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THE SITUATION OF THE DOLLAR AND ITS IMPACT ON INTER-AMERICAN TRADE

Remarks of

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From August of 1977 to last November 1 we witnessed a precipitous decline in the international value of the dollar and a corresponding escalation of the exchange values of a number of foreign currencies - notably the Japanese yen, the Swiss franc and the German mark. Over that period, to the low point for the dollar on October 30, the weighted average value of the dollar against ten leading foreign currencies dropped by over 20 per cent. That is an enormous change - far exceeding any differential in inflation rates. Over the same period the yen rose over 50 per cent against the dollar, the Swiss franc jumped by 64 per cent, and the German mark by 34 per cent. Moreover, countries whose currencies were appreciating against the dollar bought over $30 billion in an effort to stabilize exchange markets and resist further appreciation.

These are extraordinary changes in exchange rates in little over a year, clearly symptomatic of serious imbalances and uncertainties in international economic relationships. I would like to explore with you today some of the factors underlying those developments, as well as the remedies that have been set in motion by recent actions here and abroad.

Perhaps the most important underlying factor has been the discrepancy between the rate of economic growth in the United States and in other industrial countries since the recession of 1975. In the case of the United States we have seen sustained growth, with industrial production now 25 per cent above the 1975 low, and 7 per cent above the level in the third quarter of 1977 when the decline of the dollar began. In the six leading foreign industrial economies, industrial production is about 15 per cent above the recession lows, and the rise since the third quarter of 1977 has been only 3 per cent. An even greater difference shows up in the employment data-- over the past two years we have absorbed 6 million new workers into the labor force, and have reduced the unemployment rate from 7-1/2 per cent to 6 per cent. In the six foreign economies aggregate unemployment has risen throughout this period. While excess capacity has gradually been reduced in the United States, and we are probably close to effective capacity in a number of sectors, the general picture in industries abroad has been one of continued substantial excess capacity. This difference in economic performance has been a major factor in the greatly enlarged trade deficits of the United States.

Another factor in the decline of the dollar has been our difficulty in bringing inflation under control. From the third quarter of last year to the third quarter of 1978 consumer prices in the United States rose by 8 per cent; in recent months the rate of increase has been 10 per cent. At the other end of the spectrum, consumer prices in Germany, Switzerland and Japan are only between 1 and 4 per cent higher than they were a year ago, and they have not tended to accelerate in recent months. These discrepancies in inflation rates are magnified as they work through the economic system. They offset some of the competitive advantage gained through the steep depreciation of the dollar, they lead to expectations of further appreciation of the currencies of the less-inflationary countries, which feeds back into further pressure on the dollar, and the changes in the exchange rates themselves reduce the pressure of price inflation in appreciating countries while making the problem of the United States even more severe.

A third factor is our failure to take measures to curtail fuel imports. As you know, those imports jumped from about $8 billion a year prior to the price increase in 1973 to about $45 billion in 1977. Last year the entry of Alaskan oil into the picture gave us a temporary levelling off in the rate of imports, but right now such imports are estimated to be back to the $45 billion level, and we face the prospect of rising quantities and prices in the year ahead. It is true that we are beginning to move toward a more effective energy policy, but implementation will take time, and in the interim exchange markets will be influenced by the fact that we must find the means to pay for these imports.

The economic developments that I have described bear directly on our trade balance -- probably the most widely watched indicator of our international economic vitality. Over the past few years our international trade record has been disastrous -- as recently as the first half of 1976 our trade deficit was about a $6 billion annual rate; by the third quarter of 1977 the deficit rate was $29 billion, and it ballooned to a rate of over $40 billion in the fourth quarter of 1977 and the first quarter of this year. Deficits like these clearly undermined market confidence in the future of the dollar. At present the deficit rate is down to about $31 billion, and we expect it to decline considerably next year. Nevertheless, deficits of this size continue to unsettle exchange markets.

Let us look at some of the major changes in exports and imports that make up the $22 billion rise in the deficit from 1976 to the present. Exports over that period rose by $34 billion, while imports increased $55 billion. On the export side agricultural products have done well--advancing about $9 billion, with volume up about one third and prices up only slightly. Non-agricultural exports, however, have not done so well. While prices of such exports rose by about 17 percent, until the most recent months their volume was scarcely above the 1976 levels and in fact was no higher than it was in 1974. This is a clear indication of the impact of the slow recovery in economic activity abroad -- especially in the investment sectors that are so important for our exports of capital goods.

We see an even stronger consequence of the difference in economic performance when we look at what has happened to our imports. As I noted above we had a temporary reduction in fuel imports when Alaskan oil started to come in, but our fuel imports now are about $19 billion higher at an annual rate than they were in 1976. It is in the non-oil imports, however, that the greatest jump has occurred -- from about

$90 billion in 1976 to a current rate of over $125 billion. Over that period we have had a 25 per cent increase in the volume of non-oil imports, and about a 20 per cent increase in prices. The bulge in the volume of imports covered a broad spectrum of products -- basic materials and metals, such as steel, as well as foods, capital goods, autos, and all kinds of consumer goods.

Some of the explanation for this surge in imports is self-evident -- the rising level of demand in the United States coupled with excess productive capacity abroad. In the earlier part of the period the dollar was relatively strong and this helped to accelerate exports to the United States. There are also the intangibles -- the export orientation of major industries abroad, the slide in productivity here relative to foreign experience, and perhaps the foreign non-tariff barriers against U.S. goods which have had a greater effect than the ones we imposed. I hope that the current multilateral trade negotiations will succeed in reducing those barriers so that we do not adopt the ultimately self-defeating tactic of reciprocal protectionism.

Just as we can find an explanation for the weakness of the dollar in the trade deficits of the United States, we can find much of the explanation of the strength of the German mark and the Japanese yen in the trade balances of these countries. In the case of Germany, the trade surplus was $13-1/2 billion in 1976, but is now at an annual rate of over $22 billion. For Japan the trade surplus was just under $10 billion in 1976 while it is currently at a rate of about $27 billion. These enormous contrasts with the U.S. experience are simply not compatible with stable exchange rates.

While the trade imbalances set up expectations of exchange rate changes, the size and the speed of pressures on exchange rates are a reflection of the huge fund of liquidity ready to shift from dollar assets to other assets. I would not want to overstate this problem by citing data on the gross size of the Euro-dollar markets. After all, a large part of the recorded balances is interbank business rather than asset holdings or liabilities of ultimate lenders and borrowers. It should be remembered that most of the participants on both sides of the market are foreign --which means that an attempt by holders of Euro-dollar deposits to shift into other currencies must be accommodated largely by running down dollar-denominated credits to foreign borrowers. However, even though some measures of the stock of dollars available for rapid conversion into foreign currencies may be exaggerated, there can be no doubt that the amount of liquidity available to both Americans and foreigners is enormous. Moreover, massive short-term pressures can be brought to bear merely by shifting the terms of payments for goods and services -- the so-called leads and lags. Thus the potential for shifting away from dollar assets is sizeable and constitutes a destabalizing overhang which will threaten exchange rate relationships until measures are taken to reassure the public that the dollar's purchasing power will not erode further.

The President announced on November 1 a program designed to be powerful enough to convince the market that the dollar would not be allowed to drop further. Briefly summarized, the major aspects of that program are as follows:

1. On monetary policy, the Federal Reserve acted by raising the discount rate a full per cent to 9-1/2 per cent and by imposing a 2 per cent supplementary reserve requirement on large denomination time deposits. That substantial dose of monetary restraint was attuned to the severity of our inflation problem and also was consistent with the need to reassure exchange markets that resistance to deterioration of the dollar would be given a high priority.

2. A number of other actions designed to provide funds to support the dollar were also announced: an increase of $7.6 billion to $15 billion in the swap arrangements with Germany, Switzerland and Japan, and activation of the swap line with Japan; a drawing of $3 billion worth of strong currencies on the United States reserve position in the IMF; the use of $2 billion equivalent of SDRs owned by the United States to purchase currencies useable for market intervention; and plans to raise up to the equivalent of $10 billion of foreign currencies through the sale of U.S. Treasury foreign-currency obligations. These measures bring to $30 billion the ammunition available for intervention in foreign exchange markets and we pledged forceful intervention to stabilize the market. In addition, the Treasury will raise its gold auctions to at least 1,500,000 ounces per month from the previously announced 750,000 ounces.

3. For their part, authorities in other countries have undertaken vigorous market intervention to support the U.S. actions, and have pledged their cooperation to restore stability in exchange markets.

Since the low point of October the average value of the dollar has gained about 7 per cent, almost to the level at the beginning of the month. Against the German mark, Japanese yen, and Swiss franc the gains have been 10, 6, and 11 per cent, respectively. However, as usual, the market is waiting to be shown that official programs will actually deliver the desired results. What is the evidence that is likely to convince the market that the dollar is strengthening?

The most effective direct evidence would be a consistent reduction in U.S. trade deficits. For that to happen there will need to be a reversal of the cyclical pattern described earlier. The U.S. position can best contribute to this by achieving a slow growth path that is steady and stable and avoids pressure on our productive capacity. With persistence and strong citizen support present policies can achieve such a path for the United States. Cooperative and complementary actions are also needed from other industrial countries whose recovery from the recession has been far from vigorous. On this score, too, there are grounds for expecting improvement. Germany and Japan, in particular, have recently adopted fiscal measures aimed at reinvigorating their economies and these measures should start to have an effect next year. Moreover, authorities abroad are expected to carry through with additional measures should their growth paths remain sluggish.

As a consequence of these complementary policy moves, the growth rate of the United States economy in 1979 is expected to be somewhat lower than the estimated 4 per cent pace of 1978, while the growth rate of the leading foreign economies should advance to about 4 per cent in 1979 from only about 3 per cent this year. As these growth rates intersect, U.S. exports should increase but imports be retarded. In fact, recent months have already seen a pickup in the volume of exports although these recent changes probably result more from the sharp depreciation of the dollar over the past year than to a shift in relative economic growth rates.

On the inflation front the United States obviously has a tough task ahead. As noted, the rate of inflation in this country in recent months has considerably exceeded the rate in a number of our competitors. However, inflation rates abroad may rise a bit as demand picks up, and as the benefits of currency appreciation diminish, while an end to the depreciation of the dollar would reduce inflationary processes in the United States.

Taking these potential trends into account, there could be a material reduction in the U.S. trade deficit, though there may be months of erratic movements. Projections in this area are always hazardous, but I would anticipate a substantial decline next year from the current $30 billion rate. It is also worth keeping in mind that the United States has a large and growing surplus in the non-goods sector of its international current account, especially from the return on foreign investments. Including these receipts, our current account balance -- covering goods, services, and unilateral transfers -- is estimated to be in deficit by less than $20 billion this year, and may be at half that rate in the closing months of 1979.

We are now only at the beginning of the process of restoring equilibrium to international financial markets. What happens in those markets is important to us because uncertainties there feed back into our economy, holding down investment and driving up our inflation rate. An improved trade balance would also directly support our economy as we move to slow the rate of growth of domestic demand. It is sometimes overlooked that our exports are now an important part of total U.S. production accounting for over 11 per cent of all goods produced. More broadly, however, sustained reduction in our trade deficits would be a signal to the market that we are making progress on the fundamental problems of our economy. There is an especially delicate balance of risks in slowing the growth of the economy and slowing the rate of inflation. But in my view, slowing inflation is critically needed not only to restore equilibrium internationally but also as a precondition for continued healthy growth at home.

Therefore, I repeat before this audience some of the actions I recommended in early summer and again in October.

First, additional fiscal restraint must be applied not only because it is needed to reduce inflationary pressures but also because it has become a domestic and international flag bearer for market confidence. A cut of 10 per cent in government spending is the minimum we should accept but to do this you and I must reduce our demands on government.

Second, spending cuts should permit a margin of revenue to be used to spur new investment in plant and equipment to modernize our productivity capacity and generate new jobs and to encourage a lower rate of wage increase.

Third, we should lift the straight jacket of interest rate controls both at federal and state levels so that our people can be paid a positive rate for savings not the negative rates presently evident. Only by encouraging saving can we amass the needed funds for new long-term capital investment even though this will reduce the per cent of disposable income dedicated to current consumer spending. If we are to keep up with our foreign competitors, especially Germany and Japan, a strong and sustained capital spending program is not a luxury but a critical necessity. It may mean that we give up some present consumer spending but it will insure a long run competitive vitality without which the United States will become a second class economic power producing very little and consuming products manufactured abroad.

Fourth, the United States needs a strong energy program of conservation and new production of both old and new types of energy preferably financed by the private sector and stimulated by rapid investment tax write-offs and lower capital gains taxes. But if it takes more direct government effort a program of government loan guarantees, low rate loans, or even price and market guarantees could be a means of accelerating investment in energy exploration, production and new development. Again the economic and political strength of the United States could ride on this too long delayed effort.

Finally we must have the political and public strength and support to sustain monetary restraint even in the face of modest reverses of growth rate or unemployment, for the strength of the dollar at home and abroad is critical to our place in the economic world. We can no longer afford to restimulate our economy at the first sign of reverses nor accelerate its growth to levels sharply above those of our prime foreign competitors.

It must be obvious that, in my opinion, we in the United States face a series of challenges the solutions to which will probably set our course for years to come either toward continued greatness or fading glory. Do we have the collective will to forego short run excesses in consumption, plan for a stronger productive future, and take our medicine for past mistakes? I believe we do if the choices are explained and the challenges are given the highest priority in the decision making of consumers, businesses, and governments.

The success or failure of the United States in getting its economic house in order will be of importance to all our trading partners and to all who use the dollar as a transaction currency or an integral part of their international reserves. The impacts can be viewed in both short- and long-run dimensions.

If the United States is not successful in bringing its inflation rate under control or cannot reduce its balance of trade deficit, the value of the dollar would likely depreciate further, causing additional instability in the international financial markets and damaging the reserve currency characteristics of the dollar.

However, if as I believe, the United States will be successful in reducing both its balance of trade deficit and its inflation rate, there will be an obvious impact in the form of reduced imports into the United States, and/or higher exports from the United States which will create adverse short-run effects on the payments position of our trading partners. But in the long run the improved stability of the dollar and its value as a reserve currency would be enhanced and, in my view, this will strengthen the international monetary system to the benefit of all participants.

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