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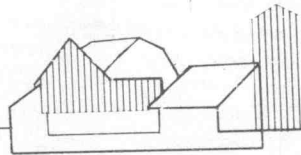
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FmHA, Fed move to assure farm credit flow

A number of programs have been announced in recent months to provide a cushion for both borrowers and lenders experiencing difficulties with farm loans. A debt deferral program initiated in September 1984 allows the Farmers Home Administration (FmHA) to grant its own farmer-borrowers deferrals on the repayment of up to 25 percent of the borrower's total indebtedness. A debt adjustment program permits the FmHA to guarantee 90 percent of a problem farm loan held by other lenders, provided the lender writes down the principal amount of the indebtedness or reduces the interest rate charged on the indebtedness by specified amounts. In addition, the Federal Reserve System's seasonal borrowing program, a long-standing mechanism designed to relieve seasonal liquidity pressures at banks, was recently modified to ensure that liquidity constraints do not hamper the flow of credit during the forthcoming planting and production cycle.

The debt-deferral program provides FmHA with a back-up option for restructuring problem loans that cannot be successfully restructured with other options. The other options include rescheduling debt payments, reamortizing existing loans over longer periods, and lowering interest rates to qualified borrowers. If the other options do not adequately improve the debt servicing ability of an FmHA borrower with a problem loan, the debt-deferral program can be used to defer a portion of the principal repayments for five years. The deferred portion can range up to 25 percent of the borrower's FmHA indebtedness, but cannot exceed \$200,000. Interest charges will not accumulate against the deferred portion of the FmHA indebtedness.

In order to qualify for the deferral program, a borrower must be able—as a result of the loan restructuring granted by the deferral—to generate a positive cash flow. Analyses of an applicant's cash flow will center on their outflows to cover farm operating expenses, debt servicing requirements and family living expenses as well as their projected inflows from farm marketings and off-farm income. To qualify for the program an individual's projected cash inflow must exceed by 10 percent their debt-restructured cash outflows.

The FmHA's debt adjustment program, originally announced last fall and recently liberalized, provides for government guarantees on problem farm loans held by private lenders. Guarantees under the program are limited to loans that are classified as substandard or worse. The original requirements of the debt adjustment program called for a lender to permanently write-off at least 10 percent of the outstanding indebtedness of the problem loan. Moreover, the borrower whose loan was to be guaranteed had to meet the same 10 percent positive cash flow as the deferral program. However,

a recent compromise between the administration and the Congress has substantially modified the debt adjustment program's requirements.

Under the compromise, lenders have an option in adjusting the structure of the loan to secure a guarantee. They can permanently write-off a minimum of 10 percent of the total principal and interest outstanding, lower the rate of interest on the loan by an amount that will reduce interest costs to the borrower by an amount equal to at least 10 percent of the current indebtedness, or use a combination of the two methods. Moreover, the cash flow requirement was eased such that the adjusted indebtedness must result in expected cash inflows that merely equal expected cash outflows for the borrower.

To qualify, the adjusted loan amount must be adequately secured. The adjusted loan can be restructured with terms of up to 15 years for operating loans and 40 years for farm ownership loans. The interest rate may be fixed or variable as agreed upon by the borrower and lender. However, the rate cannot exceed the interest rate the lender charges its best farm customers. Moreover, variable rates cannot change more frequently than monthly and any change must hold constant the initial spread between the variable rate and the rate charged to prime farm customers.

When an interest rate reduction is used in lieu of a write-off, the extent of the reduction is determined by the annual payment that would fully amortize the restructured loan under the write-off option. For example, a \$100,000 substandard loan might be written down by 10 percent and restructured as a \$90,000 loan at 13 percent interest for 5 years, to be fully amortized with five annual payments of \$25,588. Under the interest rate reduction option the same five annual payments would be applied to the \$100,000 principal, effectively lowering the interest rate to about 8.75 percent.

The guarantees will be based on the principal of the new adjusted loan plus accrued interest. In the case of a principal write-off, the FmHA will guarantee 90 percent of the remaining indebtedness. If, for example, a lender writes off 10 percent of a substandard \$100,000 loan, 90 percent of the remaining \$90,000 principal will be guaranteed. Therefore, the FmHA's dollar exposure at the time the loan is restructured is \$81,000.

If default occurs at the end of the first year, however, the FmHA's exposure increases to cover any unpaid interest that accrues during the year. Using the example of an adjusted \$90,000 loan and assuming that \$11,700 in unpaid interest accrued at 13 percent during the year, the FmHA's exposure at the end of the first year would grow to \$91,530, equal to 90 percent of the \$101,700 in principal and interest outstanding. On the other hand, if principal and interest pay-

ments are met by the borrower, the dollar level of the FmHA's exposure will decline accordingly over the life of the loan guarantee.

Under the interest rate reduction option, the proportion of the loan guaranteed will float to ensure that the FmHA's exposure will be equivalent to that which would have prevailed if the principal write-off option had been used. Returning to the hypothetical substandard \$100,000 loan, only 81 percent of it—or \$81,000—would be guaranteed initially if restructured under the interest rate reduction option. Over time, however, the percentage guarantee will rise under the interest rate reduction option to maintain the required exposure equivalency had the principal write-off option been used. In the example, with interest accruing at 8.75 percent on the loan restructured under the rate reduction option, the outstanding balance would total \$108,750 at the end of the first year. Because of the equivalency exposure requirement, only \$91,530—or just 84 percent of the outstanding balance—would be guaranteed. In subsequent years the guarantee percentage would steadily increase, approaching 90 percent at the end of the five-year period.

The changes in the debt adjustment program are likely to make it more attractive to lenders with problem agricultural loans. Allowing an interest rate reduction in lieu of an upfront write-off spreads the capital loss to be absorbed by the institution over a longer period of time. Given the time value of money, this option effectively reduces the cost of the guarantee program to the institution. Moreover, relaxing the cash flow requirement for the borrower lessens the amount of the write-off or rate reduction the bank must incur to qualify for a loan guarantee.

The changes in the Federal Reserve System's seasonal borrowing program are intended to ensure that the production decisions of farmers are not constrained by lack of access to credit. The seasonal borrowing program helps banks weather liquidity pressures that can arise because of seasonal fluctuations in their deposit and loan flows. By borrowing from a Federal Reserve Bank, qualifying institutions are better able to meet their peak loan demands, often occurring during planting season.

The regular seasonal borrowing program requires a bank to provide some of its seasonal funding needs from its own resources before borrowing from the Federal Reserve. Recent modifications to the regular seasonal loan program reduce the proportion of the seasonal funding needs that an institution must meet by liquidating assets. Under the new formula, the deductible has dropped from 4 to 2 percent of the first \$100 million in deposits, from 7 to 6 percent of the second \$100 million in deposits, with the 10 percent deductible for deposits in excess of \$200 million remaining unchanged.

The changes in the program have provided greater access to Federal Reserve Bank credit, particularly for smaller banks. For instance, a bank with \$25 million in deposits expecting a seasonal decline in its excess of deposits over loans from \$10 million to \$8.5 million would normally have to fund \$1 million of the drop from its own resources. Under the liberalized seasonal borrowing program, the bank would fund only \$500,000 of the \$1.5 million swing with its own resources and

fund the remaining \$1 million decline through borrowing from a Federal Reserve Bank.

In addition to the modifications to the regular seasonal borrowing program, the Federal Reserve has instituted a temporary simplified program to be available through September. The temporary program is targeted for smaller banks actively engaged in agricultural lending that have limited access to national money markets. General guidelines suggest eligibility for the temporary program will primarily center on banks with less than \$200 million in deposits, having farm loans comprising more than 17 percent of total loans (the average level among all banks), and a loan-to-deposit ratio of 60 percent or higher.

For banks that meet these three criteria, credit at a Federal Reserve Bank will be available to fund half of any growth in total loans in excess of 2 percent from a base level. The loan base can be either the average outstandings for February or for the two-week period immediately before submission of an application. A bank that uses the temporary program can borrow up to 5 percent of its total deposits. The program will be available through September 1985, although repayments of any borrowings can extend through February 1986. Interest on credit advanced under the temporary simplified seasonal program will be at a fixed rate during the time the credit is outstanding. The rate was initially set at 8.5 percent.

The modifications to the seasonal borrowing program and the temporary simplified program are intended to avoid localized bottlenecks in the provision of credit to agriculture. Although a lack of loanable funds has not been a constraint faced by most agricultural banks in recent years, the favorable interest rates and the reduction in the amount of the seasonal funding that must be met with a bank's own liquidity are likely to make use of the program more attractive to many institutions. Moreover, the modified seasonal loan programs will help to ensure the functioning of credit markets in areas that might be especially hard hit by the financial stress in agriculture.

Milk production, down in '84, expected to rise in '85

Annual milk production, after increasing continuously since 1978, recorded a year-to-year drop of about 3 percent in 1984. The decline in output is attributable to both the paid diversion program and a relatively weak milk/feed price relationship exerting downward pressure on production through much of the year. However, strengthening milk prices and falling feed costs later in the year tempered the fourth quarter year-to-year decline. As these trends continued into the early months of 1985, milk production has begun to approach year-ago levels, foreshadowing an upturn in this year's output.

A decline in both dairy cow numbers and output per cow contributed to the fall in milk production last year. Cow numbers registered year-to-year declines throughout 1984, averaging 2.8 percent below the previous year's level during the fourth quarter. In addition to the decline in dairy cows, a lower level of output per cow in 1984 contributed to the decline in production as well. After adjusting February data

for the extra day last year, milk output per cow registered increasing year-to-year declines through the first three quarters of 1984, dropping about 1.5 percent below the 1983 level during the July-to-September period. Fourth quarter output per cow recorded a somewhat smaller decline of 1.1 percent from the previous year.

Among District states, which account for more than 27 percent of U.S. output, the decline in milk production last year was somewhat smaller than the national trend, falling about 2 percent from a year earlier. However, milk production in District states is heavily influenced by Wisconsin, by far the nation's leading milk producing state, which recorded only a 1 percent year-to-year dip in output in 1984. Among the other District states the year-to-year production decline approached 4 percent, ranging from a 2 percent shortfall in Indiana to an almost 6 percent decline in Iowa.

Last year's cut in milk production is attributable to both the paid diversion program and the relationship between milk and feed prices through the year. The paid diversion program, by offering \$10 for every hundred pounds that marketings are reduced, encouraged participants to cull dairy herds and use other management techniques to curtail their output of milk. In addition, year-to-year declines in milk prices and sharply higher feed costs during much of the first half of 1984 exerted downward pressure on production. However, stronger milk prices and declining feed costs during the second half of the year began to ease some of the pressure. The second half price trends combined to boost the milk/feed price ratio, a rough measure of profitability in milk production, substantially above a year earlier.

Along with the decline in output in 1984, commercial disappearance of milk rose considerably. Up 2.6 percent for the year, commercial disappearance of milk in all forms recorded year-to-year gains through the first three quarters of 1984. However, as milk prices edged upward during the final three months of the year, fourth quarter commercial disappearance held at the 1983 level.

Greater utilization of milk along with lower production last year contributed to a sharp reduction in Commodity Credit Corporation (CCC) purchases of manufactured dairy products. Purchases of surplus products by the CCC is the mechanism through which the federal government supports milk prices. Throughout the year, CCC net purchases totaled 8.6 billion pounds on a milk equivalent basis, about half of the record 16.8 billion pounds of a year ago. Moreover, the sharp drop held net purchases as a percent of total milk production to 6.4 percent, still substantial but down considerably from the 12 percent share of output in 1983.

Milk production through the first two months of 1985 has approached last year's level, falling only 2 percent below the same period of a year ago. Moreover, after adjusting for the extra day in February last year, milk production in the two-month period is running just slightly below the year-ago pace. With the paid diversion program for dairy producers scheduled to expire on March 31, it is likely that the cutbacks in milk production will end as well.

A number of factors point to an increase in milk production in 1985. Although the dairy herd started the year 2.6 percent

below the 1984 level, dairy producers appear poised to substantially increase the herd size. On January 1, the number of dairy heifers kept for replacement per 100 milk cows stood at 44, a record level for that time of year. For all of this year, the dairy herd is expected to average near the 1984 level, overcoming the deficit that began the year. In addition, feed costs well below year-ago levels will encourage production. With the likely increase in concentrate feeding, output per cow in 1985 is expected to average 1 to 2 percent above last year's level. As a result of these factors, USDA's latest estimates point to a 2 percent increase in milk production this year.

Although commercial disappearance of milk is expected to be up again this year, it will not be sufficient to substantially cut net CCC purchases of manufactured dairy products. As a result, the termination of the paid diversion program will likely be followed by an April 1 cut in the support price. This 50 cent per hundredweight price cut, however, will be offset by the termination of the 50 cent per hundredweight assessment on milk marketings that has funded the paid diversion program. Producers' effective support price, therefore, will remain at the current level, offering little additional incentive to reduce output.

The April cut in the support price, unlike a deduction from producers' marketing receipts, may provide a boost to commercial disappearance. However, it is not likely to generate a drop in projected CCC net removals to 5 billion pounds over the twelve-month period beginning in July. With the current legislation stipulating a second 50 cent cut in July if removals are expected to be above that level, the milk support price will likely fall to \$11.60 per hundredweight this summer.

Peter J. Heffernan

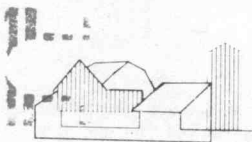
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Selected Agricultural Economic Indicators

	Latest period	Value	Percent change from		
			Prior period	Year ago	Two years ago
Prices received by farmers (1977=100)					
Crops (1977=100)	February	135	0	-6	2
Corn (\$per bu.)	February	124	-1.6	-10	6
Oats (\$per bu.)	February	2.62	-0.8	-16	2
Soybeans (\$per bu.)	February	1.71	-1.7	-9	16
Wheat (\$per bu.)	February	5.74	-2.7	-21	1
	February	3.37	-0.3	-1	-6
Livestock and products (1977=100)					
Barrows and gilts (\$per cwt.)	February	146	0.7	-3	0
Steers and heifers (\$per cwt.)	February	50.00	2.5	9	-12
Milk (\$per cwt.)	February	63.40	0.6	-2	4
Eggs (¢per doz.)	February	13.80	-1.4	3	0
	February	52.8	2.1	-43	-4
Prices paid by farmers (1977=100)					
Production items	February	164	0	0	3
Feed	February	154	0	-1	2
Feeder livestock	February	122	-0.8	-14	-2
Fuels and energy	February	165	1.2	2	-3
	February	192	-1.5	-5	-4
Producer Prices (1967=100)					
Agricultural machinery and equipment	February	293	-0.1	1	3
Fertilizer materials	February	338	-0.1	2	5
Agricultural chemicals	February	232	-0.2	-2	1
	February	453	-0.1	0	-1
Consumer prices (1967=100)					
Food	January	316	0.2	4	8
	January	307	0.7	3	7
Production or stocks					
Corn stocks (mil. bu.)	January 1	5,808	N.A.	18	-29
Soybean stocks (mil. bu.)	January 1	1,423	N.A.	10	-19
Beef production (bil. lbs.)	January	2.07	13.0	8	21
Pork production (bil. lbs.)	January	1.28	5.1	4	25
Milk production (bil. lbs.)	January	11.2	2.2	-1	-2

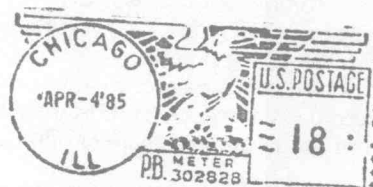
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