FEDERAL RESERVE BANK OF CHICAGO

AGRICULTURAL LETTER

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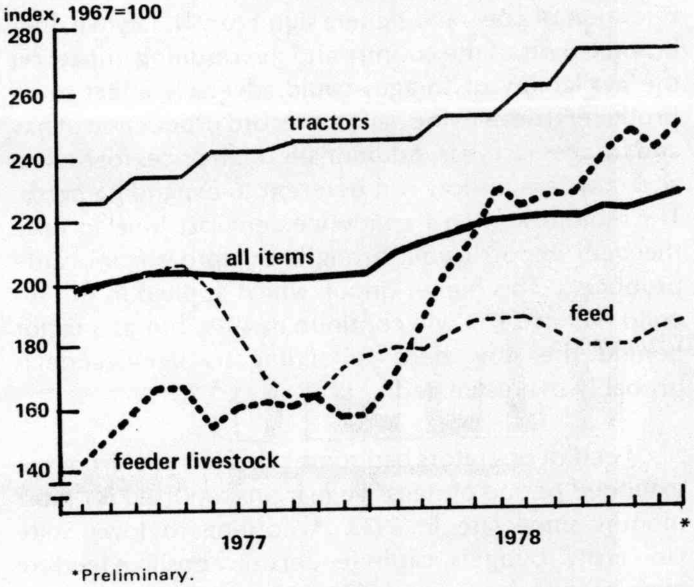
FARM INCOME was up sharply last year, due largely to the improved earnings of livestock producers. Preliminary estimates indicate net farm income before inventory adjustment surged to about $26 billion in 1978. That was up nearly $6 billion from the year before, the highest level since 1974, and the third highest on record. Unlike a year ago, when widespread concerns regarding the financial positions of farmers cast a shadow over the outlook for agriculture, farm prospects for 1979 appear much brighter. Strength in the export market and the livestock sector are expected to contribute significantly to holding net farm earnings in 1979 near last year's level.

Foremost among the concerns of a year ago was the issue of farmers' debt. Reports of lower-than-normal loan repayment rates, needs to refinance short-term borrowings with long-term debt, and instances of farmers needing to carry over operating debt into 1978 were fairly common in the fall of 1977 and early in 1978. However, improvement in farm prices, which began in the fourth quarter of 1977, gained momentum in the spring of 1978, when it became apparent that hog production would fall far short of expectations and that government programs and a Brazilian drought would strengthen crop markets. And because of the implications for earnings, the rise in farm prices contributed to a gradual subsidence of the concerns over farm debt.

The index of prices received by farmers averaged a record high in 1978, surpassing the year-earlier level by roughly 14 percent. Prices of livestock and products were up nearly a fourth while crop prices averaged 5 percent higher. The higher prices and increased government payments boosted gross farm earnings 13 percent to an estimated $122 billion.

Production expenses rose to an estimted $96 billion last year, 9 percent higher than the year before. The largest year-to-year increase was a one-third rise in livestock expenses. This was followed by a 13 percent increase in expenses associated with depreciation allowances, taxes, and interest. Interest expenses of $9.6 billion applied to an estimated total farm debt of $136 billion at year-end. For 1979, overall production expenses are expected to rise another 5 to 10 percent with the largest proportionate increase expected for interest expenses.

Index of prices paid by farmers rose sharply in 1978



Earnings of livestock producers increased more last year than earnings of crop farmers. Dairy farmers' earnings in 1978 benefited from several factors. Milk support prices were raised in April and again in October. With the higher supports and an unexpectedly strong consumer demand for dairy products, milk prices received by farmers averaged 9 percent higher even though government removals of dairy products were down nearly a third. The combination of higher milk prices and favorable feed prices sustained the milk-feed price ratio above corresponding year-earlier levels throughout the year. Also beneficial to dairy farmers last year were the higher cattle prices, which boosted sales receipts both for calves and cull cows. Utility cow prices averaged roughly 45 percent higher last year than a year earlier.

The liquidation of the inventory of cattle and calves, which had been under way since 1974, continued in 1978. The cattle inventory on January 1, 1979, has been estimated at about 111 million head, down 5 million head from the year before. However, most observers feel that the herd rebuilding, expected to begin last year, may be gaining momentum now. And in view of recent price quotes for feeder calves, cow-calf operators clearly have a powerful inducement for expansion. The December price for 400-500 pound choice feeder steers at Kansas City averaged over $78 per hundredweight, almost 80 percent more than the year earlier. For the year as a whole, feeder steer prices averaged nearly $66 per hundredweight, more than 50 percent higher than in 1977.

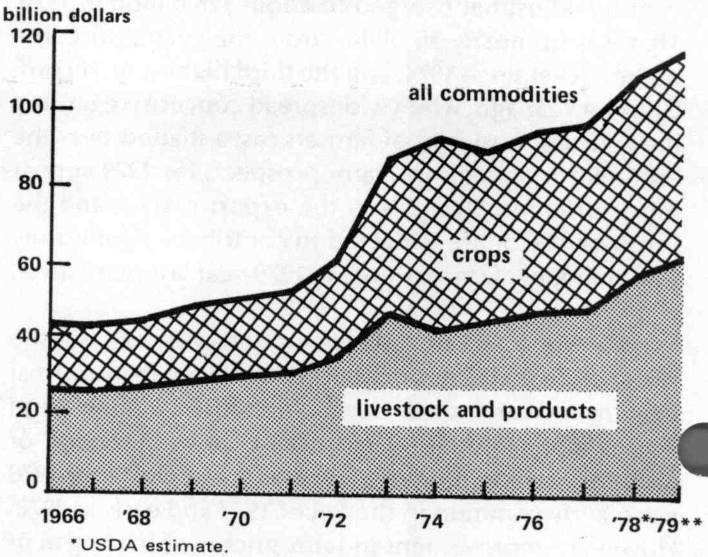
Factors that could retard the herd buildup are weather, prices, and policy developments. These factors, however, are not expected to offset the likelihood for a retention of cows and heifers significantly. Dry weather in some parts of the country and the resulting impact on the availability of forages could adversely affect some producers, despite the nation's record production of hay and forages last year. Additionally, high prices for heifers and cows are a short-run deterent to expanding herds. The Administration's announcement last June to raise the beef import quota brought an uproar from cattle producers. This higher quota, which applied in the second half of 1978, will continue in 1979, but as a factor behind the slow herd rebuilding its significance is probably overestimated.

Feedlot operators had some relief last year from the extended period of negative margins reported for most months since late in 1973. According to Iowa State University budgets, cattle feeders saw positive feeding margins in each month of 1978. Although feed costs were relatively favorable throughout the year, the sharp runup in fed cattle prices was the principal determinant of the enhanced profit picture. Unexpectedly strong consumer demand for beef and the smaller beef production combined to boost retail beef prices to record levels. An estimated 4 percent drop in beef production last year was due to the sharply reduced slaughter of cows and nonfed steers and heifers although the expansion in fed cattle marketings prevented an even larger decline. As a share of the total slaughter mix, fed cattle is expected to rise further in 1979. In light of current feeder cattle prices, however, it seems likely that profits to cattle feeders will be squeezed and that some losses may occur.

Relative to the expectations a year earlier, hog producers' earnings were one of the brightest spots in the farm economy in 1978. A large expansion in pork production for 1978—with a corresponding downtrend in hog prices—was almost an accepted fact in the last months of 1977. But the expansion in hog production failed to materialize for reasons that are still largely unexplained. As a result, barrows and gilts at seven markets averaged above $48 per hundredweight, compared with $41 in 1977. Nevertheless, the long-awaited expansion in hog production appears to be at hand. Therefore, despite the likelihood of a further reduction in beef supplies in 1979, it seems probable that hog prices will be under downward pressures throughout the year.

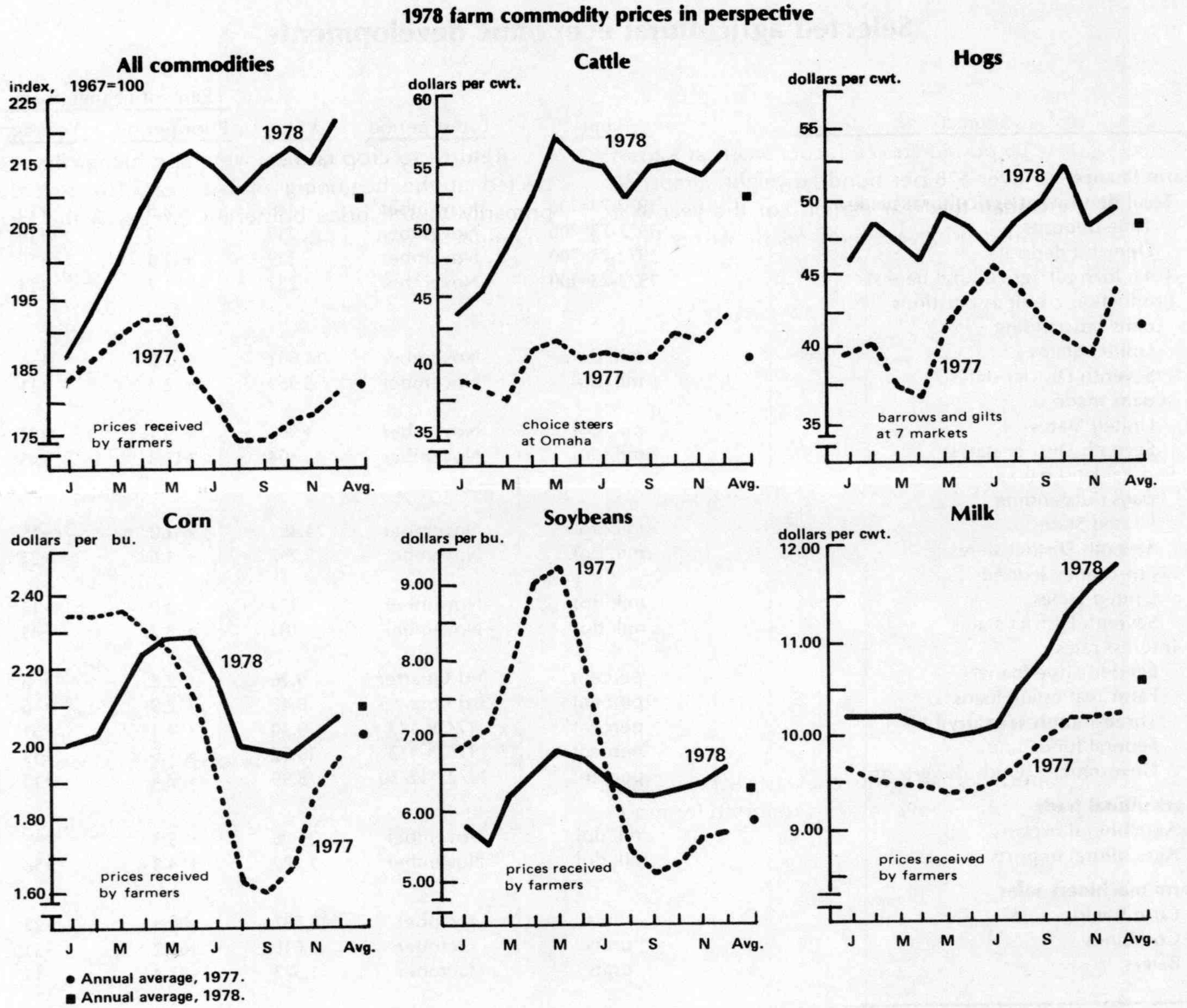
Returns to crop farmers were also higher than expected at the beginning of last year. This was due primarily to the price bolstering effects of the large quantities of grain withheld from free market supplies through government storage programs and the record exports of soybeans and corn. Even so, farm level prices trended lower as the growing season progressed and the prospects for record corn and soybean harvests became clear. The average price received by farmers for corn was only 4 percent greater than the year before, while soybean prices averaged nearly 8 percent lower. Cash receipts to crop producers totaled an estimated $51 billion, 5 percent more than in 1977, and roughly equaled the 1973 record. Nevertheless, 1978 crop receipts were 12 percent less than livestock receipts and, as such, lost the lead held since 1972.

Higher cash receipts to farmers expected in 1979 following last year's sharp rise



*USDA estimate.
**USDA forecast.

The outlook for 1979 farm earnings is generally favorable, but hinges on a number of assumptions. As last year, prospects for agricultural exports will remain sensitive to developments in world production, the exchange value of the dollar, and international trade developments. Effects of the export market on domestic crop prices are significant, but crop prices are also influenced by weather developments, farm programs, and other supply-demand factors. Therefore, while the USDA currently forecasts a slight rise in cash receipts for crops this year, the uncertainties are many this early in the year. One of the first developments to look for will probably be crop progress reports from the Southern Hemisphere. Shortly after that will follow reports of



planting progress in the United States and indications of the level of farm program participation.

Prospects for livestock producers' earnings this year are somewhat more optimistic than those for crop farmers. Cow-calf operators in particular are expected to have a good year. Prospects for lower hog prices in 1979 will be partially counterbalanced by lower beef supplies. Feedlot operators will have to be shrewd in their bidding for feeder cattle this year. Due to the limited supply of feeder cattle, successful price bids may result in thin margins for the finished product, particularly if the surprising strength in consumer demand for beef dissipates in the face of further price rises. Steady to slightly greater milk output and 6 to 8 percent higher average milk prices suggest favorable earnings prospects for dairy farmers again in 1979.

Gains in net incomes of farmers may also arise from the Revenue Act of 1978, enacted November 7. Various tax cuts point to lower income taxes for individuals and corporations. The new law retained the 10 percent investment credit, which was due to revert to 7 percent by 1981. One of the major provisions of significance to farmers was the clarification of the issue concerning the eligibility of investment credit on hog confinement facilities. Swine confinement buildings, milking parlors, and poultry houses were specifically named as being eligible for the credit. Another potential tax savings for farmers stems from the changes in figuring the tax on long-term capital gains. Where half of long-term capital gains were excluded from taxable income before, the exclusion now applies to 60 percent of such gains. Some other changes pertaining to this issue of long-term capital gains, however, could adversely affect some taxpayers.

Don A. Langford
Agricultural Economist

Selected agricultural economic developments

Subject	Unit	Latest period	Value	Percent change from: Prior period	Percent change from: Year ago
Farm finance					
Total deposits at agricultural banks†	1972-73=100	November	189	+ 0.5	+10
Time deposits	1972-73=100	November	219	0	+10
Demand deposits	1972-73=100	November	139	+ 1.8	+10
Total loans at agricultural banks†	1972-73=100	November	233	+ 1.2	+14
Production credit associations					
Loans outstanding					
United States	mil. dol.	November	14,601	− 1.0	+ 8
Seventh District states	mil. dol.	November	2,959	+ 2.3	+11
Loans made					
United States	mil. dol.	November	1,967	+ 9.1	+27
Seventh District states	mil. dol.	November	404	+17.8	+45
Federal land banks					
Loans outstanding					
United States	mil. dol.	November	24,461	+ 1.0	+15
Seventh District states	mil. dol.	November	5,257	+ 1.6	+22
New money loaned					
United States	mil. dol.	November	374	− 3.0	+15
Seventh District states	mil. dol.	November	101	+ 3.2	+45
Interest rates					
Feeder cattle loans††	percent	3rd Quarter	9.26	+ 2.8	+ 6
Farm real estate loans††	percent	3rd Quarter	9.46	+ 2.9	+ 6
Three-month Treasury bills	percent	12/28-1/3	9.30	+ 4.1	+51
Federal funds rate	percent	12/28-1/3	10.62	+ 7.6	+59
Government bonds *(long-term)*	percent	12/25-12/30	8.99	+ 2.4	+13
Agricultural trade					
Agricultural exports	mil. dol.	November	2,806	+ 5.3	+35
Agricultural imports	mil. dol.	November	1,282	+ 4.3	+58
Farm machinery sales					
Farm tractors	units	October	18,537	+86.9	+22
Combines	units	October	8,616	+66.2	+31
Balers	units	October	1,377	−32.4	−15

†Member banks in Seventh District having a large proportion of agricultural loans in towns of less than 15,000 population.

††Average of rates reported by District agricultural banks.

FEDERAL RESERVE BANK OF CHICAGO
Public Information Center
P. O. Box 834
Chicago, Illinois 60690
(312) 322-5112

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INSTITUTE OF AGRICULTURE.
UNIVERSITY OF MINN.
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