



RECOGNIZING RISK
IN GLOBAL AGRICULTURE
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**Dinner Presentation:
Macroeconomics and Agriculture**

Transcript

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Thank you very much. First of all, thank you, Paul, for a very warm introduction. Thank you all for coming here. Paul said this Bank is interested in agriculture. But, to begin with, we are a regional Bank. I am going to tell you, I value the regional Federal Reserve System as much as I value any element of how we govern this country or how we think about this country, because it really is one of the most grass-roots systems in the American democracy today.

We have 12 Banks across the country. We have constituents from every corner of the country who provide input into monetary policy that is really quite unique. It is extremely important we continue it, and therefore, our Bank has focused on things that are unique, or important at least, to this region. Agriculture is one of those areas. So it is our honor and our privilege, really, to have this program.

One of the other areas, and why it mixed so well today, is we are also a big producer of energy in this region and in almost every element of energy production in this region. It really does make sense that we have this conference and that we talk about these important issues.

This evening, though, I've been asked to kind of "macro it" a little bit. We've talked a lot about production economics, which is extremely important. I think Bruce Babcock and Bob McNally today gave compelling stories for us to think about and to listen to because it does affect the future of the country. In a way, it is going to come into play in my remarks here this evening.

But I am, first of all, going to set the context, and that is what I think of as our current state and what the outlook is for our national economy, in a global context perhaps, and then talk about some of the issues we have to confront as a nation. Because if we don't, it puts more and more pressure on the Central Bank to do more and more bad

things to give short-term remediation to long-term problems. They almost always end up in worse long-term problems.

So I begin by saying the outlook for the U.S. economy – and this is my opinion – is that we will continue to grow at a modest pace of somewhere between 2½ percent, and on a good quarter 3 percent, for at least next year and perhaps the year beyond. I say that because the U.S. economy is adjusting to the excesses and poor policy of the last 15 to 20 years. I wish there were a shortcut to taking care of those problems, but the way we are all reacting and acting, I doubt there will be any kind of even intermediate solution to this.

The most important thing for us to realize is, for all the money that is out there, and we have printed a lot of money over the last three years, there is still an enormous amount of debt we have to deal with. In all of the sectors of the economy, if you think about it, the consumer in this economy of ours made a choice approximately 15 years ago to be a consuming economy and less of a producing economy. And we did that by lowering interest rates to incredibly low levels and by encouraging leveraged debt at all levels.

So the consumer in this country increased their debt-to-disposable income the last 15 years from about 80 to 90 percent, depending on when you start, to 125 percent at the peak. Through all this adjustment we've gone through, it is now 114 percent. That is hardly a deleveraged position. So we are dealing with that. When they say the consumer is not really doing their part in all this, I think they are quite remarkable in that they continue to consume, given the leverage they have to deal with at the same time. To me, they have been a very positive force in this recovery, because they haven't collapsed.

You see that in the fact that, although the savings was almost zero at the peak of that 125 percent, it is now 5 to 5½ percent. Our long-term average is 8 percent, so you see where you have to go there. Yet, they are going there slowly, as the economy slowly recovers. With that kind of leverage, it is unfair to ask the consumer to stay at 70 percent as a portion of GDP, up from its long-term percent of about 66 to 67 percent. We have to adjust that. That reflects my first point – that we decided to be a consuming nation rather than a producing one- because of the fact with our current account deficit running

negative or with the fact we consume more than we produce as a nation, it is clear we are a consuming nation and not a producing nation.

We were saying at my table during dinner that my hometown of Fort Madison used to be a manufacturing center. It has been pretty much hollowed out. A lot of those services and a lot of the products they provided to America are now produced elsewhere. So when you say you want jobs, you have to first say you want products and services. We've moved that somewhere else. We are still consuming it, but we are producing it elsewhere.

The second thing is that our debt is also pretty significant at the state level. States can't run large deficits; we know they have these balanced budget amendments. But they have these promises that are the same as debt. The only way they can meet those promises is to take away from something else, and that's why you see our universities starved, our education system starved, as we fund these long-term commitments to my generation, if you will, but that is just the facts.

At the national level, we are also enormously leveraged. We made a decision as a nation to go into debt to help satisfy our consumption at all levels. Our debt to GDP today – and I use gross debt, I don't have any use for this “debt held in the hands of the public”, because any debt outstanding has a federal IOU on it, is debt that someone is going to claim someday – is 100 percent of our GDP and our average interest rate on that is 2½ percent.

So imagine what happens when interest rates start to go up. We are already at 100 percent and we have a future liability on everything I can think of that we promised to one another. When Bruce and Bob were talking today, think about it. The reason we can't get this debt ceiling addressed is because we all want something from the government. We all have decided that we are going to, if you will, refuse to be weaned from the government. Think about it.

Agriculture is one. You heard about it today. That is just one. Housing is another. Social Security is another. Medicare is another. These are all subsidies in one form or another. And they amount to trillions of dollars of future liabilities. If you put it on a balance sheet, depending on the time horizon you use, it is anywhere from \$20 trillion to \$50 trillion. So there is no easy solution to that.

And the fact we can't come to a solution is because we all have something to lose in the short term, and we are not willing to give it up, because the long term is enough in the future that we won't worry about it today. Someone else will.

Last year, we had the Bowles-Simpson Commission come forward with a bipartisan proposal that had all kinds of important elements to it. One of them was tax reform, which meant subsidy reform as well as tax reform. Another was that we were going to systemically decrease the debt to GDP over a generation. But, because it took away, it was dead on arrival. And now we are in this stalemate that can only lead to harsher times ahead.

Let me tell you how I suspect the pressure will come to solve this problem. I suspect that, as we have done in the past, we will look to the Central Bank of the United States and the world's central banks to inflate our way out of this, because it is so much easier. It is such a nice *hidden* tax. You don't have to take responsibility for it until it gets so bad it starts harming the economy and that is much higher than 2 percent or 3 percent or 4 percent. But that is what I suspect. What happens is, as these deficits continue to be in place at 10, 8, 9 [percent]

We will let those go forward, rather than come to an agreement on a deficit-reduction plan that all have to sacrifice to make work. We will do that. The debt will grow and what happens when that takes place, as the economy begins to recover, is real interest rates rise.

When real interest rates rise, it begins to slow the economy. When it begins to slow the economy, no one asks you to print more money. I promise you. The only thing they ask you to do is to make sure interest rates go down. Guess what? In the short run, the only way you can do that is to print more money. As you print more money, you've changed the inflation environment, and then inflation expectations begin to change the dynamics of the economy. Now debt to GDP is less, because you've grown nominal GDP so much more rapidly. And of course you have undermined the strength of your economy and your economic system, which countries tend to do, especially on fiat currencies.

My concern is that this is the course we are on. And you say, "Ah, that's nonsense, Tom. That's not possible."

QE2 was the monetization of \$600 billion of debt. It was out there in the public and would have caused interest rates to be higher – maybe only marginally in the short run. But now it is on our balance sheet, and all those dollars are out there to be circulated at some point in the future. If you can do that in this instance, you can do it in the next instance and the instance after that.

Let me give you two comparisons. I am often told this, “Tom, don’t worry about it. Inflation is low and labor costs are low.”

In the mid 1960s, inflation in this country was 1.4 percent. We went into one war; we now have three. In the early 1970s, we went off the gold reserve standard because it made it easier to manage the economy. Then we went to wage and price controls, because inflation was starting to rise. We got up to 4 ½ percent. When that didn’t work, because of misallocated resources, we went off controls and inflation went higher, the economy started to slow, and the Federal Reserve lowered interest rates in the mid-1970s. In the early to mid-1970s, inflation started to rise; that is when we did the Whip-Inflation-Now, or “WIN”, buttons. That was a real success. [laughter]

Then we got off that and the economy started to slow, so we lowered interest rates. The economy started to return, inflation started to rise, and we began to increase rates and the economy slowed. We increased rates again, until *finally* inflation rose to 13 percent in the late 1970s and 1980, and then we had to crash the economy to get inflation under control. That’s the scenario you do, when you think monetary policy can solve all your problems. Make sure you have all your subsidies in place and reform your tax structure so that all special favors go away, that’s what you get – inflation. It’s unavoidable.

The second example I’ll give you is a recent one – 2002-03. We had the technology bubble bust, we had 9/11 – a horrible experience, we lowered interest rates to 2 percent, but then we wanted to insure. It was called an insurance policy to make sure unemployment came down. In 2003, we had interest rates down to 1¼ percent and unemployment was an unacceptable 6½ percent in this nation. Unacceptable! We had to buy more insurance, so we got the interest rates, policy rates, down to 1 percent and left them there for an entire year, even though the economy started to recover and we began a wonderful credit boom, led by housing — that became a bubble, that became a bust, and

now we have unemployment at 9.2 percent. Is that the tradeoff we would really make if we knew all the facts? I hope not.

I asked you that question, because here we are today with interest rates from the Federal Reserve at zero – 0.11 – whatever you want to call it. But I consider it zero. We have had QE2, which means even at zero we've bought another \$600 billion of government securities – put the reserves out there – and what do we have? Well, inflation is still modest, it's rising, but don't worry. We have plenty of time to take care of it. It will take care of itself. Labor costs aren't going up rapidly yet, so let's not worry about it.

Now agriculture land values, when the cap rate is now down to – pick a number – 3½ or 4 percent. Be conservative, say 4½ percent. When the long-term average is 7½ percent, we are fine. When mergers and acquisitions transactions are being fed by low interest rates, the fund mergers and acquisitions further the consolidation rather than production process. You are taking production out as you consolidate. And the outcome is, of course, bubbles.

I don't predict bubbles. Maybe the land thing will pass. They will make the adjustments. We won't have any problems. Maybe the high-yield market will adjust and there won't be any problems. Maybe the mergers and acquisitions won't have a problem. Maybe the junk bond market won't have a problem. Maybe. But maybe not.

I can't tell you which one is a bubble. But I know the conditions. I have lived through three crises now. I know the conditions are ripe for bubbles. Guess what? Zero interest rates create the conditions. And you have them.

Now we won't remove it quickly, because why? No one wants to be the one responsible for lost jobs. That is the reason given. Even though from the last time, we didn't want to be responsible for lost jobs, we now have eight million more people unemployed. No one wants to take that step forward. That's what we are in the middle of right now – the inability to face hard choices.

I ask you this: You are in the commodities business. Do you know of any commodity that you trade that trades well at zero? Is there a market for zero? Do you allocate resources well at zero? Do you make wise decisions at zero? The answer is, I hope, no. Well, you are not going to do it with credit either, as illustrated by the largest

institutions in this country almost taking this country down because of zero-type interest rates that they all speculated on and will do so again.

Bruce, you thought you were giving them a bad message. Bob, you thought you were giving them a bad message. Well, I am giving you one too. My ending point is a point of hope. That is, this is the largest economic system in the world. It is still the most market-oriented system, even though it has its issues. It still has the most productive people in the world. And, if we step up to these issues, then we can solve them and remain the largest and most successful economy in the world, but it does take choosing.

Everyone is mad at Congress, because of the standoff. But my example, with the subsidies, is to point out to you that you are the problem whether you are agriculture or housing or Social Security or Medicare. They only do what you tell them to do. And they are doing exactly what you told them to do. They are playing politics. They are standing off, rather than making the hard decision. So it's up to us to make the changes. And that's my point.

So I am going to end on that cheerful note. [laughter] We have time for questions. I am *very* happy to take accusations or questions, either one, if you have them. [laughter]

Mr. Andrew Gottschalk, HedgersEdge.com: You mentioned QE2 purchasing another \$600 billion in bonds and this money is out here somewhere. Later, you suggested it went into bank reserves. Bank lending hasn't picked up at all, and it's at \$58 billion since September of last year. So is this money really circulating somewhere or is it still being isolated as reserves within the banking sector? If so, *why* is it being held? Is it because the banks have liquidity problems themselves? Is that what the Fed is trying to prop up or what is the issue?

Mr. Thomas Hoenig: I'll give you my opinion; others will disagree. If they live in New York, they will disagree. [laughter]

Here is how I look at it. First of all, banks can borrow at 25 basis points, basically reserves from us. They can invest in government securities, which ostensibly are low risk. Next week may prove it differently, but right now it is low risk. So they get a 2½ percent spread with no risk. What that does is give you an earnings flow that allows you

to amortize your losses. These large banks, for all the TARP they wanted to pay back, still had – in my opinion – losses. And you can see that by some of the announcements -- the reduced reserves and so forth, in terms of their earnings outlook, but they have been amortizing losses. In that kind of circumstance, you tend not to engage in lending.

If you look at the pattern, when the crisis occurred, lending dropped dramatically. Now it is not dropping anymore; there is barely a net increase in loans. From the largest institutions, there is a little more business lending going on at the banks; less than \$50 billion, but it is marginal as well. Part of the reason is, if you are amortizing losses and you're rebuilding your capital, you can't lend. Part of the reason is that, given the economy is uncertain and given we are not building plant and equipment, there is not the demand you would normally see there. So it is a demand-supply situation, as well, but importantly affected by finishing up the amortization of losses and rebuilding capital among the largest institutions.

Mr. Gottschalk: If I could, I have a second question for you. Would you care to comment on the concentration at the banking level, especially with the top five?

Mr. Hoenig: I would be delighted to comment on the concentration. I do it all the time. [laughter]

It is a concern to me. I tell people, if you look at the history of this country and this economic system of ours, for most of our history we have had a distribution of financial institutions in size that mirrored the distribution of businesses – from very large to small – across the United States. We were unique in that. We had a broad base of lending. It was a basis for our innovation and entrepreneurship across most communities of any size in America.

When we put a safety net – and I can't just talk about the size, I have to talk about the causes – when we put a safety net over the financial institutions, starting with the Fed, but in the Great Depression, one of the things we did then is we separated out commercial banking from investment banking and high-risk activities. If you are a pure market person, that would not be very good. But, if you are a pure market person, you wouldn't have the safety net there. But when they did that, at least they had the good sense to separate it out.

The commercial banking industry was the payments system we all rely on and the intermediation – the lending process – we all rely on. And the investment banks were the cowboys for high-risk stakes, *but no safety net*. So they really did self-regulate in that sense. That became very comfortable and they began to tear down those walls.

Then we passed what was called Gramm-Leach-Bliley that eliminated that separation. So that's taking the high-risk guys and giving them access to the candy store. And they did exactly that. They took this very low cost of funds and low cost of capital around the concept they were too big and too important to be allowed to fail. And we confirmed that really with Continental Bank of Illinois. You created the risk exposure dramatically *and* you lowered their cost of capital, because of too big to fail. That allowed them to grow at a tremendous competitive advantage, in my estimation, to the rest of the banks – regional and community banks. We've done the studies and there is evidence that is exactly what happened. There is really good evidence to that.

So here you are. If you give someone a subsidy, and too big to fail was a subsidy around the safety net, like any subsidy, you grow it. In 1913, when the Federal Reserve was formed, the first safety net, the 5 largest institutions in this country – and this was when everyone hated the individual J.P. Morgan – controlled, in terms of their assets under management, our estimates are about 2½ percent of GDP – 2½ percent of GDP. As late as 1980, just before we went through that crisis and then eliminated Glass-Steagall, the 5 largest controlled in assets under management about 14 percent of GDP. Today, those 5 largest banks control 60 percent; the largest 20 banks controls 80 percent. The other 7,000 banks control 20 percent. We have concentrated this country. In terms of the distribution of businesses, we have this line and the distribution of financial power; we have it much more highly concentrated.

If you are a very large institution, you want to deal with very large credits. It's more efficient. Remember that word, *efficient*. It's very costly, and I know some of the larger firms have small-business lending and so forth. But it much more efficient to do the other and that builds further concentration.

Where I have an issue with some – like Larry Summers, the former head of the Administration's National Economic Council, saying all we needed was five, because that is what Canada had and it worked out fine for them – I just don't agree. Canada has

a different system. They are not as innovative perhaps. I love Canada, but they are not as innovative and they have a different system that is not as democratic, if you will, as ours in the sense of access to credit. It's a sad story.

I don't want to limit size, because that causes other distortions perhaps. But, I do want to force commercial banks to be commercial banks under the safety net and then take the risk out with the hedge funds activities that Citi does, and the derivatives business out, and put private capital back to risk, so you receive better pricing on risk and a better distribution over time of wealth.

I will tell you, if it weren't for too big to fail, we wouldn't have an institution in this country that is over \$2 trillion. This last crisis would have disciplined that. That is my short view. I have a longer view, but I'll stop with that. [laughter] Any others? We have five minutes or so.

[Audience Question]: President Hoenig, I just want to once again ... I think the whole room thanks you for the courage of your convictions in being the lone wolf of reason on the Federal Reserve Board. [applause]

Secondly, I can't tell you how much you relieved me in validating that the Oscar-winning *Inside Job* is an accurate portrayal of the banking crisis in this country.

Mr. Hoenig: Thank you. If you haven't seen the movie, it's an Oscar winner, so I recommend it to you. It's pretty revealing, as well.

Thank you very much for your comments.

Are there any other questions or praise, whichever?

[Mr. (first name?) Edwards, Iowa State University]: You are an Iowa State grad. That's enough.

Mr. Hoenig: Well, I have to agree.

Mr. Edwards, Iowa State University: What do you think will happen if Congress doesn't raise the debt ceiling?

Mr. Hoenig: It is like anything else. It depends on how the Administration would decide to deal with this crisis. If they were to prioritize, and I don't know what their plan is.

We are the fiscal agents. So we are in charge of the distributions and we made it known we will put them where they tell us to put them. But they have to tell us where to put them and it's up to them.

Even if they prioritized, the hard, cold facts are that the action taken is failure to act. And the failure to act does create further uncertainty and further delays on decisions that might otherwise be made about economic choices. It would delay businesses' ability to make choices. It would raise the cost of doing business in this country, and therefore, would only harm the country further.

We need to get this settled. But remember it is a budget crisis. And what I cannot forgive the leadership of this country for is not seriously taking up Bowles-Simpson – a bipartisan commission that went through all this discussion and came to a compromise that, yes, some people liked more than others, but everyone disliked to a certain degree and everyone liked to a certain degree, that had reform in it that gave us a way out. And we just let it fall like an anchor to the bottom of the sea.

Now what do we have? We don't have a solution. We don't have a plan. We don't have projections that show debt to GDP coming back down. We have greater uncertainty. We've diminished our productive capacity because of it. We've raised other costs of doing business. That's what is so unforgiveable. *And* we will pay a dear price for that if we don't come to an agreement and we let this thing go unattended. That is what I think of this standoff. It's hurting the American people. Yes?

Mr. Larry Dreiling, High Plains Journal: President Hoenig, I am Larry Dreiling from *High Plains Journal*. My question relates to farmers, consumers, and people who live in small-town America that the Kansas City Fed serves. What you would tell the consumer today about their behavior? If you were that banker sitting in one of these seats out here, what would you tell them to tell the consumer about their spending and saving habits? And where should we go in terms of the future?

Mr. Hoenig: I think consumers react to incentives just like everyone else. If you are going to subsidize debt over savings, you are incenting them to spend. So they are going to spend. I can give them advice and say it is good to save. But, if you don't get anything for saving, you tend to not want to save. You tend to say, "All right, I'll take it now, because I get nothing for it, and I'll save later."

My advice is, pay attention to what we do and push us to get this country's debt or budget crisis under control, so we can then work on renormalizing monetary policy as we reconfigure fiscal policy. Then we can spend time, as a nation, focusing on what we do about our future productive capacity, because we have to produce as much as we consume – or nearly so, if not more so – and look at the long-term choices we have to make and can make. But we have to take care of our debt. We have to get our policy renormalized for monetary policy. And then we have to get our policies working on how we build.

You can't say, "Create jobs."

"Create jobs" is dig a ditch out here with spoons and pay people for it. That's creating jobs. No, create the ability to produce goods and services people want to buy here and around the world. Then we will have an economy that once again is the strongest in the world, the most productive in the world, and the most successful in the world, because we do have the markets to do it. That is my advice to Americans. It is not just about consumption. It is about much more than that.

I am told we issued a prescription for Prozac outside here when I am all done. So have fun. [laughter] Thank you all for being here. I look forward to tomorrow. Thank you. [applause]