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The Russian Wheat Deal—Hindsight vs. Foresight

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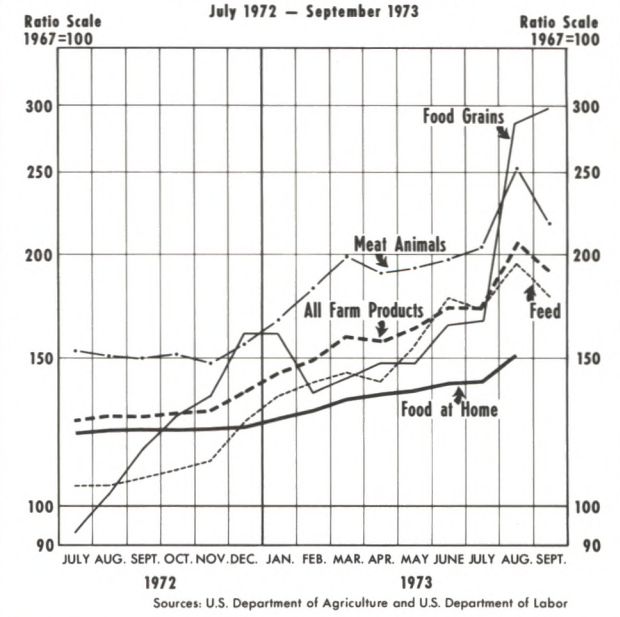
IN JULY and August 1972, the United States sold to the Soviet Union about 440 million bushels of wheat for approximately $700 million, more than the total U.S. commercial wheat exports for the year beginning in July 1971. The sales were equivalent to 30 percent of average annual U.S. wheat production during the previous five years and more than 80 percent of the wheat used for domestic food during that period. The sales involved a series of subsidized transactions following an agreement whereby the U.S. Government made available credit of $750 million to Russia for the purchase of grains over a three-year period.[1] Previously, the Russians had purchased only a relatively small quantity of U.S. farm products.

Immediately following the sales announcements, the domestic price of wheat began to rise, and within a few months the prices of feed and food grain, soybeans, and livestock turned upward and all continued to rise at a high rate during most of the next twelve months (Chart I). By year-end food prices had also turned sharply upward. The price of wheat almost tripled during the year ending in August 1973. The prices of corn and soybeans more than doubled, and the prices of steers, hogs, and broilers rose 55, 102, and 153 percent, respectively (Table I). The wholesale price index of all farm products rose 66 percent, and the wholesale price of food increased 29 percent.[2]

Chart I

Changes in Selected Prices

July 1972 – September 1973



Sources: U.S. Department of Agriculture and U.S. Department of Labor

In recent weeks most of these farm commodity prices have declined somewhat from the mid-August 1973 levels, but retail food prices have generally continued upward.

A number of critics have attributed these sharp price increases to the Russian wheat transactions. The General Accounting Office (GAO), in a review of the sales, questioned the United States Department of Agriculture's (USDA) management of the wheat export subsidy program. The GAO concluded that the

[1] Only $500 million of this credit could be outstanding at one time.

[2] U.S. Department of Labor, "Wholesale Price Index" (September 1973).

Table I

Prices of Selected Farm Products

	8/15/72	8/15/73	Percent Change
Wheat, per bu.	$ 1.51	$ 4.45	195%
Corn, per bu.	1.15	2.68	133
Oats, per bu.	.62	1.13	82
Soybeans, per bu.	3.36	8.99	168
Steers, per cwt.	35.60	55.20	55
Hogs, per cwt.	28.00	56.50	102
Broilers, live, per lb.	.15	.38	153

Sources: USDA, *Agricultural Prices* (August 1973).

export subsidies were excessive and that the sales caused a dramatic rise in the price of wheat and higher consumer prices for bread and most livestock products. The press, in addition to attributing higher food prices to the subsidized sales, referred to the transactions in such terms as "the great grain robbery," "reaping the grain harvest," and "chaff in the great grain deal."[3]

The questions raised by the critics involve both managerial problems and basic economic issues. While the accounting and auditing problems raised may be important and require additional rules and procedures for operating the program, this article deals only with those questions which relate to basic economic issues.

The position taken by the USDA on these issues was based on the established role of the Federal Government in dealing with farmers and farm commodities during most of the period since the mid-1930s. This article reviews the role of the USDA in controlling farm production, supporting farm prices, and subsidizing exports during this period. The Russian transactions are discussed in this context, and then some questions regarding the basic economic policies which were followed are analyzed.

Summary of Critical Comments

The GAO conclusions, following a review of the Russian transactions, include the following critical elements:

(1) The USDA maintained a low target price for wheat for several weeks after the sales began, obligating the U.S. Government to pay excessive subsidies to the private grain exporters.[4] The USDA is committed to pay over $300 million in subsidies on the Russian and other export sales. The GAO believes that many of these sales could have been made with smaller subsidies.

(2) Trading rules and procedures of the USDA are not adequate for dealing with the bargaining power of a foreign state trading monopoly. Such agencies are fully informed buyers and have an advantage when dealing with partially informed individual sellers.

(3) In 1967 the USDA granted to exporters the option of determining the date they register for subsidy payments. This action, as well as other features of the export program in effect at the time of the recent sales, tended to minimize risks and increase exporters' profits.

(4) Farmers were not provided with timely information with appropriate interpretative comments to help them make sound marketing decisions.

(5) The USDA has not comprehensively evaluated the wheat export subsidy program. Limited evaluations indicating that the subsidy program was not fully effective in reducing net export prices when the U.S. supply situation was scarce were dismissed by operating officials.

(6) The large volume of sales caused a dramatic rise in the price of U.S. wheat and higher consumer prices for bread, other flour-based products, beef, pork, poultry, eggs, and dairy products.[5]

The GAO made a number of recommendations as a result of its study. Among the recommended actions is a review of the wheat export subsidy program in its entirety including: a meaningful justification for the

[3]The Comptroller General of the United States, Report to the Congress, *Russian Wheat Sales and Weaknesses in Agriculture's Management of Wheat Export Subsidy Program* (July 1973), pp. 2 and 25; Martha Hamilton, *The Great American Grain Robbery and Other Stories* (Washington: Agribusiness Accountability Project, 1972); Jack Anderson, "How Soviets Pulled the Great Grain Robbery" and "Reaping the Grain Harvest," *St. Louis Globe Democrat*, July 31 and August 21, 1973, respectively; and "Chaff in the Great Grain Deal," *Time* magazine, August 6, 1973.

[4]The key determinant of the subsidy rate was the international target price – the price that the USDA attempted to maintain for U.S. wheat sold in foreign markets. Subsidies paid by the Government to exporters kept the target or international price for U.S. wheat at less than the domestic price. The subsidies were the difference between the domestic and target prices.

The wheat export subsidy programs began in 1949 as a result of U.S. obligations under the International Wheat Agreement. At that time, 42 nations agreed to trade a specified amount of wheat, under a negotiated schedule of minimum and maximum prices. Since the negotiated prices were lower than U.S. support prices to domestic wheat farmers, the exports required heavy subsidies. During the first four years of the program, subsidies averaged about 62 cents per bushel and required a Government input of $546 million. Before its suspension in late 1972, the program had incurred a total subsidy cost of about $4.3 billion for the export of about 10.5 billion bushels of wheat.

[5]Comptroller General, *Russian Wheat Sales*, pp. 2-4, 25, 55, and 56.

program's existence; a better system of coordinating sales of agricultural commodities to countries with nonmarket economies such as the USSR; a review of the legality of subsidy payments on sales to foreign affiliates of domestic exporting companies; the creation of a Government-farmer-industry committee to provide information on foreign agricultural needs; and a number of safeguards to assure that the amount of the subsidies is maintained at a reasonable level if a program review concludes that the subsidies are needed.

Based largely on the GAO findings, the press published statements to the effect that the subsidies were wasteful. It was reported that the grain exporting companies reaped large Federal subsidy payments at the same time they were making windfall profits from the export sales, and the transactions drained the United States of wheat supplies, contributing to sharply rising food prices.[6] *Time* magazine, for example, stated, "Consumers have a particularly good reason for anger: the deal contributed to a grain shortage in the U.S., driving up prices for bread, meat, poultry, and dairy products."[7] These comments suggest the following questions:

(1) Were the price increases experienced since the Russian sales anticipated at the time of the sales?

(2) Did it appear likely at that time that the quantity of wheat purchased by the Russians could be delivered out of surplus stock?

(3) Were the Russian sales at subsidized prices consistent with the role assumed by the USDA during the past two decades?

(4) Were the farm product and food price increases a result of the sales?

Only Moderate Price Increases Anticipated

There are few who question the charge of the GAO and the press that the subsidized wheat sales to Russia reduced domestic wheat and feed supplies and contributed to the higher food prices. Wheat can be used for either food or livestock feed; thus, domestic food and feed prices would not have risen as much as they did had the subsidized sales not been made and had the wheat been released for domestic use.

Only moderate price increases, however, were expected at the time of the sales. For example, on August 15, 1972, six weeks after the three-year grain sales agreement with Russia was announced and four weeks after the first Commodity Credit Corporation credit sales were registered with the USDA, the futures price for May 1973 wheat at Chicago closed at $1.85 per bushel.[8] This futures price was only a few cents per bushel above the cash price for wheat on August 15. By May 1973, however, the cash price had risen to $2.71 per bushel — $0.86 per bushel more than the market had anticipated nine months earlier.

On August 15, 1972, the futures price for corn to be delivered in May 1973 was about $0.25 per bushel less than the subsequent actual cash price in May 1973, and a futures contract for May 1973 soybeans sold for about one-half of the actual cash price for soybeans in May. Futures prices of eggs, cattle, and hogs were likewise well below actual cash prices on the delivery dates.

As late as September 15, 1972, only a week before the wheat export subsidy was removed, futures prices for 1973 delivery reflected only moderate domestic price increases for feed and livestock. In September 1972, wheat futures for May 1973 delivery sold for $2.18 per bushel, corn for $1.51, and soybeans for $3.53, somewhat above the September 1972 cash prices, but well below the cash prices of $2.81, $1.61, and $8.27 for wheat, corn, and soybeans, respectively, on the delivery dates.[9]

Market participants, as indicated by the futures prices, recognized that the Russian purchases would tend to increase prices. Hence, no confusion existed as to the direction of price movements. The amounts of the increases, however, are only clear from "hindsight." The price increases and the causal forces were readily observed as they unfolded, but at the time of the sales a number of factors which later affected prices could not be observed.

Other Forces Affecting Price Increases

In September 1972, few observable indicators pointed to the short world supply of key farm products and the sharp price increases that subsequently occurred. No widely distributed forecast indicated price increases of 140 percent for wheat, 165 percent for

[6]Anderson, "Reaping the Grain Harvest," August 21.

[7]*Time* magazine, pp. 63 and 64.

[8]The "futures price" is the price of current contracts for future deliveries of commodities. For example, the price of $8.62 per bushel agreed upon now but to be paid upon receipt of soybeans in May 1974 is called the May futures price. For a more complete discussion of futures prices and functions of futures markets, see Armen A. Alchian and William R. Allen, *University Economics*, 3rd ed. (Belmont, California: Wadsworth Publishing Company, Inc., 1972), pp. 163-67.

[9]Cash prices used are average prices received by farmers as reported by the USDA, *Agricultural Prices*. Futures prices are prices as reported by the *Wall Street Journal*.

corn, and 210 percent for soybeans by August 1973. The 40 percent annual rate of increase in the consumer price index for meat, poultry, and fish during the first six months of this year was likewise unforeseen.

Important supply and demand factors, other than the wheat sales, which contributed to the price increases became apparent following the wheat sales. The sharp cutback in output of Peruvian fish meal, a major source of protein for animal feed, was an important supply-reducing factor in the rising feed and livestock prices. A decline in production of wheat, rice, corn, and peanuts in other parts of the world as a result of unfavorable weather caused a sharp increase in the export demand for U.S. wheat, feed grains, and soybeans. Here in the United States, output of beef and pork rose less than expected because farmers were adding heifers to their beef herds, and a number of farmers had dropped their hog enterprises after experiencing heavy losses in 1971. A realignment of world currency values permitted greater farm commodity purchases from the United States with a given amount of foreign currency. In addition, the high rate of U.S. monetary growth and the unfavorable U.S. harvesting season in the fall of 1972 were important forces tending to increase farm product and food prices early this year.

The observed price increases reflected the impact of all these largely unpredictable factors converging at one time. Also, in view of the nation's extended experience with excess supplies, neither the outlook specialists nor the futures markets were able to predict the sharp price increases that actually occurred.

In July and August 1972 a downturn in Soviet wheat production was indicated. Also, the Soviets had stated that they wanted to increase meat production. However, as pointed out by the Secretary of Agriculture, their buying intentions were not made known.[10]

At the time of the sales, there was no certainty about the volume of wheat exports, since it was very late in the season before the Soviet wheat purchase intentions became apparent.[11] Thus, given the export subsidy program's objective of reducing farm surpluses, the GAO view, that much of the $300 million obligated for export subsidies was unnecessary to achieve the sales, may be based largely on supply and demand factors which unfolded subsequent to the transactions, or with the benefit of "hindsight" analysis.

[10]Comptroller General, *Russian Wheat Sales,* p. 70.

[11]Ibid.

Farm Program Objectives — Higher Prices and Income

Increases in farm and food prices following the sales to Russia are not sufficient reasons for criticizing the USDA. As the Secretary of Agriculture pointed out, "Such programs exist only to protect U.S. farmers from having to accept low world prices for a few farm commodities which depend heavily on exports and must meet subsidized export competition."[12]

Numerous public statements and congressional declarations imply that the Government farm programs are designed to achieve higher farm prices and farm incomes than are attainable in a free market setting.[13] These programs have taken several forms including programs to increase the demand for and reduce the supply of U.S. farm products. They include programs to increase the utilization of farm products, such as the domestic food and farm commodity export subsidies; programs to reduce farm production, such as acreage allotments, marketing quotas, and land retirement; programs of direct payments to farmers, such as the payments to wool, corn, cotton, and wheat producers; and programs designed to differentiate markets for farm products, such as the two price plans for certain commodities, the Government marketing orders for fluid milk and other commodities, and the import quota program for sugar.[14]

Since 1961 about 50 million acres per year have been withheld from crop production under the various Government land retirement programs. This acreage withheld from crop production under the various Government farm programs was equal to about one-sixth of the average acreage planted to the 59 principal crops during the decade 1961-70 inclusive and only slightly less than one-sixth of the planted acreage during 1971 and 1972 (Table II).

Surpluses of farm commodities arose as a result of the Government price supports for certain basic crops. The Government guaranteed a fixed price to farmers through nonrecourse Commodity Credit Corporation loans on the harvested crops. As has been pointed out by Paarlberg, rather than learning to live with an abundance of farm commodities at market prices, the nation insisted on a policy of artificial scarcity by

[12]Ibid., pp. 69 and 70.

[13]See Rainer Schickele, *Agricultural Policy* (New York: McGraw-Hill Book Company, Inc., 1954), p. 167, and Don Paarlberg, *American Farm Policy* (New York: John Wiley and Sons, 1964), pp. 68-72.

[14]For a more complete discussion of this topic, see Paarlberg, *American Farm Policy,* pp. 247-328.

Table II
Average Annual Acreage Withheld from Production Under Various Government Land Retirement Programs

	1956-60	1961-65	1966-70	1971-72
Acreage withheld (mil.)[1]	23.9	57.5	53.7	50.0
Total acreage planted (mil.)[2]	330.7	304.4	304.8	317.2[3]
Withheld as percent of planted acreage	7.2%	18.9%	17.6%	15.8%

[1]May include some acreage devoted to substitute crops.
[2]Includes 59 principal crops.
[3]1971 data only.
Source: USDA, *Agricultural Statistics*, 1972, pp. 525 and 637.

pricing farm commodities at higher than market levels throughout the late 1950s and 1960s.[15]

Surpluses — A Legacy of Government Price Supports

A look at the record of the farm price support programs prior to September 1972 reveals a long record of excess supplies of farm products — a larger quantity produced than could be sold at the Government price support levels. As indicated in Table III, carryovers and surpluses of farm commodities were relatively small in the 1926-29 period, prior to the price support programs. The "excessive" carryover stocks only developed following the Government price supports. For more than two decades, the USDA has administered a system of farm price supports that maintains farm product and food prices above free market levels. The system provides incentive for the production of more farm products than can clear the market despite the accompanying production controls, domestic food subsidies, Government subsidies on commercial sales abroad, and P.L. 480 exports (sales for nonconvertible foreign currencies and for long-term credits of underdeveloped nations).

Table III
Average Annual Carryover Stocks of Farm Products
(Percent of Utilization in Parentheses)

	1926-29	1953-55	1956-60	1961-65	1966-70	1971-72
Feed Grains (mil. tons)	9 (10.0)	33 (29.7)	59 (44.4)	69 (44.8)	45 (26.3)	41 (20.3)
Cotton (1,000 bales)	3,038 (20.1)	8,846 (73.6)	10,207 (70.4)	10,589 (80.7)	9,625 (79.0)	3,818 (29.4)
Wheat (mil. bu.)	185 (22.7)	859 (96.0)	1,086 (97.7)	1,129 (81.0)	641 (45.4)	797 (53.2)
Soybeans (mil. bu.)	—	18 (5.5)	47 (9.1)	50 (7.0)	169 (16.3)	86 (6.8)
Rice (1,000 cwt.)	—	5,177 (18.1)	5,938 (16.6)	1,736 (3.7)	2,229 (3.6)	2,474 (3.8)[1]

[1]1971 data only.
Sources: USDA, *Agricultural Statistics* (1940, 1972); *Feed Statistics*, Statistical Bulletin No. 410; *Rice Situation* (March 1973); *Fats and Oils Situation* (July 1973); *Feed Situation* (February 1973); *Wheat Situation* (August 1973); and *Cotton Situation* (May 1973).

Carryover stocks of wheat into the subsequent marketing year have often exceeded annual utilization (amount used for both domestic and export purposes). Such surplus stocks, largely held by the Government, exceeded total utilization in six of the twenty years from 1953 to 1972 inclusive, and for the entire twenty-year period carryover stocks averaged 75 percent of utilization. During the five years from 1956 through 1960, carryover stocks averaged 98 percent of annual utilization (Table III). Beginning in 1964, the wheat surplus stocks were reduced somewhat as a result of a new program which provided for direct Government payments to producers and lower support prices. Since then, carryover stocks have averaged only about 50 percent of annual utilization. Carryover stocks of all feed grain (corn, oats, barley, and grain sorghum) exceeded 40 percent of total utilization in eight of the past twenty years and averaged 37 percent of annual use for the entire period from 1953 to 1972. Surplus stocks of cotton were also a major problem until the past two years, averaging 80 percent of annual utilization from 1961 to 1970.

The major portion of the large carryover stocks of recent years was held in storage by the USDA at the taxpayers' expense. Hence, since the early 1950s, a major problem of the Government farm programs, given the level of support prices, has been the disposal of accumulated surpluses. In fact, much has been said about the "great farm-surplus" problem — the Government's holdings of a slowly deteriorating surplus product.

Reduction of Surpluses Apparently Beneficial

In view of the overall farm program costs, any returns that could be realized from the surplus product appeared to be cost-reducing. Total USDA outlays for all purposes during the period 1967-72 inclusive exceeded $49 billion, or 4.2 percent of total Federal Government expenditures (Table IV). The annual outlays rose from $5.8 billion in 1967 to $10.9 billion in 1972, or from 3.7 to 4.7 percent of total Federal Government expenditures.

Those expenditures directly associated with efforts to increase farm incomes, such as outlays for commodity price supports, acreage retirement, income payments, and export subsidies (farm income stabilization and Food for Peace), totaled $33.1 billion, or

[15]Paarlberg, *American Farm Policy*, p. 341.

Table IV

Total USDA Budget Outlays
(Billions of Dollars)

	1967	1968	1969	1970	1971	1972	Total
Agricultural and rural development	3.7	5.4	6.4	6.2	5.1	7.1	33.9
Income security	.4	.5	.6	1.0	2.3	2.3	7.1
Food for Peace	1.5	1.2	1.0	.9	.9	1.0	6.5
Natural resources	.3	.5	.5	.6	.8	.8	3.5
Net receipts	— .1	— .3	— .2	— .4	— .5	— .3	—1.8
Total	5.8	7.3	8.3	8.3	8.6	10.9	49.2
Percent of total U.S. Government outlays	3.7%	4.1%	4.5%	4.2%	4.1%	4.7%	4.2%

Source: USDA, *Demand and Price Situation* (February 1968, 1969, 1970, 1971, 1972, and 1973).

about two-thirds of total USDA expenditures during the six-year period. In addition, USDA outlays for income security, consisting largely of food stamps (intended in part to enhance domestic demand for farm products), totaled $7.1 billion. All these expenditures have been equivalent to about one-third of the net farm income since 1956 (Table V). Such expenditures have increased somewhat in recent years, but have declined relative to total farm income since 1966. With these sizable outlays to increase farm product prices and farm incomes, an easy bargaining stance with the Russians to eliminate the wheat surpluses appeared to be a cost-reducing policy.

Table V

Direct Costs to Taxpayers of Farm Income Support Programs
(Millions of Dollars)

	1956-60	1961-65	1966-70	1971-72
Farm Income Stabilization	2,846.8	3,438.6	3,966.8	4,398.5
Food for Peace	1,162.6	1,742.8	1,270.4	955.5
Total	4,009.4	5,181.4	5,237.2	5,354.0
Net Farm Income[1]	11,960.4	13,332.2	15,945.8	18,632.0
Total as Percent of Net Farm Income	33.5%	38.9%	32.8%	28.7%

[1]Includes Government payments.

Source: *The Budget of the United States Government*, 1966 and 1974, and USDA.

Russian Subsidies Consistent With the System

On the basis of the evidence available at the time of the transactions, the subsidies paid to wheat exporters in 1972 appear to be consistent with past practice. Wheat stocks carried over into the 1972-73 marketing year totaled 865 million bushels, which, added to the 1972 estimated production of 1,551 million bushels, resulted in total estimated supplies of 2,417 million bushels. Utilization (domestic use plus exports) averaged only 1,516 million bushels in the two years, 1970-71 and 1971-72, and 1,426 million bushels during the previous five years (Table VI, p. 8). The supply thus appeared adequate to meet all foreseeable demands at the support price level.

The USDA view that the Russian transactions resulted in a net saving to the Treasury of $457 million[16] is thus consistent with the farm program objectives during a two decade history of excessive wheat stocks. Such stocks were often viewed as liabilities rather than assets.[17] Hence, given the basic farm program system which was designed to channel more income to farmers, the USDA acclaimed the transactions as beneficial by (1) increasing the prices that farmers receive for their crops, (2) creating new jobs, and (3) improving the balance of trade.[18]

Basic Problem — A Faulty System

The basic objectives of the Government farm programs come into focus in an economic analysis of the Russian wheat sales. The critics' view that the subsidized transactions led to higher food prices and reduced the well-being of U.S. consumers is in direct opposition to the USDA view that the sales were beneficial. Under the producer-oriented farm programs, the sales served to enhance farm incomes, thereby achieving the programs' major objective. Neither the critics nor the USDA, however, seriously suggested that the programs may not be compatible with the economic well-being of the nation. Some recognition of a basic problem was apparent in the GAO's comment on "Matters for Consideration by the Congress:"

> U.S. agriculture's productive capacity has traditionally resulted in surplus stocks which were stored at great expense or exported with subsidy. Although exports are important to achieving U.S. trade objectives, they can have an adverse effect. Recent dramatic changes in the world supply-demand situation surfaced a need for assessing agricultural exports in a broader national context. Congress should consider requiring that agencies develop definitive ground rules so that expected benefits from exports can be appropriately weighed against their impact on various segments of the domestic economy.[19]

[16]Comptroller General, *Russian Wheat Sales*, p. 2.
[17]Paarlberg, *American Farm Policy*, p. 56.
[18]Comptroller General, *Russian Wheat Sales*, p. 2.
[19]Ibid., p. 5.

Table VI

Supply and Distribution of Wheat
(Data Available as of August 1972)[1]

	Average 1965-69	1969-70	1970-71	1971-72
		(millions of bushels)		
Beginning carryover	627	819	885	730
Production	1,437	1,460	1,370	1,640
Imports[2]	2	3	1	1
Total Supply	2,066	2,282	2,256	2,371
Food	515	520	519	523
Seed	66	57	63	64
Feed (residual)	140	214	206	287
Domestic Use	721	791	788	874
Exports[2]	705	606	738	632
Commercial	356	338	506	402[3]
Exports under Govt. programs	349	268	232	179[3]
Total Use	1,426	1,397	1,526	1,506
Ending carryover	640	885	730	865

[1]Year beginning July 1.

[2]Includes wheat equivalent of flour and other products.

[3]Excludes flour and other wheat products.

Source: USDA, *Agricultural Statistics*, 1972, and *Wheat Situation* (August 1972).

This statement, that the use of subsidies to reduce surplus stocks of farm commodities can have an adverse domestic effect, indicates recognition that the practices reviewed should be changed. The implied solution, however, is better ground rules for the administration of the programs rather than a thorough economic analysis of the issues raised. The basic economic questions involved were not approached in the discussion of the transactions. For example, are producer-oriented price and income support programs consistent with the maximum well-being of all the people? Given that artificially high price supports to producers tend to encourage production above market-clearing levels, will the entire output be sold in the absence of export subsidies?

The price system is the mechanism that brings into equality the production and consumption of farm products at an optimum level in a competitive economy without Government interference. Farming is highly competitive. It meets the major competitive tests of a large number of producers with easy entry and easy exit. No single producer can have an important effect on the output or price of farm products. When consumers desire more farm products, they will bid up the price and the higher price will attract additional resources into agriculture. Conversely, when demand for farm products falls, prices of farm products will decline and resources used in agriculture will be attracted to other industries where the returns are more favorable.

Price supports for farm products at higher than market-clearing levels, or other methods designed to enhance farm incomes above levels determined by free market prices, alter the normal relationships between resources used in production and consumption. Both high support prices and farm income supplements attract excessive resources into agriculture from alternative uses. High support prices alone provide the incentive to produce more farm commodities than will clear the market at the support price level. Furthermore, all the methods of farm income support reduce the economic well-being of the nonfarm sector of the economy, and are of doubtful long-run benefit to farm workers. Hence, it is not only the expected benefits from exports that should be weighed against their unfavorable impact on various segments of the domestic economy; rather, it is all losses from reduced nonfarm output, higher food prices, and higher tax payments to finance the farm programs that must be weighed against the probability of enhanced incomes to individual farm workers. Since returns to labor and other resources tend toward equality in a competitive economy, any gains occurring to farm workers through price or income supports are likely to be of short duration unless a monopoly position can be maintained through control of entry.

The New Farm Bill

Some unfavorable impacts of the farm programs on the well-being of most people were apparently recognized in the four-year farm bill passed by Congress in August of this year. Most crop production restrictions have been removed, and income and price support payments are likely to be less than in recent years. Wheat farmers are not required to abide by conservation reserves, and there is no conserving base or set-aside acreage requirement for grain or cotton plantings.

Crop allotments remain intact for most basic crops but are only a means for determining the acreage on which supplemental payments will be made in case the market price drops below the target price. Current market prices for most farm products are well above "target" prices which would trigger off the payments. Target prices are set for 1974 at $2.05 per bushel for wheat, $1.38 per bushel for corn, $2.34 per cwt. for milo, $1.13 per bushel for barley, and $0.38 per pound for cotton.

While it is difficult to estimate the cost of the program in terms of direct Treasury disbursements, most analysts believe that it will be well below farm pro-

gram costs of recent years. Furthermore, the less restrictive farm program coupled with the lower supplemental payments in prospect should enhance the well-being of farmers, other taxpayers, and consumers.

Summary and Conclusions

In summation, the recent sharp increase in food prices has brought the 1972 Russian wheat sales and the wheat export subsidy program to the attention of the public. The discussion in the press has centered partly around the administrative details of the transactions, but some basic economic issues have been involved in the debate. The use of subsidies to export wheat has been questioned, since such exports tend to reduce the domestic grain supply and increase prices of food used at home.

The wheat surpluses, which were exported, accrued as the result of a national policy of maintaining high price supports to wheat producers. Similar export subsidies had been used by the USDA for more than two decades to reduce surplus stocks, and the recent subsidies were generally consistent with accepted practice. The objective of the farm programs was higher farm prices and incomes. Prices rose following the Russian sales, but the extent of the increases was not anticipated because of a series of other factors, all of which tended to increase farm product prices.

The critics accused the USDA of contributing to higher food costs by subsidizing the sales. The sales no doubt tended to increase farm product and food prices, but the USDA cannot be faulted on this charge. Most of the Government farm programs in effect during the past two decades were designed to increase farm product prices even though higher food prices were a consequence of the programs. Thus, from the USDA's view, the sales were beneficial since they contributed to higher farm prices and incomes.

Furthermore, there have been few critics of these USDA actions — actions which have caused artificially higher prices in the past. Even critics of the Russian wheat sales did not discuss the underlying problem. They complained primarily of faulty USDA operations, whereas the real culprit was a faulty system of farm income and price support programs. These programs contribute to higher food prices and are wasteful of scarce resources. They provide incentive for the use of more resources in agriculture than is consistent with a level of output that can be sold at market prices. They are of doubtful benefit to farm workers and tend to reduce the output of nonfarm goods and services and the well-being of most segments of the population.

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Foreign Investment in the United States – A Danger to Our Welfare and Sovereignty?

by ANATOL BALBACH

FOR MANY years we have heard bitter debate about U.S. investments abroad. From Canada, South America, Europe, and Asia came serious complaints that U.S. capital was taking over their industries and draining their economies of resources. Now, with an apparently significant increase in foreign investment in the United States, sounds of alarm are beginning to be heard from our own businessmen and politicians. We have read that Japanese purchases of hotels, lumber stands, and land are contributing to shortages and inflation. We hear that our "need" for Middle Eastern oil is such that the oil-rich countries will eventually accumulate enough dollars to purchase and, in turn, control our industry.

The purpose of this note is to examine the impact of foreign investment on inflation and welfare, and to assess the probability of a foreign takeover of American industry. The analysis is addressed only to the investment aspect of foreign trade and not to the impact of transactions in current goods and services. Furthermore, it is assumed that all transactions are undertaken by individual decision makers who are interested in maximizing their profits or wealth rather than by governments for strategic or tactical purposes.

Does Foreign Investment Increase Our Cost of Living?

First, let us discuss the question of whether increased foreign investment causes inflationary pressures and whether it has been a factor in the recent dramatic increase in consumer prices. To be consistent with the events of the past several years, this issue should be analyzed under two conditions: one in which foreigners have no accumulated dollar assets and, as is the case now, one in which they do.

If foreigners did not have accumulated dollar balances and wished to buy a capital asset in the United States, they would first have to acquire dollars. In order to do this they would have to sell an equivalent amount of goods to U.S. residents. As a result of this process, the dollar holdings of U.S. residents who bought the imports would decline, and those of foreigners would increase. In turn, as these foreign dollar balances were drawn down, those of U.S. residents who sold capital assets would increase. The U.S. money stock would remain the same; thus there would be no reason to expect additional spending and additional inflationary pressure. To be sure, the prices of

the capital assets demanded would have a tendency to increase. On the other hand, Americans would have been induced to import more only if the prices of these imported goods were lower than prices of similar goods produced domestically.

Furthermore, consider the welfare implications of these events. We would have traded some claims on capital assets for some goods or services and, in the process, some prices would have changed. Presumably, trade was entered into willingly by those involved because they found it profitable or because it increased their satisfaction. Thus, even if there was a relative increase in some prices, society would still be better off than it was prior to the trade.

Now consider the situation in which foreigners have accumulated dollar assets from trades in the past. What is the *current* impact of foreign investment? If, as has been common practice, this dollar accumulation by foreigners is held in the form of U.S. Treasury securities, then these securities would have to be sold. The dollar balances of the securities buyers would decline and those of the sellers of claims on capital assets would increase. Again, this action alone would not increase our money stock and, hence, would not be a source of inflationary pressures. The prices of claims on capital assets demanded by foreigners would have a tendency to rise while the prices of the Treasury securities they are selling would tend to decline.

If, however, these accumulated balances were held in the form of foreign central bank balances at the Federal Reserve Banks, then the spending of these balances would increase the money stock and add fuel to inflationary pressures in the United States. In fact, this is not likely to occur; these central bank balances are relatively small and are usually maintained at a relatively stable level for use in day-to-day transactions. A significant reduction of these balances, in view of their small size as compared to foreign holdings of Treasury bills, is highly unlikely. Therefore, even if foreign investment were to continue to increase at the rapid pace exhibited in the past several months, its impact on inflation would be negligible. And since this investment is undertaken voluntarily by all the trading partners, we must presume that it will benefit society as a whole.

Can Foreigners Gain "Control" of U.S. Industry?

Another frequently heard argument is that because of our insatiable desire for oil, foreign oil producers will accumulate vast dollar reserves with which they will buy up U.S. industry and eventually control our productive facilities. We can interpret this statement in the following way: (1) *irrespective of price* we will keep buying the same or increasing amounts of oil from Middle Eastern producers; (2) these producer countries will buy goods and services from the United States at a rate which will be a relatively stable proportion of their oil revenues; (3) the remaining "surplus" will be spent on U.S. productive assets *irrespective of their price;* and (4) foreign "control" of these assets would somehow be "bad."

Suppose for a moment, as improbable as it may be, that we were to buy foreign oil at a rate like that postulated above, and that all of the surplus revenue earned by foreign oil producing countries was spent on investments in the United States. If this continued into infinity, and the U.S. economy grew at a slower rate than our purchases of oil, it would be theoretically possible for Middle Eastern oil producers to gain "control" of our industry. Whether this "control" would be good or bad is not at all clear. As we have discussed previously, such transactions ultimately amount to a voluntary exchange of our productive asset ownership for foreign oil. This exchange, if undertaken by individuals and in the absence of coercion, must be economically beneficial to them.

But what about the future? So long as our industry produces all the goods and services that we are willing to purchase, why should we be so concerned about ownership? If foreign ownership is undesirable from the political point of view, or from a strategic point of view during a war, foreign owners could be controlled by legal sanctions. But there are no economic grounds for the evaluation of foreign versus domestic ownership. Besides, if the sellers of these domestic assets still wished to own income-producing goods, and if these goods were too expensive at home because of foreign demand, they could buy foreign assets, perhaps even exploratory rights of oil fields abroad. But such speculation about what could happen and about the welfare implications of foreign ownership is not very realistic; we should really take a look at the possibility of such foreign capital invasion occurring even under the very pessimistic assumptions made above.

Let us speculate on how large this foreign investment in the United States could be and whether it could give foreigners "control" over our industry. We can proceed with the previously made interpretations of the argument which will yield the strongest case for it.

Chart I

Bilateral Trade Balance Projections

United States — Oil Producers in the Eastern Hemisphere

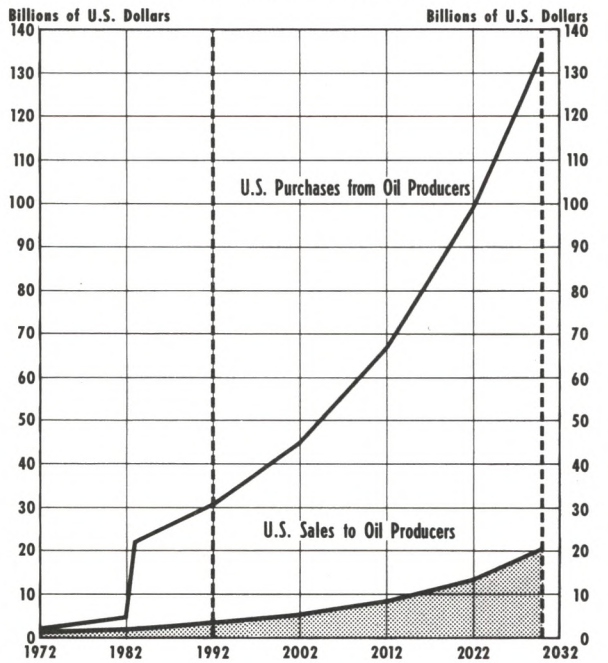
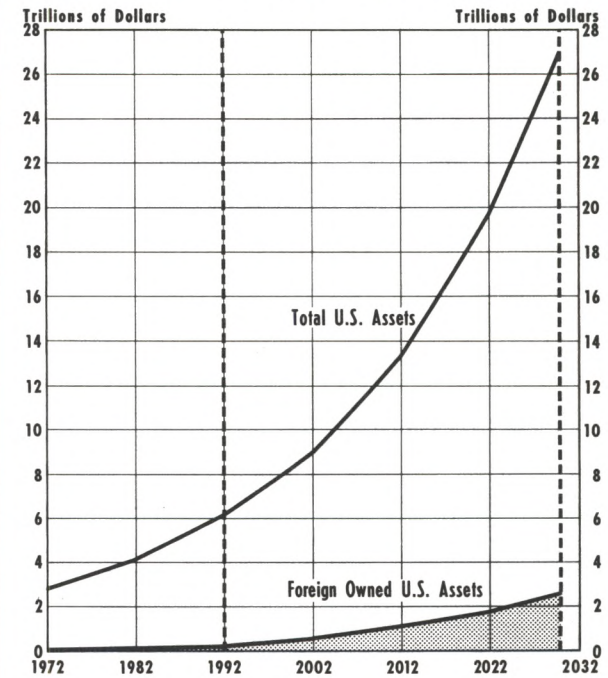


Chart II

Projections of U.S. Non-Human Wealth and Asset Accumulation by Oil Producers



Estimates have been made that U.S. oil reserves will be depleted in 10 years and Middle Eastern and North African reserves in 60 years.[1] Let us assume that our oil consumption would rise at a constant rate associated with the growth of our real GNP and that after 10 years our domestic oil output would have to be fully supplanted by greater imports from the Middle East and North Africa. Let us further assume that their imports from the United States would rise at, say, 5 percent per year, and that the remaining dollar surplus would be spent buying capital assets in the United States. Trade between Middle Eastern countries and the world outside of the United States is excluded from consideration because such trade, in relation to the investment in the United States, would set off repercussions on the exchange rate which would violate our assumption of price constancy.

Chart I shows the projected U.S. imports of oil from the Eastern Hemisphere and the projected U.S. exports to these countries. The projections are based on the assumption that U.S. oil consumption will remain at 0.7 percent[2] of our real GNP which will rise at a 4 percent annual rate. Further, it is assumed that the exports of U.S. goods and services to oil producing countries will rise at 5 percent per annum, and that the Western Hemisphere's oil reserves will be depleted in 10 years. The cumulative difference between U.S. oil imports and U.S. exports to oil-producing countries is assumed to be the amount of foreign dollar accumulation which is then invested in the ownership of U.S. industry.[3]

Chart II shows projections of the growth of non-human assets in the United States and projected accumulation of U.S. assets by foreigners resulting from import-export activities depicted in Chart I. The U.S. asset growth is simply the projected GNP multiplied by a factor of 3.5, which assumes that approximately 28 percent of our total factors of production will consist of non-human assets. All of the assumptions are admittedly simplistic yet not unreasonable.

There are two points in time that we should be concerned with — 1992 and 2030. One estimate of the Eastern Hemisphere's oil supply is 250 billion barrels.[4] Another one states that this supply will run out

[1]See Walter J. Levy, "Oil Power," *Foreign Affairs* (July 1971), p. 653.

[2]This percentage has prevailed for the past 10 years.

[3]It is assumed that: U.S. oil production will remain constant (4.1 billion barrels per year), due to limits on the refining capacity, until U.S. reserves are depleted; oil reserves in the Western Hemisphere will be depleted at the same time as U.S. reserves; and the price will remain at $2.50 per barrel.

[4]"Tankers that Move the Oil that Moves the World," *Fortune* (September 1, 1967).

in 60 years.[5] If we take the first estimate and assume that our projected U.S. oil consumption is one-half of total world oil consumption, then the reserves will be used up in 1992. The other estimate puts us in the year 2030.

As can be seen in Chart II, in 1992 the value of our non-human productive assets would be $6,100 billion and the maximum accumulation of foreign-owned assets would reach $232 billion or 3.8 percent. If we consider the year 2030, the value of assets would reach $26,900 billion and foreign ownership $2,600 billion or 9.6 percent. In either case it would not produce foreign "control" of our industry.

This simple exercise is not intended to make accurate predictions into the future. Some reasonable assumptions of growth have been made and constant prices and exchange rates have been presumed. Increases in prices of traded assets may tend to narrow the accumulation of dollar reserves. Thus, the case presented here tends to overstate the possible acquisition of U.S. assets by foreigners. Even under these pessimistic circumstances the assertion of foreign control of U.S. industry becomes ridiculous.

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[5]Levy, "Oil Power," p. 653.

Economic Issues in 1974

**Remarks by DARRYL R. FRANCIS, President, Federal Reserve Bank of St. Louis,
Before The National Association of Investment Clubs,
St. Louis, Missouri, October 19, 1973**

IT IS GOOD to have this opportunity to discuss with you some of my views on the outlook for the United States economy in the near future. It happens that we presently stand in one of those rare situations in which there is a wide divergence of forecasts with regard to almost all areas of economic interest. Moreover, economic issues, for various reasons, have become more newsworthy and of greater interest to the average citizen in recent times.

Let me first summarize briefly the current economic situation and then address myself to four broad questions:

1) When will inflation end?
2) Will there be a recession?
3) Will there be a credit crunch?
4) What is the outlook for the international monetary situation?

I must tell you now that I will advance neither specific numerical forecasts nor quick and easy solutions to our existing economic problems. The adoption of specific and usually optimistic targets, and the employment of quick, politically expedient solutions in an attempt to achieve them, have, in my opinion, contributed much to our current economic difficulties.

Current Conditions

The present time is relatively prosperous, and therefore should be an enjoyable one for most people — not only with regard to economic well being, but in other important respects. The unemployment rate is lower than it has been in several years, corporate profits after taxes are almost double their 1970 low point, per capita disposable personal income has never been greater, and even lost output due to labor strikes was at a nine-year low in the first half of 1973. Also, this country's participation in the bitterly divisive Vietnam conflict has ended, no more young people are being drafted, and social unrest has declined significantly.

However, a number of factors suggest we are not enjoying our prosperity to the degree one might expect. The stock market, often taken to reflect the public's mood, has been depressed throughout most of 1973. A new measure of welfare has been advocated by Professor Paul Samuelson which is obtained, in part, by eliminating ostensibly undesirable goods, such as pollution and military expenditures, from total output. This index has been growing progressively slower relative to gross national product in recent years, indicating our happiness has not kept pace with our GNP.

The index of consumer sentiment, which is compiled on the basis of answers to questions such as "will you be better off financially a year from now" and "will the country have good times or bad over the next five years," was about as low in the second quarter of 1973 as in the depths of the 1970 recession, and lower than at any point in the period from 1957 to 1969.

Now, I have no great confidence in any of these kinds of indexes, singly or even en masse, because attitudes and welfare are so difficult to measure. But I do happen to agree that there currently exist serious economic and noneconomic problems which are contributing to a widespread feeling of malaise, or general unhappiness.

Much of this atmosphere can be traced to the failure of policymakers to inform the public of the hard choices which must be made in a world where resources are limited and desires are not. It is my belief that by fostering the impression that there are no problems which cannot be cured by government action, policymakers have unnecessarily elevated the public's expectations and then dashed their hopes when confronted with economic reality. Let me give you some examples.

In the mid-1960s, the Federal Government greatly expanded both its domestic outlays, primarily for the Great Society Programs, and its foreign involvement, mainly in the form of defense expenditures for the Vietnam conflict. After several years and numerous glowing reports on both projects, it appears to me that the main effect on the domestic economy of the expenditure of many billions of dollars has been severe inflationary pressures. The attempt to maintain both a "guns and butter" economy has satisfied few and disappointed many.

Just a few years ago, cleaning up the environment became a major objective of public policy, with little thought as to the effects of single-minded pursuit of such an admirable goal on our energy reserves. Now that we have found that our energy resources are more limited than we thought, environmental concerns are battling crash energy programs for newspaper headlines. Thus, it is my contention that the public has discovered the hard choices to be made only after having been allowed to believe the environmental objective could be attained with minor costs over a relatively short span of time.

Some time ago, the public was told that the adoption of wage and price controls was a temporary expedient to relieve inflationary pressures in a less than fully employed economy. The controls were to be removed before shortages and economic uncertainty, two by-products of price controls in a high employment economy, would appear. The "temporary" controls are now into their fourth phase. In the current high-employment economy, shortages and economic uncertainty have emerged along with the inflationary pressures that the controls were adopted to alleviate.

There are many other cases in which the well-meaning efforts of policymakers to achieve objectives in one area have caused undesirable side effects in another. State usury laws, intended to prohibit the financial exploitation of small borrowers, have deprived such borrowers of virtually any access to credit in tight money periods. Minimum wage laws were adopted to insure a minimum level of income to everyone. However, many studies indicate that the main effect has been higher wages for workers already holding comfortable jobs and unemployment for many of the low-income workers the law was supposed to benefit. Government inducements to foreigners to buy our products, and thereby improve our balance-of-payments position, were recently reversed in order to stem complaints about foreigners buying up our scarce goods.

Attempts by the monetary authorities to moderate the tendency of interest rates to rise in the face of strong credit demand have resulted in sharp increases in the money stock and, subsequently, intensified inflationary pressures and even higher interest rates. The extended freeze on beef prices was, of course, not designed to dry up beef supplies or stimulate cattle rustling, but that was its effect. The current restrictions on domestic fertilizer prices at levels considerably below world market prices, if not relieved, could result in the marketing by U.S. farmers of smaller crops in the near future than would otherwise have been the case, despite the release of more land for crop production.

The list of well-intentioned efforts in pursuit of worthy social and economic objectives has become very long. The fact that many of our current problems are directly attributable to such efforts has not discouraged the majority of policymakers from trying. Anyone with a knowledge of a few economic principles relating to basic supply and demand forces could have predicted the adverse side effects which followed many of the earlier policy actions.

Unfortunately, predicting the policy actions themselves is much more difficult. The increased size of government, and stepped-up governmental intervention in market forces, has made it more necessary than ever before to recognize the influence of government actions on economic projections. What will happen in the remainder of 1973 has been largely determined by earlier policy actions, but much of economic developments in 1974 and beyond depend on policy actions yet to occur.

When Will Inflation End?

Recent polls have shown that the issue which Americans are most concerned about today is inflation. The fact that the current inflation has persisted longer than any in the post-World War II period may partially explain the current malaise. The public is

quite cognizant that rising prices are eroding their incomes and their savings, while depreciating the value of the dollar internationally. It is not surprising that they are worried about what inflation will do to their futures. It is an issue that directly strikes every citizen, unlike war, unemployment, or even Watergate.

It is rather disconcerting to learn from some public opinion polls that the average citizen has little or no idea of the cause (and by implication – the cure) of inflation. Large corporations, unions, or some sinister "middlemen" are typically blamed. Rarely are fiscal or monetary actions thought to be the basic cause of inflation.

The common sense answer to the inflation question, which one hears surprisingly few times outside economic circles, is "too much money chasing too few goods." The volume of goods and services produced over a long period depends mostly on the size of the population that is of working force age, their degree of education, the extent of technological development, and the quantity and quality of raw resources and capital. The quantity of money produced which chases the goods is determined primarily by the monetary authorities, and this quantity could be closely controlled.

Thus, technically, it is not a difficult matter to eliminate inflation by reducing the rate of growth in the volume of money that is chasing the goods and services. Unfortunately, historical evidence indicates that the initial consequence of a marked and sustained reduction in the rate of growth of the money supply has been a temporary slowing in the rate of growth of real output and a rise in the unemployment rate. A lessening of price pressures normally has not occurred for an extended period after adoption of the restrictive policy. This is because the public, after repeated bouts with inflation, simply has not believed that policymakers would stick with the restrictive action long enough to make it work.

Public opinion and attitudes are important not only with regard to determining the length of time it takes to get inflation under control, but they also influence the tools employed in the battle. Even after price rises had begun to slow in 1970 and 1971 as a result of the restrictive stabilization policies undertaken in 1969, progress was not fast enough to satisfy the public nor their elected representatives. Polls taken in mid-1971 indicated that many people thought direct controls should be used to slow the inflationary spiral. Controls appeared to be a costless way of curbing price rises, by getting at the "sinister" middleman, with no ill effects to befall law-abiding citizens and firms. Controls had the appearance of working for awhile when there was little excess demand in the country. Once the economy approached full capacity utilization, as it did over the past year, it became clear that controls not only were unable to stop inflation, but could cause serious shortages, black markets, and confusion.

Now, after controls have been tried, and despite the problems of floods, bad weather, and poor Russian and Chinese harvests, the basic, underlying cause of inflation remains – too much money chasing too few goods. In fact this has been the problem world-wide, as money supplies throughout the world have pushed up domestic prices.

Money supply growth in England, Japan, Germany, France, and Canada, to name a few countries, has virtually exploded during the past two or three years. In the United States, money supply growth moved up from about a 2 or 3 percent rate in the 1950s and early 1960s, to a 6 percent average rate over the past five years. The result has been inflation, high interest rates, and dollar devaluation.

The cure for inflation has not changed, despite the freezing, semi-freezing and unfreezing of prices. The reversal of stimulative monetary and fiscal actions is a prerequisite to the reduction of inflationary pressures. Because of the lag of price changes behind changes in the rate of growth of the money stock, it probably would be not only months, but several years before the adoption of moderate policy actions would have any lasting, observable effect on the inflation rate. A severely restrictive policy could accomplish the job faster, but the cost in terms of lower employment and output would be more than most of us are prepared to pay.

And I hasten to add that the use of pervasive wage-price controls in the current high employment economy would *not* serve to speed up the end of inflation. At best, controls have only some minor, distorting effect on the timing of individual price changes, but no lasting effect on the general inflation rate. Experience both here and abroad has shown that adoption of a price freeze under the current circumstances only delays the rise in prices. You can't stop inflation by passing a law against it any more than you can stop unemployment by passing a law against that.

Since it is my view that there is no easy, costless way to end inflation through controls, it appears to me that moderate stabilization actions which avoid the stop-go excesses of the past would be appropriate.

Even this course of action could not be undertaken now without some cost in terms of a transitional slowing in the rate of growth of output and probably a temporary rise in the unemployment rate.

Will There Be a Recession?

At present, there is no indication that a full-fledged recession is unavoidable. Real GNP did slow to a 2.4 percent rate of increase in the second quarter of 1973, from an 8 percent increase in the preceding year. However, third quarter data are expected to show a rise in real product closer to its long-run potential rate of about 4 percent annually.

Despite a slight rise in the unemployment rate from 4.7 percent in July to 4.8 percent in August and September, there remains strong pressure on the productive capacity of the economy. The Federal Reserve's index of capacity utilization of major materials, the volume of help wanted ads, order backlogs, and the continued high level of retail sales all suggest substantial strength in the economy.

Such strength should carry on for some time. There are widespread reports of expansion in output being limited in many industries next year by shortages of raw materials and skilled labor. Thus, I believe that a slowdown of output growth the balance of 1973 and early 1974 will be as much a reflection of supply constraints as a reduction in the growth of total demand.

The course of monetary expansion over the last half of 1973 and early 1974 could exercise such restraint on growth of total demand that a recession would be produced. For example, suppose there was a desire to curb inflation quickly by holding the money stock unchanged from mid-1973 until next summer. Our studies indicate that a recession would almost certainly occur next year if such a sharp and prolonged reduction in the rate of money growth should occur.

I believe there is a path available for making some progress toward the reduction in the average rate of inflation while avoiding a recession next year. Such a path would involve a modest deceleration in the rate of increase in the narrowly defined money stock for the last half of 1973, followed by moderate growth in the first half of next year. Our studies suggest that such a course of persistent, moderate restraint on the rate of monetary expansion would foster less inflationary pressure in 1974 than we have had this year, while not being so restrictive as to plunge us into a sharp economic slowdown. If inflation is to be reduced eventually to a low rate, moderate money growth will have to be maintained for several years.

Will There Be a Credit Crunch?

That is, will the flow of credit be sharply altered from its normal channels as in 1966 and in late 1969 and early 1970? In those years, the source of funds to financial institutions, such as savings and loan associations and mutual savings banks, was severely curtailed, as was the availability of mortgage money to home buyers. Market interest rates rose sharply because of a strong demand for credit in the face of a restricted growth in the supply. Legal ceilings on the interest rates payable by the savings institutions handicapped them in competing with market instruments for the savings of wealthy individuals and businesses. The "small" saver was unable to obtain the high yields available on market debt instruments. Consequently, the burden of monetary restraint was borne most heavily by financial intermediaries, the housing sector, and the small saver.

Whether another credit crunch will occur depends first on movements of market interest rates, and second, on the extent to which legal interest rate ceilings cause distortions in channels through which credit normally flows. The demand for credit, which is one of the factors influencing interest rates, should remain strong for some time. The quantity of credit demanded by both consumers and businesses has shown little sign of subsiding recently despite the current high level of interest rates. Surveys indicate businessmen intended to continue to expand plant and equipment capacity through 1974. Although the cash position of many firms remains strong, it is expected that a sizeable volume of the funds necessary for expansion must be obtained in the credit markets.

On the other hand, credit demands of state and local governments have moderated with the advent of Federal revenue sharing. State and local governments were adversely affected during the past crunch periods because of the legal ceilings on the rates they could offer on bond issues, but revenue sharing has lessened state and local government vulnerability to any future crunch.

The Federal Government's budget, which had been in deficit (expenditures exceeding tax receipts) for thirteen consecutive quarters (on a national income accounts basis), was finally in balance in the second quarter of 1973. Because of the strong pace of economic activity, which generated considerable tax revenues, and the exercise of fiscal restraint on expendi-

tures, the Federal Government's demands for funds have moderated significantly. If the growth of aggregate demand in the economy slows, causing growth of tax revenues to slow, some step-up in Federal Government credit demands can be expected; however, I foresee no great pressures from Government deficits in the near future.

In short, growth of credit demands throughout the economy should continue strong, but at a moderated pace. Some further growth in demand for credit can be met without sharply higher intermediate and long-term interest rates. The movement of short-term market interest rates will depend on a great many factors including monetary actions.

Regardless of the monetary policy adopted, the likelihood of an availability crunch at recent levels of interest rates is less now than in the 1966 and 1969-70 periods. Legal ceilings on interest rates paid by a number of savings institutions have been either eliminated or greatly relaxed in many cases. Moreover, expanding Federal or semi-Federal agencies such as FNMA and GNMA can be expected to supply more funds to the housing sector than in the earlier tight credit situations. Thus, the effects of monetary restraint, whenever applied, should be more evenly diffused throughout the economy.

What is the Outlook for the International Monetary Situation?

In the past, painless solutions in this area have also been sought. So far they have escaped us. With the fixed international value of the dollar from 1944 to 1971 it was quite generally believed that the best of all possible worlds had been created. The risks of exchange rate movements were virtually eliminated, the dollar became the international currency and excesses of exports and imports were to be prevented through voluntary domestic adjustments or through internationally agreeable changes in the exchange rate.

Early in the post-war period, the United States supplied dollars to the world through the Marshall Plan and various grant arrangements, thus transferring resources to the war-ravaged parts of the world. This provided us with an export balance and pacified those who were worried about the balance of payments. Later, it provided dollars for international transactions, thus transferring resources back to the United States and providing export surpluses for other industrial nations.

But as other nations built up their industrial potential and began to compete and assert their sovereignty, economic and political realities began to emerge. The maintenance of the fixed dollar exchange rate, in the face of improving foreign productivity and sharply accelerating U.S. inflation, generated an overvalued dollar.

The result was an excess of U.S. imports and a deficit in the liquidity account with a hundred billion dollar accumulation of liquid assets by foreigners. There was also a realization that this accumulation of dollars meant a transfer of real resources from foreigners to the United States. Finally, there was the realization that the fixed international value of the dollar could no longer be maintained.

The floating exchange rate system, which emerged from the so-called crisis of 1971, seems to be working reasonably well, even though it is subject to frequent interference from governmental agencies. The U.S. trade deficit has been virtually eliminated, global trade is again growing at pre-float rates, surplus countries can deal better with inflation, and all countries can pursue independent domestic economic policies.

But apparently everyone is not satisfied with this arrangement. The transition has not been without costs; our imports have become more expensive, countries who desire a permanent export balance cannot have it, and those who have a love affair with gold see it relegated simply to the status of any other commodity.

There are those who still believe that some governmental or international action can produce an arrangement quite similar to that which prevailed prior to mid-1971, and that such an arrangement would improve on the present situation. The recent meetings in Nairobi are a case in point. The participants of these meetings were groping for a more rigid exchange rate mechanism, while realizing that the old fixed rate system is unworkable. The basic argument that emerges is — how fixed should the rate be? The United States is arguing for an arrangement whereby the fixed rate must change when a country accumulates a certain amount of international reserves. Some other countries argue that a change should not take place automatically, but only after consultation and agreement.

The U.S. position is quite similar to the floating rate mechanism, and the other position is almost identical to the old fixed rate arrangement. Again, some people have not learned the lessons of the past and, again,

think that they can have all the benefits without having to pay the price.

If some fixity of exchange rates is at all desirable, then I would support the reported position of the U.S. Treasury. It is my firm belief that an international payments mechanism with a non-automatic change in the exchange rate would break down and bring about crises for which we would all have to pay.

Summary Observations

The unhappiness of many people today would be greatly ameliorated if they thought inflation would be ended tomorrow. It simply cannot be done, given the stimulative fiscal and monetary actions of the past few years. Attempts to curb inflation quickly through controls have resulted in shortages, a reduction in economic freedom, and added uncertainty to everyone's life. Efforts by monetary and fiscal authorities to quickly end inflation would likely precipitate a credit crunch and a severe recession.

Adoption now of moderate stabilization actions would eventually reduce inflationary pressures without a credit crunch or recession, but it would take considerable time, patience, and a minimum of legal interference in our market economy. Unfortunately, our past record on patience and avoiding the excesses of either stimulus or restraint is not one which inspires confidence.

Further, we seem to be developing a growing infatuation with the exercise of power to impede the operation of free markets by constantly surfacing new ideas and programs for controls which usually have ended up accomplishing exactly the opposite of what they were proposed to do. I am fully aware that there must be some minimum rules and regulations in a market-oriented democratic society, but why can't we keep our hands off the functioning of the markets and permit them to continue their proven, traditional role in the most efficient and equitable distribution of the product of our labors.