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STATEMENT

BY

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BEFORE THE

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OF THE

JOINT ECONOMIC COMMITTEE

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I am pleased to have the opportunity to participate this morning in your hearings on the importance of agriculture to the U.S. economy. You asked me to discuss the impact on agriculture of developments in the general economy and financial markets. Although conditions in the agricultural sector depend very importantly on circumstances unique to that sector, over recent years its performance has in some respects become increasingly tied to events in the rest of the economy. During the past decade, in the absence of large surplus stocks of farm commodities, crop production problems and changes in demand for farm output, whether in the U.S. or abroad, have been transmitted more rapidly to changes in the price and availability of farm products. In similar fashion, cyclical changes in the general level of interest rates have recently been reflected more quickly and completely in the cost of funds borrowed by farmers.

Agriculture, like many other sectors of the U.S. economy, has been affected by the related ailments of high inflation, high interest rates and sluggish economic activity that have plagued us for the last few years. The failure of consumer incomes to grow, after taking account of inflation, has limited demand for many farm products, particularly meat. With favorable weather in many areas of the country spurring production at the same time, retail food prices this year seem certain to register their smallest increase since 1976. Prices for meats and livestock have actually fallen this year, reflecting a shift in consumers' preferences that may have been accentuated by the uncertain economic environment. The softness in agricultural prices has helped to slow the overall rate of inflation this year--which, of course, is what we are all trying to achieve.

For the farmer, however, relatively stable prices have meant little growth in gross farm income. Other prices, unfortunately, have not stopped rising--including those paid by farmers for the goods necessary to produce

their output. Prices of production goods and services purchased from the nonfarm sector rose by 11 percent in 1981, following a 16 percent increase in 1980. The result has been a marked decline in net farm income. Moreover, not only has inflation reduced farm earnings, it has also eroded the purchasing power of this net income. In response, farmers have pared their purchases of new equipment sharply, placing great stress on the manufacturers in this sector. Thus inflation has played a major and direct role in causing difficulties for farmers and in related industries.

Inflation also has affected the agricultural sector through its influence on interest rates. When prices are expected to rise lenders seek to be compensated for being repaid in funds of reduced purchasing power by receiving a higher return on their loans. Many borrowers often are willing to pay these higher rates, because they expect the goods they are purchasing on credit will be more expensive if they wait. As a result, the rapid inflation we have experienced in recent years has been associated with historically high interest rates.

Prior to 1979, farmers borrowing from rural banks were largely insulated from fluctuations in interest rates in national markets, because these changes had little effect on the cost of funds at such banks. The introduction of smaller time deposits with ceiling rates tied to money market rates has changed that situation, however. By September 30 of this year, 6-month money-market certificates of deposit represented 30 percent of total resources at agricultural banks and large-denomination certificates accounted for another 7 percent; thus, well over a third of the footings of these banks were in the form of short-term deposits carrying market-related rates. In addition, most rural banks have been offering longer-term "small saver" certificates, which,

beginning this summer, have been issued at market-related rates. Consequently, when market interest rates increased sharply during the past spring and summer, the rising cost of funds at rural banks led to higher rates on farm loans. Even so, at their peaks, these rates remained below the prime rate at large banks. The average effective rate on farm loans at the smaller banks had reached 19.1 percent at the time of our quarterly survey conducted during the first week of August, when the prime rate at large banks was 20-1/2 percent.

Although the shift to market-related yields on the liabilities of smaller and rural banks has caused loan rates at these institutions to fluctuate with changes in market rates, there have been offsetting benefits to rural communities. Rural residents, including farmers, have been able to obtain market-related yields on their deposits in local institutions. The capacity of rural banks to compete more successfully for savings has allowed them to maintain or increase their lending ability during a period in which it would probably otherwise have been impaired. The ample liquidity and lending capacity of rural banks is illustrated by the relatively low level of their average loan-to-deposit ratios recently. Currently this measure is around 61 percent, down from 68 percent two years ago, despite growth in loans over this period. Credit has remained available to farmers, albeit at very high rates.

The rise in interest rates has greatly aggravated cash flow difficulties for those farmers who are both highly leveraged--operating at high debt-to-asset ratios--and relying on short-term financing. When one looks at the agricultural sector as a whole, however, it appears that farmers in this particularly vulnerable credit position are a small proportion of all farmers.

The average debt-to-asset ratio in agriculture is only 18 percent--less than half the average ratio found in nonfinancial corporate business. Furthermore, the average interest rate being paid on all outstanding farm debt has risen relatively slowly, and for 1981 is estimated at about 10-1/4 percent, up less than 2 percentage points from 1979. Much outstanding debt was incurred in earlier years at lower fixed rates and for long periods from sellers of farms, life insurance companies, and other mortgage lenders, or from Federal Land Banks whose variable rates have risen relatively slowly; also, a significant proportion of recent new debt consisted of drought-related Farmers Home Administration loans made at below-market rates. The increase in interest costs that has resulted from the rise in rates accounts for a relatively small part--less than one-fifth--of the drop in real net earnings of the farm sector since 1979.

By the same token, the reduction in interest rates that has occurred in the last few months is unlikely to produce dramatic improvement in the financial situation of the farming sector as a whole. The increase in total interest costs will be slowed, but average rates on new loans would have to fall below 11 percent in order to reverse the upward climb in the average rate on all debt. However, the ongoing drop in market and farm loan rates will greatly aid those highly-leveraged users of short-term loans who were hardest hit as rates rose.

The recent declines in interest rates appear to stem primarily from reductions in private demands for money and credit associated with a weakening economy--a combination that implies costs as well as benefits to farmers. Longer-term relief will not come until we see a pronounced and continuing moderation in the inflation that has gripped this country for more than a

decade. Reduced inflation will bring with it permanently lower interest rates and will set the stage for a resumption of sustained economic growth.

The Federal Reserve is following a strategy designed to bring this about. We have announced our intention to reduce gradually growth in money and credit to rates consistent with stable noninflationary economic growth. The course will not be smooth. In a world of volatile expectations and rapid changes in financial practices we cannot guarantee the achievement of our objectives for monetary expansion over short periods, nor perhaps should we attempt to do so. Moreover, even a stable growth path for money and credit may be associated with considerable volatility in the level and pattern of spending as the economy adapts to slowing inflation rates.

The current downturn in economic activity is an unfortunate example of this. I believe that the decline will be limited, partly because the recent downward movement in interest rates will buoy demands in credit-sensitive sectors. It would be a grave mistake, in my view, for the Federal Reserve to attempt to turn the economy around by greatly accelerating money growth. Such a policy might result initially in lower interest rates and a faster rebound in activity, but it would also signal once again a lack of resolve in combatting inflation. The ultimate outcome would be higher inflation and interest rates and additional strains on our economy and financial system. This outcome can be prevented if the Federal Reserve sticks to its longer run policy, and we are determined to do so.

The transition to an economy of noninflationary growth will not be easy. The problems we are facing have been building up for many years, and we cannot expect quick or painless solutions to them. Moreover, heavy reliance on monetary policy to accomplish this goal puts particular stress on those sectors of

the economy that are sensitive to changes in the cost and availability of credit--and agriculture falls increasingly into this category. The adjustment would be swifter and more equitable, were the federal government's budget policy working to reinforce the thrust of monetary policy. This does not appear to be in prospect, given the very large gaps now expected between receipts and expenditures in coming years. High budget deficits put additional strain on private borrowers, because in effect the government has first call on the nation's pool of savings. Reducing government competition for these funds would lower interest rates and encourage private spending initiatives. As important as the direct effect of lower deficits on financial markets, in my view, would be the perception fostered by a better outlook for budget balance that policy throughout the government was being formulated to accomplish the same goal. One reason that inflation has persisted at such a high level in the face of generally weak economic activity is that the public is not yet convinced that government will follow a sustained and consistent policy to end it. We must convince businessmen, farmers, consumers, and wage earners that they can no longer plan on continuing price increases--that all elements of government policy are dedicated to stopping inflation and will persist until they succeed.