

**THE ROLE OF THE FEDERAL RESERVE SYSTEM IN THE ECONOMY  
AND IN AGRICULTURE**

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to the Corporate Seminar of Gold Kist, Inc.  
March 24, 1987**

Good evening! Along with comments on the economic outlook, I've been asked to speak to you this evening about the role of the Federal Reserve System in agriculture and in the economy in general. The Fed is certainly aware of agriculture and offers ways to accommodate the unique conditions of farm lending. One example is a special borrowing provision, through which access to the discount window is made more flexible to meet the needs of smaller banks in rural areas facing seasonal needs for funds. However, the Fed affects agriculture in a far more important--though more general way--through its better known roles in the economy. A smoothly functioning payments systems helps all business including farms operate more efficiently. By helping to maintain the safety and soundness of the nation's banking system, the Fed similarly promotes the well being of agriculture along with other types of business. Probably its most direct effects come through monetary policy.

Of course, different industries may experience the impacts of monetary policy in different ways. Some may feel they bear the negative consequences of a given policy more than others. Others feel the whole process is a mystery which they don't understand. In view of the confusion that often surrounds monetary policy and the Fed in general, I think it would be useful to look at the functions of the Federal Reserve System as a prelude to discussing the nation's economic outlook and the prospects for agriculture.

## **The Role of the Federal Reserve System in the Economy**

Most countries now have central banks with the responsibility of issuing currency and controlling credit in the national economic interest, and in most countries the central bank is an arm of the government. The Federal Reserve System is one of the handful of quasi-governmental central banks. The limited autonomy of America's central bank is more in keeping with our tradition of separation of powers. In this case, monetary policy, through which the Fed affects the amount of currency and credit available through the banking system, is kept separate from fiscal policy--taxes and government spending set by Congress and the Administration. The Fed's structure internally and vis-a-vis other parts of the government also insulates it somewhat from political pressures of the moment.

The Fed is, of course, accountable to the national government at its highest level of organization. The Board of Governors is appointed by the President with the advice and consent of Congress, and the Chairman of the Board is required to report to Congress twice each year on monetary policy. However, on a regional basis the twelve district banks are in some ways more like private corporations. Like most private corporations, each Reserve Bank operates for profit from the financial services that it offers. The primary difference is that the Fed's mandate and activities are carefully regulated in the public interest. Accordingly, our profits, some \$690 million just from the Sixth Federal Reserve District in 1986, are turned over to the U.S. Treasury at the end of each week.

The work of the Federal Reserve System has two main thrusts in terms of its effect on the public. These can be described as the maintenance of the money supply in its physical and what I call its psychological aspects. Maintenance of the physical money supply entails the Fed's involvement with currency, checks, and other payments mechanisms. That is also a chief source of income. Psychological maintenance carries

into the realm of bank supervision and monetary policy. I'll talk first about the physical aspects of our work with money and its routes of movement through the economic system.

**The Payments System.** The first thing that comes to the average person's mind when he thinks about money is currency—dollar bills. Most currency is in the form of Federal Reserve notes, issued by the District Banks and collateralized for the most part by U.S. government securities. Notes are put into circulation when banks order them to meet customer demand and are sent back when banks' supplies exceed demand. Ensuring an adequate supply of currency to meet the seasonal demands associated with farming was one of the reasons for the Fed's establishment in 1913. We also maintain currency's physical condition since notes are returned to us and processed through our high-speed sorting machines, which separate out damaged and soiled bills and destroy them. At the Atlanta bank alone we shred about five tons of unfit currency a week. We also pull out counterfeit bills and report them to the Secret Service.

Cash is not the only way people pay for things, of course. The Federal Reserve System processed around 19 billion checks in 1986, a significant portion of all checks written in the country. Banks deliver them to us, and we transfer funds from the institution each check is written on to the one it is deposited in. In addition to checks and cash, payments can be carried out electronically, and here too the Fed plays a major role. An enormous stream of money is constantly passed among financial institutions electronically on the Fed's wire system known as Fedwire. It is the only one by which payments are final when received. Confidence that checks will be cleared in a reasonable time and that computers transferring large sums of money won't break down helps maintain our nation's money psychologically just as cash processing does so physically.

**Supervision and Regulation.** Aside from the Fed's role in the payment system, our involvement in bank supervision and regulation also helps maintain our nation's money supply since banks are the primary channel through which money moves into the economy at large. Supervision keeps track of banks by monitoring the quality of their assets and their levels of capital. In regulation, we decide on, subject to legislative restrictions, the product lines banks may offer. We can also mandate capital requirements. Operating a payments network and supervising and regulating banks help give people confidence in the payments network. Of course, regulation can't prevent all banks from failing. Lately there has been a rising number of bank failures, many at farm banks. The Fed's role here has been to help smooth the transfer and keep local banking service available.

**Monetary Policy.** Our monetary policy function is equally as important as our role in the payments system and the supervision of banks in affecting the economic health of the nation. People must not only have confidence that a dollar will be accepted in payment for goods and services but also that it will have essentially the same value next month, when delivery is made, as it does today, when an order is placed. Inflation, which erodes the purchasing power of savings, can profoundly harm confidence in a nation's currency. Federal Reserve policies can influence inflation. If they are too easy, they generate excess demands for goods and services, and the predictable outcome of that old saw—too much money chasing too few goods—comes to pass. On the other hand, policies that are too tight can constrain growth. Determining the optimal balance, particularly when other factors such as federal deficits also influence the economy, is one of the most difficult challenges we face at the Fed. There is also the problem that what's good for the nation as a whole, in a macroeconomic sense as we would say, may hurt particular industries, at least in the short run.

In the case of farming, for instance, the anti-inflation measures that we adopted at the beginning of the 1980s were essential to the nation's economic health. But there's no doubt that the higher interest rates that ensued made it difficult for heavily indebted farmers to service their debt. There is also no doubt that to have financed and therefore validated the decisions made in a highly inflationary environment would have been more disastrous to the nation's and even farmers' economic viability in the long run. More recently, our policies appear to have done little to improve the situation in manufacturing, energy, and agriculture. This is partly due to the delayed impacts of the earlier rise in the dollar—and partly, in the case of farming, to an abundance of crops worldwide.

The fact that the Fed needs to make policy decisions on behalf of the general welfare does not imply that the decision-making process is uninformed or oblivious to the hardships in particular industries or regions. On the contrary, one of the unique features of our structure is the enormous amount of grass-roots information that is built into the System. This information gathering is most apparent at the 12 District Banks, beginning with their research departments.

At the Atlanta Fed some 14 economists keep their fingers on the pulse of the economy by conducting research in three broad areas. The regional group investigates trends in industry and agriculture in the Southeast, the financial group studies banks and financial markets, and the macroeconomics group attends to the national and international economic scene. These economists communicate their findings and their forecasts to me on a regular basis. I add to their observations the information regularly reported by our head office directors in Atlanta and those at our five branches in the Southeast. I also make use of the commentary I and my staff hear from business leaders and bankers in our travels through the district. This anecdotal information is particularly

important in making adjustments to our outlook. Any forecast of an economy as complex as ours is fraught with uncertainty. The wide range of factors affecting consumer and business decisions and their impacts cannot be pinpointed exactly. Clearly we need to be as up to date as we can and people's views are as important to our forecasting process as are statistical data, particularly because these numbers are about what has happened as opposed to what is happening. The opinion I carry to the Federal Open Market Committee every six weeks is thus based on a broad range of information and analysis.

FOMC decisions are made as to how much, if at all, pressure on bank reserve positions should be increased or decreased. Our policy tools impact banks first by affecting the cost or the quantity of reserves in the market. They must hold reserves as a percentage of their deposit liabilities. Clearly if reserves are made more available, it will encourage banks to expand money and credit and vice versa. The best known tool we use is the discount rate, which is the rate of interest charged banks who need to borrow from the Fed to make short-term adjustments to their reserve positions. This tool is the one that Directors of the district banks have the most influence over because they can propose changes in it at any time to the Board of Governors. The press pays special attention to the discount rate, which is now 5 1/2 percent, because increases or decreases have a direct and immediate effect on the cost of bank reserves.

Far more subtle is our use of open market operations, which are the purchase and sale of government securities on the open market. Through this method, we can make gradual changes in the quantity of reserves available to banks. When we purchase securities, we add to reserves by crediting the reserve accounts banks hold with us. Conversely, when we sell securities, we reduce reserves. Through open market operations we can often test reactions to a policy change—using this action as a probing tool. Given all the uncertainties that we face with regard to the state of the economy

and its momentum, it is often desirable to initiate a policy change in this manner. The research and information we obtain from all over the country help reduce these uncertainties and also help us establish policies that are in keeping with the interest of the greatest number of people.

### **The Economic Outlook**

Let's turn now to what current research and data are telling us about the economy in general and to agriculture in particular. Through this discussion, I think you'll see that my points about the Fed's role in particular industries are borne out. As you know, there are three basic measures of performance commonly used to gauge how the nation is doing, economically speaking—gross national product adjusted for prices (or real GNP), unemployment, and inflation. Last year real GNP grew 2 1/2 percent. That was close to par for our nation's postwar performance but, with ample excess capacity in the nation, the rise did not seem all that fast. Given this relatively moderate pace of expansion, it took some time to nudge unemployment down from the 7 percent mark, where it remained lodged for most of the year. Civilian unemployment fell to 6.7 percent in December, though, and has held steady at that level through February. The measure by which we did best in 1986 is inflation. The rise in the consumer price index was the lowest in two decades. The low level of price increases was a pleasant surprise, but it was attributable primarily to the drop in oil prices. After falling briefly below \$10 per barrel, oil prices settled in at around \$14 to \$15 per barrel, bringing respite from the inflationary tendencies fueled by higher energy costs in the recent past.

Turning to the economic outlook for 1987, I foresee the expansion continuing at about the same pace as last year, that is around 2 1/2 percent. Such a growth rate is unlikely to bring about much further reduction in unemployment since the number of new jobs will just keep pace with the number of people who want them. So joblessness may

fall only a little bit, if at all. However, inflation, as measured by the consumer price index, may rise to 4 or even 4 1/2 percent since we no longer have the benefit of sharp declines in energy prices. Even though this sounds like more of the same, continued growth should bring with it greater balance among the various sectors of the economy and regions of the country. Three factors--the international sector, consumer spending, and energy prices--will be of prime importance in this move toward better balance.

The chief source of support for the growth I envision is a turnaround in the international sector. There are several reasons to expect such a pickup. During the last two years the dollar has declined substantially against the currencies of most of our major trading partners. The depreciation in the dollar's foreign exchange value last year began to be translated into higher prices for most foreign goods--with the important exception of oil--relative to domestically produced items. More recently, according to research conducted at the Atlanta Fed, the dollar's fall has finally broadened to include the currencies of Canada and the newly industrializing countries of the Pacific, though the margin of decline is still much less. Thus, there is reason to believe that the dollar doesn't need to drop any more. The decline we have had should, over time, provide U.S. manufacturers with stronger demand, from at home as well as abroad. In fact, exports have been picking up in real terms while imports have waning. Monthly data for early 1987 showed a seeming reversal of this trend, but these very preliminary estimates are for nominal as opposed to real trade flows. Despite some month-to-month volatility in trade figures, I expect the trade deficit to continue narrowing in 1987.

Aside from an improvement in our international trade position, another factor that should help maintain the pace of economic activity is consumer spending, even though it is likely to grow at a more modest pace than in the last few years. The sustaining factors underlying the rate of growth in consumer spending will be reasonably healthy

wage and salary growth and personal tax cuts that will increase disposable income in many households. Also the stock market rally has added to household wealth and is likely to boost spending moderately.

There are, to be sure, some areas of weakness. Capital spending by business will remain weak as will construction of condos and apartments. Tax changes and past overbuilding of offices and multifamily housing units are chiefly to blame for this. Another factor is that the federal budget deficit appears to be on a downward slope, certainly a welcome development, but one that means government will be providing less stimulus than in the past. Finally, agricultural prospects are not exactly glowing. However, the farm situation may be less bleak if we extend the forecast horizon somewhat.

### **Prospects for Agriculture**

The factors that I've outlined for the national economy should help establish what I hope will be a positive trend for agriculture on the heels of several difficult years. Working on the assumption that we're approaching the bottom, I'm optimistic that agriculture is in a position to make some modest recovery over the next two to three years. My reasoning rests on a slowing decline, if not a stabilization of, rural land prices, accompanied by the appearance of larger numbers of interested potential purchasers, and the anticipated turnaround in trade patterns I discussed earlier. After experiencing declines of 50 percent or greater in some localities in the value of their assets over the past five or six years, farmers in prime producing areas should not see much additional loss. A stabilization of assets would give farmers more flexibility to consolidate their

debt and to make investments necessary to rebuild and expand their businesses. Farm debt is now down 5 to 6 percent from its peak in 1983-84, reflecting some loan repayments as well as some large write-offs of uncollectable loans by lenders.

Meanwhile, agricultural exports are increasing in the wake of the dollar's decline, export subsidies, and the drop in support prices. Assisting those producers who have been able to maintain output is the fact that many overseas competitors are cutting production in response to low prices. Among the bright spots in this development is U.S. cotton, whose export volume is up more than 170 percent over the same time in the market year in 1986. Western Europe has provided some of the largest purchasers in this market and also in the reviving market for our rice exports, now 60 percent ahead of last year's pace. Foreign sales of soybeans and wheat are up slightly as the U.S.S.R. is purchasing large quantities to supplement losses from their severe winter weather. China, too, has bought significant amounts of feed grain for the first time in three years.

Low grain prices are especially beneficial for a company like Gold Kist, which consumes a good deal of grain in the form of poultry feed. I look for the poultry industry to enjoy another good year in 1987 due to sharply reduced feed prices and the continuing change in the American public's preferences in favor of poultry over pork and beef. As evidence of beef producers' adjustments to consumers' shifting tastes, the cattle inventory at the beginning of 1987 stood at its lowest level since 1962.

Here in the Southeast, agriculture is not as concentrated in export-oriented crops as in other parts of the nation. Thus, our region stands to gain less from expected international developments than, say, the Midwest, but the basic picture was less bleak to begin with. The production depressing effects of the drought that devastated much of the Southeast last summer should be largely behind us. Farmers could certainly use a

year of normal weather to recover some of their losses. At the moment Florida agriculture is faring well, having enjoyed a bountiful winter vegetable harvest and looking forward to both a larger citrus crop and sharply higher prices than in the last season.

In the long run, agriculture in the Southeast and in other areas of the country faces the need to alter its traditional patterns of production in a market that is now global in scope. The most basic adjustment necessary is to balance worldwide production so that demand for and supply of agricultural commodities become more equal. Part of this adjustment can occur through reducing the amount of resources devoted to agricultural production, a difficult but ultimately healthy process that has already begun. Public policies like the lowering of support prices can, as we have already seen, bring U.S. farm prices more into line with the rest of the world's. However, the supplemental payments to producers to make up the difference between the reduced support price and the much higher target prices for program crops further enlarges the already huge governmental subsidies to agriculture. These payments serve to thwart needed resource adjustments by encouraging inefficient farmers to continue producing unneeded commodities. Also, these subsidies raise the ire of our international competitors who are quick to point out that we are engaging in the same sort of unfair competition that we vigorously condemn when foreign producers market products in the U.S. at prices below their own production costs.

Fortunately some U.S. farmers have expertly increased yields and reduced costs to the point that they can make profits even in the absence of government support programs. Others have made rapid adjustments to reduce costs and are well on their way to becoming competitive at international price levels for farm products. These will be the long-term survivors in the healthy agricultural economy of the future. As in the

past, the billions spent to prop up incomes of inefficient farmers will serve only to delay their needed and eventual departure from an overcrowded economic endeavor. Government programs could be far more effective and less expensive if they were aimed toward assisting the transfer of inefficient producers out of agriculture rather than towards the continuing subsidization of exporting unneeded output.

While it is unfortunate that many farmers must leave their chosen work and way of life, it is in the long-term best interests of the economy for policy makers to treat agriculture as other businesses are treated. The plight of the farmer often generates calls for protectionist measures. As with other industries, however, the effort to protect agriculture from foreign competition might benefit a relatively small number of people for a time, but the vast majority of consumers would have to shoulder the financial burden of higher prices and job losses resulting from foreign retaliation. Instead, agriculture must learn to live within the constraints of the market discipline that ultimately benefits the economy as a whole.

What can the Fed do to help U.S. agriculture get back on the track of prosperity? As I said at the outset, monetary policy is a macroeconomic tool and thus not one well suited to influencing particular industries or sectors of the economy. Probably the best thing we can do to help farmers through the next few difficult years of transition is to make money and credit available in sufficient quantity to keep the current, quite lengthy expansion going while holding price increases in check. In addition, the Fed can and is working to maintain the safety and soundness of the nation's banking system by effecting smooth transitions of failing farm (and other) banks so that interruptions to local financial services are minimal. In an environment of fairly steady, noninflationary economic growth and a healthy financial system, farmers, like other businesses, can plan investments--and adjustments--with some degree of certainty that the assumptions upon

which today's decisions are made will be valid tomorrow and well beyond. Such a milieu will make it easier for agribusinesses like Goldkist to respond successfully to the global market issues facing American farmers.

Responding to the challenges—and opportunities—of international trade is nothing new to Gold Kist. Nearly thirty years ago the company saw the potential for building an international peanut business through better organization of the numerous individual companies then in the field. Recently you have taken another step in the continuing process of adjusting to the market by announcing the formation of Golden Peanut. This is precisely the type of aggressive action that the market requires, and in concluding my remarks on agriculture, I'll use your farsighted efforts as an example of the manner in which American agribusiness can evolve as an international competitive force.

### **Conclusion**

In sum, I feel that the appropriate attitude when looking toward 1987 and beyond is one of patient optimism. The stock market persists in its bullish ways, raising household wealth at the same time it indicates investors' confidence in our economic prospects. As the lagged effects of the dollar's decline lead to the expansion of foreign markets and the return of U.S. consumers to American-made products, manufacturers will be able to increase production and contribute to that balanced growth which I hope will spread to those areas of the nation that did not share the expansion of the past year.