How Can Banks Meet the Future Credit Needs of Upper Midwest Agriculture?

Remarks by Chas. N. Shepardson, Member, Board of Governors, Federal Reserve System, at the Upper Midwest Agricultural Credit Council at Bismarck, North Dakota, on June 25, 1964.

Introductory remarks

Despite the increasing urbanization of our society, Agriculture remains the biggest, most important single industry in the United States and its problems deserve the concern of us all.

American farms provide three times as many jobs in our economy as any other industry, generate more investment in capital equipment than any other industry, and serve as a mainstay of our economy in general and of thousands of smaller communities across the country in particular.

As bankers, you have a big job to do in meeting the credit needs of so huge and important an industry, and that job is made even bigger and more complex because of the changes, so informatively portrayed by Dr. Wood, that have been taking place in the amount and kind of financing required by American agriculture.

Already, a large flow of credit to farmers has been prompted by the increased capital requirements of an increasingly mechanized farm industry. Outstanding farm credit has gone up by about 10 billion dollars or approximately 50 per cent during the last five years. Banks throughout the country have contributed a significant portion of this credit. They have maintained their competitive position with approximately 13 per cent of farm mortgage loans. On other loans, however, they have lagged somewhat dropping from about 67 per cent of such loans by financial institutions in 1960 to about 64 per cent as of December 20, 1963.

The problem of marshaling new funds to continue to meet the pressing needs of farm customers is a real one, especially for country banks--a matter on which I hope to offer some suggestions later. But you also have another vitally important problem that I should like to stress now, at the very outset.

That problem is to make sure that you are applying your necessarily limited loan resources to meet real, constructive credit needs and not dissipating what you have in meeting credit "demands" that benefit neither your customer nor you. In saying this, I have in mind the question, too, often overlooked, of whether the credit requested will increase earning potential enough to provide repayment of debt without liquidation of basic assets. Except for certain recognizable emergencies, extensions of credit to a borrower that will not provide income for repayment are not apt to be beneficial to the borrower nor, in the long run to the lender. So much for that though I shall come back to it from another angle later.

When an industry's need for credit increases so much in so short a time and gives every indication of continuing to do so for some time to come, it would be fine to be able to report that this use of credit is providing more jobs and income for the nation's expanding labor force, that the demand for its product is outrunning production and that credit financed expansion of productive facilities is therefore essential. Unfortunately, this is not the case in agriculture. In the Upper Midwest, for instance, farm gross receipts and net income, while fluctuating widely, show no upward trend in recent years, and the number of farm jobs keeps decreasing. Even in the nation as a whole, realized gross farm income has increased from about $37.5 billion in 1959 to slightly over $41 billion in 1963, a gain of only $3.5 billion or less than

10 per cent while realized net income, after dropping from a peak of over $17 billion in 1947, has varied between $11.5 and $12.5 billion for the past 10 years. At the same time farm employment decreased to an annual average of $6.5 million in 1963, a drop of 13 per cent from the 57-59 average.

Agriculture, therefore, appears to be an industry that in the aggregate is using credit for modernization rather than expansion. True, some farmers are using more credit to obtain control over a larger volume of productive resources, but even this move to larger enterprises results from consolidation of smaller and usually less efficient units and can be regarded as modernization of the structure of agriculture. Other farmers are using more credit to enable them to buy equipment or adopt production techniques that will lower their costs. This is clearly modernization of the productive process. Yet, while all of this has increased productivity and improved sales and income of individual farmers it has not led to any significant improvement in total agricultural income. Instead it has increased total output faster than the increase in effective demand with a corresponding depressive effect on farm commodity prices. From the standpoint of the economy as a whole, this has given us a lower food cost in terms of man hours of labor than ever before in our history. On the other hand, with the continuing growth in size and reduction in number of farms, many rural communities have ceased to grow or actually declined both in population and gross income--a development naturally adverse to growth of the banks in these communities, since the size and lending capacity of the typical rural bank is largely determined by the income of its community. In consequence, growth in the lending capacity of country banks has not kept pace with growth in the size of credit needs on individual farms, and bankers accordingly have experienced increasing difficulty in servicing those growing needs.

Off-farm changes in agriculture further aggravated the financial problems of rural communities. A tremendous increase in purchased in-puts has resulted from the substitution of tractors and motors for home-raised horsepower, of petroleum and electricity for home-raised feed and fuel, and of complicated machinery requiring skilled maintenance for the simple tools and equipment that in earlier days could be made and repaired in the farm blacksmith shop. Thus, a vast and complex supply and service industry has come into being to meet the needs which can no longer be met by the old time country store or village blacksmith. The same can be said of the equally vast and complex assembly, processing and merchandising industries which now do more efficiently the processing and distribution formerly done on the farm or by small local plants. Just as the supermarket has replaced the little corner grocery, so the modern supply and marketing services are replacing the outmoded suppliers and processors of horse-and-mule days.

Furthermore, modern transportation and communication are bringing about a transformation in which one trading center tends to replace several smaller business communities. This transformation is affecting banks as well as other businesses all across the country. In this process of consolidation, the communities and the business and financial enterprises that survive are those who gear their operations to provide the services needed, including the needs of larger farm enterprises.

The rural banker has a key role in the competition that is determining which communities survive. The effectiveness with which he meets the problem of obtaining needed loanable funds, and the skill and courage he displays in using those funds most productively will likely determine his fate and influence that of his community.

Opportunity will always be there Although farm population has fallen to a level of less than eight per cent of the total as against approximately twenty-five per cent only 30 years ago, agriculture is a $45 billion-a-year business. Moreover, when we consider the related supplier, processing, and distribution industries directly dependent on the farm sector, we find that the total agricultural industry engaged in the job of providing our food and clothing employs approximately forty per cent of our labor force, certainly a major factor in our total economy.

It should not be necessary to remind the banker in the rural community about his economic self-interest in helping to put and maintain the farming in his area on a profitable basis. As a matter of fact, banks in this area are meeting farm credit demands at a faster pace than their own deposits are increasing as evidenced by the recent upward shift in loan to deposit ratios. Unfortunately, however, there are indications that some bankers including large, medium-sized, and small bankers in large, medium-sized, or small trade centers, are shutting their eyes to the fact that the agriculture of their respective trade areas is providing the base for a significant portion of the economic activity on which their well-being depends. In fact some bankers have indicated that they have no farm loan business or that providing credit to today's agriculture enterprises is more complex and less profitable, in a direct way, than making consumer loans for example. If as a result the farmers in their area are not properly supplied with the essential production tool that credit has become, these same bankers may find that they are serving neither the long-range development of their total communities, nor are they serving the long-range growth of their own institutions.

In view of the obvious essentiality of providing for the real credit needs of agriculture, are there any limits to the amount of credit that should be supplied, considering both the national welfare and the well-being of farmers? This is a very hard question to answer but there are some practical considerations that provide a clue to what constitutes a desirable flow of credit into agriculture. On many, if not most farms, it is possible to find adjustments that would improve the operation but that would require capital outlay from some source. As is so often true in economics, however, what is true for the individual is not necessarily true for the aggregate. When we consider farming as a whole, we find that there are limits on the rate at which changes can take place without a backfire.

Let me illustrate what I mean by a couple of examples that are current and close to home. The review of Upper Midwest farming that was done as part of the excellent Upper Midwest Economic Study revealed that many farmers are underemployed on their present farms. It showed that farmers in southern Minnesota, for instance, could expect to improve their average income substantially by increasing the size of their hog enterprise or by making significant increases in their cattle-feeding operation. Making these moves would require fairly large amounts of capital per farm, but these could be obtained on the basis of equity in land and livestock.

But what would happen if everyone tried to go into cattle feeding or hogs on the scale shown to be the optimum adjustment in this study? I am afraid that another study would be deemed advisable very soon thereafter. Something like this, after all, has been happening in cattle feeding during the last few years. Our demand for beef has been increasing as a result of higher personal incomes and a greater population reaching maturity. But adjustments that were profitable for individual farmers at prevailing prices did not remain profitable when the rate of adjustment by all farmers taken together exceeded the rate of growth of the market. Let me add parenthetically, that this, not Australian beef imports, is the real root of the present beef cattle price problem.

Here we have a clue to the upper limit on the desirable aggregate flow of credit into a particular phase of agriculture. In the livestock states, outstandings of bank non-real-estate farm loans exhibit sizable cyclical movements closely allied with the cyclical changes in the number of livestock on farms. During the last two years we have been on the sharp upward phase of the cattle cycle, and bank loans in Iowa and Minnesota, for example, have risen substantially Between the years of sharp expansion, though, outstanding loans increased at a much slower rate, more in line with the gradual increase in capital equipment and in the use of purchased inputs. In the light of present developments in the cattle market, such a period may soon be experienced again, although the secular trend must continue upward to meet the growing demand of an expanding population.

The wheat area in which we are meeting presents a somewhat different problem in evaluating the desirability of credit flows. Here, enlargement of farm acreage is a bigger factor in the adjustment and modernization process. This is amply documented by Department of Agriculture survey data showing that about 75 per cent of the farm land transfers in the plains states are for farm enlargement, as compared to about 45 per cent in the rest of the country.

Here again, I believe that there is a limit on the rate at which the adjustment toward larger and more profitable operations can take place, and that the basis of this limit is the limited supply of farm land that comes on the market in the normal course of events. When the demand exceeds this supply, the price is going to be bid up. And the man who pays the inflated price, even though he can average it down against the lower cost of his earlier holdings, will find the increased carrying charge against capital investment biting into the additional income that he hoped to achieve by enlarging his farm. Although it may still be profitable to enlarge individual farms, the resulting land price inflation is creating a real problem for the new operator who has to buy his entire unit at the higher price. As with cattle, too rapid a rate of land acquisition by farmers as a group can be self-defeating.

During the five years ending in 1963, farm land prices in North Dakota rose by 24 per cent. Total farm mortgage debt just about doubled. Apparently you have had a rather busy time here.

In Montana and South Dakota, the rise in land prices was also in the range of 20 to 25 per cent. Again, buyers apparently used large amounts of credit to consummate the transactions. Outstanding farm mortgage debt in both states went up by about 60 per cent during the course of the five years.

We can contrast the figures for these states with those for states in which farm enlargement was less significant as a factor in the farm adjustment process. In Minnesota, land prices rose 12 per cent while mortgage debt went up about 40 per cent. In Wisconsin, price was up 9 per cent and debt about 30 per cent while in Iowa, price was up only 5 per cent and debt about 20 per cent.

It's clear that we have a situation here that is becoming increasingly troublesome to many farm mortgage lenders in all types of lending institutions--banks, insurance companies, and Federal land banks. While they realize that increases in land prices are outrunning those in productive value in many instances and that more conservative appraisals and loan to appraisal ratios would dampen some of the buying fever, they are faced with competitive pressures to place available mortgage funds that may at times outrun their better judgment. In this connection it is interesting to note the wide range of response by banks in the area to this demand for mortgage loans. For example, with a national ratio of bank farm mortgage loans to total farm mortgage loans of 14 per cent in December 1962 compared with 15 per cent ten years ago, the ratio in this area ranged from 3 per cent in Montana, up 1 per cent, and 4 per cent in South Dakota, no change, to 10 per cent in Minnesota, down 5 per cent, 12 per cent in North Dakota, up 7 per cent, and 21 per cent in Wisconsin, up 3 per cent.

At any rate, when we talk about the optimum flow of mortgage credit needed to carry out the desirable adjustment to larger acreages, we must be aware of the limited supply of land on the market and of the possible consequences on land prices. And when we talk about the optimum supply of credit to finance adjustments that will tend to increase output, we must keep in mind the limit on the ability of the market to absorb this increase without resulting in disastrous reductions in prices. In the light of what has been happening recently to land prices here and cattle prices in Iowa, perhaps it is a good thing that at least some of you have had difficulty in finding funds that might have gone into loans of this character.

Thus in discussing the question "How can banks meet the future credit needs of Upper Midwest agriculture?" my first suggestion would be to conserve your funds for purposes more constructive than loans to support overexpansion in cattle production or inflation in land prices. There still remains a large and legitimate need for credit to provide desirable farm adjustment even in the areas just discussed but at rates that minimize if they do not completely avoid these difficulties.

Now, as to sources of additional funds to keep up with these growing credit needs, let us start with the outlook for demand deposits. In the aggregate, these deposits derive primarily from the gross income of the area. Since as I have already noted, the volume of gross sales is not increasing very much in farming areas of the Upper Midwest, it is not surprising that demand deposits have risen less in this area than in the nation as a whole. Furthermore, general increases in rates of interest in recent years have given people added incentive to place their savings at interest more promptly, and to place temporarily inactive funds at interest rather than holding them as demand deposits. As people have thus cut down on the amount of demand deposits held for reasons other than for use in immediate transactions, the total national volume of demand deposits has been increasing only slowly.

By competing vigorously for the demand deposits of the trade area and also for correspondent balances, it is possible that a bank interested in making farm loans can increase its share of the demand balances of the community at the expense of banks not so interested in farm loans, and that the volume of bank farm credit available in that community might thereby be increased. But since competitive efforts along this line are an old story in most areas, we would not expect this to be a particularly fruitful source of additional credit dollars for agriculture.

Time deposits, however, are another matter. Banks do not have a monopoly over savings deposits as they do with demand deposits. The banking system competes with a host of other financial institutions for the savings dollar of the public. Over the years, this competition has become increasingly fierce as the public is more and more aware of the various alternatives in which it can place its savings, and of the rates of return that can be obtained in these alternatives. For quite a while, rural residents were at a disadvantage compared to city dwellers in this respect, in that nonbank savings institutions were not as numerous in country towns. This situation now is changed. Most farmers are quite mobile, and make frequent visits to the larger trading centers. They are also exposed to save-by-mail advertisements. So they, too, are looking at the alternatives and comparing rates of return.

Hence, I would ask the question: Are country banks doing all they can to marshal the savings of their community, so that these funds will be most readily available for investment in the economy of that community? From some of the evidence, the answer is "Yes". Time deposits in all insured commercial banks increased from about $41.7 billion in 1956 to $111.6 billion in 1963 a gain of 160 per cent compared with a demand deposit gain from approximately $108.7 billion to $121.1 billion, a gain of only 11.4 per cent. In the Upper Midwest States, time deposit gains ranged from 74 to 98 per cent in three States and from 146 to 197 in three others, quite a range and yet not conclusive since the figures do not reflect the level from which each started. Neither do they take account of the wide range between individual banks. Type of farming may also be a factor since time deposits in most Minnesota and Wisconsin banks exceed demand deposits and the totals are approximately one and one-third times the recent average total annual net farm operator income in those states. In the Dakotas and Montana, demand deposits still exceed time deposits and the total of the latter is slightly less than average annual net farm operator income in each of those states. It is apparent however that banks paying 3 per cent or less for savings of which there are many are not as aggressive as those paying 3-1/2 per cent or more.

So one suggestion to banks in search of additional funds is to take a look at the job they are doing at home to attract local funds, especially savings, into their banks, realizing though, that this cannot be the entire or even a major portion of the answer. As I have already stated, the task of modernizing its agricultural industry may be beyond the financial means of many rural communities. Through such institutions as life insurance companies, Federal land banks, and production credit associations, funds have increasingly been flowing from urban areas into agriculture. If commercial banks are to maintain their standing as the leading source of farm credit, they are going to have to move in a much bigger way into participation loans to achieve this same flow of funds via the banking system. The increased use of participation loans also bears directly on the problem of individual loan requests that exceed the present lending limits of many country banks.

Anyone familiar with the correspondent system must be aware that its potential for moving loan funds from city to country is far from being fully utilized. To realize that potential requires interest and action at both ends. The rural banker must be willing to go to the extra effort required to service the farm loan needs of his area in this fashion. He may find that he has to do more in the way of getting and analyzing information on the operations and progress of his farmer-borrowers. He may have to devote more time to long-range farm planning and budgeting, operating statements, net worth progress, and repayment plans so that he and the correspondent can more accurately appraise the quality of the loan. Of course he should be doing these things in any event--because they go hand-in-hand with the provision of adequate credit service to modern farming.

At the other end, the urban bank must have people who can properly evaluate these participation requests and provide prompt action on them. That would be the absolute minimum requirement for a workable correspondent relationship in participation loans--one in which the city bank takes an essentially passive role. But the city bank should go beyond this. It should advise its correspondents of its interest in farm loans and specify the information that it needs to accompany participation requests. It should be able to help rural banks with the farm and loan plans of their larger borrowers. In areas where the rural banks persist in letting the large farmers go by default to other lending institutions, it can take a still more active role in working directly with such customers. Many rural and city banks are and I believe more can benefit from employment of personnel that are knowledgeable in the area of farming and farm credits needs.

In acting along these lines the city bank should be prompted by concern for the economic progress of its trade area and for the position of the bank as a supplier of credit for that progress. And here again, let me remind the city banker that, though he may think he has no interest in farm loans as such, he does have a real interest in the city based supporting agricultural industries whose very existence is affected by and in many cases dependent on the ability of their country customers to maintain viable, prosperous farm operations. Hence he must take an interest in the one in order to protect his interest in the other. Furthermore, some city banks may find that some rural banks faced with increasing loan-deposit ratios will no longer consider theater and baseball tickets to be adequate correspondent service to compensate for maintenance of demand balances hitherto expected. Whatever the immediate stimulus may be, I believe that real action in this area is the main thing needed to enable the banking system to hold its place in meeting the credit needs of agriculture, and to do so profitably. Thus, I am greatly encouraged as I see a number of city banks taking steps to assume a more active role in farm loan participation.

In areas of heavy demand for farm mortgage loans, perhaps banks should be making increasing use of cooperation with insurance companies as a source of long-term loan funds. Arrangements with insurance companies for early take-outs of well based mortgages are valuable to banks in several ways. They permit banks to maintain a better balance in their investment portfolio while at the same time serving the needs of their farm customers. If the arrangement with the insurance company provides for the bank to service the loan, the bank earns the service fee and also gains an additional opportunity to maintain contact with the customer and hopefully to serve his other banking needs. Incidentally, bank-insurance company cooperation has produced several times as much additional credit for farmers as have correspondent bank relationships and, as of January 1, 1960, amounted to over $1 billion of outstanding farm credit.

Finally, I would like to call your attention to farm loan discount facilities provided by law for commercial banks at the Federal Intermediate

Credit Banks. I realize of course that even the name has been and still is anathema to many country bankers. Frankly I think this is a mistaken attitude. While these facilities have been in existence for many years, they have rarely been used by commercial banks. In fact, it does not seem to be generally known that banks can discount farm loans directly with the Federal Intermediate Credit Banks, as well as through affiliated agricultural credit agencies organized for that purpose. In either of these ways, banks have access to funds obtained in the national credit market at the same discount rate (presently 4-3/4 per cent) that the FICB's charge the production credit associations. On loans thus discounted, the originating bank can, under Farm Credit Administration regulations, charge interest up to 4 per cent over the discount rate, although I realize that competitive factors may dictate a narrower margin. I would like to think, however, that any bank unable to meet a good farm loan request from its own funds or through its correspondent would look to this source rather than lose the customer. Also, discounting of farm loans in this way would also seem to be a potential source of funds for city correspondents who may wish to provide a farm service but find themselves already fairly well loaned up.

You will note that I have said nothing about the Federal Reserve as a source of funds. This was not an oversight. As you know, the resources of the "Fed" are available to member banks to aid in adjusting portfolios to unexpected deposit withdrawals or other unusual needs. Since I am to participate in a panel on that subject this afternoon, I am deferring further comments on this source until that time.

In closing, I realize that I have offered nothing new or unusual in the way of suggestions as to how banks can meet the credit needs of modern agriculture. There are no magic formulas of which I am aware. In the end, I am afraid that the answer lies in working harder and with more inspiration and originality in tapping more fully such funds as are generated locally; in increasing the flow of funds from urban centers and from the national credit market, through the banking system; and in the prudent allocation of available credit in the best interests of the borrower, individually and collectively, and finally of the banker and his community.

Agriculture, as the source of our daily bread, is and must always be our most important industry. Its changing needs must be met and I am confident that the alert and imaginative bankers will find the way to meet the challenge.