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HEDGING TECHNIQUES FOR AGRICULTURAL PRODUCERS

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I am delighted to be here today talking about hedging and how it can be applied to the marketing strategies of agricultural producers in agriculture. It is good to have so much interest developing at the marketing end of agriculture, because it seems do me that too much attention has long been paid to production and too little to marketing.

Even in the United States, which has developed perhaps the most sophisticated marketing techniques in the world, farmers are still too production oriented. Futures markets, where hedging techniques can be applied the best, are more than 100 years old in America and yet only a small proportion of America's farmers utilize them.

But before we get into the subject of marketing techniques, I thought you might appreciate a look at what the future holds for worldwide agriculture during the next 20 years.

THE SUPPLY SITUATION

In the short run food supplies should be adequate for our planet as a whole. Most experts expect global agricultural production to increase by 2 to 2.5 per cent per year during the decade of the 1980s, and that is likely to meet the foreseeable demand. Weather is an uncontrollable variable, however, and we learned during the 1970s that it is possible to have adverse growing conditions in a whole host of countries simultaneously.

In the longer run -- two or more decades into the future -- food supplies will be determined by advances in agricultural productivity throughout the world. Research and development is necessarily a major element in that picture.

Productivity is the worldwide challenge of the 80s in both the agricultural and industrial sectors. The major element in insuring sufficient quantities of food will be that of providing adequate price incentives. Many developing countries have not yet comprehended that salient truism and, in fact, follow a policy of production disincentives, rather than incentives. Such a "cheap food" policy may appease consumers in the short run, but it has devastating consequences for the long run. Such short-sightedness should be abandoned promptly! If the major agricultural producers of the world, developed and developing, will get their policy structures in order, we can readily add million of tons of additional food supplies to the world's storehouses during the remainder of this century. But too many of us are spinning our wheels at the moment. We are making progress, but it is nothing to boast about. All of us must begin to do a much better job in our commitments to research, capital formation, and incentives of the marketplace.

THE DEMAND SITUATION

The demand for food is a function of (1) population, i.e., the number of mouths to feed, and (2) purchasing power, i.e., a nation's financial capacity to produce or procure minimum daily food requirements for its people. Both factors have concerned economists and policy makers alike for centuries.

The former, population growth, has stimulated a lot of attention and dialogue, but not much public policy action. The discussion was rather academic until this century, because till then the world was really quite sparsely populated. But we have added billions of people in the past several decades, more than the number populating

the earth in all previous recorded history. That is a development dramatic enough to catch most anyone's attention. It is also the stuff of which political revolutions are made; hence, the recent interest of many nations in reducing population growth. The rate of population growth in a whole spectrum of nations is beginning to slow. That indeed is good news, though it is no cause for elation. Momentum alone will likely add another two billion children to our global society by the year 2000.

Perhaps the more relevant factor on the demand side is purchasing power. There is already too much malnutrition in the world, much of it due to people not having the wherewithal to buy the food they need. With low income families having more children than the higher income groups, this problem will inevitably increase in importance during the 1980s and beyond. It is a problem of massive proportions, but with delicate social and economic sensitivities.

Better that we teach the world how to produce more food. And better that we also help to expand their industrial production so that they can be fully integrated into the world economy.

As the low income nations of the world begin to move up the economic scale, they generate purchasing power. It becomes real, rather than artificial, and they start to pay for food, rather than beg or fight for it. That is a whole lot more self-satisfying for them, and a whole lot more profitable for exporting nations.

Summarizing the demand aspect of our discussion, the experts say it will increase globally by 2 to 2.5 per cent during the coming decade. Since that will be in balance with expected food supplies, malnutrition in the 80s will be a distribution problem,

not a production problem. For the longer term, however, the keys become population growth and purchasing power. American and Malaysian farmers will be better off if the world's future population growth is coupled with a concomitant expansion in purchasing power.

INTERNATIONAL TRADE

Some nations are simply better endowed to become major agricultural producers than others. Japan, for example can never hope to be self sufficient in food. The U.S. in contrast, is doubly self sufficient and more. As we move into the 1980s the contrasts, the production differentials, between exporting and importing nations are likely to become even more pronounced. Putting it another way, international trade in agricultural products will increase. Stating it still another way, it must increase. Stating it still another way, it must increase or malnutrition in the Third World will become calamitous, leading to political revolution.

A brief summary then of what will likely be traded, and where it will go.

In the coming decade, the food grains, wheat and rice, and feed grains will be big ticket items. The United States and Malaysia have one major crop in common and that is rice. Rice is a staple to billions of people today. As global population continues to increase, it will inevitably play that role in the future. This means that rice must also be a staple of food aid programs, as it has been for many years.

The commercial and concessional demand for food grains will be huge for decades to come. Thus, both our countries will have an opportunity to expand our export activities in the world market. But this will occur only if our farmers have a fair chance to make

a profit!

FUTURES MARKETS

If there is anything which permeates the world economy today, it is risk and uncertainty. The markets reflect it, the media emphasize it, and economists are puzzled by it. But no one challenges either its existence or its impact on productivity. To the degree that a producer must discount risk and uncertainty in his decision making, he will restrict (or be the recipient of restrictions on) the capital investment that could make his operations more productive and efficient. This is a "cost" to all of us, and it impacts negatively on our respective standards of living.

Futures trading is a marketing technique whose time has come. Twenty years ago futures markets were of no particular concern to farmers or livestock producers, but those days are gone. That has occurred for several reasons, perhaps the most important of which is the tremendous volatility in farm prices which we have already discussed.

The second reason is that capital costs in agriculture are so much higher today than they were a decade or two ago.

There are other benefits to the producer in using futures markets too. One of them is price discovery -- looking at price expectations six months or a year down the road, and then using those expectations in his own planning process.

All of this of course is just illustrative of the need to develop expertise in marketing in this day and age. It is important that farmers understand what futures markets are about and learn how to use them. They are a tool just like all other tools

available to them in their production and marketing processes.

If a producer is to engage in the use of futures markets, it is imperative that he have a very fine working relationship and level of understanding of futures trading techniques with (1) an experienced, dependable commodity broker, and (2) his banker.

How does the farmer and livestock producer go about learning how to use futures markets and learning what they are all about? Well, there are plenty of sources, of course. One is to talk with the broker that I just described. A second is to confer with a marketing economist or attend a conference or seminar such as this. Another is to write the commodity exchange with whom he might be doing business. Any or all of those sources would be appropriate for learning the process and developing an appropriate futures trading strategy.

Futures markets are probably the purest example of free enterprise extant today. There is no other market which exemplifies such a total interaction of supply and demand forces in one given place at one given point in time, with prices being established by that interaction.

Using our Exchange as an example, we have hundreds of people on the floor every day, buying and selling futures contracts in the commodities that we trade. They do this in a room that is three-quarters of an acre in size. What happens on that floor is obviously important to others around the country and around the world.

Why are futures markets important to producers? Well, first of all, the markets are a source of news dissemination. Prices established therein are quoted throughout the world, via all the

various news sources. Secondly, futures markets are a source of price prediction because the trading process crystallizes the price expectations of many people for six months, twelve months, or even eighteen months in the future.

Of course, the most valuable function of all is the risk protection that is provided to those who use the markets for hedging purposes. Futures markets also provide those same users with borrowing flexibility that they might not otherwise have.

On the consumer end, futures markets have a stabilizing effect which should be ultimately passed on to consumers in the form of lower food prices.

And finally, of course, such markets help everybody, consumers and producers alike, to plan their operations with greater efficiency and more flexibility than would otherwise be the case.

It is important that producers learn how to master the technique of hedging. This is imperative, simply because the economic risk prevalent in farming and livestock operations today makes it impossible for producers to "take their chances" in the cash market and hope to survive. This is particularly important to young producers, many of whom do not have the economic wherewithal to stand the level of risk to which they are exposed. They, therefore, need to transfer that risk to someone else, and they can do that through hedging.

One other reason producers ought to use futures markets is simply to take advantage of marketing opportunities that might not otherwise be present.

Some producers contend that they sell some of their crops or livestock every week of the year and, therefore, do not need to

hedge on a futures market. They arguably have their own hedge in the cash market. That is correct, but it is not the entire picture, for the futures market may offer opportunities to sell at a very substantial profit when similar opportunities simply are not available in the cash market (or at least may not be there when the crops or livestock are actually ready for market in the future).

There are other benefits to producers too, one of which is that hedging releases some of their working capital. It also increases their borrowing capacity. In other words, they can ordinarily go to a banker and secure more funds than would be the case if they were not hedging.

Developing and executing a hedging strategy might be compared with baseball. It has about three phases, one a wind-up, two the pitch, and three the follow-through. Let's further describe those phases.

First comes the wind-up, which means devising the strategy and preparing to engage in a hedging program. Devising the strategy, of course, requires the careful calculation of costs so that one can determine whether he is really "locking in" a profit on the futures market. (He will usually not be very exuberant about locking in a loss!)

This means knowing one's "basis" (the difference in selling prices between one's own local community and the futures market on which the hedge will be executed), knowing the seasonal and cyclical trends that are applicable at that point in time, etc. Once the producer has developed this basis information, he then needs to sit down with his banker, broker, or both and develop his hedging strategy. Included should be an agreement with his banker on the

financing of margin deposits and margin calls.

The producer is then ready to move onto the pitch part of the operation, which means executing the hedging strategy that has been designed. Here he has some options. Does he hedge all of his production, half of it, or two-thirds of it? That he must work out with his broker and his banker as well. Should he hedge part immediately, and then do some additional hedging as prices rise? Should he hedge in only a particular month, or in different months which are available on the futures market? This is all a part of the execution or the pitch phase of a hedging strategy.

Finally, the last part of the strategy is the follow-through, which occurs, of course, at the time the hedger actually liquidates his position on the futures market, and then sells his product in the cash market. If the product be rice, for example, it means he liquidates his position on the commodity futures exchange, and sells his rice to a miller or processor. He must handle these transactions in an appropriate way, otherwise the hedge will not work as expected.

If, on the other hand, the hedger does a good job in the wind-up phase, the pitch phase, and the follow-through, he will have a hedging strategy that will provide him the risk protection he desires, and hopefully the opportunity to lock in a very healthy profit.