Challenge to the Economics Profession:

World Agricultural Trade in a New Environment

As agricultural economists, we find ourselves faced by challenges of every proportion. Tonight, I will first look at the disarray in which world agriculture finds itself today--a challenge beyond our control, yet one which affects our daily work in countless ways. Second, I will discuss the coming round of Multilateral Trade Negotiations as a means to bring order to the disarray--and as a new set of challenges we will have to meet. And finally, I will try to take an honest look at where we--as a profession--find ourselves in the late 1980's, and the challenges we must meet tomorrow.

## The Current Disarray

In 1973, D. Gale Johnson published his famous book, World Agriculture in Disarray. If the international environment could be characterized as one of disarray in 1973, it certainly is true 13 years later in 1986.

We find ourselves in a situation of substantial excess productive capacity in world agriculture relative to current and prospective demand. This is somewhat ironic, given that as recently as 1981, many observers forecast that demand would continue to grow more rapidly than capacity and that real commodity prices would increase continuously into the next century.

Such analyses appear to have understated both the investments that were underway in productive capacity around the world and also the rate at which technological progress was raising global agricultural

---

Remarks delivered by Robert L. Thompson, Assistant Secretary of Agriculture for Economics, at the International Banquet, American Agricultural Economics Association, Reno, Nevada, July 28, 1986.

productivity. They also appear to have put excessive emphasis on the population growth rate and too little emphasis on the rate of growth in per capita income as a determinant of growth in global food demand. There is plenty of food produced in the world; people go hungry because they lack purchasing power.

The global recession of the early 1980's significantly slowed the growth in world food consumption. In some of the most debt-stricken developing countries, major reductions in absolute level of income actually reduced the volume of food consumed. Thus, the fact that global productive capacity and production outpaced slower demand growth has put downward pressure on world commodity prices.

The industrialized world in particular has stimulated investments in larger and larger productive capacity through various forms of price and income supports. But this is not limited only to high income countries. A number of middle income countries recently have increased the level of price supports to their farmers or removed export taxes. In addition, more and more Third World countries have found the merit in removing the price-depressing policies employed as recently as the 1970's, both as a result of conditionality imposed by the World Bank and the International Monetary Fund as well as by their own self-interest. China is an outstanding case in point.

As Third World countries permit their internal prices to rise to the world market level, and as high income countries support their domestic prices at well above that world price level, the 1980's have seen a significant increase in the incentive to expand world food production. As larger production has met a more slowly growing market, world commodity prices have been significantly lower in the 1980's. This has created an environment of increasing export subsidization and import restriction.

The 1981 Farm Bill made it more profitable for U.S. farmers to forfeit their output to the Commodity Credit Corporation at the rigidly fixed loan rate than to export for the lower world market price. This led to larger and larger stocks, and in turn, larger and larger acreage reduction programs--culminating in the Payment-in-Kind program of 1983.

In effect, the U.S. withdrawal of exports from the world markets supported world prices at a higher level than they otherwise would have found, given the prevalance of export subsidies elsewhere. The point here is that while world commodity prices in the 1980's have fallen, they would have been even lower if the United States had not set those rigid minimum loan rates in the 1981 Farm Bill.

With the passage of the 1985 Farm Bill, the United States has begun to remove this artificial support from world market levels and let world prices fall by 25 percent or more in 1986. Thus, the new environment in which we find ourselves in the late 1980's is one of low commodity prices --lower than would otherwise be the case in the absence of the production incentive programs and export subsidies in a number of countries around the world. With the Export Enhancement Program and the marketing loans for rice and cotton, the United States, too, is playing this game.

In this environment, the export subsidies and associated depressed world market prices are causing diplomatic and political tensions among normally friendly countries. Expenditures on agriculture in industrialized countries are soaring, while exports and foreign exchange earnings in less developed countries are declining. We cannot continue on our current path of trying to out-subsidize one another in the export arena without pushing costs sharply above even today's high levels. These strains are reaching the point at which it is becoming urgent that we get on with international trade negotiations to attempt to reduce the causes of these tensions.

An additional characteristic of this new environment in which agricultural trade occurs is the volatility of floating exchange rates. Fifteen years ago, this might not have been viewed as a problem because world agriculture was much more segmented. However, the years since have seen the total volume of world trade grow to a point where many more countries depend on trade for a larger fraction of their sales or of their food supply.

With the increasing perfection of the international capital markets over the past couple of decades, literally billions of dollars can move among countries at the touch of a telex key. To put this in perspective, the dollar value of the goods and services moving into and out of the United States in 1985 exceeded $550 billion. The capital flowing into and out of the United States, however, is estimated to have been as much as $35 trillion. This same size differential is at work in world trade and financial flows. The value of goods and services traded globally in 1984 was apprriximately $4 trillion, while world financial flows are estimated as high as $200 trillion.

The speed of adjustment also works to increase the importance of financial flows. Bank deposits, government bonds, and stock certificates all change hands far more rapidly than wheat, corn, iron ore, and automobiles. These size and speed considerations suggest than in many cases it could well be financial flows that lead to adjustments in the goods and services markets.

These international capital flows, therefore, become the principal engine driving changes in exchange rates. If macroeconomic policies--in particular monetary policy--are unpredictable and frequently changing, this will cause frequent and abrupt shifts in international capital flows to reflect the changing expected returns on those investments.

And there has been great unpredictability and lack of coordination among macroeconomic policies in the principal industrialized countries. This has been reinforced in the 1980's by a tendency for the Japanese to save far more than could be invested within Japan under current policies, causing large net capital outflows from that country.

The mirror image has existed in the United States where large Federal budget deficits in the face of small domestic savings have attracted large net capital inflows. Exchange rates have adjusted as necessary in order to generate the requisite offsetting current account surplus in Japan and current account deficit in the United States. For example, in 1985, our merchandise trade deficit at $124 billion counterbalanced net foreign financial investment in the United States of $125 billion.

But these frequent and abrupt changes in exchange rates have created a significant increase in the instability confronting all traded goods sectors including agriculture. If we lived in a world of instantaneous and costless adjustment, agriculture could respond to these changes in exchange rates quickly and painlessly. But agriculture is a highly capital intensive industry, and much of that capital stock has low opportunity cost in other uses.

Therefore, investments put in place under one set of expected exchange rates may turn out to have been very poor choices if the exchange rate suddenly moves in the wrong direction. Because land is the factor of production in least elastic supply, its price tends to adjust relatively most in response to changing expected returns. With the large investments made in farmland in modern agriculture, exchange rate variations get translated into land price variability that is hard for individual investors and lenders to absorb.

Need for Trade Negotiations

This environment of disarray in world agriculture puts in perspective the urgency to get on with the task of multilateral trade negotiations. In the coming GATT round, it is essential that not only border measures but also domestic farm programs be on the negotiating table.

Little progress has ever been made in past the GATT rounds on agriculture because domestic farm programs never have been considered to be on the table. Even agricultural tariffs could only be negotiated if a country offered them as candidates, and across-the-board cuts were not used as they were for industrial products.

But yet with few exceptions, the border measures in place on agricultural goods are there solely to validate domestic farm programs. And it is these domestic farm programs which subsidize larger production than would otherwise occur. This larger output ends up being dumped out into the world market, depressing world market prices below the levels at which they otherwise would find themselves.

Thus, to resolve the international agricultural trade tensions, we must get at the domestic price and income supports. Recent work at the OECD in its Trade Mandate Study has calculated a summary indicator of the net effect of the whole range of policies that augment returns in agriculture, whether they be input subsidies, price supports, export subsidies, quotas, deficiency payments or what have you. I think we must seek to freeze the total level of assistance at present levels and set them on a downward adjustment over time. It will be a new development for the GATT to consider domestic subsidies, but this is the only way by which we can hope to address the current disarray and ultimately solve agriculture's problems.

In addition, we need to get a clear understanding of what forms of assistance to agriculture will be permissible. We must recognize that, politically, governments will continue to seek to support farmers' incomes. We must seek to ensure, however, that this is accomplished by means which do not stimulate larger production but rather are carried out on the basis of need.

Further, it is well known that the prevalence of nontariff barriers to trade in farm products cuts the link between world and domestic prices. This means the adjustment to any shock in the world market must be borne by that small group of countries which transmit world price adjustments into their domestic economies.

As a result, world prices are far more volatile in this environment than they would be if only tariff barriers were employed to protect national agricultures. So another objective in the GATT should be to shift as many border measures away from nontariff barriers over to tariff barriers as possible.

A final objective in the trade negotiations needs to be establishment of a better dispute settlement process in the GATT. Few countries are satisfied with the present process which takes so long, is often indecisive and can so easily be thwarted by an adversely affected member. If the GATT is to play a useful role in the future, a more ironclad dispute settlement procedure must be agreed on.

We need to consider two other aspects of the current environment before turning to challenges to the profession. The first concerns the adjustment process which must be undertaken in response to trade policy liberalization. The second is the uncertainty imparted by the volatile exchange rates of the last decade.

Relative to the adjustment process, the large subsidies received by some parts of agriculture in each industrialized country reflect the political power and lobbying strength of the benefitted interest groups. But the existence of these subsidies generate economic rents that get capitalized into the values of the asset producing those products.

To liberalize agricultural trade will inevitably require reduction in these economic rents and in the associated asset values. It is naive to believe that we can be very successful in liberalizing agricultural trade unless adjustment policies can be put in place to facilitate the adjustment and at least compensate the losers for part of their losses--losses both in income and in land values as well as in the value of fixed capital investment.

For unless the losers are compensated, they will be able through their political power to successfully thwart implementation of the overall agreement that comes out of the trade negotiations. To avoid this, adjustment assistance has to be part of the plan for each country's MTN strategy.

We should also be clear that this adjustment process may take a number of years. Tariff concessions agreed to in the Tokyo Round took nearly a decade to be fully phased in. Thus, we will also have to agree on short-term policies to deal with surpluses as protection levels are reduced. Land retirement programs, such as those pursued by the United States, are one option.

The second concern is exchange rates and their volatility. In the 1980's, we have seen exchange rates adjust by more than 50 percent relative to one another. After spending 5 years in tortuous negotiations to come up with 10-percent changes in tariff rates, only to see the outcome totally swamped by a 50-percent adjustment in exchange rates, negotiators have little interest in entering the fray of the coming GATT round without some expectation that exchange rates will be more stable in the future. France in particular has been adamant that international monetary negotiation either should precede or be carried on in tandem with the GATT round.

The Park Hotel meeting in September 1985 and the Tokyo Summit last spring both addressed this problem. The volatility of exchange rates we've seen in the 1980's reflects in part the lack of synchronization among national macroeconomic policies. The Tokyo Summit communique produced agreement that macroeconomic policies will be coordinated in the future among the principal industrialized countries. This could contribute to an environment of greater exchange rate stability.

Nevertheless, the world awaits the effects of Gramm-Rudman-Hollings and associated U.S. measures to cut our budget deficit in order to remove the attraction to such large capital inflows into the United States and the associated danger of a precipitous drop in the U.S. dollar. While the outcome is uncertain, we must expect concern for exchange rate volatility to be in the backs of trade negotiators' minds during the coming GATT round.

## Challenges to the Profession

I feel that there are two areas where the profession must increase its efforts relative to the current international trading environment. One is educational; the other concerns research.

First, it is essential that we work on raising the economic literacy of the public and of policy decisionmakers concerning the gains from trade, the present disarray that exists in world agriculture, and the role that the United States plays therein.

The subtlety of comparative advantage and the gains from trade escape much of the public. The naive logic of protectionism finds many receptive ears. The potential losses to society from proceeding down a protectionist path are too great to ignore. We must redouble our efforts to raise the economic literacy of the public in this area.

Further, we must help the public understand the constraints that being a large exporting country imposes on our freedom of action in setting domestic policies. We cannot continue to be a large agricultural exporter without conceding that the policies we set for prices must be consistent with world supply and demand realities.

By the same token, our public needs to understand the effects that U.S. policies have on the world market. The public also needs to have a better appreciation of why the costs from multilateral adjustments in agricultural policy will be far smaller and less painful than unilateral changes.

The public needs to understand where the United States is most protectionist relative to other countries, and where we have our greatest comparative advantage. And they have to recognize that trade is a two-way street. We cannot hope to succeed in the next round of trade negotiations unless were willing to put some of our own protectionist measures on the table as well. This, of necessity, will include some of our own price and income support policies. Otherwise, there's no hope that other agricultural exporting countries will negotiate with us in good faith.

There also are several areas where our profession needs to improve its understanding of the current problem through increased research efforts. The first of these is the need for better empirical understanding of where the U.S. comparative advantage in agriculture really resides.

If we were to have true trade liberalization in global agriculture, reducing both domestic subsidies as well as border measures, where would the adjustments occur? In which commodities would the United States have to cut back on production, and which commodities would be the significant gainers? Present policies in other countries such as the European Community that distort the location of production and the pattern of trade may actually benefit some parts of American agriculture.

Before entering the trade negotiations, we need a clear-cut view of the likely adjustments that would have to be made in the United States if various negotiating strategies were successful. We need the best creative thinking available on adjustment assistance and policies that could be undertaken to compensate losers for their losses. Unless we include adjustment assistance as part of the plan from the beginning, we're unlikely to be successful in implementing whatever comes out of these negotiations.

As we look at trade liberalization, we need to carefully examine the interrelationships among agricultural commodities and also between agriculture and the rest of the economy. That is, we need more computable, general equilibrium analyses of the effects of the present protective structure in agriculture. We need to understand not only the effects on other parts of agriculture , but also the effects on the general price level, on economic growth and on unemployment in the rest of the American economy.

Interrelationships between the trading countries is the last area of international agricultural research I would cite. This is heavily tied in to evaluating the price effects of international trade liberalization, but it also is extremely important for formulation of U.S. policies as well. We still have very little professional consensus in the United States on how price responsive is the export demand confronted by U.S. traders. This probably was the single most important parameter in the 1985 Farm Bill debate, yet it was the parameter over which we had the least professional consensus.

Some argued that the long-run export demand was inelastic, and therefore that mandatory supply controls were the optimal policy for the U.S. farm sector to follow. Others argued that at least in the long run, export demand is quite elastic and therefore any policy that artificially restrains production to increase the U.S. market price over an extended period will ensure the demise of the United States as an important agricultural exporter.

The lack of consensus did much to discredit a great deal of what the profession had to offer the farm bill debate in the eyes of the members of the House and Senate Agriculture Committees. We need more work in this area for formulation of future farm policy and for analyzing future trade policy alternatives.