Policy

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Low Prices Test 1996 Farm Act

This year's significant decline in prices for many crops has raised questions about which policy tools are available to counteract current low prices.

In the last year, farm prices for several major crops have dropped sharply and are much lower than at any time in the recent past. The decline is due to large U.S. and foreign supplies, lackluster export demand due to weak economic performance in many foreign countries, and a strong U.S. dollar. From August 1997 to August 1998, the average farm price fell nearly a third for wheat (the lowest monthly price in 7 years) and one-fourth for corn (lowest in 10 years) and for soybeans (lowest in 4 years).

Prior to the 1996 Farm Act, farmers who participated in farm programs for major field crops received *deficiency payments* from the government when prices dipped below a certain level under the old target price/income support program. Deficiency payments rose when prices fell, and the intended effect was to stabilize farm income and provide some offset to declining prices.

The recent decline in crop prices likely would have led to higher 1998 income support payments under the old law than are scheduled to occur under current law. Unlike under the old law, payment rates for the new *production flexibility contract (PFC) payments* under the 1996 Act are fixed and not related to prevailing market conditions.

Assuming current loan rates and with USDA's September 1998 projected market prices, deficiency payment rates in 1998 for corn and wheat under the old law would have been about double the 1998 payment rates for production flexibility contracts. However, deficiency payments for corn and wheat would not have been double the actual PFC payments, largely because of lower program participation under old law. During the first 2 years of the 1996 Act when crop prices were high, actual PFC payments to farmers exceeded levels that would have occurred under the old law. The 1996 Farm Act, in decoupling farm prices from program payments, intended that farmers make planting decisions according to the market conditions for particular crops.

What can help farmers get over the financial hump during this downturn in prices as the market works down its large supply?

Perhaps the most visible policy response is early disbursement of fiscal 1999 farm program payments. Under legislation signed into law in August 1998, participating farmers will have the option to receive their entire fiscal 1999 payments as early as October 1998, rather than receiving half in mid-December or mid-January and the rest by September 1999 as had been provided under the 1996 Act. Total PFC payments will amount to about $5.65 billion for fiscal year 1999, typically representing about 10 percent of farm net cash income. Shifting a portion of these payments to earlier in the fiscal year under the new legislation will inject cash into farmers' bank accounts at a time when market prices are low.

Two other key policy tools are *nonrecourse marketing assistance loans* and *loan deficiency payments (LDP)*. These farm programs, which predate the 1996 Act, provide a countercyclical policy response when prices decline. Farmers are taking advantage of these programs, and money is flowing into the agricultural sector.

Loans & LDP's Shore Up Contract Payments

Nonrecourse marketing assistance loans provide interim financing to eligible producers of wheat, corn, grain sorghum, barley, oats, soybeans, minor oilseeds, rice, upland cotton, and extra-long staple cotton. Instead of selling the crop, farmers pledge the crop as collateral and use the loan proceeds to cover short-term cash needs. Loans may be taken out at any time following harvest through the following March or the following May, depending on the crop. However, most loan placements occur shortly after harvest when prices tend to be seasonally low. Farmers may repay the loan (plus interest) anytime prior to maturity and then sell the crop in the marketplace, or they can forfeit the collateral to the government as full pay-

More information on nonrecourse marketing assistance loans and loan deficiency payments is available from USDA's Farm Service Agency at http://www.fsa.usda.gov/pas/backgndrs.htm. The latest figures on loan and payment activity are available at http://www.fsa.usda.gov/dafp/psd/ under *online reports*.

ment when the loan matures in 9 months (10 months for cotton).

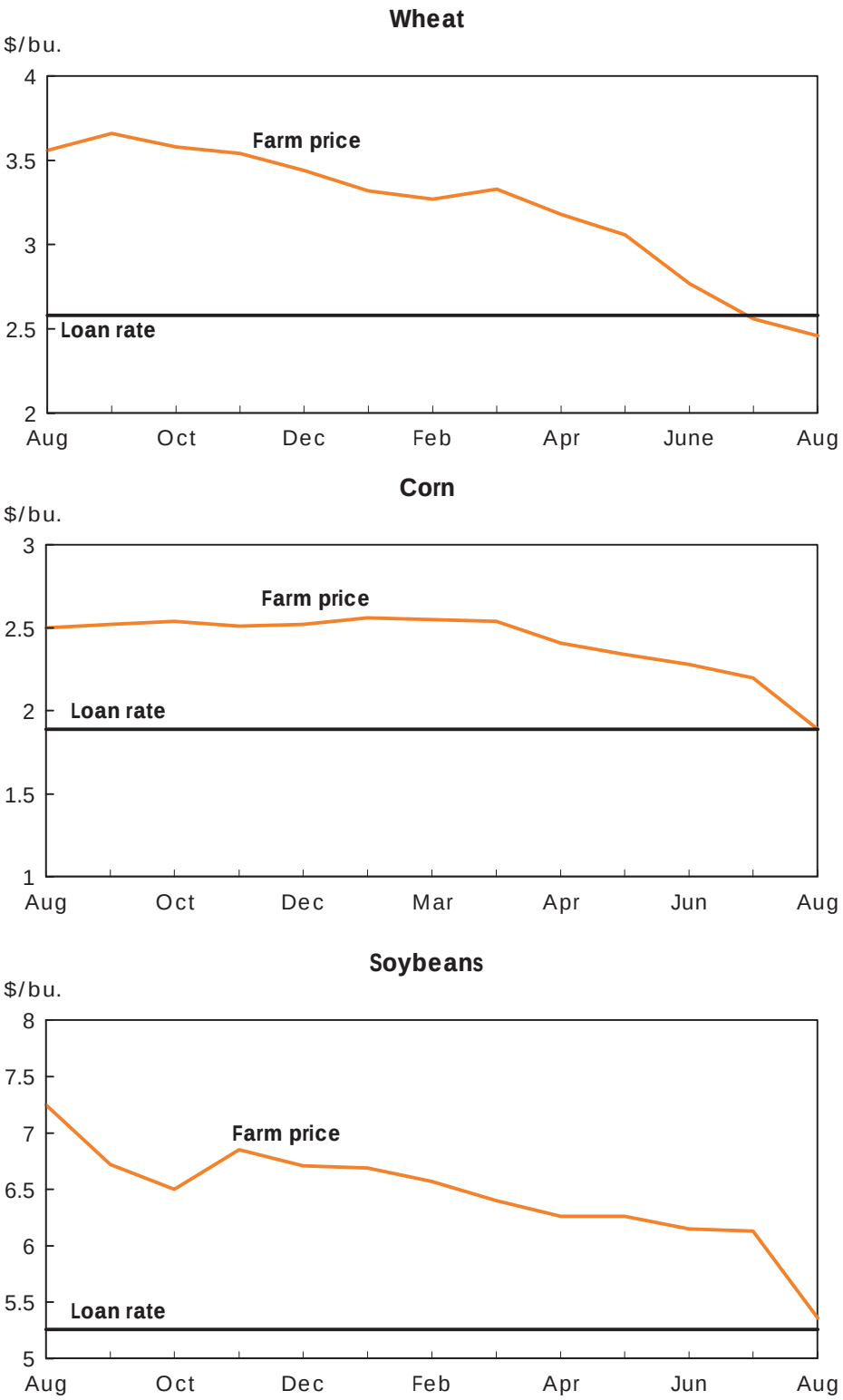
The loan program provides an effective per-unit revenue floor for farmers who put their crops under loan, with a countercyclical effect occurring once prices drop below the loan rate. For example, the national loan rate is $2.58 per bushel for wheat. Excluding adjustments for quality and location (each county where wheat is stored has a loan rate), farmers will receive at least this per-unit amount for their wheat, on average, minus interest charges.

The loan repayment rate may actually be less than the loan rate (plus interest) if the local price—called the posted county price or PCP—falls below the loan rate. (The PCP—calculated each day the Federal Government is open—is based on terminal market prices and a fixed differential to each county, largely reflecting transportation and other marketing factors.) When a farmer repays the loan at a lower PCP, the difference between the loan rate and the PCP is called a *marketing loan gain*. In addition, any accrued interest on the loan is waived when the PCP is under the county loan rate on the day the producers repays the loan.

The marketing loan repayment feature prevents a costly buildup of publicly owned stocks that would occur if many farmers forfeited their grain to the government as repayment of loans. Without the marketing loan feature, farmers would forfeit their grain if prices did not rise to at least the loan rate during the 9- to 10-month loan period. Under the marketing loan program, farmers may effectively receive a net per-unit revenue equal to the loan rate.

While the loan program provides a per-unit revenue floor for producers, it does not establish a floor for *market* prices since commodities can enter the market at prices below the loan rate (hence the phrase “marketing loan”). A price floor in the domestic market would prevent U.S. prices from following foreign price declines, and thus could reduce international competitiveness for U.S. commodities (as was the case when loan rates were high and marketing repayment features were not available in the early 1980’s).

Wheat Prices Had Dropped Below the Loan Rate by August



Average monthly farm prices. August 1998 preliminary.

Economic Research Service, USDA

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If the PCP is below the loan rate, eligible producers may opt for a ***loan deficiency payment (LDP)*** for commodities in lieu of securing a loan. The LDP rate is the amount by which the loan rate exceeds the PCP and is calculated each day the Federal Government is open. (The crop cannot go under loan once an LDP is paid.) This option is attractive if the producer thinks that market prices have bottomed out and the LDP rate has reached its maximum. LDP's may also be attractive to producers because by taking the LDP and immediately selling their crop, they effectively receive a per-unit revenue equal to the loan rate, partly from the market and the rest from the government. After an LDP is accepted, the farmer can sell the crop to avoid storage expenses or hold it in the expectation of a price rally.

Loan deficiency payments are final, unlike the regular deficiency payments under the old target price/income support program. Under the old income support program, farmers were required in some instances to return all or part of their advanced deficiency payment (but not loan deficiency payments) once final payment rates were calculated, which was after the marketing season concluded.

Government Payments Increase Rapidly

As of mid-September 1998, posted county prices for corn, soybeans, oats, and barley were below loan rates in all producing regions. In addition, PCP's for all wheat classes (except durum), grain sorghum, and oil-type sunflowerseed were below county loan rates in most producing counties.

Sinking wheat prices have forced a groundswell of farmer participation in the government's loan deficiency payment and loan programs. Almost 1.2 billion bushels of the 1998 wheat crop were either under loan (230 million bushels placed) or had received an LDP (959 million bushels), together representing nearly half of 1998's estimated production of 2.56 billion bushels. As of mid-September, wheat producers had received about $250 million under the LDP program for 1998 wheat (compared with a negligible amount in 1997), with an average loan deficiency payment of 26 cents per bushel.

Wheat accounts for the greatest proportion of overall activity so far in 1998 because it is a major crop and is harvested relatively early. For other early-harvested crops, LDP payments through mid-September were $20.8 million for barley and $4.1 million for oats. As the fall harvest advances, outlays for the later-harvested crops, particularly corn and soybeans, will grow and likely surpass those for wheat. With fall harvest just underway, corn LDP's totaled $13.3 million as of mid-September. Sorghum payments were $3.5 million, and soybean payments totaled $681,000.

As expected, major winter wheat producing States topped the LDP list for 1998 crops, as of mid-September. Kansas ranked first with $50 million, followed by Washington with $23 million. North Dakota, Colorado, Montana, Oklahoma, and Idaho each tallied $17 million. South Dakota and Texas each totaled $14 million.

Weighing Policy Options

Revenue earned by farmers in excess of variable costs is used to cover fixed costs, and any amount left over goes toward other economic costs and profit. For farmers to have a shortrun incentive to plant a crop, expected revenue from the crop must at least match their variable costs.

Current loan rate levels cover variable production costs for most producers. For example, about 89 percent of the U.S. wheat crop is produced at variable costs below the loan rate of $2.58 per bushel. Comparable numbers are 94 percent for corn (loan rate is $1.89) and 97 percent for soybeans (loan rate is $5.26). However, farmers with variable costs above the loan rate—or those with high fixed costs such as high debt service—are clearly undergoing financial stress. The question for policymakers is whether or not the level of income support provided by the current policy tools is sufficient. A number of legislative options are currently under consideration.

Production cost estimates are from Economic Research Service analysis of data from the Farm Costs and Returns and the Agricultural Resource Management surveys—soybeans for 1990; wheat, 1994; and corn, 1996.

Barring an unexpected runup in prices, planting incentives for many 1999 crops (including wheat, corn, and soybeans) will be sharply lower than in recent years in both the U.S. and abroad. If farmers act on these market signals, they may pull back on plantings of those crops, reducing total crop acreage or possibly shifting some land to more profitable competing crops. This could reduce production prospects next year for those crops with currently low prices and lead to a price upturn in the next season.

As policymakers consider options for addressing the impact of low prices, they will be weighing the impacts of these measures on the workings of supply and demand in the marketplace.

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