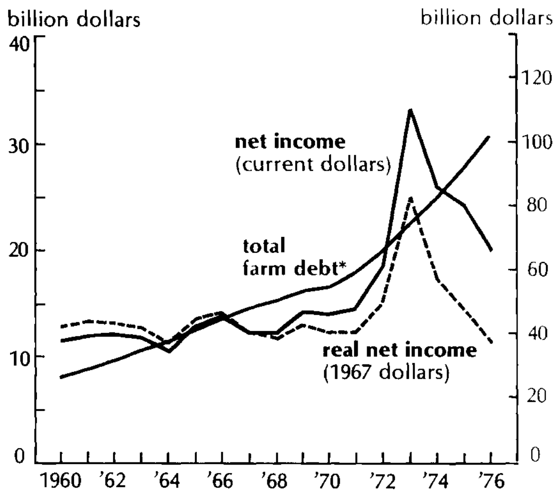
Farm credit concerns rise

The agricultural sector has experienced wide fluctuations in earnings during the past five years. Crop failures in major producing countries of the world led to an explosion in farm income during the 1972-73 period. By 1973 gross income had risen 65 percent above the 1970-71 average, while net income had more than doubled. Since 1973 gross earnings have edged slightly higher, but the trend in net farm income has been decidedly downward. Net income in 1976 was 18 percent less than in the preceding year and 40 percent below the 1973 record. Although high by most historical comparisons, last year's net farm earnings when adjusted for inflation were among the lowest since the Depression. And despite the long-term decline in farm numbers, real net income per farm was the lowest since the late sixties.

The financial position of farmers has changed markedly during the farm earnings cycle. Efforts to expand production resulted in larger purchases of higher-priced operating inputs. The high earnings also triggered a boom in capital expenditures by farmers, encompassing machinery and equipment purchases as well as real estate purchases and improvements. Despite record earnings, the surge in expenditures for capital and operating inputs resulted in record growth in farm debt, which reached $102 billion at the end of 1976, nearly double the beginning-1970 level.

The recent declines in farm earnings coupled with higher-priced inputs and record debt levels have rekindled concern about farmers' cash-flow problems. Cash-flow problems of farmers have potential impacts for a number of institutions, including agricultural lenders. Recent surveys conducted by the Federal Reserve Bank of Chicago provide some insight into the developments encountered through mid-1977 by Seventh District agricultural banks. In general, banks are experiencing exceptionally strong loan demand, slower rates of loan repayment, increased requests for renewals and extensions of existing loans, reduced liquidity, and deterioration in loan quality.

Net farm income drops as debt continues to grow



*Year ending December 31.

Survey findings

Nearly three-fourths of the approximately 600 agricultural bankers responding to the survey indicated that second-quarter farm loan demand exceeded the corresponding period in 1976. Since only 3 percent reported decreased demand, the results—on balance—showed the most solid evidence of widespread strength in farm loan demand in more than a decade of quarterly surveys. All District states—particularly Iowa, where 79 percent of the bankers reported year-to-year gains—experienced the exceptional strength in demand.

The increased farm loan demand reflects, in part, new borrowings to finance current operating expenses, which tend to be seasonally high during the spring planting season. Slower loan repayment rates and a simultaneous increase in loan renewals and

Index of District agricultural credit conditions*

	Loan demand	Fund availability	Loan repayment rates	Loan renewals and extensions	Loan/deposit ratios higher than desired
1975					
1st Quarter	134	108	65	145	94
2nd Quarter	142	120	80	122	83
3rd Quarter	133	131	105	100	80
4th Quarter	134	130	100	103	81
1976					
1st Quarter	142	130	101	109	76
2nd Quarter	147	134	102	102	81
3rd Quarter	140	124	93	109	85
4th Quarter	150	130	81	124	88
1977					
1st Quarter	161	115	79	125	94
2nd Quarter	169	103	66	140	106

*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.

extensions also have contributed to the strong demand. Forty percent of the reporting bankers indicated that the second-quarter farm loan repayment rate was lower than a year ago, while only 6 percent indicated the rate was higher. Similarly, 45 percent noted an increase in loan renewals and extensions, while only 4 percent noted a decline from the year-earlier level. The problems of slower loan repayment rates and increased renewals and extensions appear most widespread in Iowa and Illinois, where about one-half of the bankers reported such changes from the year-earlier period.

Slow repayments and increased renewals and extensions of existing loans have also contributed to a tightening in the availability of funds for lending at District agricultural banks. In essence, the slower loan portfolio turnover has placed more emphasis on deposit growth as a means of funding new loans. Although deposit growth has apparently continued fairly strong at rural banks, it has not paralleled the growth in loans. As of midyear, loan-to-deposit ratios at the surveyed banks averaged 61 percent, up from 57 percent a year earlier. In conjunction with the sharp rise in loan-to-deposit ratios, an unusually large proportion of the banks—nearly two-fifths—indicated their current ratios exceeded the levels they desired.

The tightening liquidity pressures are apparently causing rural banks to utilize correspondent bankers and other lenders more intensively. Nearly one-fifth reported greater-than-normal utilization of correspondent banks to help finance farm customers, while only 7 percent noted a decline. Roughly the same proportion reported making more referrals of farm loan requests to other lending institutions during the second quarter. Furthermore, more than one-fifth of the banks indicated they have become somewhat less aggressive in seeking new farm loan customers.

Credit requests of regular farm loan customers apparently have been fairly well accommodated during the first half of this year. The bankers reported that only a small proportion—typically less than one-tenth—of the farm loan requests were denied or scaled down this year. Nevertheless, the incidence of such actions was somewhat above normal, particularly for requests to finance land purchases. Numerous factors contributed to the increased denials and scaled-down loans, but those most frequently cited include the following: borrower already overextended, insufficient borrower equity,

Farm loan portfolios at District banks deteriorate

	Percent of portfolio value	
	Currently	Normally
No significant repayment problems	82.6	87.6
Minor repayment problems which have been, or can be, remedied rather easily with short-term solutions	11.4	8.9
Major repayment problems requiring additional collateral and/or long-term workouts	4.7	2.8
Severe repayment problems which will likely result in loan losses and/or require forced sales of borrower's real assets	1.3	0.6
	100%	100%

and the amount requested deemed unjustified based on income prospects.

The declines in farm earnings and commodity prices, as would be expected, have resulted in some deterioration in farm loan portfolios among District agricultural banks. However, the extent of the problem does not yet appear to be of major proportion. The respondents indicated that about 3.5 percent of the dollar value of their farm loan portfolios, on average, would normally have "major" or "severe" repayment problems. As of mid-1977, however, such problems were associated with about 6 percent of their farm loan portfolios. Although nearly doubled, the proportion of the portfolios so classified is still relatively small.

The implications

In several respects current conditions parallel rather closely those experienced during the first quarter of 1975—a period when farm income was also temporarily depressed. Then, as now, bankers were reporting slow repayment rates, increased renewals and extensions, and increasing pressures on the availability of funds. In probable contrast, however, the problems of two years ago were short-lived because of a commodity price boom largely triggered by the growing awareness that the USSR was experiencing disastrous crop conditions. In contrast, there appear to be no near-term prospects that would ameliorate the current situation.

Record crop harvests in the United States and large grain harvests in other areas of the world are forecast for this year. In general, the harvests are expected to exceed utilization and boost ending carryover stocks to record or near-record levels. As a result, farm earnings are likely to remain suppressed for some time.

Assuming farm earnings remain suppressed over an extended period, the current problems of farmers and their lenders could become more pronounced and far more widespread. Under such conditions bankers and other lenders will likely monitor farm lending activities more closely. In recent years lending activities have been influenced by high prices and rapidly escalating land values, while future lending activities will no doubt be geared more toward potential repayment capabilities based on depressed commodity prices. Thus, instances in which farmers are unable to obtain loans, or obtain the desired amount of borrowed funds, may rise significantly. Situations requiring farmers to sell assets—including inventories and/or real estate—to meet their fixed financial commitments will no doubt occur more often. Requests for additional governmental measures to temporarily alleviate the problems will likely be heard more frequently.

The above possibilities suggest the problems may become more widespread in the future. In some cases the impacts may be rather substantial, particularly for farmers who have accumulated large financial commitments—during the recent period of high earnings—that extend well into the future. Nevertheless, it would be premature to hypothesize a disaster for agriculture. The agricultural sector has experienced prolonged periods of tight cash-flows in the past. Concern about the "cost-price squeeze" during the late fifties and early sixties was loudly and frequently voiced, but the basic industry survived to enjoy the recent farm earnings boom. In many respects the recent boom will help alleviate the current problems. Many farmers apparently converted the recent high earnings into liquid assets, which could help alleviate the current stress. The sharply higher land values will also provide many farmers and their lenders with a buffer. Likewise, the enhanced off-farm earnings of farmers—which on a per farm basis are about 75 percent above the level of five years ago—will provide an important cushion against the tight cash-flow. Thus, without denying instances of rather severe ramifications, the current problems are not likely to undermine the basic structure of agriculture.

Don A. Langford