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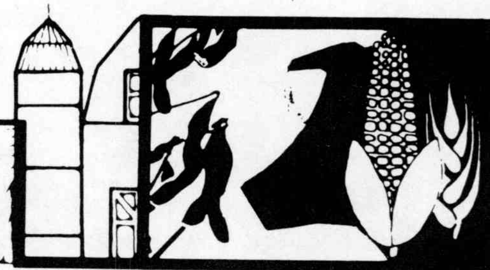
FEDERAL RESERVE BANK OF CHICAGO

AGRICULTURAL LETTER



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CREDIT CONDITIONS AT DISTRICT AGRICULTURAL BANKS in the fourth quarter reflected further significant improvement in bank liquidity, a return to record-high interest rates, and continuation of the unusually soft farm loan demand. These characteristics represent the consensus view from a recent survey of about 550 District agricultural banks.

The improved liquidity positions are evident in several measures. Loan/deposit ratios, for instance, registered an unusually large decline in the fourth quarter (see table on page 2). By year-end the average ratio stood at 60.6 percent, down nearly 6 percentage points from the ending 1979 level and the lowest level in nearly four years. In conjunction with the declining ratios, the proportion of bankers who view their loan/deposit ratio as being higher than desired retreated to 17 percent, while the proportion viewing their ratio as lower than desired rose to 46 percent. These are the strongest indications since early 1974—when loan/deposit ratios at District agricultural banks averaged about 55 percent—that banks would like to expand their loan portfolios relative to their deposit base.

Evidence of the improved rural bank liquidity is also apparent in bankers' assessments of the availability of funds for farm loans and farm loan repayment rates. Measures of fund availability and farm loan repayment rates for the fourth quarter were at the highest levels in seven years. These encouraging signs may be partially inflated because the measures compare the fourth quarter of 1980 with the very illiquid conditions of the year before. Nevertheless, there is no doubt that liquidity among rural banks in the Midwest is the best in several years.

Banks in all five District states shared in last year's dramatic recovery in liquidity. Compared to a year ago, conditions are most improved in Iowa largely because Iowa banks a year ago were less liquid than banks in other states and were still facing very strong farm loan demands. The turnaround in liquidity was less apparent for banks in Indiana and Wisconsin than for banks in the other three District states. Nevertheless, average loan/deposit ratios among agricultural banks in Indiana and Wisconsin are down to a three-year low.

Large deposit inflows and continued soft credit demands account for the vastly improved liquidity positions of District agricultural banks. At agricultural banks that are members of the Federal Reserve Bank of Chicago, total deposits rose about 4 percent in both the third and fourth quarters. The second-half increase in total deposits was the largest for that period in the past decade except for the second half of 1972. The second-half surge in deposit inflows offset abnormally slow growth in the first half. As a result, total deposits at member agricultural banks rose 11 percent last year, the largest annual increase since 1976. The annual increase was led by a 14 percent rise in time and savings deposits. Demand deposits, although recovering sharply in the second half, rose only 1 percent last year.

A number of factors probably contributed to the second-half surge in deposit inflows at agricultural banks. With market rates of interest rising to new records in late 1980, rural banks probably experienced considerable growth in interest-sensitive deposits, such as the six-month money market certificates. In addition, the second-half escalation in farm commodity prices and the marketing of corn that had been tied up in the three-year grain reserve probably generated much stronger deposit inflows from farmers. Finally, the available evidence suggests that crop marketings have been proportionately larger than normal since last fall's harvest. Reflecting this, over half of the bankers that responded to the recent survey indicated that the proportion of corn and soybeans already sold or contracted at a fixed price by farmers in their area was higher than normal for this time of year. Only 7 percent of the bankers indicated the proportion sold or contracted was below normal, while 40 percent indicated the proportion was about normal.

Loan demand at agricultural banks remained soft throughout 1980. The measure of farm loan demand from the most recent survey, for instance, fell to a low unprecedented in the past 15-year history of such sur-

Selected measures of credit conditions at Seventh District agricultural banks

	Loan demand (index)[2]	Fund availability (index)[2]	Loan repayment rates (index)[2]	Average rate on feeder cattle loans[1] (percent)	Average loan-to-deposit ratio[1] (percent)	Banks with loan-to-deposit ratio above desired level[1] (percent of banks)
1975						
Jan-Mar	134	108	65	8.84	56.4	28
Apr-June	142	120	80	8.76	56.3	22
July-Sept	133	131	105	8.81	57.0	22
Oct-Dec	134	130	100	8.80	56.6	23
1976						
Jan-Mar	142	130	101	8.74	56.2	20
Apr-June	147	134	102	8.79	57.3	24
July-Sept	140	124	93	8.76	59.2	25
Oct-Dec	150	130	81	8.71	58.8	26
1977						
Jan-Mar	161	115	79	8.71	59.4	28
Apr-June	169	103	66	8.74	61.2	38
July-Sept	161	77	52	8.79	63.5	46
Oct-Dec	147	86	59	8.85	62.3	41
1978						
Jan-Mar	152	79	64	8.90	63.7	44
Apr-June	148	73	81	9.12	64.5	46
July-Sept	158	64	84	9.40	65.8	52
Oct-Dec	135	62	93	10.14	65.4	50
1979						
Jan-Mar	156	51	85	10.46	67.3	58
Apr-June	147	62	91	10.82	67.1	55
July-Sept	141	61	89	11.67	67.6	52
Oct-Dec	111	67	79	13.52	66.3	48
1980						
Jan-Mar	85	49	51	17.12	66.4	51
Apr-June	65	108	68	13.98	65.0	31
July-Sept	73	131	94	14.26	62.5	21
Oct-Dec	50	143	114	17.34	60.6	17

[1]At end of period.

[2]Bankers responded to each item by indicating whether conditions during the current quarter were higher, lower, or the same as in the year-earlier period. The index numbers are computed by subtracting the percent of bankers that responded "lower" from the percent that responded "higher" and adding 100.

veys. The soft farm loan demand is apparently characteristic of other types of credit demands facing rural banks as well. After declining in the first half of 1980, total outstanding loans at agricultural banks that are members of the Federal Reserve Bank of Chicago rose only nominally during the second half. For the year total loans at member agricultural banks declined 1.4 percent, contrasting sharply with the average increase of 12 percent the previous two years.

The abnormally soft credit demands at rural banks are mostly due to stagnating overall economic conditions in rural areas and the impact of high interest rates on customer borrowings. Reflecting the latter, average interest rates charged by District agricultural banks on feeder cattle and farm operating loans ranged from 17¼ to 17½ percent at the end of 1980. The average for both types of loans was about 400 basis points higher than the year before, 25 basis points higher than the earlier 1980 peak, and 300 basis points higher than at the end of the third quarter. Farm mortgage rates averaged about 15¾ percent the end of 1980, up sharply from three months earlier but still about 50 basis points below peak at the end of the first quarter.

Farmers' access to other lenders whose rates were considerably below rates charged by banks no doubt contributed to the unusually soft farm loan demand at rural banks. Average billing rates charged by production credit associations, for instance, rose only about 50 basis points during the fourth quarter and by year-end averaged only 12½ percent. Including stock purchase requirements, that implies an effective PCA rate of about 13½ percent. Rates charged on most farm loans by the FmHA, despite recent increases, are still in a range of 12¼ to 13 percent. In addition, the FmHA has several more heavily subsidized loan programs—such as those that cover losses from natural disasters—that offer rates as low as 5 percent. Such programs, however, are presumably limited to farmers unable to obtain credit from other lenders. CCC rates for crops placed under loan are still 11½ percent. And following December legislation, CCC interest charges on loans covering 1980 crops enrolled in the three-year reserve have been waived. That action triggered a huge enrollment, providing about $1.5 billion in new CCC credit to farmers.

Competitively low interest rates and accelerated borrowing through emergency and disaster loan programs probably masked any softness in farm loan demands facing such government lending agencies as the FmHA and the CCC. But new lending by other commercial lenders was held in check by the soft farm loan demand. For instance, farm loans made by production credit associations in the fourth quarter were only 3.7 percent higher than the year before. That represents the smallest year-to-year increase for PCAs for any quarter in 16 years. In farm mortgage markets new loans made by federal land banks in the fourth quarter were down nearly 8 percent from the high year-earlier level, a decline exceeded only one other time in the past decade of year-to-year comparisons of quarterly data. At life insurance companies in October and November, the combination of soft demand and curtailed lending practices held farm mortgage acquisitions and new farm mortgage commitments below year-earlier levels by 52 and 31 percent, respectively. These large cutbacks in farm mortgage lending at life insurance companies extend a trend that started more than a year ago.

The outlook for bank lending to farmers is greatly buoyed by the recovery in rural bank liquidity during the second half of 1980. In marked contrast to conditions a year ago, banks are in the best position in several years to serve farm loan customers. To what extent farm loan demand recovers, however, is far less certain. Future trends in interest rates, farm income, and farm income expectations will be the determining factors in farm loan demand.

Market rates of interest have turned downward after reaching new peaks in December. Many observers believe the downtrend will continue in the near term because of the apparent softening in credit demands. Forecasts of the extent and duration of the downturn, however, are tentative. Rural bank loan rates will probably move in the same direction as market interest rates in general. But because of their high cost of funds (deposits) and the high yields available on alternative investments for banks, any change in rural bank loan rates will probably be less pronounced than changes in short-term market rates of interest.

The advent of NOW accounts may also cause some temporary stickiness in rural bank loan rates. Virtually all agricultural banks are offering NOW accounts in a very competitive environment with other depository institutions. If such accounts prove popular, rural banks face a potential loss in earnings that they will try to recoup through account service charges or higher operating margins on loan and investment portfolios.

The imbalance between loan rates charged by banks and rates charged by other farm lenders will likely narrow in the near term if market rates of interest stabilize or trend lower. PCA and FLB loan rates, which are based on their average cost of funds, will likely rise significantly in the near term because of large refinancings. To the extent that their loan rates are pegged to the U.S. Treasury's cost of funds, FmHA loan rates may also rise in the near term. Any narrowing of the spread in interest rates between lenders would likely result in larger loan demands at rural banks.

Farmers' needs for operating credit will no doubt rise this year. Prices paid by farmers for production inputs are up 11 percent from last year. Higher input prices will more than offset any production cutbacks among livestock producers, holding total operating expenses well above year-earlier levels. Higher input prices and a probable increase in planted acreage will swell operating expenses of crop farmers.

The strength of credit demands to finance capital expenditures is less certain. Recent softness in commodity prices has somewhat dampened earlier prospects for a strong rebound in farm income this year. Moreover, high interest costs were a major factor contributing to the sluggish sales in farm machinery and equipment throughout the latter half of 1980. Although a pent-up demand may exist for capital purchases by farmers, it may not surface until interest rates come down to levels more acceptable to farmers or until a brighter farm income picture emerges.

Gary L. Benjamin

Selected agricultural economic developments

Subject	Unit	Latest period	Value	Percent change from Prior period	Year ago
Farm finance					
Total deposits at agricultural banks†	1972-73=100	January	231	+ 3.4	+13
Total loans at agricultural banks†	1972-73=100	January	256	+ 0.5	− 1
Production credit associations					
Loans outstanding					
United States	mil. dol.	December	19,636	+ 2.7	+ 9
Seventh District states	mil. dol.	December	4,098	+ 2.3	+ 9
Loans made					
United States	mil. dol.	December	3,793	+62.6	+16
Seventh District states	mil. dol.	December	780	+71.4	+14
Federal land banks					
Loans outstanding					
United States	mil. dol.	December	36,032	+ 1.3	+21
Seventh District states	mil. dol.	December	8,454	+ 1.3	+26
New money loaned					
United States	mil. dol.	December	648	+48.9	+ 1
Seventh Distict states	mil. dol.	December	137	+44.0	− 4
Interest rates					
Feeder cattle loans††	percent	4th Quarter	15.80	+11.9	+25
Farm real estate loans††	percent	4th Quarter	14.72	+ 8.3	+20
Three-month Treasury bills	percent	1/29-2/4	14.78	+ 5.1	+22
Federal funds rate	percent	1/29-2/4	17.19	−14.3	+34
Government bonds *(long-term)*	percent	1/22-1/28	12.35	+ 3.7	+12
Agricultural trade					
Agricultural exports	mil. dol.	December	4,279	+12.7	+16
Agricultural imports	mil. dol.	December	1,538	0	− 5
Farm machinery sales[P]					
Farm tractors	units	December	6,938	−20.4	−23
Combines	units	December	1,687	−31.8	−13
Balers	units	December	397	−24.5	+13

†Member banks in Seventh District having a large proportion of agricultural loans in towns of less than 15,000 population.

††Average of rates reported by District agricultural banks at beginning and end of quarter.

[P]Preliminary.

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