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Deficits and Dilemmas

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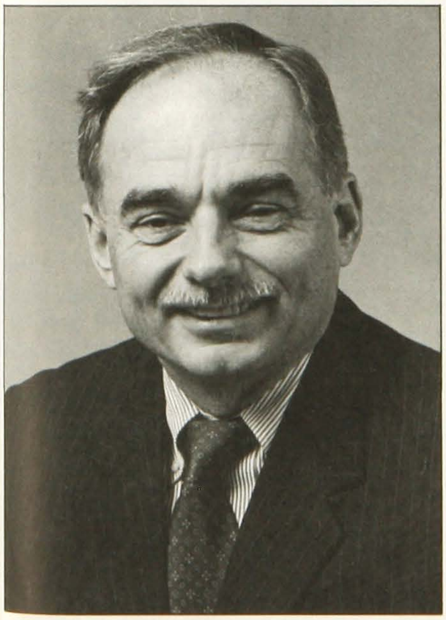
Introduction

Since the early 1970s, American agriculture has become more integrated into the national and international economies and financial markets. As a consequence, the economic well-being of agriculture and rural America is increasingly affected by macroeconomic conditions and policies. It is with this realization that this issue of the *Minnesota Agricultural Economist* addresses some key issues of national and international macroeconomic policy.

As a new national administration prepares to assume power, the American economy, at first glance, appears robust because of its high employment, low inflation, and booming corporate profits. Many Americans are enjoying high levels of personal income, and the nation's shopping malls are filled with buyers with abundant cash or credit.



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Yet, many suspect that not all is as well as it seems. One can point to regional disparities in income—the nation's interior lagging behind the coasts; sectoral problems, such as the loss of manufacturing jobs; low incomes in agriculture; and the continuing decline of many small towns in the nation's heartland.

Some of the nation's financial institutions, including certain thrift institutions appear to be in trouble. Then, there are the record federal budget deficits and continuing high trade deficits, with a low level of national saving and a high level of private as well as public debt. Some fear that the U.S. is losing its supremacy as an economic power—that its products are becoming less competitive on world markets, particularly with those of the Pacific rim nations, and that its real assets are increasingly being bought up by foreigners.

One can cite the frenzy of corporate mergers, takeovers, and leveraged buyouts which misdirect managerial talent away from productive enterprise such as more efficient production of goods and services.

Finally, the financial debacle of October 19, 1987 serves as a sobering reminder of the consequences of economic distortions left unaddressed. Could it happen again? Has the nation adequately addressed fundamental problems which preceeded the near collapse of world financial markets?

There is a widespread perception that the U.S. has undergone such distortions in its fiscal policy and its international balance of payments that, in the absence of corrective action, the continued prosperity of the nation, and the world, is at risk. Anxiety over the ability and resolve of the U.S. to take bold and decisive action to correct these distortions looms as a potential barrier to the economic stability necessary for global economic growth and prosperity.

Upon casual observation, the times appear to be prosperous. Though sobering reminders of grim realities are unwelcome while the party is in full swing, there are ominous warnings that continued prosperity requires that some fundamental problems be addressed. This will require short term sacrifice and discipline.

This article attempts to put into perspective various options in terms of fiscal policy, monetary policy, and exchange rate policy, which need to be considered by the new administration assuming power in January 1989.

The Past Decade

To place in better perspective the dilemmas facing the nation, let us review several economic trends of the past decade. The 1970s closed with high inflation, record high interest rates, and relatively high unemployment. President Reagan vowed to increase employment and reduce inflation through "supply-side" tax cuts. The logic is that "supply-side" tax cuts increase saving, reduce interest rates, increase investment, and thereby increase production. Increased production is then supposed to take pressure off prices by enlarging the supply of products, and reduce budget deficits by generating additional tax revenues through increased economic activity.

This is, to be sure, a seductive package, an apparently painless—even pleasurable—route to economic prosperity. Among the flaws in its logic however, is that it takes considerable time for these steps—reduced taxes, increased saving, increased investment (assuming that increased savings **are** invested in productive enterprise), increased productivity, and increased tax collections—to work their way through the system.

In the short run at least, massive tax cuts without attendant cuts in government spending are certain to result in substantial increases in budget deficits, which are themselves a component of national **dissaving**. Budget deficits **per se** are neither good nor bad. What is important is their size relative to capacity to service debt, trend over the course of the business cycle, and how they are financed. Incurrence of debt can sometimes be prudent—and sometimes foolish and irresponsible.

In contrast to the supply-side argument for a tax cut, the logic of a Keynesian, or demand side, tax cut is to increase disposable income, and hence, expenditures. Increasing economic activity, by increasing disposable income, gives the economy an immediate shot in the arm through employment of idle resources.

The standard Keynesian solution of a tax cut to forestall recession is seen as a short run remedy. The intention is that as the economy moves toward full employment, actual deficits are **reduced** during the expansionary phase of the business cycle.

The intended result, under either philosophy (supply side or Keynesian), is to increase economic activity and increase tax collections to reduce budget deficits incurred by the tax cuts. What is of fundamental importance is that as the economy moves toward full employment, federal deficits get **smaller** rather than larger.

In 1981, the supply-side tax cut was passed. Following a severe recession in 1982, economic expansion followed beginning in 1983. Most economists attribute the economic recovery to the fiscal pull brought about by the demand side effects of the tax cut. Supply-side effects, depending on increased saving, investment, and productivity, simply cannot occur that rapidly!

The 1981 tax cuts and economic expansion came at a price—rapidly rising budget deficits which had to accompany such massive permanent tax cuts without the attendant spending cuts. This led to a sharp increase in real interest rates.

High interest rates along with the declining power of OPEC, low food prices, and the recession of 1982, combined to reduce the inflation rate during the early 1980s. High interest rates, however, had some other effects, such as attracting foreign capital which was necessary to finance **budget** deficits, and raising the value of the dollar. The higher valued dollar reduced the prices of foreign goods to Americans, encouraging them to buy more foreign goods, thereby widening our **trade** deficits.

Further, American economic prosperity, with the economic recovery of the mid-'80s, aided by the fiscal pull of the tax cuts and budget deficits, encouraged Americans to import more, and provided further impetus to the trade deficits. In addition, the higher valued dollar made our exports, including agricultural exports, more costly in foreign markets. Thus, the supply-side tax cuts, along with continued high government spending and a high valued dollar, resulted in huge budget and trade deficits which are still with us, and contributed to the economic uncertainty which continues to plague us.

A good case could have been—and was—made by some economists for a more modest and temporary tax cut in 1981, though for different reasons than those advocated by the supply-siders who were in key policy advising positions, and who enjoyed the receptive ear of the president.

The immediate fiscal pull of the demand side effects of a tax cut would have stimulated the economy. However, as this took effect and the economic activity increased, the tax rates could have been increased **toward** their previous levels, thereby reducing the budget deficits. Another benefit of this course would be have been to reduce U.S. imports and trade deficits.

The more modest and temporary nature of such a tax cut would have called for a more expansionary monetary policy, with lower interest rates. Interest rate-sensitive industries would have been penalized less, and the value of the dollar would have increased at a slower rate, resulting in smaller trade deficits. If the economic growth rate would have been less under such policies, it would have been more sustainable, more "balanced" and almost certainly would have resulted in lower budget and trade deficits, and greater stability, avoiding the distortions which led to the October 1987 debacle.

Yet another danger of large additions to the public debt is that this creates the temptation to inflate the economy, and thus reduce the real value of government bonds outstanding. Inflating the economy is an implicit tax increase on bond holders and holders of monetary assets, and a disincentive to save.

Finally, the large amount of the public debt held by foreigners represents claims on American assets and production. Smaller deficits would require less dependence on foreign lenders to finance current American spending.

To counter charges of "Monday morning quarterbacking," it will be recalled that one of the presidential candidates in 1984, with a backing of many, if not a majority, of mainstream economists, was calling for exactly that—a tighter fiscal policy, with its distasteful tax increases—coupled with an easier monetary policy.

In any case, mistakes of the past cannot be undone, but perhaps we can learn from them. The positive side of all of this is that the rate of economic growth during the 1980s has been impressive.

But it is wishful thinking to believe that more of the same medicine is all that is required, or to assume that we can ignore the budget and trade deficits, which are the byproducts of an overly expansionary fiscal policy, naively assuming that continued growth will bring these distortions into line.

Let us look at several potential courses of action and their possible consequences.

Policy Dilemmas

The fundamental objective of macroeconomic policy is to maintain a high level of domestic employment and stable prices consistent with economic growth. This requires not only confidence in domestic financial markets, but in world financial markets as well.

The October 1987 stock market crash quickly spread to other major world financial markets. Clearly, had it not been arrested by quick action on the domestic and international fronts, the economic damage could have been calamitous.

A major cause of the crash is that world confidence in the U.S. resolve to address its rising budget and trade deficits was lacking. Rising budget deficits as the U.S. was approaching full employment were especially ominous.

Rather than falling deficits as the supply-siders had suggested would happen with greater employment, budget deficits were increasing through fiscal year 1987.

The trade deficits suggested that the value of the dollar could no longer be sustained without raising interest rates. These factors, combined with an already overly buoyant, (some would say "speculative") stock market in 1987, combined to trigger selling on an unprecedented scale.

The major assumption here is that fundamental to maintaining world confidence in financial markets, is for the U.S. to put its fiscal policy in order. This does **not** mean that the federal budget must be balanced. To balance the federal budget without unduly restricting the economy would be impossible at this stage.

It **does** mean, however, that the full employment budget must be brought **toward** balance—that actual deficits, as we near full employment, must **decrease rather than increase**. It was the prospect of increasing budget deficits as the U.S. economy moved **toward** full employment that created the impression of an economy out of control, and was a factor in leading to the near panic of October 1987.

Getting budget deficits **under control** —not eliminating them—is fundamental to restoring confidence in the ability of the U.S. to manage its economy.

Let us more systematically summarize alternative policy actions with respect to the goals of a full employment U.S. economy, reduced balance of payment deficits, and their possible consequences.

OPTION 1. CONTRACTIONARY FISCAL AND MONETARY POLICIES

This option consists of a combination of higher taxes, reduced government spending, and higher interest rates. Likely consequences: The tighter fiscal policy would have the salutary effect of reducing the federal budget (structural) deficit. The tighter monetary policy, with its higher interest rates would tend to curb economic activity.

As both of these policies are restrictive, they would tend to correct the balance of payments deficits through curbing the American demand for imports, although the high interest rates would maintain the value of the dollar, somewhat ameliorating the beneficial effect on the trade deficit.

However, the very restrictive nature of these policies, if used together, would almost certainly bring on recession, the cure for international payments deficits being worse than the disease. The very restrictive nature of these policies, used in concert, makes this combination infeasible, except in the event that significant inflation appeared imminent.

A Review of Some Basic Concepts

The Basic Elements

A high level of economic welfare for the nation's citizens depends on a full employment level of output, reasonably stable prices, and a steady rate of economic growth, defined crudely as increasing levels of real GNP per capita.

This, in turn, depends on such bedrock fundamentals as a nation's resource base, a strong work ethic, a fundamental propensity to save and invest, and related private sector inclinations. Given these fundamental factors, however, the federal government has at its disposal the means, and indeed the responsibility, to **influence**, through public policy, the levels of employment to foster a high level of well being for its citizens.

The basic tools at the disposal of the federal government for this purpose include **fiscal policy**, **monetary policy**, and since we cannot, need not, and should not, produce everything we consume, **foreign trade and exchange rate policy**.

The proper mix of these policies to encourage full employment, stable prices, and vigorous foreign trade necessary to meet the needs of people, is a tall order under any circumstance. In this particular period, however, the circumstances are most vexing, and the choices all contain some bitter economic medicine.

The Policy Variables

Fiscal policy refers to government taxing and spending for the purpose of influencing the level of employment and economic activity. The federal government often does not (some would say hardly ever) collect enough revenues to match its spending, thereby incurring a **deficit.**

Budget deficits normally are financed by selling certificates of debt, such as bonds and treasury bills, to commercial banks and the public, both domestically and abroad. In addition, bonds may be sold to the Federal Reserve Bank. This is known as "monetizing the debt," and is equivalent to printing new money. Government spending exerts an **expansionary** effect on the economy, while taxing is **contractionary**.

Spending at a higher level than taxes collected, thereby incurring a deficit, is an expansionary fiscal policy. Expansionary fiscal policies, in addition to expanding domestic income, **tend to increase domestic demand for foreign goods.**

To get a bit more refined, one can distinguish between **cyclical deficits** and **full employment deficits**, the latter sometimes referred to as **structural** deficits. In this regard, note that just as taxes have an effect on output and employment, so the level of output and employment affects tax collections in a feedback manner, higher employment resulting in rising tax **collections**.

A **cyclical** deficit refers to one which occurs because of the stage of the business cycle—that is, because an economy is at less than full employment. Thus, a deficit attributable to diminished tax collections because of recession is referred to as a cyclical deficit.

In contrast, a **structural**, or **full employment deficit**, is a deficit which occurs, or would be expected to occur, even if the economy were at full employment. Most economists assert that this is a better measure of the nature of fiscal policy.

A **structural deficit**, a deficit occurring **even at full employment**, is more expansionary than a cyclical deficit which results simply because of the diminished tax collections due to a recession. Therefore, it is possible with a full employment or structurally balanced budget, to have an **actual deficit**, i.e., a cyclical deficit, because the economy is in recession and tax collections are down.

Under a structurally balanced budget, **with the same spending and tax program,** full employment would bring about an actual balanced budget, as the **amount** of taxes collected increases.

Monetary policy refers to the management of the nation's money supply. This is implemented by the Federal Reserve Bank (popularly referred to as "the Fed") by changing the supply of money and credit available through the nation's commercial banks, by a variety of means.

OPTION 2. EXPANSIONARY FISCAL AND MONETARY POLICES

This option would include combinations of reduced taxes, higher government spending, and lower interest rates. Likely consequences: This combination of policies would certainly prevent recession in the near term. However, the expansionary nature of these policies would further distort our trade imbalances, spurring American imports from abroad.

Further, and perhaps more ominously, the perception that the U.S. budget is "out of control" is paramount. The psychological effect of increased federal budget deficits could be devastating to financial markets. This combination, with its implied expanding budget deficits, is thus infeasible.

OPTION 3. EXPANSIONARY FISCAL POLICY AND CONTRACTIONARY MONETARY POLICY.

Likely consequences of this option: The negative effect of the expansionary fiscal policy is as explained under option 2. In fact, it is exactly this combination of policies which has brought on the current dilemma. **More of the same at this time would be the worst of all possible combinations.** The raising of interest rates in August of 1988 was intended to curb inflation, and can be defended on these grounds. However, if the economy appears heading for inflation, this provides the opportunity for a needed tightening of fiscal policy for FY '90.

OPTION 4. CONTRACTIONARY FISCAL POLICY AND EXPANSIONARY MONETARY POLICY.

Likely consequences: The contractionary fiscal policy, consisting of some combination of reduced government spending and increased taxes, would have the salutary effect of reducing the structural deficit. But concern about recession raises questions about such a contractionary effect. The contractionary effect, however, could be partially countered by an easier monetary policy with lower interest rates.

The price of forestalling recession with an easy monetary policy is that the value of the dollar may fall. A fall in the value of the dollar, however, may be the unavoidable price we pay for past error. In any event, failure to act may produce a "dollar crisis" as continued high budget and trade deficits would create conditions under which the value of the dollar would certainly fall—if not collapse. While coordinated intervention by central banks may cushion the fall, such intervention cannot correct fundamental disequilibria.

A falling dollar can be inflationary, but this danger can be limited if combined with a tight fiscal policy. The positive side of a falling dollar is that it will continue to make U.S. exports more competitive.

This would tend to reduce the trade deficit. However, to be effective in reducing a trade deficit, a falling dollar is best combined with a tight fiscal policy. While the contractionary effect of the tight fiscal policy in this package must be considered, the sheer infeasability of the other options leaves us little choice. The combination of tight fiscal policy with a lower valued dollar can be expected to eventually whittle down our trade deficit as well as budget deficits.

Clearly, in the face of a recession, it would be preferable to be able to use the standard Keynesian remedy of an expansionary fiscal policy, in concert with appropriate monetary measures, to ensure continued high domestic employment.

However, because of the magnitude of the existing public debt, and the specter of the October 1987 crash which demonstrates it pernicious effects, the use of an expansionary fiscal policy at this time is infeasible. This points out with clear distinction one of the unsung casualties of U.S. economic policy during the 1980s.

By the incurrence of massive federal deficits during times of near full employment, we have stripped ourselves of the surest way to lift ourselves out of, or to prevent, **the next recession**. The use of a modest increase in the deficit now is infeasible, leaving us with only an easy monetary policy as an option to fight recession.

Table 1. Selected Federal Budget Figures for Fiscal Years 1980 - 1989.

Fiscal Year	Receipts	Outlays	Deficit	Gross Federal Debt	Gross National Product (GNP)	Federal Debt as a percent of GNP
1980	517.1	590.9	73.8	914.3	2670.6	34.2
1981	599.3	678.2	78.9	1003.9	2986.4	33.6
1982	617.8	745.7	127.9	1147.0	3139.1	36.5
1983	600.6	808.3	207.8	1381.9	3321.9	41.6
1984	666.5	851.8	185.3	1576.7	3687.6	42.5
1985	734.1	946.3	212.3	1827.5	3943.4	46.3
1986	769.1	990.3	221.2	2130.0	4192.5	50.8
1987	854.1	1004.6	150.4	2355.3	4408.7	53.4
1988*	909.2	1055.9	146.7	2581.6	4705.8	54.9
1989*	964.7	1094.2	129.5	2825.3	5023.3	56.2

* Estimated

Source: *Economic Report of the President,* February 1988, p. 337.

The Task

A classic textbook argument against the use of fiscal policy for economic stabilization is that changes in tax and spending programs are cumbersome, time-consuming to implement, and difficult to time properly. (In fact, **because** changes in fiscal policy are relatively infrequent, and monetary policy is more flexible and rapidly implemented, financial analysts and fund managers watch those monetary indicators very closely as clues to policy directions.)

One major difficulty of implementing a tight fiscal policy, with combinations of tax increases and cuts in government expenditures, is that it is unattractive to elected representatives responsible for such unpopular and unrewarding decisions. It comes as no surprise that one presidential candidate vowed "**no** tax increases under any circumstances," and the other allowed for a possible tax increase "only as a last resort."

The implemention of a tight fiscal policy through reductions in spending is exacerbated by the arithmetic of the federal budget. The largest items are national defense, which is difficult to cut; entitlements (of which social security is the largest) which are politically nearly impossible to cut; and interest on the national debt, which can't be cut. After these there is little left to cut which would make any appreciable difference on the federal budget.

Thus, unless (and probably **even if**) inroads can be made on defense and entitlements, serious discussion of tighter fiscal policy must include new revenues, or more bluntly, **increased taxes!**

Failure to acknowledge this cold fact relegates any talk of "fiscal responsibility" to utter nonsense, if not outright distortion! In fact, "fiscal responsibility" was scarcely mentioned by either candidate in the 1988 presidential race.

The task of implementing a tighter fiscal policy to reduce the budget will be extremely difficult. However, in this regard, there are at least three factors which might ease the task: First, the October 1987 crash has (or should have) demonstrated the urgency of reducing budget deficits.

Even the bankers and financial managers of Wall Street who enthusiastically applauded the "supply side" tax cuts, and who opposed tax increases in 1984, now seem to be taking a softer line. The prospect of financial ruin makes pragmatists of all but the most hopelessly ideological.

Second, a new president, who will be facing harsh realities during the next four years, and who will certainly be in a most unwelcome and embarassing spotlight if the financial markets collapse, may provide the incentive for responsible fiscal action, notwithstanding irresponsible and unrealistic campaign promises. The new president may be well advised to "take the political heat" for a tax increase early in his term, rather than take the easy way out, and risk turmoil in the financial markets later in his term.

The realities of the American political system are such that leadership for difficult national choices, such as tax increases, **must** emanate from the White House. It is totally unrealistic to suppose that a president can present a grossly out-of-balance budget to the Congress, and expect individuals in Congress to "be responsible" in coming up with a " **less** out of balance" budget, especially if they are forewarned that proposed tax increases and cuts in defense spending will be vetoed and used to bludgeon them politically.

Third, the task is eased by the proposition that the budget need not—indeed should not—be brought to absolute balance in the near term. While the magnitude of the "proper" deficit is debatable, it is only necessary that the budget be demonstratably moved **toward** structural bal-

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An **expansionary**, or "easy money" policy, involves expanding the money supply and lowering interest rates to make borrowing by business and consumers easier. A **contractionary**, or "tight money" policy involves restricting the supply of money and credit and raising interest rates.

The basic objective of monetary policy is to provide a sufficient supply of money and credit to allow full employment, while avoiding such expansion as would be inflationary. An overly restrictive monetary policy restricts the level of economic activity, while an overly expansionary policy fosters inflation.

If this seems to be a delicate balancing act, it is! The reader can thus appreciate the complexities involved when considering the "proper" monetary policy along with fiscal policy, and adding our third policy variable, foreign trade and exchange rates.

Exchange rates refer to the rate, or price, at which one nation's currency exchanges for another. If the value of the dollar is high relative to, for example, the Japanese yen, a relatively few dollars buys a large quantity of yen. Thus, prices of Japanese goods will appear cheap to Americans, and prices of American goods will appear high to Japanese. If the value of the American dollar is low relative to the yen, it takes a lot of dollars to buy relatively few Yen.

If the value of the dollar is **falling** against the yen, we say that it is **depreciating**, or being devalued. It takes more dollars to buy yen.

If the value of the dollar is **rising** against the yen, we say that it is **appreciating.** An action taken to raise the value of the dollar against other currencies is said to **revalue** the dollar. When analysts say that the "dollar is under pressure," they usually mean that market forces are pushing the value of the dollar down against other currencies.

Determinants of Exchange Rates

What determines the relative values of various currencies? The major currencies of the world are under a system of "floating" exchange rates, or more correctly, "managed" floating exchange rates. "Floating" refers to the fact that the rates float, or fluctuate, depending on market forces. "Managed" refers to the fact that governments, through their central banks, periodically intervene in the currency markets for purposes of "managing," or more accurately, attempting to **influence** these exchange rates.

What are the market forces which affect exchange rates? This is where trade and other international transactions come into play. From the point of view of the U.S., transactions which **supply** dollars to other countries, and **demand** foreign currencies, tend to **reduce** the value of the dollar relative to other currencies. Conversely, transactions which **demand** U.S. dollars, but which **supply** foreign currencies, tend to **increase** the value of the dollar relative to other currencies.

What kind of transactions are involved? The most obvious transactions which supply dollars, and demand foreign currencies, thereby reducing the value of the dollar, would be U.S. imports of foreign goods and services. This includes American traveling abroad, as this results in purchases, or imports of foreign services, supplying U.S. dollars to the rest of the world and creating a demand for foreign currencies.

Conversely, U.S. exports create a **demand** by the rest of the world for dollars, causing the dollar to **appreciate**.

The relation of the value of imports and exports is known as the balance of trade. If the value of exports exceeds imports, the balance is **in surplus**; if the value of imports exceeds exports, the balance is in **deficit.** In recent years, the U.S. balance of trade has been in deficit, thus putting downward pressure on the dollar. This second of the twin deficits, the trade deficit, has been a major factor causing downward pressure on the dollar.

Other international transactions, such as foreign aid, both civilian and military, including the maintenance and operation of military bases abroad, add to outflow of dollars. Although some of these dollars find their way back to the U.S. in the ance. But again, political leadership for this thankless task must come from the White House—from the elected official who holds office by national consent. And, economic players, both domestic and foreign, must be convinced of his resolve.

The Search for Easy Alternatives

The inescapable conclusion is that our options are few and unpleasant, and generally point to higher federal taxes. Are there more palatable ways out of this dilemma?

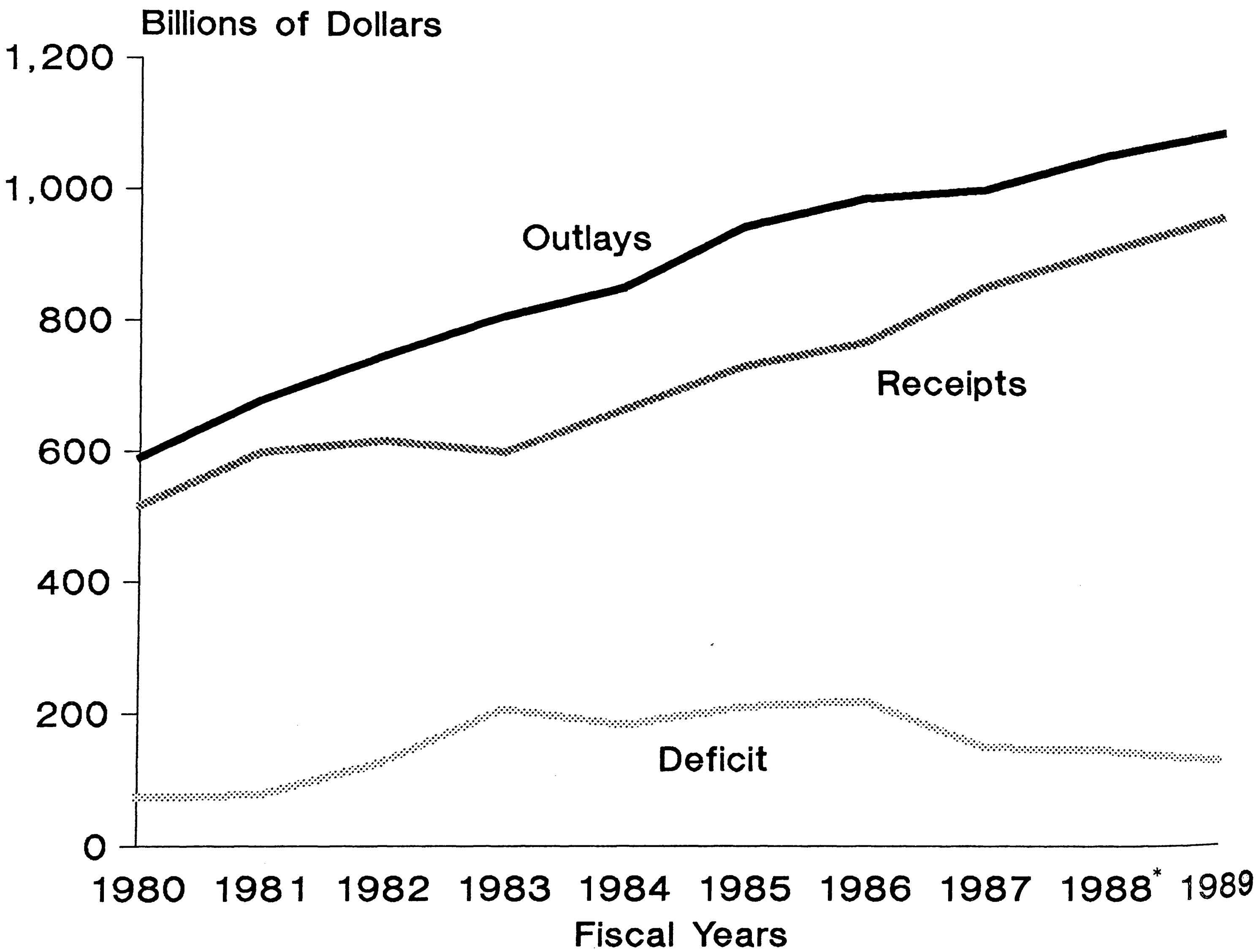
Enthusiasts of various persuasion proffer other paliatives, some having long-run possibilities, and others resembling outright tom-foolery. Let us briefly discuss several.

Expand U.S. Exports

Clearly, if the U.S. could export more, and/or import less, this would tend to reduce the trade deficit, as well as exert a welcome expansionary force on the domestic economy. The falling U.S. dollar has increased the competitiveness of U.S. goods, but the monthly trade figures **are still in deficit**. (Again, a lower valued dollar is most effective in cutting balance of payments deficits when combined with a tight fiscal policy.)

Regaining lost markets is a long term proposition, and tough economic competitors will not give them up easily, possibly choosing to lower their prices and/or profits to retain them. The temptation to erect tariff and other trade barriers to keep competing goods out **should be strongly re-**

Gross Federal Receipts, Outlays, and Deficits



* Estimated

Source: *Economic Report of the President,* February 1988.

sisted, as this can only result in retaliatory measures by foreign nations and will damage our export industries.

The balance between insisting on access to world markets, while avoiding protectionism, will require patience and diplomatic skill. Most importantly, expanding U.S. exports relative to imports is a **long run solution** and does not relieve the Congress and the new president of making extremely difficult decisions **by mid-'89** at the very latest.

Expanded Foreign Economies

Many Americans, and particularly the current administration, feel that nations with trade surpluses, such as Japan and Germany, should expand **their** economies.

This would encourage them to import more, including from the U.S., again reducing **our** trade deficit and exerting a welcome expansionary force on the U.S. economy. Clearly, this would be desirable from the American point of view. (This is with the caveat that as the U.S. economy bumps against full employment, to further reduce the trade deficit without reducing the budget deficit would produce inflationary pressures and upward pressure on interest rates.)

However, the world's largest economy cannot stand idly by, depending on others, indicating continued paralysis. Rather than wait to be "bailed out" by others, economic leadership dictates that the U.S. act decisively to put its own house in order. Any assistance from abroad then can be viewed as welcome "frosting on the cake."

Coordinated Action

The prescription advanced in this essay, a tighter fiscal policy, combined with an easier monetary policy as may be necessary, carries the prospect of a further fall in the dollar—a prospect viewed in some quarters as undesirable. However, if the low interest rates in an easy monetary policy were followed by other nations, in expanding their economies, **relative** interest rates may remain unchanged. This would ameliorate the prospect of a further falling dollar. If **all** nations expanded their economies, however, this could lead to worldwide inflationary pressures.

In any case, hoping for help from abroad does not preclude unilateral action, for we cannot depend on other nations to do what appears convenient for us. Again, if

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form of purchases of American goods, the net effect is an outflow of dollars, and downward pressure on the value of the dollar. A broader measure is the "balance on current account," which includes trade, foreign aid, and several other classes of international economic transactions.

Finally, another very important class of international transactions is international investment—U.S. investment abroad, and foreign investment in the U.S. Just as U.S. imports create a supply of dollars to the rest of the world, so U.S. investment abroad supplies dollars, exerting downward pressure on the dollar. Of course, interest on these investments, and profits, when repatriated to the U.S., once again create a demand for dollars.

Conversely, foreign investment in the U.S. creates a demand for U.S. dollars and tends to keep the value of the dollar high. But when the interest and profits, repaid in dollars, are repatriated to home countries, this adds to the supply of dollars, placing downward pressure on the dollar.

A significant element of foreign investment in the U.S. has been foreign purchase of U.S. government debt—bonds and treasury bills to finance the accumulation of annual budget deficits. This debt is in large measure the result of expansionary fiscal policy referred to earlier. The purchase of a bond or treasury bill is a loan to the federal government from the purchaser of the instrument. Thus, in the purchase of a bond by a foreigner, dollars are demanded in exchange for foreign currency to buy the bond.

In contrast to the trade deficit, which has added to the world's supply of dollars, the public debt, financed in considerable measure by foreigners, has created a demand for dollars, helping to keep the value of the dollar up, or at least, higher than it otherwise would have been. Thus, trade deficits have resulted in "dollar supplying" transactions, while the budget deficits, particularly that portion financed by the "rest of the world" has resulted in "dollar demanding" transactions.

Bear in mind that a relatively high rate of interest in the U.S., (including the rate paid by the federal government to finance its budget deficits) relative to other countries, is required to attract foreign investment, and help keep the value of the dollar high. However, foreign investment represents claims on American assets and/or future American production.

Again, a major factor which affects the demand and supply of dollars is the level of imports and exports. This, in turn, depends on such fundamentals as relative competitiveness of business and industry, consumer perceptions of product quality, tariff and other trade barriers, and relative prosperity. Those nations being relatively prosperous, or enjoying an expansionary period, tend to import more from abroad.

Relative price levels also affect demand for U.S. dollars. If the U.S., for example, experiences inflation relative to its trading partners, its goods will be more expensive (with a given exchange rate), thereby limiting exports and the demand for dollars.

Let us be reminded once again of the "managed" part of the "managed float." Central banks may intervene by purchasing one currency for another, for the purpose of affecting demand and supply, hence price, of currencies. Central bank purchases of dollars in exchange for pounds, deutschmarks, francs, and yen, will, other things being equal, increase the demand for dollars. Increased demand for dollars increases the price of the dollar, just as if foreigners were importing more goods from the U.S. If central banks **sell** dollars for other currencies, the effect is the opposite. Obviously, if a number of major central banks act in concert, simultaneously buying dollars, for example, the action is more effective. The effects of these actions are generally short run.

Finally, there is another group of actors—private operators who buy and sell currencies for purposes either of hedging or outright speculation. If speculators anticipate a fall in the value of a nation's currency, they may sell it with the intention of buying it back at a lower price, profiting by the move. This is yet another force affecting supply, demand, and relative prices of currencies.

they do, it is "frosting on the cake." In the meantime, the U.S. must act responsibly on its own, if it is to validate any legitimate claim to world economic leadership.

Use of Capital Budget

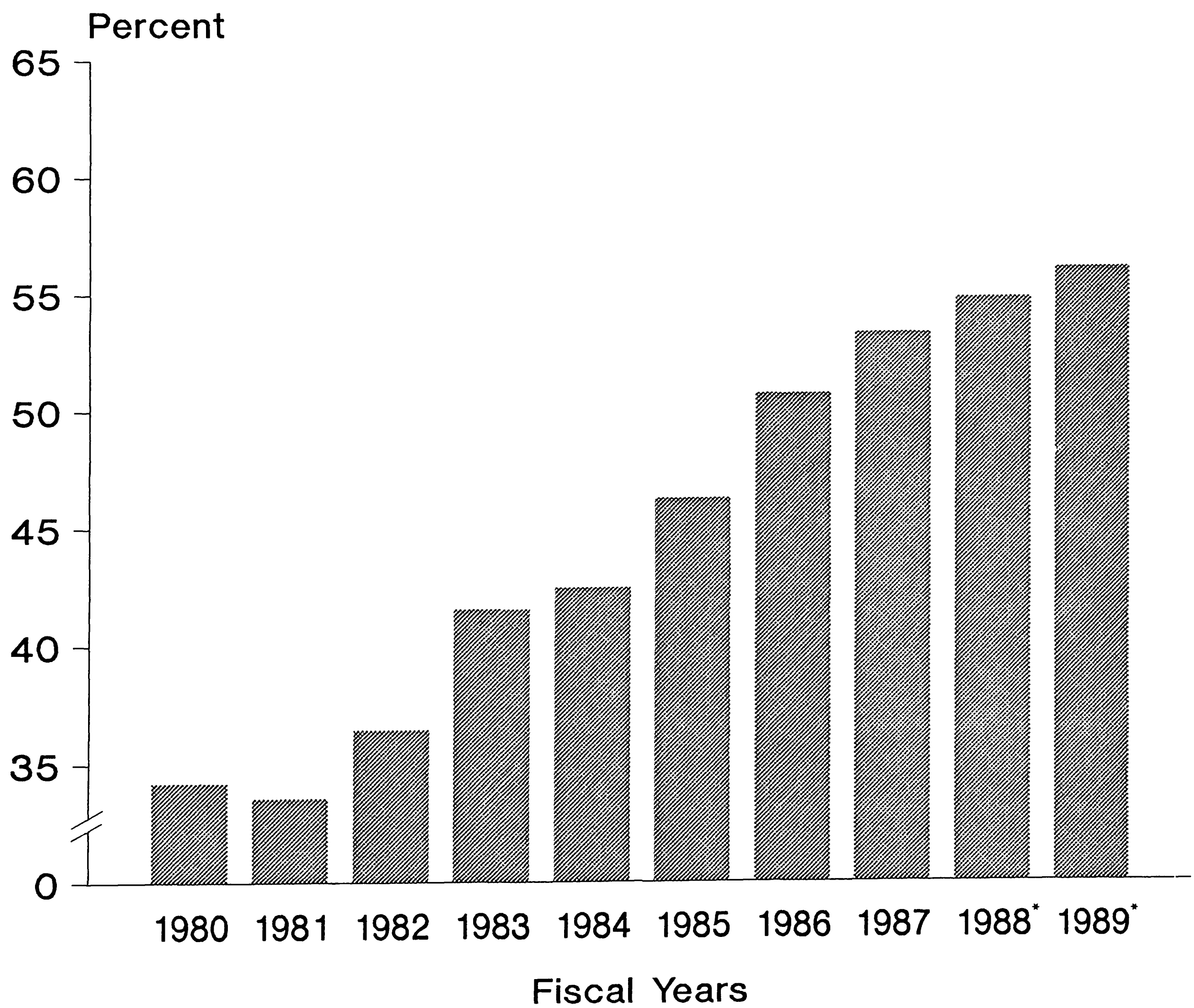
Many economists have long held that there is a good reason to distinguish between capital, and annual or recurring expenditures in the federal budget. There are good reasons for such a system. However, to make the change at this time would appear to be a devious and transparent ruse to make the budget appear less out-of-balance, and to continue avoiding the hard choices. It is unlikely that major world economic players would reflect deeply over such distinctions. In their view, the size and trend of the budget deficit is more important than the proportion which is capital as opposed to recurring expenditures.

In the temptation to avoid the hard decisions brought about by ill-conceived and ill-advised policies such as the supply-side tax cuts and the overly expansionary fiscal policies during rising employment, yet other "simple solutions" must be avoided. Space precludes detailed discussion, but the essential elements are as follows:

Balanced Budget Amendment to the Constitution

At this time, a balanced federal budget is not feasible, and the resulting contractionary shock of such action would be too restrictive for the economy and could lead to high unemployment. While a law requiring a balanced budget doubtlessly would provide "escape hatches," the political jockeying and administrative gimmicks associated with subverting the intent of the law would divert attention from the legitimate spending and taxing decisions which are the responsibility of elected representatives.

Gross Federal Debt as a Percentage of Gross National Product



* Estimated

Source: *Economic Report of the President,* February 1988, p. 337.

Political rhetoric advocating a balanced budget amendment is counterproductive, and either obtuse, or dishonest and purposely misleading. Again, it is necessary to move **toward** a structurally balanced budget. But an **actual** balanced budget is neither necessary, desirable, nor feasible at this time. In any case, such an amendment is not necessary (nor has it been necessary) should a chief executive **desire** to present a balanaced budget to the Congress.

The Line Item Veto

The "line item veto" is a provision which enables a chief executive to arbitrarily delete items in the final budget provided by the legislative branch. Some states have this provision, and some have argued that the President of the United States should have this power as a means of cutting government expenses.

It is unrealistic to expect that Congress would surrender to the executive branch this enormous power. Nor would surrendering that power be desirable. The line item veto would grant to the president the power to arbitrarily and speciously cut down or eliminate items in the budget. Such power would tilt the balance of power toward the executive branch and upset the delicate system of checks and balances on which the federal government is based. This presidential power could be used to influence votes and would compromise the independence of legislators.

The executive branch already has enormous power in **presenting** the annual budget to the Congress. A president who sincerely desires a leaner budget and a tighter fiscal policy has the responsiblity, and already possesses the power, to present to Congress a budget that incorporates this policy.

Deregulation

Further deregulation of financial institutions, such as eliminating the separation between commercial and investment banking, would cause further uncertainty. While there may be sound reasons for further deregulation, the timing could hardly be worse. The U.S. economy and financial markets need more stability and less uncertainty at this time, rather than vice versa. Some argue, and the precarious position of many thrift institutions seems to confirm, that deregulation has gone far enough.

Basic Concepts—continued from page 7

Relation between budget and trade deficits

Returning to the interest rate, if U.S. interest rates are high relative to interest rates elsewhere, foreigners will tend to invest in the U.S., thereby helping to increase the demand for dollars, and to keep the value of the dollar high.

During the 1980s, the combination of a net outflow of dollars (from the trade deficit and other current account measures) has been partially offset by an inflow of foreign exchange, which has assisted in financing the budget deficits. This explains the oft-repeated proposition that "foreigners have financed our high rate of consumption," our excess of imports over exports (trade deficits), as well as our high level of government spending (budget deficits).

Many have expressed concern as to how long the rest of the world will continue to do this, and especially, what might happen when they stop, or slow down. The dollars held by the rest of the world through the trade deficits, and the dollars loaned back to the U.S. to finance the budget deficits represent future claims on American resources.

There is some controversy over the desirability of an increasing amount of foreign investment in the U.S. It is generally agreed, however, that reduced budget deficits would place the U.S. in the position of having to depend less on foreign capital than we do now. Thus, less dependence on foreign capital is another argument for a tighter fiscal policy and reduced budget deficits.

International Ag Policy Center to Examine Macroeconomy-Agriculture Linkages

The Center for International Food and Agricultural Policy, headquartered in the Department of Agricultural and Applied Economics at the University of Minnesota, announced the appointment of its first director in November. C. Ford Runge, associate professor of Agricultural and Applied Economics and an adjunct faculty member in the Hubert H. Humphrey Institute of Public Affairs, began serving as the Center's first director on September 15. Runge recently returned from a year as special assistant to the ambassador in charge of U.S. trade negotiations at the General Agreement on Tariffs and Trade in Geneva, Switzerland.

The Center, with a current endowment in excess of one million dollars, anticipates several generous additions to its support. It will develop research, public policy options, and education programs in several areas: commodity and trade policy, agricultural research, food aid and development assistance, and problems of natural resource depletion in agriculture. Runge's research includes publications in all of these areas.

Runge, a former Rhodes Scholar, has also served in government—during the last year in the Office of the U.S. Trade Representative in Geneva and previously as an aide to House Agriculture Committee Chairman Thomas Foley (currently the House Majority leader) and in the Agency for International Development in Washington.

"Our objective," Runge noted, "is to consolidate the University of Minnesota's role as a leading center of international agricultural and natural resource policy work."

The Department of Agricultural and Applied Economics, ranked as one of the best such departments in the nation, "is already well known in the field of international affairs. Our goal is to build on this reputation, and to link international issues to the work and welfare of the people of Minnesota, who make this university and its programs possible."

Tinkering With Stock Markets

As a result of the October 1987 debacle, there have been a number of proposals for limiting the volatility of U.S. stock markets. These include such proposals as stopping trading when market indexes drop by a specified amount, and limiting computer induced trades under certain conditions.

A most generous judgment of such nostrums is that they deal with symptoms rather than causes. Such tinkering remedies no fundamental cause of instability. Serious attention to American fiscal policy would do far more to restore confidence and address fundamental problems.

Administrative rules and regulations regarding financial markets are far better addressed to preventing abuses such as insider trading. The intention of regulation should be to insure **fairness** and **integrity** of markets, rather than to tamper with and manipulate the **results** of the markets.

The Gold Standard

Charlatans profess that yet another simple solution, some ill-defined form of basing the monetary system on gold, would impose fiscal restraint. There is neither historical evidence, nor logical basis for this assertion. Such ''solutions'' simply divert attention from legitimate decisions which need to be made.

Conclusions

The U.S. economy has indeed expanded during the 1980s. However, a seductive and pernicious combination of ''supply-side'' expansionary fiscal policies, with expanding budget deficits as the nation moved toward full employment, and restrictive monetary policies, gave rise to severe U.S. budget and trade deficits, and the impression that the federal budget is out of control. Anxiety over lack of American resolve to take the necessary corrective measures was a major factor in the financial debacle of 1987.

It is difficult to escape the conclusion that to assure stability and confidence in financial markets, a significant measure of fiscal restraint needs to be imposed. Tighter fiscal policy is necessary to reduce federal budget deficits. The lower valued dollar combined with a tighter fiscal policy is the surest way to lower our trade deficits. Options for these actions are limited, and politically difficult, though necessary, unless the U.S. is willing to relinquish its claim of economic leadership to its tough, and apparently more disciplined, competitors.

Perhaps the most unsung of the casualties of growing federal budget deficits is that they have stripped us of the most effective way of countering the next recession—a tax cut. It would seem prudent to keep the U.S. deficit during full employment to such a level that in the event of impending recession, a tax cut could be imposed without the specter of adding to deficits which are seen by our economic competitors as already far too large.

The non-recurrence of the 1987 debacle should be neither cause for celebration nor complacency. A nation may lose its economic supremacy not with a bang—or a crash—but with a whimper. The new administration needs to act on these matters with a sense of urgency, determination, veracity, and above all, dispatch!

If we are fortunate, the new administration will assume the leadership necessary to impose the required fiscal discipline. Otherwise, as happened in 1987, such discipline may be imposed from without, by forces over which we have less control.

The next issue of the *Minnesota Agricultural Economist* will feature a discussion of the Uruguay Round Negotiations and agricultural trade.

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