Federal Reserve Bank
of Minneapolis

Fall 1985

Quarterly Review

Federal Reserve Bank of Minneapolis

Quarterly Review

Vol. 9, No. 4 ISSN 0271-5287

This publication primarily presents economic research aimed at improving policymaking by the Federal Reserve System and other governmental authorities.

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In This Issue

A Stirring of the Inflation Beast?

In "How Monetary Policy in 1985 Affects the Outlook" (p. 2), Robert B. Litterman uses the same Bayesian vector autoregression model he used last year to generate a forecast of the national economy. Like last year's forecast (published in the fall 1984 *Quarterly Review*), the model's current one calls for above-average growth in 1986 and 1987. This time, however, the model predicts that inflation will heat up, reaching a rate of nearly 6 percent over the four quarters of 1987. To pinpoint what caused the forecast to change, Litterman examines where the model was surprised by the 1985 data—that is, where errors occurred in last year's forecast for 1985. He then attempts to determine how much of the change in the forecast was due to one type of surprise—unexpected changes in monetary policy. By making assumptions about the immediate impact of monetary policy actions on variables in his model, he estimates that unexpectedly expansionary actions in 1985 account for about half of the upward revision to the inflation forecast for 1986 and about 40 percent of the revision for 1987.

A Ducking of the Farm Credit Risk?

In "Taking Stock of the Farm Credit System: Riskier for Farm Borrowers" (p. 14), Richard M. Todd reviews the recent history of this troubled group of lending cooperatives as background for discussing one of its little-studied problems: the instability arising from its stock requirement. The system requires farmers who borrow from its co-ops to also buy stock in them. Todd points out that this requirement adds an element of risk to borrowing in the system because borrowers can suffer capital losses on their stock if their co-ops become insolvent. But efforts to avoid these losses can add stress to a vulnerable co-op. When a co-op is under stress, its financially strong borrowers, those who can get credit elsewhere, have an incentive to do that—pull out of the co-op by repaying their loans and selling their stock back to the co-op at its original price, thereby avoiding any capital loss. Weak co-ops are thus weakened further as they are left primarily with weak borrowers, those who may not be able to repay their co-op loans or get credit elsewhere. Todd concludes by analyzing some measures to reduce this instability. His analysis suggests that it may be hard to reduce the instability without also reducing the incentive to join the co-ops.