

THE NEW ECONOMIC POLICY -- IMPLICATIONS FOR AGRICULTURE

Speech by

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It is good to have this opportunity to discuss with you some implications of the President's new economic program with respect to agriculture. I am particularly interested in this topic since the program has elicited high-pitched discussion and even more important it could have a serious impact on the volume of agricultural trade in world markets.

Major features of the program are:

1. A tax credit on investment.
2. Repeal of the 7 per cent excise tax on automobiles.
3. A speedup of the scheduled personal income tax exemptions.
4. A \$4.7 billion reduction in Federal spending and a 5 per cent cut in the number of government employees.
5. A 10 per cent cut in foreign economic aid.

6. Creation of wage and price boards to administer wages and prices in key industries.
7. Suspension of the convertibility of foreign held dollars into gold. 1/
8. Devaluation of the dollar with respect to gold and with respect to many foreign currencies. 2/

Most of this discussion will be limited to the foreign trade features of the program. This is done for several reasons. First, farm products are excluded from the direct controls on wages and prices. Second, the Phase II announcements still leave numerous questions unanswered as to how the proposed wage and price controls will be implemented. Third, the other proposals will likely have only marginal impacts on agriculture.

Foreign Trade Profitable

Although international trade represents only about five per cent of the nation's Gross National Product, it has a much greater impact on agriculture. Farm commodity exports totaled almost \$8 billion in the last fiscal year and accounted for more than fifteen per cent of total

1/ "Address by the President," August 15, 1971

2/ "Address by the President," December 18, 1971

farm product sales. Exports are thus a vital factor in determining total demand for farm products and total farm income.

Farm products cannot be sold abroad indefinitely, however, unless we are willing to purchase something in return. International trade must be a two-way exchange. A refusal to permit imports will soon cause depletion of the means-of-payment for our products. This nation can produce virtually any commodity or service that it consumes; thus we could abstain from international trade altogether. Such a highly protective route is, of course, the least desirable alternative because international trade is profitable.

Gains Accrue to Both Exporting and Importing Nations

International transactions provide the same opportunity for gain as domestic transactions. We do not question the gains resulting from domestic specialization of productive resources and the exchange of the resulting output. When a dairy farmer sells milk to an automobile worker and in turn purchases an automobile,

the welfare of both dairy farmer and automobile worker are increased. The value of the output is greater than if each tried to produce both dairy products and automobiles. Similarly, the value of total output of goods and services in the State of Wisconsin and the City of Detroit is greater as a result of the exchange of milk from Wisconsin for automobiles manufactured in Detroit. Just because Wisconsin happens to be in the United States rather than in Canada has no influence on the gains. Well-being would have been enhanced an equal amount if Wisconsin were in Canada. International trade is thus profitable to both farmer and other producers of products for export and to consumers of foreign produced goods and services. Exporters and consumers in other nations receive similar benefits.

Since all trade is profitable to both parties, any hinderance to trade through taxes, quotas, or other restrictions reduces welfare. Both dairy farmers and automobile workers would have fewer goods and services if the exchange of dairy products for automobiles were artificially reduced through restrictions. Similarly, any interference with international trade leaves each trading nation with fewer goods and services.

Some contend that protective trade barriers are necessary for the U. S. to maintain a high level of employment, high wages, and a high standard of living. I believe that trade restrictions are neither conducive to high real wages nor to a high living standard. They aid producers in the protected industries by shielding them from competition from more efficient producers abroad.

Nations following restrictive trade practices retain productive resources in less efficient lines of output thereby reducing the total volume of goods and services available to consumers. Let's view the problem in terms of protection carried to its extreme. All foreign competition for each actual and potential domestic industry would be eliminated and international trade would soon come to a halt. Each nation would be self-sufficient but, like our dairy farmer and automobile worker, self-sufficiency involves each nation trying to produce everything. It will result in less total output of goods and services. With less product, wages in terms of purchasing power for goods and services will decline. Thus in contrast to contentions of the protectionists that trade barriers which limit competition are beneficial they actually reduce real wages and well-being.

The number of jobs in the protected industries will increase but the gain will be offset by a decline in jobs elsewhere. The total number of jobs in the nation over the longer run is limited only by the number of people who want to work at the market wage rate and the legal or other restrictions on employment. Farmers have always known that those who wanted to work and could not find an acceptable job with another person or firm became self-employed producers of valuable goods and services. Unemployment is a phenomenon during which productive workers are searching for the market price of their labor and is not affected by free trade in the longer run.

Since international trade enhances well-being it is important that a means of payment be maintained which will be conducive to such trade. Like all other valuable goods, imports must be paid for, and exports are the ultimate means of payment. But, since item by item matching of imports and exports is extremely inefficient, we avoid it by using the international payments mechanism, just as we avoid the matching of goods and services in domestic transactions with the use of money. Instead of one currency, many are used in foreign transactions, and the determination of their relative value - the exchange

rate - is one of the major results of the workings of an international payments system.

The International Payments System

The international payments mechanism, as established by the Bretton Woods agreements of 1944, provided that countries can fix their exchange rates either in terms of gold or in terms of the dollar. As it turned out, the United States established the price of the dollar at \$35 per ounce in terms of gold, and most other countries established the prices of their currencies in terms of the dollar. Exchange rates were required to be maintained by foreign central bank intervention. The central banks were required to buy dollars when the price of the dollar showed a tendency to fall in terms of their currencies and sell dollars when the price of the dollar tended to rise.

Until the latter half of the 1960's the United States experienced a significantly lower rate of inflation and a lower amplitude of cyclical fluctuations than did other major foreign economies. Therefore, the dollar was the most stable of all major currencies. It was extensively used as an international means of payment despite some overall balance of payments deficits. A large resulting deficit-induced dollar balance was thus held willingly and provided a service as international money.

During the late sixties, however, the U.S. balance on goods and services began to decline and capital outflows accelerated. At the same time, our overly expansive monetary and fiscal policies resulted in large decreases in the purchasing power of the dollar, both domestically and internationally. Thus, in world trade we had an increasing rate of dollars being supplied and a reduced demand for them.

As private individuals abroad stopped accumulating dollars the international price of the dollar could remain fixed only through massive accumulations by central banks. Foreign central banks soon found their dollar reserves excessive and began converting them into gold. By September of last year our gold supply had dwindled to \$10 billion, and we were reluctant to permit its continued depletion.

With these pressures increasing, and with no hope for redress, Germany, the Netherlands, and Belgium announced that they would no longer purchase additional dollars, thus floating their currencies and permitting them to appreciate as dictated by market forces. Meanwhile, Switzerland and Austria undertook outright revaluation by announcing that their central banks would continue to purchase dollars but only at a lower price. The U.S., faced with the impossibility of maintaining the fixed dollar to gold ration, suspended convertibility, or put another way, junked its agreement

to buy or sell gold from or to official institutions.

Fixed Exchange Rates Unworkable

In view of the failure of the Bretton Woods inspired fixed exchange rate system the question of selecting an alternative or revising the old payments mechanism arose. To demonstrate the problem, let's assume that I buy a Japanese radio and send a check for \$30 to the Japanese exporter, who deposits the check in his bank.

On the dollar exchange standard which we still have, the price of a dollar is fixed in terms of gold, and the price of Japanese currency is fixed in terms of the dollar. In order for the exchange rate to remain constant or fixed, the supply of dollars must be matched by an equivalent quantity demanded or the central bank of Japan is committed to purchase the thirty dollars at the fixed exchange rate, thus increasing their foreign reserves. If the fixed rates are not consistent with market values of the two currencies, such reserves could build up as long as the Japanese central bank is willing to hold our liabilities.

The fact that our purchases abroad have in the last year, for the first full year since 1895, exceeded foreign purchases in the U.S. is evidence that the exchange rate has not reflected the market value of the dollar in the foreign exchange market. The imbalance simply means that the U.S. has been purchasing more goods, services, and capital assets

abroad than foreigners have been purchasing from the U. S. The difference has been settled through gold shipments and rising foreign liquid claims on the U. S. Thus the real value of these purchases from abroad was greater than the dollar expenditures by those making the purchase. The goods and services were thus obtained at subsidized prices with the subsidies provided in the form of U. S. Government gold shipments and excessive foreign central bank dollar holdings.

The value of the dollar in terms of other currencies could be made consistent with the fixed exchange rate. This would involve a contraction of money income and prices in the U. S. relative to money incomes and prices abroad when our purchases abroad became excessive. To date we in the United States have not indicated a willingness to pay such a price for a viable fixed rate system because attempts to reduce money income and the rate of inflation is followed by substantial unemployment. As a consequence the adjustment mechanism for the fixed rate is not permitted to work and both farm and nonfarm exports have suffered.

The devaluation of the dollar with respect to gold and to foreign currencies still retains the dollar exchange standard and the inherent seeds of self-destruction. The realigned exchange rates are closer to market rates than they were before and thus reduce the immediate problems of foreign trade but

they do not provide a payments mechanism which would avoid future crises as we have experienced recently.

Flexible Rates Workable

Most of our foreign exchange problems of recent years could be avoided by the provision of greater flexibility in the exchange rates. A flexible exchange standard implies that the price of the dollar will be determined by market forces without official intervention. In the example of my purchase of the Japanese radio, the Japanese bank would offer my \$30 on the foreign exchange market. If there are buyers of U. S. goods and services at existing prices, the \$30 will be purchased by them, and the exchange rate will not change. But if Japanese importers view U. S. prices as being too high, they will offer less Japanese currency for my \$30 check, and the transaction will be consummated only at a lower price of the dollar in terms of Japanese money. Thus my import is still paid by an export, but only when accompanied by a change in the exchange rate.

The flexible exchange rate would permit the necessary currency adjustments and establish a balance between imports and exports. An excess of imports by the United States will cause a decline in the price of the dollar in terms of foreign currencies. This would make

foreign goods more expensive to us and our commodities cheaper to foreigners. This change in relative prices would discourage imports and encourage exports.

A flexible rate does not require major central bank or government actions in the foreign exchange market. With the fixed exchange rate system such actions have been taken in attempting to mitigate the adjustments necessary to correct a disequilibrium in international trade. Such actions have resulted in persistent and fundamental trade deficits and surpluses. These imbalances have in turn produced crises requiring periodic adjustments in the exchange rate, direct controls, and other arbitrary impediments to international trade.

A flexible exchange rate does not imply domestic fluctuations in income and employment. It is self-adjusting and reacts quickly to imbalances, thus providing for smoother trade patterns. It is therefore more likely to be permitted to function without excessive interference.

Virtually all national governments are committed to the achievement of stable conditions in their domestic economies. For example, it is difficult to imagine that, given an import balance, the United States would be willing to permit a contraction of domestic production and higher unemployment. It is just as difficult to visualize Japan

deliberately submitting to inflation because their exports have exceeded their imports. In the choice of an exchange rate system, it seems to me, the crux of the matter is not the ability of a system to make necessary adjustments. They all can be made to correct imbalances provided we are willing to pay the price in terms of domestic employment and income. Given, however, the demonstrated political necessity of maintaining full production and employment, it is a matter of selecting a system which will be permitted to remain viable and correct imbalances. Flexibility in the exchange rates will meet this requirement, which is not met by fixed rates.

Impact on Total Foreign Trade

With this background of recent economic actions and some alternative possibilities available for an international payments mechanism, let's take a look at the probable impact of these actions on total volume of foreign trade.

The suspension of the convertibility of the dollar into gold has led to a substantial readjustment of exchange rates and the official devaluation on December 18 has added further changes. For example, the Canadian dollar has increased 8.1 per cent relative to our own. Other currencies with important gains relative to our own are the German

mark, up 13.6 per cent; the Netherlands guilder, up 11.6 per cent; the Belgium franc, up 11.6 per cent; and the Japanese yen, up 16.9 per cent.

A rise in the value of these currencies relative to the dollar means that importers in these countries can purchase U. S. products at a lower price in terms of their currencies. This should stimulate U. S. exports. How long this additional export stimulus will continue depends on the exchange rates required to avoid imbalances in trade between the U. S. and the rest of the world.

If floating or relatively flexible rates would have been maintained indefinitely, it is my belief that they would have contributed to a moderately rising volume of international trade. One reason for this view is that such a payments mechanism is not as likely to induce governments to interfere with the profitable exchange of goods and services between nations. In the absence of gold convertibility, there will be less reason for restricting imports to avoid gold losses. Neither will it be necessary for governments to worry about their holdings of other types of foreign exchange if exchange rates are permitted to float freely. Any nation's exchange rates will be determined by the value of its products in the export market. Without such worries there is little reason for government interference with the payments mechanism or with normal trade patterns.

Flexible exchange rates are also likely to involve less risk to exporters and importers over an extended period than fixed rates, thereby contributing to a rising volume of trade. There is little doubt, however, that daily fluctuations in flexible rates induce marginally greater daily risks and somewhat greater costs of international currency convertibility. This is supported by the sparse historical evidence and by the recent behavior of the forward rate. The forward rate, which, among other things, reflects the insurance premium for delivery of some currency at a specified price at some future date, has increased. Interestingly enough, however, the increases are minimal where the float is "clean" and large where central bank intervention is either present or anticipated. This seems to indicate that actual flexibility is a small contributor to increased costs, while intervention or anticipated revaluations under a fixed rate are the real culprit.

Most of our domestic commodity, stock, and money markets have hourly fluctuations, and the premium associated with frequent changes does not appear to be prohibitive nor does it impair the efficiency of these markets. Here too, large fluctuations in forward prices occur when there are anticipations of some natural disaster, a strike or some institutional interference, events not unlike anticipated changes in the exchange rate.

The question that should be asked is not whether costs of converting one currency to another is higher under a flexible exchange rate as compared with the fixed rate, but whether the total costs of periodic actual or anticipated revaluations are higher. Since 1944, out of 92 countries which have established parities under the International Monetary Fund, forty-five have changed par values seventy-four times. Several of these changes were accompanied by serious international economic disturbances, and most of them by domestic resource reallocations. Every sudden change in the official exchange rate causes a movement of resources between export and import competing industries, and each movement implies some structural unemployment.

These greater risks from anticipated and actual revaluations thus probably inhibit more trade than the day-to-day fluctuations in floating rates. Furthermore, the day-to-day type of risks are taken by businessmen regularly in domestic price movements. They know that such risks are likely to be offset by price movements in the opposite direction tomorrow. On the other hand, businessmen are not adept at planning for arbitrary revaluations of exchange rates. Thus, with the greater freedom of market forces under the floating or flexible system, it is my view that businessmen will feel safer in making long range investment plans for

exports and imports and that trade between nations will rise.

Impact on Agriculture

How do these prospects for increased foreign trade affect our agricultural industries? Agriculture is one of our internationally more efficient industries, and given improved trading conditions both here and abroad, farm exports should rise markedly.

Nevertheless, the picture is not as bright as a cursory view would indicate. Most nations that can pay for our farm products have programs designed to protect their farm commodity markets and to increase their farm incomes. Their programs maintain an excess of national resources in agriculture. They will therefore likely permit only limited amounts of our farm products to enter their markets. Any gains in our farm exports resulting from the President's new policies are thus likely to cause increased resistance abroad to imports of American farm products.

Furthermore, we are not in a strong position to bargain with foreign governments with respect to this protectionist problem. Our country has not been innocent in the use of these protective devices. Even in agriculture, which has such a large stake in free trade, we have established highly protectionist policies. We have sugar import

quotas which, based on the New York wholesale price, cost U. S. consumers an additional 22 cents for each five pounds of sugar purchased.^{1/} We have subscribed to international trade agreements which set minimum prices on coffee and wheat, thereby limiting trade in these commodities. We have meat import quotas which provide limits on imports of beef. Our cotton export subsidy, designed to offset the trade-retarding features of our domestic price support program, is sufficient to permit exports of cotton to Japan and imports of goods made from the cotton to the U. S. for sale in competition with our own mills. In order to avoid excessive disruptions from such competition, however, we have a tacit agreement with the Japanese to limit cotton goods exports to the U. S. Such tacit arrangements are apparently preferred to formalized legal actions, but if they are equally effective in reducing trade, they are likewise equally effective in reducing welfare.

A recent study by the University of Illinois found that Illinois farmers favor foreign trade but prefer to restrict beef and ham imports, their major farm products.^{2/}

^{1/} International Monetary Funds, International Financial Statistics, Sept. 1970, p. 29.

^{2/} Harold D. Guither, "Illinois Farmers View Current Policy Issues," Illinois Agricultural Economics, Vol. 10, No. 2 and Vol. 11, No. 1, July 1970 - Jan. 1971, p. 23.

This view demonstrates the fact that our farm sector has not thought out a consistent free trade policy. Despite its great stake in free trade, agricultural interests are confused and offer no rational program for reducing restrictive practices and freeing world markets.

However, despite our inconsistent policies, it is my conclusion that the current revalued exchange rates will provide some short run stimulus to farm exports, and if greater flexibility of the rates are a permanent feature of our payments mechanism, foreign trade could rise substantially. If this occurs we could have a larger volume of farm exports indefinitely.

SUMMARY

In summation, I am convinced that the devaluations of December 18, 1971 are going to increase United States exports and reduce imports. The devaluation of the dollar with respect to gold has no economic consequence whatsoever. It does not affect domestic prices and, since gold is not going to be bought or sold, doesn't change international prices.

The devaluation of the dollar with respect to other currencies, which could have been achieved without any reference to gold, will be instrumental in improving our International sales and balance of payments position. The agriculture, as a net exporter will certainly benefit. If

future agreements to remove trade restrictions, which are supposed to be a part of the total package to be negotiated, include removal of barriers on agricultural commodities, the American farmer will receive an additional boost. I would not be too optimistic, however, since agricultural supports, here and abroad, are the oldest and most ingrained restrictions.

My main regret is that the financial leaders chose to retain an international payments mechanism which has amply demonstrated its inequity and susceptibility to breakdown. Long-run success of any trade relations depends upon the ease with which the trading partners can adjust to changing prices and outputs. A freely flexible exchange rate system would have provided such a relatively painless adjustment, while the fixed rate mechanism will cause adjustments accompanied by crises and heavy costs of economic well-being.