FRB CHICAGO

AGRICULTURAL LETTER

FEDERAL RESERVE BANK OF CHICAGO
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New program to cut milk production

Milk production continued to exceed year-ago levels through May, according to USDA reports. However, the production gains are expected to end soon as the government program to cut milk production that began in April begins to have an effect. This program calls for the slaughter of almost 1.6 million dairy cattle over the 18-month life of the program. The intent of the program is to reduce oversupply in the milk industry and ease the burdensome government cost associated with the purchase of manufactured dairy products to support prices. While likely to be partially offset by increased output by nonparticipants, the program, along with continued gains in commercial use of milk, is expected to reduce government purchases.

Milk production in the twenty-one major producing states now surveyed monthly by USDA remained above year-earlier levels through May, but by a declining margin. Milk output in these states—which account for about 85 percent of U.S. production—totaled 11.2 billion pounds in May, up 3 percent from a year ago. The latest gain was considerably smaller than the 8 percent year-over-year increases registered in January and February, indicative of the dampening affects on milk production from the whole-herd Milk Termination Program (MTP) that started in April. Nevertheless, the May figures pushed year-to-date milk production to more than 52.5 billion pounds for the 21-major states, up 5.8 percent from the comparable period in 1985.

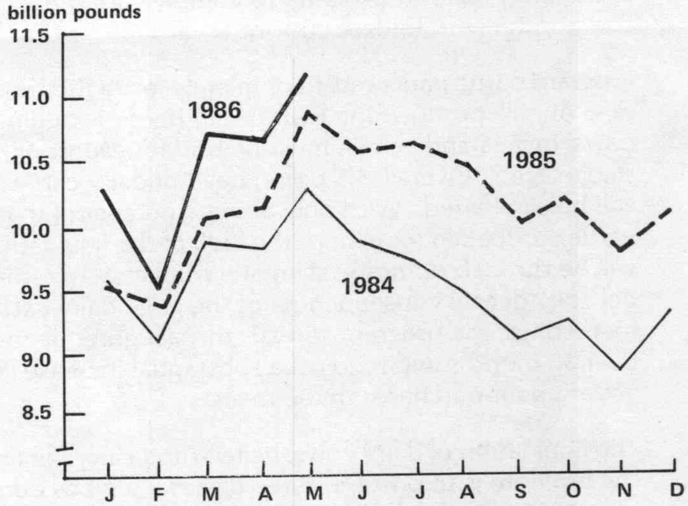
The five states in the Seventh Federal Reserve District exhibited a similar production trend through the first five months of 1986. Milk production in District states during May remained almost 4 percent above last year, while output during the first five months of 1986 was more than 6 percent above the comparable year-earlier period. Year-to-year production gains were reported in each of the District states for the 5-month period, ranging from 3.8 percent in Michigan to 8.4 percent in Iowa. Milk output in Wisconsin, which is the nation's leading producing state and accounts for almost two-thirds of District milk production, recorded a 6.5 percent year-to-year gain through May.

The increase in milk output so far this year is attributable to both greater productivity per cow and—until recently—a larger dairy herd. Output per cow in the 21 surveyed states has ranged from 3 percent to 4.5 percent above year-earlier levels so far in 1986. The increased output per cow stems partly from lower feed costs which represent the bulk of variable cash expenses in milk production. The lower feed costs have encouraged dairy farmers to step up concentrate feeding, which—in turn—has boosted average milk output per cow.

Although declining 2 percent since the beginning of the year, the number of milk cows on farms held above year-earlier levels through April before dropping slightly below last year's level in May. The downtrend in the number of milk cows, particularly in more recent months, is attributable to the liquidation of dairy cows held by farmers enrolled in the whole-herd Milk Termination Program. Although the liquidation began in late March, the bulk of the decline in cow numbers has occurred since the start of the program in April.

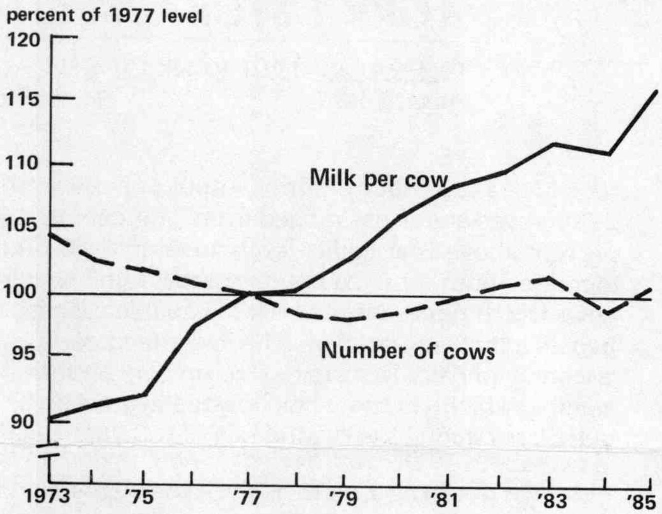
The whole-herd Milk Termination Program was authorized by the Food Security Act of 1985. It was designed to cut U.S. milk production by 12 billion pounds in an effort to reduce the excess production capacity in the dairy sector. Under the program dairy farmers submitted bids that represented the reimbursement they would accept from the government in exchange

Gains in milk production continued in May*



*Data are for production in 21 states.
SOURCE: USDA.

Trends in number of dairy cows
and milk per cow



SOURCE: USDA.

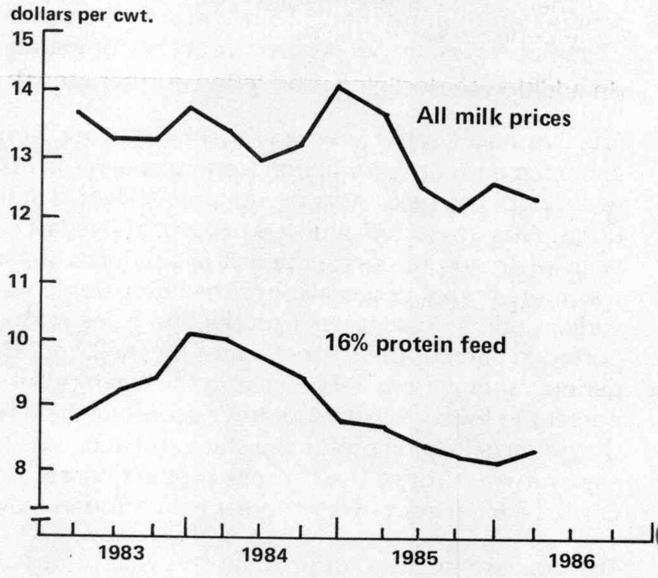
for disposing of their dairy herds and staying out of the dairy business for five years. Bids were accepted from 14,000 dairy farmers that accounted for 8.7 percent of all milk marketed by dairy farmers in 1985. The bids ranged from $3.40 to $22.50 per hundredweight of base production and averaged $14.88 per hundredweight. Participants will receive government payments equal to their bid for each hundredweight of production. Total government payments under the program will exceed $1.8 billion, spread over 5 years. Approximately 37 percent of that total will be funded by assessments on the marketings of milk by farmers who remain in dairying. For the first six months of the program, the assessment will be 52 cents per hundredweight of milk. Of that, 40 cents represents the statutory assessment to fund a portion of the MTP. The remaining 12 cents represents the approach used in the dairy support program to comply with the Gramm-Rudman budget cuts for fiscal 1986.

Program participants must completely leave the business of milk production. Entire dairy herds, including cows, heifers and calves, must be sold for export or slaughtered. Overall, 1.6 billion head of dairy cattle will be eliminated. With only about 6 percent of these cattle earmarked for export, the bulk of the liquidation will be through domestic slaughter markets. To temper the adverse consequences of the large dairy cattle marketings, the program spreads the slaughter period over 18 months and requires a substantial increase in government purchases of red meat.

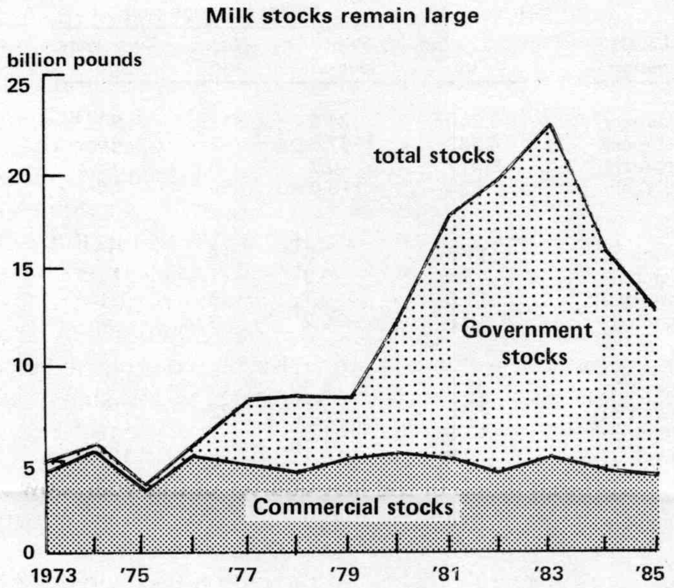
The liquidation of dairy cows, heifers, and calves under the program is to occur in three disposal periods during the 18 months of the program. A schedule of producers' initial disposal intentions for dairy cattle to be slaughtered under the MTP indicated that about two-thirds would be liquidated by the end of the first disposal period (August 31), 15 percent in the second disposal period (September-February, 1987), and the remaining 18 percent in the third disposal period (March 1987-August 1987). However, to lessen the effect of the large liquidations in the first period, participating dairy farmers were subsequently allowed to shift some scheduled first-period marketings into later disposal periods. In line with this, dairy farmers have petitioned to shift roughly 15 percent of planned first-period marketings into later disposal periods. A large share of the shift will probably come out of the bulge in planned August 1986 marketings and be shifted into the second disposal period.

Through much of the first quarter of this year, cow slaughter was only nominally above year-earlier levels. But since the onset of the MTP, cow slaughter has moved sharply higher. In the nine weeks ending May 31, federally-inspected slaughter of all cows exceeded the year-earlier level by 25 percent. Slaughter of dairy cows was up 68 percent, accounting for all the year-over-year gain in total cow slaughter in that period. The surge in dairy cow slaughter has undermined cattle prices and accounted for a significant portion of the continuing year-to-year gains in beef production. Reflecting the latter, dairy cow slaughter—although constituting less than 12 percent of all cattle slaughter—accounted for 80 percent of the more than 6 percent year-over-year rise in total cattle slaughter during the nine weeks ending May 31. With MTP scheduled marketings of dairy cattle expected to abate in June and July, gains in total cattle slaughter

Milk and dairy feed prices
have trended down



*All milk price unadjusted for deductions. 16% protein dairy feed price estimated for Q1 1986.
SOURCE: USDA.



*Year ending stocks.
SOURCE: USDA.

will narrow this summer. Nevertheless, latest USDA estimates suggest that total beef production will exceed year-earlier levels by 3.5 percent in the second quarter and remain close to year-earlier levels in the third quarter.

With the continuing movement of dairy cows to slaughter under the MTP, milk cow numbers for the next several months will lag well below the rising levels of a year ago. The decline in cow numbers is expected to offset continued gains in output per cow and lead to lower milk production. Recent estimates from the USDA suggest that milk production for all of 1986 will be about 1 percent higher than in 1985. Given the gains through May, this suggests that milk production for the June-December period will be down more than 2 percent from a year ago.

In addition to declining production, further growth in commercial disappearance of milk will also help to ease the dairy surplus. In the first four months of this year commercial disappearance of milk was up 4 percent from the same period a year ago. The latest increase follows gains of about 3.5 percent in both 1984 and 1985. With continued economic growth and moderate changes in retail prices of dairy products, commercial use is expect to continue to exceed year-ago levels, averaging 2 to 4 percent higher for all of 1986.

The continuing gains in commercial disappearance and the scaling down in milk production has already led to a slowing in government support purchases of dairy products. In the first quarter, CCC purchases of dairy products—the mechanism for maintaining the support price of milk—exceeded the year-earlier level by 23 percent. Preliminary readings for the second quarter show that CCC purchases were unchanged from the rising year-earlier level. For all of 1986, the USDA now projects that CCC purchases will drop about 19 percent from the 13.2 billion pounds (milk equivalent) purchased in 1985. If that is the case, CCC purchases during the second half of this year will be down about 70 percent from the same period a year ago. The anticipated milk equivalent of CCC dairy product purchases for this year would represent about 7.4 percent of projected milk production. In 1985, CCC purchases represented 9.2 percent of production.

The improving balance between milk production and commercial disappearance may also lead to higher milk prices in the second half of this year. In the first half, milk prices received by dairy farmers trended seasonally lower and averaged $12.15 a hundredweight, down from $13.10 a year earlier. For the second half, analysts are looking for milk prices to rise 30 to 70 cents a hundredweight from the June lows of $11.90.

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Selected Agricultural Economic Indicators

	Latest period	Value	Percent change from: Prior period	Year ago	Two years ago
Receipts from farm marketings *($ millions)*	February	10,340	-24.6	-12	-11
Crops*	February	4,389	-47.3	-2	15
Livestock	February	5,317	-0.7	-8	-9
Government payments	February	634	118.6	-56	-66
Real estate farm debt outstanding *($ billions)*					
Commercial banks	March 31	11.8	3.8†	14	22
Federal Land Banks	March 31	43.4	-2.9†	-11	-11
Life insurance companies	February 28	11.6	-0.7†	-5	-8
Farmers Home Administration	March 31	10.8	0.2†	3	9
Nonreal estate farm debt outstanding *($ billions)*					
Commercial banks	March 31	33.9	-4.5†	-11	-13
Production Credit Associations	March 31	13.0	-7.5†	-22	-31
Farmers Home Administration	March 31	17.8	-1.3†	7	15
Commodity Credit Corporation	March 31	19.8	14.1†	98	125
Farm loans made *($ millions)*					
Life insurance companies	February	44	42.7	7	-46
Interest rates on farm loans *(percent)*					
7th District agricultural banks					
Operating loans	April 1	12.36	-2.7†	-8	-11
Real estate loans	April 1	11.70	-4.7†	-12	-13
Commodity Credit Corporation	June	6.50	0.0	-26	-43
Agricultural exports *($ millions)*	April	2,120	-11.6	-22	-33
Corn *(mil. bu.)*	April	58	-40.8	-66	-67
Soybeans *(mil. bu.)*	April	80	-9.4	33	17
Wheat *(mil. bu.)*	April	65	-12.3	-15	-38
Farm machinery sales^{p} *(units)*					
Tractors, over 40 HP	May	4,235	-14.2	-26	-30
40 to 139 HP	May	3,063	-18.2	-40	-31
140 HP or more	May	1,172	-1.6	4	-26
Combines	May	133	-10.7	-72	-70

*Includes net CCC loans.
†Prior period is three months earlier.
^{p}Preliminary

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