7 Macroeconomics and the Agricultural Sector

P. MIDMORE and D. A. PEEL

7.1 INTRODUCTION

The study of macroeconomic linkages with the agricultural sector has become firmly established over the past two decades. Of course, agricultural economists have never been entirely parochial in their interests: real variables, as a matter of course, have always been used as explanatory variables in sectoral modelling (such as gross domestic product in demand functions, interest rates in cost functions and the valuation of farm assets). Occasionally, though, the range of interest has been more to do with macroeconomic issues themselves: in the 1960s, for example, concern with the macro issue of the balance of payments problem in the UK led to debate on the import saving role of agriculture (summarised, for example, by Hill and Ingersent, 1977, pp. 176–80); earlier, in the input–output paradigm, there had been interest in interindustry linkages (see Fox, 1963).¹

Macroeconomic understanding is now more centrally important to the serious student, however, principally because of changed conditions in the arena of world trade. The abandonment of fixed exchange rates in 1973, and the consequent move to flexibility of interest rates combined with widespread abolition of financial controls, have facilitated the increased mobility of international capital investment. Capital flows have thus gained considerably in influence over the determination of exchange rates, relative to real trade and production conditions: the latter are crucially determined by fiscal and monetary policies. On the theoretical side, the development of the Rational Expectations approach, and the associated Efficient Markets Hypothesis has revolutionised the way in which macroeconomists think; these have filtered through into the agricultural economics discipline, and

¹ A. J. Rayner et al. (eds.), *Current Issues in Agricultural Economics* © Macmillan Publishers Limited 1993
A useful point of departure of any discussion of macroeconomic linkages and agriculture is Schuh's (1974) article on the exchange rate and agriculture. This seminal contribution was sufficient, in the considerable volume of literature which it prompted, to identify the exchange rate as the mechanism which transmitted changes in fiscal and monetary policy to agriculture. We cannot hope to describe in detail the development of these insights: rather, we will attempt to develop a theoretical model which demonstrates the current state of thinking, and then briefly review some of the (supporting or otherwise) empirical evidence.

The chapter is organised as follows: the following section examines agriculture in the context of international macroeconomic events. In section 7.3 we attempt a brief synopsis of both the rational expectations hypothesis and the closely related efficient markets hypothesis. Subsequently, in section 7.4 we examine the model of 'overshooting' which has attracted so much attention recently. Because many international commodity prices are denominated in US dollars, the macroeconomic policies of the USA have external implications for agricultural prices in other countries. Section 7.5 briefly explores these implications for the European Community and for developing countries. Finally, section 7.6 provides our assessment of the relevance and validity of the most recent developments in thinking on these issues.

7.2 EXCHANGE RATES AND AGRICULTURE

Essentially prior to 1973, nominal exchange rates were fixed for long periods of time, and realignment occurred only in cases of severe external imbalance. Under normal circumstances, disciplined monetary and fiscal policies were expected to maintain parity: a balance of payments deficit which occurred if domestic inflation exceeded the external rate had to be dealt with by contractionary policies, and currency devaluation was reserved only for extreme cases of macroeconomic imbalance. However, this reckoned without the reserve currency status of the US dollar, effectively the unit of account for international transactions, and the standard of measurement for other currencies. Thus the USA was able to run a current account deficit almost without exception in the years from 1950 to 1971: as a result,