APAC Agricultural Policy Analysis Center

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PolicyPennings by Dr. Daryll E. Ray

Is extremism in the name of free markets a virtue or a vice?

As we write this column, it appears that Congressional and administration leaders have come to an agreement on the $700 billion bailout package for the financial industry.

At the same time, there are signs of potential problems in the agricultural sector. While record high prices have brought prosperity to many who, but a few years ago, were dependent on government payments to make ends meet, the high prices have resulted from worries about short agricultural commodity supplies. As many as 25 countries have restricted exports of rice, others have experienced food riots and the number of people without access to an adequate diet has increased.

US farmers are wary as they see input prices climbing and capturing a significant portion of the price increase. If prices were to tank, government payments could once again be a lifeline to financial security.

As Yogi Berra would say, "It is déjà vu all over again." Only this time it is the financial sector that took the hit on the chin first.

In the 1920s, it was the agricultural sector that first suffered a siege of severely low prices. It wasn't until 1929 that the financial sector felt the pain with the collapse, leading the whole nation into a depression that rural areas had been experiencing for more than a decade.

The 1930s revealed systemic problems in both the financial and agricultural sectors. To solve the problems in the financial industry, Congress passed the Glass-Steagall Act separating commercial banking from the more risky investment banking.

The 1930s also saw the development of the FDIC (Federal Deposit Insurance Corporation) to insure the deposits that individuals made in commercial banks. By the nature of their business, banks are vulnerable to "runs on the banks." The FDIC addressed that systemic issue.

To solve the problems of the agricultural sector, Congress passed the Agricultural Adjustment Act of 1933 which allowed for an immediate response to the crisis in rural areas. After this was declared unconstitutional by the Supreme Court, Congress passed the Soil Conservation and Domestic Allotment Act of 1936.

The goal of the response to both these sectors was to establish laws and regulations that would provide for the economic vitality of both while providing safeguards to protect against future disaster. The systemic issue in the case of agriculture is its inability to adjust quickly-neither food demand nor total agricultural supply respond sufficiently to low prices, even very low prices.

It's all about the nature of demand (we must eat no matter what, but we won't eat more if food prices drop into the basement) and the nature of aggregate supply (farmers produce no matter what in the short-run, since they can't individually influence price).

Since the passage of this legislation and particularly beginning in the 1980s, there has been a determined effort to move away from the governmental regulations, not only in the financial and agricultural sectors, but in other sectors as well.

The 1980s saw the beginning of "the government is the problem" era. As a result legislators began to dismantle the policies that had been put in place to ensure the long-term strength and viability of both the agricultural and financial sectors.

With regard to the financial sector, as financial institutions developed more complicated instruments, federal regulators took no action to put in place measures to protect the public should these instruments create chaos in the marketplace. Then in 1999, Congress took down the wall between commercial and investment banking. This gave investment bankers access to large amounts of ready cash-the deposits of ordinary individuals and businesses.

But when the current crisis hit, the flaws of massive deregulation became apparent. There were no rules in place to guard against the kind of questionable instruments and practices that brought the financial sector and the economy, as a whole,

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to its knees as credit dried up.

In agriculture the shift to a deregulated environment began with the passage of the export oriented 1985 Farm Bill. The passage of the 1996 Farm Bill, then, represented the end of the New Deal style of farm programs which sought to balance out the needs of both producers and consumers replacing these with a program that handed out money while ignoring agriculture's systemic problem.

The problem is equally severe in times of short supplies and long supplies. Agriculture would have had a real crisis this year if the US had experienced a 25 percent drop in the production of corn, soybeans, and/or wheat. Prices would be skyrocketing, further disrupting normal consumption patterns.

As with Katrina and New Orleans, in this financial crisis as well as the agricultural sector we have discovered once again the idea that government has a role to play in society. If government plays its hand too tightly there are problems, but if it plays its hand too lightly, disaster can strike. Moderation in all things, as they say, seems most appropriate.

And when, in the absence of adequate protection, disaster strikes it can be costly. With Katrina the costs exceeded $150 billion. With the financial crisis Treasury Secretary Paulson wants $700 billion. For agriculture between 1998 and 2002 the cost averaged a little less than $20 billion a year.

Listening to the national conversation, it seems that more and more people are returning to the realization that government has a role in keeping vital sectors-agriculture, finance, and flood control, among others-stable and protected against predictable crises.

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