Agriculture - Economic aspects (P1)

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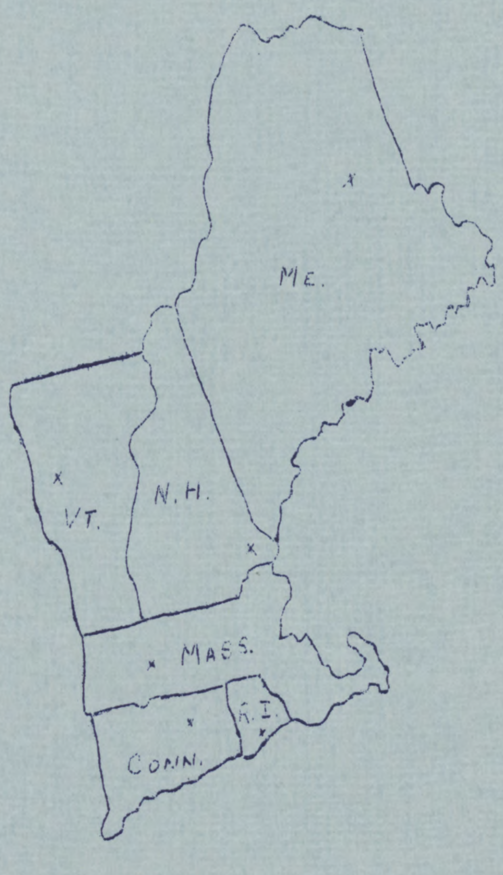

PROCEEDINGS JUNE 1957

AT THE

UNIVERSITY OF CONNECTICUT

STORRS CONNECTICUT

CREDIT POLICIES AND THEIR IMPLICATIONS FOR AGRICULTURE

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The subject assigned to me might be interpreted in either of two ways: (1) the implications of national credit policies, or (2) the implications of credit policies of individual lenders. I shall undertake to discuss both phases.

First, let us consider the role of the Federal Reserve System and its means of effectuating credit policy, the factors entering into the determination of policy, and policy itself.

Congress has delegated to the System the function of regulating the flow of credit and money. These powers are used by the System to achieve the broad objectives of stable growth in output and employment, stable purchasing power of the dollar, and rising standards of living. Sound credit and monetary policies can help restrain inflationary forces during an upswing, and also during periods of intense utilization of resources such as the present. Sound monetary policies can also encourage spending and promote economic recovery during a recession. Monetary policy, however, cannot be expected to do the entire job of promoting stable growth by itself. Federal fiscal policies are very important. So, also, are a host of other influences operating on the economy, including labor-management relations, cost and profit margins, productivity developments, and business and consumer attitudes in general. Within our institutional framework, however, monetary and credit policies constitute the principal tool for promoting sustainable growth in our complex economy and at the same time maintaining the value of the dollar.

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 balances with the Reserve Bank in their district equal to a prescribed percentage of their deposit liabilities. 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. In this way, 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. The most used 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. It is not intended to be a continuing source of funds and extensive and continuous borrowing is discouraged. In periods when demand is outrunning supply and System policy calls for restraint on bank reserves, the discount rate may be raised to keep pace with market rates in order to discourage other than necessitous bank borrowing, thus causing banks 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 by open market purchases and may also lower the discount rate. With bank reserve positions eased and with their cost of borrowing reduced, banks are encouraged to expand their loans and thus stimulate spending and employment.

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.

System credit policy must be geared to the ebb and flow of economic activity. Hence, to understand the implications of credit policy at any given time it is essential that we also have in mind the economic situation at the time. For that reason, I would like to review current and recent economic developments as a background to present credit policy.

Let us begin by taking a brief look at the current situation. The broad picture is of a strong, vigorous and resilient economy. Over-all economic activity has been on a high plateau since late last year following two years of strong expansion. Expansion in activity and upward pressure on the price structure have occurred in recent years notwithstanding the emergence from time to time of soft spots with accompanying downward readjustments, such as in automobiles and housing. Most recently business concerns have shifted from accumulation to some liquidation of stocks. Final demands for goods and services, however, continue strong and resources of manpower and machines are generally intensively utilized. Unemployment currently amounts to about 4 percent of the civilian labor force, about the same as the post-war average. While average prices of industrial commodities have been stable since February, consumer prices, significantly, have continued to rise and are now 3.5 percent higher than a year ago. Prices of farm products have been firm over the past year at a level somewhat above the low reached in late 1955 and early 1956. Demands for credit are strong both at banks and in the long-term capital markets and interest rates have advanced further.

Industrial capacity has increased steadily and rapidly in recent years. With capacity up and with business demands for inventory down, supplies of major materials are in general more adequate than earlier. The Federal Reserve Board's index of industrial production had edged down a bit in recent months but, in May, at 143 percent of the 1947-49 average, was slightly higher than a year earlier. The indication for June suggests little change from the May level. The labor market has continued stable. Nonfarm employment in May at 52.6 million persons was little changed from December but was 750,000 higher than a year earlier. Output per man hour in the manufacturing industries, which changed little from early 1955 to mid-1956, has resumed its noticeable upward trend and labor unit costs have tended to level off.

Meanwhile, the dollar value of total output of goods and services has continued to rise to new highs, in part reflecting higher prices. In the first quarter, gross national product rose to an annual rate of $427 billion, $24 billion, or 5.5 percent, higher than a year earlier. Another moderate increase in national output has apparently occurred in the current quarter and the total is likely to exceed an annual rate of $430 billion.

Recent expansion in gross national product reflects moderate increases in expenditures in most major areas of demand. Consumer expenditures for nondurable goods and services have continued to increase. Outlays for durable goods in the first half of 1957 are larger than in the first half of 1956, reflecting in large part higher prices for new automobiles. Extension of installment credit for financing purchase of automobiles has recently been close to the record rate reached in the summer of 1955.

While business has shifted from accumulation of inventories at an annual rate of $4 billion in the fourth quarter of 1956 to liquidation of $1 billion in the first quarter of this year, spending for plant and equipment is continuing to increase from very high levels, although the rate of advance is much slower than earlier. The latest Commerce-SEC survey of nonfarm business intentions to spend on fixed capital indicates an annual rate of spending $37.9 billion in the third quarter of this year, up $600 million from the estimate for the current quarter and $2 billion from the third quarter of 1956. Currently, the largest increases are in spending by public utilities and railroads. Manufacturing concerns plan a decline in spending in the third quarter following two years of substantial increases.

Total outlays for new construction so far in 1957 have been slightly above a year ago. Increases in publicly-financed construction and in most types of business construction have more than offset reductions in residential building. In May, however, private housing starts seasonally adjusted rose to an annual rate of 990,000 units, the highest so far this year but 14 percent below a year ago.

In the first five months of 1957, starts were at an annual rate of about 940,000 units compared with 1,140,000 in the year 1956. The decline in starts has been concentrated in units under VA financing; the number of conventionally financed units is about the same as a year ago.

State and local outlays for construction and other purposes have risen steadily and are scheduled to rise further. Federal purchases of goods and services have increased since mid-1955 and are also likely to rise in the year ahead, despite strong efforts towards economy.

Meanwhile, activity abroad continues to expand in most industrial countries and upward pressures on prices persist. Our exports continue close to the very advanced first quarter level.

Taken altogether, many recent developments have been gratifying. These include the resumption of significant productivity gains, the halt in the rise of industrial prices, and more cautious business inventory policies. Output, employment, and consumption have remained at advanced levels. Nevertheless, periods like the immediate present--with their high levels of demands--give rise to difficult economic problems.

Increased productivity is a principal key to our established pattern of economic growth. Our standard of living, either as individuals or as a nation, depends primarily on the amount of useable goods or services which we produce per man hour of human labor. It is also dependent, however, on the maintenance of an aggregate purchasing power which is kept in balance with available supply. This is best illustrated by the contrast between developments of the past few years and those of the '30's.

In 1939, we were still suffering from the inertia brought on by devastating effects of the world-wide depression in the early '30's. We had a total national income of $72.8 billion. Unemployment was high, amounting to about 17 percent of the labor force. Per capita income and consumer buying power were still below 1929 levels and prices generally were depressed. From 1940 to 1951 war, postwar and Korean demands were pressing capacity to the limit or beyond and resulting in inflationary price rises. Some of this price rise was perhaps unavoidable in view of the extraordinary demands of war on the Nation's resources, but some of it may also be traced to the practice of pegging Government security prices, thereby barring an effective policy of credit restraint. In early 1951 came two changes. The peg was removed following the Treasury-Federal Reserve accord in 1951 and the stimulus of heavy anticipatory buying by consumers and business ended.

From early 1952 until late 1955 we were in a period of relative stability in consumer and industrial prices. The decline in activity in the second half of 1953, resulting mainly from large reductions in defense spending, was moderate. Unemployment was relatively low and disposable income continued high. Prices of farm products and income of farmers, however, declined persistently.

In 1955 recovery developed into a strong boom. Exuberant optimism and easier credit spurred consumer demand. To expanding consumer demands was added an upsurge in business spending for plant and equipment. With the Federal

Government continuing to take a large portion of the national output, the price structure was under heavy pressure. In this situation we had a choice between two courses, neither of them universally popular. One would mean the extension of credit to meet all demands even though it would create spending power in excess of current capacity to produce. This would lead to another round of price increases, over-expansion, and possibly ultimate deflation. It would also mean more inflationary spending at the very time when we should be encouraging saving to pay for the increased productive capacity essential to our continued growth. The other course would attempt to hold expenditures to a level permitting a prudent expansion of production facilities and a sustainable rate of growth in current consumption. This course should be familiar to any farm group for the farmer has always recognized the necessity of holding back a part of this year's production for future replacement or expansion.

Just a few years ago we saw the folly of departing from this concept in the beef cattle situation. In the face of a booming demand for beef, cattlemen decided to expand, new men went into the business and both groups built or enlarged their herds at the expense of current consumption. For a time this looked like good business. But while the continuing urge to expand aggravated the shortage and boosted prices, this increase in prices was gradually curtailing demand and per capita consumption dropped from about 68 pounds in 1947 to 55 pounds in 1951. As the production from these new and enlarged herds began to hit the market, we found that supply had outrun effective consumptive demand. This, couples with drought and other factors caused a cessation of this expansionary trend and cattle prices dropped nearly 50 percent in three years' time.

Of course, no one wants rampant inflation or the resultant deflation. However, some people seem to feel that a mild or creeping inflation is tolerable or even desirable and that in any event it is inevitable. Such a position is self-defeating since persistently rising prices carry with them a widening expectation of further rise. This, in turn, leads to financial overcommitments, speculation, misdirected capacity, slackened efficiency, erosion of existing savings, discouragement of new savings, and ultimate collapse, loss of confidence and depression.

It is this sort of situation that must be guarded against in our entire economy at the present time. To accomplish this end, 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 one and one half percent in April, 1955 to three percent at the present time.

These actions have placed banks under increased reserve pressure and have induced them to adopt more prudent and selective loan and investment policies. As a result, rates of growth in bank credit and in the money supply have been relatively small and interest rates have risen sharply, reflecting the 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, rather than one of reducing the actual supply. As a matter of fact, the money supply is still growing though at a reduced rate of about 1 percent a year compared with a rate of 3 percent in 1955. It should be noted that, although growth in the money supply has been smaller than usual, the rate of turnover of each dollar has increased considerably.

Now, let us consider the implications of this policy for agriculture. The farmer's future depends on a sustainable growth, a high consumer purchasing power, and a balance of production to effective demand. Any overexpansion leads temporarily to inflation and ultimately to deflation. The experience of agriculture over the years is fraught with painful examples of this situation.

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 nonfarm economy. 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.

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.

There is a marked difference in the present situation compared with that in the '30's. Then we had loss of confidence, business and industrial stagnation, burdensome unemployment, and lack of consumer buying power. Today we have the reverse. Employment is high and consumer purchasing power is at record level.

Here, then, has been a dilemma. On the one hand, business and industry have been booming, wages and prices have increased, and inflationary pressures have continued to manifest themselves. On the other hand, agriculture has been caught in the throes of overproduction and deflation although the change in trend in recent months seems to indicate a definite improvement in that situation. This means that our agricultural problem is primarily one of adjustment in our farm output rather than one of stimulating the general economy.

For the economy as a whole, a cautious restraint of inflationary tendencies is still in order. Certainly, inflation would be of no help to the farmer. Since his price problem is definitely one of surplus supply rather than lack of consumer buying power, inflation would be of little help to him in terms of increased selling price, especially for commodities that are in surplus, and it would definitely be a detriment in terms of increased prices on the things he has to buy, both for production and for his own use.

On balance, the answer seems clear. The detrimental effect of inflation on the economy as a whole and on the rising costs of production to the farmer far outweighs any disadvantage that he may suffer from credit restraint. As you doubtless know, credit costs to farmers average something less than five percent 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 95 percent of farm costs.

As a matter of fact, we have found little evidence of reduced availability of farm credit for credit-worthy farmers. The continuing rise in farm land prices in practically all sections of the country would not indicate any lack of farm mortgage credit. Furthermore, available information on interest rates indicates that rates on farm loans, both real estate and non-real estate, have risen less than in other sectors of the economy.

Of course, some people will claim that rising money rates are not only adding to the cost of farm credit but that they are also a factor in the rise of all other farm costs. My answer is that no one can tell what the rise in costs would have been without some credit restraint. However, the history of inflation in periods of unrestrained credit expansion in this and other countries gives indication of what it might have been.

And now let us turn to the implications of credit policies of local lenders. Within the broad constraint of general credit policy, individual lenders have considerable scope to determine their particular lending practices and standards. Agriculture has gone through a technological revolution in recent years. Since 1940 production per acre on all crops has increased 22 percent and on livestock 27 percent per breeding unit. In the same period, output per man hour has almost doubled.

While this increased productivity of labor has been the key to the rising standard of living throughout our economy, it has special significance in the credit problems and policies of farmers and farm lenders. These problems stem from the fact that increased productivity is primarily the result of the substitution of capital for labor. For example, land and animal productivity is being increased by the use of improved seeds, feeds, and breeding stock and more and better fertilizers, insecticides, herbicides, and other agricultural chemicals, together with the increased use of purchased power in the form of fuel and electricity. Of course, this increases cash operating costs, and per capita operating capital requirements for these items rose from $750 in 1940 to $2,622 in 1956.

More and better power and machinery increase the number of land and animal units that a man can handle but they called for an investment of $1,748 in 1956 compared with $220 in 1940. This ability to handle more land leads to fewer and larger farms and land investment per worker rose from $2,461 to $10,793. In the aggregate, this amounts to an increase in investment per worker from $3,631 in 1940 to $15,165 in 1956, part of which of course reflects the rise in prices and depreciation of the dollar during this period.

Commercial farming, on which we depend for most of our agricultural production, has become big business and requires sound business methods both in managing and in financing the operation. Unfortunately, not all farms have attained a satisfactory level of efficiency. Out of approximately 4.8 million farms in the country today, about one-third might be classed as "commercial" farms, producing about 85 percent of our farm commodities. About one-third are what might be classed as residential farms whose owners are largely or entirely dependent upon off-farm income. The remaining third is made up of marginal or sub-marginal farms, many too small to provide even a minimal standard of living, and the owners of which have little or no off-farm income. In a way, it might be said that it is this group that is at the root of our whole farm problem. The cost of production per unit on these small, poorly equipped farms is so high as to be unprofitable even at prices well above those now prevailing, yet even their relatively small part of total farm production contributes to the surplus and the consequent depression of all farm prices.

A farm operation that obviously cannot produce a fair return on the investment over a reasonable period of time is a poor credit risk for borrower and lender alike. The borrower will either sink further in debt or he will drive himself and his family to drudgery and poverty. In either case, the farmer will have lost part of all of his equity, the banker will have lost a customer, and the community may have lost a potentially productive citizen. The operator of such a farm, if he lacks the talent or resources to alter or enlarge his operation, might better be denied credit and encouraged to seek other uses for his talents and resources.

Our principal farm credit problem is with the capable and experienced operator, large or small, who needs to enlarge or alter his farm program so as to provide a more efficient utilization of his labor and equipment and a greater gross and net income. This may call for a full-time operation or a part-time one with time available for some off-farm employment. In either case it will probably require increased extension of credit and probably on longer terms. With the increased capital requirement in many types of farm operations, he may find it advisable to continue to operate indefinitely on a certain amount of borrowed capital. In fact, many of our better tenants find it more profitable, with fair rental contracts of long tenure, to continue to rent and conserve their available capital for equipment and operations rather than to tie it up in land. In no event should the farmer tie up so much capital in land or so much of his income in the payment of land debt that he lacks operating funds to enable him to operate efficiently.

In addition to his land, he may require considerable sums for investment in livestock or equipment. Breeding livestock pay out over a period of years and not only require but justify longer term credit than feeder livestock which can be fattened and marketed in a matter of months. A man going into dairying, for example, must have a certain minimum herd to justify the equipment and production facilities essential to the production of Grade A milk. If he is burdened with unduly onerous payments on his cows and equipment, he may curtail feed and care expenditures only to find that he has cut production and hence his whole debt payment potential.

Likewise, some of the major farm equipment with productive life of several years may well merit longer credit terms than have commonly been extended. If there is justification for extensions of 30-month terms and 25 percent down payments which are becoming increasingly common on automobiles, perhaps longer terms than commonly prevail would be justified for such things as tractors, combines, and other harvesting equipment in the hands of good farm operators.

Of course, any mention of terms on agricultural loans raises the question of the hazards in farming. Having spent close to thirty years combating the droughts, floods and insect hazards of Texas, to say nothing of the vagaries of the market, I am well aware of this problem. This awareness, however, only strengthens my conviction that there must be more long-range business planning in our farm operations. This planning should include sound analysis of each enterprise, including projections of income and expense, provision for adequate reserves in favorable years to tide over the poor years, and a realistic appraisal of the adequacy and adaptability of the man and his plant to the operation contemplated.

Unfortunately, many farmers lack the training or business experience to make such an analysis. They seek credit as they need it on a piecemeal basis and frequently from several different lenders, including banks, mortgage lenders, equipment dealers and suppliers. No one lender has a picture of the total operation in such a case. Each depends primarily on the integrity of the borrower and the adequacy of his collateral with little attention to the debt repayment prospects of the farm as a whole.

The government is attempting to meet this problem through the supervision and guidance extended by Farmers Home Administration to its borrowers. I am sure, however, that we would all prefer to see the need for government lending reduced rather than expanded. This, then, presents a challenge to the commercial banks and I am glad to say that a gradually increasing number of banks are establishing agricultural departments to handle this problem. So far, this activity has been limited mostly to the larger country banks. The smaller country banks feel, and frequently with justification, that they cannot afford a competent agricultural credit man. Many city banks, on the other hand, feel that they have little direct farm loan business and hence no need for such a man.

I would like to suggest that many city banks might find that the establishment of an agricultural department to serve their country correspondents would be a profitable investment in more ways than one. In fact, I know of one large city bank with a strong agriculture department that has picked up enough trust business involving farm estates, both of its own and its country correspondents' customers, to more than pay the cost of the department, in addition to the increase in its participation-loan business.

I would also like to suggest that these changing credit needs of agriculture and the corresponding need for changes in credit policies of farm lenders point to the importance of more attention to these problems on the part of our agricultural colleges. The growth of agricultural departments in our banks is limited in no small part by the lack of men trained in farm management and farm finance. In too many cases our county agents, vocational agricultural teachers, and other agricultural workers may have excellent training in technical production and yet be poorly equipped to assist farmers with their problems of organization, management, and finance.

I realize that more training in this area may call for curricular revisions in many of our colleges but, as a former Dean of Agriculture trained in production, I would urge that you continue to press for greater recognition of this need.