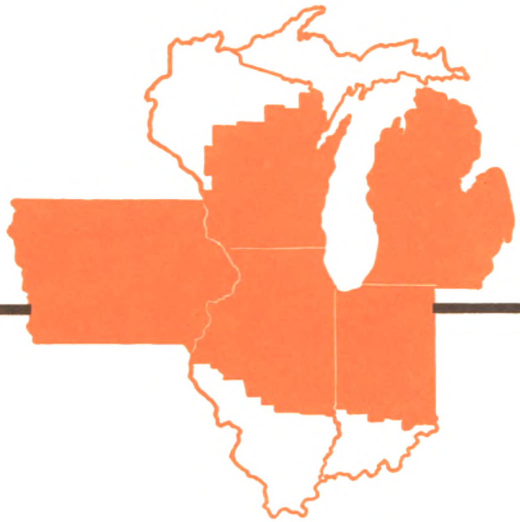
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



August 1972

Contents

Agriculture— Midyear review and outlook

The farm sector of the economy posted a record-breaking performance during the first half of 1972. Prices of farm products, which are exempt from Price Commission controls, reached record-high levels in June of this year, averaging 11 percent above a year ago. Prices paid by farmers for manufactured items used in farm production, which are controlled, have risen too, but at a slower pace. Farmers' cash receipts in the first half of 1972 increased at an annual rate of almost $4 billion, government payments increased nearly $1 billion, and cash expenses rose at a rate of $2.5 billion. As a result, net farm income rose to an annual rate of $18.3 billion—the highest level on record and nearly 14 percent above last year's final tally.

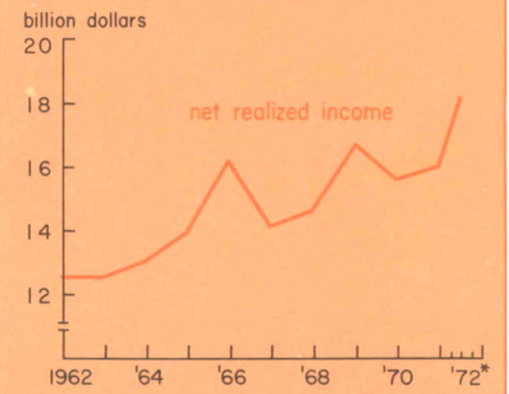
Clearly, American farmers have fared quite well under the Nixon Administration's New Economic Policy (NEP). The reinstatement of the investment tax credit, controlled prices on many farm production items, the devaluation of the dollar, and controlled wholesale and retail margins for food have aided the farmer by slowing his rising costs and expanding demand for his products. But farmers would be having a good year in 1972 even without the NEP since most of their good fortune is attributable to the fundamental market forces of supply and demand.

Workings of the market

Total supplies of farm commodities in the first half held relatively stable in the face of expanding domestic and foreign demand for food and feeds. In a market economy, prices adjust to equate supply with demand. With supplies short relative to demand, prices rose in the first half.

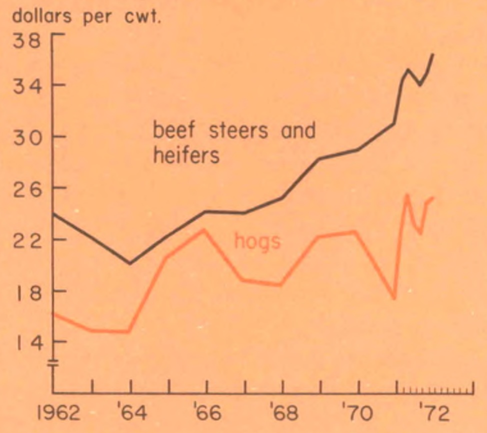
Demand for farm products is bolstered by each annual increase in population, but at the same time demand fluctuates with the general U. S. business cycle and foreign purchases. At midyear, it was increasingly apparent that the more optimistic forecasts for business recovery in 1972 were being realized. Gross national product (GNP) in the second quarter was 6 percent over a year ago after adjustment for inflation—the largest year-to-year "real" growth in the economy since 1966. The overall in-

Farm income reached a record high in the first half . . .



*Seasonally adjusted annual rate, second quarter.

... reflecting sharply higher livestock prices and ...

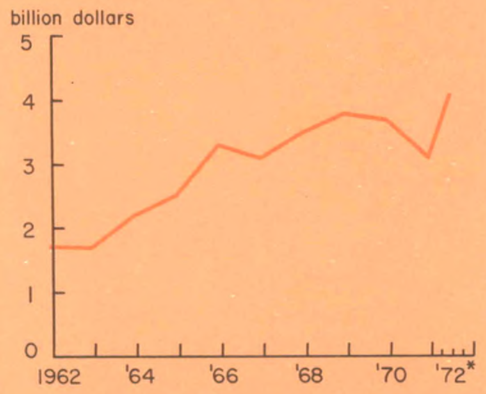


crease in economic activity was paced by a marked upsurge in consumer spending (demand). Despite the income-dampening effects of overwithholding of federal income taxes, spending surged above a year ago during the first half, as consumers reduced their savings rate and opted to spend more of their take-home pay. Total retail sales at midyear were 7.5 percent above a year earlier, although sales dipped 1.5 percent from May to June. Sales at food stores and eating places, although lagging slightly behind the advance in overall spending, posted gains of around 5 percent over a year ago.

While improving business conditions were stirring domestic demand, foreign demand for U. S. farm products was on the rise, too. For the fiscal year ended June 30, exports of agricultural products reached $8 billion, the highest ever and 4 percent above a year ago. All the increase occurred during January through June of this year, as exports surged nearly 8 percent over the first half of calendar 1971. Soybeans and livestock products (dairy products and cattle hides) led the expansion in foreign sales. Feed grain exports, especially corn, also increased over a year ago. Expanded livestock production in western Europe and poor feed grain crops in eastern European countries contributed to the expanded U. S. exports of soybeans and feed grains. A decline in foreign dairy production and cattle slaughter boosted demand for U. S. dairy products and cattle hides.

The devaluation of the dollar last December probably contributed to increased exports in the first half of 1972. Nearly two-thirds of U. S. agricultural exports go to countries whose currencies appreciated relative to the dollar. All other things equal, this means U. S. farm products are cheaper in those countries than they were prior to devaluation and are more competitive with agricultural commodities from other exporting countries.

... direct government payments to farmers



*Seasonally adjusted annual rate, second quarter.

In contrast to demand, total per capita U. S. food supplies in the first half of 1972 were about unchanged from a year ago—livestock products (primarily pork), down; poultry, eggs, and milk, up; wheat and feed-grains, up; fruits and vegetables, down. With supplies roughly the same and world-wide demand increasing, the normal workings of the marketplace pushed farm commodity prices upward.

Commodity review

Changes in hog slaughter played a key role in the farm price and income situation. A sharp drop in hog production was accompanied by an even sharper increase in hog prices. During the first half, production averaged 6 percent below year-ago levels and prices averaged over 40 percent higher. This situation was preceded by a period in 1970-71 when low prices, high feed costs, and sluggish consumer demand caused many hog producers to curtail their operations. In the first half of 1972, however, reduced pork supplies met with expanding consumer demand. Hog prices rose sharply, while feed costs declined, pushing profits to the highest level in several years. Much of this renewed prosperity accrued to Seventh District farmers in the Corn Belt states of Illinois, Iowa, and Indiana—producers of 45 percent of the nation's hogs.

Cattle-feeding profits, too, showed a marked turnaround from a year earlier. Fed cattle prices averaged 15 percent above a year ago during the first half and reached a 21-year high in June. Based on farm management budgets, Corn Belt cattle feeders made a profit of over $55 per steer in June, before charges for labor and overhead, compared to around $17 per head in the comparable period a year earlier. About 18 percent of Seventh District farmers' cash income is derived from cattle and calves.

Dairying has fared better in 1972 in the face of larger volume of production and despite no increase in price supports. Throughout the first half, milk prices averaged about 3 percent higher—with much of the firmness in the market due to larger dairy exports. Dairying is especially important in the district states of Wisconsin, where about half of farmers' cash income is derived from milk, and in Michigan, where milk sales account for approximately 30 percent of farm receipts.

Soybeans, a major source of farm income in the district, were higher priced in the first half, too, even when compared to the exceptionally strong prices in 1971. Here again, reduced supplies have coincided with expanded foreign and domestic demand, especially for soy protein meal. Although farmers harvested a larger crop last fall, the increase was not sufficient to replenish stocks used up in the 1970-71 marketing year. As a result, the total supply of soybeans is about 4 percent smaller this season than last. Prices, moving higher to ration scarce supplies, averaged 10 percent above last year's high prices in the first half.

Corn, another principal cash crop in the Seventh District, is in abundant supply this year, and prices in the first half averaged more than 20 percent below a year ago, when prices were exceptionally high because of a blight-reduced harvest in 1970. The lower prices, however, had a mixed impact on farmers, depending on their specialty. For large livestock feeders who use all the corn raised on their farms as feed and must purchase additional amounts, the lower corn prices translate into lower feeding costs and higher livestock profits. For those cash grain farmers who specialize in raising corn, the lower prices could mean somewhat lower incomes. The income-depressing effects of lower prices, however, are partly offset by much larger volume and, to an even larger extent, by government payments and price supports. Almost 85 percent of the 1971 corn crop was eligible for nonrecourse government loans at guaranteed prices.

Record-large amounts of corn have been placed under government loan which tends to provide corn prices a floor that is equal to the national average support price of $1.08 per bushel (plus storage and interest costs). Furthermore, nearly 1.8 million of the nation's feed grain producers, representing 83 percent of the feed grain acreage, are eligible for sharply higher direct government payments this year for withholding part of their acreage from production. On July 1, government checks totaling approximately $1.9 billion were mailed to feed grain producers—an increase of $850 million over 1971 payments.

Outlook for the last half

Prospects for agricultural prices and income in the second half are clouded by actions to curb advances in food prices. Nevertheless, demand for farm products, especially foreign demand, is likely to be as strong in the latter half of the year as in the first half, and only moderately larger supplies of farm commodities are expected. Activity in most sectors of the domestic economy is expected to remain vigorous, with employment and incomes expected to post sizable gains over a year ago.

Foreign demand for farm products already has been given a substantial lift in the second half by the recent agreement with the Soviet Union to buy substantial U. S. wheat, feed grains, and soybeans. Furthermore, economic activity in the major western European nations and Japan, the main customers for U. S. farm products, is expected to be more robust during the last half of 1972 than during either the first half or a year ago. In addition, most of these countries—especially Japan, the single largest U. S. customer—have substantial balance-of-payments surpluses and are under considerable economic and political pressure to ease import restrictions on U. S. products.

Boosting supplies, curbing prices

In response to rising food prices, the Administration took several steps in late June aimed at increasing food supplies and broadening price controls. Meat import quotas were suspended, an action that is likely to have relatively little impact on supplies. Imports are only a small fraction (5 percent) of annual U. S. supplies; most imported meats are used in products such as hamburgers, luncheon meats, and other processed meats, and compete only indirectly with the most desired domestic retail cuts; and there is stiff world competition for available meat supplies.

Phase II controls were extended to cover previously exempt raw farm products (fresh fruits and vegetables, eggs, etc.) and seafood after the point of first sale. Retailers still are allowed to "pass through" higher farm level costs plus add their customary margin to the increase, but their percentage margins must not exceed the average of the highest two out of the past three years. "Jaw-boning" also was renewed, with major food chain executives being summoned to Washington and admonished to lower their prices promptly as soon as farm prices decline.

In sum, these actions may be expected to have only limited effect upon supplies, although prices of agricultural products may be dampened by changes in consumer attitudes. Some in Congress have suggested stronger action including a rollback of retail food prices and direct controls on farm prices.

Are direct controls likely?

The U. S. Government has never applied direct price controls to farm commodities. The control programs of World War I, World War II, and the Korean conflict, while using some form of margin control on food items similar to current Phase II controls, all exempted farm prices.

Wage and price controls of the New Economic Policy were instituted to curb rising prices in the face of mounting unemployment and unused plant capacity—a phenomenon loosely defined as cost-push inflation. Price regulators are aware that the rise in farm prices has not been from higher costs pushing up prices, but from demand increasing faster than supplies. The remedy for high prices in such a case is increased production. But arbitrary price controls or rollbacks would likely stifle the incentive to increase output, and could eventually result in government rationing of supplies.

Higher prices are already signaling increased production—sure to be forthcoming as soon as farmers have sufficient time to adjust their production plans. But agricultural production relies on biological processes, and time lags exist between increased prices and expanded supplies. In the case of pork production, at least nine months is required from the time a farmer decides to increase output by breeding more sows until the pigs from these additional farrowings reach market. Currently, prices have begun to ease down seasonally, alleviating the urgency for action that was felt when farm prices were at their summer peaks. The latest reports on livestock numbers and crop production, however, indicate only modest price declines in the months ahead.

Outlook for major commodities

The June 1 Hogs and Pigs report indicated that short pork supplies are likely to persist at least through the first quarter of 1973. Hogs and pigs on farms to be marketed in the second half are expected to number 7 percent below a year ago. Farmers indicated they planned to farrow 5 percent fewer sows during June through November. Allowing for an upward trend in pigs per litter, hogs available for market in the latter part of the fourth quarter and through the first quarter of 1973 likely will number 4 percent less than a year earlier. Given these supply prospects, hog prices should remain relatively high throughout 1972, although some seasonal decline is likely in October and November.

Beef production, in contrast to pork output, is currently in the midst of an expansionary phase. The nation's cow herd numbers 3 percent larger than a year ago and 6 percent more beef heifers are being retained for future breeding purposes. Cattle on feed in 23 major feeding states numbered 14 percent more as of July 1. There is also evidence that Corn Belt feeders have kept cattle on feed for an extended period in an attempt to "average down" the high cost of feeder stock and utilize relatively cheap corn supplies. This could result in more heavyweight cattle coming to market in the second half, swelling beef supplies more than numbers alone might indicate. Declines in slaughter of young calves and cattle outside feedlots, along with increased holdback of replacement breeding stock, will offset part of the increase in cattle marketed from feedlots. At the present time, beef production is expected to increase 6 to 7 percent over a year ago during the second half. (First-half production was less than 2 percent larger than a year ago.) An increase of this size may well be accommodated with only moderate declines in cattle prices provided marketings are not "bunched." This is especially true in light of continued smaller competing pork supplies, and assuming the robust, first-half consumer demand for beef gains momentum in the second half. Cattle prices are likely to drift seasonally lower, however, and this coupled with record-high prices paid for feeder stock purchased this spring will squeeze feeding profits. Total receipts to cattle feeders in the second half are likely to be larger though, reflecting greater volume of cattle sold.

Dairy prices currently are expected to remain above a year ago in the second half. The first-half surge in exports appears to be waning, but an unusual jump in cheese prices during June indicates strong domestic demand, which may offset expected increases in production. Dairy receipts may rise slower than in the first half but are still likely to rise 3 percent over 1971 levels.

Both corn and soybean price prospects for the latter half of 1972 hinge on the size of the 1972 crops. The August 1 Crop Report indicated corn production may be nearly 11 percent smaller than last year. At the same time, the grain sale to the Soviet Union has substantially boosted export prospects for corn. At least $200 million worth of feed grains and wheat will be exported between now and next July. Reflecting these developments, corn prices have edged up from first-half levels and may hold 10 cents per bushel above the depressed harvesttime prices of last fall, despite near-record supplies.

The soybean harvest this fall is expected to be 9 percent larger than last year according to the latest Crop Report. But because of depleted stocks of soybeans, the increase in production is likely to result in prices holding above a year ago during the third quarter, although prices could dip below a year ago at harvesttime. Over half the soybean crop now goes to foreign markets, and export demand, which has been exceptionally strong even at record-high prices, appears likely to be sustained through the remainder of the year.

On balance, prices of livestock products and soybeans for most of the second half may average slightly lower than in the first half but well above a year ago. Corn prices, which were the weak point in the district farm economy in the first half, have strengthened. As a result, farm income is likely to continue to rise at a record-breaking pace throughout 1972.

Capital flows and the dollar

The money and capital markets of the major industrialized nations have been increasingly internationalized in the past decade. In recent months, the monetary authorities of various nations have introduced special controls to curtail speculative movements of funds. Nevertheless, the principal financial centers of the world are now interdependent to a degree unforeseen a generation ago. International flows of both short- and long-term capital have been increased by the proliferation of investments of multinational corporations, the establishment of foreign branches by large commercial banks, and the increasing knowledge and sophistication of private investors.

The increased importance of flows of funds between nations has played a large role in the dramatic developments in international finance in recent years. Financial crises and emergency regulations in major nations have been associated with large-scale capital movements. This article describes some of the more important recent developments in international financial transactions of the United States to provide a basis for a better understanding of future trends.

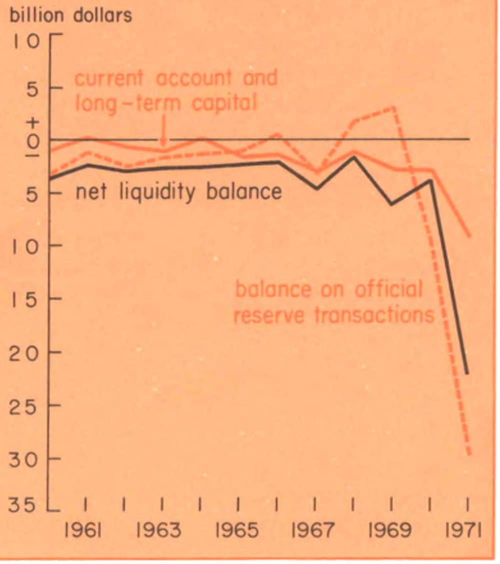
Current and capital transactions

The Department of Commerce divides U. S. international transactions into the "current account" and the "capital account." The largest share of the current account consists of payments and receipts for goods and services. Services include returns on invested capital—dividends, interest, royalties, and fees. Also included in the current account are transfers of funds, such as pensions, private gifts, and foreign aid. The capital account in the balance of payments includes extensions of credit, purchases of securities, and direct investments.

Not all international transactions are regularly reported and recorded, and the origin of changes in foreign holdings of dollar claims cannot always be identified. These unrecorded transactions are included in the balance-of-payments accounts as "errors and omissions."

Every full year since World War II, the United States has had a surplus in the goods and services sector of the balance of pay-

U. S. balance of payments deteriorated sharply in 1971



ments. This surplus reached a peak in 1964 at $8.6 billion. Since then, it has declined, as imports of merchandise rose more rapidly than exports. In 1971, the surplus on goods and services was only about $700 million. Beginning in the fourth quarter of 1971, the surplus gave way to a deficit.

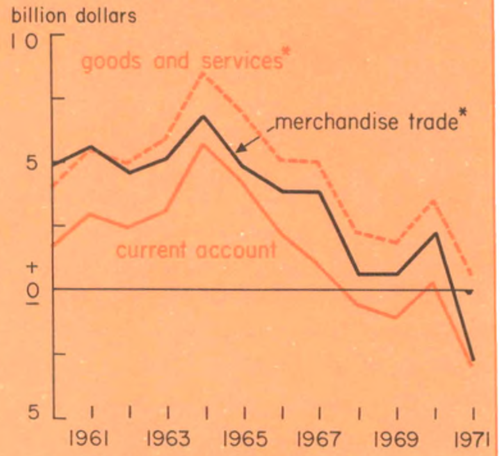
That portion of the current account recording remittances, pensions, and other transfers of funds has been in deficit continuously since World War II. But in most years, this deficit has been more than offset by a surplus for goods and services. As a result, the current account, as a whole, has shown a surplus in most years. However, the current account was in deficit in 1968 and 1969, and a record deficit of $2.8 billion was recorded for 1971.

The widely-publicized deficits in the U. S. balance of payments in recent years, however, mainly reflected developments in international capital and money flows. In the years 1960-71, the outflow of long-term private capital averaged $4.2 billion annually. Inflows averaged $1.7 billion, so the net long-term private capital outflow averaged $2.5 billion annually. Net outflow of short-term, both liquid and nonliquid capital, averaged about $300 million annually. Taken together, these flows produced an average deficit in the private capital accounts of $2.8 billion per year. Moreover, substantial fluctuations have occurred from year to year. The volatility in the private capital investment sector was instrumental in persuading the U. S. Government to adopt capital controls in the early Sixties, and led to developments that resulted in the devaluation of the dollar in December 1971.

Onset of capital controls

The first dollar crisis of the post-World War II period occurred in late 1960, as speculation grew that the payments deficit would force the U. S. Government to withdraw its offer to convert foreign-held dollars into gold at $35.00 per ounce. This crisis passed without serious consequences. But persistent payments deficits in the early 1960s caused continued anxiety both here and abroad.

Deficit in the current account last year reflected adverse trade balance



*Data exclude military grants and aid.

In the early 1960s, it was hoped that U. S. payments deficits would be reduced or eliminated if this nation's competitive position could be improved with the introduction of advanced technology and increases in output per man-hour. But the deficits in the private capital account rose further, partly because lower interest rates in the United States caused foreigners to borrow large sums in our markets. In order to discourage these transactions, the Interest Equalization Tax (IET) was imposed in 1963. Acquisitions of foreign stocks and bonds by U. S. investors were made subject to a tax of 15 to 22 percent. Securities of Canada and the underdeveloped nations were exempted from the tax.

The IET appeared to be effective because purchases of foreign securities by U. S. investors declined by almost 50 percent from 1963 to 1964. However, as purchases of foreign securities declined, foreign lending by U. S. banks rose sharply. Increases in bank loans to foreigners jumped to $2.5 billion in 1964, after averaging $1.1 billion in the period 1960-63. In addition, U. S. direct investments abroad rose to $2.3 billion in 1964 from an average of $1.7 billion in the previous four years. As a result of these developments, the overall balance-of-payments situation deteriorated in 1964, despite a record surplus on goods and services.

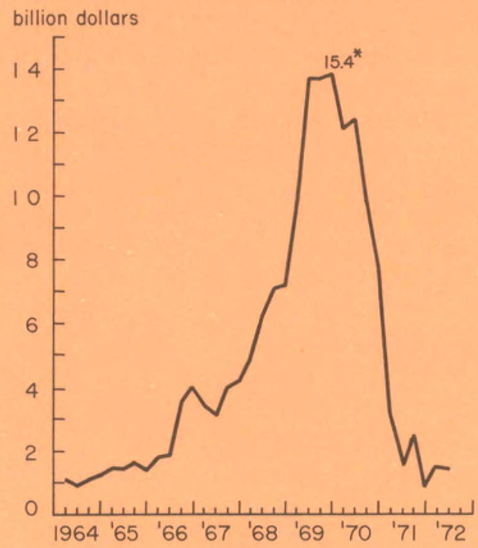
To supplement the IET, the President imposed restraints both on loans made by banks and other financial institutions to foreigners and on direct investments abroad. At first, these programs were voluntary. As in the case of the IET, the program to restrict foreign lending appeared to succeed. In 1965, a net inflow of bank funds of about $100 million was recorded. The net deficit on direct investments, however, rose to almost $3.5 billion. As a result, controls on direct investments were tightened and in 1968 were made mandatory.

Recent capital flows

Purchases of foreign securities have increased somewhat in recent years, but most of the increase has been in exempt securities. Similarly, increases in bank lending have largely reflected increases in types of loans that are exempt from controls.

Direct investment abroad by U. S. corporations continued to rise following the imposition of the restraint program. It reached $4.7 billion in 1971—more than double the amount recorded in the year prior to the implementation of the program. But the rise was largely financed by special issues of U. S. corporate securities abroad. The development and marketing of these financial instruments (the so-called Eurobonds) marked one of the major innovations in the world capital markets in recent years. Since 1966, the Eurobond market (including the Eurodollar bond market) has developed into a viable and flexible institution. Increasingly, U. S. corporations have sold securities abroad, not merely to make foreign investments, but also to provide funds for domestic operations. As a result,

Eurodollar borrowings by U. S. banks at low ebb in past year



*Data are outstandings at end of quarter.

the Eurobond market appears to have assumed a permanent role in the financial planning of U. S. corporations.

Another major development in recent years has been the increasing participation of foreigners in the U. S. capital market. Purchases of U. S. stocks by foreigners (that totaled less than $200 million net in the ten years between 1957 and 1966) rose to over $700 million in 1967. Aided by the strong performance of the U. S. stock market, relative tranquillity in the foreign exchange markets, and aggressive salesmanship by U. S. brokers, foreign purchases of U. S. stocks skyrocketed to over $2.0 billion in 1968 and to $1.5 billion in 1969.

With the sharp decline in stock market prices in 1970, net foreign purchases declined to less than $700 million. But in the latter part of 1971 and in early 1972, as the U. S. stock market strengthened and as relative tranquillity returned to foreign exchange markets, foreign purchases picked up again, suggesting that they may become a permanent phenomenom in the U. S. balance of payments.

Short-term flows

Developments in the short-term money markets since 1967 have been as dramatic as developments in the long-term capital markets. One major innovation in the short-term markets has been the operations of U. S. banks in the Eurodollar market. Another has been speculative activities of U. S. residents, especially during last year's currency crises.

Large U. S. commercial banks began to borrow in the Eurodollar market on a large scale in 1966. (Eurodollars are deposits in foreign banks that are denominated in U. S. dollars.) Banks sought funds abroad to satisfy heavy domestic loan demands because the Federal Reserve Board's "Regulation Q" (ceiling rates on deposits) closely restricted the ability of banks to sell certificates of deposit to U. S. investors in competition with other money market instruments. The huge inflows of short-term funds in 1968 and 1969 mainly reflected Eurodollar borrowings by banks. To a large extent, these funds represented dollars previously accumulated by foreign central banks.

The inflow of funds associated with the borrowings of Eurodollars was the main cause of a surplus in the U. S. balance of payments (official transactions basis) in 1968 and 1969—$1.6 billion and $2.7 billion, respectively. However, when loan demand eased and short-term funds became generally available at favorable rates in 1970 and 1971, U. S. banks began to repay Eurodollar borrowings. From a high of more than $15 billion in late 1969, these borrowings declined to about $7.5 billion at the end of 1970. Concurrent with developments in the long-term capital markets, and the deterioration in the goods and services account, the drop in Eurodollar borrowings led the way to a huge $9.8 billion deficit in the balance of payments in 1970.

Repayments of Eurodollar loans continued in the early months of 1971. Outstandings declined to less than $2 billion at the end of April, excluding special security holdings of banks' foreign branches. At the same time, speculative transfers of funds abroad by U. S. residents who believed a devaluation of the dollar was imminent became a significant element in the picture. This speculation was not a new phenomenon, but it had never been so open and in such heavy volume. Foreigners—businesses, investors, and speculators—also attempted to exchange dollars for "strong" currencies, such as the German mark.

As a result of all these factors, the recorded outflow of short-term (both liquid and nonliquid) funds from the United States during the first nine months of 1971 amounted to almost $8 billion. In addition, unrecorded transactions (mainly transfers of funds by individuals) amounted to almost $9 billion in the same period. This massive outflow of short-term funds, combined with a $4.4 billion outflow of long-term capital and with a deficit in the other balance-of-payments accounts, produced a deficit in the U. S. balance of payments (official reserve transactions basis) of almost $24 billion in the first three quarters of the year. With confidence in the dollar deteriorating rapidly, the President acted in August to suspend the convertibility of the dollar into gold. This and other actions associated with the New Economic Policy marked the beginning of far-reaching changes in the international payments system that had existed since the end of World War II.

Conclusion

International flows of funds recorded in the U. S. accounts have had their counterparts in the accounts of other nations. For most other trading nations, the impact of these flows was greater than here because their economies are smaller. Large capital flows have been relatively more disruptive, and the need for corrective measures greater.

When the major nations agreed to a substantial devaluation of the dollar relative to their currencies at the Smithsonian conference in December 1971, a new era was launched. Profound changes in the money and capital markets of the world had forced universal recognition that the dominant position in world finance long occupied by the United States was no longer tenable. The dollar was no longer invulnerable to far-reaching changes in patterns of trade and capital movements, nor were the other major currencies. Moreover, the new relationship of the dollar to other currencies is not viewed as immutable. Adjustments can and presumably will be made in the future as conditions warrant. The floating of the British pound in June suggests that governments are now more willing to make adjustments in accord with economic realities.

The economies of the world have become more closely interrelated with each passing year. Despite periodic backsliding into the realm of direct controls, nations are learning to live with, and benefit from, the flow of funds across international frontiers. New institutions, such as Eurodollars and Eurobonds, together with the willingness of nations to discuss and negotiate mutual problems, should help prepare the way to a distant goal—"One World" of finance.

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