AEI Presents *Nothing Borrowed, Nothing Gained*: How Farm Financing Works, and When it Doesn't or The Countercycle and the Future of Ag Lending

NBNG Ep 8 | Kansas City, We Have a Problem

Sarah Mock: This is *Nothing Borrowed, Nothing Gained. The story of ag lending; past, present, and future*. I'm Sarah Mock.
If you've been alive for some amount of the last 15 years, and I sure hope you have been, you've almost certainly heard of, and maybe even chafed, about the term "too big to fail."
It was a controversial idea during its heyday in 2008 and 2009, though controversial might be the wrong word. I don't think you'll find many people who would argue that "Yeah, it's great that we have some banks and businesses that if they fail, will devastate the whole of the national, and maybe global, economy."
And yet, after the great recession, we did label some institutions too big to fail, and proceeded to ensure that they did not fail- through taxpayer funded bailouts.
But as most people in agriculture and rural communities know, it's not most banks that are too big to fail. In fact, regional and community bank failures are familiar enough to many, that you end up with situations like this one, from Jim Farrell:

Jim Farrell: In southeast Minnesota I had been up there maybe six months and we were going to meet with a banker from, Marquette Bank. I recall in Minneapolis who had some farmland in the area, and he wanted to talk to us about possibly working with him on renting it out. I think he's farm operator had gone bankrupt, which was a very common scenario at that time.
And so, we would wear a suit and tie when we met with a client. Okay. Today you wouldn't, but back then we did. And, of course, he's wearing a suit and tie. He's got business with the bank in this little town of Grand Metal, Minnesota, and it's a Friday. And he wants to meet at five o'clock at the bank. And so, my colleague and I we both drive in at different cars, and we all three pull up about the same time. And we all march into the bank, and we created a little bit of a stern town. I learned later that people were concerned that we were closing the bank because we looked like federal regulators coming in, which was how it went. They show up at five o'clock or maybe four o'clock on

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a Friday afternoon and they shut her down. And the bank opens up again on Monday, hopefully, under new ownership.

Sarah Mock: In this case, the bank in question was not on the chopping block, and the whole situation turned out to be a kind of accident of coincidence. But it stirred up the town because especially during the 70s and 80s, it was not an uncommon occurrence. Today, we're going to dig straight into this phenomenon, how banks fail, to understand the mechanisms that take ag lenders in particular from solvent to bankrupt, but also to understand what the consequences can be, not just for individual debtors or lenders, but for the local, regional, even national financial system.
We're going to tackle these topics in two different eras, the 1980s and 2008 and to help guide us through all of this, we found someone who's been watching and participating since the beginning - not from within a bank, but from within the bank - the bank that was, in a lot of ways, pulling strings in both of these eras.

Thomas Hoenig: I'm Tom Hoenig and, I was the president of the Federal Reserve bank of Kansas City from 1991 to 2011.

Sarah Mock: Prior to being president in Kansas City, Tom was a division head involved in banking and bank supervision in the Central U.S.- a role he held in the late 70s and 80s during the peak of the farm crisis. This experience had a big impact on his later career. But for him, perhaps the most informative aspect of the farm crisis was not the crash, it was the boom – and specifically, the government and the Federal Reserve's role in it.

Thomas Hoenig: During the 70s, actually late 60s into the 70s. The government. Engaged in a major set of spending programs. And the Federal Reserve did accommodate that off and on through that decade by lowering interest rates, and therefore expanding the monetary base. And the effect of that during the 70s was to increase asset values, not only inflation, but we also saw a major increase in leverage, banks levered up, the farming industry levered up. I saw a great deal of expanding credit by the farm credit system, by commercial banks, including ag banks and the taking on a debt by the producer, to expand their operations, to build an ever larger, scale that they might benefit from. And over that period, the Federal Reserve, even though it did tighten policy from time to time, its fundamental policy was, to actually expand money. That led to inflation going from about, 4.5%, in the early 70s, it would

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then go up to 7% or 8% and then the fed would tighten. Then it would come back down, but never as low as it was before. And the economy would slow. The Federal Reserve would, again, lower interest rates increase the money supply. The economy would, strengthen for a while, but then inflation would take off again and it would find itself having to fall back.

Sarah Mock: Tom here is a pointing out a part of the 1980s story that we touched on only briefly in our first season. This is the aspect that the Federal Reserve is responsible for, the downward pressure they put on interest rates in the lead up to the crisis, that led to massive inflation.

Thomas Hoenig: By 1979 inflation in the United States was about 14%, but also asset inflation was very significant, and you saw the in farmland. Farmland was historic high levels. And banks were, making important, not only operating loans, but other kinds of loans related to agriculture, that reflected this desire to acquire assets using leverage. So then when Paul Volker became chairman of the Federal Reserve and we had 14% inflation and he decided with the open market committee to apply discipline, to break inflation, this was a tremendous shock to the economy. Imagine interest rates of 20%, individuals that had variable rate loans of some period of time that had to be renewed, would have to pay these incredible interest rates, and did not have the cash flow.
The effect of that was then to lower asset values, farmland values collapsed, real estate values collapsed. And those who were, holding that credit, found themselves basically, with assets that could not be paid off.

Sarah Mock: For individual producers, this reality was devastating, but for banks it was as well. Tom recalls hundreds of banks, just in his region, that failed during this period due to having insufficient capital to absorb the loans they needed to write off. And these bankruptcies only made credit harder to find for those who remained.

Thomas Hoenig: What I took away from that is you cannot, allow leverage to get out of hand. You cannot allow monetary policy to fund the desire for leverage by increasing reserves in the banking system that then becomes loaned out, for any number of speculative projects with very little payback on those, just waiting for the asset values to increase.
One of the things that happened during those 70s before this crisis was that rather than look at the cash flows, coming off the property over different scenarios of commodity

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prices, the bank was willing to land on the assumption that asset values would only go up. That the central bank would always provide additional credit and that asset values would only go up. And that assumption turned out to be quite false because once, the Federal Reserve decided to break the back of inflation, those asset values collapsed and really destroyed the infrastructure of lending in the United States.

Sarah Mock: Tom, as you might have picked up by this point, pulls no punches. But I think this "destruction of the infrastructure of lending in the U.S." deserves a more granular look. So, I asked Tom what exactly it means for a bank to fail? What brings the suits to the small-town bank on a Friday night, and how does it come to that in the first place?

Thomas Hoenig: Let's take an average size bank in the Midwest, and it makes loans, to a small business makes loans to ag producers, for operation loans and so forth. And it does so like you would for anyone else, right? What's your assets, what's your collateral value? What's your expected income based on, our experience with prices? Do you have enough cash flow coming off that, to service that debt and pay it back at the end of the loan?

And so, you go on down this road and you make the loan, based on an assumption that wheat prices, corn prices, cotton prices, whatever, and cash flows for a while. But then the Fed comes in and says, "Oh my gosh, we have 8% inflation. We've got to bring this down." They start raising interest rates and your loan renewal comes up. Here's what you see a recession has begun the cash flows coming off that business aren't as strong. The cash flows coming out of that operation against the leverage that is carried on that operation, is in question and let's say we're into a recession now and the asset value is not rising. It's actually struggling to stay steady and we're even seeing declines in the asset value so, the collateral value is weakening. So now that bank is trying to work with the borrower and so forth and the bank examiners come in, they have to go over these credits – is this bank sound, can it continue? Because they're insuring those deposits. There are depositors that have to make sure they get their money back. So, we have to be careful of that. So, they begin to look at this and they say, "Oh my gosh, we're seeing weaknesses in the cash flows coming off." Those businesses that they have to report to the bank, we're seeing that the operating loan is under pressure. The bank needs to renew that loan. They can't just pay it off this year they need to carry it into the next year. The collateral is there to do it right now, but the collateral is weakening, but they carry it for several months, but things only get worse. And the collateral value now starts to fall below the value of the loan.

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So, the loan value that used to be, say 80% when they were very optimistic or 70% is now, 102%. So now you begin to write down that loan. It's on the books for a hundred thousand dollars. Right now, you can only get 70,000 out of that. So, you have to write off 30,000 against your capital. So, your bank has several of these loans going against its $10 million of capital. It's already lost $3m of its capital. What's the outlook going forward? Things are getting worse. People now begin to wonder about the bank, and the economy gets weaker, and you see this write down, multiply.
And in some cases, the write off will be over the course of a year or 18 months the entire capital account. And at that point, the chartering authority, either the state or the controller of the currency, the federal charter says this bank is no longer viable. We have to close it down.

Sarah Mock: The thing is, Tom says, the closure of an individual bank in this case, is usually just the beginning of the crisis. Because when a bank fails, insolvent loans are often called, and as assets that have lost value, like farmland and equipment, get taken over and put back on the market, the new supply further worsens prices, and this often creates a downward spiral - impacting other banks, businesses, and individuals in the community. That can last for a long time.

Thomas Hoenig: Remember, the 70s was a decade, you went through a decade of this and the 80s then became a decade of the unwind. And so, people think of it as instantaneous when in fact it takes years should develop and years to correct.

Sarah Mock: An interesting historical point, the 1980s were actually the first time that the federal government experimented with the idea that it would simply be too painful, too devastating to the overall economy, to allow the worst of the decades impacts to go on unwinding for years and years. It was in Tom's time at the Fed, in fact, that regulators first identified an organization that they felt was too big to fail.

Thomas Hoenig: Penn Square was a commodity-based lender, but it was energy. It was oil based it was a small bank in the suburban part of Oklahoma City. And it had an owner who thought of himself as an entrepreneur of the first class, very, risk oriented, shall we say? And he was able to engage in lending to wildcatters, other developers of energy, and did so in a major way, but it was kind of the first form of originate and distribute. So, what they would do is they would make loans to these wildcatters, and

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then they would, they would base that loan on assumption of energy prices. At that point, oil was after the, Mideast. OPEC, constrain on energy, raising those prices on the assumption that prices would only go up as they went forward.

**Sarah Mock: A few brief vocab notes, in case you also don't know -
A wildcatter is a prospector who sinks exploratory oil wells, and the idea of "originate and distribute" is a type of banking made infamous in the subprime mortgage crisis. Essentially - one bank or institution makes loans - or originates them, and then maybe bundles or slices and dices them, and sells them to a third party. Back to Tom:**

Thomas Hoenig: And so here was this great opportunity to make these loans and they did, but then they would take these loans and they would package it and they would sell the loan to their correspondent bank upstream. So, they, sold the loans off to Continental Illinois, being one of the banks, but at the other banks as well, Chase Manhattan bought some of those loan. 9:26Seattle Seafirst [Seattle First National Bank] bought some of those loans and so forth in the billions of dollars so this little, suburban bank, originating billions of dollars of loans, and then selling those loans off into the large bank market allowed the leverage to go on enormously. It was incredible expansion of lending to these very risk-oriented operators of energy, and then selling those leverage loans off to other banks around the country, including Continental in a very big way.

Sarah Mock: Continental Illinois is now, as of 1994, defunct, but between its founding in 1910 and the 1980s, the bank made a name for itself as one of the premier American financial institutions in the Midwest. It was huge - at one time it was measured as one of the top 10 biggest banks in the country. But it all fell apart.

Thomas Hoenig: So now you come to the point where, you break the back of inflation, and you break the energy price spiral. So, loans that were made by Penn Square on the assumption that energy would be a $100 a barrel in 1980, 81, suddenly in 1982, 83, after Volker had run, the inflation out of the system were no longer $50 a barrel but began to fall very precipitously. So now you have all these loans that cannot even begin to cash flow and there is no collateral value left because that has just fallen. So now you have to write that stuff off and Continental Illinois had to write off hundreds of millions, of

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dollars of loan. Seattle Seafirst - hundreds of millions of dollars of loans. And they could not sustain. They did not have the capital. They could not do that.
So, in the case of Continental though, here's the interesting thing. It didn't have so much effect on other banks upstream, but many, many banks, from around the country, smaller banks, community banks, regional banks were lending that bank, federal funds. So as banks, they were lending their excess reserves to this Continental bank. So now they were in jeopardy because if you're lending to them, and you can't get your money back. You're going to fail yourself. So that was the introduction of “too big to fail” in a more formal way.

Sarah Mock: Rather than let Continental Illinois fail, and hundreds of smaller banks along with it, the government stepped in:

Thomas Hoenig: The FDIC and the Federal Reserve jointly went in and, bailed out that bank. Now the stockholders did lose. They did, but the creditors did not. And so that was the first instance of, “Yes, we’re going to let it fail but we'll issue warrants.” So, the government will become the owner and then the creditors will be kept whole, and then we'll sell the bank later, which then in fact they did.

Sarah Mock: If you want a kind of textbook example of [John Kenneth] Galbraith’s cycle of financial euphoria, this is pretty much as close as you get. It starts at the federal level, where long periods of spending and low interest rates inspire the likes of our wildcatter to say, “Look, asset values are going up, and they’ll keep going up.” Other banks buy in, and notably, the whole financial, quite quickly even realigns to this new opportunity.
But again, there was never any real value here, it was tied to the government spending and the interest rate, so when those variables changed, the bottom falls out of this new system, and panic struck– or as John Blanchfield so colorfully put it, when the federal tide goes out, we found out a lot of the financial system was swimming naked.
This kind of story almost plays as one of federal negligence, but Tom will be the first to tell anyone that the reality of Federal Reserve policy that is often overlooked by financial commentators, that there is only a very limited playbook for how to keep an economy running smoothly, and in that way, every decision, and every crisis, is happening in a way as it has never happened before.

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Thomas Hoenig: In a sense the 70s was its own new experiment, and the experiment was in 1971 the United States went off the gold standard completely. And so, we went from a somewhat, at least somewhat disciplined, policy position that is other countries, at least, Europe, other parts of the world could redeem, dollars for gold. That's what they were doing. And so, the U.S. gold reserves were being depleted and rather than tighten policy to reduce the number of dollars out there, the Nixon administration actually decided that they would just go off the gold standard and go on a Fiat currency only. That was an enormous change.

Sarah Mock: The gold standard strikes again! Honestly, I did not think discussion of the gold standard would come up as much as it has this season, but it makes sense really. The gold standard, like the gold and silver standard before it, is the norm that constrained the U.S. money supply. But as we've seen, the norm over the last 100+ years, has been a shift away from a constricted financial system and towards increasing amounts of government intervention. Nixon, unlike Wilson, was not willing to have the U.S. economy, be disciplined if instead it could be unleashed.
I want to take a beat here to dig into Tom's word choice here, because it's becoming increasingly important today. The word is discipline - specifically in the financial sense - is a keystone in Tom's understanding of good monetary policy from the central bank. I've been surprised, actually, by how much disagreement I've encountered about what "disciplined financial policy" actually looks like, but for now, I want you to hear what Tom thinks is the difference between gold standard discipline - or a monetary system limited by how much literal gold we have locked away - and the discipline that Nixon opted for instead, the discipline of the Open Market Committee, which Tom as a part of in his years at the Fed.

Thomas Hoenig: It changed the dynamics of monetary policy from at least somewhat of a rule-based system around the gold standard to a purely, central bank. And I say this carefully, central planning mechanism of the federal open market committee and depended on the federal open market committee for the discipline of money alone.
So went from an objective, very harsh system to a human, shall we say, or more flexible system called, the open market committee and only its discipline.
So, as you went through that decade, when inflation reached 4%, 4.5%, and we were off the gold standard, the first experiment we did on that was wage and price controls. And it kept inflation down for a while, but of course, shortages followed that, and it was a failure. And then inflation broke out and the open market committee and the

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government said, “Well, we have to take care of this.” Just like they're saying now. But what happened was unemployment started to rise. The economy slowed and, inflation did come down from, 6% or so, to 4.5% or so. And they said, “well that's good enough for now. So, we'll ease again.” And so when they did that, of course, inflation began to take off again. And this time it went even higher, it went up above 8%. And so, they had this stop and go policy. But each time they, started again, inflation was a little higher than it had been. So, you had this ratchet effect up in inflation, ratchet effect of asset values rising, and each time the inflationary impact became more difficult to deal with.

Sarah Mock: Eventually, of course, the inflation rate was ratcheted up to 14% and Paul Volker came on the scene - and as Jim Farrell described – he upset the whole apple cart. He headed the open market committee's final efforts to stop the ratchet, and did it by putting the brakes hard, on the expansion of money, essentially by insisting on a gold standard without the gold - or in other words, by staunchly setting a level of funds in the economy and refusing to budge on it.

Thomas Hoenig: They went to a pure, we're only going to put so much money out there that caused interest rates to go to 20%. Now people took it, but they didn't take it as well as you might think. People called for Volker’s impeachment, congressmen were furious, the housing market representatives mailed blocks of wood to him saying, “You're killing us.” So, it wasn't a pretty time. And Paul Volker was under enormous pressure. And so was the open market committee, but they knew fundamentally. And the president of the United States at that time also knew that we had to do this. And [Jimmy] Carter knew it when he appointed poker and [Ronald] Reagan knew it when he left Volker in that position.
So, you had the administration saying, “Okay, we'll stick to this as well”. And then the open market committee saying, “yes, we will be the discipline that we have to be.” And so that finally brought inflation back down really to only about 4%, but from 14%, that was a huge reduction. And once it was through, and once the economy started to recovery, then people said, okay, it was worth suffering. And the economy really took off for a while without having to reignite inflation

Sarah Mock: I asked David about the gold standard switch, and he shared his perspective on another way to think about this call for discipline from Tom.

David Widmar: Paul Volker came in and he raised rates, and he was very aggressive and very disciplined, and they had to do a lot of adjustments and that was painful. But

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the challenge is this, trade off where if we have something very rigorous, like the gold standard that was maybe too rigorous. It didn't allow for any accommodation. It was very brutal. I think there was a reason why we stepped away from that. And so, we left that for a reason. It was too rigorous. It didn't allow for flexibility. It was too rigid. And there's this other extreme of, how do we set these rates and I think it's hard because there are short run expectations and goals, but there are also long run expectations and long run goals, and it can be difficult to think about how we line those up. So, in a way, the gold standard was probably too brutal in the short run, but maybe in the long run, it was the right thing. But maybe now the challenge is, we've been maybe too short run focused at the risk of the long run.

Sarah Mock: We're going to talk about discipline - at the Fed, in ag lending, and on farms going forward, but I wanted to bring us back to reflect on the idea we've discussed so many times - that of the need in agriculture to affordable and accessible credit. I mentioned the metaphor a few episodes ago of the pendulum - in the early 1900s that John Blanchfield told us about, there was little credit for small businesses and farms, and it was extremely expensive.
By the 1970s, credit had become so affordable and available, because of government intervention like Farm Credit, because of the actions of the Federal Reserve going off the gold standard and lowering interest rates, and because of economic growth in the post-war years, credit was flowing thick and fast, and importantly, cheap.
The consequences turned out to be catastrophic because when prices inflated Volker's Fed had to act, and banks across the country buckled, under the combined weight of asset price declines and the economic slowdown that meant borrowers couldn't cashflow their loans. For me, understanding this added a dimension to the ag lending discussion that's often overlooked from the farmer side, and reminded me of a conversation I'd had with David and Brent right when we started this season.

Brent Gloy: I would say if you just weighted the number of complaints you get about lenders, there's way more complaints about loans that weren't given than there are loans that went south, just because there aren't really that many loans that go south. Cause if they make very many loans that go south, they're going to be out of business. And so, they tend to be pretty conservative, and people get really frustrated, "The bank won't give me any money" or "the bank won't do this" or "they won't do that." The reason they're not doing it is because they don't think that it's worth the risk. And so, I think

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there's more complaints about, banks being too conservative usually than there are when things go poorly. And so, that tells us most of the time that market works pretty well. The thing is I think when the government or policy gets involved to try and financial institutions lend more than they would otherwise that's when you often find troubles. Because those were loans that wouldn't have got made otherwise, now they get made they're going to fail at higher proportions probably than they would otherwise and that's, it gets everything in trouble.

Sarah Mock: This is what David means when he says that one of the motivations for investors when money is cheap and abundant, is to step out further and further on the yield curve. Brent's observation is that when the Federal Reserve is pumping money into the system and keeping interest rates low, money managers tend to get pushed out into riskier and riskier activities in search of better returns.
I think an example would be helpful, say I had $10 million dollars to lend in 1975. The problem is, every bank and investor in 1975 had money to lend, and not just money that *could* be lent, but money they *needed* to be lent to keep their businesses afloat. This meant that borrowers had a lot of options. One result is that interest rates get driven down, but another result is that I, as a lender, get fewer applications, and even some of the loans I did approve don't get taken out, likely because those potential borrowers have found a better deal somewhere else. Eventually, I'm going to start approving more and more risky loans, simply to make sure my $10 million gets put to use. This is a point that is not always obvious in public discussions of low interest rates, but it has a huge effect on the resiliency of the economy during times of stress - like say, in 2008.
That's after the break

[commercial]

Sarah Mock: We started this episode with a conversation about the idea of too big to fail in the 1980s. But that idea really meant wasn't really understood by the American people until much later. The banking sector, it seems, learned the lesson in the 1980s. Here's Tom again, wrapping up the Continental Bank bailout story.

Thomas Hoenig: That was the first instance of two big to fail for creditors and therefore took risk out of the banking industry, right? Because now creditors knew. We know we'll

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get bailed out if you're big enough important enough, and you impact enough of the rest of the economy, we'll bail you out. And so fast forward to the great financial crisis in 2008 and Citibank, which was in dire straits, was bailed out by the government. In fact, here, even the stockholders were bailed out. Now their values went down to $1, but as long as you have a stock and the stock comes back, you've been bailed out. So, the creditors were bailed out and so was stockholders, and other banks were bailed out as well.

Sarah Mock: The 2008 bank bailouts were unprecedented, but in the grand scheme, they were actually kind of a natural escalation of what was done to protect the financial system in the 1980s. The impact of saving those banks, and the hundreds of institutions and individuals they're deeply enmeshed with, is still being felt today within the banking sector, and it's in exactly the opposite way you might hope.

Thomas Hoenig: That allows these largest banks to hold less capital because, if the creditors know they're going to be bailed out, they won't insist on them having more capital. So, by the 2008 period that the largest banks had about 3% capital, they were leveraged to the hilt.

Sarah Mock: Both Mike Boehlje, the Purdue economist, and Nate Franzen from Dakota First, talked about how highly leveraged banks often are, and how that can affect the way that they, and their ability to, operate especially as compared to other businesses, farms, but Tom here points out that, even the extremely leveraged numbers that Nate described might be more generous than the reality at the country's biggest banks.

Thomas Hoenig: So even now, I get in these terrible disagreements with, people because they report on a risk-weighted basis. So, these largest banks are reporting that they have 13.5%, 14% capital but that's risk weight. When you look at their leverage, that is their capital to total assets and, certain part of the lines of credit. It's more like 5.9%. Regional banks have to have about 8% and community banks about 9% to 10%. Now you not only have too big to fail, but they have a cost of capital advantage over other banks. So, you're forcing the consolidation of the industry towards the largest "too big to fail" banks because of all the advantages they can carry. And that's why when I started banking in the 70s, there were about 18,000 banks, today there are about 4,700 banks and I assure you that number will only decline further

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Sarah Mock: Tom estimates that in the next decade the U.S. could lose half of its remaining banks to this kind of consolidation, and many of those, if trends hold, will be lost from smaller and more rural communities. When you pile the long-term consequences of the 1980s bailouts onto the unpopular idea that too big to fail already is, you might come away, like I did, with the question, how the heck did the American people let this happen? I put this question to Jim Farrell, who also served on a Fed board for a while, and he was happy to complicate my perspective.

Jim Farrell: I think there's a lot of misunderstanding about how the Fed operates. The 12 banks are independent operations or independent entities. They're not federal, so you've got 12 Fed presidents that sit on the open market committee, and their boards are made up of people within their districts. Okay, like me. And so, their perspective when they come in is the perspective they bring from their district. And then you've got the board of governors and they're subject to more political pressure if you will. Because they're in DC, Jay Powell has to testify or Janet yell before Ben Bernanke, before that, before Congress and explain their moves and explain what they're doing.

Sarah Mock: So, this is the Federal Reserve. They have a congressional mandate - in short, to get to full employment and keep inflation at 2% using the tools at their disposal, mainly affecting interest rates via the Fed funds rate and through bond purchases. These two tools, which notably do not *directly* affect the long-term interest rate, inflation, or employment are in the hands of a group of unelected representatives, empowered by the banking community in their regions to shape monetary policy by committee.
I talked to Brent briefly, about how this group was organized. He explained that it really makes sense on the surface, the whole point of the appointment system was to create a buffer between elected lawmakers who have an inevitably short-term view, and the people in charge of the nation's money - but the system hasn't turned out quite as expected. And bear with Brent's audio here – it sounds like Brent's speaking to us from the fifth dimension, but I think his insights are worth the weirdness.

Brent Gloy: it's not a political organization, but it is subject to politics. It's not supposed to be but politicians have a lot of control over the Fed at some level and so they have to try and keep it happy. And if there's any group, I would say in this country that don't

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show a lot of discipline historically, and I'm not talking about just like the last, four years, but like historically, Congress is not what you would consider, most people consider a disciplined body. So, they tend to want to have that extra drink so to speak all the time. They're buying rounds left and right and so the Fed does feel that pressure, I think at times to keep that party going.

Sarah Mock: And the thing is, it's not that Congress isn't trying to get more involved in monetary policy, for better or more likely, for worse.

Jim Farrell: Ran Paul would go on and on about, "we need to audit the Fed, audit the Fed, audit the Fed," but what he really, was it was a perception issue and I think the perception he was trying to create was that the Federal Reserve is rogue. They're running off doing their own thing. Nobody's paying any attention. And I sat on audit committee at the Kansas City Fed for, several years. I attended audit committees. The Fed was audited six ways to Sunday. They had an outside, big four firm that was rotated every four years that audited every Federal Reserve bank board of governors, audited, the banks, there were several audits - they had a staff in Kansas City. It seems to me it was eight to 10 internal auditors that audited processes all year long and they reported directly to the audit committee of the board. The Fed was audited at every angle.
It doesn't mean something can't happen, trust me running a business, my own. I understand. But the whole perception the American public had was the Fed was not being audited.

Sarah Mock: The American public still doesn't elect any members of the fed, including the chairman, so the direct accountability of the organization to the American people is limited. Nevertheless, the Fed tends to pride itself on its members advanced qualification, and the fact that they strive to reach consensus on most decisions. Jim says that despite this reputation there's actually more disagreement, especially at the district level, than is reported. And the aftermath of 2008 was a big moment for a disagreement.

Jim Farrell: My own personal opinion we would've been better off had we raised interest rates back in 2010, 11 or 12. However, there were significant differences of opinion between the districts. The Kansas City Fed was much more hawkish about wanting to move money, costs up, for a variety of reasons because we were creating bubbles and I maintained farmland was in part above, not entirely, but it is certainly a

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bubble that bubbled up in part because of low return expectations. I could pay more and accept the lower return because nothing's competing with it.

Sarah Mock: It wasn't just Jim or the ag lending community whose opinions on monetary policy diverged at the turn of the 2000s. Tom is well known in the banking community for the way his views diverged from then Fed Chairman Ben Bernanke's.

Thomas Hoenig: When we had the great financial crisis, I was very supportive of, injecting liquidity into the system. But in 2010, when the Federal Reserve decided it would, expand its balance sheet from, about $2 trillion and 2009 or so to $4.5 trillion dollars by the middle of that period, I was very, concerned about that. And in fact, in 2010, when the Fed Reserve really began its non-crisis expansion of its balance sheet, that is a creating of bank reserves, that is creating of money into the system. I opposed that systematically over a year's voting.

Sarah Mock: If you're interested in the beat by beat on Tom's resistance to the policy that Bernanke's made famous, known as "quantitative easing," you should grab a copy of Christopher Leonard's *The Lords of Easy Money*. But we're going to stick a bit closer to the ag side of this story, and to understand the long tail of 2008, and how it's affected ag lending, I think we need a better idea of the scale the Federal Reserve has been operating at in recent years.

Thomas Hoenig: Think about it this way, between the founding of the Federal Reserve system and 2008-2007, the Federal Reserve created a trillion dollars of reserves into the banking system. A hundred years, a trillion dollars over the next six years to the middle of 2014- 2015 it created $4.5 trillion, four times as much. And then over the following decade, it stayed at that amount. And then more recently gone to $9 trillion. So, my point is that if you put that much liquidity into a system, that money has to go somewhere. You have to encourage risk taking. You have to encourage leveraging and so forth and that's what we did.

Sarah Mock: I think it bears explaining what quantitative easing actually is and how it works, and let me tell you, it was not created to be understandable to the lay audience. Ben Bernanke was famous for his jargon-filled answers – whether in front of lawmakers or the press, to the extent that it was a poorly kept secret

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that he didn't actually want Fed policy to be very comprehensible to ordinary people – but I digress.
But back to what quantitative easing is. So, the Fed has two primary ways to affect the flow of money. One, they can alter the Fed funds rate. But they can also participate in the open market, and since 2008, the Federal Reserve has been doing a lot of purchasing of long-term securities from major institutions mostly - yes, those "too big to fail" banks. The brass tacks of how this works is the federal open market committee determines a target interest rate or level of liquidity, and analysts determine how much money should go into the system to meet the target. A couple of Fed buyers head into a room, and they contact the biggest banks to make the purchase. The bank accepts the transaction, and the Fed moves millions or billions of dollars into the reserve account of the bank. The rough analogy in agriculture might be, if your banker called you up one day to say, the local economy is sluggish so I'm going to put a million dollars in your account so you can do more business. It's a loan - so make sure you put it to work.
We've talked about the kind of risk-taking that the Fed was inadvertently motivating here from a number of perspectives. This liquidity motivates banks and other lenders to make riskier loans, it motivates non-banks to get into the lending business - for marketing or other reasons, and it increases the pressure on institutions to distribute more loans faster, and to push the bounds of good due diligence however they can. But Tom mentioned one other way that cheap money can motivate sub optimal activities in the market.

Thomas Hoenig: Let's say you have a manufacturing company – we'll keep it out of agriculture for the moment. And it has a good product it's selling. It has assets that are part of the manufacturing of this product and they're good assets. And it has capital. And let's say it doesn't have any leverage. So, let's say it's a million dollars, just keep it simple. So, it has a million dollars of assets. It has a million dollars of capital, and it pays a 6% dividend. That's the cost of its capital per say. And that's a very generous dividend. And now you have all this money coming in and an equity fund, or let's say the company itself says, "look, we have all these assets, interest rates have been brought down to 3% so we have, a million dollars. Let's borrow, half a million dollars. We can borrow it at 3%." And they do. So, now they have an extra half a million dollars of cash. They have a liability of a half, a million dollars, but now they buy back half a million dollars of their capital. Their stockholders are happy. They don't have to pay 6% dividends on the half a million. They only pay 3% on the loan and it's tax deductible and

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they do that. So, people get the cash. They can now invest in the stock market that raise the value of the stock market. But have, they purchased one additional, productive asset to expand their product? No, they haven't. So now they have leverage, the stockholders are happy. They get the buyback, they still get their 6%, things are great, but not one thing you increased in production, and they say, "Wow, it worked there let's do it again. Let's see if we can leverage a little further. Let's see what else we can buy." And so, the point of it is you lever, but you don't necessarily increase productivity, which is so important for long-term values. And therefore, when that unwinds that's going to unwind in a very unpleasant way, because what happens when the recession comes and you can't cash flow that debt that you've increased, that's when the harsh realities set in.

Sarah Mock: I really like this example because it gets to the heart, again, of what borrowing is supposed to be for in the first place. Remember my diner example, about buying the cooktop? To Tom's point here, that purchase – from an economic perspective, is a solid investment. It increases productivity – it leads to more burgers cooked, more customers being served, more money changing hands, and at some fundamental sense, a better quality of life for all involved. Shifting money between accounts in the way that Tom just described can make a business look successful, but only on the surface, underneath, none of these other things are happening, and when it comes to the true health of our economy, it's what's happening underneath that counts.
Now this example might apply more directly beyond the ag sector, but the farming industry has its own versions of these cheap debt-driven strategy, to avoid paying taxes, to buy unnecessary asset, and to drive rapid expansion, just to name a few. But another way that the Fed's actions directly impacted the ag economy in the years after 2008, was that it the easy money policy came with a very direct and predictable system-wide tradeoff for the whole ag economy, one that was quietly made without any elections or referendums or politicking at all. Here's Jim:

Jim Farrell: The Fed should really not be in a position to pick winners or losers. And, if you step back and take a look at where we are today, it's not all monetary policy, but monetary policy certainly had an impact on picking winners and losers. And by that, it, if you did well since 2010, you did well because you own hard assets or you've invested in stocks, which you could consider a hard asset, of sorts, but you had hard assets. If you were part of that 50% or less, that did not have hard assets or that did not have money

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that you were able to invest, you didn't do that well. And there's a certain amount of that showing up in the social structure today. And I think a certain amount of that, comes about because of the fact that we spoon fed Wall Street, and the big banks to a degree for quite a while with this, easy money and, pushing money into the system. And it was, every time we'd get ready to start pulling back, then there'd be another - Europe collapses or, there was always. It prevented, from starting to take monetary policy back to something more normal. Cause in 2011 they thought interest rate normality would be around 3.5%. Then, by the end of 2020, they're talking about, 1.5%, and it's like really? !.5% or 2%? I mean that's, to me, 3% or 4% is where probably should settle out.

Sarah Mock: Again, it was understood, even back in 2008, that lowering interest rates and increasing liquidity in the economy would likely lead to a dramatic increase in wealth consolidation at the top - in other words, those who already were wealthy would see their wealth grow in ways that far outpaced alternatives like wages.
In the short term perhaps, this was a reasonable tradeoff, the U.S. economy in 2008 was in shambles, and record high unemployment was so devastating, that any solution, even one that came at a steep long-term cost was welcome but by 2010, the worst was over, and the price of money, could have started to rise. But all over the world, it didn't. Tom sees the persistence of the "easy money" era long after 2008 was largely over and all the way to early 2022 as something of a travesty.

Thomas Hoenig: I think central banks of the world have absolutely violated their trust. I think Europe with a negative interest rate and thinking that's solving problems. I think that is - I just don't understand how trained economists can think that negative interest rates will produce good outcomes or that zero interest rates? What good is traded in the world that trades well at zero price? What market signals does it help, facilitate at a zero price? I really hold these central banks and these governments responsible for thinking that short term remedies that have obvious long-term consequences are justifiable. And that's what we've had more than a decade of, not only the United States, but in the world, at large. And that's where I think the real lessons have to be learned by these central planners, these governments that have a responsibility to be able to learn long term. But politics being what politics is and short-term thinking, being what short-term thinking is we choose not to follow, and we have to learn, we have to avoid these mistakes.

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The gold standard was a very cruel, very difficult discipline, but it was a discipline. We can find a better one perhaps, we should, but to relying on human nature, as the discipline in the short run, I think is putting a lot of faith in a committee. And I'm not sure that's the wisest choice.

Sarah Mock: And here we've come, full circle, back to the inevitable discussion of discipline. If the track record of monetary policy since 2008 is any indication, the idea of the Fed open market committee can be a disciplined body seems hollow. I wondered, in my research, whether there might be some alternative to putting our faith in the discipline of a committee of unelected bankers. Given where we are in time, perhaps some kind of computer program or another type of artificial intelligence could do it better, more dispassionately and less politically, then people can? I put my idea to David and Brent,

Brent Gloy: David has thought through this a lot. So, I would not be willing to turn our financial features over to the AI supercomputer just yet myself because it would probably just kill us all off or something. I don't know it's going to buy up all the beach front property.

David Widmar: So, Sarah, I just had to laugh because I had this very conversation – somebody emailed me saying, can we use artificial intelligence to allocate acreage around the us and the world? Couldn't, we figure out the most optimal way to allocate acreage so that farmers have profitability. We could remove these boom-bust cycles. And I also think we should just talk about how the Fed, lowered interest rates and have kept them low for a reason. It wasn't like this was a mission of malicious intent. There were good reasons why they made every decision that they made, the road to hell's paid with good intentions is that saying? So, one of the things that I think about specifically to robots making decisions is set, if it's truly artificial intelligent, then wouldn't it eventually succumbed to the same heuristics and shortcomings that humans come to? So, for example If a communist country wanted to build a machine to tell them how many acres of wheat to plant wouldn't that machine eventually tell them the answer that they wanted to hear, not the actual answer, otherwise they'd risk getting unplugged, right? Wouldn't the AI know that if I give the wrong answer, I will get unplugged. And so, I guess the temptation here is that I think that could be part of the conversation, but I think that there's always going to be these split-second decisions. I think we think about this for driving cars, like if we're going to have a computer make this decision of bad outcome A and bad outcome B how are we going to think through that as a society?

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If we programmed in which one of these bad outcomes we're going to pick, and you could just imagine Some of the challenges that we'd have is okay, are we going to let this recession last three more years and have all of this unemployment and all of these job losses, because 20 years from now, the economy will be in a better spot? Or we going to roll the dice today? And are we going to solve the today's problems?

Brent Gloy: I think what David's saying too is, exactly oh yeah, let's turn over the computer and we'll follow it until it like makes money really tight and we can't have what we want and then there'll be a march and they'll go and unplug it. And so, the computer will finally figure out that's what we're going to do. And so, it'll just make money easy.

Sarah Mock: On a more serious note, I also put the question, of weather we might already have access to some other kind of discipline better than human nature, to Tom, and to my surprise, he said, yes.

Thomas Hoenig: There is an individual, John Taylor, who created the Taylor rule. It's not perfect. but had it been followed; I think we would've been better off. And it's a simple rule. It's not hard to understand, but it gets in the way of short-term thinking. And it's not a gold standard. It has more flexibility. So, there's just one example. There may be others, but we need to go to more of a rules-based system. Not because it doesn't bring hardship because it does, but it does own in the short run and allows a long run. Years ago, central banker Swiss central banker, by the way, said to me, he said, the responsibility of a central banker is to take care of the long run so the short run can take care of itself. And I don't think we should forget that.

Sarah Mock: Despite the challenges that the Federal Reserve, and the financial sector more broadly, faced in the 1980s and 2008 in particular, ag finance, from many perspectives, didn't face quite the same level of hardship. Here's Jeff Conrad from Agis Capital to fill us in.

Jeff Conrad: When the capital markets were just locking up, the ag space did not. I'm talking 08, 09. If you look at the NCREIF Farmland Index, it's the National Council for Real Estate Investment, fiduciaries land values did not fall in the farmland space. And in fact, I remember we levered one of our portfolios in that 09 space and my friends being in more traditional investments, they were like, how can you go to market and get leverage in the middle of this chaos? And we could, farm credit was separate. When you think about, the fact that agriculture is not correlated to a lot of things, capital was

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available. It was business as usual. And if you look at the NCREIF Farmland Index, you'll see that values didn't fall. And it was actually an okay period for U.S. agriculture and farmland investors. But agriculture tends to be counter cyclical so it seems like where my friends in the stock and bond business, or even now more private equity business, when they're doing extremely well, ag might be suffering. Up until recently in the last year or so think about, the Midwest and the row crop space, corn and soybeans things weren't gone that well, where the equity markets were on a tear for several years. Things are pretty flat in, let's say the corn and soybeans space, now that's changed in the last year or year and a half where values have really taken off again.

Sarah Mock: As we look to the present – I think there's a lot more to dive into around this concept of discipline, especially in the long term. But there is one other key takeaway that came from Tom that applies in specific and dramatic ways to the ag sector. And it's a lesson he learned in the 1980s.

Tom Hoenig: One thing Volker also said is that "asset inflation is the first cousin of price inflation." And so, you can't just wait until price inflation is out of control as it is right now at 8%, you had to do it when asset values were rising, and asset values have risen enormously over the last decade.

Sarah Mock: What would Volker say about today's farmland prices?
And maybe more importantly, what would he do? That's next time on *Nothing Borrowed, Nothing Gained*.
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