

Policy Matters

Newsletter of the Agricultural Policy Analysis Center



September 1999

Agricultural Policy Questions: Do Grain Markets Self-Correct Under Current Policies?

This issue of Policy Matters is based on the testimony of Daryll E. Ray, Director of the Agricultural Policy Analysis Center, before the United States Senate Committee on Agriculture, Nutrition, and Forestry on August 4, 1999. The views expressed are those of Daryll E. Ray and not necessarily the views of the University of Tennessee.

The agricultural policy debate is again heating up in the midst of falling incomes for grain and cotton producers as bulging inventories sink prices to levels not seen in decades. The political response has been to partially plug the holes left by the market with taxpayer money. During the 1999 calendar year, the U.S. Department of Agriculture projects that \$16.6 billion will be dropped into the income gap and over \$20 billion may be stuffed into even larger income holes in calendar 2000. The 1999 payment projection is just shy of the record \$16.7 billion paid in 1987. Combining the record payments expected in 2000 with 1999 payments, the two-year total will exceed the previous two-year record by over \$5 billion. Yet even with the payments, many commercial farm operations are covering only a small portion of expenses above variable costs and some are not covering variable costs (*Policy Matters: Vol. 4, No. 3*).

Where does the 1996 FAIR Act fit into this? Weren't the contract payments to be a fixed amount each year, declining through 2002 and transitioning agriculture to free markets? Yes, and some continue to

feel that the current price and income problem is an unfortunate and rare aberration that will pass, much like a hundred year flood. But I'm not so sure.

The critical question is: *Are there systemic reasons for the chronic or periodic price and income problems in agriculture?* In other words, are there unique characteristics of agriculture that prevent grain and cotton markets from adjusting production or expanding demand when inventories become large so prices and incomes recover in a timely manner? If such reasons or conditions exist, current price and income problems are more likely to be chronic than unique.

We know that during the last couple of years, grain inventories have become burdensomely large driving down prices. But inventories get out of balance periodically in all sorts of industries. In most industries (and in economics textbooks), an over supply problem tends to be self-correcting. When inventories are bulging and prices decline, producers produce less and consumers buy more. Inventories return to normal and prices bounce back. After two years, this process of self-correction has not occurred in the grain and cotton markets.

In general, why have grain markets not self-corrected?

Limited ability to adjust agricultural production in the short run

When inventories are high and prices are low, the first response in most sectors of the economy is to reduce production. A plant manager in a non-ag sector

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can adjust output weekly or daily, shutting down lines or reducing workforce. Farmers make the output decision only once a year at planting time without a later option to idle land. Though the mix of crops may change some from year to year, as a rule, total acres planted do not.

Low agricultural prices don't trigger large increases in demand to deplete stocks

In most sectors of the economy, low prices and high inventories trigger an increase in demand for the goods or products, as consumers take advantage of low prices. But examination of the data reveals that agricultural demand—both domestic and export—has not responded to price swings sufficiently to deplete large inventories.

Also, the supply of livestock to consume feed grains is relatively fixed at any given time. It would be difficult as a nation to eat much more. Year-to-year changes in export demand are driven more by world production shortages or gluts because of yield swings and less by price swings.

Limited ability to reduce agricultural productive capacity in the long run

If chronically high inventories and low prices indicate production overcapacity, then we expect a non-ag industry to respond by downsizing its productive capacity. Plants are closed and industry capacity reduced, selling plants and equipment for use in another industry—one that is expanding.

But in the case of agriculture, when inventories continue to increase and prices remain depressed, farmers are forced out of agriculture but the land is not. The farmland is taken over by other farmers and corn, soybeans and cotton are produced just as before. Productive capacity changes little or none.

How did we get to the point of high stocks and low prices that brought us here today?

The situation of near-record low prices for major crops and soaring stock levels that underlie the current farm income crisis results from a combination of economic and policy conditions operating in this unique agricultural market.

While the recent Asian economic crisis has contributed to a slow down in export demand for some crops, especially cotton, most of the current crisis is caused by excess production rising from the additional

acres made available after the passage of the 1996 Farm Bill and above average yields. Also over the longer-term, it is clear that the optimistic projections for export demand growth beginning after the new century from China and other countries that prevailed during the last Farm Bill discussion will not come to fruition.

These economic and weather conditions that are contributing to the current farm income crisis are occurring in a policy environment unlike any we've seen in a long time. Under the 1996 Farm Bill, there are no acreage set aside mechanisms to reduce supply. Farmers have every incentive to maximize production and no incentive to voluntarily reduce acreage.

The absence of a stock control mechanism pushes stocks onto the market at the point when prices are at the very lowest levels. With the use of marketing loans in place of non-recourse loans, there is no price floor, as there has been in the past. Many have argued that free markets in agriculture allow farmers to take advantage of market signals and adjust their crop mix accordingly. Underlying this argument is the assumption that there's always a better bet, but that may not be the case when all major crops are in excess and all prices are low.

What can be done this year?

A number of suggestions have been brought forward. It will be helpful to increase the loan deficiency payment limitations, provide more money to farmers as compensation for low prices (and in some cases low yields), and make other adjustments. But, as is evident from my review of how the grain markets work, funneling money to farmers will not solve the underlying problems. Neither the money nor the low prices will cause farmers to significantly reduce their acreage/output of total grain nor will it cause users to sufficiently increase grain consumption. Next year, unless yields drop sharply and/or exports explode—which you can never rule out—stocks could continue to accumulate, prices could decline further, and even more money could be needed to cover economic losses in agriculture.

Reintroducing the Farmer-Owned-Reserve and encouraging the use of non-recourse CCC loans in place of the marketing loan would be helpful immediately. The idea behind the marketing loan was that, by allowing prices to go below the loan rate, demand would expand, especially export demand. With the lower price, import

customers would import more and export competitors would produce less. This has failed or at best has cost billions of dollars to increase demand by millions. For example, a \$2 billion dollar LDP payment that resulted in 200 million bushels of increased soybean exports, would be at a cost of \$10 per bushel.

Bringing back the Farmer-Owned-Reserve could immediately raise prices to the loan rate and storage payments would only have to be paid on a fraction of the bushels produced. (Storage could be paid for many, many years before reaching \$2 billion dollars).

What are the longer-term policy possibilities?

Some of the possibilities for the future are actively being discussed including expansion of the Conservation Reserve Program (CRP) and a shorter-term CRP. Depending on how they are structured, both of these could force a reduction in major crop acreages that lower prices could not accomplish. Other possibilities such as improved revenue insurance, whole farm insurance, and farmer savings accounts suggest continuation of the '1996 Farm Bill Mindset', i.e., 'everything will be okay

on the average'. That is not necessarily true. Given the reasons that grain markets do not self-correct in times of excess supplies, a three or even five year run of extremely low prices is possible with continuation of current policies.

Right now, the year-to-year future of agriculture is determined at the yield roulette table. To me, a more appealing approach would be to use the Farmer-Owned-Reserve and/or buffer stock mechanisms to sop up the excess stocks that currently overhang the market. The stock would be used to ensure a ready supply of feed for domestic livestock and poultry producers and reduce or eliminate the possibility of export embargoes when the yield draw comes in at 100 bushels per acre for corn and 25 bushels per acre for soybeans. Once future contingencies are reasonably covered, if production still exceeds consumption, use a total cropland acreage reduction program to reduce the supply of grains and cotton. The 'set-aside' would not be crop by crop but would require that a certain percentage of all cropland, say five percent, not be planted to crops with complete planting flexibility on the remaining acreage.



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APAC was established in 1992 around the Blasingame Chair of Excellence in Agricultural Policy to conduct research and provide information on the impacts of alternative policies and economic

conditions on agricultural output, prices, and income. Analyses are conducted at the representative farm, state, regional, and national levels.

Policy Matters is intended to be a vehicle for APAC to share analyses on farm policy issues and information on the economics of agriculture with farmers, agricultural leaders, policy makers, and researchers in the state and around the nation.

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