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Statement by

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of the

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of the

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I am pleased to appear before this Subcommittee today to discuss U.S. exports and the influences on them of recent exchange-rate movements.*

At present the dollar's exchange value on a weighted-average basis is slightly above its level of March 1973, after considerable fluctuations in the nearly five years since the widespread adoption of floating exchange rates in that month. It reached a peak value in June 1976, some 10 per cent above its March 1973 level. From June 1976 through September 1977 it declined slightly, then from September through January it recorded a sharp 7 per cent drop.

Movements against some individual foreign currencies, indeed, have been even wider. For instance, the dollar rose by 13 per cent against the German mark and by 6 per cent against the Japanese yen from March through December 1975. Then, from June 1976 to January 1978 the dollar declined by 18 and 19 per cent against the mark and the yen, respectively. During the period of September to January alone the dollar dropped by 9 per cent against the mark and by 10 per cent against the yen.

These wide fluctuations must be viewed in the light of unprecedented economic disturbances, including the quadrupling of oil prices in 1973-74, rapid and divergent rates of inflation around the world, and unprecedentedly large swings in current accounts among industrial countries. While with the benefit of hindsight it would appear that the movement of exchange rates has been excessive at times, this was not necessarily discernible at the moment. In general the system

*--For the record I have also appended a copy of a recent speech I gave related to this subject.

of managed floating exchange rates has served the United States, and the world, reasonably well. Indeed, it is hard for me to imagine the world economy functioning as well as it has, in the face of such disturbances, under other exchange rate systems.

U.S. and world trade has continued to grow, and there is little evidence of major harm to exports and imports from short-term fluctuations in exchange rates. Our exports rose by 68 per cent in value terms and 19 per cent in volume terms from 1973-QI through 1977-QIV. A serious threat to world trade, however, could arise if wide fluctuations in exchange rates were to give rise to protectionist pressures in industrial countries, including the United States. So long as we do not encounter protectionism abroad, U.S. exports should continue to grow. It should be remembered that the industries and jobs most damaged by protectionism, at home or abroad, are those that are most productive and dynamic, while those protected are usually much less so. Floating exchange rates, so long as markets function in an orderly manner, in my view, help to forestall or minimize the resort to protectionist measures.

Since 1975 the U.S. trade and current account balances have swung into heavy deficit, as U.S. export growth was dampened by economic sluggishness abroad while imports surged as our economy expanded. The magnitude, if not the direction, of this massive swing was largely unanticipated by exchange market participants, and

has been a major factor in the dollar's recent weakness in the exchange markets.

Studies by the Federal Reserve staff and by others attribute the major portion of the decline in our trade and current account balances to cyclical developments in the U.S. and foreign economies. Just as our 1975 current-account surplus reflected in part an economic recession in 1974-75 that was deeper in the United States than in other industrial countries, so our current-account deficit in 1977 reflected the fact that recovery from the recession had proceeded faster and further in the United States than abroad. As recovery abroad begins to catch up with that in the United States we may expect more rapid growth in our exports and a reduction of our deficit.

Another part of our deficit stems from the special factors affecting oil. Domestic production is dropping at a time when total consumption is increasing under the stimulus of cyclical expansion. The resulting scissors effect upon oil imports is magnified by the great rise of the price of oil. The oil problem weighs heavily on our balance of payments. Long-term improvement in the balance and a stronger outlook for the dollar depend importantly on how we deal with our energy situation.

It does appear as though we have had a decline in the share of our merchandise exports in world markets over the last year or so. However, short-run indications based on market shares have not proved to be very reliable. So far as I have been able to read the evidence, our present deficits do not stem from a general loss of price competitiveness of U.S. exports. The price performance of the United States has generally been better than that abroad over the past couple of years, with the notable exceptions of Switzerland and Germany. Indeed, adjusting exchange rates for relative price-level movements, we find that the dollar's so-called "real" exchange value has declined by some 9 per cent from the end of 1975 to January 1978. That is, taking into account both changes in relative price levels and changes in exchange rates, the price-competitiveness of U.S.-produced goods has increased over this period. (See table on page 5.)

A decline in the dollar's real exchange value produces incentives for U.S. and foreign residents to purchase more goods produced in the United States and less goods produced abroad. Federal Reserve studies based on past responses of the trade balance to exchange-rate movements indicate that, in the absence of major secondary disturbances from such an exchange rate movement, the depreciation in the dollar's weighted-average exchange value since September will lower the current account deficit by $1-1/2 to $3 billion at an annual rate by the end of 1978 and by $4 to $5-1/2 billion at the end of 1979, compared to the deficit that otherwise would have prevailed. These estimates, of course, are subject to a fairly wide margin of error.

Price-Adjusted Exchange Value
of the
Weighted-Average Dollar
(March 1973=100)

		CPI-Adjusted	WPI-Adjusted
1973	March	100.0	100.0
	June	95.9	98.3
	September	95.4	96.4
	December	100.8	98.4
1974	March	100.1	95.5
	June	98.0	93.6
	September	100.9	101.2
	December	96.4	98.5
1975	March	90.9	92.5
	June	90.6	95.0
	September	98.0	103.6
	December	98.3	103.3
1976	March	98.8	102.8
	June	100.4	104.3
	September	99.2	102.3
	December	98.0	102.1
1977	March	97.5	101.8
	June	96.3	101.2
	September	95.7	100.8
	December	91.3	96.8
1978	January[p]	88.9	94.6

NOTE: This measure is calculated for each month by dividing the index of the weighted average exchange value of the dollar (against 10 leading currencies) by the ratio of foreign to U.S. price indices. Calculations are shown using both consumer (CPI) and wholesale (WPI) price indices for comparison. A decline in the resulting index implies an increase in U.S. "competitiveness." January figures are preliminary, based on projections of price indices for that month.

Our investigations indicate that nearly all of the trade balance impact of the exchange rate change comes from the export side. We estimate that the rise in dollar import prices caused by the drop in the dollar will just about offset the decline in import volume resulting from that drop. The total value of imports, therefore, may not be much affected.

The impact of the decline in the dollar's exchange value upon exports may proceed through two mechanisms. For products that have something like a world market price, the dollar price will tend to rise quickly. This increases dollar receipts of exporters and, if U.S. supply is elastic, also the volume of exports. Industrial materials tend to fall into this category. Higher export prices also may stimulate efforts of producers to sell abroad.

For products that are less standardized, such as machinery or many consumer goods, a drop in the exchange rate may leave the dollar price unchanged initially. This enhances competitiveness and, given an elastic demand abroad, strongly favors an expansion of exports. Over time, both price and volume of exports are likely to rise.

On average, according to our studies, export prices are likely to increase only moderately in response to a depreciation of the dollar, while export volumes would tend to rise by somewhat more than half the percentage change in the exchange rate. The full impact of the rate change would normally be expected to occur over a period of two years following the exchange rate change.

With respect to particular products, the increase in export volume depends upon how demand and supply respond to price changes, including exchange rate changes. These responses, in turn, are affected by the relative importance of the United States in world markets, and by the share of exports in total U.S. output of particular industries. Increases will be greater for those U.S. products whose world market share is relatively small and also those whose export share, in relation to total U.S. output, is small. These considerations suggest that we should expect to see proportionally greater expansion of manufactured exports, particularly of consumer goods, than of food or raw material exports.

The pattern of recent bilateral exchange rate changes suggests that there will be adjustment in the volume of both exports and imports in U.S. trade with Japan and Europe. There should also be gains in U.S. exports to other markets in which U.S. producers compete with Japanese and European producers.

Much larger effects on our exports are likely to come from increasing economic activity in the rest of the world. Since this expected development may take some time to materialize, the anticipated effect in reducing our deficit may also be delayed. Moreover, so long as OPEC continues to run huge current account surpluses, other countries as a group must run deficits. The United States may have to accept some share of these deficits, since many other countries may have difficulty financing large deficits. While the OPEC countries will be placing

their surpluses outside their own territory, including presumably in the United States, it would not seem inappropriate or unsustainable for the United States to share in this aggregate non-OPEC deficit.

I now turn to the subject of exchange rates and the factors determining them. Exchange rates are determined ultimately by fundamental economic factors such as relative inflation rates, relative interest rates, relative rates of real growth, and other structural factors. Central bank intervention can play only a secondary role. This is confirmed by the fact that the dollar's decline in 1977 occurred despite net intervention purchases of dollars by major foreign central banks totaling nearly $35 billion. While a large portion of this intervention was not directly aimed at supporting the dollar in general, but at moderating the rise of certain foreign currencies and rebuilding the reserves of the United Kingdom and Italy, it nevertheless reduced the supply of dollar-denominated assets in the hands of the public, and to that extent had the effect of generalized intervention.

Despite the ultimate dominance of fundamental economic forces, the exchange market may at times, as the pattern of rate changes during the last five years described earlier indicates, produce exaggerated movements. This may happen when the market is faced with great uncertainties or is acting under erroneous perceptions. One such perception which seems to have held sway recently is an apparent and often-voiced belief that the United States would welcome a depreciation of the dollar in order to gain a trade advantage.

Purportive evidence to support such a view could be the relatively moderate scale of U.S. intervention to support the dollar.

Such an interpretation of U.S. policy, of course, would be entirely erroneous. Its unfortunate result could be an excessive depreciation of the dollar that would threaten the stability of both the U.S. and foreign economies. It could lead to significant increases in prices in the United States and depress investment in export industries and import-competing industries in relatively sluggish foreign economies. It could lead to measures such as greater protection for import-competing industries abroad or increased subsidization of foreign export industries.

The intervention policy of the Federal Reserve and the Treasury relies on free markets in which underlying economic and financial factors determine exchange rates and in which exchange rates, prices, interest rates, and other competitive factors govern the flow of trade and capital transactions. Exchange markets, possibly laboring under misperceptions of U.S. exchange rate policy, have been extremely disorderly recently. As the scale of disorder has increased, so has the scale of U.S. intervention. Intervention by foreign central banks, notably those of Germany, Japan and Switzerland also increased in the fourth quarter of last year and the first few days of this year

following extremely large and rapid appreciations of their currencies against the dollar.

This increased scale of intervention, particularly by the United States, should serve to restore some measure of calm to the exchange markets. Indeed, most recently conditions in the markets have become more settled. Let me emphasize, however, that intervention can be successful in checking short-run excesses only if the intervention has fundamental economic forces on its side.

One test which has sometimes been proposed of whether actual intervention operations serve the purpose of countering disorderly markets, by purchases of foreign exchange when the price drops sharply and sales when it rises sharply, is the degree to which intervention is profitable. With the exception of the unwinding of the pre-August 1971 support operations under fixed exchange rates, the recent record of Federal Reserve intervention in this regard is quite positive. In each of the five years of intervention operations under the regime of managed floating, the Federal Reserve has realized modest profits on its current operations in foreign currencies, totaling almost $25 million over the period. While profits are not a necessary criterion of successful intervention and certainly not its objective, they nevertheless suggest that Federal Reserve intervention has tended to smooth exchange rate fluctuations.

In addition to increasing our scale of intervention to deal with increasing disorder, the Federal Reserve Board sought to deal with the situation in exchange markets by approving an increase in discount rates from 6 to 6-1/2 per cent on January 6. This step was directed toward restoring calm in the exchange markets. A majority of the Board felt that the external situation posed dangers -- through adverse effects on economic activity abroad, an increase in the U.S. price level, and possibly through foreign protectionist measures -- that could ultimately reduce the economic welfare of U.S. citizens.

An action of this kind serves, in very modest measure, to improve the fundamentals affecting the dollar. But ultimately it is policies that affect the supply of dollars, the tax system, the budget, and through these inflation and economic growth, together with our decisions with respect to energy, that will determine the balance of payments and the value of the dollar.

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