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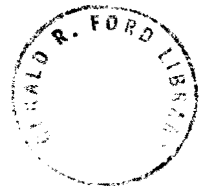
U.S. Balance of Payments

The U.S. balance of payments, as indicated by the merchandise trade and current account balances, has deteriorated at an extremely rapid rate in the course of the current calendar year. In the first quarter the trade balance was in deficit by less than $100 million while the balance on current account (excluding a $2 billion special grant to India) was in surplus by roughly $500 million. The situation has deteriorated so sharply, however, that for the year as a whole the trade balance will show a deficit of $6 to $7 billion and the current account a deficit of around $4 billion. Currently the trade deficit appears to be running at an annual rate of around $10 billion. Our current estimates suggest that the trade deficit in 1975 may be on the order of $11 billion and the current account deficit on the order of $10 billion.

The major factors in this very sharp deterioration are the increase in payments for petroleum imports and a fall in the dividend receipts of American oil companies. These estimates assume that U.S. exports of non-military goods and non-military exports to oil exporting countries will nearly double in 1974 and rise by another 60% to 70% in 1975 from a base of $3.3 billion in 1973. In projecting investment income it has been assumed that oil exporting countries will take over most of the investments of U.S. owned oil companies and will pay the companies a management fee for oil production.

Capital movements continue to finance these deficits and there does not appear to be any immediate problem in financing prospective deficits. On the contrary, many foreign observers fear that such a large proportion of OPEC surpluses will be invested in the United States that other countries will have difficulty in obtaining financing. The U.S. has, however, been receiving only about 25% of the OPEC surpluses to date. If this percentage were to increase dramatically we would need a substantial outflow of U.S. capital to avoid upward pressure on the dollar exchange rate. Most major oil importing countries will have to tolerate large trade and current account deficits as long as OPEC countries have large surpluses.



BALANCE OF PAYMENTS: CURRENT ACCOUNT
Half Years--Billions of Dollars
(Rough Estimates)

September 26, 1974

	1973			1974			1975		
	I	II	Year	I	II	Year	I	II	Year
Merchandise									
Exports, total	31.9	38.4	70.3	46.4	50.8	97.2	54.8	58.2	113.0
Agricultural	7.8	10.1	17.9	11.6	11.0	22.6	10.9	10.1	21.0
Other	24.1	28.3	52.4	34.8	38.2	74.6	43.9	48.1	92.0
Imports, total	33.2	36.6	69.8	48.1	55.4	103.5	59.6	64.4	124.0
Fuels	3.5	5.1	8.6	12.0	14.4	26.4	14.7	15.2	29.9
Other	29.7	31.5	61.2	36.1	41.0	77.1	44.9	49.2	94.1
Balance	-1.3	1.8	0.5	-1.7	-4.6	-6.3	-4.8	-6.2	-11.0
Investment Income									
Receipts	6.5	7.3	13.8	10.0	9.0	19.0	8.9	9.2	18.1
Direct investment-- petroleum (net)	1.7	2.2	3.9	3.6	1.8	5.4	1.6	1.7	3.3
other	2.7	2.6	5.3	3.1	2.7	5.8	2.8	3.1	5.9
Other investments	2.1	2.5	4.6	3.3	4.5	7.8	4.5	4.4	8.9
Payments	3.8	4.7	8.5	5.1	6.3	11.4	6.4	6.4	12.8
Interest on liquid liabilities	2.4	3.2	5.6	3.2	4.2	7.4	4.3	4.4	8.7
Other	1.4	1.5	2.9	1.9	2.1	4.0	2.1	2.0	4.1
Balance	2.7	2.6	5.3	4.9	2.7	7.6	2.5	2.8	5.3
Military Sales and Expend., net 1/	-1.6	-1.2	-2.8	-1.3	-1.3	-2.6	-1.3	-1.2	-2.5
Services, net	0.1	0.6	0.7	0.7	1.0	1.7	1.0	1.0	2.0
Remittances and Gov't pensions	-0.8	-1.1	-1.9	-0.8	-0.9	-1.7	-0.9	-0.9	-1.8
Current Transactions Excl. Gov't grants	-0.9	2.7	1.8	1.8	-3.1	-1.3	-3.5	-4.5	-8.0
Gov't grants 2/	-1.0	-0.9	-1.9	-1.3	-1.1	-2.4	-1.1	-1.1	-2.2
Current Transactions	-1.9	1.8	-0.1	0.5	-4.2	-3.7	-4.6	-5.6	-10.2

1/ Excl. transfers to Israel financed by grants.
2/ Excl. grants to India in foreign currencies obtained through loan repayments by India, and excl. grants to Israel to finance military purchases.

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ISSUE Should the U.S. accede to Italy's desire for financial assistance?

DESCRIPTION AND CURRENT STATUS

During the Annual Meetings of the IMF/IBRD and against the background of a political crisis in Rome, Italian financial officials abandoned their previous stance vis-a-vis the U.S. of doing no more than laying out their financial difficulties. However, in initiating discussion of the question of U.S. assistance, they made clear that their need was for the strongest possible signal of U.S. readiness to supplement other means of support rather than for an actual medium-term loan. Attached is a joint press release (worked out from an Italian draft) which was issued October 5 following a meeting on October 4 between Secretary Simon and Treasury Minister Colombo.

The Italian proposal submitted at the meeting contained explicit reference to expansion of the swap line with the Federal Reserve and to operations by the U.S. Exchange Stabilization Fund. The U.S. side rejected any such reference, pointing out that the Federal Reserve could not agree to an expanded swap line and that resort to the ESF raised many difficulties, particularly in view of Italy's desire to avoid granting a gold collateral.

No specific arrangements exist for continuation of the talks. Presumably, the Italian side would initiate any follow up -- probably after resolution of the political crisis and after reflecting on the discussions in Washington.

BACKGROUND

Beset by an increasingly high rate of inflation and a very large balance of payments deficit, the GOI has attempted to adhere to a monetary and fiscal stabilization program, while at the same time maintaining politically acceptable levels of domestic growth and employment. While the quadrupling of oil prices has been a heavy burden on the balance of payments and may have had a more adverse impact on production in Italy than in most other countries, the basic problems already existed as a result of several years of fiscal and monetary stimulus.

The GOI's attempts to pursue less expansive policies have suffered from the preoccupation of one of the coalition parties, the Socialists, with avoiding a rise in unemployment and specifically with securing exemptions from higher taxes and monetary restraints for particular sectors of the economy. A stabilization program agreed to by coalition parties in July and ratified by Parliament, which produced some results in the form of reduced capital outflows, is now threatened by the political crisis and the Socialists' desire to reduce its

impact. Indeed, the development of the crisis has initiated renewed heavy intervention losses by the Bank of Italy.

The trade deficit in 1974 will probably total between $9 and $10 billion, of which over 50% could be attributed to higher oil costs. The overall deficit, requiring net use of reserves or borrowing, may be almost as high, assuming continuation of the policy of supporting the exchange rate. (The overall deficit through end-September was $6.4 billion.) Recent data suggest that Italy could succeed in eliminating most of its "non-oil" deficit in 1975 -- which would significantly diminish the financing problem, particularly if confidence is thereby restored so that speculative capital outflows are reversed.

Since June 1972 Italy has borrowed over $14 billion in various forms, of which some $8 billion in 1974. As a result, the current reserve position (valuing gold at $42.22/oz) is adequate for the time being at around $7 1/2 billion. Further IMF credit totalling almost $1 billion should become available in 1975, and existing (unused) swap lines total $4 billion, although their availability is not assured.

The outlook for real growth and employment is uncertain, partly because it is not clear whether the GOI will be able to resist attempts to water down the stabilization program but also because it is hazardous to predict the impact of the envisioned substantial increase in government revenues (3% of GNP) which nonetheless leaves a massive budget deficit (perhaps 8% of GNP) and continued double digit monetary growth. It seems clear that growth in 1974 will be good, perhaps 4 1/2% compared with the very satisfactory 5.9% achieved in 1973, and that growth in 1975 will be considerably less, perhaps 1 1/2%. But even this relatively stagnant level would suffice to avoid any large scale increase in unemployment. Price increases this year should total around 20% (much higher for wholesale prices) and will probably not slow below the 15% mark in 1975. One factor working against reduced inflation is the aggressive posture of labor unions, who are pushing for revised cost-of-living adjustments which in their extreme forms would add more to purchasing power than is removed by the stabilization program.

Department of the TREASURY

WASHINGTON, D.C. 20220 TELEPHONE W04-2041

NEWS

FOR IMMEDIATE RELEASE OCTOBER 4, 1974

SECRETARY SIMON AND TREASURY
MINISTER COLOMBO HOLD TALKS

The Secretary of the Treasury of the United States, Mr. William Simon, met today with the Minister of the Treasury of Italy, Mr. Emilio Colombo.

In the course of a long and wide-ranging conversation, the complex problems of inflation and of the disequilibria arising from the higher price of oil were examined. Special regard was given to the repercussions of the higher oil prices on domestic price levels and on the external accounts of consumer countries, especially those whose economies already had structural disequilibria and conjunctural difficulties when the oil crisis broke out. In the light of the discussions held in various international forums, and especially at the Annual Meeting of the IMF, the most appropriate ways to face these problems were examined in depth.

In this connection, the desire of both countries to cooperate closely in all international organizations was reaffirmed to ensure rapid progress towards a system that favors a better balance of international trade and that promotes the proper functioning of institutions.

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(more)

The Ministers reaffirmed their support for the decision made earlier this week by the new Interim Committee of Ministers in the International Monetary Fund to consider "as a matter of urgency, the adequacy of existing private and official arrangements" for recycling of international investment.

It was recognized that Italy is among the industrialized countries hit hardest by the oil crisis. Minister Colombo outlined the prospective evolution of his country's balance of payments and the comprehensive fiscal and monetary program implemented by the Italian Government to fight inflation and to reduce the non-oil deficit. He underlined that, despite the favorable progress that has been made thus far towards the elimination of the non-oil deficit, the high oil deficit still gives rise to difficult financing problems even in the presence of substantial reserves and bilateral and multilateral lines of credit. The two Ministers recognized that in these circumstances special care must be exercised to avoid adding to existing uncertainties in the international markets.

Secretary Simon recalled President Ford's recent assurances that "the U.S. is prepared to play an appropriate, constructive and responsible role in a return to economic equilibrium in Italy." In that context, the two Ministers explored a wide range of possible concrete ways in which the two countries might work more closely together in the interest of economic stability in Italy and in the international community at large. They agreed that these conversations will be continued at an appropriate opportunity in the near future.

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The Outlook for the British Economy

Looking Ahead

The Labor government has been returned with a workable majority but faces the same severe if not intractable problems. The U.K.'s economic future looks poor. It will depend heavily on the outlook for industrial relations; the degree of agreement among industry, labor and the political parties on national economic goals and the extent of further Government control of the economy; reversing the steadily downward trend of industrial profits; rebuilding business confidence, including increased investment in manufacturing; and transferring domestic resources into exports to redress the non-oil balance of payments deficit. There are no particular reasons for optimism. Nor will North Sea oil pay any significant dividends for at least the next two to three years.

In the shorter term, during the next few months, the outlook for sterling will be strongly influenced by the ability of the Wilson Government to control domestic inflation, keeping it at a rate of increase in line with the levels of increase in the U.K.'s major trading partners, and improving business confidence. There is no reason for optimism on this score either.

There has been continuing slow improvement in reducing the "non-oil" trade deficit from a monthly average (in millions of pounds) of 189 in the first quarter 1974 to 147 in the second to 89 in the third. For the year as a whole, however, the trade deficit will be massive, about £5.2 billion, offset by an invisibles surplus of £1.25, yielding a trade deficit in the range of £3.95-4.0, slightly under $10 billion.

Nevertheless, sterling has been remarkably stable in recent months. This is due to competitive interest rates, purchases of sterling by foreign oil companies for payments in the Middle East, longterm capital inflows in part associated with investment in North Sea oil, positive errors and ommissions, and the demonstrated ability of the U.K. Government to raise funds in the market ($2.5 billion) or directly from Iran ($1.2 billion).

In financing the deficit in this fashion the British government has placed itself in a very vulnerable position: domestic interest rates must be kept high enough to draw in short-term capital, the volume of which is now such that a crisis of confidence could produce a disastrous outflow. This is why the British are now pressing urgently for a new international source of financing.

The Labor Victory

The Labor party emerged from the election with a workable majority (The initial count shows three seats). Both the stock market and sterling responded positively at first to this result, viewed as more favorable than the other likely alternative, another minority Labor government. Despite this initial favorable response the short term outlook for Sterling remains weak. Pessimism stems not only from record trade deficits and inflation and a government that is reluctant to take strong measures because of a concurrent economic stagnation and rising unemployment. It also reflects the continued statements by left wing extremists in the Labor Government about greater government control of industry, including plans for Government control and ownership of North Sea oil (which could diminish long-term capital inflows and retard development of North Sea oil until the foreign oil companies have a clearer impression of the rules under which they will be operating); the problematic outlook for cooperation from the trade unions with the government and the possible decline in the U.K.'s historic invisibles surplus to meet increased interest payments on foreign debt.

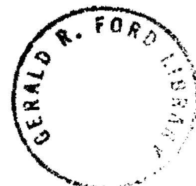
What Next?

It is not surprising that bankers and investors are nervous. Interest rates have made it attractive for foreigners to hold sterling. The U.K. has been trying to keep its interest rates at a level adequate -- but not higher than necessary -- to bring in and hold foreign short-term funds. It must keep its rates competitive with the U.S. To the extent that it builds up reliance on these short-term inflows to finance its payments deficit, the U.K.'s future monetary policy can be held hostage to the need to keep its rates high to try to retain these inflows.

On a trade weighted basis, sterling has generally fluctuated this year between 17 and 20 percent below Smithsonian rates. It is currently slightly above 18 percent. A run could develop. It is not likely that the Bank of England would -- or could -- stem a major capital outflow. Rather, it would probably let the exchange rate take the pressure, and expect that major official sterling holders would not act in a way that would deliberately reduce the value of their sterling holdings or future sterling payments.

This much said, there are large short-term foreign owned sterling deposits in London that are sensitive and nervous. There are other deposits, historic and officially held by sterling area countries, that are covered by a trade weighted guarantee when sterling falls 18.35 percent below Smithsonian rates. The British Treasury tells us that these guarantees are not available for deposits made or increased after March 1974.

In recent months, U.K. officials have sought to stress the overall trade weighted devaluation level of sterling (the dollar accounts for about 30 percent of the calculation) rather than the sterling/dollar relationship. If it appears that the pound will fall sharply and permanently in value against other currencies -- and to a degree not compensated by existing or new official sterling guarantees or higher sterling interest rates -- it would be logical to expect some shift from official and private sterling holdings to investments in other countries. There is no immediate reason to expect sterling to strengthen appreciably against the dollar.



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DEPARTMENT OF THE TREASURY

SPECIAL REPORTS

OFFICE OF ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS

September 16, 1974

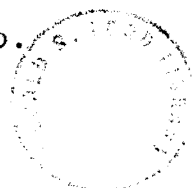
THE OUTLOOK FOR THE FRENCH ECONOMY
by Donald J. McGrew

SUMMARY

At summer's end the French economy remains in the grip of strong, persistent inflationary forces. During the first seven months of this year the consumer price index has advanced at a seasonally adjusted annual rate of nearly 17 percent. The Government has just announced that hourly wage rates soared by more than 6 percent in the first quarter. Since April the foreign trade deficit has averaged more than 2 billion francs per month, with a seeming tendency to worsen as the year advances. These most recent data on the performance of the French economy -- particularly the excessive trend of wage rates -- suggest that the malady is even more deep-seated than had earlier been thought. Hence correction will be slower and more painful than many had hoped. The data confirm to us, in our judgment, that the objectives of the Government's stabilization program -- cutting back price rises to an annual rate of 6 percent by mid-1975, holding real wage increases to 2 percent per year, and restoring external equilibrium by the end of next year -- look too ambitious for the means being employed.

Growth

We foresee a slowing of the French economic growth rate for 1974, with this trend firming somewhat in the first part of 1975, when stabilization measures will be having their main impact. In particular, business outlays on plant and equipment, which have been a mainstay of expansion, should lose steam under combined influence of an increased tax burden on business and tight money. Housing is already suffering from the latter element and probably will continue to do so.



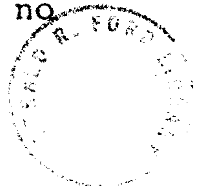
The stringent budget position will likewise dampen Government consumption and investment. On the other hand, rapid expansion of money, wages and an inflationary psychology should make personal consumption the principal motor force for continued growth. Expanded social welfare benefits to some households will tend to offset the restrictive effects on consumption of tax increases imposed on other households as part of the stabilization program. Export demand is something of a conundrum. While France might hope to benefit from some economic recovery in Germany, gains here could be largely offset by the opposite trend elsewhere -- e.g. Italy, where a highly inflationary situation has recently created an easy market for many French goods. In sum, we foresee a real growth rate of about 4.8 percent for 1974 and 4.5 percent for 1975. While down from the levels of 5.5 and 6.1 percent registered in 1972 and 1973, respectively, these figures would certainly remain among the highest for industrial countries during the two years in question.

Unemployment

In July the seasonally adjusted figure for unemployment was about 2.3 percent of the labor force, slightly higher than the level of about 2.2 percent which has prevailed over the past year or so. While unemployment may continue to creep upward in the months ahead, the growth rates forecast above should be sufficient to absorb most new entrants into the labor force. On this basis, unemployment should not rise substantially beyond 2.5 percent through the end of 1975.

Prices

In the first seven months of 1974, the seasonally adjusted consumer price index has already advanced by nearly 10 percent. There is reason to hope that the effects of steep energy cost increases have now been more or less absorbed into the price structure. As indicated above, however, the pace of wage increases accelerated in the second quarter to a near all-time record of 25 percent annual rate. It is, moreover, hard to see how in any near time span this rate can be brought down to a "reasonable" level. It seems inevitable that wage boosts will continue to exert heavy upward pressure on costs and hence on prices during the remainder of the year. We thus anticipate that the rise of consumer prices from beginning to end of 1974 will be in the range of 15-16 percent. With luck -- e.g., no new flare-up of world prices for energy and other primary

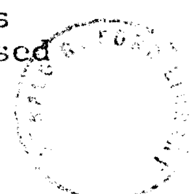


products, and a satisfactory performance of the franc on exchange markets -- the Government's stabilization program should produce some improvement in 1975 over this year's sorry record. But about the most that can be hoped for is something in the range of 10-12 percent -- still a considerable distance above the Government's price target, which implies a rise of only about 7.5 percent from the beginning to the end of next year.

Balance of Payments

Whatever may prove to be the ultimate effectiveness of the Government's stabilization measures, their influence on 1974 trade and current accounts will probably be only marginal. We foresee a trade deficit this year of about $4.8 billion and a current account deficit of some $6.5 billion. Assuming that nothing happens either in France itself or elsewhere to precipitate a massive flight from the franc, it should be possible to finance this deficit through a combination of capital inflows attracted by the current high money rates in France and the Government's program of external borrowings, and thus to maintain a floating franc at a reasonable level on the exchange markets.

The 1975 outlook is muddy. The projected growth rate for the French economy in the same range as in 1974 implies that in general the volume of imports will be increasing by roughly the same amount as this year. The Government has identified two areas where it is expressly seeking import savings: oil for space heating, and equipment goods (less in demand because of the policy-induced weakening of the investment boom). We would give some weight to these factors, but undoubtedly much less than does the French game plan. Invisibles will almost certainly deteriorate, if only because of the interest costs on large-scale external borrowings which are being undertaken to finance the deficit. Thus any significant improvement in the French current payments position would have to come through the expansion of exports. Much attention in France has focused on the gains to be had through highly publicized deals with the oil-producing countries and the Soviet Union, but many elements in these deals have not yet jelled. Even to the extent they represent firm orders rather than just possible sales , there are definite limits on how much they could contribute to the improvement of the French trade balance in 1975, because of the long lead times for many of the items involved. The main thrust for increased



exports next year would have to be towards Germany (which accounts for about 20 percent of French sales abroad) and other EC countries plus Switzerland (another 40 percent). Consequently, the state of demand in these markets is crucial, and our assumption is particularly that there will be some economic recovery in Germany. In light of the above factors, we put the 1975 trade deficit at about $3.5 billion and the current account deficit at about $5.5 billion. These figures imply that both accounts will continue in the red beyond the end of 1975.

Incidence of U.S. Economic Outlook on Projections

We do not believe that the French economic position, as depicted by the foregoing projections, could be substantially improved by a move on the part of the United States toward a less restrictive policy stance. The U.S. takes less than 5 percent of French exports; thus any expansion of French sales to U.S. induced through more buoyant business conditions there would scarcely be sufficient either to make an important dent in the French external deficit or to swell significantly the overall foreign demand for French products. Of course, a U.S. policy shift in the direction indicated might have greater effects on economic prospects for other, more important French trading partners, and these effects could in turn induce significant modification of the French outlook.

Effects of Possible Policy Modifications

The foregoing projections assume maintenance, in general, of the stabilization policies now in place: the credit squeeze, tight fiscal policy and, if necessary, quantitative restrictions to hold down consumption of energy for space heating. The French authorities appear prepared to accept some slowing of economic growth and a moderate rise in unemployment as a necessary, if unwelcome, byproduct of efforts to bring inflation under control. If, however, indicators began to signal a significant adverse trend of these two factors, the Government would doubtless move rapidly to relax restrictive fiscal and monetary policies in an effort to arrest deterioration. French official spokesmen have consistently emphasized the necessity to maintain growth at a pace sufficient to insure a high level of employment, and in his TV address earlier this week President Giscard D'Estaing again assured his listeners that the

Government would not let the anti-inflationary program do "needless harm to the substance of the French economy." Any relaxation of stabilization policies to this end, before the middle or latter part of next year, would be likely to provide a new stimulus to the price-wage spiral in 1975 and probably would lead to a swelling of the external deficit. While authorities would have some possibility to counter the latter tendency by allowing the exchange value of the Franc to fall, they could not go very far down this path without risking additional inflationary pressure in the form of rising import prices.

A more likely problem for the Government will be what to do if -- as our projections suggest -- the stabilization program does not show signs of producing the results being sought. We are inclined to view that the French authorities will think long and hard before proceeding to another turn of the screw, if only because of their concern about jeopardizing growth and employment. The specter of the 1968 events still haunts many French policymakers, who are thus exceedingly wary of taking economic measures which they think could sow the seeds of civil unrest. We should not, however, exclude some new policy initiatives, perhaps in connection with the 1975 spring session of Parliament, to strengthen anti-inflationary forces bearing on the middle and latter part of 1975. Assuming that the steps taken were similar to those decided last June -- notably a new one-shot levy on business and individual taxpayers in the upper brackets -- the result should be to dampen somewhat the projected rate of 1975 price increases -- perhaps to under 10 percent -- while cutting marginally into growth and employment. There would probably be no significant change in the projected 1975 external deficit.

Donald J. McGrew
Treasury Representative
U.S. Embassy, Paris

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DEPARTMENT OF THE TREASURY

SPECIAL REPORTS

OFFICE OF ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS

September 16, 1974

THE OUTLOOK FOR JAPAN THROUGH 1975
by William Escoubé

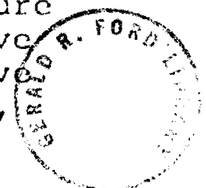
Summary

Following are my current best estimates of Japanese production, price and balance of payments prospects. Two alternative forecasts are presented. I believe slow growth assumption is more likely. Alternative rapid recovery projection more closely resembles JERC July, 1974, forecast. Balance of payments prospects are particularly clouded at this time. Import volume growth is linked to industrial production change and export performance to OECD economic outlook in the rest of the world.

End Summary

Overview

At mid-year Japan's recession may have already bottomed out, although some Japanese analysts are not so sure. Very recent forecasts project real GNP growth in the Japanese Fiscal Year (JFY 74), which ends March, 1975, at less than 2 percent because the cyclical trough is generally placed in the third quarter. The speed of prospective recovery is the subject of wide differences of opinion within the GOJ. Some foresee natural demand forces as leading to a resumption of a high growth rate in 1975. Others anticipate only slow recovery if the present tight fiscal monetary policies remain in force. Continuing upward price pressure and the possibility of another large wage settlement next year are cited by some as indicating a need for the continuation of the current restraint policy. The GOJ is now in the initial process of formulating next year's budget and future economic policy. In view of the uncertainty of future GOJ economic policies, two different paths of expansion have been projected. One alternative of slow recovery will leave excess capacity in late 1975 about as high as in late 1974,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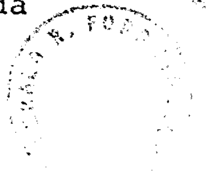
create less inflationary pressures and result in stronger balance of payments position. The other projection assumes less restraint and more rapid recovery, which will entail faster price advance and is likely to lead to a balance of payments deterioration in 1975.

Provisional second quarter real GNP figures just released show a small 0.6 percent rise compared with the first quarter drop of 4.7 percent (revised). On the other hand, real final domestic demand (i.e., GNP less inventory change and net foreign balance) probably dropped another 2.5 percent after first quarter 8.3 percent decline. Softness of domestic spending apparently continued into the third quarter. The pace of inventory buildup has not abated, and in some industries accumulation of unsold goods is resulting in production cutbacks. In certain other industries the order position reportedly is improving. The industrial production index is probably a more reliable guide for measurement of the short-term changes in the volume of output than deflated GNP statistics in a period of rapid inflation. Hence the forecast presented below is based on the percentage change of seasonally adjusted industrial production index of mining and manufacturing (which historically has an average relationship of about 1.1 to 1 with real GNP percent change). The preliminary July production index is unchanged from the revised June figure of 127.3, suggesting output at or close to cyclical trough.

Demand Prospects

The Ministry of Finance (MOF) is still keeping a tight rein on Government spending although the prospective large supplemental budget for higher rice payments and a Government salary increase is considered to be inflationary. The MOF is reportedly seeking to hold down the spending increase in JFY 75. Consumer attitudes remain cautious, but some analysts consider the prospect of increased money wages as a stimulative factor. Housing and commercial building is still hard hit by restraint policies. On the other hand, equipment investment of the manufacturing sector remains buoyant, unlike previous recession periods. Some analysts view this buoyancy as reflecting an inadequate capacity in some industries as well as a need to modernize and install anti-pollution control equipment. Others consider the strong investment plans to be based on the prospect for rapid cyclical recovery and future growth which may not materialize if a "slow growth" policy is subsequently adopted. Some GOJ officials (including former Finance Minister Fukuda



and Bank of Japan Governor Sasaki) advocate a slower and stable growth rate for Japan over the longer term to prevent a recurrence of international aggravations (e.g., pollution) and external frictions (e.g. heavy raw material demand and large export increases to pay for it). If the GOJ adopts a slow growth policy, then present demand restraint measures will, in all likelihood, be retained for a considerable period ahead.

Inflation remain a problem of serious concern. Recent and prospective hikes in utility rates and the price of rice are considered necessary even though they will raise the CPI. The GOJ is seeking ways to achieve price reductions for products in oversupply by abolishing some price controls and by removing products from resale price maintenance, and the Fair Trade Commission is seeking to prevent collusion in price setting and restraints on production. The rate of price advance has moderated in recent months. If the present trend continues, the rate of inflation in CY 75 could be reduced to around 10 percent for the WPI and 13 percent for the CPI (against prospective increases in CY 74 of 32 and 24 percent respectively). If a slower inflation rate is achieved, officials are hopeful that next year's wage demands can be restrained to perhaps no more than 15 percent. Nevertheless, the likely productivity advance under a slow cyclical recovery will be insufficient to prevent continued increases in unit costs so that considerable cost-push pressures will be unavoidable, according to a senior EPA official.

<u>Risks of Continued Restraint Policy</u>

A policy of slow economic revival may restrain demand growth and price pressures whereas rapid revival would result in more rapid productivity advance and less pressure on unit labor costs. Overhang of large inventories is creating a serious financing problem for many businesses. Production cutbacks, including some temporary layoffs, are creating apprehension about job security and employment opportunities. Consideration is being given to selective GOJ financial assistance to small businesses and other severely hit industries. Future capacity requirements in electric power, petrochemicals and steel may lead to further selective relaxation of administrative controls over investment, to ensure that bottlenecks are not encountered when economic activity recovers. If restraint policy were abandoned, Japan faces not only inflationary risk but also the possibility that within a year the economy would again become "overheated" and require reimposition of restraints. Thus GOJ officials are presently reviewing which set of policies

have the greatest advantages and the fewest risks. The outcome of the review is unlikely to be completed and a "consensus" arrived at for several weeks at the earliest. My present assessment is that the GOJ will take a very cautious attitude in dismantling most of the current restraint policies but will yield selectively to particularly strong business pressures for "relief." Therefore, the most likely prospect at this time is for a "slow growth" profile for economic recovery.

Projections

Presented below are two alternative projections of cyclical revival and their implication for Japan's balance of payments in view of the uncertainty at this time regarding future GOJ domestic economic policy. The highlights of these projections follow.

Methodology

Slow Growth Projection: Industrial production will not exceed previous peak (IV 1973) until second quarter of 1975. The rate of increase in production would be somewhat less than the trend growth in productive capacity; therefore, unused capacity in late 1975 would be at least as large as at the end of this year. Rates of inflation will moderate considerably under the pressure of excess capacity and slow demand growth. Despite considerable uncertainties in forecasting, a trade surplus is projected for the second half of this year, but the current account will be virtually in balance. In 1975 substantial surpluses on trade and current account are projected.

Rapid Recovery Projection: Beginning in the third quarter of 1974 demand will expand in all sectors. By year-end industrial production will have exceeded the previous peak of last year, and the economy will again begin to face supply constraints. Inflationary pressures will diminish but be more severe than under the slow growth projection. In the last half of 1974 a trade surplus is also projected, but the current account will remain in deficit even in CY 1975.

Balance of Payments Projection: Projections of import volume were derived from industrial production forecasts. Price changes for non-oil imports were assumed to be similar to WPI projection. Import values of rapid recovery projection do not differ greatly from JERC forecast. In view of Japan's strong export performance in the past two quarters, both in

volume and value, despite an economic slowdown in major indus-trail markets. This is assumed to continue during the current period of inventory overhang and slack production in Japan. World demand remains strong for certain products Japan can now supply to export markets, e.g., steel and chemicals. In CY 75 the pace of export advance is expected to slow somewhat. My export projection is more optimistic than that of JERC. The deficit on invisibles and transfers has grown rapidly over the past year, reaching $3 billion in the first half of 1974, and growth is expected to continue. For CY 75, the invisibles deficit is projected to reach $7 billion, which is substantially higher than Japanese projections for the same period ranging between only $5.2 - 5.7 billion.

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Financial Attachė
U.S. Embassy, Tokyo

SUMMARY OF PROJECTIONS
ANNUAL PERCENT CHANGES

DOMESTIC ECONOMY:	SLOW GROWTH	RAPID RECOVERY
Industrial Production (Mining, Manufacturing)		
1974 2nd Half/1st Half	-2.4	2.5
CY 1974	0.5	1.8
CY 1975	4.9	9.3
IV 75/ IV 74	6.9	9.6
Wholesale Price Index		
1974 2nd Half/1st Half	12.1	14.0
CY 1974	31.9	32.5
CY 1975	10.3	14.1
IV 75/ IV 74	9.1	13.6
Consumer Price Index		
1974 2nd Half/1st Half	14.2	18.7
CY 1974	23.6	24.9
CY 1975	12.7	15.7
IV 75/ IV 74	11.6	13.2

(Percentages at annual rates)

BALANCE OF PAYMENTS
(IN BILLIONS OF DOLLARS)

	1974			
SLOW GROWTH	I-II SA	III-IV SA	CY74	CY75
Exports	25.0	30.0	55.0	70.7
Imports	26.2	26.7	52.9	58.9
Trade balance	-1.2	3.3	2.1	11.8
Services and transfers	-3.0	-3.4	-6.4	-7.0
Current account	-4.2	-0.1	-4.3	4.8
RAPID RECOVERY				
Exports	25.0	30.0	55.0	70.0
Imports	26.2	27.4	53.6	64.1
Trade balance	-1.2	2.6	1.4	6.6
Services and transfers	-3.0	-3.4	-6.4	-7.0
Current account	-4.2	-0.8	-5.0	-0.4

TRADE AND
NATURAL RESOURCES

A

THE TRADE REFORM ACT

STATEMENT OF ISSUE

President Ford has made passage this year of the Trade Reform Act (TRA) a highest priority of legislative item. We need the authorities provided in the TRA to negotiate reciprocal reductions in trade barriers and improvements in managing the international trading system.

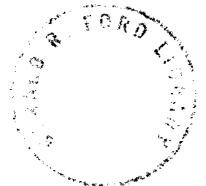
BACKGROUND

The House has passed the bill and Senator Long's Finance Committee has virtually completed mark-up. The Administration generally supported the bill as passed by the House -- with the major exception of the linkage established between Soviet emigration policies and our granting the USSR official credits and most-favored-nation tariff treatment. The bill emerging from the Finance Committee is generally acceptable -- at least as a basis to go to conference with the preferable House bill -- with a few exceptions. A major one is making import surcharges mandatory to correct a balance of payments effect if certain conditions are met, unless the President invokes a national interest exception.

The major provisions in the bill provide: (1) authority to reduce tariffs; (2) a mandate to negotiate on non-tariff barriers (NTBs) with special procedures to change U.S. law to implement NTB agreements; (3) a mandate to negotiate rules on access to supplies; (4) authority to retaliate against unreasonable or unjustifiable acts by foreign countries; (5) authority to temporarily raise or lower trade barriers for balance of payments reasons; (6) easier criteria for domestic industries and workers to qualify for import relief and adjustment assistance; (7) authority to grant tariff preferences to LDCs; (8) discretion by the Secretary of the Treasury on the application of countervailing duties. The major issue to be settled is the Soviet MFN question.

CURRENT STATUS

We expect the Finance Committee to report the bill to the Senate floor for a vote promptly after they return from the election recess in mid-November. The bill will probably go to the floor with the objectionable Jackson-Vanik language on the Soviet issue which would have to be changed by floor action.


FORD

OUTLOOK AND ACTION REQUIRED

The major problem is time. During the short post-election session the bill has to be reported to the Senate floor, passed there, go to conference, and be given final approval.

The Administration will have to continue to press for prompt action since the timetable is so tight, and seek a compromise on the Soviet MFN question. Once the bill is passed by the Senate, the Administration must press to remove the objectionable features of the Senate bill in the House-Senate conference.

October 15, 1974

B

MULTILATERAL TRADE NEGOTIATIONS (MTN)

STATEMENT OF ISSUE

Status and prospects of Multilateral Trade Negotiations ("Tokyo Round").

BACKGROUND

The Tokyo Ministerial (September 12-14, 1973) provided a political kickoff for the MTN, which is the most ambitious multilateral trade negotiation ever attempted. It will attack not only tariffs -- the traditional focus -- but all other barriers to trade as well. Its agenda reaches even to broad reform of international trading rules and institutions, in the interests of better management of international trade relations and moderation of trade-related political frictions.

The Trade Negotiations Committee (TNC) created by the Ministers at Tokyo to oversee MTN preparatory work, develop negotiating plans and supervise the negotiations, met in October 1973 and in February and July of this year. The TNC adopted a preliminary work program based on the Tokyo Declaration and assigned technical and analytical work projects to four of six working groups, covering agriculture, tariffs, nontariff barriers, and tropical products. These groups met periodically during the spring and summer. Preparatory work has continued into the fall and the two remaining TNC groups on the sector approach to negotiations and import safeguards are meeting in October for the first time.

The international preparatory work so far has been directed to building up trade statistics, assessing trends and patterns, and reviewing existing trade measures of major governments. By prior agreement it has stopped short of beginning actual bargaining. Current interagency preparatory work is directed toward choice of an appropriate tariff negotiating formula; identification of priority non-tariff barriers for early negotiation; resolution of objectives and strategy in agriculture; and development of approaches to "trade management" topics like import safeguards and supply access issues.

CURRENT STATUS

The TNC will meet within the next two months, probably towards the end of November, to lay the specific groundwork for the subsequent bargaining stage of the negotiations. Focus currently is on the U.S. Trade Reform Act (TRA), whose passage remains a key prerequisite to the elaboration of a U.S. position and substantive negotiations. Assuming that Trade Bill enactment will be assured as of the time of the TNC meeting, other countries will expect the U.S. to take the lead in getting substantive work underway. If the TRA is still in doubt, however, we will need to assure our negotiating partners of our continuing commitment. The European Communities has delayed updating its own negotiating mandate while awaiting the results of Congressional action on the TRA.

OUTLOOK AND ACTION REQUIRED

We believe there are very good prospects in the Tokyo Round, both for expanding trade and for working out better arrangements of harmonious management of international trade relations. Most governments have now publicly stressed the urgent need to press ahead on the negotiations. Moreover, we have been able to resolve a number of important trade disputes in the last few months.

Getting the MTN underway is more important now than ever because of current economic conditions: rampant worldwide inflation, higher energy costs, and shortages in many commodities have created immense pressures for restrictive and nationalistic trade actions in many countries. Many are laboring under extremely difficult international financial positions at present. These conditions emphasize the need to develop joint approaches for managing the international frictions which result. Governments may doubt their ability to pursue trade liberalization just now, but they have every incentive to pursue cooperative problem - solving efforts -- since no country is in a very good position to take unilateral measures with impunity. National actions to deal with pressing domestic problems need to be coordinated in ways which promote rather than restrict world trade. Unilateral measures which attempt to shift economic burdens to other countries must be headed off wherever possible.

October 15, 1974

C

PROPOSED GATT "MANAGEMENT GROUP"

STATEMENT OF ISSUE

GATT Director General Long proposes to achieve better coordination between GATT and the IMF -- especially on trade measures for BOP purposes -- by creating a high-level "Management Group" of key GATT members, somewhat analogous to the new Interim Council of the IMF. The Management Group would also try generally to anticipate and deal with serious trade problems more effectively than has been possible in the past.

BACKGROUND

Long proposed setting up some kind of high-level group this past spring, partly in response to the direction that C-20 discussions were taking on institutional changes and IMF actions on trade measures for BOP purposes. The U.S., without getting out in front, supported Long's idea as appropriate for a number of "trade management" purposes in addition to better coordination of IMF-GATT relations. As presently envisaged by Long, the Group's efforts would facilitate action by GATT members (1) to pursue and maintain trade policies consistent with GATT objectives and principles; (2) to forestall or if necessary, deal with, "sudden distrubances" threatening trade relations and the trading system; and (3) to deal with trade aspects of the adjustment process and GATT-IMF coordination thereon.

The level of representation is not clear yet, but we expect that whenever possible senior trade officials from capitals will attend. There will probably be seven developed country seats (US; Japan; EC -- with Commission and member state representatives; Canada; Australia-New Zealand; the EFTA countries; and the Nordic countries), one Eastern European seat, and eight LDC seats with rotational representation (2 Asian, 2 African, 2 Latin American, 2 "Mediterranean").

CURRENT STATUS

After extensive consultations among the "seven plus seven" developed and developing countries, Director General Long now plans to proceed with the Management Group "provisionally," subject to review at the end of the first year.

At this stage the Group would not take formal decisions or assume the functions of other (GATT) bodies but will serve purely as a consultation and coordinating forum, meeting several times during the year. Long will seek formal approval for the Group from the GATT Council, but the only real obstacle to proceeding now is agreement on how several of the seats will be shared on a rotational basis by some of the lesser developed countries and most LDCs.

OUTLOOK

The U.S. has supported the idea of the Management Group, not only for its potential contribution to better IMF-GATT coordination but for better management of trade relations in general. Although we have said we are satisfied that trade and monetary issues are well coordinated within our Government, we look for creation of the Group to encourage more frequent and extensive contact among monetary and trade officials in all governments. It could be one useful step in the evolution of a better overall system of international economic relations over the next several years, and it is a useful complement to our efforts to focus attention in the Multilateral Trade Negotiations on better trading procedures and improved management mechanisms.

October 15, 1974

D

GRAIN SUPPLIES AND EXPORTS

STATEMENT OF ISSUE

Early cold weather and frost in late September damaged U.S. crops, particularly feedgrains, continuing the progressive deterioration in the 1974 crop prospects that began last spring. In the past month, a dimmer outlook in U.S. grain sector has been accompanied by reports of less than expected grain harvests in Western and Eastern Europe, the USSR and Canada. At the same time, world grain demand continues strong with India, some countries in South America, and Eastern European countries now indicating an increase in their grain import requirements. The USSR, which was not expected to enter the world grain market this year, recently sought 3.4 million tons of U.S. wheat and feedgrains. These sales are being held in abeyance pending US/USSR consultations on Soviet purchases.

Grain prices have risen sharply since mid-summer, and USDA recently announced a voluntary review system for future exports in the 1974/75 crop year.

BACKGROUND

Based on crop conditions as of October, world grain production in 1974 is projected to be 925 million tons, down about 5% from last year.

Late planting, a summer drought, an early frost and generally below normal temperatures have all contributed to the lower production prospects for corn. During the same period, reports concerning other major world grain producing areas began to indicate a smaller than expected grain crop this year. Since early September, the Western European grain total has dropped 2 million tons, the USSR grain crop is estimated 5 million tons lower, the Canadian grain output is over 3 million tons less and grain crops in other areas of the world have been lowered a total of 2 million tons. Meanwhile world demand for U.S. grain continues to climb. On September 29 export sales of corn for the 1974/75 crop year totaled nearly 1.1 billion bushels, far above USDA's estimate of 750-900 million bushels. If sales to USSR are permitted, the total will be close to 1.2 billion. Other countries also will be interested in U.S. corn as the year progresses.

FORD

CURRENT STATUS

Less world grain production this year means continued upward pressure on grain prices despite some expected weakening in demand for feedgrains as livestock producers reduce animal feeding. The market mechanism will automatically ration supplies, but demand in other countries, where governments frequently subsidize livestock production, will continue strong as evidenced by the recent purchase by the Soviets. The U.S. will have to continually monitor foreign grain flows and stand ready to allocate available supplies among potentially large purchasers. EC and Japan have voluntarily agreed to limit their purchases this year.

Following the attempt of the Soviets to buy an unexpected larger quantity of U.S. grains, the Department of Agriculture has announced a new system of export supervision. The export system will require approval from USDA before grain companies can sign a contract to sell more than 50,000 tons of grain in a single day or more than 100,000 tons in any single week. This reporting and approval system is expected to provide the necessary lead time to avoid large and unexpected purchases that might disrupt U.S. grain markets.

OUTLOOK AND ACTION REQUIRED

With 1974 grain harvests at home and abroad below expectations, world grain supplies will be extremely tight and prices will continue strong throughout 1974/75. The U.S. will have to face difficult decisions in the next several months to determine the amount of grain that will be allocated to: (1) Domestic livestock and food needs, (2) traditional foreign customers, and (3) LDCs in need of food aid.

In the interests of paring foreign grain demands to minimum levels this year, the U.S. should continue discussions with the EC, Japan, Russia, the Mid-East and other major grain importers to urge postponement of grain buying wherever possible to help share the burden of shortages among all major producers, exporters, and importers. U.S. livestock producers and consumers in LDCs are expected to bear a major share of this burden.

The U.S. food aid program will be limited but every effort will be made to provide food to countries whose food supplies have been seriously diminished by adverse weather or balance of payments problems.

October 16, 1974

E

INTERNATIONAL MEAT SITUATION

STATEMENT OF ISSUE

Rapidly rising production of meat and a slowdown in demand have caused substantial excess supplies of meat in world markets and downward pressure on prices. Several countries have announced import restrictions on meat to protect their domestic livestock producers from severe price reductions. The U.S. is the only major importer which has an open market and is particularly vulnerable to a large surge of meat in international trade. U.S. livestock producers, already under a heavy cost price squeeze, will be sensitive to a sudden increase in imports and probably will demand import quotas to curb excessive meat supplies.

BACKGROUND

The European Community, Japan, and Canada have all imposed import restrictions on livestock and beef entering their markets in order to support domestic livestock prices in a period of surplus production worldwide. We have joined other exporting countries in protesting the EC's import embargo, Japan's suspension of its beef import quota, and most recently, Canada's imposition of import quotas as disruptive to world trade and the world livestock economy. We are particularly concerned over the Canadian action which will sharply curtail our exports compared to recent years and we have announced hearings to consider retaliatory action.

The European Community has also raised import levies on poultry and turkey products and has introduced export subsidies for beef and poultry entering certain third markets, particularly in Eastern Europe and the Mediterranean, with potential damage to our trade. Canada has imposed similar import quotas on eggs, turkeys and their products imported below a certain minimum price. We have initiated an anti-dumping investigation against Canadian egg exports to the United States at lower than Canadian market prices and have protested the other EC and Canadian actions.

CURRENT STATUS

Multilateral discussions among a restricted group of importing and exporting nations on the world meat situation

were held in mid-October at the suggestion of the Australian Government. We are also discussing bilateral agricultural problems with the European Community and will consider international agricultural issues at the Trade Negotiations Committee meeting this month. November 1 will be an important date to watch, as the EC will have to decide by then whether to continue its beef import embargo or, as we would hope, terminate it. The Japanese may also decide by this fall whether to re-open beef import quotas.

OUTLOOK AND ACTION REQUIRED

We should urge continuing consultations on these agricultural issues in bilateral and multilateral fora, emphasizing that international cooperation and consultation in the livestock area are vital if we are to avoid damaging countermeasures that would reduce world trade.

October 16, 1974

F

COUNTERVAILING DUTIES

STATEMENT OF ISSUE

The increased use of the U.S. countervailing law against subsidized imports has become a trade issue with our trading partners.

BACKGROUND

The Treasury has been more aggressive in enforcing the countervailing duty law than it had been in the past. This is due primarily to the mandatory nature of the law itself, but also in part to the apparent willingness of the courts to force action and increased Congressional interest as amendments to the countervailing law are incorporated in the Trade Reform Act.

CURRENT STATUS

Countervailing Cases

-- Decisions to countervail have been made this year on imports of non-rubber shoes from Brazil and Spain, of bottled olives from Spain, and of certain steel products from Italy.

-- A decision not to countervail was made on Colombian cut flowers when Colombia stopped subsidizing.

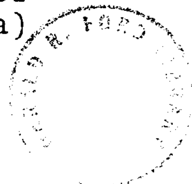
-- Cases at the preliminary investigation stage cover imports of dairy products from the European Community and of shoes from Argentina.

-- Investigations being considered are on countervail complaints against dairy imports from Switzerland and Austria, float glass from the EC, and asparagus from Mexico.

-- Investigations which have been outstanding for several years -- electronic products from Japan, rubber footwear from Korea, and steel from Mexico -- will be brought to a conclusion shortly.

Legislation

The House-passed Trade Bill provided the Secretary of the Treasury discretion to refrain from countervailing (a) on products subject to effective quantitative limits or



(b) if a countervail would "seriously jeopardize" the multilateral trade negotiations. The Senate Finance Committee dropped (a), but agreed to discretion with the addition of a new provision: that steps have been taken to eliminate or substantially reduce the adverse effect of the subsidy. Other likely changes in the countervail law are (a) the addition of time limits for Treasury action and (b) making possible countervailing duties on duty-free products for the first time, provided the imports are causing injury as determined by the Tariff Commission.

International Negotiations

Subsidies and countervailing duties are one of the major subjects to be included in the Multilateral Trade Negotiations (MTN). Some preparatory work has been done, but the real negotiating stage has not yet begun. We say the basic problem is widespread use of government subsidies in international trade; other countries say the problem is lack of an injury test in the U.S. countervailing statute.

OUTLOOK AND ACTION REQUIRED

Increased activity in the countervailing area seems likely as U.S. domestic interests become more aware of the countervailing law and foreign subsidies. The long-run solution is the negotiation in the MTN of effective international rules covering both subsidies and countervailing duties. We now need the authority in the Trade Bill, including limited discretion, to permit us to negotiate such rules.

October 16, 1974

G

U.S. VIEWS ON SUPPLY ACCESS

STATEMENT OF ISSUE

Collusive efforts by raw materials producers to impose supply restrictions as a means of raising prices, as well as problems involving natural shortages of other commodities, have turned the attention of major trading countries to the need for guidelines on access to supplies and on imposition of export controls.

BACKGROUND

Many commodity producing countries, particularly among the LDCs, have been excited by OPEC's apparent success in greatly increasing foreign earnings by raising oil prices. These increases in turn have greatly increased the need of many of the LDCs for increased foreign exchange. There have been a flurry of meetings among producer countries of commodities ranging from bauxite to bananas.

A number of agricultural and mineral producing countries use export taxes and other export restrictions on unprocessed material to promote and to protect domestic processing industries. These efforts, combined with governmental investment inducements, have met with considerable success in leading multinational corporations to invest in secondary processing in raw material producing countries.

Over the past two years genuine economic forces, including high worldwide industrial demand for raw materials, supply inelasticities, and some crop failures pushed commodity prices to historically high levels. A number of countries, facing domestic shortages or concerned about foreign demand both raising domestic prices while draining off needed commodities, imposed export controls on commodities such as fertilizers, steel scrap, and foodstuffs.

CURRENT STATUS

New producer groups have recently been formed for such commodities as iron ore, copper, bauxite, bananas, and coffee, raising concern in consumer nations of new OPEC-like efforts to raise commodity prices. A major interagency study chaired by State recently concluded that producer cartels other than OPEC are unlikely to have long term success, although they may be capable of causing short term disruptions in prices and supplies.

Members of Congress have prepared a variety of amendments on this subject to attach to pending legislation, with two receiving the most attention. An amendment introduced by Senator Mondale has been tentatively attached to the Senate draft of the TRA which would provide a mandate for the U.S. to negotiate international supply access guidelines in the Multilateral Trade Negotiations (MTN). The Conference version of S3792 which extends and amends the Export Administration Act includes both a negotiating mandate on supply access and authority for U.S. export controls in retaliation against countries restricting U.S. supply access.

OUTLOOK AND ACTION REQUIRED

While producers will continue to try to cooperate to raise prices, there is general USG skepticism as to the possibility of any other producer group successfully emulating OPEC. Most producer groups are unlikely to gain even short term success. Any that do manage to obtain short term price gains will in the long run bring on new supplies and substitutes. Meanwhile the current slowing down of the industrial world's economies will work to alleviate some of the natural shortages and weaken producer countries' bargaining positions for the time being.

The U.S. would like to see more extensive and substantial international discussions of problems relating to supply access, with particular attention to:

-- the possibility of agreed behavioral guidelines for nations contemplating the imposition of export controls for domestic short supply reasons.

-- the desirability and content of commitments on access to supplies which a country could offer in the MTN. In exchange, the country might seek supply access commitments from other countries on products of interest to it, or an improvement in the conditions of market access in other countries for its exports.

October 15, 1974

H

SPECIAL TRADE ARRANGEMENTS WITH CANADA

STATEMENT OF ISSUE

We have been urging Canada for some time to eliminate imbalances in our trade arrangements, particularly unreciprocated preferences conferred on Canada in the early 1960's. Canada continues to resist such changes.

BACKGROUND

Major issues in past trade talks with Canada have involved:

(a) elimination of the safeguards in the U.S.-Canadian Automotive Agreement,

(b) elimination of the procurement gap and the unequal provisions under the Defense Production sharing Agreement,

(c) an increase in Canada's duty-free tourist allowance,

(d) relaxation of the ban on imports of used cars and,

(e) various aspects of Canada's industrial policy (separate paper provided).

Also we have referred to the inappropriateness of Canada's high tariff level (slightly above the Japanese level), especially in light of Canada's strong payments position. Canada has objected to our countervail on Michelin tires made in Nova Scotia.

CURRENT STATUS

Canada is still studying the latest U.S. proposals for changes in the auto and defense pact. We have recently reached agreement with the Canadians on inspection procedures to assure our beef and livestock exports are free of DES (a growth hormone) and have strongly protested Canadian imposition of beef and livestock import quotas damaging to our trade. We have published in the Federal Register a notice of hearings soliciting views concerning proposed restrictions on the importation of certain livestock and beef products from Canada.

OUTLOOK AND ACTION

In the absence of corrective action, Canada's trade surpluses with the U.S. may increase in coming years, particularly in light of higher energy export prices. Appreciation of the exchange rate may be limited by discouraging capital inflows and encouraging Canadian banks and firms to place funds in the Euro-dollar market or U.S. money market. Given the present direction of Canadian policy our specific problems with Canada in the trade field are likely to persist. These and other economic issues are related to the question of our energy relations with Canada. Secretary Shultz indicated both to the GOC and the Congress the desirability of considering a package deal which would provide us access to Canadian sources, while providing Canada access to the U.S. market for manufactured goods.

A U.S. policy decision is required on whether we should pursue a trade-off with Canada and if so, on the specific types of actions we would be prepared to take.

We will push strongly for Canada's full participation in the ongoing Tokyo Round of Multilateral Trade Negotiations to reduce tariff and non-tariff barriers to trade.

October 15, 1974