Oral Statement before the United States Senate Committee on Agriculture, Nutrition, and Forestry

Hearing on the trade section of the farm bill

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Thank you, Mr. Chairman, for the opportunity to participate in today's hearings. My research center at Iowa State University and the Food and Agricultural Policy Research Institute (FAPRI) at the University of Missouri jointly develop the annual FAPRI baseline. From this baseline I have prepared a brief overview of what we see happening over the next five years in the agricultural economy.

Why Are Agricultural Prices So Low?

When are prices going to rebound? This is the number one question that I am asked. Prices have been weak for most program crops since 1997, and pork and beef prices in the late 1990s hit rock bottom, although both have subsequently recovered.

When discussing where prices are going, it helps to take a long historical view. For agriculture, the long-run, inflation-adjusted price trend is downward. With productivity increases, the supply of agricultural commodities has grown faster than the demand. Other commodities, such as metals, oil, wood, chemicals, and computer capability, have also experienced this downward price trend.

This downward trend in inflation-adjusted prices represents a success story for economic growth and wealth creation. Despite claims that the world will inevitably run short of basic commodities, low prices indicate that basic commodities have become relatively less scarce over time. Technological progress means that we can spend relatively less on basic commodities, which helps increase standards of living.

However, this long-run trend does not imply that prices cannot rise over a five-year period, particularly if prices start at a lower-than-expected base, as has been the case for program crops. How did they get so low?

First, average world yields for corn, barley, and sorghum were above trend each year from 1996 to 1999. They fell slightly below trend in 2000. Average world wheat yields were below trend in 1996 but above trend for the following four years. As we look to the future, we should expect that the number of years with above-trend yields and the number of years with below-trend yields will be more equally divided.

Second, the Asian financial crisis in 1998 also had a direct effect on U.S. prices. The economies of Thailand, South Korea, Philippines, Indonesia, and China either shrank in size or had significant declines in growth rates. This crisis caused U.S. exports to either fall, as in the case of grains, or to remain flat when they were expected to grow sharply, as in the case of meats. Most Asian countries have rebounded quickly after their recession, with the notable exceptions of Japan and Indonesia. Continued economic growth in the region should help strengthen export demand for U.S. agricultural products.

Third, U.S. prices were weakened by the strength of the dollar. Both in 1997 and again in 2000, the dollar strengthened considerably against European and most Asian currencies. It is difficult to determine if the dollar will weaken anytime soon.

Finally, changes in domestic policies in the middle 1990s contributed to weak prices. The new U.S. farm policy, passed in 1996, allowed farmers to take advantage of high market prices in the middle 1990s and expand crop acreage. Large, countercyclical farm payments have helped keep total U.S. planted acreage up, even though price levels have fallen dramatically.

China decided in 1997 and 1998 to reduce the size of its corn, wheat, and cotton stocks. This internal policy decision helped switch China from a net importer to a net exporter of these commodities.

Public and private transportation infrastructure investments in Brazil and Argentina have allowed both countries to expand planted acreage, particularly soybean acreage, which has tended to expand total world supplies.

Some of these policy decisions may be transitory. We expect China to become a net importer of corn, wheat, and cotton, as they rationalize their producer incentives under the World Trade Organization (WTO). Congress may decide to lower loan rates and eliminate any further emergency payments. Brazil and Argentina could decide to return to a policy of higher taxes for agriculture, which would hold down their supply expansion. Any of these policy changes would lead to higher U.S. crop prices.

In summary, we see no reason to believe that the long-run downward trend in real prices will be reversed in the next five to ten years. However, recent price weakness is caused by short-run factors that are reversible.

Five-Year Price Projections

FAPRI makes price projections as part of its annual baseline analysis. These are not price forecasts because we know that unforeseen supply and demand shocks make accurate price forecasts impossible. Rather, the price projections reflect the net effect of underlying trends in macroeconomics and domestic policies that affect prices. The baseline assumes "normal" growing conditions throughout.

Wheat

Wheat prices are expected to increase by 16 percent, from $2.67 per bushel to $3.17 in

2005. U.S. exports are projected to be flat. Because of its policy reforms, the European Union is able to expand exports significantly without subsidies. If major producing and consuming countries like China and India suffer poor crops, wheat prices will be much higher than projectioned.

Corn
Corn prices are projected to increase 20 percent, from $1.87 per bushel to $2.24 in 2005. Our projection that China will become a net importer of corn by 2005 is a key factor underlying the price increase. World stock levels are projected to be adequate to forestall dramatic increases in price from a single year of poor growing weather. Continued large Loan Deficiency Payments to soybeans will limit U.S. corn acreage, thus helping corn prices. If U.S. soybean loan rates were adjusted downward, corn prices would tend to be lower than projected.

Soybeans
Soybean prices are projected to remain below U.S. loan rates for the next five years. Continued expansion of soybean acreage in South America and continued expansion of other acreage of competing oilseeds combined with maintenance of large U.S. soybean acreage keep prices weak. Despite continued high U.S. support prices, the U.S. share of world soybean trade declines over this period. Productivity gains in the United States and in other countries have made soybeans a relatively attractive crop to grow.

Cotton
Cotton prices have already rebounded somewhat from their recent low levels. We project that cotton prices will remain largely at current levels over the next five years. This static projection reflects moderate growth in world demand, significant increases in cotton acreage in Brazil, and continued liquidation of large Chinese stocks.

Rice
U.S domestic rice prices are projected to rise by 25 percent, from $5.78/cwt to $7.26. Strong increases in U.S. demand and growth in world rice trade fuel this rise. However, U.S. prices do not rebound as much as strong demand growth might suggest because other exporting countries are in a position to increase their share of world markets. Thailand, Vietnam, China, and India are all projected to increase their rice exports because of declining growth rates in domestic rice consumption and continued growth in per-acre yields.

Beef
Cattle prices are the bright spot in U.S. agriculture. Strong domestic demand and continued decline in total cattle numbers have led to this strength. As herds rebuild over the next five years, we project that prices will remain strong. In the short-run, strong domestic demand attracts increased imports as exports remain flat. As U.S. domestic cattle numbers rebound, exports are projected to increase. The downward phase of the cattle cycle begins in 2004 with lower domestic prices.

Pork
Strong domestic demand and problems with foot-and-mouth disease (FMD) in other exporting countries have led to a recovery in pork prices, although prices still remain below the levels observed in most of the 1990s. Domestic hog numbers are projected to increase over the next few years, eventually driving down domestic price-especially in 2002-and increasing exports. Pork exports are projected to increase 36 percent over the next five years. The phenomenal productivity growth in the U.S. pork sector is projected to continue, making the U.S. a low-cost producer in the world market.

Dairy
In our baseline projections we assume that current policy decisions are maintained throughout the projection period. Thus, for dairy we assume that the dairy support price program is terminated at the end of 2001. This assumption slows down the growth in U.S. production as U.S. producers respond to lower dairy prices.

Some Concluding Thoughts
Overall, we project moderate growth in crop prices over the next five years. With the notable exception of soybeans, we should see significant declines in price support payments. Crop prices will rise significantly if there is a major supply disruption. But over a two- or three-year period, the extent to which prices can rise is limited by the downward pressure of continued agricultural productivity increases in the United States and other exporting nations.

We are optimistic about the health of the livestock sector. Strong demand, low-cost producers, and high-quality products are making the United States quite competitive in world markets. Of course, this strong position would be quickly eroded if the United States were to lose its FMD-free status. Public investments in maintaining this status may yield the largest short- and long-term returns in agriculture available to Congress and the U.S. Department of Agriculture.

As the committee rewrites the trade title of the farm bill, keep in mind that ten years ago, program commodities accounted for 64 percent of the value of agricultural exports. In 2000, they accounted for 49 percent. Continued world economic growth will result in relatively greater demand for U.S. exports of these higher-value commodities. A farm bill that gives U.S. agriculture the right incentives to deliver the kinds of food products overseas customers want will enhance the long-term health and competitiveness of the sector.

One last comment: this committee knows that it cannot spend more than the amber box limit of $19.1 billion under the WTO (a limit that might have been exceeded in 1999 and 2000). This constraint, along with the generally accepted notion that economic growth is enhanced by increased trade, gives momentum to policies that do not directly influence world prices or trade flows.

As the European Union considers the future of its agricultural policies, it seems that it is replacing its food security rationale for policy intervention with a rural

development/environmental quality rationale. A similar search for justification for U.S. intervention has led many to push for expansion of conservation payments to farmers, such as Senator Harkin's proposed Conservation Security Act. Supporters of conservation payments point out that taxpayers are more likely to support payments to farmers if they were getting environmental quality in return. And it is much easier for conservation payment programs to be classified as green box under the WTO.