



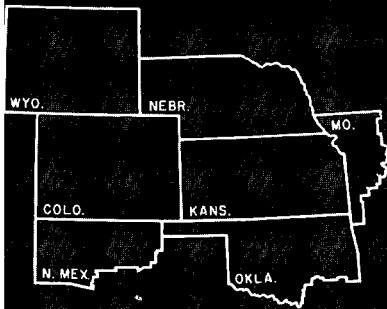
monthly review

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FEDERAL RESERVE BANK OF KANSAS CITY



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The Business And Financial Outlook for 1976

By J. A. Cacy and Glenn H. Miller, Jr.

BUSINESS CONDITIONS AND OUTLOOK

Economic statistics for the spring and summer of 1975 confirmed that the recession of 1974-75 was over and revealed the vigorous beginning of the recovery. The recession was both the longest and deepest in the United States since the 1930's. The overall rate of unemployment peaked at more than 9 per cent of the civilian labor force, and the rate of capacity utilization in manufacturing fell to 67 per cent. But in **addition** to the ills of recession, American society suffered simultaneously from some of the highest rates of inflation in its history. Indeed, the inflation was a major factor in the economic slump. It is important to keep these features of the immediate past in mind as one analyzes the outlook for economic recovery in 1976.

THE RECOVERY IN 1975

Real gross national product (GNP) grew only slightly in the second quarter of 1975—at less than a 2 per cent annual rate—but enough to mark that period as the initial quarter of the recovery. The turnaround probably occurred at some time during the quarter: industrial production reached its low point in April and the decline in total civilian employment ended in March (both on a seasonally adjusted basis). After allowing for price change, the rise in final purchases was composed of increases in

personal consumption expenditures, net exports, and government purchases, large enough to more than offset a decline in business fixed investment. (The change in residential construction spending, while positive, was very small.) But the quarterly increase in real GNP was smaller than the rise in real final sales because the liquidation of business inventories went on at a more rapid pace in the second quarter than in the first, thus making the inventory sector a continuing drag on overall output growth.

The third quarter was a different story, however, with several of the economy's major sectors making significantly different contributions to the total. Real final purchases increased by nearly \$10 billion, slightly more than in the second quarter. In the third quarter, moreover, even though business inventories continued to be liquidated, the inventory sector ceased to be a drag on total output growth as the pace of liquidation slowed considerably. Within the final demand group, the private domestic sectors provided the thrust to growth: consumer spending continued to grow strongly, business fixed investment ceased its decline, and residential construction spending grew substantially. Government purchases increased hardly at all, and net exports declined as import growth exceeded the growth of U. S. exports. This sectoral mix provided for real GNP growth in the third quarter at an annual rate of more than 13 per cent.

The recovery in total economic activity and output was reflected in improved labor market conditions and in increased productivity. Quarterly average unemployment rates for nearly all major labor force categories retreated in the third quarter from their second quarter cyclical peaks. For example, the overall rate of civilian unemployment fell from 8.9 per cent to 8.4 per cent and the rate for all household heads declined from 6.1 per cent to 5.7 per cent. Nonfarm payroll employment also rose substantially in the third quarter, and the average length of workweek edged upward. But the increase in output so far outstripped the increase in hours worked that output per hour in the nonfarm sector posted its largest quarterly gain since early 1961. This second consecutive quarterly increase in productivity, to be expected early in a recovery, followed several quarters of substantial decline. When these rates of productivity increase were coupled with the recent pattern of moderating rates of increase in compensation per hour, the result was a dramatic change from high rates of increase in unit labor costs to an actual decline. That, in turn, was reflected in a similarly dramatic decline in the rate of increase of the implicit price deflator for the private nonfarm economy, from 11.1 per cent in 1974 to an annual rate of slightly more than 4 per cent in the second and third quarters of 1975.

The total GNP deflator has also shown a sharp decline in its rate of increase during 1975 (though not as dramatic a shift as that for the private nonfarm economy). During the five quarters of falling real output (all of 1974 and the first quarter of 1975), the GNP deflator rose at an annual rate of 11.3 per cent; in the second and third quarters of 1975 the annual rate of increase averaged just under 5 per cent. (The GNP implicit price deflator is influenced by changes in the composition of output. A GNP fixed-weighted price index showed the following annual rates of increase in the first three quarters of 1975: 7.5 per cent, 5.5 per cent, and 6.8 per cent.) Price increases as measured by the Consumer Price Index (CPI) have also been smaller in 1975 than in 1974. However, after a sharp decline in the first quarter of 1975, the quarterly average rate of increase in the

CPI was above that of the preceding quarter in both the second and third quarters of the year.

THE OUTLOOK FOR 1976

As the recovery proceeds, the roles of the various sectors of the economy may be expected to change further. The contribution of the inventory sector, for example, is likely to be of less relative importance to overall growth in the near future. Liquidation may well give way to renewed accumulation around the turn of the year as stocks are brought into line with sales. The extent to which inventory investment will enhance total real growth will, of course, depend on businessmen's expectations about the growth of sales and about the effects of the recovery on the rate of inflation and the possibility of shortages. Moderation in the rate of recovery would be expected to restrain the growth of inventories on all three counts.

Personal consumption expenditures (along with inventory change) may be given considerable credit for the bottoming-out of the economy and its early recovery. The improved performance of real disposable personal income, attributable partly to a moderating rate of inflation and to personal income tax reductions, provided consumers the wherewithal for increasing purchases of goods and services, especially durable goods. Without a return to rates of inflation like those of 1973-74, and assuming at least a continuation of the personal income tax reductions of 1975 (on a full-year basis), increases in manhours worked should occur, resulting in a solid growth in real disposable income. If so, personal consumption spending is likely to continue to grow enough to provide a firm underpinning for the economy's continued recovery.

Although the turnaround in residential construction was rather late in the cycle, private housing starts in September 1975 were about 40 per cent above their low at the close of 1974 and residential construction spending contributed significantly to the third quarter's growth in total output. It is not clear, however, that strong growth in homebuilding can be sustained through 1976. The series on building permits is recovering from its cyclical

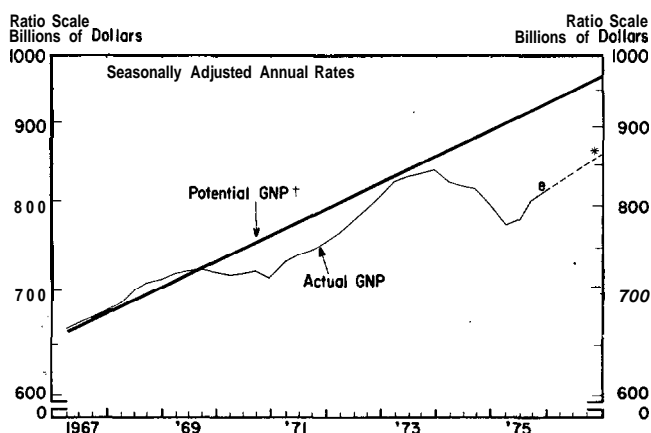
trough but is still at a historically rather low level, and questions must be raised about the underlying demand for housing at current high prices.

Finally, there is the question of sufficient financing for residential construction. Inflows of funds to thrift institutions (the major source of that financing) were very strong through most of the summer of 1975, permitting the advance in homebuilding that occurred. But the situation seems to have changed somewhat since late summer. Net new savings received by savings and loan institutions appear to have increased less than seasonally in August and September, but rebounded substantially in October. These movements apparently reflected an increase in market interest rates which was later reversed. Whether rates will again rise enough to hamper the inflow of deposits to these institutions will depend on the pace of the economic recovery and the course of monetary policy. Should homebuilding activity slow markedly (or, worse, cease to grow), the overall recovery would be weakened considerably.

Business spending for fixed investment suffered greatly from the recession, declining at an annual rate of nearly 10 per cent in real terms through 1974 and the first three quarters of 1975. The decline appears to have ended in the third quarter of 1975. Rising profits as the recovery progresses will be a positive influence on business capital spending in 1976. However, fairly strong growth in final demand for output will be required to justify very rapid expansion in fixed investment, given the low rate of utilization of existing plant. Advance indicators, such as new orders of non-defense capital goods industries, are not yet giving unambiguous signals of substantial increases in fixed investment spending. The McGraw-Hill fall survey of business spending plans for new plant and equipment in 1976 suggests a minimal real increase in business fixed investment.

Net exports, and government purchases of goods and services, are the remaining final demand sectors to be considered. Net exports supported the recovery in its early stages, but with the recoveries here and abroad proceeding out of phase with one

Chart 1
REAL GNP, ACTUAL AND POTENTIAL



• Estimated.
* Illustrative example.
† Trend line increase of 4 per cent per year.
SOURCE: U. S. Department of Commerce.

another, a reduction in that support is expected in 1976. Federal purchases are likely to increase only modestly, as are those of state and local governments. Little stimulus to economic activity in 1976 may be counted on from increased government demand for output. Thus, private domestic final demand is likely to be the key to the outlook for real economic growth in 1976.

Discussion of the outlook by sector suggests an overall pattern that might include a growth in real GNP of about 4 to 6 per cent from the end of 1975 to the end of 1976. Such a pace would be slower than in four-quarter periods in similar stages of most postwar recoveries, and considerably slower than that achieved in the last half of 1975. Growth at a 5 per cent rate, which is only slightly faster than the economy's long-run trend rate of growth, would continue to close the large gap between actual and potential real GNP that was opened by the recession (Chart 1). But because the gap is so large, the economy would remain a long way from full employment of its industrial and labor resources at the end of 1976. One measure of the degree of underutilization of resources, the overall unemployment rate, may be estimated from the size

of the GNP gap by using a convenient rule of thumb.' In this illustration, the unemployment rate at the end of 1976 might be expected to fall near the midpoint of a range of 7.5 to 8.5 per cent. Thus, recovery through 1976 at a rate near 5 per cent would still leave a large disparity between what the U. S. economy would be capable of producing and what it would actually be producing.

The continued existence of a lot of slack in the economy by the end of 1976 (and the modest speed at which the gap is expected to be reduced) has important implications for the rate at which the general price level may be expected to rise. There is little reason to believe that the illustrated growth of aggregate demand would put enough pressure on the resource base, given the amount of idle capacity (including labor) existent at the end of 1975 and expected at the end of 1976, to bring undue upward pressure on the rate of inflation in 1976, or even in 1977. As earlier cost increases were passed through and some catch-up in wage rates occurred, inflation rates remained high in 1974 in the face of a large quantity of underused resources. Many of these lagged effects appear to be over, however, as are the more direct impacts of the **runup** of food and fuel prices in 1973-74. The year 1976 is likely to be a year of rising productivity and, at worst, stable to slightly rising unit labor costs—if labor compensation increases continue to be of reasonable size in spite of a heavy collective bargaining calendar. If so, these features should combine to produce a rate of increase in the general price level well below a double-digit level,

There is, of course, the possibility of further exogenous shocks to the economy and to the rate of inflation from large increases in the prices of food and fuel, especially oil. At this time, it appears that increases in food and oil prices will be much smaller than those of 1973-74. Food prices in the United States rose 14 per cent in both 1973 and 1974, and an estimated 9 per cent in 1975. The U. S. Department of Agriculture estimated in November that

¹The relationship known as "Okun's Law" suggests that a 1 percentage point reduction in the unemployment rate is associated with a 3.2 percentage point reduction in the GNP gap expressed as a per cent of actual GNP.

retail food prices will rise at a 5 per cent annual rate in the first half of 1976. Whether or not this particular estimate is on the mark, it is clear that the overall agricultural situation now differs from that in the earlier years, in terms of both domestic harvests and export demands, in such a way that price increases of that earlier magnitude are less likely to occur.

The increase of about 10 per cent in the price of crude oil, announced by the Organization of Petroleum Exporting Countries in the fall of 1975, was near the low end of the range of earlier expectations. While that increase will have an impact on world energy prices, it will be both less than many observers had expected and much less than that of 1973-74. At the same time, however, failure to resolve the question of decontrol of domestic oil prices and the related question of the future of the \$2 tax on imported oil, leaves considerable uncertainty about the future of energy costs in the United States. Decontrol accomplished over a period as long as 39 months (proposed earlier by the Administration) would spread the effect over a longer period than would abrupt decontrol. A conclusion of cautious optimism seems warranted about the impact of rising food and fuel prices in 1976, both on the rate of inflation and on the growth of consumers' real income.

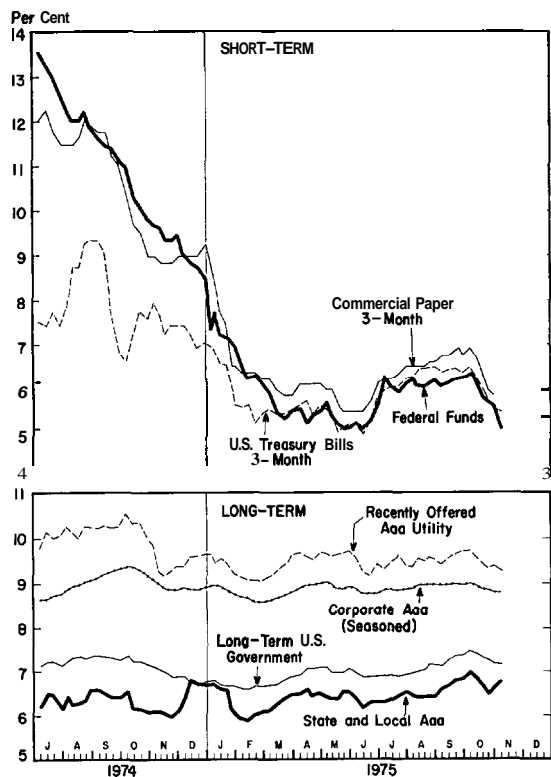
FINANCIAL DEVELOPMENTS AND IMPLICATIONS

In 1976, 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 1975 sets the stage for the treatment of prospective events.

FINANCIAL DEVELOPMENTS IN 1975

Interaction between financial and economic variables was quite evident in 1975. The first quarter decline in production and the rate of inflation was accompanied by a sharp drop in the demand for money and credit. Falling monetary demands contributed to the decline in interest rates that occurred in the first quarter. At the same time,

Chart 2
SELECTED INTEREST RATES



declining production and sluggish monetary growth encouraged an increasingly accommodative monetary policy. Monetary accommodation helped reverse the sluggish growth in the money supply and contributed to the drop in interest rates. The decline in rates was quite pronounced, especially in short-term markets. The Federal funds rate, for example, fell from around 8.5 per cent in late 1974 to around 5.5 per cent at the end of March. Long-term rates declined also but to a lesser extent. (See Chart 2.)

Rebounding economic activity in the second and third quarters helped reverse the downward movement in short-term interest rates. Consequently, short-term rates increased in the latter part of the second quarter and moved up somewhat further in the third quarter. Rapid monetary growth,

however, counteracted some of the upward pressure on interest rates emanating from the rebounding economy. Monetary growth was especially rapid in the second quarter as the public temporarily deposited income tax rebates. After midyear, the public drew heavily on rebate-inflated deposits so that monetary growth slowed sharply in the July-September period. Nevertheless, for the second and third quarters combined the narrowly defined money supply increased at a seasonally adjusted annual rate of around 8 per cent. While the 8 per cent rate is somewhat less than the spring-summer growth rate in the overall economy, monetary expansion was sufficient to counteract most of the demand-induced upward pressure on interest rates. At the end of September, the Federal funds rate was 6.25 per cent—only moderately higher than in late March.

Short-term interest rates declined early in the fourth quarter. By early December, for example, the Federal funds rate was around 5.25 per cent. The recent drop in interest rates was due partly to a more accommodative monetary policy. Greater accommodation reflected policymakers' concern about continued sluggish monetary growth. The accommodation developed at a time when financial markets were faced with increasing uncertainty associated with the financial problems of New York City.

Developments in 1975 show that changing economic and monetary conditions sometimes have little immediate impact in changing long-term interest rates. Despite sharp movements in production and variations in the pace of monetary growth, long-term interest rates fluctuated within a narrow range in 1975. For example, during most of the year, yields on Aaa utility bonds ranged between 9 and 9.6 per cent. Relative stability in long-term interest rates reflected a balancing of several conflicting factors. In the first part of the year, downward pressures from economic weakness, declining inflation, and falling short-term rates were countered by efforts of businesses to lengthen the maturity structure of liabilities. Efforts to restructure liabilities led businesses to borrow heavily in capital markets.

After midyear, businesses reduced their long-term borrowing. At about the same time, however, the U. S. Treasury began borrowing heavily in both **money and** capital markets. Increased Treasury borrowing along with the economic turnaround tended to counter the downward pressures on long-term rates produced by reduced private borrowing. In addition, sharp midyear jumps in wholesale and retail prices reinforced inflationary expectations and lessened downward pressures on long-term rates emanating from earlier declines in the rate of inflation.

FINANCIAL DEVELOPMENTS IN 1976

As in 1975, financial markets in 1976 will be importantly affected by the ongoing recovery in **business activity**. As production expands, demands for money and credit will be increasing. These rising monetary demands will be placing upward pressures on interest rates. Continued economic recovery in 1976, however, may not necessarily be accompanied by rising interest rates. While experience shows that interest rates rise at some point in the expansion phases of business cycles, rates do not always increase in the first several quarters of economic upturns. For example, interest rates declined for several quarters after the 1969 recession ended and rose only moderately following the end of the 1960-61 recession.

Factors in addition to the business recovery will be affecting financial markets in 1976. Continued price inflation, for example, will be adding to the amount of money and credit the public needs to transact business. The resulting increases in monetary demands will be augmenting the upward pressures that rising production will be placing on interest rates. The added pressure could be quite pronounced if the rate of price inflation accelerates significantly. Barring a large step-up in the rate of inflation, however, financial market pressures emanating from inflationary developments may remain moderate.

Interest rates in 1976 also will be affected by the availability of money and credit. Rising monetary availability will tend to counteract the upward pressures on interest rates emanating from in-

creasing production and prices. The resulting behavior of interest rates will depend on the extent that rising production and prices stimulate monetary demands, compared with the extent of the increase in the supply of money and credit.

Monetary availability will be largely determined by the conduct of monetary policy. The Federal Reserve intends to conduct policy so that the monetary aggregates expand in line with targeted growth rates that have been publicly announced. For example, the narrowly defined money supply, **M1**, has been targeted to expand at an annual rate between 5 and 7.5 per cent.

As the money supply expands within the targeted range, money is likely to expand less rapidly in 1976 than the overall economy. In other words, money will probably grow less rapidly than nominal gross national product (GNP), which will be reflecting the increase in both production and prices. A less rapid growth in money than in the overall economy, or in nominal GNP, means that the turnover or velocity of money will be **increasing**.²

Rising velocity is frequently associated with rising interest rates because the demand for money tends to increase in line with the overall economy. When velocity is increasing—that is, when money is growing less rapidly than the overall **economy**—monetary availability tends to grow less rapidly than monetary demand. The shortfall in availability places upward pressure on interest rates. Rising interest rates encourage the public to economize on money holdings, thereby creating a balance between the demand for and supply of money.

For various reasons, however, rising velocity is not always associated with rising interest rates. During the first several quarters of economic upturns, for example, velocity invariably increases, but interest rates sometimes fail to rise. As economic recovery begins, several factors may temper increases in monetary demand and allow velocity to increase without putting upward pressure on interest rates. The business sector is frequently in a **fa-**

2/Velocity is the ratio of nominal GNP to the money supply. Therefore, if the money supply increases less rapidly than nominal GNP, velocity increases. Velocity declines if the money supply increases more rapidly than nominal GNP.

favorable position with regard to liquidity. In addition, businesses are typically anticipating that rising profits will be augmenting their cash flows. These factors may induce firms to maintain relatively low money balances, so that monetary demands may tend to expand less rapidly than the overall economy.

Interest rate behavior during the first part of recoveries depends partly on the magnitude of the rise in velocity. Relatively small increases in velocity tend to be accompanied by moderate increases or even declines in interest rates. Similarly, relatively large increases in velocity tend to be accompanied by relatively sharp increases in interest rates. Thus, in the first year following the 1969 recession, velocity rose at a relatively moderate 2.5 per cent and interest rates declined. In the first year after the 1960-61 recession, velocity rose more—5.6 per cent—and interest rates increased moderately. Both velocity and interest rates jumped sharply in the first several quarters following the 1953-54 and 1957-58 recessions.

If economic activity advances at a moderate pace during the current recovery's initial phase, the rise in velocity may be moderate. In this case, the first part of the recovery—encompassing perhaps the period from mid-1975 through 1976—may be accompanied by stable or only moderately rising interest rates. A moderate increase in economic activity at an annual rate of around 6 per cent from mid-1975 through 1976 may be associated with a rise in velocity between 4.5 and 7 per cent. Velocity increases within this range assume an inflation rate around 6 per cent and a money growth rate within the targeted 5 to 7.5 per cent range. Experience suggests that velocity increases toward the lower end of the 4.5 to 7 per cent range are compatible with stable or moderately rising interest rates. Given the 6 per cent economic growth rate and the 6 per cent inflation rate, velocity increases toward the low end of the 4.5 to 7 per cent range imply a money growth

rate toward the upper end of the 5 to 7.5 per cent range.³

It should be noted that a 6 per cent economic growth rate over the mid-1975 through 1976 period implies a lower growth rate in 1976 because the rate exceeded 6 per cent in the last half of 1975. Thus, the assumption of a 6 per cent growth rate in the economy over the first six quarters of the recovery implies about a 5 per cent growth rate for 1976 as a whole. As noted in the section on the business outlook, a 5 per cent economic growth rate would be consistent with the pattern of business activity projected to emerge in 1976.

A continuation into 1976 of the rapid economic growth rate experienced in the last half of 1975 would likely be accompanied by sharply rising velocity and interest rates. In addition, with production expanding sharply, inflation likely would accelerate. Vigorous economic growth into 1976 would significantly reduce unemployment levels. A moderate pace may be more desirable in the long run, though, as a vigorous recovery may be short-lived.

The rise in interest rates and accelerated inflation likely to accompany a rapid recovery would create severe financial distortions and strains. These difficulties would adversely affect the economy and possibly terminate the recovery. In the face of rapid economic growth and accelerating inflation, the Federal Reserve could temporarily hold down interest rates by boosting the money growth rate. Rapid monetary growth, however, would add to long-run inflationary pressures and thereby endanger a sustainable business expansion.

³Since velocity equals the ratio of nominal GNP to the money supply, the growth rate of velocity approximately equals the growth rate of nominal GNP minus the growth rate of the money supply. The growth rate of nominal GNP is approximately equal to the inflation rate plus the economic growth rate. Thus, the growth rate of velocity approximately equals the inflation rate plus the economic growth rate minus the money growth rate. For example, if the inflation rate is 6 per cent, the economic growth rate is 6 per cent, and the money growth rate is 7.5 per cent, the growth rate of velocity is approximately $6 + 6 - 7.5$, or 4.5 per cent.

The Economic Recovery: Will Agriculture Follow in 1976?

By C. Edward Harshbarger

Keeping in step with the economy, agricultural conditions have improved considerably during the second half of 1975. After bottoming out in March, prices received by farmers began to rise sharply in response to diminishing red meat supplies and to rising total demand, especially in the foreign sector. This **uptrend** in prices was finally interrupted in October when huge grain harvests caused average farm prices to drop one-half of 1 per cent. However, as a result of improved prices, the net farm income picture for 1975 has turned out much better than originally expected. Current estimates indicate that 1975 net farm income will be approximately \$25 billion, as compared with \$27.7 billion in 1974. Most of the 1975 decline is attributable to yet another rise in production costs, which will probably exceed the \$73.4 billion spent in 1974 by about \$3.5 billion.

The brighter agricultural picture that has developed in the last several months reflects various adjustments in farm output and improvements in the general economy. In the crop sector, for example, greatly improved growing and harvesting conditions pushed production sharply above 1974 levels when yields were plagued by spring floods, a summer drought, and early frosts. New production records were established for corn and wheat in 1975, and soybean output—while falling somewhat short of the 1.55 billion bushels produced in 1973—jumped about 23 per cent above last year's weather

damaged crop. Although prices declined seasonally during the harvest period, precipitous drops were avoided because of the relatively tight world grain situation and the excellent prospects for foreign sales. Without foreign markets to absorb the bumper crops, U. S. farmers would obviously be receiving very low prices for their grain in the 1975-76 marketing year.

Livestock producers have also made significant adjustments in output. During the first 9 months of 1975, for example, total red meat production was about 3 per cent less than in the comparable year-earlier period. However, virtually all of the drop in output occurred in the hog industry as beef supplies exceeded 1974 levels by 3 per cent. These adjustments reflect the sharp deterioration in profits in 1974 which induced livestock producers to start liquidating their breeding herds. Since the hog industry adjusted rather quickly, farrowings and marketing in 1975 have fallen very sharply, running as much as 20 per cent below year-earlier levels. However, cattle producers—who also began to adjust herd size in 1974—are still in the liquidation process, which explains the small increase in beef output this year.

The strong recovery in the economy and the prospects for continued expansion, as summarized in the companion article in this *Review*, have also bolstered the agricultural sector in recent months. Since the end of the recession in the second quarter,

personal incomes and employment have risen significantly, reflecting consumers' increased ability to spend. To the extent that consumers have directed a portion of their higher incomes toward food consumption, farm prices and incomes have no doubt benefited.

PREVIEW OF 1976

Given the turnaround in the economy and the prospects for continued growth in 1976, domestic demand for agricultural commodities should strengthen in the year ahead. Certainly, the natural growth in population and rising disposable incomes will have a positive effect, but any reduction in food stamp benefits in 1976 would be partly offsetting. Nevertheless, given the outlook for agricultural exports, the total demand picture for farm commodities is excellent. On the supply side, farm producers will likely continue to **make adjustments** in their production programs for both crops and livestock. Total meat supplies are expected to increase somewhat above 1975 levels, mostly on the strength of an expansion in beef and poultry output. However, if the relationship between production costs and hog prices remains favorable for the next few months, the production of pork in 1976 may also exceed the 1975 level.

The key to 1976 crop production will probably be the weather since total acreage will not change appreciably. Over the last few years, virtually all of the idled cropland that had been held in reserve under various farm programs has been brought back into production. Since the Secretary of Agriculture has announced that there will be no set aside requirements for 1976, farmers may cultivate as much land as they wish. However, the constraints on land availability coupled with uncertainties about production costs, the weather, and new export policies will likely temper, if not preclude, a significant expansion in crop acreage. Therefore, the realization of higher production levels in 1976 will require further improvements in yields, which implies nearly ideal weather, or the substitution of one crop for another. Given recent price relationships, there is a strong possibility that corn and perhaps cotton acre-

age will increase at the expense of soybean acreage in 1976.

The volume of farm marketings in 1976 is expected to be moderately larger than in 1975 assuming that the crops are good. Although the demand prospects are strong, large supplies of farm products will likely create some downward pressure on prices, especially during the second half of the year when livestock production starts expanding more rapidly. In view of the demand structure for most agricultural commodities, which tends to be relatively price inelastic, any gain in 1976 gross farm income over 1975's estimated level of \$103 billion will likely be small. Although production costs are not expected to rise sharply during the coming year, they probably will increase enough to erode any gains in gross receipts, leaving net income a little below the 1975 figure. Barring any unforeseen shocks, therefore, the net income situation in agriculture should stack up quite well by historical standards in the coming year, resulting in either the third or fourth best year on record. Furthermore, livestock producers will probably enjoy a larger share of total farm income than they received in 1975.

An End to Rising Food Prices?

For all of 1975, it is estimated that food prices will average about 9 per cent above the 1974 average, which compares with increases of 14 per cent in each of the 2 previous years. Thus, some progress has been made in slowing the rate of increase in food prices in the last year. A continuation of this trend will require that prices at the farm level either stabilize or fall in the year ahead and that farm-to-retail price spreads do not widen unduly.

Earlier this year, great concern was expressed about the probable impact on food prices of large grain sales to Russia. Many recalled that the 1972 episode with Russia resulted in a heavy runoff of grain stocks and a sharp rise in prices at both the farm and food retail levels. Coming as it did, this **runup** in prices exacerbated the inflationary forces at work in the economy and produced an outcry for closer controls on exports. Quite naturally, therefore, the public remains very sensitive about Rus-

The Economic Recovery:

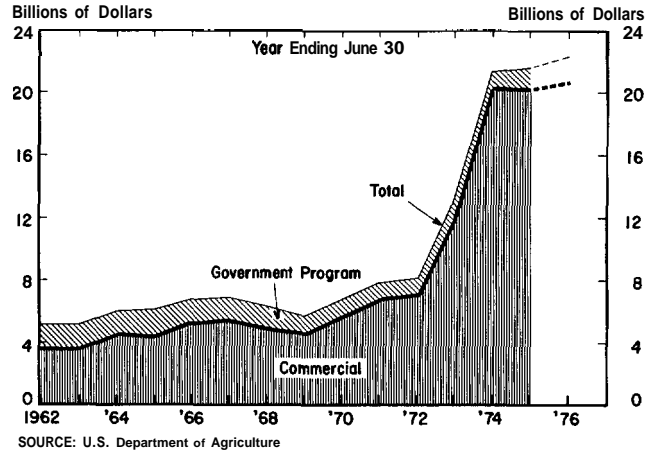
sian forays in the U. S. market, which partly explains the moratorium on grain sales that was imposed in August. In analyzing the probable impact on food prices, the Department of Agriculture has indicated that the large grain sales made to Russia this past summer will boost food prices about 1.5 per cent higher than they otherwise would be in 1976.

Considering the outlook for farm prices in the year ahead, there is a good possibility that the upward pressures on food prices resulting from the Russian grain sale will be nearly offset by price declines at the farm level if supplies materialize as expected. Therefore, the issue of food prices in 1976 will depend largely on what happens to the farm-to-retail price spread. Following a 20 per cent jump in 1974, marketing spreads for assembling, processing, transporting, and distributing are expected to average about 8 per cent higher in 1975. In 1976, the farm-to-retail margin will no doubt widen once more to cover higher marketing and processing costs. The question is—how much? Although historical evidence shows that significant year-to-year deviations may occur, marketing margins tend to reflect the general rate of inflation because the food industry is basically service oriented. The economic recovery will probably result in a higher demand for built-in food services, which will likely lead to wider spreads and higher food prices, but it is hoped that economic conditions will be stable enough in the year ahead to remove some of the impetus for ever-widening marketing margins. If so, 1976 food prices should conform more closely to the general rate of inflation, which promises to be moderate. Hence, the rate of increase in food prices in the coming year likely will be less than the 9 per cent rise posted in 1975.

Foreign Demand to Continue Strong

Although the availability of U. S. grain stocks has increased sharply this year, the prospects for world trade are more favorable than a year ago because of production shortfalls in several major producing countries, particularly in the Soviet Union. Thus, the volume of agricultural exports in the

Chart 1
U.S. AGRICULTURAL EXPORTS



1975-76 fiscal year promises to exceed the previous year's level by a wide margin—perhaps as much as 15 to 20 per cent. Prices, however, are expected to average somewhat lower in the current period, which will offset some of the gains in volume. Still, foreign sales should surpass the record \$21.6 billion posted in fiscal 1975 and provide another large surplus in the trade balance for agricultural commodities (Chart 1). The surplus from agricultural trade has amounted to about \$12 billion in each of the last 2 fiscal years, up from \$5.6 billion in fiscal 1973. Moreover, the expected surplus in the current period also should equal, if not surpass, the \$12 billion level. Obviously, the sharp expansion in agricultural exports has been extremely beneficial to the United States in balancing the payments associated with international trade.

In the last fiscal year, the volume of agricultural exports declined about 15 per cent due largely to the small harvests in 1974. Nevertheless, wheat and feed grain sales posted new highs, reaching \$5 billion and \$4.7 billion, respectively. Rice exports, rising 33 per cent, broke the \$1 billion mark for the first time. However, cotton and soybean exports fell 21 per cent and 9 per cent, respectively, because of reductions in demand. Reflecting the worldwide recession in 1974-75, sales to Japan—the largest single market for U. S. agricultural exports—fell

about 5 per cent in the last fiscal year to a level of \$3.2 billion. Interestingly, total sales to both Russia and China amounted to less than \$800 million, down sharply from the \$1.35 billion shipped in fiscal 1974.

A Word About Grain Agreements

While creating a storm of controversy, the 5-year grain agreement recently consummated with the Soviet Union merely represents another chapter in the long history of agricultural trade policy. Almost from the beginning, the Government has influenced, if not controlled, the conditions under which American farm commodities could enter international markets. However, the stance on trade policy has changed from time to time, varying from strong protectionist policies, as championed by the **Smoot-Hawley** tariffs in the 1930's, to programs that have sought to liberalize trade barriers and expand foreign markets. In addition, considerable effort has gone into developing programs that provide needy countries with food and other farm products on a concessional basis. Hence, many people are apprehensive about the Russian grain agreement because it seems to conflict with a general policy of market expansion for agricultural commodities.

Before such a conclusion is reached, however, the terms of the agreement should be analyzed carefully. Beginning October 1, 1976, Russia will be committed to purchase annually, for the next 5 years, at least 6 million metric tons of wheat and corn in approximately equal proportions. If American grain stocks exceed 225 million tons, Russia may purchase an additional 2 million tons without **prior** consultation with the U.S. Government. Furthermore, it is expected that purchases and shipments will be spaced as evenly as possible over each 12-month period. If U.S. grain stocks should fall below 225 million tons, a highly unlikely development based on historical evidence, an "escape clause" will permit the United States to reduce the quantity of grain sold to the Soviet Union below the 6 million ton minimum. Similarly, any desire by either party to go beyond the 8 million ton maximum

will require additional consultations before the sales are made. The agreement only applies to corn and wheat, which means that trade may occur in other commodities without restrictions. Finally, no concessional credit will be provided by the U.S. Government to finance Russia's purchases.

As with any agreement, there are advantages and disadvantages. On the positive side, the Russian grain agreement may remove much of the emotionalism that has characterized earlier transactions. At a minimum, the agreement promises to smooth out Russia's buying patterns for the next few years, to help her build up grain reserves during good crop years, and to partly reduce the wide price fluctuations in U.S. grain markets, assuming that sales to other countries do not vary unduly. Greater price stability not only will allow grain producers to make better decisions but will also offer some protection to the livestock industry against sharp **runups** in feed costs. Moreover, the steady flow of grain to the Soviet Union over the next 5 years will result in a substantial amount of foreign exchange to help relieve some of the pressure on the balance of payments problem.

On the negative side, the quantity limits specified in the agreement have a relatively narrow range and, as such, are tantamount to export controls. While it can be argued that Russia's access to U.S. markets should not go unchecked due to her proclivities for making massive purchases within short time periods, a maximum limit higher than the 8 million tons would still act as a constraint and, at the same time, provide a wider range within which the pricing system could operate. As it now stands, the Soviet Union has a strong incentive to glean the world market before coming to the United States to negotiate for additional quantities above the maximum limit. Although most of these lost sales would probably be offset by larger grain shipments to third countries, the net effect of this policy is to make the United States a residual supplier of grain.

A more disturbing ramification, however, is that an element of competition has been removed from the marketplace. Now that an agreement has been reached with Russia, in addition to the **Japa-**

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

	Corn (bu)		All Feed Grains (ton)		Soybeans (bu)		Wheat (bu)	
	Marketing Year Oct. 1-Sept. 30		Marketing Year*		Marketing Year Sept. 1-Aug. 31		Marketing Year July 1-June 30	
	1974-75	1975-76†	1974-75	1975-76†	1974-75	1975-76†	1974-75	1975-76†
Supply								
Beginning Carryover	483	359	22.2	15.8	171	186	247	320
Production and Imports	4653	5805	165.6	204.6	1233	1520	1795	2139
Total	5136	6164	187.8	220.4	1404	1706	2042	2459
Disappearance								
Domestic	3628	4040‡	132.9	146.8‡	808	856‡	683	706‡
Exports	1149	1450‡	39.1	49.9‡	410	475‡	1039	1350‡
Total	4777	5490‡	172.0	196.7‡	1218	1331‡	1722	2056‡
Ending Carryover	359	674‡	15.8	23.7‡	186	375‡	320	403‡

*Marketing year begins October 1 for corn and grain sorghum, July 1 for barley and oats.

†Preliminary projections available November 1, 1975.

‡Average of a range of estimates.

SOURCE: U.S. Department of Agriculture.

nese grain agreement that was reached earlier this year calling for minimum shipments of 14 million metric tons a year for 3 years, other countries wishing to line up supplies from the United States will likely seek similar commitments. Hence, this carving up of the export market among various countries would tend to reduce the aggressiveness of buyers in the marketplace, which might result in lower bids on the grain that is for sale. Such an arrangement would obviously be the ultimate form of export controls.

COMMODITY OUTLOOK FOR 1976

The important ingredients in the 1976 outlook for agricultural products are the uncertainties associated with the strength and duration of the economic recovery, future developments in export demand, and probable production levels in both the livestock and crop sectors. It is generally assumed that output will expand in the year ahead, and that total demand will rise enough to lend some support to farm prices. However, favorable crop weather and expectations of good profit margins in livestock feeding will be a prerequisite to higher production levels in 1976. Although the demand picture presently looks good, conditions can suddenly

change. A rekindling of inflation, for example, could seriously jeopardize the economic recovery, which would likely have a harmful effect on agriculture.

Crop Situation

Due to large harvests in 1975, crop supplies for the current marketing year are sharply higher than a year ago (Table 1). The production of feed grains and wheat both hit record highs, pushing total supplies of these commodities up 20 per cent. Although soybean production did not match 1973's record, the combination of a 23 per cent increase in production and a larger carryover boosted the total supply to an all-time high of 1.71 billion bushels. In contrast to 1974-75, when supplies were very tight, grain stocks for the coming year appear ample for expanded domestic and foreign demand while still allowing for some buildup in the carryover next summer and fall. This larger carryover will likely dampen any sharp upward movement in grain prices.

The grain markets are still being buffeted by the weight of large domestic harvests and uncertainties about future sales to the Soviet Union. Following the lifting of the embargo in October, Russia did

purchase additional grain—bringing the total for 1975 to more than 13 million metric tons. However, instead of rising, prices fell. Apparently, the grain trade ascertained that even if Russia decided to push total purchases to 17 million tons, an amount about equal to her acquisitions in 1972-73, the supply of wheat and feed grains would easily stretch to the 1976 harvests.

In the last marketing year, farmers received prices which averaged about \$4.00, \$3.00, and \$6.50 per bushel for wheat, corn, and soybeans, respectively. With the exception of wheat, which may average near last year's level, prices will likely average lower in the current marketing year, especially for soybeans. Furthermore, the **post-harvest** seasonal rise that normally occurs in the winter and spring months may be somewhat restricted this year unless foreign demand should strengthen further or the 1976 crop prospects run into difficulty.

A sharp decline in production and a likely increase in U.S. mill consumption highlight the cotton outlook. With relatively stable exports, ending carryover stocks for the 1975-76 marketing year should fall moderately below this year's level of 5.75 million bales, which suggests that prices will be reasonably good. Supplies of most fruits and vegetables are somewhat larger this year, but total demand promises to keep prices near, if not above, 1974-75 levels.

Livestock Situation

Despite the improved profitability picture of recent months, cattle feeders and hog producers apparently are taking a guarded approach to expanding output, due to uncertainties about future cost-price relationships. Only recently has there been any evidence of a turnaround in hog farrowing and feedlot placements. In September, for example, hog producers reported that they planned to increase farrowings for the December 1975-February 1976 period 6 per cent above the same period a year earlier, but this will still be well below the levels posted in 1973 and 1974. The number of cattle placed in feedlots during the third quarter of 1975 was 22 per cent higher than the very low levels

of a year ago. Nevertheless, this increase in placements was sufficient to boost the total number of cattle on feed as of October 1, 1975, slightly above the previous year, the first such year-to-year gain since October 1973.

Although livestock output now appears to be on the expansion path, actual production in the year ahead will depend largely on how producers assess their potential profits. In the hog industry, the outlook is quite favorable, especially for the first half of 1976. Even though farrowings will be increasing rather sharply, pork production is not expected to exceed year-earlier levels until mid-year. Slaughter during the second half of the year will likely be large enough to offset an anticipated decline of about 10 per cent in the kill rate during the first 6 months. Thus, pork supplies in 1976 should be slightly larger than in 1975, which, on a per capita basis, were the lowest in 40 years. Although prices are not likely to surpass the \$65 per hundredweight peak established last fall, some seasonal strength may occur in the spring. But once supplies of pork and other red meats begin to expand more rapidly next summer, some retrenchment in pork prices is expected. For the year as a whole, prices on barrows and gilts will probably average a little below the \$50 per hundredweight estimated for 1975.

The sharp rise in cattle and calf slaughter in 1975 apparently will stem the buildup in inventory numbers. It was estimated a year ago that the cattle inventory was 131.8 million head, and all of the evidence suggested that another increase would occur in 1975. However, a larger-than-anticipated death loss coupled with sharply higher slaughter rates for cows, calves, and non-fed steers and heifers have placed cattle numbers in better balance with market demand. Stopping the inventory buildup will not necessarily result in higher cattle prices in the coming year, but it at least sets the stage for a stronger and more profitable market at some point in the future.

Looking at potential beef supplies, fed cattle marketings in the first quarter of 1976 will likely increase about 10 per cent above year-ago levels and 15 per cent or so above the fourth quarter, 1975.

Furthermore, fed marketings in the second quarter should also be up sharply from the year-earlier period. Although increases of these magnitudes would normally presage a drop in price, marketings from the non-fed sector are expected to decline rather significantly during the winter months. Therefore, total slaughter during the January-March period may be only 3 to 4 per cent larger than a year earlier, which suggests that prices on choice steers and heifers will remain fairly strong. Reflecting a probable shift back to more grain-fed cattle and fewer non-fed steers, heifers, and calves, 1976 production levels are expected to show a moderate increase over this year. Although the price outlook is mixed, most of the evidence suggests that choice steer prices should average near the \$45 per hundredweight received this year.

While improving, the outlook for the cow-calf producer is not particularly bright for 1976. Until the cattle inventory is liquidated further or profits in cattle feeding show greater promise, feeder cattle prices are likely to hover around current levels, showing at most some seasonal strength this spring. Conditions in 1977 and 1978, however, should be much better for the rancher.

In response to more favorable prices, poultry and egg production has recently been expanding. This expansion will likely put some downward pressure on prices in the months ahead, but if the relationship between feed costs and prices does not

deteriorate significantly, 1976 profits should compare favorably with 1975 earnings. The dairy industry has benefited from higher prices and lower feed costs in 1975. Milk production for the year is estimated to be about equal to the 115.4 billion pounds produced in 1974. Some increase in output is likely for 1976, but the gain should not depress prices and incomes to any great extent. Continuing a trend of several years, lamb slaughter will probably be down again in 1976. However, larger supplies of beef and pork will temper any price movements for lambs much above 1975 levels.

A FINAL NOTE

On balance, the agricultural picture for 1976 appears good even though prices and net incomes may slip somewhat below 1975 levels. This evaluation presupposes, however, that weather conditions in the year ahead will be conducive for big crops and that profit margins in livestock feeding will remain generally favorable. There is also an implicit assumption that the economy will continue to grow in 1976, which will afford higher levels of employment and larger disposable incomes. However, because the wheel of fortune in agriculture is capable of producing surprising outcomes, farmers should exercise more than the usual amount of caution in their production and marketing decisions in 1976.