FEDERAL RESERVE BANK OF CHICAGO

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AGRICULTURAL CREDIT CONDITIONS improved markedly last year at rural banks in the Seventh Federal Reserve District. A little over a year ago, conditions were highlighted by low crop prices and mounting losses to cattle feeders. Net earnings per farm in 1977, adjusted for inflation, had fallen to the average of the second half of the sixties. Many farmers were experiencing severe cash-flow problems. There was widespread concern about the slow paydown on farm debt, the extensive refinancing of debt, and the availability of new operating credit for farmers. Farm earnings prospects for 1978 were not optimistic. Pork production was expected to be up sharply, causing hog prices to plunge. There was skepticism about grain and soybean prices because the huge 1977 crop harvest was expected to result in a burdensome buildup in carryover stocks.

But 1978 unfolded differently than expected. Pork production failed to expand, which—coupled with strong consumer demand—propelled livestock prices to record levels. Major crop prices, particularly for wheat and soybeans, were stronger than expected despite another record harvest in 1978. A drouth sharply reduced the winter and spring harvests in the Southern Hemisphere, giving the United States a decided edge in meeting the strong world demand for grains and soybeans. By year-end, the government's new farmer-held grain reserve program had isolated a large part of the burdensome grain stocks from free-market supplies. And earnings of some crop farmers were augmented by large payments from the government.

These developments paved the way for a sharp recovery in net farm income. The USDA's latest preliminary estimate shows net farm income jumped to about $28 billion in 1978, up from the depressed $20 billion in 1977 and second only to the 1973 record of nearly $30 billion. Adjusted for inflation and the continuing slide in the number of farms, real earnings per farm were up nearly a third last year. Farm earnings in district states generally paralleled the nationwide recovery, although the relative weakness in corn markets tempered the rise for many crop farmers.

The surprising turnaround in farm earnings brought considerable improvement in several measures of agricultural credit conditions. Quarterly surveys of around 600 agricultural banks in the Seventh Federal Reserve District show steady improvement in farm loan repayment rates and a slowing in loan renewals and extensions (see table on page 2). For instance, the index of farm loan repayment rates stood at 93 in the fourth quarter of last year, compared with 59 a year before. That was the highest since the summer of 1976.

Another indication of the easing rural credit conditions is the apparent softening in the strong demand for farm loans. In the fourth quarter of last year, the index of farm loan demand was the lowest in three years. A softening in loan demand could signal different things. But in the current instance, rather than signaling any slowing in farmers' operating and capital expenditures, it mostly reflects the improved farm earnings that have better enabled farmers to stay current with their debt servicing requirements. Other factors include the sharp rise in interest rates on farm loans and the huge increase in farm debt funded by governmental agencies that offset part of the loan demand at commercial lenders.

Not all aspects of rural credit conditions improved last year. In particular, liquidity pressures at rural banks deteriorated further and interest rates rose to new highs. Although bank liquidity is a complex function of many variables, rough approximations are provided by bankers' assessment of the availability of funds for lending and by the ratio of loans to deposits. In the fourth quarter, the index of fund availability was considerably below the low level of a year earlier. And loan-to-deposit ratios at year-end averaged 65 percent, 3 percentage points higher than a year before and 6.5 percentage points higher than at the end of 1976. Half the banks

Selected measures of credit conditions at Seventh District agricultural banks

	Loan demand (index)*	Fund availability (index)*	Loan repayment rates (index)*	Loan renewals and extensions (index)*	Average loan-to-deposit ratio (percent)	Banks with loan-to-deposit ratio above desired level (percent of banks)
1974						
Jan-Mar	127	133	136	72	54.1	17
Apr-June	142	89	87	117	57.9	27
July-Sept	126	69	85	121	57.3	32
Oct-Dec	122	98	79	127	56.9	32
1975						
Jan-Mar	134	108	65	145	56.4	28
Apr-June	142	120	80	122	56.3	22
July-Sept	133	131	105	100	57.0	22
Oct-Dec	134	130	100	103	56.6	23
1976						
Jan-Mar	142	130	101	109	56.2	20
Apr-June	147	134	102	102	57.3	24
July-Sept	140	124	93	109	59.2	25
Oct-Dec	150	130	81	124	58.8	26
1977						
Jan-Mar	161	115	79	125	59.4	28
Apr-June	169	103	66	140	61.2	38
July-Sept	161	77	52	152	63.5	46
Oct-Dec	147	86	59	151	62.3	41
1978						
Jan-Mar	152	79	64	145	63.7	44
Apr-June	148	73	81	126	64.5	46
July-Sept	158	64	84	122	65.8	52
Oct-Dec	135	62	93	116	65.4	50

*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.

considered their loan-to-deposit ratio higher than they would like.

Agricultural banks responded to the liquidity pressures and the strong loan demands by substantially raising interest rates on farm loans, particularly in the second half of last year. At year-end, the average rate reported for feeder cattle loans was well over 10 percent. Rates for farm real estate mortgages and farm operating loans averaged about 10.25 percent. These year-end levels were 75 to 100 basis points above the midyear levels and about 1.25 percentage points above the ending 1977 levels.

Part of the second-half surge in interest rates reflects higher costs of banks' deposits. Since last June, financial institutions have been allowed to issue a new six-month certificate of deposit that requires a minimum balance of $10,000 and offers a floating interest rate ceiling that is tied to yields on new issues of six-month Treasury bills. These deposits, called "money market certificates" (MMC), have been issued by a surprisingly large majority (over 80 percent) of the agricultural banks that responded to the latest quarterly survey. Whether rural banks offered the MMCs primarily as a means of attracting new deposits or—perhaps more likely—as a means of staying competitive to retain existing deposits is not clear. However, among the agricultural banks that had issued MMCs, such accounts represented an average of nearly 5 percent of all time and savings deposits. And for more than a tenth of the banks, MMCs accounted for 10 percent or more of total time and savings deposits.

Total farm debt rose substantially last year, despite the evidence of easing credit conditions and softening in the strong loan demand at commercial lending institutions. The USDA currently estimates outstanding farm debt at the end of 1978 approached $136 billion, up

14 percent for the year. The relative increase was virtually the same for both real estate and nonreal estate farm debt. The major difference was that commercial lenders paced the rise in real estate debt while government agencies accounted for a disproportionate share of the rise in nonreal estate debt. Preliminary estimates indicate farm mortgages held by life insurance companies increased 18 percent last year, reflecting the continued strong movement of insurance companies back into the farm mortgage market. Farm mortgages held by federal land banks—which account for over a third of all farm real estate debt outstanding—rose nearly 15 percent.

Among major commercial lenders that provide nonreal estate financing to farmers, preliminary estimates show the debt held by banks rose about 7 percent while outstandings at production credit associations rose 9 percent. Banks hold about 43 percent of all nonreal estate farm debt while PCAs hold about 23 percent. By contrast, outstandings at major governmental agencies (Commodity Credit Corporation, Farmers Home Administration, and Small Business Administration) soared 57 percent last year, accounting for over half the rise in all nonreal estate farm debt. It is currently estimated CCC loans to farmers rose $1 billion (23 percent) last year, reflecting price support operations and a surge in borrowings under the Farm Storage Facilities Loan Program. Nonreal estate farm debt held by the FmHA and the SBA doubled last year, with most of the $3.5 billion increase coming from special emergency and disaster lending provisions of these agencies. These three government agencies now hold a fifth of all nonreal estate farm debt, the highest proportion in two decades.

The outlook for 1979 encompasses prospects for continued high farm earnings and further improvement in agricultural credit conditions. Dairy and livestock earnings will likely remain high throughout the year, although a large increase in pork production may undermine some of the strength in the second half. Prices of major grains and soybeans, at least for the near-term, are expected to hold close to recent levels, but trends later this year will hinge mostly on the vagaries of weather and it's impact on 1979 production throughout the Northern Hemisphere. One concern regarding domestic crop production and agricultural credit conditions, however, relates to farm programs. Farmers have indicated tentative plans for large plantings in 1979. This could imply even less participation in set-aside programs than last year and, hence, fewer farmers eligible for CCC price support loans during the latter part of the year. In addition, the status of the farmer-held grain reserve program will affect the amount of CCC lending during the year ahead. For all practical purposes, the grain reserve has been filled to the levels the Administration has announced it is willing to hold. If the reserve is not reopened, commercial lenders may be facing increased loan demand when the initial CCC loans on 1978 crops mature.

Prospects for large crop plantings, increased pork and poultry production, and higher prices for inputs—particularly feeder cattle—indicate farmers' operating expenses will be substantially higher this year. Although the improved cash flows of farmers may be a tempering influence, nonreal estate loan demand will probably remain strong. And the demand for loans to finance capital expenditures will probably also be strong, reflecting higher land prices and prospects for increased purchases of machinery and equipment.

General trends in interest rates are difficult to project, although the recent easing in money market rates has provided some hope (perhaps premature) that interest rates have peaked. Nevertheless, tight liquidity pressures may preclude any near-term easing in interest rates charged on farm loans at rural banks. And competitive rates charged by PCAs and FLBs will push still higher as the rollover of lower-coupon yield securities are replaced by substantially higher yielding securities. For instance, about 30 percent of the FICB bonds used to fund PCA lending will mature in the first quarter of this year. Coupon yields on the replacement issues will substantially exceed the roughly 8 percent average of the maturing issues.

Liquidity pressures at rural banks may well ease during the year ahead, particularly if money market rates of interest turn down. High farm earnings will further ease farmers' cash flows and permit continued improvement in loan repayment rates. And a downturn in money market rates, if it comes, would better enable banks to use security portfolios to fund loan demand.

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Selected agricultural economic developments

Subject	Unit	Latest period	Value	Percent change from: Prior period	Percent change from: Year ago
Farm finance					
Total deposits at agricultural banks†	1972-73=100	December	188	– 0.9	+ 8
Time deposits	1972-73=100	December	219	– 0.1	+ 9
Demand deposits	1972-73=100	December	135	– 3.0	+ 6
Total loans at agricultural banks†	1972-73=100	December	234	+ 0.6	+14
Production credit associations					
Loans outstanding					
United States	mil. dol.	December	14,901	+ 2.1	+11
Seventh District states	mil. dol.	December	3,013	+ 1.8	+14
Loans made					
United States	mil. dol.	December	2,608	+32.6	+20
Seventh District states	mil. dol.	December	524	+29.6	+32
Federal land banks					
Loans outstanding					
United States	mil. dol.	December	24,668	+ 0.8	+15
Seventh District states	mil. dol.	December	5,314	+ 1.1	+22
New money loaned					
United States	mil. dol.	December	386	+ 3.2	+ 8
Seventh District states	mil. dol.	December	91	– 9.3	+32
Interest rates					
Feeder cattle loans††	percent	4th Quarter	9.77	+ 5.5	+11
Farm real estate loans††	percent	4th Quarter	9.90	+ 4.7	+10
Three-month Treasury bills	percent	1/18-1/24	9.38	+ 0.9	+45
Federal funds rate	percent	1/18-1/24	10.05	– 2.0	+50
Government bonds *(long-term)*	percent	1/22-1/27	8.97	– 0.2	+10
Agricultural trade					
Agricultural exports	mil. dol.	December	2,762	– 1.5	+19
Agricultural imports	mil. dol.	December	1,409	+ 9.9	+10
Farm machinery sales					
Farm tractors	units	November	7,165	–61.3	– 4
Combines	units	November	1,466	–83.0	+ 4
Balers	units	November	396	–71.2	+ 3

†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.

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