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96th Congress }
2d Session }
COMMITTEE PRINT

1981 AGRICULTURAL OUTLOOK

Papers Presented at the Agricultural Outlook Conference Sponsored by the U.S. Department of Agriculture—Held in Washington, D.C., November 17–20, 1980

PREPARED FOR THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

UNITED STATES SENATE

JANUARY 1981

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Committee on Agriculture, Nutrition, and Forestry

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1981
69-563 O

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COMMENTS ON USDA AGRICULTURAL FINANCE OUTLOOK

(By George D. Irwin, Economic Analysis Division, Farm Credit Administration)

The USDA agricultural finance statement is generally an optimistic one. It forecasts improving farm income and generally strong agricultural credit demand, although perhaps delayed until 1982 in those areas which suffered from drought in 1980. This demand will be based on a healthy sector rather than one requiring distress financing. It forecasts effective fiscal and monetary policies resulting in an early easing of interest rates, although comment on the extent and shape of the decline is hedged.

I find it easier to agree with the assessment of the agricultural situation than with that on interest rates. In fact, something of an ebullient mood seems to be developing in the wake of the recent commodity price increases, and this could cause loan demand for farm capital purposes to explode well beyond USDA projections. Otherwise, I generally agree with USDA views on the farm sector prospects, and will concentrate on the financial markets. I also differ somewhat on the interpretation of the conditions in the spring of 1980. I also feel it is necessary to comment a bit on structure of the financing industry and changes in financial instruments which we are seeing at the beginning of the 1980's.

First, the spring 1980—the report says "In the northern and western edges of the Corn Belt, many profitable farms had difficulty obtaining loans." The summary also refers to "this year's financial crisis." I would observe that many may indeed have had difficulty obtaining funds from their usual source—the commercial bank. Many of them were illiquid, and many more faced borrowers whose requirements exceeded their lending limits.

However, the PCA and FLB systems at no time had any shortage of funds. They, in fact, grew at record rates during most of the first half of 1980. At most, creditworthy commercial borrowers coming to the Farm Credit System for the first time might have suffered some delay in the spring months due to manpower pressures created by the unprecedented demand. Several other factors were involved. The Farm Credit System was also at the peak seasonal load for its regular customers, and the conditions described in the USDA paper called for more thorough credit analyses for them. It was also a time for commercial banks to weed out the lower quality accounts in their loan portfolios, and many sought out the Farm Credit System. These, too, required additional servicing time. Further, the interest rate differentials between the System and other lenders may have attracted additional applicants, particularly to the FLB system for short-term

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loan purposes, before introduction of loan fees and adoption of voluntary credit restraint slowed the trend. The workload was compounded in some areas by commercial bank referrals of good customers to the FLB rather than the PCA, for either interest rate or competitive reasons. Normal FLB loan processing requires considerably longer than PCA processing, because of the first mortgage security requirements. The same considerations probably stimulated commercial bank referrals to the economic emergency lending program of Farmers Home Administration and to Commodity Credit Corporation. Thus, I doubt that 3.5 percent of the 1980 acres would have gone unplanted in the absence of these Government actions, as seems to be implied on page 4 of the paper. Finally, a good portion of the complaints about "credit unavailability" did not reflect actual lack of credit, but reluctance or inability to pay going market interest rates. Farmers were in an income squeeze, and any opportunity for lower rates was extremely attractive to them. The same harsh pressures of the money market will continue in the 1980's, and will require adaptation by farmers. Neither the Farm Credit System nor any other lender would use such a short-term situation to cut off otherwise sound borrowers. A Farm Credit System policy referred to as "forbearance," is to look through any short-term distress to long-term viability.

Second, let me comment a bit on the forecast of rapid improvement in interest rates, presumably due to a new administration getting control of the economy and establishing economic policies that squash inflationary expectations. The USDA statement represents a conscientious effort to bring in the important macroeconomic consequences. I am also pleased with the recognition that real interest rates as well as nominal rates have a role in economic explanations. Real rates are often signaling economic actions far different from those suggested by nominal rates, particularly when considered simultaneously with marginal income tax rates in an inflationary period.

My quarrel is with the timing of the interest rate forecast. For we can all agree that policies to control inflation, long an economic need, have now become a political imperative. The analysis expects fiscal policy to be stimulative, with tax cuts right away and lagged response on the expenditures side. It argues that this will signal the public that it should revise inflationary expectations and bring interest rates down in the spring months.

I don't see things improving that quickly. This forecast implies a rising deficit in the short term, with increased Treasury borrowing creating more demand for funds. At the same time, the Federal Reserve will be restricting money supply. If expectations do turn favorable, won't business expansion plans be implemented and create further loan demand in the short term? I also feel the lags built into the interest rate structure are longer than one or two quarters. Events which have already occurred may have an inflationary impact next spring, which improved expectation will have to offset. Finally, we know there will be further CPI increasing pressure coming from rising food prices in 1981 as a result of 1980 production conditions, and as a result of completion of decontrol of domestic petroleum prices on or before October 1 of next year. These will be built into

automatic escalators on various wages and prices, and into the core inflation rate. I would anticipate that an improvement in expectations can bring this core rate down only with a lag. We must recognize that these changes in expectations toward inflation would increase both the demand for funds and the supply of savings. I would expect that we are embarking on a path of improved results on inflation, but I expect progress to be very gradual. Interest rates will be volatile as they start trending slowly downward, once inflation expectations moderate and new economic policies start to take effect. The pattern depends also on the Federal Reserve correctly anticipating the public's demand for money based on these revising expectations. The uncertainty over possible new economic programs and possible new "oil shocks" or other disruptions in 1981 will make it difficult for the public and the Federal Reserve to chart steady courses.

Events culminating in the Depository Institutions Deregulation and Monetary Act of 1980 will cause an evolution in the commercial banking structure in the 1980's. This may be more significant than either of the impacts mentioned in the USDA paper. Disintermediation was not really a factor, and higher interest rates to farmers were evolving even without the act. Rural banks have grown more slowly than the borrower-customers, meaning more and more have to go to secondary sources to overcome single-borrower limits. The advent of money market rates on savings certificates, and now the phaseout of regulation Q have linked smaller banks' cost of funds more closely to interest rates in national markets. More importantly, they have narrowed the operating spreads of such banks, reducing their profitability. The 1980 act further tightens the vise, by introducing local competition of thrift institutions in providing services of checking-type accounts, and of lending for various purposes formerly the province of banks, and have required monetary reserves in the Federal Reserve System. To survive, smaller rural banks are going to have to evolve to meet these pressures, via expansion, correspondent relationships, and other devices for obtaining wholesale funds that they can relend at a profit. The financial pressures to do something will be intense, and will make various forms of branching more likely. We expect participations with PCA and discounting with FICB's will become increasingly attractive alternatives to the smaller rural banks during the 1980's.

The mortgage financing area has seen major evolution in financial instruments during the past 2 years, and will continue to do so in coming years. Few institutions followed the FLB's into variable interest rates in the past decade. Now the same financial variability that forced FLB's to innovate in 1968–70 in imposing change on other institutions. During continued inflation, the long-term, fixed-rate mortgage has become an unacceptable financial investment for insurance companies, individual investors, and savings and loans. We are beginning to see shorter terms, periodic adjustment of interest rates during the life of the contract, partial amortization with balloon payments at the end of the contract, and even equity positions or shared appreciation between lender and borrower. So long as inflation and interest rate volatility are the primary threats, borrowers are going to have little alternative for long-term contracts with savers and their representatives.

Seller financing via contracts may be the one area of continued fixed rate financing. The impacts of estate tax valuation for farm purposes could cause closer holding of land in family farms in the future, perhaps stimulating contract sales and reducing the amount of open market land sales. It is an area needing much further study.

But another source of funds for agriculture may grow, if land values continue their historic performance as an inflation hedge. Farm land will continue to attract direct investment interest from various sources other than farm operations. This was a growing trend toward the end of the 1970's, which would abate only gradully as inflation concern relaxed. But there appears to be only moderate reason for concern about the level of land prices, as we move into a decade where tightening worldwide stocks in relation to demand should translate into generally strong farm incomes, picking up any gap left by less inflationary expectation in land prices.

Finally, farmer loan repayment problems will be significant in areas hit most heavily by the 1980 drought. It will be especially significant in those areas which have had problems for the past 2 or 3 years. During this period, we have seen rapid expansion in the Farmers Home Administration economic emergency lending activity. Unfortunately, we lack good information on the proportion of these accounts which reflect farm distress situations, versus the proportion which reflect other reasons. As noted earlier, commercial bank illiquidity and interest rate differentials have been among those reasons.

Since this program is due to expire during 1981, the extent of distress may be a significant determinant of prospects for extending legislation. However, budget considerations and an increasing reliance on competitive economic efficiency could suggest significant turnaround in the role of Government in financing farming, a corresponding shakeout of producers that have survived as a result of those programs, and a different risk environment for commercial lenders. All these would be consistent with an election result placing increased emphasis on self-reliance for all sectors. This potential redirection may generate significant policy debate in 1981.