The Economic Outlook

and

The Effect of Budget Deficits on American Agriculture

Martin Feldstein*

I am very pleased to be here with you today. Since I joined the Administration two months ago, one of my many pleasant experiences has been getting to know Jack Block and working with him on some of the issues that are of critical interest to American agriculture, especially on the problem of agricultural exports. I'll have more to say about that subject in a little while. But first I want to comment more generally on the outlook for the American economy.

The Economic Outlook

I can summarize my view by saying that the economy is still relatively weak but that the favorable signs of an upcoming recovery are getting stronger all the time. The most recent data that we have about most aspects of the economy relate to October. These figures generally show that the level of economic activity in October was below that of September. There were declines in industrial production, in employment, and in real average weekly earnings. The unemployment rate rose three-tenths of a percent to 10.4 percent.

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There have, however, also been several indications that business is improving. The number of housing starts was up again in October and is now running 30 percent above the level of a year ago. The number of housing permits is up even more sharply, having jumped 33 percent since August. (I might just note parenthetically that all the figures that I'll refer to today are seasonally adjusted data.)

Automobile sales have also been rising significantly, with the level of sales in the first three weeks of November significantly above that of earlier months this year. This reflects increasing consumer confidence and lower financing costs.

Looking to the future, there is every reason to think that the economy is now ready to recover. The index of leading indicators, a statistical index that summarizes 12 measures that generally turn up before production and employment begin to rise, has increased in five of the last six available months. It is not surprising that virtually every private forecaster expects that economic activity will be stronger in 1983 than in 1982. The monthly survey of 43 leading private forecasters that was done earlier this month found every one of them predicting a higher level of GNP in 1983 than in 1982, with the average of these forecasts calling for a GNP rise of 3.1 percentage points between 1982 and 1983.

One of the principal reasons for optimism that the economy is now headed for a recovery is the substantial fall in interest rates during the past few months. It is customary for a decline in inflation to induce a decline in interest rates with something of a lag, and the current period of disinflation has been no exception. Although inflation began to decline last year, interest rates remained high. By June of 1982, the 6 month commercial paper rate was only one percentage point below its average in 1981 and long-term rates were actually higher in June of 1982 than they had been in 1981.

The past five months have seen a sharp decline in interest rates. The commercial paper rate has dropped from 13.8 percent to 8.8 percent. The prime rate is down from 16 1/2 percent to 11 1/2 percent. Long-term rates have also declined substantially. The current corporate Aaa bond yield of 11.7 percent is about three percentage points below the 14.8 percent level of June. The home mortgage commitment rate has also declined sharply, from 16.7 percent in June to less than 14 percent now.

The economy's natural tendency to recovery will be reinforced by the monetary and tax policies that are now in place. Probably the best guage of monetary policy is now the behavior of the real value of the broad measure of the money supply known as M2. In the current year the real value of the money stock has been increasing at an annual rate of 4.6 percent. Last year the real value of the money stock actually declined somewhat. A positive real growth of the money stock is a key precondition for real economic growth and is therefore one of the basic leading indicators of economic activity.

I should hasten to add that this increased growth of the real money stock is not the result of any switch in the Fed's monetary policy. The Fed has continued to follow a policy of gradually decreasing the size of the nominal money supply. The level of M2 increased ten percent in 1981 and has grown at a rate of 9.6 percent this year. But the sharp decline in inflation between 1981 and 1982 has turned this relatively constant growth of the nominal money supply into a significant increase in real money balances.

A further source of stimulus to the economic recovery in the year ahead will be the decline in taxes. For many years now, inflation has been pushing families into higher tax brackets and forcing them to pay a higher share of their income in taxes. That was reversed in 1982. A middle-income family that had the same real income in 1982 as in 1981 saw its real federal income tax liability fall by about six percent. The same thing is likely to happen next year, with the 1983 real tax liability more than 6 percent below the 1982 level. In the aggregate, the Treasury's total tax receipts are likely to be about six percent lower in real terms in 1983 than they were in the 1982 fiscal year.

These changes in interest rates, taxes and real money growth take time to work but they do provide a foundation for economic recovery. It is, of course, difficult to predict the near-term outlook, especially at a time like this when the economy is presumably near a turning point. But I do agree with the broad consensus of private forecasters that real GNP and the level of economic activity will be higher in 1983 than in 1982.

Economic recovery need not be accompanied by a new round of rising inflation. There is now substantial slack in the economy and many firms are in a good position to increase output without raising prices. It is extremely important to avoid overheating the economy as it enters the recovery. Experience has shown that attempts to fine-tune a recovery are often self-defeating. The use of expansionary monetary and fiscal policies to accelerate a recovery has frequently caused an increased rate of inflation or a short-lived recovery. I certainly hope that the very high price in unemployment and lost output that has accompanied this decline in inflation will deter future governments and monetary authorities from pursuing policies that might rekindle the inflationary spiral. I am confident that this Administration will exercise appropriate caution and I believe that the Federal Reserve will also persist in its policy of aiming for a level of nominal GNP that is consistent with a gradual reduction of the underlying rate of inflation.

I know that the combination of an economic recovery, declining inflation and lower interest rates will be very much welcomed by American farmers as it will be by everyone else. There is, however, a major problem that now threatens the American economy in general and our farmers in particular. That problem is the very large potential deficits that now loom ahead of us.

Budget Deficits

A large cloud will hang over the agricultural sector unless Congress and the Administration work together to take the dramatic steps necessary to reduce the deficits now projected for 1984 and later years. Let me explain why deficits would have such a dire effect on agricultural sales and farm incomes.

The basic reason is that American agriculture depends on exports and that large budget deficits would hurt our nation's ability to export. I know that I don't have to tell you about the importance of exporting for the American farmer. Last year agricultural exports exceeded $40 billion and accounted for more than thirty percent of total agricultural sales. For some crops, the export share is very much larger. The size and shape of American agriculture today can continue and prosper only if our nation's ability to export is maintained and enhanced.

Budget deficits directly impede our export potential. A budget deficit means that the government is competing with private borrowers for available savings. This extra demand for credit causes the real interest rate to rise. A higher real interest rate attracts funds from abroad and this potential inflow of capital causes the exchange rate to rise. The stronger dollar weakens the competitive position of U.S. exports in the world economy. In short, budget deficits mean higher real interest rates and a stronger dollar. This raises the cost of U.S. farm products to buyers in other nations and therefore reduces their demand for our agricultural exports.

There is another way to see why budget deficits hurt our exports. Budget deficits must be financed and some of that financing comes from abroad. But an increased capital inflow from abroad means that there must also be an increased net inflow of goods and services from abroad. That is a basic fact that is reflected in our national income accounts: the net balance on the capital account must equal the net balance on the current account. Or, to put it differently, borrowing from abroad only transfers resources if there are more imports or less exports or both.

During the past two years our high real interest rates have contributed to an unusual strengthening of the dollar relative to other currencies. Since 1980, the German mark has increased nearly 50 percent when account is taken of differences in the rates of domestic inflation in the two countries. The story is similar for the French franc and the Japanese yen. The high real interest rates that contributed to the stronger dollar over this period were associated with the declining rate of inflation. In the future, however, the real interest rate will be kept high unless the large potential budget deficits are avoided.

Total merchandise exports of the United States have declined significantly during the past two years. Merchandise exports were $61 billion in the first quarter of 1981 but less than $52 billion by the third quarter of this year, a drop of 15 percent. Since total export prices were rising over this period, the decline in the real volume of exports was even greater. During the same period agricultural exports declined by an even greater percentage, with a much greater decline in the export of grains.

The third quarter of 1982 saw a merchandise trade deficit of more than $13 billion, the largest quarterly deficit in the postwar period. Experts now forecast that the 1983 merchandise trade deficit will be about $75 billion or more than twice the previous record level. Some of this enlarged deficit will reflect increased imports but much of it will be the result of reduced exports. Agriculture will inevitably bear its share of any such decline in exports.

A sharp decline in our exports and increase in our imports would also be likely to exacerbate the rising pressure for protectionist measures. We already see the spectre of protectionism in the political rhetoric and in the measures introduced in Congress. It is crucial to bear in mind that domestic content rules for automobiles and other policies to protect U.S. markets at home would almost surely be met by increased protection of domestic markets by other countries.

An increase in protectionism and a decline in world trade can only hurt U.S. farmers. I am well aware of the problems that our farmers already face in selling abroad, especially in competition with the heavily subsidized exports of the European community. But our farmers still export far more than we import of agricultural products. Last year there were more than two and a half dollars of agricultural exports for every dollar of agricultural imports. There can be no doubt that the U.S. farmer would be one of the major losers if there is a decline in world trade.

In short, large budget deficits in future years would hurt agriculture directly by raising the value of the dollar and indirectly by contributing to the risk of U.S. policies that induce protectionist barriers abroad. A healthy recovery for American agriculture requires shrinking dramatically the potential deficits that now loom ahead.

Projected Deficits

What are the prospects for getting the deficit under control and shrinking its value to zero?

The budget outlook for the 1983 fiscal year that began last month is not at all good. Although we are still waiting for Congress to pass some remaining appropriation bills, the budget for the current fiscal year is more or less fixed. While I cannot quote the Administration's precise forecast to you, I can tell you that a number of private estimates have placed the likely deficit at between $150 billion and $200 billion. A deficit of even $150 billion would represent more than four and a half percent of GNP, a larger share than in any previous year.

Let me emphasize that although the fiscal year 1983 deficit is now essentially beyond our control, the deficits in future years can be and must be reduced. At this time, the deficit projections for 1984 and beyond are only estimates of the implication of continuing with the status quo -- that is, with the nondefense outlays and taxes implied by current law and with the future defense outlays previously projected by the Administration.

We in the Administration are now hard at work on the changes from the status quo that will be in the budget that President Reagan will present to Congress in January. The President himself has been spending many hours in the past few weeks working on the budget. Although I cannot describe the details of our budget discussions, I can tell you that there are no easy answers. We will have to make difficult and unpleasant decisions. Moreover, we will need the help and the cooperation of the Congress in this critical task.

Although the problems that we face are severe, I am cautiously optimistic that we will succeed. I believe that we can gradually eliminate the deficit and that we can do so without violating the widely shared goals of protecting the poor, limiting the burden of distortionary taxation, and strengthening our military security.

If we do succeed in reducing and eventually eliminating the deficit, the 1980s can be a decade of unusual prosperity. The past two years have already seen inflation decline from more than 10 percent to less than 6 percent. The cloud of inflation should continue to recede on the horizon. The economy is now ready to recover and the recovery can be accompanied by falling inflation and rising employment. The combination of low deficits and the tax incentives that we have provided for increased saving and investment can cause a more rapid growth of the capital stock and therefore of productivity and well-being.

The key problem that the economy as a whole faces in the years ahead is getting the budget deficit under control and eliminated as rapidly as possible. Failure to do so will be particularly damaging to American agriculture. With your help, and with the help of others who recognize the importance of reducing the deficit, I think we can succeed in overcoming the forces of inertia and self-interest. I hope that in the months ahead you will contribute your energy to this urgent task.