

Staff Papers Series

P79-38

November 1979

AGRICULTURAL AND COMMUNITY ISSUES:
NEW CHALLENGES AND NEW OPPORTUNITIES

G. Edward Schuh



Department of Agricultural and Applied Economics

University of Minnesota
Institute of Agriculture, Forestry and Home Economics
St. Paul, Minnesota 55108

AGRICULTURAL AND COMMUNITY ISSUES:
NEW CHALLENGES AND NEW OPPORTUNITIES *

G. Edward Schuh**

This last decade has been a troubled period for the U.S. economy. We have seen the value of the dollar tumble in foreign exchange markets so that the expression "sound as a dollar" is no longer relevant. We have seen the rate of growth in productivity decline so rapidly that it is difficult to believe that not many years ago we were viewed as the technological giant of the world. After a long secular decline in the price of energy, we suddenly were faced with quadrupled petroleum prices, an oil embargo, and a rather confused body politic. And whereas we once were worried if the rate of inflation were as high as 2 percent per year, we are now becoming accustomed to double digit inflation.

In my presentation today I would like to discuss these issues with you. As my title suggests, I am neither a doomsdayer nor an eternal optimist. What distinguishes Americans from most other peoples of the world is the pragmatic, problem solving approach we take to life's problems. Problems represent challenges, and as a nation we pride ourselves on turning stumbling blocks into stepping stones.

The subjects I want to consider are not those usually on the agenda when considering the agricultural economy. But they are subjects that are terribly important to the health of the U.S. agricultural sector.

My comments are divided into five parts:

1. New Perspective on the U.S. Economy
2. The Multilateral Trade Negotiations
3. Exchange Rate Policy
4. Stagnation in Productivity Growth; and
5. Inflation.

At the end I will have some concluding comments.

* Presented at the Midwest Banking Institute, University of Minnesota, Morris, July 22, 1979.

**Professor and Head, Department of Agricultural and Applied Economics, University of Minnesota.

NEW PERSPECTIVES ON THE U.S. ECONOMY

I believe that we are now at a critical turning point in our history. As a nation we are frustrated because we have come through almost 10 years of stagnant economic growth and a corresponding decline in our relative economic and political power around the world. But by the same token, our economy has been exposed to major shocks in the form of changed rules of the game and significant changes in the economic conditions we face as a nation. We have hardly adjusted to these changed conditions because the time has been too short, so we shouldn't be too hard on ourselves. And even as we make the adjustments, some of the changes represent important opportunities for the future, rather than constraints to our further development.

Our day and age is beset by many ironies. One of the more perplexing ironies of recent years is the recurrent plea to "reindustrialize" the United States. (By reindustrializing, people who use this expression mean for us to go back to the same industrial mix we had 20 years ago.) At its best, this notion is little more than a romantic desire to return to the halcyon days of yore. The motivation for this desire is a concern that the expansion of agriculture in response to growing export markets is a return to peasantry and a concern that the growing imports of manufactured goods is a threat to the level of employment here at home.

These concerns are at best misguided. If their implications were not so pernicious, we would give them short shrift. A strong agriculture does not mean that we are returning to a peasant society, even though it sometimes seems that the pariahs of our day would have us go that route. In fact, our growing capacity to export agricultural products is a reflection that in today's world agriculture is a science-based rather than a resource-based industry. And an increase in the imports of manufactured goods is not in itself a sign of economic stagnation on our part. With low wages, other countries ought to have a comparative advantage in the more labor-intensive industrial products, or even in labor-intensive

agricultural products such as strawberries or tomatoes. Our comparative advantage, on the other hand, appears to lie in high technology industries such as agriculture, and in industries that supply the services of highly-skilled craftsmen and professionals.

It is the nature of economic development that the combination of products we produce changes as our per capita income rises. If we were to impede the forces giving rise to these changes, or to prevent them from working themselves out, we would limit our own growth potential, while at the same time preventing the diffusion of broad-based economic growth around the world. And impediments to growth in other countries ultimately become impediments to growth here at home.

The danger in permitting these economic forces to work themselves out, of course, is that we become more dependent on the rest of the world than we may feel comfortable with. National security ultimately becomes an issue. For example, do we want to depend for over half our supplies of petroleum on other countries? Apparently, we are about to decide in the negative. Similarly, does Japan want to depend on imports of agricultural products for over 50 percent of its caloric intake? That is an issue they face. And could we successfully fight another war if we let our industrial capability decline and depend on other countries for our manufactured products?

If we could be assured of a world of peace over the next 50 years, we would not be so concerned about the answers to these questions. Similarly, if we could depend on international markets being competitive, without cartels, we would also be less concerned. Clearly, we are talking about the rules of the game on the international scene: about war and peace; about new rules for economic relations among countries; and about new means of social, economic, and political intercourse among nations.

As a nation, we made a major contribution to shaping the rules and institutions that have governed international relations among countries since World War II. Unfortunately, we appear to have lost our mettle in dealing with the outside world at about the same time that many of the old rules and institutions broke down. However, there are some encouraging developments, and it is to these that I now want to turn.

THE MULTILATERAL TRADE NEGOTIATIONS (MTN)

We have just completed the seventh round of multilateral trade negotiations since World War II. It is difficult to overestimate the significance of this accomplishment. In mid-1977 when President Carter appointed Robert Strauss as our chief trade negotiator, most observers felt the negotiations were not going any place. Yet here we are two years later, with a package that passed the House of Representatives almost two weeks ago by a margin of 396-7. And this in the face of the strongest protectionist pressures we have seen since the 1930's.

This round of trade negotiations was different from previous rounds in at least three important respects. First, the United States insisted upon some liberalization of trade in agricultural products. Agriculture had benefitted little from previous rounds of trade negotiations, and if anything, barriers to trade in agricultural products had become more restrictive over time rather than less restrictive. This time the U.S. government repeatedly stated "No progress in agricultural matters, no MTN".

The second distinguishing characteristic of this round of trade negotiations was the emphasis given to reducing non-tariff barriers to trade. These barriers refer to policies such as quotas and embargoes, variable levies such as the European Community uses to protect its agricultural sector, and the use of health and sanitary regulations to keep out trade. These kinds of barriers have become increasingly important impediments to trade, and had been neglected in previous rounds of negotiations.

The third distinguishing characteristic was the emphasis given to negotiating improved rules of conduct for the use of trade policies and trade incentives. The range of issues here was great. For example, until now there had been very little discipline in the use of export subsidies to promote trade, yet almost every country uses such subsidies at one time or another. Similarly, there were few guidelines for how or when countervailing duties could be used. Yet countervailing duties are the logical response to export subsidies, and have been used frequently by most countries. Without some rules of conduct, the use of export subsidies and countervailing duties can quickly escalate and lead to economic warfare.

Other rules of the game have to do with controlling the use of product standards, product testing, and product certification systems as barriers to trade; the use of government procurement codes to discriminate against foreign suppliers; the harmonization of procedures used to furnish import licenses; and a uniform international system of customs valuation.

It is difficult to assess the benefits from trade concessions, especially when so much emphasis was placed on improved rules of the game. But estimates by the Department of Agriculture suggest that we received specific trade concessions covering approximately \$4.0 billion in agricultural exports, and that these concessions will cause our exports to increase eventually by about a half billion dollars.

Trade is a two-way street, of course, and we also granted concessions to other countries. These concessions will lead to lower prices and greater access to foreign products for our consumers here at home. Improved trade also represents one of the few disciplines we have over monopoly pricing in our concentrated industries.

EXCHANGE RATE POLICY

The rules which govern the rate at which the currency of one country exchanges for another were changed rather dramatically a few years ago. The world had operated with a system of fixed exchange rates for roughly 25 years after World War II. That policy was established at the Bretton-Woods Conference in 1944, and was based on a belief that competitive devaluations had played a major role in spreading the Great Depression of the United States to the rest of the world. Signatories to the Bretton-Woods convention agreed to fix the value of their currencies in terms of the U.S. dollar, and to change them only after consulting with other countries.

This system served the advanced countries of the world quite well. Trade expanded at a faster rate than world GNP throughout the post-World War II period. And the system imposed some much needed discipline on monetary and fiscal policy in the advanced countries. In so doing, it enabled them to keep inflation reasonably well under control.

Despite these positive benefits from the fixed exchange rate system, it became increasingly clear through the years that the system did not have the flexibility to accommodate changing economic conditions. The dollar in particular became seriously overvalued, and the German deutschemark and the Japanese yen became seriously undervalued.

Repeated exhortations by political leaders had little effect in restoring equilibrium to the balance of payments. Consequently, President Nixon undertook a once-for-all devaluation of the dollar in mid-1971. After that did not prove effective, in early 1973 he devalued once again, closed the gold window, and for all intents and purposes forced the advanced countries to shift to a system of flexible exchange rates.

Two important consequences for agriculture followed from these developments. First, an overvalued currency has the same effect as imposing an export tax on the economy. The only difference is that it is implicit, rather than explicit. The effect of the devaluation and the shift to floating exchange rates was to remove this tax from agriculture. With this change in policy, our agricultural exports became much more competitive, and of course this is one of the reasons our exports have grown so rapidly in recent years. Moreover, our agricultural resources are now reflecting their true value to society, with the result that farm incomes are substantially higher than they were prior to the devaluation and the value of land has increased dramatically.

The second consequence of this shift to flexible exchange rates is not entirely an unmixed blessing. For example, conventional wisdom had it that when we shifted to a system of flexible exchange rates we would have more independence in economic policy. The belief was that we would experience fewer shocks from abroad, and at the same time be able to manage our domestic economy without considerations for its consequences to other economies.

Paradoxically, of course, we have had more economic summits to coordinate economic policy since we shifted to flexible exchange rates than we ever had with fixed exchange rates. The reason for this is that our economies have become increasingly linked together by a very efficient and large international capital market. Whereas in the past, most of the international adjustment came about through changes in trade flows, now it comes about through shifts in capital.

This also has important ramifications for agriculture. In fact, agriculture has become much more unstable than it was in the past, and largely because of the flexible exchange rate system. Let's see how this works.

Consider, for example, the events of last October when the U.S. government finally decided to defend the dollar. It did so by raising interest rates, i.e., by pursuing a tighter monetary policy. The increase in interest rates associated

with these policies caused the value of the dollar to rise in international markets since it attracted funds that were invested in other currencies. This increase in the value of the dollar, other things being equal, acts to choke off the demand for our exports, including agricultural exports. Clearly, agriculture as an export sector has to bear a large share of the burden of any effort to defend the value of the dollar.

Now consider more recent events. Countries such as Germany and Japan have been pursuing more restrictive monetary policies than those pursued by the United States. Consequently, the rate of interest for funds invested in those currencies is higher, with the result that funds have shifted out of the dollar to the yen and D-mark. The value of the dollar, in turn, has fallen in international markets. This fall in the value of the dollar acts as a stimulant to our exports, and acts to make agriculture more prosperous.

To summarize, with flexible or floating exchange rates, agriculture as an export sector is much more subject to external events, such as shifts in monetary policy, than it was with a system of fixed exchange rates. It is for this reason that I noted earlier that we can expect agriculture to be much more unstable with floating exchange rates than it was with fixed rates.

STAGNATION IN PRODUCTIVITY GROWTH

The rate of growth in productivity has declined markedly in the U.S. economy. The President's Council of Economic Advisors noted in its 1979 report that "Between 1948 and 1965 (labor) productivity growth in the private non-farm sector averaged 2.6 percent per year. In 1965-73 this rate declined to 2.0 percent. Since 1973, private non-farm productivity growth has averaged less than 1.0 percent per year" (p. 67). A similar but less dramatic decline, of course, has taken place with agriculture, independently of whether the trend is measured in terms of labor productivity, land productivity, or some measure of total factor productivity (Schuh).

This decline in the rate of productivity growth has far reaching implications for the United States. In the first place, without growth in productivity, it is difficult to obtain an increase in per capita incomes. Second, stagnation in productivity growth is one reason for the increase in the rate of inflation. In fact, the increase in the rate of inflation almost parallels the decline in the rate of productivity growth.

Third, stagnating productivity makes it difficult for the U.S. to compete in international markets, independently of whether the decline is in the farm or non-farm sector. In the case of agriculture, it is important to note that our domestic agricultural programs are predicated on a strong export performance. Without strong exports we would have to engage in costly set-aside programs and probably accumulate large stocks in government hands.

More generally, to the extent we become less competitive in international markets, the real exchange rate between the dollar and other currencies will decline. That in itself implies a decline in real income, for it means that we have to pay more in terms of products we export to pay for those we import.

The reasons for the decline in productivity growth are not fully understood, although they are attracting increased attention on the part of both researchers and policy-makers. One problem, of course, is that our private savings rate is now one of the lowest among the industrialized countries of the world. Low savings rates translate directly into low investment rates. And our rate of capital formation has indeed been low in recent years.

Secondly, our commitment to research and development has tapered off, both at the national level and in the case of agriculture. In constant value terms, and as a share of our total GNP, we simply are investing a great deal less in R and D than we did in the past.

We also have made important shifts in our research mix. First, an excessive emphasis on accountability has caused us to de-emphasize basic research and over-emphasize applied research. Basic research is needed if we are to identify and create the production potential of the future. Without basic research this productivity of applied research will decline rather quickly. Second, we have shifted research resources away from a production orientation and channeled it toward ecological and environmental problems. A greater concern with ecological and environmental problems was probably needed. But when this concern was satisfied at the expense of production research, we shouldn't be surprised to see the rate of productivity growth decline.

Another explanation for the decline in productivity growth is the increase in regulations designed to clean up the environment, and the costs these regulations impose on the private sector. It is entirely appropriate that society should ask for clean air and clean water. But by the same token, we need to understand that such important outputs do not come as a free lunch. They involve resources, and these resources could have produced something else, or had an alternative use.

One final comment on productivity growth. Society can deal with emerging problems much more easily if productivity is growing. In effect, an increase in productivity amounts to an increase in resources, which in turn provides increased resources for dealing with the problem, whatever it might be.

The bottom line, of course, is that low productivity growth means low growth in per capita income. With low growth in per capita incomes, a struggle almost inevitably develops over the division of the pie. Hence, if this recently observed stagnation in productivity continues, we can expect to see in the future a great deal more political concern over the distribution of income and the distribution of assets.

INFLATION

There is much that I could say about inflation. It has moved center stage in current policy discussions, and appears to be one of the more perplexing policy problems we face.

I would like to focus on three rather serious consequences of inflation - consequences that are subtle and therefore difficult to observe, but which have a rather substantial impact on the economy. First, inflation has an impact on the form in which members of the society hold assets as a store of wealth. With unstable rates of inflation, individuals tend to be more concerned with the extent to which the value of their savings are preserved, and less about the productive rate of return on their investments. This means that individuals buy up land and other physical assets, and reduce their assets in savings accounts, in bonds, and so forth. This shift in portfolio is one reason why agricultural land values are rising so rapidly. It also helps explain why our measured savings rate is so low - a phenomenon that many people believe is behind the stagnation in our productivity growth.

Inflation is also destructive of capital markets - especially when governments intervene to fix interest rates. Without changes in the rules, certain credit and savings instruments will simply disappear. And without them, savings rates will decline and investments of certain kinds will decline or disappear. The effect of Regulation Q on the availability of mortgage money is an important example.

More generally, we tend to forget that with recent rates of inflation, the nominal rate of interest has to be relatively high to provide any real return. For example, with inflation now running at almost an 11 percent rate, an eleven percent interest rate is effectively a zero real rate of interest. If one takes account of the taxes to be paid on interest earnings, it is in effect a negative real rate of interest. With interest rates on savings accounts of about 5 percent

the negative real rate of interest becomes relatively large. In effect, savers are asked to pay someone to take their money and use it. Under these circumstances, we should not be surprised that savings rates are so low.

Finally, I would like to emphasize the connection between a devaluing exchange rate and inflation. We tend to forget that when the value of the dollar falls in international markets, both the prices of imports and the prices of exports increase. As trade becomes more important to the health of our economy, these effects become more and more important.

It is true that the value of a nation's currency declines because of an increase in inflation. But by the same token, the value of the currency affects the rate of inflation. As long as exchange rates are free to float we will be troubled by this linkage.

CONCLUDING COMMENTS

In concluding, I want to make three points. First, the agenda I have reviewed with you is not the conventional agenda one has in mind when thinking about agriculture. Yet I hope I have persuaded you of the importance of these issues to U.S. farm problems, and of the various linkages among them.

Second, we really have no reason to despair about the problems we face. The world has become much more complex than it once was. And we have had to adjust to some rather sizeable shocks, such as the quadrupling of energy prices, the devaluation of the dollar, and the shift to floating exchange rates. The important thing is that the remedies or medicines that some of these shocks represented were much needed. Moreover, an important part of the adjustments to these shocks are now behind us. With sound economic policy, and stability in policy, we can regain a great deal of our competitive potential in a fairly short period of time.

Finally, we do need to persevere in helping to construct the kind of world we want for the future. The United States played a major role in designing the rules and institutions which governed political and economic relations among countries throughout the post-war period. That set of rules and institutions has essentially collapsed, with little to put in its place. Consequently, we are now resorting to a great deal of ad hocery in dealing with individual problems as they arise. One of the great challenges now before us is to muster the creativity to help design a new world order that will enable the peoples of the world to relate to each other in peaceful economic intercourse, and that will enable us to deal systematically with new problems as they arise. We then need to muster the political will to help implement that new order - an order that will make a better future for us as well as for other peoples of the world.