Illustration 12.3
For Perfect Competitors a Boom Can Be a Dangerous Thing

The U.S. farm belt was riding a grain boom in the spring of 1996. According to ***The Wall Street Journal,*** corn and wheat prices had risen to their highest levels in two decades*: “Sales of pickups, tractors and combines are surging. Growers are making plans to put long-idled fields back into production. Land prices are moving up.” But, as the ***WSJ*** noted, all this good fortune was making the fortunate uneasy. One grower said, “We all know a boom can be a dangerous thing.” He was alluding to the “Grain Belt's last big party,” in the 1970s, one that ended badly.

Soaring land prices had made many area farmers millionaires. Consequently, they spent a great deal on consumption goods. But “above all, they bought land, bidding up prices wildly for the scarce supply of good soil that was for sale. [The farmer quoted above] went deep into debt to buy new equipment and triple the size of his operation.”

According to the ***WSJ,*** “Then grain stockpiles ballooned. Crop prices fell. Land purchases leveraged at the high interest rates of those days were exposed as blatantly uneconomical, and the price of land plunged. The rural Midwest sank into a 1980s debt crisis that nearly wiped out a generation of farmers.” The article asked, “Will it happen again?”

Many economists at the time thought that the upturn had a better chance of avoiding such a fate. One reason given was that exports were more firmly rooted and not as likely to fall as much as they did in the 1980s. There was less competition from European grain exports because of recent trade agreements. But a large percentage of grain sales were to Asia’s growing economies, many of which experienced sharp downturns in 1997. The U.S. market had, however, expanded.

Furthermore, farmers, scared by the bust in the 1980s, had become more conservative and more sophisticated in business. One example given was a 34-year-old farmer who, right after high school, had borrowed $228,000 to buy farmland. After watching the value of his land fall by two-thirds, he went to college, where he studied what had gone wrong, then went on to earn an M.B.A. at the University of Chicago. He returned to the family farm in 1993, and using business practices he had learned, was earning a 30 percent return on equity by 1995. He had lost a lot of his appetite for land, saying, “I learned my lesson.” Because so many young people had left agriculture after the bust, a large percentage of farmland was owned by people over 60, who were interested in avoiding risk. Much of the new investment was being made in cash rather than through debt. Farmers were being more cautious because they expected government subsidies to be gradually eliminated. Bankers had become more reluctant to make loans—debt as a percentage of farm assets was 16 percent compared with the 1985 high of 23 percent.

We conclude this illustration with a prediction made in ***The Wall Street Journal*** article: “Nobody here thinks the changes made by farmers have buried the boom-and-bust cycle. Today’s high crop prices will inevitably boost production enough to rebuild the nation’s depleted stockpiles and knock prices down again.”
This is the point of this illustration. Perfectly competitive firms and industries have ups and downs—the very nature of perfect competition is cyclical. No one farmer, acting alone, would be able to prevent falling prices before they came. When prices are high and people are earning above-normal profit, production always expands. Price will fall. Profits will return to normal or, as in the above case, to far below normal when there is too much investment. The one thing the farmers discussed here could do, and seemed to be doing at the time, was restrain some of their previous exuberance during good times so as to moderate their own losses when the market inevitably turns down. Oh, there is one other point: As in the case of the teenage land speculator turned successful businessman, a good education in economics and business is very useful in any profession.

*High Grain Price Lifts Farmers, but Will They Overexpand as Before?” ***The Wall Street Journal,*** Mar. 21, 1996.