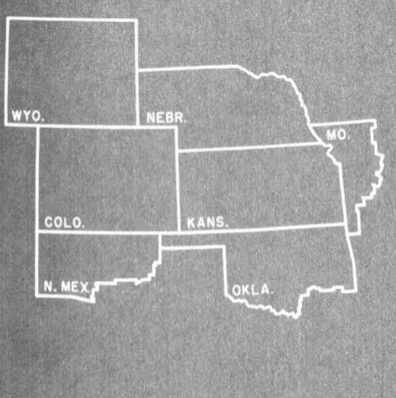
monthly review

DECEMBER 1974



FEDERAL RESERVE BANK OF KANSAS CITY

The Economy in 1975 — Uncertainties Cloud the Outlook

By Dan M. Bechter and J. A. Cacy

A year ago, this *Review* described the uncertain outlook for 1974. The consensus forecast at that time was for a weak first half, followed by a somewhat stronger second half. This consensus, however, was accompanied by general agreement that the economy's path through 1974 could well vary considerably from this best estimate.

The economic outlook for 1975 resembles, in some respects, the one anticipated a year ago for 1974. Again, the publicized forecasts seem to agree in expecting a weak first half, followed by a resumption of growth in the second half. And, again, uncertainties abound. Despite the similarities in the broad outlines of the two forecasts, however, the critical factors determining economic conditions in 1975 will differ from those in 1974.

ECONOMIC AND BUSINESS DEVELOPMENTS IN 1974

The economy did not perform well in 1974. Output declined and inflation accelerated. A slowing down in the rate of growth of real GNP had been expected; the trend had been in this direction during 1973. But, for 1974 to be recorded as a full year of recession was well into the pessimistic range of forecasters' expectations. Unfortunately, the poorer-than-expected productive performance of the economy was not accompanied by abatement in inflationary pressures. Prices rose at double digit rates as output slumped.

Some economic problems of 1974 could be attributed to special factors, of course. The overhanging distortions of wage and price controls still might be blamed for some of the materials shortages. The oil embargo certainly helped smother output growth and the subsequent increase in oil prices certainly fueled inflation. Mother Nature did not do her best for agriculture, while world demand for food and feed rose. Finally, monetary and fiscal policies had restrictive impacts on economic activity.

The 1974 slump was not evenly experienced by all sectors. Residential construction was plunged into a depression by shortages of mortgage funds in thrift institutions and by rapidly rising prices of new homes. By the third quarter of 1974, housing starts had collapsed to one-half their fourth quarter 1972 rate. Consumers were forced to retrench as spendable incomes failed to keep pace with prices. Unit sales of automobiles and other consumer durables fell off substantially and even consumer expenditures on nondurable goods and services during 1974 fell behind year-ago levels in real terms. Sources of strength were scarce. Federal government real purchases of goods and services were flat, although state and local governments bought more. Business investment did not show the degree of vigor that was expected. Expenditures on new plant and equipment in 1974, adjusted for inflation, ran just about even with those in 1973. Real additions to business inventories during the first half of 1974 exceeded those of the first half of 1973, but a weakening trend in inventory investment characterized the last half. In the international sector, the large increase in the cost of oil significantly raised the dollar volume of imports. The balance of trade deteriorated sharply in current dollar terms, even though the quantity of exports measured in real terms rose more than the quantity of real imports.

PROSPECTS FOR 1975

The economy is not likely to perform well in 1975, either. As noted above, economic activity did not pick up during the second half of 1974, as had been hoped, but weakened further. It is now widely anticipated that output will continue its quarterly decline for at least the first two quarters of 1975, making six successive quarters of drops in production. By the third quarter of 1975, positive growth rates in real GNP may reappear.

The rate of inflation in 1975 is even more difficult to forecast than is the pace of economic activity. On the one hand, the combination of a depressed state of demand and more plentiful supplies can be expected to ease the upward pressure on prices. On the other hand, the recent jumps in unit labor costs discourage much optimism. On balance, the evidence suggests a gradual slowing in the rate of inflation during 1975.

Any forecast is based on several assumptions and deductions. In particular, the choices of monetary and fiscal policies will affect the rates of inflation and economic growth. The outlook outlined assumes a continuation of the anti-inflationary policies of the Ford Administration and of the Federal Reserve. Even with no change in such policies, however, it is quite possible for business conditions to turn out somewhat better or worse in 1975 than forecast here. By the same token, more or less progress in the battle against inflation is also quite possible, given a continuation of current policies. Perhaps the best way to emphasize the range of forecasting error is to examine the assumptions and the logic of the deductions in a sector-by-sector fashion.

Government

The Federal government appears intent on buying a smaller quantity of goods and services in 1975 than in 1974. The decline in real Federal expenditures on goods and services likely will be quite small, but must be viewed as a contractionary influence on business activity. This is not a recent change in direction of policy, however. Despite increasing in dollar terms due to inflation, Federal government purchases of goods and services have declined in real terms fairly regularly since the Vietnam War peak in 1968.

Besides directly affecting economic activity through purchases of goods and services, the Federal government indirectly influences the pace of business through its fiscal policy. A measure of this indirect influence is the direction of change of the budget deficit. The combination of inflation and recession has affected the deficit in opposite ways in recent quarters. Inflation has tended to increase tax receipts, while recession has tended to hold them down. The slowing economy also has increased certain transfer-type government expenditures, thereby acting to increase the deficit. The Federal government budget deficit can be expected to increase through 1975, which will help buoy up economic activity somewhat. But since the rising deficit will result from a weakening economy, it should be viewed more as a cushion to the recession, rather than something pulling the economy out of recession. Unless offset by increased revenue, the actual deficit will increase even faster, of course, if additional spending, such as extensions of unemployment compensation, is adopted to deal with the problems of recession.

Increased purchases of goods and services by state and local governments throughout 1975 will offset the restrictive policies of the Federal government to some degree. No fiscal boost to the economy is likely to come from these levels of government; state and local governments are not as free as is the Federal government to run deficits. Adding together the probable Federal, state, and local government influences on GNP in 1975 yields a sum that indicates a neutral-to-restrictive effect on business activity.

Consumers

Next, consider consumers, who buy almost two-thirds of the country's gross national product. Many observers feel it is unlikely that much strength will come from the household sector in 1975. Surveys show that people are especially pessimistic about the economy in the year ahead. Furthermore, consumer prices have been going up faster than disposable income; only by saving less could consumers buy as much in real terms as they did in 1974. During 1974, in fact, the saving rate dropped rapidly, but consumers still purchased fewer goods and services than in 1973. The saving rate in 1973 was at a post-World War II peak; by the third quarter of 1974, it was below its long run average. Another sizable decline hardly seems likely. During 1975, real spending by consumers could well average below that of 1974, although a flat-to-improving pattern is more to be expected than is a continual decline.

Housing

Perhaps the most difficult sector to forecast is residential construction. Along with business investment, the housing industry will help to determine whether the economy performs somewhat better or worse in 1975. On the brighter side, recent declines in short-term interest rates have decreased the cost of builders' loans, and have helped return deposits to thrift institutions. Also, the depressed state of the housing industry is receiving attention in the form of recently enacted and proposed subsidies. But a combination of forces is likely to preclude significant revival in home building next year. Despite a dramatic slowing down of housing starts since early 1973, vacancy rates in rental housing were still above year-earlier levels at last report. Inventories of unsold new homes remained high, and building permits continued to decline. Prices of new homes have gone up about as fast as prices in general, a factor working against recovery for this industry and, of course, inflation and recession will continue to squeeze prospective buyers out of the market for new homes. All this suggests that residential construction may not yet have reached its trough. Indeed, the National Association of Home Builders sees starts bottoming out in the second quarter of 1975, indicating some pickup in residential construction expenditures during the second half of 1975, although the year as a whole for housing probably will be slower than 1974.

Business Investment

Industrial capacity increased during 1974, but rates of capacity utilization generally declined. Consequently, real output in 1974 was down substantially from 1973 levels. Some sectors such as producers' equipment, where production was stimulated by a strong rate of business investment, were exceptions, but even the rate of output of business equipment tailed off during the last half of 1974. New orders for equipment and business investment in structures (plant) slowed in real terms. Nor is inventory investment likely to provide stimulus to production. The rate of investment in business inventories tends to coincide with the business cycle, which is currently on the down side.

Foreign Trade

The international trade sector is especially difficult to forecast. It appears that 1975 will be a year much like this past one, with late 1974's unfavorable balance of trade in current dollar terms continuing because of the abnormally high price of imported oil.

Summary

The outlook for the individual sectors adds up to a weak economy for the year as a whole. Many analysts feel the most likely quarterly pattern for 1975 will be two more quarters of negative real growth, followed by resumption of real growth in the second half. This quarterly shape depends largely on the assumption that households will lead the way, by stepping up their rate of purchases of durable goods and new homes later in 1975. Such a likelihood follows logically from the timing (current postponement) of such expenditures, and from the gains in real disposable income expected during the second half of the year, as the rate of increase of prices slows. A more optimistic forecast cannot realistically project anything much better: perhaps a flat first half, followed by a strong, but not booming second half. A pessimist might expect the recession to last three, or even four, more quarters. The chance of a steep decline in output, however, appears remote.

There are many explanations for prevailing rates of inflation. Early 1974 was characterized by classic demand-pull inflation in some sectors, with very tight markets for materials and for many finished goods. In looking ahead to price behavior, the anti-inflation effort can count on help from softening markets. With few exceptions, shortages during 1974 have turned into surpluses and the combination of decreasing demand and increasing capacity will continue to work in that direction during 1975. In the absence of such unpredictables as oil embargoes, natural disasters, and strong cost-push pressures, inflation can be expected to slow gradually and consistently through 1975.

Labor market conditions will reflect and affect the 1975 economy. The unemployment rate, which increased surprisingly slowly during early 1974, has jumped in the past few months and is expected to increase in 1975. It appears that, until recently, employers held onto workers in the face of declining business, perhaps expecting the economy to improve. With the recession continuing, layoffs are increasing. Employment, which drifted up at a relatively slow pace through most of 1974, is likely to decline in the months ahead. As employment adjusts to the depressed level of output, the very large declines in productivity during 1974 should be replaced by modest gains. This will help slow increases in costs. But generous settlements of wage contracts threaten to keep the wage-price spiral going, a race that workers, as a whole, cannot win, but a race which no individual or group wants to lose.

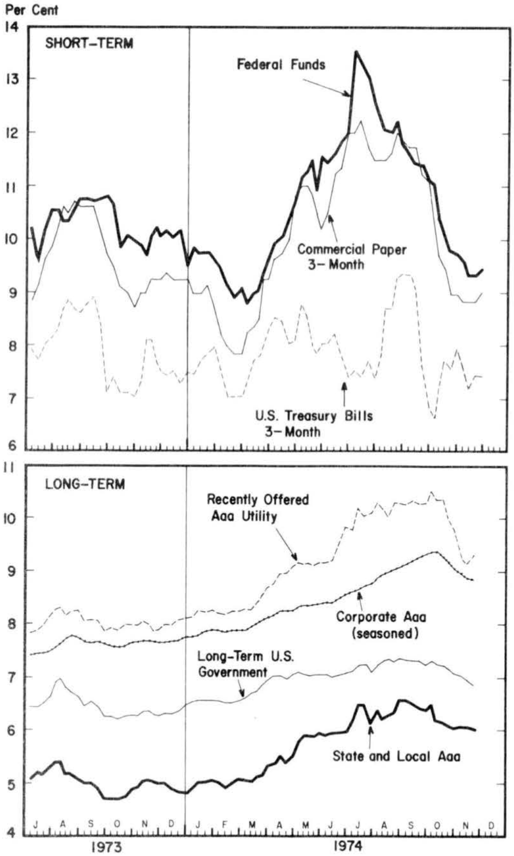
FINANCIAL DEVELOPMENTS AND IMPLICATIONS

In 1975, the course of inflation and the economy will affect and be affected by financial developments. This section discusses the ways that financial and economic variables may interact as the year unfolds. A brief review of 1974 sets the stage for the treatment of prospective events.

FINANCIAL DEVELOPMENTS IN 1974

Interaction between financial and economic variables was quite evident in 1974. The first quarter decline in economic activity was reflected in a drop in the growth rate of nominal GNP, which, in turn, placed downward pressure on short-term interest rates, which was not fully offset by the Federal Reserve. Thus, for example, the Federal funds rate declined from around 10.5 per cent in late August of 1973 to 9 per cent in early March, and averaged lower in the first quarter of 1974 than in the fourth quarter of 1973. (See Chart 1.) Following the first quarter slowdown in business activity, the pace of nominal GNP accelerated sharply in the second quarter, which contributed to the sharp

Chart 1
SELECTED INTEREST RATES



rise in most short-term interest rates that began in early March. The Federal funds rate reached 13.5 per cent in early July and averaged considerably higher in the second than in the first quarter.[1]

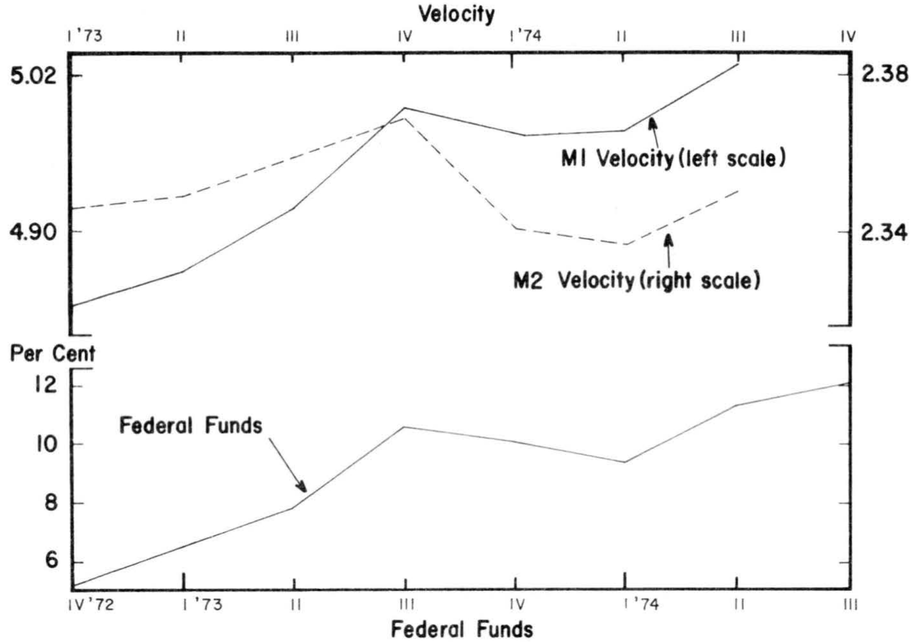
In the third quarter of 1974, the growth rate of nominal GNP increased again and helped cause a further rise in the Federal funds rate on a quarterly average basis, although the funds rate along with other short-term rates dropped sharply after mid-July. This decline was due in part to a reduction in the public's demand for money balances, which in turn reflected the lagged impact of the sharp March-July rise in interest rates. Thus, as frequently happens, short-term rates declined sharply in the summer and fall partly because they rose so sharply in the spring. In the final quarter of the year, it appears at this writing that nominal GNP may advance at a slower pace than in the third quarter and will be accompanied by lower short-term interest rates.

Developments in 1974 show that long-term interest rates, unlike short-term rates, are frequently more affected by expectations than by either current economic events or current monetary policy actions. Despite the drop in the growth rate of nominal GNP, long-term rates in the first quarter actually rose somewhat, and trended upward until the fall of the year. Heightened inflationary expectations, based on the observed acceleration in the rate of inflation, were largely responsible for this uptrend in long-term rates. As market participants came to believe that the future held more inflation than was earlier thought, they became more reluctant to commit their funds on a long-term basis. In this way, long-term rates came under upward pressure and, since credit demands were strong, rates moved up. In addition, the high levels of short-term rates prevailing in the spring and summer supported the tendency for investors to avoid the long-term market and contributed to the rise in long-term rates. Similarly, the October peaking and subsequent decline in long-term rates was due in part to the decline in short rates that occurred after mid-July.

Just as the course of nominal GNP affected short-term interest rates in 1974, movements in the latter influenced the behavior of the monetary aggregates. That is because rising short-term interest rates tend to reduce the demand

1/As may be seen in Chart 1, U.S. Treasury bill rates behaved differently than other short-term rates throughout most of the year. This was due partly to special factors associated with international oil payments.

Chart 2
FEDERAL FUNDS RATE AND VELOCITY



NOTE: The velocity figures are plotted with a one-quarter lag. For example, the velocity figures for the first quarter of 1973 correspond to the Federal funds rate for the fourth quarter of 1972.

for money balances and cause them to grow less rapidly than GNP. Similarly, falling interest rates tend to increase the demand for money and to cause the aggregates to grow more rapidly than GNP. When money grows more rapidly than GNP, velocity—the ratio of GNP to money—declines. In brief, then, falling interest rates tend to reduce velocity and rising interest rates tend to increase velocity.

The impact of interest rate changes on velocity is not immediate, however, as a current change in rates tends to affect velocity at some future time. The time lag between a change in rates and in velocity is somewhat complicated and varies from year to year, but in recent times a one-quarter lag seems to have developed. In other words, it appears that a change in interest rates during a given quarter has been affecting velocity in the following quarter. Chart 2, based on a one-quarter time lag, shows a fairly close correspondence between changes in the Federal funds rate and the velocity of both M1 and M2.[2]

Table 1
FEDERAL FUNDS RATE AND GROWTH RATES OF NOMINAL GNP AND THE MONETARY AGGREGATES

	Federal Funds Rate	Nominal GNP	M1	M2	Time Deposit Component of M2	Deposits at Nonbank Thrift Institutions
	Per Cent	Per Cent (SAAR)				
1973 III	10.5	9.70	5.49	7.72	9.94	6.83
IV	10.0	10.73	4.96	8.87	12.47	6.33
1974 I	9.4	4.40	5.79	9.59	13.03	8.11
II	11.3	7.36	7.18	8.20	9.24	5.62
III	12.1	9.13	3.60	6.21	8.39	3.38

2/M1 is the narrowly defined money supply and consists of currency and demand deposits held by the nonbank public. M2, the broadly defined money supply, consists of M1 plus time deposits at commercial banks other than certificates of deposit with denominations of $100,000 or more.

In the first and second quarters of 1974, velocity fell as M1 and M2 rose more rapidly than GNP in response to the first quarter and fourth (1973) quarter declines in the Federal funds rate. (See Table 1.) Furthermore, after the second quarter rise in the Federal funds rate, velocity increased in the third quarter—that is, both M1 and M2 grew less rapidly than GNP.

FINANCIAL DEVELOPMENTS IN 1975

As in 1974, the behavior of short-term interest rates in 1975 will be importantly affected by the path of nominal GNP, which in turn will reflect the rate of inflation and the pace of economic activity. The earlier analysis allows for some optimism about prospective developments on the inflation front. Inflationary pressure may begin to diminish and the pace of inflation may decelerate throughout the year. The outlook for economic activity, on the other hand, is not as optimistic. Real GNP may decline in both the first and second quarters. The second quarter, however, may turn out to be the trough and economic activity may advance in the third and fourth quarters of the year.

If these patterns in economic activity and inflation materialize, the growth rate of nominal GNP may be relatively low in the first part of the year, but may accelerate throughout the year. The first half declines in economic activity may tend to hold down the pace of nominal GNP in the first half of the year and, although the pace of inflation may be lower in the second half than in the first, the second half recovery of the economy may tend to increase the growth rate of nominal GNP. Under these circumstances, the rise in nominal GNP in the first quarter of 1975 may be modest—perhaps about 5 per cent—with the growth rate trending steadily upward in the remaining quarters of the year.

This pattern of growth rates in nominal GNP, if it materializes, would tend to place downward pressure on short-term rates in the first part of 1975, with the pressure being reversed in the latter part of the year. However, interest rate developments also will be influenced by the decisions of the monetary authorities with regard to the behavior of the monetary aggregates that they consider desirable. To gain some insight into the prospective interaction of these demand and supply factors, it is useful to trace out the implications for short-term interest rates under alternative growth rates in the monetary aggregates. The following analysis is confined to three alternative growth rates in the narrowly defined money supply, M1. Attention is focused initially on the likely behavior of short-term interest rates if the money supply increases in 1975 at the same rate as it did in 1974. Following this, the implications of a somewhat higher and a somewhat lower money growth rate than occurred in 1974 are considered.

If the money supply increases in each quarter of 1975 at the 1974 rate of about 5.5 per cent, and if nominal GNP follows the pattern stipulated earlier, velocity would decline slightly in the first quarter—that is, money would grow more rapidly than GNP. In subsequent quarters, as the growth rate of GNP accelerates, velocity would increase—that is, GNP would grow more rapidly than money. Moreover, the acceleration in the pace of GNP would widen the gap between the growth rates of GNP and money, so that velocity would increase more in the latter part of the year than earlier. Thus, the achievement in 1975 of the 1974 money growth rate implies a moderate decline in velocity in the first quarter, a slight rise in the second, and a moderate increase in the third. Velocity would increase considerably in the final quarter of the year.

If the one-quarter lag between changes in short-term interest rates and velocity changes continues to hold in 1975, the decline (on a quarterly average basis) in interest rates that occurred in the fourth quarter of 1974 would produce the required decrease in velocity in the first quarter of 1975. That is, the decline in short-term rates would stimulate the demand for money balances and cause them to increase more rapidly than GNP.[3] In the second and third quarters of 1975, the slight and moderate upward movements in velocity would appear to be consistent with no further downward movement in the Federal funds rate during the first and second quarters of the year. Due to the mildness of these required velocity movements, on the other hand, the achievement of the 5.5 per cent money growth rates in the second and third quarters may not necessitate increases in the funds rate in the first half of the year. However, an increase in the Federal funds rate in the third quarter may be required to produce the larger fourth quarter rise in velocity. In summary, the achievement of a 5.5 per cent growth rate in the money supply in 1975 appears to imply no further downward movement in the quarterly average Federal funds rate. Moreover, a moderate increase may be required in the third quarter of the year.

The second alternative assumes the narrowly defined money supply advances at a rate of 6.5 per cent in 1975—somewhat higher than occurred in 1974. Given the stipulated prospective behavior of GNP, a 6.5 per cent money growth rate in each quarter of 1975 would produce a rather sharp decline in velocity in the first quarter and a slight drop in the second. Velocity would then rise slightly in the third quarter and moderately in the final quarter of the year. This velocity pattern would appear consistent with some further downward movement in short-term interest rates in the first half of 1975, followed by stabilization or a small increase in the third quarter. The third alternative assumes a lower money growth rate in 1975 than in 1974—say 4.5 per cent. This money growth rate implies upward movements in velocity throughout the year, and would appear to require immediate and continuous upward movements in the Federal funds rate.

3/However, the fourth quarter decline in the funds rate was quite sharp (on a quarterly average basis), and may lead to a first quarter decline in velocity that is greater than is consistent with a 5.5 per cent growth rate in money, assuming that GNP increases the stipulated 5 per cent. In other words, the money supply may rise more than the 5.5 per cent in the first quarter.

It should be mentioned, however, that the discussion so far fails to account for the impact on nominal GNP of alternative growth rates in the money supply. If, in the first half of the year, money increases at the 4.5 per cent rate, the pace of GNP in the second half will tend to be lower than if money increases at the 6.5 per cent rate in the first half. Thus, if short-term rates increase enough in the first part of the year to result in the 4.5 per cent money growth rate, nominal GNP may grow less rapidly in the second half of the year than stipulated previously. This in turn would tend to diminish or remove the upward pressure on short-term interest rates in the second half of the year. By the same token, if interest rates decline enough in the first part of the year to produce the 6.5 per cent growth in money, the pace of nominal GNP in the second half would tend to be greater than stipulated, and this might lead to upward pressures on short-term interest rates in the latter part of the year. This latter situation illustrates the frequently stated principle that a stepup in the growth rate of money tends to reduce interest rates in the short run, but to increase them in the future. Similarly, a reduction in the growth rate of money tends toward higher interest rates in the short run, but will eventually lead to a decline in interest rates.

With regard to long-term interest rates in 1975, developments on the inflation front will probably remain the dominating influence in this sector of the market. The deceleration in the pace of inflation, if it materializes, may place downward pressure on long-term rates throughout the year. However, both the timing and extent of the decline may be affected by the behavior of short-term interest rates. For example, if short rates develop a stable pattern in the first half of the year and increase in the third quarter, long rates may follow a declining trend in the first half and stabilize somewhat thereafter.

In evaluating this analysis of prospective interest rate developments, several factors should be kept in mind. First, the relationship between interest rates and velocity might not hold in 1975 as it did in 1974. That is, the time lag between interest rate changes and velocity movements might differ, or factors other than interest rates might affect velocity.[4] Secondly, the assessment here of prevailing trends regarding inflation and economic activity may be wide of the mark. For example, the trend might not be toward a lower inflation rate, and forces tending to dampen economic activity might not be as powerful as expected. If either or both of these possibilities materialize, the growth rate of nominal GNP will be higher in the coming period than anticipated, and any given growth rate in the money supply would tend to result in greater upward pressures on short-term interest rates than indicated in this analysis. Similarly, the materialization of a lower inflation rate and/or a weaker economy than expected would tend to place less upward pressures on short-term interest rates than the analysis indicated.

4/Past experience indicates that noticeable increases in velocity do occur from time to time in the absence of increases in interest rates, and, in fact, occur during periods of falling rates. If this happens in 1975, relatively low growth rates in money could be achieved in the face of declining short-term interest rates. Even so, declining interest rates would tend to result in higher growth rates in money than would occur if interest rates stabilized or rose.

1975 Agricultural Outlook: A Year of Continuing Adjustment

By C. Edward Harshbarger

Economic developments over the past year have materially altered the financial status of many of the nation's farmers and ranchers. During the late summer of 1973, farm producers were enjoying record high prices and incomes in virtually every phase of agriculture even though price ceilings and export controls had been implemented at various times to stem the rise in food prices. But just as controls were responsible for part of the artificial increase in farm prices at that time, they also contributed to the economic upheaval that has occurred in the livestock industry in 1974.

As price ceilings and other economic controls were removed, many farmers thought that agricultural prices would go up as consumers tried to satisfy their pent-up demands for commodities that had been in short supply. However, many prices fell. Livestock prices retreated when producers glutted the market with overfed animals, and record harvests of feed grains and soybeans pushed grain prices down. About the same time, the economy was jolted by the Arab oil embargo which greatly slowed economic activity and reintensified the fires of inflation.

Much of 1974 has been spent adjusting to the unexpected events of late 1973, although other market forces, such as the rapid buildup in cattle numbers over the last 5 years, have also influenced the decisionmaking process. Some of the adjustments have been costly. According to the U.S. Department of Agriculture (USDA), cattle feeders have lost more than $1 billion this year as the industry has been buffeted by unstable prices—reflecting in part a disruptive truck strike in February—and soaring feed costs. Consequently, many producers have been forced either to curtail the size of their operations or to go out of business altogether.

In the crop sector, farmers scurried about during the early months of the year trying to line up adequate supplies of fuel and fertilizer that were needed to accommodate a sharp expansion in acreage. These needs were largely met in spite of the oil embargo, but only at substantially higher prices. To make matters worse, the nation's farmers then suffered through one of the worst growing seasons on record. First, it was too wet in the spring, then too dry in the summer; unusually early frosts inflicted additional damage on the late maturing crops. Instead of reaping a bountiful harvest in 1974, as was thought highly probable earlier in the year, crop output has fallen well below 1973 levels. In short, though grain prices are higher, bumper crops have now been transformed into bumper problems by the weather misfortunes of 1974.

For these reasons, net farm income this year is expected to drop below the record $32.2 billion realized in 1973. Most preliminary estimates are pointing to a 1974 level of approximately \$25 billion which would be down more than 20 per cent from 1973, but still well above the previous high of \$17.5 billion in 1972. On balance, then, 1974 has been a good income year for agriculture. However, it is clear that the benefits have not been evenly distributed as the financial plight of most livestock producers and some crop farmers belies the aggregate figures on farm income. For these people, it has not been a good year.

OVERVIEW OF 1975

Looking ahead, it is generally expected that 1975 will be another year in which farm producers will continue to adjust output, not only in response to developments of the past year, but to new economic conditions as well. The demand for farm commodities is expected to continue strong—especially in the foreign sector—but a sluggish domestic economy in the coming year will likely dampen the pressures for additional runups in farm prices. Total meat supplies will likely decline somewhat from 1974 levels, reflecting cutbacks in pork and poultry production, but beef supplies are expected to be larger in view of the size of the cattle inventory. A sharp rebound in 1975 crop output is almost taken for granted by many observers, but the growing conditions will have to be more favorable than this year. There are no set aside requirements under the farm program for 1975, which means that farmers will be free to produce from fence-row to fence-row if they wish. Clearly, grain prices are high enough to induce many farmers to expand acreage, but uncertainty over the availability of certain key resources, the weather, and export controls may temper acreage increases. Furthermore, over the last few years, virtually all of the idled acreage that has been held in reserve under various farm programs has been brought back into production, thereby precluding a sharp expansion in the acreage of all crops simultaneously.

The volume of farm marketings in 1975 is expected to be moderately larger than this year assuming a return to normal crop yields. With normal yields, increases in crop output should offset any declines that may occur in livestock marketings. Given the reasonably good prospects for demand, farm prices will likely compare favorably with 1974 averages. Thus, despite low Government payments, gross farm income will probably rise somewhat above the record \$102 billion estimated for this year. Although production costs are not expected to rise as rapidly as they have in 1974, the increase will likely erode any gains in gross income, leaving net income a little below the 1974 figure. The events of the past 2 years, however, serve as dramatic evidence of the suddenness with which the agriculture income picture can change. Although conditions promise to be more stable in the year ahead, any unforeseen development could significantly alter the current prognosis for net farm income in 1975. Overall, however, net farm income should stack up quite well in the year ahead, with livestock producers hopefully enjoying more of the benefits.

Continued Concern Over Food Prices

Consumers have experienced back-to-back increases of about 15 per cent in food prices in each of the last 2 years, and the prospects for a significant slowdown in 1975 are not especially promising. A major concern in recent months has been the strong tendency for the farm-to-retail price spread to widen, thereby negating most, if not all, of the price declines that may have occurred at the farm level. For example, from the second quarter of 1973 to the second quarter of 1974, the farm value of a market basket of food rose about 3.5 per cent, but the farm-retail marketing spread during this period widened more than 25 per cent, resulting in a 15.7 per cent increase in the retail cost of food. Interestingly, the prices received by livestock producers fell almost 9 per cent over this same period.

Factors contributing to wider price spreads over the last several years have been higher costs for labor, transportation, packaging, and processing. But in 1974, the spreads have also widened because the firms involved with the food marketing system have realized higher profits.

The USDA recently reported that food prices may rise another 10 to 12 per cent in 1975. Some of the impetus for this advance will likely come from the farm sector where it is expected that cutbacks in pork and poultry production will boost meat animal prices generally. On the other hand, if the 1975 grain harvest is of bumper proportions, crop-related food prices may ease downward. Nevertheless, various marketing and processing costs are expected to continue their upward spiral in the year ahead, keeping the pressure on retail food prices. As a final note, in each of the last 2 years, the USDA's preliminary forecasts on food prices for the coming year have missed the mark by a wide margin on the low side. This year, unlike earlier projections, the preliminary estimate is starting at a much higher level, which may result in smaller revisions as the year progresses.

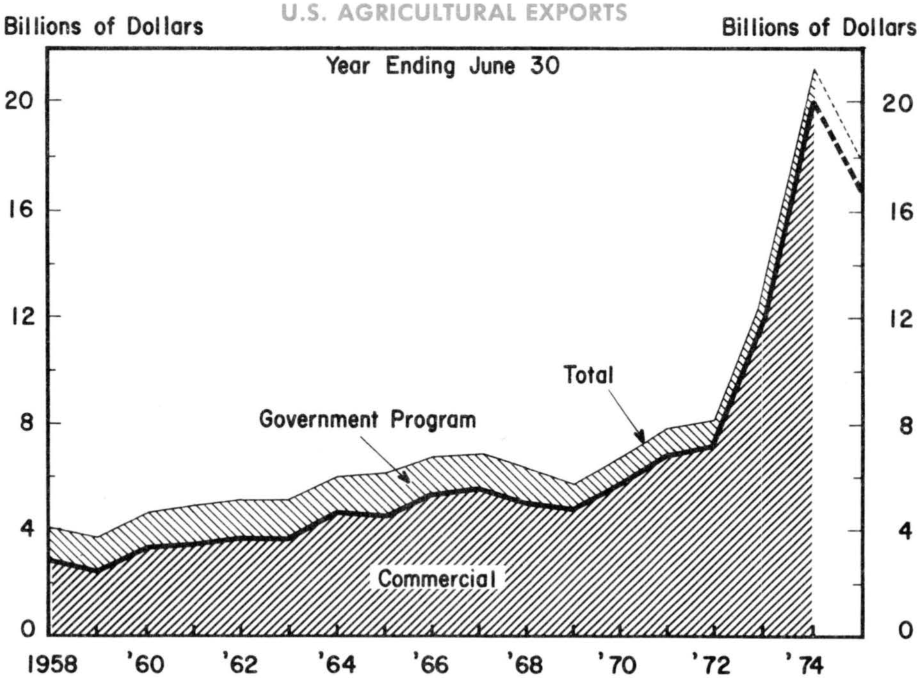
Foreign Demand Appears Strong

Although tighter supplies will likely restrict the volume of shipments to foreign countries in the current fiscal year, higher prices are expected to sustain the value of agricultural exports near the record \$21.3 billion realized in fiscal 1974 (Chart 1). The phenomenal growth in foreign agricultural sales during the last fiscal period more than offset a rather large gain in imports, and boosted the agricultural trade surplus to nearly \$12 billion, up from \$5.6 billion in fiscal 1973.

All major commodity groups posted sharp increases in foreign sales with wheat, feed grains,

Chart 1

U.S. AGRICULTURAL EXPORTS



22

SOURCE: U.S. Department of Agriculture.

and soybeans showing the largest gains. The value of these commodities and their products in foreign markets each exceeded $4.5 billion, as compared with about $2.3 billion each in the previous period. Sales to the People's Republic of China—$850 million—showed the largest percentage growth, but Japan continued as the most important market, with purchases of $3.3 billion.

As noted, agricultural exports are generally expected to slip somewhat during the current fiscal year, but several imponderables cloud the picture. It is generally agreed that the devaluations of the dollar and the resultant weakness vis-a-vis other currencies contributed heavily to the sharp growth in farm sales abroad in fiscal 1974. However, the dollar has since strengthened, reflecting the relative position of the United States in the worldwide race for energy. Several good customers for U.S. agricultural exports are being required to use a higher proportion of their foreign exchange to import crude oil, leaving less with which to buy American food and feedstuffs. Therefore, to the extent that the dollar may continue to strengthen vis-a-vis other currencies in the months ahead, agricultural sales to foreign countries may dip more than expected.

The possibility of export controls adds yet another dimension of great uncertainty in the outlook. After assurances that controls would not be necessary this year, the Administration abruptly canceled a grain sale of moderate proportions to the Soviet Union in October because of growing concern over the deteriorating condition of the 1974 crops. A system of modified controls was imposed by which all exporters are now asked to obtain prior approval before making sales of certain commodities in excess of 50,000 tons in one day—or 100,000 tons in a week—to a single country.

Whether or not an embargo on exports is ultimately imposed remains to be seen. The rationing effect of relatively high grain prices in both domestic and foreign markets will hopefully make this step unnecessary, for export controls are potentially very dangerous. For one thing, controls tarnish the reputation of a country for being a reliable source of supply, and second, they encourage countries to become more self-sufficient, no matter how inefficient this production may be in terms of resource use and costs. Furthermore, new trade barriers invite retaliatory action, and in this type of warfare there are no winners—only losers.

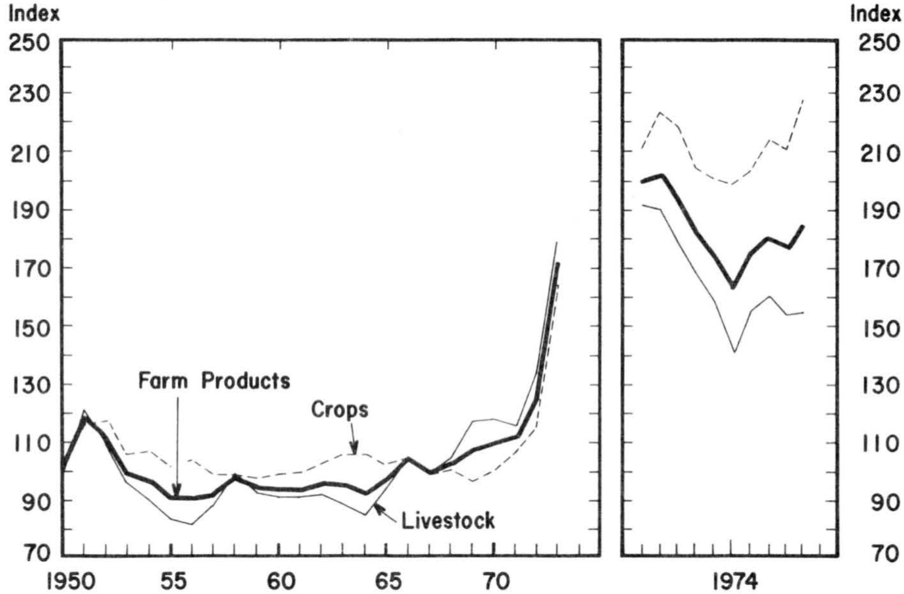
The world's supply of food reserves is simply too precarious to implement programs that encourage inefficient production. The United States enjoys a comparative advantage in the production of most foods and fibers, and if market forces are allowed to operate freely, exports should remain strong not only in the current period but in the years to come.

COMMODITY OUTLOOK FOR 1975

Given the tight supplies of most farm commodities, prices in 1975 are expected to remain sensitive to changing market conditions, but livestock prices may prove to be more stable than the wide fluctuations experienced this year. Cattle and hog prices rose sharply early this year, peaking at about $48 and $40 per hundredweight, respectively, just before the truck strike in February (Chart 2). From that point, prices began a prolonged decline which ultimately pushed cattle prices down to the mid-$30 range, while hog prices plummeted to the mid-$20 area. A significant pickup in the slaughter of overweight animals was chiefly responsible for the sharp drop in prices. As slaughter levels eased off later in the summer, prices rebounded sharply with cattle prices reaching nearly $50 per hundredweight while hogs approached $40. Since August, hog prices have held reasonably stable, but cattle prices have dipped about $10 to $12 per hundredweight.

Crop prices have behaved almost as erratically as livestock prices this year. Following a sharp rise early in the year, reflecting concern over the availability of fertilizer for the 1975

Chart 2
INDEX OF PRICES RECEIVED BY FARMERS
(1967 = 100)



SOURCE: U.S. Department of Agriculture.

crops and the fear that grain stocks were dangerously low, grain prices—especially wheat—began slipping when it became apparent that supplies would stretch to the new harvest, which was expected to be huge. However, after the wheat harvest, dry weather decimated the feed grain and soybean crops, creating strong upward pressures on prices once more. Since late summer, grain prices have fluctuated around unusually high levels as manifested by prices of \$3.50, \$8.50, and \$4.50 per bushel for corn, soybeans, and wheat, respectively.

Crop Situation

For obvious reasons, the outlook for both crop output and prices in the year ahead is uncertain. Table 1 reveals that, with the exception of soybeans, the beginning carryovers of grains for the current marketing year are not only down from a year ago but are at uncomfortably low levels. Furthermore, estimates of expected disappearance of the various grains indicate that the ending carryover stocks are likely to become even tighter before the 1975 crops are available. The implications for grain prices are clear: until more is known about the potential size of next year's harvest, prices will likely remain quite firm.

Yet, observers of agricultural statistics know that the figures will change as more information becomes available. For example, it is conceivable that 1974 crop production figures may be revised upward, but probably not by much. Similarly, the current estimates of total disappearance will likely change because market conditions often behave in a surprising fashion. Obviously, total disappearance is not likely to exceed current estimates by very much because of supply limitations, but total use could fall significantly below anticipated levels if unforeseen events should occur in either the foreign or domestic sector. Hence, new developments could easily take some of the steam out of grain prices in the months ahead.

Summarizing the crop picture, 1974 wheat production was a record high, but because of a smaller carryover, total supplies for the current marketing year are 5 per cent less than a year ago. Feed grain production was expected to be 20 per cent larger this year, but the summer drought and early frosts dropped output 18 per cent below the 1973 level. Soybean production was also down sharply, 19 per cent below 1973, but part of this reduction was attributable to smaller planted acreage. In the last marketing year, farmers received prices which averaged about $4.00, $2.60, and $5.75 per bushel for wheat, corn, and soybeans, respectively. In the current marketing year, prices will likely average well above these levels, especially for corn and soybeans. However, harvest prices were at historic highs, suggesting that the post-harvest seasonal rise that normally occurs during the winter and spring months may not be as prominent as in previous years.

This year, cotton production was down slightly from 1973 levels, but sluggish demand both here and abroad will probably lower total disappearance in the current marketing year, offering little promise for strong prices. With a few exceptions, supplies of most fruits and vegetables are slightly lower this year, and prices on the whole are expected to average moderately above 1973-74 levels.

Livestock Situation

The chief concerns of the livestock industry are prices and feed costs. As a result of soaring production costs and unprofitable prices throughout most of 1974, producers have made dramatic adjustments in their production plans for the period ahead. Hog producers are planning to farrow the fewest sows since 1965, the number of cattle on feed as of October 1 was the lowest in 6 years, and poultry production will probably be reduced by 10 per cent in 1975.

During the first three quarters of 1974, commercial slaughter of pork and beef was almost 10 per cent above the comparable 1973 period, as both numbers and average slaughter weights

Table 1
BALANCE SHEET FOR MAJOR CROPS
United States
(Millions of Bushels or Tons)

	Corn (bu) Marketing Year Oct. 1 - Sept. 30		All Feed Grains (ton) Marketing Year*		Soybeans (bu) Marketing Year Sept. 1 - Aug. 31		Wheat (bu) Marketing Year July 1 - June 30	
Supply	1973-74	1974-75†	1973-74	1974-75†	1973-74	1974-75†	1973-74	1974-75†
Beginning Carryover	709	481	32.4	20.5	60	172	439	249
Production and Imports	5644	4719	205.3	168.4	1567	1262	1715	1782
Total	6353	5200	237.7	188.9	1627	1434	2154	2031
Disappearance								
Domestic	4647	4000‡	173.4	147.7‡	913	874‡	757	788‡
Exports	1225	825‡	43.8	27.7‡	542	500‡	1148	1000‡
Total	5872	4825‡	217.2	175.4‡	1455	1374	1905	1788‡
Ending Carryover	481	375‡	20.5	13.5‡	172	60	249	243‡

* Marketing year begins October 1 for corn and grain sorghum, July 1 for barley and oats.
† Preliminary projections available November 1, 1974.
‡ Average of a range of estimates.
SOURCE: U.S. Department of Agriculture.

were higher. Interestingly, fed cattle marketings were down 5 per cent during this period, but increases in cow and calf slaughter as well as a sharp expansion in the slaughter of "grass-fat" steers and heifers more than offset this decline.

Following the substantial year-to-year increase in hog slaughter that has taken place during the second half of this year, pork output is expected to decline below both fourth quarter and year-earlier levels in the period ahead. Earlier apprehension about grain and livestock prices apparently induced many hog producers to liquidate part of their sow herds this past summer, resulting in a 10 per cent reduction in the number of breeding animals on farms as of September 1, 1974. Furthermore, the June-November pig crop, which will provide the bulk of animals for slaughter during the first half of next year, was estimated to be about 7 per cent lower than a year ago, and farrowing intentions during December 1974-February 1975 are expected to be down 10 per cent or more. Coupled with probable reductions in slaughter weights, therefore, pork production during the first half of 1975 could be 10 to 15 per cent below year-earlier levels, suggesting that prices may strengthen from current levels if competing meat supplies are not unusually large. For the year as a whole, pork prices will likely average somewhat above the $35 per hundredweight estimated for 1974.

Although the cattle industry has been through the financial wringer this year, most of the evidence suggests that some improvement may be around the corner. However, 1975 will not likely be a year in which profits return to the levels of 1972 and 1973 due to the large inventory of animals on hand. The cattle inventory has been expanding rapidly for the last 5 years and has reached the point where potential supplies of beef exceed current demand. Moreover, even with a significant increase in slaughter in 1975, cattle numbers will probably continue to advance for the next 2 to 3 years, indicating that prices may remain under pressure during most of this time.

As cattle feeders absorbed huge losses in 1974, placements in feedlots fell off sharply. As of October 1, for example, the number of cattle on feed was 24 per cent below a year earlier, and new placements during the third quarter were down 12 per cent. Although placements are generally expected to turn around and start increasing, the composition of slaughter in 1975 will probably consist of a higher-than-usual proportion of non-fed animals, as in 1974. If the profit picture improves, however, a few of these animals may move into the feedlot for a brief period.

Marketing programs in 1975 will depend not only on price-cost relationships but also on the availability of grass. If the weather is favorable and the summer pastures are green, producers may decide to withhold shipping cows and other non-fed animals to slaughter, which would tend to bolster the market for fat cattle. But another summer drought in 1975 will probably precipitate even larger movements to market than occurred this year, thus depressing prices for all classes of animals.

In the first half of 1975, fed cattle marketings will probably fall below year-earlier levels, but supplies of other beef will be large enough to boost total output moderately above January-June 1974. Unlike 1974, the profit picture for the year ahead is somewhat brighter, largely because feeder cattle prices have fallen enough to allow some hope for profit despite high feed costs. During the first half of the year, prices on choice steers are expected to average near, if not above, the $42 per hundredweight received in 1974.

Unfortunately, the outlook for the cow-calf producer is rather gloomy. Given the prospects for sluggish fat cattle prices and continued high feed costs, feeder cattle prices will likely remain depressed. Some seasonal strength may occur in the winter and spring, but it will not be enough to generate much profit.

Continuing a trend of several years, lamb slaughter is expected to be down again in 1975. Large beef supplies, however, will temper any price movements for lambs much above 1974 levels. As noted earlier, poultry production is expected to be down sharply in the year ahead, reflecting high feed costs and low profits. Prices should average higher in 1975, but the profit picture is not expected to show any sharp improvement. The dairy industry continues to be plagued with unfavorable price-cost relationships. Although some improvement is likely in 1975, it is doubtful that producers will try to expand production beyond 1974 levels.

A FINAL NOTE

Considerable attention has been focused on the agricultural sector in recent years, and 1975 will be no different. The battle against inflation is being waged on many fronts, but nowhere more intensively than against rising food prices. The outlook on food prices for next year is not good because of probable increases in marketing and processing costs. However, agriculture is continuing to adjust output in a manner that will hopefully alleviate a few of the inflationary problems associated with food at the producer level. Clearly, many farmers are presently experiencing some very painful financial adjustments following the weather and cattle feeding debacles of 1974, and for them, the process of rebounding may be a slow one. Yet, with good planning and better luck from Mother Nature, agriculture could be standing on fairly solid ground at the end of 1975.

INDEX OF *monthly review* ARTICLES IN 1974