



Agricultural Policy Questions: Why Have Grain Prices Fallen So Low?

Why has the bottom fallen out of grain prices? Yes, inventory levels are up from two years ago, but corn and wheat stocks are puny compared to record levels of the 1980s. Prior to 1998, the last time corn prices were below \$2 per bushel, corn ending-year inventories hit 4.3 billion bushels, far greater than the 1.8 billion bushels of ending stocks expected this crop year. So, again, why did prices drop so sharply? And why may we be in even worse shape if a drought here or abroad sends prices soaring? The concise answer is: *Farm policy was changed.* The farm program provisions that moderated crop prices in the past were eliminated or made ineffective in the Federal Agriculture Improvement and Reform Act of 1996, commonly called the Freedom to Farm Act. The Farmer-Owned Reserve (FOR) was mothballed as was the acreage set aside program. The nonrecourse loan program remains but was rendered ineffective as a price support and stock buffer device by the 'marketing loan'.

What is the role of the marketing loan?

With the marketing loan, there is no price floor. A program crop's price can fall (has fallen) below the 'support price' because farmers can repay their Commodity Credit Corporation (CCC) loan using the current market price or the loan rate (the price used to value the loan) whichever is less. For ex-

ample, when supplies are large, a farmer could pay off a loan on 5,000 bushels of corn based on a posted price of say \$1.40 per bushel rather than the \$1.89 per bushel loan rate used to determine the original amount of the loan. The 5,000 bushels now becomes available on market. With the marketing loan, stocks overhang the market when prices are the lowest.

Before the full implementation of the marketing loan under the 1996 Farm Act, farmers' most appealing option, when supplies were in excess, was to forfeit the grain to the CCC. By law, the CCC has no recourse but to accept the grain as full payment for the loan. By doing this, the farmer was assured of the support price or loan rate as the price for his grain. Since each farmer could do this and the forfeited grain was held off the market by the government, the loan rate became the floor or minimum price. In this case, government stocks overhang the market when prices are 'high' or more accurately as market price approaches a predetermined government release price. Under Freedom to Farm, the government no longer accumulates sufficient stocks to support prices and it currently has virtually no stocks to release when supplies are tight.

What is the role of stocks today?

The shift toward marketing loans and away

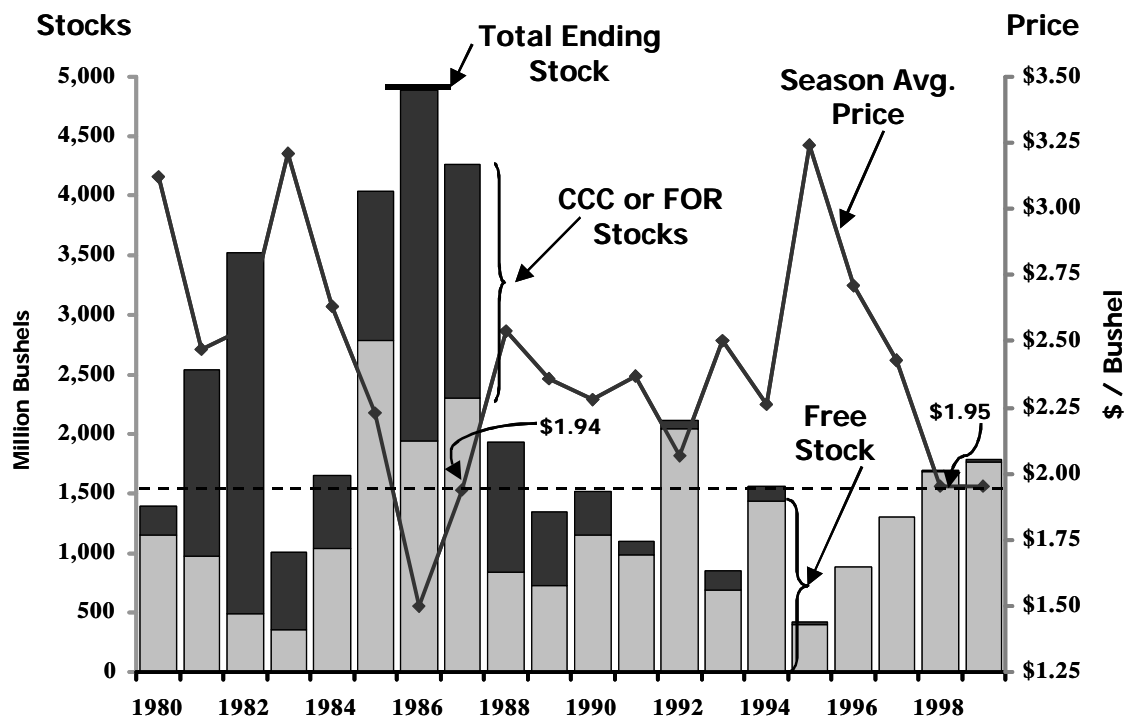
from farmers' use of grain forfeiture to repay CCC loans goes a long way toward explaining why prices fell so sharply over the last year or so as inventories increased. Since stocks aren't automatically separated from the market and put into government ownership when prices are at loan rate levels, any increase in stock bears down hard on price. Also, since neither the Farmer Owned Reserve nor set aside programs exists anymore, market participants know that grain will not be moving from the market into the FOR nor will prices be higher next year strictly because acreage set asides are imposed.

The relationship between stocks and season average price is easily seen when graphed together on the same chart. The bar graphs are corn total ending year stocks, composed of the free stocks (shown in a light shading) and CCC/FOR stocks. Corn season average price is graphed as a line using the scale on the right.

In September of 1999, the USDA estimated the season average corn price for the 1998 marketing year, which ended August 30, 1999, at \$1.95 per bushel. The \$1.95 price was based on estimated August 30, 1999, corn carryover of 1,699 million bushels. Of course, during the marketing year, price fell considerably below the estimated season average and below the national average loan rate of \$1.89 per bushel. For the 1999 marketing year, a price range of \$1.75 to \$2.15 is projected or \$1.95 plus or minus 20 cents.

The last time the season average price of corn was near \$1.95 was 1987 when it was \$1.94 per bushel. Ending-year stocks in 1987 were 4,259 million bushels, considerably above the projection for the 1998 marketing year. But about half of the 1987 stock was isolated from the market in the Farmer Owned Reserve or owned by the Commodity Credit Corporation. After subtracting out 1987 FOR and CCC stocks, commercial or 'free' stocks

Figure 1. U.S. Corn Stocks and Price, 1980-1999.



were 2,297 million bushels or still about 500 million bushels above the 1998 ending stock level that generated about the same price.

A similar pattern is evident for wheat and soybeans. In 1986, wheat price dropped to near its \$2.40 per bushel loan rate but ending year stocks that year were twice what is expected this marketing year and about two thirds of the 1986 stocks were isolated from the market in the CCC or FOR. In the case of soybeans, the last time the soybean season average price was \$5.00 per bushel, the estimate for the 1998 marketing year, was in 1985 but stocks were 40 percent higher then and 25 percent of total stocks belonged to the CCC. In 1999, soybeans may be charting new ground. Ending year stock in commercial hands for the 1999 soybean crop—the marketing year that ends August 31, 2000—is projected to be an all time record. Soybean prices could average lower than anytime since 1972.

What does this mean for prices in the future?

With the marketing loan in effect and the CCC and FOR out of the storage business, prices plummet with a much lower carryover of stock than under previous legislation. Prices will also soar higher when production is short relative to demand. Ironically, this may be more of a problem than the ‘low price’ problem being dealt with now. Congress uses loan deficiency payments, contract payments and special emergency direct payments to ameliorate a portion of farmers’ financial pain in the case of low prices. A period of excessively high prices—caused by more than one year of general drought here or abroad, for example—could eventually make the current agricultural crisis look like a minor event. With sufficient incentive, Brazil is capable of bringing into production roughly as much additional acreage as the U.S. has histori-

cally planted to soybeans. Just as in the seventies, major leaps in price, of the doubling to quadrupling sort, cause our export customers and competitors to find alternative sources of supply and to greatly increase resources devoted to agricultural production. In the U.S., rapid run-ups in land prices, machinery investment and debt complete the prerequisites for the inevitable crash.

What can we learn from the past?

We have already mentioned that the last time season average corn prices were about \$1.95 was 1987 when stock levels were at 4.3 billion bushels. It just so happened that the next year, corn yield dropped to 85 bushels per acre from 120 in 1987 causing a 2.2 billion bushel reduction in 1988 corn production. Prices did increase by 25 percent, but because 2.4 of the 4.3 billion bushels of carry-in stock were utilized, the U.S. reputation as a dependable supplier of corn for export and domestic use was not eroded. In fact, corn exports during the low-yield year exceeded the previous year. Note the drop in carryover between 1982 and 1983. Here again, stocks were able to buffer a 30 percent reduction in yield without causing prices to go sky high or jeopardize long term markets.

Without the buffering mechanisms of earlier farm legislation, even small changes in the imbalance between production and use can cause rapid and disproportionately large changes in price and market receipts. We experienced the sharp decline in prices this last year when supply outran demand. Prices could soar upward just as quickly if the balance between supply and use became tight. While farmers always like higher prices, either extreme can spell trouble for production agriculture, immediately for the low price extreme and years later for the high price extreme.

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