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AN ALTERNATE VIEW ON THE DAIRY OUTLOOK

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For the dairy industry, 1992 has been a pleasant change from the conditions of 1991. Slower milk production growth, coupled with some increased demand, resulted in relatively strong milk prices in the first half of the year. Milk prices remained at or above year-earlier levels through October, although it appears that they will slip below 1991 levels in the last two months of 1992.

Before getting to the dairy outlook for 1993 and beyond, I want to highlight a few points dairy analysts seem to ignore or at least discount these days. The first point is that dairy producers adjust milk production in response to changes in milk prices and input costs. I think everyone recognizes this as common sense, but very few industry analysts appear to take it into account when evaluating the dairy situation or forecasting the dairy outlook. I suspect this stems from experiences in the late-1970s and most of the 1980s when production moved on almost irrespective of prices.

Data from this period also drive econometric models of the dairy industry, which indicate that supply response is very small when prices change. Models such as those used by USDA, CBO, and FAPRI were used to model the dairy industry for the 1990 Farm Bill. Model results indicated that the U.S. all-milk price would hover in the $11.50 to $12.25 range (equivalent to an annual average M-W of $10.25 to $11.00) for the life of the farm bill with milk production remaining more than adequate to meet demand.

The milk production response to the drop in milk prices in 1991 (annual average of $12.26) should have caused most industry analysts to adjust their thinking. However, despite much stronger milk prices in the first half of 1992, I am amazed at how many people are surprised at the strength in milk production in the third quarter. Not only have milk producers made adjustments to changes in milk prices and net income, they have made them much more quickly than many analysts believed possible.

What are so many people missing when evaluating changes in milk prices, input prices and aggregate milk production? I believe the answer lies not at the macro level, but at the farm level. It is almost a cliche these days to say the dairy industry is undergoing structural change. Look closely at what this is doing to dairy farming. Those dairy farm managers who do not pay close attention to prices received for their outputs and prices paid for inputs are leaving the industry. By attrition, the level of management on U.S. dairy farms has increased dramatically in recent years.

I often feel that dairy farm managers today know more about economic theory than many dairy economists. They understand that a manager's job is to adjust input use and output level when relative prices change. More than ever before, they anticipate changes in supply-demand conditions and respond to changes in prices as such changes occur, rather than waiting to see what the long-term trend is. It is these farm level actions that are showing up in our aggregate industry numbers. Structural changes at the farm level have had and will continue to have a major influence on milk prices and production in the coming years. It will take several years before there is enough data for our informal and formal models of industry to reflect these changes, so until then, let's go back to using some common sense when interpreting the situation and using our crystal balls.

One final point before I get off my soapbox. I believe that one reason that analysts have tended to discount the influence of prices on milk production is that other factors affecting production are also changing. I in no way wish to minimize the impacts of a drought (1988, and to a lesser extent, 1991), or a poor growing season (1989 and, to a lesser extent, 1992), or a cool summer conducive to milk production (1992). However, I have read many accounts of why milk production growth has spurted or lagged during the past few years, and milk price is rarely mentioned as a cause, let alone a major factor. I feel this does our industry a real disservice.

One reason my remarks to this point have focussed on milk production is that Jim Miller's comments provided a good discussion on the commercial disappearance side and I agree with his analysis. However, Jim and I disagree some on our forecasts of milk production and prices. Remember, even with the low milk prices of 1991, total milk production that year was above that for 1990. I doubt that a milk price in the mid-twelve dollar range like Jim has will cause a drop in aggregate milk production for the year. I do agree that milk production growth will slow in the second half of 1993 in response to lower first half milk prices.

My forecast is for milk production to grow about 2 percent in the first half of 1993, driven by a slower decline in cow numbers and continued increases, albeit smaller ones, in output per cow. I look for this growth to slow in the second half of 1993, with total milk production for the year up one to one-and-a-quarter percent. Such growth in milk production, coupled with sluggish commercial disappearance, will put a lot of downward pressure on milk prices. My outlook for price has the M-W (or its replacement) falling over $2.00 from the 1992 peak of $12.59 (at 3.5% BF), to around $10.40 during March and April; still well above support, but I see the M-W averaging nearly $1.00 lower in the first half of 1992 than for the same period in 1991.

For the second half of 1993, I see a different story. Sluggish milk production coupled with (I hope) more evidence of growth in the U.S. economy stimulating demand, will result in strengthening milk prices. I look for the M-W to peak by October at $12.60, about the same peak as in 1992, with second half milk prices averaging slightly above the same period in 1992. Under my scenario, the average annual all-milk price in 1993 will be nearly 50 cents lower than 1992.

Some of the keys to my forecasts include the fact that I do not believe that forage quality and quantity are as poor as some claim; below average for sure, but not poor. I do expect lower grain prices, especially for corn, to keep the milk:feed price ratio from falling too far. I also expect a change in the CCC butter purchase price (with a corresponding change in the nonfat dry milk price), which will stimulate increased export sales of butter and butteroil. I do not look for any major changes in dairy policy, with the exception that there is an outside chance that legislation will pass increasing the support price 50 cents. However, this would not go into effect in time to prevent the M-W falling below $10.60, but may result in higher milk production than I forecast in the second half of 1993, and therefore an M-W peak below $12.50. Finally, I am tired of hearing hints that bST will become commercially available "next year," so my standard comment has become "even if bST is approved next year, the effect of this technology on milk production and prices will be little if any in the first year of use."