MILK PRICES -- WHERE ARE WE HEADED?

by

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PREFACE

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We are all familiar with the basic dairy marketing situation. Milk marketings increased over 3% in 1980 to a record high 125.3 billion pounds. Milk consumption fell over 1% to 118.8 billion pounds. As a result, CCC purchases of dairy products increased four-fold to almost 9 billion pounds of ME at a record cost of $1.3 billion. The outlook for 1981 indicates that there will be no decline in production and consumption will increase only modestly, such that CCC purchase could be about the same as last year. The cost of these purchases would increase with inflated prices to $1.5 billion or more.

Even before President Reagan was elected, it was clear that there would be considerable interest in reducing price support expenditures; since the election, massive reductions in dairy price supports have become a cornerstone of President Reagan's agricultural budget cutting. Dairy price supports have been featured in the New York Times and Washington Post, on prime time TV news broadcasts, and in major weekly news magazines. The American public is becoming aware of dairy price supports at a time when support price levels are least defensible. The result is not encouraging for dairy farmers.

What is the likely outcome of this intense public scrutiny of dairy price supports?

1. The odds in favor of eliminating the April 1 adjustment in the support price have been increasing for the last several months. It now looks like Congress will pass the legislation necessary to prevent a mandatory boost, making it possible for USDA to keep the official support price at the level announced last October 1 -- $12.80 for 3.5% milk. On March 4, the Senate Agriculture Committee supported the elimination of the adjustment with only 2 dissenting votes. The semiannual adjustment would add about $.90 to the support price. As of last October the national average price of manufacturing milk was $12.22 at 3.5% test, well below the support price, and the price of fluid grade milk was $13.42. In Federal Order #2, the blend price in October was $13.57, (3.5% at 201-210 miles), as recently as this January the Order 2 blend price was seasonally lower at $13.46.

2. The same 1979 Act that required the semiannual adjustment also increased the minimum support price from 75% of parity to 80%. Special legislation is required to prevent the semiannual adjustment in April, but the

1979 Act expires in September. If Congress does nothing, the minimum support will revert to 75%; this would lead to an October support price of about $13.65. The question is whether Congress will simply let that happen or enact some other revisions to the price support program.

What else could be done?

a) reduce the support minimum to 70% of parity. Implication for dairy farmers--the support price for next October would about equal the price set last October ($12.80) and it would be proportionately lower than 75% of parity in years to come.

b) switch the price support formula from parity to cost of production. Implication for dairy farmers--for the last 3 years USDA cost estimates have been well below market prices, $1.89 less in 1981. The support price for next October would not go below $12.80, although the cost of production estimated for 1981 would be less than the support price. Future support prices would probably be much lower than parity based supports.

c) switch the price support formula from the current general parity calculation to a dairy-specific parity. Implication for diary farmers--uncertain, probably no change on October 1, in the future a dairy parity price could be higher or lower than the current parity price.

d) change the parity base year from 1910-1914 to 1967. Implication for dairy farmers--probably no change in the support price on October 1, but some other changes would be required. The price at 75% of parity calculated with a 1910-14 base year equals the price at 102% of parity calculated with a 1967 base.

e) devise a schedule that would tie the support price to CCC purchases. This so-called trigger mechanism would increase prices when purchases fell below certain benchmark quantities and decrease prices when purchases rose. The minimum and maximum price would probably stay at 75 and 90% of parity. Implication for dairy farmers--the support price next October and for the following year or longer would equal 75% of parity.

f) put an annual ceiling on USDA expenditures. Implication for dairy farmers--uncertain, the Administration indicates a $600 million ceiling would be consistent with 75% parity for the next year; this may be optimistic.

g) a handful of sweeping changes to support policy, such as switching to direct payments, cow culling incentives, or milk quotas. Implication for dairy farmers--unknown. These options have been thoroughly studied in the past, and they have always been found to be inefficient or ineffective.

The President has declared his intention to propose a four-year agricultural bill. (The last two bills expired in 2 years.) Because of this and given the President's inclination not to experiment with potentially costly programs, the Administration will be reluctant to propose any major changes, such as adopting an entirely new policy, e.g. quotas or direct payments.

The President is seeking a policy that will accomodate producer interests as best he can given his budgeting objective. Milk producers hope to barter the following gains as they concede on the semiannual adjustment and a return to a 75% minimum:

1. Increase the make allowance for dairy product purchase prices by 28¢ and modify the calculation of cheese prices, which would result in unchanged cheese prices in October and a tilt in favor of butter and nonfat dry milk.
2. Reduce casein imports to zero.
3. Permanently shelve hearings on reconstituted milk proposals.
4. Increase sellback prices from 105% to 110%.

Dairy industry leaders will also probably campaign for a trigger mechanism. If the President is convinced that 75% of parity will pinch dairy farmers sufficiently to require political tradeoffs, he will listen to all of these.

The make allowance is without a doubt too low to achieve even the current support price. An increase would be appropriate; producers are unlikely to get the full 28¢ though.

Casein imports may be restricted, but don't expect a zero quota.

Reconstituted milk proposals may be further studied and delayed; but interest in it and how it relates to supports is keen. Pricing provisions of federal milk marketing orders do not directly cost the federal government anything, although there may be some indirect cost implied by changes in nonfat dry milk purchases by the USDA. The major incentive to change order provisions would stem from a desire or need to come up with a consumer oriented program change.

Sellback prices should be increased, but it is hard to say whether they will be. In the past, low sellback prices meant that the CCC could reduce its stocks more easily. At current interest rates, the 105% sellback means that commercial cheese, butter, and nonfat dry milk processors are more than happy to let the CCC carry their inventory.

Their is a good chance that a trigger mechanism will be adopted. If it is, it will have no immediate effect because purchases will be triggering 75% of parity anyway. Producers will benefit from the trigger if economic conditions lead to low purchases in the future.

If the Administration is convinced that 75% of parity will lead to balanced supply and demand, and, consequently, reduced support purchases, there is no question that they will propose simply returning to a 75% minimum. While the odds are in favor of this happening, the matter is hardly settled. Some research we have completed indicates that prices which would limit net government purchases to 1% of total production (in 1980, purchases ran about 7% of production) would have to be less than 75% of parity, perhaps as low as 65% of parity.

If this result is correct, and we will have some measure of that between April and October if the seminannual adjustment is eliminated, then the President will look for some way to get price supports lower in future years. Whatever is done should be done in a manner that sends a clear signal to dairy farmers and represents a committment that producers can count on and plan for.

What can dairymen do in this environment? Production and consumption should be brought into balance. Of course, this can be achieved by either reducing production or increasing consumption, both of which should happen if prices are sufficiently reduced.

A more preferable solution would be to encourage consumers to buy more milk and milk products. Dairymen should support and expand milk promotion efforts to a level at which they can effectively compete with producers of other beverages and dairy product substitutes.

If all of last year's surplus would have been eliminated through a production cutback, about 6% less milk would have to have been produced. This would have to have been accomplished by reducing the national herd by some 700 thousand cows and perhaps by 10,000 farms or more. A proportionate decrease in New York would translate to 63 thousand cows and 900 farms. If one assumes that the smaller farms would be most susceptible to adverse economic conditions, the number of farms figure could be much higher.

Dairy farmers will need to keep an especially tight rein on their cost management in 1981. This may not be a good year to expand operations and assume a great deal of additional debt. Good managers should concentrate on efficiency and increasing herd productivity.