FOR RELEASE ON DELIVERY
Monday, MAY 8, 1978
10:00 A.M. LOCAL TIME (5:00 A.M. EDT)

TRADE, CAPITAL FLOWS, AND CURRENCIES

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

8th International Management Symposium

at the

St. Gallen Graduate School for Business and Public Administration

St. Gallen, Switzerland

Monday, May 8, 1978

TRADE, CAPITAL FLOWS, AND CURRENCIES

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

8th International Management Symposium

at the

St. Gallen Graduate School for Business and Public Administration

St. Gallen, Switzerland

Monday, May 8, 1978

The international economy must now deal with several basic imbalances or face the prospects of continued currency disruptions, the expansion of trade protectionism and the risk of damaging world economic recovery. These imbalances reflect disparities in the pace of economic recovery, large trade deficits and surpluses and different patterns of inflation. The costs of allowing such distortions to continue -- or to escalate -- far exceed the costs of acting now to promote more comparable economic expansion rates, to control inflation, and to act on energy resource conservation and development. We are capable of dealing with each and all of these problems but they will not solve themselves or conveniently disappear unless strong actions are taken.

The Recovery Gap

Over the last two years or so, the economy of the United States and the economies of most other developed countries have gone different ways. In the United States, the first year of brisk recovery from the 1974-75 recession was followed by continued good growth at a rate of 6 per cent in 1976 and 5 per cent in 1977. In 1978, we can expect growth for the United States of the order of 4 per cent or better. As a result of this confirmed advance, the United States today is not far from full employment. Although it is too early to be sure, the latest data suggest that we are approaching the full employment zone, which I would place in the 5-6 per cent unemployment range. The reasons why these statistics of U.S. unemployment should not be interpreted in terms of European unemployment statistics are familiar. I need remind you only that the category of "married males" has a 3.0 per cent unemployment rate, not very much higher than its level of 2.3 per cent during 1973 when the economy was clearly overheating.

Most other industrialized countries meanwhile found their growth slowing down sharply after the first year of recovery. Unemployment rates have remained at levels that, by European standards, are very high. Some acceleration of economic expansion, however, is expected for the current year, but probably to a rate still below that of the United States. Nevertheless, as the United States increasingly adapts its growth rate to its long-run potential of 3-1/2 - 3-3/4 per cent, other countries should find it easier to catch up.

The consequences in the foreign trade area of this scissors movement are familiar. In the United States, imports rose rapidly, in line with the rise in GNP. The imports of other countries rose only moderately, as did the exports of the United States. The effects of this cyclical gap on the U.S. balance of trade are estimated at \$10-20 billion. Had all countries grown in step, the U.S. current account deficit, of \$20 billion in 1977, could well have been smaller by that order of magnitude. I might add here that if the United States did its balance-of-payments accounting in the same way as most other countries -- that is, by counting the nonrepatriated earnings of foreign subsidiaries as current account income and offsetting them by a capital account outflow -- the U.S. current account deficit would have been reduced by \$6 billion without, of course, changing anything but accounting magnitudes.

The Oil Gap

The United States greatly added to its deficit by failing to pass effective energy legislation. Oil imports, therefore, rose unchecked, from \$4.7 billion in 1972 to \$44.7 billion in 1977. Exports to the OPEC countries meanwhile rose only from \$2.6 billion in 1972 to \$16.5 billion in 1977, leaving a trade gap with OPEC that was not made up by adequate surpluses with other countries. One may conclude, therefore, that either greater restraint by the United States in importing oil or greater uniformity in growth rates among the developed countries would probably have left the U.S. current account deficit, if any, at a level that could easily be financed.

Since European opinion seems to focus on the oil component of the U.S. deficit, it may be appropriate to provide some perspective to this figure. U.S. oil imports rose sharply in recent years because, while the economy expanded, domestic oil production diminished as output stagnated at controlled prices. Even so, U.S. dependence on imported oil is substantially less than that of most other industrial countries. For instance, U.S. net oil imports in 1976 amounted to 1.7 per cent of GNP, as compared with 2.9 per cent for Germany, 3.6 per cent for the United Kingdom, and 5.1 per cent for Japan. Measured against total uses of energy, net oil imports for the U.S. have amounted to 19 per cent against 52 per cent for Germany, 38 per cent for the United Kingdom, and 73 per cent for Japan. In other words, the demands that each of these countries makes upon available oil supplies depend very much on domestic sources of oil and non-oil energy. For the United States these demands are, comparatively speaking, not as high as seems widely to be believed.

The Inflation Gap

During the last two years, the path followed by the United States on one side and most other industrial countries on the other began to diverge not only with respect to the rate of expansion, but also with respect to the rate of inflation. While the United States brought inflation down from the double digit rate of 11.0 which was reached in 1974 to a rate of 5.8 in 1976, a slight uptrend has occurred since that time, leading to price increases of 6.5 per cent in 1977.

The experience of other countries was not uniform, but in 1977 most countries managed to bring their inflation rates down. This divergent experience reflects to some extent, but not altogether, the divergent movement of exchange rates. Countries whose exchange rates appreciated tended to have a better inflation experience than countries whose currencies depreciated. The United States has become very much aware of the foreign exchange component of its own rising rate of inflation.

Exchange Rates

Given the sharp depreciation that the dollar has suffered against the Swiss franc, the DMark, and the yen, it seems nevertheless appropriate to note that these data greatly overstate the true effects of depreciation for the United States and of appreciation for the three countries mentioned. In terms of bilateral rates, the dollar since the end of September, when the last major move began, depreciated by 17 per cent against the Swiss franc, 11 per cent against the DMark and 14 per cent against the yen. But the trade-weighted exchange rate of the dollar over the same period depreciated by only 6 per cent. Meanwhile, the trade-weighted rates of Switzerland, Germany, and Japan appreciated by only 16, 8, and 12 per cent, respectively. (All rates weighted by multilateral trade of the G-10 and Switzerland.) Furthermore, the price-adjusted or real exchange rate of the dollar, since the end of September 1977, depreciated by approximately 8 per cent (Consumer Price Index adjusted).

From the point of view of inflation and balance-of-payments adjustment, it is trade-weighted and price-adjusted exchange rates that are relevant. Bilateral exchange rate movements, which are often much more extreme, convey misleading impressions in this regard. Nevertheless, bilateral exchange rate movements play an important role particularly in the U.S. balance of payments: They influence capital movements. Capital tends to flow in the direction of the strongest currencies. That flow, in turn, produces further exchange rate movements. This is one reason why the United States, in addition to suffering a current account deficit in 1977, also experienced an outflow of recorded private capital.

Capital Flows

The recorded net private outflows during that year amounted to $10.3 billion, with a statistical discrepancy of -$3.0 billion probably containing substantial unrecorded further outflows. This accords roughly with the fact that the total of foreign intervention and accumulation of dollars -- that is, of official capital imports into the United States -- exceeded the U.S. current account deficit by some $15 billion.

It would be a mistake, however, to assume that United States capital exports amounted to $13-15 billion in 1977. Actually, there were gross flows into and out of the United States of two to three times this magnitude on both sides. These larger magnitudes, too, involve considerable netting of gross in-and-out flows that cannot possibly be traced. To the extent that international flows in dollars for current and capital purposes are related to the operations of the Euromarkets, the volume of clearings in the Clearing House International Payments System (CHIPS) in New York City, which of course handles transactions in dollars for both current and capital account, gives an illustrative idea of the order of magnitude: The daily volume of transactions averages $70 billion.

Furthermore, it needs to be remembered that the recorded capital flows relate to flows into and out of the United States, not into and out of the dollar. Flows between the United States and the Eurodollar market, to the extent they are recorded, appear in the capital account of the United States but do not directly affect the rate of the dollar. Flows into and out of the dollar that occur in foreign exchange markets outside the United States do not appear in the U.S. statistics, but they do influence the dollar rate.

In short, the view that in the United States in 1977 a given volume of capital sought to and did flow abroad and had to be offset by official intervention is not tenable. All one can say is that, in the absence of official intervention in excess of the U.S. current account deficit, any gross outflow of capital from the United States that might have occurred would have had to be matched by private gross inflows with consequent changes in exchange and interest rates. Undoubtedly there were autonomous capital outflows of that sort, such as direct private investment and government loans. But the great bulk of capital flows tends to be adaptive rather than autonomous or structural, responding flexibly to present interest rates and exchange rates.

While the downward movement of the dollar and expectations of further decline probably induced outflows of capital, the rise in U.S. interest rates with respect to rates abroad had an opposite effect. So long as exchange markets remain disturbed, the pulling power of higher interest rates is unlikely to exert its full effect. More can be lost on the exchange rate in a week than on the interest rate in a year. In more stable markets, the cost of holding funds in a low-interest currency becomes noticeable. It is worth noting that the interest rate differentials particularly between the United States and Germany approximately equal the differential in inflation rates over the last year or two.

The capital outflow from the United States has roots that reach beyond the immediate fear of dollar depreciation. These roots go to the current account deficit and the uncertainty about how and when it will be eliminated. They also go to the specter of accelerating inflation in the United States. Inflation, in turn, has become one of the factors that threatens to increase the current account deficit. In turning from the analysis of the causes of the current and capital account deficits to possible answers to these problems, the problem of inflation, therefore, is very much in the foreground.

Remedies

Inflation is a more fundamental although more slowly operating factor in influencing the international value of the dollar than the current or capital account deficit. In the short run, to be sure, it is the level of business activity that primarily influences imports and exports and therewith the exchange rate. That clearly has been the experience of the United States and of the dollar. But in the longer run, inflation rather than the cyclical gap is likely to be the dominant force, to the extent that U.S. inflation differs from inflation abroad.

In the United States, it is becoming apparent that the control of inflation has been the least effectively pursued of our national objectives. In its pursuit of growth and high employment, the United States has recently had more success than other countries. It is inflation that from now on needs to receive priority, from a domestic as well as an international point of view. Opinion surveys indicate that inflation is now the top concern of voting Americans. President Carter has given expression to this sentiment in his recent message. I believe that the control of inflation will come to occupy an increasingly important place on the agenda of the United States.

Success against inflation would directly strengthen the dollar and would also help to reduce the current account deficit. There remains the question what other influences can be brought to bear on this gap in our international accounts.

An appropriate oil policy ranks at the top of the list. On grounds of national security even more than for balance-of-payments reasons, action to conserve energy, to develop alternative sources, and to restrain the importation of oil is urgently needed. While I am confident that such legislation will be forthcoming, I do not expect that it will produce rapid results. But the direction of policy, even ahead of concrete results, should have some effect on the market.

Export promotion will have to be another instrument by which the current account deficit is attacked. Past experience shows that this is an uphill endeavor. Nevertheless, the laggard performance of American exports suggests that there must be a great many unexploited opportunities, if only the means can be developed to interest American businessmen in pursuing them.

But all the keys to the problem of the current account deficit are not really in the hands of the United States. A very important one is in the hands of the countries whose relatively slow growth has contributed to the emergence of the deficit.

A decline of the dollar as a remedy to what should be a cyclical or temporary problem does not seem appropriate. It would imply that, once the cyclical gap had disappeared, the dollar would have to rise again. One would be compelled to ask whether such a trip was really necessary. I find it difficult to believe that the countries which have been successful in slowing and in some cases virtually eliminating inflation should not find themselves propelled, by the greater ability and predictability prevailing in their economies, toward a more rapid rate of growth. That would leave only the question of the time that would have to elapse until the industrial world outside the United States had pulled even with the United States in the fuller use of resources.

Concerning this time span, diverse opinions are being expressed. I am not one of the pessimists who believe that it would be so long that the exchange markets could not look beyond it to the other side of the valley.

The United States has shown that it intends to do its share in making this time gap bridgeable. Enlarged intervention in the exchange markets to meet any evidence of increasing disorder, use of Special Drawing Rights, the availability of IMF resources, sales of gold, are among the actions already announced. More fundamental measures, on energy, on inflation, on exports, and on the budget must follow. I believe that so far the United States has succeeded at least in making credible that it is strongly interested in a strong dollar. I hope that it will be possible also to convince the markets that it is in their national interest to bridge the time period required to bring all these developments to fruition.