FAPRI

POLICY OUTLOOK

by Abner Womack

CNFAP #8-88

Presented at
1988 Midwest Outlook Conference
Columbia, MO
August 16, 1988

Food and Agricultural Policy Research Institute - Department of
Agricultural Economics, University of Missouri,
Columbia, Missouri

Policy Outlook

- 1990 legislation will test the theme of how far U.S. Agriculture wants to go in the direction of a free market

- FSA-85 is headed on a fast track towards a market driven agriculture

- Considerable debate about changing directions or staying the course. My expectation is that under either administration staying the course with fine tuning is currently in the lead.

- Very difficult to read political focus going into the election. Much clearer signals on the Republican side than on Democrats.

  Republican - Free market leaning
    - Bilateral free trade
    - Multilateral free trade
    - Trade agreement with Canada
    - Decoupling - Boschwitz/Boren
    - Faster track on reducing target prices

  Democrats
    - Supply adjustment, commodity control
    - Staying the course but more fine tuning of FSA-85

- Democrats & Republicans calling for an increase in the Conservation Reserve from 45-65 million acres

- Common concern about regional implications of growth hormones for dairy and other livestock

- Common concern about water quality and legislation associated with banning inputs

- Technology and water quality could be leading agenda for the 1990's

- But if Louis Thompson at Iowa State is correct weather and weather related issues could also move up the scale

- My expectation is that the <u>balancing</u> or fine tuning theme has the best chance under either administration, given a continuation of the current economic environment

  - Look more closely at whether we need 45 million acres in Conservation Reserve
  - Reexamine our stock management policy, especially the heavy use of PIK certificates - Drought has changed the near term - but surpluses could come back

- Look more carefully at the international trade issue and rethink our pricing policy in regaining world trade

    - Marketing loan
    - Export enhancement
    - Competition with South America

- Level of government support - now much free market?

- Reason for selection the Balancing Theme as the most likely direction is based on research that has been going on in FAPRI/CARD for the last 2-3 years
- Start with an overview of some recent evaluations by the FAPRI Staff at MU & Iowa State

Baseline - March of 1988

Assumptions
- Moderate Eco Growth
- Inflation 4-5%
- Real Interest 5-6%
- Fuel & Energy 4-5%
- Federal Deficit - Moderate Decline
- Farm Program
    - Full implementation of CRP (45 mil acres)
    - Continued heavy use of PIK certificates
    - Target prices declining at 2% per year through 1996
    - Milk loan rate bottoming at $10.10 without BST much lower with BST
    - EEP discontinuing in 1989

Consequences - before the drought

1. Rapid decline in government cost, below $10 billion by 1992

2. Rapid decline in Net Farm Income
    - Down turn in livestock
    - Declining gov. payments
    - Increase in inputs
    - $45 billion in 87
    - $40 billion in 88
    - $30 billion in 92
    - $67 moves from $15 billion in 87 to $9 by 1992

3. Farm prices depressed with heavy use of PIK through 1992, but moving up significantly by 1995.
    + May get a similar pattern if set aside restriction are reduced in 1989. 40 million acres of land that can easily come back into production and depress prices

4. - 45 million acres conservation reserve too tight by 1992/93. If using 83 PIK year as an indicator could be within 15 million acres of land tied up, either planted or set aside by early 90's.
   If bids don't change or increase, will play itself out at about 32 million acres & still too light if take weather ruhs into consideration.

5. - Exports - fast track rebound until EEP runs out then trade shares are flat - and year over year growth is at record low levels
   - Losing the battle - big time to South America. Could end the decade 6-10 million acres ahead of the U.S.
     - Largely associated with our PIK program with low expectations for soybean returns by U.S. farmers but just the opposite in South America.

6. - Kicked the livestock sector in gear with strong expansion signals, not much change in demand signals, especially for beef and drought conditions adding near term pressures.
7. - Major groups relative to base consequences for

	(near term)	(longer term)
Consumers	+	-
Producers	+	-
Trade	+	-
Government cost	-	-

<u>Given this base of reference - several options have been considered. These include:</u>

1. Increasing Conservation Reserve to 65 million acres

2. Reducing the target price 10% per year

3. Moderation in the use of PIK certificates

4. Bilateral free trade - U.S. moving to free trade, all other countries holding

5. Multilateral free-trade, option being pushed by the administration

6. Different levels of economic growth - both in the U.S. and world economies

<u>Some general observations about options</u>

1. Increasing the Conservation Reserve to 65 million acres

   - Since baseline of 45 million is too tight - very unlikely that will go to 65 million

- Under baseline have about 15 million acres of slack - need around 35-40 to offset a drought
- Adding another 20 million
    - average rental will have to approach $100/acre
    - total planted area declines
    - prices increase sharply with tighter supplies
    - gov cost increase
    - net farm income increase
- Pretty safe to say that 45 million acres won't occur unless bid is increased. Analysis suggests that 45 million has gone too far.
- Can easily get lulled into a false sense of security about excess capacity, doesn't start showing up as a problem until early 1990's. For example, with normal weather and acreage expansion in 1989 could have surpluses and low prices in the fall of 1989. This slack runs out as stocks are depleted.
- Consequences for major groups relative to the base

Farmers or producer of crop	(+)
Livestock	(-)
Consumer food prices	(+)
Government costs	(+)
Trade	(-)

2. Reducing the target price 10% per year until reaches loan levels

- Places too much pressure on net farm income as long as have surpluses and continue the heavy use of PIK certificates. Will find this to be a major issue in next farm bill. Also expect supplies to be a problem, assuming normal weather and acreage expansion in 1989. But still expect tight supplies later as conservation reserve kicks in.
- Base line estimates places pressure on Income by 1990. If so very likely that target prices will be frozen in next legislation.

3. Moderation in the use of PIK cents FAPRI-3 (87)

- Equilibrium prices moved up to around $2.25 corn, $3.00 wheat and $5.75 beans. Amounted to a $.30/bu. increase in price over base line
- Saved an average of $4 billion per year on government cost
- Reduced farm income about $1 billion per year average
- Exports were 4% below base line
- Ending stocks were 7% higher than base line
- Corn/Soybean rates moved back in the 2.5 range with less incentive for expansion in South America
- Less of an expansion signal to livestock production

- A starting point and a <u>Major question</u> to be dealt with is where the <u>long run equilibrium price will be</u> without much government intervention. Moving U.S. prices substantially below these levels will be expensive and lead to longer run distortions similar to consequence measured.

Consequences for major groups relative to the base

Consumers	...
Producers	-
Trade	-
Government Cost	-

Makes this option more likely since fine tuning can:

- lower costs
- sustain farm income
- maintain a competitive position internationally
- keep food prices at moderate levels

4. - Bilateral free trade - U.S. moving rapidly to no supports - all other countries remain the same - Policy Scenario Report AAEA, Knoxville, TN, July 29, 1988.

- Substantial drop in net farm income to $20 billion
- Significant initial decline in crop prices - reflection drop of gasohol programs and CCC plus Farmer Owned Reserves.
- Moderate expansion is livestock with lower prices
- Relaxing set-aside and paid diversion, holds acreage near baseline levels.
- Longer term price increase reflecting set aside impact from baseline 45 million acres conservation reserve

Consequences relative to base

Consumers	+
Producers	- -
Trade	+
Government Cost	-

Conclusion - major disruptive pressures unless some transition is considered. Gives a good notion of what Ag would be like with no supports and gives a bench mark for amt. of support to be added back in. Note that this option plus $10 billion in government payments puts Ag back near FSA-85.

5. <u>Multilateral Free Trade</u> - all countries drop government support

- Exports increase 15% above base, reflecting no trade barriers in Japan and EEC

- U.S. grain prices increase, soybean decline.
- Livestock production, slight decline with moderate price
- Government cost reflects 45 million acre reserve cost only
- Net farm income about $3 billion below base

Consequences for major components

Consumers	-
Producers	+
Trade	+
Government Cost	-

Conclusion - Producers in EEC would be faced with feed grain and wheat prices at 50% of current levels. Production would necessarily decline and imports increase. Not a very likely political stable situation.

6. Alternative levels of Economic Growth. Moving world economies at about 1% per year above base line with inflation at 2 points below base

30% increase in wheat price,
35% increase in feed grain price,
40% increase in bean price

- Inelastic nature of short-run demand and supply in grains/oilseeds markets results in pronounced lagged responses to changing macroeconomic conditions.
- Boom periods are characterized by accelerated rate of price increases with world demand providing strong signals for increased production.
- Shorter run supply response elasticities ranging for 0.2 to 0.3 empty gradual production increases compared to the demand incentives
- Reverse situation occurs with the general economy down turn, world supplies tend to over shoot with sharp price declines - taking several years to readjust

<u>Conclusion</u>

Almost all of the major components are favorably impacted in a boom period. Demand leads supplies with higher prices. Consumer taking the most serious impact, but have more dollars to spend on food.

- Can be extremely disruptive since economic boom is generally followed by economic bust. Readjustment on the down side can be extremely difficult for agriculture taking several years to realign to levels of demand.

Conclusions

- Probably will stay with the FSA-85 but with some refinements
- Not likely of get 45 million acres into the conservation reserve - will place too much pressure on available area by early 90's
- Target prices likely frozen at the 1990 level because of net farm income problem
- Competition in foreign markets to be given more attention. If EEC does not back off subsidies, can expect continuation of EEP
- Will reexamine stock programs - probably continue PIK certificates but at smaller percent & rethink drought-stock implications
- Supply management will reemerge, and support will depend on the level of financial pressure. Will gain popularity if enter a recession with conditions similiar to the early 80's
- Free market themes not likely unless transition period with gov. support. If winners are willing to pay losses - i.e. an income supplement to producers of around $10-12 billion, then program moves in direction of FSA-85 supports
- Biggest decision will be how far agriculture is willing to follow the current free market path.
- Major risks
    - world economies with heavy debt
    - drought cycles
    - technology
    - water quality
    - foreign competition
    - U.S. government expenditures and budget constraint
    - level of government support - could have serious implications on production regions with marginal land and poor yields