

"MONETARY POLICY AND THE FARM PROBLEM"

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The farm problem is one of the most perplexing and troublesome problems that currently confronts this nation. It afflicts millions of people, tens of thousands of communities, and thousands of financial institutions. Whenever problems of such magnitude arise, there is widespread clamor that something--anything--be done immediately, often without regard to whether the proposed actions will really help. Too often, it seems, good intentions, and not necessarily good results, are all that matter.

As the farm problem has persisted, and worsened, there have been increasing demands that the Federal Reserve step in to alleviate the agricultural crisis. Judging from the conflicting demands that have been made, however, there seems to be considerable confusion over what the Fed's role should be. This morning, I would like to discuss what, in my opinion, the Fed can do and what it cannot do to mitigate the farm problem. To set the stage, however, first requires some discussion of the farm problem itself.

The "farm problem" really has two dimensions. The first is the well-known, ongoing decline in real returns to agricultural production--what might be termed the operating problem. Real net farm income has declined in nine of the last 15 years; it presently stands at about one-third of what it was in 1973. The real value of U.S. farm exports has declined since 1980, falling by 30.3 percent in total and declining in each of the past four years. Concomitant with these reductions in real income and export demand has been a 19 percent decline nationally in land values from their 1981 peak. And in some areas, land values are now down 30 to 40 percent or more from these levels.

Farm sector indebtedness, on the other hand, has increased 17 percent since 1981. This leads to the second dimension of the farm problem--the financial problem of trying to service an increasing debt burden against a backdrop of declining income and asset values. Many farmers simply cannot repay their debts at this juncture, and as a result banks in agricultural areas have come under increasing financial stress.

Now, what can the Federal Reserve do about either of these two faces of the farm problem? It is clear that the Fed can do nothing to directly raise farm income. The longstanding secular decline in the real returns to agricultural production seems, by all evidence, to be rooted in a variety of fundamental changes in the structure of our economy--as well as foreign economies. These changes are largely unrelated to monetary policy. On the one hand, domestic production of basic farm commodities in the past 10-15 years has expanded at a rate few thought possible. With fears of a world food shortage and shocked by the Soviet grain purchases of 1973-74, domestic farm programs put in place production incentives that achieved an incredible result in just 10 short years: we were exporting quantities of wheat in 1981 greater than total domestic production in 1971! Over the same period, soybean production nearly doubled, corn production was increased 50 percent, and the quantities we exported were up 100 percent or more.

Similar policy incentives abroad, combined with greater investment in agriculture and technological improvements, have generated a worldwide surplus of most farm commodities that, by all indications, is likely to grow larger. As a result, farm commodity prices appear headed

for further declines in the years ahead, dragging the real returns to farming with them. Projected technological gains for commodities like milk and soybeans, where yields may increase by 30 percent or more, will accelerate the decline.

Despite strong evidence that the secular decline in real farm income is the result of ongoing structural changes, the Federal Reserve has been singled out as being one of the chief culprits. In particular, the Fed has been held responsible for unleashing two villains which have contributed importantly to the demise of the American farmer.

The first villain, as we all know, is the so-called high value of the dollar. Many prominent agricultural economists have argued that restrictive monetary policy has made the dollar relatively scarcer in world markets and, consequently, driven its value up. The problem, so the argument goes, is that agricultural prices are higher when translated from dollar terms rather than peseta or cruzeiro terms. The high dollar, then, is responsible for making the prices of U.S. agricultural products more expensive on world markets than similar products from other countries. The proposed solution is for the Fed to increase the growth rate of the money supply. This, we are told, will reduce the dollar's value in world markets and, as a result, the greater farm exports will raise real farm income and alleviate the debt repayment problem.

The second villain, and one that is closely related to the first, is high interest rates. Again, tight monetary policy is said to have kept interest rates high and, of course, higher interest rates make debt repayment more difficult. In addition, high U.S. interest rates are cited as a causal link between tight monetary policy and the high value of the dollar. The solution to this problem is, again, for the Fed to

increase money growth. This, we are told, will bring down interest rates which, in turn, will ease the stress of servicing farm debt and contribute to a lower value of the dollar. Easier monetary policy, therefore, is thought to hold a double shot of benefits for agriculture: higher receipts from greater export sales after the dollar falls and lower interest costs on farm debt.

Unfortunately, faster money growth would have little remedial effect at all. Why not? Consider how faster money growth affects the value of the dollar and interest rates. Perhaps no relationship in macroeconomics has been verified for more countries and over more time periods than the long-run correspondence between changes in the growth rate of money and changes in the rate of inflation. Faster money growth, sustained for a sufficiently long period, will inevitably produce higher inflation.

In general, the dollar's value is closely associated with differences in inflation rates between countries. For example, if the U.S. inflation rate is 5 percent per year and Germany's is 10 percent, the dollar will naturally rise by 5 percent per year against the mark. But the rising value of the dollar does not make U.S. goods more expensive and German goods cheaper. Since German prices are rising 5 percent faster than U.S. prices, you can't profit by purchasing goods abroad priced in the lower-valued currency: the rise in the value of the dollar is offset by the higher German inflation rate.

Now, to be sure, the Federal Reserve can influence the value of the dollar by changing the expected rate of future inflation in the U.S. relative to expected inflation rates abroad; it could do this by

accelerating money growth. However, this will only produce higher U.S. inflation in the future and a lower value for the dollar with no net gains to farm exports.

It is certainly true that the value of the dollar is influenced by factors other than inflation differentials; some of those factors include the strength of the U.S. recovery relative to foreign economic conditions and the real returns on investments here relative to those abroad. These factors can drive up the value of the dollar by more than the inflation differentials alone would call for. If so, the relative price of our exports would rise and our export industries, including the farm sector, would suffer. In some measure, this is what has occurred in recent years. The real value of the dollar, the value after adjusting for inflation differentials, has risen in part because the U.S. recovery has been stronger and U.S. investments have yielded higher returns.

It is important to realize, however, that the Federal Reserve cannot influence, except perhaps over the very short-term, the factors that cause the real exchange rate to rise or fall. It can only push exchange rates around in nominal terms, by causing U.S. inflation to rise relative to foreign inflation. We know that this won't help farm exports.

To see evidence for this, you need only to look at nations like Canada, whose currency has depreciated sharply; they are having similar export problems. If nominal exchange rates were an important determinant of farm exports, Canada should be enjoying an export boom. Instead, its wheat exports are falling, wheat prices are declining and farm asset values are eroding. This evidence points out, again, that fundamental changes in the structure of world agriculture, and not exchange rates, are the cause of lower farm prices and income worldwide.

If monetary policy can't raise farm income by producing greater revenues from higher export sales, what does it have to offer in the way of lower interest rates? Interest rates, like exchange rates, can be viewed in both nominal and real terms. The real component is determined by supply and demand in the loanable funds market; it changes in response to changes in those basic market fundamentals. Again, the Fed and monetary policy have little impact on those fundamentals; interest rates are determined in markets where participants assess all available information. Only if a Fed action somehow surprises these individuals and forces them to reassess their outlook for future market conditions will monetary policy have any effect on real interest rates, and this effect would be only temporary.

The Fed's effect on nominal interest rates--the rates we see quoted in the marketplace--comes through monetary policy's effect on expectations for future inflation. Because lending agreements are written in nominal terms and inflation reduces the purchasing power of nominal values, lenders will make sure that the interest rates they charge will compensate for any expected loss in purchasing power due to inflation. Therefore, as expected inflation increases, the nominal rate of interest will increase as well.

Expectations about future inflation, of course, are closely related to the rate of growth of the money supply. And, since the Fed has an important influence on money growth, our conduct of monetary policy and the path that the money supply follows are important determinants of nominal interest rates.

However, the Fed can reduce nominal interest rates over long periods of time only by reducing expectations about future inflation. And, since lower inflation requires a slower long-run growth rate for the money stock, the only way to assure lower interest rates for extended periods of time is to reduce, not increase, money growth. Only then will inflation expectations and nominal interest rates decline permanently.

Suppose, however, we ignore all the evidence to the contrary and continue to believe that somehow the Fed can push down interest rates over long periods of time with faster money growth. Even if this were so, there is little to be optimistic about. A recent study shows that lower interest rates would have little impact on the degree of financial stress faced by farmers and farm banks. It is estimated that direct cash payments of at least \$20,000 per farmer to those with debt-to-asset ratios in excess of 40 percent would be required for these producers to service their debt. Lower interest rates might take several thousand dollars off the typical farmer's expenses; but clearly, the earnings to assets in agriculture are not now, and never have been, sufficient to support the debt burden which has been accumulated in recent years.

I would now like to turn to the second dimension of the farm problem--the financial problem. Commercial banks now hold about one-fourth of the farm sector's \$213 billion debt. About \$40 billion in farm production loans is held by banks and, of this amount, at least \$900 million in net charge-offs was realized in 1984; another \$200 million was written off as a loss in the first quarter of this year. By the end of March, over 10 percent of farm production loans at commercial banks were delinquent. Loan losses and delinquencies of these magnitudes have reduced farm bank incomes sharply: whereas 90 percent of agricultural

banks earned a return on equity of at least 10 percent in 1979, only 55 percent performed this well in 1984. Moreover, 12 percent of all farm banks had negative earnings last year. These statistical averages for banks engaged in significant agricultural lending seem to paint a gloomy picture.

Before drawing broad conclusions about the scope of farm bank problems, however, it is useful to place the figures in perspective. First of all, much of the pending farm loan defaults are concentrated among 7 percent of farmers; moreover, over one-half of all farm loan charge-offs last year occurred in only four states (Iowa, California, Nebraska and Missouri). Further, the average share of farm loans at banks that failed in 1984 was 10 percent of total loans, about one-half the minimum share required to be defined as an agricultural bank. When viewed in this manner, the data suggest that the problems at farm banks are perhaps more complicated and due to more factors than merely the side-effects of low commodity prices and income.

Of course, the farm debt problem is a serious concern to the Federal Reserve. Thirty-two farm banks failed last year, and 42 more have failed so far this year. It is quite possible that many additional agricultural banks will fail in 1986. Unlike the farm income problem, the Fed has a clear role to play in assuring that the agricultural banking problem does not escalate into a crisis which affects the economy and financial system at large.

In a broad sense, the most constructive thing the Fed can do in dealing with the farm problem is to pursue policies which support long-term economic growth in the context of controlling inflation and inflationary expectations. Clearly, as the agricultural industry adjusts

to the structural changes mentioned earlier, financial losses will have to be absorbed by farmers, agricultural lenders and possibly taxpayers. To the extent that this process can occur in a positive economic environment, it is desirable.

Data from the 1920s, when a similar farm problem existed, provide an interesting comparison. During World War I, the U.S. expanded agricultural output sharply to export food to Europe. As was true in recent years, much of this farm sector expansion was financed by rural banks on the basis of rising land values and commodity prices. Then, as now, the export boom ended abruptly, land and commodity prices fell precipitously, and farmers defaulted on their debt. Between 1921 and 1929, about 635 banks, on average, failed each year.

And yet, in an era without federal farm programs or deposit insurance, the economy handled losses of this magnitude with relative ease. While farm output fell sharply in 1921 as many farmers went bankrupt, the farm sector had recovered to its wartime production rate by 1925. Further, there was no spillover from the failure of farm banks to the rest of the financial system, and the economy expanded at an enviable average rate of 4.2 percent during this period. With the past as precedent, so long as the Fed prevents the money stock from falling on a sustained basis, aggregate spending in the economy should be maintained and farm debt defaults need not be a significant threat to our financial system.

With respect to the present problems of individual farm banks, the Federal Reserve has reiterated its policy of avoiding supervisory actions that may discourage banks from exercising appropriate forbearance with farmers who are experiencing temporary difficulties in meeting their

debt service obligations. In addition, the seasonal lending program was revised and extended earlier this year to assure that farm banks would have sufficient liquidity to make necessary production loans to their customers. Finally, the Federal Reserve stands ready, as the lender of last resort, to meet extraordinary liquidity requirements of farm banks, although clearly reserves provided under such circumstances must be taken into account in connection with implementing overall monetary policy objectives.

My comments today may appear to some as an apology for the Federal Reserve's failure to "do something" explicitly and directly for agriculture. Unfortunately, for those who would like the farm problem to be solved by the Fed, careful analysis points to two primary conclusions: (1) agriculture's current problems, like those of the past 50 years, are related to the low and declining earning capacity of resources in agriculture, and (2) monetary policy, whether by trying to reduce interest rates or exchange rates or even generating higher inflation, is unlikely to have much effect on real farm prices or income.

The farm financial problem is quite another matter, however. Although rooted in the declining profitability of farm production and land speculation, the accumulated burden of farm debt could pose some threat to the functioning of the banking system. If farmers default on billions of dollars of debt, it will be the Fed's responsibility to maintain sufficient liquidity in the banking system. While some banks may fail, there is no need for these failures to have spillover effects on other banks and the banking system. I assure you that we will not fail in our commitment to preserve confidence in the financial system.