Beware Unintended Consequences

By DAVID LEYONHJELM

On the remote chance you might have missed it, the world is entering a nasty recession. For those involved in the agricultural inputs market, the concern is how long and how badly they will be affected.

Economists regard recessions as a natural part of the business cycle. Normally they last a year or so, there is some belt tightening by good businesses, poor businesses disappear and the economy is better for it.

Being dependent on exports, it is impossible to escape the impact locally. My guess is we will see a mild recession accompanied by rising inflation due to all the extra money the government is spending. But some claim the extra spending will cancel out the recession without causing inflation. Time will tell.

The farm economy mostly operates on a separate cycle from the general economy, being more affected by seasonal fluctuations in supply than variations in demand. Even in a recession everyone continues to eat and wear clothes.

But commodity prices can still be affected. In the Great Depression that began in 1929, crop prices fell by 40 to 60%. Prices have already fallen significantly from their recent peaks this year. In October the price of wheat and rice was down about 50% from record highs. Soybean prices had dropped by a third.

According to the FAO the main reason for the dramatic decline is record harvests. However, it also says the balance between global production and consumption continues to be precarioius, with world inventories very low and food crop areas reduced. So while the recession will drag prices down, shortages might push them up.

On the inputs side there have also been price falls. Glyphosate, for example, is less than half the price it was in June and July. Fertiliser prices are also down, with urea below levels of a year ago and phosphate and sulphur fertilisers down significantly.

The falls are partially a result of weakening demand and the credit crisis, with emerging markets such as Russia badly affected. But additional production capacity is also beginning to come on stream around the world. This should ultimately prevent a big rebound in prices as demand recovers.

Assuming no return to widespread drought, those selling inputs to Australian farmers should be fine for a year or so. Demand for chemicals, fertilisers and machinery will be underpinned by moderately healthy commodity prices aided by a weak Australian dollar. Input prices may fall further, although not as much as if the dollar was stronger. The acute shortage of personnel should ease as the mining industry scales back.

However, there are other factors that make this recession different from others and the potential for a prolonged downturn more worrying.

One is that pretty much every major country is affected. Unless something happens, like a major war or China embarking on a renewed infrastructure spending spree, there will be no global driver of economic recovery.

Another is the high likelihood of unintended consequences from Governments attempting to to impose regulations and controls in the belief that they can prevent similar recessions in the future.

Muddle-headed regulation in the Great Depression, including frantic attempts to shore up the economies of individual nations through protectionist policies and retaliatory tariffs in other countries, exacerbated the collapse in global trade and prolonged the depression by many years.

The policy response will be different this time, but politicians seem determined to mess around with the world’s financial system. Experience suggests they are more likely to choke the market with regulations and stifle economic recovery.

Of particular relevance to Australia is the risk of a return to agricultural protectionism. Despite the World Trade Organisation and other international agreements, trade barriers in the form of subsidies, tariffs, import quotas and quarantine standards are still alive and well in the agriculture sector.

The issue now is “food security”. When prices peaked earlier this year and food briefly became scarce, there was global uproar and riots in some countries. Quite a few responded by restricting exports to guarantee local supplies and keep prices down. Others increased restrictions on imports to ensure local producers remained viable and to maximise self-sufficiency. Subsidies on inputs were raised too.

A return to high food prices in the midst of a protracted recession, made worse by regulatory intervention, could prompt a lot of protectionism in the name of food security. Add some old-fashioned scapegoating of multinational corporations and a dash of xenophobia about foreign food and you have the ingredients for some acutely sensitive and massively disrupted export markets.

Businesses tend to do best in an environment of predictability. Even a recession of predictable severity and duration is tolerable. But unintended consequences from ham-fisted regulation by politicians and bureaucrats is another matter. There is no telling where that might take us.

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