96th Congress } COMMITTEE PRINT
1st Session }

1980 AGRICULTURAL OUTLOOK

Papers Presented at the Agricultural Outlook Conference Sponsored by the U.S. Department of Agriculture—Held in Washington, D.C., November 5–8, 1979

PREPARED FOR THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

DECEMBER 23, 1979

Printed for the use of the Committee on Agriculture, Nutrition, and Forestry

U.S. GOVERNMENT PRINTING OFFICE
53–457 O WASHINGTON : 1979

OUTLOOK FOR FAMILY LIVING

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THE INFLUENCE ON FAMILIES OF THE WORLD ECONOMIC SITUATION

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The price of gold is sky high and the value of the dollar in world markets is off. So what. Are such remote events of any concern to a farm family busy getting in the crops, feeding the livestock, and trying to balance the checkbook? In a way, the answer is no. A family can keep busy and happy for years without worrying about such matters. That is, some families can—but can all of us? The repercussions plague many of us in the form of higher prices for farm supplies and consumer goods through inflation, in the form of declining markets for farm and rural products through unemployment and recession, and in the form of higher interest rates.

The United States is getting more and more intricately involved in world trade and international finance, not less. The world market for U.S. farm products grew sharply during the 1970's. These and other exports provide us with foreign exchange to buy petroleum, take vacations abroad, and acquire other imports. It is not likely that we will become isolated again—nor is it in our best interests that we should. When our international exchanges are working right, the influence on families is generally beneficial. The high price of gold and the low price of the dollar are symptoms that something has gone wrong; the influence on families can be adverse.

Why do we engage in foreign trade? Wouldn't it be better to consume only what we produce ourselves—to become completely self-reliant? We could do that, of course, but to do so we would have to reduce our consumption. One of the reasons is obvious: We import tea from India and bananas from Central America that we cannot raise at home. If we want these things, we must import them. And, if we import them, we must export something—goods, services, or gold—to pay for them.

The second reason we engage in foreign trade is less obvious but more important: When we exchange American grain for Japanese cars and TV's, the output of both countries is larger than if there were no exchange. The same effect is gained within a large country like ours when textiles produced in the South are exchanged for grain and livestock products produced in the Midwest. Unlike the tea and banana examples, it is feasible for the United States to produce more cars and TV's and for the Japanese to produce more grain. By our specializing relatively more in one and they in the other, we produce more of both and improve the incomes in both countries. This is called, by economists, the principle of comparative advantage.

The idea of comparative advantage has dominated much of the thinking about world trade over the past two centuries. It was used to advocate policies of free trade among nations for mutual advantage. There were many gains from free trade, to be sure; however, the doctrine did not work as calculated. Trade makes one country dependent on another. In happy times, such dependencies were all right, but during economic or military wars, the dependence was a source of vulnerability. So countries protected themselves by producing, say, steel at home, even when it could be imported at lower cost. Further, protection was needed in a world of a few powerful trading blocs because some trading partners were willing and able to use their monopoly power to take advantage of others.

But there was another and more difficult problem with free trade; it resulted in unstable domestic economies and it changed the international distribution of income. If a nation exported more than it imported, the difference might be made up by importing gold. This would increase the domestic money supply and decrease the foreign supply. A result was likely to be inflation at home and deflation abroad. Higher prices at home hurt the export market; lower prices of foreign goods induced more imports. These changes could lead to a drain of gold because of an unfavorable balance of trade. In this way, an attempt at free trade by one country could induce alternate periods of boom and bust—of inflation and recession. This may have resulted in economic efficiency in the long run, but in the short run it was ruthless in the way economic adjustments were forced on families; it was a source of hardship and of poverty. For example, firms that came into existence when export markets were expanding might go bankrupt when such markets declined. During declines, workers might lose their jobs and young people might find it difficult to enter the labor market.

The search for stability and equity led to protection. Free trade never actually existed, but as national policy it was replaced by import and export quotas, taxes and subsidies, fixed exchange rates, and proscribed spheres of influence. Because of such policies, for the past several decades the goal of stability was approximated. However, protection of one country was often at the expense of another. Affected countries were likely to retaliate with their own protective strategies. Some nations may have gained in a relative sense although, from the principle of comparative advantage, the world as a whole may not have attained the level of income that it might have had had there actually been free trade.

The efforts to channel international flows of goods and money misdirected some flows in the sense that some countries had persistent drains in gold and other forms of exchange, while other countries accumulated these financial resources. These imbalances led to a breakdown, a few years ago, in the carefully contrived system. We now have a more volatile arrangement which is neither fully free nor fully regulated. We have more flexibility of adjustment from some sources, such as flexible exchange rates and variable levies, but we have possibly less from other sources, such as inspections, health regulations, and other nontariff barriers to trade. Consequently, the international flows of goods and money are subject to considerable instability, yet the changes are not necessarily toward economic equilibrium.

International flows of money depend only in part on imports and exports. Perhaps more important in recent years are the flows of funds associated with investments, loans, aid, and military activity. For many years, the United States ran a negative balance of payments despite a positive balance of trade because of heavy capital outflows for various public and private purposes, including business investments in foreign countries and the Marshall plan. Currently, we are running negative on both the trade and the capital accounts. This imbalance is causing problems with both the domestic and the international money supply.

Before we see why this is so, let us digress to examine what money is. Consider the functions of money. As a medium of exchange, money facilitates trade compared to the awkwardness of a barter system. As a unit of account, money tells who owes what to whom. Money is an asset to the one who holds it, but, by the same token, it is a liability of the economic system to the holder. If you have a dollar, you are entitled to a dollar's worth of merchandise from the economic system. When you work, you receive credits in the form of dollars which can be exchanged at another time and place for things you want. It is part of the same accounting system to buy on credit, only now you owe the economy something to be repaid at another time and place. If you borrow $1,000 at your local bank and put it in your checking account, the Nation's money supply grows by $1,000 because demand deposits are considered part of the money supply. The quantity of money changes with and depends on the level of debt. The use of money as an accounting mechanism keeps the social system straight as to who owes what to whom.

As a store of value, money separates in time and place the two sides of a transaction. Instead of bartering, say, one cow for two pigs, I exchange the cow for money here, today, and use the money as a store of value until I am ready to buy the two pigs, perhaps another day in another town. Many commodities serve as a store of value. Gold, silver, and copper have long had this use. But we can also use tobacco, wheat, land, or automobiles, as a place to store our wealth. The more rapid the rate of inflation, the more important land and commodities become as a place to store wealth as an alternative to holding currency or bank deposits. It is the search for a safe place to store wealth that is driving up the price of gold. It is a symptom that people are seeking alternatives to the conventional money supply.

Now that we see that the quantity of money—defined as currency and demand deposits—depends on debt, that money facilitates exchange, that money performs an accounting function of who owes what to whom, and that money is only one place to store wealth—and in inflationary times, not a very good place—let us return to the monetary crises associated with continued and heavy imbalances in the international flows of money.

The U.S. international transactions have tended toward a positive balance of trade—except for the last 2 years—on the basis of our usual accounting methods. But, with heavy net capital outflows, we have tended toward a negative balance of payments. A century earlier, this negative balance probably would have been covered by gold outflows. We have used gold for that purpose in recent times, but there are other ways to balance our debts to the rest of the world. Let me mention two of them. First, we can write checks which can be deposited in foreign banks. Second, we can send over securities, such as U.S. Government bonds. Both the deposits and bonds represent United States debt to foreigners.

Foreign banks can use our IOU's as reserves against which to make loans and to create money just as we can. When we transfer demand deposits and Government bonds to foreigners, we reduce our money supply as they increase theirs. In this way, the capital drain in our balance of payments can lead to expansion in the money supply in other countries based on United States debt. The so-called Eurodollars are created out of the float of United States debt circulating abroad and not yet settled.

For a long time, money based on private and public debt by the United States was considered abroad to be a convenient medium of exchange, a useful unit of account, and a safe store of value. That was before there was so much of it, before the present inflationary pressures, and before several developed nations recovered from World War II. Now, United States debt underlies a significant portion of the world money supply and the simple laws of supply and demand suggest that growth in the quantity should be expected to weaken the price.

When, on top of that, you consider that inflation is causing all money to be less important as a store of value, the pressures on the dollar intensify. People are giving up dollars and other currencies to hold gold and other commodities, including land, where they think their wealth is better protected against inflation and recession. Thus, the high price of gold and the low value of the dollar in international trade are symptoms of imbalances in the international flows of goods and money—imbalances that have been widening rather than narrowing in recent years.

The international monetary situation is, of course, more complicated than the simple story told here. But this story portrays a part of the problem. And understanding the problem in this way suggests certain things we can do to ease the international monetary crisis.

Inflation at home aggravates the problem. Higher prices at home make our exports less competitive in world markets; they stimulate the use of commodities and other investments as a store of value instead of money. It would help to slow down inflation, which is part cause and part effect of the international monetary crisis.

Rising consumer expenditures, stimulated by economic growth at home, tend to raise imports relative to exports, which makes the balance-of-payments situation worse. This suggests that a recession at home would ease the international monetary crisis by reducing imports. But it would cause problems of unemployment and poverty. So we want to reject this strategy if we can.

Low interest rates at home fan the problem because domestic capital will fly to other countries where interest rates are higher. However, high interest rates at home, maintained to avoid a drain on U.S. capital have unintended side effects. High rates cause cost-push inflation on the one hand and reduced investment with possible unemployment on the other. Policies which ease the international problem can cause other and more difficult problems at home.

Recession and high interest rates may be good for the international situation, but they are not what we want for the domestic situation.

There must be some other way. If we wait for other countries to take the lead, we must hope, for our own benefit, that they will seek more real growth—which they would like and which would expand markets for our exports—plus more inflation and higher interest rates—which they might not like but which would reduce our imports and allow us to maintain high interest rates without spurring a drain on capital. To hope for that is wishful thinking.

Devaluation helps by treating the symptoms. It makes our exports more attractive in world markets, and it reduces our propensity to import. So the pressures from a negative balance of payments are eased. But devaluation by a country heavily involved in world trade can have adverse effects on other countries. If the causes of the negative balance are not treated, the initial problem will return and the beneficial effects will prove to have been temporary.

Each of the above policies clearly presents difficulties. Any single strategy is likely to help one aspect of the problem but worsen other aspects. So we have to look at several strategies operated together. The several strategies we have tended to follow over the past decade to deal with domestic and foreign macroeconomic problems are these: We have run large and inflationary Government deficits at home and negative balances of payments abroad; we have used tight money and high interest rates to fight inflation and ward off the dollar drain. Yet, while these policies have been in place, we have continued to experience a dollar drain, pressure on gold prices, rapid inflation, and high unemployment.

An alternative is to reverse some of our strategies. For example, we could raise taxes and/or reduce Government spending to ease the inflationary pressures that come from excess demand. We could then increase the money supply in order to lower interest rates, induce private investment, and maintain full employment. The loophole here is that low interest rates at home relative to abroad would induce a capital drain; something is needed to prevent this. The dollar drain could be limited, for example, by a capital export tax such as we had during the early 1970's.

It is true that the international monetary crisis is more complicated than I have presented it here. But it is also true that the view I have outlined points to economic policies that are quite different from what has actually been done during the past decade. Families generally gain from a national economic situation of steady growth, stable prices, and full employment. International trade and related flows of money in international markets play an increasingly important role in attaining these gains. Since we, as members of families, are influenced by changes in the world economic situation, we need to try to understand what caused it and how to change it, even though the actions required are not ones we can take as individuals. It is time to think the matter through again.