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CENTRAL BANKING AND THE
AVAILABILITY OF AGRICULTURAL CREDIT

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In appearing before this group of agricultural economists, I must necessarily come as a central banker - rather than as an economist working on problems of agricultural finance. However, the fact that you invited me strongly suggests that the nexus between our respective concerns is being increasingly recognized.

In the following remarks, I shall focus primarily on the performance of the commercial banking system in the provision of agricultural credit. The central theme can be summarized briefly:

The restrictive monetary policy which the Federal Reserve found it necessary to follow in the national interest in 1966 had little direct impact on the short-term credit needs of agriculture - although such credit is becoming increasingly sensitive to general credit conditions.

Several long-term trends are progressively impairing the ability of the banking system to finance agriculture. To check the relative decline of the banks in this field - and to enhance their role in the future - a number of critical changes are required: since the correspondent banking system is becoming less able to

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cope with the needs of large rural borrowers, restrictions on branch banking which exist in many farm states should be removed, and the farm sector should have greater access to the national money market.

Within the Federal Reserve System, the re-evaluation of the discount mechanism now underway may result in the greater availability of seasonal credit for agriculture.

Impact of Monetary Policy on Farm Credit

In assessing the effects of monetary policy on the availability of agricultural credit, it is necessary to have a sense of history. Beginning in the midst of World War II, and for a long time thereafter, the aggregate supply of credit for agriculture was not a matter for great concern. The amount of credit that agriculture used was effectively determined by the level of its demands.

In recent years, however, this situation has been gradually changing. The first restrictions on supply probably occurred as rural banks exhausted the liquidity they had built up during the war and in the immediate postwar years. Initially, the effect in each such case was a local one, but as more and more banks are reaching this position, a more pervasive impact is being felt.

The second constraint on supply was the reduction in farm lending activity by life insurance companies during periods of monetary restraint. At these times, high returns available on security investments tend to make this alternative temporarily more

attractive than farm real estate mortgages. The resulting effect on farm lending was already evident during 1956-57, but it was more severe in the second half of 1966.

Finally, in 1966, restrictive monetary conditions (designed to combat inflationary developments in the economy as a whole) for the first time directly affected the operations of the Federal land banks and production credit associations. As you know, demands for funds by business and governments in 1966 tended to exceed the supplies available, with considerable upward pressure resulting on interest rates. In May, 1966, the Federal government asked the Farm Credit Administration and other Government-connected lending agencies to exercise restraint in making loans and thereby reduce the volume of securities they would have to sell to finance the loans. In September, 1966, the request was strengthened. As a result the Farm Credit Administration issued lending guidelines to both the land banks and the production credit associations, asking that loans not be made for speculative or postponable purposes - but emphasizing that production and investment loans should receive high priority. These restrictions were lifted at the beginning of this year.

Thus, it is evident that the supply of farm credit is becoming increasingly sensitive to general monetary conditions. It is important to note, however, that the impact so far has been extremely small. With regard to production credit (where the needs are not postponable), year after year it has been the judgment of the Department

of Agriculture, as published in the Agricultural Finance Outlook, that the supply of credit has been "adequate. With regard to 1966, it recently stated in the Agricultural Finance Review that: "During 1966, non-real-estate farm debt...increased approximately 12 per cent....farmers seem to have been served well with short- and intermediate-term credit during a period when some other segments of the economy were experiencing difficulties in securing adequate funds." With bank and production credit association farm loans up by another 12 per cent in the first half of this year, it seems evident that such funds remain adequately available.

Outstanding farm mortgage lending by insurance companies and land banks also managed to expand during the second half of last year in spite of the difficulties mentioned above. Insurance company loans rose by 1.4 per cent, substantially below the 5 per cent average of other recent years, but an increase - nevertheless. The land bank increase of 4.9 per cent during the six-month period was not markedly different from the gains of previous years. In the first half of 1967, farm mortgages at insurance companies continued to expand, but at a slower rate than in previous years. Reports attribute this experience more to reduced farm demand, partly in resistance to the higher interest rates charged, rather than to reduced availability of funds. Federal land bank loans outstanding, perhaps assisted by a relatively favorable 6 per cent rate, expanded by 7 per cent in the first six months of this year.

Long-Term Supply and Demand for Farm Credit

While the aggregate supply of funds thus far has not been much of a limiting factor in farm credit use, the ability of the banking system to finance agriculture does appear to be increasingly impaired. This is due not so much to shifts in monetary policy as to a number of trends that have dominated the agricultural economy since the early 1950's.

The first of these trends is the relatively slow pace of expansion in the dollar value of total farm income-generating activity. Whether measured by gross marketings of farm products, by production expenses, or by net income, growth in such activity during the last 10 years has not exceeded an annual average of 4 per cent. The value of farm assets (including real estate valued at current market prices) has increased only slightly faster - at perhaps 4.5 per cent annually.

In the many agricultural states in which the organization of the banking system is legally restricted to local unit banks, this modest expansion of the primary rural industry is logically reflected in the modest growth rate of these banks. As we know, banking resources in rural areas dominated by unit banks are derived primarily from the economic activity of the local community. It is not surprising, therefore, to find that the Department of Agriculture's index of total deposits at country banks in 20 agricultural states (primarily unit banking states) has increased

at an annual rate of about 5 per cent during the last decade. With the number of banks not greatly changed over this period, the average growth of individual banks has been roughly of the same magnitude .

But there is a second trend operating in the farm economy. This is the rapid growth in the size of individual farm firms, brought about through consolidation of units and through expansion of livestock enterprises. Average assets, marketings, production expenses, and net income per farm have all roughly doubled in the last 10 years--an annual rate of increase of about 7 per cent. To finance these changes in the structure of agriculture, farmers as a whole more than doubled their outstanding debt during the decade, raising it by better than 8 per cent annually. On an average per farm basis, use of credit more than tripled, registering an annual rate of growth of 12 per cent.

When we compare these growth rates in farm credit use with the growth rates estimated for the resources of rural unit banks, we can readily appreciate the growing uncertainty about the ability of such banks to continue meeting farm credit demands. By recasting the data cited above, we can put the problem into sharper perspective. We have seen total farm production activity expand by about 50 per cent over ten years. Total deposits of rural banks have increased by somewhat more--by approximately 70 per cent according to the USDA index. Yet, this is the principal source of funds for farm loans--and farm loans increased by about 120 per cent. This is one of the horns of the farm finance dilemma faced by the banking system:

farm credit demands in the aggregate are growing faster than total rural banking resources.

During the same 10-year period, we have seen average credit use per farm triple, while the average deposit size of rural banks has probably not quite doubled. This is the other horn of the dilemma faced by rural banks: their size (and thus the size of individual loans that they can comfortably or legally make) is increasingly out-of-tune with the size of the credit requests made by their farm customers.

A more detailed look at farm finances reveals that the rapid expansion of total farm credit demands has arisen more from the need to finance the reorganization of agricultural production units, rather than from increases in total capital requirements. This relationship does not appear to be fully appreciated, but it would seem pertinent here. If the farm finance problems of the banking system arise mainly from changes in farm structure, perhaps equivalent changes in banking structure are the most logical way in which to resolve these problems.

Increased aggregate investment in farm plant and equipment is frequently cited as the basis of increased credit demands. However, aggregate data for the farm sector show that this is not the dominant factor in recent credit demands. In every year since 1954, farm debt has increased by a greater amount than total net

investment in farm plant and equipment. In 1966, for example, capital expenditures for farm structures, vehicles, machinery, and equipment were \$6.0 billion. Depreciation and other capital consumption of these items totaled \$5.2 billion. Thus, net investment was \$0.8 billion--the largest amount since 1953. However, farm debt increased by \$4.6 billion in 1966--or by about six times the amount necessary to finance the net investment. During the 10-year period 1957-66, net investment totaled only \$2.5 billion. Yet, total outstanding debt rose by \$26.3 billion. The farm sector apparently incurred this debt mainly to finance transfer and expansion of individual enterprises and units, rather than to make net additions to its total productive plant.

Future Demand for Farm Credit

The foregoing discussion has concentrated on the large and pervasive expansion in farm credit use during the recent past. But what of the future? All who have studied this subject agree that future credit demands will continue to expand rapidly. For the next few years, the issue is not really in doubt, because the foundation for such demands is provided by technological advances that have already been discovered, and remain to be applied. For example, already the optimum size of a family farm is apparently considerably above the present average, in spite of the rapid advance of the latter.

Actual quantities of future credit demands are, of course, much harder to foresee than the direction of change, but some projections have been made. These certainly indicate no slackening in the rate at which credit demands will grow. A study made for the National Advisory Commission on Food and Fiber projected a 35 to 40 per cent increase in total farm capital and a doubling of average capital investment per farm--to \$123,000--between 1965 and 1980. John Brake, in a paper presented to your association last year, projected outstanding farm debt of \$100 billion in 1980, a rather startling round number, but one that would be surpassed at the current rate of increase. This rise in debt, Brake estimates, would raise the debt-to-asset ratio in agriculture from the present 17 per cent to about 28 per cent in 1980. Use of credit in farming would then be approaching average levels currently found in non-farm enterprises: debt-asset ratios average around 40 per cent in manufacturing enterprises and near 50 per cent in nonfinancial corporate business.

Future Supply of Farm Credit

With this future demand in mind, what about the position of the banking system as a prospective source of funds? On the basis of the present situation, the outlook is far from bright.

In spite of the general growth in farm credit demands, a surprisingly large number of rural banks have not been particularly eager to serve these needs in their own communities. This is shown by the relatively low loan-to-deposit ratios that many of these banks still have. At the time of our June, 1966, farm loan survey, we found that 6,019 banks (44 per cent of all banks) had one-fourth or more of their farm loan volume in loans to farmers. At 2,428 of these banks (or 40 per cent of them) loan volume at that time was below 50 per cent of deposits. At over a thousand of these banks, the loan-deposit ratio was below 40 per cent; at 312 banks, below 30 per cent. The Federal Reserve Bank of Kansas City examined the location of the banks with low loan-deposit ratios in its District and found that the majority did not lack farm lending opportunities in their communities.

It seems evident that the disparity between bank size and farm size is destined to become an ever-greater constraint on the ability of rural unit banks to meet credit needs in their areas. In some states where farms tend to be large, it is already a common difficulty. In the 1966 Federal Reserve survey of farm loans at commercial banks, the annual dollar volume of individual loan requests exceeding the legal lending limit of the reporting banks totaled 7 per

cent of the farm loan volume outstanding at banks in the Northern Plains States on June 30. In the Mountain, Southern Plains, and Lake States, the ratio was 4 per cent. High ratios were found in important agricultural states such as Kansas, Nebraska, Colorado, Minnesota, Oklahoma, and Texas.

Deficiencies in Correspondent Banking

When a bank receives an otherwise acceptable farm loan request that exceeds its legal lending limit, the textbook solution calls for it to arrange for one of its correspondent banks, usually a larger city bank, to participate in the loan to the extent of the overline portion. There is serious doubt, however, whether the participation technique has adequately handled the overline loan problem in the past. There is even greater doubt that it will provide an adequate solution to the larger problem foreseen for the future. It is true that many banks have employed participation loans to the mutual benefit of themselves, their farm customers, and their correspondent bank. From 1956 to 1966, total participation loans outstanding increased sevenfold, and in June, 1966, the total volume of outstanding loans being handled in this way was estimated at \$574 million, or 5 per cent of total bank credit to farmers. Geographically, the distribution of these loans was highly correlated with the distribution of overline requests mentioned above.

However, these data represent the favorable side of the participation picture. On the other side, interviews with city bankers

indicate that some make little or no attempt to make such arrangements for large customers of smaller banks--whose business may in that case go by default to a production credit association. To an even greater extent, interviews with city banks have shown that many regard the farm participation not as a welcome and profitable lending opportunity, but rather as a relatively onerous service that competition for demand balances forces them to give to their country correspondents.

It is apparently fairly common for city banks to insist on receiving compensating balances equal to part or even all of the participation. This could make the servicing of an overline request a fairly expensive proposition for the small bank, and would tend to discourage meeting it. Also such requirements indicate that participations may not constitute much of a net addition to rural lending resources. Finally, it is unlikely that attitudes of large city banks generally toward farm participations will improve much if the loan demand of their own customers stays at the levels indicated by recent loan-deposit ratios of these banks.

Need for Reorganization in Rural Banking

In my view, a more comprehensive solution for the areas in which growth in farm size is running away from growth in bank size would be to remove restrictions that currently tend to keep banks small. It is significant that the 1966 survey found virtually no overline problem in the Pacific States, where average farm size is far above the national average--but also where large-scale branch

banking is permitted. Liberalization in other states of restrictions on bank branching would obviously tend to make resources of larger banks locally available to farmers that need them. It would also tend to resolve difficulties that small banks themselves are now having, such as the inability to pay salaries adequate to attract the better managers and to provide for management succession. In fact, in many ways, the small local unit bank is about as hard pressed as the small farm. To some extent, both are beneficiaries of public restriction of competition--and both face many of the same problems in our expanding economy and in our highly mobile society.

Modernization of the banking structure in key agricultural states presently restricted to unit banks would also constitute a direct attack on the second farm finance problem faced by the banking system--that of developing farm loan funds at a rate that matches the expansion in aggregate farm credit demands. So far, in the postwar period, banks have approximately maintained their share of total farm lending business. They were able to do so because they had accumulated a large amount of liquidity during World War II and in the immediate postwar years--during which the agricultural economy prospered and was paying off its indebtedness. Over the years since then, this cushion of loanable funds (which was mostly invested in government securities) has been sharply reduced in the banking system as a whole. In fact, it has been completely eliminated at many banks, including most large banks and also many rural banks. In the future, therefore, expansion of lending will have to be more closely related to expansion of total banking resources.

Tapping the National Money Market

In this circumstance, larger banks and branch banks possess several advantages that could be employed to expand the availability of loan funds for their farm customers. Large banks, for instance, are presently better able to tap national money markets through sale of certificates of deposit. Banks with branches in both urban and agricultural areas can channel funds internally from the former to the latter, if this is where loan demands are exceeding deposit growth.

Still other ways have been suggested by which funds could be channeled from urban to agricultural areas through the banking system. One frequently mentioned consists of activating the 40-year-old provision that allows commercial banks to discount farm loans at the Federal Intermediate Credit Banks, which as you know also perform this function for the production credit associations. It is sometimes forgotten that the FICB's were organized in the 1920's, before the PCA's existed, primarily to discount farm loans of banks. Both then and now, however, few banks made use of these facilities. Present provisions for discounting by banks do not provide material assistance to their farm lending operations, because the discounting is on a recourse basis and the outstanding volume is limited to twice the capital and surplus of the bank (as opposed to 10 times capital and surplus for PCA's). Also, the requirement for examination of the bank by yet another agency is probably discouraging. But if these statutory provisions were liberalized, and if the FICB's openly

encouraged bank use of their facilities and acquainted bankers with their procedures, then the intent of this long-standing legislation-- to provide the banking system with a way to tap the national money market for farm loan funds--could at last become effective. Small banks, in particular, could thereby gain indirect access to a market in which they presently do not participate.

A number of agricultural banking leaders have recently suggested other ways in which rural banks could themselves organize to obtain access to national financial markets, either with or without assistance from federal agencies. For instance, perhaps certificates of deposit of small banks could be made more saleable if they were insured. Instead of seeking participations in overlines, small banks could offer participations in a pool of such certificates. In addition, perhaps packages of farm loans, or participations in them, could be sold if insured or if credit-rated by some private or public agency. Such arrangements can materialize only through much effort by bankers and others, but perhaps such effort will be necessary to provide adequate farm financing through the banking system.

Modernizing the Federal Reserve Discount Window

Within the Federal Reserve System, there is currently in progress a major study and reappraisal of the role of the discount mechanism. Though not yet completed, this work appears to be indicating a number of ways in which improvement of Reserve Bank procedures for lending to member banks can serve better the needs

of these banks under the conditions of reduced liquidity which many of them face. Of particular significance to rural banks, we have made extensive study of seasonal flows of funds. This study shows clearly that these in general tend to be of greater relative magnitude at small banks in agricultural areas than at other member institutions. We have found that small agricultural banks are especially likely to experience a seasonal squeeze on funds through simultaneous withdrawal of deposits and expansion of loans. This is a general pattern in the spring and early summer, and it may often result in relatively inefficient use of banking resources in the areas in which it occurs. A bank subject to large seasonal fund outflows must necessarily maintain liquidity sufficient to meet them. During the off-peak season of the year, therefore, some funds that might otherwise have been committed to useful community financing--including the kind of intermediate-term loans particularly desired by modern farm managers--must instead be maintained in short-term government securities or other forms that can be readily liquidated to meet the seasonal flow.

But if a greater share of such seasonal demand could be satisfactorily met through borrowing from Federal Reserve Banks, those funds would be released for other loan purposes in the community. We are examining how our discount regulations and procedures could be changed to accomplish this objective more effectively than at present while at the same time maintaining appropriate control of the over-all reserve base of the banking system. You can appreciate that it is not simple to determine the definitions, criteria, borrowing limits, and safeguards against abuse that will be needed to expand our discount function in this way. Nevertheless, I am hopeful that it will be possible to take such a step soon, and I believe that it can be a significant one for rural banks.

Concluding Remarks

In these various problems that bear directly on the supply of bank funds for farm lending--the questions of unit versus branch banking, of banks that have funds but restrict their lending, of bank participation in funds obtained by the FICB's, of organizational or insurance arrangements that would permit small banks to sell their assets or liabilities in the national financial market, and of achieving greater effectiveness of the Federal Reserve discount mechanism--in all of these I suggest that there lie feasible and important opportunities for studies that are within the wide realm of agricultural economics.

I think it is fair to state that this area has been neglected in the past, but I am also pleased to see that its current importance is being increasingly recognized. In recent empirical work in which models of farm firm growth were developed, for instance, the importance of external financing is readily noted, and its effect on a farmer's financial progress is vividly demonstrated. Increased attention to study of rural economic development will undoubtedly lead directly to examination of rural financial markets and their impact on rural economic progress. We look forward to benefiting from your greater concern in these vital areas.