

Research Department
Federal Reserve
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Dollars and Deficits

According to many headline-writers and telecasters, the dollar has been sharply declining in the foreign-exchange markets, but the picture they draw somehow doesn't jibe with reality. In the first half of October, the trade-weighted value of the dollar was in the middle of a fairly narrow range that has prevailed since late 1975—more specifically, 10.6 percent below its value in May 1970, prior to the breakdown of the old regime of fixed exchange rates. That October figure was less than 2 percent below the March 1977 peak but about 11 percent above the March 1975 recession low.

The explanation for the difference between perception and reality is related to the diverse exchange-rate movements of the nation's major trading partners. The dollar has *depreciated* by 19 percent against the Japanese yen and by 13 percent against the German mark over the past two years, but it has *appreciated* significantly against the currencies of several other major trading partners—for example, by 7 percent against the Canadian dollar, 15 percent against the British pound, and 45 percent against the Mexican peso.

Massive, sudden decline

Still, many observers have expressed fears about the future of the dollar in the wake of the massive and sudden shift toward deficit in the nation's merchandise-

trade account. While the U.S. recorded an unusually large trade surplus of \$9 billion in 1975, the balance shifted to a deficit of like size in 1976—and in the first eight months of 1977 the deficit reached an annual rate of \$30 billion. Moreover, many analysts are forecasting an even larger trade deficit in 1978. To measure the likelihood of this occurrence, we should examine the status of the oil-import trade, the health of our agricultural and industrial exports, and (a related question) the competitiveness of U.S. producers in world markets.

The most important factor in the swing has been the increase in U.S. oil imports, which have risen from less than \$5 billion in 1972 to an estimated \$45 billion this year. A sharp rise in the price of OPEC oil, from \$2.53 to \$13.25 a barrel, helps account for this massive deficit. But in addition, U.S. oil imports have increased 80 percent in volume terms over the past five years, reflecting both a rise in domestic consumption and a decline in domestic output. Roughly two-fifths of the increase in oil imports can be attributed to our reduced production, which suggests a need for expanding Alaskan and other domestic energy sources as well as curbing domestic demand. Restraining imports can be difficult in a growing economy, because every 1-percent increase in GNP typically is accompanied by a 2-percent increase in oil imports.

(continued on page 2)

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The shifts in trade with non-OPEC countries have been somewhat more complex. As expected, non-oil imports have rebounded with the strong recovery in the U.S. economy. After a sharp increase last year from 1975's recession-depressed level, imports are rising again in 1977 by about 20 percent in value terms. Somewhat unexpectedly, however, U.S. exports have lagged over the past two years, rising in value only about 7 percent in both 1976 and 1977. Other nations have limited their purchases in this country because of bumper worldwide grain harvests and, in particular, because of the sluggishness of their own economies.

Export weakness

In the past two years, the U.S. economy has been growing at about a 5½-percent annual rate, in contrast to roughly a 4-percent growth rate in the rest of the industrial world and a 4½-5 percent growth rate in the developing (LDC) countries. This is a sharp reversal of the pattern of the several previous decades, and means a much sharper increase in U.S. imports than in U.S. exports. Business has turned sluggish especially among our more important customers.

The largest, Canada, which buys roughly 20 percent of all U.S. exports, has weakened significantly over the past year or so. The LDC countries, which take another 25 percent of U.S. exports, maintained relatively rapid growth rates until this year, but now many of them

have adopted austerity programs in order to curb the unsustainably large deficits they had incurred in their earlier period of growth. Mexico and Brazil, the fourth and tenth largest U.S. export markets, have both adopted stringent stabilization programs, and U.S. exports thus have dropped 19 percent to both countries over the past year.

Competitive weakness?

Does a sluggish export trade indicate any decline in the competitiveness of the U.S. economy? One possible measure would be a comparison of relative prices adjusted for exchange-rate changes. Since the end of 1975, the year of our record trade surplus, U.S. inflation has been lower than the weighted-average inflation rate experienced by our major trading partners. In the same period the trade-weighted exchange rate of the dollar has appreciated slightly. By this standard, therefore, our competitive position has neither improved nor depreciated substantially in the past two years.

The recent performance of U.S. exports to key LDC markets illustrates some of the complex factors involved—few of which indicate any decline in competitiveness. Between 1970 and 1976, both the U.S. and Japan increased their market shares, outperforming the other major industrial countries in LDC markets—but the U.S. (unlike Japan) lost all of that earlier gain over the past year. The major reason concerns the geographic distribu-

tion of trade. U.S. sales are heavily concentrated in Latin America, where the absolute volume of imports declined, while the Japanese sell more than two-thirds of their LDC-destined goods to Asian customers, whose markets expanded sharply in 1976-77. A second reason for this relative decline was the improvement in harvests abroad, which masked an increase in the U.S. share of manufactured imports in several major LDC markets. In fact, U.S. manufacturers maintained or increased their market share in 13 of 18 major non-OPEC markets in early 1977.

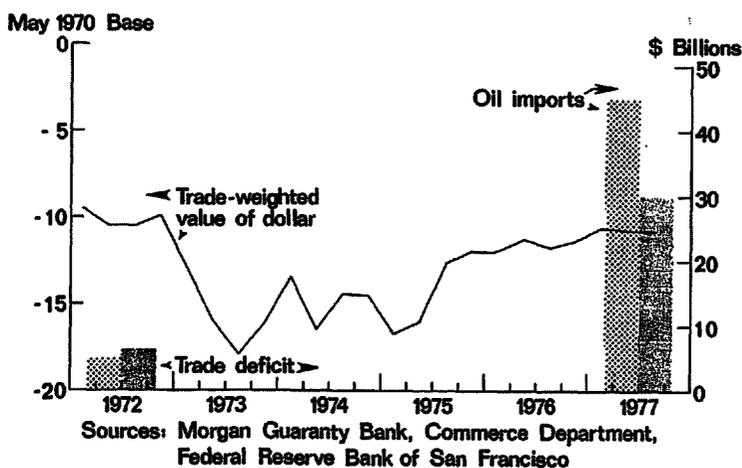
Future deficit?

Many observers see little chance of a reduction in the merchandise-trade deficit in 1978. Domestic petroleum supplies will increase because of the opening of the Alaska pipeline, but oil imports should still continue high because of purchases for the strategic petroleum reserve. U.S. farm exports may remain weak because of good harvests abroad

and large carryovers in the world grain market. Meanwhile, the trade balance in industrial products may remain unfavorable, because of the continued pattern of sluggish growth in overseas economies.

The current-account deficit (which contains transfers and services as well as goods receipts) will be much smaller than the merchandise-trade deficit, if there is a repeat of the patterns visible in the first half of 1977. During that period, transfer payments (private and public) resulted in a net annual outflow of \$5 billion, but the overall services category produced a net annual surplus of \$17 billion. (This category includes investment income, military transactions, transportation, insurance and tourism.) Nonetheless, if another massive trade deficit occurs, the current-account deficit would remain substantial. In that case, trade problems and the state of the dollar will remain in the headlines for some time to come.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/12/77	Change from 10/5/77	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	101,682	+ 285	+ 11,654	+ 12.94
Loans (gross, adjusted)—total	79,296	+ 293	+ 10,573	+ 15.38
Security loans	1,971	- 462	+ 408	+ 26.10
Commercial and industrial	24,170	+ 210	+ 1,865	+ 8.36
Real estate	25,947	+ 123	+ 5,056	+ 24.20
Consumer instalment	13,694	+ 25	+ 1,890	+ 16.01
U.S. Treasury securities	7,646	- 480	- 1,019	- 11.76
Other securities	14,740	+ 472	+ 2,100	+ 16.61
Deposits (less cash items)—total*	100,459	+ 194	+ 9,237	+ 10.13
Demand deposits (adjusted)	29,555	+ 616	+ 2,727	+ 10.16
U.S. Government deposits	305	- 150	- 6	- 1.93
Time deposits—total*	68,444	- 329	+ 5,924	+ 9.48
States and political subdivisions	5,252	- 26	+ 136	+ 2.66
Savings deposits	31,837	- 77	+ 3,790	+ 13.51
Other time deposits‡	29,054	- 177	+ 2,101	+ 7.80
Large negotiable CD's	11,373	- 203	+ 321	+ 2.90
Weekly Averages of Daily Figures	Week ended 10/12/77	Week ended 10/5/77	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	+ 118	+ 92	+ 18	
Borrowings	107	38	0	
Net free(+)/Net borrowed (-)	+ 11	+ 54	+ 18	
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales (-)	+ 277	- 590	+ 424	
Transactions with U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 480	+ 171	+ 1,164	

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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