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Statement by

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before the

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of the

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I am pleased to be here today to testify on behalf of the Board of Governors of the Federal Reserve System. It is useful to have these hearings at this time. In recent weeks, as the Chairman of this Subcommittee has noted, there has been some renewed uncertainty in foreign exchange markets about the future of the U.S. dollar. The restoration of confidence in the dollar requires, basically, a substantial improvement in our international balance of payments. These hearings provide an opportunity to make clear that the outlook for the U.S. international payments position, and hence for the dollar, is considerably better now than it has been for some time.

The outlook has been greatly improved by the exchange rate realignments of 1970-71 and early 1973. Altogether, the U.S. dollar has been effectively devalued against all other currencies by about 17 per cent since mid-1970, and by substantially more than that against some of our strongest competitors. This is a very large adjustment, which greatly improves the international competitiveness of U.S. goods. It is certain to have large effects, even though the size and timing of the expected increases in exports and slowing of import growth cannot be foreseen with precision.

The structure of our balance of payments is such that we need to earn a substantial surplus on current international transactions -- specifically on merchandise trade -- in order to balance the net outflows of Government aid and private capital which are natural and desirable for a wealthy country with a well-developed capital market. But the dominant

tendency in our international transactions from about 1965 through 1972 was a persistent worsening in our current balance -- and especially our trade balance -- to the point where they moved into deepening deficit. Last year, as you know, we had a trade deficit of almost \$7 billion and a deficit on all current and long-term capital transactions combined of over \$9 billion.

World business cycle conditions were adverse from a U.S. balance-of-payments viewpoint during 1972. Last year our economy and our imports were vigorously expanding while demand abroad, including demand for our exports, was still rather slack. But even after making a rough allowance for the adverse cyclical position, the underlying trend-rate of our trade deficit last year was probably at least \$4 billion. Compared with the mid-1960's, when we had a trade surplus averaging more than \$5 billion a year, there had been a deterioration on trade account of around \$10 billion. U.S. imports of finished manufactures rose particularly rapidly during this period, while the U.S. share of world exports of manufactures declined steadily.

The adverse trend in our trade balance from 1965 to 1972 is attributable to a variety of factors. First, after 1965 the United States experienced greater increases in costs and prices, and lower rates of productivity growth, than most other industrial countries. Second, this occurred at a time when a number of other countries -- European countries, Japan, and various other countries in Asia -- were reaching a point at which they had built up the capability to take advantage of existing

price-cost differentials. Third, and more recently, rapidly rising imports of petroleum have added to our foreign expenditures.

Now, as a result of the exchange rate changes, together with other factors, one can be cautiously optimistic. The worsening of the trade balance was halted during the course of 1972. The low point was reached early in that year, when the trade deficit approached \$8 billion at an annual rate. The U.S. share in world exports of manufactures stopped declining in 1972.

So far this year, there has been a marked improvement in the trade balance. The annual rate of deficit on trade in January-April 1973 decreased sharply to around \$2 billion, compared to \$6.8 billion for 1972 as a whole. Much of this recent improvement reflects an exceptionally large bulge in agricultural exports which is likely to prove temporary, so that the underlying gain is not nearly as large as the raw figures suggest. We should be prepared for some temporary setback during the months ahead, as the dollar prices of imports will be pushed up further in delayed reaction to the devaluation, while the volume of imports will not yet have fully reacted to the price rise. But there have been solid gains. The value of nonagricultural exports in January-April 1973 was 14 per cent larger than it had been six months earlier, a near-record rate of increase. New foreign orders for machinery in the first quarter of 1973 were up by 16 per cent from the third quarter of last year. Meanwhile the value of total imports, after rising sharply through January, has not risen at all since then,

despite booming domestic demand, a sharp rise in prices of imported raw materials, and a continuing rise in imports of petroleum.

Thus, the increased competitiveness of U.S. goods as a result of devaluation is beginning to have perceptible beneficial effects on both our exports and our imports. The corresponding opposite effects are beginning to be evident in the trade figures of other countries, notably Japan, where import expansion has accelerated and export growth is slowing down.

Later this year and in 1974, we expect to see further gains in our foreign trade balance, not only because of the cumulating effects of our strengthened competitive position, but also because business cycle conditions are likely to be moving in our favor. Growth in the U.S. economy will be slowing to a more moderate and sustainable rate from now on, while expansion abroad is likely to be continuing vigorously. It seems clear that there can be a substantial improvement in the trade balance beginning this year, and gathering momentum in 1974 and 1975, by which time we should be experiencing a sizable trade surplus for the first time since the late 1960's.

The reallocation of resources that follows upon sharp changes in exchange rates and competitive positions is, of course, not instant or automatic. It takes time and it takes effort. Sellers must alter their marketing strategies. Buyers must shift to new suppliers. New investment decisions have to be taken and implemented. The lags in this

process are considerable. That is why we are only now beginning to experience substantial benefits from the Smithsonian exchange rate changes of 1971. The benefits of the early 1973 exchange rate changes will mainly become evident in 1974 and 1975.

So far I have been discussing primarily the way we expect the trade balance to evolve in the period ahead. Of course, there will also be changes in other current transactions and in flows of private long-term capital. As to non-trade current transactions, the balance on these has tended to change rather slowly. We should be able to rely on further strong gains in returns from U.S. investments abroad. In recent years, however, these gains in income receipts have tended to be largely offset by mounting interest payments on our debts to foreigners -- especially to foreign official holders of liquid dollar claims on the United States.

Flows of investment capital are volatile, and difficult to predict. Over time, however, the influence of the recent exchange rate changes on these flows should also contribute to improvement in the U.S. balance of payments. American firms may find that there is less need than before to meet the competition by manufacturing abroad; their U.S. plants can now deliver U.S. goods abroad at much lower prices in terms of the currencies of the importing countries. By the same token, foreign producers may increasingly find that it now makes sense to think in terms of establishing plants here.

Portfolio investors are also likely to be favorably influenced as our overall balance moves towards equilibrium. In particular, foreign

investors should be encouraged to continue the large purchases of U.S. corporate stocks and bonds that have become an important feature of our balance of payments. More generally, there will be a reversal of the tendency to borrow dollars for the purpose of switching into foreign-currency denominated assets now that the possibility of large gains from exchange rate changes has been taken out of the picture.

On the other hand, the phasing out of existing controls on outflows of U.S. capital will tend to work in the other direction. On balance, this country is likely to remain a net exporter of both private and government capital to the less-developed world, which is surely the appropriate posture for a wealthy country.

During the transition period when international transactions are gradually coming into better balance, the United States will still have a deficit -- albeit a diminishing one -- on current and long-term capital transactions. And we cannot rule out the possibility of occasional periods of uncertainty in foreign exchange markets, as the experience of recent weeks indicates. The present regime of floating exchange rates provides a useful buffer during such episodes, allowing surplus countries to avoid the massive inflows of funds that caused them serious domestic difficulties for monetary management earlier this year, and thus preventing the development of a crisis that could induce large changes in currency par values.

More importantly, the main impetus for very large speculative movements has been removed by the adjustment of exchange rates to levels

that are now widely regarded as realistic, and will, we think, come to be increasingly recognized as realistic as the U.S. payments deficit diminishes. Once the trend of underlying improvement becomes clear to the market, the residual basic deficit from then on should be fairly easily covered by a return flow of short-term funds that went abroad during earlier periods of currency speculation.

What further actions are needed by us and by other countries to insure that the needed adjustment towards better international balance will in fact take place?

First, the inflationary pressures arising from excessively rapid domestic economic growth and credit expansion must be curbed, so that our prices and costs do not again get out of line with those of other countries. In addition, sufficient resources will need to be available to meet the increased demands coming from export expansion and import substitution. Second, U.S. businessmen must take advantage of the new competitive opportunities, vigorously and imaginatively. Third, foreign countries need to be willing to accept some reductions in their foreign trade surpluses. They must not manipulate export incentives or barriers to import in ways that would tend to frustrate the adjustment. Fourth, we and other countries need to pursue the search for a reformed international monetary system that provides a satisfactory international adjustment process.

In all of these areas, there is reason to be encouraged. On the domestic front, we have recently had a very disappointing revival of

inflation. But the rapid increase in prices has reflected, in part, special factors, including the food shortage, the transitional shift from Phase II to Phase III, and the dollar devaluation -- effects which should soon subside. Over a somewhat longer period, our inflation has been less than that in other leading countries. Our consumer price index rose by 5 per cent in the year from April 1972 to April 1973, while the rise in European countries and Japan was 6-1/2 to 10 per cent. Unit labor costs have generally been rising faster abroad than they have here. Our hope and expectation is that inflationary pressures here will subside in the months ahead as economic expansion slows to a more sustainable rate, and as the special problem of food supplies recedes.

In this connection, I might observe that the hectic pace of consumer expenditure experienced during this past winter seems to have moderated somewhat in April and May. Housing starts have receded recently toward a more sustainable pace. The deficit in the Federal budget is being reduced well below earlier estimates, and monetary policy has exerted increasing restraint.

The main danger of continued strong inflationary pressures arises from the possibility of an escalation of wage demands in reaction to the recent bulge in price increases, and from the possibility of an excessively large increase in business spending on fixed investment and inventories. But so far collective bargaining agreements have resulted in wage increases reasonably in keeping with the 5-1/2 per cent national standard. And there is hope that business spending decisions

will be tempered by good sense, and by the considerable tightening of credit conditions over the past few months.

The Federal Reserve has taken further actions within the past two weeks to slow down the expansion of bank lending to business. On May 16, the Board announced the imposition of marginal reserve requirements on large denomination certificates of deposit and on other money market instruments issued by large banks, in order to moderate the expansion of bank lending to major business corporations. Chairman Burns has written to all banks urging them to join in a concerted effort to curb bank credit expansion.

So far as exports and imports are concerned, U.S. businesses are already beginning to take advantage of their improved competitive position relative to foreign producers. This is evident in the figures for rising exports and export orders, and in the increasing gains of U.S. products against foreign products in our own markets -- for example, in the case of automobiles. Even more vigorous and imaginative efforts in this area are needed.

Foreign countries are showing a willingness to help bring about the needed adjustments. They have cooperated in achieving a more realistic pattern of exchange rates. Japan, in particular, is making a real effort to reduce its enormous trade surplus and to shift the focus of its economic growth away from expansion of exports and towards badly needed infrastructure investment at home.

The needed trade adjustments are not really very large in the aggregate, relative to the total volume of trade and economic activity, although sizable adjustments may be required for particular industries in some countries. The present expansive business climate abroad is favorable for the needed adjustments by foreign countries. They do need to slow their export growth and accelerate the rise in their imports, but they do not have to suffer actual cutbacks in exports. Indeed, at present they find that larger and cheaper imports are a welcome contribution to the relief of inflationary pressures.

In summary, I think we can feel some confidence that the changes in international competitive conditions that have resulted from the exchange rate changes of the past three years will bring international transactions much nearer to balance over the next two or three years.

It is true that we had a near-record deficit, on the official reserve transaction basis, of \$10.2 billion during the first quarter of 1973. But all of this deficit occurred before mid-March, as a result of heavy speculative flows before the new structure of exchange rates was established. Since mid-March, we have had an overall surplus on international transactions. During this period, the continuing basic deficit on current and long-term capital transactions has been more than offset by a return flow of liquid funds.

For the longer run, the outlook seems to me promising for the achievement of a sufficiently flexible international adjustment mechanism so that we need not again experience the very large and persistent

international imbalances that have been so troubling during the past few years. We are progressing down the road toward international monetary reform. Last week's meeting of the C-20 Deputies again demonstrated that, while international monetary reform involves difficult technical and policy problems, there exists a will to surmount these problems and to create a new and more effective international monetary system.

Table 1. U.S. Balance of Payments, 1959 to First Quarter 1973
(In billions of dollars a year)

| Item | Annual Averages | | | Annual | | 1973 1st Q at s.a. annual rates ^e |
|---|-----------------|---------|---------|--------|-------------------|---|
| | 1959-62 | 1963-66 | 1967-70 | 1971 | 1972 ^p | |
| <u>Exports of goods and services</u> ^{1/} | 27.6 | 38.1 | 53.8 | 66.2 | 73.5 | 88.0 |
| Merchandise, excl. military | 19.2 | 25.9 | 35.6 | 42.8 | 48.8 | 61.4 |
| Military transactions & services | 8.4 | 12.3 | 18.1 | 23.4 | 24.7 | 26.6 |
| Military sales | 0.4 | 0.8 | 1.4 | 1.9 | 1.2 | |
| Investment income ^{2/} | 4.3 | 6.7 | 9.9 | 12.9 | 13.8 | |
| Travel, incl. fares | 1.1 | 1.6 | 2.4 | 3.1 | 3.4 | |
| Other transportation | 1.6 | 2.1 | 2.7 | 3.1 | 3.7 | |
| Other services | 0.9 | 1.2 | 1.8 | 2.4 | 2.6 | |
| <u>Imports of goods and services</u> | -23.8 | -31.4 | -50.5 | -65.4 | -77.8 | -89.4 |
| Merchandise, excl. military | -15.2 | -20.7 | -33.8 | -45.5 | -55.7 | -65.0 |
| Military transactions & services | -8.6 | -10.8 | -16.7 | -19.9 | -22.1 | -24.4 |
| Military expenditures | -3.1 | -3.1 | -4.7 | -4.8 | -4.7 | |
| Investment income ^{2/} | -1.0 | -1.7 | -3.8 | -4.9 | -5.9 | |
| Travel, incl. fares | -2.3 | -3.0 | -4.4 | -5.6 | -6.3 | |
| Other transportation | -1.4 | -1.9 | -2.5 | -3.0 | -3.4 | |
| Other services | -0.8 | -1.0 | -1.4 | -1.6 | -1.8 | |
| <u>Balance on goods and services</u> ^{1/} | +3.8 | +6.7 | +3.3 | +0.8 | -4.2 | -1.4 |
| Merchandise, excl. military | +4.1 | +5.2 | +1.8 | -2.7 | -6.8 | -3.7 |
| Military transactions & services | -0.3 | +1.5 | +1.5 | +3.4 | +2.6 | +2.3 |
| Military transactions | -2.7 | -2.4 | -3.2 | -2.9 | -3.5 | |
| Investment income ^{2/} | +3.3 | +4.9 | +6.1 | +8.0 | +7.9 | |
| Travel, incl. fares | -1.2 | -1.5 | -2.0 | -2.5 | -2.9 | |
| Other transportation | +0.2 | +0.2 | +0.2 | +0.1 | +0.3 | |
| Other services | +0.1 | +0.2 | +0.4 | +0.7 | +0.8 | |
| Remittances and pensions, net | -0.7 | -0.9 | -1.3 | -1.5 | -1.6 | -1.7 |
| <u>Balance on goods, services, and remittances</u> | +3.1 | +5.8 | +1.9 | -0.8 | -5.8 | -3.1 |
| U.S. Govt. grants & capital, ^{3/} net | -2.5 | -3.3 | -3.9 | -4.4 | -3.6 | -3.6 |
| Private long-term capital, net | -2.1 | -3.7 | -0.8 | -4.1 | +0.1 | |
| <u>Balance on current and long-term capital transactions</u> | -1.5 | -1.2 | -2.7 | -9.3 | -9.2 | |
| Private short-term capital, net | -0.2 | +0.7 | +1.5 | -10.1 | +2.0 | |
| Errors and omissions, net | -0.8 | -0.6 | -1.2 | -11.1 | -3.8 | |
| <u>Balance on official reserve trans- actions (excl. SDR allocations)</u> | -2.5 | -1.1 | -2.4 | -30.5 | -11.0 | -40.9 |

1/ Excluding transfers under military grants.

2/ Excluding undistributed earnings of subsidiaries.

3/ Excluding military grants. Including nonliquid liabilities to other than official reserve holders.

(p) Preliminary. (e) Preliminary estimates.

Note: Details may not add to totals because of rounding.

Table 2. U.S. Merchandise Trade, 1970-73
(In billions of dollars a year; balance-of-payments basis)

| Period | Exports | | | Imports | | | Trade balance |
|---|--------------|--------|--------|---------|--------|--------|---------------|
| | Agricultural | Other | Total | Fuels | Other | Total | |
| <u>Years</u> | | | | | | | |
| 1970 | 7.3 | 34.6 | 42.0 | 3.2 | 36.6 | 39.8 | +2.2 |
| 1971 | 7.8 | 35.0 | 42.8 | 4.0 | 41.5 | 45.5 | -2.7 |
| 1972 | 9.5 | 39.4 | 48.8 | 5.1 | 50.6 | 55.7 | -6.8 |
| <u>Quarters (at seasonally adjusted annual rates)</u> | | | | | | | |
| 1971-I | 8.3 | 35.2 | 43.5 | 3.1 | 39.8 | 42.9 | 0.6 |
| II | 7.8 | 35.4 | 43.2 | 3.9 | 42.9 | 46.8 | -3.6 |
| III | 8.5 | 37.6 | 46.1 | 4.3 | 43.4 | 47.7 | -1.5 |
| IV | 6.6 | 31.7 | 38.3 | 4.6 | 39.9 | 44.5 | -6.1 |
| 1972-I | 8.9 | 37.8 | 46.6 | 4.7 | 49.3 | 54.0 | -7.3 |
| II | 8.8 | 37.5 | 46.2 | 4.9 | 48.5 | 53.4 | -7.1 |
| III | 9.6 | 39.9 | 49.5 | 5.5 | 50.1 | 55.6 | -6.1 |
| IV | 10.8 | 42.2 | 53.0 | 5.4 | 54.3 | 59.7 | -6.7 |
| 1973-I(p) | 15.2 | 46.2 | 61.4 | 6.6 | 58.4 | 65.0 | -3.7 |
| April (p) | (16.2) | (49.0) | (65.2) | (6.7) | (56.4) | (63.1) | (+2.1) |
| Jan.-Apr. 1973(p) | 15.4 | 46.9 | 62.3 | 6.6 | 58.0 | 64.6 | -2.2 |
| Percentage changes from: | | | | | | | |
| 6 months earlier | 52% | 14% | 22% | 22% | 11% | 12% | -- |
| 12 months earlier | 62% | 19% | 28% | 30% | 15% | 16% | -- |

(p) Preliminary.

Table 3. Private Capital Flows

(In billions of dollars; (-) = capital outflow)

| | <u>Annual Averages</u> | | <u>Annual</u> | |
|--------------------------------------|------------------------|----------------|---------------|-------------|
| | <u>1963-66</u> | <u>1967-70</u> | <u>1971</u> | <u>1972</u> |
| <u>Private capital, net</u> | <u>-3.1</u> | <u>+7</u> | <u>-14.2</u> | <u>+2.2</u> |
| <u>Long-term, net</u> | <u>-3.7</u> | <u>-.8</u> | <u>-4.1</u> | <u>+1</u> |
| U.S. capital | (-4.1) | (-4.8) | (-6.3) | (-5.4) |
| Direct investments abroad | -2.9 | -3.5 | -4.8 | -3.3 |
| U.S. purchases of foreign securities | -.8 | -1.2 | -.9 | -.6 |
| Other | -.5 | -.1 | -.7 | -1.5 |
| Foreign capital | (+.4) | (+4.0) | (+2.3) | (+5.5) |
| Foreign direct investments in U.S. | -- | +6 | -.1 | +3 |
| Foreign purchases of U.S. securities | +2 | +2.7 | +2.3 | +4.5 |
| Other | +2 | +8 | +1 | +7 |
| <u>Short-term, net</u> | <u>+7</u> | <u>+1.5</u> | <u>-10.1</u> | <u>+2.0</u> |
| U.S. capital | -.6 | -1.0 | -3.4 | -2.9 |
| Foreign capital | +1.3 | +2.5 | -6.7 | +5.0 |

Note: Details may not add to totals because of rounding.

Source: U.S. Department of Commerce, Bureau of Economic Analysis,
Survey of Current Business, June 1972 and March 1973.