**REVITALIZATION IN THE 1990'S:
MONEY AND THE FARM CREDIT SYSTEM**

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REVITALIZATION IN THE 1990'S: MONEY AND THE FARM CREDIT SYSTEM

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Good morning. I'm happy to be with you in St. Louis today. The Farm Credit System and agricultural credit continue to be of central importance to every farmer, rancher and agribusiness. Today, I would like to discuss several key aspects of credit, including the revitalization and progress we can look for in the remaining months of 1989, as the stage is set for the 1990s.

THE 1990 OUTLOOK

Several factors will influence the financial outlook for domestic and international agrifinance next year, including interest rates, commodity prices, land and collateral values, and net operating income. These factors remain generally uncertain and are affected by many things such as international financial fluctuations, weather-related crop disruptions, political pressures and economic growth in many sectors of the economy. Overall, though, progress is continuing as interest rates and the basics of finance continue to positively impact the farmer and the Farm Credit System alike. We are entering another phase in farm credit -- revitalization and growth.

INTEREST RATES: A DILEMMA REMAINS FOR THE FED -- WHICH SHOULD TRANSLATE INTO MORE STABLE RATES FOR THE REST OF YEAR

The financial markets continue to provide uncertainty for the credit markets. (Slide 1) With the stock market reaching new highs, investors and interest rate watchers alike must ask the question "How long can this continue?" The answer is important because interest remains your largest cash expense. A number of factors continue to cloud the direction of interest rates as Treasury borrowings, corporate restructurings, and new S & L securities provide additional risks and concerns for investors as they seek higher returns.

However, there are offsetting pressures on the international and domestic economy that might change this outlook. Positively, the recent performance by President Bush in Poland and Eastern Europe, the improved outlook for the Uruguay Round in the GATT talks and strong leadership in international trade from Clayton Yeutter, the Secretary of Agriculture, are new factors in the international equation and should bear positive results.

According to the latest economic indicators, the U.S. economic growth rate has slowed but is still moving ahead while interest rate stability and a flattened yield curve continue to provide a basis for further growth in world wide agricultural finance. Recent U.S. economic trends have dispelled fears of a recession. The international bond market rally faltered in August as the dollar strengthened against most G-7 currencies. Investors worldwide do not anticipate any easing soon by the G-7 central banks. G-7 finance ministers and central bank representatives met last week to develop strategies to combat any further rise in the dollar. U.S. Government pressures add to this uncertainty.

In Europe, the sentiment toward lower interest rates is still very negative. Strong growth and the prospect of higher inflation, aided in part by the behavior of the dollar, make it unlikely that short-term rates will drop soon. Bond market sentiment could deteriorate further if short-term rates come under more pressure from stronger than anticipated growth. Indeed, most central bankers expect to see lower returns in the U.S.

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money markets. This could cause upward pressure on rates. In Europe, the French bond market, which has performed better than Germany and the United States, could lag from this point on. In London, markets have postponed a base rate cut, so the steeply invested LIBOR yield curves still beckon investors into short-term maturities. In Asia, led by the Japanese, the short-term instruments are still preferred.

U.S. interest rates are well off their lows this summer. With a relatively flat yield curve, we are approaching a point at which financial institutions will consider refinancing their short-term debt. The dollar should remain firm this fall as other countries, principally Germany and Japan, will focus on other opportunities for investment.

U.S. AGRICULTURAL FINANCE: A POSITIVE 1989 AND EVEN BETTER 1990?

The economic and financial fundamentals that undergird the long-range recovery in agricultural lending, including land values and inventories, continue to gain strength. (Slides 2 and 3) Land prices around the country are recovering, and as a result most farm balance sheets have stabilized or strengthened in the past 24 months. This trend should continue into 1990. Stockpiles of excess commodities have been reduced by the drought beyond this to the basic imbalance that caused the severe problems five or six years ago. Supply/demand imbalance will remain a question for the 1990s.

Financial stress on highly leveraged operators and financial institutions will continue to be a problem. But, for the majority of American farmers, notwithstanding the highly leveraged, the strong crop and livestock commodity sales of the last two years should continue. Currently, $155 to $160 billion in sales is forecast for 1989.

Several other credit concerns continue:

First, the farm sector has continued to rely heavily on Government payments, a situation which cannot continue indefinitely. A few farm bill is on the drawing board in 1990; until then we can expect the current policies to continue.

Second, the U.S. Government estimates that over 15,000 commercially-sized farming operations will continue to be financially stressed, experiencing severe cash flow problems as a result of unmanageable debt.

Third, the 1989 drought reduced production in some areas of grains, soybeans and wheat with resulting higher crop prices and reduced stockpiles. Cash income was high for producers with commodities to sell, and the new drought bill and federal crop insurance is helping other farmers survive. The threat of serious drought in 1989 failed to materialize in many areas, and crop damage was spotty. Those areas not affected will have bumper crops in corn and beans.

Fourth, production may surpass worldwide demand in 1989 and might cause some excess supply problems as the international economic situation continues to develop. USDA forecasts a $40 billion total for U.S. agricultural exports in fiscal year 1989; that's a 13 percent increase over last year. As we have already discussed, it is too early to predict worldwide supply trends. But oversupply in a fixed-demand market is a possibility. The U.S. must continue to be competitive as loss of market share over the past thirty years is alarming. (Slide 4).

A final concern is an expected increase of about 4 to 6 percent in 1990 farm operating expenses. Fertilizer, chemicals, seed and equipment will cost more next year. Earlier in this decade, dealers in equipment and supplies took losses or barely held their own, but this year they expect modest growth in prices and sales. Stockpiles are down and total production will be up. Increases in expenses will be a hefty 20 percent for some fertilizers and seed varieties. (Slide 5)

A new element in the farm credit picture remains the Federal Agricultural Mortgage Corporation. Everyone is watching Farmer Mac with great interest as it gets ready to kick off around the first of the year. It has held its share of early controversy, but if it lives up to its potential, Farmer Mac could result in greater availability of credit for farmers and ranchers, at more competitive rates. Agribusiness and investors should benefit from this new secondary market for agricultural loans.

FARM DEBT OUTLOOK - A KEY PART OF THE GROWTH AND RECOVERY PROCESS

In 1989, farmers have assumed less debt, continuing a 5-year trend that started with the 1983/84 recession. A slight increase in non-real estate debt is more than offset by declining real estate debt levels around the country. Indications are that the decline in loan volume may level off in 1989, with total outstanding farm debt increasing $2 to $5 billion nationwide, excluding FmHA. For the sector as a whole (including FmHA) debt is stable this year at $140 billion. In 1990 similar small gains are anticipated.

USDA predicts financial gains for commercial farmers in the 5 to 8 percent range. Nonetheless, 8 to 11 percent of America's farmers remain financially vulnerable, with debt loads in excess of 4 to 1.

UPDATE ON THE FARM CREDIT SYSTEM ASSISTANCE BOARD AND FARM CREDIT SYSTEM: PROGRESS IN FIRST 21 MONTHS

Now that we have touched on the macro-economics of farming and agricultural finance and the national agribusiness trends this year, I would like to get more specific and give you a progress report on the Farm Credit System Assistance Board and its activities since January 1988.

The Assistance Board currently is composed of Secretary of Agriculture Clayton Yeutter, Chairman; Deputy Secretary of the Treasury John Robson; and Indiana farmer Will Erwin. (Slide 6) Each of these individuals is deeply committed to a better rural America.

Since January 1988, the Assistance Board has examined Farm Credit System institutions that are in financial trouble, worked with them to develop financial recovery plans, certified those which are eligible and monitored those institutions which receive Federal financial assistance. Today, we are able to measure steady progress by those institutions. Each is different, just as their financial problems and their business and financial recovery plans are different; but all are now in a different phase of their recovery program - a critically important stage of growth and development.

The Farm Credit System, with our help, is focusing on "back to basics" of finance that are critical to any institution's financial success. (Slide 7) Each of our actions begins with an analysis of the balance sheet, income statement, and cash flow evaluation of the stressed institution. The staff focuses on:

<u>Loan Restructuring</u> - The successful banker must quickly identify and address problem loans to avoid the growing number of non-accruing loans burdening the portfolios of weaker financial institutions in recent years.

<u>Effective Cost Controls</u> - The era of high expenses and lack of cost controls in deregulated financial institutions is over. Many financial institutions must survive on 50 to 75 basis point margins. Customers today will switch institutions for 100 basis points or less. The Farm Credit System lost over $35 billion in assets from 1984 to 1988 in large measure because many good farmers -- over 100,000 borrowers -- walked out. (Slide 8) Today there are over 100,000 borrowers -- walked out. (Slide 8) Today there are over 100,00 institutions in the financial services industry; competition is ever present and price or rates is always important.

<u>Asset and Liability Management</u> - Each institution's unique loan portfolio and funding strategy must be carefully managed. As the size of the institution grows, so does the complexity of its funding. Good asset and liability management is critical to the success or failure of any financial institution. Farmers expect low

rates, but if an institution is not careful their funding will not effectively provide low cost options.

Marginal Loan Pricing - With interest rates ever changing, every financial institution must cover the cost of money plus the costs of operation.

As we monitor the System's "vital signs" this year, we are pleased to see higher net interest income and substantially reduced nonaccrual loans. We are concerned about continuing drops in volume. This appears to be a national trend as farmers are reluctant to take on new debt.

The banks we have assisted are on their way toward balancing their assets and liabilities, minimizing their exposure to fluctuating interest rates and competing in today's lending environment. (Slide 9)

In all our dealings, the Assistance Board has maintained its priorities: First, we must assure that farmers and ranchers in troubled Farm Credit districts will have credit available at competitive rates. Second, we must protect borrower stock as required by the Act. And third, we must seek the best method of assistance to assure long-term System viability, realizing that all individual institutions may not be saved.

The System has over $50 billion in debt outstanding at June 30, 1989, at an annual interest cost of about $5 billion. (Slide 10) During the first year of the assistance program to System institutions, investor confidence increased and spreads between System securities and Treasury obligations of comparable maturities narrowed. During much of the first half of 1989, the System securities have widened their spreads due to a number of factors not truly reflecting the credit quality of System debt securities. They have narrowed again recently. The System issued its first five-year debt since 1985 a couple of months ago. I feel the investor should not overlook the basic strength of the current financial situation. The investor must remember that:

- Unlike the S & L industry, the System continues to show improvement in its financial position and results of operations and steady progress from quarter to quarter. Unlike several years ago, earnings and collateral are real and improving. The backstop mechanism is in place and working well.

- System debt securities are of the highest quality. The recovery of land values, lower nonaccruing assets, increased net interest income and margins translate to the increasing basic strength of the System and its securities.

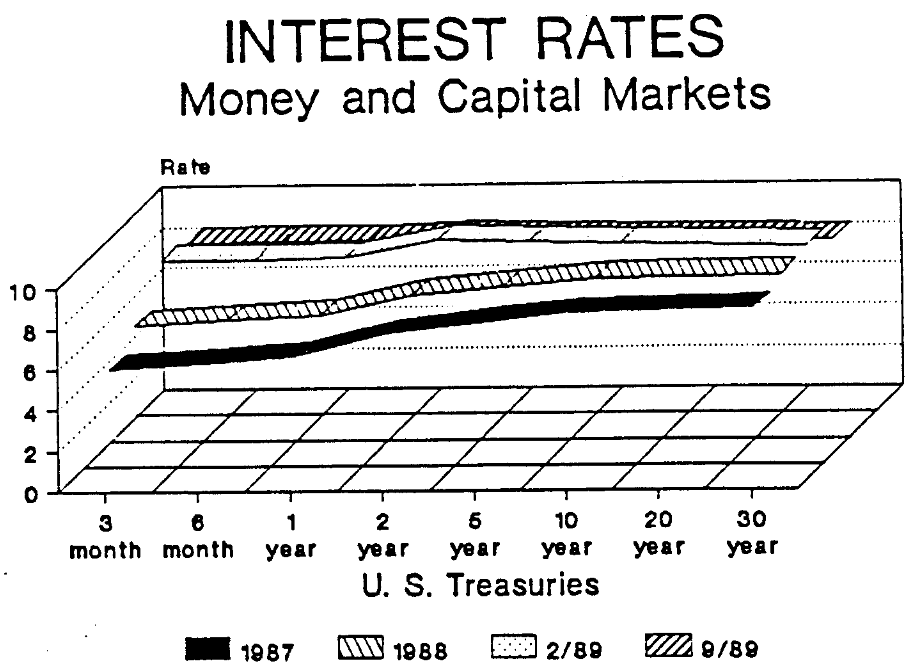
- American agriculture is currently outperforming most other sectors of the economy. Income, cash receipts, government support programs, exports and sales have all contributed to the improving agricultural sector and the Farm Credit System. Agricultural exports in the first six months of fiscal year 1989 were 18 percent above those during the same period a year earlier.

Although problems exist, the mechanism provided under the law is working, and the System institutions are working individually and collectively to make their System an effective, responsive lender. I am confident that the Farm Credit System will succeed in its financial recovery efforts and will continue to be a leader in agricultural lending.

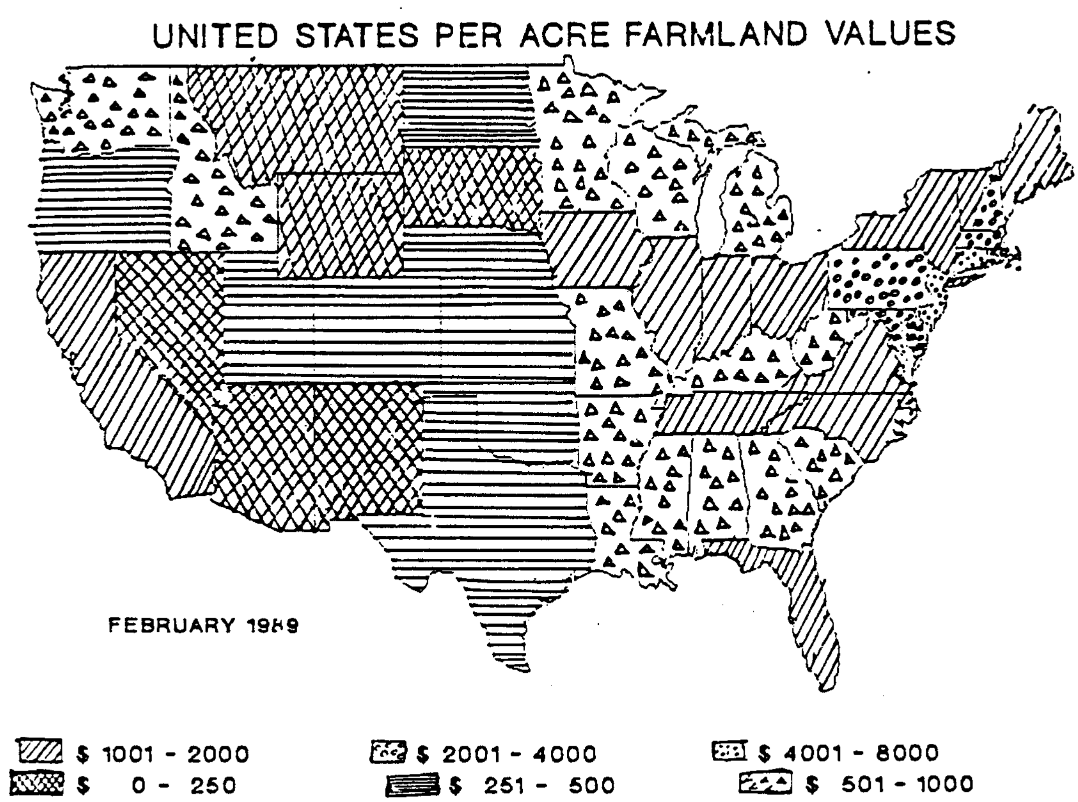
In closing, let me just say I really believe that, more than any other way of life, agriculture and its financing is the most unpredictable. The gamble, the uncertainty, is part of the fascination of farming. It's like the city businessman who, although he had never been near a farm, decided to take the big gamble, sell everything, buy a farm, and be a farmer... so he sold his house and business and bought a farm (with a loan from his local FCS office). He thought the way to farming success was to diversify, so he made his plans to grow corn, wheat, beans and chickens. When he was ready to begin farming, he went into town and bought 500 baby chicks. One week later, he was back, complaining that he had bought sick chickens. "Every one of them died," the new farmer complained. The dealer said he would replace the 500 baby chicks free of charge, because he didn't want to lose a good customer. One week later, the new farmer was back. "How are you getting along with the chicks?" the dealer asked. The new farmer shook his head. "They all died again -- lost every one." Well, I know they weren't sick," said the dealer. "Let's try to figure out what happened." "Well I think I've narrowed it down to two possibilities," said the farmer. I've narrowed it down to two possibilities, said the farmer. "What's that?" "I planted 'em either too deep or too close."

So we need more than the desire to succeed, if we are to win the gamble. We need experience and the knowledge experience brings. And still, sometimes we guess wrong. No one can predict exactly how international agriculture, current crop predictions, and the interest rates will develop. We can't really predict how things will be 6 or 12 months from now, although financial analysts and senior financial officers will continue to try.

Thank you.

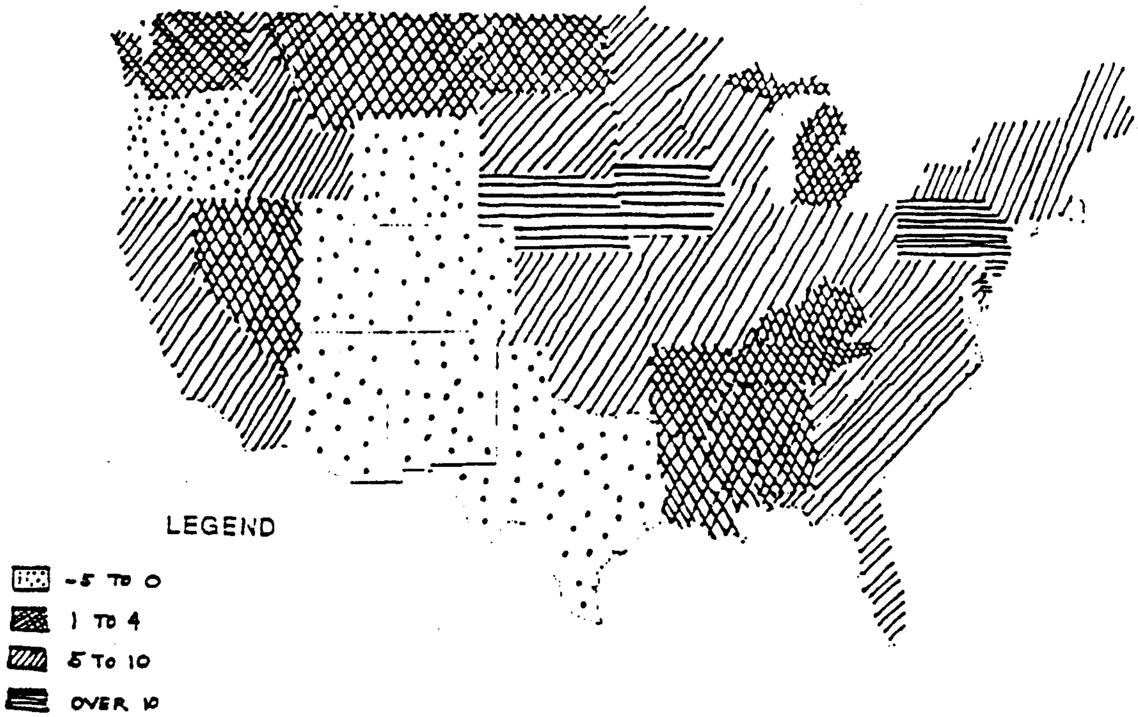


Slide 1



Slide 2

PERCENT CHANGE IN FARMLAND VALUE PER ACRE FEB. 1988-Feb. 1989



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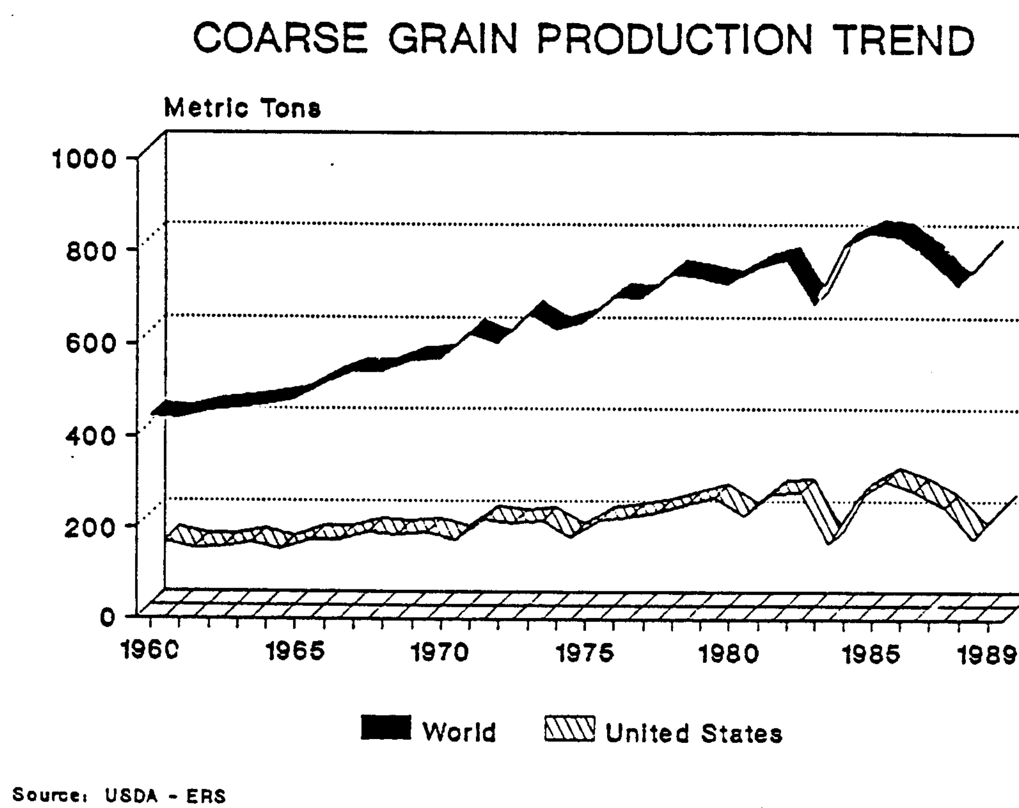
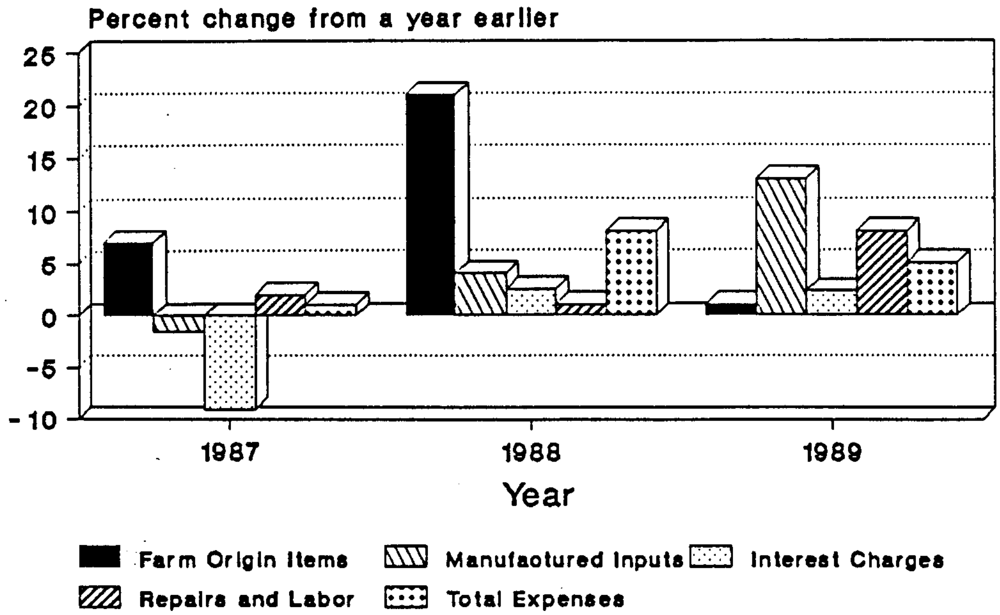


Slide 4

Growth in Farm Expenses



Slide 5

1987 CREDIT ACT

- WORKABLE AND FLEXIBLE APPROACH
- IMPAIRED STOCK IS THE TEST
- CERTIFICATION MAY NOT BE APPROPRIATE
- MERGER OR CONSOLIDATION
- OTHER OPTIONS AS DEFINED BY THE ACT

Slide 6

FARM CREDIT SYSTEM INSTITUTION

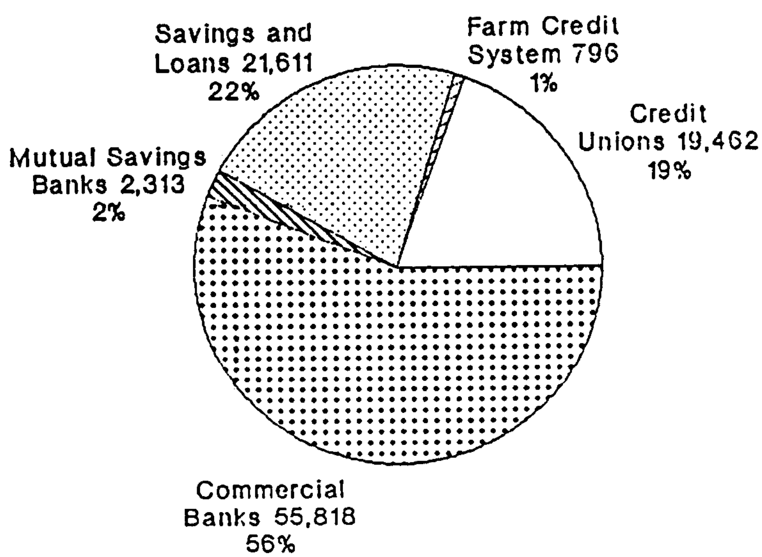
Directors and Management Control

ASSETS	=	LIABILITIES	+	EQUITY
o accrual o nonaccrual o property o high risk		o notes o bonds o other		o borrower stock o preferred stock
$5.0 Billion		$4.6 Billion		$0.4 Billion

Slide 7

The Financial Services Industry

100,000 Total Locations



Slide 8

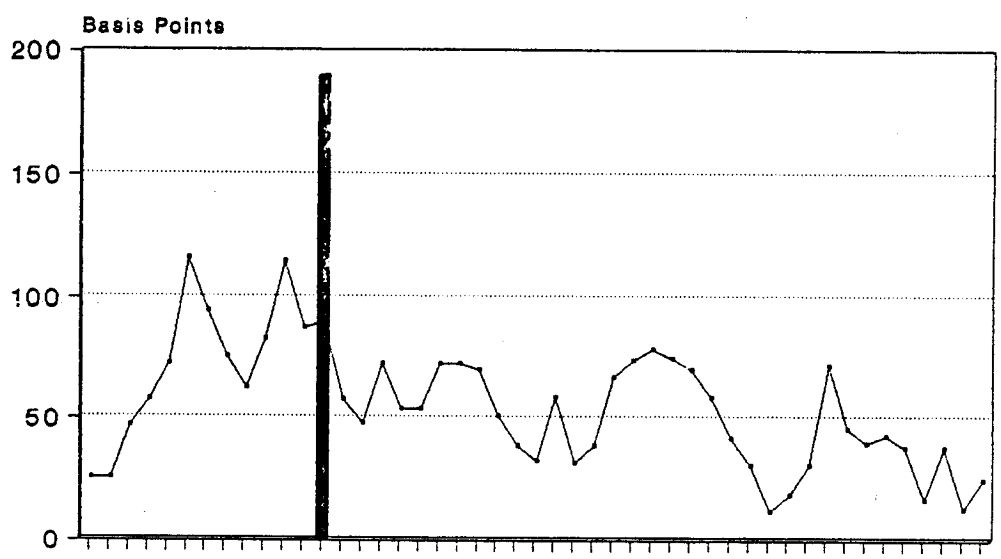
COMPETITION

"8.50% 30 Year Fixed Rate
on these (properties)"...

Iowa Realty Section of Des Moines Register
September 1, 1989

Slide 9

Federal Farm Credit Bank Six Month Bonds Spread Over Comparable Treasury Bill



vertical line is 1/21/88: the day the Assistance Board was chartered
source: FCS Funding Corporation

Slide 10