Agriculture Holding Its Own During Economic Crisis

FAYETTEVILLE, ARK.

From farm to market, agriculture is holding its own during the current economic crisis, even though a credit crunch is sending ripples of stress throughout the industry, say agricultural economists with the University of Arkansas System's Division of Agriculture.

The greatest area of stress in the agricultural economy may be grain elevators, which rely heavily on loans to invest in commodity futures, and in the livestock and poultry sectors, U of A economists said.

Bruce Ahrendsen, professor of agricultural economics and agribusiness, said that most agricultural businesses, especially farmers, are generally in good shape because they have solid assets – meaning land.

"The balance sheet has been strong for farms, particularly those owning farmland," Ahrendsen said.

Colleague Bruce Dixon, professor of agricultural economics and agribusiness, cautioned that livestock and poultry producers are more susceptible to economic difficulties than producers of plant crops because meat prices have not risen as dramatically as grain prices.

Dixon said credit is at the heart of the trouble in the U.S. economic system. The collapse of once strong banking companies has shaken confidence in loan markets.

"Banks are not lending to each other, something that banks normally do all the time," Dixon said. "That restricts money available for loans to individuals and businesses."

Those credit troubles could spill over into agriculture, Ahrendsen said. Dixon and Ahrendsen agree that farmers could begin feeling the impact of tightened credit in 2009 when they apply for loans to buy fertilizer, fuel and other production inputs.

Production costs have been rising with the price of oil and natural gas, not only because tractors and combines need fuel, but also because production of many fertilizers is energy dependent. In addition, Ahrendsen said, many fertilizers are produced overseas and the cost of importing them has risen sharply as the dollar has weakened against foreign currencies.

For producers of rice, corn, soybeans and wheat, crop prices have risen sufficiently to offset higher production costs, but prices can fluctuate dramatically.

"Energy is a double-edged sword for agriculture," Dixon said. "When fuel prices come down, it may reduce input costs, but lower fuel prices make biofuels less profitable relative to petroleum based fuels."

If demand for corn declines, Dixon said, the price farmers get for their crops goes down. More corn in the food markets would lower demand for other food crops, causing their prices to drop as well. As farmers' profit margins narrow, there could be a higher demand for credit as farmers seek bigger loans to cover their operating expenses, and they could run up against the shrinking availability of loan funds.

Grain elevators are particularly vulnerable to the credit crunch because they rely on futures markets to hedge their commodity contracts with farmers, said Andrew McKenzie, associate professor of agricultural economics and agribusiness.

Elevators serve as "middlemen" in the agricultural market system, McKenzie said. They buy grain crops from farmers and hold them in storage until selling them for livestock feed, or to food processors.

When crop prices are favorable, farmers enter into contracts with elevators as much as two or three years in advance so they can sell their crops at those higher values even if current prices fall, McKenzie said.

If crop prices fall, farmers benefit from having locked in higher prices, but the elevators face losses, McKenzie said. To hedge against such losses, elevators hedge in the futures markets at values equal to their contracts with farmers, he said.

The idea is that losses from lower crop prices will be offset by higher profits from futures holdings, McKenzie said. Conversely, losses from changes in futures will be offset when crop prices rise higher than contract prices with farmers.

Credit is essential in futures trading, McKenzie said. Investors are required to pay a percentage of the current futures prices for their holdings, or positions, usually 5 percent or less. This upfront payment is known as margin money. Although it is a small fraction of the actual value of a futures contract, because elevators deal in large volumes of grain this can still represent a large dollar commitment.

"You have to have a lot of cash on hand to get into the futures market," McKenzie said. Elevators usually borrow that cash from banks.

When futures prices go up, McKenzie said, futures brokers issue margin calls – demands that futures investors pay the difference to maintain the same percentage of the going prices. Those margin calls are often in the millions of dollars, and that means going back to the bank.

"Elevators don't usually have that cash on hand," McKenzie said, "so they need a good line of credit."

McKenzie said crop prices have been rising dramatically for the past year and a half. Rising crop prices also made the futures market more attractive to index and pension funds, which like to invest in long-range futures positions. Their investments drive futures prices even higher.

"Those margin calls have come large and fast," he said.

As the credit market tightens during the ongoing economic crisis, loans for futures investors are drying up, McKenzie said. Holding futures positions will become increasingly difficult and may cause smaller elevators in particular to get out of the futures market he said.

"This makes elevators reluctant to offer farmers long-range contracts," McKenzie said. "At some point, elevators didn't want to book crops one or two years out."

In many cases, elevators will only offer contracts for six month in advance, McKenzie said. Some will not offer advance contracts at all, or will charge fees to offset risks. The negative impact of the credit crunch backs up all the way to the farmer, who is squeezed between rising production costs and the inability to lock in high crop prices.

"Elevators play a crucial role in getting food from the farm to the grocery store," McKenzie said. "That role has been compromised."

In this time of volatile crop prices and a banking crunch, McKenzie said elevators have to look at new ways to market grain. In the meantime, he doesn't want to blow the situation out of proportion.

"Most elevators are hanging in there, operating in the traditional manner," McKenzie said. "But it's becoming increasingly expensive to do so."

"Elevators across the board have done a heroic job of maintaining our market system," McKenzie said.

"Consumers may be seeing higher food prices, but there have been no food shortage scares. Food is still getting to the stores," McKenzie said. "That's at least in part because of the remarkable job the elevators have been doing." Δ