

Why Grain Markets Don't Self-Correct Under Current Policies

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The decline in farm prices hit farm country like a tornado in the night. It was sudden, unexpected -- devastatingly severe -- and casualties are almost certain. Unlike a summer storm, however, the farm crisis continues and damage accumulates. Farmers are in shock, bankers are in denial, input suppliers are bracing, and politicians want to throw money at it.

While painful to go through, some feel this is an unfortunate aberration that will pass, much like a hundred year flood. I am going to argue that, due to the nature of grain and cotton markets, this price and income problem for U.S. agriculture is not an aberration but a continuing threat. It is a threat activated and deactivated by weather – here and abroad. The farm income problem is as sure to return as weather is to remain unpredictable.

Inventory of grains is too high. 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.

But this is not the case in agriculture. When inventories of all major crops become large, **TIMELY MARKET SELF-CORRECTION DOES NOT WORK.** We can make believe it works, we can wish it would work but to do either is to deny reality.

In general, why do grain markets not self-correct?

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 nonag sector can adjust output weekly or daily. Farmers make the output decision only once a year at planting time. When output is in excess, a plant manager shuts down lines or reduces his workforce, but a farmer does not idle his land. All his corn/soybean/cotton land continues to be planted to corn/soybeans/cotton. The mix may change but 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.

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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 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 would expect an industry to respond by downsizing its productive capacity. And, in nonag sectors, that is usually what is done. Plants are closed and industry capacity is reduced. The plant and equipment are sold for use in another industry, an industry 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 remains unchanged or is changed very little.

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 acreages made available after the passage of the 1996 Farm Bill and above average yields. Also over the longer-term, it is clear that the 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, 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?

Again, some of the possibilities for the future are actively being discussed including expansion of the Conservation Reserve Program and a shorter-term Conservation Reserve Program both of which, depending on how they are structured, 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' – 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, force a reduction in the output through the use of a total cropland acreage reduction program. The 'set-aside' would not be crop by crop but would require that a certain percentage of all cropland, say 5 percent, not be planted to crops with complete planting flexibility on the remaining acreage.