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Farm Credit and Interest Rate
Situation and Outlook

by

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FARM CREDIT AND INTEREST RATE
SITUATION AND OUTLOOK

PERSPECTIVE

The credit, interest rate, and monetary policy area continues to be a fascinating area to watch. The economy is now completing almost one year of relative stability in interest rates--a degree of stability that many experts thought would never again occur. After seeing the so-called prime rate reach almost 17% early in 1982 and then drop to 12% by fall of 1982, it has since remained between 12 and 10½%. The cycles per year have also decreased. The relatively slow decrease from 12 to 10½% in prime rate took five months. The move back up from 10½ to 11% also took five months. The Federal Reserve discount rate is now in its tenth month at 8½% without change. Corporate AAA bonds, a good indicator of long-term rates, have remained in the range of 11.3% to 12.7% for the last 12 months.

The Federal Reserve Board has demonstrated considerable skill, much courage, and cool nerves in holding to a relatively steadfast policy. They brought the economy near a disastrous collapse to wring out as much inflationary expectation as possible. Some of the Federal Reserve critics argued that Board positions should be at the pleasure of the President. They would then, of course, be more political and would probably be inclined toward more volatile stop-and-go policies depending on politics. Having paid a heavy price in terms of criticism for the manner in which they brought us to our present stage of recovery, the Fed now has the difficult job of keeping the recovery on track with neither overstimulation nor overly restrictive monetary policy. I give them very high marks over the past two years.

Financial markets continue on the road to deregulation. So far, a big part of the benefits have gone to savers. Rural areas have benefitted greatly in terms of options available for savers to obtain market rates of interest. Money market funds and CD's tied to market rates are now available in virtually every rural community. Just the first of this month, CD's have become more deregulated. Regulated rates now apply only if the amount is less than \$2,500 or the maturity is less than 31 days. Other than those two restrictions, banks may set rates of interest on their CD's. Also, the penalty for early withdrawal has been reduced. Surprisingly, however, many people continue to hold savings in passbook or savings accounts at below market rates of interest.

With deregulation and the increasing part of rural bank funds tied to money market rates, banks are having to give much more emphasis to managing assets and liabilities. Increasingly, they tie loan maturities to maturities of funding sources and/or make loans with floating interest rates. Melichar and Balides indicate, for example, that among agricultural banks, large banks went from 71% of current operating loans on floating rates in the second quarter of 1979 to 94% of current operating loans on floating rates in the second quarter of 1983. During that same period, other agricultural banks went from only 4% floating rates to 45% floating rates. These figures suggest that well over half the farm loans made today for short-term or operating purposes are on a floating rate basis to protect banks from volatile costs of funds.

Yet, interest rates to borrowers still apparently fluctuate less at smaller rural banks than at larger market-oriented banks. Melichar and Balides show that, in the second quarter of 1981 when rates were high,

average interest rates on farm operating loans at large banks averaged 18.7% while at other banks, the average was 17.6%. By the second quarter of 1983, when rates were much lower, large bank average interest rates on farm operating loans had dropped to 12.2% while interest rates averaged 13.8% on those same loans at other banks.

The interest rate differential between the Farm Credit System and commercial banks which favored the Farm Credit System lenders two years ago has now disappeared. The Farm Credit System sets interest rates based on average costs of funds while banks base their loan rates on marginal costs of funds. Hence, when rates go up, the Farm Credit System has an advantage for borrowers. When rates fall, that advantage switches to banks. After a period of stability, there is typically little difference. It is true, however, that interest rates within the Farm Credit System differ from one area to another because each region, and within each region each association, has its own cost of funds depending upon when it borrowed the money, how fast it has grown, and how many dollars were obtained from which issues of bonds.

With the agricultural recession of 1981-83, some farm lenders have had serious difficulties. The Louisville Farm Credit District had severe problems in 1982 when grain prices dropped out the bottom. Several associations lost sufficient reserves to go into loss sharing with other associations in the district. A substantial proportion of local association presidents left their positions or were fired. To the best of my knowledge, loss sharing among districts has not been implemented and is unlikely to be required. Problems within the Farm Credit System have been less severe to date in the Springfield and Baltimore districts, though the Northeast is likely to see increased problems in 1983 and 1984. In Springfield, at least, they have seen the problem developing and appear in good condition to withstand a couple of poor farm profit years.

To summarize the perspective, credit terms and costs to agriculture are tied closely to the credit situation in the nation, which in turn is dictated by national economic and monetary policy. As an industry, however, agriculture can be seen in two parts. The grains, feed, and cropping industry fell on hard times suddenly in 1982. It is now facing better prices for those farmers having crops, but those farmers decimated by drouth will need help in recovery. The livestock sector is in a period of adjustment. Meat animal producers will carry out some liquidations in '83 and '84 and will recover, from a price standpoint, in late '84 and '85. Dairymen face poor income prospects from tax assessments on milk production and high feed costs. They simply must reduce aggregate milk production, but so far they have not done so.

THE FARM CREDIT SITUATION

With the poor income prospects and high interest rates of the past two years, trends in farm asset values and farm debt came undone. Farm asset values in January 1983 were less than in January 1981 largely because of substantial reductions in farm land values. Farm real estate debt which had increased at a 13.6% compound rate from 1977-82, increased only 3.7% from January 1982 to January 1983. Outstanding farm nonreal estate debt which had increased at a compound annual rate of 13.1% from January 1977 to January 1982 also dropped to an annual rate of increase of 3.7% from January 1982 to January 1983. (Tables 1 and 2)

In short, as farmers came eyeball to eyeball with the reality of a major farm recession, they began to worry about liquidity and solvency rather than expansion and new machinery. Purchases of land and durables dropped with the change in emphasis toward short-term cash flow and survival.

The change in outstanding farm debt again demonstrates a myth many people hold relative to farm credit use. Credit in the farm sector is related to income prospects rather than to distress; i.e., farmers tend to borrow more when prices and prospects are good, they cut back on borrowing when prices and prospects turn sour.

Some other trends undoubtedly contributed to the slowing of credit use by farmers. The debt service burden and cost of credit have increased dramatically. Consider debt outstanding as a percentage of net farm income. In 1950, debt was 91% of net farm income. By 1960, debt was 215% of net farm income. By 1970, it had reached 375%, and by 1980, 825%. In 1982, outstanding debt was 965% of net farm income. Similarly, interest expense has become a major item of production expense. In 1950, interest amounted to only 3.1% of total farm expenses. By 1960, it had grown to 4.9% of expenses. In 1970, it was 7.6%. In 1980, interest reached 12.1% of farm expenses. And, by 1982, interest expense was 15.9% of farm expenses. Debt service is now a major expense of most farms.

GENERAL ECONOMIC SITUATION

Before turning to the outlook, let's consider some additional aspects of the general economic situation. We are now in the third quarter of the economic recovery. The two previous quarters were strongly upward, and we are now seeing a slight decrease in the rate of growth consistent with the Federal Reserve Board's attempt to keep a strong, but not too strong, recovery going.

It seems likely, judging by interest rate movements of the past 10 months, that the Fed is now watching interest rate levels as well as money supply figures in setting monetary policy. For example, they have been

outside their money supply growth targets for weeks on end while bringing about definite but not volatile or drastic changes in interest rates. Again, I applaud them for watching both rather than just one criterion.

Incidentally, the focus on money supply targets has led to some odd responses and interpretation. Theory suggests that increase in the money supply leads to decrease in interest rates and vice versa. During the past two to three years, however, the popular press and financial markets talk in terms of an increase in the money supply leading to higher interest rates and a decrease in supply leading to lower rates, i.e., opposite of the theory. The reason for this is an overconcern for short-term rate movements, the public release of money supply growth targets, and an expectation of future movements toward the target. A higher growth in money supply than expected on a week-to-week basis is interpreted to mean that future growth will be restricted to meet the target. Interest rates, then, tend to rise in expectation of the future tightening of the money supply to move toward the target level. Financial markets have put way too much emphasis on short-term money supply growth.

Two major and related issues are currently being debated. One is the conflict between fiscal and monetary policy. The other is a concern about the personal savings rate. Both affect future availability of credit funds, future interest rates, and future inflation rates. Table 3 shows funds raised in credit markets from 1977-83 by type of funds. Note the decrease over the last three years in funds going to mortgages, consumer credit, and some other categories while funds going to the Federal Governments and state governments are strongly higher. The 1984 fiscal year budget is projected to contain a deficit of \$170-200 billion. Subsequent years look similar. The question is whether there will be sufficient funds available

to meet all the credit needs or whether interest rates will rise strongly to ration excessive demand for those funds. If so, the argument goes, the government will get their required funds and others will be forced out of the market. Somewhat surprisingly given recent interest rates, the most recent data suggest that the savings rate as a percentage of disposable personal income dropped from 6.6% in 1981 to 3.9% in the second quarter of 1983. This drop was a major disappointment to the President and his advisors who had expected the tax cuts of 1981-83 to result in increased savings.

Why aren't people saving more? And will there be enough funds to satisfy all the credit needs? My guess is, and it's only a guess, that when people realized in early 1983 that the recession was ending and that they weren't going to lose their jobs, large numbers began purchasing major capital items that they had been afraid to purchase 6-18 months earlier. With a return to relative stability and a sound, but not heated, economic growth rate, the savings rate will return to more normal levels within a couple of quarters.

Next, how about the large credit needs of the economy? In 1977, funds raised in credit markets were 20% of GNP. In 1980, the figure had dropped to 16.8%, and in 1982, to 16.1%. It seems to me there is potential for a larger credit market relative to GNP without drastically higher interest rates.

Perhaps one problem is that our system of taxation coupled with inflation does give some odd results in terms of incentives. Consider a taxpayer in the 35% marginal income tax bracket facing a borrowing cost of 13%, a return on savings of 9%, and a 5% inflation rate. Since interest expense

is deductible, the cost for borrowing is \$8.45 per \$100 or 3.45% above the inflation rate. Savings interest which is taxable returns 5.85%--or less than 1% above the inflation rate.

But look at the change in incentives with changes in tax brackets. The 20% tax bracket individual pays a 5.4% real rate of interest to borrow and earns a 2.2% real rate on savings. The 45% tax bracket individual pays only 2.15% real interest rate to borrow and earns nothing on savings. With a substantial rate of inflation, say over 5% or more, it pays the low bracket individual (presumably one with little extra money) to save. It costs the high tax bracket individual (presumably the one with funds to invest) very little to borrow, but that individual has no incentive to save. In short, the tax system, coupled with high inflation rates, rewards low income earners for saving and penalizes high income earners for saving. In order for the latter to benefit from saving, they must invest in capital gains items or tax shelters. Until we see this problem and correct it, we will not likely have a high savings rate in this country.

1984 is now shaping up as another test of basic philosophical differences concerning the role of government and the extent of income transfer programs. The present administration attempted to cut government spending and to cut taxes believing those changes would spur economic recovery and generate sufficient increased tax revenues to hold down the budget deficits. Spending, however, still grew faster than revenues and a \$200 billion budget deficit is now expected. The basic philosophical issue is how the deficit is to be reduced--whether through further cuts in spending, removal of spending indexing, increased income taxes, postponement of tax bracket indexation, or a series of miscellaneous nuisance taxes. The outcome of the 1984 general elections, if decisive, will strongly influence how this issue gets resolved.

OUTLOOK

With GNP growth running 5-6% currently compared to the 9+% level last spring and 7% last summer, my guess is the Fed will hold fairly close to the present course. Since the 5-6% growth rate is a move down from spring and summer, interest rates should ease modestly in order to hold growth near present rates. In other words, I think the Fed considers a 5-6% rate of growth as a sustainable rate. If so, interest rates may drop $\frac{1}{2}$ to $1\frac{1}{2}$ % sometime during the next six to eight months; then, as the economy perks up again and the growth rate increases above 5-6%, the Fed will likely tighten up somewhat. Interest rates by year-end 1984 are likely to be at present levels to perhaps 1 to $1\frac{1}{2}$ % higher than present levels.

As stated earlier, the Fed appears to be watching both interest rates and the money supply. Therefore, don't expect the extreme volatility in interest rates over the next 18 months that we witnessed in the 1979-82 period.

The farm sector will increase its outstanding debt in 1983 and 1984 at rates somewhat more than the 3.7% of 1982-83 but not as much as the 13+% rate of the 1977-82 period. Farmers will be more conservative than in late '70s because of the recent recession scare. The increase in outstanding debt will come from the strength of improved price and income prospects for the crop sector. Dairy and livestock operators, on the other hand, will search for ways of maintaining liquidity and cash flow. They will not choose to add much additional debt load to their present situation.

During the next 15 months, credit will continue to be available to qualified farm borrowers though lending criteria are tighter than in the early 1980s.

For longer run projections of interest rates beyond 1984, the key determinants are the inflation rate and the federal budget deficit. If inflation stays below 5% and the budget deficit is reduced substantially, interest rates could fall several points. Conversely, return to 7+% inflation and/or substantially larger budget deficits will surely mean sharply higher interest rates.

Finally, I leave you with one caveat. If inflation rates return to double digit levels, be careful of making statements to the effect that inflation benefits borrowers at the expense of lenders. Only the tax structure works in that direction. With deregulation of interest rates, the disparity in favor of borrowers caused by past regulation of interest rates will likely not exist next time, or at least the magnitude will be greatly diminished.

Table 1: Outstanding Farm Real Estate Debt, January 1.

YEAR	TOTAL	BANKS	FEDERAL	LIFE	FARMERS	INDIVIDUALS
			LAND	INSURANCE	HOME	AND
			BANKS	COMPANIES	ADMINIS-	OTHERS
--AMOUNTS IN MILLIONS OF DOLLARS--						
1965	18894	2417	3687	4288	1285	7218
1970	29183	3545	6671	5734	2280	10953
1975	46288	5966	13402	6297	3215	17408
1976	51034	6224	16014	6726	3342	18728
1977	55858	6781	18455	7400	3657	18864
1978	63307	7780	21391	8819	3982	21335
1979	71413	8557	24619	10478	4121	23638
1980	85421	8623	29642	12165	7111	27880
1981	95513	8745	35945	12928	7715	30180
1982	105565	8387	43564	13100	8744	31770
1983	109507	8441	47180	12801	9085	32000

Source: Division of Research and Statistics, Board of Governors of the Federal Reserve System, Agricultural Finance Databook, June 1981 and June 1983

Table 2: Outstanding Farm Non-Real Estate Debt, January 1.

YEAR	TOTAL	BANKS	DEBT EXCLUDING CCC LOANS				INDIVDLS & OTHERS
			COOPERATIVE FARM CREDIT SYSTEM		FmHA		
			TOTAL	PCAs			
--AMOUNTS IN MILLIONS OF DOLLARS--							
1965	16366	6990	2402	2278	125	644	6330
1970	21168	10330	4713	4495	218	785	5340
1975	35226	18238	9893	9519	374	1044	6050
1976	39480	20129	11094	10742	352	1907	6350
1977	47687	23283	12538	12170	368	1877	9989
1978	54896	25709	13802	13428	374	3141	12244
1979	63735	28273	15385	14876	509	5780	14297
1980	75314	31034	18687	18021	666	8983	16610
1981	81465	31567	20421	19611	810	11756	17721
1982	88107	32948	21927	21014	913	14452	18780
1983	91379	36149	20941	20070	871	14759	19530

Source: Division of Research and Statistics, Board of Governors of the Federal Reserve System, Agricultural Finance Databook, June 1981 and June 1983.

Table 3: Funds Raised in U.S. Credit Markets, All Sectors (Billions of Dollars).

	1977	1978	1979	1980	1981	1982
U.S. Govt. Securities ^{a/}	79.9	90.5	84.8	122.9	132.6	224.0
State and Local Obligations	21.9	28.4	29.8	35.9	32.9	59.5
Corporate and Foreign Bonds	36.1	31.8	34.2	41.1	28.5	34.2
Mortgages	129.9	151.0	162.4	134.0	115.2	85.0
Consumer Credit	40.2	48.8	45.4	4.9	25.3	14.4
Bank Loans, n.e.c.	29.5	59.0	51.0	46.5	57.0	54.4
Open Market Paper	15.0	26.4	40.3	21.6	54.0	6.1
Other Loans	27.4	41.5	41.8	36.6	53.7	19.2
Total	379.9	477.4	489.7	443.5	499.1	496.9

Source: August, 1983, Federal Reserve Bulletin, page A44.

^{a/} Includes sponsored credit agency securities.

Table 4: Selected Financial Data, U.S., 1970 - 1981.

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
6-month Prime Commercial Paper Rate	7.72	5.11	4.69	8.15	9.87	6.33	5.35	5.60	7.99	10.91	12.29	14.76	11.89	9.46 ^{a/}
6-month T Bills New Issue Rate	6.56	4.51	4.47	7.18	7.93	6.12	5.26	5.53	7.58	10.06	11.37	13.80	11.07	9.06 ^{b/}
Consumer Prices All Items (67 = 100)	116.3	121.3	125.3	133.1	147.7	161.2	170.5	181.6	195.4	217.4	246.8	272.4	289.1	300.3 ^{c/}
Interest Rate Minus Inflation Rate ^{d/}	.81	1.39	1.95	1.95	-1.13	-2.77	-.45	-.9	.39	-.39	-1.21	4.39	5.76	6.0 ^{d/}
GNP	982.4	1055.5	1171.1	1306.6	1413.2	1528.8	1706.5	1889.6	2156.1	2413.9	2631.7	2954.1	3073.0	3274.0 ^{e/}
Personal Income	801.3	863.5	942.5	1052.4	1153.3	1253.4	1382.7	1531.6	1721.8	1943.8	2165.3	2435.0	2578.6	2715.0 ^{e/}
Disposable Personal Income	685.9	746.0	801.3	901.7	982.9	1084.4	1185.8	1305.1	1462.9	1641.7	1828.9	2047.6	2176.5	2302.8 ^{e/}
Money Supply-- MIB Dec. 31	-	-	-	-	-	-	316.1	345.1	373.6	389.0	414.1	440.6	478.2	511.7 ^{f/}
Fiscal Year Budget Deficit	2.8	23.2	23.2	14.3	3.4	43.6	65.6	45.0	48.8	27.7	59.6	57.9	110.6	

Source: Various issues of Federal Reserve Bulletin. (Figures are subject to revision and some of figures above may have been revised. Last three years of data from August 1983 issue.)

a/ July 29, 1983.

b/ Sept. 23, 1983.

c/ August 1983.

d/ 6-month Prime Commercial Paper Rate less Inflation Rate (CPI) at midyear.

e/ Second quarter rate.

f/ June 1983.

Table 5: Personal Savings, U.S., 1970 - 1981 (Billions of Dollars).

<u>Year</u>	<u>Personal Income</u>	<u>Disposable</u>		<u>Saving Rate % of P.I.</u>	<u>Saving Rate % of D.P.I.</u>
		<u>Personal Income</u>	<u>Personal Saving</u>		
1970	801.3	685.9	50.6	6.3	7.4
1971	864.0	746.4	60.5	7.0	8.1
1972	942.5	801.3	49.4	5.2	6.2
1973	1052.4	901.7	70.3	6.7	7.8
1974	1154.9	984.6	71.7	6.2	7.3
1975	1255.5	1086.7	83.6	6.7	7.7
1976	1381.6	1184.5	68.6	5.0	5.8
1977	1531.6	1305.1	65.0	4.2	5.0
1978	1721.8	1462.9	76.3	4.4	5.2
1979	1943.8	1641.7	86.2	4.4	5.2
1980	2165.3	1828.9	110.2	5.1	6.0
1981	2435.0	2047.6	135.3	5.6	6.6
1982	2578.6	2176.5	125.4	4.9	5.8
1983.1	2657.7	2255.9	121.7	4.6	5.4
1983.2	2715.0	2302.8	89.4	3.3	3.9

Source: Various issues of Federal Reserve Bulletin. (Figures are subject to revision, and some of figures above may have been revised. Last three years of data from August 1983 issue.)

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