83 Annual USDA Outlook Conference

Agriculture at the Crossroads
Energy, Farm & Rural Policy

Alternatives to Risk Management:
Confronting Conventional Wisdom

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Crossroads of Energy & Ag

Risk for LIVESTOCK HIGH

Risk for CORN - LOW

meatingplace IN PRINT ONLINE

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BYE the bushel

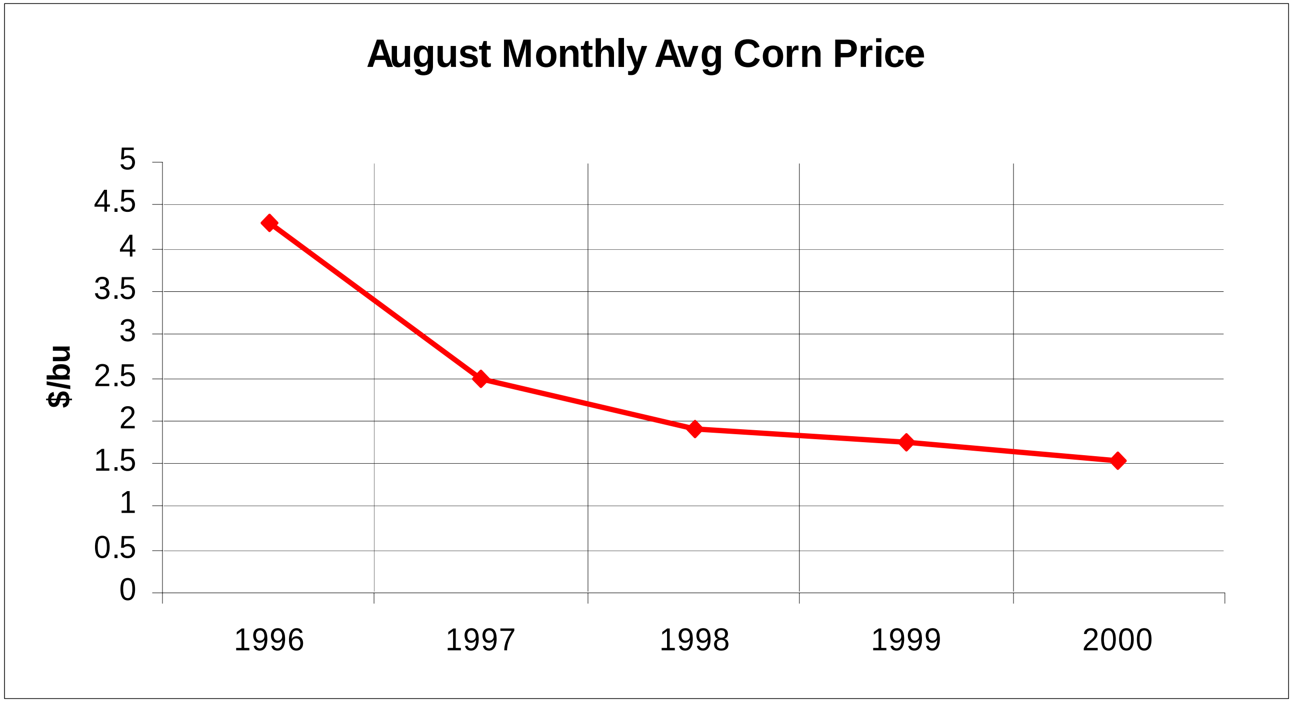
"…. In other words, don't look for corn to dip significantly below $3 a bushel again."

"Ever again."

HA! ha! Ha! ha Ha! Ha HA ha!!!

What's Next?

In all the talk about cellulosic ethanol, … have you heard anybody propose a "soft landing" for corn?



Will safety net work if cellulosic ethanol technology works?

2007 Farm Bill

Federal Budget and the Farm Bill

“*Not enough money in the budget*”

aka “*Deficit pressure*”

aka “*Fiscal Constraints*”

… is the most ***overrated*** political constraint

Remember:

- **1996 Farm Bill** – was supposed to be the *1995 farm bill* but Congress wouldn’t pass it w/o more money in it, … until farm lobby intervened in 1996.
- **2002 Farm Bill** – agreement to spend $73.5 bln, despite the budget; Senate never passed a budget resolution that year.
- **2006 Budget Reconciliation** – $2.7 bln in cuts prescribed; zero enacted.

Federal Budget and the Farm Bill

Congress is literally stuffing money into holes !!

2002 Farm Bill, ***<u>Conservation Title</u>***, Section 524(b)(2)(D) and (E) "*provides for cost share assistance to help producers enter into futures, hedging, or options contracts in a manner designed to help reduce production, price, or revenue risk* …"

<u>Real Trend in Farm Bill Spending</u> – 2002 farm bill had entitlement spending in every title, … used to be just Crop and Nutrition titles.

Federal Budget and the Farm Bill

Probably the last time budget was true factor was under the 1990 farm bill; which became part of deficit reduction act;

Budget Deficit as Percentage of GDP
Farm Bill Year/Budget Year

1990/1991	3.9 / 4.4
1996/1997	1.4 / 0.3
2002/2003	1.5 / 3.5
2007/2008	1.4 / 0.7

Annual average deficit as pct of GDP since 1962, … 2.6 pct

There's plenty o' money to go around for 2007!

1994 set-aside increase; low stocks

***Major volatility has been policy driven –** first, set-aside; now ethanol*

Budget Impact: Mission Creep

Budget – forcing "mission creep" on farm bill

*Farm Bills have traditionally addressed **price risk***

__Production/revenue risk__ is addressed by Crop Insurance

Or by lobbying for disaster relief, …

Pressure to expand farm bill as revenue protection, … 2002 counter cyclical payments (as if LDP's weren't); 2007 revenue based …

Not a bad idea on its face, … but should be considered with crop insurance

Politics of combining them into one big authorization, … at least part budgetary

Adverse Consequences

- *Crop programs essentially set a floor price.* ***Best marketers, hedgers, speculators, get a chance to do even better.***
- *Program* ***payments get tied into land values****; raise fixed costs of production*
- *Crop insurance* ***sets fixed values in moving markets****. General P&C insurance doesn't have that liquid of a market.*
- *Crop insurance tries to be all things to all people;* ***can't entice good risk in the risk pool, can't exclude bad risk****.*

Issues to Address

Crop Insurance – individual rating, proprietary policies, Cost of Production policy, more on revenue side, …

Crop Programs: Non-price triggers (like NCGA tried in 2002) – <u>heavy on inputs</u>, exchange weighted commodities; ensure payments <u>not capitalized into land values</u>, not a hindrance to value added, relevant to market, global demand. Engage the <u>private sector</u>.

Dairy: Case in What Not to Do

FMMO – *prescribes farm gate prices processors must pay*

Make Allowance – *dictates handler margins*

Dairy Price Support – *distorts market, builds government stocks*

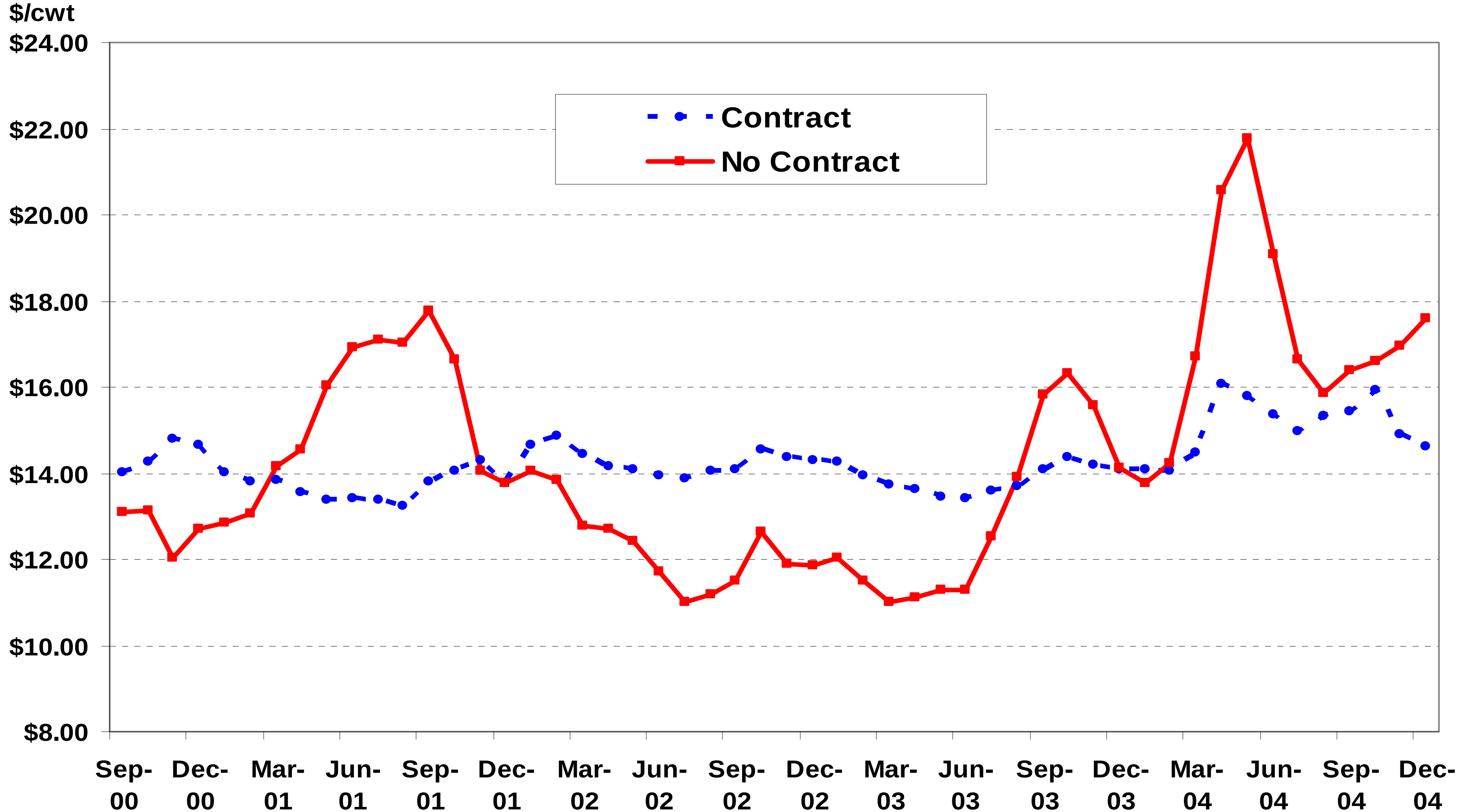
Milk Income Loss Contract (MILC) – *lowers price (retroactive, temporary x 3)*

According to USDA projections, *"without the MILC program, the remaining dairy programs raise the all-milk price by 3.8 percent over a 5 year period – when MILC is included, the increase is only about 1.5 percent."*

Range:	$ 2.832 w/ K	$10.787 w/o K
Avg Price:	$14.255 w/ K	$14.332 w/o K

Dairy Forward Contract Pilot

Milk prices received by farmers, both with and without forward contracts, during the Dairy Forward Contracting Pilot Program



Source: USDA, AMS Dairy Forward Pricing Pilot Program: Information for the Complete Program Periods, September 2000 through December 2004.

Longing for Freedom to Farm

CFTC Commissioner Joe Dial:

Throughout these presentations there was a common message: with the passage of the FAIR Act there is now a compelling economic reason for farmers to learn how to shift their risks. . . . The Congress has set the course for public sector participation in this particular educational process.

Section 192 of the FAIR Act directed the Secretary of Agriculture, in consultation with CFTC, to *"provide such education in management of the financial risks inherent in the production and marketing of agricultural commodities as the Secretary considers appropriate."*

Consolidated Grain and Barge *Equalizer*

Cargill *A+*

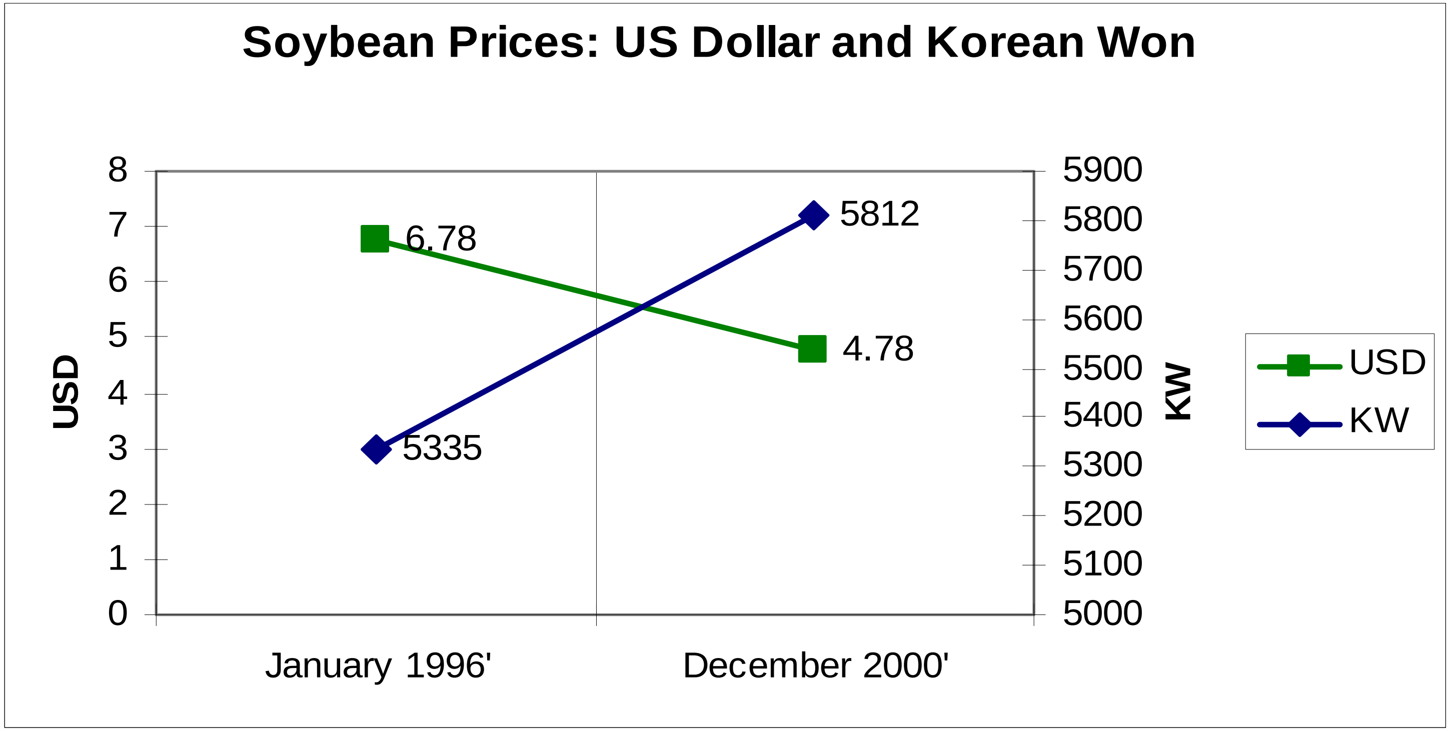
Beauty of the 1996 farm bill – it encouraged private risk management, … *hedging, ag trade options were the buzz.*

Macro Economic Risk

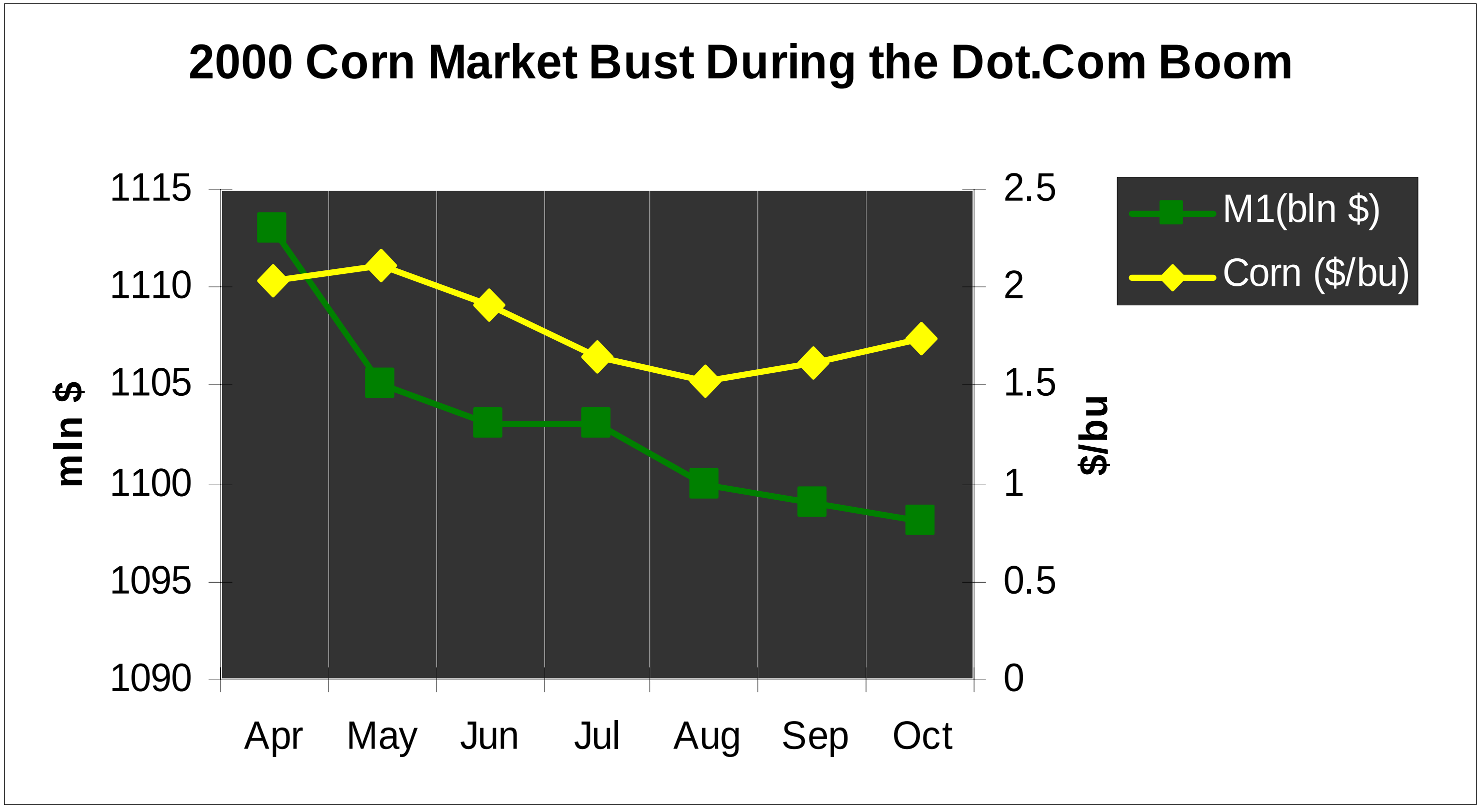
Monetary Policy

Downfall of Freedom to Farm

- *Interest Rates*
- *Inflation*
- *Money Supply*
- *Exchange Rates*



Greenspan Market



One full year before recession, money supply is dropping because of demand for money. Fed is tightening (May) fearing wage pull inflation. Corn prices see biggest Apr-Aug spread as a percent since 1988 (when prices increased with M1 expansion)

Economy of Republic of Cornstinia

Year 1 Economy

100 bu of corn supply/demand

100 $ in money supply

Corn is $1/bu

Year 2 Economy

100 bu of corn supply/demand

90 $ in money supply

Corn is $0.90

If corn production expanded 10 percent, … prices would drop to $0.81…

Could corn supply/demand increase over the life of the next farm bill? *i.e. ethanol*

Could money supply decrease? *i.e. stock market boom, housing rebound, dollar appreciation, …*

The Economics of Risk

Understood by the *Utility Theory* - utility is an abstraction that measures an individual's overall satisfaction with a given situation.

Risk Averse – has a diminishing marginal utility for money, usually that point of DMR is at some acceptable point above his costs – real and opportunity. Manager

Risk Seeking – has an increasing marginal utility for money, each and every marginal dollar is needed or applied to important or better use. Not a manager

The Economics of Risk

↓ Marginal Utility of $

- Seeking to lock in profit
- Servicing Debt
- Shareholders
- Meeting payroll
- Only source of income
- *i.e.* Larger/FT Farmer
- Wants to manage risk

↑ Marginal Utility of $

- Benefits more from higher return than suffers from lower return
- Has other source of income
- *i.e.* Smaller/PT Farmer
- Doesn't want to "manage" risk

Dose of Reality

30,000 farms account for 50 pct of all farm output; 2 million plus farms, the other 50 pct

"The <u>overwhelming majority</u> of all farmers, but especially small operators, <u>rely on off-farm employment</u> to stay in agriculture."

Farm Credit Council, January 2006

Politically, … the question is: who, and how, will the message that "access to off farm jobs saves farms" be carried into the farm bill?

Some Conclusions

We've seen record corn prices twice; both caused primarily by policy intervention into an otherwise good market.

We've seen serious commodity price deflation – arguably caused (or worsened) by monetary policy and global macro-economic issues.

Inputs are the cause of some of producers' most pressing problems (natural gas, feed, land – much of it policy driven).

Dairy policy is completely out of synch, and counter-productive.

Risk management is being "sold" to a bunch of producers whose economic profile may not be suited to managing risk.

There is not a clear game plan integrating crop insurance and crop programs.

Farm bills are written as if no one fully recognizes that half of our ag production comes from part-timers who rely on other jobs.

Since 2002, policy has moved away from encouraging customers of ag commodities to provide more solutions.

There is plenty of money to throw at the next farm bill.