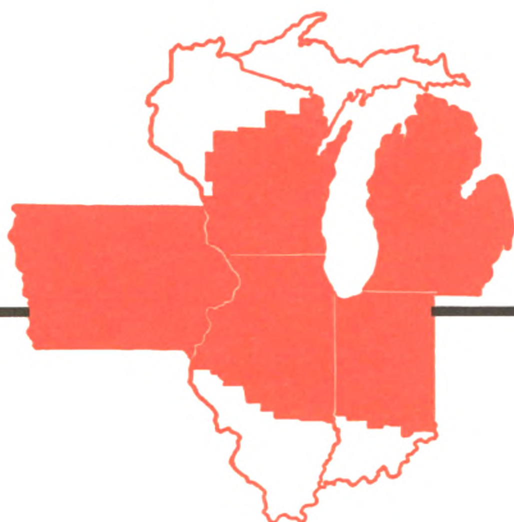
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



February 1972

Contents

Restrictions on world trade 2

What's happening to meat prices? 11

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Restrictions on world trade

Worldwide concern about the state of the international economy, including restrictions on international trade, has intensified since August 15, 1971, when the President announced that the United States would no longer redeem foreign dollar claims in gold, and imposed an import surtax affecting over 50 percent of U. S. imports. Other events of major importance for the international economy that occurred in 1971 included the completion of negotiations expanding the European Economic Community (EEC) from six to ten members as of January 1, 1973 (if candidate countries ratify the treaty), and U. S.-sponsored voluntary import quotas on textiles—and attempts to negotiate import quotas on steel—with major foreign producers. As a finale to the year, the final set of tariff reductions agreed upon in 1967 during the Kennedy Round of tariff negotiations became effective on January 1, 1972.

Still, the focus of attention during 1971 for foreign trade experts increasingly centered on the distortions existing in the financial and trade markets of the world. That U. S. producers felt intensified competition from foreign producers is seen in the deterioration of the U. S. merchandise trade balance—a $4.7 billion decline from the 1970 level to a deficit of $2.0 billion (census basis), the first U. S. trade deficit in the twentieth century. Disequilibrium in financial markets contributed to a record balance-of-payments deficit of $29.6 billion (on an official reserve basis). As these dollars streamed into Europe and Japan, pressures on governments to "do something" finally culminated in December with a combination package of foreign currency revaluations, a dollar devaluation, and an agreement by the United States and its major trading partners to at least discuss reductions in nontariff distortions to trade.

The importance of multinational negotiations on nontariff trade distortions have long been stressed by the United States. Nontariff distortions in trade have been influential in reducing U. S. competitiveness in world markets. The December currency realignment and the trade agreements reached in early February 1972, while not a replacement for full-scale negotiations, do constitute a "foot-in-the-door" that hopefully will be followed by agreement for broader negotiations under the sponsorship of the General Agreement on Tariffs and Trade (GATT). In the February agreements, the European Economic Community and Japan indicated they would support multinational negotiations to begin in 1973. In addition, the EEC and Japan made several concessions on imports of U. S. agricultural products, and Japan reduced several industrial import restrictions, including those on computers and automobiles.

Since World War II

When World War II ended, much of the world economy lay in ruins. Government officials in the free world understood that the success of the rebuilding job would depend in large part on international trade, and that the job would be difficult, if not impossible, under the extremely restrictive trade policies of the prewar period. In an

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

attempt to formulate new rules for international trade, the International Trade Organization (ITO) was proposed under the auspices of the United Nations. The attempt failed. But in 1947, and springing directly out of the previous endeavor, came the General Agreement on Tariffs and Trade (GATT).[1] Over the years, GATT guidelines have provided a yardstick nations use to gauge their own actions and those of others in matters of international trade relationships. Unfortunately, the agreement has often been abused when nations felt vital short-term interests were at stake. But GATT does supply a platform for continuing trade negotiations and, in fact, has been a major force in promoting reductions in tariff barriers. Major world governments have intensified their conscious examination of the artificial impediments distorting international trade, and the result is a concerted effort to reduce, rather than increase, these distortions.

While much has been accomplished over the years in reducing nontariff distortions, and while progress has been made in identifying distortions that remain, it is obvious that the distortions are legion and that progress toward their further reduction will be painfully slow. And all has not been progress, for while some artificial trade distortions have been eliminated in recent years, there have been new ones added. Whether the net effect has been toward fewer restrictions is not always clear.

Average tariff levels before (1967) and after (January 1, 1972) Kennedy Round—selected categories

	EEC		U. S.		Japan		U. K.	
	1967	1972	1967	1972	1967	1972	1967	1972
	(Percentage of C.I.F. value)							
Electrical machinery	14.2	9.1	13.6	7.1	17.8	10.8	20.1	12.4
Nonelectrical machinery	11.1	6.4	11.9	6.0	15.6	10.0	14.2	8.6
Transportation equipment	15.4	9.9	7.1	3.5	18.4	13.9	20.0	11.0
Base metals & metal products	9.9	7.0	8.5	6.3	11.0	7.1	12.8	9.0
Stone, ceramic, & glass products	14.1	8.0	21.0	15.0	16.9	9.5	16.4	10.3
Textiles	16.0	12.6	21.4	20.1	23.5	13.6	20.6	16.9
Pulp and paper	10.7	7.5	10.9	5.5	6.7	6.4	16.6	13.2
Mineral products	9.4	5.5	9.9	7.5	12.0	6.2	9.3	4.8
Manufactured imports	13.5	8.6	14.3	9.9	17.6	10.7	17.8	10.8
Industrial imports	12.8	8.1	13.5	9.6	15.5	9.5	16.6	10.6

SOURCE: Preeg, Ernest H., Traders and Diplomats, The Brookings Institution, Washington, D. C., 1970.

Tariff barriers to trade

A tariff often protects domestically-produced products from the competition of imports by raising the price of the import relative to its nontariff price. While a tariff may be an impediment to trade in that it interfers with the allocation of resources among nations, it does retain price as the allocating factor determining supply and demand. The quantity imported is not directly affected—rather, because the price of the import is higher due to the tax, fewer goods are imported.

Under GATT auspices, the "Dillon

[1]GATT is adhered to by the United States and other countries under a "protocol of provisional application." Basically, the General Agreement on Tariffs and Trade sets down rules of conduct in international trade and specifies maximum levels for individual tariff rates.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Round" of tariff negotiations in 1960, followed by the more extensive "Kennedy Round" (extending from May 1964 to June 1967) resulted in significant reductions in tariffs on nonagricultural goods for the major trading nations of the noncommunist world. With the final tariff reductions, which went into effect January 1, 1972, it is estimated that U. S. tariffs are 36 percent lower, that common external tariffs of the EEC are 37 percent lower, and tariffs of both Japan and the United Kingdom are 39 percent lower than they were prior to the first reduction in 1968. Average tariff rates for all industrial imports subject to duties have been estimated at 8.1 percent for the EEC, 9.5 percent for Japan, 9.6 percent for the United States, and 10.6 percent for the United Kingdom. (See table.)

Averages can be misleading in determining the degree of protection afforded by what might appear to be a relatively high or a relatively low average tariff. A very high rate, that is to say a rate high enough to effectively prohibit the importation of a product, will not show up in the averages because nothing is imported to which the prohibitive rate applies. Nevertheless, there has been a lowering in tariff levels, as well as a narrowing in the difference between average tariff rates of major trading countries. Not only did average tariff levels decline, but the decline was proportionately greater for high-tariff countries. In terms of average tariff levels, the differences among countries are quite small. This does not mean, however, that the small differential carries over to specific products or categories of products. For example, the average tariff level for transportation equipment entering Japan is 13.9 percent, while the comparable level imposed on U. S. imports is 3.5 percent. The average level for U. S. imports of textiles is 20.1 percent, while the comparable average level for EEC textile imports is 12.6 percent. Tariff rates for specific items will show far wider variations than indicated by the averages.

Nominal tariff rates are easy enough to identify. They are published in a nation's tariff schedule. It would be too simple, however, to say that a 20 percent tariff on imported shirts means the same thing in two different countries. The tariff might be applied to the value of the shirt at the port of export, or the value at the port of import (including shipping costs), or on the price of a comparable domestically-produced shirt. Each of these methods of valuation results in a different effective tariff on the import, and consequently different levels of protection for domestically-produced goods. Differences among nations in their product valuation procedures remain a point of friction in trade liberalization negotiations. It is worth noting that in a case like this it is the procedure itself that constitutes the trade distortion.

The U. S. Government generally applies its tariff schedule rates to the free on board (F.O.B.) price of imports at the foreign port. European countries, Japan, and other major trading countries (excepting Canada) apply their tariff schedule rates to the cost of imports, including insurance and freight (C.I.F.), at their port of entry.

A politically serious valuation controversy centers on the American Selling Price (ASP) valuation, used in connection with benzenoid chemicals, certain rubber-soled footwear, and canned clams. Under this procedure, the import tariff is based on the higher price of comparable domestically-produced products rather than the price of the imported product.

The ASP has long been a rallying point

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

for European countries in discussions of reducing trade restriction. The ASP is especially irritating to foreigners because it is a vestigal remains of an arbitrary valuation system generally outlawed by GATT in 1947. The U. S. Government, in Kennedy Round negotiations in 1967, agreed to its elimination subject to legislative approval as part of a separate package on tariff and nontariff distortion concessions. Although ASP was initiated in 1922 to protect the then newly-developing chemical industry, the Congress, so far, has not determined to terminate it.

Nontariff barriers to trade

The valuation controversy surrounding imports, while tied to tariffs, moves one into the realm of nontariff barriers to trade. It is within the area of nontariff barriers that the most serious, present day dislocations occur. Since the conclusion of the Kennedy Round, the U. S. Government has repeatedly proposed consideration of a possible new round of GATT-sponsored trade negotiations to deal with nontariff barriers and their undesirable consequences. GATT is developing a detailed inventory of existing nontariff barriers to trade, a necessary basis for negotiation when formal discussions eventually take place.

Even if negotiations aimed toward the reduction of nontariff barriers were to begin tomorrow, the prospect for any significant reduction in their magnitude or number lies well in the future. Existing legislated nontariff barriers represent the hard core of the problem—barriers such as the negotiated "voluntary" export quotas compound the problem. A major impeding factor is that many nontariff barriers are not specifically related to trade, or any other single area.

Broad-scale enabling legislation authorizing concessions is difficult to draft because it would have to specify the limits and conditions of concessions permissible on conceivably everything from health and safety standards, to patent requirements, to quota restrictions. Groups with vested interests in such things could not be expected to stand idle while the barricades are dismantled for the sake of freer foreign trade.

Catalog of nontariff barriers to trade

Import quotas

Import quotas, one of the most obvious nontariff barriers to trade, are a tool favored by governments desiring to protect selected domestic industries from the competition of imports, or desiring to regulate the amount of expenditures on certain products in their domestic market. An example of the latter is the tendency prevalent

Quantitative restrictions on imports

	Value of imports subject to quantitative restrictions		Proportion of imports subject to quantitative restrictions	
	Industrial	Agricultural	Industrial	Agricultural
	(billion dollars)		(percent)	
EEC	0.9	2.6	4.3	33.7
United Kingdom	0.7	1.1	4.7	21.9
Japan	1.4	0.8	11.4	27.9
United States	5.1	1.2	16.5	21.6

Compiled from: John C. Renner, "National Restrictions on International Trade," in **United States International Economic Policy in a Interdependent World, Commission** on International Trade and Investment, Vol, 1. July 1971, Washington, D. C.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

among the less developed countries to impose tight import quotas on luxury goods.

Quantitative restrictions imposed by industrial countries most often are applied to agricultural products, plus a few categories of industrial goods. In 1970, quantitative restrictions were applied to about 22 percent of the value of U. S. and U. K. agricultural imports. Comparable percentages for Japan and the European Economic Community were 28 and 34 percent, respectively. (See table.) The EEC's high degree of quantitative restriction on the value of agricultural imports is reflected in the fact that nearly 60 percent of their major agricultural import categories are covered, at least in part, by quantitative restrictions. The United States, on the other hand, imposes import quotas on only 7 percent of its agricultural import categories.

The United Kingdom employs quantitative restrictions relatively sparingly as compared with the numbers used by the EEC, Japan, and the United States.

Import licenses

Import licensing is a highly flexible form of restriction commonly used by Japan, by European countries, and by the less developed countries. Import licenses constitute a potentially serious deterrent to trade because of the low degree of visibility associated with licensing arrangements in most countries, and because of the uncertainty surrounding the issuing of licenses. A prime example of how licenses can rigidly control imports is the U. K.'s requirement that coal and solid fuels be imported under license. But the licensing authority does not issue licenses for coal, thereby barring all imports of coal. This fact causes considerable frustration in the U. S. coal industry which would be competitive, pricewise, if permitted entry into the U. K. market.

Export subsidies

Export subsidies are commonly used in international trade to expand exports, to gain a market advantage, or to dispose of excess production in a foreign market so as not to cause a disruption in prices in the home market. Subsidized exports tend to disrupt the markets to which the products are shipped, as well as the markets of third-country competitors. Countries of the EEC are among the most prominent users of export subsidies.

Direct export subsidies for the EEC's agricultural exports are a particular sore point with the United States. The Common Agricultural Policy (CAP) of the EEC supports high internal prices for many grains, and for dairy and poultry products. These high domestic prices are buffered from the competition of lower world prices by a tariff called a variable levy which raises the prices of specific imported commodities to the level of the supported domestic prices. In this way, imports are effectively restricted; furthermore, high domestic prices encourage expanded domestic production. When this situation leads to surplus production, the surplus is placed on the world market at subsidized prices, thereby cutting into the third-country markets of other leading agricultural exporters. The United States has countered EEC subsidies in some instances by instituting export subsidies of its own.

Another case of export subsidies, one becoming increasingly prevalent, is where a government actively subsidizes the financing of exports. The willingness and ability of a government to grant tax deferrals on goods exported, as in the case of the new U. S. Domestic International Sales Corporation Program (DISC), to provide loan

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

guarantees, and to provide funds directly to exporters at low interest rates, oftentimes are key factors in whether an export sale will be made. The Japanese government, for example, is especially aggressive in promoting low-cost financing for exports. In 1971, the Export-Import Bank of the United States received authority to participate more actively in export financing.

Dumping

When products are exported to a foreign market and sold at a price that is lower than that on the domestic market, it is called "dumping"—economists call this practice price discrimination. This practice may be a disrupter of markets and if it leads to injury is not sanctioned by GATT. As a defense against dumping, injured countries are permitted by GATT to impose offsetting import taxes called antidumping duties to negate the price advantage the foreign producer obtains by pricing abroad at less than in the home market.

Domestic component requirements

Minimum domestic component requirements are a form of nontariff barrier often used by less developed countries, as well as by some developed countries, in the attempt to nurture their infant industries. These requirements typically stipulate that a certain proportion of the value of the final product must be composed of components that originate in the importing country. Countries attempting to develop an automotive industry, for example, often require that key subassemblies be manufactured internally, or that a minimum proportion of foreign cars sold internally be assembled domestically. These regulations have the effect of forcing foreign car producers to assist in the industrial development of the country if they wish to sell cars in that market.

A more subtle form of the domestic component requirement is tied to tariff schedules. Developed as well as developing countries regularly apply higher tariff rates to manufactured or processed forms of primary products than to the primary product itself. There is a higher tariff on refined sugar and ground coffee than on raw sugar and coffee beans. Thus, imports incorporating foreign processing are discouraged to a greater extent than are raw products. The less developed countries find the imposition of this trade barrier by the industrial countries especially galling because it retards their industrial development by inhibiting their ability to compete in foreign markets with higher-value processed goods.

Financial controls

Some of the least visible nontariff trade restrictions are those involving financial and currency controls. The characteristic that makes this type of control of unusual significance is that currency restrictions on international commercial transactions—such as foreign exchange rates, monetary flows, interest rates on government obligations, and a nation's balance-of-payments position—are tied in with governmental image-making and national prestige. Were the roots of prestige not so deep, nontariff barriers involving financial and currency controls would be among the easiest of all barriers to overcome.

Arbitrary controls over foreign exchange introduce widespread uncertainty in international commercial transactions. Typically, exchange controls are used by governments to attack the symptoms rather than the politically difficult causes of an undesirable balance-of-payments situation. The on-again, off-again international monetary

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

turmoil of recent years has caused countries to establish exchange controls to protect their currencies against speculation, hindering trade in the process. The monetary realignment agreed upon in December 1971 has permitted elimination of many of the exchange control barriers that were in the process of being erected.

While it is true that exchange controls can be implemented in such a way as to be an effective deterrent to speculative capital flows and no more than a nuisance to trade, they also can be applied in a manner that makes trade a very expensive proposition. A common example is regulations requiring that a currency deposit cover all or part of the value of an import shipment.

"Buy-at-home" policies

Among the most conspicuous nontariff barriers to trade are "buy-at-home" policies. The United States is probably the most obvious practitioner of this form of restriction in that she is open and above board about it. For years, the "Buy American" Act has imposed, in addition to the tariff, a special restraint on federal procurement of foreign goods. A recent example of this practice of promoting domestic goods over foreign goods is a section in the U. S. Revenue Act of 1971 which provides for the exclusion of foreign-made investment goods from the investment tax credit allowed on similar U. S.-made goods. The provision was so odious to our major trading partners that the United States agreed that it would not be implemented as a condition of the international monetary accord reached in December 1971.

Western European countries typically do not employ "buy-at-home" laws per se. They do, however, follow the practice of "closed bidding." Closed bidding, potentially more restrictive than buy-domestic policies, effectively bars foreign firms from even submitting bids. Thus, whether the price is competitive with that of domestic producers makes little difference. Closed bidding is particularly prevalent in the realm of government procurement.

A related practice, based on the buy-domestic concept, is that of requiring that a minimum proportion of funds provided for foreign aid be used to purchase goods and services from the donor country. "Tied-Aid" may reduce the real value of aid to a country by forcing it, if it accepts the aid, to buy at a higher cost than necessary.

Nontariff barriers like these are difficult to dismantle because they are usually administratively and arbitrarily imposed. Often legal statutes do not identify their existence and, therefore, cannot be repealed. Administrative convention would have to be changed either by general agreement or by legal imposition of an "open tender" requirement.

Health and safety restrictions

Nontariff barriers related to health and safety include a broad and growing grouping of regulations, some of which promote the general well-being of the population while incidentally restricting trade, and some of which promise to serve the general well-being of the population but actually do little more than restrict trade. To a greater or lesser degree, such regulations are necessary, but they do make international trade more expensive than it would otherwise be. When an importing country requires safety tests on a product that has been adequately tested in the exporting country, it amounts to one more barrier to hurdle. If destructive testing is required, the direct cost of the import is consequently increased.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Measurement standards

In the near future, measurement standards will become a problem peculiar to the United States. The Canadian government is committed to adopting the metric system of weights and measures, and the British government is in the process of converting. Once these nations go metric, the United States will be the only major trading nation still using a nonmetric system. In 1971, the National Bureau of Standards published a report recommending that the United States convert to the metric system. U. S. trade now lost due to nonmetric measures is due largely to higher product costs primarily because of higher development costs associated with using the nonmetric system.

Preferential trading arrangements

Preferential trading arrangements, discouraged by the international community until recent years, represent a method of distorting trade flows that cuts across tariff and nontariff barriers alike. One of the most rapidly growing forms of trade distortions, they involve a major shift away from the Most Favored Nation principle that has been an acceptable practice in international trade since the 1930s. The Most Favored Nation principle holds that a trade concession granted to one nation will be granted to all other trading partners.

When the European Economic Community was formed, a number of African nations associated with individual members of the EEC (usually through former colonial status), but not members of the EEC, were granted special access to the markets of all EEC members. Since then, the EEC has also granted some Mediterranean nations preferential trading rights, and late in 1971 the EEC announced plans to extend preferential arrangements to those members of the European Free Trade Association (EFTA) that did not apply for membership in the EEC (Austria, Finland, Iceland, Portugal, Sweden, and Switzerland). At no point has the EEC extended similar concessions to all trading nations, thus putting these actions in direct violation of the Most Favored Nation principle, and putting nonparticipating nations at a disadvantage.

The United States also is a party to limited preferential trade agreements, such as the Canada-U. S. auto agreement. (See **Business Conditions,** November 1968). Moreover, the United States has proposed preferential agreements with the less developed countries to help further their economic developments. The EEC and Japan already have adopted preferential measures with many of the less developed countries.

The increasing prevalence of preferential trade agreements is a major point of contention between the United States and the EEC. While the U. S. concern is naturally in its own self-interest, there is a basic economic problem in agreements which disregard the Most Favored Nation principle. An economically undesirable redirection of the world's resources occurs if selective trade concessions direct trade away from efficient low-cost producing nations—nations that may not be party to the preferential trade agreements—and direct trade toward high-cost producing nations included in such agreements.

Summing up

Trade-distorting policies of nations result from an intricate combination of political and economic reasoning. They may come out of actions specifically intended to discriminate against foreign-produced goods in order to protect domestic jobs and industry. Or, at the other extreme, they may

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

occur as a secondary effect to a regulation whose intended purpose is guarding the safety and well-being of the population.

Trade barriers that are formal, with strict legal standing—such as tariffs, import quotas, legislated buy-domestic policies—are based on law; and laws can be changed, given an appropriate political climate. Informal barriers, especially those subject to administrative whim, are sometimes difficult just to identify, compounding the problem of their elimination. Informal barriers must be first recognized, and accepted as significant. This is not an easy task in itself. If they are to be removed, the removal must be through an administrative change of heart, or through legislation that restricts the imposition of the barriers themselves.

The current flurry of activity centering on bilateral trade negotiations is aimed at lessening the number of nontariff barriers and at shoring up the international commitment to the Most Favored Nation principle. The United States already has served notice that she will make a strong push to open a new multilateral "round" of trade negotiations directed especially at the elimination of nontariff barriers. The EEC and Japan now appear receptive to participating in such negotiations in 1973. More open trade among nations would be well served by a concerted multinational effort to reduce existing nontariff barriers, and to guard against erecting new ones.

Glossary of trade terms

1. **Trade distortion:** A situation in which trade between or among nations is affected by actions of government or business in such a way as to disrupt the allocation of world resources and decrease the net welfare of the nations involved, or of third-party nations.
2. **Tariff:** A tax on imports applied as a percentage of the value of the product (ad valorum tariff), as an unvarying level (specific tariff), or as some combination of the two.
3. **Quota:** A quantitative limitation on the physical amount of an import.
4. **Nontariff barrier (NTB):** A broad category referring to trade restrictions other than tariffs.
5. **Nominal tariff:** Tariff rate reported in a nation's tariff schedule.
6. **Effective tariff:** The effective tariff is determined by the degree of protection it affords the domestic industry. For example, the same ad valorum nominal tariff rate may be applied to a raw product and a finished good made of the raw product. Because the finished good is of higher value than the raw product, the absolute tariff is higher on the finished good. If the differential is large enough, only raw material will be imported, and all of the finished product will be produced domestically. In such a case, the effective tariff on the finished good is "prohibitive," providing a high degree of protection for the domestic processing industry, while the nominal rate may be, in fact, relatively low.
7. **Dumping:** The practice of selling a product in a foreign market at a price below the price in the domestic market—price discrimination.
8. **Export subsidy:** The practice by a government of subsidizing the exportation of goods. This may be accomplished through direct cash assistance, tax deferrals on profits gained through exporting, tax credits for indirect taxes applied to exports, subsidized interest rates to assist export financing, and so on.
9. **Most Favored Nation principle (MFN):** Any trade concession agreed to with a single nation will be extended to all other nations.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

What's happening to meat prices?

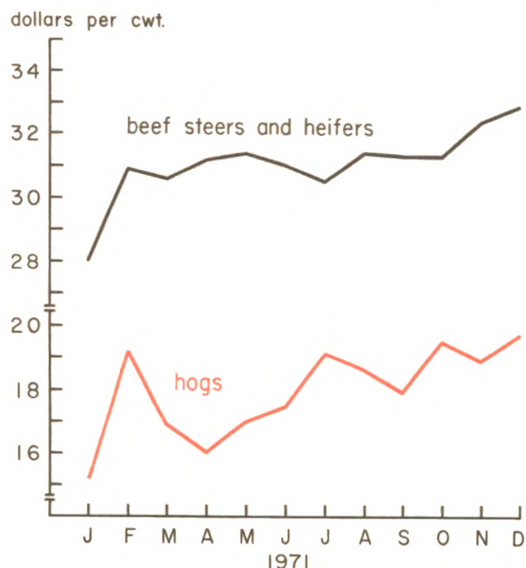
Rapidly rising meat prices amidst national wage and price controls have dismayed consumers and are viewed by some as a threat to public confidence in Phase II of the Administration's anti-inflation program. Retail prices of beef during the last two months of 1971 rose 3 percent, and pork went up 2 percent. Compared to a year earlier, beef and pork prices were up 12 percent and 7 percent, respectively. Meat prices continued their upward spiral in the new year, with January beef prices up 3 percent from a month earlier and pork prices up 5 percent. The sharp price advances stem largely from a strong rise in consumer demand at a time when farm production of livestock was on the decline.

Food prices—pre- and post-freeze

During the past several years, accelerating costs of processing and distribution rather than the cost of food commodities per se have been the major factor behind rising food prices. About three-fifths of every consumer dollar spent for food goes to pay for direct labor, transportation, utilities, and all the other services associated with moving food from farmer to consumer. The sum total of these costs associated with a typical supermarket basket of farm foods advanced over 11 percent from 1969 through 1971. In contrast to the unbroken upward spiral of "nonfood" costs, the cost attributable to raw food commodities fluctuated, with the average for 1971 falling below the 1969 level.

The price and wage freeze and Phase II apparently broke the upward momentum of food processing and distribution costs, at least temporarily. During the last four months of 1971, the proportion of food costs attributable to processing and distribution actually declined, while that attributable to raw commodities increased 5 percent. Raw agricultural commodities—including livestock—were exempted from controls both during the freeze and in Phase II. Probably the exemption was allowed because of the mammoth job of policing the prices of an industry with so many small and geographically-dispersed producers. Government officials also may have been persuaded that "market forces" alone were adequate to restrain agricultural prices, especially since farm prices were declining

Sharply rising livestock prices . . .



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

generally at the time controls were initiated. Under Phase II guidelines, meat processors and retailers are allowed to "pass through" higher costs that are directly associated with higher prices paid for livestock. Thus, as market forces shifted in the fourth quarter of 1971 and livestock prices began to rise, so did prices at the retail meat counter.

Workings of "the market"

Agricultural production and prices are often subject to disruptive fluctuations because of the many small producers, the lack of an industrywide discipline on production, and because agricultural production is a biological process subject to the effects of weather, disease, and animal physiology. Although government programs have stabilized the crop sector, at least partially, the 1970 corn blight demonstrated once again the uncontrollable nature of the agricultural production process.

The livestock-meat sector of agriculture is especially characterized by cyclic production and prices. Moreover, demand for livestock, as well as other farm products, is such that a small change in supplies results in a much larger change in prices in the opposite direction. Thus, a small drop in livestock supplies in a given period will result in sharply higher prices only to be followed a year or so later (depending on the species involved) by increased production and sharply lower prices. Recent experience provides such an example.

At the beginning of 1971, farmers were receiving $15 per hundredweight for hogs—the lowest price in seven years. Beef steers and heifers were averaging only $28 per hundredweight. In January 1972, only a year later, hogs were selling at $22.70 per hundredweight—49 percent higher—and beef steers and heifers, at over $34 per hundredweight, reached a 20-year high.

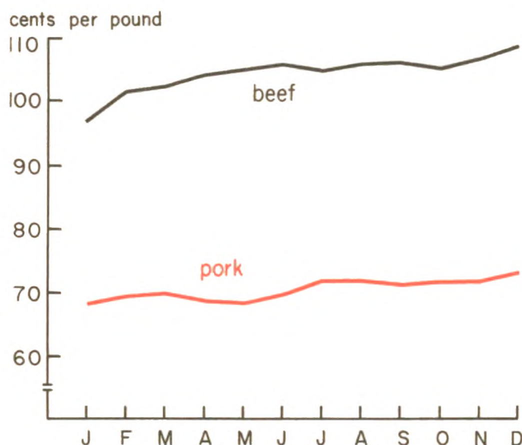
The low prices during the latter part of 1970 and through much of 1971, coupled with short corn supplies because of a blight-reduced 1970 crop, caused farmers to curtail livestock feeding, especially hog feeding. But early in 1971, the general economy began to rebound from a recessionary low, and consumer meat demand strengthened.

Supplies lag demand

Beef supplies in 1971 were only about 1 percent larger than in 1970. From January through September, supplies averaged 2 to 3 percent above year-ago levels, but then dropped below a year ago in the fourth quarter due to 5 percent smaller supplies in December.

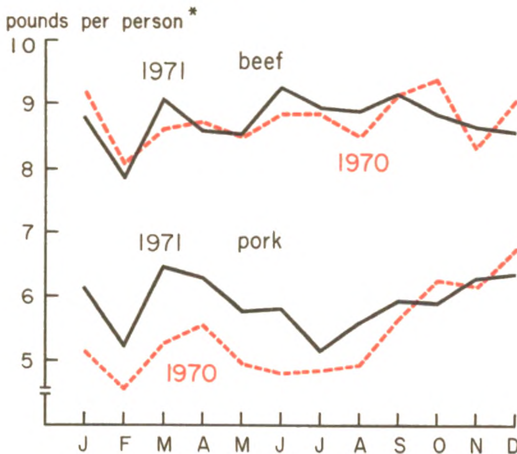
Pork output in 1971 averaged 10 percent higher than a year earlier, but nearly all the increase occurred in the first half. In October, hog slaughter dipped below a year earlier, and by December pork production slipped 5 percent below a year earlier.

. . . led to rising retail meat prices in 1971



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Meat supplies smaller at the end of 1971



*Commercial slaughter supplies.

Long dock strikes reduced the flow of meat imports in 1971 also. Imports, which typically account for 5 percent of the total meat supply, declined nearly 3 percent in 1971. Imported meat generally finds its way into such processed items as luncheon meat, hot dogs, and canned meats.

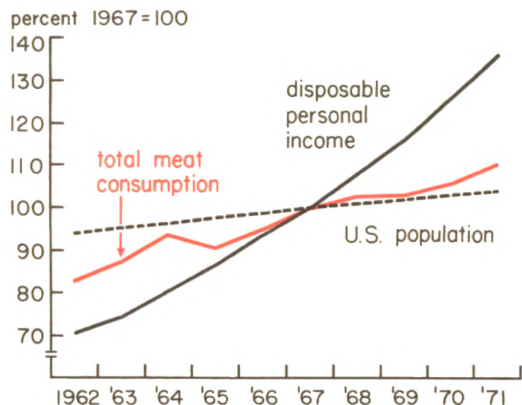
Meat supplies in the latter part of 1971 were only slightly smaller than in late 1970—a year of unusually large supplies, especially of pork. But relative to demand, meat was in much shorter supply than a year earlier.

Although changes in demand are not as readily measured as changes in supplies, the primary indicators suggest that consumer demand for meat was very strong in the latter part of 1971. The U. S. population grew by 2.2 million by the end of 1971. More importantly, as in other recent years, the greatest proportional increase occurred among teenagers and young adults, the biggest meat-eaters in the population.

A strengthening of the general economy was probably the most important factor fueling demand for meat in 1971. Although the economy still had weak spots, it was certainly more robust than it had been in 1970. Per capita disposable personal income for 1971 measured in terms of 1958 dollars gained 3 percent, compared to an increase of 2 percent the year before. And despite much unemployment, the total number of persons employed grew steadily throughout 1971. By December, there were 2.8 million more employed persons in the nation than there had been a year earlier. As more people found jobs or went back to work, meat likely appeared more often on the weekly menu.

With demand outstripping supplies, prices at all levels of the livestock-meat marketing channel moved higher in late 1971. Farm prices increased most rapidly. This is evidenced by the sharp increases in the "farm value" component (often called the farmer's share) of the retail meat dollar.

Rising meat consumption is influenced by more people and more money



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Department of Agriculture computes the proportion of the retail cost of meat per pound attributable to the farmer's share, the charges of processors and distributors, and the retail markup. The farm value of choice beef in December 1971 was nearly 28 percent higher than a year earlier. For pork, the increase was almost 36 percent.

The retail prices of beef and pork increased less in percentage terms. Choice beef averaged over $1.08 per pound in December—12 percent higher than a year earlier. Retail pork prices in December averaged 73 cents per pound—less than 7 percent above the year before.

Not much relief in sight

Cattle and hog prices in 1972 continued to increase from their December 1971 levels and were 7 percent and 30 percent, respectively, above December levels during February. Retail meat prices, which lagged the earlier farm price increases, have accelerated, and in January alone beef prices were 3 percent higher than a month earlier and pork prices jumped nearly 5 percent. Even though farm prices may continue to work somewhat lower in the months ahead, retail prices are likely to hold firm or possibly increase, reflecting a rebuilding of margins and increases in processing and distribution costs associated with food marketing.

Livestock supplies are expected to remain relatively tight throughout most of 1972. Hog marketings are expected to remain well below year-earlier levels, and cattle marketings may be only moderately larger. Last fall's pig crop (June-November) was about 8 percent smaller than a year earlier according to Department of Agriculture estimates. The smaller pig crop has already been reflected in smaller marketings last December and January. In fact, hog supplies were down by 14 percent in January from a year earlier, a greater decline than the December estimates of the Department of Agriculture had indicated. Through mid-February, hog marketings were averaging 12 percent less than a year earlier. Either the estimates contained sizable error or marketings will be "bunched" in the latter part of the quarter. Pigs on farms that will be marketed mostly in the second quarter numbered about 7 percent less than a year ago. Farmers indicated they intended to reduce winter farrowings (December-May) by 10 percent, which should keep hog marketings down by a similar amount through early fall of this year.

Low corn prices relative to hog prices have caused and will continue to cause farmers to feed hogs to heavier market weights—a factor which swells supplies more than numbers alone indicate. In January, hogs were averaging two pounds per head heavier than a year earlier. Nevertheless, the reduced marketings will hold hog prices well above the depressed levels that prevailed through most of last year, perhaps by as much as 50 percent this summer, although prices will decline seasonally in the fall.

Cattle marketings are likely to be moderately larger in 1972. A January 1 Cattle on Feed report estimated that first-quarter marketings would be 7 percent larger than a year ago. But preliminary information for January indicates marketings were down 2 percent from a year ago. And more tentative data for mid-February show marketings averaging about 1 percent *below* a year earlier. Either the January estimates were incorrect, or the increase in marketings in the remainder of February and in March will have to be substantially greater than 7 percent. Marketings in the second

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

quarter, based on weight groupings of cattle on feed in January, may be only 2 percent above a year ago. Somewhat larger increases over a year ago are likely for the second half of 1972.

Like hog producers, cattle feeders have an incentive to feed their animals to heavier slaughter weights because of abundant and relatively cheap feed supplies this year. Thus far in 1972, however, slaughter weights have not shown any significant increase. A possible explanation for this may be that in the past few months cattle have been placed on feed at younger ages, and these animals reach the desired market grade at lighter weights.

The moderate increase in cattle marketings and substantially lower hog marketings suggest total meat supplies in 1972 will remain relatively tight. Greater than usual retention of young animals to increase the breeding herds of both cattle and hogs could moderate supplies even more.

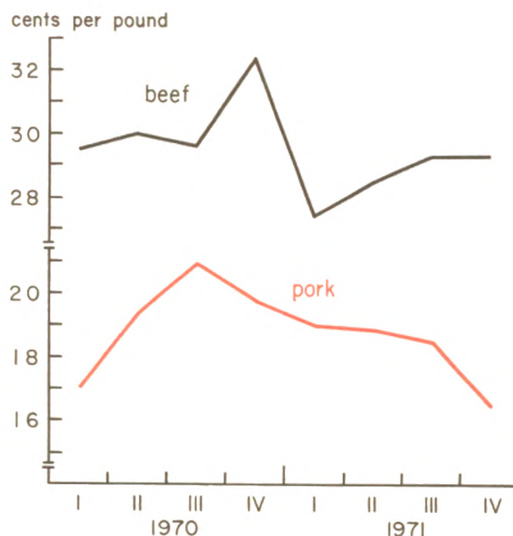
Meat imports

The possibility of raising meat import quotas in 1972 to augment domestic production has been suggested as a means of easing the upward pressure on retail prices. Normally, imports make up about 5 percent of total meat supplies, and about three-fourths of these imports are beef. An increase in meat quotas of perhaps 6 to 7 percent has been suggested for this year. This would translate into a less than 0.5 percent increase in total supplies.

The bulk of imported meat is used in such processed items as frankfurters, luncheon meats, and canned or frozen products. Some imported meat also is used in lower-priced meats, such as hamburger. Thus, an increase in imported supplies could have a dampening effect on prices of these items which, in turn, could work to moderate further increases in higher-priced cuts. The timing of an increase in imported supplies could strengthen its impact. Since the first quarter will have passed by the time any increase is implemented, an increase in imports would come sometime in the remaining three quarters of the year. But with or without an increase in imports, total meat supplies are likely to remain tight relative to demand through most of 1972.

Larger consumer after-tax incomes, a slowdown in the rate of inflation with a resulting increase in real purchasing power, and a probable lower rate of unemployment all will contribute to increased demand for meat in 1972. Total consumer outlays on all food likely will accelerate from last year's increase of 5.5 percent, with outlays for meat pacing the increase.

Retail meat margins averaged lower in 1971



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

At this juncture, the prospective demand and supply situation suggests livestock prices probably reached their peak this winter but probably will remain high throughout most of 1972 when compared to recent years.

Retailers may recoup margin

Although retailers are allowed to "pass through" their additional costs due to higher livestock prices, these increases apparently have not yet been fully reflected in retail prices, as evidenced by the decline in retailers' meat margins. Margin, as used here, is the difference between the price the retailer pays processors for the meat and the price the retailer sells it for. All costs such as labor, utilities, etc., plus profits are included. During the fourth quarter of 1971, the retail margin for beef declined nearly 7 percent, and shrank 9 percent for pork.

Falling retail margins are typical in periods of rapidly rising farm commodity prices, but margins are usually rebuilt when farm prices decline. This year is not likely to be an exception. Margins can increase by virtue of retail prices declining more slowly than farm prices, but the small decline anticipated for livestock prices in 1972 is not likely to cause retail prices to decline. Moreover, other costs will continue to creep upward, contributing to higher prices. Therefore, margins are likely to increase as retailers maintain or raise their prices even though livestock prices decline.

The Department of Agriculture recently estimated that food prices at the supermarket will increase by 4 percent in 1972, compared to a 2.5 percent increase last year. Meat prices are likely to be a main contributing factor behind the increase.

"WHAT TRUTH IN LENDING MEANS TO YOU"

A Spanish version of this Federal Reserve System leaflet has been issued by the Board of Governors as part of its responsibilities under the Truth in Lending Act. **What Truth in Lending Means to You,** in Spanish, is now available, and you may obtain copies by sending requests directly to: Circulars and Publications Department, Federal Reserve Bank of Chicago, Box 834, Chicago, Illinois 60690.

BUSINESS CONDITIONS is published monthly by the Federal Reserve Bank of Chicago. Jack L. Hervey was primarily responsible for the article "Restrictions on world trade," and Dennis B. Sharpe for "What's happening to meat prices?"

Subscriptions to **Business Conditions** are available to the public without charge. For information concerning bulk mailings, address inquiries to the Research Department, Federal Reserve Bank of Chicago, Box 834, Chicago, Illinois 60690.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis