AVAILABILITY AND COST OF AGRICULTURAL CREDIT

Remarks by Chas. N. Shepardson, Member, Board of Governors, Federal Reserve System, at meeting of Federal Intermediate Credit Bank of Houston, at Austin, Texas, on March 7, 1960.

When Mr. Stokes talked to me about this meeting, he suggested that you would be interested in anything dealing with the economic situation as it related to agriculture and particularly the future cost and availability of agricultural credit.

Let me start by describing one general development of great importance -- one that has happened so slowly that we may have failed to notice it. Agricultural credit is no longer an isolated or local problem. It is subject to the same influences that affect the rest of the economic community and must bear its share of the problem of balancing the national demand for credit with the supply of saving. In recent years credit markets have become more unified because of better information and communication. Funds that originate in one section of the country are no longer confined to outlets in that area but seek the most advantageous investment outlet throughout the economy. By the same token, those in need of funds have access not merely to local sources but access to many other sources of credit. As many of you in this audience will recall, this has not always been true. I can remember the time when local credit conditions were insulated to a considerable degree from general credit conditions in the nation. One great impetus for development of agricultural credit agencies, such as the institution which is host to this meeting, came from an effort to make credit available to farmers from a wider range of sources. The growth in size and strength of the whole farm credit system is evidence of the success that has been achieved in reaching that goal.

Another factor that must be recognized in this connection is the decline in the proportion of agricultural credit to total credit. In 1929, the first year for which we have reliable figures, farm debt was about 6 1/2 per cent of total debt. In 1959, this relationship had sunk to less than 3 per cent. The reason for this relative decline, of course, is that farm production is a declining part of total production; over the same thirty-year stretch the ratio of agricultural product to total product declined from 9 1/2 per cent to about 4 1/2 per cent. It is interesting to note, however, that the ratio of farm debt to farm product ended this three-decade interval at about the level at which it started. There was $1.25 of debt for each dollar of farm product in 1929; by 1959, debt for each dollar of product was $1.20. At times in the intervening period, farm debt was at a somewhat lower level but it might be said that farm debt has now returned to about the same position as it was before the Great Depression.

While the use of capital in farming is relatively greater per worker than in manufacturing, the relationship of debt to product is very nearly the same for agriculture as it is for other private business activity.

Credit availability and cost in the recent past

In considering the cost and availability of credit, experience in the credit markets during 1959 may be a valuable indicator as to the likely course of developments in the period ahead. During the past year, the expansion of total credit outstanding exceeded 60 billions of dollars.

This large sum was not only an all-time record; it represented an increase of almost a third over the preceding year. Thus, it can hardly be said that credit availability was limited to any significant degree in 1959 although one of the inevitable results of this great pressure on credit markets was a considerable increase in credit costs.

The Balance of Supply and Demand

Since the cost and availability of credit is largely determined by the balance between supply and demand, I would like to call your attention to some of the principal factors involved in this problem.

The Financial Needs of Federal Government

One factor of great significance is that the combined demands of Federal and State and local governments accounted for almost one-third of the gross credit extended in 1959. This year the expected credit needs of the Federal Government should be greatly reduced and it should be a net supplier of funds on balance. This is shown in the first of the charts that have been distributed to the audience. (Chart 0506) The Federal Government should be able to repay about $7 billion in the first half of calendar 1960. This will be a considerable improvement over the first half of 1959 when the Federal Government was forced to increase its debt by nearly a billion dollars. The second half of 1960, the Federal Government will be a net borrower, as is usual at that time of year, but by much less than the amount repaid in the first half of the year and by a much smaller amount than in recent years.

State and Local Governments. Year by year, State and local governments have been taking increasingly larger amounts of funds from the capital markets. The amount taken in 1959 was close to a record level even though the amounts borrowed for the more speculative revenue projects, such as toll roads, were considerably reduced from earlier periods. Both the number of bond authorizations that have been voted and the building and construction plans of State and local governments indicate that they will probably continue to be relatively strong factors in the market for funds.

An interesting relationship has recently developed in the market for State and local government obligations. Several of the principal investors in these obligations are alternatively investors in the stock market. This fact may account for the apparent tendency of the stock market and the market for State and local government securities to move in a reciprocal fashion. When one goes up, the other seems to go down.

Corporate Demands for Funds. In 1959, corporations borrowed slightly less than in 1958 although capital expenditures were starting to increase from the rather low point reached in the preceding year. This apparent inconsistency of corporate activity is largely explained by the very rapid increase in the generation of internal funds in 1959, as shown in the second of the two small charts distributed. (Chart 0610) It is possible, of course, that businesses may accumulate inventories at a rate which will lead to some increased demand for bank credit. The extent to which inventory accumulation will or should proceed, however, remains unsettled and this factor is likely to be more important in the central money markets than in the capital markets.

Demand for Funds for Construction. Mortgage debt outstanding increased more than $19 billion to a total of $191 billion in 1959, more than any other single class of debt. Analysts of the residential construction outlook have generally felt that in 1960 it probably will not reach the very high level of 1959. The accompanying chart indicates the tapering off since mid-1959. (Chart 0705) On the other hand, relatively little drop in construction activity is forecast. If this is the outcome, it might be expected that the amount of funds needed in this market will continue at a high level.

Foreign Capital Demands. Although the number of foreign capital issues offered to portfolio investors in our open capital markets has been relatively small for many years, at any juncture at which our markets become favorable relative to the rest of the world, such issues tend to appear. At the present time, interest rates in most areas of the world are as high or higher than here so that a certain number of these issues is likely to be offered on our market though probably not in greatly changed quantities from other years.

Consumer Credit. Consumer demand for credit in 1959 was at a near record level. Consumer credit outstanding increased $6.5 billion during the year to a total of approximately $52 billion. At present it is hard to find conclusive evidence of any significant change in either direction in the demand from this quarter in 1960. The outcome will depend in no small measure on the future of automobile sales. The balance of instalment credit extended and repaid is shown in the fourth small chart. (Chart 0804)

The Supply of Funds

The supply of funds for the capital money markets, aside from commercial bank credit expansion, depends primarily on the saving of business and of consumers. As already indicated in the discussion of corporation finance, business savings were quite high in 1959. Whether or not they can continue to be as high in 1960 is uncertain. At the moment, no one can make a useful forecast with respect to the principal unknown element in this judgment, which is, of course, corporate profits. Depreciation allowances are sure to continue quite large but the profits segment, which is residual to these allowances, varies greatly. It might be expected that some of the factors which worked to expand profits in 1959 may not be quite as strong at the present time or in the months immediately ahead.

Saving in financial form by consumers was large in 1959 but other forms of personal saving were less. The bars in the accompanying chart show that an unusually large proportion of such saving was channeled into stocks and bonds, which are labeled with the somewhat more formal title of "credit and equity market instruments" in this chart. (Chart, page 5, January 1960 Bulletin) Even if their total saving in 1960 should be fairly large, consumers may elect to put less into financial form and more into durable goods or other forms of "real" investment.

Bank Loans. Whether or not banks can lend as much in 1960 as in 1959 is an open question. In order to do so, they would have to liquidate rather sizable amounts of securities from their portfolios. This was possible in 1959 since a great many nonbank investors were attracted into the market for U. S. Government securities. The extent to which such a shifting of funds can be repeated in 1960, however, is not clear. The accompanying chart shows both bank loan increase and investment liquidation in 1959. (Chart 0303) You will note that funds for a loan expansion of almost $12 billion were provided in large part by the sale to other investors of $8 billion of government securities.

The Financial Environment

A number of additional elements in the financial environment deserve to be noted before summing up the expected state of the money and capital markets.

Liquidity. When commercial banks emerged from World War II, they had far more liquidity than was needed for operating reasons. In each post-war boom period they tended to reduce this liquidity somewhat in the process of making loans. In the very short recessions of 1949, 1954, and 1958, this process was briefly reversed as some increase in liquidity took place. Nevertheless, at the corresponding phase of each of these cycles of business activity, banking liquidity was somewhat lower. Unquestionably, some banks are now beginning to feel that they have all the loans they can service and would find any further conversion of investments into loans a difficult process. The number of banks in this situation is far from clear but as the number increases, as it unquestionably will, there will tend to be a greater degree of tension in the money and capital markets than has been faced in recent years.

World Markets. Another factor of renewed importance is that the United States can no longer consider its dollar to be exempt from the discipline of world markets or world opinion. During the years when our world trade position seemed to be impregnable, short-term changes in the balance of payments were not a matter of grave concern. Now they are, and the persisting balance against us must be settled by gold or by accepting larger dollar liabilities to foreigners. These foreign funds invested in our markets stay here, to some extent, according to the attractiveness of interest rates in our markets. The extent to which our rates can be under world rates for long is an open question.

I do not wish to suggest that this is an insurmountable problem but it does point up the importance of maintaining confidence in the value of the dollar and of improving our competitive position in world trade. As the accompanying chart shows, a gap in our balance of payments has existed for a number of years (Chart 1716), due in part to the narrowing of our actual trade balance and in part to the continuing high level of government grants, loans, and foreign military operations.

Capital Productivity. Still another special factor at work in the money and capital market is the demonstrable growth in the productivity of capital. The doctrine of economic maturity that was expounded in the 1930's has been proven utterly fallacious. Capital has continued to be increasingly productive in many fields. Those seeking capital in the markets can frequently afford to pay stiff rates of interest for funds because the use of capital turns out to be so profitable. The expansion of markets, as well as the development of technology, seems to be maintaining and possibly increasing the productivity of capital. This tendency is further augmented by the continuing upward pressure on labor costs. This experience creates a constantly increasing degree of pressure from the demand side of the market.

Rate of Earnings on Farm Lands

The observation I made above with respect to the general productivity of capital brings to mind a problem of special interest to this audience: the relationship between the prices on farm land and the rate of return that is earned in the use of such land. As you are all aware, until very recently farm land values continued to increase in spite of the downward trend in farm income. (See Chart 1602) At the present moment, however, a pause in the advance of farm land prices seems to be occurring, a point deserving of considerable and respectful attention.

A recent tri-annual report on "The Farm Real Estate Market," released by the U. S. Department of Agriculture, presented an estimate indicating that in four of the last five years the rate of return earned by farmers on all of their real estate was less than 5 per cent per annum. The same study indicated that in the year 1959 the rate of return approached the very low level of 3 per cent. This is surely an unusually low rate. It is sobering to reflect on the implications of this considerable decline in the earnings rate. Is it surprising that the demand for farm land has subsided when earnings on farm land now are materially below the yields on the securities of our Federal Government? Operating farmers may have found it profitable to increase the size of their holdings in order to make more economic use of machinery and other fixed investments. At some price level, however, this practice becomes uneconomic. City investors may have found farm land investment disillusioning, particularly when bonds offer such fine returns. Of course, a renewed fear of inflationary developments, a renewal which I trust we do not experience, could change this situation.

Concluding Comment.

While you might like to have me combine all of these factors into an explicit forecast of future developments in the financial markets, I am sure you recognize how improper it would be for me to do so. In any event, the most significant economic determinants of the future cost and availability of credit lie in the shape of business developments and they are beyond the certain knowledge of any of us. I have no magic sources of information that reveal the answer. An interesting chandelier hangs in the main corridor of the lobby of the Federal Reserve building in Washington near the C Street entrance. This globular chandelier is surrounded by a beautiful crystal disc etched with translucent figures representing the signs of the zodiac. Aside from this one object, we have no crystal balls at the Federal Reserve. Rather, we are dependent upon a continuing process of analysis and appraisal of the day-to-day and long-run economic developments in both the domestic and the international fields. In this work we are fortunate in having the assistance of one of the best if not the best economic research staffs in government. Even so, we have not yet been able to develop a periscope that will enable us to see very far around the next economic corner with any high degree of certainty.

For these reasons I shall not engage in prophecy but I think it might be helpful to outline the kind of developments which would be desirable for our economy. In the first and possibly most important place, I hope that a high rate of personal saving prevails. The need for capital is great and the rewards from the productive use of it are high; adequate saving to meet these needs is essential if we are to have economic growth without inflation. Second, I hope that inventory accumulation does not become excessive. We have learned that it is necessary to live with a certain amount of inventory fluctuation but sizable rates of accumulation are never sustainable for very long. In this connection, I call your attention to the rapid build-up in cattle inventory last year. I would like to see all of our resources, particularly those of presently unemployed labor, absorbed into the stream of economic activity. I certainly hope that business profits and agricultural income are well sustained. The attainment of these last two objectives is dependent in no small measure on a continuing advance in productivity and the greater use of productivity gains for the improvement of our competitive position both at home and abroad. If these various hopes are realized, problems of cost and availability of credit in the capital markets will not arise in any form that need concern us.

Up to this stage I have dealt with matters that relate to the quantity of credit. Let me close by looking briefly at the quality of credit. I mentioned earlier the leveling off or even downturn in some areas in the price of farm land. I understand that there has also been a marked shift in the attitude of many lenders. No longer are they content to look solely to the adequacy of the collateral in either mortgage or short-term lending.

Instead, they are giving increasing attention to the profit and loss statements and pay-out potential of the borrower. In my opinion, this is a most healthy development. In the face of a continuing cost-price squeeze, loans, other than emergency loans, that will not produce a return over and above their repayment requirements are of doubtful value. Furthermore, loans that only serve to prolong an uneconomic operation and a gradual attrition of the borrower's equity are apt to result in loss not only to the borrower but also to the lender and to the community.

Perhaps this point can be generalized into an even broader hope for economic development. It is not enough to hope that gross amounts of saving, capital formation, income, and employment are satisfactory. There should be a dimension of quality to these factors. Saving needs to be buttressed with confidence in the value of money, capital formation needs to be productive, income truly earned and employment truly rewarding if this nation is to realize its true aspirations. And, simple though it may sound, I believe that maintaining the sound quality of credit is one of the important steps necessary to reach this goal.

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Chart 0506

FEDERAL CASH BORROWING

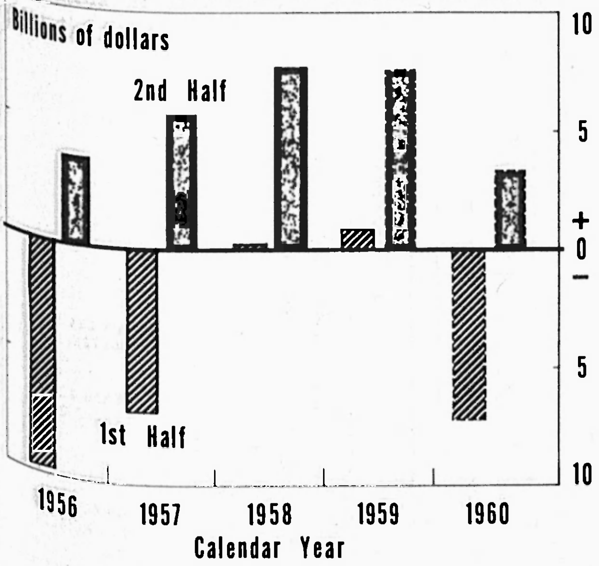


Chart 0610

CORPORATE FINANCE

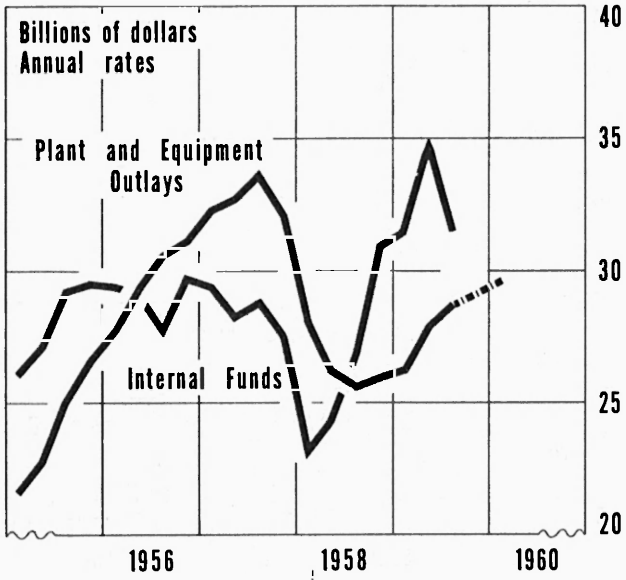


Chart 0705

NEW CONSTRUCTION ACTIVITY

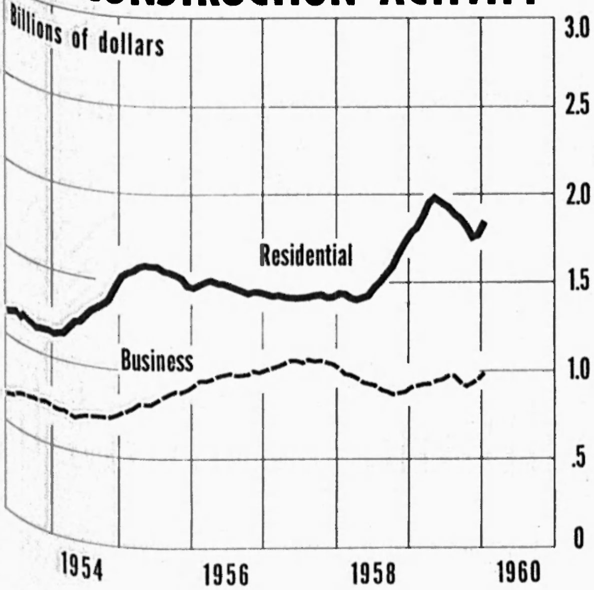
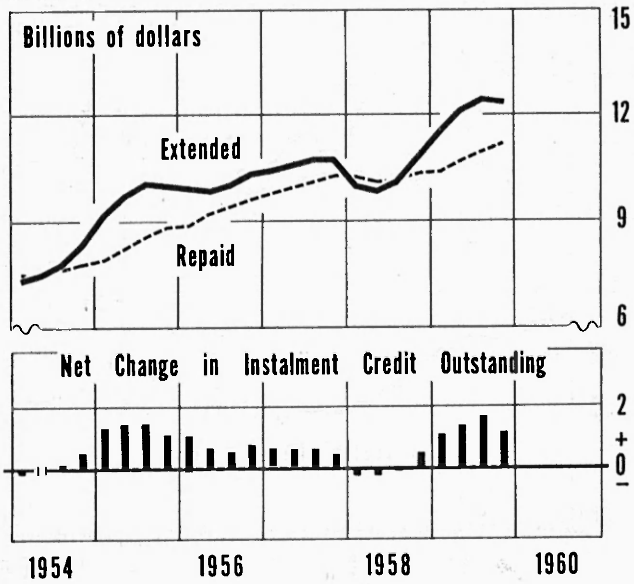


Chart 0804

INSTALMENT CREDIT



Bulletin Chart

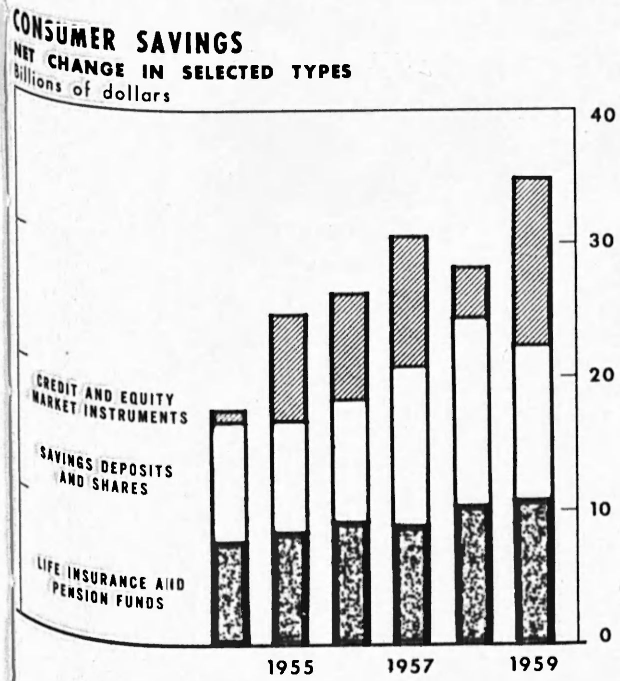


Chart 0303

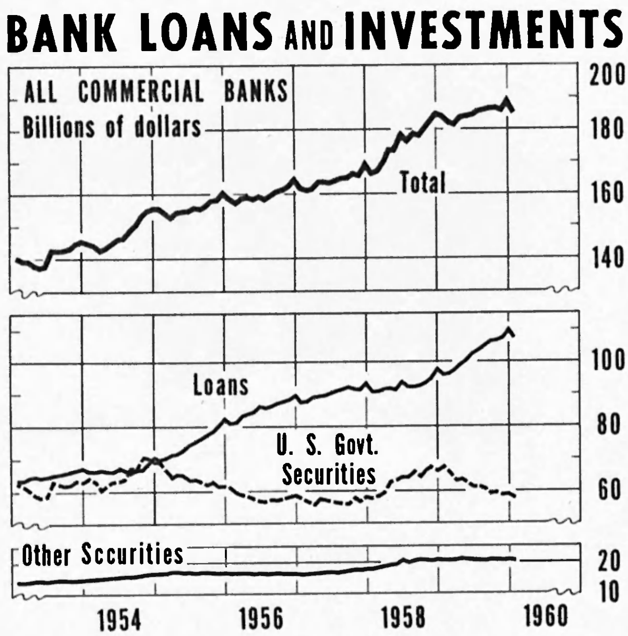


Chart 1716

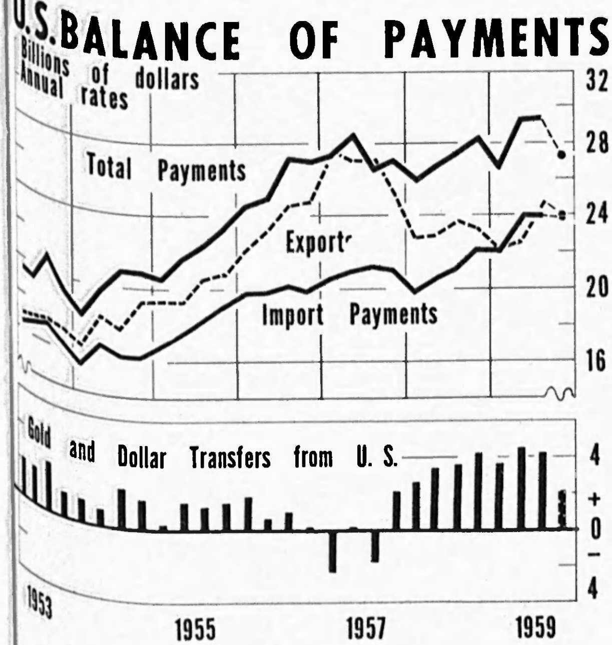


Chart 1602