Cooperative Extension Service
University of Illinois
at Urbana-Champaign

WEEKLY OUTLOOK
Department of Agricultural Economics
College of Agriculture
University of Illinois at Urbana-Champaign

July 22, 1987

MACROECONOMIC DEVELOPMENTS AND AGRICULTURE

The general economic expansion that began in 1983 continues in 1987 with surprising longevity. Growth remains sluggish, however, as the economy continues to suffer from the related effects of the large federal budget deficit, high real interest rates, and a large trade deficit. These macroeconomic trends of the 1980s contributed to the farm crisis. In contrast to the last few years, it appears that in 1987 inflation will rise, real and nominal interest rates will be slightly lower, and the dollar exchange rate will be lower against the currencies of other industrial nations. These macroeconomic developments will have limited benefits for agriculture.

The real gross national product grew at an annual rate of only 1.5 percent in 1986. Growth speeded up to 4.4 percent in the first quarter of 1987, but much of this apparent increase is due to inventory building. Growth is projected at only 1.5 percent in the second quarter. These growth rates are low in comparison with 1983 and 1984. Civilian unemployment fell to 6.0 percent in the second quarter of 1987 after having remained at 7 percent in 1985 and 1986. Continued growth and reduced unemployment should help agriculture by bolstering consumer demand.

Inflation in 1986 was a very low 2 percent due to a decline in the prices of basic commodities like oil and food. Inflation recently increased to 3.5 percent in the first quarter of 1987 and is expected to increase further. The falling value of the dollar will raise the price of imports and oil prices are not expected to decline further. A change of leadership at the federal reserve board might also bring faster growth in the money supply, which will also increase inflation. Higher inflation will give agricultural commodity prices more buoyancy and will reduce the real value of agriculture's debt burden.

Combined consumer and public debt remain at record levels and cast a long shadow over future growth prospects. The federal budget deficit set a new record of $221 billion dollars in 1986 despite intentions to reduce. The deficit is projected to begin falling during 1987, but progress is likely to be slow.

The large public deficit of the early 1980s increased demand for credit. In order to fund the deficit, high real interest rates (interest rate minus inflation) were needed to attract funds. Real interest rates in the early 1980s reached their highest levels since World War II. This put a severe burden on agriculture because it raised interest costs and helped to drive down land values. Although both nominal and real interest rates declined in 1986 and the first quarter of 1987, they are still above the levels of the 1970s. Recently, nominal interest rates increased again. The massive U.S. public debt will keep real interest rates relatively high for the foreseeable future.

High real interest rates in the 1980s encouraged foreign investment in U.S. dollars, which nearly doubled the dollar exchange rate between 1980 and 1985. Inflows of foreign capital financed the growing public and private U.S. debt. Decline in the interest rate and concerted efforts by the central banks of industrial nations reduced the dollar exchange rate drastically in 1986 and early 1987. Recently the dollar stabilized near its 1980 level.

The fall in the dollar, combined with lower loan rates, led to some recovery in agricultural exports in 1986. This recovery was limited by two factors, however. First, agricultural markets in other industrial nations were protected by government policies from the decline in world commodity prices and hence did not respond to the lower prices. Second, the decline in the dollar was uneven, so that not all countries saw the decline in world agricultural prices reflected in their own currencies. The dollar has remained high, for example, against the the currencies of major agricultural customers like Mexico and South Korea, as well as against the currencies of major competitors like Brazil and Argentina. The response of world supply and demand to lower U.S. loan rates has been limited by the uneven decline of the dollar.

Some recent and expected developments in the U.S. economy will have small positive benefits for agriculture, but the long term outlook is still clouded by the large U.S. deficit. Higher inflation, slightly lower real interest rates, and an uneven decline in the dollar exchange rate will help agriculture by reducing debt burden slightly and by providing some encouragement for exports. The large U.S. public debt will continue to put pressure on interest rates. The need to finance the debt with foreign capital inflows will continue to place pressure on the dollar and to reduce the chances for an across the board decline in dollar exchange rates. U.S. agriculture is a trade-oriented, capital-intensive sector and its long-term growth prospects will be dimmed by these trends.

Laurian J Unnevehr

Issued by Laurian J. Unnevehr
Extension Specialist
Prices and Outlook

Cooperative Extension Service
United States Department of Agriculture
University of Illinois
At Urbana-Champaign
Urbana, Illinois 61801

FIRST CLASS