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THE IMPACT OF MONETARY POLICY ON AGRICULTURE, AGRIBUSINESS AND RELATED ACTIVITIES

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This paper addresses the impact of monetary policy on agriculture and agribusiness during the 1979-83 period from a historical perspective.

Prior to 1979 monetary policy received little attention in the debate focused on farm policy, food policy and related public policy issues. As a primary role of government in a free enterprise system is that of a referee to insure equity (parity) among participants in the economic system, much of the farm policy debate during this century has revolved around the persistence of farmers to over produce resulting in chronic low prices for farm commodities. The inverse conditions of scarcity and high farm-commodity prices have also surfaced. Public concern about possible food shortages occurred mostly during wartime — WWI, WWII, Korea and Vietnam.

The major exception to concern over food scarcity, except in wartime, followed depletion of grain reserves in the United States through massive sales to the USSR in 1972 and was further aggravated by short falls in global production during the 1972-75 period. Actions on the part of the OPEC Oil Cartel further fueled the food scarcity syndrome through disruption of oil supplies and escalating prices of energy. The unprecedented increase in farm commodity exports from the USA during the mid-1970s exerted an upward pressure on commodity prices — especially grains and oilseeds. Subsequently, an unprecedented aura of prosperity in American agriculture prevailed. However, the increasing price of grains and oilseeds contributed to a severe cost/price squeeze in the animal sector resulting in liquidation of a large part of the cattle herd during the years 1975 thru 1978.

Another part of the ag-food policy debate during the half-century from about 1930 to 1980 revolved around the goal of an adequate diet for all Americans. Initial efforts to provide all citizens with adequate food related to surplus commodity disposal (1). Several food aid programs followed including school milk, school lunch and breakfast, subsidized exports to the needy abroad, and finally the costly and highly controversial food stamp program.

In essence, ag-food policy of the past half-century revolved around the two simple goals of equity or parity for American farmers, and adequate food at affordable prices for American citizens. Emphasis on the goal of parity for farmers has assured an adequate food supply for consumers at affordable prices. The problem of 1983 is that of providing employment for all consumers in order to have effective demand.

MONEY, CREDIT AND MONETARY EXCHANGE

Another vital role of government is that of creating money, and providing guidelines and regulations for a functional and equitable monetary exchange system. People create wealth in the form of goods and services that provide necessities of life, comfort, convenience and pleasure. Money and a monetary exchange system are necessary though to avoid the inconvenience of direct barter and exploit the high levels of productivity associated with specialization.

Rising economic affluence (economic development) is certainly a goal of both society and government. The direction of change rather than the level of economic activity is all important. Increasing employment and rising labor (physical and mental initiative) productivity undergird rising economic affluence.

Another role of government is to provide a sound credit system to foster economic development. An advancing economy must provide credit to innovators and entrepreneurs. The U.S. government has played a vital role in advancing the productivity of American agriculture by providing or underwriting credit for enterprising farm operators to acquire land, buildings, machinery, fuels, seeds, feeds, and industrial chemicals. Credit is also essential to advancing productivity in the farm supply, and the postfarm sectors of the food, fiber and kindred industries.

Money and credit are not ends in themselves but rather are catalysts necessary for specialization and exchange. Investment funds (credit) are provided by savings, and credit created by a central banking system. Savings represent foregone or postponed consumption with real (net of inflation) interest being the carrot that induces savings. A saver expects to increase his buying power at a later date through real interest earned on investments. A business manager such as a farmer, expects to sufficiently increase productivity through the use of credit to repay borrowed funds plus interest. Declining productivity and consumer wealth or real buying power occur when the expectations of both savers (creditors) and investors are not realized.

Scarcity and Value

Value accrues to goods and services because they contribute to the necessities of life, comfort, convenience and pleasure of people, and because they are relatively scarce. Things are scarce because they are not readily available in nature, and/or the effort and capital required for their creation. In this context, money is no different from other commodities. The more difficult it is to create

money, the more valuable it is (2). A sound monetary unit is one that retains its buying power in terms of useful goods and services over time.

Governments aspire to protect the value (soundness) of their money through constraints on the creation of money. One way to achieve this objective is to tie the value of the monetary unit to things that are scarce in nature and/or difficult to create. The gold standard that undergirded U.S. monetary policy until 1933 in the domestic economy and until 1971 in international trade simply stated that a dollar was equivalent to and redeemable in a specified unit of gold — 1/35 ounce from 1933 to 1971 for foreign dollar holders.

Abandonment of the gold (and to some degree the silver) standard removed the major natural constraints on the creation of money. Money, like all other commodities, loses value as it becomes more abundant. Saving is discouraged when the buying power of money decreases over time — especially after net real interest is taken into account.

Price Inflation and Monetary Policy

Price inflation reached alarming levels during the 1970s for the first time during peace time since the formation of the U.S. government — disregarding the confederacy and its currency. It is obvious that price inflation depends on an increasing supply of money — i.e. money becomes less valuable in terms of goods and services. Debate revolves around whether price inflation causes the creation of money, or whether the creation of money causes price inflation. The prevailing evidence suggests that inflation can be reduced through constraints on the money supply but the penalty is apparently high levels of unemployment and widespread bankruptcy.

Prior to October 1979, monetary policy was that of creating money necessary to accommodate targeted interest rates. This policy was executed largely through the discount rate for funds borrowed from the Federal Reserve System by member banks (3). This is the rock bottom wholesale price of money. However, commercial banks charge customers a higher rate to cover their costs, interest paid on funds from other sources, risks and profit. Numerous interest rates exist at any point in time depending on size of loans, duration of loan and expected risk.

Federal Reserve prevailing discount rates were rather stable from 1931 through 1979 varying from a low of 1.00% from 1937 to 1947 to a high of 8.00% in 1974. Rates were much more variable expressed in real terms — the prevailing rate adjusted for year to year changes in the Consumer Price Index. Real Federal Reserve discount rates varied from a high of 12.81% in 1932 to a low of -13.36% in 1947 between 1931 and 1979.

A drastic change in monetary policy of the Federal Reserve System occurred in October 1979. Between October 1979 and roughly July 1982, the Federal Reserve Policy was targeted money growth in the range of 2.5% to 5.5% annually, without regard to interest rates, i.e. interest rates were governed by the demand for and supply of funds. Without an announced change in policy, there appeared to be a gradual reduction in Federal Reserve discount rates, regardless of money growth rates, between July and November, 1982 (4). The policy is unclear in early 1983. The best guess seems to be some compromise

between the goals of targeted interest rates and targeted money growth rates (4).

MONETARY POLICY 1979-82 AND AUSTERITY IN THE AGRICULTURAL - AGRIBUSINESS SECTORS

The Federal Reserve monetary policy of October 1979-July 1982 was associated with unprecedented high interest rates along with highly variable and unpredictable rates. Cause - effect relationships among economic variables are at best estimates. Although the change in policy was implemented in October 1979, there was probably a 2 to 3 month lag before it began to bite in terms of the level and variability in interest rates. Federal Reserve discount rates (New York) ranged from 10.00 to 14.00% between January 1980 and July 1982 compared with a low of 1.00% and a high of 8.00% between 1931 and 1979.

Two things are a direct result of the targeted money growth policy of October 1979 - July 1982: 1) high and highly variable prevailing interest rates and 2) a substantial reduction in price inflation as measured by the Consumer Price Index (5). Relatively high U.S. interest rates led to an increase in the value of the dollar relative to foreign currencies and precious metals — especially gold and silver. Foreign investors converted other currencies and metals to dollars and invested in the more profitable U.S. money markets. The relative increase in the value of the dollar increased the price of American exports in foreign markets and decreased the price of imports in American markets. Cost of travel was reduced for Americans in foreign countries but the cost of travel increased for foreigners in the United States. Moreover, high and variable interest rates created an aura of uncertainty and apprehensions which tended to stifle innovation and stagnate productivity.

Uncertainty and apprehension among business persons together with high and variable interest rates slowed investment and lead to increasing unemployment and declining real aggregate consumer income in both domestic and export markets. Fears of unemployment and falling real income pressure consumers to substitute lower cost foods for preferred foods and food services. This reduces the demand for basic farm commodities such as grains and oilseeds in the domestic market. Reduction in demand exerts a downward pressure on commodity prices.

Due to the highly competitive structure of the farm sector and the necessity for maintaining cash flow to meet scheduled debt payments, the short run response of individual producers to waning market demand is an increase in output exerting further downward pressure on farm commodity prices. The problem may be further aggravated by favorable weather. This is in contrast to the response to declining demand in the industrial sector characterized by closing production units and furlowing employees.

As noted, high U.S. interest rates increase the value of the dollar in terms of foreign currencies and increases the price of American goods in foreign markets. This leads to a reduction in export demand for farm commodities and a further downward pressure on commodity prices.

Falling net farm income leads to a reduction in demand for items used in production. Purchases of the more durable farm inputs are postponed. This resulted in a virtual collapse of the farm machinery market leading to financial crises in both the manufacturing, and the distributing and servicing sectors of the farm machinery industry during 1980-83. There is less immediate reduction in demand for fuels and chemicals that enhance production but these will eventually be affected as farm units fail.

Handlers, processors, fabricators, transporters, storers, and distributors of farm commodities are also heavy users of credit. Credit is necessary for holding inventories, meeting payrolls, payment for fuels and utilities, purchase of packaging materials, purchase of specialized machinery, etc. Costs are increased by rising interest rates. Apprehension and uncertainty is increased by highly variable interest rates. Austerity and apprehension in the marketing system exerts a further downward pressure on farm commodity prices and slow improvements that would reduce marketing costs. Thus, both farmers and consumers are adversely affected by high and unstable interest rates for funds available to the marketing system. On the positive side, some farmers might benefit from lower land values and rental rates, and lower feed prices.

Creditors gain in the short run by unusually high interest rates — i.e., a transfer of wealth from debtors to creditors. In the longer run, however, creditors are also vulnerable to high and unstable interest rates. As the wealth creating mechanism falters — i.e. high unemployment and widespread bankruptcy — both business enterprises and consumers default on loan (interest and principle) payments. Rising foreclosure rates exert a downward pressure on the value of land, buildings (commercial and residential), machines, and other assets that serve as loan collateral.

The evidence is rapidly mounting that excessively high and unstable interest rates and/or the unavailability of credit will lead to a virtual collapse of a substantial part of the economy including the farm sector, the farm input industries, and the food-fiber fabricating and marketing system. Widespread bankruptcy accompanied by falling values of real estate and other real assets would eventually lead to a collapse of the monetary-credit system.

Conversely, unbridled price inflation would eventually lead to a collapse of the monetary-credit system. It is obvious that the economy — with a high degree of specialization and exchange — could not function under such a scenario. The lesson is clear that a solution to the price inflation problem does not lie in targeted money growth rates simply because the consequences are not acceptable.

The root cause of price inflation is insufficient competition on the supply side of the market and strong competition on the buyer (consumer) side of the market. Strong competition among sellers exerts a downward pressure on prices. Conversely, strong competition among buyers exerts an upward pressure on prices — that is consumers compete with each other for goods and services offered. Weak competition among sellers is attributed to: 1) labor unions and other systems that set salaries and wages which causes labor costs to rise faster than labor productivity; 2) cartels (such as OPEC); 3) industries that engage in branding and advertising (nonprice

competition); 4) special interest organizations that set fees for services such as medical and dental services; and 5) a government that legislates to accommodate special interest lobbyists which further weakens competition. These are the problems that are to be addressed if price inflation is to be bridled without creating high levels of unemployment and widespread bankruptcy.

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End Notes

(1) Surplus disposal may have in fact been the prime motivation for the disposal programs.

(2) Money may be scarce due to constraints such as the gold standard, and general monetary policy.

(3) Although the discount rate is what the public sees and largely believes to be the main focus of monetary policy, it is federal open market operations that is the prime vehicle for regulating money growth and credit. The discount rate is a signal of the intent of the monetary authority and there have been extended periods when it was not an accurate signal. In some instances the discount rate reached a ceiling that was several points below the levels reached by alternate money market rates. The Federal Open Market Committee regulates the money supply primarily through the sale and purchase of securities on national money markets. A sale draws down checking accounts of commercial banks as purchasers checks to the fed are cleared, reducing the funds which serve as reserves for bank loans. A purchase has the opposite effect, injecting fed checks into deposit accounts of banks, potentially enlarging the supply of loanable funds. Banks adjustments to these surplus or slack positions affects the rates at which they lend and borrow funds from one another (the fed funds rate) and eventually impact all other money market rates. The discount rate is only adjusted to keep semblance of alignment with these rates (during certain periods). The discount windows obviously use other means to govern the volume of lending to commercial banks during "nonaligned periods."

(4) There has been a blurring of the boundaries between highly liquid funds (demand deposits) - traditional M1 - and less liquid time and savings deposits - the added components in traditional M2 - since interest rate deregulation. For example, many savings accounts and money market funds also permit unrestricted checking which give them demand deposit liquidity while traditional M1 has grown rapidly since July, M2 has grown more slowly. There has also been unusual movement between expiring all-savers accounts and checking account categories. Although this has occurred during the suspect period prior to an election, timing may be coincidental and that the decline in interest rates reflects weak money demand rather than an attempt to favor.

(5) The payment of interest in checking accounts by financial institutions adds a "front end" cost to funds of lending institutions that has undoubtedly permanently raised the cost of money to the borrowing public because these costs must be passed along to customers. That increase in interest rates is not a part of Federal Reserve monetary policy in the usual sense. Some banks choose not to pay interest on checking accounts although their competitive position is weakened by that choice.

These notes are attributed to a reviewer that chose not to be identified.

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