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Is South Dakota
Agriculture Ready for the
Food Security Act of 1985



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The Food Security Act of 1985 will result in a major reduction in the support prices for South Dakota grain commodities. The national nine-month nonrecourse loan support price for corn has been reduced from \$2.55 per bushel in 1985 to \$1.92 per bushel for 1986. For wheat the national support price has been lowered from \$3.30 to \$2.40. Currently target prices, which are used to calculate deficiency payments, are frozen for two years. However, the target prices will probably begin declining in 1988. A major question that must be asked is the following, "Is South Dakota agriculture ready for the Food Security Act of 1985?"

The key issue examined in this newsletter is the agricultural marketing implications of the legislation. After identifying the legislation's implications to agricultural marketing, four possible producer marketing strategies are discussed. Finally, the newsletter reviews results from the 1985 SDSU Agricultural Lender Survey that give an indication of the agricultural marketing challenge confronting South Dakota agriculture.

Implications of Legislation

If Congress does not amend or fundamentally alter the Food Security Act of 1985, a major step will have been taken towards the deregulation of grain prices. The lowering of the 1986 support loan prices implies market prices can decline to levels below those experienced during the 1985 marketing year. Producers only deliver grain to

the government if the market prices are not higher than the principal and interest due on the government loan. Therefore, lowering the support loan price implies that market prices do not have to be as high to get producers to deliver grain to the private sector rather than to the government.

For producers that enter the farm program in 1986, the price support loans are not the only way the farm program supports producer incomes. Producers will receive deficiency payments based on the difference between the commodity's target price minus a national average price for the commodity. The lower the national average price, the larger the deficiency payment and vice versa. The maximum payment a producer can receive is equal to the target price minus the national loan level. For corn, the target price is \$3.03 and for wheat the target price is \$4.38. So the maximum deficiency payment per bushel for corn is \$1.11 and for wheat it is \$1.98.

But this additional revenue is not given by the Federal government without restricting producer production practices. For corn producers, the required set aside is 20 percent of their base acreage, of which 2.5 percent is a paid diversion. For wheat producers, the required set aside is 25 percent of their base acreage and also includes a 2.5 percent paid diversion. So producers must set aside a major portion of their land to qualify for program benefits.

Can Producers be Complacent?

Projected market prices and the 1986 target prices would appear to imply potentially high deficiency payments. This does not imply that producers and lenders should be lulled into a complacency concerning agricultural marketing. But everyone must remember that deficiency payments are based on a yield different from the actual yield and base acreages. Unlike price support

loans, the total size of the deficiency payment does not change with the actual production level of a specific producer.

If nationally and internationally we have a "short" crop in terms of production, the average national market price will be higher than if we have an average crop. This higher price would imply a lower total deficiency payment.

If we experience a "bumper" crop in terms of production, the national average price will be lower than if we had an average crop. Market prices could be at or below the "new" support levels. Producers would receive the maximum deficiency payment.

Although these scenarios may sound very similar to those for previous years under government programs, there is one major difference, namely, the support price level. One must seriously question whether producers or lenders want to or can accept the new support prices to represent their basement prices.

Producer Marketing Strategies

How can producers receive prices above the support price? First, market prices available to the producer must be higher than the support price. Second, producers must use the private market alternatives for pricing their commodities. Forward pricing contracts and minimum pricing contracts through local elevators are two of these marketing alternatives. Futures contracts and commodity options -- which require producers to trade through a commodity broker -- represent two additional market alternatives.

Strategies Involving Elevators

A forward pricing contract establishes a set price for the commodity. Many producers have traditionally resisted using these contracts, because a producer's production level can be less than the number of contracted bushels. If so, a producer would actually have to buy grain from the elevator to meet the contractual obligations contained in the forward contract. However, this is unprofitable only if price paid for the

elevator's grain is greater than the forward contract price. Because low production levels frequently cause higher prices, this is a realistic risk of forward contracting.

Also, if they had a large crop with depressed market prices, producers could always deliver the commodity to the government. Although the Food Security Act of 1985 did not greatly alter the price scenario for short crops, the downside price risk for large crops has greatly increased. Gramm-Rudman budget reduction legislation may reduce support loan price levels to even lower levels.

New Marketing Alternative at Elevators

Because of the introduction of agricultural commodity options during the past year, elevators can now offer minimum pricing contracts. These contracts establish a minimum price for the commodity, but allow the producer to take advantage of price increases. As this marketing year progresses, producers should closely monitor what prices elevators are offering through minimum pricing contracts. Is the price better than the government support loan program? If yes, maybe the private sector offers a better risk management alternative than the government for the establishment of a basement price.

But this decision should not be over simplified. For a producer to establish a price in the private sector, the producer must pay someone for taking on the price risk. The price available through a forward pricing contract will be higher than a minimum pricing contract. Within a market economy, higher potential returns become available only through accepting more risk or paying a fee to another party to take a proportion of the price risk.

Producer Trading on Commodity Exchanges

Producers do not have to use elevators to establish a price for their grain commodities. Futures contracts can be used to hedge in a price for the commodity. Options can be purchased either to assure a purchase and sale price for a specific futures contract. Unlike the futures market, the option

purchaser would not have margin requirements.

However, these marketing strategies require the producer to have a strong technical knowledge of cash, futures and options markets. Also, the producer has to have access to capital for establishing and maintaining a position in these markets. A producer has to be willing to make a major commitment in time and effort to effectively use these marketing alternatives.

Is South Dakota Ready?

For a major proportion of South Dakota agriculture, the answer is at best a conditional "maybe." In the 1985 SDSU Agricultural Lender survey, lenders indicated that on average 81 percent of their cash grain producers depended entirely on "cash marketing or government loans only" during the past year (Table 1). Only 13 percent of the grain producers were using forward contracting at local elevators. Even smaller percentages were using hedging and agricultural commodity options. These low percentages may partially reflect the lack of major profit opportunities using these marketing alternatives during the past year.

The percentage of fed cattle, feeder cattle and slaughter hog producers using only cash marketing was in excess of 80 percent (Table 1). Over 8 percent of the fed cattle producers used the futures market to hedge their production. Unlike grain producers, livestock producers tended to use the futures market more than forward contracting through a private intermediary such as packers.

Ninety-two percent of the lenders felt the major weaknesses in producer marketing are inadequate marketing skills and a "fear" of available marketing alternatives.

However, lenders acknowledge that their skills also needed improvement. For example, 74 percent of the lenders felt they needed additional training about agricultural commodity options. In fact, 40 percent felt they needed additional training in forward contracting.

Conclusions

The Food Security Act of 1985 represents a major deregulation of agricultural prices. Producers, lenders and agribusinesses are going to have to learn how to cope in this deregulated environment. During the past year, "new" marketing alternatives such as minimum pricing contracts and commodity options have been introduced. Producers, lenders and agribusinesses are going to have evaluate the potential of these marketing alternatives as methods for improving profits and managing price risk.

Last year South Dakota produced approximately 220 million bushels of corn. A one cent increase in the price received per bushel of corn produced would imply a revenue gain of \$2.2 million. The 1986 corn support price will be at least 63 cents lower than this year's support price. Although the 1986 South Dakota corn crop will probably be smaller, the dollar magnitude of these changes has major implications for all South Dakotans. During the forthcoming year, the effective use of agricultural marketing alternatives by producers will be very important to their own welfare as well as that of South Dakota's overall economy.

Table 1: Average Percentage of Producers Using Specified Marketing Alternatives during the Past Year as Indicated by South Dakota Lenders During November 1985.

Marketing Alternative	Type of Producer			
	Fed Cattle*	Feeder Cattle*	Slaughter Hogs*	Grain*
1. Cash Marketing or Government Loan Only	81.7%	85.3%	85.7%	81.4%
2. Forward Contracting	7.1%	5.0%	7.2%	12.6%
3. Hedging on the Futures Market	8.1%	7.2%	4.8%	4.1%
4. Agricultural Commodity Options	1.0%	.8%**	.7%	.9%

* Columns do not have to sum to 100 percent because not all marketing alternatives are listed.

** An agricultural commodity option for feeder cattle does not exist, but producers may be using the fed cattle options as a substitute.

