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OUTLOOK FOR DAIRY

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The events of 1989 are a reminder that market prices are not always determined solely by the amount produced and demand conditions. Fundamentally, 1989 and 1988 were not much different. The particular sequence of industry decisions and events in 1989 turned what might have been only a moderately tight market into a chaotic market with record prices.

Commercial Use

Strong domestic cheese demand and export demand for nonfat dry milk tightened markets and were the most important fundamental force generating higher prices in both 1988 and 1989. However, demand strength has not been consistent in 1989. Demand for fluid milk was fairly strong, but demand for butter and perishable manufactured products was weak.

During January-September, commercial use of cheese rose 5 percent from a year earlier. Although retail cheese prices were not as favorable as in recent years, continued economic growth and the earlier end to direct cheese donations boosted commercial use. Late-1989 use is unlikely to post large increases. Sharply rising prices have had to ration available supplies.

Fluid milk sales have run 1-2 percent above a year earlier, after the small 1988 rise. However, sales of frozen products and cottage cheese fell.

Commercial use of butter fell sharply during the first half of 1989, almost the sole cause of declines in the milk equivalent (milkfat basis) total of all dairy products. Even though butter sales may recover during the last half, earlier declines and the lack of cheese supplies may hold the 1989 milk equivalent total slightly below 1988, the first dip since 1980.

In 1990, the late-1989 price jumps may slow growth in fluid and cheese sales, partially offsetting the effects of a still strong economy. Prospects for

some recovery in sales of cream-based products are reasonably good. The support price for butter will be sharply lower after January 1 because of forthcoming realignments in support prices and last July's cut. The 1990 total commercial use may rise 1-3 percent from this year.

Commercial use of nonfat dry milk was very strong in 1989, mostly because of the 350-400 million pounds likely to have been exported. After prices declined to quite favorable levels during the first quarter, export traders obtained very large commitments for exports through the end of 1989. These commitments, along with low commercial stocks of American cheese, made the dairy industry very vulnerable to any slowing in milk production. Next year's commercial use of nonfat dry milk will be smaller because of smaller exports.

Despite continued relatively high expected prices in international markets, U.S. exports of nonfat dry milk will fall in 1990. Commercial use of cheese and fluid milk will keep skim solids fairly tight domestically. Also, nonfat dry milk makers are not likely to overcommit to the export market for a second year. Even so, export demand is expected to continue as an important price factor, unless international prices run below the support purchase price.

Milk Production

Milk production started 1989 strong, posting a 2-percent rise from a year earlier in spite of continued cost pressures from the 1988 drought. Relatively low milk-feed price ratios forestalled normal increases in concentrate feeding. However, the high quality of last year's forage and extra attention to feeding programs were enough to sustain fairly large increases in milk per cow, easily outweighing declines in milk cows of just over 1 percent.

Milk per cow collapsed during spring, as supplies of dairy quality forage were exhausted and hay crops were delayed by cool weather. Output per cow has been below a year ago since July, evidence of substantial damage from feed problems. Except for unusual patterns caused by the Milk Diversion Program, this was only the second period of year-to-year declines in milk per cow since World War II.

Dips in milk per cow and continued trimming of cow numbers by high slaughter kept July-October milk output 1 or 2 percent below a year ago. Very high milk prices and slipping feed prices created ample incentive to expand output this autumn. If production starts to respond, the 1989 total may be just slightly under 1988's 145.5 billion pounds.

Production Outlook

Feedgrain and protein meal prices will be lower in 1990, causing ration values to slip as the year progresses. Although the spread probably will widen

between ingredient values and ration values, average ration values may fall 10-15 percent in 1990.

During the first half of 1990, milk prices will fall faster than feed prices. The current quite favorable milk-feed price ratio and returns over concentrate costs will be substantially eroded by spring. During the rest of 1990, milk-feed price relationships probably will be no better than moderately favorable.

Like the July 1 inventory, the January 1 reading probably will show a large herd of dairy replacements. Large numbers of heifers entering the herd may be offset by continued high slaughter of milk cows. Slaughter cow prices are expected to stay strong in 1990.

Forage quality and the extent of mid-1989 damage to milk per cow remain key uncertainties for early 1990 production. If current incentives can generate upward momentum, milk production probably will expand during most of 1990. For the year, milk production likely will grow 1-3 percent.

Stocks

Commercial stocks followed the same general pattern throughout 1989. While butter holdings were ample, commercial stocks of American cheese stayed low, and manufacturers' stocks of nonfat dry milk were small relative to commercial use. After their 1988 experience, cheese traders probably intended to build larger stocks last spring, but waited too long to start.

The only significant Government stocks have been of butter. On November 1, Government holdings were up by half from a year ago and the largest on that date since 1984.

Government Purchases

High farm fat tests, milk going into butter-nonfat dry milk production because of powder demand, and weak sales of cream-based products kept Government purchases of butter large through mid July. Small sales back to the industry were made in late July and August, before small purchases resumed in September. For all of 1989, net removals of butter will exceed 400 million pounds for the first time since 1983.

Domestic market use of skim solids in 1989 also fell considerably short of production. However, the international market was willing to absorb even more than our domestic excess, leaving no nonfat dry milk and very little cheese to be sold to the Government.

Purchases for all of 1989 probably will total close to 1988's 8.9 billion pounds (milk equivalent, milkfat basis), even though second-half removals will have been modest by the standards of the eighties. Removals in 1990 are expected to decline slightly. However, butter purchases are likely to remain large.

Farm and Wholesale Prices

By midyear, the pattern of prices during the second half of 1989 had already been set. Export commitments and stocking decisions had made it impossible to easily absorb any slowing in output, causing a scramble for supplies and soaring prices when milk production then declined. Prices had to rise enough to ration shortened domestic supplies. Even then, supplies were not adequate to maintain normal product flow.

This autumn's record cheese and nonfat dry milk prices brought farm milk prices to records also. The Minnesota-Wisconsin price of manufacturing grade milk will hit a peak of more than \$14 per cwt, up \$2 from a year ago and \$3 above the March low. Sharp second-half rises will leave the 1989 average price of all milk more than \$1 per cwt higher than 1988's \$12.24.

Sharp decreases in wholesale prices of nonfat dry milk and cheese probably will start about yearend. In addition to the normal seasonal production expansion and demand decrease, milk output probably will be recovering and most export commitments will have ended. Rebuilding pipeline and warehouse stocks will absorb significant amounts of milk. Even so, prices must fall drastically to reach levels supported by expected output, commercial use, and international prices. By late spring, farm milk prices may be below a year earlier.

Markets are likely to be tight enough to trigger a significant seasonal rise during the second half of 1990--but nothing like this year's. In fact, merchandisers may overcompensate and be too cautious about stocks and export sales, limiting late-1990 price increases. For the year, 1990 milk prices may not be much above 1988.

Retail Dairy Prices

In early 1989, retail dairy prices were slow to reflect declines in farm and wholesale prices. Retailers may have been cautious because of early signs that prices would soon be rising. Retail dairy prices also were slow to follow the early wholesale and farm price increases. However, late-1989 rises in retail prices have been rapid. The annual average probably will increase 6 percent from 1988, the sharpest rise since 1981 and slightly outpacing rises in indices of prices of all food and of all consumer items.