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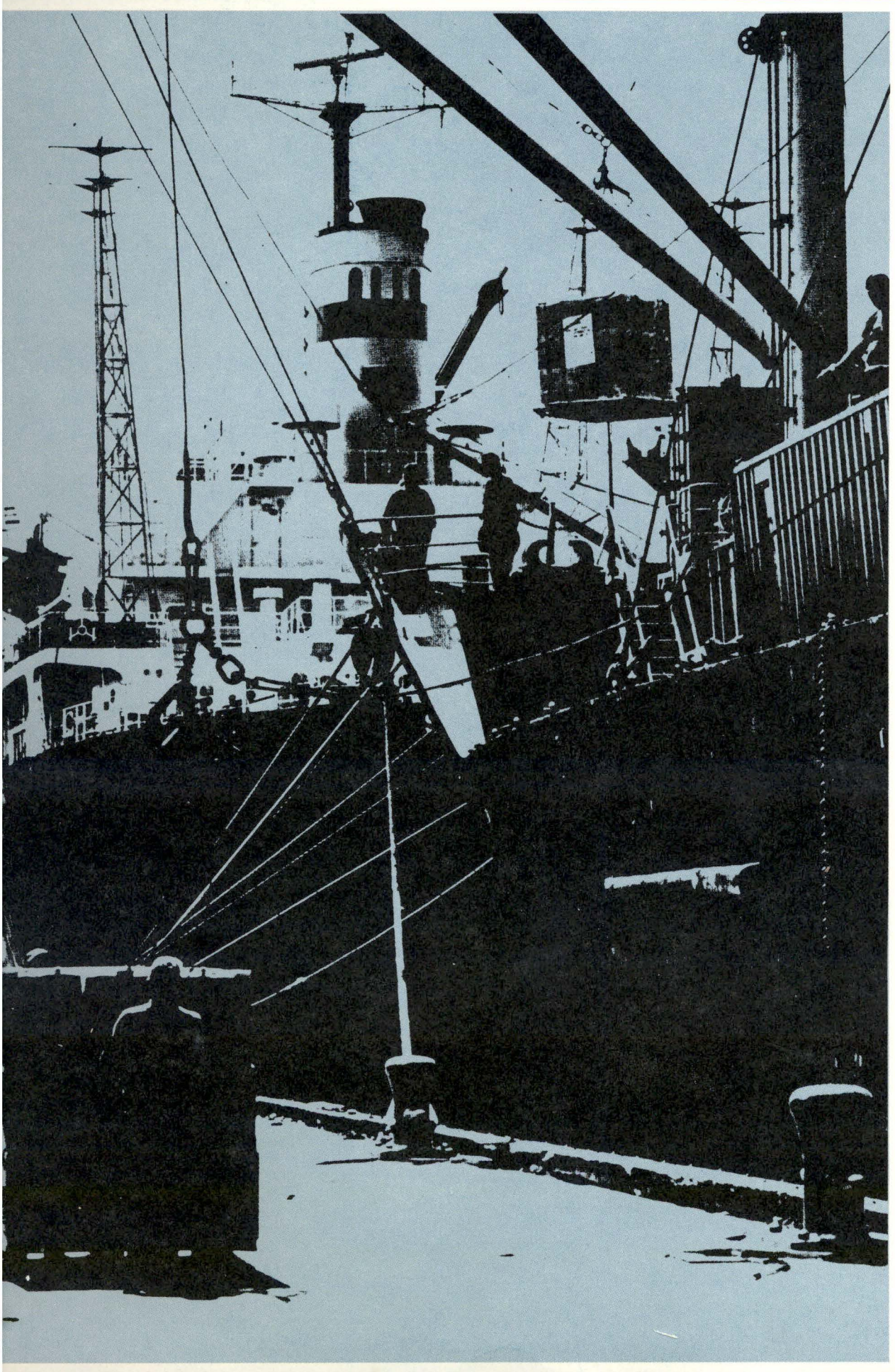
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SPEAKING OF TRADE

Key Issues for Agriculture



Commodity Marketing and World Trade

Norbert A. Dorow, Warren Trock, and Gail Cramer

INTRODUCTION

Agricultural commodities have a worldwide market, and U.S. farmers have a major stake in that market. In 1976-77, the value of our farm exports was equivalent to one-fourth of total U.S. cash farm receipts. Of obvious importance is the market system that facilitates the transfer of the export commodities from U.S. farms to the foreign customers.

The interrelated domestic and export markets influence prices of U.S. export commodities; however, the relative effect of the export market on the price of a commodity depends on the significance of its sales in the foreign market. For example, because a high proportion of U.S. wheat is exported, the U.S. domestic price is closely related to the world trading price. On the other hand, for specialty commodities such as vegetables, the domestic market dominates the price because only a small share of total production is exported.

Agricultural trade involves a complex system of communication and market services to transfer commodities from U.S. farms to foreign buyers in distant places such as Tokyo, Rotterdam, and Bombay. This publication covers (1) the market channels for U.S. farm exports, (2) the role of credit and financing, and (3) pricing U.S. farm commodities in the export market.

MARKET CHANNELS IN U.S. AGRICULTURAL TRADE

International trade in agricultural and other commodities is made possible by people, institutions, and facilities functioning together to assemble, transport, and distribute the traded commodities. Composites of firms, activities, policies, rules, and physical facilities provide the services necessary for the exchange of goods among trading nations. Frequently these facilitating, organizational mechanisms are called marketing channels.

Required Market Functions

The development and use of market channels have been a response to functional requirements of international markets. Exchange has not been possible without assembling raw materials or products, transporting them from points of origin to destinations, storing and handling the goods, financing transactions, and processing all documents and communications necessary to negotiations, agreements, and exchanges.



SPEAKING OF TRADE

Traders use procurers, processors, financiers, salesmen, transport agents, and others who may be their own employees or their agents by contract. Inasmuch

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as governments are involved in trade relationships, inspectors, negotiators, facilitators, and sometimes policemen participate in trading activities. All these market agents are channels for effective management of trading activities. They have evolved or been created, out of necessity, to perform functions that are essential to international trade.

Marketing Channels, General

In agricultural trade various marketing channels exist for exporting the hundreds of different kinds and forms of U.S. agricultural commodities. These channels are described briefly in the following sections.

For grains and oilseeds, which account for about two-thirds of the value of total U.S. agricultural exports, the unique marketing channels are described in a separate section.

From the exporter's point of view, it is useful to think of marketing channels as "direct" and "indirect." Direct channels are employed by an exporter to sell directly to overseas buyers. They may be the exporter's employees, traveling abroad or located in an overseas branch, or they may be manufacturers' representatives who work via contract for the exporter. Indirect channels are international trade middlemen, who work in various ways to facilitate sales of an exporter's products. A very general classification of trade-facilitating agents and activities follows:

Direct channels:	Indirect channels:
Exporter's salespeople	Export/import commis-
Agent and distributors	sion houses
Exporter's branch	Export/import
offices	merchants
Licensed foreign	Export/import brokers
manufacturers	Export houses or
	trading firms

Direct Channels. When deciding to sell directly to foreign customers, the exporter may organize an export department within the home business organization or establish a branch office in the country or region where the product will be sold. The exporter may employ sales people who will work out of the export department, traveling abroad and contacting potential customers, or hire foreign representatives who will work out of the branch office.

The exporter may be represented in foreign markets by agents or distributors whose function is to promote the sale of the exporter's product. Most agents or distributors represent more than one exporter and handle several product lines. An agent solicits orders for the exporters he or she represents and sends them along to be filled.

When opening a branch office the exporter ordinarily employs citizens of the foreign country or region as the sales people and managers. Their responsibilities are not only sales but processing of orders, servicing of products sold, and promotion of new business. A large volume of foreign sales usually is necessary to justify a branch office.

Not unusual is the licensing of a foreign processor or manufacturer to produce and market the product of a U.S. firm. An example might be a formulator of live-stock feeds who markets a unique product that can be effectively produced and sold by a foreign firm.

Indirect Channels. Commission houses were very active in the early development of foreign trade, and in the late nineteenth century they handled the bulk of U.S. exports. Although they are not now as important, they still represent small importers and exporters whose foreign trade is not sufficient to justify employment of sales people, agents, or distributors.

Merchants buy and sell for their own accounts, maintaining stocks of goods at home or abroad to assure prompt deliveries. But, as in the case of the commission house, merchant trading exists today mainly as a function of a multiple-function trading firm. Merchant trading has been combined with the commission house function as well as with construction manufacturing. Exceptions are import merchants who buy specialty items, including food products, for wholesale and retail trade.

Brokers, by definition, function to bring together buyers and sellers. They are found more often in the trade of raw products, such as sugar, coffee, grain, and wool, which are bought and sold on commodity exchanges.

Export houses or trading firms are the dominant international marketing middlemen. They ordinarily engage in both export and import activities and perform the functions of commission houses, export agents, import merchants, and brokers. These export houses or trading firms often have evolved from a single-function activity, as need and opportunity have dictated. They may own producing and processing enterprises, transport systems, banks, and brokerage houses. The export house now is often recognized as a multinational mercantile concern engaged in international trade.

Trading Firms and Sales Agreements

The various types of trading firms, described under marketing channels, provide the functions to facilitate foreign trade. An important function in an export sale is the sales agreement with the foreign buyer. The agreement will specify items including:

- (1) Quantity, quality, and grade of product.
- (2) Terms of sale — the price of the product and who bears the costs of shipping, insurance, etc. For example, if sold F.O.B., "free on board," the seller pays all costs including loading the vessel. If sold C.I.F., "cost, insurance, and freight," the seller pays all costs until unloaded at the foreign port.
- (3) Terms of payments.
- (4) Date and place of delivery.
- (5) Product guarantee and method of dispute settlement.
- (6) Other responsibilities of buyer and seller.

The trading firms provide the communication link between the buyer and seller to formulate the sales agreement to complete the commodity transfer.

Marketing Channels, Grains

As the United States is the world's largest exporter of feed grains, wheat, and oilseeds, each year millions of tons move through marketing channels from U.S. farms to foreign buyers around the world. These commodities are exported through the private sector by trading firms.

Five large trading firms account for about 85 percent of U.S. exports of grains and oilseeds. A number of smaller firms and several grain cooperatives handle the other 15 percent of U.S. grain and oilseed exports. The five large firms are multinational companies, two of them U.S. corporations and three foreign corporations. These large firms are highly diversified businesses that maintain sales and procurement offices in a number of countries. They have access to or control of the many functions required in procuring, handling, selling, financing, and delivering these commodities to buyers around the world. They are highly competitive firms that buy and sell commodities without respect to country of origin.

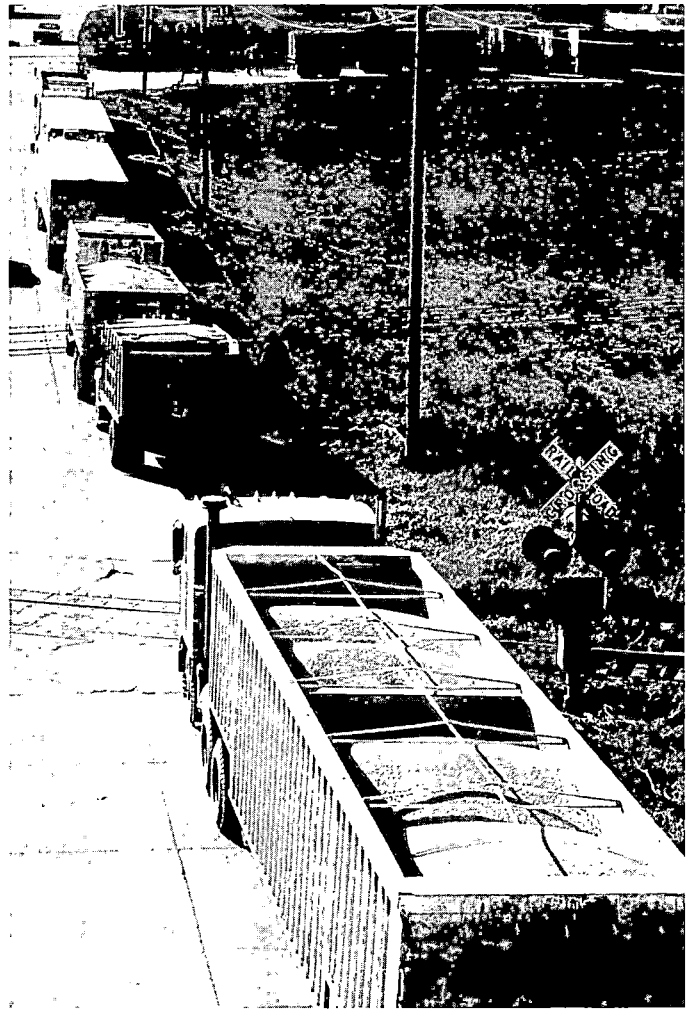
Several large cooperatives handle grain and oilseeds for export. A large proportion of these grains are delivered to a U.S. port, then sold to one of the international trading firms for selling to foreign buyers. However, cooperatives control some grains from point of origin to the port in the importing country.

The internal marketing channels of importing countries differ from country to country. The large international trading firms may sell U.S. grains to private trading firms such as in the European Economic Community or to government agencies such as the Japanese Food Agency or the Soviet International Grain Trading Agency.

A grain sale by a large trading firm to a foreign buyer requires an involved process. A prospective foreign buyer requests an offer for a specified quantity and quality of grain for future delivery at a specified time. Before making a bid, the trading firm considers the futures price, world situation, grain outlook, costs of ocean transportation, competition, available supplies, and all procuring costs. The exporting firm then cables a C.I.F. or F.O.B. offer for delivery at the time specified. If the bid is accepted or accepted after further negotiations, the trading firm may hedge the sale in the futures market and begin accumulating the grain at the best possible price or it may have an inventory on hand. It also tries to minimize handling and storage costs, bargains for the best possible deal on ocean transportation, and arranges for completing the sales agreement. Some firms may own their own ships. The exporting firm assumes the risks in the forward commitment to deliver.

FINANCING AND CREDIT

An obviously important aspect of international trade is financing the sales of products to foreign buyers. These sales often require credit. Financial needs for export sales are large. For example, a single shipload of soybeans (2 million bushels) would require financing of more than \$10 million for the time required



to accumulate, ship, and deliver to the buyer's port. Because some buyers require credit beyond delivery, payment terms are stretched out over several months or even years, causing financial requirements to multiply.

International Commercial Payments

Five classes of international commercial payments are important in completing international transactions. They are (1) cash, (2) open account, (3) bills of exchange, (4) letters of credit, and (5) special terms of payment.

Cash is both a method of remittance and a term of payment. Cash may be used under circumstances such as when the importer's credit standing is unknown, when unsettled conditions exist in the importer's country, or when the exporter may not be able to extend credit. Most banks involved in international transactions, whether in the U.S. or foreign countries, have deposit accounts abroad so that funds can be moved easily.

Under the open account, goods are shipped without payment documents except for the commercial invoice. This method is limited in use and usually is extended only to customers of indisputable credit standing.

The bill of exchange is the most common payment method in international trade. Also known as a draft,

the bill of exchange provides evidence of obligation and arrangement for payment that is agreeable to buyer and seller. The procedure followed in developing a draft is:

- (1) A seller draws a draft calling upon the buyer to pay or accept for payment a designated sum at a specific future time.
- (2) The buyer indicates acceptance by an acknowledgment written across the face of the draft.
- (3) With that, the draft becomes a trade acceptance. The draft also includes documents covering shipment, insurance inspection certificates, certificates of origin, and other terms of sale.

When the letter of credit is used as a method of payment, drafts are drawn upon a bank rather than upon an importer. These bank drafts provide greater security when attached to transactions that employ letters of credit. The authorizing letter of credit includes documents specifying the terms of the agreement.

Special terms of payment often are arranged for particular transactions. At times, exporters have been asked to accept bonds in payment for shipments when financial crises have occurred that affect payment capabilities of foreign firms or governments. And some international trade is financed by barter transactions. An exporter sometimes takes foreign currency for his merchandise. The foreign currency then must be spent

on goods in the foreign country if that currency is not convertible into the seller's currency. In other cases, goods are swapped, usually in quantities corresponding to the ratio of their prices. The Soviet Union and other Communist countries engage in such trading.

Credit in International Trade

Financial credit is vital to our exports of agricultural commodities. Importing firms or countries need credit from their own sources or outside sources to finance (1) the importing transaction to bridge the time between the order or delivery of commodities, depending on the terms of trade agreement, and the sales of the imported goods, and (2) the purchase and later sale of imported goods. The affluent countries and importing firms require credit for the first purpose, financing the transaction. Less developed countries (LDC's)¹ require the second kind of credit. Special terms and loans are especially necessary for sales of agricultural commodities and other goods to the LDC's.

Most large exporting concerns in the United States facilitate extension of credit to customers. They sell goods, using drafts with extended payment dates, letters of credit with extended payment provisions, and other similar payment devices, and they accept foreign currencies, buy back foreign products, swap products, etc. Extension of credit is costly and must be reflected in prices and pricing policies, but it is a necessary function and contributes greatly to our foreign sales.

Private capital often is not available to finance export sales, particularly where large political risks are involved or when the sale depends on long-term financing. Several lending programs supported by the U.S. government have been developed for such situations.

The Export-Import Bank of the United States was formed with government funds in 1938 as the principal agency of the U.S. government in international finance to help create better markets for U.S. products. The Export-Import Bank helps finance export sales of both agricultural and industrial goods on an intermediate-term basis. It is associated with the Foreign Credit Insurance Association which provides credit insurance and guarantees that are supportive of commercial credit facilities. The Export-Import Bank gives further support to U.S. exports by making loans to (1) foreign buyers and (2) commercial banks involved in making loans to foreign customers.

The Commodity Credit Corporation of the U.S. Department of Agriculture supports export of agricultural commodities by making intermediate-term (6 to 36 months) loans to foreign buyers. These loans are extended primarily to firms or governmental agencies in LDC's.

The U.S. also has an important program to finance agricultural exports to LDC's on a long-term concessionary basis under Public Law 480. In addition to providing for a short-term food need, this program is



¹ Countries where the gross national product is low, generally below \$500 to \$600 per capita.

expected to help strengthen the economies of the recipient nations so that they eventually will become eligible for commercial credit in international trade.

Credit in Sales Promotion

Though credit often is necessary to export U.S. agricultural commodities, we have not developed the liberal credit policies of some of our competitors. The reason seems to be that the U.S. has not needed to do so to develop a comparatively large volume of overseas business. But, if we are to expand our exports significantly, perhaps considering our growing petroleum imports, we may need to extend credit to more customers and liberalize our credit policies. This issue will be decided in the political arena and will likely require further governmental involvement in trade negotiations.

PRICING OF FARM EXPORT COMMODITIES

What factors affect the export prices for wheat, soybeans, cotton, animal products, fruits, vegetables, and all other agricultural commodities that the U.S. sells to foreign buyers? In the complex international trading arena, does the market system reflect a competitive price to U.S. producers?

Because the United States is a relatively open-market economy and a major world supplier of agricultural commodities, both domestic and international factors influence agricultural product prices in the United States. The major factors underlying U.S. prices for agricultural commodities include:

- (1) demand and supply situation worldwide,
- (2) market structure of the industry,
- (3) U.S. agricultural policies,
- (4) agricultural policies in other countries, and
- (5) exchange rates.

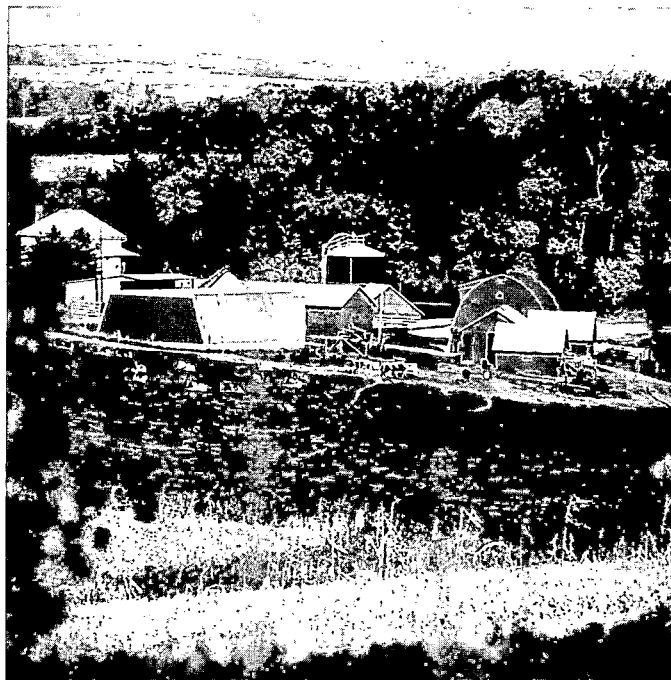
Each factor will be discussed in turn, because each influences the welfare of many customers and producers throughout the world.

Demand and Supply Situation

Assuming a relatively competitive industry, demand and supply forces determine prices. If demand increases relative to supply, prices will increase. On the other hand, if supply increases relative to demand, prices will decrease. Most agricultural commodities are highly sensitive to change in supply, that is, a relatively small change in supply causes a relatively large change in price.

Prices of agricultural commodities change rapidly because the factors underlying demand and supply constantly change. Some of the more important variables that influence the level of demand for U.S. farm commodities are price of substitute products, foreign production, government policies, and growth rates in population and incomes.

The most significant factors that cause changes in supply, other than a change in commodity prices, are changes in prices of inputs, improvements in production technology, changes in prices of imports, and

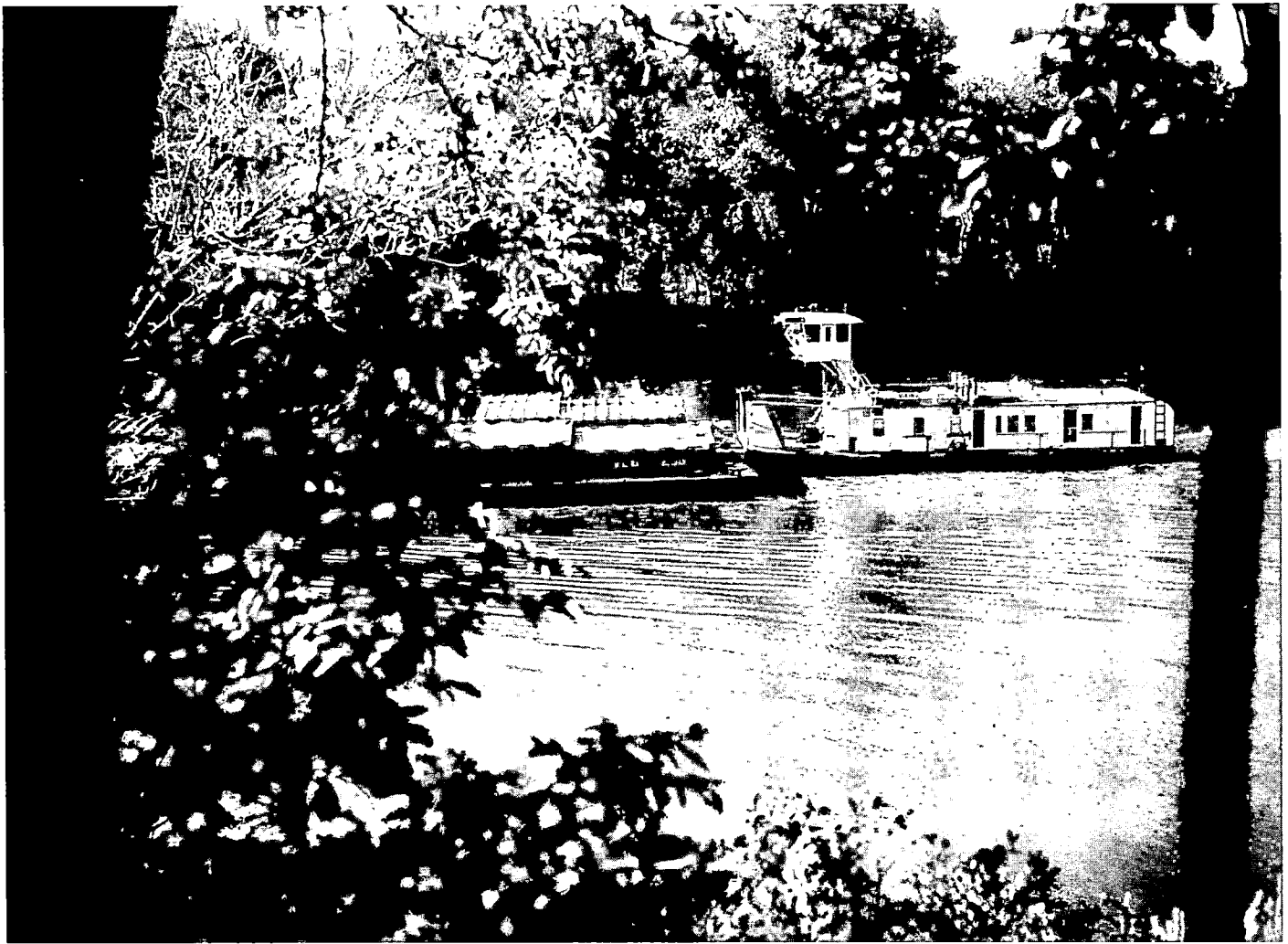


variation in weather and disease conditions. For major export commodities such as grains, soybeans, cotton, and others, changes in world supply have a direct effect on U.S. supply-demand balance and on commodity prices.

In a market economy, the interaction between demand and supply determines market price. When factors that determine demand or supply change, the market price of the commodity also changes. The grain market over the past 5 years illustrates how the U.S. market reflects changes in supply and demand. In 1972-73, total world grain production dropped because of adverse weather conditions. Russia had a poor crop and became a major grain buyer and U.S. export sales to other countries also increased. U.S. grain reserves dropped. As a result, grain prices in world trade nearly tripled. In 1976-77, however, world grain production hit record highs and world trading prices dropped sharply.

Market Structure

Although demand and supply have a major influence on agricultural commodity prices in world trade, all commodity prices are not determined in competitive markets. Factors other than demand and supply influence the prices of many products. In some commodity markets with few buyers or few sellers, the products are uniquely differentiated by the producing firm, or barriers to market entry (such as a large investment in merchandising programs) limit competition. In imperfect markets such as these, individual firms or a government-sanctioned producer agency may have some control over product prices, usually by manipulating supply. The coffee market is an example of this type of market structure. An obvious example in nonagricultural commodities is the OPEC oil cartel.



Most agricultural commodities are produced and traded over a wide geographical area and have many substitute products available. This reduces the possibility of controlling commodity prices. However, the particular market environment for a commodity affects the degree of possible price manipulation. The agricultural policies of the U.S. and other countries can have a pronounced effect on market prices in agricultural trade.

U.S. Agricultural Policies

Since 1929, the U.S. has followed domestic agricultural policies that affect world trading prices of some commodities. In recent years, as U.S. exports have dominated world trade of grains, soybeans, and cotton, our agricultural policies have had a significant effect on trading prices. For a current example, grain and cotton acreage reduction programs reduce supply relative to demand and enhance market prices. The U.S. grain reserve program reduces current market supplies. The P.L. 480 program that provides aid for exports to low-income countries increases demand relative to supply thereby strengthening prices. Also, the U.S. nonrecourse loan rate on grains establishes a "floor" under the U.S. price which also provides a protective price for competing export countries. On the

other hand, the target price payment on grains encourages production which tends to weaken prices. U.S. agricultural policies that affect supply or demand of major export commodities also influence the trading prices of these commodities.

Agricultural Policies of Other Countries

Almost all countries enact internal agricultural or food policies to protect to some degree their farmers and consumers from world market price fluctuations. The European Community (EC) has a high price support program that encourages production in the EC, discourages consumption, and reduces imports from other countries. Its policy to subsidize exports of surplus commodities increases the supply in world trade which reduces prices. The net impact of the EC variable levy system is an increase in the supplies of commodities which exerts downward pressure on world prices outside the EC, even though EC prices are maintained at high levels.

Other countries restrict their domestic consumption of imported commodities through tariffs, quotas, or nontariff barriers. These impediments to free trade similarly reduce domestic consumption, increase world supplies, and reduce trade volume resulting in downward pressure on world prices.

Exchange Rates

The exchange rate is the number of units of one currency that is exchangeable for a unit of another currency. The U.S. dollar-West German mark rate of exchange can be expressed by saying that 1 mark equals 40 cents, or equivalently that \$1 equals 2.5 marks. An appreciation of the mark to 50 cents is equivalent to a depreciation of the dollar to 2 marks. A country's competitive trade position and a number of other economic variables directly influence exchange rates.

The exchange rate affects the prices of commodities bought and sold in international trade. As an illustration, assume that a U.S. dollar equals 2.5 marks. For 15 marks or \$6, a German flour miller can purchase 1 bushel of wheat. If the dollar depreciates to equal 2 marks, the German flour miller can buy that U.S. bushel of wheat for only 12 marks. Therefore, the depreciation of the dollar makes U.S. commodities cheaper for foreign buyers whose currency has appreciated. The final result is that U.S. exports should increase with a depreciated dollar, putting upward pressure on U.S. commodity prices.

Where Is the World Market Price Determined?

The buyer and seller negotiate prices of agricultural commodities traded internationally based upon market information developed from markets all over the world. For instance, a grain sale to Russia may be based on the futures exchange quotation in the United States at a specific time, adjusted for quality, location of shipment, transportation, insurance, etc. As such, there is not one world market price but many prices that have been adjusted for quantity, quality, location, or other terms of sale. Some of the conditions of sale include policies on use of American ships, political goals of the United States, and credit terms. These conditions vary widely.

An individual trader cannot possibly collect complete knowledge of world market conditions. Although the major multinational firms operating in geographically dispersed markets throughout the world have access to many sources of information, they find it impossible to cover all market conditions worldwide. Therefore, firms engaged in international transactions tend to rely on just a few markets for price information. These markets usually are located at major export or consumption regions and in major production regions. An economist states that, "Grapefruit prices in Florida, Texas, Arizona and California tend to reference the prices determined in the Indian River region of Florida. World gold prices reference the London gold price. Milk pricing in the United States is determined in the Minnesota-Wisconsin surplus production region, playing a dominant role in Federal milk marketing orders across the country."

In the grain industry, futures markets provide the reference pricing points. These relatively competitive markets reflect worldwide demand and supply conditions through knowledgeable traders. Grain exporters can forward price grain from the futures market

quotations through hedging operations. These prices, however, must be adjusted to reflect transportation, shrinkage, insurance, handling, brokerage commissions, inspection and weighing, interest on inventory, and quality of grain. The particular price would depend on the terms of sale, whether sold F.O.B., C.I.F., or other terms.

Commodity Pricing Issues

As indicated in previous sections, U.S. public policies influence prices of some major export commodities. Thus, these policies are issues subject to debate.

Loan Rates and Target Prices. When prices have been depressed under excess supply conditions, proposals have been made to raise commodity loan rates. However, if this loan rate were above the "world trading price," it would discourage exports. In past times when domestic prices were protected above world prices, the U.S. government made up the difference with an export subsidy. If the higher price encourages excess supplies relative to demand, some type of production adjustment program is needed.

The target price provision for some commodities allows the market price to be competitive in the world market, but the producers receive government payments for the difference between the world price and the higher target price. The target price encourages domestic production, but the lower world price encourages domestic and foreign consumption. The total result is an increase in U.S. exports and a lower world price.

Reserve Stocks. Buffer stocks and/or grain reserves are designed to reduce large fluctuations in grain prices and provide emergency food aid. There is little international agreement on which countries should contribute and hold a reserve and pay for storage costs. The U.S. grain storage reserve program acts as a buffer stock and improves price stability. However, producers do not all agree with this policy, because the stocks tend to dampen price rises when production is short.

Cartels. A debated issue has been the possible formation of a wheat cartel composed of the major wheat exporting countries, the U.S., Canada, Australia, and Argentina. The countries in the cartel would make joint decisions regarding marketings and prices.

The objective of the cartel would be to raise world trading prices for wheat. Such an agreement is difficult to enforce because of the different marketing systems, economic and political goals, costs of wheat production, storage capacity, and other factors in the participating countries. Higher world trading prices would encourage production not only in the four countries but also in some other wheat producing areas. This would mean the need to control supplies in each of the countries participating in the cartel. Experience and failures in the past under the International Wheat Agreement have identified these problems. International trade agreements are discussed in more detail in the publication, "International Marketing Alternatives."

COMMENTS

U.S. farmers produce for a world market. About one-fourth of the value of total farm output is exported to foreign buyers. Therefore, it is very important that the export market system provides for an efficient transfer of commodities at prices that reflect current world supply-demand conditions.

The market channels in U.S. agricultural trade, as described earlier, provide for the many market functions required to sell in international trade. These channels include direct selling through a firm's export department and indirect selling through market intermediaries, such as trading firms, commission houses, and export merchants. This market structure is a competitive system comparable to our domestic markets. This implies absence of monopoly pricing in our export market channels.

In the complex international trade arena, the term "world trading price" is more descriptive than "world price" for most commodities. Major importing countries such as Japan and the member nations of the European Community protect their domestic farm commodity prices at levels substantially above the world trading prices influenced by supply and demand. U.S. farm policies, including provisions for loan rates, grain reserves, acreage reductions, and related programs, also influence the world trading prices of basic commodities.

The market structure (including the market channels) that serves U.S. agriculture in international trade is responsive to the continuously changing world supply-demand conditions. However, the related agricultural and trade policies of major trading countries prevent the development of an open competitive agricultural world market.

A special note of thanks to the steering committee members and others who reviewed and contributed to the development of the six publications. Mary E. Ryan, associate professor, Department of Agricultural and Applied Economics, University of Minnesota, made many helpful comments. The role of the Foreign Agriculture Service, USDA, in the development of these publications is gratefully acknowledged. The foreign travel study opportunities sponsored by FAS, USDA, in 1977 permitted many of the authors and steering committee members to broaden their trade knowledge through firsthand observation and experience.

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A note of appreciation to Alex McCalla. His guidance and counsel have shaped the nature and content of these materials as well as the earlier *Speaking of Trade: Its Effect on Agriculture*.

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Reference Handbook Available:

Speaking of Trade: Its Effect on Agriculture, National Public Policy Education Committee Publication Number 6, may be obtained from your state Cooperative Extension Service. Single copies are available for \$1.50 per copy and may be ordered from the Agricultural Extension Service, University of Minnesota, Room 3 Coffey Hall, 1420 Eckles Avenue, St. Paul, Minnesota 55108. Order Special Report No. 72. Prices for quantity orders are available upon request.

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