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The role of productivity growth and farmers' income protection policies in the decline of relative farm prices in the United States

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Abstract

The paper emphasizes three interrelated questions about the decline in relative farm to non-farm prices in the United States since 1973: (1) Is it unusual, (2) What caused it, and (3) Is it likely to continue? We find that based on historical and international evidence this phenomenon may be considered unusual. Separating farm price and income support in 1973 and growing relative productivity in agriculture have been the major contributors to changing the trend of the relative farm goods inflation. This trend is likely to continue based on predicted steady growth of relative agricultural productivity and continuation of direct payments and other forms of farm income support policies.
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1. Introduction

High inflation has traditionally been one of major concerns among economic policy makers around the world. But just as high inflation may be dangerous and disruptive to the normal functioning of an economy, the same can be said about very low inflation, which can lead at an

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extreme to deflation or a sustained decline in the aggregate price level. It was noticed that the goods prices have been falling in the United States during last several years, while the services prices continue to rise (Bureau of Labor Statistics or BLS hereafter). While the rise in services prices more than offset the decline in the goods prices thus keeping overall inflation positive, the trend caused some concerns among economists in the United States (Clark, 2004).

An equally interesting trend to people who follow agricultural commodity (farm level) prices in the United States is the increasing gap between consumer prices measured by the Consumer Price Index (CPI), Producer Price Index (PPI), and prices of all non-farm commodities on one side and the farm level agricultural commodity prices on the other side. For more than 30 years now agricultural prices grew at a rate below the growth rate of any other price index in the United States. This ultimately had to lead to the reallocation of resources, especially labor, that moved from agriculture to the sectors of the economy exhibiting more opportunities (services, for example).

This paper assesses whether the sustained slower growth of agricultural prices relative to other prices in the economy should be cause for concern among farmers or policy makers in the United States. The analysis emphasizes three interrelated questions about the decline in farm goods inflation relative to other goods and services: (1) Is it unusual, (2) What caused it, and (3) Is it likely to continue?

The paper is organized as follows. Section 2 examines the extent to which last 30 years represent an experience unusual by historical and international standards. Section 3 evaluates potential explanations for the presence of this sustained gap in inflation rates. Section 4 reports results of empirical model. Section 5 concludes with an assessment of whether this gap is likely to persist or may be narrowed or widened in the future.

2. U.S. historical and international experience

Historically, farm prices in the United States have been analyzed and considered within the agricultural sector and their relationship with other producer prices has not received much attention. Thus, in spite of the evidence presented in this paper that relative farm prices have been declining only after 1973, it is commonly emphasized that real farm prices were declining during the period 1920–1970 and after 1974 until today (*e.g.*, Cochrane, 1986; Cochrane & Runge, 1992; Knutson, Penn, & Flinchbaugh, 2004). It is further argued that even in nominal terms there were long periods of declining and depressed prices. For instance, the price of corn declined from US$ 1.52 per bushel to US$ 1.33 between 1950 and 1970, while the price of wheat fell from US$ 2.00 per bushel to US$ 1.33 during the same period (Bowens, Rasmussen, & Baker, 1984, p. 45). The only time of prosperous and favorable farm prices, according to these and other sources, was the period of the early 1970s, often referred to the golden years of agriculture (1910–1914). This increase in farm prices came about due to reduced feed grain production (due to early frosts and corn blight) and increased export demand (Knutson et al., 2004). Increased export demand occurred due to a combination of factors: falling value of the dollar (following the adoption of floating exchange rate), the opening of Soviet Union's borders to U.S. grain, and an increase in income in OPEC countries.

The above statements are of course true. However, the relevant question that one ought to ask here is how did farm prices fare relative to other prices in the economy? This is a relevant question because no sector performance over a long period of time can be meaningfully interpreted if it is isolated from the performance of other sectors or the economy overall. For instance, while real prices may be declining in a sector for long stretches of time it is possible to observe similar trends

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