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WEEKLY OUTLOOK

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THE MACROECONOMY, AGRICULTURE, AND THE DROUGHT

Developments in the general economy are important for agriculture, but their impact is usually felt only over a period of years. Should the current drought last, the generally healthy macroeconomy may reduce some of its effects on the agricultural sector in the long run. Furthermore, the macroeconomy should be able to absorb food price increases resulting from the drought without danger of a recession.

The U.S. economy grew at 3.9 percent in 1987, and continues to grow in 1988. The current economic expansion has continued since recovery from the 1982 recession and is the longest peacetime growth since the last century. The President's Council of Economic Advisers projects that the economy will continue growing at 3.5 percent in 1989.

A number of factors have contributed to the continuing strength of the economy, and these same factors are favorable for agriculture in the long run. First, the decline in the federal budget deficit reduced the demand for credit in the economy. The reduced demand for credit, in turn, lowered interest rates. The federal budget deficit was $148 billion in 1987, in contrast to $221 billion in 1986. The interest rate on 90-day Treasury bills was 5.7 percent in early 1988, down from over 9 percent in 1984.

More importantly, the *real* interest has also fallen. The real interest rate is the difference between the nominal interest rate and the inflation rate. It represents the real cost of borrowing money. The real interest rate is now between 2 and 3 percent, comparable to levels in the 1960s, and much lower than the real rate of 5 percent experienced in the early 1980s. As interest costs are now a major item in farm production costs, a lower real interest rate is good news for the agricultural sector.

Lower interest rates have also contributed to the decline in the U.S. dollar exchange rate by reducing foreign demand for dollars. The index of the dollar exchange rate to other industrial currencies has fallen by 40 percent since 1984, and is now at the 1973 level. The fall in the dollar has brought about growth in overall export demand. This growth is one of the main reasons that the U.S. economy is continuing to grow. Agriculture has shared in the benefits of the lower dollar because the demand for agricultural exports has increased in the last three years.

The main worry for the general economy is that the strong growth will lead to more rapid price inflation. The drought contributes to inflation because it may bring about substantial increases in food prices. Most U.S. government analysts have downplayed fears that food price increases will spur greater inflation, and the President's Council of Economic Advisers projects inflation next year at 4.3 percent, the same as this year. Private analysts, however, have revised inflation forecasts for next year upward from 5 to 5.5 percent as a result of the drought.

Food price increases in the early 1970s ushered in several years of high inflation and low growth, but the food price increases this year will take place in a different economic environment. The economic situation this year differs also from the situation in 1983, when sharp increases in feed prices came on the heels of an economic recession. The economy as a whole is growing well now, and coincident oil price increases are unlikely. Policy makers are more aware of the damaging effects of inflation and will take action to control it.

In summary, the developments in the general economy are good for agriculture in the long run and will help it recover after a bad crop year. Lower interest rates reduce production costs, and lower dollar exchange rates will boost export demand in the long run. Low unemployment and growth in personal income also contribute to strong demand for agricultural products, particularly livestock products. If there are substantial food price increases as a result of the drought, the economy should be able to absorb the small increase in inflation without a major slowdown in growth.

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