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"THE ROLE OF PRICE"

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As U.S. agricultural industries become more market oriented, it is appropriate to step back and examine the role of price. Price serves several functions, and it is difficult if not impossible to separate each role. More important, the new role of price has major implications on the way farmers and growers manage their operations.

The 4 Roles of Prices

First, price provides income. Price times the quantity sold results in the total income from a commodity. When trying to get a higher price,either through better marketing or government programs, it is this aspect of price which most farmers are concerned about.

Second, price determines the quantity supplied and consumed. As prices increase, more will be supplied and less consumed. The opposite is true as prices decrease. In this role, price regulates the quantity available and consumed. As agricultural industries become more market oriented, increased emphasis is placed on this role of price. Less emphasis is placed on price as only a provider of income, as the 2002 Farm Bill may stimulate more supply that consumers are demanding.

Third, price serves a signal. Especially through price incentives (premiums) and disincentives (discounts) it communicates information to provide more or less of a product, service or qualitative feature. For example, a higher price for a certain variety of sweet corn, higher protein in milk, or a specific level of sugar in grapes is designed to signal producers that these features are what processors want and consumers are willing to pay for. Farmers and growers can expect more of these types of incentives and disincentives as agricultural industries become more market oriented. Why? Because it is an efficient way to communicate to producers what consumers and processors want and need.

Finally, price transfers ownership. Once you pay the price, you are the new owner of that product, tractor or plot of land.

Costs of Production

One issue farmers and growers are always concerned about is the relationship between prices and the costs of production. Costs of production can be an ambiguous concept. There is no such thing as a single cost of production, or, for that matter, market price. For example, costs of production for any given commodity probably vary by 30 percent or more from farm to farm. In other words, there are always some producers with costs of production higher than the price, no matter what that price is. And the funny thing is that when price goes up, cost of production typically increases as well. The key is to make every attempt to be a "low cost producer", especially in commodity industries like agriculture.

In a market-oriented environment, at any given point in time the role of price has little to do with the costs of production. Sometimes prices will significantly exceed the costs of production, and at other times prices will be lower than costs. Does this make sense? Yes, when price is used to communicate market information about consumer and processor wants, instead of just trying to use price to provide producers a stable income with little concern about surpluses. However, over time price should be sufficient to cover the costs of production of the survivors.

Strategies for Farmers And Growers

The changing role of prices means farmers and growers must also change their strategies. What are some of the changes required?

First, be prepared for greater price swings. This implies one must use more equity financing and less debt financing. Equity is an essential cushion to weather fluctuations in prices.

Second, strive to be a "low cost producer". Know your costs and that of other producers of your commodity. Cooperative Extension and several commercial firms can help you in this effort. Also, continue to identify new ways to maintain a competitive cost advantage.

Third, be cautious in reacting to short-term price changes, both on the up side and the down side. For example, one should be skeptical of the reaction to expand operations based on an extremely attractive short-term price. When analyzing such alternatives, make sure you also budget for "average" and "worst" price case scenarios. Those are the prices you may experience when added production eventually comes on line.

Fourth, seek out market outlets that are providing price incentives for specific product features. However, this usually means there are also disincentives for delivering undesirable product features. In addition, work with processors and other buyers to identify qualitative characteristics and services customers are willing to pay for. That is the simplest way to find and create your own market niche. For example, today organic production receives an attractive premium in many commodities, plus demand for organic products is increasing rapidly. But remember, it always costs more to produce and deliver those added product features or services. However, if done correctly the added revenues should more than cover the added costs.

Summary

There is a tendency for some farmers and growers to long for a return to "the good ol' days" and to resist the new roles of price. However, there is little indication that those good ol' days will return anytime soon, if ever.

The alternative is to acknowledge the new role of price, and adjust one's operations according. Producers who accept the changes and adopt appropriate strategies are those who are most likely to survive and benefit from this new environment.

"**Smart Marketing**" is a monthly marketing newsletter for extension publication in local newsletters and for placement in local media. It reviews the elements critical to successful marketing in the food and agricultural industry. Articles are written by faculty members in the Department of Applied Economics and Management at Cornell University.