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Commodities daily: Capitol Hill sets tone for corn

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The tax deal between President Barack Obama and congressional Republicans will be key for agricultural commodities, particularly corn.

If confirmed, the extension of the tax credit, which formally expires on December 31, will support corn consumption just as inventories shrink to their lowest levels in 15 years. Ethanol is a big part of the corn supply-and-demand balance sheet.

According to the US Department of Agriculture, the country will consume 4.8bn bushels of corn to make ethanol in 2010-11, up 5.1 per cent from 4.56bn in 2009-10. That equates to 38.3 per cent of the crop, up from 34.8 per cent in 2009/10.

Washington mandates a minimum level of production, so independently of tax credits the country will continue to produce a gigantic amount of corn-derived ethanol. Besides, the US taxpayer subsidises ethanol output through several schemes, further boosting production above the mandated minimum levels. Among them, the "volumetric ethanol excise tax credit", or VEETC, is a credit of 45 cents for every gallon of pure ethanol blended into gasoline. According to the Congressional Budget Office, a bipartisan group, biofuel tax credits cost US taxpayers $6bn in 2009.

Only a few weeks ago, congressional Republicans and the White House were so deeply divided on tax that the market took a dim view about the extension of the ethanol tax credit. Corn futures prices lagged behind, in spite of a poor crop, strong demand and rising premiums in the spot market in the US Midwest, as traders thought that demand for ethanol would drop by up to 600m bushels in 2010/11.

But now, after a broader tax deal, it seems the credit will be extended for another year, although it could be cut by about 20 per cent to roughly 36 cents per gallon. The deal is also paving the way for a one-year extension of a 54 cents tariff that protects US corn-derived ethanol against competition from sugar-cane-derived ethanol from Brazil.

What impact will these developments have on corn futures prices?

It will be like adding gasoline to the fire.

The US exports about half of the world's corn, so domestic changes in supply or demand, even if small, have a ripple effect worldwide. Darrel Good, a respected agricultural economist at the University of Illinois, says that "a renewal of the tax credit, even at a lower level, would point to continued strong ethanol demand and the likelihood of ethanol production exceeding the mandate". He adds: "Current ethanol and gasoline prices favour ethanol blending – ethanol prices lower than gasoline prices – and would support corn prices at current or higher levels."

The market will get a clearer view as soon as details from Congress emerge, possible after the weekend.

In the meantime, the US Department of Agriculture will update its supply and demand forecast on Friday. The USDA said back in November that the country's corn stocks would drop to a 15-year low of 827m bushels by the end of the season – late August 2011 – the lowest since the 1995-96 season, when stocks fell to 426m bushels. The market is braced for a further reduction of the forecast on Friday and another one in January in spite of the highest prices for two years.

High prices have yet to restore the balance of the market.