

Remarks by
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In this talk today, I am afraid I am going to present more questions than answers. At least in this district, agricultural credit cannot be discussed in any rational way, as a thing apart from most of the social and economic issues that plague bankers, planners, politicians, educators, farmers, and even the Federal Reserve with a fine impartiality. Nor, I think, is there any other subject in this district with such implications for our prejudices. There may be a way for a more skillful speaker than I to inch his way carefully through a discussion of agricultural credit without touching any of the sensitive areas, but I doubt it. This is one pinball machine no one can play without at least one tilt. The family farm, the corporate farm, branch banking, independent banking, holding companies, the plight of the small town, out-migration, rural/urban balance, credit allocation, PCA's--the list of speaker traps inherent in this subject could be continued. Each reference is a potential irritant capable of producing a prompt visceral reaction in one or more of you.

There is no help for either you or me, for agricultural credit cannot be considered as an isolated subject. It is a service to people rendered by general purpose institutions, at least insofar as banking is concerned. This means that on the one hand the quality and quantity of agricultural credit is set by market supply and demand forces within the agricultural industry, forces which an individual banker may lead but can never lag if he is to maintain his market position. On the other, the accommodation of these market forces must be fitted by the commercial banker into the mosaic of responses to the total community requirements, of which the agricultural sector is only a part. To complicate his life further,

along the way he has to keep one eye cocked on national monetary policy, for to an increasing degree it is affecting flows of credit geographically and institutionally. It would be belaboring the obvious to point out these are not always parallel forces.

Ordinarily, policy judgments should flow in a logical way from an examination of the facts. This statement of conventional wisdom is as empty of encouragement for you as it is for me, for the fact base is certainly inadequate. Several of us concerned with the quantity and quality of ag credit, viewed in the context of the expanding demands of agriculture and the flows of money and credit in this district generally, have talked about this lack of basic data. The Federal Reserve Bank of Minneapolis has had a proposal before the Department of Agricultural Economics at the University of Minnesota for over 18 months that we jointly undertake such an inquiry, with the Bank to partially underwrite the project. I am delighted to announce today that the search for a study director is over. Vern Ruttan just told me the last and best of the candidates we have interviewed over this period has accepted our offer. For those of you familiar with western novels, his name is entirely appropriate--Matthew Shane.

Change in the economic world, however, does not wait until research projects have come up with their conclusions and recommendations. With what information is available and a look at past trends, we can anticipate some of the questions that will face the commercial banking industry with respect to agricultural lending. For example, what is the role of commercial banking in agricultural lending in this district and in what direction are we going? Further, assuming that the direction is something other than desirable for either society or the banker, what alternatives are there for policy change?

What I have for you today is little more than a partial prospectus

for this study, plus some extraneous speculations of my own. The first area of analysis will be the structure of the demand. What are the requirements of agriculture now, and what is it logical to expect them to be in the future? This requires a look at the dimensions of agriculture as these have developed over the last ten years.

Without cluttering my talk with a variety of numbers, a preliminary statistical review prepared by our research department suggests these points:

a) Aggregate farm income in the four whole states of the district has increased in an erratic way from a base in the years 1957-59 through 1966, but at a lesser rate than aggregate production expense, except for 1966. The fact that the expense rate increase has been a consistent one is fraught with special significance.

b) These trends are reflected in aggregate net profit, for in only three of the ten years has the index been over the assumed base.

c) Per farm figures show about the same pattern, notwithstanding a decline of 15 percent in numbers of units.

There are certain conclusions which would seem to be obvious. The growth in production expenses has had to be financed in substantial part from external sources. While it might be argued that gross income has not lagged as far behind production expense in aggregate growth as some spokesmen for agriculture believe, there has been a gap; and when this gap is considered in the light of the increasing capital demands of agriculture, it becomes more serious. After all, there are only two ways any business can obtain funds for capital expansion: one is through earnings, and the other is from external sources. And it appears obvious that agriculture has not been producing net income in the levels necessary to support the capital required.

What have these capital requirements been? Unfortunately, I do not

have data on capital additions broken out for this district, but I do have some observations for the nation as a whole which furnish proof that the capital requirements have been considerable. These must be viewed with considerable caution, for reasons I'll mention.

The first of these observations has to do with the growth in dollar value of assets, which between 1957 and 1966 increased 54 percent. Now, this includes an inflation factor of probably 10 percent, but even so, it represents a very major investment. A second observation has to do with the enormous growth of total farm debt--a growth of 114 percent in outstandings between 1957 and 1966--which cannot be explained by changes in either price levels or quantities of expense inputs traditionally viewed.

How these figures relate is much more of a problem. Farms have gotten bigger and there has been a major shift from extensive to intensive agriculture. Nobody knows, though, how much has been spent in pursuing each of these objectives. I doubt very much that historical relationships of long-term debt and short-term debt to capital expenditures vs. production expenses are valid in agriculture. Income tax accounting for farmers as permitted by the IRC has so many departures from accepted patterns of financial reporting that ordinary rules of financial analysis are very difficult to apply.

These points, though, it would seem are incontestable: capital inputs have been very large, and there is no likelihood they will decrease. The drive for consolidation of farms into more efficient size units, the shift from extensive to intensive production methods, the explosion of technology in the agricultural sector, will force continued enormous additional investment requirements on the farmer.

Notice I have not said anything about expansion of markets. While

it is true that this country faces expanding food requirements in this country and a share of international responsibility to feed the under-developed countries, I think it is a fairly safe assumption that domestic food requirements for most agricultural products will be geared to increase in population rather than shifts in taste.

As to the international outlook, it is no longer as clear as it was. We are in a period now when nobody is talking much about the relationship of world food needs to U.S. agriculture. The development of new wheats, for example, coupled with fertilizer plants and rains, have brought Pakistan and India a long way down the road toward self-sufficiency in a very short time. Even minor food producing nations are now shifting into surplus positions with regard to certain commodities, so it is not all that clear that the export market for U.S. agricultural products will require an expansion of production.

My point is, though, that quite apart from the possibility of expanding markets for our products, U.S. farmers will be forced to continue a high level of capital inputs because of rising costs of operations.

Who has been furnishing the credit and what changes have taken place in the mix? Total farm debt in this district has grown from \$1.8 billion in 1957 to \$4.2 billion in 1966, divided as follows: Real estate debt has gone from roughly \$986 million to over \$2 billion. Non-real estate debt has gone from \$845 million to \$2.2 billion.

Let's look at the suppliers of real estate mortgage debt first. The share of the Federal Land Bank has grown from 20 percent to 26 percent, largely at the expense of the category simply marked "Other" which includes individuals as the major component. FHA, insurance companies and banks have been virtually unchanged. However, in terms of the growth represented for

each component, the largest growth has been represented by FHA at 2.6 times. The next by Federal Land Bank at 2.48 times, with banks following at 2.3 times.

Shifts in the mix of non-real estate debt are more dramatic, with the banks dropping from 78 percent to 66 percent, while PCA's grew from 12 percent to 24 percent. In terms of their volume of ag lending, banks have roughly doubled, while PCA's have grown almost $4\frac{1}{2}$ times. Even FHA volume increased more than banks, growing to 2.6 times the base period.

Why has the bank share been decreasing? Again may I say that factual data is quite slim, so if I appear unusually cautious in discussing the possible reasons, it is because I am not sure what weight is to be attached to any of these. These are the reasons most frequently cited:

1) Loan limits of unit banks. The ABA survey of 1966 reported that 26 percent of the responding banks had received loan applications in excess of legal limits and that 90 percent of those were handled within the banking system. This survey was in the first half of 1966. I am not sure how the tightening in the last half of 1966 affected agricultural lending. My guess is that the loan overlines handled within the banking system may have decreased somewhat because of the pressures on the financial centers. Balanced against this, of course, was the unusually liquid position of banks in agricultural areas during this crisis because of the comparatively high level of farm income, which helped the correspondent banking system avoid a collision of demand forces between city and country customers.

2) The inelasticity of the money sources available to banks in rural America, where most of the ag banks are located. At least to this moment, the escape valves used by banks in larger centers are either not available to or availed of by the small country bank. Among these are marketable CD's, debentures, Euro-dollars and federal funds.

3) The quality and age of management in these banks. Small towns and limited financial incentives are usually recited as the principal reasons these banks have difficulty in attracting management talent.

4) The operating advantages of the competition. Usually it is the PCA the bank apologist has in mind. Less frequently cited but also mentioned is the competition of larger banks, savings and loans, and the money markets themselves for depositors' funds. Also on the supply side is the competition faced by the country bank for the funds of the large correspondent banks from the major industrial customers of such banks.

A variation of the last point is what may be a trend toward integration of supply and marketing services by agri-businesses. Some of these are making production credit advances as a part of a customer service package. They are financed in turn by the metropolitan banks to close the circle of credit.

I suspect each banker could add to this list. I have not attempted to comment on the weight which might be given one reason as against the others because I am not aware of any factual studies which would sustain any one position. Obviously, though, as the little old lady commented to the park service ranger as she gazed into the Grand Canyon, "something sure happened here!" For commercial banks it has been the Farm Credit System. The spectrum of their services has grown in the same way as their loan volume.

What are some of the possible ways in which commercial banks can move to recapture their share of this market? It seems to me there are two things that have to happen. The first of these has to do with bank unit size, which in turn involves restructuring of the industry. Whether done through branching; creation of more small holding companies; or the development of unified markets in some way for money instruments, which can include CD's and

agricultural credit paper, the small country bank has to find some way to broaden its base. It is a decision individual bankers are going to be forced to make, but the decision cannot be postponed. The pressures are building up in various states of the district, originating partly within banking and partly outside of banking, to bring these questions before legislatures; and it would behoove those bankers who do prefer to have a part in shaping their own destinies, rather than having it done for them, to think seriously about these pressures. I know of no banking issue where there is less assurance decisions will be made on the basis of facts rather than prejudice, so it is with some temerity I make this suggestion.

May I add there simply aren't many facts to give absolute support to any of these alternatives. Given the kinds of pressures around us, though, a restructuring of banking in some different way appears a certainty. How much wiser it would be to take part in a positive way in the process! If I may speculate for a moment, I suspect a careful analysis of the needs of this district may produce this conclusion. Because of the variety of banking markets in this district, there can be no single "best" system for any of our states. Instead of limiting the options available to the banking system by arbitrarily singling out the "best," the effort should be to broaden the list of alternatives so individual banks can choose that one best suited to their market needs.

I have not mentioned the correspondent banking system as one of the solutions. This is not to minimize in any way the services performed by the money center banks for their country bank customers. The computer is bringing banks closer each year to a realistic fee system for services instead of the archaic obsolete system of using correspondent balances as the pricing mechanism. The city bank does furnish specialized banking services--bond advice, deposit

accounting, access to trust services are some of these--but if agricultural credit demands increase as many believe they will, I doubt the correspondent banking system will afford a continuous source of additional credit for country banks. A look at the relationship of bank balances and participations may be instructive in justification of my doubts.

As of December 31, 1966, the six Twin Cities banks holding 76 percent of the inter-bank deposits in the district held purchase loans and participations equal to 29 percent of these deposits. Those banks operating substantial correspondent banking departments in the nine next smaller banking centers in the district held 14 percent of the inter-bank deposits, but had purchase loans and participations equal to 59 percent of the inter-bank deposits. Differences in accessibility and convenience for the country bank; demands of industrial customers (particularly when coupled with substantial demand deposit relationships); perhaps even differences in the degree of familiarity with agricultural lending in the two types of banking centers may be likely explanations for the reserve city banks not handling more. If I were to guess at a single answer, it would be to say these are decisions of the market place, with all the complex interrelationships of decision-making that phrase connotes.

While not an entire answer, a partial escape valve for member banks pinched for supplemental credit may possibly be provided by the revision in the discounting procedures at Federal Reserve Banks now being considered. As proposed, there would be two additional kinds of credit permitted under Regulation A, in addition to the present emergency extension. The first of these would be an automatic borrowing privilege based upon capital and surplus. The second would be a seasonal credit which would be based upon historic patterns and, like the basic borrowing privilege, would be fairly

automatic in its extension. Both of these hold promise for agricultural banks.

The real solution, though, has to be in the ability of individual bankers to innovate with new management techniques. One of the great phenomena of the last five years has been the explosion of creativity and imagination in banks in the major money centers forced to equate the volatile and at times stringent requirements of monetary policy with the enormous expansion of the U.S. economy. The development of the fed funds market in a major way, the use of the negotiable CD, tapping of world money markets, development of specialization among lending officers--the list is quite long, and one to make anyone proud of belonging to the banking fraternity. Unfortunately, there has been not all this creativity among country banks as a class.

The free enterprise system to which we all profess allegiance is a commitment to an economy ruled by the market place, except as it may be deliberately and sparingly modified by political action in an effort to accommodate what is loosely referred to as the public good. On the whole, it has functioned reasonably well. Implicit though are certain assumptions. First among these is a knowledge of the market. Customers' needs set the pattern of demand. What these needs are now and may reasonably be expected to be in the future are facts every supplier of goods and services must have in hand before he starts analyzing his alternatives. Second, there are always alternatives, even if they are only to sell now or fail later. Fortunately for most country banks, there are alternatives that offer more promise, and I have referred to some of them. One of my convictions--prejudices if you will--is that commercial banking can arrest its gradual decline in the agricultural credit field, and recapture its share of the market. You share that conviction or you would not be here. Unfortunately, the conviction is not enough. Individual bankers must be prepared to do a lot more homework if the appropriate

alternatives for him are to be isolated, and then be placed in context of the industry as a whole, preferably through the banker associations.

We at the Fed of Minneapolis also have our share of homework to do. We have an obligation to assist in the production of data, the determination of trends, and the development of alternatives for the banking industry. As I said at the outset, we are on our way.

Thank you.