

Policy Pennings by Dr. Daryll E. Ray

Futures and fundamentals

The astounding prices of recent weeks (\$5 corn, \$13 soybeans, and \$10 wheat) have been explained as a battle for acres-soybeans trying to recover acres lost to corn last year with corn and wheat trying to hold onto their acreage.

One result of this acreage competition can be seen in preliminary estimates of 2008 plantings. Corn acres are down less than expected earlier and soybean acreage is being boosted by double crop acres. As a result total acreage is up from last year with the expectation of some gains from Conservation Reserve Program (CRP) acreage and some from pasture conversion to cropland.

We must admit that in some ways the explanation makes some sense and in other ways it leaves us shaking our heads. Why is the battle taking place at these stratospheric levels? Why isn't the battle taking place with \$3 corn, \$8 soybeans and \$5 wheat? Wouldn't those relative prices, which are arguably more in line with supply-demand balances, allocate acreage just as well as current prices?

One answer asserts that \$5 corn will bring crucial additional acres into production faster than \$3 corn. Certainly we cannot argue against that.

An alternative analysis suggests that the current high commodity prices are not being driven by fundamentals alone. After all fundamentals would hold just as well at a lower level as they do at current price levels.

In this alternative analysis, the driving force is money flowing into commodity markets from index funds that buy long as a hedge against future inflation. This is particularly true for energy markets where the price of crude oil has risen from \$30 a barrel to \$100 a barrel over the last few years.

If this money were just flowing into energy markets, the impact on agricultural markets would be minimal. As a means of spreading their risks and maximizing their protection, the index funds generally balance out their investments among a range of commodities-energy, metals, and agricultural.

As a result, the more money that flows into the index funds as a hedge against rising energy prices, the more that flows into agricultural commodities-

hence the current bull market that seems to rise ever higher.

Of course, if the index funds decide to "take their profits" by closing out their positions, the liquidation orders will be for agricultural commodity contracts as well as energy and metal contracts. In the months ahead, exaggerations in price falls could be as great as recent exaggerations in price rises. A short-run possibility, and concern, is the bursting of speculation bubbles.

In the longer-run, it's the impact that current prices will have on the future output of commodities. In energy markets, higher prices have a limited ability to bring more oil out of the ground in the immediate term. But, recent prices have spurred investment in exploration and the development of alternate energy sources that will eventually come to fruition.

Agriculture may respond more quickly. Current prices are seen not only by US farmers, they are seen by farmers all over the world. It is unrealistic to believe that \$13 soybeans and \$10 wheat will not catch the attention of farmers in Brazil and Kazakhstan respectively.

While a long-term analysis of aggregate crop markets suggests that low prices do not cure low prices in a timely manner, high prices nearly always cure high prices. Additional resources will be brought into production, potentially oversupplying the market with the expected result being lower prices.

The crucial questions for farmers are "how far could a bursting of speculative bubbles drop prices in the short-run and how low a cap will increased supply put on prices in the long-run?"

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