

Farm and non-farm industries react differently to price changes

This last week I ran across an interesting discussion on an ag website. The discussion began with a farmer raising the question of whether the multinationals have an advantage over him in the grain markets. From there the discussion quickly turned into a discussion of government involvement in agricultural markets.

On the one side of the discussion were a couple of farmers who were arguing in support of free markets and against government intervention. "Get your head out of the sand, and stand up for yourself. The government is not the answer, and stop blaming others for your own problems. No system is perfect, but this is the best in the world," one farmer told the others.

On the other side were several who believe that government has an appropriate role in crop markets. One discussant noted that even the free marketers were happy to cash in their LDPs.

At the root of this discussion is a debate on the benefits of free markets for crop farmers. And, that gives me the opportunity to talk about markets. I am just as much in favor of free markets as the next fellow and what a wonderful system it is. As a rule, it works almost like magic.

The all important signal is price. Changes in price cause producers to change output levels (less output, when prices go down; more output, when prices increase). And changes in prices cause consumers to change how much they consume (more, when prices decline; less, when prices rise). The more responsive producers and consumers are to price, the faster markets can satisfactorily re-equilibrate.

So the real question is how well—how much and how quickly—consumers and producer respond to the price signal. The more and the quicker the price response, the better. Let's look at some examples.

If the prices of DVD players or clothes or vacations drop because of over-production or economic conditions, we, as consumers, anxiously take advantage of the price bargains by consuming more of the particular item. By doing so, the excess is sopped-up and prices begin to recover.

How about the "product" food? The demand for the total volume of food per person is generally fixed. If the

price drops by half, no one goes from three to six meals a day. With lower prices, people may buy better cuts of meat or additional preparation, but they don't eat more. Low prices do not bring about an increase in the consumption of agricultural products as a whole.

Likewise on the output side, when prices decline producers in other sectors cut back production to the point where they can make a profit on smaller unit sales. General Motors adjusts its production weekly to balance output and dealer sales. When sales are booming, GM produces more cars and does not offer price incentives. When sales lag, GM offers incentives to move its merchandise while reducing the production schedule.

Crop farming is different. In the aggregate, the amount of land devoted to crops is relatively constant over long periods of time. Farmers may change their mix of crops to maximize potential income and minimize costs, but the aggregate amount of acres under cultivation remains nearly constant.

Free markets work great when low prices cause people to buy more and producers to produce less. In crop agriculture, neither happens to a significant degree. Now if this were widgets, the implications of such a no-price-response market structure would be interesting but not all that important.

But, food is not widgets. Food is a biological requirement for life. We cannot survive without it. Since the dawn of civilization, governments have had, at minimum, two basic functions: to provide for the common defense and to ensure a stable supply of food for its citizenry. The U.S. is no different, but given the unique characteristics of agriculture and food, an ever-expanding supply coupled with the slow response to price signals can cause problems that have not, will not and could not occur in most other industries

Daryll E. Ray holds the Blasingame Chair of Excellence in Agricultural Policy, Institute of Agriculture, University of Tennessee, and is the Director of the UT's Agricultural Policy Analysis Center. (865) 974-7407; Fax: (865) 974-7298; dray@utk.edu; <http://agpolicy.org>.