

Economic Review



FEDERAL RESERVE BANK OF KANSAS CITY

December 1983

The U.S. Economy
and Monetary Policy in 1983

Better Times Ahead for Agriculture

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The U.S. Economy and Monetary Policy in 1983 3

By Glenn H. Miller, Jr., Karlyn Mitchell, and Dan Hoxworth

Economic performance was better than expected in 1983, mainly because of the economy's unexpectedly large response to lower interest rates. The unemployment rate dropped, production increased — boosting the rate of plant utilization — and inflation continued to moderate. The broader monetary aggregates were held near their target ranges all year. Economic performance is likely to remain good in 1984, though the expansion of production and employment may moderate.

Better Times Ahead for Agriculture 22

By Marvin Duncan and Mark Drabenstott

Farm income improved in 1983 and further improvement can be expected in 1984. The gains in 1983 were due largely to record high government subsidies. Advances in 1984 will be determined more by supply-demand relationships. Farm financial conditions will likely stabilize in 1984, but the uneven distribution of income gains in 1983 will lead to further financial stress for some farmers.

The U.S. Economy and Monetary Policy in 1983

By Glenn H. Miller, Jr., Karlyn Mitchell, and Dan Hoxworth

In January 1983, most forecasters predicted that the U.S. economy would perform rather poorly during the year. Most expected that, despite generally lower interest rates, real GNP growth would be low, the unemployment rate would be high, and the pace of inflation would be moderate.

As 1983 unfolded, however, the economy performed considerably better than forecasters had predicted. The economic recovery was fairly typical of the first years of previous recoveries while financial developments were generally more conducive to economic growth than in the recent past.

This article reviews the economic and financial developments in 1983 and suggests that the better than expected performance of the economy was due mainly to the unexpectedly large response of the economy to the decline in interest rates. The article also comments on the outlook for economic activity and the issues confronting monetary policy in 1984.

Economic recovery in 1983

The U.S. economy began its recovery in 1983, following the end of the nation's most recent recession in the fourth quarter of 1982. Economic indica-

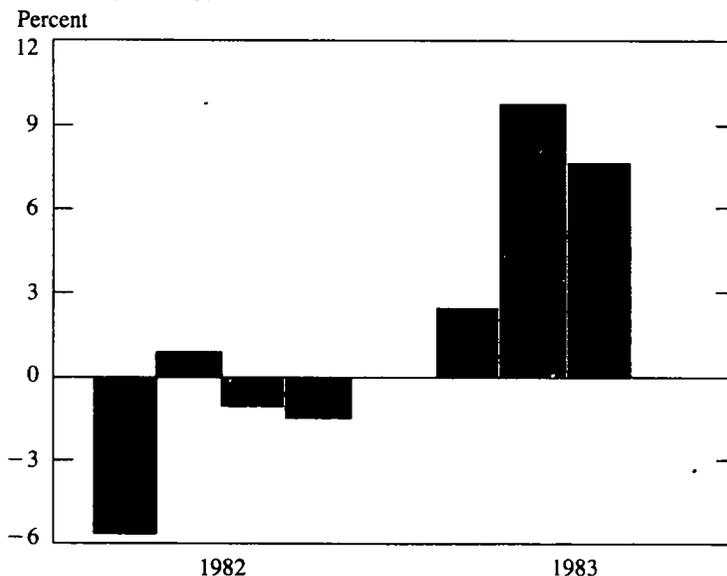
tors show the 1981-82 recession was worse than the average of post-World War II recessions. In terms of resource use and other indicators of slack in the economy, it was the worst recession in the post-World War II period. By the end of 1982, the overall civilian unemployment rate had reached a postwar high of 10.8 percent. Existing manufacturing capacity was being used only 68.8 percent, an operating rate lower than in any other postwar recession. Real GNP in the fourth quarter of 1982 was only about 92 percent of the level estimated if economic growth had followed its long-run trend — the lowest since 1949.

Cyclical recovery in 1983 brought improvement in all three of these measures of resource use. The civilian unemployment rate dropped steadily, reaching 8.4 percent in November. Vigorous increases in manufacturing output brought the October rate of capacity use up to 79 percent. And with real GNP growing at an annual rate of 6.6 percent over the first three quarters of the year, some of the GNP gap closed. Real GNP in the third quarter was about 94 percent of its estimated trend level.

The recovery got off to a slow start, with real GNP increasing at a 2.6 percent annual rate in the first quarter of 1983 (Chart 1). Total purchases of goods and services by final users increased hardly at all. A modest rise in consumer spending and a substantial increase in residential construction were

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CHART 1
Change in real GNP
 (seasonally adjusted annual rate
 compounded quarterly)



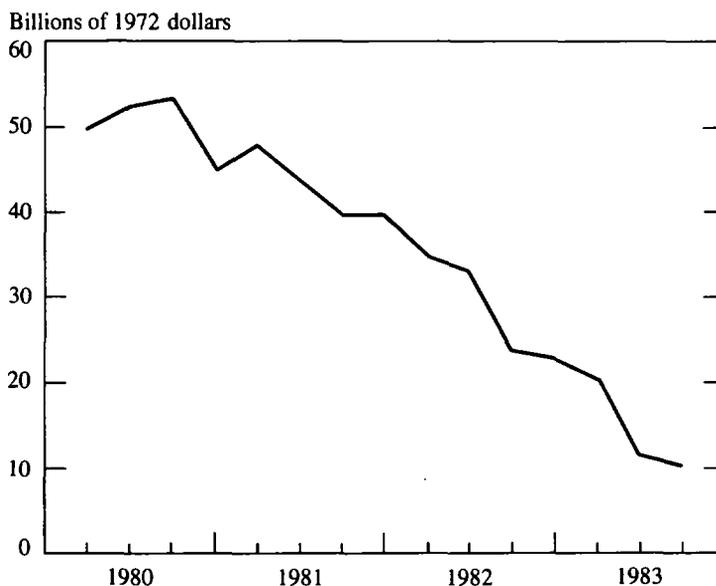
largely offset by declines in business fixed investment, net exports, and government purchases of goods and services. Nearly three-fourths of the total increase in real GNP was due to the business inventory liquidation being slower in the first quarter than in the fourth quarter of 1982.

Real output increased sharply in the second quarter, with inflation-adjusted GNP expanding at an annual rate of 9.7 percent. While a further slowing in inventory liquidation provided some of the impetus, more than two-thirds of the gain in output came from final purchases. Private domestic sectors accounted for the increases in final purchases, as both net exports and government purchases declined further in the second quarter. Somewhat atypically for early in a recovery, business fixed investment also contributed to growth in economic activity. The real punch, however, came from the usual front-runners in early recoveries — consump-

tion and housing. Benefiting from earlier declines in mortgage rates, residential construction increased sharply in the second quarter. And consumer spending, led by a surge in purchases of durable goods, rose at an annual rate of 10 percent — the largest quarterly increase in nearly 18 years.

The pace of the recovery slowed only slightly in the third quarter, when real GNP rose at an annual rate of 7.7 percent. The contribution of inventory investment to output growth was about the same in constant dollar terms as in the second quarter. The form was different, however, as business returned to accumulating stocks after six quarters of inventory liquidation. Final sales, the major source of expansion in the third quarter, accounted for nearly two-thirds of the rise in total output. Neither consumer spending nor housing showed as much strength as in the second quarter, though both remained important contributors to the continuing

CHART 2
Real net exports of goods and services



recovery. But business fixed investment was stronger in the third quarter than in the second, and government purchases changed from a drag on growth to a positive contributor to the expansion. Thus, with the public sector joining the private domestic economy as positive growth factors, only the foreign sector remained as a drag on growth as real net exports again declined.

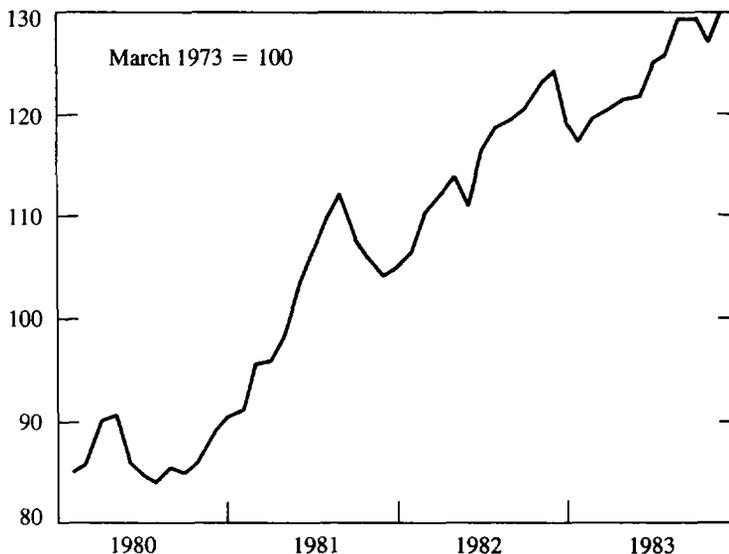
The foreign sector has become increasingly important to U.S. economic activity. From a low point in the fourth quarter of 1977 through a peak in the third quarter of 1980, real net exports tripled, increasing from \$18 billion to \$54 billion in 1972 dollars. That increase accounted for nearly 40 percent of the real gain in final sales over that period. From their peak in the third quarter of 1980, real net exports fell steadily to \$10 billion in the third quarter of 1983 (Chart 2). This \$44 billion decline in net exports was a significant drag on U.S. final sales,

which increased only \$75 billion over the period.

Much of the drop in real net exports, though not all, was associated with the substantial increase in the value of the dollar beginning in mid-1980 (Chart 3). The rising value of the dollar can be traced to such factors as lower inflation in the United States than in other countries, higher real interest rates in the United States, and the perception abroad that the United States is a safe haven for investment funds. The weighted average exchange value of the dollar rose more than 50 percent from the third quarter of 1980 to the third quarter of 1983 — the period when real net exports fell about 80 percent.

One consequence of a strong dollar is a higher price abroad for U.S. exports. The resulting reduction in foreign demand for U.S. production has been a source of weakness in the U.S. economy for the last three years. Another consequence of a strong dollar is a lower price for imports into the United

CHART 3
Weighted average exchange value
of the U.S. dollar
(monthly averages)



States. As lower import prices also help hold down prices of import-competing U.S. goods, an increasing value of the dollar tends to hold back inflation in the United States.

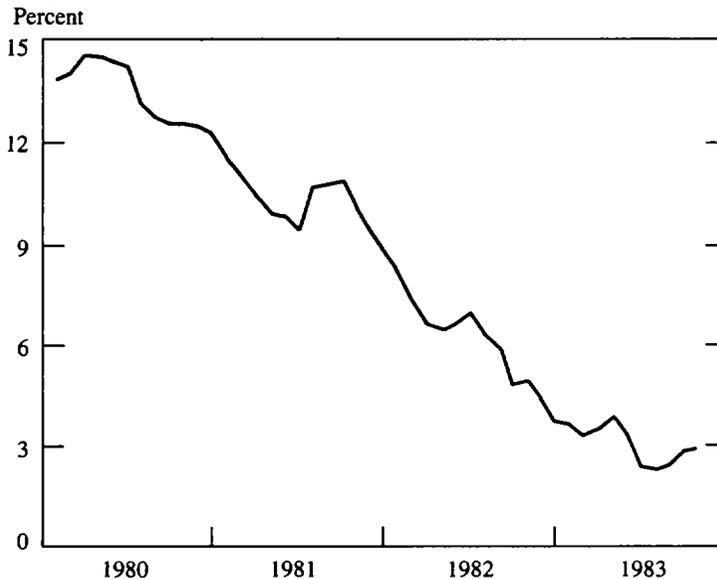
Substantial disinflation has been underway in the United States since 1980. While due partly to the strength of the dollar, the disinflation is related more to the weakness of the economy and to the slack in resource use. All major price indexes reflect the disinflation. As shown in Chart 4, the percentage change in the consumer price index (CPI) measured over one-year spans has declined strikingly from more than 14 percent in early 1980 to less than 3 percent in October 1983. As the chart shows, disinflation has continued in the first three quarters of cyclical recovery in 1983.

Another feature of recent years has been wage disinflation. Chart 5 shows percentage changes in the index of average hourly earnings measured over

one-year spans. The increase in hourly earnings, which was running at nearly 10 percent in early 1981, slowed to just under 4 percent in late summer of 1983. Unit labor costs — compensation per hour divided by output per hour, or productivity — also slowed substantially in their rate of increase after 1980. From a 12 percent increase over the year ending in the second quarter of 1980, the rate of increase in unit labor costs slowed to 1.6 percent for the year ended in the third quarter of 1983. Thus, wage disinflation, like price disinflation, has continued as the economy moved through the first three quarters of recovery.

The continuation of price and wage disinflation through the early recovery period is typical of recent U.S. business cycles. An upturn in the inflation rate as measured by the CPI typically occurs later than an upturn in business activity. The same holds for unit labor costs. Inflation as measured by the CPI

CHART 4
Change in consumer price index
(seasonally adjusted percentage change
over one-year span)



did not begin to increase in the 1950s, 1960s, or 1970s until an average of about five quarters after business cycle recoveries began. Similarly, the rate of increase in unit labor costs continued to fall on average for nearly four quarters after recessions ended. If these patterns are repeated, prices and labor costs might be expected to begin rising faster again in early 1984.

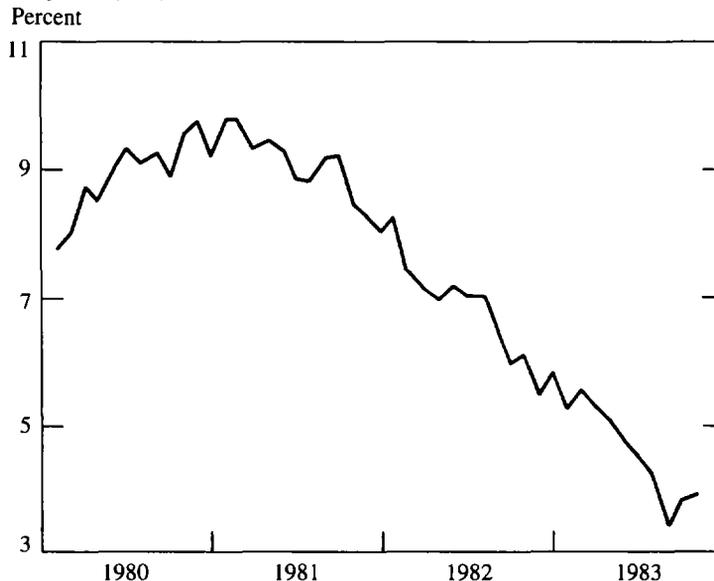
The economy's surprisingly good performance in 1983 is due mainly to the lower level of nominal and real interest rates. Lower rates, in turn, were due mainly to the Federal Reserve's anti-inflation monetary policy. Under this policy, the Federal Reserve has sought to lower the long-run inflation rate by reducing gradually the growth rate of the money supply. While this policy initially put upward pressure on interest rates, it has allowed a gradual reduction in nominal rates by reducing inflation expectations and the inflation premiums lenders require.

Declining inflation also allowed real interest rates to decline beginning late in 1982. Hence in 1983, real GNP growth was led by interest-sensitive categories of spending, particularly consumer durables housing, inventory investment, and business fixed investment. In January 1983, most economic forecasters apparently underestimated the beneficial impact that lower interest rates would have on economic activity.

Interest rates in 1983

Compared with the previous three years, 1983 was a year of relatively low and stable nominal interest rates. Although low compared with the recent past, both short and long-term rates were still high by historical standards. Also high by historical standards were measured real interest rates, computed as nominal rates minus the annualized infla-

CHART 5
Change in average hourly earnings index
 (seasonally adjusted percentage change
 over one-year span)



tion rate. Short and long-term interest rates were not nearly as volatile as in recent years, however, a factor that probably increased investor confidence.

Interest rates remained fairly stable through the spring, rose over summer, and declined somewhat in the fall (Chart 6). Short-term rates were at their 1983 lows in January. Long-term rates hit their lows for the year in April and May. Both rates began rising sharply in June, to an August peak about 1.5 percentage points higher than their respective lows. Interest rates then declined somewhat but did not reach their previous 1983 lows.

Despite increases during the summer, nominal interest rates were generally lower in 1983 than in recent years (Table 1). In the first 11 months of 1983, short-term interest rates averaged 2 to 3 percentage points less than in all of 1982, the year with the lowest short-term rates in the 1980-82 period. In the first 11 months of 1983, long-term rates aver-

aged nearly the same as in all of 1980, approximately 1.5 to 2.5 percentage points lower than in all of 1981 and 1982.

In addition to being lower than in the previous three years, interest rates were more stable in 1983. Long-term interest rates, such as Moody's Aaa corporate bond rate, fluctuated in the first 11 months of 1983 within a 1 percentage point range, compared with an annual range of 3 percentage points in the 1980-82 period. The rate on U.S. government securities fluctuated in a range of 1.3 percentage points, compared with a 3 percentage point annual range in the 1980-82 period. Even more dramatic than the increased stability of long-term rates was the increased stability of short-term rates. In the first eleven months of 1983, the 3-month Treasury bill rate fluctuated in a range of 1.5 percentage points, down from ranges of 5.5 to 8.5 percentage points in the 1980-82 period. The reduced variability of short

CHART 6
Interest Rates

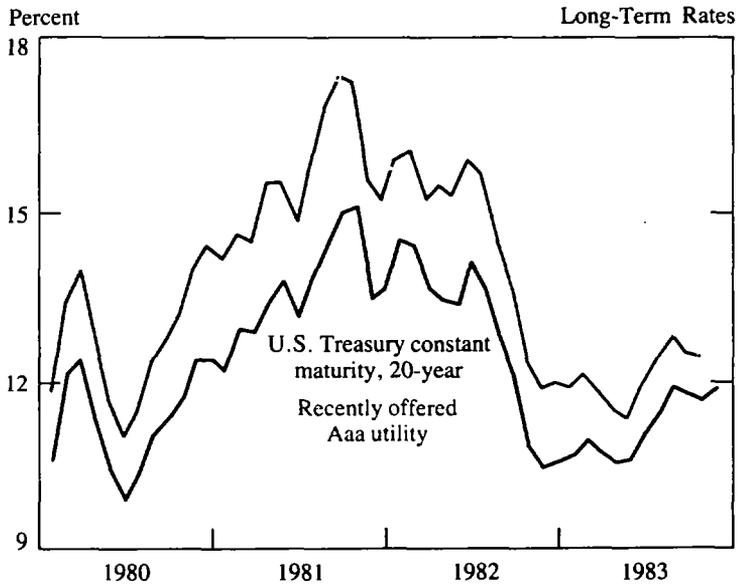
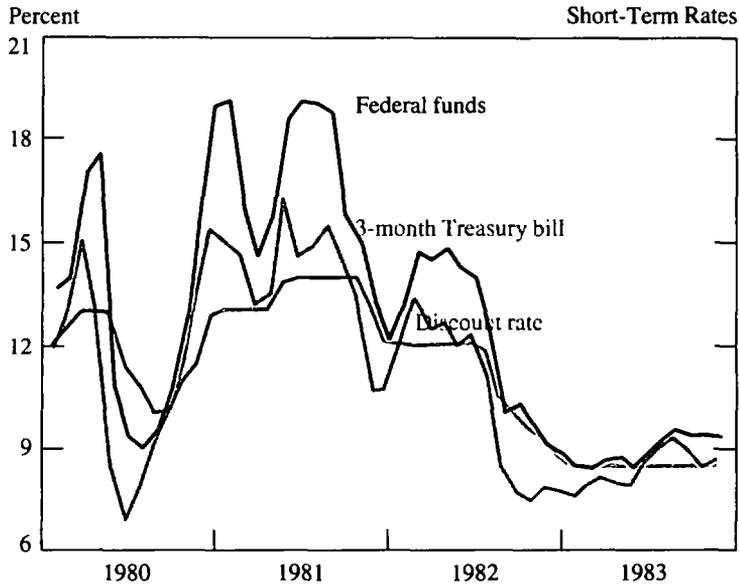


TABLE 1
Selected interest rates, 1980-83

| <u>Period</u> | <u>Federal Funds</u> | <u>3-Month Treasury Bills</u> | <u>Moody's Seasoned Corporate Aaa</u> | <u>U.S. Government 20-Year</u> |
|---------------|----------------------|-------------------------------|---------------------------------------|--------------------------------|
| 1980 High* | 18.90 | 15.49 | 13.21 | 12.49 |
| Low | 9.03 | 7.07 | 10.58 | 9.89 |
| Average† | 13.36 | 11.43 | 11.94 | 11.39 |
| 1981 High | 19.10 | 16.30 | 15.49 | 15.13 |
| Low | 12.37 | 10.85 | 12.81 | 12.29 |
| Average | 16.38 | 14.03 | 14.17 | 13.72 |
| 1982 High | 14.94 | 13.48 | 15.27 | 14.57 |
| Low | 8.95 | 7.71 | 11.68 | 10.57 |
| Average | 12.26 | 10.61 | 13.79 | 12.92 |
| 1983 High | 9.56 | 9.34 | 12.51 | 11.92 |
| Low | 8.51 | 7.86 | 11.46 | 10.63 |
| Average | 9.05 | 8.58 | 11.99 | 11.28 |

* High and low monthly average rates for each calendar year.

† Average of the monthly rates for each calendar year.

and long-term interest rates helped restore confidence to financial markets after years of uncertainty.

Like nominal interest rates, measured real interest rates were lower in 1983 than in the previous three years, but still high by historical standards. In the third quarter of 1983, the measured real prime rate was 7.4 percent, significantly lower than the 11 percent rate in the third quarter of 1982. Despite this decline, measured real interest rates were comparatively high in 1983, as shown in Table 2. The rate averaged 6.7 percent in the first three quarters of 1983, whereas in the first three quarters of the last five economic recoveries prior to 1980 the measured real prime rate averaged 1.5 percent.

Measured real interest rates remained at historically high levels because of factors that kept short and long-term nominal rates high. These factors included the large federal budget deficit, comparatively volatile interest rates, and high inflation expectations.

The large federal budget deficit put upward pressure on interest rates in 1983. Federal borrowing amounted to \$212.4 billion in fiscal 1983, \$77.5

billion more than in 1982. The large deficit contributed to the high level of both short and long-term rates by increasing the competition between government and private borrowers for a limited supply of credit.

Although nominal interest rates were not as volatile in 1983 as in the three previous years, they were volatile by historical standards. By increasing the risk of holding financial instruments, volatility put upward pressure on interest rates as investors

TABLE 2
Nominal and measured real prime rates

| <u>Date</u> | <u>Nominal</u> | <u>Real</u> |
|------------------|----------------|-------------|
| 1980 | 15.3 | 5.1 |
| 1981 | 18.9 | 10.2 |
| 1982: First Half | 16.4 | 11.4 |
| Second Half | 13.3 | 9.6 |
| 1983: I | 10.9 | 5.4 |
| II | 10.5 | 7.2 |
| III | 10.8 | 7.4 |

Note: The measured real prime rate is defined in this table as the quarterly nominal prime rate minus the rate of inflation as measured by the annualized percent change in the GNP deflator.

demanded a risk premium as compensation for the greater uncertainty.

Inflation expectations contributed to high nominal and measured real interest rates, especially long-term rates. Expectations of inflation led investors to add an inflation premium to nominal lending rates to compensate for the possibility of being repaid in dollars with less purchasing power. Two factors may have augmented investors' inflation forecasts in 1983. One was that investors were probably hesitant to lower their inflation expectations after the long period of inflation that had hurt fixed-income investors. The other was that the prospect of continuing large federal budget deficits might cause the Federal Reserve to monetize the government's borrowings. Government borrowing is projected to remain at near-record highs for several years. Massive credit demands by the Treasury raise inflation expectations by increasing concern that as nominal interest rates rise, the Federal Reserve will be forced to stabilize interest rates by increasing the money supply — which serves to monetize the debt.

Although measured real interest rates were comparatively high in 1983, real interest rates — especially real long-term rates — were probably closer to their historical norms. Real interest rates, rather than measured real interest rates, influence spending and investment decisions. The real rate is the nominal interest rate less the rate of inflation expected over the life of the investment. Because of the recent experience with rapid inflation, the expected inflation rate was probably higher than the actual rate in 1983. As a result, real long-term interest rates were probably less than measured real rates. Low real long-term interest rates may be one explanation for the rapid recovery, despite high long-term measured interest rates.

One of the significant interest rate developments in 1983 was the sharp reduction in risk premiums on the debt instruments of lower rated private firms. The risk premium is measured as the spread between interest rates on the debt of high-rated pri-

vate firms and low-rated firms. The spread follows a cyclical pattern. Because bankruptcies affect smaller, lower rated firms disproportionately, investors demand a higher premium to compensate for the increased risk. As a result, the spread increases during recessions and decreases during expansions.

As usual in economic expansions, the risk premiums required on debt of lower rated firms declined in 1983. As shown in Chart 7, the spread between Aaa rated bonds and Baa bonds reached an all-time high of 2.7 percentage points in September 1982. Over the next year, the spread fell to less than 1.2 percentage points. There was a similar reduction in the risk premiums paid by lower rated firms on short-term securities. The spread between high and medium-grade commercial paper declined from 1.4 percentage points in the third quarter of 1982 to 0.5 percentage point a year later. The extent of the decline in risk premiums, which came faster than in other recovery periods, indicates renewed investor confidence in the economic recovery.

The reduction in the level and volatility of interest rates and the reduction in risk premiums in 1983 were typical of the early phase of an economic expansion. These interest rate developments influenced — and were influenced by — the money and credit aggregates.

Growth of the monetary aggregates in 1983

Growth in the monetary aggregates in the first 11 months of 1983 generally exceeded that of recent years. M1 — the narrowly defined money supply consisting of currency held by the public, traveler's checks, demand deposits, and other checkable deposits — grew at an annual rate of 9.4 percent, a pace considerably faster than in each of the previous two years (Table 3). Growth of M2 — consisting of M1, savings deposits, small time deposits, shares in mutual money market funds, overnight repurchase agreements and Eurodollar transactions, and the

TABLE 3
Growth of the monetary aggregates: 1980-83
 (percentage change at annual rates)

| <u>Period</u> | <u>M1*</u> | <u>M2</u> | <u>M3</u> | <u>Total Nonfinancial Domestic Debt</u> |
|------------------------|------------|-----------|-----------|---|
| 1980 | 7.2 | 9.0 | 9.7 | 9.5 |
| 1981 | 5.1 | 9.4 | 11.7 | 9.6 |
| 1982 | 8.5 | 9.3 | 10.1 | 9.2 |
| 1983: First 11 Months† | 9.4 | 11.9 | 9.4 | 10.2‡ |
| 1983: I | 14.1 | 20.3 | 10.2 | 8.8 |
| II | 12.2 | 10.1 | 8.1 | 10.6 |
| III | 8.9 | 7.8 | 8.3 | 11.6 |

Note: Annual rates of growth are based on quarterly average data.
 * M1 is equivalent to M1-B in 1980 and M1-B adjusted for deposit shifts into NOW accounts in 1981.
 † Fourth quarter 1982 through November 1983.
 ‡ Fourth quarter 1982 through October 1983.

new money market deposit account balances — also rose faster than in recent years. Only M3 — the most comprehensive aggregate, which includes M2, large time deposits, and institution-only money market funds — grew slower in 1983.

Nonfinancial domestic debt also grew faster in 1983 than in previous years. This aggregate consists of the outstanding debt of all domestic governmental units (federal, state, and local), households, and nonfinancial businesses. In the first 11 months of 1983, nonfinancial debt increased at an annual rate of 10.2 percent, slightly faster than in 1981 and 1982.

All three monetary aggregates followed a similar pattern, growing rapidly in the first quarter and slowing gradually as the year progressed. The rapid growth of the aggregates early in the year was due mainly to three factors. These factors include the introduction of new deposit accounts, the lagged effects of declining interest rates and lower inflation rates, and the uncertain economic outlook.

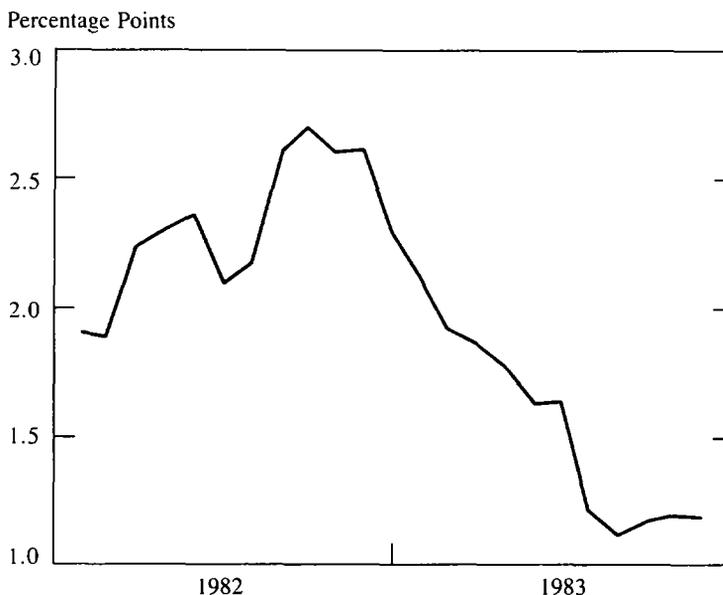
The introduction of two new deposit accounts heavily influenced the first quarter growth of the monetary aggregates. In response to the mandates

of the Garn-St Germain Act, all depository institutions were authorized to offer money market deposit accounts (MMDA's) on December 14, 1982. These investment-oriented accounts require a \$2,500 minimum balance, have no reserve requirement, allow a limited number of transactions, and have no interest rate ceiling. These institutional features of MMDA's make MMDA's directly competitive with shares at money market mutual funds (MMMF's). In addition, unlike MMMF's, MMDA's are insured up to \$100,000 by either the FDIC or FSLIC. Since MMDA's are designed for investment, they are not included in M1 but in the broader M2 and M3 aggregates.

Closely following the introduction of MMDA's, Super NOW accounts were introduced on January 5, 1983. In addition to the features available in MMDA's, Super NOW's offer unlimited checking. As a result, they are included with NOW accounts in the other checkable deposit component of M1 and are subject to a 12 percent reserve requirement.

Because of unprecedented interest rate competition, massive advertising, and the lure of deposit insurance, MMDA balances had soared to \$341 bil-

CHART 7
Long-term risk premium



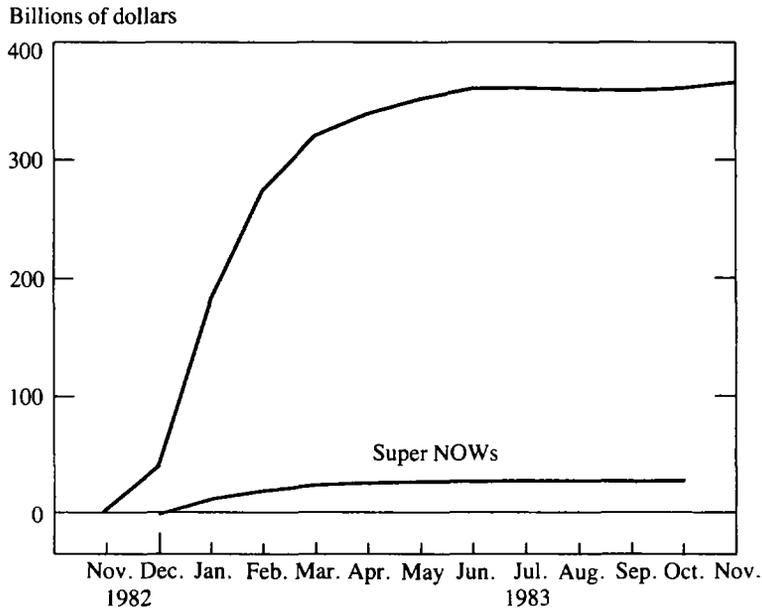
lion by April 1983 (Chart 8). Much of this growth in MMDA's came at the expense of noninstitutional MMMF's and small time and savings deposits. As all three of these accounts are included in M2, the transfer of funds among accounts did not affect total M2. Growth of MMDA's also came at the expense of large time deposits and institution-only MMMF's, which are in M3. Flows from these accounts into MMDA's inflated the growth of M2 but did not affect total M3 because all three accounts are included in M3. MMDA's also attracted funds from accounts in M1. These flows had no effect on total M2 because M1 is included in M2. The flows did, however, suppress the growth of M1.

The introduction of Super NOW's had much less effect on the monetary aggregates. Super NOW's grew to only \$30 billion in the first four months of 1983 (Chart 8). Because Super NOW's attracted

only a modest amount of funds, they accounted for little of the rapid growth in M1 in the first quarter of 1983.

The lagged effects of declining interest rates and slowing inflation also contributed to the rapid growth in the monetary aggregates by reducing the opportunity cost of holding money. This factor is particularly important in explaining growth in M1. High interest rates make currency, demand deposits, and other checkable deposits (OCD's) — principally NOW accounts — unattractive because these holdings earn little or no interest. High inflation also makes these holdings unattractive, because they offer no protection against inflation. Comparatively low interest rates and reduced inflation in 1983 made these holdings much more attractive than in recent years, with the result that most components of M1 grew rapidly in 1983. Currency and OCD's, each accounting for about a fourth of

CHART 8
New deposit accounts



M1, grew rapidly in 1983. Demand deposits grew much slower.

Another factor influencing growth in the monetary aggregates was the uncertain economic outlook. When times are uncertain, people tend to increase their holdings of money balances for precautionary reasons. The severity of the recent recession and the modest pace of recovery expected in early 1983 undoubtedly contributed to strong precautionary demands for money in the first quarter.

Unusually large demands for money were manifested in the first half of 1983 in the abnormal behavior of M1 velocity — the rate of turnover in the nation's transactions balances. The velocity of M1 normally follows a cyclical pattern. As confidence increases in an economic expansion, individuals and businesses usually reduce their precautionary balances and increase their spending. By spending more of the funds held in transactions bal-

ances, they increase the rate at which these balances turn over, and so velocity increases. Conversely, as confidence declines in an economic recession, individuals and businesses reduce their spending to build precautionary balances. By spending less of the funds held in transactions balances, they reduce the rate at which the balances turn over, and so velocity declines.

The velocity of M1 has not followed the usual pattern in this economic expansion. Growth in velocity slowed sharply in the first quarter of 1983, the first quarter of the recovery (Table 4). The slowing resulted from exceptionally strong demands for money relative to GNP. Growth in velocity turned positive in the second and third quarters, increasing 0.5 and 1.9 percent, respectively, but this growth remained far below that of previous periods of economic recovery.

The effect on the monetary aggregates of new

TABLE 4
Growth of nominal GNP, M1,
and velocity of M1

| Period | GNP | M1* | M1 Velocity |
|-----------------------------|------|------|-------------|
| 1980 | 9.3 | 7.2 | 2.1 |
| 1981 | 10.8 | 5.1 | 5.7 |
| 1982 | 2.6 | 8.5 | -5.8 |
| 1983: First Three Quarters† | 10.8 | 12.0 | -1.2 |
| 1983: I | 8.0 | 14.1 | -5.9 |
| II | 12.7 | 12.2 | 0.5 |
| III | 10.8 | 8.9 | 1.9 |

Note: Annual rates of growth are based on quarterly average data.
 * Equivalent to M1-B in 1980 and M1-B adjusted for deposit shifts into NOW accounts in 1981.
 † Annualized percentage change from fourth quarter 1982 to third quarter 1983.

deposit accounts and reductions in interest rates, inflation, and economic uncertainty appears to be subsiding. Growth of MMDA balances slowed sharply in the second quarter and stabilized in the third quarter. Account adjustments made in response to the decline in interest rates and inflation also dissipated in the later quarters as interest rates rose and inflation stabilized. The need for precautionary balances was greatly reduced by the increase in economic activity and the decline in unemployment in the second and third quarters.

The slowing in the growth of the monetary aggregates confirms the reduced effect of these factors. After growing rapidly in the first quarter of the year, the growth of all the monetary aggregates slowed in the second quarter and moderated further in the third quarter (Table 5). This trend would seem to foreshadow a return to more normal monetary growth in 1984.

Monetary policy in 1983

As 1983 opened, the Federal Reserve reaffirmed its commitment to restraining inflation, promoting

economic recovery, and contributing to international financial stability. Several unusual circumstances, however, made the formulation and implementation of a policy to achieve these goals especially difficult. In addition to the introduction of new deposit accounts and the uncharacteristic behavior of velocity, monetary policymaking was complicated by the potential for renewed inflation, large budget deficits, and international economic concerns.

Long-run targets

As required by the Full Employment and Balanced Growth Act of 1978, tentative growth ranges for the money and credit aggregates for 1983 were announced in July 1982. The tentative ranges were the same as those set for 1982 — 2.5 to 5.5 percent

TABLE 5
Growth of the monetary aggregates in 1983
(seasonally adjusted annual rates)

| Monthly | M1 | M2 | M3 |
|-------------------------|------|------|---------|
| 1983: Jan. | 9.8 | 30.9 | 13.0 |
| Feb. | 22.4 | 24.4 | 13.6 |
| Mar. | 15.9 | 11.2 | 8.1 |
| Apr. | -2.6 | 2.8 | 3.3 |
| May | 26.3 | 12.4 | 10.9 |
| June | 10.2 | 10.4 | 11.0 |
| July | 8.9 | 6.8 | 5.5 |
| Aug. | 2.8 | 6.0 | 8.6 |
| Sept. | 0.9 | 4.8 | 7.4 |
| Oct. | 1.9 | 9.3 | 8.5 |
| Nov. | 0.5 | 7.8 | 12.5 |
| FOMC 1983 growth ranges | 5-9* | 7-10 | 6.5-9.5 |
| Nov./1982:IV | 5.1† | 7.9‡ | 9.4 |

* Revised upward from 4-8 percent at the FOMC's July meeting.

† Base period for M1 is 1983:II.

‡ Base period for M2 is the average of February and March 1983.

for M1, 6 to 9 percent for M2, and 6.5 to 9.5 percent for M3. It was also announced that, as in past years, the base used in calculating the growth ranges would be the average level of the aggregates in the fourth quarter of 1982.

Circumstances unforeseen in mid-1982 led the FOMC to conclude at its February meeting that adoption of the tentative policy for 1983 would result in excessive monetary restraint. One factor contributing to this decision was the introduction of MMDA's and, to a less extent, Super NOW's. By February, these new accounts had greatly increased the aggregates, particularly M2. Retention of the tentative ranges would mean that the aggregates would be well above the upper limits of these ranges from the very start and leave little room for growth for the rest of the year. Another factor leading the FOMC to abandon its tentative ranges was unusually low growth in velocity. By February, velocity growth was expected to be atypically low in 1983, as it had been in 1982, a possibility that had not been foreseen in mid-1982. Growth of the monetary aggregates in 1983 in the same ranges as in 1982 might thereby result "in a much more restrictive monetary policy than had been intended" when the tentative ranges were announced.¹

As a result of the new accounts and the unusual behavior of velocity, only the tentative range for M3 was maintained when the FOMC announced its actual objectives for 1983 in February. The tentative fourth quarter to fourth quarter M3 growth range of 6.5 to 9.5 percent was kept on grounds that the new deposit accounts and the erratic behavior of velocity would affect this aggregate less than the other aggregates.

The growth ranges announced for the other aggregates were modified substantially from the tentative ranges. The expansion of M2 as a result of

rapid growth of MMDA's led the FOMC to suspend M2 targeting in the first quarter of 1983. When M2 targeting was resumed in the second quarter, the FOMC announced it would use the February-March average of M2 as the base for calculating the M2 growth range. This base was chosen on grounds that shifts into MMDA's from other assets would be largely complete by March. The FOMC also announced it intended to seek M2 growth of between 7 to 10 percent from the February-March base to the fourth quarter of 1983. This range, somewhat higher than the 6 to 9 percent range announced in mid-1982, was adopted to allow for further shifting of assets into MMDA's after March. The higher range also reflected the belief that velocity would continue to grow slowly in 1983.

For M1, the aggregate most affected by the atypically low velocity growth, the FOMC announced a growth range of 4 to 8 percent from the fourth quarter of 1982 to the fourth quarter of 1983. Considerably higher and wider than the tentative 2.5 to 5.5 percent range announced in mid-1982, this range reflected the belief that precautionary demands for money would continue to be exceptionally high and that the relation between money, output, and interest rates would continue to be unpredictable in 1983.

At the same time the revised growth ranges were announced, the FOMC announced it would regard the M1 range as tentative and place substantially more weight on the broader M2 and M3 aggregates in implementing monetary policy. This decision represented a significant departure from the past, when M1 was given primary weight in implementing policy. It was felt that the weight placed on M1 could be increased subsequently if there was evidence that velocity growth had returned to more normal patterns.

In addition to emphasizing the broader aggregates, the FOMC announced it would monitor the expansion of nonfinancial domestic debt, a very broad measure of credit. This was the first time this aggregate had been used in implementing monetary

¹ "Record of Policy Actions of the FOMC, Meeting Held on February 8-9, 1983," Federal Reserve press release, April 1, 1983, p. 9.

policy. The monitoring range for this aggregate was set at 8.5 to 11.5 percent.

The behavior of the monetary aggregates during the first half of 1983 justified the FOMC's modifying its aggregate objectives and procedures for 1983. MMDA's grew strongly, as indicated earlier, and velocity slowed sharply despite fairly stable interest rates and a slight increase in output and spending. As a result, M1 and M2 increased rapidly from January to March while M3 increased at rates that caused it to exceed only slightly the upper limit of its growth range (Table 5). As the FOMC had anticipated, large inflows into MMDA's subsided after March. Growth in M2 slowed substantially, falling to near the midpoint of its long-run growth range for the next several months. Growth in M3 continued near the upper limit of its growth range through the first half of the year.

In contrast to the broader aggregates, M1 continued to grow rapidly in the second quarter of 1983, with the result that M1 consistently exceeded the upper limit of its growth range by wide margins. Rapid growth in M1 resulted from unexpectedly large demands for very liquid assets that caused all the major components of M1 — demand deposits, other checkable deposits, and currency — to expand sharply. Consequently, velocity growth continued significantly lower than usual for the early quarters of an economic recovery.

In accordance with the Full Employment and Balanced Growth Act of 1978, the FOMC reviewed its monetary policy objectives for 1983 at its July meeting. Because the broader aggregates were well within their desired growth ranges, the FOMC decided to retain for the rest of the year the target ranges it announced in February for M2, M3, and nonfinancial domestic debt. The FOMC also reaffirmed its earlier decision to emphasize the broader aggregates in implementing monetary policy.

Unlike the broader aggregates, the previously announced policy for M1 was revised. The M1 monitoring range announced in February was reset at 5 to 9 percent, up from the previous range of 4 to 8

percent. The FOMC also rebased M1 from the fourth quarter of 1982 to the second quarter of 1983. This revision meant that the FOMC intended to accept the rapid growth of M1 in the first half of the year and would seek M1 growth between 5 and 9 percent at an annual rate from the second quarter to the fourth quarter.

The FOMC decided to rebase M1 in order to maintain a viable M1 target. Even though the M1 aggregate was being given less weight in implementing monetary policy, the FOMC felt that a viable M1 target was vital to the credibility of the Federal Reserve's anti-inflation monetary policy.² The target set previously was no longer viable, because only by sharply restraining M1 in the second half of the year could M1 be brought within the target range. Enough restraint to bring M1 within its previous target range would bring the broader aggregates well below the lower limits of their target ranges and threaten the recovery. The decision to rebase the M1 range also reflected the belief that the circumstances causing the rapid growth of M1 in the first half of the year would not be repeated in the second half.³

The FOMC decided to raise the long-run M1 growth range on grounds that growth in M1 faster than had been envisioned in February was appropriate for the second half of 1983. Two factors contributed to the upward revision. First, the FOMC believed that extremely large precautionary demands for money would persist in the second half of 1983, causing velocity growth to be low by historical standards.⁴ With lower velocity growth, a larger money supply would be needed to support a

² The FOMC discussed suspending M1 monitoring when it reviewed the long-run growth ranges in July. But a majority of the members believed a monitoring range should be retained for M1. "Record of Policy Actions of the FOMC, Meeting Held on July 12-13, 1983," Federal Reserve press release, August 26, 1983, p. 11.

³ Federal Reserve press release, August 26, 1983, p. 12.

⁴ Federal Reserve press release, August 26, 1983, p. 13.

given level of nominal GNP. Hence, an increase in M1 growth range was needed to avoid unnecessary restraint on nominal GNP growth.

Second, the FOMC believed that output and spending would increase faster in 1983 than had been forecasted in February.⁵ Since a higher level of economic activity requires a larger money supply, the stronger than expected recovery provided another reason for raising the M1 target.

Short-run policy implementation

In addition to setting and reviewing long-run growth ranges for the money and credit aggregates, the FOMC sets and revises short-run policy objectives when it meets every six to eight weeks. The short-run policy objectives, set at the start of each quarter and reviewed during the quarter, are consistent with the long-run ranges. By setting and implementing short-run objectives, the FOMC can adapt monetary policy to changing economic conditions without giving up the discipline longer run targets impose.

Short-run monetary policy was accommodative in the first five months of 1983. In the policy directives issued after the December 1982 and March 1983 meetings, the FOMC specified short-run growth paths for the monetary aggregates at or above the midpoints of the aggregates' long-run growth ranges. High short-run paths were set primarily to accommodate money growth caused by the introduction of MMDA's and Super NOW's.⁶

Not only were the short-run paths set relatively high in the first five months of 1983, but little effort

was made to resist growth in the aggregates in excess of these paths. Under the nonborrowed reserves targeting procedure in use since October 1979, above-target growth in the aggregates would have led to an increase in the federal funds rate as banks borrowed to meet larger reserve requirements. The federal funds rate was quite stable in the first three months of 1983, however, and was only slightly less stable in April and May.

Monetary policy gradually became less accommodative after the FOMC meeting in May. The policy directive from the May meeting stated the FOMC's intention to "increase only slightly the degree of reserve restraint."⁷ The directive from the July meeting stated that the FOMC intended to "increase slightly further the existing degree of reserve restraint."⁸ The directive issued after the August meeting indicated that the FOMC "seeks to maintain the existing degree of reserve restraint."⁹

The move toward monetary restraint after May was prompted by three considerations. The first was the FOMC's concern about the psychological effect on the market of continued rapid growth in M1. Despite the reduced emphasis on M1 as a monetary policy target and growth of the broader aggregates within or near the top of their long-run growth ranges, the FOMC was concerned that continued rapid growth in M1 was being interpreted as a sign that the Federal Reserve had abandoned its fight against inflation. Expectations of higher future rates of inflation, it was thought, were putting upward pressure on nominal interest rates by causing creditors to add larger inflation premiums to lending rates. Higher interest rates, in turn, would tend to

⁵ The FOMC members projected real GNP growth for 1983 between 5 and 5.75 percent at the July meeting. This range is significantly higher than the 3.5 to 4.5 percent range forecast at the February meeting.

⁶ "Record of Policy Actions of the FOMC, meeting held on December 20-21, 1982," Federal Reserve press release, February 1983, pp. 7-10, and "Record of Policy Actions of the FOMC, Meeting Held on March 28-29, 1983," Federal Reserve press release, April 1, 1983, pp. 4-5.

⁷ "Record of Policy Actions of the FOMC, meeting held on May 24, 1983," Federal Reserve press release, July 15, 1983, p. 13.

⁸ "Record of Policy Actions of the FOMC, meeting held on July 12-13, 1983," Federal Reserve press release, August 26, 1983, p. 19.

⁹ "Record of Policy Actions of the FOMC, meeting held on August 23, 1983," Federal Reserve press release, October 7, 1983, p. 12.

weaken the recovery. A slightly more restrictive policy, it was reasoned, would reduce the expected inflation rate, put downward pressure on long-term interest rates, and promote the recovery.¹⁰

The second consideration leading to greater monetary restraint was the FOMC's concern about the effect on the recovery of continuing large structural federal budget deficits. Large debt-financed deficits reduce the amount of credit available to finance private borrowing. When private demands for credit are strong, deficits put upward pressure on interest rates. Since private credit demands strengthen as the economy strengthens, the faster than expected pace of the recovery beginning in the second quarter of 1983 increased the likelihood that the inevitable clash of private and public credit demands and ensuing higher interest rates would occur sooner rather than later. In view of this scenario, the FOMC decided that "a slight further increase in the degree of reserve restraint . . . would provide some insurance against the possible need for a considerably greater degree of reserve restraint later. . . ."¹¹

The third consideration in the decision to seek greater monetary restraint was the FOMC's concern about the debt problems of several developing countries. The debt problems of these countries —

particularly Mexico, Brazil, and Argentina — are significant in view of the large exposure of U.S. banks to these borrowers. The burden of the debt on these countries increases with an increase in U.S. interest rates, because much of their debt carries floating rates. Hence, the prospect of higher interest rates as a result of greater inflation expectations or a clash of private and public credit demands has severe implications for the debt service problems of these countries and the stability of the U.S. banking system. In view of these implications, the FOMC decided in favor of a slightly more restrictive policy. The FOMC acknowledged that in the short run a more restrictive policy would add to the debt service problems of these countries by raising interest rates. In the longer run, however, it was believed that moderate restraint early in the recovery would promote lower interest rates and a more sustained recovery. These goals, the FOMC believed, were in the interests of both the developing countries and the United States.¹²

The restrictive stance the FOMC took at its May, July, and August meetings was accompanied by a sharp deceleration in the growth of the monetary aggregates (Table 5). By the end of August, M2 was in the lower half of its long-run growth range while

¹⁰ "[A] number of members . . . saw a need to move toward restraining its (M1's) growth. . . . Several members commented that slightly greater restraint on reserves would be desirable at this point. . . . Reference was made to the favorable effect such a move might have on market perceptions about monetary policy and the outlook for containing inflation, with the consequence that prospects for stable or declining interest rates in long-term debt markets would be enhanced. . . ." "Record of Policy Actions of the FOMC, Meeting Held on May 24, 1983," Federal Reserve press release, July 15, 1983, p. 10.

¹¹ "In their review of the economic situation and outlook, the members focused on evidence of the economy's strong forward momentum and the prospects for continuing sizable gains in real GNP during the months immediately ahead . . . members were concerned that the need to finance large Treasury borrowing in a period when private credit demands were accelerating would put increasing upward pressure on interest rates and curtail the availability of financing to private borrowers . . . [a] view was expressed that a decline in interest rates from present levels

would probably be needed to prolong the recovery during 1984." "Record of Policy Actions of the FOMC, Meeting Held on July 12-13, 1983," Federal Reserve press release, August 26, 1983, pp. 6, 15.

¹² "A number of members were . . . concerned that under current circumstances even a modest tightening of reserve conditions might have a disproportionate impact on sentiment in domestic and international financial markets and lead to sizable increases in domestic interest rates . . . appreciably higher U.S. interest rates might have particularly damaging consequences internationally by raising the foreign exchange value of the dollar and intensifying the severe pressures on countries with serious external debt problems. The view was also expressed that the external debt difficulties of a number of foreign countries were continuing problems. The Federal Reserve could best contribute to the resolution of those problems by following policies that would foster sustained, noninflationary economic growth. Deferring any action could well pose a greater dilemma at a later time." "Record of Policy Actions of the FOMC, Meeting Held

M1 and M3 were in the upper halves of their ranges. With all three monetary aggregates growing within their target ranges, market participants began anticipating an easing of monetary policy. Exceptionally good performance of the monetary aggregates probably contributed to the decline in short and long-term interest rates beginning in mid-August.

The market's expectation of some easing was confirmed when the policy directive from the FOMC's October 4 meeting was made public. The FOMC voted

. . . to maintain the slightly lesser degree of reserve restraint sought in recent weeks. The action is expected to be associated with growth of M2 and M3 at annual rates of around 8.5 percent from September to December. . . . The Committee anticipates that M1 growth at an annual rate of around 7 percent from September to December will be consistent with its fourth-quarter objectives for the broader aggregates.¹³

If the FOMC's fourth-quarter policy objectives are realized, all three aggregates will be within their long-run growth ranges at yearend.

In brief, 1983 was a year in which extraordinary judgment was needed to implement a monetary policy geared to restraining inflation, promoting economic recovery, and maintaining international financial stability. The introduction of new deposit accounts and the unusual behavior of velocity complicated the setting of long-run growth ranges for the money and credit aggregates by disrupting historical relationships among economic variables. Promoting economic recovery without reigniting inflation or contributing to instability in interna-

on May 24, 1983." Federal Reserve press release, July 15, 1983, pp. 9-10.

¹³ "Record of Policy Actions of the FOMC, Meeting Held on October 4, 1983," Federal Reserve press release, November 18, 1983, pp. 12-13.

tional financial markets required that the FOMC reassess its short-run policy objectives quickly in response to changes in economic data to prevent policy from becoming too easy or too restrictive. Despite the complexities, the goals of monetary policy were largely achieved in 1983. The inflation rate remained low, the recovery strengthened, and conditions in international financial markets remained stable. Moreover, it appeared that for the first time since the new operating procedures were adopted, all three monetary aggregates would be within their long-run growth ranges at yearend.

The outlook for 1984

The pace of the recovery in 1983 is not likely to be maintained through 1984. A major reason for slower growth is that nominal and real interest rates are not expected to decline significantly below their present levels. Real output is widely expected to grow in a range between 4 to 5 percent in 1984, a growth rate about average for the second year of a recovery. Housing and consumer spending are expected to provide less impetus to growth than in 1983, and in spite of continued gradual accumulation of stocks, inventory investment is due to contribute less to growth in GNP. Business fixed investment, however, is generally expected to provide more support to the expansion as capacity use rates rise. Government purchases should also provide support as military spending boosts federal purchases and state and local government revenues benefit from strengthening economic activity. Only the foreign sector appears to be a likely drag on growth as the strength of the dollar and weakness of recoveries abroad restrain the growth in net exports.

The moderate growth in output in 1984 should further reduce the amount of unused resources in the economy. The rate of use of industrial capacity is due to continue rising, and the rate of unemployment can be expected to decline further, though the decline may be slower than in 1983.

The outlook for inflation remains favorable. Even though the rate of price increase will almost certainly rise as the expansion proceeds, the rise is expected to be moderate in 1984. Relatively stable energy prices and continued slow increases in labor costs are expected to take the edge off increases in food prices.

The task for monetary policy will be to provide money and credit adequate for economic expansion while progressing toward reasonable price stability. In July 1983, the FOMC set tentative 1984 target ranges for M2, M3, and nonfinancial domestic debt one-half of one percentage point below the 1983 ranges. A tentative 1984 monitoring range for M1 was set one percentage point lower than in 1983. These tentative ranges will be reconsidered at the FOMC's February meeting.

One of the main issues facing the Federal Reserve in 1984 will be the importance of M1 in monetary policymaking. If velocity returns to a more normal pattern, the FOMC may consider giving more weight to M1 in the formulation of monetary policy.

Another issue in 1984 will be the monetary policy dilemma created by fiscal policy. The federal budget deficits projected for the next several years will absorb a large part of private savings. As private credit demands strengthen along with the economy, private and government borrowing will likely clash, putting upward pressure on interest rates and reducing growth in output. Higher interest rates reduce output growth by reducing housing and business investment and pushing up the foreign exchange value of the dollar, which reduces net exports. The dilemma for monetary policy is that the damage federal budget deficits do to economic growth can be delayed through an expansion of money and credit that lowers interest rates. These temporary gains, however, are bought at the expense of a greater long-run inflation rate and even more restrictive monetary policy later.

The task of formulating monetary policy in 1984 that is neither excessively easy nor excessively restrictive will require careful judgment. In making

these judgments, the Federal Reserve remains committed to promoting sustainable economic growth and reducing inflation.

Better Times Ahead for Agriculture

By Marvin Duncan and Mark Drabenstott

The U.S. farm sector began its climb back to economic health in 1983. Improved farm prices and income signalled an end to three consecutive years of economic recession. While smaller output of major crops played a dominant role in brightening the farm outlook, historically large government subsidies also were a major factor.

Farm income will likely post further gains in 1984, largely as a result of large crop production. Prospects for improved livestock profitability add further to a brighter agricultural outlook. However, farm financial stress is expected to remain a very visible problem in 1984.

This article reviews events in the farm sector over the past year and outlines prospects for farm production and market demand in 1984. The discussion includes the outlook for farm prices, farm income, and farm financial conditions.

The year in review

Prospects for improved farm income were given a boost in January 1983 when the Payment-In-Kind (PIK) program was added to U.S. Department of Agriculture (USDA) efforts to reduce 1983 crop production and grain supplies overhanging the mar-

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ket. The program was intended to hold out of production a substantial proportion of acreage normally seeded to wheat, corn, grain sorghum, cotton, and rice. Already in place was the Acreage Reduction Program (ARP) under which producers could set aside part of their historical base acres of these crops. Such an acreage reduction earned farmers a diversion payment on part of the acreage reduction and eligibility to participate in the PIK program.

Under the PIK program, producers could set aside another 10 to 30 percent of their acreage. For idling these additional acres, farmers would receive in-kind commodities equal to 95 percent of their normal wheat production and 80 percent of their normal corn, grain sorghum, cotton, and rice production. Under a separate option, farmers also could bid to remove their entire base acreage of a crop from production for a PIK payment up to 95 percent of their normal wheat production or 80 percent of their normal production of the other crops.

Farmers recognized PIK as the most generous income transfer program they had been offered in the 50-year history of federal farm programs. They signed up in large numbers and, as a result, participation in acreage reduction programs increased substantially in 1983 (Table 1).

The PIK program, while popular with crop farmers, was an unpleasant surprise to livestock producers and agribusinessmen. Livestock pro-

TABLE 1
Participation in acreage reduction
programs
 (percentage of base acres)

| Crop | 1982 (actual) | 1983 (projected) | |
|---------|------------------|---------------------|-----|
| | | Total* | PIK |
| Wheat | 48 | 75 | 50 |
| Corn | 29 | 65 | 60 |
| Sorghum | 47 | 65 | 60 |
| Rice | 78 | 98 | 85 |
| Cotton | 78 | 95 | 75 |

*Producers removed about 75 million acres from production in 1983, compared with about 11 million in 1982.
 Source: World Agricultural Outlook Board, September 26, 1983.

ducers, who had been expanding production, found feed grain prices rising sharply and livestock profits disappearing. By the second half of the year, they were cutting their herds back to sizes that would be profitable with higher production costs.

The cutback in crop production created a particularly difficult situation for agribusinesses. Machinery manufacturers and dealers were already reeling from three years of farm recession. Fertilizer, chemical, and seed dealers had built inventories based on the plantings expected before PIK. Because of the large acreage reductions, suppliers of farm inputs found far weaker demand than expected. For example, Tenth District agricultural bankers responding to an agricultural credit survey at midyear reported farm equipment sales off nearly a third from a year earlier and demand for fertilizer and chemicals down more than a fifth. Processors and marketers also faced the prospect of substantial excess capacity as total crop production declined from the record-setting levels of 1982.

A severe drought across the nation's heartland that began in July and continued through the rest of the growing season contributed to the cutback in crop production. The Corn Belt, the Southeast, and parts of West Texas and eastern New Mexico were particularly hard hit (Chart 1). For some states, it was the worst drought since the 1930s. As a result,

the fall harvest of most major crops was sharply cut. By contrast, range conditions in Rocky Mountain and western states were favorable throughout most of the grazing season and large hay crops were harvested.

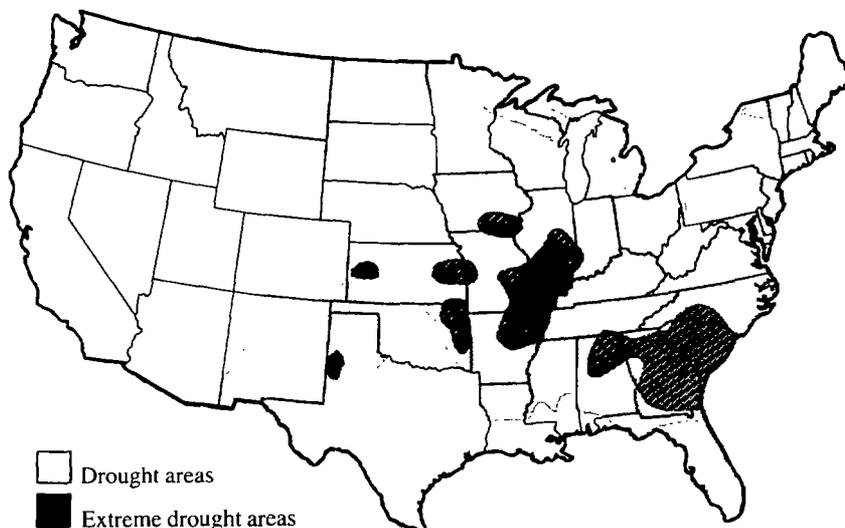
Largely as a result of the production cutbacks, prospects for farm income are substantially better this year. Higher grain and cotton prices will combine with record large livestock output — though at disappointing prices — and lower production costs to boost farm income by about \$3 billion over the 1982 level. An important factor in raising farm income, however, is generous spending on farm programs — \$18.8 billion in fiscal 1983 in addition to about \$4 billion in PIK grain and cotton distributed to farmers in 1983. In fact, costs of government farm programs in 1983 probably reached an unsustainably high level.

With improved farm income and massive government income transfers to farmers, credit conditions are better this fall and winter than previously expected. Nevertheless, for the small proportion of farmers carrying more debt than they can service, credit problems are severe. Agricultural lenders are now finding they hold more problem loans than in many years.

Crops

The recent string of successive record harvests came to an abrupt end in 1983. Because of their participation in government acreage reduction programs, farmers harvested far fewer acres of major crops. An unusually high proportion of the base acreage for the crops included in the PIK program was in compliance with government farm programs, but the drought also reduced production for most crops. Expected average yields were off 30 percent for corn, 23 percent for soybeans, and 15 percent for cotton. Only in the case of wheat, where most of the crop was harvested ahead of the drought, was the expected average yield higher than in 1982.

CHART 1
Areas affected by drought in 1983*



*Based on the crop moisture index as of August 20, 1983

Wheat production, largely unaffected by drought, was off only 14 percent from the record crop last year. Total production was 2.4 billion bushels, and large wheat stocks held average farm-level prices in the 1982-83 marketing year to \$3.53 a bushel (Table 2). Since most of the carryover wheat stocks brought into that marketing year were under Commodity Credit Corporation (CCC) loans — including the Farmer Owned Reserve (FOR) — or in the CCC inventory, prices were higher than they would have been.

Sharply reduced by drought, feed grain production totaled only 135.4 million metric tons, 53 percent of the record output in 1982. Production of corn, the major U.S. feed grain, totaled only 4.1 billion bushels, which was down 51 percent from last year's record crop and the smallest corn crop since 1965. High feed use and large amounts of corn under CCC and FOR loan programs and in CCC inventory limited market supplies and supported corn prices, despite large total stocks. Average

farm-level corn prices were \$2.70 a bushel in the 1982-83 marketing year, up somewhat from the previous year.

Soybean production, at 1.5 billion bushels, was off nearly a third from 1982. This was the smallest soybean crop since 1976. The farm-level soybean price averaged \$5.65 a bushel during the 1982-83 marketing year. That price was off substantially from the previous year due to soft world market demand, even though carryover stocks were not particularly burdensome. However, the 1982-83 marketing year had the largest total supply in recent years.

Cotton production totaled 7.5 million bales, only 63 percent of 1982's production. Total supplies were more than adequate, however. Carryover stocks at the end of the 1982-83 marketing year totaled 7.9 million bales, more than was produced in 1983. Farm-level cotton prices averaged 58 cents a pound for the marketing year, up somewhat from the previous year on the basis of world supply and

TABLE 2
U.S. farm product price projections

| <u>Crops (farm level)</u> | <u>1982-83</u> | <u>1983-84</u> | <u>Percent Change*</u> |
|--|--------------------|--------------------|------------------------|
| Wheat | \$3.53/bu. | \$3.50-3.70/bu. | 2 |
| Corn | \$2.65/bu. | \$3.40-3.80/bu. | 33 |
| Soybeans | \$5.65/bu. | \$8.50-9.50/bu. | 59 |
| Cotton | \$0.58/lb. | N/A | N/A |
| <u>Livestock</u> | <u>1983</u> | <u>1984</u> | |
| Choice steers (Omaha) | \$61-63/cwt. | \$64-70/cwt. | 8 |
| Barrows and gilts (7 major markets) | \$46-48/cwt. | \$46-52/cwt. | 4 |
| Broilers (12 city average) | N/A | 47-53 cents/lb. | N/A |
| Turkeys (NY young hens) | 58-60 cents/lb. | 60-66 cents/lb. | 7 |
| Milk | \$13.55-13.65/cwt. | \$13.60-14.30/cwt. | 3 |

*Calculated from the midpoint of the ranges.
Source: USDA World Agricultural Supply and Demand Estimates, November 14, 1983.
USDA Agricultural Outlook, November 1983.

demand.

Between PIK and the drought, excess feed grain and soybean stocks have been reduced remarkably. While cotton stocks remain large, progress was made in reducing the large carryover supplies of recent years. Wheat stocks remain burdensome since wheat production was little affected by PIK or the drought.

Livestock

Livestock production is expected to reach an all-time high in 1983, up about 3.7 percent from 1982. The increase is related partly to a buildup in hog numbers and continued heavy feedlot placements and marketings of beef cattle. But the increase also reflects efforts in the second half of the year to market greater numbers of cattle and hogs because higher feed costs made production unprofitable.

Beef and veal production increased about 2.7 percent this year. Beef production exceeded year-

earlier levels almost all year. More of the cattle slaughtered in 1983 came out of feedlots and at heavier weights. Beef cattle numbers at the end of 1983 will probably be about the same or modestly lower than a year earlier. The stable to slightly lower numbers, which reflect unprofitable production at most levels of the industry, suggest that the current upswing in the cattle cycle may have ended much earlier than usual. If so, this may have been the shortest expansion phase in this century. Slaughter steer prices at Omaha are expected to average nearly \$62.50 per hundredweight in 1983 compared with \$64.30 in 1982, a decline of about 3 percent.

Pork production, up a substantial 6 percent from 1982, began rising early in the year. The increase reflected a buildup in inventories of both breeding and market hogs that began in late 1982 and continued throughout most of 1983. By September, the number of breeding hogs was up 5 percent from a year before and the number of market hogs was up

11 percent. As a result of the increase in production, market hog prices declined throughout much of the year. It appears that prices for barrows and gilts at seven regional markets will average \$47.53 per hundredweight in 1983, a decline of about 14 percent from 1982.

Production of lamb and mutton is expected to increase 2 percent in 1983. Sheep inventories will continue their decline, in part because drought conditions have triggered increased herd liquidation. Prices farmers receive, however, probably will average about \$56 per hundredweight, down slightly from 1982.

Poultry production has likely increased about 2.8 percent in 1983. Increased broiler output accounts for most of the gain, though turkey production also may be somewhat higher. Broiler prices are expected to average 49 cents a pound compared with 44 cents in 1982, an increase of 11 percent.

Dairy producers in 1983 continued to increase both the number of cows being milked and the production per cow. As a result, milk production is expected to increase close to 2 percent over the record 135.8 billion pounds produced in 1982. Increases in production may have slowed late in the year owing to government incentives to reduce output. To reduce milk output and the cost of supporting dairy prices, the USDA in April 1983 began to assess 50 cents per hundredweight on all milk sold commercially in the United States. Another 50 cents per hundredweight deduction became effective in October, with a provision that this second assessment would be refunded to producers that reduced sales by a specified proportion from their 1980-81 and 1981-82 average.

Prices and income

Sluggish demand for farm products and abundant commodity supplies held the prices farmers received in check throughout most of 1983. Prices received in September averaged less than 1 percent

higher than a year earlier. By November, however, prices received were 5.5 percent higher than a year earlier. While crop prices averaged 16 percent higher in November than a year earlier, livestock prices averaged 2.9 percent less than a year before. With inflation slowing, the prices farmers paid also were held in check. In November, they were only 3.8 percent higher than a year earlier.

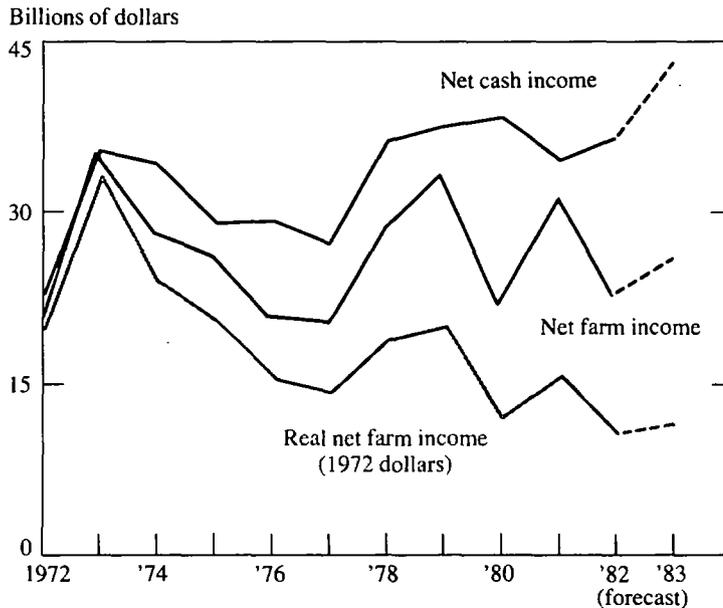
Cash receipts from farm marketings are expected to have declined about 1 percent in 1983 to about \$143 billion. Livestock receipts were probably about the same as last year, with lower crop receipts accounting for the reduction in total receipts. Direct government payments to farmers totaled about \$9 billion, up from only \$3.5 billion in 1982. Since crop inventories will be lower this year, inventory adjustment could reduce total farm income over \$7 billion. Thus, total gross income may be about \$161 billion, only slightly less than in 1982. Total farm expenses, however, declined approximately 3 percent to about \$136 billion, the first decline in farm expenses since 1953.

As a result, farm income improved somewhat. Net farm income may reach about \$25 billion, up about 13 percent from last year, though further inventory reductions could lower this forecast. Net cash income (cash income minus cash expenses) will total about \$43 billion, up 18 percent from 1982 (Chart 2). Despite these gains, farm income in constant dollar terms remains low by historical standards. Farm family welfare, however, is also determined partly by off-farm income. Farm families are expected to have earned about \$41 billion in off-farm income, with most of that being earned by small farmers.

Farmers have called the current farm recession the most severe since the 1930s. However, a recent revision of USDA farm income statistics suggests that the farm recession has not been as unremitting as previously thought. Net farm income estimates for 1980-82, for example, have been raised by \$1.4 billion, \$5 billion, and \$1.7 billion, respectively.

The farm balance sheet may show some improve-

CHART 2
Net farm income



ment at yearend (Table 3). After declines in real estate values and total assets during 1981 and 1982, both values are forecast to show an increase in 1983. Total asset values could be up 3 percent to \$1.08 trillion, while total liabilities could have declined slightly to about \$216 billion due to farmers paying down CCC loans. With these shifts, proprietors' equity could have increased to \$864 billion and the debt-asset ratio of the farm sector could have fallen to about 20 percent from its recent record high.

For the farm sector and most farmers, financial stress has probably eased some in 1983. Huge payments under government farm programs helped many farmers stabilize their financial situation. For some farmers, however, the situation has grown worse. In some cases, the drought brought credit problems to a head. In others, excessive leverage and poor farm income have eroded equity. Thus,

despite overall improvement in farm income, agricultural lenders probably had a higher proportion of problem loans than at any time since the late 1960s.

In the short run, emergency FmHA loans will help many farmers with serious drought damage. Preferential interest rates on these loans will be especially helpful where farmers are not credit-worthy with commercial lenders. The recent reopening of the FmHA Economic Emergency loan program with \$600 million in lending authority will also be welcomed by farmers hard pressed to meet production costs and service debts.

Unless prospects for farm income improve markedly, however, the relief these government loan programs provide will be short lived. Most prospective applicants for the loans already have more debt than their farms will support. Additional credit, regardless of the terms, will make the long-run prospects for these farmers even more doubtful. As

TABLE 3
Farm balance sheet on January 1*
 (billions of dollars)

| | <u>1980r</u> | <u>1981r</u> | <u>1982r</u> | <u>1983p</u> | <u>1984f</u> |
|---|--------------|--------------|--------------|--------------|--------------------|
| Assets | | | | | |
| Real estate | 756 | 828 | 819 | 773 | 790-805 |
| Nonreal estate | 208 | 219 | 220 | 276 | 270-294 |
| Total assets: | 1,005 | 1,090 | 1,083 | 1,049 | 1,060-1,099 |
| Liabilities | | | | | |
| Real estate debt | 85 | 96 | 106 | 110 | 112-114 |
| Nonreal estate debt: | 80 | 86 | 96 | 106 | |
| Total Liabilities: | 166 | 182 | 202 | 216 | 211-220 |
| Proprietors' equity | 40 | 908 | 882 | 833 | 840-888 |
| Debt-to-asset ratio | 16.5% | 16.7% | 18.6% | 20.6% | 19.2-20.8% |
| f = forecast, r = revised, p = preliminary. | | | | | |
| *Including farm households. | | | | | |
| Source: USDA, 1984 Agricultural Outlook Conference. | | | | | |

a result, there could be a difficult adjustment over the next few years as many highly leveraged farmers try to reduce their debt loads by liquidating some of their farm assets.

Agricultural bankers responding to the Federal Reserve Bank of Kansas City's quarterly agricultural credit survey reported that, during the second and third quarters of 1983, exits from farming due to financial stress were 2.8 times higher than bankers considered normal. This still represents a very small proportion of all farmers. Partial liquidations (selling some assets but remaining in business) were 3.5 times higher than bankers considered normal. On balance, the resolution of farm credit problems that have accumulated over the past decade will require extra forbearance by lenders, a more disciplined lending policy by the FmHA, and a willingness by borrowers to recognize financial problems and work with lenders in solving them.

Export sales

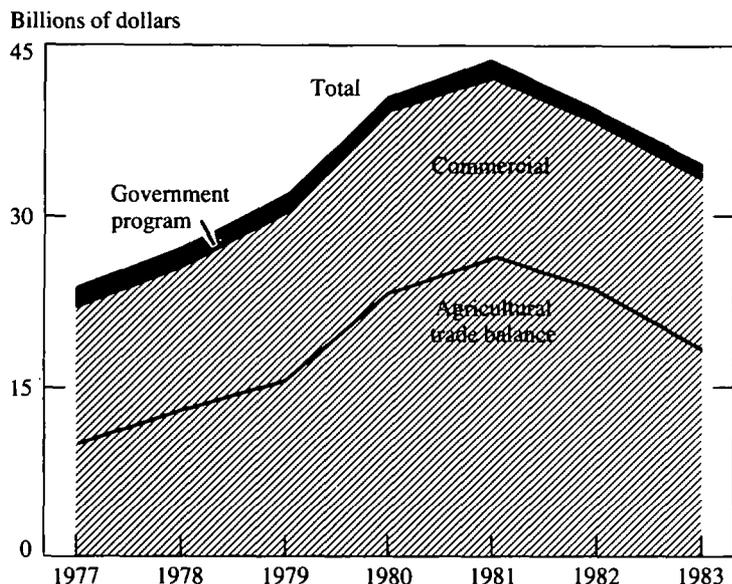
The nation's farm exports declined for the second straight year in fiscal 1983 (Chart 3). The value of U.S. agricultural exports was \$34.8 billion, 11 per-

cent less than the weakened export level in fiscal 1982 and 21 percent less than the peak in fiscal 1981. This decline in export value combined with an increase in agricultural imports to reduce the nation's agricultural trade balance sharply from \$26.6 billion in fiscal 1981 to \$18.6 billion in fiscal 1983. The volume of farm exports declined for the third consecutive year, falling to 144.8 million metric tons, 8 percent less than a year ago.

Weak export performance in 1983 provides further evidence that growth in agricultural trade in the 1980s may be disappointing. Optimistic expectations that the rapid growth in farm exports during the 1970s would continue still have not materialized. And without strong export markets, American farmers must eventually come to grips with the chronic problems of oversupply.

Farm exports remained depressed in 1983 for most of the same reasons that exports declined in 1982. Lingering world recession limited the purchasing power of many countries, especially developing countries, which make up a primary market for U.S. farm products. And difficulties in repaying foreign debts further restricted the import growth of many developing countries. The U.S. dollar rose

CHART 3
U.S. agricultural exports



against foreign currencies, raising prices of U.S. farm products to most foreign purchasers (Chart 4). Finally, competing global food supplies remained abundant in 1983. In spite of a 39 percent decline in U.S. grain production, world output fell only 6 percent in 1983. Thus, a combination of both supply and demand factors led to declining U.S. export sales.

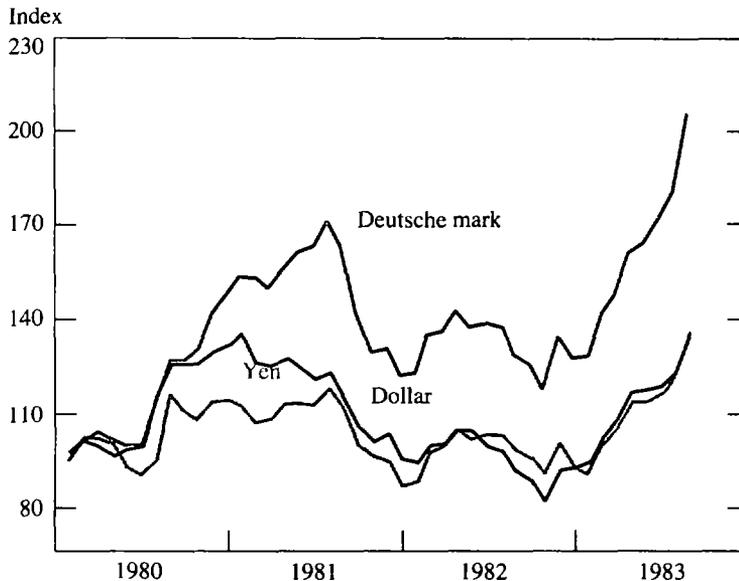
The outlook for farm exports in 1984 is somewhat brighter. The world economic recovery that began in some industrialized nations in 1983 may begin spreading to developing countries as 1984 unfolds and lead to some increased sales for U.S. farm products. Economic recovery notwithstanding, the large foreign debt burden will still limit demand in many developing nations. With the U.S. dollar probably remaining relatively strong in 1984, as large prospective federal budget deficits hold real interest rates high in the United States, U.S. farm

exports may remain high priced in the currencies of trading partners. Barring major shocks in world weather patterns, world food supplies should be large in 1984, especially if both U.S. and foreign producers respond to current high U.S. prices by increasing output. On balance, export volume may decline. Higher U.S. commodity prices, however, should increase export value as much as \$4 to \$5 billion.

Policy agenda

Farmers, their special-interest groups, and agribusinesses will be discussing a range of policy issues in 1984. In many respects, their efforts to increase public awareness of these issues will serve as a prelude to writing major farm legislation in 1985. The issue agenda is expected to include agricultural export growth, production control and price

CHART 4
Price of corn at Gulf port
 (first quarter 1980 = 100)



supports, soil conservation, and credit availability.

But agriculture now has broadened its interest to policy issues well beyond narrowly defined sector policies. It is now generally recognized that broader economic and trade policies may be more important to the wellbeing of farmers than narrowly defined farm policy. Farmers and agribusinessmen increasingly will turn attention to macroeconomic policies, trade policy, and other broad issues to improve U.S. economic performance. For example, farmers will probably join the debate over fiscal policy and how best to deal with the prospective budget deficits. Other issues, such as cargo preference and domestic content legislation, will probably be considered as well.

Current laws require that certain proportions of U.S. exports be carried in U.S. flag ships when taxpayers' money is used to fund the exports, as in Public Law 480 food aid. Cargo preference is some-

times specified for other reasons, as in the Soviet grain agreement. Because shipping in U.S. bottoms is nearly always more costly than shipping in foreign-flag ships, this kind of legislation has important competitive implications for farmers.

Domestic content legislation would require that U.S. produced goods contain some specified proportion of U.S. produced components. Although such legislation is primarily intended to protect the U.S. auto and electronics industries, many farmers fear it would bring additional barriers to entry for U.S. farm products in foreign markets.

More directly related to agricultural interests is possible legislation to increase food-aid expenditures, export credit, and export credit guarantees. As such legislation could increase farm exports, it has widespread support among U.S. farmers and agribusinesses. But others have doubts. Increased sales on credit to debt-ridden foreign customers

could turn out to be thinly disguised foreign aid. Some also question the effect of such legislation on the export subsidy policies of foreign competitors.

Even though the 1984 U.S. winter wheat crop has been planted, wheat producers are lobbying for Congress to amend next year's program. Producers argue that without a more generous program to cut acreage, many farmers will stay out of the wheat program. If that happens, wheat production could exceed use by a wide margin, adding to already burdensome surpluses. Producers say that paid acreage diversion and a higher PIK payment are needed to draw down planted acreage, production, and most important, carryover stocks.

Congress has passed and the President has signed a revision of the longstanding dairy support programs. Under the change, milk price supports have been lowered 50 cents to \$12.60 per hundred-weight. The legislation provides for a 15-month paid diversion program. Individual producers can contract to reduce their milk production by 5 to 30 percent from a base period. A producer will then receive government payments of \$10 per hundred-weight of reduction to offset the costs of cutting production. A 50 cent per hundredweight deduction on milk sales is provided through the end of 1984. The paid diversion and deduction authority applies only to the 48 contiguous states. The legislation also provides that mid-1985 supply levels could trigger further downward or upward adjustments in milk price supports. Beef and pork producers voiced strong opposition to the plan, fearing that it will increase the 1984-85 dairy-cow slaughter, boost meat supplies, and reduce livestock prices.

The year ahead

The solid gain in net farm income in 1983 should be followed by an additional gain in 1984. The crop outlook appears bright as 1984 begins because of the sharp drawdown in carryover stocks of most crops. The size of the 1984 harvest, however, will

be the chief factor in determining the outlook for crop prices. Livestock producers face unprofitable prices in early 1984. But steadily improving consumer demand throughout the year due to economic expansion and potentially significant declines in feed grain prices should strengthen profits for most livestock producers in the latter three quarters of the year.

The crop outlook

The outlook is bright for most crops because of sharp reductions in supplies, but large prospective spring plantings cast a shadow over the outlook.

After a year of sharp cutbacks in seeded acreage, plantings of major crops are likely to be much larger in 1984. They could be close to the large acreages of the early 1980s. Although higher commodity prices will be the major reason for the larger planted acreage, another will be less generous government acreage reduction programs. Farmers will receive no payments in 1984 on acreage diversions required for participation in government farm programs. PIK payments will be available on additional cutbacks in wheat acreage, but at a much less generous rate than in 1983 (Table 4).

The outlook for wheat producers is burdened by near-record wheat supplies. Wheat prices have not benefited from the large reductions in stocks that characterize other major crops. To the contrary, wheat carryover stocks could total nearly 1.5 billion bushels when the 1983-84 marketing year ends, approaching the record supply of last year.

Wheat demand will be boosted by sharply higher feed use resulting from high feed grain prices. Economic expansion could boost domestic use more than 15 percent. But because of increased foreign supplies and weak demand abroad, exports likely will fall 7 percent in 1984 to 1.4 billion bushels (Table 5). Compounding the problem of large U.S. wheat supplies is a more than doubling of free stocks, the stocks outside CCC ownership and loans

TABLE 4
Commodity program highlights — 1984

| | Wheat | Corn | Grain Sorghum | Barley | Oats | Upland Cotton |
|---------------------|------------------|--------|------------------|--------|--------|------------------|
| | (dollars/bushel) | | | | | (cents/lb.) |
| 1984 crop | | | | | | |
| Target price | \$4.45 | \$3.03 | \$2.88 | \$2.60 | \$1.60 | \$0.81 |
| Regular loan rate | 3.30 | 2.55 | 2.42 | 2.08 | 1.31 | .55 |
| Acreage reduction | 30% | 10% | 10% | 10% | 10% | 25% |
| Paid land diversion | 0 | 0 | 0 | 0 | 0 | 0 |
| PIK | 10-20%* | 0 | 0 | 0 | 0 | 0 |

*PIK entitlement is 75 percent of production.
Source: U. S. Department of Agriculture, as of October 26, 1983.

including the FOR. Free stocks will increase to 689 million bushels as large amounts of wheat in the FOR are distributed to participants in the PIK program. Large free stocks mean substantial increases in demand will be necessary to raise market prices significantly.

In addition to large carryover supplies, wheat prices in 1984 also will be determined by forecasts for 1984 production. Generally favorable weather for winter wheat and low participation in acreage reduction programs point to a large harvest in 1984. Thus, with large supplies on hand and only modest improvement in total demand, farm level wheat prices may change little from the 1982-83 marketing year average price of \$3.53 a bushel to a range of \$3.50 to \$3.70 in 1983-84.

The price outlook for feed grains is bright because of much tighter supplies. With 1983 corn production down more than a half from the level in 1982, feed grain carryover stocks at the end of the 1983-84 marketing year will decline a record 77 percent in one year, to their lowest level since 1976. While feed grain supplies will be adequate to meet projected demand, carryover stocks will be quite low. Corn supplies in the 1983-84 marketing year will total 7.3 billion bushels, compared with demand forecast at 6.8 billion bushels. This comparison suggests carryover stocks of only 512 million bushels at the end of the marketing year. Stocks

that low — only 8 percent of total use — would almost certainly result in higher prices to ration available supplies.

Feed grain prices will reflect not only tighter supplies but also prospects for a large 1984 crop. Because of high corn prices in late 1983 and early 1984, producers will plant a large acreage next spring. With normal yields, the corn crop will likely exceed 8 billion bushels. Corn exports are expected to about equal the 1.9 billion bushel level of last year. On balance, farm-level corn prices may average \$3.60 a bushel, compared with \$2.70 in the 1982-83 marketing year. The pattern for corn prices, however, may show very strong prices in early 1984, with sharp declines in late summer and fall if the crop is large. Sorghum prices are expected to average \$3.10 to \$3.40 a bushel at the farm level, with barley prices expected to be between \$2.55 and \$2.80.

The soybean outlook is dominated by even tighter supplies than for feed grains. Domestic utilization and exports are both expected to decline in response to higher prices, with total soybean use falling 15 percent. Total soybean supplies will drop even more, however, by more than one-fifth. As a result, carryover stocks are forecast to dwindle to 140 million bushels, about a third of the 1982 carryover. Ending stocks will be only 8 percent of expected demand, approaching the very low per-

TABLE 5
U.S. agricultural supply and demand estimates,
November 14, 1983
(millions of bushels, bales, or metric tons)

| | Corn (bu) | | All Feed Grains (metric tons) | | Soybeans (bu) | | Wheat (bu) | | Cotton (bales) | |
|------------------------|----------------|-----------------|----------------------------------|--------------|----------------|----------|----------------|----------|----------------|------|
| | Marketing Year | | Marketing Year* | | Marketing Year | | Marketing Year | | Marketing Year | |
| | Oct. 1-Sep. 30 | Marketing Year* | Sep. 1-Aug. 31 | Jun 1-May 31 | Aug. 1-Jul 31 | 1982-83† | 1983-84‡ | 1982-83† | 1983-84‡ | |
| Supply | | | | | | | | | | |
| Beginning stocks | 2,286 | 3,140 | 71.1 | 98.1 | 266 | 387 | 1,164 | 1,543 | 6.6 | 7.9 |
| Production and imports | 8,398 | 4,122 | 255.3 | 135.7 | 2,230 | 1,537 | 2,816 | 2,411 | 12.0 | 7.5 |
| Demand | | | | | | | | | | |
| Domestic | 5,674 | 4,875 | 174.3 | 155.8 | 1,204 | 1,064 | 928 | 1,080 | 5.5 | 6.0 |
| Exports | 1,870 | 1,875 | 53.9 | 55.3 | 905 | 720 | 1,509 | 1,400 | 5.2 | 5.6 |
| Total | 7,544 | 6,750 | 228.2 | 211.1 | 2,109 | 1,784 | 2,437 | 2,480 | 10.7 | 11.6 |
| Ending stocks | 3,140 | 512 | 98.1 | 22.7 | 387 | 140 | 1,543 | 1,474 | 7.9 | 4.0 |

*Marketing year begins October 1 for corn and grain sorghum, July 1 for barley and oats.
†Estimated.
‡Forecast.
Source: U.S. Department of Agriculture.

centage of 1976-77. Higher prices will be necessary to ration supplies this small.

As with feed grains, the strength in soybean prices will be tempered by prospects for a large 1984 crop. With normal yields, large plantings next spring could result in a crop of 2 billion bushels or more. Thus, while farm-level soybean prices are expected to average a record \$8.50 to \$9.50 a bushel in the 1983-84 marketing year, very strong prices in early months of the year could be followed by sustained declines if a large soybean harvest develops.

Cotton supplies also will be tight as 1984 begins. Carryover stocks at the end of the 1983-84 marketing year will total 4.0 million bales, a 49 percent reduction from a year earlier. Economic expansion will boost domestic mill use by about 9 percent and exports may grow by about 8 percent. Cotton prices

could maintain recent gains for a few months because of the tighter supplies. But without a large acreage reduction program in 1984, U.S. production may increase and cotton prices will again come under downward pressure.

The livestock outlook

Livestock producers look forward to a better year in 1984. The pattern of livestock profits may differ substantially, however, between the first quarter and the rest of the year. Larger red meat supplies and higher feed grain prices in the first part of the year will reduce livestock profits. But for the year as a whole, total meat production is expected to decline 2 percent from 1983's record level. Moreover, consumer demand should improve steadily in 1984 as the economic expansion continues, substantially increasing livestock prices after the first

quarter of the year.

Beef production is expected to decline 3 to 4 percent in 1984. Large fed and nonfed slaughter in the first quarter will likely be followed by cutbacks in beef output over the remaining quarters. In the second half, nonfed slaughter will probably drop well below year-earlier levels. With fewer cattle in feedlots, total beef production could decline 6 to 8 percent in the second half.

Thus, profits for both cattle feeders and ranchers should improve after the first quarter. Feeder cattle supplies will probably tighten as the year advances. However, feeder cattle prices are not likely to be much higher than fed cattle prices for the first few months of the year. Then, as cattle feeding margins improve through the spring and summer months, feeder cattle prices likely will be bid to a substantial premium over fed cattle prices.

Choice steer prices at Omaha may average in the low to mid \$60 per hundredweight range in the first quarter and in the mid to upper \$60 range in the second quarter. Strong consumer demand should partially offset the large meat supplies coming to market in the first half. Prices in the upper \$60 range should be typical in the third and fourth quarters. Prices could be even higher if red meat supplies decrease more than expected.

However, the recently enacted dairy legislation could have a significant effect on cattle prices in 1984. Its provisions to reduce dairy herds are likely to increase dairy cow slaughter enough to depress beef prices.

Pork producers also face tight profit margins early in the year, with higher profits expected later in the year. Pork supplies will be large in the fourth quarter of 1983 and first quarter of 1984 as a result of herds being liquidated in response to high feedstuff costs and low hog prices. Pork production in the first quarter could be 8 percent higher than a year earlier, with a slight increase in the second quarter. But declines in production of perhaps 6 to 8 percent in the third and fourth quarters could result in a 2

percent decline in pork output for 1984 as a whole. However, if producers do not liquidate part of the breeding herd by early 1984, larger supplies later in the year will put pork prices under downward pressure.

Prices for barrows and gilts at the seven major markets are expected to average in the low to mid \$40 per hundredweight range in the first quarter of 1984. As pork supplies begin to tighten in the second quarter, prices could average in the mid to upper \$40 per hundredweight range. If red meat supplies decline as expected in the second half of 1984, pork prices then could average in the low to mid \$50 range.

Sheep inventories likely will continue declining throughout 1984. That suggests lower lamb production in the year ahead. Lamb prices also will benefit from general strength in red meat. On balance, lamb prices are expected to average between \$56 and \$61 per hundredweight, compared with about \$56 in 1983.

Prospects for broiler producers appear unfavorable in early 1984 as high feed costs cut into profits. Nevertheless, a 3 percent year-over-year increase in broiler output is expected for 1984. Steady increases in consumer demand coupled with tighter meat supplies may push broiler prices to the low 50 cent a pound range in the second half of the year. Turkey production is expected to decline less than 1 percent in 1984. During the first half of 1984 turkey prices should be close to 60 cents per pound, rising to the upper 60 cent range in the second half of the year.

The 1984 outlook for dairy producers will be shaped by recently enacted legislation. Herd size could be reduced by as many as a million cows and production reduced substantially under provisions that pay farmers for reducing output. If reductions in dairy herds and milk production are substantial, dairy prices would rise above CCC support levels. The USDA might then decide to sell part of its stock of butter, cheese, and dried milk to limit consumer

price increases of dairy products.

Farm income

Net farm income is expected to improve modestly in 1984. Crop prices should be strong through midyear, but the prospect for large crops and continued softness in export markets threaten the longer term price outlook. Overall, crop cash receipts should increase primarily on the strength of greater output. As crops may be large, inventory adjustments could add substantially to 1984 farm income. Livestock prices will be strong most of the year, contributing to higher livestock cash receipts. As in 1983, direct government payments will be an important part of total farm income. On balance, net farm income in 1984 could reach the low \$30 billion range. Net cash income is likely to decline because of substantial increases in farm expenses resulting from greater use of farm inputs.

Uneven distribution of farm income gains in 1983 will lead to further financial stress for some farmers in 1984. Many farmers that suffered severe drought damage in 1983 and did not participate in the PIK program face substantial financial difficulty. As a result, a fairly high level of farm foreclosures and partial asset liquidations can be expected in 1984. As in the past two years, liquidations will represent only a small percentage of all farmers and will be confined mostly to highly leveraged farmers. Even though the current period of financial stress has continued four years, the farm sector as a whole has remained remarkably resilient.

Agricultural credit conditions probably will stabilize in 1984. Ample credit will be available at commercial banks and Farm Credit System outlets to meet the loan demands of qualified farm borrowers. With many counties declared disaster areas because of the drought, large amounts of FmHA disaster assistance and economic emergency loans also will be available to farmers. Average interest rates for farm operating loans remained fairly

steady in 1983 around 14.0 percent. Farm loan interest rates may be steady to only slightly lower in 1984 as lenders replace loanable funds in their portfolios at lower cost than when certificates of deposit were issued six to 18 months ago.

Farmland values may continue to be soft in 1984. Because of some continued liquidations, additional farm real estate will be offered for sale. The high debt levels of many farmers, however, will probably keep buyers cautious. Current indications are, though, that after having been largely out of the market for a couple of years, farmers and other investors are beginning to make farmland purchases again. If 1984 crops are large, exports markets continue weak, and carryover stocks begin to build again, farmland values will remain soft beyond 1984.

Food prices

Reduced grain and livestock supplies will mean higher consumer food prices in 1984. Retail food prices increased only 2 percent in 1983, the smallest increase since 1967 and the eighth year of the past nine that food prices rose less than the overall inflation rate. But retail food prices may rise by 5 to 7 percent in 1984, somewhat ahead of the generally expected overall inflation rate. Higher meat prices beginning in the second quarter will be an important component of food price increases.

Conclusion

The U.S. farm sector is recovering from its deep, longlasting recession. Farm income improved in 1983 and further improvement is likely next year. Improvement in 1983, however, was largely due to record high government subsidies to farmers. In 1984, farm income growth will be determined more by supply-demand relationships.

High prices for crops in early 1984 will boost farm cash receipts, feed costs for livestock pro-

ducers, and intended crop plantings. High crop prices also will limit growth in export sales. Barring serious production problems elsewhere in the world, U.S. production will determine crop prices in the second half. Reduced livestock output will raise prices and improve profitability for producers. Consumer food prices are now expected to increase 5 to 7 percent in the year ahead. Both total farm income and net farm income should improve somewhat from 1983 levels.

More than the usual number of uncertainties may affect the agricultural sector's performance in the year ahead. Forecasts of improving farm income are based on continued expansion of the U.S. economy and a broadening of economic recovery to trading partners. Forecasts of declining crop prices later in 1984 are based on normal crop production. Since carryover stocks are low, another serious drought would drive feed grain and oilseed crop prices sharply higher. Forecasts for higher livestock prices might not be realized if feed grain prices move higher or if dairymen sharply reduce their herds.

Farm financial conditions may improve in 1984. Farm asset values increased in 1983 after two years of decline and perhaps could increase again in 1984. Farm real estate values, however, may be relatively flat in the year ahead. Finally, the number of farmers going out of business may continue relatively high in 1984. Although representing only a small proportion of all farmers, those going out of business will be highly visible.

On balance, some growth in farm income and further improvement in farm financial conditions are likely in 1984. Thus, better times may be ahead for U.S. agriculture.

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