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Outline

"Fiscal Policy Linkages to Agricultural Finance"

by

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I. Introduction

- What can you say when your the 4th speaker in such an assemblage?
- Many of the connections between the deficit and economic conditions in the farm sector have already been described.
- Since finance is the study of the bottom line, wealth, let me quickly summarize how these linkages fit together and point out how complex the linkages are, in my opinion
- I would then like to relate some observations of how deficit reduction might influence the farm sector over the next few years.

II. Putting Linkages Together

Let's assume everyone wants to be rich so objective of farmers is to maximize their real net worth.

By definition

nw = value of assets - debt

value of assets = returns to assets/discount factor

returns to assets =

revenues minus

interest expenses

other expenses

taxes and

returns to labor

At the very least then a description of the impacts of deficit reduction needs to describe the impacts of lower deficits on

prices received and quantities produced
interest rates, debt levels and off farm investments
wage rates and labor used
other input prices and quantities used
and farm taxes

Much of the previous discussion has been focused on revenues, particularly noting and debating the effects of deficits on prices received through changes in interest rates and exchange rates. Mention of taxes--doubt tax reform will have good short term effect on farm asset values.
And, there has been some mention of the short-run stimulus of government deficits on consumers incomes and the demand for food.

While such debates are lively and necessary, they fall far short of describing all of the important interactions within the economy that, as a whole, show how financial conditions in farm sector are influenced by changes in the government deficit.

Mention impact of interest rates on domestic demand for food.

In addition, it is hard for me to believe that the behavior of individuals to economic stimuli are sufficiently linear that taking derivatives eliminates initial levels of variables. If, this is so, then there is no single answer as to what reducing the deficit will mean to financial conditions on farms. A particular answer will depend on the initial conditions throughout the economy.

Finally concurrent changes in other policies, such as monetary policies, international trade policies and farm policies will change the relative strengths of different arguments and in so doing may even change the sign of the overall relationship.

Main point here is that this is not a simple question and there is no simple nonconditional answer.

III. Some Possible Impacts of Budget Reductions

In conjunction with John Penson and Ann Adair at TAMU used our judgement and a large econometric model, COMGEM, to look at 3 possible projections of financial conditions in the farm sector.

1. First question has to be:

   What might happen without deficit reduction? Fairly simple to see that a continuation of recent policies would lead to a continuation and worsening of current problems.

Monetary policy has, to put it mildly, eased. Eventually, farmers would be faced with continued high real interest rates, growing inflation and declining nominal output prices under the 1985 Farm Bill.

If this happens, it is fair to say that we haven't seen anything yet in terms of financial adjustments in the farm sector.
We are, therefore, of the opinion that reducing the federal deficit would benefit the farm sector.

However, in our work we found that the specifics of the manner through which the deficit is reduced can have significant ramifications for the farm sector.

2. Rapid declines in Government Expenditures

Our first experiment in reducing deficits was based on the assumption that Congress would have the Gramm Rudman Hollings Ammendment in effect, pass no tax increases, and be unable to keep from passing spending legislation that keep projections of deficits growing at rates similar to those of 1983 and 1984. Thus the entire burden of balancing the budget falls on cutting spending the nonexcluded programs under the Ammendment.

Frankly this experiment did not work.

Ever growing expenditure cuts led to reduced tax revenues and on eventual deep recession.

Farm programs were projected to be cut dramatically in the late 1980's. Even lower interest and exchange rates were insufficient to overcome lower incomes.

3. Still convinced that there was some hope to be found we tried a compromise scenerio where tax rates were gradually raised and growth in government expenditures were basically flat. Monetary policy gradually tightened to hold inflation to below 5 percent.

The results here were almost too good to believe. Deficit reductions were achieved without dramatic dislocations in the economy. Domestic food demand rose with higher incomes and lower real interest rates Exports grew with a lower value of the dollar and less pressure on debt ridden Developing countries. Farm expenses declined, with interest rates and then grew more slowly than income given low inflation. Projected farm income and asset values rose.

IV. Conclusions

I hope I have made three points:

1. Our subject is complex so unconditional statements are meaningless.

2. Given the current situation the future course of fiscal policy will play a major role in determining financial conditions in the farm sector.

and 3. The approach to achieving deficit reductions is as important to the farm sector as the overall objective.

Notes for a talk on

"Monetary-Fiscal Policy Linkages
in Light of Graham-Rudman"

Theme: The interactions between monetary and fiscal policy become much more binding when the fiscal authorities run persistent large deficits.

I. The recent rise in the U.S. primary fiscal deficit is unprecedented.

   A. Primary deficits, or deficits net of interest payments are basically G-T, or government expenditures on goods and services minus taxes. They are the primary fiscal input into the economic system, the fiscal shocks that hit the system. Interest payments on government debt are among the secondary effects of these primary shocks propagating through the system over time.

   B. As the graphs in Barth, Iden, and Russek ("The Economic Consequences of Federal Deficits: An Examination of the Net Wealth and Instability Issues," Southern Economic Journal, July 1986, illustrate, primary fiscal deficits are highly variable even in normal times and are subject to extreme fluctuations associated with wars and recessions.

   C. The critical question today is whether the mean of the primary fiscal deficit has shifted upward.

      1. For most of American history, the Barth, Iden, and Russek graphs show that the primary fiscal deficit has actual been, in normal years, a surplus of about 0 to 2 percent of GNP.

      2. In times of war and also in the Great Depression, however, the primary deficit swelled sharply, reaching 5 percent or more of GNP during the Civil War, the two World Wars, and the Depression.

      3. These bulges have always been temporary, however, and were followed by periods of modest fiscal surplus.

4. As a result, the history of primary fiscal deficits (as a % of GNP) is roughly that of a series without trend, with normal moderate to large cyclical fluctuations punctuated by largely exogenous episodes of extreme deficits.

5. Since the mid to late 1970s, however, the primary fiscal deficit has been rising as a percentage of GNP, and fairly rapidly. We are now, for the first time in our history, running primary fiscal deficits in excess of 1 percent of GNP (in fact, well over 2 percent) in a period of peace and economic growth. This raises the question of how long this up trend will continue and whether it will be reversed, as previous periods of large deficits were, or whether we are witnessing a shift in the underlying mean of the primary deficit process. The implications for fiscal and monetary policy linkages are very important.

II. Much of the 20th century debate of activists versus nonactivist monetary policy refers to monetary-fiscal linkages in a world with only cyclical fiscal fluctuations and no long-run primary fiscal deficit.

A. The activist/nonactivist debate is partly premised on the monetary authority's freedom to choose its own policy, that is, on a degree of monetary policy independence that may not be possible under persistent deficits. It inherently refers, then, to monetary-fiscal linkages under cyclical, not secular, deficits.

B. The activist view, embodied in many so-called Keynesian approaches, calls for the monetary authority to react to the current and prospective paths of growth and inflation.

1. According to this view, growth and price stability are twin policy objectives.

2. Growth is temporarily promoted by either increasing the deficits or the growth rate of the money supply, also temporarily.

3. Inflation, though somewhat affected by growth and hence fiscal policy, is primarily the responsibility of the monetary authority; it can be reduced by slowing the growth of the money supply.

4. All these relationships involve lags, but these are fairly well measured and understood.

5. Optimal strategy, therefore, consists of appropriate countercyclical combinations of fiscal and monetary policy.

   a. To stimulate a stagnant economy, raise either the deficit or the growth rate of money, or frequently both. Such a coordinated easing would make monetary and fiscal ease correlated with each other.

   b. In an inflationary period, restrain monetary growth. This would shift much of the countercyclical role onto fiscal policy alone.

   c. In a noninflationary growth period, as growth reduced the deficit, maintain a degree of monetary ease to offset shrinking fiscal stimulus. This lies behind the view that the Fed should ease to offset Gramm-Rudman.

   d. Note that in any case, fiscal policy remains countercyclical, and hence for much of the post war period when this activist view was influential, fiscal ease was associated with economic slackness and, hence, with cyclically low interest rates.

C. The nonactivist view can be supported in various ways.

1. Monetarists: The lags in the workings of monetary and fiscal policy are not well understood in the short to medium run, so our attempts to use monetary policy to fine tune are quite likely to be self-defeating or worse. Best for Fed to react neither to the state of the economy or to fiscal policy.

2. Ricardian equivalence view: Deficits don't matter, since government borrowing now implies government surpluses later (to pay off the debt), which leaves present-value budget constraints unaffected. So Fed may wish to react to the economy, but not to fiscal policy.

D. For most of postwar period, both views have been influential. The result has been a generally activist policy (sometimes more, sometimes less), but with its activism tempered both by the doubts raised by proponents of the nonactivist view and by the Fed's primary responsibility to achieve long-term price stability, which often conflicts with an activist countercyclical stance.

E. This balance of forces leading to this tempered activism is at play in the current environment, and rather more visibly than in the past.

1. One activist contingent views the currency situation as one of economic weakness and low inflation; they believe some stimulus is necessary and that monetary policy would be the most appropriate means to deliver it, given our large deficits. The prospect of a fiscal tightening under Graham-Rudman, they feel, strengthens the case.

2. Others, including both activists and nonactivists, view the current economic weakness as transitory and deceptive and worry that inflation is likely to pick up; they are reluctant to ease further and, to some extent, discount the likelihood of deficit reductions.

3. The result has been a rather slow and cautions easing.

III. The current fiscal environment raises the much more disturbing possibility, however, that the activist/nonactivist debate will be rendered irrelevant by a string of deficits large enough to virtually compel rapid monetary growth and high inflation.

A. As I have noted,, the present situation of primary fiscal deficits exceeding 1 percent of GNP in the absence of war or severe depression is unprecedented in the U.S.

B. This unusual situation is made more serious by the fact, quite plausibly related, that interest rates on government debt currently exceed the growth rate of the economy, and hence the growth rate of the tax base that can be tapped to pay the interest on the debt. As a result government interest payments are growing exponentially and faster than GNP. Without some change, they will explode to exceed GNP, which is not feasible.

C. Since something has to give, we are playing a game of policy chicken.

1. Either the primary deficits will be brought back down, as in all previous episodes.
2. Or interest rates will somehow fall below the economy's growth rate.
3. Or more government debt will be monetized, boosting inflation (and also possibly pushing growth rates above interest rates).

D. This perspective, which focuses on the mean or trend in deficits rather than their cyclical fluctuations, leads to a different view of monetary-fiscal linkages.

1. The government's budget constraint forces monetary and fiscal policy to be coordinated, at least in the sense that the combined revenues from bond and money creation must finance the deficit.
2. Since large persistent deficits cannot necessarily be financed by bonds alone, the monetary authority faced with a fiscal authority threatening such large deficits faces the classic chicken dilemma: either swerve (i.e., inflate) to avoid disaster (i.e., default), or hold fast (don't inflate) in an attempt to force the fiscal authority to chicken out of its large deficits.

   a. Some take the view that, since the Fed is Congress's creation, it is inherently in the weak position and should gracefully chicken out. They would favor inflating in the absence of Graham-Rudman, but tightening if Graham-Rudman or some other mechanism signals that Congress has returned to fiscal sanity. Note this is the opposite of the "activist" response.

b. Others aren't prepared to give up so easily. They want to be as tight as possible, in order to keep the pressure on Congress to cut the deficit. This camp, however, has been somewhat silenced by the recent apparent weakness of the economy, which has caused some of them to join the activist camp for now.

Summary: Most of the postwar debate about active versus nonactive monetary policy assumed a background of cyclical rather than secular deficits. Such a fiscal environment gave the Fed the luxury of independence and made the debate relevant. It was never resolved, but the Fed's behavior remained to some degree activist, even though that activism was tempered by the growing belief in monetarist economics as well as by the necessity of combating rising inflation. This tempered activism is still at work in the Fed, as evidenced by recent cautious easings in response to the weak economy. It would probably continue to operate if Graham-Rudman or other deficit reductions further weakened the economy, though the high degree of uncertainty surrounding fiscal policy means that the Fed is not likely to loosen much simply in anticipation of a deficit reduction.

Recently, however, the traditional debate over monetary policy has been somewhat eclipsed by the prospect of a string of deficits which, combined with high interest rates, could raise the possibility of an eventual Federal government default in the absence of debt monetization. If this possibility unfolds, the Fed would be forced to play chicken against the fiscal authority. Some believe the possibility is already occurring, and they take a much different view of monetary-fiscal linkages. If they think the Fed can prevail, they advise tightening to force budget cuts on Congress. If they believe Congress will prevail, they advise easing until Congress cuts the deficit and tightening only when Congress reverses course and does cut the deficit.