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THE PRESIDENT HAS SEEN.

INFORMATION

THE SECRETARY OF THE TREASURY
WASHINGTON

C

August 9, 1977

'77 AUG 9 PM

MEMORANDUM FOR THE PRESIDENT

Subject: Cabinet Reactions to Tax Reform

As we decided, on August 8 I briefed members of the Cabinet on the tax reform options now being developed for your decision. There were a great number of specific reactions to the proposals, and I have encouraged the Cabinet to have their staffs discuss details with Assistant Secretary Woodworth. I thought you would find it useful to have an immediate report on the more general comments. We can deal with specific arguments later, in the context of final decision making.

After I reviewed the history of taxes as a percentage of personal income, and explained that inaction would lead to these percentages reaching historic highs, there was general agreement on the need for the program to result in some reduction in taxes.

There was some surprise at the sweeping nature of the proposals. Particularly during the discussion of taxing Social Security, unemployment insurance benefits, and other "sacred cows", there were numerous comments about how controversial the package was likely to be. However, no one suggested the program should be cut back, and I think the comments merely reflected the fact that we are contemplating a program that is certain to arouse considerable public controversy.

Otherwise, reactions were largely confined to individual Cabinet members' particular areas of concern. Secretary Harris was interested in the effects of the proposals on the housing market and its financing; Secretary Bergland was interested in the effects on farms and the commodities markets; Secretaries Kreps and Marshall were concerned about the effects on investment; and Deputy Secretary of State Christopher was interested in the changes regarding the taxation of foreign income.

Secretary Adams made a number of comments based on his experience with Congress, suggesting what he thought reactions would be to various specific ideas. He told me privately afterward that he thought the correct approach was to send forward as sweeping a proposal as possible, no matter what advice we got from Congress to the contrary. He argued that the more proposals we made, the better our bargaining position would be in a conference committee. He pointed out that Congress might more easily be able to disregard the special pleadings of lobbyists if they were virtually all in opposition, instead of there being only a few who had to be accommodated.

I explained our schedule and expect that the Cabinet will begin to comment on details as quickly as possible.

W. Michael Blumenthal

THE WHITE HOUSE
WASHINGTON

August 10, 1977

The Vice President
Stu Eizenstat
Hamilton Jordan
Frank Moore
Jack Watson

The attached is for your information.

Rick Hutcheson

RE: REACTIONS TO TAX REFORM

8-11

MEMORANDUM

NATIONAL SECURITY COUNCIL

~~CONFIDENTIAL~~ GDS

August 9, 1977

MEMORANDUM FOR: RICK HUTCHESON

FROM: CHRISTINE DODSON CD

SUBJECT: US Trade Deficit

The NSC staff concurs in the transmittal to the President of the Eizenstat-Ginsburg memo on the US trade deficit. But, we have reservations about several of the recommendations set forth in the concluding section.

The memo correctly notes that energy imports are the primary cause for our large and growing trade deficit. A strong energy conservation program is essential to restore equilibrium in the US trade account. There are no effective, acceptable short-term remedies available.

Nonetheless, we must be careful in our public statements not to portray the trade deficit as a critical problem. This would only encourage those in the US who advocate import restrictions. Instead, we should indicate clearly that the Administration is monitoring the deficit closely, that a certain amount of deficit now is "healthy", and that we are confident that current policies will lead to its gradual reduction.

Regarding the specific policy proposals set forth in pages 5 and 6 of the memo:

-- We agree with the recommendations made by Treasury and Commerce (points a-h).

-- We support low-key diplomatic "reminders" to those middle-income LDCs listed in paragraph 3(a) on page 5 about the need to move progressively into full observance of international trading rules, as their development warrants. However, we must move cautiously in this area. Overt pressure by the US would damage our relations with those countries and undermine our credibility in the North-South dialogue. Brazil and Mexico, for example, have adopted painful domestic stabilization programs which have adversely affected the demand for US exports. The Mexican case, in fact, cannot be dis-associated from our concern about "undocumented aliens". Economic stability in the developing world is in our long-run interest even though the short-term impact on US sales may be negative. Furthermore, in the case of Korea and Taiwan, we have sought to limit imports of "sensitive" goods (shoes, mushrooms, etc.). Asking them at this time to liberalize their import regimes as well might be more than the relationships can bear.

-- However, we also recommend <u>against</u> high-level policy statements as suggested in paragraph 3(c) which would, in effect, single out Germany and Japan for failing to do their share in assisting adjustment to the international consequences of the OPEC surplus. We have discussed this issue in depth at the London Summit, in other multilateral forums, and bilaterally. The Germans and Japanese have committed themselves publicly to meeting their growth targets, even though prospects at the moment are not good -- at least in the case of Germany. We should not press this issue further at this time -- and certainly not publicly, as we have learned through our problems with Schmidt (in particular) this year. Even if carefully phrased, a Presidential statement about the need for equitable sharing of the oil deficit would be likely to provoke an adverse reaction in Germany and possibly in Japan, and make it more difficult for those governments to adopt economic policies which will facilitate international adjustment. Schmidt would again wonder about the constancy of US policy. Furthermore, the timing of the IMF meeting is identical with the President's UN speech. He would then be put in the position of making two speeches that would <u>not</u> be complementary with one another.

The U.S. Trade Balance -- Recent Trends and Outlook

Summary and Conclusions

Summary

-- U.S. merchandise trade deficit is projected at $27 billion, an $18 billion deterioration from 1976. Fuel import increases account for $8 billion of decline. Non-fuel imports likely to grow 13% in volume terms largely reflecting strong domestic growth. Exports will rise only 2% in volume terms. Slower growth in exports mainly due to lower real growth abroad than in U.S., and lower income elasticity of demand for U.S. exports than U.S. income elasticity of demand for imports.

-- Three basic factors seem to have dominated movements in the U.S. merchandise trade balance since 1974: (1) increasing value of fuel imports caused by higher prices and declining domestic supply; (2) sharp swings in import levels caused by swings in the domestic economy and our relatively high income elasticity of demand; and (3) historically low growth rates of U.S. exports, essentially reflecting lower than normal real growth in our trading partners. These factors will continue to dominate the trade outlook at least into 1978.

-- On regional basis our trade deterioration has been mainly with OPEC and non-oil LDCs. During first five months of 1977 trade balance change was about 43% with OPEC, 38% with LDCs (mainly Latin America) where stabilization policies by Mexico (fourth largest U.S. export market) and Brazil (tenth largest market) have reduced U.S. export levels.

-- On the basis of relative prices (U.S. versus foreign) adjusted to exchange rate changes, U.S. price competitiveness has remained essentially unchanged since mid-1975, the record trade surplus year. The trade deficit increases cannot be explained in terms of relative price performance; IMF agrees. U.S. competitive position remains strong, with $13 billion surplus in manufactured trade in 1977.

-- Since U.S. export shares reached a historic low point in 1972, they increased steadily through 1975 and then declined somewhat, in the aggregate, in 1976. However, the U.S. share rose further in 1976 in some key products (e.g. chemicals and electrical machinery). Our share in 1975 may have been abnormally high, in any event, because some of our key LDC markets had not yet begun their adjustment to higher oil prices and world recession.

-- Export market shares of other industrial suppliers show mixed results. The U.S. (+6.3%); Japan (+9.6%); and France (+3.4%) have all gained market shares since 1972 (the low point in U.S. share). Germany (-1%), Italy (-9.8), Canada (-17.5%) and the UK (-1%) have all lost shares. Annual data register sharp movements year to year. Judgments regarding "competitiveness" on the basis of one year's changes should be very tentative.

-- Trade balance is only one factor in current account balance. Rising surplus transactions on services -- estimated at $11-1/2 billion in 1977 -- has offset sizable part of increasing trade deficit since 1975.

-- Beyond current account and capital flows, if foreigners do not voluntarily generate capital flows that match the current account balance, exchange rate pressures would develop on the dollar. But dollar has strengthened slightly over past 18 months, and depreciated by only about 1% in recent flurry.

-- The U.S. external position must be placed in the context of the global distribution of payments, which requires non-OPEC countries to divide up the current account deficits caused by OPEC's current account surplus of $40-45 billion. In this context, the United States can be seen as moving from a position of inappropriate surplus to a deficit that is in the appropriate range. Unfortunately, other strong countries have not matched the United States' lead, for the other "strong" countries (Japan, Germany, Switzerland, Netherlands) continue to run very sizable current account surpluses. This suggests that the United States should continue its effort to persuade other countries, where appropriate, to expand their economies and let their currencies appreciate. The evidence does not suggest that the United States should take measures which would attempt to improve its trade balance at the expense of its trading partners.

What are We Doing about the Deficit?

-- The Energy Program. Hits at the biggest factor in the trade deficit--reduced oil volumes will directly reduce trade deficits over time. This will not, however, be of any short-run help, since significant effects of the energy program on oil imports are not expected pre-1980.

-- We continue to urge Japan and Germany (and other countries) to expand domestic growth (increase imports) and allow exchange rates to rise (reducing price competitiveness of their exports). Some progress is already being made.

-- We are letting the dollar reflect market pressures. Should depreciation result, U.S. goods would become more attractive, imports less attractive.

-- Budget planning for medium-term will produce lower inflation rate (increased competitiveness of domestic products for both home markets and abroad).

-- On a more microeconomic level we have worked out "orderly marketing" arrangements on selected products and will continue to enforce U.S. lows against unfair trade practices.

What Other Policy Options Exist?

Short Run:

-- Short of direct import controls or a sharp cutback in domestic economic growth, not much can be done to change the trade balance this year. Import controls that included oil products would depress the growth rate; reduced growth would raise unemployment. Exchange rate changes take 12-18 months to work through in terms of changes in final sales; developing new export markets by export promotion is a slow education process for both foreign buyers and domestic sellers.

Longer-Run:

-- Energy policy.

-- Controlled, non-inflationary growth.

-- Maintenance of pressure on others to let exchange rates accurately reflect underlying competitive positions, especially not to intervene to prevent appreciation.

-- Increase in official resources at IMF to enable others to adjust at reasonable pace, thus avoiding sharp policy changes and enabling higher level of world demand than would otherwise be the case.

-- Increase export awareness/efforts of U.S. firms.

Public education is probably the most productive alternative for short-run. Specific testimony and speeches aimed at realistic view of trade balance, explaining causes, alternative courses of action, and the need to focus on longer-run measures. We are not complacent, have put in place number of policies aimed at solution. Point especially to need for action on energy policy.

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The U.S. Trade Balance--Recent Trends and Outlook

Large monthly trade deficits have focused increasing attention on the U.S. trade balance. Present forecasts suggest a record trade deficit in 1977 and a deficit next year at least as large. Increased concern and rising pressures for governmental efforts to "stem the tide" may be forthcoming. This paper recapitulates recent trends, highlighting the major underlying forces affecting the trade balance. The trade balance is put in the more general context of the current account and then the U.S. current account is discussed in a global framework. Finally, existing policy efforts and potential scope for additional policy measures are discussed.

U.S. Trade Balance
($ billions; balance of payments basis)

	1975	1976	1977(F)
Exports	$107	$115	$122
(% change)	(8.9)	(7.1)	(6.1)
Imports	98	124	149
(% change)	(-5.4)	(26.4)	(20.4)
Balance	+ 9	- 9	-27

(F)=Forecast

Movements in the Trade Balance--An Overview

1975

The merchandise trade balance posted a recession induced surplus in 1975--a sharp $14 1/2 billion improvement from 1974's deficit. As is typically the case with cyclical changes, variation in import levels dominated the swing. The U.S. economy experienced a sharper and deeper recession than did our major trading partners. In particular, the domestic economy experienced a truly massive inventory adjustment. For these reasons, the 1974/75 recession produced a highly unusual $5 1/2 billion decline in the absolute value of U.S. imports during 1975. The volume of total imports plummeted some 13%. The recession also held down the growth in energy demand and kept the rise in fuel imports to only $1 billion, despite an OPEC price rise during the year. Exports continued to grow in value terms, but declined roughly 2 1/2% in volume terms.

1976

As domestic recovery advanced, imports responded quickly and returned by year end from the recession induced, extraordinary low levels in 1975 to a more nearly normal relationship to GNP. Fuel imports--reflecting declining domestic production in the face of strong demand as well as the OPEC price hike--rose almost $9 billion, and non-fuel imports increased almost 25% in value--23% in volume terms alone. Exports grew

7% by value and 4% by volume. These differential import and export growth rates largely reflected both (1) faster expansion in the U.S. than abroad and (2) the higher U.S. income elasticity of demand for non-petroleum imports (roughly 2.0) than of foreign demand for our exports (roughly 1.0) (see below). In addition, energy demands returned to more normal growth rates after the pause induced by the recession.

1977--Current Forecast

Treasury staff's latest forecast--taking into account the first five months of actual trade data--is for a trade deficit of about $27 billion in 1977. Fuel imports (partly due to the cold winter and including the effects of the Saudi/UAE 5% price rise in the second half) are expected to rise almost $8 billion. Non-fuel imports are projected to rise $17 1/2 billion in value (13% in volume terms). The projected volume growth is based on the historical income elasticity of demand (roughly 2.0), without the additional catch-up which had accelerated import volume growth in 1976 beyond that expected on the basis of our income elasticity. As was the case in 1976, the faster projected growth of import value compared with exports is largely due to differential income effects, although some of the import increase is attributable to higher commodity prices (especially food). Non-agricultural exports are projected to rise about 7% in value terms and less than 2% by volume.

Two factors in this forecasting period are particularly difficult to quantify. First, and most important, is the question of when real imports by non-OPEC LDCs will rebound to more normal growth rates. For the past year or so, a number of major LDCs have substantially reduced import growth rates--some have even reduced imports in absolute terms--as stabilization programs have been implemented to redress domestic economic imbalances and to reduce demands for external financing. Aggregate LDC gross reserves rose a surprising $11 billion in 1976. At some point, LDC imports should return to more normal growth rates. Through the first five months of 1977, however, there are no indications of renewed growth of U.S. exports to LDCs. U.S. exports to Mexico (our fourth largest market) and Brazil (our tenth market) were both down 20% by value in the first five months of 1977 over the same period last year.

A second area of uncertainty is the effects of official actions limiting imports into the United States. In several specific products, we have explicit arrangements to cut back the absolute level of exports to U.S. markets. Precise data are unavailable with which to assess the extent that exports have been pushed up in anticipation of the imposition of quotas or the extent that imports of other goods will be substituted for those subject to restraint. In addition, there have been more recent discussions in Japan of general cutbacks in overall export penetration. The timing of these cutbacks is unknown, and quantification is impossible for forecasting purposes.

Recent Trends

In general terms, three basic factors seem to have dominated movements in the U.S. merchandise trade balance since 1974: (1) increasing value of fuel imports caused by higher prices and declining domestic supply; (2) sharp swings in import levels caused by swings in the domestic economy and our relatively high income elasticity of demand; and (3) historically low growth rates of U.S. exports, essentially reflecting lower than normal real growth in our trading partners. Treasury staff believes these factors will continue to dominate the trade outlook at least into 1978.

Trade Balance by Type of Product

Between 1976 and 1977, we estimate that the trade balance will deteriorate by about $18 billion.

Trade Balance by Category
($ billions, rounded)
(Balance of Payments Basis)*

	1976	1977	Change
Fuels (net)	-32.4	-40.0	- 7.6
exports	4.7	5.0	+ 0.3
imports	-37.1	-45.0	- 7.9
Agriculture (net)	+12.1	+11.1	- 1.0
exports	23.4	24.6	+ 1.2
imports	-11.2	-13.5	- 2.3
Other Non-Manufactures (net)*	- 7.7	-10.8	- 3.1
exports	12.1	13.0	+ 0.9
imports	-19.8	-23.8	- 4.0
Approximate Manufactures (net)*	+18.7	+12.9	- 5.8
exports	74.5	80.0	+ 5.5
imports	-55.8	-67.1	-11.3
Net Trade	- 9.2	-27.0	-17.8

*Manufactures/non-manufactures split derived from end-use rather than SITC data.

Estimated U.S. Trade Balance by Region
($ billions, rounded)

	1974	1975	1976	1977(E)	Change 1974-77
OPEC	-17 1/2	-14	-21	-28	-11 1/2
OECD	+3 1/2	+10 1/2	+5 1/2	+ 2	-1 1/2
Rest of World	+8 1/2	+12 1/2	+6 1/2	- 1	-9 1/2
Total	-5 1/2	+ 9	- 9	-27	-22 1/2

(E)=Estimated

The largest component of the U.S. trade balance deterioration has been OPEC. Oil is clearly the major factor in the U.S. deficit. U.S. trade remains in approximate balance with the rest of the world. Non-OPEC LDCs are the second largest gainers from our enlarged deficit, as they continue to restrain import levels and enjoy commodity price increases (especially for food items such as coffee) for some of their exports.

These general regional projections appear to be confirmed by actual trade data to date in 1977. For the first five months, the trade balance changes by region have been:

Regional Trade Balance
(Change Jan-May 1976 to Jan-May 1977)

	Change $ billion	% of Total Change
OPEC	- 4.0	42.5
Non-OPEC LDCs	- 3.6	38.3
Latin America	- 2.5	26.6
(Mexico)	(- 1.0)	(10.6)
(Brazil)	(- 0.7)	(7.4)
Other LDCs	- 1.1	11.7
Developed	- 1.4	14.9
Canada, Japan	- 1.2	12.8
Europe	- 0.1	1.1
Other developed	- 0.1	1.1
Communist Europe and Asia	- 0.5	5.3
Total	- 9.4	100.0

U.S. Trade Competitiveness

One of the most difficult concepts to measure on a timely basis is trade competitiveness. Over time, one can see significant movements in such cost factors as relative wage rates, relative unit labor costs, relative productivity, export prices, import prices, etc. However, drawing inferences about gains or losses in competitiveness over relatively short periods involves difficult judgments as to the appropriate base or "norm." Two general measures of competitiveness are often used: (1) exchange rates--either simple trade weighted, or trade weighted adjusted for relative price movements; and (2) export market shares.

Exchange Rates

On the basis of relative prices adjusted for exchange rate changes, the United States has also registered essentially no change since mid-1975--the record surplus year. Since the end of 1975, U.S. inflation has been lower than the average inflation rates experienced by our major trading partners. In terms of relative prices, therefore, the U.S. has probably experienced some small gains in competitiveness. Between January 1976 and June 1977, the trade weighted value of the dollar remained essentially unchanged vis-a-vis the OECD and has slightly appreciated vis-a-vis the entire world. Thus it would appear that our competitive position has neither improved nor deteriorated in the past 18 months. The IMF reached such a judgment in its Article VIII review of the United States last spring. We believe, therefore, that the trade deficit increase cannot be explained in terms of relative price performance in the past year and a half. There may, however, still be some effects from the lost competitiveness in the 1973/74 period affecting our recent trade performance.

Market Shares

Another indicator of the competitiveness of the United States is the market share of world exports held by U.S. manufactures. As was the case with our overall trade position, market shares declined during the latter 1960s, largely reflecting deteriorating competitiveness of U.S. products and overvaluation of the dollar. In broad terms, U.S. export shares reached an historic low point in 1972.

Thereafter, U.S. market shares increased steadily through 1975, and then declined somewhat, in the aggregate, in 1976. However, the U.S. share rose further in 1976 in some key product (e.g., chemicals and electrical machinery) and country (e.g., Britain, Mexico, Belgium) markets. Our share in 1975 may have been abnormally high, in any event, because some of our key LDC markets had not yet begun their adjustment to higher oil prices and world recession.

Percent Shares

	Total Manufactures	Chemicals	Non-Elec Mach	Elec Mach	Transport Equip	Basic Manuf	Misc Manuf
Low point (1972)	19.1	18.6	25.1	20.9	26.4	10.5	15.5
1975	21.2	20.1	27.8	22.3	27.8	12.5	17.3
1976	20.3	20.4	26.6	23.0	24.8	11.8	17.0
% above low	6.3%	9.7%	6.0%	10.1%	-6.2%	12.4%	9.7%

Market Shares of Major Trading Partners

Changes in U.S. export market shares have as their counterpart changes in the share of markets held by other exporters. If a basic change in competitiveness has occurred, it should be confirmed by a change in the market shares of our major trading partners.

Share of Industrial Country Manufactures Exports

	U.S.	Japan	Germany	France	Italy	U.K.	Canada
1972	19.1	13.5	19.3	8.7	7.1	9.7	5.7
1973	19.5	13.3	20.3	8.7	6.2	9.0	5.3
1974	20.2	14.8	20.2	8.2	6.2	8.2	4.7
1975	21.2	14.2	18.6	9.0	6.6	9.0	4.5
1976	20.3	14.8	19.1	9.0	6.4	8.5	4.7
Change 1976/72	+6.3%	+9.6%	-1.0%	+3.4%	-9.8%	-12.4%	-17.5%

Source: Commerce Department (Advance data to be published in September)

The trade share data show mixed results. The U.S., Japan, and France have gained in market share since 1972 (the low point in U.S. share). The annual data also seem to record rather sharp movements in both directions--increased and decreased shares. Judgments regarding "competitiveness" on the basis of one year's change should be very tentative. When the

U.S. was rebuilding its market share between 1972-1975, Japan and France were also enlarging their share of manufacture trade, while Germany, Italy, the U.K., and Canada were all seeing their shares reduced.

Current Account--Invisibles and Trade Balances

The merchandise trade balance is only one factor comprising a country's current account balance. Others include tourism, freight and transportation, investment income (direct and portfolio), and unilateral transfer payments (private and public). The current account balance measures a country's net balance on international transactions in goods, services, transfers, and hence its net flow of investment abroad.

In general terms, if foreigners do not voluntarily generate capital flows that match the current account balance, exchange rate pressures develop. In other words, the exchange rate is the equilibrator between transactions on current and capital accounts.

The U.S. has become a major net provider of services to the world economy in recent years as investment income receipts have registered substantial growth and as military sales deliveries have sharply increased, particularly to OPEC countries. The rising surplus from these transactions has worked to offset part of the increasing trade deficit since 1975.

In 1975, for example, net invisibles were in surplus about \$2 1/2 billion. This, added to the trade surplus of over \$9 billion, resulted in a current account surplus of \$11 1/2 billion. In 1976, the invisibles surplus rose to a level of \$8 billion--just short of the \$9 billion trade deficit. This \$5 1/2 billion rise in the invisible surplus reflected a gain of almost \$4 billion in net investment income (direct plus portfolio) and an increase of over \$1 billion in military sales deliveries plus small gains in other services accounts. Net income from petroleum investments rose about \$1 1/2 billion, that on other direct investment about \$3/4 billion, and net income on portfolio investment (largely reflecting earnings from bank lending activity) over \$1 1/2 billion.

Treasury staff projects the net invisibles surplus to increase a further \$3 1/2 billion to about \$11 1/2 billion in 1977. This would represent a further gain of about \$2 1/2 billion in net investment income, a \$1 billion further increase in military sales deliveries, and some deterioration on net travel and transportation. The net invisible surplus, added to a \$27 billion trade deficit, would leave a current account deficit of perhaps \$15 1/2 billion.

U.S. Trade and Current Account in a Global Context

The appropriateness and sustainability of the U.S. trade and current account position must be assessed in the context of the global distribution of current account positions. In the past three years, the global economy has experienced sizable changes in payments patterns in the wake of the oil price jumps. The surplus of the OPEC countries was more than $40 billion in 1976, and is expected to remain at about this level for 1977 and a few years to come. Given the large OPEC current account surpluses, the oil importers must, in the aggregate, face deficits. The distribution of those deficits among oil importers is critical to the stability of the world economy and the international monetary system. In time, with effective energy policies in the United States and elsewhere--the substitution of alternative energy sources and energy conservation--and with rising OPEC imports, the OPEC surplus will fall. But in the short-run, only a repeat of the 1975 economic slowdown in consuming countries (a highly costly way of decreasing oil imports) would reduce this surplus.

In 1975, developed (OECD) countries experienced a relatively small aggregate current account deficit of $6 billion while the LDCs ran an aggregate deficit equal to about $30 billion. This was clearly a disproportionate sharing of the requisite deficits needed to offset OPEC's surplus. Financial markets would not provide the loans needed to sustain the large LDC deficit over the longer term while the "richer" countries had substantial capacity for enlarged borrowings.

Germany, and the U.S. have to expand. The strength of the services and transfer accounts of the U.S. balance of payments--in surplus some $13 billion in 1977--requires that our trade deficit be rather large if the current account is to register a deficit in order to ease the adjustment burdens of others.

Table A gives a breakdown of world payments patterns by regions. It is clear that "strong" countries--United States, Germany, Japan, Netherlands, Switzerland--have until now exacerbated the problem. In 1977, the strong countries as a group are expected to move toward a balanced current account, but this adjustment is due entirely to the United States.

An examination of the relative size of the deficit is shown in Table B. The size of the present U.S. deficit is substantially less relative to GNP than in a number of other countries with deficits, and it is approximately the same for the U.S. as for the OECD as a whole. It should also be noted that the capacity of the U.S. economy to finance a deficit, given our well developed capital markets, stable political environment, relatively low inflation, and strong economy, is almost certainly greater than that of most other economies.

The weaker countries will reduce their external deficits one way or another. The only choice to be made is how the deficits will decline. If markets in the stronger countries

TABLE A.--World Current Account Patterns
(billions of dollars)

<table>
<tr><th></th><th>1974</th><th>1975</th><th>1976</th><th>1977 (projection)</th></tr>
<tr><td>OECD</td><td>-34-1/2</td><td>-6</td><td>-27</td><td>-32</td></tr>
<tr><td>"Strong countries"*</td><td>4.8</td><td>19.2</td><td>11.6</td><td>-1</td></tr>
<tr><td>"Weak countries"**</td><td>-24.2</td><td>-9.2</td><td>-15.7</td><td>-9.5</td></tr>
<tr><td>Greece, Portugal, Spain, Turkey</td><td>-6.0</td><td>-7.1</td><td>-9.0</td><td>-9</td></tr>
<tr><td>Other OECD</td><td>-9.0</td><td>-8.9</td><td>-13.8</td><td>-12-1/2</td></tr>
<tr><td>Non-oil Developing countries</td><td>-23</td><td>-35</td><td>-24</td><td>-24</td></tr>
<tr><td>OPEC countries</td><td>62</td><td>34</td><td>42</td><td>42</td></tr>
<tr><td>Sino-Soviet countries</td><td>-6-1/2</td><td>-12</td><td>-9</td><td rowspan="2">14</td></tr>
<tr><td>Discrepancy</td><td>2</td><td>19</td><td>18</td></tr>
</table>

Source: OECD, adjusted by CEA staff.

*United States, Germany, Japan, Netherlands, Switzerland.

**Canada, France, Italy, U.K.

TABLE B.
Current Account Deficit as Percent of GNP
(Projected 1977 Current Account and Actual or Estimated 1977 GNP)

	Current Account Deficit (bil. $)	Percent of GNP
United States	14-15	1
France	5-1/2	1-1/2
Canada	4	2
Australia	2	2
Sweden	2	3
Spain	4	4
Denmark	1-1/2	4
Austria	2	4-1/2
Greece	1-1/4	5-1/2
Turkey	2-1/2	6
Portugal	1-1/4	8
New Zealand	1	8
Norway	3-1/2	11-1/2
TOTAL OECD	32-33	1

do not expand, deficits may be reduced via sharp reduction in domestic demand in the weaker countries, trade restrictions/ subsidies, predatory exchange rate practices, or some combination. Only expanding markets in the strong countries will allow the world economy to remain on a steady sustainable growth path.

Is the Trade Deficit a Problem?

A large and growing U.S. trade deficit could pose problems on several different levels--purely economic, psychological, or political. The possible policy prescriptions tend to differ depending on the perceived source of the problem.

Pure Economic: To the extent that the deficit is oil related there is no short-run alternative. Until the Energy Program is fully effective, the only way to reduce imports of raw materials, including petroleum, would be to substantially slow domestic real growth, since oil demand is directly related to growth.

If imports are rising due to unfair competition from abroad, U.S. industry is hurt and domestic output is less than it would otherwise be (see below for possible solutions).

To the extent that the deficit represents U.S. products losing competitiveness to foreign products in foreign and/or domestic markets, then total domestic production and employment is also less than would otherwise be the case. Possible solutions center on enhancing the attractiveness of U.S. products. These include exchange rate depreciation to make goods more price competitive, increased export efforts (awareness) by U.S. producers, increased export promotion, enlarged financing capabilities, etc.

Concern has been expressed by some that the flow of dollar assets to foreigners associated with large U.S. deficits will be inflationary for the world economy. This concern is predicated on a false analogy to the experience of the late 1960's and early 1970's, when deficits were associated with large accumulations of dollar reserves by foreign central banks. At that time, these central banks were intervening to maintain fixed exchange rates. In the present floating exchange rate regime the accumulation of official reserves beyond liquidity needs is neither necessary nor desirable. The OPEC countries represent a sink into which newly created dollar liquidity will disappear as fast as it is created, so long as industrial countries pursue a sound monetary policy. Since we would anticipate the elimination of our deficit as OPEC countries eliminate their surpluses, the OPEC holdings of dollars do not represent a source of inflationary pressure.

<u>Psychological</u>:

--Some believe trade deficits simply look "bad;" partly argued on grounds that trade deficits reflect a weak U.S.

economy. This mercantilist belief is deeply ingrained in the "conventional wisdom."

--The deficit may cause some downward movement in the dollar if net capital flows do not fully match the current account deficit. To some, a depreciating ("weak") dollar per se is disturbing.

--Exchange markets could see a rising deficit as a sign of weakness for the dollar and become "jittery." Given the potential for "hot money" capital flows, exchange rate movements could be sharp and some people believe that adverse economic effects could result. It should be noted, however, that the dollar has not been subjected to such pressures during the nearly two-year period when the trade balance has been declining.

Political:

--Some may use the trade deficit to buttress a case for protection. (Farmers, for example, have told Agriculture that they could help the deficit problem by putting up trade barriers to beef imports, etc.)

--Some sectors (industry and labor) may point to an overall deficit to argue for specific industry (e.g., shoes) protection.

Abroad:

--On the other hand, some Europeans argue that our deficit is not helping global adjustment problems since the deficit goes to Japan and OPEC rather than to the Europeans or LDCs. They appear to be calling for faster domestic growth and the resultant still larger trade deficits. Nevertheless, others are worried about the inflation potential of a large U.S. deficit.

--At the same time, some Europeans are worried about the potential for downward movement in the dollar since depreciation would directly hurt their own trade competitiveness.

<u>What are We Doing about the Deficit?</u>

First and foremost is the Energy Program. This hits at the biggest factor in the trade deficit--reduced oil volumes will directly reduce trade deficits over time, and will also help global adjustment by reducing total demand for OPEC oil production, thereby easing upward price pressures. This will not, however, be of any short-run help, since significant effects of the energy program on oil imports are not expected pre-1980. It will help the psychological climate when passed by Congress.

--We continue to urge Japan and Germany (and other countries) to expand domestic growth (increase imports) and allow exchange rates to rise (reducing price competitiveness of their exports). Some progress is already being made.

--We are letting the dollar reflect market pressures.

Should depreciation result, U.S. goods would become more attractive, imports less attractive.

--Budget planning for medium-term will produce lower inflation rate (increased competitiveness of domestic products for both home markets and abroad).

In addition to these more macroeconomic policies, we are taking actions to protect individual industries from disruptively rapid changes and unfair trade practices.

--We have worked out "orderly marketing" arrangements on selected products.

--Specific provisions of the law are designed to protect U.S. producers against dumped or subsidized imports. In the first five months of this Administration, Treasury has taken roughly 30 anti-dumping actions and over 20 countervailing duty actions.

--As for other unfair trade practices, Title III of the Trade Act offers a variety of remedies. A large number of so-called "337" cases (unfair import practices) are now under active investigation by the ITC.

--U.S. industries are also entitled to relief from import injury even if those imports are not sold unfairly. The Trade

Act of 1974 authorizes the President to raise import barriers if imports are a "substantial cause" of "serious injury" to a U.S. industry. This relief is temporary--up to five years, with one possible extension of three years.

What Other Policy Options Exist?

Short Run:

--Short of direct import controls or a sharp cutback in domestic economic growth, not much can be done to change the trade balance this year. Import controls that included oil products would depress the growth rate; reduced growth would raise unemployment. Exchange rate changes take 12-18 months to work through in terms of changes in final sales; developing new export markets by export promotion is a slow education process for both foreign buyers and domestic sellers.

--Possible policies:

1. Import Surcharge. Would be inflationary. Would raise oil and other costs on much needed factors of production. Would face quick emulation and/or retaliation by trading partners, many of whom are in far worse shape than the U.S. and already leaning toward protectionism. Trade war would be disaster.

2. Export Subsidies. Would add to budget deficit. Direct subsidies may not produce much increase (in terms of new exports) since price competitiveness does not seem to have

been a factor in enlarged deficits. If U.S. trade financing loses competitiveness, efforts could be made to assure continued balanced treatment for U.S. suppliers. In flexible rate world, if some exports rise, exchange rate will appreciate making other exports <u>more</u> expensive, imports <u>less</u> expensive. Would destroy trade pledge and export credit agreements; would almost certainly lead to competitive measures by trading partners. We are already arguing that smaller OECD members and LDCs need to adjust partly via making their exports more attractive and this would run directly counter to these efforts.

3. <u>Capital controls</u>. Aimed at reducing net inflow thereby depreciating the dollar. Would need to subsidize capital exports and/or tax capital imports--or move consciously to eliminate/reduce the key currency role of the dollar. Experience in 1960's suggests capital controls produced very little in the way of net effects. Could damage monetary system severely and would also invite retaliation.

--<u>Public education</u>:

Probably the most productive alternative for short-run. Specific testimony and speeches aimed at realistic view of trade balance, explaining causes, alternative courses of action, and the need to focus on longer-run measures. We are not complacent, have put in place number of policies aimed at solution. Point especially to need for energy policy in action.

Longer-run:

--Energy policy.

--Controlled, non-inflationary growth.

--Maintenance of pressure on others to let exchange rates accurately reflect underlying competitive positions, especially not to intervene to prevent appreciation.

--Increase in official resources at IMF to enable others to adjust at reasonable pace, thus avoiding sharp policy changes and enabling higher level of world demand than would otherwise be the case.

--Increase export efforts (awareness) of U.S. producers via trade fairs, export promotion, etc., and should assure that our export financing remains competitive.

Summary Conclusions

--Oil remains the biggest problem. Declining domestic oil production coupled with domestic recovery/expansion will result in $45 billion in fuel imports in 1977.

--Excluding fuel, the trade balance will be in surplus by about $18 billion.

--Patterns of real growth in the industrial world have been altered. In the 1960's, the U.S. grew slower (4.2%) than other OECD countries (6.7%). Most economies were registering solid, sustained real growth. Differential income elasticities were more than compensated for by faster growth abroad.

Since 1975, the U.S. has led the world recovery. Growth rates abroad are uneven; but even the stronger countries (Germany, Japan) are running well below the 1960's level, while others are quite low and are <u>well</u> below 1960's rates.

--LDC stabilization programs have hurt the U.S. trade balance. Their eventual recovery will provide us with export growth gains.

--The evidence suggests that the U.S. competitive position remains strong, particularly in the manufacturing sector where a substantial surplus (about $13 billion) is expected in 1977.

Thus when the U.S. external position is placed in the context of the global distribution of payments, it suggests that the United States has moved from a position of inappropriate surplus to a deficit that is in the appropriate range. Unfortunately, other strong countries have not matched the United States' lead, for the other "strong" countries continue to run very sizable current account surpluses. This suggests that the United States should continue its effort to persuade other countries, where appropriate, to expand and revalue their currencies. The evidence does not suggest that the United States should take measures which would attempt to improve its trade balance at the expense of its trading partners.

It must be noted, however, that a strategy of pursuing or accepting a sizable current account deficit carries certain risks. While we may feel that it represents an appropriate position in light of the post-1973 trade situation, rather than a basic decline in competitiveness, others may not agree. We might therefore wish to indicate that, as a corollary to our policy about the appropriate payments position, we are not seeking a general depreciation of the dollar to regain competitiveness, although we will not resist realistic market adjustments of the currencies of the major countries.