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Statement by

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before the

Committee on Agriculture

Subcommittee on Conservation, Credit, and Rural Development

U. S. House of Representatives

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I appreciate this opportunity to appear before your committee to discuss Federal Reserve policy and the implications for the agricultural sector. The Board recognizes the critical role of agriculture in meeting fundamental human needs here and abroad; we also are conscious of the importance of a vital farm sector for the strength and stability of the American economy. We know, too, that many segments of the agricultural community are experiencing difficult times, in part because of financial conditions.

I would note that the Federal Reserve has greatly enhanced its collection of data on farm credit conditions and has become a significant source of timely information in this area. In the mid-1970s, when it became evident that the volatility of agricultural commodity prices and of credit conditions had increased, several regional Reserve Banks joined in conducting quarterly surveys of trends at agricultural banks. Then, in 1977, the Federal Reserve began a quarterly national survey of interest rates and other terms of bank loans to farmers. Most recently, an Agricultural Finance Databook was established as a regular quarterly publication of the Board of Governors.

An examination of the available data indicates quite clearly that, while the farm sector--like others--is confronted today with a problem of high credit costs, it is not facing a significant problem with respect to credit availability. You will recall that there were serious concerns about shortages of agricultural credit supply at rural banks in late 1979 and early 1980. For agricultural banks nationwide, the average loan-deposit ratio--one indicator of banks' capacity to make additional loans--had reached 68 percent by the fall of 1979, having climbed in the late 1970s from the 55 percent area that had prevailed throughout the 1968 to 1975 period (chart 1). Many agricultural

bankers believed that they might be unable to accommodate the increased loan demands they expected from farmers in the spring of 1980.

However, even during this period of concern, there were in train changes in deposit and loan trends that subsequently alleviated the liquidity squeeze. On the deposit side, favorable 1979 farm income and the availability of the attractive new 6-month money market certificate helped to maintain a substantial inflow of lendable funds. Meanwhile, with interest rates on loans at banks rising faster than those posted by production credit associations and the Farmers Home Administration early last year, demands for production credit were diverted from the banks. The business recession also cut into nonfarm loan demands. As a result of all these developments, agricultural banks saw their loan-deposit ratio fall sharply last year, to 60 percent. Thus far in 1981 loan growth at these banks has picked up a bit, but deposit growth has kept pace, so that liquidity positions in the aggregate have not deteriorated.

However, as I noted, the more comfortable credit availability situation has not isolated farmers from the stresses of high interest rates. Indeed, the direction of change in recent years has been toward a greater integration of the credit markets, lowering the old sectoral and geographic barriers. Credit developments across the economy tend now to follow a similar course. In the case of agricultural banks, the 6-month MMC has been a major factor in linking the local farm loan market to the national credit market. The MMC has enabled agricultural banks to remain competitive in the market for savings, and in the process it has transformed their liability structure. The MMC was introduced in mid-1978, and by March of this year it accounted for 27 percent of the total resources of agricultural banks; with large denomination CDs ($100,000

plus) accounting for another 7 percent, roughly a third of the banks' footings were in the form of short-term deposits carrying market-related rates.

The shift into MMCs from passbook savings and other low-rate instruments resulted in a marked upward adjustment of the average cost of funds for agricultural banks, and that cost is much more responsive than it was in the past to swings in money market rates. Traditionally, loan rates at rural banks have been based on the average cost of funds, rather than on what the banks could earn in the money market at any given time. This sluggishness of average costs in the pre-MMC era was mirrored in a comparative stability of farm loan rates, but the transformation of bank liability structure that has occurred over the past three years has changed this picture drastically (chart 2). For example, in our quarterly survey of bank lending to farmers, the effective average rate charged by smaller banks reached 17.1 percent in May 1980--in a week when the national business prime rate was 18 percent. It then fell to 13.7 percent in August, when the prime rate was 11 percent. In the latest survey, made this May, the effective loan rate at the smaller banks was 17.5 percent, at a time when the prime was 19 percent. Thus, farm loan rates at these banks, which account for about five-sixths of farm lending, have been fluctuating much more than in the past, though not as much as the business prime rate.

At very large banks that are active in national money markets, and which account for the remaining one-sixth of farm lending, the average farm loan rate follows the prime quite closely, and is usually slightly above it (chart 3). In the May survey, effective farm loan rates at these banks averaged 19.5 percent, just above the national business prime.

Of course there is a substantial dispersion of rates on individual loans. In May, for example, 13 percent of the farm loan volume was reported

at effective rates of less than 16 percent, and 16 percent had rates above 20 percent. Thus, the interest rate experience of individual farmers has varied considerably. I might also note that, on average, operators of small farms may have been able to borrow at somewhat lower rates than large farmers. At least, for example, the May survey data show that the effective rates on loans under $100,000 averaged 17.5 percent while those on larger loans averaged 18.2 percent. At small banks this difference has narrowed in recent quarters, but it remains in evidence at large banks.

On the whole, our figures indicate that farm borrowers at banks have, on average, paid somewhat lower rates than most business borrowers when market rates of interest have risen to high levels. This does not, however, alter the fact that interest charges have risen significantly for most farmers, especially for those who are heavy users of short-term production credit. These higher interest costs inhibit agricultural investment and production just as they do investment and production in other sectors of the economy. Under the circumstances it is natural to ask whether economic policies are being directed toward easing the pressures on interest rates.

In answering this question, it is necessary to recognize that the major source of the high interest rates we have today is inflation. We are faced with a deeply entrenched inflation and inflationary psychology that has created major imbalances and inefficiencies in our economy. Indeed, by now it is widely accepted that ending the inflation is absolutely essential if we are to put the nation securely on a path of balanced economic growth and high employment.

Inflation leaves its imprint on financial markets as surely as it does on the markets for commodities and labor. In an inflationary environment, nominal sales and incomes must rise in order to maintain the same real levels

of activity, and so too must the nominal volumes of money and credit. The inflated credit demands will be met by lenders only if nominal interest rates rise enough to compensate for the expected lower purchasing power of the dollars with which debts are repaid--and borrowers are willing to pay that price when they share those expectations.

Once an inflation has gathered momentum, the monetary authority has, at least in principle, several options available to it, none of which are especially appealing. It can seek to accommodate the enlarged demands for money and thus attempt to sustain the real growth of the economy. This approach has at least two major pitfalls. First, the history of inflation suggests that it is difficult to achieve a "steady state"--inflation tends to escalate. Second, even a steady inflation tends, over time, in an economy like ours to result in significant distortions and dislocations that impose real economic costs.

Another option--one that some people have advocated--is to apply a shock treatment by completely shutting off the supply of money for a period. Unfortunately, when inflationary expectations are deeply embedded in contractual and other arrangements, such a drastic approach may rend the financial fabric and exact an unacceptable toll in terms of lost economic production.

A third option, and the one we are pursuing, is in effect a middle course: we are putting the economy on a strict monetary diet--a regimen that will over time squeeze out the inflationary fat from our financial flows and force adjustments on the part of business and labor consistent with a return to price stability. Such a gradual approach is not without its risks. If the commitment to the strategy is questioned, the adjustments of wage and price behavior will be slower and the economic costs correspondingly greater. There also is the risk of misestimating the effects of the selected policy

targets, with the consequence that more or less pressure may he placed on the economy than is desirable. While the scope for fine-tuning clearly is very limited, it must be recognized that in a world of rapidly changing financial institutions, technology, and practices, there is a need to stay alert to the possibility that a given monetary growth rate may vary in its impact on financial markets and the economy.

On balance, however, the risks of this gradual approach are outweighed by its advantages. Consequently, the Federal Reserve intends to continue seeking a slowing in monetary expansion. We have set objectives for the growth of money this year that imply a significant deceleration from the pace of recent years, and we anticipate further progress toward noninflationary rates of monetary growth in the years ahead.

The consequences of this policy for interest rates cannot be predicted with any precision. Moveover, it must be emphasized that our policies are not aimed at attaining any particular level or structure of interest rates. However, knowing the concern of the committee about the outlook for interest rates, let me make a few general remarks. The first would be that the initial direct impact of monetary restraint is to place upward pressure on market interest rates--especially shorter-term rates. As the availability of money falls short of what is demanded, interest rates tend to rise as businesses, households, and others compete for the available supply. In time, the higher rates also tend to damp spending, and thereby to ease inflationary pressures--a process that may involve some economic slack. This is the circumstance in which we seem to find ourselves today. The degree and duration of that slack can be

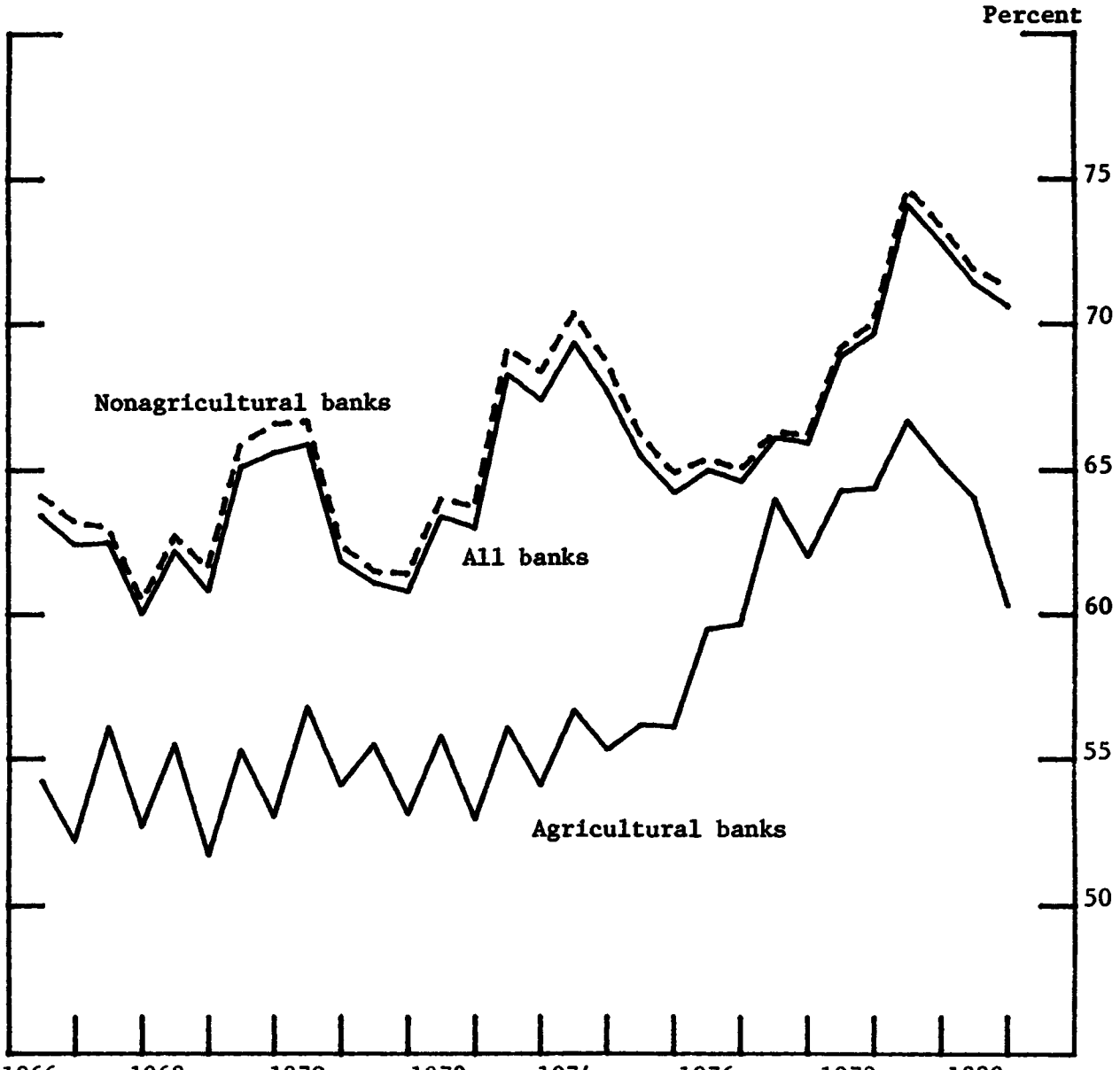
greatly reduced if, upon observing the commitment of government to anti-inflationary policy, people adapt their wage and price decisions quickly to the underlying economic realities.

As inflation and inflationary expectations begin to wind down, the groundwork will be laid for a moderation of interest rates. Over the long haul, the size of the so-called inflation premium is a major determinant of nominal interest rate levels. In this respect, it is fair to say that the Federal Reserve is pursuing a policy that offers the best hope for a sustained reduction of interest rates.

It is to be emphasized, however, that the path to lower interest rates will be shorter and less bumpy if other governmental policies move in directions that are complementary to the thrust of monetary policy. The most critical area in this regard is the federal budget. An expansive federal budget stimulates aggregate demand and, at least initially, results in an enlarged deficit and a greater federal call on the credit markets. Higher interest rates are the result, so long as the Federal Reserve does not deviate from its targets in order to accommodate the government's financial demands. Thus, because our economy is already being taxed by high interest rates--and I speak not only of agriculture, but of a good many other major sectors--I urge you to place a top priority on maintaining the current momentum toward curtailment of the growth of federal spending. I would urge you as well to exercise caution with respect to tax cuts, to take care that any cuts are not so great as to offset the deficit-reducing effect of the expenditure restraint and that they are focused as much as possible on fostering greater productivity. In this latter regard, I believe that the greatest productivity gains per dollar of reduced taxes are

available if tax cuts are directed at the business sector, including the business of agriculture; I recognize, however, that the high personal tax burdens that have developed also call for some remedy, and that well designed action on this front could well have a significant payoff in terms of enhanced productivity. But I would underscore again that it is crucial that the Congress keep its eye on the overall balance of the spending-revenue package to ensure that financial markets are not further strained in this critical period of transition to a less inflationary economy.

Chart 1
Average Loan/Deposit Ratios at Commercial Banks
Semiannual



Note: "Agricultural banks" are banks at which farm loans comprise 25 percent more of total loans.

Chart 2
Average Farm Loan Interest Rates at Agricultural Banks
Compared with National Business Prime Rate
Quarterly
First Day of Quarter

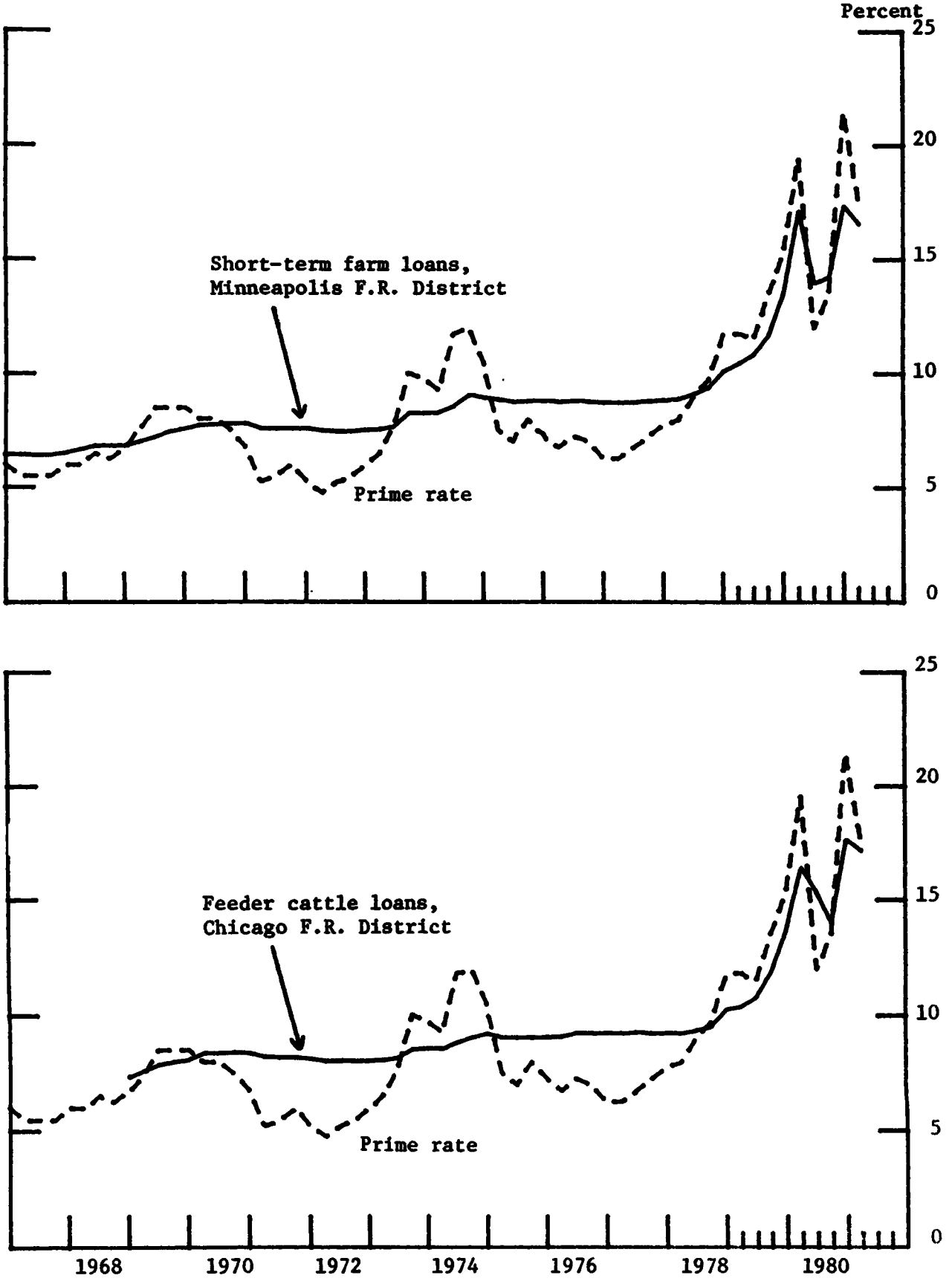


Chart 3
Average Farm Loan Interest Rates at Commercial Banks
Compared with National Business Prime Rate
Quarterly
First week of second month of quarter