

Enhancing Competitiveness: National Economic Policies

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This paper discusses the broad outlines of U.S. domestic economic policy in recent years, the resulting effects on economic performance here and abroad, and the implications for American agriculture. The paper does not attempt to deal with the specific problems of American agriculture in any detail. Other contributions to this symposium are designed to meet that need.

It will probably come as no surprise that we in the Reagan administration feel that the contribution of our economic policies has been positive. But we also recognize that economic problems remain and are intense for some parts of the agricultural community. A disinflationary process is still occurring in many primary commodity markets, including those for agricultural products, and agricultural land values are being marked down from previously inflated levels.

The situation is further complicated by its international dimension. The situation of American agriculture cannot safely be viewed from a purely domestic perspective. American agriculture has become an important factor in world markets and derives significant revenue from exports. It is clear that American agriculture must continue to be competitive internationally.

There is little possibility of separating or walling off domestic markets from international markets without suffering heavy losses. Steps have been taken recently in cooperation with the other Group of Five countries (France, Japan, the United Kingdom, and West Germany) to achieve a reduction in the exchange rate of the dollar and stronger growth abroad. This should gradually be beneficial in reducing some of the more intense international competitive pressures on U.S. domestic sectors, including agriculture.

It is easier to identify the cause of some of **agriculture's** problems than to formulate completely satisfactory short-run solutions. American agriculture is in the throes of a difficult adjustment. The very difficulty of the process and the personal hardships involved may account in part for the tendency of some in the agricultural community to look outward to national economic policy in the hope that some modification there can solve the problems of agriculture.

It is all too common to hear that the current problems of agriculture somehow result from the unbridled operation of market forces and could be solved by expanding the amount of governmental intrusion into the market process. The thrust of this paper is just the reverse. The Reagan administration believes that maximum reliance should be placed on a productive private sector that is responsive to market signals. This, in the long run, will bring real benefits to the entire economy, including agriculture. During the current difficult period of transition, targeted financial assistance will have to be available to the agricultural community. But the long-run solution for agriculture will be found in market processes, not in government programs.

The Reagan economic program: goals and accomplishments

The economy inherited by the Reagan administration in early 1981 was in disarray. Inflation was raging with consumer price increases reaching the 12 to 13 percent range in 1979 and 1980. The prime rate of interest hit a record 21.5 percent by the end of 1980 and financial markets were under heavy strain. Real interest rates had been negative for several years and heavily leveraged operations in business and agriculture had become commonplace.

Productivity growth had turned sluggish, averaging less than 1.5 percent per year from 1970 to 1980, only one-half of the pace in the previous decade. To combat soaring inflation and stagnating real growth the administration instituted a new policy approach, moving away from the modified Keynesianism that had governed **U.S.** economic policy throughout the period following World War II.

The Reagan economic program consisted of four parts.

- Federal spending restraint to return productive resources to the private sector.
- Marginal tax rate reduction and depreciation reform to restore incentives and promote growth by lowering labor and capital costs.
- **Regulatory relief** to lower production costs and encourage competition.

- Gradual restraint and stabilization of monetary growth to reduce inflation and to restore confidence to the financial markets.

A new policy emphasis on supply-related factors was embodied in the Economic Recovery Tax Act of 1981, which reduced marginal tax rates on both physical and human capital over a three-year period and thus raised the real after-tax rate of return on productivity activity.¹ In addition, it was expected that monetary policy would provide a gradual reduction in the rate of growth in the money supply (M1) consistent with the projected targets set by the Federal Reserve Board. This phased-in restraint on money growth was expected to offset any demand stimulus from the scheduled tax rate reductions leaving a decline in relative prices for work effort, saving, and investment that would encourage productivity growth.

Things did not work out quite that smoothly. The three-stage tax reduction did not become effective in any significant way during 1981. Meanwhile, there was an abrupt deceleration in monetary growth from a double-digit pace of 13 percent annual rate from January to April to a negative 4 percent annual rate from April to June. Over the whole year (fourth quarter 1980 to fourth quarter 1981) money grew at only a 5 percent rate. The result was the 1981–82 recession and a rather bumpy transition for the economy. While the temporary costs of recession were high (unemployment, lost output, and large budget deficits), inflation was cut very sharply and the stage was set for a strong economic expansion.

Vigorous economic expansion

The ensuing expansion has generally exceeded mainstream expectations. In 1982 and 1983, most economists predicted that large federal budget deficits and high real interest rates would prevent any strong or sustained expansion of the economy. Any recovery that did occur would be stunted and would have to be led by consumers. The actual pattern of developments has been quite different. The economy has expanded rapidly with capital investment rising much more strongly

¹ For studies that estimate the impact of marginal tax rate reductions since 1981, see Allen Sinai, Andrew Lin and Russell Robins, 'Taxes, Saving, and Investment: Some Empirical Evidence' *National Tax Journal*, September 1983, pp. 1-25; Mack Ott, 'Depreciation, Inflation and Investment Incentives: The Effects of the Tax Acts of 1981 and 1982,' *Economic Review*, Federal Reserve Bank of St. Louis, November 1984, pp. 17-30; Stephen A. Meyer, 'Tax Policy Effects on Investment: The 1981 and 1982 Tax Acts,' *Business Review*, November/December 1984, pp. 3-14; and James Gwartney, 'The Impact of the 1981-1984 Tax Cut,' Testimony before the Joint Economic Committee, April 23, 1985

than predicted while consumer behavior has been roughly in line with earlier cyclical patterns.

Many observers underestimated the positive effects of the 1981 tax reductions on the real rate of return to capital and overestimated the negative effects on investment of high financial market real rates of interest. As shown in Charts 1 and 2, there appears to be a much closer relationship in recent U.S. experience between the real after-tax return to capital and investment activity than there is between investment activity and the real rate of interest as measured in financial markets. This conforms with the supply-side perception that after-tax rates of return exert a strong influence on real economic activity.

Real growth was very strong in the first year and a half of the current expansion, averaging more than 7 percent at an annual rate. Last summer, the economy entered a softer phase with real growth slowing to about a 2.5 percent rate over the past year. To some extent, the slowdown was probably a normal response to a more mature stage of economic expansion—after the fastest increase for any comparable period since the Korean War—and the absence of further supply-side stimulus as the effects of the 1981 tax cuts began to fade. The growth slowdown also reflected tighter monetary conditions. Growth in M1 fell from about 10 percent during 1983 to less than 6 percent during 1984 with M1 virtually flat from June to October of 1984.

CHART 1
Real Interest Rate and the
Rate of Investment

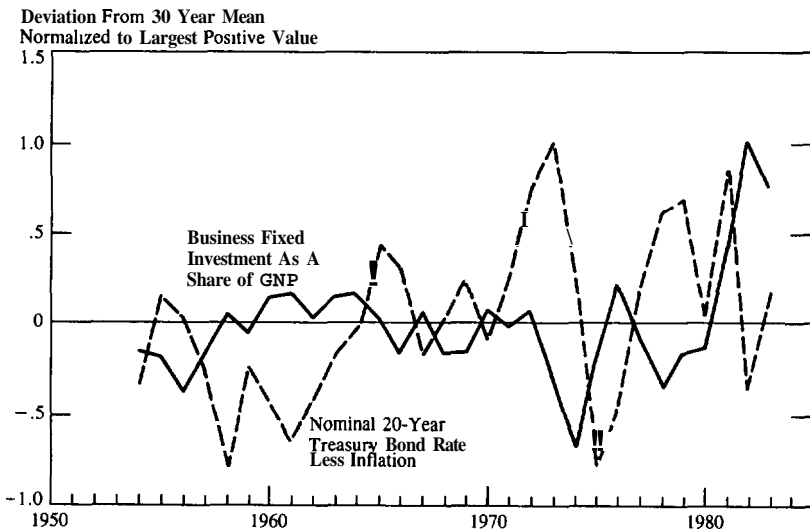
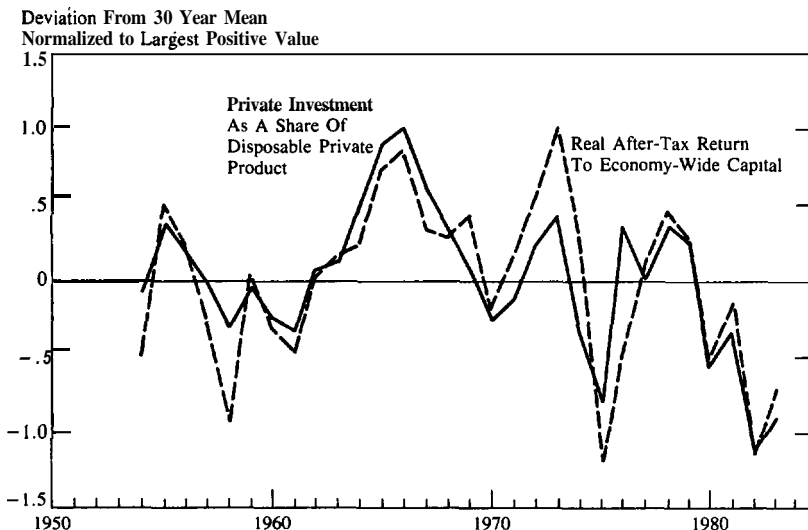


CHART 2

Real After-Tax Return to Capital and Investment's Share



The current situation and the near-term outlook

Monetary growth has resumed since late last year at a relatively rapid pace. The Federal Reserve **rebased** its monetary targets at the middle of this year but M1 is once again above target. Ordinarily, this might be a matter of growing concern on purely monetarist grounds but monetary velocity has not behaved in the expected fashion. Instead of growing near the 3 percent postwar trend rate, velocity has fallen sharply this year at about a 6 percent annual rate through the first three quarters of the year. A temporary decline in velocity, for a quarter or so, would not be unusual as monetary growth accelerated, but the persistence and size of the decline in velocity has puzzled most monetary observers. There are, however, no signs of recession, inflation is very well behaved, and there are now some fairly clear indications that the pace of real growth is beginning to pick up.

The index of leading indicators has risen for five successive months, April through September, and payroll employment has risen strongly since midyear, suggesting that the pace of activity is beginning to increase. The third quarter GNP result may not have seemed particularly strong with real GNP up at a 3.3 percent annual rate, following a 1.9 percent rate of advance in the second quarter. However, the rise in

GNP was held down by a decrease in inventory investment. Real final sales grew at about a 6 percent annual rate during the quarter. Inventory positions now appear to have been drawn down sufficiently so that the continuation of growth in demand would mean more rapid rates of advance in real GNP. Inevitably, there is uncertainty as to the near-term pace and direction of the economy—economic forecasting being what it is—but the prospects for stronger real growth seem to have improved.

Monetary policy has been more accommodative this year with M1 rising at more than a 12 percent annual rate during the first nine months of the year. Interest rates have shifted lower and by late October were below year-earlier levels by about 250 basis points on the short end and 150 basis points on the long end of the credit markets. With sensitive measures of inflation showing few signs of life, the Federal Reserve is under no pressure to alter its monetary stance.

The administration has recently published its Mid-Session Review of the Budget, including its updated economic forecast. Real GNP growth this year is estimated to be 3 percent, measured fourth quarter to fourth quarter. (This assumes growth at about a 5 percent annual rate in the second half, which may still be achieved but will require a very strong fourth quarter.) It is expected that real GNP will rise at a 4 percent pace in 1986 through 1988. Inflation is also expected to remain moderate, with annual consumer price increases in the 4 percent range through 1988. The unemployment rate should still be at about 7 percent by the end of this year but is expected to decline to just over 6 percent by the end of 1988.

The consensus private forecast for the economy is not quite as optimistic as that of the administration, although the differences are not great and are probably within the standard error of anyone's projections. A comparison of the administration and private short-term economic forecasts is shown in Table 1.

The pattern of growth

Real growth of nearly 5 percent in the first 11 quarters of the current expansion has been close to the 5 percent average for previous post-World War II cyclical expansions that lasted this long—excluding the 1949–50 expansion that merged with the Korean War buildup. There has been an even faster pace of growth in domestic demand. Real gross domestic purchases, which adds back U.S. outlays on imports and deducts foreign outlays on U.S. exports, have risen at a 6.3 percent an-

TABLE 1
Comparison of Administration and Private Forecasts

	1985			1986		4Q to 4Q		Year to Year	
	II	III	IV	I	II	1985	1986	1985	1986
Real GNP	<u>Percent change, annual rate</u>								
Data Resources, Inc. (10/85)	1.9	3.1	2.3	1.5	1.6	1.9	2.1	2.4	2.1
Chase Econometrics (9/25/85)	1.9	2.8	2.5	3.3	2.8	1.9	2.4	2.3	2.6
Wharton EFA (9/26/85)	1.9	3.1	3.4	2.4	3.0	1.2	3.5	2.4	3.1
Townsend-Greenspan (8/9/85)	1.7	2.2	4.4	4.6	3.9	2.2	2.1	2.4	3.3
Blue Chip Consensus (10/10/85)	1.9	3.1	3.5	3.3	3.0	2.2	2.9	2.5	3.1
CBO (7/23/85)	n.a.	n.a.	n.a.	n.a.	n.a.	2.6	3.4	2.6	3.6
Administration (7/22/85)	1.7	4.5	5.5	4.0	4.0	3.0	4.0	2.7	4.2
GNP Deflator									
Data Resources, Inc.	2.6	3.0	3.7	3.1	3.0	3.7	3.2	3.7	3.2
Chase Econometrics	2.6	3.2	3.1	4.0	3.3	3.6	3.9	3.6	3.5
Wharton EFA	2.6	2.9	3.7	4.0	3.7	3.6	4.0	3.6	3.7
Townsend-Greenspan	2.8	4.8	4.2	5.5	5.0	4.3	5.7	3.9	5.0
Blue Chip Consensus	2.6	3.1	3.6	3.9	4.0	3.8	4.2	3.7	3.8
CBO	n.a.	n.a.	n.a.	n.a.	n.a.	4.3	4.3	3.9	4.3
Administration	2.8	4.0	4.0	4.3	4.3	4.0	4.3	3.8	4.1
Civilian Unemployment Rate	<u>Percent (average for period or 4th quarter)</u>								
Data Resources, Inc.	7.3	7.2	7.3	7.3	7.4	7.3	7.6	7.3	7.5
Chase Econometrics	7.3	7.2	7.4	7.5	7.4	7.4	7.4	7.3	7.4
Wharton EFA	7.3	7.1	7.0	7.2	7.0	7.0	6.7	7.2	6.9
Townsend-Greenspan	7.3	7.3	7.2	7.1	7.0	7.2	7.6	7.3	7.2
Blue Chip Consensus	7.3	7.2	7.2	7.1	7.1	7.2	7.1	7.2	7.1
CBO	n.a.	n.a.	n.a.	n.a.	n.a.	7.1	6.9	7.2	7.0
Administration	7.3	7.2	7.1	7.0	7.0	7.1	6.9	7.2	6.9

nual rate in contrast to 5.0 percent in the comparable stage of four previous post-World War II expansions.

The pattern of growth in the first 11 quarters of the current and previous expansions is summarized in Table 2. As shown there, capital spending has been a much larger factor in this expansion than in previous expansions, accounting for a little less than one-third of real growth during this expansion or more than twice as much as during comparable periods in past expansions.² Growth in almost all other components of domestic demand has also been stronger this time, but the net export balance has been a large statistical negative reflecting

TABLE 2
GNP Components in the First Eleven Quarters
of the Current and Previous Expansions*

	Real Growth		Contribution to Total Real Growth	
	Average, four past expansions (Percent, annual rate)	Current expansion	Average, four past expansions (—percent of total—)	Current expansion
Real GNP, total	5.1	4.9	100.0	100.0
Consumer spending	4.7	5.0	57.0	67.4
Durables	10.3	12.2	15.9	26.2
Business capital spending	7.6	11.5	14.6	27.3
Structures	4.0	6.0	3.2	4.4
Equipment	9.8	13.9	11.4	22.9
Residential construction	10.7	16.8	8.4	10.5
Inventory investment	n.a.	n.a.	9.7	10.9
Net exports	n.a.	n.a.	2.8	-28.2
Exports	8.8	0.4	10.6	0.7
Imports	7.8	16.7	-7.8	-28.9
Federal purchases	-0.4	4.1	-1.1	7.1
Excluding CCC	n.a.	5.5	n.a.	9.0
State & local purchases	3.7	2.1	8.5	5.0

*Four post-Korean War expansions, excluding the 1958–60 expansion that lasted only eight quarters and the short-lived 1980–81 recovery. In all cases, expansion is measured from the quarter containing the NBER reference cycle trough.

²The strong cyclical expansion of investment has raised the ratio of gross investment to GNP to much more satisfactory levels. The situation is not quite so favorable in terms of net investment. On this point, and for a more critical view of the effect of recent policies, see Barry P. Bosworth, *Tax Incentives and Economic Growth*, The Brookings Institution, 1984, pp. 1-208.

the leakage of demand to overseas suppliers. (In turn, however, the net export balance has been the mirror image of a large voluntary inflow of capital to the U.S. which has supplemented domestic savings and stimulated capital formation.)

Inflation and interest rates

One of the more striking features of recent economic developments is the progress that has been made in reducing inflation. The record is summarized in Table 3. As shown there, in terms of the GNP deflator and the Consumer Price Index, inflation has been pulled down to the 4 percent range or less in recent years. Inflation has been virtually eliminated for producer (wholesale) prices. A disinflationary process, particularly pronounced at early stages of the production process, has been continuing even as real growth has resumed. For example, wholesale prices of crude materials have now declined for ten consecutive months and are more than 10 percent lower than a year earlier. While this has been extremely beneficial in terms of reducing the overall rate of inflation, it has meant economic difficulty for producers of primary products—including large segments of U.S. agriculture.

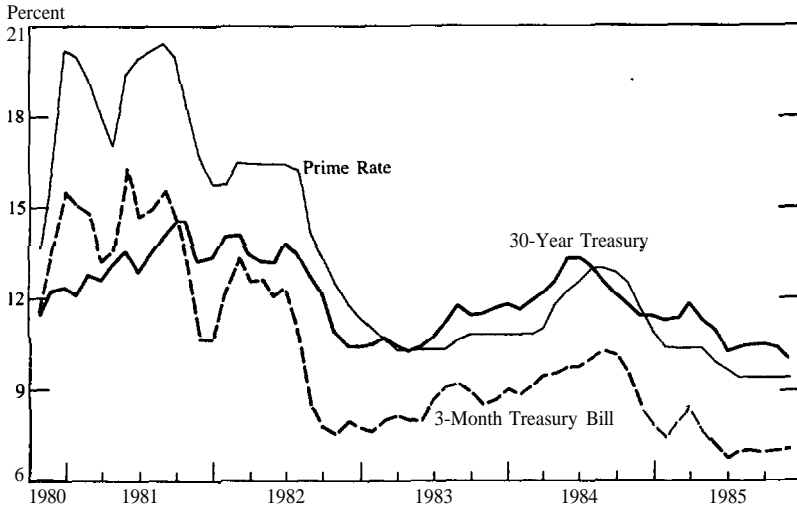
TABLE 3
Recent Progress Against Inflation
(percent change, annual rate, for period indicated)

	1980	1981	1982	1983	1984	1985 to date
GNP: Implicit Price Deflator	10.2	8.9	4.3	3.8	3.6	3.8
Consumer Price Index	12.4	8.9	3.9	3.8	4.0	3.2
Producer Price Index (wholesale prices)	11.8	7.1	3.7	0.6	1.7	-0.1

Note: CPI and PPI through September

There have been sizable declines in nominal interest rates during recent years. Chart 3 shows the record since 1980 for some key interest rates. The prime rate of interest has fallen from its 21.5 percent peak in late 1980 to 9.5 percent at the time of this symposium. The 3-month Treasury bill is currently trading near 7.25 percent, down from a cyclical peak of more than 16 percent at mid-1981 and the 30-year Treasury bond now yields about 10.5 percent in contrast to more than 15 percent at its peak in late 1981.

CHART 3
Key Interest Rates
(Monthly Averages)



Real interest rates have fallen less but seem high mainly in relation to artificially low rates during much of the postwar period because of the pursuit of Keynesian demand management policies. These policies led to serious inflation and negative real rates of interest by the late 1970s. Real interest rates in the U.S. throughout the 19th and early 20th centuries averaged in the 4 to 5 percent range, except for the clear abnormalities of war and depression.³ That is not far from the present level and tax rates are currently much higher than in the earlier period. It is very questionable, therefore, whether U.S. real after-tax rates of interest are much higher than any realistic historical standard.

The point of this brief review of recent economic performance has not been to suggest that the economy is without problems. But the evidence suggests that Reagan economic policies have been remarkably

³An interesting historical review has been provided by Stephen C. Leuthold, 'Interest Rates, Inflation and Deflation: *Financial Analyst Journal*, January-February 1981, pp. 28-41. For a thorough discussion of the measurement of real interest rates, see Robert Mundell, 'Inflation and Real Interest: *Journal of Political Economy*, June 1963; James Tobin, 'Money and Economic Growth: *Econometrics*, October 1965; and Thomas Sargent, 'Rational Expectations, the Real Rate of Interest, and the National Rate of Unemployment: *Brookings Paper on Economic Activity*, 2, 1973.

successful. The recent economic record certainly stands in marked contrast to that of the U.S. economy in the late 1970s and growth has been more vigorous here than in most other major industrial nations.

We are now benefiting from strong growth, low inflation, and rising levels of employment. Hence, we do not see that any drastic alteration in the economic policy setting is required. Quite the contrary, we feel that we need to continue further along present lines by increasing the incentives for private sector activity through a more favorable tax system, reducing the rate of growth of federal spending, and enlarging the scope for the operation of free markets. This can only be accomplished if the rate of inflation is kept securely under control. Reversion to high rates of inflation would eventually undercut the progress that has been made since the late 1970s.

Deficits, interest rates, and the dollar

Reagan economic policies **have** frequently been misinterpreted by viewing them in Keynesian terms. Large budget deficits after 1982 have been viewed as consumption-driven fiscal stimulus that would expand aggregate demand and push up interest rates and crowd out private investment. The actual pattern of results has been very different. Interest rates came down sharply after mid-1982, even while the budget deficit was widening. **Inflation** has fallen very sharply and remained low. Furthermore, the vigorous expansion of the economy has not been driven by the consumer but has featured a very strong expansion of investment in plant and equipment. Clearly, something has been happening that traditional demand-oriented theories cannot explain.

Since 1982, economic growth in the United States has run far above the projections that have been generated from standard macroeconomic models and inflation has been much lower than projected. Efforts to interpret U.S. experience in simple demand-management terms have led many economists to erroneous conclusions and inaccurate projections. The U.S. economic policy approach has not been purely demand-oriented, rather it has emphasized supply-related incentives to increase real output and monetary policy to reduce and contain the rate of inflation.

The demand-oriented view has concentrated on the size of the budget deficit and has alleged that the U.S. policy mix is wrong, with fiscal policy too loose and monetary policy too tight. This, in turn, has required a tortuous and obviously unsatisfactory line of explanation as

to why the U.S. dollar appreciated steadily in the foreign exchange markets from late 1980 to late 1984. Large U.S. budget deficits were viewed as a potent force driving up real interest rates that pulled in foreign capital and strengthened the dollar in the process. The same line of reasoning has been used by many observers in the European countries who tend to use the size of the U.S. budget deficit as a proxy for all that they feel is wrong with the international economy.

The labored nature of such lines of reasoning is all too apparent. For example, a country that ran a large budget deficit because of excessive fiscal stimulus would find domestic demand spilling abroad and its currency depreciating—the exact opposite of what has happened in the U.S. situation. It is unrealistic to argue that there was a head-on collision in the capital markets between public and private demands for credit. The share of federal borrowing in total funds raised in U.S. credit markets has declined from 39.9 percent in 1982 to 35.5 percent in 1983, 27.1 percent in 1984, and an estimated 25.7 percent in the first half of 1985 and interest rates have come down substantially.

The fact of the matter is that the simple budget deficit theory is defective and the alleged systematic linkages to interest rates and international capital flows are weak to nonexistent. In March 1984, the Treasury Department released a comprehensive study dealing with the various economic issues associated with the federal budget deficit.⁴ Probably the most important single conclusion to be drawn from that study is that there are no simple answers about the effects of federal deficits. For example, the notion that higher deficits cause interest rates to rise and the dollar exchange rate to appreciate is not at all certain. The direction in which interest rates and exchange rates move as deficits increase depends on a complex set of factors of which the following are only a few possible examples.

- The state of the business cycle here and abroad.

⁴*The Effect of Deficits on Prices of Financial Assets: Theory and Evidence*, U.S. Treasury Department, Washington, D. C.: U.S. Government Printing Office, March 1984, pp. 1-83. See also, Manuel H. Johnson, Testimony before the Joint Economic Committee, October 21, 1983, and before a Subcommittee of the Joint Economic Committee, September 13, 1984. James Girola, 'The Effects of Federal Deficits on Interest Rates': presented at the American Economic Association Meetings, Dallas, December 1984; and James Girola and Manuel Johnson, 'Do Deficits Raise Interest Rates?: A Structural Analysis of Financial Markets': presented at the Western Economic Association Meetings, Anaheim, California, July 2, 1985. For an interesting historical review, see Paul Evans, 'Do Large Deficits Produce High Interest Rates?', March 1985, *American Economic Review*, Vol. 75, No. 1, pp. 69-87.

- Whether the deficits are occasioned by tax reductions or government spending increases.
- The prevailing pattern of money supply growth and rates of inflation here and abroad.
- The prospective real rates of return in national markets discounted for any anticipated degree of political or economic instability.

Even when all these and similar factors are accounted for, it is still not possible to establish statistically a dependable systematic relationship between federal budget deficits and interest rates. One reason for this is that over the course of the business cycle there is a fairly straightforward empirical relationship between budget deficits and interest rates, but it runs in precisely the opposite direction from that which the conventional wisdom would require. Budget deficits rise in economic recession when interest rates are relatively low and budget deficits narrow in economic recovery when interest rates are relatively high. Therefore, over the business cycle, the largest deficits are associated with low interest rates and smaller deficits have typically been associated with higher interest rates. Even after correction for such cyclical effects, the deficit-interest rate relationship is weak and uncertain at best. This basic empirical finding, which has been duplicated again and again by disinterested academic investigators, stands in marked contrast to the assertions of some financial commentators. The persistence of strongly held opinion in the face of contrary evidence is not unusual in the field of economics but it is certainly very pronounced in this particular case.

One can only conclude that the deficit-interest rate relationship is a derivative and shifting one. As such, it is not particularly useful in terms of explaining current economic performance or predicting probable future developments. The shortcomings of the deficit-oriented view of interest rates and economic performance have been clearly demonstrated in recent years.

The more obvious link has been between economic policies that have improved the investment climate and higher after-tax real rates of return on capital spending for plant, equipment, and structures in the United States. Tax reduction combined with greater freedom of markets in this country, open money and capital markets, and an effective control of inflation has made the United States a uniquely attractive investment outlet, especially when considering anemic growth in Eu-

rope in the last few years and the higher risks associated with **third-world** investment.

The link between U.S. financial market interest rates and capital inflows is taken for granted in many discussions but does not survive even elementary empirical testing. Interest differentials in favor of the dollar were actually wider in 1980 when the inflow of funds and the appreciation of the dollar began than they have been recently. Undoubtedly, interest rate differentials can sometimes play a dominant role in **day-to-day** exchange rate movements, and they are always one element in the picture, but they cannot explain the continuing net capital inflows to the U.S. or the lasting strength of the dollar.

In recent years the U.S. capital account of the balance of payments has been the driving force as investors have been attracted by high real after-tax rates of return in the U.S. economy. This is an entirely different process from a demand-oriented expansion that spills over onto imports and must be financed. The budget deficit, on which some economists place so much emphasis, has more likely played a negative role in attracting capital to the United States. Foreigners invest here despite our budget deficits, not because of them.

The U.S. current account deficit is definitionally equal in amount but opposite in sign to the position on capital account. Causation has run from the capital account to the current account since only that would be consistent with a strong dollar. The current account and trade deficits, in turn, result from the joint influence of a number of factors: a higher rate of growth and resulting demand for imports here than abroad, reduced U.S. exports to LDC countries burdened with heavy debt, and foreign protectionist measures, as well as the strength of the dollar.

Implications for agriculture

The nature of these economic developments in **recent** years has important implications for national economic policy and for agriculture as well.

Federal expenditure growth needs to be cut back. That is the way to reduce the budget deficit. Tax cuts helped shape this investment-led economic expansion and raising taxes could end it. The budget deficit problem is, in fact, a government expenditure problem. Federal outlays, as a percent of GNP, in recent years have surged up to the 24 to 25 percent range, far above previous peacetime levels. On the other hand, tax receipts are about 19 percent of GNP, tracking very closely with

previous experience. The tax base remains intact. The problem is on the outlay side of the budget and that is where the solution should be sought.

The current problems of U.S. agriculture have arisen primarily because of the transition from high rates of inflation in the 1970s to low rates of inflation in the 1980s. This large adjustment has implications for monetary policy. It is, of course, crucially important to avoid a return to an inflationary environment. It must also be recognized, however, that a monetary policy that is too restrictive for too long can put unnecessary upward pressure on the dollar, pull in too much foreign capital, and unleash protectionist forces.

The recent G-5 actions represent a cooperative international effort to cope with some of the pressures induced by a very strong dollar. The best way for other currencies to strengthen against the dollar is for foreign countries to improve the performance of their economies, remove or reduce existing structural rigidities, and raise the rate of return on their capital when it is employed at home. In their recent announcement, finance ministers and central bank governors of the Group of Five industrial countries (United States, France, Germany, Japan, United Kingdom) pointed out that such a process is indeed occurring—that significant progress has been made in narrowing disparities in growth and inflation, and in restoring national vitality and responsiveness. The Group of Five expressed the view that these recent shifts in the fundamentals of economic performance and prospects have not been reflected fully in exchange markets and that a further appreciation of the main non-dollar currencies against the dollar was desirable. Since the announcement, the dollar has experienced further significant declines.

Conclusion

In the last analysis, most of the problems of agriculture appear to be largely transitional and were brought on by the puncturing of the highly inflationary expectations of the late 1970s. It is important that the disinflationary process not be pressed too far or accelerated. That is one of the important current responsibilities of monetary policy. Nevertheless, agriculture and other sectors will have to adjust to the period of relative price stability that lies ahead, an adjustment process that will likely last for a number of years. The administration is committed to helping that adjustment process.

The strength of the dollar in foreign exchange markets is largely a

reflection of the strength of the economy and its improved prospects. It is not realistic to assume that the national or agricultural situations would be improved by reversing the policies of recent years. Weakening the dollar by damaging U.S. economic performance means weakening the overall economy. On the other hand, an appreciation of other currencies relative to the dollar, in response to improved performance and prospects abroad, would be desirable. As this occurs, U.S. competitiveness will improve and agriculture as well as other sectors will benefit.

The wrong directions are also clearly apparent. Artificially low interest rates, larger budget deficits, higher taxes, preferential credit, and renewed inflation are not in the long-term interest of the country or the U.S. agricultural sector. Yet, these are the probable results of shrinking away from the necessary adjustment process and trying to meet the deep-seated problems of agriculture through expanded government programs. Agriculture would prosper much more through a greater degree of market orientation in a steadily expanding U.S. economy and open, growing international markets.