For release on delivery
11:30 A.M., E.S.T.
8:30 A.M., P.S.T.
March 16, 1999

Remarks by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

at the

Annual Convention

of the

Independent Bankers Association of America

San Francisco, California

March 16, 1999

I am pleased to have the opportunity once again to address the annual convention of the Independent Bankers Association. For the U.S. economy, the past year has been turbulent in some respects but in the end, another year of impressive performance. Economic growth was robust again, and unemployment and inflation edged down further. This month marks the eighth anniversary of the last business cycle trough, and the expansion that has ensued now ranks as one of the longest.

These accomplishments are doubtless partly the result of influences that may prove transitory, but a number of fundamental strengths imply more lasting benefits. Nonetheless, after eight years of economic expansion, the economy appears stretched in a number of dimensions, implying considerable upside and downside risks to the economic outlook. Some industries, for example, that are more exposed to international trade have been affected adversely by the severe problems of many foreign economies, which have led both to reductions in demand from abroad and to increased competition from imports. Agriculture has been one of the more notable soft spots, and I shall devote the bulk of my comments this morning to the situation in this sector, which has become a matter of increased concern to a good many community bankers from rural areas this past year.

Farmers, rather than sharing in the general prosperity, have been experiencing disappointing exports and sharply falling prices. Overall, the prices received by farmers in February were about 5 percent below the level of a year earlier. In recent weeks, corn prices have been running around $2 a bushel in the Midwest, the lowest late-winter price for that crop in a number of years. Soybean prices, reflecting increasing world supplies and additional pressures from the Brazilian currency devaluation earlier this year, have dropped sharply to the low end of their range of the past quarter-century. Wheat prices also have come under renewed downward pressure, even though U.S. farmers appear to be cutting back sharply on planted acreage. Hog producers, who usually benefit from falling feed costs, instead have suffered big losses this past year, not so much from troubles on the export side as from sharply increased production; hog prices fell about two-thirds over the course of 1998, but that decline, at least, has been partially retraced in recent weeks. By contrast, dairy prices, which have been strong over the past year, now are weakening noticeably.

The disappointing export developments and pressures on farm prices over the past few quarters can be traced to an important degree to the recession that began in Asia more than a year and a half ago and has since spread to other regions of the world. U.S. agricultural exports to Japan, which has been experiencing its most serious downturn in a half-century, fell by more than 20 percent in value terms from 1996 to 1998. Weakness in several other Asian economies, including Korea, Taiwan, Indonesia, and Malaysia, also engendered significant erosion in demand for U.S. farm products, and China has not proved to be the rapidly expanding market that U.S. producers had hoped to see. All told, falling shipments to the Asian countries accounted for more than 80 percent of the drop in the value of farm exports over the past two years. In addition, the worsening economic situation in Russia has led to reduced farm exports to that country--most notably of poultry, the exports of which previously had been growing rapidly. In this hemisphere, shipments to Canada and Mexico have continued to expand, but exports to South American countries have slowed.

In addition to soft foreign economic activity, exchange rate effects have compounded the damping of farm exports. Weakness in Asia and other parts of the world has particularly lowered the prices of the commodities that Canada and Australia produce in quantity, and the currencies of those countries accordingly have declined against the dollar. Because Canada and Australia are such large factors in the international wheat market, their weakened currencies have put additional competitive pressure on some of our exporters. The volume of our grain exports has declined, and sharply lower prices have been required to move that volume.

Meanwhile, the very strong growth of our domestic economy has contributed in only a limited way to the expansion of demand for farm products. Consumers, especially in affluent economies, do not boost spending on food to nearly the same degree that their incomes rise. In this country--for quite a number of years--real consumer expenditures for food have been trending up at a pace only a little faster than what might have occurred from population growth alone. This limited potential for expansion of domestic demand--even in an economy as strong as we have experienced over the past few years--explains why the farm sector is so critically dependent on demand from abroad. No one can predict with much confidence exactly when recoveries in demand will take hold in the troubled foreign economies. But clearly our farm sector stands to gain, perhaps appreciably, when more favorable economic conditions finally emerge.

In the interim, farmers will likely be turning even more intensely to what has been, in the past, the one tried-and-true formula for maintaining profitability--reducing the costs of production to the bare bone. For those farms that are the hardest pressed during the current period of slack demand from abroad, small efficiencies can mean the difference between survival and failure. Farm businesses that are not so hard pressed can continue to forge ahead with modernizations that will leave them better positioned once demand begins to pick up. These changes not only will affect farm profitability over the near term but also will affect supply conditions in the industry over the longer term.

I cannot stress too much the overwhelming importance of technical change as a primary force that will likely be reshaping farm supply conditions--as it has been doing for a long time. As a consequence of each producer's striving to become more efficient and thereby to contain costs, successive waves of innovation have swept through the farm sector over the decades. Crop producers, in stages, have implemented increased mechanization, heavier uses of fertilizers, new higher-yielding varieties of seeds, low-tillage methods of production that have enabled producers to economize on energy inputs, and heavier reliance on chemicals and pesticides to reduce crop losses. The payoff to these efforts is evident in gains in national average yields per acre of roughly 40 percent to 60 percent for our major field crops--corn, wheat, soybeans, and cotton--over the past three decades.

Livestock productivity also has moved up: The nation has a smaller cattle herd than it did three decades ago, but beef production has risen more than 20 percent. The dairy herd is about three-fourths the size it was in the late 1960s, but output of milk has increased more than one-third. In the poultry business, the flock of hens has changed little, on net, but the poundage of broilers delivered to retail has risen spectacularly. Pork production in 1998 was up close to 50 percent from that of three decades ago, even though the inventory of hogs and pigs on the nation's farms was up only slightly. Over time, livestock producers have been able to exert greater control at all stages of production. Increased application of industrial methods has proved especially advantageous in several of these sectors.

These technical advances have added up to a huge increase in the productivity of farmers and farm workers. Over the past thirty years, farm value-added per hour worked has grown at an average rate of more than 4-1/2 percent, roughly three times the rate of increase in output per hour in the nonfarm business sector of our economy. With the demand for farm output rising less than half as fast as productivity growth, the amount of labor input in agriculture has contracted dramatically. At the same time, the faster rate of farm productivity growth has led to a sustained decline in the prices of farm products relative to nonfarm business prices, at a compound average rate of roughly 3 percent per year over the past three decades.

Still further technological advances appear to be coming on line in farming or are waiting closely in the wings. In agriculture, as everywhere else in our economy, the computer is coming into wider use, as are other new electronic and communications devices. Moreover, some promising applications of new technologies are more farm specific. Combinations of electronic sensors, computers, and communications equipment are starting to give producers more control over farming operations that have always been vulnerable to pests or subject to the whims of nature. Applications of biotechnology have taken hold already in some parts of farming, and numerous new possibilities seem to be opening up. To be sure, many of the applications of these or other new technologies are still either in their infancy or in an early stage of adoption into standard farming practices, and some have yet to prove their commercial viability. But the general direction of change is clearly toward more precision and control of farm production processes. Over time, those changes surely will lead to a further lowering of real production costs as well.

For the most part, the successive waves of technical innovation have tended to give farmers who are able to reduce costs the most a leg up in expanding their operations. These low-cost farmers are the ones best positioned to acquire additional acreage or finance the investments that can foster still further reductions in unit costs. Over time, farms thereby become fewer in number but are larger and, in most cases, more efficient, with strengthened ties to nonfarm businesses that supply inputs that are essential to improved technologies. The new technologies seem destined to integrate farming operations still more tightly into our complex modern economy. This increased integration does not necessarily impinge on family farming as a way of life, but it does alter the image of the independent farmer that remains so deeply rooted in the American psyche, even as the percentage of our labor force that is engaged in farming has fallen from more than 35 percent a century ago to a little less than 2-1/2 percent today.

Farm cost containment depends not only on technical efficiency but also on the prices of inputs, which farmers do not control. Fortunately, however, inflation is not a problem with which farmers have had to contend of late. This past year, in fact, farmers have benefited from declining input prices that have partly relieved the pressures imposed by declines in the prices of their output. Prices are lower for gasoline, diesel fuel, fertilizers, and farm chemicals. Prices of many other production inputs--including vehicles, farm machinery, and farm building materials--have either held steady or risen only modestly. Prices paid in February for all production inputs, including those purchased from other farmers, were about 3 percent below the level of a year earlier.

The weakening of farm markets, while pressuring farm income and wealth, has not had effects as dramatic as the declines in market prices might seem to have implied. Partly because of increased government payments to farmers this past year, but also because of efficiency gains and real cost reductions that have been implemented over the past several years, net farm income and farm cash flow from operations are holding up considerably better than they otherwise would have. Indeed, an earlier string of prosperous years fostered a strengthening of farm balance sheets, and, despite the softening of land prices in some regions since the middle part of last year, aggregate farm debt remains quite low relative to farm assets.

However, the range of financial circumstances across individual farming operations is considerable, and although producers in general appear to have remained profitable, some producers, plagued by higher costs or adverse weather, are having to make financial adjustments. The severity of those adjustments are compounded for producers who are more heavily dependent on debt. In some cases, farmers and farm lenders are reworking loan-repayment schedules or taking other steps to help producers get through what presumably is a transitory--though by no means abbreviated--period of softness in the demand for farm products. Even when export demand improves, some producers may find it a struggle to stay competitive with farmers whose real costs per unit of output are being pushed ever lower by technical advance and innovation.

On the whole, commercial banks that are active in farm lending appear to have suffered little or no diminution of their profits this past year because of the increased difficulties in farming. For the most part, farmers seem to have been able to maintain repayment of their bank loans on a timely basis, and the charge-offs of farm loans by commercial banks have remained low relative to the total volume of farm loans at these institutions. These favorable readings, however, may be partly a reflection of the tendency for evidence of loan difficulties to lag behind the changes in farm market conditions, and some weakening of the financial indicators would not be altogether surprising as we move ahead. Nonetheless, the banks that are more heavily involved in farm lending are, by and large, well capitalized and seemingly better positioned to absorb financial adversities from the farm sector than was the case at the start of the 1980s, at the onset of that decade's farm financial crisis. The Farm Credit System, too, seems to be on sounder footing than it was at the start of the 1980s. Credit from these and other lenders appears to be available to most farm borrowers at present, although the terms and standards of loans may be tightening in some cases.

Despite heightened anxieties about how long the present slack conditions in farm markets might persist, both farmers and lenders appear to retain a fair degree of optimism about the longer-run prospects for the sector, apparently owing to the expectations that technical change will create new markets for farm products and that further advances in productivity and cost reduction will help the lower-cost producers retain a competitive position in world markets. At the same time, however, the near-term may be challenging for farmers and their lenders, especially if farm prices remain depressed, and the technical changes that will be helping innovative producers may even add to the stresses being felt by higher-cost producers. The magnitude of the forces now at work--which bring major uncertainties for producers both from the demand side and the supply side--suggest that the financial situation in the sector may need to be monitored even more carefully than usual as we move ahead.

Additionally, I would like to note that we at the Federal Reserve are often asked by representatives of troubled sectors of the economy whether their voices truly are heard in our policy proceedings. I can assure you that they are, most notably in the reports on regional economic conditions that are a regular part of the preparations for the meetings of the Federal Open Market Committee and in reports from Reserve Bank presidents that are a regular part of the policy discussions themselves. Monetary policy decisions, of course, must be directed toward what is deemed to be the best path for the economy as a whole. In today's integrated national markets, the Fed can no longer have different monetary policies for different Federal Reserve Districts as was the case in our very early years.

Quite apart from the attention that various sectors of the economy get in our deliberations on monetary policy, the Federal Reserve's responsibility in monitoring the safety and soundness of the banking system requires us to seek better understanding of the regional and sectoral composition of changes in prices and activity and of their effects on finance. Among other things, we have devoted special attention over the years to the collection and interpretation of data from community banks that are heavily involved in agricultural lending, a sector of the economy in which these smaller banks still appear to have a strong comparative advantage. I might note, too, that just a few months ago the Federal Reserve System's commitment to better understanding of the economic and financial conditions in rural parts of the nation was reaffirmed by the Federal Reserve Bank of Kansas City's creation of a new research unit, the Center for the Study of Rural America.

In closing let me say just a few words on financial modernization legislation now before the Congress. A broad consensus has finally arisen in this country that the vast changes in financial innovation currently in train necessitate a structure of supervision that will enable our financial institutions to progress in a safe and sound 21st century environment. A critical choice in building that new supervisory system rests on whether the new powers granted under H.R. 10 are required to be housed in an affiliate of a holding company or are allowed to function in a subsidiary of a commercial bank. This choice will have profound implications to the safety and soundness of American finance as we move forward.

We at the Federal Reserve believe that the new powers should be housed in holding company affiliates and thereby be financed in the marketplace at competitive costs of capital, not in an op-sub inappropriately employing subsidized safety net equity capital. To fully empower an op-sub in our judgment would be to compromise safety and soundness of our future financial structure. There are numerous other potential provisions in the pending legislation that would affect safety and soundness, such as the so-called unitary thrift loophole.

I am confident in the end, however, that a sensible, new, and hopefully less burdensome regulatory structure will evolve out of the current negotiations. This would be an outcome welcomed by our financial system as we move into the next millennium.

# # # #