Discussion: Agency Status for the Cooperative Farm Credit System

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At long last, the material in the Lins-Barry paper has been presented in a public forum where it can be evaluated and, if appropriate, challenged. To the uninitiated, it may seem strange that much of the paper merely presents conclusions of the USDA and Arthur D. Little (ADL) studies cited, as would a library term paper. But it contributes more than that, because these studies are not in the library! The USDA study was never released. The Farm Credit System (FCS), which paid for the ADL study, apparently considers it an internal rather than a public report.

Nevertheless, the main conclusions of these studies have appeared in the rural press and have been used by policy advisors. Thus the Grace Commission found its empirical basis for recommending restraints on FCS lending in the implicit ADL conclusion (attributed in turn to a Chase Econometrics model) that such lending was largely responsible for land price increases. Lins and Barry politely describe this conclusion as "controversial" and "not...consistent with past research on land values." As research results showing that land prices have been determined mainly by land income and rents continue to accumulate, stronger language such as "worthless" might be considered.

Unfortunately, both studies also reached a similar and erroneous conclusion--that a private FCS, although relatively creditworthy, would find it difficult to market even its current volume of securities. Before challenging this notion and offering a different argument for retaining agency status, however, it should be noted that Lins and Barry have assembled a useful summary and analysis of FCS regulatory and tax preferences. In several instances, they show why the preference affects the competitive position of the FCS less than one might at first suppose,

which implies that these preferences may be a less important issue than many private lenders appear to believe.

The viability of a private FCS, however, was the question highlighted by the USDA and ADL studies, and thus their flawed analyses of this question deserve greater attention than the "contrary view" briefly stated by Lins and Barry in their concluding comments. On the basis of discussions with security dealers and investors, the USDA and ADL studies concluded that a private FCS would be unable to raise the volume of funds now required or projected. But, at the same time, both studies indicated that a private FCS would enjoy a relatively good credit rating. This is an incompatible combination; in fact, impossible. Let us see why this is so, and then how the studies erred.

In the nation's credit markets, there is on one side of the ledger a schedule of the total flow of funds supplied by savers, the Federal Reserve System, and others, which is not much altered, if at all, by switching the FCS from agency to private status. On the other side, competing for this total flow, are potential borrowers that range throughout the full spectrum of credit quality, with credit quality representing an assessment of the odds that the borrower will develop repayment difficulties. Each borrower has a demand schedule that shows the amount of funds he wants to borrow at alternative interest rates. In such a market, it is axiomatic that, as one descends down the spectrum of credit quality, each borrower in turn receives all of the funds he wants--at increasing interest rates, of course--until the total funds supplied to the market are exhausted, leaving the remaining potential borrowers with lower quality ratings "crowded out." That is, if one finds a borrower of given quality successfully borrowing at a certain interest rate, then all borrowers of higher quality will have obtained their full

demands at that rate or lower; otherwise, lenders would not be acting rationally. Assuredly, therefore, a private FCS would be able to raise all the funds called for by its demand schedule, unless its quality rating were to fall so low as to place it in the "crowded out" group.

This logic indicates that important parts of the USDA and ADL studies are sheer nonsense. The flaw is more vivid in the ADL study, simply because it presented more specific and highly dramatic projections. In projecting the consequences of "rapid removal of agency status," the ADL study assumed that FCS initially would be able to sell only one-fourth of the amount of securities sold in a baseline scenario of continued agency status. Thus in the rapid-removal scenario, the FCS had to reduce its outstanding farm loans drastically and quickly, and by 1990 was still limited to only two-thirds of the outstanding loans it had in 1982. But because the assumed inability to market securities is invalid, these projections and their consequences are all nonsense.

Similarily, in projecting the consequences of "phased removal of agency status," the ADL study assumed that FCS would be able to sell each year only exactly the amount of securities needed to keep its outstanding farm loans at the 1982 level. Again, such a limit defies market logic, and so the projected consequences are nonsense.

How did the USDA and ADL studies arrive at their illogical conclusions regarding marketability of private FCS securities? ADL interviewed current investors in FCS agency paper, most of whom naturally indicated interest only in securities of that quality rank or higher. If ADL had asked current investors in AA and A securities if they would buy private FCS paper rated AA or A (the ratings projected by ADL), the answer, by definition, would have been yes! The USDA asked dealers now marketing private issues if they could handle the much larger FCS refundings.

Staffed only for current business, the dealers said no. If they had asked the dealers whether they would gear up to handle the new FCS business or watch it go to other firms or distribution channels, they might have obtained more insightful responses.

In concluding, let us return to the earlier logic and deduce some important effects of "privatization" on the FCS and other borrowers in credit markets. Imagine all potential borrowers stacked in order of credit quality. The FCS is now near the top. If it were to lose agency status, it would slide down the stack, re-entering at a new lower position, where it would pay a higher interest rate and therefore take down a lower volume of funds in accordance with its demand schedule. All the borrowers that it slid past would move up, and would tend to pay lower rates and thus borrow somewhat larger amounts. Borrowers below the re-entry position would be unaffected. At the top of the stack, the U.S. Treasury would be unaffected unless some present buyers of FCS issues consider their quality identical to that of Treasury securities. If so, rates paid by the Treasury might also be lowered slightly, as would, in any event, rates paid by borrowers that retain agency status.

An important, perhaps overriding, consideration also emerges from this logic. What are the chances, during a severe farm recession, of a private FCS sliding dangerously far down the quality stack, near or into the group of unsuccessful would-be borrowers? Given the size of the FCS, this would be a horrendous, though temporary, development. In view of the past boom-bust cycles posted by the farm sector, it cannot be ruled out. The Congress has helped to create a huge specialized credit institution serving an inherently cyclical industry. Perhaps, through continuing to provide it with agency status, the public obtains a useful measure of financial stability at a reasonable price.

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