∆ **Contact Dr. Daryll E. Ray** at the UT's Agricultural Policy Analysis Center by calling (865) 974-7407, faxing (865) 974-7298, or emailing dray@utk.edu.
For more info, visit: www.agpolicy.org

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Worst Financial Crisis In Decades And The Usual Remedies Are Unavailable

DR. DARYLL E. RAY
Agricultural Economist
University of Tennessee

No matter where one turns there is news about the economic crisis. What was once thought to be an event confined to some bad mortgages has now engulfed most of the world.

Japan is in crisis, Toyota has announced its first quarterly loss in seven decades; China is wondering how to maintain its middle class now that export orders have slowed; and the US reels from one set of bad numbers, increasing unemployment figures, to another, an increase in the number of mortgage foreclosures.

So far farmers have escaped the worst of it. While crop prices are half of their mid-summer highs, they are still nearly double the farm gate prices of a few years ago. Some farmers got burned with advance purchases of fertilizer and seeds, while others saw their forward contracts of corn sales vanish as some ethanol plants went under, but overall crop agriculture is in a better position than it was in 1999 and 2000.

On the other hand, even the best-protected farmers will not remain isolated from the crisis swirling around them. Certainly credit standards will be tightened and the financing of inputs may be dicey for some. While farm land prices remain stable compared to suburban homes, a price drop in the coming months could be bad news. A cost-price squeeze seems inevitable this coming year.

The challenge in all of this is to figure out what is happening. What are the dynamics of the current economic slump that some are likening to the Great Depression?

For most of us, those born after the Great Depression, economic downturns have been managed by a combination of interest rate actions by the Federal Reserve, allowing the value of the dollar to fall, tax cuts, and modest increases in government spending.

This time the Federal Reserve has run out of bullets – the interest rate is just about as low as it can go. A couple of weeks ago we kidded about the interest rate going negative. "What will they do, pay us to borrow money?" And then in the auction for three-month T-Bills it briefly did. Except in an Alice in Wonderland world, interest rates are no longer an effective means of stimulating the economy and pulling us out of the slump.

For the last several years the value of the US dollar has fallen relative to other currencies, making imports into the US more expensive and exports more competitive. One way to stimulate the economy would be increase exports thus increasing domestic employment and the domestic market. However, in this crisis, money has come flooding into the US, raising the value of the dollar, narrowing the door for an export-led recovery – not to mention the "even-in-good-times" negative imbalance of US exports compared to imports. Once again we have no bullets.

Tax cuts for average citizens are supposed to trigger consumer spending, leading to a demand-driven recovery. Tax cuts on investments and businesses are supposed to trigger business investment in research and increases in productivity, leading to a supply-driven recovery.

Early in the Bush administration we had some massive tax cuts. When 911 triggered a continued downturn in the economy, consumers were asked to be patriotic and go out and spend.

With the development of the housing bubble in an era of low interest rates, many people refinanced their homes to take advantage of the lower interest rate, the higher value of their home, and the opportunity to cash out some of their equity. For the most part they spent this money, pulling the economy out of the recession. Some refinanced their homes more than once, using the increased equity in their home and the low home loan interest rates to pay off their higher interest rate credit cards. With all this spending we had a demand driven recovery.

It was good as long as it lasted. But then the first troubling signs began to crop up with sub-prime mortgages. And then it was not long that the foreclosure rate for non-sub-prime mortgages began to creep up as housing values fell and people owed more on their house than it was worth.

This in turn created a crisis for the mortgage holders. It seems that the mortgages had been sliced and diced in so many ways that it was hard to determine the value of the financial instruments – derivatives – that depended on the timely repayment of the mortgages.

Banks became uncertain about their underlying assets, the stock market began to plunge, the commodity markets took a swan dive and suddenly credit that had been easy to get became nearly unavailable.

Fearing for their jobs and struggling to keep up with mortgage and credit card payments, the average consumer has little room to create the miracle recovery a second time. They are broke and afraid.

As we look for our way out of this crisis, we need to recognize that:

- Traditional monetary policy has shot all of its bullets – interest rates are about as low as they can go;
- Consumers have shot all of their bullets – many of them are struggling with mortgage and credit card payments and/or are afraid that they will be subject to a layoff;
- Exports are not likely to make headway with a stronger dollar and weak economies around the world; and
- Those with money are afraid to spend it preferring the security of T-Bills – even if they have slightly negative rates – to the uncertainty of the financial sector and the downturn in the stock market.

It takes spending to get an economy out of a recession/depression. Money has to circulate and at this moment the circulation is moving very slowly.

The key players are all out of bullets or are afraid to use those they have. It is like a 25 below zero Minnesota/Iowa morning and the car battery is too cold to turn the engine over. Not only that, none of your neighbors can come over and give you a jump start because their batteries are also too cold to turn over their cars. To get moving again requires something out of the ordinary.

The same is true of our economy. It is going to require something out of the ordinary to get it going again.

That is why when we hear people who have for years been talking about smaller government suddenly calling for quick government action, we know that we are in a tight spot.

Fortunately, the government has the ability to borrow money and use it to finance massive infrastructure projects that will stimulate the flow of money in the economy in the short-run and make the US economy more productive in the long-run.

The key is to wisely target the investment projects, and do it in such a way that money starts flowing once again in our economy. ∆