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Statement by

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before the

Subcommittee on Trade

Committee on Ways and Means

House of Representatives

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Mr. Chairman and members of the Subcommittee, I am pleased to have this opportunity to discuss some of the issues surrounding our large and growing trade and current account deficits. As always, the flows of trade and other payments with the rest of the world reflect a variety of forces here and abroad. A substantial disequilibrium, such as at present, can usually be traced to other difficulties and imbalances in domestic economies or economic policies. That is the case now.

To summarize my basic point, our external deficits currently are linked -- not exclusively but importantly -- to the internal budget deficit. To restore better balance in our external accounts consistent with a healthy and non-inflationary economy at home, we cannot, in my judgment, escape the need for decisive action to deal with our internal deficit. Policies aimed directly at the external deficit that cut against market forces -- for example, import restrictions or other controls -- are likely to have limited effects at best on the <u>overall</u> trade or current account balance or would work at cross-purposes to other objectives. In the end, I believe they would be counter-productive.

Our trade deficit reached the unprecedented magnitude of more than $60 billion last year -- $75 billion at an annual rate in the fourth quarter. It is now generally expected that our merchandise imports will exceed our exports by at least $100 billion this year -- already in January and February the deficit averaged more than $100 billion at an annual rate. Consistent with that trade deficit, the entire current account is likely to be in deficit by about $80 billion in 1984, or more than 2 percent of the GNP. That percentage is nearly twice as large as any U.S. historical experience since World War I.

The causes of our large external deficits can be analyzed at two different levels. The most direct approach is to explain trends in the trade balance in terms of such proximate causes as the behavior of exchange rates, the strength of economic activity at home and abroad, and relative rates of inflation. But a full explanation must look beyond those considerations to factors determining exchange rates, economic activity, and inflation. That naturally brings us to a consideration of economic policies both in the United States and abroad.

For purposes of analysis, it may be convenient to assess the change in the trade balance from a base period of late 1980 when our current account was roughly in balance. U.S. trade, during that period, was in deficit at a rate of about $25 billion. The difference reflected in large part a sizable surplus of net investment income -- income built up as a result of net investment abroad over many years but which may be dwindling away in the future as a result of our heavy borrowing abroad. Indeed, available statistics suggest that the net creditor position of the United States vis-a-vis other countries -- a position built up over many years -- is being reversed; we will shortly be a net debtor.

The deterioration in our trade balance of roughly $75 billion since the base period took place despite a sizable reduction of about $25 billion in our imports of oil. There has been an adverse swing of about $100 billion in the "non-oil balance" -- that is, the difference between our payments for non-oil imports and our export revenues. (See the table attached to my statement. To put that figure in perspective, the entire residential building sector of the GNP that attracts much attention is some $150 billion; the <u>change</u> in the non-oil trade balance over little more than three years was equivalent to two-thirds the size of that whole industry. Plainly, the deterioration in our trade position has had profound effects spread through many firms in all parts of the United States. Those engaged in foreign trade or competing with imports have not shared proportionately in the strong expansion in economic activity generally, and some important industries are still operating well below 1980 levels.

One factor that has contributed importantly to the widening of the U.S. deficit has, in fact, been the relatively stronger expansion of the U.S. economy relative to foreign industrial economies. In that sense, part of the deterioration is cyclical, and does not reflect loss of markets at home or abroad but absence of proportionate gains. In addition, exports have dropped sharply to developing countries that are burdened with large external debts and are in the midst of readjusting their own economies and balance of payments. That is particularly true with respect to our neighbors in Latin America; exports to that area have dropped by $13 billion since the base period. These two factors appear to explain a third to a half of the adverse swing in the non-oil trade balance.

The third factor directly affecting our non-oil trade balance has been the dramatic appreciation of the dollar over the past three years. Starting at a relatively low level historically, the value of the dollar against the currencies of foreign industrial countries has risen about 45 percent in nominal terms since the end of 1980. Over the same period, U.S. price performance has been somewhat better than the average in foreign industrial economies; U.S. consumer prices, for instance, rose by 18 percent from the fourth quarter of 1980 through the fourth quarter of 1983, while consumer prices in the foreign industrial countries rose almost 25 percent on average. But even allowing for the differential in inflation, the dollar has appreciated substantially, and it is now roughly 25 percent higher than its average level for the entire 11-year period of floating exchange rates. Some calculations suggest more than half of the $100 billion change in the non-oil trade balance from the base period can be traced to the dollar's appreciation.

Such calculations concern only the proximate causes of the growing U.S. trade deficit. The more relevant questions concern what lay behind those developments, and what are the prospects. We know economic recovery in other industrialized countries has been quite moderate, reflecting in part relatively restrained fiscal policies -- in the sense of working toward reduced government deficits. That approach has been motivated in large part out of concern about inflation, as well as the size of deficits carried over from earlier years. To some extent the depreciation of their currencies relative to the dollar -- in which important import commodities are denominated -- added to price pressures in those countries, and some of them probably were constrained to maintain relatively restrictive monetary as well as fiscal policies in the light of those pressures.

By now, increased exports to the United States, among other factors, have helped encourage recovery in the foreign industrial countries and expansionary momentum now appears more firmly established. Moreover, the process of adjustment in some of the deeply indebted developing countries has reached the point where some resumption of import growth appears to be developing, although imports will not reach the levels of a few years ago for some time. As a consequence, prospects for U.S. exports during the remainder of 1984 and beyond are improving, albeit moderately.

For the time being, the strength of our own expansion -- which is still proceeding more rapidly than abroad -- may continue to be reflected in imports growing as fast or faster than exports. In these conditions, and because imports are now so much larger than exports, significant progress in closing the trade deficit cannot be anticipated for some quarters.

At the same time, stronger growth abroad may well mean that savings in other countries will be more fully utilized at home, so that other things equal -- capital will flow less freely to the United States. That could pose a problem because we are bound to be dependent upon capital inflows from abroad for some time to finance our trade and current account deficits, and those inflows are moderating pressures on our financial markets.

There can be little doubt that the ready availability of imports and the strength of the dollar -- together with the related capital inflow -- has had some short-run beneficial effects during the past year in support of relatively non-inflationary expansion. With the huge federal deficit feeding purchasing power into the economy, domestic demand -- reflected in consumption, domestic investment, and government spending -- is estimated to have grown over the past five quarters at an annual rate of about 8 percent, faster than during the equivalent period of any earlier postwar recovery. Some of that demand was absorbed by imports; as a consequence, Gross National Product -- a comprehensive measure of U.S. production -- grew more slowly than demand. But that growth was still large, at a rate of 6-1/2 percent over the period; and the availability of imports has been a key factor keeping inflation in check and in avoiding strong pressures on capacity in some industries. At the same time, the capital necessary to finance the current account deficit has also increasingly supplemented the supply of domestic savings. In historical terms, interest rates have remained high in the United States; they would have been higher still had we been required to finance our domestic growth and the budget deficit from internal sources alone.

That point is illustrated in the chart attached to my statement showing the demands for, and the sources of, savings in recent years and, prospectively, in 1984. As can be seen, the combination of rising private investment and the high level of the budget deficit exceeds our savings domestically by an increasing margin.

The difference is increasingly made up by savings from abroad, supplementing domestic savings this year by perhaps 25 percent, or about 2 percent of the GNP.

Whatever their benefits at the moment for the economy as a whole -- and they are very real -- rising trade deficits and capital inflows are not sustainable indefinitely. And, of course, those industries most exposed to foreign competition do not share in the benefits, and they increasingly demand protection. In effect, our trade problems do, in my judgment, signal deep-seated imbalances in the world economy and in economic policies.

The central thrust of my remarks is that these imbalances must be dealt with in a constructive way -- by going to the source -- rather than by protectionist measures. The latter are like medical tourniquets; they may sometimes seem justified to stop bleeding, but applied too long and too strongly they cripple the limb and threaten the recovery and good health of the whole body.

Many have pointed to an "over-valued" or "artificially high" dollar as a major source of the difficulty. In terms of the trade balance, the point is understandable. But the dollar is where it is because of a balance of forces in the market, reflecting capital as well as trade flows. There is not, in my judgment, evidence that the value has been manipulated, in any significant way, by our trading partners, through intervention in the exchange markets or otherwise. Instead, appreciation of the dollar over the past three years in the face of larger trade deficits reflects the strength of incentives to place capital in the United States.

While capital flows do not always closely reflect changing interest rate differentials, there can be no doubt the persistence of high real interest rates in the United States, relative to those prevailing in most other major countries contributed importantly to attracting money from abroad. That was particularly true during a period when, in relative terms, political and economic confidence in the United States has been strong. In an uncertain world, many individuals and businesses in both developed and developing countries have looked upon the United States as a "safe haven" for their liquid funds and for their capital. At the same time, U.S. banks and others have curtailed their net lending abroad, in the light of stronger demands for credit in the United States and of political and economic uncertainties in some other countries.

It cannot be in our interest to curtail capital inflows and to precipitate a fall in the dollar by taking actions that undermine confidence in our economic policies and outlook -- specifically by undermining the progress against inflation or prospects for sustained growth. Moreover, as I emphasized a few moments ago, we are, for the time being, dependent on capital inflows to help finance <u>both</u> domestic growth and the trade deficit; neither the budgetary nor the trade deficit will end suddenly.

There is, however, a positive and constructive way to approach the problem -- a way entirely consistent with maintaining and indeed reinforcing confidence in our economic outlook and our domestic needs. Specifically, forceful action to reduce the federal budget deficit would directly reduce pressures on our financial markets by restoring a better balance between domestic sources and uses of credit and capital. The restraining effects on economic activity of the lower deficits should be wholly or partially offset by lower interest rates than would otherwise prevail, and as interest rates moved lower relative to those abroad, we would be weaned from our dependence on foreign capital. In that context, prospects for foreign growth could improve, helping our exports, and exchange rates should in time reflect a better long-run competitive equlibrium. As we move to restore a sustainable international trading position, the improved trade balance will also help maintain domestic growth.

No doubt that process will proceed more unevenly, and perhaps more slowly, than we would like. But there are enormous dangers in an effort to short circuit the process through more direct measures to curtail imports or inflows of capital, both of which would work at cross-purposes with the basic requirements for growth and stability in the United States and elsewhere.

Beware, in particular, of those arguments that suggest import restrictions designed to benefit one industry or another will produce more jobs for the economy as a whole. To a particular firm or industry, shutting off import competition offers immediate advantages; more generally, it is argued that -- other things equal -- each reduction of a billion dollars of the trade deficit represents an added billion dollars of domestic output. Given the rule of thumb that each billion dollar's worth of domestic output requires about 25,000 workers, calculations are made that, say, cutting the trade deficit in half, or by $50 billion, would produce nearly 1-1/4 million jobs. But, from the standpoint of the whole economy, the pitfalls in such reasoning at a time when the economy is already expanding strongly should be clear.

If we should actually succeed in reducing our trade and current account deficits by means of import controls, we would also lose the capital inflow and undoubtedly experience stronger inflationary pressures. Both of those factors would tend to push interest rates higher, curtailing jobs in interest-sensitive sectors of the economy, including both homebuilding and long-term business investment. Alternatively, jobs might be created in those industries directly benefitting from the controls, but the exchange rate would be driven still higher than otherwise, hurting other import-competing industries and exporters, including farmers, and multiplying the demands for protection or subsidies. No doubt, pressed very far, there would be a mixture of effects, further complicated by retaliation abroad and international political antagonisms.

That is the case -- and it seems to me overwhelming -- for not yielding to generalized demands for import protection. So long as we fail to deal with the underlying causes, our action will not only be ineffective in dealing with the trade problem, but undermine the broader goal of sustained, non-inflationary growth.

The hard fact is that, even if trade restrictions could be pressed far enough to be successful in reducing our current account deficit, they would only redistribute the strains and imbalances in the economy so long as we cannot finance rising domestic investment from domestic savings. We would assist some industries at the expense of others more sensitive to interest rates, and in the process open the way for renewed inflation and undercut efforts to improve productivity and efficiency.

No doubt there may be specific instances in which trade restrictions have been, or are, justified to counter subsidies or other unfair competitive practices abroad; carefully assessed and monitored, such action can be consistent with encouraging fairer and open trading practices around the world. But there are areas where existing restrictions can no longer be justified, and run the risk of encouraging pricing and wage bargaining inconsistent with the longer-run competitive health of the industries directly affected.

Another approach that has been proposed to reduce our external deficit is to intervene in foreign exchange markets to bring about a depreciation of the dollar and subsequent improvement in our trade balance. In my judgment, exchange market intervention can occasionally play a useful role in dealing with disturbed market conditions or even in signaling the desires or policy intent of the financial authorities in various countries, particularly when the approach is coordinated among them. But its role is subsidiary; experience strongly suggests that intervention alone is a limited tool that cannot, itself, greatly or for long change the market results unless accompanied by changes in more basic policies. And if those policies are appropriate, continuing intervention on any large scale is not likely to be necessary.

In that light, some might suggest that monetary policy should be directed at bringing about lower nominal interest rates and a depreciation of the dollar by accelerating growth in money and credit. But in the United States, with the economy growing strongly and credit growth already large, such an effort would be counter-productive. It could only rekindle expectations of rising inflation, with the clear associated danger of a perverse influence on interest rates as potential lenders withhold funds because of fears of more inflation. In those circumstances, confidence could all too easily be undermined to the point that declines in the dollar would cumulate on themselves in a manner reminiscent of some earlier years, reinforcing inflationary pressures.

We have come a long way in bringing down inflation and inflationary expectations in the United States and in laying the foundations for sustained expansion. We are beginning to enjoy the fruits of that effort. But it is also clear that our trade accounts, and our external position generally, reflect basic imbalances in our economy and in our policies that must be dealt with promptly and effectively. The main direction those efforts should take is clear enough, and I can only be encouraged by the efforts of your Committee and of many others in the Congress to take steps necessary to deal with our budget deficit.

Equally important, we must avoid striking out in the wrong directions -- toward renewed inflation, or toward controls and protectionism. Those paths would only encourage more instability here and abroad. We would risk substituting new, and even more intransigent, problems for those now before us -- problems that were all too familiar a few years ago.

Finally, Mr. Chairman, I would like to comment briefly about the general instability of exchange rates during the past decade and more since the breakdown of the Bretton Woods system. This is not the time or place, were I capable, of reviewing all the possibilities for thoroughgoing reform of the international monetary system. But I do believe the amplitude of the swings we have seen in exchange rates over that period are excessive and potentially damaging in terms of maintaining an open world economy.

In approaching that problem, I believe we must keep in the forefront of our minds the evidence that the instability and uncertainty in international markets can in large part be traced back to instability in domestic economies and policies, and to lack of coordination in the mix of policies among countries.

With great difficulty and pain, we have made progress here and abroad in dealing with inflation, and now growth has been restored. We must, and we can, deal with the remaining imbalances in ways that contribute to those fundamental goals. As we do so -- and only if we do so -- we should be able to look forward to greater stability in exchange markets.

In that connection, as we develop our "mix" of economic policies in the United States, and as other countries approach their economic policy decisions, the desirability of greater stability in exchange rates seems to me to deserve real weight. More often than not, disturbances in exchange markets, and misalignments of currency values and trade balances, are symptomatic of more fundamental problems of economic policy. That seems to me to have been the case over a number of years. We should learn from that experience -- and the current situation seems to me an apt case in point.

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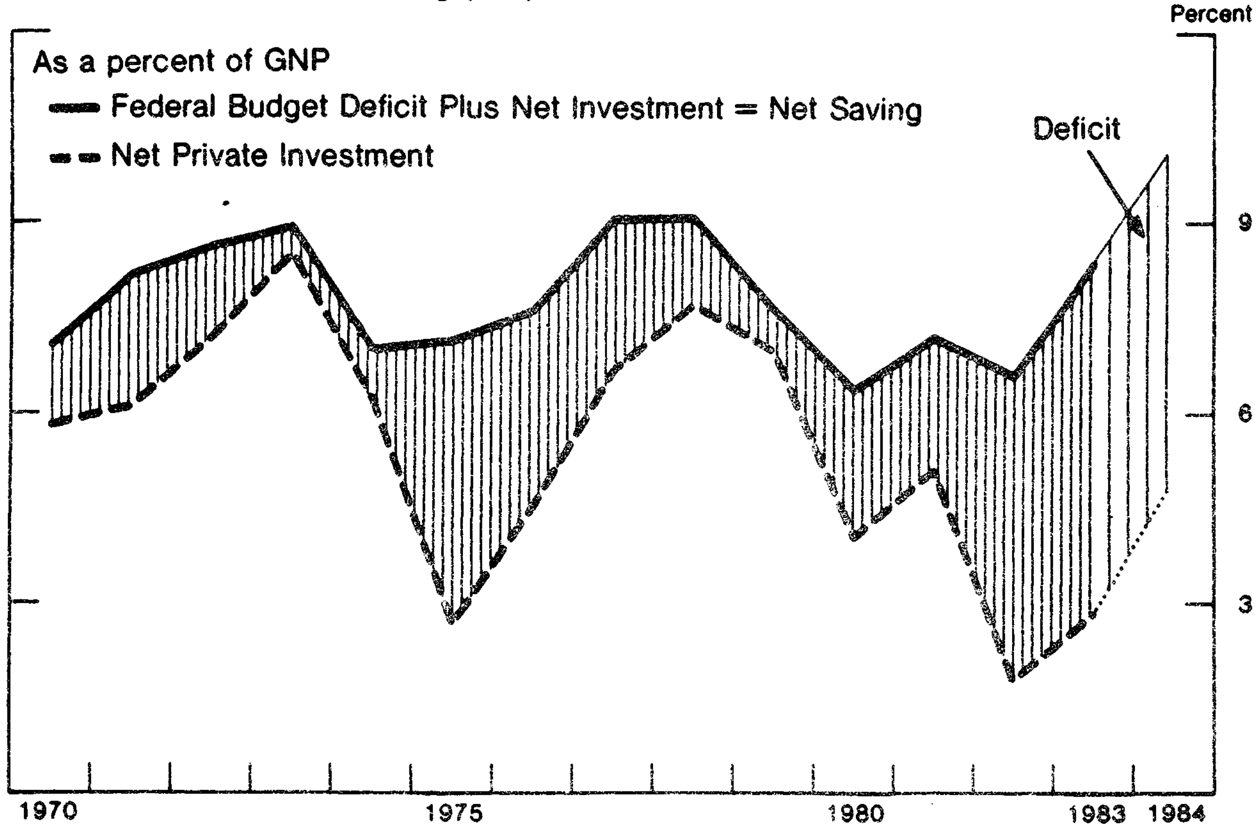
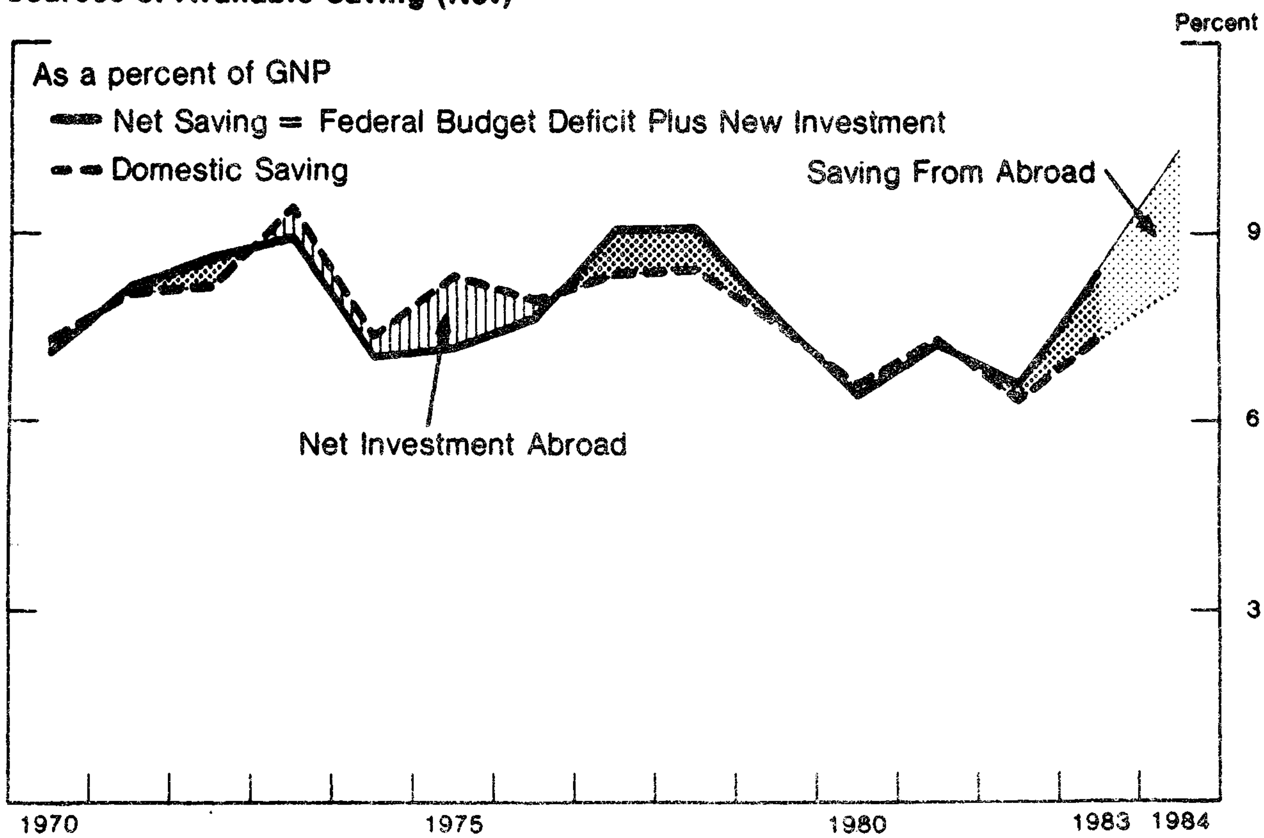
U.S. Trade Position
(Billions of dollars, seasonally adjusted annual rate)

	1980-Q4	1984-Jan/Feb	Change
Exports	231	215	-16
of which to:			
Latin America	42	29	-13
Other Developing Countries	42	40	-2
Imports	252	317	65
Oil	79	53	-26
Non-Oil	173	264	91
Trade Balance	-21	-102	-81
Non-Oil Trade Balance	58	-49	-107

Demands on Available Saving (Net)



Sources of Available Saving (Net)



Note: 1984 figures based on FOMC members' projections for the economy and estimates of the federal budget. Saving from abroad essentially equals the current account deficit.