
Viewpoint



Implications of deflation

This article by David Bartholomew was prepared in late April 1982. Bartholomew, a regular contributor to JAOCS, is manager of the oilseeds division for Merrill Lynch Commodities Inc. at the Chicago Board of Trade. In this article, Bartholomew discusses the attempts by the Reagan Administration to stem the inflationary economy in the United States and how that effort may affect the price of soybeans.

Deflation is of course the very opposite of inflation. It sounds simple to just change two letters to reflect changing economic conditions. But such a reversal is painful.

There is a strong natural tendency for humans to be consumers of ever-increasing quantities of goods and services. This is strikingly evident even in children, who, when playing games, mostly choose to be the play-store customer rather than the merchant. Some economic theoreticians latched onto the idea 50 years ago that inflation was a good thing because it would keep the majority happy. They were quickly knighted by the politicians and labor leaders in search of votes.

The ultimate end of constant inflation has to be disaster. Politicians and unions fall victim to the concept that if more is good then even more is better. Challengers and incumbents are secretly mindful, in moments of reflection, that this can't go on forever but speculate that it can go on until someone else has the responsibility for correcting the mess. Little did the policy makers realize that majority opinion could become so unhappy with the "rat race" that discipline would be demanded of new leadership which would restore to popularity the pre-1930s concepts of living within budgeted income.

Just now the big question is whether the majority opinion still favors the economic discipline espoused 18 months ago. The medicine is bitter. But this should have been no surprise when trying to correct an ailment which

had been getting worse for many years. As might be expected, the economic theorists recently pushed from power are trying to woo people back to the old inflationary beliefs by telling them how much bigger and better their buying power could be. They are scared to give the medicine time to do its job because then there will be no hope of regaining former power and prestige.

Gold and silver

In the 1960s is when the groundwork was set for the rampant escalation of the 1970s. Exorbitant deficit spending by the U.S. government, and the public as well, was the culprit. Such devaluation of the worth of the U.S. dollar could lead ultimately to only one thing: eliminate the fixed rate of exchange for gold and use metals of less value than silver for coins.

Meanwhile, the public was easy prey to entrepreneurs offering perfect solutions to beat the inflation treadmill of reduced value for increased income. First it was common stocks. Then bonds, followed by land and other real estate. Then it was commodity futures. Next it was gold and silver when these were unhitched from the U.S. currency. Finally, it was works of art and antiques. Ultimately, of course all these failed to produce the desired results. The search for a panacea came to an end when it finally had to be admitted that the only solution was to stop inflation at its source.

Petroleum

In the early 1970s the petroleum exporting countries saw wild inflation of U.S. currency causing serious erosion to the value of their earnings. Something had to be done because for most of those countries petroleum is the largest export item and for some it is the only export item.

So they banded together and formed a trade association with the objective of controlling production and marketing, and thereby price. Between 1972 and 1980 they managed

to move prices up by 20 times. At first they couldn't spend their new wealth fast enough. In a few years, and with a little practice, they found they could spend it even faster than it was coming in, just like other people do who don't have such economic advantages. Huge deficit spending programs were begun to speed the modernization process. It was easy to find lenders. Any who not, if a monopoly could put prices wherever they wished by simple adjustments of pipeline valves?

Overlooked, however were two facts. Demand could be reduced when price reached a certain level. Simultaneously supply could be increased in other areas outside the cartel when induced by an attractive price level. But to top it off was motivation from an unexpected force. The Iran hostage situation stirred deeply the patriotism of the United States causing the public to reduce demand and favor programs to increase supply so as to no longer be so dependent on imported petroleum.

Early in 1982 came the first solid visible proof of these changes. Deflationary government policies of 1981 were helping slow demand. A price war broke out between petroleum exporting countries, all of whom needed to maintain a certain level of cash flow to service their obligations. Iran, Egypt, Venezuela, Mexico, Great Britain, Nigeria, Soviet Union and others scrambled for business. Obviously, larger volume would be needed to maintain income levels if price was lowered.

Finally, an emergency meeting of exporting countries (called OPEC) has established production quotas for its members in an attempt to keep prices from falling further. But it is entirely likely that it will not be possible to maintain the quota system and price wars will resume, unless significant economic recovery is developed very soon.

Consider these news items of April:

- Iran sold crude at \$4.50 below the OPEC benchmark.
- OPEC output fell to a 20-year low of 15.85 million barrels per day.
- Nigeria cancelled plans to cut prices after OPEC promised financial aid.
- Nigerian monthly petroleum earnings have been cut in half to \$700 million. Imports cost \$1.8 billion per month and reserves are only \$3 billion.
- OPEC had a \$60 billion trade surplus in 1981, but may have a \$15 billion deficit this year.
- Kuwait is producing less than half the quota at 600,000 barrels per day and may run a budget deficit of \$1 billion.
- Mexico lost \$7 billion in revenue in the last half of 1981.
- Indonesia's reduced production quota will cost \$4.5 billion and require more foreign borrowing.
- Norway's revenue will be cut by 66% and that nation will have to borrow abroad.
- Saudi Arabia had a current account surplus of \$42.6 billion last year but this could disappear in 1982. The government has planned to spend \$230 billion on development projects between 1980 and 1985.

The list goes on and on. The point is that it probably will be impossible to reduce petroleum sales enough to support the price necessary to pay for all the grandiose obligations. Consequently, sales volume will stay too high and price will drop.

Gold and petroleum

There is an interesting correlation between prices of gold and petroleum. It's no coincidence. Petroleum is such an integral part of our modern culture that its price fluctuations coincide with those of gold. And gold is the honored barometer of economic growth and contraction.

Petroleum moved from \$2.00 per barrel in 1972 up to \$40.00 per barrel in 1980; a 20-fold increase. Gold advanced from \$41.00 in 1971 to over \$800 in 1980; again a 20-fold increase. Since that time gold has come off more than 50%. Can petroleum do the same? It has made a nice beginning. It can continue if production has to exceed demand in order to pay for debt obligations of exporting countries.

Deflating the economy

When petroleum prices climbed in the 1970s practically every segment of the U.S. economy was affected. Prices for all goods had to follow. So did wages. Some of this parallel action was the result of normal functioning of the free market. Some was due to mandated agreements with labor unions, some by government regulation.

It is estimated that in the U.S. nine million persons are employed under contracts having cost of living adjustments (COLA) clauses. Over 36 million persons receive Social Security benefits which also have cost of living adjustment factors. Approximately \$200 billion worth of business contracts also take recognition of the indexes of prices and hourly wages.

Obviously, the motivation for all of these developments was to help protect against erosion of value due to rapid and sizable inflationary rates. But COLA clauses can work both ways. We could see wages of 9 million people going down if the cost of living index turns down. It would follow also that 36 million Social Security payments would be reduced and business contracts costs would decline.

In March of this year the Consumer Price Index declined for the first time since 1965. The largest contributing factor was lower costs for gasoline. Subsequent months ahead should see declines in all kinds of goods and services as reduced costs of petroleum have their influence.

Deflation and soybeans

Costs of producing soybeans will also decline with reduced petroleum prices. Not only will it cost less for fuel for tractors, trucks, and other machinery. It will cost less for fertilizer, herbicides, fungicides, insecticides, steel, rubber, paint, plastic, and all other items used in farming.

For 1981 soybean production USDA estimates the national average cost per acre was \$150, excluding land value. That's \$5.00 per bushel at the national average yield of 30 bushels per acre. But, if the weather was indeed ideal and production reached 50 bushels on any specific farm, then the cost was just \$3.00 per bushel.

Just as recently as 1979 the average production cost was \$115 per acre. At 30 bushels production costs were thus \$3.83 per bushel while at 50 bushels it was \$2.30 per bushel.

Can the cost of production be rolled back to the 24% necessary to return only to 1979 levels? It seems quite likely if petroleum prices continue to slide. In 1974 it was \$68.35 per acre. That level probably will not be seen again.