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FARM CREDIT AND INTEREST RATE SITUATION
AND OUTLOOK

by

John R. Brake

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Current Perspective

The farm credit and interest rate situation is becoming more and more tied to the national economic situation with respect to both credit and interest rates. A number of interest rates are near all-time high levels; and some rates have reached new all-time high levels during the past three weeks. Home mortgage interest rates nationwide, for example, topped 17 percent, and corporate AAA bonds passed the 15 percent level. Ninety-day CD's and commercial paper are not quite as high as they were in December 1980 or May 1981, but they are very close to those levels.

While interest rates are near all-time highs, credit is available if borrowers are willing and able to pay the price. That is simply to recognize that credit rationing is taking place through the price mechanism and not through some other rationing mechanism.

Another feature of the present situation is the change toward less government subsidies and less government involvement in the agricultural sector. More about that in a moment.

For several years now money markets have been in the process of deregulation. Many interest rate restrictions have been removed, and those remaining are scheduled to be removed in the future. This freer

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financial market means that agricultural money and capital needs compete directly with all others. An increasing part of rural bank funds is tied to money sensitive sources. Money market certificates, for example, now constitute about 34 percent of rural bank resources. Costs of these vary directly with money market rates. This new volatility in costs of funds has important implications for rural bank management.

Interest rates in years past tended to be more stable for agriculture than for the general economy, but this relationship is disappearing. Recent data indicate that, at small agricultural banks, interest rates on farm loans still lag one to two percentage points below prime when prime rises to a high level. However, when prime drops, as it did last summer, interest rates at these banks remain one to two percentage points above prime. This is somewhat more fluctuation than would have been true, say, five years ago. However, at large commercial banks, agricultural loans average about the same as the prime rate. There is, of course, a substantial range in rates charged to different agricultural borrowers.

There are substantial rate differences among agricultural lending institutions. However, because the Farm Credit System agencies base their rates on average cost of outstanding securities rather than on new sales of bonds, their rates are still several points below rates at commercial banks where current costs of funds set interest rate levels. For the past several years of rising interest rates, the Cooperative Farm Credit System has had an interest rate advantage over rural banks. However, that advantage could well disappear if, and when, interest rates trend downward.

There is, at the same time, much variation among rates charged in the various farm credit districts, and in many cases, among individual associations

within districts. In general, each district establishes an interest rate based on its share of each bond issue, i.e. each district has its own cost of money. This means that the faster growing areas of the country have a higher weighting of recent bond sales, and therefore, have a higher interest rate because of their cost of funds.

Farmers Home Administration has also joined the high interest rate rush since their rates are, in general, now tied to the government's cost of money. The interest rate subsidies incorporated in FmHA programs of, say, 10 years ago are gone for the most part. There are still a few programs with low rates, but in general, Farmers Home Administration rates have increased substantially and in many cases exceed Farm Credit System rates. This means FmHA is no longer the help it once was in refinancing financially-troubled farm situations or in helping beginning farmers.

Life insurance companies, while not an important source of farm credit in the Northeast, are reducing their farm loan commitments nationwide. Because of contract commitments to provide policy loans to their customers at five and six percent interest--that is, rates well below market--their cash flow for such loans materially reduces funds available for their more typical investments in real estate, farms, housing, etc.

Farm Credit Situation

Let's focus a little more specifically on some aspects of the farm credit situation before we return to the bigger picture. Agriculture has continued to increase its use of credit, as can be seen in Table 1.

From 1970 to 1981, outstanding real estate debt increased about 11 percent per year compounded. Over the last five years, from 1976 to 1981, the compound rate of increase has been about 12 1/2 percent. In the last year, from 1980 to 1981, the rate of increase dropped to about 11.3 percent. Outstanding real estate debt stood at about \$92 billion, as of January 1, 1981.

Nonreal estate farm debt has increased at comparable rates. From 1970 to 1981, the compound rate of increase was 12.6 percent per year. However, for the last five years, from 1976 to 1981, outstanding nonreal estate debt increased 14.7 percent per year. Last year, 1980 to 1981, the rate of increase dropped to 10.5 percent. Outstanding nonreal estate debt was \$78.2 billion as of January 1, 1981. Total debt for the agricultural sector, not counting CCC loans, was about \$170 billion as of January 1, 1981.

In the last several years, interest charges probably have been the fastest-rising expense item for American farmers with the possible exception of fuel costs. The Cooperative Farm Credit System adopted variable interest loans back in the late 1960's. Then, with the rapidly-increasing and volatile rates of the 1970's, and especially 1978-1980, many commercial banks changed to variable rates as well.

As a result, interest charges paid by farmers doubled from 1977 to 1980 on a 50 percent increase in debt; and interest expenses are likely to increase another 20 to 30 percent in 1981 over 1980. There are now substantially fewer fixed-rate loans available to farmers. The point is that the risk of interest rate changes on past financial commitments is now borne by farmers rather than their lenders. Variable rates will likely reduce credit use by risk averse farmers.

The combination of high interest rates and reduced net farm income (1981 net farm income purchasing power is expected to be about 2/3 of 1976) has reduced real estate transfers and machinery purchases. As a result, real estate prices are likely to increase less this year than the inflation rate for only the second time in the past ten years. It seems likely to this analyst that the increase in farm credit during the next year will be less rapid than it averaged the last five years. While many of us tend to think of credit use increasing in tough times, the reality of the 1970's was that farm credit grew fastest when income prospects looked good for farmers. That was when they bought the neighboring farm and a shed full of new machinery. The depressed net farm income prospects of 1981 will keep many farmers from buying extra land or new machinery. And, of course, high interest rates dampen credit use because debt-carrying capacity is greatly reduced by high interest rates.

General Economic Framework

Let's return now to the bigger picture, that is, the general economic situation. The current economic situation is focussed on the fight against inflation. Monetary authorities have implemented tight money and high interest rate credit policies to dampen demand. The Reagan administration has succeeded in cutting some of the anticipated expenditures from the upcoming budget. But, it now looks as though deficits will still be larger than earlier expected, in large part because of the higher interest rates on public debt as well as underanticipated

growth in expenditures. And, in this respect, don't forget that the Federal government is one of the major borrowers in the money and debt markets.

The economic growth of the economy continues at a very slow pace. For over a year now we have heard predictions of recession, but the economy continues to be more resilient than expected and most economists continue to underestimate economic activity. Interest rates, the price of money, reflect joint supply and demand conditions, and financial markets are signaling that borrowing demands are heavy relative to the supply of money available.

A number of factors have been responsible for bringing us to the current situation. Table 3 shows funds raised in the credit markets from 1970 to 1980. Notice the quadrupling of total funds raised in the credit markets from 1970 to 1980 while GNP, personal income, and disposable personal income all increased less than three times. Also, note the big increases in the amounts raised in credit markets by the Federal government starting in 1975, and culminating with the highest figure ever in 1980. Note, too, the reduction in mortgages and in consumer credit in 1980 as a result of the high interest rates. In short, it appears that there was some crowding out in the financial markets in 1980.

Table 4 shows additional financial data for 1970 to 1981. The volatility of interest rates is evident. Consider the rate on 6-month commercial paper as one indicator of interest rates. That rate averaged as low as 4.69 percent and as high as 9.87 percent from 1970 to 1978. But, by July 1981, the rate was 15.46. With minor variations, other interest rates would show a roughly similar pattern.^{1/}

^{1/} While talking about interest rates, let me insert an aside here. I have tried to avoid using the term prime rate. That rate is often an exception to other rates because it is not well defined. Some people

One definition of the money stock, M1B, which is currency, coin, and demand deposits at depository institutions, has decreased slightly since April 1981 though it is 6.7 percent higher than one year earlier. This is simply an indication of the Federal Reserve Board's serious attempt to fight inflation using monetary policy. Since the Federal Reserve Board has not increased the money supply in a major way to finance the large credit demands of the Federal government, the money markets have generated the highest interest rates ever, and, as indicated earlier, there has been some crowding out of mortgage loans, consumer credit and probably, business borrowing.

In the context of the current situation, one hears a great deal about demands for credit by government, by businesses, by home buyers, and by consumers wanting to buy durables. The implication seems to be that some demands must go unmet. This is not surprising. For some years we have been demand oriented, and as is noted in the table, for six of the past seven years, lenders paid borrowers to use their loan funds since the interest rate was less than the inflation rate.

The effect of low real interest rates and inflationary expectations can be seen in Table 5. The personal saving rate in the U.S. dropped markedly in 1976 and has continued since at about two percentage points less than the level of the early 1970's. For perspective, the

1/ believe that the prime rate is the rate charged to prime commercial customers. However, prime customers usually pay less than prime. When asked to define prime rate by a congressional committee, Morgan Guarantee Trust Company said, and I quote, "The bank's prime rate shall mean the rate of interest publically announced by the bank in New York from time to time as its prime rate." In short, the prime rate really doesn't mean very much.

differences between the 1975 personal saving rate and the rate in the first quarter of 1981 would approximately eliminate the anticipated 1982 fiscal year federal budget deficit. During the last several months, real interest rates have increased substantially compared to the late 70's. As savers come to recognize the real rate of interest that can now be obtained, and as borrowers begin to recognize the real cost to borrow money, the quantity of funds supplied will increase and the quantity demanded will decrease.^{2/}

Outlook

Let's turn, then, to the outlook for the next year or so. To help my outlook be somewhat more accurate, I would really like answers to the following questions:

1. Will the Federal Reserve Board continue its recent stance on tight money?
2. Will the economy continue to resist a nose dive?
3. Will inflation stay below 10 percent?
4. Will the Federal government further shave scheduled Federal spending increases?
5. Will scheduled tax rate cuts to individuals and businesses affect the demand for, or supply of, funds in credit markets?
6. Will Congress or the President impose a form of non-price credit rationing?

^{2/} However, let us still note the effect on returns of savings, versus cost of borrowing due to taxes. Assume savers obtain 15 percent, and borrowers pay 18 percent interest with 8 percent inflation, and each is in the 32 percent tax bracket. The after-tax return to savers is 10.2 percent or 2.2 percentage points more than the inflation rate. The cost of borrowing is 12.24 percent or 4.24 percentage points more than the rate of inflation.

We don't know the answers to those questions. But, the questions themselves help us recognize factors that would have significant impact on the outlook for credit and interest rates.

Here are my guesses for the credit and interest rate outlook for the next year or so. First, credit will continue to be available. Second, interest rates will stay high for six months to a year-- perhaps longer. By staying high I mean that rates will likely stay within two or three percentage points of present levels. I hold to this view because I think it takes time for people to recognize real interest rates and act accordingly. Also, there is a substantial pent-up demand for business loans, housing loans, and the like which will require funding if, and when, interest rates start to fall.

Over the longer term, and given some time for adjustment, say six months to two years, interest rates should return to more normal levels. A normal level is probably two to four percentage points higher than the inflation rate. So, if the inflation rate were to stabilize at eight percent, we might well look for interest rates of 10 to 12 percent. However, to talk of anything being stable in the 1980's may be a contradiction of terms.

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

YEAR	TOTAL	BANKS	FEDERAL	LIFE	FARMERS	INDIVIDUALS AND OTHERS
			LAND BANKS	INSURANCE COMPANIES	HOME ADMINIS- TRATION	
- - - - - 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	51069	6296	15950	6726	3369	18728
1977	56559	6781	18455	7400	3657	20266
1978	63641	7780	21391	8819	3982	21669
1979	70833	8557	24619	10478	4121	23058
1980	82678	8623	29642	12165	7111	25137
1981	92018	8745	35944	12928	7715	26685

Source: Division of Research and Statistics, Board of Governors of the Federal Reserve System, Agricultural Finance Databook, Table 121A, June 1981.

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

YEAR	TOTAL	BANKS	DEBT EXCLUDING CCC LOANS				INDIVIDLS & OTHERS
			COOPERATIVE FARM CREDIT SYSTEM				
			TOTAL	PCAs	FICBs	FmHA	
- - - - - 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	39406	20160	11124	10773	350	1772	6350
1977	45061	23283	12601	12233	368	1877	7300
1978	51142	25709	13882	13508	374	3141	8410
1979	59998	28273	15525	15016	509	5780	10420
1980	70702	31034	18965	18299	666	8983	11720
1981	78160	31567	20837	20027	810	11756	14000

Source: Division of Research and Statistics, Board of Governors of the Federal Reserve System, Agricultural Finance Databook, Table 131A, June 1981.

Table 3: Credit Market Funds Raised, Total All Sectors (Billions of Dollars).

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Investment Co. Shares	2.6	1.1	-7	-1.6	1.0	1.6	-1.0	-.9	-1.0	-1.0	2.0
Corp. Equities	7.7	13.6	13.6	9.6	4.6	10.1	12.9	4.9	4.7	7.6	15.0
<u>Debt</u>											
U.S. Government	21.1	29.4	23.6	29.4	33.5	95.4	88.1	84.3	95.2	89.9	126.8
State & Local	11.2	17.6	14.4	13.7	17.4	15.4	15.7	23.7	28.3	18.9	22.2
Corporate & Foreign Bonds	23.8	24.8	20.2	12.5	23.3	36.7	37.2	36.1	31.6	32.9	35.6
Mortgages	26.4	48.9	68.8	71.9	54.5	57.3	87.1	134.0	149.1	158.6	124.8
Consumer Credit	6.0	11.2	19.2	22.9	9.6	5.3	25.6	40.6	50.6	44.2	3.1
Bank Loans n.e.c.	5.8	12.4	28.5	52.1	39.5	-12.6	7.0	29.8	58.4	52.5	50.7
Open Market Paper	-1.2	.9	3.3	11.6	13.6	.9	8.1	15.0	26.4	40.5	21.4
Other	7.3	4.0	7.4	17.2	21.1	6.4	15.3	25.2	38.6	39.5	32.6
Total	110.8	163.9	198.3	239.4	218.1	216.6	296.0	392.5	481.8	483.4	434.1

Source: Various issues of Federal Reserve Bulletin. (Figures are subject to revision and some of figures above may have been revised. Last two years of data from July 1981 issue.)

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

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
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	15.46 ^{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	14.04 ^{a/}
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	269.0 ^{b/}
Interest Rate Minus Inflation Rate ^{d/}	.81	1.39	1.39	1.95	-1.13	-2.77	-.45	-.9	.39	-.39	-1.21	6.46
GNP	982.4	1055.5	1171.1	1306.6	1413.2	1528.8	1706.5	1889.6	2156.1	2413.9	2626.1	2853.0 ^{c/}
Personal Income Disposable	801.3	863.5	942.5	1052.4	1153.3	1253.4	1382.7	1531.6	1721.8	1943.8	2160.2	2319.8 ^{c/}
Personal Income	685.9	746.0	801.3	901.7	982.9	1084.4	1185.8	1305.1	1462.9	1641.7	1821.7	1947.8 ^{c/}
Money Supply-- M1B Dec. 31	-	-	-	-	-	-	316.1	345.1	373.6	400.6	425.9	424.4 ^{b/}
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	

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 July 1981 issue.)

a/ July 3, 1981.

b/ May, 1981.

c/ First Quarter, 1981.

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

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

<u>Year</u>	<u>Personal Income</u>	<u>Disposable Personal Income</u>	<u>Personal Saving</u>	<u>Saving Rate % of P.I.</u>	<u>Saving Rate % of D.P.I.</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	2160.2	1821.7	101.3	4.7	5.6
1981.1 (rate)	2319.8	1947.8	88.9	3.8	4.6

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 July 1981 issue.)