

CCC DAIRY COMMODITY LOANS AS AN ALTERNATIVE TO THE PURCHASE PROGRAM

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The dairy price support program operates with the government standing ready to purchase whatever quantities of butter, nonfat dry milk (NDM), and cheese are offered to it at government specified qualities and prices (see Leaflet P-1 for further details). In the 1990s, the price support has been set at a sufficiently low level that, except for butter, prices are largely market determined — the support price may legitimately be considered a safety net policy. There are those who assert that the trend toward more market-oriented agricultural policies can be expected to continue. The result undoubtedly will be an assessment of policy options between the current purchase program and the free market. The **nonrecourse loan** program used for other farm commodities may offer such an opportunity. It would provide a means of financing the holding of inventories of butter, NDM, and cheese in anticipation of changes in market conditions with a minimum of price risk, without selling to USDA's Commodity Credit Corporation (CCC). The interest rate on a CCC loan is often lower than is typical of a private sector inventory loan. If combined with a **marketing loan**, this policy option could aid in making dairy products competitive in the world market, while providing a degree of producer income protection.

Price supports for wheat, feed grains, rice, cotton, and soybeans operate through a CCC nonrecourse loan on commodities in storage. For these commodities, producers may use their crop as collateral for a government loan. During the term of the loan, the producer can pay off the loan and sell the crop or, if market prices remain low, they can forfeit the commodity to the CCC in full payment of the loan. In other words, CCC takes ownership of the crop with no interest being due.

The term for this nonrecourse loan is nine months (10 months in cotton) based on the theory that this is a sufficient time to allow producers to market their product in an orderly fashion before the next crop becomes available. Otherwise, the term of the loan appears to be arbitrary and could be

adapted to any commodity. The nonrecourse feature means that if the commodity is not marketed during the term of the loan, it may be forfeited to the CCC and the government has no recourse but to accept the commodity as full payment for the loan. Of course, the loan holder may sell the commodity at any time and pay CCC the value of the loan plus interest. The loan holder also pays the cost of storage (except in cotton under certain conditions).

The effect of the nonrecourse loan program is a lower interest government loan with a guaranteed minimum price that tends to support market prices at a comparable level without requiring sales to the CCC except in the extreme case of forfeiture. In addition, producers of the major food grains, feed grains, and cotton (but not soybeans) can receive **direct deficiency payments** through a target price program. The target price provides the farmer with income support which is particularly useful when the loan rate for these export crops is set sufficiently low that they can be priced competitively in the world market.

A Loan Program for Dairy?

The purpose of this article is to explain how CCC loan provisions could operate if applied to dairy products. In addition, the consequences of a dairy product loan program will be contrasted with the current dairy program. Such a program may operate with or without a target price, as exists in other major commodities. (The reader can become familiar with the application of the target price option to dairy by referring to leaflet P-9.)

Relevance of Loan Option

The dairy commodity loan is not an option presently, but it has been discussed by certain industry groups and politicians as an option worth considering. It could be operated similarly, but it should be thought of as a completely new approach to dairy price supports or the current purchase programs. Because this program option is used for most of

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the major farm program crops, milk producers should be aware of how it works and how it might work if applied to dairy. While the CCC dairy commodity loan option may not currently be considered a likely option to the purchase program, the following are conditions under which it could receive serious consideration as a dairy policy option:

- A CCC dairy commodity loan could be an alternative to the current milk price support program.
- If, as a consequence of trade negotiations, dairy import quotas were eliminated and/or severely restricted, domestic milk prices would fall to the milk equivalent of the world manufactured dairy product market prices (f.o.b. port adjusted inland for transportation). With world milk prices under free trade conditions lower than current U.S. levels, dairy farmers would likely seek an alternative form of income protection on a political basis. In other commodities, this exists in the form of the target price, the nonrecourse loan and, in rice and cotton, the marketing loan. The GATT and related negotiations favor direct payments as an alternative to price supports. Direct producer payments, while increasing government costs, make total program costs more visible. Implicit in the U.S. trade position is making producer subsidies overtly visible.

This paper emphasizes the commodity loan options for dairy, although the potential for a target price option clearly exists as well. Under the target price program on crops, producers receive the difference between the target price and the higher of the market price or the loan in the form of a direct payment from the government. The amount of such payments is ostensibly limited to \$50,000 per person, although the effectiveness of such payment limits is subject to considerable question. Throughout this paper, references will be made to the relationship of a target price program to the specific loan option discussed.

Operation of Dairy Loan Options

A dairy loan program offers three main program options, each having different price support and government cost implications.

Nonrecourse Loan

Because milk is a perishable commodity with very limited storage capability, a nonrecourse dairy loan program could only function for a limited number of manufactured dairy products (such as butter, NDM, cheese), similar to the current purchase program. The nonrecourse loan (referred to simply as “the loan” for the remainder of this section of the paper) would be taken out by the processor on qualified manufactured dairy products that are placed in the processor’s storage space. The processor would pay the storage costs on commodities under loan, just as farmers now do for most crops. Because milk and dairy

products are produced year round, the term of the CCC loan could be geared to normal industry practices and to the shelf life of the product. In other words, it might be different for NDM than for cheese or butter, and different than the nine month term for most other crop commodities.

Dairy products could be placed under loan by anyone, in theory, but it is most likely to be a cooperative or investor-owned processor. There is precedence in other commodities for cooperatives taking out loans on behalf of producers. This is done through the so-called Form G lending authority whereby qualified cooperatives may take out CCC commodity loans on behalf of their producer-owners. Such producers must have signed a legally binding cooperative marketing agreement with pooling of the proceeds of the commodity sales by the cooperative. In theory, with such a legally binding arrangement, CCC is making the price support loan to the producer. In practice, the loan proceeds are used by the cooperative to make a pool advance to producers for the commodities in storage. The USDA has shown a great deal of flexibility in what constitutes pooling arrangements and in the length of the pool required to qualify for a Form G loan.

In dairy, Form G authority would probably need to be extended to investor-owned processors, thus enabling them to take out loans on commodities they hold in storage. In the absence of such a provision, the loan would likely not be effective in supporting the price of milk. That is, CCC loans effectively support product prices as long as a significant share of the product is eligible for the program. In other words, if most of the production was eligible for a loan which could be forfeited to the government at the support price, it would not make economic sense for anyone to market their product at less than the support price. Therefore, CCC loan access would have to be available to both cooperative and investor-owned processors to ensure that the loan program would act as a price floor. Otherwise, the price support loan would not perform a price stabilization function.

The degree of price support provided by the nonrecourse loan option would be expected to vary among the supported manufactured products. A larger proportion of butter and NDM is processed by cooperatives (see leaflet M-9), making the extension of the Form G loan to noncooperatives less critical. In addition, NDM and butter commercial sales specifications are consistent with CCC standards. Cheese specification for commercial sales tend to be more diverse and do not always meet CCC specifications.

Once under the loan, the processor would have the right to pay off the loan at any time during its term, plus interest and storage. As a result, the commodities under CCC loan would always be available for marketing. No cost would be incurred by the government unless the commodity was forfeited to the CCC. In other words, only if a market was not available for the commodity at a price equal to the loan rate, plus accumulated interest and variable storage costs, would dairy products

become the property of the CCC, and only in this case would the government incur costs other than those involved in administering the program.

At one time, interest rates on CCC loans were subsidized substantially by the government, compared to commercial rates. Currently, CCC interest rates are lower than commercial rates only because they are set relative to government cost of borrowing and are paid only if the products are *not forfeited* to the CCC.

To the extent that a processor forfeits products under loan, this approach is similar to the current price support program, under which processors sell products to the CCC outright. The producer-owner and pass-through characteristics of the cooperative, combined with competition among cooperative and investor-owned processors, would be relied upon to ensure that the benefits of the price support loan were passed through to the producer level.

Recourse Loan

A recourse loan would operate the same as a nonrecourse loan except that the commodity could not be forfeited to the CCC at the end of the loan period. Therefore, recourse loans would operate the same as any conventional inventory loan obtained from a bank or other financial institution — a conventional inventory loan is a recourse loan.

Recourse loans have been proposed but never implemented for crops as a means of encouraging producers to market the commodities as opposed to forfeiting them to the CCC. The proposals for recourse loans on crops have been made largely by buyers of commodities (particularly exporters) and by the USDA. These proposals result from the tendency of farmers not to market commodities when the price is near the loan rate, apparently because of the expectation that prices might rise before the loan expires. As a result, the commodities are not effectively available to the market unless prices increase sufficiently to cover not only the interest cost but also the implicit speculative value of the loan option inherent in the nonrecourse loan program. Commodities under Form G loan do not appear to experience this release problem because of the obligation of cooperatives to serve market commitments and to utilize value-added processing facilities.

With a recourse loan, the loan rate would not be a floor on the market price as it is with a nonrecourse loan. As a result, a recourse loan would simply amount to a readily available alternative source of capital for processors of eligible manufactured dairy products during a pre-set period (loan term) over which the product could be marketed. *The recourse loan, therefore, simply becomes a means of short-term financing.* However, it would be as useful in cheese as it would be in butter and NDM because the products would not need to be produced to CCC specifications.

Marketing Loan

A marketing loan gives the producer the option of paying

off a CCC nonrecourse loan at the lower of the market clearing price or the loan rate. Marketing loans were introduced in the 1985 farm bill for cotton and rice as a means of making these export-dependent crops more competitive in the world market. In cotton and rice, marketing loans are paid off at the world market price if this is below the loan rate. Any difference between the loan rate and the repayment rate is kept by farmers. Of course, this difference is a cost to the government. One reasoning the marketing loan is so popular with rice and cotton farmers is that the difference between the loan rate and the repayment rate (marketing loan payment) is not subject to the \$50,000 payment limit that applies to deficiency payments under a target price program. The marketing loan benefits, however, are limited to \$75,000 per person.

Determining how a marketing loan would apply to dairy products requires recognition that:

- The loans could only be made on manufactured dairy products.
- There is no direct assurance that dairy farmers would benefit from marketing loan payments to processors. In rice and cotton, farmers are assured of receiving loan benefits because they either obtain the loan directly from ASCS, or cooperatives take out a Form G loan on the farmers' behalf and the farmers receive the benefits through cooperative pooling provisions.

The Form G loan and cooperative pooling provisions could likewise be applied to the marketing loan concept on dairy products. That is, the loan rate for butter, NDM, and cheese would be set at a politically acceptable and economically reasonable level. The loan would be repaid at the world market price.

The nonrecourse feature of the marketing loan has not been fully effective at moving rice and cotton into the world market. This appears to be the case because of the nonrecourse option to forfeit the commodity to the CCC. As a result, farmers hesitate to sell their rice and demand premiums for its release onto the market. This has been less of a problem where cooperatives hold the commodity on behalf of the producer and feel a need/obligation to move products into the market on a regular basis. A recourse marketing loan would be more effective in allowing product prices to fall to market clearing levels.

Theoretically, a marketing loan would not need to be limited to cooperatives. Marketing loan access could also be given to investor-owned processors if there is significant competition between cooperatives and investor-owned processors in all regional markets. In other words, cooperatives would need to be a dominant force in pricing milk at the producer level to ensure that producers receive the benefits of the marketing loan. If it were set up with this in mind, a marketing loan program could replace the current Dairy Export Incentive Program (see leaflet P-11).

Consequences

Six criteria were selected for evaluation of the three commodity loan alternatives relative to the dairy purchase program with a sufficiently low price support that the market for each product clears most of the time. In other words, there are not large accumulations of stocks or high government costs. Except for butter, this was the case in the early 1990s. The evaluation criteria are as follows:

- Impact on price level
- Impact on price stability/risk
- Impact on the level of producer returns
- Impact on government stocks
- Impact on government spending
- Impact on export competitiveness

In the following analysis, it is assumed that the price support, loan rate, and marketing loan would all be at the same level unless otherwise specified. In addition, it needs to be recognized that the consequences depend on the level of support provided. If, as is assumed, the support price is low, market prices will rise above the support level regardless of whether the current support program, a loan program, or a marketing loan is in effect.

Dairy Price Support Program

The current dairy price support program provides for a fixed price at which the CCC will purchase processed dairy products. Whenever production is in excess of market needs, prices fall to the support level and the CCC ends up buying the surplus. As a result, under the price support program, the fixed price support tends to *increase* the price level and *increase* the amount of price stability, and *reduce* the downside price risk. The amount of price enhancement and stability, of course, depends on the level of the support price relative to the market clearing price.

Producer returns were enhanced more by the support program prior to the late 1980s than during the early 1990s. In the early 1990s, only the price of butter was effectively supported. The willingness of the CCC to purchase commodities at the price support level *increases* the quantity of government stocks. The lower the price support relative to the market clearing price, the smaller the government stocks.

The acquisition of stocks costs the government money. Although those stocks may be resold later to the private sector, at least the storage and related transaction costs are incurred by the government. As a practical matter, government stocks are almost always utilized at a loss relative to the original purchase price. As a result, the price support program *increases* government costs and the current price support program *reduces* export price competitiveness.

Nonrecourse Loan

A nonrecourse loan also provides a floor on the level of price. However, as envisioned, the storage costs are paid by the firm taking out the loan up to the point where the

commodity is forfeited to the CCC. If the firm taking out the loan decides to take the commodity out of loan (market it), it pays accrued interest on the loan. In contrast with the purchase program where the CCC can only make sales when the selling price is at least 110 percent above the support price, under the nonrecourse loan program, the firm may take the commodity out of loan at any time. The commodity is forfeited to the CCC only if its price rests on the loan rate plus accrued interest.

Accordingly, for commodities such as butter and NDM, prices would be as high and as stable as under the current program because the loan rate is a price floor. There may be somewhat less of a tendency for the price to rise off the support level because commodities may be taken out of the loan at any time, contrasted with the 10 percent premium sell-back price under the purchase program.

Government stocks would *decrease* because of the ability to take the commodities out of loan at any time. Government costs would correspondingly *decline*. Export competitiveness would not change significantly from the current program.

These consequences may not hold for cheese where variations in quality make forfeiture more difficult. In cheese, the loan floor may not be as effective but that may be the case currently.

Recourse Loan

A recourse loan would eliminate the ability of the processor to forfeit the commodity to the CCC at the end of the loan period. This effectively removes the floor on the level of price by requiring that the processor either sell the commodity in commercial markets or take out a loan from the private sector. As a result, the price level can be expected to *decline* and markets would become more unstable. Producer returns would correspondingly *decline* to the extent that the current program supports the level of prices and producer returns. Some increased stability and price support could be provided in the spring flush simply because capital (the loan) would be more readily available than under free market conditions. The capital availability would enable processors to hold commodities from the spring flush to the full deficit and, thereby, provide some price stability.

Government costs would *decline* because the CCC would not acquire stocks — it would only be a lender. Because the loan rate is not a floor on the market price, milk products would become considerably *more competitive* in export markets under a recourse loan.

Marketing Loan, Nonrecourse

If the nonrecourse loan is maintained as a feature of the marketing loan, a floor still tends to be maintained on the market price. However, that floor is not as firm as with the current purchase program because when CCC sells forfeited commodities, the market price could *fall* below the loan rate.

In addition, to the extent that processors sell commodities in commercial markets at prices that are below the loan rate, the price level would *fall*. The existence of a less effective floor on the market price would *increase* the amount of price instability. Therefore, the CCC resale provisions and the sales practices of the private sector would have substantial impacts on the marketing loan product price consequences.

The level of CCC stocks would *decline* as more commodities are moved into the world market. Government costs would tend to *increase* although the magnitude of this increase would be small and depend on the extent to which the nonrecourse marketing loan is an effective floor on the market price of dairy products. The current program costs of commodity acquisition and storage would be replaced, in part, by direct marketing loan payments to processors of the differences between the loan rate and the market price. As market prices decline, dairy products would be more competitive in world markets. However, the magnitude of the increased competitiveness would be reduced by the price supporting actions of a nonrecourse loan within the marketing loan framework.

Producer returns (in competitive markets) would be protected in that any differences between the market price and the loan rate would be retained as marketing loan direct producer subsidies. However, because loans are made on processed products, there is always a question of how producers would receive the benefits from the marketing loan payment. The answer lies in the competitiveness of the market. To the extent that cooperatives are recipients of the loan payment, its benefits would be transmitted to its farmer/owners through its prices and patronage refunds. Investor-owned processors would need to compete with cooperatives. In areas where competition is less than perfect, cooperatives do not *exist*, and/or cooperatives are not efficient, the transmission of loan payment benefits to the farm level could be diluted.

Because of the direct payment provision, the marketing loan could be as effective at supporting returns for cheese as for butter and NDM. This is because the forfeiture feature is

less critical to the marketing loan and direct payments provide income support.

Marketing Loan, Recourse

If a recourse loan were established as a feature of the marketing loan, a floor price, clearly, would not exist. Commodity prices would *decline* to the market-clearing level. As a result, market prices would be more *unstable*.

While market prices would *fall*, producer returns would be *protected* to the extent of competitiveness among cooperatives and investor-owned firms. Under a recourse loan, there would be no acquisition of CCC stocks except when purchased to meet government demands for other food programs. A recourse marketing loan would materially *enhance* the competitiveness of U.S. dairy products in international markets. However, government costs would also *rise substantially* as dairy product prices fell to world market levels.

Concluding Remarks

Since the formalization of the milk price support in 1949, the product purchase feature has existed as the means of implementing farm price support. For the majority of other commodities, the CCC nonrecourse loan and/or nonrecourse marketing loan are used as the means of implementing price support and, to a more limited degree, income support. The substance of this paper indicates that CCC loan options could substitute for the purchase program with consequences that are unique to each of the various loan options (Table 1). The most general of these impacts involves the potential for more market-oriented pricing of dairy products. However, some of the loan features, such as the nonrecourse loan and the nonrecourse marketing loan, could be a tool for providing cooperatives with greater control over inventories and, therefore, greater market influence — simply because the cooperatives, rather than the CCC, would be holding products in excess of market needs until they are forfeited to the CCC. Commodities would not appear in the hands of the CCC unless they were truly in surplus. However, the usefulness of the nonrecourse feature as a bargaining tool can easily be overestimated.

Table 1. Summary of Nonrecourse and Marketing Loan Impacts for Dairy Products Compared With Low Price Supports Under Current Program.

Type of Loan	Product		
	Butter	Nonfat Dry Milk	Cheese
Nonrecourse			
Price level	Same	Same	Lower
Stability	Same	Same	Less
Exports	Same	Same	Same
Gov't. stocks	Lower	Lower	Lower
Gov't. costs	Lower	Lower	Lower
Income level	Same	Same	Lower
Recourse			
Price level	Lower	Lower	Lower
Stability	Less	Less	Less
Exports	Higher	Higher	Higher
Gov't. stocks	Lower	Lower	Lower
Govt. costs	Lower	Lower	Lower
Income level	Lower	Lower	Lower
Nonrecourse Marketing Loan			
Price level	Lower	Lower	Lower
Stability	Less	Less	Less
Exports	Higher	Higher	Higher
Gov't. stocks	Lower	Lower	Lower
Govt. costs	Higher	Higher	Higher
Income level	Same	Same	Same
Recourse Marketing Loan			
Price level	M. Lower ¹	M. Lower	M. Lower
Stability	M. Less	M. Less	M. Less
Exports	M. Higher	M. Higher	M. Higher
Gov't. stocks	M. Lower	M. Lower	M. Lower
Govt. costs	M. Higher	M. Higher	M. Higher
Income level	Same	Same	Same

¹"M. Lower" means much lower. "M. Less" means much less. "M. Higher" means much higher.