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Farm Income Outlook 2006

Burton Pflueger
South Dakota State University, burton.pflueger@sdstate.edu

Jack Davis
South Dakota State University

ECONOMICS COMMENTATOR

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by
Burton Pflueger,
Professor/Extension Specialist,
and Jack Davis,
Extension Area Farm Management Specialist

Farmers across South Dakota are looking forward to beginning spring field work and hoping for another profitable year. Expectations for a profitable 2006 are based, in part, on past business performance and, in part, on the income and expense outlook for 2006. The U.S. farm sector has enjoyed very favorable business conditions for the last two years. In fact, the 2-year period 2004-2005 was one of unprecedented income creation for the U.S. farm sector, when both crop and livestock commodities experienced exceptionally favorable market and/or production conditions. (ERS)

Recently, the United States Department of Agriculture Economic Research Service (ERS) released their outlook for farm income for 2006. That outlook merits caution. ERS estimates that net farm income for 2006 will be lower than the last two operating years and will approximate the 10-year average. Net Farm Income is forecast to be $56.2 billion in 2006, which is $16.4 billion lower than 2005 (77% of the 2005 estimate of $72.6 billion) and only slightly higher than the 1996 to 2005 average of $55.7 billion. Net cash income is forecast by ERS to be $64.8 billion in 2006 which is 78.8% of the $85.5 billion record from 2004 and 78.3% of the $82.8 billion estimated for 2005.

[1]Information for this newsletter is taken from ERS Farm Income And Costs: 2006 Farm Sector Income Forecast released February 15, 2006. The complete ERS forecast can be found at http://www.ers.usda.gov/Briefing/FarmIncome/nationalestimates.htm. Direct quotes are italicized.

Expectations for lower farm income in 2006 are supported by forecasts for lower income and higher expenses. Value of production estimates for both crop and livestock are forecast to be approximately 2% lower than in 2005 while government payments are forecast to be $4.5 billion lower than in 2005. Current forecasts indicate that farmers can expect to pay more for fuel, fertilizer and labor and will experience rising interest payments on debt.

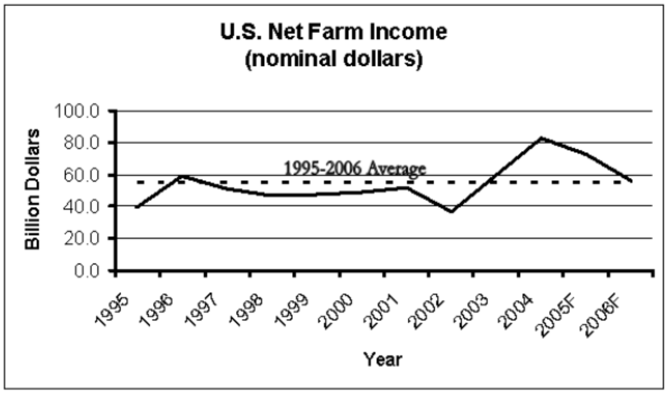
Other highlights from the ERS report include:

Cash receipts for crops are forecast to be $109.4 billion in 2006, down from the record $117.8 billion in 2004 and $114.1 billion in 2005 due to lower prices in 2006. Cash receipts from crop sales are forecast down $4.7 billion as farmers are not expected to sell off additional quantities from inventories following the drawdown in 2005. The absence of sales from farmer-owned inventories accounts for most of the $1.7-billion difference between the decline forecast for net cash income ($18.1 billion) and the decline forecast for net farm income ($16.4 billion).

Government payments for 2006 are forecast to be lower. ERS states, *Large crop supplies in 2004 and 2005 have contributed to market prices dropping to a level that triggers price-based government programs, such as loan deficiency payments (LDP's) and counter-cyclical payments. Most government payments are from programs related to crops, with the balance being from conservation programs. Calendar 2006 is expected to see a large decline in ad hoc and emergency program payments.*

Cash *receipts for livestock and products are forecast to be $122.3 billion in 2006, following successive records of $123.5 billion in 2004 and $124.9 billion in 2005, a period characterized* *by low cattle inventories, high demand, and resulting high prices.*

Table 1.



Source: http://www.ers.usda.gov/Briefing/FarmIncome/Data/Constant-dollar-table.XLS

2006 Production Expenses

There has been considerable discussion concerning production costs for 2006 dating back to the hurricane season of 2005. ERS forecast a 3.7 percent increase in total production costs for 2006. ERS predicts that interest payments will increase $1.7 billion (11 percent); fuel and oil $1.4 billion (12.5 percent); and feed, fertilizer, and labor costs will increase by more than $900 million.

Other highlights from the ERS forecast report include:

Feed prices are expected to remain the same as in 2005. The 3.2-percent rise in feed expenses will be due primarily to increases in the production of beef, pork, milk, and broilers.

The principal crop-related expenses (seed, fertilizer, and pesticides) are expected to rise 4.8 percent, versus nearly 6 percent in preceding 2 years. Slower growth in these expenses is primarily from smaller increases in the prices for these inputs.

Fertilizer expenses, in particular, are expected to rise much more slowly than the double-digit increases in the preceding 2 years. The 6.5 percent increase in overall fertilizer prices is less than half the price increases in 2004 and 2005.

Prices for fuels and oils are expected to drop in 2006, but the annual average will still be 9.6 percent higher than in 2005. Prices will be highest in the first two quarters when the greatest amount of fieldwork is done.

Government Payments Forecast

Over the past few years, direct governmental payments have helped farmers set record income levels. For 2006, ERS predicts that direct government payments will only be about 78% of the level of payments made to farmers in 2005. *The projected total in 2006 is $18.5 billion, down from $23.0 billion for 2005, yet up from $13.3 billion for 2004.*

Specific highlights from the ERS forecast report concerning government payments are:

Direct payments under the Direct and Countercyclical Program (DCP) in 2006 are estimated at $5.2 billion, a modest reduction from 2005.

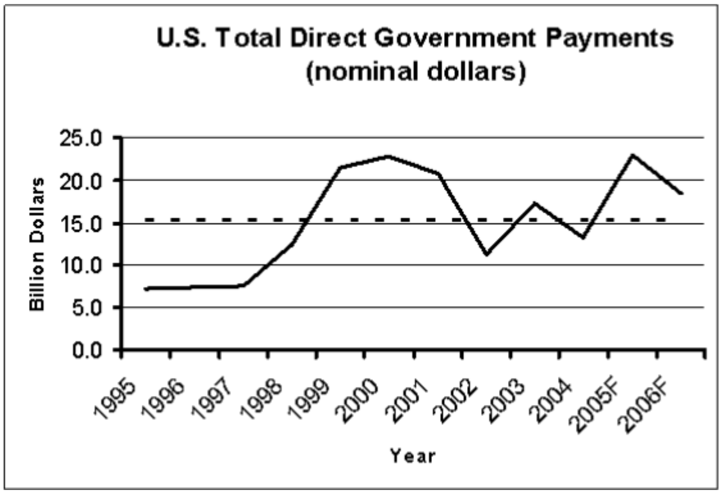
Countercyclical payments are forecast to increase from $4.1 billion in 2005 to $5.3 billion in 2006. This follows the large increase in 2005. Increases in payments to wheat and soybean producers are expected to off-set declines in payments to corn and cotton producers.

Marketing loan benefits—including LDPs, marketing loan gains, and certificate exchange gains—are projected to be down to $4.1 billion in 2006 from $6.2 billion in 2005. The expected declines in marketing loan benefit payments to rice, corn, sorghum, and cotton more than offset the increase in payments to wheat and soybeans.

Calendar 2006 is expected to see a large decline in ad hoc and emergency program payments.

Most of the benefits realized by producers in 2005 are not authorized for 2006.

Table 2.



Source: http://www.ers.usda.gov/Briefing/FarmIncome/Data/Constant-dollar-table.XLS

While the forecast for farm income in 2006 may not be regarded as highly promising, ERS has also predicted that the financial condition of farm operations may still improve in 2006. Forecast of balance sheet ratios indicate that levels of debt, while increasing, may be off-set with appreciation in assets. Thus, while farmers may not experience the same level of cash income as over the last two years, utilization of financial and risk management tools may preserve the equity holdings of farm operators.

Table 3.

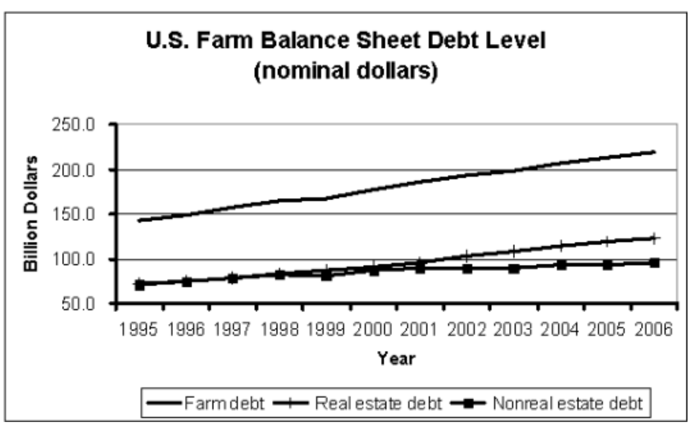


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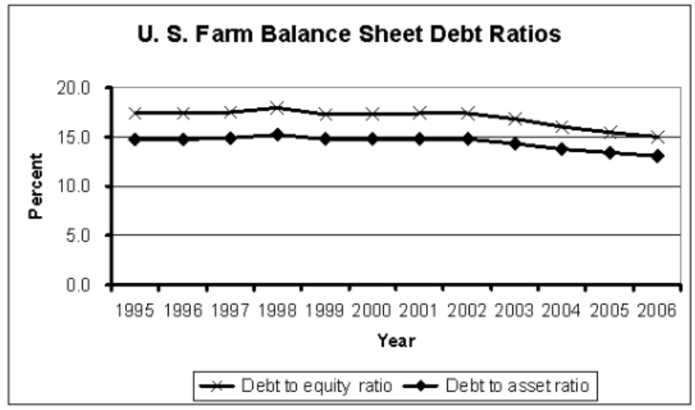
Table 4.



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Debt Repayment Capacity Utilization

While some measures of farm financial performance indicate that farm equity may be maintained during 2006, another indicator of financial strength of farm operations is the utilization rate of farm debt repayment capacity. *Debt repayment capacity utilization (DRCU) combines debt levels, interest rates on farm debt, and net cash income into one statistic that measures actual farm business debt relative to the maximum debt load farmers could service with current income. Increases in the farm sector's DRCU indicate increased exposure to financial risk and reduced credit reserves for unanticipated contingencies.*

From 1986 to 2005, U.S. agriculture's DRCU has averaged almost 51 percent. It is anticipated to rise from 46.8 percent in 2005 to 60.3 percent in 2006. This increase reflects expected increases in interest rates on farm debt, higher farm debt, and lower farm net cash income. The farm sector's unused credit repayment capacity is expected to decline to $132.9 billion in 2006, higher than its $98.5 billion estimated level for 2002 but below its 3-year average ($226 billion) for 2003-05.

Forecast Implications for Farm Business Management

With forecasts for lower income, higher expenses, and greater utilization of credit capacity, a successful 2006 will require detailed management of business and financial risk. Farm operators can utilize insurance to manage yield risk and marketing tools to manage price risk. Budgeting to calculate costs of production and operational efficiency will be necessary to determine the strengths and opportunities of farm operations while addressing the risks of higher expenses and greater reliance on debt financing.

SDSU Extension Farm Financial Management Specialists are willing to assist farm operators analyze their current operation and can assist in farm level forecasts for 2006. Utilizing a computerized farm analysis and planning package, these specialists can assist farm operators to develop enterprise budgets to determine costs of production and provide a basis for analysis of operational efficiency. These specialists can also assist with the development of financial trends and projections and will assist farm operators determine the financial impacts of enterprise alternatives.

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ECONOMICS COMMENTATOR
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Department of Economics
South Dakota State University Phone: 605-688-4141
Box 504 Scobey Hall Fax: 605-688-6386
Brookings, SD 57007-0895 E-Mail:Penny_Stover@ sdstate.edu
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SDSU
SOUTH DAKOTA STATE UNIVERSITY
Department of Economics
Box 504
Brookings SD 57007-0895

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