

POLICY ASPECTS OF INTERNATIONAL CAPITAL FLOWS IN RELATION TO U.S. AGRICULTURE

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Billions of dollars change hands daily in international currency transactions. The burgeoning size of this market and the development of new financial instruments have been part of the rapid expansion of the financial sector over the last decade. However, while the magnitude of this activity has received much public attention, the international financial flows most relevant to U.S. agriculture are of another type.

Gross purchases and sales of dollars easily mount into the trillions each year, and will continue to do so regardless of whether the U.S. balance of payments is positive or negative or whether the value of the U.S. dollar rises or falls. Of key interest to agriculture and other sectors that produce internationally traded goods is the prospect for changes in *net* capital flows and the consequent impact on the international value of the dollar.

International Capital Flows, Value of the Dollar and Competitiveness of U.S. Agriculture

Economists view the value of the dollar as being determined by supply and demand in the dollar market. There will be a greater demand for dollars when foreigners want to acquire U.S. goods, services and assets. There will be a greater supply of dollars when Americans want to acquire foreign goods, services and assets. For example, when there is a crop failure abroad and U.S. agricultural sales rise, foreign buyers increase the demand for dollars and, all else equal, drive up their value. Correspondingly, if foreigners choose to buy more U.S. farmland, again the demand for dollars rises internationally and their value will rise.

More typically, the opposite direction of causation is assumed. Instead of U.S. agriculture's fortunes driving the value of the dollar, changes in the value of the dollar are seen as driving the outlook for U.S. agriculture. Because agricultural transactions account for a rel-

atively small part of the overall demand for dollars, the latter framework is a natural one to adopt. Therefore, attention will be focused primarily on other factors determining the value of the dollar, followed by some commentary on the consequences of dollar depreciation for U.S. agriculture.

This discussion provides the background appropriate for evaluating the types of policy changes that might alter the current flow of capital in the United States.

An Accounting Framework

Two types of accounting relationships are often used in summarizing transactions that influence the value of the dollar. One is balance of payments data, which presents a composite view of international purchases and sales of goods, services and assets, and which also indicates the extent of Central Bank intervention in determining the value of the nation's currency. The other type of data is from national income accounts, which can be used to show national production of goods and services compared to national demand for goods and services, the difference being accounted for by international capital flows. The latter approach is adopted here.

A key relationship is summarized by the following condition:

$$X - M = S - I + T - G$$

where X is exports of goods and services, M is imports of goods and services, S is private saving by individuals and business, I is private investment, T is taxes and other government receipts, and G is government expenditure on goods and services.

The left hand side of the equation is the international balance on goods and services, a concept very close to the current account balance; in the case of U.S. statistics the two will differ primarily because the former measure ignores public debt service payments to foreigners, while the latter measure includes it. For the sake of simplicity, all future references here will be to the current account balance as $X - M$.

A negative current account balance shows that a country buys more than it produces. If the United States runs a current account deficit, foreigners as a group must run current account surpluses. The surpluses allow them to acquire dollars in order to buy U.S. assets and IOUs, which in turn are being sold by the United States to finance the purchase of extra goods and services internationally. Thus, what appears to be a relationship regarding international trade simultaneously represents a relationship regarding international capital flows. U.S. bonds, stocks and real estate are sold to foreigners, or foreigners pay off past debts to U.S. lenders and buy out U.S. owners of operations in their countries, using dollars they have earned by selling goods and services to Americans. In 1986 this

net capital inflow represented 3.5 percent of gross national product (Council of Economic Advisers).

The terms on the right hand side of the equation indicate why this net sale of assets occurs. The first two terms show net private saving and the next two terms show net public saving. When private plus net public saving is less than domestic investment, the current level of private spending on new machines, factories and houses, and/or the same level of government spending, can be maintained only if foreigners find it attractive to provide the financing. Otherwise, interest rates would be higher and choke off some of this spending. U.S. experience in the 1980s has been that private saving has slightly exceeded private investment, with the exception of 1986, but public saving has turned sharply negative. In 1986 the former figure represented -0.1 percent of gross national product (GNP), while the latter figure was -3.4 percent (Council of Economic Advisers).

The condition shown above also is a useful reminder of the link between international trade conditions and other macroeconomic relationships. Steps to solve the current account imbalance, either through the negative approach of protectionism or the more positive approach of trade liberalization, are unlikely to have much aggregate effect unless they also alter the underlying saving and investment conditions in the economy. Otherwise, they are likely to result in an offsetting exchange rate change.

For example, steps to get tough with Japanese imports and limit their access to the U.S. market mean fewer dollars are supplied on international markets; the value of the dollar appreciates as a result. Exporters and producers in other import competing industries that do not benefit from this special protection will both find themselves in a less competitive position than previously. Agricultural producers dependent on open markets internationally have long recognized this relationship, and they have been some of the few voices to testify in Congress against protective measures.

Exchange Rate Changes and U.S. Agriculture

Changes in the value of the dollar are an important element in determining the demand for U.S. agricultural commodities. Although foreign government intervention (exemplified by quantitative import restrictions in consuming countries or competitive export subsidies in other producing countries) is extensive in many agricultural markets, the demand for U.S. exports appears to be price elastic even for relatively restricted commodities such as wheat.

Of course, even when demand is responsive to changes in prices and exchange rates, U.S. export sales will not increase unless the price changes and currency depreciations affect the markets in which U.S. agricultural exports are sold. Measures of dollar depreciation based on trade among industrialized countries overstate the extent of

the real exchange rate change affecting ag trade (Henneberry, Drabbenstott and Henneberry). Nevertheless, some decline has occurred and more appears likely. Thus, for a given level of income in foreign markets, dollar depreciation should result in more than a hollow promise of greater agricultural exports.

However, depreciation of the U.S. dollar to the level that prevailed at the end of the 1970s will not recreate the world agricultural market of that era. The strong growth in per capita income that took place in the 1970s among developing countries has not been matched by comparable growth in the 1980s. Resolution of the Less Developed Country (LDC) debt crisis, and the potential relaxation of financial stringency imposed in many importing countries, will be an important step in reviving U.S. export sales, quite independently from dollar depreciation.

Also, if foreign governments choose to subsidize their exports to dispose of surpluses, U.S. exports may not rebound to previous levels. Steps to influence the value of the dollar may be more subject to control by U.S. policy makers than are the ag production and trade policies of other countries. Therefore, ways of affecting the value of the dollar, and the role of international capital flows in this process, are evaluated in the remainder of this paper.

Policy Choices Affecting the Net Inflow of Capital

Tighten Monetary Policy

One way to reduce capital inflows into the United States is to reduce the attractiveness of investment here. Tighter monetary policy, driving up interest rates, would push the economy in this direction. In turn, a decline in income would result in fewer imports and a decline in the current account deficit. The opposite relationship, of strong U.S. growth drawing more imports into the economy, has been an important reason for the persistence of the U.S. deficit. However, higher interest rates also attract foreign investment and if that response is particularly large, dollar appreciation may offset the tendency for the current account deficit to fall. Also, debt service payments to foreign lenders will rise, a factor that shows up as an import of services and reduces the tendency for the current account deficit to fall. Although the net effect cannot be predicted *a priori*, it is worth noting that the last U.S. merchandise trade surplus occurred in 1975, a year of economic recession.

Regardless of whether the capital inflow declines, the high cost of retarding investment and throwing the economy into a recession may cause a politician to conclude that the potential cure is worse than the disease; that strategy did not result in a pleasant outcome for Gerald Ford.

Reduce Budget Deficit

A more commonly suggested means of reducing the incentive for large foreign capital inflows is for the U.S. government to increase net public saving by reducing its large budget deficit. In terms of the symbols used above, a reduction in government spending or an increase in taxes would imply a smaller net demand for loanable funds by the government. With smaller demands on available credit, interest rates would decline and the value of the dollar would depreciate. The opposite sequence of events was observed in the 1980s as the dollar appreciated.

This recent record has differed from earlier experience with large budget deficits when economists observed declines in interest-sensitive items such as business investment, inventory accumulation, home construction and purchases of consumer durables such as autos and appliances. Instead, large budget deficits in the 1980s led to a large inflow of foreign funds, an outcome attributable in part to the liberalization of Japanese financial regulations that allowed their insurance companies and other intermediaries to acquire foreign assets. As a result, interest rates did not rise as much as they otherwise would have. Rather than interest-sensitive sectors being crowded out by government expansion, the foreign trade sector was crowded out by the appreciation of the dollar.

Just as that crowding out meant that the stimulative effect of the large federal budget deficit was diluted, a reduction in the budget deficit would not necessarily imply a large contraction in U.S. economic activity. Instead, the contraction from a cutback in government spending, or from a reduction in investment or consumption as taxes were raised, would be offset in part by an expansion of the foreign trade sector. However, a change in fiscal policy alone would be unlikely to achieve domestic and international policy goals simultaneously. Coordination of less restrictive monetary policy would most likely be necessary at the same time if a decline in economic activity were not to occur.

Unfortunately, the first step in this sequence of reducing the government budget deficit has not proven very attractive politically. Federal government spending has grown as a share of gross national product to nearly 24 percent, while net receipts of the federal government have remained fairly stable at 18.5 percent (Council of Economic Advisers). The budget impasse of the summer of 1987 has centered on the willingness of the administration to accept the principle of higher taxation, together with cuts in defense and nondefense spending. A key issue of contention in reaching a compromise is the Reagan administration scepticism that raising taxes will actually reduce the deficit rather than allow a further expansion of government spending.

Additionally, the budget proposals of the administration and the Congress both include budget gimmickry, especially with respect to the treatment of asset sales. Auctioning off loan portfolios or selling government facilities may generate higher government revenue in the current year, but not in succeeding years. If the government uses the same facilities in the future, but must rent them back from the private sector, then the one year gain in revenue is an even more misleading indicator of whether the government's claim on resources in the economy, and demand for loanable funds, is likely to decline in the future.

Some commentators argue that whether the deficit is cut is merely a side issue compared to the central question of how large a government sector the nation wants. An even more doctrinaire version of this argument holds that the form of financing, taxation or borrowing, used to cover government spending, is immaterial because the rational consumer will increase his private saving to cover the future tax liability that will arise from greater current debt financing. That response clearly has not occurred in the United States in recent years, and the lack of increased domestic saving is what has provided the incentive for foreign capital inflows.

However, if tax increases do not come at the expense of saving, then current consumption is likely to fall instead. Indeed, to reduce a current account deficit, wherein the United States buys more than it produces, will require a reduction in spending or an increase in production while spending remains fixed. If the economy starts from a position near full employment, without a lot of excess capacity, major production increases are not possible. Therefore, output must be redirected from the U.S. market to foreign markets. This occurs when taxes reduce domestic purchasing power; then domestic consumers do not drive up prices seen by foreign buyers who will find U.S. goods more attractive if deficit reduction results in dollar depreciation.

In 1984 voters did not accept Walter Mondale's proposal to raise taxes, but perhaps Americans have since found that other options are no less painful.

To summarize, budget deficit reduction is an important, but far from costless, tool to consider in reducing the inflow of capital into the United States. However, as other points elaborated below suggest, several other factors will help determine the success of this deficit reduction strategy, and not all of these factors may be under the control of the U.S. government.

Encourage Saving

The level of taxation is not the only aspect of fiscal policy that affects the inflow of foreign capital. Rather, tax measures that encourage investment in the United States are likely to result in an

inflow of capital and dollar appreciation, while measures that encourage saving are likely to result in an outflow of capital and dollar depreciation.

Some measures, such as the 1984 decision by the United States to repeal the withholding tax imposed on interest income earned by foreigners in the United States, are directed specifically at foreigners. That policy change encouraged an inflow of capital into the United States and a consequent strengthening of the dollar.

In terms of broader U.S. tax policy changes, legislation in 1981 promoted investment in the United States through measures such as the investment tax credit and accelerated depreciation. Those provisions reduced the marginal effective tax rate on new investment and real investment as a share of GNP rose. This investment response was greater than the response to saving incentives included in the same law.

By way of contrast, the 1986 reform, in spite of the broad publicity given to the reduction in the corporate tax rate from 46 percent to 34 percent, is estimated to have increased the marginal effective tax rate on domestic investment. The higher burden on new investment is likely to result in a longer-run decline in foreign capital inflows.

To treat more completely the current imbalance between domestic saving and investment, some discussion of saving incentives is appropriate. If such incentives do generate greater domestic savings, they represent a way to reduce the net inflow of foreign capital. Unfortunately, convincing evidence of their effectiveness has not yet been presented, and Canadian success with similar policies does not seem to be directly applicable to Americans. The success of any saving incentive depends upon the extent to which additional saving is encouraged in comparison with the windfall gain that accrues to saving that would have taken place anyway.

The 1986 tax reform package implicitly judged against the continuation of saving incentives such as Individual Retirement Accounts and, instead, favored a general tax rate reduction to promote work effort as well as saving. A major initiative in this area does not seem likely simply on political grounds. Major tax issues will not be re-opened so soon after a major reform has passed and, at the same time, the government is attempting to raise, not reduce, revenue.

Limit Foreign Investment

Explicit policies to limit foreign investment in the United States are a potential method of reducing the capital inflow. While this alternative is not a general principle behind U.S. policy, U.S. intervention in 1987 to discourage the Japanese firm Fujitsu's attempt to acquire Fairchild's semiconductor operations from the French firm Schlumberger raises the possibility in more than theoretical terms.

Limiting foreign investment in the United States, without altering public and private saving and investment domestically, primarily will result in dollar depreciation. This relationship can be seen in the policy choices facing other debtor nations such as Mexico. Refusal to allow majority foreign ownership or reluctance to allow conversion of debt into equity, implies that more adjustment must occur through the exchange rate. If foreigners are allowed to buy only goods, but not assets, from us, then the exchange rate must depreciate more in order to make the goods appear sufficiently attractive.

Such a policy often is defended on nationalistic grounds: foreign control results in economic exploitation; or sales of government assets, such as petroleum reserves, amount to selling off the wealth of future generations. A country's preference for national control is a plausible political choice, but in this case it is achieved only at the cost of a larger currency depreciation and a larger increase in the cost of living.

Foreign Influence

The discussion thus far has focused on various concepts seen primarily from the U.S. standpoint. Yet, similar factors operating in the rest of the world also are relevant in determining how large a capital inflow the United States will attract. For example, if Japanese and German efforts to reduce their budget deficits are successful just as the United States finally controls its budget deficit, there will be an increased outflow of funds from those countries at the same time U.S. borrowing requirements are falling. The potential reduction in the U.S. capital inflow will depend upon the alternative outlets for Japanese and German saving. If there are few viable alternatives, the U.S. capital inflow may fall very little although the United States will benefit from a lower interest rate.

The United States also has urged Japan and Germany to promote faster growth of their economies in the expectation that faster growth will result in more attractive investment opportunities there and draw in more imports of goods. If faster growth is accepted by those allies as a goal worth pursuing, the direct effect on U.S. trade still is likely to be small because the United States accounts for a relatively small share of their imports. Nevertheless, greater imports by those countries would benefit other countries and help resolve some aspects of the LDC debt crisis.

Another factor partially outside U.S. control is the degree of investor confidence in the U.S. economy relative to others. Because the United States often is regarded as a safe haven in times of unrest, political instability in debtor nations and military tension in the Persian Gulf tend to cause the U.S. dollar to strengthen. Indecisive U.S. political leadership or the expectation that the United States will inflate its way out from under the current debt burden, by sim-

ply paying back in dollars that are worth much less than at present, are circumstances likely to reduce the current inflow of foreign capital. Again, those negative steps are not reasonable policy alternatives.

Expansionary Monetary Policy

The issue of U.S. inflation warrants a further review of monetary policy. In addition to 1) tighter monetary policy with no change in fiscal policy and 2) tighter fiscal policy combined with more expansionary monetary policy, a further alternative is 3) expansionary monetary policy with no change in fiscal policy.

Some commentators have recommended that the Federal Reserve pursue a much more expansionary policy to drive down short-term interest rates and the value of the dollar. This approach particularly has been advocated by those who note that real long-term returns in the United States (the nominal interest rate less the expected rate of inflation) are at historically high levels exceeding 5 percent. However, that interpretation assumes current rates of inflation will continue in the future. Others believe that the high nominal return includes an inflation premium to compensate for an expected increase in inflation.

The effectiveness of monetary expansion depends in part on the amount of slack in the economy. The unemployment rate of 6 percent reported for July, 1987, is the lowest since 1979 and suggests that the economy cannot experience rapid growth without inflation rising substantially. Under those circumstances, expansionary monetary policy is likely to cause investors to demand an even larger inflation premium and to drive interest rates up, not down.

The role of expectations is particularly important. If foreign investors expect the dollar will depreciate in the future, they will be unwilling to lend to U.S. borrowers unless the interest rate rises enough to offset the expected depreciation. That view implies that an expansionary monetary policy may temporarily reduce U.S. short-run interest rates, but also will result in a substantial drop in the value of the dollar. Even advocates of dollar depreciation are unlikely to favor a free-fall of the dollar, particularly since that would set off further expectations of a marked increase in U.S. inflation. If expectations of lenders conform to this explanation, then a more expansionary monetary policy will be successful only as part of a package of steps that make an inflationary outcome less likely, such as simultaneously reducing the U.S. budget deficit.

Consequences of No Action

Because none of the alternatives presented above provide a costless way of reducing the current account deficit, it is quite possible that

no agreement will be reached to change U.S. policy. Therefore, the final section of this paper is devoted to discussing the consequences of living with continued capital inflows, a strong dollar and a current account deficit.

Although the trade deficit has been blamed for the loss of millions of jobs in the United States, that judgment simply considers one part of the economic relationship discussed above. Less activity may take place in sectors that produce traded goods and face more foreign competition, but the current account deficit means foreign investment enters the United States and creates jobs elsewhere in the economy. The aggregate influence on employment is minor compared to the effects within particular sectors of the economy.

Another way of thinking about this relationship is to recall the converse situation debated in the late 60s and early 70s when some commentators argued over the number of jobs lost when the United States ran a trade surplus and invested abroad. Claims that investment abroad cost U.S. jobs ignored the fact that jobs were created by the production necessary to generate a trade surplus in order to buy foreign assets. Again, the net effect on employment was insignificant.

The thrust of this argument is that many concerns about the trade deficit are rooted in distributional issues. Some would ask whether particular workers or farmers should be expected to pay the price of an unforeseen shift in U.S. economic policy toward large budget deficits and tight monetary policy. Others would ask whether the persons hurt by these changing circumstances are any more deserving than those who have found new opportunities in an expansion that has created more jobs in the 1980s than any other market economy in the world. These are clearly political questions.

However, when an economy is forced to shift rapidly from one type of activity to another, with no assurance that it may not shift back again in the future, a waste of resources and loss of economic efficiency will result. Establishing a consistent economic environment is an important responsibility of government.

A second aspect of living with an inflow of capital is to ask how these resources are being used. The United States was a net debtor nation in the 19th century and the opening up of the west occurred with strong British financial participation. Although some U.S. defaults occurred, in general the United States was able to use these resources productively enough to pay back foreign lenders and still increase national income.

If foreigners want to invest in a strong and expanding U.S. economy now, or expect to receive a real return greater than what is available elsewhere in the world, that would simply appear to be a potentially good business decision on their part.

Of course, the United States may be forced to make serious economic policy choices even as foreigners are successful in earning high returns from investing here. When newspapers editorialize over the failure of current U.S. policies that mortgage the future and cost us our world economic leadership, they implicitly are making the judgment that we are not making the same productive use of these resources that we did in the 19th century. If our current borrowing does not result in greater productive capacity, then paying back foreigners in the future will mean a smaller share of the same sized pie is left for Americans. Under those circumstances, ignoring the current account deficit does impose a burden on our children and grandchildren.

Unfortunately, our inability as a society to make decisions that might reverse this outlook is a much broader problem than dealing with international capital flows and requires more than the advice of an economist to resolve.

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