STATEMENT OF
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Before the Subcommittee on Trade
Committee on Ways and Means
U.S. House of Representatives

November 3, 1977

The Present Situation

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 here 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. This morning I will briefly outline the present U.S. balance-of-payments position and offer an explanation of how this situation came to be. I will conclude with a consideration of what federal policies might provide appropriate responses to these deficits.

Recent attention has been directed primarily at the U.S. balance of merchandise trade. If imports and exports of merchandise continue at the same rate as during the first half of 1977, the United States will have a merchandise trade deficit for the whole year of about $30 billion. This would be a marked increase over the trade deficit for 1976 (which was $9.3 billion) and would be without precedent in U.S. history.

But the merchandise trade balance is not the whole story. Nontangible services make up an important 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, but 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 dollars on services in 1977. This is up from about $13 billion in 1976.

Foreign trade in both merchandise and services are 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 per year.) Because the surplus for services partially offsets the expected merchandise trade deficit, the expected U.S. current account deficit will be less than the trade deficit, but it will still be very large by past standards. We expect that it will be in the neighborhood of $17 billion as compared with a deficit in 1976 of only $1.4 billion. The table that follows summarizes the components of the expected current account balance for 1977 and the actual balance for 1976.

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

	1976 (Actual Figures)	1977 (Projected From Half-Year Figures)
Merchandise	- 9.3	-30.0
Services	+12.9	+17.2
Net Transfers	- 5.0	- 4.8
Current Account	- 1.4	-17.6

To understand how these large deficits have arisen, we must 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 per 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. In 1977 we expect the value of oil imports to reach $45 billion. It would be incorrect, however, to attribute the growth in merchandise imports solely to rising oil imports. During the last two years, oil imports have been growing only slightly faster than other merchandise imports. As we began our recovery in 1975, oil accounted for about 28 percent of U.S. merchandise imports and in the first half of 1977 it accounted for 30 percent. (Some of this increase is probably the result of the unusually harsh winter we experienced last year and of stockpiling of oil by U.S. distributors as a hedge against further price increases by the Oil Producing and Exporting Countries.)

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.

Two possible explanations can be given for the failure of U.S. exports to keep pace with imports. The first of these explanations suggests that the current deficits are no serious cause for alarm. The second is somewhat more disturbing. Let me first address the less worrisome explanation.

The major customers for U.S. exports are the other industrial countries. In 1976 almost 60 percent of total U.S. merchandise exports went to Canada, Japan, and Western Europe. Unfortunately, most of these countries have not recovered from the recession of 1974/1975 as fast as the United States has, and particularly in late 1976 and early 1977 recovery has faltered in several of these countries. This slow recovery has reduced demand in these countries for U.S. exports.

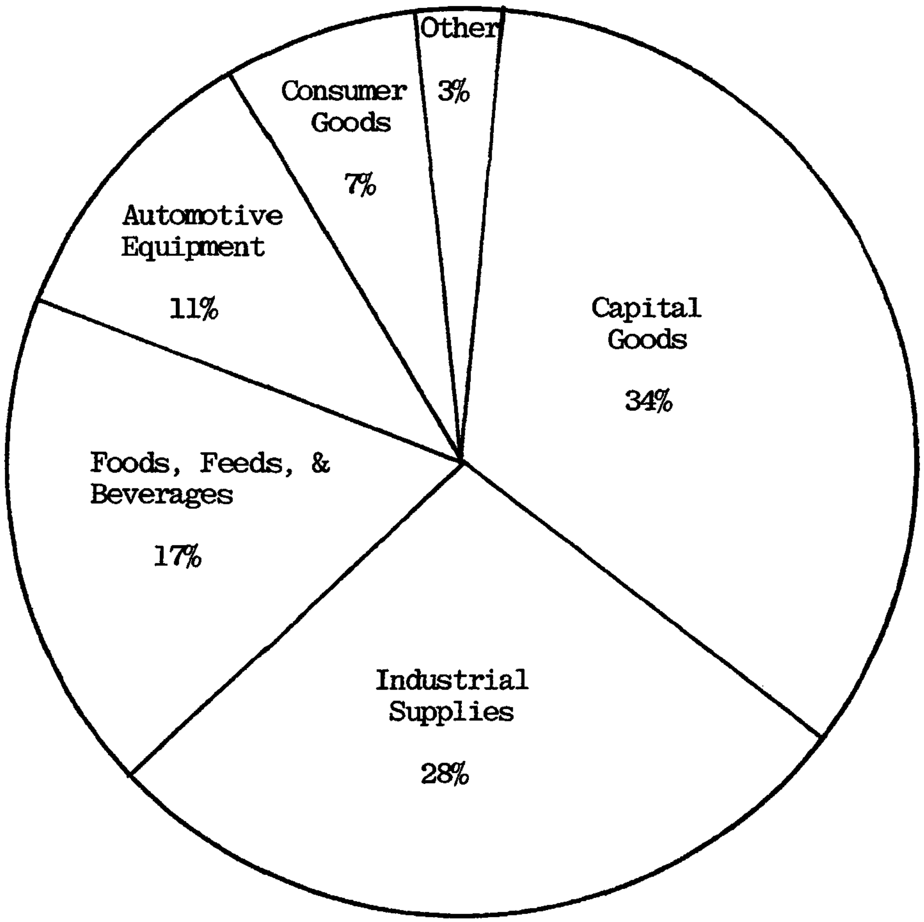
The effects of relatively slow growth abroad are intensified, by the nature of U.S. exports. Figure 1 shows the composition of U.S. merchandise imports and exports. Capital goods account for about one-third of all U.S. merchandise exports, but, because most of the other industrial countries still have significant amounts of unused industrial capacity, there has been little investment in new plants and equipment, and consequently little demand for U.S. capital goods. Another quarter of U.S. merchandise exports is made up of industrial materials--products like chemicals, metals, and fibers needed for production of other goods. Because industrial production in other countries has lagged, demand for these exports has also been weak.

This is in sharp contrast to the composition of the U.S. imports. About half of all U.S. merchandise imports are made up of fuels and industrial supplies. Demand for these products is closely related to the level of industrial production, and imports of both have risen as industrial production in the United States has risen. Consumer goods constitute about one-sixth of U.S. imports, and rising incomes in the United States have increased demand for imported consumer goods.

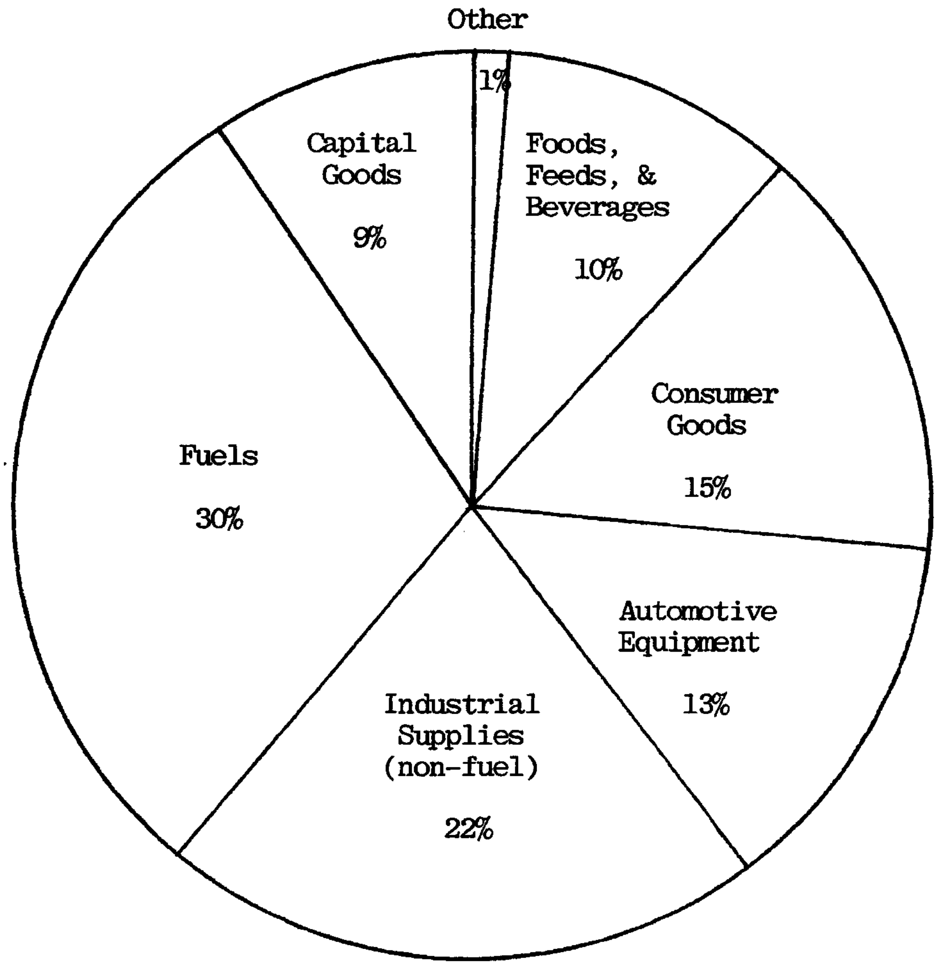
CBO has made estimates of what the U.S. foreign trade position might have been if the other industrial countries had recovered from the recession at the same pace that the United States did. These estimates indicate that, with this higher growth abroad, net U.S. exports of goods and services would be about $13 billion a year higher than they are now. Thus, only a small part

FIGURE 1.

U.S. MERCHANDISE TRADE 1976



EXPORTS



IMPORTS

of the $17 billion current account deficit expected for 1977 would remain if the other industrial countries had experienced growth as rapid as our own. The increased demand for U.S. exports resulting from this higher growth would also have had the effect of stimulating the U.S. economy, raising GNP by about $36 billion or $37 billion a year and reducing unemployment by about half a percentage point.

The more troublesome explanation for the slow growth of U.S. exports is that for various reasons U.S. products may be losing their competitive position in world markets. This has certainly been the case in a few specific industries; steel and television sets come quickly to mind. What has been happening to the competitive position of U.S. products as a whole, however, is not so clear.

To try to answer this question, we have made comparisons of the costs of industrial production in the United States with similar costs in the countries that are our principal competitors in the export of manufactured goods. Two measures of production costs were used: wholesale prices for manufactured goods, and labor costs. All costs were adjusted to take into account changes in exchange rates. Although the comparisons differ in detail for the two measures of production costs, the results are roughly similar. Figure 2 shows recent movements in these two measures of competitiveness. The lower the line, the more competitive U.S. goods were. The major devaluations of the dollar in the early 1970s improved the competitive position of the

FIGURE 2. INDICES OF U.S. RELATIVE PRODUCTION COSTS

(1970 = 100)

United States dramatically. This was followed by a period from 1973 through 1975 of erratic movements that generally reduced the competitiveness of U.S. goods. Since the beginning of 1976, however, both measures have shown only a very slow loss of competitive position--between 1 and 3 percent in the last year and a half, depending on which measure is used. By both measures, U.S. products are still far more competitive than they were in 1970.

It is usually thought that changes in competitive positions are reflected in trade flows only after a considerable lag--perhaps a year or a year and a half--so it may be that some of the deterioration in the U.S. current account that we are seeing now is because of losses in competitiveness in 1975. The relatively constant competitive position during the last year or so is reassuring, however, and one would not expect the overall trade position of the United States to change dramatically in the near future because of changes in our competitiveness.

Another bit of data that suggests that the United States is not losing its competitive position in world markets is the fact that the U.S. share in total manufactured exports has not deteriorated significantly in the past year. Our share has fluctuated around 20 percent since 1971, reaching a peak at the end of 1975 at about 22 percent and then returning to its traditional level. This suggests that U.S. exports are lagging, not because we are losing out to other suppliers, but because total world trade is not expanding as rapidly as it has in the recent past.

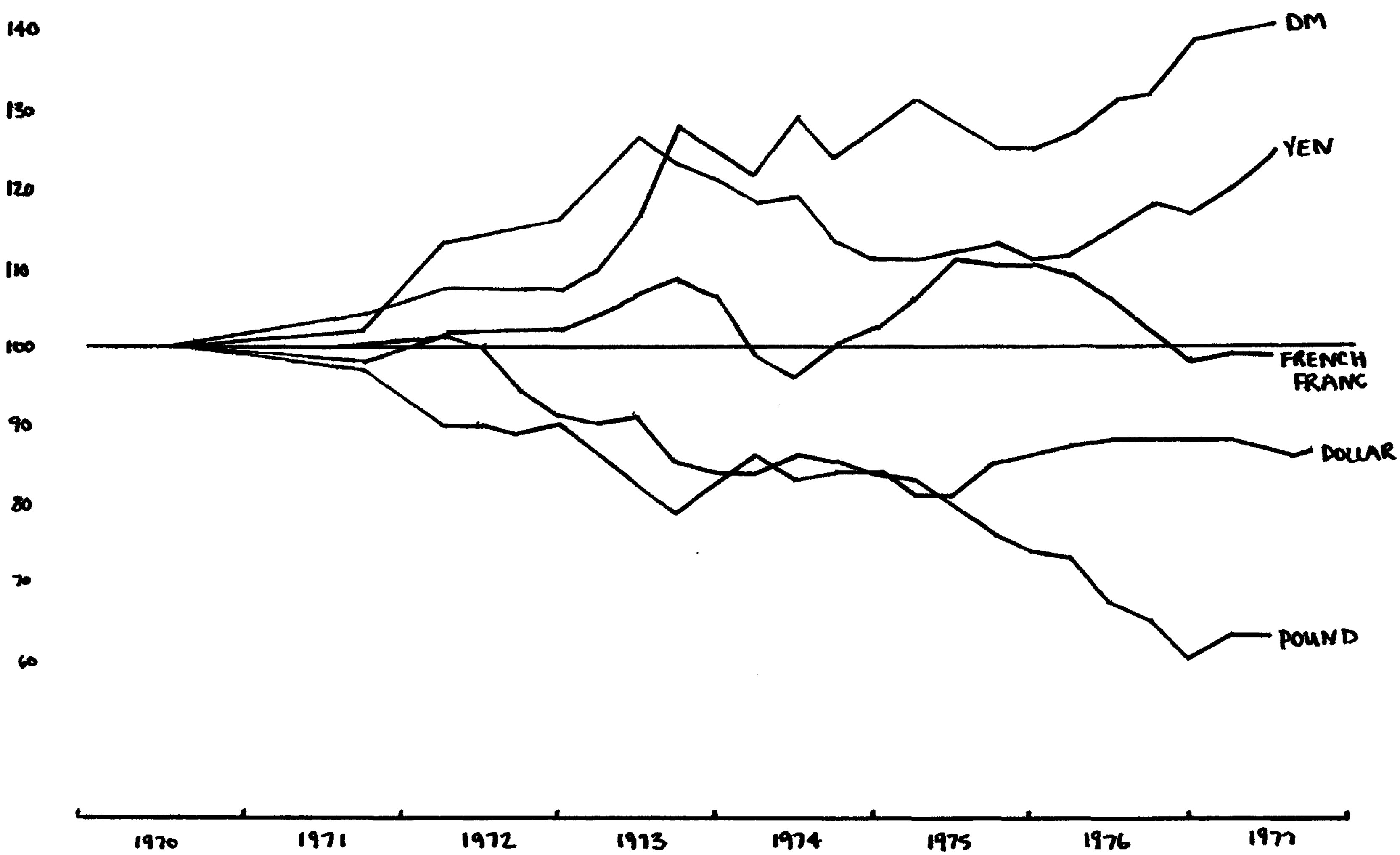
It would seem, then, that trade and current account deficits have risen mostly because of relatively slow growth in other industrial economies. A part of these deficits may be the result of some deterioration in overall U.S. competitiveness, but the evidence for this is weak.

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 would eventually lead to an improvement in our current account position. In spite of our large current account deficit, however, the value of the dollar has not fallen significantly. It is true that over the last year the dollar has fallen relative to some currencies--the mark and the yen for example--but it has risen with respect to some others--such as the pound and the Canadian dollar. (In the last few days the Bank of England has discontinued market interventions in support of the dollar and the dollar has fallen somewhat relative to the pound.) The effective value of the dollar--its value relative to the average value of the currencies of our trading partners has changed very little since the middle of 1975. Figure 3 shows the effective values of some major currencies during the last few years.

FIGURE 3. INDICES OF EFFECTIVE EXCHANGE RATES
Based on IMF Multilateral Exchange Rate Model

(May 1970 = 100)



One reason for the stability of the dollar is that foreigners seem to be willing to hold dollars or dollar-denominated assets. Many of these dollars are returning to the United States as foreigners buy assets in this country. In 1977 these capital flows have been 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.

Most of this inflow of capital has been in the form of deposits in U.S. banks or purchases of U.S. Treasury securities. There have been a few highly publicized cases of foreign direct investment in the United States, but purchases of real assets by foreigners have been relatively small. In the first half of 1977, direct investment accounted for only about 7 percent of foreign purchases of U.S. assets.

The reasons that foreigners hold dollars are varied. The dollar still retains its central position in world monetary affairs and remains the world's principal reserve currency. Recovery of the U.S. economy has provided new opportunities for foreign investors and has driven up interest rates in this country. And political uncertainty in some European countries has led some asset holders to seek the greater security of U.S. assets. Predictions of exchange rates are highly risky but, as long as foreigners desire to hold dollars for these or other reasons, it is unlikely that the dollar will fall very much in value.

Even if the value of the dollar were to decline, it would prove a mixed blessing to the U.S. economy. In the long run, perhaps after a year or so, we might expect an increase in U.S. exports and a decrease in imports. 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 an improvement in either the trade or the current account balance in the near future appear dim. Most forecasts predict continued slow growth in the other industrial countries for at least the next year. In the last few months, both Japan and West Germany have announced more stimulative economic policies but few expect these rather modest actions to lead to large increases in the rate of growth in other industrial countries. Thus, we will probably have to face continuing deficits for the immediate future.

Fortunately, the present U.S. deficits do not in themselves pose a threat to the U.S. economy. They have not arisen because of any major flaw either in the domestic economy or in the world economic system. Quite the contrary is true: these deficits are to a large extent a reflection of the relative success of the United States in recovering from recession. This does not mean that the deficits can be ignored; the unemployment that results from depressed export markets is a real problem. What it does mean, though, is that the primary aim of policy need not be the elimination of the cause of the deficits. Instead, policies should be aimed at eliminating the unemployment that results from the deficits.

A more restrictive fiscal policy would reduce the trade deficit by slowing the growth of incomes in the United States and eventually slowing the growth of demand for imports. But such a policy would do nothing to stimulate exports and would, in fact, only add to problems of unemployment by reducing domestic demand for U.S. products. Fiscal policy should be used in just the opposite manner: the weaker foreign demand is, the more stimulative a fiscal policy will be needed to meet any particular set of macroeconomic targets.

Nor is there a good case for policies to reduce imports to the United States or to expand exports at the expense of production in other countries. Unemployment is worse--at least by historical standards--in some other industrial countries than it is in the United States, and in most of these countries recovery depends heavily on export sales. Protectionist sentiment is reported to be gaining strength abroad and U.S. policies that threaten the export markets of these countries run a high risk of provoking retaliation, further hindering the growth of U.S. exports.

It would be possible to reduce U.S. imports of petroleum without fear of reprisal by other countries, but it is unlikely that this would have any positive effect on U.S. exports. There are a number of good reasons for adopting a national program to reduce oil imports, but it would be unrealistic to think that such a program would rapidly eliminate the problems associated with the present trade and current account deficits.

It would seem, then, that the only real option open to us is to live with large deficits for the next year or two as best we can. This will require a fiscal policy that recognizes that foreign demand will be weak, a trade policy that does not foster protectionist policies abroad, and perhaps more assistance to workers and industries that face the need to adjust to changing patterns of world trade. Above all, it will be important to remember that the present deficits are a sign more of strength in the U.S. economy than of weakness. Perhaps the greatest danger posed by these deficits is that they may prompt the adoption of policies that will retard the successful economic recovery that gave rise to them.