Should Farmers Use Futures and Options? A Pseudo-Experimental Analysis

Todd Hubbs
University of Wisconsin-River Falls
410 S. 3rd St., River Falls, WI
todd.hubbs@uwrf.edu

Todd H. Kuethe
USDA, Economic Research Service
355 E St.SW, Washington, D.C. 20024
tkuethe@ers.usda.gov

Robert Ebel
USDA, Economic Research Service
355 E St.SW, Washington, D.C. 20024
rebel@ers.usda.gov

Mitch Morehart
USDA, Economic Research Service
355 E St.SW, Washington, D.C. 20024
morehart@ers.usda.gov


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Research Question
Many agricultural economists suggest that farmers should use futures and options to limit risk exposure and enhance profitability. Yet, observed adoption rates are below what theory would suggest (Tomek and Peterson, 2001).

Data
The USDA’s Agricultural Resource Management Survey (ARMS) contained detailed questions on the adoption of futures and options in 2000 and 2008. Following Kuethe and Morehart (2012), we limit our analysis to farm operators for whom farming is the principal occupation and, to limit the influence of outliers, trim the upper and lower 10% of the distribution of net cash farm income.

Endogeneity
It can be difficult to estimate the impacts of the use futures and options on farm-level profits through regression analysis because adoption may depend on the characteristics of the farm operation.

Analysis
In a controlled experiment, like pairs of observations are sorted into “treated” and “control” groups, and the difference in the outcome variable is therefore attributed to treatment. We simulate a controlled experiment through propensity score matching (PSM) (Rosenbaum and Rubin, 1983). PSM matched like pairs based on farm financial characteristics, including acreage, total assets, total debt, total liabilities, legal organization, and whether the firm is predominantly a livestock or crop producer. Controlling for the relevant characteristics driving adoption, the difference in the outcome variable is attributed to adoption.

The adoption decision is estimated using weighted probit with a delete-a-group jackknife procedure (Kott, 1998).

<table>
<thead>
<tr>
<th>Variable</th>
<th>2000</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean net farm income</td>
<td>$28,348</td>
<td>$52,156</td>
</tr>
<tr>
<td>Adoption Rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Futures</td>
<td>12.7%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Options</td>
<td>22.2%</td>
<td>12.1%</td>
</tr>
<tr>
<td>Futures or options</td>
<td>31.2%</td>
<td>19.0%</td>
</tr>
</tbody>
</table>

The Impact on Farm-Level Profits
The impact of futures and options on net cash farm income were estimated via the average treatment effect for treated observations (ATT):

\[
ATT = E(Y_1 | P(Z), D = 1) - E(Y_0 | P(Z), D = 0)
\]
ATT estimates suggest that the use of futures and options did not enhance profits at statistically significant levels in 2000, but in 2008, an ATT of $28,107 was statistically significant.

**The Impact on Risk Exposure**

In order to estimate the impacts on risk exposure the distribution of net cash farm income obtained from the PSM pairs was compared using stochastic dominance. First-order stochastic dominance occurs when:

\[ F_{F\&O}(y) \geq G(y) \text{ for all } y \]

and

\[ F_{F\&O}(y) > G(y) \text{ for some } y \]

Where \( F_{F\&O}(y) \) is the distribution of net cash farm income \( y \) for farm operations that adopt futures and options and \( G(y) \) is the distribution of those that do not.

Second order stochastic dominance occurs when:

\[ \int_{-\infty}^{+\infty} [F_{F\&O}(y) - G(y)] dy \geq 0 \]

The Kolmogorov-Smirnov test was used to determine the optimal fit for the estimated distributions of net cash farm income obtained from PSM.

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Treated</td>
<td>Control</td>
</tr>
<tr>
<td>Normal</td>
<td>0.132</td>
<td>0.129</td>
</tr>
<tr>
<td>Weibull</td>
<td>0.190</td>
<td>0.180</td>
</tr>
<tr>
<td>Gamma</td>
<td>No fit</td>
<td>No fit</td>
</tr>
</tbody>
</table>

The normal distribution suggests that in 2008 adoption first-order stochastic dominates non-adoption, but in 2000 no stochastic dominant relationship exists.

It is important to note that the two years represent distinct economic conditions for the agricultural sector. In 2000, commodity markets exhibited relatively low and stable prices. However, in 2008, commodity markets witnessed a substantial run-up in prices in the early part of the year and a significant decline at the end of the year. Similarly, net cash income for the farm sector was relatively stable in the years surrounding 2000, yet farm incomes increased rapidly in the later part of the decade, including 2008. The market dynamics in each period therefore provide a contrast for the efficacy of using futures and options as a risk management strategy.
2000 Estimated Net Cash Farm Income

- Treated
- Control
Conclusions
Controlling for endogeneity of adoption, the use of futures and options enhanced farm cash income and mitigated risk in 2008 but not in 2000.

References