High prices cure high prices, but low crop prices tend not to cure low crop prices

In last week's column, we strongly urged farmers to use the profits from this year's high prices to reduce their debt load instead of giving into the temptation to go out and purchase new equipment and more land.

So why did we make that recommendation?

We understand the case that can be made that purchasing new equipment that utilizes the latest technology will allow agricultural producers to work more efficiently. From a time-utilization perspective that makes sense. Producers usually have more to do than time will allow, and the latest technology will enable them to accomplish more in a day. Also, since all equipment inevitably wears out, a time comes when the cost of maintenance begins to exceed the cost of new equipment, We also understand that accelerated IRS depreciation options are especially-tempting-purchase justifications in high revenue years.

Before making the plunge, we think it would be wise to imagine crop prices at half their current levels. Then if the purchase makes economic sense, head for the dealership.

The cost of both used and new equipment is, in part, increasing due to the shortage of computer chips, which is a relatively short-term problem, but nonetheless will likely be baked into longer-term equipment prices.

Crop prices, however, are a different story. They will fall dramatically.

We are reminded of the old saying that "low prices cure low prices." The idea behind this thought is that with low prices some producers will reduce their acreage or use of farm chemicals, resulting in lower production levels that will then result in higher prices.

That is certainly the way it works in the manufacturing sector, especially in those subsectors where 3 or 4 firms control a significant portion of the market.

But in agriculture we have a different story. In agriculture we see relatively high fixed costs—land, equipment, and even labor (the farmer cannot layoff herself)—compared to manufacturing where it is the variable costs (labor) that are relatively high, and labor can be laid off until demand increases. While they are laid off, most workers are entitled to government managed unemployment insurance benefits.

The result is that when agricultural prices are low, producers have every incentive to increase production in order to be able to spread their fixed costs out over more units of production. It turns out that in agriculture low prices do not cure low prices, at least in the short-to-intermediate run.

On the other hand, we have seen that high prices in agriculture cure high prices. With a burst of high prices, especially if it lasts for a couple of years, farmers will quickly convert pasture and other fallow land into cropland to cash in on the higher prices.

The result is more acres, more production, and lower prices. It happens every time.

Once that land has been brought back into production, it is exceedingly difficult for the sector to wring those additional acres back out of production. In the past, it has taken a government program like the Conservation Reserve Program to reduce the total number of acres in production.

So, in addition to urging producers to purchase new equipment only when the cost equation tilts in that direction, we would also urge them to resist the temptation to bring additional acres into production for a price situation that is likely temporary in nature.

Again, using the cash flow driven by the current high prices to reduce a farm's total debt load makes a lot of sense to us.

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