Research Department
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FRBSF Weekly Letter

Food — Up 10 Percent?

The U.S. Department of Agriculture (USDA) has the greatest concentration of agricultural expertise in the world. When such an organization gears up to forecast food prices, people pay close attention. Thus, last November when USDA told us that 1979 food prices were likely to average 7.5 percent over the 1978 level, there was little dissension. But today, just four months later, you would be hard put to find a single soul willing to put money on such an optimistic forecast. In 1979 as in 1978, unexpected agricultural developments have caught USDA with its forecasts down.

The treacherousness of food-price forecasting is easily illustrated by a review of 1978 developments. In November 1977 (November is the month in which the first forecast for the coming year is made), USDA said 1978 food prices would probably average 4 to 6 percent over the previous year. No one knew better than USDA that we were moving into the trough of the cattle cycle — that beef production would be down and that beef prices would be pushed upward. But USDA expected only a moderate increase in beef prices, because the nation's hog farmers had said that they intended to expand pork production by 10 percent in 1978. Since many consumers switch from beef to pork when the former becomes too expensive, USDA felt that cheap and plentiful pork would dampen demand for beef and hold beef-price increases to modest levels.

While the country's hogs were quite willing to cooperate with the necessary procreation, hog farmers saw the implications of their collective decision for the bottom line and quickly decided to limit output. The severe winter of 1978 also increased mortality rates and slowed weight gains, so by the time the year was out, pork production had expanded by only 1 percent — rather than the anticipated 10 percent. With the pigs not coming to market, beef prices shot through the roof. Add to this the impact of the Florida freeze and the inopportune California rains on fruit and vegetable harvests, and the result was a 10-percent increase in food prices for the year.— precisely double the initial USDA forecast.

Problems on the farm

Having eaten their collective hat — along with most other price forecasters — the world's largest Agriculture Department sat down again last November with pen, paper and computer to churn out a forecast for 1979. To increase the probability of being correct, USDA considerably widened the forecast range and predicted that 1979 food prices would average 6 to 10 percent above the 1978 level. The most likely scenario, the forecasters said, would be a 7.5-percent increase for the year — which translates into roughly a 5.5-percent year-end to year-end increase for those of you who keep score that way.

As things are turning out, that 7.5-percent forecast will considerably understate the actual increase, and the 10-percent top-of-the-range figure may just barely capture the final outcome. Implicit in the 7.5-percent forecast is an assumption that prices down on the farm will average only 7 percent higher in 1979. Well, the January and

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February increases were so large that, even if farm prices remained unchanged for the rest of the year, their annual average would be double the USDA assumption. Thus, the recent upsurge in farm prices by itself would push the food-price forecast above 9 percent, and any further price increases in the field will only add to this figure.

Problems off the farm

Food buyers frequently forget that the bulk of what they pay at the supermarket check-out counter — that is, almost 60 percent — goes to pay for things done to food after it leaves the farm gate. Any forecast of food prices must obviously take account of potential developments in this marketing sector, where food gets transported, stored, processed, advertised, packaged and sold. This year, USDA may have understated both the labor and energy components of the marketing bill.

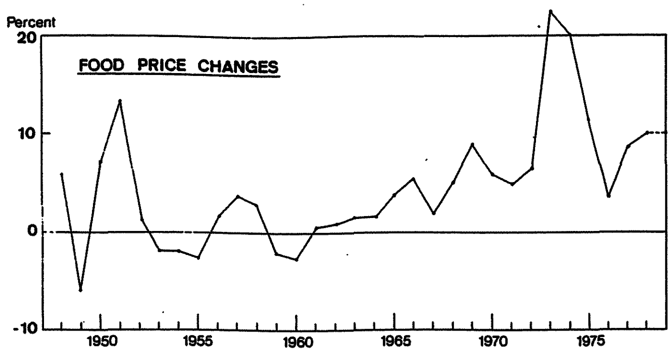
Last November, USDA projected an 8-percent increase in labor costs, which account for about half of all marketing costs. A substantial share of the unionized food workers will renegotiate contracts during 1979. (While only 20 percent of food-industry workers belong to unions, union wage settlements tend to influence non-union wages.) In view of the recent rise in forecasts of the overall rate of inflation, and in view of union leaders' perception of the huge fourth-quarter profits increases, average wage increases this year may be closer to 10 than to 8 percent.

The second untoward development in the marketing sector was OPEC's announcement of a 14.5-percent increase in oil prices, followed closely by an interruption in Iranian oil supplies. It now appears that energy costs will rise significantly in 1979, which will in turn raise the costs of transportation, packaging and processing. Reflecting all these developments, the increase in marketing costs will probably be closer to 8.5 percent than the 7-percent assumed in the USDA forecast.

Altogether, the recent farm-price upsurge would add 1.6 percentage points to the original 7.5-percent USDA forecast, and the extra marketing costs would add 0.9 percent more. Thus, it seems likely that we will be paying roughly 10 percent more for food in 1979 than we did last year. And of course, any further leap in farm prices will push the consumer price even higher.

Room for hope

There are signs of farm price moderation on the horizon, however. The main reason for this lies in the livestock sector, which has been responsible for much of the worsened price picture of the past year. When we look at the number of cattle in the beef pipeline, we might assume that the tightest supply situation and the biggest price jumps would occur this spring and summer. However, market participants may have begun to stock up in anticipation of this rise in prices. Thus, the amount of beef in cold storage has been growing very rapidly since last September, and early last month stood about a third higher than the year-ago level. Anticipatory buying thus caused



prices to rise earlier than expected, so that, come spring and summer, these high-priced cattle shouldn't be selling for much more than they are now. Actually, the futures market suggests that live cattle prices will decline by 8 percent between now and December.

In addition, last week's hog report confirmed that the pigs will indeed be coming to market this year. On March 1, there were 12 percent more pigs being held for slaughter and 20 percent more held for breeding, than a year ago. Furthermore, there will be 24 percent more baby pigs entering the world during the second quarter of this year than in the same period of 1978. Add to this a 9-percent increase in broiler production and a 20-percent increase in turkey production, and you have a plentiful supply of beef substitutes that should keep the lid on beef prices once the recent cattle price increases work their way through the marketing chain. A caveat to consumers: our current position in the cattle cycle suggests that prices will continue their ascent after this near-term moderation, and that we won't experience any serious price relief until the early 1980's.

What about other farm prices? Good wheat crops in Australia, Argentina, Western Europe and the Soviet Union, plus record inventories in this country, suggest a relatively flat trend of prices over the rest of the year. A Brazilian drought, leading to an estimated 20-percent reduction in that country's soybean crop, may continue to strengthen U.S. prices for another month or so, but our record stocks and expected record plantings this spring suggest an eventual softening in soybean prices. (The futures market sees a 9-percent drop in soybean prices between July and November). On the vegetable scene, winter acreage is up, so that adequate supplies should prevent any untoward price movements. A citrus shortage has driven up the prices of all fruits, and while there is no evidence that grower prices will weaken, it is also not clear that they will rise any further than they already have.

Rising bottom line

The bottom line is that farm prices have probably blown off most of their steam for the year, and any further increases may be rather moderate. But since it takes several months for farm prices to work their way through the pipeline, we can expect that food prices will continue to be the villain in the monthly CPI reports probably through the end of spring.

Reflecting all these developments, USDA recently raised its food-price forecast for the year from 7.5 percent to 8.5 percent. However, even this forecast may be conservative, because it implies that average increases for the remainder of the year will be on the order of only 0.3 percent per month. In view of the farm-price increases to date, as well as the above-mentioned developments in the marketing sector, this forecast may be outpaced by reality. Thus, USDA may be forced to move its forecast closer to 10 percent as the year progresses.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/21/79	Change from 3/14/79	Change from year ago @ Dollar	Percent
Loans (gross, adjusted) and investments*	122,496	936	NA	NA
Loans (gross, adjusted) — total#	100,148	943		
Commercial and industrial	29,144	168		
Real estate	35,689	99		
Loans to individuals	20,580	72		
Securities loans	1,607	34		
U.S. Treasury securities*	7,740	– 4		
Other securities*	14,608	– 3		
Demand deposits — total#	38,881	– 1,312		
Demand deposits — adjusted	28,681	– 835		
Savings deposits — total	29,720	98		
Time deposits — total#	50,275	– 138		
Individuals, part. & corp.	40,738	– 220		
(Large negotiable CD's)	17,941	– 183		

Weekly Averages of Daily Figures	Week ended 3/21/79	Week ended 3/14/79	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	– 46	53	65
Borrowings	34	27	13
Net free reserves (+)/Net borrowed(–)	– 80	26	52
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (–)]	+ 869	+ 1,620	+ 432
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (–)]	+ 2	+ 315	+ 110

*** Excludes trading account securities.**
 # Includes items not shown separately.
@ Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.

Editorial comments may be addressed to the editor (William Burke) or to the author ....
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