

California Agriculture Faces a Rough Financial Year

by
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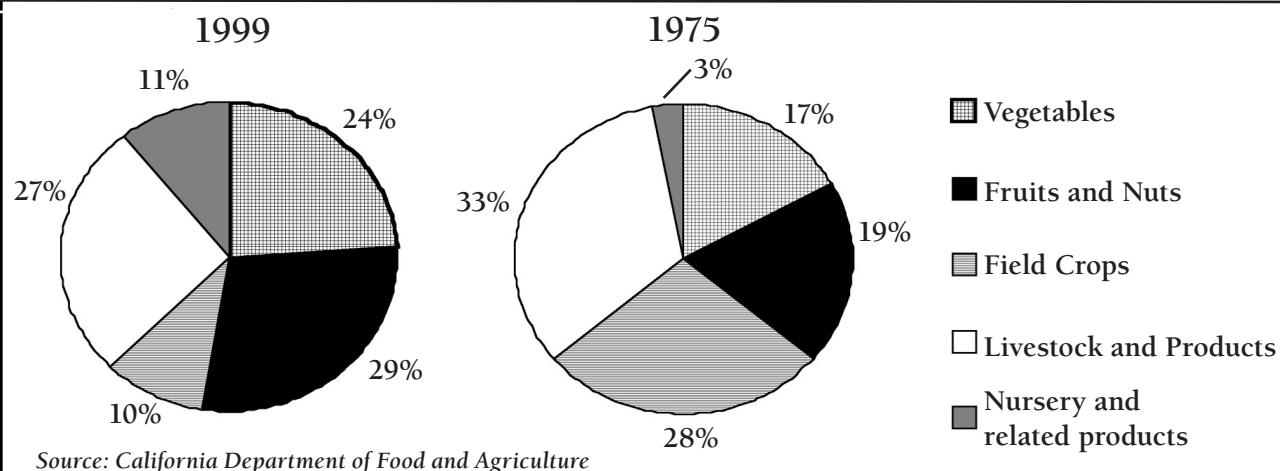
California agriculture continues to struggle with low output prices, higher energy prices, uncertain supplies, and higher prices for other inputs as well. In part, California farm prices are in the same cyclical downturn that has gripped much of the rest of U.S. agriculture. Commodity prices tend to be linked by both supply and demand factors, and some of the same forces that drove down field crop prices (good global harvests and the Asian financial crisis) also caused problems in California. But, there are also some special factors in California and some commodity-specific events that continue to affect returns and risk in California agriculture. Full returns and cost data for year 2000, when final figures become available, are likely to be at least as dismal as the data for 1999 —and year 2001 results are expected to be no better.

The depth, breadth, and length of the current down-cycle has surprised and frustrated producers, processors, investors, financiers and analysts alike, following a run of growth in production and net returns earlier in the past decade. The value of California agricultural production grew significantly for most of the 1990s, starting at about \$20 billion in

the first half of the decade and growing to \$27.2 billion by 1997, before slipping back to about \$26.8 billion in 1998 and \$26.7 billion in 1999 (in nominal terms). In 1998, the El Niño chopped output; in 1999 and 2000, crops rebounded but prices dropped. California net farm income has bounced up and down throughout the last decade. According to USDA figures, net farm income reached a peak of \$6.2 billion in 1997, but fell to \$5.8 billion in 1998 and then to just below \$5.0 billion in 1999 (all in nominal terms). Lower net farm income in recent years has been driven by increases in major variable cost outlays for manufactured inputs (fertilizers, chemicals, petroleum fuel and oils, electricity), and for cost categories reflecting the increased intensification of California agriculture—for feed purchases, for machine hire and custom-work, for marketing, storage and transportation expense, irrigation water and for contract and hired labor.

Increased gross value of production has been a long-term trend reflecting, in part, continued intensification in the use of land. Over the last several decades, growers have shifted from land extensive crops to vegetables, perennial tree and

Figure 1. California Agricultural Production, 1999 vs. 1975



vine crops, floricultural products and intensive livestock production. Figure 1 illustrates this shift. For example, as late as 1975 field crops accounted for 28 percent of the value of California agricultural production. That has fallen to about 10 percent now. The only field crop to make it into the top 10 list of important commodities in California is cotton, and even cotton production dropped off the list in 1998. The gain has been spread among fruit, nut and vine crops, vegetables and, especially nursery and related production. Among the livestock crops, intensive dairy production has continued to expand while the sheep industry has shrunk and the beef industry has maintained its importance, especially as a pasture-based industry in the more remote regions of the state.

The shift towards perennial crops and intensive livestock production requires higher levels of investment and development costs, lags in the receipt of income due to nonbearing periods for

trees and vines, and less ability to adjust to changing product prices. This increased investment per dollar of output means interest rates have become an important concern in California. Debt to assets ratios for California's farms and ranches is considerably higher than U.S. averages, in part due to more costly investments in land and improvements; hence, interest costs have risen while financial ratios have deteriorated over the past several years.

USDA indicators for 1998 and 1999 show moderately increased financial stress in response to lower farm commodity prices that began generally with the 1996-97 crop year. While financial stress indicators are rising, they are, however, at levels less than those of the farm recession and cost squeeze phase of the 1980s, due to restructuring and more conservative approaches toward credit. Still, year 2000 had the prospect to further elevate financial stress indicators for major portions of California agriculture experiencing weaker markets or higher costs of production, and we expect 2001 outcomes to be similarly affected.

Decisions for the 2001 production year have been difficult. In addition to generally weak price expectations, producers have been influenced by real uncertainties about both water and energy availability, the loss of processing capacity for important crops such as tomatoes, sugar beets, peaches and pears, competitive pressures in export markets, and concerns about pests and disease outbreaks here and abroad. Producers have been scrambling to find financially attractive alternatives and are moving ahead with planting decisions in a very risky environment.

Certain supply side issues are always a concern in California agriculture. These issues include concerns about over-plantings in perennial tree and vine crops, continued tensions about future water allocations, loss of processing or marketing outlets, access to adequate seasonal farm labor, the spread of exotic pests and diseases, higher interest rates and ever tighter environmental regulation. On the demand side, concerns center on the continued strength of U.S. economic growth, competition from foreign suppliers, and access to export markets.

Current Issues Affecting California Agriculture

California agriculture will be affected by how several public policy issues play out over the next

Table 1. California's Top 20 Crop and Livestock Commodities 1975 and 1999

Rank	1975	1999
1	Cattle/Calves	Milk/Cream
2	Milk and Cream	Grapes
3	Cotton Lint	Nursery
4	Grapes	Cattle/Calves
5	Hay	Tomatoes, all
6	Tomatoes, proc.	Lettuce, all
7	Eggs, chicken	Strawberries
8	Nursery	Flowers/Foliage
9	Rice	Hay
10	Lettuce, head	Almonds
11	Sugar beets	Cotton Lint
12	Wheat	Carrots
13	Oranges	Chickens
14	Flowers/Foliage	Oranges
15	Barley	Broccoli
16	Peaches	Avocados
17	Potatoes	Chicken, Eggs
18	Almonds	Peaches
19	Strawberries	Rice
20	Tomatoes, fresh	Cantaloupe

Source: California Department of Food and Agriculture (CDFA)

Table 2. Gross Agricultural Value and Net Income, 1990–1999 (in Billions \$)

Year	Value of Agr. Production	Net Farm Income
1990	20.0	5.7
1991	18.6	4.2
1992	20.0	5.2
1993	21.5	6.0
1994	22.4	6.0
1995	23.3	4.9
1996	25.2	6.0
1997	27.2	6.2
1998	26.8	5.8
1999	26.7	5.0

Source: CDFA

few years. These include hired farm labor and immigration, North American economic growth, exchange rates, World Trade Organization (WTO) negotiations, crop insurance subsidies, direct payments for field crop farmers, water issues, environmental regulations and food safety regulations.

Demand for hired farm labor will continue to grow as the shift to more labor-intensive crops continues and mechanization proceeds only gradually. Hired farm wages crept up very slowly until recently, but significantly higher labor costs seem on the horizon. This is both a matter of border policy and economic conditions in Mexico. A guest worker program will allow more security, but is unlikely to lower labor costs.

On the demand side, continued economic growth in the U.S. underlies whatever strength there is in markets for produce, meats and other foods and ornamentals. The recent downturn in the U.S. macroeconomic picture is also troubling, especially for winegrapes and other income-sensitive products. For the future, improved income growth in poor countries and expanded access in other markets are crucial. The value of the U.S. dollar has been

strong relative to the Euro, but on a California farm-trade weighted basis (which emphasizes the yen, Canadian dollar, peso and won) it was not stronger in 2000 than in 1999.

The importance of market access for exports is illustrated dramatically by the success of the California rice industry. For two years, the industry resisted the price collapse facing long-grain rice grown in other states in large part because of an assured WTO-created market in Japan. Potential import competition will also continue to be an issue for many commodities, including garlic, canning peaches and dairy products.

Government subsidy programs are less important in California than in most of the U.S., but that does not make them irrelevant. The doubling of direct "contract" payments and the generous use of the marketing loan programs have shifted several hundred million dollars to field crop producers in California. Recent legislation has also increased the subsidy for crop insurance or other risk management tools, and the Congress has targeted new programs for crops that have not had such subsidies in the past. Unfortunately, crop insurance subsidies have the potential to create industry disruption if not applied carefully, and many California industries have expressed reluctance to accept the proposed programs even if they include large insurance premium subsidies. This is an issue to watch carefully, as growers may find it profitable to farm the insurance subsidies by planting outside the most suitable regions or adopting other risky cultural practices.

Once again, California agriculture faces water supply uncertainties in 2001. Critical legal and political problems always affect water for California agriculture. Reduced water availability, rising uncertainties and increased costs could reduce economic returns and the capitalized value of assets in areas dependant on surface water.

Environmental and food safety regulations are expanding steadily and concerns about their effect on profitability continue. The dairy and beef feedlot industries face animal waste regulations that continue to raise production costs and affect location of facilities. Stronger federal regulation may, however, help the relative position of California producers. The range-based livestock industries face non-point source pollution issues related to small streams and watersheds. For the produce industry and other food crops, the implementation of the Food



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Quality Protection Act continues to be the central focus of concern. If current pesticides are pulled off the market, many major California industries will find it hard to find substitute materials because the costs of acquiring regulatory approval for chemical manufacturers is just too high relative to potential revenues.

Asset Values

Asset values are affected by changes in commodity prices and production costs. If recent plantings of trees and vines result in production in excess of market demands, commodity prices will fall, decapitalization will affect the less productive orchards and vineyards, and marginal plantings will be removed. Despite the recent price drops and cost increases, according to available data, the average value of land has not decreased in most production areas. However, the "spread" between low and high prices for a given class of land in a given region may widen as changing expectations influence buyers and sellers. Recent reductions in interest rates provide some support for asset values and land rents as lower interest rates mean reduced operating costs and higher capitalization rates. With lower commodity prices, land rent reductions were an active topic in lease renewal negotiations for the 2001 crop year. Share rents are reduced and cash rents less available from financially stressed producers.

Conclusions

The current 2001 crop year is a challenge for producers, and others involved in California agriculture. California producers have worked through down cycles in the past. We can expect well-managed firms to maintain or regain profitability on the upturn. Agriculture is cyclical, but there is nothing very regular about the cycles. Farm returns will turn up again, we just do not know when. Outcomes of public policy issues can influence the timing and the strength of the rebound when it does occur.

Pointers to watch for are continued economy-wide income growth in North America, a bad harvest or supply problems

elsewhere in the world, less-than-perfect weather here in California, renewed economic growth in Japan, and robust growth in the rest of Asia. Better access to markets in China will also help. Things may get worse before they get better if a slow down in North American economic growth sharply affects domestic demands, if Japanese growth slows even further, or if very large California crops overwhelm demand growth.

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