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REFLECTIONS ON THE U.S. BALANCE OF PAYMENTS

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

joint luncheon of the

American Economic Association and American Finance Association

New York City

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As we look, from the year end watershed, upon what happened in 1977 and what is likely to happen in 1978, we can derive some satisfaction from progress made and progress that we have reason to believe lies ahead. In international comparison, the United States economy did well in 1977 and seems likely to hold its own in 1978. Nevertheless we face serious challenges. At home, while growth has been reasonably satisfactory, unemployment and inflation continue at excessive levels. Important adjustments, such as in the energy field, remain to be made. Internationally, we confront a very large current account deficit and have witnessed a substantial decline in the dollar. These are matters to keep in mind as we count such blessings as we have.

We operate under an exchange rate regime in which it has been accepted that underlying economic and financial factors are to govern the level and movement of exchange rates. In the long run, I believe that this is not just a prescription for exchange market policy, but an imperative of economic life. Unrealistic exchange rates cannot long be sustained in a world in which the flows of goods, services, and particularly capital are gratifyingly free and are becoming increasingly large.

In the short run, to be sure, exchange rates can be influenced by factors other than these fundamentals. Uncertainties, erroneous perceptions and destabilizing speculation are likely to bring about such departures from time to time. In recent months, the exchange markets seem to have been passing through such a period. In particular, I believe that erroneous perceptions have played a role in the recent turbulence of the market.

One such erroneous perception seems to have been an apparently widespread belief that the United States is practicing so called "benign neglect" with respect to the value of its currency. This conclusion many market participants seem to have derived from the fact that U.S. exchange market intervention, although rising of late, has been conducted on a relatively moderate scale. In my view, any thought that the United States is unconcerned about the value of its currency, and perhaps even would like to see it decline in order to gain a trade advantage, is altogether erroneous. The United States has many reasons to want its currency to be as strong as the fundamentals would justify.

First, we have learned that exchange rate depreciation contributes significantly to inflation. This has been the lesson of the devaluation of 1971 and subsequent exchange rate movements. Prior to that, it had been widely thought that the small size of our foreign sector meant that the dollar rate had almost no influence on the domestic price level. Experience has shown that depreciation influences prices beyond the export and import sectors. Domestic prices are influenced also through the mechanism of competition. A depreciation of the dollar reduces competition for a wide range of domestically sold goods. Moreover, since 1971, the foreign sector of the U.S. economy has increased from 6 per cent of GNP to 10 per cent. The American economy has become more open. Thus the immediate impact of exchange rates on domestic prices has also increased.

The price of oil is another important factor that may be influenced by the exchange rate of the dollar. Some OPEC spokesmen have said that their decisions with regard to the price of oil will be influenced by what happens to the dollar. Although it seems clear to me that this is not a valid argument and that the OPEC would damage their own interests by raising the price of oil, one must recognize that the price of oil is of enormous significance.

Third, the usefulness of the dollar as a reserve, trade, and investment currency, both to the United States and to the world, depends on the dollar remaining an attractive asset. The United States draws advantages from this international role of the dollar. It facilitates, for instance, the smooth financing of a large current account deficit. But we must bear in mind that a currency in which the assets of official and private parties are denominated will always tend to be compared with whatever are the strongest major currencies at the time. Investors will compare the returns from holding dollar-denominated assets with the returns available on assets denominated in other currencies, making allowance for differential interest rates and exchange rate movements. If a widespread feeling should gain ground among investors that dollar assets are unattractive, an effort to get out of these assets into other currencies could produce great instability.

Finally, the value of the dollar influences business conditions abroad. When the value of an asset that is so widely held becomes uncertain, the plans of businesses and households may be upset, leading possibly to a reduction in investment and perhaps even consumption abroad. When the dollar declines sharply, profits in export industries and import-competing industries abroad shrink, and so does investment. The world's recovery from recession, which is proceeding at a painfully slow pace, could be further slowed, unless countries abroad are able to take advantage of such added slack to engage in additional stimulation.

U.S. interest in a strong dollar is undeniable. It would be a mistake, however, to say that this interest should be measured by the scale of U.S. intervention in the exchange market. U.S. intervention has been adequate to the degree of disorder in the market. As disorder has mounted in recent weeks, so has the scale of our intervention. But exchange market intervention should not and indeed cannot influence basic trends. These trends rest upon fundamentals.

The evidence that intervention cannot dominate exchange market treads is all around us. In the course of the present year, net intervention purchases of dollars by major central banks have amounted to more than $30 billion. It is probable that this intervention has had an impact on the value of the dollar, but it has not prevented a 5 per cent depreciation of the dollar against the weighted average of major currencies during 1977. The reason for this could be a perception that fundamentals did not justify a higher value for the dollar. It is only when fundamentals are appropriate and the market has moved out of line with them that intervention can be expected to have a lasting effect. But the reason could also lie, as already noted, in market psychology, which has often shown itself capable of exaggerating exchange rate movements. Fundamentals do not necessarily assert themselves instantaneously or with complete precision.

It is necessary, therefore, to examine the fundamentals of the dollar. The large current account deficit of the United States is the principal factor now being looked at by the market. This deficit was not fully anticipated and hence has led to a change in the market's evaluation of the dollar's prospects. But it is necessary to look through the size of the deficit to the circumstances that produce it and that are likely to condition its duration. One important component of the deficit is the volume of oil imports, now at a rate of 9-1/2 million barrels a day worth about $45 billion at an annual rate. Of course, this amount is not a proper measure of the "oil deficit." That measure is not even correctly taken by the excess of U.S. oil imports over exports to the OPEC countries, since we have also large invisible net receipts from the OPEC countries for which data are not readily available. Moreover, a bilateral deficit can in some degree be covered by bilateral surpluses with other countries. For instance, the modest surplus that the United States has in its trade with some European countries which in turn are selling to the OPEC countries is an indirect way of covering a part of the oil deficit.

Nevertheless, unrestrained U.S. consumption of oil and a consequent mounting of our oil imports is rightly regarded as a heavy burden on our trade account. The energy legislation now in the Congress, preceded by the measures announced by the President, should bring a reduction in the upward trend of our oil imports. Conservation of energy and development of additional and substitute energy sources is widely recognized to be necessary for reasons of national security that go beyond considerations of the balance of payments.

A second important component of the current account deficit is of a cyclical character. The United States has moved well ahead of the rest of the world in recovering from the 1974-75 recession and moving into new high ground. We can reasonably expect that eventually the rest of the world will follow. No one, I am sure, wants the U.S. to reduce its current account deficit by slowing down its economy. The underlying character of the deficit must be assessed, therefore, by making a cyclical adjustment. What, in other words, would be the magnitude of the deficit if the world as a whole were at reasonably full employment?

The methodology of a cyclical adjustment involves estimating first what economic activity and prices, both at home and abroad, would have been if there had been full employment during the period in question. Then trade flows can be estimated. An econometric model that relates U.S. trade flows to such income and price estimates suggests that the U.S. trade deficit of about $30 billion might be $10-20 billion lower if there were full employment in major industrialized countries. Since the surplus of about $12 billion on services would not be much changed by a return to high employment, the U.S. current account deficit of about $18 billion would be very substantially reduced under those conditions.

Not too much weight should be attached to calculations like these, particularly since we do not know how long it might take the world to return to high rates of employment. And, in assessing such very tentative calculations, it should also be borne in mind that some deficit for the United States is not inappropriate so long as the OPEC countries maintain a sizable surplus. The deficits corresponding to that surplus must be shared around the world. While the United States, under ordinary conditions, and, given its wealth and economic structure, ought to be a capital exporter, a sharing in the non-OPEC world's aggregate deficit does not seem inappropriate so long as some other countries may have difficulty financing large deficits.

Computation of a cyclically adjusted U.S. trade deficit, nevertheless, does not resolve the question whether the United States has not in some fundamental sense lost competitiveness. An analysis of the fundamentals, therefore, must focus also on competitiveness.

There is a fair amount of evidence on this point. Some of it comes from the analysis of market shares of exports. The United States' share of exports of G-10 countries (a measure that minimizes the impact of recent unusual developments in petroleum and other commodity markets) declined in 1976 and again slightly in the first half of this year. But those declines followed three years of increases in the U.S. share of exports in the wake of two years during which exchange rates had been substantially realigned.

Thus the U.S. share, which measured 20.0 per cent during the first half of this year, is essentially unchanged since 1971 when it measured 20.1 per cent. And it should be noted that many countries that have traditionally been large customers of ours have not expanded particularly rapidly during this period.

Another source of concern about competitiveness apparently is ready to be laid to rest. Research dating from the 1950's to the mid-1960's seemed to indicate that the elasticity of demand for U.S. exports with respect to foreign income was substantially below the elasticity for the exports of others with respect to our own income. More recent work by the Federal Reserve staff indicates that there is no statistical significant difference between those elasticities. In other words, so long as the United States and the rest of the world grow at approximately the same rate, these studies suggest that U.S. exports and imports should grow at roughly equal rates.

Finally, some evidence on competitiveness comes from the calculations of "real" exchange rates. These are exchange rates adjusted for international differences in rates of inflation. The real exchange rate of the dollar will remain unchanged with respect to any other currency or group of currencies so long as the movement in the nominal exchange rate is equal to the differential movement of prices.

Like all index numbers, calculations of real exchange rates raise questions as to the kind of index used, and the starting level. For some countries, for instance Japan, different indexes yield very different results. For the United States, however, the four customarily used indexes -- consumer prices, wholesale prices, export unit values, and unit labor costs -- all yield appromimately the same result. If a comparison is made between the dollar's value at the beginning of the float of exchange rates in March 1973 as well as the average of rates during the period from March 1973 and the present, the real exchange rate of the dollar on a trade weighted basis has depreciated and competitiveness has increased.

The real exchange rate of the D-mark, computed similarly, shows little change over the same period. For the yen, as noted, meaningful results are more difficult to obtain.

It must be remembered that an absence of major changes in real exchange rates is not necessarily evidence of equilibrium. When real rather than monetary shocks cause changes in the balance of payments, real exchange rates ought to change. But when examination of structural factors in the world economy suggests that no major adjustment is needed, movements in the real rate can be regarded as indicative of changes in competitiveness, particularly when the various indexes tend to produce roughly similar results.

One further element of competitiveness of the dollar remains to be considered. It relates to the capital rather than the current account. How competitive is the dollar as a capital asset? This depends both on interest rates and on expected exchange rate movements. Together they produce the total expected return on dollar assets in terms of foreign currencies. The dollar solidified its role as the world's leading reserve and investment currency during the postwar period when interest rates were low in the United States and high almost everywhere else. Meanwhile, this relationship has been reversed with respect to the strongest currencies. U.S. interest rates today are significantly higher than those of Switzerland, Germany, and even Japan.

During periods of market turbulence, when exchange rates and related capital values change rapidly and substantially, interest rate considerations are likely to fade into the background. But, when markets settle down, interest rates are bound to carry weight. Today, interest rate differentials among three important investment currencies -- the dollar, the D-mark, and the Swiss franc -- reflect very closely differential rates of inflation experienced in the three respective countries. Real interest rates, in other words, in these countries, are approximately equal.

In this fundamental sense, the dollar does not seem to have lost competitiveness as an asset. If that can be accepted, one would conclude that the financing of the U.S. current account deficit, which in 1977 was accomplished almost entirely through movements of official capital resulting from intervention, can also be accomplished by private capital, at an unchanged exchange rate.

Let me summarize the elements of strength of the dollar as I see them. First, there is a large cyclical component of the deficit. We do not know how long it will take other countries to return to high employment, but at any rate there is light at the end of the tunnel.

Second, there is the modest improvement in U.S. competitiveness since 1973, as measured in terms of the "real" exchange rate. It reflects the moderately good, though far from excellent, inflation performance of the United States. The main contribution to future strength of the dollar will have to come from a continuation and improvement in this performance.

Third, there are several other indicators of effective competitiveness of U.S. goods, expecially market shares and demand elasticities. This competitiveness should begin to show through as world trade recovers.

Fourth, there are substantial interest rate differentials with respect to competing currencies. As markets settle down, these should increasingly assert themselves.

Not yet in this picture is concrete evidence that oil imports will be held down. Even strong legislation, as I expect to be enacted, will not reduce U.S. oil imports in the immediate future. But, such legislation, once in place, should provide assurance to the markets that the dollar strength will not be sapped by spiraling oil imports and that, indeed, the longer run prospect is for reduced U.S. dependence on imported oil in the future.

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