PRICING PROBLEMS IN THE FOOD INDUSTRY
(With Emphasis on Thin Markets)

A compendium of papers presented at the Symposium on Pricing Problems in the Food Industry (with Emphasis on Thin Markets), Washington, D.C., March 2-3, 1978

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SUMMARY — SYMPOSIUM ON PRICING PROBLEMS IN THE FOOD INDUSTRY (WITH EMPHASIS ON THIN MARKETS)

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The objective of the "Thin Market" Symposium was to improve our knowledge and understanding of thin markets and related pricing problems in the food industry. The papers presented reflect government, academic and industry perspectives, and stimulated very active group dialogue on the extent of thin markets in the food industry, the degree of concern that is warranted, the need for and appropriateness of various policy prescriptions, and future research priorities.

The following papers and discussion indicate that many symposium participants are concerned about thin markets and their related problems and issues. Most participants feel they know what a thin market is, but have different concepts of a thin market. Some differences remain, but most participants designate thin markets as having either a small volume or a small number of transactions involved in price determination, but not necessarily unsatisfactory market performance.

The great concerns seem to be associated with markets which once were broadly traded, but which changed when vertically integrated systems or longer term contracts, especially reference or formula price contracts, became dominant. As the residual market decreased, insecurity increased regarding the representativeness of transacted and reported prices, the potential ease of price manipulation, the adequacy of market information, and the risk of having sufficient buyers or sellers available at any time to insure an equitable price.

Caves explores several potential causes for market thinness or market failure, with each characterization or causal diagnosis implying its own set of possible remedies, and suggests the need for case studies of the structural determinants and performance implications of thinness. He raises the important public policy question of whether the private gains associated with some of the causes of thin markets (like vertical integration or reference price contracts) are identical to their social productivity or whether the associated externalities are costly to society.

Powers discusses some of the practical policy issues associated with thin markets, emphasizing the ease of manipulation, the higher execution and transaction costs and associated risk premiums, and the difficulties in using prices from thin markets as reliable regulatory standards or an equitable basis for transfer prices, government support prices, etc. He explores briefly the problems of market information from thin markets, and the recent Department of Justice challenge of spot market committees at some commodity exchanges. Powers concludes that information distortions that can arise from thin markets may still be more preferable for some market participants than more costly and more accurate information gathering procedures. He then considers some causes of thin markets, and concludes that the most cost effective approach to make thin markets into more liquid markets in the short run is to facilitate arbitrage between related markets which can tie markets together more effectively, reduce transaction costs, and smooth the pattern of short term price movements over time.

In the case studies of alleged thin markets, varying degrees of discomfort are voiced regarding the performance of specific thin markets, with9 corresponding differences in related public policy proposals. The egg industry was characterized as quite thin, volatile, and susceptible to short term manipulation, even with the introduction of a new market institution (Egg Clearinghouse, Inc.) which provides a pricing mechanism to balance egg packers' excesses and deficits in a shell egg market dominated by integration and reference-price contracts. While the processed broiler market was characterized by Duffy as less thin (though no live broiler market exists anymore), some of the trends were viewed with concern. Duffy asks for the development of a revised broiler futures contract more compatible with the needs of buyers to provide more vitality in the related cash and futures markets. Schrader felt the advantages of long term coordination arrangements offset some pricing error and increased price volatility associated with thin markets, and would not advocate bans of formula price contracts. He did propose a policy of subsidizing open exchange at one level ot the production-distribution system to provide what he considered to be the positive external benefits of an open market pricing process.

The butter and cheese markets were characterized as quite thinly traded, with formula price contracts the predominant exchange arrangement. The reported prices from the National Cheese Exchange and the Chicago Mercantile Exchange spot butter market were considered to be the dominant forces influencing prices paid throughout the industry. The influence of government support prices on butter was considered a major force restricting the volume on the very thinly traded Chicago Merchantile Exchange butter futures market, often limiting the incentive for speculators. Nevertheless, most symposium participants knowledgeable about these markets felt that the industry was generally quite satisfied with the pricing base provided by these thinly traded spot markets.

In the livestock and meat markets, the decentralization of the packing industry and the multiplicity of products and market channels at the wholesale level were cited as contributors to periodic (and, in some cases, persistent) thin market conditions. The most widely publicized and clear-cut cases of thin markets were considered to be the wholesale markets for beef and pork where a high proportion of the product is priced on a formula based upon a major industry report (the National Provisioner's "Yellow Sheet"). Since this removes the mainstream of the beef and pork marketing system from the price determination process, it has led to questionable and controversial price reports, and increased the incentive to manipulate reported prices. However, that pricing system was felt to be operationally efficient with no clear-cut evidence of significant price distortion.

There is disagreement whether the possibility of distorted prices in the meat industry is likely to increase — whether the formula price system is self-perpetuating. Haverkamp feels that the problems created by too much formula-pricing will provide sufficient incentive for some market participants to negotiate prices on at least part of their volume and, thus, be in a position to report prices that should alleviate possible distortions. But shifting to other pricing systems might be too costly for some firms; this is proposed as a fruitful area of research.

However, critics of the current beef and pork pricing system felt that some other measures may be necessary. Williams considers requiring changes in the private price reporting systems, strengthening and expanding the U.S.D.A. meat price reporting service, requiring mandatory price reporting by meat industry firms, and developing electronic or computerized trading systems for meat, but feels there were some drawbacks to each. He prefers outright prohibition of formula pricing, realizing that marketing costs undoubtedly would be increased. Williams feels that the pervasive influence of potentially distorted formula pricing in the wholesale meat trade and in the closely related live cattle and hog markets is problematic in itself, and stifles exploration of alternative pricing systems. Thus, formula pricing would have to be eliminated before any other system could become feasible.

Markets in the fresh fruit and vegetable industry are characterized by the limited number of buyers involved in direct negotiations with producers, a declining product volume in wholesale terminal markets in major consumption areas, and concern about potential decreases in the quality of market information. In contrast, the markets for processed fruits and vegetables have become more direct as many firms have integrated into wholesaling functions previously done by others, reducing the pricing points involved in the marketing system. Where cooperatives or proprietary long-term supply contracts have become dominant, determining the appropriate producer price becomes difficult — in some cases, growers may not have alternative outlets for their product, or they may have poor market information to assess whether the prices being offered or negotiated are equitable. According to Garoyan and Armbruster, the appropriate role of bargaining cooperatives and cooperative pools in markets characterized by the lack of market information, pricing guidelines, and alternative product outlets remains an issue deserving further analysis in this industry.

This symposium identifies the problems of inadequate public market information, and inaccurate, inequitable, or manipulated prices as fairly general concerns when thin market policy issues and alternatives are considered. Henderson raises the question whether improvements might be made via requiring mandatory reports on a standardized basis, reporting the volumes upon which price reports were based, strengthening reports of closly related markets or reporting more non-price information. In some cases, he recommends consideration of a price reporting committee structure, or simply not reporting any price where thin markets were involved. He feels such changes could either supplant current unsatisfactory reports, or stir users of these reports to be more cognizant of the problems of thin markets, and make voluntary changes in marketing practices which might make these markets less problematic. But, the magnitude of the problems or incentives which would cause market participants to stop "trading on someone else's price" and actively participate in the pricing process certainly remains a critical research and policy question.

Knutson looks at the trend away from open, competitive markets and observes competitive inequities in the food industry, particularly at the producer-first handler level. His preference for a movement toward a more openly competitive system at the producer-first handler level prompted a debate regarding the appropriateness of the perfect competition norm at one level of a production-distribution system which clearly involves imperfect market structures at other levels.

Raikes develops a very interesting conjectural scenario of the behavioral relationships which might lead to thin markets, and measures that might be used to prevent or reverse the development of thin markets. He feels that (a) benign neglect would not suffice, that a thin market problem would not resolve itself if left alone; (b) subsidies for central market transactions could be effective, but involved some problems of implementation; (c) prohibition of formula price contracts could make price making needlessly expensive, and enforcement would be difficult; (d) establishing related futures markets might help in some situations; (e) computerized or teletype centralized pricing systems may become a useful tool if the high initial development costs and reluctance of market participants can be overcome; (f) improvements via committee price determination are somewhat doubtful; and (g) more complete market reporting would be helpful only where lack of information effectively restricts market arbitrage or entry. Raikes concludes that the most promising prospect would involve organized spot exchanges that would permit centralized pricing and direct movement of the commodity, subsidized if necessary.

The panel discussion of research priorities involves three different perspectives. Mueller suggests many persons believe thin markets in agriculture present a public policy problem because they will not concede that it is inevitable that we have the same kind of thin markets in agriculture that we have in most industrial markets. Also, he feels that the balance of power among market participants is more equal in industrial markets, so fewer people worry about pricing equity in those markets than in agricultural markets where many small producers and processors are involved.

Mueller strongly urges the use of the industrial organization framework in analyzing information systems and their structural and performance implications, and the structural forces leading to thin markets and consequent pricing inefficiency. In-depth case studies of the evolution of markets over time, or comparative studies in different geographic areas are endorsed to determine the causes and consequences of thin markets, the improvements that could be made, and the level of performance relative to society's normative standards.

In contrast, Farrell is less methodologically oriented, urging research efforts to develop useful evaluation measures and apply them to alternative exchange arrangements and various types of government intervention in markets. Economists are encouraged to evaluate the losses and gains associated with the development of thin markets, including who gained and who lost, the nature of the trade impediments contributing to thin markets and feasible means of dealing with them. In addition to earlier suggestions, Farrell listed some industry restructuring efforts by government as possible thin market remedies to be evaluated, including firm dissolution or withdrawal from designated activities (e.g. no packer feeding of livestock), government promotion of new private entrants in a business (e.g. cooperatives), or government entry into business itself (e.g. Tennessee Valley Authority).

Commissioner Dunn, as a regulator, expresses concern with the accuracy and validity of reported cash market prices so valid comparisons can be made with futures prices in situations where market manipulation may be present. He indicates further research is needed to determine the interrelationship between futures markets and cash markets, the direction of causation, whether futures market prices adequately reflect true expectations of supply and demand, and the influences of futures markets on the performance of cash markets. He feels that more research intended to improve the general level of understanding of cash and futures market interaction is necessary not only for effective regulation of current law, but to determine which criticisms of the role of speculators or futures markets are justified, and what policy changes might be appropriate.

We are left with an amalgamation of thoughts from the symposium papers and discussion which can be summarized in the following way. Yes, Virginia, there are concerns about thin markets in the food industry, some legitimate, but some where thin markets are blamed for prices too low or too high and a thin market is the undeserving "fall guy". While there are difficulties in diagnosing the causes of markets becoming thin, and evaluating the gains and losses to various market participants and society, this is a research field which could be productively cultivated. The growing concerns voiced in many parts of the food industry, and the variety of policy proposals being advanced suggest the need for better understanding of the evolution of thin markets, and better evaluation of the likely consequences of private and public policies to deal with the symptoms or causes of thin markets. While the Symposium helps to bring out some of the issues and relevant theoretical considerations, we continue to be faced with the challenge of furthering our understanding of the dynamics of thin markets, and evaluating related problems and proposed remedies in those segments of the food industry where thin market concerns abound.