U.S. exports would have been only $2.5 billion (on an annual basis) as compared with $13.1 billion in the original simulation by the second quarter of 1977. The increase in U.S. GNP would have been approximately $7 billion a year as opposed to $36.5 billion in the first simulation.

COMPETITIVENESS OF U.S. PRODUCTS IN WORLD MARKETS

Some argue that U.S. trade deficits have occurred not only because of slow economic growth among our principal customers but also because U.S. goods are being displaced in world markets by products from other countries. Rising labor costs, increased prices for industrial materials, and the costs of meeting new environmental standards have all been blamed for increasing the price of U.S. goods relative to foreign goods and subsequently causing reductions in U.S. exports and increased competition from imports in domestic markets. Certainly, some U.S. industries have been losing their competitive position relative to foreign producers. Steel is the most visible example of such an industry. Whether there has been any overall decline in the competitiveness of U.S. industry, however, is much less clear.

One measure of the competitiveness of U.S. products is provided by the share of total world exports of manufactured goods that is held by U.S. producers. If U.S. products were becoming less competitive, one would expect the U.S. share of total exports to fall. Table 6 shows the U.S. shares of total manufactured exports and of some important subcategories of manufactured exports in recent years. 5/ Share values have gone up and down since 1971, but these are small fluctuations around an average value and do not constitute a noticeable downward trend. The U.S. share of total manufactured exports in the second quarter of 1977 was 20 percent, in line with recent experience. Except for the transportation equipment category, recent U.S. shares are larger than those during 1971-1973. The transportation equipment category share fluctuates more than others, and its recent drop is not cause for alarm. Erratic delivery schedules and an unusual shift in commercial aircraft sales can produce wide variations in this category and account for the low value in early 1977. Overall, this table suggests that U.S. exports are lagging not because the United States is losing market shares to other suppliers, but because total world trade is not expanding as rapidly as it has in the recent past. The volume of world trade increased by about 11.5 percent in

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5/ Movements in these shares can come from changing volumes and prices of the products and from a changing exchange rate of the dollar.

TABLE 6. U.S. SHARE OF WORLD EXPORTS OF MANUFACTURES, 1971 - 1977:II: PERCENT OF TOTAL SHARES a/

	Chemicals	Nonelec. Mach.	Elec. Mach.	Transport Equipment	Basic Mfgs.	Misc. Mfgs.	Total Mfgs.
1971	20.0	25.6	21.1	29.7	10.8	16.1	20.1
1972	18.6	25.1	20.9	26.4	10.5	15.5	19.1
1973	19.1	25.2	21.6	27.0	11.4	16.2	19.5
1974	18.6	26.3	23.0	29.0	12.3	17.3	20.2
1975	20.1	27.8	22.3	27.8	12.5	17.3	21.2
1976	20.6	26.8	23.3	25.1	11.9	17.1	20.5
1977:I	21.1	26.3	23.4	22.3	11.7	17.0	19.9
1977:II	21.6	25.3	23.4	23.8	11.5	16.9	20.0

NOTE: The term "manufactures" refers to nonfuel industrial supplies and capital goods. Total world exports are defined as exports, excluding shipments to the United States, from 15 major industrial countries that account for approximately 80 percent of world exports of manufactures: United States, Austria, Belgium-Luxembourg, Canada, Denmark, France, Federal Republic of Germany, Italy, Netherlands, Norway, Sweden, Switzerland, United Kingdom, and Japan.

SOURCE: U.S. Department of Commerce, Commerce America.

a/ Shares are calculated from values of exports of the six commodity groups from each of the 15 countries. Beginning in 1971, when exchange rates began to fluctuate widely, share calculation is based on export-weighted exchange-rate indexes for each supplier, using official rates of exchange vis-a-vis 67 principal markets.

1976; the increase for 1977, however, is expected to be only about 7 percent. 6/

Another measure of the competitiveness of U.S. products in world markets is provided by a comparison of the costs of production in the United States with the same costs abroad. 7/ To reflect fully changes in competitive position, production costs must be adjusted to account for changes in exchange rates. If, for example, production costs in the United States rise by 5 percent relative to costs in other countries simultaneously with a fall in the value of the dollar by 5 percent relative to other currencies, the costs of U.S. goods to foreign buyers and of foreign goods to U.S. buyers remain the same and no change in the relative competitive positions results. For changes in costs and exchange rates that do not exactly offset each other, competitive positions will change.

Two standard measures of production costs are used to form indexes of competitiveness for U.S. industrial goods. One measure is the wholesale price index for industrial products. The index of competitiveness is formed by computing the ratio (after adjusting for changes in exchange rates) of U.S. wholesale prices to a composite measure of wholesale prices in those industrial countries that are chief rivals of the United States in

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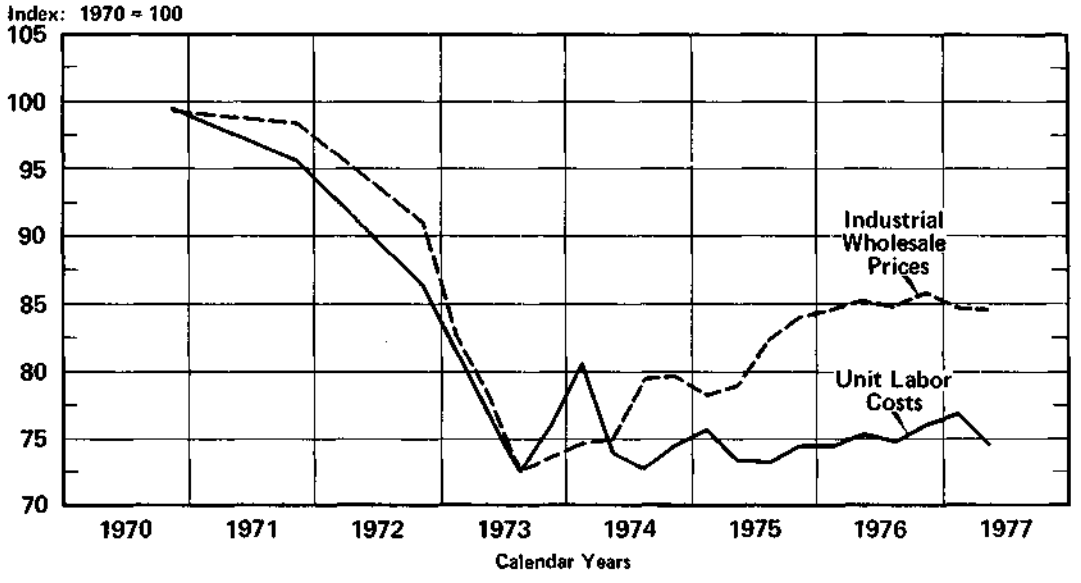
6/ International Monetary Fund, Annual Report 1977 (September 1977), pp. 9-10.

7/ For this comparison, production costs of industrial goods only are used because nonindustrial goods (mostly agricultural products) are traded in markets where the costs of production have a less direct impact on price. For many nonindustrial products, goods from one country are indistinguishable from goods from another country and one price prevails, regardless of how costs of production may differ from one country to another. For industrial goods, the products of one country are not exactly the same as those of another country, and prices are generally set by adding some margin to the costs of production. If the costs of production rise in one country relative to costs in other countries, the price of its products in world markets will rise also, assuming that profit margins and exchange rates do not change.

the production of industrial goods. 8/ The higher the resulting index, the higher the price of U.S. products relative to competing foreign products. The other measure of production costs used is the unit labor cost of industrial production--the cost for the labor required to produce one unit of output. A measure of competitiveness based on unit labor costs is computed in the same way as that based on wholesale prices. 9/ Figure 3 shows the movement of these two indexes of competitiveness since 1970.

Figure 3.

Indexes of Relative Production Costs of U.S. Goods



SOURCE: International Monetary Fund, *International Financial Statistics.*

8/ This composite wholesale price measure is a weighted average of the wholesale price indexes of 10 industrial countries. Weights are proportional to the amount of bilateral trade each of these countries had with the United States. The 10 countries are Canada, Japan, the Federal Republic of Germany, France, the Netherlands, Italy, the United Kingdom, Sweden, Switzerland, and Belgium.

9/ The only difference is that Belgium is excluded from the comparisons of unit labor costs because labor cost data are not available for Belgium.

Both measures show roughly the same pattern, although they differ in detail. From 1970 to 1973, the competitiveness of U.S. goods improved markedly as a result of two major devaluations of the dollar. From 1973 through 1975, both measures showed erratic movements that resulted in a net loss of competitiveness. This may have been because of readjustments in exchange rates that followed the 1973 devaluation, which some argue was larger than was justified. The temporary worsening of the relative labor cost measure in late 1973 and early 1974 was caused by the onset of recession in the United States before it began abroad. At the beginning of recessions, the amount of labor used per unit of output goes up temporarily because output falls quickly, while the labor force is reduced only slowly; this pushes up labor costs per unit of output. Since the beginning of 1976, however, both indexes have shown the same trend: a very slow loss of competitiveness for U.S. goods. The loss was 1 to 3 percent in a year and a half, depending on which measure is used. By either measure, U.S. goods are more competitive today than they were in 1970.

These two measures show that U.S. goods have become only slightly less competitive during the last two years. Because changes in relative prices are thought to affect the flow of trade only after a period of one to one and a half years, some of the deterioration in the U.S. trade account that occurred in 1977 may be attributable to losses in competitiveness that took place as long ago as 1975. The relatively stable behavior of the measures over the last year and a half suggests that no significant further weakening of the U.S. trade position because of these factors should be expected in the near future.

These indexes are deficient to the extent that they do not reflect the growing competition to U.S. producers that is posed by industrialization programs in some developing countries. For the most part, these programs have concentrated on the development of light industry (clothing, textiles, shoes, and electronic components, for example) and have contributed to the decline of similar industries in the United States. Unfortunately, reliable data on the costs of all manufacturing in developing countries are not available, and no systematic comparisons with the United States can be made.

Despite this deficiency in the measures of competitiveness used here, it seems that the evidence supporting the hypothesis that U.S. trade deficits are attributable to a loss of competitiveness is weak. Rather, most of the present deficit can be explained by differences in growth rates among the developed countries.

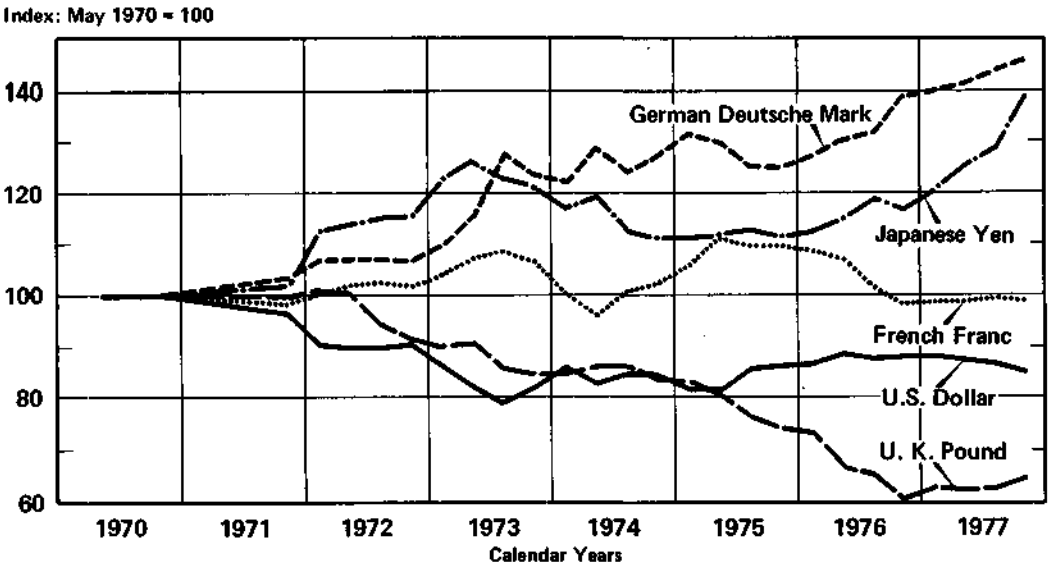
CHAPTER IV. THE VALUE OF THE DOLLAR

According to the simple textbook descriptions of how a system of floating exchange rates should operate, the large current account deficits the United States is now experiencing should be self-correcting. A large deficit reflects a flow of dollars out of the United States and into the hands of foreigners. As the stock of dollars outside the United States increases, one would expect the value of the dollar to fall. This would reduce the price of U.S. goods relative to foreign goods and should ultimately result in increased U.S. exports and decreased U.S. imports.

But the present situation is not exactly like that described in textbooks. In the last year, the dollar has fallen in value relative to some currencies; the German mark and the Japanese yen are the most notable examples. Relative to other currencies--the Canadian dollar and the Swedish krona, for example--it has risen in value. The most comprehensive measure of the value of the dollar is provided by the effective exchange rate of the dollar. This exchange rate is the weighted average of bilateral exchange rates of the dollar relative to other major currencies. To calculate this weighted average, each bilateral exchange rate is given a weight proportional to that currency's importance in the international transactions of the United States. Figure 4 shows the effective exchange rates of the dollar and of some other major currencies over the past few years. The effective value of the dollar fell in the early 1970s as a result of the large devaluations in 1971 and 1973. Since then, the dollar's value has increased somewhat. What is striking, however, is the relative stability of the value of the dollar from 1976 on. Only at the end of 1977 did the effective value of the dollar decline. During the last three months of 1977, the dollar declined 5.4 percent by this measure, but during the first month of 1978, it recovered somewhat.

The reason that the value of the dollar has not fallen further is that foreigners have been content to hold increasingly large amounts of dollars and dollar-denominated assets. Many of these foreign holdings of dollars are returning to the United States in the form of capital flows into this country. So large has been this return flow of capital that in 1977 the United

Figure 4.
Indexes of Effective Exchange Rates
(Based on International Monetary Fund's Multilateral Exchange Rate Model)



SOURCE: International Monetary Fund, *International Financial Statistics.*

States became a net importer of capital, a reversal of the role it has traditionally played in international financial markets. In the first half of 1977, the net flow of capital into the United States was about $4 billion. By contrast, in 1976, there was a net outflow of capital from the United States of about $8.5 billion.

For the most part, the flow of foreign capital into the United States has taken the form of deposits in U.S. banks and purchases of U.S. Treasury securities. From time to time, highly publicized purchases by foreigners of U.S. businesses or property give rise to fears the foreigners are "buying out" Americans, but purchases of real assets in the United States by foreigners are only a very small part of the inflow of foreign capital. In the first half of 1977, for example, such direct investment accounted for only 7 percent (about $1 billion) of total foreign purchases of assets in the United States.

Some have voiced fears that large purchases of U.S. government securities by foreigners (and particularly by foreign governments) might eventually leave the United States vulnerable to

attempts by foreign holders of U.S. debt to disrupt U.S. financial markets. In theory, if holders of a significant share of outstanding federal debt were to sell their U.S. government securities at the same time, the price of all U.S. government securities would fall. This would lower the receipts of the U.S. Treasury from the sale of government securities and would require the payment of higher interest rates on those securities the Treasury did sell.

In practice, however, such a chain of events seems unlikely any time in the foreseeable future. In July 1977, the total U.S. federal debt outstanding was $685 billion. Of this total, only $90 billion was held by foreigners or by international institutions. Further, $70 billion of this amount was held by the industrialized nations of the Organization for Economic Cooperation and Development (OECD) and by international institutions. It seems highly unlikely that these nations or institutions would have any motive for disrupting U.S. financial markets. The remaining $20 billion of foreign-held assets are scattered among a large number of nations, which would have difficulty acting in concert. Even if they were to do so, though, the effects on U.S. Treasury operations would be temporary and slight. In the month of August 1977, for example, the Treasury issued about $40 billion worth of new securities. The offering of an additional $20 billion would have a noticeable, but hardly catastrophic, effect.

The reasons that foreigners are willing to hold dollars and to return these dollars to the United States are varied. One important reason is that the dollar retains its central position in the international financial system and is still the world's principal reserve currency. There has been a worldwide increase in official reserve holdings of foreign currencies, and many countries have chosen to increase their reserve holdings by acquiring more dollars or dollar-denominated assets. In the first half of 1977, some 81 percent of the net increase in foreign-owned assets in the United States was accounted for by increases in official reserve holdings by foreign countries. Some of the inflow of capital has also been attracted by the relatively rapid growth of the U.S. economy. This has provided increased opportunities for investment and has raised interest rates in this country. Finally, some assets are being transferred to the United States to escape the political and economic uncertainties that asset holders face in some other countries.

Another reason that is sometimes given for the continued strength of the dollar is intervention in world currency markets by the central banks of other nations. It is well known that in the past year the central banks of several industrial nations have intervened extensively in currency markets, although there is no way of knowing exactly the timing and size of these interventions. 1/ The intent of recent interventions has been to limit the rise in the value of certain currencies--most notably the Japanese yen, the German mark, the British pound, and the Swiss franc--relative to the dollar. Foreign central banks have been buying dollars, thus supporting the value of the dollar and holding down the value of their respective currencies. Recently, even the United States--through operations of the Federal Reserve and use of the Exchange Stabilization Fund of the Treasury--have been intervening in currency markets to support the dollar.

There are two reasons for such intervention. The first is the desire of all central banks to preserve orderly markets for their currencies. A rapid fall in the value of the dollar followed shortly by a recovery could disrupt currency markets and hinder some international transactions. By buying and selling dollars, central banks can smooth out temporary fluctuations in the value of the dollar and thus stabilize international markets. The second reason for currency market intervention is the desire of some foreign countries that the dollar remain strong. These countries have an interest in avoiding a permanent decline in the value of the dollar, since a declining dollar would make U.S. goods cheaper and could threaten the export markets of other countries.

There is no way to distinguish between currency market interventions intended to stabilize markets and those intended to maintain for an extended period an exchange rate at a level different from the level that would prevail in a free market. It seems unlikely, however, that foreign central banks could maintain the dollar at artificially high levels for very long. It is generally thought that the value of a currency is determined in the short run (up to, say, a year) by the actions and preferences of asset holders, not by the flow of international trade. It is estimated that the total value of dollar-denominated assets

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1/ See, for example, "Dollar At Record Low Against Yen," The Washington Post (October 19, 1977), p. B-2.

in the world is in the neighborhood of $5 trillion, 2/ and extremely large and continuous interventions would be required to produce lasting changes in the value of the dollar. 3/

Even if the value of the dollar were to decline, it would prove a mixed blessing for the U.S. economy. In the long run, perhaps after a year or so, one might expect an improvement in the U.S. trade position as U.S. goods became more competitive relative to foreign goods. In the shorter run, however, the lower value of the dollar would be expected to add somewhat to inflationary pressures because the price of imported goods would be higher. The higher import prices and lower export prices that would result from a decline in the value of the dollar would temporarily increase the U.S. trade deficit.

2/ Henry C. Wallich, "Why Exchange Rates Move," Challenge (July/August 1977), p. 38.

3/ An example of how large these interventions would have to be is provided by recent actions of the Bank of England. Throughout 1977, the value of the pound had been held down by very large purchases of foreign currencies--mostly dollars--by the Bank of England. During the first 10 months of 1977, British official reserves of foreign currency increased from $4.13 billion to $20.2 billion, with $3.04 billion being accumulated in the month of October alone. To finance these massive purchases of foreign currency, the Bank of England had to allow large increases in the domestic money supply. Fear that such rapid monetary growth would increase inflationary pressures led the Bank of England to announce on October 31 that it would cease its currency market intervention. Free to move to a market-determined value, the pound initially rose by about 3.8 percent relative to the dollar, then fell back to a value in the New York currency market only 1.5 percent higher than had prevailed when the Bank of England was intervening.

CHAPTER V. PROSPECTS AND POLICIES

PROSPECTS FOR THE IMMEDIATE FUTURE

The prospects for improvement of the U.S. trade and current account deficits do not appear bright in the near future if it is true, as the evidence seems to indicate, that those deficits are attributable mostly to slow growth in other countries. In its most recent projections for the industrial economies, the OECD projects no improvement in growth rates of member countries in 1978. 1/ In recent months, both Japan and West Germany have announced more stimulative fiscal policies, but few observers expect these modest actions to have a pronounced effect on economic growth. Italy and the United Kingdom are both making progress at controlling inflation and eliminating large trade deficits, but neither country can be expected to adopt strongly stimulative policies in the near future. The general elections in France scheduled for next spring make the prospects for that country uncertain. Industrial production in Canada has shown almost no growth in the first half of 1977, and the prospects for resumed growth in the near future appear dim.

Among the developing countries, there are some signs of improvement. Most developing countries have added to their reserves of foreign currency in 1977, and borrowing by these countries has decreased somewhat from the high levels of 1975 and 1976. Improvements in the financial positions of the developing countries may allow the resumption of import growth during the next year. But until general recovery among the industrialized countries increases the demand for exports from developing countries, the ability of the developing countries to import will grow only slowly.

The growth rate of the U.S. economy may also slow slightly in the next year, 2/ but it is expected to remain higher than those

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1/ OECD Economic Outlook (December 1977).

2/ Congressional Budget Office, Recovery With Inflation (July 1977), p. 22.

of most other industrialized countries. Thus, the growth of U.S. imports may slow somewhat, but probably not enough to produce large reductions in the U.S. trade deficit. U.S. imports of oil may have declined slightly in the latter part of 1977 because unusually large stocks were accumulated early in that year, but in 1978 they are expected to return to the high levels (9.4 million barrels per day) of the early part of 1977. 3/ Oil imports might be even higher if plans for a strategic stockpile of petroleum are implemented. Overall, then, the prospect is that the trade and current account deficits that the United States experienced in 1977 are likely to continue at roughly the same level in 1978.

IMPLICATIONS FOR U.S. POLICY

The present U.S. deficits do not appear to be a reflection of any fundamental weakness in the U.S. economy. Quite the contrary is true: these deficits are to a large extent a reflection of the relative success of the United States at recovering from recession. This does not mean that the deficits are not a cause for concern; the unemployment that results from depressed export markets and the displacement of U.S. workers caused by import competition are real problems. But there is no direct relationship between the intensity of these problems and the size of the U.S. trade and current account deficits, and the solution to these problems does not necessarily require the elimination of these deficits. Indeed, there is no guarantee that restoring a balance to the U.S. current account would contribute anything toward alleviating these problems. Much will depend on whether the deficit is eliminated in such a way as to increase U.S. exports. The remainder of this section will outline the possibilities and limitations of the various policy tools available to deal with these problems.

Trade Policies

Policies to limit the imports of foreign products or to expand U.S. exports at the expense of production in other countries may provide temporary relief for some industries, but

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3/ "The U.S. Trade Deficit and Policy Alternatives," World Financial Markets (September 1977), p. 2.

such policies are potentially dangerous in the longer run. In many of the slower recovering industrial countries, economic conditions are worse than in the United States. Unemployment is higher--at least by historical standards--in many of these countries than in the United States, unused industrial capacity is greater abroad than it is here, and many foreign governments have been reluctant to adopt stimulative policies for fear of inflation. This has forced these countries to rely on growing foreign demand to lead the way to recovery and, to a large extent, what recovery there has been in the other industrial countries has been the result of growing foreign demand.

In these circumstances, it is to be expected that many governments would be highly sensitive to policies that restrict their exports to the United States. Protectionist sentiment is widely reported to be gaining strength abroad. 4/ It seems likely that U.S. policies that threaten the major source of economic growth in these countries would result in strong pressures for retaliatory measures against U.S. exports. If such retaliatory policies were adopted, U.S. export growth would slow even further.

There is a further danger in relying too heavily on restrictive trade policies to reduce import competition. The benefits of such trade policies are highly visible and narrowly focused within particular industries, and one must expect highly organized and vocal support for these policies from those who might benefit from increased earnings and employment in the affected industries. This support may, however, obscure the full costs of restrictive trade policies. In general, domestic products face import competition when the costs of the foreign products are lower than the costs of competing domestic products. To eliminate the importation of cheaper foreign goods is to increase the prices paid by all consumers of those goods. To insulate U.S. producers from foreign competition removes one more incentive to efficient domestic production. The costs inherent in restrictive trade policies are widely spread among consumers and are therefore difficult to observe or measure. They are, nonetheless, real and should be considered in deciding whether or not to adopt such policies.

4/ The most comprehensive review of the recent rise in restrictive trade policies is provided in International Monetary Fund, 28th Annual Report on Exchange Restrictions (May 1977), particularly pp. 4-6.

This is not to argue that all restrictive trade policies do more harm than good. There are certainly strong justifications for policies to prevent "dumping" of foreign products in U.S. markets--selling at prices below production costs to drive out competition--or unfair export subsidies given by foreign governments. Similarly, changes in industrial structure necessitated by changing international economic conditions can be rendered less painful by providing assistance to domestic workers or industries suffering from the effects of foreign competition. Whatever the reasons for restrictive trade policies, however, the benefits are likely to be more apparent than the less easily observed but nonetheless real costs.

Exchange Rate Policies

Neither is it likely that policies designed to affect the value of the dollar would do much to encourage the growth of U.S. exports. U.S. sales of dollars would, in theory, reduce the value of the dollar relative to foreign currencies. Such a policy, however, would require large increases in the U.S. money supply as the Federal Reserve System strove to create enough dollars to satisfy foreign demand and to drive down the dollar's value. This rapid growth in the money supply would lower interest rates in the United States and eventually work to increase inflationary pressures. The growth rate of the money supply and domestic interest rates are important elements of domestic economic policy. To allow exchange rate considerations to determine domestic monetary policy would represent a subordination of overall economic policy to the requirements of foreign trade, still a relatively small part of the total U.S. economy.

Except for very short-term interventions to preserve orderly market conditions, then, the United States could in practice do little to affect the value of the dollar directly. Further, attempts to lower the value of the dollar would likely place the United States in conflict with the central banks of other nations. In recent months, when the value of the dollar has fallen as a result of natural market forces, other nations have intervened to support the dollar. Far from attempting to counteract currency market interventions by other nations, the Federal Reserve and the U.S. Treasury have in recent months been intervening in these markets to support the dollar.

Even if U.S. monetary authorities succeeded in reducing the value of the dollar, increased growth in U.S. exports would

not result for some time. International transactions are often planned far in advance, and it often takes a year to a year and a half for the full effects of changed exchange rates to be felt. In the meantime, a devalued dollar would raise the price of U.S. imports, worsening the balance of trade and adding to inflationary pressures.

Macroeconomic Policy

As the United States has recovered from recession, its imports have risen about as would be expected. Because foreign economies have recovered less quickly, however, U.S. exports have grown more slowly than imports, and a large merchandise trade deficit has resulted. This deficit could be narrowed by adopting a more restrictive macroeconomic policy that would reduce the rate of growth of the U.S. economy and ultimately the demand for imports. But while such a policy would reduce U.S. payments deficits, it would do nothing to solve the problems of unemployment and slow growth. Indeed, restrictive macroeconomic policies would only aggravate these problems.

Demand for U.S. exports is one among a number of factors that determine total demand for U.S. products and thus determine employment and GNP. Other factors are the level of domestic consumer demand, the rate of capital formation, and government spending. When private demand--either domestic or foreign--is weak, more stimulative policies will be required to reach any given set of macroeconomic goals. The failure of foreign demand to keep pace with the U.S. recovery, particularly in 1977, will necessitate a more stimulative economic policy to sustain the U.S. recovery than would have been needed if foreign demand had remained strong. The proper response to large U.S. trade deficits, then, is a more expansionary, not a more contractionary, macroeconomic policy.

Paradoxically, the expansionary fiscal and monetary policies required to relieve the worst effects of slow export growth would be expected to increase U.S. trade deficits. More stimulative macroeconomic policies would lead to increased demand in the United States for all goods--domestic and foreign. The increased demand for domestic goods would stimulate production and lower unemployment in the United States, but the increased demand for foreign goods would--all other things being equal--result in larger U.S. trade deficits.

Because increased income in the United States leads to increased demand for imports, stimulative policies in the United States will inevitably have the effect of stimulating not just the domestic economy but foreign economies as well. To the extent that these policies result in demand for foreign rather than for domestic products, their effectiveness in stimulating the domestic economy is reduced. But this is not a reason for adopting less stimulative policies. Stimulative policies have been designed to promote economic recovery in the United States. The United States has recovered faster than have most industrial countries, and the fact that we now face large trade deficits is in large part a reflection of our relative success. To reduce the U.S. trade deficit through a restrictive macroeconomic policy would require slowing the rate of U.S. recovery--hardly an attractive option.

Energy Conservation Policies

Oil imports are a major component of total U.S. imports. The total cost of oil imports to the United States is expected to reach $45 billion in 1977, and an effective program to reduce these imports would have a major effect on the U.S. trade balance. But a reduction in imports of oil will not in itself provide increased demand for U.S. exports, nor will it reduce the competition domestic producers face from imported products. There are, of course, many compelling reasons to devise a national program to reduce oil imports, and the reduction in the U.S. trade and current account deficits that would result from reduced oil imports is among these reasons. But even a highly successful conservation program will not in itself promote higher employment in the United States.

Foreign Policy

Just as stimulative policies in the United States can foster economic growth abroad, stimulative policies in the other industrial countries can lead to a faster recovery of the U.S. economy. It is clearly in the interests of the United States for the stronger industrial nations to "reflate"--to adopt more stimulative fiscal policies and to allow their currencies to float upward in foreign exchange markets--thus increasing foreign demand for U.S. products. Recent pressure for faster growth has brought some response in both Japan and West Germany, but the ability of the United States to bring about further expansionary policies in these or other countries is questionable.

Economic and political conditions abroad are different from those in the United States, and the interests of other countries legitimately differ from those of this country. Japan and West Germany, for example, are usually named as the countries most able to join the United States in stimulating the world economy, but for internal reasons, both have chosen to adopt only moderately stimulative fiscal policies and both are intervening in currency markets to keep the value of their own currencies down. Both countries have faced serious inflation--at least in terms of their recent history--in the past few years, and both have depended heavily on exports for their recovery from the 1975 recession.

The United States can, of course, continue to call for more stimulative policies in other nations and to remind these nations that they have not met the 5 percent growth targets for 1977 that were agreed to at the London economic summit in May of that year. But the prospects for encouraging other nations to change prevailing policies seem dim.

CONCLUSION

It would seem that the United States must reconcile itself to continuing trade and current account deficits for at least the next year or so. Neither restrictive trade policies nor attempts to manipulate the value of the dollar are likely to provide more than very short-term relief from the problems associated with these deficits. Indeed, these policies could easily create further problems. There are, however, other policy tools available that could alleviate some of the problems the United States now faces. Specifically, a more stimulative macroeconomic policy could help to reduce unemployment and to sustain economic recovery by compensating for weak foreign demand for U.S. products. An effective program to reduce imports of oil would provide benefits both by reducing U.S. dependence on foreign sources of supply and by reducing the size of the U.S. trade deficit. U.S. encouragement of more rapid growth in other industrial countries has resulted in the adoption of moderately expansionary policies in West Germany and Japan, and continued pressure for such policies and for reductions in trade restrictions may prove effective in the future.

It may also be desirable to provide more relief for the workers and industries most seriously injured by sluggish export growth and increased competition. This assistance, however, should be temporary and limited; there is nothing to be gained by

insulating declining industries forever from changing patterns of world trade. Some assistance of this form is already provided through programs administered by the Departments of Labor and Commerce, but only those workers or firms injured because of import competition are eligible for assistance. As foreign trade continues to grow in importance to the U.S. economy, it would perhaps be worth considering the extension of such assistance to individuals or industries that suffer the loss of export markets. This assistance could ease the adjustment to a new structure of trade and could allow industries to survive temporary losses in export sales.

The analysis of the earlier sections of this study suggests strongly that the large trade and current account deficits that the United States experienced in 1977 are not a symptom of any general weakness in the U.S. economy. On the contrary, the evidence indicates that they are the result of the success of the United States in recovering from recession faster than did the other industrial nations. As such, the greatest danger these deficits pose to the continued growth of the U.S. economy is that policies designed to eliminate them will retard the economic recovery that gave rise to them.

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