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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

Committee on Ways and Means

of the

U.S. House of Representatives

Washington, D.C.

Thursday, November 3, 1977

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I am pleased to appear before this Subcommittee today to discuss the important topic of U.S. international transactions and our trade and current account deficits.

The deficit of the United States on current account transactions is expected to amount to $16-20 billion in 1977 and may well be at least that large in 1978. The anticipated 1977 current account deficit is the composite result of a trade deficit that could be on the order of $30 billion and a surplus on the order of $12 billion in other current account transactions. It is important to note this composition of the U.S. current account deficit. Focusing on the trade balance alone makes the U.S. situation appear weaker, just as it makes the situation of Japan and Germany look stronger, than it actually is. Japan and Germany have substantial deficits on service transactions.

The factors that may have contributed to our deficit can be grouped under three headings:

(1) The pace of recovery in the United States, compared with that in other countries;

(2) Oil imports; and

(3) The degree of international competitiveness of our economy.

I shall briefly comment on each of these factors.

The U.S. economy is substantially ahead of most other economies in the expansion phase of the current cycle. This has meant that our imports have risen faster than our exports. As other countries catch up, this situation should be corrected. On the basis of current forecasts, the OECD countries, and quite likely the non-oil-developing countries as well, should be experiencing real growth in 1978 no faster than the United States. We may, therefore, have to wait until after 1978 before most other countries have fully caught up with the United States. Making an adjustment for these cyclical differences is difficult both conceptually and operationally. I would not think it unreasonable, however, to attribute something like $10-15 billion of our current account deficit to this factor.

Our oil imports, estimated at $45 billion in 1977, have also contributed substantially to our deficit. It would be a mistake, however, to view the increase in these imports over some earlier period, as a complete measure of the impact of oil on our external position. Our exports to the OPEC countries also have risen rapidly in recent years. A more meaningful, but still not entirely satisfactory, assessment of the oil impact on the U.S. current account would be to look at our current account balance excluding both imports from and exports to OPEC. Such a calculation, which ignores our large surplus on services with OPEC, indicates that our current account position with the non-OPEC countries was in surplus in the first half of 1977.

It is also useful to remember that the United States depends far less upon imported oil than other countries in relation to the size of the respective economies. Unfortunately, this ability of the United States to take care of its oil needs from domestic sources has diminished over the past several years as domestic oil production declined.

The competitiveness of American exports and of our economy generally can be assessed by a variety of criteria although none of them is completely satisfactory. An examination of the share of U.S. exports in the markets of particular countries indicates that we have not in most of them experienced a declining share, although in the aggregate our share of G-10 exports has declined somewhat from the peak in 1975. Such calculations suggest that our exports continue to be competitive. An examination of so-called "real" exchange rates, i.e., exchange rates adjusted for different degrees of price inflation here and abroad, also suggest that neither our export nor our domestic economy have, over the past two years, lost price competitiveness.

Furthermore, recent investigations show that foreign demand for our exports responds to increases in income abroad much as our own demand for foreign goods has responded to increases in our own income.

So long as the OPEC group of countries maintains a current account surplus, presently on the order of $40 billion, the rest of the world taken together inevitably must have a deficit with these countries of equal magnitude. The greatest contribution that could be made toward better world payments balance would be a decline in the OPEC surplus. The problem created by the OPEC surplus is intensified by additional surpluses run by some oil-importing countries, including Japan, Germany, Switzerland, and The Netherlands, which may amount to over $15 billion in 1977. An important step toward better balance in world payments would be a reduction in these non-OPEC surpluses. A number of countries now in deficit are approaching debt levels that make a reduction of those deficits, and of the rate of external borrowing, highly desirable. A number of countries, indeed, have already achieved such reductions. But one must recognize that when one country reduces its deficit the deficits of other countries are likely to increase, in addition to the surpluses of those in surplus diminishing.

Under these circumstances, a current account deficit of some magnitude for the United States, despite its negative implications, seems unavoidable and indeed not undesireable from the viewpoint of global stability. An effort to bring our international balance back into equilibrium quickly could raise the deficits of other countries to unsustainable rates. We must, however, remain aware of the negative implications of a large and continuing U.S. current account deficit. Such a deficit tends to exert a negative influence on economic activity in this country. It also tends to put downward pressure on the U.S. dollar, and thereby eventually to intensify inflationary pressures. And it tends to create pressure for interference with the free flow of trade through quotas, tariffs, and other restrictions. Concern over the outlook for the dollar could also cause official and private holders of dollar-denominated assets to seek to shift to assets denominated in other currencies, thereby intensifying the pressure on the dollar. Such a development also might prompt the OPEC countries to raise the price of oil. And, taking a longer view, a stance for the United States as a heavy importer of foreign capital, which is the necessary implication of a large current account deficit, is not consonant with our position as a wealthy country that traditionally has exported capital to countries with lower per capita incomes.

The best means of dealing with our deficit, because it is also the most fundamental, is to hold down and reduce our rate of inflation. This will increase our underlying price competitiveness with respect to that very large part of the world where inflation rates remain high. Measures to reduce the importation of oil, through conservation and increased domestic production likewise are urgent.

In this way, measures that we ought to take in order to strengthen our economy from a domestic point of view also would serve the purpose of reducing our current account deficit and of contributing to a better balance in global payments positions.

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