APAC Agricultural Policy Analysis Center

The University of Tennessee

PolicyPennings by Dr. Daryll E. Ray

Reserve Issues: One is its effect on prices

We recently received an email from the Federation of Southern Cooperatives/ Land Assistance Fund referring to their 40th anniversary celebration August 16-18, 2007. The announcement, including a 1992 article by Ray Marshall, former Secretary of Labor and faculty member at the University of Texas at Austin, reminded us that as we approach the seventh anniversary of the launch of this column one of the policy areas we have yet to address is the importance of the cooperative movement.

The story of the Federation helps illustrate the importance of the cooperative movement for farmers and rural communities. In the midst of the civil rights era, African American farmers in the South began to develop cooperatives in response to the economic retaliation they were facing. Some cooperatives were well organized and flourished, while others struggled. In 1967, representatives of 22 local cooperatives gathered together and founded the Federation of Southern Cooperatives to provide the organizational and technical expertise they needed to be successful.

Our recent columns suggesting the need for a corn reserve has generated some response on the part of our readers—some for and some against. In their emails, our readers raised some thoughtful issues that we would like to address. One major concern expressed by some readers was the price depressing effects of a reserve program.

Certainly we would agree that at the top end and in a tight market, the release of reserve stocks puts a cap on prices. The key is how the reserve is administered; that is, what rules are used to release grain from the reserve.

It is also important to keep perspective. The Grand Champion price depressant is the Loan Deficiency Payment\Marketing Loan Gain (LDP\MLG) program. In the late 1990s as stock levels began to move up from their 1995 crop year low of 426 million bushels (4.6%), prices plummeted to below the loan rate as farmers collected massive LDP/MLGs in order to stave off financial ruin. Even that was not enough and Congress had to vote a succession of emergency payments to keep the farm sector afloat.

So even though relatively few stocks "overhung" the market, prices declined rapidly anyway; largely because the market had internalized the fact that the government no longer had any instruments to bring to bear immediately, such as price supports, or in the medium-run, set asides in the next or following years.

Both price bolstering instruments had been eliminated (set aside) or made ineffective (the Commodity Credit Corporation non-recourse loans that put a floor under prices).

This movement from supply management to LDP/ MLGs cost a lot of taxpayer money. Now, rather than paying the loan interest and storage costs to isolate a relatively small percent of grain production to raise prices to the "loan rate," farmers receive the difference between the loan rate and the posted county price for essentially all grain produced. In the case of corn, season average prices remained below the loan rate for four years. It took a dry summer in 2002 to bring the season average price above the loan rate.

Hence, if a grain reserve had been put into place in 1996, even with entry prices set at the relatively low loan rate levels, the following would have occurred: a) crop prices would have been higher during 1998 to 2001, b) government outlays would have been substantially less, and c) a cache of corn would be available for when, not if, we have a major yield catastrophe in the face of the extraordinary, almost unbelievably large expansion in corn demand for ethanol production.

We hasten to emphasize, that in the case of well-administered, purposeful reserve, the grain would still be there today! It would be there because, like the oil reserve, it should require a real catastrophe before grain would be released, that is a sharp drop in corn yield, say, and a large price increase.

Yes it is true that today's stocks are low and grain prices are much higher than usual but there is no catastrophe at the moment. A catastrophe would be a 10 billion bushel corn crop when corn demanders are set to use about 12 billion bushels. Given our current situation, there is no way to solve that problem but with a grain reserve. Unless "we" are willing to live with the short-run, and especially long-run, repercussions of say $6 corn on domestic users and little corn to export to our usual foreign customers.

If a reserve had been put into place in 1996, just think how much different the agricultural world would seem. Yes, livestock producers would understandably be unhappy about the increase in grain prices of late. The argument about food versus energy would still rage on but with some less intensity. But demand users would know there is a cushion of grain if the unthinkable happens.

Besides that consider this: since the creation a corn reserve would have not allowed prices to go so low, early profitability of ethanol plants would have been less, which may have slowed their development, and hence braked the rate of increase in the corn demand that drove prices up in the first place.

Now, the part that elates but should scare grain farmers: since we don't have a reserve, sky-rocketing corn prices could easily occur during one or more of the next few years. Yes, we know how crop farmers would react to that possibility—"Wow, we will finally get prices that surpass our wildest dreams." And of course, as crop farmers, you might, unless your fields are among those barren due to the drought or pest attack that caused production to be so low.

But here is the scary part: if such an extreme event did occur, the world would be flooded with grain within a few growing seasons and prices would collapse back to near late 1990 levels. How do we know that? Because anyone with access to agricultural data that go back decades, or centuries, can tell you that is how farmers react when prices get out of a certain range, that is, become very "high."

The argument that a reserve would be unwise because it would depress prices, can be true if a reserve is haphazardly run and does not view its role much like the role of the "oil reserve." Of course, anything can be set up to fail if failure is the goal.

To us, from the point of view of crop farmers, a reserve would have been a win-win proposition. Compared to the current policy, had a reserve been in place prices would have been higher during the 1998 to 2001 years and prices in recent months would still have been allowed to increase to well above cost of production levels as the ethanol demand began to grow. And in years to come, should yields tumble, with a reserve, demanders would remain long-term customers because of stable supplies. Finally, there would be reduced opportunity to bring mammoth excess resources into production due to over-response to low-yield-induced and unsustainable sky-high prices.

What does all this mean? To us, it means if we are lucky enough to get a bumper crop before we experience a catastrophe, we should grab part of that production and put it in a reserve.

Daryll E. Ray holds the Blasingame Chair of Excellence in Agricultural Policy, Institute of Agriculture, University of Tennessee, and is the Director of UT's Agricultural Policy Analysis Center (APAC). (865) 974-7407; Fax: (865) 974-7298; dray@utk.edu; http://www.agpolicy.org. Daryll Ray's column is written with the research and assistance of Harwood D. Schaffer, Research Associate with APAC.