

PolicyPennings by Dr. Daryll E. Ray

Pounding square pegs into round holes

The little wooden bench containing a series of square, round, triangular, and other shaped holes was one of our favorite toys as children. We would sit there for hours with our little wooden mallet and pound the various shaped pegs into the holes. Besides building skills in the use of a hammer, we quickly learned that, as hard as we tried, we could not pound a square peg into a round hole.

Let us now fast forward to agricultural policy 2007 style. In most of the policy forums in which we have participated, the vast majority of agricultural economists have agreed on the shape of the hole we are trying to pound policy pegs into: the total quantity supplied and demanded responds astonishingly little to changes in crop price levels. The “round” hole exists because of how consumers and crop producers behave in the marketplace.

Unlike their response to a decline in the price of most other product categories, consumers respond little to lower food prices. Large changes in price result in very modest changes in aggregate demand for food and thus for the crops from which the food is derived. Similarly, crop farmers tend to plant all of their crop acres every year, even in the face of low crop prices. Short of an industry-wide financial meltdown, farmers may change the mix of crops but they seldom leave a field unplanted. In recent years, while crop prices have varied by as much as 40 percent, aggregate US crop acreage has varied by no more than a percent and a half—not much self-correction there.

The only way that the market can accomplish the self-correction process is by producers and consumers reacting to prices. If neither react—which broadly is the case—the self-correction process is stymied. The farm commodity policy program (round peg) has historically filled the market/response void (round hole) with inventory management tools.

While ag economists tend to agree that the round hole exists, many spurn the obvious round blue peg constructed from a set of inventory management programs. Instead energy is expended promoting solutions (peg shapes) that better fit other problems (hole shapes) not the problem caused by the lack of market self-correction.

Ag economists and a host of others are advocating an amber square peg they call risk management. Risk management could include farm saving accounts, the use of tools like buying and selling futures contracts on the Chicago Board of Trade, whole farm income protection insurance, and a number of similar programs. These programs cover part of the round hole but wedge in the face of downward spirals in prices. Thus pounding the amber square peg of risk management into the

round hole could easily create a black hole that will suck up huge quantities of cash to keep the risk management schemes afloat during extended periods of low prices.

Then we have the simple, green, triangular peg of environment and conservation policies where people are trying to move money out of commodity payment programs and into environmental initiatives. Environmental issues in agriculture need to be dealt with, whether they be soil loss, the handling of concentrated animal waste, the protection of waterways, or a host of other concerns.

But trying to pound the green triangular peg into the round hole by spending the available money to solve environmental issues leaves the lack of self-correction issue for crop agriculture untouched. Receiving the same level of “environmental money,” whether corn is a \$1.50 or \$3.50 per bushel, misses the mark.

And then there is the hexagonal peg of the World Trade Organization (WTO) negotiations and the call by US trade negotiators for increased market access in exchange for reduced US agricultural payments. There is little question that increasing market access will increase world crop exports. The important question is “will the US do the exporting.”

One way to investigate that question is to identify which countries have been benefiting from recent growth in world grain exports. Over the last 15 years, the primary beneficiaries have been Brazil, Argentina, Thailand, and several other high-end developing countries, not the US. Achieving full market access would not necessarily translate into a one-to-one increase in US export demand—nor would it necessarily raise farmgate prices significantly.

For more than 20 years we have been hearing that exports will be the salvation of US agriculture while aggregate crop exports have remained nearly level. It is difficult to see how trade negotiations will change that pattern given the fungible nature of crop exports and the characteristics of international crop agriculture.

Energy demand is a more likely growth market for grains, especially corn. In a future column we will examine whether or not that peg is of the right shape or whether it is possible that it carries with it its own set of risks.

In our view, pounding square pegs into round holes doesn’t work any better today than it did when we were five years old.

Daryll E. Ray holds the Blasingame Chair of Excellence in Agricultural Policy, Institute of Agriculture, University of Tennessee, and is the Director of UT’s Agricultural Policy Analysis Center (APAC). (865) 974-7407; Fax: (865) 974-7298; dray@utk.edu; <http://www.agpolicy.org>. Daryll Ray’s column is written with the research and assistance of Harwood D. Schaffer, Research Associate with APAC.

Originally published in *MidAmerica Farmer Grower*, Vol. 23, No. 27, July 7, 2006
Reproduction Permission Granted with 1) full attribution to Daryll E. Ray and the Agricultural Policy Analysis Center, University of Tennessee, Knoxville, TN; 2) Copy of reproduction sent to Information Specialist, Agricultural Policy Analysis Center, 309 Morgan Hall, Knoxville, TN 37996-4519