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Statement by

Henry C. Wallich

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Trade

of the

Ways and Means Committee

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I am pleased to be here today, on behalf of the Federal Reserve Board, to discuss U.S. trade policy.

In my remarks today I should like first to review recent developments in our trade and current accounts, and then examine briefly prospects for the future and the more important factors affecting that outlook. Among these factors are general macroeconomic policies here and abroad as well as policies that are specifically directed toward trade in both goods and services. I shall also discuss the relationship between both types of policies and our international trade performance.

In looking at our past trade performance it is important to realize that although particular sectors face problems that are sometimes severe, the United States has in general remained quite competitive in the world economy. This is manifested most dramatically in the recent expansion of our exports; between 1978 and 1980 total U.S. exports increased nearly 60 percent in value and more than 20 percent in volume. While agricultural exports continued to grow strongly over this period, the major source of strength was the nonagricultural component. This strength was broadly based in consumer goods, capital goods and industrial supplies. With U.S. exports increasing more rapidly than those of our main competitors, the U.S. share of world exports of manufactures rose from 17 percent in 1978 to slightly more than 20 percent in the first quarter of this year.

Furthermore, this strong expansion in our exports was not matched by a comparable increase in imports. In value terms, total U.S. merchandise imports rose by somewhat over 40 percent between 1978 and 1980, whereas the total volume declined slightly, mainly as a result of a nearly

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20 percent drop in the quantity of oil imports. The decline in import volume occurred at the same time that U.S. real GNP was rising.

The strength in U.S. exports and relative weakness of imports resulted in a reduction in the deficit in the U.S. trade balance from $34 billion in 1978 to $25 billion last year. The reduction in the trade deficit occurred in the face of a rise in the price of petroleum imports of more than 200 percent, increasing our bill for imported oil to almost $80 billion in 1980. A major factor explaining these trade developments was the depreciation of the dollar that occurred between mid-1977 and late-1978. The 17 percent drop in the international value of the dollar over this period provided incentives for U.S. firms to sell more of their products in export markets and to compete more effectively with imports. Also, in 1978 and 1979 the economies of most of our major trading partners were expanding quite vigorously.

The fact that U.S. firms responded to these incentives, with a consequent improvement in our trade position, demonstrates that U.S. producers can compete effectively on world markets. This is not to deny the importance of continuing efforts both here and abroad to reduce and eliminate impediments to our exports. What our recent trade performance does indicate is that we can maintain a strong U.S. trading position without resorting to protectionist policies.

Before turning to the outlook for the U.S. trade and current accounts, it is important to note that although the U.S. merchandise trade balance has been in deficit for several years, this deficit has been partially offset, and in recent years more than fully offset, by a surplus on non-trade items. More generally, it is a remarkable feature

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of U.S. international transactions that service-account items constitute a large fraction of total current-account receipts and payments. Service-account receipts were 35 percent of total receipts (i.e., merchandise exports plus earnings from service exports) in 1980, the same figure as in 1977. On the payments side, the proportion is somewhat lower: in 1977 service account payments were 22 percent of total payments, and this fraction rose to 25 percent in 1980.

The largest positive component of the service account has been net investment income, which increased from about $18 billion in 1977 to nearly $33 billion last year. This substantial rise in our net earnings on foreign investment reflects both the fact that U.S. residents have been investing more abroad than foreigners have been investing in this country, and the growth in recent years in foreign earnings of U.S. oil companies.

As our surplus on services has grown and our trade deficit has declined, our current account (which includes merchandise trade, services, and transfers) has shifted from a deficit of $14 billion in 1977 and 1978 to a surplus of nearly $4 billion in 1980. In the first half of this year, the current account surplus was at an $8 billion annual rate. The surplus current-account position of the United States over the past 2-1/2 years contrasts with that of many industrial countries -- for example, continential European countries and Japan -- which have had current-account deficits, some of which are continuing.

Recognition of the underlying strength of the U.S. external position, as evidenced by our current-account surplus relative to the deficits in several major foreign countries, has contributed, along with

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other developments, to the substantial appreciation of the dollar in foreign exchange markets this year.

In providing this background I wish to emphasize two points. First, it is important for the United States to continue to have a strong export sector that includes a broad range of domestic industries and firms. Expanding exports as a consequence of improved domestic productivity contribute to the strength of the U.S. economy and of the dollar, which in turn helps to moderate domestic inflation. Second, although particular industries certainly face strong competition from abroad, we are not faced with a crisis in our trade position or an overall deterioration in our basic international competitiveness. Our present position, which is fundamentally a healthy one, allows us to address issues of trade policy from the perspective of long-term policy goals rather than as a hasty response to a deteriorating trade and payments situation.

Turning now to the outlook for the trade and current accounts, a number of factors must be taken into consideration. First, real growth in the economies of our major industrial trading partners next year is likely to be somewhat better than this year, which will tend to have a positive impact on our trading position. A positive impact is also likely to arise as the U.S. inflation rate continues to decline, especially if it declines relative to the average inflation rate in our main trading partners. OPEC imports will probably continue to grow at a rapid rate next year, and this will provide a source of strong demand for U.S. exports, enabling them to continue to expand. Recently, U.S. exports to OPEC have been expanding at year-over-year rates of more than 25 percent. At the same time moderation in oil price increases,

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which seems likely, and continued reduction in import demand should hold down our oil import bill.

On the negative side, the appreciation of the dollar from the level of 1980 -- to the extent that it is not offset by a better inflation performance here compared with abroad -- will make it more difficult for U.S. exporters to sell abroad and will provide encouragement for imports. Indeed, this impact of the appreciation appears to have started in the third quarter of this year. Another negative factor is likely to be attempts by non-oil developing countries to restrain their import demands and reduce to more manageable levels their large current-account deficits.

The net effect of the interaction of these factors is likely to be a shift from a current-account surplus this year to a deficit in 1982. But I would emphasize that a surplus or deficit in our current transactions is the difference between two large numbers -- each on the order of \$350-\$400 billion -- and point estimates are therefore very uncertain. Moreover, a shift to a current-account deficit should not necessarily be a cause of concern. First, it need not reflect a deterioration in the domestic determinants of U.S. competitiveness, but rather the recent strength of the dollar. Second, a U.S. deficit would match in part the OPEC surplus. While the OPEC current-account surplus is expected to decline in 1982, it will nevertheless be of sizeable magnitude. This current-account surplus must be matched by corresponding deficits on the part of other countries. The developing countries will continue to run current-account deficits next year, but it would be healthy if some of them were reduced. As a consequence some industrial countries may also have deficits (as was the case for both Germany and Japan in 1980) as

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counterparts to the OPEC surplus. Hence it is not necessarily undesirable for the United States to have a moderate current-account deficit at the same time there is a large OPEC surplus. On the contrary, if all industrial countries attempted to achieve current-account surpluses in this situation, there would be a self-defeating decline in the volume of trade. As OPEC expenditures grow to match their earnings, their surpluses, as well as other countries' deficits, will decline.

Focusing now on economic policy and international trade, I would like first of all to underscore the importance of achieving a noninflationary but expanding domestic economy as the basic underpinning of a strong and expanding U.S. foreign trade sector. We have already made some progress in reducing the rate of inflation, but we still have a long way to go before inflation is brought down and stays down. In working toward this important national objective, the Federal Reserve has a special responsibility to restrain the expansion of money and credit. In the short run one effect of monetary restraint, in an economy where there is still considerable momentum to inflation, is to contribute to the strength of the dollar. As I mentioned earlier, the appreciation of the dollar above the level in 1980 will tend to dampen the expansion of exports and make imports more competitive with domestic substitutes.

Exports and imports of goods and services have become increasingly important in the U.S. economy, each rising from 7 percent of GNP in 1970 to 13 percent in 1980. Consequently, in making forecasts of the economy and in analyzing the effects of economic policies, it has now become essential to take account of how changes in foreign economic

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conditions and exchange rate developments affect our exports, imports, and other indicators of our economic well-being.

In an economy increasingly open to international influences, it is of course necessary to recognize that export and import-competing sectors of the economy will be particularly affected by monetary policy through the impact that policy has on exchange rates. However, these sectors will benefit in the longer run from the improved price performance that is the objective of monetary policy. Recent progress in reducing inflation, part of which has come about as a result of the strong dollar, would be jeopardized by any relaxation in current policy intended to aid a particular sector. Any benefit to that segment of the economy would undoubtedly be transitory and would be outweighed by the damage to our fight against inflation. We would not gain as world traders in the long run if we have a high inflation rate accompanied by a depreciating dollar.

Our international trade has of course benefited considerably from the financial services provided by American banks. They have provided not only the direct financing needed for the healthy expansion of U.S. exports but have also fostered the growth of U.S. and world trade through their international lending activities.

I would note that the Federal Reserve has recently acted to enable U.S. financial institutions to provide additional international banking services and thereby provide more facilities for the financing of foreign trade. In response to the Congressional mandate in the International Banking Act, the Federal Reserve modified the rules for Edge Corporations to permit them to finance companies that are engaged in exporting and to establish domestic branches that can provide inter-

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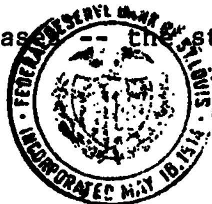
national banking services in new areas. The concrete benefits of these actions in expanding international banking services, and in particular, in facilitating the financing of U.S. exports will, of course, be observed only gradually.

It is important that other government policies contribute to improving the productivity of the U.S. economy. We need to continue our efforts to create an environment favorable to the growth of producitivity and thereby both directly and indirectly maintain a strong trading position. Reduction in the burden of government regulation would be helpful in this regard. More specifically, there are a number of government policies that probably could be amended in ways that would contribute materially to the exploitation of export opportunities by the private sector. Among the impediments that have been mentioned are the absence of clear guidelines under the Foreign Corrupt Practices Act, the reporting burden of the anti-boycott provisions of the Export Administration Act, and requirements that certain U.S. exports be shipped in American vessels.

Deregulation and other measures that improve the efficiency of the economy are the appropriate means for enhancing our competitive position in world markets. Competitiveness must be fostered not only in industries that export, but throughout our economy, and especially in sectors that may face competition from the exports of other countries in our domestic markets. What often happens is that industries protected from the winds of foreign competition do not feel it necessary to implement the innovations or undertake the investment required to stay competitive. In certain cases -- the steel industry is frequently



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cited -- costs are allowed to rise far out of line with costs in the rest of the economy, and then protection is granted from lower-cost foreign imports.

It should also be noted that when domestic industries maintain higher prices as a result of tariffs, quotas or less formal export restraints abroad, it is not only the American consumer who suffers. The American exporter is hurt as well. Since part of the exporter's inputs are imported or consist of domestically-produced goods that compete with imports, his costs of production rise when protection is granted to those sectors of the economy that compete with imports. We need to recognize that measures designed to improve one part of the balance of trade by reducing imports may well have the counterproductive effect of making our exports less competitive on world markets.

In summary, U.S. trade policy must be viewed in the context of broad U.S. economic objectives of maintaining a sustainable rate of economic growth and reducing our rate of inflation. Policies which increase the efficiency and productivity of our economy, and encourage the movement of resources into those sectors that are expanding, will help attain these objectives. Through such policies U.S. industries will be on a strong footing to compete on world markets, and will thereby make a contribution to maintaining the strength of the dollar.

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