

GRAIN OUTLOOK

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CRUDE OIL DRIVES COMMODITIES

Sighs of relief were heard throughout the grain trade this week as corn and soybean planting both progressed. However, as of May 18th, corn planting was still 15 percent behind normal and soybeans were 20 percent behind. Ordinarily, prices would drop as the Battle for Acres was resolved, but corn and soybean prices have remained strong due to rising energy prices. Corn and soybeans are now lumped together with crude oil as inflationary commodities worthy of increased attention from speculators.

Supply and demand fundamentals for grains and oilseeds have taken a back seat as crude oil price became the engine driving prices of other commodities. Increased diesel fuel demand from China for earthquake recovery efforts and to substitute for disrupted Chinese coal supplies in producing electricity has put pressure on the global supply of crude oil. The refusal of OPEC nations to increase oil production, (Saudi Arabia did agree to make a token increase in oil production in response to President Bush's request for greater production.) and production problems in Nigeria have kept the supply-demand balance tight and oil price high and rising.

U.S. oil company executives met this week with Congressional committees to explain the situation. They reported on the economics of oil such as the need to open up areas of the United States now banned from exploration and drilling. They explained that it was in the economic best interest of oil producing nations, from which U.S. oil companies must buy crude, to control supply rather than serve the needs of consumers in oil consuming nations. They talked of the need to put greater emphasis on energy conservation and to

further develop renewable energy such as biofuels. Senators and Congressmen brushed economics aside as they hinted at political measures such as breaking up the oil company mergers that took place in the 1990s when low oil prices put the survival of some companies in doubt or sharply increasing taxes on oil company profits. (Oil companies have enough market power to keep markup margins constant so total profits tend to increase as the selling prices of the products they sell increase. Oil executives complained in the hearings that the high price of purchased crude was putting a squeeze on their profit margins; the classic cost/price squeeze so familiar to farmers.)

Ethanol has been under fire recently for driving up prices of food products, even bread upon which ethanol production has little or no impact. Congress was pressured to revisit ethanol policies and perhaps eliminate the import tariff and blenders' subsidy. But, ethanol has all but dropped out of the news since Senator Grassley uncovered the Grocery Manufacturers Association's anti-ethanol publicity campaign and requested association members to put a stop to it. In fact, the USDA said this week that other factors, such as increased energy costs, have played a greater role in food price inflation than ethanol. The President's Council of Economic Advisors said that only about three percent of the rise in global food prices was due to increased demand for corn to make ethanol.

There is irony here - ethanol is a partial solution to the high gasoline prices that are affecting consumers' finances much more than high food prices. At present, about five percent of the gasoline purchased by the nation's drivers is ethanol. If that amount were eliminated, gasoline price would increase by more than five percent (studies show 10 to 12 percent) because of the inelasticity of gasoline supply and demand. Following the same logic, if ethanol supply were to increase by another five percent of gasoline supply, gasoline price would likely drop by more than five percent.

The charge that corn demand for ethanol is driving up food prices is likely to be renewed later this year. Ethanol demand for corn will rise by about one billion bushels as additional ethanol plants come online in 2008. There is concern that wet weather delays

will reduce corn acres planted and perhaps corn yield; either one of which might cause corn price to remain high or go higher.

Turning the situation around, using the USDA projected supply and demand numbers for the 2008 crop, if the ethanol demand for an additional one billion bushels of corn were eliminated, corn price would likely fall into the low \$3 range. Because of drastically higher prices farmers must pay for energy-related inputs, namely diesel fuel, fertilizer, and agricultural chemicals, both Iowa State University and the University of Illinois now put the cost of producing corn at about \$4 per bushel.

Put in another way, gasoline price would be 7 to 10 cents per gallon higher because of the three billion gallons of ethanol not produced. However, the purchaser of a box of corn flakes might see the price drop by five cents or so, if the food manufacturer and grocers were willing to pass the cost decrease through to the consumer. Corn producers would definitely be on the losing end of a cost/price squeeze.

The completion of planting will be late this year, but with the market price incentives, producers will plant all the corn and soybean seed they have and hope for the best. Given good growing conditions, it will be easier for farmers to expand supplies of grains and oilseeds than for the oil companies to expand supplies of gasoline and diesel fuel.