

Policy Pennings by Dr. Daryll E. Ray

A new plateau for corn prices would be nice but is it realistic?

Each month the USDA publishes a report called "World Agricultural Supply and Demand Estimates (WASDE) that gives an up-to-date estimate of the US and world markets for major agricultural products. The report is available on the internet at www.usda.gov/oce/commodity/wasde/index.htm.

On October 10, 2008 the new WASDE was released. We were interested to see the corn production number given all of the concern over delayed corn planting due to spring floods and wet weather in the upper Midwest.

Given the absence of a widespread early frost in the flood affected areas, the USDA raised the projected national corn yield by 1.7 bu/ac from the September report and reduced the projected harvested area by 100 thousand acres. The result was a projected increase in US corn production of 128 million bushels resulting in a projected harvest of 12.2 billion bushels, the second largest US corn harvest in history.

The report also made some adjustments in utilization resulting in an ending stocks level of 1.154 billion bushels, an increase of 136 million bushels from the previous month's projections.

Based on an increase in stock levels and a down-trending corn futures market the USDA also reduced the projected price range by 80 cents on each end resulting in a new midpoint of \$4.70 for the projected season average price paid to farmers.

As we write this column the December futures corn price-not the season average price paid to farmers-is \$4.01 after spending two days in sub-\$4.00 territory. Less than four months earlier, on June 27, 2008, corn hit a high of \$7.96, nearly double today's close.

Back in June we heard a lot of talk about a new price plateau. Today corn farmers are just hanging on. Looking at the report we wondered how close the projected price might be to what farmers could expect.

Looking at a long-term model that we use to help us explain what is going on in the corn market,

we examined what has happened over the last two years and then developed three scenarios of what corn farmers might expect.

In 2006, the season average corn price was \$3.04. By our model that was nearly 92 cents higher than the 11.6 percent stocks-to-use ratio would typically produce. A price premium became built into the market during that time because of concerns over having adequate supplies to meet the needs of a growing corn-to-ethanol industry.

For the just ended 2007 crop year, corn prices were affected not only by ethanol demand but also by the massive entry of index funds into the commodity markets. These funds bought long as a hedge against future price increases. In the end, many observers think that these funds helped drive the corn price higher than it would have otherwise gone.

Be that as it may, the season average corn price paid to farmers reached \$4.20 on a stocks to use ratio of 12.2 percent. Our model estimated a price exactly half that large, \$2.10 rather than \$4.20.

That is, according the model the two effects-ethanol expectations and index funds, plus other possible influences-raised corn prices \$2.10 per bushel above what would have been in the post-1996 Farm Bill era for an identical ending year stocks as a percent of corn utilization.

What does that tell us about the price potential for the current crop year?

Given the USDA projected 2008 crop year stocks-to-use ratio of 9.1 percent and if the price bump we saw in the 2007 crop year continues, we would expect a price of \$4.30.

Keeping the ethanol and index effects of 2007, the model estimate of \$4.30 per bushel for the 2008 crop is 40 cents below the midpoint of USDA's projected price of \$4.70 and some 65 cents above today's southern Minnesota/northern Iowa cash corn price. Cash prices here in Tennessee are similar.

But is it reasonable to assume that the ethanol

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A new plateau for corn prices

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and index fund effects will have the same price-expanding effects in 2008 as they had in 2007?

From all appearances the index funds are continuing to bail out as oil prices dropped precipitously. Upward pressure on crop prices due to the index funds seem unlikely for the 2008 crop, the reverse is more likely.

In addition, it would appear that US and world markets have by now accounted for the 4 billion bushels being consumed by the ethanol industry. But we need to take into account that the 2008 season average price will be affected by farmers who took advantage of the high April to July prices and sold a portion of their 2008 harvest.

Taking all these factors into account, especially the fact that some farmers sold early when prices were well above where they are now, suppose the net price effect is the same 92 cent price bump that farmers received in 2006 (not 2007). With that price bump, the model would project a season average price of \$3.13.

Without the 92 cent bump, the season average price could be \$2.21, a frightening thought.

The question that has been wracking our brains is, "What is out there to stop the price from falling that far?"

Under the current farm legislation we can't depend upon the non-recourse loan rate to put a floor under prices like it did when a new plateau was established in the mid-1970s. In addition we aren't likely to see the kind of double-digit inflation that

drove up the price of everything in the 70s.

Some have argued that the current increase in the price of inputs will force crop prices upward. If that were true, we would have no need for the target price or ACRE programs. Both programs are an implicit acknowledgement that crop input price increases will not, in the short-to-medium run (and we are always in the short-to-medium run), result in similar crop output prices.

In the current recessionary environment we do not see any factors that will prevent us from returning to the prices we saw in the 1998-2001 period. Not this year, but as time goes along.

If they do fall that far, farmers will have a few years of protection from the ACRE program.

The only other events that could send prices back upward would be the sudden appearance of a new use for corn or a series of feed grain crop failures around the world.

A new commodity price plateau would be nice, but since the evidence in its favor seems to apply more to the past than the future, it would only seem wise to prepare for the possibility that a new plateau has not been established.

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