∆ Contact Dr. Daryll E. Ray
at the UT's Agricultural Policy Analysis Center by calling
(865) 974-7407,faxing (865) 974-7298,
or emailing dray@utk.edu.
For more info, visit: www.agpolicy.org

syngenta
Link Directly To: SYNGENTA

Producers Leery Of Grain Reserve: The Concept Or The Implementation

DR. DARYLL E. RAY
Agricultural Economist
University of Tennessee

For the first time in years, the possibility of establishing reserve stocks has come to the fore – even if it means that the Secretary of Agriculture and a major farm group have come out against them. There was a time when the issue of reserve stocks was so far off the table that opponents did not even bother to denounce them.

The event that has brought the issue of reserve stocks to the table was the dramatic price bubble in grain and oil prices that started developing in the last half of 2006. As prices soared, many developing countries saw food riots and a number of countries took actions to protect their food markets by restricting the international trade of some commodities.

In the face of those events, some have been giving reserve stocks a new look as a means of mitigating those problems by having adequate supplies available to meet sudden increases in demand – like ethanol – as well as sudden decreases in production – crop failures in Australia and the Ukraine, as occasionally these two type of events happen at the same time creating a "perfect storm."

Without going into the details of a reserve at this time, we would instead like to look at the issue of reserves from the perspective of various market participants. This week we would like to look at reserves from the perspective of grain farmers.

Reviewing the history of modern reserve programs – beginning with the Federal Farm Board in 1929 – it is easy to see why farmers might be skittish in talking about stock-holding programs.

The Federal Farm Board was established in order to increase the price of commodities by providing loans to cooperatives to take excess production off the market and drive up prices. At the time, farmers were hurting as wheat prices had tumbled from a high of over $2.00 a bushel during WWI to 98 cents in 1928. Initially, the price of wheat rose slightly to $1.03 in the 1929 crop year.

But without any means of controlling production, the board quickly reached its loan limits and prices tumbled. In 1932 the price fell to 32 cents as cooperatives were forced to liquidate their holdings, flooding the market with surplus commodities.

Learning from that experience, the architects of the New Deal including Secretary of Agriculture Henry A. Wallace devised a reserve program that was combined with the means of managing supply so that prices could be maintained above a certain level. Various iterations of this program continued until the 1996 Farm Bill when price floors were made non-functional.

During the years of reserves and various supply management programs, farmers made a number of complaints. One of the most common complaints was that government stocks overhung the market, preventing prices from rising very far above the established floor levels. This certainly was a problem when the release price was a mere 5 or 10 percent above the loan rate. With that narrow a band commodity users had no incentive to bid up the price of crops making the farmer angry because "the government prevented me from getting the price I deserved."

When the price band was wider, farmers were resentful when corn that they forfeited to the Commodity Credit Corporation at $1.10 a bushel was sold by the government at $1.59 a bushel. They argued that they should be the ones to profit from the price rise on grain they produced. That led to the development of the Farmer-Owned Reserve (FOR), where the farmer would retain ownership of the crop for a longer period of time, increasing the potential to profit from any price increase.

With the establishment of the FOR, a defensible kind of stock release program was put in place early-on. But over a period of years farmers were given more control over when they could sell the grain they held. As a result, it faded into no stock program at all and farmers had every reason to be cynical.

Another complaint was that, with base acres divided up among crops, farmers began farming the program instead of responding to market signals. For instance, as soybean demand ramped up, farmers were reluctant to plant too many of them, but instead planted corn in order to maintain their corn base – there was no base for soybeans.

While crop-by-crop acreage management by the government might have made sense in the early years, as time went on it limited farmers' ability to respond to changing market needs.

One underlying factor is the sense of independence that nearly every farmer has. They believe that they know better how to manage their farm than any bureaucrat in Washington DC or trader on Wacker Drive in Chicago. This independence is a great asset, allowing farmers to overcome adversity and plant once more in the face of crop failures and low prices.

At the same time that sense of independence can work against farmers' self-interest, there is a nugget of truth in the complaints that crop farmers make against the operation of storage programs in the past.

That being said, we must point out that many of these complaints are more a function of the way the reserve has been operated and/or its mission has been redefined over its life, than the real way in which a reserve could/should be operated.

A close examination of the complaints reveal that the major problems are not with the concept of a reserve itself, but rather with the way that the reserve has been managed in some periods in the past.

So what does that mean? It seems to us that farmers can best use their decision making abilities when they are working within a reasonable band of prices. Looking at the history, it seems that a price band that would have a release price between 75 percent and 100 percent higher than the floor price would work well and provide producers and users with a useful set of price signals.

When prices get beyond those bounds on the low side it doesn't become a problem of land allocation among crops to make money – there is no money to be made when the price stays below the cost of production.

It is in those times that we need to be sure we accumulate that excess production because we have repeatedly seen over time that we have needed those reserves when conditions warrant – often when there is a crop failure in several part of the world at the same time or when there is a spurt in demand.

On the top side, while crop producers greet high prices with glee, when they become exceedingly large and even extreme, this leads to exuberant overreaction on the part of farmers in the US and worldwide.

Price bubbles do not provide a price level that makes sense for farmers to respond to. What actually happens is that US farmers and farmers around the world respond in a way that almost guarantees that production will explode.

The sad result of exploding production is that prices will plummet just as quickly as they went up.

As a result, low-side price extremes occur that are just as unbelievable as the peak prices that farmers are responding to.

The resulting low prices that often hang around for long periods of time are trouble for farmers, governments, and investors and are certainly not in the best interest of farmers in the US or around the world.

This supply expansion reaction is as evident today following the recent extreme prices and it has been in the past, if not more so. Countless countries have intensified their natural affinity for food self-sufficiency. They have done so in many ways, some innovative, some traditional.

China is one of several countries that has announced sharp increases in government expenditures on farmer production incentives to boost production quickly and on expanded technological research to expand output in the future.

Thanks to vast strides in globalization, developing countries of all stripes are enjoying alliances with the same multinationals that have made the US and other developed countries so productive.

In addition, to these primarily "yield" enhancing endeavors, countries are going outside their borders to secure additional land resources to further increase their ability to satisfy future food needs, not through armed takeover but via leasing and other contractual arrangements.

Combine those international reactions with the incentives farmers in the US and other developed countries have to adopt the promised high-yielding varieties coming down the pike from Monsanto, Pioneer and others, and the likely result will be the same as countless previous times when a purposeful grain reserve policy was not in place: over-response to extraordinarily high prices causing a grain glut that often take years to work off and cost farmers in lost income and equity. ∆

DR. DARYLL E. RAY: Agricultural Economist University of Tennessee.