

Policy Pennings by Dr. Daryll E. Ray

## It sure looks like a new price plateau; What about net returns?

The recently released "USDA Agricultural Projections to 2017" (<http://www.ers.usda.gov/publications/oce081/>) has corn prices above \$3.50 for as far as the eye can see (well, to 2017). As we know, the path to this price level began 17 months ago when the markets began to assess the impact of the large number of corn-to-ethanol plants that were coming online in the next couple of years.

Last year the boost in corn prices caused a dramatic shift away from other crops and into corn, resulting in a 15.3 million increase in corn planted acres. This year the price of other crops increased as well which will likely cause a recapture this year of some of the acres lost to corn last year. For those who struggled through the low prices of 1998-2001, the current prices-nearly \$14.00 soybeans and \$10.00 wheat-are astounding.

This nearly year-and-a-half run up in prices has many people wondering if crop prices have established a new plateau? To answer that question we need to identify the factors that would influence that kind of shift.

The most obvious factor is rising demand. Given the nature of crop agriculture, the establishment of a new plateau, would take a steady increase in demand at a rate equal to or greater than the increase in supply. The increase in the corn demand for ethanol production from 2, to 3, to 4 billion bushels a year runs well ahead of the immediate increase in domestic supply.

A second factor that may necessitate a new plateau in prices is a steady increase in the variable cost of production. At this point, there is ample evidence that farmers are experiencing an increase in the cost of inputs.

One of the factors that triggered the increase in demand for biofuels also increases the cost of inputs. Over the past several years, crude oil prices have jumped from the \$30 a barrel range to the \$90 a barrel range. As a result, the cost of farm fuel has increased.

The cost of drying all that corn has risen as natural gas prices have followed oil prices. The natural gas price hike has also increased the price of anhydrous ammonia with other fertilizer prices following the upward trend.

With increased production and transportation costs, the price of other farm chemicals has moved upward as well. Seed costs have risen along with the incorporation of new genetic traits that improve pest and drought resistance.

This increase in non-land production costs certainly necessitates a higher level of prices than we saw for over 30 years (1973 to 2005). In non-agricultural sectors, we know that higher production costs result in permanently higher prices-look at automobiles and houses.

In those sectors, producers respond to changes in demand with timely shifts in production-witness the current down-turn in new home construction as demand has weakened.

With crop agriculture that downward shift in production takes place much more slowly, resulting in years of prices that are well below the cost of production. As long as crop demand outpaces production increases, this problem with downward price adjustment is of little consequence.

The ethanol-based demand growth that has fueled the stellar grain price increases of the last year and a half has a much better chance of keeping farm prices elevated than the hope for sustained growth in exports had during the 1970s. Yep, mandates.

But we should not look at only the demand side. The high prices and the opportunities other countries have to increase acreage and to fill yield gaps mean that supply growth could accelerate past demand growth, as promising as demand growth seems to be. In fact, that is what typically happens.

In the 1970s, when production growth caught and then raced past demand growth, the government responded by raising the loan rate to help cover production costs that exceeded the new "higher levels" of grain prices-for corn it went to the \$2.00 plus level, locking in the new plateau.

In the present political climate, it is hard to imagine Congress responding to a decline in crop prices by increasing the loan rate and making it an effective price floor.

For crop agriculture to remain profitable for the foreseeable future, demand needs to regularly outpace production-domestic and foreign.

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