THE TRADE DEFICIT: HOW MUCH OF A PROBLEM? WHAT REMEDY?

889

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OF THE

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THE TRADE DEFICIT: HOW MUCH OF A PROBLEM? WHAT REMEDY?

TUESDAY, OCTOBER 11, 1977

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL ECONOMICS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9 a.m., in room 210, Cannon House Office Building, Hon. Henry S. Reuss (cochairman of the subcommittee) presiding.

Present: Representatives Reuss and Hamilton; and Senator Roth.

Also present: Louis C. Krauthoff II, assistant director; Thomas F. Dernburg, Sarah Jackson, John R. Karlik, Katie MacArthur, and William Morgan, professional staff members; Mark Borchelt, administrative assistant; and Stephen J. Entin, George D. Krumbhaar, Jr., and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, COCHAIRMAN

Representative REUSS. The Subcommittee on International Economics will be in order for a hearing to consider the question of "The Trade Deficit: How Much of a Problem? What Remedy?" During the first 8 months of this year, our country ran a trade deficit at an annual rate of more than $26 billion in contrast to the $9 billion actual 1976 deficit.

The Secretary of the Treasury has said that this year's deficit may be as large as $30 billion. The purpose of our hearing is to determine the seriousness of the problem and what, if anything, should be done to reduce the trade deficit. Our announcement of these hearings listed nine questions detailing the issues that seemed relevant to the problem.

What is the outlook for the U.S. trade balance in 1978 and 1979?

Does the trade deficit reflect a deterioration of this country's ability to compete in world markets for manufactured goods?

What is the impact of the trade deficit on output in the United States and on domestic employment?

To what extent does the deficit result from rigidities in the supposedly freely floating exchange rate system?

What impact is the continuing deficit likely to have on OPEC and other foreign nations' investment in the United States?

Are the substantial capital inflows the United States has attracted from abroad in recent years a blessing—in that these funds have helped the United States to pay for rapidly growing oil imports—

or a burden—in that capital inflows have sustained the value of the dollar in exchange markets and impaired the competitiveness of U.S. export industries?

To what extent would dollar depreciation reduce the deficit?

Does the large and growing size of the deficit undermine the ability of the United States to exercise international economic leadership?

What, if anything, should this country do to reduce the trade deficit?

We have an active morning laid out for us with an outstanding panel of private witnesses testifying and being questioned from now until 11, and then a group of spokesmen from the administration. Our witnesses are Mr. John Lichtblau, executive director of the Petroleum Industry Research Foundation, a widely recognized expert on energy economics; Mr. Robert L. Slighton, vice president for international economic forecasting, Chase Manhattan Bank, formerly associated with the Treasury, the Economic Research Division. We will also hear on this panel from Prof. Benjamin J. Cohen, professor of economics, Fletcher School of Law and Diplomacy, Tufts University; and Mr. Lawrence Krause, senior fellow, Brookings Institution.

Gentlemen, please proceed in any way you wish.

STATEMENT OF ROBERT L. SLIGHTON, VICE PRESIDENT FOR INTERNATIONAL ECONOMIC FORECASTING, CHASE MANHATTAN BANK, N.A.

Mr. SLIGHTON. Thank you, Mr. Chairman. I am very pleased to testify, and I hope my remarks will be of assistance to the subcommittee.

I am an officer of the Chase Manhattan Bank, but my appearance here today is as a private witness. My conclusions are my own and not those of the bank or bank management.

Mr. Chairman, members of the subcommittee, I am Robert L. Slighton, vice president for international economic forecasting, of the Chase Manhattan Bank. I am pleased to have this opportunity to testify on the subject of the causes and consequences of the U.S.-trade deficit, and I hope my remarks will be of some assistance to the subcommittee in its present inquiry.

My testimony today will be directed to three questions. First, why has the U.S.-trade account shifted from surplus to deficit? Second, what changes can be expected in the U.S.-trade account over the next 2 years? And third, given the potential economic consequences of the U.S.-trade deficit, what policy initiatives appear appropriate?

WHY HAS THE TRADE BALANCE SHIFTED?

The deterioration of the U.S.-trade account in 1976 and 1977 reflects a normal growth of U.S. imports given the rate of expansion of the U.S. economy in conjunction with a major slowdown in the growth of U.S. exports. The fact that the shift in the U.S.-trade deficit does not reflect an unusual spurt of imports is the first point I want to make in commenting on the causes of that turnaround. The relationship between the growth of imports and growth of in-

come during the current recovery is not significantly higher than during earlier periods.

The second point I want to make is that the strong U.S. demand for imports is only partly a matter of increased demand for foreign oil. Imports of mineral fuels increased $7½ billion in 1976 and are likely to increase by $10 billion in 1977. Other imports increased over $17 billion in 1976 and will probably increase by $15 billion in 1977. The trade balance at an annual rate has deteriorated by about $37 billion since 1975, $20 billion of the deterioration occurring this year. It would have shifted by something like $19 billion even if the value of oil imports had remained constant.

The third point I want to make with respect to the causes of the turnaround in the trade account is that there is no single explanation for the slowdown in the growth of U.S. exports. In part it reflects an improvement over the past several years in the balance between world food production and consumption. More important is the relatively low level of investment around the world, for capital goods account for more than half of U.S. nonagricultural exports. U.S. exports of machinery and transport equipment have shown virtually no increase this year in value terms. In terms of volume, this category of exports is actually decreasing in 1977. The slowdown in exports of capital goods is particularly marked in the case of trade with the LDC's. This year, exports of machinery and transport equipment appear stagnant even to the oil-exporting countries.

The slowdown in U.S. exports of capital goods raises two questions that I cannot answer satisfactorily. First, does this slowdown simply reflect low levels of foreign investment or does it also reflect a decreased price competitiveness of U.S.-capital goods? Second, to the extent this slowdown is a cyclical phenomenon—that is, reflecting low levels of investment abroad—can we expect a cyclical upturn in demand in the near future?

With respect to the first of these questions, it has recently been argued that the 6 percent increase in the trade-weighted relative price of U.S.-manufactured goods adjusted for exchange rate changes since March 1973 indicates a decline in the competitiveness of U.S. exports. Perhaps. Perhaps not. It is interesting to note that "expert" opinion, for whatever that is worth, was that the dollar was substantially "undervalued" in March 1973. Perhaps this change in relative prices simply reflects a correction of that undervaluation. In any event, the trade-weighted relative price of U.S.-manufactured exports adjusted for exchange rate changes has shown virtually no net change since the autumn of 1975—the period in which the trade account has moved from surplus to deficit.

The second question relating to the slowdown in U.S. exports of capital goods is whether this represents a cyclical phenomenon that will be reversed in the foreseeable future. I would like to discuss this in the context of the more general question of what changes can be expected in the U.S.-trade account in 1978 and 1979.

HAS THE TRADE DEFICIT PEAKED?

Predictions of trade balances are notoriously inaccurate, and I have no reason to believe that I have any unique insights as to these mat-

ters. Nevertheless, I do think there is reasonable justification for concluding that the deficit has not peaked—that some increase in the trade deficit will occur in 1978 and that a decline in the deficit cannot be expected before 1979 at the earliest.

Those who conclude that the deficit has already peaked—or at least has reached a plateau—base their argument on a reversal of the trend toward increasing oil imports arising from the coming onstream of Alaskan oil production. It is true that oil is a bright spot. The volume of oil imports may well decrease in 1978. Depending on the weather, the size of the Federal stockpiling program, and the vagaries of domestic production and consumption, this decline could amount to something in the order of 500,000 barrels per day, a reduction of about 5½ percent. Such a projection may be too optimistic, but at worst the volume of oil imports is not likely to increase by a significant amount next year.

Oil prices are more difficult to forecast. Barring a switch in OPEC pricing formulas resulting from a major depreciation of the dollar, I assume the dollar price of imported oil and oil products will remain roughly stable over the first half of 1978 and then increase something like 7 percent in July. If this price scenario proves to be realistic, the value of U.S.-oil imports will not show much change in 1978.

The outlook for the rest of the trade balance is considerably less promising, however. The key factor here is relative growth rates. The rate of growth of the U.S. economy was one-third higher than the rest of the OECD in 1976 and appears likely to be 60 percent larger in 1977. Next year, assuming a 4 to 4½ percent growth rate in the United States, the growth differential relative to the rest of the OECD will be at least as high as in 1976. The growth differential between the United States and the other industrialized economies has probably peaked, but it is highly likely to persist at least through 1978.

The prospects for a reversal of the deterioration of the U.S.-trade balance with the nonoil LDC's are considerably brighter, however. Some improvement in investment rates and growth rates for this group of countries in the aggregate seems probable, and the U.S.-import bill for certain LDC exports, coffee in particular, will reflect lower prices.

Putting all these factors together, it seems very likely that the U.S.-trade deficit will be larger in 1978 than in 1977. An argument for a stable or declining deficit would presume either unwarrantedly optimistic assumptions about economic growth abroad or unwarrantedly pessimistic assumptions about U.S. growth. How much the deficit is likely to increase is quite uncertain, however. The Morgan Guaranty Trust Co., in its publication "World Financial Markets," recently hazarded the guess that the U.S.-trade balance would deteriorate $5 billion in 1978 but that this shift would be largely offset by a $3 billion increase in the surplus on services. That estimate is, of course, highly speculative, but I see no compelling reason to argue with it.

I do not have a trade deficit scenario for 1979 that I find particularly convincing. A narrowing or reversal of the growth differential between the United States and the other industrialized countries is possible. If so, the U.S.-trade deficit would decrease in 1979. Several

comments need to be made in this connection, however. Most of the industrialized economies are finding the process of adjustment to higher energy prices extremely difficult, and many have been unable to follow an adjustment path other than the path of forced adjustment through growth restraint. Investment in these economies, and hence U.S. exports of capital goods, may well remain sluggish for some time.

There are other reasons to be concerned about future U.S. export performance. Barriers to growth of agricultural imports by the industrialized economies show few signs of being relaxed. U.S. foreign direct investment in manufacturing appears to be slowing down. And the technology gap between the United States and the rest of the world is probably continuing to narrow.

The third question I want to discuss is the critical one of what should be done, but before I offer my conclusions as to just what actions are appropriate, I would like to make a series of points concerning the economic consequences of the trade deficit and the likely effects of various measures that might be taken to reduce that deficit. The first point I want to make is that there is no strict relationship between a change in the trade deficit and domestic output and employment. It is true enough that other things being equal, U.S. output and employment would increase if net exports were to increase. It does not follow, however, that an increase in net exports would lead to an increase in domestic output and employment. Whether this would be the case depends on how the increase in net exports were achieved.

My second point is that I find no convincing evidence that the recent slowdown in U.S. exports and strength of imports into the United States reflect a deterioration in the price competitiveness of U.S. products. Further, to achieve a significant reduction in the U.S.-trade deficit solely through a change in relative prices would require a depreciation of the dollar of sufficient magnitude to have a noticeable impact on the rate of domestic inflation. That is assuming that such a depreciation could be sustained over time, an assumption that I find dubious. The commodity structure of U.S. exports and imports is such that the balance of trade does not appear to be strongly price sensitive in the long run. In the short run, a depreciation of the dollar would probably result in a temporary deterioration of the trade account.

The third point I would like to make is that the failure of the dollar to depreciate in the face of the rapid turn-around in the U.S. current account is the result of a foreign demand for dollar-denominated assets that is primarily motivated by portfolio considerations. Rigidities in the supposedly freely floating exchange rate system arising from official intervention in exchange markets are not an important cause of the strength of the dollar. Except in the United Kingdom, I suspect most official intervention over the past year that has had the explicit objective of influencing the average level of the exchange rate has served to prevent the appreciation of the dollar, not the dollar's depreciation. Japan is another possible exception, although in this case the net official influence over exchange rates would have been exercised primarily through controls over capital movement rather than through explicit market intervention.

The final preliminary point I would like to make is that stability of the effective exchange rate in the face of large current account deficits is not a problem requiring an exchange rate policy solution if the cause of that stability is a capital inflow that can be expected to remain reasonably stable over time. The appropriate exchange rate is the rate that clears the market for dollars, not the rate that balances the current account. The potential strength of capital inflows into the United States is such that a continuing current account deficit can be financed with little if any depreciation in the trade-weighted exchange value of the dollar and a relatively modest depreciation of the bilateral rates between the dollar and the deutsche mark-bloc currencies and the yen. This is possible but not inevitable, and herein lies a major potential problem created by a large U.S.-trade deficit. That is the problem of exchange instability.

The most worrisome aspect of the trade deficit in my opinion is not the likelihood that it will generate a further depreciation of the dollar but the possibility that the uncertainties associated with its finance will make the dollar prices of the mark and the yen relatively more unstable. This possibility is worrisome on two accounts. It is undesirable in and of itself. It discourages trade and foreign direct investment and encourages protectionist sentiment abroad. And it is worrisome in that governments may react to increased rate variability by substituting administrative judgments for market judgments in a much more thoroughgoing manner than heretofore.

What then should be done? Of greatest immediate significance would be the continued public affirmation by U.S. policymakers of our commitment to a strong U.S. dollar. Where it is determined that foreign policy actions have been undertaken with the explicit objective of preventing exchange rate adjustment, the U.S. response should be framed with due regard for the hypersensitivity of exchange markets to U.S. pronouncements.

A second, and more constructive policy step would be the development of an effective U.S.-energy program that is designed to work on both the supply and demand sides of the energy problem. The argument here is well known. I would only like to add the comment that failure to adopt a strong energy policy would introduce a further element of uncertainty and hence variability in foreign exchange markets.

A third necessary step is to enlarge the supply of official international credit. The process of adjusting to the increase in energy prices is long and painful. An increased supply of public international credit that is conditioned to the adoption of appropriate domestic policies would significantly reduce the likelihood that this adjustment will take the form of beggar-thy-neighbor policies that would depress the growth of the world economy. The proposed supplementary lending facility within the IMF is a step in the right direction, but it is not sufficient by itself.

What else? We can continue to press for more expansionary policies in those countries with strong external payments positions, but this policy has had limited success up to now and does not appear likely to prove more effective in the future. A further course of action that has been recommended is to work for selective rate

adjustment—in particular an appreciation of the yen relative to the dollar. This would be an unfortunate policy if pursued in public. I am not particularly confident whether it could be pursued quietly. I am not sure I have an answer to that question, but I do have a few tentative remarks.

A significant appreciation of the yen would very likely lead to a relatively quick slowdown in the growth of total Japanese exports. I doubt, however, that Japanese exports to the United States would be much affected in the short run, since relatively few of our imports from Japan are commodities where Japanese comparative advantage is marginal.

The Japanese trade surplus may be partly the result of an inappropriate exchange rate, but the more fundamental problem is the system of quota restrictions and internal marketing arrangements that make foreign penetration of Japanese markets very difficult. A long-run solution requires an attack on this system, and the observation that the Japanese would find it very difficult to loosen import restrictions is hardly a sufficient argument for not pressing forward.

In these circumstances, rather than pressing for an explicit bilateral exchange rate adjustment, it seems to be more appropriate to press for at least a partial dismantling of the complex web of controls maintained over capital movements to and from Japan. We suspect that these controls have worked to depress the value of the yen. Now is a good time to find out if these suspicions are correct.

Thank you.

[The prepared statement of Mr. Slighton follows:]

PREPARED STATEMENT OF ROBERT L. SLIGHTON

Mr. Chairman, members of the Subcommittee. I am Robert L. Slighton, Vice President for International Economic Forecasting of the Chase Manhattan Bank. I am pleased to have this opportunity to testify on the subject of the causes and consequences of the U.S. trade deficit, and I hope my remarks will be of some assistance to the Subcommittee in its present enquiry.

My testimony today will be directed to three questions. First, why has the U.S. trade account shifted from surplus to deficit? Second, what changes can be expected in the U.S. trade account over the next two years? And third, given the potential economic consequences of the U.S. trade deficit, what policy initiatives appear appropriate?

WHY HAS THE TRADE BALANCE SHIFTED?

The deterioration of the U.S. trade account in 1976 and 1977 reflects a normal growth of U.S. imports given the rate of expansion of the U.S. economy in conjunction with a major slowdown in the growth of U.S. exports. The fact that the shift in the U.S. trade deficit does not reflect an unusual spurt of imports is the first point I want to make in commenting on the causes of that turnaround. In spite of the well publicized incursions of imports into the domestic markets for color television, steel, clothing and shoes, there is no evidence that imports are growing at an abnormally rapid rate given the growth of domestic demand. The relationship between the growth of imports and growth of income during the current recovery is not significantly higher than during earlier periods.

The second point I want to make is that the strong U.S. demand for imports is only partly a matter of increased demand for foreign oil. Imports of mineral fuels increased $7½ billion in 1976 and are likely to increase by $10 billion in 1977. Other imports increased over $17 billion in 1976 and will probably increase by $15 billion in 1977. The trade balance as an annual rate has deteriorated by about $37 billion since 1975, $20 billion of the deterioration occurring this year. It would have shifted by something like $19 billion even if the value of oil imports had remained constant.

The third point I want to make with respect to the causes of the turnaround in the trade account is that there is no single explanation for the slowdown in the growth of U.S. exports. In part it reflects an improvement over the past several years in the balance between world food production and consumption. More important is the relatively low level of investment around the world, for capital goods account for more than half of U.S. non-agricultural exports. U.S. exports of machinery and transport equipment have shown virtually no increase this year in value terms. In terms of volume, this category of exports is actually decreasing in 1977. The slowdown in exports of capital goods is particularly marked in the case of trade with the LDCs. This year, exports of machinery and transport equipment appear stagnant even to the oil-exporting countries.

The slowdown in U.S. exports of capital goods raises two questions that I cannot answer satisfactorily. First, does this slowdown simply reflect low levels of foreign investment or does it also reflect a decreased price competitiveness of U.S. capital goods? Second, to the extent this slowdown is a cyclical phenomenon—that is, reflecting low levels of investment abroad—can we expect a cyclical upturn in demand in the near future?

With respect to the first of these questions, it has recently been argued that the 6% increase in the trade-weighted relative price of U.S. manufactured goods adjusted for exchange rate changes since March 1973 indicates a decline in the competitiveness of U.S. exports. Perhaps. Perhaps not. It is interesting to note that "expert" opinion, for whatever that is worth, was that the dollar was substantially "undervalued" in March 1973. Perhaps this change in relative prices simply reflects a correction of that undervaluation. In any event, the trade-weighted relative price of U.S. manufactured exports adjusted for exchange rate changes has shown virtually no net change since the autumn of 1975—the period in which the trade account has moved from surplus to deficit.

I am inclined to believe that prices are part of the explanation why U.S. exports of capital goods have become sluggish in recent years, but the explanation lies not with changes in relative prices but absolute price levels. That is, there has been something of a switch from U.S. to foreign suppliers of capital equipment not because U.S. goods have become relatively more expensive but because they often are top-of-the-line items that are expensive in absolute terms. I think this is particularly evident in the slowdown of exports to the oil-exporting countries. Given the increasingly sober judgment exercised in both the OPEC countries and the non-oil LDCs as to the technological sophistication required of their capital goods imports, U.S. exports have probably suffered.

The second question relating to the slowdown in U.S. exports of capital goods is whether this represents a cyclical phenomenon that will be reversed in the foreseeable future. I would like to discuss this in the context of the more general question of what changes can be expected in the U.S. trade account in 1978 and 1979.

HAS THE TRADE DEFICIT PEAKED?

Predictions of trade balances are notoriously inaccurate, and I have no reason to believe that I have any unique insights as to these matters. Nevertheless, I do think there is reasonable justification for concluding that the deficit has not peaked—that some increase in the trade deficit will occur in 1978 and that a decline in the deficit cannot be expected before 1979 at the earliest.

Those who conclude that the deficit has already peaked—or at least has reached a plateau—base their argument on a reversal of the trend toward increasing oil imports arising from the coming onstream of Alaskan oil production. It is true that oil is a bright spot. The volume of oil imports may well decrease in 1978. Depending on the weather, the size of the federal stockpiling program, and the vagaries of domestic production and consumption, this decline could amount to something in the order of 500,000 barrels per day, a reduction of about 5½%. Such a projection may be too optimistic, but at worst the volume of oil imports is not likely to increase by a significant amount next year.

Oil prices are more difficult to forecast. Barring a switch in OPEC pricing formulae resulting from a major depreciation of the dollar, I assume the dollar price of imported oil and oil products will remain roughly stable over the first half of 1978 and then increase something like 7% in July. If this price scenario proves to be realistic, the value of U.S. oil imports will not show much change in 1978.

The outlook for the rest of the trade balance is considerably less promising, however. The key factor here is relative growth rates. The rate of growth of the U.S. economy was one-third higher than the rest of the OECD in 1976 and appears likely to be 60% larger in 1977. Next year, assuming a 4–4½% growth rate in the U.S., the growth differential relative to the rest of the OECD will be at least as high as in 1976. The growth differential between the U.S. and the other industrialized economies has probably peaked, but it is highly likely to persist at least through 1978.

The prospects for a reversal of the deterioration of the U.S. trade balance with the non-oil LDCs are considerably brighter. Some improvement in investment rates and growth rates for this group of countries in the aggregate seems probable, and the U.S. import bill for certain LDC exports, coffee in particular, will reflect lower prices.

Putting all these factors together, it seems highly likely that the U.S. trade deficit will be larger in 1978 than in 1977. An argument for a stable or declining deficit would presume either unwarrantedly optimistic assumptions about economic growth abroad or unwarrantedly pessimistic assumptions about U.S. growth. How much the deficit is likely to increase is quite uncertain, however. The Morgan Guaranty Trust Company, in its publication World Financial Markets, recently hazarded the guess that the U.S. trade balance would deteriorate $5 billion in 1978 but that this shift would be largely offset by a $3 billion increase in the surplus on services. That estimate is, of course, highly speculative, but I see no compelling reason to argue with it.

I do not have a trade-deficit scenario for 1979 that I find particularly convincing. A narrowing or reversal of the growth differential between the U.S. and the other industrialized countries is not improbable. If so, the U.S. trade deficit would decrease in 1979. Several comments need to be made in this connection, however. Most of the industrialized economies are finding the process of adjustment to higher energy prices extremely difficult, and many have been unable to follow an adjustment path other than the path of forced adjustment through growth restraint. Investment in these economies, and hence U.S. exports of capital goods, may well remain sluggish for some time.

There are other reasons to be concerned about future U.S. export performance. Barriers to growth of agricultural imports by the industrialized economies show few signs of being relaxed. U.S. foreign direct investment in manufacturing appears to be slowing down. And the technology gap between the U.S. and the rest of the world is probably continuing to narrow.

WHAT SHOULD BE DONE?

If the trade deficit and current account deficit develop as I have suggested they will, do we have a problem? The answer is clearly yes. Given that we have a problem, are there policy initiatives that should be taken? The answer again is yes. I would like to stress at the outset, however, that perhaps the most important potential problem arising out of a large U.S. trade deficit is that it increases the likelihood that strong protectionist measures will be adopted in this country and abroad. Policy action is required, but a reversal of the U.S. commitment to freer trade and freedom of international capital movements is not an appropriate solution.

Before I offer my conclusions as to just what actions are appropriate, I would like to make a series of points concerning the economic consequences of the trade deficit and the likely effects of various measures that might be taken to reduce that deficit. The first point I want to make is that there is no strict relationship between a change in the trade deficit and domestic output and employment. It is true enough that other things being equal, U.S. output and employment would increase if net exports were to increase. It does not follow, however, that an increase in net exports would lead to an increase in domestic output and employment. Whether this would be the case depends on how the increase in net exports were achieved.

My second point is that I find no convincing evidence that the recent slowdown in U.S. exports and strength of imports into the U.S. reflect a deterioration in the price competitiveness of U.S. products. Further, to achieve a significant reduction in the U.S. trade deficit solely through a change in relative prices would require a depreciation of the dollar of sufficient magnitude to have a noticeable impact on the rate of domestic inflation. That is assuming that such a depreciation could be sustained over time, an assumption that I

find dubious. The commodity structure of U.S. exports and imports is such that the balance of trade does not appear to be strongly price sensitive in the long run. In the short run, a depreciation of the dollar would probably result in a temporary deterioration of the trade account.

The third point I would like to make is that the failure of the dollar to depreciate in the face of the rapid turnaround in the U.S. current account is the result of a foreign demand for dollar-denominated assets that is primarily motivated by portfolio considerations. Rigidities in the supposedly freely floating exchange rate system arising from official intervention in exchange markets are not an important cause of the strength of the dollar. Except in the United Kingdom, I suspect most official intervention over the past year that has had the explicit objective of influencing the average level of the exchange rate has served to prevent the appreciation of the dollar, not the dollar's depreciation. Japan is another possible exception, although in this case the net official influence over exchange rates would have been exercised primarily through controls over capital movement rather than through explicit market intervention.

The final preliminary point I would like to make is that stability of the effective exchange rate in the face of large current account deficits is not a problem requiring an exchange-rate policy solution if the cause of that stability is a capital inflow that can be expected to remain reasonably stable over time. The appropriate exchange rate is the rate that clears the market for dollars, not the rate that balances the current account. The potential strength of capital inflows into the U.S. is such that a continuing current account deficit can be financed with little if any depreciation in the trade-weighted exchange value of the dollar and a relatively modest depreciation of the bilateral rates between the dollar and the DM-bloc currencies and the yen. This is possible but not inevitable, and herein lies a major potential problem created by a large U.S. trade deficit. That is the problem of exchange instability.

The most worrisome aspect of the trade deficit in my opinion is not the likelihood that it will generate a further depreciation of the dollar but the possibility that the uncertainties associated with its finance will make the dollar prices of the mark and the yen relatively more unstable. This possibility is worrisome on two accounts. It is undesirable in and of itself. It discourages trade and foreign direct investment and encourages protectionist sentiment abroad. And it is worrisome in that governments may react to increased rate variability by substituting administrative judgments for market judgments in a much more thoroughgoing manner than heretofore. The argument that greater efforts should be made to smooth shortrun variations in dollar exchange rates, particularly by the U.S., has a great deal of inherent appeal. But there is a danger that a policy of "leaning against the wind" will harden into a policy of maintaining an exchange rate target.

What then should be done? Of greatest immediate significance would be the continued public affirmation by U.S. policymakers of our commitment to a strong U.S. dollar. Where it is determined that foreign policy actions have been undertaken with the explicit objective of preventing exchange rate adjustment, the U.S. response should be framed with due regard for the hyper-sensitivity of exchange markets to U.S. pronouncements.

A second, and more constructive policy step would be the development of an effective U.S. energy program that is designed to work on both the supply and demand sides of the energy problem. The argument here is well known. I would only like to add the comment that failure to adopt a strong energy policy would introduce a further element of uncertainty and hence variability in foreign exchange markets.

A third necessary step is to enlarge the supply of official international credit. The process of adjusting to the increase in energy prices is long and painful. An increased supply of public international credit that is conditioned to the adoption of appropriate domestic policies would significantly reduce the likelihood that this adjustment will take the form of beggar-thy-neighbor policies that would depress the growth of the world economy. The proposed supplementary lending facility within the IMF is a step in the right direction, but it is not a sufficient response.

What else? We can continue to press for more expansionary policies in those countries with strong external payments positions, but this policy has had limited success up to now and does not appear likely to prove more effective in the future. A further course of action that has been recommended is to work for selective rate adjustment—in particular an appreciation of the yen relative

to the dollar. I have already commented on the unfortunate consequences of pursuing such a policy in public. What I have left unsaid is whether such a step would be desirable if it could be pursued quietly. I am not at all sure that I have an answer to that question.

A significant appreciation of the yen would very likely lead to a relatively quick slowdown in the growth of total Japanese exports. I doubt, however, that Japanese exports to the United States would be much affected in the short run, since relatively few of our imports from Japan are commodities where Japanese comparative advantage is marginal.

The Japanese trade surplus may be partly the result of an inappropriate exchange rate, but the more fundamental problem is the system of quota restrictions and internal marketing arrangements that make foreign penetration of Japanese markets very difficult. A long-run solution requires an attack on this system, and the observation that the Japanese would find it very difficult to loosen import restrictions is hardly a sufficient argument for not pressing forward.

In these circumstances, rather than pressing for an explicit bilateral exchange rate adjustment, it seems to me more appropriate to press for at least a partial dismantling of the complex web of controls maintained over capital movements to and from Japan. We suspect that these controls have worked to depress the value of the yen. Now is a good time to find out if these suspicions are correct.

Representative REUSS. Thank you very much, Mr. Slighton.

Mr. Lichtblau, would you proceed? We will hear from all the witnesses before we inquire.

STATEMENT OF JOHN H. LICHTBLAU, EXECUTIVE DIRECTOR, PETROLEUM INDUSTRY RESEARCH FOUNDATION, INC.

Mr. LICHTBLAU. Thank you very much, Mr. Chairman, for inviting me to today's hearings. Following your request, I will address myself primarily to the present and future role of oil imports in our trade balance.

As our trade balance has been moving from last year's substantial surplus into this year's substantial deficit much attention has been given to the rapidly rising volume and cost of our oil imports. A figure of $45 billion is being officially quoted as the likely cost of our oil imports this year. The figure would seem to apply to the landed—c.i.f.—cost of oil imports. The f.o.b. value—the definition used in our balance of payments statistics—will of course be somewhat lower, probably $42–$42.5 billion for the year; in 1976 our import costs were about $32 billion—as shown in the table. About two-thirds of the value increase will be due to higher volume, the remainder to higher prices and increased imports of higher value products such as heating oil in the first quarter.

[The table referred to follows:]

F.O.B. VALUE OF U.S. PETROLEUM IMPORTS

	Total value (millions of dollars)	Volume (thousands of barrels per day)	Change percent from previous year	
			Value	Volume
1972	4,798	4,726.8		
1973	7,765	6,320.6	62	34
1974	24,668	6,112.5	218	(3)
1975	25,197	5,989.4	2	(2)
1976	32,226	7,229.4	28	21
1977 estimated	42,200	8,700	31	20

Source: U.S. Department of Commerce, FT-900 Series.

Mr. LICHTBLAU. The projected $10 billion increase in our oil import cost this year has naturally given rise to the question of whether we can "afford" oil imports of this magnitude. The answer from some members of the administration as well as some other analysts has been an emphatic no, with the magnitude of the quoted figure presumed to be sufficient evidence by itself that our oil imports must be curbed. Yet, I believe the question of what level of oil imports we can afford, and any meaningful answer to it, is much more complex than that. A large amount or even a large increase from a large amount, taken by itself, does not tell us anything about what we can or cannot afford.

Our oil import problem has been identified as a security problem and a potential resource problem. Having to depend for 46 percent of our oil requirements on foreign sources, with a very high concentration on one area, entails certain political risks. It also makes us indirectly subject to the individual resource policies of the major oil suppliers which in the future may differ from our interests. In addition, in the view of most petroleum geologists, physical resource constraints are likely to appear before the end of the next decade if the United States and the rest of the world should continue to increase their oil requirements at the long-term pre-1973 rate of about 7 percent annually or even at this and last year's average rate of 5 to 5½ percent.

These factors provide the rationale for our policy to curb the growth in oil imports. If they did not exist, if the known oil reserves around the world were substantially larger than they are and much more evenly distributed, geographically and politically, would oil imports still represent a problem at this time because of their cost? I believe the indications are to the contrary: The value of oil imports has risen by nearly 600 percent between 1972 and 1976, yet in all but one of these years our trade balance of goods and services was positive. Our current account balance was positive in only one of the last 3 years; but it was also negative in each of the 6 years prior to 1973 when oil prices were relatively low and oil accounted for less than 6 percent of total imports compared to about 20 percent last year. Furthermore, the deficits after 1973 were, on the whole, no larger than those before.

Thus, at least through 1976 the staggering increase in the value of oil imports has not impaired our ability to pay for them, as evidenced by the overall balances in our foreign transactions. In large part the reason lies in the fact that the OPEC oil price increases affected both sides of the ledger. For instance, U.S. merchandise exports to OPEC members rose from $3.6 billion in 1973 to $12.6 billion in 1976, as the following table shows.

[The table referred to follows:]

U.S. Merchandise Exports to OPEC Members

	Billions
1973	3. 6
1974	6. 7
1975	10. 7
1976	12. 6
1977 estimated	14. 7

Source: U.S. Department of Commerce.

Mr. LICHTBLAU. In addition to these exports, our service exports and military exports to OPEC members, particularly those in the Middle East, have also increased very sharply. All these increases are of course the direct result of the rise in OPEC oil prices. So is the increase in our petroleum exports from $500 million in 1973 to $1 billion in 1976.

There are still other less measurable but no less real balance of payments offsets to the cost of U.S. oil imports. Thus, OPEC's total merchandise imports rose from $20 billion to $67 billion between 1973 and 1976. Last year, the United States supplied directly less than 20 percent of this total. But the foreign affiliates of U.S. firms participated on a significant scale in the rest and their remittances of earnings and dividends to the United States improved correspondingly. U.S. exports to a number of non-OPEC nations were also higher because of these nation's exports to OPEC. Similarly, U.S. bank earnings abroad have been favorably affected by access to OPEC surplus funds for the purpose of foreign lending. All these factors and probably some others, such as part of the U.S. foreign oil industry's repatriated income—$4.3 billion last year—must be taken into account in determining the total impact of the cost of foreign petroleum on our balance of payments.

This year our trade balance of goods and services is likely to show a $8–$9 billion deficit, and our current account may be $18 billion in the red, according to a recent administration estimate. Obviously, if oil imports had risen much less this year than the projected $10 billion, both these deficts would be correspondingly smaller. However, in part the high level of oil imports reflects exceptional weather conditions this year: the unusually cold winter with its higher heating requirements and the drought in the West requiring the substitution of oil-fired power generation for water power in many utilities.

But whatever the reason for this year's deficit, so far, it is not of such magnitude that it cannot continue for a limited period without harming the U.S. economic strength abroad. Thus, the essential question is, what will be the cost of future oil imports and how will it affect our trade balance?

These are two separate and, at least, partly, independent aspects to this question—the future volume of oil imports and its future price. Let us look at each of these.

The administration's national energy plan—NEP—released last April, projects a decline in oil imports from last year's level of about 7.3 million barrels per day to less than 6 million barrels per day by 1985. There is now general agreement among most experts that this level will not be reached or even approached by the target year. Studies by the Library of Congress, the General Accounting Office, the Congressional Budget Office as well as by private companies and researchers, have all come to this conclusion. The two principal reasons are the inability to convert as large a share of U.S. industry to coal as the NEP foresees and the assumption that a substantial reduction in the total energy growth rate during the next 8 years can be accomplished without any significant negative impact on the GNP growth rate.

However, failure to achieve the NEP target does not mean that oil imports will keep growing at historic rates. A combination of

actions proposed in the NEP, existing legislation designed to conserve oil, the effect of the substantial price increases on demand and, presumably, some additional incentives for new domestic energy production can be expected to curb the growth in oil imports substantially between now and 1985. In fact, we will see the first evidence of this next year when our oil imports will either remain stable or slightly decline. But it would be unrealistic to assume that any policy acceptable to the administration, the Congress and the public can bring about an actual decline in oil imports between now and 1985.

Our studies indicate that an optimistic but, hopefully, not unrealistic projection might be an oil import level of 9.5 million barrel per day by 1985. This would be equivalent to an annual increase of 1.1 percent in value.

Now let us consider future world oil prices. After the quantum jumps of 1973 the marker price for OPEC oil—Saudi Arabian light crude—has increased from $9.32 per barrel in early 1974 to 12.70 per barrel in July 1977. For the 4-year period from the beginning of 1974 to the end of 1977 this is equal to an annual growth rate of 8 percent.

OPEC's leading spokesmen have repeatedly declared that their price policy, following the 1973 revolution, was to maintain the real purchasing power of oil in terms of OPEC's import requirements. Thus, the 8-percent average annual increase over the past 4 years may be assumed to reflect world inflation in dollar terms during that period. Since the rate of inflation has clearly been declining since 1976—although the weakening of the dollar has offset part of it for OPEC members—annual price increases somewhat below 8 percent would meet OPEC's stated objective.

Now let us consider the likely future growth trend in total U.S. merchandise imports and exports. Over the last 10 years—1966–76—imports have risen at an annual rate of 15.4 percent in current dollars. The rate may have been somewhat distorted by the jump in oil import costs in 1974 and the high level of world inflation in the period 1973–75. However, even in the 10-year period 1962–72, when price inflation was much more moderate, the annual average growth rate in U.S. imports was nearly 12 percent. Thus, an increase in our total merchandise imports of about 10 percent annually in current dollars over the next 8 years would not seem unreasonable. The same would be true of the growth in merchandise exports which have risen by 14.3 percent annually in the last 10 years and by 9 percent in the period 1962–72 in current dollars.

If we now combine our growth rate in the volume of oil imports with an oil price increase in current dollars equivalent to likely world inflation rates and compare it with our future growth in total U.S. imports and exports, we can see that the value of oil imports would probably grow at a somewhat slower rate than that of total U.S. merchandise imports. Similarly, the share of U.S. exports required to pay for our oil imports would probably decline somewhat.

Whether our OPEC price assumptions are realistic is of course open to question. OPEC may wish to change its current price policy when the production of several of its members will have reached the capacity level or will start declining, so that higher oil revenues can

only be obtained through higher unit prices. Alternately, a continued high growth rate in world oil demand might cause market forces to push the price up more than OPEC would do on its own. Neither of these scenarios is likely to occur for at least the next 5 years. But if and when either of them does, the share of oil imports in our foreign trade accounts could conceivably rise substantially.

In closing, I would like to turn very briefly to our potential foreign trade in one other energy source: natural gas.

Last year our natural gas imports, mostly from Canada, amounted to 954 billion cubic feet or $1.7 billion. In the future the importation of this commodity, by pipeline and by tanker, can be expected to rise substantially. We project that by 1985 the United States will import about 2.5 trillion cubic feet of gas at a cost of $8.5–$9 billion —in 1985 dollars. This amount has to be added to arrive at our future total energy import cost. Most of it will not come from the Middle East, the source of the bulk of our future oil imports, but from such countries as Mexico, Canada, Algeria, Nigeria, and Indonesia. Thus, these imports offer some diversification of energy supplies to the United States, although in each case the gas exporting country will probably also export oil to the United States.

Additional gas imports will of course increase the cost of energy imports and weigh negatively on the U.S. balance of trade. However, the gas exporters are in general countries with ambitious economic development programs and high populations, and which will require substantial imports of goods and services and will likely force these countries to run deficits in their current account balance of payments. Thus although our gas imports from these countries will grow, so will our exports to them.

Representative Reuss. Thank you, Mr. Lichtblau.

Mr. Krause.

STATEMENT OF LAWRENCE B. KRAUSE, SENIOR FELLOW, THE BROOKINGS INSTITUTION [1]

Mr. Krause. I wish to thank the committee for inviting me to testify on the subject of the U.S.-trade deficit. It is a significant problem that deserves congressional attention.

Through the first 8 months of 1977, the U.S.-trade balance deteriorated by $15.3 billion compared to 1976, and a total deterioration of about $23 billion for the year is likely. After taking into account some improvement in services, the deterioration of the current account could still reach $20 billion. The prospects for 1978 suggest no further deterioration, but also very little improvement. What will happen beyond next year cannot be foreseen since it will depend in part on policy actions yet to be taken.

The deterioration of the current account of the balance of payments is of concern for three reasons: (1) the conduct of U.S. foreign economic policy is constrained; (2) the domestic political economy is distorted; and (3) real growth of the economy is reduced. It is very hard for the administration and the Congress to provide world

[1] The views are those of the author and should not be attributed to other staff members, officers, or trustees of the Brookings Institution.

leadership or even meet our international responsibilities when our current account is weakening. Moreover, the political climate created by the large trade deficit encourages domestic producers to blame all of their troubles on imports when in fact much of their difficulty arises from other factors such as pollution or other regulations, excessive wage increases, or simply poor management. Protectionism thrives in such an atmosphere and it is understandable that the Congress would have difficulty in separating exaggerations and distortions from legitimate complaints. Finally the $20 billion increase in the current account deficit reduces the money income of the United States by an equivalent amount. Even ignoring any multiplier effects and assuming only half of the monetary loss reduces real activity, our growth rate is being reduced by 0.5 percent and in current circumstances this is the difference between a stagnant unemployment rate and one that would have continued to decline, albeit quite slowly.

A number of factors can be cited as explanations; some temporal, some cyclical and some structural or longer lasting. It is impossible to give a careful empirical evaluation of each factor—that can only be done with hindsight—but my guess is that each of them accounts for about one-third of the deterioration. The temporal factor of greatest importance relates to the increased volume of petroleum imports which occurred in response to the cold winter, the desire to increase crude oil inventories, and the need to bridge the gap between now and the time when the Alaskan oil reaches the lower 48 States. It is likely that the value of U.S. petroleum imports will rise by $10 billion this year. However, this can be expected to be offset in part by higher exports to and greater earnings from oil-producing countries so that the net deterioration is about $7 billion.

The cyclical factor arises from the fact that so far this year other industrial countries have been growing below their trend rates of growth as evidenced by their rising unemployment rates while we have been growing above ours. This leads to unusually high U.S. imports and unusually low exports. Furthermore certain developing countries—principally Mexico and Brazil—have been restraining their imports to correct imbalances. Since they are important customers of the United States their actions also worsen the U.S.-trade deficit.

The structural factor concerns the loss of competitiveness of American manufactures over the last couple of years. This is caused both by adverse price movements—corrected for exchange rate changes—and by the rapid industrialization of certain developing countries which enables them to expand their share of world trade. Some rough evidence of this is seen in the fact that the imports of the other six large industrial countries have been rising by 15.6 percent in 1977 while U.S. total exports have been increasing at a rate of only 5.7 percent, with manufactures only slighly better at 6.9 percent. Taking manufactures alone, if U.S. exports had been rising by the "expected" 15.6 percent rather than the actual 6.9 percent, the value of our exports would be about $7 or $8 billion higher for the year thus eliminating about one-third of the deterioration. This leaves about one-third of the deterioration to be explained by the cyclical factor referred to earlier.

One might well ask the question, "How is it possible to lose competitiveness under a floating exchange rate system?" The answer is that even if the floating exchange rate system were working to theoretical perfection, the exchange rate must clear three markets simultaneously: The market for goods and services; the market for long term assets; and the short term or money market. Competitiveness—as the term is commonly used—refers only to the market for goods and services. While there is evidence that in the long run competitive shifts are prevented, in the short run imbalances in the other two markets can move the exchange rate. Thus during a period like the present when short term interest rates are rising in the United States, but falling in other major industrial countries, the dollar will be unusually strong. Since a divergent trend in short-term interest rates cannot continue for very long, the situation is self-correcting. The same kind of analysis can be applied to the market for long-term assets if factors shift the relative attractiveness of assets in different countries, although the time required to reach a new portfolio balance is longer. Thus even a well-working floating exchange rate system corrects deviations of competitiveness, but only in the long run.

The system is however prevented from working as well as it might or should by the actions of various governments. Governments have not been letting the exchange market clear by itself, but instead have been intervening and on balance have been buying a substantial quantity of dollars which has kept the dollar exchange rate artificially high. Among the major industrial countries in 1976, Japan, Germany, and Switzerland were the most active in buying currency to prevent a rise in their exchange rates. This year—through July—Great Britain, Italy, and to a much lesser extent Japan have acted in a similar way.

Furthermore, 123 other countries still peg their currencies to those of major countries—or their equivalent—as was done under the old Bretton Woods system. If these countries on balance run overall balance-of-payment surpluses—and they have—then the currencies to which they peg can become over-valued. Since most of them peg directly or indirectly to the dollar, their actions tend to keep the value of the dollar artificially high.

Some of the countries who peg to the dollar are the oil exporters whose actions should be viewed in a different light. The oil exporters have a structural surplus in their balance of payments which cannot be corrected by changes in the value of their own currencies. What has happened is that the oil exporters have had a greater preference for dollar denominated assets than either the U.S. share in the world economy or the ability and the desire of U.S. financial institutions to recycle funds to other countries. Thus the dollar is raised in value relative to other major currencies. If this was the only factor that was operating, then the problem would not be very great. The slight burden involved would be properly carried by the United States as we are best able to do it during this difficult period of adjustment. However, this is not the only factor involved. The industrial countries and the nonoil developing countries are also accumulating dollars which has made the overvaluation of the dollar even more serious.

CORRECTIVE ACTIONS

What then should be done about the deterioration in the U.S. current account of the balance of payments? In the long run sustaining a sound U.S. domestic economy is the best solution. The fact that private investment in plant and equipment in tradable goods industries in the United States is rising while it is stagnating in other advanced countries is a major sign that the adjustment mechanism is at work.

Of equal importance is a strong and effective energy policy. There is no action that the Congress might take that would be more helpful in correcting our own and the world's imbalance than to pass the President's energy package. I strongly urge the Congress to act accordingly and to even strengthen it if possible.

A third action would be to urge other countries to stimulate their own economies and increase domestic absorption of resources. Germany and Japan are usually mentioned as candidates, but I would also add the U.K., France, Italy, Switzerland, the Netherlands, and possibly others. The Japanese have recently announced a new stimulative program for which they should be commended, although the addition of some personal tax reductions would have been useful.

In the short run I believe some correction of the overvaluation of the dollar would be helpful. Some observers seem to fear that a market weakening of the dollar would be undesirable because it would signal a loss of confidence in the American economy and the United States in general. Such a fear is totally misplaced. The strength of an economy and the value of its currency are not closely related. Witness the fact that Switzerland has probably the most depressed economy in the world, yet it has one of the strongest currencies. Confidence arises out of the stability of a nation's political and legal institutions and the wisdom of its leaders. No country challenges the United States in these basic characteristics.

Another suggestion is for the United States to urge other countries not to distort currency values, although intervention in currency markets for short-term control purposes should not be discouraged as long as they don't accumulate dollars over time. Moreover, we should urge some nonoil developing countries such as Malaysia, Singapore, and Korea to follow more sensible exchange rate policies. There is no rational economic reason for them to peg rigidly on the dollar.

Today the U.S. dollar is practically the only reserve currency in common use. Indeed we are closer to a pure dollar standard than before the ending of the Bretton Woods system. I confess I fail to understand why governments still choose to accumulate reserves to the degree they do. Given these proclivities, however, we should improve the reserve creating mechanism. My top preference would be to create new SDR's to satisfy this demand. The SDR, from a systems point of view, is a superior reserve asset and accumulating it does not distort currency values. If a new issue of SDR's is not possible, as a second best alternative I would urge other countries to hold foreign currencies in their reserves in proportion to the value of their transactions with the various countries. Thus European countries such as the United Kingdom and Italy should hold large amounts of German

marks. I know the Germans actively and aggressively discourage the official holding of marks. In doing so I believe the Germans are shirking an important international responsibility.

If neither of these initiatives works, then I think the U.S. Government should consider buying foreign currency in the market to even up the reserve balance. If other countries only want to hold dollars, then the United States should buy DM, yen, and other currencies to recreate a kind of SDR balance in world reserves. As this would be a sharp departure from past practices, it needs to be discussed fully with other countries and international institutions before beginning it, but it may well be necessary if other approaches fail.

The managed floating exchange rate system has been in existence since March 1973. In my view it has worked remarkably well. It is constantly evolving and becoming more market oriented and adaptable. I would urge governments to not have a preconceived view of the proper value of their currencies but instead to be guided by the market. We are making progress; we shouldn't take a step backward.

Thank you.

Representative REUSS. Thank you, Mr. Krause.

Mr. Cohen.

STATEMENT OF BENJAMIN J. COHEN, ASSOCIATE PROFESSOR OF INTERNATIONAL ECONOMIC RELATIONS, FLETCHER SCHOOL OF LAW AND DIPLOMACY, TUFTS UNIVERSITY

Mr. COHEN. Thank you, Mr. Chairman. I would like to begin by apologizing for my late arrival this morning and also to thank you for this invitation to testify before the subcommittee today.

I appreciate this opportunity to comment on the subject of the U.S. trade deficit. Is the U.S. trade deficit a cause for alarm? I would like to try to make three points in connection with that question. My own view is that the dangers of the trade deficit are easily exaggerated. That the deficit is large—exceptionally large—is certainly evident. Never before in this country's history has there been such a massive gap between our exports and imports. Indeed, until as late as 1971–72, we had never in this century even experienced a negative trade balance. In 1973, largely as a result of the two devaluations of the dollar, we were back in surplus again; and after an oil-induced deficit in 1974, we enjoyed another surplus in 1975. In 1976 the trade deficit was only about $9 billion. This year, by contrast, it is expected to be three times that figure.

However, large as these figures are, I do not believe that they are a cause for alarm or that they warrant radical revision of current U.S. economic policies. There are several reasons for this relatively more sanguine view of the situation. In the interest of brevity, I shall confine myself to just three major observations.

In the first place, I believe it is necessary to place these trade figures in their proper context. A nation does not earn its way in the world by exporting goods alone. The merchandise trade balance is only one part of its overall foreign earning capacity. Equally important are its net earnings on services—the so-called "invisibles" account. For the United States, the overseas invisibles account remains

heavily in surplus, despite the recent deterioration of our visible trade balance. In both 1974 and 1975 our net earnings on services topped $7 billion; in 1976, our invisibles surplus was almost $13 billion. And estimates for this year suggest a figure in the vicinity of $15 billion. These numbers certainly do not indicate any serious deterioration of our country's ability to compete in international markets for services.

Looked at in this broader context, the trade picture therefore does not look quite so alarming. Despite a visible deficit in 1976, U.S. net export earnings—from services as well as from goods—were in surplus by more than $3½ billion. Indeed, it was only because of a net outflow of unilateral transfers in excess of $5 billion that we experienced any deficit at all on current account last year. This year our current deficit is expected to be in the vicinity of $14 billion, only half the anticipated merchandise trade gap. The current account is the appropriate place to look if we are to know what is truly happening to a country's foreign earning capacity and competitiveness in world markets.

My second reason for taking a relatively more sanguine view of the present trade deficit is that it has been very largely dominated by three special factors.

One has been the wave of good harvests in many areas of the world, which have sharply reduced U.S. agricultural exports in both volume and price.

Second was the severe winter weather of last January and February, which considerably inflated our crude petroleum imports. Oil imports in the first 3 months of this year topped $11 billion, an increase of $3½ billion from a year earlier. Total oil imports in 1977 will probably top $41 billion, up at least $7 billion from a year earlier.

The third special factor, still continuing, has been the difference in the timing of cyclical developments in the United States and its major trading partners. Economic recovery from the recession of 1974–75 not only began earlier in the United States than elsewhere but also has been more sustained and vigorous. In most other industrial economies, real growth rates of GNP are still substantially below those typically achieved during the years prior to the 1974–75 recession. According to recent estimates of the OECD secretariat in Paris, expansion of real output in the 24 member countries of the OECD in 1977 will be about 4 percent, down from 5.2 percent in 1976. In the seven largest countries of the OECD area, accounting for 85 percent of the total output of the group, expansion will be about 4½ percent, down from 5.6 percent in 1976. In Britain, France, and Italy, expansion will be negligible; in Canada, Germany, and Japan, well below what had been hoped. Only in the United States has there been any real bouyancy lately in the growth of real output and final demand—expected to top 5 percent for the year as a whole. And this of course is what accounts for a very large part of the recent increase of our trade deficit. Strong inventory building and increases in personal consumption expeditures at home have stimulated demand for imports of industrial materials and consumer goods—as well as fuels—while U.S. exports, particularly of capital equipment, have

been severely hampered by the weakness of investment demand abroad. Statistical adjustment of raw trade data for cyclical developments of this kind is not easy to do. However, whatever the technical methodology one chooses to employ, it becomes abundantly clear that but for such differences in conjunctural conditions here and abroad, our visible trade deficit would be far smaller than it presently appears to be.

My third reason for taking a relatively more sanguine view of the present trade deficit is that it is in fact needed. From a global macroeconomic point of view, the deficit is a decidedly good thing. The counterpart of the continuing current surplus of the OPEC group of countries must be a collective deficit for the rest of the world. This deficit cannot be avoided; it can only be shared. And if a large part is not shared by the world's strongest national economy, proportionately more must fall instead on weaker economies, some of which may no longer be either able or willing to carry such a heavy burden.

Already many oil-consuming countries have built up a crushing burden of external debt in financing their oil-induced deficits since 1973. Many others have avoided substantial cumulative deficits abroad only by severely suppressing their growth rates of real output and final demand at home. Dissatisfaction with both these unpleasant policy options is growing; and in the search for alternative policy instruments that would enable them to avoid both additional foreign debt and continued domestic stagnation in the future, foreign governments increasingly seem to be looking toward the escapist solution of protectionist trade measures of various kinds, including competitive depreciations of exchange rates. This is a very real and present danger to the liberal international economic order, and it can be forestalled only if the world's strongest national economies relieve some of the pressures on weaker countries by assuming a larger share of the oil consumers' collective deficit. This, in effect, is what the United States is doing. Far from threatening America's ability to exercise continuing economic leadership in the world, the deficit in fact constitutes the very essence of economic leadership in present circumstances.

Of course, it might be objected that the largest part of the U.S. deficit is with just two groups of countries—OPEC and Japan. How can it be true that we are helping to relieve pressures on other areas of the world if our current balance with most of them, apart from OPEC and Japan, remains substantially in surplus rather than deficit? The answer is: It can be true, since the fact is that these areas in turn receive, in the form of expanded demand for their exports, a good part of the income presently being earned by the OPEC group of countries and Japan in the United States. Deficits are fungible in a multilateral world. The U.S. deficit does result in reduced pressures on other oil-consuming countries, albeit indirectly rather than directly. America thus helps to lead the world away from the slippery slope of commercial protectionism and competitive depreciations.

For all these reasons, then, I do not view the present U.S.-trade deficit with alarm, nor do I feel that radical revision of current

U.S. economic policies is warranted. But that is not meant to imply that we can merely stand pat either. These are not the times for complacency or self-satisfaction; I am not advocating a policy of benign neglect. Quite the contrary, in fact. For even if it is true, as I believe it to be, that the present trade deficit signifies neither a serious deterioration of our competitiveness in international markets nor a significant loss of a capacity for world economic leadership, the fact of the deficit remains—and because of that deficit, the fact remains as well that we are facing here at home a ground swell of protectionist pressures in many of our own exporting and import-competing industries, from shoes and textiles to electronics and specialty steels. This I do view with alarm. Those protectionist pressures must be resisted and, if possible, defused. How can that be accomplished?

In my opinion, it can best be accomplished by convincing other strong national economies to shoulder a larger share of the collective deficit of oil consumers. This means, in particular, the two so-called "engine" economies of Germany and Japan, both of which in fact have lately been running surpluses rather than deficts on current account. In 1977, the German current surplus is expected to approach $2½ billion; the Japanese, a whopping $7 billion. Both surpluses are perverse from a global macroeconomic point of view. Both directly reflect the relatively sluggish growth performance in these two economies. What is needed, obviously, is more direct demand stimulation in both, to help encourage additional purchases from outside their own frontiers—including from the United States. One effect of accelerated expansion in Germany and Japan, apart from the growth stimulus provided to other weaker economies, would almost certainly be to reduce the trade deficit of the United States by narrowing the disparity between us and them in conjunctural conditions. Promotion of reflation in their two economies therefore is the key to defusing our own problem of swelling protectionist pressures.

Of course, one might ask: Why rely so heavily on differential demand-management policies? Why not rely on a differential movement of exchange rates instead, via either appreciation of the deutsche mark and yen or depreciation of the dollar? The answer is: because this seems to be the way the adjustment process works. According to a recent study by the OECD Secretariat, such adjustment of trade balances as has occurred among industrial countries in recent years has been almost entirely due to differential movements of real domestic demand. Although nominal exchange rates have varied considerably since 1973, their changes have been confined mainly to offsetting—or being offset by—domestic cost and price inflation, with relatively few lasting effects on trade account. "Real" exchange rate movements, in the sense of sustained shifts in relative cost-price positions, have been comparatively small. This suggests that it is best to focus directly on real output and final demand in each economy, rather than on the nominal exchange rates of currencies, if the pattern of current account deficts among countries is to be genuinely affected on a lasting basis. And that pattern must be affected, I have argued, if the liberal international economic order is to continue to be viable in present circumstances.

Thank you, Mr. Chairman.

Representative REUSS. Thank you, Professor Cohen, and thanks to all members of the panel. We will now inquire of Mr. Lichtblau.

I understand you have a speaking engagement in New York City, and you would like to leave here by 10:30.

Mr. LICHTBLAU. If possible, Mr. Cochairman.

Representative REUSS. We will endeavor to see that you get questioned early in the proceedings.

Professor Cohen, I have a bone to pick with the Department of Commerce, of all people, for their nomenclature, which is illustrated by what you say in the fourth paragraph:

> In the first place, I believe it is necessary to place these trade figures in their proper context. A nation does not earn its way in the world by exporting goods alone. The merchandise trade balance is only one part of its overall earnings capacity.

Then you go on to say that it has gone way up to $7 billion, and this year it is perhaps $15 billion, and that these numbers do not indicate any serious deterioration for our country's ability to compete in the international markets for services.

In my innocence, I said that services are given by some nice missionary or a man in the healing arts, but not at all, if services are the instruments of death or arms sale abroad.

Arms shipments are just as much sales as a Buick. How have we let these rascals use such miserable nomenclature all these years?

Mr. COHEN. I am not sure I understand the implication of your question.

Representative REUSS. Well, services are not just intangibles, but include a great deal of merchandise. In other words, the merchandise account is just the nonhellish merchandise, bandages and food and so on.

Mr. COHEN. The services account that I am referring to, Mr. Cochairman, includes travel, transportation, fees, and other such things.

Representative REUSS. Doesn't it also include U.S. military arms sales? I am not picking a quarrel with you. It is with the Department of Commerce, but it seems to me——

Mr. COHEN. The net figure for transfers of U.S. goods and services under U.S. grant programs, military grant programs, is included, but that is just a small component of the surplus.

If one looks at the figures, one sees a relatively small proportion of the total accounted for by that line, line 14.

Representative REUSS. Well, I will have to look at it. But what are the services in which we started doing so wonderfully well, getting up to $15 billion this year and over $7 billion the previous year?

Mr. COHEN. The item for receipts of income on U.S. assets abroad, reflecting the heavy investment by our manufacturing corporations——

Representative REUSS. The greater part of which was returned.

Mr. COHEN. Yes. This accounts for the largest part of the increase in recent years.

Representative REUSS. What part of military activities abroad is contained in that service entry?

Mr. KRAUSE. All of it.

Representative REUSS. That is an awful sneaky way to describe the sale of arms.

Mr. KRAUSE. Mr. Cochairman, the history behind this practice is that formerly military equipment was sold abroad by private companies without Government intervention, so naturally these sales were recorded in the goods account.

However, when concern about the balance of payments rose in the 1960's the United States started to sell more of the military equipment through the Defense Department so that the Defense Department's balance-of-payments deficit would not look so large.

We were buying things abroad, and they said, "Well, you know, because we have military abroad, we sell military goods, and let's put it through the Defense Department."

That is how it got re-created as a service rather than the goods they are.

Of course, we buy goods abroad, tomatoes and other things, and that is also counted as a service on the purchase side.

Representative REUSS. Well, I am going to ask the staff to focus an eye on that matter. It does seem to me it is deceptive.

Mr. Lichtblau, in the excellent study put out in September 1977 by the Morgan Guaranty Co. of New York, entitled "World Financial Markets," they have a table showing trends in oil consumption in selected industrial countries which indicates that comparing the first half of 1977 with the first half of 1973, all the other industrial countries decreased their consumption of oil—France by 8 percent, Germany by 10 percent, the United Kingdom by 19 percent, and so on—but we and we alone actually increased our consumption of oil; the percentage increase being 7.5 percent.

How is it that the others were able to decrease their oil consumption and yet we have increased ours?

Part of it, of course, is due to somewhat greater growth during part of that time in the United States, but that certainly doesn't account for it all.

Mr. LICHTBLAU. Yes; part of it is due to greater growth in the United States, and part of it is because other energy sources are declining in the United States and oil being the swing fuel has to take over.

Our natural gas supplies are declining, and as they are being backed out of various markets, such as industrial and utility markets, more oil is used, and since our oil production is declining, the balance comes from imports.

In Europe, the trend is in the opposite direction. Natural gas supply is growing in Europe, both because of North Sea gas, and because of imports of gas from the Soviet Union, and some imports are beginning to appear from North Africa.

So, to that extent, we are moving in a different direction. However, I would think that this year Europe's oil demand is probably going to be in line with last year's.

I don't think it is declining. Europe's oil imports are declining substantially, but that is due to the coming on of North Sea crude oil, which is displacing imports into England and other countries on a large scale.

I think, by and large, Europe's oil demand is probably going to start growing again. Oil shipments into western Europe will start rising, I believe.

Representative REUSS. Would you attribute any of the difference in levels of oil imports to better conservation methods?

Mr. LICHTBLAU. No; I would not. I think conservation measures—the use of oil in Europe is, of course, much lower on a per capita level—but conservation measures in Europe are not on as large a scale or more effective than in the United States.

In fact, if you look at the GNP and energy consumption changes in the last few years in the United States, we have substantially decreased our requirements of energy per percent increase in the GNP, while the Europeans are about where they were.

The reason is, of course, in part, that we have a far larger potential to reduce our energy consumption, because we start out from a larger base.

There is very little a European can do as far as gasoline is concerned. They already have small cars. As we move from large to small cars, we are going to be able to conserve energy.

So, to that extent, the potential is bigger, and we have moved in this direction.

I don't think the reason for the low, relatively low, gasoline consumption in Europe is more efficient conservation improvements since 1973.

Altogether, the Europeans always had or required less energy per capita both in oil and total energy than the United States did, but that is largely because the entire structure of these countries are different.

If you look at the nontransportation sector, there isn't all that much difference between Europe and the United States. The principal difference is in the transportation.

That is due to a different lifestyle, living in the suburbs and all these factors, and there is not very much you can do about it in the short run.

Representative REUSS. Mr. Krause, referring to your statement about the intervention by foreign governments, and you, Mr. Slighton, on a similar subject in your testimony, come to what seems to me somewhat different views.

Mr. Krause says that intervention by various countries, including the Japanese, has kept the dollar artificially high and thus may have something to do with our less-than-glorious export performance.

Mr. Slighton says that official intervention doesn't seem to be an important cause of the high rate of the dollar. Can you address yourselves to each other so this very important issue can have some light shed on it?

Mr. SLIGHTON. Yes. Let me say, first of all, that intervention in the narrow, buying and selling of central exchange, is only one of many policy instruments used to achieve a particular foreign exchange rate objective.

Second, it is very difficult, even for an insider, and almost impossible for an outsider such as myself, to know exactly what is going on in the way of intervention in the narrow sense.

The second point——

Representative REUSS. Could I stop you there?

Granted, it certainly has eluded me, but if a country starts ending up with huge reserves of dollars suddenly, is it ungracious to suspect that they have been doing a little closet intervention?

Mr. SLIGHTON. There are many ways a country could be accumulating dollars, and strictly speaking, yes, this is intervention, but it has not historically been called so in the narrow sense.

Representative REUSS. Whatever it is, it can raise hell with this country and cause labor to go protectionist, and ruin color television, steel, motorcycles, electronics, and about 15 other industries.

Mr. SLIGHTON. The most common intervention that doesn't often get counted as intervention are the so-called off-market transactions.

For example, earnings on dollar assets held as official reserves by foreign central banks are generally credited to the account of that central bank without having gone through a market.

Similarly, in Japan, payments that are made by the U.S. Government for local currency expenses of our military establishment also do not go through the market.

This does amount to intervention in the broad sense.

I find it very difficult to distinguish between the intervention in the narrow sense and actions such as interest rate policy actions, which are taken with the explicit objective of influencing the rates.

You will find this a common occurrence within some European countries.

Within individual countries, the effect of interventionist policies has had very different effects on the dollar at different points in time.

Most recently, Italian actions have served to keep the lira from appreciating somewhat.

In the not-too-distant past, their action has had quite the opposite effect.

In the United Kingdom, there has been massive intervention this year to prevent the pound from appreciating, and also last year there was substantial intervention the other way.

The critical thing is to look at the sum total of interventionist actions rather than the simple buy-sell activities of central banks. Although I do not feel that the price of the dollar is substantially higher, that the dollar is substantially more appreciated today than it would have been had there been no net intervention over the past several years, I would not argue that there has been no effect whatsoever.

In fact, I do think the dollar has been somewhat higher, that it is slightly higher today than it would have been had we had no net intervention over the past several years, but I don't think the difference is terribly strong.

One point to be made is that when we talk about trade-weighted exchange rates, the weight given the Canadian dollar is much larger than the deutsche mark or the yen or the currencies that get more play.

Yet the Canadian dollar is substantially a cleanly floating currency.

Representative REUSS. My time is up.

Would you mind if I allow Mr. Krause to answer.

Mr. KRAUSE. I agree that there are many ways to influence the value of currencies. These ways are not, however, identical.

When a country lowers its interest rate and has an easy money policy in order to weaken the value of its currency, it affects not only the currency, but also domestic economy.

I think that it is ridiculous to have a monetary policy which is guided by the exchange rate policy, since such a policy may adversely affect the domestic economy.

If it is inappropriate to that domestic policy, the policy will be reversed aside. Not so with another policy.

I view these two methods as very different in terms of their impacts. One can be continued, and the other is self-limiting, and therefore I look very carefully at the research accumulations.

Of course, they are going to intervene if there is a market interruption, and I wouldn't object to that.

It is possible that the British are entirely justified in trying to accumulate substantial amounts of foreign exchange because they have many debts which will need to be paid off—some in the near future. Their policy of building up their assets to pay off their debts is fine.

But why are they accumulating foreign exchange only in dollars, and thereby distorting thet dollar in relation to the mark and the yen?

They should be diversifying their reserves if in fact they want more reserves. I think this is a savings matter. How much the dollar would be weakened, no one knows for sure, but if you look at the reserve accumulations for the last couple of years, they are running about $30 billion a year.

Assuming a third to a half of this reserve accumulation is held by OPEC countries, who are not holding it for savings purposes, demand for dollars is still $10 or $15 billion a year. If instead of governments accumulating reserves, the private market were forced to clear the market, I think that the demand for dollars would have much more impact on the market.

Representative REUSS. Thank you. We will return to this.

Senator Roth.

Senator ROTH. Thank you, Mr. Cochairman.

One question I have is how much of a problem is the hot money fleeing France and Italy? Is that a problem to any extent?

Do any of you gentlemen care to comment on that?

Mr. KRAUSE. Its greatest effect was probably in the capital market in the short run.

There have, however, been some secondary and tertiary effects. For example, the French stock market is, and has been, killed because of the concern about Communist election victories next year. This reduces the assets of French households and in the future can be expected to reduce consumption and affect their trade balances to some degree.

The loss of confidence is a capital flow issue.

Mr. SLIGHTON. I think those circumstances you refer to took place more in 1976 than in this year. I think most of that hot money has already found a new home.

The current capital flows arising for that reason I do not think are terribly large.

Senator ROTH. I believe, Mr. Slighton, you commented toward the end of your statement that you believe the Japanese trade surplus is primarily the result of a system of quota restrictions and internal marketing arrangements that make foreign penetration of Japanese markets very difficult.

I wonder, have you or has anybody made any careful study to document this problem?

I must say we talked to the Japanese about it. They usually say it is a problem of the American businessman not developing products for the Japanese market, or not really making the necessary marketing studies and policies necessary to penetrate there. I wonder.

I hear this charge quite often, but have not been able to find any documentation, and I wonder if you are aware of any.

Mr. SLIGHTON. I am aware of no single document that would fill the bill exactly, Senator. It is true enough that with respect to consumer goods that there has been relatively little effort made to design products specifically for the Japanese market.

For one reason, this has not happened because the Japanese comparative advantage seems to lie most heavily in these consumer durable goods which are in such demand.

I don't think one needs to do a terribly detailed study, however, to demonstrate that quotas, Japanese Government official quotas on the imports of intermediate products, chemical products, for example, are terribly important restraints on the ability of foreign countries, the United States in particular, to sell to Japan. Very few Japanese imports are manufactured goods.

Part of this is the result of insufficient marketing attention, but quotas, in particular with respect to intermediate goods, do have a very strong restrictive effect.

Now, there is another, more difficult to approach problem, and that is the role that the large trading companies play in Japan, companies that are conglomerates with production and trade in the same corporate group.

The prices charged by the trading components of these conglomerates to their production affiliates, these internal transfer prices, very often seem to bear very little relationship to arm's length prices.

I think this is particularly true in the case of petroleum.

On this, I am sorry that I can't give you an off-the-top-of-my-head reference. I believe Larry Krause has worked in this field and he can be more exact.

Senator ROTH. I would be most interested in that type of information, Larry, if you could supply it.

One further question on Japan: In 1972 and 1973, we put pressure on them, as I recall, to buy agricultural products as well as uranium ore. Do you think there are any export items at this particular time that we might try to promote the sale of to help correct this U.S. deficit, Mr. Krause?

Mr. KRAUSE. Putting pressure on Japan to inventory more agricultural products or uranium as we have done in the past is only a shortrun solution. As such I would not consider it a real solution to the deficit problem.

The solution to the Japanese trade imbalance is to convince them that "you can't export without importing." They have to recognize the ramifications of their policies. They must recognize that their policy of shoring up weak industries in Japan has the consequences of limiting imports. They have to recognize that if that is the policy they want to follow, their expanding export industries must suffer because it is not possible to expand exports without expanding imports. Because one ministry is restricting imports while another is expanding exports, the Japanese have never seen the need to assess the impact of the totality of their policies.

They seem to be doing their job well, but the rest of the world can't let them behave that way.

Senator ROTH. I wonder what your comments would be on the U.S. trade policy as far as coordination.

Do you think it is bureaucratically inefficient to have, for example, the Commerce Department concerned with one aspect of trade, another agency concerned with antidumping, another with trade negotiations, and so forth?

I might warn you before you comment that I do have a bill introduced. Senator Ribicoff and I have cosponsored a bill to create a trade and investment department at the Cabinet level.

Would any of you gentlemen care to comment generally? Would this be helpful to try to provide better coordination and better trade policy?

Mr. KRAUSE. This matter is of interest to me as I was involved in trade policy during the Kennedy round, and subsequently.

My view is that there is a lot of domestic constituencies interested in trade, and somehow, their voice has to be represented by appropriate people within the administration. There are a number of ways this coordination can be achieved. One way this coordination will not be achieved is by separating trade policy from the rest of the economic policy. Decisions on trade policy and economic policy are not separate decisions in most cases. For example, the two policy areas overlap when there is an employmnt creating policy as part of an adjustment policy to growing imports.

Therefore, I have some concern about the thought of separating, for purposes of coordination, economic policy into compartments.

There is a great need to better coordinate all domestic economic policy, all foreign economic policy, and all foreign policy in general. It is a hard coordination job, and I think that the weakness lies in this overall coordination, rather than in giving attention to the different components.

Senator ROTH. The problem is that today you already have that fragmentation. We are not talking about taking economic policy away from the State Department in the overall sense or the monetary responsibilities of the Treasury, but in the more specific area of trade, you have fragmentation.

You have it, for instance, in the case of the Special Trade Representative. I think we have a very able man heading that effort, but he doesn't speak with the authority or have the institutional authority that perhaps a department head would.

I would be very much interested in having you gentlemen take a look at this legislation that Senator Ribicoff and I have introduced on the Senate side, and we will be having hearings on it in Governmental Affairs.

Mr. Lichtblau, I think in your testimony you made the comment that with respect to the deficit that you didn't think it is of such magnitude that it cannot continue for a limited period without harming the U.S. economic strength abroad.

I am curious what you meant by the term "limited period."

Mr. LICHTBLAU. What I mean is that we don't need to take extraordinary measures this year on the basis of this year's current account deficit.

I think the same would apply for 1 or 2 more years.

If we have the current account deficits for several more years—I don't know whether it is 2 or 3, exactly, I think we may have to take some action to reduce it, but I don't think we are in an emergency now, and I don't think anything needs to be done on the basis of the deficit, the one we are likely to see here, because of its magnitude.

I think also as far as the deficit is concerned, it is primarily on the current account, and not the trade basis. If you look at our exports of goods and services, you come up with approximately $8 to $9 billion deficit this year, which is not that large. It is the first one in a number of years.

So, I think we can easily afford this kind of a deficit now and for a few more years, and while we ought to take long-term measures to improve our trade situation, I don't think we need to take any immediate steps because the magnitude of the deficit is too high.

That is what I really meant.

Senator ROTH. Mr. Cochairman, my time is up. There are two brief articles on the relationship of devaluing to inflation that I would like to have included in the record.

Representative REUSS. Without objection, both of the documents will be inserted in the record at this point.

[The articles referred to follow:]

[From the Wall Street Journal, Feb. 5, 1973]

DO DEVALUATIONS REALLY HELP TRADE?

(By Arthur B. Laffer)

In policy as well as academic circles, it is widely believed that changes in exchange rates cause changes in trade balance. Devaluations are believed to lead to improved trade balances, while revaluations are supposed to lead to worsened trade balances. Yet, more than a year after the Smithsonian accord, the U.S. trade balance has shown no sign of improving. According to many people, we need just a little more time for the devaluation to have its effects.

While obviously not definitive, the evidence presented here places doubt on the notion that devaluations bring about improvements in trade balances; the trade balance being one of the major components of the balance of payments, that component thought to be most responsive to exchange rate changes. In addition, the evidence points very strongly to a close and lasting relationship

between changes in trade balances and changes in relative rates of growth. The theory of this latter relationship being firmly placed on the well-accepted notion that a country's net demand for foreign goods depends upon its level of income.

The popular theory behind the relationship between exchange rates and trade balances is straightforward. A representative statement of that theory as it pertains to the U.S. might proceed as follows: By raising the dollar price of foreign exchange (devaluation of the dollar), the dollar cost of foreign goods will naturally rise. In a like manner—because the foreign exchange price of American export goods will now be lower, Americans will buy less of the now higher-priced foreign goods, while at the same time, American export goods should sell better abroad because of the decline in the price foreigners have to pay for them. The end result of a dollar devaluation should be an improvement in the overall U.S. trade balance (U.S. exports minus U.S. imports), though perhaps only after a lag of as much as two years.

Nothing appears to be more at odds with this theory than the current trade balance picture of the U.S. in May-June of 1970, the foreign currency value of the U.S. dollar depreciated by about 6%, vis-a-vis the currency of our major trading partner, Canada. A year later, the dollar depreciated again relative to the Swiss franc, the German mark, the Austrian schilling and the Dutch guilder. Between August of 1971 and the beginning of 1972, the dollar was further devalued versus virtually every major currency.

In sum, during 1970, the dollar depreciated (on a trade weight basis) by nearly 3% relative to our principal industrial trading partners. In 1971, there was a further depreciation of about 6% and during the first three quarters of 1972, the foreign currency value of the dollar depreciated an additional 2%.

DEMOLISHING A THEORY

While the foreign currency value of the dollar was depreciating, the U.S. trade balance, instead of improving as the theory would predict, was actually going further into deficit. Since the middle of 1970, the U.S. merchandise trade balance has continuously deteriorated, moving from an export surplus of about $3 billion annually to the current deficit rate of about $6 billion—an overall deterioration of some $9 billion annually after two and one-half years of continued depreciation of the dollar. Nor can poor price performance in the U.S. be blamed for this deteriorating trend. Compared to most foreign prices, U.S. prices have performed quite reasonably since mid-1970 as well as over the past decade or so.

Although some argue that the failure of the U.S. to improve its trade balance is due to offsetting special circumstances, it should not come as a total surprise to those who have observed other countries' experiences with devaluations or revaluations. Of the major devaluations since 1950, few have been followed by significant improvements in the particular country's trade balance.

For the devaluation experiences of Britain, Spain, Denmark and Austria, the trade balance was as bad, if not worse, three years after devaluation as it was the year prior to devaluation. Of some 14 convertible currency devaluation experiences that I have examined, a full 10 had larger deficits in trade three years after devaluation than they had in the year immediately preceding the year of devaluation.

The revaluation picture is not very different, but there are very few examples, and German mark revaluations account for nearly all of them. The effective number of revaluations that Germany has carried out depends upon how one treats changes in border tax adjustments. But, irrespective of precisely how many times the German mark has been revalued, it would be no mean task to discern a substantial deterioration in the German trade balance. Thus, given at least a casual look at the historical experience of foreign countries, it should not come as a complete surprise that the U.S. trade balance has not turned around since the foreign currency value of the dollar started to decline.

While trade balances may not respond predictably to exchange rate changes, they do appear to be quite closely related to differential growth rates. When a country increases its economic growth rate relative to its trading partners, we often find a deterioration in that country's trade balance. Perhaps the closest of these relationships is to be found between the U.S. and other industrial countries.

The corresponding relationships for Japan, the European Economic Communities and the United Kingdom are also very close. Other factors, including some associated with the special characteristics of individual countries, explain persistent deficits or surpluses in individual nations. But in each case, an increase in the differential between domestic and foreign growth is usually associated with a deterioration in the trade balance.

In the most recent of times perhaps more policy measures than ever have been pushed through in the hope of improving the U.S. trade position. The dollar has been devalued, capital controls and trade restrictions have continued to sprout everywhere. Export-Import Bank outlays have grown, voluntary quotas have been placed on a number of commodities, anti-dumping and countervading duty measures have been threatened, and so on.

In face of it all, the trade balance has proceeded much as usual.

When we consider how rapidly the U.S. has grown recently, it seems reasonable that the growth rate will taper off in the future. The rest of the world, on the other hand, has recently been growing slowly relative to historical norms and should show some resurgence. If foreign growth does rise and U.S. growth slackens, we should expect a noticeable improvement in the U.S. trade balance. This improvement should, in my opinion, be attributed to U.S. growth relative to foreign growth, and not (as it probably will) to the delayed effects of devaluation.

INCOME AND IMPORTS

From a theoretical standpoint, the relationship between a country's trade balance and its relative rate of growth is based entirely upon the unarcane, well-accepted notion that the higher a country's income is, the more that country will import. Thus, as is well documented in virtually all elementary textbooks, net imports depend upon income. Changes in net imports depend, therefore, on changes in income. And, changes in net imports, as a share of GNP, depend upon a country's growth rate.

Any one country's imports are necessarily the exports of the rest of the world, and its exports are the rest of the world's imports. Therefore, a country's trade balance surplus is the rest of the world's deficit. Because one country's trade balance surplus is all other countries' deficit, that country's trade balance must likewise depend upon the growth of the rest of the world, as well as its own growth rate. Therefore, based solely on the notion that the level of a country's imports depends on its income, we find that changes in its trade balance (or current account) should depend upon changes in its growth rate relative to the rest of the world.

From a policy standpoint, there are several observations that can be made concerning the balance of trade. (The reader must again be careful to distinguish between the balance of trade and the overall balance of payments.)

First, while no one can say for sure that exchange rate changes do not matter, it appears fair to say that their effects on the trade balance and thereby domestic employment have been greatly exaggerated in policy discussions.

Second, I think the use of the trade balance as a policy indicator distinct from domestic growth has probably been overdone and should be played down. Thus, much of the blame placed on the current administration for poor trade performance should properly be praise for bringing about rapid economic growth.

Third, both official and private pessimism as to the future American trade position also appear to me to have been substantially over-stated. While we may not soon again see the surpluses of the late forties, the very recent trade deficits also appear to be somewhat abnormal.

Finally, although no one can ever deny with certainty that trade measures other than exchange rate changes help the trade balance, there is a widely held presumption in policy discussions that these trade measures do matter and matter a lot. This point of view has clearly been given too much weight in trade policy. The trade balance, like many other economic indicators, responds both predictably and in a logical way to the overall economic environment. Using gimmicks to alter the trade balance is to a large extent futile, and perhaps even mischievous.

[*Mr. Laffer is an associate professor of business economics at the University of Chicago and is consultant to the Secretary of the Treasury.*]

[From the Wall Street Journal, Jan. 10, 1974]

THE BITTER FRUITS OF DEVALUATION

(By Arthur B. Laffer)

Inflation is plaguing not only the housewife but also the economics profession. Over the past year, wholesale prices rose 18.2% and consumer prices rose at a rate of nearly 9%. Conventional economic views did not predict and cannot explain increases of this magnitude.

The money supply has expanded at a rate some consider too high from a policy perspective, but not one that is terribly high for comparable periods over the past decade. Using past relationships between rates of growth of the money supply and inflation as our guide, it is virtually inconceivable that excessive money growth is to blame for the almost unprecedented rates of inflation recently experienced.

For quite some time now fiscal policy has been if anything contradictory. The full employment budget has been balanced, the actual deficit has shrunk and total outlays have been tightly controlled. Even government purchases, which in real terms soared prior to 1969, have been substantially reduced. All in all fiscal policy does not appear to be the culprit.

Advocates of Phillip's curves, price bulges and a whole host of other views are also faced with an inordinate amount of inflation to explain with inadequate sources. Unemployment is higher than at many times in the recent past, yet inflation is higher than at any time. Even the overall price controls program couldn't have increased inflation this much.

Nor can the recent high rates of inflation in the United States be explained as solely a part of an overall world-wide inflation problem caused by shortages of food and other goods. Over the same period that the rate of inflation in U.S. wholesale prices registered 26.5%, we find that the German and British rates at 6.2% and 7.3% respectively. World-wide inflation has been great, but other nations did not experience the sudden burst that struck the United States.

There is one way, however, to explain a large portion of the sudden burst of price increases in the United States. All economists recognize that the devaluation of the dollar, in December 1971 and again in February 1973, has some inflationary impact. If you view the domestic economy as basically a closed system with a few international inputs, as most economists traditionally have, then you will see this effect as slight. But if you conceive of the United States as but a part of a relatively unified world market, the inflationary effect of devaluation must be seen as far more dramatic, indeed fully adequate to explain the kind of inflation the United States has recently experienced.

(Immediately after the February devaluation, indeed, the author predicted privately to an editor of this newspaper that the chief consequence would be "runaway inflation in the United States."—Ed.)

COMPUTING A DEVALUATION

The conventional doctrine relating domestic inflation to currency depreciation is in essence straightforward and simple. When a country devalues, say by 10%, it will now cost $110 to buy the same amount of currency that $100 used to buy. The price of imported goods will automatically rise by the amount of devaluation.

To compute the overall inflationary effect of a devaluation, therefore, one need only know the amount of the devaluation and the share of the total goods bundle imports compose. Of total demand in the United States, imports comprise roughly 5%; therefore according to the conventional approach, a 10% devaluation of the U.S. dollar should add only 0.5% to the appropriate price index—a trifling amount.

While many versions of the conventional view of the inflationary consequences of a devaluation are far more complicated, the above description captures its essence. It is important to note that this view assumes that the foreign currency price of imported goods does not change—only the domestic currency price changes. The prices of all domestically produced goods are also assumed to remain unchanged.

This conventional approach, however, is not the only view of the consequences of devaluation. The chief alternative sees the world economy not as

a collection of loosely related closed systems, but as one relatively efficient market. In an efficient market, the price of goods does not depend on the amount flowing from one geographical sector to another.

To determine, say, how a change in the price of apples in Illinois would affect the price of apples in Kansas, very few economists would study the flow of apples from one state to another. Rather, they would expect that even if the traditional flow of apples was little changed, the price in Kansas would rise to compensate for the higher price in Illinois.

Devaluation is an attempt to change the price of apples and other goods in one nation relative to another, by changing the relationship between the yardsticks in which those prices happen to be measured. If markets are efficient, the real price of apples—relative to cars or hours of labor or other things of value—will not be affected. Nor will this real price be different, other things being equal, in one nation or another. Thus, if the yardsticks change, the prices measured by them will have to change in a way that preserves the original relationship of real prices.

Or consider the same phenomenon from the point of view of one nation. If any country produces goods that it both trades and consumes domestically, then items sold for domestic consumption will not differ in price from items sold for foreign consumption. Likewise, foreign imports into any country should also sell at the same price as domestically produced import substitutes—both before and following a devaluation. If these prices did not adjust in this manner, speculators could make virtually unlimited profits by purchasing goods in one country and selling them in another country.

Various artificial as well as natural barriers of course, keep any market from being completely efficient, and these may be higher in international markets than in domestic ones of a similar size. But if there ever were any reasons to conceive of international markets as greatly different from domestic ones, they surely have been greatly eroded by the negotiated reduction in trade barriers and improvements in international transportation and communication. The empirical results of devaluations around the world, moreover, are fully consistent with efficiency in international markets.

This alternative view of devaluation predicts, for example, that devaluations do not improve a country's trade balance, as I argued on this page several months ago. Because nominal prices will adjust and real prices will remain unchanged, the devaluing nation will not gain a competitive advantage.

With the available data on the effects of devaluations, in fact, one would be hard pressed to find much of a relationship at all between exchange rate changes and trade balances. This, of course, does not mean that I have proven that a relationship does not exist, only that I have been unable to find one. However, I did find that trade balances appear to be closely related to a country's growth rate increases, its trade balance tends to deteriorate, and contrariwise. This view is entirely consistent with the recent improvement in the U.S. trade balance, coming as it did with the peaking of the U.S. growth rate in 1973.

Similarly, the alternative view predicts that a devaluing nation will suffer rapid inflation relative to the rest of the world. Its nominal price levels will have to increase rapidly to restore the original relationship of real prices with real prices elsewhere in the world. This effect, of course, does not depend on the actual flow of goods from one nation to another. This prediction is also consistent with the U.S. experience with deveIuation in the past 30 months or so. Other countries also provide a rich inventory of case studies.

FRANCE'S EXPERIENCE

After France's 1958 devaluation, its wholesale price index rose almost 14.5% over the three succeeding years as compared to a rise of 2.4% in Germany, 5% in the United Kingdom, and a fall of 0.1% in the United States. After its 1969 devaluation, France's wholesale price index rose 17% in three years again more than the contemporaneous U.S., German or British rises. In the three years prior to its devaluation, France had experienced only a 5% increase in its wholesale price index.

Looking at the United Kingdom experience of 1967, a similar pattern emerges. In the three years before the pound was devalued, Britain's wholesale price rise was 6.2%, while in the three years after the devaluation, the same index

rose 16.8%. Equivalent U.S. and German price increases were 9.7% and 4.5%. The relative smallness of the German figure is not surprising when one realizes that the German mark was revalued during the 1968–69 period.

One could go on and list experience after experience. One can also from the more limited data notice the precise opposite price effects when a country revalues. While the price effects of exchange rate changes are more distinct using wholesale prices, they are still quite evident using the less volatile consumer prices. Even over long periods of time, the relationship between exchange rate changes and relative rates of inflation remains remarkably close.

On the basis of historical experience in numerous countries, one surely cannot disregard the alternative view of the inflationary consequences of devaluation. In point of fact, it can hardly be coincidental that so much inflation follows directly on the heels of a devaluation in such a large number of episodes. While obviously much more could be done to verify as well as quantify the relationsips, both theory and the available empirical data suggest that a devaluation has far more than the trifling inflationary impact which the traditional doctrine suggests.

In sum, I personally feel that the mystery of the current bout of inflation in the United States is readily solvable: it is as much a direct consequence of the dollar's devaluations as any other cause. I would hope that our recent experience with devaluations would make policy officials as well as academics slighly more cautious about panaceas. Looking at the current U.S. experience alone, it would seem that a robust turnaround in the trade balance did not come until the rate of economic growth slowed, but that robust inflation took off as soon as devaluation took place.

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Representative REUSS. Congressman Hamilton.

Representative HAMILTON. Thank you, Mr. Cochairman. I am trying to get a feel for how serious you view this trade deficit problem to be, and I don't know that I have got that yet. In Mr. Cohen's case, I think maybe I do, but I am not sure with the others.

Maybe I could have you comment directly on what you think of the administration's posture on the trade deficit problem at this time.

Are they accurately gaging the seriousness or the lack of seriousness of the problem?

How would you criticize the administration's attitude toward the trade deficit and its policies toward the deficit?

I would like all of you to comment on it briefly.

I think what really concerns me is that I want to know how serious you think the problem is, and I am trying to get a gage on that.

We have a lot of economic problems that are very serious, inflation, unemployment, and so forth. Where does this fit?

Mr. LICHTBLAU. May I start, because I would like to leave.

Representative HAMILTON. Certainly.

Mr. LICHTBLAU. I think it is obviously a problem. It is not one of the most serious problems facing the U.S. economy at this time.

I don't think the magnitude of the deficit is big enough for that.

Also, I believe we can afford it. I believe deficits in fact are necessary at times, as Professor Cohen said.

I think as far as the administration is concerned, it is not clear, at least not to me, where the administration stands. At times, we hear we must curb our oil imports, strictly because we cannot afford to pay for them. Statements have been made to that effect.

Other times we hear that the current account deficit for this year is not going to be of such consequences that anything needs to be done, that we can well afford it.

So, the two are contradictory.

If we import too much oil by the criteria of the balance of payments, and yet the deficit isn't too large, I don't know what is the policy.

I think at times, as is very often the case, the deficit argument is used to support other policies and I think that is the case, particularly with oil.

Representative HAMILTON. I would like each of you to comment on it.

Mr. Krause.

Mr. KRAUSE. I would be happy to comment.

In my opinion, the deficit is more serious than Professor Cohen indicated, but it is not the most serious problem in our society, or with our economy.

While there are other matters that are much more important, it is serious enough to warrant more attention than the administration was giving it in the spring.

In fact, the administration was not only ignoring it, but somehow it was putting a happy face on it, saying the deficit was a desirable thing. I think that that is wrong.

There are two major imbalances in the world today. The most serious imbalances are the OPEC surplus and the U.S. deficit. Since the OPEC surplus is disappearing the U.S. deficit should also. However, this is not automatic. If we do not take the proper actions, then the deficit may not disappear.

Thus, it is important enough to take actions to overcome.

Furthermore, ignoring a problem that exists, only makes the political pressures on you and your colleagues all the greater, because you are ignoring a problem that is in the economy.

In short, I see the deficit as something that needs attention. Conceivably the administration has in fact changed its view. Clearly, Secretary Blumenthal's comments at the IMF meetings were of a different tenor than they were in the springtime. Maybe now he is viewing it with the right degree of concern; that is, as a problem that is not overwhelming, but as something we cannot ignore.

Mr. SLIGHTON. I would like to make the same conclusion. This is a problem, but not a major problem.

It is also difficult to really know what administration policy is, because if properly carried out, a good bit of—most, I would think—the administration policy would be conducted quietly without publicity.

The best policy is the one that we do not read about in the New York Times.

I think I would agree with Larry Krause, that there was relatively little attention given in the administration to the problems associated with the deficit in this spring.

I think the administration was surprised at this rather severe exchange market perturbation in late June or early July that followed the ministerial meetings in June.

I think the administration learned a great deal from that episode.

I am presuming that the administration is working hard to talk foreign governments, in particular Japan, into doing something about those policies that do tend to restrict, or do tend to peg exchange rates at levels that the market would not ratify.

But by the very nature, this sort of policy has to be conducted privately. It cannot be and should not be conducted through the press, and as such I can only presume that it is in fact being carried out.

Representative HAMILTON. Mr. Cohen.

Mr. COHEN. I would, too, like to join the chorus that says this is a serious problem, but not the most serious problem we have.

As I tried to stress in my statement, I believe the reason why this should be regarded as a serious problem is not the reason or reasons that are usually cited in this connection.

It is not because we are undergoing a serious decline in competitiveness in the international markets, nor do I believe it is a sign of weakening economic leadership on the part of the United States.

It is a serious problem because of its implications for policy and for the pressures on policy.

It is a serious problem because of the danger of declining confidence in the dollar in the exchange market, which could lead to repetition of the kinds of disturbances that occurred in June and July.

It is serious because of the danger that we may give in to the protectionist measures that are arising as the result of declining exports and rising imports.

It is these reasons, which I have stressed, that make this a serious problem, and one that should be dealt with.

The administration, I believe, recognizes that there are really only three broad alternative policies one can follow. Those are all three "D's"—domestic deflation, devaluation, or direct controls of one kind or another, all relatively unpalatable alternatives.

In the spring, it looked as if the administration were searching for a fourth "D" and found it in "dem others," the Germans and Japanese in particular, whose own economic performance was lagging behind ours, and whose current accounts were in surplus.

This still seems to be the problem. The positions of Germany and Japan are perverse. They should be sharing part of the deficits which is the counterpart of the OPEC surplus, and they are not.

I would agree with the other observations that have been made, that the administration has retreated from a total reliance on changes of policies elsewhere, and has come to the realization that there must be some action at home as well.

But what form can that action take? Do we want to give in to protectionist measures of one sort or another? I would argue we do not. Do we want to hold back the growth of the domestic economy? I would argue we do not.

That leaves us with the possibility of downward pressure on the exchange rate. Here, I think we run a real danger, because in my opinion the only source of whatever stability there has been in international monetary relations since 1973 has been the passive attitude of the United States vis-a-vis its exchange rate, absorbing in our own exchange rate the attitudes of others.

As far as domestic policy is concerned, the great influence on the trade deficit must be conservation of energy. Here is where the administration, I think, has begun to think more seriously about what domestic policy can do.

But with respect to the other possible policy options, I would still argue that the main emphasis, as was argued in the spring, must be on moving around some of the deficit which is the counterpart of the OPEC surplus, and that means putting pressure on the other governments, continuing to put pressure on the other governments that are currently in surplus, to share more of that counterpart deficit.

Representative HAMILTON. One of the things that strikes you when you look at the remedies all of you suggest is that we are remedying our problem by asking other governments to do something, and that seems to be part of the solution, and, of course, that is a difficult thing to do, especially with a country like Germany, for example.

Let me ask you to comment on the solutions that you have all proposed here, and see if any of you think that the solution of your colleagues on the panels may be dead wrong.

The thing that strikes me is that I look at them and there is quite a bit of similarity in the way you propose solutions.

Mr. Cohen, you talk about the stimulation of the economies. Mr. Slighton, you want a commitment to a strong U.S. dollar. I am not sure what you mean by that. You want an effective U.S. energy program, but you don't identify what kind of an energy program.

You want to enlarge the supply of the official international credit. You want to press for more expansionary policies in countries with strong external payments positions, and then you talk about a selective rate adjustment.

Mr. Krause wants to sustain a sound U.S. domestic economy as the best solution, and you, too, want to stimulate the economies.

You think the dollar may be overvalued, and you urge other countries not to intervene.

There is a good bit of similarity in what you are suggesting as a remedy, and I wonder if you want to comment on the remedies that have been suggested here as to what you think is wrong, for example, or is there total agreement among you?

Mr. COHEN. I think on one point I would disagree with Mr. Krause, if I understand his statement correctly, and that is that I would be inclined to oppose any more active exchange rate policy on the part of the United States.

What we have of an international monetary system is one which relies for its stability on the passive attitude of the U.S. exchange authorities.

Every international monetary system, to be stable, must achieve a degree of consistency in the independently targeted objectives of various governments.

In the absence of some coordinating mechanism, some automatic set of rules or a supranational world bank, we only have the alternative of management by the world's strongest and largest economy, management consisting of a passive attitude, absorbing its own balance of payments and trade balance the independently targeted positions of others.

This is the way Bretton Woods worked until 1971. Our deficit largely reflected the surplus objectives of others. Likewise in a floating world, to the extent that we allow other governments to intervene to influence their own exchange rates directly or indirectly, maintenance of stability of the system—systemic stability—requires that we have a passive attitude with respect to our own exchange rate.

Now, this is not an argument, therefore, for benign neglect. It is an argument not to take a more active intervention policy in this type of system.

Also, it is an argument for doing something about the system itself which would relieve the United States of the obligation, the responsibility, to take such a passive attitude toward our exchange rate.

My feeling is that if the United States were to adopt a more active intervention policy regarding our exchange rate, this could very easily lead to inconsistent exchange rate interventions, greater instability in the exchange market, and more damage to world trade than the alternative that I have suggested.

Representative HAMILTON. My time has expired, but perhaps Mr. Krause and Mr. Slighton should respond.

Mr. KRAUSE. I think we probably do have a difference of opinion on this issue. I think that the exchange rate is the best instrument for correcting the balance of payments problem, and that it will work if the Government will let it work. So far they have not been letting it work.

All of our solutions are cooperative solutions because we have an interdependent world economy. It is impossible to do anything independently because every action impacts on other countries. For this reason, many of our suggestions involve asking other governments to do things, or doing things in conjunction with other governments.

Representative HAMILTON. That is not always true—the energy program you suggested is within our own ambit.

Mr. KRAUSE. But other countries have energy programs that could offset their own efforts, and they think we are offsetting their good efforts, so our energy program is not independent in that sense.

There are things we must do, but it must be done in cooperation.

With respect to the exchange rate, I don't think we can be totally passive.

Other countries are intervening and using the U.S. dollar to affect the value of their currencies.

The Japanese and the British must realize that when they intervene, they change the balance of the dollar.

I am not suggesting that we go into the market and counter their actions, because that gets into a conflict situation, which clearly won't work.

But we do have an obligation in my view to let them know that we disagree with what they are doing in the exchange market, and in fact there is much that they have done with which we should disagree.

Representative HAMILTON. Mr. Slighton.

Mr. SLIGHTON. I would agree with the last part of Larry Krause's statement, that we should let foreign governments know what we

feel to be the consequences of their interventionist policies, intervention being used in a broad sense here.

I do not think, however, that the United States should have it—that the exchange rate should—that we should have an explicit objective with respect to what that exchange rate should be.

We use the term "overvaluation" very loosely in my opinion.

I do not think the solution to such problems as we have arising from the trade deficit is strictly speaking an exchange rate policy solution.

We should not presume that we—we should not have an explicit target with respect to what the effective exchange rate should be, or what DM-dollar rate should be or what the yen-dollar rate should be.

With respect to U.S. intervention in the narrow carried out through the Federal Reserve of New York, I think we should be prepared over the next year to intervene on a tactical basis somewhat more heavily than we have in the past if the uncertainties associated with the funding of this deficit do result in substantial perturbations in the DM-dollar-yen exchange rate.

In saying this, I have come to some change of views. I do think this is a potentially dangerous policy for us to follow.

I think it is dangerous in that it would tend to result in a target rate approach to intervention, which I have suggested we should not try to do.

Therefore, if we do move to stronger tactical intervention policies, we should do so, I think, with some explicit guidelines, that this intervention must be reversed within particular periods of time, that no net intervention over reasonable periods of time should be accomplished.

That would be rather difficult to define here, with respect to satisfactory rules.

I do have one comment, or further comment, with respect to Larry Krause's recommendations, and that concerns a suggestion that we should create more SDR's.

I do not really think this is helpful. I do agree that a more balanced portfolio approach with respect to currency denomination by foreign central banks would be useful, and we should encourage foreign central banks toward that end.

I do not think, however, that SDR creation would be helpful to the U.S.-trade balance nor to the world economic progress in general.

Representative HAMILTON. Thank you, Mr. Cochairman.

Representative REUSS. You have said now, Mr. Slighton, that you don't think the idea of using SDR's as a reserve currency, and thus taking some of the load off the dollar would be helpful, which brings up something I wanted to pursue with Mr. Krause in any event.

It certainly wouldn't be helpful if the IMF is going to go crazy and print SDR's like mad. There is enough liquidity around as it is, but I assume what Mr. Krause has in mind, and I will ask it in a moment, is some sort of a conversion, to make SDR's attractive so that countries will have reason to exchange their dollars to the IMF for SDR's, and then let the IMF hold the dollars from here to eternity, or whatever is needed.

Why wouldn't that be useful, if you can get away with it?

Mr. SLIGHTON. Mr. Cochairman, what I was referring to was that I was presuming we were speaking of the first option, that is creating SDR additional liquidity.

A conversion scheme I am neither going to promote nor try to confound. I have no strong opinions about that.

Representative REUSS. Maybe we should turn to the author and ask you what you would do.

Mr. KRAUSE. My understanding of chapter two of this year's report of the IMF is that they believe that an SDR creation will cause SDR's to replace dollars in the reserves.

I agree that there is no need for additional liquidity in the world. I am unhappy, however, with the form of the liquidity.

If the mechanism were as you describe—that is, if the countries with dollars would buy SDR's from the Fund—then an SDR creation would be helpful, because it would eliminate the distortion in currency values that came about because of the imbalance. The fund's reselling of dollars is an important part of eliminating the distortion.

I should add that the interest rates on SDRs would have to be increased to encourage countries to exchange dollars for SDR's, and to enable governments to make a sensible choice between holding dollars and holding SDR's.

Representative REUSS. And as so elucidated, does that eliminate your difficulty with it?

Mr. SLIGHTON. Yes, sir.

Representative REUSS. Mr. Slighton, I would appreciate your spelling out for me a bit the part of the statement you made, that the first thing that should be done to counter the trade deficit was to maintain an official commitment in strong U.S. dollars.

Mr. SLIGHTON. That is a rather rhetorical statement, and I probably should apologize for it.

I do not believe, Mr. Cochairman, that the solution to the difficulties created by the deficit is a major depreciation of the dollar, and that is what I meant by stating that we have a commitment to a strong dollar.

We are solving no problem, and creating some new ones if we take steps to encourage the dollar to depreciate by, pick a number, 10 or 20 percent.

Representative REUSS. Such steps would be the very sort of dastardly things that we have been criticizing others for doing over the dead bodies of the Joint Economic Committee, I might say.

Anybody who gets the idea that we should improve our trade position by dumping dollars to reduce the external value of the dollar has this committee to reckon with.

Mr. SLIGHTON. If by some means the dollar were allowed to slide against the major currencies by 10 or 15 percent, I don't really think that change could be sustained over long periods.

I think it would provoke counter policies in the other strong currency countries that would counter those effects to a large exent, and we should be prepared, or we should work as strongly and as quietly as we can to reduce those actions that are strictly interventionist that have essentially no objective but to achieve a particular exchange parity.

Representative REUSS. Directly and by subterfuge both?

Mr. SLIGHTON. Yes, sir.

I agree with Larry Krause that there are certain actions that cannot—this is a continuum. Some policies have both domestic and international objectives, and we have to draw a line somewhere.

I think interest rate policy on occasion is in fact an interventionist act of a foreign government that we ought to be prepared to comment on.

But, to recapitulate, this rhetorical statement on commitment to a strong dollar, by that I mean we should distinctly not try to achieve a major reduction in the value of the dollar as a way out of the problems we find ourselves in here now.

Representative REUSS. Would you agree that sometimes the quest for a strong dollar can be a self-defeating thing?

For example, there are those among our monetary authorities who from time to time are heard to say that we must have a strong dollar, and therefore we must raise interest rates regardless of their horrendous consequences for the U.S. economy, in order to attract foreign capital here and thus make a strong dollar.

In fact, however, doesn't such silly conduct end up in raising the external value of the dollar, ruining our export business, increasing our deficit and ultimately producing a weak dollar in the sense that everybody is jittery about it and people are afraid to hold it?

Shouldn't this domestic aberration be zonked with the same zeal as the foolishness of the foreigners?

Mr. SLIGHTON. I think this should be pursued for domestic objectivities only.

We should not take monetary actions with the specific view of influencing the monetary markets or the trade balance or the current balance.

Representative REUSS. Would you agree, Mr. Krause?

Mr. KRAUSE. Yes, sir.

Representative REUSS. Would you agree?

Mr. COHEN. Yes, sir.

Representative REUSS. We have a minute or two left.

Mr. Krause, in your statement, you note that the growth of imports in the six other large industrial countries was at an annual rate of nearly 16 percent during 1977, in contrast to the expansion of U.S. exports to these nations of only 7 percent.

This tends to indicate that in these areas the U.S. is suffering a serious inability to compete in world markets for manufactured goods.

I don't think you mentioned who the countries were.

Mr. KRAUSE. I was trying to make the point that there are a number of factors at work. When people say that a large part of our export trade is in capital equipment and that capital demand abroad is low they are right. But Germany also exports a lot of capital equipment and they are doing better than we are.

The same is true for the Japanese.

Indeed, not even the slow growth of the other industrialized countries is an explanation.

Their exports are rising at a rate of 13 to 18 percent annually while our exports to them are rising at a much slower rate.

I believe that our exports to Japan has remained at a constant level and our exports to Europe have increased somewhat. This is an indication that we are losing shares of markets, which in turn is an indication to me of a loss of competitiveness.

Representative REUSS. Thank you very much.

The 2 hours allotted the panel are up, though there are many questions we could continue with, but your papers and testimony have been excellent and your responses have been very helpful to the committee. We are very grateful to all of you.

Will our next group of spokesmen please come forward.

We will hear first from Under Secretary Anthony M. Solomon.

STATEMENT OF HON. ANTHONY M. SOLOMON, UNDER SECRETARY FOR MONETARY AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. SOLOMON. Mr. Cochairman, I have a shorter version of my prepared statement, which I would like to read, and I am pleased to be here with the subcommittee to discuss the U.S. position in international trade and its implications.

I will present an overview. Other administration officials will be providing greater detail on certain aspects of the situation.

Our balance in international trade has undergone a very sharp change over the past 2 years. We recorded an unusually large surplus of $9 billion in 1975. In the first 8 months of 1977, the balance shifted to a deficit at an annual rate of $30 billion. Not surprisingly, the trade deficit has begun to draw attention both here and abroad. Thus it is most appropriate that your committee has provided an opportunity for an intensive examination of its causes and significance.

Let me state my conclusions at the outset.

The swing in our trade balance is due almost entirely to two factors: (A) Our growing dependence on foreign oil, and, (B) the fact that our major trading partners have achieved less than we by way of sustained economic expansion.

Various "rigidities" in exchange rates may affect the trade balance, but in both directions. In some instances, they would tend to increase the deficit, in others to reduce it.

Loss of competitiveness has not been a significant factor.

SIGNIFICANCE OF THE DEFICIT

The size of the deficit is worrisome, and we are reviewing every measure consistent with our own national interests and our international responsibilities, that can be taken to reduce it.

We are financing this defict through a fully autonomous net inflow of foreign capital—despite a very large and continuing outflow of U.S. funds, both private and public. I am confident that we can continue to attract the capital needed to finance the current account deficit.

That does not, however, lead me to advocate a course of neglect of our trade balance. I do not believe the United States should run a deficit of this magnitude over a sustained period. More rapid growth in our markets abroad will stimulate a strengthening of the trade

balance—and we are pressing vigorously for countries that are in a position to do so to expand as rapidly as is consistent with the need to combat inflation.

Most importantly, we have a clear responsibility—in our own interest and in the world's interest—to reduce our dependence on imported oil.

I recognize that nothing we can do about energy will turn around our trade balance overnight. But concrete action now to reduce our dependence on OPEC oil in the years ahead will help, establish the prospect for a reduction in the U.S.-trade deficit in the future. And it will affect oil pricing decisions of concern to the entire world.

The trade deficit is emphatically not a problem which can or should be dealt with by the imposition of import restrictions. Clearly the spread of import restrictions would do grave damage to the U.S. economy and our national interests.

I do not mean that we should or will ignore the legitimate needs of U.S. industry. International trade must be both fair and free. If injury is due to unfair foreign subsidies or dumping, our laws provide remedies to protect U.S. industries. We are also working on a new international understanding on the use of subsidies and countervailing duties.

THE OIL PROBLEM

The single most important factor in the swing is the increase in U.S. oil imports. These purchases will total about $45 billion in 1977. The increase in OPEC oil earnings has also increased our sales to OPEC countries, of course, but we still expect a U.S.-trade deficit with OPEC countries of $25 to $30 billion.

Over the last 5 years domestic production has declined by 1.5 million barrels a day. Higher consumption accounts for increased imports of 2.5 million barrels a day. Roughly 40 percent of the increase in our oil imports can thus be attributed to our reduced production, and about 60 percent to increased oil demand.

In years to come, the balance will be dominated primarily by the relationship between the growth of the Arabian Peninsula's capacity to absorb imports and the U.S. need to import oil.

Adoption of a comprehensive national energy program which would both pare consumption and expand U.S. energy production is a necessary response to this aspect of our trade position.

NON-OPEC TRADE

Our trade with the non-OPEC countries has followed a different pattern. In retrospect, we can see that the $9 billion overall trade surplus recorded by the United States in 1975 was a highly unusual aberration, resulting primarily from this sharp decline in imports.

A sharp recovery of imports was to be expected as the domestic economy recovered. Thus, during 1976, nonfuel imports rebounded sharply, increasing some 23 percent in volume. During 1977, we expect the volume of these imports to grow about 10 percent, in keeping with the traditional U.S. income elasticity of demand for imports and our anticipated real growth.

EXPORTS

The recent performance of U.S. exports has been considerably more complex. Assistant Secretary Weil will have more to add on this subject, but I would like to underline some basic points.

I believe that there are two basic reasons for the slower growth of exports: (1) Bumper worldwide grain harvests, and (2) low rates of real growth and/or stabilization efforts in major U.S. export markets.

Reflecting the good harvests around the world, last year and this year, the volume of our farm exports is expected to fall about 2½ percent in 1977. The value of agricultural exports will probably still show a small increase although prices are off from first half-price levels.

An even more important reason for the recently low growth rate of U.S. exports, however, has been the slow pace of recovery in the economies of our major trading partners.

In the last 2 years, the U.S. economy has been growing at an annual rate averaging about 5½ percent, whereas the rest of the OECD has been averaging about 4 percent and the developing countries only about 4½ to 5 percent. This is a sharp reversal of traditional postwar growth patterns which, along with oil, has dominated the U.S.-trade accounts.

Our largest single market is Canada, which buys roughly 20 percent of all U.S. exports, and the Canadian economy has been particularly sluggish.

Another 25 percent of U.S. exports goes to LDC markets. In the past year, several major LDC's have instituted significant stabilization measures aimed at redressing their domestic imbalances and reducing their external deficits.

These programs, which were essential for the countries involved, produced sharp declines in U.S. exports—roughly 19 percent in the case of both Mexico and Brazil, for example. Indeed, Mexico and Brazil alone accounted for one-sixth of the increase in the U.S.-trade deficit in the first half of this year. All non-OPEC LDC's, taken together, accounted for 35 percent of this shift.

U.S. TRADE COMPETITIVENESS

Drawing inferences about gains or losses in a country's trade competitiveness over relatively short periods is difficult and conclusions may be warped by factors which eventually prove temporary.

The recent performance of U.S. exports to key LDC markets illustrates the complexity of analyzing international trade flows, and the necessity of avoiding hasty judgments. Between 1970 and 1976, the United States and Japan increased their shares of LDC markets.

Between the first half of 1976 and the first half of 1977, however, the U.S. market share in LDC imports—in volume terms—fell 2 percentage points—a large reduction in a 1-year period. Japan, meantime, gained 1.6 percentage points, while the other country changes were not significant. Two factors explain this shift; first, the geo-

graphic distribution of the trade, and, second, improved harvests abroad.

U.S. manufacturing industries were apparently able to maintain or increase their share in most major non-OPEC LDC markets during early 1977. Yet, because of slow growth in the major U.S. markets, mainly in Latin America, the absolute level of U.S. sales declined sharply.

One partial measure of competitiveness often used is that 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, however, the trade-weighted exchange rate of the dollar has appreciated slightly. Thus it would appear that our competitive position has neither improved nor deteriorated substantially over the past 18 months.

OUTLOOK

I have no great confidence in quantitative forecasts for the U.S. trade balance. An error of only 1 percent could result in a $3 billion error in the balance.

Our outlook has to be appraised in terms of the major factors I have been talking about—the volume of our oil imports and the price of oil, and the rate of economic growth in other areas as well as growth at home.

Alaskan oil has now begun to come on stream, and will reverse the downtrend of U.S. oil production next year. Purchases for the strategic petroleum reserve, will, however, be an offsetting factor.

The growth of our economy will be a bit slower than in 1977, but growth abroad may not pick up much—it may even be a bit slower in Europe, though a bit faster in the LDC's. World crop carryovers are at high levels and good harvests are again likely.

Consequently, the value of U.S. farm exports may decline somewhat. Thus I do not see the basis for much, if any, reduction in our trade deficit in 1978, and I would not rule out the possibility of some further increase.

Just as the relative contribution of services to the domestic economy is rising, so is the contribution of services to our international transactions.

In the first half of 1977, service transactions produced a net surplus of $17 billion at annual rate. Transfer payments—private and public—resulted in a net outflow of $5 billion, but together these items reduced the current account deficit—which includes trade plus services and transfers—by roughly $12 billion below that on merchandise trade alone.

I see no reason to expect a dramatic change in this figure, and it should be borne in mind when appraising the U.S. external position.

THE EFFECTS OF EXCHANGE RATE CHANGE

Let me address several questions the subcommittee has asked about exchange rates.

First, you asked to what extent the trade deficit results from rigidities in the exchange rate system.

I would answer that it may well be that there are instances in which some types of "rigidity"—not necessarily involving intervention in the foreign exchange markets—have acted to deter the appreciation of a particular rate and may thus have adversely affected the U.S.-trade balance to some degree. On the other hand, there have clearly been instances in which countries have acted to moderate or prevent a depreciation of their rates and may thus have tended to reduce the U.S.-trade deficit. Thus, there have been rigidities in both directions, and I would not argue that one has had more influence than the other.

But we should look not only at rigidities, but also at the rate movements which have occurred, and which are facilitating adjustment of international imbalances. The actual movements, as shown in table 1 attached to my prepared statement, have been significant.

You also asked to what extent dollar depreciation would reduce the deficit. My first observation is that depreciation would not help with our oil import bill. OPEC practice is to express the price of oil in dollar terms. Thus changes in the exchange rate of the dollar do not themselves change the oil import bill.

Certainly the experience of the past few years—in which a fivefold increase in the price of oil has been accompanied by an increase of 80 percent in the volume of our oil imports—should not lead us to expect the value of our oil imports to fall if the dollar price rose.

Speaking more broadly, let me say that depreciation might be an appropriate course if our problem were a general lack of competitiveness. But the swing in our trade position results from other factors—oil, sluggish growth and stagnant markets abroad, good harvests—rather than a general lack of competitiveness.

The dollar's exchange rate should not be influenced by only one part of our balance of payments—the trade deficit—but by all elements. With large and autonomous capital inflows, the dollar, despite the large trade deficit, has remained relatively strong in the foreign exchange markets.

As of September 30, the rate, measured on a trade-weighted basis against the other industrial countries, was actually slightly higher than it was at the beginning of 1976. It is strong because investors have confidence in the future of the U.S. economy.

Our economy is still the largest single economy in the world. Our output exceeds that of all of Western Europe combined;

Our economy is growing. In 2 years, 1976 and 1977, the increase in our market will be greater than the equivalent of the entire economy of Britain;

Our money and capital markets have a size, depth, flexibility and openness unequaled anywhere in the world;

We have a stable political system;

We respect private contracts;

We maintain a competitive, market oriented economy;

We have a determination to pursue sound economic policies which will foster sustained, noninflationary growth.

THE ACTIONS REQUIRED

Mr. Cochairman, you asked what, if anything, we should do to reduce our trade deficit. My response is this, we should:

Maintain a growing, noninflationary domestic economy;

Continue to urge countries which are in a strong external position to expand their economies as rapidly as is consistent with continued control of inflation, and to accept a weakening of their current account position and an appreciation of their currencies in response to underlying market forces;

Work to strengthen the competitiveness of our exports;

Continue to pursue the multilateral trade negotiations and to resist protectionism everywhere—including here at home;

Limit our intervention in the exchange markets to the countering of disorderly market conditions;

And above all, deal effectively with our energy problem.

In conclusion, Mr. Cochairman, the U.S.-trade deficit, while understandable and explainable in terms of the factors I have mentioned, warrants our concerns and continuing close attention. I believe the steps I have outlined represent a sound and responsible approach to a future strengthening of our position.

Thank you, sir.

[The prepared statement of Mr. Solomon follows:]

PREPARED STATEMENT OF HON. ANTHONY M. SOLOMON

Mr. Chairman: I am pleased to discuss with the Subcommittee the U.S. position in international trade and its implications. I will present an overview. Other Administration officials will be providing greater detail on certain aspects of the situation.

Our balance in international trade has undergone a very sharp change over the past two years. While we recorded an unusually large surplus of $9 billion in 1975, the balance shifted to a deficit of $9 billion in 1976—and in the first eight months of 1977 the deficit reached an annual rate of $30 billion. Not surprisingly, the trade deficit has begun to draw attention both here and abroad. Thus it is most appropriate that your Committee has provided an opportunity for an intensive examination of its causes and significance.

Let me state my conclusions at the outset:

The swing in our trade balance is due almost entirely to two factors: (a) our growing dependence on foreign oil and (b) the fact that our major trading partners have achieved less than we by way of sustained economic expansion.

Various "rigidities" in exchange rates may affect the trade balance, but in both directions. In some instances they would tend to increase the deficit, in others to reduce it.

Loss of competitiveness has not been a significant factor.

SIGNIFICANCE OF THE DEFICIT

The size of the deficit is worrisome, and we are reviewing every measure consistent with our own national interests and our international responsibilities, that can be taken to reduce it. One would expect a nation such as ours to be a net supplier of goods and services to the world in more normal circumstances. Yet the size of the deficit needs to be kept in perspective to the size of our economy. A $30 billion deficit represents about 1½ percent of our GNP, and since we are a major net exporter of services, our deficit on total current account is about $16 to $20 billion—about 1 percent of GNP.

We are financing this deficit through a fully autonomous net inflow of foreign capital—despite a very large and continuing outflow of U.S. funds, both private and public. I am confident that we can continue to attract the capital needed to finance the current account deficit.

That does not, however, lead me to advocate a course of neglect of our trade balance. I do not believe the United States *should* run a deficit of this magnitude over a sustained period. More rapid growth in our markets abroad will stimulate a strengthening of the trade balance—and we are pressing vigorously for countries that are in a position to do so to expand as rapidly as is consistent with the need to combat inflation. This is not an easy line to draw, here or abroad.

Most importantly, we have a clear responsibility—in our own interest and in the world's interest—to reduce our dependence on imported oil.

Every increase of 1 percent in our GNP is accompanied by an increase of roughly 2 percent in oil imports. We must reduce that ratio. We must act promptly and decisively both to conserve oil and to develop alternative sources of energy.

I recognize that nothing we can do about energy will turn around our trade balance overnight. But concrete action now to show that our dependence on OPEC oil will be reduced in the years ahead will help. It will help establish the prospects for a reduction in the U.S. trade deficit in the future. And it will affect oil pricing decisions of concern to the entire world.

The trade deficit is emphatically *not* a problem which can or should be dealt with by the imposition of import restrictions. Few, if any, other nations—many of which are also facing oil deficits—would tolerate restrictive measures by the United States. They would react strongly, just as we would react strongly to measures which artifically restricted US exports. We need to expand—not contract—world trade. Clearly the spread of import restrictions would do grave damage to the U.S. economy and our national interests.

In saying that we should not attempt to solve our problems at the expense of our trading partners I do not mean that we should or will ignore the legitimate needs of U.S. industry. International trade must be both fair and free. If injury is due to unfair foreign subsidies or dumping, our laws provide remedies to protect U.S. industries. We are also working on a new international understanding on the use of subsidies and countervailing duties.

RECENT DEVELOPMENTS IN U.S. TRADE

I said at the beginning of my statement that the swing in our trade balance since 1975 is attributable almost entirely to our increasing dependence on oil and to cyclical developments. I would like to elaborate on that statement.

THE OIL PROBLEM

The single most important factor in the swing is the increase in U.S. oil imports. These purchases will total about $45 billion in 1977. The increase in OPEC oil earnings has also increased our sales to OPEC countries, of course, but we still expect a a U.S. trade deficit with OPEC countries of $25–30 billion. On current account our deficit with the OPEC area would be smaller than that but still very large. The level of our exports to OPEC of both goods and services is a function of the limited capacity of the sparsely populated Arabian peninsula nations to absorb imports from any source.

In *volume* terms, U.S. oil imports have risen 80 percent over the last five years. In 1972, the United States imported 5 million barrels a day. Our current estimate for 1977 is for imports of roughly 9 million barrels a day.. Actually this increase in volume, sizable though it is, would have raised U.S. oil import costs by less than $4 billion if there had been no increase in price.

The price of a barrel of crude oil, however, increased from an average of about $2.53 in 1972 to an average of over $13.25 this year. Hence the dollar cost of U.S. oil imports has risen from $4.7 billion in 1972 to an estimated $45 billion this year.

Unlike many other industrial countries, the volume of our imports has risen *both* because of higher domestic consumption *and* because of reduced domestic output.

Over the last five years domestic production has declined by 1.5 million barrels a day. Higher consumption accounts for increased imports of 2.5 million barrels a day. Roughly 40 percent of the increase in our oil imports can thus be attributed to our reduced production, and about 60 percent to increased oil demand.

The change in the price of oil plus the increase in our dependence on imported oil have thus dominated the change in the U.S. trade balance over the past five years. In years to come, the balance will be dominated primarily by the relationship between the growth of the Arabian Peninsula's capacity to absorb imports and the U.S. need to import oil. Adoption of a comprehensive national energy program which would both pare consumption and expand U.S. energy production is a necessary response to this aspect of our trade position.

NON-OPEC TRADE

Our trade with the non-OPEC countries has followed a different pattern. Reflecting the recession non-fuel imports declined in 1975 by nearly 18 percent in volume and $6.7 billion in value. In retrospect, we can see that the $9 billion overall trade surplus recorded by the United States in 1975 was a highly unusual aberration, resulting primarily from this sharp decline in imports. It is not an appropriate norm or base against which to compare our present position.

A sharp recovery of imports was to be expected as the domestic economy recovered. Thus during 1976 non-fuel imports rebounded sharply, increasing some 23 percent in volume. During 1977, we expect the volume of these imports to grow about 10 percent, in keeping with the traditional U.S. income elasticity of demand for imports and our anticipated real growth.

EXPORTS

The recent performance of U.S. exports has been considerably more complex. Assistant Secretary Weil will have more to add on this subject, but I would like to underline some basic points.

The volume of U.S. exports declined by 2½ percent during 1975 because of world recession. (This compares with the 18 percent decline in the volume of our non-fuel imports, indicating the degree to which the differential effects of world recesssion temporarily strengthened the U.S. trade balance.) In 1976, exports increased only 7 percent in value and less than 4 percent in volume. In 1977, we foresee a similar rise of only 6 to 7 percent in the value of the U.S. exports, compared with an increase of roughly 20 percent in the value of non-fuel imports.

I believe that there are two basic reasons for the slower growth of exports: (a) bumper world-wide grain harvests, and (2) low rates of real growth and/or stabilization efforts in major U.S. export markets.

In the early 1970s, agricultural exports were a major source of strength for the U.S. trade balance. They grew dramatically from about $7½ billion in 1970 to more than $22 billion in 1974. Since that time they have risen only slightly.

Reflecting the good harvests around the world, last year and this year, the volume of our farm exports is expected to fall about 2½ percent in 1977. The value of total agricultural exports will probably still show a small increase although grain prices have been declining and new crop soybean and cotton prices are off sharply from first half price levels.

An even more important reason for the recently low growth rate of U.S. exports, however, has been the slow pace of recovery in the economies of our major trading partners.

In the last two years, the U.S. economy has been growing at an annual rate averaging about 5½ percent, whereas the rest of the OECD has been averaging about 4 percent and the developing countries only about 4½ to 5 percent. This is a sharp reversal of traditional postwar growth patterns which, along with oil, has dominated the U.S. trade accounts. Our rapid recovery has naturally increased our imports much faster than the sluggish growth rates abroad promoted our exports.

Since the trough of the recession of 1974–75, world-wide recovery has been led solely by the U.S., Japan and to some extent Germany, but only about 14 percent of U.S. exports go to Japan and Germany. In addition, the Japanese economy built up extraordinarily large commodity stocks during the speculative buying boom of 1973–74. Because these stocks are still unusually high, Japanese domestic expansion has yet to induce a normal flow of raw material imports.

Our largest single market is Canada, which buys roughly 20 percent of all U.S. exports, and the Canadian economy has been particularly sluggish.

Another 25 percent of U.S. exports goes to LDC markets. Thus the economic health of these countries is also important to the U.S. trade balance. These countries maintained relatively rapid growth rates until this year, including in 1975 when most of the industrial world was in recession. This buoyed US sales, and helped produce the unusual surplus of 1975.

That continuing growth, however, required some of the LDCs to borrow very large sums to finance unprecedented current account deficits. Such a situation was clearly unsustainable, unfortunate though that turned out to be from the standpoint of US exports. In the past year, several major LDCs have instituted significant stabilization measures aimed at redressing their domestic imbalances and reducing their external deficits. Mexico, the fourth largest U.S. export market, and Brazil, our tenth market, have been quite successful in their stabilization efforts. As a result, total import volume in Mexico fell by 24 percent between the first half of 1976 and the first half of 1977. Brazilian purchases from abroad fell roughly 15 percent.

These programs, which were essential for the countries involved, produced sharp declines in U.S. exports—roughly 19% in the case of both Mexico and Brazil. Both countries also increased their exports to the U.S. as our economy grew. Indeed, Mexico and Brazil alone accounted for one-sixth of the increase in the U.S. trade deficit in the first half of this year. All non-OPEC LDCs, taken together, accounted for 35 percent of this shift—an annual rate of over $8 billion.

U.S. TRADE COMPETITIVENESS

Drawing inferences about gains or losses in a country's trade competitiveness over relatively short periods is difficult and conclusions may be warped by factors which eventually prove temporary.

The recent performance of U.S. exports to key LDC markets illustrates the complexity of analyzing international trade flows, and the necessity of avoiding hasty judgments. Between 1970 and 1976, the U.S. and Japan increased their market shares, out-performing the other major industrial countries—Canada, France, Germany, Italy and the U.K.—in LDC markets in both volume and value terms. On a volume basis, the U.S. share of LDC imports from the "Big Seven" rose by 2 percentage points, while Japan's share rose by 1½ points.

Between the first half of 1976 and the first half of 1977, however, the U.S. market share in LDC imports (in volume terms) fell two percentage points—a large reduction in a one-year period. Japan meantime gained 1.6 percentage points, while the other country changes were not significant. Two factors explain this shift: first, the geographic distribution of the trade, and second, improved harvests abroad.

On the first point, U.S. sales are heavily concentrated in Latin America, where the absolute volume of imports declined. The Japanese by contrast sell more than two-thirds of their LDC-destined goods to Asian customers where markets expanded sharply in 1976–77. This regional difference accounts for three-fifths of the drop in the U.S. market share.

On the second point, U.S. exports of agricultural products fell 11 percent in volume terms because of more favorable crops in the LDCs. This decline masked an increase in the U.S. share of manufactured imports in several major LDC markets; in three countries where U.S. agricultural sales fell precipitously and where the overall U.S. market share was down—India, Brazil, and Morocco—the U.S. market share for manufactures rose. We have found only one case—Peru—where an increase in agricultural sales hid a declining U.S. market share for manufactures.

U.S. manufacturing industries were thus apparently able to maintain or increase their share in nearly all major non-OPEC LDC markets during early 1977—in 13 of the 18 major non-OPEC markets. Yet because of slow growth in the major U.S. markets, mainly in Latin America, the absolute level of U.S. sales declined sharply.

One partial measure of competitiveness often used is that 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, however, the trade-weighted exchange rate of the dollar has appreciated slightly. Thus it would appear that our competitive position has neither improved nor deteriorated substantially

over the past 18 months. The IMF reached a similar judgment in its review of the United States economy last spring. We believe, therefore, that the increase in the trade deficit cannot be explained in terms of a worsening of relative price performance.

OUTLOOK

I have no great confidence in quantitative forecasts for the U.S. trade balance. Our forecasting efforts in recent years have been embarrassingly inaccurate—although those of the international organizations and private analysts have been even further from the mark. The total value of our trade next year will probably exceed $300 billion, and an error of only 1 percent on each side could result in a $3 billion error in the balance.

Our outlook has to be appraised in terms of the major factors I have been talking about—the volume of our oil imports and the price of oil, and the rate of economic growth in other areas as well as growth at home.

Alaskan oil has now begun to come on stream, and will reverse the downtrend of U.S. oil production next year. Purchases for the Strategic Petroleum Reserve, will, however, be an offsetting factor. The growth of our economy will be a bit slower than in 1977, but growth abroad may not pick up much—it may even be a bit slower in Europe, though a bit faster in the LDCs. World crop carryovers are at high levels and good harvests are again likely. Consequently, the value of U.S. farm exports may decline somewhat. Thus I do not see the basis for much, if any, reduction in our trade deficit in 1978, and I would not rule out the possibility of some further increase.

Just as the relative contribution of services to the domestic economy is rising, so is the contribution of services to our international transactions. Investment income, military transactions, transportation and insurance charges and tourism are important items in our international payments balance. In the first half of 1977, those service transactions produced a net surplus of $17 billion at annual rate. Transfer payments (private and public) resulted in a net outflow of $5 billion, but together these items reduced the current account deficit—which includes trade plus services and transfers—by roughly $12 billion below that on merchandise trade alone. I see no reason to expect a dramatic change in this figure, and it should be borne in mind when appraising the U.S. external position.

THE EFFECTS OF EXCHANGE RATE CHANGE

Let me address several questions the Subcommittee has asked about exchange rates.

First, you asked to what extent the trade deficit results from rigidities in the exchange rate system.

I would answer that it may well be that there are instances in which some types of "rigidity"—not necessarily involving intervention in the foreign exchange markets—have acted to deter the appreciation of a particular rate and may thus have adversely affected the U.S. trade balance to some degree. On the other hand, there have clearly been instances in which countries have acted to moderate or prevent a depreciation of their rates and may thus have tended to reduce the U.S. trade deficit. Thus there have been rigidities in both directions, and I would not argue that one has had more influence than the other.

But we should look not only at rigidities, but also at the rate movements which have occurred, and which are facilitating adjustment of international imbalances. The actual movements, as shown in Table 1 attached, have been significant.

You also asked to what extent dollar depreciation would reduce the deficit. My first observation is that depreciation would not help with our oil import bill. OPEC practice is to express the price of oil in dollar terms. Thus changes in the exchange rate of the dollar do not themselves change the oil import bill. Certainly the experience of the past few years—in which a five-fold increase in the price of oil has been accompanied by an increase of 80 percent in the volume of our oil imports—should not lead us to expect the value of our oil imports to fall if the dollar price rose.

Speaking more broadly, let me say that depreciation might be an appropriate course if our problem were a general lack of competitiveness. But the swing in our trade position results from other factors—oil, sluggish growth and

stagnant markets abroad, good harvests—rather than a general lack of competitiveness.

The dollar's exchange rate should not be influenced by only one part of our balance of payments—the trade deficit—but by all elements. With large and autonomous capital inflows, the dollar, despite the large trade deficit, has remained relatively strong in the foreign exchange markets. As of September 30, the rate, measured on a trade weighted basis against the other industrial countries, was actually slightly *higher* than it was at the beginning of 1976. It is strong because investors have confidence in the future of the U.S. economy.

Our economy is still the largest single economy in the world. Our output exceeds that of all of Western Europe combined.

Our economy is growing. In 2 years—1976 and 1977—the increase in our market will be greater than the equivalent of the entire economy of Britain.

Our money and capital markets have a size, depth, flexibility and openness unequalled anywhere in the world.

We have a stable political system.

We respect private contracts.

We maintain a competitive, market oriented economy.

We have a determination to pursue sound economic policies which will foster sustained, non-inflationary growth.

THE ACTIONS REQUIRED

Mr. Chairman, you asked what, if anything, we should do to reduce our trade deficit. My response is this: We should:

Maintain a growing, non-inflationary domestic economy.

Continue to urge countries which are in a strong external position to expand their economies as rapidly as is consistent with continued control of inflation, and to accept a weakening of their current account position and an appreciation of their currencies in response to underlying market forces.

Work to strengthen the competitiveness of our exports.

Continue to pursue the multilateral trade negotiations and to resist protectionism everywhere—including here at home.

Limit our intervention in the exchange markets to the countering of disorderly market conditions.

And above all, deal effectively with our energy problem.

In conclusion, Mr. Chairman, the U.S. trade deficit, while understandable and explainable in terms of the factors I have mentioned, warrants our concerns and continuing close attention. I believe the steps I have outlined represent a sound and responsible approach to a future strengthening of our position.

TABLE 1.—CHANGES IN VALUES OF SELECTED CURRENCIES IN TERMS OF THE U.S. DOLLAR

[In percentage]

	End December 1975 to end December 1976	End December 1976 to end September 1977	End December 1975 to end September 1977
Japanese yen	+4.2	+11.1	+15.0
German mark	+11.0	+2.3	+13.4
Dutch guilder	+9.4	+0.7	+9.3
Swiss franc	+6.9	+4.6	+12.1
Austrian schilling	+10.4	+1.6	+12.1
Belgian franc	+9.9	+0.6	+10.6
Norwegian krone	+7.7	−5.7	+1.6
Danish krone	+6.7	−5.9	+0.4
Swedish krona	+6.3	−14.5	−9.1
Canadian dollar	+0.7	−5.9	−5.4
French franc	−9.7	+1.3	−8.7
Australian dollar	−13.6	+1.9	−11.9
British sterling	−15.9	+2.6	−13.6
Italian lira	−21.9	−0.8	−22.6
Portuguese escudo	−12.9	−22.6	−32.6
Spanish peseta	−12.5	−19.3	−29.4
Brazilian cruziero	−26.5	−17.3	−39.2
Mexican peso	−37.3	−12.3	−45.0
Chilian peso	−51.2	−13.8	−57.9
Argentine peso	−77.8	−38.2	−86.3

Representative REUSS. Thank you, Mr. Solomon.
Mr. Samuel.

STATEMENT OF HON. HOWARD SAMUEL, DEPUTY UNDER SECRETARY OF LABOR FOR INTERNATIONAL AFFAIRS

Mr. SAMUEL. Mr. Cochairman, members of the committee, I am pleased to have this opportunity to make some observations on the impact of the current trade deficit on the employment situation in the United States.

It may be helpful first to review recent employment trends in the United States. Total employment has risen substantially since the trough of the recession in 1975. Total employment on nonagricultural payrolls averaged 79.4 million in 1976, an increase of 2.4 million over 1975.

It has continued to rise in 1977, and stood at 82.8 million in September—seasonally adjusted. Manufacturing employment which fell from an average of 20 million in 1974 to an average of 18.3 million in 1975, rose to 19 million in 1976 and was 19.6 million in September 1977—seasonally adjusted. It has been essentially flat in recent months and remains below the 1974 average. Individual manufacturing sectors have tended to follow a similar pattern but there are some differences.

For example, employment in motor vehicles has risen substantially over the past year, but employment in basic steel has been stagnant for more than a year and is still markedly below the 1974 level.

In commenting on the questions before the committee, I will confine my remarks to the manufacturing trade balance for which the employment issue may be of greatest relevance. This sets aside, for the purpose of this discussion, the special problems of energy and of changing crop conditions around the world which play a large part in determining agricultural trade.

The issue of the aggregate employment impact of the overall trade deficit depends largely on the reasons for the deficit. To the extent that the deficit reflects the fact that the U.S. economy has been growing faster than the economies of our trading partners, it should not be regarded as having a significant impact on aggregate employment in the United States.

On this assumption, the deficit could be considered to be a byproduct of our economic progress relative to that of other countries. To the extent that the deficit reflects reduced competitiveness of U.S. goods in domestic and export markets, then the deficit may be having an impact on the employment situation.

The balance of U.S. trade in manufactures showed a surplus of about $20 billion in 1975. It dropped to $12.5 billion in 1976 and further to $3.7 billion, at an annual rate, in the first 8 months of 1977. The balance has been falling all year. So far in the third quarter it has been in deficit at an annual rate of $800 million. I should note that these data are based on f.a.s. [freight alongside ship] valuations for imports.

In order to estimate employment impacts, it may be more appropriate to use c.i.f. [cost, insurance, freight] valuations to reflect more

closely the amount actually paid by Americans for imports and to take account of the fact that almost all transportation services for imports are performed by foreigners. If c.i.f. valuations were used, exports and imports of manufacturers would show a deficit of approximately $2 billion in the first 8 months of 1977 compared to the surplus of 3.7 billion based on f.a.s.

Secretary Solomon has made the point that the increased trade deficit is probably due in the main to increased oil imports and the pace of our recovery relative to other countries. Aggregate employment has been moving upward during the period in which the trade deficit has been rising. We recognize that the trade deficit is not a dominant factor in determining the aggregate level of employment.

But, whatever the balance of the trade account, increasing penetration by imports may have intensified employment problems in particular industries. We would note that it has been necessary to take some form of remedial action to restrain imports of footwear, televisions, apparel, and specialty steel. Other recent developments indicate potential dislocations arising from trade in other sectors. For example, the basic steel industry is deeply concerned about increasing import penetration of the domestic steel market.

While it is difficult to make systematic estimates of the relationship between the trade trends and employment, the Department of Labor has had to make judgments on trade displacement in each of the growing number of petitions for trade adjustment assistance filed by workers under the Trade Act of 1974. In each of these specific cases, the DOL must decide whether imports have contributed importantly to the unemployment or underemployment the workers have experienced. From the beginning of the program in April 1975 through September 30, 1977, approximately 255,000 workers involved in 840 petitions have been certified as eligible for worker adjustment assistance under the Trade Act of 1974.

These certifications have included more than 50,000 workers in steel, about 35,000 in apparel, 24,000 in leather and leather products, mostly footwear, 63,000 in transportation equipment, and 29,000 in electrical and electronic equipment. In the first 9 months of 1977 alone, a total of 72,000 workers have been certified. It should also be noted that a substantial number of petitions have been denied reflecting judgment under the Trade Act, that imports in those cases did not contribute importantly to employment dislocations.

From the beginning of the program through September 30 of this year, approximately 300,000 workers have been denied eligibility, many of them in the same broad sectors mentioned above. The distinction lies in the situation of the particular plant and specific product involved.

At least for the workers in the cases which have been certified, it is reasonable to conclude that increased imports have contributed importantly to their unemployment. In these cases, however, the dislocations might still have occurred even if U.S. exports had been keeping pace with U.S. imports.

There are many difficulties involved in trying to evaluate the impact of recent changes in imports and exports on aggregate employment. Ideally, we should have information on areas such as the

effect of increased imports on the demand for domestic products, and the relationship between changes in output and changes in employment.

Nevertheless, the experience with the trade adjustment assistance program indicates that recent trade trends have increased employment problems in particular sectors. This possibility was recognized by the Congress in establishing the trade adjustment assistance program, and improving access to the program by the Trade Act of 1974.

The point to be stressed, perhaps, is that it is necessary to go behind the trade aggregates reflected in the trade balance and examine trade in specific products. The Bureau of International Labor Affairs of the Department of Labor is engaged in an effort to estimate sectoral and aggregate relationships between employment and exports and imports. We hope to be able to shed more light on the trade and employment issue in the near future.

This concludes my statement.

Thank you.

Representative REUSS. Thank you very much, Mr. Samuel.

Secretary Weil.

STATEMENT OF HON. FRANK A. WEIL, ASSISTANT SECRETARY OF COMMERCE FOR DOMESTIC AND INTERNATIONAL BUSINESS

Mr. WEIL. Thank you, Mr. Cochairman.

I am pleased to have this opportunity to discuss the U.S. foreign trade position. There is no doubt that the trade deficit poses a serious and very complex problem for the United States. The problem is complicated by the fact that for much of the public, trade has become a sensitive and at times an emotionally charged issue.

There is no question in my mind that the trade deficit must be dealt with. It cannot be ignored. Though the problem is a serious one, realistically, there are no simple or quick solutions. Many possible actions could worsen, rather than improve, the impact on the U.S. economy.

The Department of Commerce currently estimates a 1977 trade deficit of close to $30 billion on a balance of payments basis, and we expect a 1978 deficit of roughly the same magnitude. Moreover, as we look down the road, it appears that a sizable U.S.-trade deficit may be a fact of life for some time to come.

Many different factors are contributing to the trade deficit, but there is no doubt that oil is by far the principal cause. The fivefold increased in oil prices since 1973, coupled with growing U.S. oil consumption and falling U.S. oil production, has led to an oil import bill that will amount to about $45 billion in 1977. This amount is as large as our total import bill for all our imports in 1971.

Effective action to reduce our future oil imports represents the fundamental basis for a return to a more reasonably balanced trade position.

Oil imports, however, are only part of the problem. Half of the expected $20 billion decline in the U.S.-trade balance this year is in products other than oil. Of particular concern to the Department of Commerce is the almost $9 billion decline in our manufactured goods trade balance.

For the first 8 months of 1977, U.S. trade in manufactured goods was in surplus at an annual rate of only $3.7 billion, contrasted with a $12.5 billion surplus in 1976. Moreover, the balance has been falling throughout 1977, and in the third quarter it was in deficit at an annual rate of $800 million.

It is particularly important that we attempt to understand the causes of our declining trade balance in manufactures. The conclusion that we and others have drawn, based on available data, is that a decline in U.S. competitiveness is not a primary cause of the U.S.-trade deficit at this time. This does not mean, however, that the United States may not have lost some competitiveness or that competitiveness is not a problem.

The predominant cause of the present decline in the manufactures trade balance is the difference between economic performance of the United States and other nations. The United States is presently the principal element of strength in the world economic recovery. Economic growth abroad, on the other hand, has been extremely slow in 1977 and is clearly reflected in our sluggish export performance.

Industrial production in other developed nations has been essentially stagnant for the last 10 months, and, in fact, was lower in July of this year than in January. In addition, many of our less-developed trading partners have been forced by oil prices and foreign exchange constraints to reduce their imports of manufactures and to slow their economic growth.

Our manufactured goods exports to these countries—which normally account for about one-fourth of all U.S.-manufactured goods exports—are virtually unchanged from 1975.

For our domestic economy, the rapidity of our import growth in certain sensitive industries has required Government action in adjusting to competition from abroad. In the aggregate, however, our manufactured imports do not appear to be out of line with what we would expect, given the strong growth in our domestic economy.

Because the quantity of manufactured imports fell so sharply in 1975, due to the recession, the 24-percent increase in quantity in 1976 barely restored the prerecession relation between imports and domestic activity.

It is important, however, that we do not allow the predominate role of growth differentials reflected in our present trade deficit to foster a complacency about our underlying competitive position. There are some indications that the United States may have lost ground to foreign competitors, though any influence this has had on our present trade performance appears to be minor.

"Competitiveness" is one of those terms that is easy to talk about but difficult to define or measure. The lack of some key data—such as market shares—beyond the first quarter of 1977—makes an accurate assessment of our competitive standing difficult.

Given the time lags involved, we might currently expect to be experiencing some negative impact on our export performance from a deterioration in our price competitiveness that occured in 1975.

For the last year, however, our international price competitiveness has remained stable, and we continue to retain a good part of the price improvement that resulted from the 1971–73 currency realinements.

As a former businessman, however, I am keenly aware that price is only one factor in termining competitiveness. It is the future that concerns me. Many economists expect that U.S. and foreign economies will grow more slowly in the future than in past decades.

This may imply increased reliance on nonprice factors—such as salesmanship, market knowledge, delivery times, product quality, credit terms, et cetera—as competitors struggle to increase their sales in slowly growing markets. Competition will be further intensified by the increasing entry of the less-developed countries as exporters of a growing range of manufactured goods.

While we should not ignore Lord Keynes' dictum that in the long run we are all dead, we are perhaps so caught up in the short-term aspects of our trade situation that we do not foresee as we should the longer run problems we face in adjusting to a more slowly expanding and more competitive world economy.

Competitiveness in the longer run, I believe will become less a question of price than of ensuring that the U.S. economy is dynamic, that it innovates and invests. We must be able to restructure our market orientation, shifting away from traditional products and markets that are slowly growing to those that are more dynamic. That is the key to international competitiveness in the longer term.

Exports have always been more important to most other nations than to the United States, which for decades could content itself with its huge continental market. Other nations have developed their economies by taking full cognizance of the need to export and the need to avoid policies that disadvantage exports. We need to do the same.

There are positive action that need to be taken to address the U.S.-trade deficit.

A reduction in future U.S.-trade deficits depends importantly upon: reducing future oil imports; more rapid economic growth abroad; and increased U.S. competitiveness in world markets.

Progress will not be easy in any of these areas, and results will take time to manifest themselves. Actions, however, should be initiated soon. I am most concerned that we get in train those policies which take a long time to start in motion and even longer to become effective.

Moreover, we need to act while we still have latitude and discretion to select the most positive and beneficial courses and are not forced into a position in which we have no choices. Reduction in our oil imports represents the fundamental way to return to a reasonably balanced trade position.

Until we, as a Nation, are capable of greater energy conservation and self-sufficiency, we should not expect an elimination of the deficit, nor is it desirable from the perspective of assuming our fair share of the world's oil burden. We really do need an energy program.

Perhaps the most immediate improvement in our trade balance would come through an increase in foreign economic activity. Unfortunately, reversal or moderation of slow growth abroad may not be quick and, unlike oil, it is not a factor on which the United States can exert a primary influence. We can and should, however, continue to impress upon other nations, especially Germany and Japan, the

counterproductive nature of excessively relying on export-led growth and the necessity of undertaking adequate measures to stimulate their domestic demand.

Longer term, but within our control, is our approach to ensuring the future competitive position of the United States in world markets. Fundamentally, this is a matter of national awareness and consciousness and of economic structure. We are going to have to export more to pay for our imports, and we have to become more competitive to do it.

Domestically, we have to ensure a strong economy capable of a more rapid change in our industrial structure than we have experienced in the past. This will require an acceleration in the replacement and renewal of our capital stock and a reduction in structural rigidities to the movement of capital and labor.

We need to examine our existing domestic policies as they affect our international competitiveness. Taxation, investment, antitrust, transportation, and many other policies affect our competitiveness, even though their proponents may not have considered that. We need to change those laws that seriously impact on our competitiveness.

We also need to ensure that new laws and policies do not hamper our competitiveness. Before implementing new policies, we should examine their effect on our trade. We need to be more systematic about such assessments. I hope that as we improve our overall economic evaluation process we can include provision for assessing the trade impact of all proposed laws and policies.

Many U.S. businessmen believe we do not do enough for our exporters compared with other nations. We need to better evaluate our efforts and to renew our commitment to exporting.

We need to ensure that U.S. exporters have credit facilities on competitive terms. We need to increase our export promotion efforts, and to restructure them to the needs of tomorrow. Only about 20,000 of 300,000 U.S. manufactures firms export—this great potential must be utilized.

Most fundamentally, we need to ensure American exporters the opportunity to compete on a fair footing in foreign markets. A most important effort is to achieve a successful conclusion to the multilateral trade negotiations. At home, we need to deal quickly with unfair trade practices such as dumping.

None of these needs that I have outlined are new. They have been discussed often before, but not enough has been done on most of them. What has been lacking is the determination and the priority to act.

I would not want to look back and say that the late 1970's marked the beginning of an era in which the United States led the rest of the world into self-defeating rounds of protectionist policies. I hope that years from now we can look back and say that the trade deficit, although presenting difficult problems of adjustment, also awakened us to the need to improve our competitive position in the international economy.

Mr. Cochairman, I have filed with the committee staff a substantially longer, more detailed prepared statement covering essentially the same points.

[The prepared statement of Mr. Weil follows:]

PREPARED STATEMENT OF HON. FRANK A. WEIL

Mr. Chairman, I am pleased to be able to discuss the U.S. foreign trade position with the Subcommittee today and to consider some of the problems and ramifications of that position.

The trade deficit poses a serious and very complex problem for the United States. The problem is complicated by the fact that, for much of the public, trade has become a sensitive, and at times an emotionally charged issue. It is extremely important, I believe, that the trade deficit be dealt with positively and rationally, with a more complete understanding of its causes and effects.

What I would like to do today is: Provide a brief overview of our general trade situation and prospects; focus your attention on the U.S. position in manufactured goods trade; respond to your questions regarding the U.S. competitive position; and suggest what actions the United States should take.

There is no doubt in my mind that the trade deficit must be dealt with. It cannot be ignored. Though the problem is a serious one, realistically there are no simple or quick solutions. Many possible actions could worsen, rather than improve, the impact on the U.S. economy.

SIZE OF THE DEFICIT

To begin with, let's look at the size of the deficit. The Department of Commerce is currently estimating a 1977 trade deficit of close to $30 billion, on a balance of payments basis. It is, of course, partially offset by a surplus on the services account, so that the current account deficit is expected to be about $18 billion in 1977—about 1.0 percent of GNP. While a figure of this size amounts to a comparatively small proportion of GNP, it is sizeable both in relation to our historical experience and in relation to our exports of goods and services. In the first half of this year, for instance, the current account deficit was equivalent to 10 percent of our exports of goods and services. We should not lull ourselves into believing that this is a low proportion in relation to the experience of other countries. In fact, it is a higher proportion than that experienced last year by the troubled economies of Italy and the United Kingdom—6 percent and 4 percent, respectively.

Current indications point to another U.S. trade deficit of about the same magnitude for 1978. While very preliminary indications lead us to suspect the trade deficit will moderate somewhat in 1979, it appears that a sizeable U.S. trade deficit may be a fact of life for some time, and we must deal with the present deficit in that context.

Many different factors are contributing to the trade deficit, but there is no doubt that oil is by far the principal cause. The five-fold increase in oil prices since 1973, coupled with growing U.S. oil consumption and falling U.S. oil production, has led to an oil import bill that will amount to about $45 billion in 1977. This staggering amount is as large as our total import bill for *all* our imports in 1971.

There can be no return to a reasonably balanced trade position without effective action to reduce our oil imports, and/or sufficient growth in OPEC import absorption. The importance of effective action to reduce oil imports simply cannot be overstated. Until we are capable of greater energy conservation and self-sufficiency in a cost-effective manner, a complete elimination of the U.S. deficit should not be expected nor, from the perspective of the sharing of the world's oil deficit, is it desirable.

Oil imports, however, are only part of the problem. Half of the expected $20 billion decline in the U.S. trade balance this year is in products other than oil.

About $2 billion of this decline is in the agricultural trade balance. The smaller agricultural surplus is the combined result of better crop conditions abroad—resulting in both lower prices for some U.S. farm products and reduced quantity levels (particularly U.S. wheat exports)—and of huge price increases in some imported agricultural commodities (notably coffee).

Of particular concern to the Department of Commerce, however, is the decline in the manufactured goods trade balance. It is this trade that I specifically want to discuss today.

MANUFACTURED GOODS TRADE

U.S. trade in manufactured goods was in surplus by $12.5 billion in 1976. For the first eight months of 1977, however, the surplus was running at an annual rate of $3.7 billion—a $9 billion decline from 1976. The balance, moreover, has been falling all year. Our manufactures trade was in surplus by about $5.9 billion at an annual rate in the first quarter of 1977 and at an annual rate of $1.6 billion in the second quarter. So far in the third quarter it has been in deficit at an annual rate of $800 million.

The declining balance is the result of both rapid import growth and slow export growth. For this year as a whole, manufactured imports will probably be up about 20 percent, but manufactured exports will have increased only about 6 percent.

The declining position in manufactured goods trade is of particular significance because of the importance of such trade to the United States. In the past, manufactures have accounted for about two-thirds of U.S. exports and about one-half of U.S. imports. It is manufactured goods, moreover, which tend to raise the greatest controversy in foreign trade, for most people typically associate changes in this balance with factors such as employment impacts and competitiveness.

Thus it is particularly important that we attempt to understand the causes of the declining trade balance in manufactured goods. The consensus among economists is that a decline in U.S. competitiveness is not a primary cause of the U.S. trade deficit at this time. This does not mean, however, that the U.S. may not have experienced some loss in its relative competitive position or that competitiveness is not a problem for the United States.

The predominant cause of the present decline in our manufactures trade balance is the difference between the economic performance of the United States and of other nations. The United States is presently the principal element of strength in the world economic recovery. Our economic growth has played the key role in the 20 percent increase in U.S. imports of manufactures this year. In certain sensitive industries the rapidity of import growth has required government action in adjusting to increased competition from abroad. Nevertheless, the current aggregate level of imports does not appear to be significantly out of line with historical relationships. During the 1975 recession, the ratio of manufactured imports to domestic shipments of manufactures fell sharply. This ratio has recently restored itself to pre-recession levels, suggesting that some moderation in the rapid pace of import growth relative to domestic output should be forthcoming.

Economic growth abroad, on the other hand, has been extremely slow in 1977. The Department's index of industrial production in other developed nations shows that, on a trade-weighted basis, industrial activity abroad has essentially been stagnant since November 1976. Industrial production abroad was, in fact, lower in July of this year than in January. Understandably, this has led to extremely slow growth in the demand for U.S. manufactures on the part of other developed nations.

Economic growth has also been slow in the less-developed nations (LDCs). This factor is more important to U.S. trade than to the trade of most other nations, as about one-fourth of all U.S. manufactured goods exports normally go to the non-oil LDCs. Many of these nations, particularly in the important Latin American market, have been forced by oil prices and foreign exchange constraints to reduce their imports of manufactures and to slow their economic growth.

Reflecting these constraints, U.S. manufactured goods exports to the non-oil producing LDCs are no larger in 1977 than they were in 1976. In fact, this is the second straight year of no growth. Our manufactured goods exports to these countries are virtually unchanged from 1975.

Compounding the problem of slow growth abroad is the fact that investment has been a slow-growing economic sector in most developed nations and LDCs. This has particularly dampened demand for capital goods, which account for half of U.S. manufactures exports. The United States, on the other hand, is traditionally an importer of consumer goods, and the consumer sector has been among the most rapidly growing segments of the U.S. economy.

These factors account for the vast bulk of the deterioration in U.S. manufactured goods trade. Their reversal, unfortunately, may not be quick.

COMPETITIVENESS

The Committee has indicated that it is concerned about the competitiveness of U.S. manufactured goods and so am I. Competitiveness, however, is one of those concepts which is easy to talk about but very difficult to define. It is also an area in which judgments abound, but accurate and timely data are in short supply.

While the available data are somewhat ambiguous of late, we tend to believe that a loss in competitiveness has not been a major cause of the decline in the manufactured goods trade balance so far. There are some indications, particularly in market shares, that the U.S. competitive position may have been weakening slightly. Any weakening in the competitive position so far, however, has been far overshadowed in its trade balance impact by the effects of slower economic growth abroad than in the United States.

Conventionally, economists use relative price changes as a measure of international competitiveness. I believe this concept has some utility, but it is far from perfect in defining competitiveness in its actual sense—in particular, it does not take into account those non-price factors which figure so importantly in determining sales in international markets.

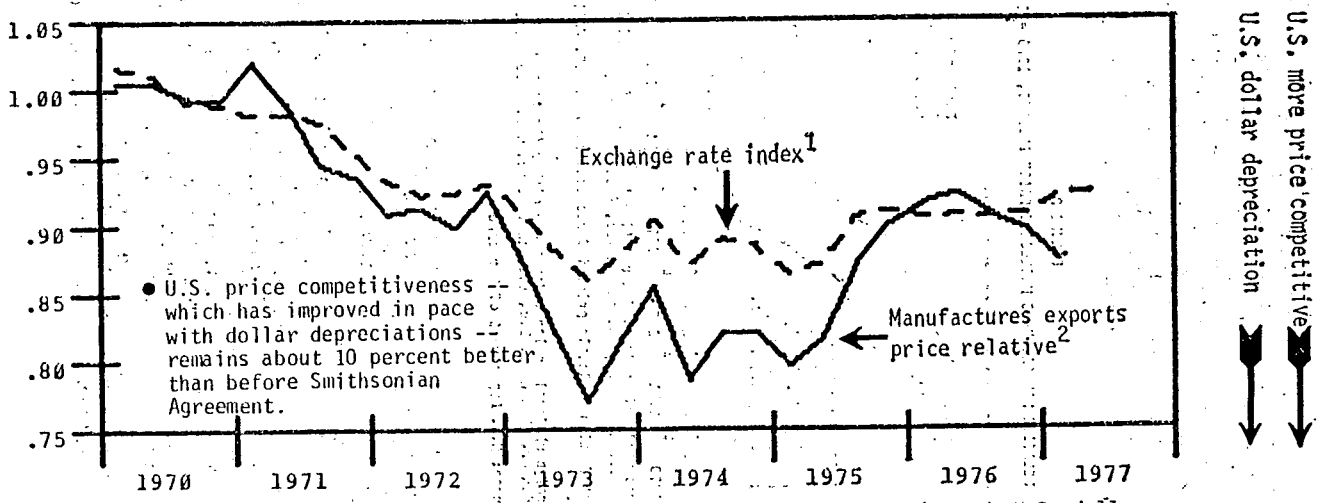
Competitiveness as measured by relative prices has fluctuated considerably since the Smithsonian Agreement, and these fluctuations have almost certainly had an effect on our trade position. Figure 1 illustrates the ratio of U.S. prices of manufactured exports to the export prices of our major industrial competitors for the period 1971 to 1976.

Also shown in Figure 1 is the export-weighted U.S. exchange rate. Clearly, the devaluations of the dollar had a positive effect on U.S. competitiveness. From the second quarter of 1971 to the third quarter of 1973, U.S. competitiveness, as measured by the relative price movements of manufactures, increased 22 percent. Since that peak, U.S. price competitiveness has declined to some degree but remains about 12 percent better than before the Smithsonian Agreement.

FIGURE 1

MEASURES OF COMPETITIVENESS:

MANUFACTURES EXPORT PRICE RELATIVE AND EXCHANGE RATE INDEX, 1970 = 1.00



[1]Export-weighted exchange rate index -- Industrial countries' currencies per U.S. dollar.

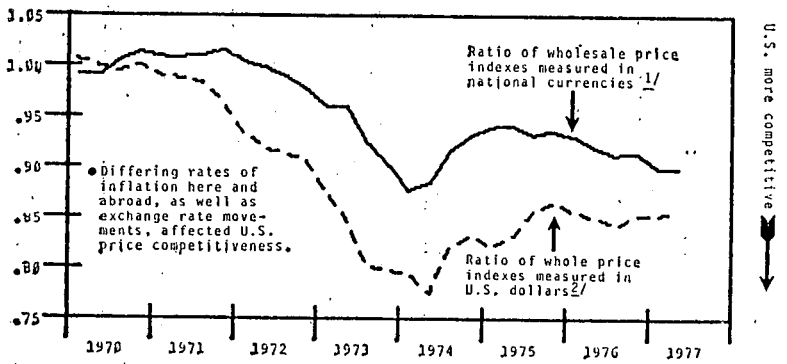
[2]U.S. manufactures export unit value index relative to foreign industrial countries' manufactures unit value indexes (measured in dollars) -- U.S./Foreign.

Source: Office of Economic Research, U.S. Department of Commerce.

The improvement in U.S. price competitiveness of manufactures since 1971 was not entirely due to exchange rate changes. Figure 2 shows U.S. wholesale prices for manufactured goods compared to the wholesale prices of our major industrial competitors. In one case the comparison is in national currencies and the other is in dollars. The gap between the two lines reflects the effects of exchange rate changes. The movement of the index in national currencies indicates that the United States had a superior domestic price performance as compared to its major competitors in the 1971–73 period. It also shows that some of our price competitiveness loss since 1973 can be attributed to higher inflation in the United States in 1974 and 1975 than abroad. In 1976 and 1977, however, U.S. inflation has been more moderate. With a relatively good domestic price performance the dollar has strengthened, so that, on balance, our recent international price competitiveness has remained relatively stable.

FIGURE 2

RELATIVE MANUFACTURES WHOLESALE PRICE INDEXES, 1970 = 1.00



1/ U.S. manufactures wholesale price index relative to foreign industrial countries' wholesale price indexes* measured in national currencies, (U.S./Foreign).

2/ As above, except foreign wholesale price indexes converted in U.S. dollars using current exchange rates.

*Foreign wholesale price indexes are either the total wholesale price index or, when available, the manufactures wholesale price index.

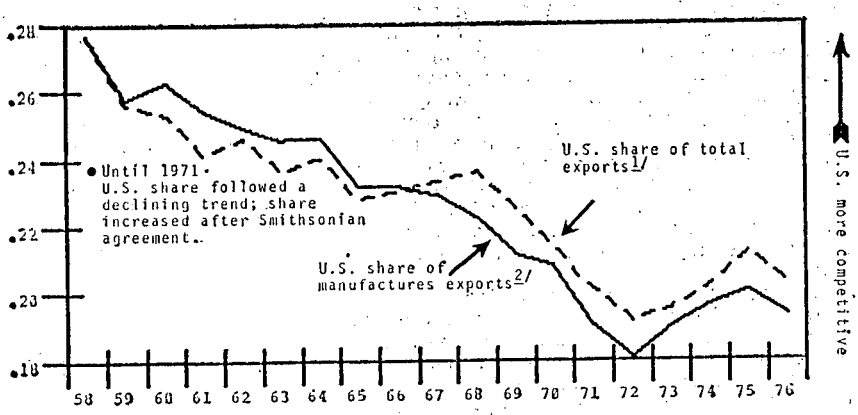
Source: U.S. Department of Commerce

These relative price indexes do not measure absolute competitiveness, but rather only relative changes. Nevertheless, the relative price movements over the last five years suggest that the devaluations did bring a significant improvement to U.S. price competitiveness, and that we continue to retain a good part of that improvement.

Another common measure of competitiveness is market share performance, but this indicator is also far from perfect. Market shares do reflect changes in competitiveness, but they also reflect changes in the composition of country and product demand. As shown in Figure 3, from the mid-1950s to the early 1970s, the U.S. share of both manufactures exports and of total trade showed a general decline. In 1972, however, our share began an upward trend that peaked in 1975. Since 1975, the share has declined somewhat. The trade share decline in the 1950s and 1960s reflected, to a considerable degree, the growth in our trading partners' economies. As other economies developed their industrial bases after the war, their exports increased relative to U.S. exports. Some of this decline, however, particularly in the late 1960s, also reflected a lack of price competitiveness due in part to an overvalued dollar.

FIGURE 3

U.S. EXPORT SHARES -- TOTAL AND MANUFACTURES



1/ U.S. share of total exports of industrial countries (current U.S. dollars and current exchange rates).

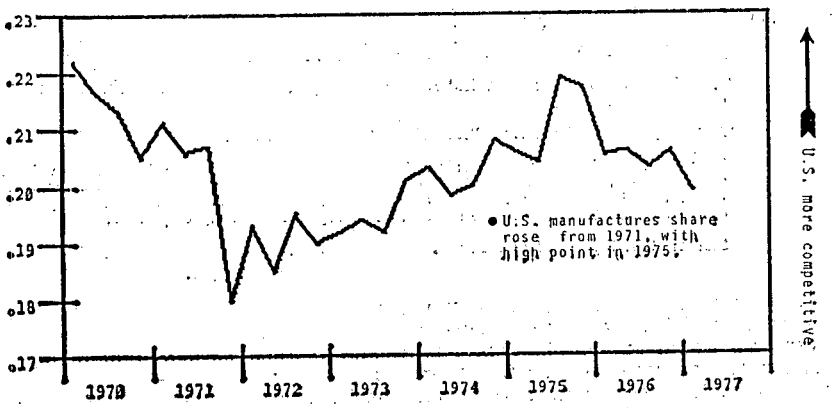
2/ U.S. share of manufactures exports of industrial countries less foreign industrial countries manufactures exports to the U.S. (current U.S. dollars and export-weighted exchange rates).

Source: U.S. Department of Commerce

It seems reasonable to conclude that the major industrial economies have attained roughly the same level of economic development, and this implies a generally more constant behavior in the trade shares of the developed world. (This assumes, of course, that the proportion of goods to services in the current account does not drastically shift.) If, therefore, we observe in subsequent quarters that our trade share again resumes the long-term downward trend of pre-1971, we must be especially concerned regarding our competitiveness.

FIGURE 4

U.S. SHARE OF MANUFACTURES EXPORTS



U.S. share of industrial countries' manufactures exports less foreign industrial countries' manufactures exports to the U.S. (using export-weighted exchange rates).

Source: U.S. Department of Commerce

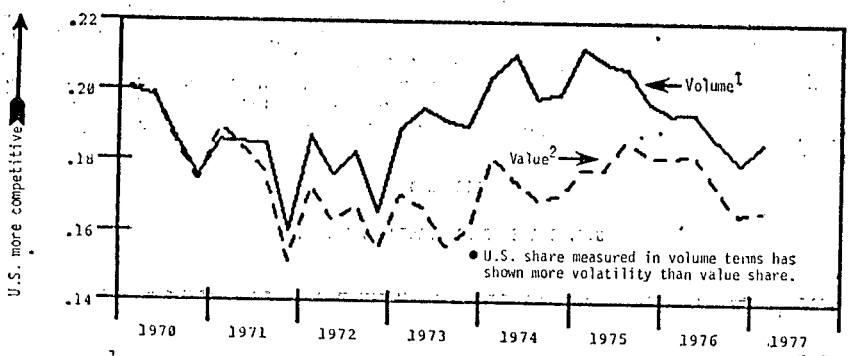
The recent behavior of the U.S. share of manufactures trade shows a generally declining pattern after several years of increase, as is evident in Figure 4. The U.S. share in the first quarter of 1977 stood at 19.9 percent, the lowest level in nearly three years. Interpretations, however, have to be drawn with caution; and these share figures must not be taken as proof of a competitive decline. For example, the entire decline in the first quarter of 1977 was due to a decline in the highly volatile category of transportation equipment (aircraft, motor vehicles, etc.). The U.S. share of other manufactures categories remained stable in the first quarter.

Many economists, moreover, argue that the high U.S. shares in the second half of 1975 were an anomaly resulting from unusual foreign demand conditions. Thus it could be argued that our recent share behavior has been stable, rather than declining. The statistical evidence is not clear, and data are not yet available past the first quarter of 1977. Even pessimistic interpretations of the U.S. share behavior in the last year, however, make it clear that through the first quarter any loss of share that represents competitive changes has been minor.

A somewhat different perspective on share performance in recent years is provided in Figure 5, which contrasts our export share measured in quantity terms (constant 1970 prices and exchange rates) with the share calculated in current value terms. (Note should be made of the slightly different methodology used to calculate the value share in Figure 5 as compared to Figure 4.) The quantity share clearly moved upwards more strongly in the 1971 to 1975 period and also declined more rapidly thereafter. Because of the terms of trade effect of the exchange rate changes, the value share showed smaller movements. Interestingly, both shares appear to be coming together at about 1972 levels.

FIGURE 5

U.S. MANUFACTURES EXPORT TRADE SHARES:
VALUE AND VOLUME



[1]U.S. share of industrial countries' manufactures exports, constant 1970 U.S. dollars and exchange rates.

[2]As above, except using current U.S. dollars and exchange rates.

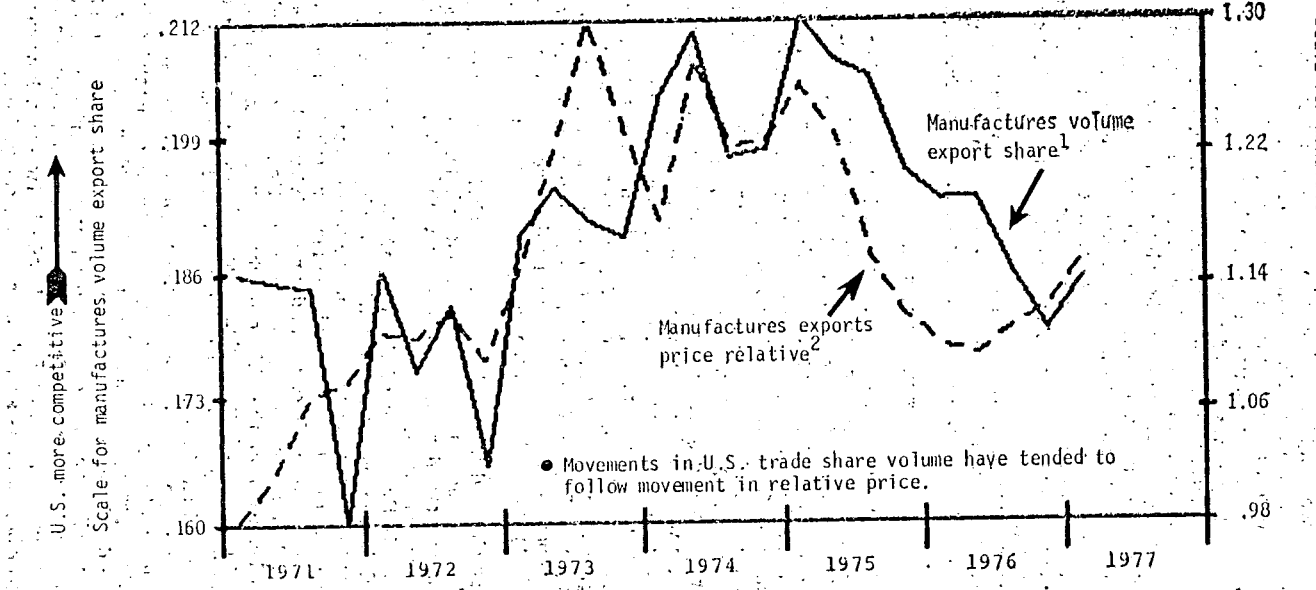
The value share in this figure differs from the value share in Figure 4 because the value share in this figure uses current exchange rates, includes foreign manufactures exports to the U.S., and differs slightly in country coverage. These differences were necessary to ensure that the value and volume shares in this figure are exactly comparable.

Source: U.S. Department of Commerce.

The movement in our manufactures trade share appears generally consistent with what we know about the lagged response of trade to changes in relative prices. We would expect our share, particularly when measured in quantity rather than in current dollar terms, to reflect prior changes in our relative price competitiveness. Figure 6 depicts our share of industrial countries' manufactured exports measured in quantity terms (constant 1970 dollars), and the relative price index of U.S. manufactures. This figure does suggest a lagged response of quantity to price changes.

FIGURE 6

U.S. MANUFACTURES SHARE AND PRICE RELATIVE



[1] U.S. share of volume of industrial countries' manufactures exports in constant 1970 dollars and exchange rates.

[2] Foreign industrial countries' manufactures export prices (unit value indexes measured in dollars) relative to U.S. manufactures export prices (unit value index), 1970 = 1.00.

Source: U.S. Department of Commerce.

Many economists believe that lags of two to three years exist between significant price movements and substantial trade effects; thus, share changes in 1976 and to some degree 1977 may reflect earlier changes in price competitiveness. In view of the greater U.S. relative price stability over the last year, however, we would not expect to see much additional deterioration in our manufactures share resulting from price effects.

Other factors, however, affect our trade shares in addition to relative prices. The competitiveness of U.S. products in international trade is and will in the future be determined by a variety of non-price factors—salesmanship, market knowledge, delivery times, product quality, credit terms, etc. These non-price factors concern me more at this time than relative price competitiveness.

Many of these non-price factors are heavily affected by or determined by government actions here and abroad in connection with exporting efforts—this is particularly true with regard to marketing and financing for exports. Thus, we must be sensitive to these non-price factors if our exporters are to remain competitive. In this regard I feel we can no longer afford a complacent attitude with regard to exporting and the environment we create for it. Other nations are simply trying harder.

In the longer run we must recognize that competitiveness becomes less a question of prices but more of an adoption to change. An economy which is not dynamic, which does not innovate and invest, will find itself falling behind the rest of the world.

THE LONGER-TERM

I have felt for some time that the U.S. position in world trade was a matter requiring more attention. Of the greatest concern, however, should be the long-run prospects for the U.S. position in world trade—problems which have existed prior to this year, even during our record trade surplus of only two years ago. Unfortunately, the deficit is not a short-run phenomenon that will disappear as rapidly as it emerged. Given the likelihood of continued large OPEC surpluses, trade deficits in all probability are going to be a fact of life for quite some time.

Therefore, the central factor guiding our policy decisions should be how the United States will respond to the very different world we now face and to the additional changes which will occur over the next decade.

How are things different now? First, we have had a more rapid rise in import prices than export prices—due principally to the massive petroleum price increases. This means that compared to 1972, before the OPEC price rises, we now have to give up more in terms of domestic output to obtain the same quantity of imports. Figure 7—which presents the real volume of imports received as a proportion of gross national product versus the real claims on U.S. resources in "payment" for these imports—is a graphic representation of this change.

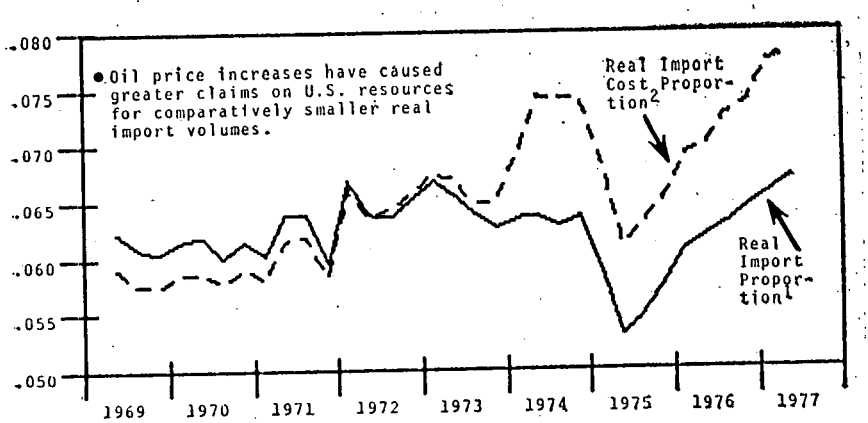
This cannot be changed in the short run. It is obvious, therefore, that in the future we need to expand exports to reach a more balanced trade account, and we must also be concerned with the efficiency with which we export and the terms of trade for our exports.

Another change is that much of the very rapid growth experienced by the developed world in the past 20 years will probably not be extended in the future. There may be limitations on the future rate of expansion—in resources and in environmental tolerance—that will be more restrictive than in the past. Whether improvement in technology and productivity will be able to offset these is unclear. While long-term forecasts are often of questionable value, many observers believe that the U.S. economy may grow more slowly in the future than over the past 20 years. Some economists also project a decline in the long-term growth rate of foreign economies that is proportionately greater than that for the United States.

A third major change is that the less-developed countries are increasingly becoming exporters and competitors in a growing range of manufactured goods. A continuation, and perhaps acceleration, of this trend is absolutely necessary for the economic development of these countries. This trend will continue and will necessitate possibly painful changes for many countries, as they attempt to adjust to this new competitive force. Already over one-fifth of our manufactured goods imports come from LDCs. Trade is two-way, however, and the LDCs will be growing markets as well as growing competitors.

FIGURE 7

RESOURCE COST OF IMPORTS:
PROPORTIONS OF U.S. GROSS NATIONAL PRODUCT



[1]U.S. constant 1972 dollar imports as a percentage of U.S. constant 1972 dollar gross national product.

[2]Exports plus trade balance, deflated by export price index (1972=1.00), as a percentage of U.S. constant 1972 dollar gross national product.

Source: U.S. Department of Commerce

Finally, the United States may have a reduced advantage in other areas. For instance, our great wealth advantage in capital stock may be a less important competitive factor in the future than in the past. Higher energy costs have made some capital equipment uneconomical now. New capital must be added through new investment which uses more efficient and more energy-saving technologies. Moreover, a continuation of the traditionally higher rate of investment in most other industrial countries would mean a higher relative rate of embodying these new technologies and energy efficiencies overseas than here.

While we should not ignore Lord Keynes' dictum that in the long run we are all dead, we are perhaps so caught up in short-term aspects of the trade situation that we do not foresee as we should the longer-run problems we face in adjusting to a more slowly expanding and more competitive world economy.

In the longer run we will only be "competitive" if we are able to change our "traditional" products and markets from those that are slowly expanding to those that are more dynamic. Over the longer run, competitiveness translates into the ability to restructure our market orientation, our export composition, the nature and usefulness of our products, and our productive efficiencies to match changing world markets and competition.

Trade is matching resources and efforts for return. Our actions now should attempt to insure that we are efficient in our production, distribution and marketing tasks and thus in the long run achieve a maximum "profit" in trading for goods we desire and which can be comparatively more easily produced abroad.

WHAT SHOULD BE DONE

A reduction in future U.S. trade deficits depends upon progress in three areas: Reducing future oil imports; more rapid economic growth abroad; and increased U.S. competitiveness in world markets

Progress will not be easy in any of these areas, and results will take time to manifest themselves. Actions, however, should be initiated soon. I am most concerned that we get in train those policies which take a long time to start in motion and even longer to become effective. Moreover, we need to act while

we still have latitude and discretion to select the most positive and beneficial courses and are not forced into a position in which we have no choices.

The reduction of oil imports is of critical importance, both in reducing our trade deficits and in avoiding the financial or supply crises that will surely come if we continue increasing oil imports at recent growth rates. The lead times are long, and effective action must be taken soon. We really do need an energy program!

Half of the increase in our deficit, however, is in products other than oil, and a reduction in this portion of our deficit over the next few years is directly tied to world economic recovery. Unlike the early 1970s, exchange rate changes cannot be expected to play the principal role in reducing our deficit. While some adjustment may take place in the value of various currencies, the impact on U.S. trade will be insufficient unless world markets begin to grow. Otherwise, at best, an adjusted exchange rate would result in a somewhat larger piece of a very slowly growing pie.

Germany and Japan especially must recognize the counter-productive nature of relying excessively on export-led growth and undertake the necessary measures to obtain adequate stimulation of domestic demand. Both have recently initiated new programs to stimulate their economies, and we hope that these will be effective.

The ability of the United States to influence the economic decisions of these nations is limited. Nevertheless, I believe the United States should continue to use all the logic, reasoning, and persuasion at its command to convince others of the necessity for more rapid growth in domestic demand.

More fundamentally, however, I believe that major actions should be addressed to the long-term competitive position of the U.S. economy. Price competitiveness has not been the cause of our deficit, but there is much more to competitiveness than price. As I mentioned earlier, we now live and compete in a very changed international economy, and I believe it is crucially important that we realize this, and that we determine to adapt ourselves to it.

Exports have always been more important to most other nations than to the United States, which for decades could content itself with its huge continental market. In 1975, for example, U.S. exports were 6.9 percent of GNP, while in Japan the figure was 11.4 percent, Germany 21.2 percent, UK 19.1 percent and France 16.6 percent. Other nations have developed their economies by taking full cognizance of the need to export and the need to avoid policies that disadvantaged exports. We need to do the same. Unfortunately, of the major industrial countries, we are among the lowest in export promotion efforts when measured in proportion to our exports; we maintain anti-trust provisions which constrain our exports; and we have made changes in the Section 911 provisions of the tax code which unfavorably affect the competitiveness of U.S. engineers and construction-related trade in world markets.

In the longer-term, competitiveness is essentially the ability to use economic resources efficiently and to adapt them to changing market conditions; and I think we're going to need more competitiveness in the future. Fundamentally, this is a matter of national awareness and consciousness and of economic structure. We're going to have to export more to pay for our imports, and to do this we have to be competitive in world markets.

We need to continue strong efforts in the Multilateral Trade Negotiations to achieve successful results, especially in the area of non-tariff barriers.

We need bilateral negotiations to work out particularly thorny problems, especially where U.S. exporters are hindered in obtaining access to foreign markets.

We need to insure that U.S. exporters have credit facilities on competitive terms, both because of the rising importance of financing in export sales and because of accelerated competition.

We need to deal quickly with unfair trade practices, such as dumping.

We need to increase our export promotion efforts, and to restructure these to the needs of tomorrow. Only about 20 thousand of the 300 thousand U.S. manufacturing firms export. The remaining firms are an unutilized export potential that needs to be tapped.

We need to examine our existing domestic policies as they affect our international competitiveness. Taxation, investment, anti-trust, transportation, and many other policies affect our competitiveness—even though their proponents may not have considered that their intent. We may need to change

those laws that have serious adverse effects on our competitiveness. We also need to ensure that new laws and policies do not unduly hamper our competitiveness. Before implementing new policies we should examine their effect on our trade. We need to be more systematic about such assessments. I hope that as we improve our overall economic evaluation process we can include provision for assessing the trade impact of all proposed laws and policies.

We need to accelerate the replacement and renewal of our capital stock to increase its energy efficiency and to increase U.S. productivity and competitiveness.

We need to facilitate the dynamic adjustment of the U.S. economy so that structural rigidities to capital and labor movement are reduced. Energy prices and the likelihood of increased foreign competition and changed markets imply a need for a more rapid rate of change in our industrial structure than in the past.

We need to nurture innovation and technology. Technology has been a prime factor in our competitive ability, and it may be even more so in the future.

None of these needs are new. They have been discussed often before, but little has been done on most of them. What has been lacking is the determination and the priority to act.

I would not want to look back and say that the late 1970s marked the beginning of an era in which the U.S. led the rest of the world into self-defeating rounds of protectionist policies. I hope that years from now we can look back and say that the trade deficit, although presenting difficult problems of adjustment, also awakened us to the need to improve our competitive position in the world economy.

Representative REUSS. Thank you, Mr. Weil.

Mr. Nordhaus.

STATEMENT OF HON. WILLIAM D. NORDHAUS, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Mr. NORDHAUS. Mr. Cochairman, I appear here today along with my colleagues to review the state of our foreign trade and international payments. My testimony will explore two different topics.

First, I will review the dramatic shifts in the pattern of our foreign trade during the current year and the outlook for the coming year. In addition, I will consider the relation between the trade balance and the rest of the economy, particularly in light of the worldwide distribution of trade flows.

I will summarize the salient points at this time.

In tables 1 and 2 of my prepared statement, I show the importance of trade and the current account balance.

In reviewing the outlook, I will pick up on the four important components of the trade balance: Oil and nonoil imports, agricultural and nonagricultural exports.

Now, I will examine each of those in turn.

First, looking at oil, it is clear that oil imports have been both a surprise and an unwelcome drain on our trade balance. Oil has contributed approximately one-half of the $20 billion decline in our balance from 1976 to the first half of 1977.

Indeed, if you look at the structure of our deficits, you might say that our trade deficit is in reality an oil deficit. In 1973, when we imported about $8 billion worth of petroleum, our nonoil trade was $9 billion in surplus.

In the first half of 1977, that $8 billion of oil imports had increased to $46 billion, again at annual rates, and our nonoil trade balance had increased from plus $8 billion to plus $16 billion.

The outlook for the coming year is, as always in this area, quite uncertain. We have reviewed a number of alternative techniques and forecasts, and our estimate is that there will be little change in the volume of oil imports for next year, that is to say, they will run around 9 million barrels a day, but this is quite uncertain, and there is a wide range of plausible numbers around that estimate.

As far as nonoil imports are concerned, these have also grown rapidly over the last year. Again, looking from the second quarter of 1976 to the second quarter of 1977, the volume of nonoil imports grew more than 12 percent.

We expect that next year should see a considerably slower growth in nonoil imports than has occurred in the last four quarters. A range of 8 to 9 percent would be in line with the normal historical relationship between imports and domestic demand.

Turning now to the export side, nonagricultural exports have been one of the major disappointments of the last year. Indeed, after removing inflation, they have been essentially flat since 1975, but the reason for the poor performance of our exports is hardly a mystery.

Economic growth in the industrial countries has been nil for almost a year. In my prepared statement, I have shown what has happened to foreign industrial production over the course of this calendar year—from the first quarter to the last 3 months of available data.

This shows that, in the major industrial countries outside of North America, there has been quite a nosedive in economic activity.

With respect to next year, our expectation for nonagricultural exports are clearly linked to the prospect for an upturn in foreign economic conditions, although we now have no clear indication of where those are going.

The prospects are for no more than a modest growth abroad, and, therefore, for no more than modest growth in our nonagricultural exports. We would expect, again, on the basis of the normal historical relations, approximately a 5-percent growth in volume of our nonagricultural exports year after year, and the prices on those will probably rise at the same rate as domestic prices.

Finally, on the question of agricultural exports, the key point here is the extraordinarily good harvest around the world. The wholesale price of grains in September 1977, was 30 percent below the level a year earlier.

Indeed, U.S. stocks are so large that there is a tentative decision to have a major acreage set aside in the United States next year. Because of good harvests abroad and lower prices, we foresee a slightly lower value of agricultural exports for next year.

This discussion of the ups and downs which I have just summarized reveals a central point. In each of the four areas we reviewed, oil, agriculture, nonoil imports and so forth, there have been surprises, and each of these surprises led to a larger trade deficit than had been anticipated, but two of these surprises were distinctly good news; that is to say, the brisk economic recovery in the first half of the year in the United States, and the good weather.

Two were bad news, the large oil imports and the poor economic performance in the rest of the world.

But the most important point is that we are meeting our target for economic growth this year while the world economy in general is performing quite poorly.

In summary, for 1977 as a whole, the trade deficit will probably be in the neighborhood of $30 billion, and the more important current account will be at a deficit of about $18 billion.

Looking ahead to next year, we see approximately the same picture. Assuming no oil price increase and treating the strategic petroleum reserve as a capital account item, we would expect the trade deficit to grow at about the same rate, or slightly slower, than the economy as a whole, and on a similar set of assumptions, we would expect the current account deficit to grow more slowly than the economy.

If I might just, then, turn to the second question, the trade balance in perspective, I would like to address two items.

First, the relation between the deficit and the economy, and, second, the relation with the rest of the world's payment position.

It is often stated that our trade deficit is costing American workers their jobs. In light of the analysis of the sources of the deficit contained in the paper, and that I summarized earlier, this viewpoint is misleading for three reasons.

First, it overlooks the fact that some imports are not produced in this country, such as coffee, or are not available in sufficient supply, like petroleum.

If I might be more specific, consider the extraordinary rise in oil imports, which was the main contributor to our deficit this year. This did not displace any domestic employment. Rather, it reflected insufficiency of domestic production. Without this imported oil, there would have been more cold homes, more factory curtailments and more layoffs during the cold weather this year.

The second point is that there are also imported goods which are domestically produced, as in the case of steel or automobiles, but it is often forgotten that these imports play a very important role in the domestic economy.

In case domestic industries should falter, either because they have inadequate capacity, as was the case in 1973 in many industries; or if they raise their prices, competition from abroad can fill the gap.

Automobiles are the best example in the second case: The current success of imports, with imports' share running slightly under 20 percent this year, probably lies in the tradition abroad of building small, fuel-efficient cars, rather than in any deficiencies in our trading structure.

I personally have no doubt that American manufacturers can build a competitive small car, and they will, but you can be sure that the discipline of the competition from abroad will assure that the era of the domestically produced small car will arrive sooner and when it does, that the price will be lower than otherwise.

The final deficiency in the argument directly linking a trade deficit to job losses is that it assumes that there are no policies by which we can alter the level of domestic employment.

I will be slightly technical for a minute at this point. We can see that over the past 3 or 4 years and especially in the past year there has been a fall in the full-employment level of net exports.

A shift in this full-employment level of net exports can be offset, however, without sacrificing output or employment goals by having either a smaller full-employment Government surplus, or more expansionary monetary policy.

In both of these cases, either the smaller full-employment Government surplus or more expansionary monetary policy, this would stimulate investment or consumption at home, raise the level of aggregate demand, and this would thereby offset the contractionary effect of the fall in the full-employment level of net export.

The final question I would like to raise here is the relation between the U.S. deficit and the world economy.

I would first note that the trade deficit is only part of our current account, and it represents a highly arbitrary division between trade and nontrade items. For example, the omission of net military sales from the trade balance makes no sense.

Similarly, the United States is more and more becoming a sophisticated service economy, and in the trade in services, the United States dominates the world economy.

Yet, it is just the service part of the current account which has had an enormous rise in its surplus, $12 billion over the last 4 years.

The second point I would like to remind you of, is that the emergence of the OPEC surplus and the troubled state of the world economy have altered the normal presumption about the U.S. current accounts position, at least for the present.

There are large amounts of unutilized resources around. Many countries face severe balance of payments constraints, and these constraints are exacerbated by OPEC and strong country surpluses.

In this situation, a smaller surplus or a larger deficit in large countries would probably lead to more, rather than less, output and employment in LDC's and in weak industrial countries.

Finally, I would like to remind you that since the surpluses and deficits across all regions must as a matter of arithmetic add to zero, the continuing OPEC surpluses imply a continuing equivalent deficit for the rest of the world.

Now, I have given you some perspective on the relative positions of the different countries in table 3. This table shows that if you look at the current account position of the United States relative to its gross domestic product, and compare this with other OECD countries, the United States is pretty much in the middle of the pack.

There are some countries with very large current account surpluses, and others with enormous deficits. But the United States is very close to the position of the OECD as a whole.

Thus, then the current account position is placed in the context of both the global distribution of payments and the large OPEC surplus, it suggests that the United States has moved from a position of highly inappropriate surplus in 1975, running about $10 billion, to the deficit that is more or less in the appropriate rate range.

Until the time when the United States and other countries are able to reduce their oil bills and OPEC countries are able to raise their imports to match their incomes, efforts to reduce the deficit at home will simply lead to further economic weakness abroad.

So to sum up, Mr. Cochairman, I regard the trade and the current account position of the United States as a cause for concern, but not for alarm.

First, the United States has a very serious energy problem and there is no legislation in place to solve it. Until the oil import problem and the associated global payments imbalance is resolved, there is very little constructive action that we can take to reduce our deficit substantially.

Second, we do have economic tools to meet our domestic growth and employment targets, even with sizable current account deficits.

Finally, although deficits have been used as debating points in the cause for protectionist policy, it is apparent that given the global balance of payments position, protectionism cannot be an effective means to reduce our deficit.

This sums up my statement, Mr. Cochairman.

[The prepared statement of Mr. Nordhaus follows:]

PREPARED STATEMENT OF HON. WILLIAM D. NORDHAUS

Mr. Chairman, I appear here today along with my colleagues to review the state of our foreign trade and international payments. My testimony will explore two different topics: First, I will review the dramatic shifts in the pattern of our foreign trade during the current year and the outlook for the coming year. In addition, I will consider the relation between the trade balance and the rest of the economy, particularly in light of the worldwide distribution of trade flows.

PATTERNS OF TRADE IN 1977 AND THE OUTLOOK FOR 1978

The size of our trade deficit during 1977 has attracted growing attention over the year, both in the financial and popular press. The attention is understandable given that the size of the deficit was both unprecedented and unexpected.

The largest previous trade deficit for a full year was the $9 billion recorded in 1976. For the first eight months of this year, the trade deficit (on a balance of payments basis) has run at $30 billion at an annual rate, and will probably be in the neighborhood of $30 billion for 1977 as a whole.

The size of the deficit was clearly unanticipated by most of the professional forecasts that we have reviewed. The change represents a turnaround of approximately $40 billion in the trade account since 1975.

Any development of this sort deserves very close examination, and we have been keeping a close eye on trade developments this year. As I will indicate, the change was not due to a single major force, but to the cumulation of a large number of smaller events which, taken as a whole, have led to a dramatic change in the overall outcome.

Before reviewing the details, however, I would like to emphasize one point: most often, discussions of the trade balance have treated a deficit as if it were a sign of weakness and cause for alarm.

In my opinion, this view is oversimplified. The state of our trade balance, and changes in the balance, tell us little in and of themselves. To judge whether movements in the trade balance are good or bad news, one must look behind the balance at the reasons for the changes. And we must look at the state of the world economy, along with the distribution of trade balances, before we can judge whether our position is or is not appropriate in prevailing economic circumstances. Finally, we must ask what measures we can take to "cure" the deficit. However much we might like a smaller deficit, measures to reduce our deficit may do greater harm than the deficits themselves.

Table 1 shows the recent trends in our current account balance through the first half of 1977 in current prices, while Table 2 shows the volume of imports and exports associated with those figures. I will now discuss each of the important components of the trade account—oil and non-oil imports, agricultural exports, and other exports.

TABLE 1.—U.S. MERCHANDISE TRADE[1] AND CURRENT ACCOUNT

[In billions of dollars]

	1973	1974	1975	1976	1977, first half[2]
Merchandise exports	71.4	98.3	107.1	114.7	119.9
Agricultural	18.0	22.4	22.2	23.4	25.6
Nonagricultural	53.4	75.9	84.8	91.3	94.3
Merchandise imports	70.5	103.6	98.0	123.9	149.8
Petroleum	8.4	26.6	27.0	34.6	45.9
Nonpetroleum	62.1	77.1	71.0	89.3	103.9
Trade balance	.9	−5.3	9.0	−9.2	−29.9
Military transactions, net	−2.3	−2.1	−.9	.4	2.0
Net investment	4.8	8.7	5.9	9.8	13.3
Net travel and transportation	−3.1	−3.1	−2.5	−2.1	−3.3
Other services, net	3.2	4.0	4.6	4.9	5.3
Unilateral transfers, net	−3.9	−7.2	−4.6	−5.0	−4.8
Current account balance	−.4	−5.0	11.6	−1.4	−17.5

[1] Balance of payments basis.
[2] Seasonally adjusted annual rates.

Sources: Department of Commerce, Bureau of Economic Analysis.

TABLE 2.—U.S. MERCHANDISE TRADE VOLUME

[1973=100]

	1973	1974	1975	1976	1977, first half
Agricultural exports	100	91.4	93.3	103.8	106.2
Nonagricultural exports	100	114.2	110.1	111.6	111.0
Oil imports	100	95.8	94.1	113.3	139.7
Nonoil imports	100	97.4	81.1	101.0	110.0

Source: Derived from Department of Commerce.

Oil has contributed approximately one-half of the $20 billion decline in our trade balance from 1976 to the first half of 1977, as can be seen from Table 1. Indeed, it is important to remember that our trade deficit is in reality an "oil deficit":

In 1973, we imported $8 billion of petroleum, and our non-oil trade balance was $9 billion in surplus.

In the first half of 1977, at an annual rate, we imported $46 billion of petroleum, and our non-oil trade balance was $16 billion in *surplus.*

Most of the very high 1977 figures are explicable with hindsight: the oil price rise, cold weather, more rapid economic growth than anticipated, and stock buildup are responsible for the very high import levels. But the Administration is extremely disturbed by the rising tide of oil imports.

Forecasts of the volume of oil imports for the next few years are extremely uncertain. We have reviewed a number of techniques for forecasting oil imports, and a central tendency for the estimates for 1978 is about 9 million barrels per day (on a Balance of Payments basis). The range of variation around this forecast, however, is quite wide and the actual outcome could easily be five percent greater or smaller.

Further into the future, the United States will have some respite from rapidly rising imports as Alaskan oil comes on stream, but not for long. The growing value of these imports is a grave problem—and not just a balance of trade problem—for our country. *Actions to reduce our trade deficit should concentrate on reducing our oil deficit.*

Non-oil imports have also grown quite rapidly over the last year. From the second quarter of 1976 to the second quarter of 1977, the volume of non-oil imports grew by 12.3 percent. During the same period, the final sales for all goods in constant dollars grew by 5.5 percent, and gross domestic demand (GNP less exports plus imports) grew at 5.3 percent. Based on the standard

econometric models, the rapid growth in demand for imports is at the upper end of the forecast range, although large forecast errors for imports are not unusual.

Next year should see considerably slower growth in non-oil imports than has occurred during the last four quarters. The growth in the economy could be marginally lower, but I also would expect a lower ratio of import growth to GNP growth. This would lead to a growth in the volume of non-oil imports of 8 to 9 percent for 1978 over 1977, but there is a wide range of plausible estimates around this number.

Prices of non-oil imports climbed in the first half of this year, with large increases in prices of primary commodities—particularly coffee and cocoa prices. For the second quarter of 1977, unit values of non-oil imports stood about 8 percent above a year earlier. Most commodity prices have turned down, and futures markets now point to a continuing slide of coffee prices. Some increases in the dollar price of imports from Japan are appearing—perhaps as a result of the yen appreciation of more than 10 percent since December. Other exchange rate changes, on the other hand, have probably had little net impact on import prices. As a result of these developments, while non-oil import price increases should average about 9 percent this year, for next year these import prices will probably decelerate significantly and could rise less than the domestic rate of inflation. It must be emphasized, however, that price forecasts are extremely hazardous, depending as they do on weather, commodity market developments, and exchange rate movements.

Nonagricultural exports have been one of the major disappointments of the last year. After removing inflation, they have been essentially flat since 1975. More recently; the volume of nonagricultural exports in the second quarter of 1977 (using 1972 prices) was $54.5 billion, as against $54.4 billion in the second quarter of 1976.

The reason for the poor performance of our exports is no mystery. Economic growth in the industrial countries has been nil for most of the year. The European economies have shown little growth since the first quarter. GNP in Japan has continued to grow on the strength of export growth and government spending (which has little import content) but private domestic demand has been weak there. The best evidence of conditions abroad is that industrial production in our major industrial trading partners declined or was essentially unchanged from the first quarter of this year to the most recent three-month period for which we have data:

Country:	*Percent change at annual rate in industrial production, most recent 3 mo from first quarter of 1977*
Canada	+0.9 (May–July)
Japan	0.0 (June–August)
Germany	−3.3 (May–July)
United Kingdom	−3.6 (May–July)
France	−6.6 (April–June)
Italy	−34.9 (May–July)
United States	+7.6 (June–August)

In the face of these steep declines in production it is no surprise that our export sales have been flat. With investment demand weak, capital goods (more than two-fifths of total nonagricultural exports) have been particularly depressed. As the industrial countries have failed to accelerate their purchases from primary producing developing countries, the squeeze on foreign exchange available to developing countries to buy imports has tightened. A number of developing countries last year began to reduce imports and stem the rapid growth in their foreign indebtedness. Thus U.S. exports to a number of LDC's have actually been reduced. As my colleagues have pointed out, this demand situation abroad roughly accounts for the failure of our nonagricultural exports to grow this year. But the evidence shows that, on average, we have held on to our shares of foreign markets. There is no evidence of a major loss of competitiveness.

With respect to next year, our expectations for nonagricultural exports are linked to the prospect for an upturn in foreign economic conditions. Unfortunately, the prospects are for no more than a modest recovery.

The outlook outside the United States, especially in Europe, is for very modest growth in the coming year. Countries are constrained from vigorous expansion by relatively high inflation rates, and fears of inflation. As a result, rates of capacity utilization are very low, but this means that there are insufficient incentives for firms to invest. Depressed economic conditions are fueling the fires of protectionism everywhere. Thus orderly economic expansion abroad is essential if the demand for our exports is to improve.

At the London summit, a strategy for economic recovery was agreed upon by the major industrial countries. The strong countries—United States, Japan, and Germany—would take the role of locomotives in the world economic recovery. The United States economy, as you know, performed quite strongly this spring, while the growth in Germany and Japan was below their stated targets. Recently they both have announced stimulus packages. We are pleased to see these initiatives. Even including the announced measures, there is some uncertainty as to whether there will be substantial growth in other strong countries. We are all watching them carefully, and are hopeful that if indeed existing or announced policies are insufficient to achieve stated objectives, then additional measures will be taken.

The big three economies comprise a bit more than 60 percent of the GNP of the OECD. Nevertheless, achieving even a modest growth for the OECD region will take more torque than the three locomotives can muster. For this reason, a movement toward expansionary policies might be appropriate for other countries which have lowered their inflation rates and have sound payments positions. The underlying rates of inflation in some countries are back much of the way to their pre-1973 levels. Given the large margins of unutilized capacity and high rates of unemployment, an orderly expansion would carry little risk of acceleration of inflation at this time.

With a return to moderate growth rates abroad, we would expect the volume of our nonagricultural exports to rise around 5 percent next year. Export prices should rise in line with domestic prices.

Agricultural exports may be up slightly this year on the basis of heavy shipments at high prices. In the first half of the year, deliveries to European countries were still high due to the effects of the drought last summer. Also soybeans were in short supply and brought high prices.

But the major unanticipated development has been the extraordinarily good harvests around the world. Because of the size of nature's bounty, the wholesale price of grains in September 1977 was 30 percent below a year earlier. Indeed, U.S. stocks are so large that there is a tentative decision to have a major acreage set aside next year. For all these reasons, there is general expectation of a lower value of agricultural exports for the coming year.

Recently, there have been trade reports of Russian purchases of grains on the world market. These reports have turned around some prices and may signal some improvement in the volume of shipments in 1978. Prices are still likely to be lower, however, and the total value of shipments is more likely to be down than up. I should remind you, however, that in forecasting agricultural trade the shortcomings of the economic forecasts are compounded by inadequacy of the weather forecasts.

This discussion of the ups and downs of our exports and imports reveals the central point: in each of the four areas that we have reviewed—oil, agriculture, non-oil imports, and nonfood exports—there have been surprises which led to a larger trade deficit than we had anticipated. Two of these surprises were distinctly good economic news—the brisk recovery in the United States and the good weather. Two were bad news—the large oil imports and the poor economic performance in the rest of the world.

But the most important point—that we are meeting our target for real growth this year while the world economy is performing poorly—is an *indication of the strength of the U.S. economy, and of the weakness of even those foreign economies that have had current account improvements.* The generally good harvests around the world should also give us satisfaction, even though our market for grain exports is smaller than in recent years when supply conditions were tight abroad. Some factors underlying our deficit signal the need for action: we must move to reduce our energy dependence and to encourage stronger growth abroad.

In summary, for 1977 as a whole, the trade deficit will be in the neighborhood of $30 billion, and the more important current account deficit will be around $18 billion. Looking ahead to next year, we see approximately the same picture: assuming no oil price increase and treating the Strategic Petroleum Reserve

as a "capital account" item (even though it will appear in the current account), we expect the trade deficit to grow at about the same rate or slightly slower than the economy as a whole. On a similar set of assumptions, we expect the current account deficit to grow more slowly than the economy.

THE TRADE BALANCE IN PERSPECTIVE

Given the size and change in our trade and current account deficits, there have been many questions raised about its sustainability and its effect on employment and the domestic economy. I will address these questions briefly.

The deficit and the economy—It is often stated that our trade deficit is costing American workers their jobs. This view supposes that imports and domestic production are perfect substitutes, and that we are simply using foreign goods for equivalent domestic goods that could be obtained at exactly the same price.

In light of the analysis of the sources of the deficit given above, this viewpoint is misleading. First, it overlooks the fact that some imports either are not produced in this country (as in coffee), or are not domestically available in sufficient supply (like petroleum). Particularly when these goods are used as inputs into domestic production (like petroleum), *a rise in imports occurs as a result of, rather than at the expense of, domestic production.*

The extraordinary rise in oil imports did not replace any domestic employment. Rather, it reflected the insufficiency of domestic production. Without the imported oil, there would have been more cold homes, more factory curtailments, and more layoffs during the cold weather.

The rise in non-oil imports was mainly due to the very rapid growth in the domestic economy. Over the last year—during which the volume of imports was rising rapidly—the American economy generated 3.3 million jobs. Given the openness of our economy, some of this growth simply spilled over our borders.

In addition, of course, there are cases where we import goods that are domestically produced (as in steel or automobiles). This occurs in years when we are in surplus as well as those when we are in deficit. But it is often forgotten that imports serve the very important role of understudy to domestic industries in case the latter should falter—either have inadequate capacity, or raise their prices above competitive levels, or because they have failed to read the signals of the marketplace. In the case of automobiles, for example, the current success of imports lies mainly in the traditional demand abroad for small, fuel-efficient cars. I have no doubt that American manufacturers can build a competitive small car. But you can be sure that the discipline of competition from imports will assure that the era of the domestically produced small car will arrive sooner, and that the price will be lower, than otherwise.

The final deficiency in the argument directly linking a trade deficit to job losses is that it assumes that there are no policies by which we can alter the level of domestic employment. If I may be slightly technical, we can see that there has been a fall in the full-employment net exports over this year. A shift in the full-employment level of net exports can be offset—without sacrificing our employment or output goals—by having a smaller full-employment government surplus or a larger full-employment government deficit. Alternatively, a less restrictive monetary policy would stimulate investment and thereby raise the level of aggregate demand to offset the contractionary effect of the fall in the full-employment level of net exports. Of course, the exact relation between alternative fiscal and monetary policies and the trade deficit is complex. But *the important point is that by appropriate policy adjustments we can offset the contractionary effects of the larger trade deficit on domestic employment and output.*

The U.S. deficit in the world economy—A final perspective on the current U.S. trade deficit can be obtained by placing it in the perspective of the overall structure of the world economy.

It must first be noted that the trade deficit constitutes only a part of the totality of the U.S. international transactions. If we look at the rest of the current account, it is clear that the division between trade and non-trade items constitutes a highly arbitrary division of transactions. Trade counts only tangible goods, and not all of these since it omits military transactions. More important, since the United States is more and more becoming a sophisticated "service economy," it omits many of the services in which the United States dominates the world economy. Thus payment for computing, banking, and

financial services, the fees and royalties on American technology and patents, as well as travel, transportation, and income from foreign investment are omitted from the trade balance. Yet as can be seen from Table 1, *the service part of the current account has gone from balance in 1973 to a surplus of over $12 billion in the first half of 1977.*

The discussion of the U.S. trade and current account position raises the fundamental question of whether our position today is appropriate. Generally, whether a country should be in deficit or surplus depends on circumstances. The presumption in the past has been that a mature industrial country would normally be in surplus, thus supporting a private capital outflow to developing countries which were capital-poor and in which the productivity of capital was relatively high.

The emergence of the OPEC surplus and the troubled state of much of the world economy have altered this presumption, at least for the present. Some of the OPEC countries have oil revenues far in excess of their current desire to buy goods and services. For this reason, OPEC will show a current account surplus of about $40 billion in this year, and that surplus is expected to decline only very slowly. The traditional view of the division of countries into capital exporting and capital importing needs rethinking today. Given the large amount of unutilized resources and the severe balance of payments constraints that many countries experience—constraints exacerbated by OPEC and strong country surpluses—a smaller surplus or larger deficit in strong countries may well lead to more rather than less output and employment in developing and weak industrial countries.

In time, as the United States and others finally accept the necessity to take effective measures to limit oil consumption, the OPEC surplus will dwindle. But, in the short run, only a repeat of the 1975 world recession will significantly reduce the OPEC surplus—and this is an extraordinarily costly way to reduce oil imports.

Since surpluses and deficits must add to zero, the continuing OPEC surplus implies a continuing equivalent deficit for the rest of the world. Over the last four years, there has been an extraordinary divergence in the extent to which different countries have accepted a share of the OPEC surplus. One of the tragedies from a global vantage point is that during 1974–76 the "strong countries"—those most able to sustain current account deficits—in fact ran large surpluses. Thus in 1975 the strong countries added to the OPEC surplus by running a surplus on current account of almost $20 billion. In 1977 the strong countries as a whole are expected to move toward a current account position near zero, but *this adjustment is due entirely to the United States.*

Some perspective on the relative positions of the different countries in the OECD is given in Table 3.

TABLE 3.—CURRENT ACCOUNT PROJECTIONS (ABSOLUTE AND RELATIVE TO GNP) FOR OECD COUNTRIES, 1977

	Current account (billions of dollars)	Current account/ 1976 gross domestic product (percent)
Switzerland	3¼	5¾
Netherlands	2	2¼
Japan	10	1¾
Germany	2½	½
United Kingdom	0	0
Belgium-Luxembourg	−¼	−¼
Italy	−1	−½
Total OECD	−30	−¾
United States	−18	−1
France	−4¼	−1¼
Canada	−4	−2
Australia	−2¼	−2½
Sweden	−2¼	−3
Ireland	−¼	−3¼
Spain	−3¾	−3½
Denmark	−1½	−4
Austria	−2	−4½
Greece	−1¼	−5½
Turkey	−2½	−6
New zealand	−1	−7½
Portugal	−1¼	−8
Norway	−4	−12½

Sources: Council of Economic Advisers for the United States. Other countries from OECD projections and sources. Current account estimate for Japan is actual for first half of 1977 at annual rate.

This table shows the projected current account positions of the OECD countries (as projected by the OECD) as well as the size of the surpluses or deficits relative to GDP. As can be seen, the relative size of the projected deficit is approximately the same for the U.S. as for the OECD region as a whole. There are several major countries which have relative deficits substantially larger than that of the United States. It should be emphasized, however, that because of the fundamental balance of the positions of all countries together, those countries in surplus inevitably put a serious strain on the fabric of the international payments mechanism. Finally, it should be noted that the ability of the U.S. economy to attract capital inflows has not been seriously questioned—given our well-developed capital markets, stable political environment, relatively low inflation rate, and strong economy.

Thus when the U.S. current account position is placed in the context of the global distribution of payments and of the large OPEC surplus, it suggests that the United States has moved from a position of inappropriate surplus in 1975 to a deficit that is in the appropriate range. Until that time when the United States and other countries are able to reduce their oil bills and when some OPEC countries are able to raise their imports to match their incomes, efforts to reduce the deficit at home will lead to further weakness abroad.

It is imperative for a healthy international economy that other strong countries reduce their inappropriate surpluses. One part of such adjustment has come through the major appreciation of the Japanese yen that has occurred this year along with the smaller appreciation of the German mark, Swiss franc, and Dutch guilder. It should be remembered that the dollar has not weakened significantly against a weighted average of currencies, and it need not. Indeed, the dollar stands higher than a year ago. But we cannot expect dramatic effects from the exchange rate movements seen this year. Induced changes on trade balance appear only after lags of one to three years, and the *initial* effect is to *increase* the surplus of an appreciating currency as the reduction in import price outweighs the shift in import and export volume. Moreover, domestic price responses tend to offset part of any exchange rate change.

In summary, Mr. Chairman, I would regard the trade and current account position of the United States as a cause for concern but not alarm:

The United States has a very serious energy problem, and no legislation is yet in place to solve it. Until the oil import problem, and the associated global payments imbalance, is resolved, there is little constructive we can do to reduce our deficit substantially.

We have the economic tools to meet our domestic growth and employment targets even with current account deficits.

The deficits have been used as debating points in the cause for protectionist policies. But, given the global payments position, protectionism cannot be an effective means to reduce our deficit.

Such policies would invite retaliation, would fuel inflationary fires, and might actually lead to lower levels of employment.

Representative REUSS. Thank you very much, Mr. Nordhaus, and gentlemen.

Secretary Samuel, I note that in your list of actions required, while you quite properly give as one piece of action that the United States should limit its intervention in these markets. I heartily concur, but you don't say anything about other countries.

Unless I am dreaming, other countries, notably Japan, have through various official and unofficial means, done a good deal to see that the yen's external value was as low as it could be goosed.

I wonder why we invest so much money in prestige, and the IMF should be willing to see them run around in circles on this question, as they have. Isn't it, in short, vitally necessary that the IMF behave like an international monetary fund, and use the undoubted powers it has to help people like our friends, the Japanese, to see that we are not a bit edified by their conduct in the last couple of years, and that they are playing a great role in contributing to the problem.

Why nothing about this? Every one recognizes it.

Mr. SOLOMON. Mr. Cochairman, taking the role of the IMF first, I think you are aware that in the board of directors, an agreement has been reached on what exchange-rate policy of member countries should be, and what the surveillance role of the Fund should be once the Articles of Amendment take legal effect.

This arrangement is in place once the amendments take legal effect, which we hope will be in the next few months, when enough countries have finished ratifying those amendments.

Representative REUSS. Isn't that amendment, good as it is, rather ineffective, though? It just relates to old-fashioned out and out, flagrant and notorious central bank intervention, which sophisticated intervenors don't do any more.

They do this by inducing their banks and corporations to lend abroad, they do it by inducing quasi-governmental enterprises to donate a meeting on their own.

They do it by domestic monetary policy which is undertaken solely for its international effect. I am wondering, herefore, if we are not sitting still for a good deal of general skullduggery by our trading partners.

I am for being more rational ourselves, but I think we ought to be broader in our outlook on this.

Mr. SOLOMON. Mr. Cochairman, first of all, I think that of equal importance to the principles agreed on in the Fund board regarding members' responsibilities, is the procedural agreement which will enable the Fund to call any country into court if there are indications of an apparent violation through various indicators of what is agreed-upon policy.

I think we have to give that a chance. I wouldn't share the feeling that once this has developed some operating experience that it would not be highly effective.

But, in regard to the question of exchange-rate movements, we fully recognize that other countries tend to intervene more than we do, not always, as you say, in terms of intervention, but frequently in terms of managing a rate to some degree, but there are also sticky leads and lags.

It is interesting to look at the information in table 1 of my prepared statement, and that shows that in this period from the beginning of 1976 of last year to now; the yen has appreciated—well, the table shows 15 percent. That is as of the end of September. As of now, it is almost 19 percent, because there has been further movement in these few days in October.

Representative REUSS. And if they hadn't been fooling around with it, it would have been 30 percent, and the 10 percent is enough to turn the American labor movement as it now has done into raving protectionists.

I just don't agree with the administration that we can sit around and wait for the IMF to do right. They haven't done anything so far.

Mr. SOLOMON. I don't think that we only sit around on this one, Mr. Cochairman.

First of all, we do feel that the Japanese current account surplus is a complicated picture. It doesn't just reflect rigidities in the

movement of the yen. It also reflects a very low-income elasticity of imports, and that represents a rather long-term structural problem. We have had conversations with the Japanese.

They, themselves, share the view that their target should be to get their current accounts down into deficit.

Some actions have been taken by the Japanese to move toward that objective. I am not saying that I have great confidence that this will turn it around very quickly, given these leads and lags and these rigidities.

We do have continued consultations about the entire question of imbalances, and adjustments to them, and the various factors that go into them.

Now that the new stimulus package of Japan has been adopted and some measures have been taken to reduce current accounts. We would hope to see some further progress.

But life is pretty complicated in these matters, and as you know, Mr. Chairman, from your own vast knowledge of how the monetary system works, you cannot burden the exchange rate too much—put too much of the adjustment problem on the movement of the rate all by itself.

Representative REUSS. I don't suggest that we can or should, but what I am upset about is our continued sweeping this problem, as I see it, under the sofa as if it didn't exist.

Why we swallow the camel of very destructive so-called trade agreements, fair-marketing agreements with the Japanese on specialty steel, color television, and God knows what else—there is a new one every other day.

Yet, we strain at the gnat of exchange regulation. Why we do that, I don't know. We are plenty gutsy in undertaking to impose quotas, which is what these agreements are, but we are so terribly timid in blowing the whistle on what in my judgment bears a large part of the responsibility for the troubles the world is in.

Mr. SOLOMON. I think just one last point. As you pointed out, sir, intervention in the traditional sense of the term is not necessarily the key instrument in managing a rate. If one looks at intervention, a very large part of the increase in Japanese reserves has been due to other factors, such as U.S. Government purchases for military needs, which now the Japanese have agreed to let us do through the market. They take their receipts of interest on their U.S. Government holdings directly into reserves, which all countries in the world do, excepting Germany. So the Japanese have actually intervened a good deal less than most other central banks, I would say.

What is true is that you have a complicated situation there where, I think, that from time to time Japanese officials have indicated certain targets they have in regard to exchange rates, and there has been some movement in the capital account which also tends to bring about, as I think you implied, certain rigidities and lags in the movement of the rate.

But it is not that simple a problem when one gets into these areas for an international monetary organization, or for that matter other governments, to be able to distinguish between what is appropriate and what isn't appropriate.

Representative REUSS. In describing a moment ago the new IMF amendment having to do with surveillance, which you described as having some teeth, let me ask you a couple of questions.

Does it envisage that from here on out the IMF is going to deny access to fund borrowing to countries, who, through one means or another, are artificially keeping their currency from depreciating, or that the Fund is going to use the "scarse currency clause" on countries who are blocking an appreciation of their currencies that would otherwise occur; that would focus the Japanese treasury's attention quite sharply?

Mr. SOLOMON. I am not sure it would, Mr. Cochairman, since, actually one of the major reasons for the increase in the Japanese reserves is the extent to which the other countries in their drawing on the Fund are using the yen.

That increases the net creditor position of Japan.

To answer your more general point, that is not envisaged, and in these early stages, what is envisaged is periodic consultation and the Fund initiating on a more emergency basis when they see a stickiness or possible violation of any of these three principles that have been adopted.

I honestly feel, Mr. Cochairman, that even though we don't live in the world of a clean float, that the Rambouillet agreement did not envisage that all countries would move into a clean float. Some would peg to the other countries, or groups of currencies.

One of the reasons we float cleanly is that it is in our own interest. We find it in our national interest, given our situation, to float cleanly, to minimize our intervention, sticking to a narrow definition of what a disorderly market is.

Other countries have broader definitions of a disorderly market.

Representative REUSS. Don't you think it would be in the interests of the Japanese people for their government to cease through one device or another from artificially appreciating the external value of the yen, and, instead, turn their attention to a greater extent to what needs to be done at home, to wit, build sewage systems, develop mass transport, housing, and the things which obviously, to a visitor to Japan cry out to be done there.

Wouldn't, in short, the Nordhaus formula, which Mr. Nordhaus gave us, whereby he said, and I agree with him, that the United States doesn't have to sit idly by and see jobs permanently lost due to foreign trade.

We can go, by fiscal, monetary, or direct policies, and make them at home. Wouldn't that work for Japan, or, perhaps, we should turn to Mr. Nordhaus.

Mr. SOLOMON. Let me make one point. I certainly do agree, and I think the Japanese Government is also beginning to recognize that they probably should move toward expansionary domestic demand management policies, increasing growth more rapidly, and I believe that will happen.

To some extent, that would bring about certain changes which I think would be salutory for them as well as for the adjustment system.

Representative REUSS. What about that? If you were the commerce economic adviser to Japan, wouldn't you be suggesting about what you said you were suggesting for us?

Mr. NORDHAUS. I am less familiar with the Japanese situation than I am our own, but I think there is no contradiction between the prescriptions we are making for the United States and those for Japan.

There are a couple of things to mention. Japan is a sovereign nation, and we don't tell sovereign nations how to manage their domestic economies.

Japan is running a very large current account surplus, and given the rules of the international monetary system, it is much more difficult to induce surplus countries to reduce their surpluses than it is to insist that deficit countries reduce their deficits.

Third, the major reason the Japanese current account has increased so dramatically over the past 2 to 3 years is because of the very low growth rate of domestic demand in Japan. There are diverse estimates, but it is pretty clear that they have been growing 2 or 3 percent slower than would be needed to keep their current account at the same level.

So, without really making any recommendation, it is pretty clear that they do have a set of policy instruments at their disposal which they can use to reduce their account surplus to levels which would be more consistent with a better overall distribution among industrial countries.

Representative REUSS. Well, if you are right, and I think you are, and if I am right, and I think I am, the Japanese should really heed this colloquy, because you have said there is a way for them.

They don't have to be adopting the "begger thy neighbor" policy that they have been pursuing.

What I say, and I think you agree with me, is that, yes, there are some things that an international body like the IMF has to tell sovereign nations—all nations are sovereign—and one of them is, "Look, fly straight, we are going to invoke the scarce currency clause on you."

I had a little difficulty, Secretary Solomon, with the testimony you gave about the competitiveness of U.S. manufacturing exports and what was earlier given by Mr. Krause of Brookings.

I don't know whether you were in the room or not.

You say in your prepared statement, Mr. Solomon, that in 13 of the major industrialized developing countries, the U.S. has maintained and in some cases increased its market share of manufactured exports to those countries.

Now, Mr. Krause came along and said, "Yes, but in the other six or seven of the 18 or so leading industrialized countries, the United States has not increased its share. Our exports have grown only 7 percent in 1977, when they might have been expected to grow by 15 percent.

Unfortunately, we are not given the names of the countries we are dealing with, either in your presentation, or Mr. Krause's.

Mr. SOLOMON. We could supply those to you later.

Representative REUSS. What about them?

Mr. SOLOMON. The last part of the statement is true. The fact that it has grown in 13 is true, but there are approximately four or five others where it has not grown.

I think Mr. Weil shares the feeling that a loss of competitiveness is not a significant factor, as we can see it, either through looking at the price effects, or looking at the relative shares.

There is room for honest men to differ in something as broad and as qualitative as this kind of judgment, and you can use various criteria in arriving at it.

I would feel fairly confident that as of this reading, based on the work which the various agencies have done on this, that we do not believe that the United States has lost across the board price competitiveness.

We are quite certain of that, and it may be that in one or two sectors, there have been developments that give us a less competitive share, but I think for this type of conversation on the broad trade deficit, we do have to look at competitiveness across the board.

I don't know what Larry Krause said in detail.

Representative REUSS. Perhaps I should do this, because it is a little unfair going into a paper you haven't seen. In his statement, and we will see that you get a copy, he sets forth the point I have been trying to replicate here, and maybe you can at this point in the record, analyze the point he makes, and either dismiss it or say, "He has a point."

[The following information was subsequently supplied for the record by Mr. Solomon:]

Mr. Krause noted that "*imports* of the other six large industrial countries have been rising by 15.6 percent in 1977 while U.S. total *exports* have been increasing at a rate of only 5.7 percent (manufactures 6.9 percent). Taking manufactures alone, if U.S. exports had been rising by the "expected" 15.6 percent rather than the actual 6.9 percent, the value of our exports would be about $7 or $8 billion higher for the year . . ."

Mr. Krause is comparing the rate of increase of imports of six countries with the rate of increase in U.S. exports to the world as a whole. The six countries he has selected are not representative of the global trade pattern. Many U.S. markets experienced very low growth in imports and in fact in two important cases—Brazil and Mexico—total imports actually declined. I would also note that part of the increase in the value of imports in the six countries cited by Mr. Krause, measured in terms of dollars, reflects the appreciation of certain currencies vis-a-vis the dollar. This is especially important in the cases of Japan and Germany.

Our studies suggest that the U.S. share of the *OECD* import market (24 countries) compared to the shares of the other eleven major industrial country exporters measured in *volume* terms did not change significantly between the first half of 1976 and the first half of 1977. There was a small loss in the U.S. export share in *value* terms, which resulted from a smaller rise in the dollar price of U.S. goods than the dollar prices of our competitors' goods (which in part were inflated in dollar terms by currency appreciations).

Representative REUSS. There is just one more question. Mr. Samuel, as I read your prepared statement, you are saying that in order to estimate whether our trade deficit hurts employment in the U.S., it may be more appropriate to use cost insurance freight valuations, and when you do that, exports and imports of manufacturers would show a deficit of approximately 2 billion in the first 8 months of 1977, compared to the surplus of 3.7 billion disclosed by the free alongside ship valuation.

What you are saying, then, is that if you use a proper valuation, I gather, namely c.i.f. that we have lost somewhat in this year in manufacturing exports, and that that does have an effect on American jobs.

Mr. SAMUEL. I would like to suggest as a matter of fact, it might be that by the end of 1977, even under f.a.s., there might be a slight deficit.

Representative REUSS. While there are a great many items in the trade deficit which don't result in the loss of American jobs, when we lose exports relatively speaking, we do lose jobs at home, don't we? There is a relationship there?

Mr. SAMUEL. Yes. The point I tried to make is that it is extremely difficult to discover; we really don't have adequate measuring tools. It is difficult to discover the direct effect of trade on employment, on an aggregate basis, and I think probably a great deal is said on that subject which is based on very slippery figures.

But I think if we look at individual industries, we probably can begin to find a little more direct relationship, which is why I dealt in my statement with the results we had found through the trade adjustment assistance program, where, pursuant to the Trade Act of 1974, we have analyzed a number of industries and have found quite large numbers of people, amounting to about 250,000 people in the last 2½-years, who have lost employment due at least to an important degree, which is the wording of the law, to trade.

Representative REUSS. Every time we get lackadaisical about some other country that is cheapening its currency and hence, grabbing a share of a market in an unfair way, we end up losing jobs at home.

Mr. SAMUEL. That could be one of the factors. There are a number of factors. The steel industry is feeling now the pressure of unemployment, and the steel industry and the steel union claim that a major factor is trade.

Whether it is or not, we are not quite sure.

Certainly, the Japanese industry and to a certain extent the British industry function on an entirely different basis as far as their costs are concerned, so it makes economic sense to continue producing, even at a loss, and shipping here at prices which may not reflect true market value.

It makes sense to them, but may not be beneficial to us. This reflects the fact that our economies are operating on a somewhat different basis, and we have to recognize that.

Representative REUSS. Thank you very much, gentlemen. We appreciate your cooperation.

We now stand adjourned.

[Whereupon, at 12:17 p.m., the subcommittee adjourned, subject to the call of the Chair.]

APPENDIX

STATEMENT OF THE AMERICAN IRON AND STEEL INSTITUTE

THE U.S. STEEL TRADE DEFICIT IN PERSPECTIVE

Size of the overall deficit

The U.S. has slipped from a $9 billion surplus in 1975 on the merchandise trade balance of payments to an estimated $30 million deficit for 1977. Even though this deficit is partly offset by a surplus in net investment income and services accounts, the current account overall is expected to register an $18 billion deficit for 1977. Sizeable U.S. trade deficits are expected to continue for some time.

Net deficits in individual commodity accounts: Steel as an example

Our total merchandise trade balance consists of the net of deficits and surpluses in individual commodity accounts. The steel sector is one of the main contributors to our country's overall deficit. Some of the factors which had led to our high steel import tonnages in recent years will be discussed below. Furthermore, we will examine why future exchange rate changes will not be sufficiently large to offset the competitive advantage that foreign producers gain through their preferential access to capital.

The underlying assumptions of economic theory

Economic theory suggests that under a system of floating exchange rates, deficits in the balance of a country's payments will cause that country's exchange rate to depreciate in order to eliminate the imbalance and maintain the competitiveness of domestic industry. According to theory, prices reflect cost of production, and comparative advantage (as demonstrated by price) determines which countries produce which commodities. Investment, modernization, and expansion should generally accelerate in those countries with comparative advantage.

Theory versus the reality of world steel trade

Many of the assumptions of economics do not hold with respect to steel trade. Policy makers must be aware of real world distortions before they espouse conclusions that may apply to a perfect "free trade" world.

The problems in international steel trade can best be analyzed through an examination of the distortions created when international trade is not conducted in a "free market" environment. World steel trade occurs within the context of a mixed system made up of both "free-enterprise" and "government owned and/or subsidized" companies. If the theory's basic assumptions are not valid, then we can hardly expect the theory's conclusions to be true.

Size of U.S. steel trade deficit

Table I shows the balance of steel trade for the years 1971 to 1976 and the first eight months of 1977. Import penetration (imports as a percentage of apparent consumption) was 14.9% for the first six months of 1977 and reached 19.4% for the month of August. If theory's basic assumptions as outlined above were true for the steel sector, one might tend to draw certain conclusions from the U.S.'s large and increasing steel trade deficit. Some observers have even claimed that comparative advantage in steelmaking now lies outside the United States borders and that the U.S. balance of steel trade is an illustration of this fact.

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TABLE I.—BALANCE OF STEEL TRADE

	First 8 mo 1977	1976	1975	1974	1973	1972	1971
Imports-all steel mill products:							
In millions of net tons	11.5	14.3	12.0	16.0	15.1	17.7	18.3
Dollar value in millions	3,321	4,000	4,100	5,100	2,800	2,800	2,600
Exports—all steel mill products:							
Imports—all steel mill products:							
In millions of net tons	1.4	2.7	3.0	5.8	4.1	2.9	2.8
Dollar value in millions	707	1,255	1,862	2,118	1,004	604	576
Balance of steel trade: dollar value in millions	(2,614)	(2,745)	(2,238)	(2,982)	(1,796)	(2,196)	(2,024)

( )=negative net balance.

Source: AISI.

Foreign steel makers can maintain investment despite losses

Such assertions would only be true if market share were determined by prices covering the full costs of production through the longer term and investment decisions were based on corporate profitability. Such is not the case in today's "mixed" world of public and private financing in the steel sector. In many instances, foreign steelmakers have preferential access to capital through governmental loans, grants, interest subsidies, and target industry programs. This means that foreign producers can operate at a loss and still maintain investment programs. They can set prices unprofitably low in order to maintain operating rates (and employment) or to capture a large market share. U.S. companies do not enjoy this financial latitude. They must submit to a profit "discipline." Their investment plans are often cut back during down turns of the market. For example, the Japanese steel industry benefits from a unique financial framework which provides target industries with financial assistance and preferential access to capital. Here are some examples excerpted from *Asia's New Giant*, a joint study by Japanese and American scholars on how the Japanese economy works released by the Brookings Institution in 1976.

"A significant role for the government as financial intermediary to ensure that adequate amounts of both personal and governmental savings flowed to the favored kinds of investment." Page 161—Ackley and Ishi.

"In a number of relevent ways Japan's government has underwritten—or at least has given its major industrial and financial corporations the feeling that it underwrites—the risks assumed by large firms whose investments support the nation's economic objectives: through its administration of government loans and foreign exchange; the approval or even encouragement of recession cartels and of mergers to avoid what is considered destructive competition; and a multitude of other special arrangements made for the protection and growth of large firms in important industries." Pages 165–166—Ackley and Ishi.

"In Japan financial risk, which is largely private risk, has been controlled and manipulated by public and private action to a high degree. As a result, risk exposures that are almost inconceivable elsewhere have prevailed in Japanese business finance without adverse consequences so far, except with respect to inflation losses accompanied by what looks like extreme risk aversion on the part of household savers." Pages 252—Wallich.

"Comparison with U.S. corporate data provides striking insights into the difference between the Japanese and the U.S. growth potential. Corporate depreciation allowances in Japan have exceeded those in the United States by one-half, measured in relation to GNP. This has occurred despite the fact that rapid growth and the relative newness of much of the capital stock would probably hold down depreciation in relation to other corporate magnitudes were it not for the effects of rapid depreciation schedules in Japan.

"Corporate profits before taxes in Japan likewise have exceeded those in the United States by approximately one-half, again measured in relation to GNP. Corporate profits after taxes have been somewhat less than twice their U.S. counterpart in relation to GNP. Dividends have been only half those in the United States; retained profits have been about three times as large. These results were attained, it must be remembered, despite an interest burden far heavier than that of U.S. corporations. In short, Japan has offered its corpora-

tions a high return on capital, has taxed them more lightly while nevertheless obtaining more revenue, and has experienced high rates of saving, investment, and growth in the corporate sector and the entire economy." Page 263—Wallich.

"Governmentally sponsored allocation largely achieved its objective of increasing the supply of funds to the designated sector during most of the postwar period." Page 267—Wallich.

"Finally, there is the government. Japan is largely free from the belief that business failures constitute a desirable process because they eliminate the inefficient, at least among large firms. In Japan a large firm is regarded as a national asset. Page 274—Wallich.

"Japanese structural policy is oriented toward particular concrete objectives rather than toward achieving maximum competition and leaving the results to the workings of the free market. Page 293—Wallich.

"The manipulation and control of risk plays an important role in the system. Risk appears high, but in fact it is held within acceptable limits by a variety of private and public techniques."

"First, no one can study the Japanese experience without being struck by the close cooperation between government and business—especially big business. Page 921—Patrick and Rosovsky.

The Japanese government has provided its domestic steel industry with massive indirect financial assistance over the past 25 years. Any attempt to accurately access the competitive position of the American steel industry versus its Japanese counterpart must not fail to take into account the benefits Japanese steelmakers derive from their country's financial structures.

U.S. Steelmakers are cost competitive

Since profits do not determine investment, and total production costs are not reflected in the prices charged by foreign producers, economic theory does not describe international steel trade flows. The U.S. steel trade deficit is not an indication of lack of cost competitiveness on the part of domestic producers. *Economics of International Steel Trade* by Putnam, Hayes and Bartlett demonstrates that the U.S. Steel industry is favorably positioned to compete in the U.S. market. Once importation costs (freight, duty, and insurance) are added to production cost, the Japanese employment cost advantage is not large enough to cover costs and still undersell U.S. producers in domestic markets. European producers are less efficient than the Japanese and yet they have been quoting even lower prices on U.S. markets'. Moreover, the Council on Wage and Price Stability's report has reconfirmed that any U.S. competitive disadvantage does *not* result from a wide gap in efficiency relative to other nations. The report indicates that the Japanese have no more than a 5% cost advantage in U.S. markets, which is insufficient to cover average discounts of 10% to 20% offered by foreign producers on the U.S. market. The CWPS report states that steel production costs in Europe are at least as high as U.S. costs, and that importation costs raise full costs "substantially above those of domestic producers," therefore, European producers are "discounting" in the U.S. market. The report points out that in the long run, neither the Japanese nor the Europeans can continue their aggressive "discounting," and that they will raise their prices when steel demand revives.

Marginal exchange rate changes will not fully correct the Steel trade imbalance

According to theory, exchange rate changes can readjust the balance of trade by making domestic producers more competitive. However, foreign producers' preferential access to capital can effectively offset the effect of any marginal exchange rate changes. We can not rely on a floating exchange rate to rectify our steel trade imbalance while other countries continue to employ predatory pricing policies which bear little relation to costs of production. Moreover there is not a full pass through in steel of a rise in the value of the yen against the dollar because raw materials purchases of the Japanese steel industry are generally denominated in dollars.

Long-run perspectives

Recent studies on worldwide steel demand and supply clearly demonstrate that our disproportionately large and growing steel trade deficits will not disappear in the near future. Various studies (*Economics of International Steel Trade* by Putnam, Hayes, and Bartlett; *World Steel Market, Continued*

Trouble Ahead—a Central Intelligence Agency paper, and *The Steel Industry: An American Tragedy* by Joseph C. Wyman) have all pointed out that world-wide net import demand for steel will fall considerably short of exportable capacity through 1980. As competition intensifies on global steel markets, both the Japanese and the Western Europeans will be subject to increased pressures to improve export performance in order to shore-up profits and employment in the face of slack domestic demand. The U.S., a net importer with only modest tariffs, will be a major target. The CIA paper states that the U.S. and possibly Canada are the only potential major outlets for surplus Japanese steel. The implications of a continued worldwide surplus of steel capacity are clear. Unless there is a change in U.S. trade policies and/or a viable multilateral initiative to deal with the problems of international steel trade flows, we can expect an increasing U.S. steel trade deficit at least through 1985.

STATEMENT OF JACK CARLSON, VICE PRESIDENT AND CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES

As the largest business federation in the country with 70,000 members, including individual firms, trade and professional associations and American chambers of commerce both here and abroad, the National Chamber is concerned about and appreciates the opportunity to state its views on the nation's growing trade deficit, its causes, and the likelihood of reducing it.

ORIGINS OF THE TRADE DEFICIT

Expert witnesses at this hearing have agreed that the huge increase in energy prices precipitated by the 1973 oil embargo has sent a shock wave through the economies of both the industrialized and non-industrialized world, drastically changing relative costs of production, national wealth positions, international investment and income flows. These witnesses also agreed on certain points regarding the surge of U.S. imports: the negative swing of $37 billion in the U.S. trade balance since 1975 has been caused about equally by increased mineral fuel imports and by increases in other imports; and the volume of imported oil may decrease slightly in 1978, because of Alaskan oil, but higher prices will offset this decrease.

The consensus regarding U.S. exports is that they have risen more slowly than the nation's imports mainly for three reasons: bountiful world-wide grain harvests have hurt our agricultural exports; a cyclically low rate of real fixed investment abroad has depressed our capital goods exports; and efforts of developing countries (such as Brazil and Mexico) have restrained their imports to protect their currencies and conserve foreign exchange.

None of the experts expects our large trade deficit to disappear within the next few years because of the unfavorable factors mentioned above which, in the short run, stem mainly from a stronger recovery here than abroad and, in the longer term, from the persistent and heavy oil "tax". So there is a broad area of agreement on the source of the trade deficit.

But there is also a crucial disagreement on whether United States manufacturers have become less competitive in world markets. One authority has made a good case that this may be so.[1] In fact, he estimates that fully one-third of our recent trade balance deterioration is traceable to this cause, with the remaining two-thirds being caused by oil and the business cycle. Although precise empirical evaluation of this argument is impossible, he cites persuasive evidence: the smaller rise of our manufactured exports relative to the combined imports of the other six industrial countries—only 6.9% compared to 15.6% so far in 1977. If the U.S. share had been constant, its exports presumably would have risen by 15.6% also. A factor undoubtedly at work has been the rapid industrialization of certain countries such as Taiwan and Korea. Among competitive factors working against this country have been sluggish productivity growth, a low rate of business fixed investment, an artificially high international value of the dollar and government-mandated cost-increasing regulations on U.S. business.

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[1] Lawrence B. Krause, Senior Fellow, The Brookings Institution, in testimony before this committee, October 11, 1977, p. 2.

SLUGGISH PRODUCTIVITY AND INVESTMENT GROWTH

The 1977 International Economic Report of the President notes that, in the 1970–75 period, fixed capital formation in this country—at 17.4% of GNP—was the lowest of the seven leading industrial nations. Low productivity correlates closely with low fixed investment at a 1.9% annual average rate, the U.S. had the lowest productivity gain of these seven countries over the same time span.

Factors peculiar to the United States have curtailed productivity improvement. Government-imposed safety standards have sharply reduced productivity in our mines, arresting the progress previously made because of increased mechanization. Stringent environmental rules have also slowed down productivity gains. Investment in anti-pollution equipment has not contributed to measured productivity gains. Our tax laws have required slow write-off of obsolete facilities, hampering productivity increases. Paradoxically, business is reluctant to invest in new, more efficient plants when much of its present capacity is unused, probably because it is obsolete at present energy cost levels; but increased capital investment is essential to a higher level of employment and income.

Congress should break this stalemate by moving quickly to approve business tax cuts and other investment incentives, thereby putting the economy on a higher growth path.

Over the long run the higher costs of energy and restrictive government regulations on business will continue to affect adversely our terms of trade, unless our competitiveness can be increased through policies that promote rather than hamper productivity. The real cost of our imports, as measured by exports and the trade balance, has increased steeply during the current business recovery.

INTERNATIONAL VALUE OF THE DOLLAR

Ordinarily a trade balance deterioration of the magnitude the United States is experiencing would have turned flexible exchange rates against the dollar and, in fact, the dollar has depreciated against the German Mark and the Yen. But the trade-weighted depreciation has been principally against these two currencies and practically non-existent against other currencies. Three reasons have been advanced to explain this fact: Governments have intervened to support the dollar in the foreign exchange market; many other countries still operate on a dollar exchange standard and peg their currencies to the dollar; and a greater preference for dollars for both short- and long-term investment purposes has increased the foreign demand for dollars. In consequence, it has been said that the dollar is overvalued vis-a-vis exports but not with respect to capital flows.

POLICY OPTIONS

Several policy options were suggested during the committee hearings on the trade deficit, all of which have been considered highly desirable: moving toward less dependence on cartel-controlled oil imports, urging foreign governments, especially Germany and Japan, to stimulate their economies to increase the demand for U.S. exports; stimulating exports by removing the extraterritorial application of U.S. antitrust laws and by providing equitable tax treatment for U.S. foreign investors.

Valuable as these suggestions are, they will be difficult to implement and implementation will take considerable time. This is especially true with respect to eliminating the many federal laws or regulations that inhibit our economy's competitiveness. Hendrik Houthakker's list of some 40 government impediments to competition ranges over the whole economy, from agriculture, banking, energy and foreign trade to general business, government operations, labor and taxation.[2]

Not only have none of these deterrents to competition been removed in the three years since his list was compiled, but the list has grown with passage recently of the increased minimum wage. Moreover, the Administration's energy proposals contain strong anti-competitive elements, as does the labor law reform bill supported by the Administration, not to mention Social Security tax proposals.

[2] In his article, "A Positive Way to Fight Inflation", Wall Street Journal, July 30, 1974, p. 12.

The highest policy priority should be attached to preventing government from adding more competition-hindering burdens on an economy whose recent productivity growth record has been so dismal.

We have testified on numerous occasions during this session of Congress about the adverse economic effects of enacting an energy law that does not even-handedly increase supply of energy as well as limiting energy consumption. The Administration's plan to conserve energy by imposing the largest tax increases in our history would cause: 2½% to 3% higher prices; a loss of 1.7 million jobs by 1985; $1,300 lower family disposable incomes than with existing energy policies; a 2½% lower real GNP; and 4% lower business fixed investment.

If, on the other hand, Congress were to modify the Administration's energy plan and require no new taxes or regulations but instead allow real crude oil prices to increase by only 6% per year and gradual deregulation of natural gas prices, the gains from conservation and production would total more than the improvement expected from the President's plan. In the case of natural gas deregulation, the increased availability of natural gas would be equivalent to reducing 3.4 million barrels of crude oil imports each day or reducing imports expenditures by at least $17 billion dollars (see Attachment 1).

It is unfortunate that the strong possibility of our nation's reduced competitiveness in manufacturing has not received more attention, especially in the context of pervasive and growing government interference with competition. Undoubtedly the other factors bearing on our poor trade performance, if corrected, would diminish the dollar drain but it is unlikely that an apparent loss of competitiveness in manufacturing would be corrected.

If the Administration and Congress are truly concerned about the international position of the dollar, they should consider carefully the adverse effects on that position of bills, such as those mentioned above, now being considered with Administration support. Otherwise, we are in danger, as a nation, of falling even further behind in the growing struggle for world markets.

Attachment.

Energy and Economic Impact of the Natural Gas Plans

(By Jack Carlson)

The Congress is considering two bills to change the Federal price controls on natural gas. The Senate Bill (S. 2104), referred to as the Bentsen-Pearson Bill, would phase out price controls on new natural gas discovered on land within two years and new natural gas discovered on offshore Federal lands within 5 years. No controls would be imposed on natural gas produced and consumed within the same state (intrastate).

The House Bill (H.R. 8444), which is similar to that proposed by the Administration, would impose more stringent price controls on interstate natural gas and impose price controls on intrastate natural gas for the first time.

PRICES

Existing natural gas regulations can be expected to allow real average natural gas prices at the wellhead to increase to $1.75 per 1,000 cubic feet (MCF) or 1 million BTU's by 1985. The Senate Bill would allow average prices to rise faster, to $2.08 by 1985. The House Bill would slow-down the increase to $1.35 by rolling back intrastate prices and slowing the increase in interstate prices; however, lower capacity utilization of existing pipelines would add costs to natural gas users.

PRODUCTION AND CONSERVATION

The magnitude of these price changes will determine both changes in production and conservation of natural gas. Based on past experience, the Senate Bill would cause producers to increase supply of new natural gas by 2.2 trillion cubic feet (TCF) by 1985 because of a 18% higher price than would occur under existing laws. As a result, natural gas supply would be prevented from falling as low as would otherwise occur. Household, commercial and industrial users would conserve 1.7 TCF of natural gas because of the 18% higher price by 1985. Both the gains from production and conservation will improve the U.S. energy situation by 3.9 TCF or one-fifth of U.S. supply by 1985, or equivalent to 2 million barrels of imported crude oil per day (MBPD).

In contrast, the 23% reduction in wellhead prices caused by the House Bill would lower natural gas production by 1.6 TCF and lower conservation by 1.2 TCF, causing deterioration of the U.S. natural gas availability by 2.8 TCF —or equivalent to 1.4 MBPD of imported crude oil. Also, the resulting lower capacity utilization of existing pipelines would add to the unit cost of natural gas when transported to users and would offset the reduction in price and cause an increase in the delivered price to consumers.

In comparison with the Senate plan, the House plan would cause 3.8 TCF less supply of new natural gas and 2.9 TCF less conservation or decrease available natural gas by 6.7 TCF by 1985—which is equivalent to importing 3.4 MBPD (see Graph 1).

COSTS

By 1985 the Senate Bill would increase natural gas costs by $9.9 billion, the House Bill would increase energy costs by $4.1 billion. The higher energy cost caused by the House Bill occurs because natural gas users who suffer loss of supply under the House Bill must find substitutes from much higher-priced foreign natural gas, electricity, imported oil and coal.

Also, the shortage created by the House Bill would cause natural gas pipelines to operate even further below built-in capacity with resulting higher unit cost of transportation and storage of natural gas until the pipelines are replaced with smaller capacity. For example, as estimated by Professor Edward W. Erickson of North Carolina State University, lower capacity utilization of the pipeline serving North Carolina has already caused the delivered-price to North Carolina consumers to increase by more than the price of natural gas at the wellhead. If this actual experience were applied to other pipelines and were based on the reduced supply and conservation caused by the House Bill, transportation costs would increase by $0.85 per MCF or $13.9 billion by 1985.

INVESTMENT, JOBS AND INCOME

The House Bill would cause the economy to grow more slowly by 1985 by discouraging investment. Job-creating business fixed investment would *decline* by $11.5 billion. Consequently, the average American family of four would earn $165 *less* real disposable income, income after adjusting for inflation and income taxes (see Graph 2). Employment would be 200,000 less.

In contrast, the Senate Bill encourages both production and conservation investment. Business fixed investment would *increase* by $7.4 billion. The average family would earn $115 *more* income. Job losses would be one-fifth as much or 40,000; and, most importantly, *the Senate Bill, by increasing natural gas user prices by only one-sixth, would provide 46% or 6.7 TCF more natural gas than would the House Bill—which could reduce imported crude oil by 3.4 MBPD.*

STATES

Each state would experience somewhat similar results. For example, by 1985, as indicated in the Table, Alabama families would experience a $38 increase in annual residential gas charges (Column 1) in contrast to $21 (Column 2) under the House Plan, or $17 less. Both commercial and industrial business in Alabama would expect to pay $112 million (Column 3) under the Senate Plan and $63 million (Column 4) under the House version, or $59 million less.

However, even though both residential and business consumers would pay modestly higher amounts under the Senate Bill, the Senate Bill would provide 80 *more* days of natural gas consumption (Column 5) for the average Alabama family and 77 days for business (Column 7). In sharp contrast, the House Bill would cause 22 days *less* natural gas (Column 6) for the average family and 25 days *less* natural gas for the average business each year (Column 8).

Alabama employment would decline by only 476 under the Senate Bill (Column 9) but employment would decline by 2,382 under the House Bill (Column 10). Income for the average family of four, after adjusting for inflation and paying income taxes, would increase by $148 under the Senate Bill (Column 11) but would *decrease* by $102 under the House Bill (Column 12), a difference of $251 in favor of the Senate Bill.

CONCLUSION

Each state would be far better off with the Senate Bill. If the Senate Bill is not enacted, the nation would be better off with existing law.

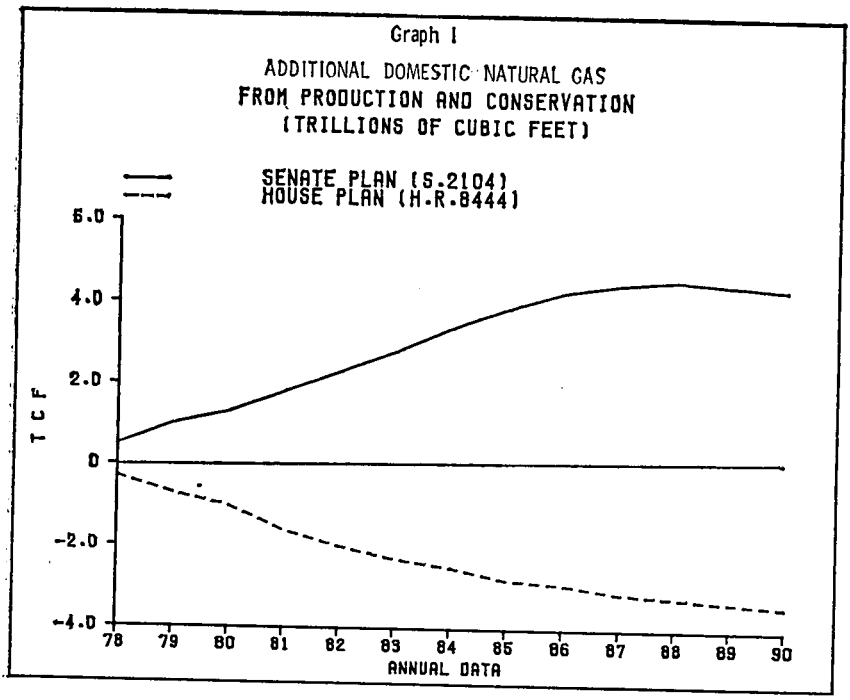
CHANGES IN NATURAL GAS BILLS, AVAILABILITY AND FAMILY INCOME FROM PASSAGE OF THE SENATE OR HOUSE NATURAL GAS BILLS BY 1985

States	Increase in the average natural gas user's bill				Additional days of natural gas consumption each year				Employment changes (jobs)		Impact on real disposable income for a family of 4 (in 1977 dollars)	
	Residential (in 1977 dollars, per family of 4)		Business (million 1977 dollars)		Residential (days)		Business (days)					
	Senate	House	Senate	House	Senate	House	Senate	House	Senate	House	Senate	House
United States	57	30	6,483	3,590	80	−24	101	−25	−40,000	−200,000	115	−165
Alabama	38	21	112	63	80	−22	77	−25	−476	−2,382	148	−103
Alaska	39	22	15	9	79	−22	80	−25	−142	−712	190	−132
Arizona	38	21	71	40	80	−22	76	−25	−287	−1,434	153	−107
Arkansas	56	32	108	60	79	−22	78	−25	−480	−2,402	245	−171
California	68	38	674	377	77	−23	79	−26	−3,454	−17,271	178	−125
Colorado	86	48	112	63	79	−22	78	−25	−614	−3,068	244	−170
Connecticut	25	14	22	12	80	−22	76	−25	−134	−669	49	−34
Delaware	31	18	8	4	80	−22	76	−25	−40	−200	77	−54
District of Columbia	51	29	9	5	80	−22	76	−25	−55	−274	96	−67
Florida	4	2	63	36	80	−22	77	−25	−249	−1,242	28	−19
Georgia	42	24	119	67	80	−22	76	−25	−538	−2,688	127	−89
Hawaii	3	1	2	1	80	−22	76	−25	−7	−37	10	−7
Idaho	30	17	26	15	80	−22	76	−25	−99	−497	146	−102
Illinois	103	58	426	239	80	−22	76	−25	−2,306	−11,528	232	−162
Indiana	73	41	191	107	80	−22	76	−25	−922	−4,612	195	−136
Iowa	81	46	128	72	80	−22	76	−25	−583	−2,914	244	−170
Kansas	98	55	202	112	74	−24	93	−26	−1,216	−6,078	423	−295
Kentucky	57	32	65	37	80	−22	76	−25	−397	−1,985	123	−86
Louisiana	50	26	255	135	48	−36	235	−29	−4,445	−22,225	301	−210
Maine	1	1	1	1	80	−22	76	−25	−4	−20	5	−3
Maryland	42	24	49	27	80	−22	76	−25	−300	−1,500	82	−57
Massachusetts	36	20	47	26	80	−22	76	−25	−325	−1,624	63	−44

Michigan	95	53	370	207	79	−22	77	−25	−1,936	−9,678	235	−164
Minnesota	64	36	112	63	80	−22	76	−25	−555	−2,777	164	−115
Mississippi	34	19	70	39	80	−22	78	−25	−313	−1,565	144	−100
Missouri	75	42	120	67	80	−22	76	−25	−672	−3,361	162	−11
Montana	80	45	31	17	80	−22	77	−25	−165	−826	233	−163
Nebraska	86	48	75	42	80	−22	76	−25	−340	−1,697	266	−185
Nevada	46	26	31	18	80	−22	76	−25	−119	−593	232	−162
New Hampshire	12	7	3	1	80	−22	76	−25	−16	−82	24	−17
New Jersey	47	26	76	43	80	−22	76	−25	−539	−2,693	81	−57
New Mexico	64	36	81	45	72	−26	105	−26	−926	−4,692	325	−227
New York	46	26	170	96	80	−22	76	−25	−1,235	−6,175	78	−54
North Carolina	13	7	43	24	80	−22	76	−25	−194	−970	41	−29
North Dakota	40	22	9	5	80	−22	76	−25	−64	−321	92	−64
Ohio	97	54	347	195	79	−22	76	−25	−2,014	−10,071	206	−144
Oklahoma	68	37	240	133	69	−27	118	−26	−1,751	−8,756	391	−273
Oregon	23	13	43	24	80	−22	76	−25	−175	−876	91	−63
Pennsylvania	62	35	251	141	79	−22	76	−25	−1,441	−7,205	135	−94
Rhode Island	33	19	7	4	80	−22	76	−25	−49	−245	58	−40
South Carolina	18	10	61	34	80	−22	76	−25	−229	−1,146	98	−68
South Dakota	43	24	12	7	80	−22	76	−25	−60	−301	107	−75
Tennessee	26	15	102	57	80	−22	76	−25	−408	−2,037	109	−76
Texas	51	27	1,106	585	48	−36	255	−28	−7,502	−37,512	382	−267
Utah	91	51	46	26	80	−22	77	−25	−260	−1,298	229	−160
Vermont	7	4	1	1	80	−22	76	−25	−7	−37	19	−13
Virginia	24	13	48	27	80	−22	76	−25	−253	−1,266	57	−40
Washington	26	14	81	45	80	−22	76	−25	−321	−1,607	109	−76
West Virginia	77	43	62	35	79	−22	78	−25	−381	−1,904	203	−141
Wisconsin	68	38	153	86	80	−22	76	−25	−727	−3,634	187	−131
Wyoming	88	49	27	15	78	−23	83	−25	−276	−1,379	349	−244

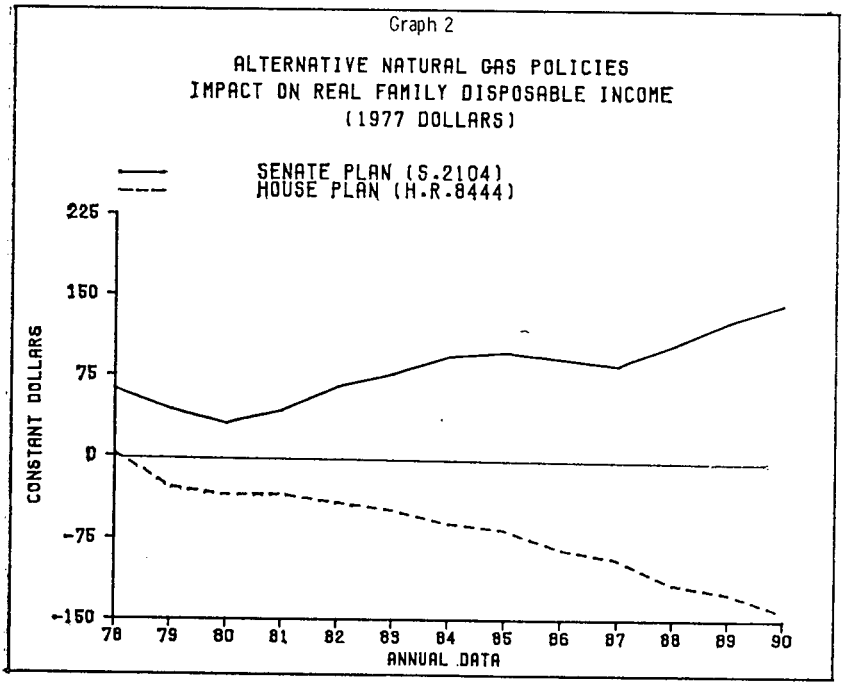
Graph 1

ADDITIONAL DOMESTIC NATURAL GAS
FROM PRODUCTION AND CONSERVATION
(TRILLIONS OF CUBIC FEET)



Graph 2

ALTERNATIVE NATURAL GAS POLICIES
IMPACT ON REAL FAMILY DISPOSABLE INCOME
(1977 DOLLARS)



METHODOLOGY AND ASSUMPTIONS

1. The profile for natural gas production under current regulation was estimated at 18.5 trillion cubic feet (TCF) in 1978, 16.2 TCF in 1985, and 15.2 TCF in 1990. This profile parallels estimates made by the Federal Energy Administration, the Bureau of Mines, the Federal Power Commission, and the American Gas Association. (See: Federal Energy Administration, *National Energy Outlook*, March 1977; U.S. Department of Interior, *United States Energy Through the Year 2000* (revised), December 1975; Federal Power Commission, Bureau of Natural Gas, *A Realistic View of U.S. Natural Gas Supply*, December 1974; American Gas Association, *Gas Supply Review*, April 1977, and *Energy Analysis*, May 19, 1977.)

2. The profile for real wellhead prices (1977 dollars) under current regulation were estimated to be $0.75 per million cubic feet (MCF) for interstate gas in 1978, rising to $1.54/MCF in 1985, and $2.03/MCF in 1990. Real wellhead prices for intrastate were estimated to average $1.03/MCF in 1978, increasing to $2.08/MCF in 1985, and $2.51/MCF in 1990. These estimates are similar to those made by Foster Associates. (See: Foster Associates, "Natural Gas Pricing Alternatives", September 1977.)

3. Sensitivity to price changes for production (supply elasticities) were estimated to be .10 in 1978, .45 in 1985, and .70 in 1990. These estimates are within the range used by the Department of Interior, and those measured by Erickson and Spann. (See: U.S. Department of Interior, Office of the Assistant Secretary, Program Development and Budget Office of Economic Analysis, *Final Environmental Impact Statement*: Proposed Deregulation of Natural Gas Prices. July 1974; Erickson, Edward W. and Spann, Robert M., "Supply Response in a Regulated Industry: The Case of Natural Gas", *Bell Journal of Economics and Management Science*, Spring, 1971.)

4. Conservation (demand) elasticities were estimated to be —.12 in 1978, —.38 in 1985, and —.44 in 1990. These estimates are also consistent with those used by the Department of Interior and the Federal Energy Administration. (See: U.S. Department of Interior, *ibid.*; Federal Energy Administration, *1977 National Energy Outlook* (Draft, January 15, 1977), Appendix D, tables D–3, D–4, and D–5.)

5. Application of the supply and demand elasticities in (3) and (4) above to the estimated price changes under the House and Senate Plans.

6. The quantities and revenues for each state were derived from the real wellhead prices under each plan and the 1976 production and consumption of natural gas for each state. These estimates are shown in columns 1–4 of the Table and Graph 1. (See: American Gas Association, *Gas Facts: 1976.*)

7. Improvement in natural gas availability was disaggregated into residential and business consumption days by comparing changes in production and consumption with volumes under existing regulations. These estimates are shown in columns 5–8 of the Table.

8. The resulting changes in the natural gas volumes, prices, and revenues were applied to the DRI and Chase Econometrics U.S. Macroeconomic Models to estimate the impact on investment, employment and income. The U.S. estimates derived from these models were then disaggregated into state categories based upon the 1976 gas production and consumption data. These estimates are shown in columns 8–12 of the Table.

9. Additional price increases caused by a shift to alternative energy sources as natural gas supply declines (particularly from the House Plan) were estimated to come from 25% of imported natural gas, 25% of electricity, and 50% of imported oil and domestic coal.

10. Contributors to this evaluation were George Tresnak, Forecasting Center, Graciela Ortiz and Erina Wessels.

UNITED STATES-JAPAN TRADE COUNCIL,
Washington, D.C., October 26, 1977.

Hon. HENRY S. REUSS,
Cochairman, Subcommittee on International Economics, Joint Economic Committee, Congress of the United States, Washington, D.C.

DEAR CHAIRMAN REUSS: During the course of the October 11, 1977 hearings of the Joint Senate-House Subcommittee on International Economics on the

U.S. Trade Deficit, several allegations were made by witnesses regarding Japanese controls on imports and exchange transactions that are not borne out by the facts.

JAPAN'S IMPORT CONTROLS

One such witness, for example, said in his prepared statement that:

"The Japanese trade surplus may be partly the result of an inappropriate exchange rate, but the more fundamental problem is the system of quota restrictions and internal marketing arrangements that make foreign penetration of Japanese markets very difficult. A long-run solution requires an attack on this system, and the observation that the Japanese would find it very difficult to loosen import restrictions is hardly a sufficient argument for not pressing forward."

The fact is that the Japanese government has already freed all but a handful of imports from controls. Japan has progressively liberalized its import restrictions since June 1960, when the government formulated its "General Principles on Foreign Trade Liberalization". Progress has been especially rapid and significant since October 1969, when 118 categories were under import restrictions. In December 1974, for example, imports of integrated circuits were freed, and a year later all remaining restrictions on imports of computers and related equipment were lifted.

Only 27 categories of imports (by CCCN 4-digit classification) are currently subject to control under the Import Trade Regulations, and 22 of these cover agricultural products (all the industrialized nations, including the United States and the EC, protect their agricultural sector to varying degrees). Leather and leather products account for four of the non-liberalized industrial products; the fifth is coal. Only Italy of the major EC powers (with 20 items in all categories under quota) is less restrictive than Japan. France restricts 74 items, West German 39 and Britain 25. In addition, these countries maintain discriminatory restrictions against certain imports from Japan (Italy on 40 such items, France 34, West Germany 10, Britain 4).

The Japanese government has stated its intention to expand its import quotas wherever possible. Quotas for many of these restricted items will be increased up to 20 percent under the Japanese government's recently announced program for expanding its imports.

DISTRIBUTION SYSTEM

A pervasive complaint is that the Japanese distribution system acts as a bottleneck to foreign goods. It is true that the system is complicated, involving multiple levels of wholesaling, but there is unlimited room for creating new marketing methods. Market penetration in any country requires strenuous efforts by exporters to adapt to the distribution system as they find it. If their current sales methods do not fit the conditions of the Japanese market, a change in methods is indicated.

The view persists in some quarters that the Japanese market is closed to foreign goods because the ultimate retailer is sometimes controlled by the manufacturer, but the relationship between large-scale retailers, specialty shops and manufacturers is by no means exclusive. Foreign businesses may find an effective way to enter the Japanese market by arranging tie-ups with these large shops, or by entering into relationships with Japan's trading houses and "superstores" in order to establish new marketing channels. Another technique often successfully used by foreign firms is franchising. It is sometimes easier to establish an entirely new distribution channel for foreign products outside the existing system by going directly to retailers. In any event, each exporter must determine for himself which distribution route is best suited to his particular products.

JAPAN'S EXCHANGE CONTROLS

The witness quoted above also called for "at least a partial dismantling of the complex web of controls maintained over capital movements to and from Japan." Such liberalization is, in fact, already well under way. Japanese authorities decided in May to ease or dismantle a range of foreign exchange controls, including the following relaxation of restrictions on short-term capital transactions:

Acquisition of foreign short-term securities (less than a year) by Japanese residents, which at present is subject to individual licensing by the Ministry of Finance, will be completely liberalized.

Until now, proceeds from redeemed principal and interest on Japanese corporate bonds, government and other public sector bonds acquired by foreign investors must be deposited in a special account with a foreign exchange bank, and only 30 percent of the total proceeds of such redemptions may be remitted abroad six months after acquisition (to prevent speculative capital movements). These restrictions will be progressively eliminated.

The limits on free yen accounts held by non-residents were eliminated, effective June 8. Foreign banks are now able to convert more foreign currencies into yen than before, providing they maintain adequate reserves against their foreign currency deposits and other liabilities.

The intra-company current account system between head offices in Japan and branches abroad (applicable to most trading companies) will be further simplified.

The flotation of yen-denomination bonds in Japan by foreign governments and international organizations will also be freed at the earliest possible date.

We ask that this letter be made part of the hearings, so that the record will reflect the considerable progress made by Japan toward easing of controls on trade and capital movements.

With all best wishes,

Sincerely yours,

NOEL HEMMENDINGER,
Director.

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