

WILL THE GOOD TIMES LAST?

by Maud Roucan-Kane and Mike Boehlje

Without a doubt, the production agriculture industry is experiencing some of the better times it has seen in recent years. The question on many people's minds is whether or not this trend is sustainable over the mid- to long-term. Answering this question is difficult, but one way to obtain some insight is to assess the supply and demand forces shaping the industry. There are five fundamental forces of particular relevance, and in this article we discuss the first three. The final two will be featured in our column in the next issue.

FORCE 1: ETHANOL AND ENERGY

By 2009, ethanol production will consume nearly 30% of the U.S. corn crop in order to generate approximately 14 million gallons of finished product. However, this growth brings challenges with it.

When looking more closely at how ethanol is shaping the agricultural industry, there are several points of interest. Currently, there is an inadequate transportation and logistics infrastructure in place to support the movement of product into the fuel supplies on the East and West coasts. Another area of concern is the current ethanol subsidy of .51¢ per gallon and the potential implications on the ethanol fuel supply if this subsidy isn't renewed in 2009.

One final consideration is the fact that U.S. corn-based ethanol is competing with Brazilian sugar-based ethanol. Because corn-based ethanol is 20% more expensive to produce, the U.S. has imposed a .54¢ tariff and an import quota on Brazilian ethanol imports, but no one knows how long it will last.

FORCE 2: EXCHANGE RATE

With the value of the U.S. dollar approaching the record-level lows witnessed in the mid-1990s, U.S. agricultural products have become increasingly attractive to importers. When combined with the strong economies and purchasing power of China, India and much of Asia, the result is a significant boost in U.S. agricultural exports.

However, the declining value of the dollar is a double-edged sword since a lower U.S. currency value also makes our imports more expensive. An increasingly larger proportion of agricultural inputs are imported — almost two-thirds of our nitrogen and an increasing amount of P & K and chemicals for pest control. In order to understand whether or not the foreign demand for U.S. agricultural products will thrive, it's critical to watch the growth in personal income and food demand in Asia, as well as foreign exchange rates and currency values.

FORCE 3: GLOBAL PRODUCTION

In the U.S., most of the land and water needed for agricultural production is being fully utilized, and the allocation of additional land and water resources toward agricultural production is highly unlikely. This is clearly not the case in much of South America (Brazil, Uruguay, Bolivia, and Argentina) as well as in parts of Eastern Europe where adoption of new technology and market-driven business models have the potential to dramatically increase agricultural output.

U.S. animal production is not constrained as much by land and

water resources, but expansion in animal industries faces equally limiting constraints with respect to the location of livestock facilities and the regulatory permitting process. This means that the U.S. will face increasing global competition in a climate where agricultural production can be more cost effectively expanded in other countries than in the U.S.

SUMMARY

All of these forces will increase the variability and volatility of your customers' operations, which in turn means that you'll face more risk in your own operation. These risks could take the form of product shortages and stock-outs, as well as price resistance from customers who will be shopping for better deals. Developing a proactive marketing strategy and accurate sales volume estimates are two tools that will help you manage these risks and maintain market share.

You can also expect to face increased financial risks. You will likely have more money tied up in financing inventory, in accounts receivables and in margin accounts if you are a grain merchandiser. Crops margins are at a historical high and your customers are generally in a strong financial position, but this is likely not a sustainable position, given the cyclical nature of the U.S. agricultural industry.

Certainly other forces could have important implications for the continuation of strong prices and incomes for the next three to five years. In our next article, we will discuss two additional factors impacting the agricultural industry. **AM**

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