Agriculture: issues of the past resurface

The past year marked a return to conditions in the agricultural sector that closely parallel those prior to 1973. Agricultural production rose to a record high, boosting "reserves" to levels comparable to the "surpluses" experienced in the late sixties and early seventies. Increased output dropped net income per farm—adjusted for inflation—to levels more typical a decade ago. Lower earnings coupled with record-high production expenses and debt-servicing obligations rekindled concerns about farmers' "tight cash flows" similar to past concerns about the "cost-price squeeze." A "farm strike" late in the year enhanced public awareness of the deterioration in farm income but probably will have no more impact on prices than past "withholding" efforts. New legislation in 1977 propelled the federal government back into a major role in supporting farm earnings at potential costs likely to surpass previous highs. The return of government has brought a number of programs—such as "set-aside acreage" and "extended Commodity Credit Corporation (CCC) loans"—that embody features similar to programs of a few years ago. These parallels may ultimately be judged as the bridging of a time span during which the farm sector experienced a major debt-financed boom in capital expenditures and land values that may result in particularly difficult adjustments in the years ahead.

Expanded government role

A sagging farm economy, a new Administration, and expiring legislation covering such diverse areas as the Food Stamp Program, the Food for Peace Program, and the various farm commodity programs made 1977 a bellwether year for agricultural policy developments. The Administration undertook several measures—many of which were ultimately incorporated into new legislation—to prop up the farm economy. Congressional deliberations also indicated an overwhelming desire for an increased government role in supporting the farm sector. Although the debate was wide-ranging, the compromise was struck in the omnibus four-year Food and Agricultural Act of 1977, which was signed in late September.

The new act retained the basic provisions for supporting agricultural commodity prices but mandated substantially higher levels of support. Loan rates—which establish effective floor prices—for 1977 and 1978 crops of corn were boosted to $2 per bushel, up from the 1976 rate of $1.50 per bushel. Direct government payments to wheat producers in 1977 were 17 percent higher than would have been the case had the new legislation not amended the expiring act.

A major feature of the new act was the authorization for a long-term wheat and feed grain reserve program. The program is currently designed to accumulate 25 million metric tons of grain in farmer-controlled storage facilities. Farmers who participate in the program receive three-year CCC loans on the stored grain plus a payment to cover storage costs. Overall, these and other provisions of the new act materially expose the federal budget to increased costs if the farm economy continues to be saddled by huge stocks. Although projections vary, the U.S. Department of Agriculture has estimated that the various farm programs covered by the new act will cost $6.4 billion annually.

Farm earnings decline despite increased government support

Farm earnings from commercial market sources declined markedly in 1977, particularly for grain farmers. Although the composite of farm commodity prices averaged only 2 percent lower, prices of feed grains and food grains declined 20 percent. Prices received by farmers for oil-bearing crops—primarily soybeans—provided a partial counterbalance, averaging about one-fifth higher in

1977. Prices of meat animals—mostly cattle and hogs—averaged 1 percent lower in 1977.

A larger volume of marketings and a marked increase in government support operations cushioned the overall decline in net farm earnings despite the lower prices. Cash receipts from farm marketings in 1977 were virtually unchanged from the year-earlier level of $94 billion, even though net proceeds from crops placed under loan with the Commodity Credit Corporation—which are counted as market receipts—were up $3.5 billion. Total gross farm income, at an estimated $106 billion, was up about $2 billion from the year-earlier level, with about one-half of the gain due to the rise in direct government payments to farmers. Since the increase in gross farm earnings offset only one-half of the estimated $4 billion rise in production expenses, net realized farm income fell to about $20 billion last year, down nearly $2 billion from 1976.

Last year's marked decline in grain prices sharply lowered returns to most District grain farmers but improved operating margins of livestock producers. Returns to dairy farmers were high throughout 1977, buoyed by lower feed costs and increased production. Earnings of hog producers remained at a relatively high level for the third consecutive year despite somewhat lower hog prices. In contrast, the prolonged financial squeeze on cattle feeders continued throughout most of 1977, although losses narrowed appreciably late in the year.

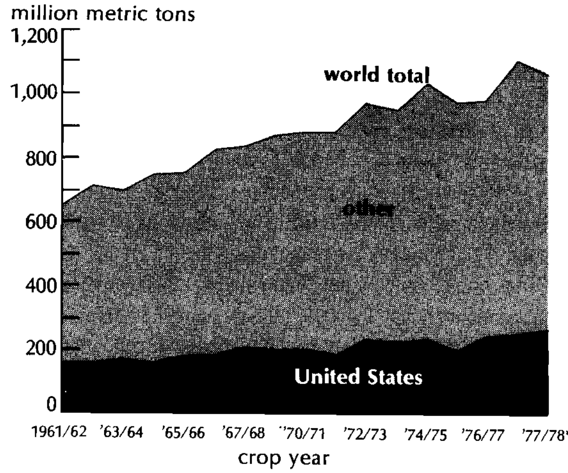
Earnings of District crop farmers were sharply reduced by last year's drop in grain prices. The extent of the reduced margins, however, hinged largely on the crop mix of individual farmers, the extent of weather-related crop losses, and farmers' land costs. Soybean prices were exceptionally high during the first half of 1977, offering excellent returns to farmers who had stored their 1976 crop. On the other hand, drought conditions over the past two years reduced the quantity of crop marketings during 1977 for a number of District farmers. Returns to corn farmers in 1977 were generally sufficient to cover all non-land costs of production. But returns to those whose production came largely from acreage purchased during the height of the land boom, or those who cash-rented most of their land, were severely squeezed.

Last year's sag in farm earnings was evident in a number of related developments. Although purchases of grain storage facilities were strong, overall capital expenditures by farmers slowed appreciably. Most evident was the decline in farm machinery and equipment purchases. Unit retail sales of farm tractors declined 6 percent last year, while combine sales dropped 11 percent. The reduced farm earnings in 1977 also ended the boom that had led to a near-tripling in District farmland values during the four and one-half years that ended in mid-1977. Surveys conducted by the Federal Reserve Bank of Chicago found that District farmland values, on average, stabilized during the latter half of 1977. Nevertheless, large increases during the first half were sufficient to hold year-ending 1977 farmland values more than one-tenth above the ending 1976 level.

Among all the various developments related to last year's decline in farm earnings, perhaps the most evident was the deterioration in credit conditions. Farmers' cash flows tightened substantially in 1977—particularly during the third quarter—reflecting lower grain prices, continuing losses to cattle feeders, and the increased operating expenses that were associated with the record agricultural output in 1977. Repayment rates on farm loans slowed considerably as a result. Renewals and extensions of existing farm loans rose sharply, as did refinancings of short-term debt with longer maturities. Simultaneously, the demand for new loans remained at a very high level. Among District agricultural banks, the strong farm loan demand outstripped reasonably large increases in deposits and resulted in substantially tighter liquidity positions. Loan-to-deposit ratios at District agricultural banks, for example, averaged more than 62 percent at the end of last year, nearly 4 percentage points above the high year-earlier level.

The deteriorating credit situation was also reflected in the national increase in farm debt. Preliminary estimates indicate total farm

Consecutive bumper grain harvests offset earlier calamities . . .



*USDA estimates.

debt rose to nearly $120 billion by the end of last year, marking a huge increase that in a historical perspective was uncharacteristic for a year of declining farm earnings. In dollar terms last year's increase of $16 billion in farm debt was almost double the average for the preceding five years, while in percentage terms the increase marked a level exceeded in only two other years since World War II.

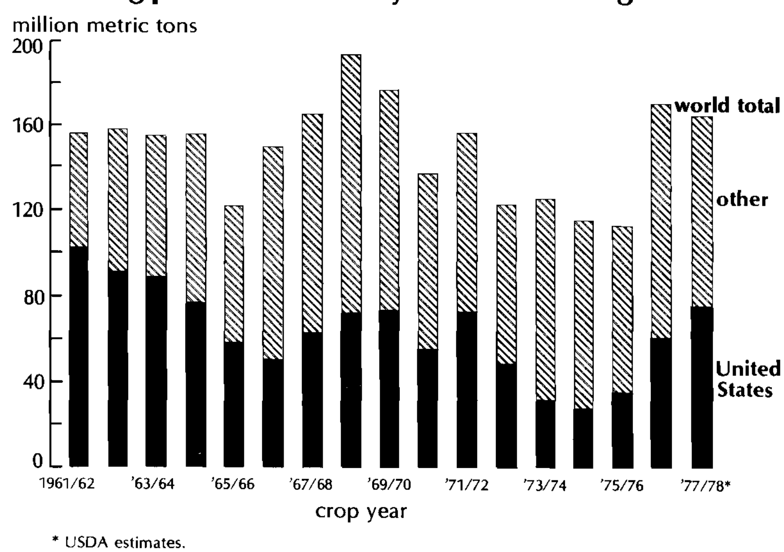
Last year's increase in farm debt culminated a five-year period during which farm debt rose more than four-fifths. In comparison, cash receipts from farming rose by only a half, while net realized farm income in 1977 was only slightly more than one-tenth above the 1972 level. These disproportionate growth rates coupled with the rebuilding of grain stocks and prospects that grain prices will closely parallel government support prices over the near term suggest the financial health of the farm sector will likely be a continuing concern this year.

Food and commodity review

Retail food prices increased more than originally expected last year, in spite of lower farm commodity prices. The upward pressures were largely concentrated within the first half, when escalating prices of imported foods were joined by fruits and vegetables reflecting the winter freeze in Florida. Overall, food prices in grocery stores averaged 6 percent higher last year, with more than half of the rise due to higher prices for fish, coffee, and other imported foods. Retail prices of domestically produced farm foods averaged about 2 percent higher as increased costs of processing and distribution more than offset the drop in raw material prices.

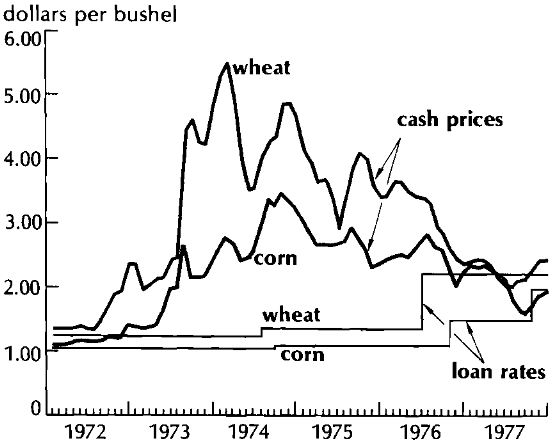
Upward pressures on retail food prices are expected to continue in the current year. The bulk of the pressures will likely be evident in processing and distribution costs, which account for two-thirds of the $180 billion spent by consumers for U.S. farm foods in 1977. Labor alone accounts for one-half of the processing and distribution costs, and in 1977—for the first time—labor surpassed raw food material costs to become the largest component of the consumer food dollar. This year's increases in the minimum wage and social security withholdings may accelerate

. . . easing pressures on carryover stocks of grain . . .



* USDA estimates.

. . . and driving U.S. grain prices down to CCC loan rates



labor costs, while increases in energy prices will have an impact on most other processing and distribution costs.

Dairy producers continued to expand production last year, encouraged by comparatively low feed prices and an increase in the support price of manufacturing grade milk from $8.26 to $9 per hundredweight last spring. Preliminary estimates indicate total milk production exceeded 123 billion pounds, up 2.5 percent from the year-earlier level and the highest annual output since 1965. The output was well in excess of the lackluster consumer demand, forcing large government purchases of manufactured dairy products in order to maintain the higher support prices. Net CCC purchases of manufactured dairy products in 1977 exceeded 6 billion pounds (milk equivalent)—a fivefold increase from the previous year and a level exceeded in only two other years since 1965.

Prospects for dairy producers look favorable again for 1978. High milk/feed price ratios are expected to lead to another increase in production. Support prices, by mandate of the 1977 act, will likely be raised again in April of this year, which would assure higher milk prices to dairy farmers. Although there has been some evidence of a pickup in commercial sales, the gain is not likely to offset the gain in production. Hence, government support purchases of manufactured dairy products will remain at exceptionally high levels during the current year.

Total meat production in 1977—including red meat and poultry—slightly exceeded the 1976 record. Beef production declined nearly 3 percent, even though fed cattle slaughter rose 3 percent last year. The overall decline in beef production permitted choice steer prices to average about $1 above the $39 per hundredweight registered in 1976. Slaughter of cows and nonfed steers and heifers declined, but remained at a relatively high level because of drought and prolonged losses to cow/calf operators. In conjunction with the high level of cow and nonfed steer and heifer slaughter in recent years, the 1977 calf crop fell to the lowest level since 1970, and the year-end inventory of all cattle and calves declined to an estimated 118 million head, down from 123 million a year earlier and the 1974 peak of 132 million head.

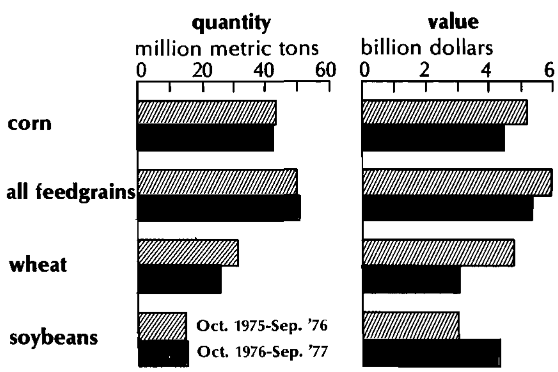
Hog slaughter in 1977 fell short of expectations, but nevertheless exceeded the year-earlier level by 5 percent. The increased pork production pushed average annual hog prices in 1977 about $2 per hundredweight below the 1976 level of $43. Despite the decline, favorable operating margins encouraged a buildup in the inventory of hogs held for breeding purposes, portending further increases in pork production for the current year.

Meat production trends in 1978 are expected to parallel the 1977 experience. Beef production, despite prospects for increased fed cattle marketings, might decline roughly 5 percent if the reduction in nonfed slaughter reaches current expectations. At present, the vastly improved moisture situation, increased feed supplies, and prospects for higher feeder cattle prices all support expectations for a marked decline in nonfed slaughter. Despite lower beef output, pork production is expected to be up about one-tenth, which coupled with larger poultry production portends total 1978 per capita meat supplies about equal to the highs of the past two years. Within this scenario cattle prices are expected to average somewhat higher during the current year, while hog and poultry prices will likely average considerably lower.

Grain supplies were in general abundance last year, due largely to record domestic and worldwide harvests in 1976. Nevertheless, adverse weather conditions provided ominous indications that the large harvests might not be repeated in 1977. Internationally, harvests in the Soviet Union, China, and the Southern Hemisphere were hampered by drought and other weather problems. Domestically, weather concerns were so widespread in 1977 that approximately three-fourths of the agricultural counties in the United States were declared a disaster area—and, hence, eligible for government and assistance loans—at some point during the past year. Winter fruit and vegetable production was reduced by a killing frost in Florida. A summer drought sharply lowered crop production in the Southeast. Drought in the West raised dire predictions of a crop failure in California. Critically low moisture supplies were a major concern in the Midwest and Plains States from the fall of 1976 until widespread showers began to alleviate the situation late last summer.

Despite the widespread weather concerns, increased use of irrigation coupled with timely rains during the growing season contributed to a record domestic harvest. Preliminary estimates indicate the index of all crop production rose to 129 (1967=100) in 1977, up from the previous high of 122 in 1976. Among individual crops, new record highs were established for corn and soybeans. Wheat production, on the other hand, declined about 5 percent from the 1976 high, but was still sufficient to meet projected needs.

Soybeans partially offset lackluster year for grain exports in fiscal 1977



The large 1977 crop harvest will be a major influence on crop prices through most of the year ahead. Exports and domestic utilization of grains and soybeans are expected to rise during their respective 1977/78 marketing years. Nevertheless, total utilization is not expected to match last year's record harvests, portending further accumulation of domestic carryover stocks. In general, carryover stocks of wheat and corn are expected to reach the highest levels since the mid-sixties, while soybean stocks may again approximate the relatively burdensome level experienced in late 1976. Barring another round of adverse weather patterns, these large stocks will likely hold 1978 corn prices close to the loan support rate of $2.00 per bushel and push soybean prices well below the 1977 average of nearly $7 per bushel.

Crop plantings in 1978 are again expected to be very large, despite the reintroduction of "set-aside" programs, which will remove some acreage from production. There will be some shift in acreage devoted to major crops due to changed price relationships. Current prospects point to reduced wheat and cotton acreage and increased soybean plantings. Corn acreage may decline slightly if set-aside provisions—as tentatively announced—remain in force. Overall prospects for large plantings, coupled with the vast improvement in moisture conditions, provide an initial foundation for assuming 1978 crop harvests may again be large. As usual, however, weather conditions both here and abroad will play an important role in determining final output and pricing patterns.