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Fuel vs. Food; Do we need cheap grain or is this just more El Toro Poop Poo? ¹

Are grain prices too “High” depends on the side of the desk you sit! Farmers producing grain who are faced with higher fertilizer prices, diesel fuel prices, chemical prices, higher cash rents, etc., the current grain prices do not seem too “high”. However, a cattle feeder or a dairy farmer faced with higher feed costs probably considers corn prices to be too “high”. Flour millers and other grain buyers are also complaining about “high” grain prices, but many grain farmers would respond that historical grain prices were too “low” and grain could only be produced with subsidies.

The real question is will a change in ethanol policy cause a major reduction in grain prices that many buyers are demanding? An Iowa State study suggests the answer is no! Any suggestion by ethanol critics that an elimination of ethanol mandates and tax credits would return the corn market to \$2.50 is not likely based on a new Iowa State University study by Doctors Bruce Babcock and Lihong Lu McPhail. The link to the paper is: http://www.card.iastate.edu/iowa_ag_review/spring_08/article2.aspx

Iowa State’s forecasted an annual average price of \$5.60. It is unclear if this is the average for futures prices or cash prices. NASS reports a Marketing Year Average (MYA) price that is cash sales weighted by bushel volume sold. Because ISU is working with futures and options, one would assume their \$5.60 price is an annual average futures

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price for corn and not a cash price. ISU then estimates the probability of price ranges, i.e. the standard error of the mean.

ISU then estimated the average price if public policy were to remove the ethanol mandate. The result was a reduction in annual average price from \$5.60 to \$5.34.

If public policy were to remove the mandate and the 51 cent tax credit, the result was a reduction in annual average price from \$5.60 to \$4.83. The decline from \$5.34 (after the mandate elimination) to \$4.83 is 51 cents, i.e. the same as the tax credit. This would suggest that all of the tax credit is being transferred to farmers. This is unlikely because the blenders would surely try to hang on to some of the credit by reducing the price they were willing to pay for ethanol.

KSU thinks the initial price reduction caused by elimination of mandates and tax credits would be more than the 77 cent estimate in this study. The psychological impact on the market by such a large change in public policy would cause the long speculators to dump their contracts. So it is likely the market would over react to the downside, but remember the Iowa study is an estimate of the annual average price not a spot price.

But there are good reasons to believe the Iowa estimates may be close and the fall in corn prices may not be as severe as many analysts would forecasts.

1. The cost of fertilizer has doubled as have many other input costs that are petroleum based. Those higher input costs would have happened without regard to the corn price. Over the long run one can not drive price below the cost of production, so in the long run average corn price would have increased even without ethanol.
2. The weak dollar has made USA corn less expensive in international markets, and this has contributed to heavy export demand. The export market has supported higher grain prices independent of ethanol.
3. Poor growing conditions for wheat are largely responsible for higher wheat prices. New crop wheat prices have declined about \$5 from their highs, so improved weather has eliminated "high" wheat prices. However, the corn price will put a "floor" under wheat prices.
4. Demand for feed has remained strong with distillers' grain providing more feed than originally anticipated.
5. Higher gasoline prices increases the demand for ethanol without the subsidies. If gasoline prices were to increase above \$4 that would drag ethanol prices higher too.
6. With only 17 cents worth of wheat in a loaf of bread and 10 cents of corn in a box of corn flakes, it is difficult to buy the argument that ethanol is driving food prices. The argument that higher corn prices will cause meat prices to increase is a stronger argument because feed is a major cost of meat production. But even then ethanol is only one of the factors causing higher food prices.

So grain farmers should support elimination of the current ethanol policy? Clearly this would not be to their benefit because ISU is forecasting a 77 cent decline. KSU considers that to be a very conservative estimate. Grain farmers' highest priority should be to retain the mandate because this makes it clear bio-fuels will be a part of the fuel supply irregardless of the crude oil market. This will cause continued demand for corn in the short run, but more importunately it will create economic incentives to find more efficient methods for producing bio-fuels and those fuels many not come from corn. However, that only means current crop acres will shift to the "energy" crop so it is still good news for farmers. Current ethanol policy creates an economic incentive to develop new engine technology that will more efficiently utilize bio-fuels or create some other technology that currently is not even under consideration.

ISU also estimated the impact on corn prices if a Corn Belt crop disaster were to occur similar to 1988 drought or a 1993 flood. Under current policy the corn price would increase dramatically. ISU estimates a price of \$8.62, but prices over \$10 would not be a big surprise. This scenario would really put pressure on Congress to eliminate the development of bio-fuels, at least until the next disruption in crude oil supplies similar to what occurred in 1973.