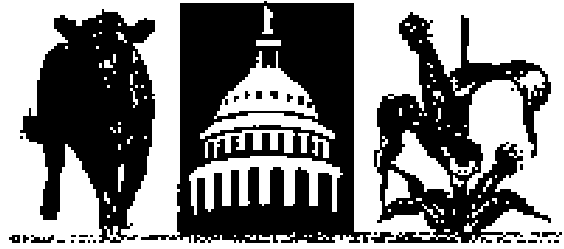


# ECONOMIC AND POLICY UPDATE

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- ▶ a weakened value of the U.S. dollar relative to other major trading currencies such as the Euro;
- ▶ increased levels of agricultural exports from the U.S. (partly as a result of a weaker dollar);
- ▶ higher prices for imported food (also partly related to a weak dollar);
- ▶ weather-related production problems in the world including portions of Australia, Southeast Asia and parts of the Corn Belt due to recent flooding;
- ▶ increased use of food and feed products such as corn for bioenergy production;
- ▶ rapidly rising input prices that are primarily energy derived (oil and natural gas);

## What's Behind Food Price Inflation?

Food prices (along with energy prices) are the fastest increasing components of the Consumer Price Index (CPI) thus far in 2008. The CPI is the most widely watched measure of increasing prices in the U.S. economy. Inflation, on an annual basis thru May, increased at a 4.2% rate while food and beverage prices were up 5% and transportation costs (primarily energy) were up 8%. Increasing food prices in May 2008 compared to May 2007 were led by price increases in fats/oils (12.8%), dairy and dairy products (11%), cereals and bakery products (10.5%), Sugar and sweets (5.5%), fruits and vegetables (4.4%), and meats (2.6%).

Reasons for increasing food prices are many and include:

- ▶ strong global demand, particularly in rapidly increasing income countries such as India, China and Brazil;

The recent rapid increases in energy prices do have a tremendous impact on the food system since energy in the form of oil (and its derivative products such as diesel and gasoline) and natural gas are essential inputs throughout the food and fiber complex. Farm commodity production is heavily dependent on fertilizers and chemicals which are closely linked to higher energy prices. Energy is also a key input in the processing and transportation necessary to move and process farm commodities into final products that are purchased at retail restaurants and food stores throughout the country. Energy, primarily in the form of packaging and transportation is estimated by the USDA to represent 16 cents of a hypothetical dollar that an average consumer spends for food in the U.S. This figure does not include the energy cost factor in farm production.

Where will food prices go for the remainder of the year? The USDA recently estimated annual food prices will increase 5-6% this year (2008). However, recent flooding in the Midwestern U.S. with a seemingly unrelenting higher price for a barrel of oil suggests that the USDA's estimate

could be on the low side. Food price increases in the 6-8% range are possible for the year. (Larry D. Jones)

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### **Update on the KFBM-KDDC Dairy Partner Incentive Program**

The first year of the collaborative program between the Kentucky Farm Business Management Program (KFBM) and the Kentucky Dairy Development Council (KDDC) has been completed with very promising results. The Dairy Partner Incentive Program was designed to recruit dairy farmers to KFBM and DHI (Dairy Herd Improvement) programs and was initially intended to run two years in conjunction with the KDDC's MILK (Market Incentive Leadership for KY) program.

KDDC received an Agricultural Development Board (ADB) grant designed to implement a comprehensive program to increase milk production in Kentucky. Part of the ADB grant was used in cooperation with Kentucky milk shippers to offer an incentive to farmers for increasing the amount of milk produced and sold. Farmers could qualify if certain quality and quantity standards were met and if they had proper production and management record systems.

Specifically, in order to qualify for the KDDC incentive money, dairy farmers had to cooperate in KFBM, be on the DHI program, increase their production by 10% over 2006 levels, and meet quality standards. Dairy farmers who met these standards received \$0.50 per cwt for their milk up to a \$10,000 per year maximum.

In all, 61 Kentucky dairy farms signed up for the Dairy Partners Incentive program for 2007. Twenty dairies were already KFBM cooperators, but the remaining 41 (most of them in the Glasgow area) were new to the program.

The Dairy Partner Incentive Program continues into 2008 with most of the 61 cooperators from 2007 remaining and hopes of recruiting new dairies. KFBM has offered a reduced dues incentive for those dairy farmers who stay with KFBM for the 2008 year. Those dairies who stay with KFBM for

2009 will receive another discount on their dues, even should the MILK program not be extended.

Other benefits of the KFBM-KDDC partnership include all that can be learned from the diversity of dairies in the program. For example, several organic and grazing dairies have joined the program. This will make for useful and interesting farm comparisons. Our partnership also involves UK dairy faculty from Animal and Food Science who are helping develop educational programs for our dairy cooperators. As a final added benefit, the program was responsible for creating a new KFBM specialist position which was filled by Kassie Celsor. Kassie is based in Bowling Green and works with 33 dairy farmers who are were all new to the KFBM program since 2007.

Overall, the first year of collaboration between KFBM and KDDC has been successful. The partnership allowed a large number of Kentucky dairies to qualify for MILK incentive funds, enhance their farm records, and plan management improvements for their dairy operation in the future. In 2008 financial comparisons to the aggregated dairy records from 2007 will allow even more opportunities. By the end of 2009, dairy cooperators should be realizing the full benefits from the farm management consulting provided by KFBM.

KFBM is an extension program that offers management assistance to farmers across the state. Assistance includes:

- Use of a detailed farm record keeping system designed to help with farm management decision-making.
- Consultation with trained specialists to develop business and family priorities, compare costs and returns, and examine alternative management plans.
- A computerized economic analysis of the farm business which includes financial statements, cost and return analyses, dairy enterprise analyses and comparative benchmarking.
- Information to use with lenders and tax professionals, and
- Personal contact with an area specialist in farm management through on-farm visits, phone calls, newsletters, and office visits.

In all, this assistance aids farmer-cooperators to improve their management and more fully realize their business goals. (Curtis Mahnken and Kassie Celsor, KFBM Specialists)

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## Grain Farmer Decisions About Prices and the CRP

Current prices are quite encouraging to our grain producers. Corn, soybeans, and wheat are at or close to historical high points. But, what do these prices mean?

First, these prices are telling producers more of these products are needed, wanted, or demanded by the market. Also, the prices are allocating the product among competing buyers. This is our markets at work doing what they are supposed to do. Therefore, a producer should not feel bad about responding to the market signals to produce more product. Producers should not feel bad about making the right decision.

The question facing our producers is: "How far should I go in responding to market prices?" Should they convert pasture land to crop production? Should they take land out of the Conservation Reserve Program (CRP) program and use it for crop production?

The answers to these questions will depend on each individual producer's specific circumstances. What will the land not recently in crop production yield? What will it cost to produce a crop on this "new" land? What can or will the producer be able to sell the chosen crop for when the crop is harvested? A producer must answer all of these questions before he "breaks new ground." After a producer has made the best estimates of all costs and returns, he can then make the decision and plant the crop(s) of choice.

However, there are those who do not necessarily agree with a producer's decision to produce more corn, soybeans, or wheat. There are numerous groups which feel the CRP ground is too important as a conservation tool to be converted to crop production. They believe producers should not be

pulling land out of the CRP for crop production. There seems to be a large difference of opinion about the land in the CRP program.

**Putting the CRP in perspective** -- This is the 20<sup>th</sup> anniversary of the CRP program. It has been a successful program. If you review the USDA's CRP website you will find a short description of the program and the successes it has achieved over its 20-year history. They are impressive.

However, the heritage of the CRP is as a supply control tool. It began as a way to remove cropland from production. When it was started, American agriculture was suffering through an ongoing period of overproduction. The average price Kentucky farmers received for corn in 1986 and 1987 was \$1.69 and \$2.02 per bushel. There was a desperate need for land to be removed from production to help reduce the supply of farm products. The CRP was the public policy tool developed and implemented to remove millions of acres from crop production. It worked!

Many acres of productive farmland were temporarily removed from production. The CRP also proved to be quite effective at conserving and improving our air, soil and water resources. If one is not familiar with the extent to which this has happened, they need only review Timothy Egan's book: *The Worst Hard Time* to get a very good perspective of how things used to be in American agriculture before conservation was a common practice. It will make you truly appreciate the CRP and the conservation of our natural resources that has been achieved. However the success achieved by the program should not cause one to lose sight of the original objective of the program; to remove land from production.

**Changing economic conditions** -- Economic conditions have changed since the CRP was developed. The grain markets are telling our producers they need to produce more grain products. There is a need for more grain products for food, feed, and fuel. A producer should not feel bad about making the right decision in this economic environment by responding to these market signals.

Another thing which should be mentioned at this point is the need for producers to make sure the decisions they are making in response to these market prices is consistent with the management goals of the farm business, farm family and personally. Producers may need to review their *Management Goals* to make sure the decisions being made are completely consistent.

It is possible some producers have gotten so wrapped up in attempting to take advantage of the situation they have lost sight of their goals. Kentucky producers who suffered through last year's Easter Freeze followed by the drought may try to make up for the opportunities missed. Everyone simply needs to insure they are not trying too hard to "Hit a Home Run" this year. A quick review of goals should help producers insure they have made and are making the right decisions. (Dick Trimble)

### **Kentucky Produce Acreage Continues Steady Expansion**

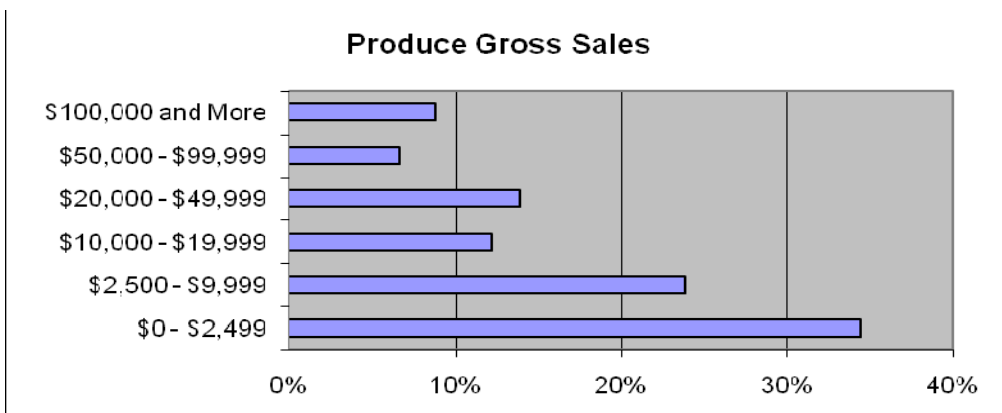
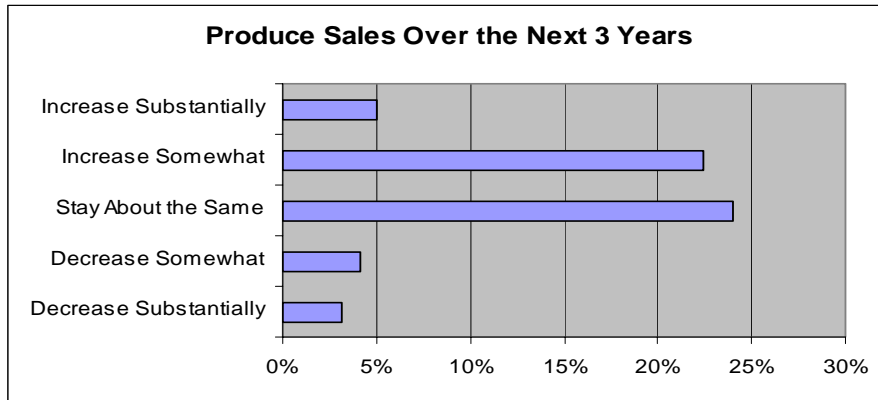
The 2008 grower survey of planting intentions and marketing activities shows that, despite the difficult early freeze and drought conditions creating a difficult production environment in 2007, growers are expanding their planting for both fruit and vegetables in 2008. The projections, based on responses from 195 usable grower surveys, anticipate a 17% increase in vegetable acreage and a 9% increase in fruit acreage with total produce acreage expected to be somewhere around 13,300 acres (see table below).

	<i>2002 USDA Estimated Acreage (Ag Census)</i>	<i>2006 Acreage Estimate</i>	<i>2007 Acreage Estimate</i>	<i>2008 Acreage Forecast</i>	<i>2007-08 Percent Change</i>
<b>Total Produce Acres</b>	<b>10,598</b>	<b>10,616</b>	<b>11,514</b>	<b>13,307</b>	<b>16%</b>
<b>Total Fruit Acres</b>	3,300	2,500	2,496	2,727	<b>9%</b>
<b>Total Vegetable Acres</b>	7,298	8,116	9,018	10,580	<b>17%</b>

Kentucky remains a relatively small state for fruit and vegetable production. Estimated sales for 2007 were around \$26 million with around \$7 million of that going through farmers markets. The direct marketing channels continue to be the main focus – community and on-farm markets, although participation in the auctions and direct to restaurant/retail also have been expanding, especially since the tobacco buyout. Most of the farmers sell produce on a small scale, 58% reported less than \$10,000 in sales. But the number of farmers looking to try produce continues to steadily increase. KDA reported over 2,000 vendors at the community farmers markets in 2007 and the auctions registered nearly 400 different growers.

The growth in the produce sector is likely to continue as opportunities for local products in local markets continue. The majority of the growers indicated they expected to see their produce sales expand at least somewhat over the next 3 years.

Gross sales for 2007 could have easily passed \$30 million in 2007 with better weather conditions. Good weather through the spring planting period in 2008, together with the continued strong growth in markets for local products could lead to a \$40-\$50 million year in 2008. Based on grower projections over the next three years, we should see the percentage of growers selling larger volumes of produce increasing (see two tables below). Kentucky has invested substantially to help farmers diversify into various enterprises. Fruit and vegetables are playing an important role in this diversification process. (Tim Woods)



### Corn Price Predictions for 2008

Take cover. I'm about to walk way out on a narrow limb with a potentially hard fall if it breaks. So here goes: I'm going to give you my predictions for corn prices for the next six months given the poor planting conditions and recent flooding in the Midwest.

Not too much needs to be said about the unprecedented spike in corn (and other grain) prices during the last year. The 2008 new-crop contract hovered around the \$4 mark during the late summer and fall in 2007. It broke \$5 in January 2008, and began steadily increasing until it hit the \$6 mark by May of this year. The ride has become even wilder with the deterioration of corn planting conditions in late May and the recent flooding in Iowa and the other portions of the Upper Midwest. A year ago \$6 corn seemed unimaginable. A month ago \$7 corn seemed unattainable. But we are now just one bull-market day away from \$8 corn. Where will this 2008 new-crop corn price end up?

To shed some light on this question, I developed a model that estimates corn prices given an initial corn inventory and projected corn demand by various user-types in the U.S. market. I should make my key assumptions clear: First and the most importantly, are the estimates of how corn use responds to corn price changes for ethanol-use, feed-use, and exports. There are not many estimates for this, and those that have been estimated occurred when corn was in the \$2-\$3 range. Whether these will hold with \$7 corn is anybody's

guess. Second, I also had to make assumptions on how the demand would have changed over the 2007-2008 marketing year had corn prices remained at 2007 levels. That said, I will stand (or fall) by my numbers come November.

Table 1 provides a summary of the predicted corn prices given specified assumptions for harvested acreage and yields. The first scenario (1) uses the acreage predictions from the USDA's March 31 Prospective Plantings Report and assumes a 152 bushel (trend-line) average yield. All of the other scenarios are based on reductions in harvested acreage and/or yields from this USDA baseline.

Two estimates are provided for the market-clearing price. The first is the clearing price with an 8% ending stocks to use ratio and the second is with a 4% stocks to use ratio. Given the current structure of the futures market, specifically a \$.70 premium for the Sept09 over the Dec09 CBOT contract, the market is giving little incentive to hold grain produced in 2008 into the 2009-2010 marketing season. So I would hypothesize that we will have very low ending stocks by the end of the 2008-2009 marketing year and the 4% ratio is thus a more likely situation. The 4% level will be used in the rest of this article for simplicity. Both, however, are provided for your reference.

The predicted prices range from \$6.30-\$8.40 for the seven different scenarios evaluated at the 4% stocks to use ratio. The market-clearing price using the Prospective Plantings Report acreage (Scenario 1) and trend-line yield is estimated at \$6.30. This is about \$.30 higher than the Dec08 contract just after this report came out (March 31), but may be justified as the market seemed to be buying back some of the corn acreage from soybeans at the time. Using the most recent USDA WASDE numbers (Scenario 2) results in a market-clearing price of \$6.50, which is about \$1.30 under the current Dec08 price of \$7.80. Clearly, the market does not put much stock in this current USDA estimate.

Scenario 3 assumes a 2.5% reduction both in harvested acres and average yield. This results in a price of \$6.80. Scenario 4 assumes a 2.5% reduction in harvested acres and a 5% reduction in average yield (144 bu) and results in a projected price of \$7.10. Scenario 5 assumes a 5% reduction in both harvested acres and average yield and predicts a price of \$7.35.

Scenarios 6 and 7 are the most bullish scenarios for the corn price. Scenario 6 evaluates a 7.5% reduction in both harvested acreage and yield (141 bu) while scenario 7 evaluates a 7.5% reduction in acreage and 13% reduction in yield (132 bu). The 20 bushel drop in average yield in the last scenario is the same loss experienced after the flooding in 1993, which is considered the worst corn planting year in recent history. Predicted prices in these two scenarios are estimated at \$7.85 and \$8.40 respectively.

<b>Predicted 2008 New-Crop Corn Prices (CBOT Market)</b>				
<b>Given Specified Conditions</b>				
<b>Current Dec08 Price \$7.80</b>				
<b>Scenario</b>	<b>Acres Harvested</b>	<b>Avg. Yield</b>	<b>Est. Price (\$/bu) @ 8% Stocks</b>	<b>Est. Price (\$/bu) @ 4% Stocks</b>
(1) Prosp. Plantings Report	78.8	152.0	\$6.75	<b>\$6.30</b>
(2) USDA June WASDE Update	78.8	148.9	\$6.95	<b>\$6.50</b>
(3) 2.5% Reduction Both	76.8	148.2	\$7.25	<b>\$6.80</b>
(4) 2.5% and 5% Reduction	76.8	144.4	\$7.50	<b>\$7.10</b>
(5) 5% Reduction Both	74.9	144.4	\$7.75	<b>\$7.35</b>
(6) 7.5% Reduction Both	72.9	140.6	\$8.25	<b>\$7.85</b>
(7) 7.5% and 13% Reduction	72.9	132.2	\$8.75	<b>\$8.40</b>

*Note: Prices are for the CBOT market. Subtract \$.30-.60 for comparable elevator prices.*

So which scenario is most likely? If I had to guess at this point I would predict we will see conditions somewhere between scenarios 3 and 6, resulting in prices between \$6.80 and \$7.85. Interestingly, the market appears to be saying scenario 6 is most likely (current market price is \$7.80 for the Dec08 contract). This scenario represents a pretty significant drop in both acreage and yield (7.5% reduction for both), but is not quite as bad as the overall losses experienced in 1993. My guess is that an already jittery market has over-reacted. Just like with a group of feeder calves, one panicked individual can soon have the whole herd running. (Greg Halich)

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