Research Department
Federal Reserve
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Riding Up the J Curve

When the devalued dollar made its debut two years ago, most observers expected that the nation's balance of payments would soon shift from deficit to surplus. It didn't happen, and newspaper readers were soon made familiar with the J-curve phenomenon, whereby devaluation leads initially to a worsening of the trade balance, and lasting improvement occurs only after a prolonged delay.

While many factors affect the balance of trade and obscure the effects of exchange-rate changes, there was indeed an early worsening of the trade balance. The merchandise-trade account, which had first shifted into deficit in early 1971, went from a $2.7-billion deficit for that year as a whole to a $6.9-billion deficit in 1972. Initially, imports rose in dollar value, reflecting the appreciation of foreign currencies relative to the dollar, while exports (priced in dollars) improved somewhat due to boom conditions abroad but otherwise tended to be little affected by the dollar's decline.

Now, two years later, the delayed upsurge in exports is occurring and the U.S. trade balance is beginning to ride the J curve upward. The lower prices of U.S. products (in foreign currencies) have increased their appeal overseas, while the higher prices of foreign goods have begun to discourage domestic demand for such products despite the continued needs of the U.S. boom.

As a result, the merchandise-trade account is rapidly shifting from last year's $6.9-billion deficit toward balance, despite some weakness in August, and in 1974 could even post a substantial surplus. The basic balance—which includes long-term capital flows, transfer payments and services as well as the trade account—should continue its shift toward balance, building on the much-improved performance of first-half 1973.

Export boom vs. imports

Merchandise exports continued to rise appreciably in the second quarter—to a $66.8-billion annual rate, or more than two-fifths larger than the year-ago figure—and the improvement apparently is continuing in the third quarter. The earlier upsurge in farm exports has recently been complemented by a rise in nonfarm commodities, which accounted for three-fourths of the second-quarter gain. Still, farm exports should remain strong into 1974, on the basis of the calorie needs of many disaster stricken developing countries and the protein requirements of the increasingly affluent countries of Europe and Japan. Bumper crops of grains and soybeans are anticipated in this country, and whatever is not needed at home should be snapped up by foreign buyers.

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Exports have benefitted from this year's depreciation of the dollar and from the continuing effects of earlier currency adjustments. The export expansion may slow down in 1974, however, as traders complete their adjustment to the new exchange-rate relationships and as other countries cool their economies in order to curb inflation.

The developing strength in exports, while a factor of expansion in an already overstimulated domestic economy, could help offset any weakness which might appear in the economy during the coming year. Over the past decade, jobs related to merchandise exports have increased more than 30 percent—half again as fast as total private employment. This sector should become an even more dynamic element now that the dollar is no longer overvalued.

In view of the insatiable demands of the continuing domestic boom, imports rose to a $68.0-billion annual rate in the second quarter, or more than one-fourth higher than a year ago. Import growth has begun to slow, however, at the same time that exports have been booming. Consequently, although the merchandise-trade account remained in deficit during the April-June period (for the ninth consecutive quarter), it has been moving rapidly toward surplus, as was noted above.

The import expansion has been restrained by the high dollar prices of foreign goods, due to two devaluations of the dollar within two years. Moreover, as time goes on, imports may be retarded by the expected deceleration in the American economy and the consequent decreased demand for foreign products—with the major exception of products needed to ease the energy crisis.

Other accounts

The trade account and the J curve do not tell the whole story, since other accounts have also been improving. The travel-and-transportation account should continue to be a large deficit item, although less so than in recent years. Receipts from foreign tourists could rise strongly, on the basis of the depreciated dollar and growing prosperity abroad. U.S. travel abroad meanwhile will be slowed by the higher prices of foreign currencies, and by rising prices abroad. In addition, such payments may be curtailed next year by the slower growth in income here as the economy cools.

The investment income account could continue very strong, in large part because the earnings made on our substantial foreign investments are now worth considerably more than before in terms of dollars. Receipts also may benefit from increased repatriation of earnings from abroad, partly as a reflection of the growing confidence in the dollar. On the other hand, overseas profits (and repatriated earnings) may be hurt in any slowdown of the international economy.

The expected increase in investment income from abroad will have as a partial offset a rising volume of payments to foreigners, reflecting the expansion of foreign investment in the increasingly attractive U.S. economy. Payment outflows currently are also being boosted by the very high level of U.S. interest rates.

Lagged effects

On balance, the nation seems at last to be experiencing the lagged effects of the exchange-rate adjustments that have taken place over the past two years. Moreover, while the dollar has recently recovered some of the ground lost against most major foreign currencies from late May to early July, its value is still well below the rates that prevailed in the early spring. Indeed, at recently prevailing rates, the dollar appears undervalued in terms of most other currencies, and the strong competitive stimulus that this gives U.S. business should help strengthen the trade account for some time to come.

However, the present exchange-rate advantage should tend to be reduced as the trade account improves and as the dollar strengthens under a regime of floating rates. The improvement in the trade balance should in turn contribute to a restoration of confidence in the dollar and to a rising demand for dollars.

Dollar assets, both long-and short term, should appeal to foreign investors at presently prevailing bargain prices and rates of return. This should further strengthen the dollar against foreign currencies, and thus reduce the exchange-rate price advantage associated with an overdepreciated dollar.

Ernest C. Olson

Foreign Investment in Asia

Copies will soon be available of the monograph, Foreign Investment in Asia, by Donald R. Sherk, Professor of Economics at Simmons College in Boston. The study sets forth the present patterns and types of U.S. and Japanese private investment in Asia, projects the investment trends through the 1970s, and discusses the host-country benefits and costs associated with these investments. In addition, it points out the potential areas of conflict implicit in these trends, and offers some suggestions for multilateral cooperation that are designed to maximize the regional economic contribution of the investment flows. . . . Copies of this monograph—single copies only—are available upon request to the Administrative Service Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 397-1137.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/12/73	Change from 9/5/73	Change from year ago Dollar	Change from year ago Percent
Loans adjusted and investments *	75,436	+ 801	+ 10,714	+ 16.55
Loans adjusted—total*	58,361	+ 710	+ 11,002	+ 23.23
Securities loans	1,782	+ 660	+ 87	+ 5.13
Commercial and industrial	20,269	+ 50	+ 3,512	+ 20.96
Real estate	17,279	+ 43	+ 3,030	+ 21.26
Consumer instalment	8,621	+ 12	+ 1,327	+ 18.19
U.S. Treasury securities	5,221	+ 28	− 881	− 14.44
Other securities	11,854	+ 63	+ 593	+ 5.27
Deposits (less cash items)—total*	73,212	+ 481	+ 9,870	+ 15.58
Demand deposits adjusted	21,765	+ 322	+ 1,446	+ 7.12
U.S. Government deposits	445	+ 200	+ 132	+ 42.17
Time deposits—total*	49,667	+ 58	+ 8,269	+ 19.97
Savings	17,380	− 46	− 842	− 4.62
Other time I.P.C.	23,365	− 12	+ 7,158	+ 44.17
State and political subdivisions	5,911	0	+ 816	+ 16.13
(Large negotiable CD's)	12,428	+ 193	+ 6,828	+ 121.93

Weekly Averages of Daily Figures	Week ended 9/12/73	Week ended 9/5/73	Comparable year-ago period
Member Bank Reserve Position			
Excess reserves	− 9	55	− 28
Borrowings	184	225	9
Net free (+) / Net borrowed (−)	− 193	− 170	− 37
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (−)	+ 241	− 752	+ 257
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (−)	+ 905	+ 122	+ 700

*Includes items not shown separately.

Information on this and other publications can be obtained by calling or writing the Administrative Services Department. Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, California 94120. Phone (415) 397-1137.