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Thinning Markets in U.S. Agriculture

What Are the Implications for Producers and Processors?

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What Is the Issue?

U.S. agricultural production is growing more concentrated or *thin* (few purchasers, low trading volume, and low liquidity), reviving longstanding tensions between producers and processors and raising concerns that producers may not be getting a fair price due to less competitive market conditions. According to economic theory, processors who have market power (little competition) could increase their profits by simply lowering the prices they pay to producers. There have also been concerns that low trading volume and liquidity in thin markets could lead to heightened price volatility due to impaired price transparency and price discovery (how new information about supply and demand affects market prices). Reduced price transparency also complicates USDA's efforts to administer price support and crop insurance programs in thin markets.

Furthermore, contracting and vertical integration are growing more popular than traditional cash markets for thin commodities, leading to additional questions of fairness to producers. Alternative exchange mechanisms like these lead thin markets to provide less data for market observers and regulators to use, analyze, and publish, so producers are left to wonder whether they are being paid a fair price in a shrinking cash market or in bilateral contracts.

What Did the Study Find?

Despite sharply increased concentration in many U.S. agricultural markets, most research finds that it has had negligible price impacts. Even in shortrun theoretical models, greater concentration does not necessarily mean significantly lower prices to producers. Most agricultural processors are forward looking; they consider their profits over the medium and long run. Therefore, processors have substantial incentives to form mutually beneficial, long-term relationships with producers and to pay at least the price that would be generated by a competitive market. This keeps their favored suppliers in business and ensures efficient processing and a stable supply of outputs for their own buyers.

In addition, the increased coordination between producers and processors afforded by bilateral contracts reduces costs of production and opportunity costs of inputs, and transmits more information about consumer demand than traditional cash markets. Both of these outcomes increase total returns to producers and processors.

Although forward-looking processors have strong incentives to pay at least a competitive price, the lack of transaction transparency in thin markets can lead to suspicion by producers, who have access to far less information than processors. This lack of transparency also complicates regulatory efforts to support producers and insure crops, as regulators may not know how much support to offer producers or how to fairly price crop insurance. Financial distress, a declining market, and higher uniformity of farm products also make shortrun profits via market power more attractive to processors (even though this can lead farmers to instead plant alternative crops, degrading longrun processor returns). Additionally, smaller producers can be left behind in thin markets due to the transaction costs associated with contracting and scale economies in production.

Given the efficiency gains afforded by coordination, attempting to impose competition by limiting vertical integration or contracting practices could have negative consequences for producers, processors, and consumers. However, targeted policies to address potential negative effects associated with thinning markets could include: (1) facilitating contracting by establishing a common contracting format in each market that uses clear language to communicate terms, reducing transactions costs and improving the footing of small producers; (2) improving data collection and dissemination of information on prices and price mechanisms, quantities transacted, and the size and number of market participants; and (3) providing production and marketing advice to producers through public extension services.

How Was the Study Conducted?

This report describes the thinning of U.S. agricultural markets and the factors driving that trend, drawing on data from the USDA's Economic Research Service and National Agricultural Statistics Service. It also reviews academic literature for evidence of market power among commodities with few buyers and develops a theoretical model of processor behavior to describe when processors may choose to forego thin market power. Several policy options to address thin market issues are discussed, along with their potential consequences for market participants.