THE NEED FOR AND AVAILABILITY OF AGRICULTURAL CREDIT

Remarks by Chas. N. Shepardson, Member, Board of Governors, Federal Reserve System, at stockholders' meeting of The Federal Land Bank of Houston, Houston, Texas, on February 21, 1956.

For twenty-seven years it was my privilege, as a member of the staff of A. and M. College, to meet with numerous farm groups throughout the State and to discuss with them some of our Texas farm problems. On this occasion, President Evans has asked me, as a member of the Federal Reserve Board, to discuss the need for and the probable cost, source and availability of funds to finance our agricultural operations. Frankly, I would feel much more at home in coming before this group as the Dean of Agriculture at A. and M. than I do in my present position, and certainly I can talk much more freely about the need for money than I can about its probable cost or availability.

I need not tell this group about the increase in capital requirements for agriculture. Most of you have faced that problem at first-hand. You are well aware of the fact that both investment and operating capital needs have practically quadrupled in the past fifteen years. In fact, the investment per worker in agriculture is now greater than it is in industry. Off-hand, the increased capital requirement might be considered an added burden on the farmer. Actually, this had to come about if agriculture was to attain true parity of earning power with the rest of our economy.

The high standard of living that we enjoy in this country is primarily a result of our high level of productive capacity per man-hour of labor in American industry. This increased productivity is largely the result of mechanization and technological improvement in production methods. Fundamentally, it is the substitution of capital in the form of mechanized power, equipment and facilities for human and animal labor. This, in turn, has not only increased the capital requirements of agriculture but it has also brought about a radical change in the type and amount of agricultural credit required to meet this need.

Few farmers, and especially few young farmers, can hope to acquire their total capital requirements early in their farming experience. They are going to have to depend upon larger amounts of credit and for longer periods than have heretofore been customary. Their credit worthiness needs to be determined by their technological "know-how", the adequacy of their plant, and the soundness of their plan of operation rather than by tangible collateral and willingness to work regardless of the effectiveness of that work. In fact, while we talk about the need for more credit, it appears that in some cases there may have been too much extension of credit merely because there was adequate collateral and the borrower was a deserving individual even though his operation was a losing one, resulting in a gradual attrition of his assets.

I mentioned earlier the relationship of productivity to parity of earning power. It seems anomalous to find agriculture suffering from burdensome surpluses and depressed prices in the face of an otherwise generally prosperous economy and a record level of consumer buying power. Actually, much of this situation stems from price incentives that have stimulated production beyond our capacity to consume and have hampered the development or even retention of our historic foreign outlets. It has also resulted in the continuation of many inefficient operations which would otherwise have been diverted to other uses. It would therefore seem that more selectivity in credit extension might contribute to the long-run solution of our over-all farm problem.

Now as to the cost and availability of funds for financing the legitimate needs of agriculture. Quite obviously, this is but a part of the all-important problem of maintaining the stable economic growth and development of the nation as a whole. Any solution to the special problems of agriculture must presuppose a stable economy, expanding steadily at a rate which can be sustained. Booms and busts are wasteful and damaging to all sectors of our economy but, as many of us can well remember, they are ruinous for the farmer. For this reason, I want to take this opportunity to discuss some of the problems of over-all economic stability as we see them at the Federal Reserve Board.

First, let me remind you that, while everyone fears deflation and too many people feel that a little inflation is a good thing, the most effective prevention of deflation is an adequate restraint of inflation. Rising levels of prosperity achieved through increased productivity at a stable level of prices should be our objective. The principal function of the Federal Reserve System is to provide the credit necessary to support a sustainable economic growth while maintaining the value of the dollar.

In many ways, 1955 provided us with some excellent illustrations of the problems involved in the attainment of stable economic growth. In the United States and in most other countries, it was a year in which output and employment advanced to new record levels. By the beginning of the year we had largely recovered from the moderate declines of late 1953 and 1954, and by mid-year our available resources were being intensively utilized despite an increase in the size of the labor force and in industrial capacity and productivity. Taken altogether, 1955 was a year of prosperity and plenty for the economy as a whole although it did not extend to all phases of the economy. Some lines of industrial activity did not share fully in the broad advance and agriculture, as we all know, actually suffered a further decline in the downward trend of recent years.

Many forces combine to determine the rate of economic activity and the general levels of employment and prices. One important factor is the cost and availability of credit and it is on this factor, of course, that the Federal Reserve System is able to exert some influence. Much has been said and written in recent years about the importance or potency of monetary policy in the maintenance of economic stability. There is no doubt in my mind that the proper adjustment of credit cost and availability to changing economic conditions is a vital, indeed indispensable, element in any valid approach to long-term economic growth and stability.

On the other hand, it is important to recognize that there are other elements in the picture together with the imperfections of human judgments in the administration of monetary and credit policy which affect stability. As a result, it is inevitable and possibly even desirable that there be some mild fluctuations in the rate of our economic growth. When demand is pressing on capacity, maladjustments and inefficiencies are apt to develop, which can be corrected only in periods of reduced pressure.

Recognizing these variations in growth pressures and in order to make their maximum possible contribution to stable economic growth, our monetary policies must obviously shift from time to time -- relaxing to encourage a more rapid expansion of credit than would otherwise occur in some circumstances and tightening at others to restrain overrapid credit growth. This flexible adjustment of credit policy to changing economic conditions is not only essential to the best interests of the nation as a whole but to the establishment of a proper setting for the essential readjustments in the agricultural segment.

It is not too difficult to persuade people of the desirability of expanding credit availability and lowering credit costs when economic activity slackens. The only criticism one is likely to encounter with respect to such actions is that they are either too little or too late.

On the other hand, the imposition of some restraint on credit expansion and the increasesin interest rates, which inevitably accompany it, are never popular and in almost every sector of the economy you can find people who will argue that the over-all restraint on credit growth works special hardships on their particular business.

I do not believe, nor do I mean to suggest, that there is any insincerity about these arguments. The pain of credit restraint is felt directly while the benefits are indirect -- largely in terms of things that do not happen. For example, if our general credit policy results in some limitation on the growth of real estate credit, builders feel the impact directly while the benefit, in the form of some restraint on the upward spiral of material and other building costs, is not so obvious. The long-term advantage to them of moderating wide swings in over-all economic activity,which cause major fluctuations in employment, income and prices, seems very remote indeed as compared with the profit they might make on the additional units they could build if they could just get the financing.

I would like to believe that farmers and, perhaps even more importantly, the officers of institutions concerned with farm financing are a little more sophisticated about this than people in some other sectors of our economy.

You are familiar with the operation of markets and their response to supply and demand pressures and are frequently reminded that an excessive fluctuation in one direction or the other is likely to be counterbalanced shortly by an opposite movement. In fact, the present depressed condition of the livestock market is a timely illustration of the effect of the over-exuberance which those markets enjoyed in recent years. These and similar fluctuations in other farm commodities lead us to wonder if farm lenders always exercise the prudent restraint of credit that our knowledge of these cyclical swings would justify. But it is true in farming, as in other segments of the economy, that the pain -- in the form of increased interest cost and more limited credit availability -- is much more apparent than the benefits, which must be found in cost increases which did not occur.

If we look at the whole picture, it is obvious that relatively small changes in interest cost, which represent only a small fraction of the total cost of farm operation, cannot be compared with the importance of retraining inflationary pressures on the price of those other non-farm goods and services which comprise ~~ninety-five~~ seventy per cent or more of total farm costs.

In this connection, too, it is important to recognize that an undue rise in prices drives consumers out of the market. It is often a slow and expensive process to get them back.. Agriculture is suffering from just that condition at the present time in many commodities, notably cotton, beef, pork and butter. We should also remember the importance to agriculture of a growing economy which can afford reasonable employment opportunities for those who must inevitably leave farming, as the progress of mechanization and other technical improvements reduces still further the percentage of our population needed to maintain farm output.

Coming back to 1955 and the developments which took place during that year, it is no secret that the Federal Reserve System directed its efforts toward credit restraint from the spring of the year. The results of these efforts have been widely discussed and commented upon and the casual reader might well gain the impression that these policy actions resulted in a sharp curtailment in lending activity during the year. I am sure you all realize that this was not the case but I wonder if you had observed that in fact 1955 witnessed the largest expansion in the dollar volume of loans at commercial banks in our entire history -- amounting to about 11 billion dollars. I mention this rather striking figure to emphasize that credit policy was not directed toward, nor did it accomplish, any reduction or even leveling of the volume of credit available to the private economy. What it attempted to do was to bring about some restraint on the rate of expansion. There was never any question that some growth in the volume of bank credit to meet the needs of our expanding economy is both necessary and desirable. The only valid limit on the rate of our economic growth is found in the emergency of inflationary pressures, resulting from an excessive rate of expansion and giving rise to maladjustments which lead to potentially serious reversals.

To accomplish the proper degree of restraint, the Federal Reserve System took several types of action during 1955. Open market operations were conducted so as to bring about greater reliance on member bank borrowing from the Federal Reserve Banks during the year. While the Federal Reserve reduced its portfolio of Government securities only slightly over the year, growing demands for currency and credit were reflected in increasing pressure on bank reserve positions. Member bank indebtedness to the Federal Reserve Banks, which had been about $150 million in the last quarter of 1954, averaged more than $900 million in the last quarter of 1955. Excess reserves also declined during the year.

Transactions in the System open market account were timed, of course, to correspond to seasonal changes in the demand for credit and seasonal needs for currency in circulation. In January and February, when bank reserves were made available by a return flow of currency from circulation and a seasonal reduction in deposits and required reserves, the System sold, or allowed to mature, about 1.3 billion of its holdings, thus absorbing reserves which could otherwise have served as the base for credit and deposit expansion. In view of the strong demand for credit, member bank borrowing increased somewhat in these and later months.

Early in July, anticipating the normal seasonal needs for additional funds in the second half of the year, the System supplied reserves through open market purchases of securities. This regular adjustment of banks' reserve positions to meet the needs of commerce, industry, and agriculture has become so customary that it attracts little attention, but I believe it is worth pointing out that even in a period when we are frankly concerned about the rate of credit growth -- as we were in mid-1955 -- it is necessary to expand the credit base to allow for these normal needs.

As the summer and fall progressed, it was apparent that credit demands were increasing more rapidly than normal seasonal factors would require and this excess demand was allowed to express itself in increased member bank borrowing from the Reserve Banks.

In November and December we carried out further purchases of securities in the market to meet the usual seasonal needs, thus supplying reserve funds to provide for both the credit and currency needs associated with the harvesting and movement of crops and the relatively high level of retail trade during the latter months in the year. In late December, as in the same period of most other recent years, the Federal Reserve purchased securities under repurchase agreements with dealers and brokers in order to moderate year-end money market pressures.

The persistent strong demand for credit throughout the year, pressing on the limited supply of loanable funds, resulted in upward pressure on interest rates, especially in the short end of the market. The consistent pursuit of the System's policy of restraint under these circumstances called for increases in the discount rates at the Federal Reserve Banks. During the year discount rates were increased from 1-1/2 to 2-1/2 per cent in all Federal Reserve Districts. By making borrowing more expensive, these increases tended to discourage excessive reliance on borrowing by individual member banks and thus to moderate expansion of bank reserves through borrowing.

The exact timing and magnitude of the changes in the rediscount rate, which are called for in particular circumstances, can never be ascertained with exactitude by any mechanical formula. These are matters of judgment which the Federal Reserve Act wisely prescribes shall be determined after a careful review of economic conditions at both the local and national level. Initial responsibility falls on the officers and directors of the twelve Federal Reserve Banks but the final review and determination is the duty of the Board of Governors in Washington. Both technically and in fact, a decision to change the rate of rediscount for the country, as a whole, is arrived at only after careful consideration by over 100 directors at the various Federal Reserve Banks. Their judgments are based on their own knowledge of credit and economic conditions in their various areas and the best information that can be assembled by the officers of each Federal Reserve Bank. These decisions are then weighed and evaluated by the Board in Washington, with the assistance of its technical staff, and it is only after this painstaking review that a new rate is determined in accordance with Sec. 14(d) of the Federal Reserve Act. This happened four times in 1955 and I assure you that in each case the final action was taken only after the most careful and detailed consideration.

As stated before, the paramount objective of the Federal Reserve System in its determination of monetary policy must continue to be over-all growth and stability. The System should, and I am sure it will, continue to adjust its policies to allow for seasonal fluctuations in the currency and credit needs of the economy. Without duplicating the work of public or private agencies which have a primary responsibility to agriculture, it should contribute all it can to a better understanding of the credit needs of agriculture and the best and most economical methods of financing farm production --- including, of course, the collection and publication of the information on farm lending, which is our appropriate responsibility. From time to time it can and does lend its support to other research or educational activities which we hope will make some contribution to the welfare of the agricultural sector. In its supervisory capacity, the System should make an effort to assure the adequacy of the banking structure, in both rural and urban areas, and to encourage lending policies which will insure the availability of credit for constructive purposes to farmers and small businessmen alike.

This is about as far, it seems to me, as the Federal Reserve System should go. If, as a part of the Federal farm program, it is determined that some further special arrangements must be made with respect to agricultural financing, these should properly fall within the framework of the institutions and agencies which have been established by law to deal specifically with farm credit. As I have indicated on other occasions, I feel that the credit needs of agriculture are changing with technological developments and with the shift to larger units and increased capital investment. It is certainly vital that lending institutions should be prepared to meet these shifting needs if we are to emerge from our present difficulties with a healthy, adequately financed, agricultural sector. But these are not matters in which the Federal Reserve System -- a central bank -- should intervene. They call for a flexible and farsighted lending policy on the part of banks and other lending institutions and for a better utilization of the available pool of trained specialists who understand farm planning and can help both the farmer and lender develop plans which will result in good loans on creditworthy and profitable farm operations.

As you all know, it is not the policy of the Federal Reserve Board to interpret its current actions in the policy field or to make predictions as to the future course of events. We issue a weekly statement which shows exactly the changes in our portfolio during the preceding week -- and leave it to the market to evaluate these operations. Therefore, you will appreciate that I must be somewhat circumspect in commenting on the current situation regarding the cost and availability of funds -- and likely developments over the coming months. As the Chairman of the Board recently testified before a Joint Committee of the Congress, we regard the present period as one in which we "must feel our way" very cautiously.

It should be borne in mind that the strength and effectiveness of monetary policy lie in its flexibility. While it must be constantly alert to the need for restraint of inflationary pressures, it must be equally sensitive to the need for cushioning any recessionary tendencies. Consequently, it is impossible to predict either the cost and availability of credit or the direction of monetary policy since this will be dependent upon the day-to-day direction of pressures in the economy with the System, serving much as a shock absorber to dampen the effect of pressures in either direction.

One thing seems reasonably certain -- the supply of loanable funds available in 1956 will be very large. Just the normal stream of repayments on instalment contracts and mortgage loans is tremendous. If credit is relatively tight in 1956, it will be because loan demand is high and business is very active. If, as many people expect, these demands are not as keen this year as last, it would be reasonable to conclude that credit availability might be somewhat easier in the period ahead. Our general feeling is one of cautious optimism and sincere hope that we can contribute our part to the stable development of this country's resources, so many of which are found here in the Great Southwest.

These remarks have been on what I have discovered people in Washington refer to as the national level -- that is, I have been talking of the country as a whole -- while, naturally enough, you are much more interested in your own area. On this, all I can do is to paraphrase the rather famous remark of a high official in Government -- "What's good for Texas, is good for the country", and vice versa.

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