## NATIONAL AGRICULTURAL BANKERS CONFERENCE

Colorado Springs, Colorado
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### I. Introduction

A. Thank you very much. It's a pleasure to be here with you today.

B. The American Farm has always been a rich part of our culture and our economy.

1. As rural bankers you share in this grand tradition.

2. Agriculture embodies a way of life that fosters a strong work ethic and performs a vital function for the world economy.

*Film to set tone here.*

C. The heritage of agriculture in this country is something we all can be proud of. However, even as we acknowledge this proud heritage, it's important to recognize that agriculture is changing significantly.

1. These structural changes in agriculture reflect in many ways the transformation of the economy we're all experiencing in all corners of America, due to factors such as rapid technological advances and expanding international trade.

2. These changes present special challenges for agriculture:

a. farms are getting bigger;

b. rural economies are becoming more diversified;

c. and science is presenting both opportunities and ethical dilemmas — the impact of which is impossible for anyone to predict.

D. I'm here today to share with you how we at the Federal Reserve see our role in this transformation.

1. We believe it's important that all Americans understand what we do and how it affects their lives.

2. What is the proper role for the Fed in this time of profound change??

3. There is no doubt about it: whether you are a consumer, (a retiree, (a banker or a farmer,/ keeping inflation low is the most important single thing the Fed can do for your financial well-being over the long run, and for the economy as a whole.

E. I'm also here to learn how you, as ag bankers, envision the future of your industry as we embark on a new millennium.

1. Ag banking is changing on all fronts. Not only will you be dealing with a reshaped agricultural industry, but the banking industry as a whole is also changing.

2. In fact, legislation is imminent which will eliminate historic barriers between banks,/ brokerage houses, and insurance companies.

3. Let me begin with a brief overview of the Federal Reserve's responsibilities as the nation's central bank.

## II. Fed and Y2K

A. As most of you probably know, the Federal Reserve's mission is to foster a safe and sound financial system and a healthy, growing economy. We have three main areas of responsibility.

1. First, we're a service provider — we provide financial services such as check processing and electronic payments to depository institutions and the U.S. government.

2. Second, we're a bank regulator — we supervise and regulate state member banks and bank holding companies.

3. Finally, but certainly not of least importance, we formulate national monetary policy.

B. To ensure that the central bank is in touch with all corners of the economy, the Fed was created with a system of 12 regional banks back in 1913.

1. The Chicago Fed serves a five-state area consisting of most of Indiana, Illinois, Michigan and Wisconsin, and all of Iowa.

C. All 12 Reserve Bank presidents along with the 7 members of the Federal Reserve Board serve on the Federal Open Market Committee, also known as the FOMC, which is the governing body that sets monetary policy.

D. The FOMC's primary concern is to set the best possible monetary policy for the nation as a whole, but the Reserve Bank Presidents also contribute their insights into how each region's economy is doing.

   1. So making sure that regional developments are communicated during FOMC meetings is an important part of my job.

   2. The Chicago Fed is particularly concerned with agriculture ... it is such an important industry in our region.

E. To ensure that I do that job as effectively as regulation departments are constantly conducting surveys and meetings to keep on top of regional developments.

   1. And we schedule forums regularly throughout our district, so that we have the opportunity to solicit and respond to feedback from people living and working in the region.

   2. Just two weeks ago, for example, I was in Western Iowa for a forum.

   3. That trip gave me a good opportunity to speak with farmers, including a visit to a 1,600-cow dairy operation about 50 miles outside of Sioux City. During that same visit I also met with 12 local bankers, including ag bankers.

   4. From both the farmers and bankers, gained new insights about how the ag sector has learned from the mistakes of the 1980s and how both bankers and farmers are making better and more informed loan decisions.

   5. We hold these forums on a regular basis because hearing the views of farmers, business people, bankers, and others throughout the district is so crucial to the work we do.

F. In addition to taking trips into the business community, we invite the business community to come to us.

   1. Next week I'll be sitting down with members of the Chicago Fed's Community Bank Council.

   2. The council's meetings allow us to meet with a group of 17 community bankers from our Fed district.

   3. I also meet twice a year with our 7- member Agricultural Advisory Council, most recently just over a month ago.

   4. And, of course, I'm in touch regularly with the members of our Board of Directors, two of whom come from agricultural areas.

   5. In short, the Fed's regional structure makes sure that we have information and ideas from all sectors and locations as we develop the nation's monetary policy.

G. At the same time, we try to keep an eye on the big picture. At the moment, one key issue on our radar screen is Y2K preparedness.

1. And on this subject I'd like to say, we're confident that the century date change will come and go with a minimum of disruption.

H. We believe that the public will keep the year 2000 rollover in perspective, realizing it is one more challenge we will meet.

1. Certainly, community banks must be given credit for the work they've done informing their customers of their readiness for Y2K.

2. Banks that have been the most effective have gone beyond the statement stuffer.lIn fact, a recent Gallup poll indicates that the more information customers have about Y2K, the more optimistic they are.

I. Internally, all of the Fed's important systems are ready for Y2K and are in production.

1. So, as a financial service provider, we're confident there will be no disruption in our ability to meet the needs of our customers: you, the commercial banks, and the U.S. government.

2. As a regulator, we're working closely with other agencies to review bank preparedness.

3. Ultimately, it's up to you to be sure that you're ready. But the results of our Y2K exams so far indicate that 99 percent of banks are making satisfactory progress.

J. Still, we have no intention of being surprised by anything Y2K has to offer.

1. For this reason the Federal Reserve is making available to you more than enough cash to cover any unusually large demands by customers.

2. In addition, we have introduced a new liquidity facility to meet Y2K-related needs.

3. You should make sure that you have made all the necessary arrangements ahead of time in case you need to access these facilities.

**III. The Changing Economy and Ag Industry**

A. Now, let's get back to the future of ag banking. There is no doubt that these are prosperous times for almost all industries.

1. Nationwide, we've seen a rare combination of robust growth,/and both low inflation and low unemployment during the past few years.

2. That trend has continued so far during 1999 as we've experienced p very good economic performance.

3. Real GDP growth has been solid, with strong consumer spending.

4. The unemployment rate has been hovering around a 29-year low.

5. The overall Consumer Price Index has been rising at a somewhat faster pace than last year, due mostly to higher energy prices.

6. But the core CPI, which excludes volatile food and energy prices, has been increasing at a slower pace than in 1998.

B. Going forward, we expect the economy to continue performing reasonably well.

1. The future news on inflation, however, might not be as good as it's been in recent years unless we can achieve a better balance between the demand and supply factors in our economy.

2. For example, if businesses can't find enough workers to provide the goods and services that customers increasingly want, we could see upward pressure on prices mounting.

3. Increased productivity can offset some of these inflationary pressures, but it's something we need to be alert to as we move into the new millennium.

C. Our overall economic prosperity is due in part to the dynamic changes I mentioned earlier, technology is allowing us to be more productive.

1. And international trade has boosted competition which has in turn pressured us to become the best at whatever we do.

2. In fact, members of the Chicago Fed's agricultural advisory council have often pointed out how important it is to reduce tariffs and non-tariff barriers so that our farmers have greater access to foreign markets.

D. However, these changes have also put a great deal of pressure on the agriculture sector.

1. Net farm income is expected to increase 9% this year. That's good.

2. The unfortunate news is that the gain comes from increased government subsidies. About 45% of farmers' net income this year is from direct government payments, if you include Congress's recent emergency aid package.

3. The serious condition of the farm sector is perhaps best captured by the fact that if we took those subsidies out of the picture, net farm income would drop 20%.

E. A big part of the problem has to do with trade. For all the good that increased trade is doing for our economy, and for agriculture, over the long term, the short-term situation has not been favorable.

1. American farmers, particularly hog and grain farmers, have been hurt by the weakened demand overseas resulting from the Asian crisis.

2. Prices have been also held down by large domestic supplies of pork and large world supplies of grain.

3. As a result, the value of agricultural exports declined nearly 9% just in the past fiscal year alone.

4. Fortunately, foreign sales of U.S. food and agriculture products are expected to turn the corner in the upcoming year. In fact, we're expecting U.S. ag exports to stage a modest recovery, as much as 2%.

5. But in the meantime, farm land values have come under pressure in states of our district where hogs, corn,and soybeans provide the bulk of gross farm receipts.

F. These two hardest-hit ag industries hogs and grain are not only suffering right now from low prices, but they are also likely to be most affected by the longer-term structural changes that are taking place in agriculture.

1. As I mentioned earlier, the issues of farm consolidation and genetically-modified, or GMO, grain are raising thorny questions for all of agriculture. But the issues are extremely urgent for grain and hog farmers.

G. The farm sector is consolidating at a remarkable pace.

1. There is nothing new about farm consolidation, of course.

2. We've seen the number of farms shrink from 6.5 million in 1935 to 2 million today.

H. It was 20 years ago that well-known ag economist Willard Cochrane described the farmers' predicament as a "treadmill".

1. It starts when farmers borrow money to purchase new technology /be it the manufactured fertilizers in the 1960s or the GMO seeds today.

2. These investments lower unit costs and increase production levels proportionately faster than demand, /causing commodity prices to fall.

3. Facing falling margins that could force them to leave production agriculture, farmers are forced to borrow, invest,land expand even more.

4. Therefore, the path to success for farmers requires that they expand their business to a size that enables them to continue investing in expensive new technology.

5. The ability to utilize government programs has also been an important requisite to survival and growth.

I. What is new is the way today's tight margins in farming are now squeezing the mid-size farm, for example, those with sales of about $250,000 per year.

1. Small farms are surviving at present because they can be maintained by fewer family members, which allows others to take on outside work and provide the necessary additional income to stay afloat.

2. Mid-sized farms,(however) face a difficult choice: scale back operations and follow the path of the smaller farms, or expand into larger operations.

J. Successful farmers in the future will continue to be the lowest cost producers, and this will continue to require the purchase of expensive technology.

1. This dilemma raises tough questions.

2. Can small- and mid-sized farms survive without government subsidy?

3. Do we want to subsidize the smaller farmer to maintain a lifestyle that may no longer be economically viable?

K. In the U.S., 94% of farms are still small- to mid-sized. So the challenges of consolidation will affect many rural communities as well as ag banks.

1. As far as additional future challenges go, I'm sure many are likely to be related to the question of GMOs. European concern over products containing GMOs is growing in the aftermath of the Mad Cow scare in Great Britain.

2. If those concerns are not resolved successfully by our trade negotiators, or if they spread to the U.S., the industry will have to change to address those concerns.

3. For example, we may face greater scrutiny in labeling that would in turn require stricter /standards. And calls for crop segregation could alter the way the industry grows and processes grain products.

## IV. Ag banking

A. I've spoken today about the current problems of low commodity prices and weak overseas demand. I've also touched upon future challenges for the small and mid-sized farm.

1. But how do all these challenges affect you, the ag banker?

B. First of all, I want to put all this into the right perspective.

1. This is not the early 1980s.farmers with the high debt-to-asset ratios that we saw in the 1080s. And we do not see land values declining precipitously. In fact, preliminary results from the Chicago Fed October Oland values survey show prices still 2% above last year on average in the Midwest.

2. Illinois, Indiana and Iowa show weakness in the third quarter/but farm land values were stable for the Midwest as a whole.

3. Furthermore, bankers are lending smarter than they did fifteen years ago. They have moved away from emphasizing collateral without considering the ability to generate sustainable earnings.

C. At the same time, commodity prices are too low to generate adequate cash flow for many farmers.

1. This means that all farmers (and their lenders), need to have a plan to get them through this transition period.

2. And for some farmers, that plan should not involve additional credit.

3. Saying yes is tempting, but in many cases it's not the long run solution, and you may not be doing your borrower any favors by increasing his or her debt levels.

4. There is no doubt that today's strong capital levels can be eroded by excessive lending.

D. So while we encourage you to work with your inviable customers, we also urge you to take a careful look at how you define viable.

1. Circumstances today call for a deeper understanding of the situation before lending decisions are made.

2. As I said earlier, consolidation in the ag sector began long before the crisis in the 1980s, and the economics of farming will ensure that this trend will continue into the next millennium.

3. Farmers, just like any other business owners, need to develop realistic business plans that provide for whatever the future holds.

E. Nationwide, the banking industry is in good health.

1. Second-quarter earnings were the second highest on record, reaching $17 billion.

2. And second-quarter problem loan indicators remain low.

F. The ag banking sector is looking almost as healthy, according to the aggregate numbers.

1. But there is mounting concern that some banks have relaxed their credit discipline.

2. In a Robert Morris Associates survey of senior risk management officers, 63 percent said that the agricultural sector will be a source of bad credits.

3. And in the second quarter, he return on assets at agricultural banks in the Midwest was 10 basis points below the average for agricultural banks nationally.

4. So as a whole we're beginning to see reduced returns at Midwest banks, where ag is taking the hardest hit.

**V. Conclusion**

A. In conclusion, I want to say that for every challenge the ag industry and ag banking is facing, there is a way forward.

1. There are two main reasons that this transition has not become a farm crisis reminiscent of the 1980s: 'the health of the banking sector and the health of the economy.

2. In our role as a bank regulator, the Fed is making sure that examiners are helping bankers better assess the risks inherent in some farm portfolios today.

3. I know we can count on you to ensure that the ag banking sector remains as healthy as possible during this period of transition.

4. And I want to reassure you that you can count on us to promote a healthy, growing economy by guarding against inflation.

B. Inflation hurts the overall economy in a number of ways.

1. Primarily, it impairs the functioning of the price system.

2. The signals sent by the price mechanism are a very efficient means of coordinating production and consumption. Inflation, especially variable inflation, can cause those price signals to be jammed.

C. Nevertheless, some of your customers may wonder whether a little bit of inflation might not be a bad thing.

1. Some farmers may think that increased inflation would allow commodity prices to rise just enough to ease the cash-flow problems they are currently experiencing.

2. Let me make it very clear that this notion could not be more off-base.

3. Farmers would like to see higher prices for the commodities they sell. But if inflation is the only reason for rising prices, then they wouldn't be really better off.

4. After all, inflation would also cause an increase in such things as rents, fertilizer, fuel, and farm machinery. And farmers' margins would not improve.

5. Commodity price increases only benefit farmers when they come from a fundamental change in the conditions of supply and demand, such as an increase in world demand for agricultural products.

D High inflation also has the potential to be especially damaging to the ag sector because it can lead to wild swings in interest rates.

1. The last time we saw that happen was during the late 1970s and early 1980s— difficult times for farmers and for a lot of other Americans as well.

2. The Fed wants, above all, to avoid that kind of situation. /And the best way to do that is to ensure price stability.

E. The Fed will continue to work to provide a firm foundation for continued healthy growth by ensuring price stability. In that way, we can help ensure a vibrant farm sector for this generation and the next.