The Role of the Federal Reserve as Related to Farm Credit Needs in the Current Economic Situation

Remarks by Mr. Chas. N. Shepardson, Member, Board of Governors, Federal Reserve System, before the National Farm Credit Directors' Conference, Hotel Statler, St. Louis, Missouri, on September 26, 1956.

The Current Economic Situation

Let us begin by taking a brief look at the current situation. The economy as a whole is in the midst of a strong expansive movement. Business and consumer attitudes show confidence in the future. With demands pushing against available supplies in important lines and with wage rates rising, both industrial and consumer prices have been advancing to new highs. Prices of farm products have tended to firm this year, following earlier sharp declines, and in August they were above the year-earlier level. Demands for credit are strong both at banks and in the long-term capital markets and interest rates have been advancing. Abroad, too, vigorous demands are continuing to press against available resources in most countries.

Most broad measures of economic activity in this country are at or near their highs. The Board's index of industrial production in August had regained the June level and a rise seems likely in September. Nonfarm employment in August returned to the June record level and unemployment, at 2.2 million, was about the same as a year earlier. In the third quarter, GNP may reach an annual rate of $414 billion, up $6 billion from the preceding quarter despite the steel strike, and up $17 billion or 4 per cent from a year earlier, probably one-third of which reflected higher prices. Another substantial increase in national output appears to be in the making for the fourth quarter with the total likely to approach an annual rate of $420 billion, partly due to anticipated large scale production of 1957 automobiles this fall.

The most striking single expansive development this year has been the burst of business spending for plant and equipment. The most recent Commerce-S.E.C. Survey of nonfarm business intentions to spend on fixed capital indicates an annual rate of spending of $38 billion in the fourth quarter, up $1.7 billion from the preceding quarter. For the year 1956 total fixed capital outlays are estimated at $35.5 billion, about $7 billion or one-fourth larger than the previous high in 1955.

The strength and resiliency of the economy are indicated by the fact that total product and personal incomes have continued to increase despite sharp declines in sales of new automobiles and in residential construction activity from late 1955 to the spring of 1956. To a significant extent, industrial resources that were devoted to these purposes in 1955 have been channeled to producing plant and equipment this year.

Consumers have continued the active use of short-term credit at levels only slightly below last year's peak. While total outstanding instalment credit has not risen as rapidly as in 1955, this is largely due to the high and rising volume of repayments on earlier extensions of instalment credit.

Although the volume of new housing units started in 1956 may be some 15 per cent below the 1.3 million of 1955, the value of total construction activity -- including business and public, as well as residential -- has been in record volume. Due to this strong demand and other influences, building costs are up significantly.

Turning from private to public expenditures. State and local outlays for construction and other purposes have risen steadily and are scheduled to rise further. Federal purchases of goods and services, after two years of relatively little change, are also likely to rise in the year ahead.

Periods of rapid economic growth like the present are certainly gratifying from the standpoint of the high level of employment and consumption that they imply, but they also give rise to difficult economic problems. As the labor force and productive facilities approach full utilization, further expansion in purchasing power and spending cannot readily be matched by additional output of goods and services. It leads instead to higher prices. This is inflation. Experience teaches us that an unrestrained inflationary boom generally involves unsound credit expansion, distorted price relationships, and economic dislocation, and usually leads to collapse. Our best safeguard against this is to restrain inflationary pressures and prevent them from getting out of hand.

Role of Federal Reserve System

The Congress has delegated to the Federal Reserve System the function of regulating the flow of credit and money. Sound credit and monetary policy can help restrain inflationary forces during an upswing. It can also help promote increased spending and economic recovery during a recession. Along with maintenance of an appropriate relationship between Federal income and expenditures and proper management of our large public debt, monetary and credit policy constitutes our principal tool for promoting a sustainable growth in our economy together with a rising level of prosperity.

Federal Reserve policy seeks these results by influencing the availability and cost of bank reserve funds. As you doubtless know, member banks in the Federal Reserve System are required to keep a prescribed percentage of their outstanding deposits as a balance in their accounts with the Reserve Bank in their district. The volume of reserve funds available to the banking system and the cost of obtaining those funds have an important influence on the supply of bank credit available to the public and on the cost, or rate of interest, which borrowers have to pay for it. Indirectly, therefore, the authority of the Federal Reserve System to regulate bank reserve positions enables the System to exert considerable influence over the total flow of money and credit through the markets of the economy and over the level of spending in those markets.

The Federal Reserve System has three principal instruments for influencing bank reserve positions. Our principal instrument is the purchase and sale of securities, mainly Treasury obligations, in the open market, commonly referred to as "open market operations." A purchase of securities by the System Open Market Account adds to bank reserve funds and bank deposits, and tends to encourage credit and monetary expansion. A sale of securities, on the other hand, reduces reserves and deposits and tends to restrain credit and monetary expansion.

Such purchases and sales provide our most flexible and frequently used instrument of monetary and credit policy. They are adaptable both for making minor adjustments and for effecting major shifts in bank reserve positions, and they are easily and promptly reversible if the situation requires. In addition to their use for regulating the volume of reserves as needed in view of the general economic situation, open market operations serve as the means by which the System ordinarily provides for the seasonal rise and fall in reserve needs for credit. They are also used from time to time throughout the year to offset what otherwise might be the disturbing effects of shorter-run fluctuations in the supply of reserves.

A second instrument for influencing member bank reserve positions is the discount mechanism. The Federal Reserve Act makes provision for member banks to obtain additional reserves by borrowing from the Reserve Banks either by discounting their customers' notes or by obtaining secured advances. The interest rate charged for this service is known as the discount rate.

Borrowing at the Reserve Banks is regarded as a privilege rather than a right of Federal Reserve membership. It is intended to be used primarily on a temporary basis to tide banks over periods of unusual drains of funds. Extensive and continuous borrowing is discouraged. In a period when demand outruns supply and banks find it necessary to meet part of their need for funds through borrowing even in the face of a rising discount rate, they tend to adopt more restrictive loan and investment policies. On the other hand, in periods of lagging demand, idle facilities or rising unemployment, when the System feels that credit expansion should be encouraged, it provides additional reserves to the banking system and lowers the discount rate, thus enabling banks to pay off their borrowing and expand their loans.

The least frequently used instrument for affecting bank reserve positions is the Board's authority to change member banks' reserve requirements, the percentage of outstanding deposits which member banks must keep in the form of a balance at the Reserve Bank. An increase in these requirements tends to have a restrictive effect on monetary and credit expansion in all banks, while a reduction in requirements tends to have a stimulating effect. Since these reserves form the basis for a multiple expansion of bank credit in all member banks, changes in reserve requirements provide a powerful instrument, suitable primarily for longer run adjustments in the need for reserves or where an immediate sharp impact on monetary and credit conditions is essential.

<u>Recent Federal Reserve Policy</u>

Since early 1955, with output in many lines pressing against capacity, with upward price movements widely evident, and with demands for credit strong, the Federal Reserve System has been following a policy of limiting credit expansion in order to prevent excessive borrowing from undermining the stability of the economy and the value of the dollar. Reserves have been adjusted to meet the seasonal needs of agriculture and industry, although not in amounts to meet the desires of all potential borrowers. In these circumstances, banks have found it necessary to meet a part of their reserve needs through increased borrowing at the Reserve Banks at rates that have risen gradually from 1-1/2 per cent in April 1955 to 3 per cent at the present time.

These actions have placed banks under increasing reserve pressure and have induced them to adopt more prudent and selective loan and investment policies. As a result, the rate of growth in bank credit and the money supply has been relatively small and interest rates have risen sharply, reflecting this limited availability of funds relative to the demand for them.

Here I would emphasize that the policy of restraint which has been followed has been one of retarding the rate of growth in the money supply to conform to the rate of growth in production, rather than one of reducing the actual supply.

Implications for Agriculture

As you well know, during most of the past several years, price and income trends in agriculture have been counter to those in most of the non-farm economy. Fortunately for agriculture, these divergent trends have shifted somewhat in 1956. Farm prices and incomes have improved materially from the low level at the beginning of the year.

It is not uncommon, however, to have such divergent trends in various segments of an economy as vast and complex as ours and policy makers in the System, as elsewhere, must appraise all of these divergent trends in arriving at a conclusion as to the general direction of the economy. During a period like the present, this problem is especially acute since we all recognize the need of an improvement in net farm income at the same time that we see the need for restraint on the inflationary pressures in the rest of the economy.

In appraising economic developments in agriculture, as in other areas, it is important to try to determine their cause. A decline in price of cattle, for example, could mean a real change in consumer attitudes toward spending and might indicate, or be a forewarning of, a general decline in consumer expenditure. Or it might mean a readjustment, within a strong consumer demand situation, to an increase in market supplies, or to a lessened demand for animals for export, or expansion. Monetary policy appropriate for the one situation might not be proper for the other.

The declines in farm prices and incomes in recent years, for the most part, appear to have been adjustments to the progressive increases in farm production and to the declines in foreign takings from their postwar peaks, rather than any indication of weakening in consumer demand. This view is clearly supported by prospects for some curtailment in production, increases in crop exports and the resulting improvement in the farm price situation since the beginning of the year. It is also supported by the recent strengthening of demand pressures generally and by the inflationary tendencies in the industrial sector.

Nonetheless, the fact that it seemed desirable to retard the growth of the money supply and to let interest rates rise during a period when farm prices and incomes were lagging meant that the effects of this policy on an industry already in some difficulties needed to be considered with great care. It appeared, however, that in taking steps to curb inflation we were also acting in the best interests of agriculture. In the face of burdensome farm surpluses, inflationary developments could do little to raise farm product prices. At the same time, with the farmers' increasing need for off-farm ~~production,~~ supplies and services, price increases for such items could prove to be a serious further burden to agriculture.

As you doubtless know, credit costs to farmers average something less than five per cent of total farm costs even with the rise in farm debt last year. It therefore seemed preferable to accept some reduced availability of farm credit and some increase in credit costs if we could thereby restrain inflationary pressures that could only result in further increases in the other ninety-five per cent of farm costs.

As a matter of fact, we have found little evidence of reduced availability of farm credit for credit-worthy farmers.

The Federal Reserve as a Source of Farm Credit

This leads me to a discussion of the role of the Federal Reserve System as a direct source of farm credit.

As I have indicated, the principal function of the Federal Reserve System is to regulate the flow of credit and money in the interest of a sound and growing national economy. You will readily appreciate the fact that the System could not properly favor any particular segment of the economy. The Federal Reserve Act is not, of course, a farm credit act.

At the same time, Congress has recognized in the Federal Reserve Act the vital importance of adequate agricultural credits. Since their inception in 1913, the Federal Reserve Banks have been authorized, at least indirectly, to provide a certain measure of credit assistance to agriculture, and since 1923 the Reserve Banks have had authority to extend credit directly to certain of the farm credit agencies of Government.

Basically, the concept of the original Federal Reserve Act was that the Reserve Banks should provide credit to their member banks only for temporary periods and only on the basis of self-liquidating commercial paper having a maturity at the time of discount of not more than 90 days. It was recognized, however, that agricultural paper was just as sound and as self-liquidating as ordinary commercial paper but that the marketing of farm crops and livestock normally requires a longer period of financing than commercial transactions. For this reason, the original Act allowed a maximum maturity of six months for agricultural paper, instead of the basic 90-day limitation.

Since 1913, there have been various changes and additions in the law affecting the extent to which the credit facilities of the Federal Reserve

System have been made available directly or indirectly in the field of agriculture. Let me briefly summarize the present situation.

In the first place, paper representing loans made by member banks to farmers, including livestock paper, can be discounted by the member banks with the Reserve Banks if the paper has a maturity of not more than 9 months -- not the original maturity but the maturity at the time of discount. Of course, the proceeds of the paper must be for true agricultural production or marketing purposes; the Reserve Banks under the law cannot discount such paper if the proceeds are to be used for fixed investments, such as land, buildings and machinery.

Secondly, the Reserve Banks can make advances to their member banks, not only on ordinary agricultural paper, but also on the security of obligations of the Federal intermediate credit banks.

Thirdly, the Reserve Banks have authority to purchase Federal Land Bank bonds and intermediate credit bank debentures, but only short-term obligations with maturities of not more than 6 months at the time of purchase.

Finally, the Reserve Banks have authority to discount paper directly for the intermediate credit banks although such discounts must have the specific approval of the Federal Reserve Board.

These last two provisions were enacted at the time the land banks and intermediate credit banks were created, a time when banks and others were reluctant lenders. Their purpose was to assist in establishing confidence in the obligations of these two institutions in the open market. With a ready market for these obligations well established, there has been no need to call on the Federal Reserve for this support. Their use would be inappropriate under present conditions when the System is struggling with the problem of too liberal extension of credit. However, they are still in effect and would be available for use in event of a recurrence of the conditions that brought about their enactment.

There are two other statutory provisions which do not relate specifically to agricultural credit but under which agricultural credit could conceivably be provided through the Federal Reserve Banks. One authorizes the Reserve Banks to make advances to any corporation on the security of Government obligations; the other authorizes advances to member banks on any satisfactory type of collateral, whether or not technically eligible for discount. However, both of these provisions were enacted in the early 1930's as emergency measures to stimulate credit under the uncertain economic conditions existing at that time, and they are not suited for use today when conditions are very different. Moreover, any advances under these provisions would, under the law, have to bear a premium rate of interest higher than the regular discount rate.

On various occasions in the past, suggestions have been made that Federal Reserve credit be made more directly and more liberally available to the farm credit agencies of the Government. In 1940, for example, and again in 1949, bills were introduced to permit the Reserve Banks to make loans to the Federal Land Banks for periods up to one year and at the regular Federal Reserve discount rate on the security of farm loan bonds or obligations of the United States.

At that time the Federal Reserve Board questioned the desirability of such a broadening of the law. It pointed out that it would result in a discrimination against member banks of the Federal Reserve System since it would permit the land banks to borrow for longer periods and at a lower rate than member banks themselves could borrow on similar security. The Board also pointed out that such a change in the law would be likely to encourage requests for similar authority by other agencies of the Government and that important questions of credit policy were involved in enabling governmental credit agencies to have direct access to Federal Reserve credit facilities.

This brings us back to the basic question whether any such further broadening of the authority of the Reserve Banks to provide long-term credit automatically to institutions, such as the land banks and intermediate credit banks, would not be inconsistent with the fundamental purposes of the Federal Reserve System. The System's primary function is not simply to provide financing, whether to farmers, businessmen or even to the member banks of the System. Its principal concern is its ability to influence the entire supply of money and credit in the best interest of the economy as a whole. As far as the credit functions of the System are concerned, it is more important to be able to grant or withhold credit as a means of regulating the over-all supply of credit than it is to provide the financial needs of individual borrowers or particular segments of the economy. This can best be done by restricting its extension of credit to member banks over which it can exercise some control through its power to regulate reserves.

At the same time, the Federal Reserve System constantly has in mind the special problems presented in the field of agricultural credit. As I have indicated, it has authority under the law to provide a certain measure of assistance in that field, and, to the extent consistent with over-all national credit policy and the public interest, the System is prepared to exercise that authority in case of need.