FOR RELEASE ON DELIVERY
Expected at 10:00 AM (E.S.T.)
March 23, 1984

Statement by

Henry C. Wallich

Member, Board of Governors of the Federal Reserve System

before the

Committee on Finance

United States Senate

The U.S. Trade Deficit: Causes, Consequences and Policy Options

SUMMARY POINTS

1. The strong dollar and our large trade and current account deficits are related in a fundamental sense to the large federal budget deficit.

2. Import restricting actions, whether broadly or narrowly applied, are contrary to the national interest of the United States, except where foreign competition is judged to be unfair as defined by our trade acts.

3. The only appropriate policy prescription for beginning to deal with the trade and current account deficits and avoid an excessively strong dollar, in my view, is to reduce the structural deficit in our federal budget. Other proposals for reducing the external deficits without reducing the budget deficit would, if successful, only shift the impact of our nation's budget problems by putting upward pressure on real interest rates.

The U.S. Trade Deficit: Causes, Consequences and Policy Options

The U.S. merchandise trade and current account deficits widened considerably during 1983. For 1983 as a whole, the trade deficit exceeded $60 billion, and by the fourth quarter it had reached a $75 billion annual rate. The current account was in deficit by more than $40 billion for the year as a whole, and reached a $60 billion annual rate in the fourth quarter. Many are predicting that the current account deficit will be around $80 billion for 1984 as a whole, and the trade deficit around $100 billion.

Causes of the External Deficits

It is customary to analyze changes in the external deficits by focusing on proximate causes, such as changes in exchange rates and the growth of economic activity at home and abroad. In that tradition, the widening of the external deficits can be related, first and foremost, to the very substantial appreciation of the dollar and the conditions that have given rise to the appreciation. On a weighted-average basis against the currencies of the other major industrial countries, the dollar has appreciated by more than 45 percent since the fourth quarter of 1980, when our current account balance was showing a small surplus. Some of the appreciation has reflected our relatively good inflation performance, but even in real terms -- adjusted for changes in consumer price levels -- the weighted-average value of the dollar is now nearly 40 percent higher than it was at the end of 1980, and roughly 25 percent higher than its average for the entire floating rate period since 1973. Against the European currencies the appreciation in real terms has come to 30 percent against the Swiss franc, 45 percent against the German mark, and higher amounts against the weaker currencies. Against the Japanese yen the dollar has risen 20 percent in real terms; against the Canadian dollar it has depreciated slightly.

The cyclical behavior of the U.S. and foreign economies has been a second factor contributing both to the time profile and to the widening of the U.S. trade deficit. The U.S. recession held down imports and thus delayed the rise in the trade deficit until after the middle of 1982, and the relatively rapid expansion of the U.S. economy in 1983 was a dominant element in last year's trade developments, accounting for more than half of the $30 billion increase in our trade deficit from the fourth quarter of 1982 to the fourth quarter of 1983.

As a third factor, the external financing problems of some countries, especially of our neighbors in Latin America, have resulted in lower exports to these countries.

A fourth factor has been the failure in the past of some of our industries to adjust adequately to the pressures of international competition.

While the strong dollar and our large external deficits reflect, in part, our improved macroeconomic performance and the greater return on financial investment in this country, in a more fundamental sense they are related to the budget deficit. When the U.S. government runs a deficit, other sectors must, on balance, finance it. Part of the financing has been provided by foreigners in the form of the net capital inflow that is the counterpart of the current account deficit. The remainder of the financing has been provided by private domestic residents and state and local governments, which has diverted resources from productive domestic capital formation. Naturally, the net capital inflow and the surplus of private domestic saving over private domestic investment have not arisen automatically, but have had to be induced. As a result, real interest rates have been higher then they would otherwise have been. In addition, the higher real interest rates have been associated with upward pressure on the dollar: such upward pressure has prevailed over whatever downward pressure may have emanated from the external deficit, which usually is a negative element in the market's evaluation of a currency. Thus the dollar has risen. In this way, high real interest rates, the strong dollar, and large external deficits are all linked to large federal budget deficits.

Consequences of the Deficits and the Strong Dollar

Some of the damaging consequences of the deficits and the strong dollar are reflected in the decline in our exports. In value terms, exports declined by about $25 billion from the fourth quarter of 1980 to the fourth quarter of 1983, with two-thirds of the drop accounted for by a 40 percent contraction of shipments to Latin America, mainly to Mexico, and the other third reflecting a 15 percent reduction in shipments to Western Europe. It is noteworthy that exports to both Japan and Canada expanded somewhat from 1980 to 1983.

In volume terms, our merchandise exports were more than 15 percent lower in the fourth quarter of 1983 than in the fourth quarter of 1980. Exports of capital goods declined by more than 25 percent in volume terms, exports of nonagricultural industrial supplies by more than 20 percent, and exports of agricultural products by about 10 percent. The longer exports remain depressed, the more difficult it becomes to maintain marketing networks, and the more costly and difficult it becomes to recover foreign sales.

If our current account deficit were to continue for long at the rate of around $80 billion that is likely to be recorded in 1984, the United States would soon become an international debtor country. At the end of 1983, the United States had an estimated international net creditor position of about $125 billion. This balance could be pushed to the minus side in little more than one year. Our position as an international creditor has been a major support to our balance of payments so far. Thanks to the very productive character of some of our foreign assets, the United States had a surplus of investment income averaging more than $30 billion annually during the years 1979-81. This has meant that we have been able to tolerate a sizable trade deficit without thereby incurring a deficit in the current account, which combines services and trade. If our international position shifts to that of a debtor country, this advantage will be eroded; indeed, it is estimated that our surplus of investment income fell below $25 billion in 1983. Eventually, the United States might find itself in the position of having to earn a surplus in the trade balance in order to cover a deficit on investment income. Other things equal, the larger the net debtor position we build up, the lower will be the value of the dollar necessary in the long run to generate the required trade balance.

In addition, I might say that, for one of the richest countries in the world, it seems hardly appropriate either to be borrowing currently on a massive scale from the rest of the world or to be a net debtor to it.

The external deficit also has a strong bearing on the future of the dollar. I have noted the severe appreciation the dollar has experienced against a number of currencies, which has been one -- but only one -- of the reasons for the trade deficit. As the United States continues to borrow abroad and moves toward net debtor status, causing the rest of the world to hold ever larger amounts of dollar-denominated assets, the good acceptance that our currency has had in the world may wear out. Nobody can predict the timing, but in the longer run it seems probable that the dollar-depressing effect of the external deficit will begin to overwhelm the dollar-supporting effect of higher interest rates.

I do not believe, therefore, that the current value of the dollar is sustainable, although it is impossible to predict the sequence or timing of events that will bring it down. If the dollar does decline substantially while the budget deficit remains unchanged, the external deficit will, with a lag, also decline. That would reduce, in a sense, the magnitude of the problem that this Committee is addressing. It would also, however, intensify other problems created by the budget deficit. With a return of the external sector toward balance, the foreign financing of the budget deficit would cease. It would have to be financed entirely at home, absorbing a still higher fraction of scarce available savings, thereby raising interest rates. The "crowding out" resulting from the budget deficit, which now goes in part against the foreign-trade related sectors of the U.S. economy and in part only against other sectors of the economy, would then be directed fully against the other sectors. This needs to be emphasized in order to make clear that a reduction or ending in the external deficit, without a reduction in the budget deficit, would only shift the impact of our nation's budget problems without resolving them.

The impacts of the external deficit and the strong dollar have been felt by our manufacturing industries, the agricultural sector, and some of our services industries. The effects are adverse not only for exports, but also for domestic import-competing sectors. On the whole, nevertheless, these impacts have been quite well absorbed. The American economy has expanded strongly. This has offset some of the pressure of mounting import competition deriving from a strong dollar. Moreover, some of the industries that have suffered from import competition are in that condition more because of factors specific to their industry than because of the high dollar. Industries that have failed to invest and reduce costs, have not kept up with modern technology, and in some cases have paid wages far above the national average for production workers, are bound to suffer even at a lower level of the dollar.

Aside from such industry-specific problems, I do not see the United States being deindustralized. The combined domestic and foreign demand for U.S. industrial output has increased since 1980. In particular, the industrial production index for manufacturing is currently almost 7-1/2 percent higher than its level at the end of 1980, when the dollar began to appreciate. Employment in the manufacturing sector, on the other hand, is currently 3-1/2 percent below its level at the end of 1980, partly reflecting relatively rapid productivity growth in the manufacturing sector, which historically has contributed to a negative trend in the share of manufacturing employment in total private employment.

Arguments Against Import Restrictions

My purpose in citing these statistics is to counsel strongly against additional import restrictions at this juncture as a means of dealing with the trade deficit. The type of import restricting actions authorized by Section 122 of the Trade Act, which would apply on a broad and uniform basis, are certainly contrary to the national interest of the United States. Thanks to the strong economic recovery last year, our tradeable-goods industries as a group have not been severely injured on balance. Their circumstances cannot justify additional import restrictions, except where foreign competition is judged to be unfair as defined by our trade acts.

The costs of import protection are well known. The decision to protect one industry invariably imposes costs elsewhere in the economy. It is costly to other industries if foreign countries retaliate against U.S. exports, of if import restrictions lead to higher dollar exchange rates than would otherwise prevail, or if the prices they must pay for inputs rise. Protection typically leads also to higher prices and less choice for consumers. An example of the consequences of protection for consumers we now observe in the recent very high profits of the automobile industry, which is protected by "voluntary" export restraints in Japan. Finally, protected industries typically delay making the adjustments that are necessary if they are ever to stand on their own feet. These costs should make us hesitant even to reciprocate against foreign protectionist actions. Retaliatory measures taken by us damage our own interests, whatever they may do to foreigners.

Reducing the trade deficit by protectionist methods without reducing the budget deficit would not resolve our problems. It would certainly not ease the pressures on our export industries which, thanks to the discipline of international competition, are bound to be among our most efficient.

Other Policy Options

The appropriate policy presciption for dealing with the trade deficit and the excessively strong dollar, in my view, is to reduce the structural deficit in our federal budget. Controls on trade or on capital inflows, or any other proposals for reducing the external deficits without reducing the budget deficit, would only shift the impact of our nation's budget problems by pushing up real interest rates.

You have asked, as well, for an analysis of whether the floating exchange rate system itself may have contributed to our problems. In my view, the floating rate system has served us fairly well. Swings in exchange rates over the past decade, to be sure, have been extremely wide. But many of these swings can be related mainly to changes in the relative outlooks for interest rates, inflation and real growth in different countries. A good part of the changes in relative economic outlooks in turn can be related to changes in monetary and fiscal policies. Given the stances of monetary and fiscal policies in the United States and abroad during the past four or five years, it is hard to believe that the Bretton Woods system of pegged exchange rates would have survived, and certainly not without major upward adjustments in the exchange value of the dollar. Greater stability of exchange rates, which is greatly to be desired, must be founded in the first place on greater domestic stability in all countries, and on policies supporting this stability.

Finally, you raised the question of whether the dollar is overvalued. In my view, the meaningful answer to this question is yes. It is sometimes argued, to be sure, that whatever exchange rate prevails in the market at any moment balances demand and supply and therefore cannot be over or undervalued. That, however, begs the question. Interpreting the question as referring to the effect of the exchange rate on the economic magnitudes in which this Committee is interested, such as the trade balance or the current account, it seems evident that the recent value of the dollar has been clearly inconsistent with even very approximate balance in either the trade or the current account and that, therefore, in this sense, the dollar is overvalued.

Given this interpretation of our situation, the right policy prescription for dealing with the trade deficit is to deal with the circumstance that is at the root of the high dollar. This brings me back to the need to reduce the structural deficit in our federal budget. Such action, of course, would not cure all the diverse problems encountered in the various sectors of our economy. But a substantial adjustment of the budget toward balance, other things equal, would lead to declines in real interest rates, a depreciation of the dollar in exchange markets, and (with some lag) a reduction in the external deficits. Recent statements by the President and members of Congress, such as the statement of the Chairman of this Committee announcing these hearings, give hope that some progress may be made in that direction. I hope that my remarks have conveyed the message that the strong dollar and large external deficits are partly symptoms, themselves damaging, of large budget deficits. I hope as well that the Congress and the Administration will resist temptations to try to suppress the symptoms without curing the disease.