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Agricultural Trade Policy and the World Economy

remarks of

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AGRICULTURAL TRADE POLICY AND THE WORLD ECONOMY

I am delighted to have this opportunity to speak before the members of the National Grain Trade Council. The topic of my talk today is the vitally important mechanism by which the benefits of the market system can be shared and enhanced among all countries of the world: unimpeded international trade. Specifically, I wish to discuss agricultural trade policy, a topic that I have been concerned with for many years, a concern shared by your organization. The liberalization of world agricultural trade has eluded the best international negotiators for decades, ever since the United States requested a waiver from the General Agreement on Tariffs and Trade (the GATT) in the 1950s for its agricultural price-support programs. The costs of these illiberal trade policies, as I will mention later, are astounding. But I firmly believe that we currently have a unique opportunity to succeed on world agricultural trade where before there has been not much more than failure. Reforms in Eastern Europe and elsewhere toward greater reliance on market forces in the economy mean that there is some momentum for changing long-standing policies. However, there is also a danger that without a GATT breakthrough Europe 1992 will take one more step toward a fortress Europe. We stand to lose significantly if we fail to achieve a breakthrough. But with a herculean effort, the United States can move world trade negotiations on agriculture forward.

Over the past decade, political and economic liberalization has accelerated around the world. The radical changes in Eastern Europe and the Soviet Union have, of course, captured the attention of the world. But, more quietly, many countries in Latin America, Asia, and even Africa have also seen a resurgence of pressures for democracy and a new appreciation of the market place as an efficient mechanism for the organization of an economy and for the promotion of economic development.

In the realm of economic reform, the fate of these countries lies in all our hands. Property rights must be secured, monetary and financial systems must be made sound, and marginal tax rates generally reduced to provide incentive for investment and production to be established. But free world trade is a vital ingredient for helping to build the prosperity of the economies formerly subject to socialist regulation. To help liberate these countries from the stifling confines of self-imposed autarky, there must exist a world market-place ready to purchase what they can produce competitively for export and to sell them what they cannot produce efficiently themselves. If greater opportunities for trade were not open to them, domestic economic liberalization would be a less attractive prospect because the perceived gains from participating in the world-wide division of labor would be smaller. Without free trade as the principle underlying transactions in the world economy, deregulation and liberalization around the world would be less successful and the benefits from the rise of market forces would be less pronounced.

The General Agreement on Tariffs and Trade must be given the lion's share of the credit for facilitating the tremendous increase in world trade after World War II. The GATT oversaw the substantial reductions in tariffs in the post-war period and enhanced the attractiveness of the market system by making it more prosperous. Exports from developed market economies grew 10 percent faster annually on average from 1970-88 than the trade of centrally planned economies. Over this period, trade has been an engine of growth in the market economies, growing at a more rapid pace than total output.

Recently, however, the GATT released some potentially ominous statistics: growth in the volume of world trade slowed from 7 percent in 1989 to 5 percent in 1990, and a further slowdown is expected this year. To some extent, these figures reflect the general slowing of economic activity that has occurred in a number of industrial countries. Nevertheless, the slower rate of growth in world trade adds to the risk of a resurgence of protectionist pressures around the world, and thus highlights the need to continue the process of world trade liberalization.

The risks associated with slower growth in world trade is particularly acute as regards agricultural trade, already riddled with government interventions and subsidies. Slower growth in world trade impinges on both agricultural exporters and importers: many agricultural exporters may undergo pressure to subsidize sales, harming free-trade agricultural exporters; and these subsidies in turn contribute to lower world farm prices that may spark renewed calls for protection in developing countries that have relied on imports of agricultural goods.

The threat of protectionism creates particular difficulties at this point in history. We cannot allow protectionist forces to keep a closed door to countries that are trying desperately to shift their economies toward a market-based system. With the collapse of communism and the world-wide reach for free-markets, we face a unique opportunity and a special obligation to press forward in those areas where trade liberalization has been elusive. It is an opportunity because respect for market forces has rarely been so high and recognition of the costs of managed trade has rarely been so great. It is an obligation because if we fail to live up to this promise, we will jeopardize forces for economic change in many parts of the Americas, Asia, and Africa, as well as in Eastern Europe, where, until recently, an appreciation for the market has been sorely lacking.

The obvious conclusion is that the on-going Uruguay Round of the GATT trade negotiations should be given a top priority and be drawn to a successful and prompt conclusion. In addition to further multilateral reductions of tariffs, it is essential that the use of quotas (which typically are more restrictive than tariffs and are found much more commonly in agricultural trade) be curbed and reduced and that other non-tariff barriers that impede the free flows of goods across borders be reduced jointly and fairly. We owe this not only to our own citizens, who will be harmed by any turn away from an open international trading system, but particularly to those people in other countries that have been denied the benefit of participating in 40 years of unparalleled growth in trade and world prosperity. We cannot hold out to these people the great prosperity generated by entrepreneurship and the free market, and then shut them out, deny them access to the markets of the developed world and to deny them the very mechanism that contributes to our prosperity, namely, unimpeded world trade.

Fortunately, accepting these countries as full trading partners within the open trading system does not entail net sacrifice on the part of the industrial countries. To create new barriers to world trade, or to keep old ones intact, not only violates the obligation we have to foster an environment where others can improve their welfare, but harms our own economic well-being. Nowhere can this be more clearly seen than in world trade in agriculture. Agriculture deserves special attention because it is in precisely this sector that the countries of Eastern Europe, the Soviet Union, Asia, Africa, and the Americas, as well as the Cairns Group led by Australia, Argentina, and New Zealand, have a vital stake in world trade, and where a number of these producing countries have an initial comparative advantage in agricultural production. Agricultural trade will be a key component to their economic development as these countries liberalize their economies.

This may come as a surprise. As we watch the television footage of chronic food shortages and empty shelves, and read about inadequate diets in Eastern Europe and elsewhere, we may wonder whether any of these countries have the potential to improve and expand agricultural production. In most cases, the source of their problem lies not with the weather or the soil, however, but with the central planning and command-economy aspects of these countries. Central planning is at fault not because of the incompetence of those in charge, but because the very nature of the system emits disastrously wrong signals. The big development error of the post-war period has been for communist and many developing countries to promote industrialization by government directive through strangling agriculture in setting prices for farmers artificially low. Taxing agriculture to sustain an artificial and (in world markets) unviable manufacturing base brought them harm and lowered their standard of living substantially.

Once private agricultural markets flourish in these countries with price reforms, there is no doubt that they have the capability of becoming major commodity exporters. In China, for example, price and incentive reforms spurred agricultural output to increase by over 60 percent between 1978 and 1984. In the Soviet Union, private plots account for only 1-1/2 percent of all agricultural land but produce as much as a quarter of all farm output. If and when the Soviets change their policy and reallocate and secure property rights, something similar to the Chinese miracle can be expected to happen there too. This will not only benefit Soviet farmers and consumers, but the additional purchasing power of the rural sector over time will generate substantial demand for U.S. manufactured exports--farm equipment, machinery, transportation goods, and the like.

If, however, such reforms are met with a closed world market because of short-sighted policies in the developed world, not only will U.S. taxpayers and consumers pay the price, but we will have stymied economic reform and possibly upset political stability on the way to democracy, in precisely the region of the world where reform and stability are most urgently needed. Emerging developing countries are apt to have a comparative advantage in agriculture and they are at risk of being shut out of the world trading system.

Unfortunately, agriculture has been one area that has eluded the efforts of Western trade negotiators in the post-war period. The United States in 1955 requested and obtained an exemption from the GATT for its agricultural price-support policies. Under a similar guise, the European

Community used this waiver to expand and extend its protectionist agricultural policy, known as the Common Agricultural Policy.

The distortions that American, Japanese, and European trade policies for agriculture engender are well documented. These agricultural policies are intended to provide a "safety-net" for farmers, taking income from consumers and taxpayers and transferring it to producers. Regrettably, these transfer payment systems are short sided; they provided large windfall gains to initial resource owners, limited benefit for tenant farmers, and potential windfall losses to farmers who are currently purchasing land. Attempts to maintain higher prices for farm output attracts additional resources into farming and thereby in the long run subsidizes food and fiber consumers. By tying income support to agricultural production, the policies misdirect too many resources into agriculture, burdens the taxpayers with excess agriculture products and thereby motivates massive agriculture dumping programs that destroy the environment for indigenous agriculture.

According to the most recent statistics from the OECD, total taxpayer and consumer transfers to agriculture in the OECD last year (1990) amounted to $300 billion. For every dollar a farm producer receives in the EC, consumers and taxpayers cough up $1.90; and in Japan, each $1 for producers comes at the cost of $3.20 from consumers and taxpayers. While the United States is somewhat more efficient by these measures, consumers and taxpayers in the mid-1980s spent $16 billion to yield producers an $11-1/2 billion per year makeup for the lower prices which emanate from overutilization of our resources in agriculture. In other words, the deadweight losses--the economist's jargon for pure waste--are tremendous.

But the Common Agricultural Policy of the EC deserves special dishonorable mention. The CAP cost EC consumers and taxpayers over $80 billion in 1990. The CAP entails greater distortions than other agricultural policies around the world--it is more than twice the total U.S. transfer of $35 billion and Japanese transfer of $30 billion. What is worse, it has proven to be more deeply entrenched and difficult to remove. The current problem of bringing the Uruguay round of trade negotiations to a conclusion is due in part to the intransigence of the EC to even consider serious agricultural reforms.

It is clearly not in the EC's direct self-interest to have the former East bloc countries join the CAP, as that would potentially double the costs. Surely the EC will recognize that this outlandish subsidy program will either be curtailed or it will double every three to five years. Clearly, a new liberalized regime in agricultural trade should be established. Indeed, the most direct but far from simple way to eliminate distortions which then would bring agriculture prices into a world market system, and thereby help the nations of Eastern Europe is an agreement to eliminate completely all agriculture subsidies and quotas by the end of this century.

This long-standing administration proposal to disengage agricultural subsidies in the industrial countries with a suitable transition period is an excellent step forward that should continue to be pressed. Liberalization is particularly urgent now if we wish to offer the poorer countries of Asia, the Americas, and Africa, as well as the East European economies access to the world economic system and give them a stake in maintaining a market-oriented system. As they join in the world trading system, their comparative advantage dictates specialization in agricultural products and low-technology manufactured goods. Hungary and Poland are well positioned to become important exporters of agricultural goods. The Ukraine is also similarly situated. Western markets should be receptive to their goods because this pattern of specialization is, of course, good for us; our purchases of their agricultural goods in which they have a comparative advantage will finance their purchases of our specialized high quality farm output and our manufactured goods. But it is particularly beneficial for Eastern Europe and others in two respects. First, it will allow these countries to raise their incomes and standards of living, bringing them out of relative or absolute poverty and into the community of trading nations. Second, economic wealth will contribute to political stability in Eastern Europe and elsewhere. Economic development and the acquisition of wealth does have a positive impact on world peace and world stability. Once again our motto should be trade, not aid.

While this opportunity for agricultural trade liberalization is best handled in the Uruguay Round sponsored by GATT, the United States is in an excellent position to assist one particular country in the immediate future: Mexico. The United States and Mexico along with Canada are currently negotiating a Free Trade Agreement. Many of those opposed to the proposed free trade agreement with Mexico have exaggerated the supposed negative impact of such an agreement on the United States and have minimized the benefits for Mexico and the United States. The agreement will help to achieve long-lasting benefits by making Mexico more economically prosperous and politically stable. The agreement will facilitate continuation of trade reform in Mexico and make its agriculture and industries--which have been sheltered behind high tariffs--much more efficient. Unfortunately, there are some who are satisfied to replicate the U.S. agriculture subsidies system in Mexico. This is most undesirable as such a large proportion of the trade between Mexico and the U.S. in a free trade environment would be due to different comparative advantages in agriculture; Mexico in produce and tropical foods and the U.S. in small grains and feed grains.

The changed attitude in Mexico toward recognizing the gains from international trade and the reform of government planning is infecting other Latin American countries as well. Several countries have initiated trade reform on their own. Trade agreements among several South American countries, such as Argentina, Chile, Brazil, and Paraguay, have also proliferated. Perhaps it is not too much to hope that by the dawn of the twenty-first century, all the countries of the Americas will be linked by free trade, allowing for the most suitable division of labor in both agricultural and industrial production.

The liberalization of agricultural trade with Eastern Europe and one hopes with Mexico and Latin America will require some short-run adjustments here at home. The tragedy of subsidies is that they confer windfall gains to some and more hidden and widely spread losses on others, such that initially the political costs of reform appear large relative to the benefits. If Eastern Europe moves to a market system with proper incentives, U.S. and EC grain exports abroad temporarily fall. If Mexico adopts free trade with the United States our policy of subsidizing water for irrigation purposes in California will need to be on the negotiating table. But the benefits of reform in agriculture are so large and so tangible that the existence of some adjustment costs for the United States is no excuse for not liberalizing, for not undertaking the reforms.

Finally, I would like to say a word about monetary policy. I am, of course, a central banker, and the question that may be on your minds is why I have spoken so extensively about reducing trade barriers and promoting international trade, which may seem to have little directly to do with monetary policy. Actually, there is a link between these trade policies that increase real economic growth and our task at the Federal Reserve in implementing monetary policy. Namely, central bankers have an interest in policies that raise the potential for real economic growth because it reduces the temptation to use monetary policy to enhance short-term growth even though long-run growth is thereby severely damaged. Higher growth rates mean that reducing inflation becomes an easier task. The rate of price increase can be edged down while real economic activity remains relatively vigorous. For central bankers, this is bliss: achieving lower inflation, not only without much of the pain that accompanies a monetary tightening, but with higher growth in incomes!

In addition, increases in protectionism in agriculture and elsewhere raises prices in the short run. These higher prices are apt to become embedded into the wage and cost structure of the economy and contribute to an inflationary environment. Removing protectionist policies not only eliminates distortions in the economy and promotes growth, but tends to lower the price level and thus contributes to a lower long-term interest rate environment that enables short-term interest rates to fall to a more permanent lower level.

Monetary policy itself, of course, cannot expand long-term growth beyond its potential. In fact, monetary policy works best not when it is doing anything to manipulate the economy, because that is largely beyond its capability; monetary policy works best by not inflicting any harm on the economy. An ill-conceived monetary policy can bring harm in two ways: it can raise uncertainty about future prices, causing investment decisions to be less efficient; and it can induce a "bunching" of activity. Repeated accelerating and braking of policy wastes economic resources and lowers the welfare of nations. Needless to say, the Federal Reserve is trying to avoid these costs by pursuing the goal of price stability. Continued commitment to such a goal will create the kind of financial stability conducive for investment and trade that will help our citizens, and those of the rest of the world, achieve more prosperity than might otherwise have been the case. Fostering and maintaining an open trading environment will assist in meeting these objectives.