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Cost-Plus Pricing Of Major Crops?: Interesting Thought But...

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Typically there are several-to-many reasons why commodity prices do what they do, especially if they have tripled from a mere few years ago. How the amalgamation of many influences leads to the formulation of crop prices is summarized in a major section of Derek Headey and Shenggen Fan's IFPRI (International Food Policy Research Institute) monograph, Reflections on the Global Food Crisis. The factors that they identify as contributing to the final determination of an agricultural commodity's price include stocks, costs, harvest area, weather, and yields on the supply side and domestic use, foreign imports, and economic and population growth on the demand side.

The analysis of the effect of rising oil prices on commodity prices caught our attention, as much for what may be implied as what it said. Headey and Fan write, "international fuel and food prices are closely linked historically. Rising oil prices were closely associated with the 1972–74 crisis and indeed were arguably the dominant factor, so there is clearly some precedent here."

They argue that "on the supply side, oil and oil-related costs constitute a substantial component of the production of most commodities, so rising oil prices provide a strong explanation of commodity-price escalation across a wide range of food…commodities." As every farmer knows, an increase in oil prices translates into higher fuel prices and has an immediate and direct effect on the cost of working each acre of land.

"And to rising fuel costs," Headey and Fan write, "we also need to add the enormous surge in fertilizer prices, most of which are made from energy products, such as natural gas. Indeed, energy costs can constitute up to 90 percent of the costs of fertilizer production (for example, nitrogen fertilizers)."

In addition, they argue that "the bulky nature of grains means that agricultural prices are strongly influenced by transport costs."

The first two, fuel and fertilizer, increase the cost of production while an increase in transportation costs decreases farm income and increases costs at the consumer level.

Though Headey and Fan tiptoe around the edge, they avoid directly asserting that higher oil-driven production costs – farm energy use and fertilizer – translate directly into higher commodity prices. They allow the reader to make that connection as they "attribute a large role to demand-side factors that would have interacted with supply-side factors affecting production costs."

As laughable as it may be to farmers, those unfamiliar with nature of major-crop markets may be lead to believe that farm-level crop prices are somehow cost-plus determined. Over a series of production periods, there is an element of truth to the assertion that increases in input costs can be reflected in crop prices via farmers' collective decision to reduce production over time, or a policy change that is put into place to reflect increases in production costs.

But neither of those considerations is relevant right now. With the "high" crop prices of late, farmers are looking for ways to increase production despite higher input prices.

As we look to the future, however, we are concerned that the higher market prices we currently experience will result in an overinvestment in agricultural production. Farmers in the major exporting countries seeing the higher prices, will bring additional acreage into production. To the extent that the resulting increase in production is not matched by increasing demand, prices will fall. And, they can fall faster than they increased.

Prices earlier this year were falling until it became apparent that the US corn crop was not going to live up to the expectations generated by excellent planting weather. As of now, the projected low level of ending corn and soybean stocks for the 2010 crop year, and short-term demand prospects, likely mean that 2011 will be a "good price year" for corn and for major-crop farmers in general.

It's the years that follow that we should be concerned about. We are just an additional "high-production" crop year away, here and abroad, from prices that could plummet to LDP levels, barring a rerun of a 4 billion bushel cumulative increase in demand from somewhere.

As we look forward to the 2012 Farm Bill, we need to remind those involved in writing it that any farm policy will work well in a period of profitable prices. What we need to be concerned about is how well a proposed farm policy will work during those extended periods of time when total production costs, on even the most efficient farms, exceed farmgate prices. Δ

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