1985

Agricultural outlook

THE U.S. AGRICULTURAL OUTLOOK IN A FARM BILL YEAR*

Agriculture is in the midst of difficult times—the most difficult, some would say, since the Depression. These are also uncertain times for U.S. agriculture. Changing economic conditions here and abroad, increasing financial stress on many farms and in many rural communities, and the inability of policy makers to agree on a new farm bill all contribute to this uncertainty. It is in this difficult and uncertain environment that we meet today to discuss the outlook for U.S. agriculture.

This uncertainty contrasts sharply with the outlook four years ago during the last farm bill debate. As the 1980's began, most analysts expected the agricultural economy to continue the bullish growth of the 1970's. Confidence in a growing export market encouraged U.S. farmers to expand cropland by 55 million acres over the decade and to invest $15 to $20 billion per year in capital improvements. The major question was whether or not U.S. agriculture could continue to expand fast enough to meet growing foreign demand.

A rising tide of optimism swept the farm belt, and those of you who attended the 1980 Outlook Conference may remember that the euphoria reached even into USDA's Jefferson Auditorium. The speakers there looked forward to another decade of expansion in world demand for farm products. They reasoned that growth in food demand abroad had outpaced growth in supply for a decade, and would continue to do so. Our farmers were challenged to fill what was expected to be a widening gap through the 1980's and possibly beyond.

The 1981 farm bill was debated and written against the backdrop of this optimistic outlook. Unfortunately, the optimism was soon dashed by global recession. The world economy slowed dramatically, reducing growth in demand for farm products and halting gains in trade. In this bearish world market, the competitive position of American farmers weakened as the value of the dollar rose and other countries expanded their agricultural output. In many cases, the rigid price supports enacted in the 1981 farm bill effectively priced our products out of the world market.

In spite of the sharp drop in exports that resulted, U.S. farm output continued to grow in the 1980's as farmers—responding to program incentives rather than to market signals--made increasing use of the capacity built up over the 1970's. Large stocks accumulated, farm prices and incomes fell in real terms, and farm asset values dropped sharply in both nominal and real terms. Some of our farmers are experiencing serious enough cashflow problems and asset losses to jeopardize their continued operation.

Once again we agricultural economists are playing an advisory role to those responsible for shaping farm legislation. Given what we have learned over the last four years, it is critical that we put today's outlook, as bearish as it may be, into a longer term context and recognize the uncertainties underlying the macroeconomic, trade, and policy areas.

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*Address by Ewen M. Wilson, Deputy Assistant Secretary for Economics, U.S. Department of Agriculture, to the American Agricultural Economics Association Annual Meeting, Ames, Iowa, August 4, 1985.

Let me start, then, by looking at these three areas before dealing in greater detail with developments in the major commodity markets.

The Economic, Trade, and Policy Environment

The Macroeconomic Environment

Macroeconomic developments have grown in importance over the last decade to become a key determinant of the agricultural outlook. Most analysts agree that macroeconomic prospects for the coming year are mixed and will provide only limited support for agriculture. The recovery is expected to strengthen in the second half of 1985 and into 1986 after slowing down considerably in the first 2 quarters of 1985. Growth in income and employment, however, are not expected to match the unusually strong gains reported in late 1983 and 1984 and could lag below the growth normally experienced at this stage of a recovery. As a result, domestic demand for farm products could remain sluggish.

In a more positive vein, most macroeconomists agree that inflation is likely to continue to be weak--possibly below 5 percent through mid-1986. This should minimize any increase in the prices farmers pay for purchased inputs. Interest rates also have declined somewhat, easing pressure on farm interest payments. But with interest rates still high by historical standards and input usage large, 1985 farm production expenses are unlikely to fall much below last year's record level.

It should be noted that there is considerable disagreement about whether the economy will perform as expected. In fact, we would do well to ask ourselves "What if...?" What if our reading of 1985 and 1986 economic growth prospects is overly optimistic--or too pessimistic?

If the economy, in fact, is headed back toward the stagflation of the 1970's, as some would argue, economic growth would grind to a halt. Jobs would be lost and inflation would begin to creep up again. Interest rates would fall initially but would turn up as inflationary expectations were rekindled. The dollar would continue falling from its high point earlier this year, but would probably not stimulate exports enough in the short term to offset weakened domestic demand for farm products. Resurgence of inflation could reverse losses in land values, but income prospects for the farm sector would suffer in the face of weak demand and rising production expenses. Agriculture could be considerably worse off.

Should the economy grow significantly faster than the Administration projects, unemployment would decline further and real per capita disposable incomes would continue to rise. This would boost domestic demand for farm products. In order to sustain increased economic activity, it would be necessary to reduce the Federal budget deficit. Failure to do so would, of course, lead to renewed upward pressure on interest rates and choke off economic growth.

These "What if..." scenarios are raised not so much to disagree with the prevailing macroeconomic outlook but rather as a reminder of the uncertainties involved in forecasting the future. What if the deficit is not brought under control? What does that mean for interest rates, for monetary policy, for the value of the dollar? These are critical questions for agriculture. Unfortunately, there are no easy answers.

The Trade Environment

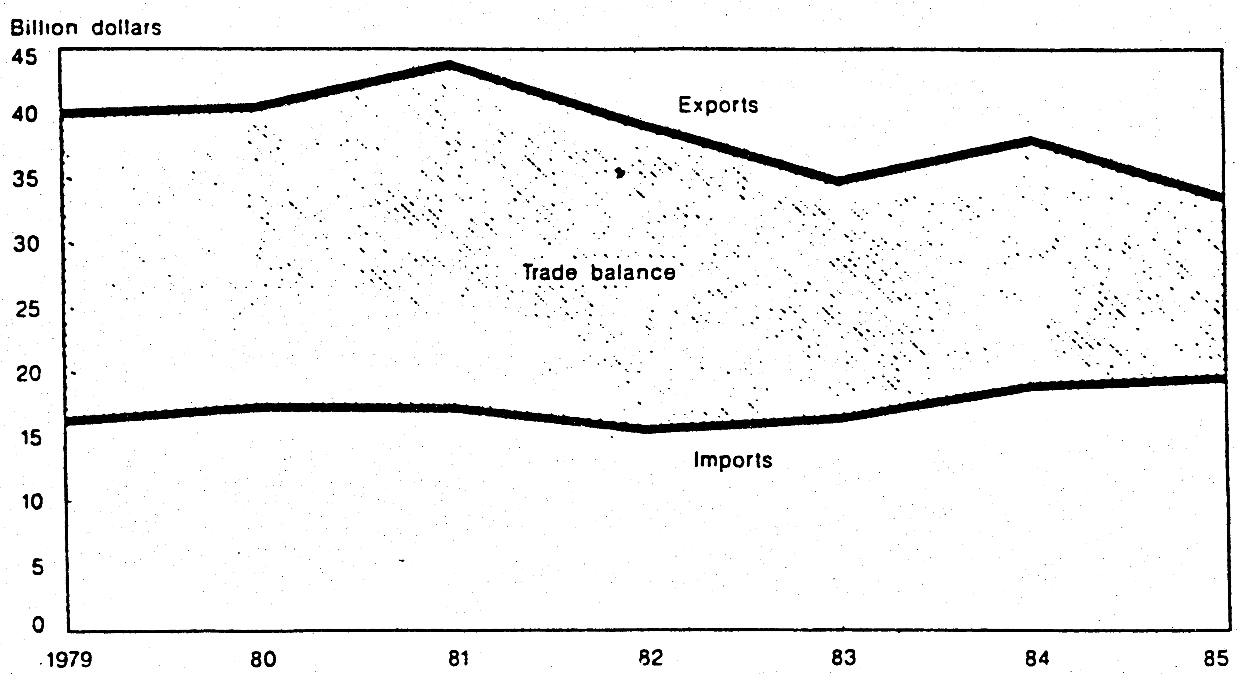
World economic growth is forecast to strengthen over the coming 4 to 6 quarters and, in turn, to boost growth in demand for farm products. This return to more normal growth in demand abroad is likely to generate stronger demand for farm products, particularly in middle income and affluent countries. Hence, even with large supplies and serious financial problems in many of the major importing countries, world agricultural trade is likely to expand in 1985--possibly by 3 to 4 percent--for the first time in 4 years.

It appears unlikely, however, that the United States will be able to capture much, if any, of this increase in trade. Obstacles include a dollar still strong by historical standards, the questionable trade practices of the other exporters, and U.S. commodity prices frozen at support levels above market-clearing prices. Increased production in several of the importing countries this year is also dampening prospects for U.S. grain and oilseed exports. In some cases, rising production has not only cut the import needs of U.S. customers, but has turned them into competitors. New exporters this year include China and India, and the EC will be a net exporter of grains.

In this trade environment, U.S. farm exports in FY 1985 are forecast at $33.5 billion, 12 percent below FY 1984's $38 billion and 24 percent below the FY 1981 peak of $44 billion. Volume is forecast at 137 million tons, a 5-percent decline from last year and down a sixth from the FY 1981 peak. Moreover, a further decline in export volumes and values is possible in FY 1986 as the same forces continue at work.

If export performance proves as weak as we fear, the U.S. farm trade surplus will also continue to erode. Agricultural imports are expanding and our agricultural trade surplus could slip from the FY 1981 record of $27 billion to $14 billion or less in FY 1985 (Figure 1).

1. **Agricultural Trade Balance**



It is important to note that these U.S. export projections assume that the world market will continue to operate smoothly. Many of the major trading countries are currently drifting toward agricultural protectionism as an alternative to making costly adjustments in their domestic farm economies. Any acceleration of this tendency during the coming year could weaken U.S. export prospects further. Equally important, protectionism in the United States is also on the rise. Congress has come under considerable pressure from steel, auto, and textile interests. A move toward limiting foreign access to U.S. markets for non-farm products could weaken our agricultural exports even further as our trading partners retaliate by limiting imports of U.S. food, feed, and fiber. We should not forget that much of the cost of closing U.S. markets to foreign products would be borne by our agricultural sector.

Farm Policy Questions

For farmers, the uncertainties surrounding the next farm bill are as significant as uncertainties in the macroeconomic and trade areas. When farm legislation eventually takes shape, the farm sector will begin to adjust quickly, even though the new programs will not become effective until the start of the 1986 marketing year. While there has been little agreement among policy makers to date, several general themes are emerging.

Both the Administration and Congress recognize that farm policy cannot be tailored to any one view of the future. Most agree that in order to be effective, farm programs will have to be substantially more flexible and more marketed-oriented. Rigid price and income supports set with little or no regard for rapidly changing market conditions reduce or eliminate producer incentives to adjust, especially in the adverse environment farmers have faced so far in the 1980's. This compounds adjustment problems.

There is also widespread agreement that the policies adopted should focus to a greater extent than in the past on enhancing, rather than weakening, the competitive position of U.S. farmers in the world market. With farm recovery dependent largely upon expansion in exports, there is strong support for expanded export promotion, export credit, and in some quarters, export subsidy programs as well. Many also emphasize linking promotion and credit programs to trade liberalization initiatives in an effort to expand the world market faster and improve its operation.

There also seems to be agreement that resource conservation should be tied more closely to the commodity and trade provisions of new legislation. For example, there is strong support for a conservation reserve that would take as much as 30 million acres of the most fragile, erosion-prone land out of production. Many proposals also include "sodbuster" and "swampbuster" provisions designed to discourage cultivation of fragile acreage and wetlands.

Finally, there is wide agreement that farm programs must be affordable. Reducing the deficit is a critical first step toward restoring the health of the farm sector as well as the general economy. Reduced federal borrowing would result in lower interest rates and a more competitively priced dollar, strengthening demand for our farm products and easing upward pressure on input prices.

Crop Prospects

Several common threads run through the outlook for virtually all of the major crop markets. Supplies are large, demand is weak, and prices low (see table). Based on weather conditions at midsummer, it looks like yields will be high enough to guarantee large harvests again this year. And with little likelihood of a strong turnaround in depressed demand for our products here or abroad, stocks are likely to build as the season progresses and prices are likely to remain near loan rates. Of course, bad weather in the next month or two, here or abroad, could easily change the picture somewhat.

Wheat

The U.S. wheat market has been dominated by large crops and burdensome supplies for several years (Figure 2). The situation is likely to continue in the 1985/86 marketing year. Although high rates of participation in the 20-percent acreage reduction program and 10-percent paid land diversion helped reduce 1985 acreage, good weather during the growing season has kept yields high. The 1985 winter wheat harvest is forecast 10 percent smaller than last year but the spring wheat crop may be slightly larger. With sizable beginning stocks, wheat supplies are, therefore, expected to be only 4 percent below last year's record.

Wheat utilization, on the other hand, is expected to decline 10 percent this year. Although domestic use may be down only slightly, disappointing export performance is likely to drive down total use to 1.2 billion bushels—the lowest level in 5 years.

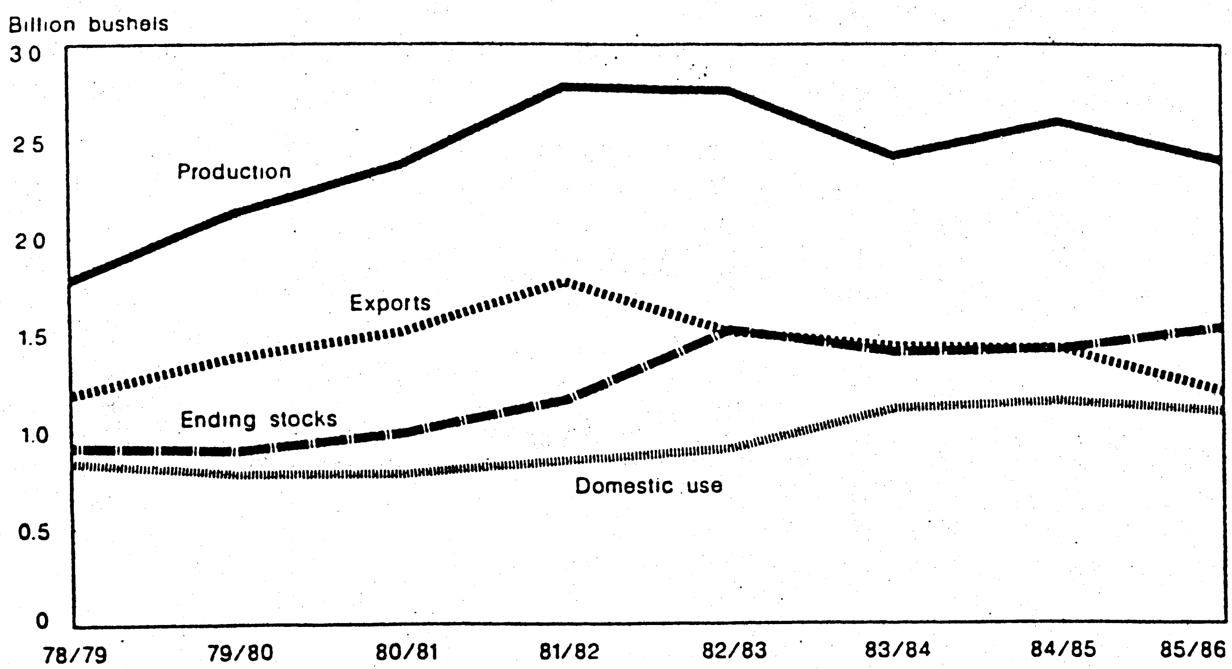
This sharp drop in prospective U.S. wheat exports reflects a number of significant changes in the world wheat market over the last four years. Foreign production has grown 20 percent, with much of the gain coming in

CROP PRICES

	WHEAT	CORN	SOYBEANS	COTTON	RICE
	$/Bu			¢/lb	$/cwt
80/81	3.91	3.11	7.57	74.4	12.80
81/82	3.65	2.50	6.04	54.0	9.05
82/83	3.55	2.68	5.69	59.1	8.11
83/84	3.53	3.25	7.81	66.4	8.76
84/85	3.38	2.65	5.85	58.7	8.25
85/86	3.20-3.40	2.45-2.65	5.25-5.95	1/	7.80-8.80

1/ USDA IS PROHIBITED FROM PUBLISHING COTTON PRICE PROJECTIONS.

2. Wheat: Supply and Use



countries that traditionally import U.S. wheat. China's output, for example, is 50 percent larger now than at the start of the decade and her wheat imports from the United States may be only a quarter of the peak reached in the 1981/82 marketing year. India imported over 1.5 million tons of wheat from the United States four years ago. However, a 25-percent gain in production since has strained India's internal distribution system and 1 or 2 million tons could move into the export market in 1985/86. Projected declines in import demand in the USSR, Brazil, and China and record export availabilities in supplier nations mean keen competition. As a result, U.S. wheat prices are likely to stagnate near the $3.30 loan level.

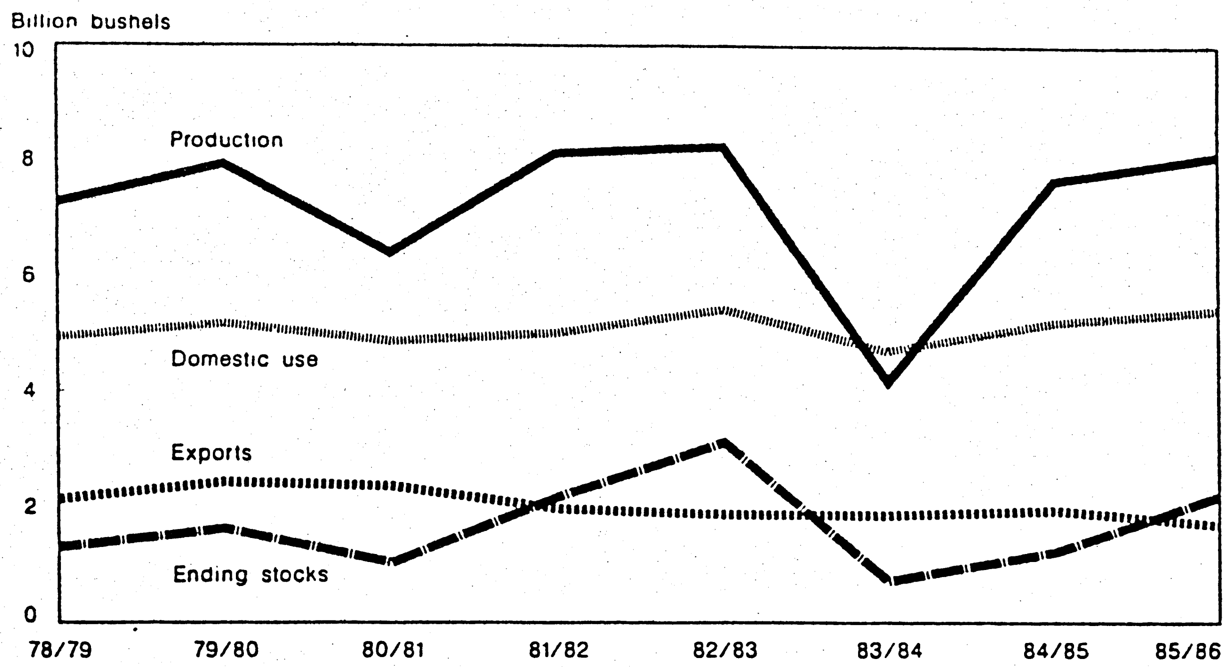
Corn

Harvested acreage of corn this fall is expected to be 4 percent larger than last year. Timely planting and adequate moisture so far point to a near-record yield. Total corn supplies in the 1985/86 marketing year are forecast at 9.3 billion bushels, second only to the record 10.4 billion bushels in the 1982/83 marketing year. While domestic use is expected to increase, exports are projected to decline, suggesting total corn use of 7.1 billion bushels (Figure 3). Exports are being depressed by a sluggish recovery in foreign demand for feed, an improved Soviet grain crop, and intense competition from other exporters. Consequently, prices received by farmers are likely to hover near the support level of $2.55 per bushel.

Soybeans

Despite a 6 percent decline in this year's soybean acreage, a return to more normal yields is likely to push production above the level of the past two years. Production in both 1983 and 1984 was depressed as a result of below average yields (Figure 4). This year's more normal 1.9 billion bushel crop,

3. **Corn: Supply and Use**



combined with an expected 285 million bushel carryin, would boost total supply to almost 2.2 billion bushels.

Unfortunately, soybean demand appears unlikely to increase enough from present levels to offset likely increases in supply. A strong dollar, sluggish growth in world livestock production, reduced Soviet demand for high protein meal, and efforts by the EC—traditionally our major bean and meal customer—to expand use of local feeds have all combined to keep any increase in exports small. Growth in South American oilseed output suggests that competition for export markets will continue to be strong. Domestic demand for meal is expected to increase as much as a tenth, but to lag well below the levels necessary to provide any price strength. Although the poultry sector is doing well, meal use in the hog sector will be down because of the cutback in hog numbers.

With sluggish domestic and export demand for beans and meal, soybean oil is playing an important role in determining crush returns. Oil's share of crush value is forecast at an unusually high 50-55 percent in the 1985/86 marketing year. In the current marketing year ending August 31 oil accounted for an unprecedented 54 percent of the crush value, well above the average 36 percent during the past 8 years. This change in crush value is due to both depressed meal prices discouraging crush and oil production as well as to relatively strong demand for oil domestically.

Oil prices should remain above normal in the 1985/86 marketing year, ranging between 26 and 32 cents per pound. Soybean meal prices are likely to continue weak, however, ranging between $100 and $130 per ton. With 80 percent of the bean price accounted for by meal, soybean prices are expected to be between $5.25 and $5.90 per bushel.

Cotton

Large stocks in the United States and the rest of the world will also dominate the cotton situation during the 1985/86 season. While world production is expected to decline, larger carryin stocks will assure large supplies (Figure 5). U.S. acreage is expected to decline only 3 percent, even with 83 percent of growers participating in the 20-percent acreage reduction program and the 10-percent paid land diversion program. The 81-cent cotton target price and low competing crop prices, especially for soybeans, favored relatively large cotton plantings.

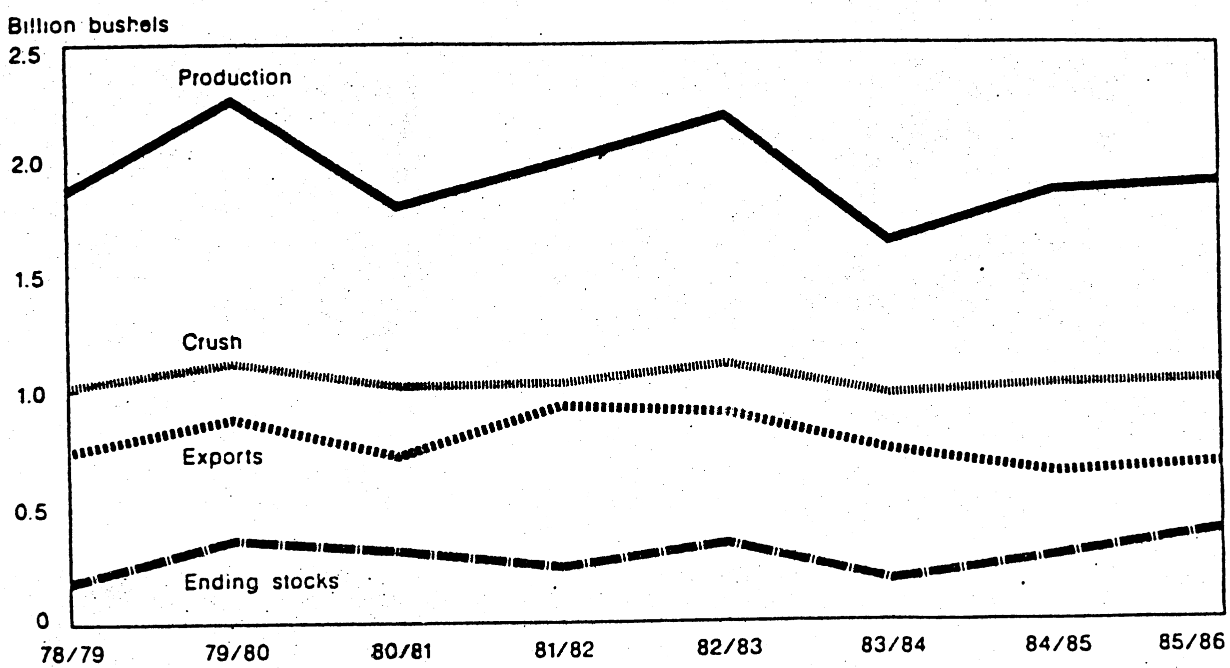
Assuming that relatively good growing conditions continue, only a slightly smaller crop is expected. However, large beginning stocks could boost supply to more than 16 1/2 million bales for the 1985/86 season, the largest supply since 1982. U.S. mill use continues to trend lower because of competition with manmade fibers and imported textiles. Textile imports accounted for 37 percent of U.S. cotton use in 1984 compared with 24 percent in 1980. As a result, mill use may amount to only 5 million bales in the 1985/86 marketing year, down from nearly 6 million bales last year.

U.S. exports are expected to decline to 4.8 million bales in 1985/86, the smallest since the mid-1970's. Shipments to Hong Kong, Japan, South Korea, and Taiwan, as well as to Western Europe, are likely to be down from last year. With these levels of exports and mill use, ending stocks would rise to a burdensome 7 million bales, the highest since 1982/83, and keep downward pressure on prices.

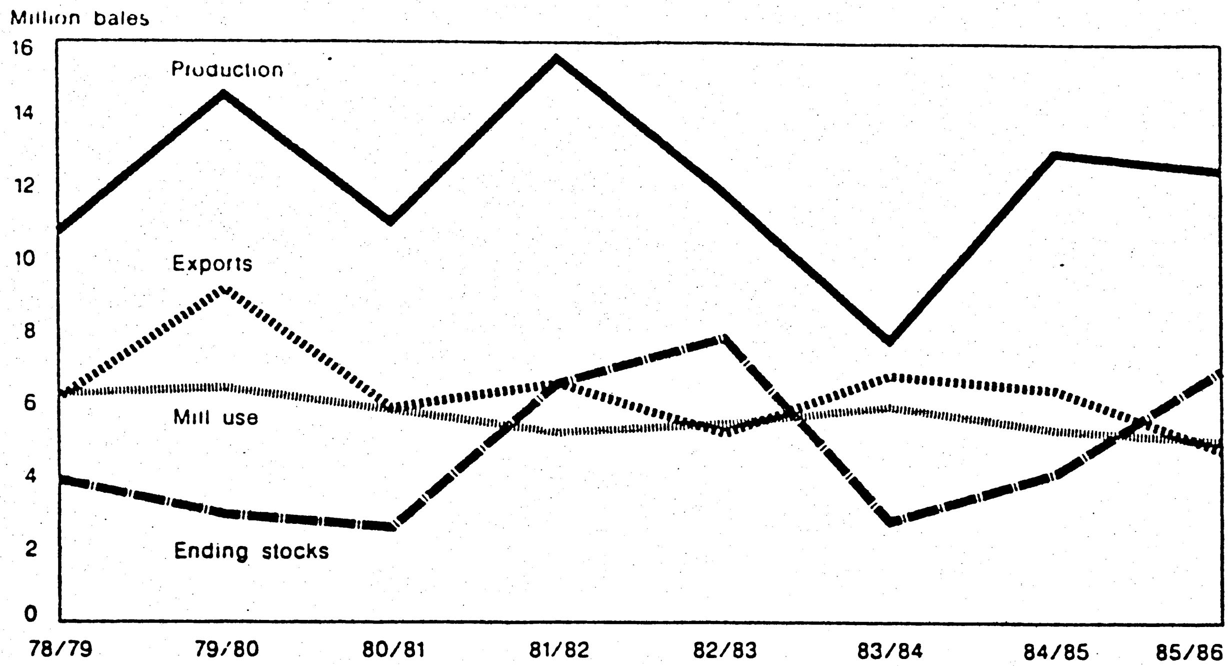
Rice

The outlook for rice continues to be bearish even with over 90 percent of the base enrolled in the 1985/86 acreage reduction program. Unless farmers experience bad weather, yields are likely to continue to increase and add to

4. **Soybeans: Supply and Use**



5. Cotton: Supply and Use



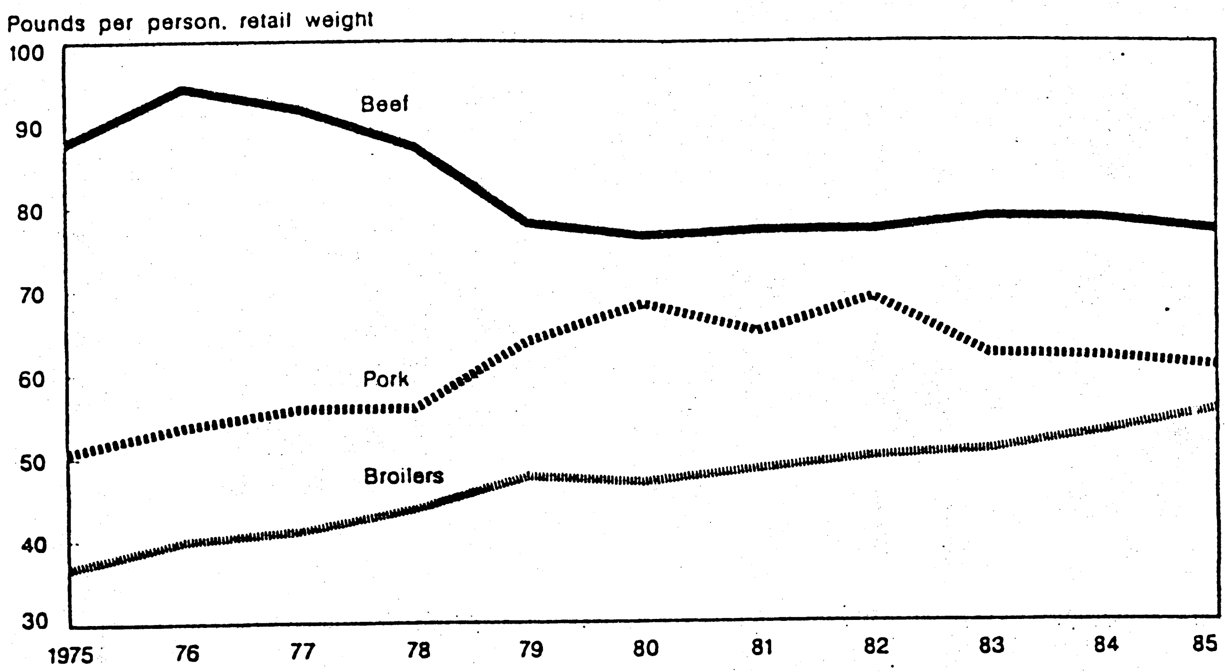
burgeoning supplies. New rice varieties and expanded plantings of long grain varieties could result in a crop of 125 million hundredweight. That would be 10 percent smaller than the 1984 crop, but still a large crop, which together with a 65 million hundredweight carryin, will likely keep the market depressed. Even if prices were to fall to the $8 support level, demand here and abroad would not likely increase significantly. World market prices currently average half the level of U.S. prices and supplies in the other exporting countries are generally good to excellent.

The only good news for rice producers is the fact that new high yielding varieties have effectively cut production costs. Unit production costs for several of the latest varieties are 5 to 10 percent lower than for conventional varieties while yields are 20 to 25 percent higher.

Livestock and Poultry Prospects

Supplies of meat and poultry this year are no less burdensome than those for crops. On a per capita basis, 1985 red meat and poultry supplies are now expected to total 211 pounds in 1985, for a third consecutive record (Figure 6). Even though production of red meats has been quite steady in the eighties, poultry output has continued to increase. Consumers today can purchase 2 pounds of chicken for the same dollar amount as they pay for a pound of pork or 3 pounds of chicken for the same dollar amount as a pound of beef. These price relationships are very different from 20 years ago. In effect, falling relative prices of poultry have induced consumers to substitute poultry for red meat. Little wonder that per capita broiler consumption has doubled in the last two decades, and will top 55 pounds this year.

6. **Meat: Per Capita Disappearance**



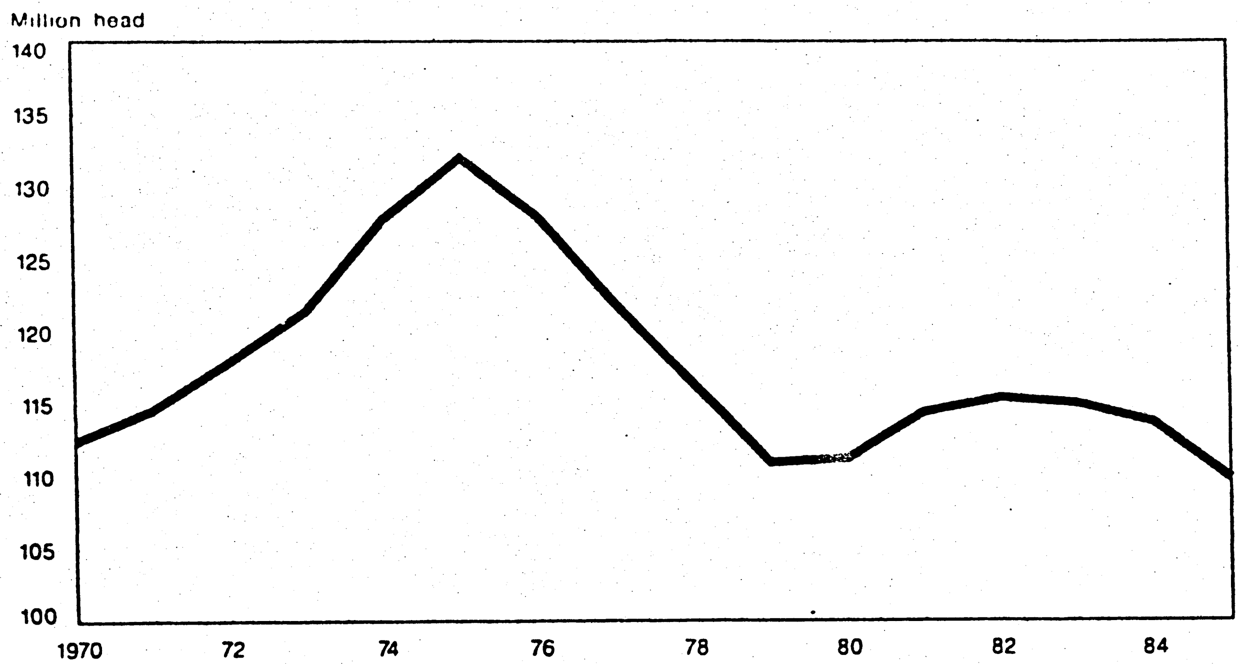
Broiler production will increase an estimated 5 percent this year. If production capacity, in particular broiler housing, had not been limiting, the increase in broiler production might have been even greater. Even though net returns to poultry producers have declined, prospects for continuing low feed costs and reduced red meat supplies may encourage further expansion in 1986.

While poultry producers have been encouraged to expand during the eighties, livestock herds have trended downwards. Drought in 1980 and 1983, economic recession, the payment-in-kind program, low profits, and record meat supplies have forced cattlemen to sell off large numbers of cows and hold back fewer heifers for breeding. The cow herd numbered 46 million at the beginning of the year, down 8 percent from the 50 million in 1982, and well below the record large 57 million cow herd reported in 1975 (Figure 7).

With the breeding herd sharply reduced, this year's calf crop will be about 20 percent smaller than those produced in the mid 1970's. Although each year of continued herd liquidation further limits the future potential to produce beef, the decline in the cattle inventory has not, so far in the 1980's, resulted in much smaller beef production. The current herd liquidation, of course, increases current beef supplies, and this year market weights have been exceptionally heavy, further adding to beef output. Once this herd liquidation has run its course, beef supplies will decline. Price response will depend on supplies of competing meats and consumer demand.

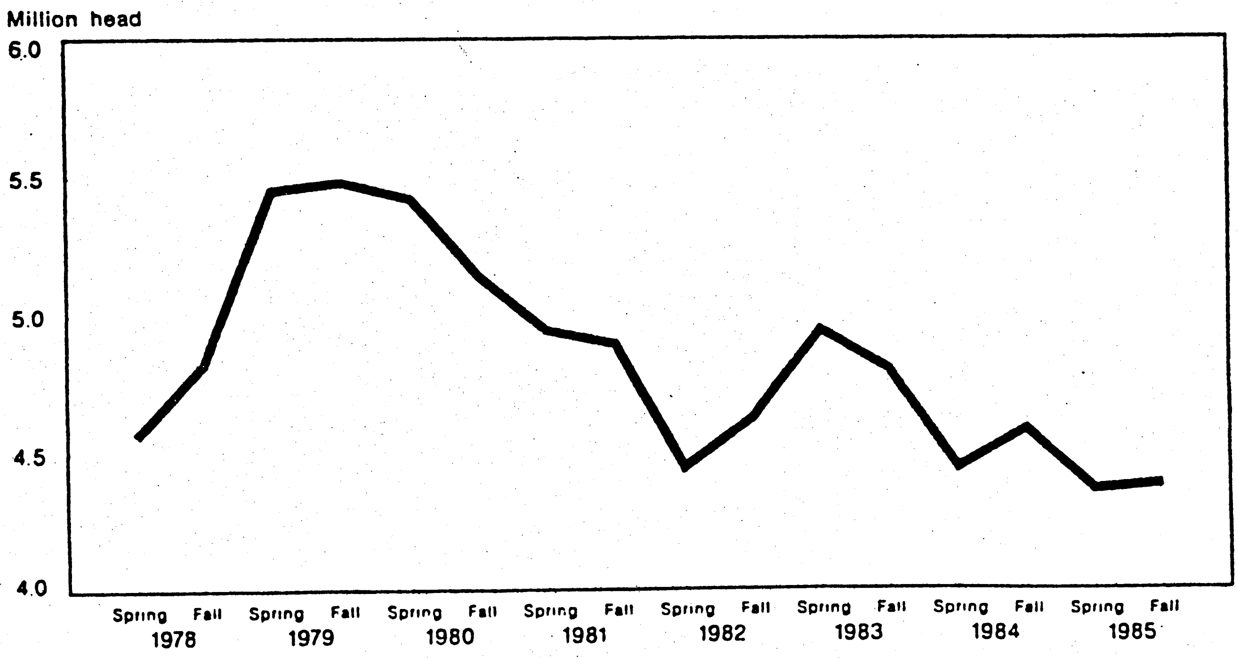
The demand for meat is always hard to measure, particularly in the short run. But diet and health concerns, changing demographics, and the sluggish economic growth have all probably contributed to weak cattle and hog prices. The broiler industry's ability to step up production quickly when the outlook calls for reduced red meat production has added to price pressures during the past year.

7. **Cattle on Farms, January 1**



Hog numbers also are likely to remain low in the second half of 1985 (Figure 8). Despite declining costs of production, low hog prices have kept producer's returns below breakeven. There has not been any incentive for farmers to expand. In fact, producers have been marketing gilts to meet cash flow needs, further shrinking the breeding herd. The liquidation of sows appears to have ended, but significant gilt retention is not likely until hog prices strengthen.

8. **Sows Farrowing**



Spring and Fall pig crops for 10 states

Dairy

Milk production, like meat output, has been large in the 1980's. Milk production did drop 3 percent last year in response to the dairy diversion program, but the uptrend resumed this spring. At midyear, the number of milk cows on farms was 2 percent larger than a year earlier and for the first time since the midyear inventory began in 1973, the number of dairy heifer replacements exceeded the number of beef heifer replacements. With Government support prices at present levels and feed costs declining, milk production this year is expected to increase at least 3 percent. The volume of Government purchases could be a one-third to one-half greater than last year's 8.6 billion pounds.

Aggregate Performance Indicators

The present tendency towards overproduction in face of eroding export markets dominates the aggregate performance of the farm sector. Farm incomes are likely to continue weak through at least early 1986 as large supplies from 1985 harvests continue to depress commodity markets. Gross income this year is unlikely to increase significantly and net cash income may stagnate in the

FARM INCOME INDICATORS

	1981	1982	1983	1984	1985
			BILLION DOLLARS		
CASH RECEIPTS	142.6	144.8	138.7	140-142	137-141
CROPS	73.3	74.6	69.5	68-70	67-71
LIVESTOCK	69.2	70.1	69.2	72-74	68-72
GOVERNMENT PAYMENTS	1.9	3.5	4.1	3-5	5-9
INVENTORY ADJUSTMENTS	7.9	-2.6	11.7	7-9	-3-1
PRODUCTION EXPENSES	136.9	139.5	135.3	138-140	136-140
NET CASH INCOME	35.0	36.8	40.1	37-40	34-39
NET FARM INCOME	31.0	22.3	16.1	33-36	20-25

$34-39 billion range. More than 20 percent of this net cash income will come from direct government payments. Another measure of income, net farm income, has fluctuated more widely than net cash income because of changing inventory values. With 1985 inventory changes taken into account, net farm income could slip from $33 to $36 billion in 1984 to $20 to $25 billion in this year (See Table).

Income prospects for 1986 will depend to a great extent on farm policy developments. But with slow growth in the economy, continued large harvests, large total meat and poultry output, and no immediate turnaround for farm exports, farm income is unlikely to show much improvement.

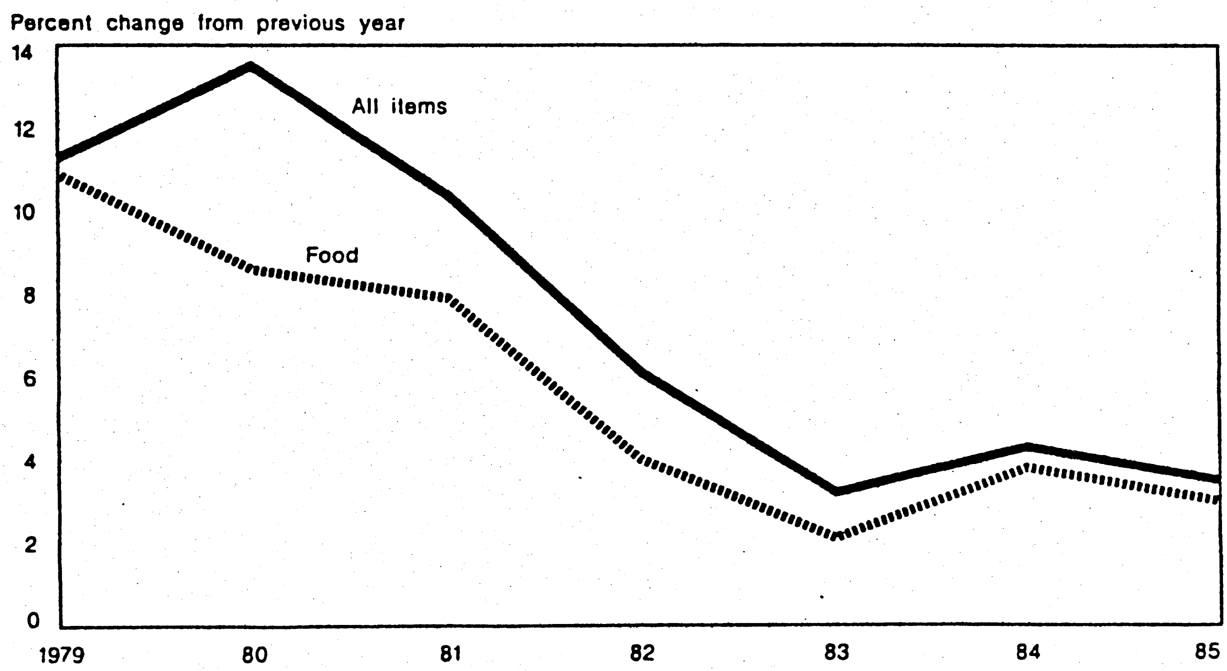
Consumers will of course continue to benefit, as plentiful supplies of grain, meat, and poultry will effectively keep a lid on retail food prices (Figure 9). Fruit prices will be the exception to the rule this year because of the winter freeze and spring frost that hit the Southeast and the Northwest. Lower production of red meat could stimulate meat prices somewhat, but overall meat and poultry supplies will be large, which will temper the rise. Thus, overall rises in food prices are likely to be moderate again next year, probably in the 2 to 4 percent range.

Conclusions

In closing, it is appropriate to mention once again that much of the stress facing U.S. agriculture relates to forces outside the sector—to macroeconomic forces here and abroad and to the changing world trade environment. The farm bill debate, however, is a key source of uncertainty much closer to home.

Agriculture's current financial difficulties stems from these forces and the impacts they have had on our major commodity markets. With the U.S. economy

9. **Consumer Price Index**



still recovering from the recession of the early 1980's and recovery abroad lagging behind, domestic and export demand for our products remains weak. A high-priced dollar and rigid supports that prevent U.S. prices from dropping far enough to clear the market have exacerbated the situation. Supplies of most farm products are at record or near-record levels and farm prices are low, although higher than they would be if it were not for costly price support programs. But even with $8 billion in direct government payments, farm incomes continue to stagnate in nominal terms and fall in real terms.

This situation creates tremendous pressures, not only on farmers, but also on those responsible for shaping farm policy. The challenge we face in 1985 is to craft a careful balance between income support and market orientation. Our farmers need an income safety net that is adequate to carry them through the present period of adversity. Yet, for the long-term health of agriculture they must be able to adjust to changes in the market. This can only be accomplished when commodity markets are unencumbered by Government programs.

This poses an almost insurmountable policy dilemma, but one which must be faced. Our challenge as economists who forecast the farm outlook is to enhance the public's understanding of the larger forces at play in the domestic and global economy. As we have learned since 1981, a robust farm policy must be able to withstand the unpredictability of the larger U.S. and global economy.