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Forum

Private Trading in Wheat: An Assessment

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In the formulation of policy for the Seventh Wheat Stabilization Plan, a decision has to be made as to whether the sole trading power of the Australian Wheat Board (A.W.B.) should be continued. Two major contributions to this debate have been the Industries Assistance Commission (I.A.C.) Report on Wheat Stabilization [2] which recommended private trading on the domestic market, and the recent High Court decision upholding the validity of wheat stabilization legislation in relation to Section 92 of the Constitution.[1] There has also been considerable public debate on the possible deleterious effects, but also on the financial advantages, of private trading. The I.A.C. proposal has drawn charges of profiteering middlemen from some sections of the industry. Conversely, others have indicated that certain equilavent domestic trading operations outside the A.W.B. system have substantially reduced costs. This paper explores some of the implications of the I.A.C. proposal, and suggests that the issues involved are much wider than the costs of alternative domestic marketing channels—making it impossible to view private trading in isolation.

The benefits of private trading in wheat can be considered in the narrow context of the comparative marketing efficiency of private traders and the A.W.B. on the domestic market, or in the wider context of price equalization and stabilization policies. The I.A.C. Report [2] recommends the discontinuance of these pricing policies. If this is unacceptable, the introduction of private trading requires the development of other policies to achieve their objectives. However it is not the purpose of this paper to question at length the desirability of equalization, or the stabilization of prices to growers and domestic consumers. The paper is more concerned with a comparison of domestic marketing efficiency, although the analysis is limited by the absence of detailed information on the operations of the A.W.B. and bulk grain handling authorities (B.H.A.s). Nevertheless it is possible to indicate the range of issues involved. Firstly, the marketing efficiency of private traders and the A.W.B. is briefly compared in terms of domestic storage and distribution charges, and in relation to quality control. Secondly, the possible adverse effects of private trading on

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1. In the view of Coper [1], a basic issue in the High Court case was whether the present wheat stabilization scheme is the only reasonable and practical method of regulating trade in wheat. This, he considered, was not adequately demonstrated by those Justices upholding the validity of the scheme; to the contrary attention was drawn by other Justices to the I.A.C. proposal. However, he noted that the wider issue under consideration was whether the advantages of organized marketing are sufficient to overcome a challenge under Section 92. Acceptance of wheat legislation by successive Commonwealth and State Governments had, he suggested, indicated a clear preference for involvement in the marketing process. Thus it would appear that the High Court decision is largely an acceptance of the Commonwealth and State Governments' role in formulating policy in this area rather than approval of a particular scheme.

price discovery are considered. Thirdly, the paper investigates how the merchanting operations of the A.W.B. would need to change in order for it to effectively compete. The paper tentatively concludes that while A.W.B. pricing policies would need to change, growers are unlikely to be worse off.

1 Implications for Stabilization and Equalization

To introduce private trading on the domestic market, present policies relating to the home consumption price, equalization between domestic and export markets, and the stabilization of export returns would have to be substantially revised, and their feasibility may be in doubt. The current procedure of vesting gives the A.W.B. monopoly power to discriminate between markets according to pre-determined pricing objectives. The sole trader provision and pooling arrangements allow payments to growers to reflect equalized prices. With private trading a different mechanism is required for relating domestic and export prices. One approach is to link the markets directly, through the A.W.B. publishing a schedule of prices at which it would accept wheat for export (suitably adjusted according to transport costs from various regions). Alternatively, different prices on the two markets (e.g., limited price fluctuations on the domestic market) could be maintained, in a way which did not involve channelling substantial Commonwealth subsidies through the A.W.B., by a system of delivery quotas where only a limited volume of wheat could be directed to the home market during times of relatively high domestic prices. Conversely, when export prices rose above domestic prices there would have to be a similar mechanism for diverting wheat onto the home market. Any mechanism would have to avoid the inequity of certain growers being allowed to consistently supply the higher priced market.

The stabilization of prices also presents difficulties under private trading. The present system involves making payments into the pool and the stabilization fund, from which payments to growers are calculated according to the formula set down in the stabilization legislation. With private trading, when payments are being made into or out of the stabilization fund, or when the market price and returns to growers diverge, growers would want to alter the volume of trade on the domestic market and cause undesirable movements in prices, or reduce their contributions to the fund. In the absence of quotas for supplying the home market, and with an A.W.B. policy of withdrawing quantities of wheat for export on the basis of its pricing policies, stabilization (which required grower payments) would have to be internalized within the A.W.B. system so that prices offered to growers differed from the prices the A.W.B. received.[2] If prices were stabilized afterwards there would be confusion between price signals and market returns. The necessity of this additional financial management on the part of the A.W.B. is likely to increase its export marketing margin, but be limited in its impact on prices.

Thus, in order to maintain a balanced perspective on the introduction of private trading, the ramifications of these changes need to be taken into account. The I.A.C. Report [2] concluded that the present stabilization measure had had

2. This assumes that price stabilization via a buffer stock scheme would not be attempted, because of the relatively small contribution of Australia to international trade.

little effect, that an inordinately large fund would be required to make it work, that "to be effective, income stabilization efforts should be directed at individual incomes" (I.A.C. [2, p. i]), and that the home consumption price policy has not significantly influenced the stability of grower returns but has distorted utilization on the domestic market such as in the use of alternative stock feed grains (I.A.C. [2, pp. 45–48]). It therefore suggested that stabilization measures be replaced by a potholing scheme whereby government assistance would be used to prevent prices falling too far too fast. This assistance would also apply to wheat handled by private traders. In such a context the possibility of private trading can be more readily considered. It is not the purpose here to comment on the merits of the I.A.C.'s position, but rather to note that if different pricing policies are to exist on the two markets, and/or if some degree of export price stabilization is desired, the presence of private trading makes the achievement of these goals much more difficult.

2 Comparative Domestic Marketing Efficiency

The I.A.C. proposal for private trading lays considerable stress on the effect of competition in identifying and selecting less costly marketing channels, and also on the ability of the market mechanism to take better account of the diverse interests and requirements present. If certain merchanting services can be undertaken more cheaply by private traders, the A.W.B. would need to reorganize their activity in this area or pass responsibility to others. The I.A.C. Report implies that the growers' returns will not be adversely affected because the A.W.B. will remain the dominant buyer of wheat, and growers who distrust private traders will be able to market their wheat through the Board. There would also not be any increase in cost to consumers since wheat users could obtain supplies direct from the Board if traders' prices were excessive. Thus the expected impact of traders is a reduction of the merchanting price margin. One example quoted by the I.A.C. [2, p. 43] involved reducing the marketing margin between grower and user from \$53/tonne to \$20/tonne, with the grower getting over half the reduction. While the magnitude may not be typical, the extent of "black market" sales in the past indicates that there are substantial price (or financial) advantages to many growers in taking this approach.

This paper, while accepting the role of competition and the market mechanism, seeks to highlight the changes needed for the A.W.B. to compete on an equal basis, and the institutional framework required for the market to correctly establish price levels. It also attempts to evaluate whether these changes and the presence of private trading will make growers worse off.

While competition may occur for standard lines of wheat, private merchants are likely to concentrate on the distribution of feed wheats and off-grade wheats which the A.W.B. may prefer not to handle. To overcome the loss of information and reduction in competition which could result from the A.W.B. withdrawing from such markets, the A.W.B. could remain ready to make such sales, and investigate the possibility of being agents in direct sales which avoid the use of bulk handling facilities. Potential competition of this kind may slightly increase A.W.B. administrative costs but would limit profit margins of private traders. In contrast to this safeguard, it should be noted that specialization in the distribution channels for feed wheat and off-grade wheats should result in lower marketing costs, help define grades and price differentials, and allow the A.W.B. to reduce the mixing of grades and increase dockages for off-grade wheat.

One argument which has been advanced in favour of retaining the A.W.B. as sole trader is that there would be an unnecessary proliferation of storage and handling facilities; that the bulk handling authorities' fixed costs would have to be spread over less grain, increasingly placing the A.W.B. at a disadvantage; that built into the A.W.B.'s domestic marketing costs are those costs associated with overseas shipment. The perspective taken here is that, given adequate dissemination of information, the marketing margin of the private trader—including handling, storage, transport and profit components—would have to be lower than those for the A.W.B. to attract trade. The question then is whether A.W.B. marketing costs would rise with private trading. Two aspects can be distinguished. The first concerns the effect of a reduction in throughput on B.H.A. costs. One could probably assume that the volume of private sales would be reasonably stable, certainly much more stable than the size of the harvest, so that a reasonable estimate could be made of the volume and distribution of A.W.B. sales to domestic consumers; the supply of storage facilities by B.H.A.'s could be reduced accordingly. The fixed cost component in grain storage handling and transport is not large relative to variable or operating costs (for N.S.W., see the Grain Elevators Board's publication, *Bulk Wheat* [3]), and hence permanent or seasonal adjustment in storage capacity should not be excessively costly. However there may be insufficient grain produced in certain regions to allow both the A.W.B. and private traders to operate bulk handling facilities and obtain economies of scale—leading to higher costs or a reduction in competition. A detailed study of the operations of a B.H.A. would be necessary to establish cost implications.

The second aspect concerns the A.W.B.'s policy of equalizing charges for storage and handling services. A view reported by the I.A.C. [2, p. 44] is that the A.W.B. will be left to provide services to locations with high costs of access—thus increasing storage and handling charges. Conversely private traders have an advantage where growers through the equalizing of charges pay more than actual costs. For instance some of the costs of seaboard terminals and administrative costs of exports may be included in domestic prices. Thus there should be opportunity for the charges of the B.H.A.'s to reflect the services rendered in relation to the market outlet, although it would be difficult to allocate benefits between growers rather than to offer concessions to consumers. While assistance by way of equalization of costs may be considered desirable on equity grounds, an alternative method of providing this would have to be found if private trading was introduced and the A.W.B. was to compete on an equal basis.

It is also suggested that private trading would make quality control more difficult and more costly.[3] Grain quality refers to moisture levels, protein levels, variety, foreign seed and other contamination, and insect infestation level. It could be argued that private traders would employ inferior pest management policies, and, given the dynamics of pest population and resistance, and difficulties of detection, that it would be unwise to introduce such a threat. Such policies will influence not only the recipients of their grain but also other producers and storers through insect movements and growth in resistance to chemical forms of control. While it may be desirable to separate the question of pest management from that of private trading, the existence of externalities and the difficulties of adequately internalizing them via price incentives, or the

3. One of the arguments in favour of private trading was that it would make "black market" sales more open to quality control and the collection of levies. This has lost its force following the High Court decision.

costs of enforcing regulations, may prohibit such a separation. However if the B.H.A. can reject wheat with insect populations above certain levels or charge the grower for treatment and insulate its stocks from outside contamination, it can ensure that export standards are maintained. Externalities associated with pest resistance impose additional costs. On the domestic market, premiums and discounts paid by private traders for various grades and varieties of wheat may not reflect appropriate quality standards, and require a relaxation of B.H.A. standards in order for the A.W.B. to compete. Conversely, B.H.A. quality standards may be excessively high when wheat is used for stockfeed purposes. As the I.A.C. [2] recommended, it appears that a further inquiry is necessary to determine the size of externalities in insect infestations, and, in particular, the cost imposed on growers by private traders.

3 Information on Prices Offered

Another component in the evaluation of private trading is its influence on price discovery. Will private trading lead to lower or more variable prices to growers than they would receive under the present system? This depends very much upon the institutional setting in which prices are established. Firstly it will depend upon whether the price offers of traders and the Board are comparable. If private traders offer cash and the A.W.B. makes payment through pool returns, growers face a difficult choice involving an assessment of anticipated price movements and wheat sales. When a liquidity shortage occurs cash offers may be accepted at substantial discounts. Consequently, the issue of private trading cannot be separated from that of providing some form of discounted cash payment for equity in pools. Secondly, if growers are to choose between the offers of private merchants and the A.W.B., information on these offers must be readily available. Where there was not public disclosure of prices paid private haggling would occur, and growers would be in a weak selling position. Through the A.W.B., growers should have better access to market information on prices paid and on marketing margins. Information on anticipated pool returns or discounted cash offers would have to be publicized in readily accessible places, perhaps as a requirement of licensing. A standard form of contract could also be devised whereby adjustments in price according to grade and location, and the conditions of payments were clearly set out.

The information made available should not be in terms of current cash prices alone. Private traders may engage in arbitrage (or, pessimistically, speculation) in relation to likely variations in domestic prices which result from changed export conditions and altered A.W.B. requirements. To make the option for, or the benefit of, such arbitrage equally available to growers, knowledge of the conditions of export sale contracts and the scheduling of shipments could be made known directly, or indirectly via adjustments in the discount cash payments. Thus the first advance plus the discounted cash payment for remaining equity in the pool would also follow price expectations. Where the discounted cash price was regularly updated to reflect new information, growers would only have to compare trader's quotes with this price. This could also be done where traders approached growers prior to harvest—although forward sales to the A.W.B. prior to harvest may not be possible. Should private trading be introduced under these conditions growers would remain in a strong position because the A.W.B., by acting as a buyer of last resort, could determine minimum price levels. Thus, in this aspect of wheat price formation, the issue is not administered pricing versus free trade, but rather a comparison between a formal structured exchange process which generates and summarizes available information, and an informal situation with low information output. This makes the price discovery mechanism quite different from that which operated prior to 1948. However while this demonstrates that price offers accepted by growers from private traders need not be lower than the price from the A.W.B., this is not to say that the A.W.B. price offer might not be affected.

4 Merchanting Policies of the A.W.B.

While private traders would not be allowed, under the I.A.C. [2] proposal, to make export sales, they will have an effect on net export returns by altering the conditions under which A.W.B. trading decisions are made. In the past the pool system has been the dominant form of making payment to growers. It has had the effect of passing from the A.W.B. to growers in the pool the costs of financing stock holdings and the risks of adverse price fluctuations. Hence the A.W.B. has acted more as a sales agent than as a merchant. In the absence of policies to pursue independent pricing policies on the domestic and export markets, the introduction of private trading would require the A.W.B. to carry some of these functions—in order to make discounted cash payments or set domestic prices through the withdrawal of stocks for export. However it would not necessarily be appropriate to regard them as increasing the costs of marketing.

(i) *Financing and risk-bearing functions*

Firstly, in relation to financing and risk bearing functions, the introduction of private trading would require that alternative forms of discounting be considered. The I.A.C. [2] suggested that a script market might be formed where the residual risk in the pool could be sold or used as collateral. The key issue in the effectiveness of such a market is the equal availability to all market participants of information on future price movements. This includes information on grain harvests, A.W.B. sales arrangements (payment schedules, interest rates, exchange rate guarantees, etc.), world stock levels, and domestic grain policies of other importing and exporting countries. Such information is not readily available to growers. Assymetrical information disclosure allows insider trading; if additional or new information is only available to certain people opportunity exists for them to engage in trading on favourable terms. Insider trading could perhaps be countered by the A.W.B. being extensively involved in supplying information, and by it trading more actively on the script market. However it may not wish to buy script in any quantity as this would involve carrying market risk, and make it open to criticism for using its position to make profits. It may also find it difficult to supply sufficient information publically for growers to assess market prospects and hence know what would be a reasonable price to accept. In the past the A.W.B. has refused to release details of sales agreements because they have believed that contracts were established in confidence and the publication of details could result in a loss of bargaining power and/or cancellation of contracts due to breach of confidence.

The alternative to a script market is provision of a discounted cash payment to growers. However there is some question as to whether the A.W.B. should make the discounted cash offer, or whether some other organization should handle the discounting arrangements. In the first instance the accounts and the administrative costs of discounted and pool payments should be kept separate, and returns from sales should be paid into each account in proportion to the quantity in each scheme. Otherwise the risks of future sales are not spread evenly and pool returns reflect the residual returns and risks. There must also be assurance that final profits and losses in the discounted cash payment accounts are not amalgamated with pool returns, but covered by insurance, or met from some contingency fund subscribed to by those using the scheme. Secondly, if the A.W.B. is to operate its own discounted payment scheme a moral hazard problem arises since growers are unable to distinguish between anticipated future returns (from actual and potential sales) and the prices offered (reflecting discount rates and risk premiums); and the A.W.B. would be unwilling or unable at reasonable cost to divulge the necessary information for growers to do so. The price offered may be excessively conservative in the light of available information, or it may be varied to influence deliveries to the Board. If full information on existing and expected sales is provided to an alternative organization specializing in financing, the moral hazard problem is partly overcome as forecasting and discounting activities are separated; financing is also likely to be undertaken at lower cost. (On the script market the moral hazard problem is minimal as other buyers have access to information and can offer higher prices.)

Further points of comparison between the three alternatives—namely the A.W.B. discounting, an independent discounting authority and a script market—are marketing margins, pricing efficiency, price variability and distribution of benefits. The formation and maintenance of a script market could be relatively more costly than the discounting options because of the incidence of broking charges and commissions for small script sales. The difference between current discounted prices and final pool realizations will also depend on accuracy of price expectations, discount rates for future benefits and the level of risk aversion. The A.W.B. is likely to operate the most conservatively, while an independent discounting authority might charge the lowest risk premium as risk can be spread more widely, and a script market may allow the best exchange of information on market prospects. Prices on the script market are likely to be more variable than discounted cash offers: the former may reflect appropriate adjustments or over-reaction to new information, while the latter may reflect the inflexibility of administered prices. Finally even if all schemes were of comparable efficiency there may be, actually or apparently, income distribution effects which may make some unacceptable. Net gains and losses in the discounted cash payment account would be visible and would accrue directly or indirectly to growers, although growers' returns from discount sales and pool realizations could differ. Profits made on the script market by commercial operators, especially those acting as agents for international grain companies, in pushing the market to an equilibrium are not sisible and would be seen as unnecessary and wasteful.

The overall effect on the A.W.B.'s marketing margin of making some form of discounting available is ambiguous, and depends in large part on which of the above approaches is chosen. Even then many details would have to be given, and cost of operations determined. As noted earlier the additional costs to the A.W.B. of discounting should not necessarily be attributed to private trading. However private trading will have important implications. Firstly, to counter price adjustments by traders the discounted price may have to be varied more frequently than thought desirable. While such movements may accurately reflect new information, it does require that growers make a decision as to when to sell. Secondly, the pool system has the effect of equalizing financing and risk charges between domestic and export markets. Assuming that these charges are higher for export sales, private traders would be able to offer relatively higher prices, or operate on lower margins. Thirdly, discussion of discounting also helps to bring into focus the merchanting functions that the A.W.B. does or does not perform, and therefore encourages more public accountability for the services it provides. As a first approximation, it can be argued that in the situation where growers have a choice of pool returns and discounted cash payment, and additional administrative costs of the latter are fully included in the discount, they should not be worse off. Growers preferring an equalized return can remain in the pool system.

(ii) *Stockholding policies*

In the second place, the introduction of private trading would require that the A.W.B. develop more explicit stockholding policies, both in order to set domestic prices and also to ensure the fulfilling of export contracts. In regard to the former, assuming independent pricing policies are not to be followed on domestic and export markets, the A.W.B. by withdrawing stocks could influence how closely domestic prices followed export prices. In regard to the latter, in negotiating export contracts the A.W.B. would have to develop expertise in assessing the effect on domestic prices of withdrawals of wheat from the domestic market; a safety margin in the supplies it holds in storage would be necessary to avoid having to buy from private traders at a premium. The task of relating export and domestic prices would be unenviable, and would require clear guidelines from the Commonwealth Government. If export prices were constant during the season the domestic price would be below the negotiated export price by an amount equal to the difference in export and domestic marketing costs—thus allowing equal prices to be paid to growers. If export prices fluctuate the A.W.B. may be required to stabilize domestic prices about the long term trend.

Where the A.W.B. or an independent discounting authority owned the stocks and/or government finance was involved, it is inevitable that export marketing costs would rise. These would include costs of financing stockholdings and carrying the risk of adverse price movements. To avoid an oversold position following receival of wheat from growers, the A.W.B. would have to consider extensive forward contracts and perhaps a hedging position on the U.S. grain futures market. Such policies would encourage arbitrage over time, and with greater fluctuations in price there is an increased need to plan the timing of sales. Cost savings are likely to accrue from making more explicit merchanting decisions. The net effect of stockholding policies is particularly difficult to determine. However one might again argue that, as a first approximation, if additional marketing costs related to financing and risk bearing were included in the discounted cash price offered to growers, then their choice would indicate if these costs exceeded the implicit costs faced by growers. The additional administrative costs of planning and implementing wheat purchases is a net loss, but would be partly offset by a reduction of government in wheat price stabilization policy. Of course, it could be argued that in an evaluation of domestic marketing efficiency such costs should be separated out and attributed more specifically to export sales.

5. Conclusions

The domestic marketing efficiency of the A.W.B. and private traders has been compared to determine whether growers are likely to be worse off following the introduction of private trading. There are several issues unresolved which make the impact of private trading ambiguous. Nevertheless, the case is much stronger than many opponents are willing to allow: prices offered to growers need not be lower than A.W.B. offers; the impact on merchanting costs can be incorporated in the discounted cash price which can then be compared with pool returns, or attributed more specifically to export sales; lower cost domestic marketing channels can be identified; cost implications for the bulk handling authorities are likely to be small following adjustment in the supply of storage facilities; a necessary competitive check on the efficiency of the A.W.B. is provided. What is not clear is the effect on B.H.A. costs of changes in the volume and distribution of domestic sales, and the effect on quality standards and costs of quality control if wheat is handled by many private traders.

While there is little doubt that certain domestic wheat marketing operations can be undertaken more cheaply by private traders, the introduction of private trading cannot be justified in such terms alone. On the one hand it has been emphasized that the institutional framework in which private trading occurs is important. This would limit or make visible the activities of traders and so reduce the suspicion that growers might have of malpractice. Safeguards include the public provision of information by traders on prices offered, the comparability of prices through the provision of discounted cash prices by the A.W.B., standard forms of sales contract, the A.W.B. maintaining a substantial role in domestic marketing, and requirements that necessary quality and pest control provisions be observed by all market participants and the cost of control equitably shared. On the other hand, the implications for equalization and stabilization policies have been highlighted, although no attempt has been made to guage the relative importance of price stability. The Board would play a more critical role in establishing domestic prices and in stabilizing export prices. Private trading would also require that pricing policies involving equalization of costs and prices over time, between producing regions and between markets, be further eliminated.

Thus the introduction of private trading would require substantial changes in the merchanting activities of the A.W.B., which would in turn require changes in its enabling legislation, and call into question its contribution to wheat marketing. The need for concomitant decisions on a number of other important facets of wheat marketing policy will probably preclude any rapid change in policy on private trading.

References

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